



Research Article

The Politics of Fiscal Devolution in India: Revenue-Sharing Institutions, Regional Inequality, and Federal Accountability

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Abstract

In Indian federalism, fiscal devolution is key. A lion's share of public spending on health, school education, policing, agriculture and local services is carried by states. However, the Union controls the most buoyant and high-yielding tax bases. The differences are covered by a layered framework of transfers, constitutionally mandated distribution of central taxes, grants-in-aid recommended by the Finance Commission and a large set of discretionary, scheme-based expenditures. This paper aims to investigate the organisation of this system, its evolution through the Fifteenth Finance Commission (2021-26) and the ongoing Sixteenth Finance Commission process (2026-31), and its implications for regional inequality and democratic accountability. Using the constitution, various budget reports and other documents, this paper advances three arguments. To begin with, the Finance Commission has created a reliable, rule-bound equalisation channel. However, in the 2021-26 award, it kept the states' share at 41%, lowered the weight of income distance from 50 to 45 per cent and placed revenue deficit grants on a tapering path, so that at the margin the redistributive core of the system is narrowing. The second factor consists of two aspects: First, the effective share of states in the total gross tax revenue of the Union is eroded through cesses and surcharges which are not part of the divisible pool. Second, the autonomy of state governments has been constrained by the design of the goods and services tax (GST) as well as the control over borrowing exercised by the Union government.

The third effect of layered transfers is a blurring of political responsibility. Voters cannot easily tell which government is responsible for what they get. Moreover, the most contested distributional choices are settled in arenas where the Union has an effective veto. The paper proposes institutional reforms to create a protected divisible pool, a more balanced GST bargaining forum, simpler conditional transfers and stronger local finances.

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1. INTRODUCTION

India is a large, diverse and territorially unequal federation, and its constitutional design tilts fiscal power toward the Union. The Constitution allocates health, public order, policing, agriculture, land, and much of local governance to the jurisdiction of the States. It assigns the Union most elastic revenue sources, among them income tax, corporation tax and customs. The outcome is a persistent vertical fiscal imbalance: states spend a greater share of total government expenditure than they raise from own sources. The Fifteenth Finance Commission's report shows that the Union collects the larger part of combined government revenue, while the states account for the larger part of combined government expenditure (Finance Commission of India, 2020).

The Union's transfers to the states are not, therefore, a peripheral aspect of Indian federalism; they are its glue. They determine whether Bihar or Uttar Pradesh can afford a primary health centre or a school teacher at a standard that is not wildly out of line with Kerala or Tamil Nadu. Political relationships are also the product of policy. A policy invariably has winners and losers. Citizens also allocate credit and blame on the basis of whose name is on the policy and whose government writes the cheque.

This question has come to us at the right time. The Sixteenth Finance Commission, chaired by Arvind Panagariya, has been constituted under Article 280 and has been asked to submit its report by 31 October 2025, for the period beginning 1 April 2026. Its terms of reference cover the sharing of tax proceeds between the Union and the states, the principles governing grants-in-aid, measures to strengthen state funds for local bodies, and the financing of disaster management. In September 2025 the 56th meeting of the GST Council overhauled GST rates. Further, opposition-ruled states demanded compensation for revenue loss.

The Fifteenth Finance Commission's term (2021-26) is now in its final year. India has reached a crucial juncture where the fiscal settlements of the 2010s are being renegotiated.

The essay poses three interrelated inquiries. What is the structure of revenue-sharing institutions in India and their evolution? What is the political economy of bargaining over devolution, and who gains and who loses? What consequences do these arrangements have for regional inequality and for the accountability of governments towards voters? Sections 2 to 10 deal with the conceptual framework, sources and approach, mapping architecture, evolution up to the Fifteenth Commission award and the ongoing Sixteenth Commission process, politics of devolution, regional inequality, accountability, reforms and finally, conclusion.

2. CONCEPTUAL FRAMEWORK AND LITERATURE

2.1 First-generation fiscal federalism

The normative case for a multi-level fiscal system rests on the classic division of functions associated with Musgrave (1959) and Oates (1972). Stabilisation and large-scale redistribution are best handled centrally, while local public goods, whose benefits are confined to a jurisdiction, are best provided by sub-

national governments that know local preferences and can be held to account for local outcomes (Oates, 1972, 1999). Tiebout (1956) added the idea that mobility lets citizens sort themselves by preferred packages of taxes and services. Buchanan (1950) supplied the equity argument that matters most for India: in a federation, residents of poorer jurisdictions would face worse fiscal treatment than equals elsewhere unless the centre transfers resources, so that equalising transfers are a requirement of fiscal equity and not only a convenience.

The implication is that expenditure should be decentralised while the most mobile and cyclical tax bases are centralised, which opens a vertical gap that transfers must fill. A second gap, the *horizontal* imbalance between richer and poorer states, is closed by the way the pooled revenue is divided.

2.2 Second-generation fiscal federalism: incentives and the soft budget constraint

Second-generation work shifts attention from who should do what to the incentives that institutions create (Weingast, 2009). Two ideas matter here. The first is the soft budget constraint: if sub-national governments expect bailouts, they have an incentive to overspend and over-borrow (Kornai, Maskin and Roland, 2003). The second is that the design of the transfer system conditions behaviour. Rodden (2006) shows that heavy reliance on transfers, combined with discretion in allocating them, weakens fiscal discipline and political accountability. Rule-based, formula-driven transfers, in contrast, are predictable and shield allocations from political manipulation.

2.3 Politics, accountability and decentralisation

A political-economy literature asks how electoral incentives affect transfers and how federal structures affect accountability. Besley and Coate (2003) show that centralised provision can produce a logrolling distribution of resources across districts, which is a warning for discretionary transfers. Seabright (1996) and Bardhan and Mookherjee (2006) examine how decentralisation changes the ability of voters to monitor governments, and Besley and Case (1995) show that voters compare their government's performance with that of neighbours, a form of yardstick competition. For India, Arulampalam et al. (2009) find that states politically aligned with the party governing at the Centre, especially swing states, receive larger discretionary transfers, while Khemani (2007) presents evidence on how delegating transfers to an independent agency, the Finance Commission, differs from reliance on discretionary channels. Rao and Singh (2005) provide the most comprehensive treatment of the Indian system, tracing how overlapping channels weakened transparency, and Tillin (2019) and Stepan, Linz and Yadav (2011) place Indian federalism in comparative perspective as a "holding-together" federation, in which the Union is stronger than in the "coming-together" model of the United States.

2.4 Analytical lenses

The paper uses three lenses that run through the analysis: *vertical devolution* (how much of the Union's revenue is shared

with the states collectively); *horizontal devolution* (how the pool is divided among states, and with what equalising effect); and *accountability* (whether citizens can identify the government responsible for outcomes, and whether institutions exist to hold each level to account). A change that is neutral across states on the vertical dimension can be bitterly contested on the horizontal one, and a change that is efficient in design can reduce accountability if it hides who decides and who pays.

3. Approach, Sources and Data Notes

The study is an institutional and interpretive analysis supported by descriptive quantitative evidence. Primary sources are the Constitution of India (Articles 268 to 293 and the Seventh Schedule), the reports of the Fourteenth and Fifteenth Finance Commissions, Union Budget documents, and the Reserve Bank of India's annual State Finances: A Study of Budgets (Reserve Bank of India, annual) for state-level fiscal aggregates. The Fifteenth Commission's figures are taken from its report and from the summary published by PRS Legislative Research (2021). The Sixteenth Commission's report was awaited at the time of writing, and the paper therefore discusses its mandate and the issues before it without assuming any award figures. Data on cesses and surcharges come from Finance Commission reports and replies of the Ministry of Finance as compiled by secondary analysts; per capita income data are from the Ministry of Statistics and Programme Implementation (MoSPI) Net State Domestic Product (NSDP) at current prices series, sourced from MoSPI's National Accounts Statistics and available at mospi.gov.in. The denominator for per capita calculations is total population from the 2011 Census, as used by the Finance Commissions themselves. State-wise devolution shares are sourced from Table 1 (or equivalent) of the respective Finance Commission reports (available at

fincomindia.nic.in), and cross-checked against the summaries published by PRS Legislative Research. Horizontal formula weights are reproduced directly from the Commissions' reports; the author has not independently recalculated them.

Two cautions apply. First, different vintages of the same series differ: the share of cesses and surcharges in gross tax revenue for 2020-21, for example, is reported as 19.9 per cent in a Finance Commission-based estimate (India Ratings and Research, 2021) and as 25.1 per cent in a later Ministry of Finance reply. Where figures differ, both are shown with their sources. Second, several quantities discussed here, especially for 2024-25 and later, are provisional and will be revised in budget documents and in the Commission's own annexures. Readers should verify any figure they intend to reuse against the primary document.

4. The Institutional Architecture of Fiscal Federalism

4.1 Constitutional assignments

The Seventh Schedule divides legislative powers among the Union, State and Concurrent Lists, and taxing powers follow the same logic. The Union levies taxes on income other than agricultural income, on corporations and on customs, while states historically levied sales tax, state excise on alcohol, stamp duties, land revenue and motor vehicle taxes. Part XII of the Constitution (Articles 268 to 293) governs the distribution of revenues, and Article 280 provides for a Finance Commission to be constituted every five years. The imbalance between expenditure responsibilities and revenue powers is the foundation on which the transfer system is built.

4.2 The transfer channels

Four channels carry resources from the Union to the states, summarised in Table 1.

Table 1. Principal channels of Union-to-state transfers

Transfer channel	Constitutional basis	Deciding authority	Character
Tax devolution	Article 270, read with Article 280	Finance Commission; accepted by Union	Formula-based, untied, predictable
Grants-in-aid	Article 275	Finance Commission	Mostly conditional or purpose-specific; need-based
Other transfers	Article 282; Union budget	Union ministries (since 2014 without Planning Commission)	Discretionary or scheme-based; often matching and conditional
GST-related transfers	Articles 246A, 269A, 279A; GST Act 2017	GST Council; Union	IGST settlement; compensation (until 2022)

Source: Compiled by the author from the Constitution of India and Finance Commission reports.

Tax devolution. Under Article 270 the net proceeds of designated Union taxes are divided between the Union and the states on the recommendation of the Finance Commission. The divisible pool excludes the cost of collection and the proceeds of cesses and surcharges, a point that proves decisive in Section 6.2.

Grants-in-aid. Article 275 allows Parliament to give grants to states in need, which Finance Commissions have used for revenue-deficit support, local bodies, disaster management and, in the Fifteenth cycle, sector- and state-specific purposes. Other transfers. Article 282 permits the Union and states to make

grants for any public purpose, and centrally sponsored schemes, with matching-fund requirements, are the main vehicle.

4.3 The Finance Commission as an institution

The Finance Commission is a constitutional body appointed by the President at least every five years. It is not permanent. Each Commission has fresh membership, terms of reference set by the Union Government, and its own methodology. This has strengths and weaknesses. Its temporary character protects independence and prevents capture by a bureaucracy with an interest in perpetuating a formula; yet it also thins institutional

memory, allows the terms of reference to shape outcomes, and leaves recommendations on grants subject to acceptance by the executive, although the Union has in practice accepted the Commission's tax devolution award.

4.4 The GST Council

The 101st Constitutional Amendment (2016) introduced the GST and created the GST Council under Article 279A. The Union Finance Minister chairs the Council, which includes the Union Minister of State for Revenue and the finance ministers of all states and of Union Territories with legislatures. The Union holds one-third of the voting weight and the states together hold two-thirds, and a decision requires a three-fourths majority of the weighted votes. The Union can therefore block any decision on its own, whereas states cannot pass anything without at least some Union support. In *Union of India v. Mohit Minerals Pvt. Ltd.* (2022) the Supreme Court held that the recommendations of the GST Council are persuasive, not binding, on the Union and the states, which reinforces the view that the Council is a forum for bargaining and not a supra-legislative body.

5. Evolution of the System: from the Planning Commission to the Fifteenth Finance Commission

5.1 Dual channels and the planning era

From the 1950s to 2014, transfers had two pillars: statutory transfers recommended by the Finance Commission and plan transfers made through the Planning Commission under the Gadgil formula and its variants. Rao and Singh (2005) argue that the overlap weakened accountability, since neither channel bore full responsibility for equalisation, and that plan transfers in particular were attractive to political bargaining. The Planning Commission was abolished in 2014 and replaced by NITI Aayog, which does not allocate funds. Since then, the Finance Commission has been the only institution with a statutory equalisation mandate, while discretionary support flows through ministries and centrally sponsored schemes.

5.2 The rise in vertical devolution

The states' share in the divisible pool rose gradually, then jumped. Figure 1 shows the sequence.

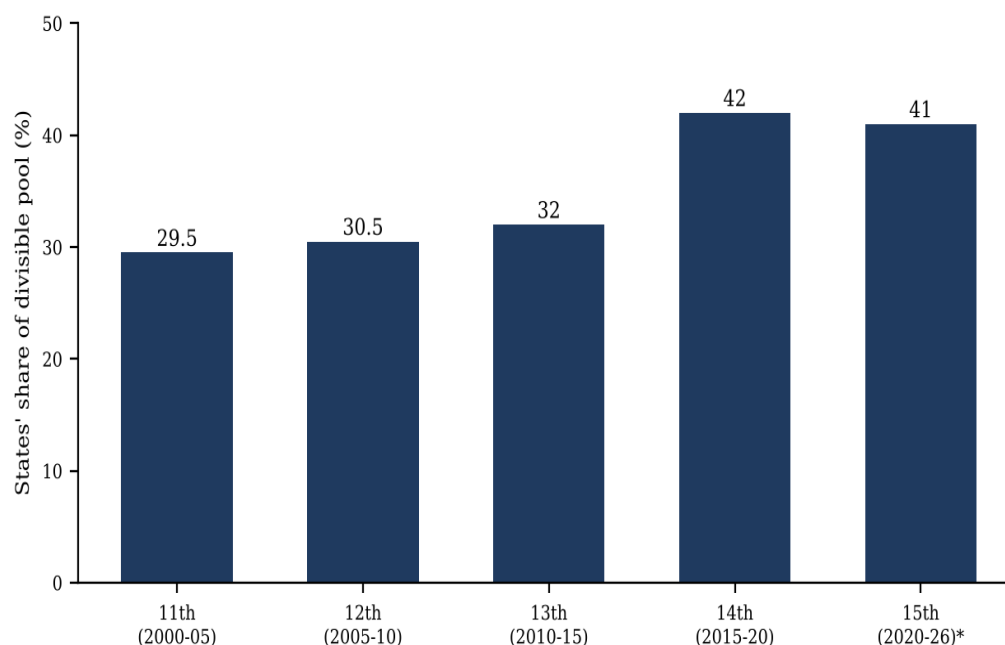


Figure 1. States' share in the divisible pool recommended by successive Finance Commissions

Source: Reports of the respective Finance Commissions. The Fifteenth Commission's 41 per cent reflects the removal of Jammu and Kashmir from the list of states after its reorganisation as a Union Territory.

The Fourteenth Finance Commission (2015-20) raised the share from 32 to 42 per cent, the largest single increase in the history of the Commission, and argued that tax devolution, being formula-based, should be the principal channel of resource transfer to the states. The Fifteenth Commission set the share at

41 per cent for 2021-26. Whether the Sixteenth Commission will retain this share for 2026-31 is the central question before it, since some states have argued in their submissions for a higher share.

The headline figures overstate the net gain to states. After the Fourteenth Commission's award, the Union reduced its funding of centrally sponsored schemes, so that part of the increase in untied devolution substituted for conditional transfers and not for additional resources. More important, the share applies only

to the divisible pool, whose size depends on how much of Union revenue is collected as cess and surcharge (Section 6.2).

5.3 The horizontal formula across two Commissions

Each Commission defines its own formula for dividing the states' share. Table 2 compares the Fourteenth and Fifteenth Commissions' criteria.

Table 2. Criteria for horizontal devolution, 14th and 15th Finance Commissions (per cent weight)

Criterion	14th FC (2015-20)	15th FC (2021-26)
Income distance	50	45
Population (14th: 1971 Census; 15th: 2011 Census)	17.5	15
Demographic change (14th) / demographic performance (15th)	10	12.5
Area	15	15
Forest (14th: forest cover; 15th: forest and ecology)	7.5	10
Tax and fiscal effort	-	2.5
Total	100	100

Source: Reports of the 14th and 15th Finance Commissions, as summarised by PRS Legislative Research (2021).

Four changes deserve attention. First, the weight of income distance, the main equalising criterion, falls from 50 to 45 per cent. Second, the population criterion moves from the 1971 Census (17.5 per cent) to the 2011 Census (15 per cent), a change that sits at the centre of the southern states' objections. Third, the Fourteenth Commission's demographic change criterion (10 per cent), which measured the change in population between 1971 and 2011, is replaced by demographic performance, based on the total fertility rate, with a weight of 12.5 per cent. Fourth, a new weight of 2.5 per cent is given to tax and fiscal effort, while the forest criterion rises from 7.5 per cent to 10 per cent and is widened to cover forest and ecology. The Fourteenth Commission's formula gave income distance a weight of 50 per cent, population in 1971 a weight of 17.5 per cent, demographic change 10 per cent, area 15 per cent and forest cover 7.5 per cent. The direction of travel between the two Commissions is a decline in the weight of income distance (50 to 45) and the introduction of measures that reward demographic and fiscal performance. Whether the Sixteenth Commission continues in this direction will be known only when its report is made public.

5.4 Grants and the fiscal roadmap

The Fifteenth Commission recommended revenue deficit grants of ₹2,94,514 crore for 17 states over 2021-26, tapering over the period; grants of ₹4,36,361 crore for rural and urban local bodies and for health; sector-specific grants of ₹1,29,987 crore; and state-specific grants of ₹49,599 crore (PRS Legislative Research, 2021). Local body grants are conditional on entry-level criteria, notably the constitution of State Finance Commissions and the publication of provisional and audited accounts.

The Commission also set a fiscal roadmap: the Union to reduce its fiscal deficit to 4 per cent of GDP by 2025-26, and states to

hold their deficits to 4 per cent of GSDP in 2021-22, 3.5 per cent in 2022-23 and 3 per cent in 2023-26, with additional borrowing space of 0.5 per cent of GSDP during 2021-25 for states that complete specified power-sector reforms. It projected the Union's total liabilities to fall from 62.9 per cent of GDP in 2020-21 to 56.6 per cent in 2025-26 (PRS Legislative Research, 2021).

The Sixteenth Commission's recommendations for 2026-31 were awaited at the time of writing. The principal questions before it are whether the states' share will remain at 41 per cent, whether the 2011 Census will remain the population base, how cesses and surcharges will be treated, and whether revenue deficit grants and conditional grants will continue.

6. The Politics of Revenue Sharing

6.1 The horizontal formula as a political settlement

Each criterion in the formula encodes a conception of fairness. Income distance rewards states with lower incomes. Population and area reflect the cost of serving more people or a larger territory. Demographic performance and tax effort reward behaviour the Commission wishes to encourage. Forest cover compensates states for the ecological services of forests. The formula is a political settlement expressed in technical terms, and its most sensitive component is population.

Since the 1970s, fertility has fallen faster in southern and western India than in the north and east. Using recent population data therefore redirects resources towards the states with larger and faster-growing populations. The southern states argue that they are penalised for implementing the national population policy, and the same concern frames the debate on delimitation of parliamentary constituencies after the next Census. Table 3 shows shares for selected states across the Fourteenth and Fifteenth Commissions.

Table 3. Individual state shares in the divisible pool (per cent) and change between 14th and 15th Commissions

State	14th FC	15th FC	Change, 14th to 15th (basis points)
Uttar Pradesh	17.96	17.94	-2
Bihar	9.67	10.06	+39
Madhya Pradesh	7.55	7.85	+30
West Bengal	7.32	7.52	+20

Maharashtra	5.52	6.32	+80
Rajasthan	5.50	6.03	+53
Tamil Nadu	4.02	4.08	+6
Karnataka	4.71	3.65	-106
Andhra Pradesh	4.31	4.05	-26
Gujarat	3.08	3.48	+40
Kerala	2.50	1.93	-57
Telangana	2.44	2.10	-34
Punjab	1.58	1.81	+23
Haryana	1.08	1.09	+1

Source: Reports of the 14th and 15th Finance Commissions, as compiled by PRS Legislative Research (2021). The 14th Commission's figures include Jammu and Kashmir (1.85 per cent), so they are not strictly comparable with later cycles.

The distributional results are nuanced. The five southern states (Andhra Pradesh, Karnataka, Kerala, Tamil Nadu and Telangana) together received 17.98 per cent under the Fourteenth Commission and 15.81 per cent under the Fifteenth, calculated from the state-wise table. Karnataka loses 106 basis points, Kerala 57, Telangana 34 and Andhra Pradesh 26, while Tamil Nadu gains 6. Meanwhile Maharashtra (+80), Rajasthan (+53), Gujarat (+40), Bihar (+39) and Madhya Pradesh (+30) gain, and Uttar Pradesh (-2) is virtually unchanged. The pattern is consistent with the southern states' argument that the move to the 2011 Census population base penalised them for their success in lowering fertility, even though the demographic

performance criterion was meant to compensate for this. Uttar Pradesh and Bihar together still receive about 28 per cent of the pool. How the Sixteenth Commission treats this concern is likely to be one of the most contested aspects of its award.

6.2 The shrinking divisible pool: cesses and surcharges

The most consequential change of the past decade is the growth of cesses and surcharges. Article 270 excludes the proceeds of cesses and surcharges levied for the purposes of the Union from the divisible pool, so the Union can raise revenue through these instruments without sharing it. Their share in gross tax revenue rose sharply, though figures vary by source and vintage (Table 4).

Table 4. Share of cesses and surcharges in the Union's gross tax revenue (per cent)

Year	Share	Source and remark
2011-12	10.4	India Ratings and Research (2021), based on Finance Commission data
2020-21	19.9	Finance Commission-based estimate (India Ratings and Research, 2021)
2020-21	25.1	Ministry of Finance reply, December 2022 (Business Standard)
2021-22	28.1	Ministry of Finance reply, December 2022 (Business Standard)

Note: The differences between the 2020-21 estimates reflect differences in vintage and definition; they are shown as reported. Compiled by the author.

As a result, the effective share of Union gross tax revenue that states receive is significantly lower than the headline figure of 41 per cent. PRS Legislative Research estimated that, because of cesses and surcharges, the states' share in the Union's gross tax revenue was only about 29 per cent in 2020-21, against the 41 per cent recommended by the Fifteenth Commission, and that tax devolution to states actually declined in that year (PRS Legislative Research, 2022). India Ratings and Research (2021) observed that the rise in cesses and surcharges led the Fifteenth Commission to recommend higher grants-in-aid to offset slower growth in tax devolution. The Union has argued that the rise in 2020-21 and 2021-22 reflected the GST compensation cess, which was needed to pay states. The argument holds for those years, but it does not account for the persistence of other cesses long after the purpose for which they were levied. The Fifteenth Commission itself noted that the divisible pool has been falling as a share of the Union's gross revenue. Whether the Sixteenth Commission will revisit the exclusion is likely to be one of the most closely watched questions before it. This is an example of what could be called a quiet change of a federal deal: there was no amendment, no new Commission, no parliamentary vote, rather an oblique changing of the real terms of the settlement by way of a constitutional exception.

6.3 The Goods and Services Tax: unifying the market, concentrating power

The goal of GST was to create a single national market and broaden the tax base. A share in the new tax and a guarantee of compensation led to states' agreement to subsume their principal indirect taxes. According to the compensation mechanisms, the states were guaranteed a 14 per cent annual rise in GST revenue with respect to 2015-16 base for five years i.e. up to 30 June 2022. This was to be created through a compensation cess on demerit and luxury goods. A distinction needs to be made between two events. On June 30, 2022, the five-year benefit guarantee period ended; from that date on, states no longer had statutory rights to a 14 per cent revenue guarantee. However, during the pandemic years, the compensation fund was less than the guaranteed level, and back-to-back borrowings were arranged by the Union from the Reserve Bank of India on behalf of states. The *cess*, which is a legally operational distinct instrument from the guarantee itself, was extended till March 2026 from June 2022, specifically for servicing these Covid-vintage borrowings. Consequently, the money that was raised from cess collected during the extended time period was used only for the repayment of debt. As a result, states lost their revenue guarantee in June 2022; however, they also continued to see a

cess operate on demerit and luxury goods for nearly four more years.

There are three key elements of the GST regime relevant to federalism. Initially, the states are no longer in control over the rate structure of their most important own-revenue source as any change must be negotiated through the Council. In addition, the voting procedure grants a real veto to the Union, even if the consensus has taken most decisions. Additionally, states lost their assured growth rate with the end of the compensation guarantee, which, along with the changes in rates and exemptions, they cannot determine alone.

The tensions were illustrated at the 56th meeting of the GST Council on 3 September 2025. The Council approved a simplified structure with two principal rates of 5 and 18 per cent and a 40 per cent rate for demerit and luxury goods with effect from 22 September 2025. Eight opposition-ruled states (Himachal Pradesh, Jharkhand, Karnataka, Kerala, Punjab, Tamil Nadu, Telangana and West Bengal) met beforehand. They raised a demand for a revenue-protection mechanism claiming that they would incur losses to the tune of ₹85,000 crore to ₹2 lakh crore a year. They proposed a revenue-protection mechanism similar to the compensation cess with FY 2024-25 as base year. The Union did not publish an official estimate of the revenue loss. The figures presented are the states' own estimates and are therefore contested, not audited. Despite this, the episode illustrates that states can contest GST design only through collective action in a forum where the Union has a veto.

6.4 Conditional transfers and the reallocation of power.

The abolition of the Planning Commission means that much of the Union's support to states now happens through conditional centrally-sponsored schemes and special-purpose assistance. The Fifteenth Commission itself moved in this direction: it introduced sector-specific and state-specific grants with performance-linked incentives and made local body grants subject to entry-level conditions. The Union justified conditionality as a means to improve outcomes in priority sectors. States that are endowed with better administrative capacity and have a fiscal space available to provide matching funds may be able to draw down the money. In contrast, poorer states may not be able to meet matching requirements. If this is the case, conditional transfers may enhance inequality rather than reduce it in service delivery. The systematic empirical evidence available on the sign and magnitude of this effect, across Indian states, remains limited, and future research should directly test this proposition using state-level expenditure and scheme-uptake data.

6.5 Borrowing limits, debt and litigation

According to Article 293 (3), a state must obtain the Union's consent to raise a loan if it owes any money to the Union. In recent years, the Union Government has set ceilings of annual net borrowing often expressed as a GSDP share (mostly at 3 per cent, with additional room linked to power-sector and other reforms) and has counted the off-budget borrowing by State

entities. Kerala has instituted an original suit against the Union in the Supreme Court (State of Kerala v. Union of India, Original Suit No. 1 of 2024), contending that these restrictions intrude upon the fiscal autonomy of states; in April 2024 the matter was referred to a Constitution Bench and it was pending at the time of writing. The Union defends these limits as a means of fiscal discipline, even if the symmetry of rules between the Union and the states is still contested. As a result, the allocation of financial powers is increasingly decided in lawsuits, as well as negotiated in committees.

6.6 Party politics and federal bargaining

India's party system has undergone a transition from the dominance of a single party to a period of coalition governments, where regional parties held significant sway at the Centre, followed by a phase where a dominant party held a majority in the Lok Sabha. When regional factions play a crucial role in government formation, they negotiate for favourable fiscal treatment; when they don't, the Union has more space to set the terms. Arulampalam et al. (2009) find that whether the politician is aligned with the government affects

how much money will be distributed. Rule-based institutions serve as the states' main defence against the party system's gyrations, which indicates that the more a channel is discretionary, the more the outcome hinges on political alignment. The split in the GST Council in September 2025 was only partly along party lines. Andhra Pradesh, whose ruling party is a partner in the Union's governing coalition, supported the Centre's proposals, whereas the opposition-ruled bloc sought compensation.

7. Regional Inequality and Equalisation

7.1 The magnitude of inequities

There are significant differences in per capita income amongst various states of India. According to MoSPI data compiled by the Reserve Bank of India (2024), for 2023-24 per capita net state domestic product at current prices was about ₹5.86 lakh in Goa and about ₹60,200 in Bihar. Goa is an outlier because of its very small size and tourism- and mining-linked economy. Even so, the ratio is more than nine to one. The gap among the larger states is narrower but still wide. Southern and western states such as Karnataka, Tamil Nadu and Telangana have per capita incomes several times those of Bihar and Uttar Pradesh. Bihar's per capita income is approximately one-third of the national average. Disparities in income correspond to variations in health, education, infrastructure and administrative capacity while a state with low revenue base also has low capacity to spend.

7.2 How much equalisation does the system deliver?

Tax devolution mainly assists poorer states at the margins. The income distance criterion, however, directs larger per capita transfers to poorer states. Under the Fifteenth Commission, Uttar Pradesh and Bihar together get around 28 per cent of the divisible pool. However, these states are also the most populous, and therefore, even large transfers result in spending

per person significantly lower than in richer states. Researchers observe that Indian fiscal federalism is equalising, but only partially (Rao and Singh, 2005). Grants, unlike devolution, are influenced primarily by population, area and the structure of local bodies and not income.

Local body grants follow rural and urban populations and the structure of local government, so that states with large rural populations, such as Uttar Pradesh and Bihar, draw most on rural local body grants, whereas more urbanised states draw more on urban grants. Revenue deficit grants, a channel that compensates states whose own revenues cannot meet their normal expenditure, were targeted by the Fifteenth Commission at seventeen states and taper over 2021-26, so that as the period ends the system relies mainly on tax devolution and on conditional local body, sector-specific and disaster grants for equalisation. Whether the Sixteenth Commission continues revenue deficit grants will shape its ability to correct what the formula leaves unequal, the very point on which the Fifteenth Commission stressed that no formula can meet every state's needs.

7.3 Factors that temper equalisation

- *Cesses and surcharges (Section 6.2).* Revenue excluded from the divisible pool escapes the formula entirely, so equalisation operates on a base smaller than the headline 41 per cent implies.
- *Conditional transfers (Section 6.4).* Matching-fund requirements may favour states with greater administrative and fiscal capacity, with the risk that poorer states underdraw available funds.
- *Uniform borrowing limits.* A common deficit ceiling of 3 per cent of GSDP gives a poorer state with greater investment needs and a smaller GSDP less absolute room than a rich one.
- *Reduced weight on income distance.* The decline from 50 to 45 per cent between the Fourteenth and Fifteenth Commissions makes the formula somewhat less progressive, and the weight the Sixteenth Commission gives to income distance will be closely watched.

7.4 Incentives versus equity

A formula based on income distance penalises success at the margin, because a state that raises its income reduces its entitlement. A well-designed system therefore couples equalisation with incentives. The Fifteenth Commission's tax effort criterion carried only 2.5 per cent, and critics argued that this gave states little reward for broadening their revenue base. A criterion based on contribution to GDP, were the Sixteenth Commission to adopt one, would reward scale of output and not effort, and many analysts argue that it would favour larger economies. The trade-off is real: a high weight on effort penalises poorer states with limited revenue capacity, while a low weight leaves little incentive. Neither answer is neutral.

7.5 The third tier

Inequality is also internal to states. The 73rd and 74th Constitutional Amendments (1992) created a third tier of government and require State Finance Commissions to recommend the sharing of state revenues with panchayats and municipalities. In practice local governments remain heavily dependent on transfers and have limited taxing power, and State Finance Commissions are often constituted late and their recommendations inconsistently implemented. The Fifteenth Commission's grants of ₹4.36 lakh crore to local bodies and for health, and its conditions on audited accounts and timely State Finance Commissions, are an attempt to use the Union's leverage to strengthen the third tier, although the conditionality also risks delaying funds to the weakest local bodies.

8. Federal Accountability

8.1 The accountability problem in a layered system

Democratic accountability requires that voters can identify who is responsible for a decision and can reward or punish them. In a federation with extensive transfers this is difficult. Voters in a state may blame their state government for the quality of schools or hospitals even when it has little control over the funds it receives. A state government may blame the Union for constraints that arise partly from its own choices. Where transfers are tied to schemes branded by the Union, the Union may claim credit for outcomes that states implement. This blurring of responsibility weakens the link between taxes, spending and electoral consequences, and is the central accountability cost of a transfer-dependent federation (Seabright, 1996; Rodden, 2006).

8.2 Transparency of transfers

The Indian system is formally transparent: Finance Commission reports are published and budget documents list transfers. Yet significant gaps remain.

- The split between formula-based and discretionary transfers is hard for non-specialists to follow.
- The effective share of states in the Union's revenue, net of cesses and surcharges, is not a headline figure in public debate, so the 41 per cent figure is widely misunderstood as the share of what the Union collects.
- Off-budget borrowing by both levels of government can obscure the true fiscal position. The inclusion of state off-budget borrowing within borrowing ceilings addresses this in part, but the reform must apply to the Union as well as states for credibility.
- The timing and conditionality of releases are sometimes unpredictable, which makes planning difficult for states.

8.3 Hard budget constraints and the soft-budget risk

The Union's control over state borrowing is justified as a means of preventing fiscal indiscipline and protecting macroeconomic stability. The risk of soft budget constraints is real, as the debt problems of several states in the late 1990s and the subsequent restructuring schemes show (Kornai, Maskin and Roland, 2003, on the general mechanism). But control by one party to the

bargain, without symmetrical rules for itself, weakens accountability in a different way, because it lets the Union set the terms without being bound by them (Section 6.5). The reform dimension — symmetric, rule-based borrowing constraints covering off-budget liabilities at both levels — is addressed in Section 9.

8.4 Dispute resolution

India lacks a dedicated, standing institution to resolve fiscal disputes between the Union and states. The Inter-State Council under Article 263 meets rarely. The GST Council has a provision for dispute resolution in principle, but a mechanism has not been constituted in practice. The Supreme Court's decision in *Mohit Minerals* confirms that the Council's recommendations are persuasive, and the doctrine that the Constitution is federal in spirit though unitary in tendency, dating from *State of West Bengal v. Union of India* (1963), has been tempered since *S. R. Bommai v. Union of India* (1994), which treated federalism as part of the basic structure. Without a stable forum, disputes tend to be resolved through litigation or political confrontation, neither of which produces predictable fiscal relations.

8.5 Downward accountability and the third tier

Accountability in a federation must run downward as well as upward. Panchayats and municipalities are expected to answer to citizens for the services they deliver, yet most of their resources arrive as transfers from the Union and the states, often late and tied to conditions they do not set. When local bodies can neither predict their revenues nor raise enough of their own, citizens cannot easily judge whether poor services reflect local mismanagement or inadequate transfers. Because service delivery usually involves several actors at once, including state line departments, centrally sponsored schemes and local bodies, a clear assignment of functions, funds and functionaries to each tier is a precondition for local accountability (Bardhan and Mookherjee, 2006).

The third tier is in closest proximity to the citizen yet has the least fiscal autonomy. For accountability mechanisms to function, panchayats and municipalities must have reliable resources, the power to produce some of their own revenue, and functional mandates that are clear. Local elections do not make better service delivery possible without them, and citizens vent their frustration at the wrong tier. The Fifteenth Commission's conditions on the publication of audited accounts are welcome in this respect because they create the public information on which local accountability rests.

9. Discussion and Reform Options

The analysis suggests that the greatest problem lies not in the formula itself, which successive Commissions have revised, but in the institutional environment around it. Seven reforms deserve consideration.

1. Protect the integrity of the divisible pool. Cesses and surcharges should be genuinely temporary, tied to a stated purpose and subject to sunset clauses; unspent cess

proceeds should be reported to Parliament every year; and each Finance Commission should report the effective share of the states in the Union's gross tax revenue, not only the headline share of the divisible pool.

2. Give the Finance Commission institutional continuity. A permanent secretariat could safeguard institutional memory, maintain data standards and prepare background analysis, while leaving each Commission free to choose its methodology.
3. Reform the GST Council. Options include a more balanced voting rule, an independent secretariat, a functioning dispute-resolution mechanism under Article 279A(11), and publication of voting records and the reasons for decisions. Greater transparency would help rebuild trust.
4. Rationalise conditional transfers. Consolidate the centrally sponsored schemes, raise the proportion of untied transfers, and make matching requirements sensitive to the fiscal capacity of states so that poorer states are not disadvantaged.
5. Apply fiscal rules symmetrically. Borrowing and off-budget limits should bind the Union as well as the states, and an independent fiscal council could assess the fiscal performance of both levels.
6. Strengthen the third tier. Ensure that State Finance Commissions are constituted on time, link local grants to credible own-revenue effort, and assign local governments a clear set of taxes.
7. Address the population question openly. Whether the formula uses the 2011 Census or the next Census, and however that choice relates to delimitation, the decision should follow a transparent consultative process rather than being left to each Commission to settle on its own.

None of these reforms is purely technical. Each redistributes power, and those who gain from present arrangements are likely to resist change. A realistic approach would therefore be incremental: fuller disclosure, better data, particularly on cesses, transfers and off-budget liabilities, and gradual institutional adaptation that builds trust between the two levels of government.

10. CONCLUSION

The ongoing negotiation in India is about how fiscal devolution will be governed. The Finance Commission has delivered a broadly credible equalisation settlement, and the GST Council shows that the states and the Union can pool their fiscal sovereignty. The Fifteenth Commission's award for 2021-26 holds the states' share at 41 per cent, reduces the weight of income distance to 45 per cent from 50 and puts revenue deficit grants on a tapering path. The Sixteenth Commission's award for 2026-31 is awaited, and the principal questions are whether the vertical share, the population base and the treatment of cesses and surcharges will change. Further, the southern states' collective share fell between the Fourteenth and Fifteenth cycles, which keeps the population question at the centre of the debate.

The system has, however, built up strain. The growth of cesses and surcharges has shrunk the effective pool for sharing. GST unified the market but concentrated power at the Centre. Conditional transfers have restored discretion to the Union, and accountability across the three tiers has become blurred. The core claim of this paper is that the legitimacy of fiscal federalism in India depends less on the munificence of any one award than on the credibility of the rules. A system which is predictable, transparent and symmetric between the Union and states can foster equalisation and accountability together. In contrast, a system which relies on discretion and opaque instruments invites suspicion and a politics of grievance.

Limitations and directions for future research

This paper is descriptive and institutional; it does not estimate the causal effect of any reform. Future efforts should measure the adverse dynamic effect of the shrinking divisible pool on state expenditure. Similarly, the effect of conditional transfers on service delivery across states needs to be evaluated along with the fiscal position of local governments. Outcomes of the 2025 GST restructuring and of the Sixteenth Commission's award should also be measured once the report is public and data for 2026-27 and later years become available. All of the above requires better, more open state-level data.

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