16TH FINANCE COMMISSION

# Do the tax devolution criteria need a revisit?

A major challenge before any Finance Commission is balancing equity and efficiency. The 16th Finance Commission has the delicate task of balancing the interests of states which have a low per capita income and larger share of population with those of "better" performing states, explains ***Manish Gupta***

## What is the task of a Finance Commission?

**THE FINANCE COMMISSION** (FC) is a constitutional body set up under Article 280 of the Constitution to make recommendations on the distribution of resources between the Union and the states. The First FC was constituted in 1951 and its recommendations covered the five-year period 1952-57. Since then, we have had 15 FCs.

Currently the 16th Finance Commission is in office which was constituted in December 2023. The Commission is required to submit its report by October 31, 2025 and would make recommendations for the five-year period starting April 1, 2026.

The FC's terms of reference (ToR) are specified in the Constitution under Article 280(3). They include (a) distribution and allocation of net proceeds of shareable taxes between the Union and the states, and (b) principles governing the grants-in-aid of revenues of the states out of the Consolidated Fund of India.

The 73rd and 74th Constitutional amendments in 1992 added two sub-clauses, which required the FC to recommend measures needed to augment the Consolidated Fund of a state to supplement the resources of the panchayats and municipalities therein on the basis of the recommendations of the State Finance Commission. Further, the President can refer any other matter to the FC in the interest of sound finance.

## Union vs states' share of resources

**THE FC ADDRESSES** the vertical imbalance arising out of asymmetric assignment of revenues and expenditure between the Union and the states in the Constitution by recommending sharing a proportion of all taxes collected by the Union government with the states (also called devolution). The 13th FC recommended sharing 32% of the divisible pool of resources with the states. The 14th FC increased this proportion to 42% while the 15th FC recommended sharing 41% with the states.

**15.8%**

SHARE OF SOUTHERN STATES IN TAX DEVOLUTION IN THE 15TH FC PERIOD (2021-26)

**WELL-PERFORMING STATES BELIEVE THEY ARE BEING DISCRIMINATED AS THEIR PER-CAPITA INCOME IS HIGHER**

**Oct 31, 2025**

DEADLINE FOR 16TH FINANCE COMMISSION TO SUBMIT ITS RECOMMENDATIONS

## Distribution among states

**A NUMBER OF** criteria (with weights) is used for distribution of the shareable tax revenue among states. These are classified under four heads: need (population, area, demographic change), equity (income distance), efficiency/performance (tax-effort, fiscal discipline, demographic performance), and fiscal disability (forest cover). The 15th FC used 2011 population (with 15% weight), area (15%), forest and ecology (10%), income distance (45%), tax and fiscal efforts (2.5%) and demographic performance (12.5%) for determining inter se shares of states. FCs also recommend grants to states. However, devolution is the dominant component, accounting for 80-85% of total FC transfers.

## Friction over terms of reference

**UNLIKE THE PREVIOUS** FCs, the ToR of the 16th FC are much shorter, limited only to those mandated in Article 280. However, the ToR of the 15th FC evoked sharp criticism. The ToR mandated the Commission to use the 2011 population data for sharing of taxes instead of the 1971 population figures as was the practice in the past. This evoked sharp criticism from the southern states as they pointed out that the use of 2011 population would reduce their inter se shares and flow of resources.

## What southern states are saying

**THE SHARE OF** southern states in tax devolution has been declining since the 2nd FC (1957-62) from 23.3% to 18.6% during 13th FC period (2010-15) and further to 15.8% in the 15th FC period (2021-26). There is a feeling among these states and other well-performing states that they are being discriminated as their per-capita income is higher than those of the backward states. They feel that they should be adequately incentivised for their performance. Further, they are of the view that even among the high per capita income states there are large intra-state differences and backward pockets. They are of the view that selection of criteria and weights by 16th FC should be such that performance is adequately incentivised.

## Finding the perfect balance

**SOME OF THE** states which the 16th FC has visited have in their memorandum asked the Commission to include contribution to the country's GDP as a new criteria for determining inter se share; one state has asked the commission to use per capita income on PPP basis in its income distance criteria and reduce the weight assigned to this criteria to 35% from the current 45%; states have also asked the Commission to use 1971 population and assign a higher weight. Further, several states have also asked for a 50-50 sharing of tax revenues. All of these need to be addressed by the Commission.

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