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EDITORIAL ANALYSIS

Finance Commission and Fiscal Federalism — The Southern States' Equity Dilemma

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GS2

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The Hindu

MAINS RELEVANCE:

GS Paper 2

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INTERVIEW ANGLE

"Southern states argue that rewarding fiscal discipline and higher GDP growth with smaller shares of devolution penalises economic success — how would you redesign the horizontal devolution formula to balance equity and efficiency?"

WHY IN NEWS

The 16th Finance Commission, chaired by Dr. Arvind Panagariya, is finalising its recommendations ahead of the October 2025 deadline, reigniting the long-standing debate over whether the horizontal devolution formula unfairly disadvantages fiscally prudent and economically advanced southern states.

THE EDITORIAL'S ARGUMENT

The devolution paradox: States that have achieved higher per-capita income, controlled population growth, and maintained fiscal discipline receive a proportionally smaller share of central tax devolution — the very criteria designed to ensure equity end up penalising performance.

Income distance as the dominant criterion: With a 45% weight in the 15th Finance Commission's formula, the income distance criterion overwhelmingly favours poorer states, creating structural imbalance against high-growth states.

Mismatch between contribution and receipt: Southern states collectively contribute a disproportionately high share to central tax revenues through GST, income tax, and corporate tax, yet receive less per rupee contributed than BIMARU states.

Demographic performance penalty: Southern states achieved replacement-level fertility decades ago — a major national goal — but the 12.5% demographic performance criterion rewards this instead of the older 2011 population share, a partial correction that does not address the full imbalance.

The efficiency argument for formula reform: Adding a GDP contribution criterion (proposed at 10% weight for the 16th FC) could incentivise all states to grow their economies rather than rely on redistributive transfers, aligning fiscal federalism with national productivity goals.

Cooperative vs. competitive federalism tension: The Finance Commission is constitutionally mandated to reduce inter-state disparities — but the editorial argues there is a ceiling beyond which redistribution becomes disincentivising, and India may have crossed it.

CONSTITUTIONAL AND STATUTORY FRAMEWORK

Article 280 — Finance Commission

The Finance Commission is a **constitutional body** established under **Article 280** of the Constitution. The President constitutes it every five years (or earlier). Its core mandate:

Recommend the **distribution of net proceeds** of central taxes between the Union and states (vertical devolution)

Recommend the **principles governing grants-in-aid** to states (Article 275)

Determine the **horizontal distribution** among states of their share

Commission	Period	Devolution %	Chairman
14th Finance Commission	2015-20	42%	Y.V. Reddy
15th Finance Commission	2021-26	41%	N.K. Singh
16th Finance Commission	2026-31	TBD	Dr. Arvind Panagariya

The slight reduction from 42% to 41% in the 15th FC was to accommodate Centrally Sponsored Schemes (CSS) and the newly created Union Territory of J&K.

Horizontal Devolution Formula (15th Finance Commission)

Criterion	Weight
Population (2011 Census)	15%
Area	15%
Forest and Ecology	10%
Income Distance	45%
Tax and Fiscal Effort	2.5%
Demographic Performance	12.5%

Income Distance = (Highest per-capita GSDP among states – State’s per-capita GSDP) × State’s population. A state with lower per-capita income gets a larger weight. This is the primary redistributive mechanism.

Demographic Performance = Ratio of Total Fertility Rate in 1971 to TFR in reference year. States that reduced fertility faster get a higher score — this was the 15th FC’s concession to southern states’ concerns.

THE SOUTHERN STATES’ GRIEVANCE

The “**Southern Five**” — Tamil Nadu, Kerala, Karnataka, Telangana, and Andhra Pradesh — have consistently argued that:

They contribute ~35-40% of India’s total GST collections but receive ~15-17% of devolved funds

Their per-capita development expenditure exceeds the national average; they run better schools, hospitals, and infrastructure with their own resources

The 2011 population-based criterion still uses older data — if the 2021 Census (delayed) were to use current populations, southern states would lose further share given their lower population growth

They have met national goals (literacy, fertility, infant mortality) and are being penalised for success

The Counter-Argument

Poorer northern and central states argue:

Fiscal equity demands redistribution from richer to poorer states

The gap in per-capita public services between Bihar and Kerala is a national development failure

Historical reasons (geography, British-era investment) explain north-south divergence, not superior “efficiency”

A GDP criterion would entrench inequality, not reduce it

GADGIL FORMULA — HISTORICAL CONTEXT

The **Gadgil Formula (1969)**, devised by Planning Commission Deputy Chairman Dr. D.R. Gadgil, governed distribution of central plan assistance to states. Its criteria:

Criterion	Weight
Population	60%
Per Capita Income (below national average)	10%
Tax Effort	10%
Special Problems	10%
Plan Performance	10%

The Gadgil-Mukherjee Formula (1991 revision) increased equity weight. With the abolition of the Planning Commission in 2014 and its replacement by **NITI Aayog**, plan transfers were subsumed into untied devolution — making the Finance Commission’s formula more consequential.

FINANCE COMMISSION VS. NITI AAYOG

Feature	Finance Commission	NITI Aayog
Constitutional basis	Article 280	Executive resolution (2015)
Mandate	Tax devolution + grants	Policy advisory, no fund transfer
Binding?	Recommendations binding on Centre if accepted	Advisory only
States’ role	Present memoranda to FC	Participate in Governing Council
Predecessor	—	Planning Commission (1950-2014)

The abolition of the Planning Commission reduced conditional transfers to states and increased states’ dependence on Finance Commission devolution — raising the political salience of the formula.

16TH FINANCE COMMISSION — KEY DEBATES

The 16th FC (2026-31) is considering:

GDP contribution criterion (10% proposed weight) — would directly benefit high-GSDP states

Updated population data — if 2021 Census is completed, formula may shift based on new population numbers

Fiscal consolidation incentive — rewarding states that meet FRBM targets

Urban local body grants — direct transfers to municipalities and panchayats (a 15th FC innovation continued)

Disaster risk reduction — weighting for states with high climate/disaster vulnerability

Prelims: *Article 280, Finance Commission composition, 15th FC devolution %, horizontal vs. vertical devolution, Gadgil Formula.* **Mains GS-2:** *Finance Commission as a constitutional mechanism for fiscal federalism; Centre-state financial relations.* **GS-3:** *Devolution and economic efficiency; inclusive growth vs. redistributive equity.* **Essay:** *“Fiscal federalism in India — balancing equity and efficiency in tax devolution.”*

★ FACTS CORNER — KNOWLEDGEPEDIA
16TH FINANCE COMMISSION:

Constituted: 2023; Chairman: Dr. Arvind Panagariya (former NITI Aayog Vice-Chairman)

Report deadline: October 2025 (covers 2026-31)

Constitutional basis: Article 280

DEVOLUTION SHARE — HISTORICAL TREND:

13th FC: 32% | 14th FC: 42% | 15th FC: 41% | 16th FC: TBD

Reduction 14th→15th: Offset for new UTs of J&K + Ladakh

15TH FC HORIZONTAL FORMULA WEIGHTS:

Income Distance: 45% | Demographic Performance: 12.5% | Population 2011: 15% | Area: 15% | Forest & Ecology: 10% | Tax Effort: 2.5%

SOUTHERN STATES TFR (NFHS-5):

Kerala: 1.8 | Tamil Nadu: 1.8 | Andhra Pradesh: 1.7 | Karnataka: 1.7 | Telangana: 1.8

National average: 2.0 (first time below replacement level)

KEY PERSONS:

Dr. Arvind Panagariya: 16th FC Chairman; former NITI Aayog Vice-Chairman (2015-17)

N.K. Singh: 15th FC Chairman; former Revenue Secretary and Finance Secretary

Y.V. Reddy: 14th FC Chairman; former RBI Governor

OTHER RELEVANT FACTS:

Article 275: Grants-in-aid from Consolidated Fund of India to states

Article 293: States can borrow only from Centre or with Centre's consent if they owe money to Centre

FRBM Act 2003: Fiscal Responsibility and Budget Management Act — sets deficit targets for Centre and states

Divisible pool: Net proceeds of all central taxes after deducting collection charges — shared between Centre and states

GST Council (Article 279A): Example of cooperative federalism; decisions by 3/4th majority

NITI Aayog Governing Council: All CMs + LGs are members; chaired by PM

Source: The Hindu, Vajiram & Ravi

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