

## Divisible Tax Pool - Centre vs. State in Unison: Is It A Bridge Too Far !!

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### INTRODUCTION

India's Federal Structure envisions both Union, States and their defined areas of Governance, assuming the respective Fisc & Revenue Management Responsibilities. Over the years, Indian Fiscal Landscape has witnessed a series of transformation reflecting country's evolving tax policies and the expansive administrative oversight framework.

The Centre-State Treasury Relationship is structured through an intricate yet effective system, which aims to ensure fair distribution of revenue between the Union and the States. It is tailored to distribute the revenue in an effective and efficient manner, ensuring a balanced system of governance. However, it is widely perceived that an unequal wedge exists in so far as distribution of revenue, leading to concerns exhibited by the States regarding their excessive reliance on the Union, thus limiting State's oversight over its Financial *Alma Mater*.

Post the recent announcement made by the Hon'ble Prime Minister from the ramparts of the Red Fort on the Independence Day, with regards to forthcoming **GST 2.0** Reforms, vide which the Government seeks to achieve **Rate Rationalization**, in as much as restructuring the Indirect Tax Regime into two standard slabs i.e. **5 per cent and 18 per cent, along with a special 40 per cent "demerit" levy** on Sin and Luxury Goods. This will effectively whittle down the existing structure which includes 5 percent, 12 per cent, 18

per cent, 28 per cent bracket, along with the removal of GST Compensation Cess. As also one ought not lose sight of Rule 2 of **Goods and Services Tax (Period of Levy and Collection of Cess) Rules 2022**, the GST Compensation Cess will cease to exist after March 31, 2026. The cessation of the cess would yield likely increase of the share of States, since the proposed **40 per cent levy** would form part of the **Divisible Pool of Taxes**, unlike the Compensation Cess which was not the part of divisible pool.

Following up on the announcement made by the Hon'ble Prime Minister, the GST Council, in its recently concluded meeting held on September 4, 2025 has taken unprecedented & path-breaking decision in restructuring the Indirect Tax Regime, popularly referred to as 'GST-2.0'

Per the announcement of GST Council, it has decided to retain the Compensation Cess and a 40 % indirect tax levied on "Sin Goods". The Hon'ble Union Minister of State for Finance of India, heading the Group of Ministers (GoM) on Compensation Cess has gone on record in stating that the cess is likely to continue on tobacco products beyond the 31<sup>st</sup> October deadline, depending upon the timing of the repayment of the interest on loan taken by the States. The Hon'ble Minister also clarified that Centre is yet to take any definitive position on the levy which would replace the compensation cess to maintain the overall taxation, especially on Tobacco products.

The Extant Fiscal Architecture of India has deep roots in the colonial past, influenced principally by The Government of India Act, 1935. The Act effectively laid down the foundation for the federal system of governance in India and how finances should be managed between the Centre and States. The provisions of the said Act did provide that the Central Government ought to garner major taxes (including Revenue generated from Income Tax & Duties of Customs), and in turn share a part of the same with the States.

This Federal Fiscal Structure was considered important since the States are primarily responsible for maintaining law and order, providing education and administering health-related sectors, and it was difficult for the States to fulfill these responsibilities with limited amount of income. To ameliorate the imbalance of fiscal imbalance between the Centre and the State, personal income tax collected by the Centre was taken as a tool to overcome this problem.

Post the enactment of the Government of India Act, 1935, Sir Otto Niemeyer, a noted British Banker and a Civil Servant, was entrusted to conduct a financial inquiry in India in 1935, released his report titled "*The Indian Financial Enquiry Report*" in the year 1936, proposing that 50 per cent of the Income Tax collected by the Central Government should be allocated to the States.

Subsequent to India's Independence, the process of drafting of the Constitution of India involved due deliberation on issue of fiscal federal structure of India. In order to address the same, The Expert Committee on Financial Provisions submitted its report on December 5, 1947, *inter-alia*, advising that instead of fixing rigid percentage for sharing taxes, a flexible mechanism be adopted, basis which the Constituent Assembly laid down a framework through which devolution of share could be determined periodically.

The responsibility of determining the devolution of share was entrusted upon the Finance Commission in terms of Article 280 (*Finance Commission*) of the Constitution of India.

As Per the said Article, the President of India shall constitute a Finance Commission in every five years or earlier, as the President deemed necessary. As Per sub-clause (a) to Article 280(3) of the Constitution of India, the Finance Commission is required to provide its recommendation to the President of India regarding the distribution between the Union and

the State of the net proceeds of taxes, which will be further divided between the Central and the State Government.

Moreover, the President under Article 281 (*Recommendations of the Finance Commissions*) of the Constitution of India, places the recommendation of Finance Commission before the House of Parliament along with an Explanatory Memorandum.

Over time, successive Finance Commission(s) have played a vital role in defining India's Fiscal Federalism by recommending dynamic and adaptive tax-sharing formula and ensuring fair distribution of national resources across the Union and the State.

The Commission from time to time has also highlighted that the increasing reliance of the Union on Revenue generated through Cess and Surcharges is primary reason behind the shrinking of the State's share in divisible pool and consistently recommended to enhance the share of the States in this regard.

Cess & Surcharge(s) do play a considerable role in India's Taxation System as a means of garnering additional revenue by the Central Government for a given objective.

While Cess, intrinsically are viewed as additional taxes collected for a specific purpose, such as education or health-related purposes, in contrast, Surcharge is usually imposed on existing duties or taxes on higher income groups or corporations to generate incremental revenue, for instance reference is limited to Article 269 (*Taxes levied and collected by the Union but assigned to the States*) & Article 270 (*Taxes levied and distributed between the Union and the States*) of Constitution of India.

In short, Surcharge is nothing but tax on tax.

Cess can be categorized primarily as, Cess Taxes and Cess Fees. Cess Taxes refers to the taxes used for specific purposes without any *quid pro quo* benefit, whereas Cess Fees is also used for specific purpose unlike Cess Taxes. By paying Cess Fees, the payer is entitled to the direct reciprocal benefits (i.e. existence of *quid pro quo*).

The revenue collected from such taxes serve as a significant contribution to the Government which is then augmented into the Consolidated Fund of India.

Cess and Surcharge are primarily associated with **Vertical Devolution** of Taxes, which involves transfer of funds from the Centre to the States. **Horizontal Devolution**, on the other hand, involves transfer of funds among states based on the overall recommendations provided by the Finance Commission.

This process of *Vertical Devolution* of funds aims in ensuring a smooth transfer of financial resources from the Union Government to sub-national governments. This practice is considered as crucial in addressing the issue of Vertical Fiscal Imbalance ("**VFI**"), which is primarily caused by the discrepancy between expenditure responsibilities and revenue generation capacities of the Union and State governments.

The increased reliance on use of Cess and Surcharge by the Union Government reduces the divisible pool, and therefore, impacts the transfer of funds to States. Despite the Finance Commission's efforts in enhancing the state's financial space, the actual share devolved to the states has declined over the years.

In light of the Evolving Fiscal Challenges, States have been demanding an increase in vertical devolution of taxes to ensure a fairer distribution of financial resources.

## Centre & State-Role Play

The Constitution of India confers upon the Union Government the exclusive authority to levy Cess and Surcharge, whereas the State Government does not possess such legislative competence.

The 7<sup>th</sup> (Seventh) Schedule of the Constitution of India outlines the areas wherein both the Union and the State Government have the authority to legislate over specific matters.

It is apt to note that Article 270 of the Constitution of India *inter-alia* provides that any Cess levied for specific purposes or Surcharge levied under any law for the time being in force, will not form part of divisible pool. Such additional taxes do not form part of the “*Divisible Pool*” to be shared with the States.

Article 270 of the Constitution of India is usefully extracted as follows:

**“270. ( 1) All taxes and duties referred to in the Union list, except the duties and taxes referred to in [articles 268, 269 and 269A], respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2).**

**(2) Such percentage, as may be prescribed, of the net proceeds of any such tax or duty in any financial year shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax or duty is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed in the manner provided in clause (3).”**

The term “*Divisible Pool*” represents a portion of Gross Tax Revenue (“**GTR**”) which is distributed between the Centre and States and comprises of all Central Taxes such as Income Tax, Customs Duty, Excise Duty, and Goods and Services Tax, but does not include Cess and Surcharge levied for specific purposes.

Before the enactment of the Constitution 80<sup>th</sup> (Eightieth Amendment) Act, 2000, Article 272 (*Taxes which are levied and collected by the Union and may be distributed between the Union and the States*) of the Constitution of India provided for the system of distribution of revenue collected by the Government of India at two levels of federation i.e., the Union and the States.

Article 272 of the Constitution of India is usefully extracted as under:

**“272. Taxes which are levied and collected by the Union and may be distributed between the Union and the States- Taxes which are levied and collected by the Government of India, and such other duties of customs and excise as are mentioned in the Union List, shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in this Chapter”**

Article 272 of the Constitution of India has played a foundational role in the Fiscal Distribution Framework, however, the same proved to be inadequate in addressing the problem of fiscal imbalance between the Centre and the State.

The scope of the said article was limited to revenue from Custom/Excise Duties & Income Tax forming part of the divisible pool, and as a result, divisible pool remained narrow and

excluded other significant sources such as Corporate Tax which were to be shared between the Centre and the State. Consequently, the States would receive a limited share, resulting in post-devolution revenue deficits.

The Finance Commission does employ different yardsticks while providing its recommendations to the President of India for transfer of funds from the Centre to the States, such as Income Distance, Population Control, Demographic Change, Tax Efforts, Fiscal Discipline, Forest Cover, and Index of Infrastructure.

The 10<sup>th</sup> Finance Commission, constituted in the year 1992, released its Report on November 26, 1994, comprising analysis of data for the five-year period (i.e., 1995-96 to 1999-2000), and recommended:

- That 26 per cent of the gross proceeds of Union Taxes and Duties, excluding Stamp Duty, Excise Duty on medicinal and toilet preparations, Central Sales Tax, Consignment Tax, cesses levied for specific purposes, and surcharges should be devolved to the States.

This amount would replace the States' existing share in income tax, basic excise duties, and special excise duties.

- That an additional 3 per cent of the gross proceeds of Union Taxes and Duties, excluding the same taxes and levies as (mentioned above), should be devolved to the States as compensation for the withdrawal of their right to levy sales tax on tobacco, cotton, and sugar.

These illustrative recommendation(s) were accordingly incorporated vide 80<sup>th</sup> (Eightieth) Constitutional Amendment in the year 2000. This amendment brought significant changes to fiscal federalism structure, by amending Articles 269 and 270, and repealing Article 272 of the Constitution of India on account of its limited scope, which allowed only Income Tax and Duties of Customs to be part of the divisible pool. Article 270 of the Constitution of India was substituted vide the said amendment with effect from April 1, 1996, implying retrospective application thereof. The amended Article expanded the scope of the divisible pool to include all the taxes except taxes mentioned under article 268 (*Duties levied by the Union but collected and appropriated by the States*), 269 & 271 (*Surcharge on certain duties and taxes for purposes of the Union*) of the Constitution of India.

The 80<sup>th</sup> (Eightieth) Amendment also expanded the scope of divisible pool and it aimed at providing to the State's greater share of the national revenue.

Despite such concerted efforts, the fiscal imbalance between the Centre and State continued to persist. The successive Finance Commissions continued holding out that Centre's increasing reliance on revenue generated from Cess and Surcharge is undermining the spirit of equitable sharing.

Although, per Report released by the 14<sup>th</sup> Finance Commission & 15<sup>th</sup> Finance Commission(s) on December 15, 2014 and on February 1, 2021, respectively, State's share in Central Taxes has significantly risen to 42 percent and 41 percent respectively, however, the actual share devolved to the States has stagnated around 29 per cent, due to increase in cess and surcharge collected by the Centre.

## **DRAMATIC RISE IN CONTRIBUTION OF CESS & SURCHARGE IN GROSS TAX REVENUE**

Over the past decade, Union Government's Gross Revenue ("**GR**") has grown impressively,

with an Annual Growth Rate of 12 per cent at Rs. 43.09 lakh crore in Financial Year (“FY”) 2024-25 (**Budgeted Estimates, BE**). Additionally, the GTR is estimated to be Rs. 42.7 Lakhs Crores per the Budget Estimates for FY 2025-26. The Cess Collections at Rs. 4.78 Lac Crores formed 17.67 per cent of the GTR (Rs.27,09,315 crore) in FY 2021-22 as per the **Report of Comptroller and Auditor General of India (“CAG”) [Accounts of the Union Government Report No. 21 of 2023]**.

In FY 2023-24, Surcharge(s) & Cess together contributed Rs. 5 Lac Crores (approx.) towards the GTR, per year-wise data released for ‘*Various Types of Cess and Surcharges Collected by the Government from 2019-20 to 2024-25 (up to 30<sup>th</sup> June, 2024)*, as disseminated on the official website of **Open Government Data (“OGD”) Platform India**. Though the Overall Revenue Pool swelled, The Divisible Pool has steadily shrunk over the years, primarily due to two factors i.e., the increasing revenue generated from cess and surcharges, and expansion of GR of the Union Government.

The **Report of India Rating and Research (“Ind-Ra”)** for FY25 suggest that the states received an average of 35.4 per cent of the divisible pool during FY21-25, which is comparatively lower than 39.8 per cent in FY16-20. The Reserve Bank of India (“RBI”), India’s Central Bank in its Report dated 19 December 2024, on “**State Finances: A Study of Budgets of 2024-25**”, *inter-alia*, highlights that due to higher dependence on Cess and surcharges, the divisible pool has shrunk from 88.6 per cent of GTR in 2011-12 to 78.9 per cent in 2021-22, despite recommendations provided by the 13<sup>th</sup>, 14<sup>th</sup>, and 15<sup>th</sup> Finance Commission.

The **15<sup>th</sup> Finance Commission**, in its report submitted for five-year period (i.e., from 2021-22 to 2025-26), also highlighted the rise in share of Cess and Surcharge as a percentage of GTR over the decade, as the total Cess and Surcharge as % of GTR has increased from 10.4 in FY 2011-12 to 19.9 in FY 2020-2021. It is evident that despite the overall growth in GTR, the state’s share has not increased in proportion to the tax revenue.

**Table 3.8: Cesses and Surcharges**

(Rs. crore)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
<b>Direct taxes</b>	29143	48862	63883	81543	40468	58840	53433	145802	155817	175807
<b>Indirect taxes (excluding GST)</b>	63394	72545	77387	86417	137482	172224	150529	172312	182665	195460
<b>GST compensation cess</b>	0	0	0	0	0	0	62612	95081	98327	110500
<b>Total cesses &amp; surcharges</b>	92537	121407	141270	167960	177950	231064	266574	413195	436809	481767
<b>Total cess &amp; surcharge as % of gross tax revenue of which</b>	<b>10.4</b>	<b>11.7</b>	<b>12.4</b>	<b>13.5</b>	<b>12.2</b>	<b>13.5</b>	<b>13.9</b>	<b>19.9</b>	<b>20.2</b>	<b>19.9</b>
<b>GST compensation cess as % of gross tax revenue</b>							<b>3.3</b>	<b>4.6</b>	<b>4.5</b>	<b>4.6</b>

Source : Union Budget Documents

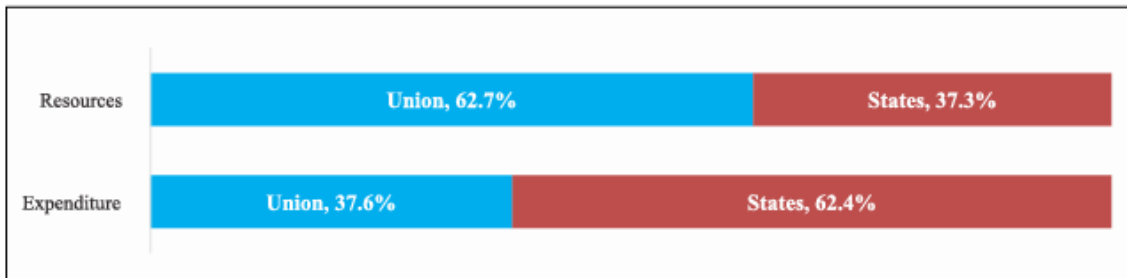
[Source: 15<sup>th</sup> Finance Commission Report]

The said report further highlights the relative shares of the Union & the State Governments

in the combined revenue expenditure, wherein the States bear 62.5 per cent of the expenditure, while the Union Government accounts for the remaining 37.5 per cent.

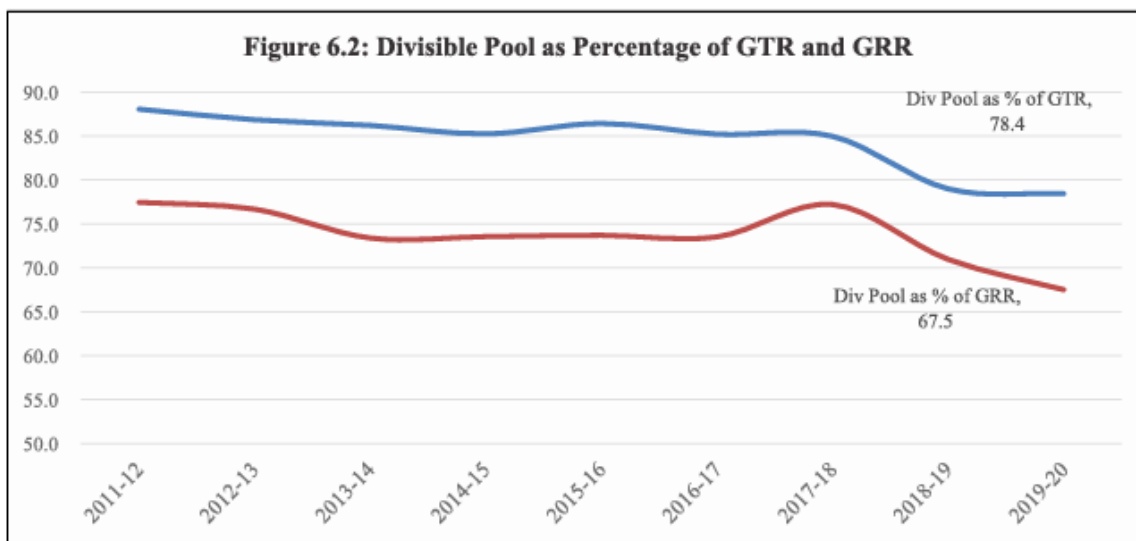
Alternatively implying that the States received only 37.5 per cent of the total revenue receipts, while the Centre receives the remaining 62.5 per cent. This all by itself suggests the Union’s entitlement over a significantly larger portion of tax base in comparison to the State Government.

**Figure 6.1: India’s Vertical Fiscal Gap (2018-19)**



[Source: 15<sup>th</sup> Finance Commission Report]

**Figure 6.2: Divisible Pool as Percentage of GTR and GRR**



GTR: gross tax revenue; GRR: gross revenue receipts

[Source: 15<sup>th</sup> Finance Commission Report]

Similarly, the aforesaid statistics do identify that the divisible pool as % of GTR and GRR has steadily declined over the decade, indicating that while the gross tax collection of the Centre has increased, only a smaller portion of it is being shared with states, leading to greater VFI.

Since Cess and Surcharge by default do not form part of divisible pool, this trend of augmentation has effectively reduced the funds transferable to states, despite the higher overall collections.

**Present Challenges - Imposition of Cess and Surcharge**

The theme of Tax Devolution between the Centre and the State Government has been a prolonged topic of some debate in the context of India's Federal System. On September 12, 2024, in the One-Day Conclave of Finance Ministers, The States expressed their concerns over growing imbalance in the Centre-State Fiscal relations and demanding fair and equitable division of resources to States.

A focal aspect of this debate revolves around the Imposition and Utilization of Cess and Surcharge(s), which has increasingly become a revenue garnering avenue for the Union.

Some of the major concerns expressed by States are outlined below:

*Effect on Divisible Pool:* The increasing use of cess and surcharge by the Union Government has led to reduction in the divisible pool, and therefore its impact on the transfer of funds to States.

The Divisible Pool's share in GTR fell from 86.2 per cent to 78.9 per cent between 2009-10 and 2024-25, as per the **Receipt Budget (2024-25)**. Meanwhile, viewing divisible pool as a share of GR equally fell from 74.2 per cent to 70.2. per cent during the same period.

There exists a **9-Basis Points (bps) gap** between divisible pool as a share of GR and GTR, which may have significant implications for State finances. As a result, the tax devolution to states as percentage of GTR of the Union Government is comparatively lower.

*Expansion of GR of the Union Government:* The Union Government's revenue from cess and surcharges has significantly increased in recent years, now at Rs. 5.39 lakh crore, while collection costs have also surged to Rs. 2.68 lakh crore.

The Revenue Collection from Cess and surcharge as a share of GTR reflects a rise from 5.16 per cent to 14.07 per cent between 2009-10 and 2024-25. This considerable increase in cess, surcharges, and collection costs has led to a marked contraction in the size of the divisible pool.

*Higher Tax Devolution:* Although the 14<sup>th</sup> and 15<sup>th</sup> Finance Commission increased the share of vertical devolution to 42 per cent and 41 per cent respectively, the actual amount available for distribution has decreased. It is evident from the proportion of the Central share of tax transfers in GTR, which accounts for only 30.39 per cent of the GTR, which is significantly lower than the proposed devolution.

This shortfall further worsens the already existing VFI in the country, wherein States are responsible for 63 per cent of total general government expenditures but collect only 37 per cent of general government taxes, as per Reserve Bank of India's Study of State Finances, 2023. This reflects that a higher tax devolution percentage would partially offset the exclusion of cess and surcharge and provide the States with access to a larger share of overall Union revenues.

*Impact on Fiscal Federalism:* The Issue of Tax Devolution between the Centre and States restricts the scope of fiscal flexibility in India. As the total resource transfers to States from the Union Government include the Central Share of Taxes & Grants [including Finance Commission Grants ("**FC**") and Non- Finance Commission Grant ("**Non-FC**")] from the Centre, State Governments cannot meet their specific needs with Non-FC grants. Therefore, transfer dynamics are considered critical in shaping the fiscal relationship between the Union and State Governments.

## **VIEWPOINT OF THE RESPECTIVE FINANCE COMMISSION**

The **13<sup>th</sup> Finance Commission** expressed its clear concerns regarding the usage of the share of revenue generated from Cess and Surcharges by the Union Government and its impact on the States' share in Central Taxes.

The Commission though did not explicitly provide any recommendations to institute constitutional amendment to include Cess and surcharge in the divisible pool, however, it certainly acknowledged that the issue of increasing reliance on such practices by the Union, which could further affect the spirit of Fiscal Federalism.

Additionally, the Commission noted that Articles 270 and 271 constitutionally exclude Cess and Surcharges from the divisible pool due to which the center's increasing use of the instruments consequently reduces the effective tax base that is shareable with states.

This has led to the shrinkage of the divisible pool. The Commission also highlighted the need for transparency in the system of tax devolution.

The **16<sup>th</sup> Finance Commission** constituted in December 2023, has sought input from various stakeholders on the Issue of Tax Devolution between the Centre and the State Government, and is also set to make its recommendations by October 2025, covering an award period of 5 years commencing April 1, 2026. Several Indian States have called upon by the Finance Commission to consider contribution to the National Economy, and increase their share of Vertical Tax Devolution from 41 per cent to 50 per cent and, further posited concerns regarding increasing reliance on Cess and surcharges which will have a severe impact on sustaining Fiscal Federalism & maintenance of State Revenues, as such additional taxes especially ought not form part of the divisible pool.

## **OUR COMMENTS**

States do play a significant role in propelling the Nation's Overall Economic Progress, and at the same time, it is widely felt that they continue to face significant fiscal challenges viz; decline in the share of tax devolution and Union's increasing reliance on use of cess & surcharge, restricting the leverage of the States from effectively implementing region-specific welfare policies.

However, several states have expressed concerns that the withdrawal of the GST Compensation Cess may adversely impact their fiscal resources. As per the Report dated August 19, 2025, by the State Bank of India on GST 2.0 Reforms, the Average Revenue Loss to the States could come around Rs. 85,000 Crores, owing to the removal of GST Compensation Cess. Some of the States have therefore suggested that the proposed 40 per cent levy should be imposed over and above the applicable GST rates, in order to increase the share of the revenue for the States. However, on an alternate sight, certain recent studies suggests that Surplus Compensation Cess of ₹45,000 crore could bridge immediate gaps. The reduced GST triggers increased consumption, which is estimated at **₹5.5 lakh crore**, which holds capacity to generate additional GST receipts, hence exaggerating revenue collection of about **₹52,000 crore**, shared equally between Centre and States.

Over the period of time, Successive Finance Commission(s) have raised concerns regarding the disproportionate share of Tax Revenue between the Centre and States. Although legislative reforms viz; 80<sup>th</sup> (Eightieth) Constitutional Amendment aimed at expanding the divisible pool, so as to enable the States with greater share of the national revenue, however, despite such concerted efforts, the fiscal imbalance between the Centre and States continued to persist.

It is imperative that the present 16<sup>th</sup> Finance Commission thoroughly assess the consequences of increasing reliance of the Union on revenue being accumulated from the

## Cess & Surcharge(s).

The existing gap between the share of divisible pool in Gross Receipts (**“GR”**) and Gross Tax Revenue (**“GTR”**) be considered as a handy measure of computing the incremental tax devolution, ensuring a tax devolution share to 50 per cent fairer share of revenue to the States, and assist the States in meeting their overall development, infrastructural and welfare expenditures, without over-relying on Union Government’s Revenue Pool.

Additionally, there is present need for implementation of financial reforms and undertaking necessary Constitutional Amendments *inter alia* reducing the dependency of the States, by changing or re-stating the existing devolution formula providing more weightage to criteria like pollution control, infrastructure gap and fiscal performance, and help proportionately to both High and Low Performing States.

There ain’t any gainsaying that a more balanced & equitable revenue-sharing framework is essential to maintain Centre-State Financial Relationship, and strengthening India’s Fiscal Federalism, acting as a catalyst of true realization of India becoming an elusive **Viksit Bharat!!**