

CHAPTER III

ALLOCATION OF ASSETS AND LIABILITIES (GENERAL)

13. The basic principles to be followed in the matter of allocation and apportionment of assets and liabilities between the States and the Centre have already been outlined in Part I of our Report (paragraphs 25 and 30).

We now explain in detail the application of those principles to the various categories of Assets and Liabilities.

14. Assets and Liabilities have to be considered under the following categories :

Classification
of Assets and
Liabilities

Assets :

(a) *Specific Capital Assets*, i.e., Specific assets of a more or less durable character, consisting of :—

(i) “Unproductive” Assets i.e., assets not capable of yielding any revenue ; and

(ii) “Productive” Assets i.e., assets yielding (or capable of yielding) revenue.

Any “specific debt” connected with these assets will go with them.

(b) *Current Assets*, i.e., liquid assets, such as Cash and Bank Balances, Investments, Securities, Current loans and advances, etc.

Liabilities :

(a) *Current or Banking Liabilities* which are of the nature of current obligations, essentially of a ‘banking’ character, payable to “outsiders”, (e.g., Bank overdrafts, Savings Bank Deposits, Provident Fund Deposits, Insurance Funds, Sinking Funds, Trustee Liabilities, etc.) ;

(b) Liabilities in respect of various *Funds* and *Reserves* ;

(c) *Permanent debt* (Public Debt), excluding “specific debt” in connection with capital assets already referred to above.

15. For the reasons explained in Part I of our Report, “productive” and “unproductive” specific capital assets, together with the Al
Cap

“specific debt” (if any) associated with them, must be allocated to the Centre or the State concerned on a ‘functional’ basis ; no “compensation”,—in the form of payment of market value or cost according to books—will be payable.

No “account” can be prepared of unproductive capital assets to be so allocated, nor is it necessary to do so. They will consist mostly of lands and buildings, aerodromes, laboratory equipment, furniture etc., actually in use by the various Departments. The Central Government should take over, by inventory on the prescribed date, such of these assets as are connected with “federal” functions and services or with “federal” revenues ; the State will retain the rest.

Similarly, the Central Government should take over all specific productive capital Assets connected with “federal” functions or services or with “federal” revenues, *e.g.*, Railways, Communications, Broadcasting, Mint, etc., together with any “specific debt” associated with them. The book values of these assets are known and must be transferred as such to the books of the Central Government.

The Funds and Reserves (*e.g.*, Railway Depreciation Funds and Reserves), and other balances (Deposits, Advances, Cash Balances etc.) connected with the Capital Assets allocable to the Centre as above should also be taken over by the Centre as from the prescribed date ; the treatment of these Funds and balances for the purpose of financial (capital) adjustments between the Central Government and the State is dealt with in paragraph 16 below.

Some of the States (*e.g.*, two Covenantee States of the Madhya Bharat Union) have been allowed to contribute towards the cost of parts of the Indian Railway System lying within State territory. In some cases, this took the form of an outright capital contribution on a profit-sharing basis ; while in others the States’ contribution was treated as “Permanent Debt” of the Government of India, at a guaranteed rate of interest, with or without a share of surplus profits. All such contributions constitute the “capital at charge” of these Railways. The entire amount so contributed was clearly intended to be, and must be regarded as, an investment in a permanent capital asset of a “federal” nature. Moreover, the terms of the Agreements under which these arrangements were made require that the States should not part with their interest in these investments to any outside party. In the circumstances, these assets must clearly be allocated to the Centre as specific Capital Assets of a “federal” character which cannot remain with the State upon federal financial integration.

All other productive capital assets, namely those associated with “provincial” functions will remain with the States concerned.

16. We now consider the allocation of the liquid or 'banking' assets and current liabilities, Funds and Reserves.

Allocation of
Liquid Assets
Current Liabilities,
Reserves
and Funds :

(a) The proper procedure here is first to allocate the "current" and funded liabilities of the State between the two "successor" Governments—*i.e.*, the Centre and the State—on a "functional" basis. All current liabilities and deposits connected with or arising out of "federal" functions and Service Departments, or related to "federal" revenues or capital Assets must be taken over by the Centre. The only exception would be where a contrary procedure would be justified on grounds of public convenience. For example, the liability for *Postal* "Savings Bank Deposits" would have to be taken over by the Centre, unless (for special reasons) the State postal department is not taken over by the Indian Posts and Telegraphs Department immediately upon federal financial integration; in the excepted case, as also where the Savings Bank Deposits are in the *State Treasuries*, the liability may well be allowed to remain with the State on grounds of public convenience.

All funded liabilities should be similarly allocated to the Centre or to the State on a "functional" basis; *e.g.*, "Village Uplift Fund", "Famine Relief Fund", "Irrigation Fund" etc., being "provincial" should remain with the State, while "Railway Development Fund", "Telephone Fund" etc., being "federal" must go to the Centre.

"Non-specific" Funds and Reserves present some difficulty, because their objectives are not always clearly classifiable as either wholly "provincial" or "federal". Where such is the case,—as for example, in regard to "Post-War Development Funds"—we recommend that these funds should be *apportioned* between the Centre and the State on some equitable basis, *e.g.*, with reference to future 'needs' and/or the anticipated liability in respect of development schemes in progress.

(b) Following these principles, we have included in the Scheme-Report for each State an analysis of the liabilities of the State arranged in their "order of priority" under the following categories, beginning with liabilities to "outsiders" and ending with non-specific Funds and General Reserves :

- (A) ' Banking ' or Current Liabilities.
e.g., Savings Bank Deposits,
 Insurance Funds,
 Provident Funds,
 Departmental Deposits etc.
- (B) Specific " Functional " Funds and Reserves.
e.g., Famine Relief Fund,
 Police, Jail and Military Funds etc.
- (C) Specific Capital Reserve Funds etc.
e.g., Railway Capital Reserve Fund,
 Electric Schemes Reserve Fund etc.
- (D) Non-Specific Funds and General Reserves,
e.g., Revenue Reserve Fund,
 Post-war Reconstruction Fund.

The above classification does not cover Public Debt which stands in a category by itself.

- (c) The next step is to consider how the current or liquid *assets* of each State should be allocated and apportioned. These include mainly cash and bullion, bank deposits, shares held in companies, investments in Government Securities, current loans and advances ; an analysis of such assets for each State is included in the respective Scheme-Reports.

The *primary* rule should be that the Centre and the State should each be given sufficient liquid assets to meet the liabilities or Funds allocated to it on the lines indicated above ; and within this over-all limit, each Government must, so far as possible, take up those specific items of liquid assets or investments which are appropriate to the liabilities allocated to it and/or to its functions.

In this connection, we make the specific recommendation that the allocation of any Reserve or Fund (in whole or in part) to the Centre must be regarded as entailing a special obligation on the Centre to ensure that the liquid assets so transferred to it with such Fund or Reserve are expended *within the State* concerned on those objectives for which the Fund or Reserve was intended. The States naturally attach a great deal of importance to this principle.

- (d) The treatment of Depreciation Funds requires special mention. Where such funds are specifically invested, they must be

allocated as such between the Centre and the State on a "functional" basis, together with the liquid assets in which they are so invested. For the rest, we consider that the amounts at the credit of such funds should be taken in reduction of the book values of the assets concerned, except to the extent that investments (in the shape of "current" or liquid assets) are actually available, *after* providing for *all* current liabilities and funded obligations.

17. The allocation of items of liability or funds to the Centre or to the State in accordance with the foregoing principles will not confer any financial advantage or disability upon either, so long as an equivalent allocation of current or liquid assets can be made to meet such liabilities. It is therefore necessary at this stage to consider the *modus operandi* in the event of there being—

(a) a surplus of current or liquid assets, after providing for all liabilities including Funds; *or*

(b) an excess of current liabilities, Funds or Reserves over liquid assets:

on the date of federal financial integration. This is dealt with below.

18. Any surplus of liquid assets or investments after providing for all liabilities, Funds and Reserves, must first provide for uninvested Depreciation Funds in full [Para. 16 (d) above]; and against the balance must be set off the Public Debt, if any. If there should still be a net surplus at this stage, it should be apportioned between the two "successor" Governments on some equitable basis, *after* making adequate provision for the depreciation in value of commercial investments such as shares, debentures, etc.

Apportionment
of overall
"surplus" of
liquid assets.

After a careful search for a proper basis for such apportionment, we are satisfied that the answer lies in the relative "needs" for expenditure in the "federal" and "provincial" fields respectively. While the surplus would mostly be required for expenditure in the "provincial" field on schemes of reconstruction and development, the "federal" needs in the States concerned cannot be wholly ignored. We accordingly recommend that the share to be apportioned to the "Centre" should be fixed at 10 per cent. of the residual net surplus. This amount must, of course, be ear-marked for expenditure by the Centre upon schemes of "federal" character such as would be of direct benefit to the people of the State concerned; and in the choice of schemes, the State Government should be consulted.

In many States, there are already "sanctioned" schemes in progress or about to be started in the near future both in the "federal" and in the "provincial" fields; in such cases, we suggest that the over-all net residual surplus of current assets should first be regarded as ear-marked against sanctioned schemes, to the extent of the estimated future liability in respect of those schemes, before arriving at the figure for "surplus" liquid assets available for apportionment on the *ad hoc* basis proposed by us.

Apportionment
of "uncovered"
liabilities :

19. We indicate below the procedure to be adopted in the event of there being an excess of liabilities over available liquid assets.

(i) *Depreciation Funds* (not specifically invested)—There can, in such circumstances, be no question of providing any liquid assets against Depreciation Funds; such Funds should therefore be taken in reduction of the book values of the assets concerned.

(ii) *Other Funds and Reserves*.—As regards the remaining liabilities, it is clear that uncovered liability in respect of "Funds and Reserves" must be distinguished from liabilities owing to "outsiders" in respect of moneys or benefits "had or received". The former is not a debt due to anyone; the latter is. The true nature of the liability in respect of Funds of this type is a *liability to incur expenditure*, (a) for the purposes for which the Funds were created, and (b) to the extent to which liquid assets are in fact available. When assets are *not* available, the Funds must be regarded as exhausted or extinguished to that extent.

But even if this last point were ignored, on the ground that assets *must* have existed when the Funds were created and that, to the extent of the shortage, those assets must have been *properly* spent (*e.g.*, by being spent on unproductive assets, both "central" and "provincial") though not accounted for as such, then clearly the matter is merely one of accounting procedure, which can now be rectified by tracing back the expenditure so incurred and writing it off against the "uncovered" balance of the Funds. There will then be no "uncovered" balance of this type of liability to be "allocated"; and nothing more will remain to be done since, on the principles already stated, there can be no question of the Centre having to *pay* anything for any unproductive "federal" assets allocable to it on a functional basis.

There is, therefore, no "allocation" to be made in respect of such uncovered "liability"; and no financial adjustments need accordingly be made between the Centre and any State on this account. All that is required is a procedure for extinguishing these "unrequitable" Funds, in the reverse order of priority.

It will be seen from the order of priority in which the liabilities have been grouped in paragraph 16 (b), that those falling under Sections (A) and (B) are either "outsider" or "earmarked" liabilities which *must* be met, whereas those under Sections (C) and (D) are in the nature of Funds or Reserves. It follows that any excess of liabilities (as thus grouped) over current assets must *first* be treated as extinguishing the Funds grouped under Section (D) and next those under Section (C). In so extinguishing these Funds and Reserves, the 'federal' portion if any, of each such Fund or Reserve may, as a matter of justifiable concession, be treated as extinguished before the 'provincial' portion.

(iii) *Public Debt and Liabilities to "outsiders"*.—The only remaining items to be considered are the *net* amount of "uncovered" liabilities to *outsiders*, together with the *net* public debt (other than specific debt relatable to particular Capital Assets), after deducting any sinking fund provision already made. The Centre must accept a share of this liability; and we recommend that in all such cases the Centre's share should be worked out in proportion to the *net* book values (after deducting "specific" debt and the "uncovered" Depreciation Funds, if any), of the specific "productive" Capital Assets allotted to the Centre and to the State, respectively.

20. We recommend that all running, or "continuing" liabilities and outstandings in each "federal" Department (whether on Capital or Revenue account) should be taken over by the Centre. They will consist of all outstanding claims for and against Government, including refund claims, pending bills for supplies, stores, contracts, services and contingencies etc., and all uncollected "federal" revenues, whether assessed or not. In view of the "cash basis" of accounting followed by all Governments, there will ordinarily be no "account" balances to be brought on to the books of the Centre in respect of these items; but an inventory, so far as possible, should be prepared by each Department at the time of taking over.

Outstanding obligations and Revenues not shown in accounts.

We must point out here that Capital expenditure on specific "productive" assets which may have accrued (but not been paid) on the date of federal financial integration, and which would be paid *after* that date by the Central or State Governments as the case may be, in accordance with the foregoing recommendation, should be taken into account in determining the book value of these assets for the purpose of apportionment of any uncovered "public debt" and obligations to "outsiders", in pursuance of the recommendation made in sub-para (iii) of the preceding paragraph.

Inter-Governmental outstandings accrued, but not settled, by the prescribed date.

21. The list of accounted assets and liabilities will not ordinarily include certain important items of *current* inter-governmental outstandings. Thus, it is possible that Central Excise collections would have been taken to the credit of State Revenues, pending payment of the amount due to the Government of India under the pooling arrangements. Similarly, a State's share of Customs Revenue, or of *net* receipts from Railways ("worked lines"), accrued upto the date of federal financial integration but not actually paid by the Centre, would not normally be included in the State's statement of assets. There are likely to be several items of this kind which, though not important individually, may amount in the aggregate to a substantial sum. Outstanding items of this nature clearly fall in a different category from the "unaccounted" arrears of revenue and pending obligations to outsiders, referred to in the preceding paragraph, and they cannot obviously be merely "written off". We recommend that all inter-governmental claims of this description between the Centre and the States, in respect of transactions up to the prescribed date (whether accounted for or not), should be settled in due course, by cash payment on either side, notwithstanding the coming into force of federal financial integration.

E.P.T. Deposits, Advance Payments of Tax, etc.

22. The liability for refundable Deposits, if any, (and for the refundable portion of E.P.T.) received by the States in connection with E.P.T. assessments (whether provisional or final) should be taken over by the Centre as a current or banking liability of a "federal" character, [paragraph 16(a) above], except where, as in some States, only Deposits were received but no assessments were made; in the excepted cases it would be more convenient to the public if such deposits were repaid or dealt with by the States themselves in accordance with the arrangements under which such deposits were first received.

Amounts collected in States under "provisional" assessments, or under "Pay-as-you-Earn" Schemes,— whether credited to

revenue or not—should be treated not as an outstanding liability (for inter-governmental adjustments) but as “revenue” creditable to the States prior to the prescribed date. The Centre will, however, be under obligation to give credit to the assesseees in respect of such payments in the assessments concerned.

23. Some States have raised the question of the payments now being demanded by the Central Government in respect of buildings and other capital Assets in “retroceded” areas such as the Mysore Assigned Tract and the various “Residency areas.” While the claims for such payments were doubtless in order in the circumstances in which these retrocessions occurred, we are of opinion that in the context of federal financial integration, the issue must necessarily be approached on the “functional” basis, founded upon the concept of Provinces and States as equal partners in the future Union of India to which we have already referred. So considered, there can, we think, arise no claim for “compensation” in favour of the Centre in respect of assets previously used (by the Centre) in the areas concerned for functions which were “provincial” according to the Constitution.

Buildings and other Capital assets in “Retroceded” areas.

24. Certain points of detail which arise in connection with particular items of Assets and Liabilities in certain States are dealt with in the respective Scheme-Reports. Reference must, however, be made here to Savings Bank Schemes, Life Assurance Schemes and Accident Insurance Funds, administered by some States. We assume that *constitutionally* there would be no objection to the States continuing to administer these schemes, after federal financial integration, if they should prefer to do so, except in the case of State *Postal* Savings Banks which must of course be taken over by the Centre along with the State Postal Systems.

Certain Specific matters relating to particular items of Assets and Liabilities.

We consider, however, that the interest rates on States Savings Bank Deposits and on future issues of States Savings Certificates (if such separate issues be permitted) should be assimilated to the Government of India rates. Existing “tax-free” rights, if any, attached to interest on Savings Bank Deposits may also be continued in respect of accounts and deposits existing on the date of federal financial integration.

The Central Government should also recognise and allow the continuance of “tax-free rights” attached to any Public Loans of the States outstanding on the prescribed date.

25. The question was raised by certain States as to whether federal financial integration would affect their powers to borrow in the open market. In our opinion, there should be no difference in this respect between State Governments and Provincial Governments.

Borrowing Powers.

The States must, however, accept all such 'working limitations' upon unrestricted borrowing as the Central Government and the Provinces generally (including the States) may mutually agree upon in order to eliminate uncoordinated or competitive Governmental borrowing.

Banking and
Treasury ar-
rangements.

26. With the taking over by the Centre of the responsibility for direct administration of Departments connected with Central Revenues and Central Services, it will be necessary to extend to the States the Rules and Regulations connected with Banking and Treasury procedure of the Central Government in so far as transactions of "Central" Departments are concerned. It will also be desirable that the Banking and Treasury arrangements of the States themselves in respect of "Provincial" transactions should be similar to those prevailing in Provinces. We have not examined this aspect of the matter in detail ; some of the State Governments represented that their existing arrangements were adequate and were working smoothly ; but we desire especially to draw the attention of the Government of India to the fact that the existing arrangements appear to be far from satisfactory in some of the Unions. We recommend that consideration of the question should be taken up by the Government of India separately, as soon as possible, in consultation with the Reserve Bank.

Ways and
means.

27. There is one other matter which may be conveniently referred to here, namely, the effect on the 'ways and means' position of the individual States of the various changes introduced as a result of federal financial integration. All collections of 'federal' revenues would be credited direct to the Government of India after the prescribed date, while the State Governments themselves would have to finance, in addition to their own current expenditure, all expenditure on 'federal' subjects entrusted to them for administration on an "agency" basis. Further, most States would also have heavy commitments in respect of foodgrain purchases. It will therefore be necessary to provide for regular quarterly 'on-account' payments being made by the Government of India to the States based on the best estimates of (i) the guaranteed annual payments referred to in our Scheme-Reports for the individual States (ii) any food subsidies in respect of imported foodgrains and (iii) the amount to be reimbursed in respect of expenditure on 'federal' subjects entrusted to them for administration on an "agency" basis. The 'on-account' payments thus made will be subject to final adjustment in due course, after the accounts for each year are closed and figures of the actual amounts payable become available.