

II. FINANCIAL RELATIONSHIP BETWEEN THE CENTRE AND THE STATES—CONSTITUTIONAL AND ECONOMIC POSITION

6. In the Government Resolution constituting the Committee it is explained how the question of the financial relations between the Centre and the States arose in connection with subsidies to States to meet the loss resulting from the sale of imported foodgrains in their areas at prices fixed by the Government of India. This question of financial relations is, however, only one aspect of the entire ambit of relationships between the Central Government on the one hand and the States on the other in an Independent India and should be examined in that wider context.

Financial Relations between States at Centre, part of wider question of general relations.

7. Prior to the 15th August 1947, Provinces and States developed on different lines—the former under the Governor-General in Council exercising the powers vested in him by Government of India Acts and the latter under the Governor-General in Council upto 1935, and later under the Crown Representative exercising undefined powers in the name of “paramountcy”.

“Paramountcy,” the basis of relations between States and Centre in the past.

Geographically, however, India is one ; Provinces and States lie interspersed all over the continent, the boundaries being in most cases artificial and not representing any natural divisions ; and all parts of the country are interlinked. With the development of India, the range of matters of common concern between Indian States on the one hand and the rest of India on the other became wider and wider and it was essential to secure co-ordinated action in both halves of India in the larger interests of the country as a whole.

Circumstances compel uniformity in matters of common concern, such as:

In Provinces this was easy enough. The Governor-General in Council could issue orders and have them carried out. In States, however, the Governor-General in Council had to act in a different capacity. He—and from 1935 the Crown Representative—invoked his “paramountcy” powers and, in the course of decades, an elaborate network of agreements and codes based on “grant, usage, sufferance etc.” came into existence covering an infinite variety of matters in order to regulate relations between what was called “British India” and the States and to ensure that action was taken in the States in furtherance of policies conceived in the interests of India as a whole.

The most important among matters of common concern was Defence and the relationships evolved under this head were political in character and covered a very wide field. These may be grouped under three heads. Firstly, the Indian Army was for the whole country ; and for

Defence

its efficient functioning the Paramount Power entered into detailed arrangements with States for "securing what is necessary for strategic purposes in regard to roads, railways, aviation, posts, telegraphs, telephones and wireless, cantonments, forts, passage of troops and the supply of arms and ammunition". Secondly, Indian States maintained troops, and schemes were introduced under which their number, arms and equipment, and the roles assigned to them were regulated. Thirdly, another class of relationship coming under 'defence' arose out of the obligation of the Paramount Power to protect States against rebellion or insurrection. In important States like Hyderabad and Baroda, troops from the Indian Army were stationed for this purpose under special treaties, but the obligation itself was a general one applying to all States alike. This obligation carried with it the responsibility to intervene and prevent misgovernment; and the Paramount Power laid down, as individual cases arose, the circumstances in which it would interfere with the internal administration of States "for the benefit of the Prince, of the State, of India as a whole".

Economic and Fiscal matters.

So much for the field covered by political relationships evolved under 'paramountcy'. Then, there were economic and fiscal relationships. Among the former were arrangements for the working of the Indian Railway system in Provinces and States alike, and for the working of the railway systems owned and operated by Indian States on essentially the same principles as the Indian Railway system in regard to safety, rates etc. Similar co-ordinated arrangements existed for posts and telegraphs, telephones etc. Among fiscal matters may be mentioned agreements with maritime States for sea customs and those with all States for the effectuation of the salt monopoly and abolition of all barriers to trade.

Emergence of Agreements and Codes, in exercise of 'Paramountcy'.

In this way, the inherent necessity for concerted action in matters of common concern was recognised, and numerous agreements and codes built up steadily over a long period. It was by the exercise of paramountcy that these agreements and codes were brought into existence, modified from time to time to suit changing conditions and enforced whenever necessary. And in this way India attained a large measure of working unity. The second world war strengthened these political and economic bonds, under the need for concerted war efforts.

The Indian Independence Act; lapse of "paramountcy" and of the "codes" built upon it;

8. With the attainment of Independence by India, however, there came a complete change. Under Section 7 of the Indian Independence Act, the "suzerainty of His Majesty over Indian States" lapsed. With this also lapsed the entire code referred to above except for 'provisions of any.....agreement which relate to customs, transit and communications, posts and telegraphs or other like matters', until they were denounced by the Ruler or the Dominion.

A void was thus created. For instance, all arrangements in the whole of the field covered under "defence" as set out above came to an end. This was a serious state of things, specially at a time when post-war conditions demanded more co-ordinated and unified action over the whole country than ever before.

the resultant void,

But the logic of facts is more powerful than legal formulæ ; and India and the States could not afford the severance or loosening of ties which had been forged over a long period of a century and had become integral parts of their political and economic systems. This was appreciated by the States and as the result of consultations in July 1947 almost all States, with the exception of Hyderabad, Kashmir and Junagadh, 'acceded' to the Dominion in the three subjects of Defence, External Affairs and Communications with effect from the 15th August 1947 and also executed "stand-still" agreements which maintained the existing 'codes' in regard to most matters of common concern. (Kashmir also acceded in October 1947 and executed the same stand-still agreement.) This was an epoch-making event. For the first time in the history of India the States came into a defined 'constitutional' relationship with the Central Government ; and Central legislation, within the defined sphere, could be applied to States exactly as in Provinces.

was filled by Instruments of Accession and "Standstill" Agreements ;

thereby establishing a "constitutional" relationship with Centre.

Soon another important step was taken in the same direction. When States were formed into Unions approximating in size and resources to Provinces, a wider field of "accession" was considered necessary.

Accession by Unions etc. over a larger field of subjects.

Saurashtra Union
Madhya Bharat Union.
Vindhya Pradesh Union.
Patiala & E. P. S. Union.
Rajasthan Union
Travancore -Cochin Union

All the Unions* have now acceded to the Dominion of India in the subjects comprised in List I (Federal) and List III (Concurrent) of the Seventh Schedule to the Government of India Act, 1935, as adapted by the India (Provisional Constitution) Order, 1947, with the exception of those relating to finance and taxation. Mysore has also accepted similar accession; Hyderabad and Kashmir alone remain out of this field of wider relations.

9. Concurrently with this, States are taking part through their representatives in the Constituent Assembly of India and are assisting in the task of establishing new relationships between States on the one side and the rest of India on the other which would accord with present day conditions. All States except Hyderabad are now represented on the Constituent Assembly.

Participation by States in the Constituent Assembly of India.

New basis : the
'Objectives'
Resolution ;
fundamental
principles of
new constitu-
tion.

10. In the ' Objectives ' Resolution, the Constituent Assembly has unanimously accepted the fundamental principles that should govern the new constitution. The portions of this Resolution relevant for our present purposes are :—

“ This Constituent Assembly declares its firm and solemn resolve to proclaim India as an Independent Sovereign Republic and to draw up for her future governance a Constitution :

(2) WHEREIN the territories that now comprise British India, the territories that now form the Indian States, and such other parts of India as are outside British India and the States as well as such other territories as are willing to be constituted into the Independent Sovereign India, shall be a Union of them all ; and

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(4) WHEREIN all power and authority of the Sovereign Independent India, its constituent parts and organs of Government, are derived from the people ; and

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Union of India
consists of Pro-
vinces and Sta-
tes, as equal
partners.

The essential points in the new relationship are that there shall be a Union of India in which Provinces and States shall be equal partners and in which all power and authority are derived from the people. (It is unnecessary to mention that a system of constitutional monarchy in Indian States is not incompatible with a Republican constitution for India). The bearing of this on the position of States in Independent India—in so far as they concern our terms of reference—should now be examined.

Powers and func-
tions of Centre
should be uni-
form in Provin-
ces and States;

11. From the concept of States and Provinces as equal partners it inevitably follows that the Central Government should function in States over the same range of subjects and with the same powers as in Provinces. It is only in this way that the Union of India will gain in strength and its policies in effectiveness. There is no federation in which the Central Government possesses different levels of power and authority in the units comprised in it. Such differences in jurisdiction from unit to unit are bound to be a source of weakness and to produce a sense of unfairness among the less favoured units which will be fatal to friendly relations and orderly progress.

12. Another result that follows is that the Central Government should act through its own officers for the exercise of its important functions in States in the same way as in the Provinces. Centre should act through its own officers in States as in Provinces ;

In all federations, the federal Government has its own organised services spread over the whole of its area. It is a recognised feature of the federal system " that general and regional Governments both operate *directly* upon the people ; each citizen is subject to two Governments ". Further, for the federal Government to rely on the agency of States to carry out its policies will lead to conflicts.

13. Uniform sources of federal revenues and, consequently, equality of the basis of contribution to federal finances follow necessarily from the concept of the sovereignty of the people and equality of Provinces and States. Centre should have uniform sources of revenue in States and Provinces.

When paramountcy existed, inequality in financial contribution between Provinces and States was possibly unavoidable. The Butler Committee put the case for this thus :—" But, whether or not a State makes a contribution to the cost of defence, the Paramount Power is under a duty to protect the states. It follows from this duty of protection, first, that the British Government is bound to do everything really necessary for the common defence and the defence of the states ". This basis no longer exists ; it has been substituted by the concept of equality of Provinces and States, founded upon the sovereignty of the people of the whole of India including the States. It follows that States should contribute to federal finances like Provinces ; it follows further that they should also receive grants and all other forms of financial and other assistance from the Centre just like Provinces.

14. The new relationship between the States and the Union of India should thus rest on the following principles :—

- (i) The Union Government should have authority in States over the same range of subjects as in Provinces.
- (ii) The Union Government should exercise its functions in States through its own administrative agency as in Provinces.
- (iii) The States should contribute to the finances of the Union on exactly the same basis as the Provinces and receive grants and other forms of financial assistance on the same basis.

New relationship between the States and the Centre, summarised.

It is not for the Committee to say how effect should be given to this in the new constitution;—whether, for instance, the provision for a process of " accession " by individual States embodied in Article 225

should be enacted or whether the constitution, — or at least the federal portions of it—should apply to these units automatically as it applies to Provinces. This is for the Constituent Assembly to decide.

Its result,—complete federal integration in all spheres including Finance.

15. What we have said above practically amounts to this—that under the new set-up, the Union of India will conform to the pattern of other Federations and function with the same rights and obligations throughout the country, and that all the units will likewise have equal rights and obligations. Only so can the Union of India make an effective contribution to the solution of the difficult economic problems that face India, meet the strains and stresses of the post-war world and maintain national unity. The States themselves will also derive substantial advantages among which the following may be mentioned :—Firstly, their people and Governments will take their place in the polity of India alongside of the people and Governments in the rest of India and share in its wider life with equal rights and obligations. Secondly, administrative standards and efficiency will increase by closer contacts with the administration of the Central Government and especially by the uniform accounting and audit system which will result from the supervision of the Auditor-General of India, recruitment to the higher services on an all-India basis, a unified judicial system and access to technical advice and assistance furnished by the Central Government. Thirdly, States will have their share of such federal revenues as may be made divisible from time to time and of the grants, loans and other forms of financial assistance given by the Centre, on the same basis as Provinces; an impetus will thus be given to development programmes in these areas.

The urgent need for federal fiscal integration;

16. The advantages which will be derived by the country as a whole, including the States, from an integrated system of federal finance, operated uniformly by the Central Government throughout the country, cannot be over-emphasised. The following observations of the Joint Parliamentary Committee on Indian Constitutional Reforms (1933—34) indicate that the dangers of uncoordinated fiscal administration in India were fully realised even at that time :—

“ The existing arrangements under which economic policies, vitally affecting the interests of India as a whole, have to be formulated and carried out are being daily put to an ever-increasing strain, as the economic life of India develops. For instance, any imposition of internal indirect taxation in British India involves, with few exceptions, the conclusion of agreements with a number of States for concurrent taxation within their frontiers, or, in default of such agreement, the establishment of some system of internal customs duties—an impossible alternative, even if it were not precluded by the terms of the Crown's

reatic- with some States. Worse than this, India may be said even to lack a general customs system uniformly applied throughout the Sub-Continent. On the one hand, with certain exceptions, the States are free themselves to impose internal customs policies, which cannot but obstruct the flow of trade. Even at the maritime ports situated in the States, the administration of the tariffs is imperfectly co-ordinated with that of the British India ports, while the separate rights of the States in these respects are safeguarded by long-standing treaties or usage acknowledged by the Crown. On the other hand, tariff policies, in which every part of India is interested, are laid down by a Government of India and British India Legislature in which no Indian State has a voice, though the States constitute only slightly less than half the area and one-fourth of the population of India.

Moreover, a common company law for India, a common banking law, a common body of legislation on copy-right and trademarks, a common system of communications, are alike impossible. Conditions such as these which have caused trouble and uneasiness in the past, are already becoming, and must in the future increasingly become, intolerable as industrial and commercial development spreads from British India to the States”.

These difficulties will disappear by the institution of a uniform and integrated federal fiscal system throughout the country. There will then emerge uniformity of law, rates, interpretation and administration of all federal fiscal measures resulting in uniform policies, principles and practice in the levy, assessment, and collection of Central taxes and duties. And tax-evasion, always a serious evil, will be more effectively checked. The abolition of internal customs duties will result in freedom of trade within the country. A co-ordinated trade and tariff policy will have a uniform impact throughout the country. Ports and other important links in the country's system of communications and transport will be free to serve their natural hinterlands. National and regional economic planning on all-India basis will become possible. In this, as in all other respects, the States will play their part, and they will become entitled to all the benefits which accrue from the execution of such plans as require the aid of Central resources and technical assistance.

and its far-reaching advantages.

India will thus have an opportunity to emerge as a well-knit unit, fully integrated in all spheres, political, constitutional and economic. Its essential fundamental unity will be re-enforced.

17. We have now dealt with item 2 of the Committee's Terms of Reference :—

Integration of federal finances desirable and feasible.

“ the desirability and feasibility of integrating Federal Finance in Indian States and Unions of States with that of the rest of India,

to the end that a uniform system of Federal Finance may be established throughout the Dominion of India”.

Our answer to this is that such an integrated system is an essential part of the new relationship between States and the rest of India resulting from the attainment of Independence by India ; that it is feasible ; and that its establishment would be in the best interests of India as a whole and also of the States.