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The Freebie Spiral — Fiscal Federalism at Risk as State Cash Transfers Surge

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MAINS RELEVANCE:

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INTERVIEW ANGLE

"Should the Finance Commission or the Supreme Court have the power to set binding limits on state expenditure on unconditional cash transfer schemes? Discuss the constitutional implications."

WHY IN NEWS

The 16th Finance Commission flagged that unconditional state cash transfer schemes — welfare payments with no conditions attached — grew from 3% to 20.2% of state subsidy spending between 2018-19 and 2025-26, raising fundamental questions about fiscal federalism, election-linked spending, and the long-term sustainability of state finances.

THE NUMBERS THAT SHOULD ALARM POLICYMAKERS

The 16th Finance Commission's data tells a stark story. Seven years ago, unconditional cash transfers — direct money payments to beneficiaries with no work requirement, training, or service provision attached — were a small, residual part of state subsidy spending at just **3% of the total** (2018–19). By the Budget Estimates for 2025–26, the same category had ballooned to **20.2%** — a near seven-fold increase in proportional terms.

The absolute numbers are equally striking:

Maharashtra: Unconditional transfers as a share of revenue expenditure rose from **0.6% to 6.2%** — a ten-fold increase. The primary driver: **Majhi Ladki Bahin** scheme (Rs 1,500/month to eligible women), announced ahead of the 2024 Maharashtra assembly elections.

Jharkhand: **0.8% to 13%** of revenue expenditure — a sixteen-fold increase — as the Hemant Soren government expanded **Maiyan Samman Yojana** and related schemes.

Odisha: From nil to **5.1%** — a new category of state expenditure created in one budget cycle.

Karnataka: **Gruha Lakshmi** scheme (Rs 2,000/month to eligible women) represents one of India's largest state-level unconditional cash transfers by per-beneficiary amount.

West Bengal: Lakshmir Bhandar scheme (Rs 500–1,000/month) — one of the earliest large-scale state direct benefit transfers.

What is common across these schemes? They were all announced in the months before state assembly elections. They are structured to disburse money directly to women — a demographic that has emerged as a decisive electoral constituency — with minimal conditionality.

THE CONSTITUTIONAL ARCHITECTURE OF STATE FINANCE

To understand the alarm bells, one must understand how state finances work under India's constitutional framework.

Vertical devolution: The Finance Commission (constituted under **Article 280**) recommends how the divisible pool of central taxes is shared between the Union and states. The 15th Finance Commission recommended **41%** of the divisible pool to states. This fixed share is the primary guaranteed revenue for states.

Own tax revenue: States levy their own taxes — State GST, stamp duties, state excise, vehicle tax. These are elastic in good economic conditions and compress in downturns.

Grants and schemes: The Centre transfers additional funds through Centrally Sponsored Schemes (60:40 or 90:10 Centre:State cost sharing) and Central Sector Schemes (100% central funding). States must provide their matching share.

Borrowings: States can borrow within limits prescribed by Article 293 and the Fiscal Responsibility and Budget Management (FRBM) Act. The FRBM targets a fiscal deficit of **3% of GSDP** for states.

When unconditional cash transfer spending rises dramatically, the money must come from somewhere — either from:

- Cuts to capital expenditure (roads, bridges, hospitals, schools)
- Off-budget financing (borrowings outside the formal budget via SPVs and state-owned entities)
- Increased borrowings (pushing against FRBM limits)
- Crowding out of productive social spending (health, education, skill development)

The Finance Commission's concern is precisely this crowding-out: a rupee spent on an unconditional cash transfer is a rupee not spent on a primary health centre, a school building, or an irrigation canal.

THE CONSTITUTIONAL DEBATE: IS FREEBIES SPENDING UNCONSTITUTIONAL?

The Supreme Court addressed the freebie question in **Subramaniam Balaji vs. State of Tamil Nadu (2013)**, where the petitioner challenged election manifestos promising free items as corrupt electoral practice. The Supreme Court declined to ban freebies, holding that:

Welfare spending is a policy choice within the executive's discretion

There is no constitutional bar on governments fulfilling welfare commitments

The electorate, not courts, should judge the prudence of welfare promises

In **2022**, a three-judge bench examined the issue again. Chief Justice N.V. Ramana's observations were nuanced: the Court expressed concern about the fiscal impact while declining to issue any prohibition, instead asking the Election Commission to consider guidelines. The ECI, in turn, has been reluctant to curb political promises.

The **FRBM Act** provides a statutory constraint: states must file Medium-Term Fiscal Policy Statements and target fiscal deficits within prescribed limits. But the FRBM has no enforcement mechanism beyond the Centre's ability to withhold some grants — a tool rarely used.

THE GENDERED POLITICS OF CASH TRANSFERS

A critical feature of the new generation of state welfare schemes is their **gender targeting**. From Majhi Ladki Bahin to Gruha Lakshmi to Lakshmir Bhandar, state governments have identified women — particularly women from lower-middle income households — as the primary beneficiaries.

The political logic is compelling: women have historically been under-represented as direct beneficiaries of rural development programmes (which tend to focus on farming and construction), while facing disproportionate economic insecurity. Cash in a woman's hand has higher development multiplier effects than the same cash in a man's hand — well-documented in development economics literature.

But there is a difference between:

Conditional transfers (like PM-Kisan, NREGA) that attach the transfer to agricultural activity, asset ownership, or productive work — building asset bases and creating work records

Unconditional transfers (Majhi Ladki Bahin, Gruha Lakshmi) that provide cash with no conditions — maximising immediate consumption benefit but creating long-term fiscal obligations without long-term productivity gains

The Finance Commission is not questioning women's welfare per se — it is questioning whether the fiscal trajectory is sustainable.

OFF-BUDGET FINANCING — THE HIDDEN LIABILITY

One particularly concerning aspect of the Commission's findings is the role of **off-budget financing**. States facing FRBM limits on formal borrowings have increasingly routed expenditure through **State Public Sector Undertakings (SPSUs)** and **State Development Finance Institutions** that borrow on their own balance sheets but with state government guarantees.

When these SPSUs borrow to fund cash transfer schemes, the contingent liability accumulates on the state's balance sheet invisibly — outside the formal fiscal deficit. The RBI's annual **State Finances: A Study of Budgets** report has repeatedly flagged this practice as a source of fiscal opacity.

WHAT THE FINANCE COMMISSION RECOMMENDS

The 16th Finance Commission's recommendations on this issue include:

Sunset clauses: New cash transfer schemes should have defined review dates — ideally within 2 years of launch — to assess fiscal impact and beneficiary outcomes

Exit mechanisms: Clear criteria for when beneficiaries graduate out of the scheme (income thresholds, employment status changes)

Beneficiary rationalisation: Eliminate duplication across central and state schemes

End off-budget financing: All cash transfer spending must be reflected transparently in the state budget, not routed through SPSUs

Periodic independent fiscal review: Finance Commissions should have access to audited SPSU accounts, not just formal budget documents

These are recommendations — the Commission has no coercive power over state governments.

A STRUCTURAL REFORM GAP

India's fiscal federalism design has a fundamental gap: there is **no institution with binding power to review the fiscal sustainability of individual state policies**. The Finance Commission can recommend, the RBI can flag, the Supreme Court can express concern, the ECI can (reluctantly) consider guidelines — but no body can prevent a democratically elected state government from making a fiscal decision, however imprudent.

This is by design — the Constitution's framers valued state autonomy. But the systemic risk has grown: if multiple large states simultaneously increase unconditional cash transfers in election cycles, the aggregate national fiscal risk (through higher Centre borrowing to bail out states in distress) becomes non-trivial.

UPSC RELEVANCE

16th Finance Commission (Article 280; chaired by Arvind Panagariya); cash transfers 3% → 20.2% of state subsidy spending; Majhi Ladki Bahin (Maharashtra); Gruha Lakshmi (Karnataka); Lakshmir Bhandar (West Bengal); FRBM (Fiscal Responsibility and Budget Management Act; 3% GSDP fiscal deficit target for states); Subramaniam Balaji vs. Tamil Nadu (2013 — freebies not unconstitutional); Article 293 (state borrowings); Article 280 (Finance Commission constitution).

*Finance Commission's role and limits in fiscal federalism; constitutional debate on freebies; Centre-state fiscal relations; FRBM and its enforcement gaps; off-budget financing as fiscal opacity. **GS-3:** Welfare economics — unconditional vs conditional transfers; fiscal multiplier effects; women's economic empowerment; long-term fiscal sustainability vs short-term welfare.*

★ FACTS CORNER — KNOWLEDGEPEDIA
16TH FINANCE COMMISSION:

Constitutional basis: **Article 280**

Chairman: **Arvind Panagariya** (former NITI Aayog Vice-Chairman)

Term: Covers 2026-31 fiscal period

Finding: Unconditional cash transfers: **3% (2018-19) → 20.2% (2025-26 BE)** of state subsidy spending

Most affected states: Maharashtra, Jharkhand (→ 13%), Odisha (nil → 5.1%)

MAJOR STATE CASH TRANSFER SCHEMES:

Majhi Ladki Bahin (Maharashtra): Rs **1,500/month** to eligible women; pre-2024 assembly election

Gruha Lakshmi (Karnataka): Rs **2,000/month** to eligible women

Lakshmir Bhandar (West Bengal): Rs **500–1,000/month** (general and SC/ST categories)

Maiyan Samman Yojana (Jharkhand): Rs 2,500/month; expanded under Soren government

FINANCE COMMISSION — CONSTITUTIONAL ARCHITECTURE:

Article **280**: Establishment of Finance Commission (every 5 years)

Article **281**: President lays FC report before Parliament

Article **275**: Grants-in-aid to states as FC recommends

Article **293**: State government borrowings (require Centre's consent if state has Central loan outstanding)

15th FC devolution to states: **41%** of divisible pool (chaired by N.K. Singh)

FRBM FRAMEWORK:

FRBM Act: **2003** (Union); state FRBM Acts enacted separately

State fiscal deficit target: **3% of GSDP** (relaxable in special circumstances)

Enforcement gap: No coercive mechanism; Centre can withhold some grants but rarely does

KEY SC CASES ON FREEBIES:

Subramaniam Balaji vs. Tamil Nadu (**2013**): Freebies not unconstitutional; policy choice; electorate to judge

Ashwini Kumar Upadhyay (**2022**): SC bench expressed concern; no prohibition; asked ECI to frame guidelines

OTHER RELEVANT FACTS:

Off-budget financing: Routed through SPSUs/State DFIs; creates contingent liabilities outside formal fiscal deficit

RBI flags off-budget financing annually in "State Finances: A Study of Budgets" report

Fiscal federalism gap: No institution has binding power over individual state fiscal policy decisions

Sources: The Hindu, RBI State Finances Report

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