IMPLICATIONS OF FCC RECOMMENDATIONS FOR SOCIAL SECTOR SPENDING ACROSS STATES

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The Fourteenth Finance Commission (FFC) set the stage for a radical overhaul of centre-state relations. Many actors, including state governments, have expressed concerns over the implication of these changes on the fiscal space available, state autonomy and social sector investments. We analyse budgets of 19 states and find that overall fiscal space for states has increased, as has social sector investment. We argue that this presents a need to significantly restructure Centrally Sponsored Schemes, improve the quality of budget data as well as an opportunity to ensure greater research and advocacy at the state level.
FISCAL TRANSFERS IN INDIA

India is a federal country with a three-tier system of government namely, the Union, states and local levels. Adequate fiscal space is a pre-requisite for these different levels of government to function autonomously. In India, the Union government collects a majority of tax revenues, and thus fiscal decentralisation is necessary to empower states and local governments. Inter-governmental fiscal transfer systems play an important role in this. First, they can help put states on a level playing field by providing additional resources to fiscally weaker states. Second, they can increase accountability and create incentives for effective service delivery. Third, they serve as an important tool for the Union government to ensure coordinated effort in areas of national priority. In India, fiscal transfers from the Union government to state governments consist primarily of two types: Constitutionally-mandated transfers and discretionary transfers.

CONSTITUTIONALLY-MANDATED TRANSFERS

The principal mechanism of fiscal transfers in the Constitution is through tax devolution. The framers of the Constitution recognised that while the Union government collects a majority of the taxes in the country, the resource needs of the states were much higher, since they were responsible for delivering most public services. This creates a “vertical imbalance”, with greater revenue collection at one level and higher expenditure need in another level. This imbalance is addressed by distributing a share of the taxes levied by the Union government to states. Resources received through means of tax devolution are often referred to as “untied” grants as the Union government cannot impose conditionalities on how states use these funds.

The Constitution also provides for fixed sums, called grants-in-aid, to be transferred to states “in need of assistance”. Unlike devolved taxes, grants-in-aid can be transferred for specific purposes, and may have conditions attached to their disbursement.

The Constitution mandates the creation of Finance Commissions once in every five years, in order to review these transfers. Recommendations made by Finance Commission are not binding, but are conventionally accepted by the Union government.

DISCRETIONARY TRANSFERS

In addition to the Constitutionally-mandated transfers to states, the Union at its discretion can fund state governments for specific purposes. Centrally Sponsored Schemes (CSSs) are an important discretionary transfer mechanism used by the Union government to assist states in fulfilling their Constitutional responsibilities in areas of national priority like agriculture, health and education. Over time, transfers through CSSs have increased significantly; in 2012, they constituted 42 per cent of the Union’s plan expenditure.

RECOMMENDATIONS OF THE FINANCE COMMISSION

In December 2014, the FFC submitted its recommendations to the Union government. The major changes include:

- an increase in the proportion of funds transferred to states from 32% to 42% of the divisible pool of Union taxes;
- a change in the formula for determining inter-state shares; and
- a reduction in state specific schemes with conditionalities to more block grants for certain areas.

The recommendations made have been summarised in Table 1.

1 For an exhaustive treatment of fiscal decentralization in India, see “Fiscal Decentralization to Rural Local Governments in India: Selected Issues and Reform Options”, Rao, Raghunandan et al. 2011
3 The Expert Committee on Financial Provisions of the Constitution, 1947
4 Article 275, Constitution of India
5 The divisible pool can be thought of as the sum of all Union taxes and duties, excluding collection costs, surcharges, and specific-purpose cesses. For a more precise definition see Arts. 268 through 271 of the Constitution of India
## Table 1: A Comparison of Recommendations of 13th and 14th Finance Commissions

<table>
<thead>
<tr>
<th>ITEMS</th>
<th>13th Finance Commission</th>
<th>14th Finance Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of Union taxes devolved to states</td>
<td>32%</td>
<td>42%</td>
</tr>
</tbody>
</table>
| Formula determining a states’ share of devolved taxes | • 1971 population: 25%  
• Area: 10%  
• Fiscal Capacity Distance: 47.5%  
• Fiscal Discipline: 17.50% | • 1971 population: 17.5%  
• 2011 population: 10%  
• Income Distance: 50%  
• Area: 15%  
• Forest Cover: 7.5% |
| Grants-in-aid | • Local governments  
• Disaster Relief  
• Post-devolution non-plan Revenue Deficit  
• Performance incentive  
• Elementary Education  
• Environment  
• Improving Outcomes (including health, justice, innovation, etc.)  
• Maintenance of Roads and Bridges  
• State-specific  
• Implementation of model GST (Goods and Services Tax) | • Local governments  
• Disaster management  
• Post-devolution revenue deficit |
| Others | • Distinction between Special Category and General Category States. Unified block grants in the form of Normal Central Assistance given to all states but a higher share to Special category states | • Removal of distinction between special and general category  
• Removal of Normal Central Assistance |

### Notes:
- Fiscal Capacity Distance: Fiscal capacity distance measures the distance of the estimate potential per capita tax revenue of each state using different weighted average tax ratios for General and Special Category States.
- Fiscal Discipline: Fiscal discipline as a criterion for tax devolution to provide an incentive to states managing their finances prudently. The index of fiscal discipline is arrived at by comparing improvements in the ratio of own revenue receipts of a state to its total revenue expenditure relative to the corresponding average across all states.
- Income Distance: Income distance is defined as the distance of actual per capita GSDP (Gross State Domestic Product) of a state from the state with the highest per capita GSDP. The farther a state is from the highest per capita state, the more transfers it will get from tax devolutions.
The Union government accepted the major recommendations of the FFC and distributed the divisible pool of resources to the states. In order to compensate for the reduced resources with the Union government, the Union Budget for 2015-16 reduced discretionary transfers to states in the form of CSSs by decreasing the number of CSSs, as well as reducing their allocations. The Government also announced that with the exception of “core of the core” schemes, the fund sharing ratio would be revised, with states expected to pay a larger share of the allocations.

The FFC recommendations and subsequent changes by the Union government raised a number of questions. They are as follows;

**INADEQUATE RESOURCES**

Many state governments argued that the gains from the increased tax devolution were in fact offset by cuts in CSSs and other grants from the Union. For instance, the state of Andhra Pradesh noted, “The reduction of the Central share for key schemes … will have adverse effect on the state development indicators.” While Bihar noted, “14th Finance Commission has done more harm than good … there is a reduction in the resources of the State and thus it is imperative that additional resources are devolved to maintain the previous level of funding under CSS.”

The fact is that much of the tied transfers to states were towards CSS which were introduced by the Centre but required a matching contribution of funds by the states. Further, it has been mentioned by various state governments that the fulfilment of matching contribution i.e., 60:40 for core schemes under CSS had squeezed fiscal space of state governments. Added to it, the financial situation of different states is not satisfactory due to various reasons.

**MORE AUTONOMY**

Union taxes shared with states, as well as FFC grants-in-aid are untied, which means the Union government cannot impose conditionalities on how states use these funds. In contrast, funding for CSSs is tied, with a detailed set of requirements, including sometimes parallel administrative machinery. By enhancing states’ share of Union taxes and removing conditionalities from grants, the FFC aimed to provide “enhanced fiscal flexibility to the States to meet their expenditure needs and make expenditure decisions in line with their own priorities.”

**PRIORTISING SOCIAL SECTOR**

A serious concern expressed was whether states would spend on the social sector adequately. Activists from a range of sectors expressed their concern that putting the onus of spending on states in an unplanned manner would lead to sharp reductions in spending. More seriously, it was feared that some state governments, at least, might not want to prioritise social sector spending at all, instead choosing to spend on infrastructure, subsidies and so on.

Using data from 19 state budgets, the paper has compared 2014-15 actuals with 2015-16 revised estimates (REs) to provide some insights into these questions and highlight a few major recommendations. Revised Estimates are produced usually 6-8 months after the start of the financial year, based on actual receipts or expenditures incurred, and projections for the remainder of the financial year. While they are usually systematically lower than the actual figures, they represent the best available data until audited actual figures for 2015-16 are made available in 2017.

**Summary of Recommendations:**

- Restructure CSSs to ensure greater state flexibility;
- Undertaking research and advocacy at state level;
- Understand Local Government Financing in view of their capacities; and
- Improve budget processes and its quality

**RESTRUCTURING CSSS TO ENSURE GREATER STATE FLEXIBILITY:**

Funds transferred by the Union government to states saw an increase from 5.4 per cent of GDP in FY 2014-15 to 6.1 per cent in FY 2015-16 RE, driven mainly by an increase in devolved taxes from 2.7 per cent to 3.7 per cent. There is some state variation in the quantum of increases in tax devolution. While all the 19 states studied received at least 20 per cent more funds from the Union government; some states such as Haryana, Telangana, Himachal Pradesh, Jharkhand and Chhattisgarh received over 60 per cent. The predominant reason for this increase in Haryana, Tamil Nadu, Telangana and Uttarakhand, were increases

1 “Core of the core schemes” include the MGNREGS, and schemes for social inclusion targeting the elderly, disabled, minorities, SCs and STs. See point 4.11 in the Report of the Sub-group of Chief Ministers on Centrally Sponsored Schemes, Niti Aayog October 2015.

2 Report of the sub-group of Chief Ministers on rationalisation of Centrally Sponsored Schemes, October 2015 http://niti.gov.in/mgov_file/Final%20Report%20of%20the%20Sub-Group%20submitter%20to%20PM.pdf

3 Chapter 2, Volume 1, 14th Finance Commission

4 As an example, “Anyone with a minimal understanding of Centre-State relations is likely to hear alarm bells”, says Jean Dreze in The Hindu http://www.thehindu.com/opinion/lead/nehruvian-budget-in-the-corporate-age/article6959755.ece
in CSSs and other funds; in Himachal Pradesh, on the other hand, a sharp increase in Finance Commission grants for revenue deficit elimination contributed the vast majority of increased funding.

However, one of the main aims of the FFC was to enhance state autonomy by providing a greater share of untied transfers. The data however shows a mixed picture. As Graph 1 highlights, the proportion of Union funding which is untied increased in 10 states. Himachal Pradesh and Andhra Pradesh saw amongst the highest increases at 23 and 18 percentage points, respectively. However, they remained unchanged in two states- Bihar and Odisha. Moreover, seven states, namely Telangana, Uttarakhand, Haryana, Uttar Pradesh, Maharashtra, Tamil Nadu and Jharkhand received higher proportion of tied funding in 2015-16 (RE) than 2014-15.

What are the causes for these mixed results? Nearly all states experienced an increase not only in the quantum of untied grants, but also more tied grants in the form of CSS funding. In states such as Haryana, Uttarakhand and Jharkhand, funding for CSSs and other grants approximately doubled, causing an increase in the proportion of Union funding which is tied. While some fiscally stronger states such as Kerala and Himachal Pradesh have seen reductions in CSSs, others such as

The Tied and Untied Union Funding to states are portrayed in the graph below.

**Graph 1:** Tied and Untied Union Funding to States

Based on the tied and untied resources transferred, the states could be categorised as follows.

**Table 2:** Classification of States Based on Dependency on Union Transfers

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low dependency on Union</td>
<td>Union transfers form less than a third of State revenue receipts, and are mostly untied. Tied Union funding is about 10% of State revenue receipts</td>
<td>Maharashtra, Gujarat, Karnataka, Punjab, Kerala</td>
</tr>
<tr>
<td>Moderate dependency on Union: type 1</td>
<td>Nearly half of State revenues come from the Union. Tied Union funding is about 15% of State revenue receipts</td>
<td>Madhya Pradesh, Himachal Pradesh, Uttar Pradesh, Rajasthan, West Bengal</td>
</tr>
<tr>
<td>Moderate dependency on Union: type 2</td>
<td>Union transfers as a proportion of total receipts is low but there is a significant increase in tied funding</td>
<td>Haryana, Tamil Nadu, Andhra Pradesh and Telangana</td>
</tr>
<tr>
<td>High dependency on Union</td>
<td>More than half State revenues come from the Union. Tied funding accounts for 20% of State revenue receipts or more</td>
<td>Uttarakhand, Jharkhand, Odisha, Chhattisgarh, Bihar</td>
</tr>
</tbody>
</table>

Source: Categorised by authors on the basis of the data available in State Budget documents, 2016-17
Haryana and Maharashtra have seen sharp increases in CSSs among others.

Kerala, Punjab, Karnataka Maharashtra and Gujarat states are less dependent on CSSs, with CSSs funds forming less than 10 per cent of their overall revenues. States such as Uttarakhand, Jharkhand, Odisha Bihar and Chhattisgarh are more dependent, with more than 20 per cent of their revenues coming from CSSs. In addition, the Union government has increased states’ share in financing CSSs to 40 per cent for most schemes. This suggests that there is a need for considerable proportion of states’ untied revenues must also be devoted to CSSs.

In the past, several objections have been raised to the model of CSSs by Union governments, state governments and Civil Society Organisations (CSOs). These objections primarily consist of:

a) Centralised Design: CSSs are designed and financed primarily by Union government through uniform norms and strict guidelines. This often hampers state autonomy and flexibility to spend based on their own needs/priorities.

b) Fragmented Transfer System: The proliferation of CSSs reduces the fiscal space available with states, as they are expected to co-finance schemes. Moreover, most CSSs have their own reporting structures, guidelines and may even have a parallel administrative structure to implement and monitor them.

c) Uncertainty and lack of transparency: Allocations to CSSs are very volatile. The Union Budget allocates funds to schemes, but not to states. Thus, state governments often don’t know in advance how much money they will get, or even when the money will be released, resulting in significant uncertainty.

With CSSs continuing to form a significant source of revenue as well as a critical part of social sector funding for many of the poorest states in the country, restructuring CSSs will be essential. Flexible CSSs will also make them more effective where they are only a supplement to states’ own revenues and programmes.

The most important step is to ensure that states can choose activities and funding levels, rather than follow a centralised design. For example, under the National Education Mission, the Union could allocate money to a particular state, but the state would choose how to distribute the funding amongst primary, secondary and higher education. A promising sign in this context is a recent press note announcing that CSSs will have “flexibility in the choice of components to the states as available under the Rashtriya Krishi Vikas Yojana.”

While preliminary attempts have been made with the grouping of CSSs into “umbrella schemes”, with most schemes retaining last year’s allocation and same guidelines, these changes are unlikely to have an impact on the fiscal flexibility of different states.

We recommend the following changes:

a) Reduce the number of CSSs to a few key programmes, linked to “national” goals such as quality education, health, drinking water, sanitation etc. This would also help reduce undue strain on state finances and administrative machinery.

b) Move away from line-item wise, rigid budgeting to a single programme that pools allocations which can be used by the state according to its need and discretion.

c) Ensure predictability of fund flows, such that allocations and releases are known in advance. NITI Aayog’s report on restructuring CSSs called for “transparent criteria based on development needs, population, potential of the State in that sector, special needs ...” Such a framework would help ensure that CSS funding responds to both states’ needs and their performance. One factor to take into account should be that larger funds go to states which are more dependent on Union funding.

d) Finally, another important measure towards predictability is to ensure that funds for CSSs are released early in the financial year. This would avoid the cascading delays in payments and activities which have become a characteristic feature of CSSs. A proposal in this regard is to establish an Expenditure Information Network, which would transform the payments system by ensuring that service delivery agencies can “pull” funds from higher levels when required, eliminating delays altogether.

UNDEARTKE RESEARCH AND ADVOCACY AT STATE LEVEL

Civil Society Organisations (CSOs) working with state governments have been limited in number and many do not focus in-depth on state finances. However,


3 Ibid

4 Ibid, points 4.30 through 4.35, contain a description of the problem and suggested procedural changes

5 For more details, see “Doing More with Less”, Mathew and Goswami, EPW Vol. 51, Issue No. 17, 23 Apr, 2016

6 For an indicative list of budget groups in India see the website of the Center for Budget Governance and Accountability at http://www.cbgaindia.org/bwi_budget_groups_india.php
even prior to the FFC recommended devolutions, states were responsible for about 80% of social sector spending in India\textsuperscript{1}. Given the large variation between states’ fiscal capacities and expenditure priorities highlighted earlier, CSOs must develop a state-specific understanding of policies, budgets and participate in budget discussions in order to ensure the proper allocation of resources to the needy sectors.

Understanding the exact implications of the FFC recommendations on social sector spending requires a careful budgetary analysis of each state. The two broad questions to be answered are the extent of additional fiscal space created, and how the state has changed expenditure patterns in the social sector. We present below an indicative analysis with illustrative examples.

As described earlier, fiscal space has increased significantly where untied funds have sharply increased in states more dependent on Union financing, or have modestly increased in states which are less dependent. For example, Graph 1 shows a 9 per cent increase in untied funds as a proportion of revenue receipts in Kerala, 11 per cent in West Bengal, and 20 per cent in Himachal Pradesh, showing significant increases in the fiscal space available for these states. At the other extreme are states where the proportion of untied funding has reduced, decreasing fiscal space, such as Uttarakhand and Telangana. Most other states see fiscal space unchanged or modestly increasing.

On the expenditure side, Graph 2 shows a comparison of FY 2014-15 Actuals and FY 2015-16 RE. This suggests that all states have significantly increased the quantum of social sector investment\textsuperscript{2} – ranging from a minimum of 16% in West Bengal to a maximum of as much as 86% in Telangana. Interestingly, some of the highest increases were visible in many of the poorest states including Bihar (46%), Chhattisgarh (49%) and Jharkhand (53%).

The proportion of social services in the total expenditure of a state highlights its priorities. Almost all states show an increase in the share of expenditure on social services by this metric. An increase of over 5 per cent are seen in Uttar Pradesh, Madhya Pradesh, Andhra Pradesh and Telangana, while modest increase is seen in 12 other states. Only two states in our sample, namely West Bengal (-1%) and Odisha (-2%) have decreased the proportionate share of social services, while Kerala sees no change.

\textsuperscript{2} Social sector has been defined as per the definition of the Comptroller and Auditor General of India. It includes budget heads on education, health, nutrition, welfare of scheduled castes, scheduled tribes, other backward classes, housing, urban development, water and sanitation, social justice and welfare etc. It does not include rural development, food and warehousing.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{Graph2.png}
\caption{Graph 2: Growth in Social Services Expenditures between FY 2014-15 and 2015-16 (RE)}
\end{figure}

Source: Calculated by authors based on the data available in the State Budget documents, 2016-17
FOURTEENTH FINANCE COMMISSION (FFC) RECOMMENDATIONS

Comparing the expenditure and revenue situation it needs to be mentioned that:

- States such as Kerala or West Bengal have the additional fiscal space to expand the social sector, but have chosen not to.
- States such as Himachal Pradesh and Andhra Pradesh have increased social sector spending, but may be able to further increase depending on their available fiscal space.
- States such as Uttarakhand and Jharkhand registered an increase in social sector spending despite decreased fiscal space. It is possible due to increased CSS allocations to these states among others.

It is useful to examine the share of various sectors such as health and education within the overall social sector. For example, in 2016-17 (BE), Bihar reduced allocations on education by 10 per cent, while increasing allocations for public health by 83 per cent, in comparison to 2015-16 (RE). Whether funds are adequate for the social sector as a whole, cannot be assessed on the basis of budgetary analysis alone rather the data on costs and outcomes, as well as an understanding of the needs and priorities of states are needed to judge the adequacy of budgetary outlays.

Understand Local Government Financing

The FFC award of Rs. 2,87,436 crores to local governments over the next 5 years amounts to Rs. 488 per capita annually in local government revenues. Understanding local government financing and engaging with local bodies is, therefore, necessary. One important step in this process is to work with State Finance Commissions (SFCs). Just as the FFC at the Union government level considers fiscal transfers to states, SFCs consider fiscal transfers to urban and rural local governments. However, their effectiveness has remained mixed. 1 Working with local governments to strengthen their accounting mechanisms, revenue powers, utilisation capacity, and build a database of their finances, planning ability and ability to converge government schemes would also help strengthen service delivery and accountability.2

Improving Budget Processes and Quality:

The FFC recommendations make it imperative that Indian public finances should be assessed in a consolidated level, rather than at the Union government level alone. Greater priority should be given to state and local government budgets to understand the national position of government investments.

As far as the quality of Budget data is concerned, audited accounts often differ widely from budget projections. For example, comparing revised estimates (REs) of 2014-15 shows that Telangana overestimated its revenue receipts by 57 per cent, while Andhra Pradesh, Chhattisgarh and Uttarakhand overestimated them by around 30 per cent. Similarly, Jharkhand, Odisha and Bihar overestimated their expenditures in 2014-15 RE by around 25 per cent as compared to audited accounts. At the time of analysis, only Revised Estimates (REs) are available for 2015.

The current form of accounts in which budgetary data is maintained makes it difficult to categorise data to answer policy questions relevant for all. For example, tracking expenditures in a particular village or town; for a particular social group; or for a sector like nutrition, requires intensive manual efforts. The problem is exacerbated for programmes which span multiple levels of government, where data reported as “expenditure” reconstitution of SFCs more than once during their tenure, shortage of staff and administrative resources and support.”, pp108

1 According to the 14th Finance Commission, “SFCs have faced several constraints in their functioning such as data availability, poor quality of available data, 2 For a description of the state of local government finances in Karnataka see “PAISA for Panchayats”, Accountability Initiative 2016 at http://accountabilityindia.in/paisa/study/download/1400
in budgetary documents are actually funds released.

An overhaul of these accounting mechanisms would be an important first step to enable better public monitoring. Currently, data are disaggregated by department, accounting major head, and schemes in some cases. A rationalised accounting system would help track allocations and expenditures by programmes, geographical area and social groups, and report actual financial progress at the final service delivery agency. Technical solutions such as integrated financial management systems and the public release of real-time, disaggregated budgetary and financial data from treasuries could help achieve a more efficient and publicly monitored fund flow system.

Equally important are the political processes behind budgets. The state legislative assemblies sit for very short periods of time, and quality of debate is weak which is due to technicality of budgets, lack of understanding of the subject and political reasons behind it1. Members of legislative assemblies (MLAs) have no role in the process of budget formulation. Once budgets are tabled, they have very little time or support to understand and debate budgetary provisions. As state governments gain greater autonomy in resource allocation, improving the quality of budget discussions and strengthening the functioning of state legislatures is important.

The response by state and Union Governments to the FFC recommendations shows a modestly positive picture for states’ fiscal autonomy, while laying to rest feelings of a drastic change in social sector allocations. This opportunity must be used to develop state-specific strategies, restructure existing schemes to further state autonomy, as well as build the capacity of states and local governments to use this autonomy in a meaningful fashion.

1 See “Legislative Performance of State Assemblies”, on the website of PRS Legislative Research http://www.prsindia.org/theprsblog/?p=3257
OXFAM INDIA

Oxfam is marking its 65th year in India this year. In 1951, Oxfam Great Britain, came to India during the Bihar famine to launch its full scale humanitarian response in a developing country. Over the past 64 years, Oxfam has supported civil society organisations across the length and breadth of the country. Oxfam India’s vision is to help create an equal, just and sustainable society by empowering the underprivileged. It works primarily through grassroots organisations to bring deep-rooted sustainable changes in people’s lives.

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