

Accountability and Capacity in Developing Country Federalism: Empowered States, Competitive Federalism

Abstract

State extraction depends in part on the degree and type of accountability to citizens. Accountability relationships are especially complex in federal systems, where multiple and overlapping jurisdictions must compete to respond to, and extract from, common citizen bases. The current project examines the operation of accountability and taxation in India. India has always been a centralised federation in which a powerful central government, made even more powerful by single-party dominance, overwhelmed most state interests. The result was a fiscal system in which the central government controlled most resources. Over the last few decades, the Indian party system has increasingly fragmented and oriented towards interests in the states, and the fiscal system has shifted in turn. What was originally a highly centralised federation has now evolved into a more decentralised regime in which resources and powers are held significantly by state governments, which compete with each other and with the federal government. Interestingly, as competition increased, the overall amount of tax decreased and, in turn, more coercive mechanisms of extraction were adopted.

Keywords: federalism, party systems, accountability, tax, decentralisation, India

Aaron Schneider
Fellow, IDS, Sussex

Citizens pay taxes to their government and expect to receive benefits in return, or at least to be left alone by the state. In federal countries, the relationship between citizens and government is far more complicated. Citizens make tax payments to multiple, overlapping jurisdictions, making the relationship between taxes and the benefits received highly circuitous and difficult to follow; and often completely disconnected. It is not uncommon for taxes from citi-

Note of acknowledgement. This article was written with the close co-operation and assistance of Renwick Irvine and Oriol Miroso-Canal. The project benefited greatly from the support and stimulation provided by the Development Resource Center at the Institute of Development Studies and partners at the Chr. Michelsen Institute. The author would like to thank James Manor, Anu Joshi, Vibha Pingle, Mick Moore and anonymous reviewers for their valuable comments.

zens in one jurisdiction to pay for benefits to citizens of another, or for revenues raised by one government to pay the debts of another. As a result, conflicts are common among groups of taxpayers seeking to control contributions and among governments seeking to secure revenues or at least claim credit for benefits. To mediate these conflicts, federations reconnect taxation and expenditures through mechanisms of accountability that extend across jurisdictions and between citizens and the state.

The current project examines shifting structures of accountability and tax in India. India began as a centralised federation in which a powerful central government, made even more powerful by single-party dominance, overwhelmed most state governments. This centralised federalism provided direct mechanisms of accountability between citizens and the central government, and limited the strength of direct links between citizens and states. Instead, the states were largely held accountable by the central government, or more precisely, the party that governed the centre. This pattern of accountability was reinforced and institutionalised in centralised decision-making bodies. The result for the distribution of revenues and revenue power among levels of government was a basically centralised tax system.

The centralised system of partisan accountability and finance peaked during the late 1960s/early 1970s. By the end of the 1980s, however, the political cohesion of the dominant party declined, regional parties and coalition government emerged, and state governments became less accountable to the centre and more directly accountable to citizens within their borders. State governments, often governed by opposition parties, pressed for and obtained greater influence in national decision-making. The result was a more decentralised system of revenues in which states controlled more resources and centralised planning was less important.

The trajectory observed in India offers a specific confirmation of the pattern noted by William Riker. 'In a variety of governments, then, the structure of the parties parallels the structure of federalism. When parties are fully centralised, so is federalism (e.g. in the Soviet Union and Mexico). When parties are somewhat decentralised, then federalism is only partially centralised' (Riker, 1975: 137). In India, we can observe how this is manifest in taxation. Tax revenues, especially direct taxes, depend on mechanisms of accountability to legitimise them. As party system change shifted accountability from the central government to the states, India's tax system followed suit. The states controlled a greater share of rev-

enues and made particular use of less accountable, indirect taxes. Interestingly, this coincided with a move towards more market-oriented fiscal strategies, which included withdrawing government from economic intervention.

The following sections describe the operation of accountability in federal countries and the role of accountability in tax. Next, we examine the party system changes that partly replaced accountability to the central government with accountability to states. Finally, we examine the implications of this shift for the structure of tax powers and revenues in India's federation.

1. Accountability and Federalism: A Framework

Accountability refers to the relationships that control power (Schedler, 1999; Schacter, 2001; Newell and Bellour, 2002; UNDP, 2002: 65). The most common metaphor has been that of an agent acting on behalf of, and in response to, the demands of the principal (Soberg *et al.*, 2000). New institutional economics has made much of the moral hazard problem inherent in principal-agent relationships, in which agents have incentives to shirk responsibilities and otherwise serve their own interests rather than those of the principal. To defend against moral hazard problems, the principal requires accountability mechanisms that can keep the agent responsive (Schedler, 1999: 18–20).¹

One of the problems with the principal-agent metaphor is that it does not consider the (almost always) reciprocal nature of accountability. It is not only agents that are held to account; principals, too, are required to fulfil certain obligations. In the case of federal accountability relationships, reciprocity is quite clear. Central governments ask states to implement public policies within their borders, and the states ask the centre not to abuse its power over them.

Subtypes of accountability coexist in federal systems. *Vertical accountability* between civil society and the state operates simultaneously on parallel tracks. Lower levels of government are accountable to citizens in their regions and the national government is accountable to all citizens. The most common mechanism of vertical accountability is elections (O'Donnell, 1999).

A different type of accountability operates between the levels of government. *Layered accountability* mechanisms tie one jurisdiction to another. For example, local governments are expected to

¹ For a discussion of different types of accountability see Schedler (1999), Kenney (2000), Soberg *et al.* (2000), O'Donnell (1999).

implement policies that meet national standards. What makes layered accountability unique and potentially in conflict with vertical accountability is the fact that each level of government represents a different, geographically defined, subset of the citizenry. In heterogeneous polities, this can mean that median voter preferences differ across jurisdictions. Thus, citizens of the nation may demand high spending on education while citizens of a single state prefer lower spending on education. For that state government, vertical accountability to its citizens is directly in conflict with layered accountability to standards set by the central government.

In most federal systems, layered accountability trumps vertical accountability. Higher echelons of government lay claim to wider legitimacy because they represent a larger subset of citizens, and they frequently possess legal and military power to impose their will on lower levels. Still, most federal systems include mechanisms that allow lower levels to restrain the federal level, such as a second chamber of parliament or constitutional provisions that specifically attribute some competencies to state governments. In extreme situations, a few individual units can restrain the national majority, for example if small states are over-represented at the national level and hold effective veto power over national decisions ('demos-constraining federalism') (Stepan, 1999: 24).

2. Federalism and Tax

Most studies of federalism take only a limited view of accountability when it comes to tax. In general, fiscal federal studies ask, 'Who should tax, where, and what?' (Musgrave and Musgrave, 1984). To derive an answer, fiscal federalists posit a government that maximises a social welfare function by distributing various tax powers and revenues across levels. This approach defines taxation as an assignment problem in which fixed and distinct layers of government (which are like layers of a cake) control power and resources (Musgrave, 1959; Oates, 1972: 55; 1996: 36; 1999). The general conclusions reached are that centrally imposed co-operation is necessary to manage broad macroeconomic policy and equity while locally driven competition in allocation can provide gains in efficiency. As much as possible, a direct relationship between taxes paid and benefits received is the most efficient. For example, user fees establish 'fiscal equivalence' between the cost of providing a service and its welfare benefit to contributors (Buchanan, 1987: 5–25).

New institutional economics provides further guidelines on when competition among jurisdictions is appropriate (Eggertsson, 1990). One begins with the assumption that competition among units to provide expenditures for taxes is akin to competition among firms to provide goods for a price (Tiebout, 1956). For some tax bases, competition among states matches packages of taxes and spending to citizen preferences. Competition may be imperfect, however, if tax bases include externalities, transaction costs, or information constraints that are difficult for any one jurisdiction to manage. For such taxes, central government intervention is required (Oates, 1972).

Most of these observations are probably correct, but a more nuanced view of accountability is necessary. First and foremost, levels of government are rarely distinct layers of a cake; more often federalism is a 'marble cake' in which governments penetrate and collaborate across levels (Elazar, 1962). For example, national governments often intrude on local revenue authority to unify markets, redistribute across regions, stabilise revenues and achieve administrative economies of scale (Ter-Minassian, 1997; Musgrave and Musgrave, 1984). Also, local units often influence macroeconomic policy and pursue income transfer policies (Gramlich, 1987; Eichengreen and von Hagen, 1996; Pauly, 1973; Bird and Chen, 1998). Finally, policies pursued at one level, say microeconomic policies, are likely to influence policies assigned to another level, such as macroeconomic policies. These overlaps make it difficult to assume that one level or another can be exclusively assigned tax functions.

Even if one allows for exclusive assignment, the notion of a market among states rarely fits reality. Citizens are far from completely mobile; governments do not respond solely to citizen preferences; and local governments are likely to vary significantly in their ability to gather enough revenues to cover their outlays (Bird, 1999). The opportunities for government policy providers to operate a market for citizen taxpayers are highly suspect.

3. Accountability, Capacity and Taxation

The current approach adds the political dimension of accountability to considerations of tax in federalism. Accountability in tax is not new. Most conceptualisations of tax see it along the lines of an accountable exchange between citizens and the state. Governments offer 'services' (external defence and internal regulation and se-

curity; welfare; and specific lines of policy) and channels of access (types of property; civil and political rights and representation) in return for both the general loyalty or consent of citizens and for resources from them – above all, taxes (Moore and Rakner, 2002; Tilly, 1992). This notion underpins the slogan ‘no taxation without representation’.

Still, our ability to understand the role of accountability in tax is limited. Citizens do not always want to contribute, and they often attempt to evade taxes outright. Tax under these circumstances is clearly not an accountable exchange but a painful burden that government tries to impose and citizens attempt to minimise. Some observers take this view to an extreme and portray government as a leviathan that uses a monopoly on the use of force to maximise revenues. In this view, citizens have little power to hold government accountable while government holds citizens fully accountable to tax requirements through coercion and force (Brennan and Buchanan, 1980).

Most observers conclude that accountable methods of collecting tax reap more revenues than coercive methods, but coercion remains an important element of most tax systems. Levi (1988) suggests the concept of ‘quasi-voluntary compliance’ in which citizens cannot unilaterally stop paying taxes but they effectively accept the legitimacy of contribution. Following Levi, the current project assumes that most sustainable tax systems balance elements of coercion and accountability. If the voluntary (or the coercive) element dominates too heavily, tax collection becomes captured by particular interests (or eventually becomes completely coercive) (Fjeldstad, 2002; Prud’homme, 1998).

The simultaneous combination of coercion and accountability becomes easier to understand if we accept the possibility that elements within society negotiate their tax burdens with each other and with government, which enjoys relative autonomy to enforce tax agreements (Evans *et al.*, 1985). The tax bargain struck between the state and different groups of citizens varies according to the degree of coercion or accountability manifest in collection. What determines the amount of coercion or accountability will vary across social groups and with the degree of autonomy and capacity of the state (Tilly, 1985). Gradual changes in economic structure or political relationships can shift the balance of coercion and accountability in tax and ultimately shift the capacity of government to extract.

We can borrow this view in understanding the way taxation operates in federal systems. In systems where vertical accounta-

bility to states predominates, citizens enjoy access to their state governments, they can control their use of funds, and they can negotiate bargains over tax with local units (Newell and Bellour, 2002: 5; Blair, 2000: 22). Competition to keep their citizens satisfied encourages states to specialise and innovate (Oates and Schwab, 1988: 333–354; Breton, 1996) and guards against excesses by central government (Brennan and Buchanan, 1980; Weingast, 1995). In such systems, one might expect central government tax capacity to be lower, and limited to a few coercive tax bases, while the states enjoy greater revenue capacity and can tax more accountably.

By contrast, where layered accountability predominates, citizens are more closely linked to the federal government than they are to states. At the centre, citizens enjoy representation and hammer out an agreement on tax. The central government then holds state governments accountable through layered mechanisms. This places a brake on competition among jurisdictions and imposes co-operation (Elazar, 1962). As new institutional economics has suggested (above), this can be a good thing. Too much competition among states can be ‘unhealthy’; states may begin from unequal starting positions; they may compete by racing to the bottom; and they may be little accountable to the local level (Wildasin, 1988: 229–240; Prud’Homme, 1995). In such instances, vertical accountability to the centre and layered accountability to the states is an important complement to direct vertical accountability to states (Fiszbein, 1997). In such systems, where layered accountability predominates, one could expect the central government to enjoy greater revenue capacity and to depend on taxes that rest on a basis of accountability.

4. Accountability and Political Parties

To examine accountability and tax in India, one more element is necessary: an observable indicator of changes in accountability relationships. For vertical accountability between governments and citizens, parties, party organisations and inter-party competition are indispensable. The way in which parties choose candidates, manage resources, mobilise supporters, organise activists and define issues of competition decisively influences the nature of vertical accountability.

In addition, parties also play a key role in the layered accountability that operates across levels of government. Party system dynamics determine whether citizen links to state governments are stronger than their links to local governments. Where links to local

government predominate, the tax system is governed by these vertical accountability relationships to local governments. Where links to the central government predominate, the tax system is governed by layered accountability in which the centre holds the states accountable.

In layered accountability, parties are centralised. They act as the 'universal solvent' of federalism by homogenising politics across districts and imposing the will of the centre in the states (Grodzins, 1960). Where a single party dominates both the national and the local level, as occurred in India for the first 40 years of independence, accountability can be enforced entirely within the party hierarchy. Layered accountability resulting from party system centralisation simplifies co-operative relationships among states and the federal level. It allows the federal government to depend on accountable tax bases, and enhances central government revenue capacity.

By contrast, decentralised party systems lead to the dominance of vertical accountability to states. Decentralised party systems are characterised by different parties in each state contesting over diverse cleavages and representing different interests. Elections, and thus political careers, are determined by fighting local battles, and citizens are more closely tied to their state government than to the centre (Ames, 1995; Samuels, 2000). As a result, the central government will have to depend more on coercive tax bases and will have less tax capacity overall, and state governments are more competitive with each other and with the central government.

Party system changes over time offer a unique opportunity to view changes in accountability. These are expressed in shifts in the predominance of vertical and layered accountability relationships. Layered accountability encourages co-operative federalism and strengthens central government tax capacity and the accountability of central government tax. As vertical accountability to states replaces layered accountability, states compete more, and they gain greater tax revenues and power at the expense of the centre. In addition, the central government increasingly relies on coercive methods of taxation and finds its tax capacity falling.

5. India

India's federal system has been characterised as 'quasi-federal', 'unitary with subsidiary federal features', and a 'federation with a strong centralising tendency' (Wheare, 1963). Over the past few decades, this structure has given way to a more decentralised system in which vertical accountability relationships with state govern-

ments has replaced layered accountability to the centre. The result has been greater competition among states, a decrease in central government control of resources, and a shift towards more coercive tax bases. The following paragraphs describe the parallel shifts in the Indian party system and the structure of federal taxation.

Until the late 1800s, the British maintained a highly centralised administration. The new democracy that emerged in 1947 was marked heavily by its colonial legacy, not least the pain associated with the partition of Pakistan.² The constitutional framers and early leaders were sceptical of localist pressures, and favoured nation-building over regional movements.³ They attributed the most important enumerated powers to the centre; left residuary powers to the centre; and allowed the centre progressively to absorb powers supposedly held concurrently with the states. Appendix 1 describes the legal framework ascribing central-state powers. Most perniciously, the constitution allowed the centre to assume control of any of the states if there was a ‘failure of constitutional machinery’ (Article 356), and this power was often used to prevent the formation of governments in opposition to the centre. Such interventions occurred 110 times before a 1994 Supreme Court ruling limited its use and regional parties defended themselves more effectively. Centralisation intensified as a result of three additional factors: the dominance of the Congress party, the centralised administrative bureaucracy and a national development strategy that further centralised resources and power (Arora and Radin, 2000: 1–18).

The dominance of the Congress party is the main focus of the current discussion. This party dominated the centre and virtually all of the states for the first 30 years of independence. It remained the dominant partisan actor for at least another ten years; and Congress/Anti-Congress continues to be a major cleavage in many states. Internally, Congress had accommodated multiple regional factions and interests, but it became more centralised in organisational and leadership terms as its power began to slip in the 1970s and 1980s.

2 ‘Partition is a watershed in the modern history of India. It damaged the dream of all-India federalism and provided enough opportunities to the non-federalists and centralists to dominate the Constituent Assembly’, *Rethinking Indian Federalism* (Khan, 1997: 107).

3 ‘The Congress thus represented the organised “centripetal force”. Leaders like Jawaharlal Nehru, B.R. Ambedkar, Sardar Patel, and Raendra Prasad certainly did a lot in silencing the dissents within as well as outside the party. Together they constituted a sort of an oligarchy.’ Ambedkar in particular criticised the idealised view of the local level: ‘I hold that these village republics have been the ruination of India. What is the village but a sink of localism, a den of ignorance, narrow-mindedness and communalism?’ (Khan, 1997: 108).

During the period immediately following independence, layered accountability between the central government and states dominated. Conflicts were internalised and defused within the Congress party machinery, and consultations and negotiations that might have occurred on an intergovernmental basis occurred within party channels. Some state and regional interests emerged, but they limited their mobilisation to internal factional manoeuvres. A few competing parties emerged, but they operated more as ‘parties of pressure’ that mobilised demands outside of Congress with the hope that Congress would take up the issue and incorporate the demands (Kothari, 1964: 1161–1173).

During this period in which layered accountability dominated, national-level Congress leaders could simply use Article 356 to dismiss any recalcitrant opposition leaders that won state power. Less Draconian safety valves were also available to head off regionalist movements, such as the reorganisation of states along ethnic-language lines, which required only a national parliamentary majority.⁴ The most common device to sustain layered accountability was the strategic distribution of development spending or ministerial positions. During the mid-1960s (1964–67), national Congress leaders appeared to accept the inevitability of increased vertical accountability to states when national power was exercised by a coalition of state-level leaders, commonly called the Syndicate (Frankel, 1978).

In many ways, this period reflected growing gaps in Congress power that had emerged in state government contests from 1957 to 1967. By the late 1960s major regionalist parties were in power or threatening in several states, especially in the south. Congress defeats in state assembly elections began to mount and boil upwards to the national level (Brass, 1994; Rudolph and Rudolph, 1987). Though Congress remained the most significant national party among a plethora of regional ones, its national dominance was on the decline, as evidenced by the brief turn towards Emergency Rule from 1975 to 1977.

Indira Gandhi attempted to stave off this decline when she took office in 1967. After achieving an electoral mandate in 1971, she became more assertive and destructive, a trend she intensified from 1980 to 1984. She centralised and personalised power, depending on direct, populist plebiscitary appeals that circumvented potential

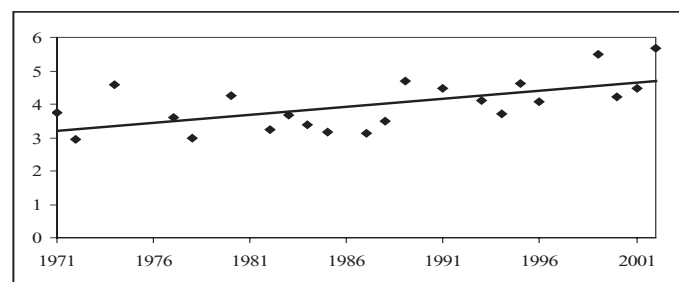
4 Of the current 28 states and seven Union Territories, some were carved from neighbouring territory (Goa and Sikkim), others were upgraded versions of Union Territories (such as Himachal Pradesh, Manipur, and Tripura, among others), and still others emerged from subdivisions of already constituted states (such as Maharashtra and Uttaranchal, among others). (Stuligross, 2002).

rivals among regional elites (Rudolph and Rudolph, 1987). For some observers, this imposed a 'patrimonial' federal system in India, and undercut the local institutional and organisational strength of the Congress party. Local brokers, who had always been important, now sought direct links to the centre at the expense of channels through state leaders. The impact was to weaken the Congress party organisation in the long run, especially with respect to its capacity to respond to regionalist demands (Manor, 1981: 32; Manor, 1988: 62–98; Arora, 1989: 198; Kohli, 1990).

By the late 1980s, when her son, Rajiv Gandhi, succeeded Indira, centralised Congress dominance was no longer sustainable. The party system was characterised by fragmentation, regionalisation and coalition government (Manor, 1988: 8). Party system cleavages had shifted, and the states were now an important, if not the major, site of contestation. Homogeneous national appeals did not necessarily resonate (Manor, 1995). Regional parties that demanded language rights and greater local control governed numerous states.

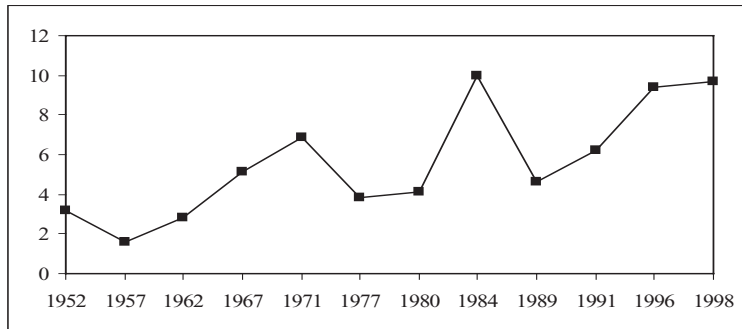
Changes in the number and kinds of parties that were gaining representation display these trends vividly. Despite prior one-party dominance and first-past-the-post electoral laws that favoured two-party competition, elections increasingly began to produce three or more 'effective' parties.⁵ The graph below displays the average number of effective parties in state elections. In years in which more than one state held elections, the effective number of parties is plotted over time. In 1972, the average number of effective parties was 2.9. By 2002, the average was 5.7. The trend line displays the steady increase that occurred over time.

Graph 1. Average effective parties in states (Rae Index of Fragmentation with trendline)



Source: Compiled from Election Commission of India, <http://www.eci.gov.in/>

⁵ The term 'effective parties' refers to Rae's Index of Fragmentation, which downplays the role of overly small (or big) parties in counting those that are

Graph 2. Regional parties in Lok Sabha (percentage of seats)

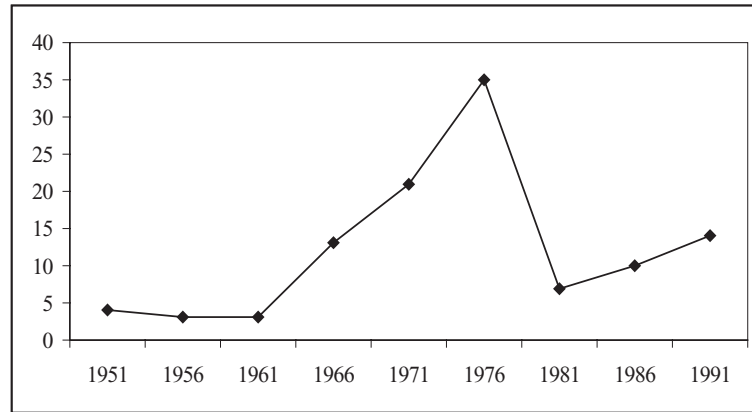
Source: Sáez (2002: 61)

The trend towards a more decentralised party system is also evident in the increasing percentage of seats in the national legislature controlled by regional parties. Graph 2 displays a consistent rise in the number of seats held by regional parties with a brief interruption in the late 1970s associated with emergency rule and the Janata Dal government. In 1957, only 1.6 per cent of Lok Sabha seats was held by regional parties; by 1998, the percentage was 9.7.

Increased fragmentation and the rise of regional parties meant that central government hopefuls would have to seek state allies. These allegiances were only forthcoming in exchange for resources and access, and more than one coalition government toppled when fickle state Chief Ministers withdrew their support.

These changes in the party system reflected the shift away from layered accountability to the centre. As Congress control declined, the central government could no longer impose its will on the states. Perhaps the most extreme reflection of this shift is offered by the pattern in use of Article 356, the proclamation of president's rule to depose a state government. In the 1960s and 1970s, Congress increasingly used Article 356 as partisan mechanisms became less effective. By the end of the 1980s, state interests had become increasingly mobilised and their bargaining position strengthened as a result of coalition government at the centre. Direct central intervention of the type symbolised by president's rule was unacceptable. Graph 3 shows the number of interventions that occurred during each five-year period. There were three interventions from 1961

most important. The formula for effective parties is $1/\sum P_i^2$ in which P_i is the percentage of seats or votes of each party.

Graph 3. President's rule proclamations per five-year period (Article 356)

Source: Khan (1997: 111)

to 1965, 13 from 1966 to 1970, 22 from 1971 to 1975, and 35 from 1975 to 1980. This was when the Janata Dal movement finally wrested power from Congress after the Emergency Period, and the number of interventions rapidly declined thereafter.

During the first 30 years of independence, India was a centralised federation. Citizens were only weakly connected to state governments, and state governments were held in check through partisan channels directed outwards from the centre. Over time, interests in the states became increasingly organised and mobilised and they sought representation through regional parties and mobilised around state-oriented cleavages. State governments became less restrained by the central government and more directly connected to local interests. In sum, India's party system shifted from one in which layered accountability to the central government predominated to one in which vertical accountability to state interests did.

6. Fiscal Impact of Party System Changes

Accountability relationships expressed in the party system shaped fiscal structures. During the long period of Congress dominance, the central government controlled most resources and exerted influence over resources held by states. As vertical accountability to state interests increased, the centre lost a portion of its revenues to the states, and with it some of its ability to influence what the states did with their money. In addition, increased vertical accountability to state governments meant that the centre was no longer as di-

rectly connected to citizens and could not extract as much from citizens. The following paragraphs describe the way the tax system shifted to match the overall shift from layered accountability to vertical accountability to states. At the end, a few observations will be made about the way this contributed to a basic withdrawal of government and weakening of its capacity to intervene in the economy.

In the early years of independence, revenues and revenue powers were highly centralised.⁶ The division of taxes and duties in the seventh schedule of the 1947 constitution included some tax handles wholly appropriated by the centre and other tax handles wholly attributed to the states (see Appendix 1). Among the state taxes, the potentially most buoyant was agricultural income tax, but rural leaders with large vote banks held power in state assemblies, and revenues from this base were low. More important in terms of revenue productivity was the tax on the sale and purchase of goods, but attempts to significantly raise revenues through these bases were limited by the central government in the interest of internal trade. In sum, allocation of revenue power limited the potential for states to mobilise revenues on their own.

The constitution writers recognised that weak revenue potential in the states was likely to generate serious imbalances between the revenues available to states and state requirements (vertical imbalances) and between the revenues available to one state or another (horizontal imbalances). To correct these imbalances, several taxes were to be divided between the centre and the states. For example, some taxes collected by the centre were assigned to states where they were levied while other taxes were imposed by the centre but collected and appropriated by states. In addition, some centrally collected taxes were to be shared with states (non-agricultural income), and others could be shared with states (excises excluding alcohol and narcotics).

Two institutions were established to manage the stream of revenue from the centre to the states: the Finance Commission and the Planning Commission. The Finance Commission, appointed every five years by the president, determines the portion of centrally collected taxes to be shared across levels and the formula for allocation across states. In addition, the Finance Commission makes recommendations for grants-in-aid to cover states in need of assistance. The level of need is calculated according to the shortfall

⁶ Much of this discussion is taken from Chaubey (2003: 27).

in current liabilities and current revenues of the states, in other words not including capital investments, which are calculated separately.⁷

The Finance Commission provides an institutional mechanism to protect the states from central influence, yet it is uniquely apolitical in comparison with the mechanisms in place in other federal systems. It is a technical body whose members are a Chairman who has had experience in public affairs and four other members who have been judges of a High Court, have special knowledge of finances, wide experience in financial matters and administration, or special knowledge of economics. No political provision is made to represent states adequately or to defend their interests. In other federations (e.g. the United States, Germany, Brazil, Canada) the negotiation between the states and the centre occurs through the upper house of the legislature. Only the Commonwealth Grants Commission in Australia is remotely similar to the Finance Commission, though its mandate is largely targeted at equalising resources across states. As a mechanism to provide political restraints on the central government, the Finance Commission is extremely weak.

On the other hand, its apolitical character gives the Finance Commission legitimacy that means its recommendations are almost always accepted in their entirety (Vithal and Sastry, 2001: 46). The funds transferred are wholly and autonomously controlled by states. These funds weaken layered accountability to the centre and strengthen vertical accountability relationships between state governments and their citizens.

The same cannot be said about the other major stream of revenues from the centre to the states. Funds channelled through the Planning Commission are tied to specific plans devised by the states and negotiated with the centre through the National Development Council (NDC). The council is a forum for consultation among the states, but it has no binding legal authority and most distribution decisions since 1969 have been set according to a formula, known as the Gadgil Formula. The formula and the negotiations with the state governments determine the overall amount to be transferred, and the transfer is split between loans and grants (70–30 for most states). Additional development schemes are funded through Union Ministries and can be opted into by states.

The funds transferred through the Planning Commission and the Union Ministry Schemes strengthen layered accountability to the

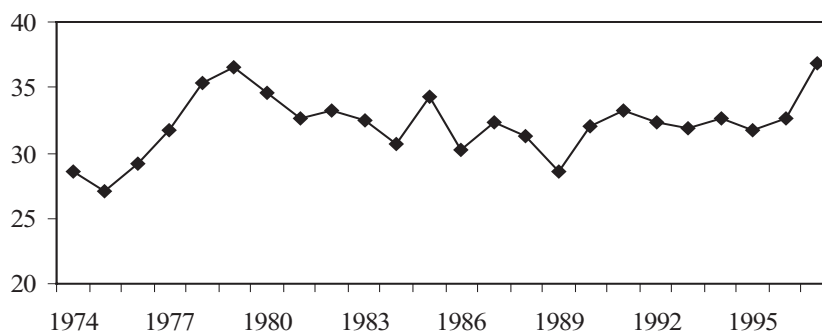
7 The practice of 'gap-filling' generated incentives for states to inflate the size of their shortfalls, perhaps by investing more in one period to generate greater current costs in the next (Vithal and Sastry, 2001: 67).

central government. The funds transferred are earmarked, and in the case of the Union Ministry schemes, the development agenda is entirely set at the central government. At least in the NDC the states have some capacity for negotiation, but their bargaining power is notoriously weak.

One institution that was intended to defend the states from excessive central intervention was the Inter-State Council. This Council includes the Chief Ministers from each of the states and was mentioned in the original constitutional debates. As a telling demonstration of the predominance of layered accountability to central interests, the Inter-State Council was not convened until 1990.

The fact that the Inter-State Council was convened only in 1990 is testament to the dominance of the central government for most of India's independence. It also suggests that the centre is progressively depending on newly assertive states. An additional institutional example can be drawn from the decisions of the Finance Commission. For example, several Finance Commissions noted that the central government was collecting the taxes it would not have to share and was not exerting as much administrative effort to collect those taxes that were to be shared with the states. After ignoring the problem for several decades, the behaviour was only finally corrected in 2000, based on the recommendations of the Tenth Finance Commission. Instead of dividing shared tax bases (income and excise) only, a fixed percentage (29.5) of all central taxes, surcharges and cesses are now shared.

Graph 4. Transfer of resources from the centre to the states 1974 to 1997 (percentage of receipts)

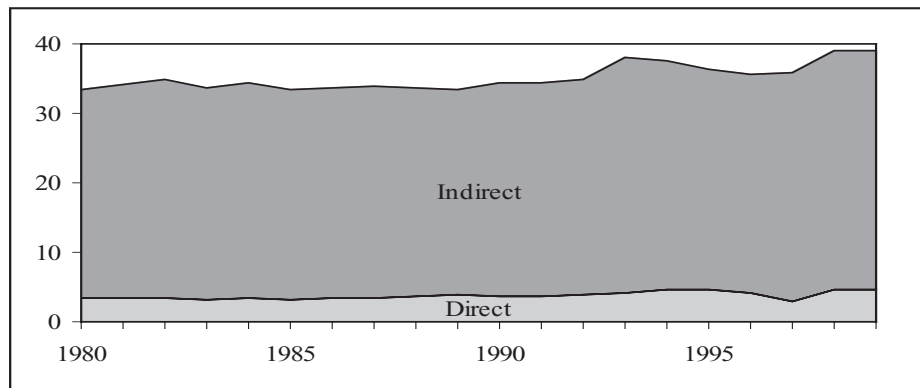


Source: Compiled from <http://www.indiastat.com>

Shifts in revenue streams over time also reflect the growing importance of vertical accountability to state interests and falling importance of layered accountability to the centre. One reflection can be seen in the increased pressure states could exert to transfer funds. From a highly centralised beginning at independence, the Indian fiscal system had become even more centralised over its first 30 years. Starting in the 1970s, it began to decentralise rapidly, and the overall amount of transfers increased as a percentage of total central receipts. Graph 4 displays the trend that rose from 28.5 per cent in 1974 to 36.8 in 1997. The overall trend is towards decentralisation, though some fluctuation and reversal during the early 1980s reflects Indira's last ditch attempts to restore her authority.

The composition of transfers displays further evidence of the impact of accountability to state interests. Centrally Sponsored Schemes through Union Ministries proliferated during the 1970s and 1980s. As a percentage of Central Government Plan Expenditure, these fell from a height of 37.7 per cent in 1984 to 24.3 by 1998. In addition, Planning Commission grants and discretionary transfers also allowed the centre to steer state policies. These transfers were earmarked and allowed the central government to steer state policies.⁸ By contrast, block grants through the Finance Commission

Graph 5. Composition of transfers



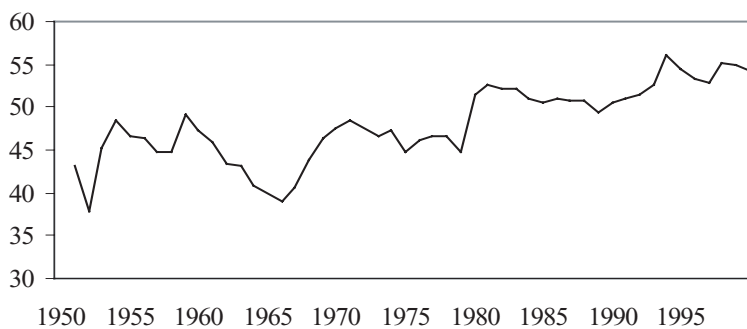
Source: Compiled from <http://www.indiastat.com>

8 I am indebted to James Manor, who correctly pointed out that the Fifth Pay Commission in 1997 introduced an additional twist to the central–local dynamics. By raising all public servant salaries, including state employees, the Commission placed a tight constraint on state finances. Those states that could not adjust on their own depended on the centre for transfers, loans and bailouts, and were forced to accept fiscal adjustment conditions imposed by the centre.

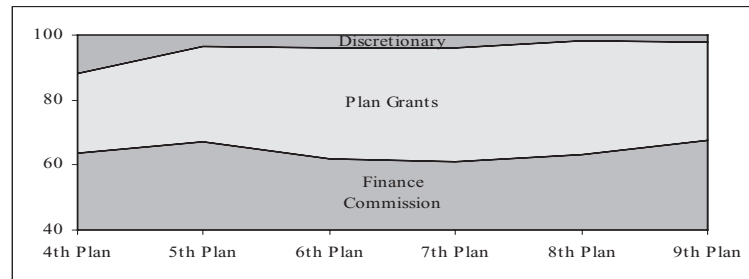
were autonomously controlled by states and offered little layered accountability to the centre. The relative weight of the types of transfers over time displays the increasing importance of the central government until the 1980s and the rapid decrease afterwards. Although Finance Commission transfers remained the largest portion of transfer revenues, Planning Commission transfers crept above 35 per cent during the 1970s and 1980s. By the mid-1990s, they had returned to their previous levels. Discretionary transfers, which allowed the greatest degree of central control, all but disappeared. Graph 5 above displays the relative proportions from one Plan period to the next.

The decrease in layered accountability to the centre was driven in part by an increase in vertical accountability to the states. Citizens were becoming more closely connected to their state governments, and this strengthened state government claims to resources. In addition, increased vertical accountability to state interests meant that regional and local representatives could respond to local interests in ways that centralised government did not. State governments could tap into local bases that lay dormant before. The graph below demonstrates the rising capacity of state governments to raise their own revenues from citizens instead of depending on central government transfers. As a percentage of total state revenues, own-revenues accounted for only 37 per cent in 1951, but by 1998 they were collecting 58 per cent.

Graph 6. States' own taxes as percentage of receipts



Source: Indian Public Finance Statistics 1999–2000, Ministry of Finance, Govt. of India

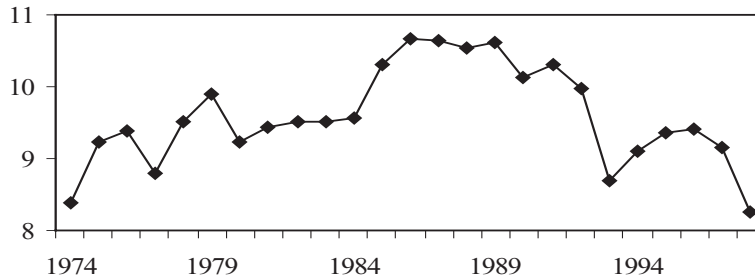
Graph 7. Direct and indirect tax as portions of the total state tax burden

Source: Compiled from Reserve Bank of India, 1999, *Handbook of Statistics on Indian Economy*

The increased vertical accountability to the states and declining layered accountability to the centre had an additional impact on the kinds of taxes citizens were willing to pay. Citizens pay visible, direct taxes only when they have strong links of accountability to government. Otherwise, government has to depend on coercive mechanisms of less visible, indirect tax. As vertical accountability to state interests replaced layered accountability to the centre, one would expect states to expand their accountable mechanisms of tax. Instead, they expanded less visible, more coercive, indirect taxes. In 1980, states collected 3.5 per cent of all direct taxes and 30.4 per cent of all indirect taxes. By 1999 state direct taxes had increased only marginally to 4.5 per cent while state indirect taxes had increased from 30.0 to 34.6 per cent over the same period. The graph below demonstrates the steady rise in the portion of state taxes collected through coercive mechanisms.

This last graph deserves several additional considerations. It is clear that state governments have responded to their increased vertical accountability links to citizens by expanding their use of indirect taxes. Still, direct and indirect tax categories do not capture the concepts of accountable and coercive taxes as well as necessary for firm conclusions to be drawn. Ideally, one could re-categorise tax bases according to the degree and type of accountability they required, but regrettably, the data on individual bases is not currently available. In the current categorisation, direct taxes in particular may be difficult to interpret. State governments have few direct tax bases to mobilise, and it is rare that subnational units of government mobilise significant direct taxes.

It is appropriate at this point to inquire whether the increased vertical accountability to states offset the decline in layered account-

Graph 8. Tax as a percentage of GDP

Source: Compiled from World Bank, *World Development Indicators*

ability to the centre in terms of the amount of resources that could be mobilised. In other words, was the trade-off between layered accountability and vertical accountability to states neutral with respect to tax capacity? As Graph 8 shows, it was not. The proportion of GDP collected in taxes by all levels of government increased from 8.4 per cent in 1974 to 10.7 per cent in 1986, only to fall off again to 8.9 per cent in 1997.

7. Conclusion

Accountability in the Indian federation shifted over time, and the tax structure followed suit. For the first 40 years of Indian independence, layered accountability to central government interests dominated. Congress party dominance meant that fiscal policy-making and resources could be channelled through central government institutions. The dominance of layered accountability increased over time, and this was reflected in the weakness of institutional restraints on the centre and progressive centralisation of resources. After the 1980s, vertical accountability to state interests slowly replaced layered accountability to the centre. The party system decentralised, and non-Congress and regional parties grew in importance. State governments became more assertive in securing revenues and powers. Eventually, the Congress party and the central government lost their pride of place in the Indian federation. At the current juncture, India is a much more decentralised federation in which vertical accountability to state interests predominates. Coalition government is the norm at the centre, Congress is no longer dominant, state governments are much more competitive with each other and with the central government, and government intervention in the economy is much more limited. Table 1 summarises the argument.

Table 1

<i>1960s and 1970s</i>	<i>1980s and 1990s</i>
Vertical accountability to states	Layered accountability to the centre
Regional parties in states and coalition government at the centre	One party dominates
Transfers mostly through apolitical, technical Finance Commission	Significant transfers through centrally controlled Planning Commission
States control significant revenues	Centre retains most revenues
States expand indirect taxes	Centre expands direct taxes
Decreasing tax capacity	Increasing tax capacity

These observations call for some wider consideration about the switch away from layered accountability in terms of Indian political economy. The 1990s began with a fiscal crisis that took India to the IMF for the first and only time in its history. It was clear to most observers that the centrally planned economy of the previous 40 years had stalled. The response favoured by conservative elites was to decrease state intervention, liberalise trade, privatise state enterprises and shrink the size of the central government.

These plans found support with the masses of small businesses and consumers who had not benefited much from central planning (Candland, 1997: 25–27). Such groups were available but would have to be drawn away from long-standing ties to Congress. Most important among the appeals used to capture these sectors have been communal appeals based on traditional animosity to minorities, such as Muslims (Jeffrey, 1994: 182–200). The chief beneficiary of these trends was the right-wing Hindu-nationalist Bharatiya Janarta Party (BJP), which adeptly combined marketising reforms with communalist appeals. A crucial ingredient to BJP success was its ability to form parliamentary coalitions, especially with regional parties that were powerful in individual states but held only a few seats in the national parliament. With the support of these parties, the BJP built a governing coalition at the national level.

In purchasing the support of regional interests, the national government had to give up power and resources to the states. Conveni-

ently, this starved the central government of funds and contributed to marketising plans to cut central government economic intervention. In addition, the centre could place part of the blame for cuts to economic programmes on states that did not pick up the slack.

For the state governments, the bargain was attractive as it increased their role in the federation. They were important partners in the national governing alliance and they could secure power and resources in exchange for their support. This meant that they had more autonomy in setting local agendas, allowing them to respond more flexibly to local demands. Interestingly, the states did not respond to increased fiscal leverage by increasing their taxes to compensate entirely for cuts made by the central government.

An explanation for this phenomenon lies beyond the purview of this article, but several possibilities for future research are appropriate. First, at least since the late 1990s, the states have come under significant fiscal pressure of their own, especially because of the Fifth Pay Commission that raised all public sector salaries and constrained room for fiscal manoeuvre on the expenditure side. Second, as the central government increasingly withdrew from developmental investment, state governments offered tax incentives to compete for private investment; a competition that wealthy and well-positioned states usually won. Third, the turn towards conservative and communal politics may operate along similar lines to right-wing populist movements in other contexts that press for weakening central governments and decreasing tax takes. These and other factors might account for the particular way in which increased vertical accountability to states has coincided with increased inequality across states and falling tax capacity. In particular, key insights might be gained by comparing the political determinants of fiscal behaviour in different states (Chhibber and Nooruddin, 2004).

In India in the 1990s, the growing role of vertical accountability strengthened the fiscal bargaining position of state governments and was congruent with marketising reforms. The confluence of strengthened regional interests, national marketisation, and decreased tax capacity suggests an interesting relationship that deserves to be studied in other federal contexts.

References

- Ames, Barry, 1995, 'Electoral Rules, Constituency Pressures, and Pork Barrel: Bases of Voting in the Brazilian Legislature, *Journal of Politics*, Vol. 57, No. 2, pp. 324–343.

- Arora, Balveer, 1989, 'Centralist and Regionalist Parties in India's Federal Polity', in Hasan, Jha and Jhan, eds.
- Arora, Balveer and D.V. Verney, eds, 1995, *Multiple Identities in a Single State: Indian Federalism in Comparative Perspective*, New Delhi: Konark Publishers.
- Arora, Balveer and B. Radin, 2000, *The Changing Role of the All-India Services*, New Delhi: Centre for Policy Research/U Penn CASI-APIASI.
- Bird, Richard M., 1999, 'Rethinking Subnational Taxes: A New Look at Tax Assignment', *Working Paper*, Vol. WP/99/165, Washington DC: IMF.
- Bird, Richard M. and Duanjie Chen, 1998, 'Federal Finance and Fiscal Federalism: The Two Worlds of Canadian Public Finance', *Canadian Public Administration*, Vol. 41, pp. 51–74.
- Blair, Harry, 2000, 'Participation and Accountability at the Periphery: Democratic Local Governance in Six Countries', *World Development*, Vol. 28, No. 1, pp. 21–39.
- Brass, Paul R., 1994, *The Politics of India Since Independence*, Cambridge, UK: Cambridge University Press.
- Bräutigam, Deborah, 2002, 'Building Leviathan: Revenue, State Capacity and Governance', *IDS Bulletin*, Vol. 33, No. 3, pp. 10–20.
- Brennan, Geoffrey and James M. Buchanan, 1980, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Cambridge, Cambridge University Press.
- Breton, Albert, 1996, *Competitive Governments: An Economic Theory of Politics and Public Finance*, Cambridge: Cambridge University Press.
- Buchanan, James M., 1987, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*, Chapel Hill: University of North Carolina Press.
- Candland, Christopher, 1997, 'Congress Decline and Party Pluralism in India', *The Journal of International Affairs*, Vol. 51, No. 1.
- Chaubey, P.K., 2003, *Fiscal Federalism in India*, New Delhi: Deep and Deep Publications.
- Chhibber, Pradeep and Irfan Nooruddin, 2004, 'Do Party Systems Matter? The Number of Parties and Government Performance in the Indian States', *Comparative Political Studies*, Vol. 37, No. 2, pp. 152–187.
- Eggertsson, Thrain, 1990, *Economic Behaviour and Institutions*, New York: Cambridge University Press.
- Eichengreen, Barry and Jürgen von Hagen, 1996, *Fiscal Policy and Monetary Union: Is There a Tradeoff Between Federalism and Budgetary Restrictions?*, Cambridge, MA: National Bureau of Economic Research.
- Elazar, Daniel, 1962, *The American Partnership: Inter-governmental Cooperation in the Nineteenth Century United States*, Chicago: University of Chicago Press.
- Evans, Peter, Dietrich Rueschemeyer and Theda Skocpol, 1985, *Bringing the State Back In*, Cambridge: Cambridge University Press.
- Fiszbein, Ariel, 1997, 'The Emergence of Local Capacity: Lessons from Colombia', *World Development*, Vol. 25, No. 7, pp. 1029–1043.
- Fjeldstad, Odd-Helge, 2002, 'Collectors, Councillors and Donors', *IDS Bulletin*, Vol. 33, No. 3, pp. 21–29.
- Frankal, Francine, 1978, *India's Political Economy, 1947–1977: The Gradual Revolution*, Princeton.

- Gramlich, Edward M., 1987, 'Federalism and Federal Deficit Reduction', *National Tax Journal*, Vol. 40 (September), pp. 299–313.
- Greenstein, F.I. and N.W. Polsby, eds, 1975, *The Handbook of Political Science: Government Institutions and Processes*, Reading MA: Addison Wesley.
- Grodzins, Morton, 1960, 'American Political Parties and the American Political System', *Western Political Quarterly*, Vol. XIII, No. 4, pp. 974–998.
- Grodzins, Morton, 1966, *The American System: A New View of Government in the United States*, Chicago: Rand McNally and Company.
- Hasan, Z., S.N. Jha and R. Jhan, eds, 1989, *The State, Political Processes and Identity: Reflections on Modern India*, New Delhi: Sage.
- Jeffrey, Robin, 1994, *What's Happening to India: Punjab, Ethnic Conflict and the Test for Federalism*, London: Macmillan.
- Kenney, Charles D., 2000, 'Reflections on Horizontal Accountability: Democratic Legitimacy, Majority Parties and Democratic Stability in Latin America', paper read at Institutions, Accountability and Democratic Governance in Latin America, at The Helen Kellogg Institute for International Studies.
- Khan, Rasheeduddin, 1997, *Rethinking Indian Federalism*, Shimla: Inter-University Centre for Humanities and Social Sciences.
- Kohli, Atul, 1990, *Democracy and Discontent: India's Growing Crisis of Governability*, Cambridge: Cambridge University Press.
- Kohli, Atul, ed., 1988, *India's Democracy: An Analysis of Changing State–Society Relations*, Princeton: Princeton University Press.
- Kothari, Rajni, 1964, 'The Congress «System» in India', *Asian Survey* (December), pp. 1161–1173.
- Levi, Margaret, 1988, *Of Rule and Revenue*, Berkeley: University of California Press.
- Manor, James, 1981, 'Party Decay and Political Crisis in India', *Washington Quarterly* (Summer).
- Manor, James, 1988, 'Parties and the Party System', in Kohli, ed.
- Manor, James, 1995, 'Regional parties in federal systems: India in comparative perspective', in Arora and Verney, eds.
- Moore, Mick and Lise Rakner, 2002, 'The New Politics of Taxation and Accountability', *IDS Bulletin*, Vol. 33, No. 3, Brighton: IDS.
- Musgrave, R.A., 1959, *The Theory of Public Finance*, New York: McGraw Hill.
- Musgrave, Richard A. and Peggy B. Musgrave, 1984, *Public Finance in Theory and Practice* (fourth edition), San Francisco: McGraw Hill.
- Newell, Peter and Shaula Bellour, 2002, 'Mapping accountability: origins, contexts and implications for development', in *IDS Working Paper*, No. 168, Brighton: IDS.
- Oates, Wallace, 1972, *Fiscal Federalism*, New York: Harcourt Brace Jovanovich.
- Oates, Wallace, 1996, 'Taxation in a Federal System: The Tax-Assignment Problem', *Public Economics Review*, Vol. 1, pp. 35–60.
- Oates, Wallace, 1998, *The Economics of Fiscal Federalism and Local Finance*, edited by M. Blaug. Cheltenham, UK: Edward Elgar Publishing.
- Oates, Wallace, 1999, 'An Essay of Fiscal Federalism', *Journal of Economic Literature*, Vol. 37, pp. 1120–1149.
- Oates, Wallace E. and Robert Schwab, 1988, 'Economic Competition Among Jurisdictions: Efficiency-Enhancing or Distortion-Inducing?', *Journal of Public Economics*, Vol. 35, pp. 333–354.

- O'Donnell, Guillermo, 1999, 'Horizontal Accountability in New Democracies', in Schedler, Diamond and Plattner, eds.
- Pauly, Mark V., 1973, 'Income Redistribution as a Local Public Good', *Journal of Public Economics*, Vol. 2, pp. 35–58.
- Prud'homme, Remy, 1995, 'The Dangers of Decentralisation', *World Bank Research Observer*, Vol. 10, No. 2, pp. 201–220.
- Prud'homme, Rémy, 1998, *State and Local Finance in Paraná: Structure and Issues*, Curitiba: Parancidade.
- Riker, William H., 1975, 'Federalism', in Greenstein and Polsby, eds.
- Rudolph, Lloyd and Susan Hoeber Rudolph, 1987, *In Pursuit of Lakshmi*, Chicago: University of Chicago Press.
- Samuels, David J., 2000, 'The Gubernatorial Coattails Effect: Federalism and Congressional Elections in Brazil', *Journal of Politics*, Vol. 62, No. 1, pp. 240–253.
- Sáez, Lawrence, 2002, *Federalism without a Centre: The Impact of Political and Economic Reform on India's Federal System*, New Delhi: Sage Publications.
- Schacter, Mark, 2001, 'When Accountability Fails: A Framework for Diagnosis and Action', *Canadian Journal of Policy Research*, Vol. 2, No. 2, pp. 134–137.
- Schedler, Andreas, 1999, 'Conceptualising Accountability', in Schedler, Diamond and Plattner, eds.
- Schedler, A., L. Diamond and M.F. Plattner, eds, 1999, *The Self-Restraining State. Power and Accountability in New Democracies*, Boulder and London: Lynne Rienner.
- Soberg Shugart, Matthew, Erika Moreno and Brian F. Crisp, 2000, 'The Accountability Deficit in Latin America', paper read at Institutions, Accountability and Democratic Governance in Latin America, at The Helen Kellogg Institute for International Studies.
- Stepan, Alfred, 1999, 'Federalism and Democracy: Beyond the U.S. Model', in *Journal of Democracy*, Vol. 10, October.
- Stuligross, David, 2002, *A Piece of Land to Call One's Own*, Berkeley: Political Science, University of California at Berkeley.
- Ter-Minassian, Teresa, 1997, *Fiscal Federalism in Theory and Practice*, Washington: IMF.
- Tiebout, Charles, 1956, 'The Pure Theory of Local Expenditure', *Journal of Political Economy*, Vol. 64, pp. 416–424.
- Tilly, Charles, 1985, 'War Making and State Making as Organised Crime', in Evans, Rueschemeyer and Skocpol, eds.
- Tilly, Charles, 1992, *Coercion, Capital, and European States: AD 990–1992*, Oxford: Blackwell Books.
- UNDP, 2002, 'Deepening Democracy in a Fragmented World', *Human Development Report 2002*, New York and Oxford: Oxford University Press.
- Vithal, B.P.R. and M.L. Sastry, 2001, *Fiscal Federalism in India*, New Delhi: Oxford University Press.
- Weingast, Barry R., 1995, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development', in *Journal of Law, Economics, and Organisation*, Vol. 11, No. 1, pp. 1–31.
- Wheare, K.C., 1963, *Federal Government*, New York: Oxford University Press.
- Wildasin, David, 1988, 'Nash Equilibria in Models of Fiscal Competition', *Journal of Public Economics*, Vol. 35, No. 2, pp. 229–240.

Appendix 1. Tax Heads

<i>National</i>	<i>State</i>
Excise on tobacco and other manufactured goods except alcoholic liquors for human consumption; narcotics	Land revenue, including the assessment and collection of revenues, the maintenance of land records, survey for revenue purposes
Non-agricultural income	Agricultural income
Non-export customs duties	Duties in respect of agricultural land
Corporation tax	Estate duty in respect of agricultural land
Capital value of assets except agricultural land; capital assets of companies	Mineral rights subject to any limitations imposed by Parliament by law relating to mineral development
Estate duty in respect of property other than agricultural land	Entry of goods into a local area for consumption, use, or sale therein
Property succession except agricultural land	Goods and passengers carried by road or inland waterways
Terminal taxes on goods and passengers by rail, air and sea; taxes on railways fares and freights	Excise on goods manufactured or produced in the state and countervailing duties at the same or lower rates on similar goods manufactured elsewhere in India
Non-stamp duty tax on transactions in stock exchanges and futures markets	Sale or purchase of goods other than newspapers (Sixth Amendment, 1956)
Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, insurance, debentures, proxies and receipts	Taxes on advertisements other than advertisements published in the newspaper and advertisements on radio or television (42nd Amendment, 1975, s.57)
Sale or purchase of newspapers and advertisements therein	Stamp duty in respect of documents other than stamp duties in National List
Sale or purchase of goods other than newspapers, where such a sale or purchase takes place in the course of inter-state trade or commerce	Tax on vehicles suitable for use on roads including tramcars, whether mechanically propelled or not, subject to provision of entry 35 on the list of shared taxes
Consignment of goods where such consignment takes place in the course of inter-state trade or commerce	Luxuries, including taxes on entertainment, amusements, betting, and gambling
Any other matter not enumerated in the National List or the State List including taxes not in either or both Lists	Professions, trades, callings, and employments
	Tolls
	Animals and boats
	Capitation
	Land and buildings
	Consumption or sale of electricity

Source: From Seventh Schedule, National Constitution of India