The International Journal of Leadership and Innovative Management (IJLIM)
e-ISSN: 3064-7207 Vol.3 Issue 4 | 2026

Federalism Under Strain: Centre–State Relations and Fiscal Autonomy in India

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Abstract: India's federal design pairs a centralising constitutional text with a large, decentralised spending burden on the States. This paper examines whether recent fiscal developments have widened the gap between what States are expected to spend and what they are able to raise or control. Using doctrinal analysis of constitutional provisions and descriptive analysis of Finance Commission awards, Union budget data and secondary datasets for 2010–2026, it traces three pressures on State fiscal autonomy: the growth of non-shareable cesses and surcharges, the pooling of indirect-tax sovereignty under the Goods and Services Tax (GST), and the expansion of conditional transfers and borrowing controls. The findings show a paradox. The formal States' share of the divisible pool rose from 32% under the Thirteenth Finance Commission to 41–42% thereafter, and the Sixteenth Finance Commission retained 41% for 2026–31. Yet the divisible pool itself shrank as a proportion of gross tax revenue, because the share of cesses and surcharges roughly doubled between 2011–12 and 2020–21 before easing. The paper argues that Indian federalism is strained less by open conflict than by a quiet erosion of fiscal discretion. It proposes a negotiated 'cess-for-share' bargain, an institutionalised estimate of vertical fiscal imbalance, a revived Inter-State Council, and rule-based borrowing limits as routes towards a more cooperative fiscal compact.

Keywords: fiscal federalism; Centre–State relations; Finance Commission; GST Council; cesses and surcharges; India.

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1. Introduction

Federalism in India has always been a negotiated arrangement rather than a fixed settlement. The framers of the Constitution chose a 'Union of States' with strong central powers, a design shaped by Partition, the integration of princely states and the perceived need for national planning (Tillin, 2019). Over seven decades, however, the actual delivery of public goods has moved steadily towards the States. They now account for the majority of general government expenditure on health, education, policing, agriculture and urban services, while the most buoyant tax bases remain with the Union.

This mismatch, known as vertical fiscal imbalance, is not unusual among federations (Watts, 2008). What makes the Indian case distinctive is the mix of instruments that manage it. A constitutional Finance Commission recommends tax-sharing every five years. A GST Council now co-governs most indirect taxation. Alongside these sit discretionary channels: centrally

sponsored schemes, cesses and surcharges outside the shareable pool, and Union consent requirements for State borrowing.

Recent years have brought these instruments into open contention. States have complained that a rising share of Union revenue escapes sharing, that GST has removed their power to set rates, and that borrowing ceilings are applied unevenly. Kerala's 2024 original suit against the Union over borrowing limits brought the dispute before the Supreme Court. The Sixteenth Finance Commission, reporting in November 2025, entered this environment and chose continuity in the headline devolution share.

This paper asks a focused question: **has the fiscal autonomy of Indian States expanded or contracted in substance, even where formal devolution has grown?** It contributes by bringing the latest Finance Commission award (2026–31) into a single framework with the cess debate and GST governance, and by distinguishing formal transfer generosity from effective discretionary control. The remainder of the paper reviews the literature, sets out the method, maps the institutional architecture, presents the evidence, discusses the sources of strain and offers policy proposals.

2. Review of Literature

2.1 Normative theories of fiscal federalism. The first-generation theory, associated with Musgrave (1959) and Oates (1972), assigns stabilisation and redistribution to the centre and allocative functions to subnational governments, which can tailor services to local preferences. Oates (1999) later framed this as the 'decentralisation theorem': where costs and benefits are local, lower tiers can supply public goods more efficiently. Transfers, in this view, correct spillovers and close fiscal gaps.

2.2 Second-generation and political-economy approaches. A later strand shifted attention from efficiency to incentives. Weingast (1995) and Qian and Weingast (1997) argued that federalism preserves markets only when subnational governments face hard budget constraints and real autonomy. Rodden (2006) showed that heavy reliance on central transfers can soften those constraints and encourage bailout expectations. Bird and Smart (2002) stressed that transfer design, especially predictability and formula-based allocation, matters as much as the volume transferred.

2.3 The Indian scholarship. Rao and Singh (2005) offered the most comprehensive political-economy account, documenting how plan transfers, discretionary grants and party politics overlaid the constitutional Finance Commission route. Bagchi (2003) described a slow rebalancing of power towards States after economic liberalisation and coalition politics. Reddy and Reddy (2019), drawing on direct experience with the Fourteenth Finance Commission, examined the jump in devolution to 42% and the abolition of the Planning Commission. More recent work by Aiyar and Tillin (2020) identifies a recentralising turn after 2014, driven by a dominant national party, flagship central schemes and a 'one nation' policy rhetoric.

2.4 Research gap. Existing studies tend to examine either the Finance Commission or GST in isolation. Few integrate the shrinking divisible pool, GST rate pooling and borrowing controls into one account of effective autonomy, and none yet incorporates the Sixteenth Finance Commission award. This paper addresses that gap.

3. Research Objectives and Methodology

3.1 Objectives. The study pursues three objectives:

1. To map the constitutional and institutional channels through which revenue flows between the Union and the States.

2. To assess trends in formal devolution against trends in the size of the shareable revenue base, 2010–2026.

3. To identify the principal sources of strain on State fiscal autonomy and propose reforms.

3.2 Research design. The paper adopts a mixed qualitative and descriptive-quantitative design. The doctrinal component examines Articles 246, 268–293 and 279A of the Constitution, the reports of the Sarkaria (1988) and Punchhi (2010) Commissions, and Supreme Court rulings on GST and borrowing. The descriptive component compiles secondary data from the reports of the Fourteenth, Fifteenth and Sixteenth Finance Commissions, the Union Government's Explanatory Memorandum on the Sixteenth Finance Commission (Ministry of Finance, 2026), Reserve Bank of India State finance studies, and curated public datasets on cesses and surcharges (Pavithra, 2025).

3.3 Analytical framework. The paper distinguishes two dimensions of autonomy. *Formal devolution* is the share of the divisible pool assigned to States. *Effective autonomy* is the proportion of resources over which States exercise real discretion, net of conditionality, non-shareable levies and borrowing controls. A widening gap between the two is treated as evidence of federal strain.

3.4 Limitations. Data on cesses vary by source depending on whether the GST compensation cess is included; the paper uses a consistent series excluding it and flags discrepancies. The analysis is descriptive and does not claim causal identification.

4. Constitutional and Institutional Architecture of Fiscal Federalism

4.1 Assignment of taxes and functions. The Seventh Schedule allocates legislative powers across Union, State and Concurrent Lists. The Union holds the elastic bases, including income tax, corporation tax and customs. The States hold land revenue, stamp duties, alcohol excise and, historically, sales tax. Expenditure responsibilities in the State List are far wider than the revenue bases attached to it, creating a structural vertical imbalance from the outset (Rao & Singh, 2005).

4.2 The Finance Commission. Article 280 requires a Finance Commission every five years to recommend the division of shareable Union taxes (Article 270) and grants-in-aid to needy States (Article 275). Since the Eightieth Amendment (2000), all Union taxes form the divisible pool, but Article 270 excludes cesses and surcharges levied for specific purposes. This exclusion is the legal root of the contemporary cess controversy.

4.3 Discretionary channels. Article 282 permits the Union to make grants for any public purpose. This provision underpins centrally sponsored schemes, which typically require States to co-finance and follow central guidelines. After the Planning Commission was replaced by NITI Aayog in 2015, scheme-based transfers moved largely to line ministries, preserving their conditional character.

4.4 The GST Council. The One Hundred and First Amendment (2016) created concurrent taxing powers over goods and services and established the GST Council under Article 279A. The Union holds one-third of the weighted vote and the States together hold two-thirds, while decisions require a three-fourths majority. The Union therefore possesses an effective veto, though no State acting alone does. In *Union of India v. Mohit Minerals* (2022), the Supreme Court held that Council recommendations carry persuasive rather than binding force, affirming that both Parliament and State legislatures retain legislative competence.

4.5 Borrowing controls. Under Article 293(3), a State indebted to the Union must obtain its consent to borrow. Since virtually every State carries some such debt, the Union sets annual net borrowing ceilings for all of them. The inclusion of off-budget borrowings by State entities within these ceilings formed the core of Kerala's dispute before the Supreme Court, which in 2024 referred the questions to a Constitution Bench (*State of Kerala v. Union of India*, 2024).

5. Results: Trends in Devolution, Cesses and Transfers

5.1 Formal devolution has risen and then plateaued. Figure 1(a) shows the States' share of the divisible pool across six Finance Commissions. The share crept from 29.5% to 32% between the Eleventh and Thirteenth Commissions, then jumped to 42% under the Fourteenth (2015–20). The Fifteenth Commission set 41%, the one-point reduction reflecting the conversion of Jammu and

Kashmir into Union Territories. The Sixteenth Commission retained 41% for 2026–31, and the Union accepted the recommendation (Ministry of Finance, 2026), despite several States pressing for 50%.

5.2 The shareable base has narrowed. Figure 1(b) tracks cesses and surcharges, which fall outside the divisible pool. Their share of gross tax revenue, excluding the GST compensation cess, rose from 10.4% in 2011–12 to 20.2% in 2020–21, before easing to 14.5% in 2023–24 after cuts in fuel duties (Pavithra, 2025). Series that include the compensation cess, reported by the Ministry of Finance to the Lok Sabha in 2022, place the 2021–22 figure near 28%. In either measure, the divisible pool fell from about 89% of gross tax revenue in 2014–15 to roughly 74–80% during the first four years of the Fifteenth Commission's award (Adlakha, 2026). A 41% share of a smaller pool therefore yields States an effective share of gross Union tax revenue well below the headline figure.

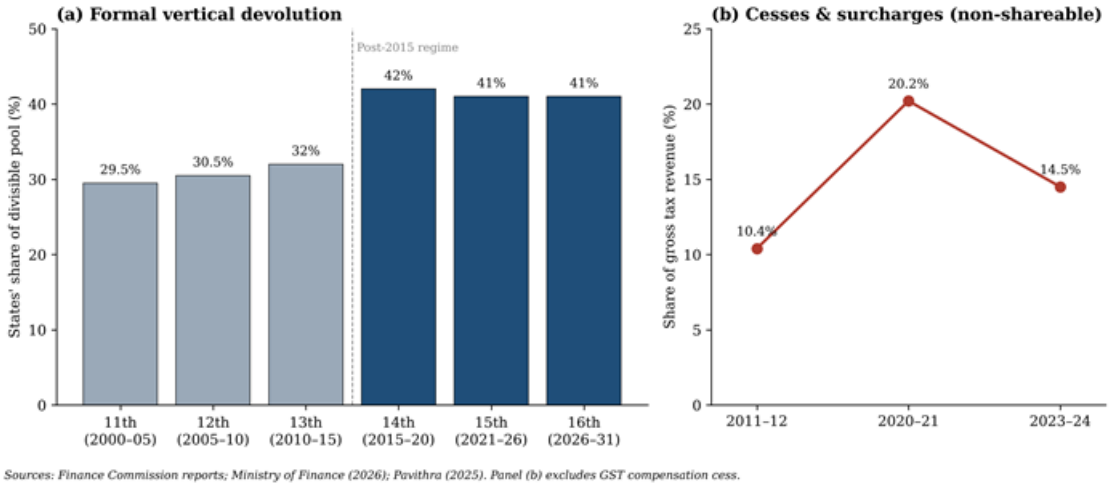


Figure 1. **(a) States' share of the divisible pool recommended by the Eleventh to Sixteenth Finance Commissions. (b) Cesses and surcharges as a share of the Union's gross tax revenue, excluding GST compensation cess.** ***Sources:*** **Finance Commission reports; Ministry of Finance (2026); Pavithra (2025).**

5.3 Horizontal distribution has shifted towards contribution. Table 1 compares the criteria used to divide the States' collective share. The Sixteenth Commission lowered the weight on income distance and area, replaced the fertility-based demographic indicator with population growth between 1971 and 2011, dropped the tax-effort criterion, and introduced a new 10% weight for each State's contribution to national GDP.

Table 1. Horizontal devolution criteria: Fifteenth versus Sixteenth Finance Commission (weights in %)

Criterion	15th FC (2021–26)	16th FC (2026–31)	Change (pp)
Income distance	45.0	42.5	−2.5
Population (2011 Census)	15.0	17.5	+2.5
Area	15.0	10.0	−5.0
Forest cover / forest and ecology	10.0	10.0	0.0
Demographic performance	12.5	10.0	−2.5
Tax and fiscal effort	2.5	—	−2.5
Contribution to GDP	—	10.0	+10.0
Total	**100.0**	**100.0**	

Sources: Fifteenth Finance Commission (2020); Sixteenth Finance Commission (2025), as summarised in Adlakha (2026).

The redistributive consequences are modest but visible. Fourteen States gained share and fourteen lost. Karnataka, Kerala and Gujarat recorded the largest gains, while Madhya Pradesh, Uttar Pradesh and West Bengal declined, although Uttar Pradesh (17.62%) and Bihar (9.95%) remain the largest recipients (Adlakha, 2026). The correlation between per capita income and tax share reportedly weakened from −0.42 to −0.36, indicating a slightly less progressive formula.

5.4 Grants have become narrower and more conditional. The Sixteenth Commission recommended ₹9.47 lakh crore in grants for 2026–31, confined to rural and urban local bodies and disaster management. It discontinued revenue-deficit, sectoral and State-specific grants. Local-body grants are split 80:20 between basic and performance components, with release tied to audited accounts and the timely constitution of State Finance Commissions (Adlakha, 2026).

6. Discussion: Sources of Strain

The evidence supports the paper's central claim: formal devolution and effective autonomy have moved in different directions. Four mechanisms explain the divergence.

6.1 The cess loophole. Article 270 exempts purpose-specific cesses and surcharges from sharing. When the Union relies more heavily on these levies, it raises revenue without enlarging the pool it must divide. The Fourteenth Finance Commission had already warned against this trend. The Sixteenth Commission declined to recommend a cap, citing constitutional and practical difficulties, but suggested a negotiated arrangement under which more cess revenue would be folded into the pool alongside a recalibrated States' share. From the perspective of second-generation theory (Weingast, 1995), such reliance on non-shareable instruments weakens the predictability that transfer systems require (Bird & Smart, 2002).

6.2 Pooled sovereignty under GST. GST traded State control over sales-tax rates for a larger, harmonised base and five years of guaranteed compensation at 14% annual growth. Compensation ended in June 2022, while the compensation cess was extended to repay pandemic-era borrowing. States now hold a collective voice in the Council but little individual power to adjust rates in response to local needs. Because the Union holds a de facto veto, the Council resembles a forum of pooled rather than shared sovereignty. *Mohit Minerals* (2022) reaffirmed States' legislative competence, yet in practice no State has legislated outside Council recommendations, given the costs of fragmenting a unified market.

6.3 Conditionality and the centrally sponsored scheme model. Transfers under Article 282 carry design templates, matching requirements and monitoring frameworks set in New Delhi. Analysts note that the States' co-funding share in many schemes has risen from about 25% to 40%. This draws State budgets towards nationally defined priorities and reduces room for locally tailored spending, which runs counter to the decentralisation theorem (Oates, 1999). The Sixteenth Commission's move to tie local-body grants to State-level compliance extends conditionality one tier further.

6.4 Borrowing controls and fiscal rules. Article 293(3) gives the Union a gatekeeping role over almost all State borrowing. Including off-budget liabilities of State entities within net borrowing ceilings improves transparency, as the Sixteenth Commission urged. However, when similar liabilities of Union entities are treated differently, States perceive asymmetric discipline. Rodden (2006) shows that credible hard budget constraints require rules that are both firm and evenly applied; perceptions of selective enforcement undermine that credibility.

6.5 Political dynamics. These fiscal mechanisms operate within a political context of strong national-party dominance since 2014 (Aiyar & Tillin, 2020). Opposition-ruled States have increasingly turned to litigation and public campaigns rather than intergovernmental bargaining. The dormancy of the Inter-State Council, recommended as a key forum by both the Sarkaria (1988) and Punchhi (2010) Commissions, leaves few routine channels to resolve disputes before they escalate.

On balance, the strain is real but should not be overstated. States still receive substantial and predictable formula-based transfers, and the Finance Commission remains a respected, non-partisan institution. The deeper problem is the steady growth of channels that bypass it.

7. Policy Recommendations

1. **A 'cess-for-share' bargain.** The Union could fold most cesses and surcharges into regular taxes, enlarging the divisible pool, while States accept a proportionately lower percentage of that larger pool. Neither side loses revenue, but transfers become formula-based and transparent. Any residual cess should carry a sunset clause and annual reporting on utilisation.
2. **An institutional estimate of vertical fiscal imbalance.** Future Finance Commissions should publish a standard, replicable measure of the gap between States' expenditure responsibilities and their revenue capacity. This would ground the vertical share in evidence rather than precedent.
3. **Rationalised centrally sponsored schemes.** Schemes should be consolidated into a small number of broad block grants with outcome targets, giving States freedom over inputs. Co-funding ratios should be fixed for the duration of a Finance Commission award.
4. **Symmetric, rule-based borrowing limits.** Net borrowing ceilings should follow published rules that treat off-budget liabilities of Union and State entities alike, with an independent fiscal council monitoring compliance.
5. **A revived Inter-State Council.** Regular meetings, a permanent secretariat and a mandate to mediate fiscal disputes would provide a forum for bargaining before conflicts reach the courts.
6. **Limited rate flexibility within GST.** The Council could permit States a narrow band of rate variation on selected items, restoring some fiscal accountability without fragmenting the common market.

8. Conclusion

Indian federalism is under strain, but the strain takes a particular form. It is not primarily a contest over the headline share of central taxes, which has been stable at 41–42% for over a decade and was reaffirmed by the Sixteenth Finance Commission. It is instead a gradual erosion of the discretion States can exercise over the resources they receive and raise. Non-shareable cesses have narrowed the pool, GST has pooled rate-setting authority, conditional schemes have shaped spending priorities, and borrowing controls have tightened.

The analysis suggests that formal generosity can coexist with declining effective autonomy. Restoring balance does not require constitutional overhaul. It requires bringing more revenue within the Finance Commission's formula, applying fiscal rules evenly, and rebuilding forums for routine intergovernmental negotiation. Future research could quantify effective autonomy State by State, and test whether greater discretion improves service outcomes, as fiscal federalism theory predicts. A cooperative federalism worthy of the name depends on States being trusted partners in fiscal policy, not merely its implementers.

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