



CHALLENGING THE CONSTITUTIONALITY OF THE FINANCE COMMISSION'S RECOMMENDATION

By Shivesh Raj Jaiswal & Anind Umrao
From Dr. Ram Manohar Lohiya National
Law University.

Abstract

The Union Government of India collects various kinds of taxes by making legislations under several heads enshrined under List I appended to the seventh schedule to the Constitution. But these collections are not there for mere use of the Union rather a portion of it is to be 'mandatorily' devolved to the states so as to enable them to meet their expenditure and perform their constitutional functions properly and thus a fiscal-federal relation is maintained in this way. This devolution or distribution of revenue (net proceeds) by the Union to the states is done on the basis of a formula devised by the Finance commission every five-year. This formula takes into account various requirements, performances, geographical conditions et cetera of the states. The Finance Commission makes a balance between "fulfilling the needs of poor/week states" and "incentivizing or rewarding the healthier states for their good performances".

Consider a scenario wherein the finance commission has devised a formula which is economically devastating for a state or a

group of states. Since the fiscal relations is the soul of the federal relation between the Centre and the States because without adequate revenue no state can perform its constitutional functions properly (especially the functions of a welfare state leave alone the bigger projects for infrastructural developments). This paper attempts to answer whether the finance commission's recommendation (particularly the formula devised by it) can be challenged by the states before the Supreme Court on the ground that the same is violative of the "Federal Structure of the Constitution" which is an indispensable part of its "Basic Structure".

Introduction

It is a settled principle of law under the Indian Constitutional Jurisprudence that only 'Constitutional Amendments' can be challenged on the grounds of the violation of the "Basic Structure" whereas ordinary legislations or policy matters cannot be challenged on the said ground. The apex court, in catena of cases¹, has explicitly confirmed the non-applicability of the *Basic Structure Test*² on Legislation and Policy matters of the government. However, the apex court in *Supreme-Court-Advocates-on-Record-Association v. Union of India*³ (popularly known as NJAC case) has opined that even legislations are not immune from the Basic Structure Test.

Part XII of the Constitution has been embodied by the Constitution framers to ensure the 'equitable distribution' of revenues between the Centre and the States⁴ which means to keep the Federal relations economically intact. Beside this, the Finance

¹For eg- *Ashok Kumar Thakur v Union of India*¹, *Indira Gandhi v Raj Narain* 1976 (2) SCR 347

² *Kesavananda Bharti v. State of Kerala* AIR 1973 SC 1461

³ *Supreme-Court-Advocates-on-Record-Association v Union of India* (2015)

⁴ Article 270, 275 and 280



Commission has to take into consideration the fundamental principles governing revenue devolution⁵ to ensure fiscal-federal-equity and horizontal-balance. An equitable distribution of revenue amongst states reasonably taking into account their 'fiscal needs' and 'developmental performances' in the previous term. 'Horizontal balance' refers to the equitable distribution of revenue between the states considering their needs, poverty, geographical conditions as well as their developmental performances.

There is no fixed or rigid 'revenue-devolution-formula' or 'method' which is binding on the Finance Commission. The Commission is very much free to keep varying the revenue devolution as per the varying needs of states every five years because the states' financial conditions and performances keep changing over the period time. But what is to be kept in mind while enacting any such formula is that any state or states should not be arbitrarily prejudiced or highly discriminated in terms of revenue allotment. A normal here and there will not be of much concern as any formula cannot satisfy all the needs of all the states. Rather what could be problematic is 'a highly-inequitable-devolution' hampering the fiscal capacity of any state or group of states disabling them to perform their constitutional obligations or welfare-functions. Although such extreme discrimination has not been hitherto witnessed in the Indian Constitutional history but it cannot be altogether ruled out for all future purposes. For example, such radical discrimination may be because of the difference of political

parties ruling at the Central level and the State/ States concerned.

The question arises: *What if the Finance Commission poorly fails in devising such equitable formula and instead devices one which is highly detrimental to the fiscal-federal-structure of the nation which (federal structure⁶) is the part of the basic structure of the Constitution?* The first question automatically leads to a second enquiry viz. *Will the Judiciary, in such scenario, act as a spectator with the rigid attitude of non-interference in policy matters or will it reject the alleged formula devised by experts who had failed in fulfilling their obligation properly?* This paper does not suggest that the judiciary should devise its own formula to replace that of the experts rather it points out to a situation where judicial interference becomes quintessential wherein states' economic rights are radically jeopardized and ultimately resulting in their economic-subversion. This research work attempts to answer the aforementioned queries in two prospective parts viz.-

(A) Whether the Finance Commission's recommendations and policy decisions can be challenged on the ground of the violation of the federal structure of the Constitution of India?

(B) What reasons, if at all, can lead to a judicial interference in challenging such policy decisions on the ground of the Basic structure doctrine?

⁵ A report in this regard was submitted by Professor Adarkar in the Constituent Assembly in the form of Nehru Adarkar-Report.

⁶ In *S.R Bommai v Union of India*, the apex court held that the federal structure of the Indian Constitution is the part of its basic structure



Coming to the first enquiry viz.-

(A) Whether the Finance Commission's recommendations and policy decisions can be challenged on the ground of the violation of federal structure of the Constitution?

Before going into this question it would be indispensable to enquire whether a highly detrimental formula devised by the Finance Commission would lead to violation of a "legal right" of a state as mentioned in Article 131 so as to enable it to invoke the said article. As we know that the disputes between the Centre and the States come within the Original Jurisdiction of the Supreme Court as per Article 131 hence state/states must be having sufficient grounds to take resort of the said provision of the Constitution. Therefore, another sub-question arises:

(A.1) Whether the "revenue-devolution-formula" enunciated by the finance commission can be challenged before the Supreme Court under Article 131?

This line of argument in this paper would go on to state as to how the issues and matters related to the Finance Commission's recommendation cannot be adjudicated or decided under Article 131 of the Constitution of India because for invoking the said Article

there must be violation of a 'legal right.'⁷ Article 131 reads as follows:

"131- Subject to the provisions of this Constitution, the Supreme Court shall, to the exclusion of any other court, have original jurisdiction in any dispute:

(a) between the Government of India and one or more States; or"

".....if and in so far as the dispute involves any question (whether of law or fact) on which the existence or extent of a legal right depends".

The phrase 'legal right' under Article 131 does not include economic and political considerations with which the courts of law have no concern.⁸ It would exclude question of policy in the absence of violation of any Constitutional provision⁹ and a policy decision taken by the Government cannot be held unconstitutional for the sole reason that another policy decision would have¹⁰ been wiser, logical, fairer or more scientific.¹¹ The Constitution excludes the matter and questions relating to distribution of revenue from justiciability because the same has been vested in a specific authority¹²(i.e. Finance Commission). Even the eminent Constitutional law expert H.M. Seervai in his famous treatise on Indian Constitution has opined that the matter relating to five-year plans are not justiciable in the court of law.¹³

⁷ VN Shulka, Constitution of India (514-519), EBC Publications 12th Edition 2013.

⁸ Durga Das Basu, *Commentary on the Constitution of India* 9379 (9d ed., LexisNexis 2017).

⁹ *State of Rajasthan v. Union of India*, A.I.R. 1977 S.C. 1361.

¹⁰ Dr. Uday Shankar & Saurabh Bindal, Policy Initiatives and the Role of Indian Judiciary, SCC Online Blog (february 5, 2020, 7:12 PM), [https://blog.sconline.com/post/2016/05/19/policy-](https://blog.sconline.com/post/2016/05/19/policy-initiatives-and-the-role-of-indian-judiciary/)

[initiations-and-the-role-of-indian-judiciary-initiations-and-the-role-of-indian-judiciary/](https://blog.sconline.com/post/2016/05/19/policy-initiatives-and-the-role-of-indian-judiciary/).

¹¹ *In re Permian Basin Area Rate cases*, 390 U.S. 747 (1968); *State of Madhya Pradesh v. Nandlal Jaiswal*, (1986) 4 S.C.C. 566, 605, 606; *Balco Employees Union v. Union of India*, A.I.R. 2002 S.C. 350.

¹² 9 Durga Das Basu, *Commentary on the Constitution of India* 9379 (9d ed., LexisNexis 2017).

¹³ H.M. Seervai, *Constitutional Law of India: A Critical Commentary* 2626 (4d ed., Universal Law Publishing 2015).



Moreover, the expert committee in the Constituent Assembly has also stated that the Commission would act as an arbitrator and its decision would be final¹⁴ thereby suggesting that the law courts should not interfere in such matters.

(A.2) Approach of Non-intervention by Indian Judiciary in Tax, Economic and policy Matters

It is an established principle of law that *only* Constitutional Amendments can be challenged on the ground of violation of the Basic Structure of the Constitution and not legislations or fiscal policy matters.¹⁵ A formula once accepted by any government becomes law¹⁶ as per the Finance Act. So, a Finance Commission's recommendation after its acceptance by the government is merely a 'law. A combined reading of the Article 270, 275 and 280 of the Constitution of India suggest that the same cannot be challenged on the ground of it being in violation of the Basic Structure of the Constitution rather it can only be challenged on the ground of violations of the provisions of the Constitution. It is a well-recognized constitutional rule and practice that legislations are challenged only if they violate any constitutional provision and Constitutional Amendments are challenged if they violate the basic structure of the Constitution as laid down in *Kesavananda*

bharti v. State of Kerala and supplanted by many subsequent decision of the apex court.

Moreover, it has been settled that the judiciary should not interfere in policy matters of the government.¹⁷ The devolution of revenue to the states by the Union Government based on Finance Commission's recommendation is completely a policy matter and the same should be left with the wisdom of the policy-makers. Furthermore, in tax and economic matters judiciary must restrain itself from interfering and indulging in law-making and these matters should be viewed with greater latitude.¹⁸ The greater the policy content of a dispute, the more reluctant the court must be to hold the said policy decision as unreasonable in law.¹⁹ A formula devised by the Commission may be imperfect but the same is not necessarily unreasonable in a legal sense.²⁰

Further, in the exercise of the power of judicial review, courts cannot and do not enquire into the "questions of wisdom" behind a legislative measure. The viability of any Formula has to be decided by the experts in the Finance Commission and the task of the court is the interpretation of laws and adjudication of their validity but not to approve nor disapprove legislative *policy*.²¹ Hence any policy related decision taken by the Government is not liable to interference²² unless and until the Court is satisfied that the law-making authority or

¹⁴ H.K. Paranjape, *Task of the Ninth Finance Commission: The Planning Commission Tangle*, 23 (38) E.P.W. 1953-58 (1988).

¹⁵ *V. C. Shukla v. State Delhi Administration*, A.I.R. 1980 S.C. 1382 (1418).

¹⁶ *Dhires Chandra Dutta v. State of Tripura*, 1999 1 Gau. L.R. 98.

¹⁷ *Fertilizer Corporation Kargar Union v. Union of India*, 1981 S.C.R. (2) 52, *State of Madhya Pradesh v. Nandlal Jaiswal*, (1986) 4 S.C.C. 566.

¹⁸ *R. K. Garg v. Union of India*, (1981) 4 S.C.C. 675.

¹⁹ *R v. Ministry of Defence*, [1996] Q.B. 517, 556.

²⁰ *Fawcett Properties Ltd. v. Buckingham County Council*, (1961) A.C. 636; *Taiarora v. Minister of Justice*, (1995) 1 N.Z.L.R. 411.

²¹ *Keshavananda Bharati v. State of Kerala*, A.I.R. 1973 S.C. 1461, 1534.

²² *Akhil Bharat Goseva Sangh v. State of Andhra Pradesh*, (2006) 4 S.C.C. 162.



institution has acted arbitrarily or in utter ignorance or violation of the fundamental rights.²³

In Economic Considerations the court doesn't put itself in the shoes of the Experts

Formulation of an economic policy is considered to be a function of experts²⁴ and the courts do not weigh it on its pros and cons or its beneficial disposition rather the same can only be checked only on the grounds of 'Arbitrariness', 'Constitutionality' or 'it being in violation of any statute'.²⁵ Hence, in the context of the dynamic economic scenario, the expertise of people dealing with the subject concerned should not be interfered with.²⁶ Once it is proved that the authority acted within their vires then the Constitution does not allow the court to advise or direct the executive in the matters of policy²⁷ or to supplant the ideas of experts with its own views.²⁸

The devising of 'revenue-devolution-formula' is a complex economic function based on experimentations and empirics hence its validity cannot be tested on any strait-jacket formula.²⁹ Even if a policy is unscientific or illogical these errors are not subject to judicial review, rather they can be declared void only on the ground of 'arbitrary

exercise of power'.³⁰ Moreover, the court cannot invalidate a policy-decision taken by any Government merely because another policy decision would have been better, fairer, scientific or more logical.³¹ While exercising the power of judicial review, the court should not be ignorant of the "practical needs of the Government" and the window must be left open for "trial and error" because the Constitutional Law, like other mortal contrivances, has to take some chances.³²

Moreover, a revenue devolution formula cannot be struck down merely because there is a variation or contradiction³³ with the previous formula. Even in the past, the courts have refused to interfere with economic policy or directions given by Reserve Bank of India³⁴ and findings of expert bodies like pay commissions.³⁵ In the *Bank Nationalization case*³⁶ the argument that nationalization of banks is against public interest was not accepted by the apex Court because that issue pertains to the economic policy of the Government whose wisdom was not the concern of the Court.

Now we would posit our question again: *What if the Finance Commission poorly fails in devising an equitable formula and enacts one which is highly detrimental to the fiscal-*

²³ *K. Narayanan v. State of Karnataka*, A.I.R. 1994 S.C. 55.

²⁴ *Peerless General Finance and Investment Co. Ltd. v. R.B.I.*, (1992) 2 S.C.C. 343.

²⁵ *State of Punjab v. Ram Lubhaya Bagga*, A.I.R. 1998 S.C. 1703.

²⁶ *Bhavesh D. Parish v. Union of India*, (2000) 5 S.C.C. 471.

²⁷ *Asif Hamid v. State of J & K*, A.I.R. 1989 S.C. 1899.

²⁸ *Shri. Sitaram Sugar Company Limited v. Union of India*, 1990 S.C.R. (1) 909.

²⁹ *Metropolis Theater Co. v. City of Chicago*, 228 U.S. 61 (1913).

³⁰ *Id.*

³¹ *In re Permian Basin Area Rate cases*, 390 U.S. 747 (1968).

³² *Keshavananda Bharati v. State of Kerala*, A.I.R. 1973 S.C. 1461, 1535.

³³ *T.N. Education Deptt. Ministerial and General Subordinate Services Assn. v. State of Tamil Nadu*, (1980) 3 S.C.C. 97.

³⁴ *Peerless General Finance and Investment Co. Ltd. v. R.B.I.*, A.I.R. 1992 S.C. 1033.

³⁵ *K. Vasudevan Nair v. Union of India*, 1991 Supp. (2) S.C.C. 134.

³⁶ *R.C. Cooper v. Union of India*, A.I.R. 1970 S.C. 564.



federal-structure of the nation? Wouldn't that be a violation of the basic structure of the Constitution? This leads us to another line of argument viz. -

(B) What reasons, if at all, can lead to a judicial interference in challenging such policy decisions on the ground of the Basic structure doctrine?

Another line of argument is that the Indian Courts, in several cases, have held that they would not hesitate to interfere and decide upon policy matters taken by the government if the same are *malafide*, capricious or arbitrary. Such category of cases can be further divided into two categories: (a) *first being the matters pertaining to the general policy decisions of the government;* (b) *and the other being the issues and matters pertaining to the fiscal policies of the state.* In the former category, when such policy decisions are mala fide, arbitrary, or contravenes the law of the land the Indian courts have widened the ambit of its power of judicial review whereas in the latter category, the scope of such judicial scrutiny is far narrower.

The financial arrangement enshrined under Part XII of the Indian Constitution has been framed by the Constitution makers in such a manner so as to ensure an “equitable distribution” of the revenues between the Centre and the states and amongst states.³⁷ Equitable distribution means such devolution of net proceeds³⁸ which can meet the needs of the states (especially the poor and weaker

ones) as well as incentivize the ‘good-performing-states’. So one can also argue in the light of the same that the ‘equitable-distribution-rights’ of any state may be violated if Finance Commission acts arbitrarily, unreasonably or capriciously with complete or substantial disregard to the needs of the States or if the Commission propounds any devolution formula which brazenly violates the fundamental principles of revenue devolution such as Progressivity, Elasticity, Adequacy, responsibility etc. And such violation of ‘equitable-distribution-right’ would lead to the violation of a ‘legal right’ as embodied under Article 131. Hence, once a state / states *prima facie* show/s before the Supreme Court that its ‘legal right’ has been violated then Article 131 can be invoked and the apex court would adjudicate the matter.

Ultimately such adjudication would automatically lead to the adjudication over the constitutionality of the ‘revenue-devolution-formula’ as devised by the Finance Commission. If the formula enacted by the Finance commission violates the ‘equitable rights’ of the states then that would automatically be a violation of a legal right, as the phrase ‘legal right’ incorporates ‘equitable rights’ as well³⁹ and violation of those equitable rights of the states would ultimately tantamount to ‘outraging the federal features of the Constitution’ which is a part of its Basic Structure⁴⁰.

³⁷ Indian Const. arts. 264-281.

³⁸ Article 279(1) of the Indian Constitution defines net proceeds as: “*net proceeds means in relation to any tax or duty, the proceeds thereof reduced by the cost of collection, and for the purposes of those provisions the net proceeds of any tax or duty or any part of any tax or duty, in or attributable to any area*

shall be ascertained and certified by the Comptroller and Auditor –General of India, whose certificate shall be final.”

³⁹ *Dominion of Canada v. Province of Ontario, (1910) A.C.637,647.*

⁴⁰ *I.R. Coelho v. State of Tamil Nadu, A.I.R. 2007 S.C. 861.*



Besides this, the court has the power to prevent an unreasonable experimentation⁴¹ and the same can be struck down on the ground of unreasonableness,⁴² capriciousness or arbitrariness.⁴³

Where the State policy is in conflict with the Constitution, courts have to determine whether the State has failed to give effect to its constitutional obligations⁴⁴ and if the state fails in doing so the court is obliged to declare the same as unconstitutional even if that declaration amounts to encroachment into the executive's domain because such intrusion is mandated by the constitution itself and there arises *no* invocation of the *separation of powers* doctrine.⁴⁵

Moreover, the criteria for revenue distribution between states must not substantially affect the 'horizontal-fiscal-federal' principle. In an explicit "recognition of vertical and horizontal imbalances", the Constitution of India embodies some 'enabling' as well as 'mandatory provisions'⁴⁶ to address the same by revenue-transfer from the Union to the States.⁴⁷ And when the 'mandatory provision' (Article 270) would be violated in an arbitrary manner defeating the very purpose of those provisions then there would arise a question for safeguarding the federal structure of the Indian Constitution.

B.1 The Finance Commission's recommendation becomes 'law' once it is accepted by the Union and the same can be challenged on the ground of Basic Structure Doctrine

In this paper what we are talking to challenge before the Supreme Court is the finance Commission's Recommendation. The Recommendation *per se* would not be brought before the Supreme Court for its adjudication rather the accepted recommendation which becomes law after its acceptance would be challenged because as we know that the mere recommendation is just an unenforceable policy until accepted by the Government. Further submission would show how the Finance commission's recommendation becomes 'law' so as to be challengeable constitutionally.

Clause (2) of Article 270 of the Constitution tells that the net proceeds 'shall' be distributed among the states in such a manner as may be "prescribed" in the manner provided in clause (3). After this, clause (3) goes on to define the word 'prescribed'. As per clause (3), 'prescribed' means-

- (i) "Until a Finance Commission has been constituted, prescribed by the President by order, and"
- (ii) "After a Finance Commission has been constituted, prescribed by the President by order after considering the recommendations of the Finance Commission."

For our purpose we are concerned with the meaning of the word 'prescribed' as embodied in sub-clause (ii) of Article 270(3). As per the combined reading of clause(1),(2) and sub clause (ii) of clause (3) of the said Article, the distribution of net proceeds shall be prescribed by an order passed by the

⁴¹ B.H. Siegan, *Economic Liberties and the Constitution* (2d ed., Transaction Publishers 2005).

⁴² *New State Ice Co. v. Liebmann*, 285 U.S. 262 (1932).

⁴³ *Chandler v. Florida*, 449 U.S. 560 (1981).

⁴⁴ Indian Const. arts. 270, 275 and 280.

⁴⁵ *Minister of Health v. Treatment Action Campaign*, 2002 (5) S.A. 721.

⁴⁶ Indian Const. arts. 270 & 275.

⁴⁷ Indian Const. arts. 268-293.



president and such order shall be passed after considering the recommendation of the Finance Commission. As we have hitherto known that the “revenue-devolution-formula and method” devised by the Finance commission would be there in such recommendation and the order of the President would be a “law” and would be binding on the Union Government. Moreover, the Finance Commission’s recommendation once accepted becomes binding on the government.⁴⁸

When the recommendation of the Finance Commission is accepted by the Union government there arises ‘legitimate expectation’ on the part of various state governments. Hence, any arbitrary deviation from execution of such recommendation will lead to the violation of the ‘Doctrine of legitimate expectation’ and would ultimately affect Fiscal-Federal Principles embodied in the Constitution. Dr. D.D. Basu has specifically opined in this regard that the recommendation of the Finance Commission gives rise to the legitimate expectation for the States and “*any arbitrary refusal to carry out the recommendation of the Finance Commission may be suicidal step against the Federal System*”.⁴⁹

It was also strongly advocated during the Constituent Assembly Debates that it would be unwise to deviate from the Finance Commission Recommendation unless it seems to be patently erroneous.⁵⁰

Therefore, in summary, this line of argument shows that the Finance Commission’s recommendation can be challenged before

the Supreme Court on the ground that the Finance Commission’s recommendation becomes ‘law’ after it is passed by the President via an order under Article 270 and this ‘law’ can be challenged⁵¹ on the ground of the violation of federal structure which is a part of the Basic structure of the Constitution. As the *Supreme Court Advocates on Record Assn. v Union of India* case has clarified that even law other than constitutional amendments can be challenged on the basis of basic structure doctrine.

This adjudication would be done by the apex court under Article 131 and states would have to show that their “legal right” (as mentioned in the said article) has been violated.

Conclusion

While devising the revenue devolution formula for distribution of taxes between the states or provinces, the Commission ought to keep in mind the fundamental rules and principles for the revenue-devolution. Drastic or substantial violation of such rules are detrimental to the fiscal-federal structure of the Country which ultimately violates the Basic structure of the constitution and the same must be challenged.

As mentioned earlier in this paper when a formula devised by the finance Commission *substantially* or *only* includes the ‘*performance based criteria*’ for revenue devolution then it acts in detriment to the weaker and poorer states who couldn’t perform because of their meagre resources, marginal infrastructure or harsh geographical conditions. Such formula would be unhealthy

⁴⁸ *Dhires Chandra Dutta v. State of Tripura*, 1999 1 Gau. L.R. 98, *Tripura government Employees Federation v. State of Tripura*, (1996) 3 Gau. L.R.227.

⁴⁹ 8 Durga Das Basu, *Commentary on the Constitution of India* 245 (8d ed., Lexis Nexis 2011).

⁵⁰ 14th Finance Commission Report, vol. 1, Chap. 8, 90.

⁵¹ *Supra* 3.



for the federal structure of the country if the said formula is ‘arbitrary’ and ‘inequitable.’ On the other hand merely *‘fulfilling the needs of Poor states’* and *not* rewarding the ‘performing states’ for their efforts would also be discriminatory as incentivizing states to take progressive steps is as important as helping them in the hour of need.

