CHAPTER - III

UNION-STATE FINANCIAL RELATIONS: FINANCIAL PROVISIONS OF THE

INDIAN CONSTITUTION
Centre-State financial relations of the present day in the Indian Union are the result of a slow and gradual development, from a single unitary system to a federal structure. Indian financial system evolved through a process of devolution since 1870, from the Government of India Act of 1935 and the new constitution.

The administration of India was taken over by the crown and a highly centralized administration was set up in 1858. India was divided into provinces as administrative units. Under this system of financial centralization (Charter Act of 1833) the revenue in all provinces was collected and expenditure was incurred in the name of Government of India. The central government controlled the expenditure of every branch. The provinces were at the mercy of central government in all matters. The Imperial Government was responsible in law but did not administer the country. The provincial government administered the country but had no responsibility in law.  

This arrangement was not only irrational but created many administrative difficulties. The responsibility of admini-


tration which was not coupled with financial power, led to irresponsibility and extravagance in financial matters. To prevent the evil of extravagance and make the provinces responsible, Lord Mayo, the then Governor General, first outlined the principles of a 'Scheme of Financial Decentralisation'.

Under the scheme outlined by Mayo, provincial governments were made responsible for the administration of certain services such as jails, police, medical services, education, roads and buildings etc. A fixed lumpsum grant was given to each province to carry out its responsibilities. It was expected that this devolution would gradually infuse in them a sense of financial responsibility both in matters of collection of revenue and economy in expenditure.3

A fixed lumpsum grant was inadequate to meet the growing expenditure of the provinces. An attempt was made to widen the area of relatively autonomous provincial action when Lord Lytton's government (1877) delegated financial control of the remaining provincial services - land revenue, stamps, law and justice and general administration - to the provinces. The novel element in the new system lay in the

3Ibid., p. 135.
transfer of certain heads of revenue to the provinces. The revenue from these taxes was to be shared by the provinces with the centre. The scheme stipulated that any rise or fall in the yield of revenue from these sources would be shared between the centre and the provinces. These agreements were only of temporary nature expiring by 1882. Therefore a Resolution was adopted in September 1881 according to which, fresh settlements were made with the provinces to last till the end of the century but revisable at quinquennial intervals.

According to the resolution of 1881, the provincial governments were given certain proportion of Imperial revenue, instead of fixed lumpsum grants. The heads of revenue that were essentially of central character such as customs, railways, posts and telegraphs, foreign exchange etc. were wholly reserved as 'Imperial' while those of local nature - police, education, law and justice etc. - were made wholly provincial.

In 1904, the Supreme Government decided to enter into contracts with the provinces, on a more permanent basis. The new contracts were to be, by and large, unalterable except in case of grave Imperial necessity. Under these contracts, al-

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though the share of revenues assigned to provinces was slightly lowered, it was fixed as a definite fraction — though different for each province — of the aggregate revenue.\(^5\)

The criterion underlying the new division of revenues was that the share of each province individually and of all the provinces collectively should bear approximately the same ratio to the provincial expenditure as the Imperial share of growing revenues bore to the Imperial expenditure. It was also decided that a proportionately larger share was to be given to backward provinces.\(^6\) The new contracts were entered into as and when existing contracts fell due for revision.

The financial control still vested in the Government of India, fixed the rates of taxes and exercised control over provincial expenditure. The Royal Commission on Decentralisation (1908), appointed by the British Government, favoured decentralisation of financial powers (greater power to provinces) in the interest of efficiency as well as harmony.

The permanent settlement in 1912 increased the provincial share of growing revenues. This was the first step in


\(^6\) Ibid.
the grant of financial autonomy to the provinces. Every step in financial decentralisation, however, small improved the status of provinces and enlarged the powers and responsibilities of provincial government.

On the basis of Montagu-Chelmsford Report, the Government of India Act, 1919 was enacted. The Act introduced almost a complete separation of the central and provincial heads of revenue. The 'Divided Heads' were abolished and most of these were assigned to the states. The authors of Montford Reforms addressed themselves to the task of providing provincial autonomy with a strong financial back-bone and the arrangements that eventually emerged altered the entire aspect of centre - province relations and placed India on the high road to federalism. The important development in the financial independence of provinces was the borrowing power conferred upon them.

The Government of India Act of 1935, which brought a major improvement in the financial position of the provinces,

9 The heads of revenue were demarcated into 'Imperial', 'Provincial' and 'divided.'
introduced the principle of federal finance. The Government of India Act of 1935 divided the powers into three categories (i) exclusively federal (ii) exclusively provincial and (iii) concurrent. Federal list includes Defence, external affairs, currency, posts and telegraphs, census, railways, shipping and navigation, major ports, customs and duties, corporation tax, tax on income excepting agricultural income, taxes on capital value of assets exclusive of agricultural land, stamp duty, terminal taxes on goods or passengers carried by railway or air, taxes on railway fares and freights etc.

Most important subjects of the provincial list were law and public order, local government, public health and sanitation, education, agriculture, forests, industries, land revenue, excise duties on alcoholic and narcotic drugs, taxes on agricultural income, succession duties in respect of agricultural land, taxes on mineral rights, taxes on professions, animal and boats, taxes on sale of goods and on advertisement etc.

Besides a clear demarcation of federal and provincial sources of revenue, Government of India Act of 1935, introduced a system of shared taxes. Government of India Act appointed a committee headed by Sir Otto Niemeyer for deciding the quantum of revenues to be transferred from the centre to
the provinces. Sir Otto Niemeyer recommended that 50 per cent of the net proceeds of income tax should be assigned to the provinces. The committee also recommended that 62.5 per cent of the net proceeds of the export duty on jute be given to the jute growing provinces. In addition to these devolutions, grants-in-aid were also given to the provinces to balance their budgets. Thus there was built-in-flexibility in the provisions adopted.¹¹

The achievement of independence and the partition of the country in 1947 disturbed the financial arrangements and necessitated readjustments of the financial arrangements between centre and provinces. However, Niemeyer award (scheme) was left undisturbed except that the share of partitioned provinces of Punjab and Bengal were reduced in proportion to their residual population,¹² and some minor adjustments were made. The share of provinces in jute export duty was also reduced from 62.5 to 20 per cent (in view of the jute growing areas which had gone to Pakistan). But the basis of the distribution of the share among the provinces remained unchanged.

The Constituent Assembly appointed an Expert Committee (Sarkar Committee) at the time of drafting of the Indian Cons-


titution, to report on financial provisions of the Indian Constitution. The committee made some recommendations, suggesting basic principles for division of taxes between union and the states. The committee also suggested the appointment of Finance Commission (on the lines of Australian Commonwealth Grants Commission) to deal with the matters relating to the division of revenues between the Union and the States and the distribution among the states.

When India achieved independence the fundamental problem before the constitution makers was to choose between a unitary or a federal set up in the country. Though isolated proposals were made here and there for framing a unitary constitution for the country on the grounds of economy and unity, the preponderant and widely held view was in favour of a federal structure consistent with the maintenance of national unity and security. India was constituted into a sovereign democratic republic and it was declared that 'India, that is Bharat, shall be union of States.'

India consists of twenty-two states and nine union territories. Unlike the federations of Canada and Australia, there is no agreement between the states to come together.

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14 Article (1)
India is not a union of independent and sovereign states. On the contrary, the Union Parliament has power to establish a new state, to increase or decrease the territory of a state. It could even abolish an existing state with a simple majority. 15

The constitution established a dual polity with the union at the centre and the states at the periphery, each endowed with sovereign powers to be exercised in the field assigned to them respectively by the constitution. The union is not a league of states, united in a loose relationship, nor the states the agencies of the union, deriving powers from it. Both the union and the states are created by the constitution, both derive their respective authority from the constitution. The one is not subordinate to the other in its own field, the authority of one is coordinate with that of the other. 16 The central government's duty is to coordinate the efforts of the state governments for development, progress and prosperity of the nation. 17

The constitution of 1950 divided the powers and functions between central government and the state governments. The essence of federalism lies in proper division of powers between various levels of government. Of these, however,

15 Article 4 (2)
17 The Hindu, Tuesday, October 9, 1954, p. 10.
finances are the back bone of politico-economic strength and hence an essential prerequisite of government. 18

The constitution of India (1950) adopted the salient features of Government of India Act, 1935. Financial provisions of the constitution were similar to that of Government of India Act of 1935. The constitution demarcated the taxing powers of the union and state governments. The Indian Constitution attempts to divide sources of revenue on the principle of efficiency, and thus avoids double taxation and duplication of the tax machinery so common in other federations. 19 The provisions of the constitution concerning financial relations between the centre and the states seem to have been designed with great care and circumspection so as to forestall precisely the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of different layers of government. 20


In its seventh schedule, the Indian Constitution enumerated the powers of the union and the state governments and concurrent powers exercisable by both. The constitution provided residuary powers to the union government. The union list contains ninety-seven items, state list sixty-six and the concurrent list forty-seven items.

The union list enumerates twelve main sources of tax revenue.

1. Taxes on incomes other than agricultural income.
2. Duties of customs including export duties.
3. Duties of excise on tobacco and other goods manufactured or produced in India except
   (a) alcoholic liquors for human consumption
   (b) opium, Indian hemp and other narcotic drugs and narcotics.
4. Corporation tax
5. Taxes on capital value of assets, exclusive of agricultural land, or individuals and companies, taxes on capital of companies.
6. Estate duty in respect of property other than agricultural land.
7. Duties in respect of succession to property other than agricultural land.
8. Terminal taxes on goods or passengers, carried by railway, sea or air, taxes on railway fares and freights.
9. Taxes other than stamp duties on transactions in stock exchanges and future markets.

10. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, debentures, transfer of shares, proxies and receipts.

11. Taxes on the sale of purchase of newspapers and on advertisements published therein.

12. Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce.

The constitution also assigns residuary powers to the centre. 'Any other matter not enumerated in List II or List III including any tax not mentioned in either of these lists.'

The State List enumerates nineteen sources of tax revenue which belong exclusively to the states.

1. Land revenue
2. Tax on agricultural income
3. Duties in respect of agricultural land
4. Estate duty in respect of agricultural land
5. Taxes on land and buildings
6. Taxes on mineral rights, subject to any limitation imposed by Parliament by law relating to mineral development.
7. Duties of excise on the following goods manufactured or produced in the states and countervailing duties at the same or lower rates on similar goods manufactured elsewhere in India
   (a) alcoholic liquors for human consumption
   (b) opium, Indian hemp and other narcotic drugs and narcotics

8. Taxes on the entry of goods into a local area for consumption, use and sale therein

9. Taxes on the consumption or sale of electricity.

10. Taxes on the sale or purchase of goods other than newspapers.

11. Taxes on goods and passengers carried by road or inland waterways.

12. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads including trams cars.

13. Taxes on animals and boats

14. Tolls

15. Taxes on professions, trades, callings and employments

16. Capitation taxes

17. Taxes on luxuries including taxes on entertainments, amusements, betting and gambling

18. Rates of stamp duty in respect of documents other than those specified in the Union list with regard to stamp duty
19. Fees in respect of any of the matters in List II but not including fees taken in any court.

Though the constitution has demarcated the jurisdiction and authority of the Union and the States in two exhaustive lists, mutually exclusive, it has also created an area of concurrent power. But their power does not extend over the financial field. 21

Though the resources of the tax revenue of Union government are small in number, they are regarded as qualitatively superior. The Indian Constitution, like the Constitution of Australia and Canada, favoured strong government at the centre. So far as the division of sources of revenue is concerned, it is said that the Union government enjoys a comfortable position with many elastic sources of revenue, like Union Excise Duties and Corporation Tax which have national tax base. In contrast, the States are deemed to have been given inadequate and less elastic sources of revenue like land revenue. 22

Having realized that there is a built-in-imbalance in the division of sources between Union and the states, the


framers of the constitution made provisions for devolution of resources from centre to the states. Article 280 of the Indian Constitution under which a Finance Commission is to be appointed for every five years or even earlier is an example of the desire of the constitution makers to impart flexibility to the financial provisions of the Indian Constitution. The devolution of resources take the form of

(a) compulsory sharing of certain taxes
(b) discretionary sharing of certain taxes
(c) grants under article 275 and 282 and
(d) loans

Article 280 of the constitution enumerated the duties that may be levied by the union but which should be collected and appropriated by the state governments.

1. Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union list shall be levied by the Government of India but shall be collected

(a) in the case where such duties are leviable with in any union territory, by the Government of India, and

(b) in other cases, by the States within which such duties are respectively leviable

2. The proceeds of any financial year of any such duty leviable within any state shall not form part of the consolidated fund of India, but shall be assigned to that state.
Article 269 enumerates the taxes levied and collected by the Union but which should be assigned to the state governments. The following are the taxes which fall under this category.

(a) duties in respect of succession to property other than agricultural land
(b) estate duty in respect of property other than agricultural land
(c) terminal taxes on goods or passengers carried by railway, sea or air
(d) taxes on railway fares and freights
(e) taxes other than stamp duties on transactions in stock exchanges and future markets
(f) taxes on the sale or purchase of newspapers and advertisements published therein
(g) taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce.

(2) The net proceeds in any financial year of any such duty or tax, except in so far as those proceeds represent proceeds attributable to union territories shall not form part of the consolidated fund of India, but shall be assigned to the states within which that duty or tax is leviable in that year, and shall be distributed among those states in accordance with such principles of distribution as may be formulated by Parliament by law.
(3) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in the course of inter-state trade or commerce.

Article 270 specifies taxes which are levied and collected by the Union and distributed between Union and the States.

(1) Taxes on income other than agricultural income shall be levied and collected by the Government of India and distributed between the Union and the States.

(2) Such percentage, as may be prescribed, of the net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, shall not form part of the consolidated fund of India, but shall be assigned to the States within which that tax is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed.

(3) For the purpose of clause in each financial year such percentage as may be prescribed of so much of the net proceeds of taxes on income as does not represent the net proceeds of taxes payable in respect of Union emoluments shall be deemed to represent proceeds attributable to Union territories.
(4) In this article:

(a) "taxes on income" do not include corporation tax;

(b) "prescribed" means

(i) Until a Finance Commission has been constituted, prescribed by the President by order, and

(ii) after a Finance Commission has been constituted, prescribed by the President by order after considering the recommendations of Finance Commission;

(c) "Union emoluments" includes all emoluments and pensions payable out of the consolidated fund of India in respect of which income tax is chargeable.

Under Article 371, Parliament may at any time increase any of the duties or taxes referred to in articles 269 & 270 by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the consolidated fund of India.

Article 272 specifies taxes which are levied and collected by the union and may be distributed between the union and the states. Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied and collected by the Government of India, but, if Parliament by law provides,
they shall be paid out of the Consolidated Fund of India to the states. The sums shall be distributed among those states in accordance with such principles of distribution as may be formulated by such law.

Article 273 speaks of Grants in lieu of export duty on jute and jute products:

(1) There shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of the states of Assam, Bihar, Orissa and West Bengal, in lieu of assignment of any share of the net proceeds in each year of export duty on jute and jute products to those states, such sums as may be prescribed.

(2) The sums so prescribed shall continue to be charged on the consolidated Fund of India so long as any export duty on jute and jute products continues to be levied by the Government of India or until the expiration of ten years from the commencement of this constitution whichever is earlier.

Article 275 of the constitution speaks of grants from the union to certain states which are in need of assistance. Such sums shall be paid out of the Consolidated Fund of India in each year as grants-in-aid of the revenues of state such capital and recurring sums as may be necessary to enable that
state to meet the costs of such schemes of development as may be undertaken by the state with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that state or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that state.

The union or a state, under Article 292, may take any grants for any public purpose, not withstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.

Executive power of the Union under Article 292, extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.

Under Article 293 the Constitution of India,

(1) the executive power of a state extends to borrow-
ing within the territory of India upon the secu-
ri ty of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such state by law and to the giving of guarantees within such limits,
if any, as may be so fixed.

(2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any state or, so long as any limits fixed under Article 292 are not exceeded, give guarantees in respect of loans raised by any state, and any sums required for the purpose of making such loans shall be charged on the consolidated fund of India.

(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.

(4) A consent under clause (3) may be granted subject to such conditions, if any, as the Government of India may think fit to impose.

Under Article 300 of the Constitution of India,

(1) The President shall within two years from the commencement of the constitution and there after
at the expiration of every fifth year or at such
erlier time as the President considers necessary,
by order constitute a Finance Commission which shall
consist of a Chairman and four other members to be
appointed by the President.

(2) Parliament may by law determine the qualifications
(which shall be requisite) for the appointment as
members of the commission (and the manner in which
they shall be selected).

(3) It shall be the duty of the commission to make re-
commendations to the President as to,

(a) the distribution between the union and the states
of the net proceeds of taxes which are to be, or
may be, divided between them and the allocation
between the states of the respective shares of
such proceeds,

(b) the principles which should govern the grants-in-
aid of the revenues of the states out of the
Consolidated Fund of India;

(c) any other matter referred to the Commission by
the President in the interests of sound finance

(4) The commission shall determine their procedure and
shall have such powers in the performance of their
functions as Parliament may by law confer on them.
Article 260 (2) of the constitution has given the Parliament the power to determine the qualifications of the Chairman and members of the Finance Commission and the procedure of their selection and to prescribe the powers of the commission for the performance of its functions. The Parliament has enacted the Finance Commission Act (Miscellaneous Provisions Act) in 1951 and amended in 1985.

According to the Finance Commission Act, the Chairman of the commission must be a person with experience in public affairs and its members should be persons who

(a) are, or have been, or are qualified to be appointed as judges of a High Court, or
(b) have special knowledge of the finances and accounts of the government or
(c) have had wide experience in financial matters and in administration, or
(d) have special knowledge of economics.

The procedure of the Finance Commission is to be determined by the commission itself. The commission has all powers of a civil court under the Civil Procedure Code in respect to

(a) summoning and enforcing the attendance of witnesses,
(b) requiring the production of documents and
(c) requisitioning any public record from any court or office.
According to Section 8 (2) of the Finance Commission Act, the commission has the power to require any person to furnish information on such points or matters which the commission considers useful for, or relevant to, any matter under its consideration. Such a person should (notwithstanding anything contained in Section 54(2) of the Indian Income Tax Act, 1922 or in any other law for the time being in force) be deemed to be legally bound to furnish such information within the meaning of Section 176 of the Indian Penal Code.

Finance Commission, an important provision in the constitution, acts as a machinery for regulating the flow of resources. The actual work assigned to a particular Finance Commission is spelt out in the terms of reference specified in the Presidential order setting up the commission. The role of the Finance Commission is to do justice between provinces and provinces and between the centre and the provinces. The provision for the periodic appointment of the Finance Commission imparts the necessary flexibility in the financial provisions of the Indian Constitution and provides an opportunity for quinquennial review of the centre-state financial relations.

As such this is a novel provision of the Indian Constitution. Therefore a review of the working of the Finance Commissions appointed so far in India would be instructive and helpful and such a review is attempted in chapters 4 and 5.

One of the important features which distinguish the centre-state financial relations in India from those of the other federations (which we examined) is that the constitution of India avoided concurrent jurisdiction in the financial field. Such concurrent jurisdiction is provided in older federations. The simultaneous levy of income tax and corporation tax by the federal government as well as unit governments in U.S.A., Canada and Australia caused lot of trouble and confusion. In the constitution of India, the taxing powers of the union and the states have been completely separated and made mutually exclusive.24

The study of federal financial relations in all these federations leads us to conclude that there is relative inadequacy of financial resources of the unit governments. Grants, contribution from the higher level government (federal) to the

lower level governments, play an important role in all these federations. In India the Finance Commission also recommends grants (non plan grants) to the states under the provision of the constitution (Article 275). The functions of the Finance Commission are similar to that of Australian Common Wealth Grants Commission. In U.S.A., most of the grants are given to the regional governments on a matching basis.

In Australia as well as in India, the powers of the State Governments to raise loans were restricted. The states have no power to raise foreign loans in India. Internal loans can be raised by the states. But in Australia, the Australian Loans Commission, an independent body, manages the total external borrowings for the whole of Australia. The borrowings of the federal and state governments is determined once a year through the deliberations of this body.26

It is to be noted that the elasticity imparted to state revenues in India, through the sharing of tax proceeds of income tax and union excise duties and the grant-in-aid on the recommendation of the Finance Commission does not jeopardise the autonomy of the states. In this respect, States of the

26 Ursula Hicks, Lectures on Federal Finances in a Developing Economy, Indian Institute of Public Administration, New Delhi, Oct. 1971, p. 9.
Indian Union seem to be in a more fortunate position than the component units of other federations. The dependence of the unit governments on a federal government in the federations of Canada, Australia and America as a result of inadequacy of their own resources is much greater than the dependence of the states, in India on the Union government.\textsuperscript{27} Details regarding the dependence of the states in India on the devolution of resources are examined in detail in chapters 4 and 5.