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Editorial

What to Expect from the 16th Finance Commission?

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ABSTRACT

This article provides an academic perspective on expectations of the broad range of stakeholders from the 16th Finance Commission which has been constituted in 2023 to draw a fiscal road map for five years from 2026 to 2031. As such, Finance Commission is a statutory body in India entrusted with the responsibility of determining broad contours for appropriation of funds between the Centre and the States in an equitable manner. The Commission recommends the guidelines for fund allocation based on set criteria lest there is any controversy regarding prejudice, discrimination and neglect. The article provides a background of the Finance Commission mandate and examines the constraints which may shape its recommendations in line with the aspirations and ground realities.

KEYWORDS: 16th Finance Commission, Fiscal Constraints, Fiscal Prudence, Fiscal Discipline, India

INTRODUCTION

The 16th Finance Commission was constituted on 31 December 2023 under the provisions of Finance Commission (Miscellaneous Provisions) Act, 1951 in consonance with Clause 1 of Article 280 of the Constitution of India with Dr Arvind Panagaria as its chairman. Recommendations of the 16th Finance Commission will be implemented from 1 April 2026 for five years. As per the Gazette Notification of the Government of India dated 31 December 2023, the 16th Finance Commission has been mandated to recommend the following:

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- The distribution between the Union and the States of the net proceeds of taxes which are to be or may be divided between them under Chapter 1, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
- The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States by way of grants-in-aid of their revenues under article 275 of the Constitution for the purposes other than those specified in the provisos to clause (1) of that article; and
- The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

People are watching the role of the 16th Finance Commission in view of the growing chasm between the Union and the States in recent times. The main refrain of the States is that the Centre is not providing appropriate share in the tax cess and surcharge pools while further constraining them with reduced financial contributions for the implementation of the centrally sponsored schemes (Patnaik, 2024). However, given the emerging scenarios manifested in socio-economic aspirations of the people and geopolitical constraints, the 16th Finance Commission can stretch itself to go beyond the traditional functions and provide transformational recommendations for steering the country towards Viksit Bharat @ 2047. Thus, the 16th Finance Commission can leverage the opportunity to emphasize on fiscal transparency, fiscal accountability, prudence in public expenditure, and outcome-based financing of the centrally funded schemes. At the same time, the 16th Finance Commission can push for clean energy, emerging technologies, climate action, and above all, appropriate incentives for strengthening the manufacturing sector with a special focus on Micro, Small and Medium Enterprises (MSME).

Even the Organization for Economic Cooperation & Development (OECD) has made following suggestions to the 16th Finance Commission (OECD, 2025):

- Refine the Transfer Formula with Incentives
- Enhance Data Analysis and Transparency
- Promote Spending Efficiency and Outcomes
- Leverage Technology for Fiscal Management

- Strengthen Fiscal Rules and Coordination
- Empower Local Governments
- Foster Regional Convergence Programs

Greenpeace India has emphasized the need for linking fiscal policies and fiscal management of the government of India with climate action goals necessitated by environmental degradation beyond immediate redemption. Wishlist of Greenpeace India (2025) is summarized below:

- Recognition of Heatwaves as a National Disaster
- Establishing a Dedicated Climate Adaptation and Resilience Fund for Marginalized and Vulnerable Communities
- Devolve funds to state governments for managing extreme weather events, with allocations based on updated epistemological evidence such as the Climate Vulnerability Mapping Atlas
- Climate Damage Tax (CDT) to hold the polluters accountable
- Climate Compensation in the form of universal basic income for informal and nature-based livelihoods, which constitutes 90% of the workforce

FISCAL CONCERNS

Thus, fiscal prudence and sustainable development are the thrust areas that the 16th Finance Commission must address in its recommendation. While the States have to bear the cost of over 60% of climate related interventions, they often complain regarding discriminatory allocation of central funds. Hence, it is imperative that the 16th Finance Commission comes up with a broad-based framework in sync with the expectations of the States and climate action related exigencies. A good beginning can be made by allowing the States to levy green taxes to cover up the interventions costs to mitigate environmental damages due to industrialization or urbanization. Mineral-rich states such as Odisha, Telangana, Karnataka, Jharkhand, etc. can rollout measures against the environmental degradation induced by mining through the green tax.

Diversion of funds by the Centre is another malaise that needs immediate course correction. For example, clean energy cess collected by the Centre is currently being appropriated for compensating the States in GST payouts (Patnaik, 2025). In the first place, clean energy cess was levied on coal production and as such, the same should have been used to fund interventions related to climate action and mitigation of environmental degradation. Ideally, the clean energy cess should be distributed among the coal-producing States in India. Coal-producing and mineral-rich States can thus be empowered to develop regional plans for climate action in consultation with the local stakeholders who are often at the receiving end.

Furthermore, it is time the 16th Finance Commission drops the forest cover and ecology criterion for determining tax devolution. In place of forest cover and ecology criterion, the 16th Finance Commission can adopt more progress and forward looing criterion like ‘climate and disaster proofing initiatives’ (Patnaik, 2025). The new criterion will help the States in effective mitigation of disasters. Funds generated under ‘climate and disaster proofing initiatives’ can be used for developing climate-resilient infrastructure, and ecosystem for rural industrialization. Existing State Disaster Response Fund is mean for post-disaster interventions. Hence, Funds generated under climate and disaster proofing initiatives can empower the States to take proactive measures.

Population criterion is another area that the 16th Finance Commission needs to revisit with fresh and unorthodox mindset. The 15th Finance Commission had used the population data of Census 2011 and inadvertently penalized southern States which had fared well in terms of managing their demographics (Debroy and Sinha, 2025). The 15th Finance Commission ‘assigned significant weight to population alongside other factors like area, forest and ecology, income distance, and tax efforts, disadvantaged states with higher human development indices but lower population growth, leading to a reduction in their financial shares’ (Debroy and Sinha, 2025). It is expected that the 16th Finance Commission rectifies the error of judgment and applies a rationale criterion like Human Development Index for allocation of funds to the States. The 16th Finance Commission can come up with an incentive plan vis-à-vis funding to promote Human Development Index in relatively underdeveloped regions of the country.

Income Distance is a unique criterion considered by the Finance Commission for appropriating funds to the poor States. While low weightage is attributed to demographic performance, highest weightage is accorded to Income Distance in the name of equity. Income distance is measured by the gap between per capita GSDP of the State with the average of the top three wealthiest States. Traditionally, income distance criterion has been used to reward the poor fiscal management of certain States. It is imperative that the 16th Finance Commission revisits the Income Distance criterion to prevent its misuse by ushering strict fiscal discipline and fixing accountability for utilization of funds and clear and tangible outcomes of public expenditures. Also, the 16th Finance Commission can come up with a mechanism to stop mindless direct benefit transfers to citizens leveraged by political parties in power for electoral gains. Also, there should be appropriate checks and balances on the off-budget borrowings by the poorer States. Rationalization of subsidies should be linked to appropriation of Central funds to the States.

Another area of concern for the States is the unreasonable spread of cess imposed by the Centre. Collection of Cess and other surcharges have increased from around 9.4% in 2011-12 to approximately 27.6% in 2021-22. The Cess collected by the Centre is not distributed among the States. Hence, the overall divisible pool of fund for appropriation among the States dwindle remarkably. Appropriate of Central cess to the States need constitutional amendment. However, there is a way out if the share of the States in the divisible pool is increased. The 16th Finance Commission must address this conundrum to eliminate disparities in the appropriation of funds between the Centre and the States. Moreover, the 16th Finance Commission also needs to suggest suitable fiscal reforms to bring down fiscal deficit to less than 3% by 2030.

The 16th Finance Commission is itself working under several constraints. For example, Census data, crucial for Population criterion is quite old and perpetuates structural blind spots. In absence of the Census Data 2021, it is difficult to assess the impact of intermittent demographic shifts due to inter-state migration as well as reverse migration triggered by Covid-19 pandemic (Mohapatra and Jha, 2019). Shrinking divisible pool of funds is another pain point for the 16th Finance Commission which is grappling with varying demands from both northern and southern States. Then, there is special category conflict as geographically challenged States located in border areas have their unique needs and aspirations. The States have limited authority to raise taxes while having absolute responsibility towards high growth expenditure like climate resilience, healthcare, and education. Shrinking divisible pool may have serious implications for the States while the 16th Finance Commission struggles for a way out for equitable allocation of funds to all. Despite all the constraints, it is expected that the 16th Finance Commission will be able to balance political push for the State autonomy and need for national fiscal consolidation.

CONCLUSION

Aspirational India has deep rooted developmental challenges. Hence the country needs new ways of resolving older issues plaguing the nation since independence. The 16th Finance Commission has been constituted in the proverbial 'Amrit Kaal' when we are preparing to move towards a prosperous country by 2047 in the centesimal year of our independence. Persistence of archaic strategies have created bottlenecks that we need to break urgently. It is possible to draw a new road map with sustainability and inclusivity as two sides. As such, the Indian Constitution mandates equitable distribution of financial resources between the Centre and the States. However, we have not reached a point where the Centre and the States move together to attain spectacular socio-economic development. Probably, the 16th Finance Commission can break the vicious cycle by proposing equitable and sustainable financial framework that accommodates the concerns and aspirations of all the stakeholders. The real test of the 16th Finance Commission will be zero complaint from the States which have traditionally been raising the issues revolving around discriminatory appropriation of the Central funds.

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