1. 16th Finance Commission- Polity

No reduction in State's share in tax devolution, says Finance Minister

The 16th Finance Commission has recommended maintaining the vertical devolution of taxes to States at 41%, rejecting demands for a hike or the inclusion of cess and surcharges in the divisible pool. While preserving the fiscal status quo, it introduced a new criterion of "State's contribution to GDP" for horizontal distribution, leading to marginal gains for southern and western states and record allocations for urban local bodies.

The Union Government has accepted the recommendations of the 16th Finance Commission regarding the devolution of funds from the Centre to the States for the award period of 2026–31.

About 16th Finance Commission

Constitution- It was constituted by the President of India under Article 280 of the Constitution of India. Date of Constitution- 31st December 2023.

Award Period- It is responsible for recommending the distribution of financial resources for the five-year period from 1 April 2026 to 31 March 2031.

Nature of Recommendations- The recommendations are advisory in nature but are conventionally accepted by the Union Government.

Composition

Chairman- Dr. Arvind Panagariya (Former Vice-Chairman of NITI Aayog and distinguished economist).

Full-time Members- Smt. Annie George Mathew, Dr. Manoj Panda, Shri Ajay Narayan Jha.

Part-time Member- Dr. Soumya Kanti Ghosh.

Constitutional Framework & Devolution Concepts

Constitutional Provisions

Article 270- Defines the Divisible Pool of net tax proceeds (includes income tax, corporation tax, CGST, and Centre's share of IGST) that are shareable with States.

Article 275- Deals with Grants-in-aid to States (for revenue deficit, local bodies, disaster management).

Article 280- Mandates the constitution of the Finance Commission.

Exclusions- Cess and surcharge are not part of the divisible pool (constituting approx. 81% of gross tax revenue in 2025–26).

Types of Devolution

Vertical Devolution- The share of the divisible pool distributed between the Union and the States.

Horizontal Devolution- The distribution of the States' aggregate share among individual States based on a formula determined by the Finance Commission.

Trends and State Demands

Past Trends in Vertical Devolution

1. Pre-14th FC- Up to the 13th FC, the States' share was fixed at 32%. States received specific transfers for Centrally Sponsored Schemes (CSS) with attached conditionalities.
2. 14th FC- Raised the States' share significantly to 42% and discontinued specific CSS transfers.
3. 15th FC- Adjusted the share slightly downwards to 41% to account for the reorganization of Jammu and Kashmir into Union Territories.

Key Demands by States (Pre-16th FC)

Higher Vertical Share- 18 States demanded raising the vertical share from 41% to 50%, while others sought an increase to 45–48%.

Cess and Surcharge- Many States demanded the inclusion of cess and surcharge in the divisible pool or the imposition of a cap on their usage by the Centre.

Horizontal Criteria- Industrialized States (Maharashtra, Gujarat, Tamil Nadu, Karnataka, Telangana) advocated for including the States' contribution to GDP as a criterion for distribution.

16th FC Recommendations on Vertical Devolution

Status Quo Maintained- The Commission recommended retaining the States' share in the divisible pool at the current level of 41%.

Rejection of Cess Inclusion- The Commission held that under the existing constitutional scheme, including cess and surcharge in the divisible pool or fixing a cap is neither permissible nor desirable.

Rationale for 41% Retention- States already receive a substantial share of total tax revenues. Union spending through Centrally Sponsored Schemes (CSS) ultimately reaches the States. The Union has higher spending requirements for defence, infrastructure, and national priorities.

Horizontal Devolution & Fiscal Impact

Guiding Principles

Gradualism- Changes in State shares should be gradual to avoid fiscal shocks.

Efficiency & Growth- There should be recognition of efficiency and the States' contributions to economic growth.

Criteria Used

Equity Considerations- Traditional parameters like income distance, population, and area continue to receive substantial weightage.

New Criterion- A new criterion of State's contribution to GDP has been introduced to reward economic performance.

Fiscal Impact on States (Winners and Losers)

Southern & Western Gain- Southern and Western States witnessed a slight increase in their share.

Northern Dip- Large Northern and Central States saw marginal reductions.

Overall Outcome- The fiscal transfer structure remains broadly similar to the 15th FC framework.

State-wise Changes in Share

State	Previous Share (15th FC)	Recommended Share (16th FC)	Trend
Andhra Pradesh	4.047%	4.217%	Increased
Karnataka	3.647%	4.131%	Increased
Kerala	1.925%	2.382%	Increased
Tamil Nadu	4.079%	4.097%	Increased
Telangana	2.102%	2.174%	Increased
Uttar Pradesh	17.939%	17.619%	Reduced
Bihar	10.058%	9.948%	Reduced

Grants to Urban Local Governments (ULGs)

Record Allocation- The Commission recommended ₹3.5 lakh crore for Urban Local Bodies (ULBs) over five years.

Comparison- This is an increase of about 230% compared to the 15th FC allocation of ₹1.5 lakh crore (2021–26).

Share in Grants- ULGs will receive 45% of total local body grants, up from 36% earlier, signalling stronger fiscal prioritization for urban areas.

Inter-State Distribution Trends-

1. Highest Increase- Kerala recorded the sharpest increase with allocations rising by over 400%.
2. Reduction- Himachal Pradesh saw nearly a 50% reduction in urban grants.

Source- https://www.thehindu.com/news/national/no-reduction-in-states-share-in-tax-devolution-says-finance-minister/article70620175.ece