

CHAPTER 25

DISTRIBUTION OF FINANCIAL POWERS

Need for Distribution of Financial Resources. NO system of federation can be successful unless both the Union and the States have at their disposal adequate financial resources to enable them to discharge their respective responsibilities under the Constitution.

To achieve this object, *our* Constitution has made elaborate provisions, mainly following the lines of the Government of India Act, 1935, relating to the distribution of the taxes as well as non-tax revenues and the power of borrowing, supplemented by provisions for grants-in-aid by the Union to the States.

Before entering into these elaborate provisions which set up a complicated arrangement for the distribution of the financial resources of the country, it has to be noted that the object of this complicated machinery is an equitable distribution of the financial resources between the two units of the federation, instead of dividing the resources into two watertight compartments, as under the usual federal system. A fitting introduction to this arrangement has been given by our Supreme Court,¹ in these words:

"Sources of revenue which have been allocated to the Union are not meant entirely for the purposes of the Union but have to be distributed according to the principles laid down by Parliamentary legislation as contemplated by the Articles aforesaid. Thus all the taxes and duties levied by the Union ... do not form part of the Consolidated Fund of India but many of these taxes and duties are distributed amongst the States and form part of the Consolidated Fund of the States. Even those taxes and duties which constitute the Consolidated Fund of India may be used for the purposes of supplementing the revenues of the States in accordance with their needs. The question of distribution of the aforesaid taxes and duties amongst the States and the principles governing them, as also the principles governing grants-in-aid ... are matters which have to be decided by a high-powered Finance Commission, which is a responsible body designated to determine those matters in an objective way... The Constitution-makers realised the fact that those sources of revenue allocated to the States may not be sufficient for their purposes and that the Government of India would have to subsidise their welfare activities... Realising the limitations on the financial resources of the States and the growing needs of the community in a welfare State, the Constitution has made... specific provisions empowering Parliament to set aside a portion of its revenues... for the benefit of the States, not in stated proportions but according to their needs ... The resources of the Union Government are not meant exclusively for the benefit of the Union activities ... In other words, the Union and the States together form one

organic whole for the purposes of utilisation of the resources of territories of India as a whole."

Principles underlying distribution of Tax Revenues..

The Constitution makes a distinction between the legislative power to levy a tax and the power to appropriate the proceeds of a tax so levied. In India, the powers of a Legislature in these two respects are not identical.

(A) The legislative power to make a law for imposing a tax is divided as between the Union and the States by means of specific Entries in the Union and State Legislative Lists in Sch. VII (see Table XIX). Thus, while the State Legislature has the power to levy an estate duty in respect of agricultural lands [Entry 48 of List II], the power to levy an estate duty in respect of non-agricultural land belongs to Parliament [Entry 87 of List I]. Similarly, it is the State Legislature which is competent to levy a tax on agricultural income [Entry 46 of List II], while Parliament has the power to levy income-tax on all incomes other than agricultural [Entry 82 of List I].

The residuary power as regards taxation (as in general legislation) belongs to Parliament [Entry 97 of List I] and the Gift tax and Expenditure tax have been held to derive their authority from this residuary power. There is no concurrent sphere in the matter of tax legislation.

Before leaving this topic, it should be pointed out that though a State Legislature has the power to levy any of the taxes enumerated in the State Legislative List, in the case of certain taxes, this power is subject to certain limitations imposed by the substantive provisions of the Constitution. Thus—

(a) While Entry 60 of List II of Sch. VII authorises a State Legislature to levy a tax on profession, trade, calling or employment, the total amount payable in respect of any one person to the State or any other authority in the State by way of such tax shall not exceed Rs. 2,500² *per annum* [Art. 276(2)].

(b) The power to impose taxes on 'sale or purchase of goods other than newspapers' belongs to the State [Entry 54, List II]. But 'taxes on imports and exports' [Entry 83, List I] and 'taxes on sales in the course of inter-State trade and commerce' [Entry 92A, List I] are exclusive Union subjects. Article 286 is intended to ensure that sales taxes imposed by States do not interfere with imports and exports or inter-State trade and commerce, which are matters of national concern, and should, therefore, be beyond the competence of the States. Hence, certain limitations have been laid down by Art. 286 upon the power of the States to enact sales tax legislation:

1. (a) No tax shall be imposed on sale or purchase which takes place outside the State.

(b) No tax shall be imposed on sale or purchase which takes place in the course of import into or export out of India.³

2. In connection with inter-State trade and commerce there are two limitations—

(i) The power to tax sales taking place 'in the course of inter-State trade and commerce'⁴ is within the exclusive competence of Parliament [Entry 92A, List I].

(ii) Even though a sale does not take place 'in the course of inter-State trade or commerce, State taxation would be subject to restrictions and conditions imposed by Parliament if the sale relates to 'goods declared by Parliament to be of *special importance* in inter-State trade and commerce'. In pursuance of this power, Parliament has declared sugar, tobacco, cotton, silk and woollen fabrics to be goods of special importance in inter-State trade and commerce, by enacting the Additional Duties of Excise (Goods of Special Importance) Act, 1957 [s. 7], and imposed special restrictions upon the States to levy tax on the sales of these goods.

(c) Save insofar as Parliament may by law otherwise provide, no law of a State shall impose, or authorise the imposition of, a tax on the consumption or sale of electricity (whether produced by a Government or other persons) which is—

(i) consumed by the Government of India, or sold to the Government of India for consumption by that Government; or

(ii) consumed in the construction, maintenance or operation of any railway by the Government of India, or a railway company operating that railway, or sold to that Government or any such railway company for consumption in the construction, maintenance or operation of any railway [Art. 287].

(d) The property of the Union shall, save insofar as Parliament may by law otherwise provide, be exempt from all taxes imposed by a State or by any authority within a State [Art. 285(1)].

Conversely, the property and income of a State shall be exempt from Union taxation [Art. 289(1)]. There is, however, one exception in this case. If a State enters into a trade or business, other than a trade or business which is declared by Parliament to be incidental to the ordinary business of government, it shall not be exempt from Union taxation [Art. 289(2)]. The immunity, again, relates to a tax on property. Hence, the property of a State is not immune from customs duty.¹

(B) Even though a Legislature may have been given the power to levy a tax because of its affinity to the subject-matter of taxation, the yield of different taxes coming within the State legislative sphere may not be large enough to serve the purposes of a State. To meet this situation, the Constitution makes special provisions:

(i) Some duties are leviable by the Union; but they are to be collected and entirely appropriated by the States after collection.

(ii) There are some taxes which are both levied and collected by the Union, but the proceeds are then assigned by the Union to those States within which they have been levied.

(iii) Again, there are taxes which are levied and collected by the Union but the proceeds are distributed between the Union and the State.

The distribution of the tax-revenue between the Union and the States, according to the foregoing principles, stands as follows:

(A) Taxes belonging to the Union exclusively:

1. Customs. 2. Corporation tax. 3. Taxes on capital value of assets of individuals and Companies. 4. Surcharge on income tax, etc. 5. Fees in respect of matters in the Union List (List I).

(B) Taxes belonging to the States exclusively:

1. Land Revenue. 2. Stamp duty except in documents included in the Union List. 3. Succession duty, Estate duty, and Income tax on *agricultural land*. 4. Taxes on passengers and goods carried on inland waterways. 5. Taxes on lands and buildings, mineral rights. 6. Taxes on animals and boats, on road vehicles, on advertisements, on consumption of electricity, on luxuries and amusements, etc. 7. Taxes on entry of goods into local areas. 8. Sales Tax. 9. Tolls. 10. Fees in respect of matters in the State List. 11. Taxes on professions, trades, etc., not exceeding Rs. 2,500 per annum (List II).

(C) Duties Levied by the Union but Collected and Appropriated by the States:

Stamp duties on bills of Exchange, etc., and Excise duties on medicinal and toilet preparations containing alcohol, though they are included in the Union List and levied by the Union, shall be collected by the States insofar as leviable within their respective territories, and shall form part of the States by whom they are collected [Art. 268].

(D) Taxes Levied as well as Collected by the Union, but Assigned to the States within which they are Leviable:

(a) Duties on 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, air or sea. (d) Taxes on railway fares and freights. (e) Taxes on stock exchange other than stamp duties. (f) Taxes on sales of and advertisements in newspapers. (g) 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. (h) Taxes on inter-State consignment of goods [Art. 269].

(E) Taxes Levied and Collected by the Union and Distributed between Union and the States:

Certain taxes shall be levied as well as collected by the Union, but their proceeds shall be divided between the Union and the States in a certain proportion, in order to effect an equitable division of the financial resources. These are—

(a) Taxes on income *other than on agricultural income* [Art. 270].

(b) Duties of excise as are included in the Union List, excepting medicinal and toilet preparations may also be distributed, if Parliament by law so provides [Art. 272].

(F) *The principal sources of non-tax revenues of the Union are the receipts from—*

Railways; Posts and Telegraphs; Broadcasting; Opium; Currency and Mint; Industrial and Commercial Undertakings of the Central Government relating to the subjects over which the Union has jurisdiction.

Of the Industrial and Commercial Undertakings relating to Central subjects may be mentioned—

The Industrial Finance Corporation; Air India; Indian Airlines; Industries in which the Government of India have made investments, such as the Steel Authority of India; the Hindustan Shipyard Ltd; the Indian Telephone Industries Ltd.

(G) *The States, similarly, have their receipts from—*

Forests, Irrigation and Commercial Enterprises (like Electricity, Road Transport) and Industrial Undertakings (such as Soap, Sandalwood, Iron and Steel in Karnataka, Paper in Madhya Pradesh, Milk Supply in Mumbai, Deep-sea Fishing and Silk in West Bengal).

Even after the assignment to the States of a share of the Central taxes, the resources of all the States may not be adequate enough. The Constitution, therefore, provides that grants-in-aid shall be made in each year by the Union to such States as Parliament may determine to be in need of assistance; particularly, for the promotion of welfare of tribal areas, including special grants to Assam in this respect [Art. 275].

Articles 270, 273, 275 and 280 provide for the constitution of a Finance Commission (at five year intervals) to recommend to the President certain measures relating to the distribution of financial resources between the Union and the States,—for instance, the percentage of the net proceeds of income-tax which should be assigned by the Union to the States and the manner in which the share to be assigned shall be distributed among the States [Art. 280].

The constitution of the Finance Commission is laid down in Art. 280, which has to be read with the Finance Commission (Miscellaneous Provisions) Act of 1951, which has supplemented the provisions of the Constitution. Briefly speaking, the Commission has to be constituted by the President, every five years. The Chairman must be a person having 'experience in public affairs'; and the other four members must be appointed from amongst the following—

(a) A High Court Judge or one qualified to be appointed as such; (b) a person having special knowledge of the finances and accounts of the Government; (c) a person having wide experience in financial matters and administration; (d) a person having special knowledge of economics.

It shall be the duty of the Commission to make recommendations 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 under this Chapter 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) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State;⁵
- (d) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State;⁶
- (e) any other matter referred to the Commission by the President in the interests of sound finance.

The First Finance Commission. The First Finance Commission was constituted in 1951, with Sri Neogy as the Chairman, and it submitted its report in 1953. Government accepted its recommendations which, *inter alia*, were that—

(a) 55 per cent of the net proceeds of income-tax shall be assigned by the Union to the States and that it shall be distributed among the States in the shares prescribed by the Commission.

(b) The Commission laid down the principles for guidance of the Government of India in the matter of making general grants-in-aid to States which require financial assistance and also recommended specific sums to be given to certain States such as West Bengal, Punjab, Assam, during the five years from 1952 to 1957.

The Second Finance Commission. A Second Finance Commission, with Sri Santhanam as the Chairman, was constituted in 1956. Its report was submitted to Government in September, 1957 and its recommendations were given effect to for the quinquennium commencing from April, 1957.

The Third Finance Commission. A Third Finance Commission, with Sri A.K. Chanda as its Chairman, was appointed in December, 1960. It submitted its report in 1962.

The Fourth Finance Commission. The Fourth Finance Commission with Dr. RAJAMANNAR, retired Chief Justice of the Madras High Court, as its Chairman, was constituted in May, 1964.

The Fifth Finance Commission. A Fifth Finance Commission, headed by Sri Mahavir Tyagi, was constituted in March, 1968, with respect to the quinquennium commencing from 1-4-1969. It submitted its final report in July 1969, and recommended that the States' share of income-tax should be raised to 75 per cent and of Union Excise duties should be raised to 20 per cent.

The Sixth Finance Commission. The Sixth Finance Commission, headed by Sri Brahmananda Reddy, submitted its Report in October, 1973. This Commission was, for the first time, required to go into the question of the debt position of the States and their non-plan capital gap.

The Seventh Finance Commission. A Seventh Finance Commission was appointed in June, 1977 in relation to the next quinquennium from 1979, with Sri Shelat, a retired Judge of the Supreme Court as its Chairman. It submitted its report in October, 1978.

The Eighth Finance Commission. The Eighth Finance Commission was set up in 1982, with ex-Minister, Shri Y.B. Chavan as its head.

The Eighth Finance Commission submitted its report in 1984, but its recommendations, granting moneys to the States, were not implemented by the Government of India, on the ground of financial difficulties and late receipt of the Commission's Report. Obviously, this placed some of the States in financial difficulty and the State of West Bengal raised vehement protest against this unforeseen situation. Responsible authorities in West Bengal threatened litigation but eventually nothing was done presumably because the matter was non-justiciable. Article 280(3) enjoins the Finance Commission to make 'recommendations' to the President and the only duty imposed on the President, by Art. 281, is to lay the recommendations of the Commission before each House of Parliament. It is nowhere laid down in the Constitution that the recommendations of the Commission shall be binding upon the Government of India or that it would give rise to a legal right in favour of the beneficiary States to receive the moneys recommended to be offered to them by the Commission. Of course, non-implementation would cause grave dislocation in States which might have acted upon their anticipation founded on the Commission's Report. The remedy for such dislocation or injustice lies only in the ballot box.

The Ninth Finance Commission. The Ninth Finance Commission, headed by Shri N.K.P. Salve, submitted its reports in 1988 and 1989; all its recommendations have been accepted by the Government.⁷

The Tenth Finance Commission. The Tenth Finance Commission was constituted on 16-6-1992, with Shri K.C. Pant as its Chairman. It submitted its report on 26-11-1994.

The Eleventh Finance Commission. The Eleventh Finance Commission was constituted on 3-7-1998. It submitted its report on 7-7-2000.

The Twelfth Finance Commission. The Twelfth Finance Commission was constituted on 1.11.2002 with Dr. C. Rangarajan as its Chairman. It submitted its report on 17.12.2004.

The Thirteenth Finance Commission. The Thirteenth Finance Commission was constituted on 1.11.2007 with Shri Vijay Kelkar as its Chairman and is expected to submit its report by October, 2009.

Safeguarding the interests of the States in the shared Taxes. By way of safeguarding the interests of the States in the Union taxes which are divisible according to the foregoing provisions, it is provided by the Constitution [Art. 274] that no Bill or amendment which—

- (a) varies the rate of any tax or duty in which the States are interested; or
- (b) affects the principles on which moneys are distributable according to the foregoing provisions of the Constitution; or

- (c) imposes any surcharge on any such tax or duty for the purposes of the Union,

shall be introduced or moved in Parliament except on the recommendation of the President.

Subject to the above condition, however, it is competent for Parliament to increase the rate of any such tax or duty (by imposing a surcharge) for purposes of the Union [Art. 271].

**Financial control
by the Union in
Emergencies.**

As in the legislative and administrative spheres, so in financial matters, the normal relation between the Union and the States (under Arts. 268-279) is liable to be modified in different kinds of emergencies. Thus,

(a) While a Proclamation of Emergency [Art. 352(1)] is in operation, the President may by order direct that, for a period not extending beyond the expiration of the financial year in which the Proclamation ceases to operate, all or any of the provisions relating to the division of the taxes between the Union and the States and grants-in-aid shall be suspended [Art. 354]. In the result, if any such order is made by the President, the States will be left to their narrow resources from the revenues under the State List, without any augmentation by contributions from the Union.

(b) While a Proclamation of Financial Emergency [Art. 360(1)] is made by the President, it shall be competent for the Union to give directions to the States—

- (i) to observe such canons of financial propriety and other safeguards as may be specified in the directions;
- (ii) to reduce the salaries and allowances of all persons serving in connection with the affairs of the State, including High Court Judges;
- (iii) to reserve for the consideration of the President all money and financial Bills, after they are passed by the Legislature of the State [Art. 360]

The Union shall have unlimited power of borrowing, upon the security of the revenues of India either within India or outside. The Union Executive shall exercise the power subject only to such limits as may be fixed by Parliament from time to time [Art. 292].

The borrowing power of a State is, however, subject to a number of constitutional limitations:

(i) It cannot borrow outside India. Under the *Government of India Act, 1935*, the States had the power to borrow outside India with the consent of the Centre. But this power is totally denied to the States by the Constitution; the Union shall have the sole right to enter into the international money market in the matter of borrowing.

(ii) The State Executive shall have the power to borrow, within the territory of India upon the security of the revenues of the State; subject to the following conditions:

- (a) Limitations as may be imposed by the State Legislature.

(b) If the Union has guaranteed an outstanding loan of the State, no fresh loan can be raised by the State without consent of the Union Government.

(c) The Government of India may itself offer a loan to a State, under a law made by Parliament. So long as such a loan or any part thereof remains outstanding, no fresh loan can be raised by the State without the consent of the Government of India. The Government of India may impose terms in giving its consent as above [Art. 293].

Before closing this Chapter, it should be pointed out that there is a growing demand from some of the States for greater financial powers, by amending the Constitution, if necessary, which was stoutly resisted by Prime Minister Desai.⁸ There are two relevant considerations on this issue:

(i) The steps taken by Pakistan to make nuclear bombs together with the equivocal conduct of China leave no room for complacency in the matter of defence. Hence, the Union cannot yield to any weakening of its resources that would prejudice the defence potential of the country.⁹

(ii) On the other hand, the welfare activities of the States involving huge expenditure, natural calamities, etc., which could not be fully envisaged in 1950, call for a revision of the financial provisions of the Constitution.

The entire subject of 'Centre-State Relations' has been reviewed by the Sarkaria Commission. Its Report is under consideration by the Government.¹⁰

REFERENCES

1. *Coffee Board v. C.T.O.*, AIR 1971 S.C. 870.
2. The maximum limit of the professions tax has been raised from Rs. 250 to Rs. 2500, by the Constitution (60th Amendment) Act, 1988.
3. *State of J. & K. v. Caltex*, AIR 1966 S.C. 1350.
4. *In re Sea Customs Act*, AIR 1963 S.C. 1760 (1777).
5. Inserted by the Constitution (73rd Amendment) Act, 1992, w.e.f. 24-4-1993.
6. Inserted by the Constitution (74th Amendment) Act, 1992, w.e.f. 1-6-1993.
7. *Vide India*, 1990, p. 349.
8. Mrs. Gandhi's Second Government has also adhered to the recommendations of the Administrative Reforms Commission that no amendment of the Constitution is necessary to alter the relation between the Centre and the States, on the ground, *inter alia*, that the financial deficiencies of particular States are being periodically examined and provided for by the Finance Commission, by making larger grants to those States from the Union revenues, according to the provisions of the Constitution.
9. For India's Annual Budget and defence expenditure for 2008-2009, see Table I.
10. *Vide Author's Comparative Federalism* (Prentice-Hall of India, 1987).