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A STUDY OF FINANCIAL RELATIONSHIP BETWEEN UNION AND STATE UNDER FEDERAL POLITY

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ABSTRACT

The financial relationship between the Union and State governments under a federal polity is a crucial aspect of governance, ensuring fiscal balance and cooperative functioning. In India, this relationship is defined by constitutional provisions, particularly under Articles 268 to 293, which outline revenue distribution, taxation powers, and financial grants. The Union government levies and collects major taxes, redistributing resources to states through mechanisms such as Finance Commissions, centrally sponsored schemes, and grants-in-aid. While this system aims to maintain fiscal equity and economic stability, challenges such as vertical and horizontal imbalances, dependency on central funds, and financial autonomy of states persist. The role of institutions like the Finance Commission and the Goods and Services Tax (GST) Council is pivotal in addressing these concerns, ensuring a balanced and sustainable fiscal framework. This study explores the evolving financial dynamics between the Union and States, the effectiveness of revenue-sharing mechanisms, and the need for reforms to enhance fiscal federalism in India.

KEYWORDS- *Financial Relationship, Federal Polity, financial relationship, Union and State governments, Finance Commissions, Goods and Services Tax (GST) Council*

INTRODUCTION

To understanding the interactions between the two governmental branches that make up the federal system is crucial. One fundamental aspect of federalism is the separation of powers between the union and the states. Each government is independent and supreme in its own sphere and cannot interfere in each other's jurisdiction. This is the ideological form of the federation. But in practice it is used by each country according to its specific circumstances.

In America and Australia, in the beginning the confederation was strictly followed in principle by defining centre the powers of the center and residuary powers were given to the states under their Constitutions. As a result, the center was weaker than the states. But later some such incidents took place in these countries, especially both the world wars, as a result of which gradually the powers of the center increased and today in these countries also the center has become more powerful than the states. Gaining experience from the events of these countries, Canada adopted the power-sharing scheme between the center and the states, in this it kept the center strong and gave the residual powers to the center. The framers of our constitution saw the wisdom in establishing a strong central authority and granting it power, considering the circumstances in our nation and the lessons drawn from the experiences of other countries. This approach aimed to facilitate economic progress while upholding national unity and integrity, which they deemed achievable. Consequently, they molded the federal system to suit Indian conditions, giving the constitution a unique character. The equilibrium of power between the Central government and the States distinctly mirrors this evolution. The three primary categories of relationships between the federal government and the states typically encompass “legislative relations”, “administrative relations” and “financial relations”. While the focus of this research primarily lies on the financial relationship, we cannot overlook the legislative relationship, which holds paramount importance. This is due to the fact that, as per the constitutional framework, the union legislature holds the authority to alter the financial relationship between the state and the union through constitutional amendments.

NATURE OF FEDERAL STRUCTURE IN EMERGENCY SITUATION

In India, federalism has undergone transformations due to wars, global crises, scientific progress, and the emergence of social welfare state ideology. Centralization trends have become noticeable, leading to the establishment of robust national governments within most federations. The framers of the Indian Constitution acknowledged these shifts and the pragmatic necessities of the nation, crafting a federal framework tailored to India's vast and varied landscape. This design aimed not to adhere to any fixed or theoretical model but to address the unique requirements of a nation as extensive and diverse as India.

In formulating federalism, the drafters of the Indian Constitution prioritized practical considerations over theoretical or preconceived notions. The Constitution introduced several innovative concepts to the field of federalism. Various terms, such as quasi-federal, unitary with federal elements, federal with unitary characteristics, and centralized federation, have been employed by scholars to characterize the Constitution. Despite the considerable power vested in the Indian Center and the Constitutional framework's emphasis on fostering extensive intergovernmental cooperation, the States do not serve as mere agents of the Center. They operate within the framework of the Constitution rather than at the Center's command, enjoying substantial autonomy during normal circumstances. Their authority stems from the Constitution itself, not solely from central legislation. Furthermore, the Center cannot unilaterally amend the federal aspects of the Constitution; instead, amendments require collaboration between the States and the Center. The Indian Federation embodies all of these characteristics, which make up the fundamentals of federalism. It has been determined that federalism is a fundamental component of the Constitution and one of its key elements.

When drafting a federal constitution, the Constituent Assembly had numerous precedents to consider, yet it wisely opted to begin with the Government of India Act49, 1935. This choice was rational because the provisions of the Government of India Act, 1935 could be easily adapted to establish a Parliamentary system of federal governance, which was the focal point of political contention in India once the various "safeguards" within the Act were removed. Indian political leaders had advocated for Dominion Status akin to that of Canada and Australia. The constitutions of these nations, crafted by the British Parliament, mirrored a parliamentary federal system modeled after the British model, with necessary distinctions between federal and unitary constitutions, akin to Great Britain. Adopting the Government of India Act, 1935 as the cornerstone of the new Constitution carried the significant advantage of ensuring continuity of old laws and constitutional provisions during the transition from British colonial rule to the new Republic of India. This bestowed upon India the advantage of evolutionary change over revolutionary rupture with the past. Moreover, the 1935 Government of India Act served as a valuable instrument for the federal government.

India is a Union of States, according to the first article of the Indian constitution. As Prof. Wheare correctly notes, “any definition of federal government which failed to include the United States would be thereby condemned as unreal". The United States Constitution established a union of States with a central government that possesses certain independent powers from the State governments, while the State governments retain autonomy in other spheres. A constitution doesn't need to fully adhere to the federal principle to be labeled as "federal"; prioritizing the federal principle as its core tenet suffices. Prior to 1913, members of the U.S. Congress's Upper House were selected by State legislatures, resulting in significant reliance of the United States' general legislature on state legislatures. This perspective was altered by the XVIIth Amendment, allowing for the direct election of senators by the people. Nevertheless, since a federal concept was prevalent even prior to 1913, the United States Constitution was accurately recognized as a federal constitution.

CONSTITUTIONAL PROVISIONS GOVERNING FINANCIAL RELATIONS

The financial relationship between the Union and State governments in India is primarily governed by constitutional provisions outlined in Articles 268 to 293 of the Indian Constitution. These provisions define the division of taxation powers, revenue distribution, grants-in-aid, and borrowing powers of states. The Seventh Schedule of the Constitution classifies taxation powers into the Union List, State List, and Concurrent List, ensuring a structured financial framework. The Union government has exclusive authority over major taxes such as income tax (except agricultural income), corporate tax, and customs duties, while states levy taxes like land revenue and state excise. Article 270 provides for the distribution of taxes between the Union and States based on recommendations from the Finance Commission, which is constituted every five years under Article 280. Additionally, Article 275 ensures grants-in-aid to financially weaker states, and Article 282 allows both the Union and States to make discretionary grants for public purposes. The introduction of the Goods and Services Tax (GST) under Article 279A further restructured the financial relations by creating the GST Council, which oversees indirect tax distribution. Despite these provisions, challenges such as fiscal imbalances and dependency on central funds persist, necessitating continuous reforms to strengthen fiscal federalism in India.

TAXATION POWERS OF UNION AND STATES

The taxation powers of the Union and State governments in India are defined under the Seventh Schedule of the Indian Constitution, which divides financial authority into three lists: the Union List, State List, and Concurrent List. The Union government has exclusive power to levy taxes on subjects in the Union List, such as income tax (except on agricultural income), corporate tax, customs and excise duties, and Goods and Services Tax (GST) on interstate trade. The State governments have authority over taxes mentioned in the State List, including state excise, land revenue, stamp duty, vehicle tax, and taxes on agricultural income. The Concurrent List does not contain taxation powers, but under Article 246A, both the Union and States share the power to levy Goods and Services Tax (GST), with the GST Council regulating its implementation. Additionally, under Article 268, certain taxes like stamp duty and excise on medicinal preparations are collected by the Union but assigned to the States. Article 270 allows for the distribution of Union taxes with States based on recommendations of the Finance Commission. Despite these provisions, issues such as fiscal imbalance and revenue dependency remain, necessitating periodic financial reforms to ensure equitable resource distribution.

ROLE OF FINANCE COMMISSION IN FISCAL FEDERALISM

The Finance Commission plays a vital role in India's fiscal federalism by ensuring a fair distribution of financial resources between the Union and State governments. Established under Article 280 of the Indian Constitution, it is a constitutional body that is reconstituted every five years or at an earlier interval when necessary. Its primary role is to recommend the distribution of tax revenue between the Union and the States and among the States themselves. Since India follows a federal structure, where the Union and the States have separate responsibilities but interdependent financial needs, the Finance Commission acts as a crucial mechanism to maintain fiscal balance and cooperative federalism.

One of the primary responsibilities of the Finance Commission is to determine the division of the net proceeds of taxes between the Union and the States. Since tax collection powers in India are highly centralized, while expenditure responsibilities are spread across different levels of government, a vertical fiscal imbalance arises. The Finance Commission helps address this by recommending the proportion of Union taxes to be devolved to the States, ensuring that the States receive adequate resources to fulfill their governance duties. The 15th Finance Commission (2020-2025), for example, recommended that 41% of the divisible tax pool be allocated to the States.

Apart from vertical fiscal balance, the Finance Commission also ensures horizontal fiscal balance among States. Since different States have different levels of economic development, revenue-generating capacity, and public expenditure needs, some States require more financial support than others. The Finance Commission determines State-wise allocations based on a formula that includes factors such as population, income distance, area, forest cover, and demographic performance. This redistribution helps bridge the gap between economically developed and financially weaker States, reducing regional disparities.

Another crucial function of the Finance Commission is recommending grants-in-aid to States under Article 275 of the Constitution. These grants provide additional financial support to States that may struggle to meet their budgetary requirements. The Commission also suggests special grants for disaster management, local governance, and sector-specific development projects. For example, the 15th Finance Commission introduced a Disaster Risk Management Fund to assist States in handling natural calamities such as floods, cyclones, and pandemics.

Furthermore, the Finance Commission plays a role in strengthening local governance by recommending fund allocations to Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs). With the implementation of the 73rd and 74th Constitutional Amendments, local governments are responsible for providing essential public services such as sanitation, water supply, and primary healthcare. The Finance Commission ensures that local bodies receive adequate financial resources to function efficiently.

Despite its importance, the Finance Commission faces several challenges, including political influence, delays in implementation, and increasing reliance on centrally sponsored schemes (CSS), which limit financial flexibility for States. To strengthen its role in fiscal federalism, there is a need to ensure greater transparency, make its recommendations legally binding, and reduce revenue dependence on the Union government. Strengthening the Finance Commission will ensure that India's fiscal federalism remains balanced, equitable, and efficient, promoting cooperative governance and sustainable development.

FEDERAL CHARACTER OF ADMINISTRATIVE RELATIONS BETWEEN UNION AND STATE

When assessing whether a Constitution embodies federalism, it's imperative to grasp the core concept: every citizen of a State is subject to laws enacted by both the Federal and State Legislatures. Moreover, the executive branch is tasked with enforcing these laws, with enforcement duties possibly falling to distinct Federal or State agencies, as outlined in our Constitution. The misconception that federalism is diluted in our Constitution arises from a failure to comprehend its fundamental principles and their inevitable consequences. Articles 245 to 255 delineate legislative relations between the Union and the States, while Articles

256 through 258A detail administrative relationships. Consequently, Parliament exclusively holds the authority to legislate on List I matters, State legislatures on List II matters, and both on List III matters.

The scenario of a conflict between a legitimate State law and a valid Union law raises a pertinent inquiry. As per Canadian court precedents, efforts must initially be made to reconcile conflicting federal and provincial laws; however, if reconciliation proves unattainable, precedence will be given to the federal law. If, that were not so "an absurd situation would result if two inconsistent laws, each of validity, could exist side by side". In the event of an irreconcilable contradiction, a legitimate Federal Law shall take precedence over a State Law, as stated explicitly in Section 109 of the Australian Constitution.

It is widely recognized that in cases of conflict between Union legislation and State laws, a provision is made under Article 254(1) of the Indian Constitution. However, due to the amendment introduced by Article 254(2), a State Legislature's law enacted under Section 107 of the Government of India Act, 193577, with the President's approval, will prevail in that State if it does not contradict a law passed by Parliament. Parliament retains the power to annul such a law either directly or by enacting a law that contradicts it.

In cases of conflict, a valid Union law takes precedence over a valid State law, necessitating measures to ensure the lawful exercise of executive power, which aligns with legislative power. However, concerning List III, the Union's executive authority does not extend to a State unless specifically authorized by the Constitution or by legislation enacted by Parliament. To enforce Union legislation in every State, State governments must utilize the executive power of the Federal government to ensure compliance with State-specific laws or laws enacted by Parliament. Article 256 allows the Union's executive authority to instruct a State in any manner necessary to achieve this objective, thereby reinforcing the federal principle rather than deviating from it. While state and federal courts coexist in the United States, our Constitution establishes a unified judicial system led by the Supreme Court. Entries 95 of List I, 65 of List I, and 46 of List II follow the format of "Jurisdiction and powers of all courts other than the Supreme Court in respect of matters in this List," with entry 95 of List I additionally mentioning "admiralty jurisdiction."

CONCLUSION

In conclusion, the Finance Commission plays a crucial role in maintaining fiscal federalism by ensuring an equitable distribution of financial resources between the Union and State governments. As a constitutional body, it addresses the vertical and horizontal fiscal imbalances that arise due to differences in revenue-raising capacities and expenditure responsibilities among different levels of government. By recommending the devolution of taxes, grants-in-aid, and special allocations for local bodies and disaster management, the Finance Commission strengthens cooperative federalism and ensures balanced regional development. However, challenges such as political influence, delays in implementation, and excessive dependence on centrally sponsored schemes pose hurdles in achieving true fiscal autonomy for States. To enhance its effectiveness, there is a need for greater transparency, legal backing for its recommendations, and a more dynamic approach that adapts to changing economic conditions. A robust and independent Finance Commission is essential for fostering fiscal stability, promoting inclusive growth, and ensuring financial sustainability in India's federal structure.

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