

16th Finance Commission: An Explainer

The 16th Finance Commission while giving its recommendations has ensured that 2 key principles—efficiency and equity—are given priority. At the same time, it also balances the requirements of the central government to meet its national obligations. Therefore, the FC has advised to keep the share of divisible pool of Union taxes unchanged at 41%. Key changes to horizontal devolution formula signal shift in focus towards changing demographic of Indian states, environmental sustainability, and incentives for greater contribution to nation's growth. Combining state and sector specific grants into grants for local bodies is also a step towards providing more resources and autonomy to RLBs and ULBs. Further, it has also been advised that central government lowers its fiscal deficit to GDP ratio to 3.5% by FY31 and states also cap their fiscal deficit ratio at 3%.

Background:

Every five years, President of India constitutes a constitutional body—the Finance Commission, which makes recommendations about:

1. How net taxes should be shared between the central and the state government.
2. The principle which governs the grants received by states from the centre.
3. Measures that can strengthen states' own consolidated fund and resources of Panchayats and Municipalities.

Noting the same, the latest—16th Finance Commission (FC), headed by Dr. Arvind Panagariya, has made recommendations on the above issues for the award period of fiscal year (FY) 2026-27 to 2030-31.

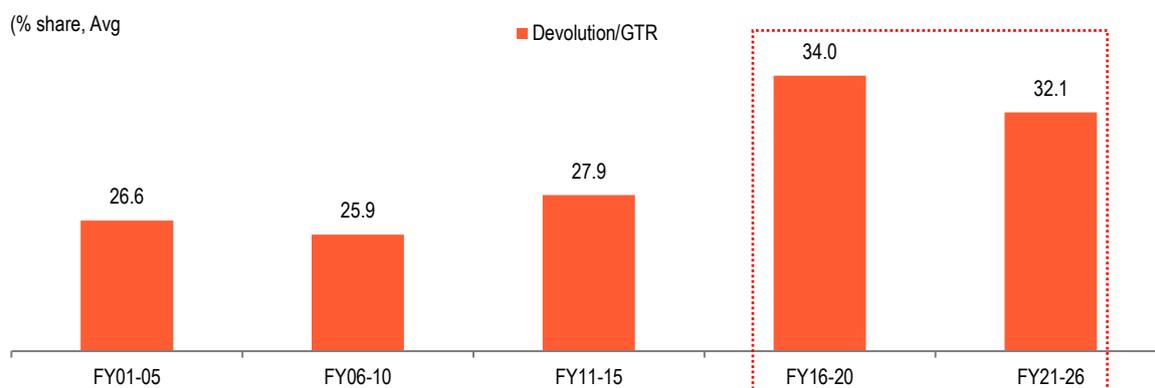
How taxes will be shared between Centre and States:

Vertical devolution: In order to decide what will be the divisible pool of taxes, the Finance Commission uses the concept of vertical devolution. This is based on the constitutional guidelines which state that “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”.

Accordingly, the latest Finance Commission has decided that 41% of centre’s gross tax revenue (GTR) will be shared with the states. This level remains unchanged from what was recommended by the 15th FC. The commission argued that any increase in this share will add to strain on centre’s finances to meet its national obligations.

The FC data shows (Fig 1), that from FY16 onwards, centre on an average (in the 5-year award period) has shared a higher percentage of its gross tax revenue as devolution with states. The effective share is usually less than 41%, as cess, surcharges and taxes of UTs are removed from the divisible pool. However, over the past 10 years states have seen a notable rise in their share of Union taxes.

Fig: 1: States have noted an improvement share in Union taxes



Source: 16th Finance Commission Report-Annexure 7.1, Bank of Baroda Research

Horizontal devolution: This implies how the divisible pool of taxes will be shared amongst all the states. Any increase in share of one state would imply reduction in share of some other state. Thus, to impart fairness to this process, the FC has recommended assigning weights to certain parameters based on which share of each state will be arrived at. To do so, the commission has intended to reward states which demonstrate efficiency and at the same time the formula also takes care of equity amongst all states. As such, the 16th FC has used 6 criteria, namely—Population, demographic performance, area, forest cover, per capita GSDP distance and contribution to GDP. It has done away with the criteria of tax/fiscal effort (used by 15th FC) and replaced it with a new criteria-contribution to GDP.

Table 1- Parameters and weights for horizontal devolution

Parameters	15 th Finance Commission (weight in %)	16 th Finance Commission (weight in %)
Population (2011 census)	15.0	17.5
Demographic performance	12.5	10.0
Area	15.0	10.0
Forest Cover	10.0	10.0
Per Capita GSDP distance	45.0	42.5
Contribution to GDP	-	10.0
Tax/fiscal effort	2.5	-
Total	100	100

Source: 16th Finance Commission Report-Table 8.8, Bank of Baroda Research

We briefly state below what each indicator describes:

1. **Population-** For this, 16th FC will use census 2011 data. Its weight has been increased from 15% to 17.5%, indicating the belief that, higher the population more resources a state would need to meet its obligations.
2. **Demographic performance-** The 16th FC has recommended 2 key changes in this criterion. Firstly, noting the problem of aging population in some states, and to stay ahead of the curve, it has been decided to do away with the use of inverse of total fertility rate (TFR) in formula,

and instead use population growth (between 1971 and 2011) for the calculation. Secondly, since removing this criterion all-together will alter the share of states drastically, thus for now, the weight of this indicator has been lowered, and it is recommended that it is phased out gradually.

3. **Area-** The earlier FCs suggested that to a minimum 2% weight should be assigned to each state, in order to make this indicator fairer for states which have a very small area. However, the 16th FC has decided to lower the floor to 1.5%, as it noted that there was large inequity in devolution between states whose share was just above 2% and those with smaller area. The overall weight of this indicator has also been brought down to 10% from 15% earlier.
4. **Forest cover-** Keeping in view the environmental concerns, overall weight of this indicator has been left unrevised at 10%. However, one notable change has been brought in. The calculation now also takes into account open forest into consideration. It has assigned weight of 0.3% to open forest (canopy density of 10-40%), 0.65% to moderately dense forest (canopy density of 40-70%) and 1% to very dense forest (canopy density of 70% or more). Change in forest cover has been taken between 2015 and 2023.
5. **Per capita GSDP distance-** This holds the maximum weight of 42.5%, as it maintains equity in devolution amongst all states. The purpose of its calculation, average per capita income of states over FY19 to FY24 excluding the Covid-19 year of FY21 has been used. As per this, distance between each state's per capita GSDP is taken from average of the highest 3 per capita states. To assign weights to the three highest per capita states (and Goa and Sikkim), their distance is calculated from the 4th highest per capita state, and the same weight is assigned to all.
6. **Contribution to GDP-** This is a new indicator which has been introduced in place of tax/fiscal effort. The idea of this criterion is to reward states which are more efficient. State's share is defined as the "ratio of square root of its GSDP to sum of square root of GSDP of all States". This indicator also reflects states' adoption of fiscal discipline.

Based on this formula of horizontal devolution, changes in the share of each state as are as follows:

Table 2- State-wise share for devolution of taxes

Parameters/ State's share in %	15 th FC	16 th FC	Change
Andhra Pradesh	4.05	4.22	↑
Arunachal Pradesh	1.76	1.35	↓
Assam	3.13	3.26	↑
Bihar	10.06	9.95	↓
Chhattisgarh	3.41	3.30	↓
Goa	0.39	0.37	↓
Gujarat	3.48	3.76	↑
Haryana	1.09	1.36	↑
Himachal Pradesh	0.83	0.91	↑
Jharkhand	3.31	3.36	↑
Karnataka	3.65	4.13	↑
Kerala	1.93	2.38	↑
Madhya Pradesh	7.85	7.35	↓
Maharashtra	6.32	6.44	↑
Manipur	0.72	0.63	↓
Meghalaya	0.77	0.63	↓
Mizoram	0.50	0.56	↑
Nagaland	0.57	0.48	↓
Odisha	4.53	4.42	↓
Punjab	1.81	2.00	↑
Rajasthan	6.03	5.93	↓
Sikkim	0.39	0.34	↓
Tamil Nadu	4.08	4.10	↑
Telangana	2.10	2.17	↑
Tripura	0.71	0.64	↓
Uttar Pradesh	17.94	17.62	↓
Uttarakhand	1.12	1.14	↑
West Bengal	7.52	7.22	↓
Total	100	100	

Source: 16th Finance Commission Report-Table 8.4, 8.6 and 8.9, Bank of Baroda Research

Grants available for states

Departing from the norm followed by 15th FC, the 16th FC has not recommended any revenue deficit grants (RDG) for states (total of Rs 2.9 lakh crore as per 15th FC). The commission has also not recommended any sector-specific (total of Rs 1.3 lakh crore as per 15th FC) or state-specific grants (total of Rs 0.5 lakh crore as per 15th FC) for the award period FY27-31. While explaining the rationale, the report notes that “when States anticipate that shortfalls in their revenue account will be compensated through RDGs, the incentive to undertake difficult but necessary fiscal reforms such as rationalizing subsidies, improving tax administration, or curbing revenue expenditures weakens. Over time, this softens fiscal discipline and embeds dependency rather than resilience.”

As such, all grants have been clubbed under grants for local bodies (rural and urban) and disaster management. Data indicates, that if states undertake all the reforms recommended by the FC, then grants (basic + performance based) to states, including those for disaster management, could go up Rs 9.5 lakh crore in the next 5-year period (2026-27 to 2030-31), compared with Rs 9.7 lakh crore in last 6-year period (2020-21 to 2025-26). Of this Rs 9.7 lakh crore, Rs 1.5 lakh crore is tied to performance-based grants (table 3). In addition, it has also been advised that that 50% of the basic grants available to local bodies should tied and directed towards ‘Sanitation and Solid Waste Management’ and/or ‘Water Management’. Within this tied component, local bodies will have flexibility to use these grants as per their needs.

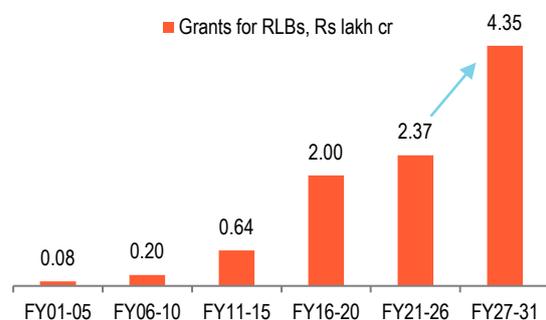
Table 3- Breakdown of total grants

Fiscal Year	Rs lakh crore
Total Grants	9.47
-Disaster Relief	1.56
-Local Bodies	7.91
--Rural Local Bodies (RLBs)	4.35
---Basic grants	3.48
---Performance based grants	0.87
--Urban Local Bodies (ULBs)	3.56
---Basic grants	2.32
---Performance based grants	0.58
---Special infrastructure component	0.56
---Urbanisation premium	0.10

Source: 16th Finance Commission Report-Table 10.5, Bank of Baroda Research

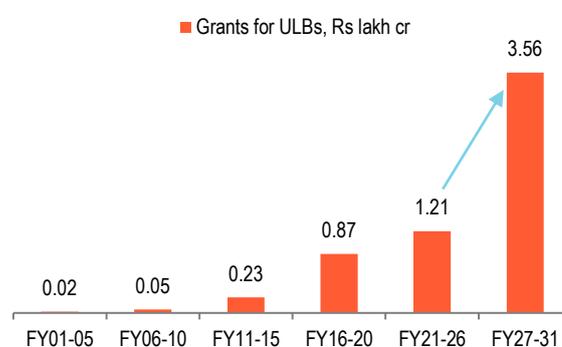
Between rural and urban local bodies, the split has been made in the ratio of 60:40, as FC notes that our urbanisation rate is estimated to reach 40.73% by the end of FY31, as per UN data. It can be seen that has been significant increase registered in local body grants for both rural and urban between FY27 and FY31. This is partly due to combining all grants (including sector/state-specific) into funds for local bodies.

Figure 1: Total grants for RLBs for award period



Source: 16th Finance Commission Report-Table 10.1, Bank of Baroda Research

Figure 2: Total grants for ULBs for award period



Source: 16th Finance Commission Report-Table 10.1, Bank of Baroda Research

FC has projected grants to gradually improve every year based on progress made in reforms undertaken. The suggested reforms include-

- Gram Panchayats increasing their own source revenue (OSR) such as—rental income, income from assets, user charges etc—in grant in year T by “in year T-1, minimum 1.025 times its OSR in year T-2 or 2.5% p.a. compounded growth applied over OSR of 2025-26, whichever is lower”.
- For Block Panchayats to qualify, they will have to ensure that at least 75% of their Gram Panchayats are qualifying for performance-based grants.
- District Panchayats will also have to raise “in year T-1, minimum 1.05 times its OSR in year T-2 or 5% p.a. compounded growth applied over OSR of 2025-26, whichever is lower”.
- For the ULB’s performance component grant in year T, it is recommended that “it raise in year T-1, minimum 1.05 times its OSR in year T-2 or 5% p.a. compounded growth applied over OSR of 2025-26, whichever is lower”.

For special infrastructure component, it is advised that ULBs develop comprehensive wastewater management system in cities (as advised by FC in annexure 10.11), which have population between 10-40 lakhs (as per 2011 census). A state can have maximum of 2 such cities. Projects upto Rs 5,00 crore can be financed through this for a city with population of 15 lakh or more and upto Rs 3,500 crore for population less than 15 lakh. Total project cost will be share between centre (60%), state and ULBs.

In case of urbanisation premium grant, it will be given to incentivise rural to urban transition. Therefore, it is advised that if a peri-urban village, near a large ULB (population of 1 lakh or above) merge, then a one-time grant may be given to the relevant ULB to develop basic infrastructure in the newly inducted area.

Table 4- Annual Grants recommended by the 16th FC

Fiscal Year	Rs lakh crore
2026-27	1.29
2027-28	1.69
2028-29	1.97
2029-30	2.16
2030-31	2.36
Total for the 5-year award period	9.47

Source: 16th Finance Commission Report-Table 10.5, Annexure 11.5 and 11.6, Bank of Baroda Research

Fiscal roadmap:

The FC has advised that central government’s fiscal deficit to GDP should be brought down to 3.5% by the end of FY31. For states, it has been suggested the fiscal deficit ratio (% of GSDP) must be capped at 3%. For states, it is also recommended that their off-budget borrowings should be brought within the ambit of their respective budgets, thereby reducing the risks to fiscal stability. Also, as states finance 80% of their deficit through market borrowings, it is recommended that they also adopt strategies like switching and buybacks to smoothen their redemption profile.

Summary: The 16th Finance Commission has maintained that Centre should share 41% of its Gross Tax Revenue (GTR) with states between FY27-31 as well. Data indicates that the effective rate of devolution is usually lower than this as cess and surcharges are removed from the divisible pool as per constitutional guidelines. However, states have seen a significant increase in the share of taxes in the past 10 years. The share of each state has also changed as per the recommendation of the 16th FC, resulting from changes made to the horizontal devolution formula. As per this, key changes have been made to the calculation of demographic performance and forest area. Except for forest area, weights of all other components have also been changed and a new indicator—contribution to GDP—has also been added. In case of grants, the commission has suggested discontinuation of Revenue Deficit Grants, state/sector-specific grants, and instead has made notable increases to local body grants. Grants will also have components of performance-based grants, which are there to incentivize local bodies to improve their revenue stream. States have also been advised to cap their fiscal deficit ratio at 3% to maintain their debt levels in future.

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