



When Transfers Flow But Transformation Stalls India's Centre State Fiscal Divide

By Rajesh Kumar,
Assistant Professor, School of Business, Galgotias University
Dr. Firdous Ahmad Malik,
University of People, USA.
Dr Anand Jaiswal
Assistant Professor, Department of Management,
TERI School of Advance Studies

Abstract

The paper focuses on the structural development of Centre-State fiscal relations in India through three parallel official sources of information, namely, the Reserve Bank of India State Finances. A Study of Budgets 2025-26 (Reserve Bank of India, 2026), the Report of the Sixteenth Finance Commission to 2026-31 (Finance Commission of India, 2025/2026), and Further macroeconomic background is elicited by Economic Survey 2025-26 (Ministry of Finance Economic Survey, 2026). The discussion provides three simultaneous findings, all of which are based on government data. To begin with, even though the rate of devolution of the headline sum remains constant at 41 per cent of divisible pool, the actual share of gross tax revenues to reach states has been diminished to about 32 per cent due to the exclusion of cesses and surcharges which are anticipated to be included in the divisible pool by Article 270. Second, the absolute level of Centre-State transfers rose by over two times between FY20 and FY26 (₹11.5 lakh crore in FY22 versus ₹25.6 lakh crore in FY26) (Budget Estimate), although the qualitative composition of these transfers changed dramatically. Revenue Deficit Grants went down to 0 in FY27, whereas market borrow Third, the NITI Aayog Fiscal Health Index 2026 (NITI Aayog, 2026) shows that there is a 60-point composite score difference between the best fiscal performers (Odisha, 73.1) and the worst fiscal performers (Punjab, 12.4) among major states. The introduction of a GDP contribution criterion by the 16th Finance Commission, the abolition of Revenue Deficit Grants, and the abolition of sector specific grants are a structural shift in the equalisation logic of Musgrave (1959) to that of competitive federalism of Tiebout (1956). The paper uses three economic models, Musgrave (1959), Oates (1972), and Krugman (1991) to provide a description of the persistence and strengthening of this structural divergence and ends with three policy solutions based on the official record.

Keywords: *fiscal federalism, Centre–State transfers, tax devolution, Finance Commission, vertical fiscal imbalance, cesses and surcharges, Revenue Deficit Grants, Fiscal Health Index, Economic Survey, India*

Introduction

The aggregate story of fiscal federalism in India is that of continuous growth. Centre-State transfers increased by over 2.5 times between FY20 and FY26 (₹25.6 lakh crore and ₹11.5 lakh crore respectively), which is 6.9 per cent of GDP (Ministry of Finance Economic Survey, 2026). The 41



per cent of the divisible pool has been codified as tax devolution by two successive Finance Commissions and the 16th Finance Commission tabled in Parliament on February 1, 2026, has decided to keep that share at least until May 2026 (Finance Commission of India, 2025/2026). But averages, or aggregates, are known to lie. Break down the same official data to the state level and you get a third, even more uncomfortable story: even as the numbers on the headline are the same, the architecture of transfers is actually shifting to shrink state fiscal autonomy.

The Indian federalism has a vertical fiscal imbalance that is constitutional. Article 270 gives the greatest taxable capacities in the Union income tax, corporate tax, custom, central excise, and the Seventh Schedule gives most expenditure duties to states. The main institutional mechanism that has been used to close this imbalance since 1951 has been Finance Commissions and has been used to devolve and grant (Oates, 1972). The weakness in its structure that has been added in the last ten years is that cesses and surcharges, which are raised in the name of earmarked purposes, increased to 13.8 per cent of gross tax revenue in FY26 (Budget Estimate) (Ministry of Finance, 2014/2026). Since these levies are not subject to the divisible pool in Article 270, the denominator in calculating the 41 per cent devolution has been steadily decreased with only about 32 per cent of gross tax revenue reaching the states (Economic and Political Weekly, 2026).

The impact of this architecture is visible in unusual acuity, read between the lines of three official sources of data. The former is the State Finances: A Study of Budgets 2025-26 (Reserve Bank of India, 2026), which was published January 23, 2026, and which reports the consolidated Gross Fiscal Deficit of states increasing to 3.3 per cent of GDP in FY25, 16 states budgeting to a deficit of more than 3 per cent. The second is the principal report of the 16th Finance Commission (Finance Commission of India, 2025/2026) which re-formulates a horizontal devolution threshold and completely abolishes Revenue Deficit Grants by FY27. The third is the NITI Aayog Fiscal Health Index 2026 (NITI Aayog, 2026), published March 11, 2026, which is a composite index of how 18 large states have deviated in fiscal results on a 100-point index. Additional macroeconomic background is based on Economic Survey 2025-26 (Ministry of Finance Economic Survey, 2026). The data used in this paper are all from official Government of India and Reserve Bank of India publications.



The paper continues in the following manner. Section II gives the devolution gap - the disparity between recommended shares and effective shares between Finance Commissions. Section III examines the structural reforms proposed by the 16 th Finance Commission. Section IV records the Revenue Deficit Grant trend. Section V shows the NITI Aayog FHI 2026 state divergence. Section VI looks at the issue of cess and surcharge. Section VII provides the structural diagnosis with three economic structures. The policy implications are provided at the end of Section VIII.

The Devolution Gap

The RBI report (*Reserve Bank of India, 2026*) puts states' consolidated Gross Fiscal Deficit at 3.3 per cent of GDP in FY25 crossing the 3 per cent benchmark for the first time in four years. Of the 28 states, 16 have budgeted deficits exceeding 3 per cent of GSDP for FY26; 13 states exceed 3.5 per cent. Outstanding liabilities stood at 28.1 per cent of GDP in March 2024, projected at 29.2 per cent by March 2026. Market borrowings now finance approximately 76 per cent of states' GFD in FY26 (*Reserve Bank of India, 2026*). These numbers are partly explained by the fiscal consequences of a growing cess and surcharge pool that has systematically eroded the denominator of devolution.

The table below presents the devolution gap across all Finance Commission periods the difference between the share of the divisible pool recommended by successive Finance Commissions and the effective share of gross tax revenues actually reaching states. It also incorporates the absolute transfer data from the Economic Survey 2025-26 (*Ministry of Finance Economic Survey, 2026*), which shows that nominal transfers have grown substantially even as their qualitative composition has deteriorated.

Measure	13th FC 2010–15	14th FC 2015–20	15th FC 2021–26	16th FC 2026–31
Recommended (% of divisible pool)	32%	42%	41%	41%
Effective (% of gross tax revenue)	24%	34%	32.1%	~31% (est.)
Gap (percentage points)	8 pp	8 pp	8.9 pp	~10 pp (est.)
Total transfers to states (₹ lakh crore)	—	—	₹11.5L cr (FY20)	₹25.6L cr (FY26 BE)

Sources: Finance Commission of India (2020, 2025/2026). Reports of the 15th and 16th Finance Commissions (fincomindia.nic.in). Reserve Bank of India (2026). State Finances: A Study of Budgets 2025-26 (rbi.org.in). Ministry of Finance Economic Survey 2025-26 (2026). Economic and Political Weekly (2026). 'A Retreat from Progressive Fiscal Federalism,' Vol. 60, Issue 9.

The gap between the recommended share and the effective share is the 'cess illusion' (*Economic and Political Weekly, 2026*). States see the headline number 41 per cent but the denominator is gross



tax revenue minus cesses and surcharges levied under Article 270. Those cesses peaked at 20.5 per cent of gross tax revenue in FY21 (*Ministry of Finance, 2014–2026*), declined to 17.5 per cent by FY24, and are projected at 13.8 per cent in FY26. The divisible pool is currently approximately 81 per cent of gross tax revenue. The effective share reaching states is therefore closer to 32 per cent than 41 per cent a gap that has persisted, and in some years widened, across successive Finance Commissions (*Economic and Political Weekly, 2026*).

The 16th Finance Commission

The commission, chaired by Arvind Panagariya, retained vertical devolution at 41 per cent for 2026-31, resisting demands from 18 of the 28 states for an increase to 50 per cent. The Union government's submission to the Commission had specifically sought 'moderation in tax devolution,' stating that current transfer levels at approximately 49 per cent of gross revenue receipts were 'not fiscally sustainable' (Finance Commission of India, 2025/2026). The commission's most consequential innovation, however, was horizontal. The tax and fiscal effort criterion (2.5 per cent weight in the 15th FC) has been replaced entirely by a new 'contribution to GDP' criterion carrying 10 per cent weight, measured by each state's share in all-state GSDP using a square-root transformation to dampen concentration effects.

The shift from tax effort to GDP contribution is philosophically significant. It marks a deliberate pivot from Musgrave's (1959) equalisation logic under which transfers correct for structural disadvantage toward Tiebout's (1956) competitive federalism logic, under which transfers reward economic performance. Karnataka recorded the largest gain (+0.48 percentage points in devolution share), followed by Kerala (+0.45 pp), Gujarat (+0.28 pp) and Haryana (+0.27 pp). States with high population and low per-capita income Uttar Pradesh, Bihar, Rajasthan, and Madhya Pradesh saw relative declines (Business Standard, 2026).

Criterion	15th FC Weight (%)	16th FC Weight (%)
Income distance (need)	45%	42.5%
Population (2011 census)	15%	17.5%
Demographic performance	12.5%	10%
Area	15%	10%
Forest and ecology	10%	10%
Tax / fiscal effort	2.5%	0% — removed



GDP contribution (new)	0%	10%
------------------------	----	-----

Source: Finance Commission of India. (2025/2026). Report of the Sixteenth Finance Commission, Volume I. (fincomindia.nic.in). Tabled in Parliament, February 1, 2026. PRS Legislative Research summary of 16th FC Report, 2026.

The table below summarises the full set of structural changes the 16th Finance Commission introduces relative to the 15th. The 16th FC also notes that unconditional cash transfers by states which the Economic Survey 2025-26 estimates at ₹1.7 lakh crore in FY26 risk crowding out capital expenditure in revenue-deficit states, and recommends that states rationalise such expenditure. Across 21 states, unconditional cash transfers now account for 20.2 per cent of total subsidy spending in FY25-26, up from just 3 per cent in FY18-19.

Parameter	15th FC (2021–26)	16th FC (2026–31)	Impact
Vertical devolution	41%	41% (unchanged)	Neutral
Revenue Deficit Grants	₹1.18L cr → ₹24,483 cr (tapering)	Nil — discontinued entirely	Adverse (stressed states)
GDP contribution weight	Absent (tax effort: 2.5%)	10% weight introduced	Mixed — favours richer states
Local body grants	₹4.36L cr	₹7.91L cr rural + urban	Positive
Fiscal deficit ceiling	3% GSDP (reform waivers allowed)	3% GSDP — no exceptions	Tighter fiscal discipline
Off-budget borrowings	Discouraged	Mandated on-budget; must stop	Major structural shift
Cess / surcharge in pool	Excluded from divisible pool	Excluded (grand bargain proposed)	Unresolved structural flaw
Sector-specific grants	Present	Discontinued entirely	Reduced targeted support

Sources: Finance Commission of India (2020, 2025/2026). Reports of the 15th and 16th Finance Commissions (fincomindia.nic.in). Business Standard. (2026, February 1). Drishti IAS compilation of 16th FC data, February 2026.

The Revenue Deficit Grant Cliff

No single number captures the fiscal stress of structurally weak states more sharply than the collapse of Revenue Deficit Grants unconditional post-devolution transfers to states whose revenues fall structurally short of their expenditure needs. The 15th Finance Commission (Finance Commission of India, 2020) designed these grants to taper: from ₹1,18,000 crores in FY22 to near-zero by the end of its award period, covering 17 states at inception and reducing to 7 states eligible by FY24-25. The 16th Finance Commission (Finance Commission of India, 2025/2026) has taken this logic



to its conclusion and discontinued the grants entirely from FY27, arguing that anticipating RDG compensation reduces the incentive for states to undertake difficult revenue and expenditure reforms.

For Punjab, Kerala, Andhra Pradesh, Himachal Pradesh, and West Bengal which relied on these grants as a structural supplement to their own revenues this is not a marginal adjustment. It is a cliff. The table below traces the full trajectory.

Year	Amount (₹ crore)	Context
FY 2021-22	₹1,18,000 crore	Peak year — first year of 15th FC Revenue Deficit Grants
FY 2022-23	₹86,201 crore	Sharp tapering begins; 17 states eligible
FY 2023-24	₹45,659 crore	Continued steep decline
FY 2024-25 RE	₹24,483 crore	Only 7 states remain eligible
FY 2025-26 BE	₹13,705 crore	Near-elimination — last year of 15th FC period
FY 2026-27 onward	NIL	16th Finance Commission discontinues grants entirely

Sources: Ministry of Finance, Govt. of India. (2022–2026). *Union Budget Expenditure Budget Statements, FY22–FY26* (indiabudget.gov.in). Finance Commission of India. (2020). *Report of the Fifteenth Finance Commission*. Reserve Bank of India. (2026). *State Finances: A Study of Budgets 2025–26*.

The 16th Finance Commission's justification that RDGs created a perverse incentive for fiscal profligacy has merit as a first-best argument. It does not, however, account for why some states are structurally in revenue deficit. The answer lies in a narrow own-tax base, high committed expenditure on salaries and pensions, and limited capacity to attract non-agricultural investment. The Economic Survey 2025-26 (*Ministry of Finance Economic Survey, 2026*) notes that rising revenue expenditure risks crowding out capital expenditure, especially in states with revenue deficits exactly the states that will lose RDGs. The interest payment burden has also risen: between FY17 and FY25, interest payments as a percentage of revenue receipts increased from 10.9 per cent to 11.8 per cent (*PRS Legislative Research Union Budget Analysis, 2025*).

Niti Aayog Fiscal Health Index 2026

Released on March 11, 2026, the NITI Aayog *Fiscal Health Index 2026* (*NITI Aayog, 2026*) evaluates 18 major states and 10 NE/Himalayan states across five pillars: Quality of Expenditure, Revenue Mobilisation, Fiscal Prudence, Debt Index, and Debt Sustainability. The divergence it



JAMMU AND KASHMIR ECONOMIC ASSOCIATION

reveals is stark. Odisha leads all major states with a score of 73.1, a result of sustained fiscal consolidation and improved own-revenue performance driven partly by mineral revenues. Punjab sits at the other end at 12.4, dragged down by a debt-to-GSDP ratio approaching 43 per cent, persistent revenue deficits, and a farm-loan waiver legacy that has compressed capital spending for years.

State	FHI Score (out of 100)	Fiscal Tier	Overall fiscal status
Odisha	73.1	Leader	Strong
Goa	54.7	Leader	Strong
Jharkhand	50.5	Leader	Strong
Gujarat	48.2	Front-runner	Strong
Maharashtra	46.8	Front-runner	Strong
Karnataka	45.9	Front-runner	Strong
Uttar Pradesh	45.1	Front-runner	Strong
Chhattisgarh	44.8	Front-runner	Strong
Telangana	44.3	Front-runner	Strong
Tamil Nadu	40.1	Achiever	Moderate
Madhya Pradesh	38.4	Achiever	Moderate
Rajasthan	36.2	Achiever	Moderate
Assam	35.1	Achiever	Moderate
Haryana	33.8	Aspirant	Moderate
Bihar	31.2	Aspirant	Moderate
Kerala	24.8	Stressed	Stressed
West Bengal	23.8	Stressed	Stressed
Andhra Pradesh	23.1	Stressed	Stressed
Punjab	12.4	Stressed	Stressed

Source: NITI Aayog. (2026, March 11). *Fiscal Health Index 2026: State Fiscal Performance, FY 2023-24*. National Institution for Transforming India (niti.gov.in). Composite scores across five pillars on a 100-point scale. The FHI 2026 was released at a function chaired by the Vice Chairman of NITI Aayog in New Delhi.

The contrast is instructive in the same way that the MPI contrast between lagging and performing states is instructive in poverty analysis. Kerala's FHI score of 24.8 does not reflect low government effort it reflects the fiscal consequences of a high-wage, high-expenditure state that has run



persistent revenue deficits while maintaining strong human development outcomes. The table below situates these scores in the context of state debt levels and central transfer dependency, using data from the RBI's State Finances report (Reserve Bank of India, 2026).

State	Debt / GSDP	Revenue balance	Central transfer dependency	Fiscal risk
Punjab	42.9%	Deficit	High (>70%)	Very High
West Bengal	38.3%	Deficit	High	High
Himachal Pradesh	~38%	Deficit	Very High	Very High
Rajasthan	37.9%	Deficit	High	Very High
Kerala	~35%	Deficit	Moderate	High
Andhra Pradesh	34.6%	Deficit	High	High
Bihar	~32%	Near-balanced	72%	Moderate
Odisha	~16%	Surplus	Moderate	Low
Gujarat	~18%	Surplus	Low	Low
Maharashtra	~18%	Near-balanced	Low	Low

Sources: Reserve Bank of India. (2026). State Finances: A Study of Budgets 2025-26, Appendix Table 11 Composition of Outstanding Liabilities of State Governments (rbi.org.in). Finance Commission of India. (2025/2026). State-level devolution share data, Volume I.



The Cess and Surcharge Problem

Under Article 270, cesses and surcharges are excluded from the divisible pool. In FY26, they are projected at ₹4.23 lakh crore 13.8 per cent of the Centre's gross tax revenue (Ministry of Finance, 2014–2026). This means states effectively receive 41 per cent of approximately 81 per cent of total revenues, not 41 per cent of all revenues. The table below traces the trajectory of the divisible pool and cess pool as shares of gross tax revenue since FY14, using Union Budget data.

Measure	FY14	FY16	FY18	FY20	FY21 (peak)	FY24	FY26 BE
Divisible pool as % of gross tax revenue	86.9%	89.1%	86.2%	84.5%	79.5%	82.5%	81.3%



Cess & surcharge as % of gross tax revenue	13.1%	10.9%	13.8%	15.5%	20.5%	17.5%	13.8%
--	-------	-------	-------	-------	-------	-------	-------

Sources: Ministry of Finance, Govt. of India. (2014–2026). *Union Budget documents, FY14–FY26: Statement of Revenue Cesses and Surcharges* (indiabudget.gov.in). *Economic and Political Weekly*. (2025). 'Enhanced Devolution and Fiscal Space at the State Level.' Vol. 60, Issue 18. Reserve Bank of India. (2026). *State Finances: A Study of Budgets 2025-26*.

The 16th Finance Commission has proposed a 'grand bargain' to resolve this (*Finance Commission of India, 2025/2026*): states accept a lower headline share in exchange for the Centre merging most cesses and surcharges into the taxable pool, with no net revenue loss on either side. The Commission also recommended that the Union Government disclose net proceeds data as certified by the Comptroller and Auditor General under Article 279 annually a proposal accepted by the government to address the 'trust deficit' that has grown from states receiving devolution on estimated, rather than audited, gross tax revenues. Until the grand bargain is struck, however, the cess exclusion remains the central hidden subsidy from states to the Centre embedded in India's fiscal architecture.

Three Frameworks for Understanding Why the Gap Persists

Three economic frameworks converge on the same structural diagnosis for the Centre–State fiscal divergence documented in the sections above and none of them suggests that more transfers alone will solve the problem.

Musgrave's theory of fiscal federalism (1959). Musgrave (1959) argued that government has three fiscal functions: allocation (public goods provision), distribution (reducing inequality), and stabilisation (macroeconomic management). In India's constitutional design, the Finance Commission is the institutional vehicle for the distribution function correcting the vertical fiscal imbalance where states spend approximately 60 per cent of consolidated government expenditure but raise only 40 per cent of revenues. The progressive erosion of untied devolution through cess proliferation, CSS expansion, and the elimination of Revenue Deficit Grants represents a structural retreat from Musgrave's distribution mandate. The Economic Survey 2025-26 (Ministry of Finance Economic Survey, 2026) documents that states' own tax revenues grew at a CAGR of 12.6 per cent post-pandemic, reaching nearly 50 per cent of their total revenue receipts yet this improved revenue



mobilisation has not translated into greater fiscal autonomy because the composition of central transfers has simultaneously shifted toward tied and conditional flows.

The principal-agent problem in conditional transfers. When transfers are conditional tied to Centrally Sponsored Schemes with matching requirements and performance conditions the Centre becomes the principal and states become agents. The agent is incentivized to align spending with the principal's priorities to capture funds, not with local needs (Oates, 1972). This produces allocative distortion, states over-invest in CSS-eligible sectors such as housing and rural roads while under-investing in tertiary healthcare, state universities, and urban infrastructure that carry no matching incentive. The EPW (Economic and Political Weekly, 2025) documented that between FY11 and FY23 the unconditional share of total transfers to states fell sharply even as total transfer volumes rose the headline disguising the structural narrowing of fiscal autonomy. The 16th Finance Commission's discontinuation of sector-specific and state-specific grants, and its warning against unconditional cash transfers, further concentrates transfer flows into compliance-driven channels.

Economic Geography and Structural Transformation (Krugman, 1991; Kaldor, 1966). Industrial agglomeration is self-reinforcing: firms locate where other firms, infrastructure, and workers already exist, making lagging regions structurally hard to revive even when labour costs are lower (Krugman, 1991; Kaldor, 1966). India's manufacturing and services growth has been geographically concentrated in the South and West Karnataka, Tamil Nadu, Maharashtra, Gujarat, Telangana. The fiscal consequence is a bifurcated revenue base: richer states generate more own-tax revenue, need fewer central transfers, and can sustain capital expenditure even during fiscal consolidation cycles. Poorer states depend heavily on transfers Bihar's dependence is 72 per cent as per the RBI State Finances report (Reserve Bank of India, 2026) which means any compression in transfer quality immediately compresses their development space. The 16th Finance Commission's new GDP contribution criterion will, over time, reinforce this geography by rewarding states that have already been industrially transformed (Finance Commission of India, 2025/2026).

Conclusion

The paper has shown through nothing but the official government and Reserve Bank of India data that the CentreState fiscal architecture of India is undergoing a structural change, which is not reflected in the number of headline devolution. There are three coexisting changes that characterize



this change. To start with, the effective proportion of gross tax revenues to states has decreased to about 32 per cent, as at an unchanged 41 per cent headline, due to the systematic increase of the non-shareable cess and surcharge pool, which reached ₹4.23 lakh crore in FY26 (Ministry of Finance, 2014/2026). Second, the qualitative structure of transfer has changed radically: Revenue Deficit Grants, which allocated 17 states 118,000 crore in unconditional supplementary support in FY22, are eliminated completely as of FY27 (Finance Commission of India, 2025/2026), and market borrowings have been positioned to fund 76 per cent of GFD of states in Third, according to the NITI Aayog Fiscal Health Index 2026 (NITI Aayog, 2026), there is a 60-point composite score difference between Odisha (73.1) and Punjab (12.4) a structural difference, not a transient one. When combined, the above changes would represent a withdrawal of the distributive mandate of fiscal federalism as formulated by Musgrave (1959) and Oates (1972) in favor of a system that is more prone to rewarding those states already endowed with the historic benefits of geography and industrial agglomeration (Krugman, 1991; Kaldor, 1966).

The Economic Survey 2025-26 (Ministry of Finance Economic Survey, 2026) is valuable supportive context. Centre-State transfers increased more than twice in nominal terms between 2020 Rs11.5 lakh crore and 2026 Rs25.6 lakh crore (Budget Estimate), which is 6.9 per cent of GDP, a figure commonly used to suggest that states are better resourced than they used to be. However, the same survey also points out that increasing revenue expenditure would be crowding out capital expenditure in states with revenue deficits, that interest payments as a proportion of revenue receipts rose between FY17 and FY25, 10.9 per cent to 11.8 per cent (PRS Legislative Research Union Budget Analysis, 2025), and that unconditional cash transfer schemes. The total transfer figure masks the structural decay in the quality, conditionality, and reliability of such transfers.

The official evidence leads to three policy conclusions. To start with, the most amenable structural reform that can be implemented in the current constitutional framework is the so-called grand bargain on cesses as suggested by the 16th Finance Commission (Finance Commission of India, 2025/2026) to combine non-shareable levies in the divisible pool in correlation with a small decrease in the headline share. It would replenish an estimated ₹4 lakh crore to the pool without legislation amendment. The Commission has also suggested that annual disclosure of the CAG-certified net proceeds under Article 279 should be adopted, which the government has agreed; this transparency assurance is the obligatory requirement of restoring the trust aspect in the Centre State fiscal



relations. Second, matching contribution requirements of Centrally Sponsored Schemes should be varied depending on the state fiscal capacity. The effect of imposing uniform co-funding ratios between states with revenue bases of widely different sizes is systematic allocative distortion (Oates, 1972) - states will spend excessively in areas covered by CSS, and they will spend insufficiently in local priority areas. Third, the new GDP contribution criterion of the 16th Finance Commission should also be followed by a compensatory mechanism of the bottom 25 percent of the FHI performers, otherwise, over time the formula will increase a fiscal difference that it was not meant to serve.

The restructuring of the backward states in India is a long-term endeavor that cannot be achieved by any formula of transfer. The overall read between the lines of the RBI State Finances report, the 16th Finance Commission data, the NITI Aayog FHI and the Economic Survey indicators point to the same conclusion: the states that have the most room to develop are experiencing the most acute squeeze in fiscal autonomy at the very time when they are most in need of investment in structure. This diagnosis on the state and district level already has data on three ministries. The key question in the eyes of the fiscal policy makers in the 16th Finance Commission cycle in India is whether it is read together, and implemented before the divergence it describes becomes institutionalized.

In-Text Citations and Data Sources

In-text citation	APA short form	Data / claim cited
RBI, 2026	<i>Reserve Bank of India (2026)</i>	GFD 3.3% of GDP FY25; 16 states >3% GSDP FY26; outstanding liabilities 28.1% GDP March 2024 → 29.2% March 2026; market borrowings finance 76% of GFD; social sector expenditure 8.2% of GDP FY26
FC-16, 2025/2026	<i>Finance Commission of India (2025/2026)</i>	41% devolution retained; GDP contribution criterion 10%; RDGs discontinued; local body grants ₹7.91L cr; 3% GFD cap; off-budget borrowings mandated on-budget; combined debt 77.3%→73.1% of GDP by 2030-31; unconditional cash transfers 20.2% of subsidy spending
FC-15, 2020	<i>Finance Commission of India (2020)</i>	41% devolution; RDGs ₹1.18L cr FY22; tax effort criterion 2.5%; local body grants ₹4.36L cr; 17 states eligible for RDGs



JAMMU AND KASHMIR ECONOMIC ASSOCIATION

MoF, 2014–2026	<i>Ministry of Finance, Govt. of India (2014–2026)</i>	Union Budget BE/RE data: total transfers ₹25,59,764 cr FY26; tax devolution ₹14,22,444 cr; grants ₹11,37,320 cr; SASCI ₹1,50,000 cr; cess & surcharge FY14–FY26; divisible pool as % GTR
NITI, 2026	<i>NITI Aayog (2026)</i>	FHI 2026 scores: Odisha 73.1 (top), Punjab 12.4 (bottom); five pillars; 18 major states assessed; released March 11, 2026
ES, 2026	<i>Ministry of Finance — Economic Survey 2025-26 (2026)</i>	Centre-State transfers doubled FY20 to FY26 (₹11.5L cr→₹25.6L cr); states' own tax CAGR 12.6% post-pandemic; UCT schemes ₹1.7L cr FY26; interest payments 10.9%→11.8% of revenue receipts FY17–FY25; capital expenditure 2.7%→4% of GDP effective
PRS-UB, 2025	<i>PRS Legislative Research — Union Budget Analysis 2025-26 (2025)</i>	Total Centre expenditure ₹50,65,345 cr; transfers to states ₹25,59,764 cr; SASCI ₹1,50,000 cr; Centre outstanding liabilities 56.1% of GDP FY26; interest payments 25% of total expenditure
EPW-a, 2026	<i>Economic and Political Weekly (2026)</i>	'A Retreat from Progressive Fiscal Federalism' — effective share 32.1% in 15th FC period; Vol. 60, Issue 9, March 2026
EPW-b, 2025	<i>Economic and Political Weekly (2025)</i>	'Enhanced Devolution and Fiscal Space at the State Level' — unconditional share declining despite rising aggregate volumes; Vol. 60, Issue 18, May 2025
BS, 2026	<i>Business Standard (2026)</i>	Karnataka +0.48pp, Kerala +0.45pp, Gujarat +0.28pp; UP, Bihar, Rajasthan, MP relative declines; February 1, 2026
Musgrave, 1959	<i>Musgrave, R. A. (1959)</i>	Three-function fiscal theory — allocation, distribution, stabilisation
Tiebout, 1956	<i>Tiebout, C. M. (1956)</i>	Competitive federalism / 'voting with your feet'
Oates, 1972	<i>Oates, W. E. (1972)</i>	Decentralisation theorem — welfare superiority of untied decentralised provision
Krugman, 1991	<i>Krugman, P. (1991)</i>	Economic geography and agglomeration — self-reinforcing industrial concentration
Kaldor, 1966	<i>Kaldor, N. (1966)</i>	Structural transformation and cumulative causation — manufacturing-led growth and regional divergence
AJR, 2001	<i>Acemoglu, D., Johnson, S., & Robinson, J. A. (2001)</i>	Institutional quality and long-run development
North, 1990	<i>North, D. C. (1990)</i>	Institutions and economic performance
BD, 2011	<i>Banerjee, A. V., & Duflo, E. (2011)</i>	Poverty traps and self-reinforcing deprivation equilibria

Note: All in-text citations appear in italic parenthetical form in the body. All official Government of India and Reserve Bank of India sources are publicly available at the official portals listed in the APA reference list below. No AI-generated data is used in this paper.



References

Government and Institutional Sources

- Finance Commission of India. (2020). Report of the Fifteenth Finance Commission for 2021-2026 (Vols. I–IV). Government of India. <https://fincomindia.nic.in>
- Finance Commission of India. (2025, November; tabled 2026, February 1). Report of the Sixteenth Finance Commission for 2026-2031 (Vol. I Main Report). Government of India. <https://fincomindia.nic.in>
- Ministry of Finance, Government of India. (2014–2026). Union Budget documents: Budget at a Glance; Expenditure Budget; Transfer of Resources to States; Statement of Revenue Cesses and Surcharges, FY 2014-15 to FY 2026-27. <https://www.indiabudget.gov.in>
- Ministry of Finance, Government of India. (2026, January 29). Economic Survey 2025-26. Department of Economic Affairs, Ministry of Finance. <https://www.indiabudget.gov.in/economicsurvey/>
- NITI Aayog. (2026, March 11). Fiscal Health Index 2026: State Fiscal Performance, FY 2023-24. National Institution for Transforming India, Government of India. <https://www.niti.gov.in>
- Reserve Bank of India. (2026, January 23). State Finances: A Study of Budgets of 2025-26. Department of Economic and Policy Research, Reserve Bank of India. <https://rbi.org.in>

Legislative Research and Press Sources

- Business Standard. (2026, February 1). 16th Finance Commission retains 41% devolution, introduces GDP criterion. Business Standard. <https://www.business-standard.com>
- Economic and Political Weekly. (2025, May). Enhanced devolution and fiscal space at the state level. Economic and Political Weekly, 60(18).



- Economic and Political Weekly. (2026, March). A retreat from progressive fiscal federalism. *Economic and Political Weekly*, 60(9).
- PRS Legislative Research. (2025). Union Budget 2025-26 Analysis. PRS Legislative Research. <https://prsindia.org>
- PRS Legislative Research. (2026). Report Summary: Report of the 16th Finance Commission for 2026-31. PRS Legislative Research. <https://prsindia.org>
- Economic Theory Foundational Works
- Acemoglu, D., Johnson, S., & Robinson, J. A. (2001). The colonial origins of comparative development: An empirical investigation. *American Economic Review*, 91(5), 1369–1401. <https://doi.org/10.1257/aer.91.5.1369>
- Banerjee, A. V., & Duflo, E. (2011). Poor economics: A radical rethinking of the way to fight global poverty. PublicAffairs.
- Kaldor, N. (1966). Causes of the slow rate of economic growth of the United Kingdom. Cambridge University Press.
- Krugman, P. (1991). Increasing returns and economic geography. *Journal of Political Economy*, 99(3), 483–499. <https://doi.org/10.1086/261763>
- Musgrave, R. A. (1959). The theory of public finance: A study in public economy. McGraw-Hill.
- North, D. C. (1990). Institutions, institutional change and economic performance. Cambridge University Press. <https://doi.org/10.1017/CBO9780511808678>
- Oates, W. E. (1972). Fiscal federalism. Harcourt Brace Jovanovich.
- Tiebout, C. M. (1956). A pure theory of local expenditures. *Journal of Political Economy*, 64(5), 416–424. <https://doi.org/10.1086/257839>

Data and Methodology

All data in this paper are sourced exclusively from official Government of India and Reserve Bank of India publications. No AI-generated or projected figures are used except where explicitly marked as estimates (est.) derived from official trend data. Devolution and effective share calculations: Finance Commission of India (2020, 2025/2026); effective share derived as $(\text{divisible pool} \div \text{gross tax revenue}) \times 41\%$, using Union Budget cess and surcharge data (Ministry of Finance, 2014–2026). Absolute transfer volumes: Economic Survey 2025-26 (Ministry of Finance Economic Survey, 2026) and Union Budget 2025-26 Analysis (PRS Legislative Research, 2025). Fiscal Deficit and liabilities: Reserve Bank of India (2026), Appendix Tables 1 and 11. Revenue Deficit Grant trajectory: Ministry of Finance Expenditure Budget statements FY22–FY26; Finance Commission of India (2020). FHI scores: NITI Aayog (2026). State debt-to-GSDP: Reserve Bank of India (2026), Appendix Table 11. Interest payments as % of revenue receipts: PRS Legislative Research (2025), citing RBI and CAG data. Unconditional cash transfers ₹1.7L cr FY26 and 20.2% subsidy share:



JAMMU AND KASHMIR ECONOMIC ASSOCIATION

Ministry of Finance Economic Survey (2026) and Finance Commission of India (2025/2026). Economic frameworks: Musgrave (1959); Tiebout (1956); Oates (1972); Acemoglu, Johnson & Robinson (2001); North (1990); Krugman (1991); Kaldor (1966); Banerjee & Duflo (2011). All rupee figures in crore unless otherwise stated. BE = Budget Estimate; RE = Revised Estimate; PA = Provisional Actuals; GSDP = Gross State Domestic Product; GFD = Gross Fiscal Deficit; GTR = Gross Tax Revenue.



JAMMU AND KASHMIR ECONOMIC ASSOCIATION

EMPOWERING ECONOMIC PROGRESS