WHEN EXCEPTIONS SWALLOW THE RULE: CESSES, SURCHARGES, AND THE EROSION OF THE DIVISIBLE POOL

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ABSTRACT

India's constitutional framework establishes fiscal federalism to create partnership-based financial cooperation between national and state governments through the Finance Commission's tax distribution system. The current fiscal operations of India show evidence that the country has moved away from its original constitutional framework. The study investigates how Union government budgetary practices of using cesses and surcharges have affected Constitution-based fiscal distribution methods which use Article 270 to operate.

The research study investigates three main research questions which are defined as follows: (i) How has the expanded use of cesses and surcharges affected the constitutionally mandated tax-sharing framework between the Union and the States? (ii) Does the exclusion of cesses and surcharges from the divisible pool under Article 270 undermine the principles of fiscal federalism? (iii) What are the constitutional and legal implications of this practice in light of the Basic Structure Doctrine?

The research employs both doctrinal research methods and empirical research methods for its investigation. The study uses constitutional laws together with Finance Commission reports, Comptroller and Auditor General (CAG) reports, judicial precedents and fiscal data to show how revenue streams and their distribution have changed through time. The study examines the Goods and Services Tax (GST) Compensation Cesses through a case study which focuses on its effectiveness during the COVID-19 pandemic to demonstrate how centralized fiscal systems affect real-world outcomes.

The research paper shows that cesses and surcharges receive constitutional authorization yet their increasing share in total tax revenue leads to a diminished pool of revenue sharing which restricts states' financial independence. The study maintains that these instruments create an ongoing system of "backdoor centralization" which disrupts cooperative federalism while violating federalism principles established in S.R. Bommai v. Union of India. Uncontrolled financial centralization creates major dangers to

India's federal system which needs judicial examination and institutional changes to restore constitutional order according to the study's findings.

INTRODUCTION

One of the essential features of the Indian Constitutional framework is “fiscal federalism”. It refers to the mechanism by which fiscal power and responsibilities are distributed among different levels of government, mainly the Union Government and State Government. Since India follows a federal system of government, there is a need to balance the financial needs of the Central government and those of the States Government. The Union government collects most of the taxes, while the State governments are primarily responsible for implementing various welfare schemes on specific subject matters. For the same, the Constitution has duly prescribed a systematic tax revenue structure[1] on the recommendations of the Finance Commission.

Article 270, through its language, establishes the concept of “divisible Pool”, which refers to the mechanism by which Union taxes should be shared with the States. The Finance Commission do periodically recommend the percentage of this pool, that how much of this should go to the State, to ensure the fairness and equitable distribution of financial resources. By this, the Constitution helps to promote cooperative federalism and financial partnership between the different levels of government.

With this, the constitutional provision itself has allowed the imposition of certain additional taxes in the form of cesses and surcharges. These are imposed over the usual taxes charged under the provision, for any specific purposes like Health, Education, Cleanliness, etc. Even by Article 271 of the Indian Constitution, the parliament has the power to impose surcharges for its own purposes. Most importantly, the taxes collected through cesses and surcharges are not included in the “division pool” under Article 270 and are wholly retained by the Union govt.

However, in recent times the, the Union govt. has increased the no. of cesses and surcharge which has raised the concern that such collection of taxes will not be forming part of the division of poll, and thus leading to the decrease in the share of the state in the taxes collected. This had a huge impact on the financial autonomy of the states and the overall functioning of

[1] The Constitution of India, art. 270

cooperative federalism in India.

For the same reason, the current study helps to examine the constitutionality of the above-mentioned practice. The research focuses on the three questions (i) how the increase in use of cesses and surcharge has affected the constitutionality of the tax sharing structure? (ii) Does the exclusion of the cesses and surcharge from the division pool undermine the fiscal federalism in India? And (iii) What are the implications of these, highlighting the Basic Structure Doctrine?

For the same, the paper adopts both doctrinal and empirical research methods. The structure of the paper flows in such a way that it starts with the analysis of its use of it and then presenting a case study related to the fiscal centralisation and analyses the constitutionality of the same. Finally, conclude on the suggestion of possible reforms for the balance between the Union and State Govt.

CONSTITUTIONAL FRAMEWORK OF FISCAL FEDERALISM IN INDIA

Concept

It refers to the concept to where the financial power, taxation authority and expenditure responsibility are distributed between the different levels of government. It helps to ensure all the levels of government have adequate resources.[2] In India, it is particularly helpful as this helps to assign a portion of the taxes for the welfare and developmental schemes. In India, a lot of important subject matters such as health, education, public order etc.… are allocated to states, but the major tax sharing goes to the Union government, which creates a fiscal imbalance in the society. Hence, a Proper mechanism of tax sharing should be there to ensure the states share sufficient financial resources to carry out their constitutional duties. In India, it is done by the recommendation of the Financial Commission, which decides the percentage division between the Union and the State. It was established under Article 280 of the Constitution to ensure the equitable distribution of the financial resources and further helps to strengthen the cooperative Federalism.[3]

[2] McMillan M, 'Review of *Fiscal Federalism* by WE Oates' (1973) 14 *Public Choice* 155 http://www.jstor.org/stable/30022712 accessed 1 March 2026

[3] Fifteenth Finance Commission, *Report for 2021–26* (Government of India 2021) https://fincomindia.nic.in/asset/doc/commission-reports/XVFC-Complete-Report-1.pdf accessed 1 March 2026.

Constitutional Scheme of Tax Distribution

It is governed through the distribution of powers between the Union and State Governments through the Seventh Schedule in the Indian Constitution. The Seventh Schedule divides the legislative subjects in the three lists: Union List, State List and Concurrent List. Each list defines the subject matter and the respective authority to have the power to make law over it, with the power to levy tax over that subject matter.[4]

If we have a look at the subject matters in the list in the Schedule, we will find that the union covers the matters which are broader and more productive sources of taxations and hence able to collect a larger portion of tax revenue. Hence, for the same reason, the Constitution has established the concept of divisible pool where certain taxes, even though collected by the Union Govt are later assign to/ given to the State government. This percentage of the division between the Union and the state has changed over the period of time. For example, in the 14th Finance Commission of India, the percentage of states' share increases from 32% to 42%, which is a significant step towards fiscal federalism.[5]

Constitutional Position of Cesses and Surcharge

Constitution by Article 270 provides for certain additional taxes to be imposed by the Union Government in the form of cesses and surcharges. As seen before, these are imposing for a specific purpose such as education, infrastructure, health initiatives, etc. Although they are forms of taxation, their constitutional treatment differs. They do not form part of the Divisible pool and thus retained by the Union Government.[6]

The original purpose of the cesses and surcharge was to impose the additional taxes whenever required by the union, but not to replace the original tax distribution system with the help of the loopholes in the mechanism.[7] But the time and gain it has been misused by the government and have severely affected the fiscal federalism in India by reducing the shares of the states in the tax revenue system.[8] This was duly highlighted in the CAG reports[9] and the 15th Finance

[4] M P Jain, *Indian Constitutional Law* (8th edn, LexisNexis 2018)
[5] Fourteenth Finance Commission of India, *Report* (2015) https://fincomindia.nic.in/asset/doc/commission-reports/14th-FC/14thFCReport.pdf
[6] M Govinda Rao, 'Cesses and Surcharges: Implications for Fiscal Federalism' *Economic and Political Weekly*
[7] Pinaki Chakraborty, 'Intergovernmental Fiscal Transfers in India' *NIPFP Working Paper*.
[8] Rathin Roy, 'Fiscal Federalism in India' Economic and Political Weekly
[9] Comptroller and Auditor General of India, *Union Government Accounts Reports*.

Commission report.

GROWTH OF CESSES AND SURCHARGES IN THE UNION TAXATION AND ITS IMPACT

The use of cesses and surcharges is not new; it has been in practice since the early years of the Republic of India. However, the reliance has been significantly increasing during the economic reforms in the 1990s. Mainly over the past two decades, has been when the union government has introduced the various number of cesseses like Education cesses, Swachh Bharat Cesses, Krishi Kalyan Cesses, etc…

According to the policy researchers, when they analyse the fiscal data of the country, they find that the share of cesses and surcharge in the union government's gross tax revenue has been substantially increased from 10.4% in 2011-12 to 20.2% in 2020-21.[10] This shows that there has been an increase in the use of this exception given to the government under Articles 270 and 271 of the Constitution. Though it slightly declined during the year 2023-24 to around 14.5%, it is still considerably high when compared to earlier levels.[11]

The government data indicates that the Union government collected approximately in the year 2021-2022 collected 4.83 lakh crore through cesses and surcharges.[12] Even the CAG reports and the Finance Commission in their report have pointed out the effect of this on the tax distribution system design in the constitution.

Data shows that even though the financial commission recommends a higher percentage for the states in the divisible pool, due to the increasing use of cesses and surcharge, a large portion of the text collected is through non-taxable levies, which overall decreases the share of states in the tax revenue system.

The data shows that in the year 2023-24, the government has collected around 71,000 crore

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[10] Pavithra K M, 'Share of Cesses & Surcharges in Gross Tax Revenue Falls to 14.5% in 2023–24, But Still Much Higher Than in 2011–12' (Factly, 8 August 2025) https://factly.in/share-of-cesses-surcharges-in-gross-tax-revenue-falls-to-14-5-in-2023-24-but-still-much-higher-than-in-2011-12/ accessed 1 March 2026

[11] Pavithra K M, 'Share of Cesses & Surcharges in Gross Tax Revenue Falls to 14.5% in 2023–24, But Still Much Higher Than in 2011–12' (Factly, 8 August 2025) https://factly.in/share-of-cesses-surcharges-in-gross-tax-revenue-falls-to-14-5-in-2023-24-but-still-much-higher-than-in-2011-12/ accessed 1 March 2026

[12] Surabhi, 'Cesses and surcharges continue to grow, estimated at Rs 6.3 lakh crore in FY27' Business Today (11 March 2026) https://www.businesstoday.in/latest/economy/story/cesses-and-surcharges-continue-to-grow-estimated-at-rs-63-lakh-crore-in-fy27-520089-2026-03-11 accessed 1 March 2026.

rupees in the name of Health and education cesses, around 74,000 crores in the name of agriculture infrastructure cesses and around 81,000 crores in the name of development cesses.[13] This has raised concerns around the overall tax revenue sharing system, its transparency and the fiscal balance between the union and the state government.

CASE STUDY: GST COMPENSATION CESSES AND FISCAL CENTRALISATION

In 2017, the introduction of the goods and services tax (GST) in India had a major impact on the indirect taxation system. It has replaced several numbers of Central and state taxes to have a unified tax structure in the country. It has a very significant impact on the federal relationship between the union and the State Government from the aspect of fiscal relationship.

The transition to GST has required this state to surrender all its power related to the taxation system around most subject matters. It has raised concern regarding the revenue lost to the states, and for the same, the GST compensation says was introduced by the union government on certain luxury and sin goods such as Tabacco products, coal, aerated beverages etc. This was imposed with the aim to re-emphasise the states for any shortfall they face in their GST revenue during the transitional period of 5 years.[14] Under the compensation formula, the states were assured by the union that their GST revenue would grow at an annual rate of 14% from the base year 2015-16, and if there is any difference found, then that would be paid to the states from the compensation cesses collected.[15]

But when the country was hit by the COVID-19 pandemic, there was a major downfall in economic activity, which led to a substantial fall in the GST collection in the states. There was a major gap in the GST revenue of the states, which was not even able to be covered with the large compensation cesses collected to date.[16] They were around a gap of 3 lakh crore. Union proposes the states to borrow the fund from the market to cover the shortfall, and later pay back in the market from the future GST Compensation Cesses collection.[17] This was denied and opposed by a lot of states, as this would create a financial burden of them.

[13] Pavithra K M, 'Data: Share of Cesses & Surcharges in Gross Tax Revenue Falls to 14.5% in 2023–24, Down from the High of 20.2% in 2020–21' (Factly, 24 March 2025) https://factly.in/data-share-of-cesses-surcharges-in-gross-tax-revenue-falls-to-14-5-in-2023-24-down-from-the-high-of-20-2-in-2020-21/ accessed 1 March 2026
[14] Government of India, *GST (Compensation to States) Act 2017*
[15] Fifteenth Finance Commission, *Report for 2021–26* (Government of India 2021) https://fincomindia.nic.in/asset/doc/commission-reports/XVFC-Complete-Report-1.pdf accessed 1 March 2026
[16] Reserve Bank of India, *State Finances: A Study of Budgets* (2022)
[17] Ministry of Finance, Government of India, *GST Compensation Borrowing Mechanism* (2020)

This shows that, even though the GST Compensation Cesses were collected for the states' benefit, as it was administered and control by the union government, the states government have limited control over it. When the state government become increasingly dependent on the centrally controlled revenue mechanism, the fiscal autonomy of the states gradually declines.

CONSTITUTIONAL AND JUDICIAL PERSPECTIVE

With the increasing use of cesses and surcharges by the union government, the debate has been raised in the society regarding its constitutionality and for the same, we need to look at the aspect that does the federalism (more specifically, the fiscal federalism) is part of the basic structure or not.[18]

Various judgments in India have recognised federalism as a basic structure of the constitution. Doctrine of basic structure was first discussed and formulated in the landmark case of Keshavanand Bharati versus state of Kerala[19] by the supreme court. The judgment said that the parliament has very wide powers to alter the constitution's articles, but that power is limited to a certain extent so that it cannot alter or destroy the basic structure of the constitution. Although the court in the case has not provide an exhaustive list of the elements which constitutes the basic structure but it emphasizes on various fundamental principle such as the rule of law, separation of power and federalism, which forms the core framework of the constitution. The judgment has observed that in the federal structure in India, there is a shared governance between the union and the state authorities, which is derived from the articles of the Constitution itself. The court further stressed on the point that there is a need of balance between the union and the state government which helps to preserve and maintain the integrity of the constitutional system.

The rising use of cesses and surcharges by the union government has raises concerned among the scholars and policy makers. An increase in use of cesses and surcharges will lead to a reduction in the amount of revenue available for the states to be distributed. This will have a huge impact on the fiscal autonomy of the state and will alter the balance that was aimed to be created by the constitution between the union and the States for their fiscal powers.[20]

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[18] MP Jain, *Indian Constitutional Law* (8th edn, LexisNexis 2018)
[19] *Kesavananda Bharati v State of Kerala* (1973) 4 SCC 225 (SC)
[20] Fifteenth Finance Commission, *Report for 2021–26* (Government of India 2021) https://fincomindia.nic.in/asset/doc/commission-reports/XVFC-Complete-Report-1.pdf accessed 1 March 2026.

Although the constitution itself, through Articles 270 and 271[21], allows the use of cesses and surcharges by the government, their growing role in the tax system of the country raises the discussion about that whether there is a need for additional safeguards or institutional reforms that are necessesary to maintain the spirit of cooperative federalism in the current society.

BACKDOOR CENTRALISATION AND FEDERAL IMBALANCE

As seen above, the increase in the use of cesses and charges by the Indian government has led to a concern that it may lead to a gradual form of fiscal centralisation, which does not form part of the traditional mechanism of tax revenue sharing, as stated under the constitution and recommended by the Finance Commission of India. The cesses and surcharges imposed by the union government are excluded from the framework established under Article 270 of the Constitution; hence, the revenue collected from them is entirely retained by the union government itself. Therefore, their portion of the revenue sharing increases as compared to what is left for the state's distribution.

This development has been described by various scholars as in the form of back-door centralisation, where the fiscal autonomy has shifted from the union government to the state government, without any formal changes in the constitutional structure.[22] It impacts in a way that even when the finance commission recommend the higher percentage of tax sharing for states, effectively the state share is lesser than the union share as a large portion of the tax collected does not form part of the tax structure under Article 270.

Another implication of this is that it will increase the dependency of the state government on the Union government for financial aspects. The states will more heavily rely on the central government for its centrally sponsored schemes or discretionary funding by the union government, whenever they feel required. This heavily impacts the fiscal autonomy of the states and limits their ability to design policies for its welfare, tailoring to the local development need.

Another implication of it is that increasing centralisation of the financial resources may also impact the cooperative federalism, which is an important part of India's governance system. Cooperative federalism is based on the idea that the Union and State governments should work

[21] Constitution of India 1950*, arts 270–271*

[22] K Venkataraman, 'Fiscal Federalism and Cesses in India' (2021) *Economic and Political Weekly*.

together as partners in achieving every national development goal. However, if at the end, there is an imbalance between the financial resource sharing and all the financial resources are concentrated at the centre level, then it may create a difference between the state and center to work together.

Therefore, several scholars and policy experts have argued that there is a need for institutional safeguards to preserve the constitutional balance between the union and the state government. The possible reforms could include the need of greater transparency in the use of cesses and surcharges imposed by the union government, periodic review of their share percentage by the financial commission etc... such reforms should help to ensure that the broader objective of federalism and cooperative governance in India.

RECOMMENDATION AND REFORM PROPOSAL

The increase in the use of cesses and surcharge has led to the rise in the concern regarding the long-term balance of fiscal federalism in India. Several scholars have suggested the reforms that need to be made in the system, to ensure that the equitable tax sharing system between the Union and state remains.

One of the reforms could be that there is a need of transparency and accountability in the system when it comes to the collection and utilisation of cesses and surcharges. The reports of the Controller and Auditor General of India have time and again, pointed out that the funds that are collected through cesses and surcharges are not always transfer fully to designated reserves funds created for the specific purposes. CAG has pointed out the discrepancies between the collection of the amount and what is actually credited to the corresponding funds in the public account of India.

Another possible reform could be that there should be a limit on the exercise of power related to cesses and surcharges by the union government. They should not excessively charge surcharges and cesses, and try to alter the overall tax structure. Various economists have observed that a large portion of the taxes is collected through these non-shareable instruments, which leads to the disturbance in the fiscal federalism in the country.[23] Various economists have suggested that there should be a periodical review by the parliament of the overall text structure, and they should ensure that cesses and surcharges should be used as a supplement

[23] McMillan M, 'Review of *Fiscal Federalism* by WE Oates' (1973) 14 *Public Choice* 155 http://www.jstor.org/stable/30022712 accessed 1 March 2026

and not as a dominant source of revenue.

The role of the financial commission should also be strengthened. Their role should not be limited to the extent of recommending the percentage for the distribution of tax, but also to assessing the impact of non-shareable instruments on the size of the divisible pool, and they should have the power to suggest the appropriate corrective measures for the same.[24] Lastly, the judicial oversite can also be helpful for overall strengthening of the fiscal federalism in the country. Time and again, the Supreme Court has recognised federalism as a constitutional basic structure in various landmark judgments.[25] So, if the court finds that any practice is significantly altering the balance of power between the union and the state government, then the court should have the power to examine such a practice.

All these forms could together help to ensure that cesses and surcharges may continue to serve legitimate policy purposes without destroying the fiscal federalism in the country.

CONCLUSION

The Indian constitution was design in such a way that the fiscal federalism between the union and the state government are assured. The mechanism of distribution of revenue collected in the form of tax on the recommendation of the financial commission under Article 270 shows that both levels of Government have financial autonomy.

However, we observe that the increase in the use of surcharges as given by the power under Article 271 to the Union Government has acted as a barrier to creating a fiscal federalism and lead to disturb the financial autonomy of the states.

The example of GST compensation cess shows how a centralised fiscal instrument can influence the financial relationship between the Union and the States. The Indian courts have time and again recognised federalism as a part of the basic structure of the constitution. Hence, there is a need for a transparent system of fiscal distribution between the union and the state government. This paper, after analysing all the situations, has suggested a few reforms that could help to strengthen fiscal federalism in the country.

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[24] Fifteenth Finance Commission, *Report for 2021–26* (Government of India 2021) https://fincomindia.nic.in/asset/doc/commission-reports/XVFC-Complete-Report-1.pdf accessed 1 March 2026
[25] *Kesavananda Bharati v State of Kerala* (1973) 4 SCC 225 (SC); *S.R. Bommai v. Union of India* (1994).