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EDITORIAL ANALYSIS

Sixteenth Finance Commission and the Erosion of Fiscal Federalism

INDIAN EXPRESS

7 April 2026 · GS2 GS3

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Sixteenth Finance Commission and the Erosion of Fiscal Federalism

The Indian Express 7 April 2026 GS2 GS3

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CONTEXT

The Indian Express editorial critiques the **Sixteenth Finance Commission (16th FC)** recommendations as a structural shift from **equity-based statutory transfers** toward **discretionary central control**. The editorial argues that effective state devolution is being reduced and **need-based grants** are being discontinued — weakening **cooperative federalism** and the constitutional guarantees of state fiscal autonomy under **Article 280**.

THE EDITORIAL ARGUMENT

1. **Statutory devolution remains constant but effective devolution falls** — while the headline tax devolution share remains around 41%, the actual money reaching states is reduced through cesses and surcharges (not part of the divisible pool)
2. **Discretionary transfers grow at the cost of formula-based ones** — Centrally Sponsored Schemes (CSS) are growing in importance, giving the Centre control over how states spend
3. **Need-based grants discontinued** — earlier Finance Commissions provided grants to states with specific revenue gaps; the 16th FC has reduced these dramatically
4. **Constitutional federalism vs cooperative federalism** — the editorial distinguishes between constitutional rights (states are entitled to a share) and cooperative arrangements (Centre offers to share)
5. **Northern vs Southern states** — fiscally responsible Southern states feel the squeeze as devolution formulas favour population-heavy Northern states

WHAT IS THE FINANCE COMMISSION?

The **Finance Commission** is a constitutional body established under **Article 280** to recommend the distribution of tax revenues between the Centre and States, and among States.

PARAMETER	DETAILS
Constitutional basis	Article 280
Established by	President of India
Frequency	Every 5 years (or earlier if needed)
Members	Chairman + 4 other members
Mandate	(1) Distribution of net proceeds of taxes between Centre and States, (2) Principles for grants-in-aid, (3) Measures to augment Consolidated Funds of States

History of Finance Commissions

FC	PERIOD	CHAIRPERSON	TAX DEVOLUTION SHARE
13th FC	2010-15	Vijay L. Kelkar	32%
14th FC	2015-20	Y.V. Reddy	42% (largest jump)
15th FC	2021-26	N.K. Singh	41%
16th FC	**2026-31**	**Arvind Panagariya**	**TBD** (recommendations under consideration)

The **14th Finance Commission** under Y.V. Reddy made the historic recommendation to raise states' share from 32% to 42% — a transformation in cooperative federalism. The 16th FC under Arvind Panagariya is expected to submit its report by **October 2025**.

TAX DEVOLUTION — THE HEADLINE NUMBER VS REALITY

Headline: 41% (15th FC)

The **divisible pool** consists of net proceeds of all taxes referred to in **Chapter I, Part XII** of the Constitution — Union taxes minus surcharges, cesses, and the cost of collection.

Reality: Cesses and Surcharges

The Centre has increasingly used **cesses** (Health and Education Cess, GST Compensation Cess, Krishi Kalyan Cess, Swachh Bharat Cess) and **surcharges** (Income Tax Surcharge for high earners) — which are **not shared with states** because they fall outside the divisible pool.

Result: Cesses and surcharges grew from ~6% of gross tax revenue in 2009-10 to ~16% in 2022-23. Effective state share has fallen below 35% even though headline statutory share is 41%.

CENTRALLY SPONSORED SCHEMES (CSS) — A DIFFERENT CHANNEL

YEAR	NUMBER OF CSS	SHARE OF CENTRE'S TOTAL SPENDING
2014-15	66	~22%
2024-25	28 (rationalised)	~30%

CSS allows the Centre to **direct state spending** on its priorities — even though the constitutional principle is that states have autonomy over List II subjects. Examples include:

- PM-KISAN (income support for farmers)
- PMAY (housing for all)
- PMGSY (rural roads)
- Swachh Bharat Mission
- Jal Jeevan Mission

States must contribute matching grants (typically 25-40%) to access CSS funds — which forces them to align spending with central priorities.

NORTH VS SOUTH DEVOLUTION DEBATE

The North-South divide in fiscal federalism stems from the **devolution formula**, which uses:

- **Population** (current criterion using 2011 Census) — favours northern states
- **Income distance** (gap from highest per capita state) — favours poorer states
- **Forest cover, demographic performance, tax effort** — secondary criteria

Southern states' grievance: Tamil Nadu, Karnataka, and Kerala argue they:

- Have lower fertility (population control success) → "punished" with smaller share
- Generate higher per capita tax revenue → "subsidising" northern states

- Have made structural development progress → no longer entitled to backwardness grants

Northern states' counter: Higher population means higher needs for services, infrastructure, and welfare.

CESSES AND SURCHARGES ISSUE

YEAR	CESSES + SURCHARGES AS % OF GROSS TAX REVENUE
2009-10	~6%
2014-15	~9%
2018-19	~11%
2022-23	**~16%**

This rise has been criticised by all major opposition parties and several state governments. The **15th Finance Commission** recommended that the Centre limit cesses and surcharges to **strict minimum** — but the recommendation has not been implemented.

UPSC RELEVANCE

GS Paper 2 — Polity & Governance

- Article 280 — Finance Commission
- Centre-State financial relations
- Cooperative federalism vs constitutional federalism
- Centrally Sponsored Schemes
- North-South divide in devolution

GS Paper 3 — Indian Economy

- Tax devolution and fiscal federalism
- Cesses and surcharges
- Divisible pool composition
- Public finance and state budgets

Mains Probable Questions:

- "Critically examine the role of the Finance Commission in maintaining fiscal federalism in India. How has the use of cesses and surcharges by the Centre affected effective devolution?" (250 words)

- "The North-South divide in tax devolution reflects deeper questions about equity, efficiency, and federal principles. Discuss." (250 words)

FACTS CORNER

- The **Finance Commission was first established in 1951** under Chairman K.C. Neogy — the first FC report was submitted in 1952.
- **K.C. Neogy** was the only person to chair the Finance Commission and also serve as a member of the Union Cabinet — a unique position in Indian constitutional history.
- The **16th FC's terms of reference**, set by the President in November 2023, include considering the **impact of GST** (since 2017), the need for revenue stability for states, and population data based on the **2011 Census** (since the 2021 Census remains uncompleted).
- **Article 270** specifies which taxes are shareable; **Article 271** allows the Centre to impose a surcharge for its own purposes that is NOT shareable — this is the constitutional basis for the Centre's growing reliance on surcharges.
- The **Goods and Services Tax (GST)** is a critical part of fiscal federalism — through the GST Council, where states have a 2/3 weighted vote — but GST has constrained states' tax-raising autonomy on most goods and services.
- **Arvind Panagariya** was the first Vice Chairman of NITI Aayog (2015-2017) before being appointed Chairman of the 16th Finance Commission.

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