One-Day Conference

on

16th Finance Commission Report

25 February, 2026

Conference Proceedings

Organised by

Finance Department,Govt. of Telangana

In collaboration with

Centre for EconomicandSocialStudies(CESS), Hyderabad

CONFERENCE PROCEEDINGS

Event: One-day Conference on the Deliberations of the 16th Finance Commission Report

Organisers: Centre for Economic and Social Studies (CESS), and Finance Department, Government of Telangana

Venue: Taj Deccan, Hyderabad

Date: 25th February 2026

INAUGURAL SESSION

Introductory Remarks by Prof. E. Revathi

Prof. Revathi, the Session Organiser, welcomed the one-day conference participants to a discussion on the 16th Finance Commission report, which had recently been tabled in Parliament along with the 2026-27 union budget. The event is a collaboration between the Centre for Economic and Social Studies (CESS) and the Finance Department of Telangana, originating from a suggestion by Dr. Montek Singh Ahluwalia to move such intellectual discourse away from the national and financial capitals of Delhi and Mumbai to regional centres in the South. In her opening address, she introduced Dr. D. Subbarao who would be giving the inaugural address and Dr. Ahluwalia giving the keynote address, while noting the unavoidable absence of the Dy. Chief Minister, Sri. Bhatti Vikramarka Mallu, and Principal Finance Secretary Sri. Sandeep Kumar Sultania. She acknowledged the presence of Sri K. Ramakrishna Rao, who will me chairing the inaugural session, members of the Board of Governors, and a diverse range of expert panellists and participants from academic institutions and government departments. She framed the conference as a critical platform for academics, policymakers, and practitioners to deliberate on the 16th Finance Commission Report, its impact on the central fiscal issues such as vertical and horizontal distribution, grants-in-aid, and fiscal consolidation. She invited the dignitaries to light the ceremonial lamp, before beginning the inaugural session by the chairperson K. Ramakrishna Rao, IAS.

Opening Remarks by the Chairperson, Sri K. Ramakrishna Rao, IAS

Sri K. Ramakrishna Rao welcomed the distinguished participants to an assessment of the 16th Finance Commission report, which entered the public domain on 1st February 2026. He observed that while the report introduced path-breaking new approaches, it also maintained a significant degree of stability. He emphasized that every Finance Commission faced the arduous task of balancing equity with efficiency to ensure that economically disadvantaged states are not marginalized. He asserted that transfers must be conducted in a rational manner that does not hinder the country's overall economic growth. He highlighted that a notable aspect of the report is the 'path-breaking' introduction of a state's contribution to GDP as a metric for tax devolution, a move that has received widespread praise. Beyond this, Rao drew attention to the report's focus on perennially loss-making and illiquid Public Sector Enterprises (PSEs). He noted the Commission's suggestion that states should initiate serious discussions regarding the future of any PSE that has recorded losses in three of the past four years, as large investments of government money are currently trapped in these enterprises.

Regarding fiscal consolidation, Rao noted that the Union government's action-taken report has accepted a 3% fiscal deficit limit for states. However, he raised a critical concern regarding the off-budget borrowings, particularly within Andhra Pradesh and Telangana. He endorsed the Commission's strategy that any off-budget debt serviced by the state must be integrated into the state's overall public debt, with a strong recommendation that states refrain from seeking fresh off-budget borrowings.

Ramakrishna Rao also addressed the growing burden of subsidies, noting that India's advanced digital infrastructure allows for the effective push of universal Direct Benefit Transfer (DBT) schemes. He pointed out that the 16th Finance Commission has rightfully opened a debate on how these increasing subsidy burdens can crowd out essential public investment and capital expenditure. Finally, he touched upon the 'grand bargain' proposed by the Commission, which suggests a reduction in the overall devolution percentage to states in exchange for expanding the shareable revenue pool to include cesses and surcharges.

As the chair, he invited Dr. D. Subbarao to present the inaugural address and Dr. Montek Singh Ahluwalia to present the keynote address.

Inaugural Address by Dr. D. Subbarao

Dr. D. Subbarao, former Governor of the Reserve Bank of India, delivered the inaugural address. He noted that the event was motivated by a desire to shift the intellectual discourse on public finance away from Delhi and Mumbai toward regional centres, ensuring that voices from the peripheries are heard.

Three Key Points

a. Resilience of the Indian Federal Structure: Subbarao characterized India's federalism as a story of remarkable resonance. While acknowledging political acrimony, he argued that India has managed centre-state relations significantly better than other global federations like Canada, Spain, or Nigeria, which face ethnic strife or separatist movements. He highlighted that the Indian Constitution uniquely blends unitary and decentralized features to navigate the challenges of a diverse country.

b. The 'Growing Importance of State Finances' A central argument of the address was that state-level fiscal management is more critical for macroeconomic stability than is typically acknowledged. Subbarao made several observations regarding this shift:

- Economic Gravity: The economic centre of gravity is moving from New Delhi to the states.
- The 60-40 Asymmetry: While the centre collects 60% of combined revenue, it keeps only 40%; conversely, states are responsible for 60% of total expenditure.
- Borrowing Power: States now borrow nearly as much as the central government, meaning state-level debt sustainability is vital to national growth.
- Quality of Expenditure: Unlike central spending on national security, state spending targets education, health, and local infrastructure, which are the primary drivers of long-term productivity and efficiency.

c. The Deepening Centre-State Cleavage: Subbarao warned of a deepening cleavage between the centre and states, observing a transition from cooperative federalism to 'combative' or 'corrosive' federalism.

- Political vs. Economic Divide: He raised concerns about the imbalance where the political centre of gravity resides in the North and East, while the economic centre of gravity is in the South and West.
- Second-Generation Reforms: He noted that unlike the 1991 reforms, which could be implemented from the centre, modern reforms involving land, labour, and taxation require state consultation and consent.

- Autonomy Concerns: He highlighted state grievances regarding limited space for spending autonomy, borrowing, and resource raising.

Assessment of the 16th Finance Commission Report

Subbarao described the 16th Finance Commission's report as a textbook affair. He praised the Commission for:

- Sticking strictly to its constitutional mandate and terms of reference without deviation.
- Avoiding grandstanding or trying to appease every state through political gestures.
- Delivering a balanced and professional document that provides a solid framework for deliberation.

Dr. Subbarao emphasised that repairing the cleavage between the centre and states is essential to achieving the Viksit Bharat goal of becoming a developed nation by 2047. He urged participants to use the overarching idea of the Commission's balanced approach as a guide for the day's technical deliberations.

Keynote Address by Dr. Montek Singh Ahluwalia

Dr. Montek Singh Ahluwalia, former Deputy Chairman of the Planning Commission, delivered the keynote address, providing a sweeping historical and structural critique of India's fiscal architecture. He opened by noting that the seminar itself was a result of his own suggestion to move the discussion of the 16th Finance Commission (FC) report—which was placed in Parliament on 1 February 2026—away from the Delhi-Mumbai axis to the South. He described this as the ultimate example of 'Atmanirbharta' (self-reliance): suggesting a conference and then being tasked with delivering the keynote. His primary goal was to ensure that regional perspectives, specifically from Hyderabad and the South, were integrated into the assessment of the Commission's work.

1. The Historical Anachronism of the Finance Commission

Ahluwalia's central thesis was that the entire Finance Commission framework is an institutional artifact .

- Post-Partition Context: He reminded the audience that the FC was conceived during a period of extreme political fragility following the partition of India. At that time, there was a powerful consensus to create a 'centralizing centre' to combat 'centrifugal forces' and ensure the country held together.
- The Planning Paradigm: Historically, the FC was designed to address non-plan needs, while the Planning Commission handled development transfers. Ahluwalia argued that this distinction is now obsolete, particularly since non-plan expenditure today includes critical areas of human development.
- The Modern Mismatch: He questioned whether the FC, as currently conceived, is still 'fit for purpose' in a modern market economy. He suggested that the Commission remains legally constrained to a simple calculation of vertical tax devolution, which fails to account for how much the global and domestic economic context has changed.

2. Fiscal Loopholes: The Fundamental Question of Cesses

Ahluwalia identified the proliferation of cesses and surcharges as a major point of friction.

- Bypassing the States: He criticized the central government's ability to levy cesses, indiscriminately, which are not shareable with the states.
- A Missed Opportunity: He asserted that even if not explicitly forced by its terms of reference, the 16th FC should have addressed this fundamental question. The current system allows the centre to shrink the shareable pool of revenue, effectively undermining the spirit of vertical devolution.

3. Managing Political Strain: Delimitation and the Concurrent List

A significant portion of the address was dedicated to the political pressures threatening the federal structure.

- The Delimitation Dilemma: Ahluwalia warned that a simplistic application of population-based delimitation would cause big strain on the political system. Citing economist Santosh Mehrotra, he proposed a mixed criteria approach: freezing the current number of seats while distributing any additional seats based on a combination of population growth and other developmental factors.
- Decentralizing the Concurrent List: He raised the radical question of whether the Concurrent List should exist at all, or if it should be drastically reduced. He specifically argued that education should never have been moved from the State List to the Concurrent List, as central intervention is often not backed by guaranteed central funding.

5. Re-bundling Large States for Better Governance

Ahluwalia advocated for a systematic effort to divide large states into smaller units.

- The Scale Problem: He argued it is illogical for a federation to have states ranging from 2 million to 250 million people (like Uttar Pradesh).
- Concentration of Power: Large states concentrate excessive national political power. Ahluwalia suggested that a country with more, smaller states would facilitate easier coalitions and less threatening political dynamics.

6. Human Capital and Technological Progress

Ahluwalia linked fiscal autonomy directly to economic growth through the lens of human capital.

- Technical Progress: He emphasised that a lot of technical progress is due to improvements in human capital. Rejecting the idea that technology falls like manna from heaven, he argued that growth is driven by learning by doing and highly skilled labour. He further argued that systems should encourage growth of technical progress.
- Local Management: Since education and health are the primary drivers of this progress, they are best managed at the state or local level rather than through centralized mandates.

7. State-Level Failures and the Third Tier Crisis

Despite his critiques of the centre, Ahluwalia was equally critical of state-level governance.

- Development Constraints: He noted that while States complain about the centre, at least half of their hurdles are due to state-level bureaucracies. Further, he observed that there is to the lack of state-level institutional research to identify specific local constraints.
- The Devolution Deficit: He pointed out that India has some of the lowest levels of devolution to the third tier—panchayats and urban local bodies. He emphasized that states do not need central permission to devolve power, but they choose not to.
- Untapped Revenue (Agriculture and Property): Ahluwalia described the state of property tax as appalling. Because states set the rates but do not receive the revenue (which goes to municipalities), they avoid raising taxes for political reasons, leaving cities with terrible infrastructure. He also questioned the continued exemption of large agricultural holdings from income tax, a power that rests solely with the states.

8. Conclusion

In his closing remarks, Ahluwalia argued that the South's ability to attract investment and participate in global supply chains depends entirely on the quality of city infrastructure. This requires a fundamental shift: empowering urban local bodies with the authority to tax and the capacity to contract. He urged younger scholars to benchmark India's performance against other emerging economies like Indonesia and Malaysia to see how out of the mainstream India remains in its local devolution and urban management function in India. He concluded that the current institutional structure is 'simply no longer fit for purpose' and requires a new political consensus to move forward.

Closing Remarks by Sri K. Ramakrishna Rao, IAS

In his closing remarks for the inaugural session, Sri K. Ramakrishna Rao synthesized the major themes presented by the keynote and inaugural speakers, Dr. Montek Singh Ahluwalia and Dr. D. Subbarao.

- Federalism Tensions: He reflected on the speakers' comments regarding the deepening divide in centre-state relations, noting that federalism has moved beyond being merely combative to a combustible state.
- Structural Asymmetry: He echoed the concern regarding the asymmetry between revenue-raising powers and expenditure responsibilities between the centre and the states.
- Institutional Architecture: Rao acknowledged Dr. Ahluwalia's historical perspective on the Finance Commission's architecture and agreed that states need to take more state-level initiatives rather than relying solely on central frameworks.
- Intellectual Gravity: He emphasized the need for regional centres and major cities to develop their own intellectual consensus and gravity to provide a voice from the peripheries that balances the nation's shifting economic and political centres of gravity.

TECHNICAL SESSION – I: FISCAL REDISTRIBUTION: VERTICAL AND HORIZONTAL DEVOLUTION

Opening Remarks by Sri A.N. Jha, IAS (Rtd.)

In his opening remarks, Chairperson A.N. Jha welcomed participants to deliberate on the 16th Finance Commission report, specifically focusing on the critical aspects of vertical and horizontal devolution. He described horizontal distribution as a zero-sum game, highlighting that while the inclusion of GSDP contribution served as a marginal correction for southern states, it resulted in a significant fall in shares for poorer, northeastern, and hill states. Regarding vertical devolution, Jha noted that the share was retained at 41%, but the commission failed to fully address the 'grand bargain' of whether cess and surcharge should be factored into the devolution formula. He also pointed to adjustments in how the commission handled demographic performance and the increased weightage given to forest coverage. To explore these issues, Jha introduced an eminent panel consisting of Dr. Joseph, Dr. Atri Mukherjee, and Mythili Bhusnurmath, allotting ten minutes for each presentation followed by a 25-minute concluding discussion.

Panellist 1: Prof. K.J. Joseph

Prof. K.J. Joseph commenced his address by noting the presence of influential figures in Indian public finance. He commended the quality of the report under discussion, describing it as exceptionally lucidly written. He framed his subsequent critiques not as hostility toward the report, but as a necessary academic discourse.

1. Institutional Co-evolution

Prof. Joseph argued that the current fiscal debate must move beyond the percentage of devolution. He posited that institutions are progeny of the context and must co-evolve to remain relevant. He argued that with the present era of 'Mission Viksit Bharat', India needs institutions which influence economic development.

Drawing on the Prime Minister's statement that "India grows when the states grow," Joseph asserted that if states are the primary engines of national ambition, the Finance Commission's role must expand. He challenged the traditional view held by some colleagues that the Commission should only provide a basic minimum of public goods, arguing that an inflexible institution can become poisonous to the development process if it fails to adapt to new national goals.

2. The FRBM Framework and Sub-national Vulnerability

Prof. Joseph contended that the FRBM was transplanted from a developed economy context, specifically the European Union, based on assumptions such as 5% growth, 60% borrowing, and 3% fiscal deficits.

He highlighted a fundamental 'replication error': applying regulations designed for sovereign nations (with total control over income and expenditure) to sub-national entities that have lost fiscal autonomy. He provided concrete examples of this squeeze:

- GST Impact: Kerala is estimated to have lost 8,000 crores following the implementation of GST-2.
- Scheme Burdens: New requirements for schemes like VBG-RAM-G are expected to increase Kerala's expenditure by another 2,000 crores.

3. Analytical Specialisation: Tradables vs. Human Capital

Prof. Joseph introduced an analytical framework dividing states into those specializing in tradables (commodities) and those specializing in non-tradables (human capital).

- The Tradable Advantage: States producing goods like steel or lasers generate immediate tax revenue for both the state and the Union while creating local jobs.
- The Human Capital Paradox: States like Kerala invest heavily in non-tradables. 59% of Kerala's expenditure is committed to salaries and pensions to produce high-quality human capital.
- National Contribution vs. State Revenue: While this mobile workforce contributes to 20% of India’s IT manpower and generates 24% of the country's $134 billion in remittances, the state government cannot directly tax this output. He argued that the state is effectively penalized for producing a national asset that it cannot monetize through traditional tax structures.

4. Redefining Capital Expenditure and Addressing Vertical Imbalance

Prof. Joseph challenged the current definition of capital expenditure, arguing it is outdated for a modern economy. He used the analogy of an AI laboratory: while the building is recorded as capital, the investments made inside the building to develop AI technology—the actual drivers of global leadership—are not.

Regarding the 41% tax devolution, he argued that the freeze at this level is a facade because it has been paired with the omission of grants. This effectively deprives states of funds, which are then redirected into centrally sponsored programs. He accused the Commission of a double standard regarding cesses and grants:

- Cesses and Surcharges: The Commission claims these are constitutionally barred from the divisible pool.
- Grants: When dealing with states, the Commission ignores the constitutional provision for grants, instead claiming that providing them would increase profligacy.

5. Conclusion

In his final remarks, Prof. Joseph debunked the assumption that higher per capita income equates to higher tax capability, noting that in many Indian states, tax-GDP ratios have actually declined as income rose. He urged for a better understanding these realities rather than relying on simple GDP metrics. He concluded by stating the session was a good start for a discussion intended to leave critical questions for future generations to resolve.

Panellist 2: Dr. Atri Mukherjee

Dr. Atri Mukherjee's presentation focused on the critical role of state governments as partners in achieving Viksit Bharat by 2047, emphasizing that states are the primary implementers of national policies and essential actors in a globalized economy. Her remarks addressed the structural challenges and evolving dynamics of fiscal federalism under the 16th Finance Commission.

1. Social Sector Spending and Vertical Distribution

Dr. Mukherjee highlighted a significant gap between current spending and national targets for human development.

- Health and Education: General government expenditure on health stands at approximately 2% of GDP, falling short of the 2.5% target set by the National Health Policy. Similarly, education spending at 4.5% of GDP remains significantly lower than the 6% target of the National Education Policy.
- The State Burden: Given that states account for 60-65% of general government spending in the social sector, Dr. Mukherjee argued that vertical distribution is essential to strengthen their capacity for sustained investment in health, education, and nutrition.

2. Devolution and the Mandate for Self-Reliance

Despite most state governments demanding an increase in tax devolution from 41% to 50%, the 16th Finance Commission maintained the share at 41%.

- Fiscal Message: By retaining this level and removing the revenue deficit grant, the Commission signalled that states must become more self-reliant in managing their resources.
- Centrally Sponsored Schemes: Dr. Mukherjee noted that states are expected to perform heavy lifting during this period, supplementing central grants for national goals. For example, under the VBG-RAM-G scheme, the revised cost-sharing arrangement requires states to contribute 40% of total expenditure, translating to roughly 0.2% of GDP in 2026.

3. Concerns Over Cesses and Surcharges

A major point of contention was the shrinking of the divisible pool due to the Union government's increased reliance on cesses and surcharges.

- Constitutional Constraints: While states have called for these to be included in the divisible pool or capped, the Commission maintained that this is not possible under the current constitutional scheme.

- Transparency and Utilization: Citing CAG reports, Dr. Mukherjee raised serious concerns regarding the efficiency and transparency of these levies. The CAG has observed that for various cesses—including infrastructure, health, and crude oil—there is often no proper framework to ensure funds are used for their intended purposes. She argued that such levies should be time-bound, exceptional, and withdrawn once their purpose is served.

4. Horizontal Distribution and Demographic Shifts

Dr. Mukherjee discussed the shift toward incentivizing efficiency through horizontal distribution criteria.

- Performance Criteria: The Commission introduced a new Contribution to GDP criterion with a 10% weight to capture spending efficiency and fiscal rectitude. Overall, the weightage for performance criteria has increased from 15% to 20%, while equity remains the primary anchor at 42.5%.
- Population and Aging: She noted changes in demographic weights of the 16th Finance Commission formula, including a redefinition of demographic change to reflect inverse population growth between 1971 and 2011, giving higher weight to states with smaller population.

5. Future Challenges:

Dr. Mukherjee warned that the primary concern for many states, such as Kerala and Tamil Nadu, is no longer population growth but population aging. She suggested that future commissions should utilize indicators like the old-age dependency ratio or the share of the elderly population to ensure more equitable resource allocation.

Panellist 3: Ms. Mythili Bhusnurmath

Ms. Mythili Bhusnurmath opened her address by identifying herself as a die-hard federalist, arguing that for a nation as diverse as India to survive, it must recognize, respect, and accept its internal differences while strengthening common bonds. She emphasized that fundamental to this survival is a resource-sharing mechanism that is fair, transparent, and equitable.

1. Core Premises of Fiscal Federalism

Ms. Bhusnurmath established three fundamental premises for the discussion:

- Inevitability of Imbalance: Vertical and horizontal imbalances are a given in every federation.
- Devolution as Basic Structure: Citing *SR Bommai vs Union of India (1994)*, she noted that federalism is part of the Basic Structure of the Constitution; consequently, fair and efficient devolution must also be considered part of that basic structure.
- Principle of Subsidiarity: Whatever tasks can be performed more effectively at a local level must be handled locally.

2. Critique of Vertical Devolution

Ms. Bhusnurmath characterized the 16th Finance Commission's (SFC) focus on continuity regarding the 41% tax devolution as timid.

- Questioning Continuity: She questioned the sanctity of continuity in a changing world, asking why a staggered increase or a roadmap for the states' share was not considered.
- The Constitution as a Living Document: She challenged the SFC's argument that there is no constitutional 'cap' on cesses and surcharges. Noting the Constitution has been amended over 100 times, she argued it should be treated as a living document rather than a rigid barrier to sharing non-tax revenues or implementing caps.

3. The Terminology Debate: Union vs. Centre

A significant portion of the address focused on the linguistic shift from 'Union' to 'Centre.'

- Constitutional Accuracy: She strongly objected to the word Centre, noting that it does not appear once in the Indian Constitution, which defines India as a Union of States.
- Ownership of Funds: Responding to claims that Centre's funds belong to every Indian, she asserted that if they belong to every Indian, they belong to the states, as that is where Indians reside. She maintained that the Union and states are equal partners.

4. Horizontal Devolution and Efficiency

While recognizing a slight shift towards efficiency in rewarding growth, Ms. Bhusnurmath raised concerns regarding demographic metrics.

- Contradictory Indicators: She noted a contradiction between higher weights for population and lower weights for demographic performance.
- Population Disincentives: She argued that using population growth data from 1971–2011 penalizes states that successfully managed population growth, as much of that success occurred post-2011.

5. Proposals for a Future-Ready System

To modernize fiscal federalism, she proposed several structural shifts:

- The GST Council Model: She suggested modelling the Finance Commission after the GST Council to ensure states have a seat at the table rather than being on the menu.
- Permanent Standing Body: She questioned the efficacy of recommendations set in stone every five years and proposed the Commission become a standing body to respond to evolving events, GDP revisions, and national defence needs.
- Tackling the Race to the Bottom: She expressed concern over election freebies and appeasement policies, quoting the Chief Justice of India's remarks on the failure to distinguish between those who can afford services and those who cannot.
- Constitutional Review: She called for a relook at the Concurrent List and suggested re-evaluating the 42nd Amendment (1976), which moved items from the State List to the Concurrent List.
- Borrowing Limits: She questioned if the Union should remain the sole arbiter of state borrowing limits or if a more collaborative body should oversee fiscal discipline.

Technical Session – I: Summary of Q&A Session

1. Fiscal Discipline and State Borrowing

- Rationale for Uniform Limits: Dr. Montek Singh Ahluwalia argued that there is no economic rationale for assuming state borrowing limits should be identical. He suggested that states with lower debt-to-GDP ratios or those projected to grow faster should be permitted a larger fiscal base.
- Constitutional Necessity of Limits: Dr. Jayaprakash Narayan completely disagreed with eliminating borrowing limits, asserted that financial stability is a constitutional principle that successive Union governments have failed to enforce.
- Inter-state Fiscal Responsibility: Ms. Mythili Bhusnurmath suggested that states can be as fiscally responsible as the Union and that a model like the GST Council would encourage states to monitor the fiscal health.

2. The Divisible Pool, Cesses, and State Resources

- The State's-Own Resources concept: Dr. Sanjaya Baru challenged the very concept of state's-own resources, arguing that every resource is constitutionally divisible and that the Union merely collects and redistributes what are essentially the states' resources, the term is inherently unfair to states.
- Shrinking Divisible Pool: Dr. D. Subbarao pointed out that while the Finance Commission mandates a 41% share, the rising use of cesses and surcharges meant states received a declining portion of the overall tax pool. He described the Union's argument—that this money is spent in India on infrastructure—as spurious, as it deprives states of the autonomy to spend.
- Distinction Between Levies: Dr. G.R. Reddy suggested making a distinction between purpose-specific cesses and surcharges, noting that surcharges lack a dedicated purpose and flow straight into the Consolidated Fund of India.
- Tying State Space: Dr. Manish Gupta observed that cesses are often used to finance Centrally Sponsored Schemes (CSS) in state list areas, forcing states to pay a 40% share and further eroding their untied fiscal space.

3. Expenditure Quality, Education, and R&D

- The Education Crisis: Dr. Jayaprakash Narayan labelled school education a disaster noting that in rural Telangana, despite high spending (Rs. 1,08,000 per student), 50% of 16-year-olds cannot read time in a watch.

- R&D Decline: Prof. K.J. Joseph highlighted that India's R&D investment has fallen from 0.9% of GDP in 1991 to 0.64% today, whereas China's R&D was 0.7% of GDP in 1991 and it has risen to 2.5% today.
- Outcome Focus: Prof. Mahender Reddy stated that it is important to assess the outcomes of university education in relation to national goals like Atmanirbar Bharat as well as Viksit Bharat.
- The 7% turnaround: Dr. Ahluwalia estimated that meeting national targets in health, education, defence, R&D, and climate, while reducing fiscal deficit by 2%, would require additional revenue to the tune 7% of GDP over five years.

4. Institutional Synergy and Reform

- The GST-FC Disconnect: Haseeb Drabu critiqued the Finance Commission for failing to coordinate with the GST Council, despite the Council now determining the tax rates that the Commission devolves.
- Irresponsive Continuity: Prof. K.J. Jospeh argued that for a Viksit Bharat and recognising the crucial role of the states in achieving the mission, it is important that the institutions evolve and be responsive to the changing ambitions, mere continuity is not Viksit.
- The GST Council Model: Ms. Mythili Bhusnurmath proposed modelling the Finance Commission after the GST Council to ensure states have a seat at the table.
- Permanent vs. Fixed Tenure: While Ms. Bhusnurmath advocated for a permanent standing body to respond to global shifts, Dr. D. Subbarao argued the current fixed-tenure model is optimal for maintaining stability. Dr. Ahluwalia suggested the Commission should remain in place until the midpoint of its recommendation period to assess implementation.

5. Federalism and Measurement

- Refining GSDP: Haseeb Drabu suggested moving from GSDP to GSVA (Gross State Value Added) to remove the distortions of taxes and subsidies that currently beef up state numbers. This would bring uniformity.
- Coercive Federalism: Haseeb Drabu characterized the current era as coercive federalism and questioned the glorification of cooperative federalism following the 2019 conversion of a state into a Union Territory.
- Modern Measurement and Data Transparency: Prof. K.J. Joseph criticized the reliance of 18^{th} century concepts, urging the use of newer and high intensity data

for economic analysis. He emphasised that, the country is not open to the 21st century research needed to make 21st century decisions. Further, he raised serious concerns on doing sensible research due to the union government's refusal to share GST data. Sanjaya Baru suggested to think of a more comprehensive measure rather than GDP alone.

- Demographic Dynamics: Dr. Atri Mukherjee suggested that future commissions should utilize old-age dependency ratios or the share of the elderly population to address the fiscal challenges of population aging in states like Kerala and Tamil Nadu. Ms. Mythili Bhusnurmath pointed that the 16th Finance Commission missed out the problem of internal migration.

- Environmental Incentives: Dr. Jeena Srinivasan questioned the sufficiency of devolution based solely on forest area and suggested performance-based incentives for air quality.

TECHNICAL SESSION – II: GRANTS-IN-AID TO THE STATE GOVERNMENTS

Opening Remarks by Dr. G.R. Reddy, IES (Rtd.)

Dr. G.R. Reddy opened the session by characterizing the 16th Finance Commission's approach to states' deficits as somewhat problematic. A primary concern raised was the impact on North-eastern states. Dr. Reddy noted that, with the exception of Mizoram, almost all these states are facing a double barrel fiscal hit: they are projected to receive less tax devolution in absolute terms compared to 2025-26, while simultaneously being denied revenue deficit (RD) grants. He raised concerns over how these states would manage their administrative and developmental needs under such a restrictive regime. He emphasized that the implications of this stance represent a major point of concern for state-level financial planning.

The Chairperson highlighted a major shift in the redistribution of local body grants, which were allocated in a 60:40 ratio for rural and urban bodies respectively. While this resulted in rural local body grants being 155% higher than those recommended by the previous Commission, Dr. Reddy flagged a significant disparity in resource mobilization:

- Urban areas are able to mobilize approximately 50% of their own expenditure.
- Rural local bodies are only able to mobilize 14% of their own revenues, making them far more dependent on external support.

He further observed that the rural share of local body grants had actually decreased from 66% to 60%, raising concerns about the long-term financial health of these institutions.

Dr. Reddy offered a sharp critique of the conditionalities attached to performance grants for local bodies. He noted that to be eligible for the 20% performance grant, a state is required to release 20% of the basic grant from its own resources within a single year. Upon analysing the numbers, Dr. Reddy found it surprising that the required state contribution (20% of the basic grant) is often higher than the actual incentive grant being offered. He questioned the logic of this design, asking, where is the incentive for putting the performance grants? He concluded that while urban bodies might find these conditions manageable, they would be exceedingly difficult for rural local bodies to fulfil.

Dr. Reddy drew attention to a subtle but significant distinction in the government's Action Taken Report (ATR). He pointed out that while the government accepts most recommendations, it merely takes note of the Commission's assessment regarding revenue deficit, sector-specific, and state-specific grants. Dr. Reddy suggested that this phrasing is highly consequential, as it leaves open the possibility that the Centre may intend to dispense with certain discretionary grants to states in lieu of post-devolution revenue deficit grants.

Panellist 1: Sri. A.N. Jha, IAS (Rtd.)

A.N. Jha opened his presentation by emphasizing that grants-in-aid, alongside vertical and horizontal devolution, constitute the three core functions of the Finance Commission under Article 280 of the Constitution. He specifically highlighted Article 275(1) and Article 283(b), which mandate the Commission to define the principles governing grants-in-aid for states 'in need of assistance'. Jha noted that the 16th Finance Commission's report represents a significant departure from established practice because it has chosen not to provide for revenue deficit grants.

1. Constitutional Conventions and the Need of Assistance

Jha argued that revenue deficit grant is an established constitutional convention that has been in practice since pre-independence. He challenged the notion that the word 'may' in Article 275(1) gives the Commission arbitrary discretion; rather, the Supreme Court has held that the need of the state is the fundamental norm for such grants. Consequently, he asserted that the Commission has a mandate to carry out a rigorous analytical exercise for each individual state to assess its specific expenditure needs and revenue sources.

2. Critique of the Aggregate Analysis

A primary critique raised by Jha was the lack of transparency regarding state-specific assessments. He observed that while the Commission might have conducted such analyses, the resulting report only provides a collective aggregate number. He argued that relying on an aggregate figure fails to address the fundamental structural problems of specific states.

3. The Challenge of Structurally Deficit States

Jha identified several categories of states that face persistent structural imbalances:

- Northeastern and Hill States: Including Himachal Pradesh and the erstwhile state of Jammu & Kashmir.
- States with Specific Structural Issues: Such as Kerala, West Bengal, and Punjab.

He emphasized that the problems facing a state like Kerala are fundamentally different from those of other states, and a broad-brush approach fails to account for these distinctions.

4. Conclusion

In his concluding remarks, Jha expressed concern for the immediate future. He predicted that significant problems would arise over the next five years, particularly for states that are at the fiscal margin or are structurally deficit. He raised concerns that by doing away with revenue deficit grants, the Commission has left these states with no other mechanism to meet their essential financial needs.

Panellist 2: Sri. K. Ramakrishna Rao, IAS

Sri. K. Ramakrishna Rao observed that the 16th Finance Commission (FC) has introduced a total change in the framework for grants-in-aid. He noted that while there may be differences of opinion on specific recommendations, the move away from state-specific grants is a welcome development. He characterised the previous system of state-specific grants as highly discretionary, rather than following a transparent, formula-based approach.

1. National Priorities and Sector-Specific Grants

Regarding sector-specific grants, Rao acknowledged they are often viewed as a kind of a wash, but argued there is a valid case for using them to nudge states toward national priorities. He suggested that apart from tax devolution, these grants serve as a necessary mechanism to push states to focus on sectors that are critical from a national perspective.

2. The Elimination of Revenue Deficit (RD) Grants

Rao addressed the revenue deficit grants as the most controversial topic. He noted that states like Telangana, which do not receive these grants, naturally support their elimination, while states dependent on them for structural or other reasons advocate for their continuation. From an economic standpoint, he argued that RD grants often create perverse incentives. By removing this gap-filling mechanism, the Commission provides an incentive for states to:

- Improve internal tax administration and efficiency.
- Plug revenue leakages.
- Ensure they get their houses in order rather than relying on external assistance.

3. The Crisis of Ballooning Revenue Expenditures

Rao focused on the unsustainable growth of revenue expenditures, specifically salaries and pensions. Commenting on Telangana, he highlighted several startling points:

- High Salary Levels: In state power utilities, a sweeper with 20 years of service can earn 2 lakhs per month, while chief engineers earn up to 7 lakhs—salaries that exceed those of Cabinet Secretaries.

- Rapid Expenditure Growth: In June 2014, the combined monthly bill for salaries and pensions in Telangana was 1,500 crores; by April 2025-26, this figure had quadrupled to 6,000 crores.
- Institutional Pressure: This growth is driven by successive Pay Revision Commissions (PRCs) every five years, which create immense pressure on the political establishment and lead to unsustainable fiscal burdens.

4. Urbanisation and Local Body Grants

Rao welcomed the Commission's increasing focus on urban grants, citing the needs of rapidly expanding metropolitan areas. He noted that Hyderabad, for example, recently amalgamated 27 municipalities and over 100 gram panchayats into the Greater Hyderabad Municipal Corporation, requiring substantial resources to provide services to these new areas. However, he echoed concerns raised by other speakers regarding rural local bodies, noting that meeting performance-based standards can be genuinely difficult for them.

5. Concluding Remarks

In his final submission, Rao stated that the decision to do away with revenue deficit, state-specific, and sector-specific grants represents a real break from the past. He concluded that while the constitutional aspects may be debated, these changes effectively nudge the states toward more responsible fiscal behaviour.

Panellist 3: Prof. K. Gayithri

Prof. K. Gayithri approached the discussion as an independent public finance expert, situating the 16th Finance Commission's recommendations within the broader framework of India's national finances. She expressed support for the decision to dispense with sector-specific and state-specific grants, noting that the sheer volume of disparate demands from individual states makes it technically difficult for a Commission to identify which specific projects truly merit support.

1. Revenue Deficits and the Need for Fiscal Discipline

Prof. Gayithri noted that following the implementation of FRBM (Fiscal Responsibility and Budget Management) acts, states largely maintained revenue surpluses until roughly 2015-16, after which they began lapsing back into deficit. Her core observations on this trend included:

- Definition of Deficit: She defined revenue deficit as the practice of using borrowed resources to fund revenue expenditure.
- Quality of Expenditure: She argued that while some revenue spending—such as on education—is vital, there must be a rigorous evaluation of expenditure quality.
- Fiscal Consolidation: She concurred with the Commission's principle that revenue deficit grants should be dispensed with to bring about necessary fiscal discipline in state operations.
- Central Comparison: She noted a positive trend at the Union level, where the share of revenue deficit in the total fiscal deficit has dropped from 70% to 35% over the last five years, suggesting states should aim for similar trajectories.

2. The Challenge of Subsidies and Data Comparability

A major point of concern raised was the ballooning of subsidies and cash transfers. Prof. Gayithri highlighted that in 21 states, subsidy expenditure has surged from 2% to over 20% of total spending. However, she flagged several operational hurdles in addressing this:

- Lack of Uniform Definition: There is no common, nationwide definition for what constitutes a subsidy, with different figures provided by the CAG and RBI.
- Misclassification: She pointed out that state budget data is often misleading; items that are genuine subsidies are sometimes not reported as such, or their classification changes from year to year.

- Cash Transfers: She noted the Commission's report indicates that 47% of total spending is now occurring through cash transfers, necessitating a wider debate on long-term fiscal sustainability.

3. Local Body Grants: The Mismatch of Conditionalities

While acknowledging that grants to local bodies have nearly doubled, Prof. Gayithri raised critical issues regarding their implementation. She argued that excessive conditionalities—such as earmarking 50% of basic grants for specific services like water and sanitation—often fail to reflect local realities.

To illustrate this, she cited examples from Karnataka, where certain local bodies had already achieved 100% service coverage in these areas. In such cases, the rigid earmarking meant the local bodies could not use the allocated funds, highlighting a significant failure to address actual local needs. She concluded that the Commission had missed an opportunity to adequately address these widely discussed operational inefficiencies.

Panellist 4: Dr. Manish Gupta

Dr. Manish Gupta opened his presentation by noting that the 16th Finance Commission (FC) is uniquely positioned as the first commission since the 73rd and 74th Amendments to have access to rich data on local body finances and updated State Finance Commission (SFC) reports. He attributed this improved data availability to the entry-level conditions established by the 15th FC, which required states to submit audited financial statements and SFC reports by March 2023.

However, Dr. Gupta highlighted a persistent gap: even with this data, there are still no clear estimates of the fiscal gap between the revenues local governments raise and their actual expenditure needs, nor are there established basic service level standards to determine the necessary funding levels. He emphasized the need to strengthen SFCs to provide more accurate estimates of these requirements.

1. Institutional Continuity and Conditionalities

Dr. Gupta commended the 16th FC for ensuring continuity by maintaining and expanding entry-level conditions for grants, including the publication of financial statements, timely elections, and the regular constitution of SFCs. He specifically noted a new caveat requiring Action Taken Reports (ATR) to be submitted within six months. He pointed out that currently, states take an average of one year to table an ATR, a delay that often dilutes the effectiveness of SFC recommendations.

2. Equity in Urban Local Body (ULB) Grants

A central critique in Dr. Gupta's remarks concerned the heterogeneity of Urban Local Bodies. He noted that while large municipal corporations (especially million-plus cities) collect 60% to 65% of their revenue from their own sources, smaller municipalities and town panchayats are highly dependent on grants.

He argued that the Commission’s decision to distribute 90% of ULB grants based on population is fundamentally unfair to smaller, poorer local bodies. His analysis indicated that larger corporations already receive more revenue per capita from both their own sources and existing transfers; therefore, focusing on population as the primary metric ignores the need for hand-holding and capacity building in smaller ULBs.

3. Transparency in State-to-Local Transfers

Dr. Gupta flagged a significant lack of transparency regarding state transfers to local bodies. He observed that the 13th FC's recommendation—that states produce a supplementary budget document highlighting these transfers—has largely been abandoned. Without this transparent data, he warned that it is impossible to know if the 20% performance grant matched by the state will become the sole source of funding for local bodies, effectively limiting their total resources.

4. Environmental Criteria and Air Quality

Finally, Dr. Gupta criticized the 16th FC's shift in environmental priorities. He noted that the 15th FC had allocated 12,000 crores specifically for air quality and used a formula weighted toward dense forest cover. By including open forest (which accounts for 43% of the total forested area) and removing specific air quality grants, the 16th FC has, in his view, diluted the signal regarding India's fight for better air quality and climate change mitigation.

Technical Session – II: Summary of Q&A Session

1. Revenue Deficit Grants and the Structural Deficit

The deliberations focused on whether state deficits are inherent to their geography or a result of fiscal mismanagement.

- Defining Structural Deficit: Sri. A.N. Jha defined structurally deficit states primarily as North-eastern and hill states that depend on central transfers for up to 80% of their requirements. These states face high administrative costs because they must maintain comparable public service structures (districts, departments) to larger states despite a limited revenue base.
- Fiscal Effort vs. Necessity: In response to a query from Ms. Mythili Bhusnurmath regarding whether deficits result from a lack of state effort, Jha argued that these states often have higher capital expenditure (5% to 20%) than the national average, indicating that funds are not merely being wandered away on freebies.
- The Nature of State Deficits: Haseeb Drabu argued that state revenue deficits are not inherently bad because they fund essential frontline services such as doctors, teachers, and police, whereas Union revenue deficits often fund non-service-providing bureaucracy.

2. State Performance and Revenue Sustainability

This section addresses the fiscal health of high-performing states, specifically using Telangana as a case study.

- Revenue Sustainability: Prof. Revathi questioned if Telangana's performance was due to asset sales or recurring taxes in recent times. Sri. K. Ramakrishna Rao clarified that out of 15.5 lakh crores in expenditure over ten years, asset sales accounted for less than 15,000 crores. He attributed the state's growth to a strong tax buoyancy of 1.1 to 1.2%.
- Labor Market Distortions: Sri. Ramakrishna Rao noted that unreasonably high salaries at lower government levels have turned the coaching industry into a roaring business in Hyderabad, with candidates spending their most productive years preparing for exams instead of skilling for the market.

3. Institutional Critiques: Methods and Omissions

Several participants criticized the SFC for its methodological approach and perceived oversights.

- Gender and Social Omissions: Prof. Amar Yumnam argued that the SFC completely forgot the gender dimension, failing to recommend sector-specific grants for women and children despite clear issues raised in national health reports.
- Methodological Rigor: Prof. K.J. Joseph critiqued the Commission for using convenience-based conclusions rather than hardcore empirical analysis. He pointed out that while states are penalised for not meeting tax potential, the Union's corporation tax has declined from 3% to 1.7% without similar scrutiny.
- Rural-Urban Equity: Prof. Gopinath Reddy posed a question to the chair and panellists on the 60:40 rural-urban grant split, arguing that poverty remains more concentrated in rural areas, making rural bodies the casualty of current arrangements. He further noted that small town panchayats lack the revenue-raising capacity of large corporations. He raised concerns regarding delays in ATRs (Action Taken Reports) making it unclear if funds are actually reaching local bodies.

4. Expenditure Quality

The quality of state spending and the resulting labour market distortions were highlighted as major pathologies.

- The Subsidy Pipeline: Sri. Ramakrishna Rao argued that while Digital Public Infrastructure (DPI) has made transfers to farmers highly efficient, there is a noted inability to roll back existing subsidies due to intense political pressure, leading to ever-increasing fiscal commitments.
- Kerala's Investment Model: A.N. Jha discussed Kerala's high social spending, noting its historical decision to invest heavily in education—a cost that is often not reimbursed in the Union's current fiscal arrangements despite its contribution to national income. Prof. K.J. Joseph added that Kerala's high social spending has allowed it to eradicate extreme poverty, a contribution often missed in national income metrics.

5. Federalism and the Trend of Centralization

The discussion concluded with a critique of the shifting power dynamics between the Union and the states.

- Centralization through Decentralization: Haseeb Drabu warned of a trend where the Union bypasses state legislatures to fund panchayats directly, effectively disempowering the states.

- State Size and Power: Drabu challenged the preference for smaller states, suggesting they cannot politically stand up to the Centre as effectively as larger states like Maharashtra or Tamil Nadu, thereby inadvertently aiding centralization.
- Institutional Vacuum: Drabu argued that with the abolition of the Planning Commission and special category status, there is currently no institutional mechanism to address the needs of sensitive border states, necessitating a rework of the entire federal compact.
- Constitutional Overreach: Prof. K.J. Joseph critiqued the Commission for reserving beyond the constitution to justify policy through convenience-based conclusions rather than hard empirical analysis.

TECHNICAL SESSION – III: FISCAL CONSOLIDATION

Opening Remarks: Dr. Jayaprakash Narayan

Dr. Jayaprakash Narayan opened the session by invoking the wisdom of economist Thomas Sowell, "The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson in economics." He emphasized that India must navigate its developmental goals within the constraints of limited resources.

He highlighted a crucial but often overlooked point in the Indian fiscal federalism debate: 63% to 65% of the general government expenditure in India occurs at the State level. This is the highest among all federal countries in the world. Conversely, expenditure by local governments accounts for only approximately 3%, which is among the lowest globally for federal nations.

Dr Jayaprakash Narayan noted that while the Union government collects the majority of revenue, approximately 54% of its gross revenues are transferred to the States through tax devolution, grants, and centrally sponsored schemes. Despite these transfers, the Union government remains in a structural deficit when accounting for its own committed expenditures like salaries, pensions, and interest payments.

1. State Fiscal Profiles and Committed Expenditure

- Committed Expenditure: In several states, salaries, pensions, and interest payments consume the vast majority of total revenue receipts. Andhra Pradesh spends 94% of its revenue on these three items, followed by Punjab (75%), Himachal Pradesh (74%), and West Bengal (62%).
- Debt-to-GSDP Ratios: When accounting for off-budget liabilities and pending bills, the debt-to-GSDP ratios for certain states far exceed the FRBM target of 20%. For instance, Andhra Pradesh stands at 61% and Telangana at 49%.
- Revenue Deficits: The fiscal profile of states varies from significant deficits—such as Andhra Pradesh at -6.4% and Punjab at -3.5%—to states maintaining surpluses like Odisha (2.9%) and Gujarat (0.8%).

2. Emerging Risks to Fiscal Management

1. Opaque Accounting Practices: This includes the heavy use of off-budget borrowings, unpaid bills (e.g., Andhra Pradesh has ~130,000 crores in pending bills), and the systematic underestimation of expenditure.
2. Unfunded Future Pension Liabilities: Some states have reverted to the Old Pension Scheme (OPS), which is viewed as a burden on the next generation for current political gain.

3. Power Sector Distress: Mounting subsidies for distressed DISCOMs (reaching Rs. 2,62,000 crores nationally) are causing enormous stress, with states like Tamil Nadu, Rajasthan, and Karnataka showing high subsidy burdens.
4. Vanity Projects: Massive capital expenditure on profligate, high-cost vanity projects (such as Kaleshwaram in Telangana) often fail to create durable, wealth-creating assets.
5. Data Gaps: Significant gaps remain in the availability and accuracy of fiscal data, with states reportedly mastering the art of fudging the accounts.

3. Proposed Framework for Fiscal Prudence

- The Golden Rule: Governments should implement a roadmap to ensure nil revenue deficits as a precondition for borrowing. Resources should be borrowed only for wealth-creating assets, not current consumption.
- Utilizing Article 293: The Union should leverage Article 293 of the Constitution more effectively to ensure fiscal discipline. It was proposed that an independent unit be established within the C&AG (similar to the UK's Office for Budget Responsibility) to provide binding recommendations on debt approvals.
- Accounting Reforms: States should switch to an accrual-based accounting system and create sinking funds from current budgets to cover future liabilities.
- Infrastructure Oversight: High-value capital expenditure projects should undergo mandatory techno-economic cost-benefit analysis before approval.

4. Concluding Remarks

Dr. Narayan concluded with a reflection on the intergenerational responsibility of debt. Referencing Thomas Jefferson, the Chair emphasized that no generation has the right to contract debts greater than can be paid off during its own existence, particularly when those debts are not backed by durable asset creation. The first lesson of politics—to disregard the scarcity of resources—must be replaced by a commitment to protecting the country's long-term financial stability.

Panellist 1: Sri. Haseeb Drabu

Haseeb Drabu began by strongly objecting to the Chairperson's assertion that state budgets are characterized by fudging. Drawing on his experience as a former Finance Minister who presented five budgets, he argued that states are often unfairly scrutinized while the Union government's own accounting practices are overlooked. He noted that the Union has historically utilized various methods to cover deficits, such as raising RBI dividends and shifting money from the oil pool account. Drabu contended that the perception of the Centre as a 'paragon of fiscal virtue' is inaccurate, and that most significant reforms have actually originated at the state level.

1. The Shrinking Divisible Pool and Statutory Transfers

- Nature of the Commission: Invoking a quote by the economist Guhan, Drabu described the Finance Commission as "a dog that barks at the states, barks at the centre and bites the states". He identified a systematic trend where successive commissions have reduced the divisible pool, mirroring the decline of the Gadgil pool in favour of centrally sponsored schemes.
- Cesses and Surcharges: He criticized the Union's increasing reliance on cesses and surcharges—which have risen from 10% to 20%, particularly post-GST—as a method to pre-empt resources from the divisible pool.
- Total Statutory Transfers: He argued that the focus should shift from simple devolution to total statutory transfers (devolution plus grants) because money is fungible within a state budget.
- Taxation Shift: RD grants were originally designed in a closed economy for consumer-oriented states. With the transition to destination-based GST, consuming states have naturally benefited, but removing RD grants without adjusting other criteria ignores the total statutory transfer needs of the states.

2. The Rise of Coercive Federalism

A major theme of Drabu's presentation was the shift toward coercive federalism and the systematic disempowerment of state legislatures.

- Centralization through Resource Transfers: The current regime, characterized by PM-led schemes, promotes centralization rather than decentralization. Drabu described this as coercive federalism, where resource transfers are used to subvert state autonomy and even disempower state legislatures through the creation of new layers like District Government Councils (DDCs).

- Accountability: Drabu rejected the idea that the Centre should monitor or name and shame states, asserting that states are legitimate governments accountable to their own people, not to central bureaucrats.

3. Union Shortfalls and State Volatility

Drabu provided evidence that state fiscal slippages are often the direct result of Union-level failures.

- Revenue Gaps: He cited an example for 2025-26 where the Union's gross tax revenue fell 2 lakh crores short of its estimates. Because states are entitled to 41% of that pool, they suffered a major revenue shortfall through no fault of their own, which manifests as a budget gap.
- Volatility: To combat this, he proposed the establishment of a minimal guarantee devolution or a corpus to ensure stability and predictability in state budgets.

4. Proposals for a New Federal Compact

Drabu concluded by advocating for a broader definition of federalism that extends beyond mere fiscal devolution:

- Broadened Federalism: He called for the introduction of regulatory federalism, resource federalism, and monetary policy federalism, noting that states currently suffer the consequences of monetary policy decisions (like interest rates on borrowings) without having any formal input.
- Lateral Federalism: Rather than states constantly looking up to the Union, Drabu suggested a move toward lateral federalism, where states cooperate horizontally, share best practices, and form different coalition combinations to strengthen the federal structure.
- Market Discipline: He agreed with the view that the market should lead the interest rate spreads based on the fiscal performance of states, providing a more transparent sense of fiscal health than central monitoring.

Panellist 2: Prof. N.R. Bhanumurthy

Prof. N.R. Bhanumurthy observed that while the 16^{th} FC report is generally well-written, it contains several technical and conceptual mistakes. The report's primary structural highlights include retaining the vertical devolution at 41 per cent, introducing a significant shift in horizontal devolution criteria, and recommending the discontinuation of revenue deficit grants (RDGs) and sector-specific grants.

1. Macro-Fiscal Consolidation

Prof. Bhanumurthy emphasized that true fiscal consolidation requires bringing the revenue deficit to zero to ensure macro stability. Prof. Bhanumurthy proposed a clear causal line for sustainable public finance:

- Capital Expenditure → GDP Growth → Total Revenues → Revenue Expenditure. By following this line rather than expanding through revenue deficits, governments can actually generate more resources for revenue expenditure in the long run.

2. Vertical Devolution and the Importance of Table 7.4

- Actual Transfers: After technical adjustments, the data shows that devolution to states was exactly 41% during the 15th FC period and 42% during the 14th FC period.
- Policy Recommendation: It was suggested that both state and union governments bring this specific issue to the table regularly to eliminate confusion regarding actual transfers.

3. Horizontal Devolution and the Efficiency Metric

A major highlight of the report is the return of efficiency criteria to the devolution formula.

- The Square Root Method: To prevent shocks to states and moderate dispersion between high and low performers, the Commission used the square root of GSDP rather than actual GDP. This method smooths the tails of the distribution to maintain stability across commissions.
- Critique of GDP as Efficiency: Prof. Bhanumurthy critiqued using GDP as a surrogate for efficiency, arguing that GDP represents a tax base rather than tax effort.

- Over-Identification: He noted a technical error where the Commission used one variable (GDP) for two different targets—income distance and contribution—leading to potential over-identification.
- Preferred Metric: Future frameworks should move toward outlay-outcome expenditure efficiency rather than simple production efficiency.

4. Economic Measurement and Data Gaps

- Lack of ICOR Estimates: There are currently no reliable estimates for Incremental Capital Output Ratio (ICOR) at either the union or state levels.
- KLEMS Data: While the RBI produces KLEMS data, it currently only covers 15 states, limiting its utility for a comprehensive national assessment.
- GSDP Uniformity: Only six or seven states are currently implementing the Dholakia Committee recommendations. Achieving uniformity in GSDP estimation across all states is critical for accurate fiscal assessments.

5. Macro-Fiscal Framework and Future Risks

- FRL Violations: Contrary to the popular narrative that only the Union violates Fiscal Responsibility Laws (FRLs), the 16^{th} FC report clarifies that many states also routinely violate their respective FRLs.
- The Pay Commission Shock: The most anticipated fiscal risk is the next Pay Commission. Estimates suggest this could push the public debt-to-GDP ratio up by 4% to 5%, potentially destabilising the Commission's current fiscal framework.
- Migration: Despite being discussed at various conferences, the issue of internal migration was notably absent from the final devolution package.
- Expenditure Rationalisation: The proliferation of cash transfer schemes and freebies (comprising 47% of cash transfers) at the state level remains a significant drag on finances.
- New GDP series: Revision of GDP base year to 2022-23 would have some impact on overall macro-fiscal situation.

Panellist 3: Sri. Krishna Bhaskar, IAS

Sri. Krishna Bhaskar prefaced his remarks by noting his current role in the power sector (where he has served for 16 months) following previous experience in the finance and industry departments. He acknowledged the constraints of being a current government official and clarified that his insights were specifically informed by his experience in the finance and power sectors.

1. The Relationship Between Power and Responsibility

He offered a logical inversion of the common adage "with great power comes great responsibility." He argued that while responsibility may not always grant power, the lack of responsibility will inevitably lead to a lack of power. This served as a framework for his critique of current fiscal management within state utilities.

2. Power Sector Dynamics: Serial Borrowings

Addressing the immediate fiscal challenges, Bhaskar described the power sector as having become a game of serial borrowing. He suggested that the sector's current trajectory requires all stakeholders to get their act together to move toward a more sustainable path.

3. Shifting Focus: From Flow to Stock

A central theme of his presentation was the need for a more comprehensive approach to measuring fiscal health:

- Public Sector Balance Sheets: He argued that the future of fiscal stress management must move beyond traditional budgets and begin examining public sector balance sheets. This includes not just power utilities, but also water utilities, transport corporations, and other institutional entities.
- Measuring Accumulated Risk: He noted that current systems are proficient at measuring flow (budgetary movements) but fail to maintain a consolidated view of the stock—the accumulated risks and assets. He described the current state of sector management as one of lived anxiety, where risks are accumulating faster than they are being rigorously measured.

4. Policy Recommendations for Fiscal Reform

- Mandated Deficit Ratios: He suggested that state governments should consider mandating revenue-to-fiscal deficit ratios for power and water utilities, similar to the metrics used for general state finances.
- Borrowing Linked to Reform: He advocated for a system where additional borrowing space is explicitly linked to measurable reforms. He believes this linkage is critical to addressing the long-term future of the sector.

5. Operational Insights and Critique of Lending Practices

In response to the Chair's comments on solar power and utility debt, Bhaskar provided further operational and institutional context:

- Power Purchase Agreements: The state is locked in expensive Power Purchase Agreements
- Peak Load: In better management of power during peak load hours, the state has saved around Rs. 1,228 crores.
- Critique of REC and PFC: Bhaskar offered a sharp critique of the REC (Rural Electrification Corporation) and PFC (Power Finance Corporation), accusing them of being too generous with power corporation loans. He argued that their willingness to provide liberal credit has allowed states to delay necessary reforms.

Panellist 4: Sri. P.V. Ramesh, IAS (Rtd.)

Sri. P.V. Ramesh highlighted a distinct disadvantage for states within the 16th Finance Commission's (SFC) recommendations. While the Union has a clear roadmap for consolidation (moving from 4.4% to 3.5% over five years), states are largely boxed in with a 3% borrowing limit relative to their GSDP. He identified several factors compounding this challenge:

- The 41% Devolution Limit: This figure does not include cesses and surcharges as part of the divisible pool.
- Grant Reductions: The elimination of revenue deficit grants and the absence of state-sector-specific grants.
- Financial Burdens: The requirement for states to make a 40% contribution to centrally sponsored schemes further strains fiscal consolidation efforts.

1. The Loss of Institutional Safeguards

Reflecting on his tenure as Finance Secretary of Andhra Pradesh (2011–2017), Ramesh argued that the abolition of the Planning Commission marked a negative transition for state fiscal management.

- The Planning Commission as a Safety Guard: He noted that the Commission previously provided essential guardrails and mentoring, acting as a buffer against political pressure for profligate spending.
- Post-Bifurcation Transition: He credited the 14th Finance Commission’s revenue deficit grants and specific assistance with smoothing the difficult transition for Andhra Pradesh following its bifurcation.

2. Power Sector and State-Owned Enterprise (SOE) Reforms

- Simplistic Privatisation: He argued that the 16th FC’s recommendation to privatise DISCOMs is a too simplistic panacea that fails to address structural policy issues.
- Structural Failures: He argued that unbundling and corporatization in the early 2000s occurred only in theory, as utilities continue to be run like government departments without fiscal discipline.
- The Subsidy Trap: He identified electricity as the easiest subsidy for political parties to give away to various sectors, noting that a fundamental restructuring of policy is required rather than just a shift in ownership.

- Inefficient Disinvestment: Regarding SOEs, he criticized the trend of disinvesting profitable enterprises while leaving non-performing or structurally challenged ones untouched. He cited the sales of HPCL to ONGC and REC to PFC as examples that were idiotic from a national developmental perspective.

3. Innovative Financial Engineering and Revenue Realities

A significant portion of his remarks addressed the profligacy and lack of transparency in modern state finances.

- Bypassing Oversight: Ramesh expressed alarm at the innovative financial engineering used by states to raise capital beyond the reach of Article 293(3) and the CAG.
- The Case of Beverages Corporations: He cited Andhra Pradesh's use of corporations to canalize and securitize excise revenues for the next decade to fund welfare programs as a prime example of this trend.
- Revenue Stagnation: He pointed out the low revenue elasticity of GST and the near-zero growth in excise and VAT in some states, which further complicates fiscal management.

4. Future Obligations and Ethical Governance

- Modern Drivers: The fiscal architecture must address demographic transitions (fertility decline and migration), technological transformations (AI), and climate change mitigation obligations.
- Procurement Integrity: He noted a complete disregard for the integrity of the procurement process and a lack of critical techno-economic analysis as capital outlays grow, leading to an exponentially increasing potential for moral hazard.

Technical Session – III: Summary of Q&A Session

1. Fiscal Policy, Data, and Economic Theory

The session highlighted significant concerns regarding the transparency of financial data and the theoretical frameworks used for fiscal targets.

- Data Transparency: Dr. Jayaprakash Narayan noted a solid mess where public sector banks refused to provide state debt information to the CAG, citing client confidentiality.
- Savings and Deficits: Prof. N.R. Bhanumurthy observed that the 6% combined fiscal deficit target (Centre and States) was established when household savings were 10–11%, but with savings now below 6%, these targets are no longer sustainable.

2. The Freebie vs. Welfare Debate

Participants debated the political and economic impact of short-term welfare measures.

- Redefining Welfare: Dr. Narayan noted that he preferred the term individual short-term welfare measures over freebies, arguing they are necessary but must follow three precautions: they must be sustainable, capacity-enhancing, and avoid market distortions like the overproduction of rice.
- Political Realities: Dr. Vijay Korra noted that while the participants critique these measures, politicians actually follow public sentiment. Divya Tiwari questioned why do politicians take the path and how to convince the politicians to take a different path.
- Social Sector Scapegoat: Prof. Sudarshan Rao observed that to meet rule-based FRBM targets while announcing new expenditure schemes, governments often make social sector spending the scapegoat.
- Scheme Rationalization: Prof. Bhanumurthy emphasized that states like Karnataka manage up to 1,800 schemes, and without rationalizing these lines in the budget, resources for new investments will remain scarce.

3. Sectoral Critiques: Irrigation and Education

High-expenditure sectors were scrutinized for their cost-to-benefit ratios and actual outcomes.

- Irrigation (Kaleshwaram): Dr. J. Srinivas defended the Kaleshwaram project, noting it raised groundwater levels and turned Telangana into a rice bowl.

Conversely, Dr. Narayan critiqued its cost, stating an annual capex of 60,000 to 70,000 rupees for a net income increase of only 15,000 to 20,000 rupees is ridiculous.

- Education: While Dr. Srinivas highlighted a lack of basic infrastructure like toilets and classrooms, and Dr. Malik questioned Dr Narayan whether education expenditure is high, if so, should it be reduced? Dr. Narayan pointed to appalling outcomes and structural inefficiencies, such as recruiting 11,000 new teachers despite declining student populations and some schools having more teachers than students.

IV. Salaries and Intergenerational Equity

- Salary Pathologies: Dr. Narayan warned that Telangana is impoverishing itself by paying salaries 30% higher than the Government of India, citing government drivers earning 80,000 rupees and teachers earning 1,50,000 rupees.
- Debt Moral Hazard: He argued that current generations have no right to burden children with debt for today's consumption without providing them the earning capacity to pay it back.

FIRESIDE CHAT

1. The Institutional Character of the Finance Commission

The discussion began by addressing whether the Finance Commission (FC) has become too technocratic. Historically, the FC was led by distinguished jurists or eminent politicians, but since the late 1990s, it has shifted toward professional economists.

- Political vs. Technical Balance: Dr. Montek Singh Ahluwalia argued that there is significant merit in having an 'economic savvy politician' as Chairman. Such a leader understands the environmental realities and the practical problems states face, having been there themselves. He suggested that while economists are necessary, they are quite cheap and can be hired as support staff; the Commission's real challenge is triggering serious evaluations of fundamental fiscal problems, which may actually need to happen outside the formal system, such as in the business sector.
- The Generalist Defence: Dr. D. Subbarao offered a defence of the IAS model, where a generalist with a breadth of knowledge sits at the top of the policy pyramid, supported by specialists. He posited that an ideal commission would be led by someone with knowledge of the front lines of the country, paired with experts in fiscal matters.

2. The Evolution of Federalism and the Vibrant Debate

Dr. Sanjaya Baru observed that the intense federalism debates of the 1980s and 90s have largely been silenced.

- Political Homogeneity: Dr. Subbarao attributed this decline to the fact that the NDA now occupies most of the political space in India, leaving very little non-NDA space for dissent. While states within the NDA likely have grievances, they are not expressing them openly.
- Historical Consensus-Building: To illustrate a different era, Dr. Subbarao recounted a 1997 meeting where Chief Ministers were demanding more money from the Centre. He highlighted the role of Jyoti Basu, who, despite wanting more for West Bengal, eventually walked around the table to persuade a hesitant Chandrababu Naidu to agree to a consensus, acknowledging that the Centre also needs money. This suggests a current lack of state leaders willing to take such a broader national role.

3. Institutional Voids: NDC, NITI Aayog, and Planning

A major concern raised was the defunct status of the National Development Council (NDC), which has not been convened by the current Prime Minister.

- Critique of the NDC Model: Dr. Subbarao argued the old NDC was often non-functional and purely political, used by Chief Ministers to give speeches for the media rather than to advance policy. He called for a new business-like forum where the Prime Minister and Chief Ministers meet away from the media to focus on a limited national agenda.
- State-Led Initiative: Dr. Ahluwalia noted that with the Planning Commission gone, there is no ostensibly independent institution to mediate these issues. He urged Chief Ministers to stop waiting for the Centre and instead use the NITI Aayog framework to demand meetings and submit technically rigorous papers to force the system to react.

4. Structural Reforms and the Governance of States

- Breaking Up Large States: Dr. Ahluwalia strongly advocated for breaking up large states like Uttar Pradesh and Bihar. He argued that achieving a Viksit Bharat is tied to the quality of cities, and creating new states allows for the establishment of new capitals and more effective land acquisition for urban expansion.
- Economic Impact of Division: While Dr. Subbarao was sceptical of the administrative costs of smaller states, Prof. Revathi pointed to studies showing that states like Chhattisgarh, Jharkhand, and Telangana have clocked high growth rates following their separation.
- States as Reform Catalysts: Dr. Ahluwalia challenged the idea that states are just impediments to reform. He noted that any Chief Minister could independently reduce unnecessary compliances by 70% without Central approval to steal a march on other states, yet few have done so.

5. Sectoral Challenges: Power, Agriculture, and Labour

- Power Privatization: Dr. Ahluwalia expressed strong support for privatization in distribution, citing Delhi's improved power supply as a prime example of Viksit infrastructure. He noted that even the current FC Chairman, Arvind Panagariya, supports privatization while acknowledging that states like Gujarat and Haryana have managed well without it.
- Agriculture and Trade: There was a call for more transparent conversion of land from agricultural to non-agricultural use. Dr. Ahluwalia argued that opening up to trade is in the interest of farmers, noting that India is already a net exporter of agricultural goods and that farmers will produce whatever there is a demand for if the market is open.

6. The Political Economy of Populism and Freebies

The chat concluded with a sharp critique of competitive populism or Revadi culture.

- Shifting Costs to the Future: Dr. Ahluwalia warned that populism is a global danger where costs are shifted to future generations while immediate benefits are mundane.
- The Message of Incompetence: Dr. Subbarao argued that when a leader offers direct cash transfers, it is an admission of political incompetence. It sends a message that the leader is unable to improve long-term livelihoods through governance or state management.
- Final Synthesis: Dr. Sanjaya Baru summarized the session by stating that fiscal irresponsibility is the flip side of political incompetence. He argued that politicians offer short-term cash transfers when they are unable to improve long-term livelihoods, concluding that fiscal policy is politics, and one cannot have the right fiscal policy with the wrong politics.


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on
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K.Ramakrishna Rao
G.R. Reddy
Ajay Narayan Jha
Manish Gupta

Centre for Economic and Social Studies (CESS), Hyderabad

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