P. L. RAJ MAINS Q & A – DAY 95

Financial Federalism and the 16th Finance Commission.

Introduction

The Balancing Wheel of Fiscal Federalism

The Finance Commission (FC) is a constitutional body that acts as the "balancing wheel" of fiscal federalism in India. Established under Article 280 of the Constitution, it is appointed by the President every five years (or earlier). Its primary mandate is to recommend a fair and equitable distribution of financial resources between the Union and the States (Vertical Devolution) and among the States themselves (Horizontal Devolution).

The Founding Fathers recognized that while the Union government has a greater capacity to raise taxes, the States have greater responsibilities for public expenditure (education, health, agriculture). To bridge this fiscal gap, they created the Finance Commission as a neutral, expert body to ensure that states have sufficient resources to carry out their functions assigned under the Seventh Schedule.

The 16th Finance Commission - Overview and Structure

The 16th Finance Commission, headed by Dr. Arvind Panagariya, was tasked with determining the federal fiscal architecture for the period 2026-2031. Its report, placed in Parliament on February 1, 2026, is a critical document for governance.

The structure of the Commission typically consists of a Chairman and four other members appointed by the President. Their expertise ranges from economics and public finance to administration and law, ensuring a multidisciplinary approach to fiscal distribution.

Terms of Reference (ToR) - A Return to Basics

One of the most noteworthy aspects of the 16th Finance Commission is its Terms of Reference (ToR). In the past, ToRs often included "nudges" or specific directives from the Union government that could be perceived as encroaching on the Commission's autonomy. However, the 16th Commission's ToR simply reproduced the core tasks specified in Article 280. This "clean" ToR allowed the Commission to operate with greater neutrality, focusing strictly on assessing the changing capacities and needs of the States without being influenced by specific central policy agendas.

Key Recommendations - Stability and Vertical Devolution

The Commission has prioritized stability and continuity. In terms of Vertical Devolution, it has recommended that 41% of the divisible pool of Union taxes be devolved to the States. This maintains the status quo established by the 15th Finance Commission, providing a predictable revenue stream for state governments.

However, a significant departure from previous practice is the discontinuation of revenue-deficit grants. The Commission also chose to stop recommending state-specific and sector-specific grants. By doing so, it aims to simplify the transfer mechanism and allow states greater autonomy in utilizing their devolved funds based on their unique local priorities.

The New Horizontal Allocation Formula - Rewarding Contribution

The "Horizontal Devolution" determines how the 41% share is distributed among the 28 states. The 16th Commission introduced several significant changes to ensure a balance between "equity" (helping poorer states) and "efficiency" (rewarding performance).

1. **Introduction of GDP Contribution (10%) -** The most revolutionary change is the introduction of the state's share in the national Gross Domestic Product (GDP) with a 10% weighting. This is a clear signal to reward states that contribute significantly to the national economy and maintain high growth trajectories.
2. **Population Share (17.5%) -** The weighting for population was increased to 17.5%, incorporating the 2.5% previously assigned to "tax effort."
3. **Income Distance (Reduced) -** To accommodate the GDP factor, the Commission reduced the weighting assigned to the "income distance" (the gap between a state's per capita income and that of the richest state).
4. **Demographic Performance -** The weight for this factor was reduced. Instead of focusing on fertility changes, the Commission used the inverse of population growth between the 1971 and 2011 Censuses. This rewards states that have successfully managed population growth over the long term.
5. **Forest and Ecology -** The Commission refined the forest cover variable by weighting it according to forest density, ensuring that states preserving dense, high-quality ecological cover are better compensated for the "opportunity cost" of not utilizing that land for industrial purposes.

Significance in Federal Relations

The recommendations of the 16th Finance Commission hold immense significance for the Indian federal structure -

1. **Fiscal Autonomy -** By providing a stable devolution percentage and reducing specific "strings-attached" grants, the Commission has enhanced the fiscal autonomy of states.
2. **Performance vs. Need -** The inclusion of GDP share marks a shift toward rewarding economic performance, which has been a long-standing demand of high-growth states.
3. **Predictability -** In an era of global economic uncertainty, the Commission's decision not to "rock the boat" provides the states with a predictable fiscal environment for their five-year planning cycles.

Conclusion - A Pragmatic Blueprint

The 16th Finance Commission has delivered a pragmatic report that balances the historical needs of developing states with the modern imperative of rewarding economic contribution. While the removal of revenue-deficit grants may pose challenges for some fiscally stressed states, the overall emphasis on stability and the 41% devolution share ensures that the federal fiscal architecture remains robust. For India to reach its goal of becoming a 'Viksit Bharat' by 2047, the fiscal health of its states is as important as that of the Union. The 16th FC report provides the necessary financial roadmap to achieve that collective progress.

Main Practice Question

Q. "The 16th Finance Commission's horizontal devolution formula marks a definitive shift from 'need-based' equity to 'performance-led' efficiency. Critically analyze the implications of this shift for the future of Indian fiscal federalism." (15 Marks)

Answer Guidelines

1. **Introduction (Approx. 30–40 words)**

   Briefly mention Article 280 and the role of the FC as a "balancing wheel." State the context of the 16th FC's 41% vertical devolution stability.
2. **Body**

   Paragraph 1 - Efficiency

   Discuss the introduction of the GDP contribution (10%) and the refined forest density weightage. Explain how this rewards high-growth states and ecological conservation.

   Paragraph 2 - Equity)

   Analyze the reduction in income distance weightage and the discontinuation of revenue-deficit grants. Discuss how this might create fiscal stress for poorer or "special category" states.

   Paragraph 3 - Federal Implications)

   Discuss the enhancement of fiscal autonomy through the removal of "strings-attached" sector-specific grants, while highlighting the risk of a widening developmental gap between states.

3. **Conclusion (Approx. 30–40 words)**
   Conclude by emphasizing that for 'Viksit Bharat', the formula must eventually synchronize the aspirations of high-performing states with the essential requirements of lagging regions to ensure "Sabka Saath, Sabka Vikas."