



Fiscal Imbalances and Decentralization in India: An Analysis of Resource Allocation

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Abstract

This paper discusses the Union-to-State tax devolution in India during the years 2015 to 2024, which is constructed based on the proposals of the 14th Finance Commission and the 15th Finance Commission. It provides the vertical fiscal imbalance that persists in India, with the Union dominating the significant sources of revenue and the horizontal imbalance between the States with varying capabilities and needs. Based on secondary data in budget documents, Finance Commission reports, and Reserve Bank publications, the study runs both descriptive analysis and chi-square tests in determining the stability and equity of tax transfers. The research results indicate that tax devolution has been inequitable and fluctuating. Big States like Uttar Pradesh, Bihar and Madhya Pradesh got the maximum shares, with little going to the smaller States like Goa, Sikkim, and Mizoram. Arunachal Pradesh was a small state because of its strategic and geographical location. This was proven right by statistical tests, which means that State size had a significant effect on levels of allocation. The general trend also showed instability, whereby devolution reached its highest point in 2015-16 and was very low in other years, and this makes it hard for the States to plan their finances. Though the share of taxes to the States was raised by the 14th Finance Commission, subsequent changes in the 15th Finance Commission led to average transfers to many States, strengthening inequalities. The research concludes that the existing devolution system still favours the bigger States and proposes a more transparent, equitable and need-based system to reinforce fiscal decentralisation and create a balanced regional development.

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Introduction

The Indian federal structure is typified by unequal distribution of fiscal powers between the States and the Union. The Union government has the advantage of having broad and elastic sources of revenues through income tax, corporation tax, customs duties and goods and services tax, whereas States have narrow and less elastic sources of revenues through excise on alcohol, property tax, and motor vehicle tax. Simultaneously, States have a significant role to play in the provision of key governmental functions such as education, healthcare, infrastructure, and social welfare. Such a disjuncture between the revenue capacity and expenditure commitments brings about a structural vertical fiscal imbalance, such that intergovernmental fiscal transfers become necessary in terms of ensuring fiscal stability and good governance.

To deal with such imbalances, the constitutional framework has been added in the tax devolution suggested by the Finance Commission that decides how the Union tax revenues will be devolved to the States. These transfers are intended to correct

vertical imbalance as well as diminish horizontal differences in fiscal capacity between States. The fiscal transfers, hence, have a key role to play in maintaining cooperative federalism, where decentralised decision-making can be made, and all the States are in a position to carry out their developmental roles. Predictable and sufficient financial resources to the subnational governments are the foundation of decentralisation in a big and different country like India.

The national fiscal period that is between 2015 and 2024 is an important stage in fiscal federalism in India, as it is characterised by major changes in policies and economic shocks. The 14th Finance Commission significantly raised the level of the share of the divisible tax pool to the States, augmenting them in fiscal power, whereas the 15th Finance Commission subsequently varied the share in response to the new fiscal demands. The COVID-19 pandemic had also influenced the decade and disrupted revenue mobilisation and heightened expenditure requirements at the State level, with the significance of stable fiscal transfers.

The research examines the devolution of the Union to State tax within this time with reference to secondary data based on the Union Budget reports, Finance Commission reports and Reserve Bank of India publications. It also looks at the trends in transfers annually, compares the allocation between States, reviews the average transfers as made under successive Finance Commissions, and looks at the distributions between large and small States. The study focuses on particular issues on whether transfers were stable and predictable and the allocation pattern encourages fiscal equity or perpetuates inequalities.

All in all, the discussion highlights that fiscal transfers do not only constitute a financial tool but an important tool that defines the outcome of development, intergovernmental relationships and how the federal system in India operates. A solid, clear, and fair system of tax devolution is necessary in enhancing decentralisation, ensuring equitable growth in regions and inclusive growth across the States.

Objectives of the Study

1. To study the trend of Union–State fiscal imbalances in terms of tax devolution during 2015–2024.
2. To find out the difference in the pattern of tax devolution between large and small states.

Statement of the Problem

The fiscal federal system of India has been plagued by an unbalanced situation where the Union takes charge of the main sources of revenue, and the States have the higher expenditure responsibility, leading to vertical and horizontal fiscal imbalance. These are the focus of the Finance Commission to solve these problems, by devolution of taxes, although its effectiveness is still a subject of debate. In 2015–2024, the 14th Finance Commission raised the States tax share to enhance fiscal autonomy, whereas the 15th Finance Commission marginally cut it due to increased national commitments. The COVID-19 pandemic also added additional pressure to the budgets of the population and raised the reliance on transfers. The patterns of allocating them also demonstrated inequality, as the bigger States were given more allocations than the smaller States. The main question is whether tax devolution in the given period has been

sufficient, steady, and fair or have the fluctuations and imbalanced distribution undermined fiscal decentralisation and even-handed regional growth.

Scope of the Study

The study is limited in its scope to the focuses on Union-to-State tax devolution in India between 2015 and 2024, representing the secondary data sources on the topic: the documents of the Union budget, reports of the 14th Finance Commission and 15th Finance Commission, publications of the Reserve Bank of India, and data of the Ministry of Statistics and Programme Implementation. It analyses both time patterns and structural tendencies of tax transfers, such as annual changes in the overall devolution, variation between high and low recipient States, changes between Finance Commission periods and allocation between large and small States. It discusses quantitative patterns of tax devolution only and omits other fiscal transfers, including grants or centrally sponsored schemes, political or administrative aspects of allocations, which would give a narrow picture of fiscal imbalances and decentralisation.

Review of Literature

Ganaie (2018) ^[10], Fiscal Decentralisation and Economic Growth in India, finds that expenditure decentralisation promotes the growth of the state governments by aligning the spending patterns to the local demands, whereas revenue decentralization is associated with mixed effects owing to ineffective tax foundations. States continue to be reliant on central transfers to become financially stable. Aiyar (2019) ^[1], The Centralisation Decentralization Tug of War and Social Policy in India demonstrates that greater central power of social expenditures decreased the policy flexibility of states. The imbalances increased even though the tax devolution increased after 2015 but real fiscal autonomy was limited. Bhanumurthy, Bose & Satija (2019) ^[5], Fiscal Policy, Devolution and the Indian Economy, Higher tax devolution increased fiscal space, development spending and provided unequal fiscal discipline among states. Decentralisation therefore enhanced autonomy and increased inequalities. The article by Chakraborty & Sinha (2020) ^[7] titled Measuring Fiscal Imbalances among Indian States illustrates the incidence of persistent horizontal imbalances with the affluent states increasing own revenue and the less well-off ones relying on grants. There have been calls of fairer distribution of formula systems that are based on need and capacity. Rajaraman (2020) ^[14], Finance Commissions and the Challenge of Vertical Fiscal Imbalances, claims that structural vertical imbalances have not been addressed through increased tax devolution. States are still hugely dependent on discretionary grants to cover fiscal gaps. Finds tax devolution stabilised revenues, but rising debt and deficits enhanced fiscal stress, particularly in weak states, Kumar & Singh (2021) ^[11], “Debt Sustainability and Fiscal Stress in Indian States”. Sounding bells about the dangers of fiscal discipline. Bhattacharya (2021) ^[4] “Fiscal Autonomy and State expenditure patterns in India”, Greater devolution led to greater autonomy but fiscal constraints constrained the developmental spending priorities. Autonomy is not a sufficient condition without enhanced revenue capacity and wisdom. Equalisation Transfers and Horizontal Fiscal

Imbalances in India by Sivaramakrishnan (2022) ^[16] Shows equalisation transfers will not fully decrease the disparities, and poorer states will be left in a disadvantaged structural position. Effective decentralisation needs stronger mechanisms of transfer. Ralte and Vanlalhrualtuanga (2024), Vertical and Horizontal Fiscal Imbalances in India: A Review. Good News: The subnational governments of India continue to be dependent on Union transfers because of ineffective revenue mobilisation and reduced autonomy. Focuses on the vertical and horizontal imbalances. Ganesh & Rabbiraj (2023), Fiscal Arrangements under the Indian Constitution and the Role of Finance Commissions, identify Finance Commissions as essential in ensuring the balancing aspects of fiscal needs, but constraints of structure, in the revenue assignment processes contribute to imbalance. Suggests institutional change to enhance fiscal equity.

Research Gap

The gap in the literature on the topic of fiscal federalism is that a significant portion of the existing literature has been on conceptual insight about vertical and horizontal imbalances or on stand-alone reports of Finance Commissions. Not much research has been conducted to compare the 14th and 15th finance commissions across the 14th and 15th Union governments, although their deliberations reflected huge transformations to the Union-State fiscal relationship. Besides, although we do recognise differences between the States, there has been a paucity of research conducted on a systematic comparison of big and small States over an extended duration, especially when it comes to tax devolution. The other gap that is imperative is the gap in handling recent fiscal data. Most of the previous research does not go beyond the year 2015, thus limiting the analysis of the cumulative effect of the institutional reforms and the external shocks, like the pandemic, on fiscal transfers. The present research attempts to fill these gaps by taking the years between 2015 and 2024, providing a comprehensive review and analysis that is based on fluctuations by years, averages by Commission, and experience within the different categories of States.

Methodology

The present study is analytical and empirical in nature as it aims to predict the trends of Union-to-State tax devolution in India, and the timeframe analysed in this study is from 2015 to 2024. The methodology will be aimed at not only researching the variations in the years, but also the distributive structure of resources between the large and small states. Special emphasis is given to the question as to whether fiscal transfers have taken an equal path or there has been an imbalance despite the recommendations of Finance Commissions after Finance Commissions. The research is purely secondary research and adopts a combination of descriptive and inferential statistical methods. Although the broad changes in the fiscal transfers can be described using descriptive statistics like an average and graphical trend, inferential statistics like the chi-square test can be used to provide evidence as to whether the distribution pattern of the allocation is related significantly to the size of states. The two methods are used to make the results statistically valid and contextually relevant.

Data Collection

Secondary data is completely used in the study to arrive at accuracy and comparability of the 14th Finance Commission and 15th Finance Commission official reports, Union and State Budget reports, Economic Surveys, and fiscal reports of the Reserve Bank of India. Further policy information was collected in NITI Aayog, PRS Legislative Research, and publications of the Ministry of Finance, and scholarly research on fiscal federalism. The period 2015 - 2024 was chosen to reflect two regimes of the Finance Commission and other significant fiscal events (institutional reforms and the effect of the COVID-19 pandemic on Union and State finances).

Tools of Analysis

To interpret the collected data meaningfully, the following tools were employed:

1. Trend Analysis

Trend analysis examined year-wise changes in total fiscal transfers to assess whether tax devolution in India remained stable and predictable or showed significant volatility over the study period, providing the temporal dimension of the analysis.

2. Comparative Analysis

Comparative analysis grouped States into large and small categories based on demographic and fiscal weight, enabling evaluation of differences in average allocations and assessing whether the principle of horizontal equity was maintained.

3. Chi-Square Test of Independence

A chi-square test was used to determine whether State size (large or small) is significantly associated with fiscal allocation levels, confirming that observed differences are statistically meaningful rather than descriptive. The analysis and results were generated using R Studio, ensuring accuracy and replicability, while graphical tools such as bar charts and trend lines were used to clearly present disparities and trends in tax devolution.

Variables of Chi Square Test

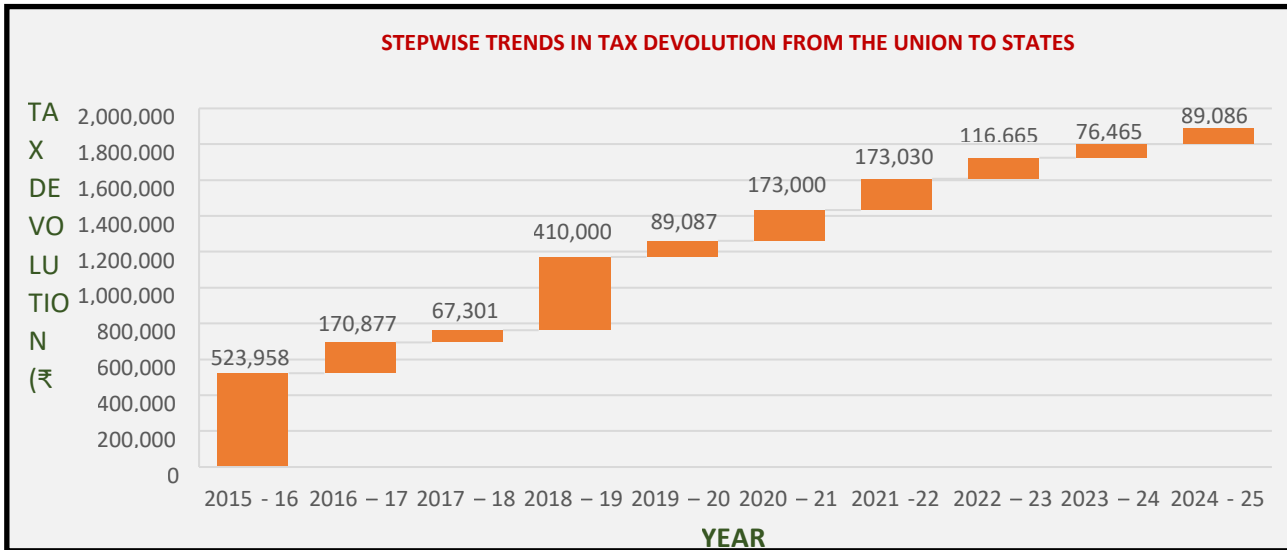
For the chi-square test of independence, two categorical variables were considered:

State Category is classified into *Large* and *Small* based on demographic and fiscal characteristics. Allocation Group is classified into *High* and *Low* based on the total average deviation during 2015–2024.

Hypothesis of Study

The hypotheses were framed to test the relationship between the size of states and the extent of fiscal transfers they received:

1. **H₀ (Null Hypothesis):** There is no significant association between the category of Indian states (large and small) and the level of fiscal allocation during the period 2015–2024.
2. **H₁ (Alternative Hypothesis):** There is a significant association between the category of Indian states (large and small) and the level of fiscal allocation during the period 2015– 2024.

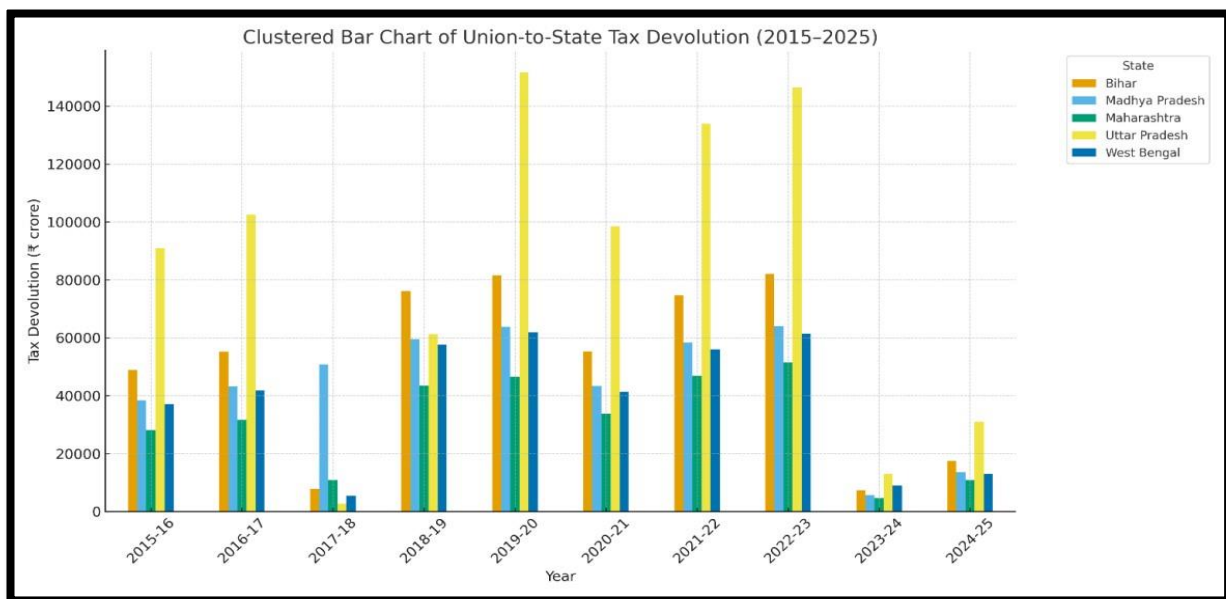


Source: Secondary data compiled from indiabudget.gov.in, fincomindia.nic.in, rbi.org.in, and mospi.gov.in.

Fig 1: Trend of Total Union-to-State Tax Devolution (2015–2024)

On an annual basis, the statistics show that tax devolution between the Union and States in India took a very unequal and variable trend over the period in question. The highest transfer amount of ₹5,23,958 crore was recorded in 201516, but it then declined drastically to ₹67,300.50 crore in 201718 and 89,086.50 crore in 201920. Despite recoveries in 202021 (9173000 crore) and 202122 (9173030 crore), the numbers

once more dropped to 76465 crores in 202324 and 89086 crores in 202425. This trend of a peak followed by erratic additions and subtractions indicates that fiscal transfers were not consistent and predictable, hence making it difficult for States to rely on a steady stream of resources for their long-term fiscal planning and development programmes.

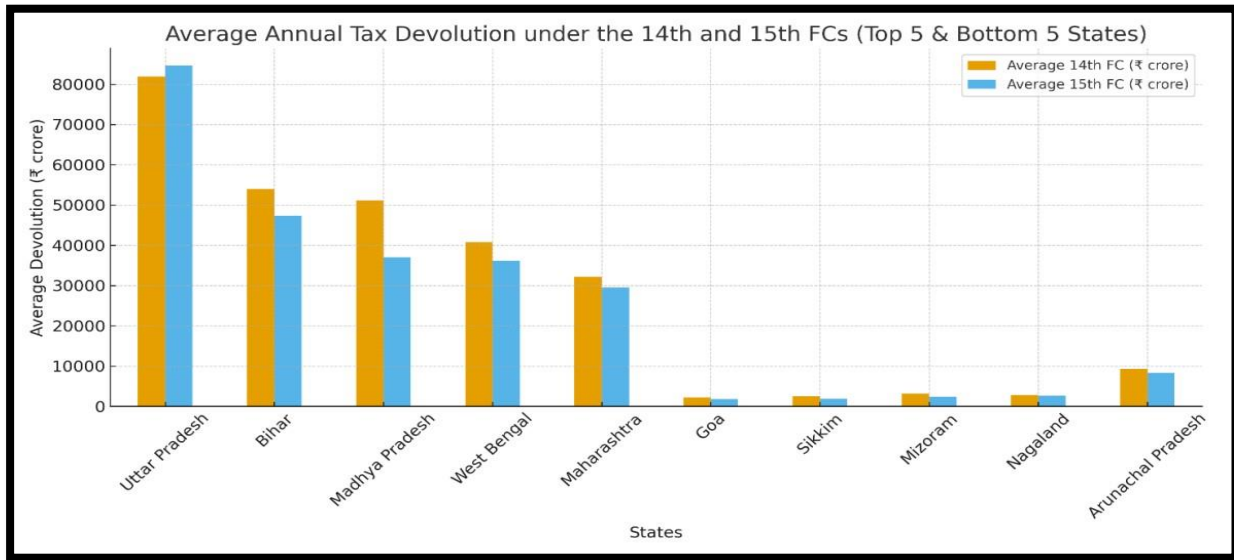


Source: Secondary data compiled from indiabudget.gov.in, fincomindia.nic.in, rbi.org.in, and mospi.gov.in.

Fig 2: Comparison of Top 5 vs. Bottom 5 States in Tax Devolution

A comparison between the most and least recipient States reveals a persistent and broad disparity in tax devolution in India. Uppsala Amid all the highest beneficiaries, Uttar Pradesh, which was 90,973.66 crore in 201516, increased to 146,498.76 crore in 202223 and Bihar, which was 48,922.68 crore, rose to 82,138.61 crore in 201523 and 202223 respectively. By comparison, much smaller transfers were made to such States as Sikkim (₹1,870.28 crore to 201516 to

₹3,168.59 crore to 202223) and Goa (₹1,923.76 crore to 201516 to 3,152.25 crore to 202223). This comparison shows that the larger part of fiscal funds was constantly directed to large States, whereas small States were working with considerably less allocations. Though these small transfers were vital to the operation of small State budgets, the data indicate that the gap between big and small States in the tax devolution was still significant during the period.



Source: Secondary data compiled from indiabudget.gov.in, fincomindia. nic.in, rbi.org.in, and mospi.gov.in.

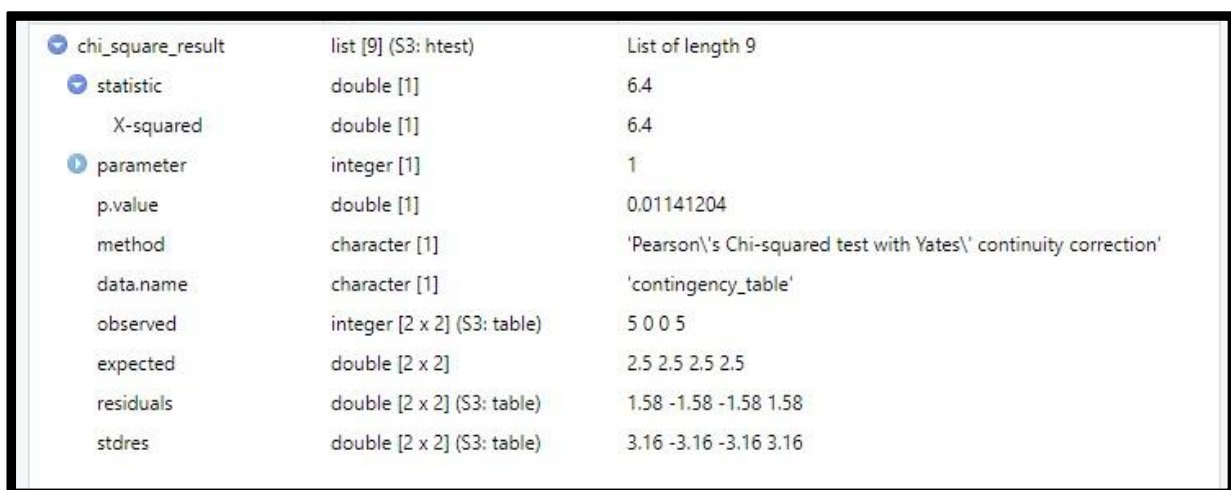
Fig 3: Finance Commission-Wise Average Allocations for Selected States

Comparable average allocation between the 14th finance commission and 15th finance commission in India depicts that transfers to many States are reduced on aggregate. There was slight growth in Uttar Pradesh, between ₹81,879.79 crore and 84,645.89 crore, but in several large States, the growth was notable, with Bihar (53,963.71 crore to 47,400.69 crore), Madhya Pradesh (51,140.59 crore to 37,033.75 crore), West Bengal (40,819.10 crore Smaller States did not show major

changes with Sikkim downward to 1,906.88 crore and Mizoram to 2,408.84 crore but Arunachal Pradesh was relatively high with a slightly decreasing 9 310.58 to 8,339.84 crore. On the whole, these changes suggest that the new devolution system established by the later Commission created less allocation room for many States, especially those that had previously been relying on larger allocations.

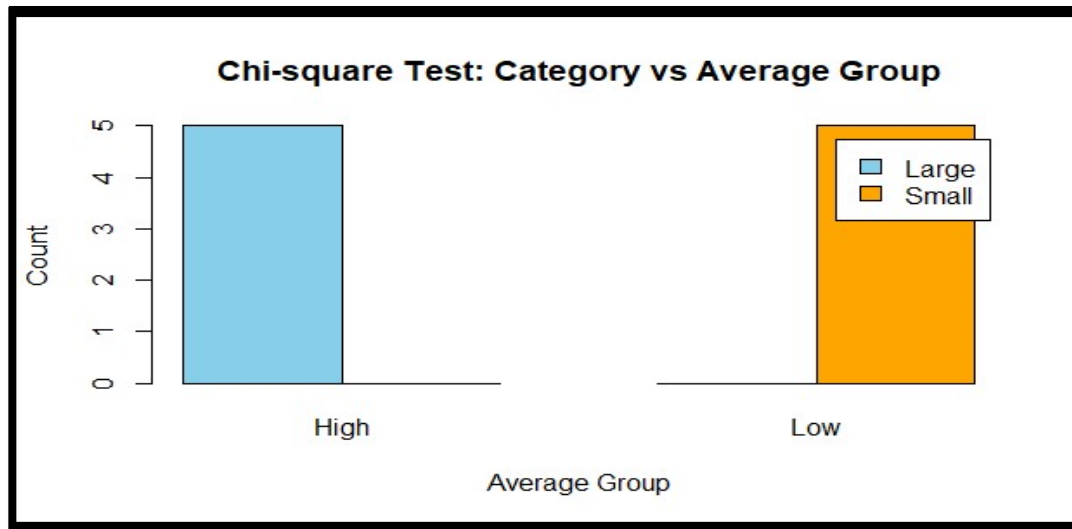
Table 1: Distribution of Tax Devolution among Large and Small States

State	Category	Total Average	Average Group
1 Uttar Pradesh	Large	166525.68	High
2 Bihar	Large	101364.4	High
3 Madhya Pradesh	Large	88174.34	High
4 West Bengal	Large	76948.17	High
5 Maharashtra	Large	61720.01	High
6 Goa	Small	4002.83	Low
7 Sikkim	Small	4425.26	Low
8 Mizoram	Small	5606.99	Low
9 Nagaland	Small	5492.27	Low
10 Arunachal Pradesh	Small	17650.39	Low



	High	Low
Large	5	0
Small	0	5

Pearson's Chi-squared test with Yates' continuity correction data: contingency table
 $X^2 = 6.4$, $df = 1$, $p\text{-value} = 0.01141$



Source: Secondary data compiled from indiabudget.gov.in, fincomindia.nic.in, rbi.org.in, and mospi.gov.in.

Fig 4: Comparative Pattern of Tax Devolution for Large vs. Small States

In terms of size, it is clear that large States are predominant receivers of tax devolution in India with Uttar Pradesh (₹1,66,525.68 crore), Bihar (₹1,01,364.40 crore), Madhya Pradesh (₹ 88,174.34 crore) and West Bengal (₹ 76,948.17 crore) and Maharashtra (₹ 61,720.01 crore) receiving much. The chi-square value ($X^2 = 6.4$, $p = 0.01141$) indicates that this difference is statistically significant and large States will always be under the high allocation category and under the low category under the fiscal needs.

Findings

1. The average allocation to Uttar Pradesh (₹1,66,525.62 crore), Bihar (₹1,01,364.40 crore) and Madhya Pradesh (₹88, 174.34 crore) was very high as compared with Goa (₹ 4,002.83 crore), Sikkim (₹ 4,425.26 crore), and Mizoram (₹ 5,606.99 crore).
2. The chi-square test ($X^2 = 6.4$, $p = 0.01141$) indicates that there is a statistically significant relationship between State size and the level of allocation, as we find the large States in the high-allocation category and the small ones in the low-allocation category.
3. Uttar Pradesh alone received over four times the summed-up allocation of various small States, and West Bengal (76,948.17 crore) also had very high transfers, which suggested a good weight of the population and finances.
4. Arunachal Pradesh was given 17,650.39 crore which is much more than most of the small States, showing that geographic problems, location on the border, and infrastructure requirements were given special attention.
5. The allocation to Uttar Pradesh (₹81,879.79 → ₹84,645.89 crore) increased, with the Bihar (₹53,963.71 → ₹47,400.69 crore) and Madhya Pradesh (₹51,140.59 → ₹37,033.75 crore) showing decreases, under the routine of the transition of the 14th Finance Commission to the 15th Finance Commission.
6. Total tax devolution was also volatile, increasing to

₹5,23,958 crore in 201516 and then declining sharply to 67,300.50 crore in 201718 and 202324 and thus made it quite hard to plan the finances of the States.

7. All in all, it has been seen that there has been a systematic horizontal fiscal imbalance, and the devolution system still favours large States and leaves the smaller States with limited ability to develop fiscally.

Suggestions

1. The formula of allocation must emphasise more on fiscal need and population; this principle is not met when the gap between Uttar Pradesh and smaller States such as Goa and Mizoram exists, indicating that development needs are not proportionately met.
2. The Finance Commission should reinforce equalisation transfers, with a preference to States whose revenue bases are less strong, although, despite Arunachal Pradesh receiving 17,650.39 crore, Sikkim and Goa still receive relatively less aid.
3. More stability in transfers is needed, because total devolution collapsed to ₹5,23,958 crore (201516) to 67,300.50 crore (201718), which caused uncertainty and offsets the long-term fiscal planning by States.
4. The efficient utilisation of devolved funds in areas such as education, health, and infrastructure should be rewarded through performance-based incentives such that the big and the small States are both motivated to improve in terms of fiscal governance.
5. Smaller States need greater fiscal freedom or special grants, as small revenue bases and low rates, like 4,425.26 crore of Sikkim and 4,002.83 crore of Goa, limit the development potential.
6. The process of distribution should also be more transparent, with transparent allocation criteria that should provide a clear explanation of the influence of population, geography, and fiscal capacity on distributing funds, enhancing trust in the process being

- run by the Finance Commission.
7. The future transfer formula needs to include the dynamic development indicators, including poverty levels, human development conditions, and vulnerability factors that can represent the actual fiscal needs across States.
 8. There is a need to have stronger monitoring mechanisms that would see to it that large allocations, usually over ₹80,000 crore per major State, are properly channelised to the services provided to the population, rather than being lost on fiscal deficits.
 9. Enhanced cooperative federalism by increasing the use of State participation in the formulation of transfer formulas would result in a more accommodating and balanced fiscal policy within India.

Conclusion

The paper finds that in India, Union-to-State fiscal transfers between 2015 and 2024 have been significantly concentrated in larger States, with Uttar Pradesh, Bihar, and Madhya Pradesh getting average allocations of more than ₹88,000 crore, and smaller States such as Goa, Sikkim, Mizoram, and Nagaland receiving less than ₹6000 crore; the statistical evidence ($X^2 = 6.4$, $p = .01141$) shows that this allocation The high transfer per population weight, although partly justified by population weight, ensues at the expense of horizontal equity, as the existence of the persistent divide makes a smaller State financially constrained, with a narrow exception of Arunachal Pradesh that has a geographic and a strategic advantage. It is also discovered that transfers have high volatility as they decreased to ₹67,300.50 crore in 201718, down from ₹335,23,958 crore in 201516, which undermines fiscal predictability and constrained decentralisation. All in all, there is a need to introduce a more equitable, consistent, and transparent scheme of allocations that would balance population with developmental requirements to enhance fiscal federalism and inclusive national growth.

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