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Indian Federalism, Economic Reform and Globalization*

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Abstract

In this paper we examine the interaction between globalization and India's federal system, in the context of the country's past decade of economic reform. In doing so, we explicitly recognize that the national government has subnational governments below it, and that all these layers of government simultaneously interact with foreign governments and corporations in a global economy. These multiple interactions have become more important as reform in India has opened up the economy to foreign trade and investment, and also reduced certain constraints on subnational governments. Globalization provides challenges as well as opportunities to federal systems such as India's and this paper seeks to elucidate what these are, as well as drawing implications for policy and institutional reform. We highlight the problems caused for the financial sector as a whole by state and central fiscal deficits. We examine the implications of the new ability of state governments to directly seek FDI. We discuss the possibility that privatization of the financial sector can discipline governments at all levels, and the possible role of capital account liberalization in achieving this. We review past and proposed reforms in the intergovernmental transfer and tax systems, and argue for harder subnational budget constraints. We discuss possibilities for politically acceptable packages of fiscal reforms. Finally, we examine issues of growing regional inequality, including the regional concentration of FDI in India's more liberalized economy. We also discuss the possibility that growing regional inequalities might require the intergovernmental transfer system to be more efficient and effective in its objectives. We examine how these possibilities may be compatible with the hardening of subnational budget constraints.

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Nirvikar Singh and T. N. Srinivasan

"India is a Union of States based on the framework of cooperative federalism. Within the cooperative framework, there is also a requirement to develop competitive strengths for the States so that they can excel at the national level and the global level. Competitiveness helps in ensuring economic and managerial efficiency and to be creative to meet new challenges. These are essential to survive and prosper in a fast changing world of today. In addition, in order to strengthen democratic processes and institution, we should all truly strive for substantive decentralization."

From speech by Dr. A.P.J. Abdul Kalam on his assumption of office as President of India
New Delhi, 25 July 2002

1. Introduction

In this paper we examine the interaction between globalization and India's federal system, in the context of the country's past decade of economic reform. In doing so, we recognize that the national government has subnational governments below it, and that all these layers of government simultaneously interact with foreign governments and corporations in a global economy. These multiple interactions have become more important as reform in India has opened up the economy to foreign trade and investment, and also reduced certain constraints on subnational governments. Globalization provides challenges as well as opportunities to federal systems such as India's and this paper seeks to elucidate these, as well as drawing implications for policy and institutional reform.[1]

In economic terms, globalization can be taken as the increased international mobility of goods, capital, labor and knowledge. A cornerstone of Indian economic reform has been opening up to flows of goods and factors, thus integrating more closely with the global economy. [2] In Section 2, we review the process of economic reform in India and the outcomes in terms of growth and other economic performance indicators. Within the context of opening up the economy, we can conceptualize reforms as falling into two groups, the first involving redrawing of state-market boundaries, and the second concerned with reconfiguring governmental institutions themselves, at several levels of the federation. The first group includes financial sector reforms, assignment of regulatory powers, infrastructure development, and privatization. The second group includes tax reforms, reform of center-state fiscal transfer mechanisms, and decentralization.

Section 3 provides an overview of India's institutions of federalism. We summarize the legislative system, which is the essence of the federal structure (because it institutionalizes constituents' expression of subnational authority), as well as federal

[1] For examples of recent interest in the intersection of federalism, globalization and economic policy see Sáez (2002), which is specifically on India, but includes some comparisons to China, and the journal symposium introduced by Watts (2001), which covers a wide range of countries and political and economic issues.

[2] See, for example, Srinivasan and Tendulkar (2002).

aspects of various branches of government, including the judiciary, bureaucracy, and regional aspects of India's political parties. We then describe the constitutional assignment of powers to different levels of the federation, including tax and expenditure assignments. We summarize the intergovernmental transfer system, both in terms of its initial conception, as well as its subsequent evolution. Finally, we discuss the formal and informal institutions of intergovernmental relations, such as the National Development Council and the Inter-State Council.

Section 4 examines the interaction of globalization and India's federal system by looking at national vs. subnational reforms. For example, greater openness has increased competition for Indian manufacturing, but both federal and state level controls on product markets substantially hinder the achievement of competitiveness, despite the removal of many industrial-licensing controls. We examine the extent to which state and central policies may need to respond, based on the constitutional assignments of authority. For example, agricultural policy reforms will require a joint approach. We examine the impact of labor market restrictions and government ownership, and the possible role of the center and states in policy reforms. Finally, we touch on infrastructure issues, such as the extreme problems of the state-owned power sector, and the important federal dimensions that make reform more difficult there. In discussing the financial sector, we highlight the problems caused for the financial sector as a whole by state and central fiscal deficits. We trace this problem to the continued importance of the central government in controlling the financial sector, including the effective 'parking' of fiscal deficits in the banking sector. We examine the changes in policy with respect to foreign direct investment (FDI), and the implications of the new ability of state governments to directly seek FDI. We discuss the possibility that privatization of the financial sector can act as a disciplining device on governments at all levels, and the possible role of capital account liberalization in achieving rapid, effective privatization of the financial sector.

In Section 5 we turn to issues of intergovernmental relations in the context of reform. Thus we view the reform process as encompassing the federal system, rather than just interacting with it. We review the ongoing process of strengthening local governments, as well as past and proposed reforms in the intergovernmental transfer and tax systems. We examine the role of the tax system in promoting or hindering the emergence of a unified internal market for goods and services in India, and the potential for reform of tax assignments, tax rates, and tax enforcement. We argue for harder subnational budget constraints as a feature of a reformed federal transfer system. To some degree, reforms in federal governance hold the key to opening the door to further reform elsewhere, by reducing the fiscal burden placed on the private sector by government deficits. We acknowledge the political economy aspects of reform of governance, and discuss possibilities for politically acceptable packages of fiscal reforms, such as combinations of changes in tax assignment that would be acceptable to the center as well as the state governments. We also examine issues of growing regional inequality in the context of an economy with fewer barriers to the movement of capital. We relate this to possible implications for regional policy, tax assignments, the intergovernmental transfer system, and the need to harden subnational budget constraints. Section 6 is a summary conclusion, where we tie in our discussion of real and financial sector reforms and

reforms of federal governance with globalization as a process that provides both pressures for change and instruments to achieve positive change.

2. Overview of India's Economy and Recent Reform

India is a large and poor developing country. After independence in 1947, it pursued economic policies that gave the government a primary role in promoting economic development. While the country's size dictated some kind of federal structure, the arrangements that were adopted in the Constitution (ratified in 1950), and their subsequent evolution gave the central government a dominant position vis-à-vis the constituent units of the nation (states and territories). India's leaders aspired toward an indigenous version of Soviet-influenced socialism, with government as benevolent guardian, leavened with a smattering of Gandhian influences in favor of smallness, self-sufficiency and rural traditions. The ruling Congress Party adopted a resolution in 1955 that to achieve a 'socialistic pattern of society' would be India's objective. This was later incorporated into the Constitution through an amendment in 1976.

Through the 1970s, India's economic growth was reasonable, averaging 3.75 percent per year, but this was not rapid enough to significantly diminish the number of poor people, nor to deal comfortably with the strains associated with governing a country with substantial ethnic, linguistic and religious diversity along with economic inequalities. Nevertheless, India was able to preserve its unity, as well as the political system of parliamentary democracy adopted in its early years. However, this political stability was accompanied by the evolution of an economic system riddled with increasing rigidities, inefficiencies and corruption, the so-called 'license-quota-permit raj'. This system was accompanied by political and economic centralization, with Soviet-style development planning, but with looser implementation, largely determined at the national level. Some states, such as West Bengal and Kerala, did pursue more independent policies, but this was within centrally determined constraints. However, no state government seriously challenged the 'socialist' approach to economic management. At the same time, with some state-level exceptions (e.g., West Bengal and Kerala), there was relatively little progress in potentially socialist policies such as land reform, or universal primary education.

In the 1980s, partly through fresh ideological influences, and partly through the observation of faster growth in many East Asian economies, India's economic policymakers at the national level began to seriously attempt some changes in the overall approach to the role of government in the country's economic development, introducing some liberalization in the trade regime, loosening domestic industrial controls, and promoting investment in modern technologies for areas such as telecommunications. While this reform process was restricted to the center, it coincided with some weakening of central political control by the end of the decade. Growth accelerated to 5.8 percent during 1980-90, but this came at the cost of macroeconomic imbalances (fiscal and current account deficits), which worsened at the beginning of the 1990s as a result of the collapse of the Soviet Union, which had become a major trading partner and ally, and of turmoil in the Middle East.

In 1991 India faced a severe balance of payments crisis, and this circumstance became the occasion for a substantial advance in the pace and nature of economic reforms that were being attempted. In particular, the major steps taken were further trade liberalization, in the form of reductions in tariffs and conversion of quantitative restrictions to tariffs, and a sweeping away of a large segment of restrictions on domestic industrial investment. These two changes in the early 1990s have come to symbolize or encapsulate the term 'economic reform' in India. Note that the collapse of the Soviet Union in 1991 and the stellar growth performance of China after its opening to the world economy and initiation of market oriented reforms in the 1980s were two very significant developments that forced systemic reform in India in the 1990s, as compared to a temporary liberalization (soon reversed) in an earlier balance of payments crisis in 1966. The more thoroughgoing nature of the 1990s reform also opened up space for action by state governments, as we discuss below.

The move to reduce the role of government in directly controlling the working of markets had additional implications. It was recognized that sectors such as finance and telecommunications required a new set of regulatory structures suitable for an environment in which bureaucrats were no longer making discretionary judgments on a case-by-case basis. This need was strengthened by the direct and indirect impacts of technological change in such sectors. Furthermore, it was recognized that removing industrial investment controls could not by itself solve India's problem of slow growth, but needed to be complemented by restructuring the working of the labor market, and by improving the economy's physical and institutional infrastructure. Achieving the first of these objectives has been hampered by understandable interest group pressures, while the second goal has been constrained by the continued high level of the government's fiscal deficit.

The high fiscal deficit, in turn, is traceable to subsidies to interest groups, as well as the nature of the interaction between the central and state governments. Table 1 summarizes the trends in central and state fiscal deficits over the 1990s.[3] It shows that much of the deterioration in the fiscal deficit has occurred at the state government level. Both the center and the states were severely affected by the large pay increases granted to central government employees in 1997-98, followed by similar increases at the state level the following year.[4]

Despite the internal political roadblocks to accomplishing comprehensive economic reforms, India was able to achieve a slight acceleration of growth in the 1990s as compared to the previous decade. However, growth statistics indicate that there was a deceleration in the latter half of the 1990s, even before the current global recession took hold. Tables 2 and 3 provide a summary of the size and structure of India's economy and

[3] For more detailed discussions of these trends, see Acharya (2002), Rao (2002) and Srinivasan (2002).

[4] This is an example of interest group pressures at work: the pay award was larger than that recommended by the technical advisory body, the Fifth Pay Commission, and was not accompanied by the reduction in staffing that the Commission also recommended. See Acharya (2002) and Srinivasan (2002) for further discussion.

changes over time (Table 2), and economic performance along a wide range of dimensions over the last two decades (Table 3). One of the striking features of growth in the last decade has been the anemic performance of Indian industry, and the associated lack of a shift from agriculture to industry in the share of GDP. On the other hand, services have done well, partly as a result of the boom in software exports and, more recently, in IT-enabled services such as call centers. These aspects of services, and remittances from non-resident Indians have contributed to India's reasonably good export performance, and to its avoidance of further balance of payments difficulties.

From the perspective of trying to capture the benefits of participating more fully in the global economy, reform, though triggered by a short-run crisis, must also be viewed in the context of long-run globalizing trends. Globalization may bring down prices of some goods, lead to more efficient allocations of factors, and allow relatively capital-scarce countries such as India to gain greater access to foreign capital and technology for enhancing economic growth. This is the standard way in which openness supports private (and potentially also public[5]) economic activity. From the perspective of the government, however, there may be new challenges in a world of factor and goods mobility. The ability of the government to tax is affected, since mobile factors can escape the incidence of taxes that initially are placed on them. Furthermore, regulatory policies can be subject to similar problems in the face of factor mobility, as in fears of races to the bottom in regulatory standard-setting.

The reforms of the 1990s gave state governments more freedom to make policies independently,[6] and this has extended the impacts of openness and globalization to the subnational level. In particular, while only the national government can determine import duties, state governments now can affect the incentives of foreign capital to enter their jurisdictions. From the perspective of an Indian state, capital from another country or from another state can be viewed through the same lens, and must be treated equally in typical policy environments. The final impacts of the entry of capital on a subnational government will therefore depend also on the internal mobility of capital and labor. Hence, in a federal system, attention must be paid to internal mobility of goods and factors, in addition to external liberalization. Subnational tax and regulatory policies can assume greater importance in a scenario of economic reform under globalization. A further consideration is that the fiscal health of the states that results from their policies is likely to impinge on the entire nation's credit rating in world capital markets.[7] We shall explore these aspects of India's subnational economic reforms in Sections 4 and 5.

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[5] This is particularly the case when the government produces private goods.

[6] The responses of the states were varied, as were the results. Bajpai and Sachs (1999) provide a detailed survey and scorecard of the efforts and outcomes for 15 major states, arguing that the enthusiastic reformers have done better in terms of human development as well as narrow economic well being. They treat the states as independent actors (within constraints imposed by the center), whereas in this paper we emphasize the interactions and overlaps of national and subnational reforms.

[7] The mechanism by which this occurs can be indirect, through contingent liabilities arising from explicit central counter guarantees for state guarantees to foreign corporations, or direct, through the observation of larger deficits for the center and states combined.

Another federal aspect of India's reform is that the decade of the 1990s has seen an increase in regional inequality in some dimensions. While inequalities may have widened within states as well (for example, the coastal and urban areas of Maharashtra and Gujarat versus their interior rural regions), the main focus has been and will be on widening disparities across the states themselves. This is natural, given the size and political importance of the states, and the fact that the states are the direct and indirect channels for significant financial transfers from the central government. We also consider whether aspects of economic reform, larger global economic forces, and state-level initial conditions and policy responses are increasing regional inequalities within the country, and whether the mechanisms that exist within India's federal structures for managing regional inequalities are adequate.

To conclude this section with a return to the national-level overview, underlying the aggregate performance statistics in Tables 2 and 3, we have a story of incomplete economic reforms, with sectors such as agriculture still shackled by an inefficient public procurement and distribution system and severe input market distortions, industry hampered by small scale reservations and inefficient financing, a financial sector still dominated by direct and indirect public control of investible resources, and labor market rigidities that hamper the entire organized (as opposed to informal) segment of the economy. Liberalization of trade and foreign investment – the 'globalization' aspect of India's reforms – has helped in some areas, but has not been sufficient to promote widespread competitiveness, nor to overcome or rectify the poor state of India's infrastructure. Thus the economic reform agenda in India remains lengthy as well as complicated.

3. India's Federal Structures

Political and Administrative Structures

We preface a discussion of the institutions and mechanisms that govern fiscal federal arrangements in India, particularly center-state transfers and loans, with an overview of India's broader federal structure. India is a constitutional democracy, comprised of 28 states, and seven "Union Territories" (see Figure 1). Of the seven, two Union Territories (Delhi and Pondicherry) have their own elected legislatures whereas the rest are governed directly by appointees of the center. All the states have elected legislatures, with Chief Ministers in the executive role. Each state also has a Governor, nominally appointed by the President, but effectively an agent of the Prime Minister. The Governor normally has only a minor political role at the state level. However, Governors have, in the past, used special constitutional provisions (notably Article 356) to dismiss elected legislatures, though this practice has been reined in more recently. The constitution also assigns certain statutory powers to the states: the exact nature of this assignment, and how it has played out in practice, determine the extent of centralization within the federation.[8]

[8] There are various special provisions (e.g., affecting scope of governance and local property ownership) with respect to the northeastern hill states, and even more so for Jammu and Kashmir (Article 370), though the latter's constitutional autonomy has been reduced over time. This reduction represents a relatively easy amendment procedure, which has tended to increase centralization: examples of this tendency are offered

In addition, since many of the Indian states are quite large in terms of population (with the largest dozen being comparable in population to larger European countries), devolution of powers to the states without any further decentralization below that level may still represent a relatively centralized federation. In practice, devolution of economic and political power to both the states and to local government bodies has arguably been weak compared to other federal systems, since both constitutional assignments and the subsequent exercise of legislative powers have tended to be in the direction of greater centralization. Centralization has also been reflected in bureaucratic and judicial institutions and their interactions with the legislative/executive branch of government, as we elaborate below.

The primary expression of statutory constitutional authority in India comes through directly elected parliamentary-style governments at the national and state level, as well as nascent directly elected government bodies at various local levels.[9] In legislatures at each level, there is the usual playing out of bargaining among individuals, factions and parties, as analyzed theoretically by authors such as Baron and Ferejohn (1989) and Inman and Rubinfeld (1997). Regional and personal factions have always been important in Indian politics, but the main spoils have typically been control of various ministries, rather than provisions attached to specific pieces of legislation. There have been some ideological factors at work in Indian politics (various shades of socialism, for example), but they are often dominated by material interests.

To the extent that the essence of federalism is based on representative democratic politics at the subnational level, the role of political parties in the interactions between central and state level politics is a crucial aspect of federal structures. To illustrate, consider the extreme case where government powers are notionally decentralized, with all residuary powers assigned to the state level, but the national and all state governments are controlled by a single, rigidly hierarchical political party. Here the outcome will effectively be the same as in a centralized, unitary system, since decisions are made at the top of the political hierarchy. For example, during the Nehru era, the Prime Minister’s personal authority and prestige were combined with almost complete legislative control of the center and the states by the Congress Party led by Nehru. In such circumstances, issues of center-state relations were often played out within the ranks of the Congress party.

Over time, Indian political parties have embodied varying degrees of centralization, including the regional political bosses of the earlier Congress party,[10] the tightly controlled personalized approach characteristic of the later Congress under Indira

later in this section.

[9] These are all single constituency first-past-the-post elections, but with some seats reserved for disadvantaged groups, such as Scheduled Castes (erstwhile “untouchables”) at each level.

[10] Following Manor (1995), we may characterize the Congress party structure itself as federal in nature at this time. In some respects, however, Nehru’s personal authority after independence allowed him to dominate decision-making, as we have noted above. The pre-independence Congress was actually more decentralized, with provincial units playing a significant role, and provincial leaders being powerful in their own right, with prominent positions in the formal party hierarchy.

Gandhi, the more institutionalized hierarchy of the BJP, which is currently the main ruling party, and the emergence of explicit regional parties, which have often been partners in ruling coalitions in the last few years. Certainly, in the last decade, regional parties throughout the country have become significant as a political force. Overall, however, we may argue that the institutional expression of federal or centralized structures within political parties has not been a major independent factor in shaping India's federal system, because other forms of central control, administrative, legal and fiscal, have mattered more.[11] As an example of central control, Article 356 of the Constitution has been used quite liberally to replace or suspend elected state governments that were deemed unsatisfactory by the central government.[12]

More recently, following a provision in Article 263 of the Constitution, and recommendations of the Administrative Reforms Commission in 1969 and the Sarkaria Commission on Center-State Relations in 1988, 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. The ISC includes the Prime Minister, state Chief Ministers, and several central cabinet ministers as members. While the ISC is merely advisory, and has been viewed as weak – especially since central governing coalitions give regional parties more direct say in policy (Majeed, 2002) – 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.[13] Another, similar, body is older than the ISC, but narrower in scope. The National Development Council (NDC) serves as a forum for bargaining over five year plan allocations (see below). The NDC is chaired by the Prime Minister, and its members include all cabinet ministers at the center, Chief Ministers of the states, and members of the Planning Commission.

The next level of governance that embodies aspects of federal structures is the bureaucracy. Just as elected politicians ideally act as agents of their constituents, bureaucrats in turn act as the agents of elected officials. Bureaucrats, as career

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

[12] The use of Article 356 appeared often to violate the spirit of the provision, which was designed for situations of government breakdown. It was in invoking Article 356 that state governors became direct agents of the Prime Minister. Often, removal of a state government was followed by lengthy direct rule by the central government. Interestingly, the central government has retreated substantially from this approach in the last few years, helped by a stand taken by the President at the time.

[13] Sáez (2002) provides a detailed history of the conception and creation of the ISC, as well as an assessment of its working to date (Chapter 4). In his conclusion, he characterizes the ISC as 'a disappointment' and 'far from being effective' (p. 216). While he is right in pointing out the many weaknesses and failures of the ISC, particularly with respect to changing Article 356, or enabling implementation of its many recommendations, we have noted instances of its usefulness in developing agreement on specific institutional reforms that have federalist dimensions. Kapur (2001) provides other examples as well. To understand precisely where the ISC plays a positive role, note that it has not succeeded in implementing its own, independent agenda, but is able to facilitate intergovernmental agreement on issues brought to the table by the center. In Section 5, we discuss the potential for expanding such a role, *contra* Sáez's view of the ISC as 'emblematic of a broader failure of inter-governmental institutions in India' (p. 216).

employees, are partly insulated from political whims and pressures, but ultimately in a democracy must be subordinate to elected representatives. Therefore a unitary, hierarchical bureaucracy cannot by itself negate a federal political structure in the same way that a powerful, centralized, national political party might. However, a centralized bureaucracy can act as the agent of such a political party, against the requirements of a federal system. There are elements of such action in the workings of Indian bureaucracy.

The Indian bureaucracy is provided constitutional recognition. The central and state level tiers of the "public services" are given shape through the provisions of Part XIV of the Constitution. Since each political layer of government requires its own administrative apparatus, any bureaucracy in a federation will have a federal character. In particular, state governments must be able to appoint and dismiss[14] bureaucrats to implement state-level policies. This is certainly the case in India, where there is a central bureaucracy as well as an independent bureaucracy in each state.

The key component of the bureaucracy is the Indian Administrative Service (IAS). IAS members are chosen by a centralized process, and trained together. However, they are then assigned to particular states, and become, technically as well as in most practical matters, members of a state-level bureaucratic hierarchy as well. While an IAS member's entire early career is spent within the home state, and senior appointments at the state level carry considerable power and prestige, the greatest attraction lies with appointments within the central government. The structure of the IAS was designed as a compromise between the desire to have an effective apparatus at the state level, where most of the tasks of day-to-day administration, development, and law and order were assigned by the Constitution, and, on the other hand, the fear of promoting regional loyalties over national ones (with the further fear of national disintegration). However, this compromise has been somewhat problematic for the working of federalism, since conflicts arise between state and central politicians (the latter acting through IAS members assigned to the central government) in directing state-level IAS bureaucrats.

At the national and state levels, the judiciary constitutes a distinct branch of government, though the legislative branch influences appointments. At the local level, IAS members are vested with some judicial authority. In judging whether the law was broken and who broke the law, the judiciary acts as a specialized agent of elected officials who frame laws. The higher levels of the judiciary also act as judges of the laws themselves, within the context of the overarching legal and constitutional framework.

The Supreme Court stands at the top of the Indian judicial hierarchy. Its powers include broad original and appellate jurisdiction and the right to pass on the constitutionality of laws passed by Parliament. In practice, there has been conflict between the Supreme Court and the legislature/executive over the scope of these powers, and their boundaries remain subject to bargaining, though one can generalize that the Court has been

[14] In practice, dismissal is almost impossible, something that is true for the entire organized sector in India. However, state governments use (and misuse) the power to transfer bureaucrats to assert political control over the bureaucracy.

overshadowed by the central legislative/executive branch.[15] The President, in consultation with the Prime Minister, appoints Justices of the Court. At the state level, below the Supreme Court, are the High Courts. Each High Court's justices are appointed by the President, in consultation with the Chief Justice of the Supreme Court and the state's Governor. Paralleling the situation at the Center, the state's Chief Minister is in a position to influence the Governor's advice. High courts also have both original and appellate jurisdiction. In addition, they superintend the work of all courts within the state, including district courts, as well as various courts subordinate to the district courts. These subordinate courts are specialized, with smaller civil matters being separated out from criminal cases, for example. Criminal cases are dealt with in magistrates' courts, where IAS members serve.

The formal judiciary, therefore, is a well-defined hierarchy, with a relatively clear assignment of tasks. This assignment and hierarchy are overly centralized, because not enough matters are disposed of at lower level courts. This reflects a lack of resources devoted to lower level courts (though the resource problem exists at all levels), as well as a centralized assignment of scope of jurisdictions. The problem is compounded by the nature of the appeals process, and by the failure of higher-level courts to control appeals.[16] Also, judges below the state level are typically not appointed by local government officials, representing a significant departure from a federal system below the state level.

The inefficiencies of the judicial system in India reflect inadequate decentralization within the judiciary itself, but also inadequate delegation of powers by the legislative/executive branch. In particular, the expansion of state intervention in the economy that occurred in the first three decades after independence, with the central government encroaching on the states' assignments, was effectively outside judicial review. [17] Inadequate judicial power is a constitutional problem, because this delegation is absent in some of the particulars of the Constitution. A weaker central legislature in the 1990s appears to be allowing the Supreme Court to play a more effective checking role. However it does not solve the resource allocation problems that must be corrected for smoother working of day-to-day judicial functions.[18]

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[15] In early constitutional decisions, the Court placed fairly narrow limits on the power of the legislature to amend the Constitution, and in specific instances, has allowed the center to extend its powers over the states quite liberally (see footnotes 8, 12, 17 and 19). The executive, particularly under Indira Gandhi, has also tried to control judicial appointments to its advantage. Many of the broader issues of federal institutions are being considered by the current Constitutional Review Commission of India.

[16] 'Public interest petitions' to the higher courts, while democracy enhancing in spirit, have also sometimes been used for obstructionist purposes to benefit particular interest groups.

[17] Furthermore, the 42nd Amendment in 1976, during the Emergency declared by Prime Minister Indira Gandhi, moved the "Administration of justice; constitution and organization of all courts, except the Supreme Court and the High Courts" from the State List to the Concurrent List.

[18] The pressure for correction might come from competition among subnational jurisdictions pursuing commercial motives. As states and localities try to attract investment and commercial activity, they may come under pressure to provide supportive judicial systems. This argument applies to contract enforcement, or property rights enforcement more broadly, more than to the criminal justice system. In this respect, the lack of training of India's lawyers and judges in even rudimentary economics has sometimes led to judicial decisions with substantial negative impacts on the economy, as in judicial interpretations of labor laws.

Finally, the police have a special role, involving both the bureaucracy and the judicial system. Ideally, the police are impartial investigators and monitors, preventing violations of law where possible, and complementing the judiciary in enforcement. However, the police are also organized as a bureaucracy under the control of politicians – like other branches of administration, but unlike the judiciary, with its notional independence. The actual functioning of the police in India has become subject to politicization and the encroachment of the central government into law and order, constitutionally a state subject.[19] India has a variety of central and state police forces, with the Indian Police Service (IPS), the superior officer cadre, being organized on similar dual lines to the IAS. This puts its members on a different footing than members of state police forces, who are recruited directly by state governments, even though IPS officers are assigned to particular states.[20]

To conclude this description, we note that the existence of different dimensions of governance implies that a federal political system cannot exist simply through a constitutional assignment of responsibilities to different layers of government. Each level of government in a federal system must not only have authority to raise revenues, but it also must have the authority to carry out decisions made at that level. In India, the IAS, the IPS and the judiciary are all perhaps more centralized than they need to be, given the current federal political system. While independent India began with a relatively circumscribed federal model, independent political competition at the state government level has thrived in recent years. This decentralization has not been fully matched in the other dimensions of government, but may need to be for a more effective federal system to operate. The growing relative importance of regional parties, coupled with the tendency for regional concentration of 'national' parties such as the BJP and Congress, appears to be leading to some change in this direction.[21]

Assignments and Transfers

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

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[19] Item 2A in the Union List, inserted by the 42nd Amendment, gives the center power to deploy "any other force subject to the control of the Union." This need not always be a negative: for example, state governments may fail to protect minority rights, as in the case of Gujarat in 2002 – however, there the central government also failed to act.

[20] For example, recently the Chief Minister of Tamil Nadu, J. Jayalalitha, came into conflict with the center over the posting of IPS officers in her state.

[21] A separate issue from the degree of decentralization in federal administrative structures is that of corruption. While it can be argued that decentralization increases the inefficiency of corruption, which is pervasive at all levels, this is not a logically necessary consequence. See Singh (2004) for a discussion of these issues.

The Indian Constitution, in its Seventh Schedule, assigns the powers and functions of the center and the states. The schedule specifies the exclusive powers of the center in the Union list; exclusive powers of the states in the State list; and those falling under the joint jurisdiction are placed in the Concurrent list. All residuary powers are assigned to the center. The nature of the assignments is fairly typical of federal nations, and broadly fits with economist's theoretical rationale.[22] The functions of the central government are those required to maintain macroeconomic stability, international trade and relations, and those having implications for more than one state. The major subjects assigned to the states comprise public order, public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals. The States also assume a significant role for subjects in the concurrent list such as education and transportation, social security and social insurance.

The assignment of tax powers in India is based on a principle of separation, i.e., tax categories are exclusively assigned either to the center or to the states. Most broad-based (in principle though not in practice) taxes have been assigned to the center, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquors) and customs duty. A long list of taxes is assigned to the states. However, only the tax on the sale and purchase of goods has been significant for state revenues. This narrow effective tax base is largely a result of political economy factors that have eroded or prevented the use of taxes on agricultural land or incomes by state governments. The center has also been assigned all residual powers, which implies that taxes not mentioned in any of the lists automatically fall into its domain.

The tax assignment system has some notable anomalies. The separation of income tax powers between the center and states based on whether the source of income is agriculture or non-agriculture has opened up avenues for both avoidance and evasion of the personal income tax. Second, even though in a legal sense taxes on production (central manufacturing excises) and sale (state sales taxes) are separate, they tax the same

[22] 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. This does not in itself justify a federal governance structure. However, 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. The assignment of expenditure responsibilities then follows, taking account of economies of scale, access to resources, and externalities or spillovers. With respect to revenue authority, tax assignments are what matter as a first approximation (neglecting intergenerational issues), since the interest on borrowing must also come out of taxes. Allocational efficiency is the usual starting point here. For example, mobility across jurisdictions makes it harder for subnational jurisdictions to raise revenue from taxes than for the central government. Of course for internationally mobile factors, even national jurisdictions face problems in collecting taxes. Also, mobility depends on the relative benefits provided through public expenditures, so that jurisdictions can counter mobility by providing appropriate benefits at the margin to those who are taxed. Finally, tax coordination by subnational jurisdictions can be an effective alternative to central assignment (see Section 5). If efficiency implies that more taxes should be collected by the center, there will be a mismatch between revenues and expenditures for subnational jurisdictions. The result of the differing determinants of optimal assignments of expenditure and tax authorities can be a "vertical fiscal imbalance", where subnational governments rely on the center for revenue transfers.

base, causing overlapping and leaving less tax room to the latter. Finally, the states are allowed to levy taxes on the sale and purchase of goods (entry 54 in the State list) but not services. This, besides providing avenues for tax evasion and avoidance, has also posed problems in designing and implementing a comprehensive value added tax (VAT), as discussed further in Section 5.

The realized outcome of the Indian assignments of tax and expenditure authority, their particular history of implementation, and the response of different levels of government and tax payers to the assignment has been a substantial vertical fiscal imbalance. In 1998-99, the states on average raised about 35 percent of total revenues, but incurred about 57 percent of total expenditures.[23] The balance was made up by transfers from the center: perverse fiscal incentives for the states in this system have, in fact, increased the imbalance. Moreover, the ability of the states to finance their current expenditures from their own sources of revenues has tended to decline over time, from 69 per cent in 1955-56 to about 55 per cent in the 1990s. In terms of total expenditure, the states were even more dependent on the center, with only 44 percent of their overall spending being covered by own revenue in 1998-99.

The Constitution recognized that its assignment of tax powers and expenditure functions would create imbalances between expenditure 'needs' and abilities to raise revenue. The imbalances could be both vertical, among different levels of government, and horizontal, among different units within a sub-central level. Therefore, the Constitution 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. Recent constitutional changes in this scheme have simplified this sharing arrangement, and are discussed in section 5.[24] The shares of the center and the states, and their allocation among different states are determined by the Finance Commission, which is also a constitutional creation, and is appointed by the President of India every five years (or earlier if needed). In addition to tax devolution, the Finance Commission is also required to recommend grants to the states in need of assistance under Article 275.

So far, eleven Finance Commissions have made recommendations and, barring a few exceptions, these have been accepted by the central government. However, the methodology and processes of these Commissions have been criticized. The main criticisms are (i) the scope of the Finance Commissions through the Presidential terms of reference has been too restricted; and (ii) the design of their transfer schemes has reduced state government incentives for fiscal discipline (through 'gap-filling' transfers), while doing relatively little to reduce inter-state inequities. Note that larger government deficits at the subnational level and, to some extent, increases in inter-state inequalities in the last decade, are related to the functioning of India's intergovernmental transfer system. We shall return to these issues in section 6.

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[23] See Rao and Singh (2002), Table 1. Figures for subsequent years are quite similar.

[24] Seignorage revenue of the central government is not recognized in the Constitution, and is not shared with the states.

While the Finance Commission decides on tax shares and makes grants, a separate body, the Planning Commission, makes grants and loans (in the ratio 30:70 for the major states) for implementing development plans. Historically, as development planning gained emphasis, the Planning Commission became a major dispenser of such funds to the states. As there is no specific provision in the Constitution for such plan transfers[25], the central government channeled them under the miscellaneous, and ostensibly limited provisions of Article 282. Before 1969, plan transfers were project-based. Since then, the distribution has been done on the basis of a consensus formula decided by the NDC.[26]

The Planning Commission works out five-year-plan investments for each sector of the economy and each state. With this as background, the states work out their respective annual plans for each year, based on estimated resource availability, which potentially includes the balance from current revenue (including Finance Commission transfers), contributions of public enterprises, additional resource mobilization, plan grants and loans, market borrowings, and other miscellaneous capital receipts. At this stage, a certain amount of bargaining for resources goes on 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.

Finally, various ministries give grants to their counterparts in the states for specified projects, either wholly funded by the center (central sector projects) or requiring the states to share a proportion of the cost (centrally sponsored schemes). 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.[27] These projects are supposed to be monitored by the Planning Commission, and coordinated with the overall state plans.

There are over 100 such schemes, and several attempts in the past to consolidate them into broad sectoral programs have not been successful. These programs have provided the central government with an instrument to actively influence states' spending, replacing the 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, which recommended scaling down and consolidating centrally sponsored schemes, implementation of this was weak.

In addition to explicit transfers, intergovernmental loans, to the extent that they are subsidized, also constitute transfers to subnational governments. Ideally, borrowing should be to finance investment, but the state governments have increasingly used borrowing to meet current expenditure needs (approaching 50 percent in 1998-99). State governments can only borrow from the market with central government approval if they are indebted to the center, and this constraint binds for all the states. Central loans now

[25] The Planning Commission was established by a Cabinet resolution, and the constitutionality of its transfers has, in fact, been questioned.

[26] The 'Gadgil formula' is named after the Deputy Chairman of the Commission in 1969.

[27] For example, they can be for very specific local projects, and can have conditionalities such as employment requirements.

constitute about 60 percent of the states' indebtedness, with another 22 percent being market borrowing, and the remainder made up of pension funds, shares of rural small savings, and required holdings of state government bonds by commercial banks (Rao and Singh, 2002; Srinivasan, 2002). While these captive sources of finance are limited, the states have been able to soften their budget constraints further by off-budget borrowing or nonpayment by their public sector enterprises (PSEs). For example, the State Electricity Boards (SEBs) have been tardy in paying the National Thermal Power Corporation, a central PSE (Srinivasan, 2002).

There are other sources of softness in state government budget constraints. The central government guarantees loans made to state government PSEs by external agencies. The center has also in the past forgiven loans made to state governments, presumably to gain political advantage. Even in the case of attempts to impose conditions on state borrowing that would encourage fiscal reforms, the center has not been able to harden budget constraints. In particular, 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. In some cases, however, the center has had to convert these advances into three-year loans. The Reserve Bank reports stopping payments to three states (Reserve Bank, 2001), but the political difficulty of not bailing out states that are both poor and populous is obvious.[28] In section 5, we will connect up these problems with implicit as well as explicit transfers, in the context of economic reform efforts, fiscal deficits, and global pressures.

4. National vs. Subnational Reforms

Manufacturing

One result of greater openness since 1991 has been increased competition for Indian manufacturing. Ahluwalia (2002b) notes that Indian firms have upgraded technology and expanded to more efficient scales of production over the last decade. Among larger firms, there have been substantial changes in relative size, indicating a dynamism that was absent before the reforms. Despite these positive signs, India's manufacturing growth has been modest, and manufacturing exports have also not taken off. Many authors have noted the fact that India's rates of protection are still relatively high, contributing to a high cost of production. Continued federal and state level controls on product markets substantially hinder the growth of this sector. Rigid labor laws and poor infrastructure are other contributing factors to low productivity and high costs, as are rigidities such as small-scale industry reservations.[29]

While many of the problems of Indian industry can be traced to laws at the national level, it is becoming clear that state level reforms are also needed. For example, a study by

[28] These kinds of political considerations also constrain the center to make plan loans at the same interest rate to all states, removing that marginal incentive device as well. In this context, the ISC may have a greater role to play in constructing a broader bargain with respect to reform, as we discuss in Section 5.
[29] Significant progress on this front has been made very recently – see Mohan (2002a).

McKinsey & Company (McKinsey Global Institute, 2001) suggests, that, starting from a base of 5.5 percent GDP growth for India, reforms at the state level can add 2 percentage points to growth, almost as much as their estimate of the potential contribution of further reforms by the central government (2.6 percentage points). The McKinsey report identifies the top three roadblocks to higher growth as product market barriers, land market barriers, and government ownership. In the case of land markets in particular, state or local-level controls on land use, including protected tenancies, rent controls and zoning restrictions, are quite significant.[30]

The situation is complicated by the fact that state laws may piggyback, or be enabled by, central level legislation. Reform therefore requires a coordinated approach, since the center is often not in a position to nullify state legislation directly. In the case of labor laws, the main legislation is at the national level, in the form of the Industrial Disputes Act of 1947, the Industrial Employment Act of 1946, and the Contract Labour (Abolition and Regulation) Act of 1970. The national laws require firms with more than 100 workers to get the permission of state governments for closing plants or laying off workers. This permission is rarely given. However, state governments also have the right to restrict contract labor, and variations in their use of this power are significant. Another key source of variation among states is the way that worker safety laws are enforced, with government inspectors in some states using these laws as a significant vehicle of rent-extraction.[31]

Dollar, Iarossi and Mengistae (2002) have examined the quantitative impact of state-level variations in policy on manufacturing productivity. Using a survey of 1000 manufacturing establishments across 10 Indian states, they find that states that are poor performers, and identified by survey respondents as having a 'poor investment climate', have total factor productivity (TFP) that is 26 percent lower than the high-performing states. About a tenth of this gap is found to be due to a higher regulatory burden (specifically, labor market regulations) in the worse states. The advantage of such quantification, of course, is that it enables a basis for policy recommendations with respect to subnational reforms.

Agriculture

Opening the economy, reducing protection of industry and exchange rate depreciation have all helped India's agricultural sector by moving relative prices in its favor, and making exports more competitive. The growth performance of agricultural exports, as measured by the increase in share of world exports, has been somewhat better than that of manufacturing (Ahluwalia, 2002b). Nevertheless, there are significant areas where coordinated reforms by the center and the states can improve performance. Severe

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[30] For example, Chennai has less restrictive land use controls than Delhi or Mumbai, and has seen a faster growth of more efficient modern food retailing (McKinsey, 2001, p. 8). Note that inefficient and lengthy judicial proceedings (Section 3) compound the problems created by these and other laws. A caveat is that the McKinsey methodology is somewhat vague, and its downgrading of infrastructure as a constraint may not be accurate. Dollar *et al* (2002, see further in the paper), emphasize infrastructure.

[31] Forbes (2002, Table 4.2) details 11 kinds of mostly state and local inspection (factory conditions, taxation, etc.) According to him, eight of these have not changed in character since 1991.

distortions of both input and output prices have distorted cropping patterns and hindered diversification into higher value-added, non-food-grain crops. Some of the price distortions (fertilizers, outputs) are the responsibility of the center, whereas others (water, electricity) are due to state governments' subsidies. Restrictions on FDI and domestic distortions have also hindered development of agroprocessing industries.

At the same time that subsidies are removed, farmers need to be freed from a range of outdated laws and institutions. Some of these laws go back in spirit to World War II-era scarcities. The Essential Commodities Act empowers state governments to restrict the movement of agricultural products across state and even district boundaries, and limit the stocks that food traders can hold. Various state-level Agricultural Produce Marketing Acts force food traders to buy produce only in regulated markets, making direct contractual relationships difficult, and sometimes reducing the bargaining power of farmers.[32] These restrictions are compounded by an inefficient central government food procurement and distribution system (Srinivasan, 2002). Ahluwalia (2002b) suggests that, in such cases, the center needs to not only repeal its own restrictive laws, but also put limits on the laws that states can pass. From a federalist perspective, however, this may require explicit bargaining between the center and the states, since the latter have considerable constitutional authority with respect to agriculture.[33]

Finally, the fall in investment in agricultural infrastructure is well known. It appears to have begun in the 1980s, before the current reforms (Gulati and Bathla, 2001). Some kinds of infrastructure relate to production, and require public investment, which has been choked off by the fiscal problems of the state governments. Other infrastructure can support more efficient marketing of agricultural produce. Some of it (airports, roads, etc.) may require public investment, but other investment may simply require removal of a range of outdated and often contradictory legal restrictions on agricultural trade within the country. A symptom of the problems of Indian agriculture is that partial liberalization has, in some cases, made imports of minimally processed foods, such as packaged juices from middle-income Asian countries, cheaper than domestic production.

Services

The rapid growth of India's service sector, reflected in its increasing share of GDP (see Table 1) has certainly been supported by the growth of the information technology (IT) sector, particularly in software. The IT sector directly and indirectly demonstrates several possible benefits of reform. While the sector clearly benefited from the availability of the right human capital, and from favorable tax policies, some of the key supporting factors were simply the absence of crippling regulations. Since software did not come under many of the restrictive laws that have strangled Indian manufacturing, new firms were

[32] Even in the richest, agricultural surplus state of Punjab, intermediaries in both the input and output markets often have monopolistic positions created by government regulations. Nirvikar Singh was told, by a state government official, of at least one case where pesticide distributors successfully lobbied the state government to prevent direct contracting of farmers with manufacturers, at steep discounts.

[33] The states' constitutional authority extends to all agriculture, including agricultural education and research, water (supplies, irrigation and canals, drainage and embankments and storage), land tenures and transfers of agricultural land, land improvement and agricultural loans, and fisheries

able to operate much more flexibly than they might have otherwise. India's new outward orientation also helped, and software exports grew from $100 million in 1990-91 to $6 billion in 2000-01 (NASSCOM, 2002a). This growth was a significant factor in India's avoidance of further balance of payments problems, and by the late 1990s, probably contributed one percentage point to GDP growth. The IT sector also benefited from, as well as spurred, reforms in the telecoms sector that included substantial liberalization and modernization of the regulatory framework.[34]

From a federalist perspective, the IT sector has helped to build a political constituency for reform at the state level, though events in 2004 suggest that this constituency is not broad enough to guarantee electoral success. States such as Karnataka and Andhra Pradesh have explicitly competed for investment in IT, through policies to develop physical and educational infrastructure. Other states, such as Punjab, have also tried to catch up in this area. However, the IT industry remains regionally concentrated.[35] Whether this contributes to regional inequalities depends on the degree of labor mobility, both geographic and occupational, and access to the education system: such mobility in India, historically low, appears to have increased in recent years, particularly for technical professionals. To the extent that much of the recent growth is coming in IT-enabled services, which require more and less technically skilled labor, the benefits can accrue to a broader group, and may diffuse some of the regional concentration issues.

Privatization, Infrastructure Development and Regulation

Government production of private goods, its provision of public infrastructure, and its regulation of industry all have important implications for the performance of the Indian economy. The low productivity and poor return on capital of public sector enterprises (PSEs) in India have been well documented (e.g., McKinsey, 2001; Kapur and Ramamurthi, 2002). With national and state governments owning enterprises in a broad cross-section of industries, the scope of potential privatization is quite sweeping. The political difficulty of this task was behind the absence of any meaningful privatization in the first decade of economic reform, and though this situation improved with the creation of a Ministry of Disinvestment and appointment of an active minister, the change in national government in 2004 reversed these developments.

The large implicit subsidies for those employed in public sector enterprises are an important aspect of the resistance to privatization, and one can guess that patronage and rent-seeking opportunities have contributed to the lack of political enthusiasm from government ministries. Also, in the case of state-level public enterprises such as the State Electricity Boards (SEBs), there are additional twin problems of huge deficits and the need for coordinated reform of the power sector (see below). The previous central government created the post of a Minister of State for Disinvestment, and in this position Arun Shourie drew up a list of 27 central PSEs to be disinvested as soon as practical. These include Air India, VSNL, Hindustan Copper Ltd, India Tourism Development Corporation, State Trading Corporation, and Indian Petrochemicals Corporation Ltd.

[34] See Singh (2002) for further discussion of the role of IT in India's economic development.

[35] For example, 80% of India's IT enabled services companies are located in only six metropolitan areas (NASSCOM, 2002b).

However, opposition within the government to disinvestment of the large oil companies, Bharat Petroleum and Hindustan Petroleum, led to a postponement of their privatization, as well as that of other central government oil, gas and power companies, and the whole effort has stalled with the change in government..

While the SEBs are directly owned by the state governments, center-state relations have also impinged on privatization when central PSEs (constituting the bulk of the assets of the public sector) in particular state jurisdictions have been privatized or proposed for privatization. Since privatization has been so limited, there are few examples, but the initial case served as a test. The first significant privatization that occurred was of the Bharat Aluminium Company (BALCO). The company's labor unions opposed the privatization and went on strike. The government of the new state of Chhattisgarh (carved out of Madhya Pradesh) took an aggressive stance against the disinvestment. While some substantive issues of the fairness of the bidding and the sale of tribal land were involved, the case raised the potential of states obstructing privatization when the center had finally got it rolling.

The stance of the Chief Minister may be understood in terms of responsiveness to a local interest group, and as an attempt to bargain for transfer payments from the center. However, the Supreme Court, however, finally upheld the sale of the company, and dismissed actions by the state government against the new private sector owners. Kapur and Ramamurthi (2002) have discussed the court judgment in detail, and conclude that it represents a significant precedent for preventing the use of legal maneuvers such as 'public interest legislation' to obstruct privatization. The Chief Minister of Chhattisgarh subsequently actively sought further investment from the buyer of BALCO.

Turning to infrastructure, the term can include various physical, social and economic indicators, but attention is usually focused on public and quasi-public goods such as electric power, irrigation, roads and railways, telecommunications and ports. In many of these cases, the poor quality of the available infrastructure acts as a constraint on growth (Dollar *et al*, 2002). Variations in infrastructure across states also explain a quarter of the difference in high-performing and low-performing states, in the sample analyzed by Dollar *et al*. Various aggregate measures of infrastructure are possible. Table 4 reproduces data on one such index, produced by the Centre for Monitoring the Indian Economy (CMIE) from Ahluwalia (2002a, Table 8). The 14 major states listed are ordered according to their per capita Gross State Domestic Product (GSDP) in the initial year, from poorest to richest. The data show considerable variation across states, but also a remarkable amount of stability over the period, with simple correlations between any two years all being over 0.96, and the coefficient of variation showing a slight decline, from 0.35 in 1980-81 to 0.29 in 1996-97.[36]

Infrastructure areas such as telecommunications and power have seen some privatization of PSEs, as well as entry by private firms. These developments require new regulatory structures to set and enforce the 'rules of the game.' These structures have been slow to

[36] These calculations do not weight the indices by population, but weighting is unlikely to change the conclusion of stability.

develop in forms that break away from old-style bureaucratic control structures. In telecommunications, the creation of a new regulatory institution, the Telecoms Regulatory Authority of India (TRAI) has been essentially at the national level, with the central government shaping its evolution. The TRAI has had problems in creating and implementing a new regulatory framework that does not involve ex ante case-by-case discretion (Dossani, 2002a). However, telecommunications reform has progressed substantially, driven in part by the success of the IT sector, which as we have noted, has been concentrated in just a few states.

In the case of electric power, however, the federal issues with respect to regulation are more salient, and have made progress more difficult.[37] Electric power is a concurrent responsibility of the center and the states. Each state has had a State Electricity Board (SEB) that is vertically integrated with respect to generation, transmission and distribution, and is part of the state government. Various political compulsions and inefficiencies have led to large losses by the SEBs, and they have been a major contributor to the states' fiscal deficits.[38] Furthermore, power generation has lagged seriously behind targets, and availability of reliable electric power has become a serious bottleneck for growth.

Given the situation described above, the power sector received early attention in the economic reform process, with attempts to attract private participation in the power sector, set forth in a 1991 policy document. Over the next decade, Rs. 373 billion in FDI in the power sector was approved, making up 14 per cent of total approvals, but actual investment has lagged, with several well-publicized disputes and withdrawals by foreign companies, the Enron case being only the most prominent of these (Mukherjee, 2002). The need to dismantle the vertical integration of the power sector, the simultaneous involvement of the central and state governments, the lack of understanding of the technical details of power contracting by some of those on the Indian side, and the role of various interest groups all had an effect in delaying or even derailing power sector reform.

One of biggest hurdles has been the effective bankruptcy of the SEBs, leading to foreign investors in generation demanding guarantees from the state governments, as owners of the SEBs, for payments for electricity sales to the SEBs. Since the state governments themselves were in financial stress, they further asked for a counter guarantee from the central government for payment in case the state government failed to fulfill its guarantee. Enron received such a guarantee and counter guarantee, and had to invoke it in 2001, meanwhile being overtaken by larger problems of the parent company. Other foreign companies that had planned to invest in generation all pulled out because satisfactory payment arrangements could not be made.

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[37] See, for example, Dossani and Crow (2001), Dossani (2002b) and Sáez (2002, Chapter 6).

[38] The problem of SEB losses is worse than budget figures indicate. In 2000-01, the losses of the SEBs were over Rs. 260 billion of which only Rs. 60 billion were accounted for in the state budgets by way of explicit subsidies to the SEBs.

In 1997, the central and state governments tried again to coordinate reform, with a Common Minimum National Action Plan for Power (CMNAP). The CMNAP recommended corporatization of the SEBs, though within a public ownership framework, and the creation of independent regulatory commissions at the central and state levels. The CMNAP also recommended some specific regulatory approaches, and private entry in the distribution component of the sector. While Andhra Pradesh, Haryana and Orissa had already set up their own State Electricity Regulatory Commissions (SERCs), other states moved after the center passed legislation in 1998 to set up its Central ERC, and to enable the states to create their own SERCs. State governments proceeded to do this in 1999, and some also moved forward with corporatization and some unbundling of generation, transmission and distribution. The delay in creating effective independent regulatory bodies, however, has meant that reform has proceeded in a somewhat chaotic manner. The regulatory commissions have not been able to establish the rules of the game, both because they have been pre-empted by earlier ad hoc decisions, and because they have not had much time to establish their own rules of operation. However, independent regulation and private sector participation appear to be the only way out of the political quicksand.

Financial Sector Reform

Much of financial sector reform has focused on making India's capital markets more efficient. Institutional improvements such as electronic trading and settlement, and guidelines for corporate governance have begun to take hold. While securities market reforms have had the highest profile, some steps have also been taken in reforming debt markets and in the banking sector. Notably, a market for government debt has been established, and the central government now borrows at rates that are more market-determined. In banking, there has been some reduction in interest rate controls and statutory requirements to invest in government securities, strengthening of prudential norms and regulatory oversight, and policies enabling increased competition from private (domestic and foreign) banks.

Financial markets require some regulation, both by market participants and the government, and the development of modern financial regulatory institutions in India is still taking place.[39] Many issues of financial sector reform are purely national in scope. However, the nature of the financial system overall involves financial repression (essentially, price and quantity controls in the financial sector) which in turn has had implications for central and state fiscal deficits. We explore this connection between financial sector reform and federalism. We also address the question of how much India's capital markets should be opened up. While trade barriers have been reduced, and current account convertibility introduced, capital account convertibility remains a topic of policy debate. We examine this debate in the context of India's federal finances.

We noted in section 3 that fiscal deficits at the state level have increased despite the central government's apparent formal authority to strictly control state borrowing. We identified two possible causes of this phenomenon. First, the central government has

[39] The Securities Exchange Board of India (SEBI), though it has had some missteps in trying to prevent market manipulation, represents a great improvement over the previous situation.

increasingly used discretionary loans, often with interest subsidies or even *ex post* conversion of loans to grants, as a component of political influence.[40] Second, the states have used PSEs and other off-budget devices to run even larger deficits in practice.[41] For both the center and the states, the ultimate enabler of both these trends has been the nature of India's financial system.

Severe financial repression, along with direct ownership and control of much of the financial system, has permitted the central government to 'park' central and state deficits in the financial system without having to print money and cause politically dangerous inflation. Public sector mutual funds, such as the Unit Trust of India (UTI), and financial intermediaries, such as the Industrial Development Bank of India (IDBI), have suffered from a combination of lack of bottom line objectives and accountability. Though the central government is rectifying these problems in individual cases,[42] these issues pervade the financial sector. One simple indicator of government financial control is the large percentage of credit allocation by commercial banks that goes to 'priority sectors'. As Table 5 shows, this ratio has not fallen appreciably since reform began, and is much higher than in 1969, when the banks were nationalized.[43]

The cost of financial repression and deficit parking has been continued inefficient capital allocation and lower growth than might otherwise be attainable. A broad reform of the financial sector is required, but the constraints imposed by the web of government-controlled financial institutions and their 'bad' loans to the public sector are a severe hurdle. If thorough financial sector reform is held back because it threatens the public sector house of cards, there may be a case for the government tying its hands through greater external liberalization of capital markets. Even without such liberalization, both the public sector and private financial sector in India are vulnerable to downgrading by international ratings agencies such as Moody's and Standard & Poor's[44], making India susceptible to the kinds of severe financial crisis that have affected other countries.

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[40] This statement is based on casual empiricism, but is consistent with the political effects found in formal quantitative analyses of explicit transfers (Rao and Singh, 2001).

[41] See also Lahiri (1999), Rao (2000b), and Mohan (2001).

[42] After two earlier bailouts, the government announced that UTI investors must bear all capital risks, but only after a third, costlier bailout announced in August 2002. It has also announced that the IDBI will be corporatized. In each case, the measures may not go far enough. Bhattacharya and Patel (2002) have made a strong case that incomplete reforms do nothing to deal with the moral hazard problems of India's financial intermediation sector. If anything, the problems may have increased in recent years. However, unlike the case of Argentina, India's state governments cannot directly borrow from banks that they own – nationalized banks are central government owned, though there are small cooperative banks effectively controlled by state governments.

[43] Shankar Acharya has pointed out to us that this observation must be qualified by noting that the definition of 'priority sector' has expanded somewhat over time.

[44] For example Standard & Poor's lowered its long-term local currency rating to 'BBB-' from 'BBB' and revised its outlook on local and foreign currency to negative in August 2001, citing 'the continued deterioration of the government's financial profile, with persistently high fiscal deficits resulting in a rising burden of public debt.' On September 19, 2002, it further downgraded India to BB+, citing similar reasons. (www.standardandpoors.com/RatingsActions/RatingsNews/Sovereigns/index.html). While ratings are notoriously imperfect, having failed to predict, for example, the 1997 financial crisis in South Korea and Thailand, they do influence foreign investors.

However, whether capital account liberalization can be a mechanism for financial sector and fiscal discipline probably depends on continued improvements in regulatory oversight.[45]

In suggesting greater exposure to global markets as a disciplining device for the Indian public and private finances, we are not neglecting other policy avenues. For example, the Eleventh Finance Commission, given a much broader charge than previous commissions, recommended a slew of measures to promote fiscal discipline: an overall ceiling of 37.5% of gross receipts of the Center for all transfers to the states; hard budget constraints for all levels of government with respect to wages and salaries; 'greater autonomy' along with hard budget constraints for public sector enterprises; more explicit controls on debt levels for state governments; and improvements in budgeting, auditing and control.[46] It is not at all clear, however, that "greater autonomy along with hard budget constraints for public sector enterprises" will work in the absence of greater competitive discipline. Furthermore, by not working, it will continue to undermine any limits on states' debt levels. In addition to external competition, internal competition in the financial sector is also necessary, and here privatization of public sector assets must be considered.[47]

Financial sector privatization, which requires central action, can affect the nature of the demand for credit by reducing politically motivated subsidies, and by reducing overall interest rates through a reduction in government crowding out of private borrowing. The other side of the equation concerns the supply of credit. Deficit parking has been abetted by the existence and operation of public sector financial institutions. The need for privatization applies to these as well. Where does this leave the different levels of government with respect to financing the urgent needs for public infrastructure? One might argue against privatization of the financial sector if the past approach of public subsidies and directed lending had been successful in efficiently and effectively building such infrastructure: in fact, it has failed badly. In any case, fiscal incentives can be used to direct lending, without public ownership, potentially increasing transparency and efficiency.

In the context of federalism, privatization in the financial sector not only can have direct impacts on efficiency and growth, but it can also support the goal of allowing explicit

[45] As Pranab Bardhan has emphasized to us, and as significant instances of accounting fraud continue to emerge in the United States, the private sector also is subject to moral hazard in the absence of effective oversight.

[46] Institutional mechanisms to detail and implement such recommendations include an Expenditure Reforms Commission, which has issued a series of reports, and a Fiscal Responsibility Act, which has been passed, followed by a task force report detailing implementation. Several states have also passed similar laws, though their enforceability remains to be seen.

[47] Note that the center-state issue with respect to the working of the financial sector has not been just one of levels of credit, but also of credit allocation across states. Hence, our discussion of fiscal deficits also relates to concerns about political economy influences and growing interstate disparities. In fact, the problem grew after the nationalization of commercial banks in 1969, which concentrated economic power in the hands of the center. With insurance and many other financial institutions already under central control, the central government became a virtual monopolist in the financial sector.

center-state transfers to meet their own objectives – particularly that of enhancing horizontal equity – more effectively, by limiting implicit transfers. With respect to transfers for capital purposes, while central and state governments will always have the option of making conditional grants and project loans to lower level governments, the practical limitations on monitoring and incentive provision for such transfers (including the ultimate fungibility of transferred funds) suggest the greater use of unconditional block grants, with marginal capital funds coming through market borrowing.[48] We take this up further in Section 5.

Foreign Direct Investment

Privatization, foreign capital flows, and infrastructure development all intersect in the realm of foreign direct investment (FDI). An important part of the Indian economic reform agenda has been to attract greater levels of FDI, especially that which will bring in new technology and improve infrastructure. While there are still restrictions on sectors where FDI is allowed (e.g., retailing and wholesale trading), limits on FDI in other sectors (e.g., telecoms, banking, insurance and civil aviation) and the government approval process can still be time-consuming[49], cumulative FDI approvals have crossed $20 billion for the last decade, though actual investment is quite a bit lower. A major policy shift allowed state governments to directly seek FDI, rather than having the central government be the only channel. As a result, state governments have actively competed for FDI, though with results that have varied dramatically across states.[50] In that respect, FDI has more transparent regional impacts than foreign portfolio investment, which was allowed from 1993 onward. In terms of magnitude, portfolio investment has been quite significant, in the order of $20 billion since liberalization.

In September 2002, the committee on FDI headed by N.K. Singh recommended raising FDI limits in some sectors, opening up others to FDI, removing some exit barriers, improving targeting of potential investors, and facilitating approvals. The last would come about through several administrative and legal changes that would provide a more integrated approval process at both the central and state levels. In particular, the committee recommended that individual states also streamline and integrate their approval processes, covering environmental clearances, industrial relations and worker health. Some of these recommendations, however, were confined to Special Economic

[48] Obviously, the smaller the government, the less will be the feasibility of significant reliance on the market. However, as we have emphasized earlier, many of the Indian states are comparable to countries in terms of population size and fiscal domain. The possibility of market borrowing raises issues of institutional reform to allow indebted state governments to seek funds in the capital market without permission from higher level governments, as well as the need for a credit rating agency to rate state governments. Credit rating in India is in its infancy, but is developing rapidly (for example, see www.icraindia.com).

[49] There are two FDI approval routes. Automatic approval through the central bank, for certain categories, is supposed to take only two weeks. The bulk of FDI approvals, however, come through the Foreign Investment Promotion Board (FIPB), which is discretionary, and takes several weeks more at a minimum. Sáez (2002) also characterizes approval processes as 'still cumbersome' (p. 226).

[50] In some cases, state governments have been less than enthusiastic, whereas in others they have faced their own obstacles. Sáez (2002) discusses some of these problems in the context of FDI in the power sector.

Zones. It is arguable whether the precise relaxations of limits proposed are optimal or likely to be effective (Roy, 2002; Jha, 2002), and the potential impacts in the absence of further domestic financial sector reform may be a cause for concern (Jha, 2002). As in the case of disinvestment, political opposition has surfaced, and even consideration of the report by the Cabinet – let alone implementation – has stalled. Despite these roadblocks, the overall direction of the proposals represents a significant conceptual step with respect to facilitating FDI, and they continue to be on the table with the new national government.

Statewise data for total FDI approvals for the 'reform decade' 1991-2001 are presented in Table 6. Using the 1991 population figures from the census of India, we also calculate per capita approvals. The simple correlation of the per capita FDI approvals with the infrastructure index for any of the three years in Table 5 is very low (less than 0.1). To some extent, this reflects the unreliability of FDI approvals as an indicator of actual investment, but more importantly, this is a consequence of the particular infrastructure index used, in which, for example, a state such as Karnataka is measured as having very low infrastructure development, despite its concentration of workers with high levels of technical skills. Most significantly, the coefficient of variation for the per capita FDI approvals (using population weighted measures of mean and standard deviation) is 0.93, which is much higher than the corresponding measure for the infrastructure index. Thus it appears that FDI is seeking a few favored locations, with a concentration even more than would be dictated by broad infrastructure measures. At least one important determinant of the intended destinations of FDI has been the success of India's IT sector, which was discussed above.

To the extent that variations in FDI across states are influenced by specific policy initiatives and narrowly focused government investments in infrastructure, such as might be the case in Karnataka, there is scope for state governments to compete more effectively for FDI that might have a longer-term impact on infrastructure. For example, Punjab, with the highest index of infrastructure, lags substantially in FDI, but might conceivably correct this with policy adjustments. In general, the result of economic reform has been to remove central efforts to direct the location of FDI, as well as to relax restrictions on its nature and amount. The regional concentration of FDI is less of a concern if labor mobility is sufficient to ensure that workers can go where new jobs are created, and if public resources are channeled in ways that allow basic social infrastructure such as urban sanitation to complement private sector investments in aspects of infrastructure such as telecommunications, where the private returns to be captured are potentially higher. In Section 5, we return to the impacts and implications of the regional concentration of FDI in India.

5. Intergovernmental Relations

Center-State Transfers

We outlined some of the problems with the current transfer system in the previous two sections. What are possible reforms that can be made in the transfer system? One

example of the process of reform comes from the case of tax sharing arrangements. The Constitution specified certain categories of centrally collected taxes that were to be shared with the states, according to criteria to be determined by the Finance Commission. In particular, personal income taxes were a major component of tax transfers from the center to the states, which received 87.5% of such tax revenues. On the other hand, income tax surcharges were kept entirely by the center. Academic commentators suggested that there were obvious incentive problems with such arrangements, and the Tenth Finance Commission recommended alternative arrangements whereby a proportion of overall central tax revenues would be devolved to the states. This required bargaining and agreement among the center and the states, as well as a constitutional amendment, but this has all been accomplished.[51]

Tax sharing between the center and the states reflects one dimension of the bargaining that must take place among a federation's constituents. Presumably, the initial effect of the change will be to leave the overall shares of the center and the states in aggregate near their previous values, avoiding the problem of creating clear initial losers from the reform. Principles of this sort might be used to tackle a harder problem, that of revising the formulae used to divide the states' share of tax revenue among them. These formulae are quite complex, without embodying any clearly defined objective, either of interstate (horizontal) equity, or of provision of incentives for fiscal prudence.

Given that there are other transfer mechanisms as well, and that those will be used with discretion, there is a case for the Finance Commission overhauling its formulae completely, to achieve greater simplicity. Such an overhaul can in theory be designed to respect the present status quo to a great extent, but to deal more directly with horizontal inequities in fiscal capacity (appropriately defined to avoid soft budget constraints). This is preferable to *ad hoc* grants for poorer states, made at the margin. In this respect, one welcome change related to tax sharing is recommended in the Eleventh Finance Commission report. This is the reversal of the earlier practice of keeping a portion of shareable tax revenues from Union excise duties exclusively for allocation among states according to the amount of their estimated post-tax-devolution deficits, which amounted to converting part of the tax share into "gap-filling" grants, lacking both in transparency and incentives for fiscal prudence. Stopping that practice is a small step toward hardening the states' budget constraints.

The case for reform of transfer formulae also applies to those Planning Commission transfers that are calculated on the basis of the 1969 Gadgil formula. The past scope of Finance Commissions has been much narrower than what the Constitution of India implies for their role.[52] Moving away from this restriction, one welcome innovation in the Eleventh Finance Commission's terms of reference was the consideration of the overall fiscal position of India's federal system. The Commission recommended a

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

[52] According to Article 280, the Finance Commission's duties include recommendations with regard to "grants-in-aid of the revenues of the States out of the Consolidated Fund of India", which appears to include Planning Commission grants made under Article 282.

reassessment of plan transfer formulae, with this task to be brought within the scope of the Finance Commission.[53] It also noted the severe muddle with respect to Planning Commission transfers, with economically meaningless distinctions between plan and non-plan categories of expenditure. It recommended reform of the financing of the plans so that plan revenue expenditure is financed from available revenue receipts after meeting non-plan expenditure, with borrowing used only for investments. Finally, a recommendation for rolling multi-year budgeting could presumably be a step away from the less flexible plan cycle.[54]

These proposed reforms would not solve problems of increasing inter-state inequalities (see below). However, they would make the formal transfer system clearer and simpler, and make it easier to understand its objectives and its impacts. Removing a significant portion of center-state transfers outside the political economy arena, clearly targeting them toward horizontal equity objectives, and doing so in a manner that does not create perverse incentives for recipients, is feasible and desirable in itself.

Of course, there are many other influences on the fiscal positions of the states. Rao, Shand and Kalirajan (1999) have noted the important impacts on state SDPs of implicit transfers and of private sector investment flows: the causality is two-way, with both these tending to favor the better-off states. They also point out the unknown regional effects of direct central government expenditures. In Section 3, we discussed the problems created by soft budget constraints in the dimension of loans made to the states through the Planning Commission and other avenues. Just tackling tax sharing and related transfers will still leave these problems open. The Eleventh Finance Commission's recommendation of an overall transfer ceiling of 37.5% does not seem to deal with loans and implicit transfers.

One might, in fact, question whether the Planning Commission is appropriate in an economy where liberalization has taken hold. Where there is a justification for national level coordination because of externalities that cross state borders (as in the case of roads or power, for example), different central ministries and/or state governments can negotiate and cooperate directly. Where there is no such justification, formulaic transfers, determined by the Finance Commission so as not to distort states' fiscal incentives, seem sufficient. The Planning Commission would be largely redundant in such an institutional framework. Srinivasan (2002) has suggested replacing it with two institutions analogous to the World Bank (IBRD) and the International Development Authority (IDA), making 'hard' and 'soft' loans respectively to richer and poorer states. While this would clarify the objectives of such 'transfers', as targeted for capital spending (something that has become lost in the current working of the Planning Commission), it would still be subject to monitoring and commitment problems that would leave budget constraints soft. A more radical alternative would be to allow all states to use market borrowing, with only poorer states receiving grants for capital spending. As discussed in Section 4, this will require further reform, including privatization, of the financial sector. Issues of credible

[53] The broader issue of the proper role of the Planning Commission is addressed below.

[54] Rao, Singh and Vasishtha (2002) find that levels of plan transfers vary substantially across plans.

commitment to a "no-bailout" policy would remain, but private lending through the market may still be more transparent and efficient than lending from central government tax receipts.

Two other areas of ongoing reform also bear on the transfer system, either by changing the environment within which it works, or through direct interactions. The assignment of tax authority is obviously important in influencing the starting point from which intergovernmental transfers are made. Second, the explicit strengthening of local governments, with formal transfer systems being introduced for state-local transfers, must impact center-state fiscal relations. We consider these issues next.

Tax Reform

There are several ways in which the tax system impinges on overall reform and the performance of the economy. Taxes create allocative distortions, and these have sometimes been particularly severe in the Indian case, often raising costs for industry to uncompetitive levels. Tax revenue is clearly a critical source of financing for overcoming infrastructure bottlenecks and providing minimum standards of public services. Globalization and opening up the economy have two direct impacts. First, to the extent that aggregate tariff revenue falls as tariff rates are lowered, they increase the importance of other sources of tax revenue. Second, the mobility of tax bases increases, making it more difficult to tap these sources. These forces mean that high effective tax rates on narrow bases, aside from the inefficiencies they create, are also now more difficult to sustain.

Some elements of tax reform in the last two decades[55] are well known: a reduction in tariff rates, reductions in direct tax rates coupled with attempts to broaden the tax base, and a gradual movement from excise duties and sales taxes to VAT at both the central and state levels, the last being to avoid cascading and very high and variable effective rates of indirect taxation. Comparing 1990-91 with 1999-2000, the impact of some of these changes has been as follows: an increase in the direct-tax-to-GDP ratio from 2.16% to 3.24 %, accompanied by an increase in the number of filers from 6.1 to 17.8 million; more than offset by a decrease in the central indirect-tax-to-GDP ratio from 8.84 % to 6.23 %, driven by reductions in the percentages of central excise duties as well as customs duties.[56] State sales taxes and excise duties have also shown a proportionate decline, so that the overall tax-GDP ratio has declined by almost two percentage points in the 1990s (Rao, 2000a). While the overall decline merely reverses an increase that took place in the 1980s, the fact that it has occurred at higher GDP levels raises questions about long-term implications. Some of the lack of buoyancy in tax revenues may be due to the recent slowdown of manufacturing. However, there are also dimensions of tax reform that have yet to be tackled.

Three areas yet to be fully integrated into the tax base are agriculture, small-scale industry, and services. Agricultural taxation, in the form of the land tax (assigned to the

[55] Many reforms started with the report of the Tax Reform Committee of 1991, but some began earlier. Mohan (2002b) lists some o f the most significant tax reforms in India.
[56] These figures are from Singh and Modi (2001), Tables I, III and IV.

states), has withered away. Small-scale units for the purposes of the reservations are either exempt from paying excise duties, or pay lower rates than other firms in the same sectors. This cuts out an important part of the tax base, provides an avenue for tax evasion, makes administration more complex, and provides a further incentive for small-scale units to remain small (Mohan, 2002a). To the extent that small-scale reservations can be removed, this problem will be reduced, but since these tax breaks were introduced relatively recently, in 1986, they might be delinked from the politically more difficult (but desirable) removal of reservations. Finally, the problem created by the failure of the Constitution to explicitly include "services" within the scope of states' sales tax authority has been recognized for some time, and is in need of correction (see below).

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

A reform that directly affects India's federal system lies in indirect taxes, which, as we have noted, have not increased proportionately with GDP in the last decade. As Rao (2000a) puts it, "The most important challenge in restructuring the tax system in the country is to evolve a coordinated consumption tax system." Rao provides some detailed recommendations on the current assignments of indirect taxes, with respect to issues such as rates, interstate sales taxes, and tax administration for a dual VAT coordinated between the center and the states. Rao also notes the problem created by the failure of the Constitution to explicitly include "services" within the scope of states' sales tax authority. This problem has been recognized for some time, but has increased in importance as the structure of GDP has shifted from commodity production to services: fixing this was also recommended by the Eleventh Finance Commission.

Moving taxation of services from the Union list, where it implicitly lies through the center's residual powers over taxes not explicitly specified in the Constitution, to the Concurrent list will require a constitutional amendment. Such an amendment must be proposed by the central government, but will benefit the states. Rao incorporates political economy considerations by suggesting that an amendment be tied to persuading the states to reduce and eventually eliminate taxation of interstate sales, thus removing some of the internal barriers that have plagued the development of a true national market within India.[57] This will also smooth the implementation of a destination based VAT for the

[57] While the fundamental problem in India is the absence of an interstate commerce clause such as that in

states. Note that such reforms can also reduce tax exporting by the richer states, (Rao and Singh, 1998; Rao, Shand and Kalirajan, 1999).

Taxation of services illustrates a broader issue addressed by the Eleventh Finance Commission, which recommended in general giving the states more power to tax, to reduce the vertical fiscal imbalance. This approach takes some pressure off the fiscal transfer system, allowing states that can obtain political support to more flexibly tax their own constituents to deliver benefits to them. Another possible example of such a tax reassignment would be to allow states to piggyback on central income taxes. This, too, would require a constitutional amendment. With tax sharing no longer applied to specific tax "handles", but to tax revenues in total, this change would give states more flexibility at the margin, where they properly should have it. Note that states are already assigned the right to tax agricultural income, though their use of this tax is minimal. This separation has no economic justification, and merely promotes tax evasion. Piggybacking, along with a removal of the distinction between nonagricultural and agricultural income (possibly with provisions to mitigate the effects of risks in agriculture), would represent a major improvement in tax assignments. Whether the political economy logic can work for this case of tied reforms, as suggested for the case of services above, is worth considering.

To summarize our discussion, much remains to be done in terms of tax reform. While some measures can be initiated by the center acting alone, many others require agreement or coordination between the center and the states. These include possible reassignments of tax authority, as well as changes in tax administration. Recognizing the play of differing interests may help in devising reform packages that balance potential losses against gains, and thereby increase the probability of acceptance. Rationalizing India's tax system at all levels of government has become more important because of the opening up of the economy to foreign competition. Therefore continued tax reform should be a priority. How to implement this across different levels of the government will be considered after we discuss decentralization.

Decentralization

The political motivations and history of local government reform in India have been quite different from those that led to the economic reforms of the 1990s. Nevertheless, there is a complementarity between the two sets of reforms that benefits from their temporal coincidence. After a long history of debate on decentralization, a central government committee recommended that local bodies should be given constitutional status. Two separate amendment bills were introduced, covering *panchayats* (village governments)

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the US constitution, there is still room for bargained solutions that will reduce internal trade barriers. For example, the recent replacement of local transit taxes (*octroi*) with state entry taxes in some states has shifted the problem up one level, reducing the number of entities that have to be involved in the negotiation. Earlier, in 1975, the central government entered into an agreement with the states to abolish sales taxes on textiles, sugar and tobacco, replacing them with an additional central excise duty, the entire proceeds of which were assigned to the states. Interestingly, this bargaining perspective of federalism, which we have emphasized heavily in this paper, finds an echo in the following statement of the recent task force on implementation of the FRBM Act (Government of India, 2004): "The Task Force proposes a 'grand bargain' whereby States will have the power to tax all services concurrently with the Centre." (p. 6)

and municipalities respectively, passed by parliament in 1992, ratified by more than half the state assemblies, and brought into force as the 73rd and 74th amendments to the Constitution in 1993. These amendments required individual states to pass appropriate legislation, since local government remained a state subject under the Constitution, and they have done so.[58]

Until the recent legislative changes, the ability to exercise local suffrage was very limited. The amendments require direct elections to local bodies to be held every five years. If a local government is dissolved prematurely by the state, elections must be held within six months, something that was not required earlier. Rao and Singh (2000, 2001) have characterized this aspect of local government reform as replacing 'hierarchy' with 'voice'[59] as the primary accountability mechanism, and have explained this as a positive step based on the ability to provide more targeted incentives to government decision-makers, based on the narrower locus on which their performance can be judged. Of course, this is subject to the caveat of transparency and effective monitoring being achievable. Local government reform has also changed the nature of tax and expenditure assignments to these governments, and instituted a system of formal state-local transfers modeled on that of the central Finance Commission. While there are some serious issues with the new assignments, including problems of local capacity and efficiency, both with respect to revenues and expenditures, we focus here on the new transfer system.

While it has been argued that formal transfers from the center and states to local governments could accentuate fiscal deficit problems, an explicit, rule-governed system can instead make existing problems more transparent, as a first step toward mitigating them. Local government finances, particularly for urban bodies, had steadily worsened over the period before local government reform, under a system of hierarchical control and monitoring by state governments. This is not to imply that the State Finance Commissions (SFCs) represent an immediate improvement. Almost all SFCs have given their initial reports, and the Eleventh Finance Commission summed them up as follows:

> Many SFC reports have not … provided a clear idea of the powers, authority and responsibilities actually entrusted to the local bodies. Many of these reports also do not clearly indicate the principles formulated for sharing or assignment of State taxes, duties, tolls, fees and the grants-in-aid. (Paragraph 8.11b)

However, this situation is somewhat better than the previous one of *ad hoc* and discretionary transfers and control of local bodies by state governments: local government reform has added welcome transparency to existing problems, as well as greater certainty to transfers.

The Eleventh Finance Commission was, rightly, reluctant to provide the states with grants requested by them to supplement their own transfers to local governments, noting that the amendments do not justify this softening of the states' budget constraints. The

[58] See Rao and Singh (2000, 2001) for more details. See also Mathur (1999) for an assessment of urban governments and reform.

[59] See Hirschman (1970) for the introduction and discussion of this terminology.

Commission's main recommendations with respect to local government related to assignment and incentive issues for various sources of tax revenue. Land and profession taxes were identified as two possible sources of revenue. The recommendation of surcharges on state taxes earmarked for local government is similar to the piggybacking we proposed for the states on central taxes. It would be useful to allow local governments to determine their own rates, perhaps subject to a state-imposed minimum level. These recommendations are straightforward – the problems arise in defining details and assuring implementation. This point also applies to the Commission's discussion of property taxes, replacements for *octroi*, and local user charges.

The analysis of Rao and Singh (2000) suggests that incentive efficiency with respect to government expenditure must be the starting point for revenue enhancement efforts. The Commission was right to suggest a quicker transfer of expenditure responsibilities to local governments: they are unlikely to do worse than state governments have so far done, in the provision of basic civic amenities. Grants to the lowest tier of local government recommended by the Commission may help to jumpstart the process of making local governments effective providers, if they can break out of their historical low-level equilibrium of revenue collection and service provision.

The Commission also recommended grants for improved accounting, auditing, and database building for local governments. These measures, if implemented effectively, can have a substantial positive impact on capacity, transparency and accountability in the delivery of local government services such as primary education and basic health. The report also discussed some of the potential conflicts between the existing institutional apparatus of central and centrally sponsored schemes and the role envisaged for local governments,[60] and problems that are arising from states' reluctance to devolve authority to their subordinate governments. One example of the latter problem is the failure of state governments to implement their own SFCs' reports. In the case of the central Finance Commission, the bargaining power of the states, and the role of precedent have worked to ensure the implementation of most recommendations. In the case of the states, local governments may need outside help, for example from the courts, to pressure reluctant state governments.

Primary education and basic health and nutrition represent important aspects of any country's development, and it is widely accepted that India's performance on these fronts has been mediocre or worse (e.g., Dreze and Sen, 1995). Global comparisons and the process of globalization have heightened this relative failure, and its negative consequences in terms of low productivity as well as direct welfare losses. In this respect, greater responsibility of state and local governments in ensuring adequate levels of education, health and nutrition as a result of the reform processes described above may have positive impacts by increasing the efficiency with which scarce public resources are

[60] Currently, central discretionary transfers, which are meant to be implemented at the district or block level, swamp local government capacity for action and for their own revenue raising (Rajaraman, 2001). Replacing these with conditional or unconditional grants from the states (with the ultimate source possibly being unconditional grants from the center), will allow more effective functioning of local governments. This ties in with our earlier discussion of reform of the center-state transfer system.

raised, transferred and spent. As we discuss later in this section, some of the poorer states have been able to overcome resource constraints to achieve quantifiable improvements in 'human development'.

Intergovernmental Institutions

Local government reform has complicated intergovernmental relations in India, by allowing the center to bypass state governments to some extent, such as by making direct transfers to local governments. In fact, it has been argued that this was the political motivation for such reform. In general, the economic reform process has changed the nature of center-state interactions, and this has been compounded by coalition rule at the center. Issues of fiscal deficits, tax reform, policies toward FDI, infrastructure development and regulation all require some coordination between the center and the states. In this context, institutions such as the Inter-State Council (ISC) may actually have a greater role to play than earlier.

While states that are pivotal, and hence politically powerful in a coalition government at the center may be able to directly extract concessions from the central government (as the government of Andhra Pradesh[61] appears to have done in some cases in the previous national government), this does not make the ISC redundant. The potential role of the ISC is precisely to provide an alternative to such *ad hoc* bargaining. Furthermore, bargaining over durable changes in rules governing the federation is quite different from bargaining over specific instances. For example, the ISC was an important forum for gaining acceptance of the change in tax sharing recommended by the Tenth Finance Commission.[62] More recently, it has also been a place where an important change in the rules governing inter-state water disputes has been approved by the states (Richards and Singh, 2002). Clearly, tax reform, changes in the way that states borrow, policies toward FDI, and regulation of sectors such as power are all areas where the ISC can provide a less public, more focused forum for bargaining over issues that jointly affect the center and the states than is possible in either house of parliament.

The role of the ISC may also be expanded if the current process of planning is reformed, as we have argued earlier in this section. The NDC now serves as the bargaining forum for plan transfers and loans, and we have suggested that these might be replaced by a dual system of block grants and market-based loans. This change would make the NDC redundant. Instead, the ISC may be the place for evolving a new institutional framework; bargaining over general rules, not specific instances. In this respect, our perspective 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). Our extensions to this concept are to include bargaining 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.

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[61] It is important to note that the Telegu Desam Party of Andhra Pradesh also controlled the state government at that time. In other cases (the Dravida Munnetra Kazhagam of Tamil Nadu and Trinamool Congress of West Bengal) the regional party in the ruling coalition may not have been in a position to represent its state's interests as forcefully or directly.

[62] See also Kapur (2001) for additional examples.

We can summarize the main message of this section as follows. A further devolution of expenditure assignments, as is being implemented in the ongoing local government reform, makes sense from an efficiency perspective, because it allows better-targeted incentives for government decision-makers. This must be accompanied by devolution of tax assignments, to keep vertical fiscal imbalances from overwhelming such incentives. Since vertical fiscal imbalances will still arise, we argue for a simpler transfer system that does not distort marginal incentives. While there is still room for transfers and loans that are earmarked for capital expenditure, we argue that here, too, marginal incentives are crucial, and that providing these through the market may be the only efficient avenue in practice. This argument is based on the recognition that political influences will distort choices in the absence of such discipline, no matter how legal restraints are structured. While decentralization and privatization may seem to exacerbate problems of interstate inequality, they also enable higher-level governments to focus more clearly and directly on redistribution as an objective wherever it is deemed necessary. The transition to a new set of rules requires bargaining over change, and we have suggested the ISC as a formal institution within which this might occur.

Regional Inequalities[63]

To the extent that globalization and economic liberalization may increase inequality across the constituent units of India's federation, they could exacerbate political tensions and, in the extreme, threaten the country's unity. Various secessionist movements have certainly existed throughout India's post-colonial history. Hence, we examine the evidence on increasing regional inequality, discuss possible causes and the likely political effects of any such increases, and consider policy responses in the context of an environment of continued globalization. In particular, we examine whether there might be conflicts between the objective of moderating regional inequalities and those of promoting market efficiency and hardening budget constraints. In doing so, we discuss some of the political and economic factors that necessarily shape a federal bargain.

Many studies have examined the issue of regional inequalities in India, whether they are increasing, and how changes are affected by initial conditions such as the level of infrastructure development. These studies are partly motivated by the fears of some that, as India integrates into the global economy, enclaves that successfully pursue this integration will grow rapidly, leaving the rest of the economy behind. These studies typically use the framework of growth theory to examine absolute or conditional convergence.[64] A small subset of these studies is summarized in Table 7.

[63] See Rao and Singh (2001) for more details on previous studies, including those not covered here.

[64] Thus, one can identify three possible scenarios: absolute convergence, where different entities are moving toward the same steady state, conditional convergence, where they are converging to (possibly very) different steady states, and divergence, where there is no evidence of convergence. The last case is inconsistent with neoclassical growth models, but conceivably fits some endogenous growth models. Note that conditional convergence is quite consistent with increasing disparities across entities. Variables such as literacy, health and physical infrastructure, as well as the economic policies followed, may be the conditioning variables. While the evidence for any type of convergence across disparate countries is quite weak, one might expect greater possibilities for convergence across similar regions or constituent units of a federation than across countries.

Here, we extend earlier studies by examining if flows of capital to different states affect regional inequalities for the 1990s.[65] We proxy interstate movements of domestic capital, with bank credit-deposit ratios for the 14 major states. Trends over the last two decades are summarized in Table 8. The average credit-deposit ratio shows a slight decline from 1980 to 1995, and is thereafter about the same in 2001. The (unweighted) standard deviation creeps up from the initial year to 1995, and increases further in 2001. While the increase is not great, the sharp decline in the credit-deposit ratio for the states of Bihar and UP is striking. Also, the correlation between the ratio and per capita SDP jumps dramatically from 1995 to 2001, after a much smaller increase in the earlier period (1980 to 1995), even when the coefficient of variation of per capita SDP for these states does not increase.

Table 9 presents results for some simple convergence regressions, focusing on three different financial variables: FDI approvals per capita over the decade 1991-2001, 1990 per capita bank credit (a proxy for private investment) and 1990 credit-deposit ratios. The results are quite striking. First, the evidence for convergence or divergence is inconclusive, since the coefficient of base-year SDP is never significantly different from one.[66] Second, any one of the financial variables taken individually is estimated to have a significant impact on growth of SDP. When two or more financial variables are included, there is evidence of multicollinearity, but otherwise the results are robust. They are consistent with a story where domestic and foreign capital are complements, and taken together with our earlier discussion of credit-deposit ratios and of FDI approvals, the evidence is suggestive of mobile domestic and foreign capital driving growth. From an efficiency point of view, this is probably a good thing, but the equity consequences bear some consideration. We assess the evidence and discuss possible policy implications.

First, it is important to note that some of the evidence for divergence among India's states appears in the 1980s, before the recent reforms. The 1980s saw an appreciable increase in India's growth rate compared to earlier periods. Hence, the 1990s reforms cannot be the sole cause in increased regional inequality. Measures such as the Gini coefficient do suggest that inter-state inequality has increased particularly in the 1990s,[67] but the evidence from our growth regressions is not conclusive.

Second, the studies typically use SDP to measure outcomes. Thus, remittances by internal migrants (e.g., Biharis working as agricultural laborers in Punjab) and external ones (Keralites working in health care in the Middle East) are being missed by the analysis. Internal as well as international remittances, once included, might change the picture. While we do not have state wise income data, other outcome measures can be used. Table 10 shows the Human Development Indices (HDIs) for the 14 major states, at decade intervals for three years, 1981, 1991, and 2001. The HDI includes literacy, infant

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[65] Migration data, when available, can allow one to also look at inter-state flows of labor. However, such data may underestimate migration (Srivastava, 1998).

[66] This is true whether one uses a one-sided or two-sided test.

[67] On the other hand, estimated Gini coefficients for personal income distribution do not show any increase from 1990 to 2000.

mortality, access to safe water and durably constructed housing, as well as formal education, poverty ratios and per capita expenditure. Not only has the HDI been rising over the two decades, but also the standard deviation of the distribution across states has not risen, resulting in a substantial fall in the coefficient of variation (CV). The CV for the HDI is also lower than the CV for SDP, though this could be an artifact of the scales used for components of the HDI. This data suggests that other factors (e.g., remittances, government expenditures) do mitigate some of the apparent regional inequalities in India.

Despite the qualifications we have discussed, commonly held perceptions of growing inequality or unfairness may be enough to require policy attention. Previous secessionist movements or other regional political tensions have been driven by a complex mix of ethnic, linguistic and economic factors, but economic policies have often been part of the political response.[68] At the same time, the central government's fiscal situation does not allow for money to be thrown at such problems. We have argued above for reforms in the intergovernmental transfer system that might allow better targeting of transfers to deal with states that may be 'left behind' by liberalization, through grants or soft loans for infrastructure investment, restricted to poorer states. Transfers may be more effective if they are based on simpler formulae and objectives, without the center trying to impose direct controls. On the other hand, Ahluwalia (2002a) argues for imposing more effective conditionalities on transfers, to improve the use of transferred funds by the states. This could work against reduction in interstate inequalities. Furthermore, this recommendation assumes that the center is able to effectively monitor such conditionalities, something that has not been true in the past.

In general, even formulaic transfers can be subject to political influence effects (Rao and Singh, 2000), as part of the ongoing federal bargaining process. Also, equalizing transfers may be offset by other, implicit transfers that favor better-off states.[69] Furthermore, the impact of intergovernmental transfers may be to distort the fiscal incentives of recipients in ways that hurt short-run efficiency and long-run growth, as is argued in the literature on 'market preserving federalism' (MPF: see, e.g., Weingast, 1993). One need not take an extreme position on this to agree with the view that limiting the size and scope of intergovernmental transfers can increase efficiency, while also arguing that targeting transfers to poorer regions or states is politically desirable.

In the context of equity objectives, it is important to be clear about the connection between reforming the intergovernmental transfer system and inter-state inequalities in income. Reforms cannot cancel out increases in inter-state income inequalities. However, they can make the formal transfer system clearer and simpler, which should make it

[68] This point also applies if one allows for internal migration. While migration may help to support convergence, in a heterogeneous country such as India, it may bring its own set of problems. If effective equalizing fiscal transfers can reduce interregional migration pressures or slow down the process, they may have a positive role in preserving interethnic, or other intergroup, peace. Srivastava (1998), based on micro surveys, suggests that temporary employment opportunities drive a substantial amount of migration in India, beyond what is reflected in national statistics.

[69] Rao, Shand and Kalirajan (1999) argue that explicit center-state transfers have had moderate impacts on interstate inequalities, and that these effects have been outweighed by implicit transfers through subsidized (public and private) lending and through interstate tax exportation.

easier to define its proper objective as one of enabling state governments to potentially provide minimal levels of public services. Table 11 (adapted from Table 4 of Rao and Singh, 2002) indicates the relative magnitudes of state government revenues and expenditures (and hence center-state transfers[70]) compared to SDPs. For the 14 major states (excluding Goa), own revenue ranges from about 5 to 12% of GSDP, and ranges from about 30 to 70% of current expenditure. Center-state transfers cannot equalize post-transfer per capita incomes, but they can substantially reduce inequalities in public service provision. The imperative is to do this in a manner that does not adversely affect incentives for raising own revenue. It is also important to note that some of the problems cannot be identified at the state level. States such as Maharashtra and Karnataka have high-income urbanized regions as well as much poorer rural regions within their boundaries. In such cases, the creation of stronger local governments and more formal mechanisms for transfers to them may help, as we have argued above.

Finally, intergovernmental transfers can only do so much, and greater decentralization of tax assignments is an important complementary policy, as we have suggested earlier. In particular, they can make it easier to harden budget constraints in the long run by clarifying accountability, even if bailouts are not completely precluded. This perspective is also in the spirit of MPF or of Breton's (1996) view of competitive federalism. At the same time, we recognize that higher-level governments will always exercise discretion where they can, a position forcefully taken by Riker (1975). In this respect, we are sympathetic to the view expressed by Frankel (2002) that avenues for the exercise of political discretion are necessary in the case of intergovernmental transfers. Nevertheless, one can strive to improve efficiency through institutional changes that promote effective monitoring and evaluation, including more market-based mechanisms for financing capital spending.

6. Conclusion

Our paper has sought to examine the interaction of India's federal system and its ongoing economic reforms in the context of globalization. In our analysis, we have explicitly recognized that the national government has subnational governments below it, and that all these layers of government simultaneously interact with foreign governments and corporations in a global economy. We have examined real and financial sector reforms, including assignments of regulatory powers, infrastructure reform and development, and privatization. Despite the incomplete nature of financial reform, we have presented some evidence in Section 6 that liberalization is making a difference, with foreign and domestic capital together driving growth, and leading to some of the differential growth across states that has been observed in the last decade. However, we have also noted the problems created by government fiscal deficits and government control of the financial sector.

Motivated by concerns over fiscal deficits, regional inequalities, and inefficient expenditures at all levels of government, we also considered reforms that directly affect intergovernmental relations. These included taxes, intergovernmental transfer

[70] The difference between revenues and expenditures is made up of transfers and net fiscal deficits.

mechanisms, local government reforms, and institutions of intergovernmental bargaining and cooperation. Reforms in federal governance may be the key to opening the door to further reform elsewhere, by reducing the fiscal burden placed on the private sector by government deficits. We have acknowledged the political economy aspects of governance, and discussed possibilities for politically acceptable packages of fiscal reforms, such as combinations of changes in tax assignment that would be acceptable to the center as well as the state governments.

The benefit of an approach that explicitly takes account of India's federal institutions is that we have been able to identify some areas in which the states may be able to achieve positive reforms acting independently, and other areas where coordination between the central and the state governments in designing and implementing reform policies may be more appropriate. Furthermore, we have highlighted the challenges of greater openness to the world economy, and of perceptions of growing regional disparities. The former requires urgent attention to the financial position of the government in particular, as well as of the financial sector as a whole. The latter requires more efficient mechanisms for managing internal inequities. Together, they suggest the avenues of further reform that we have outlined in the paper.

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Figure 1: India – States and Union Territories

Table 1: Central and State Fiscal Deficits (% of GDP)

	Center	States	Total
1990-91	6.6	3.3	9.4
1991-92	4.7	2.7	7.0
1992-93	4.8	2.6	7.0
1993-94	6.4	2.3	8.3
1994-95	4.7	2.8	7.1
1995-96	4.2	2.6	6.5
1996-97	4.1	2.7	6.4
1997-98	4.8	2.9	7.3
1998-99	5.1	4.3	8.9
1999-00	5.3	4.6	9.4
2000-01	5.1	4.3	9.1

Sources: Economic Survey of India, RBI Annual Report, Rao (2002), Srinivasan (2002)

Note: The combined deficit indicators net out the inter-governmental transactions between the Center and States, and do not equal to the sum of the deficits of the Center and the States.

Table 2: Gross Domestic Product and its Sectoral Share

	Gross domestic product (GDP)		Sectoral share in GDP* (per cent)		
	(At factor cost)	(At market prices)	Agriculture & allied	Industry	Services
At 1993-94 prices	**Rs. Crores**				
1950-51	141557	149594	55.4	16.1	28.5
1960-61	207704	222161	50.9	20.0	29.1
1970-71	298580	329227	44.5	23.6	31.9
1980-81	404246	442319	38.1	25.9	36.0
1990-91	694925	773349	30.9	30.0	39.1
1991-92	705149	781575	30.0	29.4	40.6
1992-93	737018	818544	30.2	29.1	40.7
1993-94	781345	859220	33.6	23.7	42.7
1994-95	835864	922289	33.0	24.2	42.8
1995-96	896990	992877	30.7	25.3	44.0
1996-97	964390	1061902	31.0	25.2	43.8
1997-98	1012816	1110384	29.2	25.3	45.5
1998-99	1081834	1185399	29.2	24.7	46.1

Note: *At factor cost and figures up to 1992-93 relate to prior to revision of GDP. http://meadev.nic.in/economy/gdp.htm

Table 3: Major Economic Indicators – Annual Growth Rates (per cent)

Year	Gross national product*	Gross domestic product*	Agricultural production Index	Food grains production	Industrial production Index	Electricity generation	Wholesale price index	Consumer price index	Money supply (M3)	Imports*	Exports*
1981-82	5.8	6.0	5.6	2.9	9.3	9.9	–	12.3	12	– 4.4	2.6
1982-83	2.7	3.1	– 3.8	–2.9	3.2	7	4.9	8.8	16.6	–2.6	4.6
1983-84	7.5	7.7	13.7	17.7	6.7	7.6	7.5	12.1	18.2	3.5	3.8
1984-85	4.2	4.3	–1.2	– 4.5	8.6	12.1	6.5	6.3	19	–5.9	4.5
1985-86	4.5	4.5	2.5	3.4	8.7	8.4	4.4	6.8	16	11.5	–9.9
1986-87	4.1	4.3	– 3.7	– 4.7	9.1	9.8	5.8	8.7	18.6	–2.1	9.4
1987-88	3.6	3.8	– 0.8	– 2.1	7.3	8.8	8.2	8.8	16	9.1	24.1
1988-89	10.1	10.5	21.4	21	8.7	10.2	7.5	9.4	17.8	13.6	15.6
1989-90	6.7	6.7	2.1	0.6	8.6	11.2	7.4	6.1	19.4	8.8	18.9
1990-91	5.5	5.6	3.8	3.2	8.2	7.8	10.3	11.6	15.1	13.5	9.2
1991-92	1.1	1.3	–2.0	– 4.5	0.6	9.1	13.7	13.5	19.3	–19.4	–1.5
1992-93	5.1	5.1	4.1	6.6	2.3	5	10.1	9.6	15.7	12.7	3.8
1993-94	5.9	5.9	3.8	2.7	6.0	7.3	8.4	7.5	18.4	6.5	20.0
1994-95	7.2	7.3	4.9	3.8	8.4	8.1	12.5	10.1	22.3	22.9	18.4
1995-96	7.5	7.3	– 2.7	– 5.8	12.8	8.6	8.1	10.2	13.7	28.0	20.9
1996-97	8.2	7.8	9.1	10.5	5.6	4.3	4.6	9.4	15.9	6.5	5.3
1997-98	4.8	4.8	– 5.4	–3.5	6.6	6.6	4.4	6.8	17.3	6.1	4.5
1998-99	6.4	6.5	7.5	5.6	4.1	6.5	5.9	13.1	19.4	2.2	-5.1
1999-2000	6.2	6.1	-0.7	1.4	6.7	6.9	3.3	3.4	13.9	17.2	10.8
2000-2001	3.9	4.0	1.5	-	5.0	4.5	7.0	3.8	15.0	1.7	21.0

Note: * revised (at 1993-94 prices).
http://meadev.nic.in/economy/mei.htm, http://www.nic.in/stat/stat_act_t1.htm, Reserve Bank of India, http://indiabudget.nic.in/es2001-02/chapt2002/tab12.pdf, http://indiabudget.nic.in/es2001-02/chapt2002/tab16.pdf

Table 4: Relative Infrastructure Development Indices, 14 Major States

	1980-81	**1991-92**	**1996-97**
Bihar	83.5	81.7	77.8
Rajasthan	74.4	82.6	83.9
Uttar Pradesh	97.7	102.3	103.8
Orissa	81.5	95.0	98.9
Madhya Pradesh	62.1	71.5	74.1
Andhra Pradesh	98.1	96.8	93.1
Tamil Nadu	158.6	145.9	138.9
Kerala	158.1	158.0	155.4
Karnataka	94.8	96.5	94.3
West Bengal	110.6	92.1	90.8
Gujarat	123.0	122.9	121.8
Haryana	145.0	143.0	137.2
Maharashtra	120.1	109.6	111.3
Punjab	207.3	193.4	185.6
All India	**100**	**100**	**100**

Source: CMIE and Ahluwalia (2002a)

Table 5: Commercial Bank Deposits and Priority Credit

	1969	1990	1993	1996	1997	1998	1999	2000	2001
Deposits of Scheduled Commercial Banks as percentage of National Income (at current prices)	15.5	48.6	50.4	46.3	46.4	49.6	50.3	53.5	55.7
Share of Priority Sector Advances in total	14.0	40.7	34.4	32.8	34.8	34.6	35.3	35.4	..

Source: RBI various statistical tables, www.rbi.org.in.
Note: 1969 data are for June, other years for March

Table 6: FDI approvals August 1991- July 2001, 14 Major States

	FDI Approvals (Rs. Million)	1991 Population (Million)	FDI per capita (Rs.)
Bihar	8833.43	86.374	102.27
Rajasthan	25916.69	44.006	588.94
Uttar Pradesh	43304.25	139.112	311.29
Orissa	82289.14	31.660	2599.15
Madhya Pradesh	97709.14	66.181	1476.39
Andhra Pradesh	124701.31	66.508	1874.98
Tamil Nadu	222804.00	55.859	3988.69
Kerala	14360.83	29.098	493.53
Karnataka	208156.32	44.977	4628.06
West Bengal	84234.59	68.078	1237.32
Gujarat	168555.48	41.310	4080.26
Haryana	31947.46	16.464	1940.44
Maharashtra	456286.23	78.937	5780.38
Punjab	19519.22	20.282	962.39
14 States	**1588618.09**	**788.846**	**2013.85**

Sources: FDI – Secretariat for Industrial Assistance Newsletter, August 2001; population – http://www.censusindia.net/data.html
Note: Figures for Bihar, Madhya Pradesh and Uttar Pradesh include FDI approvals for Jharkand, Chhattisgarh and Uttaranchal respectively

Table 7: Convergence Studies for India's States

Study	Period	No. of States	Main Results
Cashin and Sahay (1996)	1961-91	20	Slow absolute and conditional convergence. Weak impact of internal migration.
Nagaraj, Varoudakis and Véganzonès (1998)	1970-94	17	Absolute divergence, conditional convergence. Share of agriculture, infrastructure, political and institutional factors (state fixed effects) matter.
Rao, Shand and Kalirajan (RSK, 1999)	1965-95	14	Absolute and conditional divergence, faster in early 90s. Private investment matters.
Aiyar (2001)	1971-96	19	Conditional convergence; infrastructure, private investment and nonmeasured institutional factors matter.
Ahluwalia (2002a)	1981-99	14	Gini coefficient of per capita SDP (weighted by population) increased from late 1980s, through 1990s. Convergence not allowed for, but private investment matters for growth.

Table 8: Credit-Deposit Ratios by State

	1980	1995	2001
Bihar	0.41	0.33	0.24
Rajasthan	**0.68**	0.46	0.48
Uttar Pradesh	0.42	0.35	0.28
Orissa	0.59	0.54	0.41
Madhya Pradesh	0.56	0.53	0.47
Andhra Pradesh	**0.74**	**0.76**	**0.63**
Tamil Nadu	**0.94**	**0.91**	**0.91**
Kerala	**0.68**	0.45	0.43
Karnataka	**0.75**	**0.68**	**0.59**
West Bengal	0.60	0.54	0.44
Gujarat	0.58	0.47	0.49
Haryana	**0.72**	0.47	0.42
Maharashtra	**0.79**	**0.70**	**0.85**
Punjab	0.43	0.41	0.41
Average	0.65	0.58	0.57
Std. Deviation.	0.15	0.16	0.18
Coeff. of Var.	0.22	0.27	0.32
Coeff. of Var. (SDP)	0.32	0.40	0.36
Corr$^{n.}$ with per capita SDP	0.11	0.18	0.59

Sources: RBI Bulletins, National Accounts Statistics, and Indian Census. Figures for Bihar, Madhya Pradesh and Uttar Pradesh in 2001 include Jharkand, Chhattisgarh and Uttaranchal respectively. SDP and population figures used to calculate correlations were for closest available years.

Table 9: Growth Regressions

Dependent variable is log of 1998-99 per capita SDP
t-statistics in parentheses

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Constant	-0.86 (-0.94)	-0.02 (-0.02)	-0.70 (-0.76)	-1.16 (-1.65)	0.13 (0.11)	0.84 (0.79)	1.18 (1.12)
1990-91 ln SDP per capita	**1.14** (9.75)	**1.02** (9.79)	**1.08** (9.71)	**1.14** (12.71)	**0.96** (6.41)	**0.90** (6.21)	**0.85** (5.95)
FDI approvals p. c. 1991-2001		**5.4E-05** (2.76)	2.4E-05 (0.81)		6.3E-06 (0.19)	3.3E0-5 (1.25)	
Credit-deposit ratio 1990			0.35 (1.34)	**0.52** (3.10)	0.33 (1.26)		
Credit per capita 1990					8.9E-05 (1.12)	9.7E0-5 (1.19)	**16.6E-05** (2.71)

Table 10: State Level Human Development Indices

State	1981 Value	1981 Rank	1991 Value	1991 Rank	2001 Value	2001 Rank
Andhra Pradesh	0.298	9	0.377	9	0.416	10
Bihar	0.237	14	0.308	14	0.367	14
Gujarat	0.360	4	0.431	6	0.479	6
Haryana	0.360	5	0.443	5	0.509	5
Karnataka	0.346	6	0.412	7	0.478	7
Kerala	0.500	1	0.591	1	0.638	1
Madhya Pradesh	0.245	13	0.328	12	0.394	12
Maharashtra	0.363	3	0.452	4	0.523	4
Orissa	0.267	10	0.345	11	0.404	11
Punjab	0.411	2	0.475	2	0.537	2
Rajasthan	0.256	11	0.347	10	0.424	9
Tamil Nadu	0.343	7	0.466	3	0.531	3
Uttar Pradesh	0.255	12	0.314	13	0.388	13
West Bengal	0.305	8	0.404	8	0.472	8
All India	0.302		0.381		0.472	
Unweighted average	0.325		0.407		0.469	
Standard deviation	0.071		0.075		0.072	
Coefficient of variation	0.219		0.185		0.155	

Source: Planning Commission (2002)

Table 11: Revenues and Expenditures of the States, 1998-99

	Per capita GSDP (Rs)	Per capita own revenue (Rs)	Own revenue as % of GSDP (percent)	Per capita current expenditure (Rs)	Percentage of own revenue to current expenditure
I. Major States					
A. High Income States	**21196.0**	**2141.0**	**10.1**	**3140.0**	**68.2**
1. Gujarat	18791.6	2196.5	11.7	3301.7	66.5
2. Goa	25304.8	6608.5	26.1	8445.9	78.2
3. Haryana	19491.2	2388.1	12.3	3614.3	66.1
4. Maharashtra	22762.7	1982.2	8.7	2861.8	69.3
5. Punjab	20675.1	2058.8	10.0	3618.9	56.9
B. Middle Income States	**15305.3**	**1330.9**	**8.7**	**2385.2**	**55.8**
1. Andhra Pradesh	13852.9	1320.8	9.5	2281.6	57.9
2. Karnataka	15889.0	1644.7	10.4	2433.1	67.6
3. Kerala	17755.8	1634.6	9.2	2896.8	56.4
4. Tamil Nadu	17348.4	1766.9	10.2	2900.2	60.9
5. West Bengal	13696.4	665.5	4.9	1837.3	36.2
C. Low Income States	**8765.7**	**641.4**	**7.3**	**1620.5**	**39.6**
1. Bihar	5923.3	392.0	6.6	1090.7	35.9
2. Madhya Pradesh	10153.3	886.2	8.7	1828.5	48.5
3. Orissa	8718.9	577.7	6.6	1926.8	30.0
4. Rajasthan	11044.6	1013.1	9.2	2215.8	45.7
5. Uttar Pradesh	9078.1	569.1	6.3	1581.1	36.0
II. Special Category States	**9805.2**	**650.8**	**6.6**	**3394.5**	**19.2**
1. Arunachal Pradesh	11304.8	666.1	5.9	6559.8	10.2
2. Assam	8393.1	557.5	6.6	1716.3	32.5
3. Himachal Pradesh	12691.6	1201.9	9.5	5154.3	23.3
4. Jammu & Kashmir	10271.8	749.8	7.3	5113.4	14.7
5. Manipur	9262.6	258.5	2.8	3277.6	7.9
6. Meghalaya	10606.7	601.5	5.7	3505.6	17.2
7. Mizoram	11698.9	499.4	4.3	7599.6	6.6
8. Nagaland	15389.9	499.7	3.2	6536.4	7.6
9. Sikkim	14425.3	1336.1	9.3	9692.9	13.8
10.Tripura	9187.5	356.8	3.9	3253.8	11.0
All States	**18038.5**	**1117.3**	**6.2**	**2218.8**	**50.4**

Note: Revenues and Expenditures are net of Lotteries; GSDP – Gross State Domestic Product.
Data Sources: 1. Reserve Bank of India Bulletin, December 2000
2. Public Finance Statistics, Ministry of Finance, Government of India
From Rao and Singh (2002)