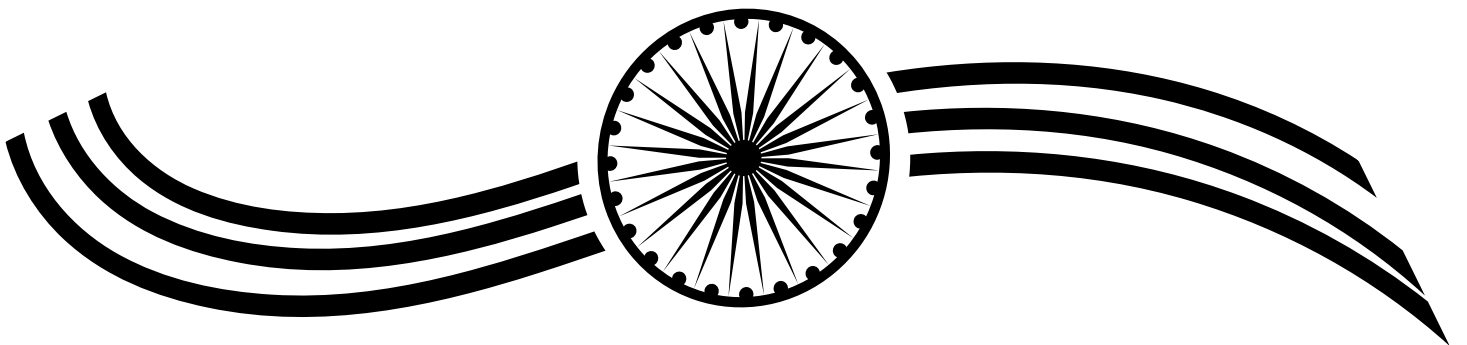
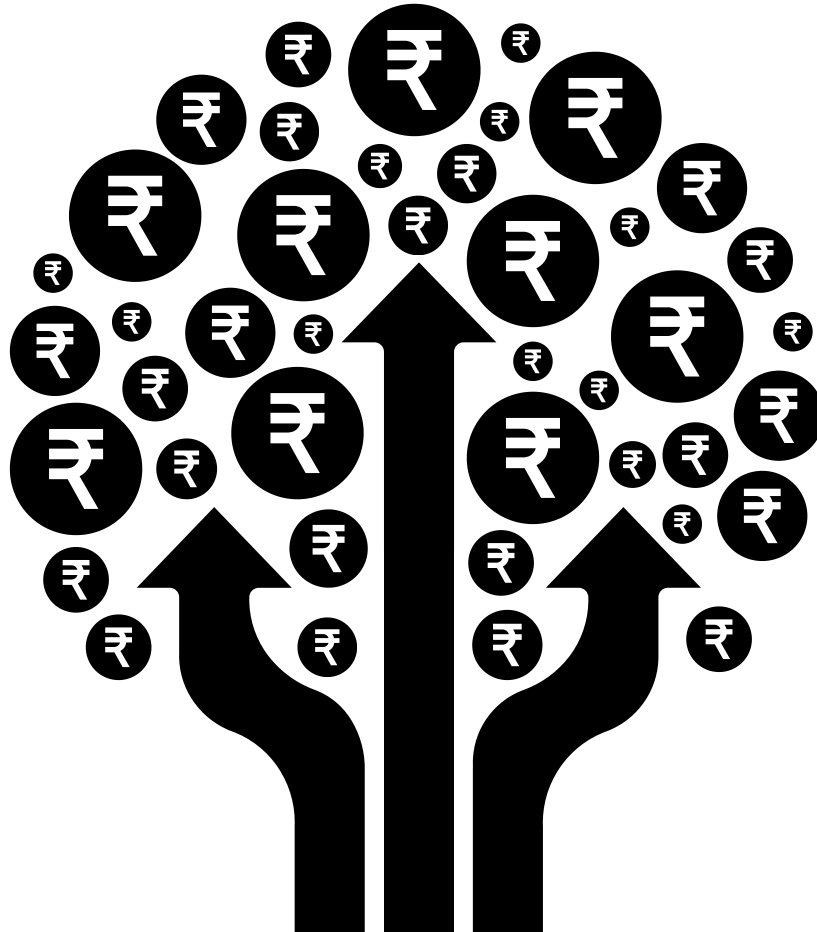




SIXTEENTH FINANCE COMMISSION



Report for 2026-31
Volume I - Main Report

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List of Abbreviations

AAI	Airport Authority of India
ACS	Average Cost of Supply
ADB	Asian Development Bank
ADCs	Autonomous District Councils
AE	Average Expenditure
AG	Accountants General
AI	Artificial Intelligence
AIDC	Agriculture Infrastructure and Development Cess
AMRUT	Atal Mission for Rejuvenation and Urban Transformation
APDRP	Accelerated Power Development and Reform Program
APTEL	Appellate Tribunal for Electricity
ARET	Additional Retail Excise Tax
ARR	Average Revenue Realised
AT&C	Aggregate Technical and Commercial
ATRs	Action Taken Reports
BE	Budget Estimates
CAG	Comptroller and Auditor General
CDEMA	Caribbean Disaster Emergency Management Agency
CDRI	Coalition for Disaster Resilient Infrastructure
CEEW	Council on Energy, Environment and Water
CERC	Central Electricity Regulatory Commission
CFI	Consolidated Fund of India
CoAs	Chart of Accounts
CPC	Central Pay Commission
CPSEs	Central Public Sector Enterprises
CPSUs	Central Public Sector Undertakings
CRF	Calamity Relief Fund
CRIF	Central Road and Infrastructure Fund
CS	Central Sector Schemes
CSS	Centrally Sponsored Schemes
CWC	Central Warehousing Corporation
DBT	Direct Benefit Transfers
DDMAs	District Disaster Management Authorities
DDMF	District-Level Disaster Mitigation Funds
DDRF	District-Level Disaster Response Funds
DDUGJY	Deen Dayal Upadhyaya Gram Jyoti Yojana
DISCOMs	Distribution Companies
DM Act	Disaster Management Act
DPE	Department of Public Enterprises
DRI	Disaster Risk Index

DVC	Damodar Valley Corporation
EBRs	Extra-Budgetary Resources
ERD	Effective Revenue Deficit
ERP	Enterprise Resource Planning
FC	Finance Commission
FCI	Food Corporation of India
FD	Fiscal Deficit
FRBM	Fiscal Responsibility and Budget Management
FRP	Financial Restructuring Plan
FSBs	Fully Serviced Bonds
FSR	Forest Survey Report
FY	Financial Year
GCOCs	Government Controlled Other Companies
GCs	Government Companies
GDP	Gross Domestic Product
GENCOs	Generation Companies
GIA	Grants-In-Aid
GPs	Gram Panchayats
GRIDCO	Grid Corporation of Orissa
GSDP	Gross State Domestic Product
G-Secs	Government Securities
GST	Goods and Services Tax
GSVA	Gross State Value Added
GTR	Gross Tax Revenue
IEG	Institute of Economic Growth
IFMS	Integrated Financial Management Systems
IGST	Integrated Goods and Services Tax
IIHS	Indian Institute for Human Settlements
IIPA	Indian Institute of Public Administration
IMD	Indian Meteorological Department
IPCC	Intergovernmental Panel on Climate Change
IRMA	Institute of Rural Management Anand
IWAI	Inland Waterways Authority of India
JAM	Jan Dhan bank accounts, Aadhar cards, Mobile phones
JJM	Jal Jeevan Mission
KALIA	Krushak Assistance for Livelihood and Income Augmentation
kWh	Kilowatt-hour
LB	Local Bodies
LFADs	Local Fund Audit Departments
LIC	Life Insurance Corporation
LPG	Liquid Petroleum Gas
MAS	Model Accounting System
MDF	Moderately Dense Forest

MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act
MH	Major Head
MHA	Ministry of Home Affairs
MoHUA	Ministry of Housing and Urban Affairs
MoPR	Ministry of Panchayat Raj
MoSPI	Ministry of Statistics and Programme Implementation
MPCs	Million-Plus Cities
MTFP	Medium-Term Fiscal Policy
NABARD	National Bank for Agriculture and Rural Development
NCCD	National Calamity and Contingency Duty
NCCF	National Calamity Contingency Fund
NCDC	National Cooperative Development Corporation
NCRB	National Crime Records Bureau
NDCR	Non-Debt Capital Receipts
NDMA	National Disaster Management Authority
NDMF	National Disaster Mitigation Fund
NDMIS	National Disaster Management Information System
NDRF	National Disaster Response Fund
NEC	National Executive Committee
NEH	North-Eastern and Hilly
NFCR	National Fund of Calamity Relief
NGO	Non-Governmental Organisation
NHAI	National Highway Authority of India
NHM	National Health Mission
NIDM	National Institute of Disaster Management
NMAM	National Municipal Accounting Manual
NMPCs	Non-Million-Plus Cities
NPS	National Pension System
NREGA	National Rural Employment Guarantee
NSSF	National Small Savings Fund
NTR	Non-Tax Revenue
O&M	Operation and Maintenance
OB	Off-Budget Borrowings
OECD	Organisation for Economic Co-operation and Development
OF	Open Forest
ONGC	Oil and Natural Gas Corporation
ORE	Other Revenue Expenditures
OROP	One Rank One Pension
OSL	Outstanding Liabilities
OSR	Own Sources of Revenue
OTR	Own Tax Revenues
PAT	Profits after Tax
PCGSDP	Per Capita Gross State Domestic Product

PCOTR	Per Capita Own Tax Revenue
PD	Primary Deficit
PES	Public Enterprises Survey
PESA	Panchayats Extension to Schedule Areas Act
PFMS	Public Financial Management System
PLI	Production-Linked Incentive
PM KISAN	PM Kisan Samman Nidhi Yojna
PM-KUSUM	Pradhan Mantri Kisan Urja Suraksha Evam Utthan Mahabhiyan
PMAY	Pradhan Mantri Awas Yojana
PMGKAY	Pradhan Mantri Garib Kalyan Anna Yojana
PPAs	Power Purchase Agreements
PRI	Panchayati Raj Institutions
PSE	Public Sector Enterprise
R-APDRP	Restructured Accelerated Power Development and Reform Program
RBI	Reserve Bank of India
RD	Revenue Deficit
RDG	Revenue Deficit Grant
RDSS	Revamped Distribution Sector Scheme
RE	Revised Estimates
RGVY	Rajiv Gandhi Grameen Vidyutikaran Yojana
RHS	Right Hand Side
RLBs	Rural Local Bodies
SASCI	Special Assistance to States for Capital Investment
SAUBHAGYA	Sahaj Bijli Har Ghar Yojana
SBI	State Bank of India
SBM-G	Swachh Bharat Mission-Gramin
SC/ ST	Scheduled Caste/ Scheduled Tribe
SCs	Statutory Corporations
SDGs	Sustainable Development Goals
SDMAs	State Disaster Management Authorities
SDMFs	State Disaster Mitigation Funds
SDRF	State Disaster Response Funds
SEB	State Electricity Board
SERCs	State Electricity Regulatory Commissions
SFC	State Finance Commission
SFA	Stochastic Frontier Analysis
SFAR	State Finance Audit Reports
SGSs	State Government Securities
SLBs	Service Level Benchmarks
SONTR	States' Own Non-Tax Revenues
SOTR	States' Own Tax Revenues
SPSEs	State Public Sector Enterprises
SPV	Special Purpose Vehicle

SS	Samagra Shiksha
SSPs	Social Security Pensions
SSRE	Social Sector revenue Expenditure
STP	Sewage Treatment Plants
SVAMITVA	Survey of Villages Abadi and Mapping with Improvised Technology in Village Areas
SWM	Solid Waste Management
TFR	Total Fertility Rate
TGR	Trend Growth Rate
ToR	Terms of Reference
TRANSCOs	Transmission Companies
TRE	Total Revenue Expenditure
UDAY	Ujjwal DISCOM Assurance Yojana
ULBs	Urban Local Bodies
UNDRR	United Nations Office for Disaster Risk Reduction
UTs	Union Territories
VAR	Vector Auto-Regressive
VAT	Value Added Tax
VDF	Very Dense Forest
WASH	Water, Sanitation and Hygiene
WB	World Bank

1.1 The Finance Commission (FC) plays a pivotal role in shaping Centre-State fiscal relations in India. In discharging its constitutional responsibilities, we at the Sixteenth Finance Commission (FC-16) undertook a range of institutional, consultative, and analytical exercises to frame its recommendations. This chapter outlines the constitutional foundation, composition, and Terms of Reference (ToR) of the FC-16. It also presents the organisational arrangements and preparatory work undertaken to operationalise the Commission, describes the extensive consultations with State and Union Governments, explains the methods of data collection and analysis, and details the broad framework adopted to guide the Commission's deliberations. The chapter concludes with an overview and organisation of the report.

Constitution and Composition of the Commission

1.2 In pursuance of clause (1) of Article 280 of the Constitution of India and the provisions of the Finance Commission (Miscellaneous Provisions) Act, 1951 (Act No. 33 of 1951), the President of India constituted the FC-16 vide Notification S.O. 5533(E) dated 31 December 2023 (*Annexure 1.1*). The Commission was mandated to make its recommendations for the five-year period commencing on 1 April 2026 and ending on 31 March 2031.

1.3 Dr. Arvind Panagariya, former Vice-Chairman, NITI Aayog and Professor, Columbia University, was appointed as the Chairman of the FC-16. Shri Ritvik Ranjanam Pandey was appointed as the Secretary to the Finance Commission (FC).

1.4 Subsequently, vide Notification S.O. 369(E) dated 30 January 2024, the President appointed the following persons as Members of the Commission (*Annexure 1.2*):

- (i) Shri Ajay Narayan Jha, former Member, Fifteenth Finance Commission and former Secretary, Department of Expenditure – Full-time Member

- (ii) Smt. Annie George Mathew, former Special Secretary, Department of Expenditure – Full-time Member
- (iii) Dr. Niranjan Rajadhyaksha, Executive Director, Artha Global – Full-time Member
- (iv) Dr. Soumya Kanti Ghosh, Group Chief Economic Advisor, State Bank of India – Part-time Member

1.5 As Dr. Niranjan Rajadhyaksha did not assume office, the President vide Notification S.O. 1625(E) dated 5 April 2024 appointed Dr. Manoj Panda, former Director, Institute of Economic Growth, as a Full-time Member of the Commission (*Annexure 1.3*).

1.6 Shri Ajay Narayan Jha tendered his resignation from the Commission with effect from 8 April 2025.

1.7 Thereafter, Shri T. Rabi Sankar, Deputy Governor, Reserve Bank of India, was appointed as a part-time Member of the Commission vide Notification S.O. 2506(E) dated 7 June 2025 (*Annexure 1.4*).

Terms of Reference

1.8 As per the order constituting the FC-16, its ToR is as follows:

“The Commission shall make recommendations as to the following matters, namely:

- i. The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
- ii. The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States by way of grants-in-aid of their revenues under article 275 of the Constitution for the purposes other than those specified in the provisos to clause (1) of that article; and
- iii. The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

The Commission may review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.”

1.9 The Commission was required to submit its report initially by 31 October 2025, covering the award period from 1 April 2026 to 31 March 2031. The period was later extended vide

Notification S.O. 4640(E) dated 10 October 2025 (*Annexure 1.4A*) to submit report by 30 November 2025.

Office Setup and Initial Challenges

1.10 An Advance Cell for the FC-16 was established within the Ministry of Finance to oversee preliminary activities in anticipation of the Commission's formal constitution. Initially comprising three officers, the Cell undertook critical groundwork necessary for setting up the Commission's Secretariat and initiating preparatory processes essential for its effective functioning.

1.11 Subsequently, the Department of Economic Affairs allocated office space for the Commission across three floors – seventh, ninth, and nineteenth – of Jawahar Vyapar Bhawan at 1 Tolstoy Marg, New Delhi. While the seventh floor was immediately operational, the ninth and nineteenth floors were in a state of disrepair and required complete renovation. Considerable effort went into refurbishing these floors, including the procurement of furniture and installation of IT infrastructure. These infrastructure and operational arrangements progressed concurrently with the Commission's early deliberations and stakeholder outreach.

1.12 Despite a strong commitment from the administrative staff, the process of fully stabilising operations took nearly four months. The period between January and May 2024 was marked by significant logistical and financial challenges. The imposition of the Model Code of Conduct (MCC) in the run up to the General Elections caused delays in financial approvals.

1.13 Infrastructural limitations also posed operational difficulties. The Jawahar Vyapar Bhawan building, houses multiple government offices, and operates with a limited number of elevators. Half of the building elevators have been out of order for several years, resulting in inefficiencies in intra-office movement and coordination, particularly across the three non-contiguous floors occupied by the FC-16. Often, visiting dignitaries were inconvenienced by this bottleneck.

1.14 In light of these experiences, we at the FC-16 are of the view that future Commissions would benefit from a more integrated and cohesive office set-up, with floors located in close proximity and pre-furnished workspaces prepared in advance of the Commission's formal constitution. Provisioning of adequate funds and basic infrastructure at the time of constitution would further ensure seamless commencement of work and timely onboarding of personnel.

Digital Infrastructure and Public Interface

1.15 To enhance transparency and facilitate wider engagement, the FC-16 developed and maintains an official website. This portal serves as a centralised information resource, offering details on the constitution and composition of the Commission, its official notifications, recruitment-related information, and procurement notices. It also hosts key documents, including background papers and presentations, and provides archival access to reports of

previous FCs. Importantly, the website featured a dedicated section for members of the public, institutions, and organisations to submit suggestions and views on the ToR, thereby supporting a more inclusive consultative process.

Secretariat Structure and Technical Expertise

1.16 The work of the FC-16 is supported by a multidisciplinary team of officers and professionals drawn from various services and backgrounds. Officers on deputation were inducted from several Central Civil Services, including the Indian Administrative Service, Indian Revenue Service (Income Tax), Indian Revenue Service (Customs & Indirect Taxes), Indian Railway Traffic Service, Indian Audit and Accounts Service, Indian Economic Service, Indian Statistical Service, and the Central Secretariat Service. In addition, officers and professionals were also deputed or seconded from the Reserve Bank of India, National Bank for Agriculture and Rural Development, the Government of the National Capital Territory of Delhi, and the National Institute of Public Finance and Policy. These officers contributed their administrative experience and domain knowledge across fiscal policy, public finance, and intergovernmental coordination. *Annexure 1.5* provides a comprehensive list of all officers deputed to the FC-16.

1.17 The process of onboarding officers to the Commission Secretariat involved coordination with multiple services and departments and was undertaken during a period of overlapping administrative demands, including the General Elections to the Eighteenth Lok Sabha. These overlapping demands created procedural bottlenecks in deputation approvals and onboarding. While some officers were temporarily engaged in election duties and others required procedural clearances from their parent cadres, the FC worked closely with the concerned authorities to facilitate timely deputations. Through sustained engagement and inter-departmental coordination, most officers were able to join by mid-2024, allowing the Secretariat to stabilise its core team and move forward with its analytical and consultative responsibilities.

1.18 In addition to deputed officers, the FC-16 engaged senior consultants, consultants, and young professionals with academic and professional training in fields such as economics, public finance, public policy, statistics, and governance. This blend of expertise enabled the FC-16 to maintain a high standard of technical and analytical rigour in its deliberations.

1.19 The FC-16 also received valuable support from multilateral development institutions. The World Bank (WB) and the Asian Development Bank (ADB) deputed public finance consultants to work directly with the Commission during its tenure. These consultants provided technical inputs and facilitated access to global best practices in fiscal decentralisation, debt sustainability, and outcome-based transfers.

1.20 To harness emerging talent and build capacity in public finance research, the Commission launched a structured internship programme, offering opportunities to graduate,

postgraduate, and doctoral-level students from diverse academic backgrounds. Interns contributed to ongoing research, data compilation, and preparatory work for State consultations, thereby enhancing the analytical capacity of the Secretariat.

Engagement with States and Stakeholders

1.21 In furtherance of its Constitutional mandate, the FC-16 established structured and multi-tiered channels of communication with State Governments to ensure a comprehensive understanding of fiscal realities and development priorities across the country. Recognising that the quality of its recommendations is contingent on the timeliness and integrity of information received, the FC-16 undertook a systematic outreach to key functionaries at various levels within the States.

1.22 The Chairman of the Commission wrote to the Chief Ministers of all States, outlining the ToR and inviting their considered views on key issues, including the principles of tax devolution, grants-in-aid, resource augmentation for local bodies, and disaster risk financing. Complementing this, the Secretary of the FC-16 addressed the Chief Secretaries of States, reiterating the data and projection requirements for the award period 2026-31.

1.23 To facilitate efficient coordination, States were advised to establish a dedicated FC Cell within their finance departments and designate a senior officer as the nodal officer. A secure, web-based portal was developed and hosted on the FC-16's official website to facilitate data and memorandum submissions, with clearly specified deadlines communicated to all States.

1.24 At the operational level, the Joint Secretaries of the FC-16 engaged with the Accountants General (Audit) of States, inviting presentations on fiscal trends, compliance with fiscal norms, and the status of local body finances. Communications were also initiated with the Director General (Government Accounts) in the office of the Comptroller and Auditor General (CAG) of India, seeking detailed finance accounts data for all States. The State verticals of the FC-16 coordinated directly with designated nodal officers in the State finance departments, providing access credentials for the dedicated data submission portal and outlining the procedural framework for interactions.

1.25 States were requested to furnish comprehensive projections for the award period (2026-2031), along with the underlying assumptions. They were also asked to share their views on the key areas covered by the ToR, particularly those relating to the distribution of net tax proceeds, structure of grants-in-aid, fiscal decentralisation, and disaster management financing.

1.26 In addition, the FC-16 sought granular financial data from 2011-12 onwards, including information on receipts and expenditure (both revenue and capital), debt liabilities, salary and subsidy outflows, deposits, and remittances. Particular emphasis was placed on obtaining disaggregated 'service heads' data and provisional accounts for the latest fiscal year. Until such detailed data was received, the Commission made interim use of Combined Finance and Revenue Accounts data to inform its pre-visit analysis.

1.27 For presentations by the Accountants General (AG) of States, the FC-16 provided a

comprehensive list of focus areas, such as the financial health of the State, performance of State-owned enterprises, implementation of past FC recommendations, local body finances, and power sector reforms. These presentations were integral to the Commission's preparatory assessments ahead of State visits.

1.28 In keeping with the principles of transparency and participatory governance, the FC-16 also invited suggestions and views from the general public, academic institutions, civil society organisations, and other stakeholders through a public notice (*Annexure 1.6*). Suggestions were sought on the ToR and any other issues relevant to the Commission's mandate. A dedicated section titled 'Call for Suggestions' was hosted on the official website of the Commission to facilitate structured submissions from interested parties.

1.29 This structured framework of communication enabled productive and continuous dialogue between the FC-16 and the States. It also ensured that the consultative process remained evidence-based, inclusive, and responsive to the evolving fiscal landscape.

Data Sources and Analytical Methodology

1.30 The recommendations of the FC are grounded in a rigorous analysis of fiscal data sourced from credible and authoritative institutions. In line with past practice, the FC-16 placed significant emphasis on data integrity, transparency, and comparability while assessing the fiscal positions of the Union and the States, as well as while examining issues relating to local bodies and disaster management.

1.31 For the assessment of Union finances, the Commission relied on the annual budget documents presented to Parliament, and publicly available fiscal data. Disaggregated details of the divisible pool of taxes were obtained from the office of the CAG.

1.32 In respect of the States, the FC-16 primarily utilised the audited State finance accounts, compiled by the respective AGs. These were supplemented by fiscal data furnished through the Commission's online data portal, where nodal officers designated by each State uploaded twenty-nine statements covering receipts, expenditures, power sector finances, subsidies, centrally sponsored schemes, and other relevant components. Additional sources included the Reserve Bank of India's (RBI) publications on State finances and the Ministry of Statistics and Programme Implementation, which provided comparable data on gross state domestic product, gross state value added, consumption, investment, savings, gross capital formation, and so on. For demographic projections, the FC-16 referred to data from the Ministry of Health and Family Welfare, which provided population estimates up to the year 2036.

1.33 In its deliberations on financing disaster management, the Commission drew on expenditure data available in State finance accounts, calculating average annual expenditures on disaster-related interventions. These were cross-referenced with data from the National Disaster Management Information System of the Ministry of Home Affairs, which offered in-depth insights into actual disaster-related expenditures reported by States over recent years.

1.34 For local bodies, the FC-16 leveraged multiple data sources to build a comprehensive picture of fiscal decentralisation. The e-Gram Swaraj portal of the Ministry of Panchayat Raj, provided data on the allocation, release, and utilisation of grants to rural local bodies, disaggregated by tied and untied categories. For urban local bodies, the City Finance portal of the Ministry of Housing and Urban Affairs offered detailed information on own source revenues, including property tax, and grants from State and Union Governments. It also provided performance data on service level benchmarks. Further inputs were collected through the FC-16 portal, which enabled consistent reporting by States on financial flows and functional capacity at the local level.

1.35 Taken together, these data sources enabled the FC-16 to undertake a nuanced, evidence-based analysis across all components of its mandate.

State Consultations and Field Visits

1.36 The months of April, May, and June 2024 coincided with the General Elections to the Eighteenth Lok Sabha. During this period, the Model Code of Conduct was in force, constraining direct engagements with State Governments. Accordingly, the FC-16 decided to defer State-level consultations until after the conclusion of the electoral process.

1.37 Following the completion of the electoral process, the Commission commenced its state visits beginning with Himachal Pradesh in the last week of June 2024. Over the course of the following twelve months, the Commission undertook consultations with all twenty-eight States, culminating with the visit to Uttar Pradesh in the first week of June 2025. *Annexure 1.7* provides the schedule of all State visits undertaken by the Commission during its tenure along with the list of participants in various consultation held during these visits.

1.38 These visits constituted a central component of the FC-16's consultative process, and provided a unique opportunity to engage directly with the highest levels of leadership in States, observe implementation realities on the ground, and gather contextual insights into fiscal and governance challenges.

1.39 The visits were preceded by preparatory presentations by the respective State's Auditor Generals, which provided an independent financial perspective and data-based diagnostics of the State's fiscal operations. These insights were instrumental in framing the FC-16's engagements with State officials. *Annexure 1.8* lists the presentations made by the AGs for each state visit.

1.40 Each visit was structured around formal meetings with the Chief Minister, Finance Minister, Chief Secretary, and senior officials of the State Government. The States presented detailed memoranda outlining their fiscal position, sectoral priorities, and expectations from the FC-16. These were followed by deliberations that allowed the Commission to seek clarifications, raise analytical queries, and better understand State-specific concerns relating to vertical and horizontal devolution, grants-in-aid, debt sustainability, and resource needs of local bodies and for disaster financing.

1.41 Following the meeting with State Government representatives, the FC-16 held structured interactions with representatives of rural and urban local bodies, including Autonomous District Councils in exempted areas, trade and industry associations, and political parties. To facilitate informed and meaningful discussions, an explanatory note outlining the key elements of the ToR was shared with the State Governments in advance, with the request that it be circulated among mentioned stakeholder groups. This step was aimed at promoting a common understanding of the Commission's mandate and ensuring that the ensuing dialogue was well-directed and substantively rich.

1.42 The FC-16 also held press briefings at the conclusion of its meetings in each State. These interactions served to inform the media and the broader public about the FC-16's mandate, the progress of its work, and the nature of consultations held with the Chief Minister and senior State officials. The Commission also shared key suggestions received from States on major elements of the ToR and responded to questions from the media, thereby promoting transparency and encouraging wider public engagement with the consultative process.

1.43 In addition to formal deliberations, the FC-16 also undertook field visits to selected districts, industrial clusters, municipalities, Gram Panchayats, health and education institutions, infrastructure projects, and tourism clusters. These site visits allowed members to obtain a first-hand understanding of implementation capacity, service delivery bottlenecks and sectoral innovations.

1.44 Thematic observations emerged from these visits in areas such as urbanisation, where challenges of financing and service delivery in rapidly growing towns and peri-urban regions were evident; tourism and heritage infrastructure, which offered insights into the potential for State-led economic development; health and education systems, where differential access and quality of outcomes were recurring concerns; and disaster risk management, particularly in ecologically vulnerable regions such as the Himalayan belt and coastal States.

1.45 In several States, the FC-16 visited sites of national and civilisational significance, ranging from pilgrimage towns and waste treatment plants to renewable energy installations, and cooperative farming initiatives. These experiences enriched the Commission's understanding of the developmental aspirations and socio-economic diversity across India.

Consultations with Union Ministries and Institutions

1.46 In the course of its deliberations, the FC-16 engaged extensively with various Ministries, line Departments, and autonomous institutions of the Union Government to gain a deeper understanding of sectoral dynamics, fiscal flows, and institutional priorities. These consultations were integral to assessing the Union's fiscal commitments, scheme design challenges, and intergovernmental financial arrangements across diverse areas.

1.47 The FC-16 held structured meetings with over twenty-five Ministries and Departments, covering key sectors such as disaster management, local governance, social protection, health,

education, agriculture, infrastructure, environment, and energy. These discussions provided valuable insights on centrally sponsored schemes, regulatory frameworks, fiscal incentives, and emerging policy imperatives that have direct implications for Centre-State fiscal relations.

1.48 Among the prominent institutions with which the Commission held consultations were the National Disaster Management Authority, the National Institute of Disaster Management, Ministry of Finance (Department of Economic Affairs), CAG of India, and regulatory bodies such as the Reserve Bank of India and Securities and Exchange Board of India. The FC-16 also engaged with line ministries responsible for key development sectors, including the Ministries of Rural Development, Health & Family Welfare, Housing & Urban Affairs, Power, Education, and Environment, Forest & Climate Change.

1.49 Particular attention was given to ministries and departments involved in supporting rural and urban local bodies, implementing/overseeing major subsidy programmes (food, fertilizer, power), and coordinating region-specific initiatives such as those in the Northeastern & Hilly States (NEH). The Ministry of Panchayati Raj, Ministry of Jal Shakti, and Ministry of Development of North Eastern Region were among the key interlocutors in this regard.

1.50 The insights gathered from these engagements not only informed the FC-16 sectoral analysis but also helped contextualise State-level submissions within the broader framework of national priorities and constraints.

1.51 A list of all Union Ministries, Departments, and institutions consulted by the FC-16, along with dates of interaction, is provided in *Annexure 1.9*.

Engagements Beyond Government

1.52 In addition to its structured consultations with State Governments and Union Ministries, the FC-16 undertook a wide range of interactions with eminent individuals and institutions to enrich its understanding of intergovernmental fiscal dynamics. The Chairman and Members held in-depth discussions with the former Chairpersons of the Twelfth to Fifteenth Finance Commissions – Dr. C. Rangarajan, Dr. Vijay Kelkar, Dr. Y.V. Reddy, and Shri N.K. Singh – whose perspectives on evolving fiscal arrangements and institutional design offered valuable historical and strategic insights. Members of various State Finance Commissions also engaged with the FC-16, sharing on-the-ground experiences of fiscal decentralisation and local body financing.

1.53 To ensure its recommendations reflect contemporary academic and policy thought, the FC-16 consulted a wide spectrum of economists, public finance scholars, and public policy professionals. These included former policymakers, think tank leaders, and academics from Indian and international institutions. Further, deliberations were held with members of civil society, grassroots governance practitioners, and representatives of sectoral associations. These wide-ranging engagements helped the Commission incorporate diverse viewpoints, practical feedback, and sector-specific considerations in the formulation of its recommendations.

1.54 *Annexure 1.10* provides a list of the FC-16's consultations with former FC Chairpersons, members of State Finance Commissions, economists, public finance experts, civil society actors, and other non-government stakeholders.

Workshops and Conferences

1.55 In order to deepen its understanding of the fiscal landscape and engage with a broad spectrum of stakeholders, the FC-16 organised a series of thematic workshops and conferences during the course of its deliberations. These platforms served as valuable fora for discussion, debate, and dissemination of ideas across the domains of fiscal federalism, disaster management, and the finances of local bodies.

1.56 The FC-16 convened regional workshops in each of the five zones – Northeast, West, East, South and North – between May and August 2024. These sessions were hosted in Shillong, Jaipur, Rajgir, Vishakhapatnam, and New Delhi respectively. These workshops brought together economists, regional experts, and public finance practitioners to deliberate on issues central to the FC-16's mandate, including vertical and horizontal devolution, disaster management financing, and local body empowerment.

1.57 A major academic event was organised in collaboration with the National Institute of Public Finance and Policy, where eminent economists presented papers and policy recommendations on core issues before the Commission. The event facilitated high-level academic engagement on vertical and horizontal devolution, expenditure efficiency, and intergovernmental fiscal relations.

1.58 The FC-16 partnered with international institutions such as the Organisation for Economic Co-operation and Development (OECD), WB, and ADB to organise high-level conferences on fiscal equalisation, urban finance, and disaster risk financing. Notable among these were the OECD 'Roundtable on Fiscal Relations', WB 'Conference on Intergovernmental Transfers' and the 'International Workshop on Financing Disaster Risk Management', and the ADB conference on 'Urban Finances: Issues before the FC-16'.

1.59 The FC-16 organised dedicated discussions on local governance such as 'Finance Commissions Conclave - Devolution to Development', jointly with the Ministry of Panchayati Raj and the National Conference of Mayors and Chairpersons. This discussion was facilitated by Janaagraha and focused on devolution and accountability mechanisms adopted in urban and rural governance. The Finance Commissions Conclave gave a unique opportunity to the FC-16 for having direct interaction with the State Finance Commissions of all States.

1.60 The Commission also engaged with national institutions working on increasing disaster resilience, particularly in the Himalayan region. A conference on disaster risk reduction was held in Leh in collaboration with the National Institute of Disaster Management and the University of Ladakh, to examine region-specific vulnerabilities and fiscal preparedness.

1.61 A list of workshops, regional consultations, and conferences organised or attended by the Commission is provided in *Annexure 1.11* along with the list of participants.

Commissioned Thematic and Sectoral Studies

1.62 In keeping with the precedent set by earlier FCs, FC-16 commissioned a wide range of studies to supplement its deliberations with empirical evidence and expert analysis. These included State-specific evaluations as well as thematic and sectoral studies, designed to inform key dimensions of the Commission's ToR and to strengthen the analytical basis of its recommendations.

1.63 To provide an independent and nuanced assessment of State finances, the Commission commissioned State-specific studies for all twenty-eight States. These were undertaken by reputed universities and research institutions across the country, and covered the fiscal situation, debt sustainability, expenditure patterns, and reform priorities of each State.

1.64 Alongside this exercise, the Commission also engaged leading national and international institutions to undertake thematic and sectoral studies. The National Council of Applied Economic Research was entrusted with several critical assignments, including an in-depth analysis of State-level growth trajectories and possibilities for convergence, and a comprehensive assessment of the fiscal situation and debt sustainability of States. The Institute of Economic Growth undertook a detailed study on the status and impact of FC grants to rural local bodies, while the Institute of Rural Management, Anand conducted a comprehensive review of panchayat finances and measures to augment their revenues. To inform the FC-16's work on urban decentralisation, Janaagraha Centre for Citizenship and Democracy provided two key studies: one on the principles of devolution to urban local bodies, and another presenting a municipal reform blueprint tailored to India's diverse urban ecosystem. The Indian Institute of Public Administration was engaged to analyse the State Finance Commissions' reports and fiscal transfers for local government growth.

1.65 Given the Commission's mandate to consider disaster risk financing, dedicated studies were undertaken on financing disaster risk management, drawing on global best practices and national experience through WB and Indian Institute of Technology Roorkee. On suggesting improvement in the Disaster Risk Index, the Coalition for Disaster Risk Infrastructure and the Council on Energy, Environment and Water were actively engaged. The WB provided analytical inputs on the prevalence and extent of off-budget financing by States, as well as a technical study on equalisation through fiscal transfers. A separate macroeconomic modelling exercise titled 'Macroeconomic Policy Simulations' for the FC-16 period was conducted by Dr. N.R. Bhanumurthy, employing a structural macro-econometric model to simulate policy scenarios over the award period. To analyse the out-of-pocket health expenditure and existing financial gaps across States, the National Health Systems Resource Centre was engaged.

1.66 In addition, targeted studies were commissioned on specific sectors and cross-cutting issues, including the power distribution sector, education, health, and subsidies, as well as an

in-house evaluation of Air Quality Improvement grants, and on subsidy. The FC-16 also received an independent analysis of the impact of FC recommendations on fiscal consolidation efforts made by States, prepared by the WB.

1.67 *Annexure 1.12* provides a consolidated list of all studies commissioned by FC-16 – covering State-specific evaluations as well as thematic and sectoral analyses – to support its deliberations and recommendations.

Internal Deliberations and Analytical Support

1.68 The FC-16 held a series of closed-door meetings to deliberate on key issues and formulate its recommendations. In total, 95 internal meetings were convened, involving the Chairman, Members, and the Member Secretary. These meetings served as the primary forum for analytical discussions and institutional decision-making.

1.69 Dedicated verticals within the FC-16 Secretariat provided comprehensive analytical support through detailed presentations on Union finances, State finances, grants-in-aid, local bodies, disaster management financing, debt sustainability, subsidies, and fiscal equalisation. These presentations also incorporated medium-term fiscal forecasting and scenario analysis to aid the FC-16 in assessing sustainability and trade-offs over the award period. State-specific verticals prepared structured in-house presentations synthesising data received from State Governments, and the diagnostic assessments of the State AGs.

Advisory Council and Expert Support

1.70 To support its work and deepen its analysis, the FC-16 constituted an Advisory Council, comprising experts in public finance and macroeconomics (*Annexure 1.13*). The members of the Advisory Council were - Dr. D.K. Srivastava, Mr. Neelkanth Mishra, Dr. Poonam Gupta (Convenor), Ms. Pranjul Bhandari and Mr. Rahul Bajoria.

1.71 The Advisory Council provided inputs on issues arising from the ToR, reviewed and monitored commissioned research studies, and brought to the table national and international best practices. A list of the deliberations of the Advisory Council and analysis conducted by individual council members in support of the Commission's work is provided in *Annexure 1.14*.

Structure of the Report

1.72 The Report of the Sixteenth Finance Commission is organised into sixteen chapters. Chapters 2-5, Issues, Approach and Review of Finances, set out the Commission's overarching approach and present a review of the finances of the Union and the States, both in aggregate and individually. Chapter 6, The Award Period: An Assessment of Union Finances, provides an assessment of the fiscal outlook for the Union during the award period. Chapters 7-11, Devolution and Grants, contain the Commission's recommendations on vertical and horizontal tax devolution, an assessment of State finances, and grants related to local bodies and disaster management. Chapters 12-15 focus on structural reforms critical for India's long-term economic

transformation, including macro-fiscal stability, electricity distribution, subsidies, and public sector enterprises. Finally, Chapter 16, Summary of Recommendations, presents a consolidated overview of the Commission's recommendations.

Conclusion

1.73 The work of an FC commences well before the formulation of its recommendations. It begins with the establishment of institutional capacity and credibility, the articulation of pertinent questions, and a commitment to engage meaningfully with the diverse voices that constitute India's federal polity. For the FC-16, this entailed not only fulfilling its Constitutional responsibilities but also navigating the inherent complexities and opportunities of Union–State fiscal relations with deliberative rigour. This chapter has outlined the institutional and consultative foundation of the Commission's work. The chapters that follow present the choices made in pursuit of a carefully calibrated balance; between competing claims, past precedents and emerging imperatives, and fiscal prudence and developmental ambition.



2.1 Article 280 of the Indian Constitution mandates that the President appoint a Finance Commission (FC) every five years or sooner to make recommendations on how to divide the net proceeds of Union taxes, commonly described as the divisible pool, between the Union and States (vertical devolution), how to apportion the States' share in this pool among them (horizontal devolution), what principles should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India, and what measures should be taken to augment the State revenues to supplement the resources of the local bodies constituting the third tier of the government during a specified period, usually five years. The current Commission is the sixteenth in the series of FCs appointed under this mandate since 1951, with the financial years 2026-27 to 2030-31 as its award period.

2.2 The terms of reference (ToR) of the past FCs have included explicit directions on the factors they must consider when making their recommendations. For instance, the FC-2 was asked to consider the requirements of the Second Five-Year Plan and the States' efforts to raise revenues from their own sources when making recommendations on grants-in-aid. Subsequent FCs were given similar, often more elaborate, directions. In contrast to this practice, the terms of reference of the present Commission adhere strictly to the charge as per the Constitutional language without any further direction on what factors the Commission should consider in making its recommendations.

2.3 Thanks to high growth catalysed by the accumulation of economic reforms over time and rapid physical and digital infrastructure build-up, India has recently emerged as the world's fifth-largest economy. During the years 2026-27 to 2030-31, for which the present Commission is to make recommendations, it is further expected to become the world's third-largest economy, with the United States and China the only two economies larger than it.

2.4 The rapid growth has turned out to be pivotal to India's mission to eradicate poverty. On one hand, this growth has directly empowered households by placing significantly larger incomes in their hands. On the other hand, it has provided the Union and State Governments with a much larger volume of revenue than they had at the beginning of the millennium, enabling them to undertake critical development and welfare programs. The result has been a near elimination of extreme poverty from India.

2.5 Estimations from the data pertaining to the Consumption Expenditure Surveys carried out by the Ministry of Statistics and Program Implementation show that the proportion of the population living below the conventional Tendulkar poverty line has fallen from 22 per cent in 2011-12 to less than five per cent in 2023-24. The sharp decline in poverty has been across all social groups, including the Scheduled Castes and the Scheduled Tribes. This experience underscores the importance of sustained rapid growth for broad-based prosperity in the forthcoming decades.

2.6 Closely following its ToRs, the Commission's report is principally devoted to answering the following key questions:

- (i) How should the net proceeds of Union taxes (the divisible pool) be shared between the Union and States from 2026-27 to 2030-31 (vertical devolution)?
- (ii) How should the States' portion in the divisible pool be allocated among the twenty-eight States over the same period (horizontal devolution)?
- (iii) What should be the principles governing the grants-in-aid of revenue of the States from the Consolidated Fund of India and what sums should be awarded to them during the award period?
- (iv) What measures are needed to augment the Consolidated Funds of States to supplement the resources of the third tier of the government during the award period?
- (v) What measures must be taken with respect to the arrangements and financing of Disaster Management initiatives during the award period?

2.7 The report begins with the Introduction (Chapter 1) describing the ToR of the Commission and its functioning throughout the term. It is followed by four chapters (Chapter 2-5), including the present one and three others reviewing the finances of the general government, the Union, and the States from 2011-12 to 2025-26. Chapter 6 assesses the likely evolution of finances of the Union during the award period. Our recommendations on the above five questions appear successively in Chapters 7-11. In Chapters 12-15, we recommend a set of reforms for sound management of public finances of the Union and States in four key areas: prudent fiscal management, addressing the problem of perennial losses of power distribution companies, streamlining the rapidly expanding subsidies and transfers and minimizing the losses of public sector enterprises. The last chapter summarizes our recommendations.

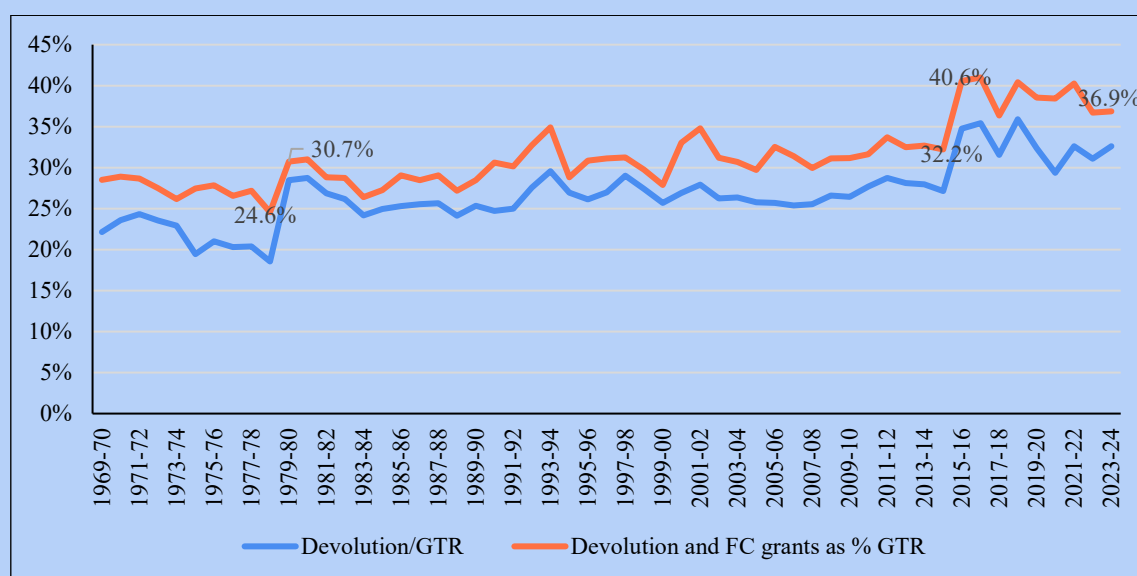
Vertical Sharing of Resources

2.8 There are three main channels through which resources flow from the Union to the States. First, under Article 270(1) of the Constitution, the Union's tax revenues, excluding cesses, surcharges, taxes accruing to the Union Territories (UTs), and the cost of collection, are shared between the Union and the States based on the recommendations of the FC. Second, under Article 275(1), the FC recommends specific grants to supplement the Consolidated Funds of the States. Finally, under Article 282, the Union provides discretionary grants to States, mainly through the Centrally Sponsored Schemes (CSS). Although the FC has no role in determining either their nature or magnitude, since they add to the overall revenue resources of the States, it must take them into account when recommending the transfers through the first two channels.

2.9 Historically, in the early post-independence decades, the Union's revenue resources were limited due to the nation's low per-capita GDP. A centralized planned development system also meant that the Union needed resources for its development schemes. Therefore, the revenue resources allocated to the States were limited. Over time, as per capita GDP and Union revenue resources increased, recognizing the large role assigned to the States in areas like education and health by the Constitution, FCs began transferring progressively larger shares of the Union's revenue resources to them. As a result, the average FC transfers increased from 23.1 per cent of the Union's gross tax revenue (GTR) during the award periods of the first four FCs (1952-69) to 38.5 per cent during the award periods of the last two (until 2023-24). *Figure 2.1* shows the annual shares of FC devolution and total FC transfers (devolution plus grants) as a per cent of GTR.

2.10 FC transfers as a proportion of GTR fluctuated considerably without a clear trend during the award periods of the first three Commissions (1952-66) but exhibited a rising trend thereafter. At the beginning of the FC-7, they witnessed a large discrete jump from 24.6 per cent of GTR in 1978-79 to 30.7 per cent of GTR in 1979-80. They saw a similar jump again at the beginning of the FC-14 from 32.2 per cent of GTR in 2014-15 to 40.6 per cent of GTR in 2015-16. The States' share in the divisible pool rose from 29.5 per cent under the FC-11 to 30.5 per cent under the FC-12, 32 per cent under the FC-13, and 42 per cent under the FC-14. In 2019, before the FC-15 gave its recommendations, the State of Jammu and Kashmir was re-organized into the Union Territories (UTs) of Jammu & Kashmir and Ladakh. Noting that the share of the UTs would amount to approximately 1 per cent of the divisible pool, the FC-15 set the share of the remaining twenty-eight States at 41 per cent. Therefore, it effectively maintained the status quo on vertical devolution.

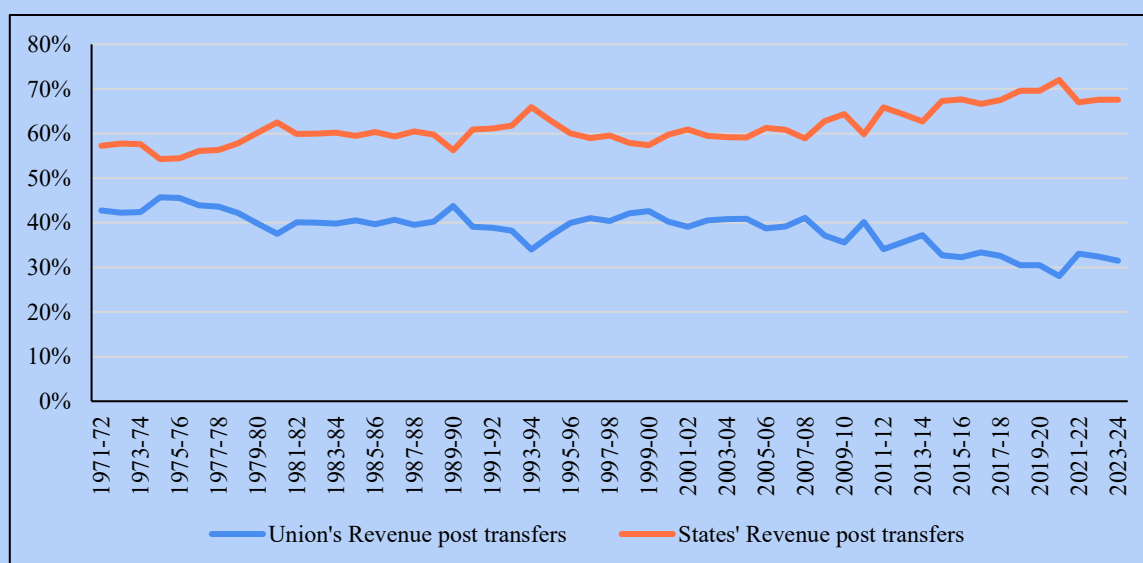
2.11 Inclusive of non-FC transfers, the total transfer of revenue resources to the States is yet larger. During the award periods of the first four FCs, the latter averaged 33.4 per cent of GTR. During the award periods of the FC-14 and FC-15, the average transfers had reached 55.8 per cent of GTR.

Figure 2.1 Devolution and Grants (percentage of Gross Tax Revenue)

Source: Annexure 7.1

2.12 Figure 2.2 shows the division of the revenues of Union and States, inclusive of non-tax revenues but excluding capital receipts, between the Union and States from 1970-71 to 2023-24. From 45.7 per cent in 1974-75 and 1975-76, the Union's share in revenues fell to 37.5 per cent in 1980-81. It recovered to 40.1 per cent in 1981-82 and, except for a brief dip during 1992-93 to 1994-95, hovered around this percentage till 2007-08. Since then, the share has seen a clear downward trend, which became especially sharp during the award periods of FC-14 and FC-15. In the COVID-19 year of 2020-21, the Union's share in revenues dipped to the all-time low of 28.0 per cent though it recovered to 33.0 per cent the following year, but only to fall again to around 32.4 per cent in 2022-23 and 2023-24. Post FC and non-FC transfers, States currently have a 68-69 per cent share of the total revenue receipts, excluding capital receipts.

2.13 The Commission has done its assessment of vertical resource imbalance in light of these shifts in revenue resources. The Union's revenues and expenditures allow us to calculate the revenue resources 'available' from the Union for devolution to the States. In parallel, the estimated revenues and expenditures of the States allow us to calculate the additional revenue resources 'required' by the States. Our recommendation on vertical devolution is based on a comparison of these 'available' and 'required' revenue resource estimates. To bridge any positive gap between the 'required' and 'available' resources, we assessed the room for further revenue growth through increased tax effort and expenditure savings through greater efficiency in spending at both levels of government. We then reworked the 'available' and 'required' revenue resources and repeated the exercise until an acceptable balance was achieved. The shares in the divisible pool were chosen in line with this balance.

Figure 2.2 Post-transfer Revenue Shares of the Union and States

Source: RBI's Database on Indian Economy

Note: The data shows revenue (tax and non-tax) receipts excluding capital receipts of Union and States from 1970-71 to 2023-24.

Horizontal Devolution

2.14 Horizontal devolution entails the allocation of the overall share of the States in the divisible pool, as determined in the vertical devolution exercise, among different States. Historically, this allocation has been based on a set of criteria that considers equity and efficiency. Each criterion is assigned a weight, which determines the percentage of the States' total share in the divisible pool that will be shared according to that criterion. For example, assigning a weight of 20 per cent to the population implies that 20 per cent of the divisible pool is allocated among the States based on their respective shares in the population of all States combined.

2.15 Until FC-6, 80 per cent or more of the divisible pool was divided based on population. This meant equal per capita allocation of 80 per cent or more of the divisible pool. These Commissions allocated the remainder of the divisible pool based on contribution to tax revenue or criteria with a stronger bias in favour of equity, such as inverse per capita income, distance of per capita income from a benchmark per capita income, or some index of development. From FC-7 onward, the equity-oriented criteria acquired greater importance. The FC-10 introduced tax effort and area as criteria, the FC-11 added fiscal discipline, the FC-14 forest, and the FC-15 inverse total fertility rate (TFR).

2.16 This Commission has taken the view that, considering India's growth imperative, there is a need for at least a small shift in the devolution criteria towards efficiency. Accordingly, we

have included the share of a State's Gross State Domestic Product (GSDP) in the nation's Gross Domestic Product (GDP) among the devolution criteria. This criterion captures the effect of various forms of efficiencies, including efficient spending and fiscal rectitude. We have accommodated this criterion by shifting some of the weight assigned by FC-15 to per capita GSDP distance, area, and tax effort.

2.17 In the interest of gradualism, we have retained the remaining criteria deployed by the FC-15, although with some tweaks. In the forest criterion, we have included the open forest, and given different weights to open, moderately dense, and very dense forests. We have also introduced a small reward for an increase in the weighted forest area over a base period. In implementing the area criterion, we have reduced the minimum area assigned to every State from 2 per cent of the total area to 1.5 per cent. Finally, for the demographic performance variable, we have replaced the inverse TFR with the inverse growth rate of population between 1971 and 2011. Throughout horizontal devolution, we have used the 2011 population. The rationales for the tweaks to different criteria are explained in greater detail in Chapter 8 on horizontal devolution.

2.18 We have deployed the inverse population growth as one of the devolution criteria in continuity with the FC-15's use of the inverse TFR to avoid large shifts in the States' shares. It is our view, however, that this criterion should be phased out over time. India is currently at risk of becoming old before it becomes rich, a prospect it must strive to avoid. We have taken a small step in this direction by lowering the weight assigned to the inverse population growth compared with that assigned to inverse TFR by the FC-15.

Grants-in-Aid and Assessment of Revenues and Expenditures over the Award Period

2.19 Article 280(3)(b) calls upon the Commission to recommend "the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India." Under the related Article 275, the President is to provide for "such sums" to be "charged on the Consolidated Fund of India in each year as grants-in aid of the revenues of such States" as she may "determine to be in need of assistance", after considering the recommendations of the Finance Commission.

2.20 A critical question we must consider when determining the sums to be provided to States as grants-in-aid is how the "need" specified in Article 275 is to be determined. The First Finance Commission recognised that the budgetary need is the starting point but laid down certain cautionary principles for assessing it. It cautioned against laxity in tax effort and lack of prudence in observing economy when carrying out this exercise. Successive FCs have followed a 'gap-filling' approach to determining the need for assistance, and recent FCs have used a 'normative' approach to assess the revenues and expenditure of States. The philosophy behind this 'normative' approach is that it will enable the FCs to determine how much revenue the

States are realistically capable of raising and how much expenditure is essential to deliver public services at a level necessary to maintain the State's development tempo.

2.21 In making their assessment, FCs exercise judgement regarding expenditures that are 'committed' in nature and those that should be excluded or normalised. For example, if a State decides to add a large number of employees to its rolls, expenditures on their salaries become a part of the committed expenditures. Interest on debt resulting from poor fiscal management is another example of a discretionary expenditure turning into a 'committed' expenditure. Some States have had to convert the accumulated losses of power distribution companies into debt. The losses themselves were the result of poor management and would not have cleared the normative assessment bar. Yet, once such losses are funded by debt, interest on the debt becomes normatively acceptable. Even in the case of certain expenditures that do not fall into the conventional committed categories, there could be ambiguity with respect to classification as normative versus non-normative. For example, there is no objective criterion for classifying certain subsidies as normatively acceptable or unacceptable. Conventionally, FCs have excluded power subsidies from 'normatively' permissible expenditures. However, how are subsidies, such as free water to all, to be distinguished from power subsidies for such classification? There are no clear answers to these questions.

2.22 Typically, normative assessments expect revenue deficits to decline and drop to zero or near zero by the last year of the award period. In reality, the actual expenditure and revenue patterns have not followed the 'normative' path charted by FCs, with revenue deficits persisting. A new FC once again begins with a substantial revenue-deficit grant, which, as per its own normative assessment, declines to near zero by the end of its award period. But the realized outcome remains at variance with the expectation.

2.23 In our assessment of State Finances, we find that the expenditure patterns of States, even for expenditure 'committed' to salaries and pensions, vary significantly. In addition, expenditure on subsidies and transfers has increased worryingly in recent years. There is also ample scope to increase tax revenues by improving tax efficiency. We conclude that the reasons for the persistent revenue deficit of some States lie in these factors. Indeed, revenue deficit grants create an adverse incentive whereby the expectation of such grants encourages States to be profligate rather than address the root causes of the revenue shortage.

Local Body Grants

2.24 The 73rd and 74th Amendments to the Constitution created the third tier of the government in an effort to decentralize and devolve administrative and financial powers from the State to local bodies. The 73rd Amendment gives constitutional status to the Panchayati Raj Institutions (PRIs) in rural India, and the 74th Amendment does the same to the municipal institutions in urban India. Recognising the need for augmenting the financial resources of the

local bodies (LBs), the amendments mandate the FC to recommend the ‘measures needed to augment the Consolidated Fund of a State to supplement the resources’ of the local bodies.

2.25 Successive FCs, appointed after these amendments, have adopted a dual interpretation of the phrase ‘measures needed to augment’. On the one hand, they have recommended grants-in-aid from the Consolidated Fund of India to LBs, and on the other, they have suggested measures to increase their own revenues. They have recognised, just as we have, that the primary responsibility for the funds and functionaries necessary to perform the functions devolved to LBs rests with the State Governments. The grants-in-aid recommended by the FC are to play only a supplementary role in helping the local bodies meet their financial needs.

2.26 Following the established practice, we held extensive consultations with various stakeholders on the expenditure needs of and fiscal resources likely to be available to the LBs during the award period of this Commission. The memoranda submitted by the States and the Union provide their views on the subject. We also interacted with the representatives of select LBs during our visits to the States. Further, we visited several Gram Panchayats and municipalities in different States. We witnessed a transformative change underway in the delivery of basic civic services, such as drinking water, sanitation, streets, streetlights, and even public libraries, by the Panchayats. Urban municipalities have begun to pay significantly greater attention to the collection and treatment of solid waste and sewerage management. The representatives of the LBs uniformly emphasized the need for the transfer of a larger volume of grants from the Union and a reduction in the extent of tied grants, enabling them to address their specific needs.

2.27 We commissioned studies and organised conferences to understand various dimensions of local body finances. Experts have emphasized the importance of the timely constitution of State Finance Commissions (SFCs), adequate resources for them, and prompt action on their reports. The Constitution also directs the FC to make its recommendations ‘on the basis of the recommendations made by the Finance Commission of the State.’ Accordingly, SFCs have a crucial role in the devolution of resources to the rural and urban local bodies. However, we have found that many States fail to appoint them in a timely fashion. Moreover, the available SFC reports are heterogeneous in their approach, methodology, and coverage of issues. As a result, we have not found them useful for framing our recommendations for the transfer of funds, which must follow a common set of criteria.

2.28 Some have argued that the FC-recommended transfers should play a gap-filling role, based on the normative assessment by the SFC of expenditure needs of and resources to be transferred by the State to the local bodies. However, recognizing that this may give rise to perverse incentives on the part of the States and LBs, we have not followed this approach. Instead, we have tried to strike a balance between the availability of resources and the needs of the local bodies, suggesting certain focus areas for increasing the own sources of revenue (OSR) of the local bodies. Currently, OSR mobilisation remains weak: total OSR of local bodies

contributes just 0.4 per cent of GDP in India. In the absence of comparable reports of SFCs, we also agree with past Commissions' view that population should be the main criterion for *inter se* sharing of grants to the LBs, with area serving as a secondary criterion for Panchayats and generation of OSR for the municipalities. One of the key areas of our focus is accelerating urbanisation. Urbanisation, by its inherent nature, acts as a catalyst for economic development. Cities concentrate physical and human resources, infrastructure, economic activities, and employment opportunities. They help production units to exploit economies of scale and improve their competitiveness. Keeping this in view, we have focused on two important areas aimed at aiding urban growth.

2.29 First, there is an urgent need for the revamp of the drainage system in Indian cities. While the large metros are in a position to raise their own fiscal resources for this purpose, the same is not true of the smaller cities. Therefore, taking into account the availability of limited resources, we have recommended the provision of some fiscal resources for revamping the drainage system in the middle-level municipalities on a cost-sharing basis.

2.30 Second, we have observed that there are unusually long delays in conferring a statutory urban status on areas that come to exhibit all urban characteristics. India's urbanisation process remains constrained by the slow and ad-hoc conversion of census towns into statutory towns and the hesitant merger of peri-urban areas into nearby urban local bodies. Such areas continue to be governed by rural local bodies (RLBs), which are ill-equipped to manage the burgeoning demands of an urbanising population. As a result, unplanned growth, deficient infrastructure, and weak service delivery persist in peri-urban areas. Hence, we have given particular attention in our recommendations to speeding up the conversion of RLBs that have already acquired substantial urban features into urban local bodies (ULBs). In pursuing this objective, we have focused on the incorporation of peri-urban areas into adjacent municipal bodies.

2.31 Finally, in designing a part of our grants to RLBs and ULBs, we have incorporated incentives for these bodies to improve upon the generation of their own source of revenues, as well as for the States to undertake at least a small matching of the grants by the FC. The former is in keeping with the principle that as LBs become more capable, they must also achieve a certain degree of financial self-sufficiency. There is greater pressure from local residents for the delivery of high-quality services when they have themselves contributed to the revenues of the LB. The latter is in keeping with the Constitutional spirit that local bodies are primarily the responsibility of the State Governments. Fiscal transfers from the Consolidated Fund of India to LBs are meant to be only supplementary in nature.

Disaster Relief Grants

2.32 The ToR of the Commission specifically mandate 'a review of the present arrangements on financing disaster management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 and to make appropriate recommendations thereon'.

Accordingly, in this report, we have provided a review of the progress in disaster management in recent years as well as recommendations for further progress and grants to be provided to meet the challenges arising during our award period.

2.33 Except for the district level response and mitigation fund, all the funds mandated by the Disaster Management Act, 2005 have been constituted by all the States as well as by the Union. Recommendations on Calamity Relief have been a part of the FC's recommendations since the FC-2. FCs have been instrumental in transforming India's disaster management framework by institutionalizing dedicated funds such as the Calamity Relief Fund and National Calamity Contingency Fund, fostering a collaborative fiscal partnership between the Union and States through shared allocation mechanisms, recommending dynamic expansions to the list of recognized disasters in line with evolving risks and assessing States' needs based on disaster risk. We acknowledge the role of the past Commissions in both creating and transforming the disaster management architecture in India. Our approach with respect to financing and management of disasters reflects a commitment to that legacy of institutional strengthening, collaborative governance and responding to evolving challenges.

2.34 We have held extensive consultations with the States and the relevant ministries of the Union Government and National Disaster Management Authority (NDMA). We have also consulted various expert institutions to deepen our understanding of the impact of the past recommendations and to identify areas where a course correction is needed. The expertise of institutions like the Coalition for Disaster Resilient Infrastructure and the Council on Energy, Environment and Water has informed our understanding of disaster risk assessment. Their inputs have been integral to our deliberative process.

2.35 In our recommendations, we have acknowledged the institutionalization of mitigation funds along with those meant for relief and response. Our analysis reveals that progress in the utilization of mitigation funds has been slow. As a result, an assessment of the likely impact of these funds is not possible as yet. Nevertheless, we have decided to continue with the current arrangements for disaster financing, as provided under law. Although the issuance of the guidelines for mitigation funds was delayed, projects taken under these funds should be continued and brought to fruition, with greater flexibility in both selection and execution at the Union and State levels.

2.36 We have deliberated extensively on improving the Disaster Risk Index (DRI) methodology, in which scores are assigned based on the probability of hazards striking a State, the State's exposure to hazards, and the extent of its vulnerability. Based on the internationally accepted definitions of disaster risk, we recognize that the DRI is a multiplicative function of the variables hazard, exposure, and vulnerability, and the risk only exists when these variables intersect. We have vastly expanded the hazard variable to include more disasters, accommodating the key demand from almost all the States. We have also acquired credible and more recent datasets on hazards from expert agencies and have ensured that our methodology

remains objective and scientific. While we acknowledge the role of risk assessment in the allocation of grants, we also appreciate the importance of past expenditure on disaster management as an indicator of the immediate future needs of the States. Past expenditure on disaster management is a valuable empirical signal of the frequency, intensity, and fiscal impact of disasters experienced by States over time and we continue to assign it an important role in designing future allocations.

2.37 Responding to the requests from various stakeholders and based on sound evidence, we have also made important recommendations with respect to expanding the list of nationally notified disasters. In our recommendations, we have paid adequate attention to capacity building and systems improvement. Based on our interactions with the States and expert agencies, we concluded that due to varying institutional capacities, wide variations exist among States in terms of utilization of the funds. We have recommended that capacity building be taken up using funds meant for mitigation, with the NDMA tasked with undertaking a comprehensive study of institutional capacity gaps at all levels and proposing targeted measures.

2.38 Recognizing the role of technology as a critical enabler in effective disaster management, we have recommended that the NDMA synergize the efforts of all concerned agencies to make technological interventions at all stages of the disaster management cycle. We recognize that data-driven decision making is vital for accurately determining the hazard profile of each State and for guiding the equitable allocation of *inter se* disaster management grants. Hence, we have deliberated extensively on all the available data sources on disaster expenditure heads, disaster wise expenditures, items on which most of the expenditure is incurred and the States' approaches in booking the expenditure in finance accounts. This analysis has informed our recommendations on how National Disaster Management Information System can be made the repository of all disaster-related data.

Reforms for Sound Public Finances

2.39 In last four chapters of the report, we focus on a set of reforms necessary to place the Union and State finances on a sound footing. Four specific areas covered are: prudent fiscal management, power distribution companies, subsidies and transfers and public sector enterprises.

Prudent Fiscal Management

2.40 A key driver of sustained growth is the robust fiscal health of both the Union and the States. Translated, this means that the Government should be able to mobilise adequate resources to fund its economic and social development expenditures. It also means a fiscal design that ensures inter-generational equity, that is, the distribution of the burden of resource mobilization between current and future generations. A balance must be maintained between taxes and debt as the means of resource mobilization. In its growth journey, India will have to

ensure that the debt incurred by both the Union and States is sustainable and does not unduly transfer the burden of current expenditures to future generations.

2.41 Since the reforms of the 1990s, the Union Government's debt profile has evolved into a portfolio that is both stable and safe. Its debt-to-GDP ratio has successfully achieved a secular decline. Notwithstanding the reversal of this trend due to the COVID-19 pandemic, the debt as a proportion of GDP is back on its path of secular decline. The Union Government is on course to reduce debt to below 50 per cent of GDP by 2030-31. The structure of Indian's sovereign debt is among the safest globally, thanks to its low rollover risk, even compared to many advanced economies. Currency risk is also minimal due to the small share of external debt in total debt and to generally prudent exchange-rate management. This fiscal stance must be maintained in the forthcoming decades.

2.42 At the State level, many large States have maintained sound finances, with fiscal deficits below 3 per cent of their GSDPs. However, certain States have had a history of repetitive breaches and a high debt-to-GSDP ratio. While fiscal imbalance in a handful of States is unlikely to threaten the country's overall fiscal stability, it does carry the risk of undermining their growth prospects. In addition to reducing high debt levels, States must adopt best debt management practices to economize on the cost of servicing it.

Electricity Distribution Companies

2.43 The electricity sector has made considerable progress in recent years, with all willing households in rural and urban areas now electrified. However, one important area with implications for State finances, financial health of power distribution companies (DISCOMs), has remained a weak link in this sector. Despite efforts by the Union and State Governments to improve operational and economic efficiency, DISCOMs in many States have been unable to achieve sustained profitability. They have remained subject to persistent losses and debt. In collaboration with State Governments, the Union Government has given bailouts on three different occasions over a period of two decades, which led to weakening the State finances of the affected States each time. Yet, DISCOMs remain subject to the largest ever debt today.

2.44 Our diagnosis of the problem suggests that the explanation for the repeated cycles of losses, debt accumulation, and bailouts of DISCOMs lies in the current governance structure. As public entities, DISCOMs lack the necessary incentive to achieve a high degree of efficiency in plugging leakages through technical losses, theft, under-billing, and under-collection. At the same time, the State Electricity Regulatory Commissions have not always fixed the tariff at cost-recovery levels. The lower tariffs suit the State authorities as well since they translate into a lower subsidy bill for the exchequer. The first-best solution to the problem is the privatization of DISCOMs. Short of this step, States must undertake serious governance reforms. To help States in this direction, we provide the case studies of governance structures of DISCOMs in Gujarat and Haryana, which have delivered healthy outcomes on a sustained basis in this area.

Subsidies

2.45 Subsidies and transfers form another area of reform with serious budgetary implications. While these instruments have a legitimate role in a welfare society, the imperative of fiscal prudence should not be ignored. Once introduced, subsidies and transfers are rarely phased out. Due to their electoral appeal and ease of disbursement through a well-developed digital payments system, large-group cash transfer schemes have proliferated. As more wealth is created over time and the revenue base expands, political pressures are likely to push further in this direction. These pressures need to be resisted, lest they undermine the future financial stability of States and the Union.

2.46 The primary role of subsidies and transfers should be to assist the poor. Any other subsidies must be predicated on compelling evidence of externalities. Both the Union and States must review the current schemes to assess whether they meet these criteria. Those that do not should be phased out. It is also important to review the beneficiary base of the schemes that are retained, to ensure that the schemes cater to only those targeted by the scheme. Finally, the schemes must have exit clauses to remove those who become ineligible over time from the list of beneficiaries.

Central and State Public Sector Enterprises

2.47 Public sector enterprises (PSEs) constitute the final subject we consider in this part of the report. Our detailed review of both Central and State PSEs reveals considerable scope for reforming PSEs to enhance their contribution to economic growth. Without such reforms, their losses will remain a burden on the State exchequer, and their assets, mainly land, would go unused. According to the *Public Enterprise Survey 2023-24* (Appendix VIII, pp. 271-2), there are seventeen central PSEs (CPSEs) under liquidation, twenty-four CPSEs approved for closure by the Government, and thirty-one CPSEs that are non-operational as on 31 March 2024. Altogether, assets of a massive seventy-two CPSEs have been rendered unproductive. To minimize further draining of public resources by these enterprises, they must be swiftly evaluated for closing down. A similar problem also exists in the States. As many as 308 out of a total of 1,635 State PSEs (SPSEs) have ceased to carry out their operations.

2.48 There also exist a large number of loss-making CPSEs and SPSEs. Almost one-third of CAG-audited CPSEs incurred losses in each of the latest four years for which we have CAG data. The annual losses of the loss-making CPSEs varied from ₹36,213 crore to ₹51,419 crore over the same period. In the States, 489 SPSEs out of 1,055 SPSEs for which data on profit & loss are available incurred losses. The losses amounted to ₹1.14 lakh crore in 2022-23. One rule of thumb worth considering is for the concerned department to mandatorily take to the Cabinet any enterprise incurring losses in three out of four consecutive years for consideration for closure, privatization or continuation.

2.49 In States, the problem of SPSE accounts in arrears is endemic. As of 31 March 2023, 1,237 SPSEs had 7,162 accounts in arrears. As many as 441 SPSEs had their accounts in arrears for more than three years. Each State must ensure that all accounts in arrears are settled and finalized, and the SPSEs are brought within the ambit of the CAG audit.

2.50 The Union Government had taken the bold step of adopting the New Public Sector Enterprise Policy in February 2021. It commits the government to closing or privatizing CPSEs in non-strategic sectors. While the closure of loss-making enterprises has gathered speed recently, action on privatization has not. Based on the experience of CPSEs privatized during 1999 to 2004, significant efficiency gains can be reaped through the privatization of CPSEs and SPSEs in the non-strategic sectors.

Concluding Remarks

2.51 With the threat of COVID-19 behind us and India well on its way to becoming the third-largest economy during the award period of the present Commission, this Commission has sought to lay a sound fiscal foundation for sustained growth in the forthcoming decades. On the one hand, we have adhered to the tradition of gradual change followed by a vast majority of the past Commissions, while on the other, we have sought to make a directional change. Our recommendation on vertical devolution reflects continuity, whereas that on horizontal devolution rewards States for their contribution to growth for the first time.

2.52 Departing from the practice followed by all the preceding FCs, we find that the revenue deficit grants have not led to adoption of policies towards reduction of revenue deficit. Instead, it has created adverse incentives and endless cycles of persistent revenue deficits and revenue deficit grants for almost the same set of States.

2.53 In the area of local body grants, our directional change has been in the incentivization of speedier urbanization, which acts as a catalyst for faster growth. Our ULB grants open two avenues to speedier and orderly urbanization – incorporating peri-urban areas that have already acquired nearly all characteristics of an urban settlement into the adjacent municipal body and revamping the drainage infrastructure of cities with populations between 10 lakh and 40 lakhs.

2.54 In the disaster management area, we have carried forward the work of recent Commissions, most notably the FC-15. Two features of our recommendation in this are noteworthy. First, in an innovative step, the FC-15 partially based its grant allocations to the States on a Disaster Risk Index. In making our recommendations, we have aligned this approach fully to the international practice, defining it as a product of hazard, exposure and vulnerability. Our hazard variable is based on a significantly larger number of disasters, accommodating a key demand of nearly all States. Second, although we found that progress in utilizing mitigation funds during the FC-15 award period has been slow, which has undermined our ability to assess the outcome of these funds, we have recommended continuing with the current arrangements to allow the efforts in this area more time. Finally, in response to requests from various

stakeholders and recognizing the existence of sound evidence, we have recommended the inclusion of heatwaves and lightning among the national disasters.

2.55 Our final set of recommendations focuses on sound public finances of the Union and States. We identify four focus areas: improving overall fiscal management, ensuring the long-term stability of power distribution companies, rationalizing and restraining the expansion of subsidies, and making the public-sector enterprises efficient and competitive. As discussed in last four chapters of the report, through further reforms, both the Union and the States can contribute and collaborate in each of these areas.

□□□

3.1 In a modern democratic society, the government discharges numerous functions. It provides public goods, such as external defence, internal security, public welfare, infrastructure, public parks, and so on, which the market fails to provide. It redistributes income and wealth in ways that are seen as socially desirable. It provides a legal and institutional framework, including laws, regulations, and judicial infrastructure, within which private parties may transact with minimal friction. It corrects market failures arising from externalities such as air and water pollution, monopoly, and other forms of imperfect competition, as well as asymmetric information.

3.2 In a large democratic country such as India, the Union Government alone cannot perform these functions efficiently. The Indian Constitution recognizes this fact and, in the Seventh Schedule, delineates areas that are solely the responsibility of the Union Government (List I or the Union List), those that are solely the responsibility of the State Governments (List II or the State List), and those that are shared between the Union and State Governments (List III or the Concurrent List). The Union List includes subjects such as defence, foreign affairs, banking, and currency; the State List covers areas such as public order, police, public health and sanitation, agriculture, and land; and the Concurrent List has items such as education, labour, forests, and economic and social planning.

3.3 Based on the 73rd and 74th Constitutional Amendments, passed in 1992, India gave constitutional status to the third tier of government in the form of local bodies represented by panchayats in rural areas and municipal bodies in urban areas. Under these amendments, some of the functions discharged by the State Governments have been gradually delegated to the rural and urban local bodies. This process of devolution is still ongoing, and the status of the functions performed by these local bodies varies considerably across States, depending on the willingness of the State Governments to share effective power with them.

3.4 Each tier of the government requires fiscal resources to discharge its assigned functions. For example, the Union Government acquires these resources through (i) taxes, such as income and corporation taxes, customs duties, the goods and services tax (GST) and excise duties, (ii) non-tax revenues, such as royalties on minerals and user charges on goods and services it provides to households and firms, and (iii) future liabilities consisting of borrowings from the market and non-market sources. Once acquired, the government must allocate these fiscal resources across different expenditure items to efficiently discharge various functions. This chapter explores how the Union and State Governments, taken together, acquired their fiscal resources in recent years, how they allocated them across different expenditure items, and whether the future liabilities have been incurred sustainably. In the following two chapters, we turn to Union and State finances individually.

Review Period and the Two Disruptions

3.5 Our analysis of Union and State finances in this report spans 2011-12 to 2025-26. The choice of the initial year is dictated by the fact that 2011-12 is the year when the last base year of the GDP series was revised. The terminal year is the latest year for which data were available at the time of writing the report. We have the definite (actual) figures until 2023-24, while we rely on Revised Estimates (RE) and provisional accounts for 2024-25 and Budget Estimates (BE) for 2025-26. In this chapter, the review is confined to years 2011-12 to 2023-24. By way of background, it is useful to note at the outset that two major disruptions, with implications for the government finances, characterized this period.

3.6 First, there was a decline in growth rate during 2019-20, primarily driven by problems in the financial sector, impacting banking as well as non-banking finance companies, mutual funds and other financial institutions, and adversely impacting the credit growth. The government had to take several corrective steps, including increased infusion of equity, to improve the balance sheets of banks.

3.7 Second, the outbreak of COVID-19 in the last quarter of 2019-20 caused significant disruptions to the economy and finances in India and globally. This was an unprecedented shock requiring out-of-the-box responses. India took necessary steps to safeguard the lives and livelihoods of the needy through a large expansion of programs such as the public distribution system and the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) programme.

3.8 Despite loud calls from nearly all quarters at home and abroad, the Union Government chose not to follow the rest of the world in stimulating demand through massive cash transfers. It foresaw that any attempts to address the demand deficiency through a large demand stimulus, with COVID-19 still disrupting supply chains, would only translate into inflation. As a result, whereas most countries worldwide were confronted with double-digit inflation as COVID-19 and its aftermath unfolded, India escaped that fate. Moreover, after a large negative growth (-5.8 per cent) in real gross domestic product (GDP) in 2020-21, India's economy rapidly recovered, registering growth rates of 9.7 per cent, 7.6 per cent, 9.2 per cent, and 6.5 per cent during the four years beginning with 2021-22 and ending in 2024-25.

3.9 This robust recovery notwithstanding, India's public finances did take a hit due to the COVID-19 crisis. While the government had to expand public expenditures to minimize the effect of the shock, especially on the poor and vulnerable, revenue collection saw a slowdown in the immediate post-COVID years. The resultant expansion of borrowing, accompanied by a downward shift in the GDP trajectory, led to a major spike in the debt-to-GDP ratio. In turn, the post-COVID-19 trends in the country's public finance were quite different from those during the pre-COVID-19 years. The following discussion brings out this contrast.

Government Finances: An Overview

3.10 Table 3.1 shows the total receipts and expenditure, including on revenue and capital account, of the general government¹ in absolute values as well as percentage of GDP. To eliminate double-counting, inter-government transactions like grants and loans by the Union to the States or interest payments by the States to the Union and vice versa, have been netted out. This chapter reviews in detail, trends and major components of receipts and expenditure. Unless specified otherwise, all GDP figures in this Report are presented at nominal values.

Table 3.1 Receipts, Expenditure and Deficit of Union and States Combined

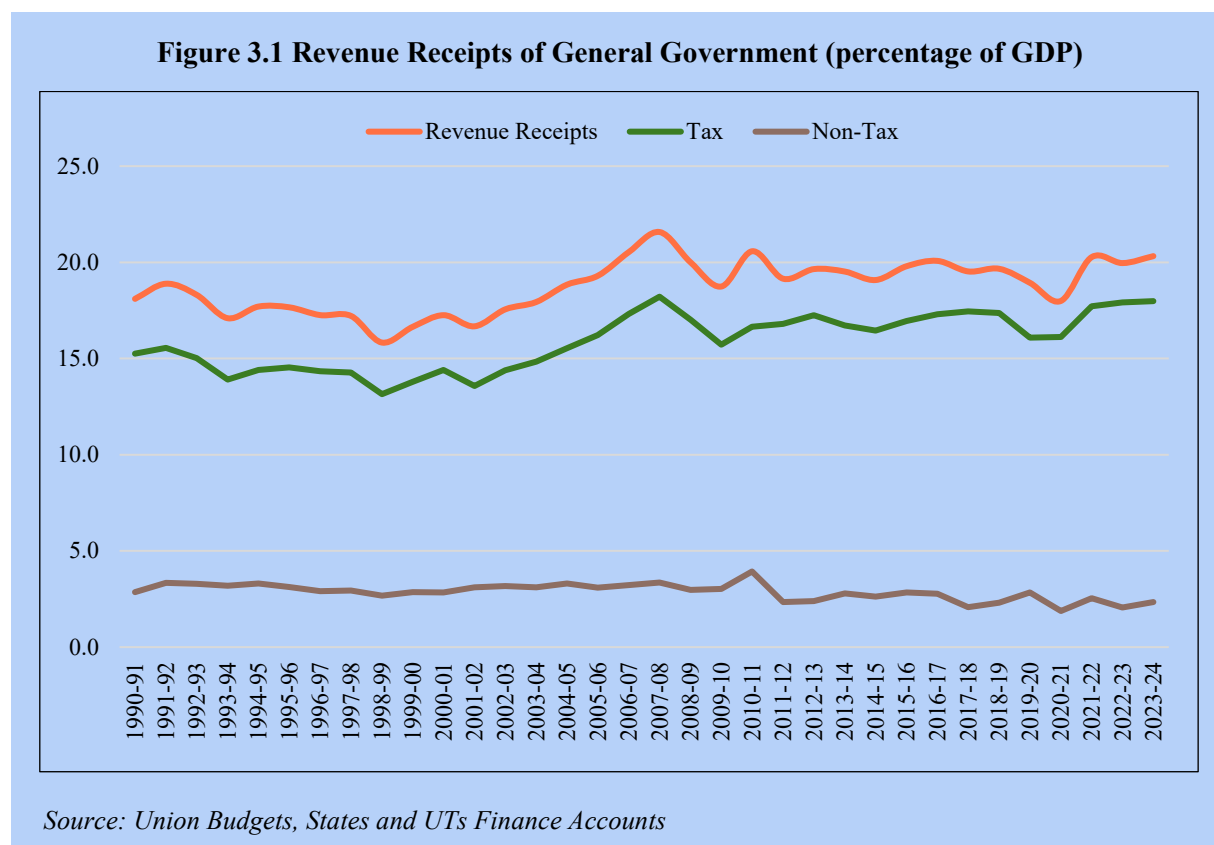
Year	GDP	Receipts	Expenditure	Fiscal Deficit	Receipts	Expenditure	Fiscal Deficit
	(Figures in ₹ lakh crore)				(Figures as percentage of GDP)		
2011-12	87.36	17.17	24.14	6.97	19.7	27.6	8.0
2012-13	99.44	19.94	26.88	6.94	20.0	27.0	7.0
2013-14	112.33	22.33	29.97	7.64	19.9	26.7	6.8
2014-15	124.68	24.40	32.77	8.37	19.6	26.3	6.7
2015-16	137.72	27.86	37.52	9.66	20.2	27.2	7.0
2016-17	153.92	31.59	42.94	11.35	20.5	27.9	7.4
2017-18	170.90	34.80	45.17	10.37	20.4	26.4	6.1
2018-19	189.00	38.57	50.38	11.81	20.4	26.7	6.2
2019-20	201.04	39.17	53.98	14.81	19.5	26.8	7.4
2020-21	198.54	36.37	63.18	26.81	18.3	31.8	13.5
2021-22	235.97	48.27	70.46	22.19	20.5	29.9	9.4
2022-23	268.90	54.30	78.20	23.89	20.2	29.1	8.9
2023-24	301.23	61.84	85.28	23.44	20.5	28.3	7.8

Source: Ministry of Statistics and Programme Implementation (MoSPI), Union Budgets, States and Union Territories (UTs) Finance Accounts

¹ The General Government here consists of the Union, State governments and Union Territories with legislatures. Transfers from the Union and States to local bodies are captured under the general government expenditures but exclude the own revenue resources of local governments and expenditures met out of them. Own revenue resources of local bodies taken together amount to approximately 0.4 per cent of GDP.

Revenues

3.11 Revenue receipts of the general government, comprising tax revenue and non-tax revenue, have mostly remained between 19 per cent and 20 per cent of GDP since 2011-12. It dipped below this range in 2020-21 due to COVID-19. Encouragingly, recent trends indicate an uptick, with revenue receipts in 2023-24 reaching above 20 per cent of GDP. Review of a longer period shows that the revenue receipts had been increasing and had touched a high of 22 per cent just before the global financial crisis as shown in *Figure 3.1*.



Tax Revenue

3.12 Tax revenue continues to be the mainstay of government financing, accounting for around 87 per cent of the revenue receipts during the review period. As per the division of tax administration in the Constitution, the Union collects taxes on corporate and personal income, customs duties and excise duties on petroleum products, while States collect value added tax (VAT) on petroleum products and alcoholic liquor, excise duties on alcoholic liquor, stamp duty and registration fees, and motor vehicle taxes. With the introduction of GST, revenues from GST are shared between the Union and the States.

3.13 As shown in *Table 3.2*, tax revenue of the Union and State Governments has steadily increased from below 17 per cent of GDP in 2011-12. While there is a dip in 2019-20 due to corporate tax reduction and early impact of COVID-19, and in 2020-21 due to COVID-19, the tax revenues have climbed up to 18 per cent of GDP in 2023-24.

Table 3.2 General Government Taxes and FC Devolution (percentage of GDP)

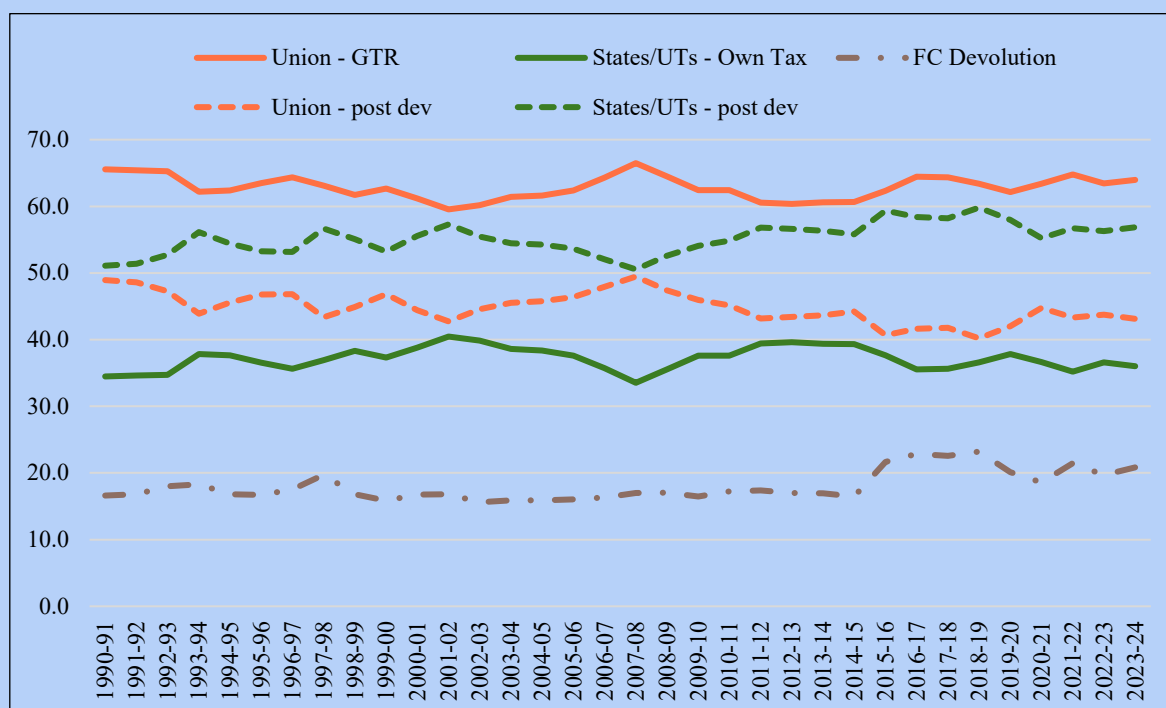
Year	Net Tax Receipts of Union	Tax Devolution (States' Share in Union Taxes)	Own Tax Receipts of States/UTs	General Government Total Tax Revenue
2011-12	7.3	2.9	6.6	16.8
2012-13	7.5	2.9	6.8	17.3
2013-14	7.3	2.8	6.6	16.7
2014-15	7.3	2.7	6.5	16.5
2015-16	6.9	3.7	6.4	17.0
2016-17	7.2	4.0	6.1	17.3
2017-18	7.3	3.9	6.2	17.4
2018-19	7.0	4.0	6.4	17.4
2019-20	6.8	3.2	6.1	16.1
2020-21	7.2	3.0	5.9	16.1
2021-22	7.7	3.8	6.2	17.7
2022-23	7.8	3.5	6.6	17.9
2023-24	7.8	3.7	6.5	18.0

Source: Union Budgets, States and UTs Finance Accounts

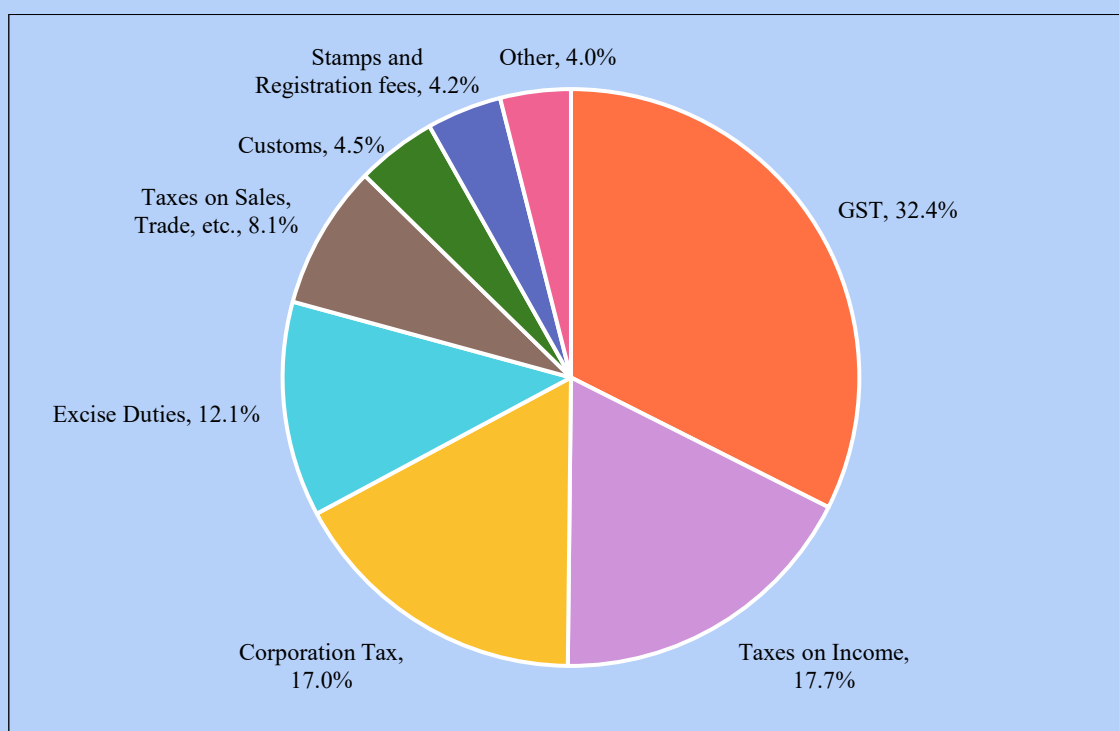
3.14 Long-term trends show that, since 1991, tax revenues have maintained a steady growth rate of 13.6 per cent, with the highest surge observed between 2004 and 2008. In the post-pandemic period, tax revenues have demonstrated resilience, growing at 13.8 per cent, a pace that surpasses the average growth rate recorded in the decade preceding COVID-19. General government tax collections have increased from around 15.2 per cent of GDP in 1990-91 to 18.0 per cent of GDP in 2023-24.

3.15 The contribution of Union taxes in general government tax receipts has historically been higher than that of States/UTs. Union taxes contributed around two-thirds of general government tax collections, averaging approximately 63-64 per cent over the period 1990-91 to 2023-24. In contrast, the States' own-tax revenue share has hovered around 36-37 per cent. In 1990-91, Union taxes accounted for 10.0 per cent of GDP, while State taxes contributed 5.3 per cent. This composition has largely persisted - Union taxes rose to 11.5 per cent of GDP and States/UTs taxes to 6.5 per cent in 2023-24.

3.16 However, this composition shifts substantially after accounting for tax devolution as recommended by Finance Commissions. For example, in 2023-24, the transfers (tax devolution) from the Union to States stood at around 21 per cent of the general government tax receipts. Post devolution, the Union Government is left with 43 per cent of taxes, while the States have access to a higher share of 57 per cent. Tax devolution has seen a level jump in 2015-16 due to a sharp increase in vertical devolution recommended by the Fourteenth Finance Commission (*Figure 3.2*). This is analysed in greater detail in Chapter 8 on vertical devolution.

Figure 3.2 Union and State Taxes (percentage of Total Tax Receipts)

Source: Union Budgets, States and UTs Finance Accounts

Figure 3.3 Composition of Tax Revenues of General Government (2021-2024)

Source: Union Budgets, States and UTs Finance Accounts

3.17 During the period 2011-12 to 2023-24, Union tax revenues grew at 11.2 per cent per annum with a buoyancy of 1.1, partly due to buoyant direct taxes. In contrast, States' own-tax revenues grew at a relatively slower pace of 9.7 per cent per annum, with a buoyancy of 0.95. Moreover, significant variations persist in tax collections across States, as we explain later in the chapter. Relatively lower buoyancy of State taxes has led to increased dependence of States, on average, on the share in Union taxes and other central transfers.

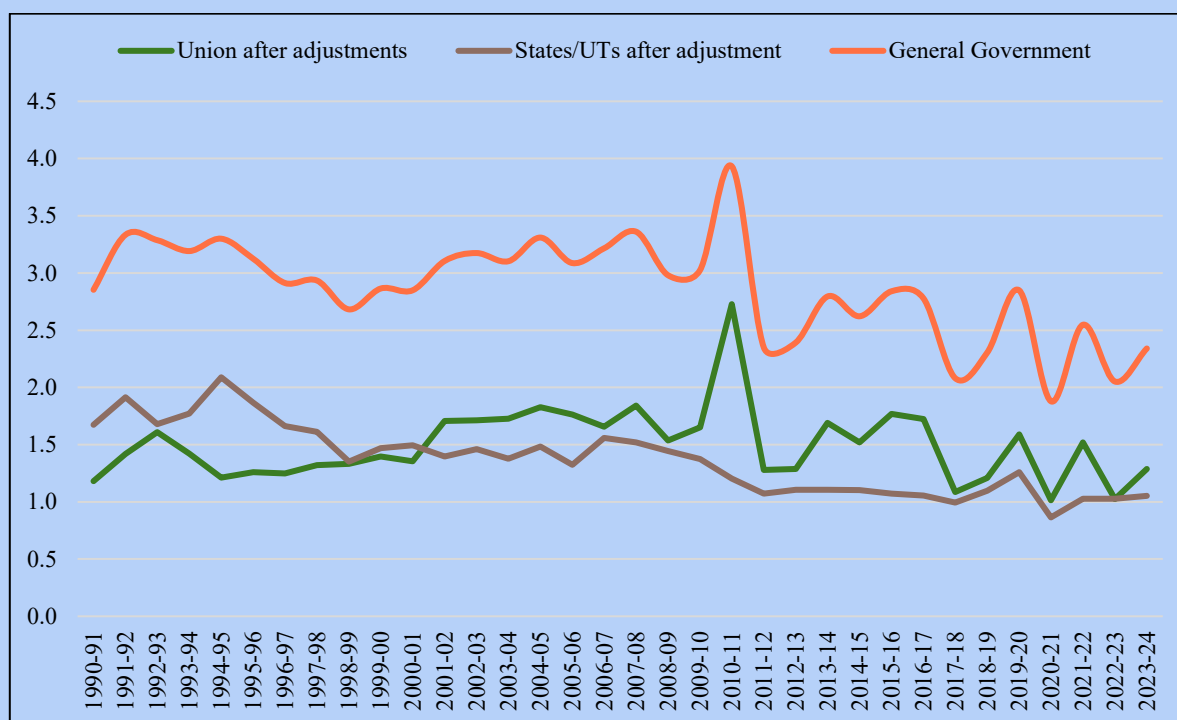
3.18 As shown in *Figure 3.3*, more than 32 per cent of the total tax revenue comes from GST, and about 35 per cent comes from direct taxes, almost equally contributed by the corporation taxes and the taxes on income other than corporation tax. With the introduction of GST, excise duties and sales tax/VAT are limited to five petroleum products and alcoholic liquor for human consumption, and they account for about 20 per cent of the total taxes. Customs duties levied by the Union contribute 4.5 per cent to the kitty, and stamps and registration fees levied by the States contribute 4 per cent. Other small taxes such as electricity duties and land revenue account for another 4 per cent.

Non-tax Revenues

3.19 Non-tax revenues comprise dividends from public sector enterprises and banks, the surplus from Reserve Bank of India (RBI), profit and royalty from natural resources and telecommunication spectrum, and user charges such as fees and tolls. In order to derive the non-tax revenue of the general government, the inter-governmental transactions such as interest paid by States/ UTs to the Union on central loans and vice versa interest received by States from the Union on cash balance investment account (Treasury bills) have been netted out. Otherwise, these form part of the non-tax revenues of individual governments.

3.20 In recent years, non-tax revenues have been around 12-13 per cent of total revenue receipts. As shown in *Figure 3.4*, they have hovered around 2.5 per cent of GDP over the review period, with most of the variation being contributed by non-tax revenues of the Union. The main contributor to this variation has been fluctuations in the transfer of surplus by the RBI to the Union Government as dividends and proceeds of spectrum auctions. While the non-tax revenues of States have remained flat at 1 per cent of GDP in recent years, they have been in a steady decline over a longer period – States' non-tax receipts stood at 1.4 per cent of GDP during the period 2000-01 to 2010-11.

3.21 Non-tax revenues have displayed some episodes of sharp spikes, often reflecting one-off policy measures. For example, they rose to nearly 4 per cent of GDP in 2010-11, driven primarily by proceeds from telecom spectrum auctions. Unlike tax revenues, which tend to grow with economic activity and can be reformed to expand the base or rates, non-tax receipts do not enjoy the same benefit. They are significantly impacted due to rigidity in pricing of administrative services and natural resources and sub-optimal performance of public sector undertakings, with which we deal in detail in Chapter 15.

Figure 3.4 Non-tax Revenues (percentage of GDP)

Source: Union Budgets, States and UTs Finance Accounts

Note: Non-Tax Receipts of Union adjusted for Interest earned on loans to the States and vice versa.

Non-Debt Capital Receipts

3.22 Non-Debt Capital Receipts (NDCR) constitute only a small fraction of the total receipts of the general government. These receipts primarily encompass miscellaneous capital inflows, with the major sources being disinvestment proceeds and the recovery of loans and advances. The NDCR for the general government is calculated after netting out recoveries of intergovernmental loans and advances. Historically, it has been around 0.5 per cent of GDP, barring a few years where it has crossed 1 per cent. In recent years, it has come down to 0.2 per cent of GDP.

Expenditure

3.23 As shown in Figure 3.5, the total expenditure of the general government, encompassing both revenue and capital expenditure, has historically ranged between 24 per cent and 30 per cent of GDP. However, total expenditure saw a sharp increase during the pandemic, soaring to 31.8 per cent of GDP (Table 3.3). While expenditure as a share of GDP has gradually declined post-pandemic, it is yet to return to pre-COVID levels. A key factor contributing to this sustained momentum is the heightened focus on capital expenditure in recent years. Increased investment in infrastructure and development projects has kept public expenditure levels

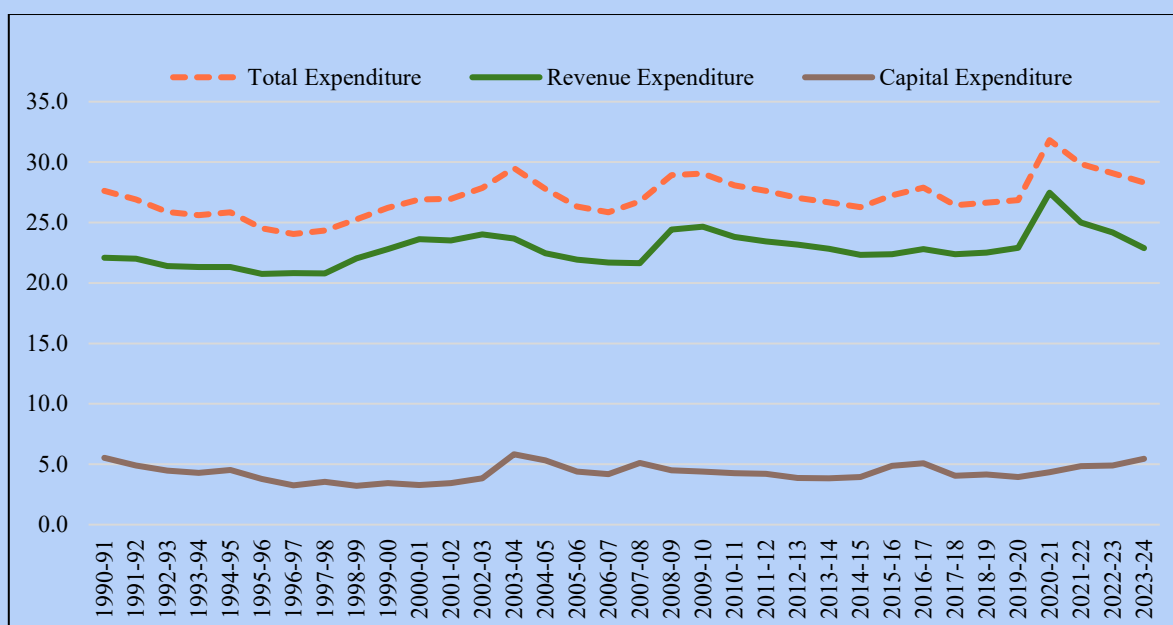
elevated. Over a long period, since 1990-91, the total expenditure of the general government has grown at an annual rate of 13.2 per cent.

Table 3.3 Composition of General Government Expenditure (percentage of GDP)

Year	Revenue Expenditure	Capital Expenditure	Total Expenditure
2011-12	23.4	4.2	27.6
2012-13	23.2	3.9	27.0
2013-14	22.8	3.8	26.7
2014-15	22.3	4.0	26.3
2015-16	22.4	4.9	27.2
2016-17	22.8	5.1	27.9
2017-18	22.4	4.0	26.4
2018-19	22.5	4.2	26.7
2019-20	22.9	3.9	26.8
2020-21	27.5	4.3	31.8
2021-22	25.0	4.9	29.9
2022-23	24.2	4.9	29.1
2023-24	22.9	5.4	28.3
Annual Growth Rate	10.9%	12.3%	11.1%

Source: Union Budgets, States and UTs Finance Accounts

Figure 3.5 General Government Expenditure (percentage of GDP)



Source: Union Budgets, States and UTs Finance Accounts

Revenue Expenditure

3.24 Revenue expenditure, which comprises the current expenditure of the government, including expenditure on interest payments, salaries and pensions of civil and defence workforce, subsidies, maintenance of assets, grants and assistance, continues to constitute more than 80 per cent of the total expenditure.

3.25 The revenue expenditure of the general government was arrived at after netting out the intergovernmental transfers, such as grants by the Union to the States and UTs and the interest payments on the inter-governmental loans. It has hovered around 23 per cent of GDP since 2011-12, reducing from 23.4 per cent in 2011-12 to 22.5 per cent just before the pandemic. It peaked at 27.5 per cent in 2020-21 due to the pandemic and has dropped back to 22.9 per cent in 2023-24, but is still above the pre-pandemic levels, mainly due to increased interest payments on account of high deficits incurred during COVID-19.

**Table 3.4 Composition of General Government Revenue Expenditure
(percentage of GDP)**

Year	General Services	Social Services	Economic Services	Transfers to Local Bodies [#]	Revenue Expenditure
2011-12	10.0	6.2	6.8	0.4	23.4
2012-13	9.9	6.1	6.7	0.4	23.2
2013-14	10.0	6.2	6.2	0.5	22.8
2014-15	10.0	5.6	6.2	0.5	22.3
2015-16	9.9	6.0	6.0	0.5	22.4
2016-17	10.1	6.1	6.1	0.5	22.8
2017-18	10.3	5.9	5.7	0.5	22.4
2018-19	10.4	6.0	5.6	0.5	22.5
2019-20	10.5	6.2	5.8	0.5	22.9
2020-21	11.4	6.7	8.9	0.5	27.5
2021-22	11.0	6.7	6.8	0.5	25.0
2022-23	10.8	6.3	6.7	0.5	24.2
2023-24	10.6	6.0	5.8	0.5	22.9

Source: Union Budgets, States and UTs Finance Accounts

[#]Transfers to Local Bodies are made under General, Social and Economic Services heads also.

3.26 Functionally, revenue expenditure is classified into general, social, and economic services as shown in *Table 3.4*. General Services, which include administration, police, and interest payments, have seen a gradual increase in share, from about 43 per cent in 2011-12 to just over 46 per cent in 2023-24. Social services, such as education, health, and social welfare, accounted for around 26 per cent of total revenue expenditure in 2023-24, a share that has remained largely stable. Economic Services, which support agriculture, rural development, and

industry, fluctuated between 25-29 per cent of revenue expenditure, except for 32 per cent in the COVID-19 year of 2020-21.

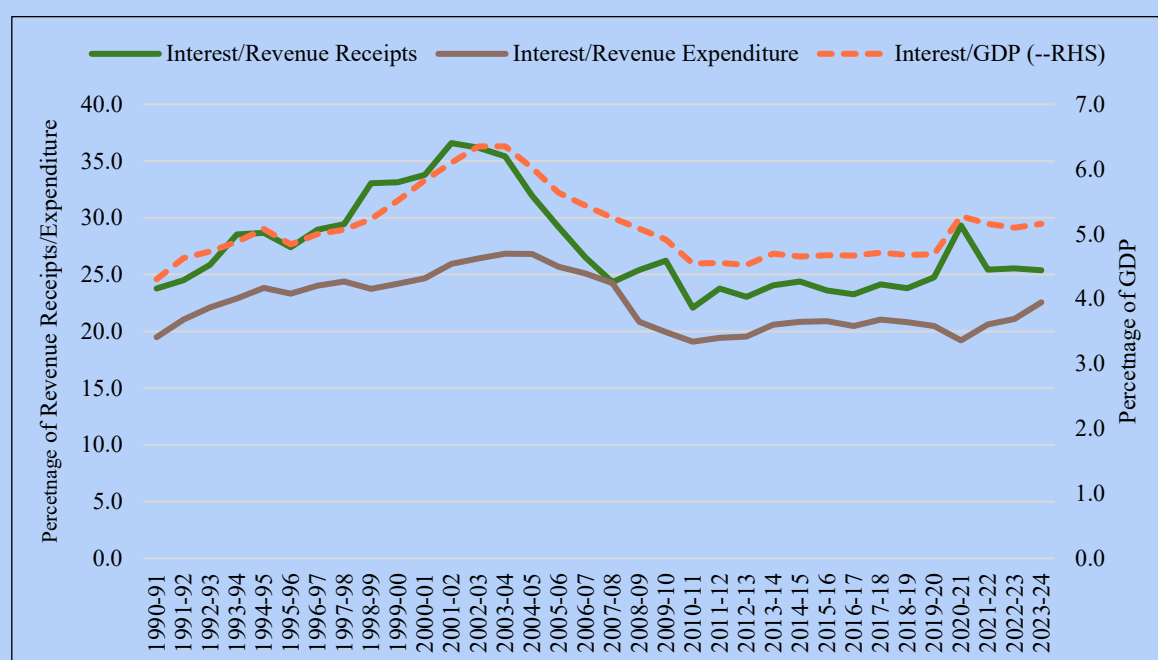
3.27 During the review period, revenue expenditure has shown an annual trend growth rate of approximately 10.9 per cent as shown in *Table 3.3*. As depicted in *Table 3.5*, the structure of revenue expenditure has remained relatively rigid on account of high interest payments, salaries, and pensions. These committed expenditures limit the fiscal space available for discretionary or developmental spending. The total committed expenditure hovered around half of the revenue expenditure during the review period, at 12.8 per cent in 2011-12 to 13.0 per cent of GDP in 2023-24.

**Table 3.5 Composition of General Government Committed Expenditure
(percentage of GDP)**

Year	Interest Payments	Pension	Salaries
2011-12	4.6	2.2	6.0
2012-13	4.5	2.2	5.9
2013-14	4.7	2.1	5.8
2014-15	4.7	2.2	5.9
2015-16	4.7	2.2	5.8
2016-17	4.7	2.3	5.8
2017-18	4.7	2.5	5.8
2018-19	4.7	2.5	5.7
2019-20	4.7	2.6	5.8
2020-21	5.3	2.9	6.0
2021-22	5.2	2.6	5.7
2022-23	5.1	2.6	5.4
2023-24	5.2	2.5	5.3
Annual Growth Rate	11.5%	12.6%	9.5%

Source: Union Budgets, States and UTs Finance Accounts

3.28 The reduction in salaries (0.7 per cent of GDP) was largely offset by the increases in the interest payments (0.6 per cent of GDP). Interest payments have consistently been one of the largest components of revenue expenditure, constituting more than 20 per cent of the revenue expenditure (*Figure 3.6*). Pre-pandemic, the interest payments were 4.7 per cent of GDP but have risen to 5.2 per cent of GDP due to a higher deficit during the pandemic. Over the long run, interest payments had been coming down since the early 2000s till the onset of the pandemic. Salaries and pensions total around 8 per cent of GDP and have shown marginal decline during the review period. While pensions have seen a level jump after the implementation of the Seventh Pay Commission, salaries as a proportion of GDP have declined.

Figure 3.6 Trends of Interest Payments by General Government

Source: Union Budgets, States and UTs Finance Accounts

3.29 Over a longer period from 1990-91 to 2023-24, revenue expenditure has generally ranged between 20 to 25 per cent of GDP (*Figure 3.5*). It has seen three phases of increased revenue expenditure followed by a reduction, first in the late 1990s, mainly due to the implementation of the award of the Fifth Pay Commission, second, during the global financial crisis, and the last during the pandemic.

Capital Expenditure

3.30 Capital expenditure, crucial for asset creation and medium-term growth acceleration, has remained between 4-5 per cent of GDP during the review period. However, post-pandemic, due to a specific push by the Union Government, the capital expenditure has increased to 5.4 per cent of GDP in 2023-24. An important institutional development during this period has been the introduction of the Scheme for Special Assistance to States for Capital Investment (initially rolled out in 2020-21), which provided interest-free loans to States for priority capital projects. This scheme has expanded significantly, with annual allocations rising from ₹12,000 crore in 2020-21 to ₹1.1 lakh crore in 2023-24, thereby incentivising States to augment their capital spending.

3.31 At the disaggregated level, the bulk of general government capital outlay is directed towards economic services – particularly transport, rural development, and energy infrastructure. Capital expenditure on the social sector, including allocations to health and education infrastructure, has also risen in recent years but remains modest.

Deficits

3.32 A key element in sound macroeconomic management is ensuring that the government does not rely excessively on borrowing on the fiscal resources side of the equation. Such reliance is measured by the fiscal deficit, defined as the gap between total expenditures and non-debt revenues. Large fiscal deficits have several detrimental effects on the economy. They add to the public debt and create future interest liabilities. As the debt grows, the threat of inflation looms. Moreover, a large debt leads lenders to demand high interest rates. Given the fixed volume of savings in the economy in any given year, a larger fiscal deficit leaves fewer investible resources for private investors to borrow. This crowding out of private investors hurts future growth. For these reasons, prudent macroeconomic management entails keeping the fiscal deficit within a reasonable limit.

3.33 To the extent that the government uses borrowings to finance revenue rather than capital expenditures, private savings that could have financed private investments end up financing current government expenditures. For this reason, the revenue deficit, equalling the gap between the expenditures and revenues on the revenue account, is viewed unfavourably. It effectively lowers the total investment in the economy, thereby undermining future growth. Symmetrically, a revenue surplus enhances the investment in roads, railways, ports, and airports and boosts growth. For this reason, attention must also be paid to the revenue deficit.

3.34 The primary deficit is a final indicator commonly monitored as part of prudent macroeconomic management. It equals the fiscal deficit minus interest payments on the existing debt. It measures borrowings beyond what is necessary to service the existing debt. The larger the primary deficit, the larger the addition to debt attributable to current year fiscal policy.

Table 3.6 Deficits of General Government (percentage of GDP)

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Revenue Deficit (percentage of Fiscal Deficit)
2011-12	8.0	4.3	3.4	53.8
2012-13	7.0	3.5	2.5	50.4
2013-14	6.8	3.3	2.1	48.7
2014-15	6.7	3.3	2.1	48.4
2015-16	7.0	2.6	2.3	36.7
2016-17	7.4	2.7	2.7	37.0
2017-18	6.1	2.9	1.4	47.1
2018-19	6.2	2.8	1.6	45.4
2019-20	7.4	4.0	2.7	54.0
2020-21	13.5	9.5	8.2	70.2
2021-22	9.4	4.7	4.2	50.4
2022-23	8.9	4.2	3.8	47.5
2023-24	7.8	2.5	2.6	32.8

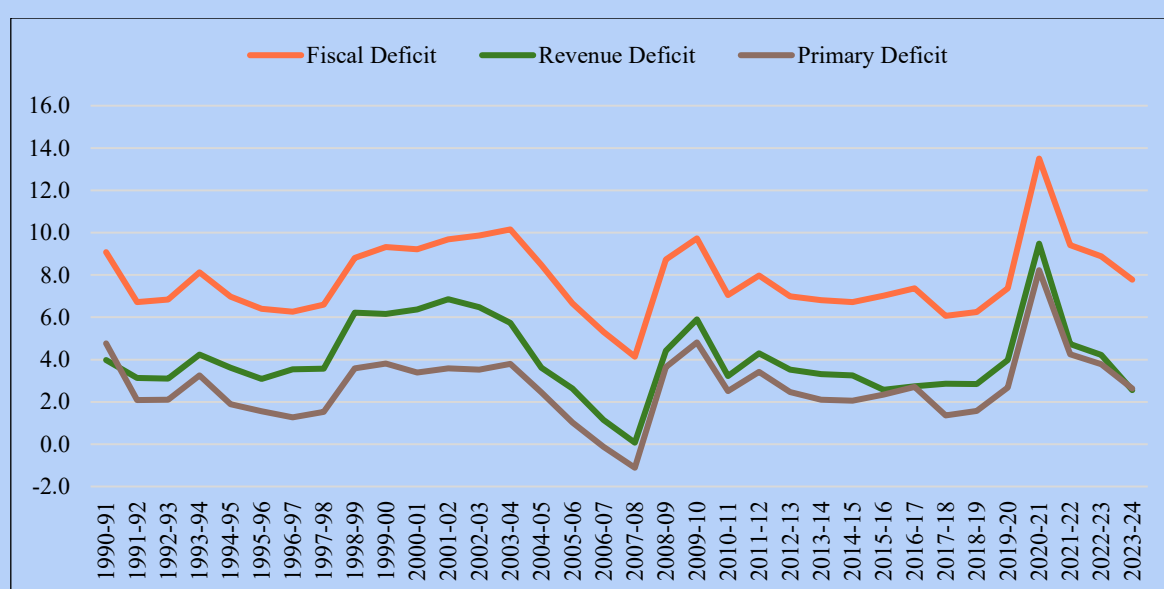
Source: Union Budgets, States and UTs Finance Accounts

3.35 Table 3.6 and Figure 3.7 show the trends in the three deficits of general government. The deficits witnessed a decline during the initial years but saw a reversal of that trend during 2019-20 due to the twin effect of economic slowdown and the corporate tax cut and then due to COVID-19. Fiscal Deficit came down from 8 per cent in 2011-12 to almost 6 per cent in 2018-19. It deteriorated in 2019-20 and climbed up to 13.5 per cent of GDP in 2020-21 due to the impact of COVID-19. The deficit has come down since then to levels below what it was during 2011-12, but the reduction has tapered due to the government's continued effort to keep the capital expenditure high. Revenue Deficit has followed a similar path, but the reduction post-pandemic has been steeper, as is evident from the improving ratio of revenue to fiscal deficit, since the focus is mainly on capital expenditure.

3.36 A longer period view shows that the deficits deteriorated during the late 1990s and the early 2000s, followed by steep consolidation, primarily driven by improvement in tax revenues, until the global financial crisis in 2008-09. The increase in deficit during the financial crisis was again followed by a period of consolidation, which has been disrupted by the pandemic, as explained above.

3.37 While the revenue receipts had been rising since the late 1990s, the fiscal deficit increased due to an even steeper rise in revenue expenditure (Figure 3.8). Due to this fiscal pressure, capital expenditure saw marginal compression. These developments led to the adoption of the fiscal consolidation roadmaps by governments and the enactment of the Fiscal Responsibility and Budget Management Act (2003). With revenue receipts still rising and revenue expenditure first plateauing and then reducing as a proportion of GDP, the fiscal stress started easing, creating more space for capital expenditure expansion as well as a reduction in

Figure 3.7 Trends of Deficits in General Government (percentage of GDP)

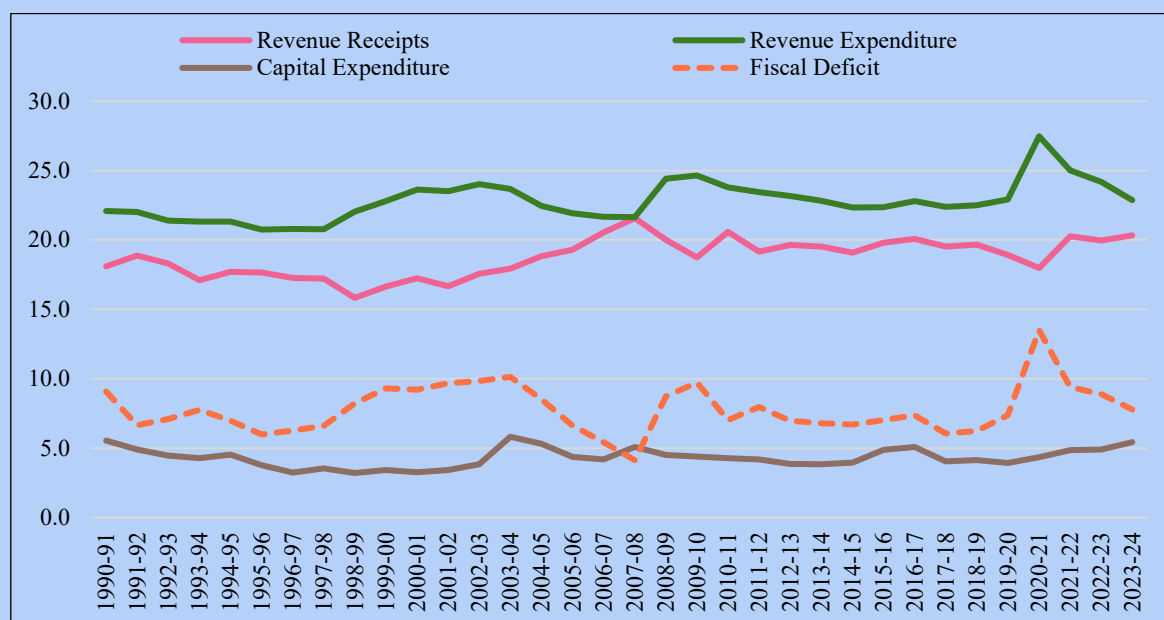


Source: Union Budgets, States and UTs Finance Accounts

fiscal deficit. This effort met a setback due to the global financial crisis, but the consolidation effort resumed after the crisis. Post-financial crisis, the consolidation effort has been led less by the expansion of revenue and more by the contraction of revenue expenditure and, to some extent, capital expenditure.

3.38 The pandemic in 2020-21 disrupted efforts to reduce the fiscal deficit, causing a temporary setback. However, the situation improved quickly, with a sharp recovery that brought the deficit down to levels even lower than those seen in 2011-12. This turnaround was mainly due to revenue receipts and revenue expenditure returning to pre-pandemic levels. Encouragingly, capital expenditure has been rising steadily in recent years, driven by increased investment from the Union Government in key infrastructure areas like railways, roads and bridges.

Figure 3.8 Components of General Government Fiscal Deficit (percentage of GDP)



Source: Union Budgets, States and UTs Finance Accounts

Debt and Other Liabilities

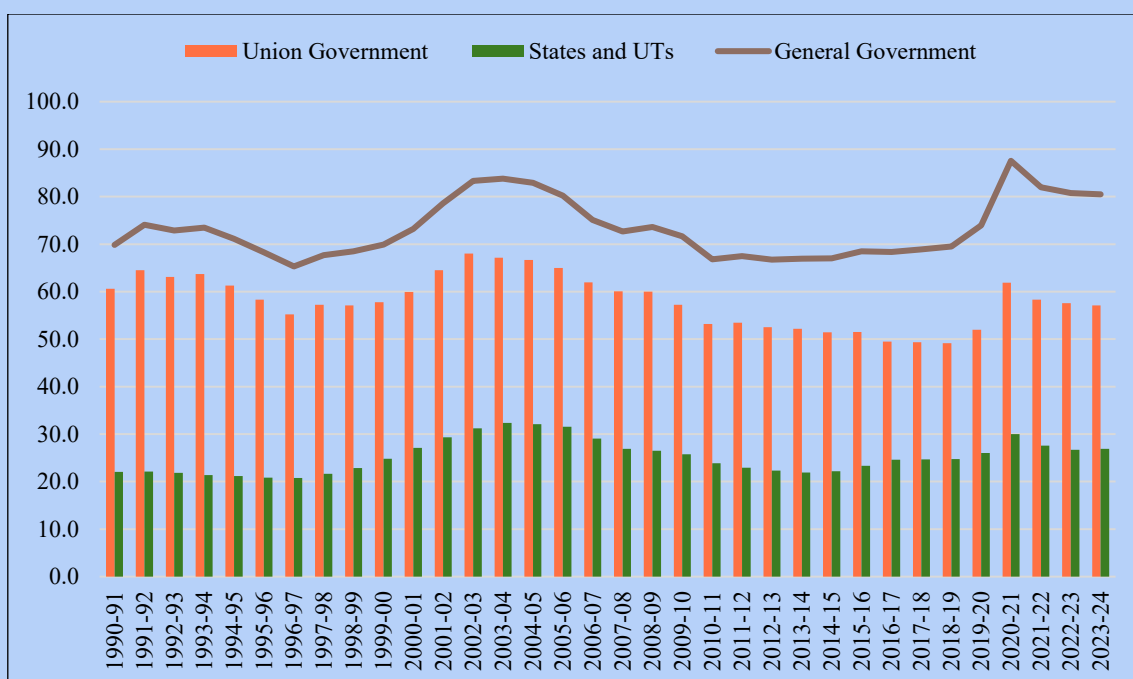
3.39 Government liabilities are divided into two broad components: public debt and other liabilities. Total liabilities, expressed as a proportion of GDP are called debt-to-GDP ratio. As general government debt represents the liability of the overall government sector as a whole, the following inter-governmental transactions are netted out to correct for double-counting.

- i. Union's loans to States and UTs
- ii. Securities issued by States to National Small Savings Fund
- iii. Investment in T-Bills by States/UTs with legislature which represents lending by States/UTs to the Union.

Table 3.7 General Government Debt (percentage of GDP)

Year	Union Government	States and UTs	Intergovernmental Lending	General Government
(1)	(2)	(3)	(4)	(5) = (2) + (3) - (4)
2011-12	53.5	23.0	8.9	67.5
2012-13	52.5	22.3	8.2	66.7
2013-14	52.2	21.9	7.1	66.9
2014-15	51.4	22.2	6.6	67.0
2015-16	51.5	23.4	6.4	68.5
2016-17	49.5	24.6	5.8	68.3
2017-18	49.3	24.7	5.2	68.9
2018-19	49.1	24.8	4.4	69.5
2019-20	51.9	26.0	4.0	73.9
2020-21	61.9	30.0	4.4	87.5
2021-22	58.3	27.6	3.9	82.0
2022-23	57.6	26.7	3.5	80.8
2023-24	57.1	26.9	3.6	80.5

Source: Status Paper on Debt, Department of Economic Affairs (Ministry of Finance), States and UTs Finance Accounts

Figure 3.9 Trend of General Government Debt (percentage of GDP)

Source: Status Paper on Debt, Department of Economic Affairs (Ministry of Finance), States and UT Finance Accounts

3.40 As shown in *Table 3.7* and *Figure 3.9*, the outstanding government liabilities were at 67 per cent of GDP till 2014-15, which saw a small increase of 2 percentage points due to States taking over debt of their power sector companies during 2015-16 and 2016-17 (for details, see Chapters 5 and 13). However, higher deficits had to be incurred due to the crisis of 2019-20 and, especially the pandemic, which led to a step jump in the debt-to-GDP ratio.

3.41 While recent years have attracted attention due to the pandemic-induced debt surge, the high level of debt is not a new phenomenon. Following the trend of fiscal deficit, early 2000s were marked by increasing debt, reaching almost 84 per cent of GDP, which came down below 70 per cent due to the fiscal consolidation efforts as explained before. Period pertaining to global financial crisis saw an increase in debt levels which started coming down soon after, but only to be reversed when the pandemic hit.

Concluding Remarks

3.42 Prior to the outbreak of the COVID-19 pandemic, the general government collected revenue of 19-20 per cent of GDP, while the expenditures ranged between 26 and 28 per cent of GDP. The excess of expenditure over revenue reflected itself in fiscal deficit of 6-8 per cent of GDP.

3.43 The government had to adopt extraordinary measures during the COVID-19 year 2020-21 and expenditure rose sharply to 31.8 per cent and fiscal deficit climbing up to 13.5 per cent of GDP. Post-COVID, the quick and strong recovery of the economy helped the finances of the general government to move on a consolidated path with declining expenditure and rising revenue, though deficits still remained high at 7.8 per cent in 2023-24.

3.44 As per the constitutional division of revenue power, the Union collects 63-64 per cent of the total revenue of the general government, and the States together collect 36-37 per cent. The States, on the other hand, have been assigned responsibilities requiring larger expenditure. This asymmetry gets corrected by devolution of about a third of the Union's revenue. Post-devolution, the share of the Union in total general government revenue gets reduced to about 43 per cent, and that of the States rises to 57 per cent. These issues are discussed in detail for the Union in the next Chapter and for the States in Chapter 5.

□□□

4

REVIEW OF THE UNION FINANCES

4.1 The Indian economy has shown sustained and resilient growth in the past decade, despite the challenges posed by the COVID-19 pandemic. During the period of review, the macroeconomic situation was largely positive despite hinderances posed by subdued credit take-off and the pandemic. The fiscal policy landscape was transformed with the introduction of Goods and Services Tax (GST) and a targeted push towards digitization.

4.2 The Union Government was on a path of fiscal consolidation in the first half of the review period. Though this trajectory was upset by the challenges mentioned in the previous chapter, there is a renewed focus on getting back on the path, which is reflected in the finances of the Union post-pandemic, with a reduction in expenditure and deficit figures. As one of the fastest-growing economies, home to the largest population in the world, India needs to strike an appropriate balance between its developmental aspirations and macroeconomic stability.

Union Finances: An Overview

4.3 We begin with a high-level overview of the Union finances, focusing on the total revenue, total expenditure, and fiscal deficit in absolute terms and relative to gross domestic product (GDP). *Table 4.1* reports GDP, total revenues, total expenditures, and fiscal deficit in rupees, with the corresponding figures as a percentage of GDP shown in parenthesis.

4.4 Nominal GDP grew from ₹87.4 lakh crore in 2011-12 to ₹301.2 lakh crore in 2023-24. As seen in *Table 4.2*, the average annual (nominal) GDP growth rate during these years was 11 per cent. Revenues grew slightly faster at the annual average rate of 11.4 per cent. The average annual expenditure growth was 10.9 per cent. With GDP growth considerably slower in 2019-20 than in earlier years, revenue growth also slowed down that year. Likewise, a negative revenue growth accompanied negative GDP growth in 2020-21.

Table 4.1 GDP, Revenue, Expenditure and Fiscal Deficit

Year	(₹ Lakh Crore) (percentage of GDP in parentheses)			
	GDP	Revenues	Expenditure	Fiscal Deficit
2011-12	87.36	7.88 (9.0)	13.04 (14.9)	5.16 (5.9)
2012-13	99.44	9.20 (9.3)	14.10 (14.2)	4.90 (4.9)
2013-14	112.34	10.57 (9.4)	15.59 (13.9)	5.03 (4.5)
2014-15	124.68	11.53 (9.2)	16.64 (13.3)	5.11 (4.1)
2015-16	137.72	12.58 (9.1)	17.91 (13.0)	5.33 (3.9)
2016-17	153.92	14.40 (9.4)	19.75 (12.8)	5.36 (3.5)
2017-18	170.90	15.51 (9.1)	21.42 (12.5)	5.91 (3.5)
2018-19	189.00	16.66 (8.8)	23.15 (12.2)	6.49 (3.4)
2019-20	201.04	17.53 (8.7)	26.86 (13.4)	9.34 (4.6)
2020-21	198.54	16.92 (8.5)	35.10 (17.7)	18.18 (9.2)
2021-22	235.97	22.09 (9.4)	37.94 (16.1)	15.85 (6.7)
2022-23	268.90	24.55 (9.1)	41.93 (15.6)	17.38 (6.5)
2023-24	301.23	27.89 (9.3)	44.43 (14.8)	16.55 (5.5)
2024-25 P	330.68	30.78 (9.3)	46.56 (14.1)	15.77 (4.8)
2025-26 BE	356.98	34.96 (9.8)	50.65 (14.2)	15.69 (4.4)

Source: Ministry of Statistics and Programme Implementation (MoSPI) for GDP and Union Budgets for Revenue and Expenditure

Note: For 2024-25, provisional figures (P) are provided instead of revised estimates (RE), wherever available. BE = Budget Estimates.

Table 4.2 Growth Rates of GDP, Revenue and Expenditure (percentage)

Year	GDP	Revenues	Expenditure
2012-13	13.8	16.7	8.1
2013-14	13.0	14.8	10.6
2014-15	11.0	9.1	6.7
2015-16	10.5	9.1	7.6
2016-17	11.8	14.4	10.3
2017-18	11.0	7.7	8.4
2018-19	10.6	7.4	8.1
2019-20	6.4	5.2	16.0
2020-21	-1.2	-3.5	30.7
2021-22	18.9	30.6	8.1
2022-23	14.0	11.1	10.5
2023-24	12.0	13.6	6.0
2012-24 (Average)	11.0	11.4	10.9

Source: MoSPI for GDP and Union Budgets for Revenue and Expenditure

4.5 Union revenues have hovered around 9 per cent of GDP, with no discernible trend. They fell below the 9 per cent mark during the growth slowdown years of 2018-21 but rose again to 9.3 per cent in 2023-24. Expenditures as a proportion of GDP exhibited a mild downward trend until 2018-19, falling from the peak of 14.9 per cent in 2011-12 to 12.2 per cent in 2018-19. This was a period of fiscal consolidation, with the fiscal deficit declining every single year as a percentage of GDP (even in 2017-18, it fell from 3.48 per cent to 3.46 per cent). The sharp decline in GDP growth in 2019-20 and the negative growth in 2020-21 ended that process. The fiscal deficit peaked at 9.2 per cent in the latter year. It was brought down to 6.7 per cent of GDP the following year, with the decline continuing at a more gradual pace in subsequent years. At 4.8 per cent in 2024-25 (P), it remained elevated and only marginally below that in 2012-13.

Union Revenues

4.6 From the high-level overview in the previous section, we now proceed to unpack the major components of revenues and expenditures, focusing on the former in this section. Unlike many Western economies, India distinguishes between current (more commonly called the revenue account) and capital accounts in the government budget. The distinction is not watertight, with some capital expenditures appearing in the revenue account. For example, revenue expenditure of the Union includes transfers to States for the implementation of centrally sponsored schemes. The outcomes of many of these schemes primarily take the form of durable assets such as schools, hospitals and houses for individuals. As the Union does not own these assets, they are not technically classified as capital expenditure. Nevertheless, the distinction is useful since the vast majority of infrastructure expenditure, an important indicator of the quality of government expenditure, forms the bulk of the capital account expenditure.

Trends in Revenue and Capital Receipts

4.7 The Union Government's total receipts comprise net tax revenue, non-tax revenue, and non-debt capital receipts. Net tax revenue and non-tax receipts together form receipts on the revenue account. Net tax revenue constitutes the predominant component of total receipts, with non-tax revenues and capital receipts making only a modest contribution. Net tax revenue equals the gross tax revenue (GTR) net of the share of States in Union taxes¹ and national calamity and contingency duty (NCCD). As a proportion of GDP, net tax revenue has seen only a modest uptick during the period under review, rising from 7.2 per cent of GDP in 2011-12 to 7.7 per cent in 2023-24. Non-tax revenues and non-debt capital as proportions of GDP have similarly moved in the narrow ranges of 1.0 - 1.8 per cent and 0.1 - 0.7 per cent respectively.

4.8 Net tax revenue receipts as a percentage of GDP have remained above 7 per cent except for two years. The fall to 6.7 per cent during 2019-20 was likely due to the transition effect of replacing myriad Union and State indirect taxes with a single nationwide GST in July 2017 and the economic slowdown during 2019-20. The COVID-19 shock, the impact of which had set in during the last quarter of 2019-20, was also a factor.

¹ This definition of net tax revenue is based on the way the Union Budget is presented annually, wherein these two items are subtracted from GTR to arrive at 'tax revenue' figures of the Union.

4.9 In the financial year 2020-21 which saw the pandemic unfold, net tax revenue as a proportion of GDP rose modestly to 7.2 per cent, but much of the rise was due to a fall in GDP. The same year, at 1.0 per cent of GDP, non-tax revenue dipped to its lowest level for any year during the period under review. However, there was a gradual pick-up in tax and non-tax revenues in the following years, reaching 7.7 per cent and 1.3 per cent of GDP, respectively, in 2023-24. Total (tax plus non-tax) revenue receipts reached 9.0 per cent of GDP in 2023-24 and are at 9.2 per cent in 2024-25 (P) as shown in *Table 4.3*.

Table 4.3 Receipts of the Union (percentage of GDP)

Year	Gross Tax Revenue	States' Share	Net Tax Revenue	Non-tax Revenue	Non-debt Capital Receipts	Total Receipts of the Union
(1)	(2)	(3)	(4) = (2) – (3)	(5)	(6)	(7) = (4) + (5) + (6)
2011-12	10.2	2.9	7.2	1.4	0.4	9.0
2012-13	10.4	2.9	7.5	1.4	0.4	9.3
2013-14	10.1	2.8	7.3	1.8	0.4	9.4
2014-15	10.0	2.7	7.2	1.6	0.4	9.2
2015-16	10.6	3.7	6.9	1.8	0.5	9.1
2016-17	11.1	4.0	7.2	1.8	0.4	9.4
2017-18	11.2	3.9	7.3	1.1	0.7	9.1
2018-19	11.0	4.0	7.0	1.2	0.6	8.8
2019-20	10.0	3.2	6.7	1.6	0.3	8.7
2020-21	10.2	3.0	7.2	1.0	0.3	8.5
2021-22	11.5	3.8	7.6	1.5	0.2	9.4
2022-23	11.4	3.5	7.8	1.1	0.3	9.1
2023-24	11.5	3.7	7.7	1.3	0.2	9.3
2024-25 P	11.5	3.9	7.6	1.6	0.1	9.3
2025-26 BE	12.0	4.0	7.9	1.6	0.2	9.8

Source: Union Budgets

Note: The difference between GTR and States' share does not exactly add up to Net tax revenue due to netting out of NCCD.

4.10 Not all tax revenues collected by the Union Government remain with it. The GTR net of cess, surcharges, and tax revenues accruing to Union Territories (UTs) minus the cost of collection constitutes the divisible pool, which is shared between the Union and State Governments as per the recommendations by FCs. For example, the Fifteenth Finance Commission (FC-15) had recommended that 41 per cent of the divisible pool be awarded to the

States and the remainder to the Union. *Table 4.3* shows the GTR, net tax revenue, and States' share as percentage of GDP, as recommended by the FCs from 2011-12 to 2025-26 BE. It is the net tax revenue, not gross tax revenue, that constitutes the tax revenue of the Union Government.

4.11 The States' share in GTR was 2.9 per cent of GDP in 2011-12, leaving the Union Government with net tax revenue of 7.2 per cent only. Till 2014-15, net tax revenue remained at or above 7.2 per cent. However, the Fourteenth Finance Commission (FC-14) (2015-20) recommended increasing the share of States in the divisible pool from 32 per cent to 42 per cent. This recommendation led to an increase in the States' share in the divisible pool from 2.7 per cent of GDP in 2014-15 to 3.7 per cent in 2015-16. The corresponding reduction in the Union Government's share was partially offset by a rise in GTR to 10.6 per cent in 2015-16, with the net tax revenue declining only modestly from 7.2 per cent in 2014-15 to 6.9 per cent in 2015-16. The remaining gap in the Union Government's share recovered the following year due to a further increase in GTR to 11.1 per cent of GDP. FC-15 continued the vertical devolution percentage of the FC-14 with a one percentage point downward adjustment in the States' share in recognition of Jammu & Kashmir and Ladakh being designated as Union Territories. As a result, on average, tax devolution to States has remained approximately 1.0 per cent of GDP above the pre-FC-14 levels. In parallel, though GTR as a proportion of GDP in 2023-24 was 1.5 percentage points above its level in 2014-15, net tax revenue as a proportion of GDP was only 0.5 percentage points above its level in 2014-15.

Major Union Tax Heads and Their Contribution to Revenues

4.12 In *Table 4.4*, we decompose GTR into its main components. Direct taxes have generally accounted for more than half of GTR. Within direct taxes, corporate taxes have contributed more than half of the revenues until 2019-20. In 2019-20, the government significantly reduced the corporate tax rate to align it with the international level. As a result, revenues from this source as a proportion of GDP fell initially from 3.5 per cent of GDP in 2018-19 to 2.8 per cent in 2019-20 and 2.3 per cent in 2020-21. However, they partially recovered in the following years, reaching 3.0 per cent of GDP in 2023-24. Income tax contributed only 2.0 per cent to 2.1 per cent of GDP from 2011-12 to 2015-16 but saw a rise thereafter, reaching 2.5 per cent in 2017-18, 3.0 per cent in 2021-22, and 3.5 per cent in 2023-24.

4.13 Indirect taxes have ranged from 4.4 per cent to 5.6 per cent of GDP, but without a discernible trend. From 4.5 per cent of GDP in 2011-12, they rose to 5.6 per cent in 2016-17, fell to 4.7 per cent in 2019-20, rose again to 5.5 per cent in 2021-22, only to drop back to 5.0 per cent in 2023-24.

4.14 Indirect taxes have four major components: customs duty, Union excise duties, service tax, and GST. Here, GST includes the central goods and services tax (CGST), integrated goods and services tax (IGST) and GST compensation cess. Introduced in July 2017, GST subsumed the service tax. As a result, GST was nil until 2016-17, and the service tax became nil 2018-19 onwards.

Table 4.4 Shares of Major Union Taxes (percentage of GDP)

Year	Direct Tax		Indirect Tax				GTR
	Corporation Tax	Income Tax	Customs	Union Excise Duties	Service Tax	GST (CGST+IGST+Comp Cess)	
2011-12	3.7	1.9	1.7	1.7	1.1	0.0	10.2
2012-13	3.6	2.0	1.7	1.8	1.3	0.0	10.4
2013-14	3.5	2.1	1.5	1.5	1.4	0.0	10.1
2014-15	3.4	2.1	1.5	1.5	1.3	0.0	10.0
2015-16	3.3	2.1	1.5	2.1	1.5	0.0	10.6
2016-17	3.2	2.3	1.5	2.5	1.7	0.0	11.1
2017-18	3.3	2.5	0.8	1.5	0.5	2.6	11.2
2018-19	3.5	2.5	0.6	1.2	0.0	3.1	11.0
2019-20	2.8	2.5	0.5	1.2	0.0	3.0	10.0
2020-21	2.3	2.5	0.7	2.0	0.0	2.8	10.2
2021-22	3.0	3.0	0.8	1.7	0.0	3.0	11.5
2022-23	3.1	3.1	0.8	1.2	0.0	3.2	11.4
2023-24	3.0	3.5	0.8	1.0	0.0	3.2	11.5
2024-25 P	3.0	3.7	0.7	0.9	0.0	3.1	11.5
2025-26 BE	3.0	4.0	0.7	0.9	0.0	3.3	12.0

Source: Union Budgets

Note: Gross Tax Revenue also includes taxes of Union Territories, which amount to less than 0.1 per cent of GDP

4.15 Among indirect taxes, customs and union excise duties have declined as a proportion of GDP, because they have been partially subsumed into GST. For the same reason, the service tax contribution now stands near nil. Initially, GST had teething pains, with CGST failing to compensate for the losses of other indirect tax revenues. However, its performance improved in later years, helping indirect taxes partially recover. CGST as a proportion of GDP rose from 2.4 per cent in 2018-19, the first full year of its implementation, to 2.7 per cent in 2023-24.

4.16 The government has been implementing tax reforms that are aimed at simplification, increasing ease of voluntary compliance and certainty to the taxpayer. Apart from the structural changes introduced in direct and indirect taxation discussed above, such as the introduction of GST, other measures have been taken in the past ten years in pursuit of these goals. These include phasing out of exemptions and deductions and nudging the taxpayer towards a

simplified new tax regime, leveraging the permanent account number as a unified identification and use of Aadhaar for GST registration. Reforms have also been introduced to reduce litigation and promote voluntary compliance through provisions for updated returns and the reduction of rates and duties. These efforts are bearing fruit, as evidenced by the rise in tax revenues.

Cesses and Surcharges

4.17 Article 246 (246A for GST matters) empowers the Union to legislate on all matters relating to subjects in the Union and Concurrent Lists of the Seventh Schedule. These powers include the power to tax, including cesses. Additionally, Article 271 gives the Union the power to impose surcharges on certain duties and taxes. As noted earlier, the cesses and surcharges, along with taxes accruing to UTs do not form a part of the divisible pool. In 2011-12, this non-shareable portion of revenues was 1.1 per cent of GDP, and the divisible pool was 9.1 per cent. By 2023-24, the non-shareable portion had expanded to 2.2 per cent of GDP while the divisible pool as a proportion of GDP stood at 9.4 per cent. GST compensation cess was levied to compensate the States for a period of five years for the expected revenue loss while transitioning from multiple indirect taxes to GST. This cess was transferred in its entirety to the States. We shall discuss cesses and surcharges in greater detail in Chapter 7.

Non-tax Revenues

4.18 Non-tax revenues comprise interest receipts from loans advanced in the past to States and central public sector enterprises (CPSEs), surplus from the Reserve Bank of India (RBI), profits and dividends from public sector commercial banks and CPSEs, and user charges such as fees and tolls. *Table 4.5* reports the contributions of these items to Union revenues from 2011-12 to 2025-26 BE.

4.19 Union Government received significant non-tax revenues under economic services owing to profits from public sector petroleum companies, royalties from offshore oil fields, revenue from the sale of telecom spectrum, and toll collections from roads and bridges as shown in *Table 4.5*. In absolute terms, revenue from these sources rose from ₹38,708 crore in 2011-12 to ₹1,51,699 crore in 2023-24. Surplus from the RBI and dividends from public sector financial institutions constitute another significant contributor to the Union's non-tax revenues. They increased from ₹50,608 crore in 2011-12 to ₹1,70,877 crore in 2023-24. It is difficult to discern a clear trend in non-tax revenues owing to either their periodic nature, as in the case of royalties/auction fees, or large fluctuations, as in the case of dividends. Nevertheless, in aggregate, the total contribution of non-tax revenues to revenue receipt of the Union is significant and ranged between 12.0 per cent in 2022-23 and 21.0 per cent in 2015-16 as illustrated in *Table 4.5*. Larger non-tax revenue as a source of revenue receipts has emerged as an important source of fiscal buffer for the Union Government in recent years.

Table 4.5 Major Components of Non-tax Revenue

Year	Non-tax Revenue (% of Revenue Receipts)	Non-tax Revenue (% of GDP)	Interest Receipts (% of GDP)	Dividend and Profits (% of GDP)	Economic Services (% of GDP)
2011-12	16.2	1.4	0.2	0.6	0.4
2012-13	15.6	1.4	0.2	0.5	0.4
2013-14	19.6	1.8	0.2	0.8	0.6
2014-15	18.0	1.6	0.2	0.7	0.5
2015-16	21.0	1.8	0.2	0.8	0.7
2016-17	19.9	1.8	0.1	0.8	0.7
2017-18	13.4	1.1	0.1	0.5	0.4
2018-19	15.2	1.2	0.1	0.6	0.4
2019-20	19.4	1.6	0.1	0.9	0.5
2020-21	12.7	1.0	0.1	0.5	0.4
2021-22	16.8	1.5	0.1	0.7	0.6
2022-23	12.0	1.1	0.1	0.4	0.5
2023-24	14.7	1.3	0.1	0.6	0.5
2024-25 RE	17.7	1.6	0.1	0.9	0.4
2025-26 BE	17.0	1.6	0.1	0.9	0.4

Source: Union Budgets

Non-debt Capital Receipts

4.20 Non-debt capital receipts form a small portion of the Union's revenues. As a percentage of GDP, they were 0.4 per cent in 2011-12, rose to 0.7 per cent in 2017-18, but fell to 0.3 per cent and 0.2 per cent during the COVID-19 years of 2020-21 and 2021-22 as shown in *Table 4.6*. Subsequently, the contribution rose modestly to 0.3 per cent in 2022-23 but fell again to 0.2 per cent in 2023-24.

4.21 One component of non-debt capital receipts, the recovery of loans and advances item, has remained constant at 0.1 per cent of GDP since 2013-14. The second component, miscellaneous receipts, which predominantly comprises receipts from disinvestment of the government's equity holdings and proceeds from the monetization of assets item, rose from 0.21 per cent of GDP in 2011-12 to the peak of 0.59 per cent in 2017-18. It has steadily declined since then. In 2016, the Union Government approved a new policy of disinvestment and strategic sale to leverage the assets of CPSEs for resource generation. This step, *inter alia*, increased capital receipts from disinvestment in Hindustan Petroleum Corporation Limited and Rural Electrification Corporation Limited in 2017-18 and 2018-19. However, despite some highly visible privatization efforts such as Air India and Neelachal Ispat Nigam Limited, the ambitious targets for disinvestment set after 2019-20 have not been realized, as can be seen from the

difference in BE and actual receipts in *Table 4.7*. Beginning in 2024-25, the Union Government has discontinued setting disinvestment targets in the Union Budget.

Table 4.6 Trends in Non-debt Capital Receipts (percentage of GDP)

Year	Non-debt Capital Receipts	Recoveries of Loans and Advances	Miscellaneous Receipts
2011-12	0.42	0.22	0.21
2012-13	0.41	0.15	0.26
2013-14	0.37	0.11	0.26
2014-15	0.41	0.11	0.30
2015-16	0.46	0.15	0.31
2016-17	0.42	0.11	0.31
2017-18	0.68	0.09	0.59
2018-19	0.60	0.10	0.50
2019-20	0.34	0.09	0.25
2020-21	0.29	0.10	0.19
2021-22	0.17	0.10	0.06
2022-23	0.27	0.10	0.17
2023-24	0.20	0.09	0.11
2024-25 P	0.13	0.07	0.05
2025-26 BE	0.21	0.08	0.13

Source: Union Budgets and Finance Accounts of the Union Government

Table 4.7 Comparison of Actual and Estimated Proceeds from Disinvestment

Year	BE (₹ crore)	RE (₹ crore)	Actuals (₹ crore)	Actuals/BE	Actuals/RE
(1)	(2)	(3)	(4)	(5) = (4) / (2)	(6) = (4) / (3)
2018-19	80,000	80,000	94,727	118%	118%
2019-20	1,05,000	65,000	50,304	48%	77%
2020-21	2,10,000	32,000	37,897	18%	118%
2021-22	1,75,000	78,000	13,627	8%	17%
2022-23	65,000	50,000	NA	NA	NA
2023-24	51,000	NA	NA	NA	NA

Source: Union Budgets

Union Expenditures

4.22 As a part of its effort to bring the fiscal deficit down to 3 per cent of GDP by 2020-21, as stipulated in the Fiscal Responsibility and Budget Management Act (FRBM), the Union

Government steadily compressed revenue expenditure, bringing it down from 13.1 per cent of GDP in 2011-12 to 10.6 per cent in 2018-19 as illustrated in *Table 4.8*. However, this effort had a setback in 2019-20, principally due to a decline in the nominal GDP growth rate. This setback was followed by the onset of COVID-19, which led to a decline in even nominal GDP on the one hand and necessitated the expansion of welfare programs such as the public distribution system and Mahatma Gandhi National Rural Employment Guarantee Programme (MGNREGA) on the other. The result was an increase in revenue expenditure as a proportion of GDP from 11.7 per cent in 2019-20 to 15.5 per cent in 2020-21.

4.23 The total expenditure mirrored the trend in revenue expenditure. As a proportion of GDP, it declined gradually from 14.9 per cent in 2011-12 to 12.2 per cent in 2018-19. This trend reversed in 2019-20, with expenditure reaching a high of 17.7 per cent in 2020-21 due to increased welfare spending in the wake of the pandemic. Since then, the expenditure has steadily declined, reaching 14.8 per cent in 2023-24 and is estimated to decline further to 14.1 per cent as per 2024-25 (P) and 14.2 per cent in 2025-26 BE. Reduction in revenue expenditure as a proportion of GDP have been the principal lever to reduce the total expenditure.

Table 4.8 Trends in Expenditure (percentage of GDP)

Year	Revenue Expenditure	Capital Expenditure	Total Expenditure (Revenue + Capital)
2011-12	13.1	1.8	14.9
2012-13	12.5	1.7	14.2
2013-14	12.2	1.7	13.9
2014-15	11.8	1.6	13.3
2015-16	11.2	1.8	13.0
2016-17	11.0	1.8	12.8
2017-18	11.0	1.5	12.5
2018-19	10.6	1.6	12.2
2019-20	11.7	1.7	13.4
2020-21	15.5	2.1	17.7
2021-22	13.6	2.5	16.1
2022-23	12.8	2.8	15.6
2023-24	11.6	3.2	14.8
2024-25 (P)	10.9	3.2	14.1
2025-26 BE	11.0	3.1	14.2

Source: Union Budgets

4.24 With an expanding public sector as a stated objective of economic policy before the launch of economic reforms, the government played a dominant role in driving capital expenditures. For example, in the early 1980s, the public sector accounted for 24 of the 30

largest firms by capital employed, and three-fourths of paid-up share capital². However, in recent years, the government has broadly moved away from this policy and has increasingly focused on investment in infrastructure. Union Government's budgetary capital expenditure remained below 2.0 per cent of GDP, hovering around 1.7 per cent on an average from 2011-12 to 2019-20. However, it steadily increased thereafter, rising to 2.5 per cent in 2021-22 and 3.2 per cent in 2023-24. It stands at 3.2 per cent in 2024-25 (P) and 3.1 per cent as per 2025-26 BE. In the Union Budget 2025-26, Government has allocated ₹1.5 lakh crore for 50-year interest free loans to States for capital expenditure. This turnaround in capital expenditures in the wake of the COVID-19 crisis has been an important achievement of the government. There has been a visible change for the better in the country's road, railway, and civil aviation network.

Revenue Expenditure: Broad Composition

4.25 The Union Government devotes a large proportion of its revenue expenditure to general services, followed by economic and social services as shown in *Table 4.9*. Interest payments, pensions, defence, and police account for approximately 95 per cent of the total expenditures on general services. Repayment of outstanding loans to the National Small Savings Fund (NSSF), implementation of the One Rank One Pension (OROP) in the defence forces, and salary increases of the government employees as per the recommendations of the Seventh Central Pay Commission (CPC) have contributed to increased revenue expenditure in recent years.

4.26 Economic services witnessed the second-highest spending during the period, though its overall percentage declined from 4.2 per cent of GDP in 2011-12 to 2.7 per cent in 2023-24. Subsidies and welfare schemes such as those mandated by MGNREGA and the National Food Security Act were the main drivers of this component of revenue expenditure.

4.27 Under the Indian Constitution, social services are primarily the responsibility of the State Governments, with the Union Government complementing their efforts by undertaking schemes to fill the gaps left by them. Spending on education, health, and drinking water & sanitation are the major contributors to social services. Expenditure on social services by the Union Government declined from 1.2 per cent of GDP in 2011-12 to 0.8 per cent in 2023-24. While the health expenditure peaked at 0.3 per cent of GDP in 2021-22 due to COVID-19, it has since come down to 0.1 per cent in 2023-24. The same year, education expenditure stood at 0.3 per cent of GDP.

Some Major Items of Expenditure

4.28 Besides the broad revenue expenditure categories shown in *Table 4.9*, it is useful to consider the major expenditure heads. *Table 4.10* shows three major expenditure heads within general services: interest payments, pensions, and defence. Interest payments constitute a large part of revenue expenditures under general services. From 2014-15 to 2019-20, they had shown

² Frankel, Francine, 2005. *India's Political Economy 1947-2004: The Gradual Revolution*, New Delhi: Oxford University Press, p. 580.

a downward trend, declining from 3.2 per cent of GDP to 3.0 per cent. However, the large additional debt incurred due to COVID-19 reversed that trend, with interest payments rising to 3.4 per cent in 2020-21 and 3.5 per cent in 2023-24. Defence and pensions have contributed approximately another 2 per cent of GDP to revenue expenditures under the general services category. This sum has been relatively stable during the period under review.

Table 4.9 Profile of Revenue Expenditure (percentage of GDP)

Year	General Services	Social Services	Economic Services	Grants, Contributions and Expenditure of UTs	Revenue Expenditure
2011-12	5.6	1.2	4.2	2.1	13.1
2012-13	5.6	1.1	3.9	1.9	12.5
2013-14	5.7	1.1	3.5	1.8	12.2
2014-15	5.7	0.4	2.9	2.8	11.8
2015-16	5.6	0.5	2.7	2.4	11.2
2016-17	5.7	0.6	2.8	2.0	11.0
2017-18	5.7	0.6	2.5	2.3	11.0
2018-19	5.6	0.5	2.4	2.1	10.6
2019-20	5.7	0.6	2.7	2.7	11.7
2020-21	6.2	0.8	5.5	3.0	15.5
2021-22	6.1	1.1	3.7	2.7	13.6
2022-23	6.0	0.7	3.6	2.5	12.8
2023-24	6.0	0.8	2.7	2.1	11.6
2024-25 RE	5.9	0.5	2.8	1.9	10.9
2025-26 BE	5.9	0.5	2.5	2.1	11.0

Source: Union Budgets

4.29 Pay and allowances of civilian employees (excluding defence personnel) of the Union Government (not shown in *Table 4.10*), which cut across general services and economic and social services categories, declined slightly from 1.1 per cent of GDP in 2011-12 to 1.0 per cent in 2023-24. Like defence and pension, this item has remained stable. Implementing the recommendations of the Seventh CPC had led to a slight rise in this expenditure category to 1.2 per cent in 2016-17, but the figure returned to 1.1 per cent and fell to 1.0 per cent in 2023-24. Salary and allowances of defence forces also declined from 0.6 per cent of GDP in 2011-12 to 0.5 per cent in 2023-24. However, pension payments increased from 0.7 per cent to 0.8 per cent during this period, partly due to implementation of OROP. Parenthetically, it may be noted that in August 2024, the Government of India announced the implementation of the Unified Pension Scheme (UPS), a hybrid defined-contribution and defined-benefit model for employees as an

option under the National Pension System (NPS). This scheme will impact future expenditures of the Union Government, though not during the award period of the present FC.

Table 4.10 Major Items of Revenue Expenditure of the Union (percentage of GDP)

Year	Interest Payments	Defence	Pension	Subsidies	Revenue Expenditure
2011-12	3.1	1.2	0.7	2.5	13.1
2012-13	3.1	1.1	0.7	2.6	12.5
2013-14	3.3	1.1	0.7	2.3	12.2
2014-15	3.2	1.1	0.8	2.1	11.8
2015-16	3.2	1.1	0.7	1.9	11.2
2016-17	3.1	1.1	0.9	1.5	11.0
2017-18	3.1	1.1	0.9	1.3	11.0
2018-19	3.1	1.0	0.8	1.2	10.6
2019-20	3.0	1.0	0.9	1.3	11.7
2020-21	3.4	1.0	1.1	3.8	15.5
2021-22	3.4	1.0	0.8	2.1	13.6
2022-23	3.5	1.0	0.9	2.1	12.8
2023-24	3.5	1.0	0.8	1.4	11.6
2024-25 RE/P	3.4	0.9	0.8	1.3	10.9
2025-26 BE	3.6	0.9	0.8	1.2	11.0

Source: Union Budgets

4.30 Like pay and allowances, subsidies cut across the broad expenditure categories as shown in *Table 4.10*. Major subsidy items of the Union Government include food, fertilizer, petroleum, and interest subventions. In *Table 4.11*, we provide their component-wise evolution. The proportion of petroleum subsidy experienced a sharp decline due to a decline in the Liquid Petroleum Gas (LPG) subsidy. While food subsidy increased gradually due to the implementation of the National Food Security Act enacted in 2013, the corresponding expenditure remained on the books of the Food Corporation of India (FCI) till 2016-17 and was financed by off-budget borrowing. FCI raised loans from NSSF, backed by a guarantee from the Government of India.

4.31 In 2020-21, Union Government decided to take the entire liability on the budget. This repayment led the food subsidy to increase from 4.6 per cent of revenue expenditure in 2019-20 to a staggering 17.6 per cent in 2020-21. The ripple effect of this one-time repayment was felt on deficit figures. In recent years, the expenditure on food subsidies has grown further due to special welfare measures taken during the pandemic. For example, in the wake of the COVID-19

outbreak, the government introduced Pradhan Mantri Garib Kalyan Anna Yojana. Under this scheme, additional free-of-cost foodgrains at the scale of 5 kg per person per month were distributed to NFSA beneficiaries, over and above their regular monthly entitlements of 5 kg of grains at subsidised rates. The Union Government announced continuation of the scheme for the next 5 years with effect from 01 January 2024 for the NFSA beneficiaries, with the modification that each beneficiary now receives only the regular entitlement of 5 kg of foodgrains per month free of cost. This means that the current level of food subsidy outgo will continue at least until 2029-30.

Table 4.11 Components of Subsidies on the Revenue Account (percentage of GDP)

Year	Food	Fertilizer	Petroleum	Interest	Others	Total
2011-12	0.8	0.8	0.8	0.1	0.0	2.5
2012-13	0.9	0.7	1.0	0.1	0.0	2.6
2013-14	0.8	0.6	0.8	0.1	0.0	2.3
2014-15	0.9	0.6	0.5	0.1	0.0	2.1
2015-16	1.0	0.5	0.2	0.1	0.0	1.9
2016-17	0.7	0.4	0.2	0.1	0.1	1.5
2017-18	0.6	0.4	0.1	0.1	0.1	1.3
2018-19	0.5	0.4	0.1	0.1	0.0	1.2
2019-20	0.5	0.4	0.2	0.1	0.1	1.3
2020-21	2.7	0.6	0.2	0.2	0.1	3.8
2021-22	1.2	0.7	0.0	0.2	0.1	2.1
2022-23	1.0	0.9	0.0	0.2	0.0	2.1
2023-24	0.7	0.6	0.0	0.1	0.0	1.4
2024-25 RE	0.6	0.5	0.0	0.1	0.0	1.3
2025-26 BE	0.6	0.5	0.0	0.1	0.0	1.2

Source: Union Budgets

4.32 Fertilizer subsidies steadily declined till 2019-20 after which they rose in 2020-21 due to one-time repayment of dues. Since these subsidies are import-dependent, their expenditures are sensitive to world market conditions. Geopolitical tensions during the last three years have led to serious disruptions of international supply chains in fertilizer, thereby leading to a sharp rise in the subsidy bill on this account.

4.33 The government's policy towards phasing out petroleum subsidies has been successful, with a steady decline from 1.0 per cent in 2012-13 to a negligible level in 2023-24. Though the trends show that overall expenditure on subsidies decreased gradually from 2015-16 to 2019-20, it was principally due to its financing through off-budget borrowing. In the years following the

one-time settlement of dues, the expenditure on subsidies remained at 2.1 per cent of GDP till 2022-23. However, the government successfully cut all major subsidies and brought the expenditure on them down to 1.4 per cent of GDP in 2023-24. The subsidy bill is expected to decline to 1.3 per cent of GDP in 2024-25 RE and 1.2 per cent in 2025-26 BE.

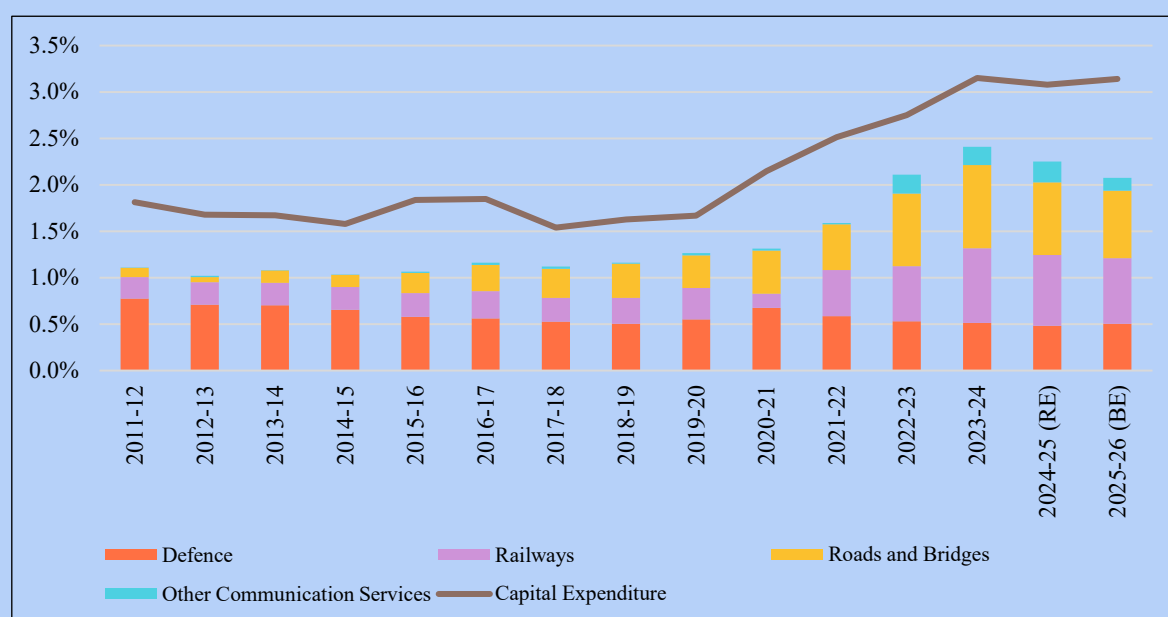
Capital Expenditure

4.34 Capital expenditure by the Union declined from 1.8 per cent of GDP in 2016-17 to 1.5 per cent in 2017-18 but recovered thereafter as shown in *Table 4.12* and *Figure 4.1*. From 2020-21, capital expenditures on economic services saw a major acceleration, with the result that the total capital expenditures of the Union reached 3.2 per cent of GDP in 2023-24. Railways, roads, civil aviation, and telecom have been the focus areas of capital spending in recent years. Expenditure in these items has increased from 0.3 per cent of GDP in 2014-15 to 1.9 per cent of GDP in 2023-24.

Table 4.12 Major Components of Capital Expenditure of the Union (percentage of GDP)

Year	Defence	Railways	Roads and Bridges	Other Comm. Services	Capital Expenditure
2011-12	0.8	0.2	0.1	0.0	1.8
2012-13	0.7	0.2	0.1	0.0	1.7
2013-14	0.7	0.2	0.1	0.0	1.7
2014-15	0.7	0.2	0.1	0.0	1.6
2015-16	0.6	0.3	0.2	0.0	1.8
2016-17	0.6	0.3	0.3	0.0	1.8
2017-18	0.5	0.3	0.3	0.0	1.5
2018-19	0.5	0.3	0.4	0.0	1.6
2019-20	0.6	0.3	0.4	0.0	1.7
2020-21	0.7	0.2	0.5	0.0	2.1
2021-22	0.6	0.5	0.5	0.0	2.5
2022-23	0.5	0.6	0.8	0.2	2.8
2023-24	0.5	0.8	0.9	0.2	3.2
2024-25 RE	0.5	0.8	0.8	0.2	3.2
2025-26 BE	0.5	0.7	0.7	0.1	3.1

Source: Union Budgets

Figure 4.1 Trends in Capital Expenditure (percentage of GDP)

Source: Union Budgets

4.35 As discussed in the introduction earlier, some expenditure of the Union which is technically classified as revenue expenditure is provided as grants to States under various schemes. These grants are utilized in the creation of assets such as houses under Pradhan Mantri Awas Yojana, schools under Samagra Shiksha and piped water infrastructure under Jal Jeevan Mission. This expenditure, though classified as revenue in the Union Budget, actually contributes to investment and the growth of the economy. Accordingly, these grants are shown separately in the Union Budget annually as Grants-in-Aid (GIA) for the creation of capital assets.

4.36 Alongside capital expenditure, it is useful to look at the trends in this component as its ultimate outcome is asset creation. *Table 4.13* shows that GIA for creation of capital assets has consistently maintained a significant role, forming around 1.0 per cent of GDP on an average between 2011-12 and 2023-24. The gradual reduction from 2011-12 to 2019-20 reflects the efforts made by the Union in reducing its revenue expenditure. Barring the anomaly of the pandemic year, this expenditure is maintained at 1.0 per cent of GDP. This sustained GIA commitment, alongside rising direct spending, reflects a balanced approach to infrastructure development. While capital expenditure has increasingly targeted key sectors such as railways, roads, civil aviation, telecom, and defence with notable shifts in spending priorities, the steady GIA share underscores the government's strategic use of transfers to States and other entities to support capital asset creation.

**Table 4.13 Capital Expenditure of the Union and GIA for Creation of Capital Assets
(percentage of GDP)**

Year	Capital Expenditure (Capex)	GIA for Creation of Capital Assets	Capex + GIA
(1)	(2)	(3)	(4) = (2) + (3)
2011-12	1.8	1.5	3.3
2012-13	1.7	1.2	2.8
2013-14	1.7	1.2	2.8
2014-15	1.6	1.0	2.6
2015-16	1.8	1.0	2.8
2016-17	1.8	1.1	2.9
2017-18	1.5	1.1	2.7
2018-19	1.6	1.0	2.6
2019-20	1.7	0.9	2.6
2020-21	2.1	1.2	3.3
2021-22	2.5	1.0	3.5
2022-23	2.8	1.1	3.9
2023-24	3.2	1.0	4.2
2024-25 RE	3.2	0.9	4.1
2025-26 BE	3.1	1.2	4.3

Source: Union Budgets

Fiscal, Revenue and Primary Deficits

4.37 Table 4.14 reports the three indicators of deficits from 2011-12 to 2025-26 BE. The movements in the indicators differ markedly before and after the pandemic. Before COVID-19, all three indicators registered downward trends. Between 2011-12 and 2018-19, the fiscal deficit fell from 5.9 per cent of GDP to 3.4 per cent, the revenue deficit fell from 4.5 per cent to 2.4 per cent, and the primary deficit fell from 2.8 per cent to 0.4 per cent. These years represented a period of effective fiscal consolidation and improved quality of expenditure, with the latter represented by a reduction in borrowing to finance revenue expenditures.

4.38 With the onset of the pandemic in the last quarter of 2019-20, all three deficit indicators saw a reversal in trend that year. The fiscal deficit as a proportion of GDP rose by 1.2 percentage points, revenue deficit by 0.9 percentage points, and primary deficit by 1.2 percentage points. A sharp decline in the growth rate of the economy during this year was accompanied by a slowdown in the growth in revenues, without a commensurate reduction in the revenue expenditures, explaining the reversal of trends³.

³ Nominal GDP growth fell by four percentage points from 10.6 per cent in 2018-19 to 6.4 per cent in 2019-20

4.39 The outbreak of the COVID-19 pandemic in the last quarter of 2019-20 led to the lockdown of almost all activities, except agriculture and essential services, for varying periods in 2020-21. The Union Government undertook a large targeted fiscal expansion to boost welfare measures. As a result, the Union Government's deficits came under severe stress. Its fiscal deficit nearly doubled to 9.2 per cent of GDP, revenue deficit rose to 7.3 per cent from 3.3 per cent in the previous year, and primary deficit rose by a similar magnitude.

Table 4.14 Deficit Indicators of the Union (percentage of GDP)

Year	Fiscal Deficit (FD)	Revenue Deficit (RD)	Primary Deficit (PD)	RD/FD (%)
(1)	(2)	(3)	(4)	(5) = (3) / (2)
2011-12	5.9	4.5	2.8	76.4
2012-13	4.9	3.7	1.8	74.3
2013-14	4.5	3.2	1.1	71.0
2014-15	4.1	2.9	0.9	71.6
2015-16	3.9	2.5	0.7	64.3
2016-17	3.5	2.1	0.4	59.1
2017-18	3.5	2.6	0.4	75.1
2018-19	3.4	2.4	0.4	70.0
2019-20	4.6	3.3	1.6	71.4
2020-21	9.2	7.3	5.7	79.7
2021-22	6.7	4.4	3.3	65.1
2022-23	6.5	4.0	3.0	61.6
2023-24	5.5	2.5	2.0	46.2
2024-25 P	4.8	1.7	1.4	36.0
2025-26 BE	4.4	1.5	0.8	33.4

Source: Union Budgets

4.40 The fiscal performance of the Union Government improved from 2021-22 to 2024-25 (P), from very high deficits. Therefore, there remains considerable scope for further fiscal consolidation. We will return to this subject in Chapter 6. However, presently, we note that on the margin, all three indicators of fiscal balance have shown improvement beginning in 2021-22, even though the pandemic had not receded by then. By 2024-25 (P), the fiscal deficit had fallen to 4.8 per cent of GDP, revenue deficit to 1.7 per cent, and primary deficit to 1.4 per cent.

4.41 To round off the discussion of deficit indicators, we present the revenue deficit as a percentage of the fiscal deficit in the last column of *Table 4.14*. This indicator steadily improved in the first few years, with its value declining from 76.4 per cent in 2011-12 to 59.1 per cent in 2016-17. It rose sharply to 75.1 per cent in 2017-18 and remained above 70.0 per cent till 2019-20. With the pandemic's severe blow to the economy, the ratio spiked to 79.7 per cent in

2020-21. It has seen a steady and speedy downward journey in the subsequent years, falling to 36.0 per cent in 2024-25 (P).

Outstanding Liabilities

4.42 *Table 4.15* shows the Union Government's liabilities against the Consolidated Fund of India (Public debt) and other liabilities (Public account) as proportions of GDP. The table divides public debt into liabilities incurred from residents (internal debt) and those incurred from non-residents (external debt). Public account liabilities are, by definition, internal.

Table 4.15 Profile of Debt and Liabilities of the Union (percentage of GDP)

Year	Internal Debt	External Debt	Public Debt	Other Liabilities	Total Liabilities
(1)	(2)	(3)	(4)=(2)+(3)	(5)	(7)=(4)+(5)
2011-12	37.0	1.9	38.9	12.8	51.7
2012-13	37.9	1.8	39.6	11.4	51.0
2013-14	37.8	1.6	39.4	11.1	50.5
2014-15	38.0	1.6	39.6	10.5	50.1
2015-16	38.5	1.5	40.0	10.1	50.1
2016-17	37.3	1.5	38.8	9.5	48.3
2017-18	37.5	1.5	38.9	9.3	48.2
2018-19	37.4	1.4	38.9	9.2	48.1
2019-20	39.9	1.5	41.4	9.3	50.7
2020-21	49.9	2.0	51.9	8.9	60.7
2021-22	48.6	1.9	50.4	7.0	57.4
2022-23	48.6	1.8	50.5	6.2	56.6
2023-24	48.8	1.9	50.7	5.7	56.4
2024-25 RE	49.2	1.9	51.1	5.0	56.1
2025-26 BE	48.8	1.9	50.6	4.5	55.1

Source: Union Budgets

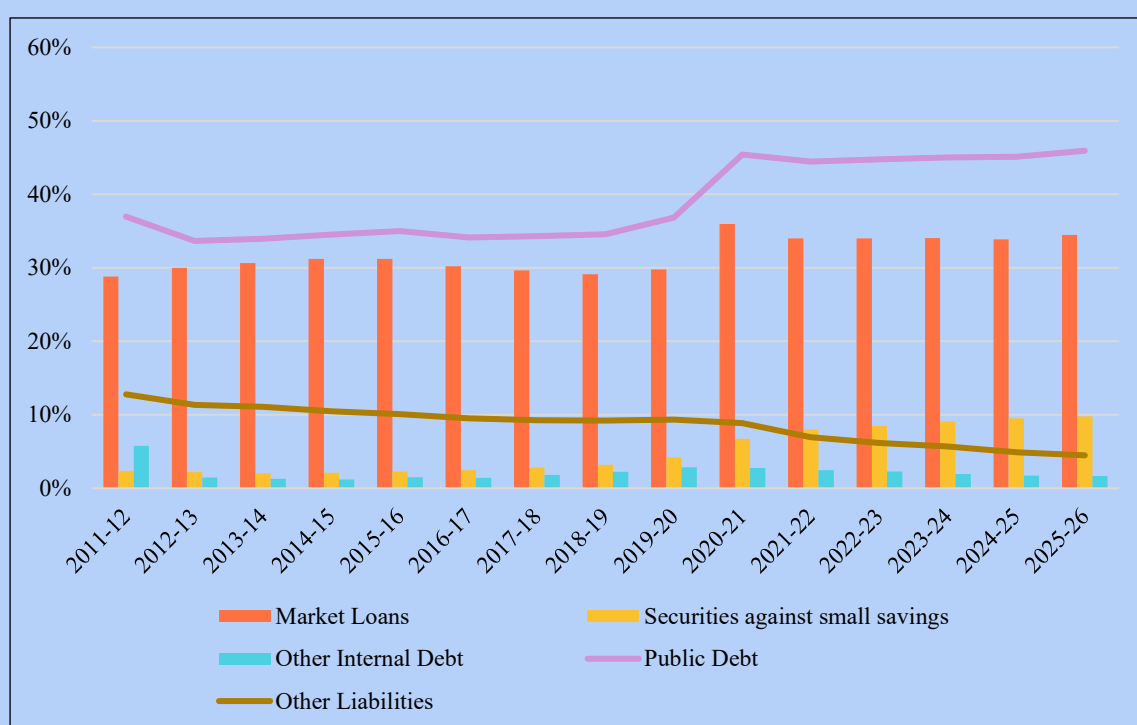
Note: The outstanding stock of external liabilities is reckoned at historical rates of exchange on which the liability was initially accounted for in the books of accounts after netting the repayments made at current exchange rates.

4.43 Internal debt has remained the dominant component, rising steadily from 37.0 per cent of GDP in 2011-12 to 48.8 per cent of GDP in 2023-24. The major components of internal debt are market loans, treasury bills (T-bills), and securities against small savings. Market loans represent the largest portion of internal debt, growing from 28.8 per cent of GDP to 34.0 per cent of GDP during the period 2011-12 to 2023-24. T-bills, while a smaller segment, have shown

consistent growth in absolute terms, reflecting increased cash management needs. The securities against small savings have expanded significantly, from 2.4 per cent of GDP in 2011-12 to 9.1 per cent of GDP in 2023-24, as States have moved away from this source.

4.44 External debt has increased moderately from ₹1.7 lakh crore in 2011-12 to ₹5.7 lakh crore in 2023-24 but has remained stable as a percentage of GDP at around 1.9 per cent, indicating the government's continued preference for domestic borrowing. Overall, public debt grew from ₹34 lakh crore in 2011-12 to ₹152.6 lakh crore in 2023-24, with its share of GDP peaking at 51.9 per cent during the pandemic year and stabilizing thereafter to around 50 per cent, reflecting the fiscal consolidation efforts taken by the Union.

Figure 4.2 Trends in Debt of the Union and Major Sources of Financing (percentage of GDP)



Source: Union Budgets

Note: Other Internal Debt includes T-bills, cash management bills, sovereign gold bonds etc ; Other Liabilities includes NSSF, SPFs, Other Accounts, Reserve Funds and Deposits

4.45 The second component of total liabilities is classified as other liabilities in the Union Budget. This category consists of NSSF⁴, State provident funds (SPF), other accounts, and reserve funds and deposits which can be interest bearing or otherwise. Although the absolute amount of these liabilities has increased from ₹11.2 lakh crore in 2011-12 to ₹17.1 lakh crore in 2023-24, their share as percentage of GDP has declined sharply, from 12.8 per cent in 2011-12

⁴ The liabilities under "NSSF" under Other Liabilities is total outstanding collections minus investments in the form of special securities issued to GoI.

to 5.7 per cent in 2023-24, reflecting a strategic move away from these sources in government finance. Notably, liabilities under the NSSF have shrunk from 6.7 per cent to 1.4 per cent of GDP during this period, while reserve funds and deposits have become slightly more significant, rising from 1.5 per cent to 2.1 per cent of GDP. These trends together highlight a clear evolution in the Union Government's liability profile towards greater reliance on market-based financing and a reduced dependence on traditional sources like small savings and provident funds. The trends in public debt and other liabilities along with major sources of financing, are presented in *Figure 4.2*.

4.46 FRBM Act, 2003 as amended in 2018 set debt-to-GDP targets of 60.0 per cent for the general government, 40.0 per cent for the Union Government, and 20.0 per cent for the State Governments combined, by the end of 2024-25. Between 2011-12 and 2018-19, the Union Government had achieved a modest reduction in the debt-to-GDP ratio from 51.7 per cent to 48.1 per cent. However, the growth slowdown in 2019-20 reversed this trend, raising the ratio to 50.7 per cent. Then, in 2020-21, the expansionary fiscal response to the COVID-19 crisis resulted in a major spike, with the ratio jumping to 60.7 per cent. This spike placed the target of reducing the debt-to-GDP ratio to 40.0 per cent by the end of 2024-25 out of reach.

4.47 In the meantime, the FC-15 laid out an indicative debt and deficit path for the Union Government. According to this path, the total outstanding liabilities of the Union were assessed to decrease from 62.9 per cent of GDP at the end of 2020-21 to 56.6 per cent at the end of 2025-26. The total outstanding liabilities of the Union in 2020-21 stood at 60.7 per cent of GDP, which decreased to 56.4 per cent in 2023-24. Assuming the absence of any major macro-economic shock, the Union Government has committed to a glide path of fiscal consolidation, which will bring down its total liabilities to 55.1 per cent at the end of 2025-26, and attain a debt-to-GDP level of about 50 ± 1 per cent by the end of 2030-31, the last year of this FC's award period.

4.48 The share of external debt in the government's total liabilities is small relative to its level during the 1980s. The country also holds a sizeable foreign exchange reserve and has a deep foreign exchange market. These facts significantly contain the risk of a balance-of-payments crisis like the one experienced in 1991.

Extra-Budgetary Resources

4.49 For completeness, we draw attention to the fact that the outstanding liabilities, as reported in *Table 4.15*, do not include the extra-budgetary resources (EBRs). EBRs are raised by various entities, through bonds sold in the market and loans taken from the NSSF and fully serviced by the Government of India through budgetary allocations. However, the government has started reporting these liabilities in the Union Budget since 2016-17 to maintain transparency. As per the statement on EBRs in the Union Budget 2025-26, the total liabilities incurred through these instruments during 2016-17 to 2022-23 were ₹1.38 lakh crore, and NIL in 2023-24.

4.50 Apart from the EBRs mobilized through the issue of bonds fully serviced by the government, financial support to certain expenditures was extended through loans from NSSF to entities such as the FCI and the Building Materials & Technology Promotion Council. The quantum of these EBRs was the highest at ₹1.26 lakh crore in 2019-20 and ₹94,636 crore in 2020-21. As per the disclosure in the Union Budget 2024-25, the government has repaid these loans.

Concluding Remarks

4.51 After a relatively successful handling of the health emergency related to COVID-19 in 2020-21, the Indian economy has reverted to its normal growth path. The Union Government took several welfare-oriented measures to protect the vulnerable, which cost 4.6 per cent of GDP, and doubled the fiscal deficit to 9.2 per cent in 2020-21. Subsequently and gradually, the finances of the Union Government have returned to the pre-COVID level. Revenue receipts of the Union in 2023-24 increased by 0.9 per cent of GDP over the pre-COVID year of 2018-19, while revenue expenditure fell by 1.0 per cent of GDP over the same period. Among the most positive developments post-COVID is a major acceleration in capital expenditures. It doubled to 3.2 per cent of GDP in 2023-24 from 1.6 per cent in 2018-19. Though the fiscal deficit remains elevated relative to pre-COVID years, the trend is downward.

4.52 The welfare spending undertaken in 2020-21 had a trifold impact. It protected the vulnerable during COVID-19, softened the immediate blow to GDP growth, and contributed to the subsequent speedy and decisive recovery of the economy. More importantly, the government successfully escaped the double-digit inflation that plagued much of the world in the aftermath of COVID-19. This was done by rejecting the calls from nearly all quarters for a much larger package to stimulate the economy, as nearly all other countries had done.

4.53 The political economy influences the level and composition of public expenditure in a democracy. Over the decades, India has witnessed an increase in public expenditure as a proportion of its GDP. However, one healthy development has been that while the Indian state directly entered the manufacturing activity on a massive scale during several post-independence decades, it has largely vacated this space since the launch of the economic reforms in 1991. Moreover, continuation of some subsidies notwithstanding, the government has come to focus more centrally on providing public goods such as infrastructure, defence, public health, sanitation, and piped water. Recently, it has also undertaken road, bridge, tunnel, and building construction projects on scale and focussed on timely completion. The quality of the Union Government's expenditures has seen a distinct improvement.

4.54 The government has also introduced new tax reforms to increase revenue and improve efficiency. The adoption of the GST on 01 July 2017 has been a major step in this direction. This has greatly improved the conventional economic efficiency by replacing many distortionary Union and State indirect taxes with a single tax nationwide on each product. It also ended the cascading of taxes and has eliminated the need for border check posts to monitor

inter-state trade. The digitization of the tax administration holds great promise for minimizing tax avoidance. The new simplified direct tax code substantially eliminates the system of exemptions and promises to reduce tax avoidance in the long run. The government has also lowered the corporation tax sufficiently to align it with international standards, while doing away with numerous exemptions. This being said, there remains scope for increasing tax collection through tax policy and tax administration reforms, given India's level of development.

4.55 On the expenditure side, the shift to the Direct Benefit Transfer system for most programs involving cash or in-kind transfers has greatly improved efficiency. Duplicate claims and claims for non-existent beneficiaries have been substantially eliminated, and the targeted beneficiaries have received their full entitlement. The Union Government has successfully replaced conventional carbon-heavy fuels with a cleaner source in nearly all poor rural households by channelling the urban LPG subsidy to the latter. It has also been highly effective in expanding toilets in rural households and ending open defecation. Its scheme to bring tap water to rural households has also seen rapid progress. These schemes have made a major difference for the better in the lives of rural women now joining the labour force in progressively larger numbers.

□□□

5.1 Within its federal structure, the Constitution empowers States to legislate on numerous subjects covered by the State List (List II) and the Concurrent List (List III). The subjects on these lists include law and order, public health, agriculture, education, labour, land, forestry, and internal trade. The legislative power naturally comes with the responsibility of delivering public services in these areas. In turn, the efficient delivery of services requires prudent financial management. This is the context of the present chapter.

5.2 Several key developments have impacted the finances of States in recent years. The jump in devolution to States from 32 per cent to 42 per cent of the divisible pool beginning in 2015-16 led to a significant increase in their total revenues and expenditures. The introduction of the Goods and Services Tax (GST) in July 2017 fundamentally restructured their indirect tax systems. The Ujjwal DISCOM Assurance Yojana (UDAY) impacted the debt profiles of many States in a major way. The economic slowdown in 2019-20 presented significant fiscal challenges. Finally, as with the Union Government, State Governments faced the pressure for increased expenditure on the one hand and a revenue squeeze on the other during the COVID-19 pandemic, resulting in a jump in the fiscal deficit and debt. In the following, we provide an overview of the revenues, expenditures, fiscal deficits, and debt of all 28 States of India combined from 2012 to 2024. This is followed by a more detailed discussion of individual States.

State Finances: An Overview

5.3 *Table 5.1* presents gross domestic product (GDP), total receipts, total expenditures, and fiscal deficit (FD) of all States combined in rupees and also as a percentage of GDP from 2011-12 to 2023-24. Total receipts include receipts on both revenue (current) and capital accounts. Likewise, total expenditures include expenditures on the revenue and capital accounts.

Accordingly, the difference between the total expenditures and total receipts represents the fiscal deficit.

Table 5.1 GDP, States' Combined Expenditure, Revenue and Fiscal Deficit

Year	GDP	Total Receipts (Revenue plus Capital)	Total Expenditure (Revenue plus Capital)	Fiscal Deficit	Total Receipts	Total Expenditure	Fiscal Deficit
	<i>(figures in ₹ lakh crore)</i>				<i>(figures as percentage of GDP)</i>		
2011-12	87.36	10.90	12.55	1.65	12.5	14.4	1.9
2012-13	99.44	12.33	14.24	1.91	12.4	14.3	1.9
2013-14	112.33	13.49	15.92	2.43	12.0	14.2	2.2
2014-15	124.68	15.82	19.04	3.21	12.7	15.3	2.6
2015-16	137.72	18.05	22.19	4.13	13.1	16.1	3.0
2016-17	153.92	20.20	25.49	5.28	13.1	16.6	3.4
2017-18	170.90	22.67	26.75	4.08	13.3	15.7	2.4
2018-19	189.00	25.58	30.12	4.54	13.5	15.9	2.4
2019-20	201.04	26.20	31.36	5.16	13.0	15.6	2.6
2020-21	198.54	26.08	32.95	6.87	13.1	16.6	3.5
2021-22	235.97	32.75	37.66	4.90	13.9	16.0	2.1
2022-23	268.90	35.22	42.44	7.22	13.1	15.8	2.7
2023-24	301.23	38.16	46.81	8.64	12.7	15.5	2.9

Source: Ministry of Statistics and Programme Implementation (MoSPI), States' Finance Accounts

5.4 Between 2011-12 and 2023-24, India's nominal GDP multiplied 3.4-fold from ₹87.4 lakh crore to ₹301.2 lakh crore. The States' total revenues and expenditures multiplied by 3.5 and 3.7, respectively, over the same period. Therefore, revenues and expenditures as a proportion of GDP saw a slight increase.

5.5 This overview of 2011-2024 needs to be unpacked in light of important changes that occurred over the review period. In 2014-15, both total revenues and expenditures as a proportion of GDP rose significantly. This rise was primarily due to a change in accounting practice, whereby the Union, which had previously transferred its allocations to certain centrally sponsored schemes (CSS) directly to the implementing agencies, began channelling them through the consolidated funds of the States. As a result, both total revenues and expenditures recorded on the States' budgets saw an upward movement. A more substantive upward shift in the total revenues and expenditures occurred in 2015-16 when the share of the States in the divisible pool rose from 32 per cent to 42 per cent.

5.6 Under GST, States replaced several of their taxes with the State GST (SGST) to be collected on goods and services consumed within the State. As part of the agreement reached between the Union and State Governments under GST, the former had promised to compensate

the latter through a grant for the gap between a projected 14 per cent annual growth in revenues from the taxes replaced by SGST over their 2015-16 base and the revenue collected through SGST for a period of five years. Therefore, although GST suffered from teething pains during its early years of implementation, the Union compensated the States as explained above. This compensation provided a significant boost to the States' total revenues in the years 2017-18 and 2018-19. However, the economic slowdown and the onset of COVID-19 led to a decline in the revenue as a proportion of GDP in 2019-20 and 2020-21 relative to 2018-19. The expenditure as a proportion of GDP fell in 2019-20, but lesser than revenue, and rose in 2020-21, leading to larger fiscal deficits during these years. The Union Government relaxed the States' borrowing limit to up to 5 per cent of GSDP to accommodate the large expenditure expansion in 2020-21. With the economy regaining some of its normalcy in 2021-22, the total revenue as a proportion of GDP returned to its higher level, but with the fiscal deficit also brought down sharply, expenditures as a proportion of GDP fell.

5.7 The five-year period over which the Union Government had promised to provide GST compensation ended on 30 June 2022. The resulting discontinuation of the GST compensation grant led to a decline in the States' revenues as a proportion of GDP in 2022-23 and 2023-24 relative to their pre-COVID but post-GST level. The States resorted to higher fiscal deficits during these years to sustain expenditure as a proportion of GDP at approximately the same level as in 2021-22.

5.8 The States' combined fiscal deficit as a proportion of GDP has remained within the 3 per cent borrowing limit set by the Union Government in all but two years. In 2016-17, the deficit exceeded the 3 per cent mark due to the implementation of the UDAY scheme in 2015-16, which led to a sudden increase in debt and, consequently, higher interest payments. In 2020-21, the source of the higher deficit was the COVID-19-induced shortfall in revenues and expansion of expenditure. We next disaggregate the sources of revenue and objects of expenditure in succession.

Trends in Receipts

5.9 At the broadest level, the States' total receipts may be divided into revenue and capital receipts. As shown in *Table 5.2*, the latter form only a small part of the States' receipts. Most of the States' capital receipts come from debt-creating instruments and are not included in *Table 5.2*. Like the Union Government, the States borrow principally from the market, though they also draw from public accounts maintained for specific purposes.

5.10 Except in 2013-14, the States' revenue receipts exceeded 12 per cent of GDP during all years under review. With non-debt capital receipts playing a minuscule role, movements in these receipts have driven the total receipts discussed in the previous section. The tax revenues of the States have thus been adversely impacted by the introduction of GST in July 2017, the sharp decline in the growth rate in 2019-20, and the COVID-19 crisis in 2020-21.

Table 5.2 Revenue and Capital Receipts of the States (percentage of GDP)

Year	Total Revenue (Current) Account Receipts	Non-debt Capital Receipts	Total Receipts
2011-12	12.3	0.2	12.5
2012-13	12.3	0.1	12.4
2013-14	11.9	0.1	12.0
2014-15	12.5	0.2	12.7
2015-16	13.0	0.1	13.1
2016-17	13.0	0.1	13.1
2017-18	13.0	0.2	13.3
2018-19	13.3	0.2	13.5
2019-20	12.8	0.3	13.0
2020-21	13.0	0.1	13.1
2021-22	13.8	0.1	13.9
2022-23	13.1	0.0	13.1
2023-24	12.6	0.1	12.7

Source: States' Finance Accounts

Components of Revenue Receipts

5.11 Revenue receipts of the States can be divided into four major components: own tax revenues, own non-tax revenues, share in the divisible pool, and grants from the Union Government. The States' own tax revenue sources include the SGST, excise tax, sales tax, vehicle tax, stamp duties, and land revenue. Their non-tax revenue sources include charges for services, fines and penalties, royalties on minerals, dividends from State public-sector undertakings and interest on loans. These revenue sources are complemented by grants-in-aid from the Consolidated Fund of India and the States' share in the divisible pool, as recommended by the Finance Commission (FC). Grants-in-aid include FC-recommended grants (deficit grants, local body grants, disaster relief grants, and sector- and State-specific grants), the Union's contribution to CSS, and GST compensation. The divisible pool consists of Union taxes, other than taxes belonging to the Union Territories, cesses, and surcharges, minus the cost of collection. Thirteenth Finance Commission (FC-13) awarded States 32 per cent of the divisible pool, which was subsequently enhanced to 42 per cent by the Fourteenth Finance Commission (FC-14). The Fifteenth Finance Commission (FC-15) recommended a marginally reduced share of 41 per cent, primarily to accommodate the exclusion of Jammu and Kashmir following its reorganization.

5.12 *Table 5.3* provides the contributions of various sources of the States' revenues as a proportion of GDP from 2011-12 to 2023-24. Except for the first five years of GST implementation (2017-18 to 2021-22), during which the Union Government provided a GST compensation grant shown under the grants-in-aid column in the *table*, the States' own tax revenue as a proportion of GDP has been remarkably stable. It accounted for approximately half

of the States' total receipts throughout the period. The States' own non-tax revenue as a proportion of GDP has also remained stable at a little above 1 per cent. Some revenue increase came from a jump in the States' share of the divisible pool (shown in *Tax Devolution* column) beginning in 2015-16. The increase amounted to approximately 1 per cent of GDP. The contribution of FC-recommended tax devolution to the States' revenues has ranged from 2.7 per cent of GDP in 2014-15 to 4.0 per cent in 2018-19 during the period under review. The grants show a jump beginning in 2014-15, but this is due to the accounting change whereby the Union Government began channelling its contribution to the CSS through the States' budgets instead of transferring it directly to the implementing agencies.

Table 5.3 Components of Revenue Receipts of the States (percentage of GDP)

Year	Own Tax Revenue	Own Non-Tax Revenue	Tax Devolution	Total Grants-in-Aid (Including GST Compensation)	Total Revenue (Current) Account Receipts
2011-12	6.3	1.1	2.9	2.0	12.3
2012-13	6.5	1.2	2.9	1.8	12.3
2013-14	6.3	1.2	2.8	1.7	11.9
2014-15	6.2	1.1	2.7	2.5	12.5
2015-16	6.1	1.1	3.6	2.2	13.0
2016-17	5.9	1.1	3.9	2.2	13.0
2017-18	5.9	1.0	3.9	2.2	13.0
2018-19	6.1	1.1	4.0	2.2	13.3
2019-20	5.8	1.3	3.2	2.4	12.8
2020-21	5.7	0.9	3.0	3.5	13.0
2021-22	6.0	1.0	3.7	3.0	13.8
2022-23	6.3	1.0	3.5	2.2	13.1
2023-24	6.2	1.0	3.7	1.6	12.6

Source: States' Finance Accounts

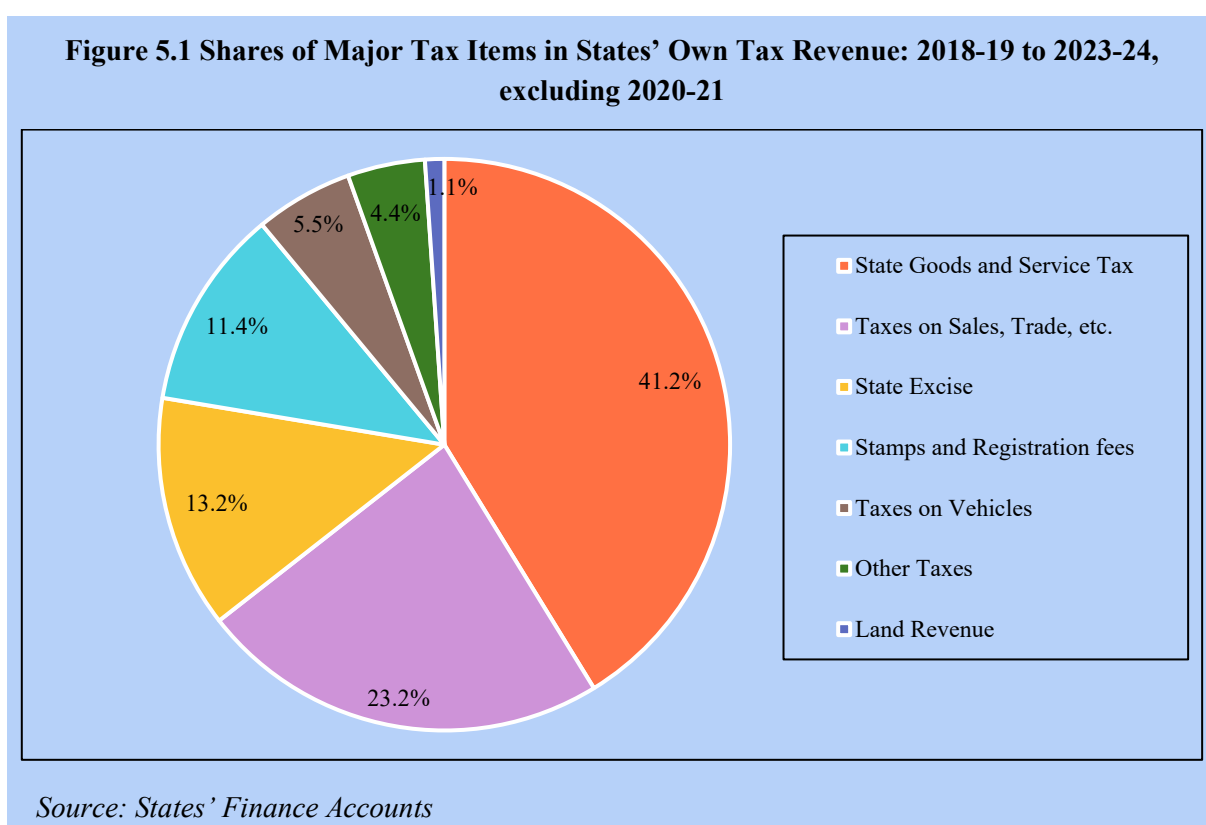
5.13 Some shifts among the components of grants-in-aid are worth noting here. FC grant data show spikes in 2019-20 and 2020-21. The former resulted from the release of pending FC-14 grants for Rural and Urban Local Bodies, and the latter from enhanced allocations for revenue deficit (RD) and disaster management grants under FC-15. Transfers under CSS peaked during 2020-21 as part of the Union Government's pandemic response. The CSS-related transfers by the Union result in the expansion of both revenues and expenditures of the States.

5.14 Before the introduction of GST, States relied heavily on taxes such as sales tax/value-added tax (VAT), excise duties, stamp and registration duties, and entertainment tax for their own tax revenue. GST has now subsumed many of these taxes, with SGST becoming a key component of the States' tax revenue. As a consequence, the States' own tax revenues are now more closely tied to the performance of GST. Its contribution to State revenues has grown

from 2.5 per cent of GDP in its first complete year of implementation in 2018-19 to approximately 2.7 per cent by 2023-24. Among the other taxes, sales tax on petroleum and liquor and excise duty on liquor have consistently contributed around 1.4 per cent and 0.8 per cent of GDP, respectively, post-GST. The stamps and registration fees contributed approximately 0.7 per cent to 0.8 per cent of GDP.

Components of Own Tax Revenue

5.15 *Figure 5.1* shows the average shares of the major tax heads in the States' own tax revenue from 2018-19 to 2023-24, excluding the COVID-19 year of 2020-21. SGST is levied and collected by a State on intrastate sales of a good or service, with the sale and consumption of the good or service occurring in the same State. However, in the State accounts, SGST also includes the part of the Integrated GST (IGST) accruing to the State on inter-state transactions and imports when the final consumption of the good or service occurs in that State.



5.16 At 41.2 per cent, SGST was the largest contributor to the States' own tax revenues during 2018-19 to 2023-24 (with 2020-21 excluded). The sales tax, collected principally on petroleum, petroleum products, and alcoholic beverages, was a distant second with a 23.2 per cent share. Excise duty, collected on alcoholic products at the manufacturing, wholesale, and retail stages, contributed 13.2 per cent. Other items were stamp and registration fees (11.4 per cent), vehicle tax (5.5 per cent), and land revenue (1.1 per cent).

Tax and Non-tax Revenue Buoyancy

5.17 During the period from 2011-12 to 2023-24 (excluding 2020-21), the combined tax revenue of all States exhibited a buoyancy of 0.96 with respect to GDP, indicating that tax revenue grew at a slightly lower rate than GDP. Non-tax revenue, on the other hand, showed a buoyancy of 0.91, reflecting an even slower growth relative to GDP. Consequently, the total own revenue receipts of the States demonstrated a buoyancy of 0.96. In contrast, Union transfers grew at a rate substantially exceeding the growth of GDP during this period. This fact underscores the growing reliance of States on Union transfers to meet their revenue needs.

Trends in Expenditure

5.18 Over the past decade, the expenditure of States as a percentage of GDP has witnessed a significant increase. As shown in *Table 5.4*, it rose from 14.2 per cent in 2013-14 to a peak of 16.6 per cent in 2016-17 and again in 2020-21. A consistent feature of the spending pattern has been the dominance of revenue over capital expenditure. Only twice during the period under review, in 2015-16 and 2016-17, did capital expenditure touch or exceed 3 per cent of GDP. The reason for this uptick is discussed in *Paragraph 5.26*. Revenue expenditure has remained persistently high, hovering around or exceeding the 13 per cent mark since 2015-16 and reaching 14.4 per cent in the COVID-19 year of 2020-21. Larger FC devolutions under the FC-14 and FC-15 have not translated into larger capital expenditures except in 2015-16 and 2016-17.

Table 5.4 An Overview of the States' Expenditures (percentage of GDP)

Year	Revenue Expenditure	Capital Expenditure	Total Expenditure
2011-12	12.0	2.3	14.4
2012-13	12.1	2.2	14.3
2013-14	12.0	2.1	14.2
2014-15	12.9	2.4	15.3
2015-16	13.1	3.0	16.1
2016-17	13.3	3.3	16.6
2017-18	13.2	2.4	15.7
2018-19	13.4	2.5	15.9
2019-20	13.4	2.2	15.6
2020-21	14.4	2.2	16.6
2021-22	13.6	2.3	16.0
2022-23	13.4	2.4	15.8
2023-24	12.9	2.6	15.5

Source: States' Finance Accounts

5.19 In 2020-21, the Union Government introduced a scheme - ‘Special Assistance to States for Capital Investment (SASCI)’ offering 50-year interest-free capital expenditure loans to States to boost their capital expenditures. The details of loans under SASCI are given in *Table 5.5* and *Annexure 5.4*. While a large number of States have taken advantage of this loan facility, it may be hypothesized that in some cases, States substituted capital expenditure projects they would have undertaken with other sources of revenue for those undertaken using SASCI. We return to this issue in our inter-state analysis later in this chapter.

Table 5.5 Interest-free Loans from the Union Government for Capital Expenditure

Year	Amount (₹ lakh crore)	Percentage of GDP
2020-21	0.12	0.06
2021-22	0.14	0.06
2022-23	0.81	0.30
2023-24	1.10	0.36
2024-25	1.50	0.45

Source: Data provided by Dept. of Economic Affairs (Ministry of Finance)

5.20 Committed expenditures, such as salaries, pensions, and interest payments, can substantially explain the stickiness of revenue expenditures. However, it bears noting that at least some of these expenditures result from the choices made by the States. Over time, the committed expenditures have absorbed an increasing share of the States’ revenue expenditures and undermined their fiscal flexibility. The problem becomes particularly serious when unexpected expenditure needs arise.

Components of Revenue Expenditures

5.21 *Table 5.6* shows the major components of the States’ revenue expenditures. They include general services, social services, economic services, and transfers to local bodies. General services are subdivided into three subcategories: interest, pension, and ‘others’. The combined expenditure on interest payments and pension has risen from 2.9 per cent of GDP during the first four years to 3.2 per cent of GDP during the last year. Besides, as a percentage of revenue receipts, States’ interest payments increased from 11.7 per cent in 2015-16 to 14.6 per cent in 2020-21, before falling to 13.0 per cent in 2023-24. Similarly, pension expenditure as a percentage of revenue receipts grew from 11.1 per cent in 2015-16 to 13.9 per cent in 2020-21 and stood at 13.0 per cent in 2023-24.

Table 5.6 Components of Revenue Expenditure of States (percentage of GDP)

Year	General Services				Social Services	Economic Services	Transfers to Local Bodies [#]
	Interest Payments	Pension	Others	Total			
2011-12	1.5	1.4	1.4	4.4	4.8	2.5	0.3
2012-13	1.5	1.4	1.4	4.3	4.8	2.7	0.3
2013-14	1.5	1.4	1.4	4.3	4.8	2.6	0.4
2014-15	1.5	1.4	1.4	4.3	5.0	3.2	0.4
2015-16	1.5	1.5	1.3	4.3	5.3	3.1	0.4
2016-17	1.6	1.4	1.3	4.4	5.4	3.2	0.4
2017-18	1.7	1.6	1.3	4.6	5.1	3.1	0.4
2018-19	1.6	1.6	1.4	4.7	5.2	3.1	0.4
2019-20	1.7	1.7	1.3	4.7	5.3	3.0	0.4
2020-21	1.9	1.8	1.3	5.1	5.7	3.3	0.4
2021-22	1.8	1.7	1.3	4.8	5.4	3.0	0.4
2022-23	1.7	1.7	1.3	4.7	5.3	3.0	0.4
2023-24	1.6	1.6	1.2	4.5	5.1	3.0	0.4

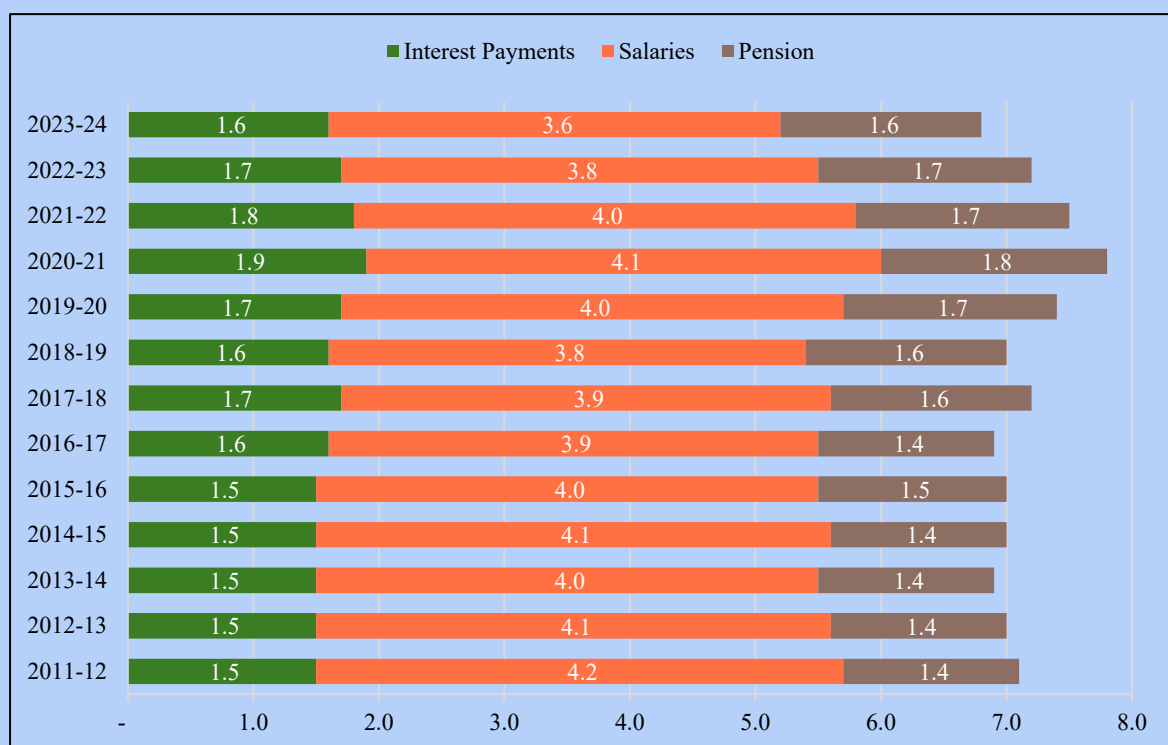
Source: States' Finance Accounts

[#] Transfers to Local bodies are made under General, Social and Economic Services heads also.

5.22 Salary expenditure, which is spread across general, social, and economic expenditures, is the largest component of the States' committed expenditures. However, it has shown a downward trend in recent years. Consolidated salary expenditure for all States has increased nearly three times in absolute terms; however, as a percentage of GDP, it has declined from 4.2 per cent to 3.6 per cent during the period under review. *Figure 5.2* depicts the States' combined committed expenditure as a proportion of GDP. It shows that with the fall in the salary component approximately offsetting the increase in pensions and interest payments, total committed expenditures, which had risen from 7.1 per cent of GDP in 2011-12 to 7.8 per cent in the COVID-19 year of 2020-21, returned to 6.9 per cent in 2023-24.

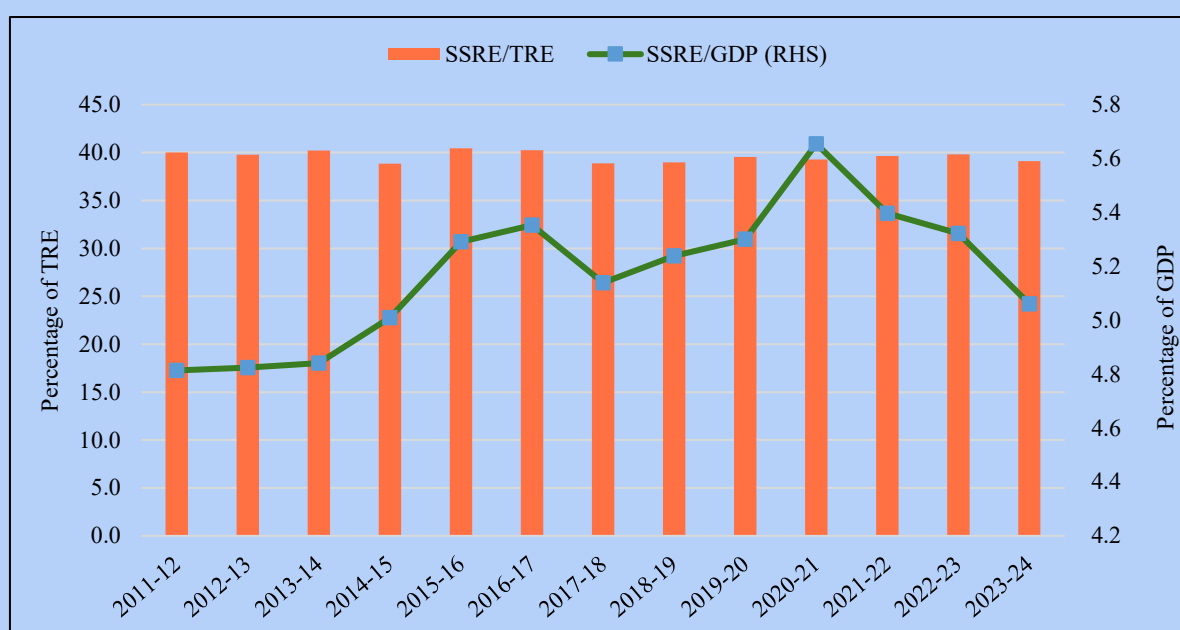
5.23 Expenditure on social services as a proportion of GDP has shown a rising trend throughout the period under review, increasing from 4.8 per cent in the first three years to a range of 5.1-5.4 per cent in the last three. Social services include education, health, and welfare programs. *Figure 5.3* depicts the evolution of expenditures on social services as a proportion of the States' total revenue expenditures and GDP. The increase in the share can be attributed mainly to increased spending on health. The expenditure on economic services increased from 2.5 per cent in 2011-12 to the peak of 3.3 per cent in 2020-21 and then fell to 3.0 per cent during 2023-24. Burgeoning power subsidies to DISCOMs have been the primary driver of this increase. This report provides a deeper analysis of the power sector in Chapter 13.

**Figure 5.2 Components of Committed Expenditure of States
(percentage of GDP)**



Source: States' Finance Accounts, States' Budgets, CAG Audit Reports on State Finances

**Figure 5.3 Social Sector Revenue Expenditure (percentage of GDP and
Total Revenue Expenditure)**



Source: States' Finance Accounts

Expenditure on Health and Education

5.24 Given the importance of education and health, it is worthwhile considering the expenditure on both separately. *Table 5.7* shows that the States' health expenditure as a proportion of GDP was barely 0.6 per cent in 2011-12. This proportion increased over the years, reaching 1.0 per cent in 2020-21 and 2021-22 but fell marginally to 0.9 per cent in 2022-23. The allocation of public expenditures to health has historically been low in India, with citizens incurring significantly larger expenditures out of their pockets. The onset of COVID-19 highlighted the fragility of existing health infrastructure, necessitating a quick expansion of health expenditure to 1.0 per cent of GDP from 0.8 per cent. The elevated level was sustained in 2021-22, though it fell to 0.9 per cent in 2023-24. The States' education expenditure as a percentage of GDP has exhibited a relatively stable trajectory, ranging from 2.2 to 2.5 per cent of GDP throughout the period under review.

Table 5.7 Expenditures on Health and Education (percentage of GDP)

Year	Health	Education
2011-12	0.6	2.4
2012-13	0.7	2.5
2013-14	0.6	2.4
2014-15	0.8	2.5
2015-16	0.8	2.5
2016-17	0.8	2.5
2017-18	0.8	2.4
2018-19	0.8	2.4
2019-20	0.8	2.5
2020-21	1.0	2.5
2021-22	1.0	2.4
2022-23	0.9	2.3
2023-24	0.9	2.2

Source: States' Finance Accounts

Note: The expenditure figures for health and education include both revenue and capital expenditure.

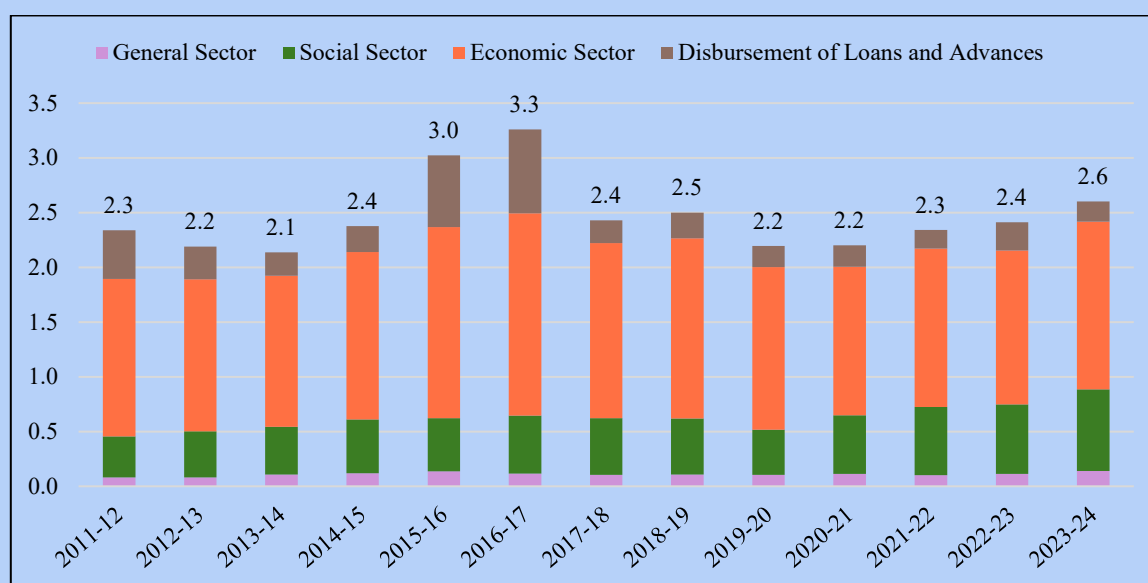
Subsidies

5.25 Subsidies, which are spread across different expenditure categories in *Table 5.6*, constitute another major expenditure item. They have seen a sharp rise in recent years. An analysis of budgets and finance accounts of twenty-one large States reveals that total expenditure by States on subsidies and beneficiary-oriented schemes has risen consistently from 2.2 per cent of their GSDP in 2018-19 to 2.7 per cent in 2023-24. Of the total of approximately ₹7.6 lakh crore spent in 2023-24 on subsidies and benefits, nearly half was allocated to the power sector (34.2 per cent) and social security pensions (15.5 per cent) together. Chapter 14 of this report provides a detailed analysis of subsidies.

Capital Expenditure

5.26 During the period, capital expenditure fluctuated between 2.1 per cent and 3.3 per cent of GDP (*Figure 5.4*). The uptick during 2015-16 and 2016-17 was mainly due to States taking over the debt of DISCOMs under the UDAY scheme. The recent increase is due to Union assistance to States in the form of an interest-free 50-year loan for capital expenditure. Overlaying the trend in capital expenditure with the trends in receipts shows that States tend to compress capital expenditure during the years in which they face resource constraints.

Figure 5.4 Capital Expenditure by States (percentage of GDP)



Source: States' Finance Accounts

5.27 Under UDAY, States assumed the liabilities of their DISCOMs, resulting in a temporary increase in borrowing from banks and other financial institutions, including LIC, NABARD, NCDC, and SBI. This borrowing, although classified as capital expenditure, was primarily directed towards providing financial support for State Public Sector Enterprises and DISCOMs, rather than creating productive capital assets. Consequently, the capital expenditure in 2016-17, which peaked at 3.3 per cent of GDP, does not fully represent investments in infrastructure that would enhance long-term economic capacity.

5.28 In addition to loans taken over by States under UDAY, States' capital expenditures also include loans and advances extended to public sector entities, along with actual capital expenditures on the creation of physical assets. As depicted in *Table 5.8*, the capital outlay of States has varied between 1.9 per cent and 2.5 per cent of GDP, while loans, advances, and investments have varied between 0.2 per cent and 0.8 per cent of GDP.

Table 5.8 Components of Capital Expenditures (percentage of GDP)

Year	Capital Outlays	Disbursement of Loans and Advances	Total Capital Expenditure
2011-12	1.9	0.4	2.3
2012-13	1.9	0.3	2.2
2013-14	1.9	0.2	2.1
2014-15	2.1	0.2	2.4
2015-16	2.4	0.7	3.0
2016-17	2.5	0.8	3.3
2017-18	2.2	0.2	2.4
2018-19	2.3	0.2	2.5
2019-20	2.0	0.2	2.2
2020-21	2.0	0.2	2.2
2021-22	2.2	0.2	2.3
2022-23	2.1	0.3	2.4
2023-24	2.4	0.2	2.6

Source: States' Finance Accounts

Deficit and Debt

5.29 Table 5.9 presents the main conventional measures of deficits as proportions of GDP, including fiscal, revenue, and primary deficits. The last column also reports the outstanding liabilities as a proportion of GDP. The fiscal deficit for all States has shown a notable increase since the 2011-12 fiscal year. It stood at 1.9 per cent of GDP in 2011-12 but steadily climbed, peaking at 3.5 per cent in 2020-21. In between, it witnessed a jump from 2014-15 to 2016-17, with a rise in the last two years resulting principally from the absorption of DISCOM debt under the UDAY scheme. Like the Union, States have also reversed this trend post-pandemic, cutting fiscal deficit to 2.1 per cent of GDP in 2021-22. However, it rebounded in the following two years, reaching 2.7 per cent in 2022-23 and 2.9 per cent in 2023-24.

5.30 Out of the 13 years under review, the States have incurred a positive revenue deficit (RD) in 10 years. Because market borrowings invariably finance it, the revenue deficit crowds out either public or private capital expenditure. It fluctuated between -0.2 per cent and 1.4 per cent of GDP during the 13 years. The revenue deficit to fiscal deficit (RD/FD) ratio is sometimes seen as an indicator of the crowding out of capital expenditure by revenue expenditure. In the early years of the decade, States maintained a tight grip on their revenue deficits, directing a significant portion of borrowing towards capital expenditures. However, by 2019-20, the RD/FD ratio had deteriorated to 25.0 per cent, peaking at 40.2 per cent during the pandemic year of 2020-21. The ratio improved in the following two years, at 11.4 per cent in 2022-23 and 12.0 per cent in 2023-24. As a group, the States have scored reasonable success in restoring fiscal stability post-pandemic.

Table 5.9 Trends in Aggregate Fiscal Indicators of States (percentage of GDP)

Year	Fiscal Deficit (FD)	Revenue Deficit [#] (RD)	Primary Deficit (PD)	RD/FD (in per cent)	Outstanding Debt [#]
2011-12	1.9	-0.2	0.3	--	22.1
2012-13	1.9	-0.2	0.4	--	21.6
2013-14	2.2	0.1	0.7	4.4	21.2
2014-15	2.6	0.4	1.1	14.0	21.5
2015-16	3.0	0.0	1.5	1.2	22.7
2016-17	3.4	0.3	1.8	8.1	24.0
2017-18	2.4	0.2	0.7	7.7	24.1
2018-19	2.4	0.1	0.8	4.7	24.1
2019-20	2.6	0.7	0.9	25.0	25.4
2020-21	3.5	1.4	1.6	40.2	29.3
2021-22	2.1	-0.2	0.3	--	26.9
2022-23	2.7	0.3	1.0	11.4	26.1
2023-24	2.9	0.3	1.2	12.0	26.4

Source: MoSPI Comparable Estimates for GDP (2011-12 series), States' Finance Accounts

Revenue Deficit and Outstanding Liabilities figures have been adjusted for loans for GST compensation

5.31 Primary deficit, which represents liabilities incurred in excess of interest payments on outstanding liabilities as a percentage of GDP, represents another measure of fiscal discipline that has been positive throughout the period. It ranged from 0.3 to 1.8 per cent of GDP. Interestingly, it peaked, not during the COVID-19 year of 2020-21 but in 2016-17. Though this measure fell to 0.3 per cent of GDP in 2021-22, it rose back to 1.0 per cent in 2022-23 and 1.2 per cent in 2023-24.

5.32 As a consequence of the increase in fiscal deficit, the debt-to-GDP ratio has shown a steady upward trend over the past decade. The ratio increased gradually from 22.1 per cent in 2011-12 to 24.1 per cent by 2017-18. The implementation of UDAY and the onset of the COVID-19 pandemic led to a sharp increase in the States' debt, pushing the debt-to-GDP ratio to a peak of 29.3 per cent in 2020-21. In the post-pandemic period, the debt ratio has begun to stabilize, dropping slightly to 26.4 per cent in 2023-24, reflecting efforts by States to consolidate their finances and reduce their borrowings.

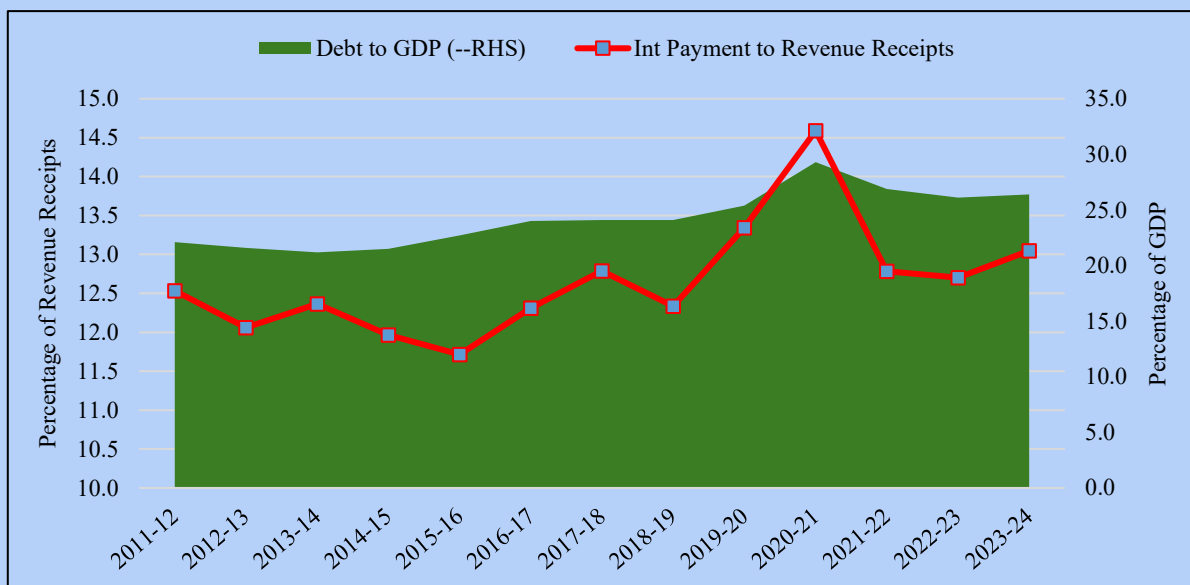
5.33 The sustained high fiscal deficits and the consequent debt accumulation have resulted in a significant portion of revenue receipts being allocated to debt servicing. From 12.5 per cent of revenue receipts in 2011-12, interest payments on debt steadily rose to 14.6 per cent in the COVID-19 year of 2020-21 (*Figure 5.5*). Though the ratio declined subsequently, it has remained elevated at 13.0 per cent of revenue receipts in 2023-24. Calculated as a percentage of their own tax and non-tax revenues, the burden of interest payments has been significantly higher: 20.7 per cent in 2011-12 and 22.6 per cent in 2023-24. The high debt service burden reduces the fiscal space for expenditures on critical items, such as health, education, and infrastructure.

Box 5.1 GST Compensation

The GST compensation mechanism was intended to insulate States from revenue losses arising from the new tax regime, which worked smoothly till 2019-20. However, the onset of the COVID-19 pandemic adversely impacted GST collections, leading to a larger need for fiscal resources for GST compensation than the cess could generate, especially in the face of the economic slowdown. At the same time, States needed fiscal resources to relieve the suffering arising from the pandemic.

In response, the Union Government introduced a special borrowing window under which the extra debt created by the compensation cess shortfall would be repaid from future compensation cess collections. Thus, the collection of GST cess was extended beyond June 30, 2022, until the additional debt was repaid. Under the scheme, a cumulative amount of approximately ₹2.50 lakh crore was disbursed to the States in 2021-22 and 2022-23, accounting for around 0.5 per cent of GDP each year. Given that these loans are serviced directly by the Union Government from the cess proceeds and do not create a repayment liability for the States, we have treated them as part of the GST compensation rather than States' debt. Consequently, these borrowings have been excluded from the States' debt and other liabilities.

Figure 5.5 High and Rising Cost of Debt Service



Source: States' Finance Accounts

Composition of Debt

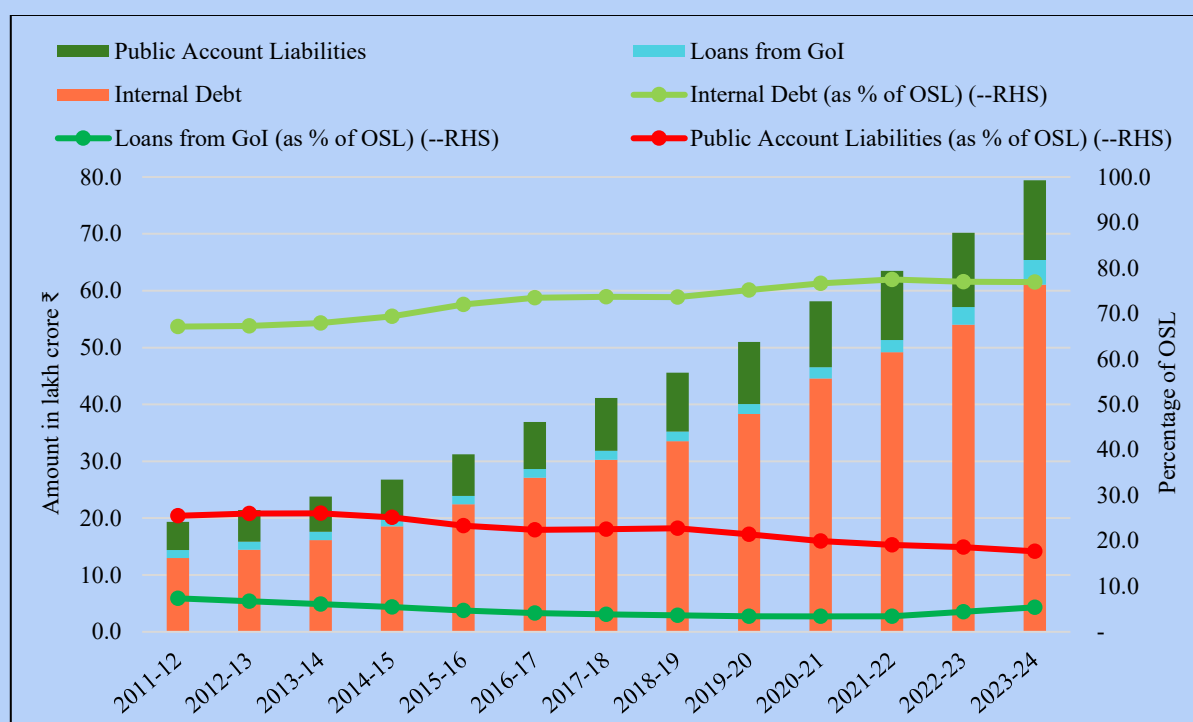
5.34 The composition of State debt has undergone significant evolution over the past decade. Market borrowings have become increasingly dominant, rising from 39.6 per cent of total

liabilities in 2012-13 to 63.7 per cent in 2022-23. In contrast, reliance on the National Small Savings Fund (NSSF) has diminished from 22.0 per cent in 2012-13 to a mere 3.6 per cent in 2022-23. This shift reflects the growing preference for market-based financing, driven by the availability of more competitive options relative to traditional sources.

5.35 The share of loans from the Union Government has declined steadily, from 7.4 per cent in 2011-12 to 3.4 per cent in 2019-20 (*Figure 5.6*). The trend towards declining dependence on Union Government loans can be traced back to the FC-12 recommendations and the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act, which together catalysed a shift away from Union on-lending to States. The debt swap scheme of the early 2000s also contributed to the States switching to market borrowings. The Union Government's scheme, SASCI, as mentioned earlier, has recently partially reversed this trend. The scheme aims to stimulate capital expenditure by providing the States with 50-year interest-free loans. The Union loans stood at 5.4 per cent of the outstanding liabilities at the end of 2023-24.

5.36 The States' sources of fiscal deficit financing reflect these shifts in the composition of debt in a more magnified form. The share of market borrowings in the fiscal deficit financing has increased from 80.4 per cent of the fiscal deficit in 2011-12 to 94.8 per cent by 2019-20. However, the SASCI loans of the Union Government has led to this share tapering down to 75.5 per cent in 2023-24, with the share of loans from the Union Government in financing States' fiscal deficits increasing from 2.1 per cent in 2019-20 to 16.9 per cent in 2020-21 and 27.2 per cent in 2021-22, before moderating to 11.3 per cent by 2023-24.

Figure 5.6 Composition of Outstanding Liabilities of the States



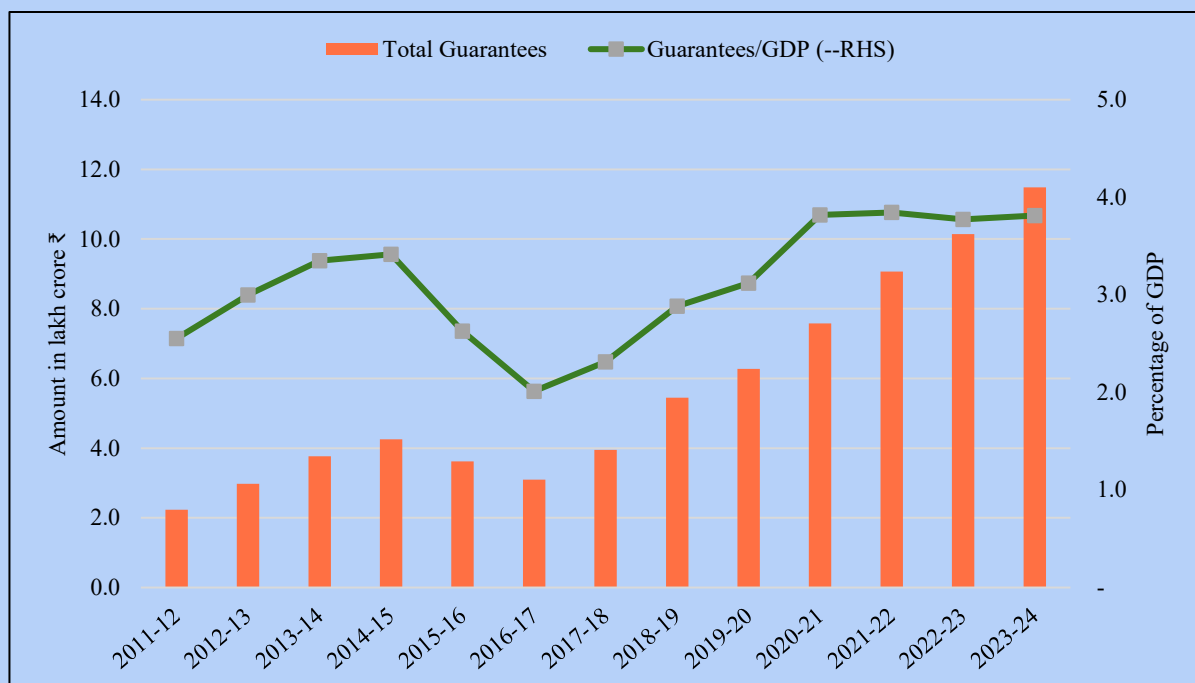
Source: States' Finance Accounts

Guarantees issued by the States

5.37 The States' guarantees, which represent contingent liabilities for the States, have seen fluctuation over the decade. In the early part of the decade, from 2011-12 to 2014-15, States' guarantees increased steadily, rising from 2.6 per cent to a peak of 3.4 per cent of GDP. The growth in guarantees during these years indicates a period of increased borrowing by State-linked entities, necessitating State backing to secure favourable financing terms. However, following this peak, there was a notable decline in State guarantees as a share of GDP, dropping to 2.6 per cent in 2015-16 and further to 2.0 per cent in 2016-17. This reduction coincides with the introduction of the UDAY scheme, under which the States took over the loans to the DISCOMs on their books, thereby reducing the amount of outstanding guaranteed loans.

5.38 From 2017-18 onward, there was a resurgence in State guarantees, with a steady increase from 2.0 per cent of GDP to 3.1 per cent in 2019-20 (*Figure 5.7*). The sharp rise of guarantees to 3.8 per cent of GDP in the COVID-19 year of 2020-21 and its continuance at that level underscores the heightened fiscal risks that States assumed. While these guarantees do not immediately impact State debt levels, they represent potential future obligations that could materialize if the entities involved are unable to meet their financial commitments. In such cases, States would be required to honour these guarantees, potentially leading to a sudden increase in public debt and straining fiscal resources. By 2023-24, the guarantees extended by States reached a new high of ₹11.48 lakh crores, i.e., 3.8 per cent of the GDP. About half of these guarantees pertained to power sector companies.

Figure 5.7 Off-budget Guarantees by the States



Source: States' Finance Accounts

Off-Budget Borrowings

5.39 Several States have accumulated significant off-budget borrowings (OBB), which are often not disclosed under the respective State FRBM Acts. Moreover, many of the entities responsible for OBBs lack independent revenue streams and are primarily involved in implementing government subsidy schemes. By their very nature, off-budget borrowings are difficult to track and measure. The instruments used vary across States, lack standard definitions, and are neither centrally compiled nor consistently reported, making it challenging to assess the true fiscal position of States. The burden of servicing the debt of these State entities eventually falls on the State budgets. The issue of OBB and the current framework of their reporting is discussed in Chapter 12.

Inter-State Comparison

5.40 The aggregate analysis of the 28 States helps assess the implications of State-level fiscal actions for the overall macroeconomic stability. However, this aggregate picture obscures important changes that occurred at the level of individual States over the period under study. For example, large fiscal deficits in some States may be offset by low or negative fiscal deficits in others. Likewise, high debt levels in some States may be offset by low debt levels in others. Even when the overall picture may appear stable, corrective action may be warranted at the individual State level to improve the efficiency of expenditures. Improvements in State-level outcomes inevitably require policy action at the State level. With this in view, we next consider the State-level revenues, expenditures, fiscal deficits, and debt.

Revenue Receipts

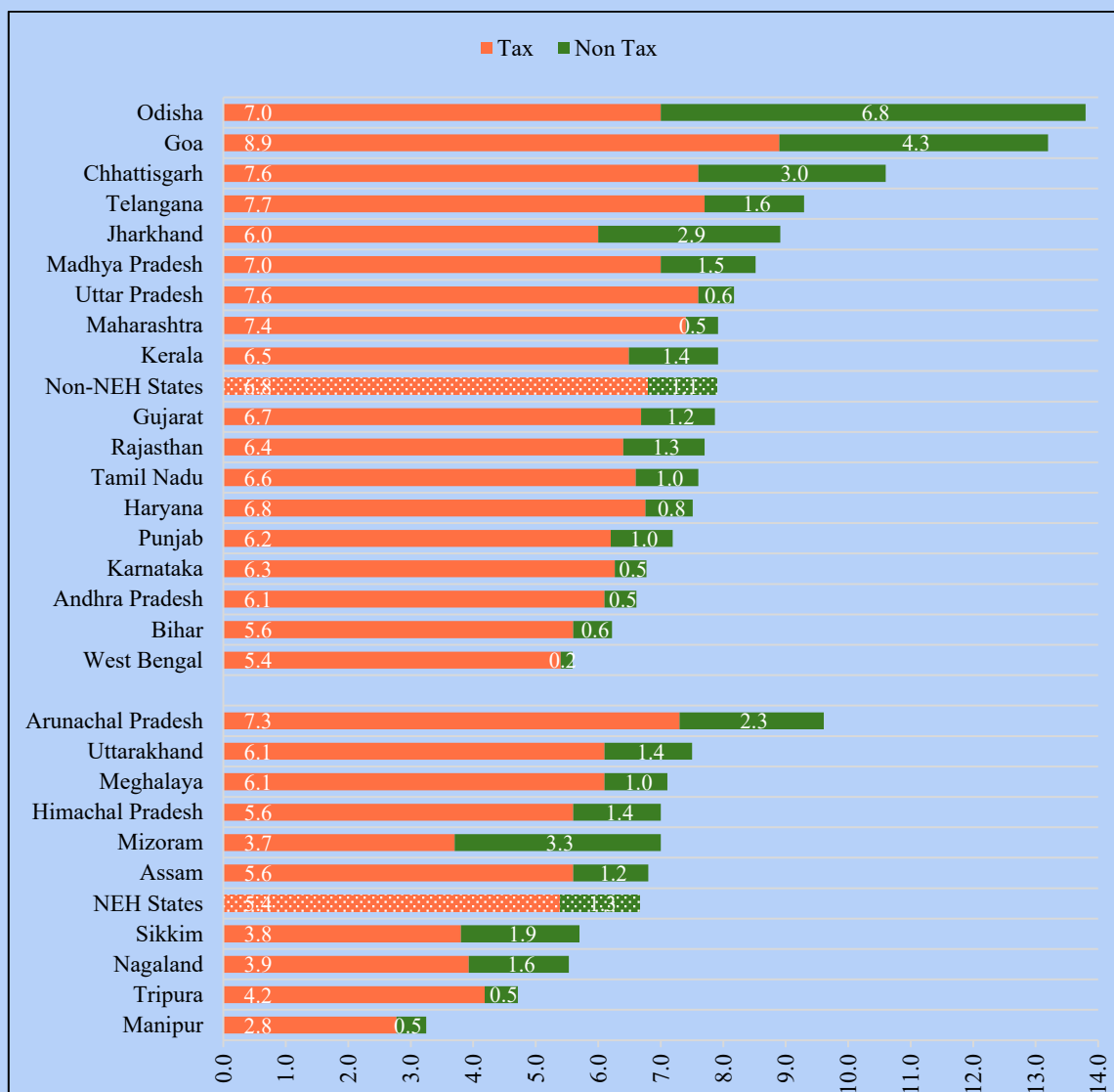
5.41 The comparative analysis of States' revenue profiles reveals significant variations in fiscal capacity, driven by differences in economic structure, governance efficiency, and reliance on Union transfers. As shown in *Figure 5.8*, States such as Odisha, Goa and Chhattisgarh exhibit higher own revenue to GSDP ratios, with Odisha leading at 13.8 per cent in 2023-24, followed by Goa (13.2 per cent) and Chhattisgarh (10.6 per cent), partially supported by mining, which brings them handsome royalties. Conversely, States like Manipur (3.3 per cent), Tripura (4.7 per cent), Nagaland (5.5 per cent), West Bengal (5.6 per cent), and Sikkim (5.7 per cent) register lower ratios, reflecting a limited capacity to generate revenue internally and a consequent higher dependence on Union transfers.

5.42 The own revenue receipts of the States are primarily driven by their tax revenues. Non-tax revenues are significant contributors only for select States with access to mineral royalties, such as Odisha, Chhattisgarh, and Jharkhand. The own-tax-to-GSDP ratios vary significantly across States even seven years after the implementation of GST. Among larger States, Telangana, Uttar Pradesh and Chhattisgarh exhibit high tax-GSDP ratios of 7.6-7.7 per cent in 2023-24, while Bihar and West Bengal lag behind at 5.6 per cent and 5.4 per cent of GSDP, respectively. Therefore, while there is a slight upward trend in the own tax-GSDP ratio for all States combined, there are significant differences among States. If the States at the lower

end of the scale push their tax-GSDP ratio even to the average level, it will lead to a higher aggregate own-tax-to-GSDP ratio for all States.

5.43 Examples in the previous paragraph suggest that the own-tax-to-GSDP ratio does not depend in any systematic manner on per capita income. The per capita income of Bihar is significantly lower than that of Uttar Pradesh, while that of Uttar Pradesh is significantly lower than that of West Bengal. Yet, both Bihar and West Bengal have had consistently lower own tax-GSDP ratio than Uttar Pradesh. Even Tamil Nadu and Karnataka, which rank among the States with the highest per capita incomes, achieve a significantly lower own-tax-to-GSDP ratio than Uttar Pradesh. This is the reason successive FCs have identified the States' own tax-to-GSDP ratio, which represents tax revenue raised per rupee of GSDP, as a measure of their tax effort.

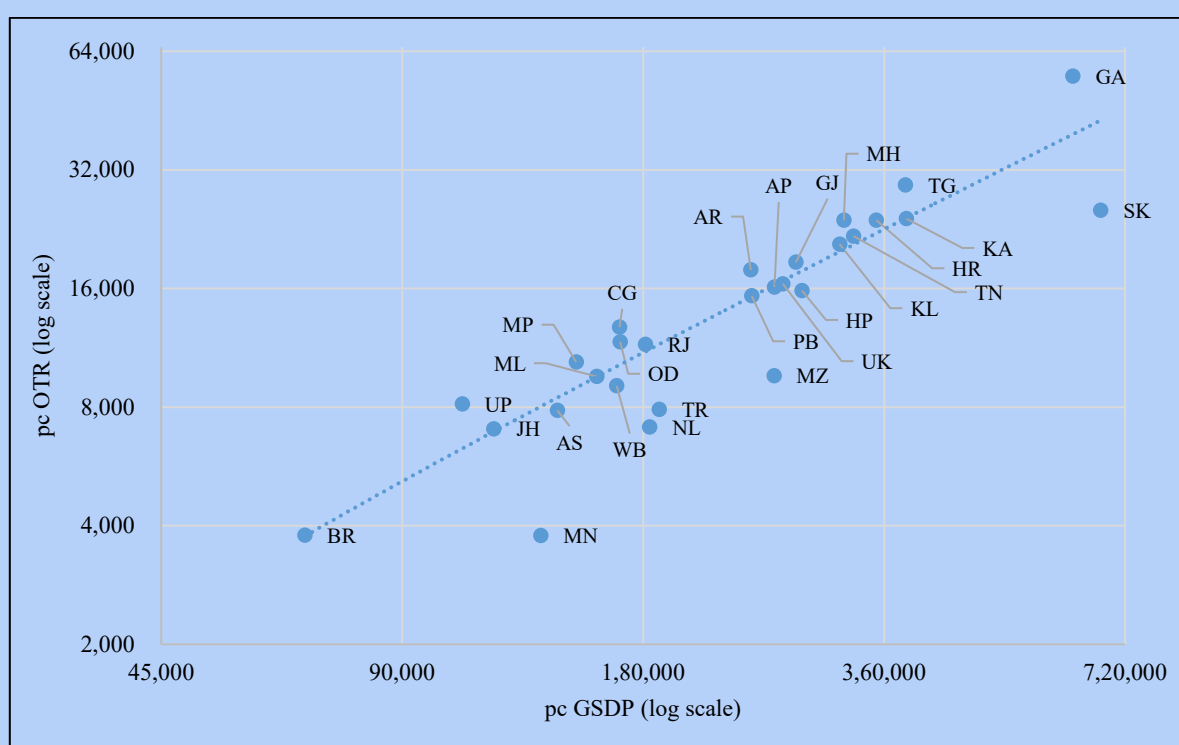
Figure 5.8 Components of States' Own Revenue in 2023-24 (percentage of GSDP)



Source: States' Finance Accounts

5.44 In contrast, the State's own tax revenue per capita does depend systematically on per capita income. Between two States with the same population, the one with a higher per capita income has a higher GSDP. Therefore, with the same tax effort, it can generate a larger volume of tax revenue, translating into higher tax revenue per capita. Differences in the tax effort may weaken this relationship, but since it exhibits no systematic relationship with per capita income, in reality, we do not observe such a reversal in the data. *Figure 5.9*, which plots per capita own tax revenue against per capita income for the 28 States in 2023-24, illustrates this point. This relationship suggests that rapid economic growth, resulting in increased tax revenue per capita, facilitates the provision of public services at higher levels.

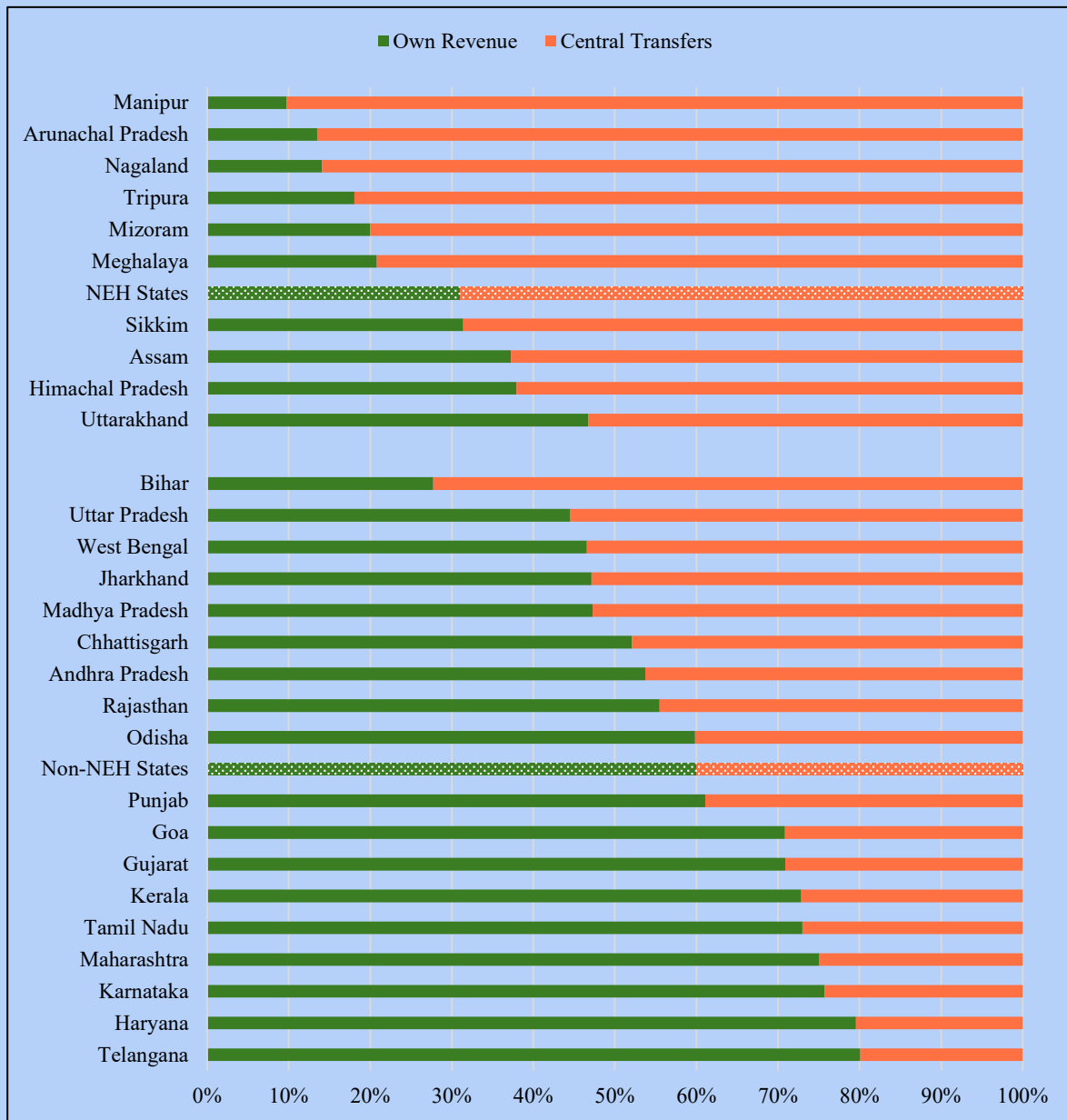
Figure 5.9 The Positive Relationship between Per Capita GSDP and Per Capita Own Tax Revenue of the States, 2023-24



Source: States' Finance Accounts

States' Reliance on Union Transfers

5.45 At 80 per cent in 2023-24, Telangana and Haryana report the highest proportions of own revenues in total receipts and exhibit the lowest reliance on devolution and grants (including the Union's contribution to the CSS). Karnataka (75.7 per cent) and Maharashtra (75.1 per cent) also exhibit strong fiscal autonomy, rooted in diversified economic bases with industry and services making substantial contributions to their GSDPs. In contrast, with limited economic bases, Manipur (9.7 per cent) and Arunachal Pradesh (13.5 per cent) are heavily reliant on devolution and grants. Details of States' own tax revenue and total revenue receipts are given in *Annexures 5.5 and 5.6* respectively.

Figure 5.10 Reliance on Devolution and Grants for Revenues in 2023-24

Source: States' Finance Accounts

5.46 The average reliance on devolution and grants, as percentage of revenue receipts, across all States was 42.2 per cent in 2023-24. The reliance is significantly higher for Northeastern and Hilly (NEH) States (69.0 per cent) than for non-NEH States (39.9 per cent). Uttarakhand's reliance on devolution and grants is 53.2 per cent, the lowest among the NEH States and lower than some non-NEH States. In the case of Sikkim, an NEH State that, nevertheless, enjoys the highest per capita GSDP in the country, devolution and grants account for 68.6 per cent of its total revenues. Among non-NEH States, Bihar (72.3 per cent), Uttar Pradesh (55.5 per cent), and West Bengal (53.5 per cent) exhibit the highest reliance on devolution and grants as sources

of revenue. *Figure 5.10* provides the full comparative picture of the States' reliance on devolution and grants for revenues in 2023-24.

Expenditure

5.47 Like receipts, expenditure levels and quality vary significantly across States. Total expenditures as a proportion of GSDP in poorer States, such as Bihar and Chhattisgarh, exceed

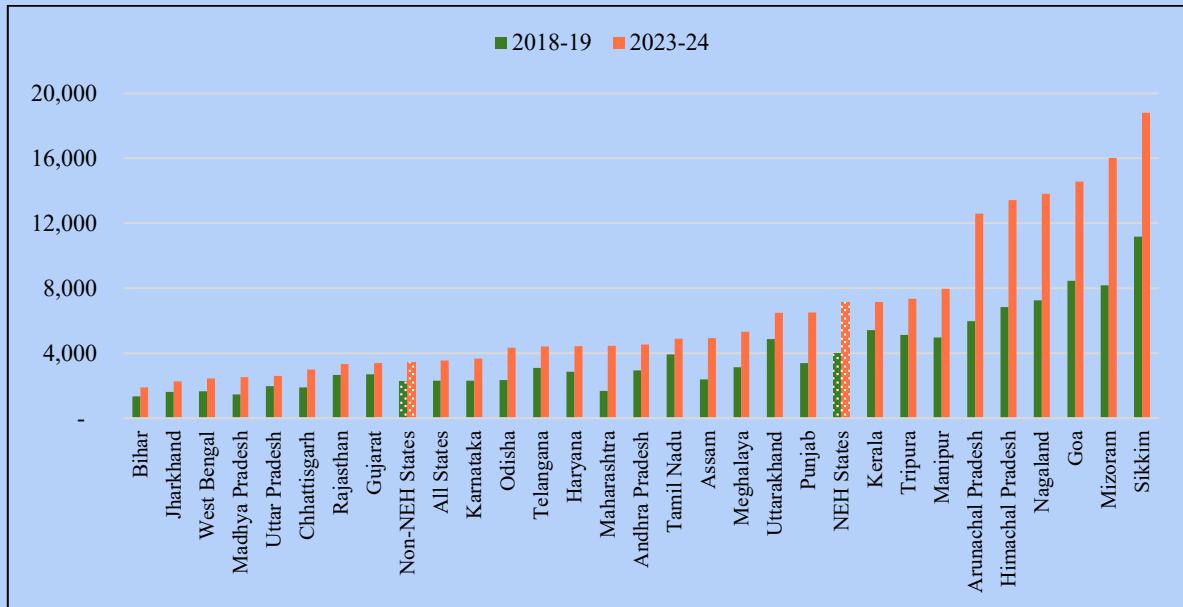
Table 5.10 Revenue and Capital Expenditure in 2023-24 (percentage of GSDP)

States	Revenue Expenditure	Capital Expenditure	Total Expenditure
Bihar	21.9	4.4	26.3
Chhattisgarh	22.5	3.1	25.6
Odisha	19.0	5.9	24.9
Uttar Pradesh	16.9	4.7	21.6
Jharkhand	16.5	5.3	21.8
Madhya Pradesh	17.1	4.5	21.6
Goa	17.2	3.6	20.8
Rajasthan	16.4	1.8	18.2
Andhra Pradesh	15.2	1.8	17.0
Non-NEH States	13.5	2.7	16.2
Punjab	15.5	0.6	16.1
West Bengal	13.6	1.7	15.3
Telangana	11.5	3.5	15.0
Kerala	12.6	1.5	14.1
Tamil Nadu	12.2	1.9	14.1
Maharashtra	10.9	1.9	12.8
Haryana	10.6	1.9	12.5
Gujarat	9.4	2.9	12.3
Karnataka	9.3	2.2	11.5
Arunachal Pradesh	53.4	22.0	75.4
Nagaland	36.0	7.6	43.6
Meghalaya	31.3	8.6	39.9
Manipur	31.8	6.3	38.1
Mizoram	33.2	3.9	37.1
Tripura	23.4	3.6	27.0
NEH States	21.2	4.7	25.9
Himachal Pradesh	21.0	2.7	23.7
Sikkim	17.7	5.7	23.4
Assam	18.6	4.2	22.8
Uttarakhand	15.0	3.5	18.5

Source: States' Finance Accounts

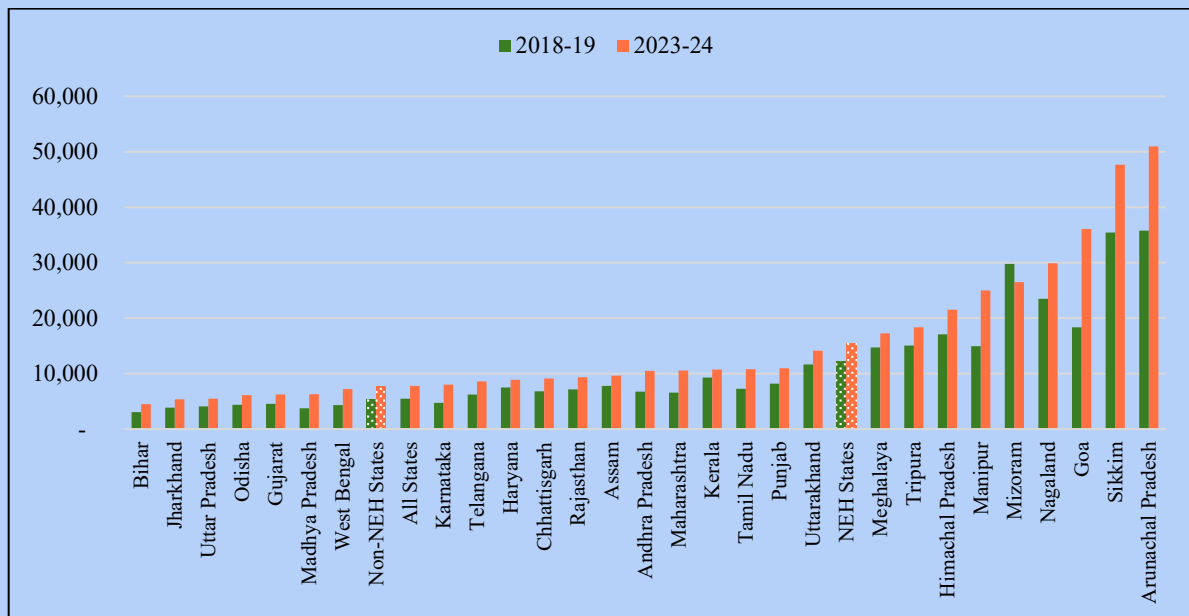
25 per cent of GSDP, while falling short of 13 per cent in richer States like Maharashtra, Haryana, Gujarat and Karnataka. This difference signifies a proportionately lower public spending in richer, as opposed to poorer States on average. *Table 5.10* details revenue and capital expenditures as proportions of GSDP in the 28 States for the 2023-24 fiscal year.

Figure 5.11 Per Capita Expenditure on Pension (in ₹)



Source: States' Finance Accounts

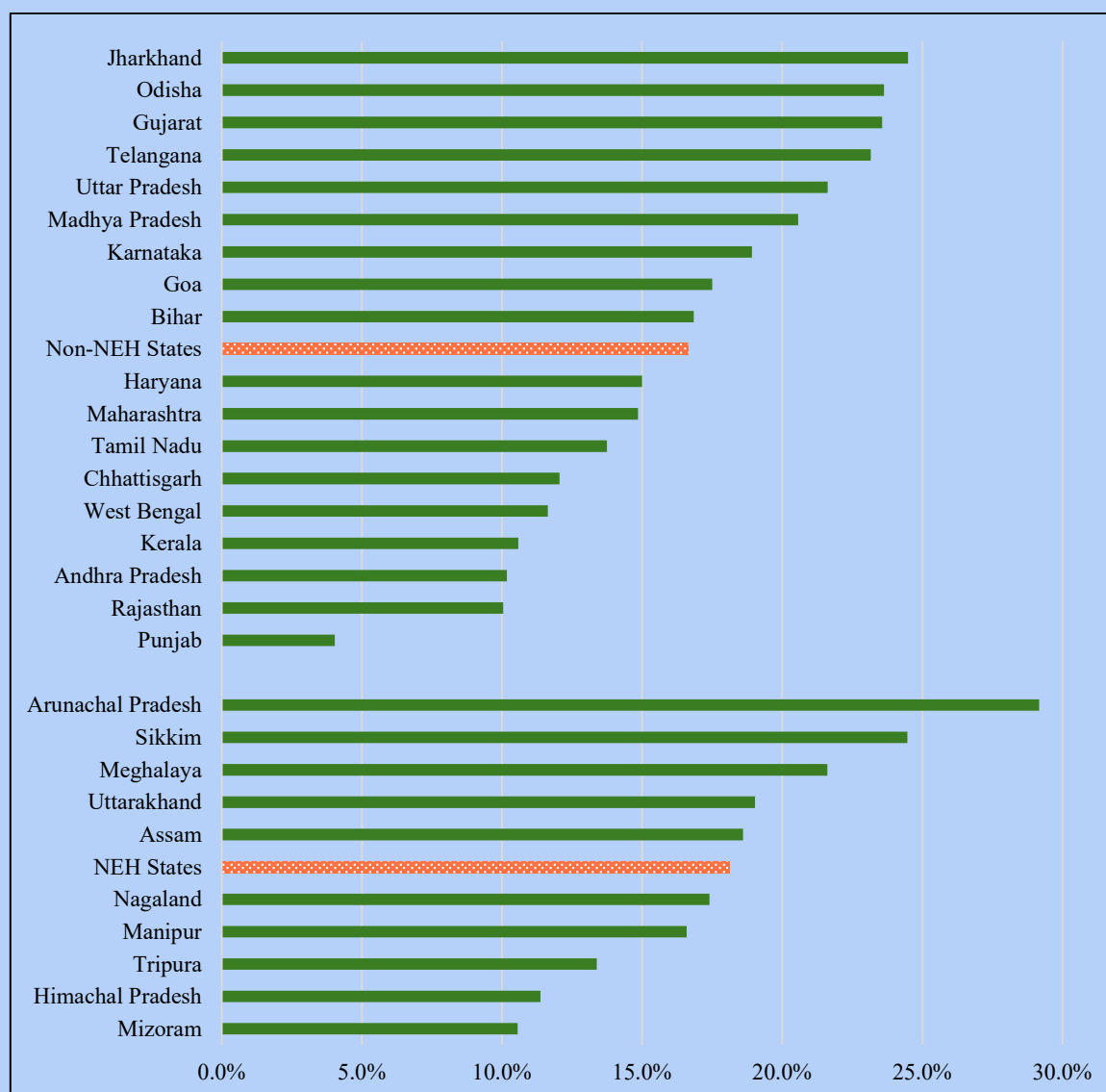
Figure 5.12 Per Capita Expenditure on Salaries (in ₹)



Source: States' Finance Accounts

5.48 Salaries and pensions, as components of government revenue expenditure, exhibit considerable inter-state variation in both scale and composition. The per capita variation reflects differences in State government workforce size and pay commission implementation timelines. Since pension expenditure reflects the legacy obligations of the government to its employees, it tends to be more inflexible in nature. Any structural changes in the salaries, such as those resulting from pay commission recommendations, are also reflected in the pension outgo. The per capita expenditures on pension and salaries are shown in *Figures 5.11* and *5.12* respectively. Hilly States and smaller population States often show higher per capita expenditure on these heads due to scale effects, whereas fiscally constrained low-income States typically devote a smaller share, as developmental spending competes for the tight fiscal resources. The state-wise details of revenue expenditure are given in *Annexure 5.7*.

Figure 5.13 Capital Expenditure (percentage of Total Expenditure) in 2023-24

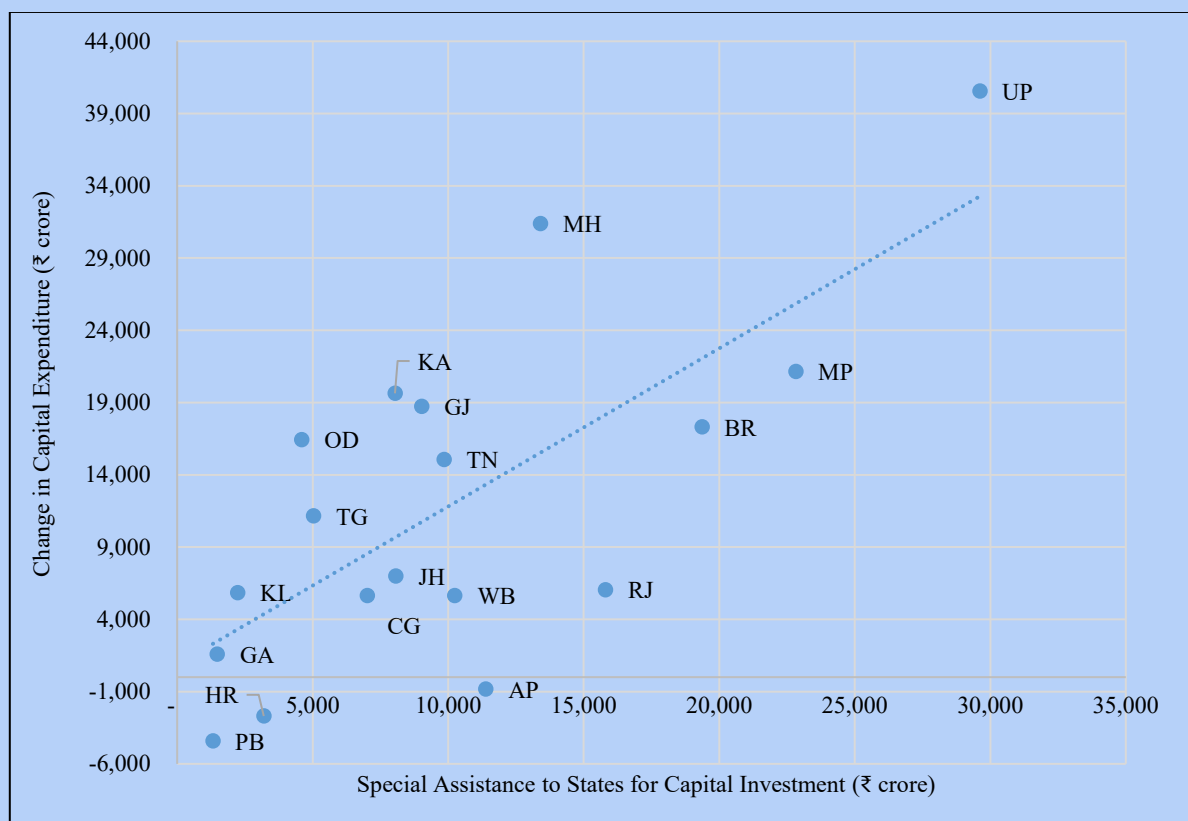


Source: States' Finance Accounts

5.49 A key indicator of expenditure quality is capital expenditure. States show significant differences on this score as well. *Figure 5.13* shows capital expenditure as a proportion of the total expenditure in the non-NEH and NEH States in 2023-24. In 2023-24, Arunachal Pradesh stands out with 29.2 per cent of its total expenditure allocated to capital projects. Each of Odisha, Gujarat, Jharkhand, Telangana, Uttar Pradesh and Madhya Pradesh allocated more than 20 per cent of their expenditures to capital items. At the other extreme, Punjab, Andhra Pradesh and Rajasthan devoted no more than 10 per cent of the expenditure to capital items. A similar variation can be found among NEH States, with Arunachal Pradesh, Sikkim and Meghalaya leading and Mizoram, Himachal Pradesh and Tripura allocate significantly smaller portions of their budgets to capital expenditure, indicating a higher priority for recurrent expenditures, such as salaries, subsidies, and interest payments.

5.50 The push from the Union Government for capital expenditure in States through the SASCI program has had a positive effect on capital expenditures, but not to the full extent of the transfers under the program. A large allocation of these loans has happened between 2021-22 and 2023-24. The average SASCI loans granted to all States was 0.24 per cent of the States' GSDP. However, the magnitude of offtake varied across States according to the historical levels of capital-account expenditure.

Figure 5.14 SASCI Utilization and Change in Capital Expenditure in Non-NEH States (2021-2024)



Source: States' Finance Accounts

5.51 The positive correlation between SASCI and the change in capital expenditure by a State provides suggestive empirical evidence that SASCI has contributed to increased capital expenditure. *Figures 5.14 and 5.15* plot this relationship for the non-NEH and NEH States, respectively. We plot the SASCI utilized by the State during 2022-24 on the horizontal axis and the increase in its average annual capital expenditure during 2022-24 compared to that in 2018-20 on the vertical axis. While the average relationship exhibits the correct direction, responses differ considerably across States. For similar levels of SASCI utilization, the increases in capital expenditures of West Bengal and Tamil Nadu are quite different. In Punjab, the average capital expenditure fell despite positive utilization of SASCI.

Figure 5.15 SASCI Utilization and Change in Capital Expenditure in NEH States (2021-2024)



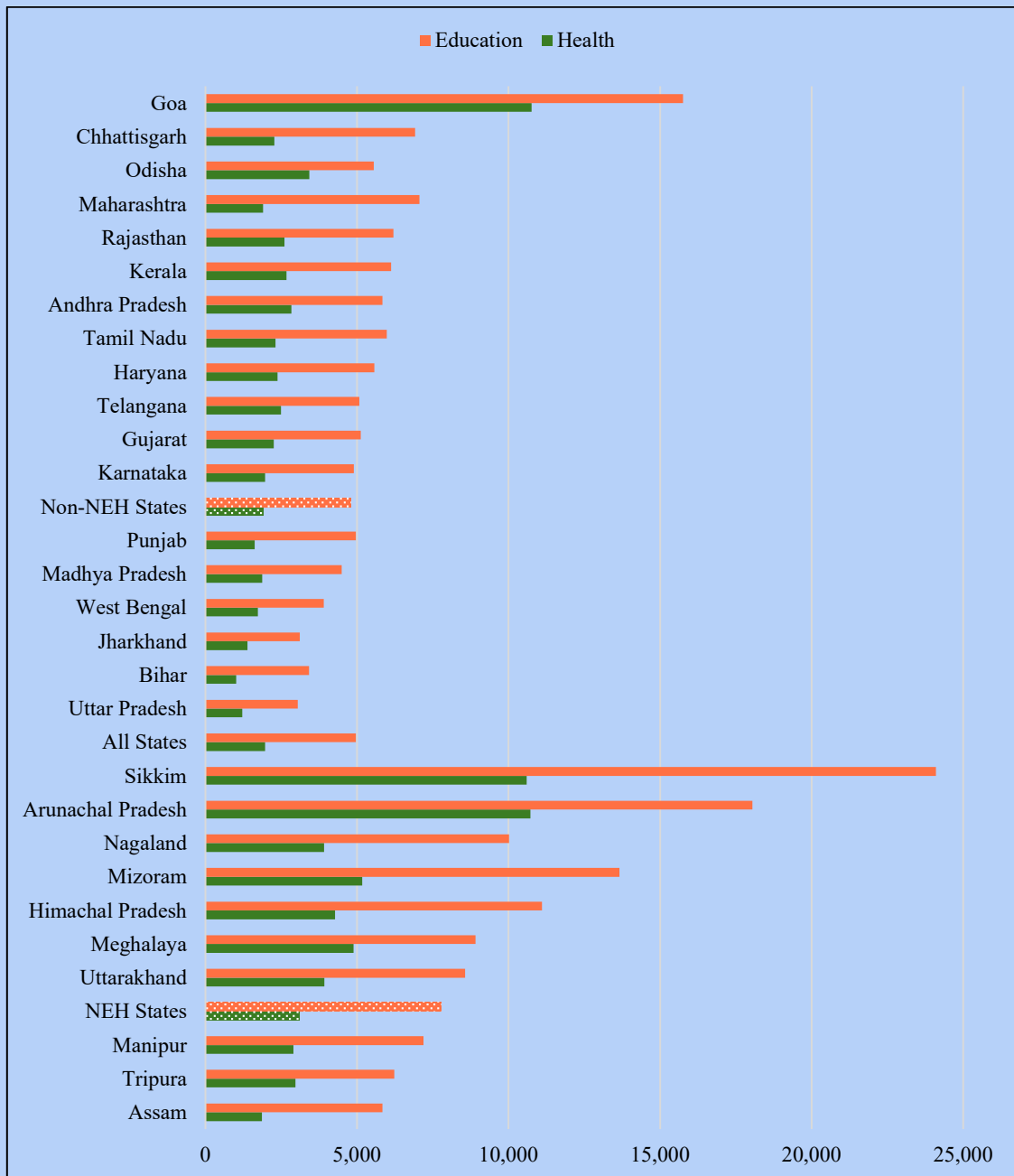
Source: States' Finance Accounts

5.52 From an immediate social welfare viewpoint, it is useful to compare per capita health and education expenditures across States. This expenditure depends not only on how the State prioritizes education and health, but also, importantly, on the fiscal capacity of the State. On average, States with low per capita income tend to have low per capita revenue and expenditure, despite decades of efforts by successive FCs to reduce this disparity through the assignment of a large weight to the income-distance criterion in the devolution formula.

5.53 *Figure 5.16* shows the differences in per capita health and education expenditures across States. Sikkim, Arunachal Pradesh, and Goa, in that order, spend the most on health and education on a per capita basis. All three of them receive significantly larger per capita amounts from FC devolution than the overall per capita devolution. Goa and Sikkim are also States with

the highest per capita incomes. On average, except Tripura and Assam, the NEH States spend uniformly more than non-NEH States on account of their larger per capita expenditures in general. Even excluding Goa, variation among non-NEH States is higher than among the NEH States. For example, leaving aside the exceptional cases of Sikkim, Goa, and Arunachal Pradesh, the ratio of the highest to lowest per capita spending is 2.2 in the non-NEH group of States and 1.8 in the NEH group.

Figure 5.16 Per Capita Expenditures on Health and Education in 2023-24



Source: States' Finance Accounts

Deficit and Debt

5.54 In our aggregate analysis, we found that once we take into account the impacts of UDAY and COVID-19, State finances do not raise serious concerns. While it is desirable to increase capital expenditure and steadily reduce the debt-to-GDP ratio, these are attainable goals. However, once we disaggregate the States, a more nuanced picture emerges. *Table 5.11* presents the fiscal and revenue deficits and debt as proportions of GSDP for the non-NEH and NEH States successively. Each group of such States is arranged in descending order of the debt-to-GSDP ratio. A quick glance at the *Table* reveals the significant variations across States, particularly regarding the debt-to-GSDP ratio. It ranges from 15.7 per cent in Odisha to 42.9 per cent in Punjab within the non-NEH group and from 25.5 per cent in Uttarakhand to 50.9 per cent in Arunachal Pradesh within the NEH group. Below, we briefly consider the evolution of debt and fiscal and revenue deficits, first in non-NEH States and then in NEH States, with detailed data relegated to *Annexures 5.1, 5.2 and 5.3*.

5.55 As illustrated in the figures for 2023-24, Punjab, West Bengal, Bihar, Rajasthan, Kerala, and Andhra Pradesh, in that order, represent the six non-NEH States with the highest debt-to-GSDP ratios. Among them, Punjab stands out for its chronic fiscal imbalances. At 31.5 per cent, its debt-to-GSDP ratio was already high in 2011-12. In 2016-17, it jumped to 43.2 per cent due to the implementation of the UDAY scheme and has not recovered since then. After peaking at 46.4 per cent in 2020-21, the ratio declined slightly but remained high at 42.9 per cent in 2023-24. Both the revenue and fiscal deficits have been large throughout, the former often exceeding 2 per cent of GSDP and the latter breaching the 3 per cent mark. In 2023-24, the State's revenue and fiscal deficits stood at 3.7 per cent and 4.4 per cent, respectively. Driven by high debt servicing costs and substantial subsidies, the revenue-deficit-to-fiscal-deficit ratio has frequently exceeded 70 per cent. A significant portion of the State's borrowing has been used to address revenue shortfalls rather than for capital investment, underscoring structural fiscal weaknesses.

5.56 West Bengal began the period under review with a high debt-to-GSDP ratio of 40.1 per cent in 2011-12. While it has managed to prevent a further increase in this ratio in the following years, except the COVID-19 year of 2020-21, it has not been successful in achieving a meaningful fiscal consolidation. Throughout the period under review, it incurred substantial revenue and fiscal deficits, with borrowings being substantially used to finance the former. Consequently, the State's capital expenditure has been low.

5.57 Bihar has the lowest per capita income in India. Its high debt-to-GSDP ratio can be partially viewed as an artefact of its low GSDP. Yet, insofar as the same low per capita GSDP determines the State's capacity to raise its own tax revenues, and it depends heavily on FC devolution and Union grants for additional revenues, the high debt-GSDP ratio is of concern. In 2011-12, the ratio was 28.3 per cent but has crept up over the following dozen years. The ratio peaked during the COVID-19 year of 2020-21 at 40.6 per cent and remained high at 37.0 per cent in 2023-24. Until 2018-19, Bihar exhibited substantial revenue surpluses, allowing it to undertake substantial capital expenditures. However, the situation has deteriorated since the

post-COVID years, with revenue balance turning negative and fiscal deficit spiking. The latter stood at 5.9 per cent in 2022-23 and 4.1 per cent in 2023-24.

Table 5.11 Composition of Debt and Fiscal Deficit (percentage of GSDP) in 2023-24

States	Fiscal Deficit	Revenue Deficit [#]	Outstanding Liabilities			
			Internal Debt	Loans from Union	Public Account	Total Liabilities [#]
Punjab	4.4	3.7	37.0	0.6	5.3	42.9
West Bengal	3.3	1.6	31.6	1.6	5.1	38.3
Bihar	4.1	-0.3	27.2	3.8	6.1	37.0
Rajasthan	4.4	2.6	27.1	2.4	8.5	37.9
Kerala	3.0	1.6	22.6	1.0	11.7	35.3
Andhra Pradesh	4.5	2.8	28.1	1.6	4.9	34.6
Goa	2.2	-1.5	23.8	2.4	5.6	31.9
Madhya Pradesh	3.4	-1.0	21.8	3.9	5.0	30.7
Haryana	2.9	1.1	26.2	0.4	3.9	30.5
Tamil Nadu	3.6	1.8	25.3	1.9	2.7	29.9
Uttar Pradesh	3.2	-1.4	24.2	1.5	4.0	29.7
Non-NEH States	3.0	0.4	21.7	1.5	4.9	28.0
Telangana	3.4	-0.1	22.8	0.8	3.8	27.3
Jharkhand	1.4	-2.4	15.2	2.6	8.8	26.5
Chhattisgarh	5.3	2.2	18.6	2.1	4.0	24.7
Karnataka	2.5	0.4	16.0	0.9	5.7	22.6
Gujarat	1.2	-1.7	16.7	0.9	3.1	20.6
Maharashtra	2.2	0.3	13.8	0.7	3.4	18.0
Odisha	1.9	-3.9	6.5	1.5	7.7	15.7
Arunachal Pradesh	4.1	-17.9	24.4	11.9	14.6	50.9
Nagaland	4.3	-3.2	33.7	5.1	5.5	44.2
Manipur	4.3	-2.0	28.0	4.3	11.2	43.5
Himachal Pradesh	5.3	2.6	28.9	2.1	11.9	42.8
Meghalaya	6.0	-2.6	26.4	5.8	8.4	40.6
Mizoram	2.1	-1.8	21.2	5.4	10.4	37.0
Sikkim	5.4	-0.3	23.9	4.1	4.6	32.7
NEH States	3.8	-0.6	22.7	2.8	6.9	32.5
Assam	4.1	0.5	22.2	2.5	4.0	28.7
Tripura	0.8	-2.8	15.2	2.0	10.7	27.9
Uttarakhand	2.5	-1.1	18.2	1.6	5.7	25.5

Source: MoSPI Comparable Estimates for GDP (2011-12 series), States' Finance Accounts

[#] Revenue Deficit and Outstanding Liabilities figures have been adjusted for loans for GST compensation.

5.58 Rajasthan saw its debt-to-GSDP ratio rise steadily from the modest 24.6 per cent in 2011-12 to a peak of 40.2 per cent in 2020-21, and then down to 37.9 per cent in 2023-24. The State has incurred large revenue and fiscal deficits throughout the period under review. Its fiscal deficit reached 9.3 per cent of GSDP in 2015-16 and 6.2 per cent in 2016-17, primarily due to the implementation of the UDAY scheme. This, in turn, caused the debt-to-GSDP ratio to rise to 30.8 per cent in 2015-16 and 34.0 per cent in 2016-17 from 24.0 per cent in 2014-15.

5.59 Kerala is a high-income non-NEH State that had a manageable debt-to-GSDP ratio of 25.5 per cent in 2011-12. However, it has run high fiscal deficits throughout the period under review, which have added approximately 10 percentage points to its debt-to-GSDP ratio. The latter peaked at 39.2 per cent in 2020-21 before declining to 35.3 per cent in 2023-24. Throughout the period under review, Kerala also incurred significant revenue deficits, which undermined capital expenditures.

5.60 The fiscal trajectory of the newly formed State of Andhra Pradesh has been marked by significant volatility. At 26.1 per cent at inception in 2014-15, the State had a higher debt-to-GSDP ratio than Telangana – the other State carved out of the original Andhra Pradesh on June 2, 2014. The debt-to-GSDP ratio of Telangana in 2014-15 was 18.7 per cent, and that of pre-bifurcation Andhra Pradesh in 2013-14 was 20.7 per cent. The newly formed Andhra Pradesh struggled to control its revenue and fiscal deficits from the outset. Throughout the post-bifurcation period, its revenue balance has been negative, and, except for the 2021-22 fiscal year, the fiscal deficit has consistently exceeded 3 per cent. Consequently, the State's debt-to-GSDP ratio peaked at 36.0 per cent in 2020-21 and remained high at 34.6 per cent in 2023-24.

5.61 At the other end of the spectrum, we have four States – Odisha, Maharashtra, Gujarat, and Karnataka in that order – with the lowest debt-to-GSDP ratios throughout the period under review. The debt-to-GSDP ratio in Odisha remained between 15.3 and 22.1 per cent until 2018-19. Due to economic slowdown, the ratio increased to 24.0 per cent in 2019-20, but it declined rapidly thereafter, reaching 14.5 per cent in 2022-23 and 15.7 per cent in 2023-24. Throughout this period, Odisha has consistently maintained a surplus in its revenue account, often exceeding 2.5 per cent and reaching a high of 7.2 per cent in 2021-22. Even in the COVID-19 year of 2020-21, its revenue surplus stood at 2.4 per cent. With just two exceptions, Odisha has maintained a fiscal deficit below 2.5 per cent from 2011-12 to 2023-24.

5.62 Maharashtra also has had a remarkably low and stable debt-to-GSDP ratio throughout the period under review. In 2011-12, this ratio was 19.1 per cent, and it remained below this level until the COVID-19 year of 2020-21, when it inched up to 20.7 per cent. However, it fell below the 2011-12 level once again the following year and stood at 18.0 per cent in 2023-24. This remarkable performance resulted from a fiscal deficit that exceeded 2 per cent during only two years: 2.4 per cent in 2019-20 and 2.2 per cent in 2023-24.

5.63 Gujarat's debt-to-GSDP ratio has remained between 22 per cent and 26 per cent during the thirteen years under review. The ratio was 24.5 per cent at the beginning of the period under review and 20.6 per cent at its end. Except for the COVID-19 year of 2020-21, its revenue account has been consistently in surplus. The State has also maintained low fiscal deficits throughout, not exceeding 2.5 per cent of GSDP even during the COVID-19 year of 2020-21.

Recently, the deficit as a proportion of GSDP was 0.6 per cent in 2021-22, 0.9 per cent in 2022-23, and 1.2 per cent in 2023-24.

5.64 Karnataka has the second-highest per capita income among the large States in India. Although its debt-to-GSDP ratio was slightly higher than that of Gujarat in 2023-24, its overall trajectory during the period under review was slightly below that of the latter. Until the 2019-20 fiscal year, its debt-to-GSDP ratio remained below 20 per cent. The ratio peaked at 23.5 per cent in 2020-21 and stood at 22.6 per cent in 2023-24. With only two exceptions, the State's revenue balance has been in surplus, while, except for the COVID-19 year of 2020-21, the fiscal deficit has remained well below 3 per cent.

5.65 The remaining eight non-NEH States lie between these two extremes, presenting a more mixed record, but without raising concerns for fiscal stability. In order of rising debt-to-GSDP ratio in 2023-24, they are – Chhattisgarh, Jharkhand, Telangana, Uttar Pradesh, Tamil Nadu, Haryana, Madhya Pradesh and Goa. At 11.5 per cent, Chhattisgarh had the distinction of having the lowest debt-to-GSDP ratio in 2011-12. However, it steadily increased in subsequent years, reaching the peak level of 26.0 per cent in 2020-21. The State maintained a healthy revenue surplus in most years until the 2018-19 fiscal year. However, it ended up with a revenue deficit of 2.8 per cent in 2019-20 and 1.1 per cent in 2020-21. During the past three years, the State has had a revenue surplus in two years and a revenue deficit in one. The State's record on fiscal deficit has been mixed, with a range of 0.5 to 5.3 per cent of GSDP. The deficit has been especially high in three of the last five years: 5.2 per cent in 2019-20, 3.7 per cent in 2020-21, and 5.3 per cent in 2023-24.

5.66 Jharkhand has the third lowest per capita income among the 28 States in the country. The period began under review with a debt-to-GSDP ratio of 20.4 per cent in 2011-12, but saw it rise sharply to 27.4 per cent in 2015-16 due to the implementation of the UDAY scheme. The ratio spiked to 36.2 per cent in 2020-21 but has since declined, reaching 26.5 per cent in 2023-24. Compared with other low per capita income States such as Bihar and Uttar Pradesh, Jharkhand has the advantage of mineral revenues, which, along with handsome FC devolution and Union grants, have provided it with sufficient revenue resources to maintain a revenue surplus in most years, occasionally in the range of 2 to 3 per cent of GSDP. The fiscal deficit in Jharkhand has been subject to greater volatility than in most other States, ranging from no deficit in 2021-22 to 5.6 per cent in 2015-16.

5.67 Telangana has the highest per capita income among the large States of India. It inherited a low debt-GSDP ratio of 18.7 per cent at inception in 2014-15. However, the ratio climbed steadily, reaching 25.0 per cent in 2019-20 and then jumped to 29.9 per cent in 2020-21. As in other States, the COVID-19-induced peak saw a decline in the following years; however, the ratio remained nearly eight percentage points above the 2011-12 at 27.3 per cent in 2023-24. With only three exceptions, the account of Telangana has been in surplus during the period under review. However, except once, its fiscal account has exhibited deficits exceeding 3 per cent from 2015-16 onwards.

5.68 Uttar Pradesh has consistently been among the top two large States in terms of its own tax revenue as a proportion of GSDP. In addition, being the State with the second lowest per

capita GDP and the highest population, it receives the largest share of FC devolutions by a significant margin. These two factors give the State an edge in terms of revenues. Against this background, the State's debt-to-GSDP ratio may be characterized as being on the high side. During the period under review, it fell below the 30 per cent mark only thrice, to 29.6 per cent in 2019-20 and 29.5 per cent in 2022-23. During the COVID-19 year of 2020-21, it rose to 34.0 per cent but fell back to 29.7 per cent by 2023-24. Given its comfortable revenue situation, the State has consistently exhibited a revenue surplus. At peak, it stood at 4.0 per cent of GSDP in 2019-20. The fiscal deficit spiked to 5.1 per cent in 2015-16 and 4.3 per cent in 2016-17 due to the implementation of the UDAY scheme. Setting aside these years, the fiscal deficit exceeded the 3 per cent mark only twice, to 3.2 per cent in 2014-15 and 2023-24.

5.69 Tamil Nadu had the second-lowest debt-to-GSDP ratio in 2011-12 among the non-NEH States. However, as in the case of Chhattisgarh, the ratio increased steadily in the following years, reaching 24.7 per cent in 2019-20 and then spiking to 31.0 per cent in 2020-21. The ratio has remained high since then, standing at 29.9 per cent in 2023-24. The State has consistently experienced a revenue deficit since the 2013-14 fiscal year. Barring 2016-17, its fiscal deficit was below 3 per cent until 2018-19 but crossed this threshold every single year since then.

5.70 Until recently, Haryana had the highest per capita income among the large States. Currently, it ranks third. Like Tamil Nadu, it had a low debt-to-GSDP ratio of 18.8 per cent in 2011-12, which steadily increased in the subsequent years, reaching 29.7 per cent in 2019-20, spiking to 33.5 per cent in 2020-21, and then declining to 30.5 per cent by 2023-24. The State ran revenue deficits throughout the period under review, which exceeded 2.3 per cent in four out of the thirteen years. It also incurred a fiscal deficit of 3 per cent or more during eight out of the thirteen years.

5.71 In terms of its fiscal situation, Madhya Pradesh is comparable to Uttar Pradesh except that its own tax revenue as a proportion of GSDP has seen a steady decline from 8.8 per cent in 2011-12 to 7.0 per cent in 2023-24. Its debt-to-GSDP ratio fell from 26.4 per cent in 2011-12 to 22.8 per cent in 2013-14, but rose thereafter, reaching a peak of 32.6 per cent in 2020-21. The ratio declined to the 30 per cent range in each of the following three years and stood at 30.7 per cent in the 2023-24 fiscal year. With its robust revenue situation, the State has maintained a revenue surplus during all but two (2019-20 and 2020-21) out of the thirteen years under review. On fiscal deficit, the record has been more mixed: in six out of the thirteen years, it has been 3.3 per cent of GSDP or more.

5.72 In terms of population, Goa is by far the smallest non-NEH State, and in terms of per capita income, it is by far the richest. The State's own tax revenue as a proportion of GSDP is the highest and, on a per capita basis, it receives by far the most in FC devolution among non-NEH States. Except for 2011-12, its debt-to-GSDP ratio has fluctuated between 26.1 and 36.3 per cent. It stood at 31.9 per cent in the 2023-24 fiscal year. Out of the thirteen years under review, the State has had a revenue surplus in nine and a fiscal deficit of less than 3 per cent in ten years.

5.73 Turning to the NEH States, consider first Sikkim, Uttarakhand, and Himachal Pradesh, three relatively richer States by per capita income, with greater proximity to the larger Indian

market and the benefit of substantial Union Government tax concessions to industrial units located within them. These States have witnessed high growth and enjoyed relatively high per capita incomes over the recent decades. Sikkim has the highest per capita income in the country. It is also the recipient of substantial FC devolution on a per capita basis. Until 2019-20, its debt-to-GSDP ratio hovered within the narrow range of 20.8 per cent to 23.7 per cent. It increased to 27.5 per cent in 2020-21 and continued to rise steadily, reaching 32.7 per cent by 2023-24. Except for 2019-20 and 2020-21, Sikkim's revenue balance has been positive throughout the period under consideration. The State's fiscal deficit remained below 3 per cent until 2018-19. However, it has been very high in the subsequent years, reaching 6.7 per cent in 2019-20, 6.9 per cent in 2020-21, and 5.4 per cent in 2023-24.

5.74 Outside of the years 2018-19 to 2021-22, Uttarakhand has maintained a debt-to-GSDP ratio below 25 per cent. After peaking at 31.8 per cent in 2020-21, the ratio slid down to 25.5 per cent in 2023-24. The State has also experienced healthy revenue surpluses over the last four of the thirteen-year period, ranging from 1.1 per cent of GSDP in 2023-24 to 2.9 per cent in 2021-22. Its fiscal deficit exceeded 3 per cent of GSDP during five of the six years from 2014-15 to 2019-20. However, during the past four years, it has remained at or below 2.5 per cent of GSDP.

5.75 In contrast, Himachal Pradesh has had a debt-to-GSDP ratio of over 32 per cent throughout the period under review. In 2020-21, the COVID-19 year, this ratio rose sharply to 45 per cent, and although it fell to 40.8 per cent in 2021-22, it rebounded to 42.7 per cent in 2022-23 and 42.8 per cent in 2023-24. For several years, ending in 2021-22, the State had maintained a revenue surplus; however, it incurred large revenue deficits in the last two of the thirteen-year period: 3.3 per cent in 2022-23 and 2.6 per cent in 2023-24. The State has also seen its fiscal deficit rise sharply over the last two years, reaching 6.4 per cent in 2022-23 and 5.3 per cent in 2023-24.

5.76 Among the northeastern States, Assam is by far the largest in both population and GSDP. Proportionately, it also has the maximum amount of plain area amongst all NEH States. It was able to keep its debt-to-GSDP ratio at 20 per cent or less during most years till 2019-20, but saw it rise to the 25-26 per cent range from 2020-21 onwards. During these latter years, it has also seen fiscal deficits rise to 3.4 per cent of GSDP or higher levels.

5.77 The remaining six northeastern States – Arunachal Pradesh, Meghalaya, Manipur, Mizoram, Nagaland, and Tripura – are small in terms of population and GSDP. They are also heavily dependent on FC devolutions and Union transfers. As we saw earlier in *Figure 5.10* that 79 per cent or more of these States' revenue receipts in 2023-24 came from devolution and Union transfers. This dependence was as high as 87 per cent in the case of Arunachal Pradesh and 90 per cent in that of Manipur. As shown in *Table 5.11*, except for Mizoram and Tripura, the remaining four States also had a debt-to-GSDP ratio over 40 per cent in 2023-24. In 2011-12, Mizoram had a debt-to-GSDP ratio of 61.9 per cent, but the State steadily brought it down to 36.2 per cent by 2019-20. In 2020-21, the ratio rose back to 41.8 per cent, but the State subsequently brought it down. It stood at 37.0 per cent in 2023-24.

5.78 Other than the COVID-19 pandemic, another event that significantly affected the States' debt position was the takeover of DISCOMs' debt under UDAY during 2015-16 and 2016-17. States which opted for UDAY - Himachal Pradesh, Haryana, Jharkhand, Madhya Pradesh, Punjab, Rajasthan, Tamil Nadu, Telangana and Uttar Pradesh – exhibited an impact of more than 0.5 per cent of GSDP on their respective debt positions, in either or both years. Punjab's disbursement of loans jumped to 1.5 per cent of GSDP in 2015-16 and 9.8 per cent in 2016-17, with its debt to GSDP ratio rising from 31.7 per cent in 2014-15 to 33.1 per cent in 2015-16 and further to 43.2 per cent in 2016-17. Similarly, in the case of Rajasthan, the issuance of UDAY bonds resulted in an increase in loan disbursements from 0.1 per cent of GSDP in 2014-15 to 5.4 per cent in 2015-16 and 1.7 per cent in 2016-17. Consequently, the debt to GSDP ratio increased from 24.0 per cent in 2014-15 to 30.8 per cent in 2015-16 and further to 34.0 per cent in 2016-17. The accumulation of huge debts by the power sector companies in these States, which constitute off-budget liabilities, poses a challenge to the fiscal sustainability of these States.

Concluding Remarks: The Big Picture

5.79 The analysis in this chapter shows that at the beginning of the review period, States had lower levels of debt and deficit than they do today. With the implementation of UDAY and the onset of the COVID-19 pandemic, the finances of the States deteriorated. Of course, the restructuring under UDAY only made explicit a problem that had been brewing beneath the surface for some years. The COVID-19 pandemic was an unexpected and unavoidable shock. Although the Union Government bore the brunt of this shock, States could scarcely escape its detrimental effects on fiscal deficits and debt. As a whole, there has been a concerted effort by States to contain deficits and debt in the aftermath of the pandemic. The combined debt of States declined from 29.3 per cent of GDP in 2020-21 to 26.4 per cent in 2023-24. Further optimism stems from the GST having overcome its initial teething pains and showing the promise of rising revenues as a proportion of GDP in the coming years. States can accelerate these gains by enhancing SGST collection through the use of AI and other tools. They may also contribute to further fiscal consolidation through reform of their tax system at both the policy and administrative levels.

5.80 States with excessively high levels of committed expenditure must pay particular attention to containing their future expansion, such that expenditure growth rates are well below the growth in their nominal GSDP. This entails exercising caution in further personnel expansion, including teachers and administrative staff. States suffering from high commercial losses in the power sector must give serious consideration to reforms aimed at containing them. The reforms may include the privatization of DISCOMs, strengthening State Electricity Regulatory Commissions, and implementing the best practices followed by States with a history of profitable DISCOMs. An effort also needs to be made to contain the expansion of subsidies and transfers, especially those creating permanent expenditure liabilities. No matter how attractive a benefits scheme appears, it has a fiscal cost. It is prudence in these dimensions that will unlock resources for growth and development while ensuring fiscal stability.

5.81 The aggregate financial picture of the States raises some concerns but is not alarming. More serious weaknesses are revealed when we look at individual States. High debt-to-GSDP ratios in some States limit the availability of fiscal resources for building infrastructure and other developmental expenditures. That, in turn, undermines growth and revenue generation. This ‘high debt-low growth-low revenue-high debt’ vicious cycle can only be broken through greater tax revenue effort and better expenditure discipline. Devolution and FC grants and Union transfers can only go so far in alleviating the problem, as they have the obvious limitation that the provision of larger financial resources to one State must translate into smaller provisions for another or the Union Government.

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6

UNION FINANCES DURING THE AWARD PERIOD: AN ASSESSMENT

6.1 After reviewing the fiscal trends in the past, we now turn to an assessment of the Union finances during the award period spanning 2026-27 to 2030-31. We assess the expenditure needs and revenue prospects of the Union in this Chapter and those of States in Chapter 9. Together, they form the basis of the shares of the Union and States in the divisible pool in the vertical devolution, the shares of each of the twenty-eight States in the horizontal devolution and grants to be disbursed from the Union to the States.

6.2 The terms of reference (ToR) of the Seventh to Fifteenth Finance Commissions (FCs), except the FC-9, specifically required them to take into account the needs and resources of the Union Government when making their recommendations. While the present Commission's ToR does not give this directive, it is only logical for it to ground its recommendations in such an assessment.

Views of the Union Government

6.3 The Union Government made four preliminary submissions to us from October 2024 to May 2025 covering different aspects of the ToR. This was followed by the submission of a consolidated memorandum in July 2025 after holding consultations with Union ministries. The memorandum provided the views of the Union Government on the state of the economy and called for a reset of the country's public finances to achieve its ambition to become a developed economy by 2047.

6.4 In its submission, the Union has emphasized its commitment to fiscal consolidation through improved quality of expenditure while remaining committed to sustained rapid growth. Among the priorities, it highlights the provision of necessary fiscal stimulus, predominantly through capital spending, optimal allocation of resources to promote national development priorities, and strengthening the social safety nets. These goals are to be achieved through

leveraging technology, partnering with States, and implementing fiscal measures aimed at greater economic resilience. The memorandum notes that inadequate net revenue receipts currently constrain the Union's efforts at fiscal consolidation. The net revenues are being unduly eroded by devolution and grants recommended by the FCs, especially since the large increase in the devolution to States by FC-14.

6.5 The Union Government has urged this Commission to incorporate in its assessment the Union Government's obligatory expenditures, such as interest payments, expenditures on national defence and security, and provision of basic amenities to all the citizens of the country. The memorandum further states that the assessment should provide for an adequate volume of financial resources for the Union to help correct the imbalance that currently exists. It specifically emphasizes that this Commission's forecasts must take into account the Union's increased need for defence expenditures.

6.6 The projections of Union finances submitted in the memorandum adhere to the fiscal consolidation path that the Union has adopted in its Medium-Term Fiscal Policy (MTFP) and Strategy Statement of the Union Budget, 2025-26. While it does not provide specific projections for the revenue and fiscal deficits, the memorandum provides the end target for the outstanding liabilities of the Union at 49.5 per cent of gross domestic product (GDP) in the final year of the award period, 2030-31. The Union Government has assumed around 11 per cent annual growth of nominal GDP for the award period. Buoyancy for gross tax revenue for the period is estimated at 1.1 with an annual growth rate of 12.1 per cent. Non-tax revenue has been estimated at 1.2 per cent of GDP, with no growth envisaged in the non-debt capital receipts.

6.7 On the expenditure side, the submission focuses on defence as the highest priority, especially in view of the critical junction at which India stands. Accordingly, the combined revenue and capital expenditures on defence, border guard and internal security are projected to reach 2.2 per cent of GDP in the final year of the award period. The overall capital expenditure (inclusive of defence) is projected to be 3.3 per cent of GDP in 2030-31, with a focus on investment in infrastructure, as compared to 3.2 per cent in 2023-24. Revenue expenditure is projected to grow at a rate of approximately 10 per cent throughout the award period. This is largely owing to committed expenditures and focus on developmental priorities through centrally sponsored and central sector schemes. With these projections, the outstanding debt to GDP ratio of the Union is projected to decline from 55.1 per cent in 2025-26 to 49.5 per cent in 2030-31.

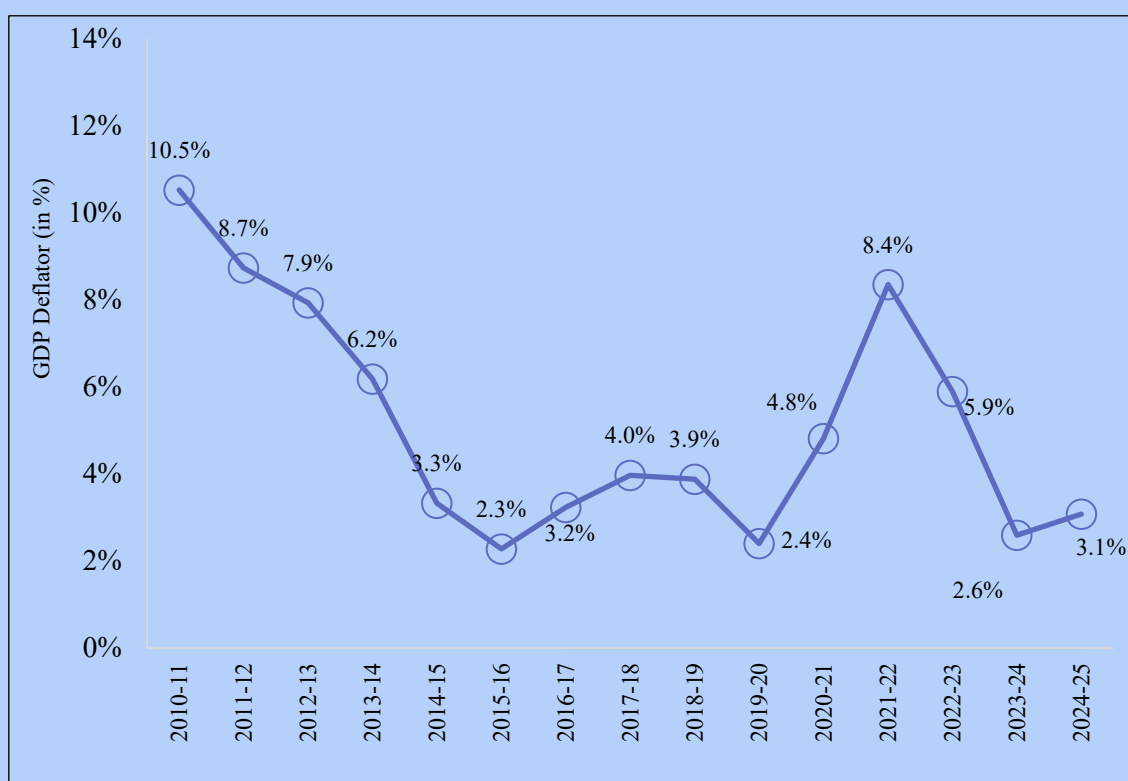
Economic Outlook

6.8 In the years following the COVID-19 pandemic, the economy has returned to robust growth, with real GDP rising from a negative growth of -5.8 per cent in 2020-21 to an average of 8.2 per cent in the following four years. Nominal GDP declined by -1.2 per cent in 2020-21 and recorded an annual average of 13.7 per cent during 2021-22 to 2024-25 (Provisional).

6.9 We need projections of nominal GDP for our base year 2025-26 and the award period 2026-27 to 2031-32. The projection exercise for 2025-26 utilizes a dynamic factor model that incorporates long-term indicators from 2005-06 to 2024-25. We then estimate GDP for the period from 2026-27 to 2030-31 by deploying a vector auto-regressive (VAR) model using annualised key structural macroeconomic variables. Model selection is based on stability tests, serial correlation diagnostics, and optimal lag criteria in addition to economic theory. The nominal GDP growth rate projected by the model equals 11.4 per cent for 2025-26 and ranges from 11.7 to 11.9 per cent for the years 2026-27 to 2030-31. These results are partly influenced by the high growth in GDP deflator during 2010-14 (*Figure 6.1*).

6.10 We noted that the Ministry of Finance, in its budget for the fiscal year 2025-26, estimated a nominal GDP growth rate of 10.1 per cent. Given that our model predictions were on the high side due to the high growth in the GDP deflator during 2010-14, after due deliberations, we adopted the Ministry's nominal GDP growth rate for our base year, 2025-26. Moreover, an average annual growth rate in nominal GDP of 11 per cent has been recorded during the period 2012-13 to 2023-24, which is also the growth rate adopted by the Ministry in its projections for the years 2026-27 to 2030-31. Considering these facts, we have settled on an 11 per cent nominal GDP growth rate for the award period as well.

Figure 6.1 Growth Rate of GDP Deflator



Source: Ministry of Statistics and Programme Implementation (MoSPI)'s published data of nominal and real GDP

Base Year Estimates and Norms for Assessment

6.11 In the Union Budget 2025-26, the Union Government has reiterated its commitment to fiscal consolidation through a balance between developmental priorities and imperatives of fiscal prudence. It presented a glide path for fiscal consolidation for this Commission's award period as part of this approach. Our review of the finances of the Union and States has informed our assessment, which also strives to create this balance by laying down a guiding path that restores fiscal balance without undermining these developmental priorities. Simultaneously, we have adopted a conservative approach while projecting expenditure at both tiers of the government to underline the importance of fiscal discipline in spending choices, staying clear of the tide of populist measures.

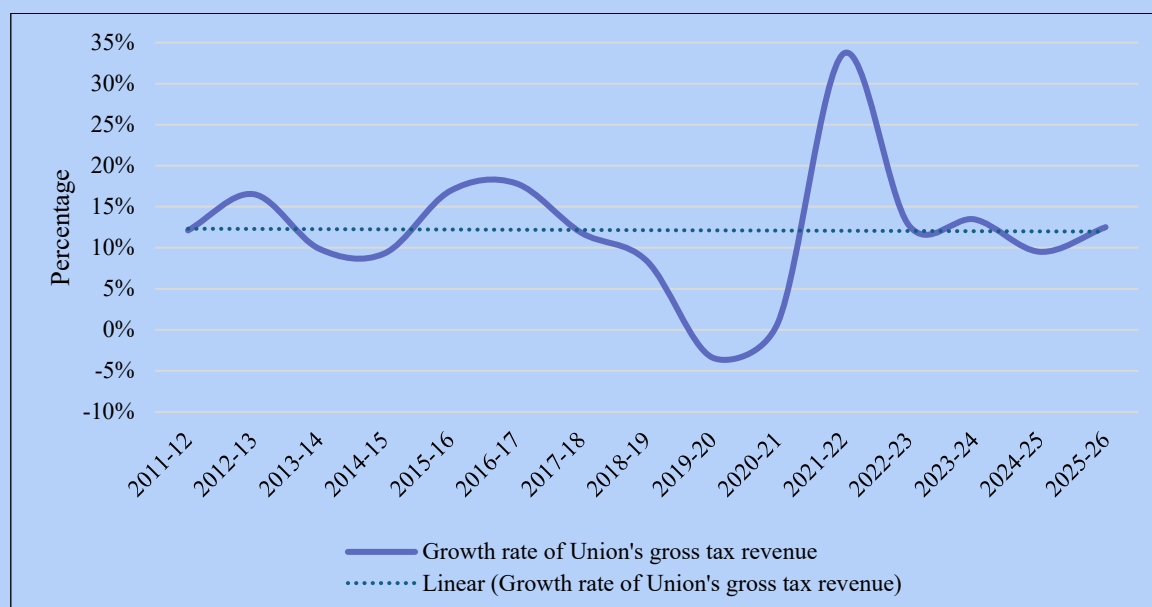
6.12 We have chosen 2025-26 to be the base year for making our projections for the award period. The budget estimates (BE) for this year, as presented in the Union Budget 2025-26, are taken as the starting point for this exercise. Adjustments, as deemed necessary, are made to these estimates on the revenue side, as explained in detail in the following paragraphs. The reference period for growth and buoyancy in the assessment of Union finances is 2011-12 to 2024-25. As already mentioned, the nominal GDP is assumed to grow at 11.0 per cent each year for the five years. Interest payments are calculated by applying the effective rate of interest on the assessed outstanding liabilities for the period 2026-27 to 2030-31. The revenue deficit path has been projected based on the assessment of revenue and expenditure. As restoring balance in the finances of the Union in a manner that is realistic and achievable is one of our primary objectives, we have laid down a path of fiscal deficit that reduces it to 3.5 per cent of GDP in the final year of our award period, 2030-31.

Assessment of Revenues

6.13 As explained in Chapter 4, the revenue of the Union consists of tax and non-tax receipts on the revenue account and the non-debt capital receipts on the capital account. Tax revenues account for the bulk of the Union's total revenues and are important even for the assessment of State finances, as States' share in net proceeds of Union taxes form a significant portion of States' revenues.

Tax Revenues

6.14 For the period 2011-12 to 2024-25, gross tax revenue of the Union grew at an average rate of 12.1 per cent annually, as seen in *Figure 6.2*, with an implied buoyancy of 0.87. When we discount the years of impact of the COVID-19 pandemic, considering its extreme and singular nature, the average annual growth rate of gross tax revenues is 11.3 per cent, and the buoyancy is 0.93. It is worth noting that the tax revenues went through significant upheaval due to unprecedented changes in the tax system during this period, such as the introduction of the Goods and Services Tax (GST), corporate tax rationalization, and also the economic slowdown of 2019-20. In light of these facts, the growth and buoyancy of taxes have been rather robust. We assume that these changes have stabilized now and the Union tax revenues will be more buoyant during the award period.

Figure 6.2 Annual Growth Rates of Union's Gross Tax Revenues

Source: Union Budgets

6.15 Considering the stabilization and recovery of corporate tax revenues after the rate change and the pandemic, revenue from this source is assumed to grow with a buoyancy of 1.1. In the Union Budget 2025-26, certain measures to give relief to personal income-tax payers were announced. These decisions are likely to cause a decline in collections. Accordingly, we have made a one-time downward revision in the base year revenues from direct taxes, over and above what is already provided in the budget estimates. On this adjusted estimate, a buoyancy of 1.1 is assumed for the growth in revenues from personal income tax and other direct taxes.

6.16 In indirect taxes, one major policy change anticipated during the award period is the end of GST compensation cess in 2025-26. For the award period, it is assumed that the GST compensation cess will be merged with the Central Goods and Services Tax (CGST) and the State Goods and Services Tax (SGST) in equal halves. Accordingly, revenue from CGST is recalculated for the first year and projected to grow at around 12 per cent rate for the remaining award period, consistent with the buoyancy of 1.1. The remaining indirect taxes have been projected to grow at marginally lower rates, given the current trends.

6.17 With this assessment, the gross tax revenues of the Union are expected to go up from 11.5 per cent of GDP in 2024-25, as per the provisional accounts, to 12 per cent in the terminal year of the award period. This would bring the tax-to-GDP ratio close to the highest level ever achieved in the past, which was in 2007-08.

6.18 To estimate the net tax revenue of the Union, we have assumed the same mix of divisible and non-divisible portions of the gross tax revenue in the budget estimates, with adjustment for the merger of GST compensation cess in CGST and SGST in equal proportions.

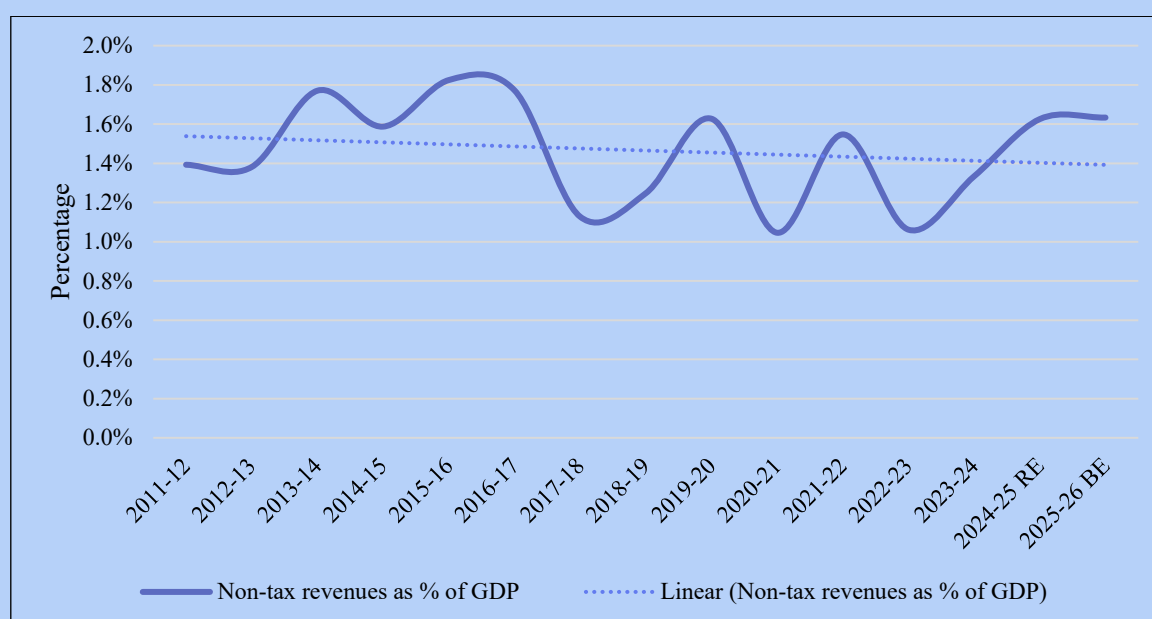
Non-tax Revenues

6.19 The annual average realisation from non-tax revenues of the Union from 2011-12 to 2024-25 has been 1.5 per cent of GDP, as seen in *Figure 6.3*. The largest contributor to this category has been the transfer of surplus from the RBI to the Union Government. It has shown substantial variations during the review period, ranging from 0.1 per cent of GDP (in 2022-23) to 0.7 per cent of GDP (in 2019-20). Considering the large fluctuations in this source of revenue in the past and its preponderance in non-tax revenues, suitable adjustments are made in the base year while assessing the dividend from the RBI. This will absorb risks from a sudden fall in this revenue, if any, during the award period, and help shield non-tax revenue collections from resultant shocks.

6.20 As discussed in Chapter 4, the other major contributor to non-tax revenues of the Union is receipts from economic services, which flow from sectors such as telecommunications, power, roads, and highways. During our consultations with the Union ministries, the Department of Telecommunications briefed us on the policy changes introduced recently, with implications for gross revenue. These changes promise to stabilize revenues starting 2025-26 and ensure that there are no sudden spikes or falls in the non-tax revenue of the Union. We have considered this factor while assessing revenues from this sector.

6.21 For all other items of non-tax revenue, growth is projected based on recent trends. Since the infrastructure sector primarily drives the revenues from non-tax sources, we have ensured that our assessment of them is consistent with the growth trajectory assumed for the economy. Based on these projections, the overall non-tax revenue of the Union is assumed to grow at the same rate as GDP, and its proportion to GDP remains almost constant at 1.2 per cent, during the award period.

Figure 6.3 Trends in Non-tax Revenues of the Union (percentage of GDP)



Source: Union Budgets

6.22 The projections made for the tax and non-tax revenues of the Union are on the conservative side and in line with the submissions made by the Union. This cautious approach helps us in chalking out a realistic fiscal consolidation roadmap. At the same time, it helps our assessment of State finances to be conservative. It also leaves room for stabilization of tax reforms and rationalisation of tax structures due to be undertaken in the years to come. This being said, there is scope for upward movement in the actual revenue collections, as we have noted in our concluding remarks in Chapter 4. With the impetus offered by changes in direct tax policies, along with the thrust on digitization leading to a rise in voluntary compliance, and the high buoyancy of GST collections witnessed since its stabilization, this expectation for a rise in tax revenues is reasonable. On the non-tax revenue side, too, there is scope for additional revenue collection, especially with the investments in infrastructure made in the recent past bearing fruit.

Non-debt Capital Receipts

6.23 The two sources of non-debt capital receipts for the Union are recoveries of loans and advances (mostly from the State Governments), and miscellaneous capital receipts (which include receipts from disinvestment). The receipts from recoveries of loans and advances have formed a very small component ever since lending by the Union has been limited to loans passed on to States on account of external assistance. In 2020-21, the Union Government started the special incentive scheme for capital investment (SASCI), wherein interest-free loans are being extended to States, which are to be repaid after fifty years. The recovery of these loans falls beyond our award period.

6.24 Receipts from disinvestment do not show any discernible trend in the past, as these receipts are intermittent due to the nature of transactions. Although the Union Government has steadfastly pursued the disinvestment roadmap to achieve better efficiency, the disinvestment proceeds in the past few years have tapered. As mentioned in Chapter 4, the Union Government has also done away with setting disinvestment targets in the Union Budget. The Union Government stated in its memorandum that disinvestment receipts cannot be expected to exhibit sustained annual growth, given the finite pool of public sector equity available for disinvestment. In Chapter 15, we have analysed the issue related to public sector enterprises in greater detail and recommend that the disinvestment policy should be actively pursued. Accordingly, we have assumed an overall growth of 11 per cent for non-debt capital receipts for the award period, given the greater need for revenue mobilization from this source.

Assessment of Expenditure

6.25 Our approach towards projections of expenditure is two-pronged. On the one hand, we have taken a conservative approach to a large part of the revenue expenditures. On the other, we have left sufficient space for increased capital expenditure within the overall objective of fiscal consolidation and for expenditures for the Union Government to meet its Constitutional functions and discharging its developmental obligations. Therefore, the assessment ensures

improved quality of expenditure, while recognizing the committed liabilities of the Union, its responsibilities as listed in the Seventh Schedule, and also its role in furthering national interests through grants and transfers to States and Union Territories (UTs) under various schemes.

The Revenue Expenditure

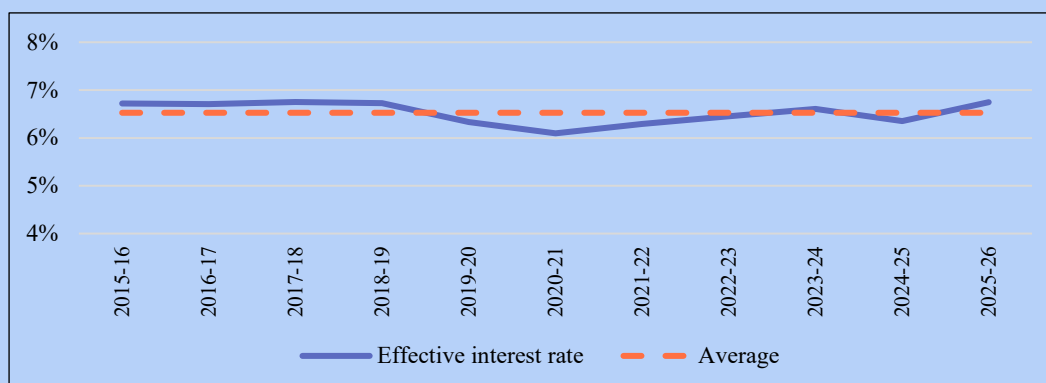
6.26 Post pandemic, the revenue expenditure of the Union has declined from 15.5 per cent of GDP in 2020-21 to 10.9 per cent in 2024-25 as per the provisional accounts, which is an encouraging trend. This has led to a reduction of revenue deficit from 7.3 per cent of GDP in 2020-21 to 1.7 per cent of GDP in 2024-25. Interest payments, defence, pensions, police, subsidies and grants to States account for 85 per cent of the Union's revenue expenditure. We have projected these separately and the remainder as a lump sum.

Interest payments

6.27 Interest payments are one of the major items of revenue expenditure for the Union, with its share in total ranging from 22-30 per cent in the last few years. Interest payments jumped from 3.0 per cent of GDP in 2019-20 to 3.5 per cent in 2023-24 due to the higher deficit incurred during the pandemic. The Union Government has projected interest payments at 3.5 per cent of GDP for the base year. As per our assessment, the reduction in fiscal deficit and, therefore, outstanding debt, should result in reduced expenditure on interest payments

6.28 As a first step in assessing interest payment expenditure, we calculated the outstanding liabilities for each year of the award period by adding the projected fiscal deficit of that year to the previous year's outstanding liabilities. Average liability of each year is calculated as a simple average of the opening and closing balances of outstanding liabilities. The average annual effective interest rate was estimated at 6.5 per cent based on past data, as seen in *Figure 6.4*. As a next step, this effective interest rate is applied to the average liabilities of each year of the award period to arrive at the expenditure on interest payments. As per our projections, interest payments are scheduled to drop back to 3 per cent of GDP by the end of the award period.

Figure 6.4 Effective Rate of Interest on Mid-year Liabilities of the Union



Source: Union Budgets

Pensions

6.29 Pension is one of the fastest-growing items of revenue expenditure. Pension payments of the Union Government have been volatile during our review period due to significant changes like the implementation of the Seventh Central Pay Commission (CPC) award and one-rank one-pension for the defence forces. While the Union Government has announced the constitution of the eighth CPC, it would be premature to account for any possible increase in pension outgo without actual inputs based on the CPC's recommendations. Therefore, pension expenditure is assumed to grow at rates based on past trends, excluding the years of sudden jump due to the aforementioned changes, which were one-time events.

Defence and Internal Security

6.30 The Union Government, in its submission, has highlighted the need to increase spending in the defence sector, considering the recent geopolitical changes and hostility at our borders. Defence is one of the primary responsibilities of the Union and is the first item in the Union List of the Seventh Schedule of our Constitution. We recognise the need for growth in defence spending but believe that this expenditure should be aimed at capacity building and modernization on the capital side, rather than on the revenue side. On the revenue side, we have split the defence expenditure into salary and non-salary components. The salary component, that is, pay and allowances, is projected to grow at 6 per cent per annum, which is marginally higher than the growth rate in the past. The non-salary component has been projected to grow at a considerably higher level of 15 per cent per annum to accommodate the growing defence needs. Expenditure on police, primarily central police forces, is projected to grow at the past trend.

Subsidies

6.31 Almost all the preceding FCs have commented on the need to rationalize subsidies at both the Union and State levels. We have carried out a detailed analysis of the subsidies and transfers in Chapter 14 of this report. Our projections for the award period for subsidies are guided by this analysis.

6.32 The past trends in food subsidy are not fully reflected in the statement for subsidies presented in the Union Budget due to the extra budgetary resources (EBRs) used to finance this expenditure in the past. This issue has been discussed in detail in Chapter 4. To analyse past trends in the true sense, we have adjusted the food subsidy shown in the budget by adding the amount financed through EBRs in those years to arrive at the actual year-wise expenditure on this item. As per the recalculated amount, expenditure on food subsidy constituted around 1.0 per cent of GDP during the majority of the review period, peaking at 1.4 per cent of GDP in 2020-21. Starting from 2023-24, there has been a decline in this expenditure, and it is estimated to be at 0.6 per cent of GDP in 2025-26 as per budget estimates. The Union Government's decision to extend the Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY) till 01 January 2029 implies a fixed outgo under food subsidy at least for the first three years of our award period.

6.33 While keeping in mind the need to ensure food security of the most vulnerable sections in the country, it is also necessary to rationalize this expenditure through better targeting. Accordingly, we have projected that food subsidies will increase marginally every year in absolute terms, instead of adopting a common growth rate. The increase in spending due to inflationary pressures should be offset by better targeting and a revision of the database of eligible beneficiaries in a continuous manner.

6.34 Fertilizer subsidy is the second largest subsidy in terms of expenditure. During our consultation with the Department of Fertilizers, issues such as unrestricted access to fertilizer use and the need for better coordination in the sector were presented to us, along with the schemes launched recently to incentivize reduced chemical fertilizer usage and production of indigenous variants. The Union Government, in its memorandum, stated that the import and production costs of materials are expected to reduce during our award period. Further, measures like the direct benefit transfer system for subsidy delivery are expected to improve tracking of sales and movement, thus bringing down the subsidy bill.

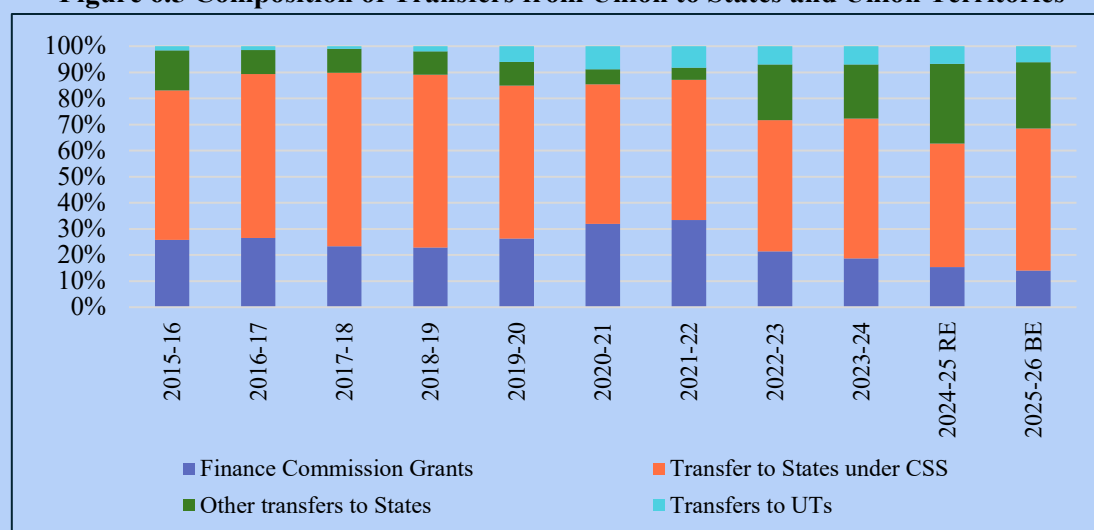
6.35 Accordingly, for projecting expenditure on fertiliser subsidy, we have followed an approach similar to that of food subsidy projections. There is a need to rationalize fertilizer subsidy through better targeting. At the same time, we acknowledge that the way forward needs to be carefully coordinated. Therefore, we have projected a very moderate increase in this item of expenditure in absolute terms.

6.36 Since petroleum and other subsidies have been rationalized and constitute a minor portion of the total subsidy provided by the Union, their projections from the base year are done based on recent past trends. Based on these considerations, the expenditure on subsidies of the Union comes down from 1.2 per cent of GDP in the base year to 0.9 per cent of GDP in the final year of the award period.

6.37 The growth of subsidies in various forms and their impact on the overall fiscal balance of the Union and States has been a major point of concern for this Commission. We have tried to treat the subsidy expenditure of the Union and States in a similar manner and set a course for the rationalization of this ever-growing item of expenditure. A reduction in subsidies is a necessary prerequisite to achieve fiscal consolidation. While there is scope for greater rationalization of this item, the projected path of reduction is highly feasible. The restraint shown by the Union Government in reducing its subsidy expenditure in the recent past makes us optimistic of continued reduction in this expenditure.

Grants-in-Aid and Transfers to States and Union Territories

6.38 In the current scheme of revenue transfers from the Union to States and UTs, grants-in-aid (GIA) and transfers include grants as recommended by the finance commission and other grants and transfers. The latter are predominantly under centrally sponsored schemes (CSS), a small portion under central sector schemes (CS) and remaining are miscellaneous items such as transfers from National Disaster Response Fund (NDRF). A snapshot of the composition of these transfers is presented in *Figure 6.5*.

Figure 6.5 Composition of Transfers from Union to States and Union Territories

Source: Union Budgets

Note: Figures are percentages of each component among total grants-in-aid and transfers from Union to States

6.39 The projected expenditures on grants based on our recommendations are discussed in detail in Chapters 9, 10 and 11.

6.40 The CSS account for more than 50 per cent of total transfers from the Union to the States. In its memorandum, the Union Government placed great emphasis on expenditure under CSS as the channel to achieve national development priorities. It has also provided details of reforms undertaken to enhance the quality of public spending under these schemes. Though the CSS were restructured and rationalized in 2015-16, over the past decade, there has been an increase in their number, with more than 80 schemes currently in operation. Run by more than 20 departments/ministries of the Union, the spending on CSS amounts to approximately 1.5 per cent of GDP every year. While there is a mechanism to review the efficacy and efficiency of these schemes once every five years, this has not resulted in the closure of any scheme, either due to the attainment of its stated objectives or otherwise. Often, the goalpost is shifted when the initial end period is reached or the objectives have been achieved, and the scheme is renewed.

6.41 In light of these observations, there is an urgent need to rationalize the existing structure of CSS by linking the implementation with measurable, real-time output indicators that would allow for a more efficient use of resources while delivering the desired results. The Commission recommends that the Union Government appoint a high-powered committee that does a fresh assessment of the schemes and recommends closure of the schemes that are not spending resources productively. Continuing schemes with low or negative social returns has the effect of crowding out higher return schemes that could replace them.

6.42 The top five CSS, based on their budget outlay, contribute to more than half of the CSS spending. These schemes are the National Rural Employment Guarantee (NREGA) Program, Pradhan Mantri Awas Yojana (PMAY, urban & rural), Jal Jeevan Mission (JJM), Samagra Shiksha (SS), and National Health Mission (NHM, urban & rural). Considering their preponderance, the expenditure on these individual schemes was analysed and projected based on past trends as the first step. While doing this, we also considered aspects such as the lifetime

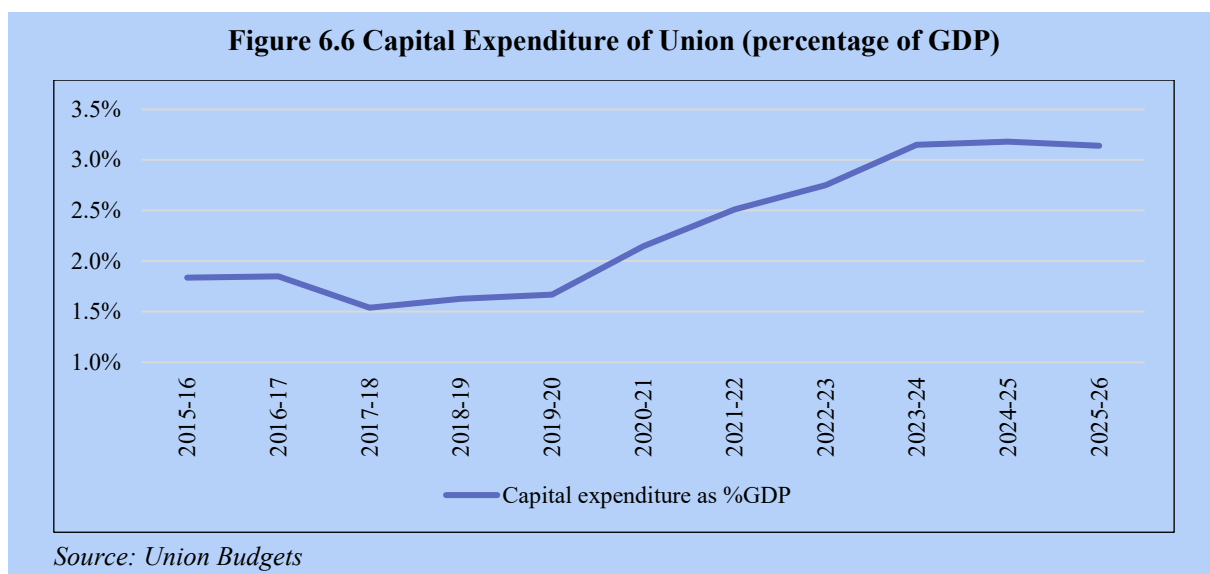
of the scheme since its inception, levels of saturation already achieved in the outcomes, and scope for prolonged continuity. The remaining CSS whose individual outlay was less than 8 per cent of total CSS outlay were projected together, and a similar methodology was followed for the remaining transfers in the next step.

6.43 Since the GST compensation regime is anticipated to come to an end, this transfer item is not projected. With this assessment, the expenditure on transfers and grants-in-aid under the Union's welfare schemes is projected to decline from 1.4 per cent of GDP in the base year to 1.1 per cent in the final year of the award period.

6.44 The residual revenue expenditure of the Union Government, comprising various line items across all ministries of the government, constitutes less than 15 per cent of the total revenue expenditure of the Union. It has been projected to grow a little above the past trend, at 8 per cent per annum.

Capital Expenditure

6.45 Capital expenditure witnessed a step jump during the pandemic, and the increase has been sustained post-pandemic, reaching 3.2 per cent of GDP in 2024-25 as compared to 1.6 per cent in 2018-19, as can be seen from *Figure 6.6*.



6.46 Expenditure on defence, railways, roads and loans to States are some of the major items under capital expenditure of the Union. In its memorandum, the Union highlighted the need for an increase in defence expenditure to achieve multi-domain operational capabilities in the context of national security. We agree with this view and see the need for increased spending on defence on the capital account. Accordingly, we have projected defence capital expenditure to grow at a rate of 30 per cent annually. With this level of increase in defence capital expenditure, the total defence expenditure will reach 1.9 per cent of GDP in the final year of the award period, as compared to the current level of 1.4 per cent in the base year. However, the Commission is of the view that such increases will require continued serious structural reforms in long-term planning and procurement.

6.47 Since 2020-21, the Special Assistance to States for Capital Investment (SASCI) has become an important instrument for boosting the States' capital expenditures. Under this scheme, 50-year interest-free loans are provided to States to undertake projects with heavy capital expenditures. During our consultations with the State Governments, most of them acknowledged the positive role of this scheme in boosting capital investments and suggested its extension. These loans are projected to increase at a rate of 15 per cent annually to reach 0.5 per cent of GDP by the end of the award period.

6.48 The remaining element of the capital expenditure, including spending on infrastructure, is projected to grow at the rate of 11 per cent in line with the growth of GDP. Based on these projections, the total capital expenditure of the Union Government is projected to reach 3.8 per cent of GDP in 2030-31 as compared to 3.1 per cent in the base year. The results of this assessment are presented at *Annexure 6.1* and *Annexure 6.2*.

Deficits and Debt

6.49 The above projections are in line with the current efforts of the Union Government towards fiscal consolidation, with a path set for increased capital expenditure. Based on these projections, the fiscal deficit of the Union would decrease from the budgeted level of 4.4 per cent of GDP in 2025-26 to 3.5 per cent by the terminal year of the award period. Out of the fiscal deficit of 3.5 per cent of GDP in the final year, 0.5 per cent of GDP would be going to States as a 50-year interest-free loan purely for capital expenditure.

6.50 The fiscal consolidation path is coupled with improving the quality of the fiscal deficit and the revenue deficit. The revenue deficit is projected to decrease from the budgeted level of 1.5 per cent of GDP in 2025-26 to a surplus of 0.1 per cent of GDP by the end of the award period. This would bring back the fiscal balance on the revenue account, with a significant improvement in the quality of expenditures of the Union.

6.51 As discussed in Chapter 4, a proportion of the Union's revenue expenditure is transferred to States as GIA for capital creation. The concept of effective revenue deficit (ERD) as a fiscal parameter was introduced in Union Budget 2011-12 and is calculated as the difference between revenue deficit and grants-in-aid (GIA) for creation of capital assets.

6.52 For our assessment, we observed the trends in GIA for creation of capital assets and projected this expenditure item to grow in consonance with the welfare schemes of the Union Government. With this assessment, the ERD is projected to decrease from 0.3 per cent of GDP in the base year to a surplus of 1.1 per cent of GDP in the final year of award period. Since the introduction of this fiscal indicator, the Union Government is poised to achieve its target of eliminating ERD through this path.

6.53 With the above consolidation roadmap for the Union, the debt to GDP ratio is projected to fall from the current budgeted level of 55.1 per cent of GDP in the base year to 47.6 per cent of GDP at the end of the award period. It bears reiterating that these paths of deficits and debt have been arrived at based on conservative estimates of revenue and expenditure. This fact makes the roadmap amply feasible and achievable.

6.54 Next, we turn to the vertical and horizontal devolution, followed by the assessment of State finances along with our discussion on grants-in-aid.

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SHARING OF TAX REVENUES: VERTICAL DEVOLUTION

7.1 Today, fiscal federalism is a central feature of India's fiscal architecture. However, this was not always the case. In the early days of British rule, India's finances were centralized to such an extent that the country could be considered unitary in fiscal matters. In fact, this is exactly how the Expert Committee on the Financial Provisions of the Union Constitution, appointed by the Constituent Assembly President Dr. Rajendra Prasad and chaired by Nalini Ranjan Sarkar, described it in its 1948 report. The report stated, "The process of financial development in this country has been one of evolution from a unitary to a quasi-federal type. The Government of India started as a completely unitary government, in full control of the country's revenues, with the provincial governments depending on the central government for all their needs."

Genesis of Fiscal Federalism in Pre-Independence India

7.2 After taking charge of the reins of the government from the East India Company, the Crown fully controlled provincial revenues and expenditures for several decades. It expanded the financial authority of provinces only gradually, first through grants for the provision of specific services and then a partial or complete transfer of some of the revenue heads to them. In the early decades, it allowed provinces to keep only a fraction of the revenue they raised, including from income tax. In effect, the devolution at the time was from the provinces to the Centre.

7.3 The first step towards a complete separation of revenue heads between the Centre and provinces was taken under the Government of India Act of 1919, a good six decades after the Crown replaced the East India Company. The fiscal arrangements under this Act came into force on 01 April 1921. Under these arrangements, excise, judicial stamps, land revenue, and irrigation receipts were assigned to provinces and income tax, customs, salt and opium to the Centre. Until 1926-27, provinces continued to be required to contribute to the Centre's revenues.

7.4 Several committees looked into different aspects of taxation during the second half of the 1920s and the first half of the 1930s. However, no significant change in Centre-State fiscal relations occurred until the Government of India Act, 1935. This act spelled out the allocation of different taxes between the Centre and provinces and provided the legal framework for the division of the proceeds of income tax between them. In 1936, the government appointed Sir Otto Niemeyer to recommend how income tax proceeds should be divided between the Centre and provinces (vertical devolution) and among provinces (horizontal devolution). Niemeyer recommended a 50:50 division between the Centre and provinces, with the provinces' share divided among them according to population and residence of the taxpayer. He also recommended fixed-amount annual grants-in-aid to five provinces to fill the gaps between their expenditures and revenues. The government accepted these recommendations. This was the genuine beginning of fiscal federalism in India. With minor adjustments, the arrangements as recommended by Niemeyer remained in force till the Indian Constitution came into force and the recommendations of the First Finance Commission were implemented, beginning in 1952.¹

The Constitutional Provisions

7.5 There are three major provisions of revenue resource sharing between the Union and States in the Indian Constitution: sharing of Union tax revenues under Articles 270 (and Article 272 until 80th Constitutional Amendment), grants from the Union Budget under Article 275(1) and under Article 282. Below, we spell out the critical details of each of these items.

Sharing of the Union Tax Revenues under Articles 270 and 272

7.6 In its original form, the Constitution required the Centre to share with States the net proceeds of income tax mandatorily (Article 270) and those of central excise tax optionally if the Parliament so decided (Article 272). These and other provisions in Part XII of the Constitution served as the legal framework within which the first ten FCs made their recommendations.

7.7 Based on the Alternative Scheme of Devolution, recommended by the FC-10, the Government of India enacted the Constitution (Eightieth Amendment) Act in June 2000. Through this Act, the Parliament amended Article 270 to make net proceeds of all taxes in the Union list, except those levied under Articles 268 and 269, surcharges on taxes mentioned in Article 271, and any cesses levied for specific purposes, shareable with States. Article 268 refers to certain taxes levied by the Union but collected and appropriated by the States, such as certain stamp duties and excise duties on medicinal & toilet preparations. Article 269 provides for certain taxes levied and collected by the Union but assigned to the States, such as taxes on the sale, purchase, or consignment of goods in the course of interstate commerce. Since the Eightieth Amendment rendered Article 272, providing for the option of sharing the proceeds of the central excise tax between the Union and the States, redundant, it was omitted from the

¹ For a more detailed account of the evolution of fiscal federalism under the British, see the Report of the First Finance Commission, Ch 2.

Constitution. The FC-11 to FC-14 (2000-01 to 2014-15) made their recommendations under these modified provisions.

7.8 The 101st Amendment to the Constitution, enacted in September 2016, introduced a major reform replacing a host of indirect taxes levied by States and the Union with a single nationwide Goods and Services Tax (GST). As a part of this reform, the Integrated Goods and Services Tax (IGST) component of the GST replaced the erstwhile tax on the purchase, sale, and consignment of goods in the course of interstate commerce and the countervailing duty on imports. To incorporate this change into the design of Union-State sharing of tax revenues, the 101st Amendment added Article 269A, relating to IGST, alongside Articles 268 and 269, cesses and surcharges, to the list of exceptions to shareable tax revenues in Article 270. Because the GST came into force on 01 July 2017, the FC-15 made its recommendations on vertical devolution under these provisions.

Grants by the Union under Article 275(1)

7.9 In addition to the devolution of tax revenues under Article 270, fiscal resources from the Union to the States flow under Article 275(1) of the Constitution on the recommendation of the FC. As a result, these grants [other than those given under proviso to Article 275(1)] are commonly referred to as “FC grants”. The grants under Article 275(1) have been given most prominently and frequently to bridge the gap between the States’ revenues and expenditures on the revenue (current) account, but also for specific sectors or to specific States for specific projects. The disaster relief and local body grants to the States, recommended by FCs, are also given under Article 275(1). We discuss these grants in greater detail in upcoming chapters.

Grants by the Union under Article 282

7.10 Under Article 282 of the Constitution, “The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.” In terms of the purposes of the grants, this is a very open-ended provision, allowing both the Union and States to make grants even in areas in which they lack the power to legislate. The Union Government currently provides substantial grants to States through its centrally sponsored schemes (CSS) under this provision. In the past, Plan grants were also provided under it. All grants by the Union Government to State Governments other than FC grants are sometimes referred to as “non-FC” grants. Beyond recording the magnitudes of the grants to States under Article 282 in the present chapter, we do not discuss them in this report.

7.11 Both FC and non-FC grants come from the Consolidated Fund of India and are in addition to the States’ share of the shareable tax revenue resources, also referred to as the divisible pool. A key difference is that grants under Article 275(1) are charged upon the Consolidated Fund of India while those under Article 282 are voted. The grants under Article 282 give the Union Government a high degree of flexibility in that it can award them for any

public purpose to any implementing agencies, including non-governmental organizations (NGOs), educational institutions, and hospitals. They can be provided for drought or earthquake relief in addition to the grants recommended by the FC. During the COVID-19 crisis, the grants for vaccination infrastructure and migrant support could be quickly mobilized under Article 282.

Vertical Devolutions by Successive Finance Commissions

7.12 In this section, we summarize the recommendations of the past fifteen FCs on the division of tax revenues between the Union and State Governments. The first ten FCs made their recommendations under the original Article 270 and Article 272, with the former providing for the sharing of income tax revenue and the latter for Union excise duties. The following five FCs made their recommendations under Article 270 as amended by the Constitution (80th) Amendment Act, 2000, and the Constitution (101st) Amendment Act, 2016.

The First Ten Finance Commissions: 1952 to 2000

7.13 *Table 7.1* summarizes the shares of States in the income tax and excise duties, as recommended by the first ten FCs. The FC-1 recommended raising the then prevailing 50 per cent share of the States in the income tax to 55 per cent. Subsequent Commissions steadily raised it, with the FC-3 and FC-4 arguing that the increase in the States' share to 66.67 per cent and 75 per cent, respectively, by them was justified because a classification change in the Income Tax Act in 1959 had led to the exclusion of corporate profit tax from the divisible pool. By the FC-7, the States' share in income tax had reached 85 per cent. The FC-8 and FC-9 left this share unchanged, while the FC-10 lowered it to 77.5 per cent. The latter argued that the 85 per cent rate had left the Union Government no incentive to increase the revenue from this source. To compensate for the reduction, however, it simultaneously recommended an increase in the States' share of Union excise duties.

7.14 Turning to the Union excise duties, the FC-1 made a modest beginning by awarding a 40 per cent share in the proceeds from three commodities – tobacco, matches, and vegetable products – to the States. The FC-2 expanded the scope to eight commodities but cut the States' share in the proceeds to 25 per cent. The FC-3 expanded the scope to all commodities that yielded ₹50 lakh or more in revenues while cutting the States' share further to 20 per cent. The FC-4 expanded the scope to all commodities and held the States' share unchanged at 20 per cent. The FC-5 and FC-6 also held the States' share unchanged. The FC-7 broke away from the practice of a gradual shift in the States' share, doubling it from 20 per cent to 40 per cent. Because the Union excise duties accounted for a large proportion of the shareable tax revenues, this change led to a large increase in the fiscal resources devolved to the States. The FC-8 raised the States' share in excise duties further to 45 per cent, with the extra 5 per cent reserved exclusively for disbursement to revenue-deficit States. The FC-9 maintained the status quo for 1989-90 while increasing the amount reserved for revenue-deficit States to 7.425 per cent for the remaining five years i.e., 1990-95. Finally, the FC-10 raised the States' share in excise duty to 47.5 per cent, reserving 7.5 per cent for revenue-deficit States.

Table 7.1 Shares of States in the Proceeds from Income Tax and Union Excise Duties (1952-2000)

FC	Share in Income Tax (percentage)	Share in Union Excise Duties (percentage)
FC-1 (1952-57)	55	40*
FC-2 (1957-62)	60	25**
FC-3 (1962-66)	66.67	20#
FC-4 (1966-69)	75	20^
FC-5 (1969-74)	75	20
FC-6 (1974-79)	80	20
FC-7 (1979-84)	85	40
FC-8 (1984-89)	85	45
FC-9 (1989-95)	85	45
FC-10 (1995-2000)	77.5	47.5

* Applied to only three commodities: tobacco, matches, and vegetable products.

** Applied to eight commodities.

Applied to all commodities yielding ₹50 lakh or more in excise tax revenue.

^ All commodities included from here onwards.

Source: Reports of FC-1 to FC-10

The Last Five Finance Commissions: 2000-2026

7.15 With the 80th Constitutional Amendment having come into force in 2000, the divisible pool for the last five FCs has included all Union tax revenues except cesses, surcharges, tax revenues accruing to the Union Territories (UTs) minus the cost of tax collection. Observing that the average share of the States in the divisible pool from 1980-81 to 1999-2000 had been 28.3 per cent and, with three minor exceptions, the share had remained consistently in the 26-29 per cent range, the FC-11 recommended a 29.5 per cent share in the divisible pool for the States. The FC-12 and FC-13 raised the share to 30.5 per cent and 32 per cent respectively. The FC-14 broke away from this gradual approach and hiked the States' share to 42 per cent.

7.16 In 2019, when the work of the FC-15 was still in progress, the Union Government reorganized the erstwhile State of Jammu & Kashmir into the union territories (UTs) of Jammu & Kashmir and Ladakh. Estimating that the tax share of the erstwhile State would have been approximately 1 per cent of the divisible pool, the FC-15 fixed the share of the remaining twenty-eight States at 41 per cent. Therefore, currently, the tax revenues in the divisible pool are shared in a 41:59 ratio between the States and the Union.

Long-Term Trends in Vertical Sharing of Fiscal Resources

7.17 In this section, we first consider the long-term trend in the sharing of revenue resources between the Union and State Governments. We then analyse the implications of this sharing of revenue resources for the revenues of each tier of the government and the distribution of the total revenue of Union and States between them. We include in our discussion of the shared resources the shareable tax revenues (divisible pool) under Article 270, FC grants under Article 275(1), and non-FC grants by the Union government under Article 282. As we will see, two features of the long-term trend in the transfer of fiscal resources to the States stand out. First, States have seen a steady rise in their share of the divisible pool and the overall fiscal resources. Second, with two exceptions, the increase in the States' share of the divisible pool recommended by FCs has been gradual. The exceptions are the FC-7 and FC-14.

The Sharing of Tax Revenue Resources

7.18 *Table 7.2* shows the evolution of the States' share in the divisible pool, FC grants, and non-FC grants as a percentage of the gross tax revenue (GTR) of the Union under all fifteen FCs. In *Table 7.3*, we report the same variables, but as a percentage of GDP. The figures in the tables are averages over the years within the award period of each FC. In the case of the FC-15, our data includes actual financials for the years 2020-21 to 2023-24, provisional accounts/revised estimates for 2024-25 and budget estimates for 2025-26. The award periods of the FC-3, FC-4, FC-9 and FC-15 spanned four, three, six, and six years respectively. Award periods of the remaining eleven FCs spanned the usual five years.

7.19 As can be seen from *Table 7.2*, the total transfers to States more than doubled from 25.1 per cent of GTR during the award period of FC-1 to 56.4 per cent during the award period of the FC-14. Until the award period of the FC-6, the transfers fluctuated considerably. For example, they rose to 40.8 per cent under the FC-2, fell to 31 per cent under FC-3, and rose again to 36.3 per cent under the FC-4. The fluctuations continued during the succeeding two FCs, but once the FC-7 pushed up the transfers to 45.6 per cent of GTR, they exhibited a gradually rising trend. The only big jump after that came under the FC-14 to 56.4 per cent from 48.8 per cent under the FC-13.

7.20 Approximately half or more of the transfers to the States have come from tax devolution throughout the period. Devolution more than doubled from 16.0 per cent of GTR during the FC-1 award period to 34.0 per cent during the FC-14 award period. The first large shift in this share came under the FC-7 when it rose to 26.9 per cent of GTR from 19.9 per cent under the FC-6. This large increase was the result of the doubling of the States' share in the Union excise duty by the FC-7 to 40 per cent from 20 per cent under the FC-6. From FC-7 to FC-12, the share stagnated and rose only marginally to 27.9 per cent in FC-13. However, under the FC-14, the share saw a step jump to 34.0 per cent.

Table 7.2 Tax Devolution and Grants (percentage of GTR)

FC	Devolution	FC Grants	FC Transfers	Non-FC Grants	Total Transfers
FC-1	16.0	4.5	20.5	4.8	25.4
FC-2	19.8	7.0	26.8	14.0	40.8
FC-3	15.2	5.1	20.3	10.9	31.2
FC-4	17.6	7.0	24.5	11.7	36.3
FC-5	23.3	4.6	27.9	14.9	42.8
FC-6	19.9	6.8	26.7	12.2	38.9
FC-7	26.9	2.3	29.1	16.4	45.6
FC-8	25.1	3.1	28.2	18.4	46.6
FC-9	26.5	4.4	30.9	18.0	48.9
FC-10	27.0	3.1	30.2	14.4	44.5
FC-11	26.6	5.3	31.9	15.1	47.0
FC-12	25.9	5.3	31.2	15.7	46.9
FC-13	27.9	4.6	32.5	16.3	48.8
FC-14	34.0	5.4	39.4	17.0	56.4
FC-15	32.1	5.5	37.7	17.6	55.3

Source: See Annexure 7.1

Table 7.3 Devolution and Grants (percentage of GDP)

FC	Devolution	FC Grants	FC Transfers	Non-FC Grants	Total Transfers
FC-1	0.7	0.2	0.8	0.2	1.0
FC-2	1.0	0.4	1.3	0.7	2.1
FC-3	1.0	0.3	1.4	0.8	2.1
FC-4	1.2	0.5	1.6	0.8	2.4
FC-5	1.7	0.3	2.0	1.1	3.2
FC-6	1.7	0.6	2.3	1.1	3.4
FC-7	2.5	0.2	2.7	1.5	4.2
FC-8	2.5	0.3	2.8	1.9	4.7
FC-9	2.6	0.4	3.0	1.7	4.7
FC-10	2.4	0.3	2.7	1.3	3.9
FC-11	2.4	0.5	2.8	1.3	4.1
FC-12	2.8	0.6	3.4	1.7	5.1
FC-13	2.9	0.5	3.3	1.7	5.0
FC-14	3.7	0.6	4.2	1.8	6.1
FC-15	3.6	0.6	4.3	2.0	6.2

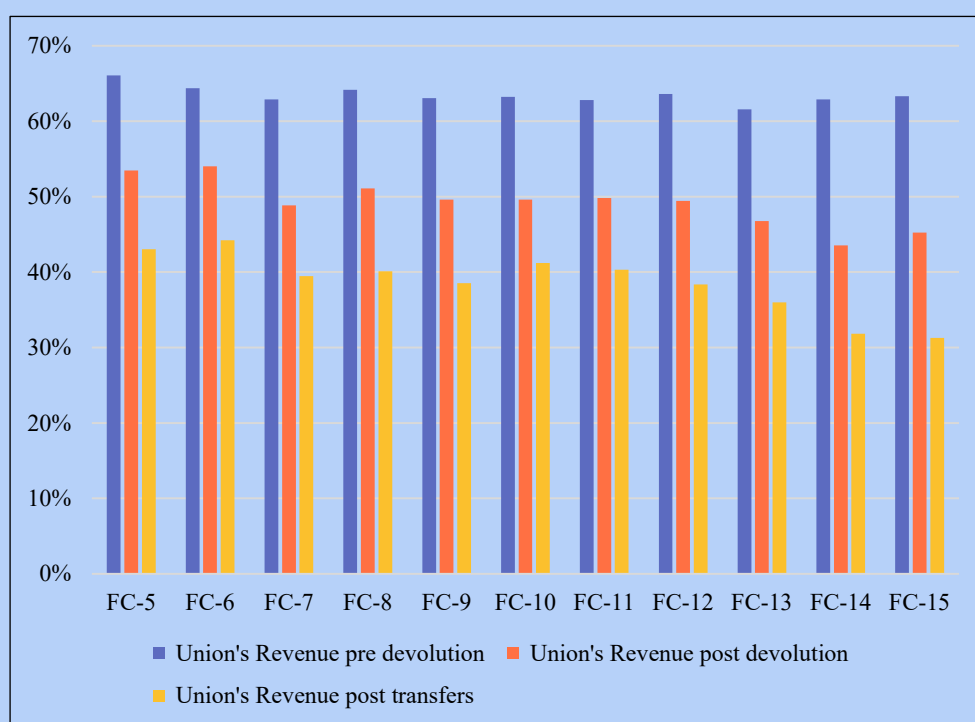
Source: See Annexure 7.1

7.21 The transfers saw a sharper rise as a proportion of GDP than GTR. This is because the GTR itself has seen an increase as a proportion of GDP over time. From 1.0 per cent of GDP during the award period of the FC-1, total transfers to States have risen six-fold to 6.1 per cent and 6.2 per cent during the award periods of the FC-14 and FC-15. Tax devolution has risen five-fold from 0.7 per cent of GDP to 3.5 per cent of GDP between the FC-1 and FC-15. Non-FC grants have seen the sharpest rise from 0.2 per cent of GDP to 2.0 per cent of GDP during this period.

Implications for the Union and State Revenues

7.22 It is instructive to analyse the trends in the Union and State revenues in relation to devolution and grants. *Figure 7.1* shows how the Union revenue as a percentage of total general government (Union plus States) revenue has evolved with devolution and grants from the FC-5 to FC-15. For each FC, the first bar shows the Union revenues pre-devolution and pre-transfers (FC and non-FC grants) as a per cent of the general government revenue. The second bar shows the Union revenue as a per cent of the general government revenue after subtracting out devolution, and the third bar shows the Union revenue as a percentage of general government revenue after subtracting out both devolution and transfers.

Figure 7.1 Trends in the Union Revenue With and Without Devolution and Grants



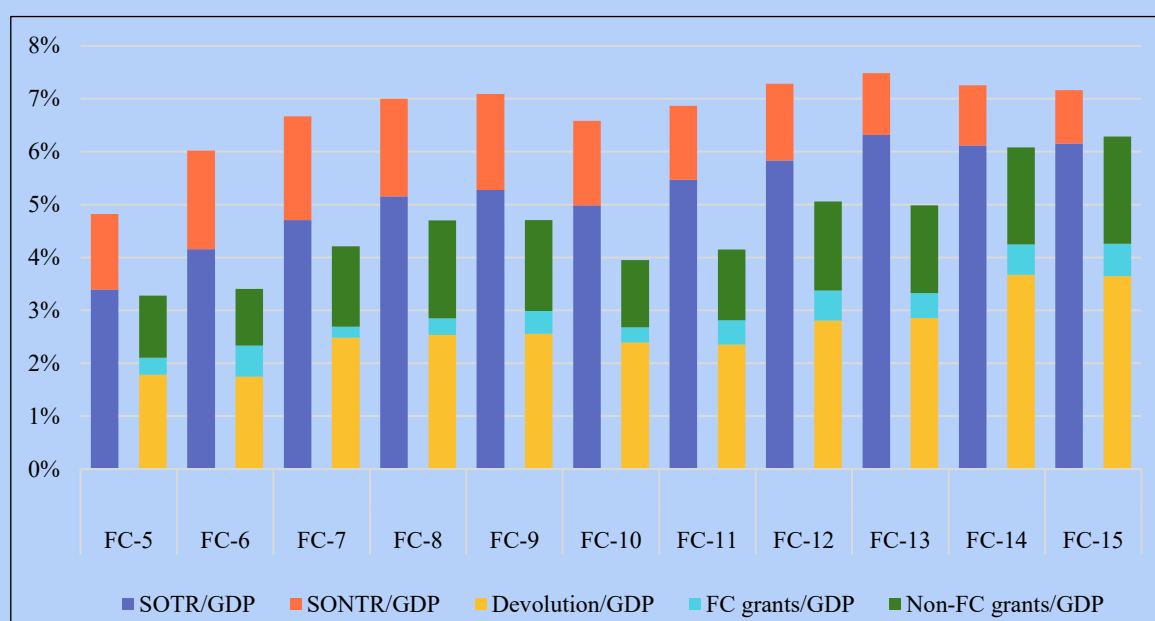
Source: RBI's Database on Indian Economy (DBIE); Union Budget

Note: FC-5 covers period from 1970-71 to 1973-74; FC-15 covers period from 2020-21 to 2025-26 BE.

7.23 Between FC-5 and FC-12, the Union revenue net of devolution and transfers fluctuated between 38.4 per cent (FC-12) and 44.2 per cent (FC-6) of the general government revenue. It then dropped to 36.0 per cent during the FC-13, 31.8 per cent during the FC-14, and 32.9 per cent during the FC-15. Net of devolution alone, the share of the Union Government in general government revenue has fallen from a peak of 54.0 per cent during the FC-6 to 43.6 per cent during the FC-14. Revenue resources have thus seen a clear movement away from the Union to the States.

7.24 *Figure 7.2* considers the States' own tax revenues (SOTR) plus non-tax revenues (SONTR) alongside devolution and grants as proportions of GDP. Between the FC-5 and FC-15, States' own revenues as well as transfers through devolution and grants, as proportions of GDP, have seen significant increases. The result has been an increase in total revenues of the States from 8.1 per cent of GDP during the FC-5 to 13.3 per cent during the FC-14 and 13.4 per cent during FC-15.

Figure 7.2 States' Own Revenues, Devolution and Grants (percentage of GDP)



Source: RBI DBIE

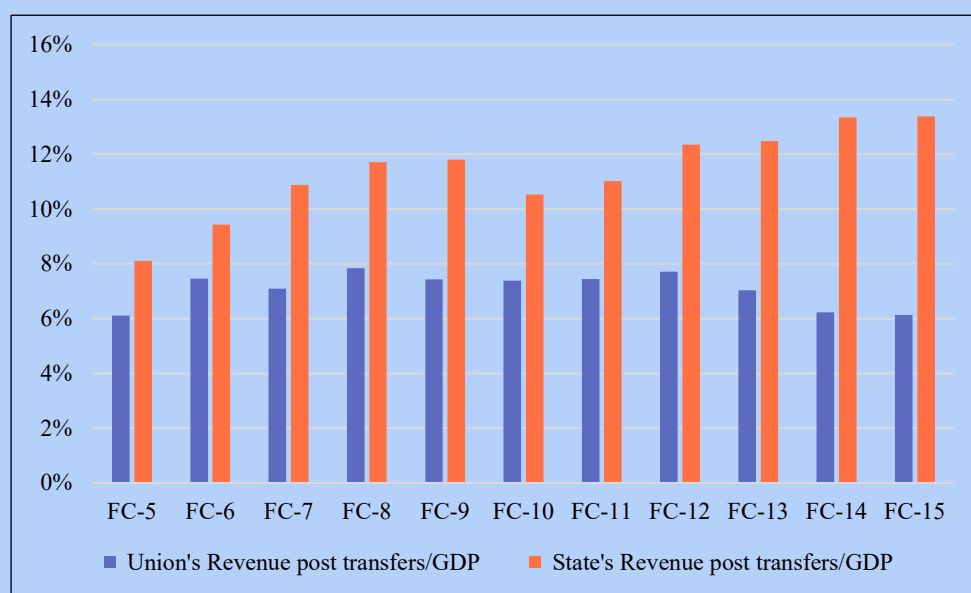
FC-5 covers period from 1970-71 to 1973-74; FC-15 covers period from 2020-21 to 2023-24

Trends in Post-Transfer Revenues of the Union and States

7.25 In *Figure 7.3*, we present the Union's and States' post-transfer revenues as proportions of GDP from the FC-5 to FC-15. We can glean three points from it. First, the Union's post-transfer revenue was 6.1 per cent of GDP during the FC-5, rose to the peak of 7.8 per cent during the FC-8, and then fell back to 6.2 per cent during the FC-15. Second, the States have unmistakably gained in total revenues over the five and a half decades covered by *Figure 7.3*.

Their transfer-inclusive revenues steadily rose from 8.1 per cent of GDP during the FC-5 to 11.8 per cent during the FC-9, fell to 10.5 per cent during the FC-10, and steadily rose again to the peak of 13.4 per cent during the FC-15. Finally, relative shares of the Union and States in the post-transfer revenues changed from 43:57 during the FC-5 to 33:67 during FC-15. Recall that the 1948 report of the Expert Committee on the Financial Provisions of the Union Constitution had described the Centre-State financial relations at the time as “quasi-federal.” This is no longer the case. At least going by the FC recommended resource transfers to States and the allocation of revenues between the two levels, India has evolved as a full-fledged federation.

Figure 7.3 Post-transfer Revenues of the Union and States (percentage of GDP)



Source: RBI DBIE; Union Budget

FC-5 covers period from 1970-71 to 1973-74; FC-15 covers period from 2020-21 to 2023-24

Two Issues

7.26 During its consultation with various stakeholders, this Commission came across two issues that it considers worthy of careful attention. First, it has been contended that the States have not been receiving their full share of the divisible pool recommended by FCs. For instance, tax revenues devolved during the FC-15 award period fall short of 41 per cent of the divisible pool which was recommended by the FC-15 and accepted by the Union Government. Second, while successive FCs have recommended increasing the share of the States in the divisible pool, this has not led to an increase in the overall resources of the States due to offsetting actions by the Union Government consisting of increased cesses and surcharges and reduced grants and transfers. Because the devolution, as recommended by FCs and accepted by the Union Government has a Constitutional status, this Commission was concerned about the suggested discrepancy between the recommended and actual amounts and looked into the matter in detail.

Devolution: Recommended versus Actual

7.27 Because the Union Government must make the initial transfer of the States' share in the divisible pool based on the estimated size of the divisible pool, once the actual size of the divisible pool becomes known, a positive or negative discrepancy between the recommended and actual devolution may appear. However, our review of the prevailing practice and available data shows that adjustments to each year's devolution are made twice to ensure that no discrepancies remain. The Union Government makes the first adjustment once the actual figures on all taxes, the divisible pool, and devolution become available to it. And the second adjustment is made when the Comptroller and Auditor General (CAG) certifies the amount of divisible pool.

7.28 *Table 7.4* presents the full process of adjustments for fiscal years 2018-19 to 2022-23, the last year for which complete data are available. The first row in the table provides the devolution for a given fiscal year, say FY T, based on RE for tax revenue as reported in the FY T+1 budget. The second row reports the devolution due in FY T based on actual tax revenue as reported in the FY T+2 budget. The third row calculates the additional devolution due to States for FY T by subtracting the amount devolved based on RE tax revenue (Row 1) from the amount due based on actual tax revenue (Row 2). This adjustment gets made in FY T+2. The fourth row reports an additional, second adjustment made based on CAG certified data. This exercise takes place during FY T+3. The fifth row reports the divisible pool as certified by CAG. True devolution due to States, shown in the sixth row, is 0.42 times the divisible pool in the fifth row for years 2018-19 and 2019-20, as per the FC-14 recommendation, and 0.41 times the divisible pool for the remaining years as per the FC-15 recommendation. The last row reports the final devolution to the States, which exactly matches the devolution due in the sixth row.

7.29 For completeness, we note that before 2018-19, whereas the first adjustment used to take place as described above, the second, CAG adjustment took place only once in ten years. Our calculations for years 2010-11 to 2017-18, not reported here, show that on a net basis, after the first adjustment, the Union Government paid the State Governments ₹15,756 crores more than what was due based on the CAG-certified divisible pools and the corresponding FC-recommended shares of States for these years. According to the Ministry of Finance, this gap has been settled by recording the excess amount as payment due on certain services that the Union Government had received from the States during these years.

7.30 The responsibility of ascertaining and certifying net proceeds which are to be shared between the Union and States is entrusted to the CAG by the Constitution. In the spirit of transparency and to put the concerns of States to rest, we recommend that, every year, the Union Government disclose the data pertaining to net proceeds as certified by CAG.

Table 7.4 Devolution to States: Due and Actual (₹ crore)

S. No.	Item	Source	2018-19	2019-20	2020-21	2021-22	2022-23
1.	States' share of FY T devolved based on RE tax revenue for FY T	Annex 4B/10B of Receipt budget (FY T+1)	7,36,880	7,14,889	5,94,988	8,19,637	9,48,406
2.	States' share of FY T due based on actual FY T tax revenue	Annex 4B/10B of Receipt budget (FY T+2)	6,78,036	6,83,353	6,15,841	8,53,107	9,72,204
3.	First adjustment: Additional devolution due (Row 2 - Row 1)	Annex 4B/10B of Receipt budget (FY T+2)	-58,843	-31,537	20,852	33,470	23,799
4.	Second Adjustment of FY T based on CAG Certified numbers: Additional devolution due	Annex 4A/10A of Receipt budget (FY T+2)	31,508	-677	-863	-16,647	-1,199
5.	Net proceeds (divisible pool) of FY T as certified by CAG	CAG certificate	16,89,390	16,25,418	14,99,946	20,40,146	23,68,305
6.	Devolution as per FC recommendations	FC calculation based on FC recommended share of States 42 or 41 per cent of (5)	7,09,544	6,82,675	6,14,978	8,36,460	9,71,005
7.	Final devolution amount of FY T after all adjustments	FC calculation (2) + (4)	7,09,544	6,82,675	6,14,978	8,36,460	9,71,005

Source: As shown in the second column of the table

FC Transfers to States Relative to the Gross Tax Revenue

7.31 During our visits, a large majority of the States made the point that the rising cesses and surcharges and, therefore, the shrinking divisible pool as a proportion of GTR have substantially wiped out the large increase in FC devolution to States recommended by the FC-14. It may be recalled that the FC-14 had recommended increasing the share of the States in the divisible pool from 32 per cent to 42 per cent. This issue is of critical importance, requiring a detailed examination.

7.32 *Table 7.5* presents the States' shares in the divisible pool, FC grants, and total FC transfers as percentages of GTR from 2010-11 to 2023-24. These years covers the award periods of the FC-13, FC-14 and FC-15. GTR represents the sum of all Union tax revenues including cesses and surcharges. Therefore, the percentages in *Table 7.5* show the States' shares in the Union tax revenues inclusive of cesses and surcharges.

Table 7.5 Devolution and FC Grants (percentage of GTR)

Year	Devolution to States	FC Grants to States	Total FC Transfers
(1)	(2)	(3)	(4) = (2) + (3)
2010-11	27.7	4.0	31.7
2011-12	28.8	4.9	33.7
2012-13	28.1	4.4	32.5
2013-14	27.9	4.7	32.6
2014-15	27.1	5.1	32.2
Average (FC-13)	27.9	4.6	32.5
2015-16	34.8	5.8	40.6
2016-17	35.4	5.6	41.0
2017-18	31.5	4.8	36.3
2018-19	35.9	4.5	40.4
2019-20	32.4	6.2	38.6
Average (FC-14)	34.0	5.4	39.4
2020-21	29.4	9.1	38.5
2021-22	32.6	7.7	40.3
2022-23	31.1	5.7	36.8
2023-24	32.6	4.3	36.9
2024-25RE	33.9	3.4	37.3
2025-26BE	33.3	3.1	36.4
Average (FC-15)	32.1	5.5	37.6

Source: Annexure 7.1

7.33 Consider first the evolution of the devolution to States as a percentage of GTR. From a 27.1-28.8 per cent range during the FC-13 award period (2010-11 to 2014-15), this share jumped to a 31.5-35.9 per cent range during 2015-16 to 2019-20 (FC-14 period). During the subsequent years (FC-15 period), it slid down to the 29.4-33.9 per cent range. In terms of the average over the life of each commission, devolution experienced an upward jump by 6.1 per cent of GTR during the FC-15 award period over that under the award period of the predecessor Commission. Then, during the FC-15 award period, devolution fell by 1.9 per cent of GTR. Therefore, there has been a partial dilution of devolution to States during the FC-15 award period over the FC-14, though its average level remains above the FC-13 award period by 4.2 per cent of GTR.

7.34 FC grants during the FC-15 increased by 0.1 per cent of GTR over the FC-14 award period. This led to a narrowing of the shortfall in the total FC transfers between the last two FCs to 1.7 per cent of GTR. In summary, FC devolution plus grants averaged 32.5 per cent of GTR during the award period of the FC-13, 39.4 per cent during the FC-14, and 37.7 per cent of GTR during the FC-15. Therefore, as far as FC transfers are concerned, the boost to them by the FC-14 has been substantially, even if not fully, preserved over the last ten years.

7.35 Before concluding this section, we note that while the claim that increased cesses and surcharges have almost wiped out the increase in the devolution recommended by the FC-14 is unsupported by data, it is true that the devolution as a percent of GTR during the award period of even the FC-14 did not rise as much as it would have had cesses and surcharges not risen as a proportion of GTR. But since cesses and surcharges as a proportion of GTR did rise, the divisible pool as a proportion of GTR ended up shrinking from 89.2 per cent of GTR during the award period of the FC-13 to 82.1 per cent during the award period of the FC-14. This trend of shrinking share of the divisible pool in GTR continued during the FC-15, with the share averaging 78.3 per cent during its award period. The decline resulted in a further fall in the devolution as a percent of GTR though it remained well above its level during the award period of the FC-13.

Views of the State Governments

7.36 States have overwhelmingly pitched for an increase in the States' share in the divisible pool from 41 per cent to 50 per cent. As many as eighteen out of the twenty-eight States have made this recommendation. Exceptions include Sikkim [40 per cent with the divisible pool expanded to the Union's Gross Revenue Receipts (GRR) or 50 per cent with the divisible pool including cesses, surcharges and cost of collection beyond 20 per cent of GTR], Madhya Pradesh (48 per cent if the divisible pool includes the entire GTR and 40.7 per cent if it includes the entire GRR), Nagaland (48 per cent), Assam (45 per cent), and Himachal Pradesh (41 per cent). States argue that the Constitution has assigned a proportionately larger expenditure responsibility to States, particularly in sectors such as health, education, agriculture, drinking water, sanitation, welfare, and law and order. To discharge these responsibilities, they need more resources.

7.37 A majority of States have also raised concerns regarding the increasing share of cesses and surcharges in GTR, as they are not a part of the divisible pool. Many submissions – including those from Gujarat, Karnataka, Kerala, Madhya Pradesh, Tamil Nadu and Uttar Pradesh – highlighted the declining share of the divisible pool in the gross tax revenues of the Union and proposed measures to counter this trend. The measures included: (i) inclusion of cesses and surcharges in the divisible pool; (ii) capping their share as a percentage of gross tax revenue and transferring any amount above that cap to the divisible pool; and (iii) compensatory enhancement of States' share in the divisible pool if these levies remain excluded.

7.38 Among other suggestions on cesses and surcharges, Telangana has recommended transferring them to a non-lapsable “Infrastructure Development Fund for Backward States,” while Madhya Pradesh has advocated a Constitutional Amendment requiring the Union Government to obtain ratification by at least 50 per cent of States to introduce any new cess or surcharge, as well as maintain the existing ones. Uttar Pradesh has proposed that cesses and surcharges be subject to a review, once the objective of the levy has been served.

7.39 In addition to tax revenues, several States, including Karnataka, Rajasthan, Gujarat, Tamil Nadu, West Bengal, Kerala, Tripura, and Madhya Pradesh, have proposed the inclusion of certain non-tax revenues of the Union Government in the divisible pool. These include revenues from the sale of natural resources such as spectrum and offshore oil, dividends from public sector undertakings, and proceeds from the monetisation of public assets. The argument made is that some of these resources originate from States or were deployed on State lands.

7.40 Some States, such as Tamil Nadu, Karnataka, and West Bengal, highlighted the need for greater fiscal flexibility in Union-to-State transfers. Recommendations include rationalisation or consolidation of CSS, increased Union contribution in CSS, and the substitution of specific-purpose schemes with untied grants. These suggestions were often linked to concerns about conditionalities and implementation flexibility in areas falling under the State List.

7.41 A final set of concerns by the States relates to the GST. Three such concerns are noteworthy. First, Karnataka, Kerala, Tamil Nadu, Telangana, and West Bengal have complained of a loss of fiscal autonomy. They argue that pre-GST, they could adjust the sales tax or VAT rates. However, under GST, they have lost this flexibility since any changes to the rates require GST Council approval. Tamil Nadu, Chhattisgarh, and Haryana contend that under GST, they have lost control over a large part of their tax base. Second, Tamil Nadu has complained about the lack of buoyancy of SGST, while Himachal Pradesh, Chhattisgarh, Gujarat, Haryana, Uttarakhand, and Punjab have argued that GST's destination-based nature shifted revenue to consuming States, resulting in a permanent loss of revenues. Finally, many States have noted that the cessation of transfers to States from GST compensation cess on 30 June 2022, has led to a sudden fiscal imbalance in their budgets, with Tamil Nadu reporting an estimated shortfall of nearly ₹20,000 crore in 2024-25. Several States, including Punjab and Uttarakhand, have noted that the guaranteed 14 per cent annual growth during the transition was unrealistic, with actual buoyancy of GST falling well short of it.

Views of the Union Government

7.42 In its memorandum, the Union Government expresses concern about the persistent fiscal imbalance in its budget and the tight fiscal space facing it. It notes that significant increases in vertical devolution recommended by the FC-7 and FC-14 were premised on providing States with more untied resources. However, these increases have had a lasting impact on the Union's fiscal space, leading to persistent revenue deficits. The Union argues that increased untied transfers aim to strengthen the fiscal autonomy of the States, but this has not always translated into sustained fiscal prudence on their part. At the same time, the Union has experienced a decline in its non-debt revenue resources. The Union's diminished fiscal space adversely impacts its ability to achieve national development goals. The Union calls for moderation in tax devolution (without suggesting a specific division) because it requires additional resources for defence modernization and prudent macroeconomic management. It argues that the current level of vertical devolution, where more than 49 per cent of the Gross Revenue Receipts (GRR) are estimated to be transferred to States, is not fiscally sustainable. It further states that a moderated vertical devolution would be adequate for fiscally prudent States to meet their development requirements.

7.43 As regards cesses and surcharges, the Union states that their exclusion from the divisible pool is by Constitutional design and has been upheld by successive FCs. Yet, States continue to argue for their inclusion, which is contrary to the Constitution. The Union views this as a settled issue and seeks an end to the debate on it.

7.44 The Union further argues that though not shareable, cesses often fund welfare and infrastructure schemes that benefit States. For instance, the Health and Education cess supports programmes like Samagra Shiksha and the PM POSHAN Scheme, while the Road and Infrastructure cess funds the Central Road and Infrastructure Fund (CRIF), part of which is allocated to States for development and maintenance of State Roads, among other things. The Agriculture Infrastructure and Development Cess (AIDC) supports agriculture-related schemes. In this way, cesses are often routed back to States via CSS and other schemes.

7.45 The Union contends that the concern that these levies shrink the divisible pool is frequently raised, but data suggests otherwise. Excluding GST compensation cess, cesses comprised 6.7 per cent of gross revenue during the FC-15 period - less than the FC-13's 7.0 per cent. Surcharges, too, though rising on income and corporate tax, remain within historical bounds. From the Union's perspective, says the memorandum, retaining cesses and surcharges allows quick, targeted fiscal responses, as seen during the COVID-19 crisis.

The Commission's Analysis

7.46 Both the States and the Union have made strong cases for their respective positions. The arguments offered by them require careful analysis.

Constitutional Considerations Regarding Non-Tax Revenues, and Cesses and Surcharges

7.47 Many of the recommendations by the States are not in accordance with the Constitutional provisions. The Constitution does not permit the sharing of non-tax revenues of the Union. Nor does it allow a cap on cesses and surcharges or their inclusion in the divisible pool. Regarding the CSS, there is certainly room for improvement in their design and implementation, but under Article 282 of the Constitution, any changes to them are the prerogative of the Union Government.

7.48 Is there a need to amend the Constitution, as would be required to implement these suggestions? This Commission's considered opinion is that the founding fathers had good reasons to include these provisions, and they have withstood the test of time. Following the design of the Government of India Act, 1935, which set the template for Union-State fiscal relations, the Constitution, in its original form, chose to limit mandatory devolution to income tax, while giving the Parliament the option to devolve a part of the excise duties. Later, when expanding the scope of devolution to all taxes with some exceptions, the 80th Constitutional Amendment once again did not consider bringing non-tax revenues into the divisible pool. One rationale for this exclusion is that the non-tax revenues come from Union-exclusive activities, such as defence production, telecom services, and central public sector enterprises (CPSEs).

7.49 As regards cesses and surcharges, the Constitution provides for them in recognition of the fact that the Union may be faced with emergencies such as war, famine, and pandemic. In such situations, it needs to raise revenue without being constrained in any way. Because the requisite amount of such revenue depends on the nature of the emergency and cannot be anticipated in advance, it would be imprudent to impose a cap on it.

7.50 An inclusion of cesses partially or wholly into the divisible pool will also conflict with the purpose of the cess itself. Cesses are earmarked for expenditures on specific heads. Therefore, their design effectively rules out the inclusion in the divisible pool unless it is levied for that purpose. However, in that case, cess can be replaced by a regular tax.

Higher Devolution to Counter Cesses and Surcharges?

7.51 This brings us to the States' suggestion on countering the increase in cesses and surcharges by a compensatory increase in the States' share in the divisible pool. The question this suggestion raises is whether a further shift in tax revenues in favour of the States is warranted. In this regard, the Commission is of the view that the current division of tax revenues, complemented by the FC and non-FC grants, gives the States sufficient resources to discharge their Constitutional responsibilities. The proliferation of transfers and subsidies by the States to various groups and for various causes in recent years suggests the existence of sufficient funds for developmental activities in their budgets.

7.52 From 2015-16 to 2023-24, the percentage share of the States in the total tax revenues has averaged 57.5 per cent (Chapter 3, *Figure 3.2*). In 2023-24, the latest year for which we have data, this share stood at 57 per cent. Resources at the States' disposal are significantly larger after we take into account FC and non-FC transfers to them. After all transfers to States are netted out, the Union Government's share in the nation's non-debt revenue resources during the FC-15 award period averaged 32.9 per cent (*Figure 7.1* in this chapter). This means that the States currently spend more than two-thirds of the nation's total non-debt revenues. Their share of 41 per cent in the divisible pool thus understates their overall access to non-debt revenue resources.

Lessons of Two Historical Episodes

7.53 When considering countering cesses and surcharges by an increase in the share of the States in the divisible pool, it is of critical importance to take into account the stress that this increase would generate on the Union finances, the shift in the Union's incentive to rely on the conventional tax instruments it would cause, and the response it would engender from the Union to shore up its fiscal space. Two historical episodes offer sobering lessons in this regard.

7.54 The FC-7 (1979-80 to 1983-84) recommended increasing the States' share in income tax from 80 per cent to 85 per cent and in the Union excise duties from 20 per cent to 40 per cent. As the excise duties constituted a large component of the Union revenues at the time, the jump in the States' share of them led to considerable stress on the Union's finances. Its share in the combined tax revenues of the Union and States went down from 55.3 per cent in 1978-79 to 48.6 per cent in 1979-80. This sharp decline led the Union Government to begin shifting its reliance from income tax and excise duties to customs duties and corporation tax, which did not form a part of the divisible pool. As a result, the combined share of income tax and excise tax in GTR fell from 43.7 per cent in 1978-79 to just 27.9 per cent in 1988-89. In the meantime, as a response to the declining share of the divisible pool in GTR, the FC-8 (1984-85 to 1988-89) raised the States' share in excise duties to 45 per cent.

7.55 It was this shrinking of the divisible pool as a percent of GTR that eventually led the FC-10 to recommend the 80th Amendment to the Constitution. In its report, the Commission argued that the significantly reduced shares had resulted in a loss of interest on the part of the Union Government in raising revenue from income tax and excise duties. To support this argument, it invoked the Ministry of Finance, which had argued, "If the Central Government wishes to raise ₹100 crores for itself through Union excise duties, it would have to raise around ₹182 crores. To get the same ₹100 crores through a personal tax yield, the Central Government would have to raise ₹667 crores."²

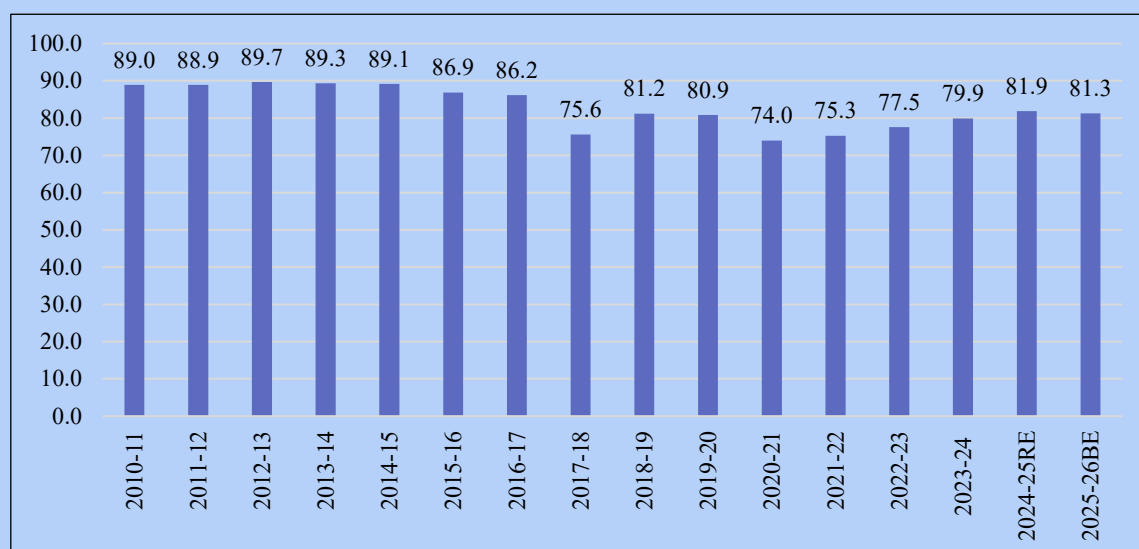
7.56 The FC-10 further cited the Chelliah Committee on Tax Reform to strengthen the case for the amendment. It noted that in its 1991 report, the latter had recommended fixing the share of States in aggregate central tax revenues at 25 per cent via a Constitutional Amendment. According to the Commission, the committee had argued, "There would be certainty then for the States and the Union regarding what revenues would accrue to their respective budgets and

² Report of the Tenth Finance Commission, chapter 13, paragraph 13.4, p. 59.

the Centre would not have to distort the pattern of taxation by being virtually compelled to raise non-shareable taxes.”³

7.57 The second episode relates to the FC-14. Like the FC-7, it recommended a large increase in the share of the States in the divisible pool from 32 per cent to 42 per cent. This generated stress on the Union’s finances, in response to which its share in majority of CSS to non-NEH States was brought down to 60 per cent immediately and the share of cesses and surcharges increased over time to meet development spending of the Union Government. Non-FC transfers to States, mainly through the CSS, fell from 22.4 per cent in 2014-15 to 16.4 per cent in 2015-16 and remained below that level for the remaining four years of the award period of the FC-14. Over time, cesses and surcharges expanded, with a corresponding shrinking share of the divisible pool in GTR, as shown in *Figure 7.4*.

Figure 7.4 Divisible Pool (percentage of GTR)



Source: CAG certificates from 2010-11 to 2023-24, Union Budgets for remaining years.

7.58 Economic efficiency argument dictates that reliance on cesses and surcharges as the sources of revenue except for short-term specific needs is undesirable. This is because efficiency is best served by broad-based taxation while cesses and surcharges are often applied to a narrow base: a specific commodity or a specific group of taxpayers. Reliance on cesses and surcharges for revenues in the long run also impedes tax reform. If the Union Government is raising a large part of its revenue from cesses and surcharges, it is likely to lose interest in the standard instruments of taxation, as noted by the FC-10 in the context of its recommendation for the 80th Amendment. The resulting neglect may adversely impact the efforts to raise revenue buoyancy of those instruments to the detriment of the States’ interests.

³ Report of the Tenth Finance Commission, Chapter 13, paragraph 13.10, p. 60.

Higher Devolution in Place of the CSS Transfers?

7.59 An argument is sometimes made that the Union's share in the CSS be passed on directly to the States in untied form through a higher devolution with the role of the CSS substantially reduced or even eliminated. The argument made in favour of this change is that the States are closer to the people and are in a better position to determine the needs of their people. The diversity of India and the different levels of development imply that the needs of different States are different. Therefore, the "one size fits all" CSSs do not make optimal use of the nation's development resources. The FC-14 had cited this among the motivations for recommending raising the States' share in the divisible pool from 32 per cent to 42 per cent. While none of the States has made this argument to the present Commission, given its salience among scholars and commentators, it is incumbent upon the Commission to address it.

7.60 The CSS have played a crucial role in the nation's development. While the dominant role of the States in development is fully recognized in the Constitution as well as by successive FCs, with fiscal resources progressively shifted towards them, in some critical development areas, the Union has led the way. Therefore, we are persuaded to maintain the status quo insofar as the issue of replacing the CSS transfers with increased devolution is concerned.

7.61 A different issue related to the CSS, raised by some States, concerns their rationalisation and consolidation, and greater flexibility for the States in implementing them. While the Commission has no direct role in the design and implementation of the CSS, it appreciates the value of regular evaluation and rationalization to pave the way for the discontinuation of schemes that are not performing as expected. It is also sympathetic to giving the States greater flexibility in choosing among different CSS since their needs differ considerably due to the differences in their levels of development and diversity in other dimensions. In Chapter 6, we recommend a High-Powered Committee to be appointed by the Union Government to carry out a fresh assessment of the schemes and recommend closure of the schemes that are not spending resources productively.

Higher Devolution to Counter the Adverse Effect of GST on the States' Revenues?

7.62 The case for increased devolution to States due to a reduction in their revenues or loss of fiscal autonomy following the adoption of GST raises two issues. First, if the adoption of GST did lead to a reduction in the States' revenues or autonomy, in all likelihood, it also led to a reduction in the Union's revenues or autonomy. The right solution to the problem is for the States and the Union to work jointly within the GST Council to reform the GST such that the revenue loss to both entities is reversed.

7.63 The second issue concerns the factual basis of the decline in the States' revenues following the adoption of GST. The GST was introduced on 01 July 2017. At the time, it was anticipated that there would be a period of adjustment to the new regime during which the States' revenues may decline. Therefore, under the GST compact, the States were guaranteed a 14 per cent growth in SGST revenues over the base year revenues yielded by the taxes that the GST came to replace for five years. This five-year period ended on 30 June 2022. In the meantime, the GST has achieved considerable stability and begun to generate significantly higher levels of

revenues. This full restoration of revenues is also reflected in the States' revenues. The rates of six-year and three-year averages of own tax revenue of States to GDP ratios ending in 2016-17 were 6.2 per cent and 6.1 per cent, respectively. In comparison, the same ratio has been 6.3 per cent in 2022-23 and 6.4 per cent in 2023-24. Therefore, the combined own-tax-revenue-to-GDP ratio of the States, which must be the basis of any shift in devolution shares, has not fallen following the adoption of the GST.

7.64 A decline in the ratio of own tax revenue to GSDP of an individual State following the adoption of GST is consistent with a lack of decline in the corresponding aggregate ratio. But such a decline cannot form the basis of an increase in the aggregate share of the States in the divisible pool. For the individual States, shortfalls in revenues are dealt with as a part of the State-level evaluation of revenues and expenditures by the Commission during its award period.

7.65 Finally, the issue of the loss of flexibility due to the GST decision being taken jointly by the Union and States in the GST Council is beyond the remit of the FC. However, we note that within its federal structure, the Indian Constitution provides for many such compromises in the larger national interest. The existence of the FC itself is an example of such a compromise. In the opinion of this Commission, GST too will emerge as a similarly outstanding example.

The Union's Case

7.66 Though the Union has made no explicit submission regarding a shift in the share of the divisible pool in its favour, it has emphasized the need for a larger share of the nation's revenues. There is no doubt that the recent shifts in the external security and defence environment call for increased capital expenditures on defence. The Union has also shown a high degree of effectiveness in building the nation's infrastructure, an effort that must be supported with more financial resources.

7.67 The only instrument available to the Commission to assist the finances of the Union is the share in the divisible pool. With cesses and surcharges having cut the size of the divisible pool from 89.1 per cent of GTR in 2014-15 to a 74-80 per cent range during the first four years of the FC-15 award period for which actuals are available, there is no room for cutting the States' share in it. The Commission is of the view that if an efficient and broad-based system of taxation is to be put in place, a grand bargain would have to be struck between the Union and States in which the Union would agree to fold a large part of the revenue from cesses and surcharges into regular taxes and States would agree to a smaller share in the resulting larger divisible pool, with no loss of revenues to either side.

Recommendation

7.68 Presently, for its award period, the Commission recommends retaining the States' share in the divisible pool at its current level of 41 per cent.

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SHARING OF TAX REVENUES: HORIZONTAL DEVOLUTION

8.1 Horizontal devolution refers to allocating the portion of divisible pool assigned to States among individual States. Like any exercise involving the distribution of a fixed pie among numerous claimants, this is a challenging task for Finance Commissions (FCs). Any increase in the share of one State over what the previous FC awarded implies a reduction in the share of one or more of the other States. Each State also has a perception of its fair share in the pie, based on its own unique circumstances, and views the award of a smaller share as unfair. However, the sum of these perceived shares across all States exceeds one. Recognizing these challenges, FCs have generally based their recommendations on a set of transparent criteria originating in equity and efficiency, though not to every State's full satisfaction.

Equity and Efficiency as Guides to Horizontal Devolution

8.2 The equity objective seeks to equalize the availability of public services across States. Two key factors leading to inter-State inequities in the provision of public services are differences in: i) available revenue resources, and ii) production costs of those services. Equity-based devolution criteria aim to compensate for both sources of differences. Devolutions based on per capita income distance address the differences in revenue resources. Area-based allocation is an example of devolution based on cost differences.

8.3 The efficiency-based criteria seek to encourage healthy revenue growth and fiscal stability. To the extent that revenue growth depends on Gross State Domestic Product (GSDP) growth, these criteria may also include incentives for growth. Rewarding efficiency is important since purely equity-based devolution undermines incentives for States to raise their own revenues or spend the available revenues prudently. For example, if a State is convinced that grants by the Union will cover any gaps between its expenditures and revenues, it is likely to slack off in raising its own revenues and may also turn profligate in its expenditures.

8.4 Equity and efficiency need not conflict, but they may. For an example of harmony between the two objectives, consider the case of a public service, such as health, provided by the State Government. Other things being the same, the lower per capita income States are able to raise less revenue of their own on a per capita basis than higher per capita income States. Therefore, with equal per capita devolution out of the States' share in the divisible pool, the lower per capita income States are able to provide health services at a lower level than the higher per capita income States. This difference implies that the marginal benefit of health expenditures in lower per capita income States exceeds that in higher per capita income States. It follows that a shift in revenue from high per capita income States to low per capita income States on the margin would yield a higher overall benefit from health services.

8.5 Another channel through which equalizing revenue devolution can contribute to efficiency is disincentivizing costly inter-state migration. In the absence of such devolution, higher per capita income States would provide public services such as health and education at a higher level than lower per capita income States. This difference would encourage migration from the latter to the former States. By eliminating the difference, equalising transfers would eliminate the incentive for such migration.

8.6 However, pursuing equity in devolution may also undermine the allocative efficiency of revenue resources. If the expectation that revenue transfers from Union taxes would compensate for all revenue deficiency leads the lower per capita income States to slack off on their revenue efforts, then the net effect of equity-driven devolution on the provision of public services will turn negative. This consideration has led FCs to generally include some efficiency-driven criteria in their devolution formulae.

8.7 An alternative classification of horizontal devolution criteria divides them into need-based, cost-disability-based, and efficiency or performance-based categories. This scheme includes population under need-based criteria; area and infrastructure distance under cost-disability criteria; and tax effort and fiscal stability under efficiency-based criteria. This classification can be subsumed under the one based on equity and efficiency, since need-based and cost-disability-based criteria can be included under equity.

Limits to Achieving Equity

8.8 At the outset, it is important to appreciate that multiple factors limit the ability of tax devolution to achieve full equity in the provision of public services across States. First, in addition to current expenditures, the ability to provide public services also depends on past investments in public assets such as schools, colleges, hospitals, roads, and human capital. With the limited fiscal resources available for devolution and grants during its award period, the FC must take the differences in these investments as given, and it cannot neutralize inequities resulting from them except marginally.

8.9 Second, to the extent that own-tax and non-tax revenues of States are large relative to the States' share in the divisible pool and feasible grants out of the Consolidated Fund of India,

FC is limited in its ability to bring about full equity into the States' capacity to provide public services. In effect, the differences arising from the States' own revenue resources may be too large for FC transfers to eliminate them through devolution and grants.

8.10 Third, even if the previous two factors are absent, and FC has sufficient financial resources to devolve, it is limited in its ability to fully equalize the capacity to provide public services due to a lack of data to meaningfully measure the differences in the costs of their provision across States. The costs of providing public services vary across States due to numerous geographical, environmental, social, and cultural factors. Per capita costs of providing public services in hilly States are significantly higher on average than those in the plains, and even within these groups, these costs differ significantly. Credible data is unavailable to measure these differences in the costs of providing public goods.

8.11 Fourth, economic and political economy constraints limit the extent to which FCs can allocate revenues and grants unevenly across States to equalize their capacities to provide public services. Economic constraints result from the possible adverse effects of the uneven distribution of the divisible pool and grants on efficiency, growth, and future revenue generation. Political economy considerations may arise from a sense on the part of some States that they have been denied their 'fair' share of tax revenues. These considerations partially explain why past FCs have avoided devolving tax revenues or awarding grants purely on equity grounds and have given some consideration to efficiency-based criteria such as tax effort and fiscal discipline. Indeed, recognising that equal per capita allocations are often viewed as 'fair', the earlier FCs had relied on population as the principal devolution criterion. The political economy constraint additionally sheds light on why the successive FCs have generally been careful not to alter the allocations made by their immediate predecessor FCs by wide margins.

8.12 Finally, even if no constraint on the FC's ability to allocate tax revenues and grants existed, it could only equalize the States' *capacity* to provide public services across States. Ultimately, the political leadership decides how the State's fiscal resources are allocated to different expenditure heads. These decisions can result in differences in the availability of public services, even when no differences exist in the *capacities* of States to provide them. In the same vein, differences across States may also arise due to differences in the governance efficiency in translating expenditures into outcomes.

8.13 Continuing differences in the provision of public services across States highlight the importance of these factors. While FC allocations of tax revenues have helped arrest the inequalities in revenue expenditures across States over the past several decades, eliminating those inequalities remains a distant goal. Nevertheless, even if substantial inequities in the States' capacities to provide public services remain, after growth accelerated and began delivering significantly larger volumes of total revenues, States have been able to raise their capacities to provide public services to higher levels and at a faster pace.

8.14 Therefore, even though horizontal devolution's power emanates from the high priority it assigns to equalization, insofar as this power depends on the magnitude of revenue resources

available for devolution, efficiency of taxation and expenditure can hardly be ignored. Indeed, the efficiency assumes even greater importance since it is at the heart of growth acceleration. Rapid improvements in infrastructure, education, health and skills are just as important as their balanced development across States.

8.15 We next provide an evaluation of the criteria the past FCs have deployed to allocate the States' share in the divisible pool among the States.

Equity-Based Criteria of Horizontal Devolution

8.16 We divide the discussion of devolution criteria applied by past FCs into those primarily aimed at achieving equity, and those that target efficiency. In principle, almost all criteria impact both equity and efficiency. As such, the classification is only suggestive and not watertight.

Population

8.17 This criterion divides a portion of the States' share of the divisible pool in proportion to each State's share in the total population of all States. For example, if 20 per cent of the States' share in the divisible pool is devolved based on population, a State having 5 per cent of all States' population receives 5 per cent of 20 per cent of the States' share in the divisible pool. This calculation translates into the State receiving 1 per cent of States' share in the divisible pool.

8.18 If the per capita costs of public services were constant regardless of scale and were identical across States, devolving 100 per cent of the States' share in the divisible pool, based on population shares, would equalize the per capita capacity to provide public services across States. But neither of these assumptions is valid. Other things being the same, the larger the population, the lower the per capita cost of public service provision. Likewise, the cost of provision of public services for a given size of population varies across States according to area (cost is higher in the State with larger area), terrain (cost is higher in hilly regions), past investments in infrastructure, schools, hospitals, and human capital, and other similar factors.

8.19 If the more populous States have lower per capita incomes (or a higher incidence of poverty), even an equal per capita tax revenue allocation can lend the distribution of tax revenue some progressivity. This is because of the economies of scale in the provision of public services. Other things being the same, a more populous State can provide a given level of public service at a lower cost. Alternatively, a State with larger population can provide the public service at a higher level with the same per capita tax revenue.

Area

8.20 The area gives rise to differences in the costs of providing public services between States. *Ceteris paribus*, the per-person cost of public service in a State with twice the area, but the same population as another State, is higher. To compensate for this cost disability, beginning

with the Tenth Finance Commission (FC-10), FCs have devolved a part of the States' share in the divisible pool according to the States' respective shares in the total area across all States.

8.21 As conventionally applied, the criterion allocates the devolved funds in direct proportion to each State's share in the total geographical area of all States. A State twice as large in area as another State receives twice as much as the latter, and a State thrice as large receives thrice as much. Empirically, the per capita cost of the provision of public services may vary, not linearly as assumed by this allocation rule, but at a diminishing or an increasing rate. However, FCs have not investigated this relationship and adopted the practical assumption of linearity in the implementation of the criterion.

8.22 It has not been generally recognized that, in terms of per capita allocation, this criterion is equivalent to an inverse-population-density criterion. Area divided by population is the inverse of the population density. The higher the population density of a State, the lower its allocation per capita according to this criterion. This interpretation makes it further transparent that the criterion is designed to correct for the cost disability from the higher per capita cost of provision of public services due to a greater dispersion of population.

8.23 According to the Census 2011, the population density in India varied from 16.5 persons per square kilometre to 1105.5 persons per square kilometre. The ratio of these two population densities is 67. Therefore, per capita devolution according to this criterion to the State with the lowest population density is 67 times that of the State with the highest population density.

8.24 This interpretation also throws new light on the implications of the assignment of a minimum of 2 per cent share under area criterion to each State by recent FCs for equity. To explain, consider two States with identical population densities, but one having a 2.1 per cent share in the total area and the other having a 0.2 per cent share. Applied without modification of area, the criterion would award each State equal per capita allocation. However, replacing the smaller State's share by 2 per cent would mean cutting its population density to one-tenth of its original level, and result in an allocation ten times that of the larger State in per capita terms.

8.25 There is another side effect of the assignment of a minimum 2 per cent share to each State. As many as twelve States in India, jointly accounting for 11.3 per cent of the total area of the twenty-eight States, have less than a 2 per cent share each in the total area. While the modification has the intended effect of benefiting the smaller States, it also has the unintended consequence of taking away 12.7 per cent (i.e. 24 per cent *minus* 11.3 per cent) of the total area from the remaining sixteen States. Such a large loss of area undermines the objective of compensation for the cost disadvantage associated with a large area that the criterion is designed to promote.

Inverse Per Capita Income Criterion

8.26 Over the years, FCs have devolved a part of the States' share in the divisible pool based on per capita income in two forms: inverse per capita income and the distance of per capita

income from a benchmark level of per capita income. In the latter case, benchmark level of per capita income is generally represented by the per capita income of the highest per capita income State among the large States. In each case, the objective is to allocate a larger revenue per capita, the lower the State's per capita income. However, the two criteria generally lead to different allocations to the States.

8.27 The idea is based on the hypothesis that States can raise equal revenue per rupee of income with equal tax effort. This implies that despite equal tax effort, States with lower per capita income have a lower capacity to raise revenue per capita than States with higher per capita income. Therefore, if fiscal capacity equalization is the goal, States with lower per capita income must receive more revenue per capita through devolution than those with higher per capita income.

8.28 One approach to achieving this objective is to make the per capita allocation to a State proportionate to the inverse of its per capita income. Under this approach, the State's share in the total transfer of tax revenue equals the inverse per capita income weighted population, divided by the sum of the inverse per capita income weighted population across all States.

Per Capita Income Distance Criterion

8.29 An alternative approach to making devolutions progressive, relative to the population criterion, is to base a State's per capita allocation on the distance between a fixed benchmark per capita income and that State's per capita income. Conventionally, FCs have proxied the benchmark per capita income to that of the highest per capita income State among large States, mostly Punjab until 2001-02 and Haryana thereafter. Under the criterion, the lower a State's per capita income, the greater the distance between the benchmark per capita income and its own, and the greater is the per capita allocation of revenues to it. Stated precisely, this criterion sets the share of a State in the tax revenue devolved equal to the ratio of its per-capita-income-distance-weighted population to the sum of the per-capita income-distance-weighted population of each State.

8.30 The progressivity of allocations under the per-capita-income-distance criterion can be enhanced by excluding the States that lie nearest to the top of the per capita income distribution. For example, we may exclude the States with per capita income in the eightieth or higher percentile. The Fifth Finance Commission (FC-5), which first introduced the per-capita-income-distance criterion, deployed a version of this formulation. It excluded States with per capita incomes exceeding the average per capita income across all States and allocated per capita revenue in proportion to the shortfall of the State's per capita income from the average per capita income across all States.

8.31 The Seventh Finance Commission (FC-7) introduced the inverse per capita income criterion. However, the FC-10 chose to drop it in favour of the per-capita-income-distance criterion. It reasoned that, whereas the distance from the benchmark per capita income is linear in per capita income, inverse per capita income is convex over the positive range. It went on to

note that, "... Compared to the distance formula, in the inverse income formula, owing to the implicit convexity in it, the middle-income States have to bear a relatively higher burden of this adjustment"¹.

Poverty

8.32 FC-7 and the first report of the Ninth Finance Commission (FC-9) used poverty as a criterion of horizontal devolution. States with a higher incidence of poverty were awarded a larger revenue per capita. However, this criterion proved controversial due to a mismatch between available poverty estimates and States' own perceptions of poverty faced by them relative to other States. As a result, even the FC-9 dropped this criterion in its second and final report, noting, "...Several States did not approve of the introduction of the index of population below the poverty line in the devolution formula. They felt that State-wise data on the number of poor people below the poverty line were not statistically reliable. ... Since even the backward States such as Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh (UP) did not favour the use of the criterion of people below the poverty line in the devolution formula, we have decided to drop it"². Subsequent FCs have not revived the deployment of this criterion. Interestingly, however, some States have recommended to the present Commission to consider basing a part of its devolution on NITI Aayog's Multi-dimensional Poverty estimates.

Indices of the Level of Development

8.33 In the early decades, some FCs used different indicators of the level of economic development (or 'backwardness', a commonly used term at the time), including infrastructure index. Once again, the objective was to allocate more revenue resources, in per capita terms, to the less developed (more backward) States. In most cases, FCs did not specify how they quantified the development features they noted in the texts of their reports, though in some cases, they did. For example, the FC-9 evolved an index of backwardness comprising "... A combination of two indices, namely, population of Scheduled Castes (SC) and Scheduled Tribes (ST) and the number of agricultural labourers in different States, as revealed in the Census for 1981"³. The FC-10 used an index of infrastructure reflecting "... the relative achievement of a State in providing an economic and social infrastructure to its citizens."⁴ and specified the index so constructed along-with the methodology used to derive it. The Eleventh Finance Commission (FC-11) was the last to use an indicator in this category, an infrastructure index, which it did quantify.

Efficiency-Based Criteria of Horizontal Devolution

8.34 Some consideration to efficiency has been given, beginning as far back as the First Finance Commission (FC-1). The FC-1 devolved 20 per cent of the States' share in income tax

¹ Report of the FC-10, paragraph 5.39, p. 23 and Appendix 4, pp. 171-75.

² Report of FC-9, paragraph 5.10, p. 19.

³ Report of FC-9, paragraph 5.10, p. 19.

⁴ Report of FC-10, paragraph 5.44, p. 24.

revenues based on the State's contribution to those revenues. Indirectly, the extent of the contribution depended on the State's income generation capacity, which in turn depended on the efficiency of resource use. Other efficiency criteria, such as forest cover, total fertility rate (TFR), tax effort, and fiscal discipline, have been added by more recent FCs. In our discussions with the States, the contribution to national gross domestic product (GDP) has also figured prominently. We briefly discuss these criteria in this section.

Forest Cover and Ecology

8.35 In recognition of growing concern for climate change, and the national importance of forests and ecology, the Fourteenth Finance Commission (FC-14) introduced the State's share in the total dense forest cover of all States as a criterion for devolution of a part of the States' share in the divisible pool. The principal argument for including this criterion is based on economic efficiency. Forests generate wider ecological benefits for the country, while imposing a net cost on the host State by depriving it of alternative uses of the forest land. Forest-area-based devolution thus provides the necessary incentive for conserving and expanding forests.

8.36 In India's special circumstances, the forest-area criterion also serves as a partial proxy for cost disability characterizing the northeastern and hilly (NEH) States. The hilly terrains lead to significantly higher costs of transporting goods and people, and of building physical infrastructure than in the plains. The NEH States also suffer from relatively poor connectivity to the rest of the country. Because the ten NEH States account for 33.4 per cent of India's dense forest area in 2021 but only 5.3 per cent of the population, on a per capita basis, the forest-area criterion awards them a significantly larger revenue than other States.

Total Fertility Rate

8.37 Introduced by the Fifteenth Finance Commission (FC-15), the TFR is the newest criterion deployed to allocate a part of the States' share in the divisible pool. The criterion rewards States for their efforts to bring down population growth. Because higher the TFR, the higher the population growth, States with high TFR receive low allocations and *vice versa*. More precisely, the share of a State in the total resources devolved, based on this criterion, equals that State's population weighted by inverse of TFR, divided by the sum of population weighted by inverse of TFR of each State.

8.38 In introducing TFR as a criterion for horizontal devolution, the FC-15 sought to partially offset the disadvantage that the shift to the 2011 Census from the 1971 Census in implementing the population criterion had brought to the States that had successfully arrested the growth rates of their populations. In the words of the Commission, "...After almost four decades, this Commission has been mandated to use the population data of the most recent Census. As mentioned earlier, some States had raised serious concerns regarding this. We feel that the use of the latest Census data, and sudden change of underlying data, should not unfairly put some

States which have performed well on the national objective of demographic management at a disadvantage”⁵.

8.39 The FC-15 classifies this criterion explicitly under ‘Performance-based Criteria’. As such, within the equity-efficiency framework, this criterion belongs under efficiency. However, consistent with the international discourse on the subject, the view that excessively low TFR, which is bound to lead to population aging, is to be resisted rather than encouraged has gained ground recently. There is now a growing concern about the country growing old before becoming rich.

Tax Effort and Tax Contribution

8.40 FC-10 was the first to use tax effort as a criterion for devolution, which was subsequently used by FC-11, FC-12 and FC-15. The rationale for including tax effort among devolution criteria is two-fold. First, if FCs establish a tradition of basing a part of the devolution on the tax effort, States would be incentivized to make a greater effort to raise their own revenue. Second, the criterion would reward States that have made a stronger effort at tax collection.

8.41 Tax effort is measured by the own tax revenue (OTR)-to-GSDP ratio, that is, tax revenue raised per rupee of GSDP. The more tax per rupee of GSDP a State collects, the greater is its measured tax effort. Under this criterion, per capita devolution is proportional to this measure of tax effort. A State’s share in the revenue devolved is equated to its population weighted by tax-to-GSDP ratio divided by the sum of each State’s population weighted by tax-to-GSDP ratio.

8.42 An alternative to this approach is to allocate revenue to each State in proportion to its share of the total OTR across all States. This approach is equivalent to allocating per capita revenue based on per capita tax revenue raised by the State. The State's share in the devolved revenue, under this criterion, equals its population weighted by per capita tax revenue, divided by the sum of population weighted by per capita tax revenue of each State. In this form, the criterion may be more appropriately described as a tax contribution (rather than tax effort) criterion.

Fiscal Discipline

8.43 The FC-11 first introduced fiscal discipline as a criterion for devolution to reward States for such discipline and incentivize them to improve upon it. It measured fiscal discipline by the extent of improvement a State made in the ratio of its own revenue receipts to its total revenue expenditure, relative to the improvement in a similar ratio for all States. The improvement was computed for a reference period over a base period. An improvement could result from a higher volume of own revenue, a lower revenue expenditure, or a combination thereof.

⁵ Report of the FC-15, paragraph 6.53, p. 162.

Horizontal Devolution by Successive Finance Commissions

8.44 We now review the history of horizontal devolution by successive FCs. For ease of exposition, we divide the discussion into three sections: the First to Seventh FC, the Eighth to Tenth FC, and the Eleventh to Fifteenth FC.

First to Seventh Finance Commissions: 1952-53 to 1983-84

8.45 The first seven FCs relied on only two criteria for horizontal devolution of the States' share in the Union income tax: i) population and ii) contribution to tax revenues. FC-1, FC-3 and FC-4 assigned 80 per cent weight to population, and FC-2, FC-5, FC-6 and FC-7 assigned 90 per cent. Tax contribution got the remainder of the weight in each case. In this scheme, the population served the cause of equity, while the tax revenue rewarded efficiency. *Table 8.1* summarizes the criteria applied by these FCs.

8.46 Regarding Union excise duties, the first FC relied exclusively on population shares as the criterion for horizontal devolution as seen in *Table 8.1*. FC-2 devolved 90 per cent of States' share in excise duties based on population and 10 per cent based on other adjustments. FC-3 also continued to base the devolution of these duties predominantly on population, but also considered, "... the relative financial weakness of the States, the disparity in the levels of development reached, the percentage of scheduled castes and tribes and backward classes in their population, etc."⁶. However, it did not explicitly spell out the relative weights of population and other criteria, nor did it explain how it measured them, providing only the final percentage shares of the States in the revenues devolved.

Table 8.1 Weights (percentage) of Different Criteria: First to Seventh FCs

	Income Tax		Excise Duty	
	Population	Tax Contribution	Population	Other
FC-1	80	20	100	0
FC-2	90	10	90	10
FC-3	80	20	Not specified	Not specified
FC-4	80	20	80	20
FC-5	90	10	80	20
FC-6	90	10	75	25
FC-7	90	10	25	75

Source: First to Seventh FC Reports

8.47 FC-4 was more explicit in assigning the weights to population and level of development. It devolved 80 per cent of the States' share in excise duties based on population, and 20 per cent based on the social and economic backwardness of the States as measured by variables such as per capita value added in agriculture and manufacturing, labour participation rates, the share of the rural population in total population, gross enrolment ratios in grades I to V, population per hospital bed, and the shares of SCs and STs in the total population. However, once again, FC-4

⁶ Report of FC-3, Chapter 4, paragraph 47, p. 22.

did not indicate how it quantified the indicators of development it had identified, reporting only the final allocations to different States out of the total share of the States in the Union excise duties.

8.48 The FC-5 also devolved 80 per cent of the States' share in Union excise revenues based on population. However, for the remaining 20 per cent, it argued, "...the States having less per capita incomes have lower potential for raising resources and are therefore placed at a disadvantage as compared to the States with higher per capita income"⁷. It concluded that it was reasonable that, "...some portion of the States' share should be distributed to States with per capita income less than the average of all States"⁸. The capacity to raise revenue is an equity consideration while contribution to tax revenue is an efficiency consideration. The FC-5, thus, introduced the State's revenue-raising capacity as a criterion for horizontal devolution for the first time. It also connected the revenue-raising capacity of the State to its per capita income. Every subsequent FC adopted these two innovations in one form or another.

8.49 The FC-5 devolved one-third of remaining 20 per cent of the States' share in Union excise duties based on an integrated index of backwardness among all States, and two-thirds according to a per-capita-income-distance formula. It restricted this latter allocation exclusively to States with below-average per capita income. It stipulated that this part of the States' share in Union excise duties "...should be distributed among States whose per capita income is below the average per capita income of all States *in proportion to the shortfall of the State's per capita income from all States' average, multiplied by the population of the State*"⁹. The phrase in italics represented yet another innovation by FC-5. It came to be known as the 'income-distance' criterion, with the vast majority of subsequent FCs adopting it in some modified form.

8.50 The Sixth Finance Commission (FC-6) set aside 75 per cent of the States' share in the Union excise duties for devolution based on population shares, and the remaining 25 per cent on "...the distance of a State's per capita income from that of the State with the highest per capita income multiplied by population of the State concerned according to 1971 census"¹⁰. This criterion was an extension of the income-distance criterion deployed by the FC-5 to include all States as beneficiaries. Rather than restricting the devolution to States with below-average per capita income, it included all States as beneficiaries. Only Punjab, the State with the highest per capita income, received zero allocation because its income distance from itself was nil.

8.51 Beginning with the FC-7, the weight assigned to population directly in horizontal devolution of States' share of Union excise revenues declined significantly, with equalizing criteria receiving larger weights. The FC-7 assigned a weight of 25 per cent to population. Of the remainder, it devolved 25 per cent based on population weighted by inverse per capita income, 25 per cent on the State's share in the total number of poor nationwide, and 25 per cent

⁷ Report of the FC-5, paragraph 4.12, p. 36.

⁸ Report of the FC-5, paragraph 4.12, p. 36.

⁹ Report of the FC-5, paragraph 4.12, p. 36.

¹⁰ Report of the FC-6, Ch IV, paragraph 16, p. 17.

on the revenue equalization principle. The first of these three criteria represented a variation on the income distance formula, allocating a larger revenue per capita to a State, the lower its per capita income.

8.52 In implementing its third criterion, the FC-7 first estimated each State's potential per capita revenue based on per capita GSDP and a common average level of tax effort. It then allocated 25 per cent of the States' share in Union excise duties in proportion to the population weighted by the distance between the highest estimated per capita revenue and the State's estimated per capita revenue. As the Eighth Finance Commission (FC-8) pointed out in its report, this criterion was equivalent to the income distance criterion¹¹.

Eighth to Tenth Finance Commissions: 1984-85 to 1999-2000

8.53 The Sixth and Seventh FCs had interpreted per capita income as an indicator of the level of development. However, like FC-5, the FC-8 returned to interpreting it as an indicator of revenue-raising capacity. To quote FC-8, "We are of the view that the distance of per capita income of States from the highest per capita income of any State, which is a well-accepted indicator of the relative backwardness of States, would also be a good indicator of the capacity of States to raise resources"¹². Given that the goal of progressive tax revenue allocations is to equalize the ability of States to provide public services rather than equalizing per capita incomes or the level of development across States, the interpretation of income distance as an indicator of the gap in revenue-raising capacity in the context of horizontal devolution is more appropriate. Unsurprisingly, this interpretation became conventional wisdom post FC-8.

8.54 The FC-8 unified the horizontal devolution criteria across income tax and Union excise duties. After setting aside 10 per cent of the States' share in income tax revenue for devolution based on contribution and 11.1 per cent of their share in Union excise duties for allocation exclusively to revenue-deficit States, it applied a common set of criteria to devolve the remaining share of States in income tax revenues plus the Union excise duties. It allocated 25 per cent of this revenue based on population shares, 25 per cent based on the inverse per capita income criterion, and 50 per cent according to the income-distance formula. To avoid allocating nil revenue to the State with the highest per capita income (Punjab) under the income-distance criterion, the FC-8 notionally assigned it the same distance as calculated for the State with the second-highest per capita income (Haryana). Notably, taking cognisance of several limitations of poverty estimates, FC-8 dropped it as a devolution criterion.

8.55 The FC-9, in its first report (applicable during 1989-90), allocated 25 per cent of the States' share in revenues from income tax and Union excise duties based on population share, 12.5 per cent based on inverse per capita income, 50 per cent based on per capita income distance and 12.5 per cent based on the proportion of poor population in the State. It devolved the States' share in revenues from income tax and Union excise duties differently in its second report

¹¹ Report of the FC-8, paragraph 6.35, p. 51.

¹² Report of the FC-8, paragraph 6.36, p. 52

(applicable to 1990-91 to 1994-95). It allocated 10 per cent of the income tax revenue based on contribution, 45 per cent based on income distance, 22.5 per cent on the population as per the 1971 Census, 11.25 per cent on a composite index of backwardness, and 11.25 per cent on the population-weighted inverse per capita income. Regarding Union excise duties, the FC-9 allocated 25 per cent based on population, 12.5 per cent on the inverse per capita income criterion, 12.5 per cent on an index of backwardness, 33.5 per cent on the income-distance formula, and 16.5 per cent on revenue deficit.

8.56 The FC-10 was the last Commission before the 80th Constitutional Amendment came into force, which brought all taxes into a single divisible pool. Because FC-10 had recommended what later became the 80th Constitutional Amendment, it is unsurprising that it returned to applying a common set of criteria to the devolving income tax and Union excise duties. Having set aside 15.8 per cent of the States' share in Union excise revenues for devolving to revenue-deficit States, it recommended allocating the remainder of the share in excise duties and the States' share in income tax revenue according to a common set of criteria. It assigned a 20 per cent weight to population, 60 per cent to population weighted by per capita income distance, 5 per cent to area, 5 per cent to an infrastructure index, and 10 per cent to tax effort. The FC-10, thus, introduced area as a criterion for the first time. *Table 8.2* summarises the allocation criteria and weights employed by the FC-8 to FC-10.

Table 8.2 Weights (percentage) of Different Criteria: Eighth to Tenth FCs

Criterion	FC-8*	FC-9* (First Report)	FC-9 (Second Report)		FC-10**
			Income Tax	Excise Duty	
Population Share	25	25	22.5	25	20
Inverse Per Capita Income	25	12.5	11.25	12.5	
Per Capita Income Distance	50	50	45	33.5	60
Proportion of Poor Population		12.5			
Tax Contribution			10		
Index of Backwardness			11.25	12.5	
Revenue Deficit				16.5	
Area					5
Infrastructure Index					5
Tax Effort					10
Total	100	100	100	100	100

Source: Eighth to Tenth FC Reports

Notes: *The weights in this column were applied to the States' share in income tax plus excise tax after taking out 10 per cent from the States' share in income tax for allocation according to tax contribution and 11.1 per cent out of the States' share in excise tax for devolution to revenue-deficit States.

**The weights in this column were applied to the States' share in the income tax plus excise tax after taking out 15.8 per cent from the States' share in excise revenues for devolution to revenue-deficit States.

8.57 We may summarise some highlights of the allocation criteria deployed by the first ten FCs (1952-2000). First, during the early decades, the FCs relied heavily on population as the basis for horizontal devolution. The first six FCs allocated 80 per cent or more of the States' share in income tax, and 75 per cent or more of their share in Union excise tax based entirely on population. During this phase, per capita devolutions were approximately equal across States, with only a small degree of progressivity based on the differences in the levels of development or per capita income.

8.58 Second, devolution became more progressive under the FC-7. With the States' share in Union excise revenues doubling from 20 per cent to 40 per cent under this FC, this source became a large proportion of the States' share in the divisible pool. Moreover, the FC-7 allocated 75 per cent of the States' share in Union excise revenues based on criteria that lent progressivity to the allocations.

8.59 Third, this shift was sustained and accelerated under the Eighth to Tenth FCs, with the devolution criteria across revenues from income tax and Union excise tax substantially unified, and the direct weight assigned to population falling to or below 25 per cent. Finally, by the FC-10, the income-distance criterion had emerged as the major source of progressivity in horizontal devolution.

Eleventh to Fifteenth Finance Commissions: 2000-01 to 2025-26

8.60 The 80th Amendment Act, 2000, was notified on 09 June 2000, and came into force retrospectively from 01 April 1996. Under it, all Union taxes and duties (except cess, surcharges, tax revenues belonging to the Union Territories) minus the cost of tax collection, became a part of the divisible pool. Therefore, beginning with the FC-11, a single set of devolution criteria disbursed the entire States' share of the divisible pool to the States. *Table 8.3* provides a summary of the criteria deployed by these five FCs.

Table 8.3 Weights (percentage) of Different Criteria: Eleventh to Fifteenth FCs

Criterion	FC-11	FC-12	FC-13	FC-14	FC-15
Population (1971)	10	25	25	17.5	
Population (2011)				10	15
Area	7.5	10	10	15	15
Income Distance/Fiscal Capacity	62.5	50	47.5	50	45
Index of Infrastructure	7.5				
Forest				7.5	10
Total Fertility Rate					12.5
Tax/Fiscal Effort	5	7.5			2.5
Fiscal Discipline	7.5	7.5	17.5		
Total	100	100	100	100	100

Source: Eleventh to Fifteenth FC Reports

8.61 Under the last five FCs, the income-distance criterion, with its progressive tilt, has been the basis of horizontal devolution of 45 per cent or more of the divisible pool. In addition, population, area, and infrastructure index also lean towards equity in varying degrees. Therefore, each of these five FCs has disbursed 75 per cent or more of the divisible pool based on equity. Forest cover is an efficiency-based criterion, but it also carries an element of equity ex-post since the seven northeastern States accounted for 25.4 per cent of India's dense forest area in 2021, but only 3.8 per cent of the population as per the 2011 Census. Madhya Pradesh and Chhattisgarh together accounted for another 20.7 per cent of the forest area and 8.3 per cent of the population. The remaining three criteria - total fertility rate, tax effort, and fiscal discipline - are efficiency-based but have accounted for the devolution of a relatively small proportion of the divisible pool.

State-wise Shares: Eleventh to Fifteenth Finance Commissions

8.62 Next, we consider the shares of different States in the total share of all States in the divisible pool under the Eleventh to Fifteenth FCs. As a preliminary point, it is important to note that the States' shares are impacted not only due to shifts in the devolution criteria applied, but also because of the changes in the values of underlying parameters. For instance, the per capita income distance of a State under the FC-15 was not the same as under the FC-14 because the per capita incomes of the States in the base years relevant to the former were different than those for the latter. In fact, analysis done by this Commission shows that, even if we were to retain the exact same criteria and associated weights as the FC-15, the States' shares shift significantly due to the updation of underlying data.

Non-Northeastern and Hilly States

8.63 *Table 8.4* shows the shares of non-NEH States, classifying them into high, middle, and low per capita GSDP States, and listing them in order of declining per capita GSDP in current rupee terms in 2023-24. We also include the population shares across all States (inclusive of Jammu & Kashmir) as per the 2001 and 2011 Censuses, the former for comparison with devolutions by FC-11 and Twelfth Finance Commission (FC-12), and the latter for comparison with devolutions by Thirteenth Finance Commission (FC-13) to FC-15. For FC-15, precision requires recalculating the 2011 census share by excluding Jammu & Kashmir, but we eschew it to avoid making the data unwieldy. Until the end of FC-13, Andhra Pradesh and Telangana formed a single State. Therefore, the 2011 population share of the undivided Andhra Pradesh should be obtained by adding the shares of the component States shown in the *Table 8.4*. Finally, the ideal comparison would be with the population shares during the award period, but given their wider acceptance, we opt for Census figures.

8.64 Devolution based solely on population would award each State a share equal to its share of the population. Under this scheme, each State would receive the same amount per capita. Therefore, comparing the devolution share of a State shown in *Table 8.4* for a given State with

its population share allows us to assess whether it got more than, equal to, or less than the per capita amount devolved nationally. Such a comparison in the light of the information on per capita GSDP levels also allows us to gain insight into the degree of progressivity of the devolutions relative to equal per capita revenue allocation.

8.65 *Table 8.4* lists eight States under the high per capita GSDP category, seven under the middle per capita GSDP category, and three under the low per capita GSDP category. Each State in the first category had a per capita GSDP of 70 per cent of GSDP per capita of Telangana or higher, the highest per capita GSDP State among the large non-NEH States in 2023-24. Taken together, these eight States accounted for 33.7 per cent of the population in 2011 but had shares in the 21.2 to 23.7 per cent range in the devolution under the five FCs (FC-11 to FC-15). The three States in the third category had per capita GSDP of less than one-third of Telangana in 2023-24. Together, they accounted for 28.3 per cent of the population in 2011 and had a share in the 30.8 to 34.4 per cent range in the devolution under the five FCs. Therefore, the devolutions have had a progressive tilt under all five FCs relative to equal per capita shares.

8.66 *Table 8.5* makes the comparison of devolution share with its population share explicit by reporting the ratio of the former to the latter. For the devolution shares under the FC-11 and FC-12, we use the population shares from Census 2001, and for those under the FC-13, FC-14, and FC-15, we use the population shares from Census 2011. For the FC-15, the shares in *Table 8.5* are calculated after recalculating the 2011 population shares, with Jammu & Kashmir excluded.

8.67 If a State's share in devolution happens to coincide with its share in population, the ratio shown in *Table 8.5* would be exactly one. In this case, the State receives a per capita devolution equal to the per capita amount devolved in aggregate. If the ratio is less than one, the State receives a smaller amount per capita than the per capita amount devolved in aggregate. If the ratio is more than one, the State receives a larger amount per capita than the amount devolved in aggregate. An allocation pattern would be considered progressive relative to equal per capita amounts devolved across all States if the ratio is less than one at the top end of income distribution and if it rises as we move to poorer States.

8.68 Among the eight high per capita-GSDP non-NEH States, Goa was the only one to receive a larger share in devolution than its share in population under all five FCs. It received more than three times the overall devolution in per capita terms under the FC-14 and FC-15. Haryana, which has served as the benchmark State for the calculation of the income-distance beginning with the FC-11, stands out for its consistently low per capita devolutions relative to the overall devolution per capita. On the other hand, Telangana, Karnataka and Kerala saw a sharp decline in their relative per capita devolutions under the FC-15 over that under the FC-14. Relative per capita shares of Haryana and Tamil Nadu remained virtually unchanged, while those of Gujarat and Maharashtra saw a modest rise.

Table 8.4 Population and Devolution Shares under the Eleventh to Fifteenth FCs: Non-NEH States

States	Population Share (2001)	FC-11	FC-12	Population Share (2011)	FC-13	FC-14	FC-15
High per capita GSDP							
Goa	0.13	0.21	0.26	0.12	0.27	0.38	0.39
Telangana	-	-	-	2.94	-	2.44	2.10
Karnataka	5.22	4.93	4.46	5.13	4.33	4.71	3.65
Haryana	2.09	0.94	1.08	2.13	1.05	1.08	1.09
Tamil Nadu	6.17	5.39	5.31	6.06	4.97	4.02	4.08
Gujarat	5.01	2.82	3.57	5.08	3.04	3.08	3.48
Maharashtra	9.57	4.63	5.00	9.44	5.20	5.52	6.32
Kerala	3.15	3.06	2.67	2.81	2.34	2.50	1.93
Total (High per capita GSDP)	31.34	21.98	22.35	33.71	21.20	23.73	23.04
Middle per capita GSDP							
Andhra Pradesh*	7.53	7.70	7.36	4.16	6.94	4.31	4.05
Punjab	2.41	1.15	1.30	2.33	1.39	1.58	1.81
Rajasthan	5.58	5.47	5.61	5.76	5.85	5.50	6.03
Odisha	3.64	5.06	5.16	3.53	4.78	4.64	4.53
West Bengal	7.92	8.12	7.06	7.67	7.26	7.32	7.52
Chhattisgarh	2.06	-	2.65	2.15	2.47	3.08	3.41
Madhya Pradesh	5.96	8.84	6.71	6.10	7.12	7.55	7.85
Total (Middle per capita GSDP)	35.10	36.34	35.85	31.70	35.81	33.98	35.20
Low per capita GSDP							
Jharkhand	2.66	-	3.36	2.77	2.80	3.14	3.31
Uttar Pradesh	16.42	19.80	19.26	16.78	19.68	17.96	17.94
Bihar	8.20	14.60	11.03	8.74	10.92	9.67	10.06
Total (Low per capita GSDP)	27.28	34.40	33.65	28.29	33.40	30.77	31.31
Memo							
Jammu & Kashmir	1.00	1.29	1.30	1.05	1.55	1.85	0.00
All Non-NEH States	94.72	94.01	93.15	94.75	91.96	90.33	89.55

Source: Reports of FC-11 to FC-15; Census of India 2001 and 2011.

Notes: *For comparing the devolution share of undivided Andhra Pradesh under the FC-13 to its 2011 population share, the shares of bifurcated Andhra Pradesh and Telangana, shown in Table 8.4 should be summed. For the FC-14, the population and devolution shares for Andhra Pradesh are as shown. For the FC-15, all shares must be recalculated after dropping Jammu & Kashmir. Inter-se shares of FC-11 to FC-14 are exclusive of the States' shares of service taxes.

Table 8.5 Ratios of Share in Devolution to Share in Population: Non-NEH States

State	FC-11	FC-12	FC-13	FC-14	FC-15
High per capita GSDP					
Goa	1.62	2.00	2.25	3.17	3.25
Telangana				0.83	0.71
Karnataka	0.94	0.85	0.84	0.92	0.71
Haryana	0.45	0.52	0.49	0.51	0.51
Tamil Nadu	0.87	0.86	0.82	0.66	0.67
Gujarat	0.56	0.71	0.60	0.61	0.69
Maharashtra	0.48	0.52	0.55	0.58	0.67
Kerala	0.97	0.85	0.83	0.89	0.69
Average (High per capita GSDP)	0.70	0.71	0.63	0.70	0.68
Middle per capita GSDP					
Andhra Pradesh*	1.02	0.98	1.67	1.04	0.97
Punjab	0.48	0.54	0.60	0.68	0.78
Rajasthan	0.98	1.01	1.02	0.95	1.05
Odisha	1.39	1.42	1.35	1.31	1.28
West Bengal	1.03	0.89	0.95	0.95	0.98
Chhattisgarh		1.29	1.15	1.43	1.59
Madhya Pradesh	1.48	1.13	1.17	1.24	1.29
Average (Middle per capita GSDP)	1.04	1.02	1.13	1.07	1.11
Low per capita GSDP					
Jharkhand		1.26	1.01	1.13	1.19
Uttar Pradesh	1.21	1.17	1.17	1.07	1.07
Bihar	1.78	1.35	1.25	1.11	1.15
Average (Low per capita GSDP)	1.26	1.23	1.18	1.09	1.11
Memo					
Jammu & Kashmir	1.29	1.30	1.48	1.76	
All Non-NEH States	0.99	0.98	0.97	0.95	0.95

Source: Derived from Table 8.4

Notes: *See the explanation below.

Census 2001 population shares have been used to calculate the ratios under the Eleventh and Twelfth FCs, and Census 2011 population shares for those under the Thirteenth to Fifteenth FCs. For the Fifteenth FC, the population shares have been recalculated from those shown in by excluding Jammu & Kashmir.

8.69 Among middle per capita GSDP States, devolutions to Andhra Pradesh, Rajasthan and West Bengal have hovered around the corresponding population shares. Devolution to Punjab, which served as the benchmark State from which most FCs calculated the per capita income distance until the FC-10, has remained consistently well below its share of the population. The remaining States in this category - Odisha, Chhattisgarh and Madhya Pradesh - have received devolutions well above their population shares. Surprisingly, their shares in devolution have exceeded the corresponding population shares by a wider margin than those of the low per capita GSDP States.

8.70 Devolution shares of the three low-income States - Jharkhand, Uttar Pradesh and Bihar, have consistently stayed above their corresponding population shares, but not by as wide a margin as Odisha, Chhattisgarh or Madhya Pradesh. In the case of Bihar and Uttar Pradesh, the shares have been significantly lower during the award periods of the last two FCs than those of the earlier three FCs. In all likelihood, the introduction of forest as a criterion under the FC-14 shifted the devolution shares from these (and other) States to Chhattisgarh and Madhya Pradesh. With more than 3 per cent share in the forests, Jharkhand could make some gains from the inclusion of the forest as a criterion. A final point is that, under the FC-11, the large 62.5 per cent weight assigned to the per capita income-distance criterion worked especially to the advantage of Bihar, Odisha, Madhya Pradesh and Uttar Pradesh. At the time, per capita GSDP in Odisha and Madhya Pradesh were much closer to those of Bihar and Uttar Pradesh than today.

Northeastern and Hilly States

8.71 *Table 8.6* and *Table 8.7* provide devolution and population shares analogous to *Table 8.4* and *Table 8.5*, respectively for NEH States. The last row of *Table 8.6* reveals that the NEH States have jointly received significantly more per capita devolution than the overall devolution per capita. Moreover, the ratio of devolution share to the population share has steadily risen from 1.1 under the FC-11 to 1.99 under the FC-15. Under the FC-15, these States have received twice the average level of devolution in per capita terms. Therefore, on average, the NEH States are amply compensated for their cost disadvantage on account of hilly terrain.

8.72 Beyond the aggregate ratio, there is considerable variation among different NEH States. Despite its high per capita GSDP status, Sikkim received over seven times the overall per capita devolution under the FC-15. Arunachal Pradesh received almost fifteen times the overall per capita devolution, and twice that of Sikkim. Mizoram received more than five times the average per capita devolution. Nagaland, Meghalaya and Manipur each received three or more times the average per capita devolution under the FC-15. Even Tripura, which is located on a flat terrain, received 2.3 times the per capita devolution across all States under the FC-15. Only Assam among the northeastern States received a more modest 1.2 times the overall per capita devolution within the Northeast under the FC-15. Its share has declined under the last two FCs.

Table 8.6 Population and Devolution Shares from Eleventh to Fifteenth FCs: NEH States

States	Population Share (2001)	FC-11	FC-12	Population Share (2011)	FC-13	FC-14	FC-15
High per capita GSDP							
Sikkim	0.05	0.18	0.23	0.05	0.24	0.37	0.39
Middle per capita GSDP							
Uttarakhand	0.84	-	0.94	0.85	1.12	1.05	1.12
Himachal Pradesh	0.60	0.68	0.52	0.58	0.78	0.71	0.83
Mizoram	0.09	0.20	0.24	0.09	0.27	0.46	0.50
Arunachal Pradesh	0.11	0.24	0.29	0.12	0.33	1.37	1.76
Tripura	0.32	0.49	0.43	0.31	0.51	0.64	0.71
Nagaland	0.20	0.22	0.26	0.17	0.31	0.50	0.57
Total (Middle per capita GSDP)	2.16	1.83	2.68	2.12	3.32	4.73	5.49
Low per capita GSDP							
Meghalaya	0.23	0.34	0.37	0.25	0.41	0.64	0.77
Assam	2.63	3.29	3.24	2.62	3.63	3.31	3.13
Manipur	0.23	0.37	0.36	0.24	0.45	0.62	0.72
Total (Low per capita GSDP)	3.09	4.00	3.97	3.11	4.49	4.57	4.62
All NEH States	5.30	6.01	6.88	5.28	8.05	9.67	10.50

Source: Reports of FC-11 to FC-15; Census of India 2001 and 2011

Note: Inter-se shares of FC-11 to FC-14 are exclusive of the States' shares of service taxes. Population shares have been calculated inclusive of Jammu & Kashmir. For the FC-15, the 2011 Census shares should be recalculated by excluding Jammu & Kashmir.

Views of the State Governments

8.73 Consultation with the States' Chief Ministers and their teams was the most enriching experience of the Commission. Each State argued its case passionately, backed it by data, charts, analysis, and arguments. Despite the wide variety of views expressed, some patterns emerge from the suggested criteria and associated weights for horizontal devolution that each State provided in its memorandum. Below, we summarise these patterns, classifying them under five major categories.

Table 8.7 Ratios of Share in Devolution to Share in Population: NEH States

States	FC-11	FC-12	FC-13	FC-14	FC-15
High per capita GSDP					
Sikkim	3.6	4.6	4.8	7.4	7.8
Middle per capita GSDP					
Uttarakhand		1.12	1.32	1.24	1.32
Himachal Pradesh	1.13	0.87	1.34	1.22	1.43
Mizoram	2.22	2.67	3.00	5.11	5.56
Arunachal Pradesh	2.18	2.64	2.75	11.42	14.67
Tripura	1.53	1.34	1.65	2.06	2.29
Nagaland	1.10	1.30	1.82	2.94	3.35
Average (Middle per capita GSDP)	0.85	1.24	1.57	2.23	2.59
Low per capita GSDP					
Meghalaya	1.48	1.61	1.64	2.56	3.08
Assam	1.25	1.23	1.39	1.26	1.19
Manipur	1.61	1.57	1.88	2.58	3.0
Average (Low per capita GSDP)	1.29	1.28	1.44	1.47	1.49
All NEH States	1.13	1.30	1.52	1.83	1.99

Source: Derived from data in Table 8.6

Note: Census 2001 population shares have been used to calculate the ratios under the FC-11 and FC-12, and Census 2011 population shares for those under the FC-13 to FC-15. For the FC-15, the population shares have been recalculated from those shown in Table 8.6 by excluding Jammu & Kashmir.

8.74 First, we have States that have pitched for a continued dominance of equity in the devolution, recommending a weight for the per-capita-GSDP-distance criterion equal to or larger than that assigned by the FC-15, which is 45 per cent. Arunachal Pradesh, Bihar, Himachal Pradesh, Meghalaya, Odisha, Rajasthan and Uttar Pradesh recommend retaining the current weight of 45 per cent for the criterion. States recommending a higher weight include, with the corresponding weight in the parentheses, Punjab (47.5 per cent), Assam, Jharkhand, Tripura and West Bengal (50 per cent), Manipur (55 per cent). Some States have additionally recommended including the Multidimensional Poverty Index by NITI Aayog among the devolution criteria. These include Assam and Madhya Pradesh (5 per cent), Chhattisgarh and Gujarat (10 per cent) and Bihar (17.5 per cent). Some States recommend including a measure of contributions by the States to the Sustainable Development Goals (SDG), such as Sikkim (5 per cent), Mizoram (7.5 per cent) and Goa (12.5 per cent). Finally, Chhattisgarh, Himachal

Pradesh, Madhya Pradesh, Odisha, Punjab and West Bengal have also recommended the inclusion of the proportion of SCs, STs, or both, in the total population among the criteria.

8.75 Second, many States have recommended reducing the weight assigned to the per-capita-GSDP-distance criterion. A subset of these States has also recommended assigning a larger role to efficiency, by including the States' contributions to the nation's GDP, or incremental GDP over a base period. States recommending a lower weight for the per-capita-GSDP-distance criterion than currently existing weight, include Haryana (15 per cent), Telangana (20 per cent), Chhattisgarh and Sikkim (25 per cent), Karnataka (25 per cent for the square root of per-capita-GSDP-distance), Andhra Pradesh, Gujarat, Goa and Kerala (30 per cent), Tamil Nadu (35 per cent with GSDP adjusted for the purchasing power parity), Maharashtra (37.5 per cent) and Madhya Pradesh, Mizoram, Nagaland, and Uttarakhand (40 per cent). States that recommended the inclusion of the States' contribution to GDP among the devolution criteria include Maharashtra and Madhya Pradesh (2.5 per cent), Gujarat (5-10 per cent), Sikkim (10 per cent), Tamil Nadu (12.5 per cent), Karnataka (20 per cent), and Telangana (50 per cent).

8.76 Third, the tax effort is another efficiency-based criterion which finds frequent mention in the States' recommendations, albeit with a small weight. Bihar, Chhattisgarh, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Nagaland, Rajasthan, Tamil Nadu, Uttarakhand and West Bengal recommended including this variable among the devolution criteria with its current weight of 2.5 per cent. States that recommended an increase in its weight include Manipur (3 per cent), Assam, Goa, Punjab and Telangana (5 per cent), Uttar Pradesh (10 per cent) and Haryana (35 per cent).

8.77 Fourth, many States have recommended maintaining the current weight of the forest and ecology criterion or increasing it. Assam, Bihar, Goa, Karnataka, Maharashtra, Mizoram and Odisha have recommended retaining the 10 per cent weight assigned by the FC-15. States recommending an increase in the weight include Arunachal Pradesh, Chhattisgarh, Himachal Pradesh and Jharkhand (12.5 per cent), Madhya Pradesh, Meghalaya and Nagaland (15 per cent), Manipur (17 per cent for the forest-to-total area ratio) and Andhra Pradesh, Sikkim, Tripura and Uttarakhand (20 per cent). A few other States have also recommended keeping forest and ecology among the criteria but with a weight smaller than 10 per cent.

8.78 Fifth, the population criterion continues to enjoy wide support. The States also generally agree on the reliance on the 2011 Census population figures for this purpose. The recommended weights vary from 5 per cent (Andhra Pradesh and Telangana) to 32.5 per cent (Kerala). The closely related demography variable, based on the TFR, also receives frequent mention among the suggested criteria. States supporting its inclusion include Bihar, Chhattisgarh, Gujarat, Himachal Pradesh, Madhya Pradesh, Meghalaya and Tripura (5 per cent), Haryana and Uttar

Pradesh (7.5 per cent), Maharashtra, Odisha and Telangana (10 per cent), Karnataka, Nagaland, Punjab and Rajasthan (12.5 per cent), Assam (12.5 per cent with a floor of 2.1 on TFR), Goa (12.5 per cent with the floor of 1.0 on TFR), Tamil Nadu (15 per cent), Andhra Pradesh and West Bengal (20 per cent) and Kerala (22.5 per cent). *Annexure 8.1* gives the details of criteria and weights suggested by the States.

Views of the Union Government

8.79 The Union's submission to this Commission views horizontal devolution as a key instrument of India's fiscal federalism that has steadily evolved from a purely equity-based exercise to one that blends equity and performance-based criteria. This shift, shaped by successive FCs, reflects a deliberate nudge to States towards greater fiscal self-reliance, prudent financial management, and efficient use of resources.

8.80 While recognizing the importance of population, income distance, and environmental factors like forest cover and geography, the Union noted a gradual reduction in the weight of pure equalization criteria and a growing space for performance-linked measures such as tax effort and fiscal discipline. Against this backdrop, it recommended a recalibration of the formula that restores fiscal discipline, measured comprehensively through indicators of deficits, debt, and recoveries from State entities like electricity distribution companies, to reward sustained prudence.

8.81 The Union also expressed concern about the disruptive volatility caused by major formula changes between Commissions. As a solution, it recommended introducing caps and collars on per capita shares under each parameter, ensuring that no State experiences abrupt gains or losses, and that transfers remain predictable for fiscal planning.

Devolution Criteria and Recommendations

8.82 In its approach to horizontal devolution, this Commission has been guided by two principles. First, the change in the States' shares in the portion of the divisible pool assigned to them as a part of the vertical devolution should be gradual. This means that any changes to the criteria and weights we recommend should take into account the magnitude of change in the States' shares they imply. In this respect, particular care must be taken concerning States that experience a reduction in their share over that under the FC-15.

8.83 Second, with growing ambition of the country as the backdrop, due recognition must be given to efficiency and especially the States' contributions to growth. Accordingly, for the first time, this Commission decided to add the State's contribution to GDP among its horizontal devolution criteria. Taking cognizance of the principle of gradualism, however, we decided that the weight assigned to the criterion should be such that it spells only a directional change without

causing a drastic shift in the States' shares. We provide the details on how we implemented this criterion below.

Devolution Criteria and Associated Weights

8.84 Other than introducing the contribution to GDP as a criterion, we rely on five criteria that have been employed by previous FCs: population, demography, area, forest and per-capita-GSDP-distance. In some cases, we make adjustments to the criteria that are novel, however. We spell out these adjustments below, with further details provided in the Technical Note at the end of the chapter.

Population

8.85 In keeping with the longstanding practice, described in the section on the devolutions by the past FCs, we continue to include population among the criteria. In conformity with the uniform recommendation by nearly all States, we implement this criterion by awarding each State an allocation based on its share in the Census 2011 total population of the twenty-eight States. We assign a weight of 17.5 per cent to this criterion. We note here that whenever any of our variables are combined with population, we rely on the 2011 Census figures. In this respect, we have fully transitioned from the 1971 Census population to the 2011 Census population data.

Demographic Performance

8.86 The FC-15 had introduced the TFR as one of the criteria for devolution. It awarded each State a per capita share in proportion to its inverse TFR. To convert the per capita share into total, it used the 1971 Census population. It reasoned that the shift from the 1971 Census population to the 2011 Census population in implementing the population criterion, as mandated by its terms of reference, had led to too large a loss in the devolution shares of States that had successfully arrested the growth rate of the population between 1971 and 2011. The inverse TFR offset some of that loss.

8.87 The Commission deliberated the merits of this criterion at length. There are arguments that under the changed circumstances, the advantages of slower population growth had been replaced by the fears of an aging population, as exemplified by the experiences of Europe, Japan and China. The Commission found itself in sympathy with the view that as India travels on the growth path, it faces the risk of aging before it becomes rich. This could adversely impact the country's growth prospects. Therefore, the justification for basing devolution on inverse TFR became weak over time. Accordingly, the Commission considered several alternative criteria that could replace it without large shifts in the States' shares in devolution. Unfortunately, this effort proved unsuccessful in that the alternative criteria implied a larger shift in the shares than what would be desirable.

8.88 Therefore, while we are of the firm view that a reward for the lower population growth through TFR or other indicators must be phased out in due course from the devolution criteria, we have opted for a gradual transition by reducing the weight of the demographic performance variable from 12.5 per cent by the FC-15 to 10 per cent. In addition, we have replaced TFR, which is a derived indicator from population data, with population growth, which is directly calculable from the Census figures. Specifically, we set the per capita devolution to a State in proportion to the inverse of its population growth between 1971 and 2011 Censuses. We convert this per capita devolution into total by multiplying it by the 2011 population. The Technical Note at the end of the chapter provides the precise formula.

Area

8.89 We have continued to include the share of a State's area in the total area of the twenty-eight States among our devolution criteria. Recent FCs have assigned every State a minimum share equalling two per cent in translating this criterion into practice. We noted in our earlier discussion that this assignment has two undesirable implications: i) with twelve States qualifying for the assignment, other States lose a substantial part of their actual share, and (ii) the assignment creates large inequity between States with an area just above two per cent and those with a small area and a small population in per capita terms. This Commission deliberated on these issues and concluded that a correction in this respect was required. Following the principle of gradualism and recognizing that a complete elimination or even a sharp reduction in the floor would have too large an impact on some small States, it opted for reducing the floor to 1.5 per cent. The Technical Note at the end of the chapter provides the precise formula. We assigned a weight of 10 per cent to this criterion.

Forest

8.90 During our consultations, some States had asked the Commission to include open forests in defining this variable. A handful of States had also recommended rewarding States for the expansion of the forest over a base period. We have incorporated both suggestions. The Forest Survey Report (FSR) defines very dense forest (VDF) cover as having a canopy density of 70 per cent and above, moderately dense forest (MDF) cover as having the canopy density of 40-70 per cent, and open forest (OF) cover as having the canopy density of 10-40 per cent. We define a weighted forest area by assigning a weight of 0.30 to OF, 0.65 to MDF, and 1.0 to VDF. These weights are the ratio of the mid-point of the range for that category of forest to the mid-point of the range for VDF. We have combined the share of weighted forest area of the State in the weighted forest area of all States and the share of increase in weighted forest area of the State in the increase in weighted forest area of all States in the ratio of 80:20 to arrive at the forest variable. For this purpose, the increase is calculated from 2015 to 2023 and for cases

where there is a decrease, change is taken as zero. The Technical Note at the end of the chapter provides the precise formula. We assign a weight of 10 per cent to this variable.

Per capita GSDP Distance

8.91 This is now a well-accepted and dominant equity variable. It is aimed at correcting for differences in fiscal capacity among States by devolving more to States with lower per capita GSDP. Most of the past FCs have set the benchmark per capita GSDP, from which the distance is measured, equal to the average per capita GSDP of the State with the highest average per capita GSDP among the large States. For this purpose, we use average per capita income of states over 2018-19 to 2023-24 excluding the COVID-19 year of 2020-21.

8.92 Shifts in per capita GSDPs in recent years have resulted in very narrow gaps among the per capita GSDPs of the three States with the highest per capita GSDPs (excluding Goa and Sikkim). Therefore, the per capita GSDP distances of the States with the second and third highest per capita GSDPs from the one with the highest per capita GSDP become too small to result in any meaningful devolutions to them.

8.93 To get around this problem, we take the average of the top three highest per capita GSDP States as the benchmark per capita GSDP. For this purpose, we exclude Goa and Sikkim. We then take the distance of the per capita GSDP of the State with the fourth-highest per capita GSDP from this average. We assign this same distance to all four highest per capita GSDP States, as well as Goa and Sikkim. For the remaining States, we take the distance of their per capita GSDP from the average of the top three. Per capita devolution is set in proportion to the per-capita-GSDP-distance so calculated. To convert this devolution into total, we multiply by the 2011 population of the State. The Technical Note at the end of the chapter provides the precise formula employed to calculate each State's devolution. We assign a weight of 42.5 per cent to this criterion.

8.94 Following the past FCs, we eschew introducing the indicators of equity, such as multidimensional poverty and shares of SC and ST populations in the total population, as criteria for devolution. The Commission concluded that per capita GSDP is a more direct measure of the State's fiscal capacity to provide public services. It also correlates positively with other measures of equity and therefore indirectly captures them.

Contribution to GDP

8.95 This is a new criterion we are introducing in recognition of India's growth ambition. Many States have also recommended to us the inclusion of this criterion. We define the State's contribution to GDP by the share of its GSDP in all States' GSDP. In implementing the criterion, however, we found that these contributions are dispersed very widely, especially at the top and

bottom ends, giving rise to large differences in the implied devolutions to the States. To moderate these differences, we have modified the criterion by defining the State's share as the ratio of square root of its GSDP to sum of square root of GSDP of all States. Further details on the implementation of the criterion are provided in the Technical Note at the end of the chapter. We assign a weight of 10 per cent to this criterion.

8.96 We note that just as the per capita GSDP distance serves as a surrogate for other equity-related criteria such as poverty and SDG achievements, the contribution to GDP serves as a surrogate for efficiency-based criteria such as tax effort and fiscal discipline. On a per capita basis, the proportionately larger contribution to GDP is indicative of generally better economic management. Specifically concerning tax effort, we note that this criterion exhibits a limited variation across States. Variation in the tax-effort weighted population shares of the States, which form the basis of devolution under this criterion, is determined principally by variation in the population shares. The correlation coefficient between tax-effort weighted population shares and their population shares is 0.98 in our data. With some exceptions, the criterion allocates funds in the same proportion as population shares.

Recommendation

8.97 Based on the above criteria and weights, the Commission has worked out the shares of the twenty-eight States in the portion of the divisible pool assigned to the States. These criteria, their assigned weights and shares of States are reported in *Table 8.8* and *Table 8.9* below.

Table 8.8 Formula for Horizontal Devolution

Criteria	Weight (percentage)
Population (2011)	17.5
Demographic Performance	10
Area	10
Forest	10
Per Capita GSDP Distance	42.5
Contribution to GDP	10
Total	100

Table 8.9 Inter se Share of States

States	Share (percentage)
Andhra Pradesh	4.217
Arunachal Pradesh	1.354
Assam	3.258
Bihar	9.948
Chhattisgarh	3.304
Goa	0.365
Gujarat	3.755
Haryana	1.361
Himachal Pradesh	0.914
Jharkhand	3.357
Karnataka	4.131
Kerala	2.382
Madhya Pradesh	7.347
Maharashtra	6.441
Manipur	0.626
Meghalaya	0.631
Mizoram	0.564
Nagaland	0.481
Odisha	4.420
Punjab	1.996
Rajasthan	5.926
Sikkim	0.335
Tamil Nadu	4.097
Telangana	2.174
Tripura	0.641
Uttar Pradesh	17.619
Uttarakhand	1.141
West Bengal	7.215
Total	100

Technical Note: Horizontal Devolution Formula

Our horizontal devolution is based on six criteria: 1) Population, 2) Demographic Performance, 3) Area, 4) Forest, 5) Per-capita GSDP distance, and 6) Contribution to GDP. In the formulas below, we represent them by index i with $i = 1, 2, \dots, 6$. Each criterion is assigned an index value corresponding to its order in this list. We index the States by j , with $j = 1, 2, \dots, 28$. The share of State j in the States' share in the divisible pool is written as,

$$(i) \quad S_j = \sum_{i=1}^6 W_i C_{ij} \quad j = 1, 2, \dots, 28.$$

In equation (1), we define various symbols as follows:

S_j = Share of State j in the States' share in the divisible pool.

W_i = Weight assigned to criterion i in the devolution formula. For example, for $i = 1$, which is the population, we have $W_1 = 17.5$ per cent or 0.175.

C_{ij} represents the share of State j in the part of the States' portion of the divisible pool disbursed based on criterion i .

With the W_i already specified by the devolution criteria, we only need to spell out how the C_{ij} are determined. This is done separately for each criterion below.

1) Population ($i = 1$)

Under this criterion, each State receives a share in the portion of the States' share in the divisible pool, devolved based on population, equalling its share in the total population of the 28 States. Denoting by N_k the population of State k ($k = 1, 2, \dots, 28$) as per the 2011 Census, we have,

$$(ii) \quad C_{1j} = \frac{N_j}{\sum_{k=1}^{28} N_k} \quad j = 1, 2, \dots, 28.$$

2) Demographic Performance ($i = 2$)

Under this criterion, each State receives a per capita amount in proportion to the inverse population growth between 1971 and 2011. The higher the population growth, the lower the proportionate per-capita amount. Denoting by G_k the growth in population from 1971 to 2011 in State k , that State's share in the portion of the States' share in the divisible pool devolved according to this criterion is,

$$(iii) \quad C_{2j} = \frac{\frac{1}{G_j} N_j}{\sum_{k=1}^{28} \frac{1}{G_k} N_k} \quad j = 1, 2, \dots, 28.$$

3) Area ($i = 3$)

Under this criterion, each State receives a share in the portion of the States' share in the divisible pool in proportion to its share in the total geographical area of the 28 States, subject to a floor of 1.5 per cent. For this purpose, the States, having geographical area less than 1.5 per cent of

the total geographical area of all 28 States, are assigned a share of 1.5 per cent; and the shares of the other States are reduced in proportion of their respective share in the total geographical area of all States, so as to restore the sum across all States to unity. Denoting by A_k the area of State k ($k = 1, 2, \dots, 28$) in the total area of all 28 States, we have,

- (iv) $C_{3j} = 0.015$ or 1.5 per cent for all $j = 1, 2, \dots, 28$ whose share of geographical area in total geographical area of 28 States is less than or equal to 1.5 per cent (i.e. $A_j \leq 0.015$ or 1.5 per cent), and
- (v) $C_{3j} = \frac{A_j}{\sum_{k=1}^{28} A_k} * \{1 - (n * 0.015)\}$ for all j and $k = 1, 2, \dots, 28$ whose $A_j > 1.5$ per cent or 0.015, where n is the number of States having $A_j \leq 0.015$ or 1.5 per cent.

4) Forest ($i = 4$)

Under this criterion, we have two components: i) based on the State's share in the forest area of all 28 States and ii) the State's share in the increase in forest area of all States between 2015 and 2023. The former is assigned a weight of 80 per cent and the latter 20 per cent to derive the forest variable. For this purpose, the forest area itself is defined as a weighted sum of very dense forest (VDF), moderately dense forest (MDF) and open forest (OF), with weights of 1.0, 0.65 and 0.30 respectively. Denote by F_k ($k = 1, 2, \dots, 28$) the forest area, which is, weighted sum of the three types of forests, in State k . Then, the share of State j in the States' portion of the divisible pool, devolved based on the forest variable, is written as,

$$(vi) \quad C_{4j} = 0.8 \frac{F_j}{\sum_{k=1}^{28} F_k} + 0.2 \frac{\Delta F_j}{\sum_{k=1}^{28} \Delta F_k} \quad j = 1, 2, \dots, 28.$$

For States experiencing a decline in the forest area between 2015 to 2023, $\Delta F_k = 0$.

5) Per Capita GSDP Distance ($i = 5$)

Under this criterion, each State receives a per-capita share in the portion of the States' share in the divisible pool devolved based on the per-capita GSDP distance criterion in proportion to the difference between a target per-capita GSDP and its own per-capita GSDP. We denote the per-capita target GSDP by y^* and the per-capita GSDP of State k by y_k ($k = 1, 2, \dots, 28$). The share of State j in the States' portion of the divisible pool, devolved based on the per capita GSDP distance criterion, is written as,

$$(vii) \quad C_{5j} = \frac{(y^* - y_j)N_j}{\sum_{k=1}^{28} (y^* - y_k)N_k} \quad j = 1, 2, \dots, 28.$$

We define y^* as the average of the per-capita GSDPs of the three large States with the highest per-capita GSDPs: Telangana, Karnataka and Haryana. For these three States, Goa and Sikkim, the latter two being small States with the highest per-capita GSDPs in the country, we set $y^* - y_k$ equal to the difference between y^* and the per-capita GSDP of the large State with the fourth

highest per-capita GSDP, which is, Tamil Nadu. Per-capita GSDP of each State is derived as its average nominal per-capita GSDPs during 2018-19 to 2023-24 excluding the COVID-19 years of 2020-21.

6) Contribution to GDP (i = 6)

Under this criterion, each State receives a share in the portion of the States' share in the divisible pool, devolved based on the contribution to GDP, equalling the share of squared root of its GSDP in the sum of squared root of GSDPs of all 28 States. Denoting by Y_k the GSDP of State k ($k = 1, 2, \dots, 28$), we have,

$$(viii) \quad C_{6j} = \frac{\sqrt{Y_j}}{\sum_{k=1}^{28} \sqrt{Y_k}}, \quad j = 1, 2, \dots, 28.$$

The GSDP of each State is measured as the average of its nominal GSDPs from 2018-19 to 2023-24, excluding the COVID-19 year of 2020-21.

□□□

ASSESSMENT OF STATE FINANCES AND GRANTS-IN-AID

9.1 Article 280(3)(b) of the Constitution mandates the Finance Commission (FC) to recommend the principles for determining grants-in-aid of State revenues from the Consolidated Fund of India. Complementing this, Article 275(1) makes provision for these grants, stating, “Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States”. Article 275(2) further stipulates that, until Parliament enacts a law under clause (1), the President may exercise this power, but only after considering the FC’s recommendations once it is constituted. Since Parliament has never legislated under Article 275(1), grants-in-aid continue to be implemented based on the Commission’s advice. In line with these Constitutional provisions, paragraph 4(ii) of the current Commission’s Terms of Reference (ToR) mandates it to recommend both the guiding principles and the quantum of grants-in-aid to States under Article 275, except for purposes specified in the provisos to clause (1). This chapter presents those recommendations.

9.2 Grants under Article 275(1) may be general-purpose, sector-specific, or State-specific. General-purpose grants, commonly known as revenue deficit grants (RDGs), bridge the gap between a State’s revenues and expenditures and have been awarded by all fifteen FCs. Sector- and State-specific grants address particular needs, such as health, education, or geographical challenges, but have been given only intermittently. The First Finance Commission introduced such grants, which have continued since then. But following the rise in States’ share of the divisible pool to 42 per cent by the Fourteenth Finance Commission, the Union Government largely discontinued releasing them. Accordingly, the present Commission confines its analysis to revenue deficit grants.

Brief Background

9.3 To date, FCs have awarded revenue deficit or ‘gap’ grants exclusively to fill the post devolution gap between revenues and expenditures on the revenue account. The first four FCs (1952-1969) based their assessments of State revenues and expenditures on past trends. Their approach was to apply past trends to estimate revenue gaps. They did not yet apply any normative benchmarks to evaluate whether State expenditure levels were efficient or whether State revenues reflected adequate fiscal effort.

9.4 Under the Fifth to Eighth Commissions (1969-1989), there was progressively greater recognition of the limitations of assessments based on the past trends. These Commissions began adopting more sophisticated approaches to assessing the revenues and expenditures, introducing certain normative elements, particularly on the expenditure side. For example, allowances for pay revisions and standardised norms for maintenance expenditure were gradually incorporated. Yet, the gap-filling nature of these grants remained predominant, and the Commissions themselves acknowledged the risk of creating adverse incentives – States with larger deficits tended to qualify for larger grants, potentially undermining fiscal discipline.

9.5 A more definite shift occurred under the Ninth Finance Commission (1989-95), with its ToR explicitly directing it to follow a normative approach to evaluating revenues and expenditures during the award period. The Commission moved to evaluating what States ought to be able to raise by way of revenues, given their fiscal capacity, and what they ought to spend, rather than projecting past trends forward. This Commission employed regression analysis to establish common norms for tax effort and the costs of providing public services across States. This normative approach was intended to delink grants from actual deficits and ensure that States did not receive larger transfers merely because of weaker fiscal effort or inefficient expenditure management.

9.6 The Tenth to Twelfth FCs (1995-2010) found the approach of FC-9 to suffer from serious limitations particularly due to the heterogeneity of initial endowments of public institutions, such as schools and hospitals, different geographical terrains, and varying governance capabilities across States. Hence, they shifted away from regression analysis and adopted an approach based on informed judgments, particularly with respect to excluding certain expenditures from their assessments. The FC-11 broke new ground by making a part of the RDG conditional on meeting certain benchmarks. The FC-12 was particularly emphatic that RDGs should be phased out for general category States by the terminal year of its award period (2009-10). Following the FC-12 recommendations, RDGs were now viewed as temporary instruments to help States transition to a situation of balanced revenue accounts. To this end, FC-12 proposed a scheme linking debt relief to debt consolidation. It provided for debt write-offs, conditional on enacting and adhering to a Fiscal Responsibility Law, which set clear targets for eliminating the revenue deficit and reducing the fiscal deficit. Accordingly, the 2000s

decade saw the emergence of the Fiscal Responsibility and Budget Management (FRBM) Acts across States.

9.7 Thanks to the debt consolidation and write-off scheme proposed by the FC-12, the assessment of revenues and expenditures by the Thirteenth Finance Commission (2010-2015) revealed that it needed to award revenue deficit grants to only eight special category States. It projected a revenue surplus for all general category States plus Assam, Sikkim and Uttarakhand, during each year of its award period. The Commission explicitly stated that the objective was for all States to achieve revenue balance by the terminal year of its award period.

9.8 Unfortunately, by the time the Fourteenth Finance Commission (2015-20) came along, revenue deficits of States had reappeared. Despite the large increase in devolution to States and the adoption of a normative approach to assessing revenues and expenditures, it still identified substantial post-devolution revenue deficits for many States, including some which did not receive RDGs recommended by FC-13. Following the closure of the Planning Commission and consequent impending end to the distinction between plan and non-plan expenditures, it included plan expenditures also in its assessments. It awarded sizeable grants in the first year of the award period, with the amounts tapering down to significantly smaller sums by the terminal year. However, in line with earlier FC trends, the actual revenue deficits did not decline commensurately as assessed by FC-14 even with the sizeable award of RDG.

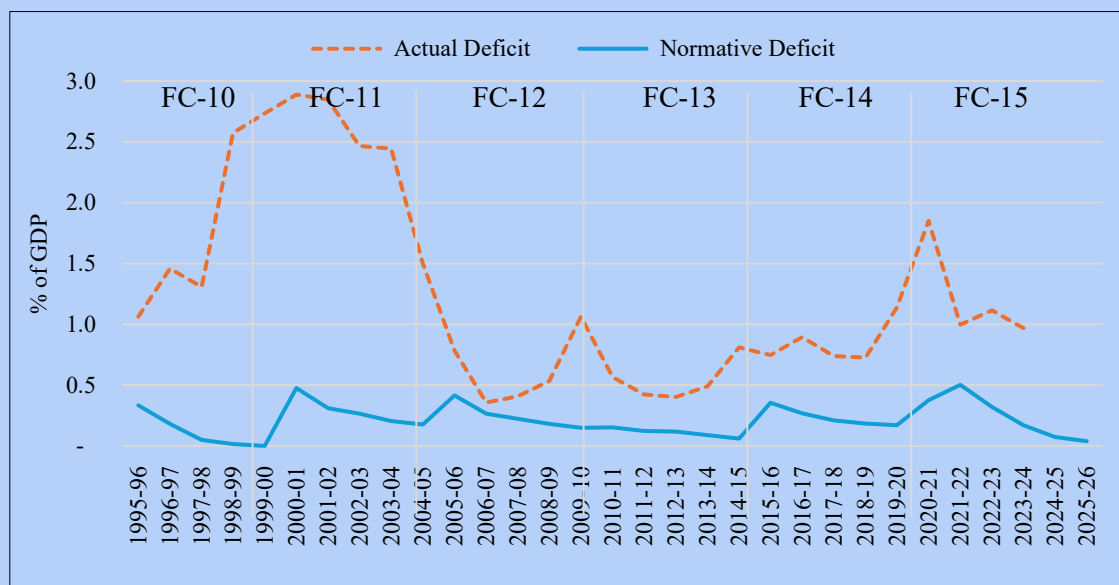
9.9 Perhaps in view of the persistence of large revenue deficits despite the significant jump in the States' share in the divisible pool and significant revenue deficit grants under the FC-14, the ToR of the Fifteenth Finance Commission (2020-26) explicitly mandated it to consider "...whether revenue deficit grants be provided at all". Upon its own normative assessment, the Commission concluded that such grants remained necessary but emphasised that the grants should not become open-ended. Applying a normative framework, it set the goal of zero revenue deficit by 2025-26 for all non-NEH States. It recommended grants to seventeen States, heavily front-loading them in the first three years of the award period. This was mainly due to the impact of COVID-19 and the post-COVID recovery projected by FC-15 – the initial years were estimated to have relatively lower revenues and higher expenditure, with revenues improving in later years, thereby reducing or even eliminating the gap.

9.10 It is instructive to compare the sum of the normatively constructed revenue deficits of the States with the sum of their actual revenue deficits, where the latter include devolution but not the RDG. This is done for the last six FCs as visible in *Figure 9.1*, where the solid curve depicts the path of normatively constructed revenue deficit and the dotted one that of the actual revenue deficit, inclusive of devolution but exclusive of RDG. It may be noted that, except for the FC-13, each of the remaining five FCs has begun its first year of the award period with a high normatively assessed revenue deficit as compared to the last year of previous FC, which steadily tapers down to a negligible level by the end of the terminal year.

9.11 The dotted line graph in *Figure 9.1* shows that the actual revenue deficit bears little to no systematic relationship with the normatively determined one. Despite the expectation of a near-zero revenue deficit in the terminal year by each FC, except for a handful of years, the

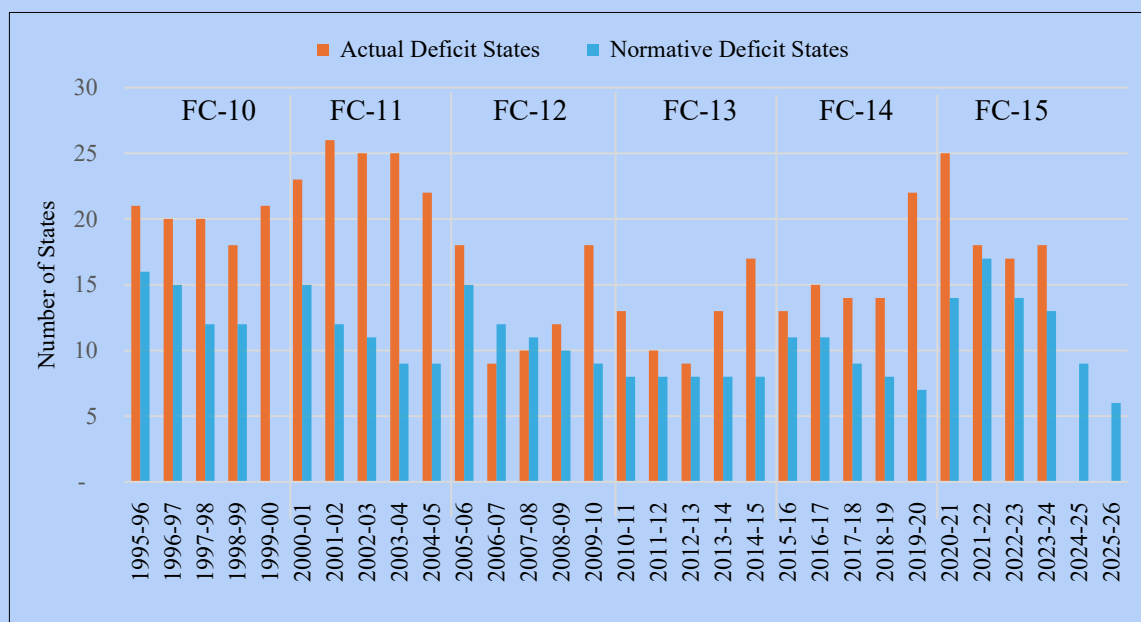
actual revenue deficit has not fallen below 0.5 per cent of GDP throughout the three-decade period. On the other hand, the normatively assessed revenue deficit has never exceeded 0.5 per cent of GDP during this period. Similarly, the *Figure 9.2* shows the number of States assessed to be in deficit, with the orange bars showing the number of States with actual revenue deficit and the large difference between the two in most of the years tells the same story. Obviously, States do not feel any obligation to move towards the normatively projected path.

Figure 9.1 Actual and Normatively Assessed Revenue Deficit of Revenue Deficit States



Source: Finance Accounts of States, FC Reports

Figure 9.2 Number of States with Actual and Normatively Assessed Revenue Deficit



Source: Finance Accounts of States, FC Reports

The Principles Governing Grants-in-Aid

9.12 Before outlining our approach to grants-in-aid, it is necessary to discuss the principles underlying it. The natural starting point for this discussion is the set of principles enunciated by FC-1. Of particular relevance to us are its first three of a total of six principles. In the following, we first summarise the three principles as articulated by the Commission itself and then explain our interpretation of them¹.

9.13 **Budgetary Needs:** The budget is the necessary starting point for assessing the need for grants-in-aid. FC-1 postulates that several adjustments to the budgets are necessary before arriving at an assessment of the grants. They include the removal of "...abnormal or unusual and non-recurrent items of receipt or expenditure which may vitiate comparisons unless these are excluded". These adjustments should reduce all budgets to a comparable basis.

9.14 **Tax Effort:** "The extent of self-help of a State should determine the eligibility for, as well as the amount of, help from the Centre". While recognising that States may differ in terms of the scope of additional taxation, FC-1 drew attention to the importance of tax effort by States, noting, "a State which is prepared to raise the maximum amount of revenue through taxation is better entitled to Central assistance than a State which does not itself act sufficiently in the same direction. ... Assistance to such a State [a State in the latter category] may have the effect of postponing action by the State to increase its own taxation".

9.15 **Economy in Expenditure:** Prescriptions offered by FC-1 in the single paragraph under this title are sufficiently important to warrant the reproduction of this paragraph in entirety: "An allowance should be made for possibilities of economy in expenditure. The principle of self-help also implies that a State should utilise its existing resources to good account before it makes a claim for assistance from the Centre. We should like to emphasise here that it is not the purpose of any system of grants-in-aid to diminish the responsibility of the State Governments to balance their own budgets. The method of extending financial assistance should be such as to avoid any suggestion that the Central Government have taken upon themselves the responsibility for helping the States to balance their budgets from year to year. If the amount of grants-in-aid were to be merely in proportion to the financial plight of a State, a direct premium might be placed on impecunious policies and a penalty imposed on financial prudence. On the other hand, if a State is eligible for a grant on other grounds, it should not be precluded from this benefit, merely because its budget is in order as a result of its sound financial management".

9.16 These are sound principles that have stood the test of time. Subsequent Commissions have explicitly or implicitly endorsed them. Indeed, the normative assessments by most of the FCs have, directly or indirectly, followed these very principles. The application of higher tax buoyancies observed in some States to the assessments of tax revenues of States with lower buoyancies is in the spirit of the tax-effort principle. Likewise, the exclusion of certain subsidies

¹ Report of the FC-1, Ch VII, paragraphs 17-19, pp 96-7. All quotations in our summary below are taken from these paragraphs.

and other items when assessing expenditures follows the principle of budgetary needs. Finally, the principle of economy in expenditure explains the systematically lower normatively assessed expenditure than that actually observed.

9.17 It is difficult to escape the conclusion that the assumption of enforceability through normative assessments, implicit in the statement of these principles, has not played out at all as originally envisioned. Successive Commissions have provided larger revenue deficit grants in the early years, which taper down to negligible levels towards the end of their award period, in the hope that the breathing room so provided would encourage States to balance their revenue accounts. However, this hope has not been realised, with revenue deficits becoming a near-permanent feature of the budgets of some States. Fiscal discipline, successfully achieved through the conditional debt relief scheme of the FC-12, has been lost once again.

9.18 The combined revenue balance of all States, which had turned into a surplus in 2006-07, 2007-08 and 2008-09 and again in 2010-11, 2011-12 and 2012-13, returned to a deficit in subsequent years. The revenue deficit of all States reached 0.3 per cent of their aggregate GSDP in 2022-23 and 0.4 per cent in 2023-24. Whereas only five States exhibited a revenue deficit in 2011-12, their number jumped to twelve in 2023-24. Several of these States that have availed of RDGs have persistently remained in deficit. In the meantime, revenue deficit grants have increased from 1.1 per cent of the gross tax receipts under the FC-13 to 2.2 per cent and 1.9 per cent, respectively, under the FC-14 and FC-15. These large and persistent revenue deficits have obvious adverse implications for the States' capital expenditures and macroeconomic stability.

9.19 These outcomes have partially resulted from a neglect of one of the prescriptions FC-1 itself had provided under the 'Economy in expenditure' principle. The Commission had warned that the system of grants-in-aid should not be such as to "diminish the responsibility of the State Governments to balance their own budgets". It was categorical in stating that the method of extending grants should avoid giving any impression that "the Central Government have taken upon themselves the responsibility for helping the States to balance their budgets from year to year".

Assessments by the Past Finance Commissions

9.20 The pattern observed above in the assessed revenue gap and, therefore, the grants originate from the way the assessment of the revenues and expenditure has been done by the successive FCs, especially in recent decades. To the extent that the assessment by FCs is based on past revenues and expenditures, the prospect of a grant filling the gap between them potentially creates a perverse incentive for States: knowing that the FC grant would fill the gap, they need not work hard on revenue collection and can afford to be profligate on expenditures. It was perhaps in recognition of this problem that, beginning with the FC-7, Commissions began to follow a 'normative' approach to assessing revenues and expenditures. Beginning with the FC-9, the ToRs explicitly directed the Commissions to follow such an approach. The idea was that the normative approach would result in the Commissions estimating the revenues that States

should collect, given their potential, and expenditures they should incur, given the likely availability of revenues and development priorities. Such an approach was expected to eliminate the perverse incentive.

9.21 The later Commissions have chosen to apply informed judgments to the latest available Finance Accounts to arrive at their assessments of the States' future needs. This has involved making various adjustments and assumptions for projecting receipts as well as expenditures for the award period of the particular FC. The adjustments included the removal of non-recurring items, such as debt relief and waivers, as well as certain discretionary subsidies, including power and food, from estimated expenditures. These adjustments aimed to make the State expenditures comparable across States.

9.22 In principle, the normative approach should have worked well; however, in practice it proved to be only partially true. FCs have come to realize that expenditures such as interest payments on debt, salaries and pensions – the so called 'committed' expenditures – are beyond a State Government's control and must be included in full in their assessments of expenditures. But this means that if a State decides to add a large number of employees to its rolls, expenditures on their salaries become a part of the committed expenditures that form the basis of revenue gap and grant assessment by FCs in perpetuity.

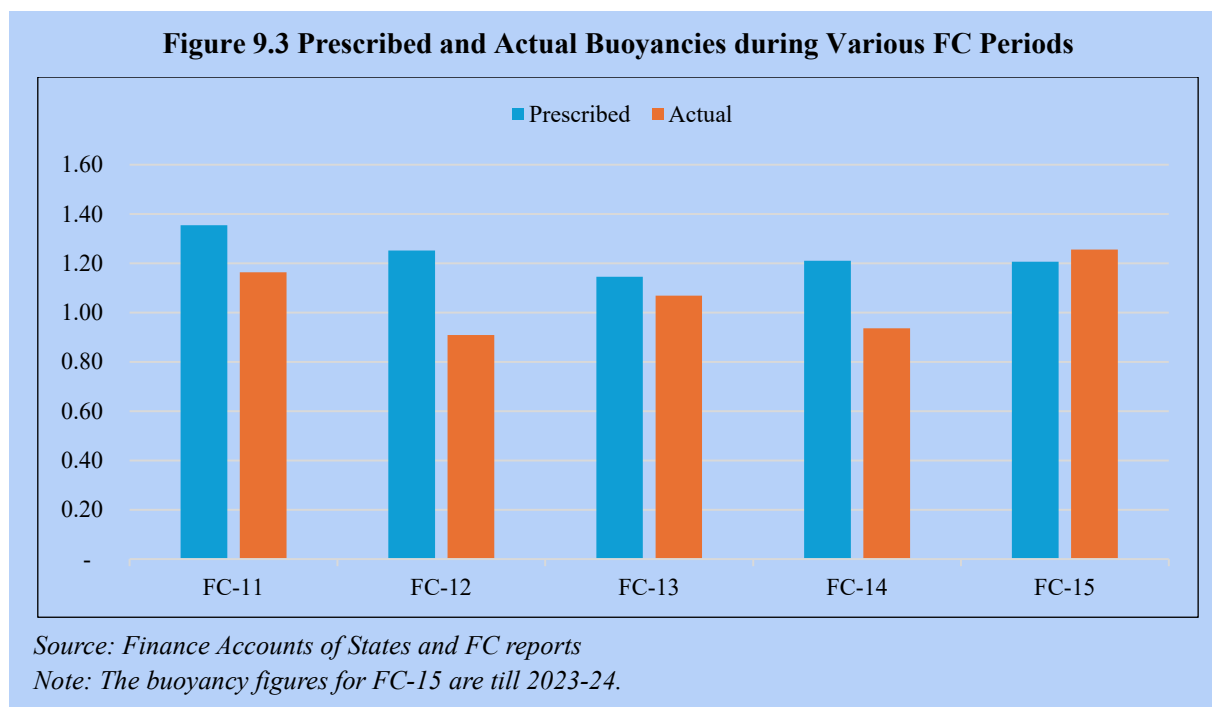
9.23 Equally, it is a challenge to distinguish between subsidies and transfers that are normatively acceptable expenditures and those that are not. Such a choice inevitably introduces an element of arbitrariness. Conventionally, FCs have treated power and food subsidies by States as being outside normatively acceptable expenditures. Yet, it is not immediately clear why the subsidies to all on water or cash transfers to large groups, should be exempt from such exclusion.

9.24 The normative approach faces a similar dilemma in assessing revenues. It is reasonable to assume that under such an approach, a State with a significantly lower tax-to-GSDP ratio than another with a similar per capita income, geography and demographics should be able to raise this ratio. Yet, in practice, such an expectation has repeatedly failed to be realised, resulting in persistent revenue shortfalls.

9.25 After making adjustments to finance accounts in an attempt to make them comparable across States, the Commissions made assumptions concerning growth rates to be applied to various components of receipts and expenditure for the purpose of making projections for the award period. These normative assumptions were made with the expectation that States will raise their respective tax efforts to mobilize resources and exercise due control over expenditures. Consideration was also given to equalizing the standards of basic social services to aid lagging States in improving the level of public services.

9.26 During our consultations, many State Governments observed that the projections made by FCs were not realistic, as they overestimated the States' own revenue receipts (ORR) while underestimating their expenditure requirements. They have stated that in the past, normative assessments have systematically assumed higher-than-actual growth rates for revenues and lower-than-actual growth rates for expenditures, resulting in higher revenue deficits than those predicted by FCs.

9.27 Figure 9.3 provides some evidence supporting the States' view. It shows the buoyancies of tax revenues as prescribed by the past five FCs and as observed *post-facto*. In the spirit of normative assessment, FCs have implicitly or explicitly incorporated certain improvements in tax administration into their revenue estimates. However, these improvements have never been realized.



Views of the State Governments

9.28 During its State visits, the Commission received varying submissions on the subject of RDGs. States such as Arunachal Pradesh, Bihar, Gujarat, Karnataka and Uttar Pradesh expressed scepticism about the effectiveness of RDGs, calling for their abolition or overhaul due to concerns regarding fiscal discipline. Others, such as Andhra Pradesh, Assam, Himachal Pradesh, Kerala, Manipur, Mizoram, Nagaland, Odisha, Rajasthan, Sikkim, Tamil Nadu, Tripura and West Bengal emphasised the indispensability of RDGs for maintaining fiscal balance, fulfilling responsibilities for basic services, and addressing cost disabilities.

9.29 The States opposed to the continuation of RDGs argue that they create perverse incentives, promoting fiscal laxity by rewarding States that fail to raise adequate revenue or curb expenditures. They contend that RDGs have not helped States achieve revenue surplus and instead created a moral hazard. They propose a shift toward performance-based incentives and expand the States' share in divisible pool, rather than continuing to rely on RDGs. Karnataka has recommended discontinuing the normative approach used to arrive at the RDGs, as it fails to account for actual fiscal pressures arising from exogenous shocks, such as the COVID-19 pandemic, expenditure commitments, including Pay Commission awards, social welfare, and centrally sponsored schemes' cost escalations, and revenue-side uncertainties, including GST volatility.

9.30 Arguments of States favouring RDGs are centred on fiscal constraints, mostly of a structural nature, high delivery costs, inadequate tax devolution and the need for equity. Some of the NEH States have described RDGs as a lifeline owing to sparse populations and high infrastructure and establishment costs, including salary expenditures. Nagaland cites special Constitutional provisions and argues for additional assistance in the form of RDGs. Others have viewed RDGs as essential support for ensuring that States start with a revenue balance every year, as horizontal tax devolution alone is insufficient. Odisha proposes expanding the scope of deficit grants to include capital account needs. Andhra Pradesh views it as essential due to bifurcation-related liabilities and provisions in the Andhra Pradesh Reorganisation Act, 2014. Assam, while supporting RDGs in principle, suggests that a two-stage devolution mechanism for the northeastern States, aligned with their fiscal needs, could obviate RDG requirements. Most of the RDG-receiving States have been critical of the tapering of RDGs, requesting a realistic assessment of their needs.

Views of the Union Government

9.31 In its memorandum to the Commission, the Union Government has favoured the discontinuation of RDGs due to the merger of plan and non-plan finance, as well as the increase in States' share in the divisible pool by the FC-14. It has argued that the fiscal reforms incentives provided by the FC-11 and FC-12 enabled the States to achieve fiscal consolidation and reach overall revenue balance. This allowed the FC-13 to avoid recommending RDGs for the general category States. The scenario has reversed with the FC-14 and FC-15 recommending RDGs even for the large and high-income States. This is despite the hike in the share of States in vertical devolution, partly due to a decline in States' own revenue effort and increase in revenue expenditure driven by higher dependence on Union transfers. RDGs thus carry with them a perverse incentive and are ineffective in addressing structural gaps. The most notable improvement in the revenue balance is witnessed when the FCs recommend incentive mechanisms linked to reforms that promote fiscal prudence, like in the case of FC-12.

Our Approach

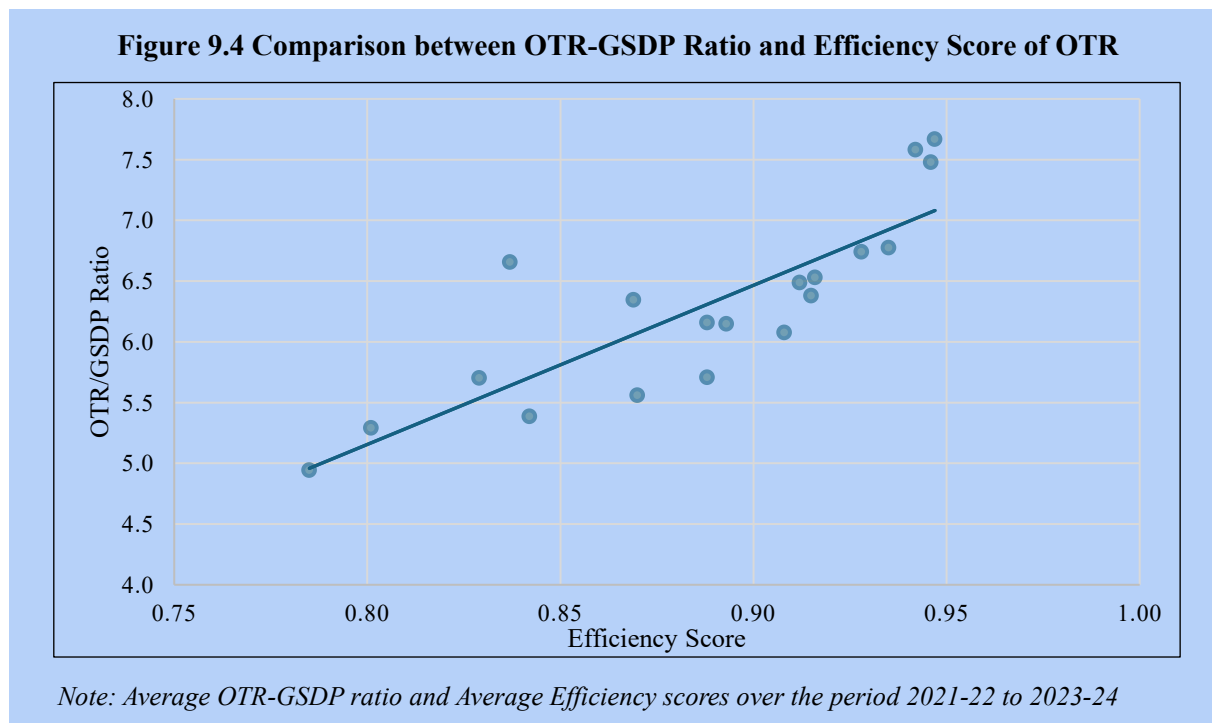
9.32 The Finance Accounts from 2011-12 to 2023-24 constitute a key source of the data we employ for our assessment. Where necessary, we also use the 2024-25 RE and 2025-26 BE. We collected additional data as required from the State Governments through the State Data Portal of the Sixteenth Finance Commission.

9.33 As a first step, GSDP of each State has been projected using the comparable GSDP data at market prices for the years 2011-12 to 2023-24 from the Ministry of Statistics and Programme Implementation (MoSPI). The elasticity of each State's GSDP growth with respect to the aggregate GSDP growth of all States has been calculated by taking the ratio of a particular State's trend growth rate (TGR) to the TGR of all States' GSDP over the period from 2011-12 to 2023-24. These State-specific elasticities are then applied to the estimated nominal GDP growth rate to derive the GSDP growth rates of various States during the period from 2024-25 to 2030-31.

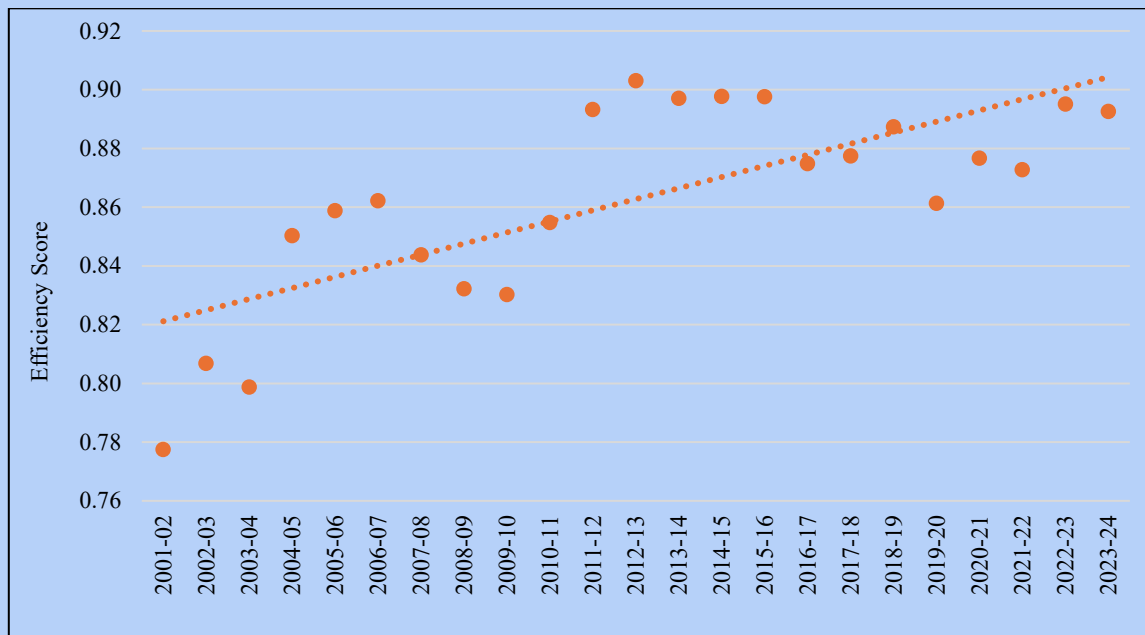
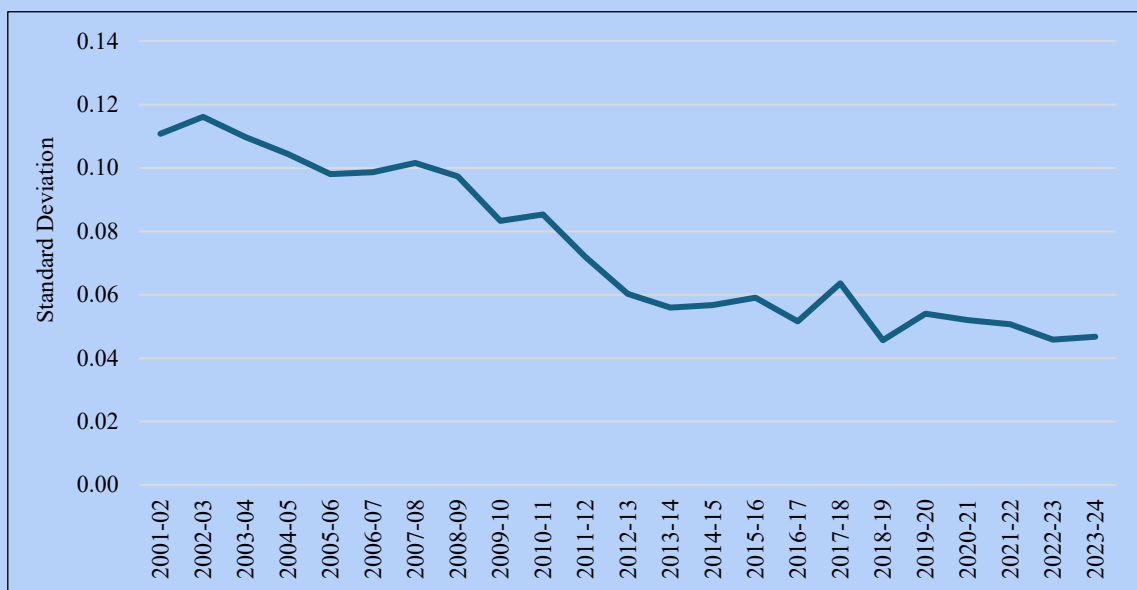
Revenue Receipts

9.34 As pointed out in the review of State finances in Chapter 5, 86 per cent of the own revenues of the States comes from their tax revenues. Therefore, we assessed tax efficiencies of the States using Stochastic Frontier Analysis (SFA), based on data from 2001-02 to 2023-24. The SFA is an analytical tool used to estimate the maximum attainable output (for example, potential OTR) given a set of observable inputs (for example, GSDP and economic structure). By constructing an efficiency frontier, SFA quantifies how far each unit (in this case, a State) falls short of its potential due to inefficiency, rather than random variation. Unlike traditional regression models, which treat all deviations from the conditional mean as random noise, SFA separates inefficiency from random error, using a composite error term. This enables the generation of efficiency scores that reflect each State's relative performance against an estimated frontier.

9.35 Our analysis shows that the mean OTR efficiency in the model is 0.887 (ranging from 0.785 to 0.947). It indicates that tax efficiencies, as measured by this exercise, are highly correlated with the tax-GSDP ratios of the States. The implication is that States with lower tax-GSDP ratios have lower collection efficiency, as shown in *Figure 9.4*. We are encouraged by the finding that the overall efficiency is improving, as illustrated in *Figure 9.5*, and that the differences are converging, as shown in *Figure 9.6*². Therefore, there is ample scope and possibility of improvement in tax revenues of the States by increasing the tax efficiency.



² Sigma convergence is a statistical approach to determine if the disparities in outcome (efficiency scores) among entities (States) decrease over time.

Figure 9.5 Average Efficiency Score of OTR**Figure 9.6 Sigma Convergence of Efficiency Score of OTR**

9.36 This analysis indicates that many States collect significantly lower taxes than their potential. Bridging the efficiency gap could have generated substantially more revenue. In principle, this unrealized revenue could have helped largely close the revenue gap and maintain fiscal sustainability without requiring new taxes. States could have generated an additional tax revenue of approximately ₹2 lakh crore in 2023-24, if they were to operate at their individual maximum potential level. In the scenario that the States were to operate at the average of best

10 efficiency levels observed across years and across States, they could have generated an additional tax revenue of approximately ₹1.5 lakh crore. In an alternate scenario, if the States were to operate only at the average efficiency level of top three best performing States in 2023-24, they could have still generated an additional tax revenue of approximately ₹1 lakh crore.³

9.37 For the assessment of revenue receipts, the base year (2025-26) figures of tax revenues are projected by compounding the tax revenues of three years (2021-22, 2022-23 and 2023-24) to 2025-26 at the State-specific trend growth rate (TGR) observed from 2018-19 till 2023-24 and then taking the average of these three figures.

9.38 For the award period, we have applied a State-specific growth rate on base year tax revenue figures thus arrived. For this purpose, we have categorized the States into three groups based on their assumed buoyancies. For States with higher tax potential, we have assumed a buoyancy of 1.15; for States that operate at or near their potential level, we have assumed a buoyancy of 1.05. The rest of the States have been assigned a buoyancy of 1.1. We have assumed a buoyancy of 1.05 for all NEH States except Assam, Uttarakhand and Himachal Pradesh. We find that these three States have higher tax potential and have therefore assigned them higher buoyancy. The resultant assumed growth rate in tax revenues has been capped at 12 per cent for every State. This has been done to keep the assumptions realistic for States for which a high GSDP growth rate is assumed.

9.39 Non-tax revenues constitute only 14 per cent of States' own resources and do not follow any consistent trend. For projecting a credible roadmap, non-tax revenues have been assumed to grow at 7 per cent per annum over the base year figures. The base year figures for non-tax revenues have been calculated in the same manner as tax revenues, however, using the TGR from 2011-12 to 2023-24 with a floor TGR of 2 per cent.

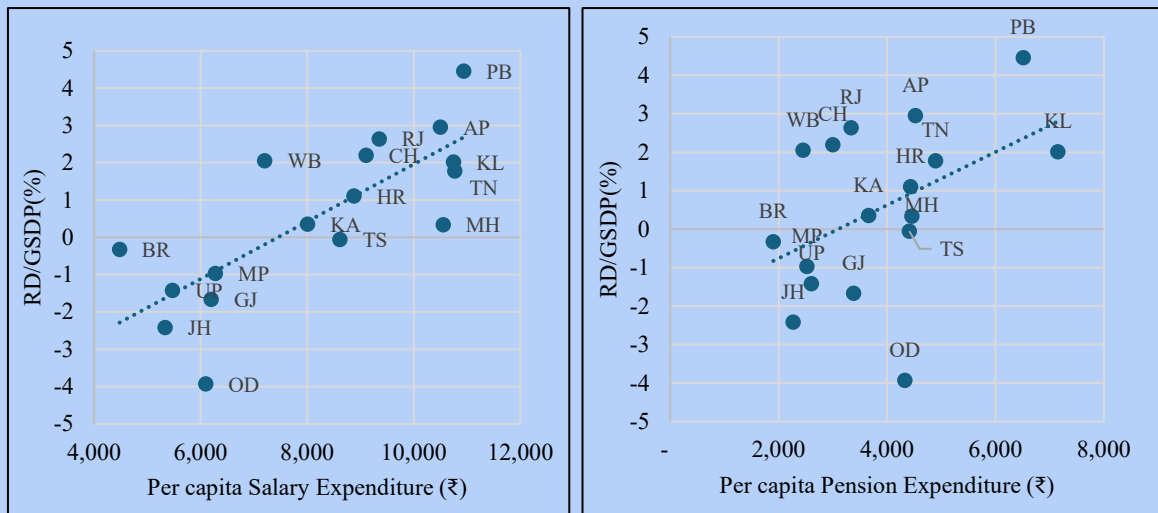
9.40 The share in Union taxes has been calculated based on our recommendations for vertical and horizontal devolution, as well as the projections for the gross tax revenues of the Union Government and the divisible pool and grants-in-aid (net of RDG) has been projected to grow at the rate of 7 per cent annually.

Revenue Expenditure

9.41 A major portion of States' revenues go towards meeting committed expenditure comprising of salaries, pensions and interest payments. Our analysis shows that expenditure on these items vary significantly amongst States. Per capita salary expenditure of non-NEH States in 2023-24 varies from as high as ₹11,000 in States like Punjab, Tamil Nadu and Kerala down to ₹4,500 in Bihar. Similarly, per capita pension expenditure of non-NEH States in the same year varies from as high as ₹7,000 in Kerala to as low as ₹2,000 in Bihar. The per capita salary and pension expenditures of NEH States is about double that of non-NEH States. *Figure 9.7* shows a definite positive relation between the per-capita salary and pension expenditure of States and the revenue deficit.

³ Similar findings on the potential for additional tax revenue generation by states have been reported across multiple studies (RBI, 2024; Rao & Azharuddin, 2025).

Figure 9.7 Relationship between RD/GSDP (percentage) with per capita Salary and Pension Expenditure for Non-NEH States (2023-2024)



Source: Finance Accounts of States, Budget documents; population projections by MoH&FW

9.42 The base year salary expenditure of States has been calculated by first adjusting the actuals of 2023-24 by taking its average with 2021-22 and 2022-23 expenditures compounded at the TGR from 2011-12 to 2023-24 and then applying the TGR to the adjusted actuals of 2023-24. For States having high salary expenditure, that is, where salary expenditure exceeds 60 per cent of the TRE net of interest and pension in the case of NEH States and 45 per cent in the case of non-NEH States, the salary expenditures during the award period has been projected at a growth of 5 per cent on the base year's salary expenditure. For the remaining States, it has been projected to grow at 9 per cent. Pension payments have been projected to grow at State specific TGRs over the base year pension expenditure, calculated the same way as done for salaries.

9.43 Interest payments for each year are then calculated as a product of the effective interest rate and the average debt stock projected for each year. The State-wise effective interest rate has been calculated by dividing the interest payments for 2023-24, for which the latest accounts are available, by the average debt stock of 2023-24, estimated as the average of the debt stock at the beginning and end of 2023-24. The debt stock from 2024-25 to the end of the award period is calculated by allowing additional net borrowing of 3 per cent of projected GSDP per annum for each State.

9.44 However, the committed expenditure is not the only cause of revenue deficit of the States. We carried out a detailed analysis of the discretionary expenditures of the States, especially that on subsidies and transfers. We present a comprehensive analysis of the same in Chapter 14. As observed in that chapter, there has been an acceleration in expenditure on subsidies and cash transfers by the State Governments, especially in the recent years. Our analysis shows that the expenditure on subsidies has increased from about ₹4 lakh crore in 2018-19 to almost ₹10 lakh crore in 2025-26 BE. While power subsidies have been a constant burden on State finances and we deal with them in greater detail in Chapter 13, recent increase in subsidies and transfers is driven by unconditional cash transfers being given by States. These

have increased from a meagre ₹73,000 crore in 2018-19 to a whopping ₹4.14 lakh crore in 2025-26 BE, far exceeding the power subsidies in that year. We have also highlighted that this is leading more and more States to incur revenue deficit, thereby borrowing to meet revenue expenditure.

9.45 For subsidies, such as those on power, food and transport, base-year expenditure has been calculated by averaging the expenditures in 2022-23 and 2023-24 and applying an annual growth rate of 8 per cent to the resultant average to arrive at base year. It is expected that the States reduce these subsidies by 10 per cent each year during the award period. To obtain the base-year expenditure on other beneficiary-oriented schemes, growth rate of 4 per cent has first been applied to the expenditures on them in 2023-24 and 2024-25 RE to arrive at the base year. The average of the number so derived and the 2025-26 BE expenditure has been taken as the base year estimate. It has been noticed that the expenditures on these schemes have spiked in some States in 2024-25 RE and 2025-26 BE. For States with spikes in 2025-26 BE expenditures, appropriate adjustments have been made. A conservative 5 per cent growth rate to the base-year estimate of expenditure on these schemes has been applied to obtain the projected amounts for the award period.

9.46 The remaining revenue expenditures, that is, total revenue expenditure net of interest, salaries and pensions, and subsidies and transfers, have been classified as ‘other revenue expenditures’ (ORE). They are spread across the categories of general services, social services and economic services. First, the 2023-24 actuals of ORE have been adjusted by taking its average with 2022-23 expenditures compounded at 9 per cent. This has been adjusted for some States to ensure that it does not vary greatly from the trend exhibited in previous years. The projections for the award period for ORE have been obtained by applying a 9 per cent annual growth rate to these adjusted actuals of 2023-24.

9.47 Summary of our assessment of State finances is shown in *Table 9.1*.

Table 9.1 Assessment of State Revenue Receipts and Revenue Expenditures of All States (₹ crore)

	2026-27	2027-28	2028-29	2029-30	2030-31
GSDP	4,04,12,911	4,48,58,331	4,97,92,748	5,52,69,950	6,13,49,645
Revenue Receipts, of which	50,88,548	56,42,430	62,58,321	69,43,309	77,05,306
Own Revenue Receipts	29,92,066	33,16,900	36,77,805	40,78,853	45,24,579
Transfers from Union	20,96,482	23,25,530	25,80,515	28,64,456	31,80,727
Revenue Expenditure, of which	51,44,907	55,40,089	59,80,564	64,70,258	70,13,591
Interest Payments	6,90,206	7,68,667	8,55,812	9,52,613	10,60,155
Pensions	7,10,656	7,97,524	8,95,266	10,05,271	11,29,105

Revenue Deficit Grants

9.48 Our review and assessment of State finances in general, and that of tax revenues, committed expenditure and discretionary expenditures in particular shows that there is significant scope of increasing revenues and rationalising expenditure. We firmly believe that the cause of revenue deficit of States, as it stands today, lies in these factors. With the pandemic behind us, States need to improve tax efficiency and rationalise their expenditure to eliminate the revenue deficit, which is hovering around 0.3 per cent of GDP post-COVID, as detailed in Chapter 5. We had also noted in our review of State finances that size of the budget of the States exhibits annual variations in either direction up to one percentage point of GDP in response to changing economic environment during 2011-12 and 2023-24. Even committed expenditure of State Governments recorded a fall after the COVID-19 pandemic and stood at 6.9 per cent of GDP in 2023-24 compared to 7.8 per cent in 2020-21 and 7.1 per cent in 2011-12. This points towards certain possible scope for downward flexibility in economising establishment expenses.

9.49 A fundamental problem with recurrent revenue deficit grants across successive FCs typically exemplifies the problem of time inconsistency where fiscal policies that appear optimal ex ante by the FCs are not adhered to ex post by the States once expectations of central assistance are internalized. When States anticipate that shortfalls in their revenue account will be compensated through RDGs, the incentive to undertake difficult but necessary fiscal reforms such as rationalizing subsidies, improving tax administration, or curbing revenue expenditures weakens. Over time, this softens fiscal discipline and embeds dependency rather than resilience.

9.50 Therefore, in continuation of the diminishing trend of the revenue deficit grants recommended by FC-15, which reduce to near-zero level by 2025-26, we do not recommend any revenue deficit grants to States. We also do not recommend any sector-specific or State-specific grants. In next two chapters, we turn to local body grants and grants for financing disaster relief.

□□□

10.1 Following Articles 280(3)(bb) and 280(3)(c) of the Constitution, the ToR of the present Commission direct it to recommend “the measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats and municipalities in the State on the basis of the recommendations made by the Finance Commission of the State”.

10.2 The provisions for measures to expand the resources of the rural and urban local bodies (RLBs and ULBs) themselves flow from the 73rd and 74th Amendments to the Constitution, brought into force in 1993. The two amendments provide the framework for the devolution of authority and finances to RLBs and ULBs, respectively. They specify the functions and fiscal powers that the State legislatures may devolve to the panchayats and municipalities. These two amendments also incorporate provisions for regular local body elections. However, full devolution of governance and financial powers to the local bodies by the State Governments, as envisaged in the Constitutional amendments, still remains a work in progress.

10.3 Successive Finance Commissions (FCs) have interpreted the phrase ‘measures needed to augment’ resources of the States as recommendations of grants-in-aid from the Consolidated Fund of India and suggestions to expand the volume of the local bodies’ own fiscal resources. Since local bodies fall under the State List of the Constitution, the grants from the Union are expected to supplement, not substitute, the resources transferred by the States on the recommendations of the State Finance Commissions (SFCs).

10.4 Reports of the SFCs have lacked uniformity in the approach adopted, periods covered and the quality of data and analyses. Time periods of appointments of SFCs by different States have also differed markedly. As a result, the past FCs have been unable to base their

recommendations on the SFC reports. This Commission too has faced these difficulties and has been unable to base its recommendations on the reports of SFCs.

Past Finance Commissions: A Review

10.5 Consequent to the 73rd and 74th Amendments to the Constitution, the Tenth Finance Commission (FC-10, 1995-2000) provided for an ad-hoc grant of ₹100 per capita for the rural population based on the 1971 census and an ad-hoc grant of ₹1,000 crore for municipalities to meet their primary obligations. The Eleventh Finance Commission (FC-11, 2000-05) provided a grant of ₹8,000 crore for the panchayats and ₹2,000 crores for the municipalities for its five-year award period. The Twelfth Finance Commission (FC-12, 2005-10) recommended a total grant of ₹25,000 crore which was divided between the panchayats and ULBs in the ratio of 80:20. The Thirteenth Finance Commission (FC-13, 2010-15) felt that the local bodies should also benefit from the buoyancy of Union taxes and recommended that the local bodies be transferred a percentage of the divisible pool of taxes (over and above the share of the States) after converting this share to grant-in-aid. The grants for the local bodies were equivalent to 1.93 per cent of the divisible pool for 2010-15. The grants were segmented into 26.82 per cent urban share and 73.18 per cent rural share based on their respective populations as per the 2001 census. The Fourteenth Finance Commission (FC-14, 2015-20) recommended grants amounting to ₹2,87,436 crore for its award period. The grants recommended for panchayats were ₹2,00,292 crore and those for municipalities amounted to ₹87,143 crore.

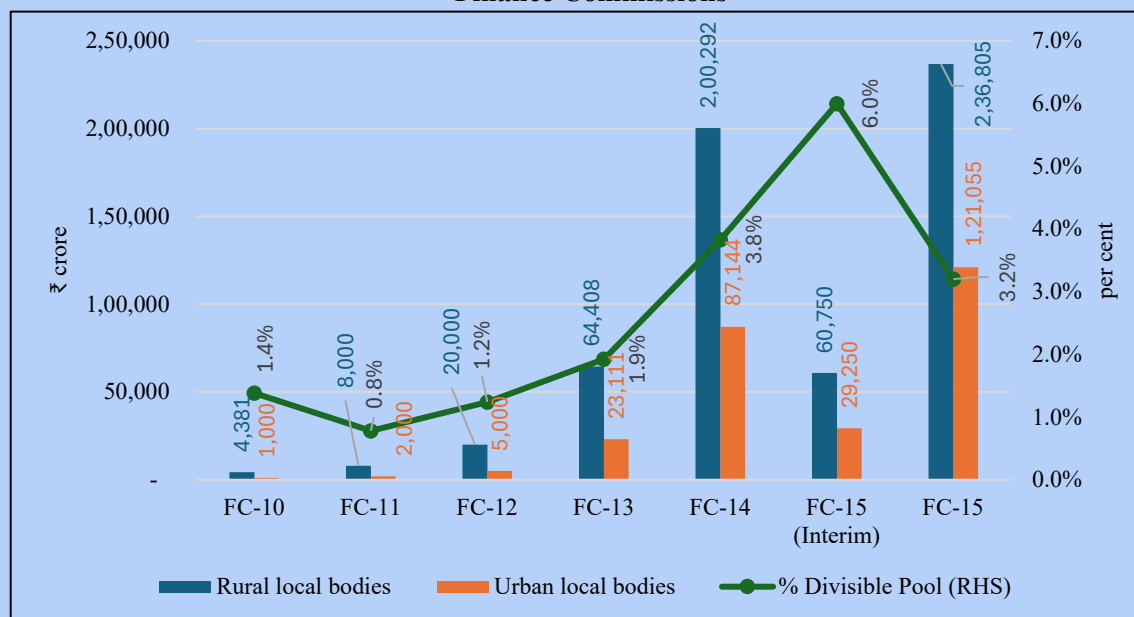
10.6 The Fifteenth Finance Commission (FC-15, 2020-26) provided for a total of ₹4,36,361 crore in grants for local bodies in its second report covering the years 2021-26. Against the backdrop of COVID-19, FC-15 had a provision of ₹70,051 crore specifically for the primary health sector in local bodies. It had also kept aside ₹8,000 crore for the incubation of new cities and ₹450 crore for shared municipal services. The balance of ₹3,57,860 crore was divided into ₹2,36,805 crore for RLBs and ₹1,21,055 crore for ULBs.

10.7 The ULB grants were further divided between Million-Plus Cities (MPCs) and Non-Million-Plus Cities (NMPCs). Expressed as a percentage of the divisible pool, the total grant of ₹4,36,361 crore by FC-15 amounted to 3.2 per cent. Leaving out the special grants like those for health and incubation of new cities, the grant of ₹3,57,860 crore for RLBs and ULBs was 2.6 per cent of the divisible pool.

10.8 The quantum of funds allocated for Local Bodies (LB) has steadily increased from approximately 1.4 per cent of the divisible pool during FC-10 to 3.2 per cent during FC-15. Successive FCs have also recommended an increase in the urban share within the overall local body grants due to the increasing share of the urban population. It has increased from 20 per cent each year under FC-11 to 35 per cent in the last year of the FC-15 award period, 2025-26.

10.9 Figure 10.1 shows the local body grants during the award periods of previous FCs in rupees, and as a percentage of the divisible pool. In parallel, Table 10.1 shows the actual releases.

Figure 10.1 Local Body Grants Recommended by Successive Finance Commissions



Note: FC-15 grant as a percentage of divisible pool (3.2 per cent) includes grants for health, incubation of new cities and shared municipal services.

Table 10.1 Previous FCs Grants Recommended versus Actual Releases (₹ crore)

	RLBs			ULBs		
	Recommended	Released	Released (per cent)	Recommended	Released	Released (per cent)
FC-10	4,381	3,576	81.6	1,000	834	83.4
FC-11	8,000	6,602	82.5	2,000	1,752	87.6
FC-12	20,000	18,927	94.6	5,000	4,470	89.4
FC-13	64,408	58,257	90.5	23,111	18,980	82.1
FC-14	2,00,292	1,79,491	89.6	87,144	74,259	85.2
FC-15	2,36,805	1,75,182	74.0	1,21,055	75,718	62.6

Source: FC-15 report and data received from the Department of Expenditure for FC-15 period (up to July 2025)

Criteria for Horizontal Distribution of Local Body Grants

10.10 While population and area have been uniformly used by all five commissions since the beginning of local body grants to calculate inter se distribution, the use of other criteria, such as per capita Gross State Domestic Product (GSDP) distance, index of deprivation, index of decentralisation and revenue effort, has varied across them. *Table 10.2* details various criteria used by different commissions. Note that the last two FCs have chosen to rely solely on population and area.

Table 10.2 Criteria and Weights (percentage) for Distribution of Grants for Local Bodies by Finance Commissions

Criteria	FC-10	FC-11	FC-12	FC-13		FC-14	FC-15
				RLB	ULB		
Population	100	40	40	50		90	90
Census	1971	1971	2001	2001		2011	2011
Geographical Area	-	10	10	10		10	10
Per capita GSDP	-	20	20	10	20	-	-
Distance							
Index of Decentralization/ Devolution	-	20	-	15		-	-
Index of Deprivation	-		10	-		-	-
Revenue Effort	-	10	20	-		-	-
Proportion of SCs / STs in Population	-	-	-	10	-	-	-
FC Local Body Grants Utilization Index	-	-	-	5		-	-

Conditionalities and Reforms Linked with Grants

10.11 FCs have linked the release of FC grants, either in full or in part, to certain performance requirements and/or tied them to particular usage, to push reforms in accounting, transparency and core functions. FC-10 advised States to design schemes and provide guidelines for grants,

required local bodies to contribute matching funds and prohibited the use of grants for salaries. FC-11 prioritised audit and financial databases, recommending that any grant funds be allocated to the provision of essential services such as health, education, water, sanitation and public transportation, while maintaining salary ban. FC-12 emphasised the need for improvement in service delivery in water and sanitation and modernisation of financial systems. It tied 50 per cent of the urban grant to the collection, segregation and transportation of waste materials.

10.12 FC-13 introduced performance grants, requiring States to submit detailed budget supplements for Panchayati Raj Institutions (PRIs), implement audit systems, establish ombudsmen, ensure electronic fund transfers within five to ten days, legislate SFC members' qualifications and empower the local bodies to collect property tax. FC-14 proposed a 90:10 split between basic and performance grants for RLBs and an 80:20 split for ULBs, with performance linked to own-source revenue improvement and audited account submissions.

10.13 FC-15 allocated 60 per cent as tied grants and 40 per cent as untied grants. The tied grant was further divided equally (30 per cent each) between (i) drinking water and rainwater harvesting and (ii) provision of sanitation and solid waste management.

Conditionality for Accounts and Audit

10.14 Successive FCs have made important recommendations to improve local body financial management, especially with respect to preparation, availability and audit of local body accounts, recognising it as a critical reform agenda. FC-11 suggested that the Comptroller and Auditor General (CAG) of India be given oversight of the maintenance and auditing of local body accounts, with audit reports to be reviewed by dedicated committees of State legislatures. FC-12 emphasised the need for disaggregated financial data in formats prescribed by the CAG and called for modernised systems and databases for efficient account management. FC-13 proposed the continuation of Technical Guidance and Supervision of Local Fund Audit Departments (LFADs) by the CAG while also suggesting measures for strengthening LFADs. FC-14 stressed the importance of clearly distinguishing various revenue sources-such as own revenues, assigned taxes, State grants, Finance Commission transfers and funds for agency functions-in local body accounts. It supported the continuation of CAG's technical role and urged timely auditing and compilation of accounts. Further, it stipulated that eligibility for performance grants for both Gram Panchayats and ULBs would be contingent upon the submission of audited annual accounts pertaining to a fiscal year not earlier than two years preceding the year in which the local body sought to claim the grant.

10.15 Building on the recommendations of predecessor Commissions, FC-15 mandated the timely availability of accounts, both provisional (for fiscal year T-1) and audited (for fiscal year T-2), of individual local bodies online in the public domain as an entry-level condition for the

local body grants in year T. These conditions have resulted in a significant improvement in the preparation and availability of financial accounts for both ULBs and RLBs, giving a fillip to transparency and facilitating more informed decision-making.

Exempted Areas

10.16 According to the Constitution (Articles 243M and 243ZC), the 73rd and the 74th Amendments do not apply to the Fifth and Sixth Schedule areas where the States have not enacted laws for the establishment of duly elected panchayats and municipalities. Post-enactment of the Panchayats Extension to Schedule Areas Act (PESA), 1996, the areas that remain exempted are given in *Table 10.3*.

Table 10.3 Areas Not Covered Under the Provisions of Parts IX/ IX-A

State/ Area Within a State	Provisions Under Which Exempt
Meghalaya	Exempt under Article 243 M(1) and 243 ZC(1) and covered by Sixth Schedule as per Article 244(2), except selected areas of Shillong municipal Areas
Mizoram	Exempt under Articles 243 M(1) and 243 ZC(1), with two administrative districts Lawngtlai and Siaha covered by Sixth Schedule as per Article 244(2)
Assam: Bodoland, Dima Hasao and Karbi Anglong districts	Exempted under Articles 243 M(1) and 243 ZC(1) and Covered by Sixth Schedule as per Article 244(2)
Tripura	Tripura Tribal Areas are exempted under Articles 243 M(1) and 243 ZC(1) and covered by Sixth Schedule as per Article 244(2)
Nagaland	Exempt under Article 243 M(2)(a) and not covered by the Sixth Schedule
Manipur: Hill areas for which district councils exist	Exempt under Article 243 M(2)(b) and not covered by the Sixth Schedule
West Bengal: Hill areas of the district of Darjeeling, covered by the Darjeeling Gorkha Hill Council	Exempt under Articles 243M (3)(a) /243ZC (2) of the Constitution and not covered by Sixth Schedule

10.17 FC-10 recommended allocating grants to all States, including those not constitutionally required to establish PRIs. This was aimed at ensuring that, even in the absence of formal panchayats, local-level representative bodies in such States receive financial support. FC-11 introduced conditionalities, stipulating that grants to Exempted Areas would be released only

after the respective States enacted legislation to extend the 73rd and 74th Constitutional Amendments. FC-12 took a more lenient approach by not distinguishing between Exempted and Covered areas; instead, it entrusted States with the responsibility of distributing the grants, considering ongoing efforts to amend the Sixth Schedule. FC-13 explicitly allocated ₹1,357 crore for these areas, guided by Constitutional provisions such as Parts IX and IX-A and Articles 244, 275 and 280. In contrast, FC-14 made no allocation for these areas, marking a shift from earlier practice. FC-15, however, reintroduced grants for Exempted Areas based on the logic followed by FC-13.

State Finance Commissions

10.18 Articles 243-I and 243-Y of the Constitution mandate setting up SFCs at the State level for the eligibility of the transfer of resources from the State to the local bodies. Successive FCs have also recognised the potential role of SFCs in promoting fiscal decentralisation upto local governments. They specifically highlighted the need for timely constitution, adequate resources and prompt action on the recommendations of SFCs.

10.19 FC-11 urged the SFCs to provide a detailed analysis of the resources of State and local governments and measures for improvement of local governments' financial standing. FC-12 recommended that the SFCs identify issues requiring action by the Union Government. Both FC-12 and FC-13 recommended that SFCs undertake a normative assessment of revenues and expenditures of the local bodies. FC-13 also recommended the creation of a common template for SFC reports.

10.20 FC-14 emphasised the need for strengthening the SFCs. FC-15 recommended that each State appoint the SFC promptly and ensure that its recommendations are acted upon. Additionally, an explanatory memorandum should be laid before the State legislature on or before March 2024 to facilitate the availing of grants.

Stakeholder Consultations

10.21 The Commission held extensive consultations with various stakeholders on the issue relating to the transfer of resources to local bodies. Apart from formal representations of Union and State Governments, the Commission separately interacted with representatives of various local bodies during each of our visits to the States and also visited several Gram Panchayats (GPs) and a few ULBs during these visits.

Views of the Union Government

10.22 The Union Government recommended inter se sharing of local body grants to States on the basis of population with 50 per cent weight, area with 15 per cent weight and States' net transfer of funds to local bodies with 35 per cent weight. It has further recommended that the State-wise allocation of local body grants be split into a rural-urban component based on the 2011 Census, to account for varying rates of urbanisation across the States.

10.23 The Union Government emphasised that the core funding requirements of the local bodies should be addressed by State Governments in line with the intent of the 73rd and 74th Constitutional Amendments. Effective devolution of functions listed in the Eleventh and Twelfth schedules was essential for empowering local bodies as the Constitutionally mandated third tier of governance and also for making Union grants for local bodies more effective.

10.24 It advocated a shift in approach for grants from the Consolidated Fund of India to 'measures' needed to augment the Consolidated Fund of States by emphasising two enablers. The first enabler could be ensuring measurement of efforts through modifications in accounts of States and local body accounting classification, and the second enabler could be assignment of functions to local bodies in accordance with the Eleventh and Twelfth schedules of the Constitution.

10.25 It also suggested that transfer of resources to local bodies should be linked with their financial performance in areas such as cost recovery for services. The role of the Union grants may shift to supplementing the SFC-recommended resources for local bodies. It was underscored that the transfer of revenue sources to local bodies builds their accountability towards providing quality citizen services.

10.26 Further, empowerment of local bodies to levy and collect property tax, betterment levy, urban planning fee including value capture charges and parking fee and purpose based cess such as cess on stamp duty, cess on motor vehicle tax, establishment of a functional GIS-based property tax system to increase the buoyancy of property tax collections, adoption of modern building bye-laws, implementation of transit oriented development and incentivisation of their inter-local body distribution based on performance in levy and collection of user charges were also discussed.

10.27 It was also suggested that at least fifty per cent of the local body grants should be allocated to capital expenditure with the goal of improving expenditure quality and promoting fiscal prudence.

Ministry of Panchayati Raj

10.28 Ministry of Panchayati Raj (MoPR) emphasised digitisation of the revenue collection mechanism and generation of own sources of revenue (OSR). MoPR also suggested a list of projects, including the construction and upgradation of panchayat bhawans and digital infrastructure upgradation of around 2 lakh Gram Panchayats, for which earmarked grants could be given to the RLBS. It further recommended including the maintenance of assets created under Jal Jeevan Mission (JJM) and Swachh Bharat Mission-Gramin (SBM-G) among the uses of the grants.

Ministry of Housing and Urban Affairs

10.29 Ministry of Housing and Urban Affairs (MoHUA) suggested a phased increase in the share of ULBs within the total local body grants from thirty-five per cent in 2025-26 to forty per cent in 2030-31, alongside earmarking funds for Rurban/Peri-Urban areas and augmenting urban local body capacity in crucial domains like accounting, engineering and urban planning. It emphasised the need to augment the OSR of ULBs and innovative mechanisms such as transit-oriented development and value capture financing. It suggested that the conversion of census towns to statutory towns should be incentivised to promote planned urbanisation.

10.30 It suggested bringing uniformity in accounting standards and informed of its initiatives towards harmonised municipal accounting as per the recommendations of FC-15, including development of an ERP solution with a finance module integrated with Public Financial Management System (PFMS). It also informed of the exercise for mapping of the existing Chart of Accounts (CoAs) of ULBS with the CoA of the Union Government and requested funds for these initiatives.

Ministry of Jal Shakti

10.31 The Ministry requested resources for Operation and Maintenance (O&M) pertaining to drinking water and sanitation assets created under the schemes Jal Jeevan Mission and Swachh Bharat Mission (Gramin). In addition, it recommended providing tied and untied grants based on the FC-15 model, classifying 40 per cent of the total grants as untied and 60 per cent as tied for Water, Sanitation and Hygiene (WASH). The Ministry recommended dividing the tied grant equally between water and sanitation. The Ministry also proposed performance grants tied to the recovery of O&M charges with respect to drinking water supply and to promote specific behavioural and functionality-based outcomes with respect to sanitation.

Other Ministries

10.32 Ministry of Environment, Forest and Climate Change proposed continuation of air quality grant for 42 MPCs and inclusion of three more MPCs (Kannur, Kochi and Kollam), which were excluded under the FC-15 period. Further, the Ministry proposed the inclusion of 51 cities with a population of 5-10 lakh for air quality grants. The Ministry of New and Renewable Energy recommended a ₹50,000 crore grant for local bodies to solarise government loads, common lighting, water supply and government assets ensuring sustained asset operations.

Views of the State Governments

10.33 In the State Governments' memoranda, Gujarat, Karnataka, Madhya Pradesh and Uttarakhand have recommended allocating rural-urban grants in the ratio of 60:40 due to rapid urbanisation, whereas Andhra Pradesh, Bihar, Kerala and Telangana have recommended grants to rural and urban, as per their proportion to their respective population of the State. Tamil Nadu

stated that the urban population receives less per capita grant than rural areas, which is inadequate given the rapid pace of urbanisation.

10.34 The States had varied views on the weights assigned to parameters for the inter se distribution of local body grants. While some States recommended continuation of the existing parameters of population and area, others suggested additionally using the index of decentralisation, the index of deprivation, income distance, forest cover, SC/ST population and the contribution of agricultural and allied sectors to GSDP.

10.35 Almost all the State Governments expressed their views on grant-related conditionalities in their State memoranda. States like Chhattisgarh, Mizoram, Sikkim, West Bengal and so on, advocated for either no tied grants, or a larger share of untied grants as compared to 40 per cent under FC-15. States also mentioned difficulty regarding meeting the condition that the rise in property tax be at the same rate as nominal GSDP. Several States also suggested the removal of the ₹2,500 ceiling on the levy of professional tax.

10.36 Karnataka urged to remove conditions such as the constitution of the SFC and audit of accounts of local bodies. Other States like Jharkhand, Manipur, etc sought relaxation in conditionalities to be minimum or no conditionalities. Kerala and Maharashtra suggested that no additional conditionalities beyond those levied by the FC should be imposed.

10.37 Uttar Pradesh recommended flexible funds under which half of the grants may be allocated to unique local priorities and the remaining half supports broader national or State policy goals. Rajasthan also suggested to relax the conditions for tied grants to allow panchayats with greater flexibility in allocation of funds for local priorities.

10.38 Tamil Nadu suggested disbursal of funds at a higher frequency, quarterly or monthly, whereas Haryana has recommended grants to be disbursed in a single instalment each year. States like Gujarat and Madhya Pradesh urged streamlining fund release to optimise utilisation.

10.39 Several States like Assam recommended financial assistance through a one-time grant to help aid infrastructure development and provide basic service delivery for newly formed ULBs in the State. Some States were of the view that FC should permit meeting expenses on salary payment out of its grants.

10.40 Bihar, Haryana, Himachal Pradesh, Nagaland, Punjab, Tamil Nadu and Tripura suggested grants for undertaking urban infrastructure projects for basic services such as sewerage treatment, public transport, green spaces, affordable housing, storm water disposal system, disaster relief and mitigation and capacity building. Odisha suggested a special grant to promote the structured development of peri-urban areas and Meghalaya recommended a dedicated infrastructure grant to address the high cost of delivering services in difficult terrain.

10.41 Arunachal Pradesh, Meghalaya and Sikkim proposed that 10 per cent of the LB grants be earmarked for the Northeastern States and made an explicit recommendation that Autonomous District Councils (ADCs) be eligible for the FC grant.

Representatives of Local Bodies

10.42 During its State visits, the Commission engaged in detailed interactions with elected representatives from RLBs and ULBs at all tiers, including those from the ADCs. The key suggestions emerging from these discussions are summarised below:

- (i) In almost every State, representatives of local bodies sought either an increase in untied grants, or a relaxation or omission of the bifurcation between tied and untied grants, to allow greater flexibility in expenditure by local bodies as per their respective priorities.
- (ii) It was further suggested that the existing system of devolving funds to all three tiers of PRIs – Gram Panchayats, Panchayat Samitis and District Panchayats – be continued to ensure comprehensive rural development.
- (iii) Additionally, it was proposed that the criteria for grant distribution be based not solely on population, but also on factors such as the States' geographical location, resource endowments and economic conditions.
- (iv) Representatives of ULBs in several States requested infrastructure development funds for priority sectors, including the improvement of roads, drains, sanitation, solid and liquid waste management, stormwater drainage, street lighting, desilting of drains, capacity building, digitisation, urban mobility, technical support and the development of renewable energy sources such as solar and wind power. They further requested grants for social themes, encompassing child and women development, education and health and family welfare, in consonance with the achievement of Sustainable Development Goals (SDGs).
- (v) Similarly, representatives of RLBs sought financial support for safe drinking water, sanitation (including Solid Waste Management), lighting and infrastructure development, alongside capacity building and staffing.
- (vi) Local bodies also advocated for a more efficient and timely grant disbursal. It was further suggested that the grants be released in a single instalment annually.

Studies Commissioned

10.43 The Commission had undertaken the following studies to analyse various issues related to local bodies.

- (i) Recommendations of the latest State Finance Commissions across States in India through the Indian Institute of Public Administration (IIPA).

- (ii) Principles of Devolution to Urban Local Bodies through Janaagraha Centre for Citizenship & Democracy.
- (iii) Draft Municipal Reform Blueprint through Janaagraha Centre for Citizenship & Democracy.
- (iv) Identification and Financing of Urbanisation in India through the Indian Institute for Human Settlements (IIHS).
- (v) Incentivising the Transition of Census Towns to Statutory Towns through the World Bank.
- (vi) Comprehensive Review of Panchayat Finances and Measures to Augment their Revenues through the Institute of Rural Management Anand (IRMA).
- (vii) Status and Impact of Finance Commission Grants to Rural Local Bodies through the Institute of Economic Growth (IEG).

Conferences organised on Local Bodies

10.44 As a part of extensive consultation, the Commission organised the following conferences on local bodies:

- (i) Finance Commission's Conclave – Devolution to Development in collaboration with the Ministry of Panchayati Raj.
- (ii) National Conference of Mayors and Chairpersons on Strengthening Urban Local Government in India, in collaboration with Janaagraha Centre for Citizenship & Democracy.
- (iii) Conference on Urban Finances with the Asian Development Bank.

10.45 The outcomes from these studies and conferences have informed and enhanced our understanding of the local bodies and their financing. Additional information on the above studies and conferences is provided in Chapter 1 and the related Annexures.

Issues, Analysis and Approach

10.46 We recognise that expanding urbanisation is critical to raising the living standards in both urban and rural areas. Workers who migrate to urban areas do so in response to superior economic opportunities that help them raise their own as well as their extended families' living standards. In addition, such migration increases land per worker in rural areas, thereby boosting average worker productivity in these areas. With 46 per cent of its workers still in agriculture, very little land is available on a per-worker basis. Almost half of the land holdings in India are smaller than half a hectare, with their average size being a little less than a quarter hectare.

10.47 From the overall productivity standpoint, with 46 per cent of the workforce and only 17.8 per cent value added (at current prices) in agriculture in 2023-24, average value added per worker in industry and services combined is 3.9 times that in agriculture. Therefore, the movement of workers out of rural into urban areas, which is strongly correlated to the movement out of agriculture into industry and services, holds considerable potential to raise the overall value added per worker.

10.48 Considering this important role of urbanization in contributing to both rural and urban incomes, in our recommendations for ULB grants, we have paid explicit attention to an improvement in urban infrastructure of mid-size cities so that they are better prepared to respond to the rising demands of urbanization. Additionally, we have recognised that there is a pressing need for a good rural-to-urban transition framework to facilitate smooth and timely incorporation of peri-urban areas, administered as rural areas, into existing adjoining ULBs.

10.49 Our approach has also been guided by the need to continue the focus on the areas of water management and solid waste management. We acknowledge that large-scale assets have been created at the ground level relating to these priority areas and in the absence of proper operation and maintenance support, they may remain underutilised or even deteriorate.

10.50 We have paid special emphasis on the need for local bodies to generate their own resources. Currently, the own resources generated by the vast majority of local bodies, both rural and urban, are minuscule. They remain heavily, if not entirely, dependent on the Union and State Governments to carry out their mandate. The FC-15 had incorporated a mechanism to incentivize ULBs to increase their own-source revenues by linking release of the grant to growth in property-tax revenue. We have taken forward this incentivisation effort.

10.51 Successive FCs have stated that the primary responsibility for the provision of fiscal resources for RLBs and ULBs rests with the State Governments. In this respect, the role of SFCs is extremely important and in our recommendations, we have ensured that States constitute the SFCs and regularly act on their recommendations. To underscore the responsibility of States to transfer resources to local bodies, we have also linked a part of our grant to some matching funds from them.

10.52 The Commission considers that transparency and accountability are of paramount importance for the effective functioning of local bodies. This has been a constant area of focus, even for previous FCs. We find that significant progress has been made on this front, but much remains to be done to ensure the timely availability of accurate accounts and their audits.

Thrust on Urbanisation

10.53 Urbanisation is a catalyst for economic development. Cities concentrate resources, including physical and human capital, infrastructure and civil amenities, thereby fostering consumption, innovation and employment opportunities.

10.54 The Census of India classifies the population of a census town as urban. It defines a census town as any contiguous land area with (i) a population of 5,000 or more, (ii) a population density of 400 persons per square km or more and (iii) 75 per cent or more of the male population engaged in non-agricultural occupations. However, a large number of census towns do not have an urban administration; that is, they are not statutory towns.

10.55 In this Commission's view, timely and rule-based identification of urban areas, coupled with proper planning and adequate financing, are crucial for imparting impetus to India's urbanisation while concurrently enhancing the productivity and liveability of its cities. Ideally, each State should establish a clear transition policy to ensure the timely and rule-based identification of areas attaining urban characteristics. This policy should include a well-defined and time-bound mechanism and a phased approach for their transition to urban administrative units. The transition period should be utilised to establish appropriate urban administrative capacities and mechanisms for urban planning, the provision of urban services and infrastructure to citizens and the seamless transfer of records and information to the new administration. In essence, such policies should be aimed at raising the resources, infrastructure, services and political and administrative capacities to urban levels. In *Box 10.1*, we describe the Rural Urban Transition Policy of Odisha, notified on 27 June 2023, as a starting point for States interested in putting such a policy in place.

Box 10.1: Odisha's Rural Urban Transition Policy

Odisha has adopted a systematic and forward-thinking approach to urbanization in peri-urban areas through its Rural Urban Transition policy (June 2023). This policy establishes a clear roadmap for the transition of these areas into Urban Local Bodies by proactively endeavouring to provide urban-level services and infrastructure even before formal urban recognition. This vision is supported by budgetary allocations and dedicated handholding to bolster local political and bureaucratic capabilities. Employing a hub-and-spoke governance model led by a high-level steering committee and the State Urban Development Agency as the hub and District Urban Development Agencies and Development Authorities as the spokes, the policy creates a robust administrative mechanism. This mechanism also ensures citizen engagement and representation from local body representatives of the concerned ULBs and RLBs, alongside the expertise of urban planners, urban designers, development economists, infrastructure experts and IT specialists. The policy outlines specific factors for the selection and ranking of areas for transition, including population, density, contiguity with existing municipalities, revenue mobilization potential, land structure, employment structure, economic importance and details concerning mobility/transport and infrastructure. It envisions targeted interventions in urban planning and design, enhancing urban governance capacities and resources, establishing political representation aligned with urban norms, developing essential infrastructure and institutions and creating effective systems for revenue mobilization. This policy underscores the critical importance of a planned and phased transition as the foundation for systematic urbanization, aiming to prevent the numerous problems associated with haphazard and unrecognised urban growth.

Resource Mobilisation by Local Bodies

10.56 The importance of own sources of revenues cannot be overemphasised. Among RLBs, OSR is collected by Gram Panchayats in most States. Bihar and Uttar Pradesh are among the exceptions, with OSR in these States collected by District Panchayats. Block Panchayats are typically the least empowered to generate OSR in most States. *Annexure 10.1* contains the figures for OSR generated by all three tiers of RLBs in the States for the period 2019-20 to 2023-24.

10.57 Panchayats across India face significant challenges in mobilising their own revenue, resulting in a heavy reliance on grants, which often constitute over 90 per cent of their revenues. And it is quite evident that these grants come with usage restrictions, limiting panchayat autonomy. The Report of the Expert Committee of MoPR on OSR of RLBs highlights that OSR of these bodies covers merely 6-8 per cent of their total expenditure.

10.58 Despite being legally empowered to collect various taxes and fees, many panchayats fail to tap into these revenue streams due to a lack of clear statutory or administrative provisions, capacity constraints and weak enforcement mechanisms. On the margin, the grants have also worked as a disincentive to mobilise OSR.

10.59 The ongoing implementation of the SVAMITVA (Survey of Villages Abadi and Mapping with Improvised Technology in Village Areas) Scheme, launched in April, 2020, promises to lay a robust foundation for the growth of property taxes in rural areas, ultimately leading to enhanced OSR generation and improved financial self-sufficiency for RLBs. This scheme identifies the owners of rural properties, which is an important and necessary step towards property tax collection.

10.60 As per the RBI report on Municipal Finances, 2024, it has been observed that the own revenue sources are not adequate for meeting the revenue expenditure of most of the municipal bodies, thereby affecting their functional and financial autonomy. Municipal revenues are disproportionately concentrated in the larger ULBs.

10.61 The OSR figures of ULBs for all the States for the period 2019-20 to 2023-24, as collected by the Sixteenth Finance Commission (FC-16) from the States through the cityfinance portal, are provided in *Annexure 10.2*. Our analysis¹ shows that municipal corporations, which account for 50 per cent of the total ULB population as per Census 2011, account for 80 per cent of the total ULB OSR. In contrast, municipalities and town panchayats, which account for 36 per cent and 14 per cent of the ULB population as per the 2011 Census, collect only 16 per cent and 4 per cent of ULBs' OSR, respectively. Among the States, the ULBs of Maharashtra and

¹ Based on the data provided by States on cityfinance portal

Gujarat lead in the generation of OSR per capita in 2023-24, while States like Bihar, Jharkhand, Manipur and Meghalaya lag.

10.62 According to the analysis by Janaagraha², OSR contributes 51 per cent of total municipal revenues for all categories of ULBs in India. As expected, the share of OSR in the total revenues declines as the size of the ULB declines. For ULBs with a population larger than 40 lakh, OSR accounts for 61 per cent of total revenues. For ULBs with a population between 5 lakh and 40 lakh, this proportion declines to 55 per cent and for those with a population of less than 5 lakh, to just 32 per cent.

10.63 The heavy dependence of local bodies on Union and State Governments for revenues undermines the independence of these bodies as well as their accountability for service delivery to the local population. Partially motivated by these considerations, the FC-13 and FC-15 recommended the enhancement of OSR through improved collection of property/ house tax. FC-13 also suggested payment of service charges on Union and State Government properties and sharing of mining royalties with local bodies.

10.64 Out of all the tax sources available to local bodies, property tax offers the greatest revenue potential. However, it remains underutilised by both ULBs and RLBs. Therefore, successive FCs have recommended measures to increase property tax collection by these bodies. FC-15, in particular, made notification of minimum property tax rates (for 2022-23) and specified growth in property tax (from 2023-24 onwards) as entry-level conditions for availing ULB grants.

10.65 However, the potential of property tax remains unrealised. An analysis conducted by Janaagraha³, covering 3,895 ULBs representing 81 per cent of the total ULBs, reveals that against a total property tax demand of ₹69,937 crore in 2022-23, only ₹36,662 crore was collected. While the property tax collections have increased, growth rate has narrowed, indicating saturation and difficulty in meeting property tax growth condition in the later years of the award period of FC-15. According to the data provided by MoHUA as of March 2025, the number of State claims for FC grants went down from 22 States in 2023-24 to 16 States in 2024-25 due to the mandatory condition of the property tax growth. The overwhelming majority of the ULBs that could not meet this condition of FC-15 belong to the category of cities with less than 1 lakh population.

10.66 Janaagraha's analysis⁴ on property tax's contribution in the total OSR of ULBs for 2021-22 shows that while it is more than 60 per cent in Bihar, Karnataka and UP, it remains less than 10 per cent in Rajasthan. There are additional large variations within each State across

² As per the study conducted by Janaagraha for the Commission wherein annual financial statements of 2,646 cities for 2020-21 on cityfinance portal were analysed.

³ self-reported property tax data available on cityfinance.in as on 01 April 2024

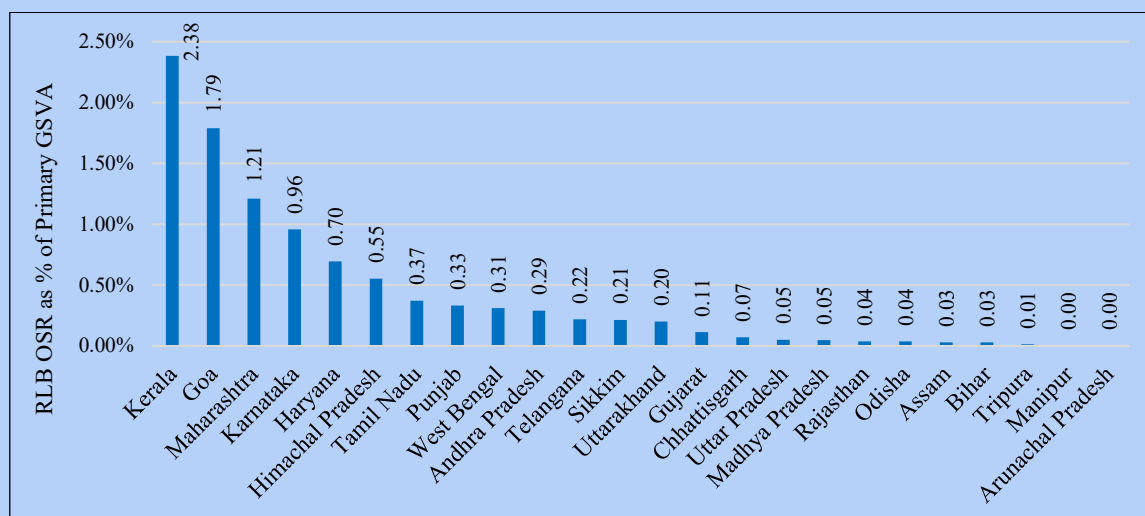
⁴ Janaagraha's analysis of audited statements of 3,322 ULBs covering 23 States available on cityfinance portal

ULBs. Incomplete and inaccurate property records, low coverage, undervaluation of properties and suboptimal collection efficiency are some of the reasons for low collection.

10.67 There is an urgent need to take steps to augment property taxes in the country to strengthen local body finances. States need to take the following steps for the enhancement of property tax collections:

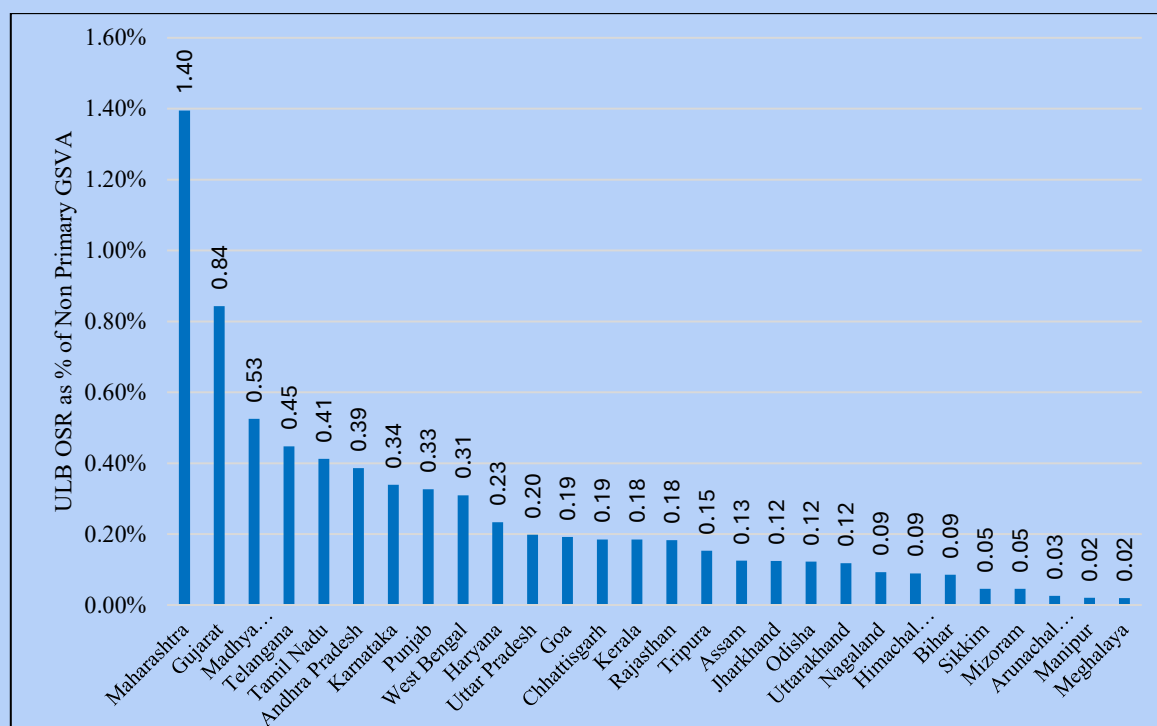
- (i) Enactment of appropriate rules and regulations for efficient levy and collection of property tax.
- (ii) Adoption of a GIS-based digital property tax register and linking with GIS-based master plan of the cities will ensure automatic updating of the property tax register whenever the master plan is revised. The register hence will reflect accurate current land use enabling upward revision of property tax.
- (iii) Mandating periodic enumeration and regular updating of property tax in line with the increase in guidance value in State acts and rules.
- (iv) An online self-assessment mechanism with a system for raising demand/sending reminders and a process for random scrutiny of self-assessment forms in urban areas.
- (v) Utilizing unique property IDs for the creation and maintenance of property databases facilitates efficient property tax billing and collections. This property database may be appropriately linked with other databases, like water, sewerage, electricity, trade license and building permissions for automatic verification of property attributes and assessment records

10.68 *Figure 10.2* shows the OSR generated by all three tiers of RLBs seen as a percentage of primary sector Gross State Value Added (GSVA) across States in 2023-24. While the overall levels are low, there is significant variation across States. The ratio of OSR to primary sector GSVA ranges from 2.38 per cent in Kerala to nil in the North-Eastern State of Arunachal Pradesh and only 0.03 per cent in Bihar. Similarly, *Figure 10.3* depicts OSR generated by ULBs as a percentage of non-primary sector GSVA across States in 2023-24. It can be seen that the percentage varies from 1.40 per cent in Maharashtra to 0.02 per cent in Manipur and Meghalaya. This disparity is indicative of the diverse degrees of devolution of powers for resource generation, the differences in the statutory landscape and administrative capacities and other related factors.

Figure 10.2 OSR of RLBs (percentage of Primary Sector GSVA, 2023-24)

Source: OSR data based on information provided by States on FC-16 portal, GSVA 2023-24 data provided by MoSPI.

Note: Jharkhand, Mizoram and Nagaland reported NA and Meghalaya provided only ADCs OSR which have been excluded from the RLBs OSR.

Figure 10.3 OSR of ULBs (percentage of Non-Primary Sector GSVA, 2023-24)

Source: OSR data based on information provided by ULBs on the cityfinance.in portal for FC -16 as on 28 August 2025 for 4,621 ULBs, GSVA 2023-24 data provided by MoSPI.

Accounts and Audit

10.69 The National Municipal Accounting Manual (NMAM), formulated in 2004, represented the first significant and concerted effort to introduce a uniform structure to the accounting practices of ULBs across the country. However, due to the absence of statutory backing, its adoption has been inconsistent and incomplete, both across different States and within individual States. Consequently, some States and larger ULBs continue to adhere to their own distinct accounting systems, often employing non-comparable accounting heads.

10.70 Based on the accounting data reported by the States for 97 per cent of ULBs through the cityfinance portal, 66 per cent follow accrual accounting, 21 per cent cash accounting and 13 per cent mixed cash-accrual accounting. There exist significant State-wise differences as well. For instance, around 98 per cent of ULBs in Andhra Pradesh, Tamil Nadu and Telangana adhere to accrual accounting in comparison to only 7 per cent in Goa and Punjab and 6 per cent in Nagaland. Such variation makes the examination, audit and a meaningful inter-State comparison extremely difficult.

10.71 An effort is currently underway at MoHUA to develop an Enterprise Resource Planning (ERP) solution for ULBs. It aims to facilitate the entry of financial transactions and the preparation of accounts in a manner integrated with the PFMS. MoHUA is also currently engaged in an effort to map the existing CoAs of ULBs with the CoA of the Union Government. The Union Government has also announced an Urban Data platform for improved governance. The Commission recommends extending the digital platform's capabilities to support ULBs in preparing accounts and financial reports.

10.72 In contrast to ULBs, RLBs have made excellent progress in providing the accounts data through the adoption of the e-Gram Swaraj platform. This web-based portal serves as a unified system facilitating planning, progress reporting and work-based accounting for over 2.5 lakh RLBs across the nation.

10.73 RLBs uniformly adhere to the cash-based Model Accounting System (MAS). This system offers a simplified accounting framework tailored to the needs of all three tiers of the PRIs. The accounting structure captures the fund flows under numerous schemes and its CoAs align with that of the Union and State Governments.

10.74 In this context, we support the continuation and strengthening of the arrangements for Technical Guidance and Supervision by the CAG. State Governments should augment the capabilities of their Local Fund Audit Departments (LFADs) by investing in skill development and addressing manpower shortages.

Data Sources

10.75 For RLBs, we procured data from States via specific formats on our dedicated portal. We also leveraged relevant data provided by MoPR, including information available on the e-GramSwaraj portal. For ULBs, data was collected by the Commission through the cityfinance portal and also provided by the MoHUA. Owing to the concerted efforts of Union Ministries and the conditionalities stipulated by previous FCs, the availability of local body data has

significantly improved over the years. The primary challenge is now shifting from the availability to the reliability and consistency of data across various platforms.

10.76 Although availability of financial data is largely there, the reliability and consistency issues impeded our analysis of data as well. Multiple rounds of efforts were required to obtain data free of obvious errors. Nevertheless, some data quality issues persisted until the very end. This experience has led us to conclude that there is an urgent need to address issues related to the quality and reliability of financial data relating to local bodies.

State Finance Commissions and Transfers by States

10.77 Successive FCs have encountered challenges in effectively utilizing the SFC reports for formulating recommendations concerning local bodies. After FC-15 made the constitution of SFCs and submission of their reports a precondition for the disbursal of local body grants, there has been a significant improvement on this score. However, most of the other issues highlighted by previous FCs have persisted. *Table 10.4* shows the status of the constitution of SFCs in various States⁵ as of May 2025.

Table 10.4 Status of Constitution of SFCs

Name of States	Last SFC Constituted
Assam, Himachal Pradesh and Kerala	VII
Bihar, Haryana, Maharashtra, Odisha, Punjab, Rajasthan, Sikkim, Tamil Nadu, Uttar Pradesh, Uttarakhand and West Bengal	VI
Andhra Pradesh, Jharkhand, Karnataka, Madhya Pradesh and Tripura	V
Chhattisgarh, Gujarat, Manipur and Nagaland	IV
Arunachal Pradesh, Goa	III
Mizoram, Telangana	II

Source: Data compiled by the Indian Institute of Public Administration and information collected from the States (as on May 2025)

10.78 Due to accounting-related limitations, the Commission was unable to make a precise assessment of State transfers to local bodies beyond the transfers under centrally sponsored schemes (CSS) and FC funds from the Finance Accounts of the States. Consistent with the Constitution, States must shoulder the responsibility of assessing the resource requirements of local bodies and make necessary transfers. The role of the grants from the Consolidated Fund of India, based on the recommendation of the FC, should be only supplementary. States should transparently report all transfers, including those from the Consolidated Fund of India on the recommendation of the Finance Commission, transfers under CSS, SFC grants and other grants from the State Government, separately for ULBs and RLBs in their budgets. These transfers,

⁵ Meghalaya has yet to constitute SFC, though it has notified The Meghalaya State Finance Commission Act, 2012 and The Meghalaya State Finance Commission Rules, 2013

with all their components, should also be reported in Appendix III of the State Finance Accounts. The Commission believes that financial reporting should adhere to standardised formats to ensure consistency and comparability across all local bodies, thereby enabling the future integration of data from the Union Government, State Governments and local bodies. States may expand their Integrated Financial Management Systems (IFMS) to incorporate a separate module that integrates information from multiple sources, which would facilitate the generation of fiscal outturns for both ULBs and RLBs in each State.

10.79 The data provided by the Accountant Generals of the States for 2022-23 indicates that States such as Haryana and Maharashtra transferred significant State funds to ULBs, whereas States like Andhra Pradesh, Nagaland and West Bengal have lagged in making the transfers. Karnataka and Kerala lead in transferring State funds to RLBs, whereas Andhra Pradesh, Assam and West Bengal lag.

10.80 There are two more issues related to SFCs deserving attention. First, it has been suggested that FC should play a gap-filling role, based on the expenditure requirements of local bodies and revenues from their own sources and grants from the States assessed by the SFCs. Such an approach runs the risk of making the States and the local bodies complacent in their revenue-raising efforts. A better alternative is to link the FC grants to States' own grants to local bodies and revenue efforts by the local bodies themselves.

10.81 Second, in Articles 280(3)(bb) and 280(3)(c), the Constitution directs the FC to make its recommendations on RLBs and ULBs 'on the basis of the recommendations made by the Finance Commission of the State.' However, as successive commissions have noted and this Commission has also experienced, serious obstacles remain in the way of meaningfully basing our recommendations on those provided by SFCs. As we do not anticipate these obstacles going away anytime in the foreseeable future, in conformity with FC-11, we recommend that the above-quoted expression be dropped from the relevant articles through a Constitutional amendment. We also recommend that NITI Aayog may study the functioning of SFCs across States and may publish a compendium of the good practices of the SFCs for the reference of all the States.

Grants for Local Bodies

10.82 In determining grants for local bodies, we have been guided by the history of RLB and ULB grants, trends in their utilisation, likely population growth of rural and urban areas and the fiscal resources available with the Union Government.

10.83 We recommend that grants for RLBs be classified into basic and performance components and those for ULBs into basic, performance, urban infrastructure and urbanisation premium components.

10.84 We recommend a total allocation of ₹7,91,493 crore as grants for duly constituted RLBs and ULBs for our award period spanning from 2026-27 to 2030-31. Out of this amount, we allocate ₹56,100 crore for a special infrastructure component and ₹10,000 crore for urbanisation premium, which we take up later. The remaining amount is allocated to RLBs and ULBs in

60:40 ratio, considering the projected urbanisation level of 40.73 per cent⁶ by 2031, coupled with the elevated cost of service delivery in urban areas. Each of the rural and urban component is sub-divided into basic and performance components in 80:20 ratio. *Table 10.5* shows the aggregate rural and aggregate urban grants over the five years of the Commission's award period. The performance components of both RLB and ULB grants are further divided into two equal halves, labelled RLB/ ULB performance component and State performance component. The RLB performance component begins in the third year of the award period for RLBs and the ULB performance component begins in the second year for ULBs. State performance component begins in the second year for both RLBs and ULBs.

Table 10.5 Local Body Grants of FC-16 (₹ crore)

Year	2026-27	2027-28	2028-29	2029-30	2030-31	Total
Rural	55,909	71,300	92,166	1,02,303	1,13,558	4,35,236
<i>Basic</i>	55,909	62,059	68,885	76,462	84,873	3,48,188
<i>RLB Performance Component</i>	0	0	13,023	14,455	16,046	43,524
<i>State Performance Component</i>	0	9,241	10,258	11,386	12,639	43,524
Urban	45,272	68,219	74,126	80,682	87,958	3,56,257
<i>Basic</i>	37,272	41,372	45,923	50,975	59,583	2,32,125
<i>ULB Performance Component</i>	0	6,161	6,839	7,591	8,425	29,016
<i>State Performance Component</i>	0	6,161	6,839	7,591	8,425	29,016
<i>Special Infrastructure Component</i>	6,000	12,525	12,525	12,525	12,525	56,100
<i>Urbanisation Premium</i>	2,000	2,000	2,000	2,000	2,000	10,000
Total	1,01,181	1,39,519	1,66,292	1,82,985	2,01,516	7,91,493

Allocation of the RLB Grant to States and Further Down

10.85 We next consider the inter se distribution of the RLB component of the grant. Once this is done, the grant allocated to a specific State must be allocated among the three levels of the PRIs: Gram Panchayat, Block Panchayat and District Panchayat. The final allocation is to individual Gram Panchayats, Block Panchayats and District Panchayats within the three levels of PRIs.

⁶ World Urbanisation Prospects 2018 by Department of Economic and Social Affairs, United Nations.

10.86 For State-level inter se allocation, we assign a 90 per cent weight to the projected rural population for 2026⁷ and 10 per cent to the total area of the State. The State wise inter se shares are in *Annexure 10.3*.

10.87 Within each State, the distribution of grants to duly constituted RLBs of all tiers may be undertaken as per the latest accepted recommendations of the respective SFC. In the absence of the SFC recommendations, the tier-wise distribution to RLBs may be in conformity with the percentages recommended in *Table 10.6*. The high share of Gram Panchayats has been allocated keeping in view their greater role and responsibilities with respect to the delivery of civic services.

Table 10.6 Inter-tier RLB Grant Sharing Within a State

Number of Tiers	GP	BP	DP
Three	80 per cent	10 per cent	10 per cent
Two	90 per cent	-	10 per cent
One	100 per cent	-	-

10.88 Within a particular tier of RLB, the distribution may be as per the latest accepted SFC recommendations or, in the absence of SFC recommendations, based on population and area in the ratio 90:10. The basic grant accrues during all five years of the award period, the RLB performance grant accrues from the third to the fifth year and the State performance grant from the second to the fifth year. State-wise shares and volumes of basic and performance components, divided in the ratio of 80:20, are given in *Annexures 10.5, 10.6 and 10.8* respectively. As explained later, conditionalities apply to the performance components of the grant.

Allocation of the ULB Grant to States and Further Down

10.89 In case of ULB grant, we first considered the State-level inter se allocation of the basic and performance components of the grant. We will return to the allocation of the Special Infrastructure and Urbanization Premium grants later. For the allocation of the basic plus performance components among the States, we assign a weight of 90 per cent to the 2026 urban population and a 10 per cent weight to an index based on own-source revenue (OSR). For the latter, we first calculate the ratio of the sum of OSRs across all ULBs within each State for the latest available 3 years, 2021-22 to 2023-24,⁸ to the sum of GSVA from secondary and tertiary sectors for the same three years⁹. We then set the share of a State within the 10 per cent of the total ULB grant equal to its population weighted by this ratio divided by the sum of the

⁷ Population Projections for India and States 2011-2036, July 2020, as per Report of the Technical Group on Population Projections of Ministry of Health and Family Welfare.

⁸ Data provided by the urban local bodies to FC-16 on cityfinance portal

⁹ Provided by MoSPI

populations of all States weighted by the corresponding OSR-to-GSVA ratio. The State wise inter se shares are in *Annexure 10.4* and the specific year-wise grants, quantum of basic and performance components for each State are detailed in *Annexures 10.5, 10.7 and 10.9* respectively. The basic component accrues all five years of the award period and the performance component from the second to the fifth year.

10.90 Within each State, the distribution of grants to duly constituted ULBs may be undertaken as per the latest accepted recommendations of the respective SFC. In the absence of SFC recommendations, 90 per cent of the State grant should be allocated according to the ULB's share in the sum of population of all ULBs and 10 per cent according to the OSR-based criterion, as explicated above.

Treatment of Exempted Areas

10.91 With reference to areas outside the purview of Part IX and Part IX-A of the Constitution, we recognise the developmental aspirations and essential service delivery needs of the significant population living in these regions. To address these needs equitably, we recommend treating these areas on par with local bodies in other areas. This is in keeping with the tradition set by FC-13 and FC-15. We recommend that the concerned State Governments make allocations for these areas on par with our recommendations with respect to the local bodies.

Conditionalities for Availing Grants

Entry Level Conditions

10.92 Consistent with the Constitution, we recommend three eligibility conditions that must be fulfilled before any local body grant is awarded. First, there should be a duly constituted body in place as required in Part IX and Part IX-A of the Constitution.

10.93 Second, there must be publicly available online, in the fiscal year T, provisional accounts of all RLBs and ULBs of the State for the fiscal year T-1 and audited accounts for the fiscal year T-2. Since this condition is being continued from FC-15, it will be applicable from the very first year of the award period. In cases where only a fraction of the local bodies meets this condition, grants should be disbursed to the State in proportion to the local bodies that meet this condition, with the condition applied separately to RLBs and ULBs. The audited accounts of ULBs should, at least, include the Balance sheet, Income and Expenditure statement, Cash Flow statement with the necessary schedules.

10.94 The third eligibility condition relates to the formation of the SFC. FC-15 had made the constitution of SFCs and the laying of an explanatory memorandum before the State legislature by 31 March 2024 a mandatory condition for States to avail local body grants for the fiscal years 2024-25 and 2025-26. This condition demonstrably exerted a significant positive influence on the constitution of SFCs by various States and the subsequent laying of their reports and the corresponding Action Taken Reports (ATRs) in the respective State legislatures. *Annexure 10.12* shows the list of States that formed their SFCs after the recommendations of FC-15.

10.95 Acknowledging the notable progress achieved by States in constituting SFCs and laying their ATRs in the State legislatures, we are inclined to continue with the conditionality established by the FC-15, albeit with certain modifications aimed at fostering the institutionalisation of timely SFC constitution within the States' administrative frameworks. Therefore, we recommend that all States comply with the Constitutional provision of forming the SFC on the expiry of five years from the formation of the previous SFC. The ATR must be tabled in the State legislature within 6 months of submission of the SFC report.

The Conditionality for Local Body Performance Component

10.96 The ULB and RLB grant has been divided into basic (80 per cent) and performance (20 per cent) components, with the latter divided into two equal halves: RLB/ULB performance component and State performance component. The basic component may be made available to the States upon fulfilment of the three entry-level (eligibility) conditions as explained in preceding paras. However, for each of the performance component, we recommend a qualifying condition.

10.97 Gram Panchayats have the necessary powers of taxation and levying user charges, with many of them already raising significant amounts in OSR. Therefore, to receive the RLB performance component of the RLB grant in fiscal year T, we recommend that Gram Panchayats raise, in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower, subject to a minimum amount of ₹1200 per household per annum. We have calculated the amount of ₹1,200 per household per annum based on user charges for services such as drinking water, sewerage and solid waste management, which are currently being collected in various States. The recommendation does not imply that the Gram Panchayats collect ₹1200 from each household annually, but rather that the total OSR from all streams, including rental income, income from assets, user charges and so on, should cumulatively equal or exceed ₹1200 per household per year.

10.98 For Block Panchayats, we recommend that they qualify for the RLB performance component of the RLB grant if 75 per cent of Gram Panchayats within their jurisdiction qualify for it. For District Panchayats, we recommend that to qualify for the grant in year T, District Panchayats raise, in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower.

10.99 For a ULB to qualify for the ULB performance component grant in year T, we recommend it raise in year T-1, minimum 1.05 times its OSR in year T-2 or 5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower. Based on the ULB OSR data reported by all States (*Annexure 10.2*), this growth constitutes a reasonable target.

The Conditionality for State Performance Component

10.100 Our data analysis shows that there is significant heterogeneity in transfers of resources to local bodies by the States. While some States are making substantial transfers to local bodies,

others provide at best limited funding to them. We have emphasised above that the primary responsibility of making adequate financial resources available to local bodies rests with the States. Transfers from Union, based on the recommendations of FCs, are meant to only supplement the State consolidated funds. Therefore, we recommend that the release of State performance components of the RLB and ULB grants in year T be contingent upon the State transferring from its own resources, in the year T-1, grants to local bodies amounting to 20 per cent or more of the basic FC grant recommended by us for the year T-1, starting from the second year. Revenues assigned and shared statutorily with the local bodies by the State would be included in these transfers for ascertaining the quantum of the transfers for the purposes of this condition.

In the Event of a Failure to Fulfil the Conditionality

10.101 If any of the conditionality discussed in this section goes unfulfilled, the undisbursed portion of a State's local body performance grants would be disbursed according to the following methodology:

- (i) The undisbursed portion of LBs failing to fulfil the conditionality in the case of the LB performance component grant of a State will be distributed to the performing LBs of the same State.
- (ii) Undisbursed portion of the State performance component due to the failure of a State to fulfil the conditionality would be distributed among the performing States according to the above-mentioned State-level inter se criteria. In turn, each recipient State will add the amount to its State performance component of the grant.
- (iii) The distribution of the undisbursed performance component of the grants, among the States and among the local bodies within a State, as the case may be, would follow the formulas spelled out above for the distribution of local body grants.

10.102 It is emphasised that this entire process would be conducted separately for RLBs and ULBs. The entry level conditions and performance conditions, along with their year of applicability, are presented in *Annexure 10.10*. The entry level conditions are mainly intended to sustain reforms initiated by previous FCs, whereas the performance conditions are directed towards bolstering the financial self-sufficiency of the local bodies and ensuring that States discharge their Constitutional duties.

10.103 To ensure that local bodies function as effective institutions of local self-governance, achieve fiscal autonomy and meet the aspirations of their citizens, Capacity building of the functionaries of the local bodies and the staff of local bodies is necessary. Creating a robust Learning Management System will go a long way in providing continuous learning opportunities and effectively strengthening the capacity of local bodies. This system could serve as a centralised platform for targeted training materials aimed at addressing the unique needs of local bodies. Such a system could also provide tailored content based on regional and State-specific needs and share national and international best practices. By collaborating with

State Governments and local bodies, the content can be customised to reflect the challenges and priorities of each area, ensuring that training is both relevant and practical. MoHUA and MoPR can work towards conceptualising and rolling out such a system so that the functionaries in the local bodies are geared up to meet the present-day challenges.

Tied and Untied Components

10.104 The flagship CSS schemes of the Swachh Bharat Mission (SBM), Atal Mission for Rejuvenation and Urban Transformation (AMRUT) and the Jal Jeevan Mission (JJM) have demonstrably generated a substantial impact on the ground across the nation within the critical national priority areas of Drinking Water and Sanitation. These initiatives have not only established significant infrastructure but have also fostered widespread awareness and facilitated notable behavioural changes. This progress, coupled with sustained funding from governmental sources, including FC-15 tied component, has yielded lasting positive outcomes in these priority sectors by 2025.

10.105 The proactive measures under the JJM have resulted in over 81 per cent of the more than 19 crore rural households being connected with tap water. Under AMRUT, water treatment plants with a cumulative capacity of 4,649 million litres per day and sewage treatment capacity of 4,429 million litres per day, along with 1.49 crore sewer connections, have been established. Similarly, under SBM-Urban, alongside the construction of nearly 64 lakh Individual Household Latrines, waste collection has witnessed a remarkable 97 per cent increase between 2014-15 and 2024-25, now encompassing 93,600 wards nationwide, while waste processing has surged from 18 per cent of waste generated in 2014-15 to 78 per cent in 2024-25. Building upon the significant success in toilet construction and promoting behavioural change towards sanitation under SBM-Gramin, the current focus has shifted towards creation of ODF plus villages. This entails not only sustaining the ODF status but also establishing comprehensive arrangements for Solid and Liquid Waste Management, ensuring visual cleanliness within the villages. As reported by the Ministry of Jal Shakti, over 3.99 lakh villages out of India's more than 6.5 lakh villages have been declared as ODF model villages. This unequivocally supports the conclusion that sustained governmental efforts, in conjunction with active citizen engagement, have created a massive on-ground impact in these national priority areas.

10.106 This collective progress underscores India's commitment in enhancing the quality of life for its citizens and demonstrates its dedication to achieve Sustainable Development Goal 6 on Clean Water and Sanitation, while also advancing towards a climate-resilient future. The Commission also observed that the utilization of tied funds recommended by the FC-15 has been higher in the area of Sanitation and Solid Waste Management compared to Drinking Water Supply for both RLBs and ULBs. This may reflect greater progress of Union and State schemes in Sanitation and Solid Waste Management on the one hand and greater scope for the effective utilization of funds in Drinking Water on the other.

10.107 Therefore, we recommend tying 50 per cent of the basic component and leaving the remaining 50 per cent of the basic component and the entire performance component untied. The tied component should be directed towards ‘Sanitation and Solid Waste Management’ and/or ‘Water Management’. Within the tied component, full flexibility should be available to local bodies to address their needs, including O&M expenditures for the above tied items.

10.108 The untied component of the local body grants would be 50 per cent of the basic component which is 80 per cent of the total LB grants (40 per cent) and 100 per cent of the performance component which is 20 per cent of the total LB grants (20 per cent), subject to fulfilment of both the performance conditions, adding up to a total of 60 per cent of the basic plus performance grants. A significantly enhanced percentage of untied funds over the previous FC would empower local bodies to address locally identified needs and the flexibility inherent in their utilisation would lead to higher rates of both disbursal and utilisation. During consultations, representatives of Local Governments from various States have repeatedly underscored the importance of increasing the proportion of untied funds to effectively address locally felt needs.

10.109 We also recommend that no local body should be allowed to spend more than 20 per cent of the untied allocation on the construction and maintenance of roads¹⁰. Moreover, the untied grants should not be used for the payment of salaries or other establishment-related expenditure. The Gram Sabha would pass resolutions for specific activities to be undertaken under both tied and untied grants by a Gram Panchayat and similar resolutions would be needed at the level of Block Panchayat and District Panchayats as well. Likewise, activities under the tied and untied grants in urban areas should be undertaken based on the resolutions passed by the concerned ULBs.

10.110 We also recommend that the practice of publishing Service Level Benchmarks (SLBs), mandated for MPCs by the FC-15, may be continued and extended to all ULBs. To enhance the credibility of the self-reported figures for SLBs by cities and establish a reliable database of service data that can be effectively leveraged for decision-making, planning and initiatives aimed at improving the levels of services provided to citizens by the ULBs, a certain degree of authentication, perhaps in the form of a third party assessment or audit, may be introduced into the system to verify these self-reported figures. MoHUA may collaborate with State Governments, ULBs and CAG in developing such a verification mechanism.

10.111 We extensively reviewed the compliance of conditions recommended by the previous Commission by the States and the subsequent release of grants. We observe that, in general, the North Eastern States face difficulties in complying with the conditions on time and, consequently, in claiming the grants. Therefore, we recommend that, once the operational guidelines are issued, MoPR and MoHUA should organize regional workshops to familiarize States with the current Commission’s recommendations, the operational guidelines, the

¹⁰ including but not limited to all types of paved surfaces such as bituminous/black-topped/asphalt, cement concrete/concrete, interlocking concrete block pavements, gravel, mud and so on.

modalities to be followed for compliance and the process of claiming grants, with special focus on the North Eastern States. The concerned ministries should, as far as possible, actively support and handhold the North Eastern States throughout this process.

Urbanisation Premium

10.112 In our earlier discussion in this chapter, we have emphasised the importance of urbanisation in general and the rural-to-urban transition in particular. We have also argued in favour of a formal rural-to-urban transition policy. However, as peripheral areas are merged into the adjacent municipalities as a part of implementing such a policy, the existing ULB itself faces a transition problem. It must immediately begin working on the provision of infrastructure and services to the newly incorporated area at the same level as those in the existing areas of the municipality. Yet, it takes a while to complete the formalities necessary to begin raising tax revenue from this area. The only way to speedily complete the transition for the municipality is to divert resources from existing municipal areas to the newly incorporated area.

10.113 To tide over this initial challenge, we recommend a one-time grant as an incentive for the merger of peri-urban villages into an adjoining larger ULB with an existing population of not less than one lakh. We have assessed the total quantum of urbanisation premium to be ₹10,000 crore for the complete award period, to be disbursed as a one-time eligibility amount of ₹2,000 per person, calculated over the population (based on Census 2011 population) of the new area being incorporated in the ULB. These grants should be made available to States to support the establishment of essential administrative structures and provide certain citizen services in the peri-urban areas transitioning from rural to urban status through mergers with an existing ULB. The final beneficiary of the grant should be the relevant municipal body, which may use it for the upgradation of basic infrastructure in the newly included areas or the upgradation of capacity for the provision of civic services in them.

10.114 Previously, we have highlighted the importance of a transparent standing rural-to-urban transition policy. We recommend the formulation of such a Transition Policy as a precondition for claiming the urbanisation premium grant. Some of the components of the Rural to Urban Transition Policy of the State could be:

- (i) Identification of transitional settlements among qualifying settlements after every Census and at a regular interval not exceeding 3 years, with the stipulation of covering at least one-third of qualifying settlements for transition.
- (ii) Detailed procedure for identification, assessment and notification of transitional areas.
- (iii) Detailed Transition plan (with approximately 3-year horizon) for:
 - (a) Impact assessment on finances, manpower, service delivery and infrastructure.
 - (b) Financial and institutional support to raise the citizen service delivery and infrastructure standards up to certain minimum pre-defined levels.

- (c) Phased levy of taxes such as property tax and user charges
- (d) Implications on master plan and land use conversion regulations.
- (e) Institutional continuity with respect to office, assets, records and staff.
- (f) Public consultations and citizen communication.
- (iv) Roles and responsibilities among State Government departments/agencies, district administration, erstwhile RLB and the newly created ULB, along with an appropriate grievance redressal mechanism.

Infrastructure Upgradation in Urban Growth Centres

10.115 In previous paras, the Commission has underscored the importance of urbanization for economic growth. The urban population of India has grown more than four times in the last fifty years. This kind of rapid urbanisation requires urgent upgradation of urban infrastructure in Indian cities. In the past, the migrating population has flocked in disproportionately large numbers to the large cities with populations of 4 million or more. Considering this fact, there is a need to invest in the upgradation of cities with populations of less than 4 million. Such an upgradation will create more centres of growth in the country, thereby lightening the burden on the cities with populations of 4 million or more. It will also enhance the living standards while keeping the cost of living low. Industry may also find locating in these areas attractive due to the lower wages it will have to pay in the medium size cities than in larger cities.

10.116 One of the major challenges that these cities face is the presence of obsolete, poorly maintained and inadequate drainage systems, coupled with apathy towards natural drainage paths, which leads to poor wastewater management. While this is adversely impacting quality of life in these cities due to poor sanitation levels, it is also causing avoidable damage to other infrastructure, such as roads and clean drinking water supply systems. With the impact of climate change clearly visible, cities are experiencing high-intensity rainfall events with erratic frequency, leading to flooding events that the existing drainage systems are unable to handle. This is not only causing inconvenience to the urban population but also has a negative economic impact due to disruption in economic activities. Cities need to have a drainage master plan, invest in and maintain their drainage systems. An illustrative example of comprehensive interventions achieving a decisive impact in wastewater management through the judicious leveraging of diverse funding sources is exemplified by Indore City, as detailed in *Box 10.2*.

10.117 Therefore, we recommend that a Special Infrastructure Component for selected ULBs be tied to the development of a comprehensive wastewater management system in cities with populations less than 40 lakh but more than 10 lakh, as per the 2011 Census, limited to two per State. We provide the list of these cities in *Annexure 10.11*. This amount is to be used to finance projects worth up to ₹5,000 crore in cities with a population of 15 lakh or more and up to ₹3,500 crore in cities with a population of less than 15 lakh, wherein the share of the Union Government would be 60 per cent of the project cost and the remaining cost would be contributed by the

State Government and the concerned ULB. The aggregate amount under this component would amount to ₹56,100 crore.

Box 10.2 Swachha Indore

Indore has consistently topped the Swachh Survekshan rankings for seven consecutive years, achieving recognition as India's first Water Plus city and a 7-Star rated city. Prior to this, Indore, like numerous other Indian urban centres, contended with significant challenges, including extensive garbage accumulation, presence of stray cattle, insufficient waste management infrastructure, nearly a century of accumulated legacy waste, widespread discharge of untreated sewage into rivers and *nallahs* and sub-optimally managed secondary storage bins. The remarkable transformation from this State to its current position at the forefront of cleanliness rankings was realised through a comprehensive set of actions, fundamentally centred upon *Jan Bhagidari*, or citizen participation.

Efficient liquid waste management was achieved through comprehensive interception of household and grey water sewage outfalls into rivers and stormwater drains, coupled with the establishment of a robust sewerage network. The city expanded the access to Sanitation services through increase in community toilets, standalone urinals, individual household latrines, etc. A comprehensive sewerage network consisting of 3 centralised and 7 decentralised co-treatment Sewage Treatment Plants (STPs) was constructed to adequately handle the wastewater generated in the city. Initiatives also included cleaning of Saraswati river as well as 200+ km of *nallahs* while also reclaiming *nallahs* as community spaces. The treated water was reused and 100+ km of piped network was created to carry treated water from STPs.

These achievements were facilitated by leveraging funds from schemes such as Atal Mission for Rejuvenation and Urban Transformation (AMRUT) and Smart Cities Mission, alongside the utilisation of OSR. Furthermore, the city deployed innovative financing mechanisms, including the issuance of green bonds and trading in carbon credits.

These actions were further complemented by initiatives fostering behavioural change, primarily through comprehensive awareness campaigns, community-based programmes and active engagement with Non-Governmental Organisations (NGOs). The confluence of these diverse initiatives and concerted funding efforts has yielded a decisive impact within the city of Indore.

10.118 These projects should lead to the development of a comprehensive wastewater management system and can be undertaken in the following indicative areas:

- (i) Upgradation of the existing drainage network, including the separation of stormwater and underground drainage systems.
- (ii) Extension of network to the uncovered areas.
- (iii) Identification of problem areas and taking up area-specific works.
- (iv) Restoration of natural drainage pathways and development of green infrastructure essential for wastewater management.
- (v) Reduction of non-revenue water.

- (vi) Development of monitoring systems and systems to ensure the free flow of wastewater.

10.119 In the first year of the award period, the selected ULBs would be required to conduct a detailed study on the kind of interventions required for comprehensive wastewater management within the allocated amount. The ULBs would be required to prepare detailed project reports with year-wise milestones and financial outlays. The tripartite MoU would be signed between the MoHUA, the State Government and the ULB. MoU should have project details, year-wise milestones and financial outlays. Grants should be released after the signing of the MoU for the first milestone and upon achieving the project milestones for the next milestone.

10.120 In addition to capital expenditure on creating infrastructure assets under this grant, the concerned ULB may ensure the necessary awareness initiatives, wherever applicable. The cities should enhance their capabilities to bear the future operation and maintenance expenditure of the assets created under the scheme from their own sources of revenue.

Timely Release of Grants

10.121 We recommend that the local body grants shall continue to be released in a minimum of two equal instalments each year, consistent with the existing practice and subject to the fulfilment of the conditions stipulated by the Commission.

10.122 The basic component can be released on fulfilment of the entry-level conditions, some of which are not relevant every year, such as the conduct of elections for the constitution of local bodies or the formation of the SFC and the submission of ATR on their reports. For the performance component, the State should provide the details of achievement on both of the performance parameters. The Union Government should ensure that where a set of local bodies within the State meet the conditions, the grants due to them are released without waiting for the rest. The release of the urbanisation premium component should be claimed by the State when mergers, as explained earlier, are notified. The release of the special infrastructure component should be made separately for each city upon achieving milestones as outlined in the MoU.

10.123 Furthermore, it is recommended that State Governments ensure the transfer of these grants-in-aid to their respective local bodies within ten working days of their receipt from the Union Government. Any delay in this transfer beyond the stipulated ten working days shall obligate the State Governments to release the funds along with interest, calculated at the effective rate of interest applicable to market borrowings/State Development Loans for the preceding financial year.

10.124 We recommend that no further conditions, other than those explicitly indicated in this chapter, should be imposed either by the Union Government or the State Governments for the release of local body grants to the ULBs and RLBs.

Summary of Recommendations

- (i) We recommend that the States should develop a citizen friendly GIS based property tax IT system for efficient enumeration, assessment and collection of property tax.
(paragraph 10.67)
- (ii) We recommend extending the Urban Data platform's capabilities to support ULBs in preparing accounts and financial reports.
(paragraph 10.71)
- (iii) The existing arrangements for Technical Guidance and Supervision by the CAG should be continued and strengthened to improve the quality of audit and accounts of local bodies in the States. State Governments should augment the capabilities of their Local Fund Audit Departments (LFADs) by investing in skill development and addressing manpower shortages.
(paragraph 10.74)
- (iv) The States should transparently report all transfers to local bodies, including those from the Consolidated Fund of India on the recommendation of the Finance Commission, transfers under centrally sponsored schemes, State Finance Commission grants and other grants from the State Government, separately for ULBs and RLBs in their budgets. These transfers, with all their components, should also be reported in Appendix III of the State Finance Accounts.
(paragraph 10.78)
- (v) In Articles 280(3)(bb) and 280(3)(c), the Constitution directs the FC to make its recommendations on RLBs and ULBs 'on the basis of the recommendations made by the Finance Commission of the States.' We recommend that the above-quoted expression be dropped from the relevant articles through a Constitutional amendment.
(paragraph 10.81)
- (vi) We recommend that NITI Aayog may study the functioning of SFCs across States and may publish a compendium of the good practices of the SFCs for the reference of all the States.
(paragraph 10.81)
- (vii) We recommend that the grants for RLBs be classified into basic and performance components and the grants for ULBs be classified into basic, performance, urban infrastructure and urbanisation premium components. The aggregate national grant allocation for basic and performance components, put together has been divided in the ratio of 60:40 between RLBs and ULBs. Inter se, the division between basic and performance components is recommended in the ratio of 80:20 for both RLBs and ULBs.
(paragraphs 10.83 and 10.84)

- (viii) A total allocation of ₹7,91,493 crore as grants recommended for duly constituted RLBs and ULBs for our award period spanning from 2026-27 to 2030-31.

(paragraph 10.84)

- (ix) For RLBs, inter-State distribution is based on a 90:10 ratio of projected rural population (2026) and area, respectively. For ULBs, the States' share has been determined by a 90:10 ratio of projected urban population (2026) and the OSR of ULBs, respectively.

(paragraphs 10.86 and 10.89)

- (x) Within each State, the distribution of grants to duly constituted RLBs of all tiers and to duly constituted ULBs may be undertaken as per the latest accepted recommendations of the respective SFCs. In the absence of the SFC's recommendations, the tier wise distribution to RLBs may be in conformity with the prescribed percentages. Within a tier of RLB, the distribution may be as per the latest accepted SFC recommendations or in the absence of SFC recommendations based on population and area in the ratio 90:10. For ULBs, the distribution may be as per the latest accepted SFCs recommendations or in the absence of SFC's recommendations, based on urban population and OSR of ULBs in the 90:10 ratio.

(paragraphs 10.87, 10.88 and 10.90)

- (xi) The concerned State Government shall make allocations for exempted areas on par with the Commission's recommendations with respect to local bodies.

(paragraph 10.91)

- (xii) There should be a duly constituted body in place as required in Part IX and Part IX-A of the Constitution to claim local body grants. This would be the first entry level condition.

(paragraph 10.92)

- (xiii) Online availability in public domain in year T of audited accounts for all ULBs and RLBs of a State for the T-2 fiscal year and provisional accounts for the T-1 year would be the second entry-level condition to avail local body grants for the year T.

(paragraph 10.93)

- (xiv) All States must comply with the Constitutional provisions pertaining to the regular constitution of SFCs due as per the Constitutional provision, that is, on expiry of five years of constitution of previous SFC and ensure laying of ATRs in the State legislature within 6 months of submission of the SFC report as a prerequisite to claim their local body grant. This would be the third entry level condition to claim local body grants from the first year of the award period, that is from 2026-27.

(paragraph 10.95)

- (xv) The ULB and RLB grant has been divided into basic (80 per cent) and performance (20 per cent) components, with the latter divided into two equal halves: RLB/ULB performance component and State performance component. The basic component may be made available to the States upon fulfilment of the three entry-level (eligibility) conditions.

(paragraph 10.96)

- (xvi) For Gram Panchayats to receive the RLB performance component of the RLB grant in fiscal year T, we recommend that Gram Panchayats raise, in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower, subject to a minimum amount of ₹1200 per household per annum. This will be applicable from the third year of the award period, that is, 2028-29 onwards.

(paragraph 10.97)

- (xvii) For Block Panchayats, we recommend that they qualify for the RLB performance component of the RLB grant if 75 per cent of Gram Panchayats within their jurisdiction qualify for it. For District Panchayats, we recommend that to qualify for the grant in year T, District Panchayats raise, in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower. Both of these will be applicable from the third year of the award period, that is, 2028-29 onwards.

(paragraph 10.98)

- (xviii) For ULBs to qualify for the ULB performance component grant in year T, we recommend it raise in year T-1, minimum 1.05 times its OSR in year T-2 or 5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower. This will be applicable from the second year of the award period, that is, 2027-28 onwards.

(paragraph 10.99)

- (xix) We recommend that the release of State performance components of the RLB and ULB grants in year T be contingent upon the State transferring from its own resources, in the year T-1, grants to local bodies amounting to 20 per cent or more of the basic FC grant recommended by us for the year T-1, starting from the second year.

(paragraph 10.100)

- (xx) If any of the performance conditionalities goes unfulfilled, the undisbursed portion of a State's local body performance grants would be disbursed according to the prescribed methodology.

(paragraph 10.101)

- (xxi) Ministry of Housing and Urban Affairs and Ministry of Panchayati Raj can work towards conceptualising and rolling out a Learning Management System for the functionaries and staff of local bodies so that the functionaries in the local bodies are geared up to meet the present-day challenges.

(paragraph 10.103)

- (xxii) 50 per cent of the basic component should be tied and the remaining 50 per cent of the basic component and the entire performance components should remain untied. The tied component should be directed towards 'Sanitation and Solid Waste Management' and/or 'Water Management'.

(paragraph 10.107)

- (xxiii) We recommend that no local body should be allowed to spend more than 20 per cent of the untied allocation on the construction and maintenance of roads. Moreover, the untied grants should not be used for the payment of salaries or other establishment-related expenditure.

(paragraph 10.109)

- (xxiv) The practice of publishing Service Level Benchmarks should be continued and extended to all ULBs along with introduction of a third-party assessment or audit mechanism in the system to enhance the reliability of the self-reported figures.

(paragraph 10.110)

- (xxv) MoPR and MoHUA should organize regional workshops to familiarize States with the Commission's recommendations, the operational guidelines, the modalities to be followed for compliance and the process of claiming grants, with special focus on the North-Eastern States.

(paragraph 10.111)

- (xxvi) The total quantum of urbanisation premium, for incentivising rural to urban transitions, to be ₹10,000 crore for the complete award period with a fixed per capita one-time eligibility amount to be ₹2,000 per person (based on Census 2011 population). The release of urbanisation premium component should be claimed by the State on mergers of peri-urban villages into adjoining larger ULB with existing population not less than One lakh and formulation of an appropriate Rural to Urban transition policy.

(paragraphs 10.113 and 10.114)

- (xxvii) A Special Infrastructure Component for selected ULBs with the outlay of ₹56,100 crore to facilitate decisive intervention in comprehensive wastewater management in urban growth centres.

(paragraph 10.117)

- (xxviii) The local body grants shall continue to be released in minimum two equal instalments each year, consistent with the existing practice and subject to the fulfilment of the conditions stipulated by the Commission.

(paragraph 10.121)

- (xxix) The Union Government should ensure that where a set of local bodies within the State meet the conditions, the grants due to them are released without waiting for the rest.

(paragraph 10.122)

- (xxx) State Governments should ensure the transfer of the grants-in-aid to their respective local bodies within ten working days of their receipt from the Union Government. Any delay in this transfer beyond the stipulated ten working days shall obligate the State Governments to release the funds along with interest, calculated at the effective rate of interest applicable to market borrowings/State Development Loans for the preceding financial year.

(paragraph 10.123)

- (xxxi) No further conditions, other than those explicitly indicated in this chapter, should be imposed either by the Union Government or the State Governments for the release of local body grants to the ULBs and RLBs.

(paragraph 10.124)

□□□

11.1 Financing of Disaster Risk Management initiatives in India has evolved significantly over the years. Earlier, the focus was mainly to finance relief and rescue operations, but now the framework has expanded to cover recovery, rehabilitation, mitigation and capacity building. The current ToR for the Commission specifically mandate “a review of the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005, and to make appropriate recommendations thereon”. While the Fifteenth Finance Commission (FC-15) recommended the continuation of the Disaster Response Funds (SDRF and NDRF), it also proposed the constitution of Mitigation Funds (SDMF and NDMF) with earmarked allocations specifically for mitigation activities which were mandated by the Disaster Management Act, 2005 (hereinafter called the DM Act). As a result, all funds envisaged under the DM Act have been constituted by all the States as well as by the Union. The only exception is the constitution of the district-level disaster response and mitigation funds (DDRF and DDMF), which FC-15 found not to be a practical idea. Yet, FC-15 recognized the need for allocations for district administration and local governments for efficient management of disasters. In addition to operationalisation of these statutory funds, the rising frequency and intensity of extreme weather events, causing widespread impact on lives, livelihoods, housing, and infrastructure, necessitate a deeper examination of varying disaster risk financing requirements of States within this review.

11.2 Disaster severely disrupts progress, destroys the hard-earned outcomes of developmental efforts and often pushes back societies by years, sometimes decades. Consequently, there has been a paradigm shift from merely responding to disasters towards adopting efficient mitigation practices, both in India and globally. This shift recognises not only the increasing frequency and intensity of disasters but also emphasises the imperative to limit the impact of disasters to cause havoc to the lives and livelihoods.

Institutional Framework

11.3 India has progressively built a robust legal, institutional, and administrative framework for disaster management. A defining moment came with the enactment of the DM Act, 2005, which provided a comprehensive legislative basis for disaster management in the country. The Act provided for the establishment of key institutions at National, State, and District levels: the National Disaster Management Authority (NDMA) headed by the Prime Minister, the State Disaster Management Authorities (SDMAs) headed by Chief Ministers, and the District Disaster Management Authorities (DDMAs) headed by District Collectors/ Deputy Commissioners/ District Magistrates.

11.4 The NDMA, as the apex body, is responsible for formulating policies, plans, and guidelines for disaster management, ensuring their enforcement and coordination across ministries, departments, and States. It oversees the application of funds for mitigation and preparedness, and exercises superintendence over the National Disaster Response Force. The National Institute of Disaster Management (NIDM), under the NDMA's guidance, focuses on capacity building, training, research, and information management related to disaster risk reduction. NDMA's mandate covers both natural and man-made disasters.

11.5 Supporting the NDMA is the National Executive Committee (NEC), chaired by the Union Home Secretary, and comprising Secretaries of key Union Ministries and Departments. It assists in policy implementation, prepares the National Plan for Disaster Management, coordinates disaster response activities, and ensures compliance with NDMA's directives.

11.6 At the State level, the SDMAs, chaired by Chief Ministers, are responsible for approval of State Disaster Management Plans in accordance with national guidelines, coordinating plan implementation, allocating mitigation funds, and integrating disaster risk measures into departmental development plans. To aid the SDMAs, each State has a State Executive Committee, headed by the Chief Secretary, which monitors plan implementation and coordinates information flow with the NDMA.

11.7 At the district level, DDMAs serve as the planning, coordinating, and implementing bodies for disaster management, following guidelines set by NDMA and SDMA. DDMAs prepare and implement district disaster management plans and monitor compliance by local authorities and district departmental offices.

11.8 Local authorities, including panchayat raj institutions, municipalities, autonomous district councils, cantonment boards, and development authorities, play a critical role in disaster management at the grassroots level. They are responsible for developing disaster management plans, building capacity among their personnel, and undertaking relief, rehabilitation, and reconstruction activities in disaster-affected areas in their respective jurisdictions.

11.9 NIDM plays a pivotal role in capacity development, functioning as a 'Centre of Excellence' for training, research, and documentation in disaster management. It collaborates

with research institutions and knowledge networks to develop national-level information bases and supports the training needs of disaster management personnel across the country.

11.10 For specialised response during disasters, the DM Act mandates the constitution of the National Disaster Response Force, comprising battalions from different paramilitary forces strategically located across the country. The National Disaster Response Force units work closely with State Governments and train State Disaster Response Forces. Their role includes rapid deployment for search and rescue, emergency medical assistance, and relief operations.

11.11 In cases of severe calamities, Inter-Ministerial Central Teams are deployed to assess damage and recommend assistance. Their assessments are scrutinised by the Inter-Ministerial Group headed by the Union Home Secretary (or the Secretary, Agriculture for agricultural disasters), and the recommendations are placed before the High-Level Committee comprising key Cabinet Ministers for final approval.

11.12 Disaster management is inherently multi-disciplinary, and it engages all ministries and departments of the Union and States. At the national level, the National Crisis Management Committee, chaired by the Cabinet Secretary, coordinates responses to major disasters with serious or national implications.

11.13 The primary responsibility for disaster management rests with the States. The DM Act mandates the preparation of disaster management plans, the integration of risk reduction into development programmes, the establishment of early warning systems, and the allocation of dedicated funds for disaster management by State Governments.

11.14 At the operational level, DDMAAs serve as critical hubs for planning, coordination, and implementation. The armed forces continue to play a crucial role in disaster response, particularly in extreme scenarios, providing communication support, search and rescue operations, health and medical facilities, and transportation. Their expertise, rapid response capabilities, and resources make them indispensable during major disasters. At the national level, the Chief of the Integrated Defence Staff is a member of the NEC to ensure better coordination between civil and military authorities during disaster situations.

11.15 States have also strengthened their internal disaster response capabilities by establishing State Disaster Response Forces, providing an important first line of defence during disasters alongside the National Disaster Response Force.

Recommendations by the Past Finance Commissions

11.16 Financing of disaster management in India has undergone a structural transformation from the concept of Margin Money by the Second Finance Commission (FC-2) to the institutionalisation of mitigation funds by FC-15.

11.17 FC-2 introduced the concept of ‘margin money’ which was to be used in the event of calamities of moderate nature. It was estimated based on the average annual expenditure on relief over the previous decade. This arrangement was followed till the Eighth Finance

Commission (FC-8) which also mandated 50 per cent contribution from the Union. FC-8 also recommended that fire be treated as a disaster in the same way as floods, cyclones and earthquakes. The Ninth Finance Commission (FC-9) recommended a new arrangement for financing relief expenditure by setting up the Calamity Relief Fund (CRF). The Union would contribute 75 per cent of the CRF while the States would contribute 25 per cent. The Tenth Finance Commission (FC-10) recommended the continuation of the CRF and setting up of a National Fund of Calamity Relief (NFCR) to assist the States affected by severe calamities. The Eleventh Finance Commission (FC-11) reviewed the functioning of the NFCR and found that not only had the entire corpus of the fund been exhausted in three years, but it also failed to make adequate funds readily available for meeting the requirements of calamities of rare severity. FC-11 dissolved the NFCR and recommended the setting up of a National Calamity Contingency Fund (NCCF) with an initial corpus of ₹500 crore which was to be recouped through the levy of a special surcharge on central taxes. The Twelfth Finance Commission (FC-12) recommended the continuation of CRF and NCCF and also recommended that landslides, avalanches, cloud bursts and pest attacks be added to the list of notified disasters.

11.18 When the Thirteenth Finance Commission (FC-13) deliberated on the issue of disaster relief and management, the DM Act, 2005 had already come into effect, which provided for response and mitigation funds at National and State levels. FC-13 reviewed the disaster risk financing arrangements in the light of these statutory provisions and recommended that the CRF be merged into the SDRFs of individual States and that the NCCF be merged into the NDRF. It also suggested that the contributions to the SDRFs be shared between the Union and States in the ratio of 75:25 for general category States, and 90:10 for special category States. The size of SDRF for States was estimated based on past expenditure. Fourteenth Finance Commission (FC-14) followed the expenditure-driven approach of previous Finance Commissions (FCs), and it also made a significant recommendation that up to 10 per cent of the funds available under the SDRF could be used by State Governments for disasters that are not included in the notified list of disasters of the Union Government but are considered as ‘disasters’ within the local context.

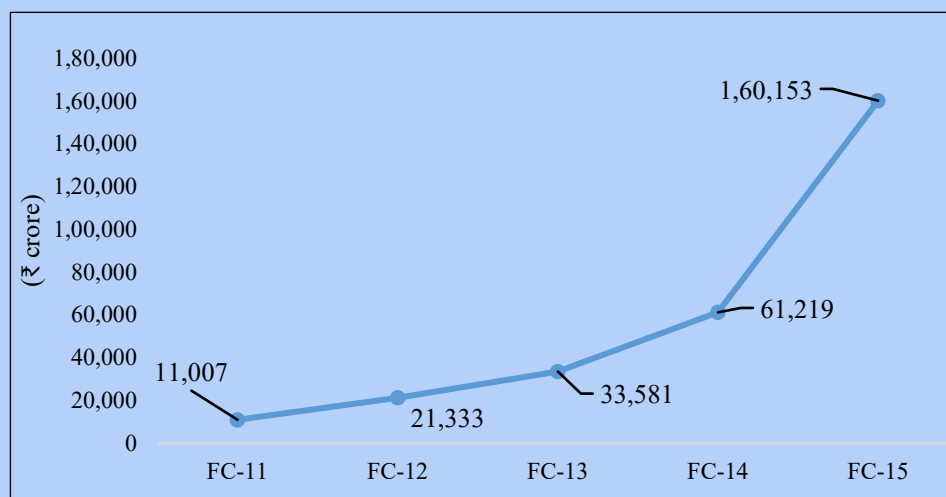
11.19 FC-15 made many far-reaching recommendations with respect to disaster risk management. It departed from the 100 per cent expenditure-based approach to inter se allocation of funds followed by past FCs and recommended a mix of Disaster Risk Index (DRI) based approach and past expenditure-based approach. It brought mitigation efforts to the centre stage of disaster management discourse by constituting mitigation funds at both the State and Union levels. It also recommended sub-windows for response and relief, recovery and reconstruction and capacity building on the one hand and various earmarked allocations for specific purposes such as mitigation of urban flooding and modernisation of fire services on the other.

Trends in Allocation for States

11.20 The allocation for disaster management has seen a substantial increase over the award periods of the last five FCs. FC-15 recommended a significant increase of 161 per cent to ₹1,60,153 crore over the period from 2021-22 to 2025-26. The allocation by the previous

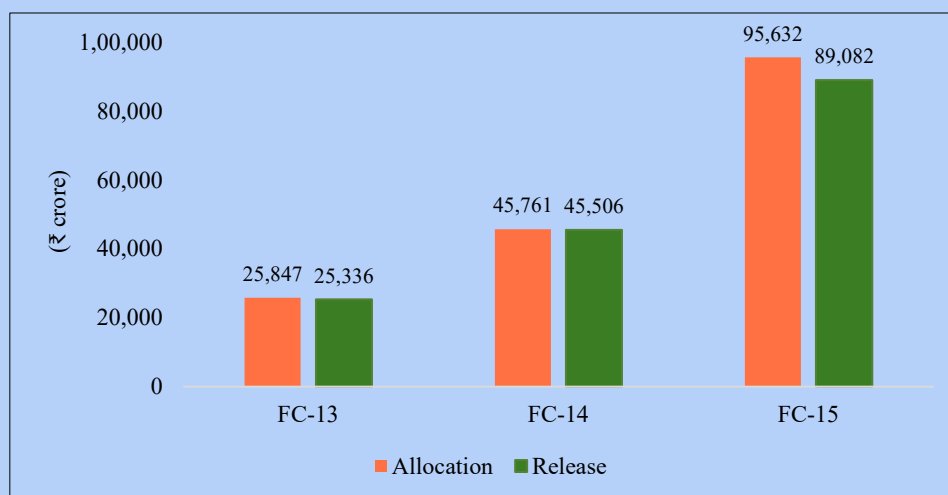
Commissions is shown in *Figure 11.1*. *Figure 11.2* shows the release of Union share against allocation. While releases against total allocation are 98 per cent in FC-13 and FC-14, it is around 93 per cent during the first four years (till 31 March 2025) of FC-15 award period.

1 Figure 11.1 Allocation of Disaster Funds to States by Past FCs (₹ crore)



Source: Past FC Reports

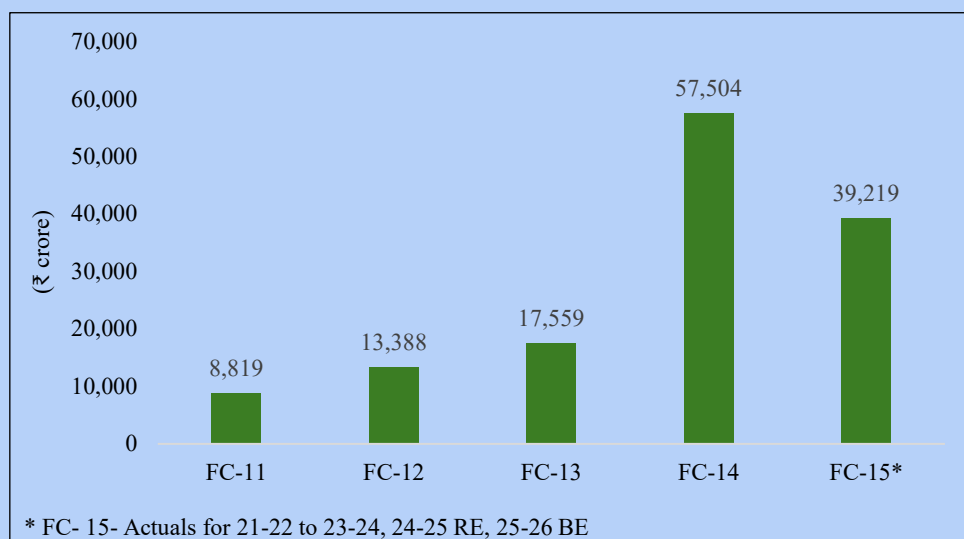
2 Figure 11.2 Allocation and Release of Union Share for the State Funds (₹ crore)



Source: State Finance Accounts, past FC reports, and MHA

Trends in Releases from the National Funds to the States

11.21 *Figure 11.3* shows the releases from the National Funds, NDRF and NDMF to the States based upon the States' proposals. During the award period of FC-15 (2022-2026), a total of ₹68,463 crore was recommended, out of which ₹10,385 crore was released during 2022-2024, and ₹13,774 crore for 2024-25 RE and ₹15,060 crore for 2025-26 BE were provisioned.

Figure 11.3 Releases from NDRF and NDMF (₹ crore)

Source: Budget documents

Stakeholder Consultation

11.22 We held detailed discussions with various stakeholders on this subject as part of our overall consultation process. In addition to Union and State Governments, interactions were also held with NDMA, the Coalition for Disaster Resilient Infrastructure (CDRI), the Principal Accountant General (Audit) of each State, and two thematic workshops were organised on various aspects of disaster management. First workshop on Disaster Risks Financing was organised in collaboration with the World Bank, and second on Disaster Risk Reduction - Special Focus on Himalayan Disaster Resilience in collaboration with NIDM and the University of Ladakh. Disaster Management was also an important theme of the regional workshops, as explained in Chapter 1.

Views of State Governments

11.23 **Comprehensive DRI:** In their memoranda, some States have requested that the DRI be modified to include more disasters, with their scores increased in some of the hazards.

11.24 **Climate Change & Extreme Weather Events:** Some States have argued that due to increased frequency and intensity of extreme weather events such as heavy rainfall, heatwaves, and cloudbursts, which have resulted in increasing severity of droughts, landslides, and floods, the Commission should consider increasing allocations for relief, response, and mitigation efforts.

11.25 **Union's share and State's share:** Many States have proposed that the sharing pattern in SDRF and SDMF be changed to 90:10 between the Union and the States and certain North Eastern & Hilly States (NEH) have proposed 100 per cent funding of the State funds by the Union Government.

11.26 Flexibility between sub-allocations: States are facing issues in shifting funds across the sub-windows of SDRF and between SDRF and SDMF. Some States have requested a complete end to the suballocations, thereby giving them complete flexibility in allocating funds.

11.27 Recommendation on increasing the number of notified disasters: There is an increasing demand for notifying more disasters, such as lightning and heatwaves, by the States in their memoranda due to the increased coverage of such disasters.

11.28 Views on norms of expenditure: The norms of relief assistance are periodically reviewed after the award of successive Commissions. FC-15 had also recommended periodic revision of the norms of assistance. The Union issued revised norms on 11 July 2023 which many States have underlined as being very low in comparison to the needs of their States and hence have proposed upward revision in the norms of assistance.

11.29 Delay in sanctioning funds from NDRF: A few States have flagged the delay in approval and disbursement of funds from NDRF.

Views of Union Government and Central Agencies

11.30 The Union Government in its memorandum has submitted that annual allocation of disaster management funds to be set at 0.15 per cent of base year GDP with 5 per cent annual increase and splitting funds at the National and State level in the ratio of 30:70. It was also suggested to allocate SDRF and SDMF funds based on 60 per cent weight to past expenditure, 15 per cent weights each to area and population, and 10 per cent to States' own preparedness. The accumulating balance was suggested to be corrected using a revised DRI. It also proposed continuation of the multi-window architecture of FC-15 (response and relief, recovery and reconstruction, preparedness and capacity building and earmarked allocations), together with allowing the mitigation projects approved under NDMF in the FC-15 period to be completed from FC-16 funds. The Union also submitted for embedding disaster mitigation and reconstruction measures into regular development plans by taking a 'whole of government' approach. The cost-graded sharing of Union assistance under NDRF and NDMF may be allowed to continue as per FC-15, except for the response and relief window. The NDRF window may only be used to fill vital gaps left unfilled by other regular windows, like State schemes, SDRF, CSS, and CS schemes.

11.31 NDMA emphasised the need for incorporating emerging disaster risks like glacial lake outburst flood, coastal erosion, heat waves, forest fires and lightning in the disaster management framework and requested dedicated funds for specific disaster management initiatives. It also called for the activation of district-level disaster management funds, mobilising resources for local governments and urban resilience, along with establishing various risk pools – hazard mortality and captive insurance, national catastrophic risk insurance pool, and national catastrophic bond.

11.32 The Ministry of Home Affairs (MHA) highlighted that FC-15 recommended central assistance from NDRF and NDMF on a graded cost-sharing basis as 10 per cent State

contribution for assistance up to ₹250 crore, 20 per cent assistance up to ₹500 crore, and 25 per cent assistance above ₹500 crore. The Union Cabinet on 21 October 2021 revisited and dispensed with graded cost sharing by States under NDRF for response and provided for adjusting 50 per cent balance of SDRF on the date of NDRF release. MHA suggested that greater flexibility in SDRF may lead to increased allocation for relief and response, overshadowing other disaster management aspects. MHA also highlighted that the present rules allow expenditure of mitigation funds on lightning and heatwave which are non-notified disasters. MHA emphasised that while the previous Commission had provided for dedicated mitigation funds at the Union and States, and several earmarked allocations, there were some delays in issuing the corresponding guidelines. However, MHA noted that the systems are now firmly in place.

11.33 MHA also raised concerns about the huge opening balances lying unspent with the State Governments and recommended that the Commission may consider putting a cap on cumulative balance, beyond which the annual allocation may stop or be diverted to the mitigation fund.

11.34 MHA strongly supported that the amount earmarked for mitigation activity should be sufficient to make an impact, and some percentage of mitigation funds needs to be allowed for central agencies and project monitoring units. MHA suggested that financing through multi-lateral technical assistance should also be taken into account for the preparation of the comparative index. Also, modalities need to be evolved for the convergence of identical schemes/ programmes with earmarked resources to avoid duplication. It is also highlighted by MHA that the nomenclature of the fund as State Disaster Risk Management Fund and National Disaster Risk Management Fund is contrary to the provisions of the DM Act. MHA emphasised that the Commission may come up with strong recommendations with respect to ensuring transparency and accountability in the management of funds. MHA strongly favoured that allocation of funds to various districts in DDRF out of SDRF may be left at the discretion of the State Government. MHA highlighted that due to procedural delays in issuing the guidelines and sanctioning the projects, the activities related to recovery and mitigation, which are long-term in nature, should be allowed to spill over beyond the FC period.

Studies Commissioned

11.35 A few research studies were undertaken to assess the need and impact of disaster risk financing and extreme weather events. CDRI, along with Council on Energy, Environment and Water (CEEW), had undertaken work on improving the DRI under the active guidance of the Commission. The World Bank has undertaken a study on the fund utilisation of SDRF, SDMF, NDRF & NDMF, and a review of DRI, as well as an analysis of extreme weather events, climate change, and economic impacts while IIT Roorkee has undertaken a study on financing disaster risk management. The outcomes from these studies have informed and enhanced our understanding of disaster risk management and its financing.

Implementation and Outcomes of Recommendations of FC-15

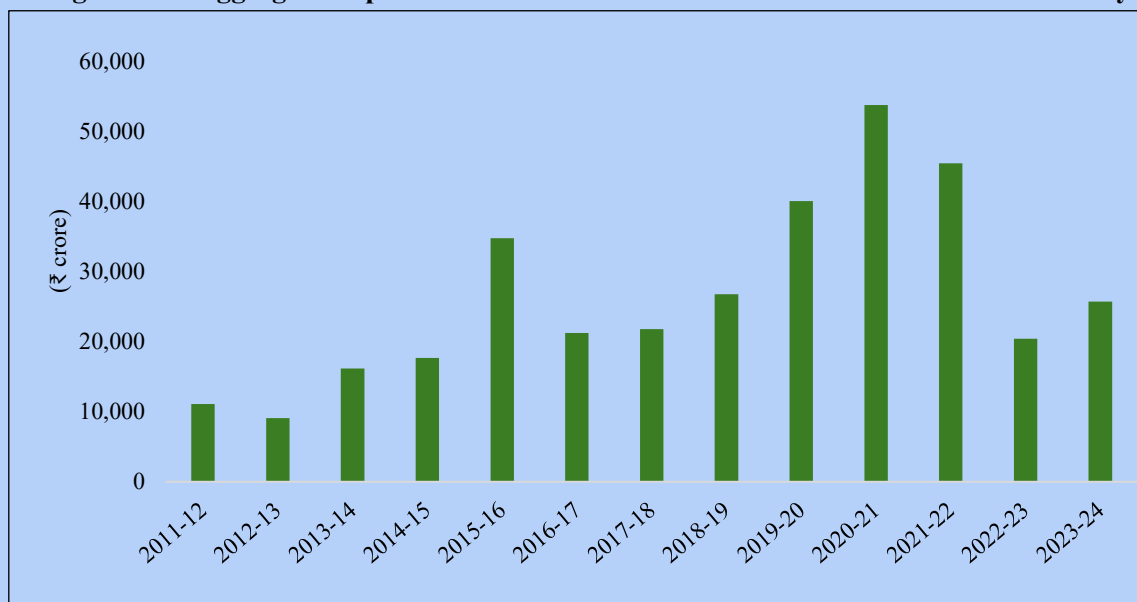
11.36 The recommendations of FC-15 marked a significant shift in the country's approach to managing disasters. Therefore, it is both timely and appropriate to undertake a detailed analysis of how the recommendations were implemented by the States, Union and NDMA.

11.37 The releases of the central share of SDRF by the Union Government are timely. For most of the States, the releases against allocation in SDRF have been in the range of 95-100 per cent for the years 2021-22 to 2024-25. However, the releases of the central share for SDMF for 2021-22 to 2024-25 have been around 80 per cent.

11.38 During our interactions with the MHA and NDMA, it was highlighted that the releases for SDMF are lower than the allocation compared to the releases for SDRF, mainly due to the delay on the part of the States in constituting the mitigation fund. It was also observed that the utilisation from SDMF is also on the lower side due to the delay in issuing guidelines. Utilisation data was collected from the States along with the details of projects being implemented through SDMF. A preliminary analysis of the projects indicated that an entire spectrum of projects focused on mitigation against various disasters has been undertaken, such as flood protection walls, firefighting systems, dam protection and restoration, deepening and widening of storm water drains, installing alarm systems, lightning arresters, ground water recharge and installation of doppler radars, and so on.

11.39 *Figure 11.4* shows the trend in expenditure of States on disaster management during 2011-12 to 2023-24. The expenditure on relief has increased gradually from ₹11,070 crore in 2011-12 to ₹25,638 crore in 2023-24, with distinct peaks during the COVID-19 years.

Figure 11.4 Aggregate Expenditure of States on Relief on Account of Natural Calamity



Source: State Finance Accounts of all States

Note: Figures pertain to the total of major head 2245 - (05 SDRF net transfer) - (08 SDMF net transfer) - (103 NDRF net transfer) + Net direct disbursement from public accounts

11.40 At the national level, NDRF has three separate sub-windows – Response and Relief (40 per cent), Recovery and Reconstruction (30 per cent), and Preparedness and Capacity Building (10 per cent). Against a total recommended allocation of ₹68,463 crore made for NDRF and NDMF by FC-15, ₹54,770 crore was allocated for NDRF. Within NDRF, the releases in response and relief sub-window got the maximum share, which is at 54.3 per cent. *Table 11.1* provides the allocations and releases so far by the Union Government following FC-15 recommendations.

Table 11.1 Allocation and Release of Sub-windows under NDRF (₹ crore)

Funding Windows	Allocation	Release (till 31 July 2025)
Response & Relief	27,385.00	14,855.00
Recovery & Reconstruction	20,539.00	818.74
Resettlement of Displaced People Affected by Erosion	1,000.00	Nil
Preparedness & Capacity Building	6,846.00	2,778.58
Modernisation of Fire Services under Preparedness & Capacity Building	5,000.00	1,214.68

Source: MHA

11.41 From the total NDMF allocation of ₹13,693 crore, FC-15 also recommended four earmarked allocations, that is Catalytic Assistance to Twelve Most Drought-prone States, Managing Seismic and Landslide Risks in Ten States, Reducing Risk of Urban Flooding in Seven Most Populous Cities, and Mitigation Measures to Prevent Erosion. The MHA has also undertaken various mitigation programmes in addition to the earmarked allocations. *Table 11.2* provides the relevant allocation and release data.

Table 11.2 Allocation and Release in Sub-windows under NDMF (₹ crore)

Earmarked Funds	Allocation	Release (till 31 July 2025)
Catalytic Assistance to Twelve Most Drought-prone States	1,200.00	350.00
Managing Seismic & Landslide Risks in Ten States	750.00	Nil
Reducing Risk of Urban Flooding in Seven Most Populous Cities	2,500.00	709.54
Mitigation Measures to Prevent Erosion	1,500.00	Nil
National Glacial Lake Outburst Floods Risk Mitigation Programme	150.00	27.73
Forest Fire Mitigation Project	818.92	Nil
Mitigation Project for Lightning Safety	186.78	Nil
Landslide Risk Reduction and Mitigation Project	1,000.00	4.54
National Project for Strengthening Community Based Disaster Risk Reduction Initiative in PRI	163.32	Nil

Source: MHA

11.42 While recommending new sub-windows and earmarked allocations, FC-15 specifically suggested that newly created funding windows need to be supported through the development of guidelines, and that NDMA should lead that process. However, significant amount of time was involved in issuing the guidelines and subsequent delays in formulation, processing, and approval of proposals were key reasons for the lower percentage of fund releases and utilisation.

11.43 The MHA has operationalised the National Disaster Management Information System (NDMIS), in which all States are expected to feed data related to expenditures on various items of relief against every disaster. Due to this effort of MHA and most of the States, for the first time, granular data with respect to expenditure incurred against each disaster is available to FC-16 for review and use in further decision making. Some States have also given suggestions on how the portal can be improved based on the challenges they face in feeding data into NDMIS. We therefore recommend MHA to conduct a rigorous consultation with the States on various features of the portal to further upgrade it so that NDMIS becomes a repository of all disaster-related data.

11.44 An analysis of the expenditure data from the NDMIS portal reveals that at the aggregate level, flood accounted for the majority of the expenditure, followed by drought, State-specific disasters, and cyclones in that order. They together account for 92 per cent of the total expenditure. The pie chart in *Figure 11.5* shows the expenditure pattern of the notified disasters, including State-specific disasters, from 2019-20 to 2023-24. Similarly, a detailed analysis of the expenditure on relief items after removing COVID-19 expenditures indicates that more than half of the total expenditure is incurred on relief measures related to agricultural inputs (55.6 per cent), followed by that on people as ex gratia (23.4 per cent) and on infrastructure (13 per cent).

Our Approach

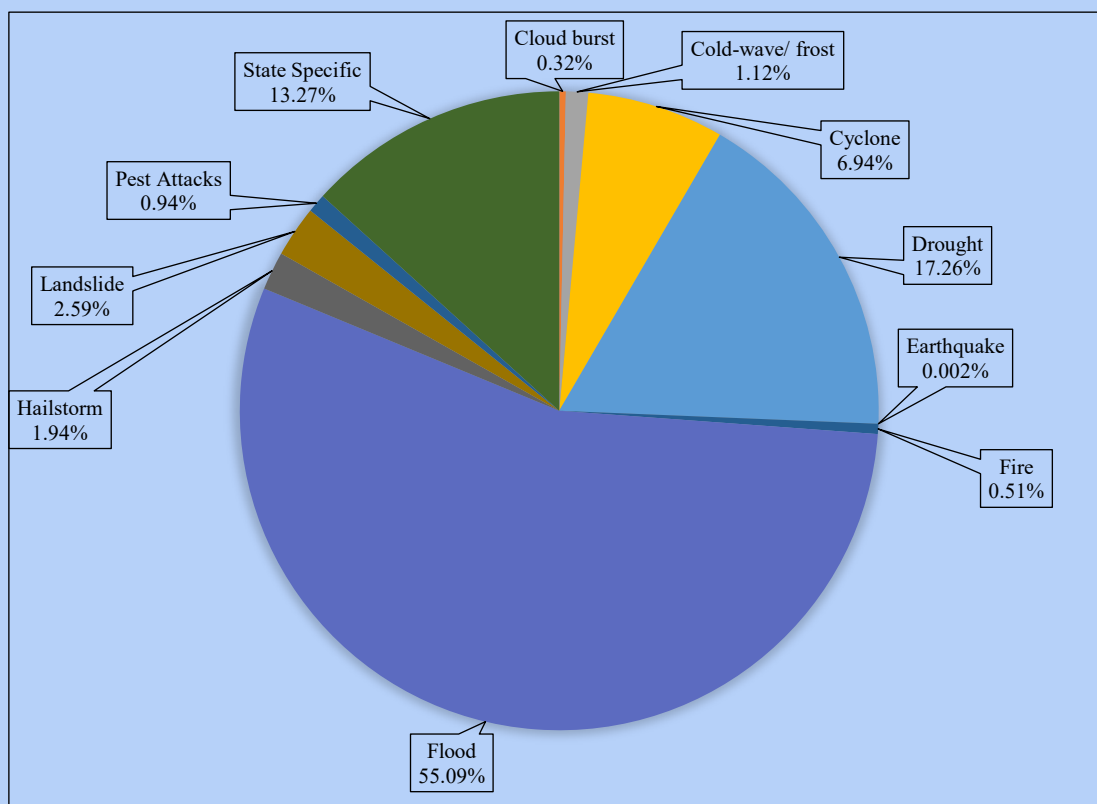
11.45 We have considered the representations of all the States and the Union, as well as discussed, the subjects extensively during various conferences and consultations with multiple stakeholders. We have also extensively reviewed how the recommendations of FC-15 were implemented. Based on our assessment and review, we are guided by the following principles.

- (i) The institutionalisation of relief and mitigation funds, along with increased allocations, has better equipped the States to respond to disasters. We are in favour of continuing with the same arrangement for disaster risk financing, as provided under the law. Although the guidelines for mitigation funds were delayed, these projects should be continued and brought to fruition, with greater flexibility in both selection and execution at the Union and State levels, a point we will return to in discussing our recommendations.
- (ii) The introduction of DRI has mapped the States' Hazard, Exposure, and Vulnerabilities into the allocation of funds in a novel fashion. This index can be

updated to take account of new data and additional disasters, and its application to the allocation of funds can be further refined. We have included more granular datasets and better aligned the construction of DRI and its application to fund allocation in line with international practices.

- (iii) Based on our study of the methodology and experience of the past FCs for the assessment of disaster funding needs, we also appreciate the importance of past expenditures as an indicator of the immediate future needs of the States. Therefore, in our assessment, we continue to assign the past expenditures an important role.
- (iv) While the recommendations of FC-15 are yet to be implemented in their entirety, partly due to delays caused by the pandemic and the time taken to issue guidelines, we believe that the necessary systems are now in place at both the Union and State levels, and the reforms initiated by FC-15 should be taken forward.
- (v) We have also given adequate emphasis on the use of technology for managing disasters effectively and the availability of reliable data for informed decision-making.

Figure 11.5 Disaster-wise Expenditure of States (2019-20 to 2023-24)



Source: National Disaster Management Information System, MHA

Risk Assessment – The Disaster Risk Index

11.46 FC-15 quantified disaster risk by assigning scores to the probability of hazards striking a State, and the extent of vulnerability. A composite score was developed for each State, leading to an index that ranks States based on risk scores. Four major hazards, namely cyclone, drought, earthquake, and flood, were taken into account, assigning a maximum score of 15 marks for each, with 60 as the total maximum score for these hazards. In addition, 10 marks were given to all States for their share of smaller hazards in the ‘other’ category. A vulnerability score of 30 marks was assigned based on the below poverty line population of each State in 2011-12 (as per Tendulkar methodology) on a graded basis and was added to the hazard score to arrive at a DRI score out of 100 for each State.

11.47 In order to account for exposure, the respective State’s area is scaled by the per square kilometre allocation of Maharashtra and the State’s population is scaled by the per capita allocation of Maharashtra (Maharashtra was used as the benchmark State by FC-15). Both these values have been given a weight of 15 per cent each. These were added to the average expenditure of the State with a weight of 70 per cent. The number so arrived was multiplied by a factor of (1+DRI) to arrive at the final allocation for each State.

11.48 We have revisited the DRI methodology. Internationally accepted definition of Disaster Risk is an interaction of Hazard, Exposure, and Vulnerability as per the United Nations Office for Disaster Risk Reduction (UNDRR) and the report of the Intergovernmental Panel on Climate Change (IPCC). It emphasises that disaster risk emerges from the interaction of weather or climate events, which constitute the physical contributors to disaster risk, with exposure and vulnerability, the contributors to risk from the human side. Caribbean Disaster Emergency Management Agency (CDEMA) also explains disaster risk through the interplay of three main components – Hazards, Vulnerability and Exposure. Hence, as per international practice, Disaster Risk represents the potential for loss and damage to susceptible people, property, and livelihoods during a hazard event. It is determined as a function of hazard, exposure and vulnerability. Importantly, the DRI is a multiplicative function of these three variables – disaster risk only exists when Hazard, Exposure and Vulnerability intersect.

11.49 The Hazard variable has been expanded to include new disasters. The expanded hazard list includes a total of ten disasters: flood, drought, cyclone, earthquake, landslides, hailstorms, cold wave, cloud burst, lightning, and heatwave. The latter two are in the State-specific disaster category. To evaluate the hazard profiles of the States, credible and objective datasets were acquired from expert agencies like the Indian Meteorology Department, Central Water Commission, Geological Survey of India, National Centre for Seismology, Bureau of Indian Standards and Ministry of Agriculture and Farmers Welfare. It was also ensured that the datasets used and the methodology adopted to arrive at the index for the States are objective and scientifically sound. Hazard scores have been assigned to each State for each disaster based on its relative position on the data scale, using quintile breaks. Subsequently, a composite hazard

score for each State has been calculated based on a weighted sum of the hazard scores of that State for each of the disasters, where the weights have been chosen based on the proportion of expenditure incurred on the management of that disaster.

11.50 The Exposure variable is based on the projected population as of October 2026, as estimated by the Technical Group of Population Projections 2020, constituted by the Ministry of Health & Family Welfare. As indicated earlier, the main elements of exposure for most disasters are crops and infrastructure, which are highly correlated with the population. Therefore, it was decided to rely on the population for measuring exposure. In addition, parameters like area are already included in the hazard score, as it is mostly based on indicators such as flood-prone area and drought-prone area. Therefore, reliance solely on the population to measure exposure avoids duplication.

11.51 For the Vulnerability variable, it was decided to use the per-capita income of the States (average from 2018-19 to 2023-24, leaving out the COVID-19 year, 2020-21) as it had a high correlation with many indicators of vulnerability, including poverty. It is also an indicator of effective per capita economic resources available to manage disaster risk and the capacity for prevention and mitigation of disasters. In the final step, hazard, exposure and vulnerability are multiplied to arrive at a DRI score for each State.

11.52 We base 30 per cent of the allocation on the DRI and 70 per cent on the average expenditure of the State over the period 2011-12 to 2023-24, excluding the two COVID-19 years, 2020-22. The base year allocation was inflated by 5 per cent each year. A detailed description of the methodology of the DRI, along with data sources, is provided in *Annexure 11.1*. The DRI scores of each State is presented in *Annexure 11.2*. A brief description of our suggested DRI is also provided in *Box 11.1*.

Box 11.1 Methodology of State Level Allocation for SDRF and SDMF

Allocation=70% (Inter se allocation based on AE) + 30% (Inter se allocation based on DRI)

Where:

- **AE** = Average Expenditure
- **DRI** = Disaster Risk Index

DRI of the State i ,

$$DRI_i = H_i * E_i * V_i$$

- $H_i = \sum_{k=1}^{10} w_k * H_{ik}$ where H_{ik} is the hazard score of State i for hazard k and w_k is the weight adopted for hazard k for each of the 10 hazards, viz floods, drought, cyclone, landslide, earthquake, hailstorm, cold wave, cloud burst, heatwave, lightning.
- E_i = Exposure of State to hazards (score based on adjusted inter se population).
- V_i = Vulnerability of the States (score based on per capita income).

State and National Level Allocations

Allocation for SDRF and SD MF

11.53 For our award period, the State-wise allocation is based on assigning 30 per cent weight to the DRI and 70 per cent weight to average expenditure from 2011-12 to 2023-24 (excluding COVID-19 years of 2020-21 and 2021-22). For arriving at the figures related to expenditure on disaster relief, the States' expenditure booked under major head (MH) 2245 for the period 2011-2024 (excluding the COVID-19 years of 2020-21 and 2021-2022) was taken. From these values, the net values of transfers to the Public Accounts of SDRF, SD MF, and NDRF under MH 2245 were subtracted. Some States debit a part of the expenditure on disasters directly from the SDRF maintained in the Public Account. This expenditure is added to the adjusted expenditure under MH-2245. The NDRF releases for each year have, then, been subtracted from these values to remove the impact of relief expenditure met from NDRF and then the values were inflation adjusted and averaged to arrive at the expenditure for a State.

11.54 A provision was made for a 5 per cent increase every year for annual allocation during our award period. A total allocation of ₹2,04,401 crore has been arrived at for the SDRF and SD MF together for the period 2026-27 to 2030-31.

11.55 The funds meant for the States shall continue to be divided between SDRF and SD MF in the ratio of 80:20. A total of ₹1,63,521 crore is recommended for SDRF and ₹40,880 crore for SD MF. The State-wise allocation for SDRF and SD MF is provided in *Annexure 11.3* and *Annexure 11.4*, respectively. The States will have full flexibility to use SDRF funds between their two sub-windows- Response and Relief and Recovery and Reconstruction. However, a shift of allocation between SDRF and SD MF should not be allowed as these are two separate funds under the Act.

11.56 As per the DM Act, 'preparedness' means "the state of readiness to deal with a threatening disaster situation or disaster and the effects thereof." The Act further defines 'mitigation' as "measures aimed at reducing the risk, impact or effects of a disaster or threatening disaster." Hence, activities related to 'preparedness' and 'mitigation' have to be undertaken in the pre-disaster phase, in anticipation of the disaster, and to ensure the vulnerable population is not impacted severely and is better equipped to deal with the disaster. Hence, we recommend that Preparedness and Capacity Building should come under the SD MF and NDMF, as it is a pre-disaster activity, unlike response, relief, recovery, or reconstruction, which are all post-disaster events.

11.57 Since SDRF and SD MF are statutory funds and their existence is essential for State Governments to handle upcoming disasters, the closing balances in SDRF & SD MF as on 31 March 2026 should be allowed to be carried forward during FC-16 as the opening balance.

Accumulating Balance of SDRF

11.58 There are cases of large accumulating balances of the SDRF in the accounts of the States. The Commission has deliberated on this issue and recommends limiting the funds in accordance

with needs-based criteria. We recommend that during our award period, if the unspent balance under SDRF exceeds the sum of past three years' total annual allocation of SDRF, further releases may be temporarily withheld. The withheld funds are to be released as and when the balance drops below the preceding three years' total allocation.

Allocation of Funds for National Funds (NDRF & NDMF)

11.59 The allocation for the National Funds is based on the actual expenditure (from 2015-16 to 2023-24), revised estimates (2024-25), and budgeted estimates (2025-26) of NDRF and NDMF. These values have been adjusted for 5 per cent inflation. The inflation-adjusted expenditure over the 11 years is averaged and then further increased by 10 per cent to arrive at the base amount. The base amount has been increased by 5 per cent for the 2026-27 allocation of ₹14,370 crore and annual increase of 5 per cent for the remaining award period has also been provided.

11.60 A total of ₹79,406 crore is recommended for the National Funds as shown in *Table 11.3*. This fund will be used for relief and rescue, mitigation, recovery and reconstruction, and capacity building. The sub-allocation within the above amount between response and relief, recovery and reconstruction and mitigation may be left flexible for better utilisation of resources.

Table 11.3 Allocation for National Funds during FC-16 Award Period (₹ crore)

Year	2026-27	2027-28	2028-29	2029-30	2030-31	Total
Allocation	14,370	15,089	15,843	16,637	17,467	79,406

Cost-sharing between the Union and the States

11.61 Disaster management in the country is a shared fiscal responsibility between the Union and the States. The States' contribution promotes active ownership, accountability, efficient fund utilisation and better disaster preparedness. Hence, we recommend a sharing pattern of 75:25 for non-NEH States and 90:10 for NEH States for SDRF and SDMF, continuing the existing sharing arrangements between the Union and States. The Union share and State share for SDRF and SDMF are provided in *Annexure 11.5* and *Annexure 11.6*.

11.62 In the case of NDRF and NDMF, FC-15 recommended graded cost sharing for all States uniformly. We observe that smaller States are finding it difficult to match the share, which could reach 25 per cent for projects above ₹500 crore. Considering this fact, we recommend a different graded cost-sharing mechanism for non-NEH States and NEH States. The non-NEH States will continue to bear the same graded cost as outlined in *Table 11.4*. However, NEH States will bear a uniform 10 per cent cost-sharing against assistance from NDRF (other than relief and response window) and NDMF, irrespective of the project size.

Table 11.4 Cost-sharing for Assistance under NDRF (other than Relief and Response Window) and NDMF

Union Assistance (₹ Crore)	Cost Sharing for Non-NEH States
Up to 250	10 per cent
251 - 500	20 per cent
Above 500	25 per cent

Norms of Assistance

11.63 The MHA has periodically revised the norms of assistance in consultation with the States and concerned Union Ministries. The Commission recommends a revision of the assistance norms periodically in line with existing practice.

List of Notified Disasters

11.64 The DM Act defines a disaster as “a catastrophe, mishap, calamity or grave occurrence in any area, arising from natural or manmade causes, or by accident or negligence which results in substantial loss of life or human suffering or damage to, and destruction of, property, or damage to, or degradation of, environment, and is of such a nature or magnitude as to be beyond the coping capacity of the community of the affected area.”

11.65 At present, the disasters covered under the SDRF include cyclone, drought, earthquake, fire, flood, tsunami, hailstorm, landslides, avalanche, cloudburst, pest attack, frost and cold waves. Additionally, States are permitted to utilise up to 10 per cent of the SDRF allocation for providing immediate relief to victims of natural disasters that are not part of the list notified by the Union Government but are considered locally significant. This is contingent upon the State having notified such disasters, along with clear and transparent norms and guidelines, duly approved by the State Executive Committee.

11.66 We note that eleven States have already notified heat wave as a State-specific disaster. Many States, in their memoranda, have strongly advocated for the inclusion of heat wave among the notified disasters under the national framework. Extreme heat events disproportionately affect vulnerable populations. Over the past four decades (1981-2022), the frequency and intensity of hot days in India have significantly increased, with notable heatwaves recorded in 2013, 2016, 2019, 2022, and 2024.

11.67 Moreover, there has been a marked rise in the number of very warm nights during the last decade. These warmer nights prevent the human body from recovering from daytime heat, thereby escalating the risk of heat-related illnesses such as heatstroke. According to data from the National Crime Records Bureau (NCRB), Ministry of Home Affairs, a total of 3,798 deaths were reported due to heat or sunstroke in India between 2018 and 2022.

11.68 While the Union Government has allowed States to undertake mitigation efforts related to heat waves through the SD MF and ND MF, it is equally important to enable States to provide immediate relief to the vulnerable population affected by heat waves through the SDRF.

11.69 Similarly, the escalating threat of lightning across India demands its urgent recognition as a national disaster. The Annual Lightning Report released in collaboration with Indian Meteorological Department (IMD) for 2020-2021 documented a significant 34 per cent increase in lightning strikes nationwide, totalling approximately 18.5 million events, a rise of over 4.7 million over the previous year.

11.70 The inherent dangers of lightning are undeniable. Capable of unleashing 100 million to 1 billion volts, billions of watts of electricity, and temperatures exceeding 35,000 degrees Fahrenheit (IMD), lightning possesses destructive power comparable to other recognised disasters. Tragically, NCRB data confirms lightning as the leading cause of death from ‘forces of nature’ in India. In 2022 alone, it accounted for a devastating 35.8 per cent of all natural hazard fatalities (2,887 out of 8,060 deaths in total).

11.71 The impact of lightning disproportionately affects the most vulnerable populations. Agricultural labourers working in open fields, lacking natural shelter and exposed to conductive water bodies, face heightened risks. Similarly, those residing in structurally weak mud houses are more susceptible to ground strikes. This pattern of impact underscores the socio-economic dimensions of lightning's destructiveness. While sixteen States have already recognised lightning's calamitous potential by notifying it as a disaster, a unified national declaration is crucial to ensure consistent relief and mitigation efforts for all affected communities. Recognising lightning as a national disaster will enable the allocation of necessary resources, the implementation of robust early warning systems, and the development of targeted safety measures to protect lives and livelihoods, particularly for those most at risk.

11.72 Although States currently have the flexibility to use 10 per cent of SDRF allocations for State-specific disasters, the rising severity, frequency, and impact of heat waves and lightning warrant their inclusion in the nationally notified list of disasters. Both heatwaves and lightning are severe events that have caused significant loss of life. Given their scale and the fact that they often exceed the coping capacity of affected communities, they merit inclusion in the list of notified disasters at the national level.

11.73 In line with the precedents and the evolving disaster landscape, we recommend that the Heatwave and Lightning be added to the national list of notified disasters under the SDRF framework. We also recommend that the existing practice of allowing up to 10 per cent of SDRF funds to be used against disasters within the local context, and which are not in the list of notified disasters, should continue.

Capacity Constraints and Systems Development

11.74 During our review of the various funds constituted for disaster management, especially the earmarked allocations, it was observed that despite increased funding, utilisation remained weak due to a lack of institutional capacity, including at the national level.

11.75 Historically, the machinery in the States and the Union operates relatively swiftly and with efficiency in organising relief and response efforts, but significant differences still exist between the States. While some States have integrated and automated digital systems, which can be effectively utilised for swift disbursement of relief during calamities, others still follow an extensive manual process in the identification of affected people, collecting documentary evidence, uploading the beneficiaries list in treasury systems, and so on, which leads to huge delays in the disbursement of relief during calamities.

11.76 Capacities need to be built at a rapid pace and on scale, at the Union and the States, with respect to preparedness, planning and execution of mitigation works, as well as recovery and reconstruction. Inadequate capacity in these areas leads to delays in the formulation of operational and technical guidelines, preparation, submission and approval of project proposals, release and utilization of funds. Even after four years of institutionalising funds for mitigation at the State and Union levels, the utilisation of funds remains abysmal.

11.77 Going forward, the disaster landscape should also be focused on preparedness, mitigation, recovery and reconstruction as much as its focus on response and relief. The expenditure pattern should reflect the actual need for each of these activities. Investment in preparedness and mitigation should be prioritised to ensure that people endure minimal impact from such disasters. We strongly recommend that the NDMA undertake a comprehensive analysis of institutional capacity gaps at all levels and propose targeted measures to strengthen SDMA.

Use of Technology in Disaster Management

11.78 Technology has become a mainstay in effective disaster management, and it enables a shift from reactive and relief-centric approaches to proactive, predictive, and preventive strategies. The amendment to the DM Act in 2025 enunciates a bold vision with respect to handling disasters by emphasising preparedness and mitigation in addition to relief and rescue. Embracing technological solutions is the key to realising this vision. Adopting cutting-edge technologies at all stages of disaster management is imperative in the light of the growing frequency and intensity of disasters.

11.79 Technological tools are indispensable not only for early warning systems and real-time hazard monitoring but also for logistics management, damage assessment, relief distribution, and long-term recovery planning. For instance, artificial intelligence and machine learning models can be used to predict flooding patterns, wildfire spread, and cyclone paths with greater accuracy. Similarly, geospatial technologies, remote sensing, and satellite imagery, provided by agencies like Indian Space Research Organisation and National Remote Sensing Centre, can play a critical role in vulnerability mapping and planning.

11.80 The effective deployment of such tools, however, depends on the availability of high-quality, granular, and interoperable data sets and the presence of trained personnel who can interpret and act on this information. It is essential that NDMA take a lead role in promoting open data frameworks by coordinating with key institutions and institutions of repute both in private and in public.

11.81 In this context, Mission Mausam, being implemented by the Ministry of Earth Sciences, is a major step forward. The mission focuses on enhancing forecasting capabilities, real-time data dissemination, and strengthening responses to climate-sensitive hazards such as urban flooding, heatwaves, and cyclones. While challenges such as geographic diversity and infrastructure gaps persist, the Commission recommends that NDMA actively support and may align mitigation resources with Mission Mausam's initiatives to maximise impact.

11.82 MHA and NDMA should consult with the States, expert agencies, research institutions and private stakeholders and make suitable provisions in the guidelines and provide for fund allocations so that technological interventions become an integral part in all the stages-mitigation (prevention and risk reduction), preparedness, response and relief and recovery-of the disaster management cycle.

11.83 The National Disaster Management Information System (NDMIS), an MHA initiative, is a commendable initiative for monitoring funds disbursement under NDRF and SDRF. NDMIS aims to bring States onto a unified platform for disaster reporting and accounting, providing disaster-wise and relief item-wise data, facilitating inter-State comparison.

11.84 The NDMIS, in its current form, may necessitate further streamlining and integration with other systems to fully realise its potential as the unified disaster database of the country. The Union Government should gather user feedback on the portal and carry out necessary improvements in the system.

11.85 We recommend that NDMIS should morph into a comprehensive disaster management information system for both the Union and the States. Such a system should capture real-time transaction-level disaster data, serving as a single source for disaster information. To ensure the effective adoption of NDMIS, we recommend that complete data feeding and validation for a Financial Year by 31 May of the succeeding year be a necessary condition for States to avail the Union share of SDRF/SDMF from the second year of the award period.

11.86 We also recommend that MHA and the States collaborate further to enhance the utility of this portal by making it the primary medium for States to submit their memoranda using standardised forms in the event of disasters and for the subsequent release of funds by the Union Government to the States. This will help streamline the process of NDRF relief disbursement and avoid delays, as all necessary information and details can be sought and provided through the portal.

Accounting Norms and Procedures

11.87 The Commission's analysis of the State Finance Accounts for assessing expenditure on disasters by various States has revealed departures from the MHA's SDRF guidelines for booking disaster expenditure. Such practices include directly booking expenditure from the Public Account without utilising the Major Head 2245 or booking expenditure under sub-heads of the transfer head 2245-05-101 instead of the relevant sub-major and minor heads of Major Head 2245. These deviations complicate the accurate assessment of disaster expenditure by

States. This issue is further compounded when States withdraw funds for transfer to bank accounts to incur disaster expenditure and make investments from those bank accounts, rather than from the treasury. As such, we recommend that the existing MHA norms pertaining to the booking of disaster-related expenditure and investment should be strictly adhered to, with compliance regularly audited by the Comptroller and Auditor General (CAG) of India.

Alternative Instruments of Disaster Financing

11.88 FC-15 had recommended insurance-based financing for supplementation of public fund mechanisms in disaster financing. However, the envisioned supplementation through insurance remains at a nascent stage, except in the domain of crop insurance, where a substantial increase in coverage, both in terms of crops and area, has been observed. The limited availability of disaster-related insurance products, low insurance penetration, insufficient awareness, and issues concerning affordability and accessibility have impeded its wider adoption. The prevailing preference among governments is for post-disaster pay-outs rather than proactive risk coverage through insurance mechanisms.

11.89 As a successful initiative of partnership between the Union, States, and the private sector, the Ministry of Agriculture & Farmers Welfare is implementing the Pradhan Mantri Fasal Bima Yojana, which is the world's largest crop insurance scheme. In this scheme, the Union Government and State Governments together contribute 85-90 per cent of the premium. Despite this substantial support, farmer penetration has reached 40 per cent over the past eight years. Out of the total farmer applications enrolled under the scheme in 2024-25, 6.5 per cent, 17.6 per cent and 48 per cent are pertaining to tenant, marginal and loanee farmers respectively. Technology-based assessment of the crop losses and timely disbursement of claims hold the keys to the success of this scheme in the future.

11.90 Another success story stands out from Nagaland. The State has emerged as a pioneer in experimenting with parametric insurance for disaster risk in India. Nagaland's Disaster Risk Transfer Parametric Insurance Solution represents the first initiative of its kind in India to comprehensively insure an entire State against the impact of extreme rainfall, thereby offering financial protection to the State's population and critical infrastructure. An extensive network of automated weather stations has enabled the State to define specific excess rainfall triggers, facilitating accurate and timely pay-outs. This initiative is a collaborative effort between the Nagaland State Disaster Management Authority, SBI General Insurance, and major global reinsurers such as Munich Re and GIC Re. However, this initiative, despite its success, currently remains an isolated example and is limited in scale and scope.

11.91 Insurance interventions and mechanisms like catastrophe bonds warrant a comprehensive study by the Union and State Governments to assess their affordability, applicability, and scope for customisation according to specific needs. Furthermore, innovative financing mechanisms for the payment of insurance premiums need to be evolved to facilitate greater affordability. Department of Financial Services and NDMA are also working on a single

peril parametric insurance product, as confirmed in the Standing Committee report on Finance, submitted to Lok Sabha in December 2024. We recommend that the concerned ministries examine and finalise such insurance products in line with global best practice.

Summary of Recommendations

- (i) The allocation of disaster management funds for the States is based on past expenditures and Disaster Risk Index (Hazard, Exposure and Vulnerability). A total corpus of ₹2,04,401 crore has been recommended for SDRF and SD MF together, for the award period from 2026-27 to 2030-31. The State-wise allocations are provided in *Annexures 11.3 and 11.4*

(paragraphs 11.53 and 11.54)

- (ii) The corpus should be divided between the SDRF and SD MF in the ratio of 80:20. The SDRF allocation is ₹1,63,521 crore and that of SD MF is ₹40,880 crore. Under SDRF there should be flexibility for reallocation between Response and Relief and Recovery and Reconstruction. Preparedness and Capacity Building will now fall under SD MF and NDMF.

(paragraphs 11.55 and 11.56)

- (iii) The accumulating balance under SDRF should be limited to the extent that if the unspent balance under SDRF exceeds the sum of past three years annual allocation of SDRF, further releases may be temporarily withheld. The funds withheld will be released if the States' balances reduce below the threshold of past three years annual allocation.

(paragraph 11.58)

- (iv) The total allocation of ₹79,406 crore is recommended based upon past expenditures for disaster management at the national level (for NDRF and NDMF).

(paragraphs 11.59 and 11.60)

- (v) States are to contribute 25 per cent of the funds of SDRF and SD MF except the NEH States which shall contribute 10 per cent, and the rest is to be provided by the Union Government. The total share of Union Government works out to ₹1,55,915.85 crore.

(paragraph 11.61)

- (vi) The graded cost sharing of central assistance through the NDRF (except Response and Relief) and NDMF should be maintained. States are to contribute 10 per cent for assistance up to ₹250 crore, 20 per cent for assistance up to ₹500 crore and 25 per cent for all assistance exceeding ₹500 crore. However, NEH States should contribute 10 per cent of all central assistance under NDRF and NDMF.

(paragraph 11.62)

- (vii) The norms of assistance should be revised periodically by the Ministry of Home affairs in line with existing practice.

(paragraph 11.63)

- (viii) Heatwave and Lightning should be added to the list of notified disasters at the National level.

(paragraph 11.73)

- (ix) The National Disaster Management Information System (NDMIS) should be transformed into a comprehensive disaster management system for both the Union and the States. The system should capture real-time transaction-level disaster data, serving as a single source for disaster information, and minimizing the compliance burden on States.

(paragraph 11.85)

- (x) Complete feeding and validation of data in NDMIS portal (for a Financial Year by the 31 May of the succeeding year) will be a necessary condition for States to avail the Disaster Management Grant from the second year of the award period, that is 2027-28.

(paragraph 11.85)

- (xi) MHA and States should collaborate to enhance the utility of NDMIS by making it the primary medium for States to submit their memorandum using standardised forms in the event of disasters and for subsequent release of funds by the Union Government to the States.

(paragraph 11.86)

- (xii) Commission recommends that the existing MHA norms pertaining to the booking of disaster-related expenditure and investment should be strictly adhered to, with compliance regularly audited by the CAG.

(paragraph 11.87)

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THE PATH TO MACRO AND FISCAL STABILITY

12.1 As India charts its path toward becoming a developed economy, ensuring macro and fiscal stability is both more urgent and more complex than ever. Elevated government debt and high debt servicing requirements could exert downward pressure on development spending, especially capital expenditure, essential for growth. Fragile global economic systems and uncertain geopolitical situations pose a big challenge to growth as well as stability. With the pandemic and its medium-term impact behind us, it is time for the Union and State Governments to consolidate their finances to create enough fiscal space for development spending towards the broader growth objective.

12.2 As we have reviewed in Chapter 3, government debt has been coming down from its peak in the early years of the millennium, with a small exception during the global financial crisis. However, due to the fiscal expansion undertaken by the Union as well as State Governments to counter the adverse impact of COVID-19, government debt shot up to a level of 87 per cent of GDP in 2020-21. Post pandemic, governments have come back to the path of fiscal consolidation, and the debt level came down to 80.5 per cent of GDP by the end of 2023-24 and is estimated to come down further to 75.5 per cent by the end of 2025-26.

12.3 Due to the high level of debt incurred during the pandemic, interest payments of general government stood at 5.2 per cent of GDP in 2023-24, up from 4.7 per cent in 2019-20. Fortunately, revenue receipts of the general government are also at a high level of 20.2 per cent of GDP in 2023-24 with scope for further increase. We discuss the implications of the roadmap for Union and State Governments for debt and fiscal deficit.

Fiscal Consolidation and Past Commissions

12.4 The Eleventh Finance Commission (FC-11), for the first time, looked into the fiscal roadmap and recommended that States restore balance on their revenue account, while the Union limits its revenue deficit to no more than 1 per cent of gross domestic product (GDP) by the end of their award period. It recommended reducing the combined fiscal deficit to 6.5 per cent of GDP and lowering the debt-to-GDP ratio to around 55 per cent. The Twelfth Finance Commission (FC-12) recommended a legislative framework for the States on the lines of the Fiscal Responsibility and Budget Management (FRBM) Act of the Union Government, mandating the elimination of revenue deficit and reducing fiscal deficits to 3 per cent of gross state domestic product (GSDP) by 2008-09. It recommended certain debt relief, contingent upon States implementing a fiscal reform legislative framework and adhering to it.

12.5 In the backdrop of the global financial crisis, the Thirteenth Finance Commission (FC-13) recommended that States with a revenue balance should maintain it and those that still have a deficit, should eliminate it by 2014-15. It also recommended maintaining the fiscal deficit at 3 per cent of GSDP, except for special category States. It laid down a consolidated deficit target of 3 per cent and 2.4 per cent of GDP for the Union Government and State Governments, respectively, with a combined deficit of 5.4 per cent of GDP by the end of its award period. It set a combined debt-GDP target of 68 per cent. The Fourteenth Finance Commission (FC-14) recommended a ceiling on the fiscal deficit at 3 per cent of GDP from 2016-17 up to 2019-20 for the Union Government. For States, the fiscal deficit targets and annual borrowing limits were anchored to an annual limit of 3 per cent of GSDP. The award period of the Fifteenth Finance Commission (FC-15) followed the implementation of Ujwal DISCOM Assurance Yojana (UDAY) scheme and the COVID-19 pandemic. It recommended restoring the fiscal deficit of States to 3 per cent of GSDP by 2022-23. It suggested bringing total liabilities down from 89.9 per cent in 2020-21 to 85.7 per cent in 2025-26.

Views of the State Governments

12.6 Many States have requested debt relief to help them reduce their debt burden, which has increased post-COVID. Some States have also sought the restructuring of National Small Savings Fund (NSSF) loans. Odisha has recommended that the Union Government should take the burden of exchange rate fluctuations on account of external loans. Uttar Pradesh has suggested that the process of taking approvals under Article 293(3) should be eased. Kerala has pointed out that the recent interpretation of Article 293(3) to include borrowings by some of its parastatals is constraining the State in its ability to finance infrastructure requirements.

12.7 Various States have made suggestions regarding the FRBM framework, including making provisions for effective revenue deficit (revenue deficit minus grants given for capital expenditure) for States on the lines of the Union, carry forward of unutilised borrowings of the past, and allowing additional borrowings in cases of higher growth or in cases of natural disasters.

Fiscal Roadmap

12.8 In our assessment of Union and State finances, we have laid out a roadmap for the fiscal deficit for our award period, wherein we have tried to strike a balance between the need for fiscal consolidation and growth. We feel that this would provide the necessary stimulus for India's growth trajectory.

Fiscal Deficit

12.9 The roadmap for fiscal deficit has been worked out keeping in mind the requirement of government expenditure, especially in social and infrastructure sectors, to achieve the desired growth path. After climbing to its highest ever level of 9.2 per cent of GDP in 2020-21, the fiscal deficit of the Union Government came down to 5.5 per cent in 2023-24. It is further estimated to come down to 4.4 per cent of GDP in the Union Budget for 2025-26. We have assessed that this should come down to 3.5 per cent of GDP by the end of the award period in 2030-31. We have estimated that out of this deficit of the Union Government, 0.5 per cent of GDP would be for onward lending to States, mostly under Special Assistance to States for Capital Investment (SASCI), to promote capital investment by the States.

12.10 We see that the fiscal deficit of States, after rising to 3.4 per cent of GDP in 2020-21 during the COVID-19 pandemic, came down to 2.9 per cent in 2023-24, out of which 0.4 per cent on account of SASCI, which was considered over and above the regular deficit limit of the States. Therefore, we have recommended that States' fiscal deficit should continue to be capped at 3 per cent of their respective GSDP. To ensure the stability of the debt of a State Government, this should be strictly enforced as per the provisions of clause (3) of Article 293 of the Constitution. It is assumed that the on-lending by the Union Government under SASCI will be over and above this limit, as is currently being done.

12.11 *Table 12.1* shows the year-wise fiscal deficit roadmap for the Union and the fiscal deficit limit for the States. As explained earlier, the roadmap for States excludes expenditure met through SASCI, while the roadmap for the Union Government includes it.

**Table 12.1 Fiscal Deficit Roadmap of Union and State Governments
(percentage of GDP)**

Year	Union Government	State Governments
2026-27	4.2	3.0
2027-28	4.0	3.0
2028-29	3.8	3.0
2029-30	3.6	3.0
2030-31	3.5	3.0

Government Debt

12.12 As we have pointed out, government debt, which had soared in the aftermath of COVID-19, is now on its downward trajectory. As a consequence of the reduction in the fiscal deficit of the Union Government, its outstanding debt will also follow a downward trajectory. However, debt being a stock variable, the reduction will be slow. The outstanding debt of the Union Government is projected to come down from 56.4 per cent of GDP by the end of 2023-24 to 47.6 per cent of GDP by the end of the award period.

12.13 Since the reduction in debt stock takes time, the impact on interest payments is also relatively slow. It is estimated that this reduction in outstanding debt will yield a reduction of 0.5 per cent of GDP in the interest payments of the Union Government.

12.14 As explained in Chapter 5, the fiscal deficit of the State Governments has remained within a narrow band around the 3 per cent mark. Overall, excluding SASCI, outstanding debt of State Governments stood at 25.7 per cent of GDP by the end of 2023-24. Since the deficit will be subject to a ceiling of 3 per cent of GSDP, the outstanding debt of State Governments will be 27.2 per cent of GDP in 2030-31, provided all States borrow up to their limit. The average fiscal deficit for States for past decade has been 2.7 per cent of GDP. With SASCI assumed to be over and above the 3 per cent fiscal deficit limit for States, the debt stock of States including SASCI will be 29.9 per cent of GDP by the end of the award period. This additional debt on the books of State Governments will not adversely impact the sustainability of their debt since this is interest free.

12.15 However, as we have pointed out in our inter-State comparison in Chapter 5, the challenge lies not in the overall debt of the State Governments but in the inter-State differences. At the end of 2023-24, the outstanding debt of different State Governments of non-NEH States ranged from 15.7 per cent of GSDP, in the case of Odisha, to 42.9 per cent of GSDP, in the case of Punjab. With adherence to the 3 per cent cap, it is expected that this difference would narrow down, in addition to stabilisation of the overall debt.

12.16 Consequently, the combined debt of the Union and States is projected to fall steadily from 77.3 per cent of GDP to 73.1 per cent over our award period. It may be noted that in all these projections, the external debt of the Union Government is valued at historical exchange rates and not the current exchange rates¹.

Off-Budget Borrowings

12.17 Off-budget borrowings (OBBs), that is, borrowings not incurred directly by governments but by their entities and serviced by the government, have been a major source of fiscal risk. These borrowings do not appear transparently in the government's accounts. Although the Union Government discloses them in the Union Budget and some States have

¹ Valuing external debt at current exchange rate increases the outstanding liabilities of Union Government by 1 per cent of GDP in 2025-26

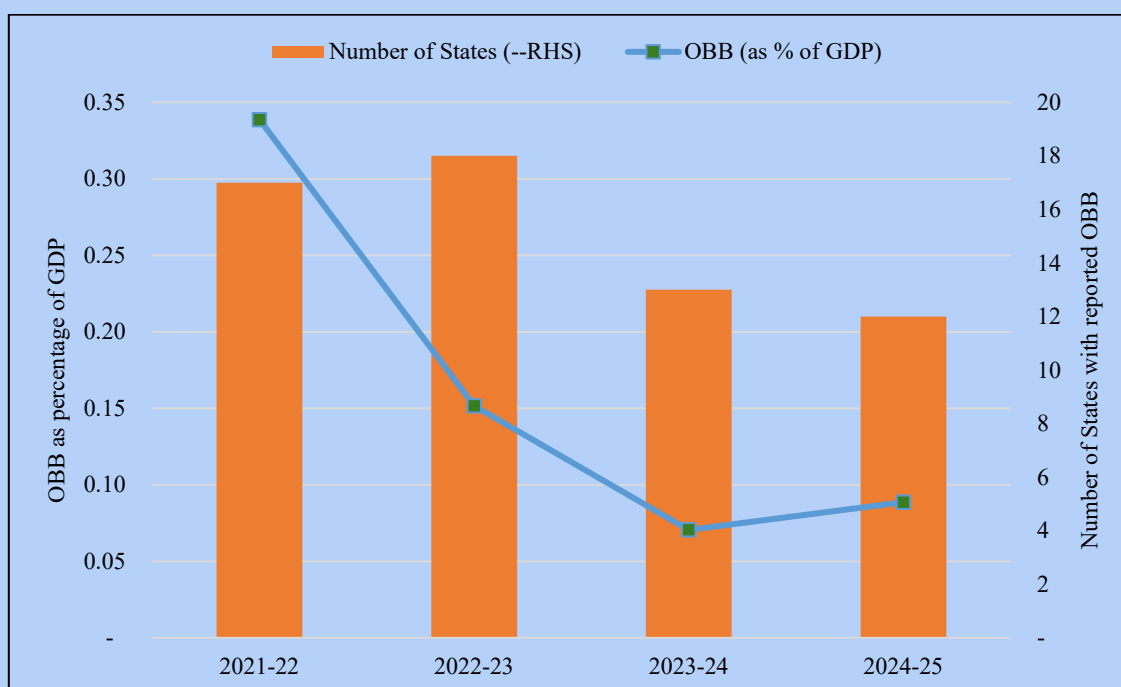
adopted similar reporting obligations in their FRBM Acts, the reporting of OBBs by States has not been transparent.

12.18 The Union Government has been incurring such liabilities, known as extra budgetary resources (EBR), for various purposes, including payment of subsidies, and the outstanding amount on this account is of the order of 0.46 per cent of GDP in 2023-24. However, the Union Government has discontinued this practice since 2022-23, and since the outstanding amount is small, it is not an imminent risk factor for overall fiscal stability. The Union Government should continue with the practice of full disclosure on these extra budget borrowings and ensure that further liabilities are directly contracted on the budget rather than off budget.

12.19 Off-budget borrowings are a significant risk factor to fiscal stability when it comes to States. As stated earlier, there is a lack of disclosure of off-budget borrowings amongst States. Comptroller and Auditor General of India (CAG) has been reporting OBBs in the State Finance Audit Reports (SFAR), but there, too, the consistency is less than desirable. At times, the reporting in SFARs is not fully comprehensive, and there is heterogeneity in reporting amongst different States. Instances of heterogeneity and even discontinuity are seen in the case of some States.

12.20 For the last few years, the Ministry of Finance has been collecting this information for the purposes of fixing borrowing limits for States and putting it in the public domain. As per the data available with the Ministry of Finance, the extent of off-budget borrowing is coming down, as shown in *Figure 12.1*.

Figure 12.1 Off-budget Borrowings by States (percentage of GDP)



Source: <https://doe.gov.in/rti-information-department-of-expenditure>

12.21 To better understand the issue, the World Bank conducted a study for the Commission, covering 12 States. It examined the types of OBBs being contracted, as well as the associated challenges and risks. The most common type of OBBs involves an entity controlled by the government incurring a debt under government guarantee to fund a government project or programme. In turn, the government provides financial assistance from the budget to service that debt. However, other types of OBB exist. Under one such type, a government allows its revenue to be escrowed to the entity, and the entity borrows on the strength of this stream of revenues. In some cases, the government postpones payment of dues to the implementing agency, as it sometimes does in the case of a subsidy, with an undertaking to pay it later. The entity then borrows on the strength of this undertaking, and the government services the debt when it becomes due.

12.22 Off-budget borrowings pose a risk to fiscal stability, as it can become a vehicle for borrowing in excess of the prescribed limits. Some of the practices, such as not crediting government revenues to the consolidated fund but instead escrowing them directly, could also be unconstitutional under Article 266. We recommend that, building on the example set by the Union Government, States should completely discontinue this practice and bring all off-budget borrowings into their budgets.

12.23 However, if, for some reason, such borrowings have to be undertaken, there should be a framework for regular reporting on an annual basis, preferably as a part of the budget. This reporting should include entity-wise details of borrowings, giving the outstanding balance at the beginning of the year, amount borrowed during the year, amount repaid during the year, amount outstanding at the end of the year, interest paid, assistance received from the government for debt servicing, the purpose of borrowing and the amount spent for the purpose. A suggested format, as in *Annexure 12.1*, could be adopted for this purpose. It is also recommended that disclosure in this format should be included in the State Finance Accounts by the CAG.

12.24 Structural challenges in reporting off-budget borrowings will persist, since disclosures by the CAG will have to rely on data furnished by State entities. Lending institutions are also in a position to provide an alternative source of data to strengthen the reporting framework for off-budget borrowing. Given that much of the financing of State entities originates from banks and government-owned financial institutions such as PFC, REC, and NABARD, we recommend designing a framework under which lending institutions periodically report the loans extended to State-owned entities where the government has the commitment to provide assistance for debt servicing.

Legal Framework

12.25 The foundation of fiscal rectitude emanates from the fiscal responsibility legislation (FRL) of the Union and the States. This legislation has been in existence for about twenty years now. In addition, the Union Government uses the powers conferred upon it by clause (3) of article 293 of the Constitution to ensure that the borrowings of States remain within the limits recommended by the Finance Commissions.

Fiscal Responsibility Legislation

12.26 The Fiscal Responsibility and Budget Management (FRBM) Act was enacted by the Parliament in 2003 to establish a system of rule-based fiscal management at the Union. States followed suit, and by 2007, all States, barring a few, had enacted legislation as well. These Fiscal Responsibility laws (FRLs) laid the foundation of prudent fiscal management and led to notable improvements in States' fiscal management. On average, States maintained their fiscal deficit at 2.2 per cent of GDP during the decade following the enactment of FRLs, well below the prescribed ceiling of 3 per cent of GDP, compared to an average of 3.8 per cent of GDP during 1997-98 to 2004-05.

12.27 States were also supported by the debt relief recommended by FC-12 and FC-13. Combined with strong GDP growth, these efforts facilitated a sustained reduction in deficits and debt. The general government debt-to-GDP ratio fell from 83.6 per cent in 2003-04 to 67.9 per cent by 2007-08 just before the global financial crisis.

12.28 While most States have adhered to fiscal targets, the commitment of some States has been less encouraging. There have been repeated amendments to the FRBM Acts of certain States to alter fiscal targets, effectively shifting the goalposts, particularly with respect to deficit and debt thresholds. For example, Himachal Pradesh amended its FRBM Act in 2023 to revise the fiscal deficit target to 6.0 per cent for the year 2022-23. Similarly, through an amendment in 2025, West Bengal raised the ceiling on debt stock, mandating that the maximum debt stock of 38.0 per cent of GSDP be maintained up to 2029-30. Arunachal Pradesh amended its Act in 2022 and removed the revenue surplus target. Even the Union FRBM Act, 2003, has undergone a series of amendments, the most significant being in 2018 when the targets for revenue deficit and effective revenue deficit were completely removed.

12.29 There are also differences in the FRBM Acts of the States in terms of scope and depth. A few States (for example, Assam, Arunachal Pradesh, Nagaland, Karnataka and Goa) have explicitly covered guarantees and off-budget items under the ambit of their FRL framework. Some States (for example, Tamil Nadu, Karnataka and Kerala) have institutionalised and explicitly mentioned a reporting mechanism to the legislature in case FRL targets are breached.

12.30 Through amendments to the State FRBM acts, States have generally aligned their fiscal deficit ceilings or debt paths in response to recommendations of successive Finance Commissions. Almost all States relaxed the targets during the COVID-19 pandemic. A few States either removed or avoided binding themselves to fiscal targets. For example, during 2021-22, Arunachal Pradesh dropped the revenue surplus target and outstanding debt to GSDP ratio targets in its amendment, while West Bengal repeatedly extended fiscal deficit relaxations beyond the original 3 per cent ceiling.

12.31 A few States have also undertaken measures to enhance transparency and oversight. The FRLs of Goa and Odisha empower independent agencies to review compliance, while Karnataka mandates regular monitoring by a Fiscal Management Review Committee. Odisha went further by establishing a Budget Stabilisation Fund to build fiscal buffers during revenue surplus years.

Karnataka also explicitly included Public Sector Enterprise (PSE) and Special Purpose Vehicle (SPV) borrowings under total liabilities, bringing more off-budget borrowings into the fiscal net.

12.32 The inconsistencies and overall lack of uniformity in coverage, flexibility, and transparency mechanisms highlight the need to address the existing limitations and develop a more effective FRL framework. FRLs are critical to ensuring adherence to fiscal consolidation as they provide legislative commitment for the same. Therefore, we recommend that governments take necessary action to amend FRLs in line with the fiscal consolidation roadmap recommended by us. FRBM Acts should require governments to report to the legislature if the deficit or debt limits prescribed under the legislative framework are breached. We also recommend expanding the definition of fiscal deficit and debt to uniformly include all off-budget borrowings.

Article 293(3) of the Constitution

12.33 Another key instrument that has reinforced the adherence to fiscal deficit limits by the States has been clause (3) of Article 293 of the Constitution. Under this provision, as long as States have an outstanding loan from the Union Government, they require its consent before they can borrow upon the security of their Consolidated Funds. Since there has been a practice of the Union Government extending financial assistance to States in the form of a loan, this condition has been fulfilled at all times for all States. As a result, this mechanism has been extremely useful for effective fiscal management. We strongly recommend that this provision of the constitution should continue to be used to ensure that the borrowings of the States follow the recommended fiscal roadmap.

12.34 In our review, we have seen instances where States have breached borrowing limits mainly due to inaccurate assessment of financing from their Public Accounts. Since this practice poses a risk, we recommend that mechanisms be put in place to estimate the financing of the fiscal deficit out of the Public Account as accurately as possible.

12.35 Off-budget borrowings are another source of risk, which can be used to side-step the administration of borrowing limits under these provisions. It is essential that if States resort to OBB, they do so within the overall permitted limits set by the Union Government under Article 293(3). While approving borrowings for States under Article 293(3), the Union Government must take OBBs into account.

12.36 FC-14 had recommended that, for determining yearly borrowing limits, GSDP should be estimated by applying the annual average growth rate of the actual GSDP observed during the latest three years for which actual GSDP data are available. The FC-15 had recommended the continuation of the same practice, and we recommend the same.

Debt Management

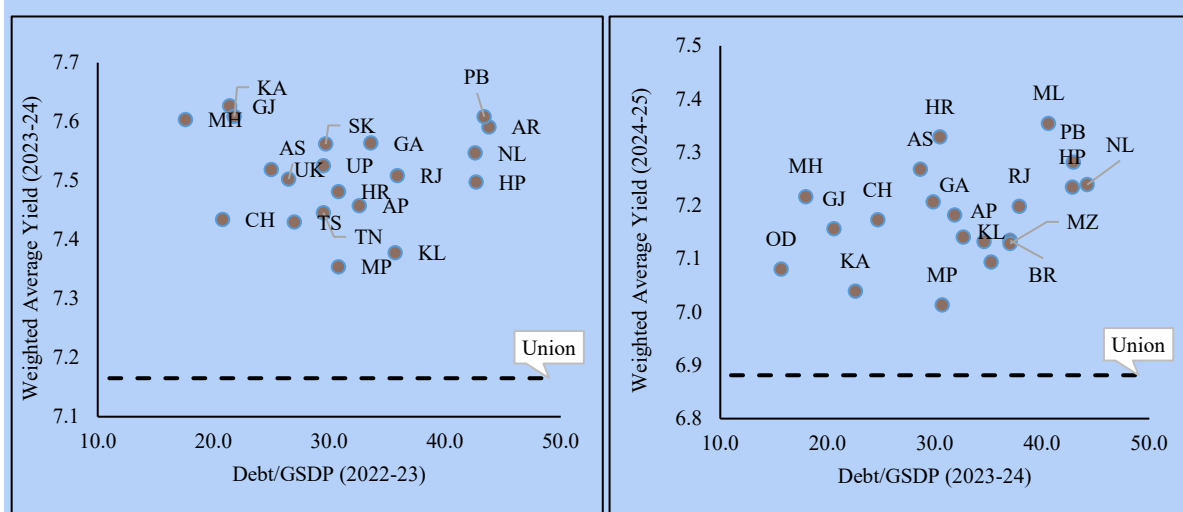
12.37 During the last two decades, the debt profile of the Union and the State Government has undergone significant changes. Following the discontinuation of plan loans from Union to State Government, as recommended by FC-12, the share of market loans in the debt profile of States

has increased. Subsequently, the borrowings by States from the NSSF have tapered off. However, with the introduction of SASCI, the stock of loans from the Union Government to States has again started increasing.

Market Borrowing by the States

12.38 In recent years, States have increasingly relied on market borrowings to finance their deficits. The share of State Government borrowings in total government borrowings has risen significantly since 2015-16. States accounted for about 33 per cent of total government securities issued in 2015-16, which increased to 43 per cent in 2024-25. Consequently, States hold around 36 per cent of outstanding securities in 2025-26, compared to 24 per cent in 2015-16. Higher market borrowings by the States also arises from the fact that the States are not availing NSSF.

Figure 12.2 Weighted Average Coupon Rate of State Government Securities vis-à-vis Debt Position of the States



Source: Data provided by RBI

12.39 Figure 12.2 depicts the weighted average coupon rate for 10-year tenor securities issued by the States in 2023-24 and 2024-25 and their debt levels in the preceding years. It also depicts the weighted average coupon rate of similar tenor securities issued by the Union Government in that year. It is evident that the yield for the States' securities is not related to the States' debt levels. Also, the States continue to borrow at a higher cost than the Union Government, even though there is hardly any credit and default risk. It is evident that in the absence of the default risk, the market mechanism will not create incentives for better fiscal management.

12.40 Furthermore, many States are maintaining sizeable average cash balances on a persistent basis, which carries a cost. States need to devise a mechanism for more optimal cash management using the instruments that are readily available to them to avoid such build up.

Debt Maturity Profile

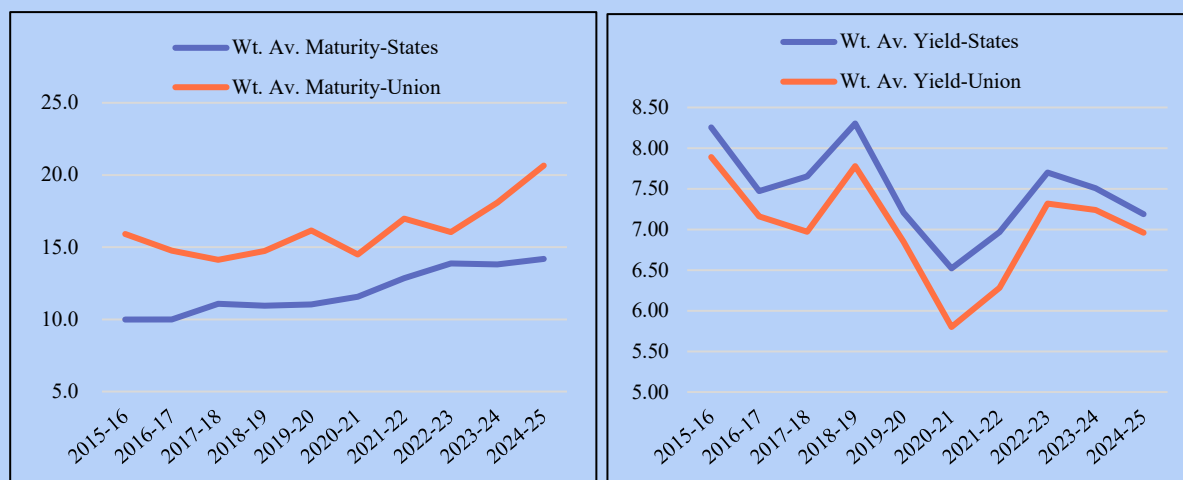
12.41 The Union Government has been financing close to 65-70 per cent of its Fiscal Deficit through domestic Market Borrowings by issuing Government Securities (G-Secs) in the last several years. It is observed that the Union Government has made a gradual shift towards issuing securities across different maturity buckets, with a clear move towards issuing G-Secs with residual maturity of over 30 years as can be seen in *Table 12.2*.

Table 12.2 Maturity Profile of Government Securities (percentage of Amount Raised)

Maturity Bucket	Union Government		State Governments	
	2015-16	2024-25	2015-16	2024-25
Above 1 year & up to 5 years	-	15.21	0.78	5.42
Above 5 years & up to 10 years	37.66	32.96	98.54	28.96
Above 10 years & up to 15 years	24.22	13.64	0.68	31.19
Above 15 years & up to 30 years	36.59	10.49	-	33.73
Above 30 years	1.52	27.70	-	0.70

Source: Data provided by RBI

Figure 12.3 Weighted Average Maturity (Years) and Weighted Average Yield (per cent) of Union and State Government Securities Issued During the Year

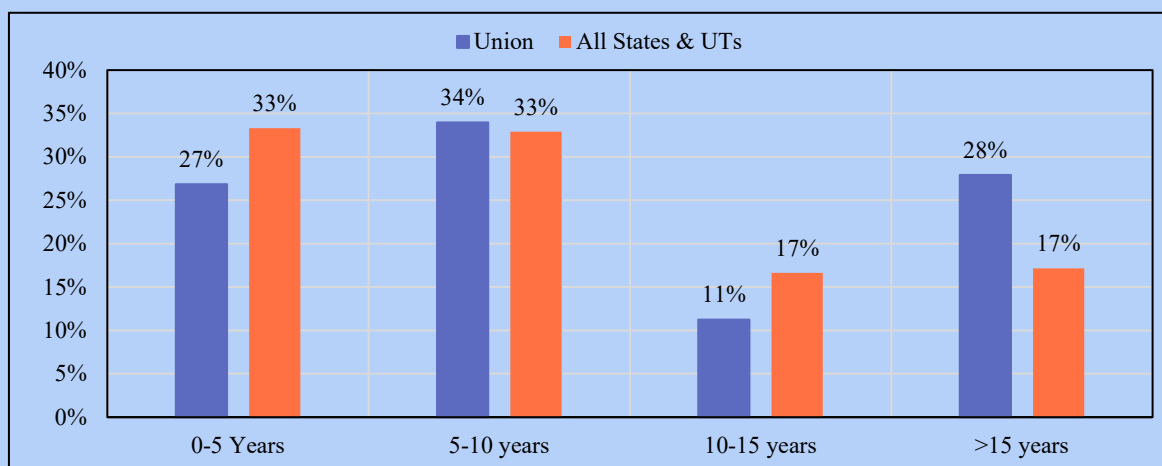


Source: Data provided by RBI

12.42 At the aggregate level, the State Governments finance almost 80 per cent of their fiscal deficit through market borrowings by issuing State Government Securities (SGSs). They have followed the same pattern by issuing securities in the longer tenors. However, the issuance is more dispersed across maturity buckets, with a few States like Kerala and Telangana issuing securities with 40-year maturity also for the first time in the last few years. State Governments, which were almost entirely issuing 10-year SGSs in 2015-16, have now dispersed the securities across different maturity buckets. Consequently, as depicted in *Figure 12.3*, the weighted

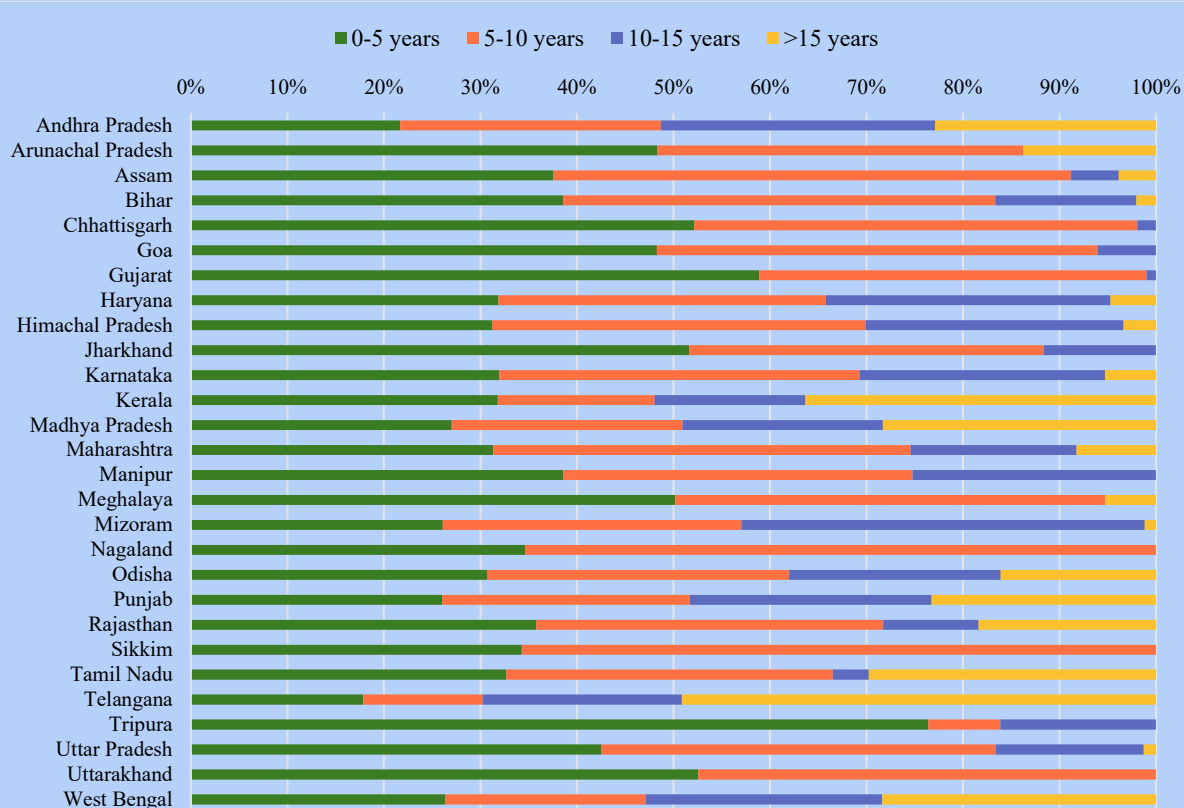
average maturity of securities issued every year has been on the rise, whereas the weighted average yield has been lowering vis-à-vis 2015-16, with the yield differential between States and Union Government securities intact.

Figure 12.4 Maturity Profile of Outstanding Debt Stock (as on 31 March 2025)



Source: Data provided by RBI

Figure 12.5 Bucket-wise Maturity of State Government Securities (as on 31 March 2025)

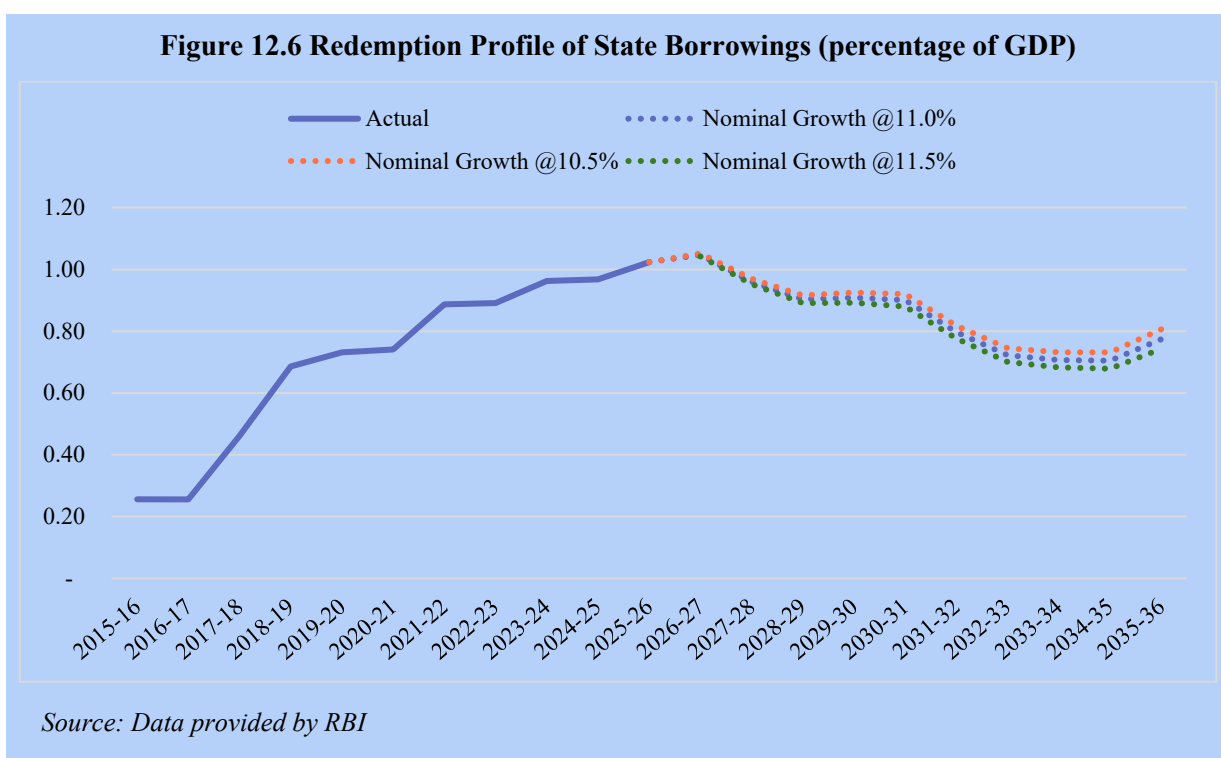


Source: Data provided by RBI

12.43 As shown in *Figure 12.4*, the debt maturing in the next ten years as a proportion of total outstanding debt is 61 per cent for the Union Government and 67 per cent for the State Governments. *Figure 12.5* depicts the State-wise distribution of the maturity profiles.

Redemption Pressure and Roll-over Risk

12.44 Due to increased financing of deficit from market borrowings by States, the redemption has increased to 1.0 per cent of GDP. Our analysis shows that while there is no specific roll-over risk, there are small kinks in the redemption profiles of State market borrowings, specifically in the first year of the award period and later in 2029-30 and 2030-31, which is mainly due to additional borrowing raised during the pandemic. *Figure 12.6* shows the projected redemptions, assuming that States continue to finance around 80 per cent of their deficit through market borrowings, for three scenarios of GDP growth rate, namely, 11.5 per cent, 11 per cent and 10.5 per cent.



12.45 To smooth out the redemption profile, the Union Government has adopted strategies like switch auctions and buybacks. Switch auction involves buying back near-term securities by issuing longer-term securities, thus helping to smoothen out the maturity profile of the outstanding debt stock. States should actively explore adopting such strategies to manage their redemption pressures in specific years.

Secondary Market Liquidity

12.46 The Union Government issues more than 90 per cent G-Secs through re-issuances, which is a distinctive feature of its Debt Management Strategy. Although State Governments have

started issuing securities in the longer tenures, very much like the Union Government, they are lagging behind in the reissuance of securities, which has been limited to around 10 per cent. This has led to proliferation of State securities which has further led to thin trade in the secondary market in SGS segment due to low outstanding stock of each individual security issued. For instance, as per the data from the Reserve Bank of India, as on 31 March 2025, there are more than 5,200 State Government securities outstanding of approximately ₹63.99 lakh crore, against just 116 Union Government securities totalling to ₹112.16 lakh crore. Thus, the average Union Government security stands at approximately ₹96,600 crore, whereas for States, it is as low as approximately ₹1,230 crore.

12.47 Further, the Union Government has issued fresh securities in the standard tenors of 3, 5, 7, 10, 14, 30, 40 and 50 years, with a 15-year security (replacing with 14-year security) introduced beginning in 2024-25. In contrast, State Governments have issued securities for all yearly tenures, ranging from 2 years to 31 years, as well as for 35 and 40-year tenures. Indeed, they have gone even further by issuing securities with half-yearly tenures, such as 3.5, 4.5, 5.5, 6.5, 7.5, all the way up to 15.5 years.

12.48 These factors have contributed to further thinning of an already thin market. The result is that States end up paying an ‘illiquidity premium’ markup on the prevailing yields of Union Government Securities. If States also adopt the practices of re-issuances and standard tenors, the liquidity of State securities would increase, leading to better price discovery and, therefore, a reduction in the interest rate spread over Union Government Securities.

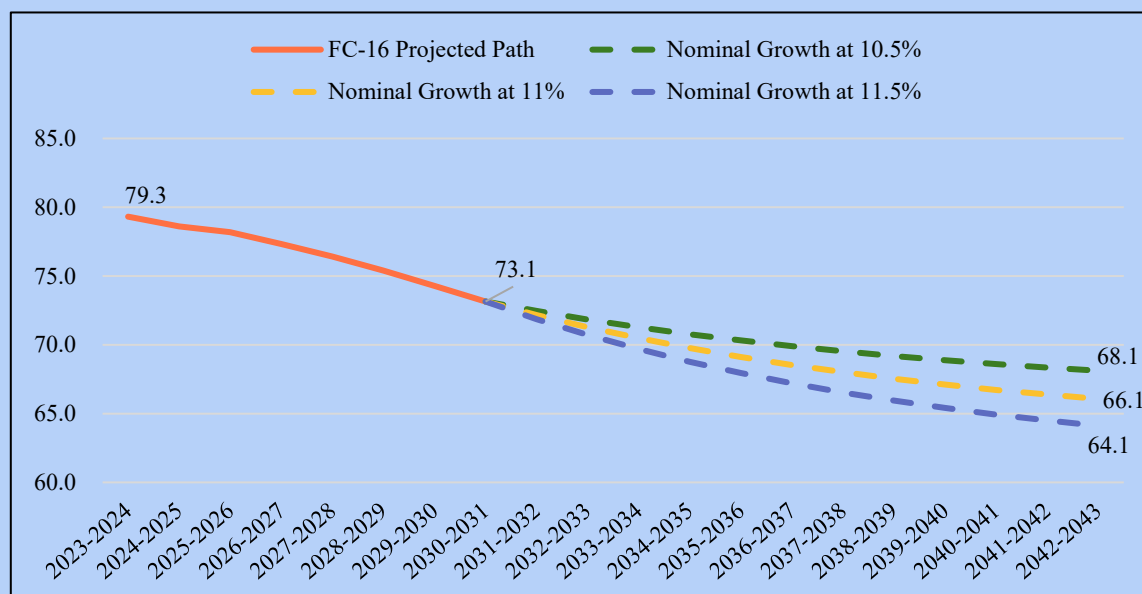
Long-Term Fiscal Roadmap

12.49 Our path for the award period will take the debt of Union and State combined to 73.1 per cent of GDP by the end of the award period. Correspondingly, the fiscal deficits of the Union Government and the State Government would be 3.5 and 3 per cent of GDP respectively, with the Union Government’s fiscal deficit including 0.5 per cent of GDP in interest-free SASCI loans to States for capital expenditure.

12.50 We are of the opinion that given the requirement of the country to develop world class infrastructure, the Union and State Governments will have to maintain a high level of capital expenditure for coming decade or two. With States maintaining a revenue balance, a combined deficit of 6.5 per cent fiscal deficit for the Union and States, including 0.5 per cent of on-lending by Union to States for capital expenditure, would be required to achieve the desired level of capital expenditure. This would imply a fiscal deficit of 3.5 per cent of Union Government including SASCI and 3 per cent for States excluding SASCI.

12.51 If both levels of government stick to these levels of fiscal deficits in future years, with an annual GDP growth rate of 11 per cent, the outstanding debt of the Union Government would reach 38.8 per cent of GDP, and that of State Governments would nearly stabilise near 32.1 per cent of GDP by 2042-43. Given that 0.5 per cent of GDP of the Union Government’s deficit goes towards on-lending to States, the debt of Union and States combined would reach a level of 66.1 per cent of GDP by 2043.

Figure 12.7 Long-term Debt Trajectory for Union and States Combined (percentage of GDP) for the Next Two Decades



12.52 With a lower GDP growth rate of 10.5 per cent per annum, the government debt would reach the 68.1 per cent mark and with a marginally higher growth rate of 11.5 per cent per annum, debt would be 64.1 per cent of GDP, as is illustrated in *Figure 12.7*. We expect that the fiscal roadmap discussed in this chapter will put India on the desired rapid growth path. It is aspirational but pragmatic.

12.53 However, we have also noticed that, while budgets have shown a healthy trend, excessive borrowings, especially to finance avoidable non-developmental expenditures, such as those on public-sector enterprise losses and poorly targeted subsidies, can have a significant adverse impact on future budgets. It is essential to address this problem on an urgent basis. In the next three chapters, we discuss reforms in three key areas where reining in avoidable expenditures can strengthen the Union and State Government finances, namely, persistent power distribution company losses, poorly targeted subsidies and transfers, and poorly performing public sector enterprises.

Summary of Recommendations

- (i) We recommend that States' fiscal deficits continue to be capped at 3 per cent of their respective GSDP. To ensure the stability of State Government debt, this limit should be strictly enforced in accordance with clause (3) of Article 293 of the Constitution. It is assumed that on-lending by the Union Government under SASCI will be over and above this limit, as is currently the practice. The Union Government should reduce its fiscal deficit to 3.5 per cent of GDP by the end of the award period.
(paragraphs 12.9 and 12.10)
- (ii) States should completely discontinue the practice of incurring off-budget borrowings and bring all such borrowings onto their budgets. If, for any reason, off-budget

borrowings are undertaken, there should be a framework for their regular annual reporting, preferably as part of the budget. A suggested format, as in *Annexure 12.1*, may be adopted for this purpose. The CAG should include disclosure in this format in the State Finance Accounts.

(paragraphs 12.22 and 12.23)

- (iii) Lending institutions are also in a position to provide an alternative source of data to strengthen the reporting framework for off-budget borrowing. We recommend that a framework should be put in place under which lending institutions periodically report the loans extended to State-owned entities where the government has the commitment to provide assistance for debt servicing.

(paragraph 12.24)

- (iv) There are inconsistencies and lack of uniformity in coverage in the existing FRL framework of the States. We recommend that governments take necessary action to amend FRLs in line with the fiscal consolidation roadmap recommended by us. FRBM Acts should require governments to report to the legislature if the deficit or debt limits prescribed under the legislative framework are breached. We also recommend expanding the definition of fiscal deficit and debt to uniformly include all off-budget borrowings.

(paragraph 12.32)

- (v) The mechanism under Article 293(3) of the Constitution mandates that States obtain the Union's consent before borrowing against the security of their Consolidated Funds, as long as they have any outstanding loans from the Union Government. This mechanism has been extremely useful for effective fiscal management. We recommend that this constitutional provision continue to be used to ensure that the States' borrowings adhere to the recommended fiscal roadmap.

(paragraph 12.33)

- (vi) There have been instances where States have breached borrowing limits, mainly due to inaccurate assessments of financing from their Public Accounts. We recommend that mechanisms be instituted to estimate the financing of the fiscal deficit from the Public Account as accurately as possible, so that the fiscal deficit limit can be enforced effectively.

(paragraph 12.34)

- (vii) For determining yearly borrowing limits, we recommend that the practice of estimating GSDP by applying the annual average growth rate of the actual GSDP observed during the latest three years for which actual GSDP data are available, should be continued.

(paragraph 12.36)

- (viii) To smooth out its debt redemption profile, the Union Government has been following strategies such as switch auctions and buybacks. We recommend that States also actively explore adopting similar strategies to manage their redemption pressures in specific years.

(paragraph 12.45)

□□□

13.1 In a modern economy, a steady supply of electricity at affordable prices is essential for the smooth functioning of all sectors, including households, government, agriculture, manufacturing, mining, and services. With the ongoing electrification of not only motor vehicles and railways but also airplanes, the transportation sector is also expected to become increasingly reliant on electricity. A vibrant power sector is a necessity for sustained rapid growth.

13.2 One extremely positive development in the past two decades in this sector has been the electrification of all willing households in the country. Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY) was launched in 2005 to rapidly expand rural electrification. In 2014, Deen Dayal Upadhyaya Gram Jyoti Yojana (DDUGJY) supplanted RGGVY. Later, in 2017, the Union Government launched Pradhan Mantri Sahaj Bijli Har Ghar Yojana (SAUBHAGYA) to electrify 100 per cent of households nationwide. The efforts and investments under these schemes have yielded handsome results.

13.3 According to the 2011 Census, the proportion of households with electricity in India that year was 67.2 per cent. According to the National Family Health Survey-4, this figure rose to 88.2 per cent by 2015-16. By the end of fiscal year 2021-22, electricity had reached all willing households, leading the government to close down the SAUBHAGYA scheme¹. In parallel, India has expanded its electricity generation and transmission capacities to ensure that electricity is available to households, businesses, and the government around the clock. As a result, by the end of 2024, the daily average availability of electricity stood at 21.9 hours in rural areas and

¹ See the Press Information Bureau (PIB), Government of India, note dated July 28, 2022, at <https://www.pib.gov.in/PressReleasePage.aspx?PRID=1845839#:~:text=Under%20Deen%20Dayal%20Upadhyaya%20Gram,31st%20March%2C%202019%20respectively> (accessed June 15, 2025).

up to 23.4 hours in urban areas. Per-capita electricity consumption has increased from 957 Kilowatt-hour (kWh) in 2013-14 to 1,395 kWh in 2023-24, representing a 45.8 per cent rise².

13.4 While these are commendable achievements, electricity distribution within the sector remains plagued by technical and economic inefficiencies, as well as financial fragility. This chapter is primarily devoted to an assessment of the efforts made to overcome these inefficiencies and fragilities, as well as possible solutions. We begin with a brief introduction to the workings of the sector and where distribution fits within it.

Distribution within the Electricity Sector

13.5 The power sector has three major components: generation, transmission, and distribution. Electricity generation, whether it be thermal, hydro, solar, wind, or nuclear, is predominantly concentrated in large plants, which are generally located far away from where electricity users - households, businesses, and the government - are. The role of transmission is to deliver electricity from the generation plant to a receiving substation located near the users of electricity. Distribution handles the last-mile delivery, transporting electricity from the local receiving substation to individual users.

13.6 In electricity generation, the private sector has emerged as a significant player in recent years. Its share in the total installed capacity rose from 15.5 per cent in 2009³ to 54.3 per cent in 2025⁴. This increase in share has come at the expense of both the central and state public sector generation companies. The share of central public sector companies in total generation capacity declined from 33.1 per cent in 2009 to 22.5 per cent in 2025, and that of state public sector companies from 51.4 per cent to 23.2 per cent over the same period.

13.7 In India, transmission is almost entirely in the public sector. Private entry is permitted, but it is a recent and, so far, a minor phenomenon. With substantial interstate transmission activity, the Union Government is the dominant player in this area. State-level entities generally handle intra-state transmission.

13.8 Being primarily an intra-State activity, electricity distribution is mostly performed by State-level entities. For approximately the first fifty years after independence, electricity policy and institutional structure were governed by the Electricity (Supply) Act, 1948. Among other things, the Act mandated the creation of a State Electricity Board (SEB) in each State with the regulation and management of electricity generation, transmission, and distribution as its key functions. By the 1960s, the SEBs had evolved into vertically integrated monopolies, encompassing generation, transmission, distribution, and regulation under a single umbrella.

² See PIB note dated January 1, 2025, at <https://www.pib.gov.in/PressReleasePage.aspx?PRID=2089243#:~:text=Rise%20in%20Per%20Capita%20Electricity,957%20kWh%20in%202013%2D14> (accessed June 15, 2025).

³ Central Electricity Authority's Executive summary on Power Sector, March 2009 (https://cea.nic.in/wp-content/uploads/2020/05/exe_summary-03-3.pdf)

⁴ Central Electricity Authority's Executive summary on Power Sector, May 2025, p.9 (https://cea.nic.in/wp-content/uploads/executive/2025/06/Executive_Summary_May_2025_Azual_Updated.pdf)

Progress in the provision of electricity during the first fifty years of independence remained slow, with SEBs performing highly inefficiently.

13.9 The launch of economic reforms in 1991 led the State of Odisha to take the lead in reforming its electricity sector by enacting the Odisha Electricity Reform Act, 1995. Soon after, the Union Government began its own reform process through the Electricity Regulatory Commissions Act, 1998. It provided for the establishment of statutorily independent Central Electricity Regulatory Commission (CERC) and State Electricity Regulatory Commissions (SERCs) for fixing electricity tariffs.

13.10 However, it was the comprehensive Electricity Act, 2003 which kick-started a genuine transformation of the sector. Among other things, this Act provided for the unbundling of SEBs into separate generation companies (GENCOs), transmission companies (TRANSCOs), and distribution companies (DISCOMs) and laid out the powers and functions of CERC and SERCs. The provision has led a majority of States and some Union Territories (UTs) to unbundle their SEBs into the three companies and delegate the responsibility for distribution to independent DISCOMs, with some even privatizing the latter. Of the remaining States and UTs, some have assigned the task of distribution to companies that additionally handle generation and transmission, or only generation. Only a handful of small States, UTs, and specific parts of the States of Kerala and Maharashtra now rely on the State power departments to handle electricity distribution.

13.11 In the post-reform era, DISCOMs occupy a unique place in the electricity supply chain. They serve as intermediaries between GENCOs which supply electricity, and households, various government entities, and businesses that consume electricity. Because generation plants require a large upfront investment due to indivisibilities and electricity output is spread over multiple decades, GENCOs require long-term power purchase agreements (PPAs) with DISCOMs when committing their investments. However, if DISCOMs are heavily indebted, they are not a credible buyer party to such agreements. Under such circumstances, even if GENCOs are prepared to invest in generation and consumers are prepared to pay for electricity, the necessary investment would fail to occur.

13.12 Being mostly State-owned, DISCOMs in India do not face the same pressure to be efficient and cost-effective as commercial entities do. Additionally, in many instances, SERCs are not strictly guided by regulatory principles to fix tariff at cost-recovery levels. These and other factors to be discussed later combine to keep DISCOMs as a whole in perpetual losses, undermining their credibility as the buyer party to PPAs. State Governments, which own the DISCOMs, get around the problem by implicitly guaranteeing payments to GENCOs. However, over time, DISCOMs' losses and interest payments on them accumulate. High interest rates paid by DISCOMs, relative to those on government debt, accentuate the problem, and eventually force the government to partially or wholly assume the debt. This in turn kickstarts the next round of losses, debt accumulation, and bailout.

13.13 Three such bailouts have been undertaken in 2000-01, 2012-13, and 2015-16. Even after the third round, DISCOMs' financial health has not improved, with their debt at the end of 2023-24 already at the highest ever level of ₹7.5 lakh crore⁵. These cycles of losses, debt, and bailouts have obvious detrimental effects on state finances, a subject of immense concern to the FC, calling for a detailed analysis of the electricity distribution sector.

13.14 Problems afflicting the distribution sector can be categorised into two broad areas: technical and economic inefficiency, and financial fragility. Post-1991 reforms have targeted both types of problems, and, in principle, our discussion of them below could examine them separately. However, reforms aimed principally at problems in one area also have components that address problems in the other area or at least impact upon them. Accordingly, rather than discussing the two sets of reforms separately, the account that follows presents them in a chronological order, describing the reforms in the two areas side by side. It is worth noting that we interpret the term 'reform' broadly in this chapter to include interventions aimed at improving operational efficiency.

The Early Reforms: 1995-2010⁶

13.15 As noted in the introduction, the earliest effort at reforming the electricity sector after the launch of the broader economic reforms in 1991 was made by the Odisha government under the Orissa Electricity Reform Act, 1995. Under it, the government split its SEB into a transmission and distribution company called Grid Corporation of Orissa (GRIDCO), two separate power generation companies, and a SERC. Later, in 1999, it separated distribution from GRIDCO into four distribution companies and privatized them between 1999 and 2001. However, for various reasons that are not relevant here, the privatisation effort was unsuccessful.

13.16 The Union Government initiated the nationwide reform of the electricity sector with the enactment of the Electricity Regulatory Commissions Act, 1998. This Act established the CERC and included enabling provisions for SERCs. However, few States took advantage of the provision.

The First Bailout: 2000-01

13.17 In the meantime, high transmission and distribution losses, power theft, unreimbursed tariff subsidies, poor metering, billing, and collection, and tariffs below cost resulted in the SEBs accumulating a massive ₹41,473 crore in dues to the coal and power Central Public Sector Undertakings (CPSUs)⁷. The dues not only created cash-flow problems for the CPSUs but also posed a threat to downstream banks with exposure to the power and energy sectors. To resolve this crisis, the Union Government implemented the One-Time Settlement Scheme in 2001, under which participating State Governments took over this debt, issued tax-free bonds for the

⁵ Power Finance Corporation Report on Performance of Power Utilities 2023-24, May 2025, Table 2, p. ii.

⁶ A more detailed account of the reforms in the distribution sector can be found in NITI Aayog, "Diagnostic study of the power distribution sector," April 2019, Annexure B, pp. 76-99.

⁷ Report of the Expert Group on Settlement of SEB Dues, May 2001

amount owed (at an interest rate below what SEBs had been paying), and cleared the dues of CPSUs. The States were also required to commit to power sector reforms, including the unbundling of SEBs, regulatory compliance, and loss-reduction plans. The scheme restored the financial health of CPSUs and provided breathing space for SEBs.

Accelerated Power Development and Reform Program, 2002-03

13.18 Closely on the heels of the 2001 bailout, the Union Government launched the Accelerated Power Development and Reform Program (APDRP) in 2002-03 to enhance the financial viability of SEBs. The program provided financial assistance to States for investments and reforms aimed at reducing Aggregate Technical and Commercial (AT&C) losses⁸ of SEBs and improving the performance of distribution in urban areas. However, it had limited success due to weak enforcement. AT&C losses of SEBs, Power Departments, and TRANSCOs selling directly to consumers showed some improvement, falling from 38.86 per cent in 2001-02 to 33.82 per cent in 2004-05⁹.

The Electricity Act, 2003

13.19 Almost concurrently with the APDRP, the Union Government enacted the landmark Electricity Act, 2003, to implement transformative reforms in the electricity sector. Its main provisions included:

- (i) Unbundling of SEBs into GENCOs, TRANSCOs, and DISCOMs.
- (ii) De-licensing of, and therefore, free entry into generation.
- (iii) Open access, whereby customers buying electricity above a specified threshold would be free to choose their electricity supplier.
- (iv) Reduction in cross-subsidy, provided to one set of customers at the expense of another through a below-cost price to the former and an above-cost price to the latter.
- (v) Multiple distribution licensees in the same area to foster competition.
- (vi) Appointment of Appellate Tribunal for Electricity (APTEL) at the Union level.

13.20 Overall, the Act aimed to create a more open, transparent, and competitive electricity market. While it undoubtedly placed India on the path to modernising the electricity sector, progress towards this goal has been significantly slower than in the telecommunications sector which was placed on the reform path around the same time. As described in the introduction to

⁸ The AT&C loss of a DISCOM is the difference between its total electricity purchase and the electricity on which it collects charges, as a percentage of the total electricity purchased. The loss has four sources: technical loss as electricity travels on transmission and distribution lines, theft along distribution lines, underbilling, and under-collection on what is billed. AT&C losses are measured as a percentage of physical units of electricity purchased, such as kilowatt-hours. They are related to the DISCOM's economic losses but are not an exact measure of it. Economic losses also depend on the DISCOM's purchase and sales prices. Conventionally, the economic loss per kilowatt-hour of electricity is measured as the difference between the average cost of supply (ACS) and average revenue realised (ARR) per kilowatt-hour of electricity. These are explained in greater detail in later sections of this chapter.

⁹ CAG Report no. 16 of 2007

this chapter, unbundling of generation, transmission, and their corporatisation varied across States and UTs. It took nearly two decades to accomplish this change.

13.21 The opening of entry into generation has had greater success, with private companies rapidly expanding their share of the installed capacity. However, the problems stemming from the weak financial conditions of DISCOMs have hindered their progress. Open access is permitted but restricted through high cross-subsidy surcharges and delays in granting permissions. With reference to provisions to limit cross-subsidies to 20 per cent of average supply cost, the cross-subsidy received by certain classes of consumers is almost 40 per cent in States like Andhra Pradesh, Bihar, Goa, Gujarat, Karnataka, Kerala, Maharashtra, Tamil Nadu, Telangana, and West Bengal in 2023-24¹⁰. The provision for multiple licensees has failed to materialise due to a lack of separation between the distribution grid and electricity supply functions. CERC and SERCs have been appointed, but whereas CERC has functioned well, SERCs have not been fully effective in implementing cost-reflective tariffs. Thus, there remains considerable scope for further reform in the distribution sector, a subject to which we will return below.

The National Electricity Policy, 2005 and Related Reforms

13.22 In 2005, the government formulated the National Electricity Policy, emphasising universal access, greater competition, private participation, and greater efficiency and financial viability in the distribution sector.

13.23 To improve access to electricity in rural areas, the Union Government launched the RGGVY, a scheme already mentioned in the introduction. To improve the financial viability of distribution utilities, it introduced the National Tariff Policy in 2006, providing guidelines on setting cost-reflective tariffs and reducing cross-subsidies. The tariff policy also called for a multi-year tariff framework to bring predictability and incentivize performance.

13.24 To improve efficiency in electricity distribution in urban areas, the government introduced the Restructured Accelerated Power Development and Reform Program (R-APDRP) in mid-2008. It was a revamped version of the 2002-03 APDRP, for IT enablement & strengthening of the distribution sector in urban areas. Its goal was to establish IT systems that would help DISCOMs collect reliable and accurate data, enabling them to achieve sustained loss reduction. The specific goal was to bring down AT&C losses to 15 per cent on a sustained basis for five years in the project area¹¹. Funds were initially provided in the form of loans, but the scheme allowed for their conversion into grants upon successful completion of the project¹².

13.25 While RGGVY was successful in significantly expanding access to electricity in rural areas, the impact of the reforms was limited. The implementation of the National Tariff Policy

¹⁰https://cea.nic.in/wp-content/uploads/fs___a/2025/06/Book_2024.pdf (p.32)

¹¹ Report of the CAG on Restructured Accelerated Power Development and Reform Program, Report No. 30 of 2016, p. 4.

¹² Ministry of Power press note dated December 1, 2014.

[https://www.pib.gov.in/newsite/PrintRelease.aspx?relid=112254#:~:text=The%20scheme%20will%20help%20in,Gram%20Jyoti%20Yojana\(DDUGJY\)](https://www.pib.gov.in/newsite/PrintRelease.aspx?relid=112254#:~:text=The%20scheme%20will%20help%20in,Gram%20Jyoti%20Yojana(DDUGJY)) (accessed June 15, 2025).

varied substantially across States, with key objectives, such as reducing cross-subsidies and adopting full cost-recovery tariffs, remaining unfulfilled. R-APDRP was unsuccessful in achieving its objectives of reducing AT&C losses to below 15 per cent on a sustained basis. This has been attributed to delays in implementation, lack of third-party verification, inconsistencies in data reporting, among other things. In its performance audit report on R-APDRP (Report No. 30, 2016), the Comptroller and Auditor General of India noted discrepancies in AT&C loss data and found them unreliable. Only a few States such as Andhra Pradesh and Kerala had AT&C losses less than 15 per cent among all States¹³.

More Reforms and Bailouts: 2011-25

13.26 The reforms undertaken during the 2000s advanced the modernization of the distribution sector to some degree but failed to adequately address both operational efficiency issues and the financial fragility problem of DISCOMs. Nationally, the average AT&C losses remained high at 26.0 per cent in 2010-11 and 26.6 per cent in 2011-12¹⁴. By 31 March 2011, the accumulated losses of the State DISCOMs had reached a staggering ₹1.9 lakh crore or 2.4 per cent of GDP¹⁵. Unsurprisingly, as the 2010s unfolded, reforms aimed at both operational efficiency and financial stability continued.

The Second Bailout: Financial Restructuring Plan, 2012

13.27 Recognising the problem, a new Financial Restructuring Plan (FRP) for DISCOMs was announced in 2012, to restore power purchasing capacity of the debt-ridden DISCOMs, and to enable banks to recover their loans¹⁶. Under this bailout, participating State Governments were to take over 50 per cent of DISCOMs' outstanding liabilities, converting them into bonds to be issued to banks. In turn, banks were to restructure the remaining debt from short-term to long-term, with a moratorium on principal repayments of up to 3 years, lenient repayment terms, and a waiver of penal interest.

13.28 The participating States were also subject to certain conditions, including improvement in several operational parameters such as eliminating the gap between Average Cost of Supply (ACS) and Average Revenue Realised (ARR) (termed as the ACS-ARR gap), and setting targets for progressive reduction in short-term power purchase by State-owned DISCOMs, and enacting the Model State Electricity Distribution Responsibility Bill, 2013, during the moratorium period. In all, seven States signed for FRP, but none met the conditions of improvement in the operational parameters, or enacted the Model State Electricity Distribution Responsibility Bill,

¹³ Report of the CAG on Restructured Accelerated Power Development and Reform Program, Report No. 30 of 2016, Ch. 5

¹⁴ Power Finance Corporation, "Report on the Performance of State Power Sector Utilities for the years 2009-10 to 2011-12," p. 4-iii and "Report on the Performance of State Power Sector Utilities for the years 2010-11 to 2012-13," p. 4-iii.

¹⁵ Ministry of Power PIB note dated September 25, 2012. See

<https://www.pib.gov.in/newsite/PrintRelease.aspx?relid=87971#:~:text=The%20scheme%20would%20be%20applied,as%20on%2031st%20March%2C%202011> (accessed June 15, 2025).

¹⁶ <https://www.pib.gov.in/newsite/PrintRelease.aspx?relid=87951> (accessed on July 22, 2025)

2013. Ultimately, FRP offered only short-term relief to the participating States, without addressing the underlying issue of large DISCOM losses which continued to rise.

Deen Dayal Upadhyaya Gram Jyoti Yojana and Integrated Power Development Scheme, 2014

13.29 Deen Dayal Upadhyaya Gram Jyoti Yojana (DDUGJY) was launched in 2014 for various rural electrification works, strengthening and augmentation of sub-transmission and distribution infrastructure and electrification of villages across the country.

13.30 Integrated Power Development Scheme (IPDS), also launched in 2014, provided fiscal resources for strengthening sub-transmission and distribution networks in urban areas, metering of distribution transformers, feeders, and consumers in urban areas, and deployment of smart meters. This scheme subsumed R-APDRP, with the fiscal resources previously approved for the latter being shifted to it¹⁷. Both schemes were closed in 2022 upon completion of works¹⁸.

The Third Bailout: Ujjwal DISCOM Assurance Yojana

13.31 The FRP scheme notwithstanding, accumulated losses and outstanding liabilities of DISCOMs had reached ₹3.8 lakh crore and ₹4.3 lakh crore, respectively, as of 31 March 2015¹⁹. The high debt not only undermined DISCOMs' ability to make capital investments of their own, but also to credibly sign PPAs with GENCOs. This adversely impacted the investment in generation and, ultimately, the ability of the government to rapidly expand the availability of electricity to all households.

13.32 Recognising these problems, the Union Government introduced the Ujjwal DISCOM Assurance Yojana (UDAY) scheme, which allowed State Governments to assume 75 per cent of the outstanding DISCOM debt over a two-year period. Under the scheme, States were to issue UDAY bonds to banks and other financial institutions to raise the necessary funds and repay DISCOM debt to the lending banks. The lending banks were to restructure the remaining 25 per cent of the debt to bring the cost down for DISCOMs. In turn, DISCOMs were to commit to reductions in AT&C losses and the ACS-ARR gap. To enforce these reductions, DISCOMs were given target dates to achieve specified reductions in the loss of power through transmission, theft, and poor metering²⁰.

Revamped Distribution Sector Scheme, 2021-22 to 2025-26

13.33 In the wake of the COVID-19 pandemic, the Union Government launched Revamped Distribution Sector Scheme (RDSS), a large-scale scheme with a proposed outlay of ₹3.03 lakh crore, and an estimated gross budgetary support from the Union Government of ₹97,631 crore

¹⁷ Ministry of Power at https://www.ipds.gov.in/Form_IPDS/About_IPDS.aspx (accessed June 14, 2025).

¹⁸ As per reply of Ministry of Power to Lok Sabha starred question no. 329 on 23.03.2023

¹⁹ NITI Aayog, "Diagnostic study of the power distribution sector," April 2019, p. 97.

²⁰ For more details on the UDAY scheme, see the Ministry of Power office memorandum of November 20, 2015, at https://powermin.gov.in/pdf/Uday_Ujjawal_Scheme_for_Operational_and_financial_Turnaround_of_power_distribution_companies.pdf (accessed June 14, 2025).

for the duration of five years from 2021-22 to 2025-26. Among the scheme's objectives are a systematic reduction in AT&C losses to pan-India levels of 12 per cent to 15 per cent, and elimination of the ACS-ARR gap by 2024-25. The scheme subsumes DDUGJY, IPDS, and the 2015 Prime Minister's Development Package for the erstwhile State of Jammu and Kashmir.

13.34 RDSS provides financial support for the installation of prepaid smart metering and system metering, upgradation of the distribution infrastructure, training and capacity building, as well as other enabling and support activities. As of December 2024, the AT&C losses at the national level have reduced from 22.32 per cent in 2020-21 to 16.28 per cent in 2023-24, while ACS-ARR gap decreased from ₹0.71/kWh to ₹0.19/kWh during the same period²¹.

Financial Assistance and Reforms Outside the Targeted Schemes

13.35 In addition to the intermittent one-time support measures described above, the Union and State Governments have provided State DISCOMs with recurring revenue and capital support through subsidies, equity infusions, and grants for electrification and network strengthening schemes, such as the DDUGJY and SAUBHAGYA. To further incentivise reforms in electricity distribution, the Union Government has relaxed the State Governments' borrowing limit from 3 per cent of gross state domestic product (GSDP) to 3.5 per cent, provided that the States implement a set of specified power sector reforms.

13.36 The Union Government has also provided assistance to DISCOMs through policy nudges, including a push for the issuance of timely tariff orders, the implementation of automatic passthrough of fuel costs in some States, and smoothening DISCOMs' payables to GENCOs. As per the data provided by Ministry of Power to this Commission in August 2024, tariff orders for 2024-25 were issued for twenty-one States²². The Electricity (Late Payment Surcharge and Related Matters) Rules 2022 were introduced to tackle cash flow challenges faced by GENCOs and TRANSCO, and to provide timely payments across the power sector. These rules have been successful in reducing the total unpaid bills by DISCOMs from ₹1.4 lakh crore in June 2022 to ₹24,684 crore in December 2024²³. These rules have been amended in 2024 to further streamline financial efficiency.

The Past Finance Commissions' Views and the Current Scenario

13.37 Previous FCs have pointed to various State Government subventions in the power sector as an important source of drain on the State finances. They have consistently called for reforms that would eliminate the need for such subventions. For example, the FC-13 noted that the lack of periodic tariff revisions, and ineffective implementation of the Electricity Act, 2003 were key reasons for the poor financial health of power sector utilities. FC-13 recommended a reduction in transmission and distribution losses through metering, feeder separation, strict anti-theft measures, prioritisation of unbundling, and strengthening of regulatory institutions to improve the efficiency of the power sector.

²¹ As per reply of Ministry of Power to Rajya Sabha Unstarred question no. 1270 on 10.03.2025

²² Except Arunachal Pradesh, Jharkhand, Kerala, Nagaland, Telangana, Tripura, Uttar Pradesh.

²³ As per reply of Ministry of Power to Lok Sabha Unstarred question no. 2906 on 12.12.2024

13.38 By the time the FC-14 was appointed, the losses and debt of State DISCOMs had reached unsustainable levels. Unsurprisingly, expressing serious concern about the state of affairs, FC-14 attributed the sector's fragile health to a lack of or infrequent revisions of tariffs, inefficiencies in power supply, as demonstrated by increasing financial gaps, and an absence of autonomy in SERCs. Among the solutions, it recommended implementing 100 per cent metering in a time-bound manner and amending the Electricity Act, 2003 to make it more stringent and effective.

13.39 Most recently, the FC-15 took note of the continuing systemic issues in the power sector and called for robust sector-wide reforms. FC-15 suggested that the Ministry of Power develop a monitorable performance index based on State-specific targets. It went on to recommend that the ministry offer financial incentives to top-performing States as measured by this index.

13.40 This Commission held consultations with the Ministry of Power, the Ministry of New and Renewable Energy, and the States' Accountants General. During discussions with them, we learned that the issues raised by the past FCs remain very much alive. While some progress has been made, issues of infrequent revisions or outright non-revisions of tariffs, as well as technical and economic inefficiencies at all levels, continue to persist.

Impact on State Finances

13.41 The modernisation of the power sector, of which distribution is an integral and critical part, is an important step towards the transformation of India into a developed country. The immediate concern arises from the adverse impact on the State finances stemming from repeated bailouts and regular infusions of fiscal resources into public-sector DISCOMs. It is no surprise that, as briefly discussed, past FCs consistently called for reforms in this area.

13.42 Under UDAY, all participating States were to issue bonds worth ₹2.69 lakh crore, which accounted for 75 per cent of the DISCOM losses. During 2015-17, the bonds worth ₹2.32 lakh crore were issued, which became part of the States' outstanding liabilities. Power subsidies booked by DISCOMs amounted to ₹2.62 lakh crore for 2023-24 as compared to ₹1.29 lakh crore for 2018-19. *Table 13.1* provides a calculation of power subsidies for each of the twenty-eight States for years 2018-19 to 2023-24.

13.43 In addition to tariff subsidies, some State Governments also disburse grants for the takeover of losses, which amounted to ₹43,600 crore for the 2022-23 fiscal year²⁴. Pressed by revenue shortage, States were often delaying the payment of governmental dues (subsidy plus charges payable for electricity consumption by government departments), which becomes a revenue-side problem for DISCOMs. However, the extent of this problem has reduced since introduction of RDSS. According to the information provided by Ministry of Power, the legacy dues of government departments to DISCOMs reduced from ₹50,286 crores in 2020-21 to ₹12,036 crores in 2022-23 and the gap between subsidy billed versus received has become

²⁴ 12th Integrated Rating and Ranking: Power Distribution Utilities (PFC, March 2024)

negligible. At the national level, State Governments collectively disbursed 97.4 per cent of the total booked subsidies for the year 2023-24²⁵.

Table 13.1 Power Subsidy by States (₹ crore)

State	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Uttar Pradesh	16,630	19,351	10,417	22,439	26,335	33,384
Tamil Nadu	12,123	13,793	21,373	20,625	26,122	32,098
Rajasthan	21,204	22,734	14,264	22,644	24,515	27,038
Madhya Pradesh	9,813	13,968	14,914	23,413	27,136	26,842
Karnataka	10,063	12,265	14,282	17,450	14,097	23,933
Punjab	8,886	9,394	10,236	13,443	20,200	18,177
Telangana	4,978	5,224	9,965	11,141	17,912	16,016
Andhra Pradesh	2,161	7,363	6,601	11,353	18,660	15,133
Bihar	6,914	5,953	7,523	8,950	12,716	13,952
Maharashtra	10,520	11,127	9,636	12,028	13,484	13,090
Gujarat	7,628	8,310	9,159	10,380	12,058	10,395
Jharkhand	2,490	2,845	1,872	3,658	3,240	8,996
Haryana	7,371	6,983	5,579	6,750	6,768	7,145
Chhattisgarh	2,079	4,691	4,394	3,800	5,362	6,694
West Bengal	1,944	1,019	1,375	1,550	1,965	2,989
Arunachal Pradesh	653	646	801	957	842	1,209
Himachal Pradesh	579	406	526	1,646	1,100	1,148
Goa	-	260	-	36	-	959
Kerala	38	38	934	381	383	842
Assam	1,641	1,404	1,350	1,301	1,151	732
Nagaland	337	421	443	420	472	486
Manipur	536	403	401	424	311	423
Meghalaya	163	20	115	680	284	274
Mizoram	313	365	408	299	204	198
Tripura	27	94	80	79	124	99
Odisha	233	18	6	5	5	23
Uttarakhand	-	-	11	-	1	-
Sikkim	-	26	-	-	-	-
Total	1,29,322	1,49,120	1,46,664	1,95,853	2,35,447	2,62,276

Source: Finance Accounts of Respective States.

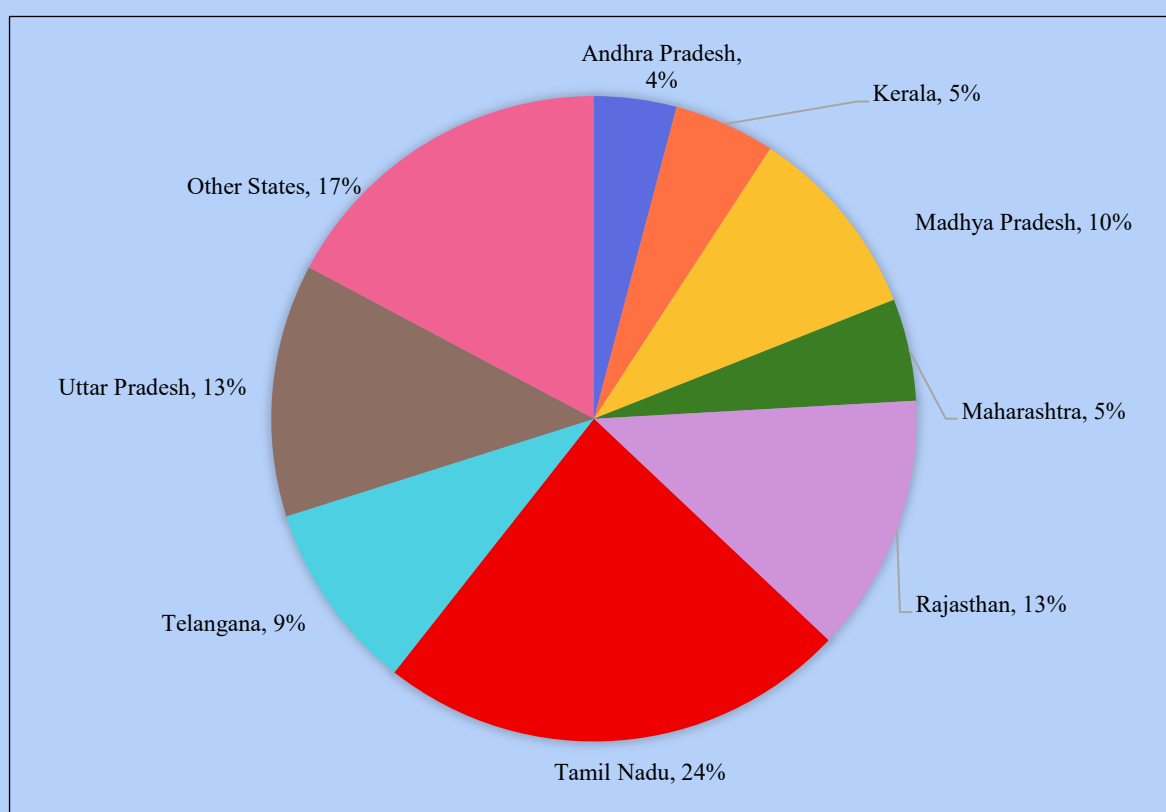
Note: In addition to explicit subsidies provided, the figure includes the grant/assistance by the State to SEB/State DISCOMs.

²⁵ 13th Annual Integrated Rating and Ranking: Power Distribution utilities (February 2025)

DISCOM Losses and Borrowings

13.44 Mounting debt, short-term borrowing, and accumulated losses have been a perpetual burden on DISCOM finances. Because the losses are disproportionately concentrated in eight States, the burden on those States is even more acute. These eight States accounted for 83 per cent of the total accumulated losses of state sector DISCOMs, amounting to ₹5.86 lakh crore of the total ₹7.08 lakh crore in 2023-24. *Figure 13.1* provides a graphical representation of the shares of the eight States with their names.

Figure 13.1 State-wise Accumulated DISCOM Losses
(percentage of Aggregate Losses of All State-owned DISCOMs, 2023-24)



Source: PFC Report on Performance of Power Utilities 2023-24 (Updated May 2025)

13.45 Seven²⁶ out of the eight States shown in *Figure 13.1*, which account for 83 per cent of the State DISCOM losses, also account for 78 per cent of the total debt by State DISCOMs in 2023-24. The seven States and their corresponding debt, as well as the annual growth in debt are shown in *Table 13.2*. As can be seen, this debt has been on a growing trajectory, increasing from ₹4.71 lakh crore to ₹7.42 lakh crore between March 2019 and March 2024.

²⁶ Andhra Pradesh, Madhya Pradesh, Maharashtra, Rajasthan, Tamil Nadu, Telangana, and Uttar Pradesh.

Table 13.2 DISCOM Debt (Top Seven States) and their Annual Growth
(as on 31 March of Each Year, ₹ crore)

Year	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Total Debt of DISCOMs	4,71,461	4,79,766	5,55,686	5,92,727	6,61,263	7,42,460
Growth (%)	6%	2%	16%	7%	11%	12%
Tamil Nadu	1,13,438	1,24,413	1,37,632	1,47,716	1,59,431	1,73,521
	12%	10%	11%	7%	8%	9%
Rajasthan	54,538	48,934	53,030	65,945	79,611	92,225
	-14%	-10%	8%	24%	21%	16%
Maharashtra	35,197	38,092	38,254	44,075	58,325	84,171
	20%	8%	0%	15%	32%	44%
Uttar Pradesh	59,212	58,326	81,952	82,047	78,307	67,936
	2%	-1%	41%	0%	-5%	-13%
Andhra Pradesh	18,023	24,463	31,375	36,364	51,464	65,710
	17%	36%	28%	16%	42%	28%
Madhya Pradesh	46,052	49,112	50,702	52,473	49,145	50,843
	22%	7%	3%	3%	-6%	3%
Telangana	17,934	22,202	31,032	30,138	35,239	46,127
	25%	24%	40%	-3%	17%	31%

Source: PFC Report on Performance of Power Utilities 2023-24 (Updated May 2025)

13.46 A rise in debt, accompanied by a commensurate rise in revenues or assets, makes the possibility of self-liquidation of debt likely. For eight States²⁷, the growth in debt between 2018-19 and 2023-24 has outpaced their growth in revenues and assets, making the self-liquidation of debt unlikely. These States account for 36 per cent of the total outstanding debt in the sector in 2023-24.

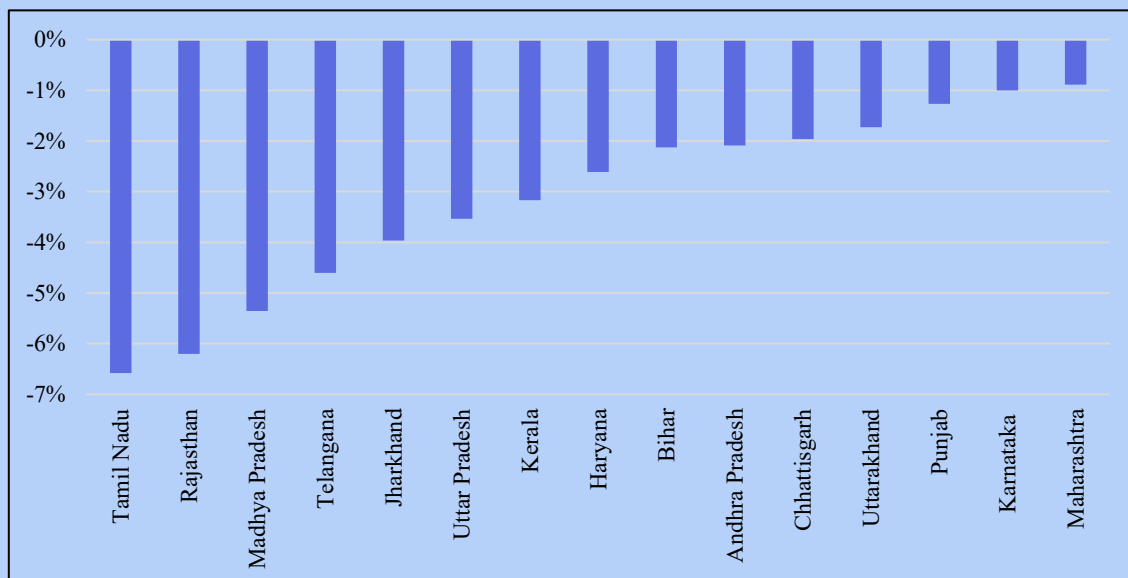
13.47 Figure 13.2 shows the accumulated losses as per cent of their GSDP for top fifteen States in terms of these losses in 2023-24. These States combined account for 99 per cent of accumulated losses of DISCOMs in the country. The aggregate accumulated losses of State-owned DISCOMs which stood at 1.5 times of the aggregate revenue-deficit of States in 2021-22 increased to 6.8 times in 2023-24. In States like Tamil Nadu and Rajasthan, the accumulated losses of DISCOMs account for more than 6 per cent of their GSDP, which is the highest among all States.

13.48 The measurement of DISCOM losses involves comparing the cost of supplying electricity per kWh to customers with the revenue realised per kWh sold. The former is referred to as the ACS, and the latter is the ARR. ACS-ARR gap represents the loss per kWh of electricity

²⁷ Andhra Pradesh, Bihar, Jharkhand, Karnataka, Maharashtra, Manipur, Meghalaya, and Telangana.

sold. Multiplying ACS, ARR, and ACS-ARR by the total kWh of electricity sold yields the total cost, total revenue, and total loss of the DISCOM.

Figure 13.2 Accumulated Losses for States in 2023-24 (percentage of GSDP)



Source: PFC Report on Performance of Power Utilities 2023-24 (Updated May 2025)

13.49 The principal source of DISCOM revenues is from operations, including subsidy from the State. The State Governments subsidises certain consumers, including farmers and low-income households. DISCOMs do not collect revenues from these consumers to the extent of the subsidy. It receives this part of the revenue from the State Government in the form of a subsidy. With the extent of consumer subsidisation varying greatly across States, the shares of revenues from operations and the subsidy in DISCOM revenues also vary significantly.

13.50 In 2023-24, nationally, revenues per kWh from operations and the subsidy accounted for 71.0 per cent and 20.7 per cent of the ARR, respectively²⁸. Ten States²⁹ exhibited a higher-than-average share of the subsidy in their ARR. DISCOMS in some major States such as Bihar, Karnataka, Madhya Pradesh, and Punjab, are heavily reliant on subsidy income, accounting for 40 per cent, 35 per cent, 47 per cent and 41 per cent of their ARR, respectively. Five States³⁰ report more than 15 per cent of ARR from ‘other revenues’, which is much higher than the national average of 8.3 per cent.

13.51 While ACS-ARR is a measure of a DISCOM’s economic loss per kWh of electricity sold, the AT&C loss represents loss due to operational inefficiency, measured in physical units of electricity. It measures the percentage of electricity purchased by the DISCOM for which it fails to collect any revenues. It is a physical measure of the effective loss of electricity in transit,

²⁸ Power Finance Corporation Report on Performance of Power Utilities 2023-24, May 2025.

²⁹ Andhra Pradesh, Bihar, Chhattisgarh, Jharkhand, Karnataka, Madhya Pradesh, Manipur, Nagaland, Punjab and Rajasthan.

³⁰ Arunachal Pradesh, Jharkhand, Meghalaya, Tamil Nadu and Telangana

where the loss may occur on the wire as electricity travels on the sub-transmission and distribution lines, or due to theft through unauthorised connections, bypassing meters, meter tampering or falsifying meter readings through underbilling, and on account of under-collection on what is billed.

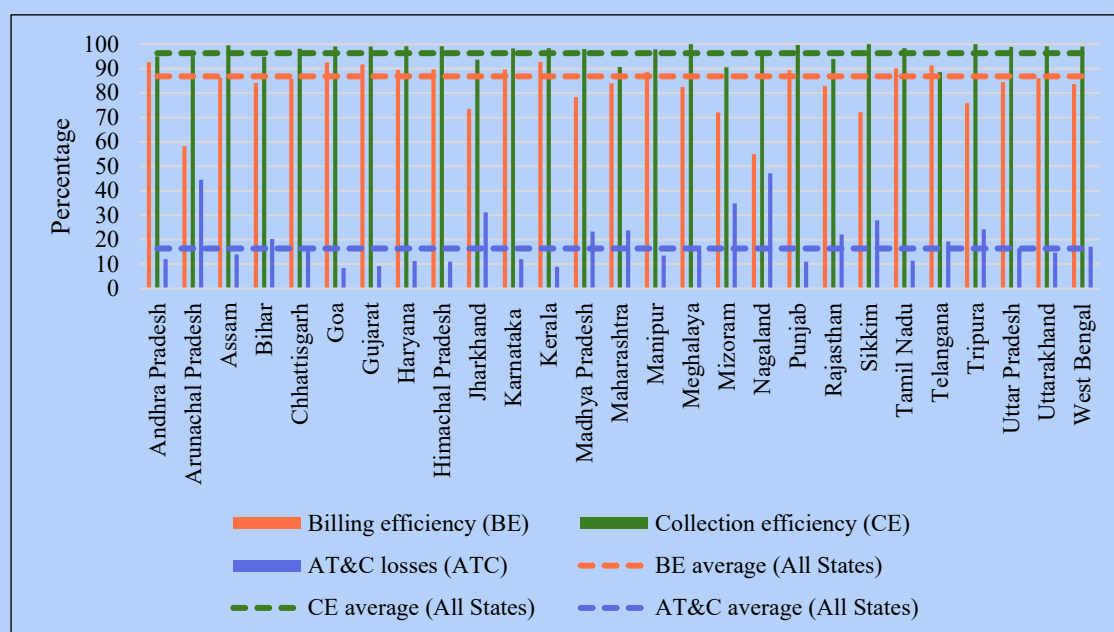
The following equation measures this loss:

$$\text{AT\&C Loss (as \% of energy purchased)} = \left[1 - \frac{\text{Billed energy}}{\text{Total energy purchased}} \times \frac{\text{Revenue collected}}{\text{Revenue billed}} \right] \times 100$$

13.52 The first fraction inside the brackets in this equation may be interpreted as billing efficiency, and the second as collection efficiency. The larger the former, the greater the billing efficiency and the smaller the loss due to inefficient transmission and distribution lines and theft. The larger the latter, the greater the efficiency of bill collection. Data are available to measure both the billing and collection efficiencies.

13.53 The AT&C loss does not measure the economic loss (which is measured by ACS-ARR gap), but it has an important bearing on it. Economic loss depends not just on the proportion of electricity purchased for which no revenue is collected, but also on the purchase and sale price of electricity. The higher the purchase price, the lower the sale price, and the higher AT&C loss, the higher is the economic loss. The sale price is nothing but the electricity tariff set by the regulatory authority. Therefore, whether or not the regulatory authority sets tariffs at cost-reflective levels is crucial to the profitability of DISCOMs.

Figure 13.3 State-wise Comparison of Billing and Collection Efficiencies, and AT&C Losses with All-State Average, 2023-24



Source: PFC Report on Performance of Power Utilities 2023-24 (Updated May 2025)

13.54 The bars in *Figure 13.3* show the average billing and collection efficiencies and AT&C losses of DISCOMs in the twenty-eight States. Additionally, the dotted lines of matching colour indicate the average billing and collection efficiencies, as well as AT&C losses, across the twenty-eight States. Predictably, States with high billing and collection efficiencies have low AT&C losses. Non-NEH States in which AT&C losses continue to be higher than the all-State average of 16.37 per cent include Bihar, Jharkhand, Madhya Pradesh, Maharashtra, Rajasthan, Telangana, Uttar Pradesh and West Bengal.

The Conundrum of Sustained Reforms, Repeated Loss, Debt and Bailout Cycles

13.55 In this chapter, we have deliberately provided a detailed history of reforms and outcomes in the distribution sector. This is to underscore the fact that, despite concerted efforts to address operational and economic efficiency issues, the problem of accumulating DISCOM losses and debt has persisted. Three explicit bailouts were given over a period of two decades, weakening the finances of the affected States each time. Yet DISCOMs have the largest ever quantum of debt today. It must be asked as to whether there is something inherent in the current governance structure that leads to this outcome. A plausible hypothesis is that, without a major policy shift to realign the incentives of key actors involved, it will be difficult to avoid cycles of loss accumulation, high DISCOM debts, and bailouts.

13.56 There are three main actors whose actions determine the profit-loss calculus of DISCOMs: DISCOMs themselves, the SERC, and the State Government. We consider the incentives of each actor below.

13.57 As State-owned entities, DISCOMs are not subject to the same commercial pressures as private entities. On their own, they are less likely to invest in closing the avenues to electricity theft, billing dues, and collecting dues. Governments have made repeated efforts to address each of these problems. Nevertheless, comparisons carried out by the Power Finance Corporation (PFC) show that, while the average AT&C losses for private DISCOMs in the country is 12.12 per cent in 2023-24, this loss is 16.37 per cent for State-owned DISCOMs. To be sure, some State-owned DISCOMs, such as those in Gujarat and Haryana, have been performing well. But a large majority of them perform significantly worse. In its twelfth rankings of distribution utilities for the year 2022-23, PFC rated fifty-five DISCOMs altogether, of which thirteen were private and forty-two State-owned. All DISCOMs rated twenty-seventh and below were found to be State-owned, while six of the top ten were privately owned. In the latest thirteenth rankings, fifty-two DISCOMs were rated, of which ten were private and forty-two were State-owned. Once again, all those ranked thirtieth and below were State-owned, while five of the top ten were private.

13.58 There are many instances where State regulators have not fixed tariff at cost-recovery levels guided by factors other than purely regulatory principles. Because State Governments subsidise farmers and low-income households, they have a vested interest in keeping electricity tariffs low to keep their subsidy bill low. Low tariffs undermine the profitability of DISCOMs. However, if these DISCOMs are State-owned, they have no strong reason to oppose such tariffs. On the other hand, if DISCOMs are private, they are more likely to not only vocally oppose low tariffs but also challenge them in the Appellate Tribunals and courts.

13.59 Finally, incentives for State Governments, especially those with a short-term horizon, also favour letting the losses accumulate on the books of DISCOMs. Populism pushes governments toward expanding subsidies to electricity users. But the scarcity of fiscal resources constrains them. As just noted, one way to circumvent this is to pressure the SERC into keeping tariffs low. However, there are two additional avenues to controlling budgetary expenditures by the States. First, the States can delay paying the subsidy that is due and allow DISCOMs to finance it by borrowing. Second, the government can also delay paying its electricity bills. In the past, it was a common practice for governments to delay paying electricity dues and to reimburse subsidies to DISCOMs.

13.60 It is essential to note that, although this scenario is plausible, it is not inevitable. A State Government, that believes in financial discipline and has a long-term perspective, would recognise that keeping tariffs low, avoiding subsidy payments, and delaying electricity bill payments might offer greater budgetary flexibility in the short term, but would lead to higher costs in the long term. For in the long run, State Governments will have to assume the DISCOM's debt, which will add to their budgetary interest payments for many years to come. The Gujarat and Haryana Governments, all of whose DISCOMs were ranked among the top dozen in the PFC rankings of 2022-23 and 2023-24, clearly appreciate the logic behind this argument.

Way Forward and Recommendations

13.61 Our discussion in the previous section leads us to conclude that while efforts to improve operational efficiency of DISCOMs through various IT-driven instruments, as well as to cut their economic losses by promoting greater independence of SERCs and ensuring timely payments of subsidies and government bills must continue, the time is ripe for proactively promoting the privatisation of DISCOMs. In the early 2000s, there was significant momentum for privatisation, but it was lost over the following two decades. It is now time to revive that momentum.

13.62 We find that one of the major roadblocks in privatisation efforts is the high level of debt on the books of DISCOMS, especially where it has been incurred not to create physical assets but to maintain liquidity for operations. To create incentives for privatisation, a mechanism needs to be devised for shielding the private investor from the accumulated debt burden, after DISCOM takeover. For this purpose, States may create a special purpose vehicle (SPV) which will function as a warehouse for the accumulated working capital and other loans not backed by any asset. This transfer will make the DISCOMs a better investment opportunity. The debt of the SPV can be negotiated for closure/prepayment by the State Governments or will eventually have to be serviced by the States.

13.63 While the outgo that the State Governments will have to bear towards closure or repayment of this loan will not be leading to creation of physical assets, it will have extremely positive effect on the fiscal health of the States in the long run. Therefore, to incentivise States towards privatisation, we recommend that the prepayment or eventual repayment of this debt could be treated eligible for assistance under the special incentive scheme for capital investment (SASCI) of the Union Government. This assistance could be made available to the State as and when the repayment of the debt comes up but only after the DISCOM has been privatised by the State.

13.64 Privatisation of DISCOMs will serve not only the short-term goal of resolving the problem of losses-debt-bailout cycle but also help modernise the distribution sector. It will help promote greater competition and efficiency, while also paving the way for SERCs to act effectively. It will also facilitate other reforms, such as putting an end to cross-subsidies and promoting open access. If the Union Government also decides to implement the reform of separating the wire from electricity supply along with DISCOM privatisation, the introduction of multiple suppliers to encourage competition, as was the pathway adopted in the telecommunications industry, will be less contentious.

13.65 While privatization of DISCOMs provides a more definitive and sustainable solution to the repeated cycles of debt and bailout, if a solution is sought within the public ownership framework, the States of Gujarat (*Case Study 1*) and Haryana (*Case Study 2*) provide two examples that are worth emulating. All four of Gujarat's State-owned DISCOMs have consistently featured among the top 10 utilities (State and Private distribution utilities included). In the case of Haryana, both of its DISCOMs emerged from a heavy debt following the successful implementation of UDAY. They have consistently shown financial profits since 2017-18 and ranked 6th and 11th with A+ grade in the latest, 2023-24, PFC ranking.

Case Study 1 - Efficient Management of State-owned DISCOMs in Gujarat

During the analysis of State-owned power distribution sector in the country, it is noticed that Gujarat's State-owned DISCOMs have consistently ranked among the top rated DISCOMs in the country, with all four of them featuring among the top 10 utilities (State and Private distribution utilities included) successively in the 10th, 11th, 12th and 13th Annual Integrated Rating and Ranking reports of PFC.

Gujarat's power sector has achieved this through technological integration, regulatory reforms, and consumer-centric initiatives and established a benchmark in advancing sustainable, consumer-focused power distribution. This feature presents the main drivers that enabled this transformation which other States can emulate, to effectively address the problem plaguing the sector.

Policy Reforms:

Gujarat Urja Vikas Nigam Limited (GUVNL), plays a pivotal coordinating role in tariff filings and power procurement, supported by the Gujarat Electricity Regulatory Commission (GERC) through a transparent and prudent tariff determination process.

GUVNL manages power procurement for all four DISCOMs in the State through a single buyer model, which helped achieve economies of scale and reduce power procurement cost. This centralised model enables better planning, procurement, and dispatch of power across the State. It ensures timely filing of tariff petitions by Generation, Transmission, and Distribution companies by 30th November each year, facilitating a uniform and aligned approach. This coordination helps ensure full cost recovery for generation, transmission, and distribution utilities, safeguarding their financial sustainability.

Technological Innovations:

Distribution losses in Gujarat have significantly declined as a result of targeted interventions that harnessed technology for efficiency such as adoption of high voltage distribution systems (HVDS) to reduce technical and commercial losses, underground cabling for network reliability and safety, GPRS enabled metering and billing to improve accuracy and arresting leakages.

These measures have enabled real-time monitoring, efficient fault detection, and transparency in consumer affairs, thus significantly improving reliability and reducing outage durations.

Operational Transparency:

GERC conducts a well-structured and transparent tariff approval process with public hearings and opportunities for consumer feedback. Tariffs are finalised before the start of the financial year, and all prudent and justified costs are allowed for recovery, ensuring that no regulatory assets or revenue gaps are created.

Tariff structure follows the National Tariff Policy guidelines, ensuring that for all consumers, except agriculture, cross-subsidy is limited to ± 20 per cent of the average cost of supply across consumer categories. This promotes both affordability and equity while maintaining utility viability.

To manage fuel and power cost volatility, GERC has a formula-based mechanism for Fuel and Power Purchase Price Adjustment, first introduced in 2004 and revised in 2013. These adjustments are computed

quarterly based on actual costs and automatically passed through in the following quarter's tariff, as per fuel charge formula, avoiding sudden tariff spikes and reducing interest burden from working capital needs.

Apart from this, the State has implemented the following administrative and regulatory measures which have contributed to its efficient management of the DISCOMs and reduction of losses:

- (i) Strict enforcement against power theft through designated police stations and courts, regular inspection drives and theft assessments
- (ii) State Government releases subsidies in advance, based on prevalent norms, which helps ensure healthy cash flow for DISCOMs. As a result, Gujarat's State-DISCOMs have an interest cost of 0.97 per cent of per unit cost of supply (for 2023-24), as against all State sector average of 7.44 per cent.

The combination of reliable supply, transparent billing, and responsive grievance redressal has led to increased consumer trust, improved payment behaviour, and more efficient electricity use. Additionally, a cost-reflective, formula-driven tariff structure, backed by rigorous prudence checks by GERC, has also supported in the long-term financial health and operational viability of Gujarat's power utilities.

Case Study 2 - Efficient Management of State-owned DISCOMs in Haryana

Both the DISCOMs of Haryana have registered financial profits since 2017-18 with improved operational efficiencies and reduction of AT&C losses. This case study provides some of the key factors contributing to reforms in Haryana DISCOMs.

Regulatory Reforms and Compliances:

The DISCOMs comply with the regulatory process by timely filing the ARR and True-up Petitions each year, by 30th November, in accordance with the Multi Year Tariff (MYT) regulations. Subsequently, tariff orders are issued by 31 March annually.

The tariff orders are being issued after considering the true-up of previous year and undertaking necessary tariff rationalisation in rates and terms and conditions of tariff. Additionally, the determination of agriculture pump set subsidy is carried out in the tariff order based on the cost of supply, which is fully reimbursed by the State Government every year.

DISCOMs are levying the Fuel Price and Power Purchase Adjustment Surcharge (FPPAS/ FSA) in a timely manner.

Open Access provisions have also been actively facilitated, allowing eligible consumers to procure electricity from alternate sources, thereby fostering competition and efficiency in the electricity market. Over the years the tariff rationalisation has been undertaken, and the level of cross-subsidy is largely kept within the limits prescribed by the National Tariff Policy, that is within ± 20 per cent of the cost of supply.

Debt Restructuring and Low-Cost Debt:

From 2020-21 onwards, the annual reduction in interest burden for Haryana DISCOMs is ₹2,113 crore and the corresponding gain on account of efficiency improvement that is due to reduction in AT&C losses, is approximately ₹3,000 crore per annum, indicating massive savings due to the successful implementation of

UDAY. Haryana DISCOMs on average resorted to capital borrowings of nearly ₹1000 crore every year from commercial banks resulted in significant savings.

Measures Taken for Improving Operational Efficiency:

- (i) Theft detection: The anti-theft provisions of Electricity Act, 2003 were effectively implemented with revision of SOP for theft detection and strengthening of dedicated police stations for theft detection. During last 10 years from 2015-16 to 2024-25, theft cases numbering 6,54,961 were registered involving penalty of ₹2,229.42 crore.
- (ii) 24x7 supply in rural domestic sector: For reducing losses in rural domestic sector relocation of meters on poles, replacement of bare conductor with armoured cable, replacement of defective and electromechanical meter with electronic meter was undertaken with the community participation of villagers.
- (iii) Energy consumption agriculture pump set subsidy: Various measures were taken for containing the agriculture subsidy. Mandating star rating of motors, drip irrigation and mandating solar agriculture pump set pump up to 10 Brake Horsepower. Importantly under PM KUSUM scheme more than 1.5 lakh solar pumps have been installed in off grid mode.
- (iv) Effective metering, billing and collection system: The centralised billing system was rolled out in all the areas, which eliminated any billing errors in local billing system as was prevailing earlier. Automatic reading for high value consumers got implemented along with data analytics.
- (v) Augmentation of distribution infrastructure to meet the increasing demand and for reduction of technical losses.
- (vi) Implementation of right to service and auto appeal system: implemented for ensuring delivery of services within prescribed timelines, wherein auto escalation to first and second Grievance authorities are undertaken.
- (vii) Call centre know-your-customer (KYC): The centralised call centre with toll-free number 1912 was implemented by Haryana DISCOMs and for efficient operations, KYC of consumers was updated and also linked with State Government Database of Parivar Pehchan Patra.
- (viii) Corporate governance: Various initiatives were taken for improving productivity like incentive and reward schemes for providing information leading to detection of theft of electricity, and for the good work of employees in improving DISCOM's functioning. A new concept of 'Area of Responsibility' was introduced. As part of this initiative, each official was made in charge of a small manageable area and made responsible for the collection of KYC data, recovery of arrears, replacement of meters and detection of possible causes of loss of revenue.



14.1 There are two reasons why successive Finance Commissions have drawn attention to government subsidies, inclusive of cash and in-kind transfers. First, their unbridled expansion, with no offsetting cuts in other expenditures, can lead to large fiscal deficits, high public debt, and ultimately fiscal instability. Second, if driven by populism, they may crowd out other high-priority expenditures, such as those on education, health, infrastructure, law and order, and defence.

14.2 The vibrant ‘freebies’ debate, triggered by the recent proliferation of subsidies alongside tight fiscal constraints, has added an additional element of urgency to these concerns. However attractive these subsidies may seem from the immediate perspective, by creating permanent entitlements, they can have a serious impact on the governments’ long-term fiscal health. The importance of exercising discretion when considering the expansion of subsidies cannot be overstated. In fact, it is essential to pay attention not only to aligning the magnitude of expenditures to potential revenues, but also to focus on their quality. Undue expansion of subsidies can crowd out capital expenditures that are critical to long-term growth.

The Challenge of Defining Subsidies

14.3 A major challenge confronting any empirically grounded analysis of subsidies, such as the present one, is defining the concept of a subsidy itself. The government finances the bulk of its expenditure from tax revenues, and those expenditures benefit one or the other section of the citizenry, often without paying for the service received or with under recovery of cost incurred. What part of this expenditure should be included in estimating subsidies, and what part should be left out? This is a difficult question, as the discussion below explains.

14.4 There is general agreement that financing pure public goods, such as defence and internal law and order, and providing them at no charge to citizens, does not constitute a subsidy¹. As long as the benefit from public goods to the citizenry exceeds the cost of their provision, they are worth providing. Once provided, no citizen can be excluded from reaping the benefits of these goods regardless of their ability to pay. Therefore, left to the market, pure public goods will not be supplied even when they benefit all citizens. Financing them with public funds is the only practical option.

14.5 Once we get past defence and internal law and order, examples of pure public goods are rare. For example, items such as education and health, on which the Union and States spend large sums, do not fulfil the condition of non-exclusion. Because they can exclude non-paying customers from accessing education and healthcare services, private providers can profitably supply them. For this reason, some economists have identified the under-recovery of the cost of supply of these services by the government as a subsidy².

14.6 However, this is not an uncontested view. An alternative view is that, insofar as primary education and primary healthcare services are concerned, universal access to them is a desirable social goal. To the extent that a literate and healthy population benefits the entire society, primary education and primary healthcare are 'merit' goods. Therefore, the society as a whole must undertake to provide them free of charge to all regardless of their ability or willingness to pay. In this view, under-recovery of the cost of providing primary education and primary healthcare is not a subsidy. We broadly accept this view in estimating subsidies in this report.

14.7 Beyond primary education and primary healthcare, the terrain gets more slippery. For example, consider the financing of highways from taxpayer money. To the extent that the social benefits from them exceed their costs, building them is desirable. But should they be financed wholly from taxpayer money? In the past, the generally accepted answer was in the affirmative. However, today, this answer is no longer accepted, and highway tolls and asset monetisation are seen as legitimate means of cost recovery from highway users. By implication, is any under-recovery of the cost of building and maintaining highways not a subsidy? The same questions may also be asked for the under-recovery of costs of airports and railways. The answer is not clear-cut, however, as highways, airports and railways create 'externalities', that is, benefits that go beyond their actual users, through increased economic productivity. In the case of under-recovery of low-fare railway passenger travel, the merit-goods argument may also apply.

¹ The academic literature distinguishes public goods from private ones based on two properties: non-exclusion and non-rivalry in consumption. Non-exclusion means that once a public good is available, no citizen can be excluded from benefiting from it. Non-rivalry means that the consumption of a public good by one citizen does not diminish its availability to another citizen. A pure public good, such as defence, satisfies both these properties, while a pure private good, such as ice cream, lacks them. An ice cream seller can deny his product to a customer unwilling to pay for it (exclusion), and once consumed by a customer, the same ice cream is no longer available for consumption by another (rivalry in consumption).

² For example, Mundle and Rao take the latter view. Thus, see Mundle, Sudipto, and M. Govinda Rao. 1991. "The Volume and Composition of Government Subsidies in India: 1987-88". *Economic and Political Weekly*, May 4th, 1992.

14.8 This discussion highlights the challenges in defining and measuring subsidies. The challenges magnify as we transition from conceptual analysis to data. Keeping this in mind, we outline our approach in the context of the available data. We first consider the subsidies provided by the twenty-one larger States and then the Union.

Approach to Measuring State Subsidies

14.9 We adopt a conservative approach to identifying subsidies by focusing only on payments that the State Governments make autonomously through their discretionary schemes, as outlined in the detailed demand for grants. This approach automatically excludes expenditures incurred for the provision of public goods or community-level services provided by the government. Four key elements of our approach are worth noting.

14.10 First, in measuring subsidies, we include only the purely discretionary items of expenditure. For example, when considering subsidies provided by States, we exclude their share in centrally sponsored schemes (CSS) since this expenditure is a means to access central resources. However, we include in our measure any top-ups by States to the CSS, as they are discretionary and like a parallel State scheme.

14.11 Second, schemes included in our subsidy measure are those whose benefits flow to identifiable individual beneficiaries in cash or kind. Schemes that provide community-level benefits or services or create a community asset are excluded. While a subsidy on agricultural equipment, provided to a farmer, is included, expenditure on a scheme aimed at watershed development is excluded. The latter is akin to a development scheme, potentially characterised by externalities or public goods characteristics. We also exclude from our subsidy measure any expenditure incurred as a part of relief and reconstruction following disasters such as earthquakes and floods.

14.12 Third, we include only revenue expenditure in our subsidy measure, thereby excluding all capital outlays, loans, or advances. This means that expenditures on asset creation, such as those on infrastructure, are excluded. A grey area item is the government support to public sector enterprises through equity that is not expected to result in any realisable return. Such capital infusion is in the nature of a grant; however, we exclude it to limit our measure of subsidy to revenue expenditures.

14.13 Finally, in measuring subsidies, we include schemes that provide subsidies on goods and services as well as income support to individual beneficiaries. These subsidies are the converse of indirect and direct taxes. Indirect subsidies distort product markets, while direct subsidies distort labour-leisure choices. With the emergence of Direct Benefit Transfers (DBT) and their superior ability to efficiently target beneficiaries, income support schemes are gaining popularity over product subsidy schemes. These are referred to as transfers. In this chapter, we frequently use the terms ‘subsidies and transfers’ to emphasise the growing importance of transfers within subsidies.

14.14 However, while we discuss transfers as a separate subsidy item where relevant, they are integral to our total subsidy estimates. The transfers can be classified as either conditional or unconditional transfers. The former are subject to performance along specified parameters, while the latter are not. For example, a scholarship scheme linked to attendance and academic performance is classified as a conditional transfer. An income transfer to all farmers, on the other hand, is an unconditional transfer. Note that unconditional transfers have eligibility criteria to identify beneficiaries. In this case, being a farmer is the criterion. However, once eligibility is established, no further conditions apply.

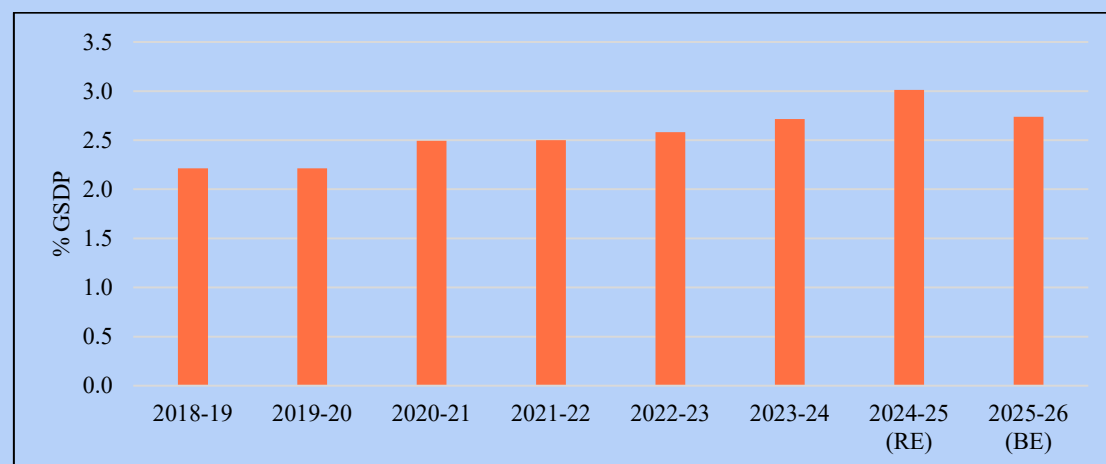
14.15 The available data allow us to classify subsidies at two levels: sectors to which subsidies are applied, and the type of subsidy. The sectors include agriculture, business, social security, education, health, food, housing, transport, power, loan waiver(s) and cash transfers. A subsidy within each sector can be further divided into four types: consumption, production, asset and transfer. For example, a subsidy provided under the National Food Security Act, 2013, is a consumption subsidy in the food sector. A production-linked incentive (PLI) is a production subsidy in the business sector. A subsidy on housing is an asset subsidy in the housing sector. Finally, an old-age pension is a transfer in the social security sector.

14.16 It is important to note that, in presenting the subsidy measures below, we deploy the sectoral classification selectively, focusing only on the major categories. The period of analysis is from 2018-19 to 2025-26, although the data for 2024-25 are revised estimates (RE) and for 2025-26 are budgeted estimates (BE). In our analysis of States, we exclude the seven small northeastern States, namely, Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura. Although we present the estimates for both the Union and States, the focus is primarily on the latter.

Total Subsidies by States

14.17 The total subsidies and transfers by the twenty-one States included in our analysis amounted to ₹3.86 lakh crore in 2018-19. Five years later, in 2023-24, they almost doubled to ₹7.59 lakh crore. The estimate rose further to ₹9.59 lakh crore in 2024-25 RE and ₹9.73 lakh crore in 2025-26 BE. As a percentage of the twenty-one States' combined gross State domestic product (GSDP), the subsidy rose from 2.2 per cent in 2018-19 to 2.7 per cent in 2023-24. The figure rose further to 3.0 per cent in 2024-25 RE before falling back to 2.7 per cent in 2025-26 BE. *Figure 14.1* shows subsidies and transfers as percentage of GSDP. As a percentage of total revenue expenditure (TRE), the subsidies and transfers have grown from 15.6 per cent in 2018-19 to 20.0 per cent in 2023-24, 21.3 per cent in 2024-25 RE and 19.8 per cent in 2025-26 BE.

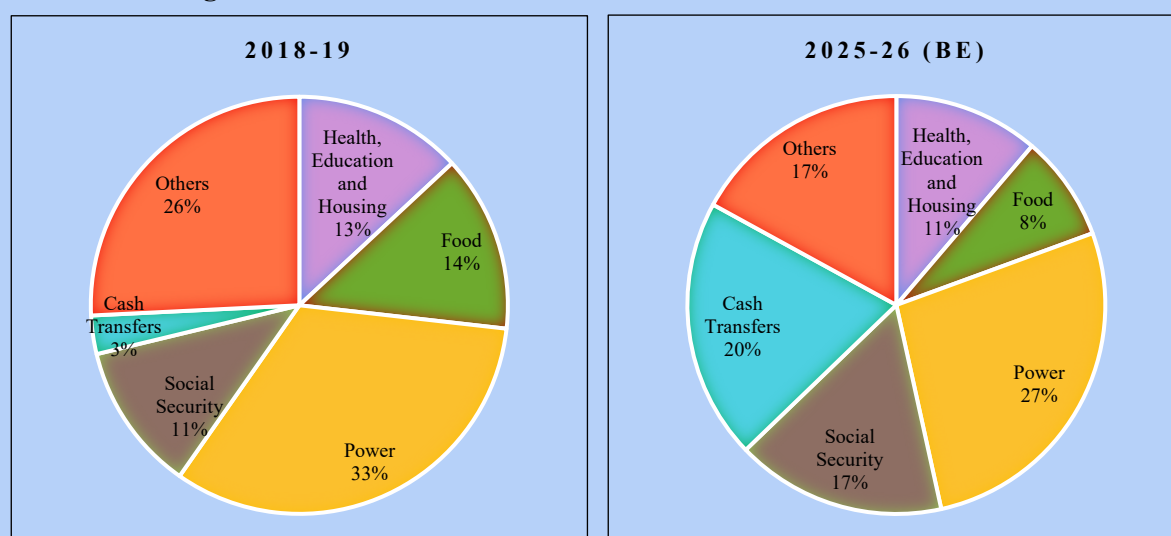
14.18 Subsidy growth in the twenty-one States during these years has primarily been driven by increasing expenditure on large-group, unconditional cash transfers, totalling ₹1.96 lakh crore in 2025-26 BE. These unconditional transfers to a large section of households have emerged as a major pillar of policy in many States. The largest unconditional transfer schemes, as per the 2025-26 BE figures, are the Majhi Ladki Bahin Yojana in Maharashtra, Gruha Lakshmi in Karnataka and Lakshmir Bhandar in West Bengal.

Figure 14.1 Subsidies and Transfers for Twenty-one Larger States (percentage of GSDP)

Source: States' Demand for Grants

State Subsidies: Sectoral Shares

14.19 Figure 14.2 and Figure 14.3 show the sectoral shares of the subsidies and transfers in the States' total expenditures on the revenue account. The former focuses on a comparison of subsidy composition between the beginning and terminal years of the period under consideration, while the latter covers the composition each year, along with the evolution of the level of subsidy in current rupees. The biggest shift in its composition has resulted from the large-group cash transfer schemes of the kind mentioned earlier. They have grown from a mere 3.0 per cent of all revenue subsidies in 2018-19 to 20.2 per cent in 2025-26 BE. The transfers under the category 'social-security' are also income transfers, but they are targeted at narrowly defined groups, such as the elderly, widows and persons with disabilities.

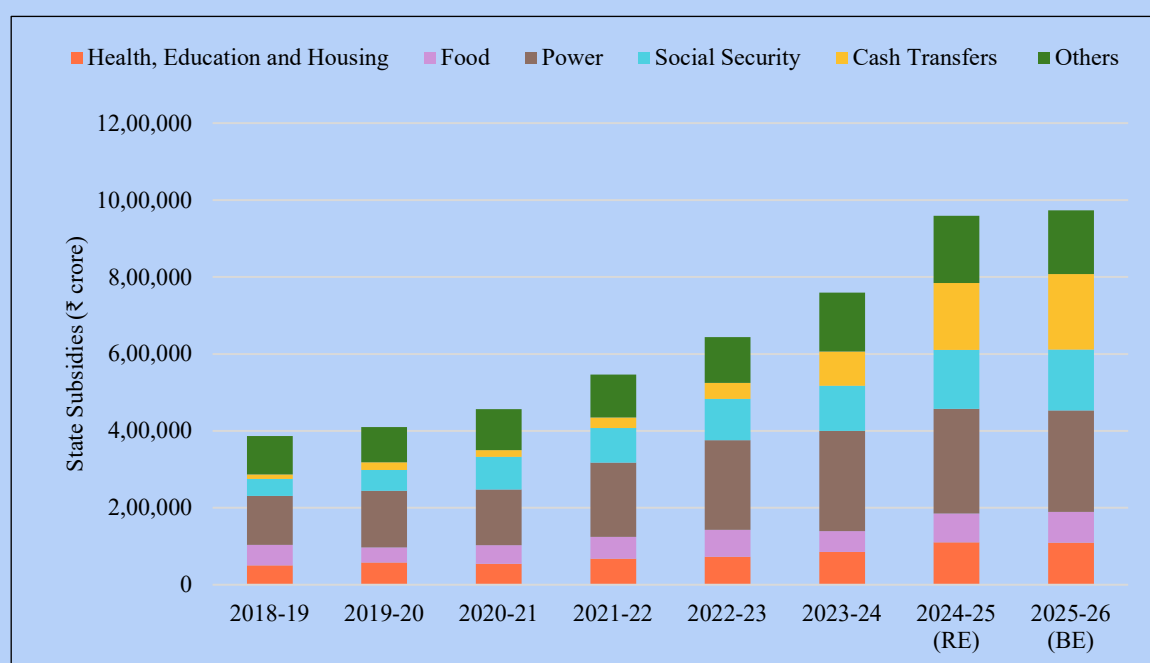
Figure 14.2 Sectoral Shares of the Subsidies and Transfer Schemes

Source: States' Demand for Grants

Power Subsidies

14.20 Power subsidies represent the largest single component of subsidies in the State revenue accounts. Although it shows a decline compositionally from 32.9 per cent in 2018-19 to 27.1 per cent in 2025-26 BE, as *Figure 14.3* shows, power subsidies item has continued to grow in absolute terms throughout the period. The power sector is the biggest beneficiary of subsidies provided by the State Governments. Although they are given to State distribution companies (DISCOMs), the ultimate beneficiaries are specified groups of consumers to whom DISCOMs provide electricity, free of charge or at subsidised tariffs, with a mandate from the State Government. States also extend support to DISCOMs through loans and equity investments, but these are capital account items that are excluded, as we focus only on the revenue-account subsidies.

Figure 14.3 Composition of State Subsidies on the Revenue Account



Source: States' Demand for Grants

14.21 As a percentage of revenue expenditure, actual power subsidies by the twenty-one States under consideration grew from 5.1 per cent in 2018-19 to 6.8 per cent in 2023-24. The total bill for power subsidy in 2023-24 was ₹2.60 lakh crore. Uttar Pradesh had the highest power subsidy expenditure of ₹33,384 crore in 2023-24, followed by Tamil Nadu with ₹32,098 crore and Rajasthan with ₹27,038 crore. Power subsidy saw the fastest annual growth in Andhra Pradesh at 26.4 per cent between 2018-19 and 2025-26 BE, followed by Telangana at 22.0 per cent, Jharkhand at 19.9 per cent and Punjab at 16.2 per cent. In 2023-24, Punjab paid the highest subsidy per capita of ₹5,893, followed by Telangana and Tamil Nadu at ₹4,195 and ₹4,169 respectively. Punjab accounted for the highest power subsidy as a percentage of TRE at 15.5 per cent in 2023-24.

14.22 Magnitude of power subsidies is greatly understated when measured by budget or finance accounts alone. This is because a large part of this subsidy remains off-budget or implicit when provided and transforms into either debt or grant when it eventually finds its way back to the budget. Since State Governments subsidise many power consumers, they have an incentive to keep tariffs low. Additionally, DISCOMs in most States are publicly owned, and do not feel the same commercial pressure as their privately owned counterparts. They incur transmission and commercial losses due to low tariff, poor management of distribution lines, underbilling of electricity sold and under-collection of billed amounts. All these factors contribute to DISCOM losses that are covered through borrowing from banks or other public sector entities under explicit or implicit State Government guarantees and are not reflected in the State budgets. However, as we discuss in the chapter on the power sector reforms, accumulated losses eventually end up on the State Government's books in the form of added debt. This additional debt, in turn, contributes to the State's debt service payments, which are reflected in its revenue budget³.

Large-Group Cash Transfers

14.23 The component that has witnessed the steepest rise in recent years is the large-group cash transfers, with a trend growth⁴ of 53.6 per cent over 2018-19 to 2025-26 BE, reaching ₹1.96 lakh crore in 2025-26 BE. This consists of subsidies that are not directed to a specific economic or social sector. With the ease and efficiency brought in by the JAM (Jan Dhan bank accounts, Aadhar cards, Mobile phones) trinity, an increasing share of revenue expenditure is being devoted to these schemes. In 2023-24, Madhya Pradesh, Karnataka and West Bengal spent the highest percentage of their TRE on general cash transfer schemes, at 7.6 per cent, 7.1 per cent and 6.6 per cent respectively.

14.24 Large part of the increase has happened after 2023-24. For example, comparing the 2025-26 BE with the actuals of 2023-24 reveals that the jump in large-group cash transfers in Jharkhand is from 0.8 per cent of TRE to 13.0 per cent. Other States with sharp increases in shares of large-group cash transfers as a percentage of total revenue expenditure in 2025-26 BE over 2023-24 are Maharashtra (6.2 per cent from 0.6 per cent) and Odisha (5.1 per cent from nil). If major States continue to allocate rising proportions of revenue expenditures to large-group unconditional cash transfers, they will not only impose a significant burden on the States' budgets but also destabilise their finances in the long run.

Social Security Pensions

14.25 A related set of schemes is classified under social security pensions (SSPs). These schemes provide pensions and welfare support to groups such as the elderly, widows, persons

³ See the study by the Asian Development Bank in this context: "A Study of Subsidies and Transfers in India," Submitted to the Sixteenth Finance Commission, Final Report, August 2025.

⁴ Trend growth rate of variable y is calculated by estimating the equation $\ln(y) = b + g.t$, where t represents the year corresponding to the y value, g is the estimated trend growth rate and b is a constant intercept. All growth rates in this chapter are trend growth rates.

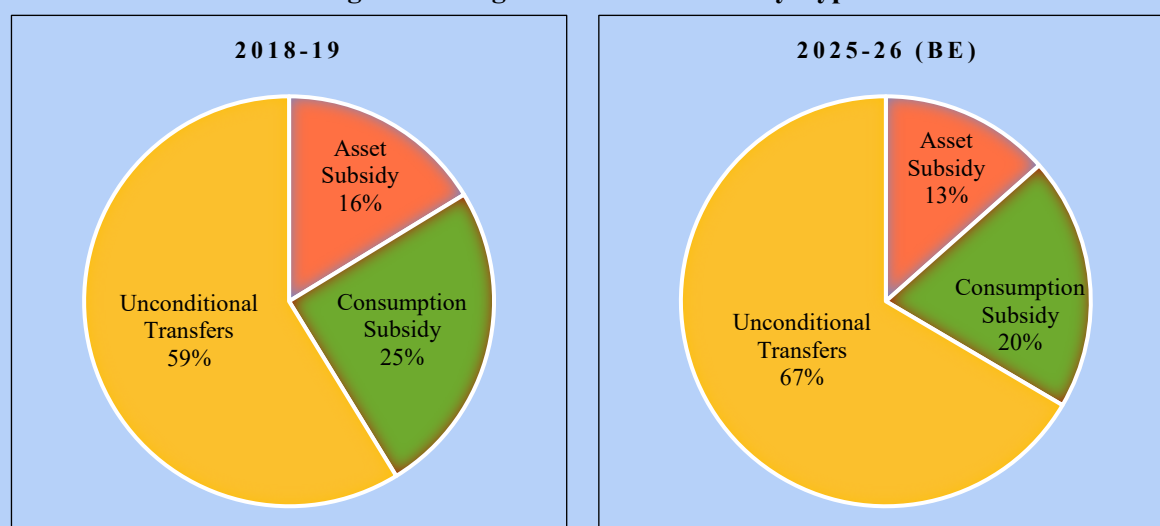
with disabilities and other vulnerable sections of society. The expenditure on SSPs reached ₹1.18 lakh crore in 2023-24, well over double of ₹44,453 crore in 2018-19 and is budgeted at ₹1.58 lakh crore in 2025-26 BE.

14.26 In 2023-24, the States with the highest expenditure on SSPs were Andhra Pradesh (₹15,060 crore), Uttar Pradesh (₹10,240 crore) and Telangana (₹10,182 crore). Per capita expenditure on SSPs is slated to be the highest in Andhra Pradesh at ₹5,061 in 2025-26 BE, representing a large jump from ₹2,827 in 2023-24. A similar trend in per capita expenditure on SSPs is followed by Kerala at ₹3,770 in 2025-26 BE, up from ₹1,762 in 2023-24 and Telangana at ₹3,348 in 2025-26 BE, up from ₹2,667 in 2023-24.

Agriculture

14.27 Agricultural subsidies encompass support for crop loans, interest subsidies, insurance, seeds and other agricultural inputs. Loan waivers and power subsidies also apply to agriculture, but they are included under a separate head. However, we have included cash transfers to farmers under schemes such as Krushak Assistance for Livelihood and Income Augmentation (KALIA) and top-ups to the PM Kisan Samman Nidhi Yojna (PM KISAN) in agricultural subsidies. The total agricultural subsidies have risen from ₹29,610 crore in 2018-19 to ₹91,389 crore in 2025-26 BE. *Figure 14.4* shows that the share of unconditional transfers within agricultural subsidies has risen considerably from 58.8 per cent in 2018-19 to 70.2 per cent in 2023-24 and 66.5 per cent in 2025-26 BE. The largest cash transfer schemes in agriculture are Rythu Bandhu in Telangana, Krishak Unnati Yojana in Chhattisgarh and Annadata Sukhibhava in Andhra Pradesh. Chhattisgarh and Telangana provide the largest subsidies in this sector, with amounts of ₹19,681 crore (17.2 per cent of TRE) and ₹15,267 crore (9.1 per cent of TRE), respectively, in 2023-24.

Figure 14.4 Agricultural Subsidies by Type



Source: States' Demand for Grants

Food Subsidy

14.28 Several States provide food subsidies in addition to the subsidised food grains provided by the Union Government under the National Food Security Act, 2013. In 2023-24, States spent ₹54,463 crore on food subsidies in addition to ₹2.3 lakh crore by the Union. The States with high per capita food subsidy expenditures in 2023-24 were Chhattisgarh (₹2,934), Tamil Nadu (₹1,722) and Karnataka (₹1,256).

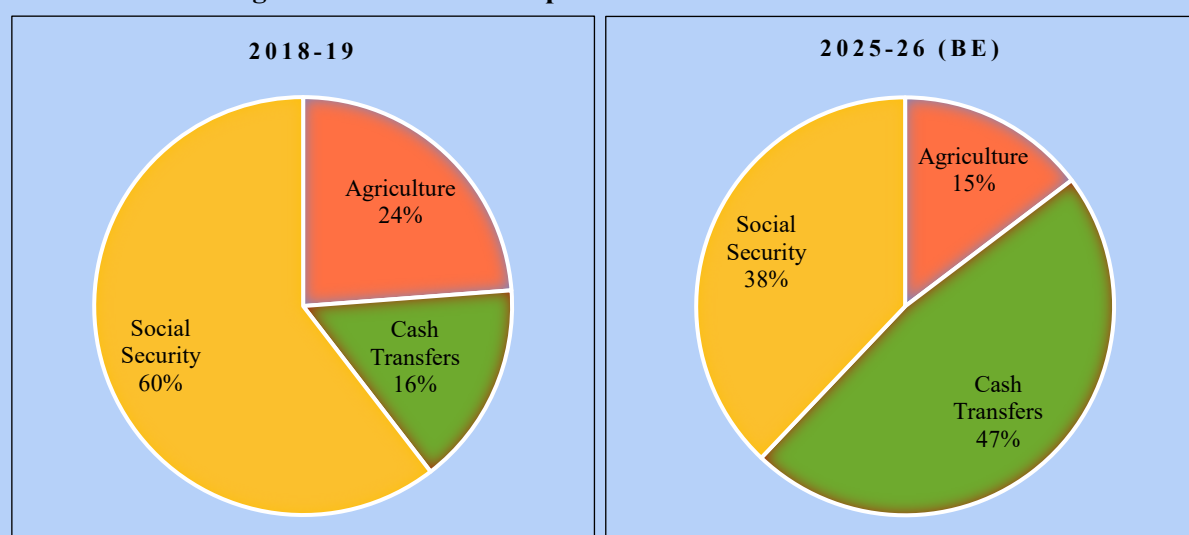
Health and Education

14.29 In 2023-24, States spent ₹72,286 crore on health and education subsidies, primarily through scholarship schemes, the free distribution of inputs such as uniforms, subsidised insurance premiums and treatment costs. At 9.5 per cent, health and education subsidies accounted for a relatively small proportion of the total subsidies in 2023-24. This suggests that non-merit goods account for a disproportionately large volume of State subsidies.

Unconditional Transfers by States

14.30 Given the sudden spike in their magnitude, special attention must be paid to unconditional transfers by the States. It is important to recall that these are transfers made to eligible beneficiaries without performance benchmarks or contingencies on the use of such funds. The unconditional transfers have grown at a rate of 28.8 per cent between 2018-19 and 2025-26 BE. In absolute terms, they have grown from ₹73,099 crore in 2018-19 to ₹2.63 lakh crore in 2023-24 and are estimated to grow to ₹4.14 lakh crore in 2025-26 BE, far exceeding the amount allocated for power subsidies.

Figure 14.5 Sectoral Composition of Unconditional Transfers



Source: States' Demand for Grants

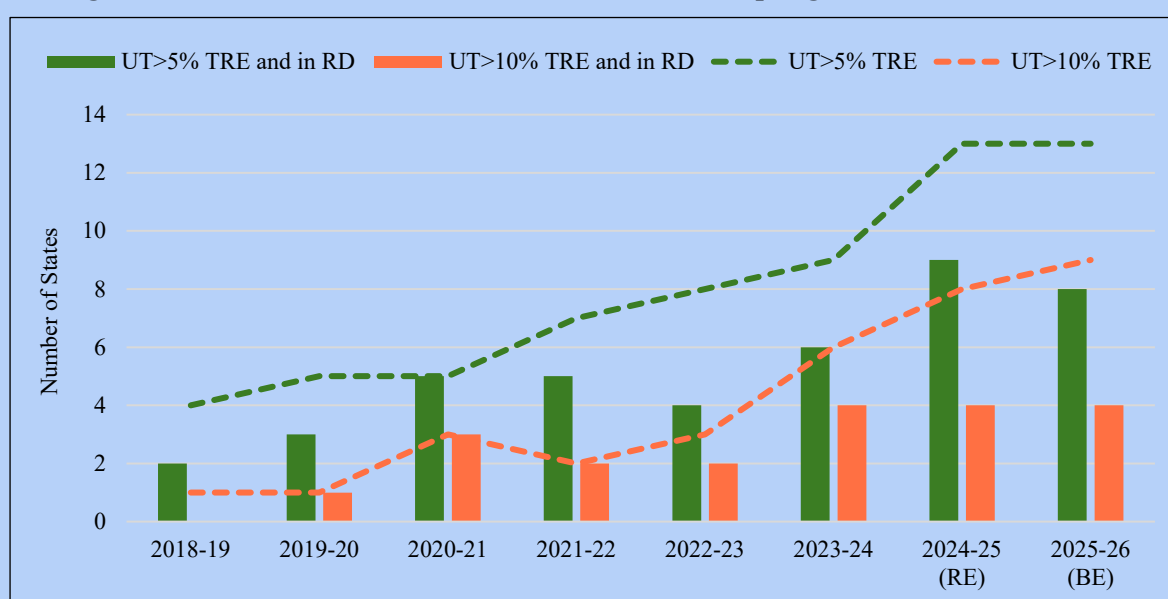
14.31 In addition to this rapid growth, unconditional transfers have undergone a dramatic shift in their sectoral composition, as seen in *Figure 14.5*. In 2018-19, 60.4 per cent of all

unconditional transfers went to social security pensioners, followed by a quarter to farmers. In the 2025-26 budget year, large-group cash transfer schemes have assumed a dominant role, accounting for 47.4 per cent of the total unconditional transfers. This is the result of a 53.6 per cent growth rate between 2018-19 and 2025-26 BE in large-group cash transfer schemes. The social security pensioners' and farmers' shares have declined to 37.9 per cent and 14.7 per cent respectively in 2025-26 BE.

14.32 Unconditional transfers are also witnessing a rapid geographical expansion, with an increasing number of States embracing them as the preferred instrument of transfers. In 2018-19, Telangana was the lone State that allocated more than 10 per cent of its revenue expenditure to unconditional transfers. By 2023-24, the number of such States rose to six and by 2025-26 BE, to nine. A similar trend is observed for the number of States with over 5 per cent of their revenue expenditure spent on unconditional transfers, as shown in *Figure 14.6*. The number of such States more than doubled from four in 2018-19 to nine in 2023-24. By 2025-26 BE, the number of States with over 5 per cent of revenue expenditure allocated to unconditional transfers further rose to thirteen. In terms of percentage of revenue expenditure allocated to unconditional transfers, the top six States in 2023-24 were Chhattisgarh, Telangana, Andhra Pradesh, West Bengal, Karnataka and Madhya Pradesh, in that order.

14.33 Notably, States that expanded expenditure on unconditional transfers also tended to be those with a revenue deficit. In 2023-24, out of the nine States with over 5 per cent of TRE devoted to unconditional transfers, six were in revenue deficit, compared to two out of four such States in 2018-19. When we consider States with over 10 per cent of TRE devoted to unconditional transfers, four out of six of them were in revenue deficit in 2023-24. The majority of States are financing their unconditional transfers by either borrowing or cutting capital expenditures.

Figure 14.6 Number of States with Revenue Deficit Adopting Unconditional Transfers



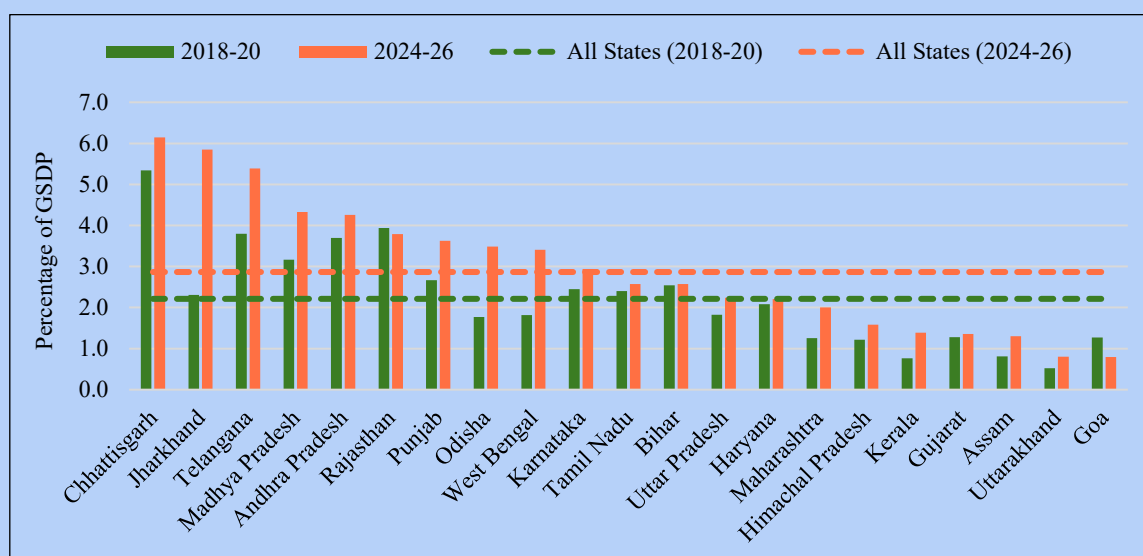
Source: States' Demand for Grants

14.34 While the JAM trinity has helped reduce last-mile leakages in transfer programs, issues related to targeting remain. For instance, a recent ground verification of pension scheme beneficiaries by the Andhra Pradesh Government in one village/ward secretariat of each district revealed that 9.0 per cent of the beneficiaries were ineligible and had been wrongly included. The share of beneficiaries found dead was also a significant 0.6 per cent. States are aware of such issues, and some have taken measures to clean their beneficiary lists. Telangana utilised integration of multiple government department databases under its Samagra Vedika initiative to weed out ineligible and bogus beneficiaries. Similarly, Tamil Nadu under its Data Purity project and Rajasthan under Jan Aadhaar have implemented integration of various databases under multiple schemes and departments like transport, power, property tax, ration cards etc. By employing IT enabled data analysis on such integrated databases, States have been able to deduplicate and streamline beneficiary listing leading to substantial savings. Maharashtra has undertaken an intensive verification exercise that utilises the Income Tax database to review the beneficiary list of the Majhi Ladki Bahin Yojana. Therefore, measures to better target benefits must be strengthened by the enforcement of clearly defined exclusion criteria and by integration of all available databases.

Interstate Comparison

14.35 There is a wide variation in subsidy levels among States. At ₹78,453 crore, Tamil Nadu had the highest absolute level of subsidy in 2023-24, followed by Karnataka, Andhra Pradesh and Telangana at ₹70,149 crore, ₹63,951 crore and ₹62,847 crore respectively. The absolute subsidy levels are somewhat misleading, as the State's size influences them. To neutralise the size effect, we consider two alternative measures: subsidies as a proportion of GSDP and as a proportion of population.

Figure 14.7 Subsidies and Transfers (percentage of GSDP)

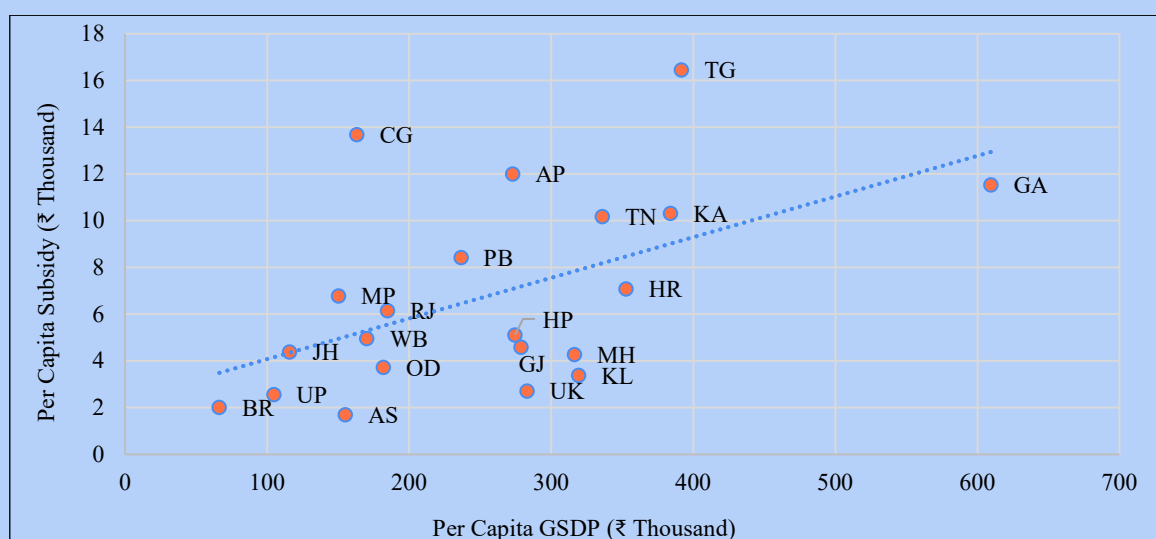


Source: States' Demand for Grants

14.36 In Figure 14.7, we depict the average subsidy as a proportion of GSDP for the first two years and the last two years of the period under consideration, for each State under study. Each dotted horizontal line represents the average of the subsidy-to-GSDP ratios across States shown in the same colour bars. Two striking patterns emerge. First, with two exceptions – Rajasthan and Goa – all the remaining nineteen States have witnessed an increase in subsidies, both in absolute terms and as a proportion of GSDP. This increase has been particularly pronounced in Jharkhand, Telangana, Odisha, West Bengal and Madhya Pradesh.

14.37 Second, in certain States, subsidy levels as a proportion of respective GSDPs have reached extremely high levels during the last two years under consideration. In the States of Chhattisgarh, Jharkhand and Telangana, they exceed 5 per cent. In Madhya Pradesh, Andhra Pradesh, Rajasthan, Punjab, Odisha and West Bengal – they stood between 3 per cent and 5 per cent.

Figure 14.8 Per Capita Subsidy vs Per Capita GSDP (2023-24)



Source: States' Demand for Grants

14.38 In Figure 14.8, we plot per capita GSDP against per capita subsidy expenditure for 2023-24. Among the twenty-one States, Telangana, Chhattisgarh and Andhra Pradesh, in descending order, ranked as the three largest providers of subsidies. Telangana's per capita spending on subsidies in 2023-24 was ₹16,460, more than nine times the amount spent by Assam. At ₹1,707 per capita, Assam had the lowest subsidy burden among all twenty-one States. An interesting observation is that, on average, States with higher per capita income spend more on a per capita basis on subsidies. The lower-per-capita-income States of Bihar, UP and Assam are among the States with the lowest per capita subsidies. Telangana and Goa, both at the top end of the per capita GSDP ladder, on the other hand, are among the three highest per capita subsidy States. At the low-income end, Chhattisgarh stands out in terms of its high per capita subsidy. At the high-income end, Uttarakhand and Kerala have the opposite distinction. This reveals the iniquitous inter-state variation of subsidy expenditure which is more a function of fiscal capacity than aid required by the vulnerable and poor. Box 14.1 further discusses and compares intra state issues in targeting of subsidies to the poor.

Box 14.1 Targeting of Subsidies: Case of Household Power Subsidies

Well targeted subsidies and transfers are potential tools to address inequity and ameliorate poverty. However, subsidies and transfers are not always observed to be progressive in nature. To understand variation in subsidies and its targeting in various States, the Asian Development Bank did a study on our behalf. In its report submitted to the Commission it has observed that the substantial chunk of subsidies are actually getting pocketed by more well-off sections of the population thereby impeding their redistributive role.

In case of power subsidies for instance, which are predominantly consumption-oriented subsidies, the study compared the percentage of households receiving free electricity in the different consumption quintile as shown at *Table 14.1*. It emerges that in States that provide subsidies to large groups of households, subsidies become less progressive. Thus, the percentage of households in the highest quintile, receiving free electricity vary from nil in States like Kerala and Goa, to around 85 per cent in Tamil Nadu. States like Tamil Nadu, Punjab, Karnataka, Rajasthan and Himachal Pradesh, that provide power subsidies to large groups, have somewhat more regressive benefits that flow disproportionately to higher consumption households. On the other hand, Kerala, Goa, Gujarat and Odisha provide relatively targeted access to free power, restricting it to specific groups such as SC/ST or to consumers with less than 30 units per month. These are targeted and have a design that allows them to support an improved quality of life of vulnerable populations with relatively less fiscal impact.

Table 14.1 Quintile-wise Percentage of Households Receiving Free Electricity

State	Q1	Q2	Q3	Q4	Q5	Total
Tamil Nadu	89.5	89.7	92.3	93.2	85.2	89.5
Punjab	92.6	88.0	89.5	84.4	75.1	82.9
Karnataka	90.9	91.4	92.3	88.5	62.3	81.4
Rajasthan	83.9	81.9	83.0	77.6	59.8	77.3
Himachal Pradesh	84.7	84.4	80.0	73.8	69.7	75.6
Jharkhand	50.3	50.9	46.5	31.1	14.8	45.7
Madhya Pradesh	39.4	47.2	40.4	29.8	13.4	38.0
Telangana	21.5	21.4	27.1	28.9	15.4	22.7
Andhra Pradesh	25.2	20.1	19.1	14.8	8.9	15.8
West Bengal	10.3	7.2	5.7	2.8	1.6	6.5
Chhattisgarh	3.6	2.7	3.6	4.5	7.2	3.6
Bihar	1.5	2.0	2.1	2.1	2.8	1.9
Uttarakhand	0.8	1.2	1.6	0.8	3.4	1.7
Other States*	1.5	1.3	1.3	1.2	1.0	1.3

Source: Household Consumption Expenditure Survey, 2023-24, MoSPI

Note: *Other States include Assam, Maharashtra, Uttar Pradesh, Haryana, Odisha, Gujarat, Goa, Kerala

Extra-Budgetary Subsidies by States

14.39 Some States have to resort to raising extra-budgetary resources for financing subsidies and transfers, either through off-budget borrowings (OBB) or debt guaranteed by the State Government. Since OBBs are serviced by the State Governments, they have a direct bearing on the budget, and impact interest payments; debt guarantees are part of contingent liability. Some States have established government corporations to access such financing. Kerala and Andhra Pradesh have assigned a portion of their own revenues through legislation to these corporations for financing subsidies. For example, Andhra Pradesh has assigned the Additional Retail Excise Tax (ARET) to Andhra Pradesh State Development Corporation Limited, which also serves as a medium for transfers and welfare schemes. Such means of financing are not transparently reflected in the budget documents of States and contribute to the opacity of subsidies and transfers. *Table 14.2* lists some cases of OBB funding of subsidies and transfers.

Table 14.2 Funding of Subsidies Through Off-budget Borrowing as on 31 March 2023

State	Organisation	Amount (₹ crore)
Andhra Pradesh	Andhra Pradesh DISCOMS including APPCC	26,466
Andhra Pradesh	AP State Civil Supplies Corporation	35,100
Chhattisgarh	Chhattisgarh Rural Housing Corporation	1,792
Kerala	Kerala Social Security Pension Ltd.	11,733
Uttar Pradesh	UP Power Corporation Ltd.	3,488

Source: State Finances Audit Reports

Transparency in Accounting

14.40 The Thirteenth Finance Commission (FC-13) had recommended proper disclosure of subsidies. Subsequently, the Comptroller and Auditor General of India (CAG) has introduced a statement in the Finance Accounts in the form of an appendix on subsidies being provided by the States, which is placed before the State Legislatures. However, significant differences remain across States in the reporting of subsidies. There is a lack of standardisation in accounting and transparent disclosure of subsidies and transfers, as it depends on how States classify their schemes. We have found many instances of expenditures that constitute subsidies and transfers but are classified as ‘assistance’, ‘grants,’ or ‘other expenditure.’

14.41 For example, schemes such as Magalir Urimai Thugai (for women heads of households) in Tamil Nadu and Rythu Bharosa (for farmers and tenants) in Andhra Pradesh are reported as subsidies in the respective States' finance accounts. However, schemes such as Orunodoi in Assam and Gruha Lakshmi in Karnataka, which provide similar benefits to the target groups, are not included among the reported subsidies in the finance accounts.

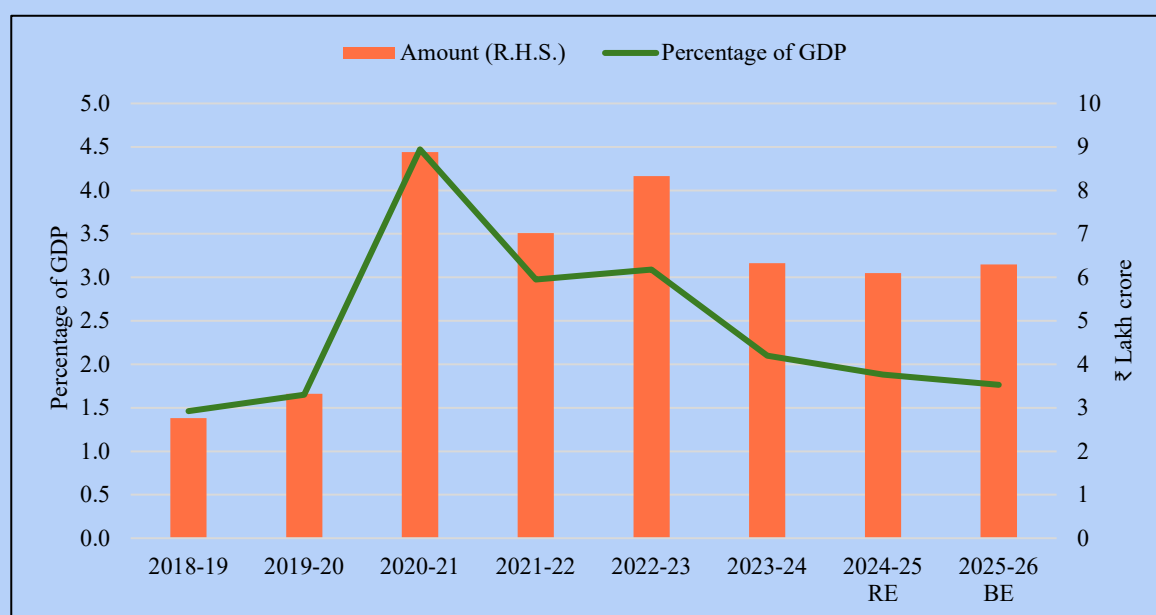
Trends in Subsidies by the Union Government

14.42 We now turn to a discussion of subsidies and transfers provided by the Union Government. Union subsidies have had a long history of study and analysis by governmental agencies and research scholars. Finance Commissions in the past have also written about them. Keeping this in view, our discussion is limited to estimating their magnitude and assessing their composition in recent years.

14.43 The Union Government publishes a statement of subsidies in Statement 7 of its budget. However, it reflects only items booked under the subsidy object head. The Union's statements ignore other beneficiary-oriented subsidy programs. For example, it books the interest subsidy for housing under PM Awas Yojana as a subsidy. Yet, it excludes assistance for beneficiary-led construction of a house under the same scheme. Similarly, there are inconsistencies with how the same scheme is reported across years. We observe this in the case of the Prime Minister Employment Generation Program. It is listed as a subsidy in the 2025-26 budget, but not in the earlier budgets.

14.44 Union subsidies rose at the annual trend growth rate of 21.0 per cent from ₹2.76 lakh crore in 2018-19 to ₹6.33 lakh crore in 2023-24 as shown in *Figure 14.9*. Their share in gross domestic product (GDP) increased sharply from 1.5 per cent in 2018-19 to 4.5 per cent in 2020-21, due to the clearing of deferred liabilities on the food and other subsidy accounts, and in response to COVID-19, before moderating to 2.1 per cent in 2023-24. Their share in the Union's revenue expenditure increased from 13.8 per cent in 2018-19 to 18.1 per cent in 2023-24. However, in 2024-25 RE and 2025-26 BE, Union subsidies show moderation reaching 1.90 per cent and 1.76 per cent of GDP, respectively.

Figure 14.9 Union Subsidies and Transfers



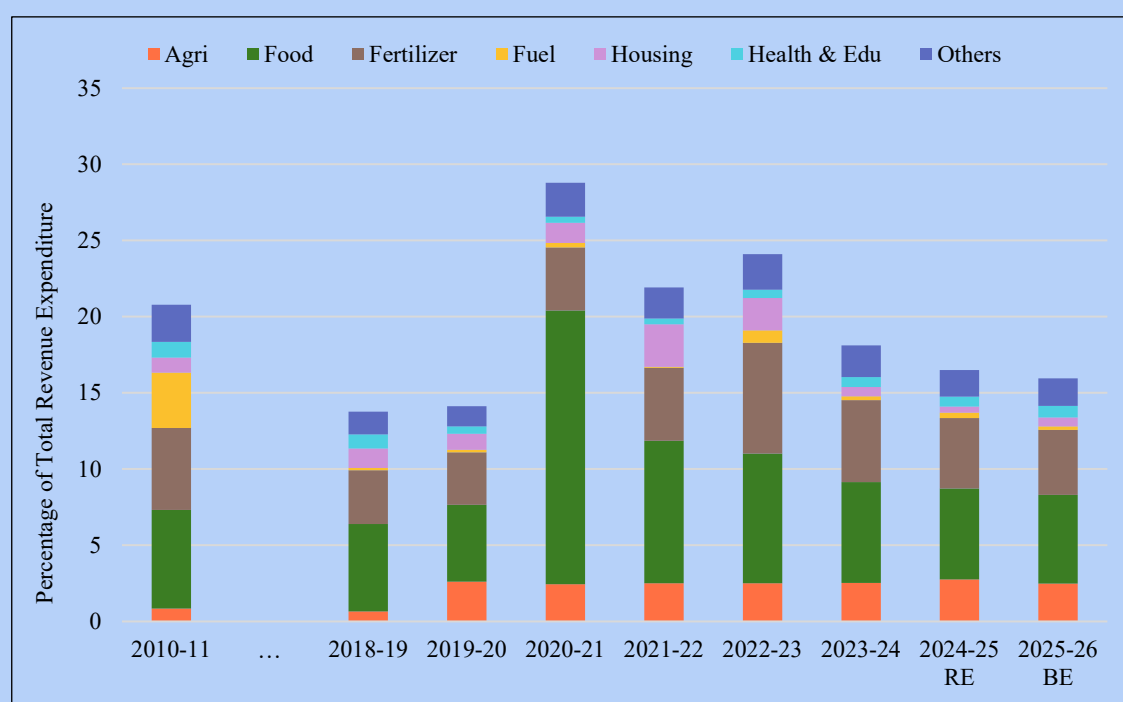
Source: Union's Demand for Grants

14.45 The major drivers of the increase in the Union subsidy expenditure from 2018-19 to 2023-24 have been agriculture and fertilizer subsidies. The subsidies and transfers in agriculture grew at a rate of 35.5 per cent per annum, rising from ₹13,178 crore in 2018-19 to ₹88,641 crore in 2023-24. This is largely due to the introduction of the PM KISAN scheme, which provides unconditional cash transfers to farmers. The fertilizer subsidies have grown at the rate of 27.4 per cent per annum during the same period, rising to ₹1.88 lakh crore in 2023-24 from ₹70,605 crore in 2018-19.

Composition of Union Subsidies

14.46 There has been a marked shift in the composition of Union subsidies since 2010-11, when they primarily consisted of food (31 per cent of all subsidies), fertilizers (25.8 per cent) and fuel (17.5 per cent). By 2018-19, fuel subsidies were reduced to negligible levels. Total subsidies and transfers had moderated to 13.8 per cent of TRE of the Union from 20.8 per cent in 2010-11. The spike in subsidies in 2020-21 to 28.8 per cent of TRE was largely due to the payment of deferred liabilities to the Food Corporation of India (FCI). Thereafter, subsidies as a percentage of TRE were sustained at elevated levels of 21.9 per cent in 2021-22 and 24.1 per cent in 2022-23, primarily due to allocations to food, fertilizer and housing as shown in *Figure 14.10*. A reduction in these components moderated the subsidy expenditure to 18.1 per cent of TRE in 2023-24, 16.5 per cent in 2024-25 RE and 16.0 per cent in 2025-26 BE. Despite the recent easing of the subsidy burden, it remains elevated compared to pre-COVID years.

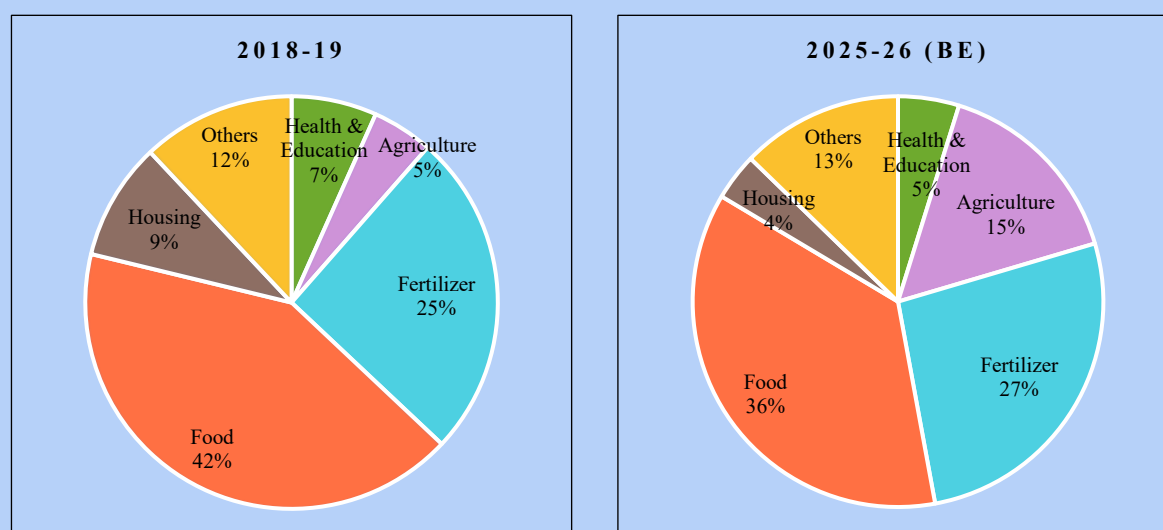
Figure 14.10 Composition of Union Subsidies and Transfers



Source: Union's Demand for Grants

14.47 It is helpful to do a further snapshot comparison of subsidy composition between years 2018-19 and 2025-26 BE to emphasise the evolving nature of subsidies. This is illustrated in *Figure 14.11*, which uses a pie chart. While food and fertiliser have remained dominant, comprising nearly two-thirds of all subsidies and transfers, the share of agriculture subsidy has increased substantially to 15.6 per cent in 2025-26 BE from 4.8 per cent in 2018-19, mainly due to the large cash transfer scheme of PM KISAN. The share of housing sector subsidies has declined substantially from 9.2 per cent to 3.7 per cent in the same period.

Figure 14.11 Change in Composition of Subsidies and Transfers between 2018-19 and 2025-26 BE



Source: Union's Demand for Grants

14.48 The estimates up to this point do not include off-budget liabilities incurred by the Union Government to finance subsidies and other scheme expenditures. A substantial amount of expenditure on subsidy schemes was incurred outside the Consolidated Fund of India (CFI) between 2016-17 and 2021-22. The extra budgetary resources were mainly mobilised through the issue of government fully serviced bonds (FSBs) and loans from the National Small Savings Fund (NSSF). FSBs have been utilised to fund subsidy schemes, such as Pradhan Mantri Awas Yojana and Swachh Bharat Mission. As per Statement 27 of the Union Budget 2025-26, a total of ₹1.38 lakh crore was raised to fund various schemes of the Union Government from 2016-17 to 2022-23. Of these funds, ₹81,107 crore was allocated for subsidies and beneficiary schemes. Additionally, as per Annexure VI of the 2021-22 budget speech, between 2016-17 and 2020-21, food subsidy amounting to ₹4.27 lakh crore was financed by loans from the NSSF to the FCI. Incurring such large liabilities for subsidies and schemes outside the CFI introduces opaqueness and underreporting of expenditure in the accounts. Recognising the need for greater transparency and disclosure, the Union Budget 2021-22 announced the discontinuation of financing of food subsidy from NSSF loans. The Union Government discontinued using extra-budgetary resources

for financing scheme expenditure after 2022-23, thereby bringing all schemes and subsidy expenditure under the budget. This change represents a significant reform by the Union Government aimed at promoting transparency and full disclosure.

Observations by the Past Finance Commissions

14.49 Apart from the transparency issue raised by the FC-13 and concerns about agricultural loan waivers by the Fifteenth Finance Commission (FC-15) regarding States, the past Finance Commissions primarily focused on Union subsidies. In addition to explicit subsidies such as on fertilizers, the Twelfth Finance Commission (FC-12) expressed concern over implicit subsidies as well, that results from the government's pricing of economic services below cost. FC-12 recommended targeting the fertilizer subsidy more effectively to make it more progressive and addressing the issue of low user charges in the power sector. The FC-13 noted that the major central subsidies – food, fertilizers and petroleum – were unevenly distributed and disproportionately favoured wealthier States. It identified large-scale subsidies as significant fiscal barriers to inclusive growth, and advocated a fiscal trajectory characterised by well-targeted subsidies.

14.50 Focusing on petroleum subsidies, resulting from administered prices amid escalating global crude prices, the Fourteenth Finance Commission (FC-14) drew attention to increased fiscal pressures from subsidy expenditures funded through oil bonds. The FC-14 noted that these subsidies undermined fiscal consolidation and called for better targeting of subsidies and insulation of subsidies from frequent policy fluctuations.

14.51 Finally, the FC-15 highlighted hidden off-budget subsidies provided through entities such as the FCI. The government delayed reporting of fertilizer subsidies by carrying them over to subsequent fiscal years. Further, the Commission raised concerns over the ‘moral hazard’ associated with populist subsidy measures, specifically agricultural loan waivers. It called for undertaking subsidy rationalisation as a part of broader administrative and institutional reform, recommending systematic reviews of public sector enterprises, including dividend policies, reserve allocations and subsidy management.

Recommendations

14.52 While subsidies and transfers have a legitimate role in redistribution and provision of public goods or private goods with large positive externalities, imperatives of fiscal prudence cannot be ignored. It is a matter of concern that the revenue balance in several States has turned negative in recent years. It is not a coincidence that many of these States are also rolling out large-scale transfer schemes concomitantly. Borrowing for expenditure on schemes of subsidies and transfers is not sound fiscal policy. The burgeoning demand on public expenditure adversely affects the State’s fiscal health and calls for a reversal of the recent acceleration in the growth of subsidies and transfers. Therefore, we recommend that States take steps to review and rationalise their schemes of subsidies and retain only those schemes that target the poor effectively.

14.53 Many subsidy schemes, especially those providing unconditional transfers, tend to have large and untargeted beneficiary bases. These are not only inefficient but also impose a large fiscal burden. They crowd out capital expenditure and other critical expenditures related to the provision of basic services, such as education and health. Therefore, we recommend that governments take immediate measures to rationalise the beneficiary base by having clearly defined exclusion criteria and a rigorous review process to ensure that benefits reach the most vulnerable. They should ensure that, through the rationalisation of schemes and the beneficiary base, the revenue deficit is reduced and eventually eliminated.

14.54 There is a need to introduce sunset clauses, especially in schemes that provide subsidies on non-merit private goods and general unconditional transfers. We recommend that governments establish mechanisms to review subsidies and transfers and include a sunset or exit clause in their implementation mechanisms. Resorting to financing of subsidies and transfers through off-budget borrowings, guarantees, or assignment of revenues is fiscally imprudent. It induces opacity in the accounting of subsidies and transfers. We recommend that such practices of off-budget borrowings for financing of subsidies be discontinued, and necessary measures may be taken to discourage them.

14.55 There is an immediate need to adopt a uniform approach in accounting and disclosure of subsidies and transfers. Therefore, we recommend that the CAG review the current practices followed in the disclosure of such expenditure items in different States and ensure that expenditures constituting subsidies and transfers are comprehensively covered in the Appendix of Finance Accounts, irrespective of how governments classify them.

Concluding Remarks

14.56 During the course of this study, except for the petroleum subsidy, we did not encounter any instances of a major subsidy or transfer scheme that was phased out. Once implemented, a subsidy or transfer scheme remains in effect indefinitely. Like salaries, pensions and interest payments on debt, subsidies in India have a tendency to turn into ‘committed’ expenditures. This reduces the already limited space for other expenditures, including those on infrastructure, health, education, and law and order. The ease of administration resulting from a well-developed IT infrastructure, as well as a large beneficiary base, has led to a rise of popularity of subsidies among the electorate. Large-group cash transfer schemes have proliferated recently; they have the potential to continue proliferating rapidly. As the economy grows and more revenue becomes available, there is likely to be political pressure to increase benefits under existing schemes and/or launch new ones. Such a development could greatly undermine the future financial stability of States and the Union. It may put a stress on the availability of funds for development action. Both the Union and State Governments need to rethink introducing yet more such schemes or extending the benefits under the existing ones. Such endless provisioning will bequeath an ever-shrinking fiscal space to successive governments.

□□□

PUBLIC SECTOR ENTERPRISES REFORMS

15.1 Beginning in the 1950s, as India embarked on its economic development, it adopted a ‘heavy industry first’ approach. The then Union Government also decided that over time, the public sector would increase its share in industry by mobilizing savings and investing them in the old and new Central Public Sector Enterprises (CPSEs). This strategy continued through the 1960s and, indeed, was intensified in the 1970s through the nationalisation of several private-sector enterprises. Consequently, by 1981-82, the public sector had come to account for 24 of the 30 largest firms by capital employed, and three-fourths of paid-up share capital¹.

15.2 Given their limited role in industrialization during the early post-independence decades, the States’ public sector did not enter the production activity on a scale comparable to the Union’s. Nevertheless, in areas open to the States, such as agriculture, infrastructure, finance, and power, States launched State Public Sector Enterprises (SPSEs). In particular, by the early 1960s, the State Electricity Boards (SEBs) had evolved into vertically integrated monopolies within their respective States. Given the need for electricity generation and distribution, by the early 1960s, SEBs emerged as the recipient of the largest State investment. Of course, States also invested in other areas, including manufacturing, with the number of SPSEs proliferating.

15.3 In this chapter, we undertake an empirical analysis of both CPSEs and SPSEs. However, considering that a substantial body of literature already exists on CPSEs and the Union Government has adopted the New Public Sector Enterprise Policy of 2021, we focus primarily on SPSEs. After presenting the salient empirical facts associated with SPSEs and, briefly, CPSEs, we recommend a set of possible reforms.

¹ Frankel, Francine, 2005. *India’s Political Economy 1947-2004: The Gradual Revolution*, New Delhi: Oxford University Press, p. 580.

State Public Sector Enterprises

15.4 Our data sources include General Purpose Financial Reports of CPSEs (Compliance Audit) for various years, prepared by the Comptroller and Auditor General (CAG) of India, as well as data provided to the Commission by CAG for more recent years up to 2023-24. Our analysis does not include public sector banks as they are not companies registered under the Companies Act, 2013, and hence, not covered under the audit jurisdiction of CAG.

15.5 The CAG classifies CPSEs and SPSEs into three categories: Government Companies (GCs), Statutory Corporations (SCs), and Government Controlled Other Companies (GCOCs). GC is defined in Section 2(45) of the Companies Act, 2013 as a company in which not less than 51 per cent of the paid-up share capital is held by the Union Government, or by any State Government or Governments, or partly by the Union Government and partly by one or more State Governments, and includes a company which is a subsidiary of a Government Company. Statutory Corporations (SCs) are companies set up under statutes enacted by the Parliament of India or by a State Legislature. GCOCs are companies, other than GCs and SCs, that are owned or controlled, directly or indirectly, by the Union Government, or by any State Government, or jointly by the Union Government and one or more State Governments.

15.6 *Figure 15.1* presents the total number of SPSEs across all States under these three categories. As on 31 March 2023, there were 1,635 SPSEs in India. GCs where the State Government's stake in paid-up capital is 51 per cent or more, account for the largest proportion of SPSEs. Out of total, 1,414 SPSEs (86.5 per cent) are GCs. There are 135 GCOCs and 86 SCs among the SPSEs. On a per-state basis, the number of SCs works out to approximately three.

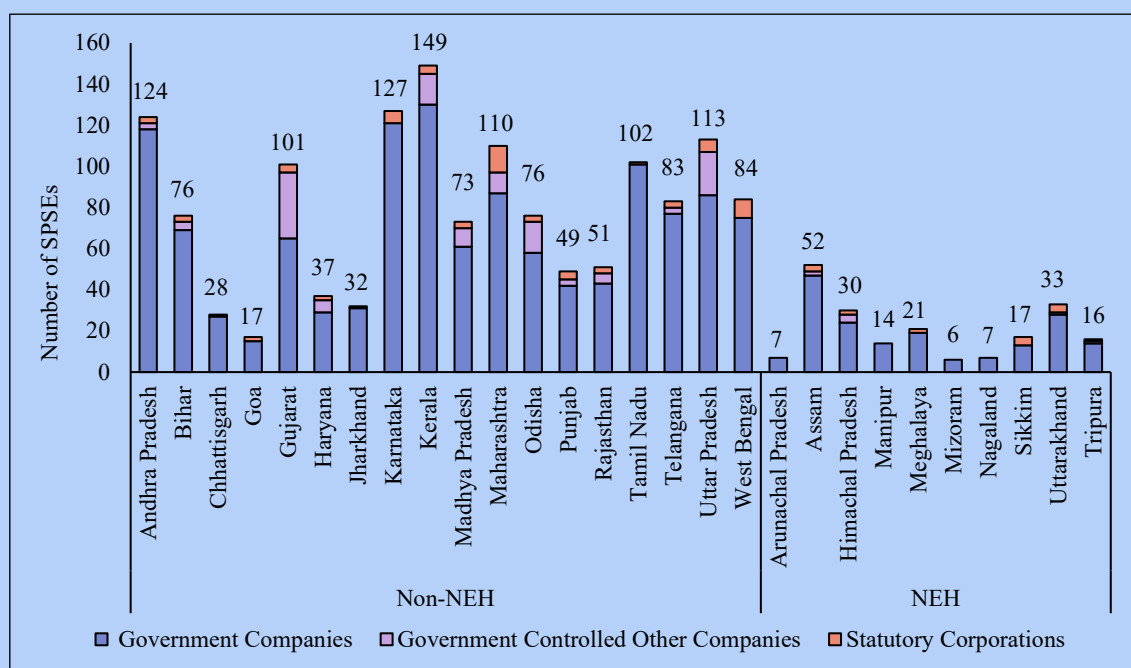
15.7 One of the major issues concerning SPSEs is the large number of non-operational or inactive enterprises. While there are some differences in how SPSEs are classified as 'inactive' in audit reports of various States, by and large, inactive SPSEs can be described as those that have ceased to carry out their operations. *Figure 15.2* provides a snapshot of active and inactive SPSEs across different States. Data show that as many as 308 SPSEs across all States are inactive as on 31 March 2023. These account for approximately 19 per cent of total SPSEs across all States.

15.8 SPSEs operate across a wide spectrum of sectors, including power, manufacturing, agriculture and allied activities, financial services, and a range of other services, such as water provision, tourism and transport. Many of these enterprises function as State monopolies, while others operate alongside the private sector in a competitive environment. Their performance varies significantly across sectors and States.

15.9 We measure the economic significance of SPSEs by the turnover-to-Gross State Domestic Product (GSDP) ratio. As on 31 March 2023, the total turnover of 1,069 SPSEs across all States, for which data on turnover of SPSEs are available from CAG for the year of their latest finalized accounts, amounted to ₹14.5 lakh crore, which works out as approximately 5.7 per cent of all States' GSDP during 2022-23. However, there is a wide variation in the contribution of SPSEs to the respective State's GSDP.

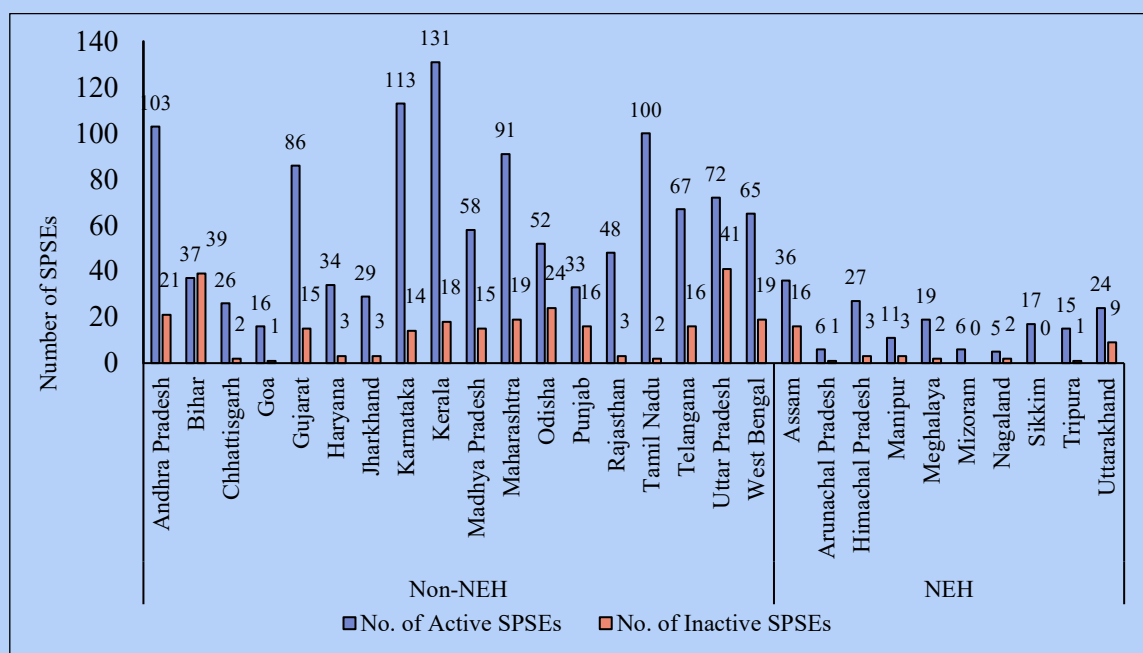
15.10 Figure 15.3 shows the ratio of SPSEs' turnover to GSDP for each of the twenty-eight States. As can be seen, this ratio varies from State to State, from almost negligible to more than 10 per cent of GSDP.

Figure 15.1 State-wise Number of SPSEs

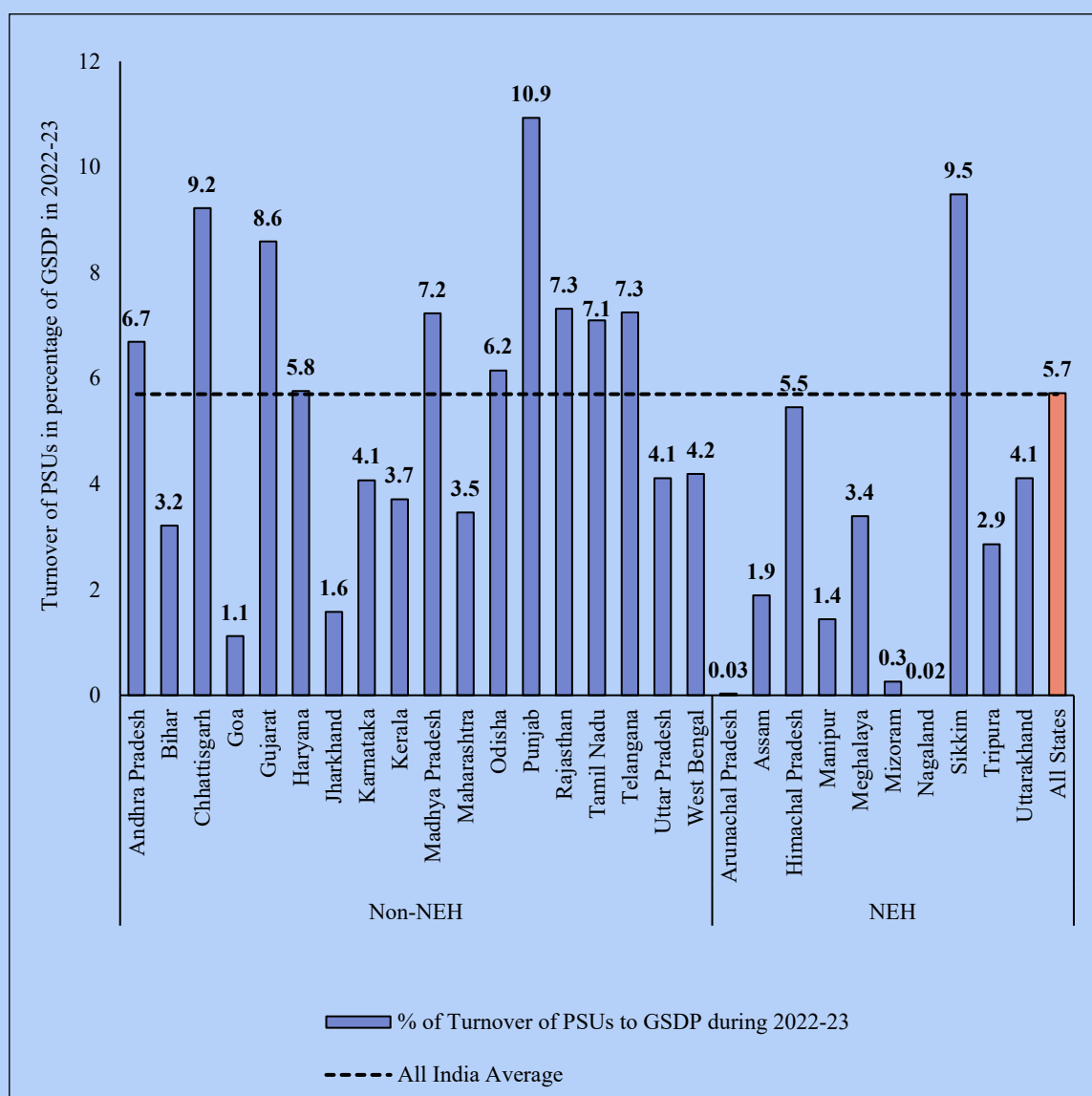


Source: State Finances Audit Reports, 2024, CAG. Data as on 31 March 2023

Figure 15.2 State-wise Number of Active and Inactive SPSEs



Source: State Finances Audit Reports, 2024, CAG. Data as on 31 March 2023

Figure 15.3 SPSEs' Turnover (percentage of GSDP)

Source: State Finances Audit Reports, 2024, CAG

Note: Data on Turnover correspond to the year for which latest finalised accounts are available during the year 2022-23.

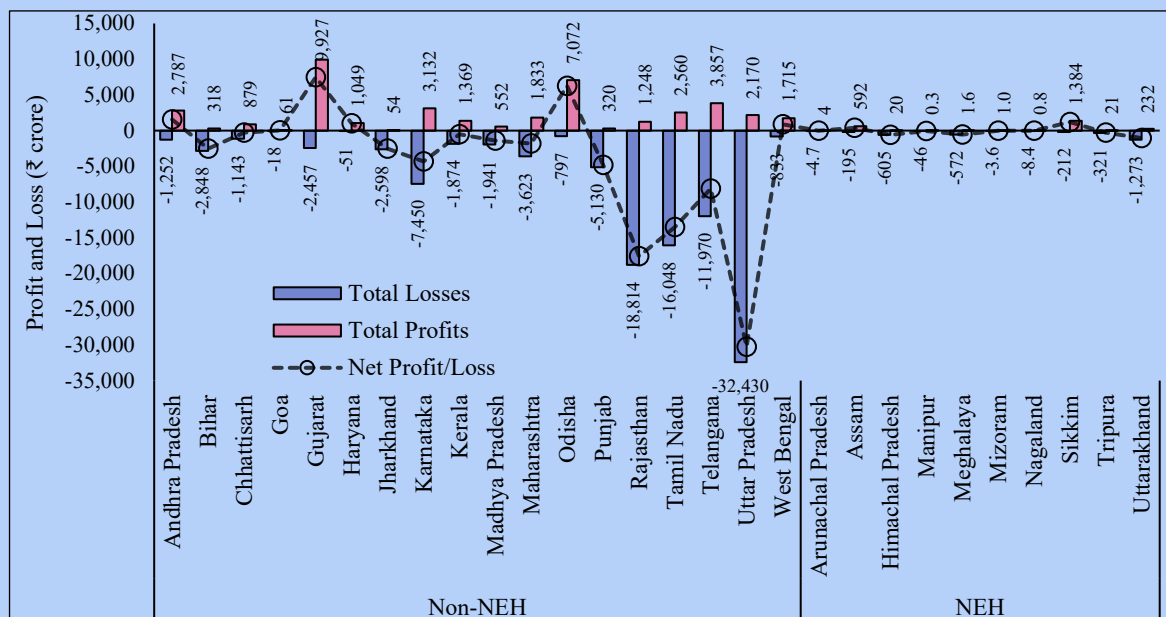
15.11 Profits are a crucial indicator of an enterprise's financial sustainability. As per the latest available data, nearly 50 per cent of SPSEs (541 out of 1,107 SPSEs for which data on profit / loss is available) across all States are either in loss or zero net profit. This statistic highlights the highly fragile financial condition of SPSEs. *Table 15.1* reports the number of profit-making and loss-making SPSEs for each State as per their latest finalised accounts as on 31 March 2023. Most of the north-eastern and hilly (NEH) States exhibit a high proportion of loss-making SPSEs. Among other States (non-NEH States), Goa, Karnataka, Kerala, Punjab, Telangana and West Bengal stand out for a large proportion of loss-making enterprises.

Table 15.1 State-wise Number of Profit and Loss-making SPSEs

States	Number of Profit-making SPSEs	Number of Loss-making SPSEs	Number of SPSEs with Zero Profit/Loss
Non-NEH States			
Andhra Pradesh	14	5	1
Bihar	16	15	5
Chhattisgarh	10	7	0
Goa	8	8	0
Gujarat	63	30	7
Haryana	19	11	1
Jharkhand	10	3	0
Karnataka	57	56	0
Kerala	58	66	4
Madhya Pradesh	11	12	9
Maharashtra	47	45	9
Odisha	17	8	8
Punjab	11	18	1
Rajasthan	27	17	3
Tamil Nadu	54	35	0
Telangana	6	11	1
Uttar Pradesh	39	27	0
West Bengal	33	32	0
NEH States			
Assam	19	17	0
Arunachal Pradesh	1	5	0
Himachal Pradesh	13	8	0
Manipur	1	8	0
Meghalaya	3	14	2
Mizoram	1	4	0
Nagaland	1	4	0
Sikkim	11	6	0
Tripura	4	11	0
Uttarakhand	12	7	0
Total	566	490	51

Source: State Finances Audit Reports, 2024, CAG

15.12 Figure 15.4 presents the State-wise quantum of profits of profit-making SPSEs, losses of loss-making SPSEs, and net profits/ losses of all SPSEs taken together for the years for which latest finalised accounts were available during 2022-23. During the year 2022-23, a total of 490 SPSEs across States reported aggregate losses amounting to ₹1.14 lakh crore as per their latest finalised accounts, while 566 SPSEs reported combined profits of ₹43,162 crore, resulting in a net loss of ₹71,355 crore at the aggregate level.

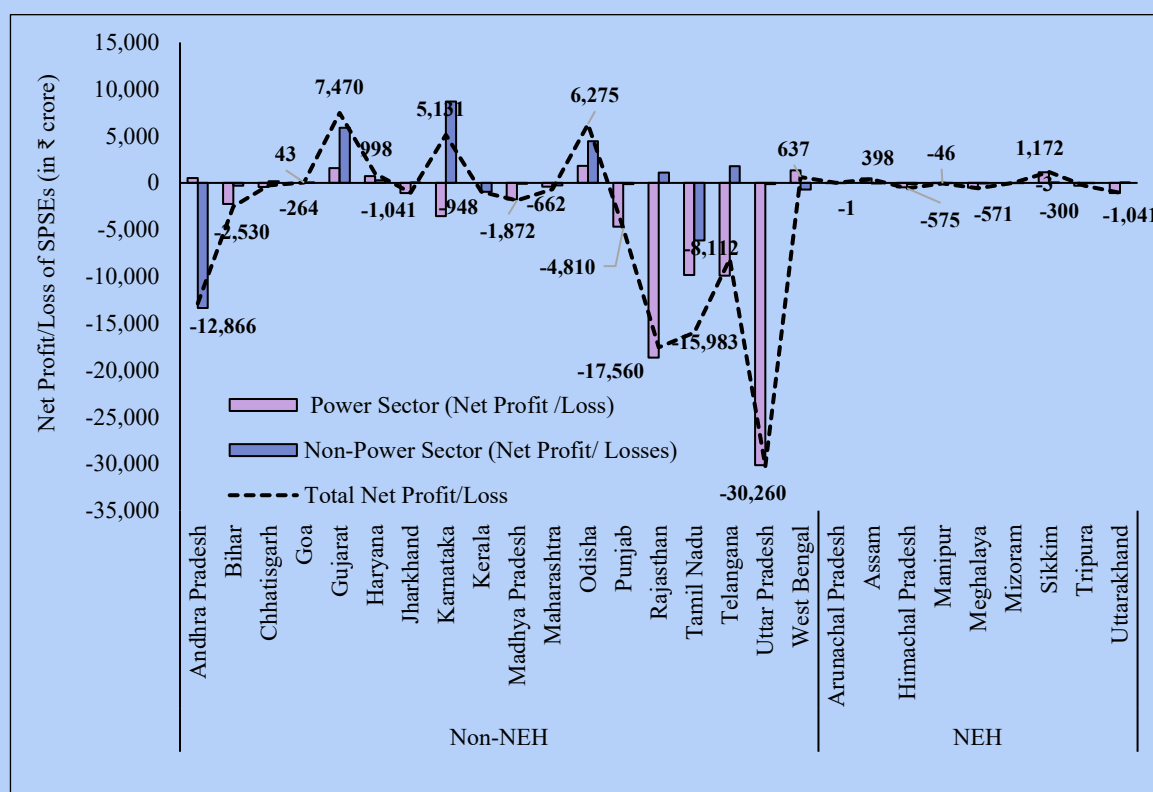
Figure 15.4 State-wise Profit and Loss of SPSEs (2022-23)

Source: State Finances Audit Reports, 2024, CAG

15.13 Among non-NEH States, the highest loss during 2022-23 was recorded by SPSEs in Uttar Pradesh (₹32,430 crore), followed by Rajasthan (₹18,814 crore), Tamil Nadu (₹16,048 crore) and Telangana (₹11,970 crore) as shown in the *Figure 15.4*. Among the NEH States, SPSEs in Uttarakhand recorded the highest losses at ₹1,273 crore, followed by those in Himachal Pradesh (₹605 crore) and Meghalaya (₹573 crore). A significant aspect of the losses incurred by SPSEs is that they are concentrated in the power sector. To underscore this point, *Figure 15.5* depicts net profits or losses of power and non-power sectors' SPSEs separately. These non-power sectors include agriculture and allied sectors, infrastructure, manufacturing, mining and quarrying and services.

15.14 State-wise top sectors with net losses and profits by SPSEs are presented in *Annexure 15.1* and *Annexure 15.2*, respectively. It is observed that power sector SPSEs are the top contributors to loss in seven out of the top ten non-NEH States with the highest net SPSE losses. Similarly, the power sector remains the highest loss-making sector in five out of ten NEH States, namely, Himachal Pradesh, Manipur, Meghalaya, Tripura and Uttarakhand. On the other hand, there are three non-NEH States, namely, Andhra Pradesh, Haryana and West Bengal, in which power sector SPSEs earned the highest profit. Among NEH States, Assam and Sikkim earned the highest profits in the power sector.

15.15 In sectors other than power, Andhra Pradesh recorded the highest loss, with one PSE accounting for majority of this loss. SPSEs in agriculture and allied sector earned the highest profits in Gujarat, Jharkhand, Maharashtra and Uttarakhand. Similarly, SPSEs in the infrastructure sector earned the highest profits in Bihar, Goa, Himachal Pradesh, Karnataka, Manipur, Punjab.

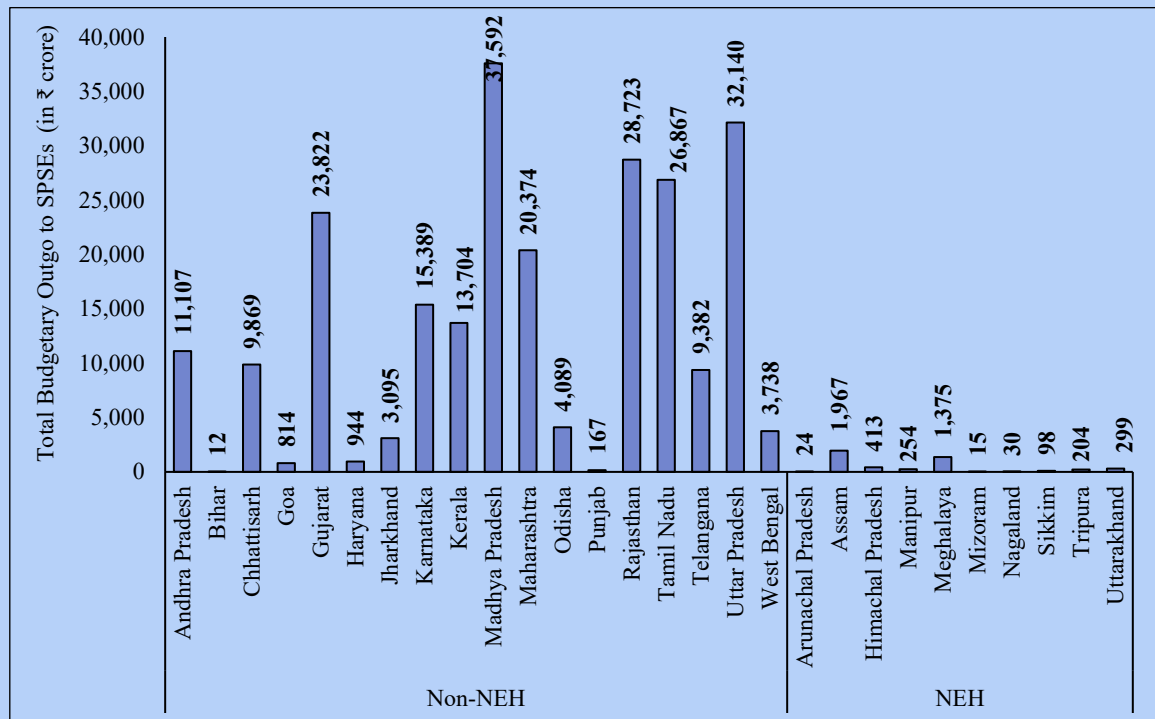
Figure 15.5 Net Profit/ Loss of SPSEs in Power and Non-power Sectors

Source: Data received from CAG.

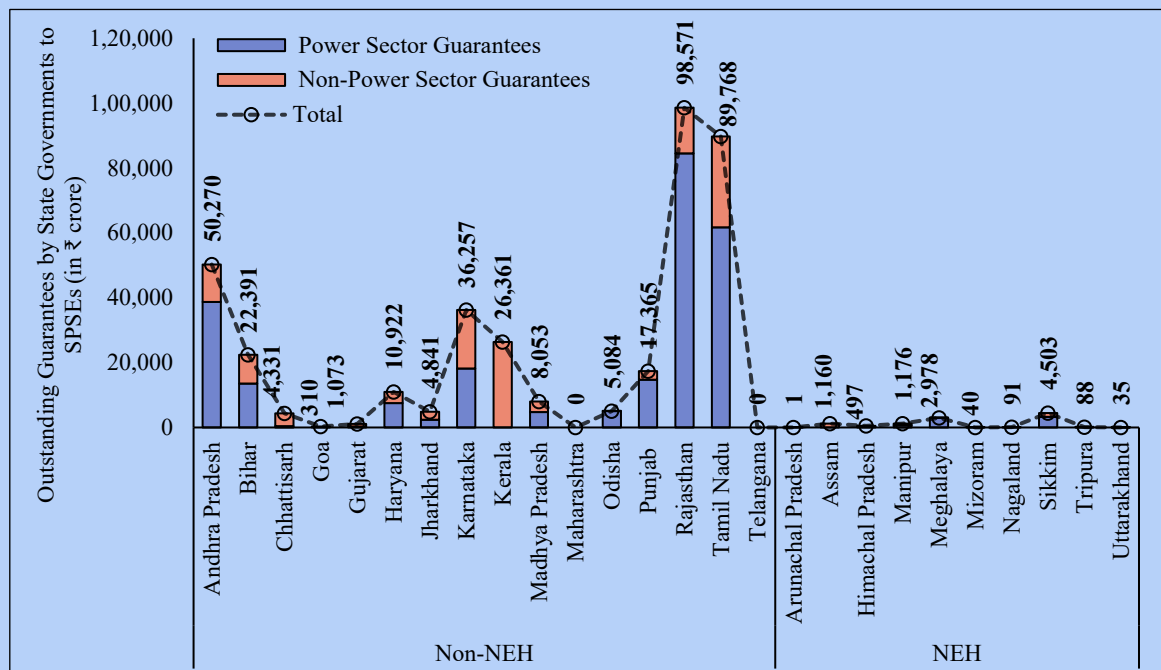
Note: Net Profit/Loss data for SPSEs in the power and non-power sector relate to the year for which latest finalised accounts are available during 2022-23 (1996-2022). Data is not available for Nagaland for 2022-23.

15.16 The poor financial performance of SPSEs becomes a burden on State budgets, resulting in budgetary expenditures in the form of subsidies, grants, equity investments, and loans. Apart from these budgetary expenditures, State Governments also provide guarantees against the loans raised by the SPSEs. The financial support extended by State Governments to SPSEs in the form of equity, loans, and grants/subsidies through the budget during the year 2022-23 amounted to ₹2.5 lakh crore. *Figure 15.6* shows State-wise budgetary outgo to SPSEs for the year 2022-23. In the total budgetary outgo to SPSEs, the subsidies and grants component constituted almost 90 per cent of the total outgo. The composition of this State-wise outgo during 2022-23 is given in *Annexure 15.3*. It is also worth noting that some States resort to off-budgetary measures to provide support to SPSEs.

15.17 *Figure 15.7* shows the quantum of outstanding guarantees issued by the State Governments to the power and non-power sector SPSEs till 2022-23. The highest volume of outstanding guarantees across all States is issued to the power sector.

Figure 15.6 State-wise Budgetary Outgo to SPSEs

Source: State Finances Audit Reports, 2024, CAG.

Figure 15.7 Outstanding Guarantees Issued to SPSEs by State Governments till 2022-23

Source: Data received from CAG.

Views of Past Finance Commissions

15.18 Various Finance Commissions (FCs) in the past have recognised and reiterated the need to review SPSE performance and undertake reform measures to enhance public sector enterprise (PSE) efficiency. As far back as 1978, FC-7 had called for the need to improve the financial health and accountability of PSEs. FCs ranging from FC-7 to FC-14 made several key observations and recommendations for SPSEs. These recommendations include ensuring that SPSEs at least cover their operating costs, maintain proforma commercial accounts to enhance cost efficiency and improve their financial sustainability. FCs in past emphasised structural reforms, such as restructuring of SPSEs - particularly of electricity boards and transport undertakings. FCs have also recommended rationalising of subsidies, merging of similar PSEs and downsizing through measures like the Voluntary Retirement Scheme, among others.

Central Public Sector Enterprises

15.19 We next turn to a brief empirical analysis of CPSEs. For CPSEs, the annual Public Enterprises Survey (PES) reports, published by the Department of Public Enterprises (DPE) provide a comprehensive picture of approximately 80 per cent of GCs, three out of the six SCs (namely Airport Authority of India, Food Corporation of India, and Central Warehousing Corporation), and 12 GCOCs. However, we continue to rely on CAG data for this analysis which has a more exhaustive coverage of CPSEs and allow us to maintain consistency with our analysis of SPSEs.

Table 15.2 Category-wise Number of CPSEs

Category of CPSEs	Number of CPSEs			
	2020-21	2021-22	2022-23	2023-24
Statutory Corporations (SCs)	6	6	6	6
Government Companies (GCs)	506	490	501	527
Government Controlled Other Companies (GCOCs)	205	202	209	215
Total Number of CPSEs	717	698	716	748

Source: General Purpose Financial Reports of CPSEs (Compliance Audit), CAG, various years, and data provided to FC-16 by CAG

Note: Number of CPSEs indicate those existing as on 31 March of the particular year.

15.20 Table 15.2 presents the number of CPSEs in the three categories identified earlier. The total number of CPSEs in all three categories combined fluctuated between 698 and 748 over the 2020-21 to 2023-24 period. In 2023-24, the latest year for which data is available, 70.5 per cent of the CPSEs are GCs. The six statutory companies under audit by the CAG include the Airport Authority of India (AAI), Central Warehousing Corporation (CWC), Damodar Valley Corporation (DVC), Food Corporation of India (FCI), Inland Waterways Authority of India (IWAI), and National Highway Authority of India (NHAI). The number of GCOCs is large, accounting for more than a quarter of all CPSEs.

15.21 Out of the total number of existing CPSEs, about 88-92 per cent of CPSEs submitted their financial statements to CAG for audit purposes during 2021-22 to 2023-24. Reasons why CAG did not receive the remaining financial statements vary. In some cases, accounts were in arrears for three or more years; in other cases, the companies were under liquidation, or the first accounts were not yet due. Table 15.3 provides the number of CPSEs that submitted their financial statements to CAG for audit purposes during the years 2020-21 to 2023-24. They account for around 90 per cent of all CPSEs in the country. As data is available only for these CPSEs, our analysis is limited to these companies.

Table 15.3 Category-wise Number of CPSEs for which Financial Data is Available

Category of CPSEs	Number of CPSEs			
	2020-21	2021-22	2022-23	2023-24
Statutory Corporations (SCs)	6 (100%)	6 (100%)	6 (100%)	6 (100%)
Government Companies (GCs)	447 (88%)	448 (91%)	463 (92%)	490 (93%)
Government Controlled Other Companies (GCOCs)	180 (88%)	188 (93%)	186 (89%)	192 (89%)
Total Number of CPSEs	633 (88%)	642 (92%)	655 (91%)	688 (92%)

Source: CAG

Note: The numbers in parentheses are CPSEs for which financial data is available as a percentage of total CPSEs in the category and year shown.

15.22 Table 15.4 provides some basic financial data available on these CPSEs from 2020-21 to 2023-24. The total equity in CPSEs, as measured by paid-up capital, was ₹7.5 lakh crore in 2020-21, which doubled to ₹15.1 lakh crore in 2023-24. As a percentage of GDP, this equity

amounted to 3.8 per cent in 2020-21 and 5 per cent in 2023-24. Of this total equity, the Union Government contributed 2.6 per cent of GDP in 2020-21 and 4 per cent of GDP in 2023-24, with the State Governments and other entities contributing the remainder. The turnover of these enterprises was between 12.2 per cent and 13.9 per cent of GDP during the four years.

Table 15.4 Financial Data of CPSEs (₹ crore)

Particulars	2020-21	2021-22	2022-23	2023-24
Paid-up Capital / Total Equity	7,53,929	8,81,681	12,08,230	15,13,552
Central Government Equity	5,12,850	6,37,036	9,25,085	11,94,715
State Government Equity	34,744	38,861	43,363	46,863
Others' Equity	2,06,335	2,05,784	2,39,782	2,71,974
Total Paid-up Capital as percentage of GDP	3.8	3.7	4.5	5.0
Central Govt. Equity as percentage of GDP	2.6	2.7	3.4	4.0
Turnover of all CPSEs	24,26,562	32,85,208	35,38,135	37,28,960
Turnover as percentage of GDP	12.2	13.9	13.2	12.4

Source: General Purpose Financial Reports of CPSEs, various years and data provided by CAG

15.23 Next, we consider the profitability of CPSEs, a key indicator of economic performance. The number of profit-making CPSEs increased from 371 (58.6 per cent of a total of 633 CPSEs) in 2020-21 to 445 (64.7 per cent of 688 CPSEs) in 2023-24, as can be seen in *Table 15.5*. Examining the quantum of profits, it is evident that the total amount of profits earned by profit-making CPSEs increased significantly from ₹2.1 lakh crore in 2020-21 to ₹3.8 lakh crore in 2023-24. However, a significant number of CPSEs have also incurred losses. The number of loss-making CPSEs varied from 226 to 234 during the last four years, with the quantum of loss also varying. Of the four years, the highest amount of combined loss was incurred during 2022-23, amounting to ₹51,419 crore by 232 enterprises, which fell to ₹36,213 crore incurred jointly by 226 enterprises during 2023-24. The high number of loss-making CPSEs and the substantial quantum of total loss remain serious concerns.

15.24 A small fraction of CPSEs report zero profit or loss. The number of these enterprises decreased from 28 in 2020-21 to 13 in 2022-23 but then rose again to 17 in 2023-24. Taken as

a whole, CPSEs have earned a significant volume of profits in each of the four years shown. All CPSEs (for which financial data is available) combined earned a net profit of ₹3.5 lakh crore during the year 2023-24, significantly higher than ₹1.6 lakh crore earned during the COVID-19 year of 2020-21.

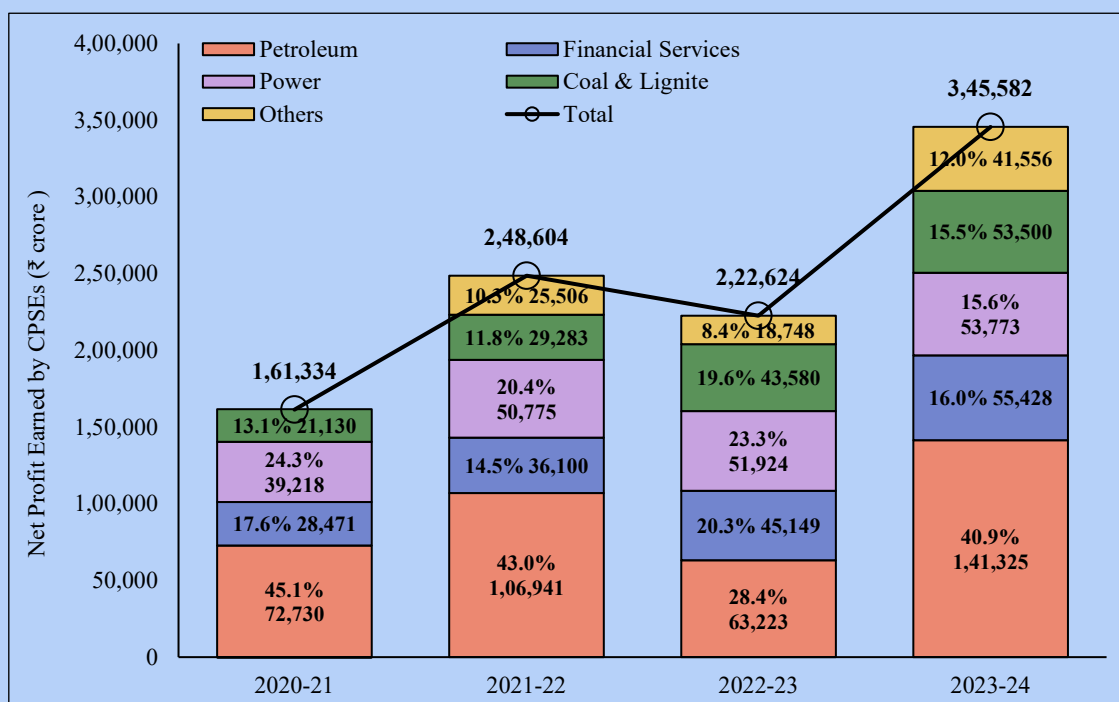
Table 15.5 Profit Earned and Loss Incurred by CPSEs

Particulars	2020-21	2021-22	2022-23	2023-24
Number of Profit-Making CPSEs	371	387	410	445
Profits of Profit-Making CPSEs (₹ crore)	2,06,588	2,84,319	2,74,043	3,81,794
Number of Loss-Making CPSEs	234	228	232	226
Loss of Loss-Making CPSEs (₹ crore)	45,254	35,715	51,419	36,213
Number of CPSEs with Zero Profit/Loss	28	27	13	17
Total Net Profit (+) / Loss (-) (₹ crore)	1,61,334	2,48,604	2,22,624	3,45,582

Source: General Purpose Financial Reports of CPSEs and data provided by CAG.

15.25 We next consider the performance of CPSEs by sector. Data show that the four top profit-earning CPSE sectors are petroleum, power, finance and coal. Together, they account for approximately 90 per cent of the total net profits of CPSEs. Petroleum sector CPSEs have earned the highest proportion of net profits across years, ranging from 28 per cent to 45 per cent of total net profits by all CPSEs during the period from 2020-21 to 2023-24. As a corollary, CPSEs in all other sectors (other than the top four sectors) collectively earned only 8-12 per cent of net profits during 2021-22 to 2023-24. The sector-wise net profits earned by CPSEs during 2020-21 to 2023-24 are given in *Figure 15.8*.

15.26 Turning to the distribution of profits and losses across enterprises, in the last three consecutive years for which we have CAG data, Oil and Natural Gas Corporation (ONGC) has been at the top of the profit-making CPSEs list. ONGC contributed about 14 per cent of the total profits earned by all profit-making CPSEs. The quantum of profits earned by the top ten profit-making CPSEs is given in *Annexure 15.4*.

Figure 15.8 Sectoral Distribution of Net Profits of CPSEs

Source: Data provided by CAG for various years.

15.27 FC-13 had recommended that the profit-making PSEs pay a minimum amount of dividend to the Government. In 2016, a detailed guideline was issued by the Union for CPSEs to pay dividends to the tune of 30 per cent of their Profits after tax (PAT) or 5 per cent of their net worth, whichever is higher. In 2023-24, the quantum of dividends paid by CPSEs was ₹1.3 lakh crore, up from ₹82,815 crore in 2020-21, as shown in *Table 15.6* below.

Table 15.6 Dividends Paid by CPSEs

Particulars	2020-21	2021-22	2022-23	2023-24
Total Profits of Profit-Making CPSEs (₹ crore)	2,06,588	2,84,319	2,74,043	3,81,794
Dividend Paid by CPSEs (₹ crore)	82,815	1,15,629	1,15,458	1,34,019
Dividend as percentage of Profits	40.1	40.7	42.1	35.1
Non-Tax Revenue (NTR) of Union Government (₹ crore)	2,07,633	3,65,112	2,85,421	4,01,785
Dividend paid by CPSEs as percentage of NTR of Union Government	39.9	31.7	40.5	33.4

Source: General Purpose Financial Reports of CPSEs for various years, data provided by CAG, and Union Budgets.

Note: Dividend paid by CPSEs include those paid to Union Government and to other shareholders of CPSEs.

15.28 As can be discerned from *Table 15.6*, the dividend paid by CPSEs increased by 61.8 per cent between 2020-21 and 2023-24. The corresponding increase in the profits of profit-making CPSEs was larger at 84.8 per cent during this period. The implication is that the dividend as a proportion of profits of profit-making CPSEs fell from 40.1 per cent during 2020-21 to 35.1 per cent during 2023-24. A final point is that dividends account for a significant proportion of the Union Government's non-tax revenue (NTR). During the four years shown here, the proportion of dividends paid by CPSEs varied from 31.7 per cent to 40.5 per cent of NTR.

15.29 The need to ensure reasonable returns on investment by the government in PSEs has been consistently recommended by the last five FCs. They have expressed disappointment at the substantial funds invested in PSEs and the low returns they have yielded. Additionally, PSEs often occupy several times the land they use for their production activity, which remains underproductive. Many CPSEs also remain inactive or in perpetual loss. The land they occupy remains unused or underused. Given the high opportunity cost of land in areas where these CPSEs are often located, bringing the land they occupy into productive use is likely to yield a high return.

The Way Forward

15.30 Our analysis in this chapter shows that there is considerable scope for undertaking PSE reforms to leverage their contribution to India's economy. In absence of such reforms, with high losses and valuable asset lock-ins, especially land, PSEs burden the State exchequer.

Closure of Inactive PSEs

15.31 Out of a total of 1,635 SPSEs, 308 are currently inactive or have ceased to carry out their operations. This calls for an evaluation of performance and closure of such inactive SPSEs to reduce the fiscal strain, since many of them continue to receive budgetary support from State Governments.

15.32 Similarly, the Public Enterprise Survey 2023-24 (Appendix VIII, pp. 271-2) lists 17 CPSEs under liquidation, 24 CPSEs approved for closure by the government and 31 CPSEs that are non-operational. The land and buildings owned by these CPSEs are valuable assets that can be deployed in alternative productive uses.

PSEs Incurring Losses

15.33 Another important issue surrounding both CPSEs and SPSEs is the large number of loss-making units, and the large volume of losses incurred by them. Out of 1,107 SPSEs for which data on profit and loss are available, 490 SPSEs incurred losses amounting to a total of ₹1.14 lakh crore as per their latest finalised accounts as on 31 March 2023. Like inactive SPSEs, there is a need for stricter scrutiny of loss-making SPSEs. One rule of thumb worth considering is for the concerned department to mandatorily take to the Cabinet any enterprise incurring losses in three out of four consecutive years for consideration for closure, privatization or continuation. The Cabinet may then decide, depending on the strategic importance of the enterprise.

15.34 Almost one third of CAG-audited CPSEs incurred losses in each of the years between 2020-21 to 2023-24. The losses of the loss-making CPSEs, as per CAG data, varied from ₹36,213 crore to ₹51,419 crore over this period. There also exist multiple CPSEs that remain persistently in losses for several years, with their burden falling on the exchequer and ultimately on the taxpayers. The most visible case of persistently loss-making PSEs in recent years was that of Air India. Its accumulated losses at the time of its privatization in January 2022 were reported to exceed ₹85,000 crore. Of the 58 loss-making CPSEs that PES 2023-24 (Statement C, pp. 136-8) lists, as many as 28 incurred losses in every one of the three years of 2021-22, 2022-23, and 2023-24.

Power Sector SPSEs

15.35 Power sector SPSEs, primarily DISCOMs, account for the highest proportion of losses incurred by SPSEs in the States. This issue has been taken up in detail in chapter 13 of our report.

Accounts in Arrears

15.36 A common issue we observed across all twenty-eight States is that many SPSEs persistently had accounts in arrears for multiple years. As a result of various delays, 7,162 accounts of 1,237 SPSEs were in arrears as on 31 March 2023. At least 441 SPSEs had their accounts in arrears for more than 3 years. State-wise details of SPSEs with accounts in arrears are given in *Annexure 15.5*. In the absence of finalised accounts, State Government's investments in such SPSEs remain outside the oversight of the State legislature. We observed in State after State that non-finalisation of accounts is one of the major problems in the closure of SPSEs that have no record of a positive contribution to the economy. Each State needs to make a concerted effort to ensure that all accounts in arrears are finalized. This effort in turn will enable their audit by CAG and the assessment of such SPSEs for continuation, closure or privatisation as soon as possible. Without such an effort, the problem of defunct and burdensome SPSEs will persist, wasting valuable taxpayers' money.

Privatisation of SPSEs

15.37 So far, the idea of State-level privatisation of SPSEs has not received any attention beyond electricity DISCOMs in the States. Even the subject of closure of SPSEs in perpetual losses has received limited attention. The issue of inactive and underperforming SPSEs has been a recurring theme of successive FCs. During our State-visits, many State Governments shared their visions for becoming developed States. A State-level policy, similar to the Union's New Public Sector Enterprise Policy, must be an integral part of this vision.

□□□

Union Finances During the Award Period: An Assessment

1. While we acknowledge the role played by centrally sponsored schemes, we feel that there is a need to rationalize their structure by linking the implementation with measurable, real-time output indicators for efficient use of resources. The Union Government should appoint a high-powered committee that does a fresh assessment of the schemes and recommends closure of the schemes that are not spending resources productively.

(paragraphs 6.40 and 6.41)

Sharing of Tax Revenues: Vertical Devolution

2. In order to bring in more transparency about the divisible pool and the actual devolution, we recommend that, every year, the Union Government disclose the data pertaining to net proceeds as certified by CAG under Article 279.

(paragraph 7.30)

3. We recommend that the States' share in the divisible pool is retained at 41 per cent.

(paragraph 7.68)

Sharing of Tax Revenues: Horizontal Devolution

4. To determine the inter se share of States, we relied on population, demographic performance, area, forest, per-capita-income-distance and contribution of the State to Gross Domestic Product (GDP) as criteria. The formula for horizontal devolution and weights assigned to various criteria are given in *Table 8.8*. The shares of States in horizontal devolution for our award period are given in *Table 8.9*.

(paragraph 8.97)

Assessment of States and Grants-in-Aid

5. Our assessment of State finances reveals that the cause of revenue deficit of States lie in committed expenditures and discretionary expenditures and there is significant scope to increase revenues and rationalise expenditures. The anticipation of revenue deficit grants by States weakens the incentive to undertake difficult but necessary fiscal reforms such as rationalizing subsidies, improving tax administration, or curbing revenue expenditures. In continuation of the diminishing trend of the revenue deficit grants recommended by FC-15, which reduce to near-zero level by 2025-26, we do not recommend revenue deficit grants to States. We also do not recommend any sector-specific or State-specific grants.

(paragraphs 9.48 to 9.50)

Local Body Grants

6. We recommend that the States should develop a citizen friendly GIS based property tax IT system for efficient enumeration, assessment and collection of property tax.

(paragraph 10.67)

7. We recommend extending the Urban Data platform's capabilities to support ULBs in preparing accounts and financial reports.

(paragraph 10.71)

8. The existing arrangements for Technical Guidance and Supervision by the CAG should be continued and strengthened to improve the quality of audit and accounts of local bodies in the States. State Governments should augment the capabilities of their Local Fund Audit Departments (LFADs) by investing in skill development and addressing manpower shortages.

(paragraph 10.74)

9. The States should transparently report all transfers to local bodies, including those from the Consolidated Fund of India on the recommendation of the Finance Commission, transfers under centrally sponsored schemes, State Finance Commission grants and other grants from the State Government, separately for ULBs and RLBs in their budgets. These transfers, with all their components, should also be reported in Appendix III of the State Finance Accounts.

(paragraph 10.78)

10. In Articles 280(3)(bb) and 280(3)(c), the Constitution directs the FC to make its recommendations on RLBs and ULBs 'on the basis of the recommendations made by the Finance Commission of the States.' We recommend that the above-quoted expression be dropped from the relevant articles through a Constitutional amendment.

(paragraph 10.81)

11. We recommend that NITI Aayog may study the functioning of SFCs across States and may publish a compendium of the good practices of the SFCs for the reference of all the States.

(paragraph 10.81)

12. We recommend that the grants for RLBs be classified into basic and performance components and the grants for ULBs be classified into basic, performance, urban infrastructure and urbanisation premium components. The aggregate national grant allocation for basic and performance components, put together has been divided in the ratio of 60:40 between RLBs and ULBs. Inter se, the division between basic and performance components is recommended in the ratio of 80:20 for both RLBs and ULBs.

(paragraphs 10.83 and 10.84)

13. A total allocation of ₹7,91,493 crore as grants has been recommended for duly constituted RLBs and ULBs for our award period spanning from 2026-27 to 2030-31.

(paragraph 10.84)

14. For RLBs, inter-State distribution is based on a 90:10 ratio of projected rural population (2026) and area, respectively. For ULBs, the States' share has been determined by a 90:10 ratio of projected urban population (2026) and the OSR of ULBs, respectively.

(paragraphs 10.86 and 10.89)

15. Within each State, the distribution of grants to duly constituted RLBs of all tiers and to duly constituted ULBs may be undertaken as per the latest accepted recommendations of the respective SFCs. In the absence of the SFC's recommendations, the tier wise distribution to RLBs may be in conformity with the prescribed percentages. Within a tier of RLB, the distribution may be as per the latest accepted SFC recommendations or in the absence of SFC recommendations based on population and area in the ratio 90:10. For ULBs, the distribution may be as per the latest accepted SFCs recommendations or in the absence of SFC's recommendations, based on urban population and OSR of ULBs in the 90:10 ratio.

(paragraphs 10.87, 10.88 and 10.90)

16. The concerned State Government shall make allocations for exempted areas on par with the Commission's recommendations with respect to local bodies.

(paragraph 10.91)

17. There should be a duly constituted body in place as required in Part IX and Part IX-A of the Constitution to claim local body grants. This would be the first entry level condition.

(paragraph 10.92)

18. Online availability in public domain in year T of audited accounts for all ULBs and RLBs of a State for the T-2 fiscal year and provisional accounts for the T-1 year would be the second entry-level condition to avail local body grants for the year T.

(paragraph 10.93)

19. All States must comply with the Constitutional provisions pertaining to the regular constitution of SFCs due as per the Constitutional provision, that is, on expiry of five years of constitution of previous SFC and ensure laying of ATRs in the State legislature within 6 months of submission of the SFC report as a prerequisite to claim their local body grant. This would be the third entry level condition to claim local body grants from the first year of the award period, that is from 2026-27.

(paragraph 10.95)

20. The ULB and RLB grant has been divided into basic (80 per cent) and performance (20 per cent) components, with the latter divided into two equal halves: RLB/ULB performance component and State performance component. The basic component may be made available to the States upon fulfilment of the three entry-level (eligibility) conditions.

(paragraph 10.96)

21. For Gram Panchayats to receive the RLB performance component of the RLB grant in fiscal year T, we recommend that Gram Panchayats raise, in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower, subject to a minimum amount of ₹1200 per household per annum. This will be applicable from the third year of the award period, that is, 2028-29 onwards.

(paragraph 10.97)

22. For Block Panchayats, we recommend that they qualify for the RLB performance component of the RLB grant if 75 per cent of Gram Panchayats within their jurisdiction qualify for it. For District Panchayats, we recommend that to qualify for the grant in year T, District Panchayats raise, in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower. Both of these will be applicable from the third year of the award period, that is, 2028-29 onwards.

(paragraph 10.98)

23. For ULBs to qualify for the ULB performance component grant in year T, we recommend it raise in year T-1, minimum 1.05 times its OSR in year T-2 or 5 per cent per annum compounded growth applied over OSR of 2025-26, whichever is lower. This will be applicable from the second year of the award period, that is, 2027-28 onwards.

(paragraph 10.99)

24. We recommend that the release of State performance components of the RLB and ULB grants in year T be contingent upon the State transferring from its own resources, in the year T-1, grants to local bodies amounting to 20 per cent or more of the basic FC grant recommended by us for the year T-1, starting from the second year.

(paragraph 10.100)

25. If any of the performance conditionalities goes unfulfilled, the undisbursed portion of a State's local body performance grants would be disbursed according to the prescribed methodology.

(paragraph 10.101)

26. Ministry of Housing and Urban Affairs and Ministry of Panchayati Raj can work towards conceptualising and rolling out a Learning Management System for the functionaries and staff of local bodies so that the functionaries in the local bodies are geared up to meet the present-day challenges.

(paragraph 10.103)

27. 50 per cent of the basic component should be tied and the remaining 50 per cent of the basic component and the entire performance components should remain untied. The tied component should be directed towards 'Sanitation and Solid Waste Management' and/or 'Water Management'.

(paragraph 10.107)

28. We recommend that no local body should be allowed to spend more than 20 per cent of the untied allocation on the construction and maintenance of roads. Moreover, the untied grants should not be used for the payment of salaries or other establishment-related expenditure.

(paragraph 10.109)

29. The practice of publishing Service Level Benchmarks should be continued and extended to all ULBs along with introduction of a third-party assessment or audit mechanism in the system to enhance the reliability of the self-reported figures.

(paragraph 10.110)

30. MoPR and MoHUA should organize regional workshops to familiarize States with the Commission's recommendations, the operational guidelines, the modalities to be followed for compliance and the process of claiming grants, with special focus on the North Eastern States.

(paragraph 10.111)

31. The total quantum of urbanisation premium, for incentivising rural to urban transitions, to be ₹10,000 crore for the complete award period with a fixed per capita one-time eligibility amount to be ₹2,000 per person (based on Census 2011 population). The release of urbanisation premium component should be claimed by the State on mergers of peri-urban villages into adjoining larger ULB with existing population not less than One lakh and formulation of an appropriate Rural to Urban transition policy.

(paragraphs 10.113 and 10.114)

32. A Special Infrastructure Component for selected ULBs with the outlay of ₹56,100 crore to facilitate decisive intervention in comprehensive wastewater management in urban growth centres.

(paragraph 10.117)

33. The local body grants shall continue to be released in minimum two equal instalments each year, consistent with the existing practice and subject to the fulfilment of the conditions stipulated by the Commission.

(paragraph 10.121)

34. The Union Government should ensure that where a set of local bodies within the State meet the conditions, the grants due to them are released without waiting for the rest.

(paragraph 10.122)

35. State Governments should ensure the transfer of the grants-in-aid to their respective local bodies within ten working days of their receipt from the Union Government. Any delay in this transfer beyond the stipulated ten working days shall obligate the State Governments to release the funds along with interest, calculated at the effective rate of interest applicable to market borrowings/State Development Loans for the preceding financial year.

(paragraph 10.123)

36. No further conditions, other than those explicitly indicated in this chapter, should be imposed either by the Union Government or the State Governments for the release of local body grants to the ULBs and RLBs.

(paragraph 10.124)

Financing of Disaster Management

37. The allocation of disaster management funds for the States is based on past expenditures and Disaster Risk Index (Hazard, Exposure and Vulnerability). A total corpus of ₹2,04,401 crore has been recommended for SDRF and SDMF together, for the award period from 2026-27 to 2030-31. The State-wise allocations are provided in *Annexures 11.3 and 11.4*

(paragraph 11.53 and 11.54)

38. The corpus should be divided between the SDRF and SDMF in the ratio of 80:20. The SDRF allocation is ₹1,63,521 crore and that of SDMF is ₹40,880 crore. Under SDRF there should be flexibility for reallocation between Response and Relief and Recovery and Reconstruction. Preparedness and Capacity Building will now fall under SDMF and NDMF.

(paragraph 11.55 and 11.56)

39. The accumulating balance under SDRF should be limited to the extent that if the unspent balance under SDRF exceeds the sum of past three years annual allocation of SDRF, further

releases may be temporarily withheld. The funds withheld will be released if the States' balances reduce below the threshold of past three years annual allocation.

(paragraph 11.58)

40. The total allocation of ₹79,406 crore is recommended based upon past expenditures for disaster management at the national level (for NDRF and NDMF).

(paragraph 11.59 and 11.60)

41. States are to contribute 25 per cent of the funds of SDRF and SDMF except the NEH States which shall contribute 10 per cent, and the rest is to be provided by the Union Government. The total share of Union Government works out to ₹ 1,55,915.85 crore.

(paragraph 11.61)

42. The graded cost sharing of central assistance through the NDRF (except Response and Relief) and NDMF should be maintained. States are to contribute 10 per cent for assistance up to ₹250 crore, 20 per cent for assistance up to ₹500 crore and 25 per cent for all assistance exceeding ₹500 crore. However, NEH States should contribute 10 per cent of all central assistance under NDRF and NDMF.

(paragraph 11.62)

43. The norms of assistance should be revised periodically by the Ministry of Home affairs in line with existing practice.

(paragraph 11.63)

44. Heatwave and Lightning should be added to the list of notified disasters at the National level.

(paragraph 11.73)

45. The National Disaster Management Information System (NDMIS) should be transformed into a comprehensive disaster management system for both the Union and the States. The system should capture real-time transaction-level disaster data, serving as a single source for disaster information, and minimizing the compliance burden on States

(paragraph 11.85)

46. Complete feeding and validation of data in NDMIS portal (for a Financial Year by the 31 May of the succeeding year) will be a necessary condition for States to avail the Disaster Management Grant from the second year of the award period, that is 2027-28.

(paragraph 11.85)

47. MHA and States should collaborate to enhance the utility of NDMIS by making it the

primary medium for States to submit their memorandum using standardised forms in the event of disasters and for subsequent release of funds by the Union Government to the States.

(paragraph 11.86)

48. Commission recommends that the existing MHA norms pertaining to the booking of disaster-related expenditure and investment should be strictly adhered to, with compliance regularly audited by the CAG.

(paragraph 11.87)

The Path to Macro and Fiscal Stability

49. We recommend that States' fiscal deficits continue to be capped at 3 per cent of their respective GSDP. To ensure the stability of State Government debt, this limit should be strictly enforced in accordance with clause (3) of Article 293 of the Constitution. It is assumed that on-lending by the Union Government under SASCI will be over and above this limit, as is currently the practice. The Union Government should reduce its fiscal deficit to 3.5 per cent of GDP by the end of the award period.

(paragraphs 12.9 and 12.10)

50. States should completely discontinue the practice of incurring off-budget borrowings and bring all such borrowings onto their budgets. If, for any reason, off-budget borrowings are undertaken, there should be a framework for regular annual reporting, preferably as part of the budget. A suggested format, as in *Annexure 12.1*, may be adopted for this purpose. The CAG should include disclosure in this format in the State Finance Accounts.

(paragraphs 12.22 and 12.23)

51. Lending institutions are also in a position to provide an alternative source of data to strengthen the reporting framework for off-budget borrowing. We recommend that a framework should be put in place under which lending institutions periodically report the loans extended to State-owned entities where the government has the commitment to provide assistance for debt servicing.

(paragraph 12.24)

52. There are inconsistencies and lack of uniformity in coverage in the existing FRL framework of the States. We recommend that governments take necessary action to amend FRLs in line with the fiscal consolidation roadmap recommended by us. FRBM Acts should require governments to report to the legislature if the deficit or debt limits prescribed under the legislative framework are breached. We also recommend expanding the definition of fiscal deficit and debt to uniformly include all off-budget borrowings.

(paragraph 12.32)

53. The mechanism under Article 293(3) of the Constitution mandates that States obtain the Union's consent before borrowing against the security of their Consolidated Funds, as long as they have any outstanding loans from the Union Government. This mechanism has been

extremely useful for effective fiscal management. We recommend that this Constitutional provision continue to be used to ensure that the States' borrowings adhere to the recommended fiscal roadmap.

(paragraph 12.33)

54. There have been instances where States have breached borrowing limits, mainly due to inaccurate assessments of financing from their Public Accounts. We recommend that mechanisms be instituted to estimate the financing of the fiscal deficit from the Public Account as accurately as possible, so that the fiscal deficit limit can be enforced effectively.

(paragraph 12.34)

55. For determining yearly borrowing limits, we recommend that the practice of estimating GSDP by applying the annual average growth rate of the actual GSDP observed during the latest three years for which actual GSDP data are available, should be continued.

(paragraph 12.36)

56. To smooth out its debt redemption profile, the Union Government has been following strategies such as switch auctions and buybacks. We recommend that States also actively explore adopting similar strategies to manage their redemption pressures in specific years.

(paragraph 12.45)

Reforms in the Power Sector

57. States should actively pursue privatization of DISCOMs. To shield the private investor from the accumulated debt burden after DISCOM takeover, a special purpose vehicle may be created by States to warehouse the accumulated debt. To incentivise States towards this move, the Union Government should make the prepayment or eventual repayment of this debt by the State an eligible component for assistance under the special incentive scheme for capital investment (SASCI), but only after the privatization process is complete.

(paragraphs 13.61 to 13.64)

58. While privatization of DISCOMs provides a more definitive and sustainable solution to the repeated cycles of debt and bailout, if a solution is sought within the public ownership framework, the States should adopt the best practices of Gujarat and Haryana which are worth emulating.

(paragraph 13.65)

Containing and Making Subsidies Efficient

59. We recognise that the revenue balance in several States has turned negative while many of them are also rolling out large-scale transfer schemes concomitantly. Borrowing for expenditure on schemes of subsidies and transfers is not sound fiscal policy. The recent acceleration in the growth of subsidies and transfers needs to be reversed. Therefore, we recommend that States take steps to review and rationalise their schemes of subsidies and retain only those schemes that target the poor effectively.

(paragraph 14.52)

60. Many subsidy schemes, especially those providing unconditional transfers, tend to have large and untargeted beneficiary bases. We recommend that governments take immediate measures to rationalise the beneficiary base by having clearly defined exclusion criteria and a rigorous review process to ensure that benefits reach the most vulnerable. They should ensure that, through the rationalisation of schemes and the beneficiary base, the revenue deficit is reduced and eventually eliminated.

(paragraph 14.53)

61. We recommend that governments establish mechanisms to review subsidies and transfers and include a sunset or exit clause in their implementation mechanisms. Resorting to financing of subsidies and transfers through off-budget borrowings, guarantees, or assignment of revenues is fiscally imprudent and induces opacity in their accounting. We recommend that such practices of off-budget borrowings for financing of subsidies be discontinued, and necessary measures may be taken to discourage them.

(paragraph 14.54)

62. We find that at present there is lack of uniformity in accounting and disclosure of subsidies and transfers across States. Therefore, we recommend that the CAG review the current practices followed in the disclosure of such expenditure items in different States and ensure that expenditures constituting subsidies and transfers are comprehensively covered in the Appendix of Finance Accounts, irrespective of how governments classify them.

(paragraph 14.55)

Public Sector Enterprise Reforms

63. Performance of various Public Sector Enterprises (PSEs) should be evaluated by the Union and State Governments, and PSE reforms should be undertaken to leverage their contribution to Indian economy.

(paragraph 15.30)

64. Inactive PSEs should be considered for immediate closure to reduce fiscal strain on Union and State Governments. The land and buildings owned by inactive PSEs are valuable assets that can be deployed in alternative productive uses.

(paragraphs 15.31 and 15.32)

65. The concerned department of Union Government and of State Governments should mandatorily take up any PSE incurring losses in three out of four consecutive years to the Cabinet for consideration for closure, privatization or continuation. The Cabinet may then decide the appropriate action, depending on the strategic importance of the enterprise.

(paragraph 15.33)

66. Each State should make a concerted effort to ensure that all accounts in arrears of State Public Sector Enterprises (SPSEs) are finalized. This effort, in turn, will enable their audit by

CAG and the assessment of such SPSEs for continuation, closure, or privatisation as soon as possible.

(paragraph 15.36)

67. We believe that the idea of State-level privatisation of SPSEs needs to be given more attention. Therefore, the States should consider to make a State-level policy, similar to the Union's New Public Sector Enterprise Policy.

(paragraph 15.37)



Arvind Panagariya
Chairman



Annie George Mathew
Member



Manoj Panda
Member



T Rabi Sankar
Member (Part-time)



Soumya Kanti Ghosh
Member (Part-time)

New Delhi
10 November 2025

Finance Commission reports are seen as the documents of their chairmen. I must confess upfront that such is not the case with this report. The Members of the Commission have played a decisive role in shaping the recommendations, on occasion, even contrary to the Chairman's view. Therefore, my first debt of gratitude is to the Members of the Commission—Smt. Annie George Mathew, Dr. Manoj Panda, Dr. Soumya Kanti Ghosh, and Shri T. Rabi Sankar—for their deep engagement throughout the Commission's work. Thanks are also due to Shri Ajay Narayan Jha, who served as a Member until April 2025.

If there was one individual pivotal to the Commission's work, it was Shri Ritvik Ranjanam Pandey, Secretary to the Commission. He brought indispensable strengths to the Commission and, I venture to say, ended up serving as a de facto Member of the Commission as a result. Shri Pandey possesses unmatched knowledge of Union and State finances, an uncanny ability to analyse and process data, and never loses sight of the forest for the trees. At the same time, he led a large team of professional staff that regularly produced first-rate presentations, packed with information and data, on a wide array of subjects for the Commission. He and his team never hesitated to put in long hours to meet the needs of a rather demanding Commission.

Of course, even as able a Secretary as Shri Pandey could not have delivered as handsomely as he did without a dedicated team of professionals. He was ably supported by Shri Kamlesh Kumar Mishra and Shri Rahul Jain, Joint Secretaries, who led major analytical verticals and supervised extensive technical work on Union and State finances, grants, and performance assessment. In this, they were joined by Dr. Prasant Kumar Panda, Economic Adviser, who brought the necessary technical and analytical muscle to the work.

A dedicated team of officers staffed the Secretariat (*Annexure I.5*). Among the Directors, Deputy Secretaries and Joint Directors, I would like to mention Shri K. Balaji, Shri Raghvendra Singh, Ms. Amrutha Varshini, Shri Davinder Chodha, Ms. Priya Sarraf, and Shri Ajit Ranjan. They led the thematic verticals, which formed the backbone of the Commission's work. Each of them worked with teams that included Deputy Directors, Assistant Directors, Officers on Special Duty, Consultants, Senior Consultants, and Young Professionals (*Annexure I.5*). Shri Manish Kumar Lal, Director, oversaw all administrative matters.

Personally, in my own work for the Commission, I greatly benefited from multiple interactions with Shri Srikanth Vishwanathan of Janaagrah, Dr. Rana Hasan and Shri Chinmaya Goyal of the Asian Development Bank, Dr. Poonam Gupta of the National Council of Applied Economic Research (now a Deputy Governor, Reserve Bank of India), Dr. D. K. Srivastava of EY, Dr. M Govinda Rao, Member FC-14 and Dr. V. N. Alok of the Indian Institute of Public Administration. From within the Commission, Ms. Amrutha Varshini, Ms. Priya Sarraf, and Ms. Nikita Jain provided valuable assistance on data and analysis. The young and bright Tanush Sawhney of Columbia University, who interned with me during the 2024 summer, significantly contributed to my understanding of State expenditure patterns.

Shri Kumar Vivek, PS to Chairman, not only deftly managed my office, but also maintained a steady flow of research inputs and analyses. I especially want to mention his superb management of the Commission's visits to the 28 states. With tight schedules and complex logistics, there was much room for slip-ups, but none happened. Shri Ramagya Maurya, another senior member of my personal staff, was equally indispensable. Thanks to him, my wife and I could smoothly settle into our new home in New Delhi and I could squarely focus on the Commission's work,

free of the worries of day-to-day existence. He and our able protocol officer, Shri Sumeet Singh Kanwal, also ensured smooth entry and exit at the airport during our numerous domestic and international travels.

Those mentioned above are but a tiny fraction of those who contributed to the Commission's work. In Chapter 1 and its annexes, we have tried to be more comprehensive. I fear that, even then, we have missed mentioning many who have contributed to the Commission's work. So, in conclusion, let me thank one and all who lent us a hand directly or indirectly.



Arvind Panagariya
Chairman

New Delhi
10 November 2025

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