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ANALYSIS**

TOPIC

**16TH FC (2026 – 31) & IMPLICATIONS
FOR LOCAL BODIES**

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16TH FC (2026 – 31) & IMPLICATIONS FOR LOCAL BODIES

Context

- The 16th Finance Commission marks a **transformational shift in fiscal decentralisation**, with an unprecedented focus on **Panchayats and Urban Local Bodies (ULBs)**, however there are concerns regarding **accountability, state autonomy, and institutional capacity**.

Constitutional and Institutional Background

- Finance Commission:**
 - Article 280(1)** mandates the Commission to recommend **distribution of net tax proceeds between the Centre and states**; grants-in-aid to states from the Consolidated Fund; and measures to augment state finances for Panchayats and Municipalities.
 - Constituted **every five years by the President of India**; the 16th FC was constituted on December 31, 2023.
 - The Finance Commission decides how **financial resources are devolved from a divisible pool of taxes vertically** (between Centre and states) and horizontally (among states) based on a formula.
- Local Bodies**
 - 73rd Constitutional Amendment (1992)**: Established Panchayati Raj Institutions (PRIs) — Gram Panchayat, Block Panchayat, District Panchayat — under Part IX.
 - 74th Constitutional Amendment (1992)**: Established Urban Local Bodies (ULBs) — Nagar Panchayats, Municipal Councils, Municipal Corporations — under Part IX-A.
 - Article 243-I & 243-Y**: Mandate State Finance Commissions (SFCs) every five years to review and recommend devolution to local bodies.
 - The Constitution refers to these institutions as institutions of local self-government; the term “local bodies” does not appear anywhere in Part IX or Part IX-A.

Key Recommendations of the 16th FC

- Retention but Dilution of States' Share:** Nominal share retained at **41% of divisible pool**.
 - Effective share reduced** from ~36% to ~32% due to shrinking divisible pool (cesses/surcharges exclusion), and increased discretionary transfers.
- Changes in Horizontal Devolution:** Revised formula led to **reduced shares for 14 states**.
 - A new **10% weightage for GDP contribution** has been introduced to reward states for their economic performance.
 - Northeastern states' share decreased by **almost 15.5%**, raising concerns of **regional imbalance and equity erosion**.
- Discontinuation of Article 275 Grants:** Revenue deficit grants abolished, and sector-specific & state-specific grants discontinued.
 - Traditionally, these grants ensured **equalisation and support for weaker states**.
- Expansion of Article 282 Grants (Discretionary):** 7.91 lakh crore allocated, in which 4.4 lakh crore and 3.6 lakh crore to rural and urban local bodies respectively.
 - It is the largest-ever allocation, signaling **deepening decentralisation**.
- Composition of Grants:**
 - Basic Grants (around 80%):** Untied, for essential services
 - Performance Grants (around 20%):** Linked to revenue mobilisation, audits & transparency.
 - Additional **Urbanisation incentives**, and sector-specific support.
 - It builds on trends from earlier FCs promoting **performance-based governance**.

Positive Implications

- **Strengthening Grassroots Democracy:** Enhances fiscal capacity of PRIs & ULBs; supports delivery of water, sanitation, health, and local infrastructure.
 - ◆ FC grants improved service delivery, especially in urban health systems.
- **Deepening Fiscal Decentralisation:** Aligns with principle of **subsidiarity**; and reduces overdependence on state transfers.
 - ◆ Fiscal decentralisation improves efficiency and responsiveness.
- **Incentivising Governance Reforms:** Performance-linked grants encourage better accounting, local revenue mobilisation, and transparency.
 - ◆ It helps address weak financial management in municipalities.
- **Urban Transformation Push:** Focus on ULBs supports urban infrastructure, smart cities & sustainable urbanisation.

Challenges and Concerns

- **Undermining State Autonomy:** Direct Union to Local body transfers bypass states, and weakens **state control over decentralisation**.
 - ◆ States remain constitutionally responsible for local bodies.
- **Structural Revenue Gaps:** Property tax collections remain low due to incomplete and inaccurate property records, low coverage, and undervaluation. Panchayats' reliance on grants exceeds 90% of their revenues. Municipal borrowings in India are estimated at less than 0.05% of GDP.
- **Conditionalities & Centralisation:** Performance grants impose conditions and reduce autonomy, risking 'centralised decentralisation'.
- **Cesses and Surcharges Outside Divisible Pool:** States continue to lose effective revenue share as cesses and surcharges excluded from the divisible pool keep rising, making the 41% vertical devolution less meaningful in real terms than it appears.
- **Weak Role of State Finance Commissions:** 16th FC recommendations often delayed, and ignored; and limits effectiveness of fiscal decentralisation.
- **District Collector Dominance:** At present, the District Collector is treated as the ultimate authority in the district. Whether it is the District Panchayat, Block Panchayat, or Gram Panchayat, everything revolves around the Collector, the power structure effectively stops there, undermining genuine self-governance.
- **Structural Issues:**
 - ◆ **Blurring Federal Hierarchy:** Treating local bodies as equal stakeholders with states, and distorts **Union–State fiscal relationship**.
 - ◆ **Shift from Equity to Efficiency:** Focus on performance over need, and it may disadvantage poor & backward regions.

Way Forward

- **Reconceptualise local bodies as constitutional governments:** They should not be treated as subordinate administrative units to align policy and perception with the spirit of the 73rd and 74th Amendments.
- **Strengthen SFCs:** Enforce strict timelines, mandate tabling of reports with ATRs, and provide technical support to state-level finance commissions.
- **Expand untied grants progressively** to allow genuine local priority-setting aligned with Gram Panchayat Development Plans (GPDPs).
- **Integrate DPDP and GIS frameworks** for real-time property tax digitisation to improve own-source revenue generation.
- **Build institutional capacity in tribal, remote, and aspirational district panchayats** before imposing performance-grant conditionalities.

- **Include cesses and surcharges in the divisible pool** beyond a threshold — a long-pending demand of states that needs structured resolution.
- **Deepen municipal bond market**, currently at less than 0.05% of GDP to reduce ULB dependence on central grants for capital infrastructure.
- **Sustained investment in decentralised**, bottom-up planning through GPDPs, community engagement, and local revenue rationalisation is critical for translating fiscal transfers into genuine local self-governance.

Conclusion

- 16th FC signals a **paradigm shift from cooperative to controlled federalism**, marked by rising central discretion, declining statutory safeguards, and reorientation toward efficiency over equity.
- While strengthening local governance is desirable, it must not come at the **cost of weakening states**, which form the bedrock of India's federal structure.
- A recalibration is essential to uphold the **constitutional vision of balanced fiscal federalism**.

Source: IE

Daily Mains Practice Question

- [Q] The recommendations of the Sixteenth Finance Commission (2026–31) have altered the fiscal architecture of local governance in India. Critically examine the tension between performance-linked conditionalities and fiscal autonomy of local bodies in India.

