

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.”

And this recommendation was endorsed¹ by the Joint Select Committee of Parliament which sat on the Reform Bill. Accordingly the Secretary of State appointed a Committee under the chairmanship of Lord Meston 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 ceases 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.

After about seven weeks of investigation the Committee produced its Report.² In advising on clause (a) of its terms of reference the Committee expressed its 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 contributions to the Central Exchequer. The principal objection urged against the plan was that in some Provinces it left no surplus and in others no adequate surplus after the payment of their respective quotas of contributions. The Committee held, and rightly too, that

“in no case may a contribution be such as would force the province to embark on new taxation *ad hoc*, which to our minds would be an unthinkable sequel to a purely administrative rearrangement of abundant general resources.”

The Committee felt itself bound by a limiting consideration in providing the contribution, as a result of which it felt itself obliged

¹ Report of the Joint Select Committee on the Government of India Bill (part V, clause 41, para. 9)—House of Commons Return 203 of 1919, p. 12.

² Report of the Committee appointed by the Secretary of State for India to advise on the question of the Financial Relations between the Central and Provincial Governments in India, pp. Cmd. 724 of 1919, Ch. III.

“to leave each *Province* with a reasonable working surplus”—a surplus which it preferred “to calculate, so far as possible, with some relation to the general financial position of the Province and the more imminent claims upon its resources.”

“To be able to comply with the requirements of leaving each Province with a surplus, and of inaugurating the new Councils without the necessity of resort to fresh taxation,”

the Committee deemed that the most equitable plan to be to take, not *equal* contributions as the Joint Report advised,¹ but *unequal* contributions from the surpluses of the Provinces liable to make them.

For the consummation of its plan the Committee held that the augmentation of Provincial Surpluses was an essential step. Without it, it deemed its task to be futile. The only way to augment the provincial surplus was to allocate some other source of Imperial revenue in addition to those already provincialized. To the provincialization of the income tax, a matter which was included in clause (d) of its terms of reference so far as Bombay was concerned, the Committee being impressed by the reasonings of the Joint Report, felt bound to oppose. As an alternative it recommended that *General Stamps* should be provincialized, as means of augmenting provincial surpluses, along with *Judicial Stamps*. The effect of this transfer of *General Stamps* from the all-India list to the provincial list was to increase the provincial resources and diminish those of the Central Government. That deficit the Committee accepted as amounting in the year 1921-2 to ten crore, composed of six crores previously

¹ The Report of the Financial Relations Committee seems to argue that the difference between its plan of levying contributions and that suggested in the Joint Report is a difference in the *basis* of the contributions; its basis being that of “increased spending power”, while that of the Joint Report was “gross provincial surplus.” The Financial Relations Committee pointedly criticized the method proposed in the Joint Report to assess the contribution from each province “as a percentage of difference between the gross provincial revenue and the gross provincial expenditure.” There does not seem to be much difference between that scheme and the scheme of the Committee consisting of a percentage levy on what is called increased spending power of the provinces under the new distribution of the revenues between the Central and Provincial Governments. That these two are different bases of assessment seems to be the general impression (cf. the speech of the Hon. Rai Bahadur Bakshi Sohan Lal on the Resolution *re* Provincial Contributions to the Central Exchequer, Legislative Assembly Debates, Vol. III, No. 8, p. 508). This of course is an error; for spending power is simply another name for gross surplus. The change made by the Committee was in proposing unequal contribution in place of equal contribution. It kept unchanged the basis of the assessment.

estimated by the Government of India¹ *plus* four crores for the loss of *General Stamps*, the revenue from which the Committee gave to the Provinces. This amount subject to certain adjustments,² which when made resulted in a clear deficit of 9,83.06 lakhs net. In strict adherence to the limiting consideration which it felt bound to respect, the Committee proceeded to fix the following ratios in which each of the nine Provinces were to contribute to make up this amount of 9,83 lakhs in the year 1921-2 :—

INITIAL CONTRIBUTIONS (IN LAKHS OF RUPEES)

Provinces	Increased spending power under new distribution of Revenue	Contributions as recommended by the Committee	Increased spending power left after Contributions are paid
Madras ...	5,76	3,48	2,28
Bombay ...	93	56	37
Bengal ...	1,04	63	41
United Provinces ...	3,97	2,40	1,57
Punjab ...	2,89	1,75	1,14
Burma ...	2,46	64	1,82
Bihar and Orissa ...	51	<i>nil</i>	51
Central Provinces ...	52	22	30
Assam ...	42	15	27
Total ...	18,50	9,83	8,67

This ratio of initial contributions was not intended in any manner by the Committee “to represent the ideal scale on which the Provinces should have in equity to be called upon to contribute.” Indeed in making its recommendations as to initial contributions the Committee paid less attention to equity of contributions and more to

“established programmes of taxation and expenditure and legislative and administrative expectations and habits, that cannot without serious mischief be suddenly adjusted to a new

¹ Recommendations of the Government of India regarding the Demarcation between Central and Provincial Revenues, Cmd. 334 of 1919, Statement III.

² These adjustments were, with regard to the Military Police Force in Burma, the payment of pensions and leave allowances. Cf. Report of the Financial Relations Committee, para. 10.

and more equitable ratio of contributions widely different (as an equitable ratio must admittedly be) from that of the past. It is accordingly inevitable, if such mischief is to be avoided, that the ratio for initial contributions should bear little relation to that which would be ideally equitable." But the Committee also recognized that "an initial ratio of this nature can only be defended as a measure of transition. It is necessary, but it is necessary only in order to give time to the provinces to adjust their budgets to a new state of affairs; and we are clearly of opinion that no scheme of contribution can be satisfactory that does not provide for a more equitable distribution of the burden of the deficit within a reasonable time."

The Committee therefore proceeded next to consider the question of *standard* contributions as distinguished from *initial* contributions, which were only transitional. As to what should be the ideal basis for such an equitable distribution of the burden the Committee felt quite certain ; for it 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."

Two questions were involved in translating this principle into practice. What is the *total* contribution of a province to the purse of the Government of India ? Secondly, what is the measure of the capacity of a Province to contribute ? With regard to the first 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.";

in other words, the pressure of the taxes from within its jurisdiction for the benefit of the Central Government. With regard to the second the Committee held that

"the capacity of a Province to contribute is its taxable capacity, which is the sum of the incomes of its taxpayers, or the average income of its taxpayers multiplied by their number."

The Committee was frank in its avowal of the fact that the data available was not sufficient for a direct quantitative evaluation either of the total net contribution which a Province made to the Government of India or of its capacity to contribute, and held that it was

“useless 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.”

None the less the Committee did not abandon the ideal basis it had selected for fixing the standard contributions. For it observed:

“We are able, after surveying such figures as are available and after close inquiry into the circumstances of each Province, to recommend a fixed ratio of contributions which in our opinion represents a standard and equitable distribution of the burden of any deficit. In arriving at this ratio we have taken into consideration the indirect contributions of the Provinces to the purse of the Government of India, and in particular the incidence of customs duties and of income tax. We have inquired into the relative taxable capacities of the Provinces, in the light of their agricultural and industrial wealth and of all other relevant incidents of their economic positions, including particularly their liability to famine. It should be observed that we have considered their taxable capacities not only as they are at the present time, or as they will be in the immediate future, but from the point of view also of the capacity of each Province for expansion and development agriculturally and industrially, and in respect of imperfectly developed assets such as minerals and forests. We have also given consideration to the elasticity of the existing heads of revenue which will be secured to each Province, and to the availability of its wealth for taxation.”

After estimating, to the best of its ability, the weight which should be given to each of these circumstances, the Committee

recommended the following fixed ratio as representing an equitable basis for the relative contributions of the Provinces to meet the deficit in the Budget of the Government of India :—

STANDARD CONTRIBUTIONS

Province	...	Per cent. Contribution to Deficit.
Madras	...	17
Bombay	...	13
Bengal	...	19
United Provinces	...	18
Punjab	...	9
Burma	...	6½
Bihar and Orissa	...	10
Central Provinces	...	5
Assam	...	2½
Total	...	100

The Committee agreed that there should be an interval of time sufficient to enable the Provinces to adjust their budgets to the new conditions before they should in equity be called upon to contribute according to this standard ratio.¹ But the Committee thought that the interval allowed for adjustment should not be unduly prolonged.

“The initial ratio which,” the Committee said, “we have proposed is a practical necessity, but the Provinces which will be called upon to pay thereunder more than they should pay in equity, ought not to be required to bear that burden for a longer period or to a greater extent than is required to prevent dislocation of the provincial budgets.”

The Committee therefore proposed

“that contributions should be made on the standard ratio to any deficit that there may be in the seventh year of

¹ For a good piece of criticism of the basis *adopted* by the Financial Relations Committee in arriving at the standard ratio, see para. 12 of a rather splenetic letter from Rai Bahadur K. V. Raddi to the Reforms Commissioner, Simla, pp. Cmd. 974 of 1920, p. 58.

contribution, and that the process of transition from the initial to the standard ratio should be continuous beginning in the second year of contribution, and proceeding in six equal annual steps.”

The following table shows the initial, intermediate, and ultimate ratios of contributions for the seven years in accordance with the recommendations of the Committee :—

PER CENT. CONTRIBUTIONS TO DEFICIT IN SEVEN CONSECUTIVE YEARS BEGINNING WITH THE FLRST YEAR OF CONTRIBUTION
(rounded off to even halves)

Province	1st Year	2nd Year	3rd Year	4th Year	5th Year	6th Year	7th Year
Madras	35½	32½	29½	26½	23	20	17
Bombay	5½	7	8	9½	10½	12	13
Bengal	6½	8½	10½	12½	15	17	19
United Provinces	24½	23½	22½	21	20	19	18
Punjab	18	16½	15	13½	12	10½	9
Burma	6½	6½	6½	6½	6½	6½	6½
Bihar and Orissa	<i>nil</i>	1½	3	5	7	8½	10
Central Provinces	2	2½	3	3½	4	4½	5
Assam	1½	1½	2	2	2	2	2½
Total	100%	100%	100%	100%	100%	100%	100%

These recommendations were accepted by the Government of India and the Secretary of State. But when the rules in which they were embodied came before the Joint Select Committee of Parliament appointed to revise the draft rules made under the Government of India Act, for consideration, the Committee made some important alterations in the allocation of revenues and contributions from the Provinces. In its Report¹ the Joint Committee recognized

“the intricacy of the problem with which the Financial Relations Committee had to deal, and the difficulty, amounting

¹ Second Report of the Joint Committee appointed to revise the draft rules made under the Government of India Act, pp. 172 of 1920, pp. 2-3.

almost to impossibility, of arriving at any solution which was likely to be acceptable to all Local Governments..... They believe that such dissatisfaction as the proposals have aroused is inevitable in distributing resources between a Central and Provincial Governments, and that the impossibility of removing by a stroke of the pen inequalities which are the result of long-standing and historical causes have been overlooked.” “None the less,” the Committee desired, “on grounds of policy, to alleviate the disappointment caused by the restraints which the system of contribution laid on the employment by the provinces of their revenues. As a means of alleviating the burden the Committee suggested :

- “(1) That there should be granted to all provinces some share 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.”

Accordingly it is provided in the Devolution Rules that:

- (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 400 lakhs.¹

¹ This arrangement was subject to the following provision attached to Devolution Rule 15:—

(2) In consideration of this allocation, each Local Government shall make to the Governor-General in Council a fixed annual assignment of a sum to be determined by the Governor-General in Council as the equivalent of the amount which would have accrued to the Local Government in the year 1920-21 (after deducting the provincial share of the cost of special income tax establishments in that year) had the pie-rate fixed under sub-rule (1) been applied in that year, due allowance being made for any abnormal delays in the collection of tax.

(3) The cost of special income tax establishments employed within a province shall be borne by the Local Government and the Governor-General in Council in the proportions of 25 per cent, and 75 per cent, respectively.

[contd overleaf]

and that

- (17) In the financial year 1921-2 contributions shall be paid to the Governor-General in Council by the Local Governments mentioned below according to the following scale :—

Name of the Province	Contributions (in lakhs of rupees)
Madras	3,48
Bombay	56
Bengal	63
United Provinces	2,40
Punjab	1,75
Burma	64
Central Provinces and Berar	22
Assam	15

- (18) From the financial year 1922-3 onwards a total contribution of 9,83 lakhs, or such smaller sum as may be determined by the Governor-General in Council, shall be paid to 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 contributions of those Local Governments only whose last previous annual contribution exceeds the proportion specified below of the smaller sum so determined as the total contribution ; and any reduction so made shall be proportionate to such excess :

Madras	$\frac{17}{90}$ ths
Bombay	$\frac{13}{90}$ ths

(4) If in any financial year the total amount payable by a Local Government under sub-rules (2) and (3) in respect of the fixed assignment and the cost of special income tax establishments exceeds the amount of the share of income tax allocated to it under sub-rule (1), the fixed assignment for that year shall be deemed to have been reduced by the amount of such excess.

Bengal	...	...	$\frac{19}{90}$ ths
United Provinces	...	...	$\frac{18}{90}$ ths
Punjab	...	...	$\frac{9}{90}$ ths
Burma	...	...	$\frac{6\frac{1}{2}}{90}$ ths
Central Provinces and Berar			$\frac{5}{90}$ ths
Assam	...	...	$\frac{2\frac{1}{2}}{90}$ ths

- (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.

Two more matters had to be settled in order to make the separation between Provincial and Central Finance as complete as possible. Both were connected with capital transactions. One was the question of the Provincial Loan Account. This Account represented the fund from which a Provincial Government advanced agricultural loans, loans to indebted landholders, to municipalities and other local bodies, etc. The capital was provided by the Government of India as required and was returned to it as it was repaid. The province paid the Government of India interest on the average capital outstanding in each year, recouping itself by higher rates of interest which were supposed to compensate it for bad debts. It was commonly agreed that it was the natural result of the Reforms Scheme that the Provinces should for the future finance their own loan transactions, and that joint accounts of this nature between them and the Government of India should be wound up as quickly as possible. The matter was referred to the Financial Relations Committee and on the basis of its recommendations in that behalf it was provided by Rule 23 of the Devolution Rules that:

“Any moneys which, on the 1st day of April 1921, are owed to the Governor-General in Council on account of advances

made from the provincial loan account of any Province shall be treated as an advance to the Local Government from the revenues of India, and shall carry interest at a rate calculated on the average rate carried by the total amount owed to the Governor-General in Council on this account on the 31st March 1921. The interest shall be payable upon such dates as the Governor-General in Council may fix. In addition, the Local Government shall pay to the Governor-General in Council in each year an instalment in repayment of the principal amount of the advance, and this instalment shall be so fixed that the total advance shall except where for special reasons the Governor-General in Council may otherwise direct, be repaid before the expiry of twelve years. It shall be open to any Local Government to repay in any year an amount in excess to the fixed instalment."

The other was the question of responsibility for capital expenditure on irrigation works. In this as in the matter of Provincial Loan Account it was agreed that it would be incompatible with the scheme of complete separation of Provincial Finance to hand over to the former the control of irrigation works and to make the latter responsible for the capital transaction incurred thereon. Hence the rule¹ that:

- (1) The capital sums spent by the Governor-General in Council upon the construction in the various Provinces of productive and protective irrigation works and of such other works financed from loan funds as may from time to time be handed over to the management of Local Governments shall be treated as advances made to the Local Governments from the revenues of India. Such advances shall carry interest at the following rates, namely :
 - (a) In the case of outlay up to the end of the financial year 1916-17, at the rate of 3.3252 *per centum*.
 - (b) In the case of outlay incurred after the financial year 1916-17, at the average rate of interest paid by the Governor-General in Council on loans raised in the open market since the end of that year.
- (2) The interest shall be payable upon such dates as the Governor-General in Council may fix.

¹ Devolution Rule 24.

Thus was broken the financial and administrative strand which tied the Provincial Governments to the Central Government and prevented the introduction into them of responsible government. As the Provinces thereby acquired “an acknowledged authority of their own” over the services and sources allocated to them it followed that they should have the freedom to borrow in their own name, which was denied to them heretofore. Consequently the Local Government Borrowing Rules’ made under the Reforms Act provided that subject to certain conditions :²

“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) for the giving of relief and the establishment and maintenance of relief works in times of famine or scarcity ;

¹ Rules under Section 2 (2) of the Government of India Act, 1919.

² The rules required 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 of the conditions under which the loan shall be raised.

(2) Every application for the sanction of Secretary of State shall be transmitted through the Governor-General in Council.

- (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 advance made by the Governor-General in Council.”

With the cutting off of the financial and administrative strand there remained only the legislative strand which had so far debarred the growth of provincial autonomy. This legislative strand, as was pointed out before, operated through the principle of requiring previous sanction and subsequent assent of the Government of India. By the rules made under the Reforms Act a field has been marked off for the free exercise of the Legislative powers of the Provinces in which that principle has been dispensed with. So far as the field of tax legislation was concerned it was provided¹ 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 Government any tax included in Schedule I.”

This schedule comprises the following heads of taxation :—

1. A tax on land put to uses other than agricultural.
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 the matter of non-tax legislation the procedure adopted by the rules has been slightly different. In tax legislation the rules stated in what cases previous sanction was not necessary. In non-tax legislation the rules required in what cases previous sanction was necessary. The effect of this difference in the

¹ Rules under Section 10 (3) (a) of the Government of India Act, 1919, Scheduled Taxes Rules.

requirements of the rules of previous sanction' was that while in matters of tax legislation a Provincial Government could only levy certain named taxes, in the matter of non-tax legislation it could do anything provided it did not infringe certain laws. The reasons for this difference are obvious. A widening of the basis of provincial taxation means a narrowing field for imperial taxation. Such a detrimental effect could not flow to the Government in the matter of non-tax legislation, be the non-tax legislative powers of the Provinces howsoever large. The taxing power to be granted to the Provinces had therefore to be more strictly circumscribed than the grant of legislative power. None the less it cannot be denied that the rules regarding previous sanction sufficiently loosened the legislative strand as to permit of the Provinces being autonomous in theory as well as in practice.

This autonomy is well reflected in the new Budget Procedure in the Provinces. Under the old regime the Provincial Budgets had to be passed by the Finance Department of the Government of India, the Provincial Accounts to be supervised by the Accountant-General and audited by the Controller and Auditor-General of the Government of India and appropriation reports submitted to the Finance Department of the Government of India. All this is changed under the new regime. The Provincial Budget, instead of being passed by the Finance Department of the Government of India, is framed by the Finance Department constituted in each Province under the Reforms Act² and is voted item by item by the Provincial Legislature.³ The accounts of the Provinces still continue⁴ to be supervised and audited by the

¹ Rules under section 10 (3) (L) of the Government of India Act, 1919, Local Legislature Previous Sanction rules. It should, however, be noted that if a Provincial Bill is such that it does not require previous sanction it does not follow that it can become law under the above rules because it has been assented to by the Provincial Legislature. For, by virtue of another set of Rules made under section 12 (1) of the Government of India Act, 1919, called Reservation of Bills Rules, it is provided that the Governor of a Province *must* reserve some and may reserve other Bills for the subsequent assent of the Governor-General before declaring them law even if the Bills be such as to require no previous sanction.

² For the constitution and functions of the Finance Department of the Provinces, see Part III of Devolution rules made under Section I of the Government of India Act, 1919.

³ See Rules 25 to 32 of the Rules of Business for Provincial Legislative Councils made under Section 11 (5) of the Government of India Act, 1919.

⁴ Rules framed under Section 96D (1) of the Government of India Act.

officers of the Government of India, but the important point under the new regime which is the hall-mark of provincial independence is that the appropriation reports, instead of being sent to the Government of India for action, are now sent to the Committee of Public Accounts constituted from amongst the members of the Provincial Legislature which sanctioned the Budget for report that the money voted by the Legislature was spent within the scope of the grants made by the Legislature. Thus is effected the demarcation of the field for the governance of India into Central and Provincial. Such a demarcation of administrative and financial matters was the dream of many an Indian politician and statesman. It was urged before the Royal Commission on Decentralization and was also urged by the late Mr. Gokhale in his political testament which he left before he died. But all these projects were ill timed and could not be given effect to until the law of the Indian constitution had been altered. Now that such an alteration has been made the ideal of Provincial autonomy bids fair to become real. But before closing this study it may be useful to evaluate the changes of its successful working.

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CHAPTER XII

A CRITIQUE OF THE CHANGE

It is obvious that good administration depends upon good finance; for finance is “the fuel of the whole administrative machine.” No aspect of the scheme of Reforms therefore demands a closer and more anxious study than the financial arrangements with which the new system of administration starts. The necessity for such an examination is all the greater because this aspect of the Reforms Scheme has received comparatively little intelligent criticism at the hands either of the public or the expert.

The first question to consider is, can the new financial arrangements be said to be *administratively* workable? To make administrative polities independent by requiring them to finance themselves entirely out of their own respective resources without having to depend upon one another must always be regarded as a very important end to be kept in view in devising a new financial arrangement. It is true that it is not always possible to realize this end, and it may in some cases be actually helpful to their working that the polities should be made mutually dependent; for interdependence, at least in matters of public finance, instead of being an impediment might conceivably furnish a basis for co-operation and strength. None the less independence in finance for each administrative policy is to be sought for wherever possible. There can be no doubt that from this standpoint the system of contributions is better than the system of divided heads. This is not to condemn the system of divided heads. The existence of several concurrent or overlapping tax jurisdictions must always be a source of difficulty whenever an attempt is to be made to distribute the different sources of revenue among the competing tax jurisdictions so as to allow each a sufficiency of funds. The reason is that this distribution of the sources of revenue must not only be governed by considerations of adequacy, but must also be governed by considerations of suitability. “The problem of efficiency of taxation,” as Prof. Seligman observes,¹

¹ *Essays in Taxation* (8th edition, 1913), Chapter XII, “The Relations of State and Federal Finance.”

“is naturally of vital importance. No matter how well intentioned a scheme may be, or how completely it may harmonize with the abstract principles of justice, if the tax does not work administratively it is doomed to failure.”

Whether among the sources of revenue to be partitioned there are any which are naturally more suitable for utilization by one tax jurisdiction rather than by another depends upon what is the basis of the tax. If the basis of the tax is narrow then the argument in favour of its utilization by a narrower tax jurisdiction will be correspondingly stronger. If its basis is wide then the scales would weigh in favour of its utilization by the broader tax jurisdiction. But as a result of following the dictates of suitability it is not always possible to make a partition such as to give each administrative polity revenues adequate for its purposes. For it may happen that a particular tax is suitable for one jurisdiction while its yield, instead of being necessary for that jurisdiction, may be required for another jurisdiction which is unfit to levy it, or may be partially necessary for both. In such a case, how are the ends of adequacy to be subserved? Two remedies suggest themselves. One is the adoption of the system of divided heads, and the second is to apportion the deficiency among the several component states and require them to make a definite contribution towards meeting it.¹

The system of divided heads was by no means peculiar to the Indian fiscal system. It has been adopted in some form or other by many other countries. In England, for instance, the inheritance tax is assessed by the Central Government, but a part of the proceeds is allotted to the Local Government. The same is true of some other taxes in England. In Germany, under the Empire, the proceeds of certain indirect taxes were divided between the federal and state governments. In Canada it is well known that a large part of the provincial revenues is derived from proceeds of taxes that are levied by the federal government.

The prejudice in India against the system of divided heads of revenue is particularly regrettable because it is founded on the view that it is opposed to the principle of separation of revenues. People who opposed it said² that it involved divided heads of expenditure which fettered the spending powers of the Provinces and enabled the Government of India directly to interfere in their

¹It will be noted that although the new Indian system is largely a system of contributions it is not without an admixture of the system of divided heads so far as the Income tax is concerned.

² R.C.D., Mit of Evid., Vol. VI, Q. 25017-25020; Vol. VIII, Q.35531, 35225-29.

Budget estimates and “to have its finger in every pie” of theirs. The system of divided heads was no doubt characterized by these objectionable features. But division of expenditure is not a necessary accompaniment of division of revenue. Nor is it a necessary incident of it that a polity which shared in the yield of a tax but did not administer it should interfere in calculating the estimates of the yield. Chipped of its evil features, the system of divided heads of revenue is simply another name for what Prof. Seligman calls¹ the system of segregation of source and the division of the yield. The essence of the system consists in the exclusive assessment of a particular source of revenue by one tax jurisdiction, coupled, however, with an apportionment of a part of the proceeds to another tax jurisdiction. The system of divided heads of revenue does not cease to be a system of separation of sources merely because there is the division of the yield. In such a system of divided heads there is a separation because the assessment of the tax is segregated—which is the essence of separation—exclusively in the hands of one tax jurisdiction, and the division of the yield can be so regulated that it need not be incompatible with real separation.

The system of contributions does what the system of divided heads aims to do. Like the system of divided heads it answers the tests of suitability as well as of adequacy by allowing the tax to be administered by the jurisdiction most competent to do it, and also of adequacy by making the taxing jurisdiction hand over a sum to the non-taxing jurisdiction. Essentially the system of divided heads and the system of contributions are alike. The only difference between the two is that so far as the apportionment of proceeds are concerned the one is an itemized arrangement while the other is a lump-sum arrangement. There is therefore really nothing much to choose between them. But this is not altogether a case of merely giving a different name to a discredited system in the hope that it might smell more sweet. For the system of contributions has one real point of superiority as compared with the system of divided heads. It does not merely permit of separation of assessment, but it also makes for a greater separation than does the system of divided heads. Under the system of divided heads the receiving party has still

¹ Op. cit., Chapter XI, “Separation of State and Local Revenues,” particularly pp. 365-6.

an anxious concern in the assessment and collection of the tax for any laxity in the administration of a divided head of revenues is bound to affect its interests adversely, and may therefore claim a hand in the administration of the tax. But under the system of contributions there is no room for such a possibility. Its quota being assured it is out of the business of assessing and collecting the tax. There is thus a greater separation under the system of contributions than there can be under the system of divided heads.

When we come to analyse the equity of the new financial arrangements we find that great objections are raised to the system of contributions. But many of these objections are misconceived. It will be recalled that the contributions from the Provinces to the Central Government in India are regulated according to their spending powers. In other words, it is the apportionment by expenditure method of dealing with the deficit. That the method subserves the ends of adequacy is of course obvious. But what does not seem to be so obvious, but which all the same is a great virtue of the system of contributions, is that it promotes economy in the giving as well as in the receiving tax jurisdiction; for extravagance in the contributing tax jurisdiction immediately increases its burden, while extravagance in the receiving tax jurisdiction is directly reflected in enhancing the contributions. None the less, the contributions, it is protested, are inequitable, for they are held to be based not on population, nor on area, nor on wealth, nor on the capacity of the Provinces. It is also complained that the system of contributions according to spending powers is unwise, for it tends to check desirable expenditures in the more progressive Provinces. The latter is, of course, a real objection to the apportionment by expenditure method of contributions in its general form. But it may be said, on the other hand, that in the first place if a jurisdiction is willing to undertake the burdens of a larger expenditure for desirable aims, it will scarcely be deterred by the slight additional burden which might result from the increase in the contribution. Secondly, if it were found that the contribution did produce such a result it would be possible to obviate it by adopting the simple expedient of exempting certain kinds of expenditure which might be deemed to be necessary. What these expenditures should be would be a matter of adjustment, which might differ in different provinces. The virtues of the system of apportionment by expenditure method of levying contributions would still be

conserved intact, and its automatic features would work equally well if certain expenditures only, instead of all expenditures, were selected as the basis of calculations.

This objection cannot, however, be urged against the Indian system of contributions. In the first place, the contribution is not a varying sum as is the case in the financial systems of other countries. Because the Provinces are made contributory towards the deficit of the Central Government it is to be remembered that they are not liable to the whole of the central deficit whatsoever it may be from year to year. On the other hand, in ordinary years the Provinces are only liable to make contributions towards meeting what is called the Standard Central Deficit of Rs. 9.83 lakhs. That being the case the contributions do not form an element of uncertainty in the Provincial Budgets. Secondly, the contributions are not a permanent feature of the financial arrangements between the Central and Provincial Governments. The levy of the contributions is contemplated to be only transitional, to allow the Government of India to work out its financial salvation, and the Government of India has promised that they will adopt such a policy as to bring about the extinction of the contributions in as short a time as possible. Lastly, the ratio of the contributions to the standard revenues or expenditure of any of the Provinces is not so great as to place a heavy incubus on their financial system, and not being a varying quantity cannot be said to check useful expenditures by Provinces which propose to incur them.

As a matter of fact whatever may be said against the flaws in the apportionment by expenditure method of levying contributions it would be difficult to deny that the system eminently answers the requirements of equity. It certainly brings about a more equitable¹ distribution of the burden than is possible under other systems. For it may fairly be assumed that expenditures very nearly correspond to the actual abilities of the communities concerned more than do population² or area. Not only is the principle equitable in itself, but care has been taken to do equity in its application as between the different Provinces. For we know that the contributions are so regulated as to leave to the Provinces, rich as well as poor, a reserve of spending power in order to enable them to meet such of their pressing needs as may not have been covered by the figure for standard

¹ Cf. Seligman, *op. cit.*, p. 360.

² In Germany under the Empire the contributions from the states were apportioned according to population. The same is the case in Switzerland.

expenditure. The main purpose of rejecting equal in favour of unequal contributions was to see that the burden of the contributions did not prevent any of the Provinces from meeting such extra expenditure as may be absolutely necessary. Indeed, no system of contributions can be said to be calculated to produce greater equity than the Indian system.

So far we have examined whether the new financial arrangement is administratively workable and equitable. What we have now to see is : Has the arrangement proved itself to be financially adequate? It will be recalled that the Financial Relations Committee held that the general resources of the country were abundant, and that it required only a wise

(In Thousands of Rupees)

Province			Standard Figures	Revised 1921-2	Budget 1922-3
Madras	...	{ Revenue	14,98,02	15,58,59	16,76,50
		{ Expenditure	14,07,20	17,15,93	17,18,55
		{ Surplus and Deficit	90,82	—1,57,34	—42,05
Bombay	...	{ Revenue	12,09,70	13,67,13	14,93,06
		{ Expenditure	11,55,03	16,52,80	15,42,17
		{ Surplus and Deficit	54,67	—2,85,67	—50,11
Bengal	...	{ Revenue	8,55,28	8,86,53	10,55,86
		{ Expenditure	8,61,13	11,10,60	10,36,90
		{ Surplus and Deficit	—5,85	—2,24,07	18,96
United Provinces	...	{ Revenue	12,29,88	13,34,31	13,58,67
		{ Expenditure	12,06,56	14,59,87	13,85,65
		{ Surplus and Deficit	1,23,32	—1,25,56	—26,98
Punjab	...	{ Revenue	9,73,51	10,73,76	11,38,26
		{ Expenditure	9,10,69	12,23,24	12,68,44
		{ Surplus and Deficit	62,82	—1,49,48	—1,30,18
Burma	...	{ Revenue	8,24,28	9,99,33	10,00,57
		{ Expenditure	7,84,78	10,27,51	11,90,70
		{ Surplus and Deficit	39,50	—28,18	—1,90,13
Bihar and Orissa	...	{ Revenue	4,30,39	4,46,15	4,62,65
		{ Expenditure	4,20,70	4,85,97	5,13,80
		{ Surplus and Deficit	90,69	—39,82	—51,15
Central Provinces	...	{ Revenue	4,35,37	5,14,80	5,35,23
		{ Expenditure	4,38,80	5,41,76	5,72,17
		{ Surplus and Deficit	—3,43	—26,96	—36,94
Assam	...	{ Revenue	1,81,46	2,01,12	2,08,06
		{ Expenditure	1,78,25	2,19,45	2,22,58
		{ Surplus and Deficit	3,21	—18,33	—14,52

plan of distribution in order to leave each Province with a sufficiently large “spending power” or surplus. That the plan recommended by the Committee was calculated to bring about such a result must of course be taken for granted. But when we analyse the Budgets of the different Provinces since the introduction of the Reforms the result appears to be entirely disappointing (see Table, p. 287).

Thus, taking the estimated revenue and expenditure of the nine Provinces for 1922-3, equilibrium between current revenue and expenditure is only to be found in two of them, Burma and Bengal, and in the latter this result could not have been attained but for the temporary remission¹ of its annual contribution to the Central Government, and a programme of taxation calculated to bring in Rs. 140 lakhs. In the rest of the Provinces the deficits of the year aggregated to the large figure of Rs. 7,74 lakhs. This huge deficit was financed by new² taxation to the extent of Rs. 3,52 lakhs, and for the rest by drawing on balances and by raising loans from the public and from the Central Government. But as the Secretary of State in his despatch³ pointed out, this

“process of financing provincial deficits in part from the accumulated revenue balances of the past will now practically come to an end, as such balances will be generally exhausted by the end of the current financial year If the financial stability of the Provinces is not to be undermined, with ultimate jeopardy to the Government of India itself, it is impossible to contemplate the continuance of a series of Provincial deficits financed by borrowing either direct from the public or from the Central Government.”

What is to be the remedy ? At the Conference held in Simla in April, 1922, “to consider various matters connected with the financial arrangements between the Central Government and the Provinces,” it was disclosed⁴ that the Government of India and the Provinces were divided as to the proper solution for the rehabilitation of Provincial Finance on a stable and secure

¹ *Legislative Assembly Debates*, Vol. III, No. 8.

² Cf. the letter of the Government of India, Finance Department, No. 13 of July 13, 1922, to the Secretary of State.

³ Cf. the despatch in reply to the above by the Secretary of State (Financial), No. 17 of November 9, 1922.

⁴ For a summary of the result of this Conference, see Letter of the Government of India, *supra*, p. 257.

footing. The Provinces proposed an increase in their resources by revising the financial arrangements made by the Reforms Act. On the other hand, the Secretary of State as a mouthpiece of the Government of India urged that

“Equilibrium can only be achieved by reduction of expenditure and the adoption of measures which will lead to an increase of revenue.”¹

The Provinces were not, however, unanimous in the suggestions they made for the revision of the arrangements effected by the Act. Some like the Government of Bombay suggested a return to the system of “divided heads” while others were opposed to it. But the majority was for securing relief through the abolition of contributions. This attitude of the Provinces towards the new financial arrangements is on the face of it a very unreasonable attitude. They are opposed both to the system of divided heads and the system of contributions as well. This is to have things both ways, and they could certainly have had it if the existing resources of the country had been properly husbanded. Inadequacy of finance is not always the result of a paucity of revenue resources. National prosperity may be great and growing and the increase of national wealth may be proceeding unchecked. If under such circumstances enough revenue is not obtained the fault does not lie with the social income. Rather it is a fault of the government which must be said to have failed to organize and marshal the national resources for fiscal purposes. The same is to some extent true of the Indian Government.

Surveying the national resources of the country, it becomes evident that there are two sources which the Government has not been able to marshal properly. One is the land revenue. It is notorious that land revenue has been the biggest resource to the Government of India. In the collection of the land revenue every landholder is laid under contribution, but the rate of assessment is not periodically enhanced for every one of them. On the other hand, in Bengal and in other parts of India the rate of assessment is permanently settled. Consequently in such parts of India which by the long period of settled government enjoyed by them, and by the consequent influx of capital, have

¹ The despatch of the Secretary of State, *supra*, p. 257.

attained to a greater advance in prosperity than any others, the land revenue yields practically no increase; the land-owners, with enormously increased incomes, contribute nothing to the increase in the financial burdens of the State. Permanent Settlement has ever since the days of Lord Canning been suggested as a panacea for improving the financial condition of the people. After the severe famine of 1860, Lord Canning, then Viceroy and Governor-General of India, recommended the extension of the Permanent Settlement to all parts of india. Sir John (afterwards Lord) Lawrence supported the recommendation, and the two Secretaries of State for india, Sir Charles Wood and Sir Stafford Northcote, approved of the proposal. Fortunately for the country the proposal for making the Permanent Settlement universal was finally rejected in 1883. Some no doubt regarded the decision as unfortunate, and continued the agitation in favour of the permanent Settlement long after. But the real force, if there was any in the agitation, was derived from the motive of putting a limit on the financial resources of an alien and an irresponsible bureaucracy. Those who then agitated in favour of the Permanent Settlement probably did not realize that some day this irresponsible bureaucracy would give place to a responsible government of the people and the Permanent Settlement which it was desired to be instituted as a curb on the unchartered licence of a bureaucracy would result in placing a fetter on the freedom of a popular government to enter upon the path of orderly progress. A bad government may abuse its financial powers, but a government cannot be a good government if there is a serious limitation on its financial powers. It was therefore a good thing that this evil of a permanent settlement was not allowed to spread to the whole of India. But it would have been better if the new financial arrangements had contrived to replace the permanent settlement system of land revenue by a periodical settlement system. That was one important way of augmenting the general resources of the country and thereby giving adequacy to all the governments concerned. Instead of this the financial arrangements were so conceived as not to

“subject the permanently settled provinces to financial pressure which would have the practical result of forcing them to reconsider the permanent settlement.”¹

If this had been done it would have augmented the general resources to the benefit of all. As it was, not only provision was

¹ Joint Report, p. 171.