2.1 Introduction

India is a multi-tier federal country with 28 States, 7 Union Territories and about 2.5 lakh local bodies all of which having constitutional status as institutions of self government. The unique federal Constitution of India described variously as federal structure with strong Centre or federal in nature but unitary in spirit or even as quasi-federal provided for distribution of sovereign legislative powers between the Union (or Centre) and the State Governments. The third tier of government viz., the panchayats and municipalities are basically devolution of State legislative powers, though accorded constitutional status, since local government remained a State subject under the Constitution. The dominant issues in Indian federalism, whether in the constitutional provisions or the institutional arrangements, therefore, pertain mostly to the Centre-State relation. Similarly, the bulk of intergovernmental fiscal transfers in India consist of Centre-State transfers. This chapter proposes to examine the historical and political context within which the federal Constitution of India and the interpretation of its provisions relating to intergovernmental transfers arrived at through administrative processes and political bargaining.

The remaining portion of the chapter is divided into different sections: section 2.2 briefly examines federalism from political and economic perspectives followed by a brief account of the colonial background of the federal Constitution of India at section 2.3. Section 2.4 deals with the Constituent Assembly debates pertaining to the subject of federal financial relations and sections 2.5 and 2.6 discuss the Constitutional provisions relating to federal financial relation and the post-Constitutional developments. A brief conclusion to the chapter is at section 2.7.

2.2 Federalism from political and economic perspectives

As a political system, federalism is seen as a way of combining the virtues of small states with that of large states in a single union. Small governments have been
considered as the means to protect the rights of individuals, encourage political participation, mutual accommodation of views, political compromise and preserve community values (Inman and Rubinfeld, 1977). Economists see this essentially political system as a means of introducing market-like alternatives into the political processes of public goods provision which can be analyzed by applying the twin criteria of equity and efficiency. Decentralization established by federalism pitches governments, especially sub-national ones, into competition with one another in the provision of public goods thereby fostering improvement in efficiency (Tiebout 1956, Brennan and Buchanan 1980) and decentralized delivery of public goods resulted in welfare gain because of local variations in tastes and costs (Oates, 1972).

The immediate issue confronted in federalism pertains to assignment of functions to different levels of governments and the corresponding instruments to carry out these functions. The traditional theory of fiscal federalism lays out normative framework for the assignment of functions and the corresponding fiscal instruments that would best suit the efficiency and equity criteria by minimizing externalities embodied in public goods provision. The scheme of assignment based the Musgravian threefold economic functions of the government (Musgrave, 1959), viz., allocation, stabilization and redistribution, argues that allocation function should be assigned to sub-national governments whereas stabilization and distribution functions are appropriate for the federal government. Stabilization function requires monetary and exchange rate prerogatives which are not in the domain of sub-national governments. Similarly, sub-national governments are constrained by mobility of economic units from effective implementation of income redistribution policy. On the revenue raising side, the general guidelines based on consideration of economic efficiency require that highly progressive and mobile tax bases should be assigned to the centre (Musgrave, 1983). Efficiency considerations apart, it is argued that effective exercise of fiscal policy instruments for stabilization and redistribution requires centralization of revenue-raising authority. Intergovernmental transfers became necessary to remedy vertical fiscal imbalance because of revenue centralization and also for sub-national governments to internalize externalities associated with inter-jurisdictional spillovers.

In reality, the assignment of functions between various levels of governments in a federal system is rarely determined on consideration of efficient provision of public
goods. Positive political theory argues that the initial assignment of functions and responsibilities are determined by the relative bargaining powers between the different levels of governments. Further, this bargaining power between the federal (Centre) and the sub-units (States) depends upon the process of confederation which may be ‘coming-together’ or ‘holding-together’. In the ‘coming-together’ federalism, the Centre is usually given only enumerated powers; the sovereignty of the States in the union remaining otherwise unimpaired. In ‘holding-together’ federalism the Centre usually has the upper hand in determining the respective powers and functions of the Centre and the States.

If assignment of responsibilities and powers in a federal system is the result of political bargain rather than that of a benevolent federal government implementing efficiency criteria, then the question arises as to what will be the pattern of assignment preferred by the citizens. Brennan and Buchanan (1980) in their ‘Leviathan’ model argued that at the initial stage of constitutional deliberation, the individual will find it efficient to decentralize taxing power to sub-national units in order to restrict the central government’s power to tax and also to create condition for intergovernmental competition. Contrary to the traditional theory, the Leviathan model propounded for assignment of mobile tax-base to sub-national governments so as to foster intergovernmental competition. “Intergovernmental competition that a genuinely federal structure offers may be constitutionally efficient regardless of the more familiar considerations of inter-unit spillovers examined in the orthodox theory of fiscal federalism” (Brennan and Buchanan, 1980). Intergovernmental transfers in this political economy perspective are seen as the means adopted by sub-national governments to reduce competitive pressure.

The process for achieving allocative efficiency in this political economy formulation is through the public process of decision-making by way of bargain at the constitutional stage and in-period competition. In this regard, the classic work of Wicksell (1896) proposes the rule for efficient fiscal system within the context of political and institutional processes of a democracy. According to this rule, to achieve efficiency in a fiscal system, each single public expenditure or category of expenditures should be assigned to definite revenue category and voted simultaneously, under unanimity rule. The

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1 Wicksell used the word ‘justice’, and not efficiency which Buchanan (1967) demonstrated to be Pareto efficient.
Wicksellian scheme of public finance based on the notion of voluntary exchange between individuals and the government, according to Buchanan (1967), 'produced an escape from free-rider dilemma inherent in large-number of public goods interdependence' and that this unanimity rule is equivalent to Pareto efficiency. This efficiency condition also minimizes the problem of inter-jurisdictional benefit spillovers in public goods provision in a multi-jurisdictional federal setting. The implication of Wicksellian efficiency rule has particular relevance to intergovernmental transfers in fiscal federalism. Such transfer funded from the pool of national tax revenue breaks the link between expenditure and taxing decision of sub-national government and hence, intergovernmental transfers are considered to be a major source of inefficiency.

2.3 The colonial background of the federal Constitution of India

2.3.1 Administrative and financial decentralization

The process of development of federal constitution during the colonial period was driven by three major forces, viz., the British administration, the Indian national movement and the Princely States. Included within the Indian national movement are the Indian National Congress, the Muslim League, the Home Rule League, Communists and others representing various communal groups. The process observably began with administrative and financial decentralization with the objectives of improved economy had turned, subsequently, into Provincial Government.

A beginning in financial decentralization was made in 1871, when the system of assigning fixed annual lump-sum grant and receipts from certain provincial services to the Provincial Governments was introduced. Then in 1882, fixed lump-sum grant was replaced with the scheme of 'divided heads' in which revenues from stamps, excise, income tax, forests, registration, irrigation and land revenue were divided between the Centre and the Provinces. Revenues from departmental services and public works were made entirely provincial. The system of quinquennial review and settlement of provincial financial allocation was introduced. Later quinquennial settlement was turned into permanent settlements in 1912. The amount of settlement that Provinces get from revenue division were determined by expenditure requirements and any balances standing to the credit of Provinces at the end of five years were to resumed by the government of India.
Decentralization measures introduced during the period from 1861 to 1919, however, were essentially informal arrangements and did not affect either the Government of India’s statutory control over Provinces or its responsibility over their financial solvency. Provincial budgets continued to require the Government of India’s approvals and Provinces had no independent power of taxation.

The Indian National Congress, formed in 1885, played an important role in the evolution of representative Provincial Governments and in the processes of decentralization. The Indian Council Act of 1909 was, in a significant way, a colonial response to the demand for swaraj\(^2\) by Congress since 1906 as the goal of India’s political progress. The Act introduced a representative and popular element in Provincial legislature and enlarged the size of the legislative councils by including elected non-official members. In its organization, the Congress developed a somewhat federal structure by organizing itself in Circles, based roughly on regional and linguistic considerations. In fact, provincial autonomy was an important ingredient of the dual concept of decentralization and democratization implicit in the swaraj demand raised by the Indian National Congress soon after its inception.

2.3.2 The Government of India Act, 1919

The outbreak of the First World War, to a great extent, strengthened the bargaining power of the nationalist movement represented, at that time, by the Home Rule Movement, demanding provincial autonomy. In need of full Indian cooperation, the British Government made commitment during the War for ‘development of self-governing institutions with a view to progressive realization of responsible government in British India as an integral part of the British Empire’. The wartime promise came to be implemented in the form of the Government of India Act, 1919, creating a landmark in the development of federal constitution of India. The Act transformed Provincial administration into the status of Provincial Government in the real sense of the term, by assigning limited legislative subjects to Provincial legislatures.

\(^2\) The term Swaraj was taken generally to mean colonial self-government or Dominion Status.
In financial arrangement, the reform abolished 'divided heads' and introduced a scheme of separation of revenue sources between the Central and Provincial Governments. Land revenue, irrigation, excise, forests and judicial stamps were entirely transferred to the Provinces while income tax, customs, commercial stamps, receipts from railways, salt, opium and posts and telegraphs were placed under Central heads of revenue. The revenue assignment under this Act was assessed to have conferred Provinces with such financial advantage that they would be required to make contributions, though progressively declining, to bridge the annual revenue deficits of the Central Government. The reform also bestowed Provincial Governments the power to raise loans for specific capital expenditures against the security of their revenues.

The Act greatly boosted up the bargaining power of Provincial Government because of their financially advantageous position vis-à-vis the Central Government. The scheme of provincial contribution and exclusion from income tax were met with stiff protests, especially by Bombay Province. As provincial contribution fixed by the Meston Committee, called the Meston Award, failed to satisfy the Provinces, the Joint Select Committee, while accepting the Award, recommended that a fraction of the increased income tax over the 1920-21 level be shared with the Provinces. This scheme of income tax sharing marked the beginning of its use as a balancing factor and later to the sharing of the proceeds in the Indian fiscal federalism.

Between 1925 and 1935 various committees have examined and submitted recommendations on federal financial relation, especially on the issue of allocation of income tax, alongside the consultative process for introduction of new Constitution. While there was unanimity that Provinces should not be excluded from income tax, the recommendations of Peel Committee I (1931) & II (1932) and Percy Committee (1932) had gone to the extent of proposing for transfer of the entire proceeds of income tax to the Provinces. The recommendation of the Joint Parliamentary Committee (1934) which got incorporated in the Government of India Act, 1935, however, proposed for sharing of not more than 50 percent of the proceeds of income tax with the province.
2.3.3 The Government of India Act, 1935

The Government of India Act, 1935 introduced truly federal elements by providing clear and precise division of powers between the Centre and the Provinces and a federal court to adjudicate disputes between units of the federation. Legislative jurisdiction between the Centre and the Provinces were divided into federal, provincial and concurrent list. Subjects assigned between the Centre and Provinces were enumerated to settle the irreconcilable differences between the autonomists and centrist over the assignment of residuary power. Accordingly, the scheme of distribution of power enumerated 59 subjects for exclusive competence of the Federal Government, 54 items under exclusive jurisdiction of Provincial legislature and the concurrent list contained 36 items. The Governor-General was given statutory power to settle, on ad hoc basis, the allocation of residuary matter to either the federal legislature or the Provincial legislature.

In federal financial arrangement, besides making a clear demarcation of sources of revenue, the Act of 1935 introduced a system of shared taxes with respect to income tax, salt duties, excise and export duties. The Act also provided for payment of Central grants-in-aid of the revenues of such Provinces as might be in need of assistance to balance their budgets. The borrowing powers of the Provinces were increased by giving permission to raise loans in the open market on the security of their revenues, subject to the sanction of federal government if the Provincial Government owed any debt to or debt guaranteed by the federal government or in cases of loans outside India. In respect of tax assignment, the 1935 Act proved to be more centralizing as compared to the expectations generated by the turn of events following the 1919 Act.

The political scenario of India in the run up to the preparation for setting up of constituent body for framing the Constitution underscored the inevitability of federal form of government. The Cabinet Mission in May 1946, after holding series of consultations with the representatives of the Indian National Congress and Muslim League, came up with the proposal for setting up of a Constituent Assembly for the whole of India with representatives from British India to be elected by members of Provincial
Assembly and nominated representatives from the Princely States. The scheme was based on loose federation with enumerated subjects of foreign affairs, defence and communication vested with the Union Government. This scheme, however, did not survive as India was partitioned thereby rendering the Cabinet Mission Plan "no longer operative" by the time the Constitution was framed for independent India.

2.4 The Constituent Assembly

The process of federal constitution making basically involves allocation of powers and responsibilities between the federal and the constituent governments and deciding the institutions and institutional processes that will govern the federal relationship. Therefore, federal constitution making is theorized as a process of reaching a bargain between prospective national leaders and leaders of constituent governments (Riker, 1964). From this perspective, it is obvious that the outcome of this process will depend upon the relative strength of each party on the bargaining table. The relative strength of a party, as mentioned in the beginning of this chapter, depends upon the process of federalization.

At the time of Constituent Assembly, the Provinces of India were already members of the federal union which in terms of political reality was indissoluble. Ambedkar made the position from which Provinces bargained amply clear when he asserts; "(t)he Federation was not the result of an agreement by the States to join in a Federation" and this being the case "no State has the right to secede from it" (Ambedkar, CAD VII, I, 43). Secondly, all Provincial Governments were ruled by the Congress Party and the premiers of Provinces like Pandit Pant, R.S Shukhla, B.G. Kher and P.C. Ghosh were also prominent Congress leaders. Therefore, when conflict between Party position and State interest arises they were compelled to go along with the Party. No matter their grievances, the reality of the situation was that Provinces could not bargain from a

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3 Constituent Assembly was to consist of 389 members of which, 292 elected by Provincial Assemblies and 93 representatives from Indian States and 4 representatives from chief Commissioners provinces. Members of Provincial Assembly were further divided into general, Muslim and Sikhs (Punjab) to ensure fair communal representation.

4 On the issue of Governor's emergency power Pandit Pant (Premiere of the United Provinces) hold a view sharply different from Assembly leadership. However, when the proposal was moved, Pant, in obedience to the Whip, did not oppose the official position. In other instances like inclusion of forest, education and labour in concurrent list, Pant and Kher initially opposed the proposal made by the Union Ministers. However, the Union Ministers with the backing of Nehru managed in getting substantial part of their demands (Austen 1966).
position of sovereign power; no provincial delegation could quit the Assembly, so a workable compromise had to be reached. Thirdly, the Princely States which enjoyed much authority during framing of 1935 Act were accorded little importance. In fact, by the time of declaration of independence most of the Princely States had signed the Instrument of Accession with the Government of India.

The Constitution of India was drafted in a one Party, viz., Congress dominated environment: 82 percent of the Constituent Assembly members were Congress and the interim government at the Centre was headed by Pandit Nehru. Of the 21 most important figures in the Constituent Assembly listed by Austen (1966), 19 were Congress and the non-Congress were B.R. Ambedkar, Saiyid Mohammed Saadulla of Muslim League from Assam and B.N. Rau who was not a member of the Constituent Assembly. The social and economic programmes that the Congress Party had in mind for the development of India were never compatible with State autonomy. In fact, even in the backdrop of Cabinet Mission Plan for loose federation, Union Powers Committee under Nehru’s chairmanship in its first report ‘expressed the hope that planning would by “agreement” be included within the scope of Union Powers’ (Austen 1966, pp.235).

The Congress leadership was least serious about federalism as they saw it as the manifestation of communalism and provincialism which does not fit into their scheme of things. As to the system of federal financial relation like assignment and sharing of taxes, they saw it as temporary arrangement which will gradually lose their significance with plan development. In the Congress‘ scheme of centralized planning and public sector led development, it was assumed that “taxation would diminish progressively as an important source of public revenue till it disappears almost entirely, and is replaced by profits or surplus from public enterprises and State Domain” (Shah, 1948, pp 104).

If an individual in his personal capacity could influence the Constitution, it would undoubtedly be B.R. Ambedkar. Ambedkar made his preference for unitary form of government clear way back in 1939 when he said “I am not opposed to a federal form of government. I confess I have a partiality for a unitary form of government. I think India

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5 Ambedkar was nominated to the Constituent Assembly by the Bombay Congress at the request of Congress high command.
needs it". This viewpoint might, in fact, be shaped to a large extent by the felt need of the constituency he represented. Ambedkar belonged to the Scheduled Caste community which he has represented since the First Round Table Conference in 1931. The community existed as marginal social group alongside more advanced communities without any specific provincial or territorial concentration. For such a community, strong central government that could protect them from the oppressive immediate local government would naturally be preferable.

When the report of the Union Powers Committee came for discussion in the Assembly, there was no concerted opposition on the propose distribution of legislative subjects and tax revenues between the Union and State Government which was largely lifted directly from the 1935 Act. The lone dissenting voice was that of K. Santhanam, who expressed apprehension over the Central Government "taking over everything" which, to him was not the way to make a strong Centre. In the revenue distribution he made forceful argument for equitable distribution of revenue source - to have, if need be, concurrent taxation so as to make responsible Provincial Governments. Santhanam touched the core issue in federal constitution when he said:

As a member of the Central Legislature, I have always wanted more money for the Centre. If you put me in the provincial legislature, I would want more money for the provinces. The spirit of the corporation is something irresistible. It overpowers us and overcomes us. Therefore, we should see that the Centre is not allowed to infringe upon the power of the State.

Obviously the other members of the Assembly could not appreciate the concern expressed by Santhanam over possible leviathan tendency of the Centre and the need for creation of explicit institutional mechanism governing Centre-State financial relation. The atmosphere of goodwill at that period of time was presumed to continue as President of the Assembly, Rajendra Prasad said, "I do not anticipate that here will be any tendency on the part of the Centre to grab more power than is necessary for the good administration of the country as a whole". Mutual trust and total faith in Central leadership appears to be the pervading mood of the time as Austen (1966) observed, 'i)n twenty memoranda from provincial governments to the Assembly about sales tax and on distribution of revenues, each placing the strongest possible claim for increased funds, no provincial government couched its demands in terms of protecting its autonomy or states right' (pp.234).

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6 M. Bhattacharya (1992)  
7 CAD Vol.V, pp.5.  
It is, therefore, not surprising that the outcome was a Constitution with strong unitary features; described variously as federal structure with strong Centre or federal in nature but unitary in spirit or even as quasi–federal.

2.5 The scheme of assignment in the federal Constitution of India

2.5.1 Expenditure assignment

The Constitution of India provides for a three-fold distribution of legislative powers, detailed in separate lists in the Seventh Schedule. In this Schedule, 97 items are kept as Centre Subjects, 66 items as State Subjects and 47 items under Concurrent List on which both the Centre and States have the power to legislate, but dominant position accorded to the Central law. Though the Constitution does not specifically mention expenditure assignment as such, it confers executive authority to the Government of India and the State Governments on subjects placed under the Union List and State List respectively. Hence, the distribution of legislative power formed the basis for expenditure assignment between the Union and the State Governments. Broadly, States are exclusively responsible for provision of basic public services such as maintenance of public order, health, sanitation, water supply, primary education and roads while the Union Government is assigned exclusive power on subjects of national importance. The assignment of legislative power between the Union and States were largely continuation of the Government of India Act 1935, except for additional centralizing features incorporated in the Constitution such as increase in items under concurrent list and allocation residuary power to the Centre.

2.5.2 Revenue assignment

The subjects enumerated in the distribution of legislative powers also contained the revenues assigned to the Union Government and the State Governments. The scheme of revenue assignment included in the Seventh Scheduled is based on ‘separation

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9 Article 73 of the Constitution makes the executive authority of the Union co-terminus with the subject matters for which Parliament can make laws and Article 162 makes executive authority of the States co-terminus with the matters for which State legislatures have powers to make laws.
principle' and like expenditure assignment, is a continuation of the 1935 Act. The scheme assigned most of the broad-based and productive taxes like personal and corporate income taxes, excise duty on manufacturing and customs duty to the Union Government while the States were assigned a long list of taxes out of which, sales tax (now State VAT) formed the only elastic source of revenue. This apart, a significant aspect of the Constitutional scheme of revenue arrangement under Articles 268, 269 and 270 are reflective of the integration and interdependence disposition of the Constitution. These are:

(i) taxes levied by the Union but collected and appropriated by the State (Art.268), viz., stamp duties, excise on medicinal and toilet preparations, central sales tax;
(ii) taxes levied and collected by the Union but assigned to the States (Art.269), viz. tax on interstate sales and consignment tax; and
(iii) Taxes levied and distributed between the Union and the States (Art.270), viz., personal income tax\(^\text{10}\).

2.5.3 Revenue sharing and grants-in-aid

The huge expenditure need of the States had, all along been recognized by the framers of the Constitution. The Expert Committee on Financial Provisions of the Constitution\(^\text{11}\) observed that that while "the expenditure of the Centre should be comparatively stable... (t)he needs of the provinces are, in contrast, almost unlimited". Hence the Committee considered "necessary to place at the disposal of provincial governments adequate resources of their own...". While the Committee, did not find assignment of additional tax base to States feasible, it recommended that the Union should share not less than 60 percent of the proceeds from income tax and corporation tax with the States. The Committee even recommended the basis for inter-State distribution of this 60 percent among the States - 35 percent on collection; 20 percent on population and 5 percent on hardship arising out of the two criterion. The Drafting Committee rejected this recommendation and provided for mandatory sharing of only personal

\(^{10}\text{Apart from compulsory sharing of the proceeds of income tax, Art 272 of the Constitution provide for voluntary sharing of Union excise duty with the States. But Constitution 80th Amendment, 2000 made the net proceeds of all Central taxes sharable with the States.}\)

\(^{11}\text{The Committee headed by N.C. Sarkar was constituted by the Constituent Assembly to work out the economic aspects of Centre-States relations. The report of the Committee was tabled in the Constituent Assembly in 1948.}\)
income while sharing Union excise duty was made permissible. But it accepted the recommendation regarding creation of the Finance Commission.

Constitution has provisions for grants-in-aid under Article 275 from the Consolidated Fund of India to States in need of assistance. This article made extensive provision for grants-in-aid to States for meeting capital and recurring expenses for development schemes and for promotion of welfare of Scheduled Tribes. The article also makes it mandatory for the President to consider the recommendations of the Finance Commission before issuing orders in respect of grants-in-aid under this provision. Apparently, all grant-in-aid from Centre to the States of significance to the federal system must have been assumed to be covered under this article and mediated through the Finance Commission. Another article the application of which remained controversial for longtime is Article 282 of Miscellaneous Financial Provisions. The Constitution under this article provided that the Union or State may make any grant for any public purpose. The practice of giving financial assistance to the States for meeting plan expenditure under this article has been objected to by several scholars who hold the view that the article was a miscellaneous provision to take care of contingencies such as expenses for refugee relief at the time of framing of the Constitution (Eapen, 1969).

Article 280 of the Constitution provided for Finance Commission to be constituted by the President of India every five year to make assessment of the fiscal resources and needs of the Centre and the States and make recommendations on (i) the distribution between the Union and the States of the net proceeds of distributable taxes and the allocation between the states of the respective share of such proceeds; (ii) the principles governing the issue of grants-in-aid to States. In addition to these obligatory duties, the President may refer to the Commission any matter on which he consider desirable to get the views of the Commission in the interest of sound finance.

The Constitutional scheme of assignment clearly epitomized the idea of cooperative federalism under the benevolent supervision of the Central Government at the cost of economic decentralization. While political decentralization was seen inevitable, economic centralization was considered necessary for rapid development and to narrow down regional disparities (Parikh and Weingast, 1997). Even the limited economic decentralization provisions of the Constitution got further diluted or trampled upon by the
centralized development planning that India adopted soon after independence, which we shall see in the subsequent section.

2.6 Post-Constitutional development

2.6.1 Development planning

Even before independence, the leadership of the national movement came to consider economic planning as necessary for any responsible government. In 1938, the Congress constituted National Planning Committee with Nehru as Chairman and K.T. Shah as Hon. General Secretary. The Committee inducted several representatives from Provincial Governments and Princely States. The work of the Committee was, however, interrupted by intensified national movement following the outbreak of the World War II. The idea of planning, nevertheless, gained relevance with post-War reconstruction programme of the Government. The Government of India in 1944, created Planning and Development Department for coordinating works regarding post-War reconstruction. Then in 1946, the Interim Government under Nehru appointed an Advisory Planning Board with K.C. Neogy as Chairman to review the work that was already done in the field of planning and make recommendation for the future (Vithal and Shastry, 2002). The Board submitted its report in December 1946 recommending for appointment of an advisory body, the Planning Commission.

From the constitutional viewpoint, other than inclusion of the item ‘economic and social planning’ in the Concurrent List of the Constitution, the Constituent Assembly did not deal with any proposal for economic planning. Under the influence of Nehru who was both the Prime Minister and Party leader, the Congress nevertheless, continued working towards creation of a planning body outside the limelight of Constitution making process. Finally in January 1950 Congress Working Committee passed a resolution for recommending to the Government of India that a statutory Planning Commission should be set up. Then in March 1950 the Planning Commission was established by a Resolution of the Government.
2.6.2 *The Planning Commission*

The Cabinet Resolution highlighted the imperatives of comprehensive planning to promote welfare of the people as enunciated in the Directive Principles of the Constitution. The assigned functions of the Planning Commission as follows:

a. Make an *assessment of the material, capital and human resources* of the country, including technical personnel and investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation's requirement;

b. Formulate a plan for the most *effective and balanced utilization of the country’s resources*;

c. On a determination of the priorities, define the stages in which the plan should be carried out and propose the *allocation of resources* for the due completion of each stage;

d. Indicate the factors which are tending to retard economic development and determine the conditions which, in view of the current social and political situation, should be established for the successful execution of the plan;

e. Determine the nature of the machinery which will be necessary for securing the successful implementation of each stage of the plan in all its aspects;

f. Appraise, from time to time, the process achieved in the execution of each stage of the plan and recommend the adjustments of policy and measures that such appraisal may show to be necessary; and

g. Make such interim or ancillary recommendations as appear to be appropriate either for facilitating the discharge of the duties assigned to it or on a consideration of the prevailing economic conditions, current policies, measures and development programmes, or on an examination of such specific problems as may be referred to it for advice by Central or State Governments.

The Planning Commission was meant to be advisory in nature; 'making recommendations to the Union Cabinet', and 'in framing its recommendations the Commission will act in close understanding and consultation with the Ministries of the Central Government and the Governments of the States'. The Cabinet Resolution also constituted the Planning Commission consisting of Nehru as Chairman, Gulzarilal Nanda as Deputy Chairman, four members, a Secretary and a Deputy Secretary. Since then it became a convention that the Prime Minister is also the Chairman of the Planning Commission. To obtain participation of State Governments in planning process and to ensure consensus about overall strategy and priorities of the development plans, the National Development Council (NDC) was established in 1952 with its members consisting of Union Cabinet Ministers, Members of Planning Commission and Chief Ministers of all States.

Even before planning commenced in India, developmental fund transfers to Provinces were already in existence viz., Post-War Reconstruction and Development grants and grants for Grow More Food Schemes. With the adoption of the Constitution and then commencement of First Five-Year Plan, these grants continued as grants-in-aid
to State Governments under Article 282 of the Constitution and the schemes subsumed in the plan outlay of the Central Government. In fact many more schemes, which should have appropriately been included under in the State Sector were included in the Central Sector as the exact distribution of their financial liability had not been decided upon by then (Vithal & Shastry, 2002). This paved the way for major Central inroad into States' sphere by way of numerous centrally sponsored schemes which remained a contentious issue in Indian federalism.

The Second Five Year Plan tried to transfer schemes relating to State subjects implemented under Central sector plan to the State Governments. It was, however, decided to retain certain categories of schemes to be shown in the plans of Central Ministries as being sponsored by the Central Government. The number of centrally sponsored schemes at the end of the Third Five-Year Plan was assessed at 92. When the exercise for the Fourth Five-Year Plan was initiated in the backdrop of severe resource crunch due to successive droughts and growing regional political formation, several States expressed the desirability of evolving objective criteria for allocation of plan assistance and for pruning the number of centrally sponsored schemes. Subsequently, after several rounds of discussions, the National Development Council adopted the Formula for allocation of Central assistance for State plans called the Gadgil Formula in 1969, putting an end to the discretionary power hitherto enjoyed by the Planning Commission. Since then, general purpose assistance for State plans called normal Central assistance distributed on the basis of the Formula came into being. At the same time, centrally sponsored schemes were continued as before.

In respect of centrally sponsored schemes, the Administrative Reforms Commission recommended that the criteria for such schemes should be (i) pilot projects, surveys and research, (ii) regional or inter-state character and (iii) overall significance from all India angle. Further, the National Development Committee, in 1968, recommended that the quantum of assistance through centrally sponsored schemes should be restricted to one-sixth of Central assistance for State plans. But the number of CSS continued to increase and by 1978 it has grown to 116. The Janata Government initiated concrete steps to limit the quantum of assistance under centrally sponsored schemes and issued guidelines for Central Ministries in this regard. With the change in Government this initiative soon came to naught. Centrally sponsored schemes remained a permanent
feature of India's centralized development policy wherein the Central Government is expected to lead in setting development agenda. Despite the oft-repeated need for restricting its proliferation, these schemes provide the means to implement initiatives of national importance that each and every Government at the Centre would take pride in making announcement.

Wide acceptance that the Planning Commission gained despite being an extra-constitutional body has been attributed to the dominance of the Congress Party both at the Centre and the States (Santhanam, 1960). Its position in the Government of India is established by the procedural requirement of obtaining Planning Commission's prior consent for all plan schemes and projects of Central Ministries while in the federal polity, its position is strengthened by its role as a major dispenser of development funds to State Governments. Though fluctuating economic fortunes and political situations of the country seems to have impacted on the relative importance of the Planning Commission through the past, the institution continue to occupy the central place in India's development policy formulation. In fact, the Commission has become a permanent forum for the continuous process of bargaining between the Central and State Governments and among the State Governments on issues pertaining to developmental priorities and federal finance.

2.6.3 The Finance Commission

The Constitution's scheme of revenue assignment between the Union and State Governments based on interdependence demands flexibility in handling the dynamics of federal relation. With this understanding, the Expert Committee on Financial Provisions of the Constitution recommended for creation of 'a neutral expert authority', every five year 'to periodically review' the Centre-State financial relations. Based on this recommendation, Article 280 of the Constitution provided for Finance Commission to be constituted by the President, within two years of the commencement of the Constitution and thereafter at an interval of every five year. The function of the Finance Commission would be to make recommendations on:

(i) the distribution between the Union and the States of the net proceeds of distributable taxes and the allocation between the States of the respective share of such proceeds;
(ii) the principles governing the issue of grants-in-aid of the revenues of the States out of the Consolidated Fund of India;

(iii) measures needed to augment the Consolidated Fund of a State.

In addition to these obligatory duties, the President can include any other matter in the terms of reference of the Commission in the interest of sound finance. Legislation relating to Finance Commission was passed in 1951 which made the Commission a semi-judicial authority enjoying vast authority in respect of financial adjustments affecting the balance of the federal system.

The statutory provisions notwithstanding, in practice, role of Finance Commission came to be restricted from the First Commission itself. With planning already under implementation, the First Finance Commission soon encountered demands for funds from State Governments for meeting expenditure under capital account arising out of plan schemes. The Commission took the view that these requirements were arising out of planning which was outside its purview. Hence it refrained from making recommendations on these demands. The Second Finance Commission further conceded its role to the Planning Commission by asserting that ‘the priorities and provisions in the plan itself should determine the fiscal needs’. More assertive approach adopted by the Third Finance Commission on its role vis-à-vis that of the Planning Commission was not acceptable to the Government. Mutual accommodation with the Planning Commission became the most feasible norm. It is now the accepted convention that the Finance Commission restricts its role to recommending the modalities for sharing of taxes and grants-in-aid for non-plan purposes.

Though there is no Constitutional restriction, it is broadly understood that the Finance Commission should keep itself to the non-plan, non-developmental area of States budget and leave the plan developmental side to the Planning Commission. The advantage of this arrangement is that the Planning Commission, as a permanent body, can

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12 Since the 73rd and 74th amendment of the Constitution, the obligatory duties of the Finance Commission include recommendations on measures to supplement the resources of the panchayats and the municipalities.

13 Majority decision of the Third Finance Commission was for the Commission to take account of 75 percent of the plan requirements of the States. Government rejected this recommendation and accepted the recommendation of the member-secretary to stay clear of the plan side of the States’ requirements altogether.
monitor and evaluate the progress of grants given for developmental schemes and projects. But the plan and non-plan dichotomy of State budget with two separate institutions responsible for each part is not particularly advantageous for prudent fiscal management of the States. This problem has been a major issue from the time of the Third Finance Commission which observe remarked, "(i)t seems to us that to draw a line necessarily arbitrarily on the basis of plan and non-plan expenditure in their treatment is not really sound ....... , we see considerable advantage in devising a machinery for taking an integrated view of plan and non-plan expenditure of the state as a whole"\textsuperscript{14}.

2.6.4 Party politics and federalism

The Constitution of India laid down the framework for federal financial system. The manner in which institutions and functions evolve over time is decided in the political arena reflecting the balance of power between the Centre and State Governments. The period from independence up to 1967 was marked by absolute dominance of the Congress Party both at the Central and the State Governments. Centralized power structure within the Congress party endorsed the country being governed in similar unitary and centralized fashion, notwithstanding the federal Constitution (Santhanam, 1960). Disputes between the Centre and States were often played out within the ranks of the Congress party and hardly came out as Centre-State issues. The report of the Administrative Reforms Commission observed: "where a single party has control over affairs at the Centre as well as in the States an alternative channel becomes available for the operation of Centre-States relationships. ..... In the process, Constitution was not violated ...... but was often bypassed"\textsuperscript{15}.

In 1967 general election the Congress was considerably weakened at the Centre and was defeated in almost half of the States. The increased bargaining power of the States following this political development was reflected in the adoption of the Gadgil Formula in 1969 for allocation of Central assistance for State plans. The Formula minimized the discretion that the Central Government enjoyed in the allocation of financial assistance the plans and gave State Governments flexibility in application of plan funds. The period also saw growing concern over Central inroad into State subjects

\textsuperscript{14} Report of the Third Finance Commission, (pp. 30,31).
\textsuperscript{15} Report of the Administrative Reforms Commission, (pp.1,2).
through the implementation of centrally sponsored schemes. In fact, the National Development Council in 1969 took the decision for a cap in the quantum of funds under centrally sponsored schemes to one-sixth of Central assistance for State plans. But this has been consistently ignored except for the steps initiated by the Janata Government which could not be taken to its logical conclusion as the Government was soon out of power.

The early 1980s saw emergence of regional parties, ruling in major States of Punjab (Akali Dal), Jammu & Kashmir (National Conference), West Bengal (CPM) Tamil Nadu (AIADMK), Andhra Pradesh (Telegu Desam) and Karnataka (Janata). Chief Ministers of these States developed a kind of forum to discuss issues of Centre-State relations. In a meeting held at Bangalore in 1983, attended by four Chief Ministers of the Southern States, demanded for formation of a commission, with adequate State representation, to review fiscal relations between the Centre and the States and to recommend remedial legislation and Constitutional changes. Later at Srinagar meeting the Chief Ministers came up with specific demands such as President's Rule was to be curbed; the States' power on State's legislative list were to be supreme; residual powers were to be for the States; removal of the provision for Central rule under financial instability (Art.360); and the contents of the legislative lists be reviewed. As the demand for greater decentralization gained support base (Austen 1999) the Central Government, in response, constituted the Commission on Centre-State Relation, also called, the Sarkaria Commission. The Commission did come out with voluminous report, but most of its recommendations remained unimplemented. Significantly, the Inter-State Council, a forum for resolving inter-State issues contemplated in the Constitution was set-up in 1989 by a non-Congress coalition government headed by V.P. Singh.

The era of coalition/minority government at the Centre since 1989 and the process of economic reforms since 1991 had, to a great extent, stimulated the process of economic decentralization. In raising loans and in accessing external aid Central Government’s regulations were minimized. Industrial deregulation and foreign direct investment liberalization had opened up the scope for State Governments to pursue aggressive industrialization and investment policies, largely independent of the Central Government. But coalition politics has also brought in a kind of vertical competition between the Central and State Governments which counteracted the decentralizing forces in the form
of various national programmes by the Governments which came into power. Therefore, in public sector development policy and schemes, innovation and initiatives remained by and large centralized and the State Governments seem to be content to play an implementing agency role.

In politics, powerful regional parties playing pivotal role in coalition governments at the Centre had become common. The emergence of regional political power, however, did not translate into coordinated demands for State autonomy. There may be two possible explanations to this. It may be the case that the existing system is conducive enough or at least adequate for handing out rewards to meet the demands of regional partners. Secondly, the 73rd and 74th amendments to the Constitution which created a third tier of decentralization may have acted as ‘counter weight’ to States bargaining power (Rao and Singh, 2005). For the State autonomy demand to be justifiable, the State Governments will now be expected to undertake credible decentralization to the local bodies within their jurisdiction.

2.7 Conclusion

The evolution of federal Constitution during the colonial period displayed unmistakable marks of bargaining. At the time of Government of India Act 1919, bargaining between the British Government and the Indian nationalists which championed Provincial autonomy resulted in unprecedented financial autonomy for the Provinces. Communal interests had not assumed federal form and Princely States were still outside the reckoning. Though the intervening period between the 1919 Act and 1935 Act saw growing readiness for greater financial autonomy of Provinces, the 1935 Act has turned out to be more centralizing, in so far as assignment of taxes are concerned, then warranted by recommendation the Peel and Percy Committees. This may be explained by the political scene of the period which was dominated by destabilizing communal issues and concerns. Therefore, given the circumstance, the scheme of federal assignment adopted in the 1935 Act might have been the most feasible and pragmatic arrangement for

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16 During the NDA regime the Telugu Desam Party (TDP) was alleged to have extracted largesse from the Central Government for the Andhra Pradesh State in allocation of rice, fund for rural development and for creation of new airport etc. http://www.rediff.com/news/2002/may/17spec.html.
a stable government. It is ironic that inevitability of federal polity when overplayed poses threat to the feasibility of federalism.

The federal side of the Constitution of India, especially the financial aspect, as we have seen from the preceding sections, did not get the amount of attention of the framers it deserves. Except for the creation of Finance Commission, the federal financial provisions in the Constitution were continuation of the 1935 Act. If federal provisions of the Constitution were the outcome of bargaining process, at best, it was a bargain between unequal parties. The framers of the Constitution were well aware that the tax base assigned to States was not comparable with their assigned responsibilities. But this has not been considered a serious problem as the whole approach was based on cooperation and interdependence with Central Government playing the leading role. State Governments were assumed to be dependent on transfers from Centre in the form of tax sharing and grants, but the nature of incentives that the system would generate did not seem to have attracted sufficient attention of the Constituent Assembly.

Soon after India adopted the Constitution, centralized planning was introduced which further affected the federal structure of India beyond the anticipation of the framers of the Constitution. The process of developmental planning entailed centralized development policy formulation and centralized allocation of resources. States have become mere implementing agencies for schemes and projects formulated within the national development planning. The concurrent list of the Constitution and the process of centralized planning together facilitated Centre’s intrusion into State subjects through various centrally sponsored schemes and specific plan programmes. But the States were not complaining overtly as it meant additional Central funds without their having to take the unpopular decision of tax rate increase or imposition of new taxes. By the end of the first decade of planning it was observed that the “disturbing feature is States are becoming dependent on Central assistance on an ever increasing scale. This diluted the accountability of State Cabinets to their legislatures and comes in the way of the development of a greater sense of responsibility in their administration”\(^1\). While the Constitution itself was not envisaged in terms of efficient fiscal system, the scope for efficiency generating in-period intergovernmental competition (Breton 1996) was stymied

\(^1\)Report of the Third Finance Commission, 1961 (pp.36,37).
by factors such as centralized planning, the system of intergovernmental transfers and tax rate harmonization measures.