International Journal of Social Science Research (IJSSR)
Volume- 3, Issue- 5 | September - October 2026 ISSN: 3048-9490

Federalism and Financial Conflicts in India: A Study of Centre-State Financial Implications

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Abstract:

Federalism is a basic feature of the Indian Constitution, as affirmed by the Supreme Court in the Kesavananda Bharati case. Institutions like the Finance Commission (Article 280) and NITI Aayog guide resource devolution, yet balancing central supremacy with state fiscal autonomy remains challenging. The primary objective of this study is to examine the growing financial conflicts between the Central government and the States and analyze how recent fiscal policies affect state financial independence. Methodologically, this study adopts a descriptive, institutional, and analytical approach, which relies on a qualitative examination of constitutional provisions and secondary data from Finance Commission reports, Reserve Bank of India publications, and parliamentary records. The major findings indicate that while Centre-state financial frictions reflect democratic bargaining in a multi-level polity, they also reveal serious vertical fiscal imbalances. States bear most expenditure obligations for health, education, and social welfare, but their revenue mobilization powers remain very limited. This imbalance has worsened because the Centre increasingly collects non-shareable cesses and surcharges, which reduces the divisible tax pool. Moreover, the Goods and Services Tax (GST) has curtailed state tax powers, and strict borrowing limits have increased state dependency on the Centre. The study concludes that current trends reflect growing financial centralization rather than cooperative federalism. Resolving these conflicts requires reforming the tax-sharing formula, revitalizing the Inter-State Council, and restoring fiscal autonomy to the states.

Keywords: Federalism, Financial Conflicts, Centre-State Relations, Tax Devolution, GST, State Autonomy, Finance Commission.

Introduction:

Federalism may be defined as “It’s a political contrivance which is intended to reconcile national unity with the maintenance of state rights.” Political scientist Montesquieu defined, “A several similar states agree to become members of a large one”. In general, it can be said that federalism is also a mode of governance in which authority is constitutionally divided between the Union and the state governments. In the Indian democracy, the above-mentioned balance is mentioned in the Constitution, which deals with executive, legislative, and fiscal powers between the central and state governments. According to the Indian federal structure,

*Corresponding Author Email: drkkrishna1110@gmail.com
Published: 31 October 2026
DOI: https://doi.org/10.70558/IJSSR.2026.v3.i5.301401
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financial policy conflicts may be identified in the headlines like resource allocation and responsibilities, taxation and expenditure, growth and developmental needs, etc. Theoretically, cooperative federalism is envisaged in the Constitution, although it reveals many tensions due to fiscal relations. Asymmetrical distribution of powers is responsible for the centre-state financial implications. This paper will summarise the entire historical and institutional reasons for fiscal conflicts. It also analyses the constitutional and institutional provisions and mechanisms, along with major policy reforms, which will map union-state relations, especially in financial matters. The objective is to demonstrate how fiscal federalism has been interpreted and contested, and to examine the implications for economic development, state autonomy, and democratic governance. Financial policy conflicts arise in the Indian federation due to taxation, expenditure, and development priorities, which are politically consequential. Financial expert Y. V. Reddy argues that Indian fiscal federalism has continuously evolved in response to economic and political pressures rather than remaining constitutionally static.[1]

Research Methodology:

Methodologically, this study adopts a qualitative, descriptive, and institutional-analytical research design to examine the evolving financial conflicts between the Union and the States in India. Fiscal federalism in India operates at the intersection of constitutional law, institutional bargaining, and public finance; the methodology combines doctrinal legal analysis with an empirical examination of public budgetary data and policy outcomes.

1. Research Design and Approach

This research is based on the following analytical approaches:

Institutional-Analytical Approach: This approach highlights the formal structures and institutional mechanisms established by the Indian Constitution. It examines how institutions such as the Finance Commission (Article 280), the GST Council (Article 279A), the NITI Aayog, and the Inter-State Council (Article 263) mediate or exacerbate resource-sharing disputes.

Constitutional and Legal Analysis: This approach deals with constitutional texts, statutory amendments, and judicial rulings to assess the shifting legal boundaries of fiscal autonomy. It also analyses how constitutional jurisprudence interprets the federal character of India's governance from Kesavananda Bharati to current rulings.

Empirical and Descriptive Trend Analysis: This approach examines public budgetary trends over the post-reform (LPG) and post-GST periods. It uses descriptive quantitative measures such as revenue-expenditure ratios, the share of cesses and surcharges in gross tax revenue, and state debt-to-Gross State Domestic Product (GSDP) ratios to illustrate structural imbalances.

2. Sources of Information

This study depends on secondary sources, which include institutional records, government documents, and scholarly secondary literature.

Primary Institutional and Government Sources

Constitutional and Legal Documents: The Seventh Schedule of the Indian Constitution provides for the division of powers between the Centre, states, and the Concurrent List. Specifically, Articles 268 to 293 of the Indian Constitution deal with the financial relations between the Centre and States. Furthermore, constitutional amendments such as the 80th Amendment Act, 2000, and the 101st Amendment Act, 2016 are also major documents for this study.

Finance Commission Reports: Generally, the official reports, recommendations, and explanatory memoranda of the Finance Commissions are important, but this study focuses on the Fourteenth and Fifteenth Finance Commissions' reports and recommendations regarding horizontal and vertical tax devolution.

Reserve Bank of India (RBI) Data: This study also depends on Annual publications of State Finances: A Study of Budgets, of RBI, which provide consolidated budgetary statistics on state own-tax revenues, market borrowings, fiscal deficits, and central transfers.

Union and State Budget Documents: This paper analyses Union Budgets, Budget Receipts, and selected State Government budget statements to analyse allocations under Centrally Sponsored Schemes (CSS) and revenue losses, particularly in the post-GST period.

Audits and Parliamentary Reports: This paper examines the Reports of the Comptroller and Auditor General of India (CAG) concerning the accounting and utilization of cesses, along with Parliamentary Standing Committee reports on finance.

Judicial Verdict: This study also depends on the following verdicts of the Supreme Court, in the light of federalism, legislative tax competence, and intergovernmental disputes: Kesavananda Bharati v. State of Kerala, S.R. Bommai v. Union of India, Union of India v. Mohit Minerals, and petitions concerning state net borrowing ceilings.

Secondary Scholarly Literature

Academic Books and Journal Articles: Journals such as Economic and Political Weekly (EPW), Journal of Asian Studies, and Journal of Public Administration are also important for this specific study because these journals deal with public finance, fiscal centralisation, and fiscal governance.

Policy Papers and Institutional Studies: This study includes policy papers and research works of policy research institutions, including the National Institute of Public Finance and Policy (NIPFP) and PRS Legislative Research.

Constitutional and Institutional Demarcation:

1. **Constitutional Wordings:**

The Indian Constitution established a Parliamentary federal system. The article first says that “India is a Union of States”. Schedule Seven lists the subjects on which the Union and State governments can legislate (Union List, State List, and Concurrent List under Article 246) and outlines fiscal relations primarily under Articles 268-203. Maximum tax revenues are in the

hands of the central government, while states are secondary in this regard. However, Article 270 is deployed in the Indian Constitution as a Divisible pool because, through the said article, a few Union taxes are shared with the states on the recommendation of the Finance Commission. Finance Commission and NITI Aayog recommend grants-in-aid under Articles 275 and 282, which allow the Union to make discretionary payments for inevitable public purposes.

2. **Finance Commission:**

It's a duty of the Indian President to constitute the Finance Commission every five years for the smooth conduct of the financial administration. Article 280 of the Indian Constitution empowers the Finance Commission to recommend tax devolution and grants-in-aid to the Indian states. In the meantime, the Commission expanded its role for the purpose of balancing equity and efficiency.[2] The major role of the Finance Commission is to recommend the distribution of Union tax revenues between the Union and the States and among the States. The Commission concludes the same based on Income disparities, population, fiscal discipline, and other socio-economic, political, and cultural reasons. The Fourteenth Finance Commission's decision to increase the states' share of divisible taxes to 42 percent marked a major shift towards decentralisation.[3] Apart from the divisible tax revenues, subsequent debates emerged over cesses and surcharges, which are directly in the hands of the Union government.

Intergovernmental Bodies:

Additionally, the Finance Commission and other institutional mechanisms also influenced fiscal federalism; these are as follows: -

- **GST Council:** It is a Constitutional body formed after the 101st Constitutional Amendment, particularly to manage the Goods and Services Tax (GST) rates and revenue sharing.
- **NITI Aayog:** This Aayog was constituted on the ashes of the Planning Commission in 2015, aimed at institutionalising cooperative federalism. This shift symbolized a move from centralized allocation to policy dialogue, though fiscal authority remains centralized.[4]

The objectives of these institutions are to accelerate cooperative financial policymaking, but they also reflect the complex negotiation processes inherent in India's federal structure.

Historical Evolution of Financial Federalism:

1. **Nehruvian model of Centralisation:**

The Government of India adopted a highly centralised economic planning model immediately after its independence. The First Five-Year Plan (1951- 56) was an output of the same. Under the chairmanship of the Prime Minister (Jawaharlal Nehru), the Planning Commission dominated economic decision-making and directed resources. Under this model, resource allocation and policy priorities were purely in the hands of the central government. All the above-mentioned incidents were happening only for rapid industrialisation and national

integration. Consequently, the fiscal autonomy of the states was gone. During the Nehruvian model of centralisation, states depended on discretionary transfer of funds for development expenditure. This structure reinforced vertical fiscal imbalance.[5]

2. **Competitive Federalism as an output of Liberalisation:**

Under the PM Narsimha Rao regime, India was a witness to a paradigm shift from centralised planning to market-oriented growth. The outcome of the 1991 economic reforms of India was as follows: liberalised trade, deregulated sectors, and an open border for global capital and finance. In this scenario, both levels (the central and state) of government were inviting foreign direct investment (FDI). That was the beginning of competitive federalism. Indian states introduced investor-friendly policies, infrastructure development strategies, and industrial promotion boards to compete for global capital. This transformed fiscal federalism into a platform for inter-state competition, particularly for manufacturing and services investment, which widened regional disparities in development outcomes. 'Structural adjustment' and 'market liberalisation' were outcomes of India's 1991 economic reforms, which point towards "competitive federalism." "Finance experts Rao and Singh observe that post-reform India saw states actively pursuing foreign direct investment and industrial corridors."[6] In the new millennium, a new debate arises that economic and financial reforms of 1990 have not narrowed the gap of poverty and inequality but rather widened it further.

Fiscal Federalism and Contemporary Conflicts:

1. **Goods and Services Tax (GST):**

The existing Goods and Services Tax (GST) is an outcome of the 101st Constitutional Amendment Act, which was passed by the Indian Parliament on 8th September 2016 through the 122nd Amendment Bill and came into effect on July 1, 2017. This Act fundamentally restructured fiscal federalism of India. The current GST Council is a major decision-making body with weighted voting. Arvind Panagariya, in his article (EPW 52, no. 33, 2017) "The GST and Fiscal Federalism in India,"[7] considered that the GST Council was a unique experiment in cooperative federalism. However, M. Govind Rao, through his article (EPW 55, no. 45, 2020) "GST Compensation and Federal Tension,"[8] observed that revenue compensation disputes during the COVID-19 pandemic exposed structural tensions. In overall perspective, states argued that delayed compensation payments violated fiscal assurances, i.e., embedded in the GST structure. It is frequently observed that the Central Government, by stepping outside the GST framework, is collecting additional taxes through various cases and surcharges. Surely, it has reduced the effective divisible pool, intensifying Centre-State tensions. "Under Article 270 of the Constitution of India, net proceeds of most central taxes are shared with the States; however, cesses levied for specific purposes (under Article 277) and surcharges (under Article 271) are explicitly excluded from this divisible pool."[9] In the post-2017 scenario, India has a GST Council, chaired by the Union Finance Minister and comprising the finance ministers of the states that oversee tax rates and the revenue-sharing formulas. Undoubtedly, the Council is an innovative cooperative federal arrangement, despite the following conflicts that are yet to be resolved:

(a) Revenue Compensation: At the time of implementation of GST, States were promised compensation for any loss of revenue for merely five years. Now, it has been abolished, resulting in substantial tax losses for the states, while on the other hand, their expenditure is rising rapidly.

(b) Rate Fixation: On the issue of rate fixation, States have argued that the Centre's role in decision-making often dilutes their autonomy, especially in rate-setting during economic downturns.

These are the dilemmas of GST to date. The states have publicly raised these issues, stressing fiscal imbalances resulting from GST implementation.

2. Vertical Fiscal Imbalances:

In the Indian federation, multiple sources of income are in the hands of the Union government. For example: Goods and Services Tax (GST), Income Tax, Corporation Tax, Customs Duty, Union Excise, and Non-Tax Revenues like Interest, Dividends and Profits, Fees and Licenses, Disinvestment, Recovery of Loans, etc. The above-mentioned sources of income reflect that India's fiscal structure exhibits a significant vertical fiscal imbalance. On the other hand, states have greater expenditure responsibilities like health, education, welfare, infrastructure, etc., which require inevitable finance and are not available in this unbalanced tax regime. Consequently, the states are heavily dependent on central transfers of funds and shared revenues. In this scenario, states are vulnerable due to financial policy shifts in favour of the Centre. State governments are continuously demanding financial policy reforms to avoid imbalances in sources of income. Apart from the demands of states, scholars of fiscal federalism are also waiting for the highly awaited reforms.

3. Centrally Sponsored Scheme (CSS):

In any federal system of governance, centrally sponsored schemes (CSSs) undoubtedly strengthen the federal structure. However, whenever the Central Government imposes the burden of additional expenditure upon the states, the situation spirals out of control. In India, Centrally Sponsored Schemes are federal programs jointly funded by the Centre and states but often implemented by states according to conditions laid down by the Union government. Schemes include MGNREGA, Ayushman Bharat, and several health, education, and public welfare missions under different central ministries and state departments. These schemes are designed and run to meet the national aims and objectives but are also criticised for constraining the state's autonomy in setting priorities. That can be justified with the following points: (a) Shifting of the funding ratio is a major painful condition for states because, sometimes, it requires higher state matching contributions. (b) No doubt that the said schemes are designed often as per national priorities, especially to meet region-specific needs. Despite the states are in strains in the light of autonomy. (c) States argue that Centrally Sponsored Schemes are bypassing the constitutional lines and intervening in the legislative affairs of the states. Article 282 of the Indian Constitution enables the Union government to provide discretionary grants for public welfare purposes. The reality is that gradually, CSS has expanded its significance, even in the sectors that are constitutionally assigned to the states. Experts of Vidhi Centre for Legal Policy argued that "excessive reliance on Article 282 dilutes state autonomy and blurs

constitutional demarcations.".[10] Financially weaker states are under stress and strain to meet the everyday growing requirements of state matching funds.

4. **Finance Commission and Devolution Debates:**

As per the Indian Constitution, fiscal federalism is moving around recommendations of the Finance Commission and the NITI Aayog. Most recently, the 15th Finance Commission (2020-26), led by N K Singh, retained the 41 percent which was reduced from 42 percent recommended by the 14th Finance Commission, share of divisible taxes, citing fiscal constraints.[11] However, the southern states raised objections, arguing that population-based criteria disadvantage demographically stable regions. Overall, available facts reflect deeper normative tensions regarding the following points: (a) Should redistribution be prioritized in underdeveloped regions? (b) Or, keeping fiscal discipline in mind, should the demographic strain be allowed to persist? Despite the power and function of the Finance Commission and the NITI Aayog regarding the devolution of national resources among the states, horizontal equity and incentive-based federalism remain contested.

Political Dynamics in Fiscal Federalism:

1. **Cooperative Federalism vs. Coercive Federalism:**

Indeed, Indian federalism is the best example of cooperative and coercive federalism because, as per the Seventh Schedule of the Constitution, most subjects of legislation are in the hands of the Union Government. From an Indian perspective, cooperative federalism envisages consultation, negotiation, and shared decision-making; institutions like the GST Council and Inter-State Council embody this approach. But the central dominance in fiscal matters indicates coercive federalism. To substantiate this, one can look at the currently operational revenue-sharing formula and conditional fund transfers, which are undoubtedly undermining the autonomy of the states. Whenever different political parties govern the Centre and States, fiscal disputes acquire political symbolism. For more clarity, anyone can examine the Central Government's financial dealings with governments led by opposition parties. In the Indian federal system, financial disputes are portrayed as a power struggle between the Centre and the States. Federal scholars such as Louise Tillin argue that Indian federalism is characterized by "centralised federalism," where institutional mechanisms exist but fiscal dominance remains with the Union.[12] Despite this, India has avoided fiscal secessionist crises common in some federations, indicating resilience in its intergovernmental framework.

2. **Inter-State Disputes and Political Contestation:**

Political contestation can be seen in the Indian federation due to the following reasons: Regional disparities in revenue-sharing, development levels, and central grants. A South Vs North dynamic has been evident in the Indian federal system from its very inception. The southern states argue that while they contribute a larger share to national revenue, they do not receive grants from the Central Government in a commensurate proportion. With special status, economically weaker states are getting the maximum share of central revenue, and it can't be justified. Population is also a major factor in inter-state disputes because whenever debate

emerged around the weightage of population and demographic criteria in the Finance Commission's formula, which some argue favours high-population states.

Emerging Trends and Reform Proposals:

1. **Fiscal Transfers Reforms:**

To strengthen fiscal federalism, numerous economists, financial experts, and policymakers have offered their significant suggestions, which are as follows: (1) "Revenue-sharing mechanisms may be more transparent."[13] (2) "States may be autonomous in tax generation (the central government reassigns certain taxes in favour of states)."[14] (3) "Cesses and surcharges levied by the central government are not shareable with the states, which reduces the states' effective revenue shares."[15] It may be revised considering the current states' expenditures. Under the current fiscal structure, affluent states bear an additional burden, while weaker states remain entirely dependent on central grants. Reform is needed in these circumstances as well.

Beyond Fiscal Transfer:

Other recommendations are as follows: (1) Sunset clauses should be made mandatory for centrally sponsored schemes to ensure their relevance and effectiveness. (2) States should improve their revenue collection capacity. (3) The Inter-State Council should be more effective in resolving disputes through dialogue, not through litigation.

2. **Suggested reforms for GST and Tax Devolution Mechanisms:**

Modernising the GST framework:

Financial experts and policymakers have recommended the structural simplification of GST slabs along with the rectification of the compensation mechanisms, with the aim of comprehensively resolving financial matters between the Centre and States. Opposition-ruled states have proposed GST rate rationalisation with assurance that any revenue loss must be compensated further. There is no need for a time limit, as earlier that was fixed merely for five years.

Revisiting GST Compensation and Tax Sharing:

On the issue of GST compensation cess, many states are facing financial shortages to meet their developmental needs. That's why the time is indicating towards its revisit, particularly in favour of weaker tax-base states. This revisit will surely enhance the bond of strong federalism.

Increasing State Share of Divisible Pool:

Since the beginning of federalism, financially, Indian states have been weak, and the reason behind this is the allocation of poor taxation powers in their favour. Most state governments have petitioned for raising the share of central taxes devolved to states from the current 41% closer to 50%, arguing that their effective share has shrunk due to rising non-shareable cess collections. Devolution of resources is the responsibility of the Finance Commission under Articles 275 and 282 of the Indian Constitution. Considering the same, the 16th Finance Commission has emphasised outcome-linked spending and greater transparency in taxation and

devolution, while retaining the 41% share but recommending improvements in formula and data usage for tax distribution. Alterations may be concluded on the following points: Expanding the divisible pool, rationalising Centrally Sponsored Schemes, enhancing fiscal transparency, and strengthening the GST Council disputes resolution mechanism.

Restructuring of Centrally Sponsored Scheme (CSS):

Recently, the Finance Ministry (GOI) has directed all the departments to attach sunset clauses and clear timelines to Centrally Sponsored Schemes. The objectives of the reforms are to enhance fiscal discipline and ensure that only effective and relevant schemes will be fit to receive funding. Policy makers suggested that without a core national objective, CSS should not be allotted to any state. The states should accept the same based on local needs rather than merely to engage the funds. There is a need for fixed funding patterns, transparent monitoring, and third-party evaluation of CSS, which will ensure remarkable results rather than merely increasing funds without efficiency and effectiveness.

Enhancements to Centre-State Fiscal Coordination & Institutional Reforms:

Policymakers recommend using the Inter-State Council as a definitive mechanism to negotiate fiscal matters and permanently resolve Centre-state financial disputes. Financial experts suggest reforming grant mechanisms under Article 275 and creating transparent, formula-based fiscal transfers that reduce discretionary transfers and reinforce predictable, equitable sharing of resources across states. They also suggested strengthening the state's fiscal data systems and real-time monitoring for fund transfers (even disaster funds), which can be marked as a quality reform. Thus, accountability and planning in fiscal federal relations may be improved.

Conclusion:

Ever since the implementation of the Constitution, India’s parliamentary federal system has been marked by ongoing federal and financial tensions. Economic and financial policy has continuously evolved through negotiation and conflict. As per the current constitutional arrangement, fast-growing tax-based powers are in the hands of the Centre, while states have the bulk of developmental, social, and welfare obligations, perpetuating structural financial dependency. However, the Fourteenth and Fifteenth Finance Commissions recommended 42% and 41% tax devolution, respectively; the Union’s increasing reliance on non-shareable cesses and surcharges excluded under Article 270 has substantially compressed the net divisible pool transferred to the states. In the post-1991 scenario, industrially developed states are getting more benefits of foreign direct investment due to the market-led competitive federalism, but the situation was totally different in the Nehruvian model of centralised planning. Controversies over rate rationalization and the rigid conditionalities of Centrally Sponsored Schemes (under Article 282) continue to curtail states' budgetary flexibility. Centre-state financial conflict is not a symbol of constitutional failure; rather, they reflect vital democratic bargaining within a complex, multi-level parliamentary polity. Restoring fiscal trust and institutionalizing participatory decision-making processes in bodies like the GST Council and NITI Aayog is crucial for long-term federal stability. Finally, fiscal trust between the Centre and states in India is inevitable for balanced development across the Indian federation, i.e., a need of the hour and circumstances.

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