

Research Article**Federalism and Fiscal Power: How Centre State Finance Shapes Development Outcomes****Dr. D. Yedukondalu**

Lecturer in Political Science, M S N Degree College, Kakinada

Corresponding Author: Dr. D. Yedukondalu**Abstract**

Centre–State fiscal relations play a decisive role in shaping India’s development outcomes by determining the fiscal capacity, autonomy, and incentives of subnational governments. India’s federal structure assigns major development responsibilities to States while concentrating significant revenue-raising powers at the Union level, resulting in persistent vertical and horizontal fiscal imbalances. The Finance Commission system is the primary institutional mechanism for addressing these imbalances through tax devolution and grants. This paper examines how the design and composition of Centre–State financial transfers influence State fiscal space, expenditure priorities, and service delivery capacity. It analyses the role of untied and tied transfers, incentive structures embedded in horizontal devolution, and the implications of growing reliance on non-shareable cesses and surcharges for effective devolution. Drawing on post–Fourteenth Finance Commission developments, the study argues that higher statutory devolution alone is insufficient to ensure improved development outcomes. Instead, effective resource flows, stability of transfers, transparent revenue-sharing arrangements, and well-calibrated equalisation and incentive mechanisms are critical for enabling States to deliver minimum service standards and promote balanced regional development.

Keywords: Fiscal federalism; Centre–State finance; Finance Commission; Tax devolution; Equalisation; Development outcomes.

1. Introduction

India’s federal architecture separates expenditure responsibilities from revenue authority. States are the principal agents for delivering development-critical public services—school education, public health, agriculture and allied activities, local and rural infrastructure, policing, and a large share of welfare administration—yet the Union government commands broader and more buoyant tax bases. This structural mismatch produces a persistent vertical fiscal imbalance, in which the level of government expected to spend more has weaker autonomous revenue capacity. India’s constitutional design addresses this imbalance primarily through the Finance Commission, which recommends the distribution of the divisible pool of Union taxes and a system of grants to support States’ expenditure responsibilities.

Alongside vertical imbalance, India faces deep horizontal fiscal disparities across States. Differences in economic structure, per-capita income, tax capacity, demographic pressures, geography, and the cost of delivering comparable public services mean that equal treatment of States in transfers would reproduce, rather than correct, unequal starting conditions. Accordingly, Finance Commission awards rely on formula-based criteria intended to equalise fiscal capacity and enable broadly comparable minimum standards of public service provision. In effect, the transfer system serves both a macro-fiscal function—ensuring aggregate stability

and predictable subnational finance—and a distributive function—reducing persistent inter-state gaps in the ability to fund core public goods.

The developmental significance of Centre–State finance lies in how transfer design and magnitude shape State fiscal space, the composition of public expenditure, and the credibility of medium-term service delivery commitments. Predictable and adequate transfers allow States to sustain recurrent expenditures that underpin service quality—staffing, operations, and maintenance—alongside capital investments. Conversely, volatility or shortfalls in transfers can compress development expenditure, delay infrastructure maintenance, and induce pro-cyclical spending patterns at the subnational level. The structure of transfers also matters: while tax devolution is generally untied and enhances budgetary autonomy, grants and scheme-linked transfers can be conditional, influencing sectoral priorities and altering incentives in planning and execution. These channels connect fiscal federal arrangements directly to the effectiveness of public service delivery and the pace of regional convergence in development outcomes.

These issues became particularly salient following the Fourteenth Finance Commission award, which increased the States' share in the divisible pool from 32 per cent to 42 per cent, signalling a shift toward greater reliance on untied devolution. The reform intensified a wider policy debate about the real incidence of fiscal power within the federation. Critics argue that expanded use of cesses and surcharges, which are typically not shareable with States, can reduce the effective size of the divisible pool and thereby constrain States' realised fiscal capacity despite a higher headline devolution percentage. The resulting tension highlights a central question for contemporary fiscal federalism in India: whether the prevailing balance of revenue instruments, devolution arrangements, and conditional transfers is sufficient to finance minimum service standards across States while preserving autonomy, accountability, and incentives for efficient public spending.

2. Review of Literature

Classical fiscal federalism provides the analytical baseline for evaluating intergovernmental transfers. In this tradition, transfers are justified on three core grounds: correcting vertical fiscal imbalance (a mismatch between subnational expenditure responsibilities and revenue capacity), reducing horizontal fiscal disparities (unequal fiscal capacity and needs across regions), and improving the efficiency and quality of public service delivery through well-designed incentives (Musgrave, 1959; Oates, 1972). The same literature also warns that transfers can generate adverse behavioural responses—weakening subnational revenue effort, encouraging inefficient spending, or enabling political capture—if formulas and conditions are poorly specified or if accountability is diluted by soft budget expectations (Oates, 2005). Rao and Singh's seminal contribution places India's transfer system squarely within this framework while emphasising that real-world transfer design often reflects administrative constraints and political bargaining alongside economic logic (Rao & Singh, 2000).

Within the Indian context, Rao (1998) is widely cited for clarifying both the normative objectives of transfers and the practical design problems that recur across Finance Commission awards. The analysis highlights tensions that are especially relevant for India: the coexistence of multiple transfer channels (tax devolution, Finance Commission grants, and plan/scheme-based transfers), the challenge of specifying transparent equalisation objectives, and the difficulty of aligning incentives without penalising need (Rao, 1998). A central argument is that transfer systems in federations tend to accumulate layers over time; even when each layer is defensible in isolation, their combined effects can blur accountability and weaken the link between spending responsibility and revenue mobilisation. This insight remains influential because India's system continues to be characterised by overlapping instruments, periodic redesign by successive Finance Commissions, and frequent disputes over whether transfers strengthen autonomy or simply reallocate constraints (Rao & Singh, 2005).

Subsequent work by Rao (2017) advances the discussion from justification toward performance: not only why transfers exist, but whether they measurably improve public services and inter-state convergence. The key contribution here is an explicit focus on service delivery outcomes and the design of transfers around minimum standards, alongside the practicalities of matching requirements and implementation capacity (Rao, 2017). The argument is that equalisation cannot be evaluated purely through the lens of aggregate resource flows; it must be assessed by whether transfers enable States to deliver a basic floor of services at reasonable quality, particularly in human development sectors where under-provision has persistent long-run effects. Rao also underscores an applied design problem: matching and conditional grants can improve targeting and performance, but they can also systematically disadvantage low-capacity States—thereby reproducing horizontal disparities—unless the grant architecture explicitly accounts for administrative constraints and differences in fiscal space (Rao, 2017).

The Fourteenth Finance Commission (FFC) award marks a pivotal point in the more recent literature because it increased the share of untied tax devolution to States, intensifying empirical scrutiny of the relationship between transfers and development expenditure (Finance Commission of India, 2015). The core question is straightforward but not trivial: did higher untied devolution translate into higher development expenditure and improvements in priority sectors, or was the apparent gain offset by other fiscal changes? A background study prepared for the Fifteenth Finance Commission (XVFC) directly addresses this issue by examining how States utilised the additional resources following the FFC award, including whether observed expenditure changes were consistent with enhanced fiscal autonomy and whether the composition of spending shifted toward development-oriented sectors (Finance Commission of India, 2019). Importantly, this study frames the evaluation in net rather than gross terms, recognising that changes in other channels of Centre–State finance can materially alter the effective fiscal space available to States even when headline devolution rates increase.

Parallel to this line of inquiry, an increasingly prominent strand of policy and research focuses on the composition of Union revenues and its implications for the divisible pool. In particular, the growing reliance on cesses and surcharges has attracted attention because these instruments are generally excluded from the divisible pool, potentially reducing the effective magnitude of devolution even when statutory devolution percentages remain unchanged (Finance Commission of India, 2020). This concern extends beyond political rhetoric and has been examined in analytical work commissioned for the XVFC, which explains the constitutional basis, fiscal rationale, and practical consequences of expanding non-shareable levies for Centre–State fiscal relations (Finance Commission of India, 2020). The implication for fiscal federalism scholarship is direct: evaluating intergovernmental finance solely on the basis of headline devolution rates can be misleading if the shareable tax base is simultaneously being compressed through shifts in revenue composition.

Overall, the literature has progressively shifted from a predominantly normative framing—how transfers should be structured—to a more institutional and empirical agenda that examines how transfer architecture interacts with service delivery capacity, administrative implementation, fiscal incentives, and the evolving composition of Union revenues (Rao, 2017; Finance Commission of India, 2019). The post-FFC debate illustrates this shift clearly. It is no longer sufficient to assert that higher devolution strengthens federalism; the critical question is whether States experience a sustained expansion in effective fiscal space and whether the transfer system promotes convergence in minimum service standards rather than reinforcing persistent regional divergence.

3. Objectives

1. To explain Centre–State financial channels and their role in State development capacity.
2. To assess how transfer design shapes fiscal space, accountability, and development priorities.
3. To identify reforms for better equalisation, transparency, and incentive alignment

4. The Architecture of Centre–State Finance

India’s system of Centre–State finance is anchored in constitutional provisions that assign expenditure responsibilities and revenue powers across levels of government, while relying on intergovernmental transfers to correct resulting fiscal imbalances. The architecture is dominated by the Finance Commission mechanism, supplemented by grants and scheme-based transfers that differ in their degree of conditionality and autonomy. Together, these instruments determine the effective fiscal capacity of States and shape their ability to finance development expenditure.

4.1 Finance Commission: The Core Equalisation Instrument

The Finance Commission is the principal constitutional body responsible for recommending the sharing of Union tax revenues between the Centre and the States, as well as among States. Its mandate addresses both vertical and horizontal fiscal imbalances.

Vertical devolution refers to the determination of the proportion of the divisible pool of Union taxes that is transferred to States as a whole. This recommendation directly affects the aggregate fiscal space available to subnational governments and reflects broader judgments about expenditure assignments, macro-fiscal stability, and the balance of fiscal power within the federation.

Horizontal devolution concerns the distribution of the States’ share among individual States. This is achieved through a formula-based approach that incorporates multiple criteria reflecting differences in fiscal capacity, expenditure needs, demographic characteristics, and fiscal performance. The relative weights assigned to these criteria vary across Finance Commissions, reflecting evolving policy priorities and political economy considerations.

Table 1: Major Criteria Used in Horizontal Devolution by Finance Commissions

Criterion	Rationale
Income distance	Addresses disparities in fiscal capacity across States
Population	Reflects expenditure needs linked to population size
Area	Accounts for cost disabilities related to geographic size
Forest and ecology	Compensates States for environmental conservation and opportunity costs
Demographic performance	Rewards efforts toward population stabilisation
Tax effort	Incentivises revenue mobilisation by States

The formula-based system aims to balance equity and efficiency objectives. While income distance and population criteria emphasise redistribution and need, performance-oriented criteria such as tax effort and demographic performance seek to strengthen fiscal responsibility and long-term sustainability. The Finance Commission thus functions not merely as a revenue-sharing body, but as an institutional mechanism for fiscal equalisation and incentive alignment.

4.2 Untied and Tied Transfers: Autonomy versus Assurance

Intergovernmental transfers to States differ significantly in their degree of conditionality, with important implications for fiscal autonomy and accountability.

Tax devolution, which constitutes the largest component of transfers, is largely untied. States are free to allocate these resources according to their own priorities, subject to overall budgetary discipline. Untied transfers strengthen State autonomy, enhance flexibility in expenditure planning, and reinforce the accountability of State governments to their electorates for development outcomes.

In contrast, grants and scheme-based transfers—particularly those linked to centrally sponsored schemes—are often tied or conditional. These transfers are designed to ensure minimum standards of service delivery, promote nationally determined priorities, and address specific sectoral objectives. Conditionality may take the form of expenditure norms, matching requirements, or outcome benchmarks.

Table 2: Comparison of Untied and Tied Transfers in Centre–State Finance

Dimension	Untied Transfers (Tax Devolution)	Tied Transfers (Grants/Schemes)
Degree of autonomy	High	Limited
Spending flexibility	Full discretion with States	Restricted to specified purposes
Accountability	Primarily to State legislatures and voters	Shared between Centre and States
Policy objective	Fiscal capacity and autonomy	Targeted outcomes and national priorities
Risk	Weak prioritisation if governance is poor	Reduced local relevance and rigid compliance

The coexistence of untied and tied transfers reflects a trade-off between autonomy and assurance. While untied transfers empower States to address context-specific development challenges, tied transfers enable the Centre to influence the composition and minimum quality of public spending across the federation. The overall effectiveness of the transfer system therefore depends on the balance between these instruments and the coherence of their design.

5. How Fiscal Power Translates into Development Outcomes

The impact of Centre–State fiscal arrangements on development outcomes operates through multiple interrelated channels. The most important among these are the size and predictability of State fiscal space, the incentive effects embedded in transfer design, and the effective versus headline magnitude of devolution. Together, these factors shape not only how much States spend, but also the composition, quality, and sustainability of development expenditure.

5.1 Fiscal Space and Service Delivery Capacity

Fiscal space refers to the ability of State governments to undertake and sustain expenditure commitments without jeopardising fiscal stability. Predictable and adequate transfers from the Centre expand this space by reducing uncertainty in revenue flows and enabling medium- to long-term expenditure planning. This is particularly important in sectors such as health, education, irrigation, and infrastructure, where outcomes depend on sustained recurrent spending alongside capital investment.

The Fourteenth Finance Commission (FFC) significantly altered the fiscal landscape by increasing the States’ share in the divisible pool of Union taxes from 32 per cent to 42 per cent. This shift was explicitly intended to enhance State autonomy and strengthen their capacity to finance development expenditure according to local priorities.

Table 3: Change in Vertical Devolution Before and After the Fourteenth Finance Commission

Finance Commission	Period	States' Share in Divisible Pool (%)
Thirteenth FC	2010-15	32
Fourteenth FC	2015-20	42
Fifteenth FC	2021-26	41

An expansion in untied fiscal resources allows States to better manage recurrent expenditure commitments, maintain public assets, and undertake multi-year investments. Conversely, volatility or erosion of predictable transfers can force expenditure compression, particularly in maintenance and service-quality-enhancing components, thereby weakening development outcomes even when headline spending levels appear stable.

5.2 Incentives, Conditionality, and Spending Priorities

Beyond aggregate fiscal space, the design of transfers plays a critical role in shaping State behaviour. Transfers can embed incentives that either strengthen or weaken fiscal discipline, administrative effort, and outcome orientation. Poorly designed transfers risk encouraging compliance-driven spending, weakening own-revenue mobilisation, and distorting expenditure priorities toward activities that maximise transfers rather than social returns.

In contrast, carefully designed transfers can improve accountability and efficiency by rewarding performance and aligning fiscal incentives with development objectives. Recent Finance Commissions have increasingly incorporated performance-oriented criteria—such as tax effort and demographic performance—into horizontal devolution formulas, reflecting an attempt to balance equity with efficiency.

Table 4: Incentive Channels in Intergovernmental Transfers

Design Element	Intended Objective	Potential Risk if Poorly Designed
Tax effort criteria	Encourage revenue mobilisation	Penalising structurally weaker States
Outcome-linked grants	Improve service delivery performance	Overemphasis on measurable indicators
Matching requirements	Ensure State commitment	Exclusion of low-capacity States
Conditionality	Enforce national priorities	Reduced flexibility and local relevance

The inclusion of incentive-based criteria in the Fifteenth Finance Commission (XVFC) reflects growing recognition that equalisation alone is insufficient to ensure improved outcomes. However, the effectiveness of such incentives depends on calibration. Excessive conditionality or poorly designed performance metrics can undermine State autonomy and shift focus away from context-specific development needs.

5.3 Headline Devolution versus Effective Devolution: The Role of Cesses and Surcharges

A central issue in contemporary Centre–State fiscal relations is the divergence between headline devolution rates and effective devolution outcomes. While Finance Commission recommendations specify the proportion of the divisible pool to be shared with States, the size of that pool itself depends on the composition of Union tax revenues.

The increasing reliance of the Union government on cesses and surcharges, which are generally excluded from the divisible pool, can reduce the shareable tax base even when the

devolution percentage remains unchanged. As a result, States may experience constrained fiscal space despite apparently favourable devolution ratios.

This divergence has significant implications for development expenditure. When effective devolution declines, States may be compelled to rely more heavily on borrowing or compress discretionary spending, potentially affecting the quality and sustainability of public service provision. Consequently, assessments of fiscal federalism based solely on statutory devolution percentages can obscure the real distribution of fiscal power within the federation.

6. What Would Improve Development Outcomes

6.1 Strengthening Equalisation Around Minimum Service Standards

A central reform priority in Centre–State fiscal relations is to strengthen equalisation in a manner that guarantees all States the fiscal capacity to deliver a minimum standard of essential public services. Equalisation transfers should be explicitly linked to the cost of providing a basic floor of services in core sectors such as health, education, and local infrastructure, taking into account inter-state differences in needs, costs, and revenue capacity. Once this minimum floor is secured through predictable transfers, States should retain autonomy to allocate additional resources in line with local development priorities. Such an approach aligns with the minimum-standards logic in fiscal federalism, which views equalisation not merely as redistribution but as a mechanism to ensure uniform access to essential public services across the federation.

6.2 Enhancing Transparency in the Divisible Pool and Grant Architecture

Improving development outcomes also requires greater transparency and clarity in the design of the divisible pool and the broader transfer architecture. When the effective size of the shareable pool is reduced through increased reliance on non-shareable instruments such as cesses and surcharges, the credibility of devolution arrangements and the spirit of cooperative federalism can be undermined. Transparent reporting of intergovernmental transfers—particularly measures that distinguish between headline devolution rates and effective resource flows to States—can improve accountability and reduce informational asymmetries. Similarly, a more rule-based and predictable grant framework, with clearly specified eligibility conditions, allocation formulas, and outcome metrics, can limit discretionary bargaining and enhance the efficiency and predictability of Centre–State fiscal relations.

6.3 Aligning Incentives While Protecting Genuine Need

A further reform challenge lies in designing incentives that encourage fiscal effort and performance without disadvantaging States with genuine structural constraints. Effective transfer systems combine need-based equalisation with carefully calibrated performance incentives, ensuring that poorer or low-capacity States are not excluded from accessing development resources due to rigid matching requirements or narrowly defined performance benchmarks. Incentive mechanisms should recognise differences in economic structure, informality, and tax bases, while still encouraging improvements in revenue mobilisation, governance, and service delivery. Achieving this balance is essential for ensuring that incentives reinforce, rather than undermine, the equity and development objectives of fiscal federalism.

7. Conclusion

Centre–State fiscal relations constitute one of the most consequential, yet often understated, determinants of India’s development trajectory. While the constitutional framework and the Finance Commission system are explicitly designed to correct vertical and horizontal fiscal imbalances, the effectiveness of this architecture depends less on formal intent and more on operational details. The size of the shareable pool, the composition of Union revenues, the criteria and weights used in horizontal devolution, and the balance between untied devolution and conditional transfers together shape the real fiscal capacity of States to deliver development.

Evidence from the post-Fourteenth Finance Commission period underscores a critical insight: higher statutory devolution does not automatically translate into improved development outcomes. What matters is the effective flow of resources to States after accounting for changes in other transfer channels, the predictability and stability of these flows over time, and the extent to which they expand genuine fiscal space rather than merely shifting constraints. Where transfers are uncertain, fragmented, or offset by reductions in the shareable base, States are compelled to compress development expenditure, defer maintenance, or rely more heavily on borrowing, with adverse implications for service quality and fiscal sustainability.

Equally important is the design of the transfer system itself. Transfers that strengthen equalisation, preserve State autonomy, and embed well-calibrated incentives can support convergence in minimum service standards and reinforce accountability for outcomes. Conversely, excessive conditionality, opaque revenue practices, or poorly aligned incentives risk weakening subnational fiscal effort and diluting the link between spending responsibility and developmental performance. The central challenge for India's fiscal federalism, therefore, is not simply to redistribute resources, but to ensure that intergovernmental finance consistently enables States to undertake sustained investments in human and physical capital.

In sum, the effectiveness of Centre-State finance must be judged by its contribution to durable improvements in core public services and balanced regional development, rather than by headline devolution ratios alone. Strengthening equalisation around minimum service standards, enhancing transparency in revenue sharing, and aligning incentives without undermining need are essential for translating fiscal power into meaningful development outcomes. How India resolves these design choices will play a decisive role in shaping the inclusiveness and sustainability of its long-term growth path.

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Citation: Dr. D. Yedukondalu 2026. "Federalism and Fiscal Power: How Centre State Finance Shapes Development Outcomes". *International Journal of Academic Research*, 13(1): 19-27.

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