{ EAR TO THE GROUND }

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The structural constraints that hinder reform in India

The 2023 *Economic Survey*, in a section describing the Centre's support to states for capital expenditure, has a table recording progress on the funds allocated to states under the Scheme for Special Assistance to States for Capital Investment, the 50-year interest-free loan, announced in the FY 2022-23 budget and continued in Budget 2024. The table has largely gone unnoticed. However, the data illustrates an enduring tension in the dynamics of Centre-state relations that constrains policy reforms. It is crucial that debates acknowledge and engage with the political economy that underlies this, because, it is this reality that enables policymakers to create the chimera of reform, leaving untouched, the deep structural constraints to reform progress.

The table reports on the actual approval and release of funds to states. Of the total ₹1.05 lakh crore allocated last year, ₹80,000 crore is unconditional, and the remainder is conditional on specific reforms (digitisation, urban reforms and disinvestment) and incentives (rural roads and PM Gati Shakti). By design, state governments submit proposals to be approved by the department of expenditure for the unconditional component. Reform proposals are assessed and approved by line departments. Data highlights that while there has been some movement on the unconditional loan, ₹68,592 crore is approved and ₹31,571 crore was released (slow releases presumably are on account of expenditure milestones to be achieved). However, states have been less than enthusiastic about reforms. No funds have been released suggesting that either the proposals had not been submitted, or not approved.

The scheme is new, it could be argued and these are teething troubles. But experience suggests this is an endemic problem. In India's federal framework, fiscal transfers are routinely deployed as tools to direct policy and reform at the state level. In line with well-accepted principles of public finance, conditionalities and results-based financing to incentivise states have been routinely recommended by finance commissions.

In 2020, at the pandemic's peak, for instance, the Centre increased the borrowing limit for states from 3% to 5% of the Gross State Domestic Product (GSDP), tying 1% to reforms. These included: One nation one ration card, power reforms, urban reforms and ease of doing business. But states were recalcitrant: 20 completed the ease of doing business reform, 13 made headway with the one nation, one ration card, but only six undertook urban reforms. None completed the power reform requirement (there were three components) in its entirety. And eventually, a mere 0.42% of available reform-linked borrowing was granted.

Borrowing aside, efforts through central schemes and grants to states and local governments tied to reform conditionalities, have met a similar fate. Change has only occurred when underlying conditions for reform are in place. This is well known and recognised, yet it is a repeatedly deployed tool by our policymakers. What explains this persistence despite failure?

There are two related factors at play here. The first concerns the very specific issue of state borrowing. Since 2005, a concerted effort was made to progressively disintermediate the Centre from state borrowing. State borrowings are governed by Article 293, particularly 293(3), which mandates states to seek Union government consent to borrow if they have outstanding dues owed to it. Progressive disintermediation was a step toward unfettering states by increasing reliance on market borrowing and, therefore, market discipline.

Against this backdrop, the return of loans (even if interest-free) is a form of centralisation, but legitimised under the guise of expenditure efficiency and reforms. The imposition of conditionalities enables this. After all, this is about shaping state policy in the direction of national goals. But states risk losing significant autonomy.

There is a wider political economy dynamic at play here. Economic liberalisation and the rise of regional parties in the 1990s weakened the role of the central government in shaping national policy, in turn, deepening federalism. National policymaking now required a new framework, one that enabled consensus building, focused on coordination, and resolved collective action problems and capacity constraints around reform pathways. But coordination and consensus were (and remain) the antithesis of the dominant administrative and policy culture. Conditionalities and results financing offered a convenient alternative. By repeatedly seeking to reform through conditionalities, the Centre was able to position states as mere implementing agents responding to their goals.

But here is the rub. In our federal system, the Centre is dependent on states to play ball, and both the Centre and states are well aware that reforms need consensus, not carrots-and-sticks-based financing. Consequently, monies allocated by the Centre to reforms are often trivial (they account for 20% of the total loan amount in the scheme that motivated this column). It is almost as though by design, "reform" incentives are meant to create the chimera of policy progress, for the Centre to make grand announcements and seek political credit, even though all stakeholders are aware that the process is designed to fail.

It suits everyone, hence they persist. Year after year, Budget speech after Budget speech, the "reform" game is played out. But without addressing the structural challenge — genuine consensus-building and cooperation between the Centre and states — there will be no winners. The current policy's penchant for centralisation legitimised through conditionalities is the real tragedy of our reform discourse.

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The views expressed are personal