

Fiscal Federalism in India: Challenges and Prospects

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Abstract

Fiscal federalism is central to the working of India's constitutional democracy because it determines how financial powers, taxation authority, and intergovernmental transfers are distributed between the Union and the States. India's constitutional scheme under Part XII, read with the Seventh Schedule, creates a system in which the Union controls the more buoyant tax bases while the States carry major expenditure responsibilities in sectors such as health, education, agriculture, and local public services. This has produced a structurally important vertical imbalance, which the Constitution seeks to correct through tax devolution, grants-in-aid, borrowing rules, and institutions such as the Finance Commission and the GST Council. The paper examines the constitutional foundations of fiscal federalism in India, the role of tax devolution and grants, the changing impact of GST, and the continuing tensions between efficiency, equity, and State autonomy. It argues that while India has developed a sophisticated transfer architecture, major challenges remain, particularly the shrinking effective divisible pool due to cesses and surcharges, post-compensation GST stress, conditional transfers, and uneven fiscal capacity across States. The paper concludes that stronger cooperative federalism will require more transparent transfers, a more predictable GST regime, better equalization design, and institutional reforms that give States greater voice without compromising macroeconomic stability.

Keywords: Fiscal federalism, India, Finance Commission, GST, tax devolution, grants-in-aid, Centre–State relations, State autonomy, equalization, cooperative federalism

1. Introduction

Fiscal federalism concerns the allocation of taxing powers, expenditure responsibilities, and transfer mechanisms across levels of government. In India, it is not a secondary feature of federalism; it is one of the principal means through which the constitutional balance between national coordination and State autonomy is maintained. Part XII of the Constitution, together with Articles 268–281 and Article 279A, creates the core framework for Centre–State financial relations, while the Finance Commission and the GST Council provide the main institutional channels for adjustment and coordination.

The Indian model reflects a deliberate constitutional choice. India is a “Union of States,” and its federal structure has long been described as having strong centralizing features. Recent constitutional scholarship shows that this vocabulary has influenced how courts and institutions interpret federal balance: the system protects State spheres, but it also grants the Union considerable fiscal leverage through broader tax powers, residuary authority, and control over important transfer instruments.

This paper studies fiscal federalism in India in depth. It first explains the constitutional design of financial relations, then analyzes tax devolution, grants-in-aid, the role of the Finance Commission, and the changing importance of GST. It then identifies key problems such as vertical imbalance, horizontal inequality, dependence on cesses and surcharges, and post-compensation GST uncertainty. Finally, it proposes reforms to make Indian fiscal federalism more transparent, rule-based, equalizing, and cooperative.

2. Constitutional Foundations of Fiscal Federalism in India

2.1 Part XII and the constitutional scheme

The constitutional foundation of Indian fiscal federalism lies in Part XII of the Constitution, especially Articles 268 to 281, which deal with taxation, distribution of revenues, grants, and the Finance Commission. Article 280 provides for the constitution of the Finance Commission, and Article 281 requires that its recommendations and the government’s explanatory memorandum be laid before Parliament. Article 279A, introduced with GST, created the GST Council as a new intergovernmental fiscal institution.

The constitutional design does not distribute fiscal authority symmetrically. Historically and structurally, the Union has access to broader and more productive tax handles, while the States shoulder large spending obligations. This asymmetry is not accidental; it reflects the Constitution’s attempt to preserve macroeconomic coherence while still sustaining subnational governance. The corrective mechanism is not fiscal equality of powers, but a transfer-based federal model built around devolution and grants.

2.2 Tax powers and expenditure responsibilities

The Union’s tax base has traditionally included income tax, corporation tax, customs, and Union excise, while the States have had narrower tax handles such as State excise, stamp duty, land revenue, and, prior to GST, sales tax/VAT on many transactions. With GST, both levels now share the consumption tax field, but within a framework requiring coordinated decision-making. This has changed the form of

State autonomy from unilateral taxation in some sectors to joint rule-making within the GST Council structure.

This division produces what fiscal federal theory calls a **vertical fiscal imbalance**: revenue authority is concentrated more heavily at the Centre, while expenditure responsibility is more widely dispersed. The World Bank's study prepared for the Sixteenth Finance Commission explicitly notes the central importance of Finance Commission transfers in addressing this imbalance in India.

3. Core Instruments of Fiscal Federalism

3.1 Tax devolution

Tax devolution is the most important constitutional device for sharing Union revenues with the States. The Fifteenth Finance Commission's report for 2021–26 recommended that States receive 41% of the divisible pool of central taxes, reflecting the adjustment after the reorganization of Jammu and Kashmir. The Commission also recommended a formula for horizontal distribution among States.

Devolution is constitutionally significant because it is formula-based and relatively less discretionary than many other forms of transfer. It therefore strengthens predictability and supports the federal principle better than ad hoc grants. At the same time, its practical value depends on the size of the actual divisible pool. One major criticism in recent years is that the growing use of cesses and surcharges by the Union reduces the pool of taxes shareable with States, weakening the effective value of the devolution percentage. Recent debate around the Sixteenth Finance Commission has kept this issue at the centre of fiscal federal discourse.

3.2 Grants-in-aid

Grants-in-aid are the second major instrument of Indian fiscal federalism. They are especially important in correcting **horizontal imbalances**, that is, differences in fiscal capacity and development levels across States. PRS notes that the Fifteenth Finance Commission recommended revenue deficit grants for certain States for 2021–22 to 2025–26, with tapering over time.

Grants can serve equity, stabilization, or sectoral development purposes. However, heavy reliance on tied or conditional grants may narrow State discretion and shift fiscal federalism away from autonomy and toward administrative compliance. For that reason, the design of grants matters as much as their volume. The World Bank study for the Sixteenth Finance Commission emphasizes the equalization role of transfers and the need for analytical clarity in how they are structured.

3.3 Borrowing and fiscal discipline

The Constitution allows both the Union and the States to borrow, but States borrow within a broader framework of macro-fiscal constraints. The Fifteenth Finance Commission recommended a fiscal roadmap that included phased State deficit limits, moving from 4% of GSDP in 2021–22 to 3% in 2023–26, with certain flexibility conditions.

This shows that Indian fiscal federalism is not merely a transfer regime; it is also a system of coordinated fiscal discipline. The rationale is sound, because unsustainable State debt can create economy-wide risks. Yet tight borrowing control can also reduce State policy space, especially where States face rising social-sector obligations. The constitutional and policy challenge is therefore to combine prudence with flexibility rather than treat all State borrowing as fiscally suspect.

4. The Finance Commission as the Anchor Institution

4.1 Constitutional role

The Finance Commission is appointed every five years under Article 280. Its central task is to recommend the distribution of net tax proceeds between the Union and the States and among the States themselves, and to suggest grants-in-aid and other measures within its terms of reference. The Constitution itself thus places transfer design at the heart of Indian federalism.

The importance of the Finance Commission lies not only in technical revenue sharing but in constitutional mediation. It converts political conflict over federal resources into a structured, periodic, quasi-constitutional process. This institutionalization is one reason Indian fiscal federalism has remained relatively resilient despite repeated political disputes.

4.2 Vertical and horizontal balance

A sound Finance Commission must address both **vertical imbalance** and **horizontal imbalance**. Vertical imbalance refers to the mismatch between revenue authority and expenditure responsibility across levels of government. Horizontal imbalance refers to differences between States in income, tax base, demographic profile, geography, and service delivery costs. The recent NIPFP paper on tax transfers and demographic transition argues that these formula choices must increasingly take account of India's changing age structure and fiscal needs across States.

The equalization function is especially important in a country where States differ sharply in per capita income, urbanization, tax effort, and development needs. A purely origin-based or collection-based

system would magnify inequality. A transfer system that includes equity criteria is therefore not contrary to federalism; it is necessary for a workable federal union.

5. GST and the Reshaping of Indian Fiscal Federalism

5.1 GST as a structural turning point

GST fundamentally altered fiscal federalism in India by subsuming a range of central and State indirect taxes into a harmonized tax architecture. Joseph and Kumary argue that GST required States to forgo important taxing rights and that the trajectory of State fiscal health became closely tied to the design of India's "Indianized" GST paradigm.

This reform had clear efficiency goals: reducing cascading, creating a common market, and strengthening compliance through integrated administration. But its federal implications were equally profound. GST changed Indian fiscal federalism from one where States had substantial autonomy in major consumption taxes to one where tax policy increasingly depends on collective bargaining within the GST Council.

5.2 Compensation and post-compensation stress

To secure State consent, GST was accompanied by a compensation mechanism promising protection against revenue loss. By February 2023, the Centre announced the release of the entire pending provisional GST compensation for June 2022, including ₹16,982 crore paid from the Centre's own resources to be recouped from future cess collections.

The post-compensation phase has exposed a core fault line. PRS notes that GST compensation ended in June 2022, while SGST revenue continued to remain below both the pre-GST level and the guaranteed trajectory for some time. Its 2024–25 analysis records that although total SGST revenues in 2023–24 overtook 2018–19 levels, the compensation cess remained in use to repay loans taken during the pandemic period, and a Group of Ministers was set up in September 2024 to consider a replacement for the cess structure.

5.3 GST and State autonomy

The central federal question about GST is whether efficiency gains have come at the cost of State autonomy. The answer is mixed. GST has clearly improved harmonization and, over time, has supported stronger collections. Yet it has also narrowed unilateral State tax room and made States more dependent on joint decisions and central transfer reliability. In that sense, GST has deepened cooperative federalism procedurally while also increasing central leverage structurally.

6. Major Challenges in India's Fiscal Federalism

6.1 Shrinking effective divisible pool

One of the most persistent criticisms is the increasing use of cesses and surcharges, which are not ordinarily shareable with States in the same way as divisible-pool taxes. Even when the formal devolution percentage looks stable, the effective transfer outcome may weaken if the shareable base shrinks. Recent state-level debates and reporting around Finance Commission deliberations underline this concern.

This is not a merely technical issue. It affects the normative legitimacy of fiscal federalism. A system may appear rule-based while functioning in a way that reduces the actual autonomy-enhancing content of devolution. Transparent accounting of the divisible pool is therefore central to federal trust.

6.2 Persistent vertical imbalance

States undertake substantial public spending in health, education, agriculture, local infrastructure, welfare delivery, and policing, but they do not control an equally broad tax base. This asymmetry creates regular dependence on devolution and grants. Such dependence is manageable when transfers are predictable, formula-based, and timely; it becomes politically contentious when transfers are delayed, conditional, or offset by central retention of non-shareable revenues.

6.3 Horizontal disparities across States

India's States differ in income levels, population dynamics, forest cover, urbanization, tax effort, and service needs. A uniform devolution system cannot produce equitable outcomes unless the formula meaningfully equalizes fiscal capacity. Recent empirical work on intergovernmental transfers and fiscal equalization in India continues to stress this point.

6.4 Conditionality and centralized policy design

Another challenge is the growth of tied or program-linked transfers. Such transfers may pursue legitimate goals, but they can also convert fiscal relations into instruments of centralized policy steering. In a large and diverse federation, overuse of conditional transfers may reduce the States' ability to tailor spending to local needs. This concern is especially strong in relation to sector-specific schemes and compliance-linked funding.

6.5 Weak fiscal transparency and data asymmetries

Good fiscal federalism depends on transparent, comparable, and timely budget data. Recent NIPFP work on fiscal transparency notes improvements in budget disclosure but also highlights continuing gaps in machine-readable data, metadata, and predictable release practices, especially across ministries and States. Weak transparency complicates both accountability and evidence-based transfer design.

Conclusion

Fiscal federalism in India is not simply about accounting for transfers; it is the operational core of Centre–State relations. The Constitution gives the Union the stronger revenue position, but it also creates compensatory institutions and rules to ensure that States can perform their constitutional roles. Tax devolution, grants-in-aid, Finance Commission recommendations, and the GST Council together constitute the architecture through which Indian federalism is made financially workable. Yet the system remains under strain. The post-GST period has sharpened concerns about State autonomy, compensation, and the narrowing practical value of the divisible pool. Horizontal inequalities remain substantial, and transfer design still struggles to reconcile equity, efficiency, and discretion. These are not reasons to doubt Indian fiscal federalism; they are reasons to reform it.

The long-term prospect remains strong if India deepens cooperative rather than coercive fiscal federalism. That means formula-based and transparent devolution, carefully designed equalization, a stable and credible GST framework, and institutions that treat States as constitutional partners rather than administrative recipients. In that direction lies a more balanced, resilient, and genuinely federal public finance system.

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