GENERAL STUDIES III

16th Finance Commission: Concerns – UPSC 2027

Faculty/Author: Faculty Editorial Board
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Analyse the Sixteenth Finance Commission's 2026–31 recommendations, including 41% tax devolution, GDP contribution criteria, changes in grants, cesses and surcharges, State fiscal autonomy and the equity-versus-efficiency debate. Original UPSC Mains 2027 notes by Civil Service Gurukul.

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UPSC MAINS 2027 | INDIAN ECONOMY | GS II & GS III

An examination of India's changing fiscal federalism architecture, the balance between equity and efficiency, State financial autonomy, tax devolution and development priorities.

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Executive Summary

The Sixteenth Finance Commission, chaired by Dr. Arvind Panagariya, submitted its report on 17 November 2025 for the award period 2026–27 to 2030–31.

The Commission recommended retaining the States' share in the divisible pool of Union taxes at 41%, introduced a new GDP-contribution criterion for horizontal devolution and substantially restructured its grants-in-aid recommendations.

Its recommendations have triggered policy debates around the balance between fiscal equity and incentives for economic performance.

Key concerns include the unchanged vertical devolution percentage, cesses and surcharges outside the divisible pool, the discontinuation of revenue-deficit grants, and the implications of performance-linked local government grants.

The broader issue is how India's fiscal federal system can reward economic efficiency without compromising the fiscal capacity of less-developed and structurally disadvantaged States.

41%
Vertical tax devolution

10%
Weight for GDP contribution

?9.47L cr
Recommended five-year grants

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Important UPSC Note: The 41% recommendation refers to the divisible pool of Union taxes, not gross Union tax collections. The Commission's recommendations and stakeholders' criticisms must be distinguished from one another.

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1. Introduction: Fiscal Federalism at a Crossroads

Fiscal federalism concerns the division of revenue powers, expenditure responsibilities and financial transfers among different levels of government.

India's federal structure creates two major fiscal challenges.

First, the Union and States differ in their revenue-raising capacities and spending responsibilities.

Second, States have different economic capacities, demographic profiles, geographical conditions and development requirements.

The Finance Commission attempts to address these imbalances through recommendations on tax sharing, grants and related fiscal arrangements.

> **Core UPSC Argument:** A sustainable fiscal federation requires an appropriate balance between redistribution to disadvantaged States, incentives for good fiscal management and adequate resources for public services.

2. Constitutional Basis of the Finance Commission

Article 280

Article 280 provides for the constitution of a Finance Commission by the President of India.

The Commission generally makes recommendations on:

- Distribution of specified Union tax proceeds.
- Allocation of States' share among States.
- Principles governing grants-in-aid.
- Measures to supplement local government resources.
- Other matters referred under the Constitution.

Article 281

The Finance Commission's recommendations, along with an explanatory memorandum on the action taken, are laid before Parliament.

Article 270

Article 270 provides the framework for distribution of specified Union taxes between the Union and States, subject to constitutional exclusions.

Article 275

Article 275 deals with grants-in-aid of revenues of States from the Union.

Vertical versus Horizontal Devolution

Vertical Devolution

Determines how much of the divisible pool goes collectively to States.

Horizontal Devolution

Determines how the States' collective share is allocated among individual States.

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3. Major Recommendations of the Sixteenth Finance Commission

3.1 Vertical Tax Devolution

The Commission recommended maintaining the States' share at 41% of the divisible pool for 2026–31.

This continues the share used under the Fifteenth Finance Commission.

3.2 Horizontal Devolution

The Commission revised the formula used to distribute the States' share of Union taxes.

A significant development was the introduction of a criterion based on contribution to GDP with a weight of 10%.

3.3 Grants-in-Aid

The Commission recommended approximately ?9.47 lakh crore in grants over five years for local governments and disaster management.

3.4 Discontinuation of Certain Grants

The Commission did not recommend the continuation of revenue-deficit, sector-specific and State-specific grants provided under the previous Finance Commission framework.

3.5 Local Government Financing

A substantial share of grant support was directed towards rural and urban local governments, with basic and performance-linked components.

3.6 Fiscal Sustainability

The Commission also addressed fiscal deficits, debt, subsidies and the financial management of public entities.

4. Changes in Horizontal Tax Devolution

Criterion	15th FC	16th FC
Income Distance	45%	42.5%

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Criterion	15th FC	16th FC
Population (2011)	15%	17.5%
Demographic Performance	12.5%	10%
Area	15%	10%
Forest	10%	10%
Tax and Fiscal Effort	2.5%	Not retained separately
Contribution to GDP	Not included	10%
Total	**100%**	**100%**

Income Distance

Income distance seeks to address differences in fiscal capacity among States.

A higher weight generally places greater emphasis on redistribution towards States with lower per-capita incomes.

GDP Contribution

The Sixteenth Finance Commission introduced GDP contribution as a distinct criterion.

It is calculated using a transformation based on the square root of State GSDP, rather than a direct proportional share of national output.

This modification moderates the difference between large and small contributors.

Why the Change Matters

The new formula attempts to incorporate both economic contribution and redistributive considerations.

However, changes to the weights influence individual States differently.

> **UPSC Analytical Point:** A State's final share cannot be determined from any one criterion alone. It depends on the full formula and the underlying State-level data.

5. Major Misses and Concerns

5.1 Retention of 41% Vertical Devolution

Several States sought a higher share of Union tax revenue.

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The Commission retained 41%, creating debate over whether that share adequately reflects State expenditure responsibilities.

Supporters of the existing arrangement emphasise the Union's own spending obligations, fiscal constraints and national-level responsibilities.

5.2 Discontinuation of Revenue-Deficit Grants

The withdrawal of revenue-deficit grants has raised concerns among States that relied on them to finance recurring expenditure needs.

Critics argue that disadvantaged States may find it difficult to replace these transfers through their own tax capacity.

An alternative perspective is that open-ended deficit support may weaken incentives for revenue mobilisation and expenditure discipline.

5.3 Treatment of Cesses and Surcharges

Cesses and surcharges excluded from the divisible pool can limit the volume of Union tax receipts available for ordinary sharing with States.

The concern is particularly important when the headline devolution percentage remains unchanged.

5.4 GDP Contribution Criterion

The new 10% criterion recognises economic contribution.

Critics question whether it could benefit States with stronger existing production bases at the expense of regions facing structural disadvantages.

Supporters consider it a means of recognising economic performance while retaining substantial redistributive weight.

5.5 Lower Weight for Demographic Performance

The reduction from 12.5% to 10% has raised questions about incentives for States that achieved earlier demographic transitions.

5.6 Local Government Grant Conditionality

Performance-linked grants can encourage transparent accounts and better service outcomes.

However, local governments with weak administrative capacity may face challenges meeting compliance conditions.

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5.7 Regional Cost Disabilities

Mountainous terrain, dispersed settlements, climate vulnerability and border-related conditions can raise the cost of service delivery.

Policy debate continues over whether the formula adequately captures these different cost conditions.

> **Critical Examination:** The debate is not simply whether redistribution or performance is preferable. The key issue is designing a transfer system that promotes economic efficiency while preserving access to essential public services across all States.

6. The Divisible Pool and Cesses-Surcharges Debate

The divisible pool is derived from the relevant net proceeds of Union taxes after constitutional exclusions.

Cesses earmarked for specified purposes and Union surcharges are generally excluded from ordinary tax devolution.

Illustrative Example

Assume gross Union tax collections are ?100 and the shareable divisible pool is ?80.

At 41% vertical devolution, States collectively receive ?32.80 from that pool, not ?41 from gross taxes.

This illustration demonstrates why the composition of Union tax revenue matters.

Policy Options

- Increase transparency of cess and surcharge collections.
- Review continued justification for individual levies.
- Publish clear and accessible divisible-pool calculations.
- Improve predictability of fiscal transfers.
- Strengthen Union-State consultation.

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7. Equity versus Efficiency in Fiscal Federalism

Dimension	Equity Approach	Efficiency Approach
Primary objective	Reduce fiscal and developmental disparities	Reward improved economic and fiscal performance
Policy instruments	Income-distance criteria and equalisation transfers	Economic contribution and performance incentives
Major concern	Potentially weaker incentives for fiscal effort	Potential reinforcement of existing advantages
Required safeguard	Accountability and expenditure efficiency	Protection for structural disadvantages

Why Equity Matters

States have different historical endowments, economic bases and public-service needs.

Redistributive transfers help preserve minimum levels of public services across the federation.

Why Efficiency Matters

Fiscal incentives can encourage stronger revenue mobilisation, productive expenditure and better governance.

The Balanced Approach

An effective fiscal formula should combine basic revenue adequacy with appropriate incentives for performance.

8. Local Body Grants and Disaster Management

Grant Category	Recommended Amount
Rural local bodies	?4,35,236 crore
Urban local bodies	?3,56,257 crore
Total local government grants	?7,91,493 crore
Disaster management grants	?1,55,916 crore
Total	**?9,47,409 crore**

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Local Government Concerns

- Ability to meet conditions for grant release.
- Administrative and accounting capacity.
- Need for predictable basic transfers.
- Different needs of rural and urban bodies.
- Autonomy in expenditure decisions.

Disaster Management

Financing for disaster preparedness, relief and mitigation remains important because States have different exposure to climatic and geographical hazards.

The transfer framework must consider both fiscal discipline and risk-responsive funding.

9. Fiscal Discipline, State Debt and Autonomy

A central challenge of India's fiscal system is balancing State borrowing flexibility with debt sustainability.

State-Level Concerns

- High committed expenditure.
- Debt servicing obligations.
- Off-budget liabilities.
- Power-sector fiscal risks.
- Limited discretionary spending capacity.

Why Fiscal Discipline Matters

Unsustainable borrowing can increase interest costs and reduce future development spending.

Why Flexibility Matters

States may require countercyclical fiscal capacity during economic slowdowns and natural disasters.

> **UPSC Analytical Insight:** Fiscal responsibility should not be interpreted as indiscriminate cuts to development expenditure. Spending quality, debt sustainability and economic growth must be evaluated together.

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10. Way Forward: Strengthening Cooperative Fiscal Federalism

1. Improve Divisible-Pool Transparency

Publish clear accounts of Union tax sharing and excluded revenues.

2. Examine State Revenue Adequacy

Assess whether transfers support essential public-service obligations.

3. Design Targeted Equalisation Mechanisms

Consider support for States facing significant structural disadvantages.

4. Balance Performance and Need

Create incentives for sound fiscal management without undermining basic developmental equity.

5. Strengthen Local Body Capacity

Support accounting systems, financial management and reliable grant delivery.

6. Improve Own-Source Revenue

Encourage effective State tax administration and sustainable non-tax revenues.

7. Address Off-Budget Fiscal Risks

Strengthen disclosures, guarantee management and medium-term debt assessment.

8. Protect Development Expenditure

Prioritise healthcare, education, infrastructure and human capital.

9. Support Constructive Federal Dialogue

Use institutional consultation to evaluate changing fiscal needs and revenue arrangements.

10. Measure Fiscal Outcomes

Evaluate transfer systems through service delivery, regional convergence, fiscal resilience and economic opportunity.

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11. UPSC Syllabus Relevance

Paper	Relevant Topic
GS II	Federalism and Centre-State relations
GS II	Constitutional bodies and governance
GS III	Indian Economy and government budgeting
GS III	Fiscal policy, debt and public finance
GS III	Inclusive growth and regional disparities
Essay	Equity, efficiency and national development

12. UPSC Mains 2027 Practice Questions

Question 1 | 150 Words | 10 Marks

Explain the major recommendations of the Sixteenth Finance Commission regarding vertical and horizontal tax devolution.

Question 2 | 250 Words | 15 Marks

"The Sixteenth Finance Commission has renewed the debate between fiscal equity and economic efficiency." Critically examine.

Question 3 | 250 Words | 15 Marks

Discuss the implications of discontinuing revenue-deficit grants for States with structural fiscal constraints.

Question 4 | 150 Words | 10 Marks

How do Union cesses and surcharges affect the divisible pool of central taxes?

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Question 5 | 250 Words | 15 Marks

Evaluate the opportunities and challenges associated with introducing GDP contribution as a criterion for horizontal tax devolution.

13. UPSC Mains Model Answer

Question

Critically examine the major recommendations and concerns associated with the Sixteenth Finance Commission in the context of Indian fiscal federalism. (250 Words)

Introduction

The Sixteenth Finance Commission, constituted under Article 280, recommended fiscal transfers for 2026–31. Its framework retains 41% vertical devolution while revising horizontal distribution and grants.

Key Recommendations

- 41% share for States in the divisible pool.
- 10% weight for contribution to GDP.
- 42.5% weight for income distance.
- Approximately ?9.47 lakh crore in grants.
- Discontinuation of revenue-deficit and certain other grants.

Major Concerns

- Retention of 41% may not fully address demands for increased State fiscal flexibility.
- Cesses and surcharges reduce the size of the shareable tax pool.
- Discontinuing revenue-deficit grants may affect fiscally weaker States.
- GDP contribution as a criterion may raise equity-versus-efficiency questions.
- Grant conditionality may challenge local bodies with weak institutional capacity.

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Way Forward

India should improve transfer transparency, strengthen State revenue capacity, provide support for structural disadvantages and improve local public-finance management.

Conclusion

The Commission's framework highlights the continuing challenge of balancing fiscal discipline, economic incentives and equitable development. A sustainable federation requires all three.

14. Quick Revision Notes

Topic	Essential Fact
Commission	Sixteenth Finance Commission
Chairman	Dr. Arvind Panagariya
Constitutional Article	Article 280
Report Submitted	17 November 2025
Award Period	2026–27 to 2030–31
Vertical Devolution	41% of divisible pool
Income Distance	42.5%
Population	17.5%
Demographic Performance	10%
Area	10%
Forest	10%
GDP Contribution	10%
Recommended Grants	?9,47,409 crore
Local Government Grants	?7,91,493 crore
Disaster Management Grants	?1,55,916 crore

Final UPSC Takeaway: The Sixteenth Finance Commission has made fiscal incentives a more explicit part of the devolution framework, while retaining substantial redistributive criteria. Its long-term effects must be assessed through State fiscal capacity, regional equity and quality of

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public services.

15. Frequently Asked Questions

Who chaired the Sixteenth Finance Commission?

Dr. Arvind Panagariya.

What is the 16th Finance Commission award period?

Financial years 2026–27 through 2030–31.

What percentage of taxes is devolved to States?

41% of the divisible pool of Union taxes, not 41% of gross Union tax collections.

What is the new GDP contribution criterion?

It is a horizontal devolution criterion carrying 10% weight, calculated using the Commission's specified GSDP-based methodology.

Were revenue-deficit grants continued?

The Commission did not recommend continuing revenue-deficit grants for the 2026–31 award period.

Why is this topic important for UPSC Mains?

It connects constitutional federalism, public finance, regional inequality, economic incentives and cooperative governance.

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16. Conclusion: Building a Fair and Sustainable Fiscal Federation

India's fiscal transfer system must respond to very different economic and developmental conditions across States.

The Sixteenth Finance Commission has introduced important changes in the method of distributing tax resources and structuring grants.

At the same time, concerns relating to State fiscal autonomy, the divisible pool, structural disadvantages and the adequacy of development financing deserve sustained examination.

A resilient fiscal federation must reward prudent financial management while protecting the capacity of every State to provide essential public services.

> **Memorable UPSC Conclusion:** Fiscal federalism succeeds not when every State receives an identical amount, but when the transfer system balances fairness, fiscal responsibility and the opportunity for all regions to develop.

SEO Topic Tags

Sixteenth Finance Commission | UPSC Mains 2027 | Fiscal Federalism | Indian Economy | Article 280 | Tax Devolution | GDP Contribution | Income Distance | Revenue Deficit Grants | State Finances | Cooperative Federalism | Local Government Grants | Cesses and Surcharges | Civil Service Gurukul

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