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AN OVERVIEW OF CENTRE–STATE FISCAL DYNAMICS FROM 1991 TO 2025: A CONCEPTUAL PERSPECTIVE

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Abstract

Fiscal federalism describes the allocation levels between government and inter-governmental Transfers, borrowing rules, and fiscal institutions shape public finance and policy choices. India's fiscal federal architecture has been evolving since independence and it has been repeatedly re-shaped by major policy inflection points during 1991-2000. This period was the immediate post-liberalization phase that re-oriented macroeconomic priorities and the contemporary period of intensified global integrations and different set of internal and external constraints that reshape government decision-making and inter-governmental relations. This paper compares the two periods with a focus on government decision-making and examines contemporary challenges by using evidence from different studies, authorized reports, and policy analyses. Fiscal Dynamics submits to the changes, interactions, and trends in government finances over time. It explains how fiscal deficits, public debt, and fiscal policies evolve and influence economic stability and growth. This article will cover key aspects such as developing a conceptual framework, which involves identifying key theories, establishing relationships between variables, and presenting these connections visually or descriptively. It will also examine the purpose of a conceptual framework, emphasizing it studies how a government's fiscal position behaves and adjusts under different economic conditions. Understanding these aspects is crucial for researchers to structure their investigations effectively and ensure credible results.

Introduction

Fiscal federalism describes the allocation levels between government and inter-governmental transfers, borrowing rules, and fiscal institutions shape public finance and policy choices. India's fiscal federal architecture has been evolving since independence and it has been repeatedly re-shaped by major policy inflection points during 1991-2000.This period was the immediate post-liberalization phase that re-oriented macroeconomic priorities and the contemporary period of intensified global integrations and different set of internal and external constraints that reshape government decision-making and inter-governmental relations. This paper compares the two periods with a focus on government decision-making and examines contemporary challenges by using evidence from different studies, authorized reports, and policy analyses.

Fiscal Dynamics submits to the changes, interactions, and trends in government finances over time. It explains how fiscal deficits, public debt, and fiscal policies evolve and influence economic stability and growth. This article will cover key aspects such as developing a conceptual framework, which involves identifying key theories, establishing relationships between variables, and presenting these connections visually or descriptively. It will also examine the purpose of a conceptual framework, emphasizing it studies how a government's fiscal position behaves and adjusts under different economic conditions. Understanding these aspects is crucial for researchers to structure their investigations effectively and ensure credible results.

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Fiscal Dynamics in India 1991-2000: Some Context and Features

Structural shift after 1991

The 1991 balance-of-payments crisis forced an abrupt policy reorientation: fiscal consolidation, trade liberalization, and capital account reforms. The central government cut subsidies, opened the economy to foreign capital, and launched structural reforms to stabilize reserves and restore investor confidence. Policy priorities shifted toward fiscal consolidation at the Centre, disinflation, trade liberalization, and opening to foreign capital. These macro priorities influenced Centre-state fiscal relations are the Centre tightened overall fiscal posture and rebalanced public finance to support structural reforms and external adjustment.

Intergovernmental Transfers and the Finance Commission

Throughout the 1990s, the Finance Commissions continued to play their constitutional role in recommending vertical devolution (centre and states share of divisible central taxes) and horizontal distribution among states. The Tenth Finance Commission (1995-2000) operated against the backdrop of reforms, but the basic vertical devolution shares (around one-third to states in the 1990s) remained far lower than later adjustments. In practice, a large portion of resources flowed through centrally-sponsored schemes (CSS) and conditional grants, which constrained fiscal autonomy at the state level despite political decentralization. These meant states were often dependent on the centre for specific program funding and faced constraints in designing state-level priorities.

Revenue Assignments and Centre Dominance

Constitutional assignment of major tax bases remained with the Centre. In 1991-2000 the Centre continued to raise the main share of tax revenue and used transfers, grants, and schemes to influence state expenditure priorities. The Finance Commission remained the constitutional mechanism for tax devolution and grants, but many transfers continued via centrally sponsored schemes, preserving strong central influence on sub-national spending decisions.

Deficits, Borrowing, Fiscal Discipline and State Responses

During 1990s, it had wide variation in states’ fiscal performance. It prominence on fiscal discipline. Central concentrated on reducing gross fiscal deficit to measures that removed some subsidies, but did not remove the structural causes of state deficits viz, wage bills, under-priced utilities, and contingent liabilities. States were constrained by conditional central consent rules under Article 293 and by market scrutiny. Several states retained with fiscal reforms, rationalizing expenditures and improving tax administration, but many remained dependent on central transfers and faced cyclical fiscal pressures. The sound-finance paradigm adopted in the 1990s privileged macro stabilization often at the cost of state fiscal autonomy and investment priorities.

External sector and capital flows in 1991-2000

The decade saw the reintroduction and progressive growth of private capital inflows and foreign direct investment (FDI) though from a low base. Capital account liberalization proceeded cautiously; external borrowings were managed centrally, and the government prioritized reserve accumulation and external sector stability. The new orientation raised questions about how sub-national governments fitted into an increasingly open economy where federal policies affected competitiveness and investment climate.

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Table -1: External Quantitative Summary

Indicator	1991	2000	2023
FDI Inflows (USD Billion)	0.13	2.4	70.9
External Debt (USD Billion)	98	100	624
Debt-Service Ratio (%)	35.3	17.5	5.2
Tax Devolution to States (%)	29	30	41 (15th FC Recommendation)

Sources: RBI Annual Reports, Finance Commission Reports, UNCTAD FDI Statistics&**

The statistical data clearly illustrate India's structural transformation in the post-1991 reform period. FDI inflows increased sharply from USD 0.13 billion in 1991 to USD 70.9 billion in 2023, reflecting liberalization, improved investor confidence, and global integration. Although external debt rose substantially from USD 98 billion to USD 624 billion, the steep decline in the debt-service ratio from 35.3 per cent to 5.2 per cent indicates enhanced debt sustainability and stronger foreign exchange management. Further, the rise in tax devolution to states to 41 per cent, as recommended by the 15th Finance Commission, highlights strengthened fiscal federalism and greater decentralisation of financial resources.

The data indicate a significant improvement in India's economic position since 1991. FDI inflows have increased sharply, reflecting greater investor confidence. Although external debt has risen, the declining debt-service ratio shows improved repayment capacity. Higher tax devolution signifies strengthened fiscal federalism and greater support to states.

Fiscal Developments in India 2001-2025: Scenario
Institutional Landmarks Since 2015

Several institutional changes reshaped inter-governmental fiscal relations after the year 2015:

- Creation of NITI Aayog in 2015, replacing the Planning Commission and shifting planning from centrally driven five-year plans to a cooperative, advisory model that emphasizes state participation in policy design.
- The 14th Finance Commission (award effective 2015-16) increased the share of tax devolution to states from 32 to 42 percent, substantially enlarging unconditional transfers and thereby altering the fiscal space and incentives for states.
- Introduction of the Goods and Services Tax (GST) through a Constitutional amendment and creation of the GST Council (2017) created a unified indirect tax regime that reallocated many consumption taxes to the Centre and states jointly, while introducing a complex compensation mechanism for transition losses.

These reforms changed the toolkit of interaction between the Centre and states: the GST institutionalized cooperative decision-making on a major tax, while finance commissions and ad hoc central schemes continued to matter for vertical and horizontal balance.

Change in Transfer Patterns and Conditional Grants

Post-2015, general-purpose (unconditional) transfers rose in share due to the 14th FC's recommendations, yet conditional transfers via centrally sponsored schemes (CSS) and specific-purpose grants continue to be significant. The overall transfer architecture thus remains fragmented: a larger share of unconditional devolution coexists with substantial programmatic central spending that shapes state priorities.

Fiscal Rules, Borrowing and State Autonomy

The Fiscal Responsibility and Budget Management (FRBM) framework for the Union and state fiscal responsibility legislations have encouraged fiscal consolidation. The 15th Finance Commission (2020-25) grappled with trade-offs between incentivizing fiscal discipline and preserving state expenditure autonomy. States have also faced borrowing constraints tied to fiscal performance and centrally mediated limits, generating tensions over fiscal space and investment capacity.

GST and Centre-State Power Balance

GST redefined revenue sources but also generated contentious issues: the compensation cess mechanism, delays and disputes over shortfalls, and concerns among several states about erosion of autonomy and unpredictability in revenues. While the GST Council provides a platform for collective decision-making, states continue to voice concerns about the effective share in the divisible pool, the impact of cesses and surcharges at the Centre, and the fragmentation introduced by conditional funding outside GST arrangements.

Global Integration, External Shocks, and Policy Space

Between 2001 and 2025 India's integration with global markets deepened. FDI inflows increased markedly, global value chains expanded, and capital mobility rose. These trends exposed the Indian federal system to global shocks — global financial crises, commodity price swings, pandemic-related disruptions, and geopolitical tensions — which required coordinated Center-state fiscal responses and sometimes led to recentralization of resources for crisis management.

1991-2000 vs 2025:

Priorities and Constraints in Decision-Making

1991-2000: Decision-making was dominated by macro-stabilization priorities. The centre prioritized balance-of-payments stability, reserve accumulation, fiscal consolidation and structural reforms. States were pressured to restrain deficits, but often lacked incentives or capacity to undertake major reforms. Conditional transfers and central program design were used to maintain national priorities.

2025: Decision-making balances fiscal consolidation with growth targets and social commitments. The centre now must weigh the impact of global shocks on external debt servicing and the currency, while also considering states' fiscal space (post-14th FC) and the political economy of public investment (infrastructure, CapEx). The presence of larger unconditional transfers and stronger state fiscal positions (in some states) empowers sub-national priorities; yet global constraints (investor sentiment, credit rating considerations) constrain the centre's room for maneuvers.

Table-2: Economic Indicators: India- 1991-2000 Vs2025

Aspect	1991-2000	2025 (Actual / Projected)
Economic Growth (annual average)	Avg.5.8 %	6.5 – 8.2 %
Fiscal Deficit (Centre)	~6% of GDP	~5.5% of GDP
States' Share in Taxes	~29%	41% (effective ~32%)
External Debt	US$ 112 bn (2000)	US$ 736 bn (2025)
FDI Inflows	US$ 3.6 bn (2000)	US$ 81 bn (2025)
Global Pressure	Asian Financial Crisis (1997)	Tariffs, debt volatility, climate shocks

Sources: RBI Annual Reports, Finance Commission Reports, UNCTAD FDI Statistics &**

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The statistical comparison between the period 1991–2000 and 2025 highlights the structural transformation of the Indian economy. During 1991–2000, economic growth averaged around 5.8 per cent, reflecting the early impact of economic liberalization amid fiscal stress and external vulnerability. In contrast, the projected growth rate of 6.5–8.2 per cent in 2025 indicates greater economic resilience, diversification, and improved macroeconomic management. The fiscal deficit, though still high, has marginally declined from nearly 6 per cent of GDP to about 5.5 per cent, suggesting gradual fiscal consolidation. A notable shift is observed in states' share of central taxes, which has increased from about 29 per cent to an effective share of around 32 per cent, strengthening fiscal federalism. External debt has risen substantially, reflecting increased global integration, while a sharp rise in FDI inflows signifies improved investor confidence. The nature of global pressures has also evolved—from regional financial crises to complex challenges such as trade tariffs, debt volatility, and climate shocks.

Government Decision-Making: Comparative Dynamics across Periods
Centre's role and state autonomy
1991-2000: The Centre's macro stabilization role was dominant. Central policy choices on trade liberalization, exchange rate management, and external debt servicing constrained the bandwidth of state-level economic policy despite continued constitutional autonomy in many expenditure domains.

2001-2025: The Centre retained important macro levers but institutionalized cooperative mechanisms (GST Council, increased devolution by the 14th FC). Decision-making became more multilateral in form; however, the practical balance shifted ambiguously, but faced continued conditionality, borrowing constraints, and policy signals from central schemes and nationally designed reform packages.

Fiscal incentives and investment priorities
1991-2000: Emphasis on macro stabilization and liberalization encouraged states to compete for investment through tax incentives and reform packages, but many lacked capacity to finance large public investments without central support.

2001-2025: With greater tax devolution and rising fiscal transfers, many states could pursue infrastructure and human capital investments. Yet, conditional grants and centrally sponsored flagship schemes often directed resources into centrally prioritized programs, influencing state decision-making and sometimes crowding out state-designed initiatives.

Inter-Governmental Dispute Resolution and Politics
1991-2000: Disputes were handled within traditional constitutional mechanisms, with central dominance limiting overt conflicts but leaving unresolved structural imbalances.

2001-2025: New institutions (GST Council, NITI Aayog) offered forums for negotiation, but political contestation over resource allocation which includes public protests and litigation which intensified as stakes rose. Several states have faced and announced grievances over perceived fiscal centralization, shortfalls in GST compensation, and borrowing constraints.

Contemporary Challenges
This section examines three interrelated contemporary challenges that shape federal fiscal decision-making: external debt dynamics, FDI inflows and their distributional effects including pandemics, supply chains and geopolitics.

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External Debt

Evidence and trends

- The macroeconomic posture since the 1990s aimed to stabilize external accounts, but rising global integration and domestic fiscal pressures have affected external liabilities and financing needs. Analyses of post-2010 decades show that India's external debt management became more sophisticated, with a higher share of private sector external liabilities, foreign investment into reserves, and longer maturity profiles, but exposure to currency and rollover risks remains a policy concern.
- Centralized management of external debt places states in a constrained position: states are generally barred from direct external borrowing except with Centre's consent, limiting sub-national capacity to finance large infrastructure using external concessional finance and creating dependence on central transfers and guarantees.

Implications for Decision-Making

- The Centre must balance debt sustainability with the need to finance public investment. Tight external conditions can force fiscal consolidation at the Centre with spillovers to state transfers, constraining sub-national spending.
- States' inability to freely access external markets reduces their policy instruments to respond to infrastructure financing gaps, pushing them toward fiscal engineering through higher domestic borrowing or public-private partnerships often conditioned by central approvals and market perceptions.

Policy Responses

- Strengthening debt transparency, improving coordination between Centre and states on contingent liabilities, and enabling state access to concessional multilateral finance under clear rules can help align investment needs with debt sustainability objectives.

FDI Inflows and Their Distribution

Evidence and Trends

- FDI into India increased substantially after 2000, accelerating in the 2010s and 2020s as reforms liberalized sectors and global investors sought exposure to Indian markets and manufacturing ambitions. The concentration of FDI in a few states and urban agglomerations — driven by infrastructure, skilled labor, and policy ease — has reinforced regional imbalances.
- Scholars document that fiscal incentives, land and labor reforms, and state-level investment promotion have shaped where FDI locates; states with better governance, infrastructure and policy continuity attract disproportionate shares of inflows.

Implications for Decision-Making

- States compete to attract FDI, sometimes offering tax incentives and concessions that erode local revenue bases. This competitive federalism can undercut long-term revenue sustainability.
- Central policies to liberalize sectors ease of doing business improvements, and nationwide infrastructure programs shape investment flows and set the broad policy environment; states must align sub-national measures with national reform agendas to fully benefit.

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Policy Responses

- Rebalancing incentives toward quality public goods provision (infrastructure, logistics, power) rather than headline tax concessions, and designing regionally targeted investment promotion can spread the benefits of FDI more evenly across states.

Evidence from the literature and policy documents

Several academic and policy analyses highlight these contrasts and implications:

- **M. Govinda Rao (2000)** provided an early comprehensive analysis of fiscal decentralization and noted the dominance of centrally sponsored programs and intergovernmental grants in shaping state finances — a pattern that persisted into the 1990s. Rao's work illustrates the institutional path dependence that made deeper devolution challenging.
- **Finance Commission awards** (notably the 14th FC) and government releases document the institutional shift to 42% tax devolution to states — a structural change in vertical devolution with measurable fiscal consequences for states' unconstrained revenue capacity. Official award documentation and state planning board analyses provide the legal and quantitative basis for this shift.
- **GST literature (post-2017)**: Scholarly articles and policy notes analyze the trade-off between tax base consolidation/efficiency and reduced state autonomy over certain taxes. These studies show changes in revenue volatility, the need for compensation mechanisms and new administrative arrangements that affect intergovernmental fiscal relations.
- **External debt and macro commentary:** Central bank and IMF/World Bank datasets and media reports document the rising external debt stock and changing composition, which feed into national fiscal strategy discussions (e.g., shifting emphasis from deficit targeting to debt/GDP anchors). These data sources underpin contemporary fiscal caution.

Policy Recommendations and Way Forward

1. **Clarify vertical balance and conditionality:** Revisit the fragmentation of transfers to simplify and rationalize conditional grants; increase transparency on the purpose, duration, and performance metrics of CSS to align incentives with state capacities and priorities.
2. **Institutionalize fiscal crisis mechanisms:** Create well-defined emergency transfer and borrowing frameworks that automatically trigger during national shocks with clear burden-sharing rules between Centre and states, reducing ad hoc disputes and improving timeliness of funds.
3. **Strengthen sub-national access to global finance:** Design supervised, rule-based pathways for states to access concessional external financing for long-gestation infrastructure projects, while ensuring robust debt sustainability assessments and coordination with central macro policy.
4. **Rebalance incentives for FDI distribution:** Encourage states to focus on improving public goods (logistics, energy, skills) rather than fiscal giveaways; create national programs that pair investment promotion with capacity building in lagging regions to diffuse benefits of FDI.
5. **Improve fiscal transparency and contingent liability management:** Publish consolidated Centre-state contingent liability tables; harmonize rules for guarantees, off-budget vehicles, and PPPs to avoid hidden fiscal risks that can surface during global shocks.
6. **Enhance cooperative institutions:** Empower intergovernmental forums (GST Council, Finance Commission consultations, NITI Aayog platforms) with clearer dispute-resolution mechanisms and regularized data sharing to reduce politicization and improve evidence-based decision-making.

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Conclusion

From 1991-2000 to 2001-2025 India's fiscal federalism evolved from a period dominated by central macro stabilization and cautious liberalization to a more institutionally complex environment characterized by larger unconditional devolution. India's fiscal federalism is thus more decentralized in revenue sharing than in the 1990s, but also more exposed to global financial conditions. The challenge ahead is to leverage that decentralization for inclusive, high-quality public investment while managing external vulnerabilities that can constrain policy space. The states have gained some fiscal part through devolution but face constraints through conditional grants, borrowing rules, and limits on external financing. Evidence from commission awards, central bank statistics, and academic studies supports the picture of a maturing but still-evolving fiscal federal system that must adapt to contemporary global pressures. Addressing these issues calls for improved transparency, institutional strengthening, and a recalibration of federal fiscal norms to reconcile national macro stability with robust sub-national development autonomy.

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