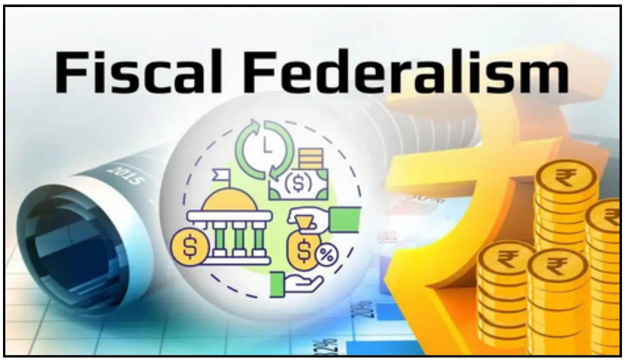
Federal Finance and Fiscal Discipline



The Union Budget 2026–27 emphasizes strengthening India's federal fiscal framework while maintaining a disciplined approach to government finances. This involves preparing for the 16th Finance Commission (which will set the rules for Centre-State fiscal relations for 2026–31), ensuring states get adequate transfers, adhering to fiscal deficit targets and debt management plans, and balancing the roles of the Union and states in funding development. In essence, it's about how India's two tiers of government share resources and responsibilities, and how they jointly maintain fiscal health.

India's federal system entrusts states with critical responsibilities (like agriculture, healthcare, education, infrastructure at the local level), but the Centre collects and controls a large share of revenues. The Finance Commission (a constitutional body set up every five years) is pivotal in recommending how much of the Union's tax revenue is shared with states and on what principles. With the current 15th Finance Commission's award ending in March 2026, the 16th Finance Commission's recommendations will kick in from FY 2026-27 onwards. Therefore, Budget 2026–27 is the first year of a new federal finance blueprint.

At the same time, the Union government has been on a fiscal consolidation path after the COVID shock, and states too have their deficit limits. The Budget reaffirms commitments like bringing the central fiscal deficit down, capping states' deficits, and reducing debt ratios. Let's break down the key components: the 16th Finance Commission, state transfers, fiscal deficit targets, debt management, and the Centre-State fiscal balance.

The 16th Finance Commission: Setting the Stage for 2026–31

The 16th Finance Commission (FC) is tasked with recommending how central taxes should be divided between the Centre and states (vertical devolution) and how the share for states is distributed among the states (horizontal devolution) for the five-year period 2026–27 to 2030–31. Its report appears to have been finalized around the time of Budget 2026.

One of the headline outcomes is that the 16th FC has kept the states' share in the divisible tax pool unchanged at 41%.

This means out of the net proceeds of Union taxes, 41% will be given to states in aggregate, just as under the 15th FC's award. Many states had lobbied for raising it to 42% or even 50%, arguing that states have higher expenditure burdens. However, the Commission noted that states already account for about two-thirds of total public sector (non-debt) revenues in India. In other words, when considering not just central tax devolution but also states' own taxes, the states control a large chunk of public spending. If the Centre's share were to fall too low, it could cripple the Union's ability to fund national programs and defense, etc. The Commission thus rejected states' plea for 50%, reasoning that raising the share further could "limit the Centre's ability to fund national priorities".

That said, keeping 41% ensures continuity – states will keep getting a significant portion of central taxes, amounting to many lakh crores of rupees each year. In FY27 BE (Budget Estimates), the total tax devolution to states has likely increased in absolute terms (with a growing economy and tax base). For example, if the Centre's gross tax revenues are say ₹60 lakh crore, 41% would be about ₹24.6 lakh crore to states.

Horizontal Distribution – Winners and Losers: The Commission has redesigned the formula for how that 41% is split among states, which has led to some states gaining share and others losing relative to the previous formula. Key changes include: - Inclusion of "contribution to national GDP" as a new factor with 10% weight. This rewards states that are larger contributors to the economy (often the more industrialized states). - Increase in weight for population by 2.5 percentage points. This favors states with higher population (which tend to be the northern states like UP, Bihar, Madhya Pradesh, though many northern states also have high population already reflected). - Reduction in weights for area, demographic performance (fertility control), and income distance (inverse of per capita GSDP). The "income distance" criterion had traditionally allocated more funds to poorer states to ensure equity. Reducing its weight means richer states don't lose as much share and poorer states get slightly less than before proportionally. - Removal of the tax effort criterion (which rewarded states with higher tax collection efficiency).

Animal Husbandry: From Subsistence to Enterprise

As a result of these changes, several southern and western states gain, while some northern, poorer states lose share (though not in absolute money, because the pie is growing, but in relative percentage). For instance: - Karnataka is the biggest gainer, with its share rising from 3.64% to 4.13%. This translated into about ₹63,000 crore for Karnataka in FY27, up from ~₹50,800 crore in FY26 – a hefty jump. - Kerala, Gujarat, Haryana also see notable increases in share, reflecting their better socio-economic indicators and contributions to GDP.

Kerala's share rose by 0.45 percentage points, Gujarat's by 0.27, Haryana's by 0.26, etc. - On the other hand, Uttar Pradesh (the largest recipient in absolute terms) saw its share dip from 17.93% to 17.61%. Still, because total divisible revenues grew, UP gets ₹2.69 lakh crore in FY27 vs ₹2.50 lakh crore earlier. - Bihar's share slightly declined (10.05% to 9.94%), Rajasthan (6.02% to 5.92%), and Madhya Pradesh saw the sharpest drop (7.85% to 7.34%). Yet all these states get more in absolute terms year-on-year due to growth, just a smaller slice of the total.

What this reflects is a subtle rebalancing: after years of a tilt towards equity (helping poorer states), the Commission has nudged the formula slightly towards efficiency and output by adding GDP contribution and rewarding states that have done well economically. This could incentivize states to focus on growth and not rely solely on transfers. However, it's a politically sensitive outcome; poorer states often argue they need more support. The Commission's stance likely assumes that direct transfers are not the only way to support those states – the Centre can still give grants for specific purposes.

It's worth noting the Commission also addresses grants to local bodies and disaster funds. They earmarked about ₹7.91 trillion for local bodies (panchayats and urban bodies) for 2026–31, split 60% rural, 40% urban, focusing on services like water, sanitation, and urban infrastructure. This is instead of state-specific grants of previous commissions Additionally, ~₹2.04 trillion is likely set for the State Disaster Response Fund over five years. By allocating significant resources to local bodies, the Commission is pushing decentralization – ensuring money goes to the third tier for local public goods.

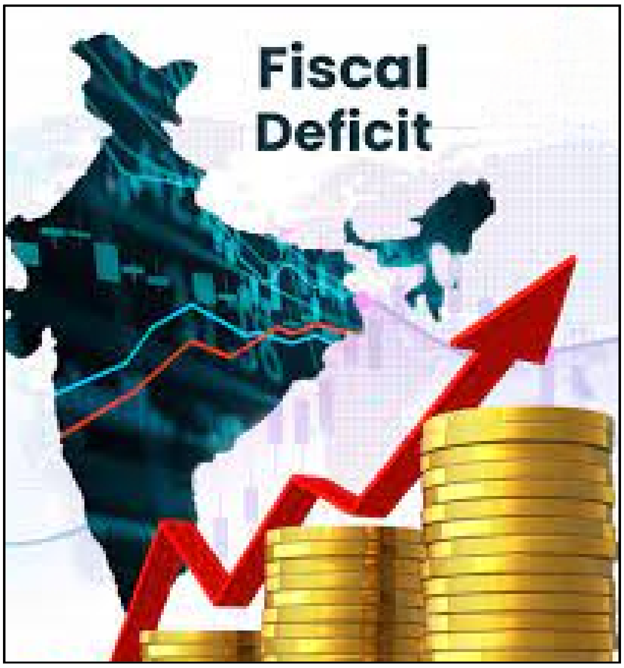
The Budget 2026–27 presumably accepts these recommendations (Finance Commission reports are usually tabled in Parliament and the government issues an Action Taken report). One Business Standard piece even titled it "Budget 2026: Sitharaman lays 16th Finance Commission report in Lok Sabha".

To sum up, under the 16th FC: - States collectively keep 41% of Union taxes. - Distribution formula changes mildly in favor of higher-income states (while still compensating lower-income ones significantly). - Large grants for local governments and disaster management are provided, rather than myriad small grants. - Fiscal consolidation path is recommended (more on that below).

Fiscal Deficit Targets: Center and States on a Glide Path

Fiscal discipline is a major theme, and the Budget outlines the path for reducing deficits for both Centre and states in the coming years.

For the Centre, the Finance Minister reaffirmed the commitment to bring the fiscal deficit below 4.5% of GDP by FY25-26. In fact, she achieved 4.4% in FY25-26 (RE), slightly beating the 4.5% target. Now, the aim is to further reduce the deficit to 4.3% of GDP in FY2026-27.



This is a modest reduction of 0.1 percentage point – as Moody's commented, "the smallest pace of reduction since India emerged from the pandemic". Some might view it as too cautious, but given an upcoming election in 2026 and the need to support growth, the government chose a gradual approach.

The fiscal policy statement indicates: - FY27 BE fiscal deficit = ₹16.96 lakh crore, which is 4.3% of projected GDP. - FY26 RE fiscal deficit = 4.4% of GDP. - The revenue deficit is 1.5% of GDP in FY27 BE, same as FY26 RE – meaning improvement is largely on capital side or higher nominal growth effect.

Looking ahead, the 16th FC's guidance (as reported by Angel One and others) suggests a glide path for combined deficits: They recommended the Centre gradually reduce to 3.5% by FY30-31, and states be capped at 3% of GSDP each. Specifically, the FC proposed: - Combined (Centre+States) deficit of 6.5% of GDP during 2026-31. - Centre to go from ~4.2% in FY27 down by 0.2% yearly to ~3.5% by FY31. - States to stick to 3% (excluding borrowings under the 50-year capex loan scheme). - Importantly, the 3.5% Centre target includes an allowance of 0.5% of GDP for the 50-year interest-free capex loans to states. Essentially, Centre's own "pure" deficit would be 3.0%, plus 0.5% on-lent to states which in effect is states' capex. States' 3% limit would exclude those loans so they don't count it in their deficit (preventing double counting).

The Budget speech likely endorsed at least the broad contours of this. The Finance Minister even noted that interest-free capex loans to states would continue (they were ₹1.3 lakh crore in FY26, maybe increased slightly for FY27) and clarified how they're accounted in deficits.

For FY27 specifically: - Centre's 4.3% target is slightly higher than the 4.2% recommended by FC. Possibly the government took a bit more leeway in year one, but aims to catch up later. - States' borrowing limit for FY27 has historically been 3.5% of GSDP (including 0.5% if they achieve certain power sector reforms or capex milestones).

The 16th FC seems to be suggesting a hard 3% (excluding loans) going forward. This might imply the extra 0.5% reform-linked leeway (that was given from 2021-22 to 2025-26) could be curtailed, pushing states to tighter discipline.

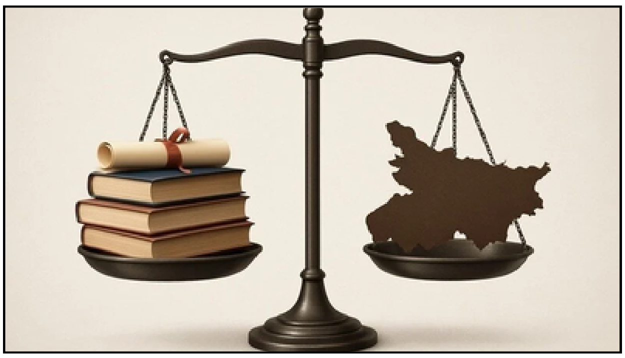
Ensuring states keep deficits in check is crucial because while the Centre's deficit draws more attention, states together also borrow heavily. The 15th FC had allowed states 4% then 3.5% then 3% with some leeway each year in its award. The 16th FC now wants a stable 3%. This will require prudent budgeting by states and perhaps some trade-off: they will rely more on the central grants and devolution (which the FC ensured by keeping 41% share).

The Budget also likely updated the statutory fiscal rules (FRBM Act) or gave signals of updating them, to align with the new targets. We know the old FRBM target was 3% for Centre by 2020 (which got derailed by pandemic). Now perhaps a new medium-term anchor might be set around 3.5% by 2030 for Centre.

From the debt angle: The debt-to-GDP ratio of the Centre is estimated at 55.6% in FY27, down from 56.1% in FY26. A declining debt ratio is highlighted as a positive, as it "will gradually free up resources for priority sectors by reducing interest outgo". Indeed, interest payments are one of the largest line items in the central budget (~3.4% of GDP in FY26). Reducing debt slows the growth of interest payments, allowing more expenditure on productive things like capital investment or social programs. Since 2020, India's general government debt (Centre+states) actually fell by about 7 percentage points from its peak, thanks to growth and calibrated deficits. Continuing this trend is important for inter-generational equity and to retain market confidence (credit ratings etc).

Moody's and others appreciated the commitment to consolidation but noted the pace is slow. However, Barclays pointed out the budget assumptions (10% nominal GDP growth, moderate revenue growth) are credible and might even leave room to overachieve if growth surprises positively.

In sum, the fiscal targets section of the Budget says: we've met our 4.5% by FY26 goal, we'll go to 4.3% in FY27, and we remain on track to ~3% by end of decade, all while keeping states to 3% so that combined debt is sustainable. This discipline is noteworthy as many countries have delayed consolidating after the pandemic; India is ensuring it doesn't stray into unsustainable territory.



Centre-State Fiscal Balance: Transfers and Cooperative Fiscal Federalism

Ensuring a balanced fiscal relationship involves not just dividing revenue, but also coordinating on spending priorities and debt management. The Budget touches on multiple aspects that maintain a healthy Centre-State balance:

- **Tax Devolution:** As discussed, 41% share to states continues. The absolute amount of devolution is rising with buoyant taxes (GST, income tax, etc.). For instance, total devolution in FY25 was around ₹10.21 lakh crore; in FY26 it rose to about ₹12.8 lakh crore; FY27 might be even higher (roughly estimated ₹14-15 lakh crore if taxes grow ~10%). Timely release of these funds is emphasized for state cash-flow.
- **Grants and Schemes:** Apart from FC-mandated transfers, the Centre provides various grants: e.g., centrally sponsored scheme funds, finance commission grants for local bodies and disaster, special assistance. In this Budget, notable ones include:
- The continuation of the **50-year interest-free capex loan to states,** with an outlay of (likely) ₹1.5 lakh crore in FY27. This scheme, started in FY21, has been a key tool to encourage states to spend on capital projects. The loan doesn't count as states' debt (for fiscal limits) if used for capex, and is to be repaid to Centre in installments but interest-free. Essentially it's quasi-grant (value of interest waived) but keeps states accountable to use on capex. The 16th FC even built this into the deficit formula.
- **Sector-specific or state-specific grants:** The 15th FC had given some for health, agriculture, etc. The 16th FC prefers fewer, focusing on local bodies. The Budget likely adjusts allocation accordingly, pushing more funds to panchayats and urban local bodies for water supply, sanitation, etc., rather than myriad small scheme grants.
- **Eastern States and Northeast focus**: The Budget speech mentioned focus on Purvodaya (eastern India) and NE as part of Sabka Vikas. This could mean continued financial packages or higher central share in schemes for those states, acknowledging their developmental gaps.

- **Cooperative Federalism in Reforms:** The Centre m often incentivizes states to reform via money. For example, the extra borrowing 0.5% for power sector improvements (like smart metering, DISCOMs viability) has been a tool. The Budget might have updated on results of that (some states improved, others didn't). The municipal bond incentive is another such idea, pushing big city municipal bodies (which are under states) to embrace market financing.

- **Debt Management and Guarantees:** Some fiscally weaker states have high debt ratios (Punjab, Bihar, Kerala, etc.). The Budget and the 16th FC likely flag that states must manage debt prudently. The FC possibly recommended that states maintain a revenue surplus or at least limit revenue deficit, as "states maintaining a revenue balance is essential" to the fiscal structure. If states don't borrow for operating expenditure, it's healthier. The Centre in recent years even stopped the practice of giving states unconditional loans; now they tie it to capex.
- **FRBM Review:** The FRBM Act, which governs fiscal responsibility, may need amendments to incorporate the new goalposts (4.3% now, 3.5% by 2030, etc.). The Budget might have signaled an update or extension of the "escape clause" due to pandemic. The 16th FC likely gave a template for a new FRBM framework. For example, they might recommend targeting a combined debt ratio, or an expenditure rule. There is mention of a combined deficit of 6.5% being appropriate which could hint at a future legal target.

The Centre-State fiscal balance also involves political economy: states often ask for more funds or complain about centrally sponsored schemes being too rigid. In Budget 2026, some rationalization of schemes was expected (15th FC had recommended reducing number of CSS). The government might have consolidated a few or increased flexibility. For instance, agriculture and rural development schemes might be streamlined, giving states more say.

Importantly, the Centre's own fiscal consolidation indirectly helps states, because if the Centre hogs too much of the borrowing headroom, interest rates go up for everyone. By limiting its deficit to 4.3% and going lower, the Centre leaves space for private credit and for states' 3% without crowding out.

It also keeps the sovereign yield in check, which affects cost of borrowing for states (states often pay ~50-100 bps over G-sec rates).

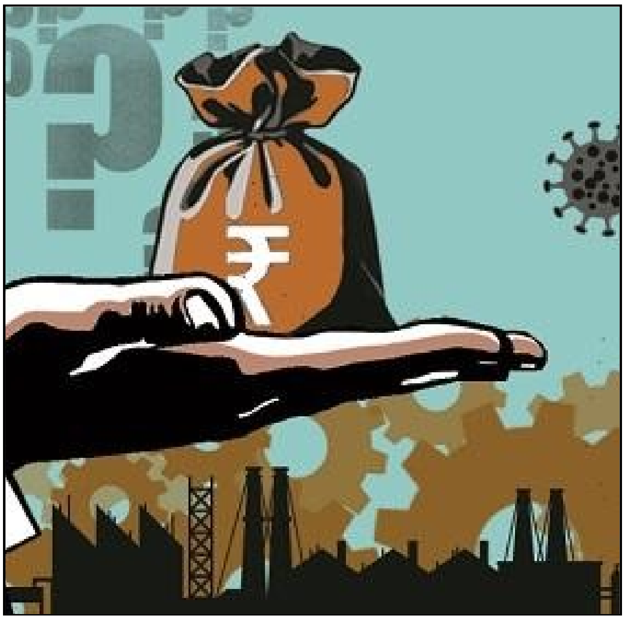
As of now, India's general government debt is around mid-80s % of GDP (Centre ~55%, states ~30%). The 15th FC wanted it down to ~75% by FY26 (which was optimistic). The 16th FC's glide path of combined 6.5% deficits aims to bring it down to maybe 70% by FY31. This is still higher than FRBM's original 60%, but given growth needs and global context, it's a pragmatic interim target.

From a Centre-State balance perspective, one can say: - The Centre is ensuring it doesn't squeeze states financially – 41% devolution maintained (in fact, effectively slightly more when you add some grants). - States are expected to shoulder responsibility by adhering to deficits and using funds effectively (especially capex loans). - Both levels are in a partnership to maintain macro stability (as emphasized by coordination in borrowing limits, etc.).

Conclusion: Strengthening Fiscal Federalism with Prudence

The Budget 2026–27 lays the groundwork for the next phase of fiscal federalism in India – one that is collaborative but also accountable. The setting up of the 16th Finance Commission's recommendations in this Budget is a pivotal moment: it balances the needs of high-income and low-income states, incentivizes performance (through the new formula and conditional loans), and secures resources for grassroots governance (via big local body grants).

By committing to fiscal discipline (4.3% deficit for Centre, ~3% for states), the Budget sends a reassuring message to investors, credit rating agencies, and future generations that India will not live beyond its means. The fact that general government debt has been trimmed by over 7 percentage points since the Covid shock is no small achievement – it required restraint and prioritization of growth-enhancing spending over handouts.



Going forward, the real test will be execution: - Will states be able to increase their own revenues to compensate for only modest rises in transfers? (Many states need to improve tax effort – ironically the FC removed the explicit tax effort criterion, but the spirit remains.) - Can the Centre continue to trim deficit in an election year and beyond? (Political will to not announce populist giveaways en masse in Budget 2027 will be crucial.) - How effectively will the massive funds for local bodies be used? (Capacity building at local level must accompany money, else funds may lie unutilized or be spent sub-optimally.) - Will a new debt and fiscal responsibility framework be legislated that both Centre and states adhere to? Possibly a new FRBM with a debt ceiling could be introduced, which would institutionalize these targets.

Encouragingly, the attitude of "all in it together" seems to underpin the Budget. The Finance Minister talked about Sabka Vikas (growth for all) including states and regions left behind. The Special focus on the Northeast and East – through both FC grants and budgetary schemes – is an example of balancing development. At the same time, states like Karnataka, Kerala that performed well economically are rewarded with a bit more funds, which is fair and motivates others.

Finally, maintaining fiscal discipline is itself a form of inter-generational equity in a federal context: it ensures today's deficits don't become tomorrow's burden, which could crowd out resources for states in the future or force emergency cuts. As Christian de Guzman of Moody's noted, the 4.3% target shows continued consolidation albeit at a slow pace, but importantly, India has established a "track record of fiscal consolidation" now. This credibility will serve both Centre and states well – it keeps borrowing costs lower and allows more fiscal space when truly needed (like if another shock hits).

Sources: The Business Standard reports on the 16th Finance Commission confirm that states' share stays at 41% and describe how the formula changes benefit southern/western states while northern states see relative declines. It provides specifics on Karnataka, Kerala, Gujarat, etc. gaining shares and Uttar Pradesh, Bihar, MP losing a bit. The Indian Express Explained piece details the High-Level Committee for banking and mentions restructuring of PFC/REC (a part of Centre's financial management), while also noting banks' improved metrics and coverage of villages, which is part of broader federal considerations (more villages covered means more state inclusion too). The Times of India piece highlights the fiscal deficit targets: 4.3% in FY27 from 4.4%, debt/GDP to 55.6%, and the FM's statement of fulfilling the sub-4.5% by FY26 pledge. Angel One's summary of the 16th FC provides the combined deficit path (6.5% combined, Centre to 3.5%, states 3%) and clarifies the treatment of interest-free loans in deficit calculations. Together, these sources illustrate how the Budget is steering federal finances: adhering to a consolidation glide path, implementing a new revenue-sharing arrangement through the Finance Commission, and fostering a cooperative approach with states on borrowing and development priorities.