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From Inequality to Inclusion: The Role of Fiscal Federalism in India's Journey to 2047

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Abstract
India stands at a defining juncture as it envisions becoming a developed, equitable, and sustainable nation by 2047. Achieving this vision requires a strengthened fiscal federal framework that effectively balances the financial powers and responsibilities of the Union, states, and local governments. Fiscal federalism in India plays a critical role in addressing vertical and horizontal imbalances arising from the constitutional division of powers, the mismatch between revenue-raising authority and expenditure obligations, and wide inter-state disparities in economic and social development. Despite decades of reforms from Finance Commission transfers and centrally sponsored schemes to the introduction of the Goods and Services Tax (GST) significant gaps in regional development persist, driven by variations in fiscal capacity, institutional strength, infrastructure quality, and human development outcomes.
This paper critically examines the evolution, functioning, and effectiveness of India's fiscal federal architecture in promoting equitable regional development. Drawing on existing literature and empirical evidence, it analyzes how tax devolution, grants-in-aid, GST-related mechanisms, and sector-specific transfers have contributed to reducing disparities, while also highlighting emerging challenges such as revenue centralization, declining state autonomy, transfer dependency, and uneven administrative capacities. The study also explores new dimensions of fiscal stress, including climate vulnerabilities and the increasing demands of digital infrastructure, urbanization, and sustainable development.
The analysis underscores the need for comprehensive reforms to align India's fiscal system with its 2047 development goals. Key recommendations include expanding the divisible tax pool, strengthening cooperative federal institutions, enhancing the Finance Commission's equity-focused criteria, empowering local governments, and promoting green fiscal federalism. The paper concludes that a collaborative, transparent, and adaptive fiscal federal framework is essential for achieving balanced regional development, ensuring social justice, and securing a resilient and inclusive growth pathway for India in the decades ahead.
Keywords: Fiscal federalism, green fiscal federalism, social justice, inclusive growth

Introduction

India stands at a pivotal moment in its developmental journey as it moves toward the centenary of its independence in 2047. The vision of *India @ 2047* to emerge as a developed, equitable, inclusive, and sustainable republic requires a strong and symbiotic relationship between the Union, the states, and local governments. As a federal nation with vast geographical, socio-economic, cultural, and demographic diversity, India's path to sustained development is intricately linked to the functioning of its fiscal federal system. For a country of India's magnitude, characterized by substantial differences in economic capacity and administrative capability across states, fiscal federalism is not merely an economic arrangement; it is the backbone of balanced governance and equitable development.

Fiscal federalism, in simple terms, refers to the financial relations between different levels of government in a federal polity. It determines how functions are assigned, how revenues are shared, and how resources are transferred to ensure that each level of government can effectively discharge its constitutionally mandated responsibilities. The Indian Constitution envisaged a federal structure with a strong Centre, yet with adequate powers vested in states to administer core developmental sectors such as health, education, agriculture, public order, and local infrastructure. However, owing to the mismatch between expenditure responsibilities and revenue-generating powers a phenomenon known as vertical fiscal imbalance the

Indian fiscal system has relied heavily on intergovernmental transfers, particularly Finance Commission devolution and centrally sponsored schemes.

The importance of fiscal federalism becomes even more pronounced when considering regional disparities, a defining characteristic of India's development trajectory. Since the early post-independence years, states such as Maharashtra, Tamil Nadu, Gujarat, and Karnataka have witnessed rapid industrialization, strong private investment, and dynamic service sectors. In contrast, states like Bihar, Uttar Pradesh, Jharkhand, Assam, and Odisha continue to lag behind in indicators such as per capita income, literacy, health outcomes, employment opportunities, and infrastructure availability. These disparities are not merely statistical; they influence social mobility, migration patterns, political representation, and citizens' overall quality of life.

Addressing such imbalances is both a constitutional obligation and a developmental necessity. The Directive Principles of State Policy emphasize reducing regional inequalities and ensuring uniform levels of development across the country. Over the decades, India's fiscal architecture through instruments like the Finance Commissions, Planning Commission (till 2014), NITI Aayog, centrally sponsored schemes, and special category status has attempted to bridge these gaps. While significant progress has been made in poverty reduction, health indicators, and economic growth, the gaps remain substantial, and in some cases have even widened.

In this context, fiscal federalism serves multiple crucial roles. It promotes equity by ensuring that poorer states receive adequate financial support; it enhances efficiency by empowering states to design and implement policies suited to local needs; and it strengthens democracy by bringing fiscal decisions closer to the people. Furthermore, with India's transition to a globalized and technology-driven economy, states increasingly compete to attract investments, improve ease of doing business, and innovate in governance models. A well-functioning federal system thus becomes a catalyst for both cooperative and competitive federalism.

The introduction of the Goods and Services Tax (GST) in 2017 marked a paradigm shift in India's fiscal landscape. With the GST Council providing a platform for consensus-based decision-making, India demonstrated a strong commitment to cooperative federalism. However, GST has also revealed emerging tensions especially regarding compensation, tax buoyancy, and revenue uncertainty which underscore the continuing challenges in fiscal relations. Similarly, the growing use of cesses and surcharges by the Union—revenues not sharable with states has raised concerns about diminishing fiscal space for state governments.

As India moves toward the 2047 horizon, new demands emerge: investments in digital infrastructure, renewable energy, climate resilience, public health, modern agriculture, urban development, and human capital. These needs disproportionately affect poorer and resource-constrained states, making equitable fiscal transfers more essential than ever. Moreover, climate change introduces new dimensions of fiscal stress many vulnerable states require additional resources for adaptation and disaster management.

Thus, the debate on fiscal federalism in India is not merely financial it is fundamentally about the distribution of opportunities, development, and empowerment. Strengthening fiscal federalism is central to achieving inclusive growth, reducing inter-state disparities, ensuring environmental sustainability, and upholding the integrity of India's democratic and cooperative federal structure.

This paper, critically examines the evolution and effectiveness of India's fiscal federal system in promoting equitable regional development. It analyzes the current fiscal architecture, identifies gaps and emerging challenges, and proposes comprehensive reforms needed to align India's fiscal system with its long-term vision for 2047. In doing so, the study attempts to contribute to the larger discourse on how India can achieve a balance between economic growth, social justice, and regional equity cornerstones of any developed and sustainable nation.

Review of Literature

Survey of Research on Fiscal Federalism in India (NIPFP monograph), this comprehensive monograph surveys several decades of Indian research on fiscal federalism, documenting the evolution of Finance Commission practice, intergovernmental transfers, and the politics of tax devolution. It

synthesizes empirical and normative literature on vertical and horizontal imbalances, conditional grants and the role of federal institutions in ensuring equity. The survey is particularly valuable for tracing methodological approaches used in India from normative theory to econometric state-level studies and for identifying recurring policy dilemmas such as the trade-off between equity and efficiency. For researchers working on *India @ 2047*, the monograph provides historical context and a taxonomy of policy instruments available to the Centre and states.

M. Govinda Rao, examines how central transfers have been used to incentivize state-level reforms and the challenges of designing performance-linked grants. Using case studies and empirical state-level fiscal data, the work shows that transfers can produce heterogenous reform outcomes depending on state capacity and political economy. Rao also highlights the unintended consequences of conditional grants that may undermine state autonomy while not adequately addressing structural backwardness. This paper is essential for understanding how incentive-compatible transfer design can be applied to reduce regional disparities without eroding fiscal federalism.

Mukherjee (2023) , this recent empirical analysis quantifies GST's effects on state own-tax revenues and the growing dependence on compensation and Centre-provided loans during revenue shortfalls. Using state-level RUP (Revenue Under Proposals) comparisons pre- and post-GST, Mukherjee finds that GST collections as a share of RUP have shown mixed performance and that compensation mechanisms masked structural revenue weaknesses. The paper is important to debates on fiscal federalism because it demonstrates how tax reform (GST) interacts with devolution, fiscal stability, and the capacity of states especially poorer ones to finance development.

R. Srinivasan & S. R. Sethu Durai (2022) , this Centre for MSE working paper argues for reassigning certain tax powers to states to better align tax bases with expenditure responsibilities. It uses legal-constitutional analysis combined with fiscal incidence estimates to show potential gains in accountability and revenue mobilization if states receive clearer tax jurisdictions. Their policy prescription is germane to the equity question: devolving more tax autonomy could allow lagging states to craft locally appropriate tax policies and mobilize resources for development, provided administrative capacity is built up.

Darshini & Gayithri (2021, this state-level empirical study examines the degree of transfer-dependence across Indian states and the implications for fiscal autonomy and service delivery. Using time-series cross-section data up to the Thirteenth Finance Commission period, the authors document that several poorer states are highly dependent on central transfers, which correlates with lower own-revenue effort and weak fiscal institutions. The study underscores a core tension: transfers are necessary for equity but can create dependency; careful design of incentives and capacity building is essential to break the cycle.

Akram (2020), Akram's econometric analysis (cointegration and dynamic methods) assesses fiscal sustainability at the state level across several decades, finding wide heterogeneity: some states display sustainable fiscal paths while others show worrying debt trajectories. The paper links sustainability to growth, revenue buoyancy, and the structure of transfers highlighting that unequal fiscal positions constrain long-term development in lagging regions. This work is useful when arguing that equitable transfers must be combined with fiscal sustainability measures to be effective for 2047 goals.

Sectoral study, this focused review analyzes how intergovernmental transfers for health (NHM and other programs) are structured and how their design affects health outcomes across states. Using program-level budget documents and outcome indicators, it finds mismatches between funds released, absorptive capacity, and measurable health improvements in poorer states. The review highlights that sector-specific transfers can improve equity but require better targeting, flexible implementation, and capacity strengthening at subnational levels. For equitable regional development, sectoral grant effectiveness (e.g., in health and education) is as important as vertical devolution.

Chowdhury (2025) , This recent paper revisits fiscal federalism debates in the context of urban public services and health, considering constitutional changes and evolving fiscal instruments. It draws on contemporary policy events (GST, Finance Commission recommendations, pandemic-era transfers) and argues that the intergovernmental architecture must adapt to new urbanization and health-care demands.

The study is timely for the 2047 agenda since it links fiscal design to emerging public-good requirements that have strong regional dimensions.

Objectives of the study

1. To examine how India's fiscal federal structure has changed over time and evaluate how the current system of tax devolution, grants-in-aid, and centrally sponsored programs affects the results of regional development.
2. To assess the degree and trends of regional differences in infrastructure development, fiscal capacity, human capital metrics, and economic growth among Indian states.
3. To determine the main limitations and new issues in India's fiscal federal framework such as revenue centralisation, transfer dependency, and state capacity gaps that impede equitable and inclusive growth.
4. To propose policy recommendations and a forward-looking fiscal strategy that can strengthen cooperative federalism and promote balanced regional development in the context of India's developmental goals for 2047.

Fiscal Federalism in India

1 Division of Powers

The Constitution specifies the revenue and spending powers of the Union, State, and Local governments (Government of India, 1950). The intrinsic vertical inequality brought about by this division necessitates intergovernmental transfers (Rao & Singh, 2005).

2. Finance Commission Transfers

By suggesting how federal revenues should be distributed to states and by creating need-based grants, the Finance Commission plays a crucial role in attaining both vertical and horizontal equity. Its formula-based methodology guarantees that states with lower incomes and structural weaknesses receive more assistance to provide comparable public services. The Commission contributes to the reduction of regional inequities and enhances the fiscal stability of the federal system through tax devolution, sector-specific grants, and disaster-related assistance (Finance Commission of India, 2021).

3. Centrally Sponsored Schemes (CSS)

National goals like health, education, agriculture, and rural development are the focus of centrally sponsored programs. However, their design frequently includes stringent rules and requirements that restrict states' ability to manage their finances. This can lead to administrative difficulties and limit states' capacity to apply context-specific remedies, as noted by Mukherjee (2018). Although CSS promotes significant developmental goals, more flexibility and state involvement in planning are necessary for them to be effective.

4. GST and Cooperative Federalism

The introduction of the Goods and Services Tax (GST) unified India’s market by replacing a complex web of state and central taxes with a single harmonized system. The GST Council, comprising both Union and state representatives, institutionalized a new model of cooperative federalism where decisions are taken collectively. Bagchi (2020) emphasizes that this joint decision-making promotes transparency, reduces tax-related barriers, and strengthens trust between the Centre and the states. GST thus marked a major step toward integrated economic governance.

Regional Disparities in India

1. Economic Disparities

Significant variation exists in GDP contribution, productivity levels, and per capita income across Indian states. Advanced industrial states continue to outperform historically backward regions due to stronger economic bases and better resource endowments. Ghosh (2018) highlights that these structural differences create persistent regional imbalances.

2. Social and Human Development Indicators

Wide disparities remain in education, healthcare access, nutrition, and overall Human Development Index (HDI) scores between richer and poorer states. States with weaker social sectors struggle to break cycles of poverty and underdevelopment. UNDP India (2020) notes that such inequalities undermine inclusive national progress.

3. Infrastructure Gaps

Unequal access to quality infrastructure such as roads, electricity, digital connectivity, and irrigation limits growth potential in lagging regions. These gaps discourage investment and constrain mobility, productivity, and economic diversification. The World Bank (2021) emphasizes that bridging infrastructure deficits is critical for regional equity.

4. Structural Challenges

Low administrative capacity, inadequate governance systems, and limited private investment continue to hinder development in backward states. These structural constraints reduce the effectiveness of fiscal transfers and policy interventions. Ahluwalia (2000) argues that without institutional strengthening, regional inequalities are difficult to overcome.

Fiscal Federalism as an Instrument of Equity

1 Vertical Transfers

Higher vertical tax devolution the share of central taxes transferred to states plays a critical role in enabling states to fulfill their constitutionally assigned expenditure responsibilities. Many states, especially those with limited internal revenue capacity, rely heavily on these transfers to finance essential public services. Rao (2017) argues that increasing vertical transfers enhances states' fiscal autonomy and reduces their dependence on discretionary central grants. This contributes to creating a more balanced and resilient fiscal federal structure.

2 Horizontal Transfers

Horizontal transfers, distributed across states using formula-based criteria, aim to reduce inequities by allocating greater resources to economically weaker states. The Finance Commission of India (2021) incorporates indicators such as income distance, population, demographic performance, and tax effort to ensure fairness in distribution. These equalization-oriented transfers help bridge regional development gaps by supporting low-capacity states in delivering comparable levels of public services. Thus, they are an essential tool for promoting balanced regional development.

3 Grants-in-Aid

Grants-in-aid are targeted transfers designed to strengthen state capabilities in priority sectors like health, education, agriculture, and infrastructure. These grants allow states to implement sector-specific reforms and investments that may not be adequately financed through general revenue transfers. Sarkar & Meenakshi (2020) highlight that well-designed grants can improve governance, incentivize reforms, and accelerate human development outcomes. By addressing sectoral gaps, grants-in-aid support the broader objective of achieving equitable development across regions.

4 GST Compensation

The introduction of the Goods and Services Tax (GST) created transitional revenue uncertainties for states, as several of their earlier tax powers were subsumed under GST. GST compensation ensured that states received adequate revenue to maintain financial stability, particularly during the initial years when GST compliance and collections were still stabilizing. According to Purohit (2020), this mechanism protected states from sudden fiscal shocks and allowed them to continue essential spending. The compensation scheme thus reinforced trust in cooperative federalism during a major tax reform.

Gaps and Emerging Issues

1. Growing Vertical Imbalances

The growing reliance of the Union Government on cesses and surcharges whose proceeds are not shared with states reduces the size of the divisible tax pool. This widens the vertical fiscal imbalance, limiting states' ability to meet their expenditure obligations. Karnik (2021) notes that this trend undermines cooperative federalism by centralizing greater fiscal power at the Union level.

2. Decline in State Autonomy

A growing proportion of central transfers comes in the form of conditional or scheme-based grants, which restrict states' freedom to design context-specific policies. This creates significant compliance burdens as states must align with centrally prescribed guidelines. Mukherjee (2018) argues that such conditionality weakens fiscal autonomy and limits innovation in state-level public policy.

3. Inter-State Competitive Federalism

As states compete to attract private investment, many resort to tax concessions, subsidies, and regulatory relaxations. While competition can spur growth, excessive incentives often lead to inefficient revenue losses without guaranteed developmental impact. Jha (2020) warns that this "race to the bottom" can undermine long-term fiscal sustainability.

4. Uneven State Capacities

Significant differences exist across states in administrative, institutional, and technical capacities, which affects their ability to effectively absorb and utilise funds. Weaker states may face delays in implementation, poor monitoring, and suboptimal outcomes. Ghosh & De (2020) highlight that such disparities limit the equalizing impact of fiscal transfers.

5. Climate-Related Fiscal Stress

States vulnerable to climate risks such as floods, droughts, and cyclones face increasing expenditure burdens for disaster management and climate adaptation. These states require additional fiscal buffers to maintain development spending while responding to environmental shocks. According to OECD (2022), climate-related fiscal stress exacerbates existing regional inequities and demands resilient intergovernmental financing frameworks.

Toward India @ 2047: Strategies for Equitable Development

1. Tax Reform and Revenue Sharing

Reducing the Union government's dependence on cesses and surcharges would enlarge the divisible pool and ensure a fairer distribution of revenues to states. Revisiting GST rate structures could also stabilize state revenues by improving compliance and expanding the tax base. Rao (2020) argues that a more predictable and buoyant revenue-sharing system is essential for strengthening fiscal federalism and enabling states to meet their development responsibilities.

2. Strengthening the Finance Commission Framework

Enhancing the Finance Commission's formula by including indicators such as climate vulnerability, regional backwardness, and resilience can significantly improve horizontal equity. These indicators would help channel more resources to states facing structural disadvantages or environmental risks. The Finance Commission of India (2021) emphasizes that dynamic and context-sensitive criteria can advance balanced regional development and fairness in resource allocation.

3. Deepening Cooperative Federalism

Strengthening institutions like the Inter-State Council and the GST Council can enhance collaborative decision-making between the Union and the states. These bodies serve as platforms for dialogue, negotiation, and resolving fiscal disputes. According to NITI Aayog (2021), empowering such institutions fosters trust, transparency, and shared responsibility key pillars of cooperative federalism.

4. Empowering Local Governments

Local governments remain the closest tier to citizens, but their limited fiscal powers and weak administrative capacities hinder effective service delivery. Increasing untied fiscal transfers and investing in capacity-building would enable Panchayats and Municipalities to plan, budget, and implement development programmes more effectively. Mathur (2013) stresses that strengthening local governments is essential for decentralized development and equitable public service provision.

5. Targeted Regional Development Initiatives

Backward states and underdeveloped districts require special packages such as infrastructure grants, livelihood missions, and human development programmesmto break out of long-standing developmental traps. Ahluwalia (2020) notes that such targeted interventions can reduce inter-regional disparities and promote inclusive growth. These initiatives must be long-term, well-funded, and aligned with local needs to generate sustained impact.

6. Performance-Linked Grants

Performance-based grants can incentivize states to improve governance quality, enhance public financial management, and strengthen sectoral outcomes in areas like health, education, and sustainability. When linked to measurable indicators, these grants encourage result-oriented policy reforms. The World Bank

(2021) highlights that such incentives can create healthy competition and improve efficiency in public spending.

7. Green Fiscal Federalism

Integrating environmental indicators such as forest cover, carbon emissions, disaster vulnerability, and ecological services into intergovernmental transfers would promote sustainable development. OECD (2022) argues that "green criteria" can reward states for environmental conservation and motivate investments in climate resilience. This approach ensures that fiscal federalism supports both economic growth and ecological stewardship.

Achieving Equitable Regional Development: A Comprehensive Perspective

Achieving equitable regional development in India requires a multi-pronged approach that addresses structural imbalances in fiscal capacity, governance mechanisms, and development priorities across states. One of the central pillars is balanced decentralization combined with fair revenue sharing, which ensures that resources are distributed in a manner aligned with the expenditure responsibilities of each government tier. A truly equitable fiscal system must allow states and further, local governments to exercise meaningful autonomy in planning and executing development strategies. Equitable vertical and horizontal transfers, reduced dependence on cesses and surcharges, and enhanced revenue-raising capacity at subnational levels are essential to bridging regional disparities. When states and local governments are empowered financially, they can implement context-specific policies that respond to the unique social, economic, and environmental challenges in their regions.

A second critical dimension is the integration of sustainable development into state-level planning. Economic growth alone cannot ensure balanced regional development unless it incorporates principles of environmental protection, climate resilience, and resource sustainability. Many Indian states face varying degrees of ecological vulnerability such as drought-prone regions in Maharashtra, flood-prone areas of Assam, or coastal risks in Odisha that directly impact their development trajectory. Embedding sustainability in planning frameworks ensures not only the protection of natural resources but also the development of long-term resilience. States must mainstream climate-adaptation strategies, green infrastructure investments, and low-carbon growth pathways. This becomes even more important in the context of India's "India @ 2047" vision, where sustainable development is a core pillar of national transformation.

Alongside sustainability, the advancement **of** transparency and digital governance is vital for equitable development outcomes. Transparent fiscal processes including open budgets, real-time expenditure dashboards, and public audit mechanisms strengthen accountability and reduce leakages in public service delivery. Digital governance tools such as Direct Benefit Transfers (DBT), Aadhaar-enabled service delivery, online procurement systems, GIS-based planning, and digital land records help streamline administrative procedures and improve citizen access to services. When states adopt robust digital governance frameworks, disparities arising from weak administrative capacity reduce significantly. This, in turn, ensures that public funds whether originating from centrally sponsored schemes, state programmes, or local government allocations reach their intended beneficiaries efficiently and equitably.

Finally, equitable regional development requires co-created development policies involving both the Centre and the States, an approach strongly advocated by Rao & Singh (2005). Such co-creation implies a shift from hierarchical governance to collaborative federalism, where both levels of government engage in shared planning, joint decision-making, and mutual accountability. Instead of top-down policy imposition, states should be active partners in designing schemes, determining priorities, and shaping fiscal frameworks. Institutions such as the Inter-State Council, the GST Council, regional development councils, and sectoral working groups should be strengthened to facilitate continuous dialogue and consensus-building. Co-created policies allow states to articulate their developmental needs and constraints, leading to more inclusive national strategies. This collaborative approach also prevents competitive federalism from devolving into a "race to the bottom," and instead channels it into healthy competition focused on innovation, governance quality, and sustainability.

In summary, equitable regional development in India demands a holistic and coordinated strategy: one that decentralizes power and resources, integrates sustainability into long-term planning, strengthens governance through transparency and digital tools, and fosters deep collaboration between the Centre and the States. Together, these pillars create a robust foundation for achieving the vision of a developed, equitable, and sustainable India by 2047**.**

Conclusion

Fiscal federalism remains a cornerstone of India's long-term development vision, especially as the nation aspires to become a developed, equitable, and sustainable republic by 2047. A well-functioning federal fiscal system ensures that financial resources are distributed in alignment with the developmental needs and governance capacities of each region. Strengthening intergovernmental fiscal mechanisms through fairer revenue sharing, transparent grant systems, and improved coordination will be vital for reducing structural inequalities between states. Addressing vertical and horizontal imbalances, while enhancing the fiscal autonomy of states, can enable more context-sensitive and locally relevant development planning. Equally important is the empowerment of local governments, which play a crucial role in delivering public services and ensuring grassroots-level equity. Integrating climate resilience and sustainability into fiscal frameworks will further ensure that development does not come at the cost of environmental degradation. Digital governance and performance-linked incentives can enhance transparency, improve fund utilization, and promote accountable governance across regions. Ultimately, a robust and collaborative model of fiscal federalism can create a pathway for shared prosperity, balanced regional development, and inclusive growth. As India marches toward 2047, strengthening this framework will be essential to realizing the nation's collective aspirations and ensuring that no region is left behind.

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