

III. FINANCIAL INTEGRATION--GENERAL PRINCIPLES FOLLOWED BY THE COMMITTEE

18. We now proceed to explain briefly the scope of federal financial integration and the general principles followed by us in preparing schemes for that purpose for individual States.

Scope of federal financial integration.

19. When federal financial integration comes into effect, the following items (*inter alia*) of "Central Revenues" and "Federal" Services together with the administration of the departments concerned should be taken over from the States by the Central Government :—

"Federal" Revenues and Expenditure of States to be taken over by the Central Government.

CENTRAL REVENUES :—

- (1) Duties of customs including export duties.
- (2) Income-tax and Corporation tax (excluding agricultural income-tax).
- (3) Central Excises.
- (4) Railways.
- (5) Posts, Telegraphs and Telephones.
- (6) Opium (so far as regards cultivation and manufacture or sale for export).
- (7) Taxes, other than Stamp Duties, upon transactions in Stock Exchanges and " futures" markets.
- (8) Taxes on the Capital value of assets (exclusive of agricultural land) of Individuals and Companies ; and on the Capital of Companies.

(9) Salt.

OTHER " CENTRAL " SERVICES :—

- (1) Defence. (" I.S.F " Units only).
- (2) Aviation.
- (3) Broadcasting.
- (4) Meteorology.
- (5) Archaeology.
- (6) Geological Survey.
- (7) Patents, Copyrights, Trade marks.
- (8) Registration of Joint Stock Companies.
- (9) National Highways.
- (10) Currency, Coinage and Mints.
- (11) Accounts and Audit.

It will be observed that in our view federal financial integration in States involves not merely the taking over of all their "federal" revenues by the Centre, but also the assumption of all expenditure in States upon Departments and Services of a "federal" character. The extent to which their *administration* need also immediately be taken over is a different question which we have considered separately ; for the present we are concerned with making it clear that any financial integration of this kind, whether considered, as we think it should be, on the wider "functional" basis—(paragraphs 11 to 15)—or on the narrow financial basis, necessarily involves that the Centre must undertake also the financial responsibility for all expenditure of a "federal" character in the States.

Accounts and Audit.

20. Considered strictly in terms of the Draft Constitution, Accounts and Audit need not necessarily become 'Central' by reason merely of the existing practice in the provinces, since Articles 210 and 211 of the Draft Constitution allow an option, which in principle States are entitled to exercise, to have their own organisation in this respect, subject to the powers conferred upon the Auditor-General of India under Clause (6) of Article 210. Some States have preferred to exercise this option ; and we have taken this as the basis in preparing our computations of the revenue effects of financial integration. We ourselves would prefer, however, to see the States adopting the Provincial practice in this matter. If this recommendation is carried out, our computations of the expenditure to be borne by the Central Government upon integration of federal finance will have to be suitably modified.

Further points of difference between Provinces and States.

21. There are, further differences between Provinces and States in the following respects :—

- (i) Most of the States derive considerable revenues from internal customs duties upon trade with the rest of India ; in Provinces, such duties are not levied.
- (ii) States maintain armed forces, portions of which are integrated with defence and security arrangements of the Central Government under a carefully devised scheme.
- (iii) States have to pay the Privy Purses of Rulers.

On these points we make our recommendations below.

Internal Customs Duties.

22. As regards internal customs duties upon trade with the rest of India, the Sub-Committee of the Constituent Assembly on Fundamental Rights recommended that they should be abolished as they constituted a serious hindrance to trade. It was felt, however, that this reform, which was needed in the interests of the States themselves, should be effected gradually so that there might be no sudden dislocation of their finances, as the revenue derived from this source constituted a fairly

Large proportion of the total revenues of some States. Accordingly, as recommended by the Fundamental Rights Sub-Committee and the Union Powers Committee and agreed to by the Constituent Assembly, the Draft Constitution provides for the total abolition of all internal customs duties within a period of ten years—Article 16 read with Article 244.

In this connection, in paragraph 83 of its Report, the Expert Committee on the Financial Provisions of Union Constitution recommended as follows :—

“ As a first step it may be arranged that —

- (1) a State shall not in future levy land customs on a commodity on which there is no such duty now ;
- (2) a State shall not after a fixed date, increase the rate on any commodity ; and
- (3) a State levying land customs should grant refunds on re-exports.

Gradual abolition over a period of 10 years should not cause any serious dislocation to the finances of these States, nor can there be any question of paying any compensation to these States, for the simple reason that the Union Government will not gain any corresponding revenue.”

Our reviews of the position of individual States have shown that except in one or two cases there should be no difficulty whatever in abolishing these duties immediately upon the integration of federal finances in the States. In most cases, the immediate financial gains, both direct and indirect, resulting from federal financial integration, together with the estimated receipts from alternative sources of “ provincial ” revenues, —for example, Sales Tax, — and, in one or two cases, some direct financial assistance from the Centre, should enable the States concerned to replace the resultant loss of revenue in the first year following financial integration. Our integration schemes for individual States embody recommendations to this effect. We endorse, of course, the Expert Committee’s recommendation that no compensation should be paid for the abolition of these duties in any case.

23. We referred in paragraph 21 to armed forces maintained by the States. In computing the effects of federal financial integration upon the revenues of States, we have included the cost of the I.S.F. units (*i.e.*, Units of the “ Indian States Forces ” properly so called) as an item to be borne by the Centre. These units have roles assigned to them in defence and internal security arrangements ; and their main

Defence.

tenance should accordingly be a charge on federal revenues. This does not, of course, affect the existing arrangements for the *administration* of those forces.

The "irregular" forces maintained by States are in a different category and do not come into the computation.

Privy Purses.

24. As regards Privy Purses of Rulers, it has been urged before us by most States that the liability for paying these should be taken over by the Centre on the grounds that—

- (i) Privy Purses have been fixed by the Centre ;
- (ii) they are " political " in nature ; and
- (iii) similar payments are not made by Provinces.

Similar arguments have also been urged in regard to political payments made in some States to subordinate chiefs. This question raises constitutional and political issues on which we, as a Committee appointed to report on financial integration, are not competent to advise. We have, therefore, prepared for each State a computation of the financial adjustments required, consequent upon federal financial integration, on the basis that such payments will continue to be made by the State concerned ; but we have also indicated the lines on which these computations would require modification if the liability should be taken over by the Central Government.

" Federal " Assets and Liabilities to be taken over by the Centre.

25. So far we have dealt with the integration of " federal " Revenues and Services. There remains the question of Assets and Liabilities. We indicate below the general principles which should govern their allocation and apportionment between the Centre and the States; a more elaborate exposition of these principles and the detailed workings in accordance with them for individual States are contained in Part II of our Report.

The main principle to be observed in the allocation of assets and liabilities between the Centre and the States is that it should also follow the concept of " functional " division adopted as the basis for the integration of " federal " revenues, expenditure and Service Departments of the States with the Centre. Accordingly, all assets and liabilities, of whatever character, connected with " federal " revenues, expenditure and Service Departments,—paragraph 19—should be taken over by the Centre ; the rest, being associated with " provincial " functions, should remain with the States. No question of payment for the assets so transferred to the Centre can arise ; this is dealt with more fully in paragraph 30 below.

Whether federal financial integration should be gradual.

26. The integration of federal finances affects a wide field of functions and will have important financial and administrative repercussions upon the States. It will be convenient, therefore, to examine at this

stage the first part of our third Term of Reference, which asks us to consider and report

“whether and, if so, the extent to which, the process of so integrating Federal Finance in the Indian States and Unions with that of the rest of India should be gradual and the manner in which it should be brought about ;.....”

27. Our reviews of the finances of States have convinced us that the integration of their federal finances with the Centre, *if unaccompanied by appropriate financial adjustments over a transitional period*, will, in most cases, cause dislocation of their finances and lowering of standards of administration which will cause discontent. The net “revenue-gaps”, *i.e.*, the net short-fall of revenues, resulting from federal financial integration are shown in the separate chapters relating to each State in Part II of our report and we do not propose to repeat the details here. It should be noted, however, that in some cases the net revenue-gaps are *negative* that is, they are favourable to the States and would require appropriate financial adjustments over a short transitional period in favour of the Central Government. The need for proceeding with financial integration cautiously is thus apparent.

We may here invite attention to the following extract from paragraph 2 of the report of the Union Powers Committee :—

“ We realise that, in the matter of industrial development, the States are in varying degrees of advancement and conditions in British India and the States are in many respects dissimilar. Some of the above taxes are now regulated by agreements between the Government of India and the States. We, therefore, think that it may not be possible to impose a uniform standard of taxation throughout the Union all at once. We recommend that uniformity of taxation throughout the Units may, for an agreed period of years after the establishment of the Union not exceeding 15, be kept in abeyance and the incidences, levy, realisation and apportionment of the above taxes in the State Units shall be subject to agreements between them and the Union Government. Provision should accordingly be made in the Constitution for implementing the above recommendation. This is in addition to the recommendations of the Sub-Committee on Fundamental Rights regarding internal customs duties.”

This recommendation has been accepted by the Constituent Assembly. But the “Draft Constitution of India” prepared by the

Drafting Committee, while inserting Article 258 in the Constitution to implement this recommendation, has reduced the maximum period from 15 to 10 years. An amendment has, however, been tabled for restoring the maximum period originally recommended by the Union Powers Committee.

Financial integration need not be gradual, if effected subject to certain transitional adjustments.

28. We have examined the whole problem, in all its bearings. In our view, however, financial integration need not itself be a gradual process ; for we consider that the difficulties set out above are capable of being adequately met by appropriate devices and adjustments over a transitional period. More specifically, we recommend as follows :—

- (1) Integration of federal finances of States with those of the Central Government should not itself be a gradual process. Subject to the temporary limitations indicated below, it should be complete in all essential respects from the outset.
- (2) Except in the case of one or two States, internal customs duties should be abolished simultaneously with the integration of federal finances ; in the excepted cases, these duties may be abolished gradually over a period of three to five years (*cf.* paragraph 22 above).
- (3) The integration of all federal taxes, duties and revenues, (including Railways, Posts * and Telegraphs, Telephones and Currency and Mints) should be complete in *every respect* from the outset. In regard to other " federal " Departments and Services, however, such as Defence, Registration of Joint Stock Companies and Firms, Patents & Trade Marks, etc., their *administrative* integration with the corresponding Central Services and Departments may, in some (or all) States, be a gradual process, if so desired for administrative or other reasons ; but the *financial* responsibility for (and, therefore, the *financial* control over), these Departments and Services should be assumed by the Centre in all States simultaneously with the integration of their federal finances (*cf.* paragraphs 23 above and 39 below).
- (4) In some States, Income-tax cannot immediately be imposed at the full Indian rates ; in such cases, provision should be made for graduating the process in convenient stages (*cf.* paragraph 33 below).

* With the exception of the "Anchal" Service in the Travancore—Cochin Union.

- (5) During such transitional period as may be provided under Article 258, financial adjustments will be necessary between the Centre and the State Governments in order that the process of reaching complete parity with Provinces at the end of that period may not throw an undue burden upon either (cf. paragraph 32 below).

In brief, our answer to the first part of item (3) of our Terms of Reference is that we are satisfied that the process of financial integration in States should not itself be gradual; all that is necessary is to provide for a measure of gradualness in the full effect of its impact in the directions and to the extent indicated in sub-paras (2) to (5) above; and for that purpose we regard the period of 10 years provided in Article 258 of the Draft Constitution as necessary, especially for the transitional financial adjustment between the Centre and the States proposed by us (cf. paragraph 32).

29. We shall now deal with the fourth of our Terms of Reference—

“the results of such a policy of integrating Federal Finance upon the finances of Indian States and Unions and the consequential financial adjustments and relations which should subsist between the Governments of the Indian States and Unions on the one hand and the Government of India on the other.....”

Financial consequences of federal financial integration.

30. A general question which arises in this connection at the very outset and to which we have devoted much attention and which we have also discussed with the Governments concerned, is whether, upon the integration of their present “federal” functions and finances with those of the Union of India, States are entitled to “compensation”, in the form of payment of market value or capital invested according to accounts,—for the “federal” assets transferred to the Central Government. The most important of these assets are the Railway systems in States.

No “Compensation” payable for “federal” assets passing to the Centre; but—

We have no doubt whatever that the question of compensation in this form does not arise and cannot be raised.

We shall first take the case of a State like Baroda, which is being “merged” in the Bombay Province. The constitutional position here is that the Ruler of Baroda, by agreement with the Dominion Government, cedes to the Dominion “full and exclusive authority and jurisdiction and powers for and in relation to the governance of the State”. The Dominion Government thereupon takes over all the “Federal” or “Central” functions appertaining thereto and by an order under Section 290-A of the Government of India Act, 1935, as adapted by the

India (Provisional Constitution) Order, 1947, directs that Baroda State "shall be administered in all respects as if the State formed part" of the Governor's Province of Bombay. When such an order is made the Government of Bombay assumes only the "Provincial" functions in the area, with all the revenues, assets and liabilities appertaining thereto. It is obvious that there can be no question in this case of the Government of India paying compensation to the Bombay Government for any federal assets.

Essentially similar is the case in respect of States which retain their individuality. Like Baroda, before its "merger", they now have "composite" Governments, comprised of two functional entities—one with "federal" functions and the other with "provincial" functions. Complete "federal integration" means a "functional" bifurcation of these composite Governments and upon such bifurcation, the "federal" portions of the State Governments are to become integrated with the Government of the Union of India, leaving behind "provincial" State Governments with purely "provincial functions". There can, therefore, be no question of the revenues of the Union of India paying compensation of the nature indicated, to the "provincial" section of the States' Governments, when the Railways and other services, which are to be "federally" administered for the benefit of the people in these areas, are taken over by the Union Government of India.

Federal integration, thus essentially involves a two-fold process,—one, of "functional partition" of the present "composite" State Governments; and the other, of "merger" of the partitioned "federal" portions of the State Governments (together with the revenues, assets, liabilities and functions appropriate thereto), with the present Central Government in India (together with its corresponding resources) to constitute a *new* Government of the Union of India.

Fundamentally, it is not a case of the present Government of "British India" purchasing the Railways of "Indian States" as a commercial investment for the benefit of "British India". What is involved is a process of *pooling together* the "federal" resources of the people of the States with the "federal" resources of the people of "British India"; the result is a merger of the "federal" resource of the people of India as a whole,—that is, of the States and of "British India" alike—for administration, in the interests of all, by a new Central Government of the Union of India whose "power and authority", (together with the where-withal for their exercise), are derived from all the Units. In the circumstances, no question of payment of "compensation" can obviously arise.

What we have said above in regard to Railways applies equally to all other federal assets. It logically follows, of course,

- (i) that the Centre should also take over all public debts specifically incurred in connection with such assets ; appropriate liabilities to be also taken over; and—
- (ii) that where the public debt of a State is not specifically earmarked as incurred for individual capital assets, it should be distributed between the Centre and the State in proportion to the " federal " and " provincial " productive capital assets ;
- (iii) that where, apart from public debt, there is in any State, an excess of current liabilities over liquid assets, such excess should also be distributed between the Centre and the State in the same proportion as above ; and
- (iv) that, to the extent that the loss of *revenue* from those assets taken together with the loss of other " federal " revenues, as reduced by the savings in " federal " expenditure, in consequence of financial integration, is likely to cause sudden dislocation of the finances of any State, the problem will be one of necessary financial adjustments on revenue^e account between such State and the Centre, *i.e.*, should form part of the over-all problem of the financial consequences of the integration to be dealt with under item (4) of our Terms of Reference. dislocation of finances of States to be avoided.

We consider, therefore, that except for certain necessary financial adjustments referred to above, no " compensation " as such should be paid for any assets passing to the Centre as a result of the integration of the federal finances of the States with those of the rest of India.

31. We are equally clear that no similar question of " compensation " arises in connection with the integration of such " federal " revenues of the States as Customs duties on foreign trade, Central Excise Duties, Income-tax and the like. No "compensation" payable for " federal " revenues passing to the Centre ;

We recognise, of course, that the integration of all " federal " revenues of States with those of the Centre will give rise to maladjustments in their financial position ; and the remedy for this lies in ascertaining the precise extent of the *net* over-all dislocation likely to be caused, and then providing necessary financial (revenue) adjustments between the Centre and the States, over such transitional period as may be permitted by the Union Constitution under article 258, so as to avoid such dislocation. but financial dislocation to be avoided.

Federal financial integration Schemes for individual States; financial adjustments over transitional period.

32. For this purpose, we have prepared schemes of federal financial integration for individual States based on the principle that integration should be brought about with the least dislocation of their finances. The method followed by us is briefly this :—

Firstly, 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* the actuals of one completed year only)—immediately preceding, integration are taken; and for expenditure, the figures of the last completed year.]

Secondly, so much of the loss as represents the revenue from internal customs duties is (except to a small extent in one or two cases) to be wholly borne by the State, in the manner already suggested in paragraph 22 above.

Thirdly, in respect of the *balance* of the loss (if any), :—

the Central Government is to guarantee the whole amount of the loss, or the share from the divisible pool of federal revenues allotted to the State,—whichever is higher,—for an initial period of five years;

thereafter, it guarantees annually the amount of the loss diminishing by certain amounts every year until it is reduced to 60 per cent of the initial *over-all* net loss (inclusive of the loss of internal customs duties)* in the tenth year, or the State’s share from the divisible pool of federal revenues, whichever is higher;

there is no guarantee from the 11th year; (if, however, the time-limit under Article 258 is extended to 15 years, the guarantee in force in the 10th year will continue from the 11th to the 15th year).

* [Note —Where the loss from the abolition of internal customs duties itself accounts for 40 per cent. or more of the initial over-all net loss, there is no such reduction.]

In some States, there is no loss to be guaranteed in the above manner; in other words, apart from the loss on land customs, if any, which as stated above is to be wholly borne by the States themselves, the loss on account of ‘federal’ revenues transferred to the Centre upon financial integration is more than counterbalanced by the amount of

federal' expenditure to be taken up by the Centre. In such cases, there will be a *net profit* to the State with a corresponding burden thrown on the Centre. Our schemes for those States do not, however, provide for any transitional adjustments in favour of the Central Government, except in respect of the additional burden that will be thrown on the Centre if 'Privy Purse' is made a Central liability.

The above plan has been evolved after discussions with the Governments concerned and with due regard to the general, financial and economic position of the States. In some of the States, their present dependence upon 'federal' sources of revenue is considerable and the scope for further development of 'provincial' revenues is rather limited. In other cases, the existing volume of 'federal' revenues is negligible and it will require time to develop those as well as the 'provincial' sources of revenue. In yet another group of case 'federal' expenditure is far greater than 'federal' revenues, so that their contribution to the Centre upon federal financial integration will be negative until the future development of 'federal' revenues is sufficient to overtake the initial unfavourable impact upon the resources of the Centre. The problem is further complicated in some cases by the considerable dependence upon revenues from internal customs duties to which we have already referred.

We are satisfied that the individual schemes prepared by us for the States, following the plan already described, provide the only practical approach to the problem in a manner which would cause the least dislocation during the transitional period and meet the variety of financial situations arising in the different States as a result of federal financial integration.

The Committee is confident that all States will agree to conform to the pattern suggested. It is difficult to forecast what the divisible pool of income-tax will be in the next ten years and what Central excises will be divided between the Centre and the units during the same period. For this reason, it is not possible to give accurately the payments that will be made by the Centre to the States in the ten years. For the same reason, it is also not possible to say whether the transition from the 10th to the 11th year, or from the 15th to the 16th (when guarantees will cease) will not be too sudden, at least in some cases; however this is a point we have especially kept in view in working out individual schemes.

33. Financial integration implies that income-tax should ordinarily be levied in all States at the same rates as in the rest of India. The Committee agrees with the very pertinent observations made in this connection by the Expert Committee on the Financial Provisions

Income-tax:—
gradual raising
of State rates
to Indian level.

of the Union Constitution in paragraphs 92 and 93 of its Report. We consider, accordingly, that income-tax should be imposed, throughout the territories of the Union of India, assessed under a common federal law and uniformly administered directly by the Centre. We think, however, that the immediate application of the full Indian rates in areas in which income-tax is not now levied, or in which the rates are low, will give rise to difficult problems both to the Governments and to private interests. We have, therefore, prepared a scheme under which the present income-tax rates in the States will be raised to the level of the Indian Income-tax rates in two or three stages—taking into consideration the income-tax rates now in force, if any, and other considerations. This scheme is embodied in the Annexure to this Report; the Annexure also deals with special transitory provisions that will be needed when income-tax is first introduced in an area or when existing rates are raised. We desire, however, to emphasise two points:—

- (i) Income-tax should be introduced in all areas as from the date of federal financial integration, the rates being adjusted to local conditions as suggested in the Annexure ;
- (ii) the assessment and collection should be made by the Central Government's officers under the Indian Income-tax Act.

Among other advantages, the most important is that this will enable the Income-Tax Department to check evasions effectively. Income-tax is eminently a tax for Central assessment and collection, following uniform principles and technique throughout the country.

Income-tax
"divisible pool.

34. At this stage, we invite the attention of the Government of India to the need for taking up, as soon as possible, the revision of the existing distribution to Provinces of the proceeds from taxes on income. This was specially brought to our notice by the Government of Bombay. Areas which were formerly Indian States have recently been added to the Provinces of Bombay, Bihar, Orissa, Madras, East Punjab and the Central Provinces. There are, further, the changes in the existing basis of distribution recommended by the Expert Committee on the Financial Provisions of the Union Constitution (paragraphs 50—56 of its Report).

After orders are passed on the proposals contained in our Report and financial integration takes effect in States, further revision will become necessary. In this connection, we recommend that there should be no departure whatever from accepted principles (such as may be applicable from time to time, to Provinces) in connection with States,—neither as regards the proportion of the net proceeds of income-tax which should constitute the divisible pool, nor as regards the proportion thereof which may be allocated to individual States. And there should be no separate divisible pool for the States, except where, over a transitional period

the rates of income-tax may (as proposed by us) be lower than the full Indian rates ; some *ad hoc* temporary arrangements would be permissible in such case only.

35. We have now dealt with the fourth of our Terms of Reference. We have explained the need for financial adjustments between the Centre and the States over a transitional period and the general lines on which we have prepared schemes of integration of federal finance in States. We are confident the individual schemes are workable and such as will not cause sudden dislocation of the finances of the States concerned. We find it necessary, however, to sound a note of warning. Representatives of the Governments of States who met us referred to plans prepared in their States for prohibition, abolition of Jagirs, etc., for implementation in the near future. We hold the view that the Governments concerned should proceed in these matters with caution. We are convinced that for a number of years their finances cannot bear the losses of revenue involved and, as has been pointed out by the Government of India to Provinces, the execution of such policies will defeat the efforts now being made to check inflation.

Individual integration schemes are workable and

36. We recommend the individual schemes for sanction. We have already explained that they are equitable from the point of view of the States. We believe also that they are reasonable from the point of view of the Central Government. During the transitional period, we recommend that the general revenues of the Central Government should be entitled to a subvention from the Railway budget in view of the fact that part of the "revenue-gap" arising in States is due to the loss of railway income to them. We also recommend that an announcement should be made that, with effect from the date of integration, States will be eligible for all grants (including those referred to in Article 255 of the Draft Constitution), "subsidies", and other forms of financial and technical assistance from the Central Government on the same basis as Provinces.

equitable both to States and Centre ;

37. The legal basis for these schemes is to be found in Article 258 of the Draft Constitution. They are "agreements" entered into with States as contemplated under sub-paragraph (1) of Article 258 and will come under review by the Financial Commission contemplated in Article 260 of the Draft Constitution at the expiration of five years from the commencement of the Constitution of India and thereafter every fifth year or at such other time as the President considers necessary.

their "legal" basis would be as "agreements" under Art. 258.

38. We consider that there is need for a special machinery to watch the working of the sanctioned schemes of integration. This need not take the form of a special "States Commission" such as that suggested by the Expert Committee on the Financial Provisions of the Union Constitution, in paragraph 94 of its Report. Our proposal

special machinery for watching their working.

is that, as soon as the schemes have become effective, the President of the Union should appoint a Committee whose duty will be to keep in continuous touch with the manner in which the schemes are worked and submit annual reports to the Government of India, with special reference to the following points :—

- (1) *Internal Customs*.—Whether steps are being taken for their abolition— (Paragraph 22 of this Report) ;
- (2) whether the financial arrangements in the States are organised from the outset in such a manner that the diminution of the Central guarantee from the 6th year onwards and its total withdrawal from the 11th year (or the 16th year) onwards will not have an upsetting influence on the finances —(Paragraph 32 of this Report) ; and
- (3) whether there is any deviation from the scheme of integration sanctioned for each State and, if so, in what respects —(*cf* individual schemes in Part II of our Report).

The Committee might consist of—

- (i) a member drawn from the States.
 - (ii) } one representative each of the Ministry of States and of
 - and (iii) } the Ministry of Finance,
- with a Chairman who will be a non-official gentleman selected by the President in view of his high qualifications.

Such a Committee will also be of assistance to the States in the administration of their finances.

Administrative
matters arising
out of federal
financial inte-
gration.

39. We now come to the second part of item (3) of our Terms of Reference, *viz.*, the question of the administrative organisation needed to give effect to our proposals. As we have already said, it is an essential feature of our scheme that the Central administrative machinery should function in States exactly in the same manner as in the Provinces, though there is no objection to the Central Government, purely as a temporary measure, entrusting certain functions to the agency of States until the necessary Central personnel becomes available.

We do not think there will be any difficulty in the Central Government taking over the administration of Customs, Central excises and minor departments like Broadcasting, Telephones, etc. In regard to “Posts”, Cochin and Travancore have referred to the extensive facilities provided for the rural population by the “Anchal” system and are anxious that these should not be curtailed. We have dealt with this in our Second Interim Report (relating to those States).

Nor do we think that the taking over of Railway administrations by the Centre will present difficult problems of personnel. Railway systems in States are being worked from a long time on lines more or less

similar to the railway systems under the Central Government and the bulk of the local staffs can be taken over without impairing efficiency. The taking over by the Centre of railways in States is linked up with the larger question of the regrouping of railway systems all over India. The whole subject should be considered by the Railway Board immediately, so that proposals, viewing the railway systems in India as a whole, may be worked out before the 1st April 1950.

It is in regard to Income-tax that special arrangements will be needed for the training of administrative personnel. In Cochin, Travancore, and Mysore, where Income-tax is already levied and in which there is a well-organised public service, competent staffs are available who can be taken over by the Centre. They may need a short period of training in the methods of assessment and technique of scrutinising accounts now prevalent in the Provinces of India ; but that should present no special difficulty. For States in which no Income-tax is levied or the tax has only recently been introduced, special arrangements must be made at once to recruit and train staffs. Such areas are Hyderabad, the Saurashtra Union, the Madhya Bharat Union, the United State of Rajasthan, the Vindhya Pradesh Union, and the Patiala and East Punjab States Union. We think that approximately 80 Income-tax probationers together with an appropriate complement of subordinate staff should be recruited immediately and trained for work in these areas. Recruitment should be made on a regional basis, as knowledge of local languages in which accounts are maintained is essential.

If, as recommended by us—paragraph 20—the Centre takes over Accounts and Audit in States, this will also require trained staffs in considerable numbers. We attach much importance to these functions being assumed by the Centre. Nothing is more essential in States than independent compilation of Accounts and an independent Audit system functioning under the Auditor-General of India and ensuring compliance with regulations and sound financial canons.

In any case, there is, in our opinion, the urgent need to appoint at once a Deputy Auditor-General for States, with appropriate staff, working directly under the Auditor-General of India and in consultation with the Ministry of States, with the following immediate responsibilities, *inter alia* :

- (a) in the case of those States which may retain their own Accounts and Audit organisations, to plan the arrangement required for the efficient accounting and audit of “federal” transactions with effect from the date of federal financial integration so as to enable the Auditor General to fulfil his statutory responsibilities in that connection ;

(b) in the case of those States —e.g., Vindhya Pradesh, Saurashtra, etc.—where it may be decided to accept our recommendation to “centralise” the Accounting and Audit of both “federal” as well as “provincial” transactions (as in the case of Provinces), to work out details of the organisation and staff that will be necessary to enable smooth transition to be made from the existing arrangements with effect from the date of federal financial integration ; and

(c) in the case of *all Unions of States* ; immediately to report upon their present system, and its effectiveness, in the matter of

(i) expenditure control generally;

(ii) technical and administrative scrutiny of proposals for new expenditure ;

(iii) the nature and extent of *independent* control exercised by the Finance Department and the Chief Accounts and Audit Officer(s) ;

(iv) accounting and control of expenditure *at its origin*, that is, in Treasuries and Sub-treasuries and at P.W.D and other departmental divisional offices ;

(v) compilation of accounts at Headquarters ;

(vi) progress of expenditure generally, and with special reference to sanctioned grants ;

(vii) Audit, particularly “ appropriation ” audit.

Date of federal
financial integ-
ration.

40. As regards the date from which integration should come into force, the Committee recommend that this should be the 1st of April 1950. By this time, the new Constitution of India will have been settled by the Constituent Assembly and, perhaps, already come into operation. In regard to Cochin and Travancore, however, the Committee has suggested and the Governments concerned have accepted, integration from the 17th August 1949—the commencement of their next financial year. These two States which have since merged into a United State, are now faced with complicated problems arising out of the Union and, as explained in our Second Interim Report, integration with effect from August next appears to be the best course in their case. If this be accepted, the Travancore-Cochin Union will accede also on items relating to taxation and finance comprised in Lists I and III of the Seventh Schedule of the Government of India Act, 1935, as adapted under the Indian Independence Act.

The other States will have to comply with the legal formalities, prescribed under the new Constitution. As we have already said, it will be for the Constituent Assembly to decide whether Article 225 providing for accession by States and Unions of States should be enacted or whether the Constitution should apply to States and Unions of States automatically in the same way as it applies to Provinces. If individual accession is provided for, the States will have to accede in all subjects in the Seventh Schedule, Lists I and III, in the new Constitution. The accepted schemes of integration will be agreements contemplated under Article 258. Formal agreements will, we think, have to be entered into with all the States after the enactment of the Constitution, and before it comes into actual effect. The special machinery we have suggested in paragraph 38 will also have to be embodied in these agreements.

41. The plan of Part II of our Report,—in which are set out the integration schemes for individual States,—is as follows :—

Plan of Part II of Report, containing individual integration schemes.

Chapter I Introductory.

Chapter II Specific matters concerning “ Federal ”
Revenues and “ Federal ” Service Departments.

Chapter III Allocation of Assets and Liabilities (General).

Then follow separate Chapters for individual States setting out the integration scheme appropriate to the facts and circumstances of each case.

The schemes already submitted by us in our First and Second Interim Reports, concerning Baroda and the Travancore-Cochin Union, respectively, are not reproduced in Part II.

Hyderabad is dealt with in a separate (supplementary) Report which will follow shortly after this Report.

42. We desire, before concluding this section of our report, to express our gratitude to the Governments of States for the assistance they have given us in the formulation of our proposals. All of them had a clear understanding of the basic principles of the Draft Constitution and co-operated with us in evolving schemes equitable to the Central Government as well as to the States. The financial proposals embodied in these schemes concern large areas and populations; and they will have effects of a lasting character upon the economy of the whole country. We are confident that the Governments concerned will work them with every desire to promote the happiness and well-being of the people of the States.

Federal Financial Integration will have far-reaching consequences.