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## Federalism Erosion: Centre-State Finances Post-15th Finance Commission

Varsha P <sup>1</sup>, Ch. Venkateswarlu <sup>2</sup>

<sup>1</sup>Research Scholar, School Of Law, Vels University Of Science And Technology, Pallavaram, Chennai, India.

<sup>2</sup>Associate Professor, School Of Law, Vels University Of Science And Technology, Chennai, India.

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### Abstract

This article examines whether the 15th Finance Commission's recommendations erode India's federal structure through constitutional and institutional analysis. India's federal architecture, enshrined in Articles 268-293, establishes a framework for Centre-State financial relations with the Finance Commission as the constitutional mechanism under Article 280 to balance vertical and horizontal fiscal distribution. The 15th Finance Commission (2021-2026) introduced significant reforms including reduced vertical devolution from 42% to 41%, performance-based grant conditionalities, and sector-specific earmarking that fundamentally altered the fiscal autonomy of states. This paper analyzes these recommendations against constitutional principles of federalism, examining their impact on state fiscal independence, the proliferation of cesses and surcharges bypassing divisible pool, and the shift toward conditional grants. Through doctrinal analysis and comparative constitutional examination, this research argues that while the 15th Finance Commission's approach responds to legitimate governance concerns, it marks a concerning departure from cooperative federalism toward centralized fiscal control. The article concludes by proposing reforms to restore federal balance while maintaining accountability mechanisms.

**Keywords:** - Fiscal Federalism, Fifteenth Finance Commission, Cooperative Federalism, Cesses and Surcharges, Conditional Grants, Article 280

## I. INTRODUCTION

Federalism in India represents a constitutional compact balancing unity with diversity, centralization with autonomy. The Supreme Court has repeatedly affirmed that federalism is a basic feature of the Constitution (S.R. Bommai v. Union of India, 1994). At the heart of this federal arrangement lies the fiscal relationship between the Centre and States, mediated through the constitutional architecture of Articles 268-293 and operationalized through the Finance Commission established under Article 280. This institution serves as the constitutional mechanism to ensure equitable distribution of financial resources while preserving state autonomy.

The 15th Finance Commission, constituted in November 2017 with recommendations covering 2021-2026, represents a critical juncture in Indian fiscal federalism. Its terms of reference included unprecedented mandates that raised concerns about centralizing tendencies, particularly the requirement to examine "performance-based incentives" and sector-specific grants (Ministry of Finance, 2017). The Commission's final recommendations reduced the states' share in central tax revenue from 42% to 41%, introduced substantial conditionalities, and endorsed continued proliferation of cesses and surcharges that bypass the divisible pool entirely.

This article examines whether these developments constitute erosion of federalism from three analytical perspectives. First, it analyzes the constitutional framework governing Centre-State financial relations and the Finance Commission's role. Second, it critically evaluates the 15th Finance Commission's key recommendations and their operational impact on state fiscal autonomy. Third, it assesses whether these changes align with or deviate from constitutional principles of cooperative federalism. The central argument advanced is that while governance concerns justify performance accountability, the

cumulative effect of reduced devolution, enhanced conditionalities, and unchecked cesses represents a structural shift undermining federal principles.

## **II. CONSTITUTIONAL FRAMEWORK OF CENTRE-STATE FINANCIAL RELATIONS**

### **2.1. Distribution of Taxing Powers**

The Constitution establishes a clear demarcation of taxing powers through the Seventh Schedule. Union List (List I) grants exclusive taxation authority to the Centre over customs duties, corporation tax, taxes on income other than agricultural income, and excise duties on goods manufactured or produced in India except alcoholic liquors for human consumption (Entries 82-92B). State List (List II) provides states with exclusive authority over land revenue, taxes on agricultural income, succession and estate duties, excise on alcoholic liquors, taxes on goods and passengers, and taxes on professions and trades (Entries 45-63). The Concurrent List contains limited taxation entries, primarily confined to stamp duties (Entry 44).

Article 270 embodies the federal principle of revenue sharing by mandating that all taxes levied and collected by the Centre, except those specifically excluded, shall be distributed between the Union and States. The constitutional scheme recognizes that while the Centre possesses superior taxing capacity through access to elastic revenue sources like income and corporation tax, states shoulder substantial expenditure responsibilities particularly in social sectors. The Finance Commission serves as the constitutional mechanism to operationalize this vertical distribution.

### **2.2. Role and Powers of Finance Commission**

Article 280 mandates establishment of a Finance Commission within two years of Constitution's commencement and thereafter every five years. The Commission's constitutional mandate encompasses:

- Distribution of net proceeds of taxes between Union and States and inter se allocation among States;
- Principles governing grants-in-aid to states from Consolidated Fund of India;
- Measures to augment state Consolidated Funds to supplement panchayat and municipality resources; and
- Any other matter referred by the President in the interest of sound finance.

The constitutional design envisions the Finance Commission as an independent, expert body insulated from political pressures (Sarkaria Commission, 1988). Its recommendations, though not binding, carry significant constitutional weight. The Supreme Court has emphasized that Finance Commission recommendations represent 'constitutional wisdom' demanding serious governmental consideration (Bihar v. Union of India, 1991). This institutional architecture reflects the framers' intent to establish an objective mechanism balancing Centre's revenue-raising superiority with states' expenditure responsibilities while preserving federal equilibrium.

## **III. 15TH FINANCE COMMISSION: KEY RECOMMENDATIONS AND DEPARTURES**

### **3.1. Reduced Vertical Devolution**

The 15th Finance Commission reduced states' share in central taxes from 42% to 41%, justified primarily by creation of Union Territory of Jammu and Kashmir requiring direct central transfers (Fifteenth Finance Commission, 2020). This one percentage point reduction, while seemingly marginal, represents substantial absolute revenue given the divisible pool's magnitude. For 2021-22, this amounted to approximately ₹75,000 crores transferred from states collectively to Centre's direct control. The Commission argued this maintains aggregate resource transfer when accounting for grants, but critics contend it fundamentally alters the character of transfers from entitlement-based devolution to discretionary grants.

More concerning is the reversal of progressive devolution trajectory. The 14th Finance Commission's increase to 42% was hailed as strengthening federalism by enhancing unconditional resource transfers (Rao & Singh, 2006). The 15th Commission's reduction, even if contextually justified, establishes precedent for downward revision based on administrative reorganization. This raises fundamental questions about whether Article 270's constitutional mandate can be calibrated based on Union's administrative decisions regarding territory reorganization.

### **3.2. Performance-Based Conditionalities**

The Commission introduced performance-based incentives across multiple sectors including power, implementation of flagship schemes, and incremental compliance. While accountability in public expenditure is constitutionally valid, the extent of conditionalities raises federal concerns. Performance grants totaling ₹3.5 lakh crores over the award period were made conditional on specific outcomes in sectors like elimination of rural poverty, improvement in nutritional outcomes, and progress toward Sustainable Development Goals (Fifteenth Finance Commission, 2020).

Constitutional propriety of such extensive conditionalities merits scrutiny. Article 275 authorizes grants-in-aid "as Parliament may determine," but the Finance Commission's constitutional mandate under Article 280 focuses on distribution principles, not performance management. The shift toward conditionality transforms the Commission's role from objective resource allocator to performance auditor, potentially compromising its constitutional character. Furthermore, performance parameters often reflect national priorities that may not align with state-specific developmental needs, effectively constraining state policy autonomy guaranteed under federal distribution of legislative powers.

### **3.3. Cesses and Surcharges: Constitutional Bypass**

Perhaps the most significant threat to federal finance emanates not from Finance Commission recommendations but

from Centre's increasing reliance on cesses and surcharges exempt from Article 270's divisible pool. The 15th Commission acknowledged that cesses and surcharges constituted 15.8% of gross tax revenue in 2019-20, up from 10.2% in 2011-12 (Fifteenth Finance Commission, 2020). This proliferation directly erodes the effective devolution rate: while nominal devolution is 41%, actual transfer considering the entire tax base (including cesses) is substantially lower.

The Commission recommended restraint in imposing cesses but lacked constitutional authority to enforce limitations. Courts have upheld Centre's power to levy cesses for specific purposes, requiring only that they serve the stated 'objective and revenue be appropriately utilized (Hingir-Rampur Coal Co. v. State of Orissa, 1961). However, the expanding use of cesses for general revenue purposes rather than specific projects subverts Article 270's constitutional scheme. Cess revenues, exceeding ₹3.7 lakh crores in 2020-21, represent resources constitutionally intended for state sharing but legally diverted through nomenclature rather than constitutional amendment (Reddy & Reddy, 2019).

## **IV. CRITICAL EVALUATION: FEDERAL IMPLICATIONS**

### **4.1. Erosion of Fiscal Autonomy**

Fiscal autonomy constitutes the core of federal governance, enabling states to translate their legislative competence into effective policy implementation. The Supreme Court has recognized that fiscal federalism is integral to the basic structure, stating that "financial provisions are the backbone of the federal structure" (S.R. Bommai v. Union of India, 1994). The 15th Commission's recommendations cumulatively undermine this autonomy through three mechanisms.

First, reduced devolution combined with increased conditional grants alters the ratio of unconditional to conditional transfers. States now receive larger proportions through tied grants requiring compliance with central priorities rather than autonomous policy formulation. Second, performance conditionalities impose ex-post compliance burdens, effectively subordinating state policy choices to centrally determined outcomes. Third, unchecked cess proliferation reduces the predictable, constitutional resource base states rely upon for medium-term fiscal planning.

These structural changes contravene the constitutional principle that states are not subordinate administrative units but constituent polities with guaranteed autonomy. The Sarkaria Commission emphasized that fiscal arrangements must ensure states possess "adequate resources to discharge their constitutional functions without being financially dependent on the Centre" (Sarkaria Commission, 1988). Current trends move precisely in the opposite direction.

### **4.2. Deviation from Cooperative Federalism**

Indian federalism, described as "cooperative federalism" by the Supreme Court, requires collaborative governance rather than hierarchical control (State of West Bengal v. Union of India, 1963). The Finance Commission institutionalizes this cooperation by providing an objective mechanism for resource sharing insulated from political negotiations. The 15th Commission's enhanced conditionalities transform this relationship from cooperative to conditional, with Centre using fiscal instruments to direct state policy.

Comparative federal systems illuminate this concern. In mature federations like Canada and Australia, unconditional transfers constitute the primary mechanism for vertical fiscal redistribution, with conditional grants limited to specific national programs requiring cooperative implementation (Watts, 2008). India's trajectory reverses this model, expanding conditionality while constraining unconditional devolution. This risks transforming states into implementing agencies for centrally determined programs rather than autonomous policy laboratories.

### **4.3. Accountability versus Autonomy Balance**

The constitutional challenge lies in reconciling legitimate accountability concerns with federal autonomy. Proponents argue performance-based grants ensure prudent resource utilization, prevent fiscal profligacy, and align state actions with national developmental goals (Government of India, 2020). These concerns possess constitutional validity Article 293 authorizes central control over state borrowing, reflecting constitutional recognition of fiscal discipline needs.

However, accountability mechanisms must remain constitutionally appropriate. The Finance Commission's mandate focuses on equitable distribution, not performance management. The constitutional scheme assigns accountability through democratic processes state electorates evaluate governments' fiscal management through elections. Conditional grants circumvent this democratic accountability by substituting central judgment for electoral assessment. Moreover, performance metrics often reflect capacities rather than efforts, penalizing fiscally weaker states facing structural disadvantages (Chakraborty, 2021).

### **4.4. Implications for Federal Governance**

The cumulative impact of these developments extends beyond immediate fiscal consequences to fundamental constitutional implications. First, the progressive centralization of fiscal authority undermines the constitutional distribution of legislative powers. States possess constitutional competence over vital sectors like health, education, agriculture, and police, yet lack adequate unconditional resources to exercise this competence effectively. This creates implementation deficits in state subjects, eroding federal governance quality.

Second, reduced fiscal autonomy diminishes states' experimental capacity. Justice Brandeis famously described American states as "laboratories of democracy" where innovative policies could be tested (New State Ice Co. v. Liebmann, 1932). Indian states have historically served similar functions Kerala's health model, Gujarat's agricultural development, and Karnataka's technology policy emerged from state-level innovation. Fiscal centralization constrains such experimentation by binding states to centrally prescribed outcomes and methodologies.

Third, the trend poses risks to India's constitutional stability. Federal systems derive legitimacy from balancing unity with diversity, allowing regional aspirations expression through state autonomy while maintaining national cohesion.

Excessive centralization generates centrifugal pressures, as evidenced by growing demands for greater state rights and, in extreme cases, separatist movements. Fiscal federalism's erosion could exacerbate such tensions by denying states meaningful autonomy despite constitutional guarantees.

Fourth, these developments require urgent constitutional attention. While the Finance Commission lacks enforcement authority over cess proliferation, Parliament possesses constitutional power to address this through legislation. The Commission itself recommended considering a constitutional amendment to include cesses in the divisible pool or legally define and limit their scope (Fifteenth Finance Commission, 2020). Such constitutional reforms merit serious consideration to restore federal fiscal balance.

## V. CONCLUSION

This analysis reveals that post-15th Finance Commission developments constitute significant erosion of federal fiscal principles, though not irreversible constitutional violation. The cumulative effect of reduced vertical devolution, enhanced performance conditionalities, and unchecked cess proliferation substantially undermines state fiscal autonomy, shifting Indian federalism from cooperative toward centralized control. While individual measures may be contextually justified creation of Jammu and Kashmir Union Territory necessitated some adjustment, and accountability in resource utilization serves legitimate governance objectives their combined impact threatens constitutional federal balance.

The constitutional architecture established by the framers envisioned Finance Commission as an objective mechanism balancing Centre's revenue superiority with states' expenditure responsibilities while preserving federal equilibrium. Current trends deviate from this vision by transforming resource transfers from constitutional entitlements to conditional grants and allowing constitutional bypass through cess proliferation. This transformation is particularly concerning because it occurs not through formal constitutional amendment requiring broad consensus, but through administrative decisions and Finance Commission recommendations lacking rigorous constitutional scrutiny.

Restoring federal fiscal balance requires multifaceted reforms. First, future Finance Commissions should resist pressures for reduced devolution and enhanced conditionalities, recognizing their constitutional mandate focuses on equitable distribution, not performance management. Second, Parliament should legislate definitional boundaries and quantitative limits on cesses to prevent constitutional bypass. Third, constitutional amendment bringing cesses within the divisible pool merits serious consideration. Finally, institutional mechanisms ensuring states' meaningful participation in national fiscal policy formulation perhaps through empowering Inter-State Council or formalizing state consultations in Finance Commission appointment would strengthen cooperative federalism.

The fundamental question is whether India will maintain its federal character through genuine fiscal autonomy or drift toward centralized control contradicting constitutional federal commitments. The answer requires recognizing that federalism is not merely administrative convenience but a constitutional basic structure safeguarding India's unity in diversity. Fiscal federalism constitutes the material foundation enabling this political framework to function effectively. Its erosion, therefore, threatens not just efficiency in governance but the constitutional compact itself.

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