Performance over Privilege: The 16th Finance Commission's New Fiscal Formula

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Introduction

The President of India constituted the extant 16th (XVI Finance Commission) Finance Commission in accordance with Article 280 of the Indian Constitution under the Chairmanship of renowned economist Sri. Arvind Panagariya, former vice-chairman of NITI Aayog. Its primary mandate is to define the financial relationship between the Central Government and the States for a five-year "award period." This committee had submitted its report on 17th November, 2025, and the same was placed in Parliament on 1st February 2026, on the same day as Budget 2026-27.

Like the 15th Finance Commission, it has also recommended transferring 41% of the Centre's Gross Tax Revenue (GTR) to the states. Unlike the 13th and 14th Finance Commissions, which employed only four parameters, both the 15th and 16th Finance Commissions have used six criteria for distributing central taxes among states, but with a twist. This commission has dropped the state's tax effort criteria and introduced, for the first time, a new criterion- contribution by a state to the country's GDP with a weight of 10%.

Among all the parameters, the most dominant one is the income distance criterion. The commission has reduced the weightage by 2.5% (from 45% to 42.5%). This parameter spells out how far a state's average per capita income is below the per capita income computed by taking the three best-performing states. As this parameter is enjoying a greater share, it helps the poor states to get a better share. Other parameters that have seen a reduction in their weights are demographic performance by 2.5% and area by 5%. The Commission has assigned 10% weightage to the new criteria by reducing the weightage of the above three parameters.

The weightage for the population criterion was enhanced by 2.5%, effectively replacing the 2.5% weightage previously assigned to the states' tax effort criterion, which had been introduced by its predecessor.

Of these six criteria, it is the forest criterion that alone has enjoyed the same weightage under both the 15th and 16th Finance Commissions as depicted in table no. 01.

Considering the contribution by a state to national GDP, it has helped almost all better-performing states as their share in the devolution has increased a little, including Karnataka.

Taxes to be shared

The following are the Central taxes divided among the states

1. Corporation Tax
2. Personal Income Tax
3. Central Goods and Services Tax
4. Center's share of IGST

Table No. 01: Criteria for distribution of the center's taxes among states in the 16th Finance Commission

Criteria	15th FC Weight	16th FC Weight	Change in %
Income Distance	45%	42.50%	-2.5
Population (2011)	15%	17.50%	2.5
Area	15%	10%	-5
Forest & Ecology	10%	10%	0
Tax Effort	2.50%	0%	-2.5
Contribution to GDP	0%	10%	10
Demographic Performance	12.50%	10%	-2.5
Total	100%	100%	

Sources: 16th Finance Commission Report

Table No. 02: List of states that have witnessed a slight increase in their share

Sl. No.	States	Share in Central taxes in RE of FY 2026 (%)	Share in Central taxes in BE of FY 2027 (%)	Increase (%)
1	Andhra Pradesh	4.047	4.217	0.17
2	Assam	3.128	3.258	0.13
3	Gujarat	3.478	3.755	0.277
4	Haryana	1.093	1.361	0.268
5	Himachal Pradesh	0.83	0.914	0.084
6	Jharkhand	3.307	3.357	0.05
7	Karnataka	3.647	4.131	0.484
8	Kerala	1.925	2.382	0.457
9	Maharashtra	6.317	6.441	0.124
10	Mizoram	0.5	0.564	0.064
11	Punjab	1.807	1.996	0.189
12	Tamil Nadu	4.079	4.097	0.018
13	Telangana	2.102	2.174	0.072
14	Uttarakhand	1.118	1.141	0.023
	Total	**37.378**	**39.788**	**2.41**

Source: Budget FY 2026-27

The divisible pool forms about 81% of the Center's Gross Total Revenue for 2025-26 after excluding cesses and surcharges.

States that have gained and declined their share in the 16th Finance Commission

The 16th Finance Commission has tweaked the formula of horizontal distribution; as a result, 14 states have gained marginally in their share of the divisible pool of taxes, and the other 14 states have witnessed a decline in their share.

The above table no. 02 depicts that among all the states that witnessed a gain in their share, Karnataka is the biggest gainer. Its share has been increased to 4.131%, up from 3.647% under the 15th Finance Commission. This hike in its share is likely to increase around Rs. 12,248 crore annually to the state's exchequer.

Together, these states receive a higher tax share by 2.41% points. The commission would like to recognize the contribution made by these states in enhancing the nation's GDP.

Table no. 3 shows that among all the states, the share of Madhya Pradesh has witnessed a huge decline of 0.503%. The marginal decline in their share because the "needs-based" criteria (poverty/ income gap) were diluted to reward "growth-based" criteria.

States bargain

Many states have demanded a larger share. Around 18 states have demanded an enhancement of the state's share of distributable tax from 41% to 50%. Besides, they

Table No. 03: States that have witnessed a decline in their share

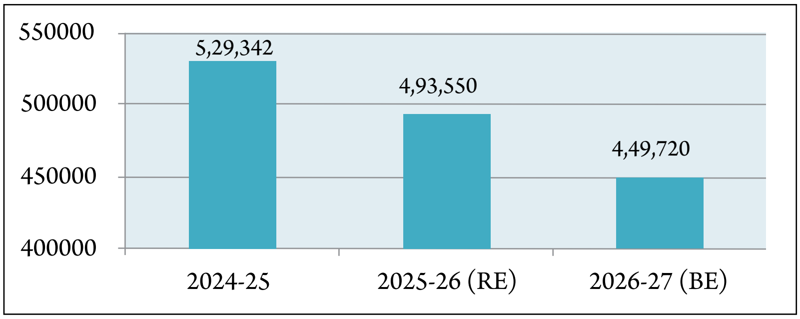
Sl. No.	State	Share in Central taxes in RE of FY 2026 (%)	Share in Central taxes in BE of FY 2027 (%)	Difference (%)
1	Arunachal Pradesh	1.757	1.354	-0.403
2	Bihar	10.058	9.948	-0.11
3	Chhattisgarh	3.407	3.304	-0.103
4	Goa	0.386	0.365	-0.021
5	Madhya Pradesh	7.85	7.347	-0.503
6	Manipur	0.716	0.626	-0.09
7	Meghalaya	0.767	0.631	-0.136
8	Nagaland	0.569	0.481	-0.088
9	Odisha	4.528	4.42	-0.108
10	Rajasthan	6.026	5.926	-0.1
11	Sikkim	0.388	0.335	-0.053
12	Tripura	0.708	0.641	-0.067

Source: Budget FY 2026-27

Sl. No.	State	Share in Central taxes in RE of FY 2026 (%)	Share in Central taxes in BE of FY 2027 (%)	Difference (%)
13	Uttar Pradesh	17.939	17.619	-0.32
14	West Bengal	7.523	7.215	-0.308
	Total	**62.622**	**60.212**	**-2.41**

Sources: Budget FY 2027

Table No. 04: Reduction in Cess and Surcharge (Rs. in Cr)



Sources: 16th Finance Commission Report and Union Budget

also demanded the inclusion of cess and surcharge in the divisible tax pool. Of course, the cess and taxes collected and retained by the central Government have been declining from the FY 2024-25 as depicted in table no. 04.

However, the commission has a different version and views that "states already account for more than 2/3rd of the nation's non-debt revenue" and any further increase would adversely hinder the Government's fiscal space and its ability to meet national obligations.

Further, the Commission suggests that if both the center and states would like to have an efficient and broad based tax system, they should come to a mutual Consensus in which case the center would forgo a large part of the revenue from cesses and surcharges into divisible pool of taxes and state would also agree to forgo a small share of this increased center's divisible pool of taxes, that protects interest of both the parties.

Major discontinued grants in the 16th Finance Commission

The Commission explicitly stated that it would not recommend three specific types of grants that were provided during the previous Finance Commission's tenure:

- **Revenue Deficit Grants (RDG):** The Commission has scrapped this grant to encourage states to achieve fiscal self-reliance and improve their own tax-to-GSDP ratios, and rationalize the expenditures.
- **State-specific Grants:** Grants previously pegged for specific sectors like health, education, or agriculture have been discontinued. These sectors are better funded through Centrally Sponsored Schemes (CSS) or the state's own increased tax shares.
- **Sector Specific Grants:** Specialized grants for specific projects within a single state, like building a specific bridge or university, have been scrapped to prevent political subjectivity and ensure a uniform formula-based distribution.

Recommendations to bring fiscal discipline to the State and the Center

- Most defining feature of the 16th Finance Commission report is its aggressive stance on Off-Budget Borrowing (OBB) by the States. The Finance Commission's report mandates that all OBB must be brought onto the books to ensure investors and the Union have a clear picture of India's debt-to-GDP ratio.
- The Finance Commission has established a clear fiscal roadmap to ensure long-term stability and debt sustainability for both the Union and the states. Deficit target for the state is 3% of its SGDP and the center 3.5% of GDP by the end of the award period (March 2031)

Strategic Roadmap for the Next Finance Commission

1. With a view to bringing financial discipline among the states, this Finance Commission has recommended the discontinuation of the Revenue Deficit Grants (RDG) to the states.

   The table no. 05 shows Revenue Deficit Grants provided during the last four Finance Commissions and the number of states benefited from the grants.

   In contrast to the prevailing practice of earlier Finance Commissions, this Commission explicitly mentioned in Para 9.48 of its report that it will no longer undertake assessments of post-devolution revenue needs for each state, nor will it recommend grants on this basis.

   Keeping in view the revenue-generating potential of some states and hill states like Himachal Pradesh and Uttarakhand, where tax collection potential is limited, the Commission could have proposed a gradual phasing

Table No. 05: Revenue Deficit Grants provided during the four Finance Commissions

Commissions	Amount provided (Rs in Cr)	No. of States Benefited
12th FC	56,856	15
13th FC	51,800	8
14th FC	1,94,821	11
15th FC	2,94,514	17

Sources: Finance Commission reports of 12th, 13th, 14th and 15th

out of the RDG instead of discontinuing it abruptly.

2. To bring transparency into the devolution of taxes, the 16th Finance Commission has recommended that the center unveil financial data pertaining to the net proceeds, as certified by the Comptroller and Auditor General under Article 279 of the Constitution. It is also advisable on the part of the center to certify that the rate of vertical devolution of the tax pool is in tune with the rate of devolution as recommended by the Finance Commission.

   Table 06 illustrates that throughout the 15th Finance Commission's tenure, the effective rate of devolution consistently fell short of the recommended 41% target.

3. Currently, the center collects cesses and surcharges that do not form part of the divisible pool of taxes. These now account for more than 10% of the Government of India's gross tax revenue (Table 4). Given that almost all states are demanding their inclusion in the divisible pool, future Finance Commissions should give serious attention to this issue.

4. Keeping in view the FRBM Act, the Finance Commission advises both the center and the state governments to bring the combined debt from 77.3% in 2026-27 to 73.1% of GDP by 2030-31. This trajectory aims to instill fiscal discipline and eliminate hidden liabilities, ensuring a transparent reflection of India's sub-national debt. Consequently, both the center and the states should strictly adhere to these recommendations.

5. Horizontal tax devolution currently relies on six criteria, where need-based factors like equity, population, and area carry over more than two-thirds of the weight. Performance-based criteria, such as demographic performance, contribution to GDP, and forest account for only one-third. Many performing states argue that this distribution is skewed and penalizes efficiency. To ensure fairness, the future Finance Commission should reassess the weightage assigned to various parameters rationally.

6. The newly introduced GDP contribution criteria employ the "Square Root" formula to determine a state's share in horizontal distribution. The square root formula was meant to protect smaller states, but it creates a diminishing incentive.

   The square root function flattens the curve. A state that is 100 times larger than another in terms of GDP, it only receives a 10-fold reward. This ensures that the 10% weight doesn't lead to a catastrophic drop in funds for smaller or mid-sized states.

Table No. 06: Devolution of Taxes among States

Year	States Share (in Cr)	Divisible Pool (in Cr)	Share (in %)
2021-22	8,83,100	22,17,737	39.8
2022-23	9,48,982	25,48,723	37.2
2023-24	11,29,494	29,55,296	38.2
2024-25	12,86,885	32,57,513	39.5
2025-26 (RE)	13,92,971	35,74,600	39.0
2026-27 (BE)	15,26,255	39,44,110	38.7

Sources: 15th and 16th FC Reports and Union Budget

Consequently, the core objective of the efficiency-based criterion is largely undermined by 'neutralizing' the reward. The formula fails to provide a meaningful fiscal incentive for states to maximize their economic contribution. The Finance Commission should guarantee an evenhanded relationship between performance and fiscal payoff.

Conclusion

The 16th Finance Commission marks a historic pivot in India's fiscal architecture. By introducing a 10% weightage for "Contribution to GDP", the Commission has finally addressed the long-standing grievance of industrial states, moving away from a purely redistributive model. While it maintained the vertical devolution at 41%, the real impact lies in its demand for fiscal discipline, specifically the strict ban on off-budget borrowings. Ultimately, the 16th FC serves as a financial manifesto for "Viksit Bharat 2047," signaling that the next phase of India's growth will be driven by efficiency, transparency, and urban transformation.

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