

PART II

CHAPTER I

INTRODUCTORY

In Part I of our Report we explained the scope of 'federal' financial integration of States*, conceived as a necessary consequence of the basic conception underlying the new constitution of the Union of India,—that of Provinces and States as equal partners. For facility of reference, we briefly recapitulate below the main principles to be kept in view in considering the integration schemes for individual States (Chapters IV *et seq* of this Part of our Report). Further, certain matters to which we made only brief references in Part I of our Report are now elaborated; and others, which, being matters more of detail than of basic issues, were not previously touched upon by us, are also dealt with here.

Scope of Part II of Report.

2. Federal Financial Integration must be based upon complete equality between Provinces and States in the following respects :—

Basic conceptions; and main principles of federal financial integration.

- (1) The Central Government should perform the same functions and exercise the same powers in States as in Provinces;
- (2) The Central Government should function through its own executive organisations in States as in Provinces;
- (3) There should be uniformity and equality in the basis of contributions to Central resources from Provinces and States;
- (4) There should be equality of treatment as between Provinces and States in the matter of common services rendered by the Central Government, and as regards the sharing of divisible federal taxes, grants-in-aid, "subsidies", and all other forms of financial and technical assistance.

Consequently :—

- (a) All present and future revenues from "federal" sources and all expenditure on functions and services of a "federal" character, together with all Assets and Liabilities connected therewith, must be transferred from the States to the Centre; so, too, the administration of all these Departments. And all internal trade barriers must be abolished.

*In this as in Part I of our report, the word "State" should be understood as including "Unions of States" also, except where the context otherwise requires.

- (b) Subject to a measure of gradualness in certain directions as regards the full effect of its impact, federal financial integration should be complete in all respects from the outset.
- (c) The principle of gradualness need be invoked only in respect of the following matters—
- (i) the abolition of internal customs duties in one or two states may be spread over three to five years ; in all other States these duties should be abolished as soon as financial integration becomes effective ;
 - (ii) The rates of Income-tax in States should be raised to the level of Indian rates in two or three stages ;
 - (iii) the *administrative* transfer of certain “federal ” functions and services to the Centre may be effected gradually ;
 - (iv) the transfer of the net “burden ” of financial integration to the States (or the Centre) must be gradual ; it should take the form of appropriate financial adjustments between the Centre and the States, extending over such transitional period,—ten years, or fifteen,—as may be provided in Article 258 of the new Constitution ; and these adjustments should be so devised as to cause no sudden dislocation of the finances of States or of the Centre at the commencement of financial integration, or during (or at close of) the transition period.
- (d) Apart from the transitional financial adjustments referred to above, no “compensation” as such would be payable to the States for any assets or revenues passing to the Centre upon federal financial integration ; but there would, of course, be an equitable apportionment of the liabilities of the States between them and the Centre.

Date of federal financial integration.

3. The date of federal financial integration should be the 1st April 1950, except in regard to Travancore and Cochin where it would be advantageous to the States if it were made effective from the 17th August 1949—the date of commencement of their next financial year.

(The expression “prescribed date” wherever it occurs in this Report denotes the date from which federal financial integration takes effect for the particular State under reference).

“Basic Period” for Financial Adjustments :

4. It is necessary to adopt a “basic period” extending over one or more financial years for each State with reference to which the *net* revenue result of the integration of its federal finances can be worked out ; all financial adjustments on revenue account during the transi-

tional period would then be related to the actual (or average of the actual) figures of the period so determined.

On this point, in explaining the basis upon which we have drawn up integration schemes for individual States, we stated in Part I of our Report (Paragraph 32) as follows :—

“.....the initial over-all *net* loss of revenue to the State resulting from financial integration is calculated. This represents the loss from the abolition of internal customs duties, together with the “federal” revenues which would accrue to the Centre, *minus* the “federal” expenditure to be borne by the Centre, as a result of the integration.

[For revenues, averages of the three completed financial years of the State —(in the case of *Unions*, actuals of one completed year only)—immediately preceding integration are taken ; and for expenditure, the figures of the last completed year.]”

The choice of the financial years referred to in the above passage, by reference to which the net revenue result of financial integration is computed for each State, requires some explanation. We consider that this ‘basic period’ should be fixed as follows :—

(a) In regard to Revenue, the three completed financial years of the State immediately preceding the prescribed date.

(In the case of Unions of States, however, it is obviously impossible to adopt a three-year period ; accordingly, only the last complete financial year before the prescribed date can be taken as the “basic period”, except in regard to Railway revenue for which a three year period may be taken, as audited figures are likely to be available for all those years).

(b) In regard to expenditure, only the last completed financial year of the State immediately preceding financial integration.

Individual items of revenue are liable to fluctuate in either direction ; and a three-year average for revenues, wherever reliable accounts are available, is thus fully justified.

In the case of expenditure, however, having regard to the trend in recent years, the level is hardly likely to go below that reached in the latest year; we have accordingly adopted that year as the basis for our purposes.

The fixation of the basic period in the case of Rajasthan Union presents certain special difficulties; these are dealt with in the separate Chapter for that Union (Chapter VIII).

Plan of Part
II of Report.

5. Certain administrative, legal and other matters of general importance will arise in most States in connection with the taking over by the Centre of all "federal" revenues and expenditure, and of the administration of the Departments concerned therewith. These—with the exception of those relating to Income-tax—are dealt with in Chapter II; matters connected with Income-tax have been dealt with in the Annexure appended to Part I of our Report.

The basic principles governing the allocation and apportionment of assets and liabilities between the States and the Centre, as set out in Part I of our Report (Paragraph 25) are further elaborated in Chapter III by reference to a more detailed classification of assets and liabilities into appropriate categories.

Then follow, in separate Chapters (IV to IX), the integration schemes for individual States. Each of these (hereinafter referred to as "Scheme-Reports") is in two Sections—A and B. The plan of these Sections is explained below.

Plan of "Scheme-
Reports"; Section
A :—

6. *Section A* of each Scheme-Report is concerned with—

- (a) computing the net revenue effect upon the State, of federal financial integration as a result of—
 - (i) the transfer of "federal" revenues and expenditure to the Centre;
 - (ii) the termination of all "immunities";
 - (iii) the abolition of internal customs duties;
- (b) evolving a scheme of transitional financial (revenue) adjustments between the Centre and the State, consistent with the main principles (summarised in paragraph 2 above) and in accordance with the general plan recommended in Part I of our Report (paragraph 32);
- (c) dealing with certain specific matters relating to "federal" revenues or expenditure, "federal" Service Departments, internal customs, etc. which arise only in the particular State with which the Scheme-Report is concerned.

For purposes of (a) above, Section A of each Scheme-Report is accompanied by two computational "Statements"—described as Statements I and II. The first shows the revenues (or the revenue value of certain "immunities") which will be lost to the State as a result of federal financial integration; it thus includes (i) "federal" revenues which will pass to the Centre, (ii) the value of certain "immunities" which will be extinguished, thereby resulting in a corresponding "gain" to the Centre, and (iii) revenues which will be lost

to the State without any corresponding gain to the Centre, *e.g.*, revenue from internal customs duties. The second statement shows the expenditure which will be saved to the State as a result of federal financial integration ; it thus includes (i) the cost of collection of federal revenues, (ii) the expenditure hitherto incurred by the State on "federal" Service Departments, and (iii) expenditure connected with departments (such as that of "internal" customs) to be abolished.

The figures embodied in these two Statements are purely illustrative, and are subject to the following limitations :

- (1) even from the purely computational point of view, many of the figures in these Statements will require further scrutiny and correction in the light of the remarks embodied in the "Notes" appended to them ;
- (2) furthermore, when decisions are taken concerning some of the matters referred to in Part I of our Report and in Chapters II and III of this Part, or on some of the specific issues raised or recommendations made in particular Scheme-Reports, further modifications of these figures may be necessary ;
- (3) finally—and most importantly—the Scheme-Reports for the States, are based upon the "actuals" of only that (latest) financial year for which figures were readily available, and those for Unions are based only upon the budget (or revised) estimates of their latest financial year.

Accordingly, when these Statements are prepared afresh, in final form for each State, the figures to be inserted will be the actuals of the "basic" period recommended in paragraph 4 above, computed in accordance with the principles followed in preparing the present Statements, having due regard to what is stated in sub-paras. (1) and (2) above.

Nevertheless, the figures upon which we have worked in preparing the integration schemes for individual States, are, we believe, of a sufficient order of accuracy to constitute a basis for drawing valid conclusions both as regards the magnitude of the *net* revenue-result of federal financial integration in each case and the nature of the corresponding transitional financial adjustments required to avoid sudden dislocation of the States' financial structure.

Though conforming to a general plan, the details of each scheme of transitional (revenue) adjustments between the Centre and the State must necessarily vary from State to State, if fundamental differences in basic facts are not to be ignored.

And Section B.

7. *Section B* of each Scheme-Report contains a detailed working of the allocation and apportionment of assets and liabilities of the State, consequent upon federal financial integration, in accordance with the detailed exposition of principles set out in Chapter III of this Part.

These workings are also merely illustrative, based as they are upon the figures (actual or estimated) at dates different from the prescribed date ; they will, therefore, have to be computed afresh on the lines there indicated.

Legal Basis,
Agreements,
under Article
258(1).

8. The legal basis for these schemes will be as " Agreements " entered into between the Centre and the States under Article 258(1) of the Draft Constitution. It is important that these Agreements should embody all the principal points concerning which we have made recommendations, either in the Scheme-Reports themselves or in Part I of our Report read with Chapters II and III of this Part.