Federalism and social policy

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THE last five years have heralded a new phase in India's fiscal federalism reflected in several changes in the planning and design of Inter-Governmental Fiscal Transfers (IGFTs). In August 2014, the Planning Commission – an apex body responsible for formulating central plans for national development – was disbanded. It was replaced by the NITI Aayog, which unlike its predecessor moved away from a centralized planning approach to one focused on fostering 'cooperative federalism' by bringing states together.[1]

In February 2015, Government of India (GoI) accepted the 14th Finance Commission (FFC) recommendations aimed at strengthening fiscal decentralization. Specifically, in accordance with its constitutional mandate to share the proceeds of centrally levied taxes with states, the FFC enhanced state's share in the divisible pool taxes[2] by 10 percentage points. Moreover, the FFC provided unconditional transfers including an unprecedented Rs 2.87 crore over five years directly to local bodies, a departure from previous practice of giving sector specific grants. Further, by taking a comprehensive view of all transfers[3] and concerned about the intrusion by GoI in states' domain, it recommended reforms in the design and implementation of Centrally Sponsored Schemes (CSSs) a primary vehicle through which GoI financed and controlled social policy spending in India.[4]

Its recommendations were accompanied with constitution of a sub-group of chief ministers on restructuring CSSs. The report made key recommendations including scheme rationalization, need for a transparent criterion for fund allocation, increasing fiscal flexibility to states by earmarking 25% as flexi-fund, and allowing states to choose their priority areas within a CSS or across CSSs.

Institutionally, these events aimed to create a clear division of IGFTs. General purpose transfers focused on reducing the vertical imbalance of states by *enabling* states to provide comparable levels of public service were now in the exclusive domain of the FFC. In contrast, with the disbandment of the Planning Commission, the onus of specific purpose transfers given to *ensure* minimum standards of public services fell on central ministries.[5]

Fiscally, these reforms aimed at increasing untied funds to states enabling them to demarcate their own priorities in keeping with first principles of decentralization to ensure local preferences are captured. Simultaneously, reforming CSSs which had been plagued with issues of overlapping objectives, unpredictable fund flows, limited spending autonomy and cumbersome procedures (the National Health Mission had 2000 budget line items for reporting plans and expenditures!) were necessary to ensure effective implementation of national priorities.

To what extent have these reforms been implemented in spirit and what are the consequences of these changes on social policy? Through an extensive review of Union budgets and planning documents, and 20 state budgets and finance accounts, this paper seeks to present a descriptive account of emerging trends and the unfolding dynamics of central-state relations in the context of social policy investments in India. Specifically, it draws on three main sources of information. First, data on budgets of the Union government and key schemes has been used to understand Union government perspectives. Second, actual receipt and expenditure data compiled for 20 states sheds light on state responses. Finally, the study draws on a series of interviews conducted with bureaucrats in the finance and planning departments to understand the evolving nature of fiscal federalism.[6]

The study covers the period from 2012-13 till 2016-17[7] (and 2017-18 for Union government transfers); 2012-2015 forms the currency period of the 13th Finance Commission (TFC) and the period from 2015-16 till 2016-17 is the currency period of the FFC.

The Union Budget took the first step in implementing the FFC reforms by increasing tax devolution to states from Rs 3.37 lakh crore in 2014-15 (actuals) to Rs 5.06 lakh crore in 2015-16.[8] To accommodate this increase, given the limited fiscal space available with the Union government, there was a reduction in specific purpose transfers to states, particularly a cut in the number of, and funding for, CSSs. Thus, eight schemes were delinked from GoI support, 24 schemes were to receive lower GoI funding with general category states expected to contribute a greater share and the remaining 31 schemes remained unchanged. Central assistance to state plans including for CSSs, reflected a drastic decrease from Rs 2.64 lakh crore in 2014-15 to 1.96 lakh crore in 2015-16 budget estimate (BEs).

What followed immediately after this announcement, however, was a near consensus in favour for reverting to a centralized rather than decentralized financial architecture for social sectors. In budget speech after speech, state governments accused GoI of undermining its fiscal role by decreasing funding for CSSs.[9] Similar comments were also echoed by many in the NITI Aayog meetings on CSSs, as well as by civil society members.[10]

Consequently, the Union government through passing supplementary budgets increased allocations for many previously cut CSSs from Rs 1.96 lakh crore in 2015-16 Budget Estimate (BEs) to Rs 2.03 lakh crore in 2015-16 (Actuals).

The increase in CSSs due to change in fund sharing ratios and through passing of supplementary budgets, has meant that the change in the composition of transfers is not as stark as expected and the overall composition of tied and untied grants remains roughly the same. For instance, it is estimated that changed fund sharing ratios for CSSs led to an average burden of 0.69% of GSDP amongst general category states, while the gain from tax devolution was 0.71% of GSDP in 2015-16,[11] and same is 0.68% and 0.69% of GSDP respectively in 2016-17.

From the perspective of CSSs, while schemes were reclassified as 'core of the core', 'core' and 'optional', there with no real change to implementation. Planning meetings of education and health programmes continued as before and GoI's notification of allocating 25% as flexible, discretionary funds, were not reflected in planning documents. Instead, in fact, GoI directed priorities by significantly increasing allocations and issuing instructions to concentrate efforts on key priorities of the ruling NDA party such as Swachh Bharat Mission (SBM-G) and Pradhan Mantri Awaas Yojana. Alook at the change in quantum of GoI funds released for CSSs clearly demonstrate a focus on GoI priorities. (Table 1)

TABLE 1
GoI Releases for Key CSSs

	GoI release in 2014-15 (in Rs crore)	*GoI release in 2015-16 (in Rs crore)*	*GoI release in 2016-17 (in Rs crore)*	*Change between 2014-15 and 2016-17*
SBM-G	2730.30	5731.04	10587.8	288%
PMAY	10423.62	9715.781	15748.505	51%
MGNREGS	32139.1	35974.64	47411.72	48%
NHM	17160.31	17462.89	18424.23	7%
MDM	10465.21	9132.31	9478.61	-9%
SSA	24030.16	21590.14	21657.45	-10%
ICDS	14688.48	13342.36	12257.35	-17%
NRDWP	9301.87	4264.58	5931.9	-36%

Source: Collated individually from scheme portals.

So where are we today? Theoretically, states have received a greater share of tax devolution from the Union. A comparison between the TFC period to FFC period shows that as a percentage of Union governments Gross Tax Revenue (GTR),[12] devolution has increased from 27% in 2014-15 to about 35% in 2016-17. As a proportion of GDP, this reflects an increase from 2.9% in 2012-13 to 4% in 2017-18. The composition of financing for many states, however, has not changed significantly, and design of CSSs continue as before and in fact, the increase in state share for many CSSs has led to further ring-fencing of untied money back to schemes.

More importantly, with the introduction of several cesses[13] and surcharges, there has been a decline in the share of the divisible pool in total GTR. In 2012-13, the divisible pool constituted 88% of the GTR. This decreased to 79% in 2016-17. Thus, despite an increase in tax devolution from GoI to the states, it has not kept up with the growth in the tax base, resulting in states losing out on the increased revenues of the Union.

The previous section establishes that while states in theory had greater untied resources available to them, the centralization trend by the Union government continued to creep in. So how did states respond? State budget data suggests that overall investments for social sector have not fallen. An analysis of 20 state budgets indicate that the total quantum of funds for the social sector increased 35% in nominal terms (38% in real terms) from Rs 6.52 lakh crore in 2014-15 to Rs8.88lakh crore in 2016-17. It is useful to analyse social sector expenditures as a proportion of GSDP as it reflects growth in social sector relative to the state's economy. The analysis finds significant differences across states. States with lower per capita NSDP at current prices predominantly spent 9-14% of their GSDP on social services,[14] while those in the top spent between 4-7%.[15]

However, these overall proportions between 2014-15 (the year prior to the implementation of the recommendations and 2016-17 (two years after the implementation) have remained roughly constant at around 7%, reflecting only a 0.5 percentage point increase for all states combined.

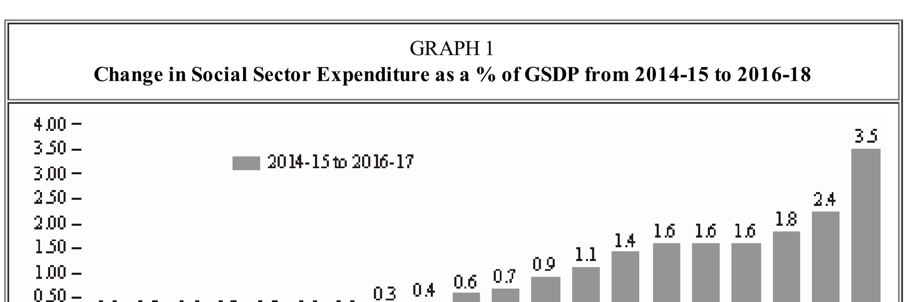
Importantly, the overall expenditure trend is similar regardless of development levels. Himachal Pradesh, for instance, has a high per capita income of Rs 1,34,376 and high literacy levels of over 80%[16] and low infant mortality rate[17] (IMR). Chhattisgarh, on the other hand, is much poorer with a per capita income of Rs 84,767 in 2015 and weaker performance on social indicators. Yet, social sector expenditure as a proportion of GSDP increased by around one percentage point in both states.

Finally, a disaggregation of the composition of social sector expenditure over the three years from 2014-15 till 2016-17 also does not reflect stark changes.

The analysis above suggests that from the perspective of social policy, the effort to restructure the federal framework for social policy financing through greater fiscal decentralization has not resulted in any major disruptive shifts in social policy expenditure at the sub-national level. Rather, both the Union and state governments have preferred to maintain the status quo.

What explains these trends? Part of it lies in the very nature of India's fiscal federalism. The political context of its birth – the Partition in 1947 and the need to bring states together – resulted in several centralizing features embedded in India's federalism. Scholars have often described India as 'quasi federal' or one with a 'centripetal bias with the Centre having overwhelming and overriding economic powers.'[18] This inherent centralization has persisted even during periods of increased regionalization of India's politics and shifts towards greater state autonomy.[19]

GRAPH 1
Change in Social Sector Expenditure as a % of GSDP from 2014-15 to 2016-18



Source: Authors calculations based on state budgets. GSDP data from Central Statistical Organization.

For social policy, this is reflected in the continued presence of specific purpose transfers even in areas under state control. FFCs own analysis between 2005-2012 showed that GoI spending on state subjects increased from 14%-20% and its spending on Concurrent subjects increased from 13%-17%.[20] From GoI's perspective the continuance of CSSs serve as important patronizing instruments to aid political objectives of the ruling parties including to gain favour with states and the electorate by expanding its reach to spend on state subjects.[21] It is then no surprise that past attempts to rationalize CSSs since as early as 1969, have been met with limited enthusiasm.

With the disbandment of the Planning Commission and control of CSSs now resting with central ministries, they are also important instruments of ensuring control by central ministries. Thus, when the budget for Integrated Child Development Services (ICDS) was cut in 2015, Maneka Gandhi, Minister for Women and Child Development, was quick to lobby for additional allocations.[22] Attempts by central ministries to exercise control by controlling planning and budgeting is also reflected in the local body grants recommended by the FFC. While the FFC called for no conditionalities to be placed on the release, a series of orders passed by Ministry of Finance and Ministry of Panchayati Raj laid down a framework for states of preparing detailed plans (Gram Panchayat Development Plans) which converged FFC funds with other Government of India CSSs.

Finally, controlling social policy by the Union government is justified based on a need to ensure minimum basic standards and an argument that state capacities for planning and implementation remain weak.

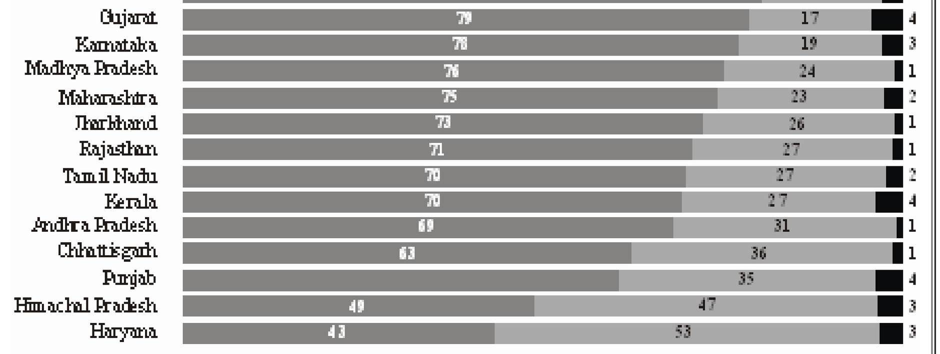
States too seem to prefer this status quo. Politically, a CSS set-up allows chief ministers to leverage their role as implementers to take credit for central schemes when implemented well or blame the Union government in case of failed programmes. The launch of the Mukhyamantri Saath Nishchay Programme by Bihar Chief Minister Nitish Kumar is one such example. Touted as a flagship programme of the chief minister, the scheme subsumes several existing CSSs including for drinking water and sanitation.[23]

Bureaucrats too prefer the CSS model. Interviews with state officials in finance and social sector line departments repeatedly argued for important role of CSSs in 'ring-fencing' money for the social sector, without which it would be made by the finance department entirely on directions from chief ministers with political rather than policy considerations in mind. In fact, with many CSSs implemented through specially created societies that function parallelly to state line departments, social sector bureaucrats are often more accountable to central line departments than to their own state governments.

Further, it is indeed interesting that the argument regarding weak state capacity is held not just by the Union government to continue control but was also regularly repeated by state officials during our interviews. Oft repeated comments included it being far easier to invest in social sector through CSSs as 'they come with clear guidelines and rules.'[24] At the same time, studies conducted by Kapur and Dasgupta[25] demonstrate that states often don't have an incentive to invest in building local capacity, thereby legitimizing the need for increased centralization.

So where do we go from here? In the short run at least, a significant shift to a decentralized federal architecture is unlikely and specific purpose transfers will continue to be an important source of financing for social policy.

GRAPH 2



Source: Accountability Initiative, Budget Briefs, Samagra Shiksha 2019-20, CPR.

Yet as several studies have shown, the deeply centralized architecture of the CSS model has failed to achieve desired results. A recent study on the impact of the ICDS scheme on access and equity found that while over-all access had improved, the scheme had failed to reach the poorest quintiles of the population, particularly in states with the largest malnutrition burden.[26] These differences exist not just within a state but even across states, putting the effectiveness of CSSs in ensuring states provide basic services into question. An analysis of the NHM found that despite the original objective of providing additional resources to states which needed them, complexities in design and processes meant that states with poorer health indicators did not necessarily get larger per capita transfers. The same was true for Sarva Shiksha Abhiyan (SSA), where per-child expenditures were positively related to per capita GSDP and not need, indicating that CSSs did not have the desired equalizing effect.[27]

A possible middle ground then can be by undertaking the reforms as suggested by the NITI Aayog's Committee on Restructuring CSSs. The recently launched Samagra Shiksha – an overarching programme for the school education sector extending from pre-school to class 12 by merging previously independent CSSs – is one such example of reform. In theory the scheme allows states to prioritize interventions and sectors (elementary/secondary) as per their need. Preliminary evidence of the scheme budget shows that indeed states (albeit guided by GoI) are making decisions in keeping with their specific needs. Thus, while Uttar Pradesh and Bihar which continues to lag in elementary education allocated over 80% of their Samagra Shiksha budget for elementary education, states such as Haryana and Himachal Pradesh have also focused on secondary education, allocating over 40% to the same. (See Graph 2)

Such systematic rationalization and increased flexibility in design of CSSs, along with simplification of procedures, could go a long way in increasing fiscal decentralization to states and enabling them to take decisions for their social policies.

This, however, will need to be coupled with an institutional mechanism – like the Inter-State Council as envisaged by the FFC, which allows for a more holistic planning process for specific purpose transfers, rather than the current approach of discussions with individual line ministries. It may in turn allow for states to build their own planning capacities and thus could pave the way for the next phase of fiscal decentralization – one with greater alignment with local preferences and therefore greater accountability of social policy outcomes.

* This paper draws from a paper co-authored titled, 'The Centralization Vs Decentralization Tug of War and the Emerging Narrative of Fiscal Federalism for Social Policy in India', *Journal of Regional and Federal Studies* 29(2), 2018, pp. 187-217, DOI: 10.1080/13597566.2018.1511978.

Footnotes:

1. http://niti.gov.in/content/overview

2. Divisible pool comprises total central taxes minus the revenue from cesses and surcharges and cost of collecting the taxes.

3. Previous commissions focused on tax devolution and non-plan grants-in-aid.

4. Finance Commission, 'Report of the Fourteenth Finance Commission', GoI, New Delhi, February 2015.

5. M.G. Rao, 'Redesigning the Fiscal Transfer System in India' presented during the roundtable on *Fiscal Federalism in India: Contemporary Perspectives* at the Madras School of Economics, Chennai on February 22-23, 2019. Chennai.

6. See Yamini Aiyar and Avani Kapur, 'The Centralization vs Decentralization Tug of War and the Emerging Narrative of Fiscal Federalism for Social Policy in India', *Journal of Regional and Federal Studies* 29(2), 2018, pp. 187-217.

7. Expenditure analysis has been restricted to 2014-15 as the base year. This is because prior to 2014, funds for many CSSs (amounting to Rs 1,12,708 crore in 2013-14) were transferred directly to implementing agencies, by-passing state budgets making it difficult to compare budgets prior to 2014.

8. Government of India, Union Budget Documents, for 2016 and 2017. Available at: www. indiabudget.nic.in (accessed on 31.03.2019).

9. See for instance budget speeches by Karnataka and Odisha finance ministers.

10. https://www.thehindu.com/opinion/lead/nehruvian-budget-in-the-corporate-age/article6959755.ece

11. H.K. Amarnath and Alka Singh, 'Impact of Changes in Fiscal Federalism and Fourteenth Finance Commission Recommendations: Scenarios on States Autonomy and Social Sector Priorities', National Institute of Public Finance and Policy, Working Paper 257, New Delhi, March 2019.

12. Gross Tax Revenue of the Union government in this analysis is net of cost of tax collection.

13. For instance, a Krishi Kalyan cess and Swachh Bharat cess was introduced in 2016 (now abolished), and a 4% health and education cess in 2018.

14. For instance, Bihar (14), Jharkhand (12), Chhattisgarh (10), Madhya Pradesh (10), Odisha (10), Assam (10), Uttar Pradesh (10), Andhra Pradesh (9), Rajasthan (9).

15. Uttarakhand (7), Telangana (7), Kerala (6), Karnataka (6), Gujarat (5), Tamil Nadu (5), Haryana (5) and Maharashtra (4).

16. Literacy rate as per Census 2011.

17. IMR from Sample Registration System. Collated data available online at: http://niti.gov.in/content/infant-mortality-rate-imr-1000-live-births

18. K. Wheare, *Federal Government.* Oxford University Press, New York, 1964; M.G. Rao and N. Singh, *The Political Economy of India's Fiscal Federal System.* Oxford University Press, New Delhi, 2005.

19. T. Srinivasan and J. Wallack, 'Inelastic Institutions: Political Change and Intergovernmental Transfer Oversight in Post-Independence India'. *India Policy Forum* 7, 2011, pp. 203-251.

20. Calculations for FFC in M.G Rao, Central Transfers to States in India: Rewarding Performance While Ensuring Equity. NITI Aayog, New Delhi, 2017.

21. Ibid

22. https://www.firstpost.com/politics/after-50-fund-cut-maneka-gandhi-to-ask-jaitley-for-more-money-for-women-children-2164573.html

23. For instance, in letter number 741 dated 01.06.2016, Government of Bihar.

24. Interview conducted in Jaipur, Rajasthan, 7 June 2017.

25. A. Dasgupta and D. Kapur, The Political Economy of Bureaucratic Effectiveness: Evidence from Local Rural Development Officials in India. 2017. Available at: doi:http://dx.doi.org/10.2139/ssrn.30 (Last accessed 28.03.2019)

26. S. Chakrabarti, K. Raghunathan, H. Alderman, P. Menon and P. Nguyen, 'India's Integrated Child Development Services Programme: Equity and Extent of Coverage in 2006 and 2016', *Bulletin of the World Health Organization*, February 2019.

27. M.G. Rao, Central Transfers to States in India: Rewarding Performance While Ensuring Equity. NITI Aayog, New Delhi, 2017.