

Sharing of Tax Revenues: A Review of Horizontal Devolution

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Abstract: The Constitution has adopted three-tier federal structure i.e. Union, State and local bodies. In India the role of fiscal federalism is not only related to taxation and expenditure responsibilities, but also to the systematic levels within the government. The Article 280 of the Constitution mandates that the President will appoint a Finance Commission (FC) every five years, or sooner, to make recommendations on how to divide the net proceeds of Union taxes. The divisible pool of Centre taxes is commonly known as Consolidated Fund. The ToR of President works as the guiding source for the Vertical devolution (Share of Union taxes between Centre and States) and Horizontal devolution (Share of the States in Union taxes to be distributed amongst States). The main challenge faced by the FCs includes the talking of 'Horizontal Devolution' i.e. how to apportion the States' share amongst States. Sixteenth FC 2026-31 defines, "Horizontal devolution refers to allocating the portion of divisible pool assigned to States among individual states." The current Commission is the 16th FC in continuation with the first Commission appointed in 1951. To resolve the issues related to regional imbalances previous Finance Commissions followed the principle of equity and efficiency. 14th Finance Commission tried to alleviate the difference of fiscal capacity and cost disability amongst States. The 15th Finance Commission utilized a multi-criteria formula to distribute the funds. For horizontal distribution suggestion of the States has also been a guiding force. The paper seeks to observe the issues related to horizontal devolution as a corrective measure to regional imbalances. The formulaic modus operandi of the recent FC's will be taken as a reference to assess the devolution criterion of the current FC.

Keywords: Fiscal federalism, Horizontal devolution, Finance Commission, Divisible pool, Population, Income distance, Fiscal discipline, Vertical devolution, Contribution to GDP, Demographic performance.

1. Introduction

The report of the FC does closely follow the ToRs recommended by the President of India on the advice of Union cabinet. After making recommendations on the vertical devolution as per article 280(1) of Constitution FCs are supposed to divide the divisible pool among 28 states. Horizontal devolution entails the allocation of the overall share of the states in the divisible pool, as determined in the vertical devolution exercise, among different States. Previous FC's have also devised different criteria for the horizontal devolution. These criteria devised by FC's were the deciding factor of share to be divided amongst States. Each of the criterion has been demarked weightage and the States were allocated with the funds according to their performance. From first to sixth FC, approximately 80 percent of the divisible fund was distributed on the basis of population; rest of the funds was allocated on the basis of income, distance of per capita income from benchmark per capita income. While observing the trends in horizontal devolution from 7th onwards criteria based on equity gained importance. Later 10th and 11th FC's laid emphasis on the tax effort and area to be considered as the criteria of the formulaic further forest cover and total fertility rate were introduced by 14th and 15th FCs. A comparative study of the criteria of formulas developed by the FC's will be done in the current paper. The important take aways of 16th FC will be the focus of the study.

2. Fiscal Imbalances and Horizontal Devolution

According to Mr. Kelkar, "Fiscal transfers from Centre to States are critical in India. Unlike many developed federations when the tax base differentials are not very significant, India has large and growing horizontal fiscal imbalances besides a high degree of vertical imbalances arising from the assignment of tax powers and expenditure responsibilities in Constitution. Therefore, design and implementation of general and specific purpose transfers is critical in Indian federation from the viewpoint of not only ensuring horizontal equity, balanced regional development and overall stability and integrity of federation. "State governments, being closer to the people, are better positioned to understand and address regional needs effectively. However, their expenditure often exceeds their revenues, creating a fiscal gap that must be bridged. To support the states in partially filling this gap and creating a balance between resourceful and

laggard states, the Centre transfers a portion of its tax collections to the states through the constitutionally mandated mechanism of tax devolution.

3. Horizontal Devolution by Successive Finance Commissions

The net proceeds of income taxes are to be distributed between Centre and States (vertical transfers); afterward the share of States is divided among states that devolution of resources between the States is known as horizontal transfers. After making recommendations regarding tax devolution, Finance Commission devises formulaic for horizontal distribution amongst States. Inter-se distribution has always been a tricky task due to horizontal imbalances. State disparity, i.e. historic background, population density, per-capita income, infrastructure, capacity to raise resources and contribution towards nation building are the few criterias that have been followed by the different Finance Commissions. Endowment of resources follows the Constitutional mandates for the horizontal distribution. Constitution's clear provisions regarding vertical and horizontal allocations paves direction for the Finance Commissions. A comprehensive flowchart of successive FCs is presented in the table:1,2,3 respectively 1st-7th,8th-10th and 11th-15th. The taxes that are included in the divisible pool are: Corporation Tax, Personal Income Tax, Central GST (CGST), and the Centre's share of Integrated GST (IGST).

First to Seventh Finance 1952-53 to 1983-84: First seven FCs relied on only two criteria for horizontal devolution of the States' share in the Union income tax and excise duty:

- [1] Population
- [2] Contribution to tax revenue.

The mandate of first FC was totally for the population, but second FC allocated the share to 90%:10%, as displayed in the Table:1, further third FC has not mentioned any such division, though 4th FCs clearly devoted 20% of the share of excise duty to be distributed on the basis of social and economic backwardness and 80% was distributed as per the status of population. The division of 5th,6th and 7th FCs for the income tax collection remained 90:10 and the excise duty tax collection was distributed as 80:20 by 4th and 5th FCs. The 6th and 7th FCs decided to divide the share of excise duty as followed: 75:25 for 6th and for 7th FCs it was 25:75

Table-1 Weights (percentage) of Different Criteria: First to Seventh FCs

	Income Tax		Excise Duty	
	Population	Tax Contribution	Population	Other
FC-1	80	20	100	0
FC-2	90	10	90	10
FC-3	80	20	Not specified	Not specified
FC-4	80	20	80	20
FC-5	90	10	80	20
FC-6	90	10	75	25
FC-7	90	10	25	75

Source: Reports of 1st to 7th FCs & Report of 16th FC 2026-31,

Eight to Tenth FC's 1984-85 to 1999-2000: Table-2 is representing the Weights (percentage) of different Criteria mandated by 8th-10th FCs. To quote FC-8' report, "We are of the view that the distance of per capita income of States from highest per capita income of any of State, which is a well-accepted indicator of the relative backwardness of States, would also be a good indicator of the capacity of States to raise resources." The mandate of 8th and First report of 9th FC merged the criteria of income tax and excise duty but the second report 9th FC kept two criteria for income and excise duty. 10th FC was the last one before 80th Constitutional amendment all the taxes were put into single divisible pool for the matter of fact, the 80th amendment was suggested by the 10th FC itself. The 10th FC put forward strong mandate," The share of the Union Territories would not be determined on the grounds used for state share but it would be decided on the basis of population solely. The percentage would be 0.927% for the years 1995–2000. Out of the total income obtained from certain central taxes and duties, 29% should go to the states. This is known as the 'Alternative Scheme of Devolution' and came into effect retrospectively from April 1, 1996."

Table-2 Weights (percentage) of Different Criteria: Eight to Tenth FC's 1984-85 to 1999-2000

	FC-8*	FC-9*	FC-9*(Second Report)		FC-10*
			Income Tax	Excise Duty	
Population Share	25	25	22.5	25	20
Inverse Per Capita Income	25	12.5	11-25	12.5	
Per Capita Income Distance	50	50	45	33.5	60
Proportion of Poor Population		12.5			
Tax Contribution			10		
Index of Backwardness			11.25	12.5	
Revenue Deficit Area				16.5	
Infrastructure Index					5
Tax Effort					10
Total	100	100	100	100	100

Source: Eight to Tenth FC reports.

10th FC brought forth some crucial amendments in the Constitution that gave a massive impact on the devolution criteria of upcoming FCs. The recommendations of 10th FC were as follows: The proceeds from the 'penalties' and 'interest recovered' under the miscellaneous receipts should be included into the divisible income tax pool as recommended by Ninth Commission with effect from 1 April 1995. The share of the net proceeds would be 77.5% for five years.

Eleventh to Sixteenth FC's-2000-01 to 2026-31: After implementation of 80th Constitutional Amendment all the Union taxes and duties were put together and after deducting the tax collection cost the sum of amount was supposed as the divisible pool. The main criteria for horizontal devolution were income distance with progressive tilt, 45% or more was devoted to the income distance and Population of 1971 was still the basis of population criteria for the division of State' share of divisible pool. It can be inferred that the last five FCs considered the criteria of devolution on the basis of population, area, and infrastructure index with a slight leaning towards equity base division, Table -3 is representing the criteria of horizontal devolution adopted by the last five FCs. Index of infrastructure was an important criterion introduced by 11th FC but for some reasons any of the future FCs did allocate weight to the infrastructural criteria. A new sustainability factor was introduced by the 14th FC by considering 7.5% weightage to Forest cover further 15th and 16th FC followed the tradition by devoting 10% weightage to the forest cover criterion.

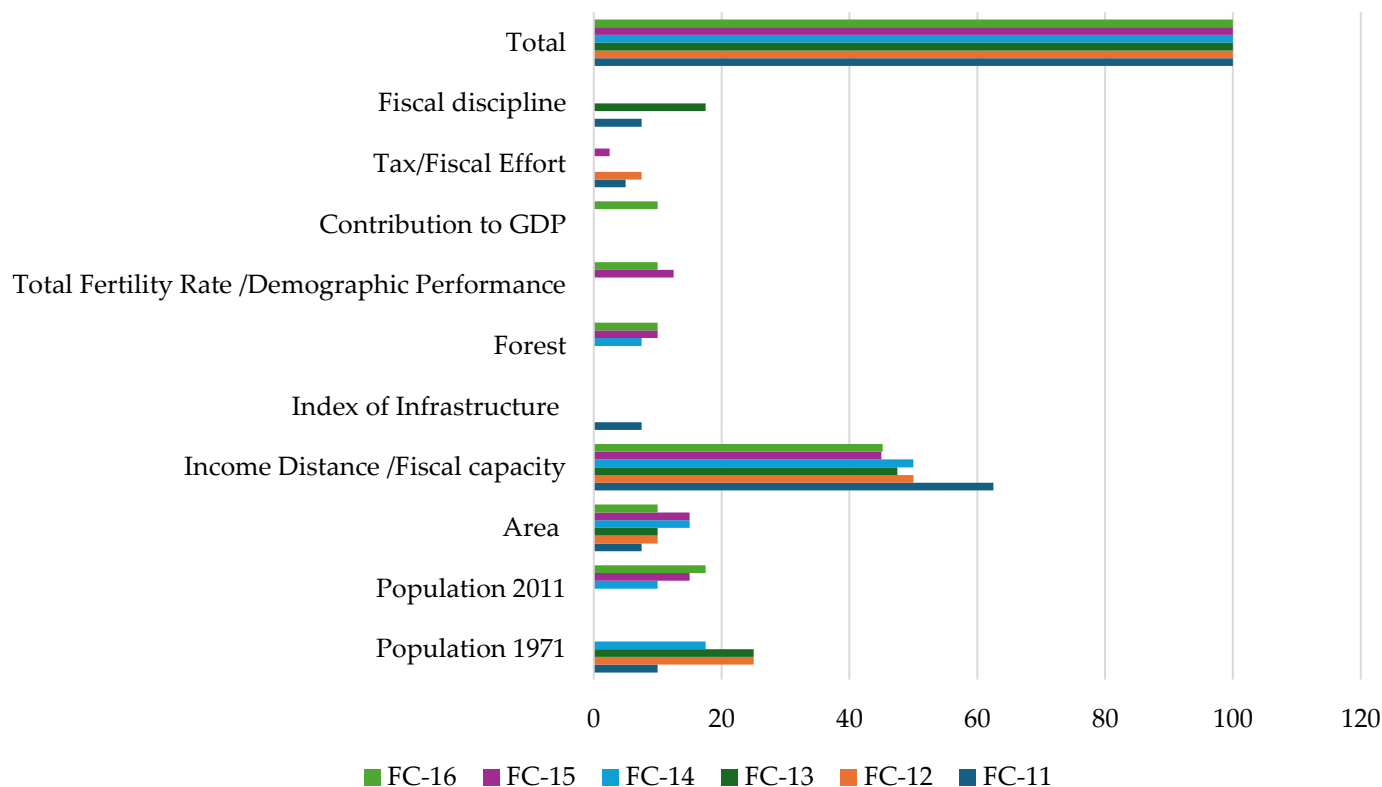
Table-3 Weights (percentage) of Different Criteria: Eleventh to Sixteenth FC's-2000-01 to 2026-31

Criterion	FC-11	FC-12	FC-13	FC-14	FC-15	FC-16
Population 1971	10	25	25	17.5		
Population 2011				10	15	17.5
Area	7.5	10	10	15	15	10
Income Distance /Fiscal capacity	62.5	50	47.5	50	45	45.2
Index of Infrastructure	7.5					
Forest				7.5	10	10
Total Fertility Rate /Demographic Performance					12.5	10
Contribution to GDP						10
Tax/Fiscal Effort	5	7.5			2.5	
Fiscal discipline	7.5	7.5	17.5			
Total	100	100	100	100	100	100

Source: Reports of 11th to 16th Finance Commissions.

The 16th Finance Commission: The Report of the 16th Finance Commission (Chair: Dr. Arvind Panagariya) was tabled in Parliament on February 1, 2026 for the five-year period between 2026-27 and 2030-31. The demand of States was to increase the State' share in divisible from 41% to 50%. Kerala has reinforced to increase the share for social sector expenditure to cater the need of education and health on the priority basis. The states like Tamil Nadu argued to include the Cess and Surcharges like health and education should be included to the divisible pool.

Weights (percentage) of Different Criteria: Eleventh to Sixteenth FC's-2000-01to 2026-31



The take aways from 16th FC are “Contribution to GDP” criterion and enforcing strict fiscal discipline on States by capping deficits and ending off-budget borrowings. The details of each are explained further and inter se share of States are also represented in the Table No.4.

Horizontal Devolution Formula adopted by 16th FC: The horizontal devolution formula of 16th FC is based on six criteria:1) Population, 2) Demographic Performance,3) Area,4) Forest,5) Per-capita GSDP distance, and 6) Contribution to GDP.

Devolution Criteria based on Population Census 1971 & 2011: “Under this criterion, each State receives a share in the proportion of the State’s share in divisible pool, developed based on population, equaling its share in the total population of 28 States.” Population has always been used as a criterion for determining horizontal devolution amongst states by the previous FCs. The 10th to 13 FCs utilized the demography of 1971 population census but from 14th FC Dr. Vijay Kelkar suggested to follow population census of 2011, further as per the report of 15th FC, “the horizontal devolution, while 15th FC agreed that the Census 2011 population data better represents the present need of States, to be fair to, as well as reward, the States which have done better on the demographic front, 15th FC has assigned a 12.5 per cent weight to the demographic performance criterion. 15th FC has re-introduced tax effort criterion to reward fiscal performance.” Table-4 is reflecting the inter se share of States which is reflecting the highest share of Uttar Pradesh i.e. 17.619 as we all know the population of UP is largest and according to the devolution criteria the State has secured highest share in the devolution criterion.

3. Demographic Performance

“Under this criterion each State receives a per capita amount in proportion to inverse population growth between 1971 and 2011. The higher the population growth, the lower the proportionate per-capita amount.” The 15th FC had introduced this parameter to award states for controlling population on the basis of Total Fertility Rate (TFR). The 16th FC has redefined this to account for population growth between 1971 and 2011 instead of relying on change in TFR. States with lower population growth will have a higher share under this parameter. The allocation of funds on the basis of demographic performance was first considered by 15th FC 12.5 % of the total States’ share was devoted to this segment. Moving ahead towards 16th FC 10% share of total divisible pool is allocated to the demographic performance.

4. Per capita GSDP Distance

“Under this criterion, each State receives a per-capita share in the proportion of the States’ share in the divisible pool devolved based on the per-capita GSDP distance criterion in proportion to the difference between a target per-capita GSDP and its own per-capita GSDP.” This criterion is well accepted and considered weight that has been welcomed as equity variable for correcting the fiscal performance of the States. As mentioned in the report of 16th FC, “It is aimed at correcting for differences in fiscal capacity among States by devolving more to States with lower per capita GSDP. Most of the past FCs have set benchmark per capita GSDP from which the distance is measured, equal to average per capita GSDP of States with second and third highest per capita GSDP among the large States. For this purpose, we use average per capita income of states over 2018-19 to 2023-24 excluding COVID-19 year 2020-21.”

Forest: Under this criterion, we have two components :i) base on the States’ share in the forest area of all 28 States and ii) the States’ share in the increase in forest area of all States between 2015 and 2023.

Table-4 Inter se Share of States

States	Share (percentage)
Andhra Pradesh	4.217
Arunachal Pradesh	1.354
Assam	3.258
Bihar	9.948
Chhattisgarh	3.304
Goa	0.365
Gujrat	3.755
Haryana	1.361
Himachal Pradesh	0.914
Jharkhand	3.357
Karnataka	4.131
Kerala	2.382
Madhya Pradesh	7.347
Maharashtra	6.441
Manipur	0.626
Meghalaya	0.631
Mizoram	0.564
Nagaland	0.481
Odisha	4.420
Punjab	1.996
Rajasthan	5.926
Sikkim	0.335
Tamil Nadu	4.097
Telangana	2.174
Tripura	0.641
Uttar Pradesh	17.619
Uttarakhand	1.141

West Bengal	7.215
Total	100
Source:16 th FC Report	

5. Contribution to GDP 2026-30

“Under this criterion, each State receives a share in the proportion of the States’ share in the divisible pool, devolved based on the contribution of GDP, equaling the share of squared root of its GSDP in the sum of squared root of GSDPs of all 28 States.” The criterion of contribution to GDP is a new one whereas 10% share of total funds has already been allocated to the divisible pool. Some States demanded rewards on the basis of industrial efficiency. Maharashtra and Gujarat, contributing nearly 25% of India’s GDP combined, argued they face higher urban infrastructure costs due to rapid industrialisation. 16th FC has rewarded 10% weight to the States performing best economic outcomes.

6. Conclusion

In the history of Finance Commission in India since 1952 the funds are being distributed between Centre and States: Vertical Devolution further States’ share divided amongst States: Horizontal devolution. With the growth of the Indian Economy, the resources were multiplied and the liabilities of States also increased with rising population. The regional diversity became more fatal with shrinking resources and increasing population in such crucial condition the role of horizontal devolution becomes more important in the States’ growth and performance. In this paper it was witnessed that the periodic issues were handled very tactfully with the shift in the devolution criteria, the changing values of underlying parameters also changed with the slight difference of criterion. A change in the State’ share of the divisible pool marks a considerable change in the transferred percentage and that may change the future growth trajectory of the State.

India is a developing nation with a Vision @2047, the geopolitical issues price of petroleum products and the regional turbulent have impacted the pace of State’ Economy. A Historical preview of horizontal devolution has represented a clear picture of Indian States; in this crucial time the criteria of horizontal devolution needed a revisit and the ToR of President able guidance of Centre Government the balanced allocation of resources shall have a positive impact on the growth and development of the Indian state. 16th FC has strictly enforced the States; fiscal deficit capping at 3% of GSDP. Off Budget borrowings have set to an end all the liabilities of the State should duly be sanctioned through Budgetary provisions. The criteria of weightage like demographic performance, per capita GSDP distance, contribution to GDP, and forest cover are the six criteria that are the basis of horizontal devolution. Taking experience of previous FCs and with the ToR given by the President and with demand of all the 28 States the 16th FC is on board and seems to be landing safely.

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