CHAPTER II

FINANCIAL SYSTEM PRIOR TO THE GOVERNMENT OF

INDIA ACT 1935

(A) FINANCIAL SYSTEM UNDER THE EAST INDIA COMPANY

When the East India Company established its foothold in India, the Indian finances were in ruin. The efficient revenue system which was evolved during the Mughal empire had largely fallen into disuse by the time the Company entered upon the administration of the land. The system was worked on the basis of the division of the country into subahs and each subah was to pay for its own government and had to send the surplus revenue to the Imperial Treasury.

The Feudatory States under the governance of local princes had their own systems of government. They were not under any obligation to assimilate their financial systems with those of the Empire. These States used to pay regularly or on special occasions, a fixed amount of gold coins to the Emperor and except for this, they were in no wise interfered with in their internal administration. The system, though not well integrated according to Prof. K.T. Shah, it can be said to have been only an "approximate to a federal organisation." Though, the genius of the Mughal administration was all for centralisation but the Mughal Emperors "wisely respected provincial feelings and interfered little in the day-to-day life of the provinces." Also the relations between the imperial authority and the provincial chiefs tended to be variable and at the close of their reign, centrifugal forces had the last word and "led to the disintegration of the empire when supermen ceased to rule from

3. Id. at 164.
Not only this, "but in those days of primitive transportation and communication, the provinces of a vast Empire like that of Akbar and his immediate descendents, must necessarily have enjoyed a measure of financial autonomy."\(^7\)

Such was the heritage the Company entered into from their Mughal predecessors. With no assurance of enjoying that heritage for long, the Company did not interest itself in much beyond keeping order and collecting taxes.\(^7\) Territories were acquired piecemeal and, for that reason, the early settlements of the Company were scattered and unconnected. Therefore, there was no central government during the early days of its rule. These settlements (known as Presidencies) necessarily independent of one another, possessed the powers of sovereignty, such as the legislative, the penal and the taxing powers. They were also independent in their finance, their financial method and procedure differed in many respects.\(^8\) The term 'Indian finance' thus can hardly be used with reference to the early administration by the company.\(^9\)

The Regulating Act, 1773

But with the acquisition of territories by the Company things changed and the policy of centralising authority took birth. The Regulating Act 1773 was the first attempt to remedy the abuses of power in India. The Act brought the Presidency of Bengal under the Governor-General and Council and they were to have the powers of superintending and controlling the governments

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7. Thomas, 6.
and management of the Presidencies of Madras and Bombay. It was followed by the Pitt's India Act, 1784, which created a Board of Control appointed by the King, and the Board was empowered "to superintend, direct and control all Acts, Operations and Concerns, which in any wise relate to the Civil or Military Government or Revenue of the British Territorial Possessions in the East Indies." The East India Company Act of 1793 carried the centralising process further and brought the Presidencies under the effective financial control of the Governor General in Council. But due to the difficulties of communication, the peculiarities of local circumstances, the legally complete supervision of the Supreme Government over the other Governments did not in any great measure diminish the discretion of the Local Governments and they kept divergent "methods of taxation and financial procedure" often determined by their local peculiarities of land tenure.

Centralized System Under The Charter Act, 1833
It was, however, the Charter Act of 1833, which brought the coup de grace. The Act drastically curtailed the financial powers of the Presidency Governments by laying down that "no Government shall have the power of granting any new office or granting any new salary, gratuity or allowance without the previous sanction of the Governor-General." The Governor General of India in Council was thus to be the sole authority for making laws for all persons and courts of Justice. All the revenues of British India

11. Sections 31, 32, 35 and 36, Regulating Act 1773.
15. Section 59, Charter Act 1833.
16. Id., Section 39. See also Prasad, supra note 14, p.4. The Act created a real Central Government for India; the 'Governor General of Bengal' became the Governor General of India.
were regarded as a single fund and were applied to the purposes of the Government of India as a whole. Revenue and expenditure were completely centralised and the financial powers were also concentrated in the Governor General in Council. As a necessary consequence, no Provincial Government could keep any part of its collection or undertake any expenditure without the previous sanction of the Central Government. Centralisation was thus the chief note so far as the financial matters were concerned and the Government of India had complete supremacy. This was understandable in view of their responsibility for the solvency of the Empire. The need for central control was accentuated by the gradually altering conditions of Indian administration, the increasing financial needs of the Central Government during a period of constant wars and the resulting budgetary deficits that marked the last few decades of the Company's rule. The Centre's supremacy was more fully expressed in relation to provincial expenditure than in provincial revenues. All proposals regarding the creation of any new office or grant of gratuity or pensions or allowances were to be submitted for the sanction of the Government of India. Every addition to expenditure howsoever inconsiderable required their previous sanction. All taxation, its imposition and remission was centrally controlled. But, because of the absence of a uniform system in all parts of India, many local or provincial imposts were allowed to continue. The Supreme Government occasionally regulated even purely local taxes such as town duties but 'latitude was often given to the Local Governments to retain or abolish them'.

For Bengal Presidency, a separate Government was established although for some years the Governor General of India continued to have charge of Bengal also. Thomas, 12.


19. Id. at 28-29.
Since, it is difficult in a centralised system of finance to distribute funds equitably between the different provinces, the system developed under the Act of 1833, inevitably, gave rise to frequent clashes and bickerings between the Central and the Provincial Governments. "The gradual absorption of all financial control by the Government of India depriving the Local Governments of discretion to spend even a pie without its sanction, the ineffective yet vexatious interference with the administration of the Presidencies", says Bishashwar Prasad, "was bound to bring it into conflict with the Governments of Madras and Bombay which had all the paraphernalia of semi-independent governments and had the means of appealing to the highest authority over the head of the Supreme Government."20 The Act of 1833 effected an unfortunate divorce between the Legal and administrative responsibility. The Central Government were responsible in law but did not administer the country while the Provincial Governments administered the country but had no responsibility in law. Such a state, thus, had a fatal effect on the economy in the finances of the country.21

(B) FINANCIAL SYSTEM UNDER THE CROWN TILL 1919

One of the consequences of the India's revolt against the foreign rule in 1857 was that the administration of the country passed into the hands of the British Crown. It however, did not result in any administrative change in India. At that time the British possessions in India consisted of the Presidencies of Madras, Bombay and Bengal, the North-West Provinces and the Punjab. At the helm of the administration of the entire British territories there was a Governor General and his Council with their seat at Calcutta. The Governor General in Council carried on the administration through a separate administrative machinery for each Province called the Local Government. These Local Governments were completely subordinated to him and functioned as his agents, under his superintendence, direction and control. These Governments were headed by a Governor and his Council or

20. Id. at 41.
a Lt. Governor or a Chief Commissioner. The Governor General in Council, the Supreme authority in India, exercised complete control in all matters financial, legislative and administrative. In the financial sphere, however, the control was most rigid, there being only one exchequer and one budget for the whole of British India. Steps were taken to systematize the financial procedure by prescribing the preparation of annual estimates of revenues and expenditure of India as a whole.

Reforms of the Finance System Under the G.G.I. Act 1858

By the Government of India Act 1858, the Crown assumed responsibility for the Company's debts and liabilities; its contracts and covenants. The expenditure of the revenues of India thus came under the control of the Secretary of State in Council and no grant or appropriation of funds was to be made without his consent. For introducing reforms in the financial machinery, a new post of the 'Finance Member of Council' was created in 1859 and James Wilson was appointed as the first holder of that post. This made the Central Government's financial supremacy complete. Hitherto, the interference with Local Governments was vexatious without being effective, but with the introduction of the budget system, the Government of India obtained a powerful weapon in their hands.

The Position of the Local Governments vis-a-vis the Central Government After 1858

After 1858, the financial authority of the Government of India over the Provinces thus became complete. In the years 1858-61, the trend was towards centralisation of financial control. The Local Governments were not given independent resources to maintain the supplies and services required. They were collecting and spending agents of the Supreme Government which prepared the budget and controlled every penny of the public revenues of British India. They would receive a fixed grant from the Centre,

23. Thomas, 141.
to be used strictly in the manner prescribed by it. They could not initiate any new expenditure in whatsoever form, nor raise any tax. For all financial purposes, they were completely dependent on the Central Government. The position occupied by the Provincial Governments in financial matters was described by Sir John Strachey, in the following words:

The whole of the revenues from all the provinces of British India were treated as belonging to a single fund, expenditure from which could be authorised by the Governor-General in Council alone. The Provincial Governments were allowed no discretion in sanctioning fresh charges... If it became necessary to spend £20 on a road between two local markets, to rebuild a stable that had tumbled down, or to entertain a menial servant on wages of 10s a month, the matter had to be formally reported for the orders of the Government of India. No central authority could possibly possess the knowledge or find the time for the efficient performance of such functions throughout so vast a tract of country. The result was complete absence of real financial control, frequent wrangling between the Supreme and Provincial Governments, and interference by the former not only in financial but in administrative details with which the local authorities were alone competent to deal. Under these circumstances, as Sir Richard Strachey wrote at the time, the distribution of the public income degenerated into something like a scramble, in which the most violent had the advantage, with very little attention to reason; as local economy brought no local advantage, the stimulus to avoid waste was reduced to a minimum, and as no local growth of the income led to local means of improvement, the interest in developing the public revenues was also brought down to the lowest level.

Factors Leading to Decentralization

Thus the Local Governments were progressively entrusted with the larger agency functions of administration. They were in charge of administration but had no financial responsibility.

25. Strachey was the Finance Member during 1877-1880.
It has been called by Dr. Ambedkar, 'the system of Imperial Finance Without Imperial Management'. This division of financial responsibility from administration led to financial indiscipline and extravagance. With the responsibility for finding revenues resting completely in the Central Government and the Provincial Governments in-charge of expenditure, the latter were in a position to request more funds than necessary. They thought that 'they had a purse to draw upon of unlimited, because unknown depth'. Their demands were practically unlimited, because, "they saw, on every side, the necessity for improvements; their constant and justifiable desire was to obtain for their own provinces and people as large a share as they could persuade the Government of India to give them out of the general revenues of the empire." In requesting and pressing their requirements, they felt that they did what was right and they left upon the Government of India, which had taken the task upon itself, the responsibility of refusing to provide the necessary means. The distribution of funds was not based on any fixed principles or on the resource needs or expenditure of the Provinces. It was, rather, given, according to the relative claims and demands of each Provincial Government on the purse of the Government of India. This system, thus, offered no incentive for thrift since any economies effected by a Local Government in one direction could not be utilized by it in another without the express sanction of the Central Government, while reduction in its expenditure in one year was sure to be followed by a corresponding reduction in its share of the imperial revenue in the following year. As the revenues collected through a provincial agency bore no relation to the revenues allotted to its share, no Provincial Government was interested in developing them. "The distribution of public income"

27. Supra note 8, 46.
29. Id. at 136-37.
30. Ibid.
wrote Sir Richard Strachey at the time, "degenerated into something like a scramble, in which the most violent had the advantage, with very little attention to reason; as local economy brought no local advantage, the stimulus to avoid waste was reduced to a minimum, and as no local growth of the income led to local means of improvement, the interest in developing the public revenues was also brought down to the lowest level." 31

No wonder, the period was one of recurring deficits. India had deficit budgets for a period of seventeen years, 1834-35 to 1857-58. 32 The unsatisfactory condition of the financial relations between the Central and the Local Governments led to other evils. Conflicts with the Local Governments regarding questions of provincial administration, of which they were the best judges and of which the Government of India could know little, became frequent. The financial relations between them, being thoroughly inharmonious, were more demoralising to the provincial Governments. 33

The rapid changes in the economic and political situation of the country also made centralization unworkable and irksome. Evidently matters had come to such a state that only a radical change could remedy the evil. Voices were frequently raised against this wasteful system which inhibited both initiative and responsibility in the Provincial Governments, though there was no dearth of advocates of centralization too.

Early Proposals for Federal Finance

Soon after the Revolt of 1858, it was found that centralisation, though the political creed of the time in India', 34 had not been without serious difficulties and defects of its own. Centralisation was found incompatible with the genius of so vast a country with its multifarious population having different languages,

31. Id. at 137-38.
32. See Banerjee, 116. It was these Imperial deficits which suggested a policy of financial decentralisation. Misra, 41. Wilson in his Financial Statement 1860 suggested local participation in the appropriation of income-tax.
33. Thomas, 150, quoting Sir R. Strachey.
34. Prasad, 98.
as well as varying social and economic systems. Thus spoke Sir John Bright in 1858 while proposing a scheme of decentralisation. "What you want" he said, "is to decentralise your government. You will not make a single step towards the improvement of India unless you change your whole system of Government, unless you give to each Province a government with more independent powers than are now possessed." Since then decentralisation implying the largest measure of discretion to the Local Governments both in general administration and finance, became part of the policy of the Indian Reformers in England and it became the basis of proposals for administrative change.

In respect of the financial control, decentralisation was proposed as the only remedy for the inharmonious relations between the Central and the Local Governments and the dislocation of finances resulting in constant deficits. As early as 1860, General Dickens, then Secretary to the Government of India, in the department of Public Works, forcibly suggested provincialisation of Indian Finance. In his Financial Statement of 27 April, 1861, Mr. Samuel Laing, the then Finance Member in the Governor-General's Executive Council dwelt strongly on the evils of the existing system. He perceived that the finances of the Government of India could not be put in order unless certain amount of devolution of power was made to the Provinces. He then proposed a more definite scheme for making over to the Local Governments certain objects for local taxation to meet local expenditure, but the Plan could not make any headway. The proposal was criticized by Mr. Matby, a member of the Executive Council of Madras, as inadequate for

35. John Bright's speech in the House of Commons, 24 June 1858, quoted in Prasad, 99.
36. Strachey Brothers, 134-35.
37. See Prasad, 113. Financial Statement by Laing, 27 April 1861. Laing also circulated his scheme among the Provincial Governments in a confidential letter March 1861, and the proposal met with a good response from them.
achieving the aim in view. Matby observed: "If they (provinces) are to enjoy real liberty of action and management, it seems to me that the Acts of Parliament affecting India must be altered so as to give them a control over the general taxation and expenditure within their range, subject to the condition of supplying a fixed contribution to the imperial treasury, and I would, with all deference, point to the present papers as a proof of how impossible it is that one Central Government overwhelmed with political and other great questions should successfully master the details of local administration throughout our extensive Empire."³⁸

In 1862, Mr. Laing put forward a revised plan and made out a strong case for financial decentralisation. He advocated: "It is most desirable to break through the system of barren uniformity and pedantic centralisation which have tended in times past to render all India to dependence on the bureaux of Calcutta, and to give to local Governments the power and responsibility of managing their own local affairs... But there is a wide field, both of revenue and expenditure, which is properly local, which in England is met by local rates, and which in fact, must be met locally or not at all."³⁹

Massey became the Finance Member in 1866. He took up the question anew and was convinced of the futility of the Imperial Government managing the whole of the finances of India. He, therefore, decided upon a scheme of provincial finance, and in 1866 addressed a circular letter to all Provincial Governments proposing to transfer to them certain heads of expenditure and requiring that funds might be found from a licence-tax, a house-tax, an octroi and a succession duty. But the scheme was received coldly by the Provincial Governments as it fell far short of the expectations.

³⁸ Letter from the Government of Madras to the Government of India, dated April 22, 1861, National Archives of India, New Delhi.
³⁹ Financial Statement by Mr. Laing, April 16, 1862, p. 89, National Archives, New Delhi.
⁴⁰ The heads of expenditure proposed to be transferred were: Education, Police, Jails and Public Works. Circular Letter (Finance) to Local Governments, 21 Feb. 1866.
of their expectations and was considered second to that of Mr. Laing. Mr. Laing put forward another scheme of decentralisation in January 1867. The details of the plan were worked out by Sir Richard Strachey, who argued that 'the old rigorously centralized system of finance had shown the most unmistakable signs of its incompatibility with the existing state of things', and suggested as remedy that so far as practicable 'the entire responsibility of managing the local revenues and expenditure should be placed on the Local Governments'. The scheme was one of federal finance for India which was designed to make the financial position of the Government of India gradually analogous to that of the Federal Government of the United States of America.

'Federalism' says Thomas, "was thus the definite goal aimed at by Strachey and Massey". Massey emphasized, "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."

These proposals for the separation of the revenues and services, leaving greater responsibility to the Provincial Governments, had their origins in the desire to secure harmony...

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41. Prasad, 115.
42. Id. at 116-17. See also Thomas, 156-57.
43. Note by Col. Strachey, 17 August 1867. See ibid.
44. Thomas, 158.
45. Financial Statement 1867-68, Legislative Council Proceedings, 154, National Archives, New Delhi. It was, rather, on the basis of this statement that Col. Strachey formulated his plan. This scheme suggested that roads, jails, education and medical services should be transferred to the Provinces and in order to meet the expenditure on their count, the whole of the revenue under the heads law and justice and education should be transferred to them. Further, 1/16th of the land revenue and 1/4th of the proceeds of licence... continued
in the relations between the Provincial Governments and the 
Government of India and to afford relief to the latter. They 
were also advocated in the interest of economy, plenty and 
equity. Decentralisation in some degree was the keynote of all 
the proposals, though a few would go to the length of establishing 
a sort of federation in India.

However, India was not then ripe for a full-fledged system 
of federal finance. It would have, rather, been altogether 
anomalous to expect the introduction of the federal principle in 
the sphere of Centre-Province financial relations while the 
prevailing unitary relations remained unaffected in other spheres. 
For that reason, Lord Napier, the Governor of Madras, though 
recognising the merits of the federal system, preferred the 
imperial system. He had no faith, in half-measures and therefore 
opposed the 'partial' proposals of Massey. Despite the wide 
support given to Strachey's plan by all Provincial Governments 
(except that of Madras) as well as by a majority of the Central 
Council's members, the scheme was smothered by the personal and 
uncompromising opposition of the Governor-General Sir John Lawrence. 
Counterweighing the argument in justification of the federal 
proposal, that, when the Provinces got the power to spend money 
they would raise more taxes, Lord Lawrence maintained that whether 
fresh taxation was imposed by the Central Government or by the 
Provincial Governments, it would be equally unpopular, for neither 
tax should be allotted to the provinces. The Provinces 
could further augment their coffers by fresh taxes and cesses 
on existing taxes. Dr. P. Diwan, Union-States Fiscal 
Relations, 42, f.n. 6, Light & Life Publishers, New Delhi, 
1981, See also Thomas, 158-59.

46. Prasad, 119.
47. Thomas, 163.
48. An ardent believer in centralisation, Sir Lawrence observed, 
"We are a handful of foreigners in this country. To tax 
the people the least and to use the taxes for beneficient 
administration is our best policy and this is the way to 
consolidate our hold on the country." Minute, 22 October, 
1867, quoted in Thomas, 164.
of those Governments existed by the people’s consent. That wisdom laid in keeping taxation light. He firmly believed that if the Provincial Governments were left free to tax, it might create discontent and might end in another Mutiny. When the scheme was referred to the highest quarters, i.e., the Secretary of State for India in England and was debated in the House of Commons, the line of argument of Lord Lawrence was followed there also. "It was the fear of another mutiny" says Thomas, "that weighed with Parliament in assenting to this view." 50

‘Federalism’ was then considered premature for India. It is clear, however, that the ground was being prepared for the first bit of relaxation in the rigid central control of Provincial finance. The first step, in this direction, was taken in 1871 by Lord Mayo who acted in the belief that the provincialization of certain revenues and heads of expenditure would lead to economy, to increased provincial responsibility, to avoidance of much administrative difficulty and above all, it would enable the rulers of the country gradually to institute, in various parts of the Empire something in the shape of local self-government and that it would eventually tend to associate more and more natives of this country in the conduct of public affairs. 51

Lord Mayo’s Financial Reform

On December 14, 1870, Lord Mayo issued the famous Financial Resolution in which he proposed to enlarge the control and responsibility of the Provincial Governments in respect to the details of their own expenditure. He transferred to the provincial control the following heads of expenditure:

49. Ibid.
50. Ibid.
51. Thomas, 169.
"Jails, Registration, Police, Education, Medical Services, Printing, Roads, Civil Buildings and Miscellaneous Public Improvements"  

Expenses on these services were to be met from receipts under those heads and fixed grants from the Centre. The Provinces were granted a fixed grant of £ 4,688,711 in a lump sum to be distributed among the Provinces according to their needs, together with the receipts from services handed over to them. The deficiency, if any, was to be met either by economy or by provincial taxation. The Provincial Governments were allowed the freedom to make their own appropriation in respect of these services. They were thus free to allocate these revenues among the different services under their charge as seemed best to them. Besides, any savings made at the end of the year, was not to lapse to the Imperial revenues, but was to remain at their disposal. The Provincial Governments were required to prepare their own local budgets on the basis of the assignments so made and to distribute the assignments between the several services, which were to be known as 'Provincial Services.'

Some restrictions were, however, imposed upon the financial powers granted to the Provincial Governments. Without the previous sanction of the Government of India, no new appointment was to be created with a salary of more than Rs.250 a month, no addition was to be made to the salary of any officer if they exceeded Rs. 250 a month; no classes or grade of

52. Financial Resolution No.334, 14 December 1870, National Archives, New Delhi.
53. At first Mayo suggested that the cost of the services transferred to the Provinces which was £ 4,514,332 according to the figures of 1869-70, was to be met by the transfer to them the excise receipts of £ 2,000,000 and a lumpsum assignment of £ 1,500,000, the remaining million pounds to be raised by them through extra local taxation. Later this idea was dropped. See P. Banerjee, Provincial Finance in India, 62, Macmillan And Co. Ltd., London, 1929.
55. These conditions were imposed so as "to restrict the powers of the Local Governments within the limits assigned by the Secretary of State to the powers of the Central Government"
officers was to be created or abolished and the pay or grade of no class of officers was to be raised; no additions were to be made to the pay and allowances of any individual or class of officers that would lead to an increase in the emoluments of any public servant, doing duty in the same province, whose pay or allowance was charged to the Government of India. The Government of India also retained power to forbid alterations in rates of pay or allowances which, in its opinion, would produce inconvenience in other Provinces. No moneys were to be removed from the public treasuries for investment. No services rendered to other departments at the cost of departments then made over to the Local Governments were to be diminished.56 The Provincial Governments were required to publish in the local Gazettes their yearly estimates of income and expenditure and to place them before the Local Legislative Councils.57

Subject to these conditions, the Provincial Governments were free to manage the administration and expenditure of the transferred services. The Central Government was to confine its interference in the administration of the "Provincial Services" to what would become necessary for the discharge of that responsibility which the Viceroy in Council owed to 'the Queen and her responsible advisors' and for the purpose of securing adherence to the financial conditions then prescribed and to the general policy of the Government of India.58

The Governor General in Council hoped that the adoption of their new policy would "produce greater care and economy" in provincial administration, that it would import "an element of certainty" into its fiscal system which had "hitherto been
absent* and also would "lead to more harmony in action and feeling between the Supreme and Provincial Governments". The most important advantage which Lord Mayo hoped for, was the application of "local interest, supervision and care" to these subjects which would "afford opportunity for the development of self-government, for strengthening municipal institutions and for the association of natives and Europeans to a greater extent in the administration of affairs."59 The scheme was forwarded to the Secretary of State with the remark that it would "effect a most salutory reform in Indian administration."60 The Secretary of State approved the plan, but made it clear that the proposed arrangements were experimental and would, if necessary, be "subject to revision, either in principle or detail."61 The scheme came into force in April 1871 and accordingly the budget for the year 1871-72 was framed. "It was the first concrete result" says Bisheshwar Prasad, "of the discussions extending over more than twelve years, and became the basis for further developments in the direction of what is known as 'Provincial Responsibility'."62

Success of Decentralisation

Lord Mayo's scheme for the delegation of financial authority to the Local Governments was prompted by four principal objects, namely, (i) relief to the Imperial finances, (ii) economy, (iii) greater harmony between the Central Government and the Provincial Governments, and (iv) association of the people's representatives in the financial administration of the country. It would not be wrong to say that the reforms served the purpose for which they were adopted, so far as the first three

59. Ibid.
60. Government of India, Financial Despatch No. 265, December 14, 1870.
61. Financial Despatch from Secretary of State No. 5923, February, 1871.
62. Supra note 14, 133.
objects are concerned. 'A study of the Imperial budgets between 1871-72 to 1876-77 shows that the Central Government gained an annual relief of £330,801. It was repeatedly admitted by Sir Richard Temple\(^63\) and Sir John Strachey\(^64\), that improvement in the Imperial finances would not have been possible had it not been for the transfer of the expanding departments from Central to local management.\(^65\) Even in the case of provincial budgets between 1871-72 to 1876-77, it is evident that surpluses outnumbered the deficits.\(^66\) While securing relief to Imperial finances, decentralization resulted in greater economy. The relation between the Government of India and the Provincial Governments became more and more harmonious. Writing on the success of the Mayo's scheme four years after its introduction, Mr. Chapman, Financial Secretary to Government of India, commented "The reform thus introduced has been thoroughly successful... it is now generally acknowledged that its effects have been to promote a good understanding between the Central and the Local Governments; to increase the interests of the latter Governments in their work; to enlarge their power to do good; and to relieve the Imperial exchequer from an old class of urgent demand. These results have been obtained without sacrifice of the authority and dignity of the Government of India, and without any tendency to financial disintegration."\(^67\) The arrangement thus provided an opportunity to the Provincial Governments of developing local resources and institutions, and made them more responsible in the matter of collection of revenue and economy in expenditure.\(^68\)

**Drawbacks of 1871 Reform**

Lord Mayo's scheme became the starting point for subsequent progress in the direction of financial decentralization of the

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\(^{63}\) Sir Temple was the Finance Member during 1869-1874.

\(^{64}\) Sir Strechey became the Finance Member in 1877 and continued in that capacity till 1880.

\(^{65}\) Thomas, 183. See also Prasad, 137.

\(^{66}\) Misra, 42.

\(^{67}\) Prasad, f.n. 1, 142, quoting from Hunter, Vol.II, 61.

\(^{68}\) P.N. Masaidan, Evolution of Provincial Autonomy in India, 1858-1950, 5, Hind Kitabs Ltd., Bombay, 1953.
country. No doubt, it was a great improvement over the completely centralized system existing in the country for half a century. However, the system was not without defects of its own. The first serious drawback of the scheme was that the assignment of Imperial revenue for Provincial expenditure was based on the grants actually made for the year 1870-71, the year of financial stringency "when expenditure was low", and thus it could not provide scope for the development of provincial services without recourse to fresh local taxation. Secondly, the settlements made in 1871 were inequitable, as these were not determined by the actual needs or resources of the provinces, but were proportionate to the actual expenditure of the different Governments in the year 1870-71, which for example, in the case of Bombay was twice that of Madras and thrice that of Bengal. It thus ignored the fact that there were gross disparities among the Provinces which imparted a certain amount of unreality to the Mayo's scheme. No attempt was made to redress the existing injustice or to give grants on the basis of the actual needs of the Provinces. In the words of Mr. Gokhale, such distribution stereotyped the inequalities. Such a basis of allotment was advantageous for the clamorous Governments in the pre-decentralization period. Thus were laid the foundations of inequalities in provincial finance which

69. Prasad, 139-140, quoting Minute by Chief Commissioner of British Burm, dated 23 March 1872.

70. Lord Napier, the Governor of Madras, in 1872 while acting as Viceroy (pending the arrival of Lord Northbrook) pointed to the inequalities of the apportionment in a vigorous Minute, 3 May, 1872. See Thomas, 175.

71. Dr. Diwan, 24.

72. Mr. Gokhale in his evidence before the Royal Commission on Indian Expenditure (The Commission with Lord Welby as President was appointed in 1896, commonly known as Welby Commission) said,"the fact is that these inequalities are a legacy from the pre-decentralization period, when the expenditure of different Provinces was determined... not by the resources or requirements of those Provinces, but by the attention that their Governments succeeded in securing from the Central Government, i.e., by the clamour that they made. And when the first step was taken in 1870 in the matter of decentralization, the level of expenditure... continued
gave rise to discontent and complaints among the Provinces of the method of devolution. These inequalities tended to become more fixed with each step taken towards the financial decentralisation of the country.\textsuperscript{73}

The other defect of the reforms was the rigidity of assignment which offered no inducement to economy. While giving to the Provincial Governments the stimulus to distribute their resources properly and spending them economically, it did not generate in them the desire to observe economy in the collection of revenue, for example, the excise and stamp duties were notoriously evaded and the Government suffered.\textsuperscript{74}

Nevertheless, the adoption of the system produced good results. In the words of Chanda, "The step taken in 1871 was of some significance, it rationalized the financial arrangements by assigning to the Provinces in stages, the proceeds of the whole or part of specified heads of revenue for general administrative purposes."\textsuperscript{75} Roberts, on the success of Lord Mayo's plan, said, "Lord Mayo found serious deficit and left substantial surplus.

\textsuperscript{73} The successive financial settlements, we will find, not only did not remove these inequalities but accentuated them in some instances. See infra, Misra observed that some of the present day problems relating to financial adjustments among the States owe their origin to the days of extreme centralization. \textsuperscript{74} K.T.Shah, \textit{Sixty Years of Indian Finance}, 445, P.S.King & Son Ltd., London, 1927.

\textsuperscript{75} \textsuperscript{Supra} note 24 at 135.
He found estimates habitually untrustworthy, he left them thoroughly worthy of confidence. He found accounts in arrears and statistics incomplete, he left them punctual and full.  

The reform thus set in train a perceptible process of devolution of resources and delegation of financial authority to the Local Governments. The arrangement, though informal in character, for the Government of India retained their statutory powers of control and supervision, set out the process of solving the thorny question of the relations between the Supreme and the Local Governments. This small and limited measure of decentralization was significant as a first step towards re-shaping the basis of Centre-Provence relations in India. "Lord Mayo", rightly says Thomas, "set in motion a force which, gathering momentum in successive periods, has brought India to the threshold of federal finance."  

Directions for the extension of Mayo's Scheme

Lord Mayo's scheme had effected a large reform, but the services left to the Provinces to manage were few. They, therefore, asked that more departments might be transferred to their control and that instead of fixed grants, a share of Imperial revenues might be made over to them. Lord Mayo himself looked forward to the time when specific revenue rather than lump sum grants would be assigned to them. John Strachey, the architect of Mayo's plan was fully aware of the weakness of the scheme. He believed that real financial responsibility in the Provinces needed that they should be given a stimulus to administering revenue collection properly. It was also recognised that in order to encourage economy, the interference of the Government of India should be lessened. That economy and efficient management go together was the belief Strachey held when he stated that good management of finance was to be

76. Quoted in Sethi, The Last Phase of British Sovereignty, 7-8, Chand, 1958.
77. Supra note 1 at 168.
78. Id. at 218.
had "not by an action which gentlemen of the Finance Department or any other department of the Supreme Government can take whilst sitting hundreds or thousands of miles away in their offices in Calcutta or Simla, not by examining figures and writing circulars, but by giving to the local governments a direct and ... a personal interest in efficient management." He was confident that the Local Governments had been taking little interest in the collection of revenues and its administration. For these reasons it was proposed to apply the principle of decentralization to selected items of revenue as well. For whatever measures of responsibility had been granted to the Provincial Governments in 1871 related to public expenditure only. No revenue heads had been transferred. This step was taken in 1877 during the Governor-Generalship of Lord Lytton.

**Lord Lytton's Provincial Contracts of 1877-78**

The Government of Lord Lytton opened negotiations with the various Provinces for settlements on a new basis. The first settlements were made with the North-Western Provinces and Bengal in 1877. According to the contracts, the financial control of land revenue, excise, stamps, law and justice, stationery, printing and general administration, in short, for all the remaining services not administered directly by the Government of India, was transferred to the Provincial Governments. To meet the expenses of administering these heads, the Provincial Governments were given this time, not a central lump sum grant but handed over to them the revenue raised from excise, stamps, law and justice and some miscellaneous items, on the condition that the Central Government would take half of the excess of realised income over the estimated income. It also promised to meet the deficit to the extent of one half. The settlement with the North-Western Provinces was for two years, but with Bengal for five years, after which it was to be revised so as to enable

79. Sir John Strachey's Financial Statement 1877-78, quoted in Strachey Brothers, supra note 28, at 143. He was the Finance Member during 1877-1880.

80. Owing to the famine in Madras and Bombay, they were not considered for fresh settlement immediately.
the Central Government to share in any growth of revenues during the period. Such like contracts were made with other Provincial Governments later, but Madras refused to have it and they continued to receive their revenues under the settlement of 1871. An important departure was made with Burma and Assam which were given a share of land revenue. An adjusting Imperial grant was given to Provinces with deficits. These reforms were introduced in the form of separate contracts with the Provincial Governments and thus contained different provisions with different Provinces. 81

The reforms of 1877 were based on the belief that the step would induce the Provincial Governments to take greater interest and care in the collection of revenues in their territories than they did in the past. As a result of these changes, more than twenty per cent of the total revenue of India and the ordinary services were transferred to the Provinces. 82 The Provincial Governments thus availed themselves freely of their resources under the contracts, but still these were found insufficient in many cases and demands were made on the Central Government for separate consideration. To avoid the possibility of perpetuating an inequitable arrangement (resulting from different contracts with different Provinces), the settlements were made revisable every five years.

The novel element in the new system lay in the transfer of certain heads of revenue to the Provinces, thus introduced an unprecedented element of elasticity in their finances. In the words of Shah, "admission to a share in the revenue was a distinct step forward on the road to federalism." 83 The reforms also provided a stimulus to greater interest in the development of provincial resources and aroused in the Provincial Governments a deeper sense of responsibility. 84

81. It so happened mainly because the settlements had been concluded at different dates.
82. Shah, supra note 74 at 446.
83. Shah, supra note 2 at 89.
84. See Dr. Diwan, 25.
The system introduced in 1877 worked well and the settlements made thereunder remained in force till 1882. There was economical management of the services as well as an increase in the collection realised from the taxes. But the revenues transferred to the Provincial Governments were scanty and the bulk of provincial expenditure had to be met by lump sums assigned by the Central Government. The Provinces, having no share in land revenue did not bother to augment this source. All this soon made the inadequacy of the financial arrangement patent. Strachey himself noticed this defect and devised a system of allotting a share in land revenue to the Provinces. It was, therefore, considered advisable to increase the scope of provincial finances by giving to the Provincial Governments some share in the more important branches of revenue, thereby creating in them an abiding interest in fostering revenue.

Lord Ripon's Provincial Contracts of 1882-83: Quinquennial Settlements

The Government of Lord Ripon decided that the principle of the settlement with Burma should be applied to the whole of India. By its Resolution of 1881, the step further in financial devolution was taken, thus increasing the responsibility of the Provincial Governments in financial matters still further. The most important change brought about by the settlements made in 1882 was that system of giving Provincial Governments fixed sums of money to cover the differences between provincial expenditure and provincial income was abolished and they were now granted the entire yield of some of the sources of revenue and a share in some of the Imperial sources. The entire field of the revenues and expenditure of India was classified in three divisions, wholly Imperial.

85. Strachey Brothers, 145-47.
86. Thomas, 224-25.
87. Financial Resolution, 30 September 1881. The Government was also moved by the idea to secure an early establishment of the decentralisation system in all the Provinces on a uniform and extended basis.
wholly Provincial, and Joint or Divided. Revenues from the Imperial heads which included Land Revenue, Customs, Posts & Telegraphs, Railways, Opium, Salt, Tributes, Mint, Home Charges and Military Receipts, were to go to the Central Government, while the Provincial Governments were to retain revenues derived from Civil Departments and Provincial Public Works. Excise Stamps, Forests, Registration, Licence (Income) Tax and Irrigation were made divided heads; revenues from them were to be equally shared between the Centre and the Provinces in which they were collected. Along with the division of revenue, there was also a division of expenditure which generally followed the incidence of the corresponding heads of receipts. As the expenditures of the Provincial Governments tended to overtake the revenues they received, the difficulty in adjusting means to needs remained. These deficits in the provincial budgets were, to some extent, made up by allotting to each Province a percentage of land revenue collected in it, which otherwise was an Imperial source of revenue. It is from 1882 onward that there developed a system of what is known as "the divided heads of revenue". Here we find for the first time the classification of revenues into Imperial, Provincial and Divided heads.

These settlements gave to the Provincial Governments a direct interest not only in the provincial sources of revenues but also in the divided heads within their jurisdiction. It thus brought the Central and Provincial finances 'into greater unison' with a wider basis and greater elasticity for the latter, the Central and the Provincial Governments sharing not only the receipts but also the expenditure on certain heads. The

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88. Civil Department heads included Provincial Rates, Receipts from Law and Justice, Education, Police, Stationery and Printing, Medical Receipts and certain miscellaneous items.
89. Thomas, 227-29.
90. Misra, 46.
Provinces now had greater scope for the development of the services entrusted to them, with a definitely free hand.

The Revolution of 1882 made another important change. In order to reduce the element of uncertainty involved in annual arrangements, it introduced the principle of quinquennial settlements. The division of revenues made once was to continue for five years. The Provincial Governments were not to look to the Central Government for any special aid, except in the case of severe famine, and the Government of India was not to make any demand on the Provincial Governments except in the case of a disaster so abnormal as to exhaust the Imperial reserves and resources and to necessitate a suspension of the entire machinery of public improvement throughout the empire.\textsuperscript{91}

The Settlements made in 1882 were revised in 1887 and again in 1897 without affecting any change in the principle underlying the division of revenues and expenditure.

**Criticism of Quinquennial Contracts: Schemes for Financial Re-Adjustment 1888-1897**

The needs of the Provinces continued to grow while their share of revenues, remaining unchanged, was insufficient to meet the needs. The main object of the quinquennial settlements was to introduce an element of greater financial stability for the Provinces. Instead, it resulted in uncertainty. The main trouble with the system was that, at the end of each five year period, the balances standing to the credit of a Province were resumed by the Government of India.\textsuperscript{92} This created much ill feeling between the Central and the Provincial Governments. Not only that the quinquennial settlements created uncertainty rather than

\textsuperscript{91} Financial Statement (1882-83), p.10. See also Shah, supra note 74 at \(447\).

\textsuperscript{92} Prof. K.T. Shah beautifully describes the fate of Provincial Governments when he says, "The provincial governments... necessarily got the worst in every reshuffling of the cards, because from the outset they were debarred from having any trumps." Supra note 74 at 451.
stability, they also crystallised the inequalities between the Provinces which had started taking shape in 1871. Sir A. Mackenzie, the Lt. Governor of Bengal, a strong critic of the system, stated, in the course of an address to the Imperial Legislative Council: "I deprecate the way in which the quinquennial revisions have so frequently been carried out. At each of these revisions, 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 balance in the fear that if not spent they will be annexed by the Supreme Government, directly or indirectly, at the time of revision."  

Inevitably, the quinquennial arrangement tended to put a discount on economy on the part of the Provincial Governments for they knew that any reduction in local expenditure was to be used as a basis for proportionately unfavourable settlement at the next revision in respect of the Province concerned. As a result, there was an unhealthy tendency on the part of Provincial Governments, to incur ill-considered or needless expenditure for no better reason than to prevent their savings from lapsing to the Centre. Sir Arthur Havelock, the then Governor of Madras said: "When we are in wealth we try to hide our money and spend it recklessly lest the Central Government should lay hands on it. When we are poor we try to give undue emphasis to our poverty." The Provinces, therefore, became indifferent to economy. Their constant effort had been to inflate their standard expenditure, so that they could claim maximum amount of assigned revenue in the next revision of settlement and prevent the Government of India from enjoying the fruits of their economy.

The defects of periodical revision were also noticed by Indian politicians. They were generally guided in their view by the scheme proposed by John Bright early in 1858. They favoured financially autonomous Local Governments, free to regulate their budgets subject only to the control of the Local Legislative Councils. Criticising the allotments made to the Provincial Governments as inadequate, the Indian National Congress passed a resolution in 1896 demanding that "the time has arrived when a further step should be taken in the matter of financial decentralisation, by leaving the responsibility of the financial administration of the different provinces principally to the Local Governments, the Supreme Government receiving from each Local Government only a fixed contribution levied in accordance with some definite and equitable principle, which should not be liable to any disturbance during the currency of the period of contract, so as to secure to Local Governments that fiscal certainty and advantage arising from the normal expansion of the revenues which are so essential to all real progress in the development of the resources and the satisfactory administration of the different provinces." Mr. Gokhale opposed the revision of the contract in 1896, while giving evidence before the Welby Commission, as the revision of the settlement gave "more to the Government of India to spend on items like the army etc." He pointed to these defects in the system, viz., that it was one-sided, that it was not based on any fixed principle in regard to the burden it imposed on the different provinces and lastly that while operating as a check on the growth of provincial expenditure, it imposed no similar restraint upon the Government of India. He advocated the abolition of divided heads. He pleaded that the Indian financial system should be placed on a sound basis so as to come 'in line with the federal systems of finance in other countries, e.g., Germany, Canada and the United States of America."  

96. See supra.  
The remedy favoured by the Indian leaders and the Provincial Government was a clear demarcation between central and provincial revenues on the lines suggested by the four members of the Finance Committee of 1887.99 The Committee recommended that all the revenues should be divided between the Imperial and Provincial Governments and the 'divided heads' should be abolished. The excess of Imperial expenditure over imperial income should be met by provincial contributions. However these suggestions had to wait till 1919 when they could materialize.

Quasi-Permanent Settlements of 1904 under Lord Curzon

The evils of quinquennial settlements were admitted and the Central Government took up the matter for consideration. The Government of India, almost as much as the Provincial Governments, recognised the need for greater certainty and stability in their financial arrangements with the Provinces.\(^1\) The revision of the contracts became due in 1902, but it was in 1904 that the Government of India took the step for removing the defects, though partly, of quinquennial settlements.

In 1904 Lord Curzon's Government entered into contracts with the Provincial Governments on a more stable basis than before. Henceforward, the settlements were to remain unaltered "except in case of grave imperial necessity or when the variations from the initial relative standards of revenue and expenditure have over a substantial term of years been so great as to result in

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99. The Committee was appointed by the Government of India to inquire into the state of finances of the different Provincial Governments. It was on the basis suggested by the Committee that the Contracts of 1887 were entered into. Its four members were: Sir Charles Elliot, President, Sir William Hunter, Mr. Justice Cunningham and Mr. Justice Ranade. See Shah, *supra* note 74 at 448-49.

1. The defects of quinquennial contracts were openly admitted by the Government of India in the Financial Statement for 1904-5, p.66. See also *Report*, Decentralization Commission, 123, Vol.1, 1908.
unfairness either to the Province itself or to the Government of India", thus the settlements made were quasi-permanent. The principles underlying the new settlements were: "(1) The Local Governments must be given a more permanent interest in their revenues and expenditure. (2) The assignments to them must include a slightly smaller share of growing revenues. (3) The share of revenues 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 bear to the Imperial expenditure." The division of revenues into Imperial, Provincial and Divided still remained, nor was there much difference in the items so classified. However, the 'divided heads' this time came to be more provincialized. Thus the Central Government received the entire revenue from Opium, Salt, Customs, the Mint, the Railways, Posts and Telegraphs, Military Receipts and Tributes from Indian States. The revenues from Registration, Ordinary Public Works, Police, Education, Medical Services, Courts and Jails were entirely provincial. The receipts from Land Revenue, Excise, Stamps, Income-tax and Forests were divided between the Imperial and Provincial Governments, but the division was effected in different proportions in the different Provinces. The division of expenditure went according as the item was Imperial or Provincial, i.e., Imperial revenues were made wholly responsible for those items of expenditure which were in connection with the sources or revenues, reserved for the Imperial Government and provincial revenues were responsible for expenditure incurred within the Province in connection with their sources of revenue. Thus the Central Government was to bear expenditure related to Defence, Railways, Posts and Telegraphs, Interest on debts and

2. However, the Government of India did not surrender its ultimate right to revise the terms, nor could they surrender that right, so long as they and not the Provincial Governments, were responsible to the British Parliament for Indian financial administration.

3. Explanatory Memorandum to the Financial Statement of 1904-05.

Home charges. The Provincial Governments were responsible for the whole of expenditure incurred in connection with Land Revenue, General Administration, Registration, Law and Justice, Police, Jails, Education, Medical Services, Stationery, Printing and Provincial Civil Works. The charges in connection with stamps, Excise, Income-tax and Forests were to be borne by the Central and Provincial Governments, in the same proportion as the revenue from them. The incidence of Irrigation expenditure followed that of the receipts. The expenditure on scientific and minor departments as they were administered and the political charges in connection with the Indian States under their control, was to be met wholly by the Provincial Governments. Ecclesiastical charges and the bulk of the political expenditure were shouldered by the Central Government. 5

Very often the expenditure of the Provincial Governments exceeded their revenues. The measures taken to offset this difference were: (1) a fixed assignment was to be made, as formerly, from the land revenue; (2) initial grants in a lump sum were made principally with the object of enabling the Provinces to undertake works of public utility; and (3) special grants were made for the development of police reforms, agriculture and education.

Soon after the new system was adopted, one important change was introduced with regard to sharing of the expenditure for famine relief. The Provincial Governments were hitherto fully in charge of famine relief and the Government of India stepped in for help only when they had completely exhausted their resources. Henceforth a new famine scheme was drawn up according to which the Government of India created a fund putting aside a definite amount annually, roughly calculated with reference to the famine liabilities of each Province. The Provincial Governments were entitled to draw from this fund during a period of famine. If this fund was exhausted, the famine expenditure

5. Thomas, 264. See also Report, Royal Commission on Decentralization, para 61, 1908.
would then be divided equally between the Central and Provincial Governments and in case more funds were necessary, assistance was granted from Imperial treasury.  

**Improvement of Financial Relations Under the Quasi-Permanent Contracts 1904-05**

To some extent, the quasi-permanent settlements were an improvement over the old system of quinquennial revisions. Under the old system, the Provincial Governments were always open to risks of an unfavourable settlement at the end of five years. The quasi-permanent settlements gave them a more independent position and a more substantial and enduring interest in the management of their resources than had been possible earlier. The risk of meeting unfavourable treatment at the end of the interval was also remedied to a great extent. According to the authors of Joint Report on Indian Constitutional Reforms, Local Governments could count on continuity of financial policy and were able to reap the benefit of their own economies without being hurried into ill-considered proposals in order to raise the apparent standard of expenditure. The new arrangement also smoothened relations between the Central and Provincial Governments, as it avoided their usual quinquennial controversies. It was on the whole, says Thomas, 'a great advance on the old system,' Chanda puts it as 'the first step in the grant of financial autonomy to the provinces.'

**Tightening of Administrative Control under Lord Curzon:**

**Appointment of Decentralisation Commission 1907**

Soon after the series of quasi-permanent settlements were concluded, the subject of Provincial and Central Finance

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6. Ibid. See also the Femine Insurance Scheme elaborated in the Financial Statement of 1907-08 by Sir James Meston.
8. Thomas, 265.
10. In 1904-05 settlements were made with the Provinces of Bengal, Madras, Assam and the United Provinces, in 1905-06 with Bombay and Punjab, from 1 April 1906 with the Central Provinces, and from 1 April 1907 with Burma, Ambedkar, 123-28.
in British India was investigated by the Royal Commission on Decentralization appointed in 1908. The reason for this was the change of Government in England. The Liberals had come into power with a thumping majority and their traditional policy was in favour of political reforms and conciliation in India. Another reason being the general discontent on the enlargement of the scope of supervision by the Central Government of the activities of the Provincial Governments. Lord Curzon's Viceroyalty saw the tightening of the central control. Though he had affirmed that "these new settlements,..., the most important step in the nature of decentralization that has been adopted for many years, and will I hope be the forerunner of others in the future"\textsuperscript{11}, yet he was not prepared to leave the Provincial authorities uncontrolled. He desired to have all the strings of administration in his hands and the Provincial Governments to act merely as executive agents of the Supreme Governments. During his regime, therefore, the interference of the Government of India was considerable leading to outcry against centralisation. There was, in fact, financial decentralisation coupled with administrative and legal supremacy of the Government of India.\textsuperscript{12} It was, therefore, natural, that soon after Lord Curzon left India, the overweening powers of the Central Government over the Provincial Governments became the subject of repeated complaints from the latter and this caused considerable tension in the relations between them. The Indian political leaders like Gokhale had begun to take up the cause of the Provincial Governments. They wanted the Indian finance to be organised on a federal basis.\textsuperscript{13} They believed that with greater independence accorded to the Provinces, the representatives of the people there would be able to check the smaller and less powerful Provincial Governments.\textsuperscript{14} The decentralisation of finance as it obtained by then, afforded, a spectacle of a conflict between the old principle of observing

\textsuperscript{11} Lord Curzon's Budget Speech 1904, Proceedings, Legislative Council 1904, p.238, National Archives, New Delhi.

\textsuperscript{12} Prasad, 258.

\textsuperscript{13} Gokhale's evidence before Welby Commission, 1896. See supra also.

\textsuperscript{14} Shah, supra note 74 at 456.
the convenience of the Imperial Government and the new ideal of
encouraging the development of the provincial services. The Local
Legislatures which were only to express their opinion on the
budget items explained by the departmental Heads concerned,
were demanding the power to control the purse.

Discerning this change in the Indian public opinion which
came to support heartily the Provincial case, Lord Minto decided,
"that the time had come for a further extension of representative
principles in our administration." He fully realized the
impasse into which the Provincial Governments were pushed by the
policy of centralization. He, therefore, proposed to appoint a
departmental committee to inquire into the financial grievances
of the Provinces and set to working out a scheme for the
satisfaction of the aspirations of the Indian people. But while
the Government of India was considering the suggestion the
'Home Government' determined to appoint a Royal Commission 'to
report on the advisibility of larger degree of decentralization
in the civil administration of British India'. The Commission
known as the "Royal Commission on Decentralisation" was appointed
in 1907 "to consider the relations now existing, for financial
and administrative purposes, between the Government of India and
the Provincial Governments, and between the Provincial Governments
and the authorities subordinate to them; and to report whether,
by measures of decentralisation or otherwise, these relations can
be simplified and improved, and the system of government can be
better adapted to meet the requirements and promote the welfare
of the different Provinces, and (without impairing its strength
and unity) to bring the executive power into closer touch with
local conditions." 17

The grievances placed before the Commission related to
(1) the system of "divided heads" claimed to be injurious to

15. Many heads both of revenue and expenditure, such as provincial
rates, assessed taxes, purely imperial revenue and charges
debt charges, statutory charges were to be non-debatable.
See papers relating to Constitutional Reforms in India, 1908,
National Archives, New Delhi.
16. Prasad, 267, quoting from Speeches delivered by Lord Minto
17. The members of the Commission were Mr (later Lord) Hobhouse,
Provincial Governments; (2) the policy of giving grants (fixed assignments i.e. doles) to the Provinces, which made the arrangements unduly rigid; (3) budgetary restrictions; (4) the inability of the Provinces to tax and borrow on their own account; (5) the rigour of codes and regulations and (6) the unequal treatment of the Provinces, i.e., inequalities inter se which led to jealousies and recriminations. Almost all the Provincial Governments complained against the excessive intervention of the Central Government in provincial matters, and asked for a substantial extension of their financial powers. 18

Recommendations of the Decentralisation Commission

The Commission submitted its Report in February 1909. The Commission expressed their satisfaction with the existing financial relations between the Government of India and the Provincial Governments. While recommending measures for removing some defects, the Commission upheld, in principle, the existing method of allocating revenue and charges between the Central and Provincial Governments. 19 They recognised that larger financial decentralisation would be possible when the scope of the Provincial Legislative Councils was enlarged. But to suggest any such change in the Constitutional position was beyond the purview of the terms of reference of the Commission. 20 They, however, held that with the grant of wider financial powers to the Provincial Councils, it would be desirable to give to the Provinces more distinct sources of revenue and concomitently more financial power over the budget. But this would be possible only when the Provincial Legislative Councils obtained an effective control over provincial finance. Without this popular control

Chairman; Sir Frederic Lely; Sir Steyning Edgerley; Mr. R.C. Dutt; Mr. W.3. (later Sir William) Meyer; and Mr. W.L. Hichens. Report, Royal Commission on Decentralisation, para 1, 1908.

20. Id., paras 87, 99, 122, 130.
from below they were not prepared to recommend any great relaxation of the control from above. For this purpose, the Commission suggested that a general Act of Delegation should be passed.\textsuperscript{21}

Impressed by the necessity for uniformity of system, the Commission recommended that "the Provincial Governments should be subject in all respects to the general control of the Government of India", but that "the future policy should be directed to the enlargement of the spheres of detailed administration entrusted to them."\textsuperscript{22} In respect of public works department, Forest, Excise, Police and Medical Services and Land Revenue, they recommended some enhancement of powers of the Provincial Governments.\textsuperscript{23} Financial decentralisation thus recommended by the Commission was, through provincialisation of more divided heads; substitution of large fixed assignments by shares in revenue heads, allowing the Provinces to impose provincial taxes with the approval of the Government of India and the Secretary of State for India, giving the Provinces greater powers in matters of land revenue settlements and by liberalization of the Civil Accounts Code. But within the restricted terms of reference\textsuperscript{24} by which they were bound, the Commission found that they could not recommend any radical reform.\textsuperscript{25}

\textbf{Lord Harding's Permanent Contracts 1912}

The recommendations of the Decentralization Commission were under consideration for long. Before any effect could be given to them, the question received the attention of Lord Hardinge who in 1912 took the bold step of declaring the quasi-permanent settlements of 1904 as permanent. It thereby put an

\begin{itemize}
\item \textsuperscript{21} \textit{Id.}, paras 72, 87, 99, 122, 130, 133.
\item \textsuperscript{22} \textit{Id.}, paras 46, 49.
\item \textsuperscript{23} \textit{Id.}, paras 210-2, 206, 208, 210, 214, 220, 223, 349-51, 379, 384.
\item \textsuperscript{24} See supra.
\item \textsuperscript{25} \textit{Report, R.C.D.}, Vol. I, paras 87, 99.
\end{itemize}
end to a system which for long caused strained financial relations between the Central and the Provincial Governments. It was expected that this would give the Provinces a powerful incentive for economizing their resources.  

Following the recommendations of the Commission the Government of Lord Hardinge decided to make certain modifications in the existing allocation of revenue and charges so as to relax the iron grip of the Central Government over provincial finances. The practical steps taken for achieving this end were embodied in the Financial Resolution of 1912. The Government of India first revised the provincial settlements. Some additional heads of revenue were declared either wholly or partially provincial. Thus, Forest was made wholly provincial. In addition to it, Excise wholly provincialized in Bombay and was made three-fourths provincial in Central Provinces and United Provinces. Land Revenue was made one-half provincial in the Punjab and five-eighths in Burma. Punjab was to receive half of the revenue from major irrigation works.

The Provincial Governments were allowed a little more freedom in framing their budgets so that they could budget even for a deficit under certain conditions. They were not, in future, to be so minutely controlled by the Finance Department of the Government of India. Only the 'divided heads' and the proposed totals of revenue and expenditure were made subject to modifications by the Central Government. In the matters of creating new appointments, abolishing them, alienating revenue, to make grants or subventions to Local or Municipal bodies and to undertake a new general service or duty, more latitude was given to the Provincial Governments.

The Government of India were not prepared to give to the Provinces any powers of taxation and borrowing under the existing

27. Financial Resolution, 18 May 1912.
28. Ibid.
conditions. In regard to the system of grants-in-aid, the Government accepted the recommendations of the Commission to relax the excessively strict control over the provincial estimates drawn up for the utilisation of those grants.29

The Central Government defended the existing inequalities in treatment of different Provinces, on the ground that they were the inevitable result of circumstances and not the outcome of any favouritism. For the revenues of India belonged, constitutionally speaking, to the Central Government and it was perfectly legitimate for the Government of India to use the revenues in whatever ways they deemed essential for the peace and security of the Empire, i.e., 'by drawing additional revenue from those who were able to pay and spending it on those who were needy'.30

The relaxation of control in many matters of details of provincial finances affected by the Resolution of 1912 was, no doubt, a very useful reform. But it did not in any manner affect the fundamental basis of the relations of the Provincial Governments with the Government of India. Except for some liberation of the Provincial Governments from making reference to the Government of India on rather trivial matters, there was no change in the administrative and legislative control of the Provinces by the Government of India. The principles underlying the financial settlements remained unchanged. The basis of these contracts was still the "outlay which each Province might reasonably incur upon the services which it administer." The system of divided heads continued to afford the Central Government sufficient control over the management by the Provincial Governments of their financial business. The demand for the separation of revenues and the financial independence of the Provincial Governments could not be satisfied. The provincial budgets still required the sanction of the Government

29. Ibid.
30. Id. para 7.
of India. Hence, the time had not yet come when the "Provincial Governments would have a legal title to certain sources of revenue whose yield would determine their expenditure." The position continued till the introduction of the Reforms of 1919, when provincial finance entered an entirely new phase.

Financial Relations on the eve of the Reforms of 1919

We may now examine the salient features of the financial relations between the Government of India and the Provincial Governments which existed on the eve of the constitutional reforms of 1919. These were: the heads of revenue were demarcated into 'Imperial', 'Divided' and 'Provincial'. The Government of India had complete control over taxation. All proposals for taxation from Provincial Governments had to go to the Government of India for sanction, which were to be scrutinized by the Finance Department to see that they were not in any way inconsistent with the taxation policy of the Centre. Provincial budgets had to be submitted to the Government of India for approval before these could be placed before the Local legislatures. The Provincial Governments could not borrow money for financing their projects. The various codes like the Civil Accounts Code, the Public Works Code and the Civil Service Regulations restricted the power of the Provincial Governments in many respects. In short we can say that whatever limited freedom was given to the Provinces in financial matters, was granted to them only for the purpose of administrative convenience. The Provincial Governments had only delegated authority which could be increased or withheld at the will of the Government of India. The Government of India, themselves, were subject to the control of the Secretary of State who was the final authority in all matters relating to the revenue of India.

Even within the prescribed limits of Provincial Finance, the Provincial Governments were not free from the control of the Government of India. It was due to the fact that through all the stages of financial evolution from 1833 to 1919, the financial settlements were based not on provincial revenues but on
provincial needs. This inevitably led to a close supervision from the Central Government because "the Government of India could not allow a province to go bankrupt." Moreover, as the share of the Government of India in the revenues from 'divided heads' depended on its own competing needs and the needs of the Provinces, the Government of India had a distinct desire to keep down provincial expenditure to the minimum. Again, as regards revenue, so long as the Government of India took a share in the proceeds, they had to interfere in the details of provincial administration to see that its share was not diminished by the negligence or inefficiency of the latter. The main argument in defence of the then existing system thus expressed in the Report of the Reforms Commission 1919 was: "If many buckets are dipping into one well, and draught cuts short the supply of water, obviously the chief proprietor of the well must take it upon himself to regulate the drawings."33

All said, the period between 1833 to 1919 is marked by a gradual decentralization of financial powers. Beginning with a highly centralized system, each step towards financial decentralization was marked by an effort to enlarge the powers and responsibilities of the Provincial Governments in financial administration. With the small beginning of assignment budgets (in fixed grants for the upkeep of some definite services) the scheme of provincial finance in British India advanced through the system of budgets by 'assigned revenues' to that of 'shared revenue' budgets. Thus developed a system of allocation known as 'provincial financial settlements' which were first reviewed quinquennially and then made quasi-permanent and ultimately permanent. At each stage, however, a distinct further step in financial decentralization arose out of the need to secure efficiency, economy and responsibility. The history of financial devolution in India" says Misra, "points to one unmistakable conclusion, namely, that in such a continent like India,

32. See Report, Indian Constitutional Reforms, 92, 1918. See also Ambedkar, 215.
administration whether political or financial, needs to be decentralized in the interest of efficiency." It may further be noted that financial decentralization has followed pari passu the constitutional development of the country and "in this system of division of financial administration, the seeds of federalism were sown."³⁵

(C) **FINANCIAL SYSTEM UNDER THE GOVERNMENT OF INDIA ACT - 1919**

The successive reforms in the financial field could hardly be expected to satisfy the aspirations of a rising nation. Political leaders like Gokhale and Surindranath Banerjee had already begun to press for a definite and exclusive division of revenue and expenditure between Imperial and Provincial and for the abolition of 'divided heads'. While presenting his scheme to the Welby Commission, Gokhale submitted that his proposal aimed at bringing the Indian financial system in line with the federal systems of finance in other countries, i.e., Germany, Canada and the United States of America.³⁶ Surindernath Banerjee was even more explicit in stating his view that the purpose of decentralisation schemes was "to establish a Federation of India".³⁷ The inquiries of the Decentralisation Commission had brought out that no further advance in financial decentralization would be possible until government in India came under some degree of popular control.³⁸ Financial decentralisation without popular control was rejected by the Indian leaders.³⁹ In spite of the pronouncements of 1911 and the many liberal measures carried through by Lord Hardinge, the position of the Provincial Governments did not improve to any material extent. The outbreak of World War I

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³⁶ See *supra* at 84, 93. Mr. Gokhale's Memorandum of 1918 suggesting the line which the post-war reforms should take.

³⁷ Banerjee's evidence before Welby Commission, 1896, Q 19233-34.

³⁸ See *supra*.

in 1914 made the situation more anomalous. The educated classes got seriously agitated and cherished hopes of a better system at the end of the War. The Political parties set to the task of formulating agreed schemes which could be presented to the authorities for immediate adoption. The British Government was called upon in 1915 to make a declaration about the goal of constitutional development in India. The Congress-League Scheme of 1916 presented the claims of the leading Indian political organisations. The Scheme, inter alia, provided for the abolition of 'divided heads' of revenue and provincialisation of all sources except those of All India Importance. About this time, the Round Table Group took up the Indian problem, Sir William Duke, a member of the Indian Council, prepared a memorandum on the practical application of the principle of dyarchy in Indian Provinces. He recommended the transfer of the provincial departments like education and local self-government to popular control and an increase in the financial powers of the Local Governments, at least to the extent as recommended by the Decentralisation Commission. Mr. Lionel Curtis found that in India 'provincial' and 'national' subjects were not demarcated and the Provincial Governments were "merely the Government of India operating in the Provinces."

Lord Chelmsford, who came out as Viceroy of India in 1916, was soon convinced that a radical modification of the framework of Indian Government was needed and that it should be made without any delay.

It was in this background that Mr. Montagu, the Secretary of State for India announced the goal of India's constitutional development containing the famous phrase: "The increasing association of Indians in every branch of the administration and

41. See the Duke Memorandum in L. Curtis, Dyarchy, Ch. III, 1920.
42. Curtis's letter to B.K. Basu, see id. at 107. Several features of the Duke's Memorandum and the Curtis's scheme were incorporated in the Reforms of 1919.
43. Thomas, 316.
the gradual development of self-governing institutions with a view to the progressive realization of responsible government in India as an integral part of the British Empire.44

Mont-Ford Financial Scheme 1918

In consonance with this declaration, Mr. Montagu visited India, along with Lord Chelmsford, in November, 1917 and held consultations and discussions with Indian leaders from all walks of life as well as some rulers of the Princely States. Their conclusions were embodied in the Report on Indian Constitutional Reforms 1918,45 submitted by Mr. Montagu in July 1918.

The Report, which was not merely a constitutional document but a literary masterpiece, would always be regarded as one of the monuments of British political wisdom and of British faith in popular freedom. The Report conceived that a federal form of government was the only suitable goal for India. A federation of Indian Provinces to which Native States could also join was thus planned.46 But the authors of the Report were not prepared to recommend the introduction of full responsible self-government at once. It must be brought in by stages and that the beginning must be made in the provincial sphere. The Report thus made the Provinces the arena of further political development and decided to give to the Provincial Governments the largest measure of independence, legislative, administrative and financial.47

Since transfer of responsibility in the sphere of the Provincial Governments as a whole was considered premature, the authors of the reforms introduced there a dyarchic system of government.48

45. The Report is popularly known as "Montagu-Chelmsford Report, 1918".
46. The Report said: "Our conception of the eventual future of India is a sisterhood of States, self-governing in all matters of purely local or provincial interest,....Over this congeries of States would preside a Central Government....In this picture there is a place for the Native States." Report, I.C.R., 349, 1918.
47. Id., para 210.
48. Under this system, Ministers, responsible to the legislature, ...continued
The Mont-Ford Report recommended not merely a demarcation of function between the Central and Provincial Governments, but separation of resources between them was also contemplated. Along with other suggestions the Report attached greater importance to financial devolution. Like the Congress-League Scheme, the Report recommended complete separation of Provincial and Imperial sources of revenue and specified the distribution of the existing 'divided heads' between the two, thereby leaving no 'divided heads'.

The fundamental principle of the reforms contained in the Report of 1918 was to grant to the Provinces 'the largest measure of independence, legislative, administrative and financial', of the Government of India, which was compatible with the discharge by the latter of its own responsibility. The authors of the reforms emphasised that "if provincial autonomy was 'to be placed on a secure basis' and was to mean anything 'real' clearly the provinces must not be dependent on the Indian Government for the means of the provincial development." Accordingly, they addressed themselves to the task of providing provincial autonomy with a strong financial backbone, and the arrangements that eventually emerged, altered the entire aspect of Centre-Province relations and placed India on the high-road to federation. The

were to be incharge of such subjects as were transferred to the popular control, while the Governors and Councillors were to administer the remaining subjects and were to continue to be responsible to Parliament in respect of them. See Report I.C.R., paras 218-220.

49. See supra.

50. According to the suggested financial scheme, customs, non-alcoholic excise including salt, general income-tax stamp duties, receipts from railways, posts and telegraphs were assigned to the Central Government while land revenue, irrigation, alcoholic excise, forests, courtfee, stamps, registration fees and other minor sources of revenue were given to the Provinces. See Report, para 203.


52. Id., para 201.
solution suggested by the Report was that: "an estimate should first be 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." The authors calculated that on the basis of the budget for 1917-18, such a division of resources would result in deficit to the Centre to the tune of Rs. 13.63 crores while the Provinces would be favoured with a surplus of Rs. 15.75 crores. In order to meet the imperial deficit, the Report suggested a system of contributions from each Province assessed 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 make the separation between Provincial and Imperial Finance as complete as possible, the Report conceded the right of taxation to the Provinces, as well as, the power of borrowing. It gave a certain number of reserved subjects for taxation to the Provinces and made the Government of India a sort of residuary legatee for the rest. The Province would be free, within the scheduled list to levy tax without the previous sanction of the Government of India, subject to a veto on the part of the latter to whom, therefore, the proposal would have to be forwarded to see if it trenched upon their own preserves. Outside the listed subjects, the Provinces might tax, but with the previous sanction of the Central Government.

The right to borrow was conceded to the Provinces, but it could be exercised only under much more stringent conditions. The Report required the powers of borrowing to be ordinarily exercised through the Government of India and the distribution of money thus raised to be made by the latter Government or by a Committee consisting of representatives of the Provincial as well as the Central Governments. 'It was only when the course was considered

53. Ibid.
54. Id., para 206.
55. Id., para 207.
to be inadequate for the needs of a Province, which nevertheless hoped to influence the money market by a direct appeal\(^1\) that a Province was allowed access to the money market. Under such circumstances even the Report required the Province to obtain the approval of the Government of India for the terms of the loan and the rate of interest and observe certain prescribed rules.\(^56\)

The Report gave the final touch to the financial autonomy of the Provinces and suggested the abrogation of the existing rules about minimum balances, deficit budgets and the like and provided that the balances of the Provincial Governments\(^57\) be no longer under the rigid control of the Government of India.


The Mont-Ford Report was given an elaborate examination by the Joint Select Committee of the British Parliament which sat on the Reforms Bill. Based on the Report, the Government of India Act 1919 was passed. The Act introduced almost a complete separation of the Central and Provincial heads of revenue. The 'divided heads' which so far had been a source of considerable Central interference, were done away with\(^58\) and for revenue purposes, subjects were now classed as Central and Provincial only. The financial provisions of the Government of India Act 1919 were incorporated in the 'Devolution Rules' framed on the basis of the recommendations of the Meston Award.\(^59\)

Under the Reforms of 1919, the control of the Government of India over Provincial Governments in financial matters, was greatly reduced. Provincial budgets were completely separated

56. First Reforms Despatch, para 62. See Shah, supra note 74 at 446.
57. Except the accumulation of famine assignments of the Provinces. See Shah supra note 74 at 466.
58. Most of them were assigned to the Provincial Governments. See supra.
59. These Rules were enacted under Section 10(3)(a) Government of India Act 1919, vide Notification No.311, dated 16 November,1920.
from the Central budget, it was no longer necessary for the Provincial Governments to obtain the approval of the Government of India (say Governor General in Council) for their budgetary proposals before submitting them to the Local Legislatures. The Provincial Governments were to have their budgets worked out, quite independently except for the control of the Auditor-General. Each Province was to have a Finance Department under a non-responsible member of the Executive Council. The Finance Department was to be the final authority on the financial aspects of all governmental proposals and to control the finances of other departments as well.

**Provincial Contributions to Meet Imperial Deficit**

The authors of the Mont-Ford Report, as already seen, proposed that the Imperial deficit would have to be met by provincial contributions. It was in assessing these contributions that they met with various obstacles due to the disparities which existed between one Province and another in the extent of their revenue and scales of expenditure because of the inequalities of treatment in earlier financial settlements.

Several plans were presented for removing the Central deficit and minimising inequalities of provincial financial burdens and resources. Finally the scheme was chosen by which each Province had to make a contribution based on "a percentage of

60. The various alternative proposals examined by the authors were as follows: "One way of meeting it would be to maintain the basis of the present settlements, but to allot to the Government of India a certain proportion of growing revenue instead of its share of the 'divided heads'. But the device would have stereotyped all the existing inequalities between the Provinces which by reasons of the permanent settlements in some of these were considerable, while it would have also introduced an element of great uncertainty into the Indian Government's Finance". A second plan was that "we should take an all round contribution on a per capita basis". But this expedient also would have not obviated every undesirable variations between Provinces in the rate of levy owing to the inequality of provincial resources and of provincial needs. A third scheme was "to take an all-round percentage contribution based on gross provincial revenue". This was open to the objection, *inter alia*, that

...continued
the difference between the gross provincial revenue and the gross provincial expenditure" that each Province would enjoy under the new allocation of revenues.  

This meant, levy on the surplus of the estimated gross revenue of the Province, when all divided heads were separately allotted over, its estimated normal expenditure including expenditure on famine relief and protective irrigation.

When calculated on the basis of the Budget figures of 1917-18, it was found that the deficit of the Government of India estimated to be Rs. 1,363 lakhs and the estimated gross provincial surplus (after deducting normal expenditure of all Provinces) was Rs. 1,564 lakhs. A net-surplus of Rs. 201 lakhs was then left available for provincial distribution. Accordingly, it was proposed that each Provincial Government should contribute 87 per cent of the difference between the gross provincial revenue and the gross provincial expenditure.

The authors of the Report, however, admitted the inequality of the burdens. "Equality of contribution was impracticable" they confessed, but they were careful to observe: "We have, for the present, accepted the inequality of burden which history imposes on the Provinces because we cannot break violently with traditional standards of expenditure or subject the permanently-settled Provinces to financial pressure which would have the practical result of forcing them to reconsider the permanent settlement." They thus recommended that "It should also be one of the duties of the periodic Commission which we propose should be appointed to examine the development of constitutional changes after ten years' experience of their working or of some similar body at that time, to re-investigate the question of the provincial contributions to the Government of India."
But the mighty words of the authors of the Report could not receive due consideration at the hands of their critics who strongly opposed the proposal on the ground that they were unfair and unjust, 'for the richest as also the most thrifty Province would be called upon to contribute the most, while the most extravagant Province would pay the least'.

Appointment of Meston Committee

The scheme of provincial contributions contained in the Report would have encouraged extravagance and inefficiency and penalized thrift. The Government of India was so moved by clamour made by the Provinces that it pressed the Home Government for an early treatment of the matter. In their letter to the Secretary of State, the Government of India thus observed: 'we recommended that the initial contributions should be recognised as temporary and provisional, and that steps should be taken as soon as possible to fix a standard and equitable scale of contributions... The whole question... requires skilled investigation; (the difficulty of the position was foreseen in the Report and investigation by the first statutory commission was promised but) we propose that a Committee on Financial Relations be appointed either by you or by us, to advise fully upon the subject, so that each Province may know exactly how it stands before the new regime starts.' This recommendation of the Government of India was accepted by the Joint Select Committee of the House of Parliament which sat on the Reforms Bill and the Financial Relations Committee with Lord Meston as its Chairman was appointed by the Secretary of State in January 1920.

64. Government of India Despatch of March 5, 1919, National Archives, New Delhi. See also Ambedkar, 233.
65. Report, Joint Select Committee on Government of India Bill (Part I, Clause 41, para 9), House of Commons Return 203 of 1919, p.12. The Meston Committee was to advise on:
(a) the contributions to be paid by the various Provinces to the Central Government for the Financial Year 1921-22;
(b) the modifications to be made in the Provincial contributions thereafter, with a view to their equitable distribution, until there ceased to be an all-India deficit;
(c) the future financing of the provincial loan accounts; and
(d) whether the Government of Bombay should retain any share of the revenue derived from income-tax"...continued
After about seven weeks of investigation the Committee submitted its Report. The allocation and distribution of financial resources between the Central and the Provincial Governments between 1921-2 to 1936-37, were primarily based on the recommendations of the Meston Committee.

The Meston Award

As regards the question of provincialization of income tax, the Committee, being impressed by the reasoning of the Mont-Ford Report, felt bound to oppose it. The two strong reasons advanced in the Joint Report were that first, the necessity of maintaining a uniform rate throughout the country, and second, the difficulty of finding out the exact locale of the tax.

The authors of the Joint Report had divided Stamps into two categories - General Stamps and Judicial Stamps, the former, they had allocated to the Central Government, the latter to the Provincial Governments. The Meston Committee, in order to help the poorer Provinces, recommended that General Stamps should also be provincialized. This, they thought would also remove the last taint of 'divided heads'. Moreover, such an arrangement would facilitate the control and collection of revenue from this head by the same agency. As a result of their recommendations, the Committee estimated a total deficit of Rs. 9.83 crores in the Central budget for the year 1921-22. They thus proceeded to fix the contribution to be made by the Provinces to meet this deficit with the Central Government.

Initial Contributions

The Meston Committee was asked to advise, inter alia, on the questions of 'Initial' and 'Standard' contributions. In advising on the question of 'Initial Contributions', the Committee

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66. Popularly called as Joint Report 1918.
68. Ibid.
expressed their dissatisfaction of the plan set forth in the Joint Report of taking from the Provinces a fixed uniform proportion of their respective surpluses as their contribution to the Central fisc. They considered this basis as unfair, since it left no surplus in some Provinces, while in others the surplus left after the payment of their respective quotas of contributions, was found to be inadequate. Accordingly, the Committee dropped the plan. They held that the normal revenue of the Provinces was ascertainable with greater accuracy than their normal expenditure. For that, they abandoned altogether, the consideration of expenditure in fixing the contributions.

The Committee recommended that the contributions should be assessed on the increased spending power of the Provinces resulting from the additional resources which a Province would acquire under the new allocation. They, however, felt themselves bound by two broad considerations in applying this principle, namely, (a) that in providing the contribution, each Province must be left with a certain reasonable working surplus; and (b) that in no case should the contribution be such as would force the Provinces to embark on new taxation ad hoc. Applying these two principles, i.e., leaving each Province with a workable surplus and enabling the inauguration of new Council without the necessity of resort to fresh taxation, the Meston Committee felt that the most equitable plan would be to take unequal contributions from the surpluses of the Provinces liable to make them. They, thus, considered the case of each Province on its merits, looking into "the established programme of taxation and expenditure, and legislative and administrative expectations and habits, that cannot without serious mischief be suddenly adjusted to a new and more equitable ratio of contribution widely different (as an equitable ratio admittedly be) from that of the past." The Committee, therefore,

70. Report, Meston Committee, para 16, 1920.
71. See Ambedkar, 234-35.
recommended the 'initial contributions' on the basis of the existing financial position of each province, admitting them as not ideally equitable but merely transitional. These recommendations were accepted by the Joint Select Committee and were as given in the following table:

<table>
<thead>
<tr>
<th>Provinces</th>
<th>I.S.F.</th>
<th>C</th>
<th>I.S.F. left</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madras</td>
<td>576</td>
<td>348</td>
<td>228</td>
</tr>
<tr>
<td>Bombay</td>
<td>92</td>
<td>56</td>
<td>37</td>
</tr>
<tr>
<td>Bengal</td>
<td>104</td>
<td>63</td>
<td>41</td>
</tr>
<tr>
<td>United Provinces</td>
<td>397</td>
<td>240</td>
<td>157</td>
</tr>
<tr>
<td>Punjab</td>
<td>289</td>
<td>175</td>
<td>114</td>
</tr>
<tr>
<td>Burma</td>
<td>246</td>
<td>64</td>
<td>182</td>
</tr>
<tr>
<td>Bihar and Orissa</td>
<td>51</td>
<td>Nil</td>
<td>51</td>
</tr>
<tr>
<td>Central Provinces</td>
<td>52</td>
<td>22</td>
<td>30</td>
</tr>
<tr>
<td>Assam</td>
<td>42</td>
<td>15</td>
<td>27</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,850</strong></td>
<td><strong>983</strong></td>
<td><strong>867</strong></td>
</tr>
</tbody>
</table>

I.S.F. denotes increased spending power under new distribution of revenue.

C denotes contribution recommended by the Committee

I.S.F. left means I.S.F. left after contributions are paid.

Source: Report, Meston Committee, 8, para 17, 1920.

Evidently this arrangement did not make any change in the existing situation and the Provinces which hitherto burdened heavily were still left in the same position. Admitting this, the Committee defended this contribution as a measure of transition necessary in order to give time to the Provinces to adjust their budgets to the new state of affairs and to avoid the mischief of sudden disturbance in the existing established programmes of taxation and expenditure.\(^74\)

\(^73\) Id., paras 19 end 20. See id., para 23 also.

\(^74\) Ibid.
Standard Contributions

The Committee proceeded next to consider the more thorny question of 'Standard Contributions' as distinguished from 'Initial Contributions' which were meant only for the year 1921-22. They sought to find, for the future occasions, a basis of contributions, which should be more satisfactory, equitable and certain. In order to have such an ideal basis, the Committee stated that "to do equity between the provinces it is necessary that the total contribution of each to the purse of the Government of India should be proportionate to its capacity to contribute." However, they were faced with two important difficulties involved in translating this principle of 'capacity to contribute' into practice. These were: what were the total contributions of a Province to the purse of the Central Government? Secondly, what were the capacities of the provinces to contribute?

With regard to the first question, the Committee observed that "the total contribution of a Province to the purse of the Government of India will consist in future of its direct contributions towards the deficit, together with its indirect contribution (as at present) through the channels of customs, income tax, duties on salt etc." Turning to the second question, the Committee held that the capacity of a Province to contribute was "its taxable capacity which is the sum of the incomes of its tax-payers, or the average income of its tax-payers multiplied by their number." But they submitted frankly that the data available with them was not sufficient for a direct quantitative evaluation either of the total net contribution which a Province made to the Central Government or of its capacity to contribute. They thus observed that it was "useless

75. See 'terms of reference' of the Committee, supra note 66 at 151.
76. Report, Meston Committee, para 24, 1920.
77. Id. para 25. The Committee here were considering the claims of industrial Provinces like Bombay and Bengal which contributed the largest share to the Central fisc through customs and income tax. See infra.
78. Report, para 26, 1920. Here the Committee recognised the claims of the poorer Provinces like Assam, Bihar, and Orissa, whose resources had not fully developed and whose capacity to pay was small.
to attempt to state a formula, to serve as a basis for a
standard ratio of contributions, capable of automatic
application from year to year by reference to ascertained
statistics.\(^7\)

However, the Committee did not altogether abandon
the ideal basis it had evolved for fixing the standard contrib-
But they attached little importance to indirect contribu-
tions and fixed the contributions giving attention to the gener-
al circumstances and the economic conditions of the Provinces
they observed: "We are able, after surveying such figures
available and after close inquiry into the circumstances of
each province, to recommend a fixed ratio of contribution
burden of any deficit. In arriving at this ratio, we have
into consideration the indirect contributions of the Provi-
ces to the purse of the Government of India, and in particular
incidence of customs duties and of income-tax. We have in
into the relative taxable capacities of the Provinces. In
light of their agricultural and industrial wealth and of other
relevant incidents of their economic positions, inc-
porarily their liability to famine. It should be obser-
that we have considered their taxable capacities not only
they are at the present time, or as they will be in the im-
future, but from the point of view also of the capacity of
Province for expansion and development agriculturally and
industrially and in respect of imperfectly developed asset
as minerals and forests. We have also given consider-
tion the elasticity of the existing heads of revenue which will
secured to each Province, and the availability of its weal-
for taxation."\(^8\)

After estimating to the best of their ability, the
which should be given to each of the circumstances, the Cc
recommended the following fixed ratio as representing an
equitable basis for the relative contributions of the Prov-
to meet the deficit in the budget of the Government of Ind

79. Id., paras 26-27.
80. Id., para 27.
81. Ibid.
The Committee, in order to avoid sudden dislocation in provincial budgets, further safeguarded their findings by requiring an interval of seven years to enable the Provinces to adjust their budgets to new conditions before they should in equity be called upon, to contribute according to the above standard ratio. The following table shows the initial, intermediate and ultimate ratios of contribution for the seven years in accordance with the Meston Award.

### Per Cent Contributions to the Deficit in Seven Years Beginning With the First Year of Contribution (rounded off to even halves)

<table>
<thead>
<tr>
<th>Provinces</th>
<th>1st year</th>
<th>2nd year</th>
<th>3rd year</th>
<th>4th year</th>
<th>5th year</th>
<th>6th year</th>
<th>7th year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madras</td>
<td>35½</td>
<td>32½</td>
<td>29½</td>
<td>26½</td>
<td>23</td>
<td>20</td>
<td>17</td>
</tr>
<tr>
<td>Bombay</td>
<td>5½</td>
<td>7</td>
<td>8</td>
<td>9½</td>
<td>10½</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>Bengal</td>
<td>6½</td>
<td>8½</td>
<td>10½</td>
<td>12½</td>
<td>15</td>
<td>17</td>
<td>19</td>
</tr>
<tr>
<td>United Provinces</td>
<td>24½</td>
<td>23½</td>
<td>22½</td>
<td>21</td>
<td>20</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>Punjab</td>
<td>18</td>
<td>16½</td>
<td>15</td>
<td>13½</td>
<td>12</td>
<td>10½</td>
<td>9</td>
</tr>
<tr>
<td>Burma</td>
<td>6½</td>
<td>6½</td>
<td>6½</td>
<td>6½</td>
<td>6½</td>
<td>6½</td>
<td>6½</td>
</tr>
<tr>
<td>Bihar &amp; Orissa</td>
<td>N11</td>
<td>1½</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>8½</td>
<td>10</td>
</tr>
<tr>
<td>Central Provinces</td>
<td>1½</td>
<td>1½</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2½</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

(Source: Report, Meston Committee, para 28, 1920.)
Criticism of the Meston Settlement

The Meston Settlement was subjected to severe condemnation at the hands of the Provincial Governments, who criticised the Award as unfair, unjust and inequitable. The Government of Bengal, as well as that of Bombay, vehemently protested that under an equitable settlement, the true test of what they were paying to the Central Government was not their contribution under the Meston settlement, but, rather what the Central Government actually received from them in the shape of direct or indirect contributions which far exceeded such contributions from other Provinces. Bombay complained that since she was an industrial Province with high administration costs, she had been unfairly treated with regard to her claim for a share in the proceeds of income-tax, which she regarded as her best source of income.\(^3\) The Government of Bihar, although contributing much less, claimed that as a backward province she had need of a large capital expenditure to bring her into line with an advanced industrial province like Bengal. The Central Provinces made similar claims because of their backward conditions. The Government of Assam protested for some changes in the existing arrangements, for unless the arrangement was quickly changed, she was 'predoomed to impotence and failure'. Burma demanded larger revenues to develop her vast natural resources. The Governments of United Provinces and Punjab complained that they were hard hit on account of the heavy contributions they were to make.\(^4\)

These claims made by different Provincial Governments were based on the assumption that each Province had a natural right to the revenues collected within its territory as its own. Such demands were made in those days when the element of responsible Government had not yet been introduced in India. These parochial consideration still continue to guide the popular Governments in the present days when the Constitution has

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\(^3\) The Government of Bombay had put forward the suggestion that income-tax should remain a 'divided head'. But both the Mont-Ford Report as well as the Meston Committee rejected this suggestion. See supra.

\(^4\) Report, Meston Committee, 1920.
integrated the British Provinces into one integral whole, guaranteeing the freedom of trade, commerce and intercourse throughout the territory of India.

Such claims were particularly indefensible in India, where the tax jurisdictions were artificially made with the haphazard growth of British power in India. Let us examine the claims and counter-claims made by the Provinces over the injustice of the Meston Award. Taking, for example, the income tax and customs. In the case of income tax, the place where the tax is collected is not necessarily the place where the tax is earned. The profits in the case of business enterprises having their branches scattered throughout the country or in the territories of more than one Province, are collected at the head offices of the business, but it is difficult to calculate what percentage of the profits are earned within the Province where the business has its head offices. Similarly, the case of companies with share-holders scattered all over the country, but the income tax is collected at the head office of its business. The customs revenue, collected in the country at the important ports, but it is a tax paid by the consumers of imported goods living in the most remote corners of the country and not only by the residents of the Provinces where the ports are situated. It is, in fact, impossible to find out the exact amount contributed by each Province unless some more accurate and elaborated system of bonding is developed to trace the ultimate destination of the imported goods.

It may be noted that Meston Settlement was in keeping with the constitutional machinery of the time. Those who condemned the scheme, did not study it in a scientific impartial spirit under the circumstances then prevailing. They could also suggest no better alternative to the scheme they condemned so vehemently. They overlooked the impossibility of removing by a strike of the pen inequalities which were the result of longstanding and historical causes. The Joint Select Committee of Parliament appointed to revise the Draft Rules made under the Government of India Act 1919, could recognise, "the intricacy of the problem with which the Financial Relations Committee had to deal, and the difficulty amounting almost to impossibility, of arriving at any
solution which was likely to be acceptable to all Local Governments..."  

The scheme, though not an ideal system which it did not claim to be so, according to B.R. Misra "was in harmony with the spirit of Reforms." 

**Adoption of Meston Settlement**

The Finance Relations Committee's recommendations were accepted by the Government of India and the Secretary of State. But when rules in which they were embodied came before the Joint Select Committee for consideration, the Committee, in view of the loud protests raised by the Provincial Governments, made some important alterations in the allocation of revenues and contributions from the Provinces. The Committee sought to alleviate the discontent among the Provinces and suggested:

"(1) That there should be granted to all provinces some interest in the growth of revenue from taxation on incomes so far as that growth is attributable to an increase in the amount of income assessed; (2) That in no case should the initial contribution payable by any province be increased, but that the gradual reduction of the aggregate contribution should be the sole means of attaining the theoretical standards recommended by the Financial Relations Committee." 

The Joint Committee emphasized the disadvantages of a system of provincial contributions and recommended their very early cessation. They also recognized the peculiar financial difficulties of the Government of Bengal and commended its case to the special consideration of the Government of India.

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86. Indian Provincial Finance, 1919-39, 103, Humphrey Milford, Oxford University Press, 1942.
88. Ibid. See also Second Report of Joint Committee, 2-3, 1920. See infra also.
89. Ibid. The recommendations were given effect to by Devolution Rules 15, 17 and 18.
90. Ibid.
Devolution Rules

The financial scheme so approved by the Joint Committee was incorporated in the Devolution Rules enacted under the Government of India Act 1919. The Devolution Rules provided:

(15) There shall be allocated to each Local Government a share in the income tax collected under the Indian Income Tax Act, 1918, within its jurisdiction. The share so allocated shall be three pies on each rupee brought under assessment under the said Act, in respect of which the income tax assessed has been collected. The number of pies to be specified shall be so calculated as to yield at the outset to the Local Governments collectively a sum amounting as near as may be to Rs. 400 lakhs.

(17) In the financial year 1921-22 contributions shall be paid to the Governor-General in Council by the Local Governments mentioned below according to the following scale:

<table>
<thead>
<tr>
<th>Name of Province</th>
<th>Contribution (in lakhs of rupees)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madras</td>
<td>348</td>
</tr>
<tr>
<td>Bombay</td>
<td>56</td>
</tr>
<tr>
<td>Bengal</td>
<td>63</td>
</tr>
<tr>
<td>United Provinces</td>
<td>240</td>
</tr>
<tr>
<td>Punjab</td>
<td>175</td>
</tr>
<tr>
<td>Burma</td>
<td>64</td>
</tr>
<tr>
<td>Central Provinces and Berar</td>
<td>22</td>
</tr>
<tr>
<td>Assam</td>
<td>17</td>
</tr>
</tbody>
</table>

(18) From the financial year 1922-23 onwards a total contribution of 983 lakhs, or such smaller sum as may be determined by the Governor-General in Council, by the Local Governments mentioned in the preceding rule. When for any year the Governor-General in Council determines as the total amount of the contribution a smaller sum than that payable for the preceding year, a reduction shall be made in the contribution of those Local Governments only whose last previous annual contribution exceeds the


92. Certain conditions were imposed on the Local Governments under Rule 15 in respect of their liability to pay to the Governor General in Council, the proportionate cost of special income tax establishments.
proportion specified below the smaller sum so
determined as the total contribution, and any
reduction so made shall be proportionate to
such excess:

<table>
<thead>
<tr>
<th>Province</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madras</td>
<td>17/90 th</td>
</tr>
<tr>
<td>Bombay</td>
<td>13/90 th</td>
</tr>
<tr>
<td>Bengal</td>
<td>19/90 th</td>
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<tr>
<td>United Provinces</td>
<td>18/90 th</td>
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<tr>
<td>Punjab</td>
<td>9/90 th</td>
</tr>
<tr>
<td>Burma</td>
<td>6 1/2/90 th</td>
</tr>
<tr>
<td>Central Province and Behar</td>
<td>5/90 th</td>
</tr>
<tr>
<td>Assam</td>
<td>2 1/90 th</td>
</tr>
</tbody>
</table>

(19) In cases of emergency the Local Government of any Province may be required by the Governor-General in Council, with the sanction of the Secretary of State, to pay to the Governor-General in Council a contribution for any financial year in excess of the amount required by the preceding rules in the case of that year.

Other Changes in Financial Relations Under 1919 Reforms

A few more changes introduced by the Reforms of 1919 in respect of financial relations between the Central and Provincial Governments are discussed in the following paragraphs:

Scheduled Taxes

Prior to the Reforms of 1919, the Provincial Governments were required to seek the previous sanction of the Government of India before they could impose any taxes. This principle, the authors of the Mont-Ford Report pointed out, had debarred the growth of provincial autonomy. They thus recommended that the Provinces should be allowed to impose tax (of local importance) without the previous sanction of the Central Government. This recommendation was accepted and by the Rules made under the Reforms Act, a field was marked off for the Provincial Governments to impose taxes without seeking the Central sanction. The Scheduled Taxes Rules provided that:

The Legislative Council of a Province may, without the previous sanction of the Governor-General, make and take into consideration any law for imposing for the purposes of the local Governments any tax included in Schedule I.

The Schedule comprised the following heads of taxation:

1. A tax on land put to use other than agriculture.
2. A tax on succession or acquisition by survivorship in a joint family.
3. A tax on any form of betting or gambling permitted by law.
4. A tax on advertisements.
5. A tax on amusements.
6. A tax on any specified luxury.
7. A registration fee.
8. A stamp duty other than duties of which the amount is fixed by Indian legislation.

In other cases, the previous sanction of the Governor General in Council was necessary. The Governor General in Council could, by an order make any addition to the taxes enumerated in the above schedule. The Legislative Council of a Province was further empowered to impose or authorise any local authority to impose, without the previous sanction of the Governor General, any tax included in Schedule II to the Rules.

Schedule II comprised the following taxes:

1. A toll
2. A tax on land or land values
3. A tax on buildings
4. A tax on vehicles or boats
5. A tax on animals
6. A tax on menials and domestic servants
7. An octroi
8. A terminal tax on goods
9. A tax on trades, professions and calling
10. A tax on private market
11. A tax imposed in return for services rendered, such as: (a) a water rate, (b) a lighting rate, (c) a scavenging, sanitary or severage rate, (d) a drainage tax, (e) fees in the use of markets and other public conveniences.

NOTE: 'Tax' in this schedule included a cess, rate, duty or fee. Tax under item 8 was modified in 1924. See Ibid.
Provincial Borrowings

Under the Reforms 1919, the Provinces had acquired "an acknowledged authority of their own" over the services and sources allocated to them. In order that such a real measure of independence could enable the Provinces to pursue their own development policy, the authors of the Reforms of 1919 conceded them the freedom to borrow in their own name, which was denied to them heretofore. Consequently the Local Government Borrowing Rules 95 made under the Government of India Act 1919, provided that, subject to certain conditions 96:

"A Local Government may raise loans on the security of the revenues allocated to it for any of the following purposes, namely:

(a) To meet capital expenditure on the construction or acquisition (including the acquisition of land, maintenance during construction and equipment) of any work or permanent asset of a material character in connection with a project of lasting public utility, provided that:

(i) the proposed expenditure is so large that it cannot reasonably be met from current revenues, and

(ii) if the project appears to the Governor General in Council unlikely to yield a return of not less than such percentage as he may from time to time by order prescribe, arrangements are made for the amortization of the debt;

(b) to meet any classes of expenditure on irrigation which have under rules in force before the passing of the Act been met from loan funds;

(c) the giving of relief and the establishment and maintenance of relief works in times of famine or scarcity;

95. Rules under Section 30(1a) of the Government of India Act, 1919. See id. at 177-78.

96. The conditions were that:

"(1) No loan shall be raised by a Local Government without the sanction (in the case of loans to be raised in India) of the Governor General in Council, or (in the case of loans to be raised outside India) of the Secretary of State in Council, and in sanctioning the raising of a loan the Governor General in Council or the Secretary of State in Council, as the case may be, may specify the amount of the issue and any or all the conditions under which the loan shall be raised."

...continued
(d) for the financing of the Provincial Loan Account; and

(e) for the repayment or consolidation of loans raised in accordance with these rules or the repayment of advances made by the Governor-General in Council.

Loans were made a charge on the entire revenue of the Province, and the debt charges were to be given priority to all other charges excepting the Provincial Contribution payable to the Central Government, interest on advances made to the Province from the Central Government and interest due on previous loans raised by the Provincial Government. 97

The autonomy marked by the Reforms of 1919 was well reflected in the new Budget Procedure in the Provinces. As already discussed, the Provincial Budgets, instead of being passed by the Finance Department of the Government of India, were now framed by the Finance Departments of the Provinces constituted under the Reforms Act, and were voted item by item by the Provincial Legislatures. Though the accounts of the Provinces still continued to be supervised and audited by the Auditor-General (an officer of the Government of India), but to strike the hallmark of provincial independence, it was provided that the appropriation reports, instead of being sent to the Central Government were now to be sent to the Committee of Public Accounts constituted from amongst the members of the Provincial Legislatures which sanctioned the Budget for report on the proper utilization of the money. 98

Limitations on Financial Powers

The Government of India Act 1919 conferred financial powers on the Provinces, thus demarcating the field for the governance of India, into Central and Provincial. But the

(2) Every application for the sanction of the Secretary of State...shall be transmitted through the Governor General in Council". Section 3 of the Rules, 1920.

97. Section 4 of the Local Government (Borrowing) Rules, 1920.
98. Devolution Rules Part III; Rules made under Section 1 of the Government of India Act, 1919; Rules 25 to 32 of the Rules of Business for Provincial Legislative Councils, framed under Section 11(5) of the Act, 1919. Also see Rules framed under Section 96(1) of the Act.
powers so conferred were limited under the control and interference vested in some non-provincial authorities. The Secretary of State was given powers with regard to loans raised by the Provinces, outside India. The expenditure over the reserve side was also under his control. His previous sanction was necessary in all cases of expenditure over the transferred departments that affected the services appointed by him, or the purchase of stores by him.99

The Governor-General, during an emergency, could with the approval of the Secretary of State, demand from a Province more than its fixed amount of contribution.1 He was to sanction loans raised by the Provinces within India and in doing so, he was empowered to prescribe his own terms and conditions.2 His previous sanction was required for imposing taxes other than the Scheduled ones. He was authorised to express his own opinion on applications made to the Secretary of State by the Provinces for the sanction of expenditure on the reserved departments and the loans to be raised outside India.

The position and powers of the Governor of the Province were the serious restrictions on the free exercise of responsible government under Dyarchy. In the matters of finance, the final decision on the allotment of funds between the two sides lay with him although it could very well have been left to the majority of the entire Executive. Proposals for loans and taxation required his approval. He could restore any grants demanded for the reserved departments but reduced or refused by the legislature and he could also sanction in any emergency, an expenditure over any department.

The Finance Department under the charge of an irresponsible member of the Governor's Executive Council, was to approve all

2. Section 3, Local Government (Borrowing) Rules.
schemes of expenditure, loans and taxation. It gave the
Finance Member power to reject any scheme of a transferred
department initiated by a Minister. 3

Another serious defect in the system was the provision
of certain non-votable items in the budget. The Provincial
Legislature could not affect the grants on these items in any
way. Items like the provincial contributions, debt-charges,
salaries of servants appointed by the Secretary of State or by
or with the approval of His Majesty were not to be submitted
to the Legislative Council. 4

These limitations over the Provincial Governments' independence of action in working the Reforms made the Reforms a
niggardly gift and a sham. Lord Reading while addressing the
Joint Session of Indian Legislatures in 1923, termed the
Reforms "a dress giving only the trappings of reality to a
dead body which had neither life nor force." 5

But it was an extremely shallow view of the Reforms.
The history of the relations of Provincial Governments with the
Central Government as discussed in the foregoing pages, brings
out that it was a gradual escape from a position of complete
subordination to a position of relative though limited
independence. The abolition of the divided heads, the liberty
of appropriations, the freedom to use the balances, and the
power (though limited) of taxing and borrowing had definitely
set the Local Governments on the path of financial autonomy.
"From the Reforms" says Mishra, "did emerge a steady, though
slow, process of administrative devolution from the Government
of India to the Provincial Governments", which had "profoundly
affected the whole course of India's future constitution." 6

3. Rules 30 to 35, Devolution Rules enacted under Section 45
4. Section 72D of the Act 1919.
5. Lord Reading's Speech, July 28, 1923.
6. E.R. Mishra, Indian Provincial Finance 1919-39, 81,
In the words of Thomas, "The financial system adopted in India in 1919 was a half-way house between unitary and federal. As regards the allocation of revenues, the system was completely federal and perhaps even more federal than in many Federations... Nevertheless in regard to audit and accounts, borrowing and allied matters the provincial Governments continued to depend largely on the Central Government." In the same vain, Chanda labelled the system, "a halfway house between control and autonomy", for "though the sources of revenue of the Centre and the Provinces had been separated with freedom to them to exploit and adjust the levels, the Provinces had yet to gain control over audit and accounts, borrowing and allied matters." In their assessment of the system of 1919, the Joint Committee on Indian Constitutional Reforms said that it produced three important results. These were, "It had tended to remove provincial administration from the immediate purview of His Majesty's Government and, by thus weakening the direct accountability of Indian administrators to Parliament, it had, perhaps rendered inevitable, the introduction, in some degree, of local responsible government. At the same time, it had tended to make the Provinces the centres of the development of social services; and it had also tended to transfer to the Provincial Executives the prime responsibility for the preservation of law and order."

Conclusion

In conclusion, it may be noted that the separation of resources under the Reforms of 1919 altered the character of the relationship between the Central and the Provincial Governments. The Act and the Devolution Rules made thereunder, gave the Provinces considerable latitude in financial matters. Despite certain statutory restrictions which hedged around the taxing and borrowing powers of the Provinces, the Provincial Governments acquired almost complete freedom to frame their own budgets, to

7. Thomas, 323.
8. Chanda, 139.
adjust the levies on transferred heads of revenue, to spend whatever they liked on the transferred subjects. Though a certain amount of Central control flowed through the channel of the Finance and Audit Departments, particularly on the expenditure on reserved subjects, the Provincial Governments were given a free hand in the expenditure of their funds. However, it would be an exaggeration to say that the Reforms of 1919 put the Centre-Province financial relations on a clearly federal basis, yet the powers of taxing, borrowing and of using their balances, though circumscribed by limitations, set the Local Governments on the path to financial autonomy. The Reforms had thus brought Provincial Autonomy nearer and had paved the way for the ultimate establishment of a federation in India.10

**Defects of the Meston Settlement Leading to Further Enquiry**

The financial provisions of the Government of India Act 1919 had been evolved on the basis of the Meston Report and were titled as 'Devolution Rules. The distribution of resources made thereunder did not prove satisfactory. The scheme of contributions embodied therein was based on certain budgetary assumptions which proved to be wholly incorrect. While expanding sources of revenue had been allotted to the Central Government, the sources made over to the Provinces were inelastic. To add to it, the activities of the Central Government remained more or less static under conditions then prevailing, those of the Provincial Governments expanded with the transfer to them of social services such as education, public health, sanitation, etc. This all created an imbalance in the provincial budgets and thus provincial autonomy, limited though it was, had become meaningless without adequate financial resources. Discussions were, therefore, continued to find a more rational and acceptable distribution. All this led to the demand for a major readjustment of tax resources.

The question of a reallocation of resources between the Central and Provincial Governments was thus soon taken up, which formed part of the subject matter of the inquiries by the

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10 Prasad, 376.
Muddiman Committee (Reforms Enquiry Committee, 1924), the Indian Taxation Enquiry Committee (1924-25), and finally the Indian Statutory Commission (1929-39). 11

Kuddiman Committee

The Reforms Enquiry Committee, with Sir Alexander Kuddiman as its Chairman was required to inquire, inter alia, into the defects of the working of the Reforms and to suggest remedies consistent with 'the structure, policy and purpose of the Act of 1919'. The Committee submitted two reports: 'Majority Report' and a 'Minority Report'. 12

The Majority recommended very few changes. They recommended the relaxation of Central control over provincial borrowing and the separation of provincial balances from that of the Central. As far the position of the Financial Department, the system of joint purse, the Governor's powers of restoring a rejected or reduced grant and his legislative powers, the majority favoured status quo. 13

The Minority recommended an amendment of the Act of 1919. They wanted the provincial finances to be put on a sound basis after a re-examination of the whole question. They suggested that finance should not be reserved from the responsible Ministers.

The unpopularity of the 1919 Reforms, in the opinion of the Majority of the Muddiman Committee, was largely due to the difficulties in finding additional sources of revenue. They observed: "It is due to it (i.e. the Meston Settlement) that Ministers have been unable to enter upon a policy of progressive development in the spheres of administration committed to their care. If they had been able to do so, they would have been able

11. The Government of India Act 1919, had itself stipulated for the appointment of a Statutory Commission at the expiry of ten years of the working of the Reforms of 1919. The Commission was required inter alia to investigate and report as to what extent the responsible Government granted under the Act of 1919 should be extended or curbed. See S.64A of the Act 1919.


to provide an answer to those critics who have reiterated the
allegation that the Reforms were a sham and they would also
have been able to consolidate their position or else have been
required to make way for other Ministers who could have
enunciated a policy more acceptable to the Councils which would
incidentally have assisted in the establishment of the
responsibility of the Ministers to the Councils. 14 The
Majority thus recommenced the revision of the Meston Settlement
as soon as a favourable opportunity occurred. But the minority
considered that a revision should better take place along with
the general revision of the Constitution. They stated: "We are
firmly of the opinion that the earliest possible opportunity
should be taken to put provincial finances on a sound footing,
without which we think the development of the Provinces must
continue to be retarded." 15

The Reports of the Muddiman Committee could have little
effect on the constitutional evolution of the country, for it did
not result in the introduction of any change.

Appointment of Statutory Commission: Simon Commission-1920

The rising tide of hostility in India led to the appoint­
ment of Statutory Commission in November 1927, as promised in the
Government of India Act, 1919. The Commission with Sir John Simon
as its Chairman and six other members (all Britishers) was asked
to enquire into the working of the system of 1919. The Commission
had no Indian member and, therefore, was boycotted by the Indian
people at large at the instance of the nationalists. But they
could secure the Indian views from the Nehru Report prepared by
the All Parties Conference in 1928. 16

The Commission submitted its Report in May 1930. In the
matter of provincial finances the Commission accepted the
findings of Sir Walter Leyton 17 its financial assessor. After

16. The Report presented by Nehru Committee appointed in May
1928 at the All Parties Conference. The Committee was asked
to draft the principles of a Constitution on the basis of
full responsible government.
17. Leyton, the financial advisor to the Commission was asked
an elaborate examination, Sir Leyton expressed his dissatisfaction with the existing financial relations between the Central and Provincial Governments. He was convinced of the injustice done to the Provinces under the Devolution Rules and found that there was serious disproportion between the administrative burdens and resources of the provinces. The chief sources of provincial revenue were inelastic and the Provinces, he said, had also not utilized the scheduled taxes. He, accordingly, suggested that the revenues of the Provinces had to be raised by fifty per cent to meet their increasing expenditure. He, therefore, recommended that the Provinces should be given the yield of certain centrally raised taxes some of which would be distributed between the Provinces on a population basis and others according to needs. The Provinces were to get a substantial share of income-tax and they could also levy surcharges on their share of the tax. The proceeds from salt duty and half of those from taxes on agricultural and personal income, were also to be distributed to the Provinces according to their needs. Commercial stamps, for the sake of uniformity were to be surrendered by the Provinces, while customs duty on foreign liquors was to be adjusted according to the provincial excise policy. 18

Sir Walter, further suggested the establishment of a Provincial Fund of the new All India Taxes, to be distributed on a per capita basis. On the constitutional side, he recommended the separation of provincial accounts from the central and abolition of external control over provincial borrowing (except by an All India Council for co-ordinate purposes). Provincial balances might be kept on a commercial basis with the Central Government and provincial accounts were to be audited by the Auditor General. 19

19. Ibid.
The Commission adopted the recommendations of their assessor fully. By this time political agitation in India had assumed a mass scale and there was great discontent over the issue of Simon Commission. Before its Report could be published Lord Irwin, the Viceroy of India went to England for consultation. He came back with a programme that the natural issue of India's constitutional progress, was the attainment of 'Dominion Status' and that after the publication of the Simon Commission's Report, its consideration by His Majesty's Government in consultation with the Government of India, a Round Table Conference would be convened to seek a common basis of agreement among various political parties and interests in British India.

Round Table Conference 1930

The Report of the Simon Commission was published in May 1930. As per the recommendations of the Commission and the announcement of Lord Irwin, the First Round Table Conference met in London between November 12, 1930 to January 19, 1931. The federal issue dominated it and the Conference unanimously approved the proposal for a 'federation of All India comprising British Indian Provinces and the Indian States'. It also raised afresh the question of financial adjustments between the federal government on the one hand, and the Provinces and the Indian States, on the other.

The whole question of financial relations between the Federal Government and the units under the proposed scheme, was

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21. It may be pointed out that the Mont-Ford Report 1918 anticipated that the developments in British India would inevitably influence the pace of change in the native States also. The Report stated: "Hopes and aspirations may overlap frontier lines like sparks across a street. There are in native states men of like minds to those who have been active in spreading new ideas in India... no one would be surprised if constitutional changes in British India quicken the pace in the native states as well". Report, quoted in Krishnaswami, A., The Indian Union and the States: A Study in Autonomy and Integration, 81 Pergamon Press, London, 1964.
examined by a Sub-Committee of the Federal Structure Committee which had been constituted by the Second Round Table Conference. The Sub-Committee presided over by Lord Viscount Peel made an elaborate examination of the whole problem.

**First Peel Committee 1932**

The Peel Committee started its proceedings from the standpoint that the existing division of resources between the Central and Provincial Governments should not be changed except for imperative reasons and said that federal resources should be limited to indirect taxes and such direct taxes as would affect the Indian States as well. They specified about a dozen sources as federal and gave to the Provinces the rest of the taxes, mentioning among them land revenue, excise on drugs etc., and succession duties. They gave to the Provinces the full proceeds of income-tax other than corporation tax (which in their opinion should be a federal tax). For reasons of uniformity and administrative convenience, the Committee required the tax to be levied and collected by the Federal Government. It was to be distributed among the Provinces on the basis to be recommended by an Expert Committee. On such arrangement, if any deficit resulted at the Centre, the Committee proposed that such deficits were to be made up by the Provinces by contributions, to be extinguished by annual stages over a period of ten to fifteen years, as the case was under Meston Settlement. To do away with the existing rigidity it recommended that when there were permanent surpluses in the federal budgets, the federation should be free to allocate them to the Provinces as an alternative preferable to reduction of taxation. The Committee suggested that the Constitution should itself lay down the principles on which the funds thus available should be divided among the Provinces, whether according to respective revenues or to populations or to some other criterion. This being a matter for detailed study, the Committee recommended that the Expert Committee should advise on this aspect as well as on the criteria which should be applied in distributing the proceeds of income-tax to the Provinces.22

An Expert Committee was accordingly constituted with Lord Percy as its Chairman to give practical shape to the principles enunciated by the Peel Committee (1932). The Percy Committee, as it is popularly known as, concentrated on the question of the place to be given to income-tax in the distribution of resources. The Committee doubted the wisdom of the suggestion of Peel Committee (First) to assign income-tax in its entirety to the Provinces. This by itself, they felt, would affect the viability of the federation and make it largely dependent on contributions from the Provinces. They, therefore, proposed that Corporation Tax (super-tax on companies), tax paid by residents in federally administered areas and tax paid on salaries of federal officers should be retained by the Centre and the rest of the proceed should accrue to the Provinces.

On the main question referred to them, namely the determination of the principle which should regulate the distribution of income-tax among the Provinces, the Committee felt that it should satisfy three fundamental tests:

(i) it should be simple, easily understood and administratively workable;
(ii) it should give results likely to be accepted as fair between different provinces;
(iii) and it should be compatible with the idea of a federation of autonomous units.

The Committee then proceeded to examine the merits and demerits of three possible alternations, namely, basing distribution on 'collection', 'population' or 'origin' and came to the conclusion that none of these by itself would be equitable or suitable for adoption. 'Collection', they said, would result in the industrialised Provinces receiving the bulk of the yield, leaving little for distribution to others and thus, they ruled it out. 'Population' in their opinion would not be a scientific basis for overall distribution; it would be suitable only for elements of the tax whose incidence was indeterminate. 'Origin' though theoretically a rational basis, but administratively unworkable unless the allocations were made on arbitrary lines.
After this detailed examination, the Committee concluded that it would be best to adopt 'residence' as the basis, in one of the forms, either the basis of personal incomes assessed or assessable or the amount of income-tax attributable to each province. The formula ultimately advocated was in two parts: The Province should receive an estimated amount of personal income-tax of local incidence, personal super tax on the basis of collection from their residents a share of the tax on non-residents and undistributed profits of companies on the basis of population. The amount they separately computed for each Province should be added and expressed as a percentage of total collection as its share.

In order to stabilise the provincial estimates, the Percy Committee suggested that the provincial shares should not be calculated every year but once every five years, in the light of figures of personal income-tax for the previous quinquennium. The Committee expected that under the arrangement so proposed, the federal centre might not be left with sufficient resources at least in the beginning. Thus, as a transitional safeguard, they suggested that each of the Provinces should make a contribution to the Centre, primarily with reference to their additional resources, i.e., generally in proportion to the share of income tax. Income tax was, thus, retained a balancing factor both directly and indirectly.

The Percy Committee recommended that the federal Government should be empowered to impose a surcharge, for its own purposes, on any tax levied and collected by it for the benefit of the Provinces. Federal grants, if and when they became feasible, they said, should be made on a population basis, as they believed that the surplus would arise mostly from taxes on consumption, and per capita distribution would in their opinion, be the most equitable basis to adopt.

White Paper 1931

Meanwhile, the British Government had in December 1931, issued a White Paper embodying their proposals for 'Indian Constitutional Reforms' with a view to provide a basis for further
discussions at the forthcoming session of the Round Table Conference (Third R.T.C.). The White Paper contained a detailed analysis relating to financial proposals. It reverted to the idea earlier canvassed of making income-tax a divisible head of revenue and suggested that an amount not less than fifty per cent and not more than 75 per cent of the proceeds should be assigned to the Provinces on a prescribed basis. In this computation, tax on companies, as also tax on agricultural income, the Paper suggested, should be excluded, the former should be retained by the Centre and the latter should accrue to the Provinces.

The White Paper also proposed that out of the amount so assigned to the Provinces, the Federal Government should retain an amount which should remain constant for three years and thereafter diminish gradually to zero over a further period of seven years. The Governor General was empowered to suspend these reductions, if circumstances made it necessary to do so. The purpose was to give the Federal Government time to adjust its finances and to explore the field of indirect taxes. The Federal and the Provincial Governments were also to have power to impose surcharges on income-tax for their own purposes.

To provide additional balancing factors, the White Paper proposed that the Federal Legislature should be empowered to assign to the Provinces the whole or a part of the yield of salt duty, excise duties on commodities in the Central list and export duties. Further, it proposed that though the levy and collection of terminal taxes and death duties should be in the hands of the Federation, the entire net proceeds of both these levies, should be distributed to the Provinces. The Federal Government, however, have the right to impose a surcharge under both heads for its own purposes and retain the whole proceeds.

The 'Finance' side of the proposed new Constitution was the main issue before the Federal Structure Committee of the Third Round Table Conference, which met in 1932. The Committee had before them the Reports of First Peel Committee, the Percy Committee and the White Paper of His Majesty's Government.
The Federal Structure Committee thought it desirable that the question of financial allocation should be reviewed afresh in view of the changing political conditions of the country. For the purpose, they constituted a Sub-Committee with Lord Peel (who also headed the earlier sub-committee) as its Chairman.

Second Peel Committee

The Second Peel Committee being benefitted by the conclusions of the Percy Committee and the proposals contained in the White Paper made considerable changes in their earlier recommendations. This time, they did not support the earlier view of provincialisation of income-tax but recommended, instead, that there should be a two-fold division of its proceeds and the assignment so made, should be a permanent constitutional arrangement. The Federal Government should be entitled to the proceeds of certain sub-heads of the tax which were not derived solely from the residents in British India, such as corporation tax, tax on federal officers, tax in federal areas, tax on Government of India's securities and tax on the income of persons not resident in British India. The whole of the remaining proceeds from income-tax were to be assigned to the Provinces.

At the outset of the Federation, the Second Peel Committee proposed that, in order to ensure the solvency of the Central Government, out of the provincial share of taxes on income, the Federal Government should retain a block amount until such time as new sources of revenue had been developed to compensate it for the loss it would sustain on the distribution proposed. The amount would be deducted by the Federal Government from the total yield before any distribution took place. The initial amount fixed, it was recommended, should gradually be reduced to zero. The duration of the period was divided into two parts. During the second half, the amount so deducted was to be finally allocated to the Provinces.

Like the First, the Second Peel Committee gave to the Provinces, the residuary powers of taxation and agreed with the

23. Recommendations of the First Peel Committee, see supra.
proposals of Percy Committee regarding provincial borrowing. It also recommended federal subventions for the deficit Provinces in approved cases and on certain conditions to enable them to balance their budgets on the basis of providing for bare necessities. The Committee suggested that the exceptional difficulties of Bengal might perhaps be met by granting it some share in the revenue from jute export duty, but it made no definite proposal as to the form which the share would take.

The Committee also favoured both the Federal and the Provincial Government to have power to levy, for their respective purposes, a surcharge on income tax. The Provinces, however, could levy their surcharge on the personal tax levied on, their residents under the heads permanently allotted to them, and in their case the maximum levy prescribed was 12½ per cent of the basic rate and this surcharge like all other taxes on income, was to be collected by a federal agency.

**Examination by the Joint Parliamentary Committee 1933-34**

The foregoing analysis make out that there was hardly any unanimity in the recommendations made by the various Committees, not only on the 'allocation of resources', but even on the fundamentals of the relations that should subsist to make both the Federation and the Provinces viable. Even the Peel Committee held different views and suggested differently both the times. This led the question of allocation of resources to yet another examination in 1933-34, by the Joint Parliamentary Committee on Indian Constitutional Reforms. The Joint Committee made a thorough study of that was suggested by all these committees and the proposals contained in the White Paper.

The Joint Committee agreed with the main lines of the White Paper scheme. They, however, made certain modifications (of relatively minor importance) in the proposals of the White Paper. The Committee feared that owing to the trade slump and the needs of the deficit Provinces, it would not be possible to fix in the Act, the percentage of income-tax proceeds to be assigned to the Provinces. They, therefore, suggested that this distribution should be made in the first instance by an Order-in-
Council. They, however, did not see any prospects of fixing a higher percentage than fifty.

The Joint Committee rejected the White Paper proposal of empowering the Provincial Legislature to impose surcharge on personal income-tax.

Apart from these modifications, the Joint Committee left the other recommendations in the White Paper substantially undisturbed. The modified provisions relating to distribution of income-tax and other matters were incorporated in the Government of India Act 1935. It was in the light of this vast mass of discussions and inquiries into the central problem of Federal Finance that the constitutional provisions on the subject were enacted. But, "It was the wisdom of White Hall" rightly says Chanda, "that ultimately prevailed in the immediate distribution." 24

The Government of India Act 1935

The Government of India Act 1935, accepted the need of a Federal Government and thus gave to India federal Constitution. It embodied the federal concept of division of functions and resources. The financial provisions were contained in Part VII of the Act. Earlier experience had, however, shown that no clear-cut division of resources was feasible without jeopardizing the viability of the Centre or the Provinces. The Act thus followed a measure of inter-dependence as regards allocation of financial resources, but this was kept down to the minimum by incorporating the element of obligatory participation of both in the yield of income tax and jute export duty (then in force) and making a room for discretionary grant-in-aid by the Centre to the Provinces, in need of assistance.

The Act incorporated the recommendations that the Federal Legislature should be given the authority to levy and collect certain taxes though their net proceeds would be

24. Chanda, 150.
distributed wholly to the Provinces. There was a built-in-flexibility in the provisions adopted in regard to the share of the Provinces in the proceeds of income-tax and grants-in-aid.

The Act embodied a new scheme of federal finance, according to which, the revenues of India were divided into three main categories, namely, (1) Federal, (2) Provincial, and (3) Jointly Federal and Provincial.

The financial provisions of the Act strengthened further, though indirectly, Central control over the Provinces, even in the demarcated field of their political authority resulting from their dependence on the Centre for financial support. It thus opened a new chapter in the Centre-Provincial financial relations. In the words of Chanda, "the Act had incorporated the wisdom of all the earlier examinations. It had collected strands and woven them into the texture of the Constitution."  

The next chapter is devoted to a study of the provisions of the Government of India Act 1935, relating to financial relations and their impact on the evolution of federal finance under the Constitution of Independent India.