The Dynamics of Reform of India's Federal System*

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Abstract

This paper analyzes the process of reform of India's federal system, with a focus on fiscal federalism. We first summarize the basic features of, and recent reforms in intergovernmental relations, including the role of political institutions, assignments of expenditure responsibility and revenue authority, the system of intergovernmental transfers, and institutions and mechanisms for government borrowing. We then discuss the institutional specifics of the reform process, to understand the dynamics of India's federal system.

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1. Introduction

Starting from very different initial conditions in terms of political institutions, and pursuing a very different set of policies, India has followed China in being an economic reformer as well as a star economic performer. The dimension of reform that has received the most attention in India is that of redrawing the boundaries of authority and action between government and market, including liberalizing government restrictions on international trade and domestic corporate investment, and changing the nature of government regulation of the private sector. What has received less attention in this context is the ongoing transformation of India's federal system of governance, through deliberate reforms and through unintended consequences of other policy changes. This transformation has the potential to sustain and accelerate economic growth in India. Specific reforms, with respect to decentralization to local governments, taxes and intergovernmental transfers have all previously been considered in detail, and continue to be discussed. The contribution of this piece is to put these individual changes into the context of the overall dynamics of India's federal system, so that the process can be understood from a positive perspective.[1] Thus, we go beyond description (which reforms have occurred) and prescription (which reforms are best?) to analysis of the process (why have these reforms happened?).[2]

The plan of the paper is as follows. In the next section, we summarize India's federal institutions – as concisely as possible, given their complexity. The political institutions that underlie the explicit mechanisms of fiscal federalism are critical to the analysis, and are highlighted here, in addition to assignments of expenditure and revenue

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[1] The Chinese experience has received considerably more analytical attention in this respect, e.g., Montinola, Qian and Weingast (1995); Qian and Weingast (1996); Qian and Roland (1998); Cao, Qian and Weingast (1999); Laffont and Qian (1999); Qian, Roland and Xu (1999); and Jin, Qian and Weingast (2005).

[2] For previous discussions that provide more descriptive detail, see Rao and Singh (2005), Singh and Srinivasan (2005) and Singh and Srinivasan (2006). The last of these does draw on analytical frameworks similar to those used for the China case, as does Singh (2007). Rao and Singh (2007) introduce some of the ideas considered more explicitly in this paper. Sàez (2002) tackles similar issues to the current piece, but interprets the process and evidence quite differently. Sinha (2004, 2005) offers a conceptual framework somewhat similar to that offered here, though with differences of emphasis. An important cross-country comparison of the dynamics of reform in federal systems is Wallack and Srinivasan (2005).

authority, and arrangements for intergovernmental transfers. In section 3, we give an overview of the reforms that have been taking place in the country's federal structure, including political institutions, fiscal assignments, and intergovernmental transfers and borrowing arrangements. Section 4 offers an analytical narrative to explain these developments, and some tentative predictions that follow from this analysis. Section 5 is a summary conclusion, with suggestions for further research.

2. India's Federal System

India became an independent democratic nation in August 1947 and a constitutional republic in January 1950. The constitution explicitly incorporated a federal structure, with states as subnational entities that were assigned specified political and fiscal authorities. However, these states were not treated as independent sovereigns voluntarily joining a federation. In particular, the states' boundaries were not inviolate, but have been repeatedly redrawn by central action (though often in response to subnational pressure), as allowed by the constitution.[3] India is now comprised of 28 states, six "Union Territories" (UTs) and a National Capital Territory (NCT), Delhi.[4] In general, the constitution was structured to give the central government residual authority and considerable sovereign discretion over the states, creating a relatively centralized federation. In particular, the assignment of residual political and fiscal authorities to the center, either explicitly or through escape clauses, represents the polar opposite of the principle of subsidiarity,[5] found, for example, in United States and European federal institutions.

The primary expression of statutory constitutional authority in India comes through directly elected parliamentary-style governments at the national and state levels, as well as (relatively new) directly elected government bodies at various local levels. The

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[3] In addition, the princely states that existed at the time of independence, under the umbrella of British rule, were rapidly absorbed and consolidated into the new political structure, with their special status greatly attenuated, and ultimately (by 1970) totally removed.

[4] Population sizes for the states range from about half a million to 166 million, with a median of about 24 million (2001 census figures). Ten states have populations exceeding 50 million.

[5] This principle would assign residual or implicit authorities to the lower level of government.

national parliament has two chambers, one (the *Lok Sabha* or peoples' assembly) directly elected in single member, first-past-the post constituencies, the other (the *Rajya Sabha*, or states' council) indirectly elected by state legislators. The Prime Minister and council of ministers serve as the executive branch, rather than the largely ceremonial President of the republic. The states, plus the NCT and the UT of Pondicherry, mostly have single-chamber, directly-elected legislatures, with Chief Ministers in the executive role. The other UTs are governed by central government appointees. Each state also has a Governor, nominally appointed by the President, but effectively an agent of the Prime Minister. Overlapping political authorities at the central and state levels have been dealt with through intra-party bargaining, and, more recently, through explicit bargaining and discussion.

Concentration of powers in the hands of the central government did not create serious conflicts in the early years of the functioning of the constitution since the same political party, the Indian National Congress (INC), ruled at the center and in the states. Many potential interstate or center-state conflicts were resolved within the party. The INC was essentially an umbrella organization that had pursued a campaign of independence from colonial rule, and this nationalist history contributed to its initial near-monopoly of political power.

India's relative political centralization was also reflected in bureaucratic and judicial institutions. The national Indian bureaucracy is provided constitutional recognition, and there are provisions for independent bureaucracies in each state. The key component of the bureaucracy is the Indian Administrative Service (IAS), whose members are chosen by a centralized process and trained together. They are initially assigned to particular states, and serve varying proportions of their careers at the state and national levels. The judiciary is a constitutionally distinct branch of government at both national and state levels, though the legislative/executive branch exerts influence through appointments and budget allocations.[6] The Supreme Court has broad powers of original and appellate jurisdiction, and the right to rule on the constitutionality of laws passed by

[6] At the local level, IAS members are vested with some judicial authority.

Parliament. In specific issues of center-state relations concerning taxation and property rights, the basic centralizing features of the constitution have tilted the Court's interpretations towards the center. More recently, in the 1990s, it has made decisions checking the center's ability to override subnational political authority by means such as dismissing state legislatures.[7] At the state level, the High Courts superintend the work of all courts within their jurisdictions, including district[8] and other subordinate courts.

At inception, the Indian constitution clearly laid out the areas of responsibility of the central and state governments, with respect to expenditure authority, revenue raising instruments, and legislation needed to implement either. Expenditure responsibilities are specified in separate Union and State Lists, with a Concurrent List covering areas of joint authority. Unspecified residual expenditure responsibilities are explicitly assigned to the center. Tax powers of the two levels of government are specified in various individual Articles. Legislative procedures for each level, particularly with respect to budgets and appropriations, are also spelled out in the constitution.

Powers of legislation for the center and states follow the responsibilities assigned in the three constitutional lists, but there are several broad "escape clauses," which give the national parliament the ability to override the states' authority in special circumstances, with a role for the Supreme Court as arbiter in some cases. The power to amend the constitution also resides with the national parliament, with a weak requirement that half or more of the states ratify the amendment for it to take effect.

The constitutionally assigned expenditure responsibilities of the central government are those required to maintain macroeconomic stability (e.g., all monetary and financial issues), international trade and relations, and those having implications for more than one state, due to economies of scale or spillovers (e.g., defense, transport and communications, atomic energy, space, oil and major minerals, interstate trade and

[7] On the other hand, the Court has also tended to engage in some centralizing judicial activism, to enforce laws down to the local level.

[8] In many ways, India's almost 600 districts are the fundamental administrative units of government, in a structure that goes back at least to the colonial period, in which Indian Civil Service (the precursor of the IAS) officers acted as chief executives of districts.

commerce, and interstate rivers). The major subjects assigned to the states comprise public order, public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals. The Concurrent list includes major areas such as education and transportation, social security and social insurance.

The initial constitutional assignment of tax powers in India was based on a principle of separation, with tax categories being exclusively assigned either to the center or to the states. The center was also assigned all unspecified residual tax powers. Most broad-based taxes were assigned to the center, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquors) and customs duty. These were often taxes where the tax revenue potential was greater, as a result of relatively lower collection costs, and higher elasticities with respect to growth. At the subnational level, a long list of taxes was constitutionally assigned to the states, but only the tax on the sale of goods has turned out to be significant for state revenues. This outcome is largely a result of political economy factors (e.g., rural landed interests were initially quite powerful in government at the state level) that have eroded or precluded the use of taxes on agricultural land or incomes (and even user charges for public irrigation and electricity) by state governments. Inefficiencies arose in indirect taxes because, while in a legal sense taxes on production (central manufacturing excises) and sale (state sales taxes) are separate, they tax the same base, causing overlapping and cascading, and effectively leaving the states less room to choose indirect tax rates.

The framers of the constitution were aware of the need for a common market, but included another broad escape clause.[9] An early amendment to the constitution added clauses that enable the central government to levy taxes on inter-state transactions. Furthermore, sales taxes have been levied by exporting states on the inter-state sale of goods, making these taxes origin-based, and relatively more distortionary in practice.

[9] Article 301 of the Constitution states, "Subject to the other provisions of this part, trade, commerce and intercourse throughout the territory of India shall be free". However, Article 302 empowers Parliament to impose restrictions on this freedom in the "public interest" – a term that is both very broad and not clearly defined in this context.

Finally, adding to internal impediments to trade, states and localities have been permitted to impose various entry taxes, under a separate (and somewhat inconsistent) constitutional provision.

The situation with respect to local governments is somewhat distinct from the center-state division of powers. Two constitutional amendments in 1993 gave local governments a firmer political footing, but had to leave many legislative details to the states, since local government was, and remained in, the State List. Furthermore most local responsibilities are subsets of those in the State List. There is no "Local List" as such, but the constitution now includes separate lists of responsibilities and powers of rural and urban local governments.[10] The lists of local expenditure areas, though now broader and more explicit than was typical of past practice, still overlap considerably with the State List, so most local responsibilities are, in practice, concurrent responsibilities. This includes major areas such as education, health, water and sanitation.

With assignment of local tax powers and details of expenditure assignments left to state-level legislation, there has been considerable variation across the states, though in general they have provided very little revenue autonomy to local governments, especially rural bodies. Local governments have relied on building and property taxes in the past, as well as entry taxes for some urban areas, but significant new taxes have not been assigned to local bodies after reform.[11] In many cases, states chose to hold back in devolving the full constitutional list of local functions,[12] and capped village level authority to directly approve expenditures, often at very low levels. Paralleling these constraints, local governments also have little legislative autonomy. This is particularly true for rural governments, though traditional village level committees (*panchayats*) have a history of

[10] The Union, State and Concurrent Lists are in the Seventh Schedule, whereas the new responsibilities of rural and urban local governments are in the Eleventh and Twelfth Schedules, added through the 1993 amendments.

[11] Local governments often have a large number of relatively unimportant taxes at their disposal, including entertainment and profession taxes, but are not permitted to piggyback on significant state and central taxes such as income and sales taxes.

[12] For example, while the constitutional schedule of local responsibilities includes "Health and sanitation, including hospitals, primary health centres and dispensaries," in practice, the states have maintained control over these functions.

acting as quasi-legal arbiters and enforcers through social norms. City governments, of course, do have a well-established tradition of local ordinances.

At both the state and local levels, revenue authority falls short of what would allow each level to independently meet its expenditure responsibilities. To some extent, this is a natural outcome of the different driving forces for assigning revenue authority and expenditure responsibility.[13] In 2004-2005, the states on average raised about 39 percent of combined government revenues, but incurred about 66 percent of expenditures.[14] Transfers from the center, including tax-sharing, grants and loans made up most of the difference, with the states also borrowing moderately from other sources.

The constitution provided for tax-sharing between the center and the states, as well as central grants to the states The shares are determined by a constitutionally-mandated Finance Commission, which is appointed by the President of India every five years (or earlier if needed). These transfers are mostly unconditional in nature.[15] The Commissions have developed an elaborate methodology for dealing with horizontal and vertical fiscal imbalances. In particular, the formula for tax devolution is quite complicated, as a result of attempts to capture simultaneously disparate or even contradictory factors. The end result of Finance Commission transfers is a mild degree of horizontal equalization across the states (Rao and Singh, 2005, Chapter 9). A completely separate body, the Planning Commission (PC), makes categorical grants and loans for implementing development plans. As economic planning gained emphasis in independent India's early decades, the PC became a major dispenser of such funds to the states, and it also coordinates central ministry transfers:[16] almost one-third of center-state transfers are

[13] Most significantly, mobility across jurisdictions increases as the size of the jurisdictional unit decreases. A tax base that is mobile may shrink dramatically in response to a tax, making it harder for smaller jurisdictions to raise revenue from taxes.

[14] These figures are constructed from various tables in RBI (2006). Both proportions do vary somewhat from year to year, and have been subject to political cycles. Such calculations still include local government spending.

[15] Some transfers have been earmarked for health and education spending by the states, and, after 1993, for local governments.

[16] There are over 100 ministry-sponsored schemes, ranging from specific projects to broad programs. Their effectiveness is generally deemed to be low.

made through these channels. Transfers through these channels tend to slightly increase horizontal inequality in fiscal capacities.

Local governments are even more dependent on transfers from higher levels. In 2002-03, rural local governments' own source revenues were less than 7 percent of their total revenue and less than 10 percent of their current expenditures (Finance Commission, 2004). Urban local bodies did somewhat better, with proportions closer to those of the states. They raised about 58 percent of their revenue and covered almost 53 percent of their expenditure from own revenue sources. Note that aggregate local government revenue and expenditure constituted just about 1 and 5 percent, respectively, of total government revenue and spending at all levels.[17] Thus, the overall scope, as well as fiscal autonomy, of local governments in India remains very limited.

Since 1993, a system of formal state-local transfers with State Finance Commissions (SFCs) has been mandated. These SFCs have struggled to formulate the principles for sharing or assigning state taxes and fees, and for making grants. There remains considerable variation in the quality of analysis, methodologies used, and implementation of transfers across the different states. The states' own fiscal problems have restricted progress in this dimension. Some states have been slow to constitute SFCs, and some have been tardy in implementing their recommendations. The outcome has been significant uncertainty, which hampers effective use of funds by local governments. Sometimes, SFC recommendations have been largely ignored by state governments. Thus, while the SFC system has made local government financing somewhat more transparent than before, it has not significantly altered the fiscal constraints faced by local governments.

A final aspect of India's federal system concerns subnational borrowing. According to the constitution, states cannot borrow abroad, and they require central government approval for domestic borrowing whenever they are in debt to the center. In

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[17] This contrasts sharply with China, where the corresponding percentages for revenue and expenditure are about 23 and 51 (Singh, 2007).

fact, that condition has prevailed almost invariably, since the central government was, until fairly recently, the states' main source of lending, and every state is indebted to the center.[18] Many central loans are made under the supervision of the Planning Commission (PC), and have been tied to PC grants in a fixed proportion. Central loans also include funds from multilateral agencies or other external sources for specific programs and projects in particular states, *ad hoc* loans based on exigencies in individual states, and short term ways and means advances.

States also tap the National Small Savings Fund, consisting of mostly rural savings collected through post offices.[19] Other, effectively captive, sources of borrowing for the states are mandated pension and insurance contributions of government employees (minus payouts), and state-owned financial institutions such as public sector banks. States have also "borrowed" by delaying payment of bills, especially in the case of State Electricity Boards (SEBs), state-government-owned utilities that failed to pay their bills to the central government-owned National Thermal Power Corporation. Central lending – often subject to debt relief or rescheduling – and state borrowing from captive sources have softened subnational budget constraints in India. However, overall, this problem is less severe in India than in Latin America, and perhaps even than in China.[20]

To place India's federal system, as summarized above, in international context, a high-level view does not obviously distinguish it from other *de jure* federations. The constitutional division of powers is similar in form to many other countries. The use of a tax sharing arrangement governed by a quasi-independent body parallels arrangements in other ex-British colonies, such as Australia and Canada. Broad goals of horizontal equalization of fiscal capacity are also common across many federations. However, India's federal system differs in many of its institutional details and practices, including

[18] Central loans account for about 22 percent of the states' present debt stock (RBI, 2006, Appendix Table 36).
[19] This category makes up about 27 percent of states' debt stock.
[20] See the contributions in Wallack and Srinivasan (2005). While the references in footnote 1 stress the hardness of subnational budget constraints in China, particularly for provinces, and early in the reform process there, more recent evidence suggests that local government budget constraints have softened: see Singh (2007) for references.

the parallel system of plan transfers, the nature of the formulas used for intergovernmental transfers, and the institutional mechanisms for intergovernmental bargaining. Overall, India appears to be much more centralized than other federations, especially when size is accounted for. The only comparator on that dimension is China, which is politically more centralized, but gives local governments much greater fiscal autonomy. China is also different in relying more on central administrative discretion and intergovernmental bargaining to set the rules of the game, achieving *de facto* federalism.

3. Federal Reforms

Despite periodic discussions of constitutional overhaul, India's political institutions have remained remarkably stable. The legal underpinnings of these institutions have not changed dramatically, with the single exception of the creation of directly-elected local governments in 1993, as outlined earlier. So far, that reform has not had major consequences for the conduct of India's polity, though it has dramatically increased the number and diversity of elected officials nationwide. One institutional reform that did emerge in 1990 was the creation of the Inter-State Council (ISC), which includes the Prime Minister, state chief ministers, and several central cabinet ministers as members, and has become a forum where political and economic issues of joint concern can be collectively discussed, and possibly resolved.[21]

Within this relatively static institutional framework, the 1991 economic reforms, which substantially loosened central government control of foreign and domestic corporate investment, allowed state governments to become more autonomous actors in economic policy (e.g., Sinha, 2004; Singh and Srinivasan, 2005; Singh, 2007), with horizontal competition among (at least some) state governments replacing rent-seeking interactions with the center. In this respect, therefore, reforms that liberalized central

[21] The flexibility and breadth of scope of the ISC's possible concerns distinguish it from the much older National Development Council (NDC), which has somewhat similar membership, but focuses only on five-year-plan allocations.

government control of the private sector also promoted greater *de facto* federalism at the state level. [22]

Tax reform has been a significant and ongoing part of the overall economic reform process in India. Initially, the central government emphasized extreme progressivity and narrow targeting, resulting in a very inefficient tax structure (including prohibitively high tariffs), and tax administration that was highly susceptible to corruption. Economic reform has led to a substantial rationalization of the central government tax structure, in terms of lowering marginal rates, simplification of the rate structure, and some degree of base broadening. This reform agenda was laid out in several expert committee reports, from 1991 to 2004. In the realm of tax administration, also, some progress has been made, through simplification of taxes, changes in administrative procedures and use of information technology.

Tax reform has been slower at the state level. However, by early 2007, the center had persuaded the states to replace the old system of taxation of interstate sales with a destination-based VAT. This represents a major improvement in the efficiency of the tax system, including addressing impediments to an internal common market. Agreement on this shift came through the workings of a committee of state Finance Ministers, which developed a stepwise implementation plan. The Finance Commission offered a formula for compensating states for revenue losses during the transition.[23] The next step will be to create a unified Goods and Services Tax (GST), which combines the central and state VATs. One anomaly in this transition has been the status of taxes on services. The original constitution implicitly assigned service taxes to the center, through its residual powers over taxes. In 2004, the central government chose to add service taxes explicitly to the Union List, via a constitutional amendment. According to the new institutional regime for service taxes, they are to be shared with the states, in a manner to be determined by Parliament, and therefore outside the "common pool" that is divided

[22] The references cited in footnote 1 examine the salience of this kind of development in China, which remained politically highly centralized. In the Chinese case, much of this economic decentralization took place down to the local level – this has not happened in India to date (Singh, 2007).
[23] A detailed account and analysis of the features of the new system, and the process of adoption, is given by Rao and Rao (2006).

among the states by the Finance Commission. Moving toward a comprehensive GST will include resolving this anomaly.

A major reform of the intergovernmental transfer system was initiated in 1994, with the recommendation of the Tenth Finance Commission that the original constitutional scheme of revenue change from only a small number of taxes being shared between the center and the states, to the entire consolidated fund of the center being so shared. This change was implemented through a constitutional amendment ratified in 2000, and has reduced the incentive of the central government to discriminate among the different taxes it collects.[24]

Formulas for dividing allocated tax revenues among the states, and for making Planning Commission allocations, have remained relatively static over the years, reflecting the power of precedent. One change, however, was driven by developments in the 1980s and 1990s.[25] By the late 1980s, the fiscal positions of the states, as well as the center, had already begun to deteriorate. In 1991, fiscal deficits were quite high, and the process of overall economic reform was tied to the need for fiscal consolidation of government. The Eleventh Finance Commission was the first to be asked to examine government finances in an integrated manner, and to make recommendations for enhancing fiscal consolidation. Initial ad hoc attempts by the center to impose fiscal discipline included "contracts," in the nature of MOUs with states that exchanged promises of fiscal reform for ways and means advances; these ran into problems of credibility and commitment. The Eleventh Finance Commission therefore recommended that a portion of central-state transfers be made conditional on fiscal reforms, according to a preset formula. However, the incentives for fiscal discipline thus provided were again too weak to be effective.

[24] For example, in the old arrangement, income taxes were shared, and almost all assigned to the states, but income tax surcharges were entirely kept by the center. Unsurprisingly, the central government favored using surcharges whenever possible. As noted in the previous paragraph, now only service taxes are outside the consolidated sharing arrangement; this anomaly has been obliquely criticized in the latest Finance Commission's report.

[25] The creation of independently elected local governments has also given the Finance Commission a new role of making transfers earmarked for local governments, and in monitoring the workings of the SFCs.

The latest approach to encouraging fiscal discipline involves commitment to explicit targets for deficit reduction through fiscal responsibility legislation. The central government and many state governments have passed such legislation. The Twelfth Finance Commission, in 2004, recommended pushing the remaining states toward this commitment by tying debt relief (which was also included in the commission's charge) to the passage and implementation of fiscal responsibility laws. Even in the absence of such incentives, fiscal responsibility legislation has created public benchmarks for evaluating state fiscal performance. The Commission has also reiterated earlier criticisms of the process of making plan transfers as being opaque, cumbersome, conceptually ill-defined, and poorly coordinated and monitored. Arguably, these problems contribute to difficulties in enforcing hard budget constraints at the state level.

Market borrowing has always been available to the states, subject to national government control and discretion. However, much of this borrowing has been through private placements with financial institutions at controlled interest rates. The Twelfth Finance Commission recommended that states should, instead, primarily access the market directly for borrowing, paying market-determined interest rates. The Commission also proposed ceilings on aggregate borrowing (including state-level guarantees) and debt, and these constraints would be an important component of a market borrowing regime. Several states have included such limits in their fiscal responsibility laws. Furthermore, the central bank (Reserve Bank of India, or RBI) is actively studying the development of institutions to support this shift to market borrowing, including offering mechanisms, secondary markets for government debt, credit ratings, and methods of regulation and monitoring. The background for this process is the center's own shift in the 1990s toward paying market rates for its borrowing.

If one can sum up the different components of federal system reform that have taken place in about the last 15 years (the approximate period of systematic overall economic reform and liberalization), tax reform – working toward conventional microeconomic efficiency – can be characterized as the area where the greatest progress

has been made. The scope of the Finance Commission to make recommendations regarding overall federal finances has been enhanced significantly, though actual practice has changed less. Some isolated institutional reforms, such as the tax-sharing arrangement and the creation of the ISC, have been significant. On the other hand, many other features, such as the process of planning and making plan and programmatic transfers, have changed relatively little. The proposal to shift to true market borrowing for the states (and to some extent for larger urban local governments) represents a major reform that is still in process. At the same time, many of the other efforts to deal with subnational fiscal deficits have the flavor of dealing with symptoms rather than causes. Understanding this process of incomplete and piecemeal federal reform therefore requires an analysis of the causes, in terms of political power and bargaining, that goes to the heart of federal arrangements in India.

4. Reform Dynamics

Political power at the national level in India has always required some degree of coalition building, since regional identities are strong. The Hindi-speaking states located in the northern Indo-Gangetic plain have some degree of homogeneity, and traditionally were the source of core support. At the southern extreme of the country, the state of Tamil Nadu was already asserting its individuality by the 1960s, with political power at the state level being impossible without support from a state-based (i.e., Tamil-specific) party. In the 1970s and 1980s, centralization increased, but more as a response to inherent pulls for a more decentralized polity (Brass, 1990). From 1989 onward, no national party has been able to form a government at the center without some degree of coalition-building, with emergent regional parties claiming pivotal roles.[26] This dynamic of political decentralization has shaped many of the reforms we have described, as we explain in this section.

[26] In some cases, there are overlaps between ideology and region, as in the communist parties of West Bengal and Kerala. The role of regional parties is detailed in the references cited in footnote 2.

There is empirical evidence that central loans, food assistance and subsidies to the states were all linked to electoral considerations (Chhibber, 1995) in the 1970s and 1980s. Thus, the deepening of rent-seeking by politicians and interest groups was driven by intensifying needs of political competition, and powers of patronage for electoral support overwhelmed concerns about the inefficiency of the system. The attempt to strengthen local governments can also be seen in this light. Whereas there had been a decades-old ideological strand favoring decentralization of government, it was only in the late 1980s that an attempt was made to institutionalize decentralization through constitutional changes. It has been argued that the impetus came from the desire of the national ruling party (the Congress) to balance the growing power of state-level politicians. This motivation also explains why many states have been reluctant to devolve significant financial powers to their subordinate local governments. Nevertheless, an unintended consequence of the change has been a genuine effort to build local capacity: in particular, some larger urban governments have received more political space to pursue policies for local economic development, including borrowing from the market for infrastructure projects. NGOs and multilateral institutions have also been able to be more involved at the local level.

Another unintended consequence for India's federal system emerged from the liberalization of national industrial controls. State governments have been able to pursue subnational economic agendas more freely. Regulatory and permission issues for the private sector were now often shifted to the state level rather than the center (Sinha, 2004, 2005). States have even been able to negotiate with multilateral institutions, in ways that may have shifted potential costs to the center (Chakraborty and Rao, 2006), in the form of softer budget constraints. Many of the federal system reforms that have been attempted (e.g., incentives for overall fiscal discipline) or proposed (e.g., subnational market borrowing) can be seen as responses to the unintended consequences at the state level of relaxing national control of private sector economic activity. Central government motives themselves reflect a mix of concerns for overall economic performance, as well as a desire for rent-capture. In some cases, concerns for rent preservation are salient at the state level, and this hampers overall reform. The most striking example of this is in the

electric power sector, where the SEBs are loss-making and highly inefficient, but also large public sector employers: power supply remains perhaps the greatest and longest-standing constraint on India's growth (Singh, 2006).

It is also true that academic (or technocratic) inputs have played a role in reforms (Rao and Singh, 2007). Typically, these work through government-appointed expert committees (such as several on tax reform), or through the Finance Commissions, which can include academics among their members. The reform of tax sharing owes something to this process, as does the entire conceptual framework of tax reform. It remains the case, however, that politicians and bureaucrats choose what to implement, and clarity about who benefits and loses is important. Thus, changing the basis of tax sharing between the center and the states in aggregate was much easier than coordinated reforms of the indirect tax system across the states. Even making substantive changes in the formula for allocating transfers across states is difficult in this respect. Only a subset of academically inspired (and presumably desirable) reform proposals lead to political action, with uncertainty with respect to consequences for different interest groups and problems of compensating losers being twin obstacles to adoption.

If one makes the political bargaining process the focus of understanding the dynamics of reform, it is clear that the institutions that govern this process are critical. Arguably, as the INC fragmented, party institutions deteriorated, and legislative quality and processes eroded (Kapur and Mehta, 2006), there emerged a gap in the institutions to manage conflicts with a federal dimension. In fact, 'center-state relations' became a topic of urgent concern: the formation of the ISC followed quickly on a 1988 recommendation made by a major governmental commission that was appointed to address this issue. The ISC has sometimes been seen as too weak and ad hoc, and it is less transparent than parliament, for which it substitutes as a discussion and consensus-building forum, but it appears to have filled the gap adequately. For example, how to go forward with the proposal to change the tax sharing arrangement was hammered out in the ISC, and other federal matters such as sharing of inter-state river waters have also been dealt with there (Richards and Singh, 2002; Kapur, 2005). In fact, in areas such as tax reform, another,

more specialized bargaining forum has emerged using the same model, the "Empowered Committee" of State Finance Ministers. This committee has made recommendations on the process of the states' switch to a VAT (now essentially complete), and tax harmonization such as floor rates to avoid any "race to the bottom" in tax rates.

One may argue that institutional developments still lag behind changes in India's situation with respect to its federal character. Economic reform has initially benefited some states and regions more than others (Kochhar et al, 2006; Rao and Singh, 2005, and references therein), and increased regional inequality makes it both more important and more difficult to build winning subnational coalitions for reform. Most recently, central government policy actions have been aimed at boosting political support in poorer, more rural states. Unsurprisingly, buoyant tax revenues resulting from reform and consequent higher growth rates have been earmarked for increased spending on health, education, rural infrastructure, and social insurance, rather than accelerated reduction of the fiscal deficit.

Current federal institutions also get pulled in opposite directions. Thus, the latest Finance Commission has changed the tax sharing formula to favor better-off states, while simultaneously increasing targeted grants to poorer states. In some ways, intergovernmental transfers remain an arena for significant subnational influence activities and bargaining over division of the government revenue pie. The Planning Commission has articulated a case for further decentralizing expenditure authority in areas such as health and education, as well as for measuring outcomes of spending from categorical transfers, but complementary institutional reforms,[27] which would make these objectives feasible, have not been pursued. The Finance Minister has also raised the issue of civil service reform (which could have an important federal dimension), but again there is enough opposition within government to make such reforms difficult: in such cases, government decision-makers are themselves potential losers.

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[27] Essentially, such reforms would transfer revenue authority, including spending on personnel, to lower level governments.

5. Conclusions

Explicitly recognizing the political dynamics of federal reforms creates a different perspective for making policy recommendations. Even in cases where the reform does not change federal institutions, it may require coordinated action at different levels of government (e.g., in areas such as agriculture, power supply, health and education: see, in particular, Singh and Srinivasan, 2005). Instead of examining ideal and isolated reforms, the focus instead is on political feasibility. Where winners and losers can be identified, it may be possible to create packages of reforms that are politically acceptable, e.g., assigning greater revenue authority to local governments may be combined with reassigning some taxes from the center to the states (or allowing piggybacking), and cutting the states' share of the consolidated fund of the center (Rao and Singh, 2007). Thus, combinations of reforms may be accepted, where individual reforms would lose: the traditional economic compensation principle is implicitly applied in such cases. This approach can also guide the redesign and changes in the working of institutions such as the Finance Commission, Planning Commission, and ISC (e.g. Rao and Singh, 2005; Singh and Srinivasan, 2006).[28]

The perspective taken here for India can be seen in a more general context. It is an extension of Riker's instrumental view of federalism, as "a constitutional bargain among politicians", with the motives being "military and diplomatic defense or aggression" (Riker, 1975, pp. 113-114). Here, bargaining is not just in constitution making, but also in evolution of subsequent governance, and not just for territorial protection or gain, but also over splitting the economic pie. Many of the large countries grappling with economic reform include, unsurprisingly, those with variants of federal systems (e.g., Brazil, Indonesia, Russia, and South Africa, in addition to India and China). There are special challenges for implementing change in countries with multiple layers of political authority and divided sovereignty. The literature on federalism has not sufficiently addressed the issue of reform in developing countries with federal structures (Wibbels, 2005). Nor has there been adequate attention to the political determinants of federal

[28] Hence, the positive analysis offered here also has some potential normative implications.

institutions, and how these shape the reform process (Rodden, 2006). This piece contributes to that ongoing research program.

The approach articulated here is also related to recent work by Rajan and Zingales (2006). They argue that interest groups, or rent-defending constituencies, may, depending on the initial distribution of endowments, trump democratic institutions and block economy-enhancing reforms. In such cases, direct redistribution is also going to be politically infeasible. We conjecture that federal systems may have an additional degree of freedom, where supplementing subnational revenue and expenditure authorities may also relax political constraints to economic reforms that provide aggregate benefits. This is a topic for future research.

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