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FISCAL FEDERALISM AND POLITICAL AUTONOMY: ANALYSING RECENT TRENDS IN CENTRE–STATE RELATIONS IN INDIA

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ABSTRACT

Fiscal federalism in India has undergone significant recalibration over the last decade, shaped by the Fifteenth Finance Commission (15th FC), the Goods and Services Tax (GST) regime, pandemic-era borrowing relaxations, rising use of cesses and surcharges, and new centrally-designed capital support mechanisms. This paper analyses how these shifts have altered the balance between the Union and the States, with implications for political autonomy, budgeting discretion, and development priorities. Using official budget documents, Finance Commission reports, Reserve Bank of India (RBI) studies, Comptroller and Auditor General (CAG) audits, Supreme Court jurisprudence, and Parliamentary/ministerial releases from 2019–2025, we trace three core trends: (1) the composition and predictability of intergovernmental transfers; (2) conditionality in borrowing space and capital support; and (3) institutional dynamics within the GST Council and the Governor's assent process that indirectly affect fiscal autonomy. Descriptive indicators show that States' own revenue remains the majority of their revenue receipts, yet dependence on Union transfers is still large; cesses/surcharges—receipts not shareable with States—remain material even after falling from COVID-era peaks; and committed expenditures crowd out flexible spending headroom in many States. We argue that political autonomy is increasingly determined not only by constitutional devolution shares but also by the design of conditional loans, the structure of grants, and the interpretive space left by courts and councils. The paper concludes with policy suggestions to strengthen cooperative fiscal federalism: make vertical transfers more predictable, reduce non-shareable levies, rationalise conditionalities, strengthen institutional fora (Finance Commission, Inter-State Council, GST Council), and align borrowing frameworks with macro-stability and counter-cyclical needs (PRS, 2024).

KEYWORDS: Fiscal federalism, Finance Commission, GST Council, cesses and surcharges, tax devolution, grants-in-aid, State borrowing, political autonomy, Centre–State relations, India.

1. INTRODUCTION

India's Constitution envisages a union of States with a carefully crafted intergovernmental fiscal architecture. Articles 268–281 allocate taxing powers and revenues, establish the Finance Commission, and provide for grants-in-aid and other transfers. Contemporary fiscal federalism combines this constitutional template with institutions such as the GST Council and periodic Finance Commission awards. Since 2014, three structural developments have reshaped the terrain: (i) the transition to GST (101st Constitutional Amendment) and compensation mechanisms; (ii) the 15th FC's award period (2021–26), fixing the vertical devolution share at 41% while re-casting several grant categories; and (iii) a proliferation of central schemes and conditional capital support/borrowing dispensations, especially during the pandemic and thereafter. Each of these affects States' fiscal capacity and their political autonomy to prioritize programme choices.

The past five years have also seen legal-institutional frictions—particularly regarding gubernatorial assent to State bills and the allocation of administrative powers—that spill over into fiscal decisions and implementation. Together, these changes warrant a systematic, data-driven assessment of recent Centre–State fiscal relations and their implications for autonomy.

2. Objectives

This paper pursues five objectives:

1. Map the evolving composition of States' revenue, distinguishing own sources from Union transfers.
2. Analyse trends in vertical devolution, grants-in-aid, and non-shareable levies (cesses /surcharges).
3. Examine conditional borrowing space and capital assistance schemes and their autonomy implications.
4. Assess institutional developments (GST Council, Finance Commissions, courts/governors) shaping fiscal federalism.

5. Offer actionable policy suggestions to strengthen cooperative federalism while safeguard state.

3. Conceptual frame: From constitutional devolution to "operational autonomy"

Fiscal federalism scholarship distinguishes vertical balance (Union vs. States), horizontal balance (among States), and assignment of functions/finances. In practice, **operational autonomy** for States arises from: (a) predictable vertical devolution; (b) the share of non-shareable Union revenues; (c) design of tied/untied grants; (d) freedom to borrow; and (e) the working of institutions (Finance Commission, GST Council, Inter-State Council, courts, governors). Autonomy is maximized when (i) predictable untied resources dominate, (ii) conditionality is transparent and limited, and (iii) institutional processes equilibrate divergent Centre–State preferences.

4. Data and method

We rely on publicly available sources: PRS India's **State of State Finances 2024–25**; PRS analyses of Union Budget 2025–26 (BE) and cesses/surcharges; the **Ministry of Finance Budget at a Glance 2025–26**; RBI's **State Finances: A Study of Budgets**; CAG State Finance Reports; and official releases/notifications (PIB/CBIC/Finance Ministry) concerning GST compensation cess and capital assistance to States. We analyse trends from FY 2019–20 through FY 2025–26 (BE/RE as available), with descriptive statistics and simple charts/tables to illuminate magnitudes and composition. Citations are provided inline (PRS, 2024).

5. Analytical data and recent trends

5.1 The composition of States' revenue: own sources versus transfers

According to the **State of State Finances 2024–25**, States budgeted **58%** of revenue receipts from their own sources in 2024–25 (BE), with **42%** from Union transfers (tax devolution + grants). Figure 1 visualises this composition. While the majority of revenue is "own," the **transfer component is still decisive** for cash-flow stability, equalization, and program continuity—especially in low-income or special category States. (PRS, 2024)

Figure 1: Composition of States' Revenue Receipts, 2024–25 (BE).

Source: PRS Legislative Research, State of State Finances 2024–25.

5.2 Vertical transfers: devolution vs. grants

Union transfers have two pillars: **tax devolution** (formula-based sharing of divisible pool as recommended by the Finance Commission) and **grants-in-aid** (revenue deficit grants, sector-/state-specific, local bodies, disaster relief, etc.). In **Budget 2025–26 (BE)**, tax devolution is budgeted at **₹14.22 lakh crore**, and **grants-in-aid** at **₹11.37 lakh crore**. These magnitudes highlight how grants approach the size of formulaic devolution in budget arithmetic, with implications for predictability and conditionality. Figure 2 displays the 2025–26 BE split. PRS Legislative Research.

Figure 2: Components of Union Transfers to States, 2025–26 (BE).

Source: PRS Union Budget Analysis 2025–26.

The Finance Commission context. The **15th FC** fixed the vertical devolution share at **41%** of the divisible pool (2021–26)—one percentage point lower than the 14th FC's 42% on account of the exclusion of Jammu & Kashmir as a State—while using criteria such as income distance, population 2011, area, forest & ecology, demographic performance, and tax effort to drive **horizontal devolution** across States. The **16th FC** was constituted for 2026–31; its recommendations (pending as of September 2025) will shape the next phase of transfers, with debates around equity, incentives, and the treatment of non-shareable cesses.

5.3 Cesses and surcharges: the non-shareable wedge

Because **cesses and surcharges** are **not shareable** with States (outside the divisible pool), their use directly affects the **effective vertical share** even when the devolution rate remains 41%. After peaking during the pandemic, the **share of cesses/surcharges in Gross Tax Revenue** fell from **20.2% (2020–21 Actuals)** to **14.5% (2023–24 RE)**, but remains material (Figure 3). The policy relevance is straightforward: a **larger non-shareable wedge** dilutes the buoyancy gains States should otherwise get from the divisible pool.

Figure 3: Cesses & Surcharges as % of Gross Tax Revenue (2020–21 to 2023–24).

Source: PRS/OBI (2025).

5.4 GST: Compensation cess and Council dynamics

The GST transition (2017) was accompanied by a **five-year compensation** to States for revenue shortfalls, originally through end-June 2022. During the pandemic, the Union borrowed on behalf of States and extended the **GST compensation cess till March 2026**, **not to extend compensation to States**, but to **service and repay** the borrowings undertaken for compensation during 2020–22. This extension shapes the indirect tax landscape, while States have had to adjust to the cessation of compensation transfers after mid-2022. The GST

Council remains the locus for rate/structure changes; however, compensation's expiry has prompted States to focus on compliance/collection gains and on SGST buoyancy.

5.5 Committed expenditure and constrained discretion

Budgetary **autonomy** depends not just on receipts but on **expenditure rigidity**. Aggregate data show States have budgeted **around 53%** of their revenue receipts towards **committed expenditure** (salaries, pensions, interest) in 2023–24, leaving limited space for discretionary development outlays without higher borrowing. CAG audits for individual States frequently highlight similar crowding-out dynamics. In high-debt States, this ratio can be far higher. PRS Legislative ResearchNITI AAYOG

5.6 Borrowing space, conditionality, and special capital assistance

During COVID-19 (FY 2020–21), the Union temporarily relaxed the FRBM limit, allowing **additional borrowing of 2% of GSDP**, of which **1%** was conditional on implementing **four State-level reforms** (One Nation One Ration Card, Ease of Doing Business, Power Sector reforms, and Urban Local Body/utility finance reforms). Post-pandemic, the Centre has also offered **50-year interest-free loans to States for capital**—the **Special Assistance to States for Capital Investment**—continued in **2024–25 with an outlay of ₹1.3 lakh crore**, with tranches linked to reform milestones and timely project execution. These mechanisms add capital headroom but—by design—**shape States' priorities** and reform trajectories.

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5.7 Judicial and gubernatorial frictions and their fiscal spillovers

The Supreme Court has, in recent terms, **admonished delays** by some Governors in granting assent or acting on State bills, noting that constitutional functionaries should not **thwart elected governments**. While these rulings are about process, the **fiscal spillover** is real: delays can stall taxation, borrowing, or expenditure authorisations embedded in State legislation or appropriation/budget bills, affecting execution and cash flows. The Court has also taken up issues concerning the federal design more broadly, including a **Presidential Reference** on Governors' powers. Although the doctrinal line is still evolving, the direction of travel reinforces **cooperative federalism** norms over unilateral procedural vetoes.

6. Table of key indicators (2019–2026)

Table 1. Selected indicators referenced in the paper.

Indicator	Year	Value
Composition of States' revenue receipts (Own vs Transfers)	2024–25 (BE)	58% own; 42% transfers
Union transfers to States: Tax devolution	2025–26 (BE)	₹14.22 lakh crore
Union transfers to States: Grants-in-aid (all)	2025–26 (BE)	₹11.37 lakh crore
Cesses & surcharges share of GTR	2020–21 (Actuals)	20.2%
Cesses & surcharges share of GTR	2023–24 (RE)	14.5%
Committed expenditure as % of States' revenue receipts (aggregate)	2023–24	≈53%

Source: PRS Union/State Budget.

7. Discussion: What do these trends mean for political autonomy?

7.1 Predictability versus discretion

The **divisible pool share** of 41% offers a predictable baseline, but **effective shares** are mediated by the scale of non-shareable **cesses/surcharges** and the composition of **grants** (tied vs. untied). When cesses form a larger slice of Union tax collections, States receive less buoyancy from central tax growth than the headline devolution rate suggests. The recent decline in the cess share from pandemic highs is positive, yet today's ~15% remains large in a system premised on shared buoyancy.

7.2 Grants architecture and autonomy

Grants-in-aid have grown in aggregate. Some are **formula-based and predictable** (post-devolution revenue deficit grants; grants to local bodies), while others are **scheme-linked** with detailed guidelines. A rising share of **tied grants** increases **policy influence** from the Union on State choices—beneficial when coordination is necessary (e.g., national infrastructure standards) but potentially constraining when **State-specific needs** demand flexible responses (e.g., climate adaptation in coastal districts versus arid-zone water management).

7.3 Conditional borrowing and capital loans

The 2020 **additional borrowing window** created room for counter-cyclical support but linked a significant portion to **reform conditionalities**. The continuing **50-year loans** for capex deepen this pattern: States gain low-cost capital yet face **compliance and pacing requirements** that nudge reforms and project selection. Properly designed, such **"cooperative conditionality"** can be autonomy-enhancing if it expands States' opportunity set; poorly designed, it can substitute Centre's priorities for State preferences. Empirically, the **scale** of these windows in 2024–25 and the steady releases underline their centrality in states' capex planning. ETInfra.comDigital Sansad

7.4 GST's steady state

With **compensation** expired (except for cess collections used to repay past borrowings), States' SGST performance and the **GST Council's** rate/structure choices are now the primary drivers of **indirect tax autonomy**. The Council's voting shares (one-third Centre and two-thirds States) institutionalise joint decision-making; in practice, consensus has held in most meetings, but political economy tensions remain—especially regarding rate rationalisation, compliance intensification, and place-of-supply issues affecting producing/consuming States.

7.5 Judicial signals and gubernatorial practice

Supreme Court observations in 2024–25 on **assent delays** and on maintaining constitutional balance do not directly change fiscal formulas, but they **buttress autonomy** by preventing procedural roadblocks to budgetary or tax legislation. If these signals translate into improved gubernatorial practice and clearer timelines, States could face fewer execution bottlenecks in their fiscal calendar.\

8. Findings

1. **States' own revenues are the majority but transfers remain pivotal.** In 2024–25 (BE), **58%** of States' revenue is from own sources; **42%** remains transfer-dependent. This mix underscores that vertical arrangements still meaningfully shape State capacity.
   PRS Legislative Research

2. **Grants nearly rival devolution in arithmetic importance.** With **₹14.22 lakh crore** in devolution and **₹11.37 lakh crore** in grants in 2025–26 (BE), the **design** of grants (tied/untied, transparent, timely) is almost as consequential as the devolution formula for day-to-day autonomy.

3. **Non-shareable levies dilute effective sharing.** Although the **cess/surcharge share** fell from **20.2%** (2020–21) to **14.5%** (2023–24 RE), it remains sizable, depressing the **effective vertical share** vis-à-vis the 41% notional rate.

4. **Committed expenditure crowds out policy space.** With **~53%** of revenue receipts pre-empted by salaries, pensions, and interest (on average), many States have **limited flexibility** to reprioritise without additional borrowing or higher transfers. (PRS, 2023)

5. **Conditional borrowing/loans are a double-edged sword.** Pandemic-era **2% of GSDP extra borrowing** (with **1% reform-linked**) and ongoing **50-year capex loans** have enhanced capital outlays but introduced **policy conditionality** into the intergovernmental compact, increasing the Union's steering capacity over State reforms. (PRS, 2020)

6. **GST is in its post-compensation steady state.** With **compensation ended in 2022** and the **compensation cess** running to **March 2026** only for debt service, **SGST buoyancy** and **Council decisions** now dominate indirect-tax autonomy.

7. **Jurisprudence supports cooperative practice.** Recent **Supreme Court** positions on gubernatorial roles and federal functioning, while evolving, strengthen the **normative environment** for State autonomy in legislative and budget processes.

9. Suggestions and policy options

1. **Make the vertical share "effectively" transparent.** Publish an **"effective devolution rate"** each year that adjusts the 41% for the scale of cesses/surcharges. This single number would improve clarity and accountability in Centre–State fiscal debates.

2. **Rationalise cesses and surcharges.** Limit their proliferation, sunset stale cesses, and, where policy-critical, **hard-cap their aggregate share** of GTR. Consider sharing a portion with States or replacing them with divisible-pool taxes.

3. **Prefer predictable untied grants.** Within total grants, **increase untied components** (e.g., for local bodies and equalisation) while **streamlining conditionalities** to core outcomes rather than micro-design details.
4. **Calibrate conditional borrowing.** Retain reform-linked borrowing headroom only for **high-externality** reforms (portability, power distribution efficiency, municipal finance)

and **publish transparent scoring**, timelines, and grievance redressal for States. (PRS,2021)

5. **Institutionalise multi-year, counter-cyclical borrowing paths.** Through the **16th FC** and FRBM frameworks, offer **multi-year borrowing envelopes** with **counter-cyclical triggers** and macro safeguards; protect **capex** during downturns.

6. **Strengthen the GST Council's data and dispute resolution.** Create a **technical secretariat** with independent analytical capacity; establish **time-bound mechanisms** for rate rationalisation and place-of-supply disputes.

7. **Revive the Inter-State Council** as a regular forum to discuss fiscal architecture changes (cess policy, CSS redesign, borrowing frameworks), reducing the load on ad-hoc mechanisms.

8. **Clarify gubernatorial timelines and practices.** In line with Supreme Court guidance, specify **outer time limits** for assent/return of bills—especially appropriation/finance bills—to cut procedural uncertainty that can disrupt State budgets.

9. **Deepen local finance capacity.** Encourage States to **activate State Finance Commissions** on a fixed cycle, link a **portion of devolution to SFC compliance**, and expand **property-tax and user-charge reforms** that raise urban/local revenue buoyancy.

10. CONCLUSION

India's fiscal federalism has matured into a complex web where **headline devolution rates** coexist with **non-shareable levies**, **intricate grant architectures**, and **conditional borrowing/capital support** schemes. The net effect on **political autonomy** is neither linear nor uniform across States. While central support has helped sustain capex and reforms after the pandemic, the system also embeds **strong central steering** through conditionalities and scheme design. The next Finance Commission cycle will be critical to **rebalance predictability and flexibility**: (i) make the effective vertical share transparent; (ii) rationalise cesses and prioritise untied grants; (iii) codify counter-cyclical, multi-year borrowing envelopes; and (iv) strengthen institutional fora (GST Council, Inter-State Council) and gubernatorial practices to align constitutional design with on-the-ground fiscal autonomy. Done well, these steps can reinforce **cooperative federalism** and empower States to tailor development strategies to their diverse contexts.

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