to the logical conclusion the tendencies already visible in 1920. So far as the Provinces were concerned, the problem of 1935 was, briefly stated, as follows:

THE PROBLEM IN 1935:

Equity in Resources and Obligations as between Units and the Federation

(a) So far as possible, the complete and even a rigid division of resources and obligations, as between the Provinces and the Federation should be made, so that there need be no heart-burning as between one Province and another, or as between the Provinces and the Centre. The system of divided heads of revenue had been abolished in 1919. But the centre taking the Taxes on Income almost wholly was resented, particularly by those advanced industrial and commercial Provinces, which, like Bombay and Bengal, had an increasing proportion of the taxable wealth within the Province in non-agricultural forms. These, therefore, wanted all direct taxation,—on land as well as on other forms of income,—to be at their disposal, especially as the needs of progressive administration were making an almost insatiable demand on their purse.

The principle, therefore, of a complete separation of resources and obligations was, indeed, more easy to enunciate than to achieve, inasmuch as considerable changes had come over the financial position of India as a whole, since 1920-21. For one thing, indirect taxation had assumed, since 1923, very much more important proportions than was the case in the Pre-war Indian Budget. Customs revenue, particularly, had become a most important single source of income for the Government of India, between 1923 and 1935, accounting for as much as 50 crores per annum in round terms. This was mainly because of the adoption of a policy of discriminating protection to Indian Industry. Before the war, the largest single source of income, namely, the Land Revenue, which was assigned, in 1920, exclusively to the Provinces, did not exceed, for all the Provinces together, Rs. 35 crores. The Income Taxes had also increased considerably, both in rate and in yield. Addition to the number of direct taxes was also made in the shape of Super-Tax, or the Excess Profits Tax (subsequently abolished). But none of these could equal the rise in the Customs Revenue, which fell wholly to the Government of India.

Shrinking Provincial Resources

(b) The provinces had got, under the Scheme adopted in 1920, almost exclusively one form of Indirect Taxation for their own use, namely Excise Revenue on intoxicating drinks and drugs; while the Centre got exclusively the other form of Indirect Taxation, namely, Customs. But, whereas the Provincial items of the Indirect Taxation were such that, enlightened public opinion was intent upon progressively reducing it till that item of revenue disappeared altogether, the Central form of Indirect Taxation was such that, the Nationalist Indian public opinion went on demanding a line of policy which steadily increased the yield of that revenue.

The same happened as regards Direct Taxation. While the provincial share of Direct Taxation namely, Land Revenue, was an item fixed for a number of years, and therefore, inelastic, at any given moment, Income Tax on non-agricultural incomes, which was taken exclusively by the Central Government, was capable of easy expansion by a slight manipulation of the rates charged.

Growing demands of spending Departments

(c) The Provinces, moreover, under the impulse of a Responsible Government, introduced by the Dyarchical system, were becoming more and more conscious of the claims of the spending departments left in their charge. The new Ministers could not but realise the great leeway which had to be made up in almost every Province, before the standard of civilised administration in these departments could be brought up to anything like a desired level. Hence, while the revenue left to the Province was shrinking, or at least inelastic, generally speaking, the departments of expenditure left to them were steadily expanding, and increasing the demands upon the Provincial purse.

Borrowing Powers

(d) The right to borrow for provincial purposes was, though not entirely a dead letter, difficult to exercise in practice, under the conditions and limitations laid down in the Constitution, or the Devolution Rules framed thereunder. The projects of Provincial development,—apart from certain Irrigation Works, as in Sind and the Punjab; or some authorised industries developed, as in the United Provinces—had to be held over for want of funds, or taken up on such a restricted

scale as to be always more burdensome than beneficial.

Deficit Provinces

(e) Add to all this, the institution of certain new Provinces, like Sind and Orissa, the separation from the Government of India of Burma, and the realisation of some other older Provinces being under a steady deficit. The separation of Burma is alone estimated to worsen the Government of India's finances to the tune of 2·75 crores at the least, assuming that Burma pays regularly what the Amery Tribunal has decreed it should pay in regard to her share of the Debt, &c.* The revenues left to these Provinces were unable to meet even their normal expenditure. So some means had to be devised to make all these "deficit" Provinces balance their Budget. In a manner of speaking, almost all the Provinces in British India could well be described as "Deficit Provinces," in so far as, in almost every instance, the standards of public welfare and civilized administration are still very rudimentary. Vast proportions of the people still remain illiterate in almost all the Provinces; sanitation and public health measures are of the most elementary kind; and economic resources are all but undeveloped. In view of these, hardly any Province in India can be called really of a level, where the real deficit could be measured

*Says the Explanatory Memorandum by the Financial Secretary on the Indian Budget for 1937-38. "The separation of Burma thus leads to a net reduction in the revenue of 6,61—3,36 or 3,25, and to a saving in expenditure of 2,35—1,43.

The net cost of separation will, therefore, be 2,33.......... All these figures are of a provisional character. There are many uncertain factors to be taken into account, particularly under the heads "Customs" and "Taxes on Income," and moreover the final material for the calculation of the annuities payable by Burma will not be available until some time after the 31st March."

The figures in this para represent lakhs of Rupees.

by comparing only the revenue and expenditure of these provinces. But even if we thought in terms of revenue and expenditure only, several Provinces, old as well as new, show a steady deficit, which has to be met in one way or another, either by contributions or subsidies from the Centre, or by handing over to the Province certain sources of productive and elastic revenues. As shown more fully in a later section of this Chapter, the aggregate deterioration in the Central Finances, due to the separation of Burma (2·75 crores), subsidies to Deficit Provinces (4·50 crores), and handing over progressively of a part of the Income Tax (6 crores at most) to the Provinces, would amount to over 13 crores per annum, without reckoning the additional expenditure due directly to the institution of the new constitutional machinery, in the Federation as well as in the Provinces, (aggregating $1\frac{1}{2}$ crores), or the irrepressible and irresistible claims of such unproductive services as Defence.

Federating States

(f) This very serious ingredient of the problem of Federal Finance has next been complicated by the introduction of another factor, namely, the proposed admission of Indian States to the new organisation of a Federation of India.

The Indian States had hitherto been regarded as distinctly separate units, for the actual internal administration of which the Government of India did not hold themselves directly, or theoretically, responsible. If, however, and in so far as, the States could be induced to join a common system of governance for the whole country, as for example, a Federation, the problem would be considerably altered.

The States have been claiming, since 1929, at least, a share in the Customs Revenue, because, they urge, a part of it is paid by their people. Those of them who are on the seaboard, and, therefore, able to have a direct overseas trade through their own ports, collect and retain considerable amounts of such revenue, levied at rates laid down by the Government of India, and so yielding vast amounts of income to these States, who use them to develop still further their own ports and transport facilities to make an ever intensifying rivalry with British Indian ports.*

Besides the Maritime States making a considerable hole in the Customs revenue of the Government of India, many of the Inland States also levy local Customs duties of their own, which yield considerable income to these States. The existence of internal Customs barriers like these is incompatible, generally speaking, with the creation of a common, uniform system of government throughout the continent of India, as in a Federation.

If, therefore, these States were to be induced to forego their own separate Customs revenue, by abolishing their own local Customs duties, or by bringing into a common pool the income the Maritime States derive from their own Ports, no doubt the Federal Exchequer would benefit considerably. But on the other hand, for such sacrifices, the States would demand a *quid pro quo*, which would perhaps more than offset the benefits derived from this sacrifice on the part of the States.

*Very few maritime States are, like Cutch, free to devise their own Customs duties.

The States are, no doubt common beneficiaries in the general provision for the Federal Defence, which the new Federal Government would be obliged to make. But they had already some defence provision of their own in many cases. And, in the last analysis, in the eyes of the States, it is the Federal Government of India which is responsible for the National Defence, as also for the maintenance of peace and tranquillity within the country against forces of internal disorder; so that the States might not deem themselves adequately compensated for the sacrifice of their own sources of revenue by being covered in a common measure of Federal Defence.

Solution Proposed

The scheme of Federation set out in the Act of 1935 requires the States to assume their share of the obligation for the Pre-Federation Debt of the Government of India, as also for the Pensions and other contingent liabilities of that body, incurred before the Federation comes into being; and to contribute to the common purse through Customs revenue &c. We need not, however, pursue this matter further at this stage.

Trade Depression and Budget Deficits

This situation was complex indeed, in a very high degree; but it was made infinitely more so by the prevalence of an intense Trade Depression all over the world, and particularly in agricultural countries, like India. The prices of the staple production in this country sagged so heavily after 1929, that the main sources of public income began to suffer heavily. In spite of economies which the Government of India and the various Provincial Governments had ordered, when depression became too strong and too prevailing to be overlooked, heavy and recurring deficits in the Central and the Provincial Budgets became the rule all over the country.

So far as the Government of India are concerned, even though they appear to have covered part of their deficit caused by the Depression, by adding surcharges to their existing taxes or increasing their rates, by reducing the provision for reduction or avoidance of Debt, and by curtailing expenditure wherever possible, their financial position as a whole cannot be said to have improved substantially. Some of the old productive items of Revenue, like the Railways, have not yet turned the corner, and continue to show recurring substantial deficits. The Railways in fact are, even now, the biggest single source of anxiety to the Government of India; and until and unless they at least make their own Budget balance, without recourse to any financial sleights of hand, there is no hope of any solvent system of Federal Finance being devised in this country.*

The principles, again, governing the Indian Finance Department, in its effort to obtain a net revenue from the so-called Commercial departments of government,—like the Railways and the Post Office, —are obsolete and unproductive; and so they succeed

*Says Sir Otto Niemeyer:—''The position of the Railways is frankly disquieting. It is not enough to contemplate that in five years' time the Railways may merely cease to be in deficit. Such a result would also tend to prejudice or delay the relief, which the Provinces are entitled to expect. I believe that both the early establishment of effective coordination between the various modes of transport and the thorough going overhaul of Railway expenditure in itself are vital elements in the whole Provincial problem.'' It is interesting to note that the Wedgwood report on Indian Railways dashes all these expectations to the ground.

by their efforts rather in injuring the trade and industry of the country than benefiting Government Exchequer.

A Fall in Customs

Some of the Customs Duties, again, shows signs of sagging, which is not all made up for by the imposition of Countervailing Excise Duties on the products of protected industry within the country. The high rates of duties on articles becoming more and more the indispensable adjuncts of modern industry and commerce,—like motor vehicles,—act like the butcher's knife on the goose that lays the golden egg. The opinion is, therefore, gaining ground in some quarters that the Tariff schdule,—at least in respect of purely revenue duties,—needs a drastic revision with a downward trend. If these ideas materialise, Customs revenue may show a further decline for some years to come, especially if the trade depression continues, and intense economic nationalism prevents its recovery.

Debt Provision

There is, moreover, legitimate anxiety, in quarters which are overimpressed with the extreme need of India to maintain "sound finance," as regards the very restricted provision in the Central Budget on account of Reduction or Avoidance of Debt. The bulk of the debt of the Government of India is, really speaking, unproductive, and would not admit of conversion at the present low rate of interest; and such conversion as has taken place does not make a saving sufficient to insure or indemnify against the contingencies noticed above.

Stagnation in Income-Tax Receipts

While business continues to be depressed, receipts from taxes on income cannot improve, and the entire system of taxation of incomes demands radical reforms which may cause still further loss to the Exchequer. The Provinces, also, demand their share, which, when conceded to the full, would, on the present basis of such tax receipts, involve a loss of 6·5 crores to the Central Government, assuming that the Province should get only ½ of the Income-Tax levied in their own jurisdiction, and, that, too, after 5 years or so.

Threatening Rise in the Defence Budget

The authorities responsible for the Defence of India have held out more than one threat, in recent years, of no further economies being possible in their Budget; but that, on the contrary, considerable additions might have to be made on this account in the near future. Other charges of the Government of India are, similarly, either fixed and guaranteed by the Constitution Act of 1935, or are steadily increasing. Hence the necessary margin of improvement in the general financial position is not visible to make the working of the new Constitutional machinery smooth or fruitful.

Constitutional Provisions Sections—136-180

The same tale is told in the Provinces, though in a minor key. Let us however, study the actual provision made in this behalf in the new Constitution to understand this aspect of its working more correctly.

The authors of the Act of 1935 proceeded to solve the problem before them in a characteristic fashion.

They abolished the still surviving traces of the historical origin of decentralised Provincial Finance, and made a clean division of the sources of revenue and expenditure between the Federation and the Provinces.*

*The Lists given below, compiled from Schedule VII to the Government of India Act, 1935, indicate the line of division of revenue resources between the Federation and the Provinces:—

Federal Sources

1 Duties of Customs including Export Duties.
2 Excise Duties on Tobacco and other goods manufactured or produced in India, except alcoholic drinks, opium, hemp and other drugs, and toilette preparations containing alcohol.
3 Corporation Tax.
4 Salt Tax.
5 Taxes on Income other than agricultural.
6 Taxes on Capital Value of assets, exclusive of Agricultural land, of individuals and companies.
7 Taxes on capital of companies.
8 Succession Duties, except as to agricultural land.
9 Stamp Duties on Bills of Exchange, Cheques, Pronotes, Bills of Lading, Letters of Credit, Insurance Policies, Proxies, and Receipts.
10 Terminal Taxes on goods or passengers carried by railways or air.
11 Tax on Railway fares or freight.
12 Fees in respect of any matter in the Federal List of Legislation.

Provincial Sources.

1 Land Revenue.
2 Excise Duties on alcoholic liquors, opium, hemp, other narcotic drugs, non-narcotic drugs, medicinal and toilette preparations containing alcohol—manufactured or produced in the province, and countervailing duties on similar articles manufactured or produced in other parts of India.
3 Taxes on Agricultural incomes.
4 Taxes on land and buildings, hearths and windows.
5 Succession duties in respect of agricultural land.
6 Taxes on mineral rights subject to any limitation imposed by a Federal land relating to mineral development.
7 Capitation Taxes.
8 Taxes on Professions, trades, callings or employments.
9 Taxes on animals or boats.

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In the resultant situation, they found that several of the Provinces could, from their own resources, never meet the obligations imposed upon them; while several others, even though able to meet the existing burdens from the resources made available to them, would never be able to develop to the full the territories under their jurisdiction.

For these two classes, they suggested an enquiry,—a sort of an Arbitral Award,—at a date as near the advent of Provincial Autonomy as possible,—so as to determine the amount and nature of assistance from the Central Exchequer to carry on the irreducible minimum of provincial administrative machinery. The same authority was also to advise upon the distribution, between the Provinces and the Central authority, of the Income Taxes. These are collected in the Provinces, from the Provincial citizens, or from provincial wealth, and are the most easily expansible item of public income in India, which the Provinces rightly claim ought to belong wholly to them.

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10 Taxes on the sale of goods and on advertisements.
11 Cesses on entry of goods for consumption in local areas.
12 Taxes on luxuries, including entertainments, amusements, betting and gambling.
13 Stamp duties in respect of documents other than those assigned to the Federal Government for such taxation.
14 Taxes on goods or passengers carried on inland waterways.
15 Tolls.
16 Fees in respect of any matters contained in List II.

N.B. Some of these are made over to the Local self-governing bodies, and the resources available to the Provinces are to that extent curtailed.

There is, in this division, no proper principle of scientific classification and distribution at work. Not all the Direct Taxes are assigned to the Provinces, nor all the Indirect Taxes to the Federation. The scheme of division is rather the outcome of historical tradition and immediate expediency, than any logical principle of financing for a Federal system.

Let us review now:—

(i) the statutory arrangements made in the Constitution proper, of the division of resources and obligations, between the Provinces and the Federation;

(ii) the provisions to be made under the Arbitral Award for aiding the Deficit Provinces, as also for enabling the more solvent Provinces to undertake schemes of local development, which they cannot if adequate resources are not available to them; and

(iii) the exact significance of the final picture, as it would emerge, after effect had been given to all these changes and reocmmendations.

Statutory Provisions re: Provincial Finance

The Statutory Provisions regarding the scheme of Federal Finance are found in Part VII, sections 136—180, both inclusive, of the Government of India Act, 1935.

These, indeed, are not all the sections of the Constitution Act, which will affect our national finances. A number of the Governors', or of the Governor-General's Discretionary duties, Special Responsibilities, and other privileges accorded to the Public Services, are scattered over several sections in all Parts of the Act. They involve financial liabilities, or restrictions upon the authority of the Provincial Governments, which cannot all be summarised here.

There are, again, provisions in the Part of the Act dealing with the Powers and Procedure of the Legislatures,—both Provincial and Federal,—which may have their reaction upon the system of finance in

the Provinces under the new regime. Finally, the reservations, conditions or limitations of particular Instruments of Accession of individual States may affect the Provinces in their financial administration, the full effect of which we cannot assess in this place.

We must, therefore, confine our summary of the Statutory Provisions only to the terms of Part VII of the Act, and with special reference to the Provincial Finances,—leaving the other provisions bearing on the same subject to be glanced at in passing as they appear to be relevant in their appropriate place.

What are Public Revenues?

Section 136 gives a definition of the revenues of the Federation, and of the Provinces, which is remarkable in that it seems to include not only the normal, recurrent income, but also the extraordinary, non-recurrent receipts, *e.g.*,—borrowed funds, or the proceeds of the sale of property. Says the Section:

136. "Subject to the following provisions of this Chapter with respect to the assignment of whole or part of the net proceeds of certain taxes and duties to Provinces and Federated States, and subject to the provisions of this Act with respect to the Federal Railway authority, the expression **"Revenues of the Federation" includes all revenues and public monies raised or received by the Federation,** and the expression "Revenues of the Province" includes all revenues and public monies raised or received by a Province."

"All revenues and public monies raised or received" must mean an extension of the term "Revenues of the State," which is in no way justified by any precedent, nor explained by any specific reason adduced to support such an extension. Under the Act of 1919, the corresponding expression could not possibly be extended to include anything but the normal, recurring proceeds of taxation, fees, or the profits of State enterprise; certainly not the loans, borrowed monies, or capital sums obtained in one way or another. The only explanation of this very unsual definition might be found in the apprehension the framers of the new Constitution seem to have entertained of the ability of the new Federation, or its autonomous Provinces to bear the burdens imposed upon them, or to make contributions in aid of Britain's Imperialistic adventures; and the consequent necessity they must have felt of securing,—at least so far as the interest on British investments, the salaries and pension of British public servants in India, and the continued maintenance of the British garrison in India were concerned,—adequate resources in the hands of the Executive to meet those obligations, punctually and regularly. But those are matters of Imperial policy as guaranteed by the special powers and responsibilities of the executive, which will not help the cause of effective autonomy in the Provinces.

The foregoing remarks will be understood in their proper perspective, if we read, along with Section 136, section 150 of the Act. That section provides:—

"(1) **No burden shall be imposed on the revenues of the Federation or the Provinces except for the purposes of India or some part of India.**

(2) Subject as aforesaid, the Federation or a Province **may make grants for any purpose,** notwithstanding that the purpose is not one with respect to which the Federal or the Provincial Legis!ature, as the case may be, may make laws."

We have already commented upon the contrast this provision affords with the existing law on the subject, in another part of this work; and so need not linger more on that topic, beyond pointing out the light it casts upon the interpretation of Section 136, as indicated above. When all the income, whether in the nature of capital receipts or revenue proper, are pledged, as it were, for "the purposes of India",—even if the particular purpose in any given case is not one on which the Legislative authority for the entity is entitled to make laws,—and, therefore, with respect to which the ordinary constitutional executive have no authority to act,—these extra-legal purposes can be financed out of "the revenues of India" by the supreme executive officers,—Federal or Provincial. What check can there then be on the spending propensities of the executive?

Method of Central Collection

There are some sources of revenue, the rates of which are left entirely to the Provinces to regulate from time to time; while there are others, the net proceeds of which are to be distributed among the Federating Units, which are to be levied and collected by the Federal Government. Under Section 137,* duties in respect of:

(i) succession to property other than agricultural land;

*137. Duties in respect of succession to property other than agricultural land, such stamp duties as are mentioned in the Federal Legislative List, terminal taxes on goods or passengers carried by railway, water or air, and taxes on railway fares and freights, shall be levied and collected by the Federation, but the net proceeds in any financial year of any such duty, or tax, except in so far as those proceeds represent proceeds attributable to Chief Commissioners' Provinces, shall not form part of the revenue of the Federation, but shall be assigned to the Provinces and to the Federated States, if any, within which that duty or tax is leviable in that year, and shall be distributed among the Provinces and

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