OPINION | India's 16th Finance Commission: Status quo amidst grand bargain

The 16th Finance Commission retains states' share of central taxes at 41%, adds a new GDP contribution criterion, and emphasises efficiency and fiscal discipline, sparking debate over equity and potential impact on poorer states

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There is a shadow of 16th Finance Commission on Union Budget 2026-27 presented today.

The Sixteenth Finance Commission (FC-16) report, tabled in Parliament today, covering the period 2026-31, retains the magnitude of tax transfers at 41 percent amidst the grand bargain by the states. It offers a balanced yet cautious approach to India's evolving fiscal federalism. However, prima facie, incorporating a grand new efficiency variable of "contribution to GDP" in tax transfers formula by 16th FC with 10 percent weightage can raise a question about the 'economic convergence' perspectives of a Finance Commission. The Indian states like Maharashtra, Tamil Nadu and Gujarat which are relatively fiscally rich as well as contribute significantly to GDP. It is intriguing why 16th FC incorporated this new variable, in addition to adjusting the weightage of already existing criterion of per capita income distance (distance of a State from the high per capita income State) as it can affect the progressivity of fiscal transfers.

It is heartening to see the retained ecological fiscal transfers (EFC) which was a radical approach by the 14th FC, along with their path-breaking recommendation for 42 percent of divisible pool as tax transfers . Now with Jammu and Kashmir out to the status of Union Territory (UT), 15th and 16th FC retained the magnitude to 41 %. The UT Finance Commissions regularly appointed by the Ministry of Home, design and determine the intergovernmental tax transfers to UTs in India, which is beyond the purview of 16th FC.

Status quo

Retaining the states' share in the central divisible tax pool at 41%, the Commission resists calls for a higher vertical devolution while emphasising fiscal discipline and efficiency in resource allocation. This decision maintains continuity with the Fifteenth Finance Commission amid a clarion call from states for up to 50% arising from their fiscal space crunch and concerns from the Union about constrained fiscal space to maintain macroeconomic stability - with national priorities like defense and infrastructure.

The recommendation to keep the states' share at 41% reflects a recognition of competing pressures. States argued for greater resources to fulfill expanded expenditure assignments in health, education, and welfare, while the rising cesses and surcharges—now averaging over 20% of gross tax revenue—that shrink the divisible pool. 16th FC notes that actual transfers, including grants, already exceed 60% of gross tax revenue. However there is heightened volatility in intergovernmental fiscal transfers in India.

Critically, this status quo avoids exacerbating moral hazard. By holding the line, rather than reducing the tax transfer share, 16th FC potentially walked a knife edge equilibrium through a "grand bargain" by the States. However fiscal space crunch still persists in a few States with the abandonment of revenue deficit grants. How the 16th FC addresses the widening subnational fiscal space concerns? Increasing the tied grants can affect the fiscal autonomy of the States and kill the flexibility of finances at the subnational government levels.

Horizontal Devolution: Shifting Towards Efficiency

Population 2011 (17.5 %) and income distance (42.5 %) take the lion share in weightage with 60 percent total. The rest 40 % weightage is equally divided for four variables - demographic transition, forest, area and contribution of a state to GDP.

The devil lies in details. It is interesting to note that 16th Commission's horizontal formula introduces a notable tilt towards efficiency, reportedly incorporating a new 10% weight for states' contribution to national GDP alongside other criteria of income distance, area, climate and demographic performance. This marks a departure from heavier equity focus in prior commissions, where income distance often dominated with 45% in 15th FC. This new criterion of economic growth variable is the function of personal characteristics of 16th FC Chairman Dr Arvind Pangariah who believes in 'growth' , recall his stance all the prior debates with Amartya Sen in growth versus equity. Public choice scholars increasingly analyse the personal charecterstics of leaders and their influence on public policy outcomes.

On equity versus efficiency question, the new GDP contribution criterion rewards economic performance, potentially benefiting high-GDP states like Maharashtra, Gujarat, and Tamil Nadu. However, it risks diluting progressivity, as richer states already enjoy fiscal advantages. Compared to 11th FC to 15th FC (it was not divisible tax pool , but tax specific shares till 10th FC) which progressively emphasised need-based factors, this shift prioritises incentives for economic growth and tax mobilisation, aligning with global best practices but at the cost of deeper equalisation for poorer states.

Likely losers include low-GDP, high-need states like Bihar and Uttar Pradesh, though mitigated by retained criteria like income distance. Southern states, having controlled population growth, may see reduced shares based on population 2011 criterion which was given comparatively higher weightage by 16th FC. Though Kerala received 2.382 percent interstate share by 16th FC when compared to 1.92 per cent by 15th FC, it is still less than what 14th FC has assigned which was at 2.50 per cent. The debates persist.

Addressing Demographic Transition and Climate Risks

Demographic change receives nuanced treatment. Building on 15th FC's total fertility rate (TFR) criterion, the Commission acknowledges risks of overly low fertility leading to ageing populations.

Climate considerations feature through the forest and ecology criterion, retained at 10% for forests. It aligns devolution with environmental externalities, a modest continuity since 14th FC.

Grants and Reforms

FC-16 decisively ends revenue deficit grants, citing persistent dependency and adverse incentives in recipient states. This break from past commissions emphasised fiscal prudence, however it may strain chronically deficit-prone states in the short-term.

Local body grants emerge as a highlight with substantial allocations however with strong conditionalities - for instance, GIS-based property tax systems, timely audits, performance incentives for urbanisation. These tied funds to third-tier reforms, enhancing grassroots governance and revenue mobilisation—prima facie a “big deal” for decentralised service delivery, but no fiscal autonomy as it is tied.

Retaining 41% vertical devolution and emphasising efficiency in horizontal shares (via GDP contribution) incentivises economic growth and centralised rules for fiscal responsibility, with risks for widening inter-state disparities. The rejection of revenue deficit grants and push for local reforms apparently signaling maturity in federalism, reducing moral hazard while linking funds to outcomes. Time will tell if this balance hold.

To conclude, along with intergovernmental fiscal transfers, 16th FC also articulated a grand fiscal consolidation path for the States with symmetric fiscal rules for fiscal deficits and public debt trajectory, with Union Government on course to reduce debt to below 50 per cent of GDP by 2030-31 with reduced roll over risks as India’s external debt is insignificant . Power sector reforms are given emphasis by 16th FC with reducing AT&C losses of DISCOM companies across Indian States.

With the electoral appeal and ease of disbursement through a well-developed digital payments system, 16th FC noted that large-group cash transfer schemes have proliferated. The 16th FC recognised that “the primary role of subsidies and transfers should be to assist the poor. Any other subsidies must be predicated on compelling evidence of externalities. Both the Union and States must review the current schemes to assess whether they meet these criteria. Those that do not should be phased out.”. With elections in anvil, it is tough to undergo this process of cleansing by the Union and State governments to move away from populist announcements.

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