

Sixteenth Finance Commission - The Gain to The states and Their Demands

Mains: GS II - Polity and Governance

Why in News?

The 16th Finance Commission under the chairmanship of Dr. Arvind Panagariya has submitted its report for the period of 2026-31 and The Central government has accepted its recommendations with respect to devolution of funds from Centre to States.

What are the net proceeds and devolutions?

- **Constitutional mandate** - The Constitution in Article 270 provides for the scheme of distribution of net tax proceeds collected by the Central government between the Centre and the States.
- **Taxes shared** - The taxes that are shared between the Centre and the States include:
 - Corporation tax
 - Personal income tax
 - Central Goods and Services Tax (GST)
 - Centre's share of the Integrated Goods and Services Tax (IGST) etc.
- This division is based on the recommendation of the Finance Commission that is constituted every five years as per the terms of Article 280.
- **Excluded levy** - This divisible pool, however, does not include cess and surcharge that are levied by the Centre.
- For the year, 2025-26, it is estimated that the divisible pool constitutes only around 81% of the gross tax revenue of the Centre after excluding cess and surcharge.

What were the past recommendations?

- **Till the 13th FC (2010-2015)** - The devolution involved specific transfers for Centrally Sponsored Schemes (CSS) with extensive conditionalities.
- The share of States in Central taxes (vertical devolution) was fixed at 32%.
- **Since the 14th FC (2015-2020)** - The specific transfers for CSS were discontinued and the vertical devolution was increased to 42%.
- It was revised down to 41% in the 15th FC (2020-2026) due to the reorganisation of Jammu and Kashmir into two Union Territories.
- The criteria for distribution amongst the States (horizontal devolution) since the 13th FC is provided in Table.
- As can be observed, higher weightage has been given for equity (income gap) and needs (population and area) when compared to efficiency (forests, demographic

performance and tax effort).

The share for States

Till the 13th FC (2010-2015), the devolution involved specific transfers for Centrally Sponsored Schemes (CSS) with extensive conditionalities

Table 1: Criteria for horizontal devolution amongst States

Criteria	13th FC 2010-15	14th FC 2015-20	15th FC 2020-26	16th FC 2026-31
Income distance	47.5	50	45	42.5
Population (1971)	25	17.5	-	
Population (2011)	-	10	15	17.5
Area	10	15	15	10
Forests	-	7.5	10	10
Fiscal discipline	17.5	-	-	
Demographic performance	-	-	12.5	10
Tax effort	-	-	2.5	
State's contribution to GDP				10
Total	100	100	100	100



What were States' demands?

- **Increase of shares** - As regards of vertical devolution, 18 States had demanded that the States' share be increased from the current 41% to 50%.
- Few other States had demanded an increase of 45% to 48%.
- Many States had demanded the inclusion of cess and surcharge in the divisible pool as well as fixing a cap on cess and surcharge that could be levied by the Centre.
- **Equity in Criteria** - Secondly, as regards horizontal devolution, many States had pitched for the continued dominance of equity parameters in the criteria.
- Equally, many States had recommended reducing the weight assigned to 'income distance' as a criterion.
- Industrialised States such as Maharashtra, Gujarat, Tamil Nadu, Karnataka and Telangana had recommended the inclusion of States' contribution to GDP among the horizontal devolution criteria.

What did the 16th FC recommend?

- **On Cess and Surcharge** - With respect to the demands regarding vertical devolution, the FC opined that under the present constitutional scheme, it is neither permissible nor desirable to fix a cap on cess and surcharge or for their inclusion in the divisible pool.
- These instruments may also be needed to raise resources for the Union to meet any exigencies.
- **Vertical devolution** - Similarly, the FC recommended retaining the States' share in vertical devolution at its current level of 41% considering three main reasons:
 - The States' share in total tax revenues of the country;
 - Much of the spending of the Union in CSS is anyway ultimately routed to the States;
 - The Union government needs increased funds for defence and infrastructure.
- **Horizontal devolution** - In its approach for horizontal devolution, the FC was guided by two principles:

- First, changes to each State's share in the portion of divisible pool should be gradual.
- Second, due recognition should be given to efficiency and especially the States' contributions to growth.
- **New Criteria** - A new criterion of *State's contribution to GDP* has been added.
- The weightage to this new criterion as well as other criteria has been assigned in such a way that it spells a directional change without causing a drastic shift in States' shares.

What lies ahead?

- Considering all the above factors, the share of southern and western States has marginally increased while the share of big north and central States has marginally decreased.
- Hence, one may conclude that it is status quo as far as vertical and horizontal devolution is concerned with a directional change towards providing due recognition for efficiency.
- Additionally, the following observations of the FC should be borne in mind.
- The Centre should progressively reduce raising revenues through cess and surcharge.
- The States should make their subsidies efficient and targeted, actively pursue reforms in the power sector, and rein in the levels of their fiscal deficit and debt.
- The Centre and States should undertake various public sector enterprise reforms.

Reference

[The Hindu| 16th FC and State's Demand](#)