



# **16<sup>th</sup> Finance Commission (2026–31)**

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## Constitutional Mandate Under Article 280

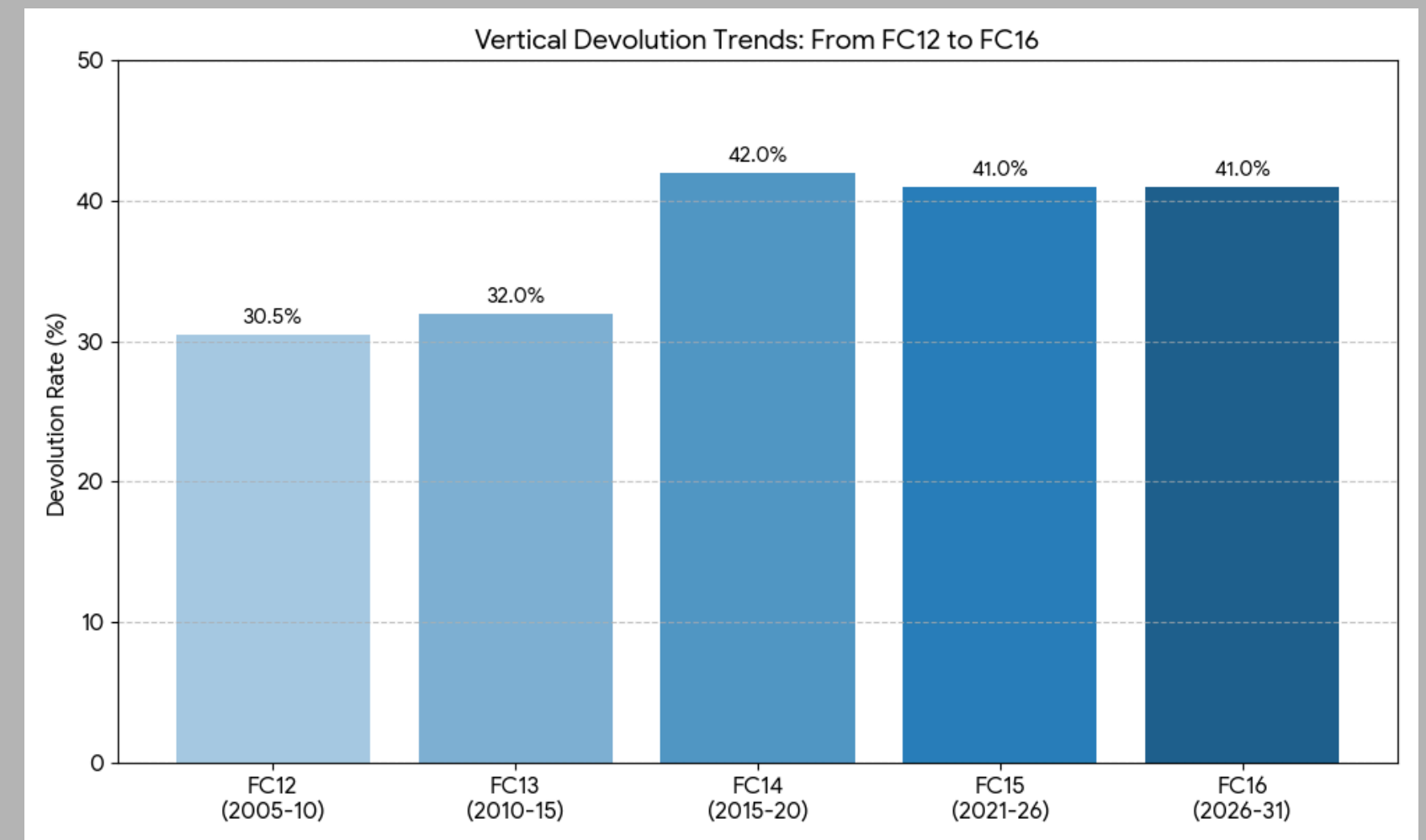
The 16th Finance Commission (FC16) derives its legitimacy from Article 280 of the Constitution, a provision designed to mitigate the inherent fiscal imbalances within the Indian federal structure. By mandating an independent body every five years, the Constitution ensures a periodic recalibration of the nation's financial architecture. The commission's primary responsibility involves defining the vertical devolution, the share of Union taxes assigned to the States, and the horizontal formula that determines how these resources are distributed among the States themselves. Beyond mere tax-sharing, the FC16 is tasked with outlining the parameters for grants-in-aid and establishing long-term fiscal consolidation targets to ensure national economic stability.

For the 2026–31 award period, the commission functions as a sophisticated technocratic intermediary. Its recommendations, however, carry a significant caveat: they are strictly advisory until they undergo Presidential acceptance and subsequent Parliamentary adoption. This procedural nuance creates a complex political landscape where the Union government can adopt distributive outcomes that satisfy immediate state demands while effectively side-stepping or deferring structurally transformative, yet politically fraught, reforms. Consequently, the FC16 does more than just move numbers; it balances the immediate expenditure responsibilities of the States against the overarching necessity of central fiscal discipline.

# Vertical Devolution: The Stagnation of the Divisible Pool

The FC16 decision to maintain vertical devolution at 41% represents a significant moment of fiscal continuity and yet showcases an intensifying friction within India's cooperative federalism. While States are currently tasked with managing approximately 67–68% of general government expenditures, their primary source of untied revenue, i.e. the divisible tax pool, has remained static. This plateauing of funds occurs despite vigorous appeals from State governments for a higher share to offset their increased responsibilities in healthcare, education, and social welfare.

Moreover, the 41% share is becoming an increasingly deceptive metric due to the proliferation of cesses and surcharges. Because these levies are retained exclusively by the Union and excluded from the divisible pool, the actual base of shared taxes is shrinking relative to gross tax revenue. Consequently, while the statutory percentage remains unchanged from the previous cycle, the structural fiscal space for States is being subtly constricted, leaving them increasingly reliant on conditional grants and central discretion rather than constitutional entitlement.



Source: 16<sup>th</sup> Finance Commission Report

Criterion	15th Finance Commission	16th Finance Commission	Change Summary
Income Distance	45%	42.50%	Reduced by 2.5%
Population (2011)	15%	17.50%	Increased by 2.5%
Area	15%	10%	Reduced by 5%
Forest & Ecology	10%	10%	No change
Demographic Performance	12.50%	10%	Reduced by 2.5%
Tax & Fiscal Effort	2.50%	<i>Discontinued</i>	Replaced
Contribution to GDP	<i>New Criterion</i>	10%	Added to reward large economies

Source: 16<sup>th</sup> Finance Commission Report

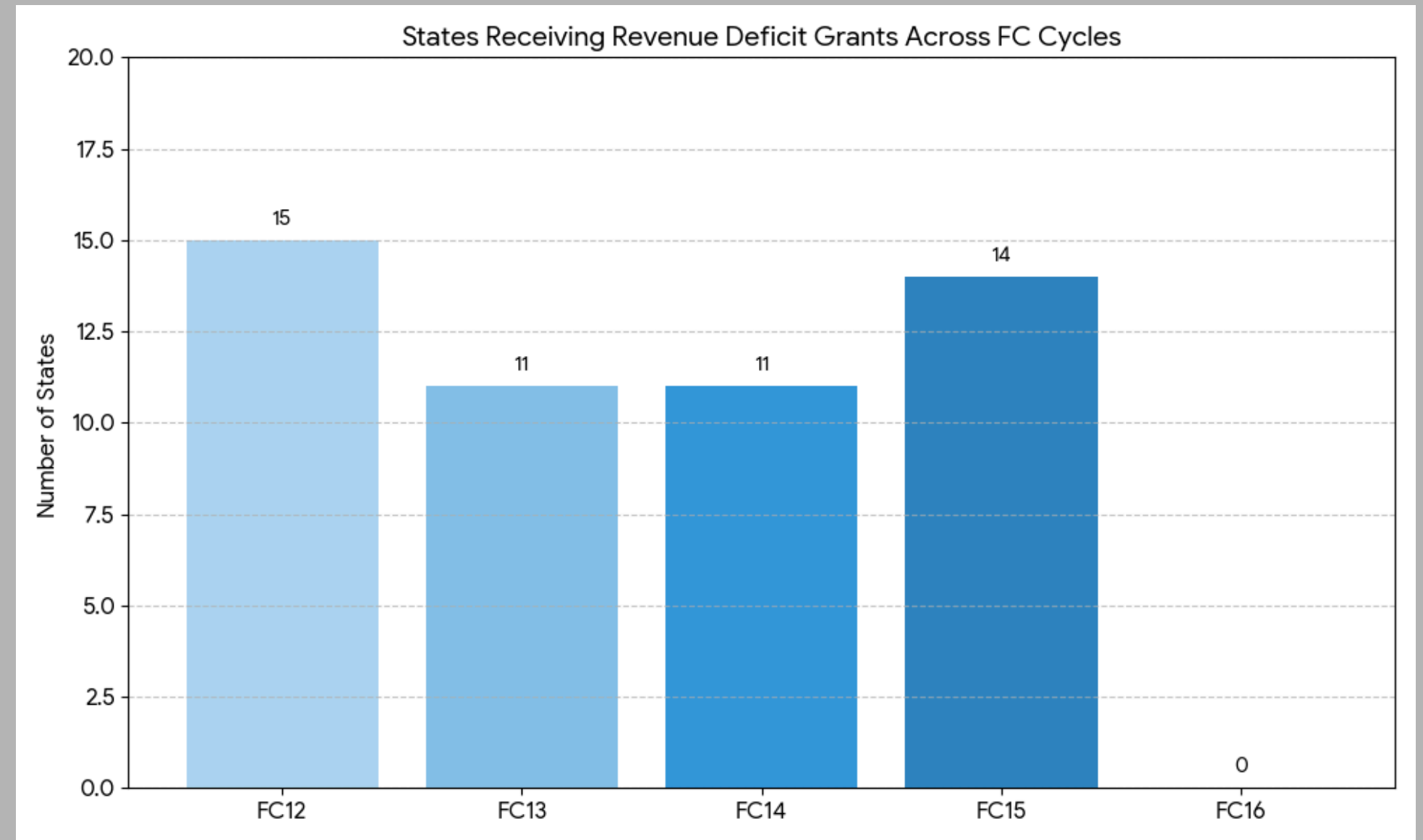
## Horizontal Devolution: A New Equilibrium Between Equity and Efficiency

- The FC16 has introduced a significant recalibration of the horizontal distribution formula, signaling a shift in how the Indian federation values economic output alongside historical disadvantage. The current formula allocates resources based on Income Distance (42.5%), Population (17.5%), Demographic Performance (10%), Area (10%), Forest cover (10%), and the newly introduced Contribution to GDP (10%). This architecture attempts to balance the needs of geographically vast or low-income states with the performance of economic engines.
- A pivotal feature of this cycle is the inclusion of the Contribution to GDP criterion, which effectively replaces the 15th Commission's focus on Tax and Fiscal Effort. By prioritizing absolute GDP contribution, the formula inherently favors large-scale economies, potentially at the expense of per-capita productive States that may be smaller in absolute size. Furthermore, the retention of Demographic Performance continues to reward states with lower fertility rates, a metric that, while promoting population stability, persists as a point of structural tension for more populous States that face higher service delivery pressures.

# Revenue Deficit Grants Discontinued

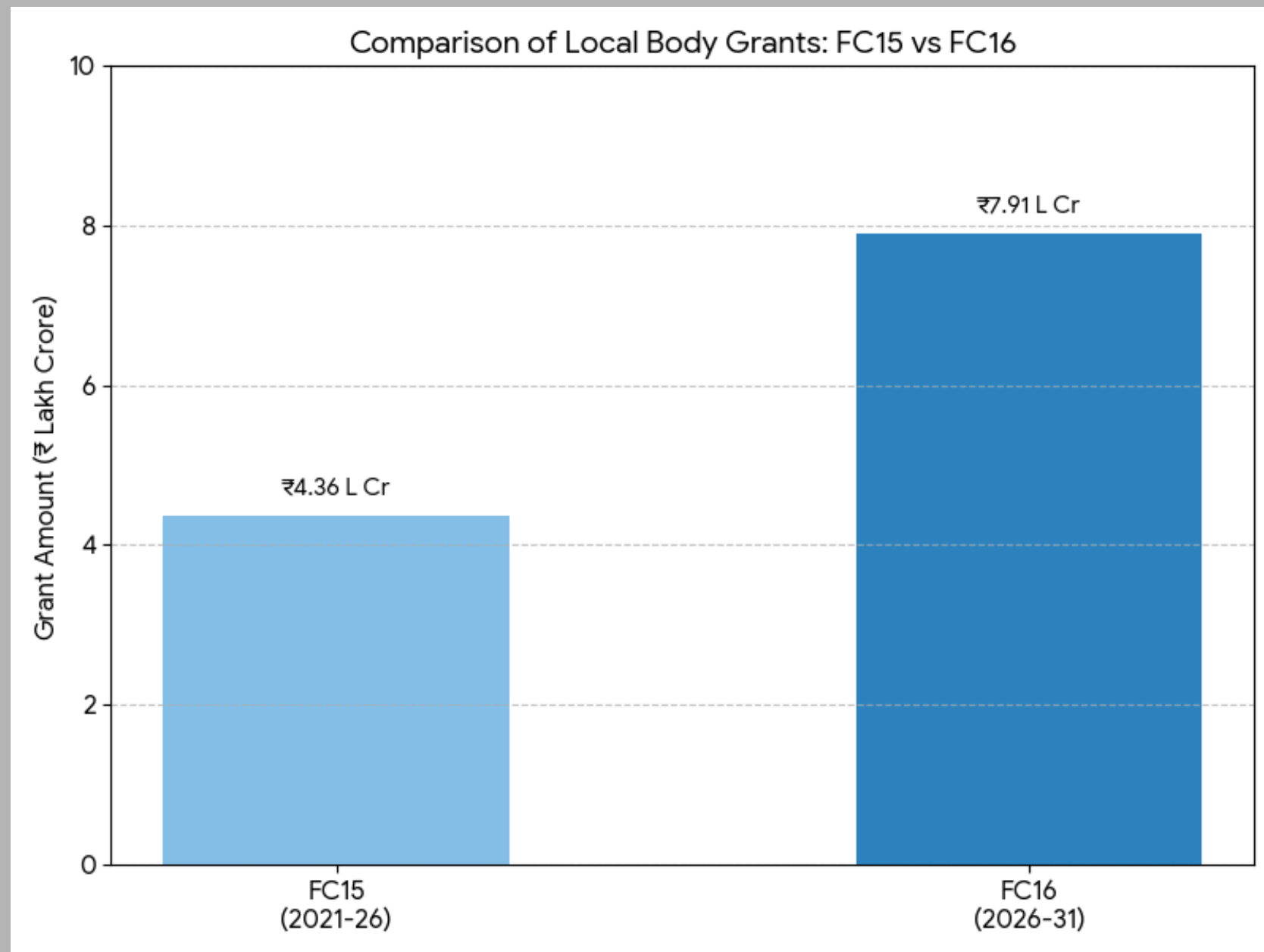
The FC16 has introduced a rigorous pivot in fiscal policy by entirely discontinuing Post-Devolution Revenue Deficit (PDRD) Grants. While the 15th Finance Commission extended these grants to 14 States to bridge the gap between their assessed expenditures and revenues, the FC16 operates on the assessment that States possess the latent capacity to broaden their own revenue bases and rationalize expenditures. This withdrawal aims to enforce fiscal discipline without the need for binding, externally imposed reform conditions.

However, this transition is not without its structural risks. The discontinuation disproportionately impacts Northeastern States and those with limited internal revenue potential, who have historically relied on these transfers to maintain essential public services. By removing this safety net, the FC16 implicitly signals a shift toward a self-reliance model of federalism. While this may drive fiscal efficiency, it risks exacerbating regional disparities, as revenue-deficient States are now forced to navigate their fiscal responsibilities without the traditional compensatory framework that mitigated their structural disadvantages.



Source: 16<sup>th</sup> Finance Commission Report

# Local Body Grants Expansion with Performance Conditions



Source: 16<sup>th</sup> Finance Commission Report

- FC16 significantly scales up the fiscal resources directed toward the grassroots, allocating a total of 7.91 lakh crore for rural and urban local bodies over the 2026–31 period. This substantial increase in quantum is, however, tethered to a more rigorous set of performance conditions. To access these funds, local bodies are required to maintain audited accounts, achieve own-revenue benchmarks, particularly through improved property tax collection, and populate a centralized online database.
- From an analytical perspective, this framework effectively creates a direct Centre-local body fiscal linkage, a move that fundamentally bypasses State governments and centralizes the oversight of local administration. While the objective is to enhance transparency and financial self-sufficiency, the implementation faces significant headwinds. The current performance monitoring infrastructure remains weak, and the enforcement mechanisms for these stringent conditions are yet to be clearly defined, raising concerns about the administrative burden on smaller, resource-constrained local entities.

# Disaster Management Grants (FC16)

- **Massive allocation:** FC16 earmarks a total of ₹2.044 lakh crore for disaster funds (SDRF + new State Disaster Mitigation Fund) in 2026–31, of which the Centre provides ~₹1.559 lakh crore
- **Allocation formula:** Grants are distributed by formula (area, population, disaster history, vulnerability). Under current DM Act norms, the Centre bears 90% of SDRF cost in Himalayan/NE states and 75% in other states (the rest borne by states).
- **Response focus:** About 80% of the corpus goes to SDRF (response) and 20% to mitigation. In practice the emphasis remains on post-disaster relief rather than proactive adaptation. Special-category states retain their higher 90:10 funding share.
- **Comparison:** The 16<sup>th</sup> FC has recommended grants worth Rs 9.47 lakh crore over the five-year period. These comprise grants for: (i) urban and rural local bodies, and (ii) disaster management. The 16<sup>th</sup> FC has discontinued the following grants recommended by the 15<sup>th</sup> FC: (i) revenue deficit grants, (ii) sector-specific grants, and (iii) state-specific grants.

Table 2: Grants-in-aid for 2026-31 (in Rs crore)

Grants	Amount
<b>Local governments</b>	<b>7,91,493</b>
<i>Rural local bodies</i>	<i>4,35,236</i>
<i>Basic Grant</i>	<i>3,48,188</i>
<i>Performance Grant</i>	<i>87,048</i>
<b>Urban local bodies</b>	<b>3,56,257</b>
<i>Basic Grant</i>	<i>2,32,125</i>
<i>Performance Grant</i>	<i>58,032</i>
<i>Special Infrastructure Component</i>	<i>56,100</i>
<i>Urbanisation Premium</i>	<i>10,000</i>
<b>Disaster management</b>	<b>1,55,916</b>
<b>Total</b>	<b>9,47,409</b>

Source: Report of the 16<sup>th</sup> Finance Commission; PRS.

# Fiscal Consolidation Targets

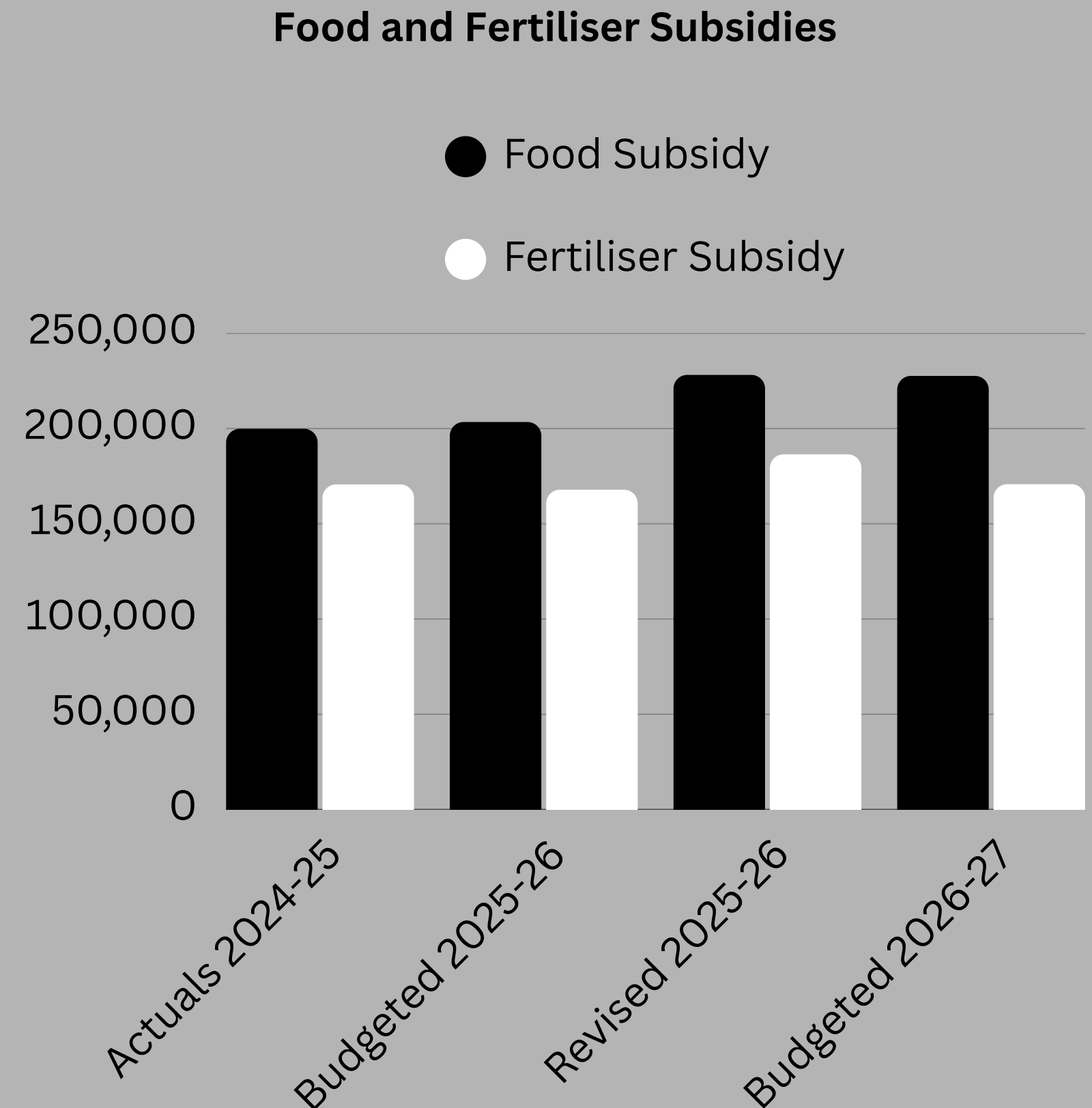
- **Deficit glide-path:** FC16 mandates a union deficit of 3.5% of GDP by 2030-31, down from ~4.4% initially, and limits every state's fiscal deficit to 3% of GSDP each year.
- **Underlying assumptions:** This path assumes sustained GDP growth (~10–11%) and improved tax buoyancy. In reality, the states' 3% FRBM cap is binding, whereas the Centre uses off-budget borrowing (e.g. NHAI bonds) to keep spending higher.
- **Risks:** Major shocks (global slowdown, commodity spikes) or unbudgeted costs (climate relief, subsidies) could make the targets difficult to meet.
- **Graph (Visual):** Line chart of fiscal deficit (%GDP) – projecting Union deficit from ~4.1% in 2026-27 to 3.5% by 2030-31, per FC targets.
- **Fiscal Roadmap- 31.** It recommended the annual fiscal deficit limit for states to be 3% of GSDP. It also recommended strictly discontinuing the practice of off-budget borrowings for states and bringing all such borrowings onto their budgets. The definition of fiscal deficit and debt should be expanded to uniformly include all off-budget borrowings. The Commission has projected the combined debt of the central and state governments to decline from 77.3% in 2026-27 to 73.1% of the GDP in 2030-31.

# DISCOM Privatisation Deferred

- FC16 recommended making repayment support for accumulated DISCOM working capital loans conditional on privatisation. The government deferred this "for separate examination" with no binding timeline, extending a pattern across five successive bailout cycles since 2001.
- The sector posted a thin collective profit of ₹2,701 crore in 2024-25, but this headline obscures the structural position. Accumulated losses stood at ₹6.47 lakh crore in 2024-25 on state government balance sheets, and total borrowings rose to ₹7.53 lakh crore by March 2024, a 12% increase in a single year.
- AT&C losses worsened from 15.11% in 2022-23 to 16.12% in 2023-24, the first reversal after years of improvement, while tariff subsidies billed by utilities rose to 20.21% of total revenue from 17.56% the year before, confirming that political commitments on pricing are actively offsetting operational gains.
- The RDSS, launched in 2021-22 with a ₹3 lakh crore outlay, had installed only 20.8 million of 220 million targeted smart meters as of February 2025, less than 10% of the target in its fourth year. The scheme addresses technical infrastructure but leaves the underlying problem, free and subsidised power embedded in state electoral politics, entirely untouched.
- Each bailout cycle transfers the DISCOM burden to state budgets or future taxpayers without resolving the incentive structure. Quasi-fiscal DISCOM losses sit outside official deficit calculations, meaning FC16's consolidation path is arithmetically consistent only because the largest source of state-level fiscal stress is not counted in the numbers it targets.

# Subsidy Rationalization Deferred

- FC16 recommended DBT expansion, calibrated tariff increases and sunset clauses for food, fertiliser and power subsidies. The government deferred, citing "comprehensive examination with States," a formula that has appeared in successive budgets without producing binding reform.
- Food and fertiliser subsidies together total ₹3,98,428 crore in 2026-27, constituting 87% of the total subsidy bill. Food subsidy has risen to ₹2,27,629 crore, and fertiliser to ₹1,70,799 crore, meaning both lines are higher or flat relative to 2023-24 despite the stated consolidation objective.
- The urea retail price has been frozen at ₹242 per 45 kg bag since March 2018, unchanged across eight years and multiple global input price cycles. The Economic Survey 2025-26 explicitly recommended a modest increase in urea prices, paired with a per-acre income transfer. Budget 2026-27 was not adopted.
- PMGKAY, the free grain scheme introduced as a COVID-19 emergency measure, has been institutionalised without a sunset clause, making ₹2.28 lakh crore an effective floor rather than a contingent allocation. With interest payments pre-empting 25% of expenditure and capital spending protected, the fiscal adjustment falls on discretionary programmes that cannot bear the arithmetic of FC16's 3.5% deficit target without structural reform to these two lines.



Source: Expenditure Profile, Union Budget 2026-27 through PRS Legislative Research

# Off-Budget Borrowing Constraints Deferred

- FC16 raised formal concerns about Extra-Budgetary Resources – borrowings by entities such as FCI, NHAI and IRFC, where debt is serviced from the government budget but sits outside the headline fiscal deficit. It recommended hard ceilings and consolidation into the official deficit. The government deferred for "inter-ministerial examination."
- Ministry-level EBR allotments fell from 0.9% of GDP in 2020-21 to 0.1% in 2021-22, and were eliminated entirely in 2022-23. This looks like reform, but the closure of ministry-level EBR was accompanied by a shift toward commercially issued PSU borrowings, such as NHAI and IRFC bonds, which continue to be serviced through the budget without being counted in the FRBM deficit.
- The Budget at a Glance 2026-27 itself acknowledges that FRBM Act debt includes liabilities from extra-budgetary resources as disclosed in Statement 27, treating this as a disclosure item rather than a consolidated fiscal constraint. Acknowledging a liability in a footnote while excluding it from the headline target is the operational definition of creative compliance.
- FC16's 3.5% deficit target for 2030-31 is framed around the reported fiscal deficit. So long as commercially run PSUs continue to accumulate government-serviced debt outside Statement 27 with no binding ceiling, the glide path measures headline consolidation rather than the full-spectrum fiscal position that India's creditors and rating agencies are assessing.

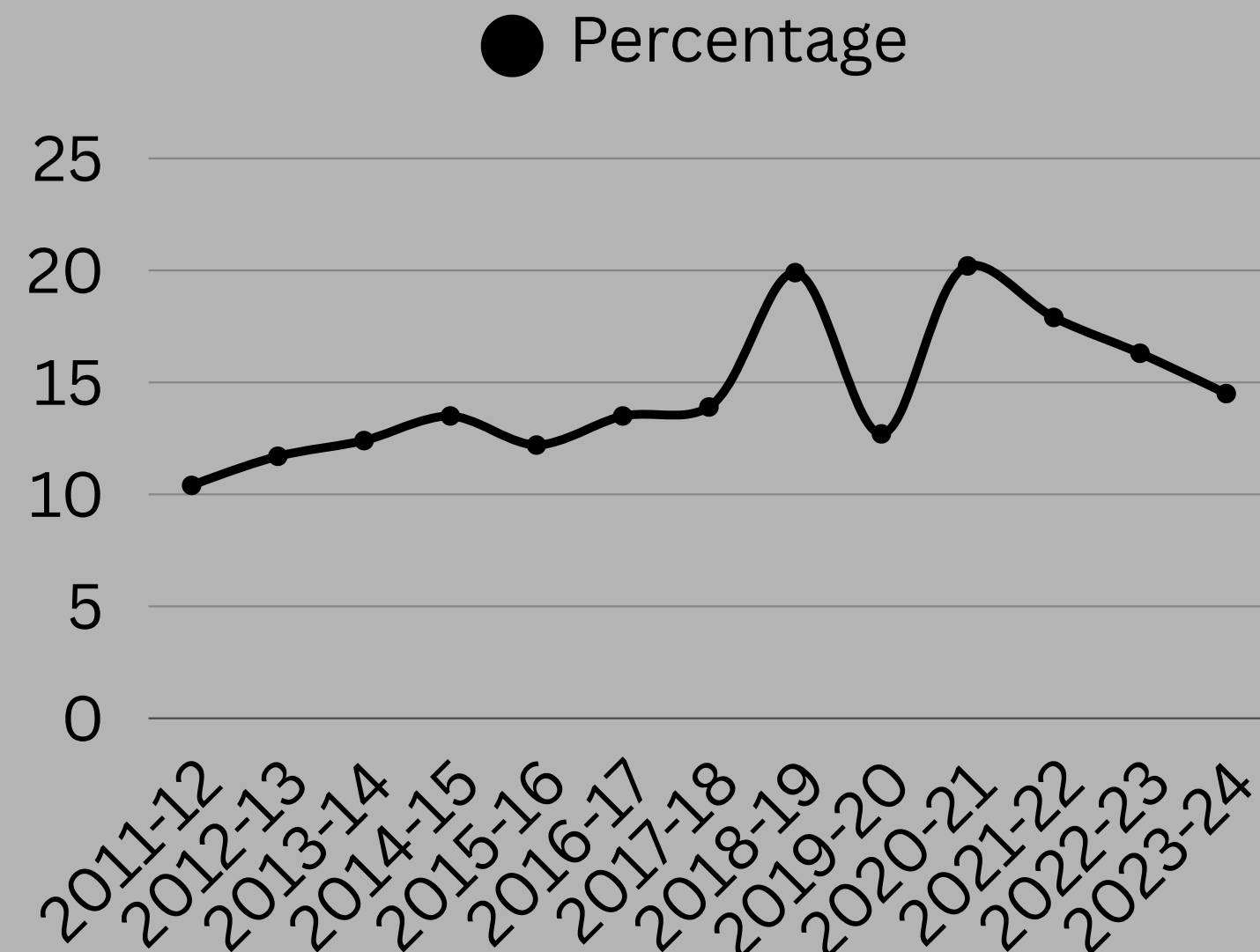
# GST Compensation Cess Expiry in 2026

- The GST Compensation Cess guaranteed states 14% annual revenue growth from July 2017. After COVID-19 caused a severe shortfall, the Centre borrowed ₹2.69 lakh crore and extended the cess to March 2026 solely to service this debt. States received no fresh compensation after June 2022.
- Total cess collected through March 2025 was projected at ₹8,66,706 crore against compensation released to states of ₹6,64,203 crore up to September 2024. The difference went entirely to servicing the Centre's pandemic borrowings, not to states.
- From September 2025, the cess was discontinued on most goods and retained only on tobacco pending final loan settlement. A GoM recommended raising the peak GST rate ceiling from 40% to potentially 60% to accommodate merging the cess into regular rates, which would preserve Union revenue while replacing a state-compensating mechanism with proceeds flowing into the divisible pool at only 41% devolution.
- FC16 made no recommendation for a transitional grant or devolution adjustment to compensate states for the loss of the cess floor. The 14% growth guarantee was the political precondition for state buy-in to GST in 2017; its expiry without replacement shifts the Centre-State fiscal bargain from guaranteed protection to market-driven GST volatility, hitting revenue-deficient states disproportionately.

# Cess and Surcharge Proliferation

- Cesses and surcharges are excluded from the divisible pool under Articles 270 and 271, allowing the Centre to expand its effective tax take without sharing incremental revenue with states. FC16 acknowledged this but lacked constitutional authority to restrict the Centre's cess imposition powers.
- The share of cesses and surcharges in gross tax revenue rose from 10.4% in 2011-12 to a peak of 20.2% in 2020-21, before falling to 14.5% in 2023-24 following excise reductions on petrol and diesel. The 2026-27 estimates project cess and surcharge revenue at ₹6.3 lakh crore, indicating the trajectory has resumed upward.
- The CAG found in 2018-19 that only 60% of ₹2.74 lakh crore collected through 35 cesses was transferred to their designated Reserve Funds, with 40% retained in the Consolidated Fund contrary to earmarked purpose, compounding the transparency problem.
- In 2022-23, states' effective share of gross tax revenue was approximately 30% despite a 41% devolution rate, because the divisible pool base had contracted through cess proliferation. The 41% rate is applied to a shrinking share of what the Centre actually collects, making the devolution headline a progressively less accurate measure of real fiscal transfers to states.
- FC16 proposed a grand bargain wherein the Centre would fold excess cess revenue into regular taxes while states accepted a smaller devolution share of a larger divisible pool. This has no legislative anchor. Every Finance Commission from FC14 onwards has raised the same concern without result. The constitutional amendment required to bring cesses within the divisible pool requires a two-thirds parliamentary majority and ratification by half the states, making structural resolution politically improbable within any single award period.

**Percentage share of Cesses & Surcharges in Gross Tax Revenue**



Source: Ministry of Statistics and Programme Implementation through Dataful

# Post-Transfer Fiscal Position – States Command ~67–68% of Revenue

- **Vertical imbalance:** After tax devolution and grant transfers, states collectively control roughly two-thirds of total Centre+State revenue receipts (on the order of 67–68%). This reflects the FC's push to correct imbalances.
- **Conditional transfers:** Much of that revenue is tied: large portions flow as earmarked Centrally Sponsored Scheme (CSS) funds, capital grants, or performance-linked transfers (e.g. to local bodies).
- **Autonomy gap:** Wealthier states (with strong tax bases) enjoy more fiscal autonomy, while poorer or resource-constrained states rely heavily on central transfers for basic expenditures. Thus, states fund most public services, but with limited independent revenue-raising.

# Centrally Sponsored Schemes Fragmentation Persists

- **Proliferation of Schemes**: The 16th Finance Commission (FC) cycle inherits a landscape with over 150 active schemes and sub-schemes. However, structural bottlenecks exist. These schemes are characterized by overlapping objectives, separate implementation units, and complex, differential cost-sharing ratios.
- **FC16 Recommendations Deferred**: The Commission proposed a radical shift toward sectoral block grants and simplified cost-sharing to improve state autonomy; however, the Union government has deferred these structural reforms. States are forced to maintain parallel bureaucracies and Project Management Units (PMUs) for each individual scheme to meet central reporting and audit requirements.
- **The "Ratchet Effect"**: Proliferation persists because new schemes are frequently introduced to meet political priorities, while older, less relevant ones are rarely retired.

FC Cycle	Approx. Number of CSS/Umbrella Components
13th FC (2010-15)	147+
14 <sup>th</sup> FC (2015- 20)	66 (initially consolidated to 28 Umbrellas)
15 <sup>th</sup> FC (2021-26)	131+
16 <sup>th</sup> FC (2026-31)	150+

Table: CSS Schemes Over Time

# Special Category States—De Facto Continuation

- **Label Abolished, Practice Retained:** While "Special Category Status" (SCS) was formally abolished post-FC14, its differential treatment remains embedded in implementation and grant-specific ratios.
- The 16th FC implicitly retained the preferential 90:10 ratio sharing ratio for North-Eastern and Himalayan states, particularly for disaster management and most CSS.
- **Constitutional Ambiguity:** This de facto continuation lacks clear contemporary criteria or a constitutional basis, leaving it subject to arbitrary government discretion.
- In contrast, the General Category states face a higher burden as it shoulders more of the burden, typically contributing 25% to disaster relief (a 75:25 ratio) and 40% to most CSS.

State Category	Disaster Management (C:S)	CSS Sharing (C:S)
Former Special Category	90:10	90:10
General Category	75:25	60:40
UTs (with Legislature)	Varies	~60:40
UTs (without Legislature)	100:0	100:0

Table: Centre-State Cost-Sharing Patterns

# Medium-Term Fiscal Risks Inadequately Stress-Tested

- The optimistic assumptions are that FC16's roadmap targets a combined debt of 73.1% of GDP by 2030-31, assuming a favourable interest-growth (r-g) differential and sustained 10.1% nominal GDP growth.
- However, the downside risks exist. Downside scenarios like global slowdowns, investment deceleration, and extreme climate events are not fully integrated into the debt sustainability modelling.
- The hidden contingent liabilities are such that while FC16 recommends bringing Off-Budget Borrowings (OBB) onto budgets, the historical stock of liabilities from loss-making DISCOMs and PSUs remains a threat.
- The climate finance gap is evident when we examine that the consolidation targets (3.5% for Centre, 3% for States) severely constrain the fiscal space needed for upfront investments in 2070 net-zero goals.

Scenario	GDP Growth Assumption	Outcome (Debt-GDP)
Baseline	10.5% (Nominal)	73.1%
Moderate Downturn	8.0% (Nominal)	78.4%
Severe/Climate Shock	5.5% (Nominal)	85.0%+

Table:Debt-GDP Trajectory Scenarios  
(2031 Outcome).

# Political Economy: Electoral Calculus Over Fiscal Discipline

- There seems to be a 'selective acceptance' agenda in place. The Centre traditionally accepts technological formulas for tax distribution but defers structural changes that alter power dynamics or spending control.
- The political logic of deferment is evident. Structural reforms (like CSS consolidation) impose concentrated political costs on ministries today for diffuse future benefits, incentivizing delay.
- **Procedural Shields:** The Union often invokes the need for "consensus building" and "inter-governmental coordination" as a shield for political caution in implementing reforms.
- While the FC operates on technocratic-constitutional logic, the government focuses on visible, centrally branded schemes critical for voter mobilization.

Recommendation	Status	Underlying Reason
41% Tax Devolution	Accepted	Avoids friction; maintains status quo
Local Body Grants	Accepted	High visibility; politically popular
CSS Consolidation	Deferred	Resistance from Central Ministries
Cess/Surcharge Reform	Rejected	Centre protects its discretionary tool
OBB Disciplining	Partial	Enforced on states; flexibility for Centre

Table:Debt-GDP Trajectory Scenarios  
(2031 Outcome).

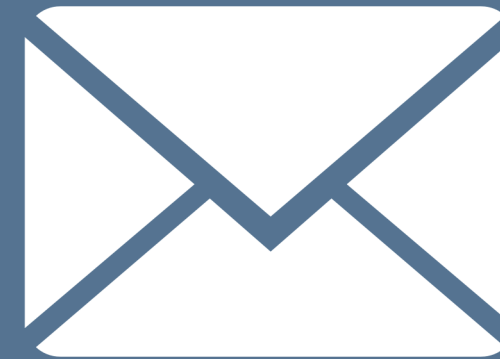
# Federal Fiscal Asymmetry: Centre's Discretion vs. States' Constraints

- **Shrinking Divisible Pool**: The share of non-shareable cesses and surcharges in the Union's Gross Tax Revenue (GTR) rose from 9.3% in 2014-15 to budgeted ~14.0% for 2025-26, effectively reducing the states' real share.
- **Extra-Constitutional Mobilization**: The Centre utilizes these discretionary instruments to fund CSS while states are required to provide matching contributions. A monitorial asymmetry can be observed. The Centre's fiscal performance is self-reported, whereas states' performance is strictly monitored by the FC and subject to borrowing limit penalties for off-budget activities.
- States face rigid constraints including Article 293(3) borrowing caps, FRBM ceilings, and the discontinuation of the carry-forward provision for unutilized borrowing.
- **The "Grand Bargain" Failure**: The Centre has rejected proposals to fold cesses into the divisible pool, ensuring the structural fiscal asymmetry remains intact.

# Continuity Without Structural Reform

- **Devolution preserved:** FC16 keeps the 41% tax-devolution share for states (as under FC15) and adds GDP contribution to the horizontal formula. Local government grants are expanded, but now tied to strict performance conditions.
- **Deferred reforms:** All major structural recommendations have been postponed. Proposals on DISCOM privatisation, subsidy rationalisation, full consolidation of off-budget borrowing, and CSS overhauls were sent for “further examination”.
- **Revenue grants cut:** “Revenue deficit” grants (previously for weaker states) have been eliminated without any compensating rise in devolution – a move criticised as shifting fiscal power back to the Centre.
- **Optimistic assumptions:** The FC’s fiscal roadmap relies on strong growth and revenue buoyancy; in reality, debt and deficits remain vulnerable to shocks (e.g. climate events, contingent liabilities).

# Thank You!



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