

STATE GOVERNMENT FINANCES

16th FC: Several economically stronger states to benefit from change in their inter-se share, despite retention of tax devolution at 41%

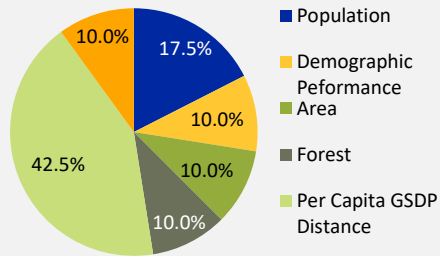
FEBRUARY 2026





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EXHIBIT: Criteria and weights of horizontal devolution by 16th FC



Source: FC reports; ICRA Research

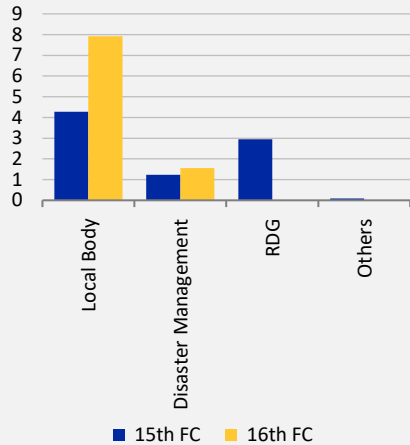
The Sixteenth Finance Commission (16th FC) has maintained the vertical tax devolution to the state governments at 41% of the divisible pool of taxes of the Government of India (GoI) during FY2027-FY2031, in line with what had been recommended by the 15th FC for FY2022-FY2026. To determine the state-wise share in tax devolution, the 16th FC has retained five of the six horizontal devolution criteria used by the 15th FC, with some changes in weights and/or calculation methodology. Among these criteria, the changes related to the Area criterion to 10% would lower the inter-se share of states with very large and very small geographical areas. Further, the 16th FC replaced the tax and fiscal effort criterion used by the 15th FC (2.5% weight) with a new criterion, Contribution to gross domestic product (GDP; 10% weight). This change is one of the key factors in enhancing the inter-se share of states with largely healthy economic management, in ICRA's view.

Based on the vertical devolution and the inter-se share recommended by the 16th FC, the share of half of the 28 states in the divisible pool would increase during FY2027-FY2031, relative to the 15th FC's award period, with Karnataka being the biggest gainer. Kerala, Gujarat, Haryana, Punjab, Andhra Pradesh (AP), Assam, Maharashtra, Himachal Pradesh (HP), Telangana, Mizoram, Jharkhand, Uttarakhand, and Tamil Nadu (TN) are the 13 other states that will gain from this rise in inter-se share in the said period.

On the grants side, the 16th FC continued to follow the approach of previous FCs of linking the release of grants to completing some basic reforms and/or tying the amount for a particular sector. The 16th FC has recommended a sharp increase in local body (LB) grants to Rs. 7.9 trillion for FY2027-FY2031, from Rs. 3.9 trillion transferred during FY2022-FY2026 revised estimates (RE). Given that a sizeable 90% of the largely conditional LB grants recommended by the 15th FC were released to the states, during FY2022-FY2026 RE, it imparts confidence that the states will be able to fulfill the conditions stipulated by the 16th FC for such grants and avail a much higher amount. Encouragingly, 60% of the LB grants are conditional but untied and 40% are conditional and tied towards sanitation, solid waste and water management.

For disaster management, the 16th FC has recommended the share of the Union Government at Rs. 1.6 trillion for FY2027-FY2031, 27% higher than the grant recommended during the 15th FC period. Overall, the total LB and disaster management grants are recommended to increase by an impressive 72% to Rs. 9.5 trillion during FY2027-FY2031 from Rs. 5.5 trillion (LB and disaster management grants) recommended by the of 15th FC.

EXHIBIT: Recommended grants by the 15th and 16th FCs (Rs. trillion)



Source: FC reports; ICRA Research

Interestingly, the 16th FC discontinued the unconditional and untied revenue deficit grant (RDG) citing ineffectiveness of such grants in meeting their intended purpose. After factoring in nil RDG by the 16th FC, the total grants of Rs. 9.5 trillion are a moderate 11% above the Rs. 8.5 trillion recommended by the 15th FC, which had included Rs. 2.9 trillion RDG to 17 states and Rs. 85 billion for certain other grants. As many as 13 of these 17 states, which had received RDG during the 15th FC period, are set to receive lower total grants during the 16th FC period due to discontinuation of RDG, as per the FC's recommendations.

Notably, the 16th FC has recommended states to strictly adhere to fiscal deficit target of 3% of GSDP during FY2027-FY2031, to ensure stability of their debt. This target is the same as the normal fiscal deficit target prescribed by the 15th FC for the last three years of its award period (FY2024-FY2026). However, unlike the 15th FC, the 16th FC has not proposed any additional reform linked borrowings for the states. Moreover, unlike the previous two FCs, the 16th FC has not recommended the carry-forward of any unutilised borrowing by a state in a fiscal to the following year until the end of its award period. We fear that this change may nudge some states to exhaust their annual borrowing limits during the 16th FC's award period, and carry forward unspent cash to the following year, something seemingly the Commission wants to avoid.

At the same time, the GoI has budgeted an increased allocation of the 50-year interest-free capex loan to the 28 states to Rs. 1.9 trillion in FY2027 from Rs. 1.4 trillion in FY2026 RE. These loans are over and above the net borrowing limit of the states and are expected to boost their capital spending. It has also substantially enhanced the grants in aid for capital assets to Rs. 4.9 trillion in FY2027 budget estimates (BE) from Rs. 3.1 trillion in FY2026 RE, which will flow to the states shifting a greater share of the responsibility for incremental capital spending to them.

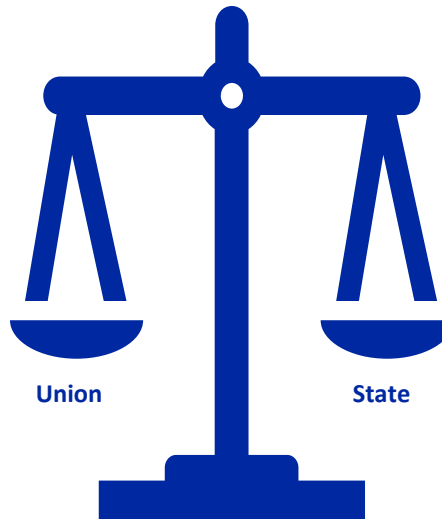
Overall, higher funds for capex (through grants and loans from the GoI) and the absence of additional borrowing and RDG, may result in some recalibration in the spending priorities by the state governments in favour of capex instead of welfare schemes. Moreover, the 16th FC has recommended that states should discontinue the use of off-budget borrowings (OBBs) entirely and bring all such borrowings onto the state budgets.

FCs play key role in addressing fiscal asymmetries between the Centre and states

Under Article 280 of the Constitution of India, the President constitutes a FC typically for a five-year period to guide the fiscal relationship between the Union and the States.

Vertical Devolution: The FC recommends the proportion of Union taxes to be shared with the state. This aims to correct the vertical imbalance between the Union and States, which arises on account of the mismatch between the taxing powers and expenditure responsibilities.

Horizontal Devolution: States differ in their ability to raise revenue due to variations in economic strength, resource availability, and geographic advantages. The FC reduces these horizontal disparities by using inter-se distribution criteria to allocate shared resources more equitably.



Grants: Beyond sharing taxes, the Finance Commission also recommends grants—such as those for local bodies, specific sectors, and revenue deficits—to help states bridge developmental gaps and maintain essential public service standards.

Others: Apart from taxes and grants, the FC may also provide recommendations on matters specifically referred to it by the President through the Terms of Reference. In the past, these references have included guidance on fiscal deficit limits and debt trajectories.

The 16th FC has kept the vertical devolution for FY2027-FY2031 at 41%

EXHIBIT: Composition of the Gol's Gross Tax Revenues (cess and estimated divisible pool)

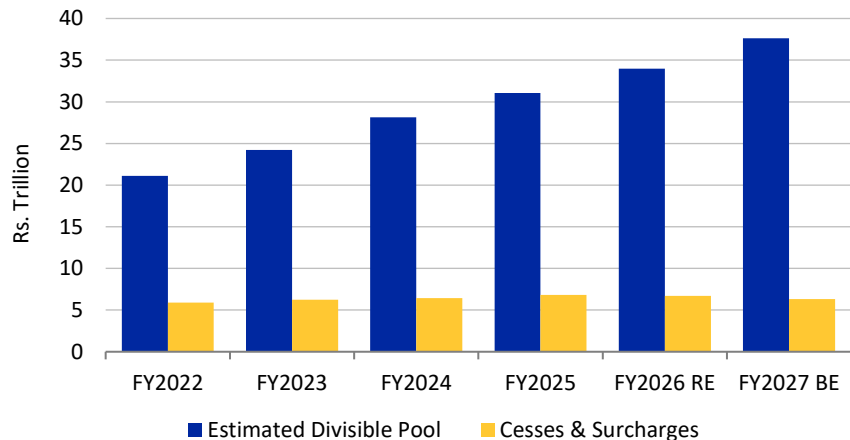
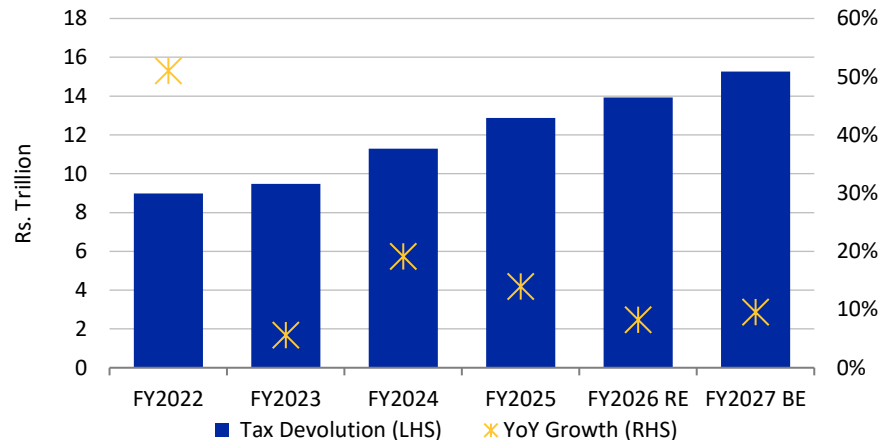


EXHIBIT: Trends in tax devolution



- The divisible pool is defined as gross tax revenues of the Gol less any cesses, surcharges and collection charges. The 16th FC has recommended that 41% of the divisible pool will be devolved by the Gol to the states during its award period spanning FY2027–FY2031 (referred to as vertical devolution). Notably, the share of cesses in total tax collections is budgeted to decline to 14% in FY2027, from 22% in FY2022, partly on account of the cessation of the GST compensation cess.
- Based on the recommended vertical devolution, the Gol has projected to transfer Rs. 15.3 trillion to the states in the FY2027 BE. This is about 10% higher than the devolution of Rs. 13.9 trillion in the FY2026 RE. Notably, in FY2026 RE, the Gol has adjusted Rs. 91 billion from the tax devolution on account of excess devolvement of revenues in FY2024 and FY2025.

Source: FC reports; Union Budgets; ICRA Research

Contribution to GDP – new criteria by 16th FC for inter-se share is broad based; states with largely healthy economic management benefitted from this change

EXHIBIT: Horizontal devolution criteria and weights

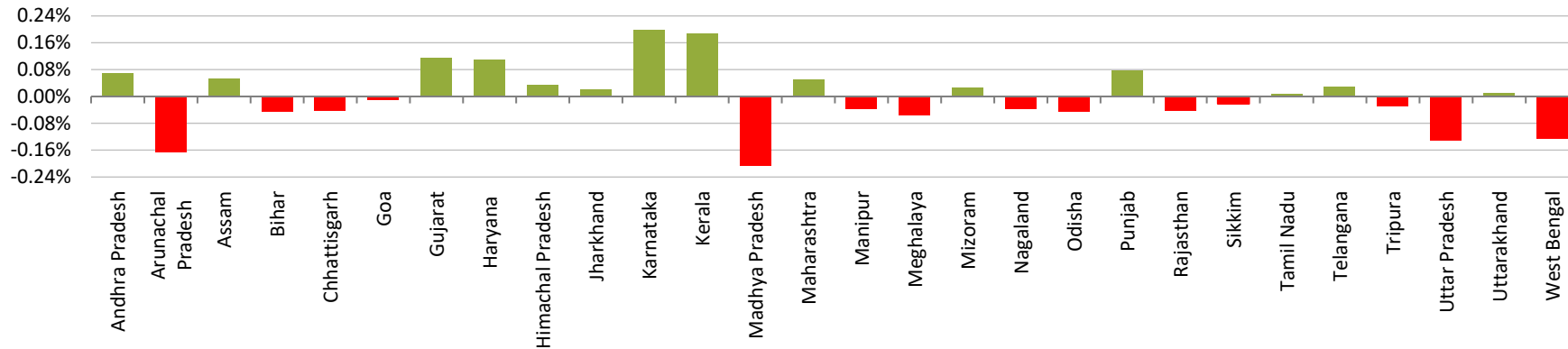
	15 th FC (FY2022-2026)	16 th FC (FY2027-2031)	Changes in 16 th FC over 15 th FC
Population (2011)	15.0%	17.5%	Weight Increased by 2.5%
Demographic Performance	12.5%	10.0%	Weight reduced by 2.5% with change in methodology
Area	15.0%	10.0%	Weight reduced by 5% with slight modification in methodology
Forest and Ecology/Forest	10.0%	10.0%	Methodology changed
Income Distance/Per Capita GSDP Distance	45.0%	42.5%	Weight reduced by 2.5% with change in methodology
Contribution to GDP		10.0%	Introduced
Tax and Fiscal Efforts	2.5%		Dropped

- While deciding the horizontal distribution criteria, the 16th FC's intent has been to make modifications in a manner that avoids significant disruptions to state finances. It particularly emphasised the need for caution in the case of states whose devolution share had already declined during the 15th FC's award period. Therefore, in line with the 15th FC, the 16th FC retained the criteria of population, area, forest, per-capita GSDP and demographic performance; albeit with some changes in weights of these criteria and/or some change in the calculation methodology.
- For instance, the 16th FC has reduced the weight for the Area criteria to 10% from the 15% assigned by the 14th and 15th FCs, while also lowering the minimum share of a state's area in the total area of 28 states to 1.5% from the 2% followed by several FCs in the past. The decline in weight and lowering of the floor would have contributed to lowering the inter-se share of states with very large and very small geographical areas.
- Additionally, the 16th FC has introduced a new criteria – Contribution to GDP – with a weight of 10%, for arriving at the inter-se share of each state in total devolution, by replacing the tax and fiscal effort used by the 15th FC with a modest weight of 2.5%. The Commission highlighted the increasing importance of economic efficiency and recognised the states' contribution to the national economy and noted that this indicator is a proxy for tax effort and fiscal discipline. This is a key change in the horizontal devolution criteria, which would have lifted the inter-se share of states with healthy economic management, in ICRA's view.

Source: FC reports; ICRA Research

Share of 14 states in divisible pool to rise during FY2027-FY2031 over FY2022-FY2026; Karnataka is the biggest gainer

EXHIBIT: Changes in divisible pool share for FY2027-FY2031 over FY2022-FY2026



- Based on the criteria and weights determined by the 16th FC, Karnataka’s inter-se share has been fixed at 4.131%, higher than the 3.6470% awarded by the 15th FC. Taking this and the 41% share of the divisible pool into account, Karnataka’s share in the aggregate pool of sharable Union taxes is estimated at 1.6937% during the 16th FC award period, up from 1.4953% during the 15th FC period. This represents the sharpest increase in inter-se among the 28 states, followed by Kerala, Gujarat, Haryana, Punjab, AP, Assam, Maharashtra, HP, Telangana, Mizoram, Jharkhand, Uttarakhand, and TN. Most of these states seem to have benefitted from the introduction of the new criterion – Contribution to GDP – by the 16th FC.
- In contrast, MP’s inter-se share has declined to 7.347% under the 16th FC from 7.850% under the 15th FC. Consequently, the state’s share in the divisible pool has dropped sharply to 3.0123% from 3.2185% over the same periods. MP is followed by Arunachal Pradesh, Uttar Pradesh (UP), West Bengal (WB), Meghalaya, Bihar, Odisha, Chhattisgarh, Rajasthan, Manipur, Nagaland, Tripura, Sikkim, and Goa. Several of these states seem to have been negatively impacted by the reduction in weight of Area criterion by 5 percentage points by the 16th FC from the previous two FCs, and the lowering of the minimum share of a state’s area in the total area of 28 states to 1.5% from 2%. Several of these states received sizeable Central transfers, with many of them reporting revenue surpluses, benefitting in part from their erstwhile high inter se shares; therefore, this change could compress the extent of their revenue surpluses, going forward.

Source: FC reports; ICRA Research

Sharp rise in local body and disaster management grants recommended by the 16th FC

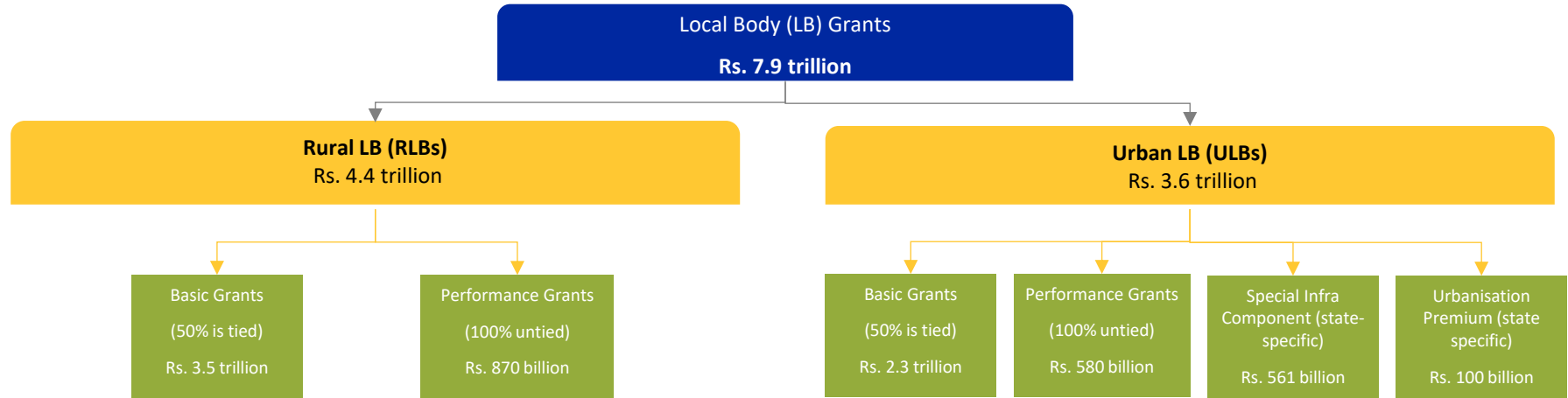
EXHIBIT: The 15th FC's recommended (accepted by the GoI) and actual grants and the 16th FC's recommendations for grants for its award period

Rs. billion	15th FC (FY2022-FY2026) [^]		16th FC (FY2027-FY2031)					YoY growth of 16th FC's grant over actual 15th FC grants	
	Recommended	Actuals*	FY2027	FY2028	FY2029	FY2030	FY2031		Total (FY2027-31)
Local Bodies	4,279	3,852	1,012	1,395	1,663	1,830	2,015	7,915	105%
Disaster Management	1,226	1,226	282	296	311	327	343	1,559	27%
Revenue Deficit Grants (RDG)	2,945	2,945							
Other Grants	85	2							
Grand Total	8,535	8,025	1,294	1,691	1,974	2,157	2,358	9,474	18%

- Overall, the total Rs. 9.5 trillion grants recommended by the 16th FC for its award period are expected to be about 18% higher than the actual transfers of Rs. 8.0 trillion made during the 15th FC's award period (FY2022–FY2026 RE); the latter were a substantial 64% higher than the grants during the 14th FC's award period (Rs. 4.9 trillion; FY2016–FY2020). The 16th FC has recommended Rs. 7.9 trillion as grants for local bodies, more than double the Rs. 3.9 trillion transferred by the GoI to the states during FY2022–FY2026 RE, based on the recommendations of the 15th FC. Additionally, to encourage large cities to issue higher bond issuance exceeding Rs. 1,000 crore, the GoI will provide an incentive of Rs. 100 crore.
- Additionally, the 16th FC has proposed Rs. 1.6 trillion as disaster management grant to the states during FY2027–FY2031, 27% higher than the Rs. 1.3 trillion transferred to the states during FY2022–FY2026 RE. Notably, a sizable 92% of the local body and disaster management grants recommended by the 15th FC was released to the states during FY2022–FY2026 RE.
- However, RDG, which was recommended by all the previous 15 FCs, has been discontinued by the 16th FC as it assessed that such grants were ineffective in reducing the structural gaps. While ICRA fully concurs with the rationale of the 16th FC for ending the RDG, several states could perceive this as a negative, because the RDG was an unconditional and an untied source of funds.

Note: [^] Local Body grants includes health grants; * Including actuals up to FY2025 and RE for FY2026; Source: Union Budget; FC reports; ICRA Research

60% of grants to LBs are conditional but untied in nature, with remaining 40% being conditional and tied to sanitation, solid waste and water management



- The 16th FC has recommended that RLB grants be divided into basic and performance components in an 80:20 ratio. For state-wise allocation of RLB funds, the Commission has largely retained the methodology used by the 15th FC, assigning 90% weight to rural population and 10% to geographical area. For ULBs, the Commission has proposed a similar structure of basic and performance grants, but with an additional split into urban infrastructure and urbanisation premium components. Unlike the framework used for RLBs and by the 15th FC, the state-wise allocation for ULB basic and performance grants will be determined using population (90%) and an index of own-source revenue (OSR; 10%). The Special Infrastructure Component will be extended to cities with populations between 10 lakh and 40 lakh, covering 13 of the 28 states. For the urbanisation premium, the 16th FC has recommended that a dedicated policy framework be formulated to guide its allocation among states.
- The 16th FC has recommended that half of the basic local body grants and the entire performance grants will be conditional but untied. This implies that Rs. 2.6 trillion of RLB grants and Rs. 1.7 trillion of ULB grants equivalent to 60% of the Rs. 7.3 trillion grants to local bodies will be conditional and untied. Of Rs. 7.3 trillion, the balance Rs. 2.9 trillion are conditional but tied towards sanitation and solid waste management and/or water management.

16th FC imposes three entry level conditions for availing LB grants and certain qualifying conditions for performance related LB grants

Three entry-level conditions for both basic and performance LB grants

- To avail the basic and performance LB grants, there should be a duly constituted body in place as required in Part IX and Part IX-A of the Constitution. This will be applicable for the state governments from FY2027 onwards.
- The provisional accounts for all RLBs and ULBs of the state for the year T-1 and audited accounts for the year T-2 should be publicly available, in the fiscal year T. Since this was a continuation of the 15th FC's entry level condition, this condition will also be applicable from FY2027 onwards for the LBs
- Constitution of State Finance Commissions (SFCs) and laying of SFC report and its Action Taken Report (ATR) within six months of SFC report submission to state. This condition will be applicable to the state governments from FY2027 onwards.

Qualifying conditions for performance related LB grants

- State performance components of the RLB and ULB grants in year T will depend on the state government transferring from its own resources, in the year T-1, grants to LBs amounting to 20% or more of the basic FC grant recommended by the 16th FC for the year T-1. Accordingly, this grant will start flowing from FY2028 onwards. Revenues assigned and shared statutorily with the LBs by the state would be included in these transfers for determining the quantum of the transfers for the purposes of this condition.
- For a ULB to qualify for the ULB performance component grant in year T, if in the year T-1 they can raise their OSR by a minimum 1.05 times on a YoY basis or by 5% CAGR over OSR of FY2026, whichever is lower. This grant will start from FY2028.
- Gram Panchayats can receive the RLB performance grant in year T if they increase their OSR in the previous year (T-1) by at least 2.5% or achieve at least Rs. 1,200 OSR per household annually, whichever requirement is lower. Block Panchayats qualify if 75% of the Gram Panchayats under them meet their criteria. District Panchayats must also increase their OSR by at least 2.5% annually (or meet the lower threshold) to qualify for the grant. This will be applicable from FY2029 onwards.

Ten state governments to receive three-fourths of the total LB grants

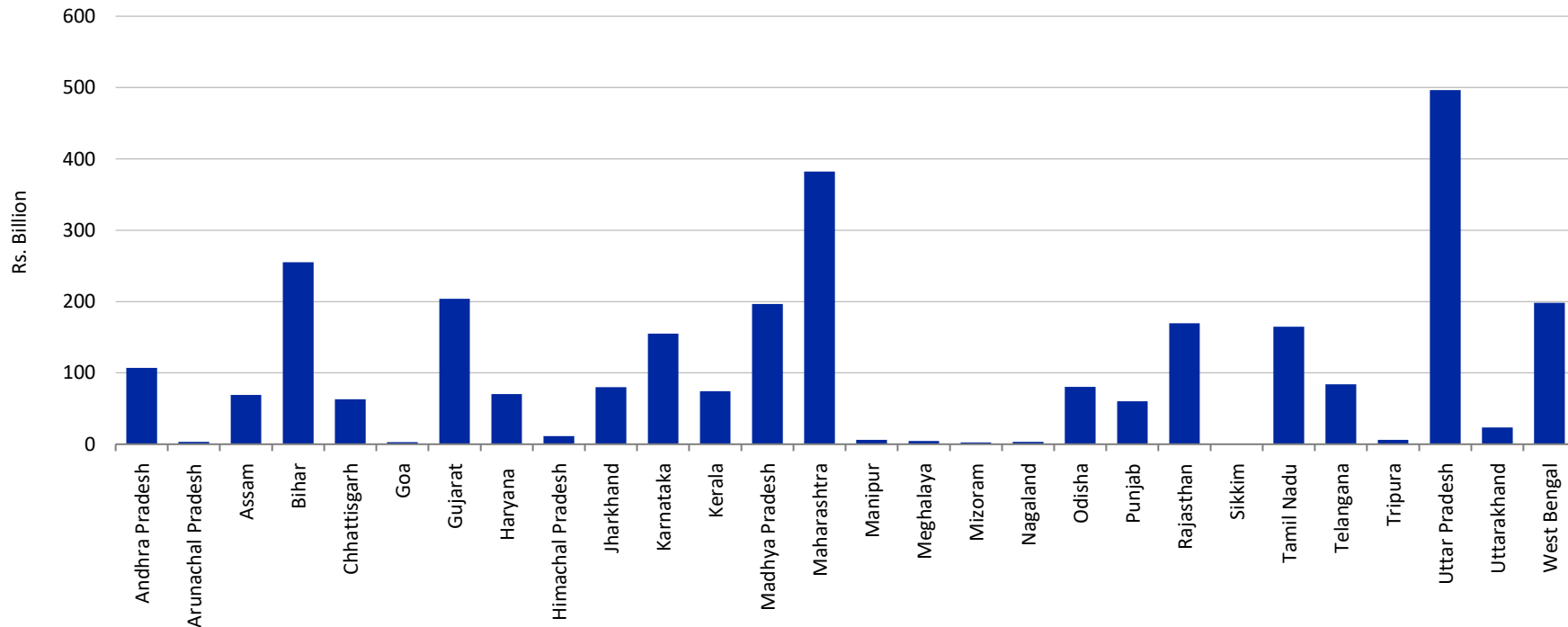
EXHIBIT: Allocation for RLB and ULB (excluding special infrastructure and urbanisation premium component) grants for top 10 states

Rs. Billion	FY2027	FY2028	FY2029	FY2030	FY2031	FY2027-FY2031
Uttar Pradesh	150	198	245	272	302	1,168
Maharashtra	102	140	166	184	204	796
Bihar	78	102	129	143	159	611
West Bengal	65	87	105	117	129	502
Madhya Pradesh	62	82	101	112	124	480
Rajasthan	57	75	93	103	114	441
Gujarat	55	75	89	98	109	426
Tamil Nadu	54	74	87	97	108	420
Karnataka	48	65	78	87	96	374
Andhra Pradesh	37	50	60	67	74	288
Sum Total	707	949	1,152	1,279	1,420	5,507
Total RLB and ULB grants	932	1,250	1,518	1,685	1,870	7,254

Source: FC reports; ICRA Research

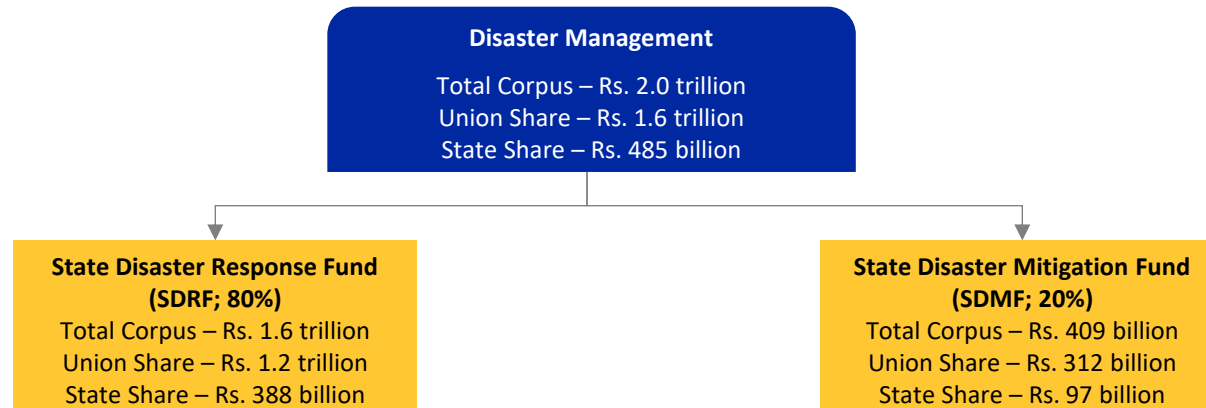
More than half of the increase in LB grants during 16th FC period from 15th FC period is for UP, Maharashtra, Bihar, Gujarat and WB

EXHIBIT: Absolute variation in the recommended grants for LB grants* by 16th FC from 15th FC



Note: The recommended grants for the 15th FC includes health grants and the recommended grants for the 16th FC excludes special infrastructure and urbanisation premium component; Source: FC reports; ICRA Research

Disaster management grants to continue to be split under relief and mitigation, with greater flexibility for utilising SDRF funds



- The 16th FC has recommended that the financing of disaster management should continue to be split between SDRF (80%) and SDMF (20%), with Rs. 1.6 trillion for SDRF and Rs. 409 billion for SDMF.
- It also recommended that the state governments should contribute 25% of the funds of SDRF and SDMF, except the North East states, whose share will be 10%. The balance will be provided by the Centre. Unlike 15th FC, the 16th FC has allowed states to freely use SDRF funds across its two windows—Relief & Response and Recovery & Reconstruction, but they cannot shift funds between SDRF and SDMF.
- For allocating funds between states, the 16th FC assigned a 30% weight to the Disaster Risk Index (DRI) and 70% weight to states past disaster related spending from FY2012 to FY2024 (excluding the Covid-19 years). The DRI used by the 16th FC included three factors: Hazard, Exposure, and Vulnerability. Hazard covered eight of the 12 disasters notified at the national level by the Centre and state specific disasters like heatwaves and lightning. Population projections for October 2026 were used to measure exposure, and per capita income was used to assess the vulnerability of each state.
- As included in the DRI, the FC also recommended adding heatwaves and lightning to the national list of notified disasters and continuing the rule allowing up to 10% of SDRF to be used for locally relevant but non-notified disasters.

Source: FC reports; ICRA Research

Disaster management grants to rise by 5% each year during the 16th FC period

EXHIBIT: Allocation for disaster management grants (Union share) for top-10 states

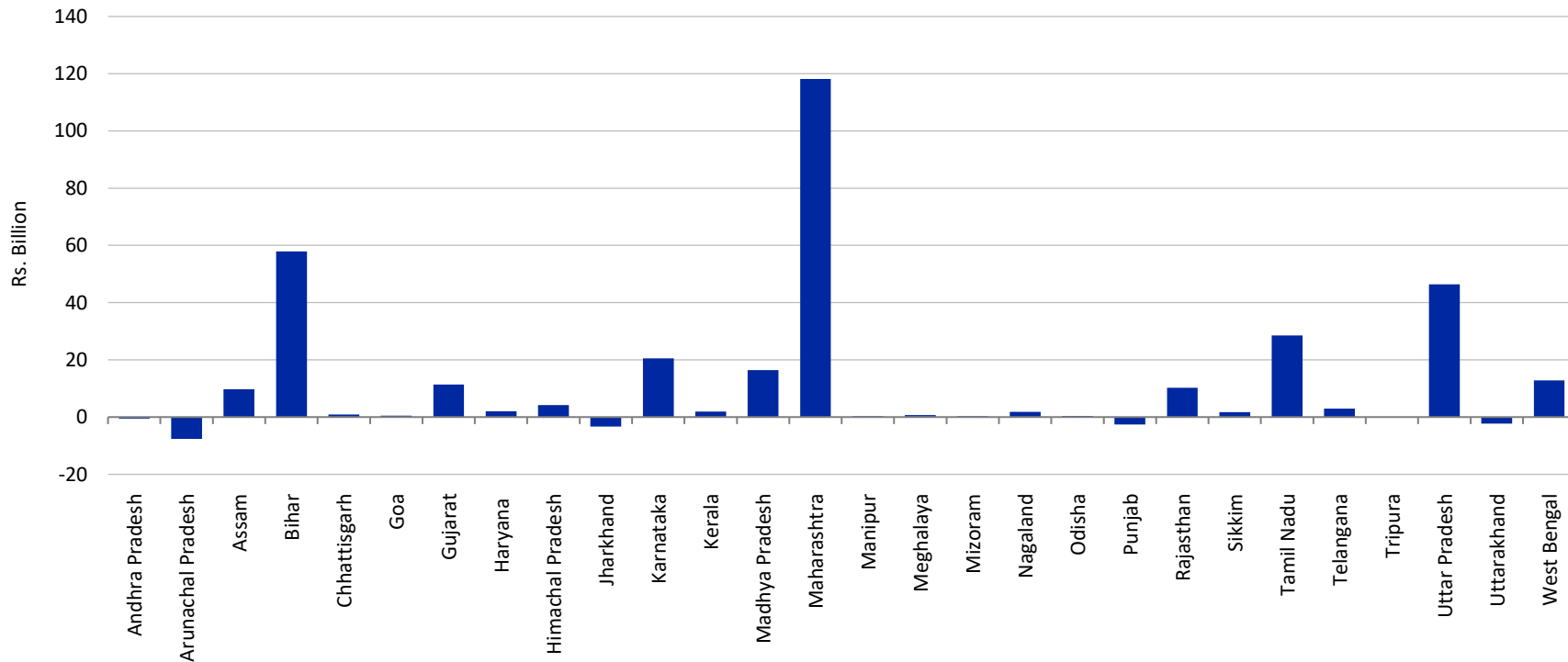
Rs. Billion	FY2027	FY2028	FY2029	FY2030	FY2031	FY2027-31
Maharashtra	54	56	59	62	65	296
Uttar Pradesh	28	29	31	32	34	153
Bihar	25	26	27	29	30	136
Madhya Pradesh	21	22	23	25	26	117
Rajasthan	17	17	18	19	20	92
Odisha	16	17	18	19	20	89
Tamil Nadu	15	16	17	18	19	85
Gujarat	15	16	17	18	19	85
West Bengal	12	13	14	14	15	69
Karnataka	12	12	13	13	14	64
Sum Total	215	225	237	248	261	1,186
Total disaster management grants	282	296	311	327	343	1,559

Source: FC reports; ICRA Research

- The Commission has recommended that state governments strictly adhere to the existing Ministry of Home Affairs norms for booking their disaster-related expenditure and investment, with their compliance regularly audited by the CAG.
- On fund balances, the 16th FC has proposed that any unspent balances as of March 31, 2026, should be allowed to be carried forward. Also, if a state's unspent SDRF balance grows beyond the total allocation of the previous three years, future releases may be paused until such balances are reduced below the total allocation of the previous three years.

A third of the increase in disaster management grants recommended by 16th FC will flow to Maharashtra in line with 15th FC's award period for such grants

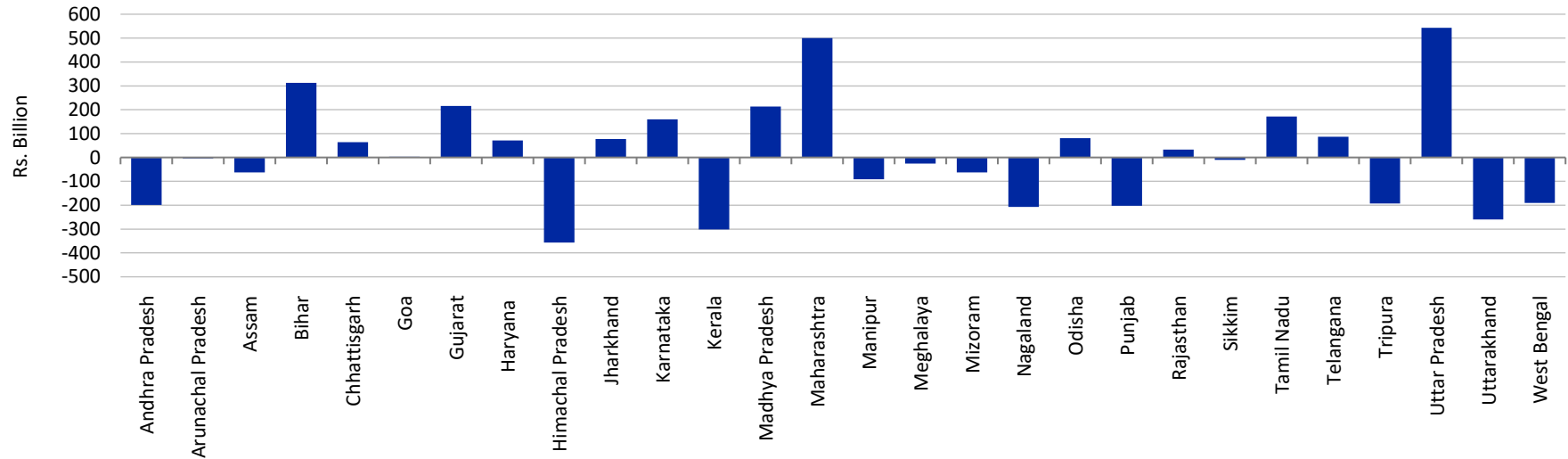
EXHIBIT: Absolute variation in the recommended grants for disaster management by 16th FC from 15th FC



Source: FC reports; ICRA Research

13 states are set to receive lower grants during the 16th FC period over the 15th FC period due to discontinuation of revenue deficit grant

EXHIBIT: Absolute variation in the total recommended grants* by 16th FC over 15th FC

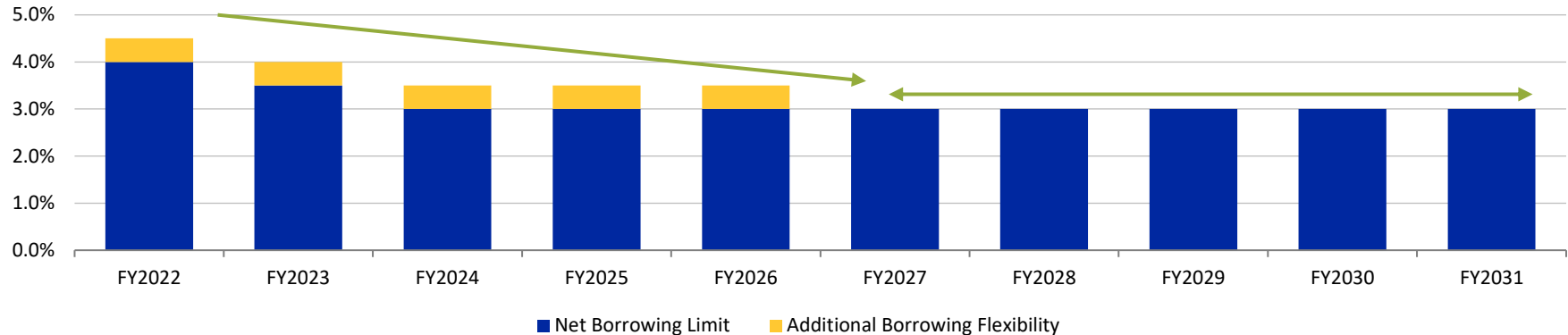


- During the 15th FC award period, 17 states (namely AP, Assam, Haryana, HP, Karnataka, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Rajasthan, Sikkim, TN, Tripura, Uttarakhand and WB) had received total revenue deficit grant of Rs. 2.9 trillion. Of these 17 states, 13 states (AP, Assam, HP, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Sikkim, Tripura, Uttarakhand and WB) are expected to receive lower grants during the 16th FC's period on account of discontinuation of RDG. Further, among these 13 states, the 16th FC has recommended a higher inter se share for AP, Assam, HP, Kerala, Mizoram, Punjab and Uttarakhand for the award period, which is a positive.

Note: *Recommended grants for 15th FC excludes grants for incubation of new cities and shared municipal services and for 16th FC it excludes grants Special Infrastructure Component and Urbanisation Premium, as state-wise allocations are unavailable; Source: FC reports; ICRA Research

Net borrowing limit of states capped at 3.0% of GSDP during 16th FC's award period with no additional borrowing and carry forward provision

EXHIBIT: Fiscal deficit glide path recommended for state governments by the 16th FC for FY2027-FY2031



- The 16th FC has recommended that the normal net borrowing limit for state governments be fixed at 3.0% of GSDP for its award period FY2027–FY2031, which the GoI has accepted. The 16th FC noted that to maintain the stability of state government debt, fiscal deficit limits must be strictly adhered to in accordance with clause (3) of Article 293 of the Constitution, which entrusts the GoI with oversight if the states are indebted to it.
- Unlike the previous two FCs, the 16th FC has not provided any additional borrowing flexibility above this limit. Notably, while the GoI has also not announced any extra borrowing space for the states for FY2027 in the Union Budget, it has enhanced the allocation of 50-year interest free capex loan to Rs. 1.9 trillion in FY2027 BE for 28 states from Rs. 1.4 trillion in FY2026 RE, which continues to be over and above the net borrowing limit.
- Notably, unlike the 14th and 15th Finance Commissions, the 16th FC has not retained the carry forward mechanism for unutilised borrowing space. This and absence of additional borrowings during the 16th FC may warrant recalibration of spending priorities by states that had relied on this provision in previous years. **As a result of this change, it is possible that some states will prefer to exhaust their annual borrowing limits in each year during the 16th FC's award period and carry forward unspent cash to the next year, something that the Commission seemingly wants to avoid.**
- For determining annual borrowing limits, the 16th FC has retained the extant methodology for estimating the base GSDP, used by both the 14th and 15th FCs.

Source: FC reports; Union Budget; ICRA Research

16th FC made several suggestions on disclosure of OBBs, liabilities under the public account, subsidies and state enterprises

Off-Budget Borrowings (OBBs)

- The 16th FC reviewed various forms of OBBs, including direct guarantees to state entities, escrowing state revenues, and payment delays that compel entities to borrow against undertaking of future state repayments. It also noted that escrowing revenues directly to entities by circumventing the Consolidated Fund of a State could be unconstitutional under Article 266.
- The 16th FC recommended that states fully discontinue the OBBs and bring all such borrowings onto their budgets. If, however, OBBs are still undertaken, a standardised reporting format should be published with the state budget, and the CAG should include these disclosures in the finance accounts. Lending institutions should also periodically report data on lending to state entities.

Fiscal Responsibility and Budget Management (FRBM) Act, and Borrowing Limits

- The 16th FC noted inconsistencies and lack of uniformity in the coverage of State Fiscal Responsibility Legislations (FRLs), including repeated amendments to FRBM Acts by some states. It recommended that states align their FRLs with the fiscal consolidation roadmap proposed by the 16th FC.
- The 16th FC further observed that FRBM Acts should mandate states to report to their legislatures whenever fiscal targets are breached. It also advised expanding the definitions of fiscal deficit and debt to uniformly include all OBBs.
- The 16th FC highlighted instances of inaccurate assessment of financing fiscal deficits through the Public Account, resulting in states exceeding their borrowing limits. It recommended establishing a mechanism for accurately estimating Public Account financing to ensure strict adherence to fiscal deficit limits.

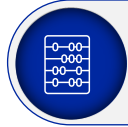
Power Sector, Subsidies and Public Sector Enterprises (PSEs)

- The 16th FC recommended that states pursue DISCOM privatisation, with a special purpose vehicle used to warehouse legacy DISCOM debt so that private investors are not burdened. Repayment of this debt may be treated as eligible expenditure under a capex loan scheme by the GoI only after privatisation.
- It also urged states to rationalise subsidies through exclusion criteria, periodic reviews, and sunset clauses, and to avoid financing subsidies through OBBs or guarantees. Uniform disclosure of subsidies should be ensured, with the CAG standardising reporting.
- On PSEs, the FC recommended regular evaluation by both Union and state governments and inactive PSEs should be closed quickly, and their asset put to more productive use. The FC suggested that states consider creating a state-level privatisation policy, similar to that of the Centre's.

Key recommendations of the 16th FC related to SGS and debt levels of state governments



- The 16th FC noted that even as the yield of State Government Securities (SGS) do not reflect the states' debt levels, and the states still borrow at a higher yield than the Government securities (G-Secs), even though there is hardly any credit and default risk. The FC observed the absence of the default risk does not create incentives for better fiscal management for the states.



- Lack of enough re-issuances by the state governments unlike the G-Secs also leads to states ending up paying an 'illiquidity premium' markup over the G-Secs. The 16th FC suggested that if states also adopt the practices of re-issuances and standard tenors, which would improve the liquidity of the SGS and lead to a better price discovery and, therefore, a reduction in the spread over G-Secs.



- The 16th FC noted that several states maintain sizeable average cash balances on a persistent basis, which carries a cost for the state governments. The FC proposed that the states should devise a strategy for optimal cash management to avoid such build up of excess cash.



- Additionally, the FC recommended the states to smoothen their redemption profile by using switch auctions and buybacks, in line with the practice followed by the GoI.



- The 16th FC assessed the GoI's fiscal deficit would moderate to 3.5% of GDP by FY2031 from 4.3% of GDP as per FY2027 BE. As per the Commission, nearly half a percentage of GDP would be onward lending to states largely for allocation towards interest-free capex loans.



- The FC noted that both the GoI and state governments stick to the recommended levels of fiscal deficits in future; and assuming an annual GDP growth rate of 11%, the debt outstanding of the GoI would be 38.8% of GDP and debt outstanding of the states would nearly stabilise at 32.1% of GDP by FY2042-FY2043. Since 0.5% of GDP of the GoI's fiscal deficit goes towards on-lending to states, the combined debt of the GoI and the states would be 66.1% of GDP by FY2043.



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