UPSC & STATE PCS CURRENT AFFAIRS · UJIYARI.COM

EDITORIAL ANALYSIS

Efficiency Against Equity: What the Sixteenth Finance Commission Changed

THE HINDU

6 August 2026 · POLITY ECONOMY · GS2 GS3

CURATED & WRITTEN BY

Bharat Choudhary

UPSC Educator & Content Creator

linkedin.com/in/epicbharat

Efficiency Against Equity: What the Sixteenth Finance Commission Changed

The Hindu 6 August 2026 GS2 GS3

INTERVIEW ANGLE

"A Finance Commission is asked to correct both the vertical imbalance between the Union and the States and the horizontal imbalance between rich and poor States. If it now also rewards fiscal discipline, and fiscal discipline is easier for a rich State, has it introduced an instrument that works against its own equalisation mandate?"

Every fact web-verified against primary sources

THE LIFT LINE

A Finance Commission exists because the Union collects where the money is and the States spend where the people are. An instrument that rewards the States which already collect well does not correct that. It confirms it.

WHY THIS EDITORIAL MATTERS FOR YOUR EXAM

Finance Commission answers are usually written from a template: Article 280, vertical and horizontal devolution, the criteria and their weights, and a closing line about cooperative federalism. That template is now out of date in one important respect, because the single most consequential recommendation of the Sixteenth Finance Commission is not the 41 per cent that everyone quotes but the **zero Revenue Deficit Grant**, which most candidates will not know.

This editorial also gives you the analytical frame that turns a list of recommendations into an argument: the tension between **equalisation** and **conditionality** as competing theories of what a transfer is for.

GS Paper 2: Functions and responsibilities of the Union and the States; issues and challenges pertaining to the federal structure; devolution of powers and finances up to local levels; statutory bodies.

GS Paper 3: Government budgeting; mobilisation of resources; fiscal policy.

CONCEPT	MEANING	WHY IT IS TESTABLE
Vertical devolution	The share of the divisible pool of central taxes transferred to the States as a whole	The headline number, 41 per cent for 2026-31
Horizontal distribution	How the States' share is allocated among individual States, by a weighted formula	Where income distance, population, area, forest and ecology, and demographic performance enter
Divisible pool	Net proceeds of Union taxes shareable with States under Article 270	Excludes cesses and surcharges, which is the whole controversy
Revenue Deficit Grant	A grant to a State whose assessed revenue expenditure exceeds assessed revenue receipts after devolution	The principal **needs-based** instrument, now recommended at **zero**
Sector-specific and state-specific grants	Grants tied to a named sector, or to a particular State's identified need	Both **discontinued** by the Sixteenth Finance Commission
Equalisation	Transfers designed so that States can provide comparable services at comparable tax effort	The theoretical purpose of a Finance Commission
Conditionality	Tying a transfer to a specified use, outcome or behaviour	The efficiency alternative to equalisation

BACKGROUND AND CONTEXT

The authors are **K.J. Joseph** and **Sumalatha B.S.** of the **Gulati Institute of Finance and Taxation**, Thiruvananthapuram, writing in The Hindu on 6 August 2026.

The **Sixteenth Finance Commission**, chaired by **Arvind Panagariya**, submitted its report on **17 November 2025** for the award period **2026-31**.

A Finance Commission exists to correct two imbalances that are structural rather than accidental.

The vertical imbalance. The Union commands the more buoyant and more easily administered tax bases: income tax, corporation tax, customs, and the central component of GST. The States carry the larger share of expenditure responsibility: police, public health, school education, agriculture, irrigation, roads and local government. The gap between where revenue accrues and where obligation lies is deliberate in the constitutional design, and devolution is its correction.

The horizontal imbalance. States differ enormously in per capita income and therefore in own-revenue capacity. A State cannot provide a comparable standard of public service at a comparable tax effort if its base is a fraction of another's. Equalisation is the principle that transfers should close that gap.

Both are the Commission's constitutional business under **Article 280**.

THE ANALYSIS

1. The 41 per cent is the least interesting number in the report. It was retained, against a demand from eighteen States for 50 per cent. Retention is a decision, but it is a decision to change nothing, and it dominated the coverage precisely because it is the number the template expects.

2. Zero Revenue Deficit Grant is the real change. The Revenue Deficit Grant was the Commission's explicitly needs-based instrument. It was computed as the gap remaining after devolution between a State's assessed revenue expenditure and its assessed revenue receipts, and it therefore flowed by construction to States with weaker own-revenue capacity. Recommending zero withdraws the one transfer whose logic was equalisation rather than purpose.

3. Grants were cut, and their character changed at the same time. Total grants recommended are about **Rs 9,47,409 crore**: local-body grants of **Rs 7,91,493 crore** plus disaster-management grants of **Rs 1,55,916 crore**. That is against roughly **Rs 10.1 lakh crore** under the Fifteenth Commission, so the aggregate fell. More strikingly, grants as a share of total Finance Commission transfers **more than halved, from 19.4 per cent to 8.3 per cent**.

The composition narrowed too. **Revenue-deficit grants, sector-specific grants and state-specific grants were all discontinued.** Only local-body and disaster-management grants survive, and both are purpose-tied. Local-body grants did rise substantially in absolute terms, which is the one genuinely expansionary limb.

This is why the editorial's framing is efficiency versus equity. The surviving instruments are the ones that fund a specified purpose; the ones that closed a fiscal gap are gone.

4. Conditionality has a capacity bias, and the bias runs the wrong way. Drawing down a performance-linked or sector-specific grant requires a State to prepare compliant proposals, maintain the statistical apparatus to demonstrate outcomes, staff the institutions that implement, and meet utilisation timelines. These are functions of administrative capacity, and administrative capacity correlates with fiscal capacity.

The result is that the States best able to access conditional grants are the States that least need equalising, and the States the mandate exists to assist are the least equipped to comply. An instrument intended to raise standards can therefore widen the very gap the Commission is constituted to close.

5. The base is eroding under the percentage. Cesses and surcharges, levied under **Articles 270 and 271**, are not part of the divisible pool and are retained wholly by the Union. Their share of gross central revenue has risen substantially over the last decade. A Commission can hold vertical devolution at 41 per cent for three successive award periods while the States' effective share of what the Union actually collects declines, because the percentage is applied to a shrinking proportion of the whole. No Finance Commission can fix this, because the constitutional exclusion is not within its remit.

6. Where this touches today's news. The addition of heatwave and lightning to the notified calamity list, reported on 4 August 2026, came on this Commission's recommendation and sits within the enlarged disaster-management grant window. It is a good illustration of the shift working well: a purpose-tied transfer responding to an identified and rising risk, which an untied grant would not have addressed with the same certainty.

DATA AND INSTITUTIONS VAULT

PRELIMS-GRADE FACTS:

- Sixteenth Finance Commission: chaired by Arvind Panagariya; report submitted 17 November 2025; award period 2026-31
- Vertical devolution retained at 41 per cent, against a demand from eighteen States for 50 per cent
- Zero Revenue Deficit Grants recommended for the award period; sector-specific and state-specific grants also discontinued
- Total grants-in-aid recommended: about Rs 9,47,409 crore, being local-body grants of Rs 7,91,493 crore plus disaster-management grants of Rs 1,55,916 crore
- This is against roughly Rs 10.1 lakh crore under the Fifteenth Finance Commission, and grants fell as a share of total Finance Commission transfers from 19.4 per cent to 8.3 per cent
- Constituted under Article 280, every fifth year or earlier, by the President
- Composition: a Chairman and four other members; qualifications prescribed by Parliament under Article 280(2)
- The divisible pool is defined by Article 270; cesses and surcharges under Articles 270 and 271 are excluded from it
- The Fifteenth Finance Commission also set vertical devolution at 41 per cent (reduced from the Fourteenth's 42 per cent to account for the reorganisation of Jammu and Kashmir into Union Territories)
- Recommendations of a Finance Commission are advisory, not binding; the Article 281 requirement is that the report and an explanatory memorandum on action taken be laid before each House of Parliament
- Heatwave and lightning were added to the notified calamity list, taking it from 12 to 14, on this Commission's recommendation

WATCH THE TRAP: RS 7,91,493 CRORE IS THE LOCAL-BODY GRANT ALONE, NOT TOTAL GRANTS. MANY SUMMARIES QUOTE IT AS THE HEADLINE GRANTS FIGURE AND THEN DESCRIBE A LARGE INCREASE, BECAUSE LOCAL-BODY GRANTS DID RISE STEEPLY. TOTAL GRANTS ARE ABOUT RS 9,47,409 CRORE AND ARE LOWER THAN THE FIFTEENTH COMMISSION'S ROUGHLY RS 10.1 LAKH CRORE. QUOTING THE COMPONENT AS THE AGGREGATE REVERSES THE DIRECTION OF THE CHANGE.

THE DEBATE

Argument FOR the efficiency turn. An unconditional grant computed to fill an assessed revenue deficit is a subsidy for not raising revenue. It rewards the State that under-taxes its own base and penalises the one that taxes it properly, and over successive award periods Revenue Deficit Grants became concentrated in a small number of recurring recipients, which is the signature of entrenched dependence rather than transitional support. Purpose-tied grants also protect the citizen rather than the treasury: a grant conditioned on health or education outcomes reaches the service the citizen receives, whereas an untied transfer may finance salary arrears, subsidy or debt servicing. Equalisation that never terminates has stopped being equalisation.

Argument AGAINST. The Commission's constitutional function is to correct imbalance, not to grade performance, and the instruments it has adopted have a capacity bias that runs against poorer States. Fiscal weakness in a low-income State is very largely structural, arising from a narrow base rather than from want of effort, and no amount of incentive resolves within five years a gap that arises from the composition of a State's economy. Meanwhile the conditionality is designed at the Union's discretion and the money is tied to Union priorities, which converts a constitutional entitlement into something closer to a centrally sponsored scheme, with the accountability of the State government running upward to Delhi rather than outward to its electorate.

Balanced verdict. The two objectives have been treated as alternatives when they are separable. The moral hazard the efficiency case identifies is real, but it attaches to **effort**, which a State controls, and not to **outcomes**, which depend on where it started. A design that incentivises own-revenue effort and service delivery while retaining a residual needs-based window would capture the disciplinary gain without vacating the equalisation function that no other institution in the Indian federation performs.

HOW TO THINK ABOUT THIS

The transferable pattern: **when a transfer becomes conditional, ask who can satisfy the condition.**

A condition is never neutral. It selects. The question to ask of any conditional transfer, grant, subsidy, credit-linked scheme or matching-grant window is not whether the condition is reasonable in the abstract, but **whether the intended beneficiary is systematically less able to satisfy it than the unintended one**.

If capacity to comply correlates with the advantage the transfer was meant to offset, the instrument is regressive in operation however progressive it is in intent.

This pattern recurs constantly. It is the same analysis that applies to matching-contribution requirements in centrally sponsored schemes, which poorer States struggle to fund; to documentation requirements in welfare delivery, which exclude those without documents; and to competitive challenge-fund models in urban policy, which reward cities that already have planning capacity.

DIAGRAM-IN-WORDS

```
THE TWO IMBALANCES A FINANCE COMMISSION EXISTS TO CORRECT

VERTICAL:  Union collects (buoyant bases) ─── gap ───→ States spend (police,
                                                         health, education)
           CORRECTION = devolution (41%)

HORIZONTAL: Rich State (wide base) ─── gap ───→ Poor State (narrow base)
           CORRECTION = formula weights + Revenue Deficit Grant
```

```
WHAT THE 16th FC DID
41% held constant ──────────────────────────→ vertical correction unchanged
Revenue Deficit Grant → ZERO ────────────────→ needs-based instrument REMOVED
Total grants ↓ to Rs 9,47,409 cr ────────────→ and share of FC transfers
(local bodies 7,91,493 + disaster 1,55,916)   falls 19.4% → 8.3%
Sector-specific + state-specific grants ────→ ALSO DISCONTINUED
                                              only purpose-tied grants survive

           ↓
CAPACITY BIAS: drawing down a conditional grant needs
               proposals + statistics + staffed institutions
               ↓
               these correlate with FISCAL capacity
               ↓
      the States least able to comply are the States
      equalisation exists to help          ← the editorial's core claim

LEVERS: (1) separate EFFORT incentives from OUTCOME incentives
        (2) retain a residual needs-based window
        (3) bring cesses/surcharges into the divisible pool
        (4) strengthen income distance in the horizontal formula
```

TAKEAWAY BOX

Devolution corrects an imbalance. Conditionality grades a performance. A Finance Commission was constituted to do the first, and the Sixteenth has moved a substantial part of its instrument set to the second.

Article 280 (constitution), Article 281 (report laid before Parliament with action-taken memorandum), Article 270 (divisible pool), Article 271 (surcharges); 16th FC chaired by Arvind Panagariya, report 17 November 2025, award period 2026-31; **41 per cent** *vertical share retained against a demand from 18 States for 50 per cent;* **zero Revenue Deficit Grants***, and sector-specific and state-specific grants discontinued; total grants about* **Rs 9,47,409 crore** *(local bodies Rs 7,91,493 crore plus disaster management Rs 1,55,916 crore), against about Rs 10.1 lakh crore under the 15th FC; grants' share of Finance Commission transfers fell from* **19.4 per cent to 8.3 per cent***; notified calamity list expanded 12 to 14.*

a condition attached to a grant is designed by the party that holds the money and satisfied by the party that needs it. What obligation does the designing party owe to the capacity of the complying party, and is a condition that cannot realistically be met a form of refusal?

UPSC has repeatedly examined the erosion of the divisible pool through cesses and surcharges, the shift from Planning Commission transfers to NITI Aayog and the Finance Commission route, and the tension between conditional central schemes and State autonomy. This editorial updates all three with the current award.

"The Sixteenth Finance Commission reduced grants overall while removing every grant designed to equalise." Critically examine the implications for horizontal equity in Indian fiscal federalism.

Sources: The Hindu, Finance Commission of India, PRS Legislative Research, PIB

Source: Efficiency Against Equity: What the Sixteenth Finance Commission Changed — Ujiyari.com | Free UPSC & State PCS Editorial Analysis

KEY ARGUMENTS AT A GLANCE

By holding vertical devolution at 41 per cent while reducing Revenue Deficit Grants to zero and rebuilding grants-in-aid around fiscal discipline and performance incentives, the Sixteenth Finance Commission has shifted the centre of gravity of Union transfers from equalisation towards conditionality, and the authors argue this sits uneasily with the constitutional function of a Finance Commission, which exists to correct an imbalance between a revenue-rich Union and expenditure-heavy States rather than to grade State behaviour.

✓ SUPPORTING

- The vertical share was held at 41 per cent despite eighteen States seeking an increase to 50 per cent, so the aggregate quantum of unconditional transfer did not expand even as States' expenditure responsibilities in health, education, urban services and disaster response continued to grow.
- The most consequential change is the recommendation of **zero Revenue Deficit Grants** for 2026-31. The Revenue Deficit Grant was the Commission's principal equalisation instrument, paid to States whose assessed revenue expenditure exceeded assessed revenue receipts after devolution, and it went disproportionately to States with weaker own-revenue capacity. Removing it withdraws the transfer that was explicitly needs-based.
- Grants-in-aid fell in aggregate and collapsed as a share of transfers. Total grants recommended are about **Rs 9,47,409 crore**, made up of local-body grants of **Rs 7,91,493 crore** and disaster-management grants of **Rs 1,55,916 crore**, against roughly **Rs 10.1 lakh crore** under the Fifteenth Finance Commission.
  Grants as a share of total Finance Commission transfers **more than halved, from 19.4 per cent to 8.3 per cent**. Local-body grants rose substantially, but revenue-deficit, sector-specific and state-specific grants were all discontinued, so the surviving instruments are purpose-tied rather than equalising.
- The divisible pool itself continues to be eroded from outside the Commission's reach, because cesses and surcharges are levied under Articles 270 and 271 and are not shareable with States, so a Commission can hold the percentage constant while the base it applies to shrinks in relative terms.

⚠ COUNTER

The efficiency case is serious and should not be caricatured. Unconditional gap-filling has a documented moral hazard problem: a grant calculated to fill an assessed revenue deficit rewards the State that fails to raise its own revenue and penalises the one that does, and Revenue Deficit Grants had become concentrated in a small number of States over successive award periods. Performance-linked grants also protect the citizen rather than the State treasury, since a grant tied to health or education outcomes reaches the service the citizen actually receives, whereas an untied transfer may finance salary arrears or subsidy. Equalisation that never terminates is not equalisation but permanent transfer, and a Commission that entrenches dependence has not served the poorer State either.

→ WAY FORWARD

Retain a residual needs-based instrument even within a performance framework, so that a State with structurally low own-revenue capacity is not penalised for a fiscal weakness it cannot resolve within one award period; separate incentives for effort, which States control, from outcomes, which depend on the base a State starts from; bring cesses and surcharges progressively into the divisible pool so that the 41 per cent applies to a stable base; strengthen the horizontal formula's equity weights, particularly income distance, to carry the equalisation load that Revenue Deficit Grants previously carried; and institutionalise consultation with States on grant conditionalities, since a condition designed without the implementing government is a condition designed to be missed.

MAINS ANSWER FRAMEWORK

QUESTION

The Sixteenth Finance Commission retained the States' share of central taxes at 41 per cent while restructuring grants-in-aid around fiscal discipline and performance. Examine whether this represents a departure from the equalisation mandate of a Finance Commission. (250 words)

INTRODUCTION

Article 280 requires the Finance Commission to recommend the distribution of the net proceeds of taxes between the Union and the States, the allocation among States, and the principles governing grants-in-aid of State revenues. Two imbalances give the institution its purpose: the vertical imbalance, since the Union commands the more buoyant tax bases while States carry the larger expenditure responsibilities, and the horizontal imbalance among States of very unequal fiscal capacity.

The Sixteenth Finance Commission, whose report for 2026-31 was submitted on 17 November 2025, has retained the vertical share at 41 per cent while substantially restructuring grants.

BODY

The restructuring is where the significance lies. The Commission recommended zero Revenue Deficit Grants for the award period, and discontinued sector-specific and state-specific grants as well.

The Revenue Deficit Grant had been the principal needs-based transfer, paid to States whose assessed revenue expenditure exceeded assessed revenue receipts even after devolution, and it flowed disproportionately to States with weak own-revenue capacity. What survives is a narrower set: local-body grants of about Rs 7,91,493 crore and disaster-management grants of about Rs 1,55,916 crore, roughly Rs 9,47,409 crore in total, against about Rs 10.1 lakh crore under the Fifteenth Commission.

Grants have therefore fallen in absolute terms and have more than halved as a share of total Finance Commission transfers, from 19.4 per cent to 8.3 per cent. The shift is both a contraction and a change of character: from unconditional gap-filling towards conditional, purpose-tied transfer.

Two consequences follow. First, conditionality favours administrative capacity.

A State with a functioning statistical system, staffed municipal bodies and the ability to prepare compliant proposals will draw down performance-linked grants more fully than one without, and the States least able to do so are the States the equalisation mandate exists to assist. The instrument can therefore widen the gap it was designed to close.

Second, the vertical share of 41 per cent is less protective than it appears, because cesses and surcharges levied under Articles 270 and 271 are not part of the divisible pool, so the base to which the percentage applies has been shrinking relative to gross central revenue irrespective of what any Commission recommends. Against this, the efficiency argument has real force: an unconditional grant computed to fill an assessed deficit rewards low own-revenue effort, and equalisation that never terminates becomes permanent dependence rather than correction.

CONCLUSION

The two objectives are not genuinely alternatives, and the Commission has treated them as though they were. A design that separates incentives for fiscal effort, which a State controls, from incentives for outcomes, which depend on its starting base, could retain the disciplinary gain without abandoning equalisation.
Restoring a residual needs-based window, strengthening income distance within the horizontal formula, and progressively bringing cesses and surcharges into the divisible pool would let the Commission pursue efficiency without vacating the constitutional function that only it can perform.

RELATED DAILY ARTICLES

13 Aug **Current Affairs Today, August 13, 2026**

13 Aug **India's Retail Inflation Rises to 4.45% in July 2026, a...**

13 Aug **Tamil Nadu's Vetri Investors' Conclave 2026 Signs Rs...**

13 Aug **Himachal Pradesh Levies 60 Paise/Litre "Widow and...**

CURATED & WRITTEN BY

Bharat Choudhary

UPSC Educator & Content Creator

linkedin.com/in/epicbharat

📖 Read Full Article on Ujiyari →

https://ujiyari.com/editorials/2026/08/th-fiscal-federalism-efficiency-versus-equity-2026/