

POLITICAL ECONOMY OF FISCAL FEDERALISM IN INDIA

A SUMMARY

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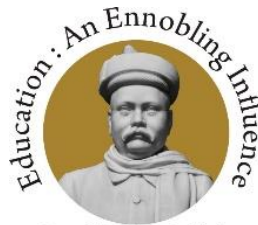
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SUMMARY

Fiscal federalism in India has its own characteristics and nuances. The patterns in Centre-State financial relations within the Constitutional framework of unique and well-defined transfers leave enough room for fiscal bargains and exigencies of coalition politics between the Union and the States. Understanding the framework of transfers in India requires an integrated view of the Finance Commission, the Planning Commission and the uneasy relationships between these two transfer agencies. It also requires an analysis of the discretionary transfers by Central Ministries. All these factors lead to a considerable variance in the funds transferred by the Centre to the different States. The persistent variability in transfers to different States is all the more interesting when one contrasts it against the stated objective of statutory arrangements, which is to use transfers as an equalizing instrument.

In this thesis, we analyze the trends in transfer of funds from the Centre to States in India and attempt to describe and explain the differences in fund transfers across States. In doing so, we check the validity of a rather popular argument in positive Public Economics; namely, Federal fund transfers are not just equalizing transfers, but rather are tools through which the Union of India enters political bargains with its constituent State units.

A Brief Historical Review

The various political forces at play at the time of Independence, the bargains driven between the Centre and the various Princely States, the need to ensure social equality through legal means and the demands for autonomy by regional interest groups were instrumental in shaping the design of the Constitution of India. Holding together a heterogeneous mix of people with

different religions, castes, sects, languages and ethnicities was a challenge since every of these variables created a “group identity”. Group identities were especially prominent where there was a concentration of the population belonging to a particular language or ethnicity within an area. Thus, group identities started manifesting themselves as regional identities and with these came the demand for more autonomy or safeguards. The Constitution again re-organized the country on a linguistic basis and in case of North-East India, on the basis of ethnicities. Each of these constituent units now represented a regional grouping, had unique developmental issues and interestingly, hosted political parties that shared regional, caste and ethnic characteristics with the electorate of the State.

Multiple Transfer Mechanisms in India: Finance Commission, Planning Commission and Central Ministries

At the same time, the economic logic within the Constitution created a set of different issues. The Constitution of India assigns the most productive taxes to the Centre and allocates development expenditures to the States, leading to a vertical imbalance between Centre and States. The Constitution also creates a mechanism to correct for the vertical imbalance, namely the Finance Commission (FC). The FC recommends the percentage of Central taxes to be shared with the States as also the inter-se distribution of the tax proceeds between the States. FC transfers to States are driven by distribution formulae, and hence could not accommodate political demands made by the constituent State units on the Centre.

It is here that another parallel, non-Constitutional body to recommend transfers to States entered the design of fiscal federalism of India. This body was the Planning Commission (PC).

The PC was created in 1950 through a Government Resolution in order to assess the country's resources and to create a Plan that would facilitate development through optimal utilization of the same. However, execution of the Central Plan would require the co-operation of the States. Further, optimization also required integration of State Plan targets with the Central targets. In order to facilitate the process of integrating planned development across Centre and States, the National Development Council (NDC) was set up in 1952.

By its design, the NDC was a federal institution. It was a platform to assess States' resources and to recommend to the Centre the quantum of assistance that each State would require for fulfilment of its Plan targets. The meetings of the NDC used to be presided over by the Prime Minister of India and States would be represented by respective Chief Ministers. The platform soon became one associated with hard economic bargains being driven as a result of political relations. However, it is important to note that PC transfers too became formulaic over a period of time and were driven by the Gadgil-Mukherjee formula.

There is a third route of funds transfer to the State Governments. This is the fund transfer done by the Central Ministries. The Central Ministries (Agriculture, Health, Education, etc.) transfer funds to States for running developmental schemes with those funds. Those schemes which are directly implemented by the Centre are called as Central Sector Schemes. For example, the Crop Insurance Scheme (Prime Minister Fasal Bima Yojana launched in the 2017-18 Budget) or the Rashtriya Swasthya Bima Yojana (launched in the 2018-19 Budget) are Central Sector Schemes, which are implemented by the Union Ministry of Agriculture and Union Ministry of Health respectively. Apart from Central Sector Schemes, the Central Ministries also give funds for Centrally Sponsored Schemes (CSS). For example, Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) is a Centrally Sponsored Scheme. CSSs are funded

partly by the Centre and partly by the State Government. In contrast to Central Sector schemes, CSSs are implemented by the State Governments.

Transfers given by the Central Ministries for funding Central Sector and Centrally Sponsored Schemes are not formulaic and are at the discretion of the Union Government. Thus, the transfers given by the Central Ministries create a very interesting contrast when compared to the Finance Commission transfers, which are more formulaic in spirit.

Analyzing and contrasting the trends in these two routes of transfers would help us to understand if there are different sets of States that have stood to gain under the formula-driven and discretionary transfer routes. If there indeed are, and the States showing positive deviation from the formulaic transfers are the ones with political influence at the Centre (in terms of supporting the party in power at the Centre or in terms of being coalition partners), then it could indicate the validity of the conjecture mentioned above.

Issues that the Thesis Examined

The thesis examines an oft-repeated argument in the positive literature on fiscal federalism in India: Do political variables affect the extent of fiscal transfers from Centre to States?

We first review the rationale for this argument. Why would political variables affect economic transfers? The States are important for the Centre because of the powers of legislation that they carry in the Rajya Sabha. Further, States also function as useful means through which the political party at the Centre can access the remote voter. States and the regional parties in power are also important for the Centre particularly if there exists a coalition rule at the Centre, wherein a major National Party forms a coalition with State-level or regional or local parties. In India, the period after 1990 has been particularly associated with coalition politics. Weaker the position (in

terms of number of seats held) of the major National Party within a coalition, higher would be the possibility of using discretionary transfers to politically relevant to advance its own power within the coalition.

The presence of possible political bargains could thus drive the possibility of higher transfers to politically relevant States, especially when the transfers are discretionary in nature.

We examined data on transfers done by the Finance Commission, Planning Commission and Central Ministries from 1993-94 to 2013-14 to fourteen large, General Category States.

In order to check whether discretionary transfers are at all impacted by “political alignment” of the State with the Centre, we created “clusters” of politically aligned and non-aligned States for each year within the dataset. We also created clusters of States having high, medium and low transfers under FC, PC and Central Ministries for every year.

We juxtaposed the clusters to find out instances of those States which simultaneously belong to the “high transfers” cluster as well as the “politically aligned” cluster. This exercise was done for FC, PC as well as Central Ministry transfers separately. The results are interesting.

Key Findings of the Thesis

We find that there is no significant simultaneity of being politically aligned as well as being a high transfers State under the FC route. In other words, political alignment does not matter for receiving transfers under the FC route. This was an expected result, given that FC transfers are formulaic.

However, using the same diagnostics for discretionary transfers, we get a very surprising result. We find that political alignment does not matter for receiving transfers under the discretionary

route either! Thus, it is not political alignment that is causing the variation in the fund transfers to States under the Central Sector and Centrally Sponsored Schemes.

If it is not political variables, then what really explains the differential discretionary scheme transfers to States?

We go on to examine three main Centrally Sponsored Schemes in India, namely, Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA), Pradhan Mantri Gram Sadak Yojana (PMGSY) and National Health Mission (NHM) in order to identify why different States receive different levels of transfers under the aegis of these schemes. We find that the explanation to the differential levels of transfers to States lies in the design peculiarities of the schemes.

The Centre, for ease of administering the schemes, normally uses a “one-size-fits-all” approach and creates a common set of rules regarding compliance, financial declarations, sharing of funds between Centre and States, administrative processes and implementation of the program. Given that financial, administrative and implementation capacities are vastly different across States, at least a few of the States could find it cumbersome to fit into the design of the scheme. Some States may not have the fiscal capacity to support the part funding that the scheme demands. Even though a State is politically aligned to the Centre, bureaucratic paperwork entailed by the design of the scheme may stall the movement of funds to such a State. Similarly, inefficiencies of the local Government may create non-utilization of funds, thereby affecting fund transfers in the next time-period. These factors thus lend “rigidities” to scheme transfers, and create situations in which States normally gravitate to what could be called as an “equilibrium” fund-position for that State within a particular scheme.

Consider the case of MNREGA. MNREGA provides a “legal guarantee of at least 100 days of employment on asset creating public works programs every year at minimum wages for at least one able-bodied person in every rural, urban poor and lower middle class household”. In order to introduce transparency and accountability at the level of local governments, electronic Fund Management System (e-FMS) was introduced for financial accountability. How did this impact fund transfers across States?

While introduction of e-FMS led to the intended consequences of reducing the leakage of funds, it also created a huge requirement for training the administrative machinery. Many of the administrative staff for running CSS are contractually hired and did not have the required skill sets to carry out transactions under e-FMS.

Here, it would not be wrong to claim that the Southern States, with higher literacy levels in general and higher exposure to IT management systems in particular could adjust better and more quickly to this “new normal”. This partly helps to explain why the performance of Southern States in terms of fund utilization tends to be stronger than other States for all CSSs in general and MNREGA in particular.

Andhra Pradesh used the e-FMS aggressively. It is seen to be one of the success stories under MNREGA. Interestingly, Andhra Pradesh was politically aligned to the UPA Government from 2005-06 to 2013-14. Statistically, the higher grants received by Andhra Pradesh from the Centre for MNREGA and political alignment would show up as a positive correlation between transfers and political alignment. However, what is perceived to be a politically driven transfer is actually a design issue under MNREGA.

There are many such instances, which actually are design issues, but are perceived as being a part of the political nexus between Centre and States. It is interesting to compare two large States, Uttar Pradesh and Bihar, in this context. Uttar Pradesh was politically aligned to the UPA Government right from the launch of MNREGA in 2005-06 upto 2013-14, whereas Bihar shows non-alignment for the same years. Both States have recorded lacklustre performance in terms of fund utilization under MNREGA. What causes this poor performance?

MNREGA mandates no more than 6 per cent of the total expenditure to be earmarked for the administrative support for the scheme. In States such as UP and Bihar, in which the number of Gram Panchayats is high and in which the geographical area to be physically covered by works proposed under the scheme is huge, the administrative expenses are high. State Governments are curtailed by the 6 per cent administration expense norms. Shortage of staff leads to planning issues and under-utilization of funds. Further, the scheme mandates that 33 per cent of the works be reserved for women workers. However, women culturally have been unwilling to apply for jobs under MNREGA in UP as well as Bihar and hence there are delays in commencing the works. These are again design issues. The one-size-fits-all approach of the scheme is a design problem that cannot adjust for size of the administrative staff or cultural issues. This design problem then manifests itself in terms of differences in State performances under MNREGA.

Thus, the explanation to the differentials in discretionary transfers to State does not lie so much in political alignments as it lies in the design of the transfers. This does not mean that political bargains and negotiations do not play a role in influencing transfers. They do, but the role of such bargains might manifest itself more in terms of implicit transfers rather than explicit ones. Implicit transfers could be in the nature of the Centre giving loans to States at lower interest

rates, changing compliances for certain schemes at the behest of States or declaring certain development objectives perceived important by States as immediate priorities.

There is a limited role that political influences can play in explicit scheme transfers. It is true that transfers given by the Central Ministries are discretionary, but that discretion is also subject to various administrative, financial, manpower, and design conditions.

Thus, differentials in fiscal transfers from Centre to States need not only be the result of political nexus between them. More often than not, the differentials are driven by flawed and rigid designs of the Centrally Sponsored Schemes, rather than by political factors.

Suggestions for further research

While a lot of research studies focus on output or outcome assessments of different Centrally Sponsored Schemes in the country, these pertain to how many beneficiaries the scheme managed to reach and other overall increment in development indicators achieved due to the intervention. However, there is scant literature pertaining to the specific “design components” of the schemes, which lead to the scheme performing or not performing well. Research needs to focus on identifying the exact micro-points within each process of a scheme which either create problems or help to resolve issues. While there is now a growing interest in “ethnographic “documentation of several Government interventions in India, a lot of areas are still unexplored. Since the success of CSS interventions depends on a large number of actants such as bureaucrats, elected representatives, administrative officers, consultants, contractors and beneficiaries, micro case studies are perhaps one of the best methods to identify design issues in the CSS.