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## The Political Economy of India's Federal System and its Reform

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# **The Political Economy of India's Federal System and its Reform**

**M. Govinda Rao and Nirvikar Singh**  
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## **Abstract**

This article examines the nature of India's federal system, and recent and potential reforms in its structure and working. We summarize key federal institutions in India, focusing particularly on the mechanisms for Center-state transfers. These transfers are large, and are the major explicit method for dealing with inequalities across constituent units of the federation. We examine the evidence on how India's political economy has affected the practical workings of the transfer mechanisms. This is followed by a consideration of actual and possible reforms in India's federal institutions, including tax assignments and local government, and a discussion of how they might be implemented in a politically feasible manner.

**Keywords:** intergovernmental transfers, economic reform, federalism, regional inequalities

**JEL codes:** P26, P35, H1, H7

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## **The Political Economy of India's Federal System and its Reform**

This article provides an analysis of India's federal institutions in the context of economic reform. Its goal is to bring out the evidence for political economy elements in the working of India's federal system, and the implications for possible reforms of the system. In particular, we focus on political feasibility of structural reforms in India's fiscal federal institutions.

### **FEDERAL INSTITUTIONS IN INDIA**

India is comprised of 28 states, six "Union Territories" (UTs), and a National Capital Territory (NCT). The NCT of Delhi, and the UT of Pondicherry have their own elected legislatures, whereas the remaining UTs are governed directly by appointees of the Center. All the states have elected legislatures and chief ministers in the executive role, though state governors can exercise some powers in certain circumstances. The constitutional assignment of certain statutory powers to the states is what makes India a federal system. The nature of this assignment of powers, and how it has played out in practice, determine the extent of centralization within this system. In addition, the size of the states also has implications for this characterization. For example, because many 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 substate (local) government bodies was quite weak before the 1990s.

The primary expression of statutory constitutional authority in India comes through directly elected parliamentary-style governments in the national and state arenas, as well as nascent directly elected government bodies in various local jurisdictions. The rise of regional parties, and of explicit coalitions in the national Parliament, have together led to some decentralization in legislative governance. Other dimensions of governance structures that embody aspects of federalism include the bureaucracy and judiciary. In India, both are relatively centralized.

Assignments of authority include important non-fiscal dimensions, but 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 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, and exclusive powers of the states in the State List. Those powers falling under joint jurisdiction are placed in the Concurrent List. All residuary powers are reserved to the Center. The nature of these assignments is fairly typical of federal nations. The functions of the central government are those required to maintain macroeconomic stability, as well as 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, including education, transportation, social security and social insurance.

The assignment of tax powers in India is based on a principle of separation, that is, 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 duties. 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 the 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 states. 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 2002-2003, the states on average raised about 38 percent of government revenues, but incurred about 58 percent of 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 revenue has seen a long-run decline, from 69 percent in 1955-1956 to 52 percent in 2002-2003.

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 originally provided for the compulsory sharing of the net revenue from the non-corporate income tax (Article 270), and optional sharing of the proceeds of the Union excise duty (Article 272). Recent constitutional changes in this scheme are discussed below. The shares of the Center and the states and their allocation among different states of both the taxes are determined by the Finance Commission, which is appointed by the president of India every five years (or earlier if needed). In addition to tax devolution, under Article 275, the Finance Commission is required to recommend grants to states in need of such assistance.

So far, eleven Finance Commissions have made recommendations and, with a few exceptions, these have been accepted by the central government. However, the functioning of these commissions, their design of the transfer system, and their methodology have been criticized, the main criticisms being (1) the scope of the Finance Commissions through the Presidential terms of reference has been too restricted; and (2)

the methodology for the transfer scheme employed by the commissions has not had the most desirable equity and incentive consequences.

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, a central government body, makes grants and loans for implementing five-year (indicative) 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).<sup>1</sup> However, various central ministries still wished 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 more than 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.

Overall, as noted, transfers from the central government contribute significantly to state finances. Until 1993-1994, 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 percent in 1970-1971 to 44 percent in 1993-1994, and then declined to 37 percent in 1995-1996. It rose again in 1997-1998 to 44 percent, but thereafter, until 2001-2002, stayed under 37 percent. The share of transfers in state revenues showed a similar pattern over time. State expenditures increased even faster during this period, so that the share of transfers in state expenditures declined steadily, from well over 40 percent in the 1970s and 1980s, to less than one-third currently. The relative shares of the three channels of central transfers to states since the Fourth Plan (1969-1974) highlight two important changes in the pattern of transfers. 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.

### **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 the 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 was 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. Later in this article, we examine 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. We first examine the theory and evidence for political-influence factors in the system of explicit intergovernmental transfers.

In the large literature on the political economy of federalism, some analysts focus on the formation and stability of the federation itself, using bargaining models.<sup>2</sup> 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. Robert Inman and Daniel Rubinfeld, building on Albert Breton and Anthony Scott and David Baron and John Ferejohn,<sup>3</sup> 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. They do not explicitly treat intergovernmental transfers in their analysis. Kenneth Kletzer and Nirvikar Singh<sup>4</sup> 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. In the analysis of Avinash Dixit and John Londregan, voters can belong to groups, and care about their private consumption as well as having ideological positions. Political parties determine policies, including ideological positions as well as taxes and transfers. Sugato Dasgupta, Amrita Dhillon and Bhaskar Dutta extend this model to incorporate intergovernmental transfers.<sup>5</sup>

The theoretical models have been the basis for recent attempts to estimate political influences on Center-state transfers.<sup>6</sup> Rao and Singh estimated a model with dependent variables being different categories of transfers, in per capita terms. The explanatory variables were 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)<sup>7</sup> coming from a particular state, and a dummy variable measuring whether the same party was in power at the Center and in the state receiving the transfers. The latter two variables can be viewed as measuring "power" and "alignment." 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. One robust 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). There was also some evidence that political and economic size, as measured by SDP and population, had positive impacts on per capita transfers.

Biswas and Marjit, using a different specification, also found that political variables were statistically significant in explaining the level and pattern of Center-state

transfers in India. Dasgupta et al used three political explanatory variables: two were similar to the Rao-Singh and Biswas-Marjit measures of “power” and “alignment,” while the third captured 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. Dasgupta et al obtained strong results in support of the hypothesis that political effects affect discretionary transfers. They found that the “power,” “alignment,” and “swing” variables all tended to have empirical effects consistent with their extension of the Dixit-Londregan model.

The empirical studies suggest that political factors, whether captured through direct political variables, or through measures of demographic and economic importance, matter for the actual pattern of transfers in India. In particular, Rao and Singh showed that these effects extend to Finance Commission transfers as well as to more obviously discretionary transfers. In fact, the empirical analyses above were restricted to explicit transfers. Political economy considerations can also 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 states. Often these implicit resource transfers were unintended (as in the case of India’s freight-equalization scheme). Financial repression, allocation of loans at below market rates of interest to states, and mandated allocation of loans to priority sectors have also resulted in “invisible” transfers with differential regional impacts.<sup>8</sup> 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 interstate tax exportation.

In addition to political influence effects, Rao and Singh also looked at equalizing effects of different categories of transfers.<sup>9</sup> While simple correlation coefficients support the view that Finance Commission transfers have favored states with lower per capita SDP, more so than Planning Commission transfers, regression analysis provides a more ambiguous picture. For example, when state fixed effects were included, per capita Finance Commission transfers did not vary inversely with per capita SDP. While more empirical work needs to be done, the general point is that, after one controls for political and economic factors that may affect bargaining power, the residual equalizing impact of Center-state transfers is unclear. Whether this should be of concern when the unconditional impacts – as reflected in the simple correlation coefficients – are in the right direction depends on the changing nature of central government control of the economy. In particular, increases in the potential for greater disparities across states, as a result of market-oriented reforms, put more of the burden on an effective system of Center-state transfers.

Various studies have attempted to address the issue of trends in disparities across states' per capita incomes. In a pioneering study, Paul Cashin and Ratna Sahay found weak evidence for convergence across India's states in the period 1961-1991.<sup>10</sup> Rayaprolu Nagaraj, Aristomene Varoudakis and Marie-Ange Véganzonès used data for 1970-1994, and found conditional convergence, with the conditioning being done on the share of agriculture and the relative price of agricultural and manufactured goods.<sup>11</sup> This study emphasized the importance of infrastructure and of nonmeasured political and institutional factors (captured in state fixed effects) in explaining differences in steady-state growth rates across states. Since Center-state transfers can affect these determinants

of growth, they are important in this analysis. Rao, Ric Shand and Kaliappa Kalirajan examined data for the period 1965-95 and found evidence for absolute as well as conditional divergence.<sup>12</sup> They emphasized the role of private investment in explaining growth differences across states, finding that private investment goes disproportionately to higher-income states, as well as to states that have higher per capita public expenditures. They also argued that explicit Center-state transfers had had moderate impacts on interstate inequalities, and that these effects had been outweighed by implicit transfers through subsidized (public and private) lending and through interstate tax exportation.<sup>13</sup>

The evidence from these studies suggests growing inequality among the Indian states in the past three decades, with the rate increasing in the 1990s. 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.

What are possible reforms that can be made in the transfer system, if growing regional disparities are a concern, and can they be politically feasible? One example of the process of institutional 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 percent of such tax revenues. However, 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 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 was all accomplished by 2000.

Tax sharing between the Center and the states reflects only one dimension of the bargaining that must take place among a federation's constituents. The initial effect of the above change was 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, and also to deal more effectively with increases in interstate inequality.

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 positive change related to tax sharing was recommended in the Eleventh Finance Commission report. This was 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 in efficient incentive provision.

The case for reform of transfer formulae applies also 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 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 recommended a reassessment of plan-transfer formulae, with this task to be brought within the scope of the Finance Commission.<sup>14</sup> The report also noted the conceptual muddle with respect to Planning Commission transfers, with economically meaningless distinctions between plan and non-plan categories of expenditure, these categories failing to correspond to capital and current expenditures. It recommended reform of the financing of the plans so that the plan’s 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 artificial cycle of five-year plans, which may introduce temporal distortions in transfers.<sup>15</sup>

These reforms would not directly solve the problem of increasing regional inequality, but would make the formal transfer system clearer and simpler, in turn making it easier to understand its objectives and its impacts.<sup>16</sup> There will always be some component of explicit transfers that is subject to central government discretion, but 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 feasible and desirable from an economic policy perspective.

### **REFORM OF INDIA'S FEDERAL INSTITUTIONS**

The previous section discussed integrating and simplifying the formulaic components of Center-state transfers, focusing them more clearly and expanding their importance relative to discretionary components. The success of the recent overhaul of tax-sharing arrangements provides some evidence that reform in this area is politically 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 contrast to the minimal assistance provided to the Finance Commission. Elsewhere it has been suggested that the Finance Commission could be more effective if provided with ongoing resources for conducting its analyses and making recommendations.<sup>17</sup>

One might also question whether the resources used by the Planning Commission continue to provide any benefit in India's now more market-based economy. Where there is a justification for national coordination because of externalities that cross state borders (e.g., roads and power), different ministries or even state governments can negotiate and cooperate. Where there is no such justification, unconditional grants, determined by the Finance Commission, which do not distort states' fiscal incentives,



would be the appropriate channel. The Planning Commission might be largely redundant in such an institutional framework.

This last point 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 impacts. 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 now taking place, with formal transfer systems being introduced for state-local transfers, impacts 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. Given that 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 undertaken during 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 a VAT by both the central and state governments. Comparing 1990-1991 with 2002-2003, the central direct-tax-to-GDP ratio increased from 2.2 percent to 3.7 percent (accompanied by a tripling in the number of tax filers from about 6 to 18 million), but this was more than offset by a decrease in the central indirect-tax-to-GDP ratio from 7.9 percent to 5.3 percent, driven by reductions in the percentages of central excise duties as well as customs duties.<sup>18</sup> State sales taxes and excise duties have also

shown some proportionate decline, so that the overall tax-GDP ratio declined by almost two percentage points during the 1990s.<sup>19</sup> While this overall decline merely reversed an increase that took place in the 1980s, the fact that it occurred at higher income levels, and during a period of economic reform, raises questions about long-term implications. These issues are connected to dimensions of tax reform that have yet to be tackled effectively.

The Tax Reform Committee of 1991 had recommended minimizing exemptions and concessions, simplifying laws and procedures, developing modern, computerized information systems, and improving administration and enforcement.<sup>20</sup> Das-Gupta and Mookherjee detailed the problems with Indian tax administration, in terms of the incentives of both those paying taxes and those enforcing them.<sup>21</sup> However, there has been little progress to date. Improvements in tax administration might lead to direct benefits of improvements in central information systems and institutions of enforcement, and also be a model for states to improve their tax administration.

A reform that more directly affects India's federal system lies in indirect taxes, which, as noted, did not increase proportionately with GDP in the last decade. Evolving a coordinated consumption-tax system remains a major challenge.<sup>22</sup> Earlier, we summarized some of the problems with the current assignments of indirect taxes. Rao provides detailed recommendations with respect to issues such as rates, interstate sales taxes, and tax administration for a dual VAT coordinated between the Center and the states, and 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 the Eleventh Finance Commission also recommended its correction.<sup>23</sup>

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 would benefit the states. One can incorporate political economy considerations by tying such an amendment to persuading the states to reduce and eventually eliminate taxation of interstate sales. This would remove some of the internal barriers that have plagued the development of a true national market within India. It would also smooth the implementation of a destination-based VAT for the states, which in turn could also reduce tax exporting by the richer states, complementing the role of transfers in keeping interstate divergence from becoming politically unacceptable.<sup>24</sup>

The case of taxation of services illustrates a broader issue addressed by the Eleventh Finance Commission. Its report recommended, without giving any specifics, a reduction in the vertical fiscal imbalance by 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 tax their own constituents more flexibly in order 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. States are already assigned the right to tax agricultural income, though their current use of this tax is minimal. This separation has

no economic justification, and, as noted earlier, 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. The political economy logic suggested for taxation of services may also work for tied reforms in this case, since one tax “handle” for the states is replaced by another.

To summarize, while some tax reform 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 country’s economic reforms of the 1990s. Nevertheless, there is a complementarity between the two sets of reforms. After a long history of debate on decentralization, a central government committee recommended that local bodies be given constitutional status. Two separate bills, covering rural and urban governments respectively, were 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 because local government remained a state subject under the Constitution. All states have done so. These legislative changes were the beginning of a major process of local government reform in India.

Until the recent legislative changes, the ability to exercise local suffrage was very limited; at any given time since independence, 40-50 percent of local government bodies in India had been under state supersession.<sup>25</sup> Also, there was previously a structural limitation on this exercise because 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 change brought about by the amendments was a reduction of state government discretion concerning elections to rural local government bodies. Direct elections to local bodies must be held every five years. One can characterize this aspect of local government reform as replacing “hierarchy” with “voice” as the primary accountability mechanism.<sup>26</sup> This is a positive step to the extent that it provides more refined incentives, subject to the caveat of effective monitoring and transparency being achievable. Local government reform also has 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 that is governed by the Finance Commission. While there are some serious issues with the new assignments, including problems of local capacity and efficiency of raising and spending money, we focus here on the new transfer system.

One view has been that formal transfers from the Center and states to local governments have the potential to accentuate fiscal deficit problems. Alternatively, a formal, rule-governed system will make existing problems more transparent. In fact, the evidence suggests that this is the case. It is now apparent that local government finances,

particularly for urban bodies, steadily worsened over the period before local government reform, under a system of hierarchical control and supposedly strict monitoring by state governments. While the new state finance commissions (SFCs) have struggled to formulate the principles for sharing or assigning state taxes, tolls, and fees and for making grants-in-aid,<sup>27</sup> this situation seems no worse than the previous one of ad hoc and discretionary transfers and control of local bodies by state governments.

The central Finance Commission has been reluctant 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 related to assignment and incentive issues for various sources of tax revenue. Land and profession taxes were 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 proposed above for the states on central taxes. These recommendations are conceptually straightforward; the real issues arise in defining details and assuring implementation. This point also applies to the commission's discussion of property tax, replacements for octroi (a local-area entry tax), and local user charges.

Incentive efficiency with respect to government expenditure is a natural starting point for revenue-enhancement efforts. The commission suggested a quicker transfer of expenditure responsibilities to local governments; they are unlikely to do worse than state governments have done so far 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 recommended grants for improved accounting, auditing, and database building for local governments. These measures, if implemented effectively, could have a substantial positive impact on capacity, transparency, and accountability in the delivery of street-level government services. The report discussed 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 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 SFC 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 summarize, there is a 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 policymaking. 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, 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.<sup>28</sup> Replacing these with conditional or unconditional grants from the states (with the ultimate source possibly being unconditional grants from the Center) would 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

An innovation in the Eleventh Finance Commission's recommendations was its consideration of the overall fiscal position of India's federal system. This was a significant part of the Commission's terms of reference, and a major broadening of scope, 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 state governments, making it very much an issue of federalism. Fiscal deficits in the states 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, as discussed above. Second,



the states have used public sector enterprises and other off-budget devices to run larger deficits in practice.<sup>29</sup>

The ultimate enabler of both these trends has been the nature of India's financial system. 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 possible cost 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, further reform of the financial sector may be desirable, beyond areas such as the functioning of India's stock markets, corporate governance, regulation of banking, and methods of central government borrowing. However, 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.

The problem as stated is recognized, but the solution may not be easy to implement. The Eleventh Finance Commission recommended a slew of measures to promote fiscal discipline: an overall ceiling of 37.5 percent 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.<sup>30</sup> However, "greater autonomy along with hard budget constraints for public sector enterprises" may be impossible in practice due to political pressures, leaving privatization of (non-financial) public sector assets as an alternative, one with its own political problems.

Privatization will affect the nature of the demand for credit, as well as its supply. Deficit parking has been abetted by the existence and operation of public sector financial institutions, where the possibility of privatization also needs to be considered. The past approach of supply distortions through subsidies and directed lending has been unsuccessful in efficiently and effectively building public infrastructure, reducing the case against financial sector privatization. A further issue with respect to the working of the financial sector has been credit allocation across states. Hence, the discussion of fiscal deficits also relates to the earlier discussion 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 the role of the formal intergovernmental transfer system has been overshadowed by invisible transfers through directed lending.

Privatization in the financial sector therefore can support the goal of allowing explicit Center-state transfers to meet their own objectives more effectively. With respect to transfers for capital purposes, while the Center 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.<sup>31</sup> Ultimately, because repayment of such borrowing comes from taxes and user charges, this means that each level of government is more responsible at the margin,

and more responsive to its constituents' preferences. This possibility is as drastic as that of curtailing the Planning Commission's role, but it seems to be a necessary complement to other aspects of financial sector reform.

## **CONCLUSION**

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 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 India, we have discussed several dimensions of reform. One possibility is that the system of Center-state transfers be simplified, and that the Finance Commission be given a greater role in governing these explicit transfers. Another is that tax reforms include some realignment of tax assignments to remove anomalies and to reduce the extent of vertical transfers. We have offered some possibilities on what might be politically feasible policy packages. We have assessed some aspects of local government reform, and 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. Privatization in this sector may complement a more streamlined system of explicit transfers that deals better with interstate disparities.

Our final message is that understanding India's federal system is a vital part of conceptualizing economic reform in India. Shifting the boundary of ownership between state and market 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. Various kinds of decentralization, which involve changing the nature of the powers of and interactions among the different levels of government, constitute the third, often most neglected dimension of reform. We have emphasized this dimension, and related it where possible to issues that arise in other dimensions, including privatization and the nature of regulation.

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## Endnotes

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<sup>1</sup> 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.

<sup>2</sup> See Rao, M. Govinda, and Nirvikar Singh (2002), “The Political Economy of Center-State Fiscal Transfers in India”, Institutional Elements of Tax Design and Reform, ed. John McLaren (Washington DC, World Bank), pp. 69-123, for a brief discussion and references.

<sup>3</sup> Inman, Robert P. and Daniel L. Rubinfeld (1997), “The Political Economy of Federalism,” Perspectives on Public Choice: A Handbook, (ed.) Dennis C. Mueller. Cambridge, U.K., pp. 73-105; New York: Cambridge University Press; Breton, Albert, and Anthony Scott (1978), The Economic Constitution of Federal States, Toronto: Toronto University Press; Baron, David, and John Ferejohn (1989), “Bargaining in Legislatures,” American Political Science Review, pp. 1181-1206.

<sup>4</sup> Kletzer, Kenneth, and Nirvikar Singh (1997), “The Political Economy of Indian Fiscal Federalism,” ed., Sudipto Mundle, Public Finance: Policy Issues for India, New Delhi: Oxford University Press, pp. 259-298; Kletzer and Singh (2000), “Indian Fiscal Federalism: Political Economy and Issues for Reform,” eds., Satu Kahkonen and Anthony Lanyi, Institutions, Incentives, and Economic Reforms in India, New Delhi: Sage Publications, pp. 37-76.

<sup>5</sup> Dixit, Avinash and John Londregan (1998), “Fiscal Federalism and Redistributive Politics”, Journal of Public Economics, Vol. 68, pp. 153-180; Dasgupta, Sugato, Amrita

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Dhillon and Bhaskar Dutta (2001), “Electoral Goals and Centre-State Transfers in India”, processed, Indian Statistical Institute, New Delhi.

<sup>6</sup> Rao and Singh (2002), op cit.; Biswas, Rongili and Sugata Marjit (2000), “Political Lobbying and discretionary Finance in India: An Aspect of Regional Political Influence in a Representative Democracy,” working paper, Centre for Studies in social Sciences, Calcutta; Dasgupta et al. (2001), op cit.

<sup>7</sup> 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.

<sup>8</sup> Rao, M. Govinda (2000c), “Invisible Transfers in Indian Federalism”, Public Finance/Finances Publiques, Vol. 52, No. 3-4, 429-448.

<sup>9</sup> Rao and Singh (2002), op cit.

<sup>10</sup> 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.

<sup>11</sup> Nagaraj, Rayaprolu, Aristomene Varoudakis and Marie-Ange Veganzones (1998), “Long-Run Growth Trends and Convergence across Indian States,” OECD Technical Paper No. 131.

<sup>12</sup> 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, 769-778.

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<sup>13</sup> Related studies include Ahluwalia, Montek S. (2000), “Economic Performance of States in Post-Reforms Period,” Economic and Political Weekly, May 6, 1637-1648; Ahluwalia (2001), “State Level Performance under Economic Reforms in India,” Working Paper No. 96, Center for Research on Economic Development and Policy Reform, Stanford University; Chaudhuri, Saumitra (2000), “Economic Growth in the States – Four Decades-1”, Money and Finance, Oct.-Dec., 45-69; and Shand, Ric and Shashanka Bhide (2000), “Sources of Economic Growth: Regional Dimensions of Reforms,” Economic and Political Weekly, October 14, 3747-3757.

<sup>14</sup> The broader issue of what the role of the Planning Commission should be is taken up in the next section.

<sup>15</sup> See Rao, Singh, and Garima Vasishtha (2004), “The Political Economy of Center-State Transfers in India: Further Analysis”, manuscript, UC Santa Cruz.

<sup>16</sup> Also, this is not the only channel for impacts on interstate inequality, as Rao, Shand and Kalirajan (op cit.) demonstrate.

<sup>17</sup> See, e.g., 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.

<sup>18</sup> These figures are derived from Reserve Bank of India (2003), Annual Report, Mumbai: Reserve Bank of India; Table 4.6.

<sup>19</sup> Rao (2000a), op cit.

<sup>20</sup> Rao, M. Govinda (2000a), “Tax Reform in India: Achievements and Challenges”, Asia-Pacific Development Journal, 7, 2, 59-74.

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<sup>21</sup> Das-Gupta, Arindam, and Dilip Mookherjee (1998), Das-Gupta, Arindam, and Dilip Mookherjee (1998), Incentives and Institutional Reforms in Tax Enforcement: An Analysis of Developing Country Experience, Delhi: Oxford University Press.

<sup>22</sup> Rao (2000a), op cit.

<sup>23</sup> Finance Commission (2000), Report for 2000-2005, New Delhi: Government of India.

<sup>24</sup> Rao, M. Govinda, and Nirvikar Singh (1998), “Fiscal Overlapping, Concurrency and Competition in Indian Federalism”, Working Paper 30b, Center for Research on Economic Development and Policy Reform, Stanford University.

<sup>25</sup> Dillinger, William (1994), “Decentralization and Its Implications for Urban Service Delivery,” UNDP/UNCHS/World Bank Urban Management Program Discussion Paper, UMP 16.

<sup>26</sup> Hirschman, Albert O. (1970), *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*, Cambridge, MA: Harvard University Press; Rao and Singh (2001), op cit.

<sup>27</sup> Finance Commission (2000), Paragraph 8.11b.

<sup>28</sup> 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.

<sup>29</sup> See, for example, 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; Rao, M. Govinda (2000b), “Fiscal



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Decentralization in Indian Federalism”, processed, Institute for Social and Economic Change, Bangalore; and Mohan, Rakesh (2001), “Achieving Higher Economic Growth: The Fiscal Deterrent”, paper presented at Stanford Conference on Indian Economic Reform, June.

<sup>30</sup> In this context, the Center and several states have passed “fiscal responsibility” laws, but it remains to be seen how credible these legal commitments are, since penalties for noncompliance are ambiguous or nonexistent.

<sup>31</sup> Obviously, the smaller the government, the less will be the feasibility of significant reliance on the market. However, as noted earlier, many of the Indian states are comparable to countries in terms of population size and fiscal domain.