Contemporary Challenges of Fiscal Federalism in India

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Abstract

Contemporary fiscal federalism in India faces growing challenges shaped by structural reforms and global disruptions. The introduction of GST has centralized revenue authority, creating tensions over compensation and states' fiscal autonomy. The COVID-19 pandemic intensified revenue shortfalls, increasing states' dependency on central transfers and borrowing limits. Recent Finance Commission recommendations have sparked debates on equity, criteria shifts, and balancing needs with performance. In the global context, federal systems worldwide confront similar pressures of resource redistribution, rising health expenditure, and economic volatility. Strengthening cooperative federalism, transparent transfers, and flexible revenue mechanisms remains crucial for resilience and sustainable inter-governmental financial relations.

Keywords: Fiscal Federalism, GST, COVID-19 and resilience

Introduction

In India, fiscal federalism regulates the distribution and operation of borrowing regulations, fiscal institutions, spending responsibilities, and revenue-raising authority among the Union, states, and local governments. The immediate after math of macro economic liberalization and stabilization occurred between 1991 and 2000; subsequent institutional reforms, the GST era, growing global integration, the COVID shock, and its fiscal ramifications are covered between 2001 and 2025. Using statistical data and journal / official references to highlight trends and policy trade-offs, this paper examines four current issues: post-COVID fiscal stress, digital taxation, environmental federalism, and global pressures. It compares the two eras with an emphasis on government decision-making.

Historical Context and Institutional Trajectory

1991–2000: Stabilization, Liberalization and a Central Macro Role

A macro stabilization pack age and structural reforms that opened trade and capital accounts and started restructuring taxes and public spending were compelled by the balance of payments crisis of 1991.

States were frequently hampered by conditionalities and market forces while attempting to sustain investment and social spending; the Union maintained control over significant tax bases and used transfers and centrally sponsored programs to influence sub national priorities. The focus on macro stability and central government fiscal consolidation influenced the decade's intergovernmental agreement.

2001–2025: Institutional Changes, Greater Devolution and Cooperative Mechanisms

When the Planning Commission was abolished and NITI Aayog was established in 2015, the 14th Finance Commission significantly increased tax devolution to states (effective 2015–16), and the Goods and Services Tax(GST) was introduced constitutionally with the GST Council(2017). These significant institutional changes after 2000 reshaped the federal fiscal architecture. In addition to the GST' s institutionalization of cooperative decision-making on indirect taxes and the 14th Finance Commission's significant increase in states' share of the divisible pool, these developments created a new center-state bargaining space as well as new points of contention over compensation, cesses, and the divisible pool.

Comparative Over View of Government Decision Making (1991–2000 vs 2001–2025)

Balance of power and fiscal instruments

- During1991–2000: Union macro priorities (stabilization, rebuilding reserves, and cautious capital account opening) influence decision-making and limited the fiscal autonomy of the states. As states attempted to draw in investment and implement reforms within a constrained budget, conditional central schemes and centrally managed finance limited state discretion.
- Between 2001 and 2025, states received more unrestricted funding following the 14th FC; however, the coexistence of significant centrally sponsored programs, GST transition plans, and borrowing regulations resulted in an uneven increase in autonomy. The GST Council, Finance Commission discussions, and NITI Aayog

forums all saw an increase in multilateral decision-making, but in reality, there was still political and technical disagreement.

Incentives and fiscal behavior

- In the 1990s, the sound finance paradigm placed a higher priority on low inflation and fiscal consolidation than on countercyclical state spending; many states relied on Center funds for capital programs, which limited their ability to make independent investment decisions.
- From 2001 to 2025, increased devolution gave states more flexibility overall, allowing some to spend on social services and infrastructure. However, the continued use of conditional transfers and grants tied to performance steered state priorities toward nationally defined goals and performance indicators.

Intergovernmental dispute resolution and politics

- Between 1991 and 2000, the Center's hegemony decreased overt intergovernmental negotiations but failed to address structural imbalances.
- 2001–2025: There are new forums, but disagreements have gotten more heated (GST compensation gaps, borrowing caps, and alleged political bias in conditional funding). States have pressed for fiscal claims through protests, legal action, and political negotiations, demonstrating the limited ability of institutional forums to automatically resolve conflicts in the absence of clear guidelines and transparency.

Contemporary Challenge - I Post COVID Fiscal Stress

Fiscal shock and magnitudes

The COVID 19 pandemic produced a sharp revenue collapse and a surge in pandemic related expenditures at both Union and state levels, forcing emergency spending, revenue concessions and expanded safety nets.

- Increased central fiscal interventions and temporary fiscal rule relaxations were observed in the post-COVID era.
- States experienced tighter borrowing windows, delayed GST compensation receipts, and compressed own revenues, which highlighted liquidity stress and capital expenditure cuts.

In 2023–2024, protests and political mobilization over perceived fiscal embargoes and unfair treatment resulted from several state governments' public disclosure of significant deficits in central transfers, GST compensation, and borrowing capacity. State implementation burdens and localized health and social expenditures resulted in mismatches between the Union's large, immediate stimulus and coordinated policy responses (medical supplies, targeted transfers).

Decision making trade offs under stress

- Due to implementation burdens and localized health and social expenditures, the Union frequently took the lead on significant, immediate stimulus and coordinated policy responses (medical supplies, targeted transfers); this led to a mismatch between duties and revenue flows.
- The ability of states to react counter cyclically was limited by borrowing limits associated with fiscal performance; the emergency borrowing windows' structure and conditions dictated the degree of flexibility with which states could invest in capital projects and recovery.

Policy options and lessons

- To prevent ad hoc recentralization, institutionalize automatic stabilizers or contingency grants with predictable financing shares and clear triggers.
- In order to maintain subnational planning and investment continuity, increase the transparency of center-state fiscal flows and ensure prompt GST compensation and transfer disbursements.

Contemporary Challenge-II—Digital Taxation and Taxing the Digital Economy

Why digital taxation matters for federal fiscal relations

Traditional bases of consumption and corporate taxation are being undermined by the growth of digital platforms, cross-border services, and online commerce. Two federal questions are raised by the way digitalization alters tax incidence, compliance, and the location of economic activity.

- Which governmental level can impose taxes on new digital bases, and how will the money raised be distributed?

- How can regulations be created to prevent double taxation, safeguard subnational revenue shares, and maintain investment incentives?

India's national and international policy responses

While engaging in international negotiations under the OECD-led two-pillar solution for profit allocation and minimum taxation, India adopted domestic tax laws (read down of Permanent Establishment norms and digital services taxation) and introduced the idea of a "equalization levy" on specific cross-border digital services. Since the Union controls the majority of direct and indirect tax bases, digital tax revenues are primarily a center domain. The GST changed the indirect tax base of the states by absorbing many consumption taxes while allowing digital services to influence the dynamics of the divisible pool.

Implications for Centre state decision making

- In the event that cesses and surcharges rise and compress states' shares, the Center's digital revenues may decrease the size of the divisible pool or change its makeup.
- To avoid revenue erosion and disputes, states must have clear compensation or sharing plans for bases lost to digitalization, as well as cooperative rules for administration and compliance (data sharing, audits).

Policyproposals

- To address the incidence and revenue sharing of digital service taxes, establish institutional mechanisms within the GST Council or Finance Commission consultations.
- Invest in the state's ability to manage local taxes digitally and establish explicit guidelines for allocating revenue from the digital economy.

Contemporary challenge III—Environmental federalism

The rise of environmental responsibilities across levels

Air and water quality, forest and coastal management, disaster resilience, and climate adaptation and mitigation are examples of environmental issues that transcend administrative borders and call for coordinated financial solutions. Land use, local regulations, and service delivery are implemented by the states on the front lines, while national policy, standards, and international commitments are set by the center.

Fiscal instruments and inter-governmental frictions

- Investments in the environment and climate change are lengthy and capital-intensive, frequently exceeding state budgetary limits in the absence of outside funding and centralized support. Centrally sponsored programs and aid grants are frequently utilized, but they can be short-term, conditional, and fragmented, which compromises integrated long-term planning for mitigation and adaptation.
- Carbon pricing and pollution charges are examples of market-based instruments that raise issues with assignment. If they are implemented at the center, revenues are collected centrally; if they are implemented at the states, competitiveness and leakage issues emerge, which could lead to interstate spill overs and legal challenges.

Case for new fiscal architecture for environmental federalism

- Create a collaborative national-state environmental fund with multi-year predictable flows for resilience, adaptation, and mitigation that are distributed in accordance with integrated planning and established criteria.
- Harmonize environmental levies and increase transparency to prevent revenue arbitrage and lawsuits; align fiscal incentives (matching funds, grants) to encourage green public investments at the state level.

Contemporary Challenge IV—Global Pressures: Trade, Capital Flows, and Geopolitical Risk

Deepening global integration since 2001 and its federal implications

India's capital, services, and goods integration significantly increased between 2001 and 2025. FDI flows increased, global value chains grew, and India's macro policy decisions became more susceptible to changes in global rates, commodity prices, and investor sentiment. These changes have an impact on subnational decision-making because states compete for mobile capital, offer incentives, and modify local regulations to draw in exports and foreign direct investment.

FDI concentration and regional divergence

FDI tends to concentrate in states with better governance, infrastructure, and human capital, according to empirical research. This reinforces spatial disparities and encourages interstate competition, which is frequently manifested through tax incentives that deplete revenue bases. States' desire to draw in investment must be balanced with national goals and fair development under the federal system.

External debt, contingent liabilities and sub national exposure

- Although private external liabilities and PPP contingent liabilities can have an impact on macro stability and displace development spending, the Center is responsible for managing external sovereign debt. Informed decision-making and risk assessment are hampered by the absence of consolidated, transparent reporting of center-state contingent liabilities.
- The Center may have to make abrupt macro adjustments as a result of global shocks (such as spikes in commodity prices, financial tightening, supply chain disruptions, or geopolitical events), which may result in lower transfers or more stringent conditions for states during downturns.

Policy responses for resilience

- To monitor and manage PPP, state guarantees, and external exposures, combine contingent liability reporting and establish cooperative Center-state mechanisms.
- Encourage national infrastructure initiatives and regionally balanced industrial policies that improve logistics, power, and skills in lagging states, thereby reducing the excessive spatial concentration of foreign direct investment.

Statistical Evidence and Stylized Facts

- By increasing the states' portion of the Central divisible pool to 42% from previous lower levels, the 14th Finance Commission greatly increased unconditional transfers and changed the fiscal space of the states.
- Despite the increase in general-purpose transfers after 2015, conditional transfers (Centrally Sponsored Schemes) still make up a sizable portion of central spending, resulting in a disjointed transfer system that continues to influence state priorities.
- Divisible pool erosion: despite higher nominal devolution percentages, analyses show that rising cesses and surcharges have decreased the share of gross central tax revenue that forms the divisible pool (for example, estimates show a decline from around 88.6 percent in 2011–12 to about 78.9 percent by 2021–22).

- This limits the effective resource base available for states. Distress and political responses following COVID-19: a number of states (e.g. 3. Kerala and Karnataka) made public the deficiencies in transfers and GST.

Policy Recommendations Reconciling National Stability with Sub National Autonomy

Predictable contingency financing and automatic stabilizers: To create rule-based, automated shock buffers or contingency grants that are activated by objective indicators (e.g. GDP decline, health emergency metrics) in order to prevent politicized transfers and ad hoc recalls during emergencies.

Rationalize transfer architecture and conditionality: To promote states' long-term planning and reduce fragmentation, centrally sponsored programs should be made simpler, time-limited, and more transparent. Conditional grants should also be linked to multi-year results.

Digital taxation cooperation and revenue sharing: In order to prevent revenue from digitization from inadvertently reducing the divisible pool or jeopardizing state finances, it is necessary to institutionalize center state consultations (GST Council/Finance Commission) on digital tax incidence and design sharing rules.

Environmental fiscal framework and Green Funds: To support state investments in adaptation and mitigation, establish jointly funded national-state climate and disaster resilience funds with predictable multi-year allocations and performance standards.

State access to global finance under rules: To manage contingent liabilities and maintain macro stability, states should establish regulated, rule-based avenues for raising concessional external financing for infrastructure with required central coordination.

Transparency and consolidated fiscal reporting: To enhance market discipline, information for policymakers, and public accountability, mandate consolidated reporting of Center State contingent liabilities, State guarantees, and off-balance sheet vehicles.

Promote balanced FDI diffusion: For a more equitable distribution of investment benefits among states, substitute targeted public goods investments (logistics, energy, and skilling) backed by central matching funds for tax giveaway competition.

Conclusion

The structure and implementation of fiscal federalism in India changed from a macro framework that was heavily dominated by the Center to a more intricate but politically contentious system between 1991 and 2000 and 2001 and 2025. Devolution and cooperative mechanisms underwent major changes during the 14th Finance Commission and GST era, but center-state interactions are still shaped by transfer fragmentation, cesses that reduce the divisible pool, borrowing restrictions, and ad hoc crisis responses. The challenges of today, such as digital taxation, environmental federalism, post-COVID fiscal stress, and international pressures, underscore the need for more transparent regulations, predictable contingency funding, cooperative institutions for digital and green taxation, and mechanisms that allow states to access international capital while adhering to prudential guidelines. It will take institutional changes that reframe incentives and transfer authority to reconcile national macro stability with true subnational fiscal autonomy.

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