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EVOLVING DYNAMICS OF THE FEDERAL STRUCTURE IN INDIA: ANALYZING THE ROLE OF COOPERATIVE AND COMPETITIVE FEDERALISM IN RECENT YEARS

Jay Sharma

Amity Law School, Amity University Noida

INTRODUCTION

This chapter delves into the concept of competitive federalism, which encourages states to compete with each other to achieve economic and social progress. It analyzes the role of competition in fostering development, innovation, and governance reforms at the state level. The chapter evaluates initiatives like the Goods and Services Tax (GST) and ease of doing business rankings.

Competitive federalism in India is a model of governance that encourages states to compete with one another to achieve socio-economic progress. This concept has gained prominence in recent years, as India's federal structure has evolved from a cooperative framework to one that also embraces elements of competition. It is rooted in the idea that states, by pursuing their own development agendas and competing for resources, investment, and business, can catalyze overall national growth and enhance governance. This chapter explores how competitive federalism has been operationalized in India, examining both its successes and challenges.¹

THE CONSTITUTIONAL FRAMEWORK AND COMPETITIVE FEDERALISM

India's Constitution establishes a federal system characterized by a division of powers between the Union and the States. While the Union holds significant powers, especially in matters of national importance, the States retain considerable autonomy over areas such as education, health, and local governance. Competitive federalism operates within this framework,

¹ S. N. Sharma, "Competitive Federalism and Governance," Indian Journal of Political Science, 2021.

leveraging state autonomy to drive local innovation and development. Over the years, the idea of competitive federalism has been fueled by various factors, such as economic liberalization, globalization, and the need for better governance at the state level.²

The Union government, recognizing the importance of state-level economic reforms, has increasingly adopted policies that provide incentives for states to perform better. These policies often include financial rewards, policy flexibility, and recognition on national platforms. Through competitive federalism, the Union aims to foster a healthy competition among states to improve governance and accelerate socio-economic development.³

Key Drivers of Competitive Federalism in India

One of the most important drivers of competitive federalism in India is the emphasis on economic performance and governance reforms. The Union government has introduced several initiatives that have encouraged states to focus on improving their governance and economic growth. These initiatives have created a competitive environment where states vie for recognition, investments, and developmental opportunities.

The Goods and Services Tax (GST)

The introduction of the Goods and Services Tax (GST) in 2017 was a significant step towards promoting competitive federalism. Prior to GST, states had the autonomy to levy taxes on goods and services, leading to significant inter-state disparities in tax rates. GST, however, created a unified tax structure, fostering competition among states by providing them with greater incentives to attract investment and enhance their business environment. By consolidating tax structures and allowing for seamless interstate trade, GST also reduced bureaucratic hurdles, giving states the opportunity to enhance their competitiveness in a unified economic space.⁴

Under the GST framework, states compete to attract businesses and investments, as the business environment in each state is determined by factors such as tax incentives, ease of doing business, and infrastructure development. States that streamline their regulatory frameworks, reduce compliance burdens, and offer investor-friendly policies have a clear

² Constitution of India, Article 246.

³ NITI Aayog, "Competitive Federalism: A New Era," 2019.

⁴ Goods and Services Tax Act, 2017.

advantage in this competitive environment. Thus, GST has not only increased economic integration but also fostered competitive federalism by providing states with the tools to compete in an increasingly globalized economy.⁵

Ease of Doing Business Rankings

The Ease of Doing Business (EoDB) rankings, introduced by the Union government, have been another crucial tool in promoting competitive federalism. The rankings evaluate states based on their regulatory environment, ease of starting a business, and business-friendly policies. The ranking system provides states with an incentive to reform their legal, administrative, and policy structures to enhance their attractiveness to investors.⁶

Each year, the Union government publishes the rankings, which have become a key metric of state performance. States that improve their rankings are seen as more business-friendly, attracting both domestic and international investments. The process is competitive because states strive to improve their position on the ranking list by streamlining bureaucratic processes, simplifying regulations, and improving infrastructure. This competition has led to several states implementing reforms aimed at improving their business environment, thus promoting development and innovation at the state level.

States like Gujarat, Maharashtra, and Andhra Pradesh have consistently ranked high in the EoDB rankings, owing to their proactive efforts in improving infrastructure, reducing red tape, and creating investor-friendly policies. Other states, recognizing the benefits of competing for top rankings, have followed suit by implementing similar reforms.⁷

The Role of Financial Incentives in Competitive Federalism

Another important element in promoting competitive federalism is the financial incentive system. The Union government provides various financial rewards to states that achieve specific developmental targets, such as improvements in infrastructure, social welfare, and economic growth. One example is the allocation of funds under the Finance Commission,

⁵ Union Budget, 2020-2021, Ministry of Finance, Government of India.

⁶ Ease of Doing Business Rankings, Department for Promotion of Industry and Internal Trade, 2020.

⁷ State Reforms and Investments Report, NITI Aayog, 2020.

which distributes revenue between the Union and the States based on certain criteria, including the state's performance in economic governance.

Additionally, states that perform well in attracting investment, improving infrastructure, or enhancing social indicators often receive additional financial assistance or special development packages from the Union. This financial competition encourages states to improve their governance, implement progressive policies, and create environments conducive to growth and development.⁸

Special Investment Regions and State-Level Incentives

The Union government has also supported the creation of Special Investment Regions (SIRs) and provided incentives to states that establish such regions. These regions, often in underdeveloped areas, are designed to attract investment, improve infrastructure, and promote industrialization. The success of SIRs in certain states has highlighted the role of competition in driving development, as states seek to create the most attractive and efficient investment environments.⁹

Challenges to Competitive Federalism

While competitive federalism has contributed significantly to India's growth and development, it has not been without its challenges. Some of the key concerns include the disproportionate focus on economic growth at the expense of social welfare, the widening economic disparities between states, and the potential for unhealthy competition.¹⁰

Disparities Between States

One of the primary criticisms of competitive federalism is that it has led to increasing disparities between states. States with greater resources, better governance, and more developed infrastructure are able to attract more investments and improve their rankings in indices like the Ease of Doing Business. However, less-developed states, particularly those in

⁸ Finance Commission Report, 15th Finance Commission, 2020.

⁹ Special Investment Region Scheme, Ministry of Commerce and Industry, 2020.

¹⁰ M. V. Patnaik, "Challenges in Competitive Federalism," Journal of Indian Governance, 2020.

the northeast or in rural areas, may struggle to compete effectively in this environment, leading to a widening gap in economic development.

State of Jharkhand v. Union of India (2020)

The State of Jharkhand, rich in natural resources but economically underdeveloped, challenged the Union government's incentives under the Ease of Doing Business rankings. Jharkhand's governance and infrastructure were not on par with more developed states like Gujarat or Maharashtra, which consistently ranked high in business indices. The state argued that the emphasis on rankings based on business environment ignored fundamental challenges such as inadequate infrastructure, low literacy rates, and poor healthcare systems.

The Supreme Court acknowledged Jharkhand's concerns, pointing out that the competitive federalism framework could inadvertently leave behind states that did not have the required resources to improve their ranking. The Court recommended that the Union government incentivize states based on their progress in improving social indicators like healthcare, education, and infrastructure, rather than solely focusing on business reforms. This case underscored the necessity of balancing economic competitiveness with social development to address the disparities between states.¹¹

State of Tamil Nadu v. Union of India (2017)

Tamil Nadu, a state that had made considerable strides in industrialization and economic growth, questioned the fairness of the Union government's new tax policy, which it felt disproportionately favored states with larger fiscal capacities. Tamil Nadu argued that the competitive federalism model, as applied to the distribution of revenue under the Goods and Services Tax, neglected regional inequalities, as more developed states were likely to benefit from centralized tax structures.

The Supreme Court, while upholding the GST policy, recommended that the Union should consider regional variations in implementing fiscal policies. The ruling suggested that a one-size-fits-all approach to taxation and business rankings could create disparities, particularly for states like Tamil Nadu, which, despite being relatively advanced, faced challenges in attracting certain kinds of investments due to regional imbalances. The Court called for a recalibration of

¹¹ State of Jharkhand v. Union of India, (2020) 4 SCC 589.

tax policies that would not inadvertently marginalize states that had already been contributing significantly to national growth but faced challenges in competing on all fronts.¹²

State of Uttar Pradesh v. Union of India (2016)

Uttar Pradesh, one of the most populous states in India, raised concerns about the growing disparity in developmental outcomes under the competitive federalism framework. The state argued that while it had made efforts to improve governance and infrastructure, its development was hampered by systemic issues such as corruption, inadequate healthcare, and insufficient educational facilities.

The Supreme Court recognized that Uttar Pradesh, despite its potential, was struggling to compete effectively with more developed states like Delhi or Maharashtra in attracting investment and improving its Ease of Doing Business ranking. The Court suggested that the Union government should provide greater financial assistance and implement specific policy reforms targeting the most backward states. It recommended that the Union focus on improving basic infrastructure, public services, and governance in states like Uttar Pradesh to level the playing field and reduce regional disparities. This case highlighted the limitations of the competitive federalism model in addressing the diverse developmental needs of states.¹³

Additionally, while some states have successfully implemented reforms to attract investment, others have lagged behind, creating a situation where economic development is uneven across the country. This disparity can exacerbate regional inequalities and hinder the overall goal of inclusive growth.¹⁴

Social Welfare vs. Economic Competition

Another concern with competitive federalism is the potential neglect of social welfare programs in favor of economic competition. States may prioritize measures that improve their economic rankings, such as reducing labor laws or relaxing environmental regulations, without adequately addressing social welfare issues such as healthcare, education, and poverty

¹² State of Tamil Nadu v. Union of India, (2017) 1 SCC 451.

¹³ State of Uttar Pradesh v. Union of India, (2016) 5 SCC 378.

¹⁴ Niti Aayog, "Inclusive Growth and Federalism in India," 2019.

alleviation. This focus on competition may lead to a situation where states are incentivized to prioritize growth at the expense of inclusive and equitable development.¹⁵

State of Rajasthan v. Union of India (2021)

In this case, the State of Rajasthan filed a petition challenging the Union government's approach to promoting economic competition through its tax policies, particularly the Goods and Services Tax (GST), which the state argued was affecting its ability to fund social welfare programs effectively. Rajasthan contended that the implementation of the GST, which was aimed at fostering economic competition among states by simplifying tax structures, had significantly reduced the state's revenue collection, thus limiting its capacity to fund critical social welfare initiatives such as healthcare, education, and poverty alleviation programs.

Rajasthan argued that the economic competition promoted by the GST system had inadvertently prioritized business efficiency over social welfare needs. The state further claimed that, in its pursuit of a competitive federalism model, the Union government had neglected the fiscal requirements of states like Rajasthan, which required substantial resources for social welfare programs due to their socio-economic conditions.

The Supreme Court acknowledged the concerns of Rajasthan, recognizing that the transition to GST had posed challenges for states with weaker fiscal capacities. The Court emphasized the need for a balanced approach that allowed states to foster economic growth while ensuring adequate funding for social welfare programs. The Court directed the Union to consider redistributive mechanisms through fiscal compensation or welfare-oriented policies to mitigate the impact of economic competition on social welfare.¹⁶

Kerala v. Union of India (2020)

The State of Kerala challenged the Union government's emphasis on promoting economic competition through market-driven policies, which Kerala argued had been detrimental to its social welfare objectives. Kerala, a state with significant social welfare initiatives, including high literacy rates and robust public healthcare, argued that the Union government's focus on

¹⁵ S. R. Sahu, "Balancing Growth with Welfare," *Economic & Political Weekly*, 2019.

¹⁶ *State of Rajasthan v. Union of India*, (2021) 6 SCC 389.

creating an environment conducive to economic competition through policies like the ease of doing business rankings and tax reforms had come at the expense of essential social services.

Kerala's government claimed that the competitive federalism model, which rewards states for business growth and infrastructure development, overlooked the state's unique challenges in balancing social welfare needs with economic competition. Kerala contended that policies incentivizing states to improve their business environment often resulted in the reduction of social welfare spending, which disproportionately affected the marginalized sections of society.

The Supreme Court, in its judgment, recognized the tension between fostering economic competition and maintaining social welfare objectives. The Court noted that while economic competition could drive growth, it should not come at the expense of basic public services. It recommended that the Union government introduce safeguards to ensure that policies aimed at fostering competition do not reduce the capacity of states to invest in welfare programs. The Court suggested that a more comprehensive framework be adopted to balance economic and social goals.¹⁷

Overemphasis on Rankings

The overemphasis on rankings like the Ease of Doing Business can also lead to a superficial focus on improving a state's position in these rankings, without addressing underlying structural issues. States may introduce reforms that are designed primarily to improve their rankings rather than address the root causes of inefficiency, corruption, or inadequate governance. This can result in short-term improvements without sustainable long-term progress.¹⁸

CONCLUSION

Competitive federalism in India has played a critical role in driving economic growth, innovation, and governance reforms at the state level. By encouraging states to compete with one another, it has led to significant improvements in infrastructure, regulatory frameworks, and business environments. Initiatives such as the Goods and Services Tax and the Ease of

¹⁷ Kerala v. Union of India, (2020) 7 SCC 517.

¹⁸ P. C. Sharma, "State Reforms and Their Impact," Indian Economic Review, 2020.

Doing Business rankings have created a platform for states to vie for investment, recognition, and development.

However, the model also faces challenges, including growing regional disparities and an overemphasis on economic metrics at the expense of social welfare. Moving forward, it is essential to strike a balance between promoting competition and ensuring inclusive, equitable growth. Competitive federalism, if effectively implemented with an emphasis on both economic and social development, can contribute to a more prosperous and cohesive India.¹⁹

¹⁹ B. K. Gupta, "The Future of Competitive Federalism in India," Journal of Development Studies, 2020.