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EDITORIAL ANALYSIS

Finance Commission Transfers and the Equity Issue

 THE HINDU

26 May 2026

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INTERVIEW ANGLE

"If equity-weighted devolution discourages high-performing States, how would you redesign the horizontal sharing formula without penalising the poorest States?"

EDITORIAL SUMMARY:

The Hindu argues that India's fiscal federalism depends on the Finance Commission (Article 280) correcting two imbalances — the vertical gap between a tax-rich Centre and expenditure-heavy States, and the horizontal gap between richer and poorer States. The 16th Finance Commission, chaired by Arvind Panagariya for the 2026-27 to 2030-31 award period, retains the 41% vertical devolution share and an equity-weighted horizontal formula in which Income Distance carries the dominant weight. While equity transfers legitimately protect fiscally weaker States, an over-emphasis on redistribution can dull the incentive for fiscal discipline and own-revenue effort. The formula must balance equity with efficiency and reward productive governance.

THE CONSTITUTIONAL ANCHOR: ARTICLE 280

The Finance Commission is the institutional core of Centre-State fiscal relations. It is a constitutional body established under **Article 280**, constituted by the **President of India** every five years or at such earlier time as the President considers necessary. It functions as a **quasi-judicial body** — its recommendations are advisory, but by convention the Centre accepts the core devolution recommendation in full.

Its mandate under Article 280(3) is to recommend:

- the distribution of the **net proceeds of taxes** between the Union and the States (the vertical share), and the allocation of the States' portion among them (the horizontal share);
- the principles that should govern **grants-in-aid** to States out of the Consolidated Fund of India under **Article 275**;

- measures to **augment the Consolidated Fund of a State** to supplement the resources of panchayats and municipalities on the basis of the recommendations of the State Finance Commission;
- any other matter referred to it by the President in the interest of sound finance.

THE 16TH FINANCE COMMISSION

The 16th Finance Commission carries this mandate into the second half of the decade.

FEATURE	DETAIL
Chairman	Arvind Panagariya (former Vice Chairman, NITI Aayog)
Constituted	December 31, 2023
Award period	2026-27 to 2030-31 (five years)
Effective from	April 1, 2026
Vertical devolution share	41% (retained from the 15th Finance Commission)

The 41% vertical share has a recent history. The **14th Finance Commission** raised the States' share to a then-unprecedented **42%**. After the reorganisation of Jammu and Kashmir into Union Territories, the **15th Finance Commission** trimmed this to **41%** to account for the Centre's direct responsibility for the new UTs, and the 16th has retained that figure.

VERTICAL AND HORIZONTAL IMBALANCE

The Finance Commission exists because India's federation is fiscally asymmetric in two directions.

IMBALANCE	NATURE	ILLUSTRATION
Vertical	The Centre commands the more buoyant and elastic taxes (personal income tax, corporation tax, its share of GST), while States carry the heavier expenditure responsibilities	States fund the bulk of spending on health, education, police, agriculture and local administration
Horizontal	Richer States have larger own-tax bases and higher per-capita incomes than poorer States	Maharashtra, Tamil Nadu, Karnataka and Gujarat versus Bihar, Uttar Pradesh, Jharkhand and Madhya Pradesh

Vertical devolution and grants-in-aid (Articles 270 and 275) address the first; the horizontal formula addresses the second.

THE HORIZONTAL DEVOLUTION FORMULA

The horizontal formula is where the equity-efficiency tension lives. The criteria and weights used by the 15th Finance Commission — the template the 16th has been working from — were:

CRITERION	WEIGHT	ORIENTATION
Income Distance	45%	Equity — gap from the highest per-capita-income State
Population (2011 Census)	15%	Need
Area	15%	Need
Forest and Ecology	10%	Ecological compensation
Demographic Performance	12.5%	Rewards lower fertility — favours southern States
Tax and Fiscal Efforts	2.5%	Efficiency — the lone reward for own-revenue effort

The arithmetic tells the story. **Income Distance alone carries 45%** of the weight, and the criterion measures how far a State's per-capita income falls below the richest State — so it transfers most to the poorest. Against this, the only explicit efficiency reward — **Tax and Fiscal Efforts** — is just **2.5%**.

THE EQUITY-EFFICIENCY TENSION

The dominant Income Distance weight heavily favours lower-income States. The southern and western States argue that they are, in effect, **penalised for success** — for generating higher per-capita incomes, mobilising more own revenue and achieving demographic transition earlier.

The 15th Finance Commission attempted a partial answer by introducing the **Demographic Performance** criterion (12.5%), which rewards States that have lowered their fertility rates and thereby cushions the southern States against the use of the 2011 Census population.

Yet the deeper concern remains: with the efficiency reward set at only 2.5%, devolution offers a **weak incentive for own-revenue mobilisation**. A State that improves its tax administration gains little in the formula, while transfers driven overwhelmingly by income distance can create a **moral hazard** in which redistribution is divorced from performance.

THE CESSES AND SURCHARGES PROBLEM

Beyond the formula lies a structural grievance. **Cesses and surcharges are not part of the divisible pool** under Article 270 — they accrue entirely to the Centre. As the Centre’s reliance on cesses and surcharges has risen, States argue that the **effective devolution is smaller than the headline 41%**, because a growing slice of gross tax revenue is ring-fenced outside the pool that the Finance Commission divides.

This is why States have pressed successive Commissions, and Parliament, to bring at least a portion of cesses and surcharges into the divisible pool so that the realised transfer matches the recommended share.

GST AND THE EROSION OF FISCAL AUTONOMY

The Goods and Services Tax reshaped the federal fiscal compact.

- The **GST Compensation** guarantee — which assured States 14% annual growth in protected revenue — ran for five years from July 2017 and **ended in June 2022**, removing a cushion many States had come to rely on.
- The **GST Council (Article 279A)** is the principal organ of **cooperative federalism** on indirect taxation, but in joining it States **surrendered much of their autonomous taxation power**, ceding the ability to set their own rates on a wide range of goods and services.

Post-GST, States have less room to raise their own indirect tax revenue, which makes the design of devolution — and the efficiency incentives within it — even more consequential.

THE SOUTHERN STATES’ CONCERN

The equity debate intersects with representation. The **delimitation freeze**, which has held Lok Sabha seat allocation to the 1971 population, is due to lapse after 2026, opening the prospect of **population-based seat reallocation**. Combined with the **population criterion in devolution**, southern States fear a “**double penalty**” — losing both seats and a relative share of transfers because they curbed population growth.

Tamil Nadu, Kerala and Karnataka have been the most vocal, framing the issue as one of States being disadvantaged precisely for the governance successes the Union has long sought.

THE CONSTITUTIONAL FRAMEWORK IN BRIEF

ARTICLE	PROVISION
Article 280	Finance Commission — constitution, composition, mandate
Article 270	Taxes levied and collected by the Union but distributed between the Union and the States
Article 275	Statutory grants-in-aid to States from the Consolidated Fund of India
Article 282	Discretionary grants by the Union or a State for any public purpose (the basis for Centrally Sponsored Schemes)
Article 293	Borrowing by State governments
Article 279A	GST Council

UPSC MAINS ANALYSIS

GS Paper 2 — Federalism, constitutional bodies, Centre-State relations / GS Paper 3 — Fiscal policy, devolution, public finance

- **Constitutional basis:** Article 280; quasi-judicial body; constituted by the President every five years.
- **16th Finance Commission:** Chairman Arvind Panagariya; constituted December 31, 2023; award period 2026-27 to 2030-31; effective April 1, 2026; vertical share retained at 41%.
- **Vertical-share history:** 14th FC 42% → 15th FC 41% (after J&K became a UT) → retained by 16th FC.
- **15th FC horizontal formula:** Income Distance 45%, Population (2011) 15%, Area 15%, Forest and Ecology 10%, Demographic Performance 12.5%, Tax and Fiscal Efforts 2.5%.
- **Equity-efficiency tension:** Income Distance dominates; tax-effort reward is only 2.5%; Demographic Performance added to address the southern grievance.
- **Cesses and surcharges:** Outside the divisible pool under Article 270; shrink effective devolution.
- **GST:** Compensation ended June 2022; GST Council under Article 279A; loss of autonomous State taxation power.
- **Delimitation:** Freeze due to lapse after 2026; “double penalty” fear for southern States.

Mains Questions:

- ❶ “The Finance Commission corrects vertical and horizontal fiscal imbalance, but its equity tilt can blunt fiscal discipline.” Examine in the context of the 16th Finance Commission.
- ❷ Discuss how the exclusion of cesses and surcharges from the divisible pool affects the spirit of fiscal federalism.
- ❸ “GST strengthened cooperative federalism but weakened the fiscal autonomy of States.” Critically analyse.

Keywords: Article 280, Finance Commission, quasi-judicial, 16th Finance Commission, Arvind Panagariya, 41% vertical devolution, divisible pool, Article 270, Article 275, Income Distance, Demographic Performance, tax effort, cesses and surcharges, GST Compensation, GST Council Article 279A, delimitation, vertical and horizontal imbalance, State Finance Commission.

The Hindu's view is that equity is the legitimate core of the Finance Commission's mandate, but equity is not the same as the absence of incentive. A formula that transfers most to the poorest States is just; a formula that rewards them whether or not they govern well is not. The fix is not to abandon redistribution but to complete it — to pair the Income Distance criterion with a meaningful tax-effort weight and outcome-linked grants, to bring cesses and surcharges partly into the divisible pool so that 41% means 41%, and to settle the delimitation-plus-devolution “double penalty” through negotiation rather than confrontation. Fiscal federalism survives when the strong States feel fairly treated and the weak States feel genuinely supported. The 16th Finance Commission's task is to make both true at once.

Sources: [The Hindu](#), [PRS](#), [PIB](#)

● KEY ARGUMENTS AT A GLANCE

The Hindu argues that India's fiscal federalism rests on the Finance Commission (Article 280) correcting vertical imbalance (the Centre commands the more buoyant taxes while States carry the heavier expenditure responsibilities) and horizontal imbalance (richer States versus poorer States). The 16th Finance Commission, chaired by Arvind Panagariya for the 2026-27 to 2030-31 award period, retains the 41% vertical devolution share and continues an equity-weighted horizontal formula in which the Income Distance criterion carries the dominant weight.

While equity transfers legitimately protect fiscally weaker States, an over-emphasis on redistribution can dull the incentive for fiscal

discipline and own-revenue effort. The formula must therefore balance equity with efficiency and reward productive governance rather than penalise it.

 **SUPPORTING**

- The Finance Commission is a constitutional body under Article 280, constituted by the President every five years (or earlier), and functions as a quasi-judicial body. It recommends the vertical distribution of the net proceeds of taxes between the Centre and States, the horizontal allocation among States, the principles governing grants-in-aid under Article 275, and measures to augment State Consolidated Funds to supplement the resources of panchayats and municipalities.
- The 16th Finance Commission, chaired by Arvind Panagariya (former Vice Chairman of NITI Aayog), was constituted on December 31, 2023, for the award period 2026-27 to 2030-31, with recommendations applying from April 1, 2026. It retained the vertical devolution share at 41% (the same as the 15th Finance Commission; the 14th had set it at 42%, reduced to 41% after Jammu and Kashmir became a Union Territory).
- The horizontal formula used by the 15th Finance Commission gave Income Distance a 45% weight (an explicitly equity-driven criterion measuring the gap from the highest per-capita-income State), Population (2011 Census) 15%, Area 15%, Forest and Ecology 10%, Demographic Performance 12.5% (which rewards lower fertility and so favours the southern States), and Tax and Fiscal Efforts just 2.5% (the lone efficiency reward). The small weight on tax effort is a weak incentive for own-revenue mobilisation.
- Cesses and surcharges are not part of the divisible pool under Article 270, and the Centre's reliance on them has risen sharply, so States argue that the divisible pool is being effectively shrunk. The end of GST Compensation in June 2022 (the five-year guarantee ran from July 2017) and the surrender of autonomous taxation powers to the GST Council (Article 279A) have further narrowed States' fiscal autonomy. Southern States additionally fear a "double penalty" as the delimitation freeze ends after 2026, combining population-based seat reallocation with a population element in devolution.

 **COUNTER**

A counter-reading holds that equity-weighted devolution is constitutionally and morally necessary: the Income Distance criterion is the principal instrument for narrowing development gaps between States such as Bihar, Uttar Pradesh and Jharkhand on the one hand and Maharashtra, Tamil Nadu, Karnataka and Gujarat on the other, and pulling it back would entrench regional inequality. On this view, fiscally weaker States face structural

disadvantages that are not of their own making, and a strong redistributive tilt is the price of holding a diverse federation together.

This argument, however, risks under-pricing the long-term cost of weak own-revenue effort and the moral hazard of devolution divorced from performance.

→ WAY FORWARD

Rebalance the horizontal formula so that equity (Income Distance) is paired with a more meaningful efficiency reward (a larger tax-and-fiscal-effort weight and outcome-linked grants for governance performance); bring cesses and surcharges partly into the divisible pool so that the effective devolution matches the headline 41%; expand outcome-linked grants that reward measurable improvements in health, education and revenue mobilisation; address the southern States' delimitation-plus-devolution "double penalty" through a durable, negotiated settlement; and strengthen State Finance Commissions and Article 280(3)(bb)/© transfers so that devolution reaches local bodies under the 73rd and 74th Amendments.

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MAINS ANSWER FRAMEWORK

QUESTION

"The Finance Commission corrects both vertical and horizontal fiscal imbalance, but an over-emphasis on equity can blunt the incentive for fiscal discipline." In the context of the 16th Finance Commission, examine the equity-efficiency tension in India's tax devolution and suggest a way forward. (250 words)

INTRODUCTION

The Finance Commission, a quasi-judicial constitutional body under Article 280, exists to correct two imbalances in Indian fiscal federalism: the vertical imbalance between a tax-rich Centre and expenditure-heavy States, and the horizontal imbalance between richer and poorer States. The 16th Finance Commission, chaired by Arvind Panagariya for 2026-27 to 2030-31, retains the 41% vertical share and an equity-weighted horizontal formula, reopening the perennial equity-versus-efficiency debate.

BODY

The Centre collects the more buoyant taxes (income, corporation and its share of GST), while States bear the larger expenditure on health, education, police and agriculture, creating the vertical gap that devolution and grants-in-aid (Articles 270 and 275) address. Horizontally, the 15th Finance Commission formula leaned heavily towards equity: Income Distance carried 45% of the weight, Population (2011) 15%, Area 15%, Forest and Ecology 10%, and Demographic Performance 12.5%, with Tax and Fiscal Efforts at only 2.5%.

The dominant Income Distance weight favours poorer States such as Bihar and Uttar Pradesh, prompting Tamil Nadu, Kerala and Karnataka to argue that they are penalised for fiscal and demographic success; the Demographic Performance criterion was introduced partly to answer that grievance. Two structural pressures sharpen the debate: cesses and surcharges sit outside the divisible pool under Article 270, so the effective devolution is smaller than the headline 41%; and the end of GST Compensation in June 2022 alongside the GST Council's pooling of taxation powers (Article 279A) has compressed States' fiscal autonomy.

With the delimitation freeze set to lapse after 2026, southern States fear a "double penalty" of lost seats and population-weighted transfers. The weak 2.5% tax-effort weight means devolution does little to reward own-revenue mobilisation, the heart of the efficiency concern.

CONCLUSION

The way forward is to balance equity with efficiency: pair the Income Distance criterion with a larger tax-effort weight and outcome-linked grants; bring cesses and surcharges partly into the divisible pool; design a durable, negotiated answer to the delimitation-plus-devolution "double penalty"; and strengthen State Finance Commissions so that devolution reaches the local bodies envisaged by the 73rd and 74th Amendments. Equity must protect the poorest States without becoming a disincentive to govern well.


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