



# Vidhi

Centre For Legal Policy

BETTER LAWS. BETTER GOVERNANCE

# RESEARCH REPORT ON QUERIES RAISED BY THE FOURTEENTH FINANCE COMMISSION

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## 2. ON CENTRAL CONTROL OVER SUB- NATIONAL DEBT IN INDIA

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## INTRODUCTION

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This Note enquires into the control exercised by the Central Government of India over the public debt of State Governments through the mechanism of Article 293 (3) of the Indian Constitution. Article 293 (3) requires State Governments that are indebted to the Central Government to seek the consent of the Central Government before raising further borrowings. In recent years, the outstanding liabilities of State Governments to the Centre have declined rapidly, and it is possible that over the horizon of the next few years, some State Governments *may* be able to repay all Central Government loans. Under Article 293 (3) consent would no longer be required by such States in order to raise fresh borrowings, raising concerns about the inability of the Central Government to control the combined fiscal deficits of the Centre and the States, with potential consequences for macroeconomic stability. In this context, two queries have been raised by the Fourteenth Finance Commission for our consideration:

1. Whether the FRBM legislations can be taken to be covered under the debt limit that the Parliament or the State Legislature is required to fix under Articles 292 and 293?
2. What are the options for the Central Government to regulate sub-national debt in case States are no longer indebted to the Union of India?

To answer these queries, in this note, we present several alternative recommendations to extend Central control over the aggregate level of State Government borrowings. Our recommendations fall into the following categories:

1. Amending Article 293 to ensure its applicability in a wider number of scenarios;
2. Ensuring that Article 293 (3) continues to apply to all borrowings by State Government even beyond the next few years; and
3. Developing statutory and non-statutory fiscal frameworks derived from Article 293.

It is to be noted that our research does not directly address the normative question as to whether Central control over sub-national debt in India is either necessary or desirable. It proceeds largely on the basis of the queries raised which assume this to be so.

Section 1 establishes the role played by Article 293 in ensuring the combined fiscal sustainability of the Central and State Governments. Section 2 provides information on the background of Article 293. Section 3 presents data on the historical and present composition of State Government liabilities. Section 4 presents recommendations for fiscal discipline going forward. Lastly, Section 5 summarises and concludes this note.

## 1. Fiscal sustainability and macroeconomic stability

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Fiscal discipline underpins macroeconomic stability in a country. Unsustainable fiscal deficits and high debt burdens can compromise both growth and stability, leading to high inflation, reduced expenditure on development, deteriorating government services, as well as macroeconomic distress.<sup>1</sup> In the context of a decentralised federal economy, ensuring the sustainability of fiscal policy is further complicated by the presence of State Governments that can also make spending and borrowing decisions.<sup>2</sup>

State Governments can pose a specific threat to fiscal sustainability and, therefore, macroeconomic stability, because their interests are not always aligned with those of the Central Government. In particular, State Governments may rationally prioritise their interests, and those of their constituents, over national interests. This may be exacerbated by the implicit understanding that the Central Government will bail out a State Government that is in distress: this commitment problem makes it even less likely that State Governments will pursue sustainable fiscal policies.

There are several sobering examples of the close relationship between sub-national debt crises and national debt crises. Brazil suffered several sub-national debt crises in the 1980s and 1990s, with multiple provinces requiring Central Government refinancing of their debt in 1989, 1993 and 1999. Argentina's default on its sovereign debt in 1991 has been associated with sub-national debt crises in two of its provinces. Mexico's 1995 Tequila currency crisis plunged several sub-national entities into distress. Following Russia's 1998 financial crisis, more than half of its provinces defaulted on debt.<sup>3</sup>

In such a context, mechanisms to ensure fiscal discipline across the entire country, including State Governments, are critical to ensure growth and stability. India has long relied on a rule embedded in the Constitution to control the spending and borrowing of State Governments. Article 293 (3) of the

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<sup>1</sup> There is a large literature on the macroeconomic effects of unsustainable fiscal policies. A very short and non-exhaustive list includes Sargent, Thomas J. & Neil Wallace, 1981. "Some unpleasant monetarist arithmetic," *Quarterly Review*, Federal Reserve Bank of Minneapolis, Federal Reserve Bank of Minneapolis, issue Fall; Elmendorf, Douglas W. & N. Gregory Mankiw, 1999. "Government Debt," *Handbook of Macroeconomics*, edition 1, volume 1, chapter 25, pages 1615-1669, Elsevier; Burnside, C., M. Eichenbaum, and S. Rebelo, 2001, "Prospective Deficits and the Asian Currency Crisis," *Journal of Political Economy*, Vol. 109 (6), pp. 1155-97; Gale, W. and P. Orszag, 2003, "The Economic Effects of Long-term Fiscal Discipline," Urban-Brookings Tax Policy Center Discussion Paper No. 8 (Washington: Brookings Institution); Hemming, R., M. Kell, and A. Schimmelpfennig, 2003, *Fiscal Vulnerability and Financial Crises in Emerging Market Economies*, *IMF Occasional Paper No. 218*, Washington: International Monetary Fund; Kumar, Manmohan S. & Jaejoon Woo, 2010. "Public Debt and Growth," *IMF Working Papers 10/174*, International Monetary Fund; Reinhart, Carmen M. & Kenneth S. Rogoff, 2010. "Growth in a Time of Debt," *American Economic Review*, American Economic Association, vol. 100(2), pages 573-78, May.

<sup>2</sup> See Rodden, Jonathan A. and S. Gunnar Eskeland, 2003. *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, vol. 1, 1 ed., The MIT Press, for a review of the literature on subnational borrowing.

<sup>3</sup> For a review of these cases and further references, see Liu, Lili, and Michael Waibel, 2008. "Subnational borrowing, insolvency, and regulation." in A. Shah, ed., *Macro Federalism and Local Finance*, chapter 6, pages 215-41, World Bank.

Constitution of India requires State Governments that are indebted to the Central Government to seek the consent of the Central Government before raising further borrowings from other sources. Since all the State Governments have been and continue to be indebted to the Central Government, the Central Government effectively controls the amount of public debt raised by State Governments. This constitutional mechanism has been used by the Central Government to ensure that State Governments do not exceed annual borrowing limits that are set at the beginning of every year. Presently, these limits are set by the Finance Commission in accordance with a formula that ensures that the fiscal deficit of no State exceeds 3% of Gross State Domestic Product ('GSDP').<sup>4</sup>

The indebtedness of the State Governments to the Central Government, however, is not a permanent condition; it seems increasingly likely that many State Governments may be in a position to eliminate all liabilities to the Central Government by, as early as 2020. In short, we need a new framework for fiscal sustainability. This note presents recommendations for extending Central Government's control over the total borrowings of State Governments in order to ensure federal control of the combined fiscal deficits of the Centre and the States.

## 2. Article 293: Present mechanism that ensures fiscal sustainability of State Governments

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Chapter II of Part XII of the Constitution of India deals with borrowing by the Central Government and State Governments. It comprises two provisions— Article 292 which covers borrowing by the Central Government and Article 293, which covers borrowing by State Governments. Since the focus of the present enquiry is State debt, it is only Article 293 that will be looked into in this section.

This section is divided into two sub-sections. Sub-section 1.1 is a historical recounting of the pre-constitutional position pertaining to State borrowing and Constituent Assembly Debates in this regard. Sub-section 1.2 analyses the scheme of Article 293 and argues why it requires amendment to address present day needs.

### 1.1. Borrowing by Provinces- The Pre-Constitutional Position

The provisions of Article 293 are substantially derived from Article 163 of the Government of India Act, 1935 ('GOI Act').<sup>5</sup> In essence Article 163 allowed the Government of the Provinces to borrow any money

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<sup>4</sup> For the most recent borrowing limits, see para 9.85 of the Report of the Thirteenth Finance Commission.

<sup>5</sup> Article 163 reads,

“(1) Subject to the provisions of this section, the executive authority of a Province extends to borrowing upon the security of the revenues of the Province within such limits, if any, as may from time to time be fixed by the Act of the Provincial Legislature and to the giving of guarantees within such limits, if any, as may be so fixed.

upon the security of the revenues of the province. This was subject to any law made by the Provincial Legislature. If the borrowing was a loan from the Federal Government, then the Federal Government could impose conditions as it deemed fit. If Provinces had taken such loans and were indebted to the Federal Government, then the taking of any subsequent loans by the province from the market would be subject to the Federal Government's consent. The same condition would apply if the Province was desirous of taking a foreign loan. Consent however, it was mandated, ought to be provided by the Federal Government in ordinary circumstances. Disputes over the legality of withholding consent, if any, would be resolved by a decision of an arbitrator appointed by the Chief Justice of India (earlier this was decided by the Governor-General).

The principle underlying Article 163 was that Provincial autonomy to borrow is secured constitutionally; however in cases where the Federal Government has a direct stake (when the Province is indebted to it, or it has given a guarantee on a market loan by a Province) and when the macroeconomic stability of the country is potentially threatened by a Province's recourse to external lenders (foreign loans), the Province would have to seek the consent of the Federal Government. Thus Article 163 sought to strike a balance between Provincial autonomy and Federal control, that its drafters believed would be appropriate to the time.

The Expert Committee on the Financial Provisions of the Union Constitution presided over by Nalini Ranjan Sarker, appointed by the Constituent Assembly, underlined the need for such balance. Provincial autonomy in raising loans from the market, the Committee felt was essential since it creates financial responsibility and is a dependable metric to assess the credit rating of a province. At the same time, co-ordination between borrowings by different provinces was felt to be equally essential not only to fix priorities between borrowings *inter se* but also to prevent unhealthy competition between Provinces and

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(2) The Federation may, subject to such conditions, if any, as it may think fit to impose, make loans to, or, so long as any limits fixed under the last preceding section are not exceeded, give guarantees in respect of loans raised by, any Province and any sums required for the purpose of making loans to a Province shall be charged on the revenues of the Federation.

(3) A Province may not without the consent of the Federation borrow outside India, nor without the like consent raise any loan if there is still outstanding any part of a loan made to the Province by the Federation or by the Governor-General in Council, or in respect of which a guarantee has been given by the Federation or by the Governor-General in Council.

A consent under this sub-section may be granted subject to such conditions, if any, as the Federation may think fit to impose.

(4) A consent required by the last preceding sub-section shall not be unreasonably withheld, nor shall the Federation refuse, if sufficient cause is shown, to make a loan to, or to give a guarantee in respect of a loan raised by, a Province, or seek to impose in respect of any of the matters aforesaid any condition which is unreasonable, and, if any dispute arises whether a refusal of consent, or a refusal to make a loan or to give a guarantee, or any condition insisted upon, is or is not justifiable, the matter shall be referred to the Governor-General and the decision of the Governor-General in his discretion shall be final.”

thereby preserve the capital market.<sup>6</sup> A tentative suggestion was thus made that such co-ordination be done by a Ministerial Conference or Loans Council, as was the arrangement in some other countries. This suggestion however was not accepted.

Article 163 of the GOI Act was adapted as Article 269 of the Draft Constitution. When Draft Article 269 was taken up for discussion in the Constituent Assembly<sup>7</sup> two key concerns were its focus— the extent of legislative control over borrowing by Centre and States<sup>8</sup> and the need to ascertain the purpose of a State loan.<sup>9</sup> Draft Article 268 (dealing with Central Government borrowings) and Draft Article 269 both made borrowing an executive act. However it allowed the Parliament and State Legislatures to impose limits on borrowing by the Central Government and State Governments respectively. Further for any loans from the Centre to the States, the Central Government would have to act subject to any law made by Parliament in this regard. Taking this further, HV Kamath recommended that the purpose for which the loan was being sought should be a key factor on the basis of which parliamentary control ought to be exercised.<sup>10</sup> Thus profligate borrowing by States for non-urgent purposes could be effectively checked by the Parliament.

Responding to both these concerns, Ambedkar felt that borrowing should remain an act of the executive. Further, Parliament and State Legislatures were given the power to exercise control over such borrowing. Such power could even extend to ‘an Annual Debt Act made by Parliament prescribing or limiting the power of the executive as to how much they can borrow within that year.’<sup>11</sup> These powers were significant and Ambedkar thus felt that it would be ‘very difficult to imagine any future Parliament which

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<sup>6</sup> Report of the Expert Committee on Financial Provisions, December 5, 1947 in *The Framing of India's Constitution: Select Documents Vol. 3* (B Shiva Rao ed., New Delhi: Universal Law Publishing, 2012) 260, 282-3.

<sup>7</sup> Underlining the importance of the provisions, a member M. Ananthasayanam Ayyangar said,

“Though the entire borrowing both of the Centre -as well as of, the provinces and loans may be granted by the Union Government to States are put compendiously in two articles 268 and 269, they are more important and- require greater scrutiny than the powers to impose taxation, with respect to which and for the -distribution of which-the revenues of both the Union and the States-we have devoted a long Chapter.”

Constituent Assembly Debates, 10<sup>th</sup> August 1949 available at <<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm>> accessed on 25 September, 2014.

<sup>8</sup> See speech by KT Shah, Constituent Assembly Debates, 10<sup>th</sup> August 1949 available at <<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm>> accessed on 25 September, 2014.

<sup>9</sup> See speech by HV Kamath, Constituent Assembly Debates, 10<sup>th</sup> August 1949 available at <<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm>> accessed on 25 September, 2014.

<sup>10</sup> *Ibid.*

<sup>11</sup> Per BR Ambedkar, Constituent Assembly Debates, 10<sup>th</sup> August 1949 available at <<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm>> accessed on 25 September, 2014.

will not pay sufficient or serious attention to this matter and enact a law.’<sup>12</sup> Thus, apart from formal changes in this article, making express reference to the Consolidated Fund of India, which was set up under the Constitution, and exclusion of foreign loans from the remit of the article, the basic structure of Article 163 of the GOI Act remained unchanged.

Draft Article 269 thus became Article 293 of the Constitution.

### 1.2. Scheme of Article 293

Article 293 is in four sub-clauses.<sup>13</sup> Sub-clause (1) states the general principle that the State Government is free to borrow money within the territory of India upon security of the Consolidated Fund of the States. Two safeguards are key— first, the limits on such borrowing may be fixed by the State Legislature from time to time and second, the freedom to borrow is subject to the rest of the article, i.e. the remaining sub-sections. Limits on State borrowings have been specified by fiscal responsibility legislations in States, a matter that we will turn to presently;<sup>14</sup> the restrictions in the article itself may be found in sub-clauses (2), (3) and (4) which is the focus of attention in this section.

Sub-clause (2) provides a restriction on the State Government’s freedom to borrow in a situation when the loan in question is made by the Central Government or guaranteed by it. In such a situation the Parliament may lay down conditions for such loan or prescribe limits only within which guarantees on loans can be given. This is conceptually sound since a lender has the right to specify the terms and conditions of lending. When such a loan has been taken and the State is still indebted to the Centre on

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<sup>12</sup> *Ibid.*

<sup>13</sup> Article 293 reads,

“Borrowing by States

(1) Subject to the provisions of this article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed

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

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

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

<sup>14</sup> *Infra.*



it or any other loan, or when the Central Government is a guarantor on a loan taken by a State, in such situations, sub-clause (3) provides that the State Government must seek the consent of the Central Government before raising any loan. Sub-clause (4) allows the Central Government to prescribe conditions it deems fit. It is instructive to note that unlike Section 163 of the GOI Act there is no default rule that such consent ought to be provided. This is also logical— the Central Government, not only by virtue of being a creditor, but also being responsible for macroeconomic stability in the country, should play a determinative part in State borrowings from the market.

Thus it is clear that the autonomy of State Governments to borrow is circumscribed primarily in case of loans given or guaranteed by the Central Government (sub-clause 2). If the latter has been taken and not repaid, only in such situations would other loans raised by the State from the market also require Central Government consent (sub-clauses 3 and 4). This scheme of division was appropriate at the time the provision was drafted. This is because Central loans to States were a key component of the State's finances at the time of the drafting of the Constitution. The taking of such loans would obviously have to depend on the Central Government and any law Parliament might make in this regard. Further, though the drafters envisaged State loans from the market, since State Governments were expected to be indebted to the Central Government, it would automatically trigger the application of sub-clauses (3) and (4).

Thus while States had the formal autonomy to borrow as they wished according to Article 293(1), the spirit of the section is to ordinarily subject State borrowing *de facto* to the formal control of the Central Government. In practice, this control is exercised by the Department of Expenditure in the Ministry of Finance which is the nodal department for granting consent under Article 293(3).<sup>15</sup> This provides an avenue for the Central Government to both have knowledge of, as well as control State borrowings, should the need arise.

This is the practical working of the balance between State financial autonomy and the need for Central co-ordination and oversight that was drawn by the drafters of the Constitution and followed thereafter. However the data encapsulated in the next section demonstrates that this balance may have to be redrawn.

### 3. Composition of State liabilities: decline in Central Government loans

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The composition of State Government liabilities has changed significantly in the last 25 years. The share of loans and advances from the Centre has declined from just over 57% of all State liabilities in 1991 to 6.6% in 2014 (based on budgetary estimates; see Table 1). There are several reasons for this

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<sup>15</sup> Source: <[http://www.finmin.nic.in/the\\_ministry/dept\\_expenditure/plan\\_finance/DEbt/permission-loans.asp](http://www.finmin.nic.in/the_ministry/dept_expenditure/plan_finance/DEbt/permission-loans.asp)> accessed on 26 September, 2014.

transformation. First, a change in the accounting procedure for small savings deposits in 1999 shifted a large share of State liabilities owed to the Central Government to a fund in the Public Account. Second, the Twelfth Finance Commission (FC-XII) has recommended that the Central Government stop intermediating in the raising of borrowings by States to finance their fiscal deficits.

### 3.1. National Small Savings Fund

Prior to 1999, small savings in the form of postal deposits, purchase of savings certificates and other social security schemes were deposited into the Public Account of the Central Government, while loans to State against these deposits were made out of the Consolidated Fund of India.

On the recommendations of the ‘Committee on Small Savings’ (chair: Mr RV Gupta), a separate fund called the National Small Savings Fund (‘NSSF’) was created within the Public Account into which all small savings were deposited and out of which loans to State Governments were made against these deposits.<sup>16</sup> As a result, the investments by the NSSF in State securities do not comprise loans from the Central Government, as presently specified in Article 293. Instead the Central Government determines the mandatory minimum share of NSSF deposits that must be shared with the States. In 2011-12, this mandatory share was reduced from 80% to 50%. Since this debt is relatively expensive, States have not borrowed beyond the mandatory minimum share from the NSSF.

**Table 1: Composition of outstanding liabilities of State Governments (in billions of Rupees)<sup>17</sup>**

| Year | Market loans, power bonds and other bonds | % of total | National Small Savings Fund | % of total | Loans from Banks and Fls incl WMA | % of total | Loans and Advances from Centre | % of total | Provident Fund, Reserve Fund, Contingency Fund, Net balances | % of total | Total Outstanding Liabilities |
|------|---|------------|-----------------------------|------------|-----------------------------------|------------|--------------------------------|------------|--|------------|-------------------------------|
|      | 1   |            | 2                           |            | 3                                 |            | 4                              |            | 5  |            | sum(1 to 5)                   |
| 1991 | 157.1                                     | 12.3%      | -                           | -          | 35.6                              | 2.8%       | 735.2                          | 57.4%      | 353.6  | 27.6%      | 1,281.5                       |
| 1995 | 312.8                                     | 14.4%      | -                           | -          | 46.1                              | 2.1%       | 1,152.4                        | 53.2%      | 653.5  | 30.2%      | 2,164.8                       |

<sup>16</sup> For a review of the creation of the NSSF, see Report of the Committee on Comprehensive Review of National Small Savings Fund (2011). Available at <[http://finmin.nic.in/reports/report\\_committee\\_comprehensive\\_review\\_nssf.pdf](http://finmin.nic.in/reports/report_committee_comprehensive_review_nssf.pdf)> accessed on 28 September, 2014.

<sup>17</sup> Source: *State Finances: A Study of Budgets of 2013-14*, RBI, Appendix Tables 11 and 12. Available at <<http://rbi.org.in/scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budget>> accessed on 25 September, 2014.

|        |          |       |         |       |       |      |         |       |         |       |          |
|--------|----------|-------|---------|-------|-------|------|---------|-------|---------|-------|----------|
| 2000   | 755.0    | 14.8% | 252.5   | 5.0%  | 244.4 | 4.8% | 2,303.3 | 45.2% | 1,540.1 | 30.2% | 5,095.3  |
| 2005   | 2,434.4  | 24.0% | 2,822.0 | 27.8% | 694.2 | 6.8% | 1,600.5 | 15.8% | 2,589.6 | 25.5% | 10,140.7 |
| 2010   | 5,346.5  | 32.4% | 4,550.2 | 27.6% | 839.6 | 5.1% | 1,431.5 | 8.7%  | 4,318.7 | 26.2% | 16,486.5 |
| 2011   | 6,185.9  | 33.8% | 4,946.4 | 27.0% | 831.3 | 4.5% | 1,441.7 | 7.9%  | 4,884.4 | 26.7% | 18,289.8 |
| 2012   | 7,527.7  | 37.8% | 4,864.2 | 24.4% | 836.9 | 4.2% | 1,435.5 | 7.2%  | 5,275.1 | 26.5% | 19,939.2 |
| 2013RE | 8,833.5  | 40.6% | 4,867.5 | 22.4% | 855.5 | 3.9% | 1,504.1 | 6.9%  | 5,691.9 | 26.2% | 21,752.5 |
| 2014BE | 10,966.6 | 45.1% | 4,801.5 | 19.7% | 900.9 | 3.7% | 1,603.4 | 6.6%  | 6,060.3 | 24.9% | 24,332.8 |

Notes: RE - revised estimates. BE - Budgetary estimates.

### 3.2. Recommendations by FC-XII

A more fundamental reason for the decline in Central loans to States is the recommendation by FC-XII in 2004-05 for the disintermediation of the Central Government from the raising of public debt by State Governments. This recommendation led to the elimination of the loan portion of Central plan transfers to States, as the Central Government since 2007-08 only makes grants to States under plan transfers. The remainder of the plan funds must be raised by States themselves through, for example, market borrowings. The FC-XII further recommended that the size of the plan projects and the plan grants must take into account the debt capacity of every State: to this extent, there is some indirect control imposed on the debt borrowing of States through the allocation of grants for projects (4.68, FC-XII Report). However, the share of Central Government liabilities for State Governments has declined since 2007-08.

The rationale for this recommendation by the FC-XII was that States would now rely on market borrowings to finance their expenditure and would, accordingly, be subject to the disciplinary action of markets. States that borrowed unsustainably would face higher interest rates while fiscally prudent States would be able to borrow at rates well below those offered on Central Government loans. Moreover, most developed federal economies primarily rely on market discipline to ensure fiscal sustainability at the sub-national level.

In India, however, there is the concern that market discipline in the present scenario may be ineffective in ensuring fiscal sustainability. State Government securities - States development loans (SDLs) - are presently held, in the main, by commercial banks and other financial institutions as a part of their statutory liquidity requirements ('SLR'). While market discipline is undoubtedly a sustainable and sensible mechanism for managing fiscal prudence, it may be something of a long-term solution in the Indian context. In the interim, effective mechanisms will need to be in place to ensure that States do not imprudently borrow and endanger the economy's macroeconomic stability.

## 4. Recommendations: Mechanisms to ensure management of State borrowings

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### 4.1. Amending Article 293 to allow Central control over sub-national debt

From the description and analysis in the Sections above it is clear that the constitutional balance between financial autonomy of States and Central control over States borrowings needs to reflect a changed reality. To this end, two solutions are proposed:

#### 4.1.1. Amend 293(2)

1. Amend Article 293 (2) to insert the words ‘regulate taking of any loans by any State, or’ after ‘make loans to any State or,’

The amended Article 293 (2) would thus read:

‘(2) The Central Government may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, **regulate taking of any loans by any State or**, so long as any limits fixed under article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.’

As discussed in Section 2 of this Note, the scheme of the article is to list the chief sources of loans that the State Government can avail of subject to any conditions in Article 293 (2). This refers to loans from the Centre to the States as well as loans guaranteed by the Centre at the time of drafting of the Constitution. Since these loans were significant at the time, meaning that States were indebted to the Centre, a third category, i.e. loans from the market, would also require consent of the Central Government. This served two purposes— first, allowing the Central Government as a creditor to consent to any subsequent loans by States; second, arming the Central Government, as the authority ultimately accountable for macroeconomic stability in the country to keep track of and check the taking of all sub-national debt.

Given the reduction in loans from the Centre to the States, the former function may have limited relevance for most States. However the latter function continues to remain significant. It is thus necessary that Central Government power to check sub-national debt is secured. This can be done by enlarging the scope of Article 293 (2). Thus apart from the situation when States are indebted to the Centre or loans are guaranteed by the Centre (covered under Article 293 (3)), the taking of any loan by the State may be made subject to regulation by the Central Government as may be prescribed by a parliamentary law. The effect of this amendment is thus to ensure that there is the possibility of Central Government control over sub-national debt, irrespective of the source of such State borrowing.

Constitutionally, this proposal has two clear merits. Besides ensuring that the Central Government both knows of and needs to consent to sub-national debt by States, irrespective of its indebtedness it achieves this in a manner that is flexible and consonant with the original scheme of the article. The flexibility is a product of the fact that Parliament is now vested with the power to make an appropriate law regulating the consent-granting function of the Central Government over State borrowing. Thus, if borrowing limits are breached with potential to affect macro-economic stability then the law may provide that consent may not be given. Any exceptions to this or alternative methods of regulation can also be built into the law. In this way it factors in the key concerns that were the subject of intense scrutiny by the Constituent Assembly.<sup>18</sup> Thus it provides an institutional, long-term yet flexible solution to the envisaged problem of uncontrolled sub-national debt.

Secondly, the proposal provides a new modern manifestation of the balance between States' autonomy and Central control over sub-national debt. The drafters of the Constitution drafted Article 293 in a manner that reflected their perception of the balance at the time. *De facto* control of State debt by the Centre was provided for with State loans taken from the Centre being the trigger for such control. Now that such loans have reduced, it is essential not to throw the baby out with the bathwater. A notional control of State loans by the Centre must remain. Making this amendment will ensure such control remains, while allowing the Parliament to strengthen or mitigate the rigour of the provision. This not only strikes an alternative balance between State fiscal autonomy and Central control but also allows Parliament to alter the balance in the interest of macroeconomic stability in India.

It must be noted though that this amendment is not entirely without demerits. Requiring all State borrowing to be subject to Central Government regulation, whether or not States are indebted to the Centre, would come into conflict with recent efforts to increase the operational independence of States in the area of public debt. Several recent policy measures have strengthened the ability of the States to raise borrowing on their own. For example, as of 2006-07, all open-market borrowings in the form of the sale of State Development Loans - State Government securities - have taken place through a transparent auction-based system managed by the RBI, in order to enable price discovery.<sup>19</sup> The recommendations of the FC-XII (discussed in Section 3.2) were also intended to minimise the role of the Central Government in raising State borrowings. Amending Article 293 (2) may reverse some of these recent attempts. However on an overall assessment, the benefits of such amendment might be felt to outweigh the costs.

#### 4.1.2. Amend 293(3)

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<sup>18</sup> It is to be noted that the Assembly did not reject these views but merely recommended that Parliament pass a law in this regard.

<sup>19</sup> See Section VII of Gopinath, S, "Sub-national Fiscal Reforms and Debt Management - Indian Experience", Paper presented at the workshop on 'Sub-national Fiscal Reform and Debt Management', April 29, 2009, Washington, organised by the Economic Policy and Debt Department, World Bank.

2. Insert an Explanation after sub-section (3):

‘In this clause of this article “any part of a loan which has been made to the State by the Government of India or by its predecessor government” includes loans made from the public account of India as defined in Article 266(2).’

As demonstrated above, loans from the Central Government to State Governments have diminished considerably over time,<sup>20</sup> especially after FC-XII recommendation to this effect.<sup>21</sup> However, it is not as if loans to State Governments from all sources have declined concomitantly. As discussed in Section 3, one important reason for the decline in Central Government loans to States has been the setting up of the National Small Savings Fund (NSSF) in the Public Account of India.

The public account of India is constitutionally enshrined in Article 266(2). Any public money received by the Central Government that is not part of the Consolidated Fund of India shall be part of the public account of India. Explaining the distinction, the Delhi High Court in *Shri Vashist Bhargava v. ITO, Salary Circle*<sup>22</sup> held that moneys in the public account of India do not belong to the Central Government unlike money in the Consolidated Fund of India. The operation of both, however can be regulated by law.

The exclusion of transfers from the public account of India from the scope of Article 293 (3) is without clear justification and limits the efficacy of the aggregate borrowing limits recommended by the Finance Commission for the States and implemented by the Central Government. This is especially so since in the overall determination of state borrowings under Article 293 (3) state borrowing from NSSF funds are included. Currently, there are separate borrowing restrictions on different categories of liabilities - a limit on market borrowings by States (subject to the terms of Article 293), as well as a mandatory minimum share in NSSF funds.

Combining different sources of borrowings together and setting an overall borrowing limit will streamline the fiscal disciplining mechanism and allow States more flexibility to raise debt on the best possible terms. At the same time, the extension of the scope of Article 293 (3) will allow the Central Government to monitor overall fiscal sustainability and set appropriate limits on public borrowings by States.

The recommended Explanation conforms to this understanding of the public account. By deeming loans from this account to constitute the sum total of loans made to the State by the Central Government, it merely deems such loans, for the purpose of Article 293(3) to constitute loans from the Central

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<sup>20</sup> *Supra* note 16.

<sup>21</sup> See Recommendations of the Twelfth Finance Commission, available at <<http://www.indiabudget.nic.in/es2004-05/chapt2005/chap25.pdf>> accessed on 26 September, 2014.

<sup>22</sup> ILR (1975) 1 Del 634.

Government. Such deeming provisions for a limited purpose are a well-known feature of law. In *J&K Cotton Spinning and Weaving Mills Limited v. Union of India*,<sup>23</sup> the Supreme Court held,

“The Legislature is quite competent to enact a deeming provision for the purpose of assuming the existence of a fact which does not really exist.”<sup>24</sup>

Creating a legal fiction for a specific purpose is thus the rationale for a deeming provision. Explaining the linkage between a deeming provision and its purpose, the Supreme Court in *State of Uttar Pradesh v. Hari Ram*<sup>25</sup> held,

“In interpreting the provision creating a legal fiction, the Court is to ascertain for what purpose the fiction is created and after ascertaining this, the Court is to assume all those facts and consequences which are incidental or inevitable corollaries to the giving effect to the fiction.”<sup>26</sup>

It is clear that it is within the competence of Parliament to legislate a deeming provision for a specific purpose. Further, such deeming provisions exist in the Constitution. Article 169 (3) provides that when Parliament by law abolishes the Legislative Council of a State, the constitutional amendments that are necessary to give effect to such a law would not be deemed to be amendments to the Constitution.<sup>27</sup> Though such amendments would *in fact* be amendments to the Constitution, as commonly understood, *in law*, they would not be considered so, since that would entail an onerous procedure for amendment that the drafters felt unnecessary in this case.

At the same time, explanations of particular terms in articles are a commonly used drafting device in the Constitution. Explanations occur 34 times in the Constitution (excluding Schedules). While several Explanations are clarificatory, some define terms in a manner that entails specific inclusions or

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<sup>23</sup> (1987) Supp SCC 350.

<sup>24</sup> *Ibid*, para 40.

<sup>25</sup> (2013) 4 SCC 280.

<sup>26</sup> *Ibid*, para 17.

<sup>27</sup> Article 169 reads:

“(1) Notwithstanding anything in article 168, Parliament may by law provide for the abolition of the Legislative Council of a State having such a Council or for the creation of such a Council in a State having no such Council, if the Legislative Assembly of the State passes a resolution to that effect by a majority of the total membership of the Assembly and by a majority of not less than two-thirds of the members of the Assembly present and voting.

(2) Any law referred to in clause (1) shall contain such provisions for the amendment of this Constitution as may be necessary to give effect to the provisions of the law and may also contain such supplemental, incidental and consequential provisions as Parliament may deem necessary.

(3) No such law as aforesaid shall be deemed to be an amendment of this Constitution for the purposes of article 368.”

exclusions. For example, Article 220 which provides restriction on practicing after holding a position as permanent judge of a High Court has an Explanation to specifically exclude High Courts in erstwhile Part B States from the ambit of this provision. This meant that this restriction did not apply to those holding office as judges in the High Courts in those States, which included Mysore, PEPSU and Madhya Bharat High Courts. In other words, these High Courts, while considered as such for ordinary purposes, would be deemed not to be High Courts for this article.

Thus it is a constitutionally accepted practice to incorporate explanations to particular articles. In these explanations, Parliament is legislatively competent to enact a deeming provision that defines a term in a certain way, including or excluding specific interpretations. It is in this vein that “any part of a loan which has been made to the State by the Government of India or by its predecessor government” is sought to be explained by including within its remit loans from the Public Account of India.

In conclusion, the extension of the scope of Article 293 (3) to cover transfers from the public account of India to State Governments is consistent with economic and legal principles. This will extend the ability of the Central Government to regulate sub-national debt while eliminating the arbitrary exclusion of certain types of borrowings from the overall fiscally prudent borrowing limit. At the same time it is important to note that both proposed constitutional amendments, according to Article 368 of the Constitution of India require passage by the requisite majority in Parliament alone, without having to seek ratification from any State Legislatures. Thus the proposal is not only sound in principle but capable of being implemented in practice.

#### 4.2. Ensuring Article 293 (3) continues to apply to States

Another approach to extend Central Government control over State borrowings is to ensure that States remain indebted to the Centre for as long as possible; this would effectively ensure that State Government will have to approach the Centre for consent to issue debt. The main components of Central Government loans to States are the following:

1. Loans for State plan schemes, Central plan schemes, and centrally sponsored schemes, miscellaneous loans by Central ministries, including the Ministry of Finance
2. Ways and means advances from the Central Government
3. Additional Central Assistance for Externally-Aided projects

The following sections discuss opportunities to extend Central Government loans to the State Governments under each of these categories. In general, the scope for extending Central loans is limited, however, and such a solution can only be a temporary one, at best.

##### **4.2.1. Loans for State plan schemes, Central plan schemes, and others**



Following the recommendations of the FC-XII, discussed in Section 3.2, the Central Government no longer intermediates in State borrowings, with the exception of on-lending of loans procured for externally aided projects. As per the recommendations of the FC-XII, existing Central Government loans to the States were consolidated into fresh 20-year loans, and, since 2007-08, central transfers to States have been almost entirely in the form of grants. Even those schemes that have been partially funded by loans are now being replaced by grant-only transfers. For example, police modernisation funds have included a small loan component but transfers going forward are likely to take place through grants only. Similarly, Central Government contributions to the National Disaster Response Fund ('NDRF') and the State Disaster Response Funds ('SDRFs') are presently made on a grant basis only.

Since no new loans are being issued from the Central Government to the States, one approach would be to restructure existing debt to extend the maturity for a number of years. Restructuring loans would require consolidating existing loans from the States to the Centre to longer-term loans. Following the debt consolidation recommended by the FC-XII, most loans owed to the Centre were reset for 20 years. Many are expected to terminate by 2020. These loans could be restructured to a longer time frame with corresponding interest rate relief on the earlier repayments. However, this creates several problems: an extended debt overhang, which creates pressure for State Governments struggling to reduce their debt as a proportion of GSDP. Restructuring these loans will also entail costs for the Central Government. Finally, it is possible that States will choose not to restructure loans further, particularly those States with healthy finances. A restructuring of debt must be acceptable to the debtor before it can be achieved.

Another temporary solution could be the extension of a specific loan facility to certain States. For example, the Centre makes loans to States to fund post-disaster reconstruction, as this is not covered by the NDRF and the SDRFs. Most of these transfers are on-lending of loans from external funding sources. However, were the Central Government to set aside funds for this purpose, these loans would ensure indebtedness of the States to the Centre, invoking Article 293 and ensuring control over State borrowings. However, this solution will be temporary and will only apply to those States that require access to post-disaster reconstruction funding.

Finally, it may be possible for the Finance Commission to recommend non-interest bearing loans, in addition to grants, that it makes as part of its standard allocations. By recommending loans, as opposed to grants, the Finance Commission will leave the current year Central fiscal deficit unchanged while at the same time generating a debt overhang that will postpone the problem of States no longer being indebted to the State.

In conclusion, following the recommendations of the FC-XII, the intermediation of the Centre in the public borrowing of the States has been largely eliminated. As a temporary measure, certain specific and narrow categories of loans, and even non-interest bearing loans could be reintroduced and extended to

the States in order to ensure that Article 293 continues to apply over the short term. However, we do not recommend reversing the recommendations of the FC-XII solely for the purpose of retaining Central control over State borrowings as a long-term solution to managing fiscal sustainability.

#### 4.2.2. Ways and means advances

The ways and means advances ('WMA') are a facility offered by the Reserve Bank of India ('RBI') to the States to manage short-term liability mismatches. The terms of each State's agreement with the RBI is determined on the basis of bilaterally signed Memorandum of Understanding. Beyond the facility offered by the RBI, the Central Government also extends a WMA facility of up to Rs. 1000 crore in its annual budget (Demand 36). These advances are made automatically to States with a standing order from the Ministry of Finance to approve the loans under Article 293 (3). If some States approach a position of zero indebtedness to the Centre, transfers under the WMA facility must also be reconsidered. In particular, we recommend that the Centre consider denying States access to the WMA facility operated with Central funds if they do not conform to annual borrowing limits as determined at present. This acts both as a disincentive for States to breach their borrowing limits without prior permission from the Centre, as well as ensure that States which breach Article 293 (3) do not subsequently become indebted to the Centre through short-term advances.

Access to the WMA offered by the Central Government has previously been linked to fiscal prudence on the part of the States. In 1999-2000, eleven States signed Memorandums of Understanding ('MoUs') with the Central Government in which they committed to introducing fiscal reforms in exchange for WMA transfers on the tax and grant transfers due to them.<sup>28</sup> However, the use of this facility is quite limited compared to the RBI window. Since the RBI uses funds at its own disposal to make short-term loans to States under the WMA facility, these transfers do not fall within the scope of Article 293. However, the extension of any credit facility to any State should rely on the credit-worthiness of that State. In the past, the RBI has shut the WMA window for States which have breached the terms on which they borrow from the RBI (see, for example, RBI Annual Report 2001, which documents the suspension of WMA to three States) and this process of disciplining is an important part of maintaining sub-national debt sustainability.

In conclusion, we recommend that States that breach their annual borrowing limits be denied the use of WMA funds from the Central Government, which may act as a disincentive for them to over-borrow. However, the use of this facility is not substantial: most States primarily rely on the RBI for WMA funds. Linking State access to RBI WMA with debt sustainability will be an effective supplementary mechanism for enforcing fiscal prudence.

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<sup>28</sup> Srinivasan, T.N., 2002. "India's Fiscal Situation: Is A Crisis Ahead?" in A. Krueger, ed, *Economic Policy Reforms and the Indian Economy*. Chicago: University of Chicago Press.

#### 4.2.3. Additional Central Assistance for Externally Aided Projects ('ACA for EAP')

An important component of Central loans to States is through on-lending of funds sourced from international institutions, multilateral agencies and other foreign financiers. Most of these loans are to fund investment in infrastructure. Since States are denied direct access to foreign funding owing to 'foreign loans' being a matter within the sole legislative competence of the Central Government,<sup>29</sup> and consequently a matter to which executive power of the Union extends, the Central Government must take on the loan on behalf of the States and on-lend the funds to the States. Following the recommendations of the FC-XII, as of April 1, 2005, this money is loaned to the non-special category States on the same marginal terms at which the Centre receives the funding. As such, the Central Government is within its constitutional right to deny States that do not remain within their prescribed borrowing limits access to funding from external sources.

Andhra Pradesh, Bihar, Karnataka, Madhya Pradesh, and Tamil Nadu account for over 60% of all ACA for EAP. However, many other States also have outstanding liabilities to the Central Government in this category. Many of these loans tend to be of longer maturities, which ensures that Article 293 (3) will remain applicable to all attempts by such State Governments to raise funds from the market.

In conclusion, while we do not make any explicit recommendation in this regard, it is clear that Article 293 (3) will continue to apply for as long as States seek access to external funding, particularly to finance infrastructure projects. If State Governments wish to raise funds from international institutions, they will have to abide by the borrowing limits set for them at the Centre, and this will be an important incentive for them to comply with fiscal rules.

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<sup>29</sup> Entry 37, List I, 7<sup>th</sup> Schedule to the Constitution.

**Table 2 State-wise maturity profile of outstanding government assistance for States for Externally Aided Projects<sup>30</sup>**

| States             | Per cent of Total Amount Outstanding |              |               |             |                |
|--------------------|--------------------------------------|--------------|---------------|-------------|----------------|
|                    | 0-1 Year                             | 1 to 5 Years | 5 to 10 years | 10-20 Years | Above 20 years |
| 1. Andhra Pradesh  | 1.4                                  | 9.2          | 19.3          | 40.6        | 29.4           |
| 2. Bihar           | 0.5                                  | 5.4          | 18.0          | 52.5        | 23.6           |
| 3. Chhattisgarh    | 3.7                                  | 24.1         | 30.1          | 42.1        | 0.0            |
| 4. Gujarat         | 0.1                                  | 6.1          | 19.4          | 38.9        | 35.5           |
| 5. Goa             | 0.0                                  | 4.9          | 22.8          | 45.7        | 26.6           |
| 6. Haryana         | 0.0                                  | 14.0         | 20.0          | 40.0        | 26.0           |
| 7. Jharkhand       | 0.0                                  | 6.7          | 14.7          | 62.7        | 15.9           |
| 8. Karnataka       | 0.9                                  | 9.5          | 21.7          | 43.4        | 24.4           |
| 9. Kerala          | 1.0                                  | 6.4          | 23.3          | 47.5        | 21.8           |
| 10. Maharashtra    | 5.4                                  | 28.4         | 38.1          | 17.1        | 11.1           |
| 11. Madhya Pradesh | 1.9                                  | 12.5         | 22.5          | 49.5        | 13.6           |
| 12. Odisha         | 0.8                                  | 10.2         | 21.7          | 38.4        | 28.9           |
| 13. Punjab         | 2.3                                  | 12.9         | 25.0          | 37.5        | 22.3           |
| 14. Rajasthan      | 0.4                                  | 3.1          | 11.6          | 47.6        | 37.3           |
| 15. Tamil Nadu     | 1.4                                  | 7.5          | 21.4          | 41.6        | 28.1           |
| 16. Uttar Pradesh  | 0.0                                  | 3.5          | 17.1          | 42.7        | 36.7           |
| 17. West Bengal    | 0.4                                  | 8.7          | 22.9          | 45.2        | 22.8           |
| 18. Multi-States   | 0.6                                  | 10.1         | 20.1          | 40.5        | 28.7           |
| <b>Total</b>       | <b>1.2</b>                           | <b>9.2</b>   | <b>21.1</b>   | <b>43.2</b> | <b>25.3</b>    |

#### 4.3. Developing a Framework derived from Article 293

##### 4.3.1. Managing debt through Fiscal Responsibility Legislation

The Central Government and all State Governments are bound by their Fiscal Responsibility and Budget Management legislations (hereinafter 'FRBM legislations' / 'FRBM Acts'). Though specific legislations may have different titles, the rationale for all these laws is to ensure fiscal stability and prudence by reducing fiscal deficit, eliminating revenue deficit and establishing transparent processes regarding matters pertaining to public finance. Several such legislations were enacted in States pursuant to the recommendation of FC- XII, which mandated the enactment of fiscal responsibility legislation as a precondition for availing the debt relief scheme offered to States. FC-XIII too recommended certain amendments to be made to these legislations as preconditions for certain fiscal transfers.

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<sup>30</sup> Source: *State Finances: A Study of Budgets of 2013-14*, RBI, Table V.8. Available at <<http://rbi.org.in/scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budget>> accessed on 25 September, 2014.

Each of these legislations in States contains the maximum acceptable fiscal deficit as a percentage of GDP, which, in turn, yields the annual borrowing limit of each State Government.<sup>31</sup> Presently, the borrowing limits are set by the Finance Commission and enforced through the requirement of the consent for any borrowings by State Governments of the Central Government under Article 293(3).<sup>32</sup> The key question is to assess the methods of enforcement of Fiscal Responsibility Legislation in the event that Article 293 (3) consent is no longer required by State Governments in order to raise market borrowings, and if found deficient, suggest reforms in order to ensure that sub-national debt does not breach the limits established by law. To this end, this section is divided into two sub-sections: sub-section 1 explores whether FRBM legislations constitute legislations prescribing limits on borrowing for the purpose of Article 293 (1). If so, it looks into the consequences of this interpretation. Sub-section 2 consequently looks at strengthening enforcement mechanisms under these legislations. Thus holistically, this section looks to address regulation of sub-national debt without amending Article 293 of the Constitution.

#### 4.3.2. The Legal Basis for FRBM Legislations

As discussed in Section 2 above, Article 293 (1) allows the executive of a State to borrow upon the security of the Consolidated Fund of the State, within India, subject to any law the legislature may make fixing limits on such borrowing. The FRBM legislations, as per FC-XII recommendations, all contain a provision that sets targets for fiscal deficit reduction. These targets may be revised from time to time by the State Government. Thus given that such laws lay down limits on borrowing and are passed by the State Government, they quite self-evidently qualify as law for the purpose of Article 293 (1).

This implies that the breach of such limits will not only be illegal, since it would be contrary to the relevant statutory provision, but it would also be unconstitutional. This is because of the fact that Article 293 (1) itself prescribes that the executive power of every State to borrow shall be restricted to the limit prescribed by the State Legislature by law. If such limits laid down in FRBM legislations are not followed, the failure of the States to do so would be unconstitutional.

A consequence of such interpretation is the possibility of legal challenge if a State flouts its borrowing limits. In *Matthew v. Union of India*,<sup>33</sup> a case before the enactment of fiscal responsibility legislations, it was contended by way of a public interest litigation that the borrowing of money by the Kerala Government at a time when the State was already facing heavy deficits was contrary to Article 14 as well as Article 293 of the Constitution. *Locus standi* was sought as a taxpayer; a violation of Article 14 was claimed because borrowing by the Government was considered to be profligate and thereby arbitrary; a

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<sup>31</sup> At the Centre, the maximum acceptable fiscal deficit and consequently borrowing limit are to be prescribed by rules under the Act. This is not relevant for our purposes.

<sup>32</sup> For the most recent borrowing limits, see para 9.85 of the Report of the Thirteenth Finance Commission.

<sup>33</sup> *Mathew v. Union of India (UOI)*, ILR 2003 (1) Kerala 559.

violation of Article 293 was contended based on the view that the State was borrowing money in excess of what was to its credit in its Consolidated Fund. Though the petition was admitted, the petitioner being a taxpayer whose interest was affected by State borrowing, it was dismissed on merits. The dismissal was based on one factual and one legal ground. Factually, no arbitrariness in the State's actions was made out; legally it was held that Article 293 did not prescribe any borrowing limit on the State.

It must be noted that this case was adjudicated before the enactment of the Kerala Fiscal Responsibility Act, 2003. However, given that FRBM legislation now, not only in Kerala, but also in other States, unlike Article 293 itself, does prescribe borrowing limits, it might be possible to file a public interest litigation challenging the breaching of such limits as unconstitutional. How courts will rule on these matters is debatable given the contrarian pulls of the matter being a question of economic policy, which courts have seldom intervened in, with the overarching need for courts to uphold the rule of law. Irrespective of which way the Court goes, it is necessary to assess and if necessary reform the enforcement mechanisms of this Act. This provides the surest protection that courts will refuse to entertain such petitions since alternative remedies are prescribed by the Acts.<sup>34</sup>

#### 4.3.3. Scheme of Enforcement

Under the scheme of the Acts, enforcement of its provisions is sought through a variety of methods. While there are 13 types of enforcement measures that can be culled out of the State FRBM legislations, they can be classified into 4 broad categories. A table with a detailed breakdown of the type of enforcement mechanism and whether a particular State FRBM legislation contains it or not may be found in the Appendix at the end of this note. A brief survey of such methods may be appropriate here before looking at mechanisms to strengthen them.

The four categories of enforcement measures are:

- I. Measure(s) to be undertaken by the Minister of Finance;
- II. Measures to be mandatorily undertaken by the State Government;
- III. Measures which the State Government may undertake; and
- IV. Prohibitions on the State Government.

#### I. MEASURE(S) TO BE UNDERTAKEN BY THE MINISTER OF FINANCE

##### 1. Review Report by the Minister of Finance

Review of the trends in receipts and expenditures in relation to budget estimates is a measure that is followed by nearly all states. The frequency of the review may vary among quarterly, half-yearly or

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<sup>34</sup> It is a standard principle governing admissibility of writ petitions that alternate remedies be exhausted before a writ court is approached. See *Thansingh Nathmal v. Superintendent of Taxes*, (1964) 6 SCR 654.

yearly. The outcome of this review is a 'Review Report' is to be placed before the House(s) of the concerned State Legislature.

## **2. Statement of the Finance Minister explaining deviations**

State Governments cannot deviate from the obligations cast on them under their respective FRBM Acts. However, due to any unforeseen circumstances, if any deviations are made, the Finance Minister shall make a statement in the House(s) of the Legislature explaining

- (i) the said deviation;
- (ii) whether such deviation is substantial and relates to the actual or the potential budgetary outcomes; and
- (iii) the remedial measures that the State Government proposes to take.

While there is no requirement for the Finance Minister to submit a Review Report in a few states (see Appendix), the Finance Minister's obligation to make a statement explaining deviations is a measure undertaken by most States in India.

## **II. MEASURES TO BE MANDATORILY UNDERTAKEN BY THE STATE GOVERNMENT**

### **1. Measures for increasing revenue and/or reducing expenditure**

In the event of either shortfall in revenue or excess of expenditure over the intra-year targets mentioned in the Fiscal Policy Strategy Statement mandated under the FRBM Acts or the rules made under the Acts, the State Government is mandated to take appropriate measures for increasing revenue and/or for reducing the expenditure. One of these measures, as mentioned in the FRBM Acts, is the curtailment of the sums authorised to be paid and applied from out of the Consolidated Fund of the State. The FRBM Acts of Odisha, Uttar Pradesh and Uttarakhand mention that the concerned State Governments may take interim measures for revenue augmentation, or curtail the sums authorised to be paid out of the Consolidated Fund of the State, or take up a combination of both these measures.

It is instructive to note that the States of Karnataka, Uttar Pradesh and Uttarakhand have inserted a proviso to this particular provision which says that while adhering to the fiscal targets, the State Government will give priority to protecting certain expenditure declared in the Medium Term Fiscal Plan as "high priority development expenditure" (including, *inter alia*, elementary education, basic health and rural water supply) from curtailment or may impose a reduced or partial curtailment. Also, the Meghalaya FRBM Act, 2005 only mentions "appropriate measures" measures to be taken by the State Government in case of shortfall or excess, but nothing about curtailment of sums from the Consolidated Fund of the State.

### **2. Statement of remedial measures in case of possible measures which may lead to revenue deficit**

In case any measure is proposed by the State Government in the course of the financial year, which may lead to an increase in revenue deficit, either through increased expenditure or loss of revenue, it shall be accompanied by a statement of proposed remedial measures. These remedial measures should strive to neutralise such increase or loss and such statement shall be placed before the House(s) of Legislature.

### **3. Consistency with the objectives of the Five Year Fiscal Plan**

Another measure which is imposed by several States is that principally, the Annual Budget and the policies announced at the time of presentation of the budget shall be consistent with the objectives and target set in the Five Year Fiscal Plan, the Medium-term Fiscal Policy Plan and the Fiscal Management Targets of the State Government.

### **4. Proposals for Supplementary or Additional Demands and Statements for curtailment of expenditure**

Several States have measures relating to supplementary or additional statements of expenditure. The provision relating to this measure mandates that not more than one supplementary statement of expenditure shall be presented in a financial year. Whenever such supplementary estimates are presented in Assembly the State Government shall also present an accompanying statement indicating the corresponding curtailment of expenditure to fully offset the fiscal impact of the supplementary estimates in relation to the budget targets of the current year and the Medium Term Fiscal Plan objectives.

### **5. Increase in revenue deficit and fiscal deficit in case of unforeseen demands**

In case the revenue deficit and fiscal deficit increase in the case of unforeseen demands on the finances of the Government, the Government shall identify the net fiscal cost arising due to natural calamity and such cost would provide ceiling for extent of non-compliance to the specified limits.

### **6. Triggers and Corrective Actions**

The measure relating to triggers is also prevalent in only a few States. It says that triggers as well as corrective actions that shall be initiated upon activation of triggers shall also be the integral part of the budget.

### **7. Guidelines to be issued by the State Government for timely spending of budget**

This is a measure followed by only one State, Odisha, under the Odisha FRBM Act, 2005. This enforcement measure mandates that State Government of Odisha shall issue appropriate guidelines from time to time, for timely spending of budgetary grants.

## **III. MEASURES WHICH THE STATE GOVERNMENT MAY UNDERTAKE**

### **1. Establishment of an independent agency**



This is a provision that finds mention in various State FRBM Acts. It says that the State Government may set up an agency independent of the State Government to review periodically the compliance of the provisions of this Act and table such reviews in the House(s) of the State Legislature.

Though 15 States have such a provision in their Acts, only the States of Odisha, Goa and Haryana have taken measures to implement this provision and got each of their independent reviews conducted through the assistance of the National Institute of Public Finance and Policy ('NIPFP').<sup>35</sup> The States of Karnataka, Himachal Pradesh and Madhya Pradesh appear to have considered implementing the above-mentioned provision, however there is no evidence to indicate that each of their independent reviews have in fact been conducted by any entity.<sup>36</sup>

#### **IV. PROHIBITIONS ON THE STATE GOVERNMENT**

##### **1. No guarantees to be given after a certain limit**

This is a measure that is observed by a few States (See Appendix). It mandates that whenever outstanding risk weighted guarantees exceed the limits specified in the Act, no fresh guarantee shall be given. The Punjab FRBM Act, 2003 specifically says that no fresh guarantee shall be given except for the purpose of replacing high cost debt with low cost debt in such a way that there is no net increase in outstanding guarantees after such debt swap.

##### **2. No liability to be given outside the budgetary provision, personal liability of the officers responsible**

A more onerous measure for enforcing compliance is prevalent in Jharkhand and Odisha. It says that no liability shall be created outside the budget provision in a financial year without the approval of the Government in the Finance Department. Creation of any such unauthorised liability shall be treated as gross negligence and the officer(s) responsible for creation of such liability shall be personally liable for such additional liability created.

##### **3. No unpaid liabilities beyond a certain period of time**

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<sup>35</sup> According to a variety of sources, since the provision regarding the setting up of such independent agencies is relatively new, several States are yet to operationalise such agencies within the purview of their FRBM Acts. See Report on Centre-State Financial Relations and Planning, Vol. III, Commission on Centre State Relations (March, 2010) para 5.12.06.

<sup>36</sup> See Second Report of the Expenditure Reforms Commission, Government of Karnataka (February, 2011). Available at < <http://www.finance.kar.nic.in/erc-web/secondrep-full-e-final.pdf> > accessed on 30 September 2014; Document seeking Expression of Interest for Appointment of Long-Term Consultants for strengthening Public Financial Management in Madhya Pradesh (2012). Available at <[http://www.dif.mp.gov.in/Tenders/EOI\\_PFM\\_final.pdf](http://www.dif.mp.gov.in/Tenders/EOI_PFM_final.pdf)> accessed on 30 September, 2014; Rakesh Lohumi, "New GSDP series to raise loan cap", *The Tribune India* (April 18, 2011).

This is a measure that is present only under the Punjab FRBM Act, 2003. It says that no department of the State Government shall allow any liabilities,

- (i) which have become due, to remain unpaid for a period of more than three months; or
- (ii) to incur fresh liabilities, if previously incurred liabilities, have remained unpaid for a period of more than three months.

#### 4.3.4. Analysis

There are two inferences which can be derived from the breadth of enforcement mechanisms under FRBM Acts. First, the Acts are directed primarily at preventing revenue and fiscal deficit targets from being breached. A range of measures— measures for increasing revenue and reducing expenditure, statement on remedial measures and a few prohibitions to prevent widening of revenue and fiscal deficits— are thus provided for. Second, in the event such targets are missed, the Acts do not prescribe significant punitive action to ensure enforcement but instead opts for a soft accountability measure— a Review Report by the Finance Minister to the State Legislature and a statement explaining deviations. A further provision— to make such review independent by setting up an agency for this task— has only been established by a few State Governments. In any event, accountability in case of deviations is sought to be enforced through a reporting obligation, rather than any more stringent consequences.

There is a reason why this is so. FRBM legislations are supplements to the constitutional framework regulating State debt. Article 293 (3) and (4), key elements in this framework, provide for Central Government consent with the power to impose conditions on any State loan when the State is indebted to the Centre or the loan is guaranteed by the Centre. Since all States are indebted to the Centre, this has functioned as a *de facto* mechanism to enforce borrowing limits, such that States do not breach their deficit reduction targets. Further, if they do, stringent conditions can be imposed by this clause, which lays down no limitations on the nature and scope of conditions which can be imposed. This allows FRBM Acts to simply prescribe softer preventive measures and avoid more stringent consequences for borrowing limits breaches altogether, a concern addressed by the operation of Article 293 (3) itself.

However with some States being in a position to repay Central debt making Article 293 (3) inapplicable in their case, there is a vacuum in the law for regulating sub-national debt. Further, independent reviewing agencies that were meant to be set up under FRBM Acts, have in a majority of States not been established, or when they have, lack any real enforcement powers. It is thus necessary to bolster the architecture of the FRBM Acts to replace the enforcement function performed by Article 293 (3) of the Constitution.

#### 4.3.5. Recommendation

It is recommended that a Joint Fiscal Responsibility and Budget Management Council (hereinafter ‘Council’) be established by the Central Government. The purpose of such a Council will be to act as an expert, independent body to co-ordinate fiscal strategies between the Centre and States and oversee compliance with FRBM legislations. One of its key functions will be to advise both Central and State Governments on borrowings and if felt necessary approving borrowings by State Governments if and when Article 293 (3) does not apply.

The recommendation for such a body is not a new one. A Loans Council to oversee borrowings was considered by the Expert Committee on Financial Provisions set up by the Constituent Assembly.<sup>37</sup> Such a body has been recommended in academic literature on the Indian fiscal system.<sup>38</sup> It was also mentioned in the previous two Finance Commission Reports.<sup>39</sup> Finally, several foreign jurisdictions also have analogous bodies.<sup>40</sup> However, given the widely felt need for co-ordination between Centre and States on fiscal strategy coupled with the real possibility of unregulated sub-national debt militating against such need, the time for such a Council has now come. Three key facets of this Council— its composition, functions, the legal process necessary to bring it into existence and constitutionality thereof are discussed presently.

#### 4.3.5.1. *Composition and Functions*

The principle underlying the composition of the Council should be a combination of effectiveness and participation. Consequently the Council must not be too large, as that would impede effectiveness; at the same time it must be participatory with representation from the Centre and States. It is thus proposed that the Council be a five-member body. The power of appointment of the Chairperson and Members of the Council should be vested in the reformed Inter-State Council, as suggested in the following Note

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<sup>37</sup> *Supra* note 5.

<sup>38</sup> For a review of the arguments for fiscal councils internationally, see Ter-Minassian, Teresa, and Jon Craig. 1997. "Control of subnational government borrowing." *Fiscal Federalism in theory and practice*: 156-72; and section 2.5.5 in Eichengreen, Barry, Robert Feldman, Jeffrey Liebman, Jurgen von Hagen, and Charles Wyplosz, 2011. *Public debts: nuts, bolts and worries*. Vol. 13. CEPR. For references to the Indian context, see Chelliah, RF, 1983. "The Economic and Equity Aspects of the Distribution of Financial Resources Between the Centre and the States in India", paper presented at the Seminar on Centre-State Relations at Bangalore, August 1983, published by Government of Karnataka (Bangalore, 1983); Anand, Mukesh, Amaresh Bagchi and Tapas K. Sen, 2001, "Fiscal Discipline at the State Level: Perverse Incentives and Paths to Reform", NIPFP Fiscal Conference paper; Singh, Nirvikar, and T.N. Srinivasan (2005), "Indian Federalism, Globalization and Economic Reform," in T.N. Srinivasan and Jessica Wallack, eds., *Federalism and Economic Reform: International Perspectives*, Cambridge, UK: Cambridge University Press; and Singh, Nirvikar, and T.N. Srinivasan, (2006), *Federalism and Economic Development in India: An Assessment*, Conference Paper, Stanford Center for International Development Conference on Challenges of Economic Policy Reform in Asia, May 31-June 3 2006, Revised, October.

<sup>39</sup> Twelfth Finance Commission Report (2004), para 15.7, 4.1.11; Thirteenth Finance Commission Report (2009), para 9.65, 9.66.

<sup>40</sup> See IMF Policy Paper, "Budget Institutions in G-20 Countries - Country Evaluations". 2014. Washington: International Monetary Fund for details on Loan Councils in federal G-20 countries. Available at <<http://www.imf.org/external/np/pp/eng/2014/040714d.pdf>> accessed on 25 September 2014.

(Note 3). It should be provided that no decision of the Inter-State Council to appoint the Chairperson or Member shall be taken without the concurrence of the Prime Minister. The Chairperson and Members should be persons with significant experience in public finance, economics, public administration or law and must satisfy other eligibility criteria as the Central Government may deem fit. They should have a five-year term and their independence in functioning must be statutorily secured.

The most important function of the Council will be to determine borrowing limits for Centre and the States in consultation with all parties. The second function will be to monitor and oversee the implementation of the decisions taken by it. In particular, the Council can increase the transparency of budgetary and fiscal policy by commenting publicly on the budgets passed by the Central and the State Governments, particularly on the models used to forecast growth, revenue and expenditure estimates. The Council would also comment on the outcomes achieved by the States, measured against targets. Another aspect of the role of the Council could be to rank States according to fiscal prudence, which will further sharpen incentives to ensure fiscal sustainability. Several countries have fiscal councils that provide this role, such as Belgium, Netherlands, Slovenia and Sweden.

It should be mandatory that borrowings by Central and State Governments should only be after seeking advice from the Council. Further, any amendment to the limits themselves should also be on its advice. Given the expert nature of the body, it is expected that a healthy convention would develop by which the advice of the Council would ordinarily be accepted. Necessary exceptions in cases of national emergencies may be provided. Such an advisory role will serve two functions: *first*, the Council will become the Central repository of information pertaining to borrowings by all Governments in India, a key component of determining India's fiscal strategy. *Second*, it will provide the foundation for the Council to play a more assertive role in approving State borrowings at a time when Article 293 (3) does not apply.

#### 4.3.5.2. *Legal Process*

The Council must be set up by a parliamentary legislation. The legislative competence to do so is derived from Article 246(2) of the Constitution read with Entry 20 of List III which deals with 'Economic and Social Planning'. Since the purpose of the Council is to ensure overall fiscal co-ordination and strategy including oversight of union and State borrowings, its functions are squarely covered by this legislative entry. In any event, Entry 97 of List I is a residuary entry which gives the Central Government competence to legislate on matters which are not specifically provided for. Since there is no entry more specific to this matter than Entry 20 of List III, the matter could also be covered by Entry 97 of List I. Thus passing such a law would be entirely within the competence of Parliament.

Once the legislation is passed and the Council is established, States must be mandated to amend their respective FRBM Acts. The amendment should detail the actions which the State Government may only take on the basis of advice from the Council. A suitable incentive to enact these amendments should be

provided by the Finance Commission along the lines of FC-XII and FC-XIII Reports, which tied the enactment and amendment to FRBM legislation to financial packages and relief for State Governments.

Today when Article 293 (3) continues to have relevance to all States since all States are indebted to the Centre, an *advisory* role for such a body is most appropriate. This is because making it mandatory for States to seek permission from the Council would unduly delay the process of borrowing, being an additional step, apart from seeking Central Government consent under Article 293 (3). At a time when it becomes necessary, if and when the relevance of Article 293 (3) is diminished, a future Finance Commission may recommend, if it feels in its wisdom, that the Council be given a consent-granting function over State borrowings. This would be perfectly consonant with the overarching need for macroeconomic stability while at the same time respecting fiscal autonomy for States.

## 5. Conclusion

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Unsustainable levels of sub-national debt pose a threat to macroeconomic stability. National concerns about macroeconomic risk are not internalised by individual States. If no control is imposed on individual States, then each State will have an incentive to “over-borrow”, relative to the norms that would ensure that macroeconomic stability is maintained. To this end, the Centre ought to be able to exert some control over individual States with a view to maintaining systemic stability. Legitimate concerns that Central control of the fiscal capacity of States is a violation of the principles of political and economic federalism must be balanced against the systemic risk posed to the economy from the imprudent fiscal management of a handful of States. With this in mind, we make the following alternate recommendations to extend Central Government control over State borrowing.

1. Amend Article 293
  - a. Amend Article 293(2) to vest the Government of India with the power to regulate States’ borrowing from the market subject to Parliamentary law;
  - b. Amending Article 293(3) to include loans from the public account of India as loans from the Centre to State Governments thereby ensuring its continued applicability.
2. Ensure that Article 293 (3) continues to apply
  - a. Deny WMA to States that exceed their borrowing limits;
  - b. Deny States access to external funding via the Centre if borrowing limits are exceeded.
3. Developing a framework derived from Article 293
  - a. Establish an independent Joint Fiscal Responsibility and Budget Management Council to oversee the implementation of State FRBMs and ensure adherence to borrowing limits therein.

## APPENDIX - Enforcement Measures and States which follow the said measures

| S. No. | Measure to Enforce Compliance   | Followed by   |
|--------|---|---|
| 1.     | Review Report by the Finance Minister   | Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Odisha, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh, Uttarakhand |
| 2.     | Statement of the Finance Minister explaining deviations                                       | All States  |
| 3.     | Measures for increasing revenue and/or reducing expenditure                                   | Andhra Pradesh, Bihar, Chhattisgarh, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Nagaland, Odisha, Punjab, Tripura, Uttar Pradesh, Uttarakhand, West Bengal  |
| 4.     | Statement of remedial measures in case of possible measures which may lead to revenue deficit | Andhra Pradesh, Bihar, Goa, Haryana, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Punjab, Sikkim, Tamil Nadu, Tripura   |
| 5.     | Consistency with the objectives of the Five Year Fiscal Plan                                  | Assam, Goa, Gujarat, Jharkhand, Karnataka, Mizoram, Odisha, Rajasthan, Sikkim, Tamil Nadu, Uttar Pradesh, Uttarakhand   |
| 6.     | Establishment of an independent agency  | Andhra Pradesh, Bihar, Goa, Haryana, Jammu and Kashmir, Madhya Pradesh, Manipur, Meghalaya, Nagaland, Odisha, Punjab, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh  |

|     |  |   |
|-----|--|---|
| 7.  | Proposals for Supplementary or Additional Demands and Statements for curtailment of expenditure          | Arunachal Pradesh, Assam, Goa, Jharkhand, Karnataka, Odisha, Sikkim, Uttar Pradesh, Uttarakhand |
| 8.  | Increase in revenue and fiscal deficit in case of unforeseen demands                                     | Arunachal Pradesh, Goa, Jharkhand, Odisha, Sikkim   |
| 9.  | No guarantees to be given after a certain limit  | Goa, Punjab, Tamil Nadu   |
| 10. | Triggers and Corrective Actions  | Gujarat, Kerala, West Bengal  |
| 11. | No liability to be given outside the budgetary provision, personal liability of the officers responsible | Jharkhand, Odisha   |
| 12. | No unpaid liabilities beyond a certain period of time  | Punjab  |
| 13. | Guidelines to be issued by the State Government for timely spending of budget                            | Odisha  |







# Vidhi

Centre For Legal Policy

BETTER LAWS. BETTER GOVERNANCE

# RESEARCH REPORT ON QUERIES RAISED BY THE FOURTEENTH FINANCE COMMISSION

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## 1. ON WIDENING THE TAXING POWERS OF THE STATE

Alok Prasanna Kumar  
Ananya Kapoor  
Yashaswini Mittal

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## Introduction

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Two queries have been raised by the Fourteenth Finance Commission for our consideration:

1. Scope for levy of a surcharge on Income Tax by State Governments.
2. Scope and approach to amend the constitutional provision to levy professional tax by States in terms of enhancing the rates prescribed. Secondly, will it be in the spirit and design of the constitutional framework to make the amount of professional tax to be open-ended to the extent that the amount can be prescribed from time to time by the Central Government through a simple notification, say at an interval of three years, without resorting to a constitutional amendment every time the enhancement has to take place.

In this note, our observations and recommendations with regard to the above mentioned queries are along the following lines:

1. States do not have the power to impose a surcharge on income tax collected by the Centre.
2. An amendment to the Constitution permitting the State to impose such surcharge on income tax would not be feasible without consensus between the Centre and the States on the basis of charge, collection mechanism, and tax revenue distribution.
3. The limit of Rupees Two Thousand Five Hundred may be increased by Parliament by amending the Constitution along the lines suggested below to allow for the limits on amount of professional tax payable by a person to be imposed by law made by Parliament, subject to certain procedural safeguards to ensure that the amendment does not change the federal character of the Constitution.

Section 1 of this Note deals with the feasibility of imposing a surcharge on income tax. Section 2 deals with the feasibility of amending the Constitution to increase the limit of professional tax that can be imposed. Lastly, Section 3 summarises and concludes this note.

### 1. Feasibility of imposing a surcharge on income tax

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During its deliberations with the various State Governments in the course of preparing its report, we have been informed that the Fourteenth Finance Commission (“the Commission”) received requests from certain States seeking the power to impose a uniform surcharge on income tax payable under the Income Tax Act, 1961. This section of the Note is thus divided into two sub-sections; one dealing with the legality of this proposal under the present constitutional scheme; the second dealing with the feasibility of any proposal to amend the Constitution for this purpose.

### 1.1. Constitutional position on income tax

The power to impose taxes on income is vested in the Union Parliament under clause (1) of Article 246 read with Entry 82 of List I of the Seventh Schedule of the Constitution of India. As such, being an entry in List I, i.e. the “Union List”, the State Legislature will have no power to legislate on this subject matter, and therefore, State Legislatures cannot impose a tax on income.

However, State Legislatures are empowered under clause (3) of Article 246 read with Entry 46 of List II of the Seventh Schedule of the Constitution of India, to impose taxes on agricultural income. Therefore, the power of the State Legislature to impose a tax on income is limited exclusively to the agricultural income of persons, whereas the Union Parliament has the power to tax income from all other sources except agricultural income. In this context as well, it is relevant to note that clause (1) of Article 366 vests Union Parliament with the power to determine what is “agricultural income” in the income tax law.

In tax law, a “surcharge” means an additional imposition which results in enhancement of the tax and the nature of the additional imposition is the same as the tax on which it is imposed.<sup>1</sup> Therefore, the power to impose a surcharge is concomitant with the power to impose the tax itself in the first place. Absent the power to impose the tax, there is no power to levy a surcharge on such tax.

In the specific context of taxation of income, this principle was clarified by the Supreme Court of India in *CIT v. K. Srinivasa*,<sup>2</sup> where it was held that:

“9. As mentioned before the legislative Entry 82 in List I relates to taxes on income other than agricultural income tax, super tax and surcharge would all fall under this entry. It is in exercise of the legislative power conferred by that entry that the Union Parliament enacts the provision in the Finance Act each year relating to them.”<sup>3</sup>

Therefore, absent the legislative power to levy income tax, there is no legislative power to impose a surcharge on such income tax. State Legislatures therefore do not have the power under the Constitution to impose a surcharge on income tax levied by the Union Parliament.

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<sup>1</sup> *Bisra Stone Lime Co v OSEB* (1976) 2 SCC 167, 170 para 11, followed in *Sarojini Tea Co (P) Ltd v Collector of Dibrugarh* (1992) 2 SCC 156, 164 para 16.

<sup>2</sup> (1972) 4 SCC 526

<sup>3</sup> *Ibid* at page 530 para 9.

## 1.2. Feasibility of proposal to allow State Legislatures to impose a surcharge on income tax

In light of the above legal position, this section will try to answer the question of whether it would be feasible to amend the Constitution appropriately to permit State Legislatures to impose a surcharge on tax on income. Such a proposal would theoretically involve the insertion of a separate entry into List II of the Seventh Schedule allowing the States to impose a surcharge on income tax.

We do not feel that such a proposal is, at present, feasible within the existing constitutional structure for the following reasons:

*First*, there is no instance of any tax which can be imposed both by the Centre and by the State Governments. List III of the Seventh Schedule i.e. the “Concurrent List”, which gives concurrent legislative powers to the Parliament and State Legislative Assemblies, does not contain any entry on taxation. It is well-established law that in the absence of a separate entry permitting taxation, the mere power to make law on that subject matter does not imply the power to impose a tax on that subject matter.<sup>4</sup> Consequently, there is no area where both the State and the Centre have the power to impose a tax.

*Second*, even if there were to be a provision permitting the Centre and the States to levy a tax on the same subject matter (as is being attempted to be done in the context of the Goods and Services Tax regime), the same cannot be introduced in the absence of consensus between all the States and the Centre on a number of key issues, namely the basis for taxation, allocation of tax revenues between Centre and States, and a collection mechanism for the tax, as discussed below:

### 1.2.1. **Basis for Taxation**

There are two bases for income taxation in India: source and residence. All persons, whether individuals or companies, resident in India according to the tests laid down in Section 6 of the Income Tax Act, 1961 will be taxed on their incomes accruing and arising anywhere. For those persons who are non-residents, only their incomes which accrue or arise in India are brought to tax.

At present, there is no concept of sub-national residency within the Income Tax Act. Residency of an individual for instance is determined under Section 6 of the Income Tax Act on the basis of the following criteria:

1. Whether they have been in India for at least one hundred and eighty two days in the “previous year” or

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<sup>4</sup> *MPV Sundararamaier v State of Andhra Pradesh* AIR 1958 SC 468 and *State of West Bengal v Kesoram Industries* (2004) 10 SCC 201, 312-3, paras 108-110.

2. Whether they have, within the four years preceding the “previous year”, been in India for an overall period of at least three hundred and sixty-five days, and at least sixty days in the “previous year”.

Likewise, for source-based taxation of income accruing or arising in India to non-residents, there is no further basis to classify sub-nationally where such income arises from.

The issue of residency and source become crucial in the context of income taxation since a State cannot, by definition, extend its laws beyond the boundaries of the State. There is no material yet to suggest any concrete definition of “residence” or “source” which can be applied to surcharges on income tax imposed by a State. Absent a common and coherent definition of “residence” and “source”, a surcharge on income tax by States will only lead to confusion and difficulty for taxpayers.

### 1.2.2. Collection of Income Tax Revenues

At present, income taxes are collected by the Centre and apportioned between the Centre and the States, in accordance with the provisions of clause (1) of Article 270, on the basis of the Finance Commission’s recommendation. State Governments do not have a mechanism to collect such a surcharge on income tax, let alone provisions to collect tax deducted at source or advance tax. There is every likelihood that without consensus on how such taxes are to be collected, there will be a repeat of the difficulties caused when all States sought to impose sales tax on inter-state and international sales.<sup>5</sup> It was for this reason also that the Constitution had to be amended to make it clear that the Centre was the only entity which had the power to impose sales tax on inter-state sales.<sup>6</sup>

Even in those federal systems where the power to tax income is given to both Federal and State Governments, we find that there are vastly different mechanisms at the Federal and State level for levy and collection of taxes. Two examples that of the United States of America and Canada, are discussed here briefly to highlight the differences in tax administration.

In Canada, the constitutional authority for the Federal income tax is found in Section 91 paragraph 3 of the Constitution Act, 1867, which assigns to the Federal Parliament power over “The raising of Money by any Mode or System of Taxation”. The constitutional authority for the various provincial income taxes is found in Section 92 paragraph 2 of the Constitution Act, 1867, which assigns to the Legislature of each

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<sup>5</sup> The Constituent Assembly, in inserting Article 286, was also aware of these difficulties. See Constituent Assembly Debates, Volume 10, speech by Dr Ambedkar, 16th October, 1949, available at <<http://164.100.47.132/LssNew/constituent/vol10p9.html>> accessed on 26 September, 2014. Also see *Bengal Immunity Co v State of Bihar* (1955) 2 SCR 603, para 39 where the Court observes that such chaos continued post-Constitution as well.

<sup>6</sup> See *MPV Sundararamaier v State of Andhra Pradesh*, *supra* note 4.

Province the power of "Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes".<sup>7</sup>

The system of collection of income tax by Provinces and territories and the Federal Government is harmonised through "tax collection agreements". The Federal Government, through the Canada Revenue Agency ('CRA') collects personal income taxes on behalf of all Provinces and territories except Quebec and collects corporate income taxes on behalf of all Provinces and territories except Alberta and Quebec. Provinces and territories that have entered into tax collection agreements with the Federal Government for collection of personal/corporate income taxes must use the federal definition of "taxable income" as the basis for their taxation. This means that they are not allowed to provide or ignore federal deductions in calculating the income on which Provincial tax is based. If any refunds need to be given to taxpayers, the CRA is the source of all such refunds, whether of Federal or Provincial taxes.<sup>8</sup>

Conversely, in the United States, each State has its own elaborate mechanism for levy and collection of income taxes in addition to the Federal income tax. The States' power to impose income taxes however is traceable not from the United States Constitution which vests power to impose taxes on income only on Congress,<sup>9</sup> but from the individual States' Constitutions which vest legislative power of the State in the respective State Legislatures.<sup>10</sup>

While the examples of Canada and the United States are possibly the two extremes on how to implement concurrent taxing powers between Centre and States, they show that there needs to be some level of consensus on how such taxes should be collected at the State and Central level.

### 1.2.3. Allocation of Tax Revenues

Another aspect of this issue that needs to be highlighted here is that at present the States have a share in the income taxes levied and collected by the Centre with allocations determined by the Finance Commission. If States are also empowered to levy and collect income taxes in parallel with the Centre, in order to impose a surcharge, then the existing scheme of apportioning of tax revenues between Centre

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<sup>7</sup> This, the Courts in Canada have held to mean that "an income tax is the most typical form of direct taxation". See *Forbes v A.-G. Man.* [1937] A.C. 260,268

<sup>8</sup> Structure and Operational Framework, The Canadian Revenue Agency. Available at <<http://www.cra-arc.gc.ca/gncy/bkgrd-eng.html>> accessed on 26th September, 2014.

<sup>9</sup> Sixteenth Amendment of the United States Constitution, which reads, "Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

<sup>10</sup> Constituent Assembly Debates, Vol. 9 part 8b, Speech of Dr. BR Ambedkar, 9th August, 1949. Available at <<http://parliamentofindia.nic.in/ls/debates/vol9p8b.htm>> accessed on 7 October, 2014.

and State will have to be re-looked in its entirety, especially since an existing source of revenue for the Centre is now being carved out for the States.

The implementation of the proposal would therefore require amendment of the Constitution to allow both State and Centre concurrent power to impose income taxes and also recast the present structure of sharing of revenues between Centre and States. However, this cannot be undertaken without consensus between the Centre and the States, not just on rates, but also on the basis of taxation, whether residence or source, and the common collection mechanisms, somewhat similar to the procedure being presently adopted in the context of the Goods and Services Tax. The process through which such amendments are introduced will have to take place under proviso to clause (2) of Article 368 requiring the assent of at least half the State Legislatures in order to take effect.

To summarise the above discussion:

1. It is not permissible under the Constitution for a State Legislature to impose a surcharge on income taxes paid to the Centre.
2. Amendment of the Constitution to permit a State Legislature to impose such a surcharge can only be carried out once there is consensus between the Centre and States on the following issues:
  - a. Basis of surcharge, specifically whether source or residence and how to define source and residence in the context of a State.
  - b. Mechanism for the collection of surcharge by the States.
  - c. Allocation of tax revenues from income taxes.

In the absence of consensus on the above three issues, vesting power in the States to impose income taxes would be premature.

## 2. Feasibility of increasing the limits for imposition of professional tax

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This query has been divided into three separate sub-sections which are dealt with below. The sub-sections 2.1 and 2.2 deals with the feasibility of increasing the limit for the imposition of professional tax in a State; while sub-section 2.3 looks at whether such limits may be left to the Union Parliament to increase from time to time.

### 2.1. Raising the limits of professional tax

#### 2.1.1. History of the power to levy professional tax

The power of the State Legislature to impose a professional tax can be traced to Entry 60 of List II of the Seventh Schedule, i.e. the “State List”, read with clause (3) of Article 246 of the Constitution of India.



Entry 60 speaks of “taxes on professions, trades, callings and employment”. This is different from Entry 26 of List III which gives concurrent power to both the Central and State Legislatures to make legislation with respect to the “legal, medical and other professions” but which does not give the Centre or States any power to impose any tax on persons carrying on such professions.

Insofar as professional tax is concerned, Article 276 is also relevant. Clause (1) clarifies that a law of a State Legislature levying professional tax shall not be invalid merely because it relates to a tax on income. Clause (2) of Article 276 states that no one shall be required to pay more than Rupees Two Thousand Five Hundred by way of Professional Tax to any State or any local authority within that State. Clause (3) also clarifies that the State’s power to impose a professional tax does not in any way impinge on the Centre’s powers to impose an income tax on persons who are engaged in professions, trades, calling or employment.

The genesis of Article 276 can be traced back to Section 142-A of the Government of India Act, 1935 (“GOI Act”) where the limit was initially set at Rupees Fifty per annum. Section 142-A was inserted in 1940 by Section 2 of the India and Burma (Miscellaneous Amendments) Act, 1939. Sub-sections (1) and (2) of Section 142-A are almost identical to clause (1) and (2) of Article 276 of the Constitution of India.<sup>11</sup> As with the Constitution of India, under the GOI Act as well, the Federal Legislature had the power to tax incomes whereas the Provincial Legislatures had the power to impose professional tax.

The rationale for the insertion of Section 142-A has been explained elaborately in the judgment of the Supreme Court of India in *Jadao Bahuji v. Municipal Committee*<sup>12</sup>, as follows:

“12...It was, however, felt that these taxes [professional tax] might come into clash with tax on income in the Federal List, and also if unlimited in amount, might become a second tax on income to be levied by the Provinces. It was to remove these contingencies that Section 142-A was enacted. Sub-section (1) provided that a tax on professions, etc., would not be invalid on the ground that it related to a tax on income. Sub-section (3) was a counterpart of sub-section (1), and provided that the generality of the Entry in the Federal Legislative List relating to taxes on income would not be construed as in any way limited by the power of the Provincial Legislature to levy a tax on professions, etc. The fields of the two taxes were thus demarcated. No other implication arises from these two sub-sections.

13. It was also apprehended that under the guise of taxes on professions, etc., the Provincial Legislatures might start their own scheme of a tax on income, thus

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<sup>11</sup> See *Kamta Parsad Aggarwal v The Executive Officer*, Panchayat Samiti, Ballabgarh ILR (1968) 2 P&H 695, 700.

<sup>12</sup> (1962) 1 SCR 633.

subjecting incomes from professions, etc., to an additional tax of the nature of income tax. A limit was therefore placed upon the amount, which could be collected by way of tax on professions, etc., and that limit was Rs. 50 per annum per person. The second sub-section achieved this result...”<sup>13</sup>

Subsequently, in the Constitution of India, this limit was raised to Rupees Two Hundred and Fifty per annum in 1950. While the Drafting Committee had initially recommended Rupees One Hundred and Fifty, this was ultimately raised to Rupees Two Hundred and Fifty.<sup>14</sup> It was only in 1988, subsequent to the recommendations of the Commission on Centre-State Relations (‘Sarkaria Commission’) that the limit was raised to the present level of Rupees Two Thousand Five Hundred per annum by the Constitution (Sixtieth Amendment) Act, 1988.

Before examining the question as to whether the limit should be raised, it is relevant to note why the limit exists in the first place. The GOI Act, as enacted in 1935, did not contain any limit on the amount of professional tax that could be levied by the Provincial Legislatures in exercise of their powers under sub-section (2) of Section 100 read with Entry 46 of List II of the Seventh Schedule. As pointed out by the Supreme Court in *Jadao Bahuji*, when doubts were raised as to whether the nature of the tax on the professions would not in fact be a tax on income, Section 142-A was introduced to clarify the position and curtail the Provinces’ powers.

The existence of Article 276, like Section 142-A, is tacit acceptance that the professional tax, in effect, is a tax on income. The tax base for a professional tax is a subset of the tax base for the personal income tax. The tone and tenor of the Constituent Assembly Debates on the topic seem to suggest that the majority were not particularly keen in keeping the tax on the books. Dr. Ambedkar stated that the only reason the professional tax was being continued, despite being in conflict with the income tax, is only because certain municipalities are being funded from it at the moment and such municipalities’ administration should not be affected by it.<sup>15</sup>

The question of raising the limits on professional tax was considered by the Sarkaria Commission in its report and it was recommended that the then limit of Rupees Two Hundred and Fifty be increased and the limits be raised from time to time.<sup>16</sup> The Sarkaria Commission stated that taking into account

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<sup>13</sup> Paras 12-13.

<sup>14</sup> *Supra* note 10.

<sup>15</sup> *Ibid.*

<sup>16</sup> Report of the Commission on Centre-State Relations, Chapter X, paragraphs 10.5.59-60, available at <<http://interstatecouncil.nic.in/Sarkaria/CHAPTERX.pdf>> accessed on 27 September, 2014.

inflation, there needs to be periodic review of the limit.<sup>17</sup> The Sarkaria Commission also noted that the States were unwilling or unable to garner much revenue from professional taxes as a result of the low limits set therein.<sup>18</sup>

### 2.1.2. Present position of professional tax.

At present, twenty-one States impose professional tax through various laws, all of them adhering to the limit of Rupees Two Thousand Five Hundred. As far as the scope of the professional tax is concerned, in some States such as Bihar<sup>19</sup> and Kerala,<sup>20</sup> the levy is generally applicable to all persons engaged in any employment or in any profession whereas in the others it is only for enumerated professions.<sup>21</sup> In some States such as Bihar<sup>22</sup> and Karnataka,<sup>23</sup> the tax is levied and collected by the State alone, but in others, such as Kerala<sup>24</sup> and Tamil Nadu<sup>25</sup>, municipal bodies also levy and collect the professional tax under a State legislation.

At present, the amount collected from the levy of professional tax seems to be a negligibly small percentage of the total tax revenues collected by a State. For instance, in the State of Karnataka for the Financial Year 2013-14, out of an estimated total tax revenues of Rupees 77,519 crores collected by the State, professional tax was estimated to account for only Rupees 825 crores or about 1.06% of the tax revenues.<sup>26</sup> Likewise in Andhra Pradesh, for the Financial Year 2013-14, out of total tax revenue of Rupees 96,575 crores, professional tax provided only Rupees 710.95 crores or about 0.7% of tax revenues.<sup>27</sup> The low contribution of the professional tax to the revenues of the State could be attributed to not only poor

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<sup>17</sup> *Ibid* para 10.5.60.

<sup>18</sup> *Ibid* para 10.5.59.

<sup>19</sup> See Section 4 of the Bihar Tax on Professions, Trades, Callings and Employments Act, 2011.

<sup>20</sup> See Section 4 of the Kerala Tax on Employment Act, 1976.

<sup>21</sup> See for instance, Maharashtra State Tax on Professions, Trades, Callings and Employments Act, 1975.

<sup>22</sup> See the Bihar Tax on Professions, Trades, Callings and Employments Act, 2011

<sup>23</sup> See the Karnataka Tax on Professions, Trades, Callings and Employment Act, 1976.

<sup>24</sup> See Section 245 of the Kerala Municipality Act, 1994.

<sup>25</sup> See Section 198-B of the Tamil Nadu Panchayats Act, 1994.

<sup>26</sup> Source: <<http://www.finance.kar.nic.in/bud2013july/bdocs13-14/002-Rev%20Receipt.pdf>> accessed on 27 September, 2014.

<sup>27</sup> 'Budget Estimates (2014-2015): Detailed estimates of Revenue and Receipts', Vol. II, available at <<http://www.apfinance.gov.in/uploads/budget-2014-15-books/Volume-II.pdf>> accessed on 27 September, 2014.

collection mechanisms and enforcement at the State level, but also perhaps to the low limit up to which a State may collect professional tax as pointed out by the Sarkaria Commission.

In effect it seems that Article 276, while giving validity to the States' power to impose professional tax with one hand, by imposing a low limit on how much professional tax can be collected, substantially limits the scope for exercising such power with the other.

### **2.1.3. Cross jurisdictional survey of professional tax collection systems.**

From a survey of federal systems across the world, we have found that either the levy or collection of income and professional tax is wholly within the purview of the municipal bodies (such as in Switzerland) or with the Federal Government (as in Mexico). As we have already pointed out in the context of the United States and Canada, in some federations both Federal and State Governments have the power to impose income taxes but that does not extend to separation of the power to impose professional taxes between Federal and State Governments. In none of these countries is the State Government's power to impose a professional tax limited by the Federal Government.

The one other federation which seems to be an exception to the above general norm is Pakistan. The provisions of the GOI Act, relating to professional tax were transposed into the Constitutions of Pakistan and continue to this day. At present, the 1973 Constitution of Pakistan contains a provision similar to Article 276 of the Constitution of India in so far as professional tax are concerned as give below:

“Article 163. Provincial taxes in respect of professions, etc.-

A Provincial Assembly may by Act impose taxes, not exceeding such limits as may from time to time be fixed by Act of Majlis-e-Shoora (Parliament), on persons engaged in professions, trades, callings or employments, and no such Act of the Assembly shall be regarded as imposing a tax on income.”

The key difference between Article 163 of the Constitution of Pakistan and Article 276 of the Constitution of India is that the former permits the Parliament to set the limit on professional tax leviable on a person whereas the Constitution of India itself fixes the limit.

The limit on professional tax at present is Pakistani Rupees One Lakh per annum as provided for in Section 2 of the Professions Tax Limitation Act, 1941 (“the 1941 Act”), with effect from 1977.<sup>28</sup>

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<sup>28</sup> Section 4 of the Federal Finance Act, 2006 amended the 1941 Act to impose this limit. The 1941 Act was initially enacted in furtherance of proviso to sub-section (2) to Section 142-A of the Government of India Act, 1935 and has been repealed in India by virtue of Article 395 of the Constitution of India, which inter alia, the GOI Act and laws amending and supplementing it, shall stand repealed.

At present, Provinces in Pakistan are levying a professional tax in some form or the other up to a limit of Pakistani Rupees One lakh.

Keeping in mind the recommendation of the Sarkaria Commission and the interests of allowing fiscal space to the States to increase their sources of revenue, if there has to be an increase the limit on the professional tax payable by a person per annum to a State, it would, of necessity, require a constitutional amendment since the limits are placed by the Constitution and ordinary legislation cannot supersede the Constitution.

The simplest course of action would be for Parliament to introduce a Constitutional Amendment to replace the phrase “Rupees Two Thousand Five Hundred” with a higher figure in clause (2) of Article 276.

However, such increases may have to be made periodically to account for inflation. Thus the question which arises is whether it would be constitutionally permissible to have this limit set by law made by Parliament and whether it would be permissible for the Constitution be amended reflect this. We already have a model for such an amendment in the 1973 Constitution of Pakistan. However whether such a provision would be lawful in the context of the Constitution of India and the law laid down by the Supreme Court of India will be examined in detail in the next section.

## 2.2. Leaving the Limits to the Union Parliament

Although the Constitution of India has been described variously as “quasi-federal” or having a “strong unitary bias”, it is however more federal in structure than unitary.<sup>29</sup> States have an independent constitutional existence and are politically sovereign in their own sphere. While the Centre may, in exceptional circumstances, override the States’ sovereignty, the fact remains that in normal circumstances, they are neither “satellites” nor “agents” of the Centre.<sup>30</sup> States are not therefore mere appendages to the Centre and within the sphere allotted to them, they are supreme.<sup>31</sup> This includes the power to make laws levying and collecting tax. Federalism thus understood, is a basic feature of the Constitution and cannot be abrogated even through an amendment of the Constitution.<sup>32</sup> What this section will analyse is whether the proposal to amend the Constitution give Parliament the power to place limits on the amount of professional tax payable by a person per State would violate the basic structure of the Constitution.

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<sup>29</sup> *SR Bommai v Union of India* 1994 3 SCC 1, 65 para 4. Per Pandian J.

<sup>30</sup> *Ibid*, 115 para 99. (Per Sawant J).

<sup>31</sup> *Ibid*, 216, para 276 (Per Reddy and Agrawal JJ).

<sup>32</sup> *SR Bommai v Union of India*.

That the State Legislature's power to levy a tax is plenary is evident from Article 245 and clause (3) of Article 246 of the Constitution. Entries 45 to 63 of List II in the Seventh Schedule relate to the specific subject matters on which the State Legislature may pass a law imposing a tax thereon. The source of the State Legislature's powers are these articles and not subject to any limitations imposed by Parliament. However, there are only three provisions of the Constitution which seem to, *prima facie*, permit Parliament to limit the powers of the State Legislature to impose a tax. They are Entry 50 of List II of the Seventh Schedule, Clause (1) of Article 366 and Clause (3) of Article 286. We discuss each clause and its implications in detail below:

### **2.2.1. Entry 50 of List II of the Seventh Schedule**

Entry 50 of List II states that the State shall have the power to impose taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development. While at first it seems that the Parliament will have power to restrict the taxing power of the State, it is not so. This provision has been clarified by the Supreme Court to mean that Entry 50 does not permit the Centre to limit the taxing power of the State but merely clarifies that the regulatory power of the Union under Entry 54 of List I cannot be encroached upon by the State in exercise of its taxing powers.<sup>33</sup> Parliament cannot, in exercise of its regulatory power, limit the power of the State Governments to impose a tax on mineral rights designed to augment the revenues of the State. A law made by Parliament to regulate mines and minerals in India cannot prohibit or restrict State taxation of such mineral rights. Entry 50 of List II therefore does not actually permit Parliament to place a fetter on the State's taxing power.

### **2.2.2. Clause (1) of Article 366**

This clause defines "agricultural income" to mean whatever meaning the term has been given in the income tax laws made by Parliament. This would seem to suggest that the Centre is free to determine the scope and extent of the term "agricultural income". However, the Constitution has placed a procedural restriction on this power as well. Any amendment to the Income Tax Act, 1961 or introduction of any law imposing tax that affects the meaning of the word "agricultural income" has to be on the recommendation of the President under Article 274. Parliament's power to limit the scope of the State's taxation power therefore, in this context as well, is not unfettered.

### **2.2.3. Clause (3) of Article 286**

Clause (3) of Article 286 mandates that a tax imposed by the State Legislature on the sale or purchase of goods will be subject to certain limitations imposed by the Parliament. Specifically, taxes on goods which are declared of "special importance" to inter-State trade and taxes on goods involved in works

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<sup>33</sup> *Supra* note 4, 325 para 129(9).

contracts, hire purchases and leases would be subject to limitations imposed by Parliament. *Prima facie*, this would appear to be a substantive limit on the power of the State Government's plenary taxing powers. However the history of how sub-clause (b) came to be inserted into the Constitution suggests otherwise.

Sub-clause (b) came to be inserted as a result of a peculiar set of circumstances. The Supreme Court of India, in *State of Madras v Gannon Dunkerley*<sup>34</sup> held that the State had no power to impose a sales tax on goods which were purchased as part of a single indivisible contract to construct a building. This settled a cleavage of opinion between High Courts in India as to the exact scope of the power of the State to impose a sales tax on such transactions that involved an indivisible combination of goods and services.

The narrowing of the State's taxing powers in these and other judgments,<sup>35</sup> led to a reference being made to the Law Commission of India to determine how the powers of the State to tax sales of goods in such circumstances could be narrowed. In its 61st report, the Law Commission of India certain amendments including, *inter alia*, the insertion of clause 29-A of Article 366 and amendment of clause (3) of Article 286 along the lines as they stand now.<sup>36</sup>

In effect therefore, the provisions of clause 3(b) of Article 286 extend the powers of the State to levy sales tax to transactions which were held to be outside the purview of the State but subject to the limitations imposed by the Parliament. Even so, such limits do not apply to the general power to impose tax on sale of goods but only to the limited categories of goods where the Centre might also otherwise have the power to levy tax upon.

#### 2.2.4. Federalism as the Basic Structure of the Constitution

What emerges from these three instances is that Parliament's function here is not so much to limit but to draw the boundaries between the State Legislature's and Parliament's powers of taxation or law making, as the case may be. In no case has it been given the absolute power to legislate on how and in what manner the State manner the State may exercise its taxing power.

Even when it comes to the power of amendment of the Constitution by the Parliament, important safeguards have been placed in the text of the Constitution in the interests of protecting the State's taxing powers. The first of these is found in Article 368 itself, specifically in proviso to clause (2), according to which Constitutional amendments that affect States' law making powers will not take effect

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<sup>34</sup> 1959 SCR 379.

<sup>35</sup> See for instance *Northern India Caterers (India) Ltd v Lt. Governor of Delhi* 1978 4 SCC 36.

<sup>36</sup> Law Commission of India, 61st Report on Certain Problems connected with the Powers of the State to Levy a Tax on the Sale of Goods and the Central Sales Tax Act. 1956, May 1974 available at <<http://lawcommissionofindia.nic.in/51-100/Report61.pdf>> accessed on 28 September, 2014.

unless they have been ratified by at least half of the State Legislatures. Similarly, Article 274 also requires that before any Bill or even Constitutional amendment that affects any tax or duty which States are interested in, it should do so only on the recommendation of the President.

Additionally, any amendment to the Constitution that damage or destroy the basic features of the Constitution such as judicial review,<sup>37</sup> fundamental rights,<sup>38</sup> or rule of law<sup>39</sup> would be beyond the powers of Parliament in exercise of its amending power.<sup>40</sup> Federalism being part of the basic structure of the Constitution, any amendment that damages or destroys the federal character of the Constitution would be struck down by the Supreme Court.

The norm therefore still remains that in a Federal Constitution, a State Legislature is as sovereign in its field of legislation as Parliament. In certain exceptional situations, the Parliament may limit the powers of the State through ordinary legislation. However this power of Parliament is itself restricted. In no case is Parliament given the power to control the core of the taxing power itself, with no procedural limits. An amendment that would empower Parliament to limit the State Legislature's power to tax in a given subject matter area, totally and with no restrictions as to procedure, would go contrary to the Constitutional scheme and the basic structure principle of federalism. An amendment giving such uncontrolled power would be struck down by the Courts as being contrary to the basic structure of the Constitution.

In our view, any measure that seeks to limit the power of the State Legislature to tax and give Parliament the power to determine what these limits are, will be against the basic structure of the Constitution. A provision allowing the Centre to restrict the State's taxing powers unilaterally and without limits is unprecedented in the context of the Constitution of India. A provision along the lines of the 1973 Pakistan Constitution giving the Centre absolute power to determine the limits of the State's power to levy professional tax would, in our view, go against the principle of federalism.

### 2.3. A restricted power of imposing limits on Professional Tax would be acceptable.

However, the reasons for giving the Union Parliament power to determine the limits of professional tax imposed by States are valid. That there have to be limits cannot be disputed since otherwise a professional tax would impinge on income tax imposed by the Centre. If there are limits, it is obvious that such limits have to be periodically reviewed to keep up with inflation. As we have already noted,

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<sup>37</sup> See *L Chandra Kumar v Union of India* (1997) 3 SCC 261.

<sup>38</sup> See *IR Coelho v State of Tamil Nadu* (2007) 2 SCC 1.

<sup>39</sup> See *Indira Gandhi v Raj Narain* 1975 Supp SCC 1.

<sup>40</sup> *Kesavananda Bharati v State of Kerala* (1973) 4 SCC 225.



giving the Union Parliament an uncontrolled power to restrict a State's taxing power is not permissible. However a specific, limited power may be granted to the Parliament in certain cases along the lines of extant provisions of the Constitution allowing for limited restrictions to be imposed by Parliament on the State's taxing power, as discussed in the previous section. In this instance, since the base for both the income tax and the professional tax are one and the same, Parliament can justifiably be given such a power subject to certain Constitutional restrictions designed to protect the State's interests as to when Parliament may invoke this power. In all the three cases discussed above, Parliament's ability to "limit" a State's taxing power is restricted either to the scope of the taxing power or comes with restrictions to ensure that States' interests are protected.

Taking a cue from the above, we suggest that the procedural restriction of Article 274, applicable in the context of defining "agricultural income" under the Income Tax Act, would be appropriate in the context of Parliament fixing the limits of professional tax since this also would have an impact on taxes on income. Article 274 states:

"274. Prior recommendation of President required to Bills affecting taxation in which States are interested

(1) No Bill or amendment which imposes or varies any tax or duty in which States are interested, or which varies the meaning of the expression agricultural income as defined for the purposes of the enactments relating to Indian income tax, or which affects the principles on which under any of the foregoing provisions of the Chapter moneys are or may be distributable to State, or which imposes any surcharge for the purposes of the Union as is mentioned in the foregoing provisions of this Chapter, shall be introduced or moved in either House of Parliament except on the recommendation of the President

(2) In this article, the expression "tax or duty in which States are interested" means-

(a) a tax or duty the whole or part of the net proceeds whereof are assigned to any State; or

(b) a tax or duty by reference to the net proceeds whereof sums are for the time being payable out of the Consolidated Fund of India to any State"

A Bill fixing limits on the levy of professional tax by States must therefore be recommended as such by the President before being introduced as a Bill in Parliament.

Two further requirements are necessary in our view for any law imposing limits on professional tax; first there must be periodicity in the raising of limits and second, the limits must be set in a manner which balances the interests of the Centre and the State in obtaining tax revenues. Both these requirements, we believe, will be met if the limits on professional tax are set on the basis of a Finance Commission recommendation. The Finance Commission submits its reports once every five years, thus ensuring that

the question of professional taxes is likely to be addressed on a sufficiently periodic basis, even if it may not necessarily recommend a change in the limits.

The Finance Commission already has the power to make recommendations to the States under sub-clauses (bb) and (c) of clause (3) of Article 280. Under sub-clauses (bb) and (c) of clause (3) of Article 280, it is also empowered to suggest how state revenues may be augmented to ensure proper funding of local self-government bodies. This, in our view, would also include suggestions as to how much professional tax should be permitted to be collected by the States.

It is also our view that the Commission itself is best placed to evaluate the claims of the States vis-à-vis the claims of the Centre and accordingly place its recommendations before the President for action.

We therefore propose that the following amendment be made to the Constitution of India.

1. *In clause (2) of Article 276, for the words “two thousand and five hundred rupees per annum” the words “such amount as Parliament may by law specify” shall be substituted.*
2. *In Article 276 of the Constitution, after clause (2) the following provisos shall be inserted:*

*“Provided that no Bill or amendment which imposes or varies the amount shall be introduced or moved in either House of Parliament except on the recommendation of the President made in pursuance of a recommendation of the Finance Commission to this effect.”*

*“Provided further that nothing contained in clause (2) shall be construed to give Parliament the power to prescribe different limits on the amount payable as tax on professions, trades, callings and employment for different States.”*

The provisos place certain fetters on the powers of the Parliament to limit States' power to levy professional tax. The first being the precondition of Presidential Recommendation, similar to the precondition found in clause (1) of Article 274. Since the Finance Commission makes its recommendations to the President, it would be constitutionally appropriate therefore that the recommendation to change the limit of professional tax inform the recommendation of the President to Parliament.

The second fetter is placed more by way of abundant caution than necessity. In the second proviso, it is clarified that the limit has to be uniform and applicable across the country to all States. This is to prevent the Parliament from effectively setting the State's tax policy by prescribing different rates for different States. This is also to prevent the Centre from playing favourites with any State and choosing to implement recommendations selectively.

### 3. Conclusion

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1. States do not have the power to impose a surcharge on income tax collected by the Centre.
2. An amendment to the Constitution permitting the State to impose such surcharge on income tax would not be feasible without consensus between the Centre and the States on the basis of charge, collection mechanism, and tax revenue distribution.
3. The limit of Rupees Two Thousand Five Hundred may be increased by Parliament by amending the Constitution along the lines suggested above to allow for the limits on amount of professional tax payable by a person to be imposed by law made by Parliament, subject to certain procedural safeguards to ensure that the amendment does not change the federal character of the Constitution.





# Vidhi

Centre For Legal Policy

BETTER LAWS. BETTER GOVERNANCE

# RESEARCH REPORT ON QUERIES RAISED BY THE FOURTEENTH FINANCE COMMISSION

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## 3. ON THE INTER-STATE COUNCIL

Srijoni Sen  
Shubhangi Bhadada

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## INTRODUCTION

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One of the main functions of the Planning Commission is to co-ordinate the allocation of financial resources in the form of grants to States to finance plans and schemes. With the Prime Minister announcing the dismantling of the Planning Commission,<sup>1</sup> it is important to explore the options available to ensure the smooth transition of this function into the hands of another body. This note looks at the option of the Inter-State Council ('ISC'), a body comprising State and Centre representation, taking over the functions of recommending the manner in which allocation of financial resources to the States should be carried out. The chief merit of such a proposal would be that it would ensure greater participation of the States in the process of grants being made by the Centre. In this context, the query that has been raised by the Fourteenth Finance Commission for our consideration:

1. In what way can the Inter-State Council be strengthened or organised to take over the functions of allocation of financial resources currently dispensed through the Planning Commission?

In this note, our main recommendation with regard to the above mentioned query is the following:

The ISC should be strengthened in order to play an effective consultative role in the task of financial allocations, while the primary decision making process should remain in the domain of the Central Government.

In this regard, Section 1 of this note looks at the financial allocations currently being made by the Planning Commission to States and the constitutional basis for the same. Section 2 looks at theoretical perspectives and various institutional designs internationally for making grants to States from Central Governments. Based on this, Section 3 outlines a recommendatory role that the ISC can play in the allocation of finances. Section 4 of this note suggests ways to strengthen and organise the ISC, so that it can effectively play this role. Lastly, Section 5 summarises and concludes this Note.

### 1. Constitutional position

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The Constitutional scheme for grants made by the Centre to the States is laid out in Part XII of the Constitution. Article 275 introduces the concept of 'for grants-in-aid of the revenues' of States, and provides that Parliament may fix different grants-in-aid to different States after considering the recommendations of the Finance Commission. According to Article 280, which sets up the Finance

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<sup>1</sup> Suvojit Chattopadhyay, 'Disband the Planning Commission, focus on states instead' (23 September 2014) available at <<http://www.livemint.com/Home-Page/vOYwMl4hgXSVXYGoKVsw7N/Disband-the-Planning-Commission-focus-on-states-instead.html>> accessed on 27 September, 2014; Also see "Replacement of Planning Commission still under consideration", *Zee News India* (21 September, 2014) available at <[http://zeenews.india.com/news/nation/replacement-of-planning-commission-still-under-consideration\\_1473443.html](http://zeenews.india.com/news/nation/replacement-of-planning-commission-still-under-consideration_1473443.html)> accessed on 27 September, 2014.

Commission, the body is charged with recommending to the President 'the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India'.

From this, it seems fairly clear that grants by the Central Government to the State Governments must be made on the recommendations of the Finance Commission. Planning Commission and other Ministry grants, however, are made under Article 282, which reads

“The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.”

Through the channel of Article 282, the Planning Commission has co-ordinated the grants from Centre to States under the Annual Plan, which determines the allocation of resources between various Central and State departments and agencies for the implementation of the broad objectives of the Five Year Plan. The budgetary allocations to States under the 2013-14 Annual Plan as part of Central Assistance consisted of Rs. 1.4 lakh crores. In recent years, about half of the total grants made by the Centre to the States has been channelled through the Planning Commission.<sup>2</sup> Of this, over time, the share of discretionary or non-formula grants by the Planning Commission has increased to over 70% of the total Central plan assistance to States.<sup>3</sup>

Much has been written about the lack of Constitutional status of the Planning Commission.<sup>4</sup> In addition, the use of Article 282 to make grants that are not based on the recommendations of the Finance Commission has been the subject of much debate.<sup>5</sup> The Supreme Court has also weighed in on the issue

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<sup>2</sup> According to the RBI Report on State Finances, the total grants in 2011-12 from Centre to State was 1864.2 billion rupees. According to the Annual Plan published by the Planning Commission, the total Plan Central Assistance in 2011-12 was 104015.9 crore, which works out to about 56% of the total Central Grants. See *State Finances: A Study of Budgets of 2013-14*, RBI, 83 ('State Finances: A Study of Budgets of 2013-14') available at <<http://www.rbi.org.in/scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budgets>> accessed on 26 September, 2014; Planning Commission of India, 'Annual Plan 2013-14', 6, available at <[http://planningcommission.nic.in/plans/annualplan/annual\\_plan13\\_14.pdf](http://planningcommission.nic.in/plans/annualplan/annual_plan13_14.pdf)> accessed on 26 September, 2014.

<sup>3</sup> Reserve Bank of India, *State Finances: A Study of Budgets of 2013-14* at 5.

<sup>4</sup> See, for example, HK Paranjape, 'The Task of the Ninth Finance Commission: The Planning Commission Tangle', in *The Ninth Finance Commission: Issues and Recommendations* (NIPFP, 1993); 'Note of Shri NC Jain on Restructuring: Suggestions for some Constitutional and Legal Changes' in Report of the Eleventh Finance Commission for 2000-2005, available at <[http://fincomindia.nic.in/writereaddata/html\\_en\\_files/oldcommission\\_html/fcreport/11threport.pdf](http://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fcreport/11threport.pdf)> accessed on 26 September, 2014.

<sup>5</sup> This issue has especially been discussed in detail in the First Administrative Reforms Commission, the Fourth Finance Commission and the Ninth Finance Commission Reports. The question being considered was whether Article 275 dealt only with revenue grants, since the phraseology used therein was 'grants-in-aid of revenue', while Article 282 gave residuary grant making powers to the Union and States in their discretion. Eminent jurists such as M.C Setalvad, P.V. Rajamannar, Nani Palkhivala, A.G. Noorani and KK Venugopal have provided differing views on this matter over the years. See HK Paranjape, 'The Task of the Ninth Finance Commission: The Planning Commission Tangle', in *The Ninth Finance Commission: Issues and Recommendations* (NIPFP 1993).



in *Bhim Singh v. Union of India*<sup>6</sup> where it said that Article 282 could be the source for ‘emergent transfer of funds’, and restrictions could not be placed on the scope of Article 282 by reference to other articles or provisions.

The extensive use of Article 282 as the main channel of grant-making has also been criticised on the ground that it has led to overly centralised fiscal relations.<sup>7</sup> However, regardless of whether Article 275 or Article 282 is used as a channel for grant-making, the Constitution does not explicitly provide for a role for States in this matter. The question of State involvement in fiscal transfers was considered during the drafting of the Constitution. The Expert Committee on the Financial Provisions of the Union Constitution, appointed by the Constituent Assembly in September, 1947, recommended that two of the five members of the proposed Finance Commission be nominated by the States, two from a panel nominated by the Central Government while the President would appoint the Chairman.<sup>8</sup> This suggestion of the Expert Committee, to have representation from the States in the Finance Commission, was ultimately not adopted by the Constituent Assembly.<sup>9</sup> Conflicts between Centre and the States, or between States, were left to be resolved through an Inter-State Council that could be appointed under Article 263, the terms of which were widely worded.

Therefore, the Constitution does not explicitly provide for the involvement of States in the process of financial allocations. However, accepted theories of institutional design, as well as international practice indicate the need for State units to play a role in the decision-making process for fiscal allocations from Centre to State. This will be discussed in more detail in the next section.

## 2. Institutional Theory and International Best Practices

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The first principle that emerges from a study of scholarly work on fiscal transfer mechanisms is that there should be clarity in the system of assignments, based on principles that are set at the stage of constitution-making.<sup>10</sup> Rather than purely discretionary allotments made by a Central Government, “jurisdictional boundaries and the assignment of functions and finances have to be taken as determined

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<sup>6</sup> (2010) 5 SCC 538.

<sup>7</sup> M. Govinda Rao, Nirvikar Singh, *Political Economy of Federalism in India* (OUP 2005) 198.

<sup>8</sup> Report of the Expert Committee on Financial Provisions, December 5, 1947 in *The Framing of India’s Constitution: Select Documents Vol. 3* (B Shiva Rao ed., New Delhi: Universal Law Publishing, 2012).

<sup>9</sup> Constituent Assembly Debates, 9<sup>th</sup> August 1949 available at <<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm>> accessed on 25 September, 2014.

<sup>10</sup> M Govinda Rao and Tapas K. Sen, ‘Federalism and Fiscal Reform in India’ NIPFP Working Paper No. 2011-84, 2011 available at <[http://www.nipfp.org.in/media/medialibrary/2013/04/wp\\_2011\\_84.pdf](http://www.nipfp.org.in/media/medialibrary/2013/04/wp_2011_84.pdf)> accessed on 25 September 2014.

at some earlier (constitutional) stage and not open to further discussion in normal circumstances”.<sup>11</sup> Thus, adherence to constitutional norms is critical to a well-designed system of fiscal transfers.

The second principle articulates the need to consult State units in the determination of fiscal transfers.<sup>12</sup> This is a crucial element of co-operative federalism, which requires continuous consultations on issues that affect the interests of Central and State Governments. Institutionalised channels of consultation are given importance in recognition of the fact that governmental actions affect other governments, and therefore exchange of views and information before acting is necessary, although the action of each government is taken independently.<sup>13</sup> By way of implementation of this principle, the World Bank recommends, as a ‘good practice to strive for’, the establishment of an inter-governmental forum to achieve consensus on the standard of equalisation and the objectives and designs of all fiscal transfer programs.<sup>14</sup>

A survey of institutional solutions in different countries establishes that almost all federal countries have inter-governmental institutions to facilitate consultation and collaboration, even if it is not mandated by the Constitution or by law. In some cases, these inter-governmental arrangements are set up explicitly with detailed rules and commitments, while in others, they have developed as a matter of convention.<sup>15</sup> Arrangements vary from a Council of State Governments acting as the Upper House of Parliament, as in Germany, to annual meetings of the provincial heads of government, as in Canada. In most cases, inter-governmental consultation is assisted by a permanent secretariat which provides technical assistance.<sup>16</sup>

The success or failure of these inter-governmental forums depends on a number of factors that impact their effectiveness and efficiency, including the degree to which the executive branch dominates inter-governmental relations, and the number of units in a federation. With smaller units, more ad hoc and informal bargaining may be pursued, whereas if the federation consists of a large number of units, more formal institutions will have to be established to ensure efficient cooperation. These formal arrangements may be instituted by law where constitutional amendment is difficult.<sup>17</sup> In South Africa,

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<sup>11</sup> Bird, Richard M., and Michael Smart, ‘Intergovernmental Fiscal Transfers: Some Lessons from International Experience’ (World Bank 2001).

<sup>12</sup> Anwar Shah, ‘Institutional Arrangements for Intergovernmental Fiscal Transfers and a Framework for Evaluation’, in Robin Broadway and Anwar Shah eds., *Intergovernmental Fiscal Transfers: Principles and Practice* (World Bank 2007) (‘Intergovernmental Fiscal Transfers by Robin Broadway and Anwar Shah’).

<sup>13</sup> Ronald Watts, ‘Origins of Cooperative and Competitive Federalism’ in Scott L. Greer ed., *Territory, Democracy and Justice Regionalism and Federalism in Western Democracies* (Macmillan 2006) 208.

<sup>14</sup> *Supra* note 12, p. xxxi.

<sup>15</sup> R. H. Neumann and T. R. Robinson, ‘The Structures and Conduct of Intergovernmental Relations’, in R. M. Bird and F. Vaillancourt eds., *Perspectives on Fiscal Federalism* (World Bank Institute 2006) 57 (‘Perspectives on Fiscal Federalism’).

<sup>16</sup> *Supra* note 12.

<sup>17</sup> R. M. Bird and F. Vaillancourt eds., *Perspectives on Fiscal Federalism* at 60, 66.

for example, the Inter-governmental Fiscal Relations Act, 1997 lays down the consultation procedures to be followed before the Budget is finalised [See Section 4.2 of this Note for more details].

Another important tool in effective inter-state consultation is the development of ‘trust-ties’ among public servants in different State Governments, establishing good working relations at the bureaucratic level.<sup>18</sup> The embodiment of this may be seen in the Canadian system, where inter-governmental coordination occurs at different levels of government with different degrees of frequency. The process of consultation with Provincial Government takes place on an ongoing basis. Permanent committees composed of federal and provincial finance officers communicate on a regular basis to settle technical issues related to fiscal transfers. These committees monitor and review the fiscal equalisation programme on a continuing basis, conducting an intensive review every five years to suggest revisions for the enactment of new national legislation for the next five-year period. Their recommendations are sent to the Continuing Committee of Officials on Fiscal and Economic Matters, made up of federal and provincial deputy ministers of finance. These Committees are given organizational and secretarial services by an inter-governmental body, the Canadian Inter-governmental Conference Secretariat. The final recommendations of this committee are then sent to the bi-annual meeting of the provincial and federal ministers of finance, which reaches final decisions. In turn, these decisions are communicated to the Prime Minister and Premiers of the Provinces in the First Ministers’ Conference, which takes place every year and consists of the Prime Minister and the Premiers. In this way, recommendations and feedback from the lowest levels of inter-governmental consultations are channelled upwards to equip the heads of the Provincial and Federal Governments in their annual discussions.<sup>19</sup>

The importance of an inter-governmental forum becomes clear from a survey of the literature on this issue. It is important to note, however, that in both theory and practice, the role of an inter-governmental forum is limited to **consultation** and **recommendation** to the Central Government on matters related to fiscal allocations. In no instance did we find such an inter-state body entrusted with the primary task of allocating financial resources to themselves.

The ISC, which has been set up under Article 263 of the Indian Constitution as a body to promote co-ordination between the Centre and States, is a suitable inter-governmental forum present under our constitutional framework which can take over the role of consultation and recommendation on matters related to fiscal allocation. The ISC currently consists of the Prime Minister, some Union Ministers and Chief Ministers of all States and its mandate is wide enough for it to take over this role. The ISC has the potential to ensure that there is meaningful State participation in fiscal allocation. While other inter-governmental forums such as the National Development Council also exist, this note focuses on measures

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<sup>18</sup> *Ibid*, at 61.

<sup>19</sup> J. M. Simmons, ‘Securing the Threads of Co-operation in the Tapestry of Intergovernmental Relations’ in J. P. Meekison et al eds., *Reconsidering the Institutions of Canadian Federalism*, available at <<http://www.queensu.ca/iigr/pub/archive/SOTF/SOTF2002.pdf>> accessed on 27 September, 2014.

to strengthen the ISC, in accordance with the Terms of Reference presented by the Fourteenth Finance Commission.

Thus, with due regard to both the relevant constitutional provisions and international experience, our conclusion in this paper is that the ISC should be strengthened in order to play an effective consultative role in the task of financial allocations, while the primary decision making process should remain in the domain of the Central Government. However, the ISC would have to be rejuvenated in order for such a role to be meaningful. The next section of this paper looks at the current status and functioning of the ISC, and suggests ways in which it can be made a more effective body.

### 3. The Inter-State Council - A Study

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#### 3.1. Constitutional position and history

The ISC is an advisory and consensus-seeking body set up under Article 263 of the Constitution with the powers to investigate, deliberate and recommend on “subjects in which some or all of the States or the Centre and one or more of the States have common interest”.<sup>20</sup> It consists of (a) the Prime Minister as the Chairperson; (b) Chief Ministers of all States; (c) Chief Ministers of Union Territories having a Legislative Assembly and Administrators of Union territories not having a Legislative Assembly; and (d) Six Ministers of Cabinet rank in the Union Council of Ministers to be nominated by the Prime Minister.<sup>21</sup> In addition, other Ministers having independent charge in the Central Government can be included as permanent invitees by the nomination of the Chairperson or for a meeting, as and when any item relating to a subject under their charge is to be discussed.<sup>22</sup> Therefore, this is a body which provides full representation to each State, Union Territory and the Centre.

The mandate of the ISC stems from Article 263, which empowers the President of India to establish an Inter-State Council if he feels it necessary and justifiable in the interest of the public. The scope of an Inter-State Council can be:

1. Inquiring into and advising upon disputes which may have arisen between States;
2. Investigating and discussing subjects in which some or all of the States or the Union and one or more of the States, have a common interest; or

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<sup>20</sup> Article 263 of the Indian Constitution, 1950; See Commission on Centre State Relations, Chapter IX (January, 1988) ('Commission on Centre State Relations') available at <<http://interstatecouncil.nic.in/Sarkaria/CHAPTERIX.pdf>> accessed on 27 September, 2014.

<sup>21</sup> Clauses 2 and 3, Inter-State Council Order, dated 28 May 1990.

<sup>22</sup> Clause 2, Inter-State Council Order, dated 28 May 1990; Inter-State Council (Amendment) Order, dated 24 December 1996.

3. Making recommendations upon any such subject and in particular, recommendations for the better co-ordination of policy and action with respect to that subject.

The Presidential order can specify the scope of such a council as well as lay down its organization and procedure.<sup>23</sup> The Constitution envisages the Inter-State Council as an arrangement to identify and investigate issues of common concern to States and give policy recommendations.<sup>24</sup>

While other inter-state bodies with specific mandates such as the National Development Council ('NDC') have been in operation since the 1950s, the ISC was only set up in 1990 based on the recommendations of the Commission on Centre-State Relations ('Sarkaria Commission') in 1988.<sup>25</sup> This was because it was felt that the issues of Centre-State cooperation were being discussed in a number of different channels in an 'ad hoc and fragmented manner', and that there was a need for a single high-level body that could make authoritative pronouncements on issues of national concern.<sup>26</sup> The need for such a body had become acute since various political parties held power in the States, and co-ordination between the Centre and State could no longer be done through party channels only.<sup>27</sup> Thus, the Sarkaria Commission observed that "there is no high-level coordinating forum other than the Inter-State Council envisaged in Article 263 of the Constitution"<sup>28</sup> and gave recommendations regarding the setting up of such a body, along with the composition and procedures to be adopted by it.

### 3.2. The mandate and functioning of the Inter-State Council

The Inter-State Council Order defines the duties of the ISC as the following:

1. Investigating and discussing such subjects, in which some or all of the States or the Union and one or more of the States have a common interest, as may be brought up before it;
2. Making recommendations upon any such subject and in particular recommendations for the better coordination of policy and action with respect to that subject; and

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<sup>23</sup> Article 263 of the Indian Constitution, 1950.

<sup>24</sup> "Inter-State Council must be a Statutory Body", *Indian Express* (3 September 2014), available at <<http://www.newindianexpress.com/editorials/Inter-State-Council-Must-be-a-Statutory-Body/2014/09/03/article2411184.ece>> accessed on 26 September, 2014.

<sup>25</sup> The Sarkaria Commission added to recommendations by previous Commissions such as the First Administrative Reforms Commission in 1966 and the Rajamannar Committee in 1969, both of which recommended the establishment of an Inter-State Council under Article 263.

<sup>26</sup> Inter-State Council, "Formations", available at <[http://interstatecouncil.nic.in/formations.html#subnav1\\_2](http://interstatecouncil.nic.in/formations.html#subnav1_2)> accessed on 26 September, 2014.

<sup>27</sup> "First Administrative Reforms Commission", available at <[http://interstatecouncil.nic.in/first\\_arc.html#subnav3\\_2](http://interstatecouncil.nic.in/first_arc.html#subnav3_2)> accessed on 26 September, 2014.

<sup>28</sup> Commission on Centre-State Relations at Chapter IX.

3. Deliberating upon such other matters of general interest to the States as may be referred by the Chairman to the ISC.<sup>29</sup>

The ISC has not been assigned the function envisaged in clause (a) of Article 263 of the Constitution, namely inquiring into and advising upon disputes which may have arisen between States.<sup>30</sup> However, the scope of its deliberative powers are broad and generic - as long as States have a common interest, it can be discussed in the ISC and recommendations can be made. Where a topic is one of 'general' rather than 'common' interest, the Chairman (i.e. the Prime Minister) may refer it to the ISC.

In addition, the ISC has framed 'Guidelines for Identifying and Selecting Issues' to be brought up before it to refine its scope. This excludes certain topics from discussion, such as topics which fall under the mandate of the NDC, the Planning Commission, the Finance Commission etc. It also excludes from discussion topics which relate to 'the discharge of any duty or special responsibility of the Union under the provisions of the Constitution or any law of Parliament' unless a majority of members, with the approval of the Chairman, feel it is important to include.<sup>31</sup> Thus, the ISC has itself narrowed the scope of its deliberations considerably, at odds with the broad mandate it received under the Presidential Order, and the reasoning that it would establish itself as the principal platform for discussion and co-ordination.

Further issues plague the functioning of the ISC. The Inter-State Council Order mandates that the ISC meets three times a year.<sup>32</sup> In practice, however, it has only met ten times since its inception in 1990, the last being in 2006.<sup>33</sup> It has not been reconstituted since the 2014 Lok Sabha elections with new Union Ministers.

The meetings of the ISC are held in-camera and its proceedings are not made public. The agenda of these meetings indicates that the chief topic of discussion in a majority of the meetings has been the recommendations of the Sarkaria Commission Report of 1988. In addition, tax matters have been discussed from time to time.<sup>34</sup>

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<sup>29</sup> Clause 4, Inter State Council Order, dated 28 May 1990.

<sup>30</sup> Report of the Commission of Centre-State Relations, Vol. II (March 2010) ('Report of the Commission of Centre-State Relations, Vol. II'). Available at <<http://interstatecouncil.nic.in/downloads/volume2.pdf>> accessed on 27 September, 2014. The Sarkaria Commission, however, had suggested that dispute resolution be included within the mandate of the ISC.

<sup>31</sup> Guidelines for Identifying and Selecting Issues, available at <[http://interstatecouncil.nic.in/guideline\\_identify\\_issues.htm](http://interstatecouncil.nic.in/guideline_identify_issues.htm)> accessed on 27 September, 2014.

<sup>32</sup> Clause 5, Inter-State Council Order, dated 28 May 1990.

<sup>33</sup> Inter-State Council, "Meetings" available at <[http://interstatecouncil.nic.in/meetings.html#subnav1\\_5](http://interstatecouncil.nic.in/meetings.html#subnav1_5)> accessed on 27 September, 2014.

<sup>34</sup> *Ibid.*

Both the Presidential Order and the Guidelines are silent on the consequences of recommendations made by the ISC. There is no positive duty imposed upon the Union or the State Governments to consider these recommendations. This led to the Eleventh Finance Commission (FC-XI) observing that the ISC, which should have been utilised for evolving national consensus on economic and other matters, has not seen ‘effective use’.<sup>35</sup>

Another oft-quoted reason for the limited role of the ISC in its present shape is its lack of functional autonomy, in the absence of a committed professional secretariat.<sup>36</sup> As of July 2014, three of the five senior-most positions in the Secretariat were vacant.<sup>37</sup> Further, the Secretariat is appointed on the choice of the Prime Minister only, with no say from the other members of the ISC.<sup>38</sup> The Secretariat, and as a consequence the ISC, is not sufficiently empowered at present to enable it to function as an effective body.

As international experience discussed above has shown, meaningful State consultation in matters of fiscal allocation requires an effective inter-governmental forum equipped with the technical and bureaucratic support. It is clear from this brief summary of the functioning of the ISC that it cannot perform this task meaningfully in its present form. The next section, therefore, looks at ways in which the ISC can be strengthened.

## 4. Recommendations to Strengthen the ISC

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Three main sets of changes may be considered to the working of the ISC, to fulfil its need for autonomy and effectiveness. First, there is a need for sufficient independent legal standing for it to function autonomously, and for its recommendations to be given due consideration. Secondly, specifically with respect to the issue of fiscal allocations, there is a need for an expert committee to be constituted under the ISC which will present independent recommendations on the financial allocations proposed by the Central Government. Thirdly, there is a need to strengthen the working of the ISC and the expert committee appointed under it with sufficient resources and the requisite infrastructure. This section elaborates on these three measures.

### 4.1. Strengthening the legal position of the ISC

As mentioned in Section 2 of this Note, studies have shown that where the number of federal units is large, as in the case of India, it becomes necessary to establish formal bodies for effective co-operation.

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<sup>35</sup> Eleventh Finance Commission Report (2000), p. 14.

<sup>36</sup> Report of the Commission of Centre-State Relations, Vol. II.

<sup>37</sup> “Deployment position and sanctioned strength of ISCS as on 18<sup>th</sup> July 2014” available at <[http://interstatecouncil.nic.in/downloads/Incumbancy\\_Position\\_ISCS.pdf](http://interstatecouncil.nic.in/downloads/Incumbancy_Position_ISCS.pdf)> accessed on 27 September, 2014.

<sup>38</sup> Clause 6, Inter-State Council Order, dated 28 May 1990.

One suggestion with respect to the functioning of the ISC which draws on this belief is to grant it greater institutional recognition by way of constitutional amendment.

The ISC is a constitutional body envisaged under Article 263 as a forum for consultation and coordination between the States and the Centre. However, it only comes in to existence through a Presidential Order. The Order determines its composition, the number of times it is supposed to meet, and its procedure. It is therefore subject to unilateral alteration by the Central Government. In addition, there are no procedures established with respect to consideration of the recommendations made by the ISC. To address this issue, the Second Commission of Centre-State Relations ('Punchhi Commission') suggested that the ISC should be given either constitutional or statutory status, giving its actions greater authority and respect.<sup>39</sup> This would ensure that the ISC "meets regularly, is endowed with sufficient resources to carry out its functions effectively, is accorded greater deference by the Centre as well as State Governments, and also commands a certain space in the domain of civil society and public deliberation".<sup>40</sup> Similarly, the FC-XI Report suggested making a constitutional amendment to Article 263 to make the ISC responsible for arriving at decisions on fiscal policies having inter-State or Centre-State ramifications as well as ensure that the ISC meets regularly and a national consensus is arrived at all important issues.<sup>41</sup>

In order to provide statutory basis for the ISC, a necessary first step is amendment of Article 263. Currently, Article 263 clearly mandates that the **President** by order may establish an Inter-State Council and define its duties, organisation and procedure. Therefore, statutory basis to the ISC cannot be established simply by Parliament, unless an amendment is introduced to Article 263 to the effect that Parliament may by law determine the composition, powers and procedures of the ISC. This can then be detailed through an act of Parliament. This will grant the same legal status to the ISC as is currently enjoyed by the Comptroller and Auditor General and the Finance Commission.

However, experience from other countries has shown that effective coordination between federal units is largely a matter of convention and practice rather than simply legislative prescription. In India, the Finance Commission also serves as a good example of this proposition. It is a constitutional body set up by a Presidential Order along with some supporting legislature, but the majority of its practice, and the acceptance of its recommendations, has developed through convention. Therefore, as an alternative to introducing a Constitutional amendment, which is a cumbersome process, Sections 4.2 and 4.3 below suggest other ways in which the objective of a stronger ISC may be achieved, by promoting the adoption

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<sup>39</sup> *Supra* note 36.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Supra* note 35, p. 35.



of appropriate conventions, and making small changes to the existing Presidential Order setting up the ISC.

The other question related to the legal position of the ISC has been whether to make its recommendations binding on the Centre and the States.<sup>42</sup> The language of clauses (b) and (c) of Article 263, which lay down the scope of the role of the ISC, envisage a recommendatory role for this body, using language such as “investigating and discussing subjects...” and “making recommendations upon any such subjects”. Further, while suggesting that the ISC should be formed, the Sarkaria Commission categorically stated that it should be a recommendatory and advisory body and “it will not therefore in any way erode or encroach upon the responsibilities and powers which, under the Constitution, are the exclusive concern of the Union and the States, respectively”.<sup>43</sup> The Punchhi Commission considered this suggestion in detail in its report but ultimately stated that making the recommendations binding would go against the constitutional framework of separation of powers and was not feasible in a federal system.<sup>44</sup> Rather, it suggested that the ISC is important for consensus-building and voluntary settlement of disputes and needs to be strengthened in other aspects.<sup>45</sup> This is an important point to be considered when tackling the issue of whether the ISC can take over the task of financial allocations currently performed by the Planning Commission. Looking at the language of Article 263 outlining the scope of the ISC, it is clear that the ISC is better suited to a recommendatory role, rather than a primary role in the allocation of financial resources.

While the recommendations of the ISC should not be made binding, it may be considered to impose a positive duty upon the Centre and States to give due consideration to any such recommendations. This is elaborated on further in Section 4.2.3 below.

#### 4.2. Need for technical expertise

For the ISC to make relevant suggestions on matters such as the complex system of grant-making, its policy research and investigation capacity must be significantly strengthened. This has been a long-standing suggestion - the Sarkaria Commission, for example, suggested that the proposed Inter-State Council and its standing committee should be given the power to set up ad hoc Sub-Committees to investigate special matters.<sup>46</sup> In addition, the Punchhi Commission also recommended that the ISC could

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<sup>42</sup> “Rajamannar Committee” available at <[http://interstatecouncil.nic.in/rajamannar.html#subnav3\\_3](http://interstatecouncil.nic.in/rajamannar.html#subnav3_3)> accessed on 27 September, 2014; Amitabha Pande, “PM Narendra Modi should resurrect inter-state council to firm up his federalist intentions”, *Economic Times* (2 September 2014) available at <[http://articles.economictimes.indiatimes.com/2014-09-02/news/53480173\\_1\\_pm-narendra-modi-inter-state-council-gst](http://articles.economictimes.indiatimes.com/2014-09-02/news/53480173_1_pm-narendra-modi-inter-state-council-gst)> accessed on 28 September, 2014.

<sup>43</sup> *Supra* note 28.

<sup>44</sup> *Supra* note 36.

<sup>45</sup> *Ibid.*

<sup>46</sup> *Supra* note 43.

have expert advisory bodies or administrative tribunals with quasi-judicial authority to give recommendations to the ISC if and when needed.<sup>47</sup>

A study of international theory on fiscal transfers showed that sound systems are built around pre-articulated constitutional principles, rather than ad hoc political bargains. Such systems are more feasible and transparent. Implementation of such principles, however, rapidly becomes a complex task requiring high levels of information and technical expertise.<sup>48</sup> In response to similar challenges in Canada, South Africa and Australia, the solution has been to set up expert bodies with members who have specialised in relevant subject areas.<sup>49</sup> This was the reasoning behind the establishment of the Finance Commission as a neutral expert authority in the Constitution as well.<sup>50</sup>

From this lesson, we can establish that for the ISC to provide relevant inputs on proposed financial allocations, it would require specialised assessment of the proposals from experts who are appointed by the ISC, yet are sufficiently removed from political considerations to make an independent assessment. An Expert Committee may therefore be constituted under the ISC with a two-year term, with the mandate of providing inputs on grants that the Centre proposes to make to the States, which are currently allocated by the Planning Commission. The following sub-sections explore some options regarding the composition and qualifications of such a body, as well as suggested procedures to be followed in the formulation and consideration of recommendations by this body.

#### 4.2.1. Composition of Expert Committee

The challenge with the appointment of an Expert Committee by a body such as the ISC is to keep the numbers small enough for the Committee to function effectively, yet reflect the often disparate concerns of the various State units and the Centre. This is a challenge that has been faced in other countries as well, with varying solutions. In this sub-section, we present various options regarding the method of appointment of the Expert Committee by the ISC, based on international experience.

The Committee should ideally be a small group. One combination could be to have twelve members: six State representatives and six representatives of the Centre. Such a combination would ensure equitable participation from the States and the Centre. The chairperson of the Expert Committee, who would be a member appointed to the post by the Prime Minister, would have a casting vote in case of any ties. In addition, it may be useful to have an ex-officio member who is a senior bureaucrat from the Union

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<sup>47</sup> *Supra* note 44.

<sup>48</sup> *Supra* note 12, p. 93.

<sup>49</sup> See, for example, the composition of the Australian Commonwealth Grants Commission, the Canadian Expert Panel on Equalization and Territorial Formula Financing Website and the South African Financial and Fiscal Commission

<sup>50</sup> Constitutional Assembly Debates, 4 November 1948, available at <<http://www.indiankanoon.org/doc/1054056/>> accessed on 28 September, 2014.

Ministry of Finance, to ensure co-ordination between the expert committee's recommendations and the ministry.

To determine State representation, some form of regional grouping should be adopted for States to ensure that there is equitable geographical distribution in the membership of Expert Committee (for example, to ensure that there is always representation from the North-East). Election of members on the basis of geographical distribution is a common criterion for appointment in international bodies, especially within the United Nations. For example: in the International Court of Justice, the fifteen judges are appointed not only on the basis of the prescribed highest legal qualifications,<sup>51</sup> but also with due regard to ensuring that the judges-elect represent 'the main forms of civilization' and the 'principal legal systems of the world'.<sup>52</sup> Similarly, one of the considerations for appointment of non-permanent members to the Security Council is equitable geographical distribution.<sup>53</sup>

In India, one possible regional model to be followed is the grouping done for Zonal Councils, wherein six Zonal Councils currently exist on the basis of geography.<sup>54</sup> This could be used as a model given the advantage of familiarity of such grouping. However, an issue with using this grouping is that the groups are not equal in size, i.e. some groups have more States than others, thereby making the nomination frequency dependant on the group the State is in. Therefore, a new grouping of States may also be envisaged where each group ideally consists of the same number of States.

Once these groups are formed, the expert members can be nominated to the ISC in one of the following ways:

1. The first option would be for the ISC to collectively appoint the Expert Committee through majority voting. In this process, each State would nominate one Expert; the nominees would be grouped in accordance with the State groups; and the entire ISC would vote to elect one member from each group. In addition, the Centre would nominate ten members and the ISC would collectively elect six members from the Central list. This is similar to the process followed in the appointment of the UNESCO Executive Board.<sup>55</sup> The advantage of this approach is that the Expert

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<sup>51</sup>Article 2 of the Statute of the International Court of Justice, 1945.

<sup>52</sup> *Ibid* at Article 9; See also *Starke's International Law* 449 (11<sup>th</sup> ed., I.A. Shearer, ed., New Delhi: Oxford University Press, 1994). Under a kind of 'gentleman's agreement' applicable, the regional distribution of judges to be elected is: Africa: 3; Latin America: 2, Asia: 3, Western Europe and other countries: 5; Eastern Europe: 2.

<sup>53</sup> Article 23 of the Charter of the United Nations, 1945. See also Brian Lai and Vanessa A. Lefler, "U.N. Security Council Non-Permanent Membership: Equitable Distribution for equitable Representation?", available at <<http://myweb.uiowa.edu/bhlai/workshop/lailefler.pdf>> accessed on 28 September, 2014. At present the ten non-permanent Security Council seats are distributed according to four regional electoral groupings: Africa and Asia, Eastern Europe, Latin America and the Caribbean, and the Western European and Others group.

<sup>54</sup> Zonal Councils, "Background", available at <[http://mha.nic.in/zonal\\_council](http://mha.nic.in/zonal_council)> accessed on 28 September, 2014.

<sup>55</sup> Appendix 2, Rules of Procedure of the General Conference, UNESCO, available at <<http://unesdoc.unesco.org/images/0018/001874/187429e.pdf#page=65>> accessed on 29 September, 2014.

Committee is appointed collectively by the ISC, while the disadvantage is the potential lack of consensus if the ISC as a whole has to agree on the composition of the group.

2. The second option is to have each State group nominate one person to the Expert Committee, and the Centre to nominate six members. Within a group, members should be sent to the Committee on a rotating basis. This will ensure that each State gets representation in turn in the Expert Committee, while regional representation is also maintained. The advantage of this option is that there is less chance of conflict between the States with respect to deciding the composition of the Expert Committee, and each State would have a chance to have its appointee on the Committee at some point.

A number of different methods may be followed in the appointment of the Expert Committee. Of the two considered here, the second alternative is preferable since it allows for representation by every State in the Expert Committee by rotation.

#### **4.2.2. Qualifications of Members**

There must be some minimum qualifications prescribed, in the manner of Finance Commission, for a person to be nominated and appointed on this Expert Committee. This is to ensure that the members of this group are not purely political appointees, but also have the requisite expertise and can make valuable recommendations that will not only benefit the States they represent, but the entire fiscal system. Some possible qualifications, adapting the ones required for the Finance Commission, could be:

1. having substantial experience in the fields of economics, public administration, finance, management, etc.; and
2. have special knowledge of the finances and accounts of government.<sup>56</sup>

#### **4.2.3. Procedure for the Report of the Expert Committee**

In addition to appointing a qualified Expert Committee, it is important to establish procedures regarding its workings, and the implementation of its final report. The Committee should be empowered to extensively consult with Union and State Ministries, independent regulators and experts, and also receive dedicated research and technical support from a committed secretariat. Suggestions with regard to strengthening the secretariat are detailed in Section 4.3 below.

It is also very important to empower the ISC to be able to follow up on the implementation of its decisions in a structured manner, and such procedure should be provided for in the new statute governing the ISC, or in the Order setting up the ISC, as the case may be.<sup>57</sup> As observed by the Punchhi Commission, “the

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<sup>56</sup> See Section 3, The Finance Commission (Miscellaneous Provisions) Act, 1951; Section 3(3), Lokpal and Lokayuktas Act, 2013.

<sup>57</sup> See Report of the Commission of Centre-State Relations, Vol. II.

Government will be well advised to evolve an appropriate scheme to utilise the full potential of ISC in harmonising Centre-State relations which has become urgent in the changed circumstances”.<sup>58</sup>

The South African model is a useful one to study in this context. In South Africa, the Inter-governmental Fiscal Relations Act, 1997 formalises the process of consultation to be followed before the Budget is presented. It mandates that the South African Fiscal and Financial Commission make recommendations on revenue sharing and fiscal allocations to the Central Government, following which the Union Finance Minister **must** consult with the Budget Council, which consists of the Finance Ministers of the Union and the Provinces.<sup>59</sup> Timelines regarding the consultation are also prescribed in the law to ensure that the Budget Council has adequate time to consider the proposals of the Union. Enshrining of the process of consultation in law goes a long way in establishing the importance of consultation with the States in matters of fiscal allocations by way of grants.

Similarly, it could be provided under the new law governing the ISC, or by amending the Presidential Order constituting the ISC, as the case may be, that the financial allocations proposed by the Central Government are to be placed before the ISC within a certain time frame. The ISC may in turn refer it to the Expert Committee for its recommendations. These may be adopted or rejected by the ISC, and a duty placed upon the Central Government to give due regard to the ISC’s recommendations. As with the recommendations of the Finance Commission, the Finance Ministry may be obliged to present a memorandum explaining the actions it has taken with respect to the ISC’s recommendations.

#### 4.3. Other Suggestions to Strengthen the ISC

In order to increase the efficiency and competence of the Expert Committee as well as the ISC, it should be given sufficient resources and authority to carry out its functions effectively and autonomously as an independent constitutional body.<sup>60</sup> Some suggestions in this regard are as follows:

1. Staff from both the Centre and the States should be appointed to the Secretariat of the ISC, in order to inspire confidence and enhance co-ordination.<sup>61</sup> This is the approach followed in Canada where a dedicated Inter-Governmental Conference Secretariat facilitates co-ordination between provinces.
2. The meetings of the ISC should be conducted more frequently, at least thrice a year,<sup>62</sup> with detailed preparation of the agenda by the Secretariat in consultation with the parties, and

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<sup>58</sup> *Ibid.*

<sup>59</sup> Section 10(3), Inter-Governmental Fiscal Relations Act, 1997.

<sup>60</sup> *Supra* note 36.

<sup>61</sup> *Supra* note 36.

<sup>62</sup> This is also provided for in the Inter-State Standing Order, dated 28 May 1990.

position papers from all relevant parties.<sup>63</sup> Such agenda, papers etc. should be circulated prior to the meeting to ensure adequate preparation and understanding of the different viewpoints and would ultimately promote consensus building in the meetings.<sup>64</sup>

3. The infrastructure and resources of the Secretariat should be enhanced to make it more efficient.<sup>65</sup>

The ISC should also be a platform where continuing consultations between State bureaucrats and Ministers take place. An example that may be followed in this regard is the bi-annual conference of State Finance Secretaries organised by the Reserve Bank of India. These conferences are held on a voluntary basis, despite there being no statutory obligation.<sup>66</sup> Regular meetings of State officials from various levels of government can inform the working of the Expert Group and allow them to get an accurate picture of the issues faced by States in fiscal matters.

Finally, the Report of the National Commission to Review the Working of the Constitution had suggested that it was desirable for the States to be involved in deciding additional terms of reference of the Finance Commission and this could be done through the NDC discussing and endorsing such additional terms of reference which would take care of aspects of the financial relations between the Centre and the States in a comprehensive way.<sup>67</sup> It is suggested that such discussion and endorsement may be done by the ISC instead of the NDC.

#### 4.4. Relationship between the ISC and the NDC

A final point to be considered with regard to the functioning of the ISC is its relationship to the NDC, going forward. At present, the scope of the ISC is curtailed as its guidelines indicate that it will not discuss a topic that falls within the ambit of the NDC.<sup>68</sup>

The NDC was set up on 6 August 1952 by an executive order on the recommendation of the Planning Commission. It however has not been set up under Article 263 and thus its constitutional validity is not as firm as that of the ISC. Further, going strictly by the wording of Article 263, the mandate of the NDC

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<sup>63</sup> *Supra* note 36.

<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid.*

<sup>66</sup> Dr. Y.V. Reddy, “The Reserve Bank and the State Governments: Partners in Progress” (24 September 2007). Available at <[http://www.rbi.org.in/scripts/BS\\_SpeechesView.aspx?Id=355](http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=355)> accessed on 29 September, 2014.

<sup>67</sup> The Report of the National Commission to Review the Working of the Constitution, Volume I, Chapter 8 (31 March 2002). Available at <<http://lawmin.nic.in/ncrwc/finalreport/v1ch8.htm>> accessed on 29 September, 2014.

<sup>68</sup> Guidelines for Identifying and Selecting Issues, available at <[http://interstatecouncil.nic.in/guideline\\_identify\\_issues.htm](http://interstatecouncil.nic.in/guideline_identify_issues.htm)> accessed on 29 September, 2014.

is narrower than that of the scope envisaged for the ISC, and it essentially acts as an adjunct body to the Planning Commission.

It is unclear what the role of the NDC would be after the dismantling of the Planning Commission. It would be more efficient, and have a stronger constitutional basis, to merge the NDC with the ISC, and transfer some of the manpower and assets of the Planning Commission to the ISC Secretariat.<sup>69</sup> This would also avoid potential duplication of work.

## 5. Conclusion

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Based on the above discussion, this note concludes that the ISC should be strengthened in order to play an effective consultative role in the task of financial allocations, while the primary decision making process should remain in the domain of the Central Government. In order to strengthen it in its functioning, a number of steps can be taken including:

- a. Improving the effectiveness of ISC by establishing clear norms for consultation between the Centre and the States through the platform of the ISC;
- b. Setting up an Expert Committee with adequate regional representation and infrastructure, along with a clear procedure for making recommendations on fiscal allocation to States;
- c. Improving the bureaucratic machinery that supports the ISC; and
- d. Merging the NDC with the ISC.

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<sup>69</sup> Amitabha Pande, "PM Narendra Modi should resurrect inter-state council to firm up his federalist intentions", *Economic Times* (2 September 2014). Available at <[http://articles.economictimes.indiatimes.com/2014-09-02/news/53480173\\_1\\_pm-narendra-modi-inter-state-council-gst](http://articles.economictimes.indiatimes.com/2014-09-02/news/53480173_1_pm-narendra-modi-inter-state-council-gst)> accessed on 29 September, 2014.