



# 16TH FINANCE COMMISSION: KEY PROVISIONS DECODED

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**Context:**

- The 16th Finance Commission (16th FC), chaired by Dr. Arvind Panagariya, submitted its report for the 2026-31 period, maintaining the states' vertical tax devolution share at 41%.

**1. What is Finance Commission?**

- The Finance Commission is constituted by the President under article 280 of the Constitution, mainly to give its recommendations on **distribution of tax revenues between the Union and the States and amongst the States themselves.**
- It is **not a permanent body** and the **President of India** constitutes the Finance Commission every **fifth year** or at such earlier times as he/she considers necessary.
- **Two distinctive features of the Commission's work** involve redressing the **vertical imbalances between the taxation powers and expenditure responsibilities of the centre and the States respectively** and **equalization of all public services across the States.**
- As the **recommendations of the 15th FC** cover the **six-year period up to 31st March 2026**, the **16th FC** is proposed to be constituted now.
  - This will enable the **Finance Commission** to consider and appraise the **finances of the Union and the States for the period immediately**, preceding the period of its **recommendations.**
  - **The Advance Cell of the 16th FC was formed in Ministry of Finance on 21.11.2022**, to oversee preliminary work, pending formal constitution of the Commission.

**2. What is the composition of Finance Commission?**

- The Finance Commission consists of a **Chairman and four other members** to be appointed by the **President.**

- The **Chairman** and other members of the Commission hold office for such period as specified by the **President in his/her order**.
- The **Chairman and other members** of the Commission are eligible for **reappointment**.

<b>16TH Finance Commission</b>	
<b>Chairman</b>	<b>Arvind Panagariya (former Vice Chairman of NITI Aayog)</b>
<b>Members</b>	<p><b>Smt. Annie George Mathew</b></p> <ul style="list-style-type: none"> <li>● Full-time Member of the Sixteenth Finance Commission &amp; Former Special Secretary-Department of Expenditure, Ministry of Finance</li> </ul>
	<p><b>Dr. Manoj Panda</b></p> <ul style="list-style-type: none"> <li>● Full-time Member of the Sixteenth Finance Commission &amp; Former Director of the Institute of Economic Growth, Delhi and the Centre for Economic and Social Studies (CESS), Hyderabad</li> </ul>
	<p><b>Mr T Rabi Sankar</b></p> <ul style="list-style-type: none"> <li>● Part time Member of Sixteenth Finance Commission and Deputy Governor, Reserve Bank of India</li> </ul>
	<p><b>Dr. Soumya Kanti Ghosh</b></p> <ul style="list-style-type: none"> <li>● Group Chief Economic Adviser of SBI</li> </ul>

### 3. What are the qualifications of members of Finance Commission (FC)?

- The **Constitution authorizes the Parliament** to determine the qualifications of members of the **Commission**.
- As per the provisions contained in the **Finance Commission [Miscellaneous Provisions] Act, 1951 and The Finance Commission (Salaries & Allowances) Rules, 1951**, the qualifications of the members of the Finance Commission are as follows:
  - The **Chairman** should be a person having **experience in Public Affairs**.
  - The **four other members** should be selected from amongst the following:
    - a **judge of the High Court or one qualified to be appointed as one**.
    - a **person who has specialized knowledge of finance and accounts of the government**.
    - a **person who has wide experience in financial matters and administration**.
    - a **person who has special knowledge of Economics**.

**4. What are the functions of the Finance Commission?**

Functions of the Finance Commission	Description
<b>Tax Devolution (Vertical &amp; Horizontal Distribution)</b>	<ul style="list-style-type: none"> <li>● Recommends <b>distribution of net tax proceeds between Union and States (vertical sharing)</b>.</li> <li>● Allocates shares <b>among States (horizontal sharing)</b>.</li> </ul>
<b>Principles of Grants-in-Aid</b>	<ul style="list-style-type: none"> <li>● Suggests <b>principles governing grants-in-aid</b> to States.</li> <li>● <b>Funds</b> are provided from the <b>Consolidated Fund of India</b>.</li> </ul>
<b>Strengthening Panchayati Raj Institutions</b>	<ul style="list-style-type: none"> <li>● Recommends measures to <b>augment State Consolidated Funds</b>.</li> <li>● Aims to supplement resources of <b>Panchayats based on State Finance Commission recommendations</b>.</li> </ul>
<b>Strengthening Urban Local Bodies</b>	<ul style="list-style-type: none"> <li>● Suggests measures to <b>enhance State funds</b>.</li> <li>● Supports financial needs of <b>Municipalities based on State Finance Commission recommendations</b>.</li> </ul>
<b>Advisory Role on Fiscal Matters</b>	<ul style="list-style-type: none"> <li>● Addresses any <b>other matter</b> referred by the President</li> <li>● Ensures sound <b>financial management and fiscal stability</b></li> </ul>

**5. What safeguards exist to ensure impartiality of members of the Finance Commission?**

- **Personal interest to disqualify members:**
  - Before **appointing a person to be a member of the Commission**, the **President shall satisfy himself** that that person will have no such **financial or other interest** as is likely to affect prejudicially his functions as a **member of the commission**; and the **President shall also satisfy himself from time to time with respect to every member of the Commission** that he has **no such interest** and any person who is, or whom the **President proposes to appoint** to be, a member of the **Commission shall**, whenever required by the **President** so to do, furnish to him such **information as the President considers necessary** for the **performance by him of his duties** under this section.

**6. What is the time period of 16th Finance Commission?**

- The **16th Finance Commission of India**, chaired by **Dr. Arvind Panagariya**, is tasked with recommending the formula for sharing tax revenue between the **Central and State governments for a five-year period**.

- The commission's recommendations cover the **financial years 2026-27 to 2030-31, officially starting on April 1, 2026.**

**7. What are the Key Recommendations of the 16th Finance Commission (2026–31)?**

- 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.**
- Key recommendations of the **Commission include:**

Key Recommendations	About
<b>Share of states in central taxes</b>	<ul style="list-style-type: none"> <li>• The <b>share of states in the divisible pool of central taxes</b> has been recommended at <b>41%.</b></li> <li>• This is same as the <b>share recommended by the 15th Finance Commission.</b></li> <li>• <b>Divisible pool</b> is arrived at after <b>excluding cost of collection and cesses</b> and surcharges from the <b>gross tax revenue collected by the central government.</b></li> </ul>
<b>Criteria for devolution</b>	<ul style="list-style-type: none"> <li>• The <b>16th Finance Commission (2026–31)</b> recommended maintaining the <b>vertical devolution of central taxes to states at 41%,</b> while revising horizontal distribution criteria to include a <b>10% weight for "Contribution to GDP."</b></li> <li>• Key criteria include <b>Income Distance (42.5%), Population (17.5%), Demographic Performance (10%), Area (10%), and Forest &amp; Ecology (10%).</b></li> </ul>
<b>Per Capita GSDP Distance (Income Distance)</b>	<ul style="list-style-type: none"> <li>• The <b>16th FC has defined income distance</b> as the difference between the <b>per capita GSDP of a state</b> and the <b>average of the per capita GSDP of the top three large states with the highest per capita GSDP.</b></li> <li>• <b>Per capita GSDP</b> has been computed as the average over the <b>period 2018-19 and 2023-24,</b> excluding the pandemic year of <b>2020-21.</b></li> <li>• States with a <b>lower per capita GSDP will receive a higher share</b> on this parameter, to maintain equity among states.</li> </ul>
<b>Population</b>	<ul style="list-style-type: none"> <li>• On this parameter, the <b>share in devolution is determined based on the share in the population as per the 2011 Census.</b></li> </ul>
<b>Demographic Performance</b>	<ul style="list-style-type: none"> <li>• The <b>15th FC had introduced this parameter</b> to award states for controlling population on the basis of <b>Total Fertility Rate (TFR).</b></li> </ul>

	<ul style="list-style-type: none"> <li>• The <b>16th FC</b> has redefined this to account for population growth between <b>1971 and 2011</b> instead of relying on change in TFR.</li> <li>• States with lower population growth will have a <b>higher share under this parameter</b>.</li> </ul>
<b>Forest</b>	<ul style="list-style-type: none"> <li>• The <b>16th FC</b> has assigned weightage to both the share of a state in the overall forest area, and its <b>share in the increase in overall forest area between 2015 and 2023</b>.</li> <li>• Further, it has also <b>considered open forests</b> in arriving at the total forest area.</li> <li>• In contrast, the <b>15th FC</b> had considered <b>only dense and moderately dense forests</b>, and defined the <b>parameter only in terms of share in the overall forest area</b>.</li> </ul>
<b>Contribution to GDP</b>	<ul style="list-style-type: none"> <li>• The <b>16th FC</b> has introduced this parameter to account for the <b>contribution to national GDP</b>.</li> <li>• This replaces the <b>tax and fiscal efforts parameter</b> used by the <b>15th FC which rewarded states with a higher tax collection efficiency</b>.</li> <li>• <b>Contribution to GDP by a state is calculated</b> as the squared root of its GSDP to the sum of squared root of <b>GSDP of all states</b>.</li> <li>• <b>GSDP of each state has been measured as the average nominal GSDP between 2018-19 and 2023-24 (excluding the pandemic year of 2020-21)</b>.</li> </ul>
<b>Grants-in-aid</b>	<ul style="list-style-type: none"> <li>• The <b>16th FC</b> has recommended grants worth <b>Rs 9.47 lakh crore</b> over the <b>five-year period</b>.</li> <li>• These comprise grants for: <b>(i) urban and rural local bodies, and (ii) disaster management</b>.</li> <li>• The <b>16th FC</b> has discontinued the following grants recommended by the <b>15th FC: (i) revenue deficit grants, (ii) sector-specific grants, and (iii) state-specific grants</b>.</li> </ul>
<b>Grants for local bodies</b>	<ul style="list-style-type: none"> <li>• The <b>16th FC</b> has recommended grants worth <b>Rs 4.4 lakh crore</b> and <b>Rs 3.6 lakh crore</b> for <b>rural and urban local bodies</b>, respectively.</li> <li>• These grants are divided into <b>basic (80%) and performance-based (20%) components</b>.</li> </ul>

- **Special Infrastructure Grants and Urbanisation Premium Grants** have also been recommended for **urban local bodies**.
- These are discussed in further detail below:
- **All local body grants will be made available upon fulfilment of three entry-level criteria:**
  - (i) constitution of the local bodies as per the Constitution,
  - (ii) publication of provisional and audited accounts of the local bodies in the public domain, and
  - (iii) timely constitution of the State Finance Commission.
- **Basic grants:**
  - 50% of the basic grant will be untied and the rest 50% will be tied to:
    - (i) sanitation and solid waste management, and/or
    - (ii) water management.
- **Special infrastructure grants:**
  - This component will be tied to the development of a comprehensive wastewater management system in cities with population between 10-40 lakh as per the 2011 census.
  - Grants worth Rs 56,100 crore have been recommended over five years.
- **Urbanisation premium grant:**
  - These will be released to states as a one-time grant for:
    - (i) merger of peri-urban villages into adjoining urban local body areas and
    - (ii) formulation of a Rural to Urban Transition Policy.
  - Rs 10,000 crore have been recommended under the urbanisation premium component.
- **Disaster management grants:**
  - The **Commission has recommended disaster management corpus of Rs 2,04,401 crore for State Disaster Relief and Management Funds (SDRF and SDMF).**
  - The cost-sharing pattern between the centre and states is recommended to be:
    - (i) **90:10 for north-eastern and Himalayan states, and**

	<p><b>(ii) 75:25 for all other states. Centre's share in total will be Rs 1,55,916 crore.</b></p>
<p><b>Fiscal Roadmap</b></p>	<ul style="list-style-type: none"> <li>● The <b>Commission has recommended that the Centre</b> should bring down fiscal deficit to <b>3.5% of GDP by 2030-31.</b></li> <li>● It recommended the annual <b>fiscal deficit limit for states to be 3% of GSDP.</b></li> <li>● It also recommended strictly discontinuing the practice of <b>off-budget borrowings</b> for states and bringing all such borrowings onto their budgets.</li> <li>● The definition of <b>fiscal deficit and debt should</b> be expanded to uniformly include all <b>off-budget borrowings.</b></li> <li>● The Commission has projected the combined debt of the <b>central and state governments to decline from 77.3% in 2026-27 to 73.1% of the GDP in 2030-31.</b></li> </ul>
<p><b>Subsidy Expenditure</b></p>	<ul style="list-style-type: none"> <li>● The <b>Commission recommended states to review and rationalise their subsidy expenditure.</b></li> <li>● It noted that schemes providing unconditional <b>cash transfers tend to have large and untargeted</b> beneficiaries.</li> <li>● It recommended <b>setting clear exclusion criteria and a rigorous review process</b> to ensure <b>effective targeting.</b></li> <li>● In addition, it <b>recommended discontinuing financing of subsidies through off budget borrowings.</b></li> <li>● The <b>Commission also noted a lack of standardisation in defining and accounting of subsidies and transfers across states.</b></li> <li>● It observed that <b>subsidies and transfers across states are being misclassified as assistance, grants, or other expenditure.</b></li> <li>● It recommended <b>adoption of a uniform approach</b> for accounting and disclosure of subsidies and transfers.</li> </ul>
<p><b>Power-sector reforms</b></p>	<ul style="list-style-type: none"> <li>● The <b>Commission recommended that states</b> should actively pursue <b>privatisation of electricity distribution companies (DISCOMs).</b></li> <li>● To shield the <b>private investor from debt burden after discom takeover,</b> a special <b>purpose vehicle may be created to warehouse the debt.</b></li> </ul>

	<ul style="list-style-type: none"> <li>● <b>Pre-payment or eventual repayment of this debt</b> may be allowed using the funds from the <b>Special Assistance Scheme</b> for Capital Investment.</li> <li>● It also recommended that states should be allowed to utilise this <b>assistance only after the privatisation</b> process is complete.</li> </ul>
<b>Public Sector Enterprise Reforms</b>	<ul style="list-style-type: none"> <li>● The <b>Commission</b> recommended a review and closure of <b>308 inactive State Public Sector Enterprises (SPSEs)</b>.</li> <li>● It recommended formulation of a <b>state-level PSEs disinvestment</b> policy to target inactive and underperforming SPSEs.</li> <li>● <b>State or union PSEs</b>, which incur losses for three out of four consecutive years, should be placed for the respective Cabinet’s consideration.</li> <li>● The Cabinet may decide <b>closure, privatisation, or continuation</b> depending on the strategic importance of the enterprise.</li> </ul>

**8. Highlight key differences between 15th and 16th Finance Commission (2026–31)?**

**Table 1 :** The criteria for horizontal devolution among States over the last five FCs

Criteria	11th FC 2000-05	12th FC 2005-10	13th FC 2010-15	14th FC 2015-20	15th FC 2021-26
Income Distance	62.5	50	47.5	50	45
Population (1971 Census)	10	25	25	17.5	-
Population (2011 Census)	-	-	-	10	15
Area	7.5	10	10	15	15
Forest cover	-	-	-	7.5	-
Forest and ecology	-	-	-	-	10
Infrastructure index	7.5	-	-	-	-
Fiscal discipline	7.5	7.5	17.5	-	-
Demographic performance	-	-	-	-	12.5
Tax effort	5	7.5	-	-	2.5
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

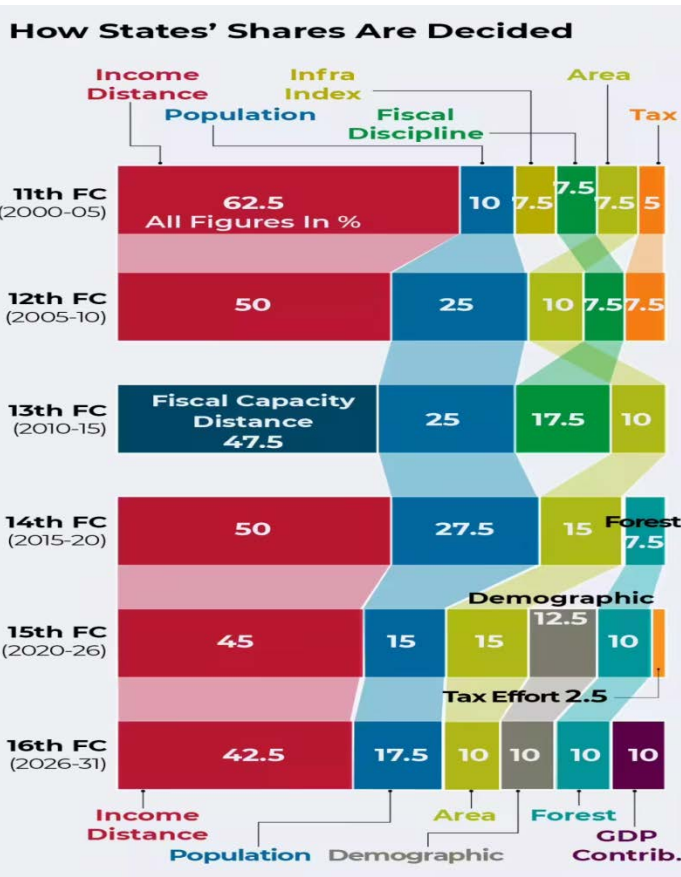
**Table 1: Criteria for distribution of central taxes among states**

Criteria	15 <sup>th</sup> FC (2021-26)	16 <sup>th</sup> FC (2026-31)
Income Distance	45%	42.5%
Population (2011)	15%	17.5%
Demographic Performance	12.5%	10%
Area	15%	10%
Forest	10%	10%
Tax and Fiscal Efforts	2.5%	-
Contribution to GDP	-	10%
<b>Total</b>	<b>100%</b>	<b>100%</b>

Sources: Reports of the 15<sup>th</sup> and 16<sup>th</sup> Finance Commissions; PRS.

## 9. How State's share is decided?

How States' Shares Are Decided		
Criteria	What They Mean	
Population	Per capita distribution of tax revenues should be as uniform as possible	
Area Adjusted	States with large inaccessible tracts need additional money	
Forest Cover	Forest as % of total area	
Infrastructure Index	States with less developed social and physical infra get more funds	
Income Distance	Distance of a state's income from the income of the richest three states, adjusted for the state's population	
Fiscal Capacity Distance	Distance between a state's per capita tax capacity and that of the highest-performing state	
Tax Effort	Measures taken by states to increase tax collections	
Fiscal Discipline	Efforts by states to control spending or raise revenues	
Demographic Performance	Reward for state with lower fertility, counter balances population criterion	
Contribution to GDP	Share of a state's GDP in all states' combined GDP, a new criterion	



10. Why GDP contribution enters the Finance Commission formula?

- For the first time, **contribution to national GDP** has been included as a horizontal devolution criterion with a **10 percent weight**.
- **Karnataka gains 0.48 percentage points**.
- **Kerala gains 0.45 percentage point**.
- **Madhya Pradesh loses 0.50 percentage point**.
- **Bihar loses 0.11 percentage points**.
- The formula now combines **income distance, population, demographic performance, area, forest, GDP contribution**. **Income distance** continues to drive equalisation.
- GDP contribution introduces an **efficiency signal**.
- It helps to distinguish **between efficiency of a production system and efficiency of a fiscal system**.
- **GSDPs and GDP are the outcome of the production system** in a country which is largely driven by market forces.
- **Inter-state variation** in the contribution of the **GSDP of an individual state to the overall GDP** depends largely on the inter-state concentration of **capital stock, inter-state movement of financial and human resources** and state level availability of infrastructure.
- The introduction of **contribution to GDP** as a parameter is a bold step as it clearly **puts growth and consequent improvement** in the per capita incomes of citizens as an important imperative.

**Individual share of states in the taxes devolved by the centre (out of 100)**

State	14th FC (2015-2020)	15th FC (2021-26)	16th FC (2026-31)
Andhra Pradesh	4.31	4.05	4.22
Arunachal Pradesh	1.37	1.76	1.35
Assam	3.31	3.13	3.26
Bihar	9.67	10.06	9.95
Chhattisgarh	3.08	3.41	3.30
Goa	0.38	0.39	0.37
Gujarat	3.08	3.48	3.76
Haryana	1.08	1.09	1.36
Himachal Pradesh	0.71	0.83	0.91
Jammu and Kashmir	1.85	-	-
Jharkhand	3.14	3.31	3.36
Karnataka	4.71	3.65	4.13
Kerala	2.50	1.93	2.38
Madhya Pradesh	7.55	7.85	7.35
Maharashtra	5.52	6.32	6.44
Manipur	0.62	0.72	0.63
Meghalaya	0.64	0.77	0.63
Mizoram	0.46	0.50	0.56
Nagaland	0.50	0.57	0.48
Odisha	4.64	4.53	4.42
Punjab	1.58	1.81	2.00
Rajasthan	5.50	6.03	5.93
Sikkim	0.37	0.39	0.34
Tamil Nadu	4.02	4.08	4.10
Telangana	2.44	2.10	2.17
Tripura	0.64	0.71	0.64
Uttar Pradesh	17.96	17.94	17.62
Uttarakhand	1.05	1.12	1.14
West Bengal	7.32	7.52	7.22

Sources: Reports of the 14th, 15th, and 16th Finance Commission Reports

**11. Why local body transfers are performance linked now?**

- **Local bodies will receive Rs 7.91 lakh crore** between 2026 and 2031, with **60 percent** going to rural bodies and **40 percent** to urban bodies.
- Within this, **80 percent** is basic grants and **20percent** is performance-linked.
- Performance conditions include **audited accounts publication, property tax system strengthening, and own revenue growth targets.**
- **A shift to uniform, on-budget accounting** will ensure states remain committed to the path of fiscal prudence.

**Grants-in-aid for 2026-31**  
(in Rs crore)

Grants	Amount
<b>Local governments</b>	<b>7,91,493</b>
<b>Rural local bodies</b>	<b>4,35,236</b>
Basic Grant	3,48,188
Performance Grant	87,048
<b>Urban local bodies</b>	<b>3,56,257</b>
Basic Grant	2,32,125
Performance Grant	58,032
Special Infrastructure Component	56,100
Urbanisation Premium	10,000
<b>Disaster management</b>	<b>1,55,916</b>
<b>Total</b>	<b>9,47,409</b>



**12. What are the key concerns associated with the 16th Finance Commission? Vertical Devolution Concerns**

Concerns	About
<b>Concern Over Rising Cesses and Surcharges</b>	<ul style="list-style-type: none"> <li>● <b>No recommendation to curb</b> the increasing reliance on <b>cesses and surcharges.</b></li> <li>● This is viewed as against the <b>spirit of fiscal federalism and constitutional principles.</b></li> </ul>

	<ul style="list-style-type: none"> <li>● The Commission did not strongly assert its constitutional role under <b>Articles 270 and 280 in addressing this issue.</b></li> </ul>
<b>Missed Opportunity on Equalisation:</b>	<ul style="list-style-type: none"> <li>● <b>Devolution formulae</b> alone cannot capture cost and <b>need differentials across India's diverse States.</b></li> <li>● <b>Article 275</b> allows for <b>grants to address specific needs and equalise public services.</b></li> <li>● The discontinuation of <b>revenue gap and State-specific grants reduces the equalisation function.</b></li> </ul>
<b>Reduction in Resource Transfers to States</b>	<ul style="list-style-type: none"> <li>● <b>Discontinuation of revenue deficit grants.</b></li> <li>● Removal of <b>sector-specific grants.</b></li> <li>● It will reduced <b>fiscal support from Centre to States.</b></li> </ul>
<b>Changes in Horizontal Devolution Criteria</b>	<ul style="list-style-type: none"> <li>● Introduction of a new parameter: <b>Contribution to GDP.</b></li> <li>● However few concerns in it are:</li> <li>● It is <b>not aligned with demand of richer States (wanted share in total tax contribution).</b></li> <li>● Use of <b>square root formula dilutes its overall impact.</b></li> </ul>
<b>Concerns Over Dropping Revenue Deficit Grants</b>	<ul style="list-style-type: none"> <li>● <b>Commission avoided complexities in estimating deficits by removing the provision altogether.</b></li> <li>● The <b>16th Finance Commission (FC) has eliminated Post-Devolution Revenue Deficit Grants (RDGs) for the 2026-31 period,</b> marking a <b>major departure from previous commissions</b> that provided these grants to bridge the <b>gap between states' revenue and expenditure.</b></li> </ul>
<b>Issues with Population Criterion</b>	<ul style="list-style-type: none"> <li>● Current <b>approach does not adequately account for migration trends.</b></li> <li>● This may <b>disadvantage certain States, especially those experiencing high in-/out-migration.</b></li> </ul>
<b>Local Body Financing:</b>	<ul style="list-style-type: none"> <li>● <b>Mandatory conditions</b> require states to transfer <b>20% of grants to local bodies</b> and enforce stricter property tax collection, placing pressure on <b>local revenue generation.</b></li> </ul>
<b>Subsidy &amp; Spending Control:</b>	<ul style="list-style-type: none"> <li>● The <b>Commission urges states</b> to cut <b>unconditional cash transfers</b> and stop off-budget borrowing to <b>manage debt, promoting stricter fiscal consolidation.</b></li> </ul>

**KERALA**

- The Centre slashed the borrowing limit for the state **from Rs 32,442 crore to Rs 15,390 crore.**
- The Centre insists on considering borrowing by Kerala Infrastructure Investment Fund Board as the state's borrowing.
- Cessation of the GST compensation led to a shortfall of around Rs 7,000 crore for the State.
- Share of Kerala was 3.875% of the divisible pool to be distributed among states during the term of the 10th finance commission. It came down to 1.925% during the 15th finance commission's term.
- Shortfall of around Rs 6,700 crore due to the reduction of the revenue deficit grant by the Centre.

 The Centre has been adopting a negative attitude towards the development of the state while also trying to undermine federalism. It's move to curtail the state's borrowing limit reflects its sadistic mentality."  
- **PINARAYI VIJAYAN**, Kerala CM

**WEST BENGAL**

 The ruling Trinamool Congress alleges that the Centre owed West Bengal government **over Rs 12,300 crore** dues under various central schemes

**PUNJAB**

- The Centre slashes borrowing limit for Punjab **from Rs 39,000 crore to Rs 21,000 crore.**
- The Centre has also stopped grant of **Rs 2,600 crore** (Special Assistance Grant for Development of Capital Assets) and **Rs 800 crore** grant under the National Health Mission for Punjab.
- The AAP government of Punjab condemned Centre's "discrimination" against the state.

 "The curtailing of the borrowing limit is an attack on federalism. The Centre is showing a step-motherly attitude towards Himachal Pradesh."  
- **SUKHVINDER SINGH SUKHU**  
Himachal Pradesh CM

**HIMACHAL PRADESH**

- The Centre has cut Himachal Pradesh's borrowing limit **from Rs 14,000 crore to Rs 9,000 crore.**
- The state's Congress government has been asking the Centre to release **Rs 9,242.60 crore** deposited under the New Pension System with the Pension Fund Regulatory and Development Authority.
- Himachal Pradesh is one of the states that reintroduced the Old Pension Scheme for its employees.

 "We are not begging for alms. We are asking for the state's dues."  
- **BHAGWANT SINGH MANN**  
Punjab CM

**KARNATAKA**

 Chief Minister Siddaramaiah alleges that the Centre has not yet released **Rs 5,495 crore** special allowance recommended for the state by the 15th Finance Commission in its interim report.

**TAMIL NADU**

- The DMK government since 2021 has been pushing for extension of the GST compensation period from 5 to 7 years.
- M K Stalin's government has been opposing late disbursement of the state share of the GST.
- The state government opposes bringing petrol under the ambit of GST.

**TELANGANA**

 T Harish Rao, the finance minister of the BRS government, alleges that the Centre flouted principle of federalism by cutting Telangana's loan limit by **Rs 15,033 crore** in 2022-23.

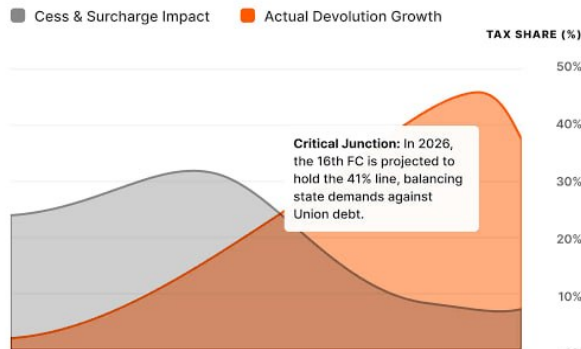


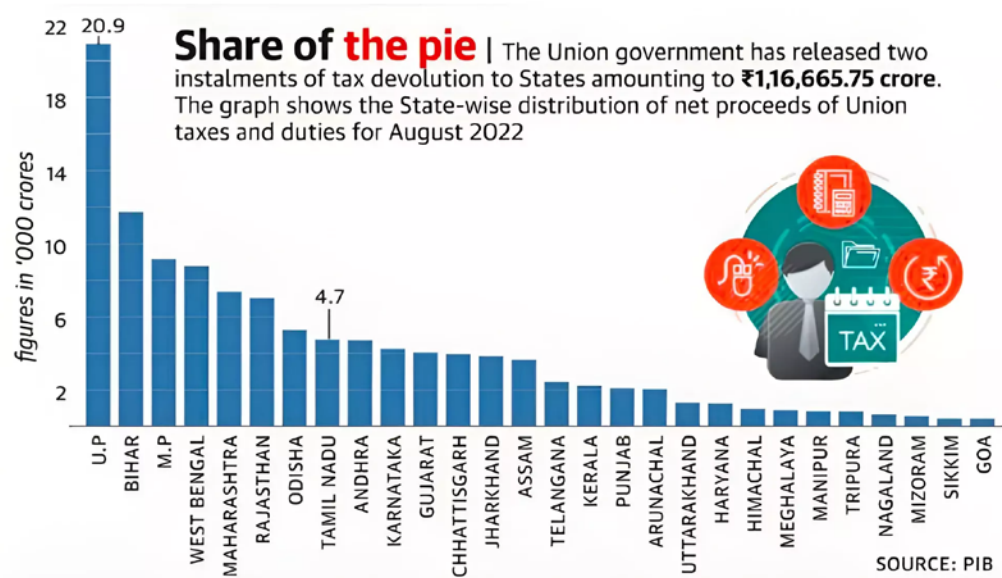
**Fiscal Federalism Debates**

Exploring the 16th Finance Commission's decision to maintain state tax devolution at 41% amidst rising central fiscal pressures.

This visual was created for "The Federal Dilemma Ahead of 2026". Get exclusive insights at [politicalmarketer.com/report](https://politicalmarketer.com/report)

REPORT

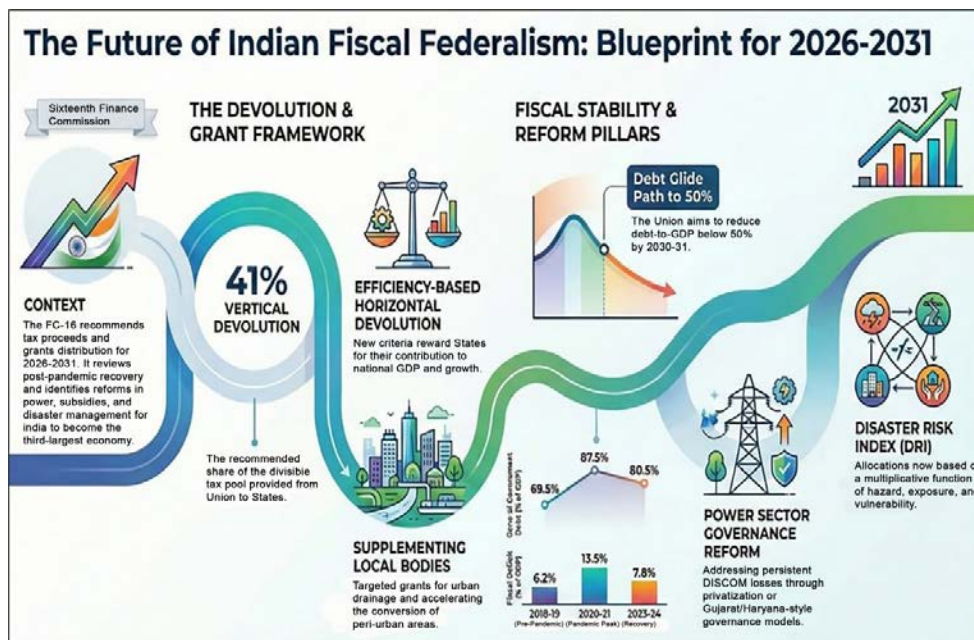




### 13. What is Fiscal Federalism?

- **Fiscal federalism is an economic framework for understanding the relationship among federal, state, and local governments that focuses on the division of spending and taxing powers among these governments.**
- Fiscal federalism is primarily an **economic, rather than political, theory of relationships among central and noncentral governments.**
- Main focus is the **division of responsibilities** among different types of governments.
  - For example, the **traditional theory of fiscal federalism** argues that the **central government should be responsible for macroeconomic policies** but local governments should be primarily responsible for fire protection services.
- Another **focus of fiscal federalism** is the **division of revenue-raising powers among various governments**, often referred to as “tax assignment.”
- The **traditional theory of fiscal federalism** argues that taxes on highly mobile entities should be **assigned to the central government**, and taxes on less mobile entities to state or local governments.
- Finally, **grants-in-aid** become an important topic in fiscal federalism because of the potential mismatch between a government’s **expenditure responsibilities and its tax capacity.**
- The traditional theory of **fiscal federalism** sets out principles regarding the **proper division of spending responsibilities** and taxing powers among types of governments.
- The term “**fiscal federalism**” is often used in a broader sense that includes a description of the **actual division of spending and taxing powers.**
- Economists often use the term “**fiscal federalism**” to refer to one part of the field of **public finance.**

- **Public finance is the economics of government** spending and taxation, and when more than one type of government is involved economists apply the label of **“fiscal federalism.”**
- There are some differences between **fiscal federalism and political theories of federalism.**
  - **Fiscal federalism applies to any country with both central and decentralized governments,** as long as the decentralized governments have **some control over spending and taxing policies.**
  - This control does not have to be **substantial or constitutionally based.**
  - Thus **fiscal federalism applies to many countries** that **political** scientists would categorize as **unitary rather than federal.**
  - When applied to the **United States, fiscal federalism** typically includes **local governments in addition to the federal government and state governments.**
  - In the fiscal federalism framework, the fact that **local government powers are not constitutionally independent** is irrelevant.



## 14. Discuss the major challenges confronting fiscal federalism in India?

Major Challenges	Description
<b>Shrinking Divisible Pool (Cesses and Surcharges)</b>	<ul style="list-style-type: none"> <li>● The <b>Centre has increasingly relied on cesses and surcharges</b> rather than basic taxes, which are not shared with states, reducing the overall state share from <b>35% in 2015-16 to around 30% in 2023-24.</b></li> </ul>
<b>Reduced Financial Autonomy and GST Implementation</b>	<ul style="list-style-type: none"> <li>● <b>Post-GST, states have limited capability to raise their own taxes,</b> leading to reliance on compensation from the Centre.</li> <li>● Issues with timely <b>GST compensation and a complex rate structure further hinder fiscal flexibility.</b></li> </ul>

<b>Vertical Fiscal Imbalance and Dependence on Transfers</b>	<ul style="list-style-type: none"> <li>● <b>States are responsible for substantial public spending</b> but face inadequate revenue generation, forcing them to rely <b>heavily on central transfers</b>.</li> </ul>
<b>Overdependence on Centrally Sponsored Schemes (CSS)</b>	<ul style="list-style-type: none"> <li>● Increasing reliance on <b>tied transfers (CSS) restricts states' autonomy</b> to design policies tailored to local needs. These schemes force states to contribute more to <b>centrally mandated projects</b>.</li> </ul>
<b>Borrowing Constraints and Debt</b>	<ul style="list-style-type: none"> <li>● The <b>Centre restricts state borrowing to around 3% of GSDP</b>, limiting their capacity to finance infrastructure projects, per the RBI 2023 report.</li> <li>● Additionally, <b>state borrowing is constrained by existing central loans</b>.</li> </ul>
<b>Horizontal Disparities and Formula Disagreements</b>	<ul style="list-style-type: none"> <li>● <b>Diverse regional economic levels make it difficult to balance the needs of developed versus developing states</b>, particularly with the <b>15th Finance Commission's</b> criteria, which some states feel penalizes them.</li> </ul>
<b>Political Bias in Allocation</b>	<ul style="list-style-type: none"> <li>● <b>Opposition-ruled states</b> frequently raise concerns about <b>political bias and a lack of transparency</b> in central funding decisions.</li> </ul>
<b>Fiscal Crisis of Local Governments</b>	<ul style="list-style-type: none"> <li>● While <b>states seek more power, they often fail to decentralize finances to local urban and rural bodies</b>, which are left with severely limited revenue options.</li> </ul>

### 15. What measures can be adopted to strengthen fiscal federalism in India?

Measures to be adopted	About
<b>Empowering Institutions</b>	<ul style="list-style-type: none"> <li>● <b>Strengthening Constitutional Bodies:</b> <ul style="list-style-type: none"> <li>▪ Institutions like the <b>Finance Commission should be granted greater functional autonomy</b> and a wider mandate to ensure fair and transparent fiscal transfers between the Centre and States.</li> </ul> </li> <li>● <b>Revitalising Cooperative Federal Platforms:</b> <ul style="list-style-type: none"> <li>▪ The <b>NITI Aayog must be further empowered</b> to act as an effective platform for <b>Centre–State collaboration</b> through institutionalised dialogue and policy coordination.</li> </ul> </li> </ul>
<b>Enhancing Role of Local</b>	<ul style="list-style-type: none"> <li>● Institutions such as <b>Panchayati Raj Institutions and Urban Local</b></li> </ul>

<b>Governments</b>	<b>Bodies</b> should be strengthened through greater <b>financial devolution, administrative capacity building, and functional autonomy.</b>
<b>Institutionalising Fiscal Discipline</b>	<ul style="list-style-type: none"> <li>● Mechanisms like <b>Fiscal Responsibility legislation and independent fiscal councils</b> should be reinforced to ensure <b>transparency, accountability, and prudent fiscal management.</b></li> </ul>
<b>Reducing Dependence on Cess and Surcharge</b>	<ul style="list-style-type: none"> <li>● The Union government should limit the use of <b>cesses and surcharges, as these are not shareable with States,</b> to ensure a more <b>transparent and equitable fiscal distribution system.</b></li> </ul>
<b>Addressing Inequities</b>	<ul style="list-style-type: none"> <li>● The foundational vision of the <b>Constitution’s framers to reduce socio-economic disparities</b> appears to be weakening in present <b>fiscal policies.</b></li> <li>● Over time, this <b>objective has been distorted,</b> with excessive centralisation contributing to a <b>relatively regressive taxation structure.</b></li> <li>● There is a <b>need to reorient India’s intergovernmental transfer system</b> towards greater <b>equity and inclusiveness.</b></li> </ul>
<b>Towards a New Fiscal Federal Architecture</b>	<ul style="list-style-type: none"> <li>● India can realise the spirit of the ‘grand bargain’ by building a robust fiscal federal framework, where <b>GST functions as a unifying mechanism.</b></li> <li>● Strengthening this architecture will <b>reinforce cooperative federalism</b> and ensure <b>better coordination among all levels of governance.</b></li> </ul>
<b>Rationalising CSS and Public Expenditure</b>	<ul style="list-style-type: none"> <li>● The <b>structure of Centrally Sponsored Schemes (CSS)</b> needs to be reworked to restore greater <b>fiscal autonomy</b> to States.</li> <li>● A <b>cooperative framework</b> should be developed for <b>rationalising both Central Sector schemes and CSS.</b></li> </ul>

**16. What is the relevance of the topic for UPSC CSE?**

- **For Prelims:** Finance Commission, Tax Devolution, Cess, Surcharge, Total Fertility Rate, Fiscal deficit
- **For Mains:** Recommendations of the 16th Finance Commission, Tax Devolution its significance and its Constitutional Mandates, Evolution and role of Finance Commissions in Indian federalism

**Some previous years prelims questions.**

- Q1. Consider the following (2023)
1. Demographic performance

2. Forest and ecology
3. Governance reforms
4. Stable government
5. Tax and fiscal efforts

For the horizontal tax devolution, the Fifteenth Finance Commission used how many of the above as criteria other than population area income distance?

- (a) Only two
- (b) Only three
- (c) Only four
- (d) All five

**Ans: (b)**

### Some previous years mains questions.

Q1. Examine the evolving pattern of Centre-State financial relations in the context of planned development in India. How far have the recent reforms impacted the fiscal federalism in India? (2025-15Marks)

### Some questions from this year and previous years interview transcripts.

#### Board Suman Sharma mam:

- Who is the chairman of 16th finance commission?

#### Board Anuradha Prasad:

- Define Fiscal discipline?
- Are you ok with current fiscal discipline in Budget?

#### Board Anuradha Prasad:

- What is the revenue deficit?
- What is the fiscal deficit?
- What is the current revenue deficit?
- How are we bridging the gap between them?

#### Board Anuradha Prasad:

- Tell me about Finance Commission: Horizontal and Vertical devolution?
- What is Criteria for Horizontal devolution
- What is Percapita Income distance used in FC devolution?

**Board Sanjay Verma sir:**

- What is fiscal federalism?
- How are revenues shared between the Centre and the states?

**Board B.B. Swain Sir:**

- Should finance commission's 41% recommendation be increased?

**Some questions for QUIZ.**

Q1. Consider the following parameters

1. Demographic performance
2. Forest
3. Tax and Fiscal efforts
4. Contribution to GDP

For the horizontal tax devolution, the Sixteenth Finance Commission had used how many of the above parameters?

- (a) Only one
- (b) Only two
- (c) Only three
- (d) All four

**Ans: (c)**

**Some questions for POLL.**

Q1. Do you think the 16th Finance Commission has been given adequate autonomy to strengthen fiscal federalism?

- (a) YES
- (b) No
- (c) Can't say.

Q2. Should States be granted more powers to raise their own financial resources under the Finance Commission framework?

- (a) YES
- (b) No
- (c) Can't say.

Q3. Do you believe that current Finance Commission recommendations ensure equitable distribution of resources among States?

- (a) YES
- (b) No
- (c) Can't say.

- Q4. Should State governments be allowed to levy income taxes to enhance fiscal autonomy?
- (a) YES
  - (b) No
  - (c) Can't say.
- Q5. Do you think centralized fiscal policies have weakened cooperative federalism in India?
- (a) YES
  - (b) No
  - (c) Can't say.
- Q6. Should the Finance Commission place greater emphasis on reducing regional inequalities?
- (a) YES
  - (b) No
  - (c) Can't say.
- Q7. Do you agree that GST has strengthened fiscal federalism in India?
- (a) YES
  - (b) No
  - (c) Can't say.
- Q8. Should States have more discretion in utilizing funds allocated by the Finance Commission?
- (a) YES
  - (b) No
  - (c) Can't say.

