CHAPTER III

FINANCIAL RELATIONS UNDER THE GOVERNMENT OF INDIA

ACT 1935

Introduction

The Government of India Act 1935 proposed a federal polity\(^1\) for the country. But because of the unwillingness of the Indian Princes to join it the provisions of the Act relating to Federation never came into operation. However, so far as, the Provinces, the Act came into force in 1937.\(^2\) The Provinces, thus, became autonomous units and it carried to the logical conclusion, the tendencies towards independence or separation of resources already visible in 1920.\(^3\) The Act brought about a major improvement in the fiscal position of the Provinces by introducing the principle of federal finance. The statutory provisions regarding the scheme of federal finance were contained in Part VII, sections 136-180 (both inclusive), of the Act 1935. These financial provisions are to be read as supplemented by the Distribution of Revenue Order, 1936, - an Order-in-Council which was made on the Report of Sir Otto Niemeyer, who was appointed to examine the financial position of the Central and the Provincial Governments under the distribution contained in the Act and to make recommendations on assignments proposed in it.

The federal concept of division of functions and resources was generally embodied in the Act of 1935. But the principle of a complete separation of resources and obligations is indeed, more easy to enunciate than to achieve. Though, a certain degree of fixity in the division of revenue is desirable so that petty

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1. The Act of 1935 did not inaugurate the Federation, rather it provided that the federal provisions would be promulgated by a proclamation only when a specified minimum number of Native Princes acceded to the federation. As it happened, these provisions never came into operation. See Section 5, Government of India Act 1935 (hereinafter cited as the Act 1935).
3. See supra Chapter I.
jealousies and troubles may not arise, but the Central Government must possess some powers of co-ordination in regard to the resources in the broader national interest. It was as true about India of 1935 as that of the classical federations of United States of America or Australia. The experiences of these federations had shown that no clear-cut division of resources was feasible without jeopardizing the viability of the Centre or the Provinces. A measure of interdependence was inevitable. The Act, thus, adopted built-in flexibility in its provisions. It provided for important adjustments in the financial relations between the Central and Provincial Governments and based them on the general principle of financial independence for the Provinces, tempered by considerations of the financial solvency and stability of the Centre.  

Besides the clear demarcation of federal and provincial sources of revenue, the Act of 1935 introduced a system of 'shared taxes'. Apart from this prop to the financial equilibrium of the Provinces, the Act provided for further devolution of funds to the Provinces which could be made under the authority of an Act of the Federal Legislature. This devolution of funds was provided not on obligatory but enabling basis. In addition to this devoluntary support for provincial finances, the Act provided for the payment of Central grants-in-aid to the Provinces to meet their residual needs. Finally, the Act increased the borrowing powers of the Provinces which could now

4. Prof. Adarker points out that besides the principles of independence and responsibility, the principles of adequacy and elasticity and administrative economy must be observed in the division of resources between the Centre and the Units. B.P. Adarker, The Principles and Problems of Federal Finance, 218, P.S. King and Son, London, 1953.
5. See the recommendations of the Second Peel Committee, supra.
6. Section 138, Government of India Act 1935. This was indeed a partial return of the system of 'divided heads' so unpopular for its inbuilt central control of provincial finances. But with the introduction of provincial autonomy, it was hoped that it would work satisfactorily. The genius of the system lies in the fact that the system is also incorporated in the Constitution of Independent India.
7. Id., Section 140.
8. Id., Section 142.
raise loans in the open market on the security of their respective revenues, but subject to the condition of seeking Central sanction in case a Province wished to float a loan outside India or when it owed any debt to the Federation or when any debt guaranteed by the latter remained outstanding. ⁹

The Act 1935 embodied the principle that the Federal Legislature should be empowered to levy and collect certain taxes though their net proceeds would be distributed wholly among the Provinces. ¹⁰ The whole field of taxation was divided into four categories. First of all, there were those items on which the Federal Government had the sole authority to levy and collect taxes, the proceeds thereof were kept fully by it. ¹¹ Secondly, there were those items on which taxes were levied and collected by the Federation but their proceeds were shared between the Federation and the Provinces. ¹² The third category included items on which taxes were levied and collected by the Federation for the mere purpose of uniformity and the proceeds of these taxes were completely handed over to the Provinces. ¹³ The fourth category related to items with respect to which the Provinces had independent power of taxation. These taxes were levied, collected and appropriated by the Provinces themselves. ¹⁴

There was a further division of powers between the Federal and Provincial Governments so far as legislation was concerned. The Seventh Schedule to the Act of 1935 contained three lists - List I (Federal Legislative List); List II (Provincial Legislative List) and List III (concurrent Legislative List). On the subjects contained in List I, the power to legislate vested exclusively with the Federal Legislature and on the subjects enumerated in List II, the Provincial Legislatures were

⁹. Id., Section 163.
10. Id., Section 140.
11. See Section 139, also see infra.
12. Id., Section 138.
13. Id., Section 137.
14. Id., Section 142-A; List II read with Section 100.
exclusively empowered to legislate. While with respect to subjects of List III, both the Federal and Provincial Legislatures had concurrent powers to legislate. The entries in List I and List II also included the respective areas of taxation of the Federal and Provincial Governments. Concurrent List hardly contained any tax entry. It was also ensured that no one could encroach upon the field assigned to the other. The scheme of distribution of revenue between the Federation and the Units contained in the Act of 1935, is discussed in the following pages.

The Government of India Act 1935, for the first time marked a clear-cut distinction between the revenues of the Central Government and that of the Provinces by defining the terms "Revenues of Federation" and "Revenues of Provinces". "Revenues of Federation" included all revenues and public moneys raised or received by the Federation. This was subject to the assignment of the whole or part of the net proceeds of certain taxes and duties which the Federation was to make to the Provinces and Federating States. "Revenues of Province" included all revenues and public moneys raised or received by a Province. These were the taxes a Province levied and collected and the assignment of revenues and grants-in-aid made to it by the Federation.

Distribution of revenues between the Federation and the Provinces was made in accordance with the scheme summarised below:

A. Exclusively Federal Revenues - These included the taxes levied, collected and retained by the Federal Government. In this list were included:

1. Corporation tax.
2. Coinage profits and share in profits of Reserve Bank.
3. Contributions from Railways.
4. Receipts from other Federal Commercial Undertakings.

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16. Section 100 read with List I of the Seventh Schedule to the Act 1935.
17. Entry 46, List I, Seventh Schedule.
18. Id., Entry 5.
20. Id., Entry 33.
5. Import and export duties. 21
6. Military receipts. 22

B. Exclusively Provincial Revenues: These may be classified as follows:

I. Taxes levied, collected and retained by the Provinces 23

In this sphere, the Provinces had independent power of taxation. These are contained in various entries of List II of the Seventh Schedule to the Government of India Act 1935. These were:

1. Land Revenue. 24
2. Irrigation. 25
3. Duties of excise on the following goods manufactured or produced in the Province and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:
   (a) alcoholic liquors for human consumption;
   (b) opium, Indian hemp, and other narcotic drugs and narcotics, non-narcotics drugs;
   (c) medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry. 26
4. Taxes on agricultural income. 27
5. Taxes on lands and buildings, hearths and windows. 28
6. Duties in respect of succession to agricultural land.

21. Id., Entry 44.
22. Id., Entry 2.
23. Section 100 read with List II, Seventh Schedule. In respect of the taxes and duties contained in this category, the power of legislation and administration laid with the Provincial Government.
24. Entry 39, List II.
25. Id., Entry 19.
26. Id., Entry 40.
27. Id., Entry 41.
28. Id., Entry 42.
29. Id., Entry 43.
7. Taxes on mineral rights subject to any limitations imposed by any Act of the Federal Legislature relating to mineral development. 29A

8. Cessation taxes. 30

9. Taxes on profession, trades, callings and employments, subject, however, to the provisions of Section 124A. 31

10. Taxes on animals and boats. 32

11. Taxes on the sale of goods and on advertisements. 33

12. Taxes on the entry of goods into a local area for consumption, use or sale therein. 34

13. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling. 35

14. Stamps and registration. 36

15. Dues on passengers and goods carried on inland waterways. 37

16. Tolls. 38

17. Fees in respect of any of the matters in the Provincial Legislative List, but not including fees taken in any court. 39

II. Taxes levied and collected by the Federation but assigned completely to the Provinces. 40 These were the taxes which were, for the sake of uniformity and administrative convenience, levied and collected by the Federation, but the

29A. Id., entry 44.
30. Id., Entry 45.
31. Id., Entry 46 read with Section 124A of the Act 1935.
32. Id., Entry 47.
33. Id., Entry 48.
34. Id., Entry 49.
35. Id., Entry 50.
36. Id., Entry 51.
37. Id., Entry 52.
38. Id., Entry 53.
39. Id., Entry 54.
40. Section 137.
net proceeds thereof were wholly allocated to the Provinces. These were as follows:

1. Estate duty in respect of property other than agricultural land.
2. Such stamp duties as were mentioned in the Federal Legislative List.41
3. Terminal taxes on goods or passengers carried by Railways or air.
4. Taxes on railway fares and freights.

Section 137 further provided that the proceeds from the above taxes so far as these represented proceeds attributable to Chief Commissioners' Provinces were to go to the Federation. In the net proceeds, the Provinces were to share inter se in accordance with such principles of distribution as were to be formulated by an Act of the Federal Legislature.

The Federal Government's only means of benefiting from these revenues was by imposing surcharges under Section 137 itself.42

C. Shared Revenues: This category included two kinds of taxes mentioned below:

1. Compulsorily Shareable Tax - Income Tax.43 The Federation under Section 138 had the responsibility of levying and collecting taxes on income other than agricultural income and it was obligatory on it to share the net proceeds of these taxes with the Provinces. The proceeds attributable to Chief Commissioners' Provinces and taxes payable in respect of Federal emoluments as well as any surcharge which might be levied for purposes of the Federation, were kept out of the divisible pool

41. These included stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, proxies and receipts. See item 57, List I, Seventh Schedule.
42. Proviso to Section 137.
43. Section 138.
of revenue arising from taxes on income.

The distribution of the provincial share was to be prescribed by an Order-in-Council.  

II. **Voluntarily Shareable Taxes**\(^4\): These included the following:

1. Salt duties.
2. Duties of excise on tobacco and other goods manufactured or produced in India except -
   (a) alcoholic liquors for human consumptions;
   (b) opium, Indian hemp and other narcotic drugs and narcotics, non-narcotics drugs;
   (c) medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
3. Export duties (with special provision for the export duty on jute and jute products contained in Section 140(2) of the Act 1935).

These duties were to be levied and collected by the Federation. If an Act of Federal Legislature, so provided, the net proceeds of revenue from these duties was to be assigned wholly or in part to the Provinces. The distribution thereof, among the Provinces was to be made in accordance with the principles to be formulated by such Act of the Federal Legislature.  

The purpose was not only to balance the budgets of the Provinces so as to make the financial scheme more elastic, but also to facilitate the introduction of new taxes.

While it was discretionary with the Federation to share, in any proportion, the proceeds from these duties, with the Provinces, in regard to export duty on jute and jute products, the Act of 1935 specifically laid down that at least one half

\(^4\) See Government of India (Distribution of Revenues) Order 1936 (3-7-1936) made under the Niemeyer Award. See also **Infra**.

\(^4\) Section 140(1).

\(^4\) As were to be provided in the Act of Federal Legislature.

\(^4\) This proportion could be increased by an Order-in-Council. See **Infra**, Niemeyer Award.
of the net proceeds were to be assigned to the Provinces in which jute was grown, in proportion to the respective amounts of jute grown therein. This provision was made with an avowed purpose of helping Bengal which had been accumulating deficits since 1930.

D. Grants-in-Aid: The Act of 1935 also authorised the Federal Government to make grants-in-aid to the deficit Provinces. The amount of such grants was to be prescribed by Order. Different amounts could be prescribed for different Provinces. The purpose was to balance the budgets of the Provinces and to fill the gaps and inequalities in their finances.

At the same time, Section 150(2) of the Act of 1935, enabled both the Federal and Provincial Governments to make grants for any public purpose. These were known as grants for special purposes.

Borrowing Powers

The Act of 1935 also enlarged the powers of the Provincial Governments in respect of borrowing. The right to borrow was though not entirely a dead letter under the Act of 1919 and the Devolution Rules made thereunder, yet it was in practice, difficult for the Provinces to borrow for their own purposes under the conditions and limitations which could be imposed on them. Under the Act of 1935, this control was brought to the minimum. Now the Provinces could raise loans in the open market on the security of their respective revenues. But the Federal Government could prescribe conditions in cases where the Provinces wished to float a loan outside India or owed any debt to the Federation or any debt guaranteed by the latter was remaining outstanding. In all these cases the Act

48. Section 140(2).
50. Section 142.
51. Section 163(1).
required the Provinces to seek previous section of the Federal Government. There was no other statutory restrictions on the Provinces' right to borrow. The Act also did not specify any specific purposes for which alone the Provinces could borrow. In view of the fact that the duty to maintain the financial stability and the credit of India was cast on the Governor General, he was to be duly cautious in such matters. However, he could not withhold giving his consent in such matters unreasonably. It was likely that in practice, the Provinces at least, the newer or weaker ones, would prefer to borrow from the Federation, in which case the latter could exercise considerable control over the Provinces' liberty of action.

As regards the Federation, Section 162 authorized it to borrow on the security of the federal revenues within such limits as might be fixed from time to time by Act of the Federal Legislature. Section 161 terminated the power of the Secretary of State to raise money on the security of the revenue of the British India, except that during the transition period he was to exercise the power to borrow in sterling under certain conditions.

Residuary Power of Taxation

In respect of the residual power of taxation, the Act of 1935 introduced a unique provision. The framers of the Act having been benefited by the experiences of federations elsewhere, carefully delimited the respective tax domains of the Federation and the Provinces. They attempted to avoid the question of residual power by making three exhaustive lists. All unspecified subjects were to be allocated by the Governor-General either to the Federation or to the Provinces. To this effect, Section 104 of the Act laid down that the Governor General "may by public notification empower either the Federal Legislature or a Provincial Legislature to enact a law with

52. Section 163(2).
53. Section 12(1)(b).
54. Section 163(4).
respect to any matter not enumerated in any of the Lists in the Seventh Schedule to this Act including a law imposing a tax not mentioned in any such list, and the executive authority of the Federation or of the Province, as the case may be, shall extend to the administration of any law so made, unless the Governor General otherwise directs." It was expressly made clear that in the discharge of this function, the Governor General was to act in his discretion. However, looking to the fact that subjects unspecified were few, this would not have given much power to the Centre.

**Surcharges**

The Act of 1935 made no mention of super-taxes and it was open to doubt that within the respective field of taxation, the Federation or the Provinces could impose such taxes. As far surcharges, the Act specifically empowered the Federal Government to levy surcharges on income tax and on the taxes mentioned in Section 137. These charges could be imposed in times of emergency and for the purposes of the Federation. A corresponding right to increase the amount of the field of Provincial revenues by adding to the rates of the taxes imposed in the Provinces had not been provided for.

**Growing Provincial Expenditure**

As far the freedom in spending the revenue so raised by the Provinces which forms an important element in the concept of financial autonomy, they were not required to look to the Centre. In this respect, provincial autonomy was almost complete under the Act of 1935. The most serious limitation on the right of the Provinces to allot their revenues was provided by the items to be charged upon their revenues, such as the salaries

56. Clause (2) of Section 104.
57. Sub-section (1), para (b) of proviso to Section 138.
58. Proviso to S. 137.
of the Governor, certain services and High Court judges, the
sums required for the administration of the excluded areas etc.,
which generally came to about 20 per cent of the entire revenues
of the Provinces.\(^59\)

The freedom to spend money, contributed to the growing
provincial expenditure. The Provinces were becoming more and more
conscious of the claims of the spending departments left in their
charge. This factor added to the expenditure of the Provinces,
for while the revenue left to them was shrinking or at least
inelastic, the departments of expenditure left to them were
steadily expanding and increasing the demands upon their purse.\(^60\)

Conclusion

The foregoing analysis makes out that the Act of 1935
brought about considerable improvement in the financial position
of the Provinces. The Act had for the first time marked a
clear distinction between the provincial and federal sources of
revenue. But the distribution so incorporated, worked steadily
to the disadvantage of the Provinces. The sources of revenue
assigned to them, being inadequate and inelastic, resulted in the
deficits in the budgets of most of the Provinces. Though the Act
attempted to achieve financial equilibrium of the Provinces,
their dependence to the Centre did not come to an end. The
reason for all this as explained by one critic was that
"provincial prosperity and development were consciously
subordinated to central security" and that "all elastic sources
of revenue had been collared by the Government of India."\(^61\)

It is thus an exaggeration to say with Thomas that under
the Act of 1935, "the financial authority of the Province is
now nearly as complete as can be under a Federal Constitution."\(^62\)

\(^59\) Section 78. See also P.N. Masaldan, Evolution of Provincial
Autonomy in India 1858 to 1950, 154, Hind Kitab Ltd.,
Bombay, 1953.

\(^60\) See Shah, supra note 55, 365-66.

\(^61\) Masani, in C.Y. Chintamani, and M.R. Masani, India's
Constitution at Work, 39-40, Bombay, 1940.

No.1 July-September, 1939, p.69, quoted in Bombwall, f.n1 109
at 215.
Governments had to manage with less lucrative and inelastic sources. This was perhaps the weakest aspect of the federal structure woven into the fabric of the Government of India Act 1935. But in this respect, the Act is not an exception. This defect can be found in almost every system of constitutionalism and no federation has so far succeeded in devising a financial system wholly satisfactory from the point of view of both independence and adequacy. It has been aptly said: "There is and can be no final solution to the allocation of financial resources in a federal system. There can only be adjustments and re-allocation in the light of changing conditions."63 This is as much true about the system contained in the Act of 1935 as it is about the financial provisions of the Constitution of Independent India, the constitutionalism of which is the subject matter of the next chapter.

The Niemeyer Enquiry, 1936

The scheme of the Government of India Act, 1935 had left several questions undecided. The questions regarding the distribution of income-tax proceeds between the Government of India and the Provinces and Provinces inter se, the distribution of jute export duty; grants-in-aid to Provinces and certain other ancillary matters were yet to be decided by an Order-in-Council, before the arrangements contained in the Act could be put into operation. The British Parliament held the belief that the success of the reforms introduced by the Act would depend very largely on the financial position of the Government of India.64 It was also necessary at the commencement of the new Constitution that the Provinces should be placed on an 'even keel' so that they could maintain their financial stability with a careful management of their resources (including devolution and grants-in-aid), and the use of their taxing powers.65 It was, therefore,


64. Thomas, 416.

decided that before giving effect to Part III of the Act relating to Provincial Autonomy, there should be an expert enquiry into the financial position of the Provinces, the special assistance required by each and the modes of distributing the provincial share of the income-tax in addition to certain other matters. The British Government, therefore, requested Sir Otto Niemeyer to review the budgetary position and the debt liability of the Provinces and to give a sort of Arbitrator's Award, suggesting relief where necessary, to give to the Provinces a fair start when the Act of 1935 came into force. His assignment was thus, very comprehensive. He was to make recommendations as to:

(i) the period within which the distribution of income tax receipts collected by the Federal Government should be made among the Provincial Governments, and the proportion of such distribution including the principles on which the amount so determined should be distributed among the Provinces.\(^{66}\)

(ii) The proportion of jute export duty to be assigned to the jute growing Provinces.\(^{67}\)

(iii) the amount and mode of offering further subventions from the Federal resources to such of the provinces as were found to be in deficit.\(^{68}\)

Sir Niemeyer started his job on the assumption that "At the inauguration of Provincial Autonomy, each of the Province should be so equipped as to enjoy a reasonable prospect of maintaining financial equilibrium and in particular, that the chronic deficit into which some of them had fallen, should be brought to an end.\(^{69}\) Sir Otto kept two main objects in view while

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66. See Section 138(1) and (2). Also see 'Terms of Reference', Niemeyer Report, 1936.
67. See Section 140(2).
68. See Section 142.
making recommendations, namely, the stability of the Central finances and secondly, the attempt to equip the Provinces as to enjoy a reasonable financial equilibrium so that with prudent house keeping and development of their resources, they should be able to forge ahead with their plans and programmes.\(^{70}\)

After taking the financial difficulties of individual Provinces into account, Sir Otto found that relief would be necessary for the following Provinces to the extent stated below:

<table>
<thead>
<tr>
<th>Province</th>
<th>In lakhs of rupees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bengal</td>
<td>75</td>
</tr>
<tr>
<td>Bihar</td>
<td>25</td>
</tr>
<tr>
<td>Central Provinces</td>
<td>15</td>
</tr>
<tr>
<td>Assam</td>
<td>45 (apart from 7 lakhs in respect of the Assam Rifles, para 15)</td>
</tr>
<tr>
<td>North-West Frontier Provinces</td>
<td>110</td>
</tr>
<tr>
<td>Orissa</td>
<td>50 (plus 19 lakhs non-recurrent as indicated in para 14)</td>
</tr>
<tr>
<td>Sind</td>
<td>105 (plus 5 lakhs non-recurrent and to diminish as indicated in para 13)</td>
</tr>
<tr>
<td>United Provinces</td>
<td>25 for 5 years</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>405</strong></td>
</tr>
</tbody>
</table>

This assistance was irrespective of the allocation of income tax and was recommended to be given to the Provinces in three ways:

1. Cancellation of debt.\(^{72}\)
2. Distribution of further 12½ per cent of the export duty on jute.\(^{73}\)
3. Annual cash subventions to supplement the other two forms of aid.\(^{74}\)

\(^{70}\) Ibid.
\(^{71}\) Id., at 7-8.
\(^{72}\) Id. at 8-9. See infra also.
\(^{73}\) Id., at 9-10.
\(^{74}\) Ibid.
In regard to the distribution of income tax, Sir Otto considered that the maximum practicable distribution of the yield of income tax should be made to the Provinces at the very outset. In determining this maximum, he felt that the growing needs of the Provinces should be balanced against the need for ensuring the continued financial stability of the Centre. On the consideration, he felt that it would be unwise to give away more than 50 per cent of the proceeds of this tax. Even this distribution would weaken the resources of the Centre and a temporary expedient was, therefore, to be found to restore the balance. In order to arrive at the provincial share of the net proceeds of the tax, various deductions allowed to be made were: the cost of collection, proceeds attributable to Chief Commissioners' Provinces, tax collected from federal emoluments, the wholly federal corporation tax and the share of Burma (which the Centre would lose on its proposed separation).

Sir Otto then proceeded to discuss various alternative principles on which to recommend the distribution of income tax to the Provinces inter se. Each Province advocated the basis of division which gave it the largest dividend. 'Collection' as the basis of distribution, he held, was an unsuitable guide as it did not necessarily reflect the origin of the tax. 'Residence' was a convenient practical dividing line when the purpose was to avoid double taxation between separate political units, but as this consideration did not arise in India, he rejected this basis also, as being unsuitable. 'Incidence' would be rational, in his view, to adopt, but its determination might prove to be difficult. Also distribution on the basis of incidence alone would have benefited the Provinces unequally and thus could not be adopted.

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75. Riemeyer Report, 11, 1936
76. Ibid.
77. Ibid.
78. Id. at 13.
79. Ibid.
80. Ibid.
His approach to the distribution of this tax was conditioned only by one consideration that in a Federation, the purpose of federal assistance should be to make the constituent units, as far as possible, viable. That, federal assistance should aim at removing the imbalance among Units (budgetary imbalance) to the extent possible. This object should be the guiding principle not only in making discretionary grants but also while determining the distribution of shared taxes. 81

After carefully examining the pros and cons of all the alternatives advocated by the Provinces, Sir Otto came to the conclusion that substantial justice would be done by working out a percentage for each Province based partly on residence and partly on population, paying to neither factor a 'rigidly pedantic deference'. 82 In justification of adopting population as the major factor, he held that population reflected needs and in a Federation central assistances should be based on needs. The final distribution among Provinces, inter se, thus recommended by him was as follows:

<table>
<thead>
<tr>
<th>Province</th>
<th>Percentage to shareable income tax proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madras</td>
<td>15</td>
</tr>
<tr>
<td>Bombay</td>
<td>20</td>
</tr>
<tr>
<td>Bengal</td>
<td>20</td>
</tr>
<tr>
<td>United Provinces</td>
<td>15</td>
</tr>
<tr>
<td>Punjab</td>
<td>8</td>
</tr>
<tr>
<td>Bihar</td>
<td>10</td>
</tr>
<tr>
<td>Central Provinces</td>
<td>5</td>
</tr>
<tr>
<td>Assam</td>
<td>2</td>
</tr>
<tr>
<td>North-West Frontier Province</td>
<td>1</td>
</tr>
<tr>
<td>Orissa</td>
<td>2</td>
</tr>
<tr>
<td>Sind</td>
<td>2</td>
</tr>
</tbody>
</table>

(Source: Niemeyer Report, para 35, p.11f)

Sir Otto gave the Provinces, the maximum share of the proceeds of income tax suggested by the White Paper. 83 He felt

83. See the proposals in the White Paper, i.e. 50 per cent of the net proceeds of the tax. See supra.
that even this minimum distribution would reduce considerably the resources of the Centre. He said that the Centre would be able to consolidate its position within a period of about five years after undertaking the initial adjustments. Therefore, he recommended that the Centre should retain for a period of first five years, in each year, the whole or such amount as, together with any general budget receipts from the railways, would bring the Central Government's share in the divisible total up to 13 crores,\textsuperscript{84} whichever was less, and for a second period of five years, in the first year five-sixths of the sum, if any, retained in the last year of the first period, decreasing by a further sixth of that sum in each of the succeeding five years.\textsuperscript{85}

In regard to the distribution of export duty on jute or jute products, Sir Otto recommended that the percentage under section 140(2) of the Act should be increased to 62\(\frac{1}{2}\) on the estimated gross yield of the duty in 1936-37. He, however, did not admit that the jute-producing Provinces had any special claim to this proceed, particularly in the absence of any concrete statistical proof of this contention. Then without going into the argument of the validity of this claim he justified his recommendations not by any inherent right of those Provinces, but only on the ground that they stood in need of financial assistance. The recommendations resulted in the following addition to the resources of the Provinces concerned:

<table>
<thead>
<tr>
<th>Province</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bengal</td>
<td>Rs. 42,00,000</td>
</tr>
<tr>
<td>Bihar</td>
<td>Rs. 2,50,000</td>
</tr>
<tr>
<td>Assam</td>
<td>Rs. 2,25,000</td>
</tr>
<tr>
<td>Orissa</td>
<td>Rs. 25,000 (rather over)</td>
</tr>
</tbody>
</table>

Sir Niemeyer suggested the cancellation of the debts which the Provinces owed to the Centre. In this regard he thought

\textsuperscript{84} This amount, he calculated to be the 1936-37 budget estimated receipts from all forms of Income Tax reduced by certain estimated deductions.

\textsuperscript{85} Niemeyer Report, 14-15, 1936.

\textsuperscript{86} Id., at 9-10.
that his sort of help was necessary because, "when financial assistance is to be given by a creditor to an existing debtor, elementary common sense suggests that the shortest and simplest method of adjustment is by reducing the claim of the creditor on the debtor." On this consideration he recommended that all debts contracted prior to April 1, 1936 by Bengal, Bihar, Assam, Orissa and North West Frontier Province should be wholly cancelled and that the outstanding debt of the Central Provinces should be substantially reduced. The debts recommended to be cancelled were as follows:

<table>
<thead>
<tr>
<th>Province</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bengal</td>
<td>Rs. 33,00,000</td>
</tr>
<tr>
<td>Bihar</td>
<td>Rs. 22,00,000</td>
</tr>
<tr>
<td>Assam</td>
<td>Rs. 15,50,000</td>
</tr>
<tr>
<td>Orissa</td>
<td>Rs. 9,50,000</td>
</tr>
<tr>
<td>North-West Frontier Province</td>
<td>Rs. 12,00,000</td>
</tr>
<tr>
<td>Central Province</td>
<td>Deficit debt as on 31-3-1936 and approx. 2 crores of pre-Reforms debt.</td>
</tr>
</tbody>
</table>

To complete the picture, Sir Otto recommended the following grants-in-aid to the Provinces for a limited period. The newly created Provinces with budgetary deficits were the main beneficiaries of this grant. The annual grants-in-aid recommended were:

<table>
<thead>
<tr>
<th>Province</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Provinces</td>
<td>25 lakhs for 5 years</td>
</tr>
<tr>
<td>Assam</td>
<td>30 lakhs</td>
</tr>
<tr>
<td>North-West Frontier Province</td>
<td>100 lakhs subject to reconsideration at the end of 5 years.</td>
</tr>
<tr>
<td>Orissa</td>
<td>40 lakhs, with 7 lakh addition in the first year and 3 lakhs additional in each of the next four years.</td>
</tr>
<tr>
<td>Sind</td>
<td>105 lakhs for 10 years with 5 lakhs additional in the first year.</td>
</tr>
</tbody>
</table>

87. Id. at 8-9.
88. Ibid.
89. Id. at 10.
The recommendations of Sir Otto Niemeyer were accepted in toto and were embodied in the Government of India (Distribution of Revenues) Order 1936. This Order continued to regulate the distribution of revenues between the Central Government and the Provincial Governments till 1940. With the promulgation of the Order, the Provinces were assured of pre-determined Central assistance for a period of 5 years and they were given full authority to adjust the revenues allocated to them. The Government of India took these recommendations as an Award.90

However, the Award raised a valley of protests from the Provinces.91 It was received in the same manner as any other financial arrangement in India. Madras Government pointed out that its comparatively sound financial position was due to its orthodox policy of balancing the budget with adequate taxation. With respect to income tax distribution, it contended that Bombay with a population of 18 million was disproportionately benefited with an allocation of 20 per cent as against its population of 24 million with an allocation of 15 per cent. Bengal was dissatisfied and put forth the claim to entire export duty on jute. Punjab, a financially sound Province, made out a strong case and contended that thrift was penalised. The United Provinces Government, though accepted the award happily, but claimed a larger share in income-tax proceeds in view of its size and population and more particularly on account of agrarian difficulties. It is interesting to note that almost every Province complained about the unfair treatment meted out to it by the Award. As the Award could satisfy none, it must be just and fair to all.

It may be concluded that the Niemeyer Award has been a very influential factor in patterning the system of federal finances in India. It was the first instance, when income-tax proceeds were distributed to the Provinces, at the same time, the Centre was placed in a position of considerable advantage with growing sources of revenue such as the Corporation tax. This was

90. Dr. P. Diwan, Union-State Fiscal Relations, 37, Light & Life Publishers, New Delhi, 1981.
91. The views of the Provincial Governments are set out in the Explanatory Memorandum on the Draft Orders, 1936.
the financial system which India inherited when she became independent in 1947.

Amendment of Niemeyer Award

The Niemeyer Award was subjected to a change in 1940 necessitated by the outbreak of World War II, which entailed increasing expenditure on the Centre. Steps had to be taken to strengthen the Central finance. The Order-in-Council 1936 was thus amended accordingly to secure this. The amendment inter alia provided for the exclusion of contributions of the railways to the Central revenue while calculating the net proceeds shareable between the Central and Provincial Governments, thus adding to the Central revenue that contribution. Secondly, the Government of India was to retain Rs. 4.25 crores per annum out of the provincial share of the income tax proceeds. This was the average sum retained by the Central Government during 1937-39 under Otto's Award. Thirdly, it was laid down that the formula under the modified provision would regulate the distribution of the tax from 1939-40 to 1941-42, after which the portion so retained would be reduced by 1/6th each year as provided in the Niemeyer Award. However, this formula remained in operation till 1945-46. In each of the next four years, the sum retained by the Centre under the amended rule was reduced by Rs. 75 lakhs a year over the previous year and the full provincial share was restored to them in 1950-51.92

The partition of the country in 1947 presented a new situation. The separation of certain parts of India necessitated a re-adjustment of financial arrangements between the Government of India and the Provinces especially as regards the distribution of income tax and jute export duty. The Government of India (Distribution of Revenues) Order 1948 was thus issued on March 17, 1948 amending the Niemeyer Award in minor respects. As regards the income-tax the basic scheme of Sir Otto was retained. The shares of the divided Provinces of Bengal and the Punjab were reduced in proportion to population and the released percentages as well as

the percentages of Sind and North-West Frontier Provinces were pooled for re-distribution. The provincial share after distributing the lapsed quota among the Indian Union Provinces fixed is given in the Table below.3

<table>
<thead>
<tr>
<th>Provinces</th>
<th>Percentage under Otto's Award</th>
<th>Percentage under the Order 1948</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bombay</td>
<td>20</td>
<td>21</td>
</tr>
<tr>
<td>Bengal</td>
<td>20</td>
<td>12</td>
</tr>
<tr>
<td>Madras</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>United Provinces</td>
<td>15</td>
<td>19</td>
</tr>
<tr>
<td>Punjab</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Central Province</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Assam</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Orissa</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Bihar</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Sind</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>N.W.F.P.</td>
<td>1</td>
<td>-</td>
</tr>
</tbody>
</table>


As regards the jute export duty, the Order 1948 reduced the provincial share from 62½ per cent to 20 per cent, roughly in proportion to the jute-growing area which was truncated to Pakistan. However, the basis of distribution of this duty among the concerned Provinces was not disturbed.4

Grants-in-aid were also made to the Provinces of Assam and Orissa for the years 1947-48 and 1948-49.

Meanwhile, the Constituent Assembly had under consideration the draft of the Constitution prepared by the Constitutional Advisor Sir B.N. Rau. The financial provisions contained in the Draft Constitution were discussed in the Assembly. On the
suggestion of Shri N. Gopalaswami Ayyanger, the President of the Constituent Assembly considered it advisable to remit the financial provisions of the Draft for study and report to an Expert Committee of three under the Chairmanship of Shri N.R. Sarkar.\footnote{Shri Sarkar was a former member of the Governor-General's Executive Council and a well-known industrialist and financial expert. See The Framing of India's Constitution, Select Documents, 255, edited by B.Shiva Rao, Indian Institute of Public Administration, New Delhi, Vol.III,1967, (hereinafter cited as Select Documents).}

The Draft, it may be pointed out, had largely followed the scheme of the Act of 1935 in respect of the financial relations between the Government of India and the Provinces.\footnote{See Part IX of the Draft Constitution, Select Documents, Vol.III, 81-87.}

The Sarkar Committee did not attempt to revamp the distribution of resources but concentrated their attention on two aspects only, namely, the distribution of income-tax and jute duty.

In regard to the distribution of income-tax, the Committee did not consider it either rational or necessary to isolate elements of the tax and give them different treatment. The Committee, therefore, recommended that the entire net proceeds of income tax including realizations from Corporation tax and federal emoluments (but not the realization from centrally administered areas), should be made shareable between the Government of India and the Provinces (States). They further proposed that the provincial share of the enlarged pool should be raised to 60 per cent to be distributed in the following manner: 35 per cent on the basis of collection; 20 per cent on the basis of population; the remaining 5 per cent should be used for making marginal adjustments to mitigate any hardships that might arise from the application of proposed criteria.\footnote{Report Expert Committee on the Financial Provisions, Dec.5 1947, para 38. Select Documents, 271, Vol.III,1967.}

As regards the jute export duty, the Committee recommended the abolition of the existing arrangements for sharing of the net proceeds with the Provinces, as in their view, it was inappropriate that any element of import or export duties should...
be made divisible. They suggested that the yield from these duties should accrue wholly to the Central Government. But with a view to avoid hardship to the four jute-growing Provinces, the Committee proposed fixed grants-in-aid for a period not exceeding ten years or till the duty was abolished whichever was earlier.

Another interesting recommendation of the Committee related to the Central excise duties. They remarked that the Provincial Governments had been almost unanimous in demanding some share of excises. They considered the problem as only of finding more resources for the units but felt that the further allocation of resources to the units was necessary both to strengthen their financial base and to give them a better balanced revenue structure. They recommended, therefore, that 50 per cent of the net proceeds of the excise duty on tobacco should be distributed among the Provinces on the basis of consumption.

Finally the most important recommendation, the Committee made was that an independent Finance Commission, somewhat on the lines of the Australian Commonwealth Grants Commission, should be constituted to deal periodically with financial questions, more particularly with the division of revenues between the Centre and the Provinces.

The recommendations of the Sarkar Committee were not wholly incorporated in the Constitution which was finally adopted by the Constituent Assembly. On the other hand, the scheme of the division of sources of revenues and powers of taxation embodied in the Constitution was substantially the same as in the Government of India Act 1935. Following the precedent of the Act of 1935, the Constitution of India neither prescribed the provincial share of income tax nor did it define the basis of its distribution among the Provinces inter se. Both these questions were left to be determined by an Order of the President who was however required

98. Id., para 35.
99. Id., para 40.
1. Id., paras 64, 65.
before making the Order to take into consideration, the recommendations of the Commission to be appointed in this respect.

The Constitution having been introduced in January 1950, the provisions relating to financial devolution had to be regulated by an Order of the President. The Finance Commission provided in the Constitution could not be set up immediately. Meanwhile, some of the States (Provinces) had expressed dissatisfaction with the arrangements regarding the allocation of income tax and jute export duty made by the Government of India immediately after the partition in 1947 and they continued to agitate for a revision. It was accordingly decided to refer the question to an impartial authority for reconsideration. In December 1949, Shri C.D. Deshmukh was requested by the Government of India to enquire into and decide these two questions. It was also agreed that his recommendations would be treated as an award to be promulgated by an Order by the President.  

The reference made to Shri Deshmukh was limited in scope. It did not require him to redetermine the share of the States in the yield of income-tax, nor was he requested to deal comprehensively with the problem of the distribution of the States' share among them inter se. He was only to recommend the distribution between the States of the 50 per cent previously prescribed, i.e., the reallocation of the percentages realised as a result of the partition from the share of the divided Provinces and the Provinces wholly included in Pakistan. He was also not to concern himself with the Princely States, now admitted into the Indian Union as Part B States or the shares allocable in respect of the territories of the Princely States merged in the Part A States. He had only to deal with two aspects before him:

(a) to determine the shares to be taken from Bengal, Punjab and Assam in respect of parts of those Provinces included in Pakistan, and

(b) to reallocate among the Part A States in the Indian Union these lapsed percentages as well as the percentages formerly prescribed for Sind and North

3. Ibid.
West Frontiers Province which then were wholly included in Pakistan.

In approaching the limited task before him, Shri Deshmukh merely attempted to estimate as nearly as possible the percentages that might have been allotted by Sir Otto to those parts of the Provinces now included in Pakistan had they been in existence as separate Provinces. Having determined the aggregate quota available for redistribution, he distributed it largely on the basis of population, making minor adjustments for the purpose of rounding off and to give some weightage to the weaker States. In justification of population as the basis of reallocation, he advocated the factors which influenced earlier Sir Otto. That federal grants should be used to provide financial equilibrium to the States individually and thus bring about gradually a general equalization of the levels of administration throughout the country. An award which gave additional weightage to residence, would, in his view, hinder the progress of such general equalisation. The table below indicates the percentage received by each State as its share of income tax (1) before partition, (2) under the re-allocation made immediately after partition under the Order 1948 and (3) under the Deshmukh award:

<table>
<thead>
<tr>
<th>Province</th>
<th>Pre-partition share percentage</th>
<th>Share under the G.O.I Order 1948 (per cent)</th>
<th>Share under Deshmukh award (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madras</td>
<td>15</td>
<td>18</td>
<td>17.5</td>
</tr>
<tr>
<td>Bombay</td>
<td>20</td>
<td>21</td>
<td>21.0</td>
</tr>
<tr>
<td>West Bengal</td>
<td>20</td>
<td>12</td>
<td>13.5</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>15</td>
<td>19</td>
<td>18.0</td>
</tr>
<tr>
<td>Punjab</td>
<td>8</td>
<td>5</td>
<td>5.5</td>
</tr>
<tr>
<td>Bihar</td>
<td>10</td>
<td>13</td>
<td>12.5</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>5</td>
<td>6</td>
<td>6.0</td>
</tr>
<tr>
<td>Assam</td>
<td>2</td>
<td>3</td>
<td>3.0</td>
</tr>
<tr>
<td>Orissa</td>
<td>2</td>
<td>3</td>
<td>3.0</td>
</tr>
</tbody>
</table>

(Source: Report, First Finance Commission, 25, 1952)

4. Id. at 24-25.
In regard to grant-in-aid in lieu of a share in the export duty on jute and jute goods, Shri Deshmukh considered that these had been treated as 'compensation payments', 'constituting a means of financial assistance to the four Provinces'. He recommended that this assistance should be continued for the period covered by his award, but, as fixed grants unrelated to the yield of the duty. The grants so recommended were as follows:

<table>
<thead>
<tr>
<th>Province</th>
<th>Rupees in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>West Bengal</td>
<td>105</td>
</tr>
<tr>
<td>Assam</td>
<td>40</td>
</tr>
<tr>
<td>Bihar</td>
<td>35</td>
</tr>
<tr>
<td>Orissa</td>
<td>5</td>
</tr>
</tbody>
</table>


The Deshmukh Award remained in force for the two financial years of 1950-51 and 1951-52. Thereafter, the distribution was made on the recommendations of the successive Finance Commissions.

Financial Integration of Former Princely States

The problem of federal finance had been complicated by the introduction of another factor namely, the proposed entry of Indian States to the new organisation of a Federation of India contemplated under the Government of India Act, 1935. The States, had, hitherto, been regarded as distinctly separate units, for the internal administration of which the Government of India did not hold themselves theoretically responsible. They had remained outside the fiscal and financial system of the British Indian Provinces except for certain arrangements entered into with them by the Government of India regarding such matters as coinage, maritime customs, central excises, posts and telegraphs and railways. These arrangements were based upon different treaties and engagements with different states and thus were

5. Id., at p. 25.

6. The relations between the Indian States and the Crown (i.e., the Government of India) were based upon different treaties and engagements.
different with different States. Under these arrangements, the States exercised a great deal of financial autonomy.

Under the Government of India Act of 1935, the States were to accede in regard to foreign relations, defence and communications, with option to accede in regard to other central subjects also. This scheme of accession to the Federation involved a measure of financial integration which was inherent in it. This required an extensive examination of the problems connected with the assimilation of the States (of varying sizes with different systems of finance and having different kinds of relationship) with the Government of India into a workable system of financial relations in the proposed Federation. But it was difficult to evolve a principle uniformly applicable to all the States.

When the Indian States Committee was appointed in 1928, with Sir Harcourt Butler as Chairman, the States Rulers ventilated their grievances, but the Committee while agreeing with some real grievances existed, could not suggest a remedy and concluded that it required an exhaustive enquiry into the whole matter. Thus in order to inquire into the financial relations between British India and the Princely States, a Committee under the Chairmanship of Mr. J.C.C. Davidson, was appointed in 1932. The Committee was to inquire into the details of the financial relationship between the Government of India and the States, with a view to estimate the contributions made by the States and the value of immunities enjoyed by them, and to determine how these should be adjusted to fit in with an equitable scheme of federal finance. The demand of the Provinces that the States should share the burden of income tax and the corporation tax, and the claim of the States that they should share in the proceeds of customs duties (as they urged that a part of it was paid by their people) complicated the situation. The States contributions,

7. Chanda, 151-152. See also Report, First Finance Commission, 18, 1952.
direct and indirect to the Government of India and in particular the rights of the Maritime States - Travancore Cochin and the Kathiawar States, in relation to sea customs duty presented problems of unusual difficulty. The Davidson Committee recommended that the contribution made by the States in excess of the immunities enjoyed by each State should be abolished. In respect of Maritime States, they, by way of a compromise, recommended that these States should be enabled to retain the revenue from duties on goods imported through their own ports for consumption by their own people.

The Joint Select Committee gave its general approval to the Davidson Committee's recommendations in regard to the gradual abolition of contribution which were in excess of the value of immunities. They also emphasized the need for freedom of trade within the federal territory. "Internal Customs Barriers", they said, "are in principle inconsistent with freedom of inter-change of a fully-developed Federation and we are strongly of the opinion that every effort should be made to substitute other forms of taxation for their internal customs."

As regards the sea-customs collected at various Maritime ports, the Joint Committee suggested: "The general principle which we should like to see applied in the case of Maritime States which have rights to levy sea customs is that they should be allowed to retain only so much of the customs duties which they collect as is properly attributable to dutiable goods consumed in their own States."

The scheme of Federation set out in the Government of India Act 1935, required the States to assume their share of the obligation for the pre-Federation debts of the Government of India.

10. Direct contribution comprised payments in acknowledgement of suzerainty; payments in commutation of obligations for the provision of military assistance; payments for the maintenance of a British subsidiary force; payments fixed on the increase of territory; payments for special or local purposes etc. Indirect contribution included the amounts accruing to the revenues of British India from the people of States under the heads of customs, salt tax, income tax, etc.
13. Id., at 140-41.
15. Ibid.
India, as also for the pensions and other contingent liabilities of that Government, incurred before the Federation came into being. Certain States were given some sort of a refund on account of valuable rights or privileges surrendered by them, but, almost all of them were expected, in all probability, to surrender their separate customs revenues.

Under the Act 1935, it was accepted that income tax might not be leviable in the Federated States, but surcharges on income-tax, if any, were to be paid by them, in the same manner as the Provinces. In this respect it was provided that a particular State could agree to make specific contribution in lieu of the surcharge being so levied and collected in its jurisdiction. In respect of corporation tax, the States were placed in a somewhat favourable position. The corporation tax was not to be levied by the Federal Government in any federated States until 10 years had elapsed from the establishment of the Federation. The Act also gave the Rulers of the Indian States the option of making a contribution to the revenues of the Federation as near as equivalent to the net proceeds of the corporation tax leviable within his territory. In the event of any dissatisfaction, as regards the determination of the amount, the Ruler could appeal to the Federal Court and the Court could reduce the amount if it was considered excessive.

As regards the tributes and contributions, made by the Princely States, the Act 1935 provided that if they were to join the Federation, such special provisions of which there was no corresponding provision in British India, should be abolished. The Federal Government was also to make general provision for the defence, the States so acceding would become the common beneficiaries in that. Further the privileges and immunities enjoyed by the States were to be quite out of harmony with their new status as the units of the proposed Federation, the Act thus provided for their replacement.

17. Id., Section 139(1).
18. Id., Section 139(2) & Section 139(3).
19. Id., Section 147.
20. Id., Section 149.
The proposals were unacceptable to the Princely Rulers for they were not willing to surrender their fiscal independence. They, therefore, refused to join the all-India Federation. It was thus not until after independence that the States were integrated into the fiscal system of the country.

Within less than two years from the date of independence, almost all the Indian States to the side of India, were either formed into sizeable units or merged in the neighbouring Provinces or constituted into separate centrally administered Chief Commissioners' Provinces. The political integration had been thus completed by the end of 1948, but financial integration had yet to be effected.

Accordingly a Committee named the Indian State's Finance Enquiry Committee was constituted on October 12, 1948, under the Chairmanship of Shri V.T. Krishnamachari with Shri S.K. Fatil and Shri N. Dandekar as other members, with an avowed purpose of finding a settlement which would make both the political and financial provisions of the Constitution uniformly applicable to all the constituent parts of the Indian Union. The Committee was requested to examine and report, inter alia, upon the desirability and feasibility of integrating federal finance in the Part B States with the rest of India; (2) the extent to which the process of integration should be gradual and the manner in which it should be brought about; (3) the effect of integration on the finances of the States and the measures of financial assistance which they would require to administer the 'provincial' subjects. The Committee was also to report on the ways and means of rationalizing the levies and for strengthening their financial base, so that any special central assistances to them, could be extinguished at the earliest possible time.

Earlier to the integration of the States, the Expert Committee had also taken up the matter. This Committee had

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21. The territories of some of the States were left undisturbed and it was proposed to give these States the status of Part B States in the Constitution. The territories of some others were integrated to form unions of States which were also to have the status of Part B States. A few States by themselves or after merger with neighbouring States were proposed to enjoy the status of Part C States to be administered centrally by Chief Commissioners.
recommended that the States acceding to the Indian Union should gradually give up without compensation, their right of levying internal customs but that the administration of the Maritime States should be taken over by the Government of India with compensation to the affected States. As regards income tax and central excise, the Sarkar Committee had suggested that these taxes should be uniformly made applicable to the States who should be compensated for the loss of privileges and immunities hitherto enjoyed by them. Expressing their inability to make detailed recommendations regarding the States, the Expert Committee suggested that a State Commission with four members having wide knowledge of the financial administration of Provincial, Federal or State Governments, should be established to deal with the problem before it with understanding and sympathy and suggest solutions which would not only be fair both to the States and to the Provinces, but enable the States to come up to the provincial standards in as short a time as possible.

The Krishnamachari Committee argued that for the units to have different relations with the Federation would be "a source of weakness and ... produce a sense of unfairness among the less favoured units... fatal to friendly relations and orderly progress." They, therefore, recommended that the States and the Provinces should be equal partners in the Federation and that "it inevitably follows that the Central Government should function in States over the same range of subjects and with the same powers as in Provinces. It is only in this way that the Union of India will gain, in strength, and its policies in effectiveness. There is no federation in which the Central Government possesses different levels of powers and authority in the units comprised in it." Having said this, the Committee made the following recommendations:

23. Id., paras 90, 91, 92.
24. Id., para 94.
26. Ibid.
27. Id., paras 11-14.
The Central Government should take over from these States the subjects and services falling under the Union List together with their related assets and liabilities. No compensation for such taking over was to be paid. As this would upset the budgetary position of the States, a transitional scheme of financial assistance was recommended. The Central Government would completely reimburse for a period of 5 years the net loss arising from such a transfer; and reimbursement would continue thereafter on a gradually diminishing scale for another 5 years. After the transitional period of 10 years, the Committee suggested that the scheme of grants-in-aid to cover the revenue gap would be merged in the general scheme of financial aids for all constituent units.

The income tax and corporation tax should be introduced in the Union and all the States including those where there was none, at rates suited to local conditions. It should be brought up to the full Indian level, within a maximum period of 5 years. The assessment and collection should be made by the officers of the Central Government.

As a result of integration, the internal customs duties should be abolished. No compensation for this should be paid, because loss of revenue would be covered by the direct and indirect gain resulting from financial integration. Instead, alternative taxes like the sales tax should be levied to cover the loss.

The recommendations of the Krishnamachari Committee were accepted and with the agreement of the Princely States to be placed in Part B, the ground for the drafting of a common financial code for all the States was set. Though the Committee's recommendations were specifically meant for Part B States, they were also extended to such Part A States as had accretion of territories belonging to one or more Princely States. They received the share of income tax or the revenue-gap grant, whichever was larger in respect of the merged territories.

As a result of the recommendations of Shri Deshmukh regarding the reallocation of shared taxes and the integration of federal finances in terms of the Krishnamachari Committee Report, a rational interim solution of the issues resulting from the partition of the country and the absorption of the former
States into the structure of Indian Union was thus evolved. However, it remained for the Constituent Assembly to give final shape to the financial provisions and to provide a uniform pattern of financial relations between the Union on the one hand and all its component units on the other.