



# INDIAN FINANCIAL ENQUIRY REPORT

By

Sir OTTO NIEMEYER, G.B.E. K.C.B.

*Presented by the Secretary of State for India  
to Parliament by Command of His Majesty.*

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To

THE MOST HONOURABLE THE MARQUESS OF ZETLAND,  
P.C., G.C.S.I., G.C.I.E.,

*His Majesty's Secretary of State for India.*

MY LORD MARQUESS,

1. The Terms of Reference to the Financial Enquiry with which I was entrusted by His Majesty's Government were:—

“To make recommendations to His Majesty's Government, after reviewing the present and prospective budgetary positions of the Government of India, and of the Governments of the Provinces, on the matters which under Sections 138 (1) and (2), 140 (2) and 142 of the Government of India Act, 1935, have to be prescribed or determined by His Majesty in Council (subject to the approval of both Houses of Parliament) and on any ancillary matters arising out of the financial adjustments between the Government of India and the Provincial Governments regarding which His Majesty's Government may desire a report.”

By a letter dated the 18th December, 1935, Your Lordship further informed me with regard to the last phrase in the above Terms of Reference as follows:—

“His Majesty's Government do not desire, at present, to particularise any matters that may fall within this category. It appears to them, however, that the survey which you will make of the existing financial relationships of the various Governments in India may itself give rise to questions requiring to be answered. It may appear that the objects which the relevant sections of the Act are designed to promote may be better achieved if initial financial adjustments are made in respect of other matters, so far as the provisions of the Act permit, upon the introduction of the new Provincial Constitutions. For example, it might well seem desirable that the question of adjustments in connection with the existing liabilities of the Provincial Governments to the Central Government should be taken into account.

They accordingly desire you to have regard, in the course of your investigations, to any such possibilities and to make such recommendations thereon in your report as you think fit.”

Section 138 (1) and (2) of the Government of India Act, 1935\*, deals with the allocation of Taxes on Income (other than taxes on agricultural income); Section 140 (2) with the assignment of the net proceeds of the Jute Export Duty; and Section 142 with grants in aid of the revenues of the Provinces.

2. Before my departure to India I was supplied with a large number of documents bearing on the questions arising under these Terms of Reference, and both then and later I have received from the Provincial Governments detailed and lucid memoranda on the financial position of their respective

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\* See Appendix I.

Provinces. While in India I had the advantage of discussing these statements with the financial authorities of each Province: and I am much indebted to these gentlemen both for their original memoranda and for enabling me, often at some inconvenience to themselves, to hear their further oral comments and explanations. I had in addition the advantage of personal discussion in Calcutta with the Governors of Bengal, Bihar and Orissa, and Assam, in Bombay with the Governor of Bombay, in Lucknow with the Governor of the United Provinces and in Lahore with the Governor of the Punjab. While I did not think it necessary to hear formal evidence from non-official bodies, I have duly considered a number of written non-official representations which were addressed to me.

In Delhi I had lengthy and continuous discussions with the Finance Department of the Government of India and owe much to their ready aid, both in preparing material for the Enquiry before my arrival, and in supplying me with information and assistance at a time when they were in addition engaged in the annual preparation and discussion of the Indian Budget.

My Secretaries (Mr. V. S. Sundaram, Mr. K. Anderson and Mr. H. S. Stephenson) greatly assisted my work by their knowledge, zeal and assiduity.

3. Throughout the discussions leading up to the Government of India Act, it has been recognised that at the inauguration of Provincial Autonomy each of the Provinces should be so equipped as to enjoy a reasonable prospect of maintaining financial equilibrium, and in particular that the chronic state of deficit into which some of them had fallen should be brought to an end. My first object has accordingly been to examine the present and prospective financial position of the Provinces and to determine the extent to which special assistance would be needed in order to achieve the above aim. Next it is necessary to consider how far the Central Government is in a position to render such assistance without jeopardising its own solvency. Finally, I have had to look further into the future and to suggest to what extent and when it may be possible for the Centre to place additional resources at the disposal of the Provinces out of the proceeds of Taxes on Income. From the Provincial point of view, the desirability of attaining this final result is undeniable, and the only question (though in itself a difficult question) is to determine an equitable basis of distribution. From the Central point of view, on the other hand, it is clear that the financial stability and credit of India as a whole must remain the paramount consideration. Moreover, this is as essential to the Provinces and to the success of Provincial Autonomy as it is to the Centre itself. Throughout my recommendations I have kept the stability of the Central finances continuously in mind.

4. Previous discussion of these problems has taken place in the deep shadow of economic depression, and inevitably in that discussion the difficulties and uncertainties of the position have predominated. Thanks to the prompt measures taken in the early stages, the initial collapse in the Central Budget under the impact of the depression in 1930 was rapidly corrected. But the question of immediately pressing concern was to devise measures to increase or maintain the revenue and to reduce expenditure. The probable pace of recovery could not be gauged, and the practicality of transferring resources from the Centre to the Provinces thus remained problematic. On the other hand, the efforts of the Provinces (some of which, it must be admitted, were more drastic than others) to achieve a similar degree of budgetary improvement were less rapidly successful, and the extent to which the Provinces appeared to be dependent on Central assistance, if an 'even keel' was to be attained, was thus at times exaggerated. Today it is possible to view the

situation in the light of five years' experience since the commencement of the slump, to appreciate how far recovery has occurred and to envisage an actual position nearer the decisive date. Compared with deficits of over 11 crores in each of the years 1930-31 and 1931-32, the Central Budget has produced surpluses of considerable magnitude in the year 1932-33 and every subsequent year,\* and this in spite of the abolition of pay-cuts and the remission of most of the increase in rates of Income-tax, and in spite also of the annual surrender since 1934-35 to Bengal, Bihar and Orissa, and Assam of nearly 2 crores of Jute Export Duty. In the Provinces, likewise, a comparison of the anticipated budget outturn in 1935-36 reveals very substantial improvement over the deficit position of, say, 1930-31, though this is partly due, of course, to the above assistance from the Centre.

5. While it is true that the revenues of India have not returned to the exceptionally high figure prevalent before 1930-31 and it may be a long time before they again reach that level, there has been an appreciable recovery from the bottom—perhaps more than is generally realised in India. The improvement is parallel to, if not precisely identical with, what has occurred in many other parts of the world and reflects the same underlying conditions. There is no sign that it has ended, or that the natural tendency to automatic growth has ceased to function. It would, I think, at least be legitimate to anticipate a continuation of the recent rise at a moderate pace.

Both the Centre and the Provinces may expect to profit by this circumstance. While it is often said that Provincial revenues are less expansive than Central revenues, I think, despite Permanent Settlement in two Provinces, too much stress may be put on this difference. Consumption taxes in the Provinces might reasonably be expected to rise with consumption taxes (Customs and Excise) at the Centre. On the other hand, Central Customs duties, particularly if highly protective, are subject to definite limitations as revenue producers : nor does it seem to be a fact that Income Tax (at the same rates of tax) increases in yield much more rapidly than other taxes. An important item of previous Central Budgets and forecasts, the net revenue from the Railways,† from which the Percy Committee in 1932 anticipated a future receipt of 5 crores per annum, has not yet resumed its place in the resources of the Centre.

6. Expenditure at the Centre cannot be expected, consistently with safety, to decrease much below the point to which it has now been reduced. There may be future savings on debt conversions, but so far as they remain with the General Budget, they hardly seem likely to do more than assist in reinstating a more adequate contribution to debt redemption than the present reduced figure of 3 crores. It is, however, at least unnecessary to contemplate any serious increase in total expenditure, unless the Railway Budget, contrary to expectation, fails to improve.

7. Expenditure in the Provinces could obviously be increased, with advantage, on many heads. This is a question of degree and opportunity. Some expansion in fact took place even with existing Provincial resources, especially in the years before the slump when many Provinces were able, for instance, to increase substantially their expenditure on education, agriculture, medical and public health. And some expansion may now be anticipated from the

\* The position in the later years is not clearly visible from the usually quoted figures owing to the inclusion of these surpluses as special non-recurring grants in revised estimates and final accounts.

† The Railways bear no amortisation charge on the debt incurred on their behalf by the Government of India.

recovery of Provincial revenues, not all of which are or need be static. Nevertheless, the allocation at an early date of a share in Taxes on Income under Section 138 of the Government of India Act constitutes for many Provinces the main hope for future expansion.

8. On a general review of existing tendencies, I should conclude that the budgetary prospects of India, given prudent management of her finances, justify the view that adequate arrangements can be made, step by step, to meet the financial implications of the new constitution. A change of constitutional and administrative arrangements cannot, of course, in a moment alter the general financial position or enable all conceivable financial desires to be met. But I see no reason why a cautious but steady advance should not be achieved.

9. I turn now more particularly to the prior question : the present position of the Provinces and their contrasted positions *inter se*, both of which fall under the objective of starting the Provinces on the occasion of Autonomy on 'an even keel'. Various matters arise in this connection : how far in actual fact is each Province now solvent and likely to remain solvent—a matter which cannot be judged on one year only ? How far, whatever may be its present position, has a Province administered its affairs, whether in taxation or in expenditure, with adequate firmness ? How far has this or that Province, for whatever reason, been financially neglected in the past and thereby condemned to a lot from which others have escaped ? It is obviously impossible to reconcile all the conflicting views and arguments on these issues. The recommendations I shall make represent in my belief an equitable settlement as between the various contestants and will, I hope, be accepted on that basis. I would only add here that in any country of the size of India there must inevitably be substantial differences in standards of administrative needs and possibilities, just as there are in other areas of the same size in the rest of the world, or for that matter even in much smaller units.

10. The present position and relative size of the Provincial Budgets are shown in Appendix II. As regards the figures for 1936-37, it must be borne in mind that they are estimates ; and experience suggests that the deficits thus prognosticated will in the actual result be smaller. Apart from that, there are a number of adjustments\* to be made—in either direction—before these figures can be regarded as any necessary indication of the future. Nor can any settlement undertake to secure that no Province shall, at any time and whatever the course of its administration, be freed from the ordinary risk of a casual budgetary deficit. Provincial Autonomy necessarily implies autonomous responsibility in this direction also.

It is obvious, as the Percy Committee said, that special assistance to certain Provinces, which, whatever precise form it takes, can only be given at the cost of Central revenues, must operate to delay *pro tanto* the general transfer to all Provinces of their share of Taxes on Income. This consideration cannot be absent from the mind of anyone endeavouring to deal fairly with the whole problem, and sets one limit to the amount of prior readjustment which can reasonably be admitted.

At the same time it is equally clear that some Provinces are intrinsically better off than others and at the moment less urgently in need of additional resources ; and it is both fair and inevitable that a certain measure of correction should be applied, even if it means that Provinces which have been able

\* For instance, cost of new constitution : cessation of certain small revenue receipts from the Centre : in addition to general trend of existing revenue and expenditure.

to attain higher standards of administration should now to some slight extent have to progress more slowly.

11. Certain further general comments may be made. Bombay has just received annual relief to the extent of approximately 90 lakhs from the separation of Sind; Madras and Bihar approximately 20 lakhs and 8 lakhs respectively from the separation of Orissa. Madras, Bombay and the Punjab have certainly not the lowest administrative standards in India. Bengal is clearly on a low standard, while Bihar and Orissa has been generally recognised as the poorest Province in India. To a less extent similar considerations apply to the Central Provinces. The position of the United Provinces is in so far peculiar that while its ultimate future gives less reason for anxiety, its immediate difficulties are considerable. Sind and Orissa, as newly instituted Provinces, have special problems of their own.

12. At this stage a rather lengthier comment is required on certain individual Provinces.

13. *Sind*.—For the year 1936-37, the Government of India have provided a subvention to Sind of 1.02 lakhs plus non-recurrent grants of 4 lakhs for initial equipment and election costs and 2 lakhs unallocated. In addition, the Government of India have undertaken to provide 17½ lakhs for buildings in Karachi from their anticipated surplus for 1935-36.

The deficit for the future (excluding the Llyod Barrage, but allowing for certain reasonable additions both to revenue and expenditure) may be estimated at 1.05 lakhs—a considerably higher figure than the estimate of the Sind Conference in 1932 (approximately 80 lakhs). There are possible increases in revenue, for instance in Land Revenue from the Barrage Lands, and the above figures exclude any ultimate receipt from the allocation of Taxes on Income.

I think the initial subvention under the Act may properly be fixed at 1.05 lakhs a year, to which should be added a single non-recurrent grant of 5 lakhs which can be used, for instance, towards the cost of a jail at Shikarpur.

The more difficult question is what modification should be made in this subvention in later years.

The future of Sind and of the subvention as part of Sind finances is inseparably bound up with the financial future of the Llyod Barrage. In considering to what extent it is justifiable to continue this charge on the Centre, I must assume that the Barrage scheme will be administered on lines comparable with similar schemes elsewhere and that adequate rates will be charged for the facilities it will provide.

From a survey of the prospects of the Barrage scheme just made by the Government of India, it would appear that the charging of part of the interest to capital (which is necessary during construction and the earlier years of partial working) can cease at the end of 1937-38, after which year net revenue and capital receipts should cover interest; and that by the end of 1939-40 new capital expenditure will cease. After that date it will be possible to fix the definite service (interest and amortisation) of the Barrage debt, which will of course be a future charge on the revenues of Sind. As there will be special capital receipts in the earlier and not in the later years it would be appropriate to fund this debt, not on the basis of an equated annuity over a period of years, but on the basis of suitable instalments of principal together with interest on the balance outstanding. Until the date of funding all receipts in excess of interest should be applied to reduction of debt. If the service is spread over 40 years from 1st April, 1942, at 4½ per cent. interest, with capital repayments of 75

lakhs a year in the first 15 years, 60 lakhs a year in the next 10 years and 50 lakhs a year thereafter, the latest estimate of net receipts from the Barrage (capital and revenue)—net in the sense of excluding 1/10th of the revenue as Land Revenue, and also deducting the equivalent of prebarrage net Irrigation receipts—make it probable that in the early 1940's there would be a growing margin over the required debt charges.

While naturally all such estimates must be treated with caution, on this basis Sind (apart from a growing receipt in the 1/10th Land Revenue) would be making a profit on the irrigation scheme after providing for debt charges thus adjusted, and it would not be reasonable that the subvention should continue unaffected by this fact.

In all the circumstances and bearing in mind the necessarily conjectural nature of estimates for a period stretching so far into the future, I recommend that the Sind subvention should remain at 1.05 lakhs for a period of 10 years (i.e., till 1946-47 inclusive); and should then be diminished by 25 lakhs a year for 20 years, by 40 lakhs a year for the next 5 years, by 45 lakhs a year for the next succeeding 5 years, and thereafter until the whole Barrage debt is repaid by 50 lakhs a year. When the debt has been repaid (i.e., in about 40 years from funding in 1942) any remaining portion of the subvention will, of course, in any event cease.

Under this arrangement it should be possible for proper administration to secure in every year a balance from the Barrage in favour of the general revenues of Sind over and above the debt charge and after allowing for the periodic reductions of the subvention; and it will therefore be in the direct interest of Sind to achieve results at least as favourable as those on which the estimates are made.

14. *Orissa*.—The Government of India propose to assist Orissa in 1936-37 by a grant of 50 lakhs, of which 40½ lakhs are in respect of the deficit in the revenue budget, 7½ lakhs are required for non-recurrent purposes (establishment of Famine and Road Funds and initial equipment), and 2 lakhs are unallocated to specific expenditure.

Some increase in expenditure is inevitable: it is impossible to ignore the fact that the existing standard of expenditure in Orissa is extremely low; and the scope for expansion in the Province's own resources in the early future is unusually limited.

As against the provision of 40½ lakhs in 1936-37 for recurrent Orissa expenditure, it is therefore necessary to contemplate a somewhat higher normal scale of assistance, and my conclusion is that the figure should be increased to approximately 50 lakhs.

I recommend also, in order to ease the position in the earlier years, that the Government of India should make a further grant to the Orissa Famine Fund so as to raise the total in the latter to the figure of 10 lakhs prescribed in the Orissa Order in Council. 5 lakhs have already been provided for this purpose and a contribution of 1½ lakhs is included in the 1936-37 Orissa Budget, so that a further non-recurrent sum of about 4 lakhs would be needed.

Finally, it is clear that the cost of providing the new Province with such essential buildings as are required will be rather more than the sum of 27½ lakhs for headquarters alone, which the Government of India are setting aside out of their anticipated surplus of 1935-36. In my view, a further sum of 15 lakhs should suffice if a reasonable standard is set; and I recommend that assistance for this purpose, additional to what has been proposed in the two preceding sub-paragraphs, should be provided at the rate of 3 lakhs per annum in each



of the first five years. The total assistance which I propose should be given to Orissa is thus about 57 lakhs in the first year, 53 lakhs a year in the next four years and thereafter 50 lakhs a year.

15. *Assam* has been universally recognised as a deficit Province and must undoubtedly receive assistance. The measure of the assistance depends partly on the prospective revenue of Assam allowing for a very moderate amount of continued recovery, and partly on the degree to which the existing Provincial deficit (47 lakhs in 1935-36) can be regarded as having been unavoidable (either as regards expenditure or taxation). Allowance has further to be made for the cost of Provincial Autonomy, and for certain adjustments of expenditure with the Centre, including the cost of the Assam Rifles, hitherto mainly borne by the Central Government.

Taking all these considerations into account, I recommend that Assam should be given assistance to the extent of approximately 45 lakhs a year, irrespective of the special arrangement for the Assam Rifles mentioned in the next sub-paragraph.

At present the Central Government pays 12 lakhs per annum towards the total cost of the Assam Rifles (15 lakhs). In future the Central Government will in any case pay the cost of the Manipur Battalion (approximately 3 lakhs). The Central Government now proposes to bear 7 lakhs of the cost of the remaining Assam Force and to treat this payment separately from any assistance for Provincial needs proper. I think this is an equitable arrangement.

The Assam Government put forward a special claim in connection with the proceeds of the Excise Duty on Assam oil, though the incidence of the tax obviously does not fall on the producing Province. I do not think there is any economic justification for this particular claim or that it presents any real analogy with superficially similar claims which it may be alleged have been recognised elsewhere. In any case, having regard to the amount of the proposed assistance, which such a receipt could only operate to reduce, it is unnecessary to pursue this matter further.

16. The *North West Frontier Province*, which has since 1932 received an annual subvention of 1 crore from the Central Government is so far in a special position that Section 142 of the Government of India Act permits an increase in its subvention at any time without an address from the Federal Legislature. It is, however, desirable both from the point of view of the Province and from that of the Central Government, that the subvention should be fixed for a certain period of years. After examining the past and prospective budgetary position of the Province (and also incidentally the various references made in the past to equivalence in certain respects with neighbouring districts of the Punjab), my recommendation is that the existing subsidy of 1 crore should be supplemented by approximately 10 lakhs per annum. In so far as this assistance may take the form of a subvention under Section 142, it should be fixed for a period of 5 years, after which it should be subject to revision in the light of the then existing circumstances. By revision I am far from implying a further increase. I contemplate merely that the position should then be reviewed in the light of 5 years' further financial administration.

17. To revert now from these specific cases to the wider considerations of paragraphs 10 and 11, and summarising the whole provision which I believe to be requisite, I think that assistance of the following approximate annual amounts should be given to the Provinces mentioned below, as from the date on which Provincial Autonomy commences. This assistance should

be given irrespective of the ultimate allocation of Taxes on Income and should not be affected by that allocation.

	Lakhs.	
Bengal . . . . .	75	
Bihar . . . . .	25	
Central Provinces . . . . .	15	
Assam . . . . .	45	(apart from 7 lakhs in respect of the Assam Rifles as indicated in paragraph 15).
North-West Frontier Province . . . . .	1,10	
Orissa . . . . .	50	<i>plus 19 lakhs non-recurrent as indicated in paragraph 14.</i>
Sind . . . . .	1,05	<i>plus 5 lakhs non-recurrent, and to diminish as indicated in paragraph 13.</i>
United Provinces . . . . .	25	<i>for 5 years.</i>
	<hr/> 4,50	

Against this sum, 2,58 lakhs (North West Frontier Province 1,00 lakhs, Orissa 50 lakhs, Sind 1,08 lakhs) are already provided in the Budget of the Government of India for 1936-37. The recurrent additional cost to the Centre would therefore be 1,92 lakhs a year. In addition, certain further non-recurrent grants are contemplated, amounting in aggregate to 24 lakhs.

18. Can the Centre support such an additional demand? Apart from this sum of nearly 2 crores per annum, concurrently with the inauguration of Provincial Autonomy, Burma will be separated from India at a net loss to Central Revenues now estimated by the Government of India at about  $2\frac{3}{4}$  crores. These two items together clearly would present a budgetary problem of some magnitude if they had to be faced in 1937-38, at one blow and so soon, from the normal resources of a single financial year. Thereafter, owing to the expansion in Central resources which may with confidence be anticipated, they need occasion no special difficulty. Thanks, however, to the Reserve Fund of about 2 crores, which is being constituted out of the anticipated surplus of the year 1935-36, I see no reason why the grant of these additional resources to the Provinces should not commence in 1937-38. In so concluding, I should be lacking in frankness if I did not make it clear that the scope in the next few years for relaxation of revenue burdens is likely to be extremely small unless economic improvement takes place at a rate well in excess of what can now safely be assumed. I have, however, felt it right to assume that the establishment of Provincial Autonomy must be regarded as an objective to which the Government of India will give special consideration in assessing the relative order of its financial aims. From the financial point of view, I conclude that His Majesty's Government may safely propose to Parliament that Part III of the Government of India Act, 1935, should be brought into operation a year hence.

19. It remains to consider what form this measure of assistance should take.

Where financial assistance is to be given by a creditor to an existing debtor, elementary commonsense suggests that the shortest and simplest method of adjustment is by reducing the claim of the creditor on the debtor, and I have naturally been led to consider whether the assistance I recommend that the Centre should give to the above Provinces cannot conveniently be provided in whole or part by such an adjustment of debt relations.

In so doing, however, I must first of all take into account the effect on the existing debts of the Provinces of certain arrangements which the Government of India propose to make (see Appendix III). On many grounds, financial and administrative, I think the proposed method of decentralisation of balances extremely desirable. In so far as the Provinces will thus be using surplus balances as a set-off to debts due by them to the Centre, I must count any saving from such reduction of their debts as part of the assistance I propose, as the charge for these debts has swollen their existing and prospective budgets. But the proposal in Appendix III will leave the Provinces to bear certain interest charges which have hitherto fallen on the Centre, and for that I must make allowance before counting as assistance the results of debt cancellation.

In certain cases it is convenient to combine the results of decentralisation and of debt cancellation and I therefore propose, on the definite assumption that the Government of India's decentralisation proposals are accepted, as I think they should be, to cancel in the case of Bengal, Bihar, Assam, North West Frontier Province and Orissa the entire existing debts of these Provinces to the Government of India, counting against the assistance I propose only the net annual budget saving. In the case of the Central Provinces I propose to cancel part of the debt to the Centre. In the case of the United Provinces and Sind, it is not in my opinion convenient to cancel debt, and assistance must be given in a different form.

20. Parenthetically and to complete the picture, it should be added that the Government of India's proposals further contemplate the consolidation of such Provincial debts as remain, on terms which appreciably benefit the Provinces. I see many advantages in this proposal which I should support. I welcome the fact that Madras, Bombay and the Punjab, to whom I do not suggest any immediate assistance as part of my proposals, will derive certain advantages from this scheme. And I do not think it necessary to modify my own proposals because of the additional benefits which would accrue to the United Provinces, the Central Provinces and Sind.

21. On the basis indicated in paragraph 19 I thus recommend that the following cancellations of debt should take place—

		Approximate net annual saving of which I take account.
		lakhs.
Bengal . . . . .	} All Debt contracted with the Centre prior to 1st April 1936.	33
Bihar . . . . .		22
Assam . . . . .		15½
North West Frontier Province . . . . .		12
Orissa . . . . .		9½
Central Provinces . . . . .	Deficit Debt as on 31st March, 1936, and approximately 2 crores of pre-Reform debt.	15

22. The claim of the jute-producing Provinces to the whole or part of the Jute Export Duty has already been recognised to the extent of 50 per cent. by the Government of India Act. In my opinion, it is doubtful whether the argument that the incidence of this particular Duty falls wholly on the producer can be maintained. No concrete statistical proof of this contention has been produced, and even if such proof could be produced for a specific date, it may be doubted whether it would be valid in all circumstances of a changing market. Further, even if the argument were completely sustainable, it would not be

conclusive on the question whether or not the community as a whole in India was entitled to tap this source of revenue as it must in fact tap other sources of revenue of unequal provenance among the different parts of India. No source of revenue, whether Customs, Excise or Income Tax, can in fact in any country be derived equally from all parts of the country alike, rich and poor, industrial and agricultural. In so far as a claim may be put forward on the ground that the taxable capacity of Bengal is limited by the incidence of this Duty, that is a claim not so much to this particular Duty as to financial assistance generally; it is part in fact of the case for a share in Taxes on Income or for such prior special treatment as it is the object of my present recommendations to secure.

It may be thought that whatever validity there may be in the economic argument has already been met by the surrender to the Provinces concerned of 50 per cent. of the net produce of the Duty. It will, however, be convenient that part of the assistance I contemplate should take the form of an increase in this figure, and therefore I recommend that the percentage should be increased under Section 140 (2) of the Act to 62½. On the estimated gross yield of the Duty in 1936-37 at 3,80 lakhs, this increase of 12½ per cent. would mean in round figures the following additions to the resources of the Provinces concerned, at a corresponding cost to the Central Government:

	Lakhs.
Bengal. . . . .	42
Bihar . . . . .	2½
Assam . . . . .	2½
Orissa . . . . .	rather over ½

23. The result will be, after allowing for the advantages derived from debt cancellation (paragraph 21), to complete the required assistance (paragraph 17) except in the case of Assam, the North-West Frontier Province and Orissa, which will still require 30, 1,00 and 40 lakhs respectively. In addition there remain the special cases of the United Provinces and Sind, in which, for differing reasons, the method of adjustment by debt cancellation was not thought appropriate.

24. I recommend therefore that annual grants in aid under Section 142 of the Act should be charged on Central Revenues as follows:—

	Lakhs.	
United Provinces . . . . .	25	for a fixed period of 5 years.
Assam . . . . .	30	(subject to the proposal as to the Rifles in paragraph 15).
North-West Frontier Province .	1,00	subject to reconsideration at the end of five years.
Orissa . . . . .	40	with 7 lakhs additional in the first year, and 3 lakhs additional in each of the next four years.
Sind . . . . .	1,05	for 10 years with 5 lakhs additional in the first year, then falling as provided in paragraph 13 until the grant ceases entirely on the extinction of the Barrage Debt in about 45 years' time.

25. The next matter on which I am asked to make recommendations is the distribution of residual Taxes on Income

(1) as between the Federation on the one hand and the Provinces and States on the other, and

(2) as between the Provinces (and States) *inter se*.

Under the first head I have to recommend what percentage of net Taxes on Income, after deducting proceeds attributable to Chief Commissioners' Provinces and to taxes payable in respect of Federal emoluments, is to be assigned to the Federal units. Thereafter I have to suggest over what period and subject to what conditions the units shall gradually come into possession of the resources represented by the ultimate percentage. The second aspect is the basis of distribution among the units concerned of the share at any time accruing to them.

26. The 1936-37 budget estimate of receipts from all forms of Income Tax (including corporation tax) is 15·7 crores, which for the present purpose must be reduced to about 13·6 crores on account of cost of collection and the prospective separation of Burma. Of this latter sum it may be estimated that about 1 3/4 crores pertain to the wholly Federal heads of corporation tax, Chief Commissioners' Provinces and Federal emoluments, leaving a residuum of about 12 crores divisible between the Centre and the units. The precise sum will, of course, fluctuate from year to year according to the yield of this head of tax, but it is at present of this order of magnitude.

27. There are two considerations to be balanced in arriving at the percentage of some such total to be assigned to the Centre and the units respectively. On the one hand, there is the vital necessity, to which I have already referred, of safeguarding the financial stability of the Centre. On the other hand, having regard to the obvious future needs of the Provinces and in order to maintain a reasonable adjustment of relative burdens between the various units, it is clearly very desirable that the maximum practicable distribution should be achieved.

28. On a balance of the various considerations and risks involved, I recommend that the prescribed percentage of these taxes that shall not form part of the revenues of the Federation [Section 138 (1)] should be 50 per cent.

29. The next question is what amount out of this 50 per cent. and for what periods should temporarily be retained by the Federation [Section 138 (2)].

It is clear that in the years immediately following the introduction of Provincial Autonomy there can be no question of the Centre's relinquishing a further six crores or so of its resources.

Apart from the separation of Burma and the provision of 2 crores assistance for the Provinces which I have already recommended, the additional cost of new Federal institutions (probably something over half a crore) may be imminent, and provision may have to be made for financial adjustments in respect of the States under Section 147 of the Act, at a net ultimate annual cost now estimated at rather more than half a crore, though the full annual charge on this latter account will presumably not fall to be met in the early years. If, however, there is bound to be delay, the Provinces will no doubt recollect that they will be receiving from the Centre the amounts proposed in paragraph 17 above, in addition to what certain of them have already been receiving from the Jute Export Duty and about 1½ crores per annum for Roads, as well

as certain grants (3½ crores) for rural purposes. Some of them have also received substantial assistance through being relieved of deficit areas.

30. In my opinion a term of about five years would safely cover the period during which the Centre will be consolidating its position after undertaking the initial adjustments ; and this is the length of the period that I recommend to be prescribed under Section 138 (2) (a). It is less easy to prescribe within this first period how much in fact can be surrendered. Obviously conjectures fixing now specific dates in this period might, in the present state of economic flux in the world, in fact prove substantially wide of the mark : and if such a conjecture had to be made so soon in terms of such and such a year, it might perhaps more easily err on the side of caution than on the side of temerity, to the disadvantage of the Provinces. To avoid these inconveniences, it will be preferable to base the amounts to be withheld not so much on specific but entirely conjectural dates, but on the realisation of certain concrete facts.

The power of the Central Government to surrender a share of its revenues will in fact depend largely on the extent to which its main expansive revenue head, *viz.*, Income Tax, progresses, and on the extent to which the Railways move towards attaining a surplus, as contemplated by the Railway Administration at the time of the Percy Committee. It is in my view very desirable to give both the Central Government and the Provinces an interest in securing these results and a share in their advantages if and as soon as they are achieved.

I recommend therefore that, the initial prescribed period under Section 138 (2) (a) being five years, the prescribed sum which during that period the Centre may in any year retain out of the assigned 50 per cent. shall be the whole, or such sum as is necessary to bring the proceeds of the 50 per cent. share accruing to the Centre together with any General Budget receipts from the Railways\* up to 13 crores, whichever is less.

31. I wish to add two comments on these recommendations—

- (1) After the abolition of tax on the smaller incomes and the two successive reductions in the rates imposed in 1931, the rates of Income-Tax and Supertax in India, especially on the higher incomes, are by no means excessive. The general scheme of Indian taxation (Central and Provincial) operates to relieve the wealthier commercial classes to an extent which is unusual in taxation schemes, and there would be no justifiable ground of complaint if a slight correction of this anomaly were maintained. The assignment of Taxes on Income is the main method of assisting Provincial finances contemplated by the Government of India Act : and if the remaining surcharge were maintained, it would materially contribute to the early receipt by the Provinces of additional resources.
- (2) The position of the Railways is frankly disquieting. It is not enough to contemplate that in five years' time the Railways may merely cease to be in deficit. Such a result would also tend to prejudice or delay the relief which the Provinces are entitled to expect. I believe that both the early establishment of effective co-ordination between the various modes of transport and the thorough-going overhaul of Railway expenditure in itself are vital elements in the whole Provincial problem.

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\* On the basis at present provided by the Railway Convention.

32. The Act requires that, during a second prescribed period, the Centre shall relinquish to the Provinces by equal steps so much of the Provincial share as it is retaining in the last year of the first period. Under the scheme proposed in the preceding paragraphs, the amount so to be relinquished will depend on the two factors of Income Tax yields and Railway revenue; and if, by the favourable operation of these factors, the amount held back proves in fact to be substantially less than the whole Provincial share, it is obvious that the task of the Centre in relinquishing it will *pro tanto* be lightened. Here again a long and somewhat conjectural view of the future has to be taken. In my opinion, however, it should prove safe to fix the second prescribed period at 5 years, so that within about ten years from the commencement of Provincial Autonomy the Provinces may hope to be enjoying their full share in this revenue head. It is necessary, however, to add a word of warning, lest the Provinces be tempted to mortgage in advance these prospective additional resources. No one can say in present circumstances that this programme will with certainty prove feasible, and it must be regarded as subject to the important reservation that if necessary the Governor-General will have to exercise his delaying power under the second proviso to sub-section (2).

33. There remains finally the difficult question of the manner in which any proceeds of Taxes on Income available under the foregoing arrangements should be distributed.

During the past decade this question has arisen in one form or another on many occasions. Much of the previous discussion is now largely irrelevant since it related to a constitutional scheme differing from that which the Act embodies and to financial dispositions differing from those which have now to be envisaged. Moreover, it has, in my view, suffered from an undue preoccupation with the quest for some automatically applicable statistical factor, and a tendency to raise technical problems which would be soluble, if at all, only with disproportionate labour and expense.

Naturally each Province advocates the basis of division (population, residence, etc.) which gives it the largest dividend. It cannot be said that any of the proposed bases have any particular scientific validity or satisfy in any appreciable degree the ideal but practically unascertainable test of capacity to pay. The mere accident of place of collection, as has frequently been pointed out in previous discussions of this subject, is clearly an unsuitable guide. The residence of the individual, though it may be a convenient practical dividing line for purposes of avoiding double taxation between separate political units, is not in itself a very scientific criterion, particularly in a Federation, and in fact in India gives results (of necessity partly estimated) too suspiciously near those of collection to inspire much confidence. Finally, even supposing it were practicable to ascertain to what part of India particular fractions of income (and therefore the incidence of the taxation burden) properly adhere, it is still arguable that in a Federation other considerations also are involved, particularly if the benefits and incidence of other forms of common taxation are unequally divided as between the various partners.

34. After full consideration of the various elements of this problem, including the uncertainty of some of the statistical data on which practical calculations must necessarily depend, I conclude that substantial justice will be done by fixing the scale of distribution partly on residence and partly on population, paying to neither factor a rigidly pedantic deference, for which the actual data provide insufficient justification.

I am further strongly of opinion that from a practical administrative standpoint it is essential to base the distribution, not on figures to be ascertained each year (so far as they may be ascertainable), but on fixed percentages.

35. I thus recommend that the division between the Provinces of the amounts available in respect of the 50 per cent. share of residual Taxes on Income should be as follows :—

	Per cent.
Madras . . . . .	15
Bombay . . . . .	20
Bengal . . . . .	20
United Provinces . . . . .	15
Punjab . . . . .	8
Bihar . . . . .	10
Central Provinces . . . . .	5
Assam . . . . .	2
North-West Frontier Province . . . . .	1
Orissa . . . . .	2
Sind . . . . .	2
	<hr/> 100 <hr/>

36. The above allocation does not allow for the participation of the States. If at any time any State comes into Federal Income Tax and thus qualifies for a share in the residual tax, a minor adjustment would have to be made. But it would be desirable that such adjustment, which could no doubt be arranged in connection with the act of accession, should not involve an alteration in the above percentages but should rather operate to affect the total to which the percentages apply just as it would operate to increase the initial amount of that total.

37. My final recommendations, in so far as they involve the issue of Orders in Council under the Government of India Act, 1935, may now be summarised as follows :—

(1) (a) that the percentage prescribed under Section 138 (1) should be 50 per cent. ;

(b) that the distribution of this share to be prescribed under the same sub-section should be :—

	Per cent.
Madras . . . . .	15
Bombay . . . . .	20
Bengal . . . . .	20
United Provinces . . . . .	15
Punjab . . . . .	8
Bihar . . . . .	10
Central Provinces . . . . .	5
Assam . . . . .	2
North-West Frontier Province . . . . .	1
Orissa . . . . .	2
Sind . . . . .	2



- (2) that the amount to be retained under Section 138 (2) from this share should be :—

for a first period of 5 years, in each year, the whole or such amount as, together with any General Budget receipts from the Railways, will bring the Central Government's share in the divisible total up to 13 crores, whichever is less, and

for a second period of 5 years, in the first year five-sixths of the sum, if any, retained in the last year of the first period, decreasing by a further sixth of that sum in each of the succeeding five years ;

- (3) that the percentage of net proceeds of the Jute Export Duty to be assigned to certain Provinces under Section 140 (2) should be  $62\frac{1}{2}$  per cent. ;

- (4) that the Central Revenues should be charged with the following grants in aid under Section 142 :—

United Provinces . . . . .	25 lakhs for 5 years.
Assam . . . . .	30 lakhs.
North-West Frontier Province . . . . .	1,00 lakhs, to be reconsidered after 5 years.
Oriassa . . . . .	40 lakhs, increased to 47 lakhs in the first year and to 43 lakhs in the 2nd, 3rd, 4th and 5th years.
Sind . . . . .	1,05 lakhs, increased to 1,10 lakhs in the first year ; subject to reductions set out in paragraph 13.

I have the honour to be,  
 My LORD MARQUESS,  
 Your Lordship's most obedient Servant,

O. E. NIEMEYER.

6th April 1936.

## APPENDIX I.

*Text of relevant Sections of Government of India Act, 1935.*

**138 (1).** Taxes on income other than agricultural income shall be levied and collected by the Federation, but a prescribed percentage of the net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Chief Commissioner's Provinces or to taxes payable in respect of Federal emoluments, shall not form part of the revenues of the Federation, but shall be assigned to the Provinces and to the Federated States, if any, within which that tax is leviable in that year, and shall be distributed among the Provinces and those States in such manner as may be prescribed:

Provided that—

- (a) the percentage originally prescribed under this sub-section shall not be increased by any subsequent Order in Council;
- (b) the Federal Legislature may at any time increase the said taxes by a surcharge for Federal purposes and the whole proceeds of any such surcharge shall form part of the revenues of the Federation.

**(2)** Notwithstanding anything in the preceding subsection, the Federation may retain out of the moneys assigned by that sub-section to Provinces and States—

- (a) in each year of a prescribed period such sum as may be prescribed; and
- (b) in each year of a further prescribed period a sum less than that retained in the preceding year by an amount, being the same amount in each year, so calculated that the sum to be retained in the last year of the period will be equal to the amount of each such annual reduction;

Provided that—

- (i) neither of the periods originally prescribed shall be reduced by any subsequent Order in Council;
- (ii) the Governor-General in his discretion may in any year of the second prescribed period direct that the sum to be retained by the Federation in that year shall be the sum retained in the preceding year, and that the second prescribed period shall be correspondingly extended, but he shall not give any such direction except after consultation with such representatives of Federal, Provincial and State interests as he may think desirable, nor shall he give any such direction unless he is satisfied that the maintenance of the financial stability of the Federal Government requires him so to do.

**140 (2)** Notwithstanding anything in the preceding subsection, one half, or such greater proportion as His Majesty in Council may determine, of the net proceeds in each year of any export duty on jute or jute products shall not form part of the revenues of the Federation, but shall be assigned to the Provinces or Federated States in which jute is grown in proportion to the respective amounts of jute grown therein.

**142.** Such sums as may be prescribed by His Majesty in Council shall be charged on the revenues of the Federation in each year as grants in aid of the revenues of such Provinces as His Majesty may determine to be in need of assistance, and different sums may be prescribed for different Provinces:

Provided that, except in the case of the North West Frontier Province, no grant fixed under this section shall be increased by a subsequent Order, unless an address has been presented to the Governor-General by both Chambers of the Federal Legislature for submission to His Majesty praying that the increase may be made.

## APPENDIX II.

## A.—BUDGET OF THE GOVERNMENT OF INDIA.

(In lakhs of rupees).

	1930-31.	1931-32.	1934-35.	1935-36. (Revised).	1936-37. (Estimates as presented).
Revenue . . . . .	1,24,60	1,21,64	1,25,10	1,24,37	1,22,77
Expenditure . . . . .	1,36,18	1,33,39	1,20,15	1,21,95	1,22,70
	<u>—11,58</u>	<u>—11,75</u>	<u>+ 4,95</u>	<u>+ 2,42</u>	<u>+ 7</u>

NOTES.—All the above figures include Burma.

The 1934-35 result is given before providing 2,81 lakhs for rural economic development and other special grants totalling 1,78 lakhs out of the surplus of that year: and the 1935-36 result before providing 45 lakhs for buildings in Sind and Orissa and 1,97 lakhs for Revenue Reserve out of the anticipated surplus of that year.

Expenditure both in 1935-36 and in 1936-37 includes a grant of about 1,90 lakhs to the jute-producing Provinces and a subvention of 1,00 lakhs to the North West Frontier Province. Expenditure in 1936-37 includes in addition a grant of 1,08 lakhs for Sind and 50 lakhs for Orissa.





## APPENDIX III.

(See paragraph 19.)

## NOTE ON THE PROPOSED ARRANGEMENTS WITH REGARD TO BALANCES HELD BY THE GOVERNMENT OF INDIA ON ACCOUNT OF THE PROVINCES AND ON PRE-AUTONOMY DEBT.

On the institution of provincial autonomy, the Government of India contemplate the following steps with regard to—

- (a) decentralisation of balances,
- (b) consolidation of pre-autonomy debt.

(a) *Balances.*

1. The accounts of provinces with the Reserve Bank will be credited with their unearmarked provincial balances, Famine funds, Depreciation Funds, etc., and the unspent amounts of Road and Development resources assigned to provinces in the past in advance of requirements.

2. There are various other deposits banked with the Government of India (such as, interest carrying provident fund deposits and interest free balances of municipal and other local authorities) which are of an intrinsically local nature or definitely associated with provincial functions. These, together with any liabilities attached to them, will also pass to the provinces concerned. So far as the provinces will require cash in their treasuries and minimum balances with the Reserve Bank, they will take these from this source (as, in effect, they have hitherto done). Cash in treasuries to the extent required will become the property of provinces while the accounts of the provinces with the Reserve Bank will start with the necessary minimum credits. But in so far as there is a remanet beyond the amounts so required in cash, it is proposed to write off that remanet against debt owed by the provinces to the Government of India. The Government of India might in the last resort contemplate making over the remanet also to provinces in the form of cash, but, inasmuch as the debts of the provinces to the Government of India carry interest above present market rates, it is clearly advantageous to them to cancel a corresponding amount of such debt. These balances are likely to grow rather than to diminish. In effect therefore they are a permanent asset. Accordingly, if they are used to cancel debt, permanent debt is the most appropriate to choose for the purpose. For this reason, and also because it carries a rate of interest (about  $3\frac{1}{2}$  per cent.) which, though well above, most nearly approximates to present market rates, it is proposed to adjust these balances by the cancellation at par of pre-1921 debt. Even taking into account the liability for the payment of interest on provident fund deposits (assumed at  $4\frac{1}{2}$  per cent. for 1937-38—a rate which is likely thereafter to fall), each province will reap a budgetary benefit by this process.

(b) *Consolidation.*

3. Owing partly to changes in the constitution of the Government of India's own debt, from which the capital of the Provincial Loans Fund is derived, the existing arrangements for borrowing from the Provincial Loans Fund have resulted in an unsatisfactory relationship between the periods for which that Fund has lent to the provinces and those in which the Fund's capital is repayable to the market. In order to correct this anomaly it is proposed to revise the means by which provincial borrowing requirements should be met for the future; and in this connection it is very desirable to simplify the present relations of the provinces to the Fund by consolidating the pre-autonomy debt of each province into a single debt carrying a single rate of interest. This step is also advisable in the interests of future provincial credit, to which end also it should include provision for the redemption of the remaining pre-1921 debts, which at present are not amortised.

4. If the period of repayment of such a single consolidated debt were fixed at 45 years, the above objects could be accomplished without imposing any additional burden on the budgets of the provinces and indeed with some relief to each. The Government of India would have preferred to consolidate on the basis of a shorter period, but 45 years is at any rate more in accord with the Government of India's own obligations to the market than the existing periods of repayment of many of the provinces' present obligations to the Fund, and they would be prepared to accept that period. Certain exceptions would be necessary to comply in all cases with the desire to avoid increased burdens on the provinces. Owing to the disproportionately large amount of pre-1921 debt of the Punjab, the general plan would not be entirely satisfactory in that case, and it is proposed to exclude from consolidation Rs. 10 crores of the Punjab pre-1921 debt, the Punjab Government retaining that debt at  $3\frac{1}{2}$  per cent. on its present basis with the option to redeem it if at any time they desire to take advantage of market conditions to do so. In the case of Bombay, it is proposed to exclude a block of comparatively short term debt of the Pr. Sidney Corporations and to continue this block entirely on the present terms.

5. The average rate of interest payable on the debt to be consolidated has been calculated, to the nearest quarter per cent., to give credit in advance for the near conversion operations of the Government of India. According to the existing terms of the Provincial Loans Fund, provinces could thereafter expect no substantial benefit from conversion operations until the Government of India 1945—55 and 1960—70 loans are redeemed. In order that the provinces may share any advantage arising on those occasions, it is proposed to give them the right [subject to any restrictions which may be imposed under section 163 (3) of the Government of India Act], within a year on each side of the first optional dates of repayment of these loans, to redeem in cash at par a part or possibly the whole of the amounts outstanding on those dates of their pre-autonomy debts due to the Government of India (any balance to be repaid over the remainder of the 45 year period).

6. In addition, the Government of India will be prepared to provide free of charge any ways and means advances required by any province during the year 1937-38 on the understanding that these are completely liquidated by 31st March 1938.

7. The detailed effect of the above proposals is set out in the accompanying table.

Table.

	Madras.	Bombay.	Sind.	U. P.	Punjab.	C. P.
I.—(1) Pre-1921 debt . . . . .	827.8	615.6	274.9	1219.4	1086.7(c)	151.0
Deduct (2) Balance available on decentralisation . . . . .	577.2	361.1	49.4	322.6	294.2	151.9
Add (3) Post-1921 debt . . . . .	727.5	2070.8	229.7	1760.3	998.9	378.6
(4) Debt to be consolidated . . . . .	978.1	2325.3	455.2	2647.1	1791.4	378.6
II.—(5) Proposed rate of interest on consolidation . . . . .	4.5	4.5	4.00	4.25	4.00	4.25
III.—(6) Debt charges as in 1936-37 revenue budget (d) . . . . .	90.5(b)	139.0	24.0	146.6(a)	96.9	27.1
(7) Annual total debt charges on existing debt (d) . . . . .	90.5	149.3	24.0	157.4	96.9	45.6
(8) Annual debt charges under consolidation . . . . .	51.2	121.5	22.1	133.5	86.5	19.0
(9) Gross benefits against budget 1936-37 . . . . .	39.3	17.5	1.9	13.1	10.4	8.1
(10) Gross benefit against total debt charges . . . . .	39.3	27.8*	1.9	23.9	10.4	26.6
(11) Liability of province in respect of that portion of (2) which carries interest assumed at 4½ per cent. . . . .	13.1	13.3	1.2	11.2	8.7	5.7
(12) Net benefit as against 1936-37 budget (d) . . . . .	26.2	4.2	.7	1.9	1.7	2.4
(13) Net benefit as against total debt charges (d) . . . . .	26.2	14.5*	.7	12.7	1.7	20.9

(a) U. P. debt charges on 1936-37 borrowing excluded and also 6.82 special repayment of 1935-36 borrowings.

(b) Madras debt charges on 1936-37 borrowing excluded.

(c) After cancelling one crore against debt due by Government of India and isolating further 10 crores at 3½ per cent. excluded from consolidation.

(d) The difference between items (6) and (7) or items (12) and (13) in some provinces is due to amortisation charges being met from resources which have not entered the revenue accounts, e.g., capital receipts into the Provincial Loans Account or other balances.

\* These figures may possibly be regarded as 4.9 too high.