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FISCAL FEDERALISM IN INDIA: CONSTITUTIONAL DESIGN, JUDICIAL INTERPRETATION, AND CONTEMPORARY CHALLENGES

AUTHORED BY - RAHUL KUMAR & DR. CHARVI KUMAR

ABSTRACT

Fiscal federalism forms the financial basis on which constitutional federalism is built. operates. The Constitution provides, in the Indian context, an institutional and methodological balance that centralises revenue-raising powers while decentralizing expenditure responsibilities, therefore This would in turn call for institutional mechanisms of fiscal redistribution. The present paper attempts to look at the paper highlights constitutional design, judicial interpretation, and therein the barriers to fiscal federalism in India. modern-day challenges thrust by fiscal centralization, most especially in the post-Goods and is at the threshold of the Services Tax era, it contends that recent fiscal practice has been constitutionally They are permissible, they endanger the normative foundations of cooperative federalism and constitutional morality.

Keywords: *Fiscal Federalism; Cooperative Federalism; Finance Commission; GST; Cesses and Surcharges; Constitutional Morality; Indian Federalism.*

INTRODUCTION

Federalism in India is not just a structural arrangement, but also a constitutional strategy for The tasks of political diversity, economic inequality, and administrative complexity¹. The framers of the Indian Constitution consciously adopted a strong central government while the preservation of States' autonomy through constitutionally guaranteed powers and institutional safeguards. Fiscal federalism constitutes the operational core of the latter, inasmuch as financial independence reflects the actual capability of the States to exercise their competency in legislation and executive power. the importance of fiscal federalism lies in its dual function². On one hand, it ensures macro-economic stability and national unity. It allows subnational governments, on the other hand, to respond to local needs and democratic preferences. In India, this balance has historically the latter scenario has been maintained through a centralized tax

system combined with constitutionally mandated fiscal transfers. However, recent fiscal developments especially post 2017 have triggered intense debate over State autonomy erosion. Goods and Services Tax, increasing rates of Union cesses and surcharges, and increasing dependence on conditional grants have changed the financial balance between the Union and the States. These developments raise critical constitutional issues as to what cooperative federalism means, and what are the constraints official centralization. This paper Doctrinal and empirical.

CONCEPTUAL FOUNDATIONS OF FISCAL FEDERALISM

Fiscal federalism is a concept that emanates from the theory of public finance, especially in the works of Richard Musgrave, who distinguished the allocative, distributive, and stabilization functions of the state. As posited in classical theory, though local governments are better positioned to It can be concluded that if an economy performs allocative functions efficiently, it requires redistributive and stabilization functions. Central coordination to prevent regional disparities and macroeconomic instability³. However, fiscal federalism in constitutional democracies extends beyond economic. efficiency. This exposition embodies the exhortation of political autonomy, democratic accountability, and Subsidiarity. The way in which fiscal powers are allocated not only determines economic outcomes but also democratic governance. Excessive fiscal dependence undermines political in this way, autonomy, accountability is distorted, and States are reduced to administrative units rather than co-equal partners in governance. the Indian context, fiscal federalism has to be understood essentially against the backdrop of historical centralization under colonial rule and post-independence nation-building imperatives. regional disparities⁴. The Constitution reflects a pragmatic compromise that it vested power in Union to ensure economic integration and stability while compensating States through revenue-sharing and grants. This compromise forms the very spirit of India's cooperative federalism.

COOPERATIVE FEDERALISM AND CONSTITUTIONAL MORALITY

The Supreme Court of India has time and again identified federalism as part of the basic structure of the Constitution. Above all, Cooperative federalism has been emphasized as a guiding constitutional principle that calls for mutual respect, coordination, and trust between the Union and the States. Fiscal arrangements give concrete meaning in an emphatic way and therefore, to this principle. The constitutional morality deems it necessary to adhere not only to the text but also to its underlying values. In the fiscal domain, this means that whereas the

Union may exercise its constitutional powers to raise revenue, then such power ought to be implemented in such a way that does not violate the autonomy and financial viability of States. Practices that technically conform to Constitutional provisions yet systematically undermine fiscal balance raise some serious normative considerations⁵. How does one balance constitutional permissibility with constitutional morality? The tension between the two is particularly evident in contemporary fiscal practices. While the Constitution permits cesses and surcharges, excessive use of these surcharges to avoid sharing revenue goes against the spirit of cooperation. federalism. The tension constitutes the core analytical framework of the study.

CONSTITUTIONAL DESIGN OF FISCAL FEDERALISM IN INDIA DISTRIBUTION OF LEGISLATIVE AND TAXING POWERS

The Constitutional architecture of Fiscal Federalism in India is primarily structured through Articles 246, 268 to 281, and the Seventh Schedule⁶. Article 246 distributes legislative the competence between the Union and the States was sought to be divided through three lists, with powers relating to taxation being given to both. allocated distinctly with no overlaps⁷. The Union List comprises broad-based and elastic taxes. are examples, such as income tax not of agricultural income, customs, and excise duties, whereas the State List assigns comparatively narrow and less buoyant taxes such as land revenue, agricultural income tax, and taxes on professions. This asymmetry reflects a conscious Constitutional choice for fiscal centralization on the ground of macroeconomic stability. The framers of the Constitution foresaw this imbalance between revenue-raising Capacities, therefore, will vary greatly, and to make the provision of equality of living conditions a reality, capacity and expenditure responsibility would require a strong system of fiscal transfers. Accordingly, the Constitution incorporates redistributive mechanisms to redress the States for their limited powers of taxation. This was not the basis for fiscal subordination but ensure functional federalism in a socially and economically diverse polity. Distribution of Taxation power thus represents a compromise between unity and autonomy, rather than a strict division of fiscal sovereignty. Article 268 provides for duties levied by the Union but collected and appropriated by the States⁸, whereas Article 269 deals with taxes levied and collected by the Union but assigned to the States⁹. Article 270 creates the divisible pool of central taxes, which forms the backbone of vertical fiscal devolution¹⁰. These provisions put together will demonstrate that fiscal federalism in India is constitutionally engineered through shared arrangements rather than watertight ones. compartments.

GRANTS-IN-AID AND ARTICLE 282

Beyond tax sharing, there are grants-in-aid under Articles 275 and 282¹¹. Article 275 prescribes grants to States which are needy, especially in respect of regional disparities and special needs¹². These grants are advised by the Finance Commission and are thus embedded within a constitutional and institutional framework. Their purpose is corrective rather than discretionary, aimed at enabling States to discharge by their constitutional duties. Article 282 permits both the Union and the States to make grants for any public purpose, even outside their legislative competence. Although originally conceived as an Additional provision, Article 282 has increasingly been used by the Union to channel discretionary and conditional grants¹³. This has resulted in an altered fiscal balance of allowing the executive to bypass Finance Commission-recommended transfers, thereby This has raised several concerns about the dilution of institutionalized fiscal federalism. the increasing reliance on Article 282 grants obscures the distinction between co-operative federalism and fiscal command. Whereas such grants may be justified on grounds of national Priorities and policy coordination, the fact that they are discretionary detracts from predictability and undercuts State autonomy¹⁴. This trend accents a structural tension between constitutionally from this perspective, devolution mandated and executive-driven fiscal centralization go hand-in-hand.

THE FINANCE COMMISSION AND INSTITUTIONALIZED FISCAL FEDERALISM

It is the Finance Commission that occupies the pride of place in the fiscal constitution of India. Established according to Article 280, it shall recommend the sharing of the net proceeds of taxes between the Union and the States and among the States themselves. The Commission is It was designed as an independent, quasi-judicial body insulated from the pressures of politics, in that objectivity and fairness in fiscal transfers. Its periodic nature allows fiscal arrangements made in order to adapt to the changing economic and social situation. Over time, the scope of the Finance Commission has expanded significantly¹⁵. In addition to Once merely tax devolution, it now covers fiscal discipline and debt sustainability, disaster management. financing, and transfers to local governments. This evolution reflects the growing complexity Fiscal governance has become more interdependent at different levels of government. The Finance Commission can be conceptually seen to represent the most important forum for cooperative fiscal constitutional negotiation¹⁶. The effectiveness of the Finance Commission, however, lies not only in its recommendations but also on their faithful implementation. The increasing share of Union Revenues mobilised through cesses and surcharges-excluded from

the divisible pool- has decreased the practical impact of Commission recommendations. This development raises serious questions about whether executive fiscal practices undermine the constitutional role of the Finance Commission.

JUDICIAL INTERPRETATION OF FISCAL FEDERALISM

FEDERALISM AS A BASIC STRUCTURE

The Supreme Court of India has held time and again that federalism forms part of the basic structure of the Constitution. Such view has been reiterated by the Court in *S.R. Bomai v. Union of India*¹⁷, where it has highlighted that States are not mere administrative units but constitutional entities with autonomous powers. Although the case primarily concerned the misuse of Article 356, its reasoning has wider This therefore has a great bearing on fiscal relations since financial autonomy is central to political autonomy. Subsequent decisions have explained that Indian federalism is not rigid but flexible, allowing for a robust Centre while maintaining State autonomy¹⁸. This flexibility in federalism, but does not mean unlimited central dominance. The Court has time and again cautioned it was a principle that constitutional powers must be exercised in a manner consistent with federal balance and democratic values.

JUDICIAL DEFERENCE IN FISCAL MATTERS

However, while recognising federalism as a basic feature the judiciary has broadly adopted an approach where Deferential approach to fiscal matters, courts have recognised that taxation and fiscal policy are complex economic issues best left to the legislature and executive¹⁹. While As a result, challenges to fiscal arrangements have often been reviewed under a limited standard of arbitrariness rather than substantive federal impact. In grant cases, taxation, and revenue sharing, the Supreme Court has maintained the wide discretion of Parliament, provided constitutional procedures are followed. This judicial Restraint has contributed to stability in fiscal governance but has also enabled gradual fiscal centralization sans meaningful constitutional overview²⁰. Without a strong federal Review standard in fiscal cases represents a significant gap in Indian constitutional jurisprudence.

COOPERATIVE FEDERALISM IN JUDICIAL DISCOURSE

The Court in recent times has invoked the doctrine of cooperative federalism with increasing frequency. especially when such coordination is inter-governmental. In *State (NCT of Delhi) union of India*, the Court underscored that constitutional governance necessitates cooperation. rather than confrontation between different levels of government. Although the case did not

Though the decision did not directly concern fiscal matters, its reasoning has been highly relevant to fiscal federalism²¹. The Court's articulation of cooperative federalism underscores the normative expectation that the Union and the States should work together as partners. However, judicial rhetoric has not yet translated into binding fiscal rules²². The gap between normative commitment and doctrinal enforcement has remained a central concern when evaluating the role of the judiciary in preserve fiscal federalism.

GOODS AND SERVICES TAX AND THE RESTRUCTURING OF FISCAL FEDERALISM

CONSTITUTIONAL TRANSFORMATION THROUGH THE GST REGIME

Introduction of Goods and Services Tax through the One Hundred and First Constitutional Amendment Act, 2016 represents the most significant re-configuration of India's fiscal-federal architecture since independence. By subsuming a wide range of central and indirect taxes into one uniform tax regime, GST fundamentally changed the way Distribution of taxing powers between Union and the States. Article 246A, 269A and 279A establish together a structure of concurrent taxation where both levels of state and central government share authority over indirect taxation²³. While GST was justified on such grounds as economic efficiency, market integration, and ease of Conducting business, yet its constitutional consequences for federalism are significant. The states relinquished a substantial part of their independent taxing power, especially in terms of sales tax and the value-added tax, which traditionally had constituted their most important source of own revenue. In return, States were promised assured compensation for revenue losses and a through participatory role in the decision-making through the GST Council. Conceptually, GST reflects cooperative federalism through institutional design but introduces functional centralization through revenue control²⁴. The constitutional This amendment thus reflects a shift from fiscal autonomy to fiscal coordination, raising questions regarding over whether coordination has gradually given way to subordination.

THE GST COUNCIL AND ASYMMETRIC DECISION-MAKING

The GST Council, constituted under Article 279A, is the apex decision-making body²⁵. responsible for determining tax rates, exemption, and administrative procedures. Its composition includes representatives of both the Union and the States and decisions are based on the weighted voting mechanism, where the Union has one-third of the total voting. power. While formally consensual, this system provides the Union with a de facto veto in Decisions

by the Council. The Supreme Court in the case of Union of India v. Mohit Minerals Pvt. Ltd.,²⁶ has clarified that GST Council are not legally binding, and both stress constitutional autonomy. the Union and the States. While the judgment reaffirmed the principle of cooperative While federalism itself was promoted, it concurrently exposed the weakness of fiscal coordination based upon political grounds. international standards of human rights and respect for the rule of law, however, remain a matter of consensus rather than enforceable constitutional guarantees. in practice, States' dependence on GST compensation has limited their willingness to deviate. of Council decisions²⁷. This asymmetry between formal autonomy and practical dependence shows how fiscal structures can restrict political choice even in the absence of explicit legal coercion.

COMPENSATION UNDER GST AND TRUST DEFICIT

The GST compensation mechanism, guaranteed for five years under the constitutional Amendment, was targeted at offsetting States' revenue risks. However, delays in compensation payments, particularly when the economy is bad, have raised significant Centre–State conflict. Many States contended that compensation on account of delayed payment eroded the fiscal bargained below the GST and reduced their capacity to finance important public services. These disputes demonstrate a critical weakness in India's cooperative federal model—the absence of enforceable fiscal guarantees. While the Constitution facilitated the transition to GST, it depended so much on political trust and compliance from the executive. The rupturing of this trust has Intensified demands for re-evaluation of GST's fiscal implications from a constitutional perspective perspective.

CESSSES, SURCHARGES, AND THE BYPASSING OF FISCAL DEVOLUTION

CONSTITUTIONAL BASIS AND EXPANSION OF CESSSES

Cesses and surcharges are constitutionally authorized under both Articles 270 and 271²⁸. While taxes form part of the divisible pool and are required to be shared with States, while cesses and surcharges are not. must be expressly excluded from such sharing. What were originally designed to be temporary and purpose-specific levies, these instruments have gradually but surely been becoming the key source of revenue for the Union. The increasing reliance on cesses has changed the fiscal balance in terms of reducing the effective share. of States in central revenues. Even when the nominal per cent of devolution recommended Since the share of the states in the net proceeds, as assigned by the Finance Commission increases with the

increasing proportion of non-divisible revenues, in practice neutralizes this benefit²⁹. This phenomenon points out how formal compliance with Constitutional provisions can coexist with substantive erosion of fiscal federalism.

CONSTITUTIONAL MORALITY AND FISCAL CENTRALIZATION

Cesses, however well-intentioned, are a constitutional morality question from the perspective of their excessive use. normative concerns. Legally permissible, but strategic deployment of non-shareable revenues run counter to the spirit of cooperative federalism and the institutional role of the Finance Commission. Fiscal federalism, if reduced to a technical distribution of powers if it is without regard to its democratic purpose, risks losing its constitutional legitimacy³⁰. The Supreme Court has not yet subjected cess-based financing to substantive federal scrutiny. However, jurisprudence on constitutional morality suggests that constitutional powers must be exercised in a manner consistent with underlying constitutional values. Application of this Reasoning to fiscal federalism would require the evaluation not only of legality but also of structural factors. impact on State autonomy.

CONDITIONAL TRANSFERS AND CENTRALLY SPONSORED SCHEMES

Centrally Sponsored Schemes, or CSS, are another mechanism through which fiscal The mechanism of centralization works here, while these schemes actually are designed for national development. objectives, they frequently lay down elaborate conditions with respect to implementation in States and spending priorities. Therefore, States are forced to make their policy decisions conform to centrally determined schemes, even in matters falling within their legislative competence. This conditionality has important consequences for democratic accountability. When States act primarily as implementing agencies for centrally designed programs, electoral accountability becomes blurred. For instance, citizens may hold State governments responsible for policy outcomes over which they have limited control. Such distortion undermines the federal Principle of decentralization of responsiveness and accountability.

REVISITING RESEARCH PROBLEM

Structural Undermining of Fiscal Federalism The analysis so far has brought the central research problem in sharp focus. As the constitutional framework of fiscal federalism remains

formally intact; however, contemporary fiscal practises are GST centralization, cess-based revenue mobilization, conditional transfers in their entirety point in the direction of a structural weakening of the fiscal autonomy of the State. problem is not one of outright constitutional violation, but of gradual erosion through permissible mechanisms. This is a critical constitutional question whether the cooperative federalism might survive. It means, when fiscal dependence replaces fiscal partnership. In order to resolve this problem, the following shifts are necessary: beyond doctrinal formalism toward the substantive consideration of federal balance, institutional trust, constitutional morality, and so on.

COMPARATIVE PERSPECTIVE ON FISCAL FEDERALISM

A comparative analysis of fiscal federalism in other constitutional democracies underlines the following features. the particularity of the Indian experience and provides useful normative benchmarks. In Canada, fiscal federalism does work within a paradigm of high levels of provincial autonomy, wherein provinces retain substantial taxing powers, e.g., income tax. Transfers from the federal government are guided by constitutionally entrenched equalization principles, ensuring fiscal redistribution does not violate provincial sovereignty³¹. The Canadian Supreme Court has ever treated fiscal autonomy as a component of federal balance. A further instructive model is that of Germany, which exhibits cooperative federalism with constitutionally mandated revenue sharing³². The German Basic Law explicitly requires both Vertical and horizontal fiscal equalization, and the Federal Constitutional Court actively enforces these. Judicial review in Germany, beyond formal legality, reaches to assess whether fiscal arrangements preserve the functional autonomy of Länder. This That approach contrasts sharply with the Indian judicial deference in fiscal matters³³. Indeed, as compared to these systems, fiscal federalism in India reflects a more pronounced dominance of the centre. and weaker judicial enforcement, while cooperative institutions exist, their effectiveness depends more on political goodwill than on enforceable constitutional standards. This A more comparative perspective would emphasize the need for a constitutionalism that is much more substantive. engagement in fiscal federalism in India.

FINDINGS OF THE STUDY

The study produces several important results. First, the constitutional design of India deliberately Centralizes the revenue powers while compensating States through institutionalized transfers. The model was intended to bring a balance between national unity and regional autonomy, not to create permanent fiscal dependence. Second, judicial

interpretation has recognized federalism as part of the Constitution's basic structure but has largely abstained from substantive scrutiny of fiscal arrangements. This Since judicial restraint has allowed for gradual fiscal centralization through constitutionally acceptable but normatively problematic mechanisms. Third, in particular, the GST regime has changed fiscal federalism from shared sovereignty. from a consumption-based indirect taxation system into one of coordinated administration. The GST, while proving advantageous in certain respects by improving economic efficiency, has Indeed, the State fiscal autonomy was seriously handicapped without legally enforceable Compensation guarantees. Fourth, the increasing resort to cesses, surcharges, and conditional grants has structurally Reduced the effective share of States in national revenues, undermining the role of the Finance Commission and undermining cooperative federalism³⁴.

RECOMMENDATION & PROPOSALS FOR REFORM

Restoring the constitutional balance of fiscal federalism requires several reforms. First, the use of cesses and surcharges constitutionally or statutorily limited to extraordinary circumstances, with more clarity and time-bound goals. Alternatively, portion of such revenues must be brought within the divisible pool for preserving intact fiscal devolution. Secondly, the Finance Commission needs to be reiterated as the premier institution for fiscal negotiation. The Executive must be made less dependent upon discretionary transfers under Article 282. curtailed, and Finance Commission recommendations accorded greater normative weight through parliamentary accountability mechanisms. the third is that judicial review of fiscal federalism should evolve from formal deference to substantive. evaluation. While courts need not pronounce upon fiscal policy, they have to ensure that the fiscal arrangements do Not hollow out State autonomy or undermine the federal structure. Drawing from comparative Thus, in a manner similar to that in which the Supreme Court has articulated a "federal exhaustion test,"⁵¹ there would emerge in jurisprudence, a "federal impact test" that may examine structural consequences. Fourth, meaningful implementation must empower local governments fiscally. of the recommendations of State Finance Commissions. Without grassroots fiscal decentralization, the promise of three-tier federalism remains unfulfilled.

CONCLUSION

Fiscal federalism in India is at a constitutional crossroads. While the textual framework the essence of fiscal federalism remains in place, contemporary fiscal practices demonstrate a gradual shift toward centralization that threatens the normative foundations of cooperative

federalism. The increasing dependence on extra-divisible revenues, centralized indirect taxation, and conditional transfers reflects a model of governance that favors administrative convenience over constitutional balance. This paper has contended that mere constitutional compliance falls far short in keeping fiscal Federalism. What is needed is an adherence to constitutional morality a commitment to the spirit of partnership, autonomy and trust which underpins the federal compact. Strengthen Institutions like the Finance Commission, rebalancing judicial involvement, and facilitating True intergovernmental dialogue should be continued to ensure that fiscal federalism endures. serve as an instrument of democratic governance and inclusive development in India.

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