Favour 50% tax devolution to states

NEW DELHI – Given the severe fiscal constraints of state governments, the 16th Finance Commission should ideally recommend 50% vertical tax devolution to states, according to National Institute of Public Finance and Policy Professor Lekha Chakraborty. However, this is ambitious given the global economic headwinds and their amplification of revenue volatility at the central level, she said.

"A core challenge for the 16th Finance Commission lies in navigating how far it can intervene without infringing on states' fiscal autonomy, while ensuring overall fiscal sustainability for the federation," Chakraborty told Informist in an e-mail interview.

The 16th Finance Commission, headed by Columbia University Professor Arvind Panagariya, submitted its report to President Draupadi Murmu on Nov. 17. As per its terms of reference, the commission was mandated to determine the formula for sharing central taxes and grants-in-aid with states for five years starting 2026-27 (Apr-Mar).

Vertical and horizontal devolution are two components of financial distribution. Vertical devolution refers to tax revenue sharing from the central government to state governments, while horizontal devolution pertains to the distribution of states' share among individual states.

The commission presented its report after meeting representatives from each state and Union territory. A majority of them, including states ruled by the Bharatiya Janata Party, reportedly sought 50% share in central taxes. The 15th Finance Commission had recommended that 41% of the divisible pool be devolved to states. The share of states was one percentage point below the ratio mandated by the 14th Finance Commission due to the reorganisation of Jammu & Kashmir and Ladakh into Union territories.

According to Chakraborty, the Centre's growing reliance on non-divisible cesses is reducing the divisible tax pool, disadvantaging states in resource sharing. Besides, states already lack full autonomy to access bond markets or to secure additional borrowing, she said.

The Centre is projected to transfer INR 14.22 trillion to states in FY26 as their share in taxes, out of the INR 42.70 trillion in total tax that the government aims to collect this fiscal year. The devolution of central taxes is well below 41% of total taxes collected, as the Centre administers a host of cesses and surcharges that are not part of the divisible pool.

Chakraborty talks about how the commission should determine horizontal devolution, and the need for a definite fiscal consolidation glide path and a flexible borrowing ceiling for states.

Below are edited excerpts of the interview:

Q. Keeping in mind the Centre's as well as states' current fiscal condition, what do you think is the ideal share of vertical devolution that the 16th Finance Commission should recommend and why?

A. Amid current fiscal realities, I would lean toward 50%, recognising the severe constraints on states' fiscal space. However, this is ambitious given global economic headwinds and their amplification of revenue volatility at the central level. We must balance the need for state-level fiscal autonomy with the Centre's macroeconomic stabilisation responsibilities in an uncertain world.

Q. Many states have shown an inclination towards populist schemes that have huge fiscal implications. Against this backdrop, what do you think are some of the key challenges before the 16th Finance Commission?

A. The proliferation of cash transfer schemes designed to appeal to voters is exerting significant fiscal pressure across states. Empirical models of voting behaviour suggest that these transfers can be effective in retrospect, particularly during crises, when basic income support plays a vital role in stabilising livelihoods. Yet, their increasing use as electoral tools raises concerns in a context of limited fiscal space. A core challenge for the 16th Finance Commission is navigating the extent to which it can intervene without infringing on states' fiscal autonomy, while ensuring overall fiscal sustainability for the federation.

Q. Amid the rising clamour by states about the shrinking pool of divisible taxes, do you think the 16th Finance Commission has the scope to address the issue? How?

A. Geopolitical uncertainties and persistent global headwinds constrain the scope for expanding the divisible tax pool through higher devolution magnitudes. Moreover, if the Centre's revenue projections fall short – due to fiscal marksmanship issues – this further diminishes the transfer pool, compounding the problem. The commission could address this by recommending mechanisms to enhance revenue buoyancy and transparency in projections, fostering a more predictable fiscal environment for states.

Q. Because of the Centre's increasing non-divisible cess, do you think states are getting a raw deal?

A. The growing reliance on non-divisible cesses is indeed contracting the divisible tax pool, which disadvantages states in the sharing of resources. One could argue, as the commission's chair might, that the Centre requires these funds for its macroeconomic stabilisation role. However, states are increasingly vulnerable to the same global shocks, making this a delicate balance. The key is to ensure that such instruments do not undermine the principles of cooperative federalism.

Q. The commission's report would have been largely prepared by the time GST 2.0 was announced. Do you think it had to revisit its model after GST 2.0, considering both Centre and states' revenues will be dented? Was the one-month extension likely because of this?

A. My assessment is that the 16th Finance Commission likely lacked sufficient time to fully incorporate the implications of GST 2.0 and related-tariff changes before the submission deadline. The revenue impacts of the reforms on both the Centre and states could necessitate revisions to fiscal models, and it's plausible that the one-month extension was granted precisely to allow for such adjustments amid evolving policy landscapes.

Q. What, according to you, are the metrics of horizontal devolution that need to be addressed?

A. Horizontal devolution metrics must carefully balance equity and efficiency. The sarcasm from a southern chief minister – questioning whether states should revert to larger families – highlights tensions when population is a dominant criterion, especially with impending delimitation. In states where population growth has been controlled and is declining, population density may be a more equitable metric than absolute population.

Similarly, we should avoid penalising high-performing states through the huge weightage on the income distance variable. The demographic transition factor, currently tied to total fertility rates, could be better captured by the elderly population ratio. I hope the 16th Commission retained the ecological fiscal transfer component – a pioneering inclusion from the 14th Commission. This ecological fiscal transfer framework, the first globally in intergovernmental fiscal transfers, remains a game-changer that other countries are yet to adopt.

Q. Do you think the 16th Finance Commission should introduce an altogether new metric for horizontal devolution, keeping up with modern technology and public policy? If yes, what will it be?

A. Incorporating artificial intelligence and innovation into intergovernmental fiscal transfers is essential, but not via unconditional tax devolution metrics. Instead, it should feature in conditional transfers to support state-level initiatives like data centres and AI-driven innovation. I trust the 16th Commission has not been behind the curve in addressing AI and such forward-looking priorities. Machine learning and large language models are increasingly being used in macroeconomic realms, and they are efficacious for sustainable economic growth recovery.

I hope the 16th Finance Commission has taken demographic transition seriously and addressed the concerns judiciously, along with pressures from modern technologies.

Q. To sum up, what would be your criteria to determine horizontal devolution and how much weightage would you give to each if you were part of the commission?

A. Several macro-fiscal concerns underpin horizontal devolution. However, I hesitate to engage in a hypothetical exercise assigning normative weights without full access to the states' deliberations and data symmetry that commission members enjoy. Should I participate in future finance commissions from within, I would propose a matrix grounded in those insights. For now, we await the latest commission's design. Historically, finance commission tax transfer design has been conclusive. India has never rejected finance commission recommendations. If this one proves inconclusive, it would mark a historic shift amid the evolving political economy of fiscal federalism.

Q. The 16th Finance Commission's terms of reference mentioned only the determination of the tax devolution formula for FY27-31. But do you think the Commission will also announce a glide path like the 15th Commission did?

A. This is an astute observation: Finance commissions increasingly extend beyond five-year tax formulas to encompass states' debt and deficit dynamics. A macro-fiscal glide path is invaluable, providing a credible strategy for fiscal prudence that enhances credit ratings. Rating agencies' fiscal pillars emphasise such clarity, making such formidable glide paths critical for both national and subnational governments.

Q. How necessary is a new fiscal glide path now, given there is ambiguity on how the debt-to-GDP path will be followed?

A. I strongly advocate a fiscal deficit-to-GDP glide path for states, rather than a debt-to-GDP trajectory, which is more complex due to hidden liabilities. This approach would offer clearer guidance amid current ambiguities.

The innovative financing modes like thematic bonds, for instance, climate (green bonds) and oceanography (blue bonds), complicate the financing pattern of deficits further.

Q. An improvement in general government debt is mandatory for a rating upgrade for India. In this context, do you think it is appropriate for the Centre to cap states' borrowing ceiling? How can the 16th Finance Commission ease states' fiscal pressure?

A. States already lack full autonomy in accessing bond markets or additional borrowing. The general government debt provision in Section 4 of the FRBM Act is ambiguous and should be disaggregated to clearly delineate asymmetric fiscal rules and debt thresholds for the Centre and states. The 16th Commission could alleviate states' pressures by recommending flexible borrowing frameworks tied to performance metrics, while promoting revenue-enhancing reforms.

Q. State governments are increasingly announcing populist measures to win votes. How is this affecting states' fiscal consolidation efforts?

A. When former chief economic adviser Arvind Subramanian proposed universal basic income transfers, it was envisioned as a response to livelihood crises. However, their co-optation as electoral tools diverts fiscal space toward clientelistic spending, crowding out investments in social infrastructure like education, health, and employment. Within fiscal consolidation frameworks, this repurposing shifts priorities from capital expenditure to transfers, undermining long-term growth and sustainability.