

## Second Flagship Seminar, March 15, 2021

### Centre for Social and Economic Progress

#### Federalism and Human Capital

##### Press Release

India's record with centralisation in the context of its human capital interventions may explain why the government's many schemes and interventions are not leading to better human capital outcomes, said Anoop Singh, member of the Fifteenth Finance Commission at the Centre for Social and Economic Progress' (CSEP) Flagship Seminar on Federalism and Human Capital on March 15. He added that India's human capital indicators could worsen due to the impact of the COVID-19 pandemic.

"In Indonesia, in the last 20-25 years, there has been a broad trend towards decentralisation of human capital and the early evidence indicates that their outcomes have improved and been sustained as a result of this decentralisation", said Singh, also a Distinguished Fellow at CSEP. Singh explained the constitutional system of division of powers across the three tiers of India's federal system, and the role played by the Finance Commission in resource-sharing. He concluded that, "Overall, India's constitutional structure has a clear preference for States to take the lead in health and education, and also envisages an important role for the third tier." But he noted that, despite this, there has been significant centralisation in practice, particularly through the use of Centrally Sponsored Schemes (CSSs).

Singh was in conversation with Yamini Aiyar, President and Chief Executive, Centre for Policy Research (CPR) and Prachi Mishra, Advisor, Research Department, International Monetary Fund (IMF). The session was moderated by Montek Singh Ahluwalia, Distinguished Fellow, CSEP and former Deputy Chairman, Planning Commission of India. The seminar was the second of a three-part series on India's public finances, focusing on the key themes and recommendations of the Fifteenth Finance Commission's report, as well as the unique challenges faced by the constitutional body amid the uncertainties caused by the pandemic.

Anoop Singh emphasised the importance of having a functionally and fiscally empowered third tier and the States' responsibility on this front. He also touched upon the recommendations of the Fifteenth Finance Commission regarding State Finance Commissions and property tax collection, which would help the third tier. He observed that the Centre might have to rethink the nature of its interventions in human capital for outcomes to improve, and asked whether regulatory changes such as constitutional amendments might be needed in order to utilise the full potential of India's multi-level federal system.

In the context of CSSs, Yamini Aiyar mentioned a problem in the culture of accountability, "where accountability is often mistaken for the act of accounting," and lower levels of government responded to orders from a higher level rather than to needs on the ground. According to Aiyar, the heart of the tension in fiscal federalism is to identify "what are the core national priorities that ensure minimum standards of public services to all citizens on one hand, and what is the best mechanism to deliver these priorities considering the reality that all states, districts and villages are on very different pathways and thus need to have flexibility."

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Aiyar also argued that performance-linked transfers are not effective. “The bigger question is, are local governments meant to be implementing agents of central and state governments... or should they be genuine institutions of self-government that respond to the needs of their electorate? That’s the tension at the heart of the performance-incentive structure that Finance Commissions have created as a response to the failures of fuller decentralisation.”

Prachi Mishra cited data on per capita income of states to show the failure of convergence across states. “India is a federation and has broadly tried to follow the principles of decentralisation, subject to caveats. But the main question to ask ourselves is, what has fiscal federalism achieved so far, especially in a macroeconomic context?,” Mishra asked.

Comparing India with other East Asian economies when they were at similar levels of development, Mishra observed that, if you look at the share of employment in industry, it is in line with where China was, but the share of value-added to industry has been “distinctively flat” in India. In the services sector, the share of employment was relatively high when India took off, but its growth has been comparatively slow, and the share of value-added has continued to rise quickly. “So, while the productivity is high, the services sector has not created as many jobs. The opposite is true for the industries,” she said, highlighting the importance of education and skilling in the service sector.

Mishra observed that the rate at which Indian women have been participating in the labour force has declined dramatically and consistently over the last few decades, with India having the lowest female labour force participation compared to its Asian peers. “Fiscal federalism has a big role to play: how to incentivise the states to actually skill and train their women,” she said. On the impact of the COVID-19 pandemic, she said that “if you look at the latest round of the Periodic Labour Force Survey, you can see that states with higher COVID infection rates for women also reported higher female unemployment rates.” Anoop Singh later added to this point by highlighting the link between higher female unemployment rates and lower nutrition outcomes, particularly in India’s cultural context. Mishra concluded that fiscal federalism and human capital involved “a complex interaction of ... resources, incentives, and some affirmative action. One needs to carefully balance a combination of all three to be able to progress on this front.”

### **The political context**

Stating that the challenge of fiscal federalism in India is as much a political one as it is a constitutional or fiscal one, Aiyar said: “Until we create an institutional sphere within which politics can be negotiated and centre-state bargaining can be recreated...no amount of constitutional amendments is going to solve to create a genuinely fiscal federal structure that India sorely needs.” She also cited the political context to CSSs, observing that the political incentive for central schemes is increasingly visible and will perhaps only increase.”

Moderating the session, Montek Singh Ahluwalia made observations regarding how politics at the state level do not represent the constitutional division of powers and are instead a replica of national politics, the need for increased analysis of differences across states to understand why some states outperform others, and the flexibility that states should be afforded to pick their own CSSs. He was of the view that “wherever flexibility exists for state governments, we should double it” as the current system of centrally sponsored schemes “is not adding its value.”