

Editorial
Gains on Paper, Losses in Reality Sixteenth Finance
Commission and Kerala

K J Joseph

Director, Gulati Institute of Finance and Taxation, Thiruvananthapuram.

India's fiscal federalism has always been a terrain of productive tension. The Finance Commission - a constitutional instrument of that tension - has, across fifteen incarnations, navigated the competing claims of equity and efficiency, need and performance, unity and diversity, with commendable care. The Sixteenth Finance Commission (hereafter SFC), whose report was tabled in Parliament on 1 February 2026, arrives at a peculiarly consequential moment: India is in the throes of a developmental ambition of becoming a developed economy - Vision India 2047 - that demands accelerated growth, massive investment, and the active participation of every state. Against that backdrop, this editorial offers a critical assessment of what the SFC means for Kerala - and, by extension, for the larger questions it raises about the kind of fiscal federalism that a developing India needs.

The Arithmetic of Deception: What Kerala Actually Receives

On the face of it, Kerala appears to be a gainer: its inter-se share in horizontal devolution has increased from 1.925% under the 15th Finance Commission to 2.382% - a rise of 0.457 percentage points, restoring the state roughly to its 13th Finance Commission share. The introduction of 'Contribution to National GDP' as a new criterion with a 10% weight, which rewards economic productivity, has benefited the relatively high-income southern states. GIFT's analysis, however, revealed that there has been a big slip between the cup and the lips. The gross devolution gain for Kerala, measured against what it would have received at the old 1.925% share of the same divisible pool, amounts to approximately Rs.42,583 crore over the five-year period.

Against this must be set the losses. The SFC has discontinued post-devolution revenue deficit grants - under which Kerala received Rs.37,814 crore during the previous award period, the largest such grant to any state. State-specific and sector-specific grants, which yielded Rs.2,412 crore over the 15th Finance Commission period, have also been discontinued. The net arithmetic is laid out in Table 1.

Table 1- Net gain for Kerala from the 16th Finance Commission's Tax Devolution.

Item	Rs. crore (5-year period)	Annual impact
+ Gross gain: higher inter-se devolution	+ Rs. 42,583	+ Rs. 8,517
– Revenue Deficit Grants forfeited	– Rs. 37,814	– Rs. 7,563
– State/sector-specific grants forfeited	– Rs. 2,412	– Rs. 482
NET REAL GAIN (16th FC vs 15th FC)	Rs. 2,357	Rs. 471

Source: GIFT estimates.

It is evident that Rs.471 crore per year is the true net improvement the SFC has delivered. Against a structural revenue gap that exceeds Rs.27,000 crore annually, and a committed expenditure ratio that has now reached 69% of revenue receipts (salaries, wages, pensions, and interest consuming nearly seven out of every ten rupees the state collects), this is not a gain. It is a rounding error dressed as federal generosity.

The cesses and surcharges problem compounds the picture further. Excluded from the divisible pool, these levies rose from 9.5% of the Union's gross tax revenues in 2013-14 to 14.8% in 2023-24 (PRS India, 2026). The SFC declined to cap them, declined to include non-tax revenues in a broadened resource-sharing framework, and declined to raise the vertical share from 41% to the 50% demanded by 18 out of 28 states. By retaining 41% of a divisible pool that is itself shrinking relative to gross fiscal flows, the Commission has maintained a status quo that its predecessor already acknowledged as problematic.

The Uncompensated Fiscal Spillovers

The deeper problem lies not in the arithmetic of any single award period but in the conceptual framework within which Finance Commissions have historically assessed states' needs and contributions. The SFC is no exception. To understand why, it is necessary to invoke a

principle that is foundational in fiscal federalism theory yet entirely absent from Indian Finance Commission methodology: fiscal spillovers articulated by Oates.

Wallace Oates (1972), in his seminal work on fiscal federalism, demonstrated that when a subnational government invests in goods or services whose benefits spill over to other jurisdictions, for example public health, education, environmental protection, and infrastructure, it systematically under-provides those goods relative to the socially optimal level, because it bears the full cost of provision while capturing only a fraction of the benefits. The welfare-maximising remedy, as Oates showed, is an inter-governmental transfer from the benefiting jurisdictions to the investing jurisdiction - a Pigouvian subsidy for the positive externality. Without such a correction, the subnational entity that invests in spillover-generating public goods is penalised fiscally as its own fiscal balance deteriorates.

This is not an abstract theoretical possibility. It is Kerala's lived fiscal history. Kerala's public investment in education and health - sustained over decades through a unique public-private partnership model that combined state funding with community participation - has generated human capital of a quality that has migrated to 183 of the world's 197 countries and to virtually every other Indian state. As the Kerala Migration Survey led by Irudaya Rajan (GIFT, 2024) documents, 2.2 million Keralites working abroad sent home approximately Rs.2.16 lakh crore in 2023 - constituting approximately 23% of India's total remittances on just 2.76% of India's population. Those remittances help India build its foreign exchange reserves and improve its current account balance: an unmistakable fiscal benefit to the Union. An estimated 2 million skilled Keralites working in other Indian states contribute to those states' productivity and growth: an unmistakable developmental benefit to receiving states. Yet no Finance Commission has ever designed a criterion that compensates Kerala for these spillovers. Instead, it has been blamed for high committed expenditure on the one hand while successive Commissions have watched Kerala's share in the divisible pool slide - from 3.9% in the 10th Finance Commission to 1.925% in the 15th - even as the spillovers Kerala generates have grown larger. To its credit, the 15th Finance Commission was realistic when it provided the highest revenue deficit grant to Kerala among all states.

The SFC's discontinuation of revenue deficit grants, far from correcting this asymmetry, deepens it. The Rs.37,814 crore Kerala received under the 15th Finance Commission's RDG was the fiscal federal system's sole, partial, and imperfect acknowledgement that Kerala's revenue deficit is structurally different from other states' deficits - that it is, in Oates's (1972)

terms, the fiscal shadow of an uncompensated positive externality. Removing it without replacing it with an equivalent mechanism is not fiscal discipline. It is fiscal punishment for a developmental choice that has benefited the entire nation.

The FRBM Fallacy: Applying Sovereign Rules to Non-Sovereign Actors

The SFC's fiscal discipline agenda - a strict 3% GSDP ceiling on state deficits, the discontinuation of off-budget borrowings, and no additional reform-linked borrowing space - is more stringent than either of its two predecessors. It is also, in its application to Indian states, conceptually misconceived in a way that deserves direct intellectual challenge. The 3% fiscal deficit rule has its roots in the developed economies for whom the prime concern is stability. The fallacy of adapting the same for developing countries with a focus on growth with stability, without adequate analytical and empirical analysis, is an indication of serious intellectual deficit.

India's fiscal framework applies sovereign fiscal rules to governments that are structurally, constitutionally, and fiscally non-sovereign. This is not a marginal technical point. It is, as Lahiri (2000) observed, the central structural tension of India's intergovernmental fiscal architecture. A sovereign government - the Union of India being the relevant reference - has constitutional authority to levy income tax, corporation tax, customs duties, and excise; can issue currency; has unlimited access to capital markets; and manages its own monetary environment. Indian states have none of these freedoms. They cannot levy any of these taxes, while the introduction of the Goods and Services Tax has led to an unprecedented erosion of their fiscal autonomy. On average, over 50% of the revenue receipts of states depend critically on Union transfers over which they have zero discretion - and which can deviate sharply from Finance Commission projections. Expenditure commitments of the states are also often beyond their control. When the Union alters Centrally Sponsored Scheme cost-sharing ratios - as the proposed restructuring of MGNREGS from approximately 90:10 to 60:40 illustrates - states face immediate, non-discretionary expenditure increases with no compensating revenue transfer and no adjustment in their FRBM ceilings. The fiscal rule misattributes a federal governance problem as state fiscal indiscipline (Rao & Singh, 2007).

The structural incomparability is empirically visible through an analysis of own-source revenue across states. Bihar raises 27.7% of its revenue from own sources; Manipur raises 9.8% (RBI, 2024). Kerala, even at a comparatively high 72.8% own revenue ratio (adjusted for lottery gross receipts, as required by the CAG Kerala Audit Report, 2024), faces

committed expenditure consuming approximately 70% of its revenue receipts - leaving genuinely limited discretionary fiscal space. The North-Eastern states face the starkest condition: Arunachal Pradesh, Nagaland, and Manipur raise only 13-14% of revenue from own sources, with 86-87% arriving as central transfers. For these states, the fiscal deficit is determined overwhelmingly by the Union's transfer decisions, not by subnational fiscal choices. To hold them to the same 3% GSDP deficit ceiling as Maharashtra (75.1% own revenue) or Karnataka (75.7%) is not equity. It is the formal equality that produces substantively unequal outcomes.

Isaac et al. (2019) show how the FRBM framework compresses the fiscal space of states at precisely the moments - economic downturns, revenue shortfalls, central transfer reductions - when developmental spending is most needed. The SFC's decision to apply its tightest-ever deficit ceiling, with no additional reform-linked borrowing space and no unfunded mandate adjustment mechanism, compounds this structural injustice.

The application of the same fiscal deficit ceiling to a sovereign government and to a constitutionally constrained subnational entity is not merely inequitable - it is analytically incoherent. As the growth literature since Nelson (1956) has established, a developing economy constrained by low domestic savings can escape the low-level equilibrium trap only through borrowing for investment. The moot question is not the quantum of borrowing but the quality of its deployment. A state that borrows to invest in education and health - generating returns that accrue to the national economy, as Kerala does - is fiscally more virtuous than a state that borrows for current consumption within its 3% ceiling. The SFC's single-number rule cannot distinguish between these cases, and its mechanical application penalises the former.

What India needs - and what Vision India 2047 (Vikasit Bharat) demands - is not the prevailing Fiscal Responsibility and Budget Management (FRBM) Act but something more genuinely developmental. The need of the hour is to articulate, based on the golden rule of public finance (Musgrave, 1939), a Fiscal Responsibility of Borrowing Utilisation (FRBU) Act which ensures that every rupee borrowed is invested to ensure a return higher than the cost of borrowing. Equally importantly, capital expenditure on education and health should be exempt from deficit calculations for states that can demonstrate the developmental spillovers those investments generate; and borrowing ceilings should be linked to investment returns rather than to an arbitrarily inherited percentage of GSDP. The institutions of Indian

fiscal federalism must co-evolve with the developmental context they are designed to serve (Freeman & Perez, 1988). The SFC's fiscal discipline agenda represents, in this respect, a costly inertia that is bound to make institutions a stumbling block to development - which India cannot afford any more.

The Knowledge Investment Blind Spot

India's fiscal classification system carries forward an industrial-era conception of capital into a 21st century knowledge economy. Under India's budget classification, capital expenditure means spending that creates tangible fixed assets. Spending on a highway bridge is capital expenditure. Spending on AI-driven public health surveillance, open-source digital public infrastructure, or scientific research is largely classified as revenue expenditure - consumed in the period of spending, subject to the zero revenue deficit constraint, and outside the scope of borrowing-financed investment. This is analytically untenable.

The System of National Accounts 2008 - jointly published by the United Nations, IMF, OECD, and World Bank - reclassified R&D expenditure from intermediate consumption to gross fixed capital formation, recognising that R&D creates durable knowledge assets with multi-period productive returns (United Nations et al., 2009). For reasons that remain unexplained, India's budget classification has not followed suit. India's gross expenditure on R&D declined from 0.86% of GDP in 2008-09 to 0.64% in 2020-21 - far below the government's own 2% target (Department of Science and Technology, 2022). As the Seventh Kerala Public Expenditure Review Committee (Government of Kerala, 2025) observed, this creates a paradox for development-oriented states: the more a state invests in long-term growth through innovation, education, and health, the more it is penalised under deficit-based fiscal rules.

For Kerala, whose developmental model is founded precisely on investments in human capital and knowledge infrastructure - the investments that produce the engineers, doctors, nurses, and IT professionals who work across India and the world - this classification blind spot is not peripheral. It is central to the structural fiscal injustice the SFC perpetuates. The SFC's discontinuation of RDGs, combined with strict deficit ceilings that treat education and health expenditure as current consumption rather than capital formation, structurally obstructs the very investments that have made Kerala's developmental model nationally and globally significant.

What was Missed Out?

The deeper question is whether India's fiscal federal architecture - as reproduced by the SFC - is adequate for the ambition of Vision India 2047 - Vikasit Bharat. Several structurally transformative measures were available to the SFC but were not taken.

The official request by 18 states for raising the share of states in the divisible pool from 41% to 50% was ignored by the Commission, on the grounds of the Union's growing revenue requirements. The divisible pool has been hollowed out by cesses and surcharges that rose from 9.5% to 14.8% of gross tax revenues in a decade. Capping this ratio, or including non-tax revenues (the Union's dividend income alone has risen from Rs.1 lakh crore in 2023 to an estimated Rs.3.25 lakh crore in 2026) in a broadened sharing framework, was available to the Commission. It was not done - reflecting a concern for the fiscal health of the Union that was conspicuously absent when the constitutionally provided revenue deficit grant for states was discontinued without replacement.

The horizontal devolution formula still lacks any mechanism to measure and compensate for developmental spillovers of the kind Oates (1972) identified and Kerala's experience illustrates. The new GDP contribution criterion is a partial acknowledgement of economic performance, but it does not capture remittances, ecological services, or public health investments that generate inter-jurisdictional benefits. An Index of State-level Contribution to Indian Development (ISCID), as proposed in GIFT's submission to the SFC (GIFT, 2025), would have provided such a mechanism. It was not adopted.

The constitutionally provided revenue deficit grant - whatever its imperfections as an instrument - was the one mechanism that partially compensated for structural fiscal asymmetries among states. It has been discontinued without replacement. States such as Kerala, whose deficits were structurally determined, are now treated identically to states that received RDGs because of fiscal slippage - a category Kerala does not belong to. The institutional penalty for developmental success could not be more clearly written.

The relationship between fiscal rules and development investment remains unaddressed. An FRBM framework that excludes R&D, education, and health capital expenditure from the deficit calculation - for states that can demonstrate developmental spillovers - would have been both analytically defensible and developmentally appropriate. It was not proposed.

There are also serious issues with finances for the local self-governments and disaster management which are reserved for discussion elsewhere.

The Way Forward for Kerala

This editorial has argued that the SFC's report, read honestly, delivers Kerala a net gain of Rs. 471 crore per year - a rounding error against the scale of its structural fiscal challenge. More fundamentally, it misapplies sovereign fiscal rules to a non-sovereign actor, and fails to compensate for the developmental spillovers that Oates's (1972) theorem has long prescribed as the basis for inter-governmental transfer.

None of this means Kerala can wait for the fiscal federal framework to reform itself. Hence the relevance of a New Deal for a Resurgent Kerala (GIFT, 2026), built on the recognition that the SFC award, as it stands, is a structural setback - and that the state must therefore close the gap left by the withdrawal of revenue deficit grants primarily through its own fiscal efforts. This calls for invigorating the production base and making the economy more vibrant. A vibrant economy is a precondition for a strong treasury. At the same time, there is an imperative to work with other states to ensure that India's fiscal federal relationship is more equitable than it is today.

Vision India 2047 requires, as the political leadership of the country has acknowledged, that India grows when the states grow. States grow when the fiscal federal architecture enables them to invest in their developmental strengths rather than penalising them for doing so. This is an imperative in the current geopolitical context, which acts as a drag on India's growth prospects. The SFC has not built that architecture. While the intellectual task of designing it falls on the academic community, the political task of demanding it rests with state governments.

Prof. K J Joseph

References

- CAG of India. (2024). Audit report on state finances, Kerala 2023-24. Office of the Comptroller and Auditor General of India.
- Department of Science and Technology, Government of India. (2022). Research and development statistics at a glance 2022-23. Ministry of Science and Technology.
- Freeman, C., & Perez, C. (1988). Structural crises of adjustment: Business cycles and investment behaviour. In G. Dosi, C. Freeman, R. Nelson, G. Silverberg, & L. Soete (Eds.), *Technical change and economic theory* (pp. 38-66). Pinter.
- GIFT. (2024). Kerala migration survey 2024 (S. Irudaya Rajan, Principal Investigator). Gulati Institute of Finance and Taxation.
- GIFT. (2025). Submission to the Sixteenth Finance Commission. Gulati Institute of Finance and Taxation.
- GIFT. (2026). New deal for a resurgent Kerala, Gulati Institute of Finance and Taxation.
- Government of Kerala. (2025). First report of the Seventh Kerala Public Expenditure Review Committee. Government of Kerala (Chairman K J Joseph).
- Isaac, T. M. T., Chakraborty, L., & Mohan, R. (2019). Challenges to Indian fiscal federalism. LeftWord Books.
- Joseph, K. J. (2026). Reimagining fiscal architecture for a transforming India: From curative consolidation to preventive developmental finance (Mimeo GIFT)
- Joseph, K. J., & Anithakumary, L. (2023). India's GST paradigm and the trajectory of fiscal federalism: An analysis with special reference to Kerala. *The India Economic Journal*, 71(1). <https://doi.org/10.1177/0019466222114>
- Lahiri, A. K. (2000). Sub-national public finance in India. *Economic and Political Weekly*, 35(16), 1539-1549.
- Musgrave, R. A. (1939). The nature of budgetary balance and the case for a capital budget. *American Economic Review*, 29(2), 260-271.
- Nelson, R. R. (1956). A theory of the low-level equilibrium trap in underdeveloped economies. *American Economic Review*, 46(5), 894-908.
- NITI Aayog. (2024). Vision for Viksit Bharat @ 2047: An approach paper. Government of India.
- Oates, W. E. (1972). *Fiscal federalism*. Harcourt Brace Jovanovich.
- PRS India. (2026). Report summary: 16th Finance Commission for 2026-31. PRS Legislative Research.

Rao, M. G., & Singh, N. (2007). The political economy of India's fiscal federal system and its reform. *Publius: The Journal of Federalism*, 37(1), 26-44.
<https://doi.org/10.1093/publius/pjl023>

Reserve Bank of India. (2024). State finances: A study of budgets 2024-25. RBI.

Sixteenth Finance Commission. (2026). Report for 2026-31. Government of India.

United Nations, European Commission, International Monetary Fund, Organisation for Economic Co-operation and Development, & World Bank. (2009). System of national accounts 2008. United Nations.
<https://unstats.un.org/unsd/nationalaccount/docs/SNA2008.pdf>