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The 16th Finance Commission and Cooperative Federalism

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Abstract

The study examines imbalances in the vertical and horizontal devolutions of successive Central Finance Commissions (CFCs). The Union government budget documents and reports of earlier finance commissions were used for the study. It is observed that imbalances in the vertical and horizontal devolution have been widening for the last two decades. It is also found that southern states with better socio-economic indicators have been on the receiving end in the devolution process over successive CFCs. The share of Kerala from the 16th CFC was estimated under multiple scenarios. Under scenario 1, Kerala's share will increase from 1.925 percent to 2.114 percent. In the case of the second scenario, Kerala's share will be increased to 2.808 percent. The study suggests a permanent fiscal council for redressing the finance commission-related grievances of the Union and State governments during the award period of the 16th finance commission.

Keywords: Central Finance Commission; Vertical Devolution; Fiscal Federalism; Horizontal Devolution, Intergovernmental Transfers; Kerala Economy

JEL Classifications: H77, H61, H71, R58

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Introduction

The Finance Commission is constituted under Article 280 of the Constitution of India. It is constituted for a fixed time period with a mandate to give recommendations on sharing financial resources between the Union and states. The 1st Central Finance Commission (CFC) was constituted on November 22, 1951 under the chairmanship of K.C. Neogy. The commission submitted the report on December 31, 1952 for the period 1952-53 to 1956-57. The 16th CFC is constituted on December 31, 2023 by the President of India under the chairmanship of Dr. Arvind Panagariya and the 16th CFC is mandated to give its report before October 31, 2025. The recommendations of the 16th CFC will remain valid for five years from April 1, 2026.

The Terms of Reference (ToR) of the finance commissions have varied from one commission to another. The ToR of the 16th FC is limited to devolution of resources as specified under Article 269 and 270 of the Constitution; governing principles for the grant-in-aid under Article 275; grant-in-aid provided under Article 275 (1); and provide funds for local governments. The mandate of the 16th CFC includes the review of arrangements for financing disaster management initiatives.

The Constitution of India has demarcated the role of tax collection and tax-sharing between the Union and State governments. The 80th Constitutional Amendment Act, 2000, replaced the system of a specific tax sharing with another broader divisible pool of taxes. Earlier, Articles 270 and 272 dealt with the sharing of the income tax and excise revenue, respectively, between the central and state governments based on the Finance Commission recommendations or by the order of the President of India. The 80th Amendment Act, 2000, deleted Article 272 and included all the divisible taxes (income tax, corporate tax, Union excise duties, and custom duties) in Article 270, except the items included under Articles 268, 269, and 271 of the Constitution, to share the revenue between the central and state governments from a broader divisible pool. Article 268 includes certain excise duties and stamp duty to be levied by the central government but collected and apportioned by the state government. Article 269 includes taxes, which were collected and levied by the Union government but retained by state governments. Further, the 101st Constitutional Amendment Act,

2016, included the Central GST (CGST) under Article 270 of the Constitution, and the CGST was brought under the purview of the divisible pool of taxes to be shared between the Union and the states. Most of the taxes under Articles 268 and 269 were either abolished or transferred to Article 270 of the GST regime. The article 271 renders additional financial space to the central government to levy surcharges and cess on any items included in Articles 269 and 270. The share of cess and surcharges (net of GST compensation cess) increased to 23 percent of the gross tax revenue of the Union government in 2020-21 from 15 percent during the pre-GST period (2014-15 to 2016-17) (Chakraborty & Gupta, 2024). It has been widely argued that the surcharges and cesses are used as a mechanism to bypass the constitutional mandate of sharing the central tax revenue with the state governments. The limited relevance of Article 268 and 269 for the state government's finances and collection of disproportional revenue under Article 271 by the central government emerged as a new set of challenges to cooperative federalism in India.

The Central Finance Commission (CFC) has to ensure the financial autonomy of the states, while addressing the imbalance in financial resources between the Union and state governments (vertical devolution) and among the states (horizontal devolution). It provides grant-in-aid to certain states as enshrined in Article 275 of the Constitution in order to maintain regional equity in basic services.

Given the setting, the study analyses the changes in the vertical and horizontal devolution criteria of the successive Finance Commissions. The analysis in the paper is divided into five sections. Section 1 looks into the vertical devolution criteria of the successive Finance Commissions and their impacts on state finances. Section 2 examines the evolution of the horizontal devolution criteria and its implications for different states. The Finance Commission's awards to local governments are discussed in section 3. The cumulative impact of the changes in the criteria for horizontal devolution with respect to Kerala is addressed in section 4. The conclusion of the paper is presented in section 5.

Section 1

1. Vertical devolution since 1952

Earlier finance commissions recommended a certain share of the income tax (other than agricultural income) and a fixed share of excise tax to the states. The 55 percent share of the income tax, while 40 percent of the excise duty on three articles, viz., mill-made textiles, sugar, and tobacco, were shared with states under the 1st CFC. The share of income tax reached 85 percent during the 7th CFC. The base for the excise duty was expanded by successive finance commissions. The 11th CFC recommended a constitutional amendment by which a single divisible pool was created. The 11th CFC shared 29.5 percent of the divisible pool of taxes with the states, and the share was increased to 42 percent during the 14th CFC. However, the 15th CFC reduced it to 41 percent. An important criterion considered by the finance commission for vertical devolution was the relative share in the fiscal burden and the fiscal crisis management during unfavourable economic circumstances. Notwithstanding the higher scale and magnitude of the fiscal burden of state governments, the finance commission assigned a higher share to the Union government, taking cognisance of the unforeseen economic circumstances, viz., war, national security, development expenditure, poverty eradication programme schemes, and programmes for self-sufficiency in food production. An increase in the share to the state governments during the 14th CFC is attributable to the decision to do away with the allocation to states for development expenditure through the planning commission.

Table 1: States' share in the divisible pool of central taxes – 1st CFC to 15th CFC

Finance commission	States' share in the net proceeds of income tax (%)	States' share in the net proceeds of union excise duties (%)	Finance commissions	States' share in total divisible pool of the union taxes
1st FC (1952-57)	55	40*	11th FC (2000-05)	29.5
2nd FC (1957-62)	60	25**	12th FC (2005-10)	30.5
3rd FC (1962-66)	66.66	20*^	13th FC (2010-15)	32
4th FC (1966-69)	75	20	14th FC (2015-20)	42
5th FC (1969-74)	75	20	15th FC I st -(2020-21) II nd - (2021-26)	41
6th FC (1974-79)	80	20		
7th FC (1979-84)	85	40		
8th FC (1984-89)	85	45		
9th FC I st -(1989-90) II nd - (1990-95)	85	45		
10th FC (1995-2000)	77.5	47.5		

Note: *3 commodities; **8 commodities; *^35 commodities

Source: Finance Commission Reports (1st FC to 15th FC)

Transfer of resources to states as a proportion of gross revenue receipts reveals the changes in vertical devolution by successive finance commissions. The 15th CFC report brought out the imbalances in vertical devolution. The Union government raised 62.7 percent of the aggregate resources raised by both Union and States, while States spent 62.4 percent of the aggregate expenditure of both Union and States in 2018-19 (15th FC Report, 2020).

Table 2: Devolution to states as percentage of gross revenue receipts

Finance Commission	Finance commission transfers			Other transfers			Total transfers (4+7)
	Share in central taxes	Grants	Total FC transfer (2+3)	Plan grants from planning commission	Non-plan grants from centre	Other non-FC transfers (5+6)	
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>
7th FC	22.39	1.96	24.35	12.11	1.66	13.77	38.11
8th FC	20.25	2.52	22.77	13.56	1.54	15.10	37.86
9th FC	21.37	3.42	24.79	14.48	1.06	15.54	40.33
10th FC	22.22	2.34	24.56	10.57	0.67	11.24	35.79
11th FC	20.59	3.88	24.47	10.10	0.70	10.80	35.27
12th FC	22.03	4.35	26.38			21.01	47.39
13th FC	23.80	3.96	27.75			20.47	48.22
14th FC	31.37	4.51	35.88			14.74	50.62

Source: Finance Commission Reports

The tax devolved to the states as a percentage of the gross tax revenue (GTR) for the first two years of the 15th CFC declined to 31.1 percent as compared to 34.85 percent under the 14th CFC. The share of central expenditure on items in the union list declined to 66 percent in 2016-17 from 77 percent in 2002-03. Conversely, central expenditure on items in the state list increased to 19.3 percent from 13.3 percent during the reference period. Similarly, central expenditure in the concurrent list increased to 14.5 percent from 9.5 percent between 2002-03 and 2016-17 (**Chakraborty and Gupta, 2024**). The mismatch between state expenditure and funds shared with the states has widened over the years. It has wider implications for the autonomy of the states under cooperative federalism as enshrined in the Constitution.

Table 2 shows the trend in central transfers to the states since the 7th Central Finance Commission (7th CFC). During the 7th CFC, the finance commission transfers through inter-se share and grants together constituted 24.35 percent of the gross revenue receipts, while non-FC transfers were 13.77 percent of the gross revenue receipts of the Union Government. Effectively, the total transfers during the 7th CFC period were 38.11 percent of the gross revenue receipts. It is observed that until the 11th CFC period, the finance commission transfers varied between 22 percent and 24 percent. The FC and non-FC transfers together constituted 35 percent to 40 percent. For the 12th and 13th CFCs, a moderate increase in the FC transfers to states could be observed. The finance commission and central government jointly transferred 50 percent of the gross revenue receipts of the Union Government to the states during the 14th CFC period (Table 2). The 50 percent of the gross revenue receipts of the Union Government could be considered as the benchmark for the vertical devolution to the states. However, a clause has to be added to incorporate a certain limit on cesses and surcharges, barring exceptional exigencies.

Section 2

2.1. Trends in horizontal devolution

The horizontal devolution criteria have been substantially altered over the years. The horizontal devolution is the devolution of funds among the states by the CFCs. The criteria are designed to satisfy the principle of needs, equity, and performance (efficiency). Population was the dominant criterion for horizontal devolution for the first seven Finance Commissions. The performance of the tax collection was substantially factored into the horizontal devolution since 1951. The performance criterion was largely concentrated on the performance of tax collection by states. It shows that earlier Finance Commissions had assigned importance to the needs and performance criteria. The 4th CFC introduced the equity principle for the horizontal devolution. The 7th CFC focused on the equity-based criteria and introduced the inverse of income, poverty ratio, and revenue equalisation. Efforts of the 7th CFC on equity criteria were continued till the 10th CFC.

The Income Distance Criteria (IDC) was refined from its earlier version. The IDC was evolved as an important equity-based criterion till the 10th CFC.

The 11th CFC recommended the 80th constitutional amendment and brought all central taxes to the divisible pool. However, if any particular tax is not enforced by any state, the horizontal share for that tax would be estimated separately. For example, service and expenditure tax were not enforced in Jammu & Kashmir, and therefore, the horizontal share for the service and expenditure tax was estimated separately by excluding Jammu & Kashmir since the 11th CFC. The 13th CFC was heavily reliant on equity and performance criteria.

The weightage for the need and cost disability criteria increased from 17.5 percent in the 11th CFC to 50 percent in the 14th CFC. However, it was reduced to 40 percent in the 15th CFC. Incorporation of forest cover and 2011 census replacing the 1971 census in the 14th and 15th CFCs brought in substantial changes in the horizontal devolution. Further, the weightage of the equity criteria was reduced from 70 percent in the 11th CFC to 45 percent in the 15th CFC. The performance-based criteria were not even considered by the 14th CFC. The usual tax effort and fiscal performance criteria have also been substituted with demographic performance. The change in the criterion of demographic change was intended to compensate for the losses on account of replacing the 1971 population with the 2011 population in the horizontal criteria.

2.2 Trends in inter-se devolution across states

A disaggregated analysis of the horizontal devolution revealed the impact of changes in the devolution criteria across the states. Table 3 presents Finance Commissions' transfers, including grants, during the first six CFCs. The relative size of the state with respect to population, geography, tax collections, and reorganisation cost changed substantially till 1956. Therefore, it is advisable to compare from the 2nd CFC.

The first three Finance Commissions provide an indicative trend. In the case of the 3rd and 4th CFCs, Uttar Pradesh secured the top position, while Andhra Pradesh (3rd CFC) and Maharashtra (4th CFC) secured the second position. Uttar Pradesh was closely followed by Bihar and West Bengal during the 6th FC.

Table 3: Finance Commission Transfer including Grants by States (% share)- 1st to 6th FC

State	1st FC (1952-57)	2nd FC (1957-62)	3rd FC (1962-66)	4th FC (1966-69)	5th FC (1969-74)	6th FC (1974-79)
Andhra Pradesh	7.940 ¹	8.585	9.317	8.051	7.765	8.076
Assam	4.239	4.324	4.468	5.036	3.651	4.575
Bihar	10.841	9.087	7.830	6.912	9.570	8.791
Bombay ²	15.427 ³	13.884				
Gujarat			6.499	4.227	4.342	3.836
Haryana				1.190	1.416	1.256
Himachal Pradesh					0.945	2.124
Jammu & Kashmir		2.342	1.659	2.273	2.170	2.417
Kerala	0.842 ⁴	3.614	5.222	6.514	4.379	4.995
Madhya Pradesh	9.131 ⁵	6.820	6.623	5.603	6.454	5.657
Maharashtra			9.118	9.008	9.158	7.405
Manipur					0.504	1.332
Meghalaya					0.354	0.911
Mysore	1.315	7.003	6.197	7.482	4.652	3.993
Nagaland			0.052	2.013	1.535	1.412
Orissa	4.683	4.524	7.721	8.035	5.406	6.008
Punjab ⁶	5.594 ⁷	4.950	4.500	2.222	2.129	1.758
Rajasthan	3.596	4.578	5.356	4.520	4.986	5.869
Tamil Nadu ⁸	9.079	6.948	7.000	7.169	6.975	5.605
Tripura					0.635	1.376
Uttar Pradesh	15.011	13.508	11.287	12.964	14.531	14.040
West Bengal	12.302	9.853	7.150	6.781	8.445	8.564
Total (Rs. Crore)	420.43	1048.97	1310.76	1745.02	5315.99	9608.85

Note: 1. Hyderabad (4.115) was annexed to Andhra Pradesh; 2. Bombay was reorganised to Gujarat and Maharashtra in 1960; 3. Saurashtra (0.590) was annexed to

Bombay in 1956; 4. Travancore-Cochin till 1956; 5. Madhya Bharat (3.753) was annexed to Madhya Pradesh in 1956; 6. Punjab was reorganised into Punjab and Haryana in 1966; 7. Patiala & East Punjab States Union's (PEPSU) was annexed to Punjab in 1956; 8. Madras was renamed as Tamil Nadu in 1969.

Source: Finance Commission Reports and Budget Documents of Central Government

Table 4: Finance Commission Transfer by States (Excluding Grants and Service Tax) (% share)- 11th to 15th FC

State	11th FC (2000-05)	12th FC (2005-10)	13th FC (2010-15)	14th FC (2015-20)	15th FC-I (2020-21)	15th FC-II (2021-26)
Andhra Pradesh	7.701	7.356	6.937	4.305	4.111	4.047
Arunachal Pradesh	0.244	0.288	0.328	1.37	1.76	1.757
Assam	3.285	3.235	3.628	3.311	3.131	3.128
Bihar	14.597	11.028	10.917	9.665	10.061	10.058
Chhattisgarh	-	2.654	2.47	3.08	3.418	3.407
Goa	0.206	0.259	0.266	0.378	0.386	0.386
Gujarat	2.821	3.569	3.041	3.084	3.398	3.478
Haryana	0.944	1.075	1.048	1.084	1.082	1.093
Himachal Pradesh	0.683	0.522	0.781	0.713	0.799	0.83
Jammu & Kashmir	1.29	1.297	1.551	1.854		
Jharkhand	-	3.361	2.802	3.139	3.313	3.307
Karnataka	4.93	4.459	4.328	4.713	3.646	3.647
Kerala	3.057	2.665	2.341	2.500	1.943	1.925
Madhya Pradesh	8.838	6.711	7.12	7.548	7.886	7.85
Maharashtra	4.632	4.997	5.199	5.521	6.135	6.317

Table 4: Cont.

State	11th FC (2000-05)	12th FC (2005-10)	13th FC (2010-15)	14th FC (2015-20)	15th FC-I (2020-21)	15th FC-II (2021-26)
Manipur	0.366	0.362	0.451	0.617	0.718	0.716
Meghalaya	0.342	0.371	0.408	0.642	0.765	0.767
Mizoram	0.198	0.239	0.269	0.46	0.506	0.5
Nagaland	0.22	0.263	0.314	0.498	0.573	0.569
Orissa	5.056	5.161	4.779	4.642	4.629	4.528
Punjab	1.147	1.299	1.389	1.577	1.788	1.807
Rajasthan	5.473	5.609	5.853	5.495	5.979	6.026
Sikkim	0.184	0.227	0.239	0.367	0.388	0.388
Tamil Nadu	5.385	5.305	4.969	4.023	4.189	4.079
Telangana	-	-	-	2.437	2.133	2.102
Tripura	0.487	0.428	0.511	0.642	0.709	0.708
Uttar Pradesh	19.798	19.264	19.677	17.959	17.931	17.939
Uttarakhand	-	0.939	1.12	1.052	1.10	1.118
West Bengal	8.116	7.057	7.264	7.324	7.519	7.523
Total (Rs. Crore)	296268.23	617504.56	1219885.67	2960302.51	615840.81	5658182.82

Note- 1. It does not include the grants and service taxes; 2. From 14th FC onwards, Telangana was bifurcated from Andhra Pradesh; 3. From 12th FC onwards, Jharkhand, Chhattisgarh and Uttarakhand were bifurcated from Bihar, Madhya Pradesh and Uttar Pradesh respectively.

Source: Finance Commission Reports (11th FC to 15th FC)

**Table 5: Finance Commission Transfer by States (Including Grants and Service Tax)
(% share)- 11th to 15th FC**

State	11th FC (2000-05)	12th FC (2005-10)	13th FC (2010-15)	14th FC (2015-20)	15th FC-I (2020-21)	15th FC-II (2021-26)
Andhra Pradesh	6.889	6.653	6.576	4.718	4.478	4.371
Arunachal Pradesh	0.597	0.450	0.545	1.295	1.534	1.661
Assam	2.974	3.219	3.425	3.224	3.880	3.255
Bihar	13.017	10.337	10.407	9.115	8.851	9.465
Chhattisgarh	0.000	2.423	2.455	2.908	3.010	3.222
Goa	0.190	0.238	0.263	0.356	0.337	0.371
Gujarat	2.561	3.285	3.009	2.912	3.007	3.340
Haryana	0.873	0.995	1.076	1.022	0.956	1.094
Himachal Pradesh	1.945	1.804	1.291	1.876	2.373	1.443
Jammu & Kashmir	4.381	2.620	2.385	3.393		
Jharkhand	0.000	3.180	2.797	2.962	2.928	3.129
Karnataka	4.447	4.192	4.218	4.448	4.040	3.569
Kerala	2.739	2.549	2.329	2.639	3.946	2.451
Madhya Pradesh	7.954	6.125	6.848	7.124	6.967	7.449
Maharashtra	4.190	4.594	5.092	5.212	5.419	6.020
Manipur	0.845	0.892	0.838	0.885	1.043	0.862

Table 5: Cont.

State	11th FC (2000-05)	12th FC (2005-10)	13th FC (2010-15)	14th FC (2015-20)	15th FC-I (2020-21)	15th FC-II (2021-26)
Meghalaya	0.773	0.575	0.590	0.658	0.744	0.788
Mizoram	0.685	0.604	0.536	0.795	0.731	0.593
Nagaland	1.234	0.958	0.847	1.017	1.075	0.892
Orissa	4.725	4.905	4.649	4.381	4.089	4.293
Punjab	1.128	1.615	1.445	1.487	2.687	2.173
Rajasthan	5.283	5.083	5.659	5.188	5.249	5.960
Sikkim	0.425	0.243	0.266	0.346	0.404	0.398
Tamil Nadu	4.832	4.862	4.817	3.796	4.275	3.919
Telangana	0.000	0.000	0.000	2.300	1.987	2.030
Tripura	1.145	1.089	0.801	0.756	1.095	1.011
Uttar Pradesh	17.988	18.160	18.683	16.939	15.812	16.893
Uttarakhand	0.000	1.560	1.190	0.992	1.710	1.574
West Bengal	8.180	6.789	6.962	7.256	7.371	7.774
Total	100.00	100.00	100.00	100.00	100.00	100.00

Note- 1. It includes the grants and service taxes; 2. From 14th FC onwards, Telangana was bifurcated from Andhra Pradesh; 3. From 12th FC onwards, Jharkhand, Chhattisgarh and Uttarakhand were bifurcated from Bihar, Madhya Pradesh and Uttar Pradesh respectively.

Source: Estimated from Finance Commission Reports and budget documents of Central Governments.

Table 6: Finance Commission Transfer to Kerala (% share) (11th-15th CFC)

Type of Transfer	11th FC (2000-05)	12th FC (2005-10)	13th FC (2010-15)	14th FC (2015-20)	15th FC (2020-21)	15th FC (2021-26)
FC Devolution Share (Ex. Services & Grants)	3.057	2.665	2.341	2.500	1.943	1.925
FC Devolution Share (Incl. Services)	3.058	2.669	2.346	2.502	1.943	1.925
FC Devolution Share (Incl. Services and Grants)	2.739	2.549	2.329	2.639	3.946	2.451

Source: Estimated from Finance Commission Reports and budget documents of Central Governments.

An analysis of horizontal devolution by the first six CFCs and the recent five CFCs revealed a structural shift in horizontal devolution in India. The share from horizontal devolution for southern and eastern states has declined, while the share for major northern states, viz., Bihar (including Jharkhand), Uttar Pradesh (including Uttarakhand), and Madhya Pradesh (including Chattisgarh) has increased significantly (Table 3, 4, and 5) since the 6th CFC. The observed structural shift in horizontal devolution is attributable to the equity criteria.

The horizontal devolution share for Kerala during the 15th CFC was the lowest in history. Table 6 presents the CFC transfer to Kerala from the 11th to the 15th CFC by three categories: (i) share of CFC transfer excluding share of service tax and grants, (ii) share of CFC transfer including service taxes but excluding grants, and (iii) share of CFC transfer including share of service taxes and grants. It is found that the share aggregate CFC transfer (including service taxes and grants) to Kerala had been lower than the inter-se share for Kerala during the 11th to 13th CFC. During the 14th and 15th CFC, the share

of aggregate CFC transfers had been higher compared to the inter-se share for Kerala. The decline in aggregate as well as inter-se share CFC transfer posed challenges to the state to sustain socio-economic development.

Section 3

3.1. Central Finance Commission and Local Governments

The 73rd and 74th Constitutional Amendments in 1992 empowered the local governments to sustain themselves by managing their own development actions and plans. Article 280 (3) (bb) and (c) of the Indian Constitution mandated the CFC to suggest measures to support the local governments. Funds devolved to local governments by CFCs are crucial in determining the financial autonomy of local bodies. The 11th and 12th CFCs had identified certain areas for the local governments to utilise the funds. The 13th CFC suggested six criteria for rural local governments and nine criteria for urban local governments for the utilisation of performance grants. The 14th CFC divided allocation to local governments into basic grant (50%) and performance grant (50%). The 14th CFC had also defined areas of interest for the utilisation of grants for local governments. The 15th CFC modified the allocation of local government by categorising it into untied and tied funds at a ratio of 40:60. The tied funds curb the financial autonomy of local governments, and it is against the spirit of the 73rd and 74th Constitutional Amendments.

Table 7 presents the share of CFC grants received by local governments out of the total grants recommended by the CFCs. It shows that the grants availed by local governments are much lower when compared to the recommendations of CFCs. During the 11th and 12th CFCs, local governments received only 17 percent of the grants recommended by the CFCs, and it touched 53 percent during the 14th CFC.

The funds available to local governments as recommended by the CFCs call for a critical re-assessment. The 15th CFC observed that the conditions attached to the utilisation of funds for local governments have resulted in lower utilisation of the funds. There has also been a concern about the delayed fund transfers to local governments. A major portion of the annual fund allocation to local governments is usually credited in their treasury in the last

quarter of the financial year, and it becomes difficult to utilise the funds effectively during the three months. In this respect, it is suggested that the conditions imposed on the utilisation of the funds have to be reviewed from the perspective that the local governments construe themselves as independent.

Table 7: Actual Grant Received as Percentage of FC Grants by the Local Governments

Finance Commission	Grant Recommended (Rs. Crore)	Grants to Local Bodies (Rs. Crore)	Share of Actual Grants to Recommended Grant (%)
10th FC	20300	5381	26.50
11th FC	58587	10000	17.07
12th FC	142640	25000	17.53
13th FC	258581	87519	33.85
14th FC	537353	287436	53.49
15th FC- Ist	201023	90000	44.77

Source: Finance Commission Reports (10th FC to 15th FC)

3.2. Central Finance Commission and Local Government in Kerala

The 15th CFC assigned 90 per cent weightage to population and 10 per cent weightage to geographical area for the devolution of grants to local governments. Kerala accounted for 3.89 per cent of the total population in India in 1971, and the population share of the state declined to 2.75 per cent in 2011. The decline in the population share has left a substantial fall in the relative share of grants devolved to Kerala by the 15th CFC. The 11th CFC considered the 1971 census data for population weightage and also incorporated criteria such as geographical area, decentralisation index, revenue effort, and distance from the highest per capita income (State Level) for the devolution of funds to local governments. On the contrary, the 15th CFC considered only two parameters (2011 census population and geographical area) for the devolution of grants to local governments.

Accordingly, the inter-se share of Kerala declined to 2.93 per cent. Kerala's demographic achievements have negatively impacted the state's allocation of CFCs for local governments.

It has been widely acknowledged that the remarkable performance of local governments in Kerala with respect to the devolution of power and resources that they received from the state government, as well as their overall functioning as local governments. Kerala stood first in the devolution index comprising: (1) operational core of decentralisation, (2) support system for devolution, and (3) improved index of devolution (Government of India, 2016). However, such achievements of local governments across states were not considered by the 15th CFC for the devolution of grants to local governments.

The 15th CFC adopted a uniform fund-sharing ratio of 65:35 between rural and urban local governments for all states. It is based on the projected rural-urban population share for 2021 at the national level. Kerala had an urban population share of 47.70 per cent, whereas the national average was 31.14 per cent (Census 2011). There have been significant differences in the proportion of the rural and urban population across states, as the urbanisation process is also not uniform at the national level. A one-size-fits-all approach does not work in this context. Therefore, the 16th CFC should take this issue into account and adopt a more scientific approach for the devolution of funds among rural and urban local bodies across states.

The introduction of the Goods and Services Tax (GST) has subsumed certain taxes (Octroi, Entertainment and Advertisement taxes) that were previously collected by local governments in the country. Studies have shown that the introduction of GST has reduced the sources of Own Source Revenues (OSR) of local governments in the country, especially for urban local bodies (Riyas, 2024). Grants from the CFCs under the divisible pool to local governments have increased over the years, while they are still inadequate to address the financial development and administrative needs of local governments. Efforts have to be made to compensate for the loss in the OSR of local governments. The CFC may also consider the inclusion of local governments in sharing the GST. A share of the GST to the local government may be helpful in addressing the financial requirements of the local governments for the million-plus cities in the country.

Section 4

4.1. Central Finance Commissions and Kerala

As mentioned elsewhere, Kerala is one of the states with the maximum loss in the relative share in revenue due to alterations in the criteria for horizontal devolution. The share of the state declined from 3.057 percent to 1.925 percent between the 11th and 15th CFCs. Table 8 shows the weightage for horizontal devolution criteria adopted from the 11th to the 15th CFCs. Important observations from Table 8 are: (1) the relative weight for the income distance has been substantially reduced from 62.5 percent to 45 percent between the 11th and 15th CFCs award periods. (2) the weightage for tax effort declined to 2.5 percent from 7.5 percent between the 12th and 15th CFCs.

Table 9 presents the horizontal devolution share with respect to Kerala from the 11th to the 15th CFCs along with alternative approaches. The relative share of Kerala under the income distance criteria in the 15th CFC was reduced to one-fourth as compared with the 14th CFC (Table 9).

Table 8: Weightage for Horizontal Devolution Criteria

Criteria	11 th	12 th	13 th	14 th	15 th	16 th	16 th
Population 1971	10.0	25.0	25.0	17.5			
Population 2011				10.0	15.0	32.5	27.5
Area	7.5	10.0	10.0	15.0	15.0	5.0	12.5
Forest Cover				7.5	10.0	7.5	7.5
Income Distance	62.5	50.0		50.0	45.0	30.0	32.5
Fiscal Capacity Distance			47.5				
Fiscal Discipline	7.5	7.5	17.5				
Infrastructure Index	7.5						
Tax Effort	5.0	7.5			2.5		2.5

Table 8: Cont.

Criteria	11th	12th	13th	14th	15th	16th	16th
Demographic Change					12.5	22.5	17.5
Population Density						2.5	
Total Devolution	100	100	100	100	100	100	100

Note: 1. Following Government of Kerala recommendation to 16th CFC; 2. Alternative approach presented in the paper

Source: Finance Commission Reports (11th FC to 15th FC)

The decline in horizontal devolution share under the income distance criteria for Kerala is attributed to three major factors: viz., (i) changes in the relative weightage of the income distance criteria; (ii) change in the definition of GSDP base from the per capita GSDP of the top three states as used under the 11th and 12th CFC to the per capita GSDP of the single state with the highest per capita GSDP under the 14th and 15th CFC; (iii) The average per capita GSDP of Kerala changed from 10th place to 4th place between 2011-2013 and 2017-2019. It narrowed down the distance in per capita income of Kerala with respect to Haryana. The notable difference in the income distance between the 14th and 15th CFC for Kerala is attributable to a relatively higher per capita GSDP growth rate for the state as compared to others during the reference period for the 15th CFC. A higher weightage for the income distance criteria has pushed down the growth prospects for the state as compared to others.

The continuous fall in the horizontal devolution share to Kerala had adverse implications on the state's budget and development activities. Kerala's rank in the per capita GSDP declined to 9th place in 2021-24 from 4th place in 2016-19. The share of the elderly population in Kerala increased to 16.5 percent in 2021 from 12.5 percent in 2011, and it is projected to exceed 20 percent by 2030 (UNFPA, 2023).

Table 9: Composition of Kerala's Devolution Share under Various Criteria

Criteria	11th FC	12th FC	13th FC	14th FC	15th FC	16th FC ¹	16th FC ²	16th FC ³
Population 1971	0.393	0.980	0.983	0.688				
Population 2011				0.281	0.425	0.425	0.921	0.780
Area	0.150	0.200	0.200	0.300	0.300	0.300	0.100	0.250
Forest Cover				0.207	0.295	0.291	0.218	0.218
Income Distance	1.854	0.891		1.024	0.260	0.453	0.302	0.357
Fiscal Capacity Distance			0.535					
Fiscal Discipline	0.327	0.280	0.623					
Infrastructure Index	0.069							
Tax Effort	0.263	0.314			0.074	0.074		0.074
Demographic Change					0.572	0.572	1.029	1.129
Population Density							0.109	
Total Devolution	3.057	2.665	2.341	2.500	1.925	2.114	2.679	2.808

Note: 1. Estimated from the weight assigned by 15th FC; 2. Estimated following Government of Kerala recommendation to 16th CFC; 3. Estimated following alternative approach presented in the paper.

Source: Estimated from Finance Commission Reports (11th FC to 15th FC)

It needs to be underlined that population is not a homogenous entity. Therefore, the age structure of the population, the scale and magnitude of

social security schemes for the aged by states, have to be factored into the index for horizontal devolution. The relative share of the elderly population (60+) in the total population of the state and the life expectancy are highest in Kerala among major states. A higher life expectancy and elderly ratio demand a proportional increase in investment in the health infrastructure, pension fund, and other social welfare schemes. The government of Kerala provides old age pension to 26.44 lakh people above 60 years from BPL families, and a total of 62 lakh people receive pension under different social welfare schemes in the state. The Old Age Dependency Ratio (OADR) shows the number of persons aged 65 years and above over 100 persons of working age group (20 to 64 years). The OADR was 19.6 percent for Kerala, while the same for India was only 14.2 percent in 2011. In addition, other social security measures for the senior citizens, viz., old age homes, elderly care centres, palliative care units, and other measures under the local governments, need to be assured. It underlines that the 16th CFC has to take into account the demographic transition stage of the population and the level of state mediation while assigning weight to the award of CFC.

Kerala has entered into second-generation development issues. The per capita expenditure on education, health, infrastructure development, expenditure for social security and care for the elderly is relatively higher for states with higher per capita income. The per capita expenditure on medical and public health of Kerala was Rs 2635 while the national average was Rs 1979 for 2023-24. Kerala has the lowest Infant Mortality Rate (IMR) in the country (Table A2) and a high life expectancy at birth (Table A3). Other indicators, viz., Child Mortality Rate (CMR), number of doctors and paramedical staff per 1000 population, and primary health centres per lakh population, have to be considered in the Demographic Performance Criterion. Under the present scenario, states with a high per capita income receive a low share from the divisible pool. With the present criteria for horizontal devolution, states like Kerala will find it difficult to continue with their level of expenditure on health and education.

If special grants for the health sector are not awarded, the achievements in the social sector will be reversed. The relative position of Kerala in per capita health expenditure has slipped from 4th to 7th position between 2015-16 and 2023-24 (Table A1). Important health indicators such as life expectancy at birth have become either stagnant or started declining (Table A1 and A3).

The states with higher scores in the SDG/HDI have higher expenditure in the social sector to sustain the achieved standard. Conversely, a relatively low per capita expenditure in such high-performing states in the social sector might reverse the performance indicators in the long run. The SDG score and Human Development Indicators (HDI) in Kerala are even at par with some of the countries of the global north (Table A1, A2, A3, A4, and A5).

4.2. Alternative approach to horizontal devolution

Although the 15th Financial Commission provided revenue deficit grants to Kerala, it was inadequate due to methodological fallacy. A weighted average GSDP method is suggested to estimate the income distance criteria. Further, the weightage for the income distance criteria needs to be reduced to 32.5 percent (Table 8, last column). The 15th CFC has adopted the 2011 population instead of the 1971 population to estimate the devolution on account of population. The 16th CFC may consider raising the weight assigned to population size from 15 percent to 27.5 percent to accommodate the present needs of the states, and it is consistent with the weightage given by the 14th CFC (Table 8, last column).

The 15th CFC assigned 15 percent weightage to the geographical area of the state and 10 percent weightage to the forest coverage under the cost disability criteria. A cumulative weightage of 25 percent was assigned to the cost disability criteria. However, the overlapping of the forest area with the total geographical area of the state had not been accounted for by the 15th CFC. It is suggested that (i) the area under forest cover may be subtracted from the geographical area of the state to estimate the devolution for area criteria to avoid double counting; (ii) a provision for a minimum of 2 percent of the allocation to each state regardless of geographical size needs to be retained; (iii) the weightage for the total geographical area and forest coverage may be reduced to 12.5 percent and 7.5 percent respectively so that a judicious balance in the weightage for the cost disability criteria under horizontal devolution may be maintained (Table 8, last column).

Performance criteria include tax efforts, fiscal discipline, and demographic performance. The Union Government's regulations on borrowing limits and borrowing options for the state do not leave space for maintaining fiscal

discipline. Further, performance on fiscal discipline and tax efforts needs sustained efforts and volatility in the outcomes.

The demographic performance requires sustained efforts. Rewarding the demographic performance motivates the states. An index of demographic performance with precisely crafted weightage and composition of the demographic indicators has the potential to balance the disability cost associated with higher demographic performance, such as escalated levels of pension burden, healthcare expenditure, and dependency ratio. It is suggested that (i) the weightage of the tax effort may be retained at 2.5 percent; (ii) the weightage for the demographic performance should be raised to 17.5 percent; (iii) the product of the 1971 population (p) and the reciprocal of the total fertility rate (f) for each state is used to estimate the demographic performance by the 15th CFC ($p*f$). It is suggested that the product of the 1971 population (p), the reciprocal of the total fertility rate (f), and the share of the elderly population (e) in the total population of the state may be used to estimate the demographic performance by the 16th CFC ($p*f*e$). The inclusion of the elderly share in the estimation of the cost of disability will account for the rising cost of demographic performance for the southern states. The total fertility rate and the share of the elderly in the population are sensitive to the major costs of the demographic performance, viz., higher dependency ratio, pension burden, and healthcare burden, as discussed above.

The CFCs follow four broad principles of horizontal devolution, viz., (i) need; (ii) equity; (iii) cost disability; and (iv) performance. The present study suggests modified weightage for horizontal devolution to manage imbalances under the above-mentioned criteria for a holistic. A reduction in the relative importance of criteria such as equity (income distance) and cost disability (geographical area and forest coverage) are suggested for a judicious balance with needs (population 2011) and performance (demographic performance) criteria. The study has estimated the inter-se share for Kerala under the 16th CFC by two approaches, viz., (i) the 15th CFC approach; and (ii) an alternative approach based on the modified weightage discussed above. Horizontal devolution under the first approach shows an increase from 1.925 percent to 2.114 percent for Kerala, while the second approach provides a 2.808 percent share. The alternative approach is balanced and justified based on its contents (Table 8).

Section 5

Conclusion

This study discusses the imbalances in the vertical and horizontal devolution of tax-revenue in India. The share of the Union Government in public expenditure on the state and concurrent list is continuously increasing over the years. It is observed that the CFCs and the central government have cumulatively transferred 50 percent of the gross revenue receipts of the central government to the states. Therefore, it is suggested that the 16th CFC may consider the need for a 50 percent share of the divisible pool under vertical devolution to states.

The imbalances in the horizontal devolution are the primary concern of the southern states with higher socio-economic indicators. It is observed that horizontal criteria are skewed in favour of equity, while need and performance are not given adequate attention. The study has estimated the share of Kerala under the 16th CFC by two approaches, viz., (i) the 15th CFC approach; and (ii) an alternative approach based on the modified weightage in section 4.2. Horizontal devolution under the first approach shows an increase from 1.925 percent to 2.114 percent for Kerala, while the second approach provides a 2.808 percent share. The alternative approach is balanced and justified based on its contents.

An independent and permanent Fiscal Council as a regulatory/monitoring body for fiscal decentralisation is useful in handling various tasks related to regulation and management of public finance in India, such as (a) grievance redressal system for states; (b) soundness of the estimation of fiscal capacity and expenditure of the states. The independent Fiscal Council is found more realistic in fiscal projection for expenditure and revenue (Roel Beetsma et al., 2019). (c) Fiscal advisory to centre and state governments: It may regularly advise the governments on fiscal policies and performance. The independent fiscal council in India is advocated for a long time by various committees and reports on the finances in India, such as the 13th CFC and 14th CFC, N. K. Singh committee (2017), and D. K. Srivastava committee (2018). In this context, the 16th CFC may also critically review the need for a permanent Fiscal Council.

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Appendix

Table A1: Per Capita Expenditure on Medical and Public Health by Major States (Revenue + Capital Account)

State	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Jammu & Kashmir	1934	2121	2244	3279	3080	3566	3883	5661	5611
Himachal Pradesh	1591	2062	2310	2585	2594	2776	2979	4061	3381
Uttarakhand	1277	1299	1380	1789	1773	2105	2547	3994	3645
Kerala	1262	1584	1699	1869	1989	2359	3162	2499	2635
Gujarat	976	1020	1075	1219	1141	1246	1642	1575	1598
Chhattisgarh	930	1122	1351	1242	1536	1867	2130	2456	2471
Haryana	882	1047	1151	1347	1660	1934	2259	2598	2786
Telangana	880	1013	1000	1108	1127	951	1253	2343	2639
Tamil Nadu	841	905	1104	1227	1234	1772	1952	1923	1977
Punjab	835	924	863	1015	1101	1203	1218	1634	1738
Karnataka	816	974	1156	1334	1268	1658	2159	1877	2101

Odisha	807	1002	1033	1190	1284	1643	2169	2703	3293
Assam	805	886	1234	1276	1460	1707	2030	2213	1976
Maharashtra	797	846	947	997	1111	1306	1597	1886	1846
West Bengal	767	799	850	920	1009	1198	1584	1640	1743
Andhra Pradesh	755	990	900	1037	1030	1144	1580	1798	2307
Rajasthan	727	804	977	1188	1132	1153	1563	1946	2199
Madhya Pradesh	654	706	881	894	1100	1100	1435	1530	1801
Jharkhand	595	668	762	886	838	1072	1252	1481	1785
Uttar Pradesh	422	501	521	560	593	585	670	938	1101
Bihar	375	443	485	558	584	680	854	1482	1202
All States	765	865	963	1074	1126	1289	1603	1872	1979

Source: State Finances- A Study of Budgets of 2023-24, RBI

Table A2: Infant Mortality Rate by Major States

States	2010	2020	Sr. No.	States	2010	2020
Kerala	13.0	6.0	13	Bihar	48.0	27.0
Tamil Nadu	24.0	13.0	14	Haryana	48.0	28.0
Maharashtra	28.0	16.0	15	Chhattisgarh	51.0	38.0
West Bengal	31.0	19.0	16	Rajasthan	55.0	32.0
Punjab	34.0	18.0	17	Assam	58.0	36.0
Uttarakhand	37.9	24.0	18	Odisha	61.0	36.0
Karnataka	38.0	19.0	19	Uttar Pradesh	61.0	38.0
Himachal Pradesh	40.4	17.0	20	Madhya Pradesh	62.0	43.0
Jharkhand	42.0	25.0	21	Telangana	--	21.0
Jammu & Kashmir	43.0	17.0	India	47.0	28.0	
Gujarat	44.0	23.0				
Andhra Pradesh	46.0	24.0				

Source: Office of the Registrar General of India, Ministry of Home Affairs;
Economic Survey 2023-2

Table A3: Life Expectancy at Birth by Major States (in Years)

State	2014-18	2014-18	2014-18	2016-20	2016-20	2016-20
	Male	Female	Total	Male	Female	Total
Kerala	72.5	77.9	75.3	71.9	78.0	75.0
Jammu & Kashmir	72.2	76.2	74.0	72.6	76.3	74.3
Himachal Pradesh	69.6	76.8	72.9	70.3	77.5	73.5
Punjab	71.0	74.8	72.7	70.8	74.5	72.5
Maharashtra	71.3	73.8	72.5	71.6	74.3	72.9
Tamil Nadu	70.2	74.2	72.1	71.0	75.5	73.2
West Bengal	70.7	72.6	71.6	71.1	73.6	72.3
Andhra Pradesh	68.7	71.4	70.0	69.1	72.2	70.6
Gujarat	67.8	72.3	69.9	68.1	73.2	70.5
Haryana	67.7	72.3	69.8	67.3	73.0	69.9
Karnataka	67.9	70.9	69.4	67.9	71.9	69.8
Odisha	68.0	70.8	69.3	69.1	71.4	70.3
Bihar	69.4	68.7	69.1	69.7	69.2	69.5
Rajasthan	66.5	71.6	68.7	67.1	71.7	69.4
Assam	66.1	67.9	66.9	67.3	68.6	67.9
Madhya Pradesh	64.8	68.5	66.5	65.5	69.5	67.4
Uttar Pradesh	64.8	65.8	65.3	65.3	66.7	66.0
All India	68.2	70.7	69.4	68.6	71.4	70.0

Source: Office of the Registrar General of India, Ministry of Home Affairs;
Economic Survey 2023-24

Table A4: Performance of Kerala on Various Indicators of the SDG Goals

Major Head	Sub-head	SDG3-2020-21	SDG4-2023-24
SDG1 No Poverty	MPI Headcount Ratio (%)	1.10	0.55
	Households covered by health scheme/ insurance	47.7	57.8
	MGNREGA- Employment offered against Demanded (%)	88.85	100
	Beneficiary under PMMVY (%)	97.75	50.40
	Households living in Kachha Houses (%)	0.30	0.30
SDG2 Zero Hunger	Beneficiaries under NFSA (%)	100	100
	Children under 5 years, who are underweight (%)	18.70	19.70
	Children under 5 years, who are stunted (%)	20.50	23.40
	Pregnant women (15-49 years) who are anaemic (%)	22.60	31.40
	Pregnant women (15-49 years) whose Body Mass Index is below 18.5 (%)		10.1
	Rice and Wheat produced per unit area (Kg/Ha)	2920.12	2882.2
	GVA (constant prices) in agriculture (Lakhs/worker)	2.20	2.28
SDG3	Maternal mortality ratio (per 1000 live births)	45.00	19.00

Good Health and Well-being	Under 5 mortality rate (per 1000 live births)	10.00	8.00
	Children (9-11 months) fully immunized (%)	92.00	85.40
	Tuberculosis Cases (notification against target) (%)	75.00	97.45
	HIV incidence per 1000 infected population	0.02	0.01
	Life expectancy (in years)		75.00
	Suicide rate (per 1 lakh population)	24.30	28.50
	Death rate due to road traffic accidents (per 1 lakh population)	12.42	12.10
	Institutional deliveries out of the total delivery reported (%)	99.90	99.85
	Monthly per capita out of pocket expenditure on health (%)	17.00	17.00
	Health worker density (total health worker per 10000 population)	115	144.03
SDG4 Quality Education	ANER in elementary education (class 1-8) (%)	92.07	100
	Average annual dropout rate at secondary level (class 9-10)	9.14	5.50
	GER in higher secondary (class 11-12) (%)	80.26	85.00
	Class 8 students achieving minimum proficiency level in language and maths (%)	86.80	77.00
	GER in higher education (18-23 years)	37.00	41.30

	Persons with disability (<15 years) having completed secondary education (%)	24.30	24.30
	GER for higher education (18-23 years)	1.40	1.44
	Persons (<15 years) who are literate (%)	94.60	94.80
	School with access to electricity and drinking water (both %)	99.24	99.51
	Schools with computers (%)		98.30
	Trained teachers at secondary level (class 9-10) (%)	94.53	96.60
	Pupil teacher ratio (PTR) at the secondary level (class 9-10)	16.00	15.00
Gender Equality	Sex ratio at birth	957	951
	Average wage/salary received (female to male)	0.84	0.80
	Married women (15-49 years) having experienced spousal violence (physical/sexual) (%)		9.90
	Female to male LFPR (15-59 years)	0.45	0.53
	Women in managerial position in listed companies (per 1000 persons)	241	166.67
	Demand for family planning satisfied by modern methods (15-49 years)	75.30	72.20
	Female operated operational land holdings (%)	22.98	22.98
	Women (15-49 years) who own a mobile phone that they themselves use (%)		86.60

	Married women (15-49 years) who usually participate free household decisions (%)		94.10
Clean Water and Sanitation	Safe and adequate drinking water within premises through PWS (%)	35.29	52.46
	Rural population having improved source of drinking water (%)	99.35	99.50
	SEM (G)- Individual household toilets constructed against target (%)	100	100
	SEM (G)- Districts verified to be ODF (%)	100	100
	Schools with girl's toilet (functional separate toilet facility) (%)	99.28	99.50
	Stage of ground water extraction (%)	51.75	51.55
	Blocks/ Mandals /Talukas over exploited (%)	0.66	0.00

Source: NITI Aayog, Government of India

Table A5: Performance of Kerala on Various SDG Goals

SDG Goal	Goal Name	SDG Score 2020-21		SDG Score 2023-24		Kerala Rank by States	
		India	Kerala	India	Kerala	2020-21	2023-24
SDG 1	No Poverty	60	83	72	81	2	7
SDG 2	Zero Hunger	47	80	52	84	1	1
SDG 3	Good Health and Well Being	74	72	77	80	12	5
SDG 4	Quality Education	57	80	61	82	1	1
SDG 5	Gender Equality	48	63	49	66	2	3
SDG 6	Clean Water and Sanitation	83	89	89	87	7	16
SDG 7	Affordable and Clean Energy	92	100	96	100	1	1
SDG 8	Decent Work and Economic Growth	61	62	68	74	12	12
SDG 9	Industry, Innovation and Infrastructure	55	60	61	69	9	3
SDG 10	Reduced Inequalities	67	69	65	71	12	11
SDG 11	Sustainable Cities and Communities	79	75	83	84	17	12
SDG 12	Responsible Consumption and Production	74	65	78	53	23	27

SDG 13	Climate Action	54	69	67	80	2	3
SDG 14	Life Below Water		53		51	6	7
SDG 15	Life and Land	66	77	75	88	6	7
SDG 16	Peace Justice and Strong Institutions	74	80	74	82	5	5
	Overall	60	70	71	79	1	2

Source: NITI Aayog, Government of India
