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Inelastic Institutions: Political Change and Intergovernmental Transfer Oversight in Post-Independence India

Introduction

The basic structure of India's fiscal federalism was in place within five years of the country's independence on August 15, 1947. India's Constitution came into force on January 26, 1950, specifying the division of responsibilities and broad assignment of taxes between levels of government, provisions for intergovernmental grants, and a mechanism, the Finance Commission (FC), for allocating central government tax revenues to offset the imbalance between revenues and responsibilities. The Planning Commission (PC), the second major institution involved in intergovernmental transfers, was created by a resolution of the central government Cabinet in March 1950 to draw up plans for national development. Although the PC's role in formulating plans did not inherently require it to have a role in implementing them or in independently determining the size and terms of intergovernmental transfers, in fact it became a vehicle for conditional, specific-purpose transfers alongside the FC's unconditional transfers.[1]

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1. The Cabinet Resolution explicitly stated that the responsibility for taking and implementing decisions would rest with the central government and the state governments. The Planning Commission was expected to make recommendations to the Central Cabinet but also to act in close understanding with the ministries of the central government and the state governments in framing this advice.

The fiscal federal arrangements, essentially assigning rights to sources of revenue and responsibilities for expenditures (including investment for development) across units of the federation, contained a number of centralizing features. The Constitution enabled rather than mandated the central government to share some of the most significant revenue sources.[2] It retained substantial central government control over many policy areas. The lists of responsibilities for exclusive state and central jurisdictions is similar to other federations around the world and consistent with the normative principles of federal design, but many functions that are commonly sub national in other federations are considered "concurrent" between center and states in India. The central government retains the final word in case of conflict between state and central policies in these cases. Residual powers remained with the central government.[3] The constitutionally created FC stands out among other countries' institutions for intergovernmental transfers as an independent mechanism explicitly designed (as much as intent can be inferred from the transcripts of the Constituent Assembly) to preserve states' autonomy in managing their budgets, but it is just one of two major institutions for intergovernmental transfers. The other institution, the PC, de facto has been able to allocate revenues as well as monitor their uses for specific purposes even when the programs they support are in policy areas that are constitutionally part of the states' domains.

The centralizing features in the "original position" of India's fiscal federalism are understandable in light of the economic and political context of the decade, but their persistence over the post-Independence decades is more difficult to explain.

India is widely seen as an example of "unitary federalism,"[4] but most observers have noted a steady decentralization, or at least deconcentration,

2. The original division of taxes in Articles 268 (taxes levied by the union but collected and kept by the states), 269 (taxes levied and collected by the union, but assigned to the states), 270 (taxes levied and collected by the union that must be shared between center and states), and 272 (taxes levied and collected by the Union that may be shared between center and states among other provisions) was later modified in 2000 to create a broader-based pool of taxes to be shared.

3. It is not clear that the framers of the Constitution considered the assignment of residual policy powers to be a centralizing feature. T. T. Krishnamachari, e.g., argued that this residuary power meant little "because we have gone to such absolute length to enumerate the powers of the Center and of the States and also the powers that are to be exercised by both of them in the concurrent field." Dr Ambedkar made a similar point emphasizing the extent to which policymaking powers had been assigned to states.

4. Wheare (1964) noted that India was only "quasi-federal." Stepan (1999) calls it a "holding together federation," noting that powers for sub national governments were granted by

of economic and political power over the decades since Independence. India's polity and economy have changed dramatically, generally in ways that one would expect to have created stronger demands for decentralization of fiscal power, yet its fiscal federal framework remains as centralized, if not more centralized, than it was when it was created. This paper documents the often-overlooked persistence of central government control over allocation of public resources for development and seeks to understand the reasons behind the slow structural response to India's evolving economy and polity.

Members of the Drafting Committee for the Constitution were discussing the framework for the nation in the shadow of Partition and fear of further disintegration. Members of the Constituent Assembly argued that sub national autonomy would exacerbate "centrifugal" and "fissiparous" tendencies and that a strong center was required to bring states into cohesion and consolidate the country after Independence.[5] Even those opposed to a strong central government couched their arguments in terms of the dangers of disintegration—from a diverse people being forced to submit to a "central oligarchy" rather than free to unite on the basis of the "solid foundation of India's past."[6] Similarly, the creation of the PC implemented the consensus across the political spectrum that had emerged in the pre-Independence era on the desirability of planning as a means for articulating national development plans to achieve the nation's intrinsic overall objective of eradicating mass poverty through accumulation and efficient utilization of the nation's natural, human, and physical resources to produce rapid and well distributed economic growth. Onlookers from around the world may have been amazed and impressed at the audacity of attempting planned development in a democratic federal setting (Paranjape, 1963), but the appropriateness of planning for development was not in question. The strong consensus on planning,

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the Constituent Assembly, not accorded to previously sovereign states that were in strong bargaining positions to carve out independent arenas. Outside the fiscal federal provisions, the Indian constitution does have some striking provisions reinforcing central government dominance. It gives the central government the power to dismiss elected state governments, e.g., if it determines that the constitutional machinery has broken down in those states. Dr Ambedkar did not anticipate that this power would be used extensively and justified it as a necessary provision for effective governance in emergencies, but the article has been used for political ends over the years.

5. Words "centrifugal" and "fissiparous" were used on 5th January 1948 by Pandit Lakshmi Kant Maitra, member elected from a general constituency in West Bengal. Available online at http://parliamentofindia/ls/debates/vol7p2b.htm (accessed on May 2, 2011).

6. "The words "central oligarchy" and "solid foundation of India's past" were used on 5th January 1948 by Shri Lok Nath Misra, member elected from a general constituency in Orissa (Ibid.)

the fact that the Indian National Congress (INC) Party was in control of all central and state governments, and the personal credibility and popularity of Prime Minister Nehru, Chairman of the Planning Commission, enabled the Planning Commission not only to achieve prestige but also substantial influence over economic issues involving the center and the states.[7]

The context has evolved. The single party political setting at Independence has given way to a multi-party democracy over the past six decades with regional parties not only coming to power in several states but also as partners in coalitions in power at the center. The economy has changed significantly, with the slow growth of 1950–80 being followed by progressively accelerating growth in the subsequent decades. Society has changed dramatically as well, particular with groups that had been economically, socially, and politically discriminated against for millennia coming into their own and acquiring an increasingly significant voice.

Yet the fiscal federal framework, and in particular the intergovernmental transfer regime at the heart of intergovernmental fiscal relations, remains as centralized, if not more so, as it was in the 1950s. India's constitution has been amended often, but none of these substantially changed the foundation for fiscal federalism. A few expenditure responsibilities were adjusted and more taxes were added to the pool to be allocated by the FC by the 80th Amendment, but the constitution's statements on the mechanisms for resolving the resource imbalances have remained essentially unchanged. The most notable amendments, the 72nd and 73rd Amendments of 1993, fleshed out and elaborated a third level of government in urban and rural areas, but did not alter the prior balance between center and states.

The two institutions overseeing intergovernmental transfers, namely, the FC and PC, still exist and continue to occupy more or less the same niches in the overall flow of resources. The PC has thrived, even though the rationale for the type of planning it practiced during 1950–90 no longer exists. It has become more rather than less intrusive in state domains. The FC's role, on the other hand, has remained limited and relative to its potential. It would have been natural for it to become a major player in discussions leading to fiscal reforms involving center and states, e.g., but it appears to have been sidelined in some of the most important of these debates. Major changes in the economy, polity, and society have induced only minor changes in the

7. Nehru had been the chairman of the Congress Party's National Planning Committee of 1938 and became actively involved in the functioning of the Planning Commission as its Chairman during the formulation of and presentation to the Union Parliament of the first three five-year plans.

frameworks of center–state relations in general and in fiscal federalism in particular. Although nothing in the Constitution or the polity in principle precluded the formulation and adoption of structural changes in intergovernmental relations more generally, nonetheless they were not adopted.

The section "Intergovernmental Transfers In Perspective" establishes that the absence of change in India's fiscal federal institutions is a puzzle worthy of examination. The institutions we discuss oversee a significant portion of the revenues that could be channeled into India's development. The dynamics of the institutions that determine the investment choices are therefore of interest for understanding the political economy of India's underdevelopment and the potential for changes in the future. The case that we document adds a new twist to the conventional wisdom that India is economically, politically, and institutionally decentralizing.[8]

The section "The Puzzle: Contextual Change, Institutional Stasis," the heart of the paper, documents the puzzle of glacial institutional change alongside rapid political change. We discuss changes in the economic and political context as well as two aspects of institutional evolution: the relative roles of PC and FC in overseeing intergovernmental transfers, and changes within the methods used by the PC to allocate funds. We focus in particular on the implications of institutional and policy choices for states' autonomy in fiscal decision-making. We establish that while the context has changed dramatically, and there have been significant public debates and calls for greater state autonomy in fiscal decision-making in the 1960s and late 1980s in particular, there have been limited actual changes.

The section "Why?" presents some possible explanations for the institutional persistence, focusing on the ways in which India's economic conditions and political structure discourage collective action by states. The concluding section contains a discussion of the implications of our analysis for India's economic and political development. Our comments are largely speculative at this point, but we find the continuing absence of incentives and a mechanism to deliberately move to a more balanced federation that encourages policymaking to be more responsive to citizens rather than central mandates troubling.

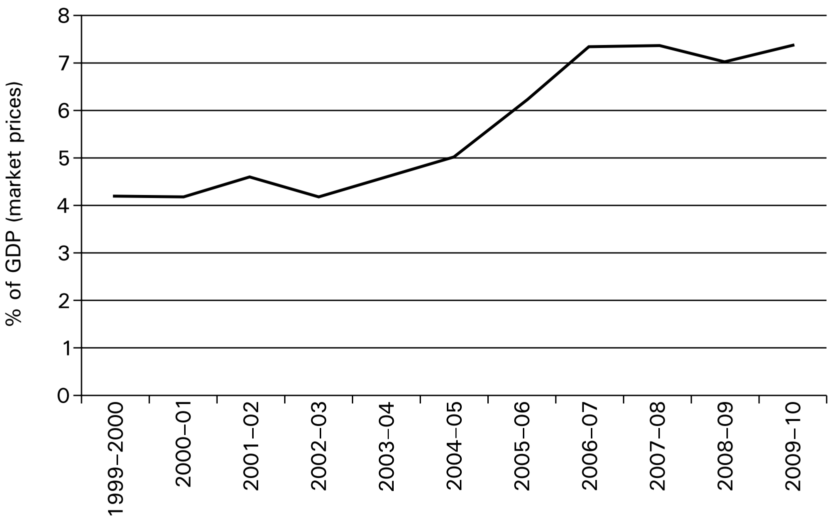
8. See, e.g., Ganguly, Sumit, Diamond, Larry, and Marc Plattner, eds, *The State of India's Democracy* (Baltimore: Johns Hopkins University Press, 2007). The essays contained within analyze developments in caste politics, the party system, media, economic policy, and other areas and nearly universally conclude that India's survival as a democracy is due to its ability to accommodate and provide space for these emerging voices.

Intergovernmental Transfers in Perspective

Much of our analysis in this paper focuses on the evolution of the institutions governing intergovernmental transfers and their uses. These institutions are of more than academic interest; governance of intergovernmental transfers affects control rights over public resources and their use for public expenditure. Transfers overseen by the PC and FC comprise a significant portion of GDP, as well as of sub national current expenditure.

Figure 1 shows the trajectory of total transfers[9] as a percentage of GDP at market prices, while Figure 2 shows these as a percentage of overall revenue expenditure. Intergovernmental transfers, even excluding subsidized loans, accounted for more than 7 percent of GDP and supported nearly 45 percent of state's revenue expenditure in 2009–10. Both graphs show a noticeable upward trend. The terms on which these funds are allocated, the purposes for which they can be spent, and the accountability of the authorities overseeing these funds obviously play important roles in the potential to convert public resources into public goods.

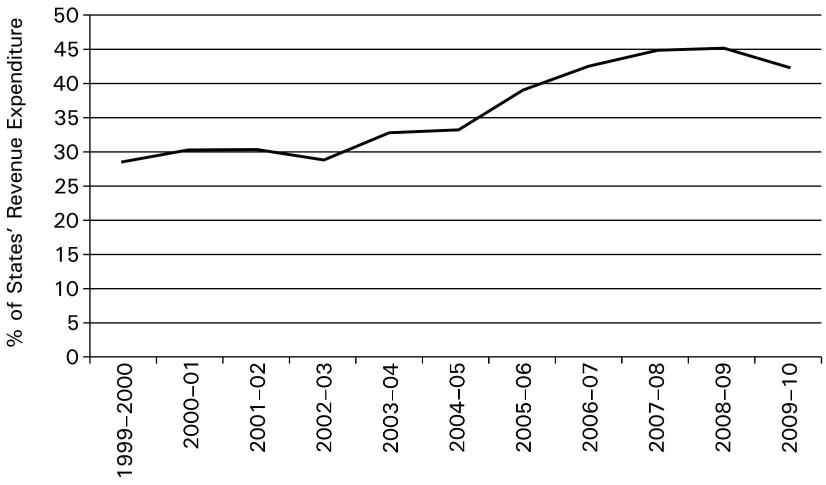
FIGURE 1. Total Transfers as % of GDP



Source: Calculated from Reserve Bank of India (various years) *A Study of State Finances*.

9. Total transfers are calculated as states' share of taxes plus statutory and non-statutory grants.

FIGURE 2. Total Transfers as a % of State Revenue Expenditure



Source: Calculated from Reserve Bank of India (various years) *A Study of State Finances*.

The Puzzle: Contextual Change, Institutional Stasis

India's polity, economy, and society have changed dramatically in the six decades since independence, while the institutions that govern allocation of a substantial portion of public expenditure have remained remarkably constant. This contrast is puzzling for several reasons. First, the de facto institutional framework for fiscal federalism is neither clearly specified nor firmly embedded in Constitution. The section "Intergovernmental Transfers: Intentions and the Original Institutions" discusses the discussions underlying the fiscal provisions in the constitution and highlights the ambiguity created by the Constituent Assembly's attention to fiscal autonomy and the practical realities implied by a national planning process. The FC's constitutional mandate was limited to fiscal issues including center–state resource transfers among the center, states and other units of the Federation and the imbalances thereof, while the PC's mandate as per the founding Cabinet resolution was to invest in national development through five-year plans for utilizing human and material resources efficiently for achieving the overarching objective of eradication of mass poverty within a reasonable time. It implied some need for broad national coordination between development investments and expenditure. Neither the Constituent Assembly that created the FC nor the Cabinet resolution that created the PC addressed the basic conflict at their birth between the two bodies' mandates, leaving the resolution of the conflict to ad hoc future adjustments. Second, as discussed in the section "Changes in the Context," political and social changes have empowered groups that would plausibly be interested in a larger stake in decision-making, while economic changes have eliminated much of the rationale for planning. The section "Changes in the Institutions" documents the "stubborn center."

Intergovernmental Transfers: Intentions and the Original Institutions

The Constituent Assembly debates' emphasis on the importance of state fiscal autonomy and lack of attention to a central government role in planning are striking in light of subsequent institutional developments. The FC was explicitly designed to ensure that states would have a stable source of revenues with minimal central government interference, while the PC was not mentioned. The members of the Assembly must have been aware and part of the consensus on planning as a strategy for achieving development, but they did not discuss institutions for planning, much less any central government role in planning. They also did not address the challenge of coordination between the FC's work and any future planning organization. This failure to recognize the need for coordination and balance it with the desire for state autonomy within its constitutionally assigned jurisdiction left the formal roles of an relationship between the organization open to interpretation and adjustment.

The President of the Constituent Assembly had appointed an Expert Committee on Financial Provisions of the Union Constitution. Its terms of reference, inter alia, required it to "examine … the existing provisions relating finance and borrowing powers in the Government of India Act, 1935, and their working in the last ten years and to make recommendations as to the entries in the lists and sections to be embodied in the new Constitution." The Committee began its work on November 17, 1947 and forwarded its report to the President on December 5, 1947. The report was not discussed in the Constituent Assembly at that time, but its recommendations were discussed a year later when the financial provisions in the Draft Constitution were debated starting November 4, 1948.

The Expert Committee was charged with determining how best to divide resources to ensure that all levels of government could carry out their assigned tasks within the constraints of an arrangement being administratively feasible, in the national interest, and equitable. It is clear that the members of the Expert Committee were fully cognizant that the pursuit of development required mobilization of fiscal resources at all levels of government, but they seemed to view the task of development as one for states rather than a subject for national coordination.

The Committee advocated a regime in which stable, predictable, and substantial flows of resources would be delivered to the states. It recognized that the needs of the provinces, in contrast to the stable, normal expenditures of the central government, are

> almost unlimited, particularly in relation to welfare services and general development. *If these services, on which the improvement of human well-being and increase of the country's productive capacity so much depend, are to be properly planned and executed, it is necessary to place at the disposal of Provincial Governments adequate resources of their own, without their having to depend on the variable munificence or affluence of the Centre.* The Provinces must, therefore, have as many independent sources of revenue as possible.[10] (Emphasis added)

The Expert Committee also advocated substantial autonomy for the states to make their own decisions about expenditure.

While the Committee recognized the need for specific purpose grants, it noted that these would be necessary "in the developmental stages of the country" from "time to time." These were mainly to be used for equalization, noted the Committee, "There is undoubtedly something attractive in seeking to bring up the backward units at least to 'average' standards, both in effort (severity of taxation) and in performance (standards of services)."

The Expert Committee's institutional recommendations followed these principles: by embodying the arrangement regarding the division of the tax bases between the central and the provinces as well as the distribution of proceeds of taxes in the Constitution, the Committee made its implementation automatic and free from interference as possible. It recommended a review of the principles for revenue distribution every five years by a neutral expert body, the FC, in order to address changing conditions and incorporate lessons from experience. The Commission's mandate was clearly stated, as was its status:

10. Taken from paragraph 28, ANNEXURE 1. Available at http://parliamentofindia.nic.in/ls/debates/vol7p1c.htm (accessed May 2, 2011). Colonial India consisted of Provinces and other units directly under the control of the colonial government and Princely States ruled by princes under the suzerainty of the colonial government. The provinces referred to in the debates and documents of the Assembly were to become states under the Constitution that was adopted.

> (a) To allocate between the Provinces, the respective shares of the proceeds of taxes that have to be divided between them; (b) To consider applications for grant-in-aid from Provinces and report thereon; and (c) To consider and report on any other matter referred to it by the President.[11]

It's status was defined as a "high level tribunal of five members including a Chairman who has been or is holding high judicial office not lower than that of a judge of a High Court."

The Expert Committee did not specify detailed membership criteria (these were later enacted by Parliament) but recommended that two should be selected from a panel of nominees of Units Governments and two others from a panel of nominees of the Central Government, the Chairman being selected by the President himself. One at least of the five should possess close knowledge of the finances and accounts of governments, while another at least should have a wide and authoritative knowledge of economics. It would be an advantage if one or more were public men with wide experience. It would be a further advantage, if a member possessed more than one qualification, and steps should be taken to secure the services of such individuals. The appointments might be made for five years and be renewable for another five years.

The Drafting Committee generally seemed to agree with the principles, although there was substantial debate about the exact limits of the FC's powers as well as to whom it would report. On the one hand, many members reiterated the importance of an independent authority for determining revenue sharing. Brajeshwar Prasad, later MP from Bihar, contended that the center must levy and collect all taxes and duties so as to prevent provinces from becoming financially autonomous and eventually seceding and becoming independent, but that collection did not imply decision-making over expenditure. In his view "there should be an independent authority at the Centre to allocate funds between the different units in accordance with the needs of each province."[12] Other members reiterated the importance of having an independent body and/or guaranteed assignment of some revenues to sub national governments. B. Das (Orissa) hoped that the provinces would not be treated as a "charity boy" of the North Block of the Central Secretariat in Delhi where the Finance Department of the Central Government was located and where the Union Finance Ministry still is.

11. The quote is from the Report of the Expert Committee on Financial Provisions of the Union Constitution, presented to the Constituent Assembly on Delhi, 5 December 1947 and recorded at http://parliamentofindia.nic.in/ls/debates/vol7p1c.htm (accessed May 2, 2011).

12. He noted that the Finance Commission could be this independent central authority.

R.K. Sidhva (C.P. & Berar) moved an amendment for ensuring that proceeds of the terminal tax be assigned to local authorities to add to their income from tolls and octroi. Upendra Nath Barman (West Bengal) recommended a formula and wanted the allocations to provinces be fixed without waiting for the FC to be appointed, in order to enable the provinces to launch their development schemes.[13]

The Expert Committee was also criticized by some as being too reticent with its recommended allocation of powers to the FC. T.T. Krishnamachari (Madras), one of the most severe critics of the Expert Committee, its competence, and its report[14] chastised the committee for not considering the implications of the constitutional allocation of expenditure responsibilities or thinking about any revolutionary changes in the financial structure established under British rule. He argued that the FC should have been given the power to change the assignment of expenditure responsibilities between levels of government. His colleague Sir Alladi Krishnaswamy Ayyar (Madras) was less vehement in his call for revolutionary change, but agreed with the recommendation of additional powers for the FC.

Most of the calls to make the FC more accountable to political oversight were based on the Drafting Committee's concerns that it would not necessarily represent both center and state interests. Shiban Lal Saxena (United Provinces) argued for an important role for Parliament in making final decisions regarding allocation of revenues between center and states, on the grounds that it has the power of decision-making by law and represents all actors in a federal democracy. H.V. Kamath (C.P. & Berar) also argued against centralizing the power to review and respond to the recommendations of the FC with the President. Saxena wanted a provision that the President should place his proposals for action to be taken on the recommendations of the FC before Parliament and that Parliament would have the right to

13. In anticipation of the Gadgil Formula(e) he suggested an allocation based on popultion (33 1/3 percent), on tax revenues collected (58 1/3 percent), with the remaining (8 1/3 percent) being distributed in such manner as may be prescribed.

14. During the debate on the Draft Constitution on November 5, 1948, he stated:

> Well, to my own mind, the way the [Expert] Committee worked was not altogether satisfactory, though the members of the Committee were eminent enough. I had the opportunity of giving evidence before the Committee and I did come away from that meeting feeling that the Committee was not seized of the seriousness of the matter they were entrusted with, nor were they competent to advise the Drafting committee in regard to the subjects referred to them. Sir, the proof of the pudding is in the eating. I have with me a copy of the report of the Expert Committee, and I am not satisfied with it.

amend the proposals by its resolutions. Thakurdas Bhargava (East Punjab) supported Kamath and Saxena on the ground that the report of the FC, whose membership qualifications would be set by Parliament and in which provinces are represented, will be a historic record and furnish the basis for those proposals that would affect the provinces vitally. He felt that provinces should have a say in the matter through their representative in Parliament, without the Central Cabinet or the President being the sole judge of those proposals of the FC. Surprisingly, however, there were no references to the state legislatures in the debate in spite of these misgivings about the preferences and influence of the central government and Parliament on determination of intergovernmental transfers.

In the end, the Draft Constitution left the distribution of taxes for the FC to recommend to the President, who would then submit a memorandum to the Parliament describing the action taken on these recommendations. The Constitution required the President's report to be laid before Parliament without stating whether this was to be for Parliament's approval or merely its consideration. Dr Ambedkar, the Chairman of the Drafting Committee for the Constitution, argued that the proposed amendments assigning more power to Parliament would have contradicted other already-approved articles assigning power to the President and defining division of revenues.

Following the Expert Committee's recommendations and the Draft Constitution, Article 280 of the Constitution provides for the appointment of a FC every five years to make recommendations to the President on the share of the revenue from the divisible pool of taxes it should transfer to states, and also how the share accruing to states ware to be divided among states and union territories. Article 280, 3(b) also orders the Finance Commission to make recommendations on the principles to be used in making certain grants (under Articles 275 and 282) and their amounts from the union government to states (and by one state to another) and also loans from the central government. The Constitution also notes that its deliberations should cover "any other matter referred to the Commission by the President in the interests of sound finance." States set up similar institutions to determine transfers to local governments after the 73rd and 74th Amendments gave these bodies constitutional recognition.

The PC emerged from the pre-Independence consensus on the responsibility of the state to eliminate poverty and on planning as a strategy to do so. The INC took the lead by establishing a National Planning Committee (NPC), under the chairmanship of Jawaharlal Nehru in 1938. As the war was coming to an end and independence seemed near, several groups besides the NPC, including most prominently a group of businessmen of Bombay, the Indian Federation of Labor, and even the Colonial government had prepared and circulated other plans for India's post war reconstruction and development once the war was over (Srinivasan, 2000, 2007).[15] All of them had their own definitions of poverty, but each proposed argued that the state had a major role in eliminating poverty quickly. The 1950 Cabinet Resolution establishing the PC noted this consensus as well as the provisions in the constitution relating to directive principles of state policy as motivating factors. Drawing on these and on the economic trends and problems since independence in August 15, 1947, the resolution noted:

> [P]rogress has been hampered by the absence of adequate co-ordination and of sufficiently precise information about the availability of resources.… The need for comprehensive planning based on a careful appraisal of resources and on an objective analysis of all the relevant economic factors has become imperative. These purposes can best be achieved through an organization free from the burden of the day-to-day administration, but in constant touch with the Government at the· highest policy level. Accordingly, the Government of India has decided to set up a Planning Commission.[16]

The resolution set out the tasks, inter alia, as:

(i) to formulate a Plan for the most effective and balanced utilization of the county's resources after making an assessment of their availability in relation to requirements;
(ii) to set priorities, define the stages in which the Plan should be carried out and, propose the allocation of resources for the due completion of each stage;
(iii) to make such interim or ancillary recommendations as appear to it to be appropriate either for facilitating the discharge of the duties assigned to it, or on a consideration of the prevailing economic conditions, current policies, measures and development programmes or on an examination of such specific problem as may be referred to it for advice by Central or State Governments (Government of India, 1950).

15. Although it had done much of its work, the NPC could not complete its report before the end of the Second World War as its members were imprisoned by the colonial government in the early 1940s.

16. Government of India, 1950. Available online at http://planningcommission.nic.in/aboutus/history/index.php?about=funcbody.htm (accessed May 2, 2011).

As a creation of the Cabinet, the PC has no legal right to exercise powers other than those explicitly delegated to it by the union government.

In spite of the discussions about protecting the states' autonomy, and the fact that the Constitution lists economic and social planning as a concurrent subject (Item 20 in the Seventh Schedule), neither institution requires approval from the state governments to carry out its duties. Neither the PC's national and state plans nor the central government's actions on the recommendations of the FC require formal approval Parliament or state legislative assemblies. State government representatives have no formal role in either institution. The FC generally consults state leaders as part of its deliberations and often cites their views as justification for its recommendations to the central government, but the Constituent Assembly debates on state government representation on the FC did not lead to any provisions to do so. The National Development Council (NDC), a body consisting of chief ministers and members of the PC, was formed in 1952 to "review the workings of the National Plan from time to time, to consider important questions of social and economic policy affecting National Development, and to recommend measures for the achievement of the aims and targets set out in the National Plan."[17] It has never been seen as having an especially strong role in overseeing the Plan. The First Administrative Reforms Commission (ARC) (1966) noted that it was largely ceremonial and recommended reconstitution as well as more frequent meetings. An October 1967 Government Resolution implemented these recommendations, noting that it should meet "as often as may be necessary and at least twice in each year." However, as of 1999, the council had not met more than once a year on average. The Ninth Plan (1313 pages in two volumes) was distributed to members for discussion one week before the meeting (EPW, 1999).

Changes in the Context

Politically, the major shift has been the evolution from single-party dominance in center and state governments to multi-party coalitions in both levels of government. The INC, the party that led the struggle for independence, won a majority of seats and formed governments in the Union Parliament and all states in 1952, the first election after the Constitution was created. It retained this hegemony for the most part until 1967. The INC won more than two-thirds of the national Parliament seats in 1952, 1957, and 1962 as well as a majority of seats in all state assemblies with the exception of

17. Government of India Resolution 62/CF/50 of August, 1952.

a Communist government being elected in Kerala in 1957.[18] Two features of the electoral system helped sustain this position in an era of fragmented opposition parties: that a candidate need only have plurality of votes cast, not a majority, to win a constituency and that the national Parliament and state Assembly elections were simultaneous. The first helped the INC convert a plurality of votes (between 40 to 48 percent from 1952 to 1967) to a majority of seats, while the electoral coattails from the second helped local Congress candidates against regional rivals. The conventional wisdom is that conflicts between the center and states were articulated and resolved within the INC Party during this era.

This order began to break down in the 1970s. Congress lost power in eight of sixteen states in the 1967 elections in the wake of an economic crisis that led Indira Gandhi's government to seek assistance from the International Monetary Fund (IMF) and World Bank to tide over the crisis. The conditions attached to this aid—economic liberalization involving the devaluation of the rupee and reduction of trade barriers—were unpopular both with party leaders and the electorate. Although the party won about the same share of votes—40 percent—as before, its seat share in Parliament fell to 54 percent as the opposition consolidated around fewer, more viable candidates.

Party leader Indira Gandhi split the party into two in 1969 as internal party dissent increased. The wing she led, a much more centralized organization called Congress (I) for Congress (Indira), gained a two-thirds majority (again, with 43 percent of the vote) in the 1971 elections. It also won most of the state elections in 1972, but the political landscape had clearly changed. Most of the states were politically unstable during the 1970s, with non-Congress coalitions of national and regional parties holding power for brief periods of time. Stable non-Congress alternatives started to emerge in the late 1970s, however. West Bengal, in which a coalition of left parties have been in power since 1977,[19] and Tamil Nadu, in which two coalitions, one led by Dravida Munnetra Kazhagam (DMK) and other led by All India Dravida Munnetra Kazhagan (AIDMK) have alternated in power again since 1977, were the earliest to consolidate, but multi-party political stability including

18. Conflicts quickly appeared—the Congress government at the center dismissed it under Article 356 in 1959. Subsequently many state governments have been dismissed under Articles 356.

19. Interestingly, its hold on power in West Bengal considerably weakened in the parliamentary selection of 2009 and seems to be weakening further as the elections to the West Bengal's legislative Assembly in 2011 are approaching. In contrast, the hold of the ruling DMK in Tamil Nadu seems to be strengthening.

a role for regional parties became increasingly evident from the early to mid-1980s in other states. The fragmented opposition steadily coalesced into stronger challengers in state elections from 1967–1989, as evidenced by the increasing vote-shares of the top non-Congress party or coalition in state elections (Gowda and Sridharan, 2007).

The first challenge to the Congress's national leadership emerged with the short-lived Janata Party government, a coalition of parties united only by their opposition to Congress. It came to power in the wake of the 1975–1977 "Emergency" declared by Mrs Gandhi, but disintegrated quickly and Congress regained control of some states in 1978 and the central government in the 1980 election. It won a record vote share of 48 percent and three-fourths majority of seats in the subsequent 1984 elections.[20] However, the underlying dynamics of increasingly strong non-Congress options did not die out and the National Front alliance of left and regional parties was a significant challenger in the 1989 and 1991 elections. Congress lost its majority in 1989 (in part because of corruption allegations against Rajiv Gandhi) and political instability at the center ensued, with four different prime ministers governing in two years.

The Indian emergence of the Front marked the beginning of the current era of India politics, the era of coalition governments in which parties with regional bases and presumably regional priorities hold positions and influence over national policy. The Congress continued to win the most votes of any one party in every election, but it did not retain a seat majority. It had one last full term as a minority government formed in 1991 with Narasimha Rao as prime minister, after an election campaign in which its then-leader Rajiv Gandhi was assassinated, but coalitions have been in power since 1996. The Bharatiya Janata Party (BJP) won more seats than Congress in 1996, 1998, and 1999 and is currently the main national party challenger. A BJP-led, National Democratic Alliance (NDA) governed the country during 1999–2004. Both BJP and Congress, however, rely on alliances with state-specific parties for national leadership as well as state-level presence.

Similarly, economic policy has moved away from central planning toward more decentralized policies emphasizing the role of the market rather than any particular level of government. Prior to Independence there was an emerging consensus across the political spectrum for the adoption of central planning for articulating India's development strategy using its material and human resources efficiently and the mechanism of national five-year and

20. This reflects the "sympathy vote" after Indira Gandhi's assassination—and the assumption of power by her son Rajiv Gandhi.

annual plans. The consensus also extended to the need for the state to play a dominant role in the economy and for insulating the economy from the world economy. These consensuses were driven largely by the disastrous experience of the international trade and capital flows between the two world wars and the perceived success of the Soviet Union in transforming a largely rural and agricultural economy at the turn of the revolution into an industrial economy.

India's external environment, both for international trade and capital flows, improved dramatically after the second World War with the establishment of and India's founder-membership in the IMF and International Bank for Reconstruction and Development (the World Bank) in the early forties and the conclusion of the General Agreement on Tariffs and Trade (1947) for reduction of tariff barriers. World trade grew rapidly and faster than growth of World output after 1950 until the oil shock of 1973 and at a slower pace but still faster than output. Capital flows, (private and official) also expanded and accelerated particularly after 1980.

In the six decades after 1950, the international enthusiasm for planning, which some Western nations also practiced in the 1950s, also waned. Even some of the Eastern European countries in the Soviet Bloc and breakaway states such as Yugoslavia under Marshall Tito began experimenting with allowing the private sector and market forces to play a role in resource allocation. With the collapse of the Soviet Union and its system of Central planning for resource allocation in 1991 and the evident success in the acceleration of economic growth in China since Deng Xiaopins opened China to the world economy in 1978 and allowed for a greater role for market forces to play in the domestic economy, planning and insulation from competition lost their advocates.

India's domestic economy also has changed significantly since 1950. Although the average annual growth rate between 1950 and 1980 was only 3.5 percent per year, a diversified, albeit internationally non-competitive, industrial structure had developed with capacity to produce heavy equipment and industrial inputs including heavy chemicals. In spite of its role being heavily circumscribed by planning and a plethora of intrusive controls ostensibly for implementing the plan targets, the private sector's capacity to be innovative and dynamic did not disappear but lay dormant to be energized given the opportunity.

Transport and telecommunications infrastructure enabling a deconcentration of economic activity have expanded as well, the latter particularly after mid-1990s with the introduction of mobile phones. Although agriculture has always remained almost entirely in the private sector, there were many government interventions in the market, in domestic and international trade and others, some of which were intended to support the adoption of newly available green revolution technologies and crop varieties in the mid- to late 1950s. The success of the adoption led to the elimination of India's dependence on concessional food imports by late seventies.

During the 1950s and 1980s in particular, the location of public and private projects that required significant investment, foreign exchange, their technology and input choices were, in effect, decided by the PC and the administrative agencies that awarded investment and import licenses. Regional development was a key goal of planning, but it is commonly believed that considerations other than economics or more generally social cost-benefit calculations largely determined choices about location of investment, particularly with respect to public sector investment projects such as integrated steel mills or in petroleum refiners, heavy chemicals. Interstate competition for location for a particular project took the form of (sometimes violent) demonstrations, statewide strikes, and *bandh*s. Since the mid-1980s and particularly after the systemic reforms of 1991, market forces play a greater role relative to the public sector in the economy as a whole. With large public sector investment projects no longer as dominant in total investment, private investors who are more likely to consider scale and agglomeration economies are making most of the location decisions.

Finally, social changes also reflected an increasing deconcentration of power from the traditional elites to new social groups. The era of planning also saw the expansion of primary education and also of institutions of higher education though less so in secondary education. Quota policies, unfortunately driven by electoral considerations as much as more noble goals, also expanded access to education for social groups long denied such benefits. More generally, the groups that were outside the political processes became increasingly assertive and vocal and are part of the political process.

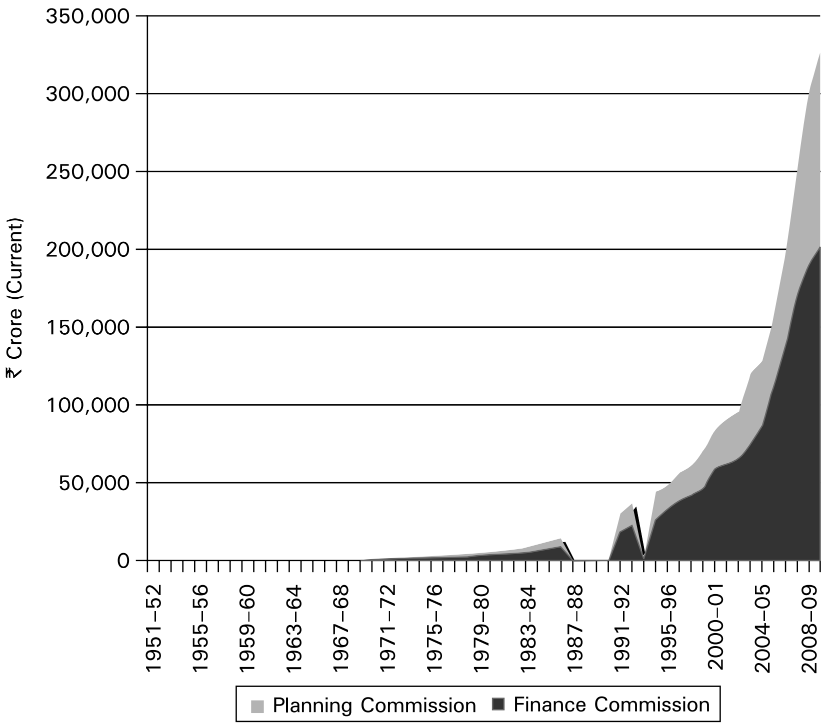
These changes have led analysts of Indian political economy emphasize the trend toward decentralization and the increasing power and relevance of "voices from below" in shaping the national agenda. In that light, the increasing concentration of economic and fiscal power in the central government stands out.

Changes in the Institutions

We focus on two aspects of institutional history: the observed roles of the FC and PC in determining the size and allocation of intergovernmental transfers, and changes within the activities of the PC. In each section, we trace the evolution of institutional arrangements that affect the central government's discretion in allocating funds and states' autonomy in determining development expenditures and managing their budgets.

GOVERNANCE OF INTERGOVERNMENTAL TRANSFERS The fact that the PC has retained its significant role in governing intergovernmental transfers is one illustration of the persistence of centralizing aspects of India's fiscal federalism institutions. Figures 3a and 3b display the trends in grant allocation and the proportion of the overall grants awarded by the two bodies.[21] While there is variation—the 1960s saw an increase in the proportion of funds allocated

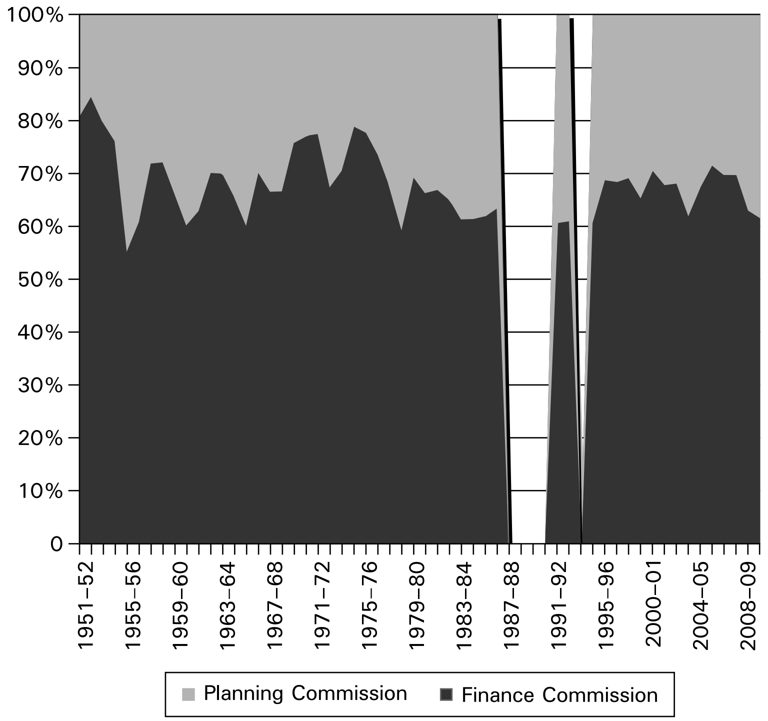
FIGURE 3a. PC and FC Transfers



Source: Calculated from Reserve Bank of India (various years) *A Study of State Finances*.

21. The PC also provides loan support to the states, which is equivalent to the grant at least in part, if not whole, to the extent that loans are forgiven, deferred, or provided at below-market rates. We do not include this grant in our analysis since it would be difficult to calculate on the basis of available data and would not change the main point we emphasize—that the role of the FC has not increased over time.

FIGURE 3b. PC and FC Transfers (Proportion)



Source: Calculated from Reserve Bank of India (various years) *A Study of State Finances*.

Note: FC transfers are calculated as the states' share of central taxes plus statutory grants. PC transfers are calculated as the total central grants less statutory grants for 1951–69 and as the sum of grants for state plan schemes, central plan schemes, centrally sponsored schemes (CSS), and North Eastern Council (NEC)/Special Plan schemes in years for which more detailed data on grants were available. It is therefore possible that our figures for PC transfers for the early years include some grants that were neither channeled through FC nor PC.[22]

by Planning Commissions, the 1970s a reversal of this tendency—the graphs do not show any noticeable trends over time.

The PC is nearly universally perceived as an instrument of the central government. Its members are political appointees who serve at the discretion of the government and have often been dismissed when governments

22. Determining the institutional oversight of various forms of grants was the main challenge in constructing this dataset, since detailed data on grants were not available from a single source for all years. Data on grants provided by the FC from 1951 to 1969 was obtained from Appendix IV to the Report of the Seventh Finance Commission, all other data are from the

change. Membership was relatively stable for the first decade and a half of the Commission under Congress-led governments but the turnover increased as factions within the Congress party developed and political competition intensified in the 1960s. Central government ministers often serve as members and civil servants have occupied increasingly senior positions over time, edging out technical personnel. Many of these features were conscious design choices to improve coordination between the Commission and the ministries in planning, but most analysts argue that they have also been vehicles for increasing politicization, especially after the Nehru era. Although a portion of the transfers is determined by a formula, the Commission has ample discretion in its decisions about awards to states through its ability to introduce new programs as well as review annual disbursements of even the formula-based allocations. Its grants are provided for specific purposes, including for policy areas that are constitutionally under states' domain.

The FC, on the other hand, is generally perceived as less politicized and the transfers made on the basis of its recommendations are not conditional. Once accepted, the committed transfers cannot be revised. Relatively vague appointment criteria do offer some opportunities to influence the Commission's decisions, but there is little evidence that this opportunity has been exploited extensively.[23] FC policy recommendations have been explicitly rejected as well as pocket-vetoed through relegation to consideration "as and when needed," but the central government has generally accepted the recommended transfers and must give a reason when it does not do so. Khemani's (2007) analysis of intergovernmental transfers between 1972 and 1995 brings out the difference between the two institutions: she finds that PC transfers often favored states that were politically important for the central government, while FC transfers showed no such patterns.

These distinctions are well known among policymakers as well as academics and the role of the PC has been challenged more than once. These

Reserve Bank of India Annual Bulletins and yearly reports on "State Finances: A Study of Budgets." We are grateful for assistance from the State Finance team at the RBI for filling in some of the gaps in published data.

23. According to the Finance Commission Act of 1951, the Chairman was to have been a person with "experience in public affairs," while other members were to include people "are, or have been, or are qualified to have been appointed Judges of a High Court, or have special knowledge of finances and accounts of government, or have had wide experience in financial matters and in administration, or have special knowledge of economics." Thimmaiah (2002) argues that the "or" has created scope for politically motivated appointments, but does not present any systematic evidence that this has been exploited.

challenges could be seen as a turf war between two institutions operating in overlapping territory, but nevertheless, they are couched in the language of state autonomy.

The Third Finance Commission, appointed in 1960, was the first to challenge the role of the Planning Commission in allocating funds. Its Terms of Reference requested it to consider the needs of the Plan in recommending principles for grants-in-aid. The FC, however, took it upon itself to "obtain the views of the State Governments on the dual allocation of grants, under Article 275 of the Constitution on the recommendations of the Finance Commission and under Article 282 by the Union Government" in addition to its standard requests for state revenue and expenditure information.[24] Its report included a separate chapter "embodying [their] general observations on issues germane to a correct determination of Union-State financial relations *in terms of our Constitution* [emphasis added]."[25]

The Finance Commission claimed that it, not the Planning Commission, should oversee most of the grants in support of states' revenue expenditures. In doing so, it emphasized the importance of the mechanism through which grants were given, as distinct as the amount committed. It acknowledged that covering plan needs with FC grants would "render difficult" the annual reviews of the Plan, but argued that the Plan has been endorsed by the National Development Council and approved by Parliament, so that states should just be given the resources to "forge ahead." The report also invoked the constitution's emphasis on state autonomy as it argued that states should be given fixed grants that could potentially be reviewed by Parliament rather than commitments subject to annual review:

> It is suggested that devolution and grants-in-aid by the Finance Commission would be more in tune with the provisions of the Constitution and that it would inculcate a greater sense of responsibility in the States as the grants-in-aid would then become an integral part of their resources.

and

> While we appreciate that in a planned economy a measure of centralization and even regimentation is inescapable, it is no less necessary that the States should not feel that their autonomy is being unduly frustrated.[26]

24. Finance Commission, 2005.
25. Ibid., Chapter 2, para 15.
26. Ibid., Chapter 6, para 65–66.

The FC's proposal to the government that the 75 percent of the revenue portion of the state plans be covered under FC grants rather than PC grants was rejected, however. Member-Secretary G.R. Kamat's note of dissent and the eventual government rejection of the proposal also emphasized the impact of channeling funds through the PC on the central government's ability to influence states. The note of dissent argues that the measure would have "serious impact on the concept and mechanism of national planning" because the grants are untied and "virtually unconditional" even if the FC indicated the broad purpose for which they were made. Mr Kamat considered the existing system of dispensing grants on an annual basis after review of state performance as an essential tool for coordinating the plan and ensuring performance, especially given the constitutional division of powers that prevented the center from using anything other than these tied grants to influence state behaviors.[27] The government's explanation for rejecting the proposal echoed these points, arguing that the plan "provides sufficient assurance the revenues will be available if the states undertake the necessary efforts to mobilize resources and if there are no major surprises in the financial and economic situation," and that the annual plans are essential for "improving performance in all sectors, ensuring the fullest efforts to raise resources, and maintaining a satisfactory balance between different types of projects."

This tacit division of grants between FC and PC mechanisms was revisited in 1987 with the terms of reference for the Ninth FC, which contained two significant departures from past practice: first, no distinction between Plan and non-Plan parts of the states' fiscal status; and second, a call for the FC to adopt a "normative approach" in assessing states' revenue receipts and expenditures.

27. In a somewhat contradictory second line of logic, Kamat also argued that the conditionality of Plan transfers is actually fairly light. He pointed out that unconditional revenue support for the state plans would not really increase state autonomy since the capital requirements, which are a bigger part of the Plan requirements in any case, would still be allocated after consultation. Also, that while of course states find the consultations with the Planning Commission "irksome," in reality they include reasonable flexibility to reallocate funds to different purposes has been granted during the consultations and that these "informal" consultations are a reasonable way of effecting some degree of coordination and conditionality. He pointed out that the possibility of Parliamentary review of transfers under Article 275 might make for an even more cumbersome review process. Kamat argues that issues with the consultations can be resolved by adjusting procedural details and that to "displace that system by a system of statutory grants is like throwing the baby out with the bathwater." (Finance Commission, 2005)

The FC responded by reiterating its pre-eminent role in overseeing the devolution of resources from center to state. The discussion around the role of the FC and PC included some strong views about the unconstitutionality of the past practice of limiting the FC's grants to meet non-Plan revenue needs, although the actual recommendations were much milder.[28] The FC, however, was deferential to the PC's role in economic planning:

> Though the Finance Commission has therefore to assess both Plan and non-Plan expenditure, it was our decision made at an initial stage that the Finance Commission shall not disturb or weaken the planning process; economic planning must continue to be the prerogative of the Planning Commission.[29]

In the end, however, the grants-in-aid recommended by the FC represented 95 percent of the total grants-in-aid for State Plans in 1989–90, excluding externally aided projects; more than the 75 percent of Plan revenue that the Third FC had suggested be given under FC auspices. Given that the recommendation was just for one year, there was no practical distinction between PC and FC processes for transferring funds (guaranteed allocations versus annual consultations and adjustments). The arrangement could have set a precedent, but did not. The government's response was tepid: it agreed to "take the [recommendations of the first report] in view while finalizing the last year of the Plan allocations" in its Action taken Report.

The Ninth FC's second report also staked its constitutional claim to the right to oversee transfers in support of the Plan worked out by the PC:

> [W]e must make it clear that under [Article 275], the Finance Commission is obliged to recommend the grants-in-aid of revenue to States and, *therefore, the grants for financing the State Plan are very much within the purview of the Commission under the said article.* In fact there is a view that all grants to the States could be channeled through Article 275 only. Mr. K.K. Venugopal, an expert on Constitutional law opined before us that Article 282 is clear and unambiguous and unless the article is re-written with the additional and subtraction of words it would not be possible to arrive at the conclusion that Article 282 is an independent source of power vesting in the Central government a discretion to make grants to states for special purposes.[30] (Emphasis added)

28. The Ninth FC had consulted a number of constitutional experts regarding the interpretation of relevant articles (275, 280, and 282). Discussions are available in *The Ninth Finance Commission: Issues and Recommendations: A Selection of Papers presented at NIPFP Seminars held in February 1988 and May 1990*, NIPFP, 1993.

29. Finance Commission, 2005.

30. The paragraph goes on to cite the similar opinions of N.A. Palkhivala and D.D. Basu. Finance Commission, 2005.

The recommendations do not stray into evaluating the amount of Plan allocations:

> While thus determining the area of our work we have kept in view the traditional and important role played by the Planning Commission … We have attempted to work out an approach which, while enabling us to *perform our legitimate constitutional role,* would not prove detrimental to the planning process or to the role played by the Planning Commission in that process.[31] (Emphasis added)

Neither of these public challenges to the role of the PC has dislodged it from its place in channeling intergovernmental resources to the states.

The FC, on the other hand, continues to be sidelined not only in its constitutional mandate to oversee transfers, but also in its potential role as an arbiter in center–state fiscal discussions with significant distributional implications. It has emerged as a forum for discussing coordination on fiscal consolidation since the Seventh FC's terms of reference asked it to review the resources of the central government and the demand for expenditure on civil administration, defense and border security, debt servicing, and other committed expenditure or liabilities.[32] The Eleventh FC was asked for the first time to review the state of the finances of the center and the states and suggest ways and means by which the governments, "collectively and severally," might bring about a restructuring of the public finances in order to restore budgetary balances and maintain macro-economic stability, while the Twelfth FC was told to suggest a restructuring plan to achieve debt reduction along with equitable growth in addition to macro-economic stability. The terms of reference for the Thirteenth FC solicited its recommendations for a blueprint for fiscal consolidation that had eluded the central and state governments from completing since it was announced as a priority in the reforms of 1991.

The comments of Vijay Kelkar, Chairman of the Thirteenth FC at the India Policy Forum 2010 session in which an earlier version of this paper was presented underscore this view of the FC's role as an arena for center–state discussions: "Because of the nature of reforms happening in the Centre, the Finance Commission has been increasingly used by different arrangements as one more instrument to at least make unthinkable thinkable in terms of reforms." He cited three examples: First, the Twelfth Commission chaired

31. Ibid., Chapter 2, para 11.

32. Prior terms of reference had only referred to the resources of the states and their demand for expenditure and revenues.

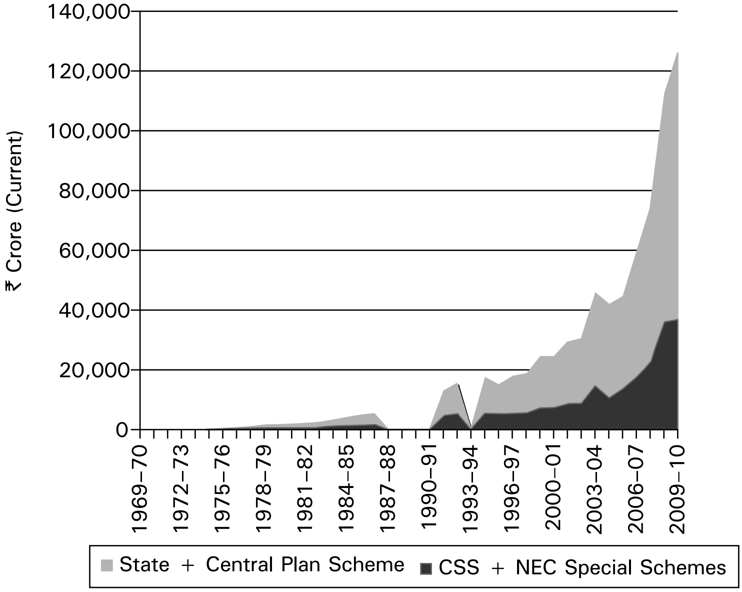
by Rangarajan "brought fiscal discipline at the State level and was very successful and now it has become part of the Indian political class' acceptance that … we require fiscal…discipline." Second, the Tenth Commission chaired by K.C. Pant changed the rule that gave the center the entire revenues from import duties, a change that, according to Kelkar, accelerated India's trade liberalization and reform since it weakened the center's incentives to preserve high import duties. Third, he went so far as to attribute India's survival as a Union to the "the sagacity of the First Finance Commission, headed by M. Neogi, which really laid out the framework of this devolution that was basically maintained by all the Finance Commissions." Finally, he commented that "the President can assign to the Finance Commission any issue which is important for sound public finance. So, under that rubric increasingly I think the reforms have been introduced by the system by using that as the instrument."

The limits of the Commission's role, however, are apparent in the ongoing debate about one of the most significant fiscal reforms under discussion today: the introduction of the Goods and Services Tax. The FC weighed in on the topic, commissioning research and offering specific recommendations as well as proposing a fund to support implementation in its report. Its Chairman, Vijay Kelkar, had been part of an earlier committee recommending the GST and discussing an implementation plan. Nevertheless, the GST modalities including the revenue neutral rate and the compensation to states for loss of various sales taxes are now being negotiated by an Empowered Committee of State Finance Ministers.

Planning Commission: The Persistence of Centrally Sponsored Schemes This section documents a second aspect of the persistence of centralizing features in fiscal federal institutions: the resilience of CSS and similar specific-purpose programs in the PC' repertoire of processes for allocating funds to states for development. Figures 4a and 4b show the absolute and relative size of the funds that the PC has provided through the two main routes of Central Assistance for annual plans and CSS since 1970.[33]

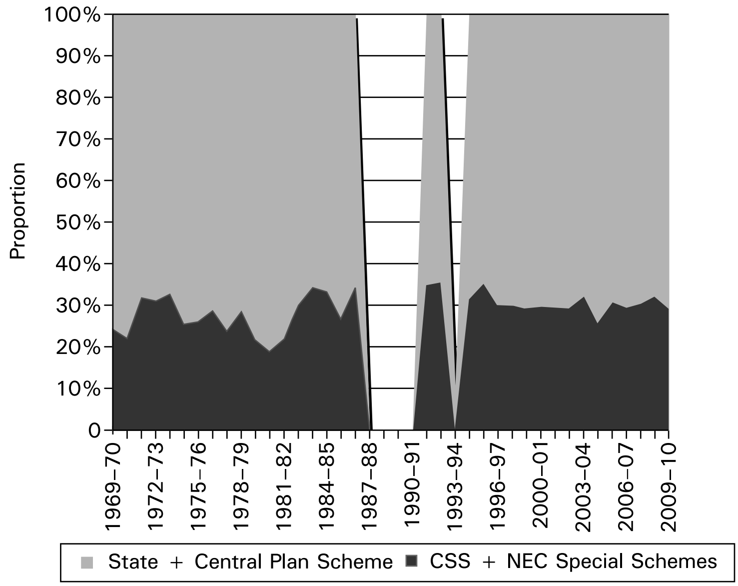
33. The breakup of Plan assistance is not available before 1970. The distinction between these two forms was not clear for the first two Plan periods, when the assistance to states was effectively the sum of requirements for particular development schemes defined in accordance with the Plan framework, but the two streams started to separate in the Third Plan period (1962–1967) and they became quite distinct after introduction of the Gadgil Formula and its successors for allocating Central Assistance in and after the Fourth Plan period starting in 1970.

FIGURE 4a. CSS and Plan Transfers



Source: Calculated from Reserve Bank of India (various years) *A Study of State Finances*.

FIGURE 4b. CSS and Plan Transfers (Proportion)



Source: Calculated from Reserve Bank of India (various years) *A Study of State Finances*.

Central Assistance consists of block grants allocated according to specific indicators of state development and policy performance.[34] CSS are specific-purpose development programs focused on various sectors, including some that are constitutionally defined as state responsibilities. They are proposed and designed by central government ministries, ostensibly in collaboration with their state counterparts, and financed in whole or in part by the central government. They often include specific restrictions on how money can be spent, including detailed specifications for building materials, qualifications for employees, and pay scales. Money is obviously fungible, so the fact that states received grants earmarked for education, health, or other specific programs does not entirely constrain their ability to use their development budgets as they see fit, but the Centrally Sponsored Schemes (CSS) do create additional compliance costs for states. These schemes have played a significant role in determining overall transfers in spite of state-led efforts to ensure that more plan assistance comes as formula-driven block grants to support the plans that states themselves have proposed.

Given that there were no institutional restrictions on how the PC allocated funds and what strings would be attached, one might have expected a move toward more formulaic transfers as the states' political power increased and the economic rationale for coordinated planning faded, but this has not happened. CSS have persisted in the face of constant and critical discussion in the NDC and committees it has appointed to review the matter.

The first three plans (1951–1966) are generally seen as sincere, though somewhat opaque, efforts to coordinate investment in India's development. The early plans had no clear formula for disbursing aid; instead stating principles and then reporting on estimated gaps between states' resources and their intended investment.[35] The Plan size, or intended investment, was reportedly determined on the basis of discussions between state chief ministers and the PC as well as the resources required for development schemes proposed and designed by central government ministries (Vithal and Sastry, 2001).

34. Total Central Assistance falls into two categories: Normal Central Assistance, allocated on the basis of some version of the Gadgil Formula since the Fourth Plan period, and Additional Central Assistance. Support under Additional Central Assistance, including pass-through of international donor funds for development programs, is allocated according to a variety of criteria.

35. The process seemed to be quite flexible. Implementation of the First Plan, e.g., started before the transfers were finalized because the Commission was waiting for the recommendations of the FC to determine the resources that states had at their disposal. The Second Plan laid out some factors that the PC would consider in determining the size of the Plan, but these were somewhat vague and actual Plan assistance for the Annual Plans was determined only after further discussions between state leaders and the PC.

The First Plan did not distinguish between development schemes included in state plans and those that were outside the Plan but supported by PC transfers; the Plan document does not mention "Centrally Sponsored Schemes." The second plan started to distinguish between development schemes included as part of state plans and those that were outside the plan but eligible for support, but there did not seem to be a distinction in how transfers were determined for Plan versus CSS development programs.

The Third Plan (1961–1966) was the first to specify a quantum of assistance for states rather than determine the transfer amount by adding requirements for Plan and non-Plan development schemes. It still provided funding based on scheme requirements, but added a category of "Miscellaneous Development Loan Assistance" to make sure states received the amount promised in the discussions between PC and state leaders.

The implications of this bargaining process for state and central governments' authority and the implied balance of economic power in the federation were largely ignored. India's efforts to plan were regarded as an exciting development practice and eminent economists from around the world took part in determining strategies and principles. Nehru was closely involved in these, as an active chairman of the PC, raising the political and moral stature of the whole process. As late as the Third Plan, Nehru wrote at least part of the first chapter outlining the approach (Chakravarty, 1987).

The first challenges to the PC's discretion in Plan allocations came about in the NDC discussions during 1964–1966, in the lead-up to the Fourth Plan. Vithal and Sastry[36] (2001) preface describes the mood diplomatically: "[I]t was felt that, in the interest of better Centre-State understanding, plan transfers should also be regulated by an objective formula." In this round of discussions, states suggested various criteria for formulas in bilateral discussion and the August 1966 NDC meeting, which the PC aggregated to produce guidelines for the original Fourth Plan Period starting in 1966–67. The NDC discussions also criticized the CSS, and an NDC subcommittee composed mainly of state leaders recommended that 36 of the 92 schemes then in operation be transferred to State Plans to be aided by general Plan assistance.[37]

36. The authors are a former member of Finance Commission and a high-level staff member of the Planning Commission as well as Finance Commmission, respectively.

37. The subcommittee also outlined specific circumstances in which CSS were appropriate: matters of national policy, schemes for specialized research that would benefit more than one state or be of all-India importance, pilot projects for R&D, new schemes introduced after Plan finalized. Reported by Vithal and Sastry (2001) on the basis of agenda papers for the Committee.

These recommendations were never implemented since the Plan was replaced by a series of one-year plans (and new CSS), but the exercise was repeated in 1968. The PC again asked states for their views on the formula for distribution as well as on the development schemes. The views were discussed at the NDC meeting in May 1968, at which point a committee of chief ministers and the Deputy Chairman of the PC was appointed to suggest a formula. The committee meetings and NDC discussions were contentious, with most states proposing and defending formulae that would favor their interests, but Vithal and Sastry (2001) report an interesting example of inter-state collaboration that they argue was crucial in obtaining a consensus. The Chief Minister of Maharashtra, then the best-off state, agreed to a formula that left 10 percent of the total to be distributed to backwards states only, a concession that, according to the authors, set an example for other states to follow in determining a formula. The Committee's formula was adopted as an NDC recommendation and followed by the PC.

The introduction of the so-called Gadgil Formula for allocating Plan assistance is one of the only successful state-led efforts to alter the balance of fiscal power between center and states. The formula is similar to one discussed in the Expert Committee on Financial Provisions in the Constitution. Based on population, per capita income, tax effort, and (in early iterations) spillover in investment needs from previous plans, and "special problems," it still allows for some discretion in determining the "problems" and has been modified several times since its introduction but it was a major departure from the previous approach of providing assistance to fill the gap between states' resources and an investment plan determined in bilateral discussions between states and the PC. The grants provided under the Normal Central Assistance are also relatively fungible. The sectoral distribution of funds has to be approved as part of the Plan, but states can adjust spending across sectors and then notify the PC for formal approval in many cases. Some "earmarked" areas require changes to be proposed in advance and delays in utilization are penalized, but for the most part the Plan assistance allows the states to adjust its expenditure and investment between broad areas (Vithal and Sastry, 2001).

However, the formula's impact on the clarity of allocations and the autonomy states have in using them for plans that they formulate, has been limited by the continued use of CSS as a mechanism for transfers. The NDC and subcommittees appointed by it have considered the role of CSS numerous times over the past five decades and have recommended abolishing or limiting them to a specific set of areas in nearly every report, with almost no lasting impact on the volume of funding channeled through the programs.

The saga of repeatedly ignored recommendations to reduce scope of CSS is almost comical.[38] The Administrative Reform Commission (ARC) of 1966 noted that schemes were used too widely and recommended reducing their numbers and funding. A 1968 NDC Committee adopted the ARC's recommendation of a limited set of purposes for which schemes could be used and suggested limiting schemes to 1/6 of total central plan assistance to states. According to the agenda papers, states wanted the number of CSS to be reduced and have those that continued be funded 100 percent by the central government with fewer conditions on building codes, pay scales, and other aspects of the projects. Kerala suggested abolishing them, while Uttar Pradesh wanted to fix five-year outlays and then club annual outlays with the discussion of the annual plan outlays. Most central government ministries, on the other hand, wanted to continue the CSS, add more, and transfer schemes out of the State Plan sector (aided as part of Plan assistance) to be CSS.[39]

The number of schemes was actually cut from 92 to 47 in the beginning of the Fourth Plan, but ministries continued to introduce new schemes, many for purposes not on the list approved by the NDC over the Fourth and Fifth Plan periods. There were 116 schemes by 1978–1979.

A 1978 NDC Committee appointed to look at center–state relations, the Gadgil Formula, and the CSS, repeated the recommendations made a decade before. States again wanted the schemes to be included in the State Plans and to have more assistance from the center for the State Plans, while central government representatives argued that the CSS were innovative and that states' development efforts would be inadequate without them. The Working Group recommended reducing the number of schemes and transferring most of the savings to the states as additional block assistance (Planning Commission, 2006). The draft Sixth Plan (1980–85) cut 70 schemes, but the actual plan saw an increase in the number and the amount of funds going to CSS. The total amount was well in excess of the cap of 1/6 of total transfers that had been agreed to in 1968 and there were 201 schemes in place by the end of 1985.

The NDC appointed another expert committee under K. Ramamurti in 1984 for the Seventh Plan. This committee had to survey the ministries to even assess the number of schemes and their structure. The committee did a thorough analysis of the data, however, and found that the expenditure on CSS

38. The following paragraphs draw on Planning Commission (2006) and Vithal and Sastry (2001) as well as summary reports of the NDC discussions.

39. From Agenda paper III of May 1968 NDC meeting, reported in Vithal and Sastry (2001).

was highly concentrated: 13 of the 201 schemes accounted for 80 percent of the total transfers, which tended to be better for the richer states. Most of the schemes by this point were based on some kind of matching funding from states. Some of the poorer states got less money than they would have if the whole amount going to CSS had instead been allocated by the Gadgil Formula. As before, central ministries justified the schemes as important for achieving national goals, as a financial incentive for recalcitrant states, and as a way for the central government to monitor development expenditure since states did not provide information on implementation of Plan programs. The Committee disagreed and pointed out that ministries were inconsistent, only paying attention to schemes when they were CSS, and not when they were plan schemes even if they retained the same goals and should have thus also been of national importance. The committee's recommendations were similar to those of its predecessors: fewer schemes, more restrictive conditions for introducing them, etc.

The Ramamurti Committee report provoked yet another Committee, this time appointed by the Prime Minister and led by then-Minister of Human Resource Development P.V. Narasimha Rao. The Committee, a group of three Union Cabinet members, 11 chief ministers, and a member of the PC, reviewed the same issues as before: the number and modalities of schemes, which ones should be pruned, and what should be done with the savings. It decided to set up yet another Group of Officials, consisting of 7 Union Secretaries and 11 State Chief Secretaries to tackle most of these questions. This committee found schemes that the last group had overlooked, recording 262 compared to the 201 that the Ramamurti Committee had found.

The PC appeared to accept this report for the Eighth Plan, distributing a note called "Distribution of Central Budget Support for States' Plan Expenditure," (reproduced in Vithal and Sastry, 2001) that said that there should be a drastic revision of the CSS regime to "free the major part of the funds from strict regulation by the different Central Ministries." It also recommended that most of the schemes be transferred to the states to get regular Plan assistance as block grant/loan. The catch came up at the October 1990 NDC meeting, however, when the prime minister emphasized that this change would only take place if the funds saved were channeled to Panchayats, stating, "Therefore, the commitment from the Chief Ministers has to come that this will be further decentralized to the Panchayat level or the appropriate level with a particular scheme of improvement."[40] Regardless of the merits of the proposal, this was clearly an example of

40. Summary Record of the NDC Meeting, paragraph 118.

the central government using its fiscal powers to influence states in their constitutionally provided jurisdictions. According to the Seventh Schedule of the Constitution, "Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, districts boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration" is a state subject. In any case, the Schemes remained the same.

The topic arose yet again at the January 1997 NDC meeting, with the request from some chief ministers that some CSS and the associated funds be transferred to states. The PC discussed these points in an internal meeting and circulated a note offering to transfer some of the scheme resources to states using the Gadgil Formula, while others would be transferred with funds earmarked for local bodies and some "in a phased manner." States disagreed on which ones to be transferred as well as the way in which the transfer would take place in their response to the note and a new Committee of the NDC on Transfer of CSS was created. The Committee's recommendations on reducing redundancy, improving monitoring, and creating more flexibility for states to tailor expenditure and implementation patterns were delivered in 2006. These have yet to be implemented.

WHY?

The contrast between the rapid evolution of India's economic and political milieu and the glacial change of fiscal federal institutions is striking. Public debates about the PC and FC and their effects on state fiscal autonomy have occurred, yet these have not had any significant impact on the functioning of the institution. The institutions have changed, but not in a direction that enables more state autonomy. What explains this phenomenon? We argue that although change in the framework for fiscal federalism is possible, India's economic and political context and its institutional framework pose significant barriers to state collective action to enact such reforms.

There are three possible explanations for the stubborn center: institutional change is impossible, states and their representatives are uninterested in systemic change, or states cannot or will not cooperate to effect systemic change.

The first is not true. Altering the FC's foundations would require a constitutional amendment and thus the assent of a super-majority in both houses of Parliament and ratification by states, but this has not been a significant barrier in other policy areas. The Indian constitution is one of the most-amended constitutions in the world. The PC was created by a Cabinet Resolution and thus could be altered by the same—basically, an agreement by the government to change its position. It has the anchor of a sizeable bureaucracy and historical inertia, but neither of these confers any formal institutional foundation. Its position could also be altered relatively easily on the President's order. Article 263 of the Constitution states:

> If at any time it appears to the President that the public interests would be served by the establishment of a Council charged with the duty of—(a) inquiring into and advising upon disputes which may have arisen between States; (b) investigating and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest; or (c) making recommendations upon any such subject and, in particular, recommendations for the better co-ordination of policy and action with respect to that subject, it shall be lawful for the President by order to establish such a Council, and to define the nature of the duties to be performed by it and its organisation and procedure. (Government of India, 2005)

The 1988 Report of the Sarkaria Commission in fact recommended that the President use this power to create a stronger NDC.

The second reason, that states do not want systematic reform is plausible, but not entirely convincing given the written record of state protests about not only the amount of transfers but also the mechanism of transfers over the years. While there are reasons to believe that systemic change in the federal framework may not be on the top of states' agendas, such incentives to maintain the status quo seem to be weakening.

States may avoid pressing for systemic change for several reasons. First, because it is not necessary—they can achieve their goals without altering the federal balance of power. Sinha (2005), for example, documents the many ways in which regional leaders have stalled, subverted, and altered development agenda and programs being promulgated by the central government. The "sub national strategic choices" that she shows have contributed to regional variation in economic outcomes take place within the system without a strong rebellion against central government policies. Some analyses also imply that state leaders may not need the autonomy to experiment and deliver better outcomes in order to survive politically. Singh and Verney (2003) and Wilkinson (2000), for example, argue that the evolution of the party system towards a greater variety of regional, linguistic, caste, class, and ideological issues has created an outlet for many of the social changes to be expressed in the political process without any change in the formal institutions. By giving these interests a voice in national political debates and an opportunity to claim some of the spoils from public programs, the party system has absorbed the social changes without passing the resulting pressures on to change the deeper institutional structure of fiscal federalism. Stepan (2010) argues that this has created a new politics of inclusion, in which previously marginalized groups focus on securing their political rights, rather than a politics of delivery, in which groups agitate directly for economic and social objectives. Ethnic and linguistic groups as well as disadvantaged groups within Hindus have increasingly demanded recognition as distinct groups and the advantages that come with such recognition.

Second, the central government's role in designing development programs also may offer a foil for state failures, a way to pass on the blame for poor development outcomes. Rajaraman (2008), for example, argues that unpredictability in transfers has contributed to states' in ability to invest effectively in health, education, and other social infrastructure. Her paper takes this as a motivating assumption rather than proving a causal link between the design of transfers and economic outcomes. To the extent that state leaders can convey this "theory of blame" to their constituents, they are absolved of having to deliver. Survey data and the voting record, however, suggest that people are starting to hold states accountable for their performance. Nearly three quarters of the people surveyed as part of a nationally representative sample in 2001 view the states as responsible for providing electricity and education facilities as well as controlling crime.[41] About 70 percent of the people surveyed held states responsible for public rations and medical facilities, and over half saw states as the providers of roads, pollution control, and drinking water (Chhibber et al., 2004). Gupta and Panagariya (2010) show that voters pay attention to states' economic performance: in the 2009 election, they rewarded candidates from ruling parties when states grew more than average and tended to vote against candidates from ruling parties when state economic performance was poor. In such an environment, states would plausibly want the freedom to respond to these voter demands.

Finally, the benefits that come from state political representation in central government decision-making through participation in ruling coalitions at the center—the level at which constitutional and significant institutional changes would have to be made—may also create strong incentives for

41. The survey was conducted for a carefully selected sample of more than 8,300 people as part of the State and Society Project, jointly coordinated by Bangalore University, Ohio State University, and the University of California, Berkeley, with Dr Pradeep Chhibber, Dr Sandeep Shastri, and Dr Richard Sisson as principal coordinators.

individualistic behavior by states. Sinha (2005) argues that sub national regional leaders who have better access to central government decision-makers have an advantage relative to their competitors in securing support for investment projects or gaining advance knowledge of schemes that may have openings for private investment or affect private returns. In the fiscal arena, state parties who come to power as members of central government coalitions in Parliament can wield substantial influence over the central government machinery for delivering benefits to their states. Any state anticipating continued access to this power would have little incentive to dismantle or curtail the PC's discretion.

Beyond the mixed political logic of states' incentives to press for systemic change in the transfer regime, the record of states' inputs into national committees examining the fiscal framework suggests that states are interested in the mechanism as well as the amount of transfers. Every time states are on record in discussions of fiscal federal arrangements, they argue for not only larger transfers (as would be expected), but fewer conditions on these transfers. The section "The Puzzle: Contextual Change, Institutional Stasis" above discussed state positions as recorded by the FC and in the NDC debates. The First Administrative Reforms Commission (ARC) reports from 1966–71 contain similar sentiments. It is telling that the one period of discernible shift in fiscal control, the creation of the Gadgil Formula, coincided with the emergence of non-Congress parties in power at the state level.

States' inputs into the Sarkaria Commission's work (1983–88) reiterate the need to return to constitutional principles of autonomy. Chapter 10, Paragraph 3.4 of the report states:

> It has been pointed out by a State Government than the heavy dependence of States on the Union for financial resources has resulted in a progressive erosion of the jurisdiction, authority, and initiative of the States in their own constitutionally defined spheres. Further, it has manifested in a gradual decline in the relative share of States' Plan outlay in the total, growing outlay of the Union on State subjects, proliferation of Centrally Sponsored Schemes and the Union's tight control over planning in the States.

Paragraph 3.25 goes on to note:

> Closely related to the issue of vertical imbalances is the alleged inadequacy of the mechanisms provided in the Constitution to rectify the same. Almost all the State Governments have pointed out that resource transfers outside the channel of the Finance Commission, have increased year after year and now overshadow the statutory transfers.

The Commission also reports the states' "allegations" that "the expectations of the Constitution-makers that the devolution of resources from the Union to the States through mechanism devised by them, in an impartial and 'automatic' manner free from 'interference,' has suffered change (Chapter 10, para 7.01)."

Political parties and state leaders have continued to issue public statements decrying the central government's fiscal incursion into state policy jurisdiction. Saez's (2002) book on center–state relations takes its name *Federalism without a Centre* from a defiant statement issued by a group of chief ministers and regional leaders after a 1996 meeting in Hyderabad. Bihar's government (led by a regional party in alliance with the national BJP) held an international meeting on poverty statistics in 2007, in part with the aim of discrediting the central government's definition of poverty and its implications for transfers and social programs meant for the state. Even national parties have evoked states' rights. BJP passed a resolution at its June National Executive Meeting 2010 meeting complaining that the Sarkaria Commission's recommendations "had been thrown to the winds," that BJP governments in states were being "systematically harassed financially," and that "Steps initiated by the [Congress-led] Governments at the Centre are aimed at surreptitiously seizing powers vested with the States and concentrating them in the hands of the Government in Delhi."[42] These statements probably reflect political posturing as much as real concern for the Constitution, but they are consistently calling for decentralization of effective control over development expenditure.

We argue that the survival of the stubborn center is rooted in the difficulties of collective action by states. States were in some ways created to be distinct political actors: acting on the recommendation of the States Reorganization Committee, the post-Independence Parliament created states covering contiguous areas with a majority of population whose mother tongue was the same.[43] This was an effort to create shared interest, as commonality of languages of the majority had long been presumed to imply cultural homogeneity and commonality of other interests, but it seems to have been more effective in reinforcing interstate divisions than reinforcing intrastate harmony. Many of the most active intergovernmental debates

42. Resolution on Centre's Assault on the Federal Structure of the Indian Union passed in BJP National Executive Meeting, Patna (Bihar). June 12–13, 2010. Available online at http://www.bjp.org/content/view/3354/394/ (accessed November 15, 2010).

43. "India" after Independence consisted of British India that did not go to Pakistan during partition and Princely States that acceded to India or were annexed.

and federal political tensions have in fact been about preserving ethnic and linguistic distinctions among states.[44] However, the split of the unilingual states into new states and the agitation for such splits in other states suggests that the presumed commonality of interests within linguistic groups was also not realistic.

Interstate differences in development also complicate collective action on autonomy, as central coordination is required for redistribution. Autonomy in economic matters might have greater appeal to richer or better performing states than for poorer states that might prefer a strong central involvement in redistributive transfers as well as in accelerating their economic development. As Vijay Kelkar pointed out in his comments at the India Policy Forum Session, India's horizontal imbalance is one of the highest among federations:

> The per capita income difference between the poorest states and richest states of India is 9 to 1 if you take all the 28 States, the highest being Goa and lowest being Bihar, but even if you take out these two outliers, still the difference is still 6 to 1 and compared to Australia it is 1.2 to 1 or and in Canada it is 1.5 to 1 and US must be something similar.[45]

Saez (2002) notes that in addition to being unequal, states are also increasingly competitive with each other, as economic liberalization has unfolded. The Maharashtra Chief Minister's concession regarding extra allocations to poorer states in the Gadgil Formula seems to have been a rare political moment.

Divergence of fortunes also seems to have interacted with the underlying ethnic and linguistic tensions as groups use ethnic or linguistic identities to demand preferential access to opportunities and economic divides exacerbate dormant caste, linguistic, or other social divides. The Telengana separatist movement in Andhra Pradesh, for example, is at least in part a demand for job quotas to help interior regions of the states claim economic opportunities available to the better educated, richer coastal areas. Weiner (1978) also highlights the economic impetus behind politicization of caste identities: Madigas in Andhra Pradesh accepted categorization as part of the general Scheduled Caste group when affirmative action was first introduced

44. For example, in the anti-Hindi agitation of the 1960s non-Hindi speaking Bengal and the southern states were united in demanding the continuation of the use of English as a link language for interstate communications rather than Hindi alone.

45. This is a quote from a comment made by Vijay Kelkar at the India Policy Forum Meeting held on July 16, 2010, Delhi at which an early version of this paper was presented.

in Andhra Pradesh, but were demanding separate recognition by 1998 so that their share of the overall quotas for SC could be guaranteed.

Third, the political insulation built into India's federal institutions is likely to be a factor slowing the pace of institutional change. India has the institutions that federal countries in other regions such as Latin America, or at least analysts of Latin America, aspire to have—transfers are overseen by a constitutionally defined expert body and a somewhat arms-length, somewhat expert body (PC), rather than just a series of laws to be negotiated between politicians representing party and regional interests. However, the unresponsiveness of these institutions to the reforms proposed in public debate also creates a cautionary tale of "be careful of what you ask for, lest it come true" in that creating independent and at least distinct entities also makes them somewhat immune to the pressures of representative democracy that are supposed to push institutions to evolve to meet changing circumstances.

India's version of federalism has been called "executive federalism," since center and state leaders interact through consultative bodies such as the Interstate Council and NDC rather than through the legislature as in many other federations (Singh and Verney, 2003). These bodies have reportedly become more active in recent decades (Sinha, 2005), but they still appear to wield limited clout in the political changes that would be required to alter the institutional structure.

The impetus for change in intergovernmental transfer institutions would have to come from the Parliament, which has not functioned as a forum for center–state discussions. Parliamentary debates are largely structured along party lines and parliamentary procedure places smaller parties outside of the ruling coalition at a disadvantage in representing their constituencies (Wallack, 2008). The national party system is also highly fragmented, which, according to standard political theory, limits the extent to which voters and politicians' choices can be channeled into confronting national-level problems.[46]

The public statements discussed in the section "Changes in the Institutions" have created reference points in the public debate about federalism, but have had little impact. The 1988 report of Sarkaria Commission on center–state relations is widely cited, but almost none of its proposals have been implemented. The 2002 report of the Venkatachaliah Commission

46. Sartori, 1976, 1986 makes the general argument about the value of having a few parties to form platforms and channel politics into larger issues; Nayar (1999) and Saez (2002) discuss the specific challenges and consequences of coalition government in India.

raised many of the same issues and its consultation papers have been made public online, but no significant group of politicians has advocated action on these points.[47]

These explanations imply that we will see little change in the intergovernmental transfer system. Even if individual state's demands for change strengthen as citizens start to focus more intently on outcomes and hold states responsible for failure to produce these, the most powerful state parties who have achieved representation in coalitions in the central government are unlikely to advocate a reduction in the powers of the central government that would reduce the options they have at their disposal unless they start to fear that these powers would be used against them if they were no longer in the coalition. The separation between the Parliament and the other forums for intergovernmental discussions seems unlikely to change.

Conclusion

Conventional public finance theory favors decentralization of decision-making with respect to the financing and provision of public goods and services. This is based on the presumed heterogeneity across localities, districts, states, or regions within a country, both in the constraints they face for their provision and above all in the preferences of their residents reflecting the trade-offs among the various goods and services they would like to see provided, as well as, their shares in the financing of their provisions. It is argued that the local decision-makers are very likely to have more information (or at least better information) on the preferences of their residents as well as on constraints. With this asymmetry in information, even if the central and local decision-makers agree on the ranking of the outcomes of public policy for the locality, centralized decision-making in which the centralized decision making based on limited (and/or lower quality) information on national and local policies and transfers to localities, would in general lead to worse policies and transfers compared to decentralized decision-making in which the center sets the transfers and local decision-makers choose the policies that would maximize local welfare, given the local constraints and preferences.

In the Indian context, the conventional argument for decentralization and local autonomy based on information considerations suggests that decentralization should extend beyond the state level to local governments. The

47. Venkatachaliah, 2002.

arguments about the information advantage that sub national governments have loses its salience if the local units are very large, and most states in Indian state are large in area and population. Political and other differences within localities (on states or regions) among social groups about their weight in local welfare cannot be ruled out.

The persistent centralization of authority over a substantial portion of resources that could be directed toward investments in India's development is therefore troubling. India needs to exploit the benefits of federalism as a laboratory for social and development policy, but the centralized decision making inherent in the transfer system currently precludes many regional experiments. The fact that decisions about resources are made in Delhi, albeit under some oversight from and in conversation with representatives of various states, means that valuable information and pressure for accountability is being lost. The "voices from below" are increasingly valuable as an information source about what is needed in a fast-changing world and are still valuable as an incentive mechanism to improve state performance.

Comments and Discussion

Dilip Mookherjee: T. N. Srinivasan and Jessica Wallack's document poses an interesting puzzle—despite significant deconcentration of political and economic power of the central government over the past three decades, the institutional framework of center–state financial transfers in India has remained relatively unchanged. The relative importance of transfers via the two principal mechanisms, the FC and the PC, as well as their powers and responsibilities have changed little since the 1950s. Why haven't the states demanded shrinkage in the role of the PC which lacks any direct constitutional authority, is appointed by and reports to the cabinet of the central government, and continues to direct large flows of plan expenditure throughout the country in the form of an ever-growing number of CSS?

They examine three possible explanations: institutional change is not possible in India; the states do not want the change; or the states face a collective action problem in enforcing such a change. They dismiss the first, pointing to the large number of amendments to the Indian Constitution over the past 60 years. Some arguments in favor of the second hypothesis are discussed: state governments like to pass the buck for poor performance on the stepmotherly treatment of the central government, and some in proximity to the party in power at the center have gained by being able to influence central plan expenditures to their states. Yet states are being held increasingly accountable by voters for poor performance, and have been vocal critics of the inordinate power wielded by the center by virtue of its control over transfer of plan expenditures. So they side mainly with the collective action hypothesis, explained in turn by ethno-linguistic diversity and extraordinary interstate economic inequality. They conclude by foreseeing little change in center–state fiscal relations in the near future.

Some additional speculations for the institutional persistence may also be put forward. First, the economic decentralization embodied in the rise of private-investment-led growth over the past two decades has already transferred significant power to state governments. Gone are the days when decisions on large investments were made or regulated by the central government. Now the states have to attract private investors, and much of the regulatory authority has passed to state governments. The stakes involved are perhaps not that high for the states anymore in trying to bend center–state financial institutions in their own favor.

Second, the fact that PC transfers are discretionary allows considerable elasticity of interstate transfers to shifting needs and political influence. The process of decision-making is highly nontransparent; state chief ministers exercise influence through the NDC formally and perhaps also informally behind the scenes. There is considerable empirical work on center–state transfers that bear this out (Arulampalam, et al., 2009; Rao and Singh, 2007; Khemani, 2010). FC transfers being formula-bound do not allow such elasticity. So a state that has a compelling need or is in a position to make a strong political demand can simply lobby for PC transfers, rather than pursue the arduous task of building a sizeable coalition of other states to demand a constitutional change. The latter option would take a lot more effort and time. Even if it were easy to accomplish, expanding the powers of the FC would diminish the leverage this state would be able to extract. This explanation overlaps and interweaves the second and third hypotheses proposed by the authors, with a bit more weight on the former than they are willing to place.

One question that Srinivasan and Wallack do not address head-on is the normative consequence of the persistence of the current set of institutions. But they seem to regret it, by pointing to the lack of democratic accountability it entails. This is an issue that also needs to be debated. While granting there may be some advantages in terms of greater decentralization, my own view is that there are a number of advantages of retention of central government powers which should not be overlooked.

First, there is no overarching a priori argument that democratic accountability is greater at the state compared with central government level, as Pranab Bardhan and I have argued elsewhere (Bardhan and Mookherjee, 2000, 2005, 2006). James Madison and Babasaheb Ambedkar, designers of the US and Indian constitutions respectively, made compelling arguments for potential for greater elite capture at the local level, motivating the powers accorded to the central government in both constitutions. There is likely to be considerable diversity with regard to the quality of governance across different states, which tends to be highly correlated with economic performance. Greater decentralization would then be likely to increase interstate inequality, which is already high and tending to increase over the past two decades. There is a real danger that the more backward states will fall further behind.

Second, the principal responsibility of the government nowadays in the economic arena is provision of infrastructure, environmental regulation, development of legal and financial institutions, promoting human development, and insuring against large covariate risks. Many of these involve significant scale economies, technical expertise and require interstate coordination. Dwindling control of the central government may result in a setback on many of these dimensions.

Third, to return to the issue of growing interstate inequality in one of the most ethnically and linguistically heterogenous countries in the world, there is a potential danger of states wanting to secede. The central government has made significant investments via various CSS in various border states, something that will become more difficult if the PC were to be dismantled or its wings significantly clipped.

Finally, it needs reiterating that CSS are just that: a significant portion of the funds are provided by the central government, but matching contributions are made by state governments who have considerable say in their disbursement and implementation through the Panchayats. This is in line with concurrent responsibilities of the central and state governments in many of the concerned areas defined by the Constitution. While it is difficult to defend the bewildering proliferation and patchwork nature of these schemes, or various details concerning the way they are implemented, the overall structure seems in line with the constitutional division of responsibilities.

Sudipto Mundle: In this paper Srinivasan and Wallack trace two contrasting patterns of evolution in Indian federalism. In the political sphere the distribution of power has evolved from monopoly of power by a single party, the INC, both at the center and in the states to a sharing of power by different parties or coalitions in different states, and ultimately by coalitions of different parties even at the central level. This plurality has meant considerable decentralization and redistribution of political power from the federal government to the states. However, the institutional arrangement for intergovernmental transfer of resources has remained highly centralized despite some evolution in the roles and shares of the two main institutions, i.e., the Finance Commission and the Planning Commission. The authors present a tight yet well-documented account of these two contrasting patterns of evolution and then ask the question why. Why has the institutional arrangement for intergovernmental resource transfers between the center and the states not matched the decentralization of political power?

In an earlier version of this paper Srinivasan and Wallack attempted to answer this question within a transactions-cost politics framework. That attempt has now been abandoned, presumably because the framework was found unsuitable for addressing the issue under consideration. However, the authors do not replace that framework by any alternative theory to explain the outcome. Instead they offer their judgment on what provides a possible explanation for their empirical puzzle.

One possible explanation is that such decentralizing institutional change was simply not possible. Srinivasan and Wallack reject this explanation for compelling reasons. Another possible explanation is the states or their representatives were not interested in such systemic change. The authors also reject this explanation, documenting that the states did seek such decentralization of resource transfer arrangements on many occasions. They conclude that the main reason why transfer arrangements did not get decentralized is that the horizontal conflict of interests and competition between states prevented collective state action vis-à-vis the central government.

This is certainly a plausible explanation. However, the paper does not offer any means for testing or rejecting other competing explanations. Two in particular should be mentioned. One alternative explanation is the emergence of different parties in power in different states, some states being governed by the same party or coalition that rules at the center and others by parties or coalition that are in the opposition at the center. Discretionary transfer powers of the central government give the party in power at the center a powerful instrument to keep the opposition ruled states in check, and also to tilt the vertical transfers in favor of its own states. When there is a change of guard at the center, the new party or coalition in charge of the federal government maintains the centralized arrangement for the same reason.

Another possible explanation is that decades of centralized transfer arrangements may have created powerful stakeholders with a vested interest in retaining central control over the transfer of resources to the states, in particular the bureaucracy. Senior bureaucracy and police, even those serving in the states, belong to All India service cadres that are centrally controlled, apart from the numerous central service cadres. Though serving their political masters, the bureaucracy is also an autonomous interest group, a strong centralizing force counter posed to the decentralization of political power. This is the "iron frame" that the founding fathers of the country established as an insurance against the possible balkanization of India in its formative years. Though bureaucrats serving in the federal government and the state governments represent their respective governments in resource allocation negotiations, the Indian bureaucracy as an institution is on balance a centralizing force.

Thus, there are possible explanations other than that offered by Srinivasan and Wallack for their puzzle, and those alternatives need to be tested and rejected if their hypothesis alone is to be maintained. It is also possible that the correct answer to their question is not one exclusive explanation but a combination two or more of those on the table.

General Discussion

The presentation of the paper at the conference generated a very lively discussion that ranged well beyond the subject of the paper to include many aspects of fiscal federalism. In addition, the final paper represents a substantial revision of the conference version that limits the comparison between the published paper and the prior discussion.

Abhijit Banerjee stressed the importance of discussing the theory of coalition building as it relates to the topic, and the importance of talking about who colludes with whom and how the coalitions play out during key negotiations. Do the coalitions cut across party lines and are they stable over time? He went on to say that it is important to consider two layers: first, how do the institutions' rules influence and constrain the process of coalition building. Here it would be interesting to contrast the operations of the Planning Commission and the Fiscal Commission because the objectives and rules are different. Second, the institutional rules need to account for the wide differences among the states in their willingness and ability to take advantage of the schemes. The center needs some powers to pull in the recalcitrant states, but not so much power as to completely undermine the process of coalition formation.

Robert Lawrence argued that the central question is the optimal level of government, and that there are strengths and weaknesses of centralized and local government. Thus, the optimal approach would vary depending on what is to be accomplished. He argued that the Planning Commission and the Finance Commission can best be understood by first considering what they are trying to achieve. Devesh Kapoor pointed to other fiscal transfer mechanisms, such as the Agricultural Prices Commission, and suggested that the same issues that are discussed in terms of the Planning and Fiscal Commissions also arise in these other situations.

According to Pronab Sen, the central issue is the political economy of fiscal federalism, and he pointed to three specific major sources of tension. The first is that some part of the transfers, particularly from the Finance Commission, are meant to be redistributive transfers, which causes tension between the logic of redistributive transfers and the logic of efficient development. The second tension is that while it seems that politically power seems to be moving away from the center to the regional formations, fiscally the opposite is happening, with the states becoming increasingly dependent on the center for fiscal transfers. The final source of tension he described is that certain mineral and forest resources are greatly increasing in value, and yet they are largely concentrated in certain areas where the governance structure is particularly weak, and in some cases collapsing.

Urjit Patel observed that there is a perception of the center using ad hoc measures to reward its friends among the states. That perception is reinforced by the large amount of revenue that the center collects as taxes or fees, but which it is not obliged to share. This causes resentment among the states, but it also gives the center a source of revenue with which to reward its partners in the region who are needed to support the coalition. Patricia Annez pointed out that the role of the federal transfer system underwent a lot of change in the United States during the 1980s, and the research that was done to explain these outcomes might be helpful in considering the case of India's federal transfer system.

Vijay Kelkar emphasized the large vertical and horizontal imbalances in the federation. There is a very large horizontal imbalance, demonstrated by the per capita income difference between the poorest and richest states in India of 9 to 1. There is also enormous vertical imbalance in the taxation policies of the states and the center, although this is changing rapidly with the new tax reforms, with the VAT and the GST. He also noted that there are now three tiers of government—center, state, and local. Kelkar also stressed the gradual rate of change: large changes are not acceptable; therefore, each Finance Commission has been able to only do small subtle changes at the margin, although taken as a whole, the cumulative change has been substantial. He concludes that the Finance Commission is one of the reasons why India has survived as a union, especially the first Finance Commission which laid out the framework of this devolution that was maintained by all of the Finance Commissions that followed.

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