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Author(s): George Findlay Shirras

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Public Finance in India

By George Findlay Shirras, M.A.

Principal and Professor of Economics, Gujrat College, University of Bombay; Reader in Currency and Finance, University of Calcutta, 1914; Hon. Fellow, Royal Statistical Society, 1920

SOME years ago when I lectured at Harvard and Princeton I remember the interest that was taken in the Indian financial system and the changes brought about in Federal and State finance—I use the American terms—consequent on the Reforms introduced by the new Constitution embodied in the Government of India Act 1919. The object of this Memorandum is to describe so that he who runs may read and reading understand the main features of this financial system as it works in this country today.

Like the great and friendly Republic before the war and like the Union of South Africa, Australia, Canada, and many other countries today, India is a debtor country in the sense that foreign capital is invested in her railways and irrigation works and in industries in excess of her own investments abroad. She has also to remit an amount varying between $150,000,000 and $175,000,000 (£30 and £35 million sterling) annually, known as Home Charges, to meet the expenditure connected with railway material, military, pension and other sterling adjustments. The question of exchange, therefore, is of great importance. To liquidate the claims official and nonofficial exports have to exceed imports, that is, India has to maintain a favourable balance of her visible grade.

Economic Condition

India, it will be remembered, is as large as Europe without Russia, and her population is one fifth of the human race. The area is 3,750,000 square miles with a population of 319,000,000, while Europe, including Russia, has an area of 1,805,332 square miles and a population of 475,000,000. The wants of the people are simple and are chiefly available within reasonably close proximity to the consumer. Agriculture is far in a way the most important industry and India's exports (which amount to one eleventh of her total production) are to the extent of nine tenths agricultural products. Thus she is more like the United States in that she relies on internal markets to a large degree, and is unhampered by interprovincial trade barriers. Her industries, especially the cotton textile industry, iron and coal, have felt the effects of world depression. During the war many of her industries increased their capacity and with the absence of demand and of the stimulus of high prices these have suffered considerably.

The slump of 1920–21, and subsequent years, affected the economic life of India in various ways. In the first place it was necessary, if India was to purchase the same volume of imports as before, that she should export proportionately much more of her raw materials to pay for the highly priced manufactured goods. The prices of manufactured goods increased more than those of raw materials. Three quarters of India's exports are raw materials and approximately the same proportion of her imports are manufactured goods. In 1924 and 1925, however, exports did increase as compared with prewar levels but imports were relatively less. Fluctuation in

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prices has been serious. There has, too, been the lag in the rise of wages in regard to prices. When a fall of prices occurred and trade became depressed a reduction in wages was not possible. At the International Economic Conference Geneva in May, 1927, the representatives of this country stated that,

Partly as a result of war and postwar conditions, and partly as a result of the adoption of a policy of discriminating protection, a change has occurred in the character of India's foreign trade. Manufacturers account for a slightly lower proportion of her imports and a slightly higher proportion of her exports. While, thanks to a succession of good harvests, agricultural production has increased, local consumption has in the main increased more rapidly than exports.

FINANCIAL SYSTEM

The facts stated in the preceding paragraphs have an important bearing on public finance in many ways. For example, indirect taxation is the main source of taxation as might be expected where the population to a large degree depends on agriculture. Again fluctuations in exchange were brought about by the trade boom and its aftermath. From 1s. 4d. the rupee rose to 2s. 10½d. in the spring of 1920. It fell approximately to 1s. 3d. in 1921, and subsequently rose to 1s. 6d. where, by legislation in 1927, it has been stabilised.

With this explanation of the basic facts behind the Indian financial system we may now plunge *in medias res.* The Reforms *inter alia* were designed to secure a greater measure of independence for Provincial (or State) Governments and each Provincial Government has its own budget and is responsible for its own finance. The Indian or Native States are also responsible for their own finances which are not, of course, included in the Central or Federal or in the Provincial Budgets. The General Budget is divided into two heads (1) Revenue and expenditure charged to revenue and mainly representing current revenue and expenditure; and (2) "Receipts and disbursements" which represent capital transactions. This part of the budget is often called the "Ways & Means" budget. The receipt side of this latter budget (which is often misunderstood) includes any surplus or deficit in revenue, after meeting the expenditure charged to it, railway capital contributed by railway companies and Indian States towards outlay on State railways and proceeds of loans and other credit transactions including the annual additions to certain funds which may be classified as "debts, deposits and advances." The expenditure side of this account includes capital account disbursements and "debts, deposits, and advances." The financial year extends from April 1st to the following March 31st. The Budget is prepared about the middle of the current financial year, is submitted to the Legislature on the last day of February, and voted before the beginning of the financial year to which it refers.

REVENUE AND EXPENDITURE OF THE CENTRAL GOVERNMENT
(In millions of Rupees)

	Revenue	Expenditure	Surplus+ Deficit−
1913–14 (prewar year)	813.27	778.58	+34.69
1923–24......	1331.7	1307.8	+23.9
1924–25......	1380.4	1323.6	+56.8
1925–26......	1333.3	1300.1	+33.2
1926–27......	1302.5	1271.5	+31.0
1927–28......	1289.6	1252.6	+37.6

In the last five years, financial equilibrium has been obtained, and the country looks forward with an improvement in the international trade position to a period of commercial ex-

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pansion. The years 1917–18, and their four immediate successors, were years of unbalanced budgets and are a real blot in the history of Indian finance. The total deficits in these five years amount to over 980 millions of rupees. In the five years ended 1927–28 the surpluses have amounted in the aggregate to over 180 millions of rupees.

SOURCES OF REVENUE

The main sources of revenue of the Central Government are customs, railways, income tax, salt, opium, currency and mint, military receipts, and contributions and assignments to the Central Government by Provincial Governments. The main heads of expenditure are military services, railways, and debt services, which accounted for 1,060 millions of rupees out of a total expenditure of 1,300 millions of rupees in 1926–27 (Budget Estimates). The sources of revenue just mentioned amounted, in the same year, to nearly 1,230 millions of rupees out of a total revenue of 1,300 millions. It may be noted here that the export of opium to China was prohibited in 1913 and in June, 1926, the Government of India decided to reduce progressively exports of opium from India, except for strictly medical and scientific purposes, so as to extinguish them altogether at the end of 1935. Thus the revenue from this head is a dwindling one.

In addition to the Central or Federal Government's budget there are the budgets of the various Provincial or State Governments. The Budget Estimates for 1926–27, the latest available year show a total revenue of 940 millions of rupees and a total expenditure of 970 millions of rupees. In this connection the Finance Minister of the Central Government said, some years ago:

It has been suggested to me by more than one spokesman for the provinces that there is a feeling in the minds of the Provincial Governments and of their legislatures that it would be unwise for them to show balanced budgets. They are, it is hinted, taking a leaf out of the book of some charitable and religious bodies which make a habit of showing an annual deficit in order to make a striking appeal to their supporters to come to their rescue. The Provincial Governments think, it will be said, that they will get more sympathy from the Central Government and get rid of their provincial contributions (to the Central Government) quicker if they can show a handsome deficit and appeal to the charity of the Central Government. I should like to say for my part that the strongest appeal that the Provincial Governments can make to me in this matter of provincial contributions is to show themselves worthy of assistance from the Central Government by strenuous and successful endeavours to make ends meet for themselves.

The main heads of revenue for 1926–27 (Budget Estimates) of the Provincial Governments are land revenue, excise, stamps, irrigation, and forests—Rs. 820 millions out of a total revenue of Rs. 940 millions. Of the expenditure of Rs. 970 millions, salaries of civil departments including education were Rs. 520 millions, civil works Rs. 110 millions, irrigation Rs. 70 millions, assignments and contributions to the Central Government Rs. 54.5 millions, and land revenue Rs. 40 millions. To some of these items we shall refer in a subsequent paragraph where the questions of provincial contributions and provincial stringency are discussed.

It will thus be clear that the Central Government's budget is the controlling factor in Indian Public Finance today. It is far greater than all the Provincial budgets put together. It possesses elastic heads of revenue (such as income tax and customs) which, or at least a share of which, provincial governments long to have for the develop-

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ment of education and sanitation. On the other hand the Central Government has the all important duty of defence. India has 1,400 miles of dangerous frontier and although Rs. 590 millions out of an expenditure of Rs. 1,300 millions is on military services this is a far less proportion if provincial budgets are also taken into account. The Central Government has, too, the control of India's public debt and the preservation of the high credit which India has in the London money market. Added to this there are the railways which are a source of profit to the State. The total capital at charge on Railways to the end of 1925–26 was Rs. 7,630 millions and the average return on the capital at charge 5.61 per cent.

From 1924–25 Railway Finance has been separated from the general finances of Government. There is now a fixed contribution from railways to general revenues of Rs. 50.9 millions and Government obtains in addition one third of the excess over Rs. 30 millions of the net balance shown by receipts over expenditure. There is a Railway Reserve apart from Government revenues, and Railways are run on a commercial basis.

CENTRALISED FINANCIAL ADMINISTRATION

In India financial administration was for long centralised. All the revenues of British India went into one purse and the Central Government allowed the provincial governments so much annually. When the government of the country was simple this system worked but when after the Mutiny with the development of police communications, and education, the needs of provincial governments became greater and some decentralisation of financial powers became more and more necessary.

In 1870 it was decided to give provincial governments some incentive to practise economies and to make them take part of the burden of administration off the shoulders of the Central Government. The outlines of the scheme of Lord Mayo were published in the Government of India Gazette of December 14, 1870, and it was in brief that there were two groups of services, one of which was to be administered by the Central Government and the other by the provinces. The latter group included such services as police, education, sanitation, and public works (roads and buildings) belonging to local governments.

The expenditure in connection with these was provided for by an annual consolidated grant, fixed as a rule for five years, for each province. Any savings made in these grants (which were not reduced except in the most urgent necessity) went to the Provincial Government and did not lapse to the Central Government at the end of the year. This was in general terms the system which was in force until the new constitution came into being in 1921. It will be noted that under the Mayo Scheme, instead of fixed grants to provincial governments, certain specified heads of revenue were given to them in whole that is, income from stamps, excise, law and justice or in part. Thus began the system of "divided heads," divided heads of revenue between the central and provincial governments which were believed to be the most capable of expansion under proper management. At each five-yearly settlement the terms were slightly altered. In 1904 the financial settlements between the Government of India and the provinces were made quasi-permanent and in 1912 absolutely so. In 1904 the provinces were given the right to keep their own savings.

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DIVISION OF HEADS

The constitution contemplated by the Government of India Act 1919 necessitated with the new status and responsibilities of provincial governments a complete revision of the financial relations and division of revenues between the central and provincial governments. Provincial governments were given additional powers to borrow and to tax and the system of divided heads was abolished. The Central Government retained income tax, customs and salt while the provincial governments had land revenue and the other heads referred to above.

In the division of heads the Central Government was left with insufficient resources and thus it was necessary to ask the provinces to pay back to the Central Government, each year, an amount which was fixed by the Meston Committee in 1920. The Committee were aware that the scale of expenditure differed from province to province, but thought that it would be fairest for those provinces, which gained most by the proposed new allocation of revenues, to pay most to the Central Government. The disadvantages of this scheme were (1) that a province that had been economical in the past was penalised for its economy, because the new scheme made the difference between its expenditure and its newly gained revenue all the greater and therefore it would have to pay more to the Central Government; (2) that in the past, provinces had not developed their communications and services adequately and that this difference between revenue and expenditure should be kept by the provinces in order to correct the harmfully low expenditure hitherto followed.

The Committee had to fix ideal or standard contributions to be made by government until the deficit in the Government of India's (that is the Central Government's) finances should be abolished. This new settlement produced great indignation in the provinces which for the first time saw how much they were contributing to the Central Government, and there was much eagerness to push on with the nation-building departments and at the same time owing to the increased cost of living to meet the increased pay required for the provincial services. When it is remembered that during the first years of the Reforms, Madras had to pay Rs. 34.8 millions, the United Provinces Rs. 24 millions and the Punjab 17.5 millions the seriousness of the situation can be imagined and how impeded has been the working of the reforms in the provinces owing to financial stringency.

By 1926 the total contributions to the Central Government were reduced from 98.3 millions to Rs. 60.8 millions per annum and on February 28, 1927 the Finance Minister announced a recurring surplus of 36.4 millions of rupees of which he proposed to use 35 millions for the remission of provincial contributions. For special reasons the whole of Bombay's contribution was remitted and all but 19.5 millions of the provincial contributions have been permanently remitted while Rs. 35 millions have been remitted for the year 1927–28 only. In the present year 1928–29 it is hoped that the remaining sum of Rs. 19.5 millions will be permanently remitted. During 1927–28 no province will pay anything to the Central Government in the way of contributions and thus no less than 54.5 millions of rupees (35 + 19.5) have been given to the provinces as additional spending power or power to command goods and services. This remission is the most important event in the financial relations between the Government of

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India and the governments of the provinces and may have an important bearing on the development of the Indian constitution.

Taxation

Local legislatures cannot without the previous sanction of the Central Government impose or authorise the imposition of any new tax unless the tax is a scheduled tax that is, (1) a tax on land put to uses other than agriculture; (2) a tax on succession or on acquisition by survivorship in a joint family (This raises the interesting question of inheritance taxation in India); (3) a tax on any form of betting or gambling permitted by law; (4) a tax on advertisements; (5) a tax on amusements; (6) a tax on any specified luxury; (7) a registration fee; and (8) a stamp duty other than duties of which the amount is fixed by Indian legislation, not provincial legislation. Taxes, cesses, rates, duties and fees such as a toll, a tax on buildings, servants, professions, markets, etc., which are for purely local authorities, are also included under scheduled taxes. All other taxation requires the sanction so far as provincial authorities are concerned of the Central Government or Legislature.

Since 1921 the year of the introduction of the Reforms the financial story is a remarkably good one to relate. The financial machinery has been improved, notably in regard to the separation of railway finance from the general finances as explained above. No longer is there an alternation between raids by the Railways on the taxpayer and raids by the taxpayer on the Railways. It will lead to valuable dividends in future budgets and to great economies in the working of Indian railways. It gives a real incentive to increase their efficiency. The taxpayer, instead of paying the whole of the expenses and taking the whole of the incomings of the railways, has entered into a bargain with the railways to receive from them (1) a sum sufficient to pay in full the interest on capital invested in the commercial lines; (2) an additional dividend of fives sixths of one per cent on that capital and (3) a share of any surplus earnings that may be secured. In return the railways will be left to carry on as a business and to retain any surplus over and above what they pay to Government and to apply it to railway purposes (a) for creating reserves and (b) to use these reserves to improve the services. The Government of India and the Assembly are in complete control just as hitherto. The Railways in short are now a real commercial undertaking managed on commercial lines and the taxpayer gets the benefit of commercial accounts and management. Considerable progress has, it has been seen, been made in regard to the extinction of Provincial contributions. The salt tax, an elastic and on the whole a good tax in India, has been reduced and the cotton excise duty has been abolished. The rains or weather conditions have favoured us. The level of taxation is still high as compared with 1914 but not in compulsion with other countries, as the following data shows:

TAXATION PER HEAD

	1913–14	1926–27
India	Rs. 3.42	Rs. 6.03*
Great Britain	£3-11.4	£14.11.8
France	Fcs. 84.5	Fcs. 910.2
Germany	R.M. 31.3	R.M. 113.4
Italy	Lire 53.8	Lire 394.4
United States †	$6.8	$30

* *Science of Public Finance* (Macmillan), p. 644 table XX.

† Federal only.

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The balance between direct and indirect taxation in India today is as follows:

	50 Years Ago	Prewar Year 1913–14	1921–22 *
Land Revenue	45.9	41.5	25.8
Other direct taxes....	3.5	5.4	19.2
Direct taxes........	49.4	46.9	45.
Indirect taxes.......	50.6	53.1	55.
	100	100	100

* P. 160, *Science of Public Finance.*

IMPORTANT MATTERS

A review of the Indian financial system would be incomplete without some reference to three matters that deserve notice in view of their importance in recent years—retrenchment, certification, and the public debt. In the winter of 1922–23 a strong Committee presided over by Lord Inchcape examined the whole range of expenditure in so far as it related to Central finance. The Committee realised the importance of financial equilibrium and of the place of expenditure in securing this equilibrium. Savings to the extent of nearly Rs. 193 millions were recommended, the largest items of economy being on the military side (Rs. 105 millions), railways Rs. 45 millions, Post and Telegraphs (Rs. 13 millions) exclusive of five millions in the capital expenditure of the Telegraph Department. In the sphere of general administration a reduction of five millions was recommended towards which every Department of the Government of India had to contribute by very drastic economies. In the 1923–24 budget the Government was able to include the major portion of the economies recommended.

In regard to certification it is sometimes necessary to certify, restore, or authorise expenditure as an Act of the Executive. This is provided in the constitution as defined in the Government of India Act 1919 and is described elsewhere[1] both in regard to the central and provincial governments. The Finance Bill of 1923 and the Finance Bill of 1924 were certified and the Governor-General stated at length the reasons which led him to certify these Bills. In the pre-reform days the official bloc on the Legislature enabled the Executive to pass necessary legislation. The reason for entrusting these powers of certification to the Governor-General and to Governors is the fact that the Central Government is responsible not to the Central Legislature but to the British Parliament and with the lessening of this responsibility to Parliament the certifying powers will *pro tanto* be reduced.

The debt position of India today is one of considerable interest to students of finance because of the large proportion of the total debt that is productive. The productive portion is invested mainly in irrigation works and in railways which pay a return on the capital invested. The total debt of India on March 31st, 1927, was as follows:

	R (*millions*)
In India..........................	5231.4
In England[2]......................	4524.0
	9755.4
Productive	
for Central Government...........	6544.2
for Provinces....................	1194.1
	7738.3
Unproductive.....................	2107.1
	9755.4

[1] Vide ch. XXXIX, the Legislation of the Budget, *Science of Public Finance,* p. 594.

[2] Converted at 1s. 6d. to the rupee. The sterling amount of the public debt was £339.3 millions.

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The unproductive debt of India includes the true war debt, the building of the capital, New Delhi, and accumulated deficits of the five years ended March 31, 1923. Taking the periods of 80 years for productive debt and 50 years for unproductive debt as the period reasonable to fix for the redemption of these classes of debt and assuming that the sums provided year by year are set aside to accumulate at 5 per cent compound interest we find that Rs. 36.6 millions is the amount to be provided annually beginning with the year 1924–25 to redeem the whole debt of India within the assigned period. An annual provision of Rs. 40.4 millions would for the next five years achieve the same end for the quinquennium. A statutory programme for the redemption of debt such as the one adopted is most desirable. The Government of India have made regular provision for reduction or avoidance of debt and have been able accordingly to borrow on favourable terms in the market.

India has been buying back the titles to some part of her sterling loans and this is a process that is the beginning of India's becoming a creditor nation in the ordinary sense of the words. Hitherto she has been a creditor in the sense her exports exceed her imports and hitherto the payment has been mainly in the form of gold and silver. A Provincial Loans Fund has been established and it will regulate on definite principles the borrowing of the Provinces. In short, the interest charges and the terms on which the advances are granted, for various purposes are to be repaid, will be the same for all provinces, and at such rates as will keep the Fund solvent. The Fund has the germs of a noteworthy development as it is likely some day to be the Fund which should be administered by an Indian body corresponding to the National Debt Commissioners and the Public Works Loan Commissioners in England.

It would be advantageous to the finances of India if the advances made by the Central Government to the Provincial Governments could be excluded from the Public Debt of the Government of India in the same way as advances made on the guarantee of the British Treasury to public bodies in Great Britain are excluded from the British Public Debt. It would show better the real facts of India's Public Debt and the single borrower, the Government of India, would then raise what was necessary for itself on the sole security of the Indian revenues.

PRINCIPLES OF SOUND FINANCE

The principles of sound finance must be applied to every function of Government and this is the problem that has been successfully tackled in India. It is not without criticism as ever since the creation of a Finance Membership in the Governor-General's Council in 1859 the policy has in the main been the policy of law and order first. Since 1910 the policy of spending more and more on education and other social services has been followed but the amount spent is still deplorably insufficient. In the last Census the number of males able to read and write was 19,800,000 as against 142,600,000 unable to read and write. The number of females who were literate were 2,800,000 as against 150,800,000 unable to read and write.[3] Provinces, therefore, require funds to remove this blight of illiteracy and in the next few years the question of provincial and central finance will be one of the hardest India will have to solve. Financial reform will be an urgent necessity and the

[3] Census. These numbers fall short of the total population of India as literacy was not enumerated in one or two tracts.

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aims of our taxation will have to be further explored.

One cannot conclude this survey without a reference to the Rt. Hon. James Wilson the first Finance Minister of India. He did for Indian Finance what Alexander Hamilton did for American Finance. A former Financial Secretary of the British Treasury, he came to India in 1859, and in eight busy months laid the foundations of sound finance, foundations which remain up to the present time. In the words of Bagehot, the son-in-law of Wilson:

> He united high financial reputation, considerable knowledge of India acquired at the Board of Control, tried habits of business, and long experience at the English Treasury, to the sagacious readiness in dealing with new situations which self-made men commonly have, but which is commonly wanting in others.

Wilson's successors carried on the tradition and until recent years the orthodox English or Gladstonian finance of the 19th century was the order of the day. The 20th century has passed or is passing away from this tradition, as the Reforms introduced in 1921 have changed the complexion of Indian finance. We are apt to forget the first, and perhaps the greatest, of our finance ministers and we say this remembering all the famous galaxy. Wilson, like Hamilton, is outstanding among them. Indeed the words of Madison applied to Hamilton are true of Wilson,

> That he possessed intellectual powers of the first order, and the moral qualities of integrity and honour in a captivating degree, has been awarded him by a suffrage now universal.

Wilson, in short, had Hamilton's strong will, unbounded energy, unmistakable courage and great self-confidence.

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