THE INDIA FORUM
A JOURNAL-MAGAZINE ON CONTEMPORARY ISSUES

April 3, 2026

Continuity and Change in the 16th Finance Commission

By: R. Mohan

The 16th Finance Commission has avoided estimating the Vertical Fiscal Imbalance which would have given an idea of the gap in the states' resources; elsewhere the commission has made changes to the formula on distribution of tax revenue among states, not all of which are convincing.

The recommendations of the Sixteenth Finance Commission (16th FC) along with the Action Taken Report, were laid on the table of Parliament as required under Article 281 of the Constitution, on 1 February 2026. The report of the 16th FC has recommendations for the period 2026-31.

Before getting into a discussion of the main recommendations and their impact, a brief discussion the constitutional arrangements regarding the Finance Commission (FC) will be in order.

Finance Commissions: An Overview

In our constitutional division of fiscal powers, relatively more buoyant sources of revenue, like Personal Income Tax, Corporation Tax and Customs Duty are with the Union while the States have relatively larger expenditure obligations in social and economic sectors like health, education, agriculture etc. The revenue sources of the states are mainly commodity taxation, land revenue, taxes on sale of petroleum products and on alcoholic liquor for human consumption. These are relative less buoyant tax revenue sources.

This distribution of fiscal powers creates a fiscal imbalance vis-à-vis the expenditure obligations and own revenue sources of the States. In several countries like Canada, Australia and Germany, different mechanisms are put in place to ameliorate what is called the Vertical Fiscal Imbalance (VFI) between the federal and sub-national governments.

The VFI can be reduced either (a) by transferring power to levy more buoyant taxes to the States, or (b) by reducing expenditure obligations of the States or (c) by having a constitutional mechanism for sharing a prescribed portion of the taxes levied by the Union with the States. The first two options are considered inefficient by experts in the field for at least two important reasons.

First, if the power to levy direct taxes which have substantial distributional impact are left with the States, competitive rates can create a situation where both physical and human capital move across sub-national boundaries in search of a conducive tax regime and this can lead to inefficient exploitation of tax potential, and to a race to the bottom,

Second, expenditure obligations, especially in the social sectors, are considered best done by the government closer to the beneficiaries (States or local governments) as they have a more intimate knowledge of the allocational needs.

In view of these reasons, which have generally been accepted across countries, the only feasible option open to ameliorating the VFI is to have a mechanism for sharing a part of the Union tax revenue with the States. In the Indian context, the constitutional mechanism provided for this is the FC which is to be constituted every five years or, if necessary, earlier by the President under Article 280 of the Constitution. The Commission is constitutionally mandated to recommend:

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds

(b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India;

(c) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State;

(d) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State;

(e) any other matter referred to the Commission by the President in the interests of sound finance.

In addition to Article 280, the grants to States-in-need of assistance under Article 275 are also disbursed based on the recommendation of the FCs. These post-tax devolution grants, which are based on the assessment of revenue and expenditure needs of particular States, are commonly called the Revenue Deficit grants (even in FC reports).

The FC, after consideration of the views of the State and Union governments and experts in the field, makes suitable recommendations. In recent FCs, there has been a substantial expansion in the scope of the Terms of Reference (ToR). To cite an example, the 15th FC contained many items, including review of grants under Article 275, a review of the impact of the 14th Finance Commission's recommendations for substantially enhanced tax devolution to States on the fiscal situation of the Union government, making recommendations on performance incentives to state governments for control or lack of it in incurring expenditure on populist measures, mandating the use of population based on the 2011 census etc. Some States had at the time made a representation to the President expressing their apprehensions on these ToR.

The FCs from the 11th Finance Commission onwards have been laying the path for fiscal consolidation in States, drawing up targets for deficits, debt etc., on the strength of the constitutional provision "any other matter referred to the Commission by the President in the interests of sound finance."

Terms of Reference of the 16th FC

As already pointed out, Article 280 of the Constitution enumerates the items which are to be referred to the quinquennially constituted FCs by the President (implying the Council of Ministers headed by the Prime Minister).

After the long ToRs given to the previous FCs, the ToR of the 16th FC was limited to what was contained in Article 280 (3) (a) to (c) and to review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.

This is the first article in a two part series on the 16th Finance Commission. Read the second article here.

The item contained in Article 280(3) (d), that is, "any other matter referred to the Commission by the President in the interests of sound finance", was not part of the ToR of the 16th FC. It is this ToR that enabled the previous FCs to lay down the roadmap for fiscal consolidation and set fiscal and revenue deficit targets for the Union and the States.

The ToR of the 16th FC were thus the exact reproduction of what was constitutionally mandated. The commission was not even required to follow the population based on any specific census, as the previous commissions were (the 8th to 14th FCs to use population estimates based on 1971 census and the 15th on the 2011 census).

Distribution of Taxes Between the Union and the States

The 16th FC, while determining the States's share in the divisible pool of Union taxes [Gross Tax Revenue of the Union - (surcharges+ cesses+ cost of collection), called Net Proceeds under Article 279], has maintained the share at the same as the 15th FC -- 41 per cent.

Though many States had asked for 50 per cent of the Net Proceeds to be distributed, the retaining of the share at 41 per cent has come as a relief, as there were apprehensions that the share may be brought down.

Many States had demanded a higher share from Union taxes, as the proportion of surcharges and cesses in Gross Tax Revenue of the Union has been going up, especially since 2014-15, an aspect pointed out in the 16th FC report. After the 14th FC recommended a share of 42 per cent of Net Proceeds to be devolved to the States, two measures adopted by the Union were (a) to levy more surcharges and cesses which will naturally expand the non-divisible part of the Union taxes (as surcharges and cesses are not shareable as per provisions of Article 270) and (b) lowering the share of central assistance in many Centrally Sponsored Schemes (CSS) from 75 to 60 per cent.

Paragraph 7.67 of the 16th FC report states thus:

"The only instrument available to the Commission to assist the finances of the Union is the share in the divisible pool. With cesses and surcharges having cut the size of the divisible pool from 89.1 per cent of GTR in 2014?15 to a 74?80 per cent range during the first four

years of the FC?15 award period for which actuals are available, there is no room for cutting the States' share in it. The Commission is of the view that if an efficient and broad?based system of taxation is to be put in place, a grand bargain would have to be struck between the Union and States in which the Union would agree to fold a large part of the revenue from cesses and surcharges into regular taxes and States would agree to a smaller share in the resulting larger divisible pool, with no loss of revenues to either side."

Pending this grand bargain, the 16th FC recommended retaining the States' share in the divisible pool at its current level of 41 per cent

It would have been better if the 16th FC had made an estimation of VFI using standard methodologies like estimating the uncovered gap of States' own expenditure from their own revenues. Such an exercise was necessary and would have been extremely useful, especially when many States had in their memoranda to the 16th FC demanded devolution of 50 per cent of the Net Proceeds.

Three issues called for the 16th FC to undertake an estimation of VFI:

(i) The apportionment of Goods and Services Tax (GST) rates between the Union and the States at 50:50, which has led to a rate fall for many commodities taxed at 14.5 per cent during the Value Added Tax (VAT) period to 9 per cent in the GST period, [as the standard rate under the GST regime is 18 per cent out of which the States' share is 9 per cent],

(ii) the increase in the States' share in most of the Centrally Sponsored Schemes (CSS) from 25 to 40 per cent, and

(iii) the rising share of surcharges and cesses resulting in a lower share of devolution as a proportion of the Gross Tax Revenue (of the Union.

The standard methodology employed in the literature on fiscal federalism estimates the VFI as the gap uncovered between the own revenues of the States and their own expenditure. (See 'Vertical fiscal imbalances and fiscal performance in advanced economies', Luc Eyraud and Lusine Lusinyan, Journal of Monetary Economics, Volume 60, Issue 5, July 2023, pp. 571-587.)

The 16th FC with the data at its disposal could have estimated the VFI in the Indian context. Such an estimate by the 16th FC would have been both a very useful addition to the information on Indian public finance and provided an empirical backing or otherwise for the recommendation of the Union sharing 41 per cent share of the Net Proceeds with the States.

Equity vs Efficiency: The act of Balancing

The underlying principle behind the horizontal distribution of taxes across States is to take into account their differences in fiscal capacity to mobilise resources. The basic idea behind augmenting resources of the States with a formula, which is equity oriented, is that every State should be able to provide a certain basic level of public services to the people at comparable costs irrespective of where they reside.

Given this principle, two criteria that should find a place in the formula are population and fiscal capacity. States with a larger population will have to provide basic services to a larger number of persons. If a State has a lower fiscal capacity, proxied by a relatively lower per capita income, the horizontal distribution criteria should be one that allots a higher share to that State.

Population and per capita income distance (distance of per capita income of a State from that of the per capita income of the highest State or the average of the per capita income of the three highest per capita income States) are the two equity criteria.

But population in the Indian context has not only been an equity criterion but also an efficiency criterion. In order to ensure that the States which have controlled their population in accordance with the National Population Policy, 1976, are not adversely affected, FCs from the 8th to the 14th were mandated in their ToR to use the population as in the 971 Census. However, the 14th FC gave a weightage of 12.5 per cent to Population based on 2011 Census, based on the equity principle that the latest population should be the basis for providing basic minimum services at a comparable cost. The 15th FC was mandated in its ToR to use Population based on 2011 Census. But the Commission gave weightage to the inverse of the Total Fertility Rate (TFR) to ensure that the adverse impact for States with a lower population growth is minimised.

Table 1 Criteria- Comparison from 11th to 16th Finance Commissions

Criteria (Category)	Weights (%)					
	11th	12th	13th	14th	15th	16th
Population (Equity)	10	25	25	17.5	15	17.5
Demographic Change (Equity and Efficiency)				10	12.5	10
Income (Distance Method) (Equity)	62.5	50	47.5	50	45	42.5
Forest Cover (Cost Disability)				7.5	10	10
Area (Cost Disability)	7.5	10	10	15	15	10
Contribution to GDP (Incentive?)						10
Index of Infrastructure (cost disability)	7.5					
Tax Effort (Incentive)	5	7.5			2.5	
Fiscal Discipline (Incentive)	7.5	7.5	17.5			
	100	**100**	**100**	**100**	**100**	**100**

From Table 1, it can be seen that the combined weightage for the two equity criteria, Population and Income Distance has been 72.5, 75, 72.5, 77.5, 60 and 60 per cent, respectively, in the recommendations of the 11th,12th, 13th.14th, 15th and 16th FCs respectively. Though use of Population based on 1971 census (used by 11th to 14th FCs as mandated in their ToRs) has an incentive element in it, it is essentially an equity criterion.

The 14th FC, though mandated to use Population based on 1971 Census, introduced the Population based on 2011 Census (Demographic Change) as a criterion with 10 per cent weightage and this was an additional equity criterion. The use of inverse of TFR and inverse of population growth rate in the name of demographic change by the 15th and 16th FCs are incentive criteria. The decline of the combined weightage of equity criteria to 60 per cent in the 15th and the 16th FCs has been compensated by the use of Population based on 2011 Census instead of that based on 1971 Census.

Changes in Criteria for Horizontal Distribution

In the 16th FC, the basic equity criteria, Population (2011 Census) and Income Distance, comprised 60 per cent, with the weightage for Population rising by 2.5 per cent and that of Income Distance falling by an equal share. The overall weightage has remained as at the level of 15th FC.

Incentives for Population Control: The 15th FC had used the inverse of the Total Fertility Rate as an indicator of demographic performance. The methodology was to divide the female population into five age-groups and calculate the ratio of number of live births in each age- group to mid-year female population of that age-group (based on the 2011 Census), aggregate the ratio and take the inverse. This was done for each State and scaled by population based on the 1971 census. The 16th FC has taken the inverse of the growth rate of population for 1971 to 2011 and the scaled it with population based on the 2011 census.

Cost Disability: Forest Cover and Area: The 15th FC had defined Forest Cover as share of dense forest in each State as a ratio of dense forests in all States. The 16th FC has taken the weighted average of very dense (70 per cent), moderately dense (40-70 per cent) and open forest (10-40 per cent) assigning weights of 1.0,0.65 and 0.30 to each category respectively. The criterion was computed by combining the share of weighted forest area of the State in the weighted forest area of all States, and the share of the increase in weighted forest area of the State in the increase in weighted forest area of all States in the ratio of 80:20 to arrive at the forest variable.

The Area criterion was given a floor of 2 per cent by the previous FCs weightage to benefit States with a smaller area. The 16th FC has reduced this to 1.5 per cent.

Efficiency Criterion: The contribution of GSDP is defined as the share of the GSDP of a State in the aggregate GSDPs of all States. To eliminate wide dispersions, the 16th FC has taken the square root of the State's GSDP in the sum of the square root of the GSDP of all States.

The 16th FC has done away with the fiscal performance criterion of Tax Effort as in the 15th FC. Though the 14th FC did not use this criterion, it had made a recommendation for additional borrowing space based on criteria for prudent fiscal management. In fact,

retaining Tax Effort would have been a better criterion than Contribution to GSDP, as the former clearly reflects how effectively the tax base is being tapped. Using contribution to GSDP as a criterion does not incentivise the performance of a State and rather rewards historical and locational advantages.

The movement of inter-se share of States based on the recommendations of 15th and 16th FCs are in Table 2

Table 2: Inter-Se Shares of States in 15th and 16th FC Recommendations

State	Tax Share-15th FC (%)	Tax Share-16th FC (%))	Change (16th-15th)
Andhra Pradesh	4.047	4.217	0.17
Arunachal Pradesh	1.757	1.354	-0.403
Assam	3.128	3.258	0.13
Bihar	10.058	9.948	-0.11
Chhattisgarh	3.407	3.304	-0.103
Goa	0.386	0.365	-0.021
Gujarat	3.478	3.755	0.277
Haryana	1.093	1.361	0.268
Himachal Pradesh	0.83	0.914	0.084
Jharkhand	3.307	3.357	0.05
Karnataka	3.647	4.131	0.484
Kerala	1.925	2.382	0.457
Madhya Pradesh	7.85	7.347	-0.503
Maharashtra	6.317	6.441	0.124
Manipur	0.716	0.626	-0.09
Meghalaya	0.767	0.631	-0.136
Mizoram	0.5	0.564	0.064
Nagaland	0.569	0.481	-0.088
Odisha	4.528	4.42	-0.108
Punjab	1.807	1.996	0.189
Rajasthan	6.026	5.926	-0.1
Sikkim	0.388	0.335	-0.053
Tamil Nadu	4.079	4.097	0.018
Telangana	2.102	2.174	0.072
Tripura	0.708	0.641	-0.067
Uttar Pradesh	17.939	17.619	-0.32
Uttarakhand	1.118	1.141	0.023
West Bengal	7.523	7.215	-0.308
Source: Reports of the 15th and 16th FCs.			

The progressivity (states with a lower per capita income getting higher share in tax devolution) has come down in the tax shares recommended by the 16th FC, with States with higher per capita incomes gaining and States with lower per capita incomes losing. For the 15th FC, the Spearman Rank Correlation Coefficient is -0.4231 and is significant at the 0.0249 per cent level. For the 16th FC, the relationship is negative, indicating progressivity, but the coefficient is -0.3558 and is not significant at 5 per cent level.

Post-Devolution Grants

The most significant change in the 16th FC recommendations is the non-recommendation of post-devolution grants under Article 275. Even if revenue deficit grants were not recommended, the 16th FC could have considered recommending a tapering balancing grants for States that had witnessed a fall in tax share, so that they could maintain the level of expenditure in social and economic sectors.

There needs mention here that grants to 'States-in-need of assistance' cannot be seen through a narrow perspective of grants that are disbursed to fill the gap in revenue deficits of States, gaps estimated using certain criteria by the FCs.

When FCs assess that post- tax devolution, some States need assistance to meet a certain level of expenditure given their revenue mobilization efforts, grants under Article 275 are then recommended. While the decision of the 16th FC not to recommend sector-specific grants can be welcomed on the ground that further rigidities in the spending priorities of the States are not set in place since

CSS have such criteria, the decision not to recommend general purpose grants needs a critical look.

When the vertical share is retained at 41 per cent and the change in tax devolution criteria has resulted in a fall in tax share to as many as 14 States, the 16th FC should have considered recommending general purpose grants under Article 275 for some of the States.

Grants to Local Governments

As regards grants to Local Governments, more or less the same conditionalities as before have been used. But two aspects are very restrictive: (i) withholding grants to Block Panchayats, if 75 per cent of the Grama Panchayats in their geographical jurisdiction do not meet the own revenue target, and (ii) withholding grants to Local Governments, if the State does not meet the criterion of transfer of funds.

Block Panchayats have no administrative control over Grama Panchayats and a performing Local Government should not be deprived of grants if the State fails to meet the given criterion.

Road Map to Fiscal Consolidation

Even though the ToR of the 16th FC did not contain a reference to recommendations in the interests of sound finance, the FC in its report has made elaborate recommendations on how to treat off budget borrowings by the States and prescribed formats for disclosure of such borrowings.

The Action Taken Report states that these will be examined separately. But the road map to the Fiscal Deficit target has been accepted. The 16th FC has not targeted a zero Revenue Deficit for the States, in line with the amended Union Fiscal Responsibility and Budget Management (FRBM) Act. But the question of making recommendations which have no mention in the Presidential ToR is a question beckoning answer by constitutional experts.

Highlights

The 16th FC while recommending the 41 per cent share of Union taxes for the States has not attempted to measure the Vertical Fiscal Imbalance in the States. As regards criteria for horizontal distribution of tax share across the States, the 16th FC has omitted the incentive criterion like Tax Effort, though in the report, there is an elaborate discussion about the efficiency of the States in tapping their own tax potential. The criterion of contribution of a State's GSDP in aggregate GSDP of States is not a sound incentive criterion, as it rewards historical and locational advantages. Last but not the least, the 16th FC has made elaborate recommendations on the Fiscal Roadmap to the States and Union, without being mandated to do so by the Terms of Reference.

This article was first published in The Forum for State Studies.

R. Mohan was a member of the Indian Revenue Service.