Redesigning the Fiscal Transfer System in India

M Govinda Rao

An overwhelming proportion of the poor live in low-income states in India. These states are home to over two-thirds of the children in the 0–14 age group. Therefore, provision of comparable levels of basic social services and physical infrastructure is important to ensure balance and stability in the Indian federation. This underlines the importance of intergovernmental transfers. Conceptually, general purpose transfers are given to enable the states to provide comparable levels of public services at comparable tax effort, and specific purpose transfers are given to ensure a minimum standard of public services. The shortcomings in both the design and implementation of the transfer system in India hinder its ability to achieve the objectives.

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An important implementable rule of fiscal decentralisation is that the public services should be, by and large, paid for by the beneficiaries (Bird 2000; Rodden et al 2003). A strong linkage between revenue raising and expenditure decisions or the "Wicksellian Link" is important for reasons of both efficiency and accountability. However, the assignment of revenues and expenditures according to comparative advantage results in vertical imbalances, and wide differences in the fiscal capacity among the states result in horizontal imbalances. Thus, even as it softens the hard budget constraint, fiscal transfers are inevitable. However, it is important to design them to ensure equity along with incentive compatibility.

This paper analyses the design and implementation aspects of general and specific purpose transfers in India. The recommendation of the Fourteenth Finance Commission (FFC) and even more importantly, the abolition of the Planning Commission has brought about a measure of conceptual clarity in the landscape of intergovernmental transfers. The FFC, while covering the entire revenue account requirements of the states in its assessment, has desisted from giving specific purpose grants. Besides analysing the Finance Commission transfers, the paper also brings out important issues relating to some centrally sponsored schemes (CSSs).

The Rationale

Intergovernmental transfers are important to provide a level playing field for the states with revenue and cost disabilities. An overwhelming proportion of the poor live in low-income states, and providing them access to comparable levels of public services, particularly in building human capital, will help in accelerating growth and encouraging migration to places where income earning opportunities exist. The children in the 0–14 age group constitute 37% of the population and 67% of them live in less than average per capita income states. Therefore, it is important to ensure the provision of adequate public services to empower the next generation of workers.

The rationale for the transfer system is extensively discussed in the literature (Rao and Singh 1999). For reasons of redistribution and stabilisation, which is predominantly (not exclusively) a central function, all broad-based and redistributive taxes, money supply function and borrowing powers are mostly assigned to the centre (Oates 1972). At the same time, most expenditure functions are assigned to the states due to their comparative advantage in providing public services according to the diversified preferences of the people in different jurisdictions. In this scheme, vertical imbalance is unavoidable and the intergovernmental transfer system is necessary to resolve it.

In addition to the vertical fiscal imbalances, horizontal imbalances arise from differences in the ability to raise revenues and unit cost of providing public services. Horizontal equity is violated when there are differences in revenue and cost disabilities across states (Buchanan 1950; Boadway and Flatters 1982). If people are perfectly mobile, across jurisdictions, they will migrate from places where the net fiscal benefits are lower to those where they are higher. Even when there is no perfect mobility, if the property market is reasonably well developed, fiscal differentials will be capitalised into property values (Oates 1969). In developing countries, there is neither perfect mobility nor a developed property market and the only way left to offset these fiscal disabilities is through intergovernmental transfers. Such transfers should 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 such as elementary education, basic healthcare and anti-poverty interventions. Such transfers should be purpose-specific and linked to providing the specified minimum standards. The states may be asked to make matching contributions to avoid substituting these transfers to own expenditures. Given the varied levels of service provision prevailing in different states, it is possible to design the transfer system with varying matching requirements (Feldstein 1975).

Fiscal Federalism

The federal fiscal system and institutions: India is the largest democratic federal republic, inhabited by 1.3 billion people spread over 29 states and seven union territories covering an area of 3.29 million square kilometres. The intention of 73rd and 74th amendments of the Constitution was to evolve a three-tier federal structure. However, Entry 5 of the State List in the Seventh Schedule assigns the affairs of local governments entirely to the state governments which denies them independent status. At best, the arrangement is akin to deconcentration and not surprisingly, the devolution of powers to the third level is uneven across the states.

The Seventh Schedule to the Constitution specifies functions in terms of union,[1] state, and concurrent lists. Most of the broad-based taxes are assigned to the union government and states are given the predominant responsibility of providing social services and coequal responsibility to economic services. The founding fathers of the Constitution were aware of the resulting vertical imbalance and provided for the sharing of central taxes with the states and giving grants to them from the consolidated fund of the centre. They also provided for the appointment of an independent Finance Commission every five years.

The total revenues—tax and non-tax—collected by the union and states relative to the gross domestic product (GDP) amount to about 20.5% and total expenditures are about 27%. The states collect about 37.5% of revenues but incur over 60% of the total public expenditures. Thus, the states' total expenditure is 18.3% of GDP of which they raise about 8% from their own sources and receive transfers amounting to about 7% of GDP. The remaining expenditure is financed from borrowing.

Some important features of the states' economy and finances presented in Table 1 may be summarised here. First, inter-state disparities in per capita incomes (gross state domestic product [GSDP]) have been high and increasing over the years. In 2014–15, among the general category states, at ₹1,65,728, Haryana, the state with the highest per capita income had five times the per capita income of Bihar, the lowest income state. The coefficient of per capita incomes in the states has steadily increased from 0.30 on 1981–82 to 0.35 in 1991–92 and further to 0.40 in 2014–15. Second, not surprisingly, per capita revenues vary with per capita incomes predominantly due to variations in revenue capacity. Third, although per capita transfers are higher in the states with lower per capita incomes, they fail to fully offset the revenue disabilities.

General Purpose Transfers

Article 280 of the Constitution mandates the President to appoint the Finance Commission every five years. 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 be given 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

Table 1: Differences in Per Capita NSDP and Fiscal Variables among States (2014–15) (₹)

States	Per Capita NSDP	Per Capita Revenue	Tax–GSDP Ratio	Central Transfers General Purpose	Transfer Specific Purpose	Total Transfers	Total Expenditure	Development Expenditure
Andhra Pradesh	1,06,263	10,687	8.00	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	1,41,405	11,187	6.85	2,067	1,263	3,329	17,446	12,486
Haryana	1,65,728	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	1,44,869	11,788	7.63	2,488	2,121	4,609	19,482	13,987
Kerala	1,55,005	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	1,52,853	10,887	6.42	1,795	1,426	3,221	16,822	11,383
Odisha	71,184	6,411	6.40	4,392	2,295	6,686	14,356	10,740
Punjab	1,26,606	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	1,46,503	11,668	7.20	2,839	1,910	4,749	20,062	12,995
Telangana	1,41,979	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
General category states	95,802	7,895	6.63	3,498	1,531	5,030	14,082	9,807
All states	95,802	7,419	6.58	3,757.99	1,641.16	5,399.15	9,977	14,637

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

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 of disaster management systems, strategic approach to public enterprise reform and incentivising the states to undertake tax reforms. So far, the FFC has submitted its reports and the Fifteenth Finance Commission is deliberating at present.

After the FFC made the recommendations, the entire architecture of the transfer system changed. A clear distinction has emerged in respect of general purpose and specific purpose transfers in Indian fiscal federalism after the report of the FFC 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. Unlike the past commissions, the FFC had to assess the requirements of the states in their revenue accounts entirely without making a distinction between plan and non-plan. Besides, the analysis done by the FFC showed that between 2005 and 2012, the central government's spending on state subjects increased from 14% to 20% and its spending on concurrent subjects increased from 13% to 17%. Therefore, the commission increased the share of the states in the divisible pool of taxes to 42% from 32% recommended by the previous commission.[2] The commission adopted a formula for distribution comprising of variables representing revenue and cost disabilities. It gave 50% weightage to deviation from the highest per capita income, 27.5% weightage to population, 15% weightage to the area and 7.5% weightage to the forest area.

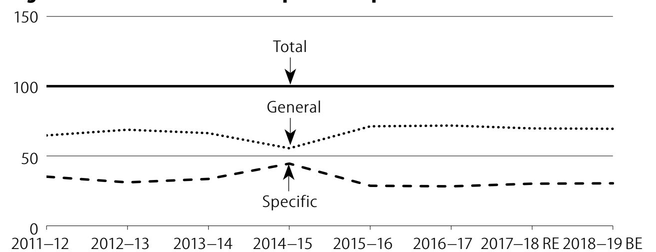
The FFC's recommendations have substantially altered the landscape of federal fiscal transfers (Table 2). While there was no significant change in the total transfers to the state in 2015–16 over 2014–15 in the first year of the award, the share of general purpose transfers rose significantly from 55.5% to 71% (Figure 1). In other words, the increase in tax devolution by the FFC resulted in the share of general purpose transfers going up significantly, but this was countered by the central government reducing the specific purpose transfers (Chakraborty and Gupta 2016). Thus, about 1 percentage point increase in general purpose transfer was countered by equivalent reduction in allocation to central schemes.

Table 2: Trends in General and Specific Purpose Current Transfers

	General Purpose Transfers	Specific Purpose Transfers	Total Current Transfers	Share of General Purpose in Total Current Transfers
2011–12	3.63	1.97	5.60	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	5.22	1.81	7,03	74.25
2017–18	5.08	1.87	6.95	73.06
2018–19 RE	5.17	1.97	7.14	72.42
2019–20 BE	5.28	1.83	7.11	74.25

Source: Budget documents of the Union Government.

Figure 1: Shares of General and Specific Purpose Transfers



In this connection, it is useful to refer to the recent suggestion by Kelkar (2019) in his Sukhamoy Chakravarty Memorial Lecture that Finance and Planning Commissions had two different objectives, the former allocating resources for the provision of basic public goods and services in the states and the latter allocating resources to create physical and social infrastructure and its even spread. Following the Tinbergen principle of matching the number of instruments with objectives, it is argued that the two different sources of transfers should have continued and therefore, NITI Aayog should have powers to allocate resources to the states for fulfilling the objective of balanced regional development by mitigating infrastructure differences in low-income states.[3] The problem with this argument is that: (i) the distinction made between plan and non-plan over the years had lost meaning and they were far remote from being considered for creation of infrastructure and provision of consumable public services; (ii) the creation of infrastructure and its equitable spread requires equalisation of capital expenditure and this should be addressed mainly through borrowing and not through current transfers; (iii) most conditional transfers are given through various central ministries and an overwhelming proportion of these are not for creation of physical infrastructure equalisation; (iv) the capital expenditure component of the plan itself had come down over the years and it was hardly 20% when the Planning Commission was disbanded; and (v) the analysis shows that the high weights assigned to the population factor, the transfers given for state plan schemes based on the Gadgil–Mukherjee formula were much less redistributive and were not related to infrastructure deficiency in any case. In fact, the Finance Commission transfers have been found to be much more redistributive as will be shown later in the paper.

A recent proposal by Subramanian (2018) for reforms attributes three objectives to the tax sharing system, namely (i) redistribution; (ii) risk sharing in response to shocks; and (iii) incentives for better performance. The paper proposes four transfer pots: (i) the default pot; (ii) redistributive pot; (iii) a risk sharing pot to deal with national (currency crisis, financial crisis) as well as state-specific (monsoon, droughts) shocks; and (iv) an incentive pot to lift the subnational governments from the low equilibrium trap by giving incentives to generate more revenues through matching grants. The default pot is meant to return a part of the divisible pool based on origin and akin to offsetting the vertical imbalance, and the redistributive pot is a pure horizontal imbalance transfer.

The problem with this scheme is that, first, the default and redistributive pots could substantially offset each other and

the final distribution will depend upon the composition of the two pots. In this scheme, what happens to the overall objective of unconditional transfers—of enabling the states to provide comparable levels of public services at comparable revenue effort? And second, attributing revenues based on origin in a federation has problems. The businesses of corporate entities come from the market spread across the country, therefore attributing profits earned and taxes paid to any specific state would be difficult. Furthermore, tax returns are filed from head offices which are located in major cities even though the incomes/profits are earnt from the businesses spread throughout the country. As regards the objective of risk sharing, there is already a mechanism that is put in place with the establishment of National and State Disaster Relief Funds and separate grants are given to the latter. The financial and currency crisis should be dealt with at the national level and it cannot be a mandate for tax sharing. To sum up, the Finance Commissions are the creatures of the Constitution, and, constrained by history, do not have the luxury of catering to objectives other than dealing with fiscal imbalances.

On the whole, the designing of the transfer system by the Finance Commissions is still a work in progress. Over the years, the commissions have evolved norms for making normative assessments of revenues and expenditures and yet, there are areas where further work is needed. First, while the commissions claim that they adopt uniform approaches for assessment between the union and the states, it is virtually impossible to enforce norms in the former. Second, admissibility of interest payments without applying any norms on the ground that this is a legacy does not penalise a state which is profligate and accumulates huge debt as compared to a state which has been frugal. Third, the approach has been partial as the problems of electricity utilities and transport undertakings do not get reflected in the overall fiscal assessment. The FFC suggested that in the future, the commissions should take into account the extended concept of deficits and debt, the states do not finalise the accounts of these enterprises in time. Finally, the Finance Commissions have serious constraints of time and this makes detailed scrutiny of the states' budget a challenging task.

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. Although the objective of specific purpose transfers is to ensure minimum standards of meritorious services in the Indian context,[4] this has been used to serve political objectives by the ruling parties at the centre to influence the electorate.

In 2012, there were 147 CSS, and these were consolidated into 66 by a Planning Commission committee chaired by B K Chaturvedi. After the FFC made the recommendation to increase the tax devolution to 42% of the divisible pool, a committee of selected chief ministers of the states, appointed by the NITI Aayog with the chief minister of Madhya Pradesh as the convener, consolidated the schemes into 28 and classified them into "Core of the core," "Core" and "Optional," with matching requirements from the states set at 30%, 40% and 50%, respectively. 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 CSS in 2016–17 amounted to 1.8% of GDP constituting about 28% of total transfers. Of these, only three schemes, namely the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), National Health Mission (NHM) and Sarva Shiksha Abhiyan (SSA) constituted 41%.

Considering the wide variations in per capita GSDP among the states, completely offsetting the revenue disabilities of low-income states to equalise per capita expenditures is politically infeasible in India. It is in this context that the role of specific purpose transfers becomes critical. In fact, ensuring minimum standards of specific meritorious services such as education and healthcare can help in equalising human capital expenditures, and considering that almost 68% of the children in the age group 0–14 years are concentrated in low-income states, empowering them with human capital is important. However, with as many as 28 specific purpose grants in place and with limited fiscal space available with the centre, this has meant thin spread of resources without much impact on service levels in the recipient states.

A detailed study of three important schemes, namely the SSA, NHM and MGNREGA which account for 41% of the transfers under the CSS undertaken for the NITI Aayog (Rao 2017, 2018) brings out the design and implementation shortcomings of these schemes.

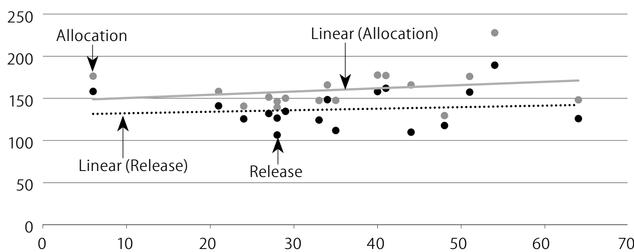
National Health Mission: The NHM is a specific purpose grant given to the states to augment their healthcare system to provide "accessible, affordable, accountable, effective and qualitative" healthcare. The core values of the programme are to: (i) safeguard the health of the poor, vulnerable and disadvantaged persons; (ii) strengthen public health systems as a basis for universal access and social protection against rising costs; (iii) build an environment of trust between the people and health service providers; (iv) empower the communities to become active participants in attaining the highest possible levels of health; and (v) improve efficiency and optimise the use of resources. The NHM support to states has five key components of reproductive and child health, augmenting infrastructure control of communicable and non-communicable diseases, and infrastructure and maintenance assistance for family welfare and the elderly. As this is a "core" programme, the centre bears 60% of the cost, whereas the states are required to contribute 40%.

For allocating funds to individual states, the Union Ministry of Health and Family Welfare (MoHFW) works out the resource envelops for each of the states based on area and weighted population. The weights for the latter is determined according to the states' socio-economic backwardness and health lag. Ten percent of the funds are given to the states based on their capacity to absorb funds as seen from the progress in key areas of

institutional reform identified in the memorandum of understanding. The states are required to prepare their annual Programme Implementation Plans (PIPs) keeping the envelop in view and based on the state's context and felt needs. These are appraised and approved by the National Programme Coordination Committee (NPCC) chaired by the secretary; MoHFW and the states are required to implement the plan as approved.

The analysis of the schemes brings out a number of policy issues. First, the analysis shows that there is a considerable difference between original allocation and final release which brings in a lot of uncertainty about the funding to the states. Second, specifying multiple objectives creates lack of clarity and makes evaluation of the programme difficult. The Action Agenda document of the NITI Aayog states that there are as many as 2000 budget heads under which the assistance is given. This betrays a lack of trust with the states, imparts inflexibility in the spending plan, creates a lot of bureaucratic hurdles, makes accountability difficult. The design of the transfers based on the population weighted according to health lags are too general and not surprisingly, states which are more deficient in health standards do not necessarily get larger per capita transfers (Figure 2). Thus, both the allocation and release of funds to the states are not to ensure minimum standards of services. Finally, econometric analysis of the NHM grants shows that these grants tend to substitute the expenditures financed by own resources significantly (Rao and Choudhury 2012).

Figure 2: Distribution of Central Grants according to Infant Mortality Ratio



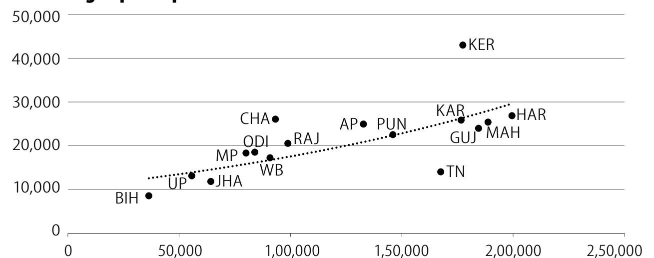
Sarva Shiksha Abhiyan: The SSA is a CSS implemented to achieve universalisation in elementary education in the country. The National Mission for SSA was started in January 2001. The objectives of the scheme are to ensure universal access and retention, inclusiveness by bridging gender and social category gaps in education, and enhancement in the learning levels of children. These are sought to be achieved through 42 different interventions such as opening of new schools, construction of schools and additional classrooms, toilets and drinking water, provisioning of teachers, periodic teacher training and academic resource support, textbooks and support for learning achievement. The insertion of Article 21A in the Constitution after the enactment of the Right of Children to Free and Compulsory Education (RTE) Act in 2009 mandates that every child in the 6–14 age group is entitled to have free and compulsory education in a neighbourhood school till the completion of elementary education. An important provision of the act is the requirement of admitting 25% of the seats in private schools for the children belonging to the weaker sections and disadvantaged groups in Class 1 or pre-primary class with the government reimbursing the fees of these children. During the period 2010–14, the sharing ratio between the centre and states was 65:35 for general category states and 90:10 for special category states. After 2015–16 this was changed to 60:40 in the case of general category states.

The share of the central government is released in three instalments in different months: ad hoc, first, and second instalments. The release is done after the provisional/audited utilisation certificate, the state's share statement, outstanding advances and pace of expenditure implementation are submitted. The central share is released to the states and the latter in turn release the funds to State Implementing Societies (SIS). They release the funds received by them to government schools, government-aided schools and private schools identified by the state government for giving grants.

As mentioned earlier, there are as many as 42 interventions to achieve multiple objectives and this makes defining the minimum standards difficult. For example, while enrolment ratio can be defined, it is not possible to clearly define and set minimum standards for the quality of education to be achieved through the transfer system. The focus then shifts to inputs such as teacher–student ratio or physical infrastructures provided rather than learning outcomes. At the end, the RTE ends up with attendance at schools rather than educating the young.

There are several problems in both design and implementation of the scheme. As may be seen from Figure 3, the expenditure per child in the schoolgoing age (6–13) in the states is positively related to per capita GSDP with a correlation coefficient of 0.688. This shows that the SSA does not have a significant impact on equalising per child expenditures 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 expenditures, the poor implementation results in lower teacher–student ratio, employment of untrained teachers, absenteeism of teachers and inability to provide teaching accessories. Thus, the basic objective of equalising standards of elementary education gets defeated.

Figure 3: Expenditure per Child in the Age Group 6–13 in States Arranged According to per Capita GSDP



As mentioned earlier, the preparation of plans for the SSA is done on an incremental basis and is not based on the shortfall in standards of elementary education. In the event, the grants are given not necessarily to overcome the shortfall in the standards of elementary education but based on the ability of the state to prepare its plans and in making matching contributions. The spread of grant per child in the age group 6–13 in the states arranged according to per capita GSDP shows

Figure 4: Grant/Child according to per Capita GSDP in States

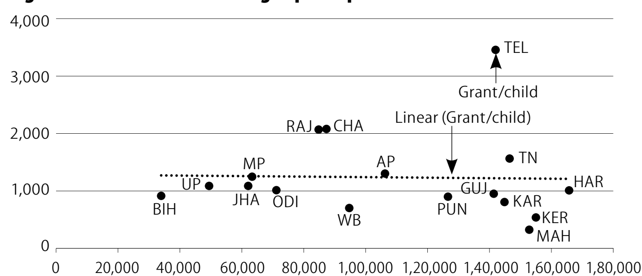
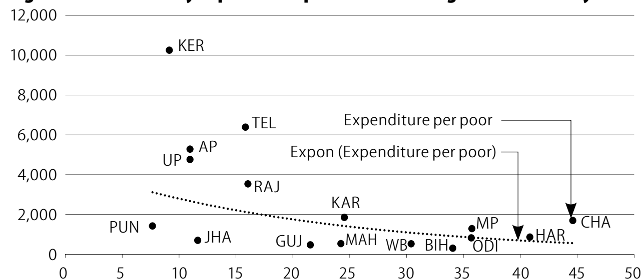


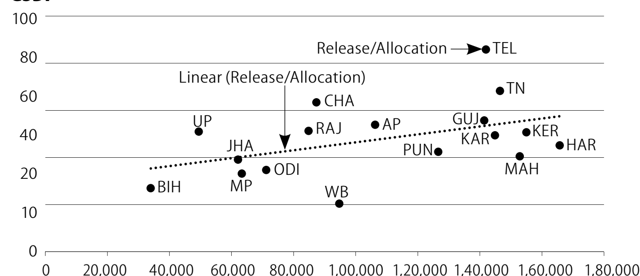
Figure 6: Rural Poverty Expenditure per Poor according to Rural Poverty Ratio



virtually no relationship between the two variables (Figure 4). This shows that the distribution of grants has not been according to the deficiency in the standards or revenue disabilities of the states. This is a matter of concern as the per child expenditures in the states with low per capita incomes and high population and having higher proportion of children in the schoolgoing age are low. This will accentuate educational inequality.

The lack of equalisation in the SSA grants is not only because of the shortcomings in the design of the grant system but also due to the implementation problems. The low-income states have been lagging in fulfilling the requirements for availing the grants allocated to them in full. The positive relationship between the ratio of grants release to allocation with per capita GSDP shows not only that the per child grant allocation to these states is lower, but also that they are unable to utilise the grants allocated to them in full (Figure 5).

Figure 5: Grant Release/Grant Allocation in States according to per Capita GSDP



Mahatma Gandhi National Rural Employment Guarantee Act: According to the World Bank report, MGNREGA is the world's largest 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 that volunteers to undertake manual work. The National Rural Employment Guarantee Act, 2005 provides the framework for the design and implementation of the scheme. The salient features are: (i) this is a rights-based scheme for adult members willing to do manual labour; (ii) the employment must be provided to the job cardholders within 15 days of their application failing which they are entitled to receive unemployment allowance; (iii) job cardholders can receive employment entitlement up to 100 days in a financial year; (iv) the works chosen must be labour intensive with unskilled wages constituting 60% of the cost; (v) implementation of the scheme is done at decentralised levels with village panchayats required to implement 50%; the entire work plan is supposed to be identified and recommended by the gram sabha; (vi) facilities such as crèche, drinking water, first aid and shade should be provided at the worksites; (vii) women beneficiaries must constitute one-third of the employment provided; (viii) there must be proactive disclosures through social audit, grievance redressal mechanisms to ensure transparency and accountability; and (ix) the states are responsible for implementation and guarantee that work as demanded for up to 100 days is ensured.

The funds to the states are released normally 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. After the approval by the empowered committee and adoption in the budget, the state government is required to prepare district-wise and month-wise projections of labour demand. Based on this, fund requirement is estimated by the NREGASoft. The first tranche is estimated based on the fund requirement for the first six months of the financial year or 50% of the labour budget of the state, whichever is lower. The first tranche is released in April.

The release of the first tranche is subject to the submission of: (i) a certificate to the effect that accounts of all the district of the state for the financial year before 2014 have been settled; (ii) a certificate on the settlement of all audit paras under the MGNREGA; (iii) a detailed action-taken report on the complaints forwarded to the state; (iv) a certificate indicating satisfactory compliance of ministry's clarifications/suggestions/guidelines and observations from time to time; (v) 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. The quantum of funds released in the second tranche depends on the performance in the utilisation of the funds available.

The MGNREGA is undoubtedly an important anti-poverty intervention. Although there are multiple objectives in the scheme, the principal focus is to mitigate the distress caused by rural poverty. This would mean that the spending on the MGNREGA should be such that the states with higher concentration of poverty should receive higher amounts. The analysis of per poor spending on the MGNREGA across different states shows that in 2014–15, per rural poor expenditure negatively correlated (-0.572) with the rural poverty ratio according to the Tendulkar measure (Figure 6). This shows shortcomings in the targeting of the MGNREGA.

Figure 7: Person Days Employed according to Rural Poverty Ratio (in Lakh)

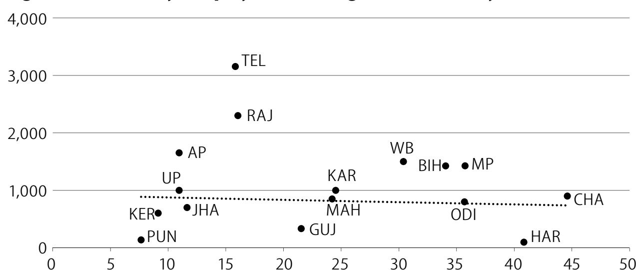
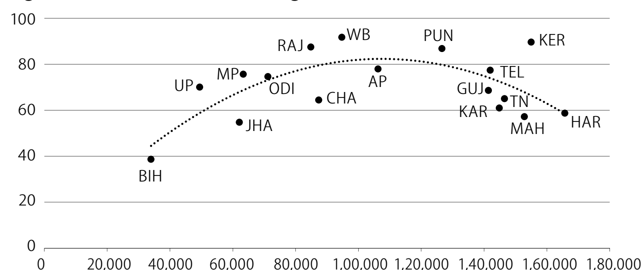


Figure 8: Percent of Release to Original Cost Estimate



The above finding is reinforced by the pattern of person days of employment generated through the MGNREGA in different states relative to their rural poverty ratio (Tendulkar measure) in 2014–15. Figure 7, which presents the analysis, does not show any particular pattern. It is seen that Tamil Nadu had the highest number of person days employed even though the rural poverty ratio in the state was just 15.8%. In contrast, Bihar, Chhattisgarh, Jharkhand and Madhya Pradesh which had the highest rural poverty ratios had much lower person days of employment.

The 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 Socio-economic Caste Census (SECC) estimates and frequency of the occurrence of natural calamities. In this list of factors, SECC poverty is the only measure that targets the spending on rural poverty. Besides being largely incremental, there is considerable discretion by the empowered committee. Consequently, the states with larger poverty concentration do not necessarily get the higher MGNREGA grant.

A comparison of originally estimated allocation with the final release of funds under the MGNREGA in 2014–15 shows interesting results. First, although the funding for the MGNREGA is claimed to be open ended, the actual release of funds in 2014–15 was lower than the originally estimated expenditures in every state by varying magnitudes (Figure 8). The figure plotting the difference between the original allocation and final release of expenditures arranged according to per capita GSDP shows an inverted "U" shaped pattern. The difference, in states with very low per capita GSDP, is the lowest. The ratio is higher for higher per capita GSDP states but at very high levels of per capita GSDP, it declines. The low per capita income states have a high concentration of rural poverty and therefore, attach much greater importance to the programme. However, at 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.

The important point is that as MGNREGA is a programme of giving wage employment to the poor, it is desirable to design the grant system based on the single factor of rural poverty rather than bring in 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 on providing assured wage employment to the rural poor is met.

One of the reasons for the low ratio of actual release of grants to the original expenditure estimate in the states with 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 varying system of matching ratios depending on the revenue raising capacities of the states. This would help the states with low per capita GSDP having high concentration of rural poverty.

Major shortcomings in specific purpose transfers: The analysis points to a number of shortcomings in the schemes. First, there are too many schemes and within each scheme, too many sub-schemes with different objectives to be financed. Specific purpose transfers should be given only to those schemes which are meritorious, and the objective should be to ensure minimum standards of services in them. Taking as many as 28 schemes only results in spreading resources thinly across them. While this may serve various political constituencies, it may not achieve the objective of equalising standards of services which are meritorious.

Second, the grants for the schemes are not determined based on the shortfall in the prescribed standard of services. Both the aggregate 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 on 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 that an educationally backward state or a state with poor health indicators gets more education or health grant. The telling case is of MGNREGA. The volume of grants depends on the ability of the bureaucracy in preparing the plans and fulfilling the formalities, including furnishing of the utilisation certificate.

Fourth, the uniform matching ratio across states makes it difficult for the low-income states to utilise 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. The introduction of varying matching ratio depending on the shortfall in service levels could improve the design of the grant system. Fifth, there is a considerable difference between the approved allocation and the actual release of grants. In 2014–15, only 71% of the allocated funds were disbursed in the case of rural employment guarantee scheme and the extent of difference varied between 38% in Bihar, the poorest state and 91% in West Bengal, a middle-income state. This creates uncertainty in implementing schemes and invariably the states with larger poverty ratios suffer the more. Sixth, the analysis of grants for healthcare shows that the states are able to substitute grants to their own spending and increase in spending on healthcare is much less than the grant amount. Seventh, approval of the schemes with various components and the requirement to adhere to the originally approved composition often leads to micromanagement, proliferation of bureaucracy and inefficiency. In the case of education, for example, the states have to prepare the budget and the centre has to monitor in terms of 42 different interventions. In the case of healthcare, the Action Agenda report of the NITI Aayog referred to 2,000 budget heads in which the grants are given. Most schemes suffer from micromanagement, inadequate allocation to different activities and wastage therefrom.

Overall Equity of the Transfer System

To analyse the extent of equity of transfers, individual component as well as the aggregate per capita transfers are regressed on per capita net state domestic product (NSDP) in a double log equation. The analysis shows that the general purpose transfer given on the recommendations of the Finance Commission is the most equalising with the elasticity coefficient of (-) 0.452 and the specific purpose transfers are the least equalising with the elasticity coefficient of 0.162 which is not significant. The overall transfer system is equalising with the elasticity coefficient of (-) 0.267.

To estimate the extent of equalisation of the transfer system, revenue capacity of the states is estimated by regressing per capita own revenues of the states with their per capita NSDP and the share of non-agricultural NSDP in a double log equation. By substituting the actual values in the equation and taking all-state average as 100, an index of revenue capacity is calculated. This is compared with the index of revenue capacity augmented with transfers. These results plotted against per capita NSDP in Figure 9 show that the index of own revenues of the states (with all-state average specified at 100) increases steeply with per capita incomes. The index of total revenues (including transfers) too shows a positive slope with per capita incomes but is flatter than the former reflecting the extent of equalisation.

Thus, it is seen that (i) the Finance Commission transfers are equalising but offset the fiscal disabilities of the states only partially; (ii) the central schemes are not equalising at all; and (iii) even after the fiscal transfers are considered, per capita revenues accruing to the states are positively correlated with per capita incomes of the states. The resources in low-income states enable them to incur much lower levels of spending than their richer counterparts.

Figure 9: Progressivity of the transfer System 2014–15

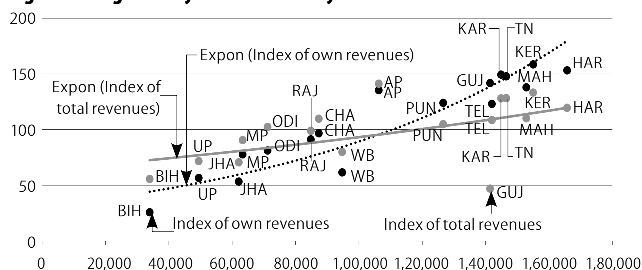


Table 3 brings out the regression results in which per capita expenditures on various services are regressed on per capita incomes of the states for 2014–15 in a double-log function. It is seen that total as well as almost all expenditure categories except capital expenditures show a positive and significant relationship. In the case of total state expenditures, per capita expenditures are higher by 0.65% when per capita incomes are higher by 1%. The relevant elasticity is 0.69 in the case of current expenditures. 0.65 in the case of expenditures 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 3: Elasticities of per Capita Expenditures with Respect to per Capita Incomes in the States

	Expenditure Category	Constant (a)		Regression Coefficient (b)		Adj R^2
1	Revenue expenditures	1.5486	(1.2189)	0.6906	(6.2535)*	0.70
2	Capital expenditures	2.6142	(0.8169)	0.4248	(1.5202)	0.077
3	Expenditures on economic and social services	2.9471	(2.0104)	0.5488	(4.3063)*	0.52
4	Expenditure on social services	1.1281	(0.8551)	0.6511	(5.6781)*	0.66
5	Expenditure on economic services	3.5793	(1.8422)	0.4274	(2.5307)*	0.25
6	Expenditures on education	0.4324	(0.2499)	0.6420	(4.2681)*	0.52
7	Expenditures on public health	-1.6654	-(1.0743)	0.7185	(5.3322)*	0.63
8	Total expenditures	2.0866	(1.6440)	0.6562	(5.9465)*	0.68

Estimated Equation is: Per capita expenditure = Log a + b log per capita income + $\in$
* Denotes significant at 1% level.

The analysis shows that despite equalising transfers, public expenditures are higher in more developed states. This trend leads to increasing inequalities in infrastructure levels and human development causing divergence of incomes across Indian states. The matter is particularly so in the case of education and healthcare where the elasticities are high, and given the staggered demographic profile in low-income states, the requirement for public spending in these states is much higher, but these states continue to spend lower per capita expenditures despite the transfer system.

Concluding Remarks

Fiscal transfers from the centre to states are critical in India. Unlike in many developed federations the interstate differences in revenue capacity are large and increasing. Considering such horizontal imbalances, design and implementation of transfer systems are critical.

Although general purpose transfers are given to offset fiscal disabilities of the states so that all the states are enabled to provide comparable levels of public services at comparable tax

rates, given the large variations in fiscal disabilities in Indian states, it becomes difficult to design the general purpose transfers to fully offset the revenue and cost disabilities. This brings in the importance of specific purpose transfer to ensure minimum standards in meritorious services like education and healthcare so that the future generation is endowed with human capital.

The analysis of intergovernmental transfers shows that the tax devolution and grants given on the recommendations of the Finance Commission are equalising, able to offset the revenue disabilities of low-income states only partially. The consequence of this is that the higher income states are able to incur significantly larger per capita expenditures on all major social and economic services. This tends to accentuate interstate inequalities in social and economic services leading to increasing divergence in developmental outcomes.

There are a number of problems with the design and implementation of specific purpose transfers. First, there are too many schemes resulting in the thin spread of resources. Second, there are multiple objectives in each of the schemes and grants are not linked to service-level outcomes but tend to be incremental. Thus, the transfers are not designed to achieve the basic purpose of ensuring minimum standards of services. Third, the grants are not linked to shortfall in the chosen services. Thus, educationally backward states do not get larger grants for education and states with the lowest health standards do not get higher per capita grants for health. Fourth, there is considerable difference between the originally approved allocation and final release of funds under various schemes. In the case of the MGNREGA, the shortfall was 20% in 2014–15. The differences are larger in the case of low-income states. The inability of the centre to provide the funds allocated in the beginning of the year creates considerable uncertainty. Fifth, a part of the reason for the greater shortfall in low-income states is perhaps their low fiscal space and uniform matching requirements. Sixth, the requirement to compartmentalise grants under several different interventions within a scheme results in lack of flexibility in the use of funds. Finally, in some schemes like healthcare, the states were able to substitute grants for spending from own resources with the result that commensurate increase in spending on healthcare does not take place.

The central government may not be able to influence much as far as the Finance Commission's recommendations are concerned as this is an independent body making assessments of union and state finances and recommending tax devolution and grants. However, the application of norms by the Finance Commissions is still a work in progress and much more research in this area is important to enable them to incorporate norms. On the CSS, the centre can certainly do well to rationalise the design and implementation systems. Here, it is important to limit the number of schemes and fund them adequately to make a difference to service levels and link them to shortfall in specified services to achieve the objective of ensuring minimum standards. There is certainly a case for having differential matching requirements with the states' contribution increasing as the shortfall in services reduces. The FFC has made the recommendation that the number of transfers should be minimised 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.

NOTES

1 The terms "union" and "centre" are used interchangeably in this paper.

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

3 Thurow (1966) had applied the principle to argue that both conditional and unconditional grants are needed to achieve allocative and redistributive goals.

4 This section is taken extensively from the study report submitted by the author to the NITI Aayog. See Rao (2017).

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