

Federalism in India: Political Economy and Reform*

M. Govinda Rao[†] and Nirvikar Singh[‡]

September 2001

Abstract

The objective of this paper is to examine the nature of India’s federal system, the reforms that have occurred over the last ten years, and what remains to be done. We begin by briefly describing the key federal institutions in India, focusing particularly on the mechanisms for center-state transfers. These transfers are quite large, and are the major explicit method for dealing with inequalities across constituent units of the federation. We then examine the evidence on how India’s political economy has affected the practical workings of the transfer mechanisms. We next describe recent and potential reforms of the center-state transfer system, in the context of evidence of widening interstate economic disparities. This is followed by a consideration of broader actual and possible reforms in India’s federal institutions, including tax assignments and local government reform. We conclude by relating our discussion to other dimensions of economic reform in India.

* This paper has been prepared for presentation at the conference on “India: Ten Years of Economic Reform”, at the William Davidson Institute, University of Michigan, September 2001. It forms part of a larger, ongoing study of Indian federalism by the two authors. The second author has benefited from the hospitality and support of the Research School of Pacific and Asian Studies at the Australian National University; the National Institute of Public Finance and Policy, New Delhi; and the Center for Research on Economic Development and Policy Reform at Stanford University, where his stays as Visiting Fellow have provided congenial environments for some of the research reported here. We are also grateful for financial support from ANU and the UCSC Academic Senate. Remaining shortcomings are our responsibility.

[†] Director, Institute for Social and Economic Change, Bangalore, India; email: mgrao@bgl.vsnl.net.in.

[‡] Professor of Economics, University of California, Santa Cruz, CA 95064, USA; email: boxjenk@cats.ucsc.edu, Ph: (831) 459-4093, Fax: (831) 459-5900

I Introduction

This paper provides an overview and analysis of India's federal institutions in the context of economic reform. The paper is structured as follows. In section II, we briefly describe the key federal institutions in India. We summarize some of the federal characteristics of India's polity, its bureaucracy, and institutions of law and order. We then focus particularly on fiscal aspects of federalism: assignments of revenue and expenditure authority and the mechanisms for center-state transfers. These transfers are quite large, and are the major explicit method for dealing with inequalities across constituent units of the federation. We discuss the multiple mechanisms used for making such transfers.

In Section III, we examine the evidence on how India's political economy has affected the practical workings of the transfer mechanisms. While empirical analysis in this area is in its early stages, evidence is emerging that supports earlier casual empiricism, namely that political influences and other manifestations of bargaining power do play a role in determining the pattern of actual transfers in the various channels that are used.

Section IV describes recent and potential reforms of the center-state transfer system, in the context of evidence of widening interstate economic disparities. We argue that, given quite strong evidence of persistent and widening economic gaps among the states in India, the need for a clear and simple approach to formulating and implementing center-state transfers is greater than ever. We also argue that this recommendation is not vitiated by the existence of multiple channels for transfers, and the importance of political influence.

In Section V we consider broader actual and possible reforms in India's federal institutions, including tax assignments, local government reform, and financial sector reform. We suggest that reforms of tax assignments may be tied to other aspects of tax reform, in order to achieve joint acceptability to the center and the states. We summarize some of the key features of local government reform as legislated, and summarize the Eleventh Finance Commission's assessment of its status, as well as providing a novel conceptual tie-in with the process of 'liberalization'. We suggest that explicit and implicit intergovernmental transfers for capital projects, as well as lending by public sector institutions, be largely replaced by block grants and by market borrowing.

We conclude in Section VI by reviewing our arguments and relating our discussion to other dimensions of economic reform in India, and the general issue of political economy of reforms. We suggest that reforming India's federal structures is a crucial component of overall economic reform, and we attempt to put this suggestion into a general conceptual perspective.

II Federal Institutions in India

In this section, we focus on the institutions and mechanisms that govern fiscal federal arrangements in India, particularly center-state transfers. We preface this discussion with an overview of India’s broader federal structure. India is comprised of 28 states, and seven “Union Territories”. Of the seven, two Union Territories (Delhi and Pondicherry) have their own elected legislatures whereas the remaining ones are governed directly by appointees of the center. All the states have elected legislatures and Chief Ministers in the executive role. The constitutional assignment of certain statutory powers to the states is what makes India a federal system. The exact nature of the assignment of powers, and how that has played out in practice, determine the extent of centralization within this federal system. In addition, the size of the states also has implications for this characterization. For example, since many of the Indian states are quite large in terms of population (with the largest dozen being comparable in population to larger European countries), devolution of powers to the states without any further decentralization below that level may still represent a relatively centralized federation. In practice, devolution to both the states and to substate (local) government bodies has arguably been quite weak. Reforms in this assignment of powers will be a major theme of the paper.

Political and Administrative Structures

The primary expression of statutory constitutional authority in India comes through directly elected parliamentary-style governments at the national and state level, as well as nascent directly elected government bodies at various local levels. To the extent that the essence of federalism is based on representative democratic politics, the role of political parties in the interactions between central and state level politics is a crucial aspect of federal structures. To illustrate, consider the extreme case where government powers are notionally decentralized, with residuary powers residing at the state level, but the national and all state governments are controlled by a single, rigidly hierarchical political party. Here the outcome will effectively be the same as in a centralized, unitary system.

Indian political parties have embodied varying degrees of centralization, including the regional political bosses of the earlier Congress party, the tightly controlled personalized approach characteristic of the later Congress, the more institutionalized hierarchy of the BJP, and the emergence of explicit regional parties. Overall, the institutional expression of federal or centralized structures in political parties would not seem to have been a major independent factor in shaping India’s federal system.¹

The next level of governance that embodies aspects of federal structures is the bureaucracy. If elected politicians act as agents of constituents or voters, bureaucrats in turn act as the agents of elected officials. Bureaucrats are partly insulated from political whims and pressures, but ultimately in a democracy must be subordinate to the people’s

¹ There are many nuances that this conclusion glosses over. See Rao and Singh (2001) for a more detailed discussion.

elected representatives. This means that a unitary, hierarchical bureaucracy cannot by itself negate a federal political structure in the same way that a powerful, centralized, national political party might. However, a centralized bureaucracy can act as the agent of such a political party, in acting against the requirements of a federal system. There are elements of such action in the workings of Indian bureaucracy.

The Indian bureaucracy is provided constitutional recognition. The central and state level tiers of the "public services" are given shape through the provisions of part XIV of the Constitution. Of course any bureaucracy in a federation will have a federal character in the sense that each layer of government requires its own administrative apparatus to accompany the political structures. In particular, state governments must be able to appoint (and dismiss) bureaucrats to implement state-level policies. This is certainly the case in India, where there is a central bureaucracy as well as an independent bureaucracy in each state, as indicated by the Constitution.

A key component of the central bureaucracy, the Indian Administrative Service (IAS) has a dual allegiance. The IAS is an all-India bureaucratic hierarchy: its members are chosen by a central process, and trained together. However, they are then assigned to particular states, and become, technically as well as in most practical matters, members of a state-level bureaucratic hierarchy as well. While an IAS member's entire early career is spent within the home state, and senior level appointments at the state level carry considerable power and prestige, the most prestige, power, and resulting attraction lie with appointments within the central government.

While the structure of the IAS was designed as a compromise between, on the one hand, the desire to have an effective administrative apparatus at the governmental level to which most of the tasks of day-to-day administration, development, and law and order were assigned by the Constitution (i.e., the state level), and on the other hand the fear of promoting regional loyalties over national ones (with the further fear of disintegration of the nation), this compromise has been inherently problematic. A bureaucracy in a democratic system is the administrative tool of elected politicians, and a lack of clear lines of authority creates difficulties for incentives.

The efficiency consequences of the scope of bureaucratic governance are, to some extent, independent of the structures of federalism. They point to guidelines for constraining bureaucratic interventions at any level, whether national or subnational. However, the consequences of mistakes in assignment with respect to bureaucratic authority are more likely to be felt in a centralized structure. Competitive federalism is more likely to lead to corrections than is a unitary state, to the extent that electoral monitoring and incentives are more effective in a federal system. While competition among subnational jurisdictions may lead to a race to the bottom in tax rates or environmental regulations, it also puts more pressure on politicians to correct mistakes in bureaucratic decision-making than may exist in a centralized system.

The judiciary is, in some respects, a specialized bureaucracy, but is conceptually more separate, constituting a distinct branch of government at its higher levels. Much

judicial activity involves judging whether the law was broken and who broke the law in particular cases, in which capacity the judiciary acts as a specialized agent of elected officials who frame laws. The higher levels of the judiciary also act as judges of the laws themselves, within the context of the overarching legal and constitutional framework. Furthermore, the judiciary in theory can check the actions of politicians in ways that may be difficult for bureaucrats: "no one is above the law".

The Indian Supreme Court stands at the top of the judicial hierarchy. Its powers include broad original and appellate jurisdiction and the right to pass on the constitutionality of laws passed by Parliament. In practice, there has been conflict between the Supreme Court and the legislature/executive over the scope of these powers, and their boundaries remain subject to bargaining. The President, in consultation with the Prime Minister, appoints Justices of the Court.

At the state level, below the Supreme Court, are the High Courts. Each high court's justices are appointed by the President, in consultation with the Chief Justice of the Supreme Court and the state's Governor. Paralleling the situation at the Center, the state's Chief Minister is in a position to influence the Governor's advice. High courts also have both original and appellate jurisdiction. In addition, they superintend the work of all courts within the state, including district courts, as well as various courts subordinate to the district courts. These subordinate courts are specialized, with smaller civil matters being separated out from criminal cases, for example. Criminal cases are dealt with in magistrates' courts.

The formal judiciary, therefore, is a well-defined hierarchy, with a relatively clear assignment of tasks. This assignment and hierarchy are overly centralized, in the sense that not enough matters are disposed of at lower level courts. This partly reflects a lack of resources devoted to lower level courts (though the resource problem exists at all levels), but also a centralized assignment of scope of jurisdictions. The problem is compounded by the nature of the appeals process, and by the failure of higher-level courts to control appeals. Note also that judges below the state level are typically not appointed by local government officials, representing a significant departure from a federal system below the state level.

The microeconomic inefficiencies of the judicial system in India partly reflect inadequate decentralization within the judiciary itself, but ultimately are a consequence of inadequate delegation of powers by the legislative/executive branch. In turn, this is a constitutional problem, because this delegation is absent in some of the particulars of the Constitution. While a weaker central legislature may allow the national judiciary, particularly the Supreme Court, to play a more effective checking role, it does not solve the resource allocation problems that must ultimately be corrected for smoother working of day-to-day judicial functions. The pressure for correction might come from competition among subnational jurisdictions pursuing commercial motives. As states and localities try to attract investment and commercial activity, they will be under pressure to provide judicial systems that support such commercial activity. It should be noted that

this argument applies to areas such as contract enforcement, or property rights enforcement more broadly, rather than the criminal justice system.

Finally, the police have a special role, involving both the bureaucracy and the judicial system. Ideally, the police are impartial investigators and monitors, preventing violations of law where possible. Their role complements that of the judiciary in enforcement. However, the police are also organized as a bureaucracy that is under the control of politicians, like other branches of administration, but unlike the judiciary, which has a notional independence. The actual functioning of the police therefore becomes subject to politicization and the encroachment of the central government into law and order, constitutionally a state subject.

The Indian Police Service (IPS), which is the superior officer cadre for the police in India, is organized on similar dual lines to the IAS, that is, centralized recruitment and bureaucracy, but without the same key role in the Central government that belongs to the IAS. This latter difference reflects the fundamental difference between the generalist IAS and the functional specialization of the IPS. The IPS follows only the Indian Foreign Service and the IAS in prestige. Furthermore, the fact that the IPS is a central bureaucracy, as in the case of the IAS, puts its members on a different footing than members of state police forces, that is, those recruited directly by state governments, even though IPS officers are assigned to particular states. While each state has its own police force, the central government possesses several police forces also, which give it considerable power over policing, well beyond what might be suggested by the constitutional assignment of powers. In practice, therefore, the Center has taken a substantial role in the maintenance of law and order.

The existence of different dimensions of governance implies that a federal political system cannot exist simply through a constitutional assignment of responsibilities to different layers of government. Each level of government in a federal system must not only have authority to raise revenues, but it also has to have the authority to carry out decisions made at that level. In India, the IAS, the IPS and the judiciary are all perhaps more centralized than they need to be, or should be, given the current federal political system. While independent India began with a relatively circumscribed federal model, independent political competition at the state government level has thrived, as we have outlined above. This decentralization has not necessarily been matched in the other dimensions of government, but may need to be for a more effective federal system to operate.

Assignments and Transfers

Assignments of authority include important non-fiscal dimensions, as we have briefly discussed in the context of politics, administration and law. However, the control over how public resources are raised and spent represents a crucial aspect of any federal system. We describe the tax and expenditure assignments that form the basis of India's fiscal federal institutions, and consider the system of Center-State transfers that results from, and complements the assignment of fiscal authorities in India.

The essence of economic theories of government is the idea that some goods or services are not well provided by the market mechanism. If a good can be consumed by someone without reducing its availability to others (non-rival) and if others cannot be prevented from consuming it (non-exclusive), it is a pure public good, and a candidate for provision by government. This economic rationale for the existence of government does not justify a hierarchical structure. However, geographic distance can matter, in limiting the number who benefit from provision of a public good. If the information available to governments is not perfect and they are not intrinsically benevolent, subnational or local governments will be better able to judge the desired levels of some public goods, and can be given more powerful or refined electoral incentives to do so. Given the motivation for decentralization of government down to lower levels, based on better information and better incentives, the assignment of expenditure responsibilities follows. Wherever economies of scale, access to resources and externalities or spillovers do not indicate otherwise, the expenditure assignment should match the locus of beneficiaries. In other words, if the benefits of a public good are local, then local government should have the responsibility for provision.

With respect to revenue authority, tax assignments are what ultimately matters, since the interest on borrowing must also come out of taxes. Putting aside issues of collection efficiency, the allocational efficiency of different tax assignments is most significant. For example, mobility across jurisdictions within a federation is greater than mobility across nations. A tax base that is mobile may shrink dramatically in response to a tax. Therefore, it is harder for subnational jurisdictions to raise revenue from taxes than it is for the central government. If this factor implies that more taxes should be collected by the center, there will be a tendency for there to be a mismatch between revenues and expenditures for subnational jurisdictions, to the extent that subnational governments are relatively better able to respond to diversity of preferences, as noted above. A further push toward more centralized assignment of taxes may come from redistribution motives. The result of the differing determinants of optimal assignments of expenditure and tax authorities can be a "vertical fiscal imbalance", where subnational governments rely on the center for revenue transfers. However, the divergence of revenue and expenditure decisions at the margin can have adverse incentive effects.

The Indian Constitution, in its Seventh Schedule, assigns the powers and functions of the Center and the States. The schedule specifies the exclusive powers of the Center in the Union list; exclusive powers of the States in the State list; and those falling under the joint jurisdiction are placed in the Concurrent list. All residuary powers are assigned to the Center. The nature of the assignments is fairly typical of federal nations. The functions of the central government are those required to maintain macroeconomic stability, international trade and relations and those having implications for more than one state. The major subjects assigned to the states comprise public order, public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals. The States also assume a significant role for subjects in the concurrent list like education and transportation, social security and social insurance.

The assignment of tax powers in India is based on a principle of separation, i.e., tax categories are exclusively assigned either to the Center or to the States. Most broad-

based taxes have been assigned to the Center, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquors) and customs duty. A long list of taxes is assigned to the States. However, only the tax on the sale and purchase of goods has been significant for state revenues. The Center has also been assigned all residual powers, which implies that the taxes not mentioned in any of the lists automatically fall into its domain.

The tax assignment system has some notable anomalies. The separation of income tax powers between the center and states based on whether the source of income is agriculture or non-agriculture has opened up avenues for both avoidance and evasion of personal income tax. Second, even though in a legal sense taxes on production (central manufacturing excises) and sale (state sales taxes) are separate, they tax the same base, causing overlapping and leaving less tax room to the latter. Finally, the states are allowed to levy taxes on the sale and purchase of goods (entry 54 in the State list) but not services. This, besides providing avenues for tax evasion and avoidance, has also posed problems in the levy of a comprehensive value added tax.

The result of the Indian assignments of tax and expenditure authority, and their implementation in practice has been a substantial vertical fiscal imbalance. In 1997-98, the states on average raised about 31 per cent of total revenues, but incurred about 57 per cent of total expenditures. The balance was made up by transfers from the Center. In fact, the ability of the states to finance their current expenditures from their own sources of revenues has tended to decline over time, from 69 per cent in 1955-56 to around 55 per cent in the 1990s.

The Constitution recognizes that its assignment of tax powers and expenditure functions would create imbalances between expenditure 'needs' and abilities to raise revenue. The imbalances could be both vertical, among different levels of government, and horizontal, among different units within a sub-central level. Therefore, the Constitution provides for the assignment of revenues (as contrasted to assignment of tax powers), sharing of the proceeds of certain centrally levied taxes with the states, and making grants to the states from the Consolidated Fund of India. The Constitution also provided for the compulsory sharing of the net revenue from non-corporate income tax (Article 270), and optional sharing of the proceeds of Union excise duty (Article 272). Recent constitutional changes in this scheme are discussed in Section III. The shares of the center and the states and their allocation among different states of both the taxes are determined by the Finance Commission appointed by the President of India every five years (or earlier if needed). In addition to tax devolution, the Finance Commission is also required to recommend grants to the states in need of assistance under Article 275.

A notable feature of India's federal fiscal arrangements is the existence of multiple channels of transfers from the center to the states. First, as noted, the Finance Commission decides on tax shares and makes grants. Second, the Planning Commission makes grants and loans for implementing development plans. Finally, various ministries give grants to their counterparts in the states for specified projects either wholly funded by the center (central sector projects) or requiring the states to share a proportion of the cost (centrally sponsored schemes).

Historically, as development planning gained emphasis, the Planning Commission became a major dispenser of funds to the states. As there is no specific provision in the Constitution for plan transfers, the central government channeled them under the miscellaneous and ostensibly limited provisions of Article 282. Before 1969, plan transfers were project-based. Since then, the distribution has been done on the basis of a consensus formula decided by the National Development Council (NDC)². However, various central ministries still felt the need to influence states' outlays on selected items of expenditure through specific purpose transfers, with or without varying matching requirements: these are monitored by the Planning Commission. There are over 100 such central sector and centrally sponsored schemes, and several attempts in the past to consolidate them into broad sectoral programs have not been successful.³

Overall, as noted, transfers from the central government contribute significantly to state finances. Until 1993-94, the growth of transfers was faster than both the center's and the states' own revenues. Thus, the share of transfers in central revenues increased from 32 per cent in 1970-71 to 44 percent in 1993-94, and then declined to 39 per cent in 1995-96. Similarly, the share of transfers in state revenues increased from 39 per cent to 44 per cent and declined to 38 per cent in 1995-96. State expenditures increased even faster during this period, so that the share of transfers in state expenditures declined steadily. However, they still finance almost a third of state expenditures. The relative shares of the three channels of central transfers to states since the Fourth Plan (1969-74) bring out two important features. First, there has been an increase in the *discretionary element* of transfers. Second, within statutory transfers, the proportion of tax devolution, which had already been high, has shown a steady increase while that of grants has declined.

So far, eleven Finance Commissions have made recommendations and, barring a few exceptions, these have been accepted by the central government. However, the working of these Commissions, their design of the transfer system, and the approach and methodology adopted by them have come in for criticism. The main criticisms are (i) the scope of the Finance Commissions through the Presidential terms of reference has been too restricted; and (ii) the methodology for the transfer scheme employed by the Commissions has not led to optimal equity and incentive consequences. We shall return to these concerns in Section III.

As noted earlier, plan transfers from the center to the states consist of grants and loans. The Planning Commission works out five-year-plan investments for each sector of the economy and each state. With this as background, the states work out their respective annual plans for each year, based on estimated resource availability, which includes the balance from current revenue, contributions of public enterprises, additional resource mobilization, plan grants and loans, market borrowings and other miscellaneous capital

² The NDC is chaired by the Prime Minister and its members include all cabinet ministers at the Center, Chief Ministers of the states, and members of the Planning Commission.

³ The Planning Commission appointed several committees to examine the usefulness of these programs and consolidate them into broad categories. However, the recommendations of these committees remain on paper.

receipts. The Planning Commission then approves the state plans. Thus, given the amount of central transfers to the states as determined by the Gadgil formula, at the margin it is mainly the states' own resource position that determines their plan sizes.

Finally, assistance given to states through central sector and centrally sponsored schemes, constituting about 15-20 per cent of total transfers, is in some respects the most controversial form of transfers, being wholly discretionary. Central government ministries initiate a number of "National Programs", either by themselves, or at the request of the relevant ministries at the state level. Central sector schemes are assisted entirely by way of central grants and the states merely have the agency function of executing these programs. Centrally sponsored schemes are cost sharing programs, and the share of central assistance is through grants or loans decided for each individual program. The ostensible rationale for these programs is financing activities with a high degree of inter-state spillovers, or which are merit goods (e.g., poverty alleviation and family planning).

These programs have provided the central government with an instrument to actively influence states' spending. Until 1969, the volume and pattern of assistance to state plan schemes were decided for each project, and the central government did not need such transfers. Once plan assistance was given according to a formula, the center introduced these specific purpose transfers and expanded them significantly. At present, there are dozens if not hundreds of centrally sponsored schemes with detailed conditionalities, such as requirements on staffing patterns, which tend to distort the states' own spending. Also, the proliferation of schemes seemingly has increased the bureaucracy considerably. Therefore, the NDC appointed an investigative committee, which recommended scaling down and consolidating centrally sponsored schemes. This recommendation, however, has been partially implemented.

III The Political Economy of Center-State Transfers

We may summarize the evolution of India's institutions for center-state transfers as follows. The Finance Commission was envisaged in the Constitution as the key institution responsible for dealing with fiscal imbalances between the center and states, as well as among the states. Instead, its role has been circumscribed by the working of the Planning Commission, which has typically been put outside the Finance Commission's terms of reference. Furthermore, as Planning Commission transfers became formulaic, there has been a tendency to move toward using discretionary grants determined by the central ministries. Thus, the overall tendency seems to have been for the central government to try to exercise as much political control as possible over transfers to the states. Also, within each channel for transfers, there has been anecdotal evidence that there are attempts to influence the outcomes of the process. For example, even though the Finance Commission has used 'objective' formulae to determine tax sharing, it also makes various grants, and it has been suggested that states that are represented in the membership of the commission do relatively well in terms of such awards. We will turn to issues of how such influence effects might be moderated through institutional reform, in cases where they are believed to lead to inefficiencies or failure to meet equity

objectives in the system of center-state transfers. In this section, we examine the actual evidence for political influence factors in the system of explicit intergovernmental transfers.

There is, by now, a large literature on the political economy of federalism in general. Some approaches focus on the formation and stability of the federation itself, using bargaining analysis.⁴ An alternative branch of literature examines distribution and redistribution in the context of existing nations, without the threat of secession or breakup being considered. Again, bargaining perspectives are important in this genre of models. Inman and Rubinfeld (1997) provide a transactions cost analysis of the federal provision of public goods. Their particular focus is on the role of legislative structures in determining this allocation. Given a clear assignment of tasks, a level of representation, and legislative institutions, one can compare the economic efficiency of different combinations of these three institutional variables. Building on the work of Breton and Scott (1978) and Baron and Ferejohn (1989), they make this comparison based on an assessment of different types of transactions costs. They do not explicitly treat intergovernmental transfers in their analysis. Kletzer and Singh (1997, 2000) analyze a median voter model of a federation with taxation, representative government, and intergovernmental transfers. In their model, the constituent units of the federation realize that transfers have to be financed by taxes, and so they care about net transfers. They show in an example how coalitions may form to determine the winners and losers from transfers, based on factors such as income and agenda-setting power.

The analysis of Dixit and Londregan (1998) is the most complete treatment of fiscal federalism in the context of distributive concerns. They also provide an excellent survey of some of the literature in this area. In the Dixit-Londregan model, voters can belong to groups. They care about their private consumption as well as having ideological positions. They allow for political parties, and different political power of groups. The parties determine policies, including ideological positions as well as taxes and transfers. The political power of groups is positively affected by a greater willingness to compromise ideology for private consumption, and greater demographic importance at pivotal points in the preference distribution. Groups with greater power, measured in this way, are therefore predicted to do better in a federal system. Dasgupta, Dhillon and Dutta (2001) extend the Dixit-Londregan model to incorporate intergovernmental transfers, as a basis for empirical work that we report below.

The formal theoretical models, as well as casual empiricism, have been the basis for several recent attempts to estimate political influences on center-state transfers. We next summarize the empirical work of Rao and Singh (2000), Biswas and Marjit (2000), Dasgupta, Dhillon and Dutta (2001), and Rao, Singh and Vashishta (2001). We begin with the first of these papers. Rao and Singh begin with five categories of transfers, which are:

1. Shared Taxes
2. Non-Plan Grants
3. Grants for State Plan Schemes

⁴ See Rao and Singh (2000) for a brief discussion and references.

4. Grants for Central Plan Schemes
5. Grants for Centrally Sponsored Schemes

The first two categories are Finance Commission transfers, the next two are Planning Commission transfers, and the last constitutes transfers directly governed by the central government's ministries. Rao and Singh aggregate these categories as follows:

1. Statutory Transfers = Shared Taxes + Non Plan Grants
2. Grants for State Plan Schemes
3. Discretionary Transfers = Grants For Central Plan Schemes + Grants For Centrally Sponsored Schemes

The argument for the above categorization is that shared taxes and non-plan grants are those determined by the Finance Commission, which is ostensibly free of direct political influence. Grants for central plan schemes and centrally sponsored schemes, on the other hand, are both directly subject to discretion by the center, and should be where political influence shows up. Grants for state plan schemes involve central approval of state government proposals, so there is scope for discretion, but it is at least potentially different than in the case of transfers based on center-initiated proposals. Rao and Singh use data on the 14 larger Indian states for 10 years, 1983-84 to 1992-93. They estimate a model with state-specific fixed effects. The dependent variables are transfers in the three categories, in per capita terms. The explanatory variables are State Domestic Product (SDP), SDP per capita, population, and two explicitly political variables, the proportion of the ruling party's Members of Parliament (lower house only)⁵ coming from a particular state, and a dummy variable measuring whether the same party was in power at the center and the state level. For brevity, we refer to these variables as roughly measuring 'power' and 'alignment'. Note that the other explanatory variables may also measure political and economic power, while the per capita SDP variable can measure the extent to which transfers meet equity objectives.

Rao and Singh estimated linear, log-linear and translog functions, to test the robustness of the results. One very robust and plausible result was that the alignment variable always had a positive and statistically significant effect on grants to state plan schemes, albeit with a lag (which may reflect the five-year decision cycle for such transfers). More surprising was the result that in the logarithmic specifications, statutory transfers were positively affected by the 'power' variable. There was also some evidence that political and economic size, as measured by SDP and population had positive impacts on per capita transfers, but these results were not quite as robust across specifications. One consistent result, however, is the differences in explanatory patterns for the three components of transfers that were examined.

Biswas and Marjit use a different specification in their empirical exercise. Their only dependent variable is based on discretionary transfers as defined in Rao and Singh, but they use the per capita share of such transfers, i.e., transfers to state j in year t are

⁵ The lower house of the Indian parliament is the only directly elected national legislature, and it is where legislative power resides almost exclusively. The upper house is indirectly elected, and is not powerless, but is very limited in its role.

divided by total discretionary transfers in year t , and then by state j 's population in year t . This has the advantage of eliminating the effect of aggregate year-to-year fluctuations. They try three different specifications, with a variable similar to Rao and Singh's 'power' variable, a variable similar to the 'alignment' variable, and a third with an alternative 'lobbying power' variable based on representation of different states in the ministerial cabinet. They estimate their equations for the same 14 states as Rao and Singh, but for the period 1974 to 1995 (with two gaps, leaving 20 years of data). They do not allow for fixed effects, but include two dummies in one of their regressions. In each case, Biswas and Marjit find that the political variable is statistically significant, and has the right sign.

While the data period and specifications used by are different in several respects from those of Rao and Singh, the latter do find that the significance of the political variables is sensitive to the inclusion of fixed effects. In fact, Rao, Singh and Vashishta (2001) re-estimate the Rao-Singh fixed-effect specifications with the inclusion of the Biswas-Marjit lobbying power variable, and find that it is statistically insignificant, whether the other political variables are included or not. Hence there is clearly room for further empirical analysis.

Dasgupta, Dhillon and Dutta (D3) use data for 29 years, from 1968-69 to 1996-97, and include the smaller state of Goa in their estimations. They use three dependent variables, numbers 3-5 of the five basic categories, in logarithms of per capita transfers. Their 'non-political' control variables are SDP per capita, share of agriculture in SDP, annual rainfall and voter turnout in the last state legislative assembly election. They use three political explanatory variables: two are somewhat similar to the Rao-Singh and Biswas-Marjit measures of 'power' and 'alignment', while the third captures whether a state's legislative assembly election was close or not, reflecting whether the state might 'swing' in a favorable direction as a result of transfers. The alignment variable enters independently as well as determines a switch in the estimated regression for the other political variables. D3 allow for fixed effects as well as various lagged effects in the political variables. D3's results are perhaps the strongest in support of the importance of political effects on discretionary transfers: they find that the 'power', 'alignment' and 'swing' variables all tend to have empirical effects that are consistent with their extension of the Dixit-Londregan model.

One institutional feature that is not fully captured in any of the above papers is the five-year cycle of decision-making that affects both the Finance Commission and the Planning Commission (though these cycles no longer are contemporaneous). Rao, Singh and Vashishta (2001) have re-estimated the Rao-Singh equations with the following modifications. They estimate separately for the two components of discretionary transfers, they fix the political variables at the levels that are current in the year that decisions are made, and they include dummy variables for the different Planning Commissions. The effect of the last factor is very strong: different Planning Commissions have very different fixed effects on transfers. On the other hand, the political variables are still statistically insignificant in these estimates.

What is one to conclude from all these empirical exercises? First, one should not be dismayed by the lack of absolutely clear-cut results. After all, the underlying

institutions are often viewed as complex and opaque, perhaps deliberately so. These papers are certainly an excellent start in sorting out the political-economic interactions that determine the actual levels of various kinds of center-state transfers in India, and their insights can be combined in future empirical work. Second, the papers taken together do suggest that political factors, whether captured through straight political variables, or through measures of demographic and economic importance, do matter for the actual pattern of transfers in India. In particular, Rao and Singh suggest that these effects extend to Finance Commission transfers as well as to more obviously discretionary transfers. We would like to argue, later in this paper, that there is a case for institutional reform of the center-state transfer system that is supported by the empirical work summarized in this section. In doing so, we need to first examine the evidence on convergence or divergence across India’s states.

Before turning to questions of interstate disparities, it is useful to acknowledge that the empirical exercises above have all been restricted to explicit transfers. Political economy considerations can work through a variety of additional channels. The various types of controls, regulations, and priority sector lending, as well as the center’s own investments, have determined resource flows across India’s regions. Often these implicit resource transfers were unintended (as in the case of India’s freight equalization scheme). Also, financial repression, allocation of loans at below market rates of interest to states, and mandated allocation of loans to priority sectors have all resulted in “invisible” transfers (Rao, 2000c) with differential regional impacts: we return to this issue in Section V. Political economy factors can also manifest themselves in the design of the tax system at the state level, with regional implications. For example, the origin-based sales tax system has caused significant inter-state tax exportation: again, we treat this issue in Section V.

IV Convergence, Divergence and Reform of the Transfer System

In addition to political influence effects, Rao and Singh (2000) also look at equalizing effects of different categories of transfers. Their regressions tell a somewhat different story than simple correlation coefficients, which support the view that Finance Commission transfers have favored states with lower per capita SDP, more so than Planning Commission transfers (Table 6 in Rao and Singh, 2000). Instead, the fixed-effect regressions provide a more ambiguous picture. For example, when state fixed effects are included, per capita Finance Commission transfers do not vary inversely with per capita SDP. While more empirical work needs to be done, the general point is that *conditional* on political and economic factors that may affect bargaining power, the equalizing impact of center-state transfers is unclear. However, whether this should be of concern when the unconditional impacts – as reflected in the simple correlation coefficients – are in the right direction, is a separate matter. We would argue that it is of concern, because economic reform has changed the nature of central government control of the economy in a way that increases the potential for greater disparities across states, putting more of the burden on an effective system of center-state transfers. We support this contention by examining the evidence on convergence and divergence across the states of India.

The number of papers on convergence or divergence among the Indian states has mushroomed in the past few years. This interest has been driven by the general resurgence of growth theory as much as by the experience of India. Studies of convergence across countries have focused on catching up by poorer nations through faster growth. Where faster growth is also affected by other variables besides initial income levels, the convergence is conditional: in other words, a poorer country (or region) may converge to a steady state that is different from that of the richer country (or region).⁶ Variables such as literacy, health and physical infrastructure may be the conditioning variables, as well as the economic policies followed. Clearly, the conditioning variables themselves may be endogenous. While the evidence for any type of convergence across disparate countries is quite weak, one might expect greater possibilities for convergence across similar regions or constituent units of a federation such as India.

In one of the first studies of convergence within India, Cashin and Sahay (1996), examined data for the period 1961-91, thus excluding the reform period of the last decade, but including the Rajiv Gandhi reform period of the 1980s. The analysis is performed on 20 states, thus including some of the special category states, which receive central transfers according to different, and typically much more generous formulae than the major states. This is important to note because the authors use state disposable income per capita, adding in all central transfers, except for shared taxes, to SDP. They find some evidence for unconditional convergence in the period of analysis, with the strongest effect being identified in the 1961-71 decade. These results are not changed in essence by controlling for other variables. Furthermore, the results indicate much slower convergence than that found across regions of developed countries such as the US and Japan. This meant that cross-sectional dispersion of per capita incomes across states actually increased over the three decades studied, despite the inclusion of center-state transfers (though dispersion was greater when these were excluded). Cashin and Sahay also examine the role of internal migration in convergence, and find it to be weak.

Several analyses followed Cashin and Sahay. Rao and Sen (1997) argue that the inclusion of four special category states in the Cashin-Sahay sample muddies their analysis. Furthermore, they argue that adding of transfers to SDP involves some double counting. Finally, Rao and Sen also take issue with the analysis of the equalizing effect of transfers, arguing that excluding shared taxes gives misleading results. Cashin and Sahay's response, however, disputes these criticisms on empirical and conceptual grounds. Marjit and Mitra (1996) independently analyze a data set similar to Cashin and Sahay's, but with different empirical methods: they argue that the evidence for convergence is weak.

Nagaraj, Varoudakis and Véganzonès (NVV, 1998) examine data on 17 states for 1970-94 (including three special category states). They find no evidence for absolute

⁶ Thus, one can identify three possible scenarios: absolute convergence, where different entities are moving toward the same steady state, conditional convergence, where they are converging to (possibly very) different steady states, and divergence, where there is no evidence of convergence. The last case is inconsistent with neoclassical growth models, but conceivably fits some endogenous growth models. Note that conditional convergence is quite consistent with increasing disparities across entities.

convergence. Using panel data (rather than a cross-section as in Cashin-Sahay) and per capita GDP (excluding transfers), NVV find that there is evidence for conditional convergence, with the conditioning being done on the share of agriculture and the relative price of agricultural and manufactured goods. Adding infrastructure indicators substantially strengthens the estimated rate of conditional convergence. While NVV do not explicitly consider transfers, they emphasize the importance of infrastructure and nonmeasured political and institutional factors (captured in state fixed effects) in explaining differences in steady state growth rates across states. To the extent that center-state transfers have a potential role in affecting these determinants of growth, they are important in this analysis.

Rao, Shand and Kalirajan (RSK, 1999) examine data for the 14 major states, for the period 1965-95, using GDP as the output measure. RSK find evidence for absolute as well as conditional divergence, a result that is quite robust across sub periods as well. They suggest that the speed of divergence increased in the last half-decade of their sample. However, this does not seem to be the decisive factor in explaining the difference from Cashin-Sahay: instead, the exclusion of special category states, and of center-state transfers are of greater importance. The differences in conditioning variables and estimation methodology from NVV (who use a fixed-effects panel model) may explain the difference in conditional convergence results between RSK and NVV. RSK emphasize the role of private investment in explaining growth differences across states. They find that private investment goes disproportionately to higher-income states, as well as to states that have higher per capita public expenditures.⁷ RSK also argue that explicit center-state transfers have had moderate impacts on interstate inequalities, and that these effects have been outweighed by implicit transfers through subsidized (public and private) lending and through interstate tax exportation.

Ahluwalia (2000, 2001) examines the most recent data on the performance of India's states. He uses the Gini coefficient for the 14 major states, and finds that interstate inequality, after being stable for most of the 1980s, increased, starting from the late 1980s, and even more in the 1990s. Many of the factors that he identifies as affecting growth performance are those emphasized earlier by NVV and RSK, suggesting that the fundamental situation that India faced earlier in the reform period has persisted through the decade of the 1990s.⁸ Ahluwalia (2000) does argue for reform of the center-state transfer system, but in the direction of imposing more effective conditionalities on transfers, to improve the use of transferred funds by the states. In fact, this would work against reduction in interstate inequalities. Furthermore, this recommendation seems to implicitly assume that the center (the Planning Commission in particular) is able to impose and monitor such conditionalities in an effective manner. Our discussion of the political economy evidence in the previous section leads us to be more cautious about

⁷ Marjit and Ghosh (2000) obtain results quite consistent to those of RSK, for the period 1970-96, using a slightly different sample of states and somewhat different data. Interestingly, they exclude most of the special category states 'endogenously', based on an outlier analysis.

⁸ See also Shand and Bhide (2000) for further empirical analysis, including sectoral decompositions. Chaudhuri (2000) also profiles Indian states' growth experience, amplifying the work of Ahluwalia, and highlighting some of the differences between the 1990s and earlier decades.

such an approach. Ahluwalia (2001) adds some simple regressions to his earlier analysis, but these do not change the overall analysis or conclusions.

Two final studies of possible convergence among India's states are those of Bajpai and Sachs (1999) and Aiyar (2001). The former study examines data for a sample of 19 states for 1961-93. For the subperiod 1961-71, they find some evidence of convergence, but not for later subperiods or for the period as a whole. Allowing for conditional convergence does not qualitatively alter these results. Aiyar also uses the 19-state sample, for 1971-96. He finds weak evidence of absolute convergence for the 1970s, but divergence for later subperiods (especially the 1990s), as well as for the overall period. He estimates a panel with fixed effects, as do NVV, in which he does find evidence of conditional convergence. His conclusions are similar to those of NVV and RSK, emphasizing the importance of infrastructure, private investment, and nonmeasured institutional factors.

What can we conclude from these studies? The overall evidence certainly seems to support absolute divergence among the Indian states in the past three decades, with the rate increasing in the 1990s. The evidence on conditional convergence is less decisive, but even if one accepts conditional convergence as descriptive of India's states, the conclusion remains that they may be converging to very different steady states. The differences in infrastructure and institutions that seem to explain interstate differences have been persistent, and neither Finance Commission transfers, Planning Commission transfers, nor centrally sponsored schemes have made a substantial dent in regional inequalities in India. One might argue that the center-state transfer system is being asked to do too much, both in terms of short term amelioration of interstate inequalities or in promoting development and poverty alleviation in the long run. If that is the case, however, the present tangle of multiple channels of transfers, with its combination of two extremes of complex formulae on one hand and ad hoc discretion on the other, ought to be simplified dramatically. Alternatively, one may argue that the transfer system has an important role to play in overall national development, and that this role has become more important as the centrifugal force of economic reform will put pressures on the other institutions of India's federal system, and perhaps even on India's political fabric.⁹

What are possible reforms that can be made in the transfer system? One example of the process of reform comes from the case of tax sharing arrangements. The Constitution specified certain categories of centrally collected taxes that were to be shared with the states, according to criteria to be determined by the Finance Commission. In particular, personal income taxes were a major component of tax transfers from the center to the states, which received 87.5% of such tax revenues. On the other hand, income tax surcharges were kept entirely by the center. Academic commentators suggested that there were obvious incentive problems with such arrangements, and the Tenth Finance Commission recommended alternative arrangements whereby a proportion

⁹ This point also applies if one considers migration, a factor that has received relatively little attention after Cashin and Sahay's effort to quantify its impacts. While migration may help to support convergence, in a heterogeneous country such as India, it may bring its own set of problems with it. If effective equalizing fiscal transfers can reduce interregional migration pressures or slow down the process, they may have a positive role in preserving interethnic peace.

of overall central tax revenues would be devolved to the states. This required bargaining and agreement among the center and the states, as well as a constitutional amendment, but this has all been accomplished.¹⁰

Tax sharing between the center and the states reflects one dimension of the bargaining that must take place among a federation’s constituents. Presumably, the initial effect of the change will be to leave the overall shares of the center and the states in aggregate near their previous values, avoiding the problem of creating clear initial losers from the reform. Principles of this sort might be used to tackle a harder problem, that of revising the formulae used to divide the states’ share of tax revenue among them. These formulae are quite complex, without embodying any clearly defined objective, either of interstate (horizontal) equity, or of provision of incentives for fiscal prudence. Given that there are other transfer mechanisms as well, and that those will be used with discretion, there is a case for the Finance Commission overhauling its formulae completely, to achieve greater simplicity. Such an overhaul can in theory be designed to respect the present status quo to a great extent, but to deal more aggressively with future increases in interstate inequality.

We would argue that an approach that builds equity concerns into a formula is preferable to one in which *ad hoc* grants are made at the margin. In this respect, one welcome change related to tax sharing is recommended in the Eleventh Finance Commission report. This is the reversal of a practice – introduced by the Eighth Finance Commission – of keeping a portion of shareable tax revenues from Union excise duties exclusively for allocation among states according to the amount of their estimated post-tax-devolution deficits. This amounted to a conversion of a part of the share of taxes into “gap-filling” grants, lacking both in transparency and efficient incentive provision.

The case for reform of transfer formulae applies equally strongly to the portion of Planning Commission transfers that are calculated on the basis of the 1969 “Gadgil formula”. One of the problems in the past has been the overly narrow scope of Finance Commissions, much narrower than what the Constitution of India implies for their role. Moving away from this restriction, one welcome innovation in the latest Finance Commission’s terms of reference was the consideration of the overall fiscal position of India’s federal system. The Commission forthrightly recommends a reassessment of plan transfer formulae, with this task to be brought within the scope of the Finance Commission.¹¹ The latest report also notes the severe muddle with respect to Planning Commission transfers, with economically meaningless distinctions between plan and non-plan categories of expenditure. It recommends reform of the financing of the plans so that plan revenue expenditure is financed from available revenue receipts after meeting non-plan expenditure, with borrowing used only for investments. Finally, a recommendation for multi-year budgeting could presumably be a step away from the

¹⁰ See Rao and Singh (2001) for further detail on the new arrangements, as well as initial implementation by the Eleventh Finance Commission.

¹¹ The much broader issue of what the role of the Planning Commission should be is taken up in the next section.

artificial cycle of five-year plans, which the evidence in Rao, Singh and Vashishta (2001) suggests may introduce temporal distortions in transfers.

We are not suggesting that any of these proposed reforms would solve the problem of divergence that seems to be creeping up quite quickly in India. Instead, they would make the formal transfer system clearer and simpler, which should make it easier to understand its objectives and its impacts. This is a first step in actually tackling problems of divergence, or of convergence to greatly different steady states. We are also not suggesting that this is the only channel for impacts on interstate inequality. RSK have noted the important regressive impacts of implicit transfers and of private sector investment flows. They also point out the unknown regional effects of direct central government expenditures, which will also incorporate individual MPs' pork barrel efforts. Finally, there will always be some component of explicit transfers that is subject to central government discretion. However, in our view, removing a significant portion of center-state transfers outside the political economy arena, clearly targeting them toward horizontal equity objectives, and doing so in a manner that does not create perverse incentives for recipients, is both feasible and desirable.

V Reform of India's Federal Institutions

In the previous section, we have argued for integrating and simplifying the formulaic components of center-state transfers, focusing them more clearly, and expanding their importance relative to discretionary components. We suggested that the success of the recent overhaul of tax sharing arrangements provides evidence that reform in this area is feasible and workable. The recommendation of the Eleventh Finance Commission to bring formulaic plan transfers under the scope of the Finance Commission raises some interesting broader issues. The resources that have been devoted to the operation of the Planning Commission stand in stark contrast to the minimal assistance provided to the Finance Commission. Elsewhere (most recently in Rao and Singh, 2001) we have argued that the Finance Commission could be more effective if provided with ongoing resources for conducting its analysis and recommendations.

One might extend the earlier argument to question whether the resources used by the Planning Commission provide any benefit in an economy where liberalization has taken hold. Where there is a justification for national level coordination because of externalities that cross state borders (as in the case of roads or power, for example), different ministries or even state governments can negotiate and cooperate. Where there is no such justification, unconditional grants, determined by the Finance Commission, that do not distort states' fiscal incentives seem to be the appropriate channel. The Planning Commission may be largely redundant in such an institutional framework. Tackling this issue head on is likely to be politically infeasible, but gradually shifting responsibility and resources to the Finance Commission may well be a possible approach.

This last recommendation flows directly from the previous section's discussion of how to improve the center-state transfer system. Three other areas of ongoing reform also bear on the transfer system, either by changing the environment within which it works, or

through direct interactions. The assignment of tax authority is obviously important in influencing the starting point from which intergovernmental transfers are made. Second, the explicit strengthening of local governments, with formal transfer systems being introduced for state-local transfers, must impact center-state fiscal relations. Finally, financial sector reform interacts with the conditions under which subnational governments or other public entities can obtain funds for capital projects. Since funds are fungible, the institutions for current and capital transfers affect each other. We consider each of these issues in turn.

Tax Reform

Some elements of tax reform in the last decade (some beginning earlier) are well known: a reduction in tariff rates, reductions in direct tax rates coupled with attempts to broaden the tax base, and a gradual movement from excise duties and sales taxes to VAT at both the central and state levels. If we compare 1990-91 with 1999-2000, the impact of some of these changes has been as follows: an increase in the direct-tax-to-GDP ratio from 2.16% to 3.24 %, accompanied by an increase in the number of filers from 6.1 to 17.8 million; more than offset by a decrease in the central indirect-tax-to-GDP ratio from 8.84 % to 6.23 %, driven by reductions in the percentages of central excise duties as well as customs duties.¹² State sales taxes and excise duties have also shown some proportionate decline, so that the overall tax-GDP ratio has declined by almost two percentage points in the 1990s (Rao, 2000a). While the overall decline merely reverses an increase that took place in the 1980s, the fact that it has occurred at higher income levels, and during a period of economic reform, raises questions about long-term implications. Some of the issues are connected to dimensions of tax reform that have yet to be effectively tackled.

The Tax Reform Committee of 1991 had also recommended minimizing exemptions and concessions, simplification of laws and procedures, development of modern, computerized information systems, and improvements in administration and enforcement (Rao, 2000a). Work in the mid-1990s by Das-Gupta and Mookherjee (1998, Chapter 6) detailed the problems with Indian tax administration, both in terms of the incentives of those paying taxes and those enforcing them. However, in May 2001, N.K. Singh and Modi (focusing on central tax collection) were still led to write, "The tax enforcement effort has left much to be desired ... from the view point of a decline in total tax collected as a percentage of collectible tax, the pendency of assessment work and the dilatory process of the Appeal redressal mechanism." Thus it is clear that much remains to be done in this respect. We would like to suggest here that the benefits of improvements in this area are likely to be large, not only because of the direct benefits of improvements in central information systems and institutions of enforcement, but also because these can provide a model for states to improve their tax administration as well.

A reform that more directly affects India's federal system lies in indirect taxes, which, as we have noted, have not increased proportionately with GDP in the last decade. As Rao (2000a) puts it, "The most important challenge in restructuring the tax system in

¹² These figures are from N. K. Singh and Modi (2001), Tables I, III and IV.

the country is to evolve a coordinated consumption tax system." In Section II, we noted some of the problems with the current assignments of indirect taxes. Rao provides some detailed recommendations in this regard, with respect to issues such as rates, interstate sales taxes, and tax administration for a dual VAT coordinated between the center and the states. Rao also notes the problem created by the failure of the Constitution to explicitly include "services" within the scope of states' sales tax authority. This problem has been recognized for some time, and is clearly in need of correction, as also recommended by the Eleventh Finance Commission in its report.

Moving taxation of services from the Union list, where it implicitly lies through the center's residual powers over taxes not explicitly specified in the Constitution, to the Concurrent list will require a constitutional amendment. Such an amendment must be proposed by the central government, but will benefit the states. Rao incorporates political economy considerations of the kind that we have discussed in earlier sections, by suggesting that an amendment be tied persuading the states to reduce and eventually eliminate taxation of interstate sales, thus removing some of the internal barriers that have plagued the development of a true national market within India. This will also smooth the implementation of a destination based VAT for the states. Note that such reforms can also reduce tax exporting by the richer states, which has been discussed in Rao and Singh (1998), complementing the role of transfers in keeping interstate divergence from becoming politically unacceptable.

The case of taxation of services illustrates a broader issue that was addressed by the eleventh Finance Commission. Its report recommended in general terms a reduction in the vertical fiscal imbalance by reassignment of tax authorities, giving the states more power to tax. This approach takes some pressure off the fiscal transfer system, allowing states that can obtain political support to more flexibly tax their own constituents to deliver benefits to them. Another possible example of such a tax reassignment would be to allow states to piggyback on central income taxes. This, too, would require a constitutional amendment. It might seem redundant where tax sharing exists, but with tax sharing no longer applied to specific tax "handles", but to tax revenues in total, this change would give states more flexibility at the margin, where they properly should have it. Note that states are already assigned the right to tax agricultural income, though their use of this tax is minimal. This separation has no economic justification, and, as we noted in Section II, merely promotes tax evasion. Piggybacking with a removal of the distinction between nonagricultural and agricultural income would represent a major improvement in tax assignments. The latter would also be an important step forward in broadening the direct tax base. Whether the political economy logic can work for this case of tied reforms, as suggested for the case of services above, is worth considering.

To summarize our discussion, much remains to be done in terms of tax reform. While some measures can be initiated by the center acting alone, many others require agreement or coordination between the center and the states. These include possible reassignments of tax authority, as well as changes in tax administration. Recognizing the play of differing interests may help in devising reform packages that balance potential losses against gains, and thereby increase the probability of acceptance.

Local Government Reform

The political motivations and history of local government reform in India have been quite different from those that led to the economic reforms of the 1990s. Nevertheless, we would argue that there is a complementarity between the two sets of reforms that benefits from their fortuitous temporal coincidence. After a long history of debate on decentralization, a central government committee recommended that local bodies should be given constitutional status. Two separate amendment bills were introduced, covering *panchayats* and municipalities¹³ respectively, passed by parliament in 1992, ratified by more than half the state assemblies, and brought into force as the 73rd and 74th amendments to the Constitution of India in 1993. These amendments required individual states to pass appropriate legislation, since local government remained a state subject under the constitution, and individual states have done so. These legislative changes are the beginning of a process of local government reform in India.

There are three tiers of rural local governments, roughly, village, block and district. The population per village government is extremely small, raising questions of economic efficiency. Populations per block are considerably larger, and blocks approximate the constituencies of Legislative Assemblies, the lower houses of the state legislatures. The highest tier, the district, is approximately the size of the constituency of the member of the Lok Sabha, the lower house of the national parliament. The block and district levels – particularly the latter – have been important components of the central administrative and plan implementation apparatus.

Until the recent legislative changes, the ability to exercise local suffrage was very limited: at any given time since independence, 40-50 per cent of local government bodies in India have been under state supersession (Dillinger, 1994). Also, there was previously a structural limitation on this exercise, since in most states only the lowest level of rural local government had directly elected local government officials. Some states did not have even indirect elections at the higher two levels of rural local government, those bodies instead being nominated by state governments. A key changes brought about by the 73rd and 74th amendments was the reduction of state government discretion concerning elections to rural local government bodies. Direct elections to local bodies must be held every five years. Elections to constitute new bodies must be completed before the term expires. If a local government is dissolved prematurely, elections must be compulsorily held within six months, the new body to serve out the remainder of the five-year term.

Previously (Rao and Singh 2000, 2001) we have characterized the above aspect of local government reform as replacing ‘hierarchy’ with ‘voice’¹⁴ as the primary accountability mechanism, and we have explained this as a positive step based on the ability to provide more refined incentives, subject to the caveat of effective monitoring and transparency being achievable. Local government reform has also changed the nature of tax and expenditure assignments to local governments, and instituted a system of formal state-local transfers modeled on the component of the existing center-state system

¹³ See also Mathur (1999) for an assessment of urban governments and reform.

¹⁴ See Hirschman (1970) for the initial terminology of ‘voice’.

that is governed by the Finance Commission. While there are some serious issues with the new assignments, including problems of local capacity and efficiency, both with respect to revenues and expenditures, we refer readers to our earlier discussions, and focus primarily on the new transfer system.

While one view has been that formal transfers from the center and states to local governments have the potential to accentuate fiscal deficit problems, our own perspective is that a formal, rule-governed system will make such problems more transparent. In fact, the evidence suggests that this is the case. Local government finances, particularly for urban bodies, have steadily worsened over the period before local government reform, under a system of hierarchical control and supposedly strict monitoring by state governments. This is not to imply that the new institutions, particularly the State Finance Commissions (SFCs), represent an immediate improvement. Almost all SFCs have given their initial reports, and the Eleventh Finance Commission sums up its appraisal of them as follows:

Many SFC reports have not addressed the specific terms listed in articles 243I and 243Y, nor have they provided a clear idea of the powers, authority and responsibilities actually entrusted to the local bodies. Many of these reports also do not clearly indicate the principles formulated for sharing or assignment of State taxes, duties, tolls, fees and the grants-in-aid. (Paragraph 8.11b)

Again, we would argue that this situation is no worse than the previous one of ad hoc and discretionary transfers and control of local bodies by state governments.

Interestingly, the central Finance Commission has been reluctant, and rightly so, to provide the states with grants requested by them to supplement the states' own transfers to their local governments, noting that the amendments do not justify this softening of the states' budget constraints. The Commission's main recommendations with respect to local government relate to assignment and incentive issues for various sources of tax revenue. Land and profession taxes are identified as two possible sources of revenue. Perhaps the most promising is the recommendation of surcharges on state taxes earmarked for local government, similar to the piggybacking we proposed for the states on central taxes. These recommendations are straightforward at this general level – the real problems arise in defining details and assuring implementation. This point also applies to the Commission's discussion of property tax, replacements for octroi, and local user charges.

Our analysis in earlier papers suggests that incentive efficiency with respect to government expenditure must be the starting point for revenue enhancement efforts. Here the Commission is right to suggest a quicker transfer of expenditure responsibilities to local governments: they are unlikely to do worse than state governments have so far done, in the provision of basic civic amenities. Grants to the lowest tier of local government recommended by the Commission may help to jumpstart the process of making local governments effective providers, if they can break out of their historical low-level equilibrium of revenue collection and service provision.

The Commission also recommends grants for improved accounting, auditing, and database building for local governments. These measures, if implemented effectively, can have a substantial positive impact on capacity, transparency and accountability in the delivery of street-level government services. The report also discusses some of the potential conflicts between the existing institutional apparatus of central and centrally sponsored schemes and the role envisaged for local governments, and problems that are arising from states' reluctance to devolve authority to their subordinate governments. One example of the latter problem is the failure of state governments to implement their own SFCs' reports. In the case of the central Finance Commission, the bargaining power of the states, and the role of precedent have worked to ensure the implementation of most recommendations. In the case of the states, local governments may need outside help, for example from the courts, to pressure reluctant state governments.

To conclude this discussion, we note that there is a clear conceptual and empirical connection between the nature of past regulation of local governments in India and the overall top-down approach to economic policy, relying on the case-by-case discretion of government decision-makers in areas such as industrial location and expansion, that characterized pre-reform policy-making. The central point here is that the ideas that are guiding changes in how the national government interacts with the private sector are also important for how state governments interact with local governments. The expanded assignments legislated for local governments, and the increased role for local 'voice', together require the state governments to fundamentally change their regulation of local governments underneath them.

Furthermore, expanding and strengthening the scope of the central Finance Commission in determining center-state transfers, while simplifying the formulae that govern them (something we have advocated earlier in this paper), can have the added benefit of giving states a clearer road in achieving their own devolution to local governments. Currently, central discretionary transfers, which are meant to be implemented at the district or block level, swamp local government capacity for action and for their own revenue raising (Rajaraman, 2001). Replacing these with conditional or unconditional grants from the states (with the ultimate source possibly being unconditional grants from the center), will allow more effective functioning of local governments. Thus, our perspective on local government reform ties in with our earlier discussion of reform of the center-state transfer system.

Financial Sector Reform

One innovation in the Eleventh Finance Commission's recommendations was its consideration of the overall fiscal position of India's federal system, in particular the Central and state governments. This was, in fact, a significant part of the Commission's terms of reference, and represented a welcome broadening of its scope. It was clearly motivated by the ongoing issue of fiscal deficits that India has struggled with for the past decade. Furthermore, the problem of fiscal deficits has, to a large extent, been pushed down to the level of the state governments, making it very much an issue of federalism.

Fiscal deficits at the state level have increased despite the central government's apparent formal authority to strictly control state borrowing. There are two causes of this phenomenon. First, the central government has increasingly used discretionary loans, often with interest subsidies or even *ex post* conversion of loans to grants, as a component of political influence. This statement is based on casual empiricism, but is consistent with the political effects found in the analyses of explicit transfers, which were discussed in Section III. Second, the states have used public sector enterprises and other off-budget devices to run larger deficits in practice.¹⁵ For both the center and the states, the ultimate enabler of both these trends has been the nature of India's financial system. Severe financial repression, along with direct ownership and control of much of the financial system, has permitted governments to 'park' deficits in the financial system without having to print money and cause politically dangerous inflation.

The cost of financial repression and deficit parking has been inefficient capital allocation and lower growth. If growth is to be promoted by improvements in the efficiency of capital allocation, and not just increases in savings and investment, reform of the financial sector is required. Such reform has, indeed been taking place in areas such as the functioning of Indian stock markets, corporate governance, regulation of banking, and methods of central government borrowing. Whatever the other specific problems that these reforms have encountered¹⁶, the constraints imposed by the web of government-controlled financial institutions and their 'bad' loans to the public sector are a severe hurdle to more thorough financial sector reform. Hence, while tax reform and local government reform are directly issues of reform of India's federal structures, within the public sector, tackling the ways in which public sector capital finances are handled is a case of interaction of the private and public sectors. Financial sector reform threatens the public sector house of cards, and is therefore held back.

The problem as stated is well recognized. The solution may not be so clear, or easy to implement. The Eleventh Finance Commission recommended a slew of measures to promote fiscal discipline: an overall ceiling of 37.5% of gross receipts of the Center for all transfers to the states; hard budget constraints for all levels of government with respect to wages and salaries; 'greater autonomy' along with hard budget constraints for public sector enterprises; more explicit controls on debt levels for state governments; and improvements in budgeting, auditing and control. We would like to suggest that "greater autonomy along with hard budget constraints for public sector enterprises" will not work. Furthermore, by not working, it will continue to undermine any limits on states' debt levels. The only clear-cut solution is privatization of public sector assets. The political difficulty of this task is highlighted by the absence of any meaningful privatization in a decade of economic reform. It differs fundamentally from other aspects of reform, involving more than just reform within government or changing the nature and methods

¹⁵ See, for example, Lahiri (1999), Rao (2000b), and Mohan (2001).

¹⁶ Problems have included dealing with moral hazard and corruption, lack of regulatory capacity, political interference, and simple mistakes in institutional design. Nevertheless, the story has often been one of uncovering problems that were earlier hidden, and the overall picture is probably more encouraging than newspaper headlines about financial scandals would suggest.

of regulating the private sector, instead explicitly shifting the boundary between private and public ownership.

If privatization affects the nature of the demand for credit, the other side of the equation concerns the supply of credit. Deficit parking has been abetted by the existence and operation of public sector financial institutions. The need for privatization applies to these as well. Where does this leave the different levels of government with respect to financing the urgent needs for public infrastructure? One might be tempted to condemn privatization of the financial sector if the past approach of public subsidies and directed lending had been successful in efficiently and effectively building such infrastructure: in fact, it has failed badly.

Note that the issue with respect to the working of the financial sector has not been just one of levels of credit, but also of credit allocation across states. Hence our discussion of fiscal deficits also relates to our analysis, in Sections III and IV, of political economy influences and growing interstate disparities. In fact, the problem grew after the nationalization of commercial banks in 1969, which concentrated economic power in the hands of the center. With insurance and many other financial institutions already under central control, the central government became a virtual monopolist in the financial sector. It might even be argued that, in such circumstances, the role of the formal intergovernmental transfer system has been overshadowed by invisible transfers.

Privatization in the financial sector therefore not only can have direct impacts on efficiency and growth, but it can also support the objective of allowing explicit center-state transfers to meet their own objectives more effectively. With respect to transfers for capital purposes, we suggest that, while central and state governments will always have the option of making conditional grants and project loans to lower level governments, the practical limitations on monitoring and incentives of such transfers (including the ultimate fungibility of transferred funds) support the greater use of unconditional block grants, with marginal capital funds coming through market borrowing.¹⁷ Ultimately, since repayment of such borrowing comes from taxes and user charges, this means that each level of government is more responsible at the margin, and responsive to its constituents' preferences. This recommendation is perhaps as drastic a reform of 'development finance' in India as that of curtailing the Planning Commission's role, but it seems to be a necessary complement to other aspects of financial sector reform.

We may summarize the main message of this section quite simply. Overall, we are suggesting that a further devolution of expenditure assignments, as is being implemented in the ongoing local government reform, makes sense from an efficiency perspective, because it allows incentives to be more refined and effective. This must be accompanied by devolution of tax assignments, to keep vertical fiscal imbalances from overwhelming such incentives. Since vertical fiscal imbalances will still arise, we argue for a simpler transfer system that does not distort marginal incentives. While there is still

¹⁷ Obviously, the smaller the government, the less will be the feasibility of significant reliance on the market. However, as we have emphasized earlier, many of the Indian states are comparable to countries in terms of population size and fiscal domain.

room for transfers and loans that are earmarked for capital expenditure, we argue that here, too, marginal incentives are crucial, and that providing these through the market may be the only efficient avenue in practice. This argument is based on the recognition that political influences will distort choices in the absence of such discipline, no matter how legal restraints are structured. Thus our recommendations here are in keeping with our discussion of the political economy of center-state transfers in Section III. While decentralization and privatization may seem to exacerbate problems of interstate inequality and divergence that we highlighted in Section IV, a counterargument is that, instead, they enable higher-level governments to focus more clearly and directly on redistribution as an objective where it is deemed necessary.

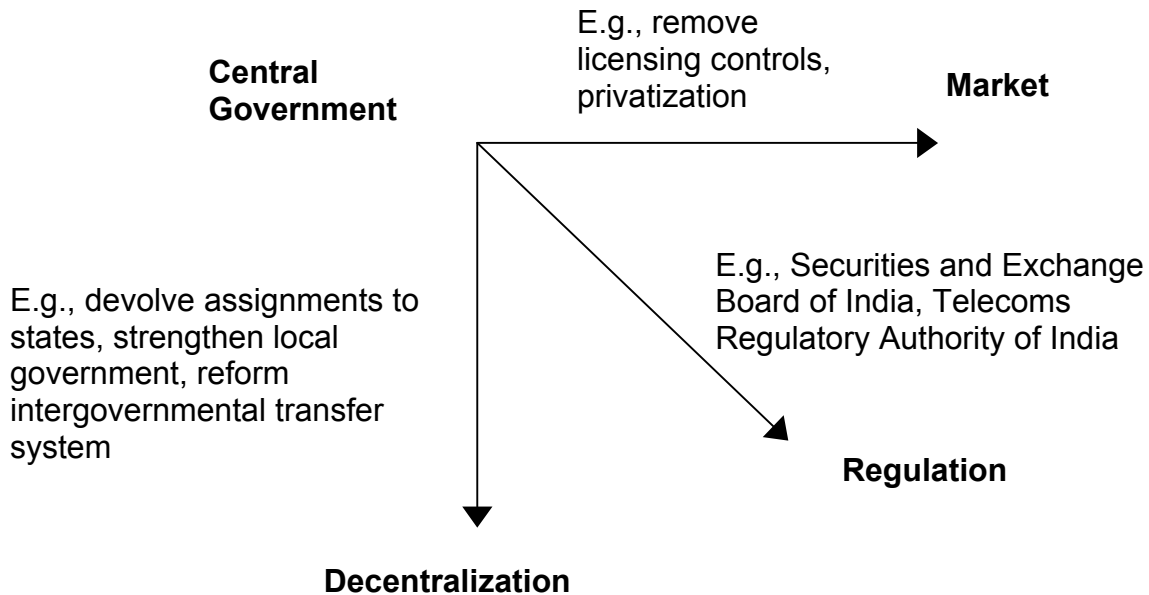
VI Conclusion

In this paper, we have argued that India's federal structures are an important aspect of its political and economic system. We have tried to assess the state of these federal structures, looking at their development, the reforms of the last decade, and what remains to be done. We have emphasized several ideas. One is that center-state fiscal transfers do not take place in a technocratic utopia, but are subject to political influences. This idea is not new, but we have marshaled recent empirical evidence for India. Another theme has been the use of multiple channels for explicit and implicit transfers: this is very consistent with a story that emphasizes political economy factors. A third idea has been that the transfer system has not done much (or not enough) to manage interstate disparities, and the evidence suggests that this shortcoming will matter more as regional economic disparities have been widening over the last decade.

Based on our analysis of the Indian situation, we have discussed several dimensions of reform. We have suggested that the system of center-state transfers be simplified, and that the Finance Commission be given a greater role in governing these explicit transfers. We have suggested that tax reform must involve some realignment of tax assignments to remove anomalies, and to reduce the extent of vertical transfers, and we have offered some thoughts on what might be politically feasible policy packages. We have assessed some aspects of local government reform, and suggested that it is very promising for promoting effective public expenditures, though also very much a work-in-progress. We discussed how reform of the center-state transfer system, and of the Planning Commission's role, can aid the effectiveness of local governments.

Finally, we have related our discussion of center-state transfers to financial sector reform, suggesting that privatization motivated by efficiency concerns can be an effective complement to a more streamlined system of explicit transfers that deals with interstate disparities or the needs of poorer states. In discussing these proposals, we have tried to highlight the political difficulties that may arise in such cases, particularly with shifting ownership of resources from the public to the private sector. Our perspective in doing so has been an instrumentalist one, which also shapes our view of the political economy of federalism in general.

Figure 1: Dimensions of Economic Reform



Our central message is that understanding India’s federal system is a vital part of conceptualizing economic reform in India. We illustrate this message in Figure 1, which is a modified version of a graph we used in Rao and Singh (2001). Shifting the boundary of ownership between state and market (the horizontal arrow in Figure 1) is just one aspect of reform. Another dimension involves altering the nature of regulation of the market, moving from case-by-case permission and input control to arm’s length regulation and performance-based monitoring (the diagonal arrow). Various kinds of decentralization, which involve changing the nature of the powers of and interactions among the different levels of government (the vertical arrow), constitute the third, often most neglected dimension of reform. In this paper, we have emphasized this dimension, and related it where possible to issues that arise in other dimensions, including privatization and the nature of regulation (whether of private entities or lower-level governments). Ultimately, because India faces bottlenecks in what we might lump together as “social capital” (using that term somewhat more broadly than is usual), we think that future economic growth will depend on what happens along this third, vertical “axis”, as India attempts to improve its endowments of basic human capital, public physical infrastructure, and public institutions.

References

Ahluwalia, Montek S. (2000), "Economic Performance of States in Post-Reforms Period," *Economic and Political Weekly*, May 6, 1637-1648.

Ahluwalia, Montek S. (2001), "State Level Performance under Economic Reforms in India," Working Paper No. 96, Center for Research on Economic Development and Policy Reform, Stanford University.

Aiyar, Shekhar (2001), "Growth Theory and Convergence across Indian States: A Panel Study", Chapter 8 in *India at the Crossroads: Sustaining Growth and Reducing Poverty*, ed. Tim Callen, Patricia Reynolds and Christopher Towe, International Monetary Fund.

Bajpai, Nirupam, and Jeffrey Sachs (1996), "Trends in Inter-State Inequalities of Income in India," Development Discussion Paper No. 528, Harvard Institute for International Development.

Baron, David, and John Ferejohn (1989), "Bargaining in Legislatures", *American Political Science Review*, pp. 1181-1206.

Biswas, R. and S. Marjit (2000), "Political Lobbying and discretionary Finance in India: An Aspect of Regional Political Influence in a Representative Democracy," processed, Centre for Studies in social Sciences, Calcutta.

Breton, Andre, and Anthony Scott (1978), *The Economic Constitution of Federal States*, Toronto: Toronto University Press.

Cashin, Paul, and Ratna Sahay (1996), "Internal Migration, Center-State Grants, and Economic Growth in the States of India," *International Monetary Fund Staff Papers*, 43, 1, 123-171.

Cashin, Paul, and Ratna Sahay (1997), "Internal Migration, Center-State Grants, and Economic Growth in the States of India: A Reply to Rao and Sen," *International Monetary Fund Staff Papers*, 44, 2, 289-291.

Chaudhuri, Saumitra (2000), "Economic Growth in the States – Four Decades-1", *Money and Finance*, Oct.-Dec., 45-69.

Dasgupta, Sugato, Amrita Dhillon and Bhaskar Dutta (2001), "Electoral Goals and Centre-State Transfers in India", processed, Indian Statistical Institute, New Delhi.

Das-Gupta, Arindam, and Dilip Mookherjee (1998), "Redefining the Economic Role of the State: The Role of 'Positive' and 'Negative' Institutional Reforms in India", paper presented at conference on Economic Liberalization in South Asia, University of California, Berkeley, April.

Dixit, Avinash and John Londregan (1998), "Fiscal Federalism and Redistributive Politics", *Journal of Public Economics*, Vol. 68, pp. 153-180.

Dillinger, William (1994), *Decentralization and Its Implications for Urban Service Delivery*, UNDP/UNCHS/World Bank Urban Management Programme Discussion Paper, UMP 16.

Finance Commission (2000), *Report for 2000-2005*, Government of India: New Delhi.

Hirschman, Albert O. (1970), *Exit, Voice, and Loyalty; Responses to Decline in Firms, Organizations, and States*, Cambridge, MA: Harvard University Press.

Inman, Robert P. and Daniel L. Rubinfeld (1997), "The Political Economy of Federalism", in *Perspectives on Public Choice: a Handbook* (ed.) Dennis C. Mueller. Cambridge, U.K.; New York: Cambridge University Press.

Kletzer, Kenneth, and Nirvikar Singh (1997), "The Political Economy of Indian Fiscal Federalism", in S. Mundle, ed., *Public Finance: Policy Issues for India*, New Delhi: Oxford University Press.

Kletzer, Kenneth, and Nirvikar Singh (2000), "Indian Fiscal Federalism: Political Economy and Issues for Reform", in Anthony Lanyi (ed.), *Institutions, Incentives, and Economic Reforms in India*, Sage Publications.

Lahiri, Ashok K. (1999), "Practising Sub-National Public Finance in India", NIPFP, New Delhi, paper presented at The First Meeting of the Global Network Conference, Session on Decentralization, Governance and Public Goods in Large Economies, Bonn, Germany, December.

Marjit, Sugata, and Buddhadeb Ghosh (2000), "Economic Growth and Regional Divergence in India, 1970-1996," processed, Centre for Studies in social Science, Calcutta.

Marjit, Sugata, and S. Mitra (1996), "Convergence in Regional Growth Rates: Indian Research Agenda," *Economic and Political Weekly*, 31, 33.

Mathur, Om Prakash (1999), "Decentralization in India: A Report Card", Working Paper, National Institute of Public Finance and Policy, New Delhi, March.

Mohan, Rakesh (2001), "Achieving Higher Economic Growth: The Fiscal Deterrent", paper presented at Stanford Conference on Indian Economic Reform, June.

Nagaraj, Rayaprolu, Aristomene Varoudakis and Marie-Ange Veganzones (1998), "Long-Run Growth Trends and Convergence across Indian States," OECD Technical Paper No. 131.

Rajaraman, Indira (2001), "Growth-Accelerating Fiscal Devolution to the Third Tier", paper presented at NIPFP-DFID-World Bank conference on India: Fiscal Policies To Accelerate Economic Growth, New Delhi, May.

Rao, M. Govinda (2000a), "Tax Reform in India: Achievements and Challenges", *Asia-Pacific Development Journal*, 7, 2, 59-74.

Rao, M. Govinda (2000b), "Fiscal Decentralization in Indian Federalism", processed, Institute for Social and Economic Change, Bangalore.

Rao, M. Govinda (2000c), "Invisible Transfers in Indian Federalism", *Public Finance/Finances Publiques*.

Rao, M. Govinda, and Kunal Sen (1997), "Internal Migration, Center-State Grants, and Economic Growth in the States of India: A Comment on Cashin and Ratna Sahay," *International Monetary Fund Staff Papers*, 44, 2, 283-288.

Rao, M. Govinda, Ric Shand and K.P. Kalirajan (1999), "Convergence of Incomes across Indian States: A Divergent View," *Economic and Political Weekly*, March 27-April 2.

Rao, M. Govinda, and Nirvikar Singh (2000), "The Political Economy of Center-State Fiscal Transfers in India", paper presented at the Columbia University-World Bank Conference on Institutional Elements of Tax Design and Reform, February 18-19, 2000, forthcoming, ed. John McLaren.

Rao, M. Govinda, and Nirvikar Singh (2001), "India's Federal Institutions and Economic Reform", paper presented at the conference on India's Public Institutions, at Harvard University, February 9-10, 2001

Rao, M. Govinda, Nirvikar Singh, and Garima Vashishta (2001), "The Political Economy of Center-State Transfers in India: Further Analysis", in progress.

Shand, Ric and Shashanka Bhide (2000), "Sources of Economic Growth: Regional Dimensions of Reforms," *Economic and Political Weekly*, October 14, 3747-3757.

Singh, N.K., and Arvind Modi, "Direct Tax Reform in India", paper presented at Stanford Conference on Indian Economic Reform, June.