CHAPTER I
INTRODUCTION

"From the notion that national unity can be reconciled with state independence by a division of powers under a common constitution between the nation on the one hand and the individual states on the other, flows the three leading characteristics of completely developed federalism, - the supremacy of the Constitution - the distribution among the bodies with limited and co-ordinate authority of the different powers of government - the authority of the courts to act as interpreters of the Constitution." The essential characteristics of federalism have been thus explained by Dicey in his classic work on Constitutional law.¹

Structurally looked at, Indian Constitution contains the basic requisites of classical federalism. The Legislative powers are demarcated and distributed between the Union and the State Governments² and three lengthy lists of legislative subjects of these governments³ are integrated in the Constitution itself. The territorial jurisdiction of laws enacted by various governments is also stipulated by the Constitution.⁴ Dealing with the Executive powers of the Union and the State Governments, the Constitution declares that they are coextensive with their respective legislative powers.⁵ By vesting the original and exclusive jurisdiction upon the Supreme

² Articles 246 and 248 of the Constitution.
³ Lists I,II and III of the Seventh Schedule to the Constitution.
⁴ Article 245.
⁵ As per Articles 73 and 162 of the Constitution, the executive power of the Union and the State Governments extend to the laws made by them with an exception that in the case of concurrent legislation the Union laws shall be administered by the State's machinery unless otherwise specifically provided for.
Court of India\textsuperscript{6} on disputes between the Union and the State governments, inbuilt mechanism is assured in the Constitution to ensure effective operation of the federal governance with least friction, wastage and overlapping. Democracy and federalism are the essential features of our constitution and are part of its basic structure.\textsuperscript{7}

However, there is no unanimity about the nature of the Constitution. The degree of federalism under Indian Constitution has been a subject of incessant debate. Various writers have taken different ideological positions\textsuperscript{8} calling it as unitary, federal, federal with unitary characteristics, cooperative federal, etc. While interpreting the federal characteristics of the Indian Constitution, the Supreme Court also expressed divergent views. In \textit{State of West Bengal v. Union of India}\textsuperscript{9} the Supreme Court opined that “the exercise of powers, legislative and executive, in the allotted fields is hedged in by the numerous restrictions so that the powers of the States are not co-ordinate with the Union and are not in many respects independent.”\textsuperscript{10}

\textsuperscript{6} Article 131 of the Constitution.
\textsuperscript{9} A.I.R. 1963 S.C. 1241
\textsuperscript{10} \textit{Ibid.}, at p. 1252
Beg C.J. pointed out that "In a sense, therefore, the Indian Union is federal. But, the extent of federalism in it is largely watered down by the needs of progress and development of a country which has to be nationally integrated, politically and economically co-ordinated, and socially, intellectually, and spiritually uplifted."\(^{11}\)

*In S.R. Bommai v. Union of India\(^{12}\)* the Supreme Court declared: "The fact that under the scheme of our Constitution, greater power is conferred upon the Centre vis-à-vis the States does not mean that States are mere appendages of the Centre. Within the sphere allotted to them, States are supreme. The Centre cannot tamper with their powers."\(^{13}\)

However, a constitution cannot be branded as unitary or federal by merely looking at it from the theoretical point of view. The mere presence of federal features in a Constitution does not make it federal in practice and vice versa.\(^ {14}\) What is important is the working of the Constitution. In order to ascertain the true characteristics of a Constitution, instead of a pedantic or doctrinaire approach, what is needed is an evaluation from the functional point of view because a constitution is not what it says but what it practices. In this sense, true characteristics of Indian Constitution can be ascertained only by analysing its provisions relating to

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\(^{11}\) *State of Rajasthan v. Union of India* A.I.R. 1977 S.C. 1361, at p. 1382

\(^{12}\) A.I.R. 1994 S.C. 1918

\(^{13}\) *Ibid.*, per Jeevan Reddi at p. 2033

\(^{14}\) For example, the Canadian Constitution, which contains strong unitary features, has been more federal in practice than many other federal constitutions. See Wheare, *Federal Government* (1947), pp. 17-20.
federalism on the basis of practical applications and functional efficiency.¹⁵

Theoretical analysis of Indian Constitution shows that all the principles necessary for an effective federal structure have been incorporated in the Constitution and it is predominantly federal. Legislative and executive functions of different layers of governments are well demarcated and distributed. Viewed from the functional angle, distribution of legislative subjects between the Union Government and the State Governments is not mere legislative directive but is also area of obligations where they have to deliver optimal services to the public. These obligations are to be read in consonance with the positive directives under Part IV of the Constitution. The importance of the Directive Principles of State Policy in the governance of the country cannot be undermined in view of the pronouncement by the Supreme Court that they are “fundamental in the governance of the country and all the organs of the State, including the judiciary, are bound to enforce those directives.”¹⁶

The objectives of the Constitution are declared in the Preamble and the political governance of the country should strive to achieve those goals. The success of the Constitution is to be assessed on the basis of achievements made in this direction. The preamble of the Constitution affirms to constitute a socialist democracy wherein

¹⁵ "The law of the Constitution is one thing; the practice is another" Wheare, op.cit., at p.19.
social, economic and political justice shall be ensured to all.\textsuperscript{17} The essence of preamble was underscored in \textit{Minerva Mills}\textsuperscript{18}, as

"This is not mere semantics. The edifice of our Constitution is built upon the concepts crystallised in the preamble. We resolve to constitute ourselves into a Socialist State which carried with it the obligation to secure to our people justice – social, economic and political. We therefore, put Part IV into our Constitution containing directive principles of State policy which specify the socialistic goal to be achieved."\textsuperscript{19}

The principal aim of a socialist state is to eliminate inequality in income and status and standards of life. The basic framework of socialism is to provide a decent standard of life to the people and to provide security from cradle to grave. This amongst others on economic side envisaged economic equality and equitable distribution of income."\textsuperscript{20}

It is obvious that the Constitution perceived to constitute democratic socialism in the economic sphere and the structure of government conceived is federal. Through well-designed federal governance, the Constitution intends to realize the noble objectives manifested in the Preamble. In this sense, the success of federalism in India should be appraised on the basis of operational efficiency in attaining constitutional objectives.

Scrutiny of Lists I and II of the Seventh Schedule to the Constitution reveals that the subjects, which are directly related to

\textsuperscript{17}Preamble of the Constitution is an integral part of the Constitution and democratic form of government, federal structure, socialism, social justice are basic features of the Constitution. \textit{S.R. Bommai v. Union of India} A.I.R. 1994 S.C. 1918 at p. 2045

\textsuperscript{18}Minerva Mills v. \textit{Union of India} (1980) 3 S.C.C. 625

\textsuperscript{19}Ibid., at p. 654

\textsuperscript{20}See \textit{D.S. Nakra v. Union of India} (1983) 1 S.C.C. 305, at pp. 325-326
the social welfare of the people, are assigned to the States. Assigning subjects of social welfare to the exclusive jurisdiction of the states means positive obligation upon the States to deliver optimal services to the society in these sectors. These subjects are result oriented and successful implementation of programmes in respect of these subjects is directly related to the social development of general population. In view of the constitutional mandate contained in the preamble, it is obvious that the States are duty bound to ensure positive results in the functional sectors assigned to them.

Since functional responsibilities are allotted to the Union and the State Governments, it is a condition precedent that adequate resources are also made available to the governments to deliver their responsibilities effectively. But while allotting resources to the two layers of governments, apart from the consideration of adequacy of resources, certain other important aspects in respect of fiscal administration are also to be taken into account. Efficiency in tax collection, prevention of evasion, avoidance of duplication of levy, cost of compliance etc., are some of the important facets that are to be considered for efficient fiscal governance. Effectuating _adequacy principle_ and _public fiancé logic_ simultaneously in the operational field is the major impasse for achieving efficient fiscal governance in a federal set up. The real challenge in achieving an effective fiscal federalism under Indian Constitution is about striking a balance between these two important aspects in the area of fiscal governance.

In the field of fiscal governance also the Constitution perceives a federal structure. The subjects of Taxes and Duties are distributed between the Union and the State Governments. In order to have an operationally efficient fiscal federalism, the subjects of taxation are to be allotted to different layers of government on the
basis of economic as well as administrative rationales. A cursory view of various provisions in the Constitution relating to the Centre-State financial relations gives an impression that it has taken into account the various aspects of classical fiscal federalism\textsuperscript{21}. It appears that the distribution of functional subjects of exclusive jurisdiction to national and sub-national governments and allocation of the subjects of taxation to various layers of governments are in conformity with the principles of optimal services, cost effectiveness, equity, easy compliance, and evasion preventive. Despite the above distribution of the subjects of taxation to the Union and the State Governments, if the States are confronted with fiscal deficiency, it is constitutionally provided for the transfer of resources from the Centre to the States under the recommendations of the Finance Commission. Are these constitutional provisions able to provide a functionally effective federal system? Are these provisions complimentary to the constitutional objectives? Has the Indian Federation stood up to the demands, which it has been called upon to meet? To answer these crucial questions, a functional approach to the provisions relating to the Centre-State financial relations is indispensable.

\textsuperscript{21}The primary consideration in allocating subjects of exclusive jurisdiction to various governments should be the benefit incidence. The "Decentralisation Theorem" suggests that the subjects, the services of which are nationwide in their benefit incidence, should be given to the national government and the subjects, the services of which are local in their benefit incidence, should be given to the local governments. Stabilisation and redistributive functions, which involves macro economic policies, should be assigned to the national governments and the allocative functions may be shared between the national and local governments depending upon the benefit incidence. See W.E. Oates, \textit{Fiscal Federalism} (1972), p. 35. For an effective fiscal administration, the subjects of taxation should be allotted to various governments on the basis of certain principles. Subjects with national base should be allotted to the national government and subjects with local base should be allotted to local governments. Subjects, which are susceptible to multiple taxation, should be under the national government and in all cases the levy should be cost effective. Where a tax can be evaded by shifting the habitation, such taxes should be within the jurisdiction of the national governments. See Hugh Dalton, \textit{Principles of Public Finance} (1970), pp. 29-47
The provisions relating to the division of powers in the Constitution are substantially different from the recommendations made by the Cabinet Mission in 1946, which were accepted by the national leaders, and the principles contained in the Resolution of Aims and Objects presented in the Constituent Assembly. The recommendations of the Cabinet Mission and the declaration in the Constituent Assembly aimed at a true federal Constitution. However, ultimately the Constitution ‘adopted, enacted and given to ourselves’ was more unitary in nature.

Even at the time of framing of the Constitution there were some demurs regarding the plausibility of the scheme of Centre-State financial relations perceived to be incorporated in the Constitution. Strong objections were raised in the Constituent Assembly by some members as they were feared that the Centre-State fiscal relations in the Constitution would be disadvantageous to the States and it would result in the subordination of the States to the Centre. “The Provinces will be beggars at the doors of the Centre”, K. Santhanam opined. According to Sir A. Ramaswami Mudaliar, the provisions relating to fiscal transfers were unfavourable to the States. As the States were to carry the burden of nation-building activities, their financial resources would not be commensurate with their responsibilities. But, in general, the members did not oppose the basic principles of fiscal federalism adopted by the Constitution. At no time of Constitution making, the States claimed for themselves any of the tax resources proposed to be allotted to the Union, instead they were demanding greater share in the proceeds of taxes levied and retained by the Union.

33 Ibid. at p. 85.
The fundamentals of fiscal federalism under Indian Constitution were not seriously challenged till 1967 as the Governments at Centre as well as in the majority of States were led by a single political party, the Indian National Congress. The non-Congress governments, which raised the issues, were either silenced or in some cases dethroned.\textsuperscript{24} In the general election of 1967, non-congress governments came into power in nine States. These state governments did challenge many of the practices of the Union Government for its non-federal character. In 1969 The DMK Government in Tamil Nadu appointed a committee headed by Dr. P.V. Rajamannar, who was the Chairman of the Fourth Finance Commission, to consider the entire question regarding the relation that should subsist between the Centre and the State in a federal set up and to suggest measures necessary for augmenting the resources of the States without prejudice to the integrity of the country as a whole.\textsuperscript{25} The Rajamannar Committee observed that “though the Constitution set up a federal system .... there are several provisions which are inconsistent with the principles of federalism.”\textsuperscript{26} In the fiscal field, the Rajamannar Committee strongly recommended for measures reducing, if possible removing, the economic dependence of the States on the Union. The committee argued for an automatic devolution of resources without the interference of the Union Government or any other agency. The Committee further observed that the Union should not have any power to curtail the powers of

\textsuperscript{24} For example, the first government of Kerala (1957-59) had raised some fundamental issues relating to the federal characteristics of the Constitution. The government was dismissed from power on the pretext of the collapse of law and order. See Shriram Maheswari, President's Rule in India (1977), pp. 35-42, K.T. Zacharias, Autonomy to the States (1979), pp. 83-84.

\textsuperscript{25} Government of Tamil Nadu, Report on the Centre-State Relations inquiry Committee (1971), p.1

\textsuperscript{26} Ibid., p. 6
taxation of the States and there should not be any interference in the matters of States either through the Union ministries or Planning Commission or any other agency. During the last three and a half decades there had been lot of demands from the State Governments and political parties to review the Centre-State relations prevailing under the Constitution.\textsuperscript{27} The Left Front Government that had come into power in West Bengal in 1977 vociferously asked for a complete review of the Centre-State financial relation under Indian Constitution. Supporting this position, the Akali Dal Government in Punjab also came forward saying that the Constitutional provisions relating to Centre-State fiscal relations were only to push the States into serfdom. Since 1977 there had been a lot of uproar in the political arena demanding fundamental changes in the Centre-State financial relations. On June 9, 1983, a Commission for Centre-State relations was constituted by the Union Government with Justice R.S. Sarkaria as Chairman and B. Sivaraman and Dr. S.R. Sen as members 'to review the existing arrangements between the Centre and the States while keeping in view the social and economic developments that have taken place over the years. The review will take into account the importance of unity and integrity of the country and recommend such changes as might be appropriate within the present Constitutional framework'.\textsuperscript{28} The Sarkaria Commission submitted its report in 1988.\textsuperscript{29} The Commission approved the basic scheme of Centre-State fiscal relations and did not recommend any fundamental changes in the fields where the States were seriously

\textsuperscript{27} For details, see the Government of Assam, Keynote address of Shri. Prafulla Kumar Mahanta, Chief Minister of Assam, in the seminar on the 'Need to Restructure Centre-State Relations for a Democratic & Federal Polity' at Thiruvananthapuram on 22\textsuperscript{nd} October 2000.

\textsuperscript{28} Indira Gandhi, the then Prime Minister of India on the Sarkaria Commission. See B.P.R. Vithal and M.L. Sastry, \textit{Fiscal Federalism in India} (2001), p. 56.

\textsuperscript{29} Government of India, \textit{Report of the Commission on Centre-State Relations} (1988)
concerned. Subsequently, many State Governments constituted expert committees and commissions to go into the details of Centre-State relations demanding more financial autonomy and greater resource transfer. It is clear that the States are dissatisfied with the existing Centre-State relations under the Constitution of India. What has led the States to take a very rigid stand against the system of fiscal federalism existing under Indian Constitution? Are the provisions under the Indian Constitution and the practices in this field highly detrimental to the interests of the State finances? Are the States unable to fulfil their obligations to the people due to deficiency in resources? These are not questions merely related to public finance or fiscal management. They are multi dimensional questions that have far reaching political ramifications. In a constitutional democracy, to preserve the national fabric from being besieged, it is imperative to address these issues without delay.

The developmental indicators of India in various crucial sectors are not giving any promising picture. The balance sheet of Indian federal governance for more than half a century is presenting high rate of illiteracy, unemployment, poverty, high infant mortality rate, female infanticide, lack of proper drinking water facilities etc. In the year 2001, 26.10 percent of Indian population was below poverty line. In the case of habitation, only 41.6 percentage of

30 In respect of making the Corporation Tax sharable with the States, the Commission suggested that 'the net proceeds of corporation tax, while continuing to form part of the Consolidated Fund of India, should be permissively shareable with the States and distributed among them on the authority of law passed by the Parliament.' Ibid. Para. 10.6.16 and 19

31 The Government of Assam in July 2000 constituted a High Powered Committee on Greater State Autonomy and the Report of the Committee was presented before the Legislative Assembly in September 2000.

32 Government of India, National Human Development Report 2001. The poverty is not equally distributed among the States. As percentage of the population, it is highest in Orissa (47.15 percent) followed by Bihar (42.6 percent) and Madhya Pradesh (37.43 percent).
Indian population has pucca houses and only 49.3 percent have toilet facilities. Safe drinking water is yet to be made available to a good portion of Indian population. Out of the total population of India, only 62.30 percent has the access to safe drinking water. Of the rural population, it is only 55.54 percent. Only 42.4 percent of households have access to electricity in their houses. As per the Census Report, 2001, the all India literacy rate is 65.38 percent of which female literacy rate is 54.16 percent and male literacy rate is 75.85 percent. The literacy rates of Scheduled Castes and Scheduled Tribes in India are 37.40 percent and 29.60 percent respectively. The infant mortality rate is 71.6 and the mother mortality rate is 4.08 for 1000 deliveries. In addition to the above negative factors, social evils like child labour, untouchability, dowry deaths etc., are the other peculiar facets of Indian society. On the other hand, in some areas such as military capability, nuclear power, space research, telecommunications, railways, information technology etc., the country is very much advanced and in some sectors she is among the most developed of nations.

A peculiarity can be noticed from the above facts and figures. In those areas, which are exclusively within the jurisdiction of the State Governments, there is no remarkable progress whereas in the

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33 Ibid.
35 Ibid.
36 Ibid.
37 Ibid.
38 Number of deaths per 1000 live births in the first year of the child’s life.
40 In the administration of many subjects there are overlapping due to Entry 20 of the Concurrent List, which says “Economic and social planning.” The Union Government under this entry implements various schemes, which concurrently runs with many State plans. Although the subject ‘education’ is under entry 25 of the Concurrent List and certain agencies and institutions for higher, professional and (Contd. in p.13)
case of subjects under the jurisdiction of the Union Government, outstanding development can be noticed. Why have the State Governments performed so badly in their respective areas? Is it due to any resource crunch? Are the subjects of revenue allotted to the States extremely inadequate to meet their revenue requirements? Are the schemes of distribution of functional subjects and the subjects of taxation between the States and the Union Governments scientific and operating effectively? Are the constitutional provisions relating to devolution of revenue to the States not effective to fill the gaps of resources of the States? These are questions of great importance not only from the point of view of effective and viable Centre-State financial relations but also from the standpoint of the welfare of the citizens.

Reports of various Finance Commissions, especially the last three Finance Commissions also have highlighted the fiscal crisis of the States and their mounting debt positions. As per the Reports, the burgeoning revenue deficits of the States have been viewed very seriously by the Finance Commissions. The Reserve Bank of India Bulletins on State Finances regularly supply the details of the Revenue position of the States and the situation is alarming. Many States have been thrown to the dreadful debt trap. For many years the States have been compelled to make borrowings only to repay their earlier debts. A significant share of the revenue receipts of the States are used to repay loans and interests. Due to the acute resource gaps, many states have slashed their developmental expenditure. In many states the Government Treasuries remain

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technical educations are under the Union Government (Entries 63, 64, 65 and 66 of List I), the primary education and eradication of illiteracy is still the responsibility of the State Governments.

41 Ninth, Tenth and Eleventh Finance Commissions.
closed recurrently. These aspects point towards the traumatic situation of the fiscal position of the States under the federal structure of Indian Constitution.

The present fiscal status of the States raises doubts about the operational efficiency of the scheme of Centre-State financial relations under Indian Constitution. The underlying principles demand a thorough revision in view of the experiences of the last five decades. The basic question is whether there is any fundamental problem with the fiscal federalism enshrined in the Constitution?

Fiscal federalism in India is mainly historical in nature. Constitutional fiscal federalism in India is a contribution of British rule. If the fiscal federalism under Indian Constitution is evaluated in its historical perspective, it can be seen that the Indian Constitution owes much to the systems followed by the British Indian Government in the financial relations between the Federal and Provincial Governments. The origin of formal decentralisation of finances to the Provinces in India can be traced to the Report of Montague-Chelmsford on Constitutional Reforms and the Government of India Act, 1919. But the Mont-Ford Report and the Government of India Act, 1919 were not accidental. They were the results of historical evolution in the financial administration of the nation for more than six decades by an alien country whose interests were neither good governance nor public welfare.

Although the British Government had assumed direct sovereignty over the territories of East India Company only in 1858, the financial administration in the territories prior to it was regulated by the Charter Act of 1833. It provided for a highly centralised

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42 Montague-Chelmsford Report on Constitutional Reforms was submitted in 1918, which led to the passing of the Government of India Act, 1919.
system where the Provinces were assigned responsibilities with no independent revenue resources. They were fully dependent on the cash assignments from the Centre to run the administration. The fiscal arrangement under the Charter Act, 1833 was highly irrational and led to irresponsibility and extravagance in financial matters. It is relevant to quote the words of Sir John Strachey: “The distribution of the public income degenerates into something like a scramble, in which the most violent have the advantage with very little attention to reason. As local economy leads to no local advantage, the stimulus to avoid waste is reduced to a minimum; so, as no local growth of income leads to an increase of the local means of improvement, the interest in developing the public revenues is also brought down to the lowest level.”

The British Crown took over the administration of the Provinces from the above state of affairs and ruled the country for nearly nine decades. During the British rule, the highly centralised system of financial administration was gradually transformed into a limited constitutional fiscal federalism. In this process, plenty of committees, commissions, enactments, rules and regulations played crucial roles. Personal contributions of some of the British rulers also have helped in this transformation.

Even in the initial periods of British rule, when the financial administration was rigidly centralised, there were initiatives to delegate some fiscal powers to the Provinces. Provincial Financial Settlements of 1870 transferred some subjects to the Provinces along with the power to appropriate the departmental receipts under the subjects. The additional finances required for the administration

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44 Popularly known as Mayo Scheme, after the name of Lord Mayo who was the Governor-General in 1870.
of the transferred subjects were met by the grants from the Centre.\textsuperscript{45} In 1872, Samuel Laing, who was then the financial member in the Governor General’s Council, also had argued for local taxation for local purpose.\textsuperscript{46} In 1877, more subjects were transferred to the Provinces with no power to levy tax on them. However, for the first time the system of sharing taxes between the Centre and the Provinces was introduced.\textsuperscript{47} This was further widened by the quinquennial settlements in 1882.\textsuperscript{48} A crude form of sharing of tax subjects between the Centre and the Provinces can be noticed in the quinquennial settlements. In 1904 the Provincial settlements attained a quasi-permanent nature and the sharing of revenue with the Provinces was made on the principle that the resources of the Provinces must have some relation with their expenditure.\textsuperscript{49}


\textsuperscript{45} Although this was a significant step in the decentralisation of finance, it proved defective due to various factors such as lack of finances, ignorance of the Central Government about the local realities etc. The importance of this transfer is elucidated by Ashok Chandra as follows: “The steps taken in 1871 were of some significance; it rationalised the financial arrangements by assigning to the Provinces in stages, the proceeds of the whole or part of specified heads of revenue for general administrative purposes. It was expected that this devolution would gradually infuse in them a sense of financial responsibility both in the matter of collection of revenue and economy expenditure.” Ashok Chandra, Federalism in India (1965), p. 135

\textsuperscript{46} He presented his views as follows: “I am as strongly as ever in favour of the principle of local taxation for local purposes. In fact, if this great Empire is ever to have the roads, the schools, the local police and other instruments of civilisation which a flourishing country ought to have, it is simply impossible that imperial government can find either the money or the management.” Minutes of the Select Committee on East India Finance dated 9th July 1872.

\textsuperscript{47} The system of sharing of taxes prevailing under the Constitution of India may find its origin in the 1877 decision.

\textsuperscript{48} Subjects of taxations were divided as Imperial heads, Provincial heads, and Divided heads. The income from Imperial heads was retained by the Centre, Provinces retained the revenue from Provincial heads and the income from Divided heads was shared between the Centre and the Provinces.

\textsuperscript{49} The quasi-permanent settlement accepted the relation between revenue and expenditure of the Provinces and operated on the principle that the share of revenue allotted to the Provinces should bear approximately the same ratio to the Provincial expenditure. This is the basis principle adopted by the Indian Constitution in the sphere of Centre-State financial relations.
transformed the Centre-State financial relations more federal in nature. Most notable aspect of the Government of India Act, 1919 was that it abolished the ‘divided heads’ and introduced separate heads of revenue for the Centre and the Provinces. However, the most elastic subjects of revenue were retained by the Centre and the Provinces received inelastic revenue subjects. The residuary power of taxation also was held by the Centre. It is interesting to note that the Constitution of India also follows a similar pattern of fiscal sharing.

The working of Centre-State financial relations under the Government of India Act, 1919 had put forward the demand of fundamental changes in the system. Lots of committees and commissions were appointed to go into the details of the Centre-State fiscal relations and to make suggestions for improvement. The reports of various committees and commissions resulted in the passing of the Government of India Act, 1935. In respect of fiscal federalism under Indian Constitution, the Government of India Act, 1935 provided the framework. The system followed under the Constitution of India in the field of Centre-State financial relation is exactly the same as recommended by the Government of India Act, 1935 except for the provision relating to the Finance Commission. The provisions in the Government of India Act, 1935 in respect of division of subjects between the Centre and the Provinces, sharing of tax revenue between them, grants-in-Aid to the Provinces, and borrowings by the Provinces were copied in the Constitution of India. It is not wrong to say that the Constitution of India, in respect
of Centre-State financial relations, is an upgraded version of the Government of India Act, 1935.\textsuperscript{50}

It can be seen that the fiscal federalism in India has a long chequered history. But, there is a paradox in the system of Centre-State financial relations that was adopted by the Constitution of India. It was a reproduction of a pattern, which was moulded by a colonial government mainly to serve the ends of the imperial rule. It is doubtful whether adopting such a system to an independent sovereign country, the Constitution of which at the outset declares to constitute a socialist democratic republic, was appropriate? The ground realities in the social and political milieu at the time of drafting of the Constitution and the intention to maintain continuity in the field of fiscal administration might have forced the founders to lean more in favour of centralisation. As the system has failed to achieve the constitutional objectives, it is mandatory to review the provisions relating to the fiscal federalism under the Indian Constitution.

Since most of the subjects of nation building and social welfare are assigned to the States, the development of the nation is directly related to the efficient discharge of the positive obligations by the States. It goes without saying that the adequacy of resources available to the States is a condition precedent for the efficient functioning of the States. In the case of Indian States there is a wide gap between the revenue resources available and the functional responsibilities assigned. Over the time this gap has been widening.

\textsuperscript{50} The Government of India Act, 1935 was condemned by the national leaders when it was enacted. See S.L. Sikri, \textit{Constitutional History of India} (1979), p. 129. But when these national leaders were assigned with the responsibility of framing of a Constitution for the Country, the Government of India Act, 1935 was taken as a model in many fields.
due to the inelastic tax subjects allotted to the States. Elasticity of revenue subjects is a relative aspect. A subject of taxation, which is elastic during a period of time, may not be during another period due to changes in the political and economic conditions of the country. In such circumstances it is necessary to make appropriate alterations in the tax division scheme between the Union and State Governments. Unfortunately, no such exercise has been done under the Constitution so far; on the contrary, many constitutional amendments have adversely affected the revenue potential of the States. In the case of subjects allotted to the States, only Sales tax has considerable elasticity and all the other subjects of State taxation are highly inelastic. On the other hand all the major subjects of taxation under the jurisdiction of the Union Government are fairly elastic.

Sales tax contributes around sixty percent of the Own Tax Revenue of the States. Due to various problems associated with the levy of sales tax, the States are not able to exploit the potential of this subject fully. Major problem with this levy is that it has not been fully allotted to the States. Tax on the interstate sales is levied by the Union Government and the States are precluded from levying sales tax on various other transactions like penultimate sale or purchase in the course of export out of the territory of India, sale in the course of import into the territory of India etc. Certain commodities are declared by the Union Parliament by law as having special importance in the course of interstate trade or commerce and the States' power to levy sales tax on such commodities is restricted. The Union Government levies Additional Duties of Excise\(^1\) on sugar, textiles and tobacco and the States are restricted from levying

\(^1\) Hereinafter mentioned as 'ADE'
sales tax on these commodities. Although the States are allotted with the net proceeds of the ADE on these commodities, the Union Government has not tapped the actual potential of these goods and consequently the States are not receiving their due share. Sale of goods, which is the incidence of sales taxation, is an integrated activity and in most of the cases, along with the transfer of goods services are also transferred. In such cases the consideration for the transfer of goods includes the consideration for the services also and this element of consideration is taxed by the Union. This has created the situation that a levy that should have naturally gone to the State exchequer has been grabbed by the Union Government. Excise Duties, the second largest tax revenue of the States, are also not free from problems. Excise duties on limited commodities only are given to the States. Though it is a tax on commodities, the Centre has preferred to retain it with them. This indirect tax should have gone to the State as a tax on commodities.

From the point of view of revenue, tax administration, procedures and simplification there are serious faults in the allocation of subjects between the Union and the State Governments. Many tax subjects, which should have gone to the States, are retained by the Union Governments. This has resulted not only in revenue loss to the States but also has created hindrances to the States from exploiting the tax potential of other subjects, which are under their jurisdiction. One of the causes of the resource gap of the States is the above unscientific distribution of subjects of taxation between the Union and the State Governments.

The inertia on the part of the Union Government in making laws on such subjects, the revenue of which were assigned to the
States\textsuperscript{52} has affected the revenue potential of the States. On the other hand, many enactments by the Union parliament have reduced the fiscal efficiency of the States. Central inroads into the States' fiscal territories by specific enactments have further weakened the financial status of the States. Considering these aspects, it is necessary to analyse the constitutional provisions relating to the Centre-State financial relations and identify those areas, which warrant alterations.

The Constitution of India recognizes only Finance Commission as the agency to determine the quantum, and decide the modus operandi, of the devolution of resources from the Centre to the States. But in practice many extra constitutional agencies regulate the transfer of resources from the Centre to the States. Operations of these multiple agencies have affected the constitutional principle of 'gap filling' of States' revenue resources. Lion's share of Central transfers is regulated by the Planning Commission, which is not a Constitutional body. Over the period, the Planning Commission has eclipsed the Finance Commission in the field of resource transfer from the Union to the States. But, devolutions through Planning Commission and various central ministries are with specific objectives of the planning of economy. Since planned economy is a constitutional theme, these devolutions are in conformity with the constitutional spirit and cannot be dispensed with. In this situation, functions of the Finance Commission and the Planning Commission are to be streamlined and a more rational method of fiscal devolution is to be developed. The problem is about making the practice of devolution more scientific.

\textsuperscript{52} Situation under Article 269 as existed prior to the Constitution (Eightieth Amendment) Act, 2000. Even after the said amendment, the Centre has not enacted a law to tax the consignment transfer.
and consistent with the federal fiscal principles underlying Indian Constitution. A search in this direction is essential to strengthen the federal structure of the Constitution.

All major Indian States are confronted with serious revenue deficits. The growth of Revenue Deficits as percentage of Revenue Receipts is alarming and the growth of Revenue Deficits as percentage of the Gross Domestic Product is awful. The growth of Gross Fiscal Deficits is equally traumatic. But the methods adopted to finance the Gross Fiscal Deficits of the States, i.e., through loans and borrowings, have only helped the States to worsen their deficit position.

The provisions under the Indian Constitution for the devolution of resources from the Union Government to the State Governments are mainly intended to fill the resource gaps of the States. But from the current status of the fiscal position of the States it can be seen that these transfers have not helped the States to balance their revenue and expenditure. This is a very serious constitutional problem. Why has the system of devolution of resources failed to achieve the constitutional goal? Is it merely due to the faulty computation of the share of the States or any other basic problem affecting the transfers? Have the presence of multiple agencies and lack of holistic approach contributed to the dismal state of affairs? Unless these questions are answered, problems in a major area in the fiscal federalism under Indian Constitution cannot be solved.

Loans and advances from the Centre is an aspect that has imposed serious stress upon the fiscal management of the States. Various Finance Commissions have highlighted this problem. Repayments of loans and payment of interest on the previous loans
make considerable dent in the State economy. In some cases these two aspects together contribute more than the amount received during that year as loans. The net receipts in such years are negative.

The Centre Government grants loans to the States from the resources it has mobilised from the people of India and the same is intended to be used for the service of the people of India. The Union Government is capable of mobilising more resources because of the potential of the subjects of taxation under its jurisdiction. This revenue is to be expended for the social development of the people which demands expenditure in the subjects of States' jurisdiction. The constitution does not have the absurd goals of Union development or State development. It is committed to the development of the people of India who are the inhabitants of the various States. Hence, it is binding on the Union Government to provide the States with adequate resources to meet the expenditure related with developmental activities. However, it is obvious that instead of making resource transfers to the States in this direction, a good portion of resource transfers are aimed at expanding the economic base of the Union Government. Does the Constitution grant power to the Union Government to make use of such resources purely on commercial basis? When the States are saddled with the fiscal crisis, is it constitutionally proper for the Union Government to impose further burden on the States in the form of loans? Hasn’t this attitude of the Centre compelled the States to depend upon loans from other external agencies to meet its resource crunch?

The problems of inappropriate distribution of resources between the national and sub-national governments, the consequent vertical and horizontal imbalances, resource gaps of the State governments, inadequate and operationally defective transfer of
resources from the Union government to the State governments, etc. are not unique to the Indian federal set up alone. Major federal constitutions in the world are also facing similar problems. But, they have addressed these problems and have formulated some methods to solve them. To what extent such methods can be incorporated in the Indian Constitution and implemented in the functional areas of centre-state fiscal relations is a matter to be probed into.

Even with the adverse nature of Centre-State financial relations, certain States could achieve distinguishable developments in social sectors. Social, political and historical specialities of such States have forced them to expend more in the social developmental sectors, which has resulted in higher degree of social developments. The State of Kerala has a distinct position among the Indian States in respect of developmental indicators. In the case of high literacy, high life expectancy and low infant mortality, high rate of enrolment of girl's in schools, low maternal mortality rate, low birth rate etc., Kerala stands much above all other Indian States.\(^{53}\) Kerala has the highest human development index among Indian States despite relatively low per capita income.\(^{54}\) The 'Kerala model of development', characterised by high social development with low economic growth, has been acclaimed as an example for the welfare of the people and betterment of their social, cultural and political situation if there is an effective intervention of public action in this direction despite poor economic growth.\(^{55}\) The State of Kerala has achieved this enviable position mainly due to the public expenditure in the relevant fields. Since the per capita economic position of the

\(^{53}\) Government of Kerala, Economic Review 2002, Chapters 9, 10 and 11

\(^{54}\) Ibid, Chapter 3

State is not commendable and it is weak in the agricultural and industrial sectors, the people mainly depend on the governmental support for their requirements in the basic social sectors. Considering all these aspects, it can be definitely said that if the achievements in the social sectors are to be maintained, public spending in such sectors is indispensable. But from mid-eighties, the share of Developmental Revenue Expenditure in the total Revenue Expenditure has drastically come down and the share of Non-Developmental Revenue Expenditure in the total Revenue Expenditure keeps on increasing.\textsuperscript{56} This pattern of public spending is harmful to the social structure of the State and will have serious consequences in the civil society of the State. Naturally a question arises about the real cause behind the shifting of priorities in the public spending. The changed pattern of expenditure must be due to the fiscal stresses of the State. The State Government must have been compelled to cut the size of the Developmental Revenue Expenditure due to fiscal shortage, as reductions in the Non-developmental Revenue Expenditure cannot be made since many heads of expenditure in this sector are contractual in nature.

Has the fiscal crisis of the State been worsened to that extent, so as to compel the State to reduce the expenditure in the vital social sectors? If it is so, a detailed analysis of the fiscal situation of the State is necessary. Whether the fiscal relations between the Union and the State Governments under the Constitution have made any contribution to such a miserable State of affairs is another important area to be probed into. From the point of view of fiscal federalism under Indian Constitution such a question is of vital importance.

\textsuperscript{56} Table 2.5, \textit{Infra}. 

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Fiscal federalism under Indian Constitution has been a subject of persistent interest to the academicians and activists alike. A lot of studies have been conducted in this area and there has been copious literature on the subject. But such studies suffer from two major defects. Firstly, most of the studies approach the subject exclusively as an economic issue and the analysis of the problems in this sector is directed in this way. Secondly, with regard to the problems related to fiscal crisis of the States they give an idea that it can be solved by fiscal adjustments within the given constitutional framework.

In fact the Centre-State financial relations under the Indian Constitution is not purely an economic issue. It is rather a political issue of greater dimensions. The problems relating to fiscal federalism are basically constitutional and they are not matters exclusively related of fiscal management or financial adjustments. Minor fiscal issues may be solved with fiscal adjustment. But, when the fiscal situations of the States are saddled with acute crisis, attempt to treat it as a pure economic issue is superficial and striving to solve the problem with fiscal adjustments is erroneous. What is necessary is a serious search for constitutional solutions since the roots of the whole issue are lying deep in the Constitution. But such approaches are neglected. The basic issues of Indian fiscal federalism are twofold. Firstly, there are fundamental problems with the division of functions and resources between the different layers of governments. Secondly, there are inconsistencies between the principles of fiscal federalism perceived by the Constitution and the fiscal practices in force between the Governments. Unless these defects are cured, fiscal manoeuvring of any degree will be helpful only to solve the problem temporarily.
Since constitutional federalism is not a mere congregation of dogmas but an agenda for activism, its success should be gauged on the basis of practical achievements in the social and economic sectors. Under the Socialist Constitution of India, the principal aim of every activity of the State should be elimination of inequality of income, status, standards of life and opportunity and to end poverty, ignorance, and disease. Indian Constitution, "envisages the establishment of a welfare state at the federal level as well as the State level. In a welfare state the primary duty of the Government is to secure the welfare of the people." As federalism is the system of governance perceived by the Constitution, it must be appraised on account of its contribution in achieving the above objectives.

In the wider perspective of Constitutional Jurisprudence, a Constitution is not a collection of dead letters but a growing spirit. Sacrosanctity of a Constitution is protected not by keeping it impassive but making it adaptable to the needs of the time through appropriate inductions and omissions. By making suitable amendments to attain the objectives, the organic strength of the Constitution is fostered. The Structural peculiarities of the fiscal federalism, as existing under the Indian Constitution, are to be evaluated from this point of view. To what extent have the provisions of fiscal federalism, as originally incorporated in the Constitution, contributed to develop a healthy Centre-State financial relation and in the successive years? Have these provisions created

any hindrance to the further development in this area and what are the changes indispensable for strengthening the relations between the national and sub-national governments in their fiscal relations? These are questions of great importance. Majority of the provisions in the Constitution relating to Centre-State fiscal relations were imported from the Government of India Act, 1935 and due to the peculiar political happenings during the process of the making of the Constitution, it had been heavily imbued with unitary elements. The wisdom of the framers of the Constitution is not challenged for they acted according to the demands of the time. But, over the years, the politico-economic situation of the country has undergone substantial changes and the present day political circumstances demand a different fiscal relation between the Union and State Governments. The federal mode of fiscal governance is purpose-oriented and the system should be capable of attaining the objectives of the Constitution. However, it can be seen that in some cases, certain constitutional provisions are themselves acting as hindrances to this purpose. Due to the changes in the basic operating field of public finance, many constitutional provisions have become redundant or inappropriate. But such areas are to be identified and corrective steps are to be taken immediately. In case of any impediment from the side of any constitutional provision in attaining the objectives due to operational weakness, it is mandatory to remove such hindrances and make the system functionally effective. From the point of view of the fiscal crisis of the Indian States, a thorough analysis of the Constitutional and other legal provisions relating to fiscal federalism is indispensable. Such an analysis will

59 Partition of the country, communal carnage, opposition of many Princely States to join the Indian Union, peculiar world political situation after second world war etc.
be helpful to identify the real causes of the fiscal crisis of the States and it will be also useful to make appropriate amendments in the relevant areas.

The basic premise of this study is the efficiency of the Centre-State financial relations under the Indian Constitution in achieving the noble, vibrant and sacred objectives of the Constitution. Operational efficacy of the fiscal federalism under the Indian Constitution is called in question on the basis of the fiscal crisis of the States. The social developmental indicators of the country are, by no means, supportive to the functional competency of the principles of constitutional fiscal federalism. It demands modifications at the fundamental level.

**Methodology**

The scope of the study is undoubtedly vast. The present study is, however, confined to the functional efficiency of the Constitutional provisions relating to fiscal federalism and to highlight the important issues prevailing in that field.

The crucial areas of Indian fiscal federalism are analysed with the help of the British Indian statutes, Reports of various Commissions and Committees, Parliamentary Resolutions, and the Speeches in the British Parliament and in the Indian legislatures. Researcher also depended on the Reports of Finance Commissions, Reserve Bank of India Bulletins, official website of the Reserve Bank of India, and the Reports of the Centre for Monitoring Indian Economy.

Various provisions of the Constitution relating to the fiscal structure of the Union Government and the State Governments are analysed and the working of the provisions are assessed on the basis of details of tax revenue of these governments from 1950-51 to
2000-01. For the statistical analysis, data are taken from 1980 onwards, owing to the fact that Indian fiscal scenario started showing the signs of crumbling tendencies during the eighties by registering mounting revenue deficits of the States. Judgments of the Hon'ble Supreme Court of India are also made use of for ascertaining the real objectives of the Constitution of India and to identify the major concerns relating to the fiscal federalism in India. An overview of the fiscal federal governance under the Constitutions of Australia, Canada and United States of America is also made.

The details regarding the social development of the State of Kerala and the fiscal profile of the State is prepared from the Census Reports, Reports of the Planning Commission, the Economic Review and the Budget in Brief of the Government of Kerala.

The primary data relating to the fiscal aspects of the Union and the State Governments are taken from the official sources and they are used to generate various tables and graphs. These tables and graphs are used to corroborate the points discussed in the study.

For the collection of data, the researcher has visited various libraries, viz., the Kerala Legislature Library, Thiruvananthapuram, the British Library, Thiruvananthapuram, the Public Library, Thiruvananthapuram, the Legislature Library, New Delhi, and the libraries of Centre for Taxation Studies, Thiruvananthapuram, Centre for Development Studies, Thiruvananthapuram, University of Kerala, Thiruvananthapuram, School of Indian Legal Thought, Kottayam, Government Law College, Ernakulam, State Planning Board, Thiruvananthapuram, National Institute of Public Finance and Policy, New Delhi, Indian Law Institute, New Delhi, and Madras School of Economics, Chennai.
In the course of research, discussions and interviews were held with academicians, political leaders, bureaucrats, Members of the Planning Board etc., for their views and opinions.

Chapter Scheme

The Study contains six Chapters including the introductory Chapter. Chapter II elucidates the historical perspective of the Centre-State financial relations in India. Chapter III is mainly devoted to analyse the principles, schemes and practices of fiscal federalism under Indian Constitution. The roles of Finance Commission and Planning Commission in the fiscal devolution are pointed out and the Central enactments, which interfere with the fiscal powers of the States, are also elaborated. In Chapter IV attempts have been made to describe the administrative and procedural problems resulted from the improper and unscientific allocation of revenue subjects. Special attention is given to highlight the problems relating to tax on commodities and services in view of the fact that sales tax is the only subject of taxation under the jurisdiction of the States with significant elasticity. The role of Planning Commission and other Central Ministries in transferring resources from the Union to the States and how they are used to flout the Constitutional precepts of devolution of resources are exposed. Enough space is devoted to show the instances of central inroads into the State subjects through Constitutional amendments and Central enactments. The magnitude of fiscal deficits and various other problems resulted in the vertical and horizontal revenue imbalances are explained. Chapter V deals with the major achievements in the social sectors by the State of Kerala and the expenditure pattern of the State is depicted to show that the deliberate public expenditure in the social sectors was the real cause
of the social developments of the State. On the basis of the analysis of Constitutional provisions and other laws and practices prevailing in the fiscal federal set up, the suggestions to rectify the defects are given in Chapter VI. Since the issues relating to Centre-State financial relations are fundamental in nature, appropriate amendments are proposed to the Constitution and other enactments. Changes in institutional and procedural aspects are also proposed for strengthening the functional efficiency of federal fiscal system under the Indian Constitution.