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REPORTS

Central Transfers to States

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CENTRAL TRANSFERS TO STATES (NITI AAYOG REPORT)

Growth and stability of Indian federation critically depends on the convergence of incomes across the States and this can be achieved only when there is a balanced spread of physical infrastructure and human development across the country. To achieve this, it is important to design and implement the transfer system that offsets the revenue and cost disabilities of the states and ensures a required minimum standard of meritorious public services with significant externalities so that people irrespective of their location are able to access these services.

Thus in the following report NITI AAYOG has analyzed the utilization of Central Transfers to States, and challenges related to it.

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CENTRAL TRANSFERS TO STATES (NITI AAYOG REPORT)

Introduction

Mismatch between revenue capacity and expenditure need of sub-national governments is an inherent feature of all federations.

There are wide differences among the States in the capacity to raise revenues as the size of the tax base varies widely. The variations in the tax base among the States results variations in the standards of public services delivered even when the States make uniform effort at raising revenues.

In India, the Constitution recognises the problem of fiscal imbalances. It provides for the appointment of the Finance Commission by the President of India every five years to resolve them by making recommendations on tax devolution and grants in aid of revenues. The Commission's recommendations are placed in the Parliament along with the Action Taken Report by the Ministry of Finance. By and large, the recommendations of the Commission are in the nature of general purpose unconditional transfers though some of the Commissions have made some specific purpose non-matching transfers for activities such as education, healthcare, police and judiciary. Specific purpose grants are mostly given through centrally sponsored schemes administered by various central ministries.

The rationale for general purpose transfers is to *enable* all the states to provide comparable levels of public services at comparable tax rates. The emphasis is on enabling the States and therefore, the transfers are supposed to be unconditional. The objective of specific purpose transfers, on the other hand is to *ensure* minimum standards of public services. The focus in these is ensuring minimum standards. This implies that the transfers are required to be conditional and they should equalise the expenditure levels of the states to achieve the minimum standards in respect of specified services.

The Rationale for Intergovernmental Transfers

Indian economic growth has shown a steady acceleration from just about 3.5 per cent per year during the period, 1950-80 to 5.8 per cent during 1980-2000 and further to 7.4 per cent since 2001-02. Although it decelerated after the global financial crisis in 2008, India is one of the countries which turned around fast and is presently one of the fast growing emerging economies.

Despite the impressive growth performance, its regional spread has been uneven, and even as some of the low income States have been trying to catch up with their more advanced counterparts, inter-state disparities have shown an increase, particularly after the market based reforms were initiated in 1991. The States with better physical and social infrastructure and market friendly governance were able to grow faster.

It is important to accelerate growth and development in the low income States for reasons of both inclusiveness and stability in Indian federation for a variety of reasons. Overwhelming proportion of the poor are concentrated in low income States and therefore, accelerating growth in these States is an important pre-requisite for creating income earning opportunities to them.

While in developed federations, high mobility of population can take surplus labour to capital rich jurisdictions to overcome adverse effects of uneven development, in countries like India the restrictions on mobility caused by linguistic, cultural and other institutional factors makes it important to ensure an even spread of physical and social infrastructures.

Furthermore, acute inter-State inequalities in the levels of living can be a source of instability and unrest.

Regional differences in social and infrastructures can be mitigated either through regional policies or through intergovernmental transfers. In a small country, the Central government can identify the diverse needs for public services and accordingly allocate resources to achieve the required balance. In a large, diverse federation, this has to be mainly achieved through intergovernmental transfers as the lower level jurisdictions are better placed to provide public services according to the diversified preferences of the people. In almost all the federations, therefore, the policy of intergovernmental transfers plays and important role in ensuring equitable access to public services.

The rationale for intergovernmental transfers is to offset the fiscal disabilities of subnational jurisdictions.

There is also a case for transfers to *ensure* that people, irrespective of the jurisdiction they live in receive prescribed minimum standards of meritorious public services or those with high degree of spillovers such as elementary education, basic healthcare, water supply and sanitation and anti-poverty interventions. Such transfers have to be purpose specific, but linked to providing the specified minimum standards.

The Transfer System in India

Article 280 of the Constitution mandates the President to appoint a Finance Commission every five years. The Commission has a Chairman and four other members whose qualification for appointment is laid down in the Finance Commissions (Miscellaneous Provisions) Act, 1951. The terms of reference (TOR) of the Commission are (i) the distribution of the net proceeds of Union taxes between the Union and States and among the States *inter-se*; (ii) grant in aid of revenues to begiven to the States; (iii) measures to augment the consolidated funds of the States to supplement the resources of rural and urban local governments in the States based on the recommendations of the State Finance Commissions and (iv) Any other matter referred to the Commission by the President in the interest of sound finance. Under the last item, a number of tasks have been assigned to the Commission in the past such as setting the fiscal rules and targets for the Union and States, measures to be taken for sustainable development and the protection of ecology and environment, rescheduling and writing off of States' loans, examination of public expenditure management systems, review disaster management systems, strategic approach to public enterprise reform and incentivizing the States to undertake tax reforms.

After the Fourteenth Finance Commission made the recommendations, the entire architecture of the transfer system has changed. A clear distinction has emerged in respect of general purpose and specific purpose transfers in Indian fiscal federalism after the report of the 14th Finance Commission was implemented. All general purpose transfers are now recommended by the Finance Commission and all specific purpose transfers are given by the respective Central ministries. Although the 14th Finance Commission made a recommendation that the design and implementation of specific purpose transfers should be decided by a Committee comprising of the representatives of Central and State governments as well as domain experts (India, 2014, Chapter 12), the Central government has continued the practice of taking decisions on these transfers at the relevant Central ministry level.

a) **General Purpose Transfers:** The Commission increased the share of the States in the divisible pool of taxes3 from 32 per cent recommended during the 13th Finance Commission to 42 per cent. Thus, according to the Commission's reasoning, the increase was partly on account of the inclusion of plan expenditure requirements of the States which was given by the Planning Commission based on the Gadgil formula and partly to provide greater flexibility to the States by giving them untied transfers. The Commission adopted a formula for distribution comprising of a mix of variables representing revenue and cost disabilities. It gave 50 per cent weightage to deviation from the highest per capita income, 27.5 per cent weightage to population, 15 per cent weightage to the area and 7.5 per cent weightage to the forest area.

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The 14th Finance Commission's recommendations have substantially altered the landscape of federal fiscal transfers. The sharp increase in tax devolution by the 14th Finance Commission resulted in the share of general purpose transfers going up significantly, but this was countered by the Central government reducing the specific purpose transfers Thus, about one percentage point increase in general purpose transfer was countered by equivalent reduction in allocation to Central Schemes.

b) Specific Purpose Transfers: In addition to the tax devolution and grants given to the States based on the recommendations of the Finance Commissions, the Central government gives specific purpose grants for various purposes through the respective ministries. The objective of specific purpose transfers, as mentioned earlier, is to *ensure* minimum standards of services in respect of those services that are considered meritorious or those services with significant inter-state spillovers. However, in Indian context, this has been used as a patronizing instrument to serve political objectives of the ruling parties at the Centre to woo the States and the electorate by expanding its reach to spend on the State subjects.

In 2012, there were 147 such schemes initiated by various Central ministries and many of them were directly implemented by numerous implementing agencies specifically created for the purpose and the grants were given to them directly bypassing the States. In 2013, these schemes were consolidated into 66 and in 2014, based on the recommendation of the Expert Committee on Efficient Management of Public Expenditure the Central Government channeled all the grants through the State governments. After the 14th Finance Commission made the recommendation to increase the tax devolution to 42 per cent of the divisible pool, the Central government appointed a Committee of selected Chief Ministers of the States with the Chief Minister of Madhya Pradesh as the Convener to further consolidate and rationalize the schemes. The Committee consolidated the schemes into 28 and classified them into "Core of the core", "Core" and "Optional" with matching requirements from the States stipulated at 30 per cent, 40 per cent and 50 per cent respectively.

There are six "core of the core" schemes including the MGNREGA and 22 "core" schemes.

Critical analysis of General Purpose Transfers

Considering the wide variations in per capita GSDP among the States with the richest State having more than five times the per capita GSDP of the poorest, completely offsetting the fiscal disabilities to enable the low income States to equalize their per capita expenditures may simply not be politically feasible in India.

- First, presently the Union government does not have fiscal space to meet its own obligations and cannot be expected to make any significant increase in the transfers.
- Second, there are significant deficiencies in the standards of physical and social infrast5ructures provided even by high income States and they too need to spend large amounts on the developmental heads. Therefore, there is a clamour for higher transfers from all the States.
- Third, there are arguments that equitable transfers may reduce the overall growth of the economy which, in the long run may prove inimical to the interests of the poorer States themselves.

Therefore, the general purpose transfers, which are supposed to enable all the States to provide comparable levels of public services at a comparable tax rates can do so only to a limited extent.

It is in this context that the role of specific purpose transfers becomes critical. In particular, equalization in specific meritorious services such as education and healthcare, rural roads and anti-poverty interventions can help in augmenting the services in these areas.

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Issues in Centrally Sponsored Schemes

- First, there are too many schemes and within each scheme, too many sub-schemes with different objectives to be financed. This results in the thin spread of resources and it is not possible to clearly specify the target in terms minimum standards of services to be achieved.
- Second, the grants for the schemes are not determined on the basis of the shortfall in the prescribed standard of services. Both the total and individual State allocations are based on incremental plans prepared by the respective State governments and approved by the Committee. Inability to link the transfers with service levels makes it difficult to judge them based on achieving minimum standards. The focus is on spending money rather than ensuring services.
- Third, designing the grants not linked to meet the shortfall in services from the prescribed levels results in significant misallocation. It is not necessarily the educationally backward State or the State with poor health indicators that gets more education or health grants. The telling case is of rural employment guarantee. The volume of grants depends on the ability of the bureaucracy in preparing the plans and fulfilling the formalities including furnishing of the utilization certificate
- Fourth, the uniform matching ratio across States makes it difficult for the low income States to utilize the grants allocated to them fully. In a situation in which the general purpose transfers are not able to offset the fiscal disabilities of the low income States satisfactorily, they will not have the fiscal space to provide matching requirements. In the event, Kerala, one of the most advanced States in elementary education and healthcare comparable to many advanced economies also avails the grant by making the same matching contribution while Bihar which is educationally the most backward State does not get adequate grants as it finds hard to contribute the same matching ratio.
- Fifth, there is considerable difference between the approved allocation and actual grants given.
- Sixth, approval of the schemes with various components and requirement to adhere to the originally approved composition often leads to micromanagement, proliferation of bureaucracy and inefficiency.

Conclusion

With too many schemes for equalization and with limited fiscal space available for giving grants this has meant thin spread of resources without much impact on service levels. Most of these schemes are in the areas specified in the State List and truly belong to the domain of the States and if the latter are not able to provide these services adequately, they should be enabled to provide them through general purpose transfers rather than through conditional transfers. Of course, specific purpose grants should be given to augmenting services with high degree of inter-state externalities or those which are considered highly meritorious, but these will have to be a few to make a difference in the service levels.

The Fourteenth Finance Commission has made the recommendation that the number of transfers should be minimized and the design and implementation mechanism for each scheme should be decided by a committee comprising of Union and State government representatives and domain experts.

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