INTRODUCTION

India adopted federalism out of need. Its heterogeneous qualities being clearly manifest, linguistic and cultural particularism being expressed broadly through historically integrated geographical units, constituted the most powerful centrifugal forces in India which have always acted as a check on any movement towards unitarianism. The flowing of regional literature through remarkable development of regional languages reflecting the characteristic spirit of regional cultures created a consciousness of regionalism. These manifold regional diversities broadly based upon linguistic and cultural distinctions and the gigantic size of the country made the founding-fathers aware that a federal form of Government alone would suit the requirements of India. The conflicting social forces in India, engaged in competition for ascendancy, exerted divergent pulls and pressures on the drafting of the Constitution and shaped the form and pattern of Indian federalism in varying degrees. The federal polity which was eventually fashioned was not one with minimal Centre but a Union with vast powers for the Central Government without discarding the essentials of a federal forms of Government.

Finance being an essential pre-requisite of a good Government, a sound federal system would envisage that allocation of the financial resource between the Centre and the Units is effected in such a way that there exists a balance, and equilibrium, between the functions and resources at each Government level. Its absence creates stresses and strains which jeopardise the smooth functioning of the federal structure. Federal-financial relations broadly reflect the equation of power and influence between the Centre and the Units inter se. The fact that there are no fixed criteria for delineating the Federal-State financial relations, and that each country adopts its own set of rules and regulations, implies that there can always be a lack of unanimity regarding the exact form which a specific federation should adopt. That is why, Centre-State financial relations in India, admit of sharp differences of opinion as to the specific
provisions in our Constitution to this effect. The slow-moving economy like ours spells a growing complexity of the system and brings to the fore numerous issues and problems. A meaningful and enduring fiscal system should, therefore, be able to overcome such hurdles through its inbuilt flexibility and, if need be, constitutional changes.

The financial provisions of the Indian Constitution - perhaps more than any other part of our Constitution - bear ample testimony to the vision and foresight of the founding-fathers. They were not the result of any haphazard choice, but the wisdom of a long and cool headed debate, in which the experience of some older federations like the United States, Australia and Canada, was also taken notice of to avoid typical problems which crop up later in these federations.

The Indian Constitution incorporates a very elaborate scheme of Centre-State fiscal relations. Its three chief characteristics are the complete separation of taxing powers between the Centre and the States, tax-sharing between the two and the allocation of funds to the States. The taxes enumerated in the Union List of the Seventh Schedule to the Constitution, are leviable by the Centre exclusively, while those mentioned in the State list are leviable by the States exclusively. The Concurrent List contains only a few tax entries of little significance. Further, no tax can be levied outside the specific taxing entries enumerated in the several lists. Of course the residuary power of imposing tax, like the legislative power, is vested with the Centre.

In financial matters, the framers were mainly fortified by the studies of a series of advisory bodies appointed during the British regime since Lord Mayo's Financial Resolution of 1870. The scheme of the division of taxing power and references incorporated in the Constitution is, to a great extent, a replica of the scheme contained in the Government of India Act, 1935. However, various considerations have been kept in view while framing the scheme. The Centre is made to have vast resources
at its command. Administrative convenience, efficiency and effectiveness have been kept in view while conferring power on the Union and the States for the collection of taxes. Where it is desirable to maintain uniformity of incidence throughout the country, taxes have been allotted to the Centre. Taxes which extend beyond the confines of one State, have been given to the Centre. Keeping economic development of the country in view, those taxes which have a close relationship with national economy and which, if allotted to the States, might create hindrance in the economic development and the free flow of trade and commerce, have been left with the Centre.

A notable feature of the Indian financial scheme is that it seeks to avoid the possibility of overlapping and multiple taxation. However, a comparison of tax powers of the Union and the States brings forth that the distribution incorporated in the Constitution unduly favours the Union. The allocation has consistently produced surpluses at the Centre and deficits in the States with the consequences that the latter have been increasingly relying on the devolution of taxes, grants and loans from the Centre. Having been conscious of this fact, the founding-fathers provided for both obligatory sharing of income-taxes and permissive sharing of excise duties and for grants-in-aid to the States, in order that financial inequalities between the two layers of Government and the States inter se are eliminated to all possible extent. But they neither prescribed shares nor defined the basis of allocation. They thought that in view of the changing economic and social conditions in the country, the quantum of devolution and the basis of its allocation amongst the States inter se should be flexible and adjustable and reviewable periodically without causing friction between the Centre and the States. Confidence in the machinery and process of allocation and distribution of resources is fundamental to the integrity of a federal system. They, therefore, provided the device of Finance Commission to advise the President on these matters. All these provisions have been designed with great care and circumspection so as to forestal precisely the kind of difficulties that even the older federations do not appear to
have overcome in securing closer correspondence between resources and responsibilities of the two layers of the Government. However, it does not imply that the present matrix of financial relations between the Centre and the States does not admit of improvement. All that it means that the financial provisions of Indian Constitution give enough room for reconciling such conflicts of interests as may arise from time to time between the Union and the constituent States.

Since adequate safeguards could not have been provided against all such eventualities, the actual working of our Constitution has revealed tensions between the Union-State fiscal relations. Probably, it was the expectation of the founding-fathers that with the passage of time, the Centre-State financial relations would acquire a degree of maturity and refinement and that the techniques of measuring and removing inter-regional disparities would be perfected and efficient methods would be developed for solving the problems as they would arise. But this is precisely what has not happened and the States are increasingly mounting a pressure on the Union, for better fiscal autonomy. One cause for this probably, has been the advent of massive economic and social planning and the establishment of the Planning Commission. 'Economic and social planning' is an item specifically mentioned in the Concurrent List. It is this entry which, among other things, gives the Centre the necessary sanction for the formulation of a national Plan. A national Plan has necessarily to comprehend the entire range of developmental activities, cutting across the delimitation of forces between the Centre and the States. In the process, the Central Government and the Planning Commission have acquired a voice even in matters in which, under the Constitution, the initiative and control should remain entirely with the States. The Planning Commission, which was constituted as an advisory body of experts, has assumed 'the role of super cabinet' by the fact that our then Prime Minister, Shri Jawahar Lal Nehru, would not brook any criticism of the way the Planning Commission was usurping the role of the Government

1. Entry 20.
On account of the totalitarian role of the Planning Commission, the role of the States in actual formulation of the plans has become limited. The National Development Council, where all the States are represented with the drawing up of the draft of the Plan, ends up in a mere annual ritual (since massive financial resources are transferred to the States under the aegis of the Planning Commission). It has also resulted in the overlapping of functions of the Finance Commission and the Planning Commission.

It is claimed at many quarters that the Centre has been following a policy which pushes the States into a situation of financial stringency. Some of the revenues which were originally intended to accrue to the States over the years have been grabbed by the Centre. For instance, until 1959 income from companies was included in income tax and shared with the States. That year the terminology was changed by the Centre and the income from the companies entirely appropriated by describing it differently as a corporation tax. In another instance, the Centre deprived the States of their share of the higher income tax by levying a surcharge on income tax for the past 30 years and has been conveniently pocketing the additional revenue.

The States also bear considerable responsibility for the spectacular change in the balance of financial resources between the two layers of the Government. The tax on agricultural income is a glaring instance where the States have refused to tax the rich farmers because they constitute the vote-bank. The conversion of the sales tax on textile, sugar and tobacco into "additional excise duties" which are collected by the Union, though the proceeds are transferred to the States, is another instance of the inefficiency of the States as tax collectors.

All this has led to a continuing debate on the Centre-State financial relations in India and the dissatisfaction with the working of the distribution scheme. Currently, however, they are

being debated with an unprecedented intensity. As the Report of the Rajamannar Committee, the Report of the Study Team of the Administrative Reform Commission and others have put it, the dissatisfaction with the working of the Constitutional arrangements never assumed serious proportions so long as the same party was in power both at the Centre and the States. Any dissatisfaction which might arise was sought to be removed at the political level and such a solution, which would in effect be only symptomatic of political discipline of the party, was construed to imply that the real problem did not exist. But the general elections in 1967 put an end to the era of one-party dominance and a political party system of diverse hues came into operation. With the result, the Congress Government at the Centre came to be faced not only by several non-Congress State Governments, but also by a sizeable opposition vocal in espousing the theory of State rights. The first expression of open confrontation of the discontent of the States against the Centre-State financial relations appeared in 1969 when the then Tamil Nadu Government ruled by an opposition party appointed a Committee under the Chairmanship of Dr. P.V. Rajamannar, who was the Chairman of the Fourth Finance Commission, to examine the case for revision of the original allocation of functions and financial resources between the Union and the States and suggest specific rearrangements in view of the need to provide autonomy for the States in the field of planning and finance. The Committee submitted its report in 1971 and suggested that the financial dependence of the States on the Centre be eliminated. The Committee subscribed to the "principle of federal finance" that the devolution of resources on the States should be more or less automatic and not based upon the discretion of the Centre. The Committee made out that strong feelings had been voiced "against the attitude of the Centre in curtailing the powers of taxation enjoyed by the States before the introduction of the Constitution" and the manner in which the Centre had been "interfering with the affairs of the States ever since". It further emphasised the fact that through the agency of the

3. Report, Centre-State Relations Inquiry Committee (Chairman P.V. Rajamannar) 60, Government of Tamil Nadu, 1971.
4. Id. at 9.
Planning Commission, the Centre had assumed greater control over the States. Amongst various measures, the Rajamannar Committee recommended the creation of an Inter-State Council as provided under Article 263 of the Constitution. The Committee wanted the Council to be more broad based and recommended that it should consist of all the Chief Ministers or their nominees, with the Prime Minister as the Chairman. No other Cabinet Minister was to be member of the Council. The recommendations of the Council, the Committee emphasised, were to be binding upon the Centre and the States. But the report of the Rajamannar Committee did not prove to be more than a flutter in the Union-State financial relations and for the next five years or so not much was said on remodelling of Centre-State financial relations.

By the time the 1977 elections to Lok Sabha came, the political scene appeared remarkably changed. As a result of these elections, a party system of diverse complexities arose and the ruling party, at the Centre, was a coalition of diverse interests. All this set in motion a genuine federalising process. Immediately after the Janta Party came to power, Prime Minister Morarji Desai emphasised that "stronger States means stronger Centre" and that "decentralisation of political power will be an important check against any autocratic dictatorship at the Centre." But when the West Bengal Chief Minister Jyoti Basu submitted a Memorandum on the Centre-State Relations to the Central Government

5. Id. at 219.
7. The West Bengal Memorandum stated:

In a country like India with such diversities in race, religion, language and culture, national integration can be achieved only through conscious voluntary efforts. Devolution of power may help ward off fissiparous tendencies instead of encouraging them. A strong and united India can only be one in which the democratic aspirations and the distinctiveness of the people of different States are respected and not treated with disdain. We are definitely for strong States, but on no account do we want a weak Centre.

"West Bengal's Memorandum on Centre-State Powers", adopted by the West Bengal Government at its Cabinet meeting held on December 1, 1977.
for initiating dialogue between the Prime Minister and the Chief Ministers on the question of giving more autonomy to the States in political, legislative and financial spheres, Sri Desai turned down the demand for more State autonomy branding it as an attempt to break the country. Therefore, nothing positive and concrete in the way of mitigating the regional imbalances was initiated.

The West Bengal Chief Minister's move received support, in the beginning, only from a few Chief Ministers like Sheikh Abdullah, the Chief Minister of Jammu and Kashmir. But he found a very vocal supporter in the then Finance Minister of Punjab (Akali Dal) Shri Balwant Singh, who, in fact, flew to Calcutta for consultation with the West Bengal Chief Minister and he also made a statement in the Punjab Legislative Assembly demanding better fiscal autonomy. Soon the number of advocates of revised approach increased. The agitation for a revision of the whole set of Centre-State relations gained a wide-spread hearing and sympathy. The severity of the debate drew in comments from even unexpected quarters. The then President Shri Neelam Sanjiva Reddy, in his Govind Vallabh Pant Memorial Lectures said that a considerable devolution of authority from the Centre to the States within the constitutional framework and without endangering the fundamental unity of the country would be necessary if the common man was to play an effective role in national development. In his special Republic Day interview with Link Magazine, he emphasised the need for a national political consensus on Centre-State powers. He pointed out "the federal structure as envisaged in the Constitution has been eroded somewhat" and that "the federal set up must become a little more flexible and worked in its true form and spirit".

The advocates of the revised approach say that although the Indian Constitution is federal in character, practically all


authority is concentrated in the Central Government restraining the rapid economic and cultural growth of the States. What they have been demanding is comprehensive review of the Centre-State relations so as to work according to the spirit of the federal character of the Constitution which ensures greater autonomy to the States. The outcome of the recent elections in Andhra Pradesh and Karnataka pointed out to a new political trend leading to the emergence of strong regional groups elsewhere. The newly elected Chief Ministers Shri Ramakrishna Hegde and Shri N.T.Rama Rao of Karnataka and Andhra Pradesh respectively, have pleaded for a review of Centre-State relations. They, however, made it clear that they were keen to strike a cordial relationship with the Centre. In a new move, they along with Chief Ministers of Tamil Nadu and the Union Territory of Pondicherry have set up a Chief Ministers' Council, as a first step to work out a common strategy to solve common problems. The emerging political realities, therefore, did call for a change of attitude and approach by the Centre. Accepting the reality, the Centre Government has constituted a Commission headed by Mr. Justice R.S. Sarkaria, a former judge of the Supreme Court, to go into the Centre-State relations and recommend appropriate changes.

Scope of the Study

Obviously the problem of Centre-State relations is a big one. The present study is confined to only the financial position of such relations. The purpose is to examine this fundamental issue in the background of the Indian federalism. An attempt has been made to trace the historical background of the Constitutional provisions relating to the allocation of taxing power and the distribution of revenue and examine objectively the working of the whole system with a view to identifying the exact nature of the maladies of the system. The study seeks to examine the related issues: Has the scheme of division of resources provided

10. See address by Tripura Chief Minister and of Shri S.S. Barnala, the Akali Leader, at a seminar organised by the All India Lawyers' Union at New Delhi, The Hindustan Times, March 11, 1983.
11. Elections were held on January 5, 1983, routing out Congress(I) from power in these States.
in the Constitution been rational and practical? Has it been broadly able to cope satisfactorily with the new demands made on it from time to time in reconciling conflicts of interests between the Union and the States? Has the financial position of the States been eroded over time? Have the States become far dependent on the Centre for their financial needs? Has the Planning process led to excessive centralisation? Is there any specific need for redistribution of financial resources? What are the parameters of true federal financial relations? Here the objective is to find out the possibility of a workable solution to all these problems and to examine whether there is a possibility of reducing Centre-State financial tensions.