Sixteenth Finance Commission: Misses and Concerns

Mains: *GS II – Constitutional Bodies*

Why in News?

The Sixteenth Finance Commission marks an important phase in India's fiscal federal framework, But several concerns arise regarding its approach and outcomes.

What about the vertical devolution?

- **Background of increasing state share –** The Fourteenth Finance Commission had significantly raised the States' share in the divisible pool of central taxes from 32% to 42%.
- This was justified by the discontinuation of State Plan grants, which constituted around 3% of the divisible pool at that time.
- Subsequently, the Fifteenth Finance Commission reduced the share marginally to 41%, primarily due to the reorganisation of Jammu and Kashmir.
- The Sixteenth Finance Commission retained this 41% share, thereby imparting a degree of semi-permanence to the arrangement.
- **Issue of cesses and surcharges –** Following the Fourteenth Finance Commission's award, the Centre responded to the enhanced State share by:
    - Increasing non-shareable cesses and surcharges
    - Reducing its contribution to Centrally Sponsored Schemes
    - Not fully accepting sector- or State-specific grants recommended by the Fifteenth Commission

***Cesses and surcharges**, by constitutional design (Articles 270 and 280), are not shareable with States.*

- Their growing use effectively reduces the divisible pool.
- Instead of firmly addressing this issue, the Sixteenth Commission proposed a "grand bargain," whereby:
    - States would accept a smaller share of a larger divisible pool
    - The Centre would merge a significant portion of cesses and surcharges into regular taxes
- However, this approach raises concerns:
    - It appears to dilute the Commission's constitutional responsibility to objectively determine States' share.
    - It does not explicitly critique the steep increase in cesses and surcharges, which

arguably undermines fiscal federalism.

- **Declining effective transfers –** Effective transfers (tax devolution plus Finance Commission grants) as a percentage of the Centre's pre-transfer gross revenue receipts show the following trend:
  - 11th–13th FC periods: 27–28%
  - 14th FC period: 35.6% (sharp increase)
  - 15th FC period: 34.4%
  - 2026–27 (first year of 16th FC award): 32.7% (Budget Estimate)
- Thus, although the statutory devolution share remains at 41%, the effective transfer ratio shows a declining trend.
- The Commission assumed nominal GDP growth of 11% for 2026–27, higher than the Budget estimate of 10%.
- It did not account for the revenue-reducing effects of major GST reforms undertaken in September 2025.
- These factors may result in overestimation of the divisible pool and actual transfers.
- **Discontinuation of revenue deficit and sector-specific grants –** The Commission discontinued revenue deficit grants and did not recommend State- or sector-specific grants.
- The Implications are:
  - Reduces fiscal space for vulnerable States
  - Lowers effective transfer share compared to the Fifteenth Commission
  - Limits scope for need-based equalisation

What about the horizontal devolution?

- **Introduction of "contribution" criterion –** The Commission introduced *a new efficiency-based criterion* called "contribution," measured through a State's share in aggregate Gross State Domestic Product (GSDP).
- The concerns are:
  - GSDP reflects production efficiency, not fiscal efficiency.
  - Inter-State GSDP differences are influenced by capital mobility, labour migration, and market forces.
  - Concentration of capital in developed States skews outcomes.
- Thus, production-based indicators may not accurately measure fiscal performance.
- **Conceptual contradiction in use of gsdp –** The Commission used GSDP in two opposite ways:
  - **Income distance criterion** – Lower per capita GSDP → Higher share
  - **Contribution criterion** – Higher per capita GSDP → Higher share
- To moderate the distortion, the Commission used the square root of GSDP rather than the absolute value.
- This was intended to reduce excessive benefits to richer States.
- Nevertheless, this adjustment appears largely judgement-based rather than normatively grounded.
- **Dropping fiscal discipline criterion –** The Commission removed the tax effort/fiscal discipline criterion—an established fiscal efficiency indicator.
- This appears inconsistent with its stated emphasis on efficiency, as fiscal responsibility and revenue effort directly reflect governance quality.

What are the Losses and Gains?

- **Major losing states –** Compared to the Fifteenth Commission, the main losing States include:
  - Madhya Pradesh
  - Uttar Pradesh
  - West Bengal
  - Bihar
  - Odisha
  - Chhattisgarh
  - Rajasthan
- Additionally, several north-eastern and small States—Arunachal Pradesh, Meghalaya, Manipur, Nagaland, Tripura, Sikkim, and Goa—also witnessed relative losses.
- **Uneven gains –** Richer States gained, but not uniformly.
- The redistribution pattern reflects the altered weights and criteria in the new devolution formula.
- **The missing equalisation framework –** Devolution alone cannot address India's wide cost and need differentials.
- Article 275 provides for grants-in-aid to meet State-specific needs. These need not be confused with revenue deficits.
- They can be normatively designed to:
  - Equalise standards of essential services like health and education
  - Address structural disadvantages
  - Neutralise losses arising from formula changes
- While ad hoc grants are undesirable, well-designed equalisation grants remain crucial in a heterogeneous federation like India.
- By discontinuing revenue gap grants entirely, the Sixteenth Commission arguably adopted an expedient route rather than undertaking the complex normative assessment required for balanced equalisation.

What lies ahead?

- The Sixteenth Finance Commission sought to balance fiscal prudence, efficiency, and federal equity. While it retained the 41% devolution share, concerns persist regarding:
  - The unchecked expansion of cesses and surcharges
  - The decline in effective transfers
  - The conceptual inconsistency in the horizontal formula
  - The abandonment of revenue gap and equalisation grants
- In a deeply diverse and asymmetrical federation like India, fiscal federalism must reconcile efficiency with equity.
- The Sixteenth Commission's approach tilts toward formulaic redistribution while weakening the equalisation function—raising important questions about the evolving nature of India's cooperative federalism.

Reference

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