India's 16th Finance Commission and the equity-efficiency nexus in federalism

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India’s fiscal federalism is at a crossroads. On November 17, 2025, the 16th Finance Commission (FC), chaired by Professor Arvind Panagariya, submitted its report to President Droupadi Murmu. Covering the period 2026–31, this quinquennial exercise will determine how the world’s largest democracy allocates resources between the central government and its 28 states.

With India’s economy eyeing a $5 trillion milestone amid geopolitical headwinds and climate imperatives, the Commission’s recommendations are more than technocratic—they are pivotal for sustaining inclusive growth.

Two paths on vertical devolution

Market guesses point to continuity in vertical devolution: a steady 41 percent share of the divisible pool of central taxes to states, mirroring the 15th FC’s benchmark. Or did they reduce the status quo 41 per cent, citing that macroeconomic stabilisation function is the core function of Centre and it can devolve only less than 41 per cent, given the geopolitical uncertainties, polycrisis and global headwinds?

If that is a possibility, it holds firm against southern states’ clamour for 50 percent, fuelled by perceptions of fiscal space erosion from rising cesses and surcharges (now ~22 percent of gross tax revenues, per Union Budget 2025– 26).

Need for a balance between equity and efficiency

The clamour for 50 per cent devolution underscores a deeper fiscal imperative: harmonising equity—bridging inter-state disparities—with efficiency, that is, rewarding fiscal prudence and reform dynamism.

As an economist who has dissected federal transfers for over two decades, I hope that the 16th FC refined its horizontal devolution formula to prevent penalising high-performers, lest it stifle the very growth that amplifies equity.

Historical Foundations: From tax-specific to tax-pool transfers

India’s Finance Commissions, enshrined in Article 280 of the Constitution, have evolved as architects of cooperative federalism since 1951. Early iterations were “tax specific transfers”, (1st to 10th FCs, 1952–2000) devolved shares in siloed taxes—income tax (55–85 percent) and select excise duties (20–47.5 percent)—yielding effective rates below 30 percent of total central revenues.

The 80th Constitutional Amendment (2000) unified the tax pool, excluding only cesses/surcharges, paving the way for the 11th FC’s 29.5 percent share of tax pool for the States. Subsequent hikes—the 12th’s 30.5 percent, 13th’s 32 percent (post-2008 global financial crisis), 14th’s game-changing 42 percent, and 15th’s 41 percent adjustment for Jammu & Kashmir—reflect a maturing system attuned to global norms, akin to the EU’s cohesion funds or Brazil’s Fundo de Participação dos Estados.

Horizontal devolution has been the battleground between different aims

Yet, vertical devolution is but half the story. Horizontal devolution— apportioning states’ aggregate share—has been the equity-efficiency battleground. Pre-2000, tax transfer criteria bifurcated by tax type: population dominated (80–90 percent for income tax), with nascent nods to backwardness and revenue equalisation for excises.

The 10th FC (1995–2000) prototyped unification: 20 percent 1971 population, 60 percent income distance (favouring low per capita states), 5 percent area, 5 percent infrastructure, and 10 percent tax effort. Post pooling of taxes since 2000, refinements accelerated. The 11th (2000–05) introduced fiscal discipline (7.5 percent), incentivising fiscal deficit control. The 12th (2005–10) balanced with 25 percent population and 7.5 percent each for tax effort and fiscal discipline.

The 13th (2010–15) boosted tax effort to 17.5 percent, signalling efficiency’s rise amid post-crisis fiscal austerity. The 14th (2015–20) pivoted to fiscal sustainability: 50 percent income distance, 17.5 percent 2011 population (pitching the 1971 freeze for demographic reality), 10 percent demographic performance (reciprocal fertility rates), 15 percent area, and 7.5 percent forest cover.

The 15th (2021–26) tweaked to 45 percent income distance, 15 percent population, 15 percent area, 10 percent ecological fiscal transfers, 12.5 percent demographic performance, and a slim 2.5 percent for tax/fiscal efforts—yielding sharper inequities, like Bihar's share contracting from 11.68 percent to 9.21 percent.

The 16th FC's Tightrope: Anticipating reforms amid status quo

Retaining 41 percent, if not riding to 50 percent, devolution is fiscally astute. This cushions states against GST shortfalls (compensation ends 2026) and funds SDGs and human development (as many merit goods are assigned at the state level), without crowding out central capex (target: 3.3 percent of GDP). Yet, the divisible tax pool's shrinkage—cesses ballooned from 10 percent in 2014 to 22 percent now—demands guardrails.

Has the 16th FC considered a fiscal transparency code, with a cap on non-shareable levies at a threshold percent and earmark them for international public goods like climate adaptation? We have to wait to know the details till the report go public.

Is demographic transition only about fertility rates?

Equity, too, evolves. Have they considered income distance (45 percent) to integrate multidimensional poverty indices, human development index (HDI) or climate risk (ND-GAIN scores), weighting vulnerability a threshold percent?

The 15th's demographic tilt (12.5 percent) rewarded demographic transition, have they considered TFR or replaced it with elderly population? Has the 16thFC addressed urbanisation? Have they allocated to urban local bodies substantially?

Area and Ecology weights are apt for India's climate related mandates aligning with Paris Agreement pledges. Have they retained it? Or considered 'population density' instead of treating Area and Population variables separately?

Will AI skilling enter the realm of grants?

Grants offer another lever. The 15th's performance-linked grants to power reforms and urban local bodies were useful. Has the 16th expanded it to green bonds issuance and AI skilling? We have to see the report.

Sector-specific grants (health, education) indeed could be tied to outcome metrics, reducing leakages. Have they addressed the "second generation reforms" in health and education sectors of a few performing States in social infrastructure?

Lessons for the world from India's federalism

India's federal experiment holds lessons for global federations.

Data integrity: India has authentic data building process and subnational governments provide audited fiscal data.

Transparency: opaque deliberations erode trust; India's finance commission team pledged open consultations with all the States.

Efficiency without exclusion: over-equity risks "flypaper effect," where fiscal transfers inflate fiscal deficits. Hope 16th FC respects the balance between efficiency and equity.

Preference for technocrats: Indian FC Chairman and members are technocrats and not political representatives. The awards and recommendations so far have been accepted and been 'conclusive' in India.

Global integration: Should the 16th FC factor external vulnerabilities—e.g., 5 percent weight for trade openness in tax transfer formula?I am guessing this, given the expertise of 16th FC Chairman about trade vulnerabilities and its impact on the states.

As the report heads to Parliament, we can only hope that states, Centre, and Commission might have designed a fiscal federalism that is resilient, inclusive, and growth-maximising. Hope a more equitable India, powering Global South leadership is in the anvil.

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