Recommendations of 16th Finance Commission

Mains: *GS-II – Constitutional bodies | GS-III – Economy*

Why in News?

Just ahead of Budget speech, Finance Minister said the government had accepted the recommendations of the recently released 16th Finance Commission.

What is a Finance Commission (FC)?

- **Finance Commission (FC)** – It is a ***constitutional body*** formed by the President of India ***under Article 280*** of the Indian Constitution to give suggestions on centre-state financial relations.
- **Composition**
    - **Chairman** - Appointed by the President, usually an expert in public affairs.
    - **Members** - Four, appointed by the President, often including experts with experience as High Court judges, knowledge in finance/government accounting, and expertise in economics.
- **1st FC –** It was constituted on November 22, 1951, by a Presidential Order under Article 280, under the chairmanship of Shri K.C. Neogy.
- **State Finance Commission** – It is constituted under the ***Article 243*** of Constitution by the Governor of the State every five years.
- **Functions -**
    - **Vertical Devolution** (Union vs. States) – Division of the net proceeds of Union taxes (the divisible pool) between the Centre and all States.
    - **Horizontal Devolution** (among States) - Apportioning the States' share among individual States.
    - **Grants-in-Aid** (from Consolidated Fund of India) - Transfers to States beyond tax devolution, to meet specific needs.
    - **Augmenting State Revenues for Local Bodies** - Measures to strengthen Panchayats and Municipalities (third tier).
- **Channels of Resource Flow from Union to States**
    - **Article 270(1)** – The Union's tax revenues, excluding cesses, surcharges, taxes accruing to the Union Territories (UTs), and the cost of collection, are shared between the Union and the States based on the recommendations of the FC.
    - **Article 275(1)** – The FC recommends specific grants to supplement the Consolidated Funds of the States.
    - **Article 282** – The Union provides discretionary grants to States, mainly through the Centrally Sponsored Schemes (CSS).
- **16th Finance Commission** – It was constituted by the President on 31 December

2023, mandated to make its recommendations for the five-year period commencing on 1 April 2026 and ending on 31 March 2031.

- **Chairman** - Dr. Arvind Panagariya (Former Vice-Chairman, NITI Aayog).
- **Members** - Shri Ajay Narayan Jha, Smt. Annie George Mathew, Dr. Manoj Panda (Full-time).
- **Part-time Member** - Dr. Soumya Kanti Ghosh.

What States asked for vs. What they got?

State's Demand	Commission's Decision	Implication
Increase tax devolution to 50%	Share remains 41% (same as 15th FC)	Centre retains fiscal space; States feel constrained
Continue revenue deficit grants	Discontinued	Poorer States lose a safety net; fiscal stress likely
More weight for equity & fiscal needs	10% weight to GDP contribution (replacing tax effort)	Richer States benefit; weaker States disadvantaged
Higher sectoral & social grants	Focus shifted to local body grants (doubled)	Grassroots governance strengthened, but State-level fiscal needs unmet
Flexibility in borrowing limits	No major relaxation	States remain dependent on Centre's borrowing approvals

What are the key recommendations of the 16th Finance Commission?

- **Vertical devolution** – The Commission has kept the vertical devolution intact, retaining the states' share in the ***divisible pool at 41%.***
- **Horizontal Devolution** – In determining the horizontal devolution, it has deviated from the previous Commission on the criteria and weights to be used.
- **6 Criteria**
    - Population (17.5 % weight),
    - Demographic performance (10%),
    - Area (10%),
    - Forest (10%),
    - Per capita GSDP distance (42.5%) and
    - Contributions to GDP (10%).
- **New criteria 'contribution to GDP'** – With 10% weight and lowering the 'area' criteria to 10% from 15%, seem to have worked in favour of southern states, whereas, poorer states relying on equity-based criteria lose relative advantage.
- **State Finances** – The FC has argued that states should discontinue the practice of incurring off-budget borrowings, while keeping the deficit capped at 3% of GSDP.
- **Addressing Fiscal Populism –** It has recommended the rationalisation of subsidy schemes & introduction of "sunset clauses" for schemes that give subsidies on non-merit private goods and unconditional transfers.
- **Power Distribution Sector Reforms** – It has recommended privatising the country's power distribution sector to modernize and address the long-standing financial stress in discoms.
- **Investor protection** – It also sought to create incentives for privatisation by devising

a mechanism to shield private investors from accumulated debt burden of distribution utilities after their takeover.
- **Special Purpose Vehicles (SPVs)** – The state governments should create SPV where all the accumulated working-capital loans and other non-asset-backed debt are parked to make discoms more attractive for investment.

What are the major issues with 16th Finance Commission?

- **"Divisible Pool" Problem** – The 16th FC kept the States' share at 41%, the same as before, this unchanged share is seen as prioritizing the Centre's fiscal needs.
- **Shrinking State Revenue** – With the Centre relying more on cesses and surcharges instead of standard taxes, the divisible pool has shrunk—so even though the 41% share remains unchanged, the actual amount available to states is smaller.
- **States vs. Centre** – States wanted to increase their share to 50%, Centre wanted for moderation (reduction), and the Commission stuck with 41% effectively siding with the Centre's conservative stance.
- **Why the Commission Sided with the Centre?** – The 16th FC gave several reasons for not increasing the States' share like national security, infrastructure, emergencies.
- **Growth Bias** – GDP-based criterion rewards industrialized States (Tamil Nadu, Maharashtra, Karnataka) over weaker ones, but the poorer states lose relative advantage, raising equity concerns.
- **Grassroots Focus** – Doubling of local body grants is positive but does not offset State-level fiscal stress.

What lies ahead?

- The 16th Finance Commission is to ensure fiscal discipline and efficiency while protecting the equity principle of federal transfers.
- This requires compensatory grants, stronger local governance, and a balanced approach to urbanisation and debt management.

References

1. Indian Express | 16th FC: Higher tax share for south states
2. The Hindu | Has the 16th FC sidelined the States and prioritised the Centre's needs?
3. Live Mint | 16th Finance Commission