Chapter 4

The effects of central-government transfers to states in India

by
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India has witnessed an impressive growth performance since the market-based reforms were introduced in 1991. However, its regional spread has been uneven. Considering the fact that over 63% of the population lives in economically lagging states and they have over 67% of children in the age group 0-14 demographic dividends can only be realised when a system of intergovernmental transfers is designed to offset their fiscal shortfalls. The present paper analyses the design and implementation of general and specific purpose transfers in India. The general purpose transfers are given to enable the states to provide comparable levels of services at comparable tax rates. However, given the large differences in the revenue-raising capacities of the states with the richest large states having five times the per capita income of the lowest, it is politically infeasible to offset the differences in revenue-raising capacities completely. Therefore, the specific purpose grants which are meant to ensure minimum standards of meritorious services with strong externalities are extremely important. However, the analysis shows that there are too many specific purpose transfers, they are poorly targeted and inclusion of multiple objectives in each of the specific purpose transfers makes the compliance by the states difficult. Inclusive development requires a reform of the transfer system.

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Introduction

Indian economic growth has been accelerating steadily, from nearly 3.5% per year during 1950-80 to 5.8% during 1980-2000, and further to 7.4% since 2001-02. Although after the global financial crisis in 2008 there was some deceleration, the Indian economy turned around swiftly and is presently one of the fastest growing countries. Nevertheless, most observers consider this growth to be well below India's potential and that further reforms to liberalise the economy would accelerate its growth further.

Despite India's impressive growth performance, its regional spread has been uneven; as some of its low-income states have been trying to catch up with their more advanced counterparts, inter-state disparities have increased, particularly following the market-based reforms initiated in 1991. The states with better physical and social infrastructure and market-friendly governance institutions have been able to grow faster (Panagariya, Chakraborty and Rao, 2015). This has led to significant divergence of incomes among the states, with a coefficient of variation in per capita incomes increasing from 0.33 in 1991-92 to 0.47 in 200-01 and to 0.40 in 2014-15. Ironically, most of the low-income states are resource-rich, which implies that physical and social infrastructure has been a binding constraint in their development (Rao and Mandal, 2009).

It is essential to accelerate growth and development in India's low-income states, for reasons of both inclusiveness and the stability of the Indian federation. An overwhelming proportion of the poor are concentrated in low-income states; therefore, accelerating growth in these states is an essential prerequisite to lift them out of the poverty trap. Overall, India has a working-age population (15-64 years) of 63.4%. Low-income states have a staggered demographic profile, however: the high proportion of the working-age population will continue to fluctuate for a longer period. As the school-age population (6-13 years) is higher in these states, their need for public spending on services like healthcare and education is more substantial.

Regional differences in social and physical infrastructures can be reduced through either regional policies or intergovernmental transfers. In a small country, the central government can identify the diverse needs for public services and make investments in different states to achieve the required regional balance. However, in a large, diverse federation, this has to be mainly achieved through intergovernmental transfers - as the lower level jurisdictions are better placed to know the diverse preferences of the people and provide public services accordingly. In almost all large and diversified federations, therefore, reducing regional differences in social and physical infrastructure has to be achieved through intergovernmental transfers (Ahmad, 1997).

The rationale for intergovernmental transfers is to offset the revenue and cost differences of the states. The assignment of functions and sources of finance according to comparative advantage results in vertical fiscal imbalances (Rao, 2009). While intergovernmental transfers to reduce imbalances are unavoidable, it is crucial to avoid perverse incentives from such transfers. It is also important to match the revenue and expenditure decisions at the margin for sub-national governments for reasons of efficiency and accountability. An efficient system of tax assignment provides tax powers to sub-national levels up to the point where the marginal efficiency loss due to tax differences is matched with marginal efficiency gains from fiscal autonomy.

In addition to vertical fiscal imbalances, horizontal imbalances arise from differences in the ability to raise revenues and the unit costs of providing public services. Horizontal equity is violated when there are differences in revenue and cost differences across states (Buchanan, 1950). The problem is exacerbated when there are origin-based taxes, and

similar other factors alter the net fiscal benefits in different sub-national jurisdictions (Boadway and Flatters, 1982). In mature market economies, fiscal differentials can, to some extent, be equalised through population mobility. However, in countries like India with several institutional impediments to mobility, fiscal differences have to be offset through intergovernmental transfers. Such transfers have to be unconditional – to *enable* every state to provide a standard level of public service at a normative tax rate.

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 and those services with a high degree of spillovers, such as education, 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 states may be asked to make matching contributions to avoid substituting these transfers to own expenditures. When the existing inter-state differences in such meritorious services are large, it is also possible to design the transfer system with varying matching requirements (Feldstein, 1975).

This chapter analyses the effectiveness of intergovernmental transfers in providing public services to achieve balanced regional development in India. The next section describes the federal fiscal arrangements and transfer system in India. The third section analyses the equity and efficiency issues relating to the Indian fiscal transfer system. The fourth section examines three important specific-purpose transfers relating to elementary education, healthcare and anti-poverty interventions to identify the design and implementation problems of these transfers. Concluding remarks are presented in the final section.

The Indian federal fiscal system and institutions

The Indian constitution describes India as a "union of states" and a "sovereign, secular, socialist, democratic republic". It is the largest democratic federal republic, inhabited by 1.3 billion people, spread over 29 states and 7 union territories, covering an area of 3.29 million square kilometres. India is a developing country federation with an average per capita gross domestic product (GDP) (purchasing power parity [PPP]) of USD 5 855 (2015). A distinguishing feature of the Indian economy is its marked diversity. People of several races and religions, who speak 114 languages (18 of which are "scheduled" or official), coexist peacefully, bonded together by way of their shared history and culture. The country is predominantly rural; according to the 2011 census, 55.5% of the population lives in rural areas.

India has a three-tier federal structure with governments at union, state and local levels. There are 29 states and 7 centrally administered territories – 2 with their own legislatures. Below the state governments, in urban areas, there are 96 municipal corporations, 1 494 municipalities and 2 092 smaller municipalities (called *Nagar Panchayats*). There are 247 033 rural local bodies or *panchayats*, of which 515 are at the district level, 5 930 at the block level, and 240 588 at the village level. However, the devolution of powers by the states to the third level is rare, and their participation in public service delivery is negligible.

There are wide variations in the size and economic structure among the states. In 2011, Uttar Pradesh, with 200 million people was the largest state; and Sikkim, with 0.6 million, was the smallest. The per capita gross state domestic product (GSDP) in 2014-15, at INR 165 728 (USD 2 550) was the highest in Haryana (excluding the small state of Goa on the west coast, which had a higher per capita GSDP of INR 304 666), and the lowest in Bihar, at INR 33 954 (USD 522), the second largest state in the Gangetic Plains in northern India.

Due to their small size, low economic base, and strategic location, the 11 small, mountainous states are categorised as “special category states” (SCS).

With most broad-based taxes assigned to the union government, and states given the primary responsibility of providing social services, and co-equal responsibility for providing economic services, there is a significant vertical fiscal imbalance. Wide variations in the levels of development among the states, with the per capita GSDP in the most affluent state at over five times that of the least developed, there is a considerable horizontal imbalance as well. The market-oriented reforms embarked upon in 2010 have further accentuated the horizontal imbalance. Although these reforms have helped to free the economy from excessive government controls, resulting in an acceleration in economic growth and reduction in poverty, the vestiges of the planned era have continued as far as fiscal decentralisation is concerned (Rao, 2010).

The Constitution’s founding fathers were conscious of the need to resolve such imbalances and provided for the appointment of a finance commission every five years to share central taxes with the states and give them grants. However, with the adoption of planned development and the appointment of the Planning Commission in 1951 through a cabinet resolution, the Planning Commission intruded into the domain of the Finance Commission by giving grants for planning purposes. The Finance Commission was confined to meet only the non-plan requirements of the states.

Table 4.1 presents the central and state governments’ shares in revenue and expenditures. The total revenue collected in the country is about 20.5% of GDP and of this, 37.5% is raised by the states. The states, however, incur over 60% of total public expenditures, amounting to 27% of GDP. Thus, the states’ total expenditure is 18.3% of GDP, of which they raise about 8% of GDP from their own sources and receive transfers amounting to about 7% of GDP. The remaining expenditure is financed from borrowing.

Table 4.1. **India: States' shares in revenue and expenditures**

Years	Total revenue (Union + states)	Total expenditure (Union + states)	States’ share in revenue			States' share in expenditures		
	% of GDP	% of GDP	Tax revenue	Non-tax revenue	Total revenue	Current expenditure	Capital expenditure	Total expenditure
1990-91	17.4	26.7	34.4	44.9	35.9	55.2	44.5	53.6
2000-01	16.7	25.8	38.2	40.8	39.1	56.0	57.0	56.5
2005-06	18.9	24.9	37.7	34.7	36.8	55.2	59.4	56.7
2007-08	20.2	24.4	31.9	38.5	32.9	53.5	53.1	54.7
2008-09	18.7	25.7	33.9	40.5	34.7	49.3	64.2	53.8
2009-10	18.2	27.2	37.6	39.6	37.5	51.2	61.5	54.3
2010-11	19.9	26.4	37.6	23.8	35.0	51.3	53.7	53.1
2011-12	18.4	26.8	38.9	38.3	34.0	53.7	60.9	55.8
2012-13	19.1	26.1	39.2	40.8	39.0	54.9	59.6	54.9
2013-14	20.4	27.6	40.3	35.7	37.3	56.0	62.4	56.9
2014-15	20.5	27.3	39.0	37.3	37.3	62.2	56.9	60.7

Source: Public Finance Statistics, Ministry of Finance, Government of India, relevant years; Finance Accounts of Central and State Governments, Comptroller and Auditor General, Government of India.

There is considerable variation among the states with regard to their fiscal dependence on the union government. There are 18 relatively homogenous general category states (GCS), but even these have vast differences in size, revenue-raising capacities and efforts, expenditure levels, and fiscal dependence on the union government. In addition, in terms of economic characteristics, the 11 mountainous states in the north and northeast differ markedly from the rest and are therefore designated as “special category” states (as

mentioned above). For reasons of comparability, the analysis in this chapter is confined to the general-category states, which covers more than 90% of the population.

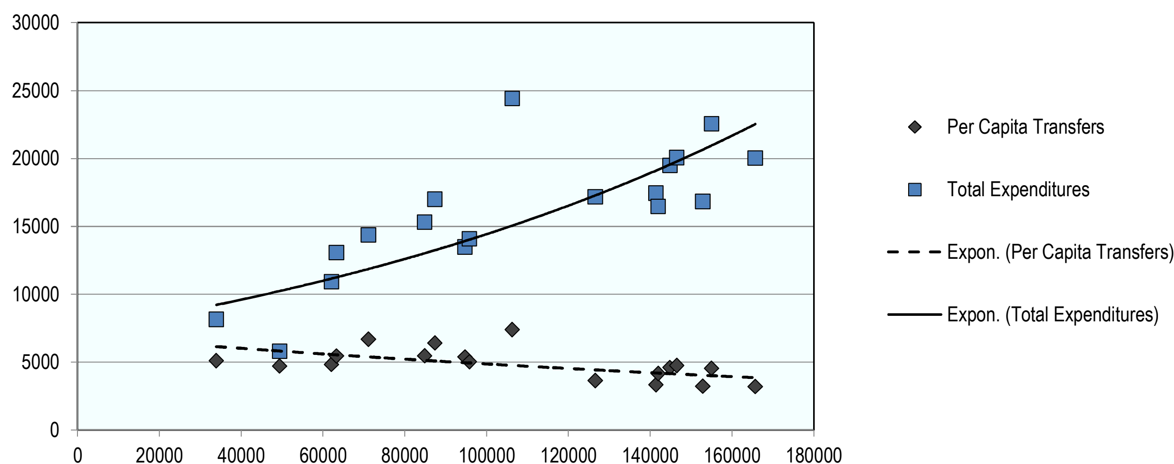
Analysis of the economic and fiscal information presented in Table 4.2 shows a number of interesting features. First, inter-state disparities in per capita incomes (GSDP) are not only high, but have been increasing over the years. In 2014-15, at INR 165 728, the state of Haryana had the highest per capita income, five times the per capita income of Bihar, the lowest income state. As mentioned earlier, the coefficient of per capita incomes in the states has steadily increased from 0.30 in 1981-82 to 0.35 in 1991-92 and further to 0.40 in 2014-15 (Panagariya, Chakraborty and Rao, 2015). Second, not surprisingly, per capita revenues vary with per capita incomes, largely due to variations in revenue-raising capacity. The tax-GDP ratios do not show a clear trend; thus, the variations are mainly due to revenue-raising capacity rather than differences in tax effort. Third, although per capita transfers are higher in the states with lower per capita income, the impact is negligible, and more affluent states end up spending significantly higher per capita than their poorer counterparts (Figure 4.1). It is not surprising that the low-income states with larger infrastructure deficits are unable to catch up with their more affluent counterparts.

Table 4.2. **India: Inter-state differences in per capita GSDP and fiscal variables**

States	Per capita GSDP	Per capita revenue	Tax-GSDP ratio	Per capita general purpose transfers	Per capita special purpose transfers	Per capita total transfers	Per capita total expenditures	Per capita development expenditure
	INR	INR	%	INR	INR	INR	INR	INR
General category states								
Andhra Pradesh	106 263	10 687	8	5 376	2 017	7 393	24 410	18 588
Bihar	33 954	2 026	5.55	3 872	1 223	5 095	8 136	5 579
Chhattisgarh	87 354	7 629	6.65	4 830	1 584	6 414	17 005	13 202
Gujarat	141 405	11 187	6.85	2 067	1 263	3 329	17 446	12 486
Goa	304 666	41 616	8.55	6 453.18	3 360.48	9 813.65	57 666	39 800
Haryana	165 728	12 095	6.25	1 836	1 371	3 207	20 030	13 579
Jharkhand	62 091	4 199	4.77	3 343	1 484	4 827	10 903	7 772
Karnataka	144 869	11 788	7.63	2 488	2 121	4 609	19 482	13 987
Kerala	155 005	12 512	6.69	2 942	1 600	4 542	22 549	11 376
Madhya Pradesh	63 323	6 135	7.55	3 732	1 718	5 450	13 073	9 564
Maharashtra	152 853	10 887	6.42	1 795	1 426	3 221	16 822	11 383
Odisha	71 184	6 411	6.4	4 392	2 295	6 686	14 356	10 740
Punjab	126 606	9 787	6.95	2 371	1 266	3 637	17 153	8 932
Rajasthan	84 837	7 193	6.32	5 251	213	5 463	15 291	11 355
Tamil Nadu	146 503	11 668	7.2	2 839	1 910	4 749	20 062	12 995
Telangana	141 979	9 719	5.61	2 752	1 411	4 163	16 461	12 469
Uttar Pradesh	49 450	4 460	7.11	3 557	1 150	4 707	5 802	4 667
West Bengal	94 711	4 853	4.92	3 385	1 993	5 378	13 465	8 290
All gen. cat. states	95 802	7 895	6.63	3 498	1 531	5 030	14 082	9 807
Special category states								
Arunachal Pradesh	110 217	6 185.6	2.82	30 159.6	25 094.3	55 253.8	34 257	58 102
Assam	60 621	3 630.2	4.77	5 325.3	2 728.7	8 054	7 700	13 156
Himachal Pradesh	147 330	11 323.6	1.59	11 189.5	2 675.3	13 864.8	17 186	31 423
Jammu and Kashmir	77 559	6 278.4	2.68	12 231.7	3 348.4	15 580.2	13 060	26 032
Manipur	58 442	2 269.2	1.13	18 021.7	5 616.2	23 637.8	13 087	27 855
Meghalaya	75 156	4 005.2	0.1	11 587.6	4 482.9	16 070.5	13 211	23 018
Mizoram	93 136	4 297.2	0.06	30 945.2	11 331.7	42 276.9	32 982	55 607
Nagaland	89 607	3 207.8	0.37	15 122.5	18 900.5	34 023	32 907	37 886
Sikkim	240 274	19 361.1	0.51	40 251.8	1 0876	51 127.9	33 186	74 434
Tripura	77 358	3 572.1	0.54	13 905.4	6 615.7	20 521.1	11 961	26 793
Uttarakhand	153 076	8 929.2	0.91	7 408.8	2 795	10 203.8	12 361	24 667
All special category states	84 572	5 604.4	0.97	9 836.3	4 243.8	14 080.1	12 449	22 738
All states	95 802	7 419	6.58	3 757.99	1 641.16	5 399.15	9 977	14 637

Source: Finances of the State Governments 2016-17, Reserve Bank of India.

Figure 4.1. **India: Per capita transfers and expenditure in states according to per capita GSDP**



Source: Finance Accounts of State Governments, Comptroller and Auditor General, Government of India.

The economic and demographic profiles of the general category states classified in high income and low-income categories highlights some important features (Table 4.3). First, the low-income states with a population share of 57% had a GSDP share of just 36.5%. Thus, there is considerable state dependence on central transfers to meet the cost of delivering public services. Second, the low-income states not only suffer from revenue shortfalls, but higher needs for public services as well. The low-income states have a disproportionate number of rural, as well as total, poor living in their jurisdictions. This requires considerably higher outlays on anti-poverty interventions. Similarly, the staggered demographic profile in these states shows a disproportionate share of children in the age group 0-14 years living there. The proportion of children in this age group, at 62.8%, is substantially higher than their population share (57%). These are the states where the demographic dividend will last longer. However, unless outlays on education and healthcare are substantially increased, instead of a demographic dividend, greater problems could arise. This underlines the importance of having a well-designed transfer system not only to offset revenue and cost differences, but also to cater to the varying public service needs of the states. Inclusive development is possible only when fiscally disadvantaged states are empowered to provide comparable standards of public services.

Table 4.3. **Economic and demographic profiles of the states in India**

States	Per capita GSDP (INR)	Population (millions)	Share in GSDP 2014-15	Population 2011	Rural poverty	Total poverty	Children aged 0-14 years
	2014-15	2011	%	%	%	%	%
Andhra Pradesh	121 371	86.9	9.44	7.5	6.1	6.3	6.3
Gujarat	141 405	63.4	8.02	5.5	4.2	3.7	5.2
Haryana	165 728	26.7	3.96	2.3	1.3	1.4	2.3
Karnataka	144 869	63.5	8.24	5.5	3.8	4.4	4.8
Kerala	155 005	34.0	4.72	2.9	1.6	1.7	2.3
Maharashtra	152 853	117.3	16.04	10.1	9.0	10.4	9.4
Punjab	126 606	29.1	3.29	2.5	1.2	1.4	2.2
Tamil Nadu	146 503	74.6	9.78	6.5	4.1	4.9	5.1
High-income states	143 184	495.3	63.49	42.9	31.3	34.2	37.5
Bihar	33 954	110.1	3.35	9.5	14.5	12.8	12.1
Chhattisgarh	87 354	27.1	2.12	2.3	3.1	2.9	2.5
Rajasthan	84 837	72.2	5.48	6.2	5.4	5.5	6.9
West Bengal	94 711	84.6	7.17	7.3	7.5	7.6	6.3
Jharkhand	62 091	35.0	1.94	3.0	3.7	3.4	3.4
Madhya Pradesh	63 323	76.5	4.34	6.6	8.3	8.4	7.2
Odisha	71 184	43.5	2.77	3.8	6.4	5.8	3.5
Uttar Pradesh	49 450	211.0	9.34	18.3	18.5	19.4	20.9
Low-income states	61 799	659.9	36.51	57.1	67.6	65.8	62.8
All India	95 802	1155.2	100	100	100	100	100

Source: Economic Survey, 2015-16, Government of India; Planning Commission, Government of India; Census, Registrar General of Population Census, Government of India.

The transfer system in India

As mentioned above, the Constitution recognises the need to have an independent, impartial mechanism to offset vertical and horizontal imbalances, and has provided for an independent finance commission to make recommendations on the devolution of central taxes and grants to be given to the states. Article 280 of the Constitution mandates the president to appoint a finance commission every five years. The commission has a chairperson and four other members whose qualification for appointment is laid down in the Finance Commission Act passed by the parliament. The terms of reference of the commission are: 1) distribute the net proceeds of union taxes between the union and states and among the states *inter-se*; 2) provide grants to the states; 3) carry out 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 4) address any other matter referred to the commission by the president in the interest of sound finance. So far, 14 finance commissions have submitted their reports. Their recommendations have been well regarded and generally accepted and implemented by the governments.

The role of the Finance Commission as envisaged in the Constitution was curtailed when the Planning Commission was created through a cabinet resolution. The Planning

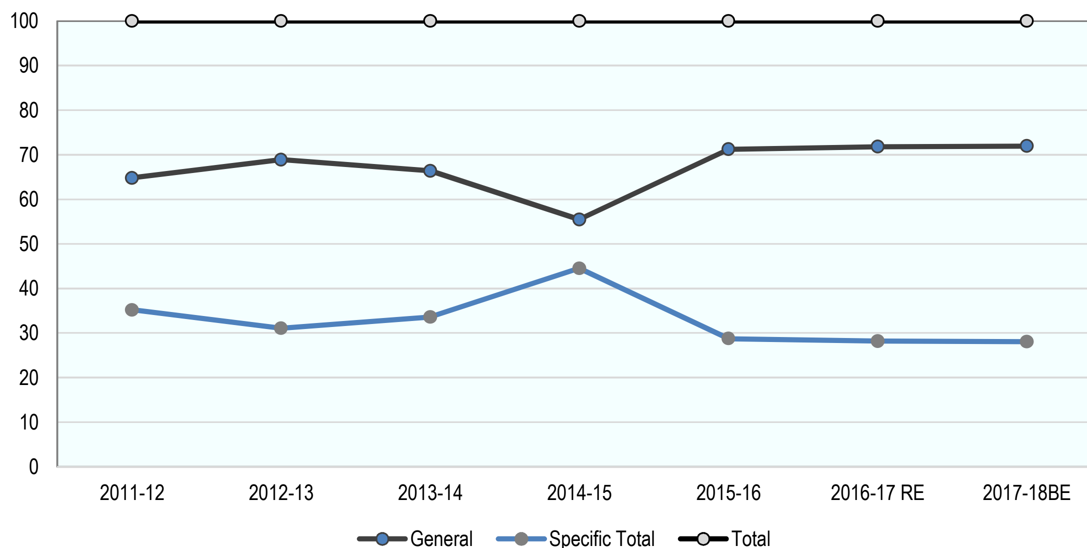
Commission took over the powers to issue grants to the states for planning purposes. The scope of the Finance Commissions' review was confined to assessing the non-plan requirements of the states and making tax devolution and grants to meet these requirements. However, as the Fourteenth Finance Commission's (FFC) terms of reference did not restrict its scope to assessing non-plan requirements, the commission made recommendations to cover the entire general purpose transfers. Thus, when the Planning Commission itself was abolished in August 2014, it did not create any discontinuity. However, even as the Finance Commission is empowered by the Constitution to give all transfers – general or specific - given its temporary nature, the FFC itself decided that it would refrain from giving specific-purpose transfers, which require continuous monitoring.

After the FFC made the recommendations, the entire architecture of the transfer system was changed (Ministry of Finance, 2015). With the Finance Commission making recommendations on tax devolution and block grants and refraining from making any specific-purpose grants, a clear distinction has emerged between general- and specific-purpose transfers. 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 FFC made a recommendation that the design and implementation of specific-purpose transfers should be decided by a committee comprising the representatives of central and state governments as well as domain experts, the central government has continued the practice of making decisions on these transfers at the relevant central ministry level.

The FFC was also concerned with the intrusion of the central government in states' domain through the proliferation of specific-purpose transfers. Its analysis showed that between 2005 and 2012, central government spending on state responsibilities increased from 14% to 20%, and spending on concurrent responsibilities increased from 13% to 17%. Therefore, the FFC increased the share of the states in the divisible pool of taxes[1] from 32%, recommended by the previous commission, to 42%. The increase was mainly on account of the inclusion of plan grants, which was recommended earlier by the Planning Commission, and partly to provide greater autonomy to the states by giving them untied transfers. The FFC adopted a formula for distribution, comprising a mix of variables representing revenue and cost differences. It gave 50% weight to the deviation from the highest per capita income, 27.5% weight to population, 15% weight to the area and 7.5% weight to the forest area.

A significant increase in tax devolution by the FFC has substantially altered the landscape of federal fiscal transfers. While there was only a marginal increase in the total transfers to the states in 2015-16 over 2014-15, in the first year of the award, the share of general-purpose transfers rose significantly from 55.5% to 71% (Figure 4.2). In other words, the sharp increase in tax devolution by the FFC resulted in the share of general-purpose transfers rising significantly, but this was countered by the central government reducing the specific-purpose transfers (Chakraborty and Gupta, 2016). Thus, the about 1 percentage point of GDP increase in general-purpose transfers was countered by an equivalent reduction in the allocation to central schemes.

Figure 4.2. **Share of general- and specific-purpose transfers in India**

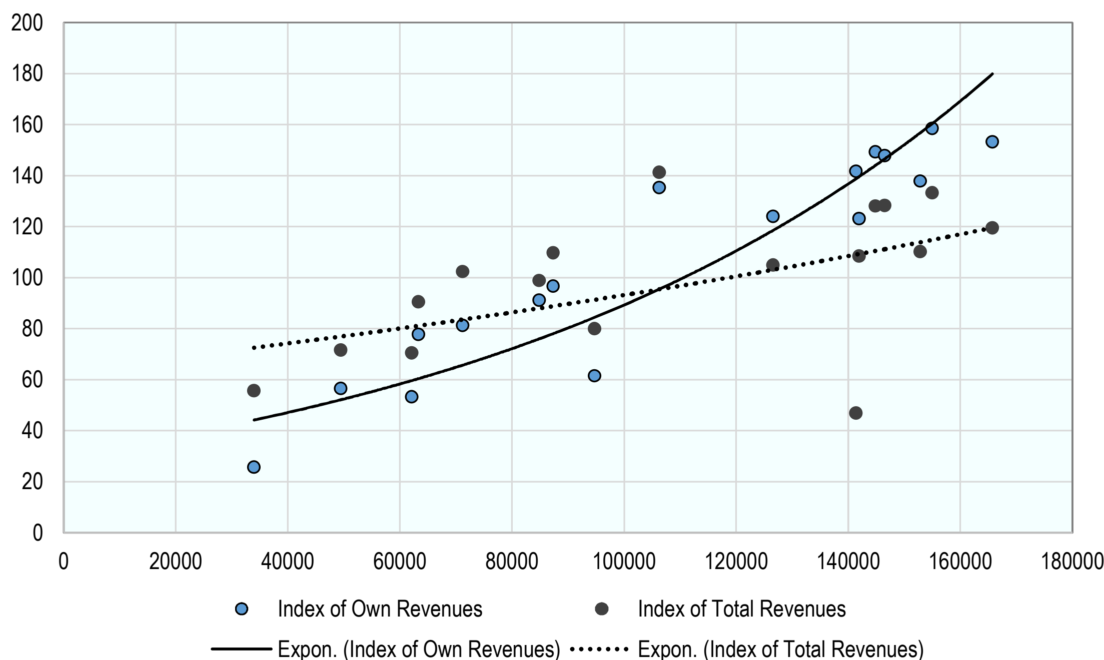


Source: Budget documents of the central government, Ministry of Finance, Government of India.

It must be noted that fully offsetting the revenue differences would require giving the states with the lowest per capita revenue capacity five times the per capita transfers, to compensate for the highest state's per capita revenue capacity (as measured by per capita GSDP), which is five times that of the lowest-income state. Even the apolitical technical institution like the Finance Commission has found this to be infeasible, and it could fulfil the objective of general-purpose transfers – of enabling the states to provide comparable levels of services at comparable tax rates - only partially. In this context, the role of specific-purpose transfers in ensuring the minimum level of public services required becomes extremely important.

What is the overall impact of the transfer system in terms of equalising expenditure across the Indian federation? In order to analyse this, the index of per capita revenue actually collected by the states in 2014-15 (by setting the average per capita revenue collection at 100) is compared with the index of per capita revenue accruing to them after the transfers. This is presented in Figure 4.3. The difference in the slopes of the two indexes seen in the figure shows the extent of equalisation. The two important inferences that may be drawn from the figure are that: 1) the transfer system as a whole is equalising; and 2) even after the equalisation, the index of revenue accruals is positively sloped, which implies that the states with higher per capita GSDP have higher per capita revenues available for spending. Thus, while the transfer system as a whole has been equalising, it has not fully offset the revenue shortfalls of the states with lower per capita GSDP.

Figure 4.3. **Equalising the impact of intergovernmental transfers in India, 2014-15**



Source: Author's estimation based on data from budget documents of state governments.

The analysis of the various components of transfers shows that general-purpose transfers are most equalising with the income (GSDP) elasticity coefficient of -0.452 (significant at 1% level), and the specific-purpose transfers have a positive elasticity coefficient of 0.162, which is not significant. The overall transfer system is equalising with the elasticity coefficient of -0.267. As shown in Figure 4.3, the index of the states' own revenue (with the all-state average specified at 100) increases steeply with per capita income. The index of total revenue (including transfers) too shows a positive slope with per capita incomes, but is flatter than the former, reflecting the extent of equalisation. Thus, it can be concluded that: 1) the transfer system as a whole is equalising; 2) the Finance Commission transfers are equalising but offset the fiscal differences of the states only partially; and 3) the grants for central schemes have a positive coefficient and tend to be de-equalising though the coefficient is not significant. As the Finance Commission transfers do not fully offset the revenue differences, the per capita expenditure on public services are substantially higher in states with higher per capita GSDP, even after receiving all the transfers from central government.

The lower levels of per capita expenditure in states with lower per capita incomes is clearly highlighted in Table 4.4, where per capita expenditure under various categories are regressed on per capita incomes in the states for the year 2014-15 in a double-log function. Total, as well as almost all expenditure categories except capital expenditure, show a positive and significant relationship. In the case of total state expenditure, per capita expenditure are higher by 0.65% when per capita income is higher by 1%. The relevant elasticity is 0.69 in the case of current expenditure. It is 0.65 in the case of expenditure on social services and 0.43 in the case of economic services. Within social services, the elasticity is 0.64 in the case of education and 0.72 in the case of healthcare.

Table 4.4. **India: Trends in general- and specific-purpose transfers**

Period	General-purpose transfers	Special-purpose transfers	Total transfers	General-purpose transfers
	% of GDP	% of GDP	% of GDP	% of total transfers
2011-12	3.63	1.97	5.6	64.78
2012-13	3.61	1.63	5.24	68.89
2013-14	3.48	1.76	5.24	66.39
2014-15	3.41	2.74	6.15	55.49
2015-16	4.32	1.74	6.06	71.23
2016-17 RE	4.69	1.84	6.53	71.81
2017-18 BE	4.61	1.80	6.41	71.93

Note: “BE” represents budget estimate and “RE” represents revised estimate.

Source: Budget documents of the central government, relevant years.

The analysis shows that despite equalising transfers, public spending is higher in more developed states. The elasticity of spending with respect to GSDP is positive and significant with respect to all categories, as is shown in Table 4.5 and Figure 4.4. The elasticity is 0.66 for total expenditure and 0.55 for economic and social services. It is unusually high in the case of education and healthcare expenditure, which are critical to human development. This feature leads to increasing inequalities in infrastructure levels and human development, causing divergence of incomes across the Indian states. The matter is particularly concerning in the case of education and healthcare where the elasticities are high, and given the staggered demographic profile in poorer states, the requirement for public spending is higher. These figures confirm the fact that the transfer system has been helpful in offsetting the fiscal shortfalls of the poorer states only partially and significant inequalities in the standards of public services continue to persist.

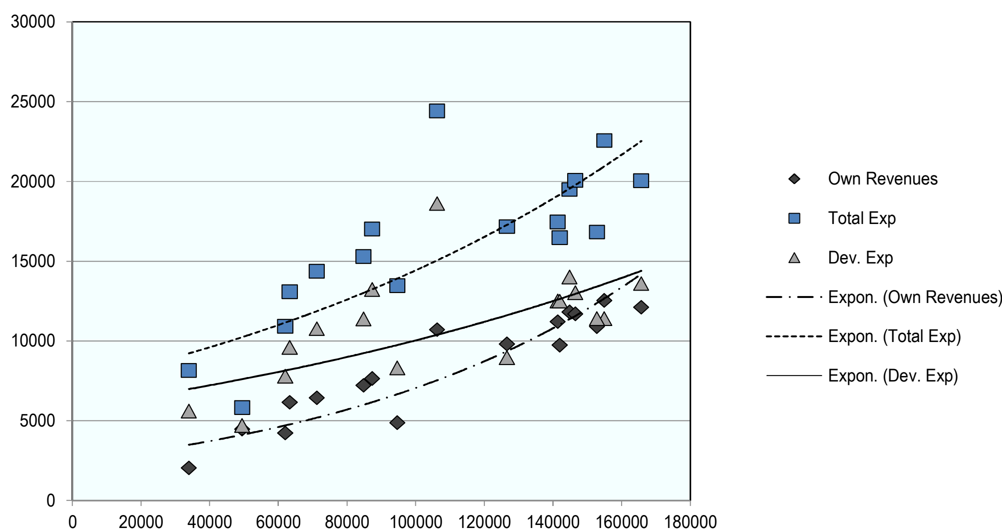
Table 4.5. **Elasticities of per capita expenditures with per capita GSDP in Indian states**

Expenditure category	Constant (a)	Regression coefficient (b)	Adj. R^2
Total expenditure	1.5486 (1.2189)	0.6906 (6.2535)*	0.70
Capital expenditure	2.6142 (0.8169)	0.4248 (-1.5202)	0.08
Expenditure on economic and social services	2.9471 (2.0104)	0.5488 (4.3063)*	0.52
Expenditure on social services	1.1281 (0.8551)	0.6511 (5.6781)*	0.66
Expenditure on economic services	3.5793 (1.8422)	0.4274 (2.5307)*	0.25
Expenditure on education	0.4324 (0.2499)	0.642 4.2681)*	0.52
Expenditure on public health	-1.6654 (1.0743)	0.7185 (5.3322)*	0.63
Total expenditures	2.0866 (1.644)	0.6562 (5.9465)*	0.68

Note: Estimated equation is: Per capita expenditure = Log a + b log Per Capita income + ∈, * Denotes significant at 1% level.

Source: Author’s calculations.

Figure 4.4. **Per capita revenues and expenditures in Indian states according to per capita GSDP, 2014-15**



Source: Author's estimates based on data from the budget documents of the States.

As mentioned above, considering the high degree of inter-state inequality in per capita GSDP, completely offsetting the fiscal differences to enable the low-income states to equalise their per capita expenditures may simply not be feasible in the prevailing political environment. First, presently the union government does not have fiscal space to meet its own obligations, to assume any significant increase in the transfers. Second, there are significant deficits in the standards of physical and social infrastructure provided even by high-income states, and they too need to spend large amounts on the development. Therefore, all states clamour for higher transfers. 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 more impoverished states themselves. Therefore, the general-purpose transfers, which are supposed to enable all states to provide comparable levels of public services at 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, equalisation in specific meritorious services, such as education and healthcare, rural roads and anti-poverty interventions can help augment the services in these areas. However, as pointed out above, in India, the central government has adopted 28 schemes under its Centrally Sponsored Schemes (CSS) programme and another 45 central sector schemes are competing for assistance. With too many equalisation schemes and with limited fiscal space available for giving grants, this has meant spreading the resources thinly, 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. If the latter is 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 augment services with high degrees of inter-state externalities or those that are considered highly meritorious, but these will have to be limited, to make a difference in service levels.

Specific-purpose transfers: Three case studies

In addition to tax devolution and the grants given to the states based on the recommendations of the finance commissions, the central government gives conditional grants for various purposes through the respective ministries. The objective of specific-purpose transfers, as mentioned earlier, is to ensure minimum standards of services that are considered meritorious or those services with significant inter-state spillovers. However, in the Indian context, this has been used to extend patronage to serve the political objectives of the ruling parties at the centre of government in order to influence the electorate.

In 2012, there were 147 such schemes initiated by various central ministries and the grants for many of them were directly given to numerous implementing agencies created explicitly for the purpose of 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 channelled all the grants through the state governments. After the FFC made the recommendation to increase tax devolution to 42% 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 rationalise 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%, 40% and 50% respectively.

There are six “core of the core” schemes including the major rural employment programme for the poor and 22 “core” schemes. In addition to these, there are 45 central sector schemes implemented in states for specified purposes. The total amount of funds spent on all central sector and centrally sponsored schemes in 2016-17 amounted to 1.8% of GDP, constituting about 28% of total transfers. Of these, only three schemes – the National Health Mission, the Universal Elementary Education Programme, and the Mahatma Gandhi National Rural Employment Guarantee - are implemented.

National Health Mission

The National Health Mission (NHM) is a specific-purpose grant given to the states to provide “accessible, affordable, accountable, effective and qualitative” healthcare (Ministry of Health and Family Welfare, 2012, p .2). The essential features of the programme are: 1) safeguard the health of the poor, vulnerable and disadvantaged persons; 2) strengthen public health systems as a basis for universal access and social protection against rising costs; 3) build an environment of trust between the people and health service providers; 4) empower the communities to become active participants in attaining the highest possible level of health; and 5) improve efficiency and optimise the use of resources. These are intended to be achieved by building an integrated network of primary, secondary and a substantial part of tertiary healthcare facilities, and achieving inter-sectoral co-ordination to address food security, nutrition, access to safe drinking water and sanitation, the education of female children, occupational and environmental health determinants such as women’s rights and employment, and different forms of marginalisation and vulnerability. The programme is financed through a specific-purpose grant with the central government contributing 60% in the case of general category states and 90% in the case of special category states.

The funds are allocated by the Union Ministry of Health and Family Welfare determining the resource envelope on the basis area and population weighted by perceived disadvantage, socio-economic disadvantage and the health lag of the states. In addition, a

10% weight is given to the demonstrated absorption capacity. Based on the resource envelope communicated to the states, they prepare their annual programme implementation plans (PIPs), and these are appraised and approved by the National Programme Coordination Committee (NPCC), chaired by the Secretary of the Ministry of Health and Family Welfare. The states are then required to implement the plans as approved. The analysis of the design and implementation of the scheme highlight a number of policy issues that should be revisited for the programme to be made effective, as follows:

1. Although the objective is supposed to be to ensure minimum standards, the programme as it has evolved lacks clarity of purpose. Specifying too many objectives results in too many interventions and spreads the resources thinly across many activities, in addition to increasing the difficulties in monitoring. In a shared cost programme, it is vital that the implementing level of government should be allowed to plan and implement the programme. Allocating resources across several activities within the health sector will increase bureaucracy without ensuring efficient resource allocation. Such micromanagement of the programme betrays the lack of trust in the states. It would be useful to set the targets in terms of infrastructure created, such as the number of health centres and sub-centres, the number of health professionals and availability of medicines as per the norms; and institute an accountability system in which the health system is made accountable to the people. Specifying the targets in terms of the above would help to link the outlays to the creation of health facilities, making it easy to achieve accountability.

2. If the objective is to ensure minimum standards of healthcare services, the resource allocation should be determined on the basis of the shortfall from the specified standards or the extent of health lags. The current formula gives some arbitrary weights to the states on the health lags. In other words, it is hard to find a significant and positive correlation between the grants given and the health status in the states. Kerala, the state with the best infant mortality rate (IMR) gets the third highest grant allocation as well as release. This is clearly seen in Figure 4.5, where the per capita NHM grant allocation as well as release to states is shown against IMR according to the National Family Health Survey (NFHS) IV. Similarly, for Uttar Pradesh, grants allocated as well as released to states with the highest IMR is much lower than many states with much lower IMR. Thus, both the allocation and release of funds to the states are not to ensure minimum standards of services.

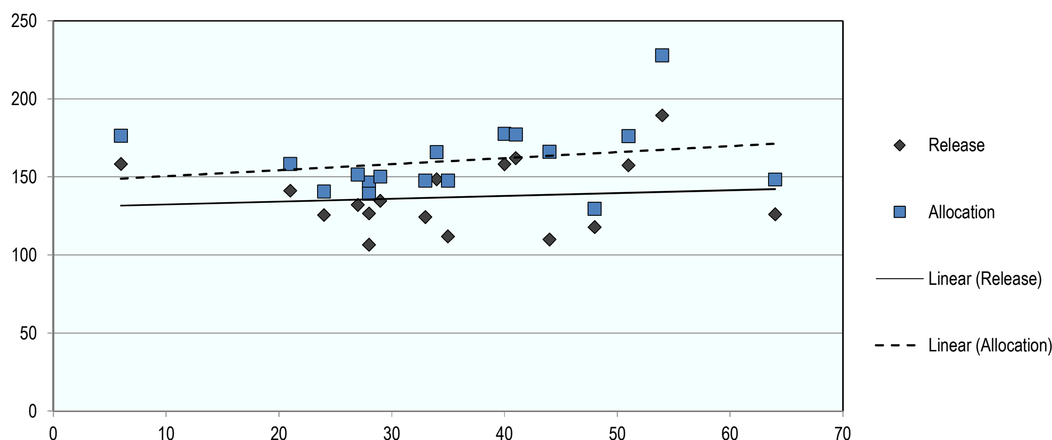
3. The analysis of actual release of funds shows that the release of funds was lower than the original allocation in all the states. The most significant shortfall was in Jharkhand followed by the newly created states of Andhra Pradesh and Telangana. Among the low-income states, besides Jharkhand, the shortfall was more than 15% in Chattisgarh and Uttar Pradesh.

4. The fact that there was a shortfall in the actual release from the original allocation implies that this was largely due to the budget cut. This is revealed by the fact that the actual expenditure on NHM in 2014-15 was lower than the budget estimate by 20%. Cutting the expenditure arbitrarily defeats the purpose of ensuring minimum levels of expenditure.

5. It has been mentioned that one of the reasons for the shortfall in the actual release of expenditure from the original allocation is the inability to provide the utilisation certificates and fulfil other compliances in time. At the same time, as the Union Ministry of Health and Family Welfare wants to utilise the funds, the funds allocated to those states that do not fulfil the compliances are distributed to those

that do. This defeats the purpose of equalisation. The issue must be addressed by building capacity in non-complying states and perhaps, introducing multi-year budgeting so that these states get the funds and use them in an efficient manner to get the desired outcomes.

Figure 4.5. **Per capita grant allocation and release according to the infant mortality rate in Indian states, 2014-15**



Source: Author's calculations.

Universal Elementary Education Programme (Sarva Shiksha Abhiyan)

Sarva Shksha Abhiyan (SSA) is a shared cost programme to ensure universal elementary education in the country. It is implemented in partnership with the states. The objectives of the scheme are to ensure universal access and retention, inclusiveness by bridging gender and social category gaps in education, and enhancement in the learning levels of children. The enactment of the Right of Children for Free and Compulsory Education (RTE) Act in 2009 has introduced additional issues. The act mandates that every child in the 6-14 age group is entitled to have free and compulsory education in a neighbourhood school until the completion of elementary education. The framework for implementation of SSA was accordingly amended in September 2010 to align it with the provisions of the RTE Act. An important provision of the act is the requirement to allocate 25% of the seats in private schools to children belonging to disadvantaged groups in Class 1 or pre-primary class with the government required to reimburse the fees of these children.

The objectives of the programme of universal elementary education, closing the gender and social groups' gaps, and improving the quality of education is aimed to be achieved through 42 interventions grouped under 8 different components. These include access and retention, quality, gender, equity, reimbursement of expenditure for 25% of admissions in private schools, infrastructure development, programme management and other issues. This is a shared cost programme between the central and state governments. During the period 2010-14, the sharing ratio between the cental government and states was 65:35 for general category states and 90:10 for the special category states. After 2015-16 the ratio for GCS changed to 60:40, while the ratio for SCS remained the same.

Analysis of grants

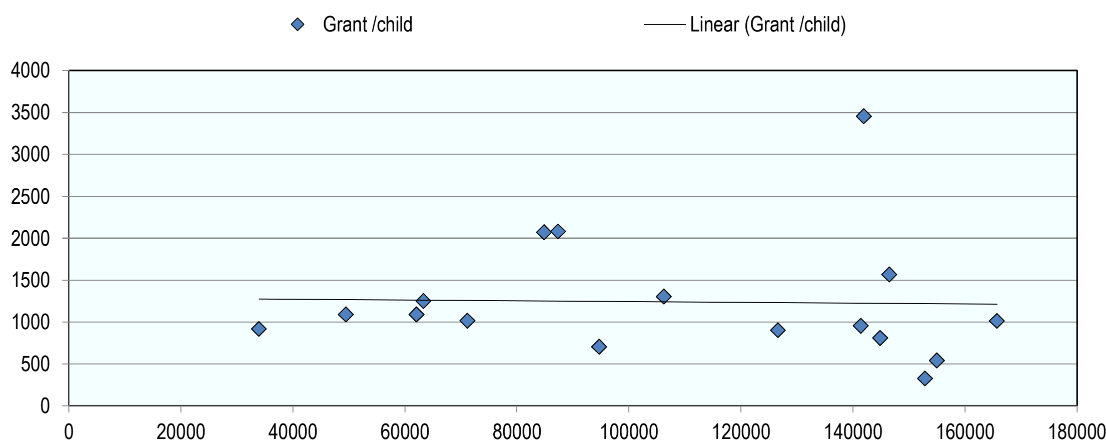
There are as many as 42 interventions within the SSA with multiple objectives, and the states are required to prepare their plans for each of the interventions. Multiple objectives

make defining the minimum standards difficult. For example, while the enrolment ratio can be defined, it is not possible to clearly define and set minimum standards for the quality of education to be achieved. The focus then shifts to inputs such as a teacher-student ratio or physical infrastructure provided rather than learning outcomes. In the end, the RTE ends up with attendance at schools rather than educating the young.

There are a number of issues of both design and implementation regarding the scheme. As may be seen from Figure 4.6, the expenditure per child of school age (6-13 years) in the states is positively related to per capita GSDP with a correlation coefficient of 0.688. This shows that the SSA has not had a significant impact on equalising per child spending and the states with low revenue capacity continue to suffer from poor educational standards as compared to their more affluent counterparts. In addition to lower expenditure, poor implementation results in a lower teacher-student ratio, employment of untrained teachers, teacher absenteeism and an inability to provide teaching materials. Thus, the basic objective of equalising standards of elementary education is defeated.

The preparation of plans for the SSA is done on an incremental basis and not on the basis of the shortfall in standards of elementary education. Thus, the grants are given not necessarily on the basis of the shortfall in the standards of elementary education, but on the basis of the ability of the state to prepare its plans. The spread of grants per child aged 6-13 across the states arranged according to per capita GSDP shows virtually no relationship between the two variables (Figure 4.6). This shows that the distribution of grants has not been according to the shortfall in the standards or revenue differences of the states. This is a matter of concern, as in low income–highly populated states with a higher proportion of school age children, the low per child expenditure will accentuate educational inequality.

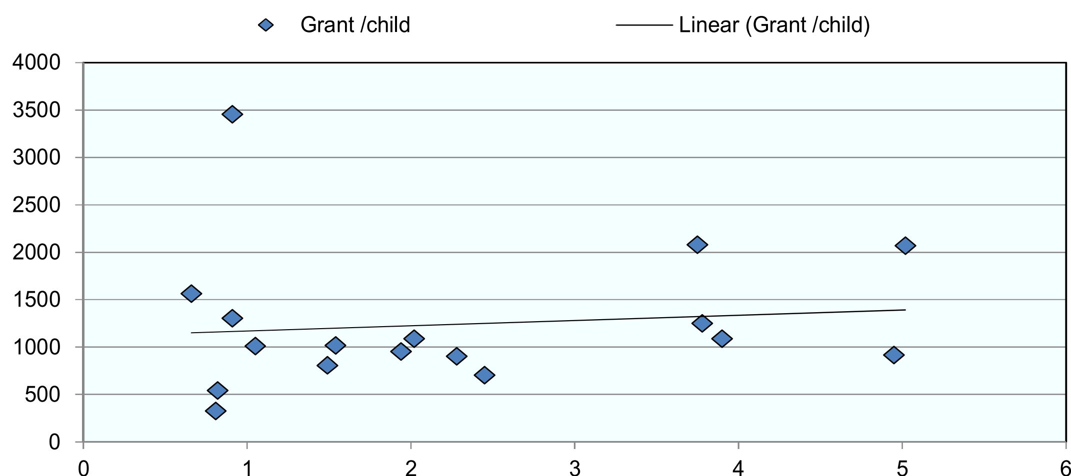
Figure 4.6. **Grant per child according to per capita GSDP in Indian states**



Source: Author’s calculations.

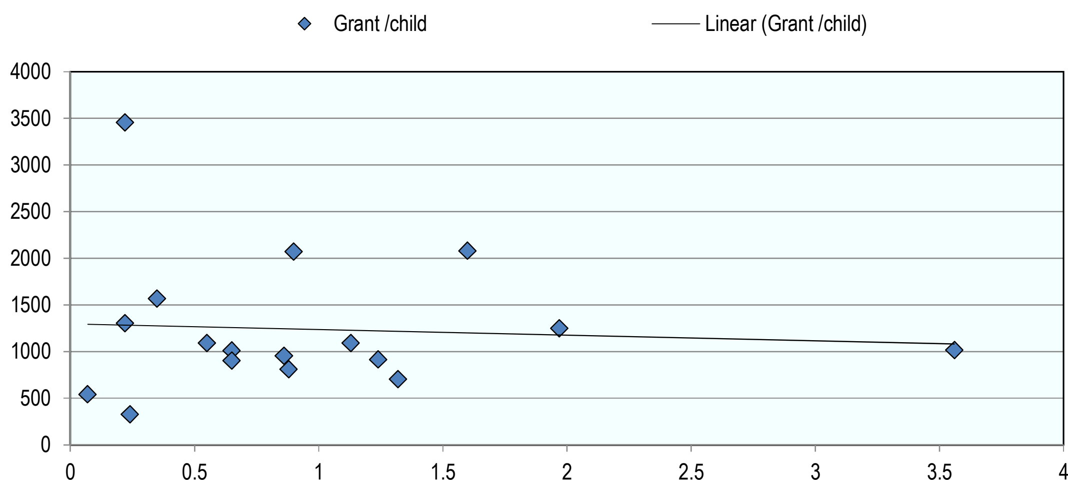
The shortcoming in the design of the grants under the SSA is reinforced when we look at Figures 4.7 and 4.8. In Figure 4.7, the SSA grant in 2014-15 in the states is shown against the ratio of out-of-school children taken from the *Statistics on School Education 2011-12*, published by the Ministry of Human Resource Development. If out-of-school children are taken as a measure of educational standards, the figure shows that there is hardly any relationship between the grants given and educational standards in the states (correlation coefficient: 0.112). Similarly, per child grants to states according to the dropout ratio (Figure 4.8), too, show virtually no relationship between the two variables with a correlation coefficient of -0.0698.

Figure 4.7. **Grant per child according to the ratio of out-of-school children to total children in Indian states**



Source: Author's calculations.

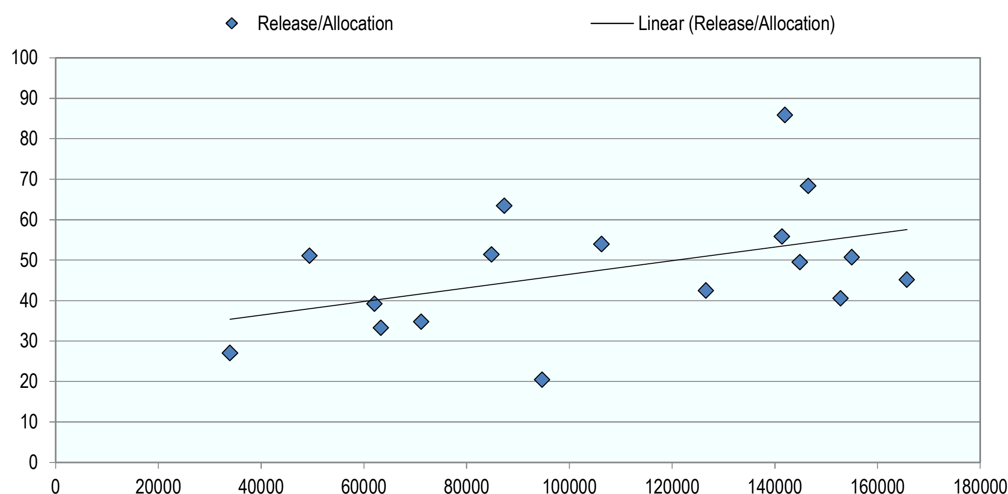
Figure 4.8. **Grant per child according to the dropout ratio in Indian states**



Source: Author's calculations.

The lack of equalisation in the SSA grants is not only due to the shortcomings in the design of the grant system, they are also due to implementation problems. The low-income states have been lagging in fulfilling the conditions and the grants allocated to them in full. The positive relationship between the ratio of grants released to allocation with per capita GSDP shows that the higher income states are able to implement the scheme better than the less affluent states (Figure 4.9). In other words, the low-income states not only are allocated lower per child grants, but they are also unable to utilise the grants allocated to them. The variations in the utilisation rates could be due to their inability to implement the schemes expeditiously, or an inability to fulfil the conditions, like timely auditing of the accounts, a compilation of information on the utilisation from the village level or simply an inability to provide matching resources, as required in the scheme. This implies that there is a need to revisit the conditions to make them simpler, as well as a need to build capacity to implement the schemes in poorer states.

Figure 4.9. **Ratio of the release of grants to allocation in SSA, according to per capita GSDP in Indian states**



Source: Author's calculations.

Considering the importance of the scheme, it may also be useful to think in terms of multi-year implementation plans to avoid losing the grants. As far as matching ratios are concerned, encouraging educationally lagging states, the central government could introduce different matching ratio requirements depending on the extent of educational backwardness or revenue shortfalls. The special category states, in any case, should make lower matching contributions. Even among the general category states, it may be appropriate to classify them into three categories in terms of educational backwardness/revenue shortfalls and have a matching ratio of 30%, 40% and 50% for the most backward, median and least backwards category states.

After the enactment of the RTE, a provision was made to provide 25% of the seats in private schools to disadvantaged children, with reimbursement of the fees by the government. While this can be a gateway to these children to avail elite education, it can also create social problems. First, only a minuscule minority of the students can get a chance to get admitted by private schools. Second, given that the social background of the disadvantaged students admitted under RTE is very different from that of the regular students, there can be a feeling of segregation and discrimination. Furthermore, given the varying family backgrounds with the general students having access to parental guidance or paid tuitions after school, the RTE students may find it hard to compete with the regular students. It is crucial that the states should work towards improving the standards in government schools by having an adequate number of trained teachers, constantly upgrading their skills, enforcing their attendance and regular teaching in schools and providing them with teaching materials and aids.

The critical issue in the SSA should be to reduce educational inequalities among the states so that children are provided with access to education irrespective of where they live or their economic and social background. The focus will have to be not on enrolment, but on learning. This requires improvements in the design and implementation of the scheme and the capacity and willingness by the states to enforce compliance among the teachers. In particular, there is a need to build capacity in the lagging states. Multiple interventions with cumbersome conditions only add to the problems of implementation and bureaucratic interference.

Mahatma Gandhi National Rural Employment Guarantee

According to the World Bank, the Mahatma Gandhi National Rural Employment Guarantee (MGNREGA) is the world's most extensive public works programme. This is a programme designed to ensure livelihood security by providing 100 days of guaranteed wage employment in a financial year for an adult member of every household who volunteers to undertake manual work. It was started in 200 districts in 2006, expanded to an additional 130 districts in 2007 and rolled out to the entire country in 2008.

The salient features of the scheme are:

1. This is a rights-based scheme for adult members willing to do manual labour.
2. The employment must be provided to the job cardholders within 15 days of their application, failing which they are entitled to receive unemployment allowance.
3. Job cardholders can receive employment entitlement up to 100 days in a financial year depending on their demand.
4. The works chosen must be labour intensive with unskilled wages constituting 60% of the cost.
5. Implementation of the scheme is carried out at decentralised levels with village-level government (*panchayats*) required to implement 50%. The entire work plan is supposed to be identified and recommended by the village assembly. The *panchayats* have been given the primacy in planning, implementing and monitoring the scheme.
6. Facilities such as crèche, drinking water, first aid and shade should be provided at the work sites.
7. Women beneficiaries must constitute one-third of the employment provided.
8. There must be proactive disclosures through social audit and grievance redressal mechanisms to ensure transparency and accountability.
9. States are responsible for implementation and ensuring that work, as demanded for up to 100 days, is guaranteed.

Under the MGNREGA, the work plan is supposed to be decided on the basis of a participatory planning exercise. The responsibility for preparing the labour budget for the next financial year along with the details of unskilled labour requirements is assigned to the district programme co-ordinator, and this task has to be completed by December. The work plan including the shelf of works and employment demand is determined right from the village level and is aggregated at the block, district and state levels. These estimates scrutinised by the state government are submitted to the Empowered Committee, chaired by the Secretary of Rural Development within central government. After taking these inputs into account, the Empowered Committee finalises the labour budget based on the performance of the state in terms of: the employment created during the preceding four years; the planning process adopted to finalise the labour budget in the state; an appraisal of the initiatives and strategies of the state to improve delivery mechanisms and assessment of the requirement of the state in terms of magnitude and intensity of rural poverty as reflected in the *Socio-Economic Caste Census, 2011* (SECC) estimates; and frequency of the occurrence of natural calamities. The labour budget thus, finalised, is only indicative and

not a ceiling. The states are required to cater to the actual demand for work during implementation.

The funds to the states are usually released in two tranches, and there can be more than one instalment in a tranche. The amount in a tranche depends upon the approved labour budget, opening balance, pending liabilities of the previous year and overall performance. The release of the first tranche is subject to the submission of: 1) a certificate that the accounts for all the districts of the state for the financial year before 2014 have been settled; 2) a certificate on the settlement of all audit paras under the MGNREGA; 3) a detailed action-taken report on the complaints forwarded to the state; 4) a certificate indicating satisfactory compliance with the ministry's clarifications/suggestions/guidelines and observations from time to time; 5) a certificate to the effect that there has not been any mutualisation and misappropriation of funds.

The second tranche is released subject to the fulfilment of the prescribed conditions and on submission of the proposal in the prescribed format by the state. The proposal can be submitted only after the district/state utilises 60% of the available funds. If the second tranche proposal is submitted after 1 October, it is necessary to submit the audit report of the previous year. The amount of funds released in the second tranche depends on the performance in the utilisation of the funds available.

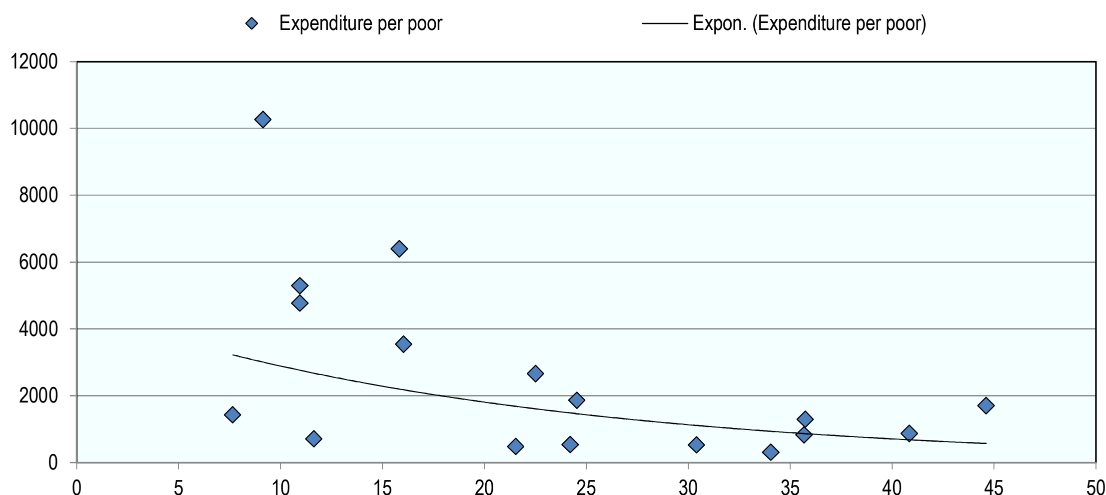
Analysis of the scheme

Redistribution by government is necessary because markets do not bring about the distribution of income and wealth desired by government. While funding for redistribution has to come predominantly from the central government, implementation of anti-poverty interventions has to be at the local level for reasons of comparative advantage (Rao and Dasgupta, 1995; Rao, 2002)

This is undoubtedly an important anti-poverty intervention. The self-selection through unskilled manual work in the scheme makes targeting the benefits of the scheme to the poor automatic. Indeed, there are challenges in implementation and possibilities of misappropriation at the grass-roots level in the feudal oligarchic power structure in rural areas. There are also administrative costs and bureaucracy at various stages with the potential power to seek rents. These issues of implementation have to be addressed by strengthening checks and balances, including an effective social audit.

Although there are multiple objectives in the scheme, the principal focus is to reduce the distress caused by rural poverty. This would mean that the spending on MGNREGA should spread across the states such that the state with a higher concentration of poverty should receive higher amounts. The analysis of per poor spending on MGNREGA across different states shows that in 2014-15, per poor rural expenditure negatively correlated (-0.572) with the rural poverty ratio according to the Tendulkar measure (Figure 4.10). This shows shortcomings in the targeting of MGNREGA.

Figure 4.10. **Rural poverty expenditure per poor, according to the rural poverty ratio, in Indian states**

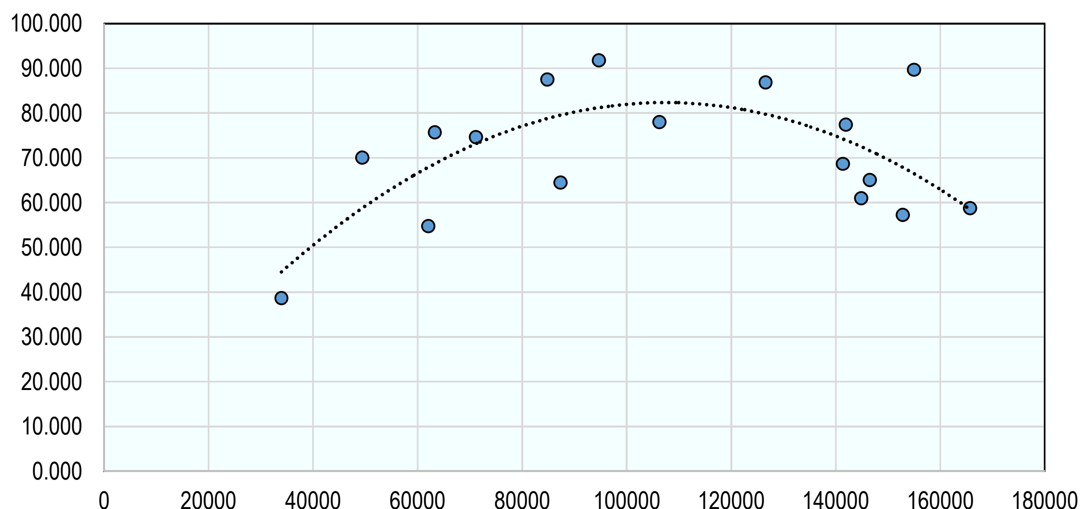


Source: Author's calculations.

This result is not surprising, as despite being a demand-driven programme, the labour budget is finalised on the basis of factors such as performance of the state in creating employment during the preceding four years; the planning process adopted to finalise the labour budget; the initiatives and strategies of the state to improve delivery mechanisms and assessment of the requirement of the state in terms of magnitude and intensity of rural poverty as reflected in the SECC estimates; and frequency of the occurrence of natural calamities. In this list of factors, the SECC poverty measure is the only factor that targets the spending on rural poverty. Besides being largely incremental, there is considerable discretion exercised by the Empowered Committee. As a result, it is not necessarily the states with the highest poverty concentration that receive the highest MGNREGA grant.

Figure 4.11, which plots the difference between the original cost estimate and the final release of expenditure arranged according to per capita GSDP in the states, highlights an interesting pattern. The ratio of grant releases by the central government to the states with very low per capita GSDP is the lowest. The ratio increases as per capita GSDP increases and then declines at very high per capita GSDP levels. The states with low per capita GSDP have the highest concentration of rural poverty, and the programme is much more important for them than for more affluent states. At very high income levels where the rural poverty ratio is low, the states themselves may not attach much importance to the programme and utilise the funds.

Figure 4.11. **Release as a percentage of allocation, according to per capita GSDP, in Indian states**



Source: Author's calculations.

The important point is that as MGNAREGA is a programme of giving wage employment to the poor, it is desirable to design the grant system based on a single factor of rural poverty rather than on other considerations. If indeed the states do not have the capacity to design the works and implement the programme, the solution lies in developing their capacity through handholding so that the overall objective to provide assured wage employment to the rural poor is met.

One of the reasons for the low ratio of the actual release of grants to the original expenditure estimate in the states with a low per capita GSDP may be due to their inability to provide matching contributions. Although MGNREGA is considered as a "core of the core" programme, the states are required to make a matching contribution of 30% to the central contribution. The contribution is uniform across the general category states. As suggested in the case of NHM and SSA, it may be desirable to devise a different system of matching ratios depending on the revenue-raising capacities of the states. This would help the states with low per capita GSDP, which are also those with a high concentration of rural poverty, to utilise the grants better.

Reform issues in specific-purpose transfers

The foregoing analysis of the three crucial specific-purpose transfers shows that there are serious shortcomings in their design and implementation. Essential reform issues to render the schemes more effective are as follows:

1. Considering that the objective of specific-purpose transfers is to ensure minimum standards of services, it is important to define the minimum standards and estimate the cost of providing them. In other words, the objective of each of the specific-purpose transfers must be clearly defined. This also implies that it is necessary to avoid multiple objectives and focus on the single objective of ensuring minimum standards of services chosen for equalisation across the country. This would avoid multiple interventions, micromanagement of the programme, the thin spread of resources across interventions, and high transaction costs of administration, including reporting requirements.

2. The resource envelope allocation to the states should be made purely on the basis of shortfalls in infrastructure and services according to the specified norms. In the case of NHM, for example, the present system of allocating funds on the basis of area and population-weighted according to health lags is arbitrary and does not allocate resources according to the varying standards of the health care infrastructure. This is also the case for the SSA. In each case, it is necessary to define the minimum standard sought to be equalised and make allocations accordingly.

3. The difference between original allocation and ultimate release creates difficulties in implementing the planned activities. The difference mainly arises on account of cuts in the central budget for the schemes or inability of the recipient state governments to fulfil the compliance requirements, including the timely provision of utilisation certificates. Simplification of the transfers would reduce the compliance requirements for the states. In some cases, considering the vast inequality in the standards of services, multi-year budgeting may have to be introduced in order to avoid the lapsing of funds for disadvantaged states. In some cases, there should be provisions for capacity building to meet the compliance requirements for obtaining grants.

4. Given the vast differences in the standards of services as well as spending across states, and the constraints on fund availability, it is important to limit the number of schemes for specific purpose transfers, to the most important merit goods to achieve a reasonable degree of equalisation. Furthermore, it is also desirable to introduce different matching requirements for different states depending on their revenue-raising capacity. The GCS may be grouped into three categories depending on their revenue-raising capacity as high, moderate and low capacity states and the matching ratio for the states could be fixed at 50%, 40% and 30%. This way, low capacity states will find it easier to contribute their matching requirements and obtain the central transfers.

5. Considering the objective of ensuring minimum standards, it is vital to ensure that the grants given to the states add to the expenditure on the services and are not substituted by the states. This would require adding a condition for obtaining the grants. This could be done either by stipulating that the expenditure excluding the transfers on the service does not fall short of the projected expenditure excluding the transfer for the year or by stipulating that the share of the expenditure on the service in the total budgetary expenditure increases by the volume of grants received.

Conclusion

The design and implementation of general- and specific-purpose transfers are critical in the Indian federation from the viewpoint of not only ensuring horizontal equity, but also balanced regional development, inclusive growth and overall stability and integrity of the federation. This becomes even more important when there are significant barriers to the mobility of the population; therefore, it is necessary to take capital to the people and not wait for the people to move to the capital.

Analytically, general-purpose transfers are given to offset fiscal shortfalls of the lagging states so that all states are able to provide comparable levels of public services at comparable tax rates. However, given the significant variations in fiscal differences across

the Indian states – with per capita income in the highest income state five times that of the lowest income state – it becomes difficult to design the general-purpose transfers to offset the revenue and cost differences fully. Even the wealthiest state suffers from severe infrastructure deficits; therefore, all states clamour for transfers. This poses constraints on the extent of equalisation through instruments like tax devolution. This raises the importance of specific-purpose transfers to ensure the minimum standards of required services.

In India, after the recent changes in the institutional architecture, all general-purpose transfers are given based on the recommendations of the Finance Commission. The latest is the FFC whose recommendations have been implemented since 2015-16. The second source of grants is from various central ministries, which are scheme based. There are at present 28 centrally sponsored schemes and another 45 central sector schemes for which grants are given by various central ministries.

The analysis of intergovernmental transfers shows that that tax devolution and grants given on the recommendations of the Finance Commission have a robust equalising element, whereas those given by various central ministries do not. Even the former is able to offset the revenue shortfalls of low-income states only partially. The consequence of this is that the higher income states are able to incur significantly larger per capita expenditure on all major social and economic services as well as in the aggregate. This tends to accentuate inequalities in social and economic infrastructures among the states, leading to an increasing divergence in developmental outcomes.

There are a number of problems with the design and implementation of specific-purpose transfers:

1. They are not linked to service-level outcomes, but tend to be incremental.
2. The large number of specific-purpose transfer schemes taken up for equalisation results in the thin spread of resources, with hardly any impact on service levels.
3. The grants are not linked to improving service levels, and it is not necessarily the states with a more substantial shortfall in services that receive higher grants. Thus, educationally backward states do not receive higher grants for education and states with the lowest health standards do not get higher per capita grants for health. The analysis shows that the states with a higher concentration of the rural poor get lower per poor grants for rural employment.
4. There is a considerable difference between the initially approved allocation and final release of funds under various schemes, and the difference is more significant in the case of low-income states. The inability of the centre of government to provide the funds allocated at the beginning of the year creates considerable uncertainty about the use of funds.
5. One reason for the more significant shortfall in low-income states is perhaps the uniform matching requirements. The low fiscal space available in poorer states makes it difficult to provide the matching contributions to utilise the funds allocated to them fully.
6. The requirement to seek grants under several different interventions within a scheme results in lack of flexibility to the recipient in the use of funds.
7. In some schemes like healthcare, the states were able to substitute grants for their own spending with the result that there has not been a commensurate increase in spending on healthcare after the grants are received.

The central government may not be able to influence much as far as the Finance Commission's recommendations are concerned, as the commission is an independent body recommending tax devolution and grants. However, the centre of government can certainly do well to rationalise the central sponsoring schemes. There is an urgent need to reduce the number of schemes and fund them adequately to make a difference to the service level. It is important to link them to a shortfall in specified services so that the overall objective of ensuring minimum standards is achieved. There is also undoubtedly a case for having differential matching requirements, with states' contributions increasing as the shortfall in services declines.

Note

1. The divisible pool of taxes comprises total central taxes (excluding the revenue from earmarked taxes) minus the revenue from cesses and surcharges and cost of collecting the taxes.

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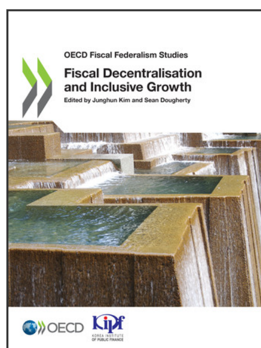

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