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**Intergovernmental Transfers and the
Fiscal Federalism in India:
Rethinking the Divisible Pool and
Grants-in-Aids Framework**

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**Intergovernmental Transfers and the Fiscal
Federalism in India: Rethinking the Divisible
Pool and Grants-in-Aids Framework**

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Abstract

India's fiscal federal structure is undergoing a critical phase marked by widening asymmetries in intergovernmental resource sharing. Despite the rapid expansion of the Union government's revenue base, the divisible pool of taxes shared with states has contracted, primarily due to the growing prevalence of cesses and surcharges that are excluded from devolution. Simultaneously, the composition of fiscal transfers has shifted towards conditional, non-Finance Commission grants, reducing the share of unconditional transfers that are essential for state-level fiscal autonomy. This study examines the evolving dynamics of India's fiscal federal resource-sharing framework, with particular emphasis on the changing balance between tax devolution and grants-in-aid. Using longitudinal data from Union budgets and Finance Commission reports, the analysis reveals a persistent and deepening vertical fiscal imbalance coupled with increasing centralisation in the transfer system. The paper argues that the Sixteenth Finance Commission must recalibrate the grant architecture and redefine the divisible pool to enhance equity, efficiency, and fiscal sustainability in India's intergovernmental fiscal relations.

Keywords: fiscal federalism, divisible pool, grants-in-aid, devolution

Introduction

The evolving contours of India's fiscal federal framework present formidable challenges for the Sixteenth Finance Commission (FC). Addressing the rising discontent among subnational governments regarding the allocation of federal resources, both through tax devolution and Grants-in-Aid (GIA) has become a central issue in contemporary fiscal policy debates. While such tensions have always been embedded in India's intergovernmental fiscal relations, they have now intensified due to increasing expenditure responsibilities of states, declining shares in the divisible pool, and the growing discretionary nature of central transfers. As the Sixteenth Finance Commission prepares its recommendations for 2026–2031, two pivotal questions arise that are how can the transfer mechanism be optimized to better support state finances and reduce vertical fiscal imbalance? And, more fundamentally, should the divisible pool of central taxes be redefined to reflect the evolving revenue patterns of the Union government?

India's fiscal federalism is characterized by a constitutional asymmetry between the revenue-raising powers of the Union and the expenditure responsibilities of the States. The Union government controls the most buoyant and broad-based tax sources such as income and indirect taxes, while states bear the primary responsibility for social and developmental expenditure. This asymmetry results in a persistent Vertical Fiscal Imbalance (VFI), a structural gap between revenue capacity and expenditure needs across levels of government (XV Finance Commission, 2020). The framers of the Constitution, as articulated in Articles 270 and 275, anticipated this asymmetry and instituted the Finance Commission as an institutional mechanism to periodically correct such imbalances through tax devolution and grants (Bagchi, 2003).

Comparative studies show that India's VFI remains among the highest globally, exceeding that of other large federations such as Brazil, Canada, and Australia (Reserve Bank of India, 2023; Sharma & Chakraborty, 2019). This imbalance has been exacerbated by the growing share of cesses and surcharges, which are excluded from the divisible pool, effectively shrinking the states' share of central taxes. At the same time, Horizontal Fiscal Imbalances (HFI) arising from variations in economic capacity, demographic structure, and developmental needs among states remain substantial (Bird & Tarasov, 2004; Rao & Singh, 2005). These disparities raise critical questions about the equity and efficiency of India's resource-sharing framework.

Classical theories of fiscal federalism provide a conceptual lens for understanding these challenges. Oates (1972, 2001) argued that the optimal assignment of fiscal responsibilities across tiers of government must account for externalities, economies of scale, and local preferences in public goods provision. While Oates (1972, 2001) emphasized the allocative efficiency and decentralisation theorem, Boadway and Shah (2009) advanced this framework by distinguishing between vertical and horizontal fiscal imbalances and proposing an integrated system of intergovernmental transfers that combines equity and efficiency objectives. According to Boadway and Shah (2007), an optimal federal transfer system must balance revenue adequacy at the subnational level with national fiscal stability, while ensuring that equalization mechanisms correct disparities in fiscal capacity without undermining local accountability. Their approach provides a useful normative benchmark for analysing India's evolving fiscal transfers.

Intergovernmental transfers, therefore, play a dual role correcting vertical imbalances and equalizing horizontal disparities. In India, the Finance Commission's recommendations have historically

been guided by principles of equity, efficiency, and fiscal discipline, reflecting the country's evolving political economy (Rangarajan & Srivastava, 2011). Over time, however, the relative weights accorded to these criteria such as population, income distance, tax effort, and fiscal discipline have fluctuated, leading to periodic shifts in the balance between equalization and incentive objectives (Rao, 2021).

Recent developments, however, point toward a growing centralization of fiscal power. States have increasingly voiced concerns that the proliferation of Centrally Sponsored Schemes (CSS) has eroded their fiscal autonomy. The declining proportion of untied transfers and the rising share of conditional grants have constrained states' ability to align spending with local developmental priorities (Chakraborty & Chakraborty, 2018; Rao & Agarwal, 2023). Moreover, with the introduction of the Goods and Services Tax (GST), states' independent revenue capacity has become more limited, deepening their dependence on central transfers. The erosion of fiscal space has led to renewed debates on whether the divisible pool currently limited to central taxes net of cesses and surcharges adequately reflects the spirit of cooperative federalism (Kelkar, 2020).

Despite an extensive body of literature on fiscal federalism in India, several critical gaps persist. Most empirical studies remain confined to the pre-GST period, offering limited insight into how the new indirect tax regime has altered the fiscal balance between the Union and the States (Rao & Singh, 2005; Sharma & Chakraborty, 2019). The dynamic link between the shrinking divisible pool due to the expansion of cesses and surcharges and the widening vertical imbalance has not been systematically explored. As the vertical gap widens, the capacity of the Finance Commission to redress horizontal inequalities becomes

constrained, suggesting the need for a framework that jointly examines both dimensions (Oates, 2001; Rao & Agarwal, 2023).

Equally underexplored is the effectiveness and predictability of the grant system. Although successive Finance Commissions have experimented with conditional, performance-based, and sector-specific grants, there is little empirical evaluation of their impact on expenditure autonomy, equity, or developmental outcomes across states (Chakraborty & Chakraborty, 2018; Rao, 2021). The rapid expansion of non-Finance Commission grants often outside the constitutional framework further complicates the transfer landscape and raises questions about transparency and accountability in intergovernmental fiscal relations. Moreover, there is a dearth of studies assessing whether the current definition of the divisible pool aligns with the fiscal needs of states or with the constitutional intent of shared tax federalism.

This study seeks to fill these gaps by empirically investigating the shrinking share of the divisible pool, quantifying the impact of cesses and surcharges on states' fiscal capacity and revenue autonomy. Third, it re-evaluates the grants in aid mechanism, distinguishing between Finance Commission and non-Finance Commission transfers to assess their role in promoting fiscal balance and expenditure quality. The findings add to the ongoing debates on redefining the divisible pool and restructuring the grant system to strengthen India's fiscal federalism.

Related Studies

Fiscal federal systems like India often face inherent imbalances in resource sharing between different levels of government. These fiscal imbalances arise when there is a structural mismatch between the revenue-raising capacities and expenditure responsibilities of the central and subnational governments. The

Indian Constitution, through the Seventh Schedule, establishes this functional division by assigning taxation powers and expenditure responsibilities across the Union, State, and Concurrent Lists. While this framework ensures administrative clarity, it also institutionalizes a degree of asymmetry where the Union controls more elastic tax bases, and the States shoulder the larger share of developmental and welfare spending (Bagchi, 2003; Boadway & Shah, 2009).

Within this structure, two broad categories of fiscal imbalance emerge vertical and horizontal. VFI refer to the gap between the Union's higher revenue capacity and the States' greater expenditure obligations, while horizontal fiscal imbalances capture disparities among the States themselves in terms of resource endowment and fiscal capacity (Boadway & Shah, 2007; Oates, 2001). Persistent vertical imbalances can lead to fiscal stress and debt sustainability concerns at both levels, whereas horizontal imbalances perpetuate regional inequalities in public service delivery and developmental outcomes (Darshini & Gayithri, 2024).

Despite successive Finance Commissions and numerous fiscal reforms, both types of imbalances continue to characterize India's fiscal federal landscape. The income distance criterion—currently the dominant mechanism for horizontal devolution—has attracted particular criticism. The criterion assumes that higher per capita income equates to higher fiscal capacity and, therefore, lower need for transfers. However, empirical studies have shown that the relationship between income and fiscal capacity is non-linear; in some cases, fiscal capacity can actually decline as per capita income rises, due to factors such as tax base erosion and structural dependence on non-tax revenues (Joseph & Kiran, 2025). Consequently, the existing transfer system may inadvertently penalize relatively better-performing States by

reducing their share in the divisible pool of central taxes. This has constrained the equalization potential of Finance Commission transfers and limited their effectiveness in ensuring comparable levels of public services across regions (Chakraborty, 2015; Rao & Agarwal, 2023).

The Finance Commission (FC) remains the principal constitutional mechanism for addressing these imbalances, recommending both tax devolution and grants to ensure fiscal balance (Kelkar, 2019). The upcoming Sixteenth Finance Commission has an opportunity to revisit not only the devolution formula but also the broader structure of fiscal federal relations. Srivastava (2025) suggests that the Commission should adopt an integrated approach jointly addressing vertical resource sharing, fiscal deficits, and debt sustainability at both central and state levels rather than treating them as separate domains. Such an approach aligns with the principles articulated in the international literature, where rule-based, transparent, and formula-driven transfer systems are viewed as essential to maintaining efficiency and equity in federations (Boadway & Shah, 2007; Shah, 2014).

A critical contemporary challenge is the rising share of cesses and surcharges in the Union government's gross tax revenue, especially since 2014–15 (Ramakumar, 2024; Reserve Bank of India, 2023). These levies, unlike regular taxes, are not part of the divisible pool and therefore not shared with States. Their increasing prevalence effectively shrinks the pool of resources available for devolution, intensifying vertical fiscal stress. Moreover, concerns have emerged regarding the diversion of certain cesses from their intended purposes. For example, nearly half of the Union's education expenditure is now financed through an education cess, raising questions about how States can meet their own growing educational obligations when their fiscal space is constrained (Motkuri & Revathi, 2023).

To correct these imbalances, several scholars advocate stronger compensatory mechanisms and more predictable transfer frameworks. Mohan and Ramakumar (2024) recommend that the Sixteenth Finance Commission should enhance untied grants and consider raising the devolution rate to around 45.5 percent of the net proceeds of Union taxes to better equalize vertical fiscal gaps. Complementarily, Koley and Mandal (2019) demonstrate empirically that reducing vertical fiscal imbalances significantly improves States' fiscal performance, leading to lower primary deficits and enhanced expenditure quality. Together, these studies underscore that restoring a more equitable balance in fiscal powers is essential for strengthening cooperative federalism and ensuring fiscal sustainability in India.

Changing patterns of fiscal federal resource allocation

The fiscal relationship between the Union government and the states in India involves two primary mechanisms for resource transfers. The FC established under the provision of Article 280 of the constitution provides guidelines for grants-in-aid, which are essential for state finances. Importantly, these recommendations carry legal weight and are binding. Beyond the FC's purview (Non-FC grants), the Union government directly disburses funds to states through various schemes. These include Centrally Sponsored Schemes (CSS) and Central Sector Schemes. These non-statutory grants are earmarked for specific purposes, such as infrastructure development, healthcare, or education. However, they come with conditions, tying state expenditure to predefined areas (P. Chakraborty & Bhadra, 2024). Consequently, states have limited autonomy in utilizing these funds. On the other hand, the central share of taxes, the tax devolution remains a significant channel for resource transfers through vertical and horizontal transfers. More specifically, the Non-FC grants are spent at the discretion of the Union government for specific schemes. On the

contrary, the FC grants are considered the Indian states' lifeline owing to their unconditional nature, meaning FC grants provide states with the autonomy to allocate funds according to their state-specific requirements. Therefore, transfer dynamics are crucial in shaping the fiscal federal relationship between the union and state governments.

Recent years have witnessed significant shifts in the pattern in which the union government disburses federal resources to the states. The central share of taxes, through tax devolution, commands the largest share in total transfers, followed by non-FC and FC grants. Tax devolution to the states hovered around 25 percent to 28 percent of the total resource transfers while FC grants have considerably decreased from 6 percent to 3.6 percent during 2009-10 to 2022-23. On the other hand, non-FC grants, particularly grants for Centrally Sponsored Schemes (CSS) have risen from 13.4 percent to 17.2 percent during the same period (Table 1). Given, the non-FC grants are conditional; giving nil autonomy to the states, the increasing share of conditional grants is clear evidence of an increasing tendency towards centralization rather than decentralization. It poses a significant threat to the fiscal federal framework of the country.

Table 1: Transfers as a share of Gross Revenue of the union government (In Percentage)

	Central Share of Taxes	FC Grants	Non-FC Grants	Total Transfers to the state
2009-10	21.30	6.08	13.42	40.80
2010-11	20.95	4.67	10.95	36.57
2011-12	24.38	4.98	12.81	42.17
2012-13	24.00	3.98	11.55	39.53
2013-14	23.07	4.87	10.06	38.00
2014-15	22.61	4.78	17.36	44.75

	Central Share of Taxes	FC Grants	Non-FC Grants	Total Transfers to the state
2015-16	28.44	4.75	13.56	46.75
2016-17	29.60	4.65	12.68	46.93
2017-18	30.21	4.14	14.08	48.43
2018-19	31.35	3.86	14.25	49.46
2019-20	27.05	5.14	17.08	49.27
2020-21	25.96	8.03	20.06	54.05
2021-22	28.85	6.66	13.33	48.84
2022-23 (A)	27.80	5.06	20.66	53.52
2023-24(RE)	28.55	3.63	17.20	49.38

Source: Authors' calculations from Union receipt budget, various years

Notes: Gross is revenue is Gross Tax Revenue, non-tax revenue and non-Debt receipts; Debt receipts are excluded from the calculation

Declining share of FC grants

FC grants are crucial because they are largely unconditional, allowing states flexibility in their use. However, their continuously declining share portrays a disturbing picture of India's fiscal federal framework. Out of the total grants in aid, FC grants now account for only 17.4 percent of total central grants to states while the non-FC grants which are often conditional, make up 82.6 percent. Despite constitutional provisions stipulating that grants-in-aid should come from the Consolidated Fund of India (CFI), the Finance Commission has been allocating these grants from the divisible pool. The divisible pool is the source from which the states receive their share of fiscal resources from the Union government. The 14th FC set aside 5.72 percent of this pool for grants in aid to the states, while the 15th FC increased this allocation to 10.03 percent. Under this allocation, the share of non-FC grants which are conditional has been rising. During the 14th FC tenure, conditional grants comprised 16 percent of the

divisible pool, increasing to 19 percent under the 15th FC. These conditional grants pose a challenge for states, as they are earmarked for specific purposes, limiting states' ability to allocate funds according to their unique development needs and priorities. This lack of flexibility can hinder states' capacity to address their most pressing issues effectively.

Article 275 of the Indian Constitution governs grants from the Union government to specific states. According to this article, Parliament has the authority to allocate funds from the Consolidated Fund of India as grants-in-aid to states requiring assistance. Different amounts can be fixed for different states based on their specific needs. Besides, Article 273 determines grants related to export duties on jute and its products, benefiting states like Bihar, Assam, West Bengal, and Orissa. Subsequent Finance Commissions (FCs) continued this pattern, adjusting grant categories to address various sectors and challenges. While the Fourteenth and Fifteenth FCs streamlined the grant categories, they still emphasized disaster management, post-devolution revenue deficit grants, and support for local governments. The Twelfth FC implemented significant modifications in grant categories, introducing ten specific areas for grants-in-aid. These areas covered sectors such as health, education, road and bridge maintenance, and building and forest upkeep. Following a similar pattern, the Thirteenth FC expanded the grant categories by adding four more: improving outcomes, issuing Unique Identification Numbers (UIDs), performance incentives, and enhancing statistical systems at the state and district levels. Subsequently, the Fourteenth and Fifteenth FCs streamlined the grant categories, emphasizing disaster management, post-devolution revenue deficit grants, and support for local governments. Further, the Fifteenth FC continued this trend by recommending sector-specific and state-specific grants, aligning with the Fourteenth FC's approach.

Grants-in-aid are recommended from the Consolidated Fund of India in accordance with constitutional provisions. However, the Fourteenth and Fifteenth Finance Commissions (FCs) have allocated grants-in-aid from the divisible pool. Considering that the size of the divisible pool is relatively small compared to the gross revenue of the Union government, it is advisable to allocate a portion of the gross revenue directly as grants-in-aid, separate from the divisible pool share. This approach would enhance the overall share of grants-in-aid provided to the states.

According to the Fourteenth Finance Commission (FC) recommendation, FC grants constitute only 5.72 percent of the total devolution (out of 47.72 percent of total FC transfers). However, in the Fifteenth FC, this percentage has increased to 10 percent (as indicated in Table 2). It's essential to recognize that the size of FC grants remains relatively low within the overall devolution. Consequently, there exists significant potential to enhance the overall size of grants-in-aid, considering that it must be sourced from the gross revenue.

Table 2: Transfers recommended by the Finance Commission

Categories	14 th Finance Commission		15 th Finance Commission	
	Amount (crore)	As a percent of divisible pool	Amount (crore)	As a percent of divisible pool
Divisible pool	9400444		10304292	
Total transfers to states	4485541	47.72	5257822	51.03
Tax share	3948187	42.00	4224760	41.00
Grants from FC	537354	5.72	1033062	10.03
Fiscal Space for Union Govt	4914903	52.28	5046470	48.97
Provision of other transfers to states	1477943	15.72	1966199	19.08
Total grants from the Centre	2015297	21.44	2999261	29.11

Source: Respective Finance Commission Reports

A case for increased FC grants

The constitution of the Sixteenth Finance Commission is in a period where the states grapple with mounting fiscal pressures. Hence the call for enhanced FC grants grows louder. With the growing Vertical Fiscal Imbalance (VFI), shrinking divisible pool, contracting volume of Finance Commission grants, and increasing share of discretionary transfers, the woes of state finances have worsened in recent times. The loss of financial autonomy due to paradigm shifts in tax regimes like the Goods and Services Tax (GST) exacerbated the concerns. Intriguingly, the post transfers through devolution and grants in aid, the revenue retained by the union government comes to around 50 percent while the state governments have disproportionately higher expenditure responsibilities than the union government. While states shoulder a whopping 62.4 percent of expenditure responsibilities, their revenue-generating capacity stands at a mere 37.3 percent. In stark contrast, the Union government, with only 37.6 percent of expenditure duties, commands a formidable 62.7 percent of revenue capacity. This disparity has set the stage for a fiscal tug-of-war, with states increasingly finding themselves on the losing end. With the declining share of unconditional FC grants, these imbalances further exacerbate.

Due to the prominence of conditional non-FC grants, there is a considerable wedge between the states' requirements and transfers. For instance, the state of Kerala submitted a grant request across 38 categories to the 14th FC, however it received only grants for a mere four items. This disconnect between state needs and central allocations underscore the urgency for a more responsive grants system.

Issues in vertical devolution

Another important challenge lies in redefining the divisible pool of taxes with the continuously growing revenue kitty of the union government. The divisible pool is the source from which the states receive their share of taxes from the union government. The Sixteenth Finance Commission needs to seriously consider the states' demand to enhance the size of the divisible pool and increase the share of vertical devolution. Therefore, it's worth examining the union government's expanding revenue pool, concerns about the shrinking size of the divisible pool and the need to redefine the divisible pool and the portion of revenue retained by the union government post-resource transfers.

Union government's expanding revenue pool

Over the past decade, the union government's Gross Revenue (GR) has grown impressively, with a compound annual growth rate of 12 percent at Rs. 43.09 lakh crore in 2024-25 (Budget Estimates, BE). This revenue pool or GR comprises GTR, non-tax revenue, and non-debt receipts. GTR, the largest component (Rs. 38.31 lakh crore), has mirrored this growth trajectory (Table 3). Other components, such as non-tax revenue and non-debt receipts, amount to Rs. 4 lakh crore and Rs. 0.79 lakh crore respectively in 2024-25(BE). The union government's debt receipts, Rs.16.82 lakh crore during the same period are excluded from the GR calculation. However, a closer examination reveals a concerning trend: while the overall revenue pool expands, the divisible pool - the portion shared with states - is shrinking in relative terms.

Table 3: Revenue position of the union government (In Rs. lakh crore)

Year	Gross Tax Revenue	Gross Revenue
2009-10	6.25	7.74
2010-11	7.93	10.47
2011-12	8.89	10.48
2012-13	10.36	12.15
2013-14	11.39	13.79
2014-15	12.45	14.94
2015-16	14.56	17.80
2016-17	17.16	20.54
2017-18	19.19	22.27
2018-19	20.80	24.29
2019-20	20.10	24.06
2020-21	20.27	22.92
2021-22	27.09	31.14
2022-23 (A)	30.54	34.12
2023-24(RE)	34.37	38.69
2024-25(BE)	38.31	43.09

Source: Union Receipt Budget, various years

Shrinking divisible pool: A cause for concern

The divisible pool, defined as the GTR of the union government net of cess and surcharges as well as collection cost, has been steadily shrinking over the years primarily due to two factors - the increasing revenue generated from cess and surcharges which are excluded from the divisible pool, and the expanding gross revenue of the union government (Ramakumar, 2024); (Motkuri & Revathi, 2023). The union government's revenue from cess and surcharges has significantly increased in recent years, now at Rs. 5.39 lakh crore. Similarly, collection costs have surged to Rs. 2.68 lakh crore (Table 4). This considerable increase in cess, surcharges, and collection costs has led to a marked contraction in

the size of the divisible pool. The revenue collection from cess and surcharge as a share of GTR is showing a marked rise from 5.16 percent to 14.07 percent during 2009-10 and 2024-25 (Figure 1).

Previously, the union government fully retained all corporation taxes and customs duties, with only income tax and excise duty being shared with the states. The 80th Constitution Amendment in the year 2000 added all union taxes to the divisible pool except cess and surcharges. Initially, these exclusions were based on specific FC recommendations, but the constitutional amendment provided legal backing for such exclusions.

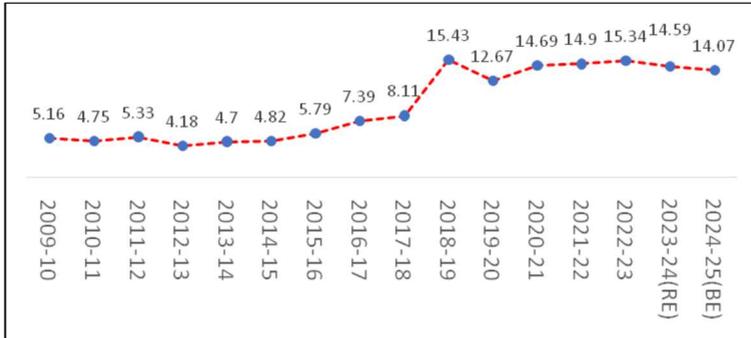
Table 4: Estimated size of the divisible pool (In Rs. lakh crore)

	Gross Tax Revenue	Cess and Surcharge	Collection Costs	Divisible Pool
2009-10	6.25	0.42	0.44	5.39
2010-11	7.93	0.51	0.56	6.86
2011-12	8.89	0.60	0.62	7.67
2012-13	10.36	0.62	0.73	9.01
2013-14	11.39	0.74	0.80	9.85
2014-15	12.45	0.62	0.87	10.96
2015-16	14.56	0.86	1.02	12.68
2016-17	17.16	1.29	1.20	14.67
2017-18	19.19	1.56	1.34	16.28
2018-19	20.80	3.21	1.46	16.14
2019-20	20.10	2.55	1.41	16.15
2020-21	20.27	2.98	1.42	15.87
2021-22	27.09	4.04	1.90	21.16
2022-23	30.54	4.69	2.14	23.72
2023-24(RE)	34.37	5.02	2.41	26.95
2024-25(BE)	38.31	5.39	2.68	30.23

Source: Union Receipt and expenditure Budget, various years

Note: collection cost is assumed at 7 percent, derived from the previous averages

Figure 1: Revenue collection of the union government from cesses and surcharges (as a percentage of GTR)



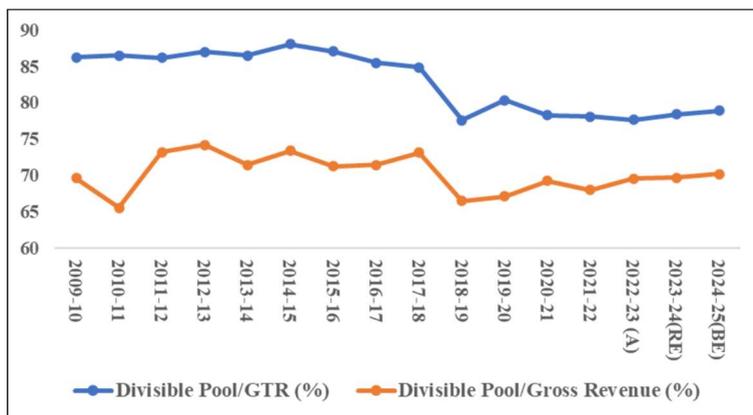
Source: Union Receipt Budget, various years

Between 2009-10 and 2024-25, the divisible pool’s share of GTR fell from 86.2 percent to 78.9 percent (Receipt Budget, 2024) (Figure 2). When viewed as a proportion of Gross Revenue, the decline is even starker, dropping to 70.2 percent. There is a 9-point gap between the divisible pool as a share of GR and GTR. This shrinkage has significant implications for state finances. Despite recommendations for higher vertical devolution by recent Finance Commissions¹, the actual share of taxes received by states has consistently fallen short of targets (Figure 2). It is evident from the proportion of the central share of taxes to states in GTR of the government is at 30.39 percent, way lower than the proposed devolution. This shortfall is exacerbating the already

¹ The 14th FC (2015-16 to 2019-20) recommended a higher share of 42 percent compared to the previous commission (2010-11 to 2014-15)(XIV FC, 2013). The 15th FC recommended a 41 percent tax devolution(XV FC, 2020).

significant VFI in the country, where states bear 64 percent of total expenditures but collect only 37 percent of resources. The situation becomes even direr when examining the union government’s revenue retention post transferring the resources to the state governments.

Figure 2: Evidence of shrinking divisible pool (In percentage of GR and GTR)



Source: Authors’ calculation from the Union Receipt Budget, various years

Substantial revenue retained by the union government post-resource transfers

Post-transfers through tax devolution and grants, the union government holds onto approximately 50 percent of the revenue pool, despite its expenditure commitments are only 37 percent. On the other hand, states bear about 63 percent of expenditure responsibilities. This lopsided distribution is putting immense pressure on state governments, particularly in South India, where

protests and legal actions against the union government are gaining momentum recently.

The prevailing imbalances in revenue sharing significantly contribute to the contraction of fiscal space of the states, especially considering the sub-national governments' diverse and expanding expenditure responsibilities. Nevertheless, the states' dependence on transfers from the union government, measured by the ratio of transfers to their expenditure is still unfavourable to many states particularly southern states. It gives room for interrogation about the existing vertical sharing mechanism.

Conclusion and the way forward

As India looks to the 16th Finance Commission, the opportunity for meaningful reform presents itself. There is an urgent need to argue for a recalibration of the FC grants system, advocating for the increasing share of FC grants relative to conditional allocations. This will enhance the states' autonomy and cater to the specific development needs of the state. Expanding the base for FC grants to include gross revenue or the Consolidated Fund of India is another recommendation that requires immediate attention. It is also justified by the growing revenue kitty of the union government. By increasing the size of FC grants, there will be greater alignment between state-specific needs and grant allocations. Addressing these concerns, the 16th FC could play a pivotal role in bridging the widening resource gap between the Union and state governments, nurturing a more equitable and efficient federal financial structure. As the debate unfolds, one thing remains clear that the future of India's fiscal federalism hangs in the balance, with the potential to reshape the nation's economic landscape for years to come.

As states grapple with the challenging task of balancing fiscal objectives and fulfilling their extensive expenditure responsibilities, the need for redefining the divisible pool becomes increasingly apparent. The tax devolution or the central share of taxes that commands the major share of total transfers is sourced through a divisible pool, defined as the Gross Tax Revenue (GTR) of the union government net of cess and surcharges and collection cost. Therefore, enhancing the size of the divisible pool and increasing the vertical devolution share is essential. Given the challenges in expanding the divisible pool through constitutional amendments, an immediate step would be to increase the vertical devolution share of taxes from 41 percent to 50 percent. The 9-point gap between the share of the divisible pool in GR and GTR could be the basis for increasing the devolution share to 50 percent. A higher devolution percentage would partially offset the exclusion of cess and surcharge and provide states with access to a larger share of overall union revenues. The divisible pool dilemma has sparked fresh constitutional debates and calls for fiscal reforms. As a long-term measure, the necessary constitutional amendments need to be in place to deal with the surging cess and surcharges. A reduction of the rates of cess and surcharges in income tax and corporate tax can be considered by increasing the sharable portion of these taxes without affecting the overall collection of taxes. The task of the Sixteenth Finance Commission would be to ensure redefining the divisible pool for mitigating the imbalances in fiscal federal resource sharing.

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