COOPERATIVE FEDERALISM IN INDIA

PARALLEL STREAMS: POLITICAL FEDERALISM AND ECONOMIC INTEGRATION IN INDIA

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ABSTRACT

Economic integration is an important component of the design of political federations, a fact that was evident to the framers of the Indian constitution, but has been given inadequate attention in much of the subsequent literature on Indian federalism. In this paper, we examine the slow progress of economic integration in India, revisit the policy debates on the need for fewer barriers on interstate trade, and end with a set of unfulfilled recommendations to further strengthen cooperative federalism in India.

"Free flow of trade, commerce and intercourse within and across interstate borders is an important prerequisite for ensuring the economic unity, stability and prosperity of a country having a two-tier polity."

— Report of the Sarkaria Commission[1]

1 Sarkaria Commission, Report of the Sarkaria Commission (New Delhi: Government of India, 1984), http://interstatecouncil.nic.in/.

POLITICAL INTEGRATION, ECONOMIC INTEGRATION, AND FEDERALISM IN INDIA

By 1950, the political integration of India as a modern nation-state was largely complete. Economic integration, however, has inevitably been slower to unfold over the subsequent decades. In this paper, we consider how the relationship between federalism and economic integration has evolved over the seventy-five years since the country's Independence.

As a conceptual and theoretical framework, economic integration has a long history of discord and disagreement—much of it still unsettled. Each of its elements, including the existence of a common market, have different definitions and their own measures.[2] For the purposes of this paper, economic integration, either within a country or between a set of countries, can be considered some combination of four issues: the free movement of goods and services, the free movement of factors of production, harmonized tax rates, and a common monetary and fiscal policy framework. [3],[4] Due to the difficulty of measuring these in a country as complex as India, this paper considers the ordinal rather than cardinal nature of these factors. In other words, we're less concerned with whether India has crossed a value threshold on a singular observable measure, and more focussed on whether India shows promise of moving towards greater economic unity.

The initial design of Indian federalism was crafted whilst India was in the process of being politically integrated. The economy, however, remained fragmented.[5] The framers of the Indian Constitution understood that to sustain the political union, the nation would eventually have to become an economic union as well. Thus, they empowered the Union government to protect a common market against internal protectionism—albeit with some escape clauses under specified conditions. Although the fundamental rights to movement, residence, and choice of profession are guaranteed in Article 19 of the Indian Constitution, a separate section—Part XIII, which covers Articles 301 through 307—deals with the freedom of internal 'trade, commerce and intercourse'. The use of the phrase "trade, commerce and intercourse *throughout the territory of India*" (emphasis added) in Article 301 means that these constitutional provisions cover restrictions on intra-State as well as inter-State commerce.

The centrality of the common market to the overall political vision of the Constitution was underlined in a landmark judgment dealing with Article 301 in 1961. Justice P.B. Gajendragadkar ruled in *Atiabari* Tea Company v. State of Assam that the internal freedom to trade "embodies and enshrines a principle of paramount importance that the economic unity of the country will provide the main sustaining force for the stability and progress of the political and cultural unity of the country" (emphasis added).

2 Among others, see Jacob Viner, The Customs Union Issue (Oxford: Oxford University Press, 1950); Heinrich Von Stackelberg, *Grundlagen der Theoretischen Volkswirtschaftslehre* (Tübingen: Mohr Siebeck, 1951); Bela A. Balassa, *The Theory of Economic Integration* (London: Routledge, 1962); Wallace E. Oates, "An Essay on Fiscal Federalism," *Journal of Economic Literature* 37, no. 3 (1999): 1120-1149.

3 This is not too divergent from the elements of market integration outlined by Viner or Balassa in precisely differentiating a free-trade area from a customs union, common market, and economic union. Balassa, in fact mentions that total economic integration refers to unifying fiscal, monetary, social, and counter-cyclical policies with a common supra-national authority. See Viner, *The Customs Union Issue*, and Balassa, *The Theory of Economic Integration*.

4 The literature on other countries' definitions of and strategies for evolving towards a single market point to a different direction than India. The biggest reason for this is that India was already a monetary union before being a fiscal one. Other countries needed to ensure this first. For instance, the Maastricht criteria—from the Maastricht Treaty of 1992, also known as the convergence criteria—dealt with controlling inflation rates, capping public debts and deficits of sovereign countries, stabilizing exchange rates, and regulating domestic interest rates. The Indian experience deals with 'intra-national' integration. Thus, we don't consider these measures in our analysis.

5 Commissions including the Dar Commission in 1948, the JVP Committee in 1948, and the several States Reorganisation Commissions all suggested principles along which Indian States could be reorganized. Economic integration wasn't a part of those principles.

His words still resonate today, as the dichotomy between political integration and economic fragmentation has gradually been whittled away. In the process of economic development, India has moved towards greater internal economic integration—and accelerated in that direction since the introduction of the Goods and Services Tax in 2017.

This evolutionary transition towards greater economic integration within the country has major implications for Indian federalism in the twenty-first century. While history, culture, and identity have all contributed to the drawing of State borders, economic networks have expanded beyond these subnational boundaries. The 1955 report of the States Reorganisation Committee considered—and rejected—the idea that "administrative units could be made to conform to natural economic regions." It maintained that identifying such natural economic regions as well as applying the principles in a dynamic manner would be difficult as India undergoes structural transformation.

The standard literature on Indian federalism does not, in our view, pay adequate attention to the country's transition from a fragmented to an integrated economy. Much of the debate on the original design of Indian federalism is focussed on political factors, such as the need to build a strong centralized state to avoid repeating the Partition of India in 1947. However, more recent work on market-preserving federalism gives due importance to a common market as a feature of federal systems.[6] In one recent paper, scholar Louise Tillin argues that "distinctive elements of Indian federalism were shaped at their foundations by the desire to boost industrial development and lay the foundation for a national welfare state in a post-colonial future by preventing . . . unregulated inter-provincial economic competition." [7]Tillin shows that the various representatives of Indian business houses, labour leaders, and nationalist politicians saw the need for a centralized government to promote a future national economy as well as introduce common labour legislation, while providing space for decision-making at the State level.

For India, while political integration and economic integration can be viewed as either complements or substitutes, there is no doubt that they are intertwined processes that together deepen market linkages, lower transaction costs, promote specialization, and boost productivity. Economic historian Robert C. Allen posits that European nations, as they jockeyed to catch up with England in the nineteenth century, employed a standard development strategy with four building blocks: creating an integrated national market by abolishing internal tariffs as well as investing in transport infrastructure; erecting external tariff walls to protect domestic infant industries; creating a modern financial system to secure monetary stability as well as provide capital to domestic enterprises; promote mass education to help the diffusion of new technologies. [8] The integration of the national market is thus seen as a core element of the larger political project, or a complementary act. For example, the political integration of Germany in 1871 was preceded by the Zollverein customs union between different German states in 1834.

However, the need to integrate the domestic market for productivity gains can be less intense when domestic producers have access to a larger international market, rather than singularly depending on a domestic market that is often limited in size. The possibilities of global trade as a substitute for the home market can play an important role in the creation of nation-states in general, and their size in particular.

6 Nirvikar Singh and T.N. Srinivasan, "Federalism and Economic Development in India: An Assessment," Department of Economics, UC Santa Cruz, October 2006, https://escholarship.org/uc/item/2qs4h3t9; Mala Lalvani, "Market Preserving Federalism: Where Does the Indian Federation Stand?," Department of Economics, University of Mumbai, February 2003, https://archive.mu.ac.in/arts/social_science/eco/pdfs/depart/dwp20.pdf.

7 Louise Tillin, "Building a National Economy: Origins of Centralized Federalism in India," Publius: The Journal of Federalism 51, no. 2 (2021): 161–85.

8 Robert C. Allen, *Global Economic History: A Very Short Introduction* (Oxford: Oxford University Press, 2011).

In a world where trade between nations is restricted by high tariffs, the viability of political units will be dependent on the size of the internal market.[9] On the other hand, smaller countries with limited internal markets can exist when there is free trade between nations. This indicates that political and economic integration within national boundaries can sometimes be substitutes rather than complements—there can be political integration with incomplete internal economic integration under conditions of free trade. A small region that can easily integrate into the larger global economy has fewer incentives to politically integrate with neighbouring regions with which it otherwise shares common characteristics.[10]

This interplay between economic integration and political integration is both complicated and contextual. It also has profound implications for federalism. Markets function well when there is a common set of rules regulating the conduct of participants. Such a common institutional structure covers a diverse set of tasks, ranging from maintaining macroeconomic stability and enforcing contracts to the provision of national public goods and welfare. This institutional framework must be the same across a common market within the boundaries of a sovereign political unit.

The several variants of constitutional federalism can thus be seen as striking a balance between building a common set of economic rules for the entire country while simultaneously providing some element of autonomy to the constituent parts, irrespective of whether they have joined a political union or have been created by a central government. [11] India's experience since 1950—prioritizing political integration, while slowly moving towards economic integration—is a testament to this relationship.

INDIA IN 1950: POLITICALLY UNIFIED, ECONOMICALLY FRAGMENTED

At the time of Independence, the Indian economy was severely fragmented.[12] Beyond the usual idea of a dual economy with a traditional sector existing alongside a modern sector, India's fragmentation was spatial as well, with weak economic links between different parts of the country. The political leadership at the time understood well that economic integration would have to follow political integration. Because there is no existing data to measure India's economic fragmentation at the dawn of the republic—and creating such a dataset is outside the scope of this paper—we instead must depend on some illustrative vignettes. By examining agricultural commodity markets, credit markets, capital markets, and labour mobility in those early years, we can start to determine the extent of India's political fragmentation at the time.[13]

First, economic historians have often used the convergence or divergence of prices across different regions to establish whether a political unit is economically unified. The distance from a common price can be seen as a measure of economic fragmentation in any market.

9 Alberto Alesina, Enrico Spolaore, and Romain Wacziarg, "Economic Integration and Political Disintegration," *American Economic Review* 90, no. 5 (2000): 1276–96.

10 Ibid.

11 John Kincaid, "Confederal Federalism and Citizen Representation in the European Union," *West European Politics* 22, no. 2 (1999): 34–58.

12 At Independence, India was an amalgamation of 600-odd Indian kingdoms (Copland, 1995). The process of integrating these kingdoms (their accession, merger and democratization) was in parallel to framing the constitution and defining the economic framework. For more details, see Ian Copland, "The Integration of the Princely States: A 'Bloodless Revolution'?," *South Asia: Journal of South Asian Studies* 18, no. 1 (1995): 131–51; and V.P. Menon, *Integration of Indian States* (Hyderabad: Orient BlackSwan, 2014).

13 The Supreme Court of India notes in *Jindal Stainless* Ltd. v. *State of Haryana*: "Fundamentally the creation of a common market for goods and services requires the removal of obstacles to the free movement of goods, persons, services and capital between the states which constitute the Union of India. . . . These four freedoms guaranteeing the free movement of goods, services, persons and capital among the states, form the basis of the guarantee under Article 301."

In India, the isolation of regional commodity markets was gradually replaced by some element of integration between 1860 and 1947. The standard deviation of prices for wheat, rice, and cotton across various regions in India fell sharply from around 45 to 20 between 1861 and 1920, although fully integrated markets with a single price was still a distant possibility.[14] The increased—but incomplete—convergence of agricultural prices was largely driven by new infrastructure such as the railways. Economist Dave Donaldson has used a unique dataset from Indian salt mines to show that the expansion of railways in colonial India decreased price gaps between regions through lower transport costs.[15] Another factor was access to better information about prices—and, hence, arbitrage opportunities—with the spread of post offices.[16]

However, the economic integration revealed through the lower dispersion of agricultural commodity prices fell short of reaching a set of common nationwide prices. Indeed, even seventy-five years after Independence, food markets are still not integrated due in part to the persistence of laws that restrict the movement of agricultural commodities across State boundaries .[17]

Second, credit markets offer similar evidence. In the mid-twentieth century, India had two types of price divergence in the credit markets: between regions and between formal and informal finance. The dispersion of interest rates was a result of a fragmented financial system. Before the three Presidency banks were merged in 1921 to form the Imperial Bank, the banking system operated with little coordination between various regions. Interest rates continued to diverge across India even after the merger. In 1931, the Central Banking Enquiry Committee reported that the interest rates of banks varied considerably across territories such as Bombay, Madras, Punjab, the United Provinces, and Assam.[18] In his classic 1929 study of indigenous banking in India, L.C. Jain showed that the rates of interest charged by cooperative credit societies varied across provinces as well.[19]

This variation in credit markets continued after Independence. The 1951 All India Rural Credit Survey classified districts into five groups according to the prevalent interest rates, ranging from very high to very low.[20] However, this data combined with data from the All India Debt and Investment Surveys shows that interest rates did begin to gradually converge after Independence.[21] The spread of branch networks after the nationalization of commercial banks in 1969 and 1980 helped to further integrate Indian credit markets.[22]

Third, private sector capital also had a stronger regional than national footprint in the early years after Independence. R.K Hazari's 1966 report on industrial licensing provides very useful insights about this.[23]

14 Michelle B. McAlpin, "Famines, Epidemics, and Population Growth: The Case of India," *Journal of Interdisciplinary History* 14, no. 2 (1983): 351–66.

15 Dave Donaldson, "Railroads of the Raj: Estimating the Impact of Transportation Infrastructure," *American Economic Review* 108, no. 4-5 (2018): 899–934.

16 Tahir Andrabi, "Post Offices and British Indian Grain Price Convergence," *Economic History of Developing Regions* 35, no. 1 (2020): 23–49.

17 C.S.C. Sekhar, "Agricultural Market Integration in India: An Analysis of Select Commodities," Food Policy 37, no. 3 (2012): 309–22; Anirudh Burman, Shubho Roy, Ajay Shah, and Ila Patnaik, "Diagnosing and Overcoming Sustained Food Price Volatility: Enabling a National Market for Food," National Institute of Public and Finance Policy, July 24, 2018, https://www.nipfp.org.in/media/medialibrary/2018/07/WP_236.pdf; Michael Andrle, and Patrick Blagrave, *Agricultural Market Integration in India* (Washington, DC: International Monetary Fund, 2020).

18 Bhupendranath Mitra and the Indian Central Banking Enquiry Committee, I*ndian Central Banking Enquiry Committee, 1931*, vol. 1, part 1, Majority Report (New Delhi: Indian Central Banking Enquiry Committee, 1931).

19 Lakshmi Chandra Jain, *Indigenous Banking in India* (London: Macmillan and Co. Ltd., 1929).

20 All India Rural Credit Survey, *Report of the Committee of Direction: The General Report* (Volume II) (Bombay: Reserve Bank of India, 1954)

21 Reserve Bank of India, *All India Debt & Investment Surveys*, 1951 and 1971 editions.

22 There were two phases in the nationalization of the banks: the first in 1969 and the second in 1980. The average population served by a bank office declined from 92,000 in December 1960 to 46,000 in May 1971. Similarly, at the beginning of 1980, the total bank branches of scheduled commercial banks stood at 32,419. This almost doubled to 60,220 in 1991. See R.G. Saraiya, N.R. Rao, B. Datta, and V.G. Pendharkar, *Report of the Banking Commission* (New Delhi: Government of India Press, 1972).

23 R.K. Hazari, *Industrial Planning and Licensing Policy: Final Report* (New Delhi: Planning Commission, 1966).

The major industrial groups at the time were defined in terms of either their region or their community, which Hazari himself said was an approximation. The data shows that most industrial investment between 1959 and 1966—the period studied by Hazari—was clustered according to the regional or community profile of companies. Gujarati, Punjabi, Bengali, Southern, and Parsi groups each made between 65 and 80 percent of new investments to just two States. For example, Gujarati groups made 53.87 percent of their new investments in Maharashtra and 24.29 percent in Gujarat. Bengali groups, meanwhile, made 41.18 percent of their new investments in West Bengal and another 23.59 percent in Bihar. The only significant exceptions to this pattern were Marwari business groups and the public sector, which had a much more diverse regional base. Though no data is available, it is likely that both the supply chains as well as the customer bases of these business groups had a strong regional flavour as well.

Finally, evidence on the extent of labour mobility in India is mixed. Sociologist Kingsley Davis argued in his 1951 classic study that internal migration was low due to multiple factors including cultural values, linguistic diversity, the caste system, and the existence of joint families.[24] More contemporary research, however, shows that migration has been a persistent feature of the twentieth century, especially remittance-based migration rather than seasonal or permanent spatial shifts.[25] Beyond the obvious economic reasons, high levels of migration from some parts of India can also be explained by non-economic factors such as a migration culture (motivated by marriage, obligation to ageing parents, etc.) and social networks.

In terms of absolute numbers, census data shows that the number of migrants doubled from 159.6 million in 1971 to 300.9 million in 2001.[26] However, the number of migrants as a percentage of the total population has been stable over the same period. Since then, rising inter-State migration has continued to be a hot-button issue for Indian federalism. Data from the 2011 census shows that the number of internal migrants as a percent of the total Indian population increased from 30 percent in 2001 to 37 percent in 2011. There continue to be debate over whether the census underestimates decadal migration numbers. The Ministry of Finance has used railway passenger traffic data to claim that 9 million Indians have migrated across State borders every year since 2011,[27] compared to the census-based estimates of between 5 to 6.5 million annual internal migrants in the previous decade.

These vignettes show the degree of fragmentation within the economy at the time of independence. The framers of India's Constitution were aware of such challenges. They were discussed while formulating the laws regulating trade and commerce. The discussions show that economic unity was, however, always an implicit goal, subservient to maintaining the political unity in the country.

THE VISION FOR AN ECONOMICALLY UNIFIED INDIA

During the drafting of the Indian Constitution, the Drafting Committee debated the idea of an integrated economic unit—albeit without as much passion as some other, more divisive parts of the framework. Despite relevant freedoms being enshrined in various parts of the Constitution, a separate section—Part XIII, including Articles 301 through 307—was drafted specifically to deal with trade and commerce.[28]

24 Kingsley Davis, *The Population of India and Pakistan* (Princeton, NJ: Princeton University Press, 1951).
25 Chinmay Tumbe, *India Moving: A History of Migration* (Gurugram: Penguin Random House India, 2012).
26 Ram B. Bhagat, "Internal Migration in India: Are the Underprivileged Migrating More?," *Asia-Pacific Population Journal* 25, no. 1 (2010): 27–45.
27 Ministry of Finance, *Economic Survey of India* (New Delhi: Government of India, 2017).
28 It is noteworthy to mention that T.T. Krishnamachari praised the Drafting Committee, calling their draft pertaining to these clauses "about as nearly perfect as human ingenuity could possibly make them." See Constituent Assembly, *Constituent Assembly Debates: Official Report*, Vol. 9 (New Delhi: Lok Sabha Secretariat, 1949).

The reasons for assembling this part of the Constitution were made clear by Dr. B.R. Ambedkar, the chair of the Drafting Committee:

> …originally the articles dealing with freedom of trade and commerce were scattered in different parts of the Draft Constitution. . . . In order, therefore, to give the House a complete picture of all the provisions relating to freedom of trade and commerce the Drafting Committee felt that it was much better to assemble all these different articles scattered in the different parts of the Draft Constitution into one single part and to set them out seriatim, so that at one glance it would be possible to know what are the provisions with regard to the freedom of trade and commerce throughout India.[29]

Most of the discussion about these Articles centred around three key questions: (1) Will the individual States work together in the interest of the nation or fight to serve self-interest? (2) To what extent should coercive powers on trade and commerce be granted to benefit the economic development of the nation in the long term? (3) If such restrictive powers on trade are important, who should be given the legitimacy to limit the freedom of movement? All three of these questions have a direct bearing on the federal structure of India, despite not explicitly being recognized as such.

Ambedkar, on behalf of the Drafting Committee, made it clear that trade and commerce should not be completely free. In the draft, powers to restrict economic activity were accorded to both the States and the Centre.

State legislatures were given powers to regulate trade on the grounds of so-called public interest. Many committee members were against giving States any controlling powers, contending that it would lead to cleavages and possibly even break up the Union.[30] In East Punjab, for instance, crores worth of food had been locked up due to the exercise of such powers, which increased the price of the food and put pressure on other provinces to import more. Others stepped in with examples from Uttar Pradesh, Himachal Pradesh, and Bihar, arguing that such restrictions would hurt India's economic development.[31] Pandit Thakurdas Bhargav added that "if the provinces are allowed to have their own way to impose restrictions upon the citizens of any other State, then this one Nation talk, this unity and this one-Government and one-country talk will mean nothing."[32]

The Centre was given powers to redistribute goods, especially food, to alleviate scarcity in one part of the country if there was abundance in another. For example, Parliament could overrule a State's decision not to transport grain across its borders. This, they concluded, would be one way to preserve India's integration into a union. Alladi Krishnaswamy Ayyar noted:

> . . . first, you will have to take into account the larger interests of India and permit freedom of trade and intercourse as far as possible. Secondly, you cannot ignore altogether regional interests. Thirdly, there

29 Ibid.

30 The debates show a recurring fear of provincialism by according such powers, and a rich debate on solutions to draw out the necessary balance. For instance, an amendment proposed by Bhargav aimed to change "public interest" with the words "in the interest of the general public." His key motivation was that "public interest" encourages provincialism, as States would take into account the interests of the people they are accountable to, whereas "general public" would encompass the general people of India—outside the respective States as well. The amendment was rejected.

31 B.P. Jhunjhunwala gave four examples. (1) The Uttar Pradesh (UP) government limited the sale of mustard seeds so that the seeds were crushed in UP, taking the competitive advantage away from mills in other States. The UP government did not consider the economic well-being of India, but rather acted selfishly. (2) UP banned the sale of potato seeds to other provinces "unless the exporter obtained a certificate from . . . the agricultural department of the consignee's province." This had two negative effects—the price of potato seeds increased in UP and the quality of potatoes grown in the country drastically fell. (3) Himachal Pradesh put an export duty on potatoes at a time when the price of food for the country should have been reduced. (4) UP and Bihar passed an order that no more cane would be crushed due to surplus sugar. This led to a loss of crores of rupees for the poor cultivators who had to let their cane dry in the fields, yielding no revenue.

32 Constituent Assembly, *Constituent Assembly Debates:* Official Report.

must be the power intervention of the Centre in any case of crisis to deal with peculiar problems that might arise in any part of India.[33]

Was such scarcity a temporary or permanent affair? Some, like T.T. Krishnamachari, opposed Bhargav's contention, believing that scarcity would be "more or less permanent" and last for decades.[34] This, in turn, justified imposing limitations on trade and freedom of economic activity. Government intervention was seen necessary to balance regional development and keep India integrated as an economic union for a long time to come.

The assembly recognized that the effects of intervening in a market system could lead to a flailing economy in the long run. However, strong socialist leanings justified the cost-benefit trade-off. Krishnamachari noted that "the primary condition in regard to satisfaction of human needs must be satisfaction of their necessities." [35] It was a Faustian bargain. In the event that prices rose (due to artificially created shortages from government intervention), the consumers were expected to bear the cost or simply not purchase that product—a small sacrifice, some argued, in return for the larger goal of balancing scarce resources. Such sacrifice was justified "for the benefit of the masses of the country and not for the benefit of a few traders or merchants."[36]

Other federations, such as the United States and Australia, were brought up to highlight where their laws have prevented them from taking steps to benefit their country. "There is no point in shutting the hands of the future Government in operating this Constitution," stated Krishnamachari. According to him, advocating for a laissez faire system was a "nineteenth century" idea—implying that it was outdated and not helpful to the current discourse.[37]

Within the committee, a consensus formed around supporting laws to limit the freedom of trade and commerce under a control of some kind. Greater freedom to practice trade and commerce, they believed, would impede with the economic development of the country. Almost all amendments to the draft—especially those arguing for greater freedom to trade within India—were rejected. To keep a politically fragmented India together, the Constituent Assembly awarded coercive powers over intra-State trade to both State governments and the Centre. However, over the next seventy-five years, economic progress towards an integrated market was made possible only by strengthening the federal structure and dismantling many of these restrictions on internal trade.

TOWARDS AN INDIAN COMMON MARKET

In the seventy-five years since the Drafting Committee's deliberations, a gradual lifting of restrictions on trade has evolved a common market within India. From the 1950s through the 1970s, the Centre was heavily involved in resource allocation via centralized planning. But this began to shift during the economic liberalization of the 1980s and accelerated in the 1990s. Since the start of the 2000s, fundamental policy shifts on inter-State taxation have further enabled economic integration.

33 Ibid.
34 Ibid.
35 Ibid.
36 Ibid.
37 Ibid.

From the 1950s through the so-called commanding heights period of the late 1970s, Indian economic policy was bridled with controls. The Centre imposed physical controls using quasi-fiscal instruments and regulations—many of which were a continuation of World War II–era controls initiated under the 1939 Defence of India Act—to govern the production, distribution, and pricing of Indian products.[38] Production licenses were awarded in line with the five-year targets set by the Planning Commission and as allowed under the Industrial Policy Resolutions of 1948 and 1956.[39] In 1955, the Essential Commodities Act enabled the government to set the quantities and prices at which goods were sold, making it impossible for an internal market to develop within the country.[40]

These controls continued and intensified in subsequent decades, retarding the process of economic integration. During shortages, the government issued policies directing factories on their inventory and production practices. In November 1966, for example, when cotton was in short supply, mills were ordered to not keep more than two months of stock at any time. Similarly, they were ordered to give their workers an extra holiday every week so that the short supply of cotton could be distributed across all mills.[41] Companies could not improve manufacturing technologies without government permission due to fear of letting off employees. Textile mills, for instance, could not replace looms to improve production without the permission of the textile commissioner.[42]

Equally important was the enactment of the Central Sales Tax Act, which allowed taxes to be levied on inter-State trade. Article 286 of the Constitution explicitly disallowed any laws that taxed the sale or purchase of goods "(a) outside the state, or (b) in the course of import of goods into, or export of goods out of, the territory of India." However, the Sixth Amendment, on the recommendation of the 1953 Taxation Enquiry Commission, added two additional clauses that authorized States to tax inter-State sales.[43] This tax, regrettably, was origin-based, so the revenue accruing from the tax went to the State in which the sale originated. States also introduced their own taxes—such as octroi, mandi taxes, or even an "export tax"—which were distortionary and impeded the functioning of a common market.[44]

Research by M. Govinda Rao and Nirvikar Singh in 2006 shows that even regulatory policies, not just fiscal policies, impeded the creation of a common market.[45] For instance, by passing the Freight Equalisation Policy in 1952, the government granted the freedom to set up a factory anywhere in India by subsidizing the costs of transporting goods, such as minerals, between States or across long distances. "The transport subsidy given to equalize the prices of these basic inputs throughout the country has not only robbed the forward linkage benefits of locating these industries in poorer regions but has also led to allocative distortions," write Rao and Singh.[46] These policies and controls had major implications for commerce and federalism alike.

Businesses had a difficult time operating enterprises that crossed State boundaries. When challenged in court, inter-State taxes were often blamed for impeding the freedom of trade and commerce. In deciding

38 Rakesh Mohan and Vandana Aggarwal, "Commands and Controls: Planning for Indian Industrial Development, 1951–1990," *Journal of Comparative Economics* 14, no. 4 (1990): 681–712.
39 Industrial Policy Resolution, Government of India (1948); Industrial Policy Resolution, Government of India (1956).
40 Essential Commodities Act, Government of India (1955).
41 Vadilal Dagli, *Report of the Committee on Controls and Subsidies* (New Delhi: Government of India, 1979).
42 Rakesh Mohan, ed., *India Transformed: Twenty-Five Years of Economic Reforms* (Washington, DC: Brookings Institution Press, 2018).
43 Such powers are subject to a ceiling of 4 percent.
44 M. Govinda Rao, "Impediments to Internal Trade and Allocative Distortions in India," National Institute of Public Finance and Policy, May 1993, https://nipfp.mimirtech.com/media/pdf/working_papers/WP_1993_127.pdf; M. Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (New Delhi: Oxford University Press, 2006).
45 Rao and Singh, *The Political Economy of Federalism in India*.
46 Ibid.

these cases, the Supreme Court ruled differently on multiple occasions. In Atiabari Tea Company v. State of Assam, the petitioner challenged that a tax on transporting goods from Assam to Calcutta impeded with the freedom of trade under Article 301. The Supreme Court agreed with the appellants and declared the Assam Taxation Act of 1954 void.[47] In Automobile Transport (Rajasthan) Ltd. v. State of Rajasthan, however, the Supreme Court held that a tax charged by the State on motor vehicles used in public places did not hamper but rather facilitated trade in India.

During the 1980s, a process of economic liberalization—dubbed "liberalisation by stealth" [48]—coincided with a broader rethinking of the Indian federalist structure. In 1983, the Sarkaria Commission was set up to suggest changes in the functioning of Centre-State relations. In its report a year later, the commission continuously held that the unity and integrity of a common market must be maintained. It recommended creating an expert body under Article 307 to comment on trade, commerce, and intercourse in India. This expert body, it suggested, could range from being merely advisory to endowed with punitive powers. It also recommended that the value-added tax (VAT) system replace inter-State taxes for a more streamlined trade structure.[49]

Economic liberalization accelerated during the balance of payments crisis in 1991 and continued throughout the 1990s. To successfully integrate India into the global economy, policymakers had to seriously consider the country's dysfunctional economy. Integrating it internally became a crucial objective. Under Dr. Raja Chelliah, the 1992 Tax Reform Committee suggested multiple reforms towards creating a common market. The committee identified the inter-State tax as a major reason for the national economy's continued fragmentation. In its report, the committee recommended imposing a credit system between States, in which exporters paying a tax would get credit against the imports. It also recommended that the Central Sales Tax be brought down to 1 percent. Notably, it too recommended replacing the various central excise and State taxes with a VAT to harmonize the market.[50]

In a 1994 speech titled "India as an Emerging Common Market," Chelliah said:

> In a common market, the sub-national governments cannot enjoy complete freedom to levy whatever kinds of local taxes they please even if they are within their constitutional powers. The experience of the European Union has shown that cascading type indirect taxes must be disallowed, as otherwise taxes on inputs, being embedded in costs and being shifted forward in varying degrees, distort fair competition and raise export costs. Levies such as octroi must also be disallowed.[51]

As a consumption tax, the VAT avoids tax cascading. It is, therefore, a key instrument in harmonizing inter-State trade—leading to a common national market.

Multiple committees in the decades after Chelliah's report reiterated the twofold problem hindering a common market.[52][53] First, there were multiple rates of sales taxes (more than ten in some States), which

47 In 2016, the Supreme Court, while hearing the case of *Jindal Stainless Ltd. v. State of Haryana*, upheld the right of States to levy entry taxes.

48 Arvid Panagariya, *India: The Emerging Giant* (Oxford: Oxford University Press, 2008).

49 Sarkaria Commission, *Report of the Sarkaria Commission*.

50 Tax Reform Committee, *Report of the Tax Reform Committee* (New Delhi: Government of India, 1992).

51 R. J. Chelliah, "India as an Emerging Strong Common Market and the Role of the Economist," *Indian Economic Journal* 42, no. 3 (1995): 1-13.

52 Baldev Raj Nayar, "Globalization, the State, and India's Halting March to Common Market: The Political Economy of Tax Reform Under Federalism," *India Review* 10, no. 3 (2011): 201–45.

53 In his 1993 budget speech, Finance Minister Manmohan Singh indicated the move to a VAT. A committee under Dr. Amaresh Bagchi was formed to explore the possibility. Similarly, Finance Minister Yashwant Sinha formed an Empowered Committee of State Finance Ministers. A white paper by this committee endorsed a design of the VAT and highlighted various advantages. However, it didn't mention creation of a common market as one of them. See Empowered Committee of State Finance Ministers, "A White Paper on State-Level Value Added Tax," January 17, 2005 (on file with authors).

were different for the same commodity across different States. Second, the States were engaged in a so-called rate war, which prevented the integration of subnational markets in India.

To resolve this enduring problem, the government introduced a VAT in 2005, which streamlined sales taxes. States agreed to a list of 550 goods being taxed under the VAT at two basic rates of 4 percent and 12.5 percent. The Centre agreed to compensate States for the staggering revenue loss—100 percent in the first year, 75 percent in the second year, and 50 percent in the third year—which underscores the importance of this move.[54]

Starting in the 2000s, the emerging idea of cooperative federalism strongly encouraged the creation of a common market. Due to liberalization, States had a larger say in central policies than ever before. They demanded that the Centre consult them before enacting policies that would affect them. Transregional relationships dominated transnational ones, as States started to receive foreign direct investments that shaped foreign economic relations.[55] Organizations such as the World Bank negotiated separate packages with different States,[56] shifting inter-State economic dynamics.

In 2007, the Puncchi Commission was set up to re-examine Centre-State relations. Like the Sakaria Commission before it, the Puncchi Commission reiterated the removal of inter-State taxes and called for the formation of an independent authority under Article 307. It further supported the introduction of the Goods and Services Tax (GST)—a big leap towards an integrated market.

The GST law was first drafted by a committee set up in 2000 by Prime Minister Atal Bihari Vajpayee. In 2017, the GST replaced India's fragmented indirect tax system—consisting of the excise tax, VAT, service taxes, and more—with a dual tax for the States and Centre. This eliminated the cascading effect of taxes and ensured that every State would charge the same rate on each product or service. By assisting fiscal consolidation and eliminating distortions caused by tax-induced economic behaviour, the GST improves economic efficiency and productivity across sectors.[57]

With the states willingly giving up their fiscal autonomy, the GST purported to usher in a new pivot towards cooperative federalism. India, seemingly, had moved closer to realizing the idea of "one nation, one market." However, with delays in payments, tense negotiations during the COVID-19 pandemic over the transfer of cess, and hasty decisions made by the GST implementation committee, the jury is still out on the GST's effects on federalism.

CONCLUSIONS AND RECOMMENDATIONS

The constitutional provisions to maintain a common internal market with minimal restrictions were written at a time when the Indian economy was fragmented. In terms of the European Union's "four freedoms" framework— free movement of goods, free movement of people, free movement of services, and free movement of capital—India has made substantial progress since 1950.

54 Empowered Committee of State Finance Ministers, "A White Paper on State-Level Value Added Tax."

55 Aseema Sinha, "The Political Basis of Decentralization," in *Asia's Giants: Comparing China and India*, eds. Edward Friedman and Bruce Gilley (New York: Palgrave Macmillan, 2005).

56 A direct loan of US$350 billion was given to the government of Orissa, which restructured its power sector by breaking its electricity board into three separate bodies.

57 Nayar, "Globalization, the State, and India's Halting March to Common Market."

The Indian economy has gradually become more closely integrated over the decades, with increased nationwide production networks, falling transaction costs because of better infrastructure, and improved labour mobility across State borders. The grand federal bargain leading to the introduction of the GST in 2017 has been an important milestone in the country's journey towards an integrated economy based on a common internal market.

However, the constitutional provisions continue to allow governments to restrict internal trade on the basis of public interest. These escape clauses were originally included in the context of a country facing periodic shortages of food and other essentials, which are now rare events. Since then, newer concerns have arisen. For example, the spate of job reservations for locals in several States could impede the free movement of labour. The COVID-19 pandemic has brought to the fore other policy challenges, such as restrictions imposed on the movement of people or goods for reasons of public health and the portability of social benefits across State borders. These may not directly affect the freedom of commerce, but they have serious implications for factor mobility within India.

An internal common market is necessary for the conduct of cooperative rather than competitive federalism. Article 307 of the Indian Constitution provides for an authority to carry out the internal free trade provisions in Articles 301 through 304. While the Sarkaria Commission recommended setting up a largely deliberative, rather than decision-making, body, much has changed since the commission met in 1983. Given the enshrined objective of the Inter-State Council — to advise on disputes among states —it now makes more sense to include contentious issues on internal commerce under the mandate of the Inter-State Council, which was set up in 1990 under Article 263 of the Constitution but has been relatively moribund since then.[58] The Inter-State Council should also have powers of a Fiscal Review Council, as suggested by Singh and Srinivasan.[59] It would review the medium and long-term growth fiscal policies of every state and give recommendations towards achieving those. This would further strengthen cooperative federalism in the country.

58 Interstate Council of India, "Genesis," accessed February 20, 2023, http://interstatecouncil.nic.in/isc-genesis/
59 Nirvikar Singh and T.N. Srinivasan, "Federalism and Economic Development in India: An Assessment," 2006, https://doi.org/10.2139/ssrn.950309.

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