Holding India together: The role of institutions of federalism

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Abstract

India is a large, heterogeneous and complex nation, with multiple languages, religions and ethnicities, and over one billion people. It stands out in having held together while sustaining a working democracy for over five decades, at relatively low levels of income. One of the main institutional aspects of managing heterogeneity to preserve national unity is the structures of Indian federalism. This paper traces some of the features of Indian federal institutions, focusing on their contribution to this 'holding together.' It reviews the conceptual and analytical underpinnings of the role of federal structures in sustaining unity, and summarizes historical developments and current institutional structures of the Indian case. It assesses the role of federal dimensions of political, administrative and judicial structures in the holding together function. It also examines fiscal federal institutions and their impacts, including distributional and growth issues. It also separately focuses specifically on the special treatment of what may be characterized as India's periphery.

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1. Introduction

India is a large, heterogeneous and complex nation, with multiple languages, religions and ethnicities, and over one billion people. In some respects, it stands out in its political structures, having sustained a working democracy for over five decades at relatively low levels of income. It also is distinguished by its institutional richness and the relative stability of these institutions (Kapur, 2005). These factors have arguably contributed to the survival of Indian democracy, and of the Indian nation itself. One of the main institutional aspects of managing heterogeneity to preserve national unity is the structures of Indian federalism. In this paper, we trace some of the features of Indian federal institutions, focusing on their contribution to this 'holding together.'

The key idea that the structure of federalism can have a role in holding together a democratic nation has a long history, being found, for example, in the debates over the United States constitution. Echoes of these debates, as well as concerns specific to the Indian situation, are found in the discussions that shaped India's own constitutional structures. More recently, academics have refined some of the conceptual underpinnings for the manner in which federal institutions achieve national 'togetherness.' This specific aspect of federalism is tied to, and in some sense logically prior to, the many analyses of the detailed workings of federalism – including political, administrative and fiscal dimensions – which take the holding together function as a given, or not a constraint that binds other objectives such as distribution and growth in a federal system. Nevertheless, those detailed systemic structures and functioning can also be assessed in the light of the 'holding together' objective, since they affect its achievement.

This paper is structured as follows. We begin in section 2 with a brief literature review, in order to provide a conceptual and analytical framework for examining the Indian case. In sections 3 and 4, we summarize historical developments and current institutional structures, drawing considerably on previous work on this topic. Section 5 assesses the role of federal dimensions of political, administrative and judicial structures in the holding together function. Section 6 examines fiscal federal institutions and their impacts. Section 7 discusses distributional and growth issues more broadly, since they can have long term impacts on the holding together function. Section 8 focuses specifically on what may be characterized as India's periphery, and discusses some aspects of special treatment of the periphery. Section 9 is a summary conclusion.

2. Conceptual Background

The key underlying idea of a federal structure is that there are at least two levels of sovereignty or authority, national and one or more subnational levels. In some cases, there may be an explicit, voluntary coming together of the constituent units of the federal system, and in others, the joining together may be the result of conquest. In either case, if subnational units have the option of exit, there is a problem of holding together the nation. This problem exists whether or not the nation has a federal structure (with explicitly divided areas of representation and authority).

An explicitly federal structure is supported in cases where political power rests to some extent with constituents, and there is a trade-off between economies of scale and the desire to satisfy heterogeneous constituent preferences. Several papers explore this kind of trade-off (e.g., Friedman, 1977; Alesina and Spolaore, 1997, 2005; Bolton and Roland, 1997; Alesina, Spolaore, and Wacziarg, 2000), looking for equilibrium national boundaries, possibly with internal features of federalism. If there are gains from cooperation there is a coming together, which is assumed to be enforceable in a static equilibrium.

Building on this literature on the size of nations, de Figueiredo and Weingast (2005) extend it in several ways.[1] First, they consider a repeated situation, so that cooperation is sustained by punishment strategies, even when it would be unstable in a one-time interaction: therefore federalism is 'self-enforcing.' Hence, federal systems are modeled as 'ongoing concerns,' and the 'holding together' problem is somewhat delinked from the issue of coming together. Second, the center is given somewhat broader powers of making payments to constituents, in order to maintain their participation in the joint system. Finally, they are able to explore a trade-off not only in terms of policy efficiency, but also in terms of institutional choice. They show that including a unit in a federation that is weaker than existing subnational units requires diluting central power to prevent the center exercising ex post opportunism against the weaker unit. The constituent units of the federation will therefore choose to include a marginal unit only if the scale benefits from its inclusion more than offset the costs associated with dilution of central authority.

The payments by the center to subnational units can be in the form of a pure public good such as national defense or the maintenance of a common market. The latter interpretation therefore ties in the model of self-enforcing federalism with ideas such as market-preserving federalism. Subnational units may find it beneficial to cede power to the center (e.g., through a constitution) to increase the center's ability to provide national public goods, but may also want to place limits on this power, in order to restrain the center's ability to punish 'noncooperative' units. In applying this analysis to the early post-independence United States, and to post-Soviet Russia, the argument is made that in the former case, a successful transition was made from a too-weak center to one with powers that could support cooperation, while in the Russian case, the center went from too weak to too strong to sustain a cooperative outcome. In the latter case, the center's powers to behave opportunistically trigger a noncooperative response from subnational units.

The case of Indian federalism has not really been examined analytically in terms of the trade-offs identified in the above models. Rao and Singh (2002, 2005) were among the first to explicitly model distributional concerns, though many other papers have subsequently followed this path. In these analyses, the focus is on the impact of federal institutions on the distribution of gains to cooperation, or other rents generated by the

[1] It should be noted that the analysis is motivated by broader concerns about federal structures, including the common pool problem, and the issue of the center expanding its authority to overawe the constituent units of the federation. See also de Figueiredo, McFaul and Weingast (2007) for an application of these ideas to the United States and Russia.

system, without seriously examining the underlying issue of whether the cooperation can be maintained. Singh (2007) discusses the idea of cooperative federalism in terms of distribution of the gains from cooperation among the center and subnational units, and applies a theoretical model to the Indian and Chinese cases, but again, the constituent units do not have an exit option in that framework. A partial exception is the discussion in Rao and Singh (2005, Chapter 4), where secession threats are linked to center-state transfers or assignments of property rights, and the durability of commitments to particular subnational units is also examined in the Indian context.

3. Historical Developments

The origin of many of India's federal institutions can be found in its history as a British colony. At the same time, the circumstances of independence, with its traumatic partition of the country, also played a major role in shaping the structure and working of the country's intergovernmental relations. Furthermore, different ideological positions and economic circumstances have also shaped the country's federal institutions.

In the 1800s, the British gradually took over a subcontinent that had been politically fragmented and strife ridden for well over a century. Creeping extension of British rule crystallized with the Government of India Act, 1858, which imposed direct sovereignty under the British Crown, implemented through an *ad hoc* mixture of centralized and decentralized administrative structures. Centralization was reflected in the power of the London-based Secretary of State for India, governing through the Viceroy, an Executive Council, and a small number of district level British administrators, who exercised all sovereign powers, with no separation of legislative, executive and judicial functions. Decentralization was exemplified by the relationship of Indian princely states to the British administration, where these states retained considerable internal sovereignty.

As Crown rule was consolidated in the second half of the nineteenth century, the British tried to decentralize based on considerations of administrative efficiency. Municipal governments were introduced in the 1860s. In some cases, sub-national units ("presidencies") were divided to facilitate more effective administration, e.g., by creating a more manageable span of control, and these provinces became the basis for India's main subnational locus of sovereignty. While a nationalist political movement grew during this period, the British further developed their fiscal structures, motivated by an interplay of administrative and political considerations. In 1858, the provincial governments depended completely on annual central allocations, since the center had authority over all revenue receipts and expenditures. In 1870, some financial decentralization was begun as a prelude to meeting the perceived need for some local self-government. Initially, some expenditure categories (e.g., police, health, education) were assigned to the provincial governments, which received annual lump-sum grants, and had to have separate budgets. Subsequently, further expenditure assignments were devolved to the provinces, along with some revenue authority and arrangements for revenue sharing.

After World War I, the British dealt with the rise of nationalism and sub-nationalism in a series of political and administrative responses, which included federal ideas to varying degrees. The 1918 Montagu-Chelmsford Report on constitutional reforms articulated a vision of India as a decentralized federation. The Government of India Act of 1919, based on the report, devolved some authority to the provinces, and nominally restricted the powers of the central government over matters assigned to the provinces. While the Indian government remained essentially unitary, there was some relaxation of central control over provinces by separating the subjects of administration and sources of revenue into central and provincial jurisdictions. Provinces received unambiguous control over sources of revenue such as land, irrigation and judicial stamps. The initial assignment of revenue authority proposed would have required provincial contributions to fund the central government, but this scheme was quickly modified towards greater central fiscal autonomy, including the sharing of central income taxes with the provinces.

The Indian Statutory Commission of 1928, headed by Lord Simon, also included a review of India's financial arrangements. Sharing of the income tax between the center and the provinces was an important part of the new fiscal proposals. Various innovations in taxation were also proposed. Subsequently, several committees met to consider the new bases for revenue sharing, particularly the formulas for distributing income tax proceeds between the center and the various provinces. The beginning of the 1930s was marked by three conferences involving Indian leaders, on the future status of India's governance. These conferences, and the British government's own deliberations, led to the 1935 Government of India Act, which proposed relatively loose federal structures that would build alliances and support their rule. The 1935 Act provided for the distribution of legislative jurisdictions with the three-fold division of powers into Federal, Provincial and Concurrent Lists. The legislature, however, did not have the features of a sovereign legislature, as its powers were subject to several limitations. The Act also enabled the establishment of Federal Court to adjudicate the disputes between units of the federation and was also the Appellate Court to decide on constitutional questions. On the fiscal front, the Act provided an assignment of tax authorities and a scheme of revenue sharing that, in many respects, laid the foundations of fiscal federalism in independent India.

The Second World War and the intensification of the Indian freedom movement overtook the implementation of the federal provisions of the 1935 Government of India Act. Partition along with independence became more and more likely in this period. Nevertheless, the framers of the Indian Constitution, beginning in the Constituent Assembly in 1946, relied heavily on the 1935 Act for the new constitutional framework. However, the effect of the planned partition of the country strengthened the vision of a strong Center. The more decentralized aspects of the federal structure of the 1935 Act were rejected after the chaos of partition. Two key individuals supported the more centralized vision for India: Jawaharlal Nehru, who became India's first Prime Minister, and B.R. Ambedkar. Considerations of peacekeeping, coordination and a socialist economic vision all pushed Nehru toward centralization. Ambedkar, the Chairman of the Drafting Committee for the Constitution, had a strong preference for a unitary form of government. His conception of federalism was shaped accordingly: a division of powers between center and states, but with residuary powers at the center, and central ability to impinge severely on the states in special circumstances.

Thus, the Indian Constitution incorporated centralizing features that were not in earlier British legislation, though closer to British practice in India. Centralizing features included provisions for altering states or their boundaries, central supersession of state legislatures, and explicit restrictions on state powers. However, the Constitution did allow for states with elected governments and fiscal authority. This basic fact has permitted Indian federalism to exist and continue. While the political structures envisaged in the 1935 Act were largely abandoned in the Constitution, the details of assignments of expenditure and revenue authorities, as well as of revenue sharing and grants were preserved. Article 246 provides for a three-fold distribution of power, detailed in separate lists in the seventh schedule. These enumerate the specific exclusive powers of the center and the states, and those powers that are concurrently held. The three lists are long and close to exhaustive, though residuary powers are explicitly assigned to the center.[2]

4. Current Institutions

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. Thus, for example, 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. As noted, the states' boundaries were not inviolate, and have been repeatedly redrawn by unilateral central action, as allowed by the Constitution. India is now comprised of 28 states, six "Union Territories" (UTs) and a National Capital Territory (NCT), Delhi. The typical Indian state is as populous as a larger European country, so is a significant geographic and political unit. Nevertheless, the Constitution was structured to give the central government residual authority and considerable sovereign discretion over the states, creating a relatively centralized federation.

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 nascent directly elected government bodies at various local levels. The national

[2] Another centralizing provision is Article 249, which empowers the upper house of parliament to transfer legislative jurisdiction from the states to the center. While the conditions for doing so are necessity or expediency in the national interest, the transfer requires only a two-thirds majority of members present and voting. In any case, Article 250 allows the central legislature to make laws with respect to matters in the state list. Furthermore, Article 353 (b) authorizes Parliament to make laws on matters not explicitly in the Union list. Finally, Article 354 empowers the President to order the suspension of the provisions of Articles 268 to 279 relating to transfers of revenues from the center to the states during a proclaimed emergency.

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.[3] The other UTs are governed directly by appointees of the central government. 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. The Inter-State Council (ISC) was created in 1990, and has become a forum where some political and economic issues of joint concern can be collectively discussed and possibly resolved.[4]

India's relative political centralization was also reflected in bureaucratic and judicial institutions. The national Indian bureaucracy is provided constitutional recognition. There are also provisions for independent bureaucracies in each state. However, 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 may serve varying proportions of their careers at the state and national levels. There are varying views on the effectiveness of the bureaucracy, with increasing concerns about competence and corruption leading to active consideration of civil service reform. However, bureaucratic functioning in India is relatively transparent and rule-bound, though the traditional economic policy approach vested the bureaucracy with considerable discretion in such matters.[5]

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. At the local level, IAS members are vested with some judicial authority. The Supreme Court, at the top of the judicial hierarchy, has powers that include broad original and appellate jurisdiction and the right to rule on the constitutionality of laws passed by Parliament. At the state level, below the Supreme Court, the High Courts superintend the work of all courts within the state, including district and other subordinate courts.

A potentially major change in political institutions was initiated in 1993 when, after decades of debate on decentralization, two constitutional amendments (the 73rd and 74th) gave firmer legal recognition, enhanced political status, and potentially greater expenditure responsibilities to urban and rural local governments. The amendments

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[3] Initially, all the states had bicameral legislatures, with indirectly elected Legislative Councils (LCs) in addition to Legislative Assemblies but over time, most chose to abolish the former. Currently, five states (Bihar, Jammu and Kashmir, Karnataka, Maharashtra and Uttar Pradesh) still have LCs.

[4] The ISC includes the Prime Minister, state Chief Ministers, and several central cabinet ministers as members. While the ISC is merely advisory, it has formalized collective discussion and approval of several important matters impinging on India's federal arrangements, including tax sharing and inter-state water disputes.

[5] See Singh (2004) for a review of some of these issues.

reduced state governments' discretionary control over elections to rural local government bodies. Direct elections to local bodies must now be held every five years, potentially replacing "hierarchy" with "voice" (Hirschman, 1970) as a primary accountability mechanism. Local government reform also changed the nature of tax and expenditure assignments to local governments by specifying their authority and responsibilities more fully, and it instituted a system of formal state-local transfers modeled on one component of the existing center-state system.[6]

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.[7] Expenditure responsibilities are specified in separate Union and State Lists, with a Concurrent List covering areas of joint authority.[8] Over time, through various amendments, these three lists have been altered in the direction of greater centralization, by expanding some powers in the Union List, and shifting some items from the State to the Concurrent List. The nature of the assignment of expenditure functions remains fairly typical of federal nations, and broadly fits with economists' theoretical rationale,[9] though the breadth of the Concurrent List in some cases creates problems of lack of clear responsibility.

Tax powers of these two levels of government are specified in various individual articles. 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. 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. The center was also assigned all residual tax powers. At the subnational level, a long list of taxes was constitutionally assigned to the states (Table 5), but only the tax on the sale of goods has turned out to be significant for state revenues. This narrow effective tax base 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 also of user charges for public irrigation and even electricity) by state governments.

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6 See later in this section for a discussion of intergovernmental transfers.

7 Legislative procedures for both national and state levels, particularly with respect to budgets and appropriations, are spelled out in detail in the constitution, and are similar to parliamentary democracies elsewhere, having followed the British model. The quality of functioning of legislative institutions has been criticized, but it remains the case that rules of process are followed quite well.

8 All residual areas not explicitly mentioned are under the center's authority, adding another centralizing feature to the constitution.

9 Economic theories of government are based on the idea that public (non-rival and non-exclusive) goods are not well provided by the market mechanism. In addition, if governments are not perfectly informed and intrinsically benevolent, subnational governments may be better able to judge the desired levels of local public goods, and, potentially, can be given more specific electoral incentives to do so than national governments. Spillovers and economies of scale work in the direction of favoring centralized provision of public goods (see, e.g., Olson, 1986).

The situation with respect to local governments is somewhat distinct from the center-state division of powers. The 1993 amendments, which gave a constitutional imprimatur to local governments, also 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. In the case of local governments, the constitutional amendments provided no explicit guidelines for revenue authority. The language of the amendments simply leaves such assignment up to the states, which are supposed to decide which taxes local bodies may levy themselves, and which state-collected taxes are to be assigned to local governments.

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. 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. One can think of the problem as being one of tax "capacity": this being lower for states, and still lower for localities. If this factor implies that more taxes should be collected by the center, there will be a tendency for there to be a mismatch between revenues and expenditures for subnational jurisdictions, to the extent that subnational governments are relatively better able to respond to diversity of preferences.[11] This is certainly true in India, and is dealt with through significant intergovernmental transfers, which are discussed next.

In 2004-2005, the states on average raised about 39 percent of combined government revenues, but incurred about 66 percent of expenditures.[12] 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. Focusing on current expenditure only, states financed about 58 percent of that total from their own sources of revenue in 2004-05, up from 52 percent in 2002-2003, but considerably lower than the ratio that had prevailed in the early days of the republic. In terms of total expenditure (including capital

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[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] This problem can be avoided to some extent by coordination of taxes among subnational jurisdictions. For example, different states might agree to charge the same minimum sales tax rate or income tax rate. Unlike national taxes, these would only be on state-level tax bases, but the incentive for the activities that are taxed to move to other, less-taxed locations would be reduced. There are enforcement problems in such agreements, since each state might wish to cheat, either directly reneging, or using nontransparent subsidies to compensate for the taxes, say to attract capital to their own jurisdictions. One response to this might be central imposition of this coordination of rates.

[12] 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.

spending), the states covered only about 42 percent by their own revenue receipts in that year. There has always been considerable variation across the states in their transfer dependence, and the ranking is not completely determined by per capita income. For the three years 2000-2003, of the 16 larger states,[13] the three with the highest ratios of own revenue to revenue expenditure were Haryana (0.78), Maharashtra (0.68) and Tamil Nadu (0.65), while the three with the lowest ratios were Bihar (0.25), West Bengal (0.32) and Orissa (0.34) (Finance Commission, 2004, Annexure 7.10).

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. 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 expenditure constituted just about 5 percent of total government spending at all levels.

The large vertical fiscal imbalances between levels of government have not been unanticipated, and constitutional provisions exist to deal with them, in particular, the creation of a Finance Commission (FC) to advise on center-state transfers. The FC, in turn, served as a model for State Finance Commissions (SFCs) mandated by the 1993 local government amendments to make state-local transfers. The SFCs were created by individual states, as required by the constitutional structure wherein local government is a state subject. Other channels of transfer also exist. The creation of an apparatus of central planning soon after the constitution was ratified led to a complex system of plan transfers which involve both subnational levels. This planning mechanism is modeled in some ways on the now defunct Soviet system. In addition, and somewhat intertwined with the planning system, are various transfers from central and state government ministries to lower levels. It is convenient to first treat the three channels of center-state transfers in turn, and then discuss the various aspects of state-local transfers together. Loans to subnational governments can also have a transfer element, when there is a subsidy element, or some degree of debt forgiveness.

Finance Commission Transfers

The constitution provided for the sharing of the proceeds of certain centrally levied taxes (e.g., non-corporate income tax, Article 270; and Union excise duty, Article 272) with the states, as well as grants to the states from the Consolidated Fund of India (under Article 275). Recent constitutional changes (the 88th amendment, passed in 2000) in this scheme have simplified this sharing arrangement, replacing it with an overall share of the consolidated fund. The shares of the center and the states, and their allocation among different states are determined by a constitutionally-mandated Finance Commission, which is appointed by the President of India every five years (or earlier if needed). FC transfers are mostly unconditional in nature. The FCs' approach to federal transfers has consisted of (i) assessing overall budgetary requirements of the center and states to determine the resources available for transfer from the center during the period

[13] This excludes mostly the hill states, which have greater transfer dependence, as well as the small, high-income state of Goa. The hill states are discussed explicitly in Section 8 of the paper.

of recommendation, (ii) projecting states' own revenues and non-plan current expenditures, (iii) determining the aggregate and individual states' share of the consolidated fund of the center, and (iv) using grants to fill projected expenditure-revenue gaps remaining after tax devolution.

Twelve FCs have made recommendations to the central government and, with a few exceptions, these have been accepted. 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 result has been that the impact of FC transfers on horizontal equity (equalizing fiscal capacity across states) has been limited.[14] Despite the *ad hoc* nature of the tax-sharing formula, its persistence reflects the nature of precedent that has grown around the FC, even though it is not a permanent body, and lacks continuity in its staffing and its analysis. Grants recommended by the FCs have typically been based on projected gaps between non-plan current expenditures and post-tax devolution revenues. As with tax sharing, these grants have generally been unconditional, although some commissions have attempted to enhance outlays on specified services in the states by making closed-ended specific purpose non-matching grants. In either case, the incentive problems with this "gap-filling" approach are obvious.

Planning Commission Transfers

While the FC decides on tax shares and makes grants, a completely separate body, the Planning Commission, makes grants and loans (in the ratio 30:70 for the major states)[15] for implementing development plans. As development planning gained emphasis, the Planning Commission became a major dispenser of such funds to the states, and it also coordinates central ministry transfers: almost one-third of center-state transfers are made through these channels. As there is no specific provision in the Constitution for such plan transfers, the central government channeled them under the miscellaneous (and limited) provisions of Article 282. Before 1969, plan transfers were project-based. Since then, the distribution has been done on the basis of a consensus formula decided by the National Development Council (NDC).[16] As in the case of the FC, the Planning Commission formula tries to aggregate disparate objectives in its calculations, with the result that the overall impact is less than clear.

One major contrast with the FC is the conditional nature of Planning Commission transfers, since they are earmarked for "developmental" purposes. However, while the

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[14] See Rao and Singh (2005) and World Bank (2005). The exception is the so-called 'special category' states. These are hilly states on India's borders, with strategic importance as well as cost disabilities in public good provision, and they are discussed specifically in section 8 of this paper. Bagchi and Chakraborty (2004) provide some illustrative calculations of how transfers would need to change to achieve greater horizontal equalization for the major states.

[15] The special category states receive a much higher proportion (90 percent) of their Plan fund allocations as grants.

[16] The NDC is chaired by the Prime Minister, and its members include all central cabinet ministers, Chief Ministers of the states, and members of the Planning Commission. Like the ISC, it serves as a bargaining and log-rolling body, though with a much narrower scope.

special category states (footnote 13) receive plan transfers based on projects that they formulate and submit, the general category states' plan transfers are not related to the required size or composition of plan investments. Hence there is not even implicit matching of states' own resource commitments in this transfer channel, let alone an explicit matching formula. The process for determining plan transfers involves competing proposals from the Planning Commission and the states, with a certain amount of bargaining through the NDC, as well as in state-by-state discussions, to determine plan loans and grants. At the end of this process, the Planning Commission approves the state plans. The allocation and spending process does appear to distort states' budgeting and expenditure decisions, and not necessarily in ways that are desired by the center or more socially efficient.

Central Ministry Transfers

Various ministries give grants to their counterparts in the states for specified projects, either wholly funded by the center (central sector projects) or requiring the states to share the cost (centrally sponsored schemes). The ostensible rationale for these programs is financing activities with a high degree of inter-state spillovers, or which are merit goods (e.g., poverty alleviation and family planning), but they are often driven by pork-barrel objectives. These projects are supposed to be monitored by the Planning Commission, and coordinated with the overall state plans, but both monitoring and coordination are relatively ineffective. There are well over 100 schemes, and attempts to consolidate them into broad sectoral programs have been unsuccessful, though they continue. These programs have provided the central government with an instrument to actively influence states' spending, replacing pre-1969 plan transfers in this role. The proliferation of schemes may also have increased the size and control of the bureaucracy. While the NDC recently appointed an investigative committee that recommended scaling down and consolidating centrally sponsored schemes, implementation of this proposal was weak: new proposals have recently been floated with similar objectives. For all channels of center-state transfers, but particularly more discretionary transfers such as ministry grants, there is some evidence that political factors influence allocations across states.

State-Local Transfers

The new SFCs have struggled to formulate the principles for sharing or assigning state taxes, tolls, and fees and for making grants-in-aid. There remains considerable variation in the quality of analysis, methodologies used, and implementation of transfers across the different states. Lack of political will at the state level and, perhaps most significantly, 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 mostly ignored by state governments. Nevertheless, the SFC system has made local government financing more transparent.[17]

[17] In fact, the problems of uncertainty and arbitrariness in state-local fiscal relations are a heritage of the old system of discretionary control, rather than a consequence of reform (Rao and Singh, 2003).

While detailed and accurate data on the nature of state-local transfers (especially in terms of the source of the funds and the effective degree of conditionality) remains elusive (Finance Commission, 2004, Chapter 8),[18] some recent studies have collected such data (World Bank, 2004) and the FC itself has compiled data provided by state governments. These data include FC grants made to augment to consolidated funds of the states, but earmarked for local governments. They also sometimes[19] include Planning Commission transfers to the states that are then further devolved to local governments. In sum, local revenues, particularly for rural governments, include a large component of which the spending is predetermined by higher-level agencies (e.g., Rajaraman, 2001).

Borrowing by subnational units

The constitution (Article 293) specifies borrowing rules for state governments. States cannot borrow abroad, and they require central government approval for domestic borrowing whenever they are in debt to the center. In 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. Currently, central loans make up about 22 percent of the states' debt stock (RBI, 2006b, Appendix Table 36). Operationally, the RBI, as central bank, manages the debt of all levels of government, and, in the past, typically did not allow market borrowing by state governments that were already indebted. 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 can also include funds that originally come from multilateral agencies or other external sources, which are earmarked for specific programs and projects in particular states. Finally, there can be *ad hoc* central loans based on special circumstances or exigencies in individual states, and short term ways and means advances to provide revenue smoothing.

There are also various sources of captive borrowing for the states, such as the National Small Savings Fund, consisting of mostly rural savings collected through post offices, mandated pension and insurance contributions of state government employees, minus any payouts that occur, and state-owned financial institutions such as the Life Insurance Corporation of India, and various public sector banks. States also "borrow" by delaying payment of bills, and as they came under fiscal stress in the 1990s, this became an increasingly important, albeit precarious means of financing deficits at the state level. Finally, there is also some off-budget borrowing by state level public sector enterprises.

Local government borrowing in India has been *ad hoc* and limited in nature, although, in many cases, the distinction between loans made by state governments as part of the planning process, and institutional financing of local projects, also routed through the states, has been blurred. Local government reform has had only a marginal impact on the previous situation, especially for rural governments. The SFCs have been charged with making recommendations with respect to loans, but the ability to assess projects and

[18] In particular, the data does not yet permit an analysis of political economy determinants of state-local transfers, whether with respect to variation across localities or over time. Since data before the reforms is essentially non-existent, one cannot ever examine the impact of reform per se. However, over time, it may be possible to isolate political economy factors in changes in the pattern of stat-local transfers.

[19] There is a lack of consistency in accounting and reporting among the states in this respect.

monitor outcomes is already beyond the state governments' capacity. A relatively new development has been the issuance of bonds by a few urban bodies, including municipal corporations as well as specialized government organizations such as water supply agencies.

5. Holding Together – Politics, Law and Bureaucracy

The legacy of the chaos of partition and independence was a very strong emphasis on maintaining centralized authority as much as possible. The army and police, both trained on British models, played an important role in achieving law and order and consolidating the boundaries of the new nation. Meanwhile, the drafting of the Constitution created a centralized federal system, with parliamentary democracy at the national and state levels as its underpinning. Any federal system is subject to 'overawing' (Riker, 1975) of the subnational units by the national government, and this was very much the case initially, in India.

In the early years of the republic, the same political party, the Indian National Congress (INC), ruled at the center and in the states. 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. Thus, even when there was pushback against centralization from India's states, these issues were resolved within the party hierarchy. Members of the colonial-era Indian Civil Service (precursor of the ICS), including Britons as well as Indians, contributed to this centralized stability, since they formed an elite, unified and experienced administrative cadre, in contrast to the political leadership, which had little practice in day-to-day running of government.

Political and bureaucratic centralization was facilitated by key provisions in the Constitution. In fact, many centralizing constitutional provisions, governing the relative authorities of the center and the states, did not need to be exercised, because other avenues sufficed. In particular, the center was less concerned about explicit transfer of powers from the states to itself, or temporary suspension of state powers under constitutional provisions, because it was able to exercise political control more directly through Article 356 of the Constitution. This allows the Governor of a state to advise the President that the government of the state was unable to carry on "in accordance with the provisions of this Constitution", and allows the President to assume "to himself all or any of the functions of the Government of the State". In practice, President's rule means rule by the Prime Minister and the ruling party at the center, and provided a direct means to exercise central political control, bypassing the electoral will of the people as expressed at the state level.

There are other examples of political and administrative centralization. While powers of legislation for the center and states follow the responsibilities assigned in the three constitutional lists, there are several relatively broad "escape clauses" which give the national parliament the ability to override the states' authority in special circumstances. Furthermore, the assignment of legislative powers ignores potential conflicts, such as when international treaties, the signing of which is a central power, affect state subjects.[20] When conflicts over legislation arise between the center and the states, the Supreme Court is the arbiter. The framework of the constitution tends to favor central authority in such cases. In specific issues of center-state relations concerning taxation and property rights, the basic centralizing features of the constitution tilted the Court's interpretation towards the center. The power to amend the constitution also resides with the national parliament, with a weak requirement that just one half of the states ratify the amendment for it to take effect. This set of ratifying states could conceivably be the smallest 14, with less than 20 percent of the population.

The bureaucracy in India has played a crucial role in the country's governance since independence, and this role has been an important aspect of the conflicts over the degree of centralization. In particular, the structure of the IAS, with state IAS officials implicitly subordinate to their senior colleagues at the center, in addition to political leaders in the state, has facilitated central control. Political centralization of political and economic authority reinforced this effect, since it increased the incentive for state bureaucrats to look to the center for decision-making guidance. This situation, in many respects, reflected the intention of the framers of the Constitution, carrying on the tradition of the colonial Indian Civil Service as the 'steel frame' of the nation.

The Indian Police Service (IPS), which is the superior officer cadre for the police in India, is organized on similar dual lines to the IAS, that is, centralized recruitment and bureaucracy In power and prestige, the IPS follows only the Indian Foreign Service and the IAS. The fact that the IPS is a central bureaucracy, as in the case of the IAS, puts its members on a different footing than members of state police forces, and facilitates central control. While each state has its own police force, the central government possesses several police forces also. The Central Reserve Police (CRP) was created by legislation in 1949, before the division of powers assigned by the Constitution in 1950. It is meant to be used for assisting states in times of large-scale public disorder, and for guarding frontiers, and directed by an inspector general in the central Home Ministry. Other centrally controlled enforcement agencies include the Border Security Force (BSF), and the Railway Protection Force. All these together give the Central government considerable power over policing, well beyond what might be suggested by the constitutional assignment of powers. In practice, therefore, the center has taken a substantial role in the maintenance of law and order, sometimes usurping the states' constitutionally assigned responsibilities in this area. Furthermore, this role has often shaded into control or suppression of insurrections, popular protests and secessionist movements.

To some extent, the use of central police forces to aid in the objective of preserving law and order as well as national unity is problematic for the federal division of powers, since it erodes the authority of the states. At the same time, one can argue that a role for the police in these cases is preferable to involving the army. In fact, the army has also been heavily involved in quelling some secessionist movements. Despite this

[20] Kapur and Mehta (2006, p. 29) give the example of international trade agreements on agriculture, which is itself in the State List, while international affairs are in the Union list.

extension of the army's functioning beyond narrow national defense, the armed forces have stayed relatively detached from politics, and have certainly not directly sought political power. This forbearance represents a major positive feature of Indian democracy. In short, the use of force to preserve national unity has been achieved without this force being turned inward on, and destroying or corrupting core democratic institutions. One can conjecture that the heterogeneity of India, without a single dominant ethnic or linguistic group, has served a constraining role on the armed forces.

While the institutional framework has remained relatively unchanged, practice has varied with respect to the functioning of the legislative and judicial branches, and of the bureaucracy. One can identify changes in the nature of political cohesion and balance as the key drivers of this process. In particular, the nationalist coalition encapsulated in the immediate post-independence INC eroded over time, with opposition emerging on both sides of the ideological spectrum, as well as through smaller parties based on a combination of regional and other (class, caste, ethnic) interests. When the INC began to lose legislative control in some states, political and constitutional conflicts became more open. The states, which are, by history and by construction, relatively linguistically and culturally homogeneous did successfully exert pressure on the center in some cases (for example in redrawing state boundaries).[21] Often, this pressure was expressed through street politics, more in the tradition of the independence movement, than through electoral competition.

Periodic attempts to ameliorate open conflicts in center-state relations through the appointment of various expert commissions led to some institutional innovations (e.g., the creation of the ISC), but not to any fundamental constitutional changes in the federal balance. However, the rise of regional parties in the states, which began relatively early in India's post-independence history, but accelerated in the 1980s and 1990s, was in many ways a natural evolution of India's democratic practice toward a situation that matched its size and heterogeneity. These regional parties, in addition to dominating subnational politics in several states, have also come to hold the balance of power in coalitions at the national level. Economic reforms that began in the same decades of the eighties and nineties paralleled and accentuated this process of political decentralization. Some aspects of these reforms are discussed further in Section 7. In brief, what they did was to loosen central controls on economic activity, thereby giving the states more leeway in economic policymaking. In turn, this has tended to make state-level assignments more attractive for many bureaucrats, and reduced, to some extent, the centralizing effects of the nation's administrative structures. Without being able to quantify a comparison, one can also suggest that administrative decentralization has not proceeded as far as the political decentralization that has occurred as a combined result of national level coalition governments and economic policy liberalization.

In the last two decades, the Supreme Court also began to exercise more strongly its potential power to provide checks and balances on the legislative/executive branch. From the perspective of federalism, most important were decisions it made the 1990s,

[21] Regional groupings also have led to several UTs on the periphery of the country becoming full-fledged states, and to the recent splitting of three large states. The former cases are discussed in Section 8.

circumscribing the center's ability to override subnational political authority by means such as dismissing state legislatures. In particular, the use of Article 356 has been challenged more successfully, and its invocation has declined.[22] On the other hand, the Supreme Court has not articulated any consistent position on the division of powers across levels of government. In fact, the Court has recently also tended to engage in some forms of judicial activism in enforcing laws, even at the local level. These actions replace legislative and executive centralization with judicial centralization. However, the cases where the Court has ruled involve issues such as pollution and zoning, and do not have significant implications for issues of 'holding together' through centralization of government.

6. Holding Together – Fiscal Federalism

A key economic aspect of national unity is the existence of a national common market. As pointed out by Weingast (1995) in his formulation of market-preserving federalism, the center must constrain subnational units to ensure that a national common market is sustained. The framers of the Constitution of India were aware of the need for a common market, but also included a major escape clause. 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.

In practice, the most significant fiscal impediment to free inter-state trade has been the manner in which states levy inter-state sales taxes. In general, sales taxes have been levied by exporting states on the inter-state sale of goods, making the tax origin-based. On the other hand, the Constitution's framers intended that the sales tax system in India should be destination based. While there is no clear theoretical argument for choosing one taxation principle over the other, clarity and consistency in tax administration are virtues, and these were lost in the evolution of sales taxation in India. According to Article 286 of the Constitution, "No law of a state shall impose, or authorise the imposition of the tax on the sale or purchase of goods where such sale or purchase takes place (a) outside the state, or (b) in the course of import of goods into, or export of goods out of, the territory of India." This principle was gutted very early on. Based on the recommendations of a taxation commission in 1953, the Sixth Amendment to the Constitution added clauses that enable the central government to levy taxes on inter-state transactions. Under these new provisions, the central government authorized the states to levy a tax on inter-state sales, subject to a specified ceiling rate (4 percent).

A further problem in tax assignments lies in an inconsistency in constitutional provisions. Although Article 286 does not allow restrictions on inter-state transactions,

[22] Brass (1994) argues that the earlier increased use of Article 356 to impose President's Rule in the states was a response to increasing political decentralization, rather than an indicator of a movement in the other direction. This is not inconsistent with the argument here, which suggests that what Brass highlighted was a temporary phenomenon and unsuccessful response in the long run.

entry 52 in the State list empowers the States to levy tax on the entry of goods into a local area for consumption, use or sale. In many states, the tax has been assigned to urban local bodies (octroi). In some states, the local entry taxes were eventually replaced by state entry taxes. Thus, taxes are levied not only on the exports from one state to another but also on all imports into local areas, including imports from other states. These entry taxes are destination-based, so the problem of inter-state taxation has had another side as well as those created by the amendment to Article 286.

The arena of intergovernmental transfers has been a major avenue for the center to influence state governments – not necessarily to prevent secession, but certainly to buy political support. Chhibber (1995) explains the deepening of 'rent-seeking' in the 1970s and 1980s – including the persistence of the economic policies that make it possible – in terms of the intensifying needs of political competition. Essentially, powers of patronage for electoral support became more important, overwhelming any concerns about the inefficiency of the system from the perspective of economic growth. Chhibber provides empirical evidence that central loans, food assistance and subsidies to the states were all linked to electoral considerations.

Rao and Singh (2005), Kapur and Mehta (2005), and others have argued that large payments were directed by the center in the late 1990s to the states (Andhra Pradesh and Punjab) from which regional parties that were key coalition partners originated. In this case, the political support mechanism was more direct, the objective being to build a majority coalition in parliament after elections, whereas in Chhibber's analysis it derived from the pre-election need to mobilize state-level political resources for national elections. Rodden and Wilkinson (2004) also find empirical support for the proposition that distributive politics in India changed in the 1990s as a result of the shift from single party dominance to coalition governments.

Many other studies examine the impact of central government transfers on state-level policy choices, and mostly find evidence of political motivations in some transfer channels (e.g., Biswas and Marjit, 2000; Rao and Singh, 2002; Das-Gupta, Dhillon and Dutta, 2004; Khemani, 2004, 2006a,b; Purfield, 2003; Singh and Vasishtha, 2004). Thus, the evidence suggests that the central government tries to influence voters at the state level through this indirect mechanism.[23] Again, most of the states do not typically have a credible exit option, but transfers can be seen as aiding the achievement of cooperative outcomes, with less severe alternatives as threat points in bargaining: the models discussed in Section 2 include precisely this sort of logic. The peripheral hill states of India are in a somewhat different category, and are discussed separately in Section 8.

[23] One complicating factor for these studies is the de-linking of national and state-level elections, which now typically occur at different times, rather than simultaneously, as was the case in the first two decades after Indian independence. On the other hand, Khemani (2001) looking at both national and state elections, finds evidence that voters reward (punish) governments for good (poor) economic performance, but do so more vigilantly at the state versus the national level. This result is consistent with recent survey evidence, which indicates voters look primarily to state governments for provision of many important public goods (Chhibber, Shastri and Sisson, 2004).

Other aspects of center-state fiscal relations include implicit transfers, particularly through subsidized direct and indirect lending to the states. Rao and Singh (2005, Chapter 9) examine such transfers in detail, and attempt to quantify them. Unlike explicit transfers, which are weighted toward the poorer states (within the class of general category states), implicit transfers tend to favor states with higher per capita incomes. It is conceivable that this is just a side effect of policies whose chief aim is to support investment with more favorable social returns. However, the pattern of implicit transfers is also consistent with an objective of avoiding conflict with states that may have more economic clout in the federation (Rao and Singh, 2002). The 'holding together' function that is typically served, therefore, is with respect to the political coalition that rules at the center, rather than of the federation itself. However, it is also true that a systematic bias in the transfer system against some constituent units could eventually lead to separatist pressure. Implicit transfers provide an escape valve in such cases. In one case, that of Punjab, such transfers seem to have been driven partly by an explicit separatist movement. Loans were made to the state for combating this movement, and then later forgiven. One could argue that the resultant transfer represented a special-case compensation for increased costs of maintaining law and order, but it is plausible that some of this money was simply an additional payout to the state.

7. Federalism, Distribution and Growth

Economic liberalization in the 1980s and 1990s coincided with, and probably contributed to, increased regional inequality (e.g., Ahluwalia, 2002; Singh et al., 2003; Singh and Srinivasan, 2005). The reforms of the 1990s gave state governments more freedom to make policies independently, and those states which had favorable initial conditions were more able to attract new capital to their jurisdictions. At the same time, the fiscal deficit, which deteriorated at the central level, and then was reined in, early in the 1990s, began to balloon again, especially at the state government level, in the second half of the 1990s. This increase in deficits was tied partly to the states' greater discretionary policymaking, compression of central government spending, pay raises for civil servants, and ultimately to the need to buy political support in an era of increased political competition and coalition governments. Burgeoning deficits represented a threat to growth, since they increased the likelihood of a fiscal crisis.

The center responded to the severe deterioration of the states' fiscal positions with various attempts to create new budgetary control mechanisms and institutions. Previous mechanisms had included intra-party bargaining, borrowing controls enforced by the central bank (the Reserve Bank of India, or RBI), and bureaucratic traditions. The first and third of these began to erode even before the 1990s, while the RBI's oversight became less effective as economic liberalization which gave state governments more freedom of action. Essentially, the Indian federal system had to be redesigned for the new economic environment, and this had to be done in a transparent manner, perceived as fair and reasonable by the states.

Initial attempts to impose conditions on state borrowing that would encourage fiscal reforms, were relatively unsuccessful. For example, in 1999-2000, eleven states signed Memoranda of Understanding (MOUs) with the center, promising fiscal reforms in exchange for ways and means advances (essentially, overdrafts) on tax devolution and grants due to them. However, this approach was temporary and limited in nature, and therefore lacked credibility of commitment. In some cases, the center had to convert these advances into three-year loans. The RBI reported stopping payments to three states (Reserve Bank of India, 2001), but there was obvious political difficulty in not bailing out poor and populous states.

In a different approach, the Eleventh Finance Commission tried to build incentives for fiscal reform into the transfer system, but the manner in which these incentives were structured left them too weak to make a difference to state expenditure and borrowing decisions. The pool of money that was to be disbursed conditional on fiscal reform was too small to matter, and the criteria were perhaps not simple and clear enough. The lack of an integrated assessment and control of state finances, and the existence of multiple channels of intergovernmental transfers also contributed to the relative failure of this approach, since there continued to be alternative sources of funds for the states who might be penalized.

The alternative that seems to have worked partially is that of commitment to explicit targets through fiscal responsibility legislation. The central government passed its own Fiscal Responsibility and Budget Management (FRBM) Act in 2003, laying down specific targets for deficit reduction. The state governments subsequently followed the center's lead. The RBI provided model legislation, and the Twelfth Finance Commission recommended tying debt relief and restructuring for the states to their passage and implementation of FRBM laws, to extend the scope and impact of such laws to all the states. The Twelfth Finance Commission also recommended minimum provisions for state level FRBM laws. While issues remain of enforceability of such laws by sovereign governments, or by subnational governments that can count on being bailed out, this legislation gets closer to making explicit and credible commitments. Initial assessments of the impact of the state FRBM laws are quite positive (e.g., Howes, 2005). The laws, though not a necessary route to fiscal consolidation, have had a positive effect on states' fiscal positions.[24]

The connection between the system of intergovernmental transfers and growth has now also begun to receive attention (Singh and Srinivasan, 2007). Understanding the connection requires modeling how subnational governments can affect their tax bases. Subnational government decision-makers can either capture rents, or increase their jurisdiction's income, and hence its tax base. Hence, the marginal subnational retention rate of *all* taxes levied on the subnational tax base matters (Careaga and Weingast, 2001), with a lower rate leading to rent capture at the expense of growth. Singh and Srinivasan (2007) provide some illustrative calculations that suggest that the effective marginal

[24] One can conjecture that such laws, especially without sanctions for failing to meet targets, are a symptom or symbol of a political consensus with respect to fiscal consolidation, rather than an exogenous constraining factor.

retention rate in India may be quite low, and they discuss some possible reforms. Such reforms can be undertaken in a manner that does not have serious distributional effects across states, and therefore should be politically feasible. Indeed, one can argue that reforms that increase growth or sustain higher growth make it easier to achieve redistributions necessary to peacefully sustain unity of the federation. Increasing regional inequality, and the limited horizontal equalization achieved under the current system of intergovernmental transfers together imply that a more effective system of addressing regional inequality is required. It will be important to achieve this without dampening growth.

8. Asymmetries and the Periphery

Asymmetric arrangements in Indian federalism have a long history and varied motivations. In unifying the country under their rule, the British gave the princely states some autonomy. At independence, some individual rulers received differential treatment. The Constitution classified the states into four categories. The provinces directly ruled by the British were classified as Part A states. Those princely states that had a relationship with the Government of India based on individual treaties signed were classified as Part B States. These included the states of Hyderabad, Mysore, Jammu and Kashmir and five newly created unions of princely states.[25] In the case of Jammu and Kashmir, the special powers were given in the terms of accession. The remaining princely states acceding to the union were grouped under Part C states. Finally, the territories ruled by other foreign powers (French and Portuguese) – when eventually absorbed – and areas not covered in the above three categories were brought under the direct control of the center to form Part D states or Union Territories. Most of these distinctions eroded fairly quickly in the decade after the Constitution came into effect, as state boundaries were reorganized, and administrative structures were developed further.

A partial exception to the homogenization of center-state relations was that of Jammu and Kashmir,[26] which included several diverse populations and regions, but had an overwhelming Muslim majority in the Kashmir valley. The state also bordered the new Muslim nation of Pakistan. The history of the conflict over Kashmir has been written on extensively, and remains subject to debate. For present purposes, we note that the state acceded to the Indian Union under very special terms, subsequently incorporated in Article 370 of the Constitution. This article provided the state with a unique position in the Indian Union, with its own constitution, a title interpreted as the equivalent of Prime Minister for its chief executive, and a special assignment of functional responsibilities. Specifically, the jurisdiction of the center was restricted to foreign affairs, defense and communications, with the state's legislature having residuary powers. This was a striking contrast to the situation of other states, where the center's assignment

[25] In the case of Hyderabad, explicit military force was used to annex the state into the union. Certainly, the military power of the center was important in achieving consolidation, even in cases where it was not exercised.

[26] A good discussion on the asymmetric arrangements in Jammu and Kashmir and North-Eastern States can be found in Arora (1995)

of responsibilities was much more extensive, and where the center retained residuary powers. Eventually, however, even Jammu and Kashmir's special constitutional provisions were eroded.

Another major example of asymmetric arrangements has been the northeastern region of India. At independence, this entire region except the North-Eastern Frontier Agency (NEFA) was administratively part of Assam province. First, several union territories were created by separation from Assam, based on cultural and ethnic divisions in addition to language differences. Now, this part of India contains the states of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura, or over a quarter of the Indian states. Of these, only Assam has a population comparable to other typical Indian states. Most of these states were upgraded from the status of Union Territories[27], this reclassification giving them, at one level, a political status equivalent to that of larger states such as Bihar, Madhya Pradesh and Uttar Pradesh. Each state carries equal weight in mustering the 50 percent of states required to ratify an amendment to the Constitution.

There are various clauses in Article 371 of the Constitution that accord special powers to the northeastern states. These provisions have been introduced through amendments, typically at the time of conversion of a UT to a state or, in the case of Sikkim, after its accession to India. The safeguards provided to these states through the special provisions of Article 371 include respect for customary laws, religious and social practices, restrictions on the ownership and transfer of land, and restrictions on the migration of non-residents to the state. State legislatures are typically given final control over changes in these provisions.

The eight northeastern states, together with Jammu and Kashmir and the hill states of Himachal Pradesh and Uttarakhand are classified as special category states. This terminology originates in the practices of the Planning Commission, which gives these states special status in dispensing plan assistance. The 11 special category states comprise about six percent of India's population, and contribute about 4.5 percent of its GDP: thus, they are poorer on average than the 'general category' states, though none is as poor as Bihar. In fact, the comparison is heavily influenced by Assam, the poorest of the special category states, although even without Assam, the special category states are less well off than the median general category state. The disparity in per capita incomes, however, is much less than the compensating disparity in transfers.

The special category states receive per capita central transfers over four times the level received by the general category states. Among the latter group, there is relatively minor variation in transfers by state per capita income level. Revenue effort is not very different between the two groups of states, so the result of the higher transfers is that special category states have much higher per capita government spending. The asymmetry in transfer amounts is driven to a large extent by the formulas for plan

[27] The UTs themselves were mainly created by separation from Assam. Meghalaya was directly carved out of Assam state, while Sikkim was formerly an Indian protectorate. See, for example, Brass (1994) for a chronology.

transfers flowing from the center to the state. First, 30 per cent of the central government's assistance for state plans is earmarked to the special category states, even though their population share is only about six percent. Second, 90 percent of plan assistance to special category states is given as grants, with the remaining fraction as loans, whereas the proportion of grants in the plan assistance to other states is only 30 percent.

It is possible to rationalize these differences in terms of cost disparities for provision of public services, but it is also plausible to argue that higher transfers to the states on the periphery partly reflect inducements not to attempt exit. This interpretation is consistent with a history of separatist movements among the peripheral special category states. Another reason for the large disparity may be the need for these states to participate more in national defense, but this justification may be difficult to distinguish from the 'holding together' motive. It is also the case that the small populations of this group (especially when Assam is excluded) imply that it is not very costly in the aggregate to increase central transfers to the group by relatively large per capita amounts. At the same time, the strategic benefits of holding on to the peripheral states are very large. These strategic benefits are also be joined by reputational concerns, that allowing a loosening of the center's grip on the periphery could trigger similar demands elsewhere in the country. Therefore, one can understand the asymmetries in Indian federal structures as providing clear institutional mechanisms, with flexibility as well as constraints, to keep the periphery within the Indian union.

9. Conclusion

Since independence, India has performed remarkably well in some respects, given its size and heterogeneity. It has stayed politically united, and maintained a robust democratic system, now extended to the local level as well. Growth and human development, where the nation was an underachiever, have also begun to improve more quickly. To some extent, the country's performance has been determined by a balance of interests, regional as well as in other dimensions such as class and caste. At the same time, India's federal system has been important in allowing these disparate interests to exercise their preferences. In addition to legislative institutions, administrative structures and judicial institutions have been important components of federalism in India.

Over time, relative political and economic centralization have given way to a more truly federal framework, with greater autonomy for subnational units. Institutional innovations have been incremental, and in some respects have yet to catch up with the new political and economic environment. The intergovernmental transfer system, tax system and assignments of expenditure responsibilities all are in need of reform (Singh, 2007). An overarching issue may be that of how to reform the institutions that govern bargaining among the center and the states. The national government has responded in various ways to conflicts in the past, with short-term carrots and sticks, but most effectively with institutional changes that allowed more subnational autonomy while preserving the core unity of the nation.

Singh and Srinivasan (2007) have provided several specific suggestions for longer-term institutional reform, with a focus on the objective of maintaining high growth rates. However, this goal has to be achieved without disrupting the distributional bargain that is implicit in the Indian polity. To some extent, much of the recent political maneuvering in India has been driven by distributional concerns, not just regional, but also with respect to caste and class. The danger is that policies will be enacted that achieve redistribution at the expense of growth, once again, as happened in India's past. India urgently needs institutions for center-state cooperation and policymaking that avoid this unnecessary tradeoff.

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