COOPERATIVE FEDERALISM IN INDIA

THE RISE AND RESILIENCE OF FISCAL TRANSFERS AMIDST PARTY SYSTEM CHANGE

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THE RISE AND RESILIENCE OF FISCAL TRANSFERS AMIDST PARTY SYSTEM CHANGE

ABSTRACT

Has political centralization induced fiscal centralization in India? This paper examines this question through an institutional analysis of India's Finance Commission, a constitutional body tasked with determining fiscal transfers from the Union government to the States, and through an analysis of Union government incentives to make discretionary transfers under various schemes. It finds no simple correspondence between political centralization and fiscal devolution. In recent years, despite the presence of a dominant party and considerable centralization of power, fiscal transfers from the Centre to the States have not undergone the sharp reversal that many expected. We argue that a nuanced understanding of the Finance Commission's unique position is central to understanding India's institutional landscape more generally. We also argue that understanding the interplay between political contestations and the pursuit of efficiency in the fiscal relations between the Union government and the sub-national governments can help shed new light on how centre-state relations are evolving.

THE PUZZLE

In India's multi-level governance structure, each tier of government has defined but overlapping and contested scopes of authority. While villages and municipalities—the third and lowest tier of government—enjoy few powers, the Union and State governments exercise significant authority. The Constitution, however, provides for a significantly centralized federal structure. It grants the Union government considerable capacity to intervene in affairs of the States, including suspending elected State governments and reconstituting State boundaries. This centralization also characterizes India's fiscal federal relations, with the bulk of revenue-raising powers residing with the Union government. As a result, Union government transfers to the States are vital for the latter's fiscal space.

The Union government's fiscal transfers to States are made through two mechanisms: the Finance Commission and a variety of Central government schemes. The first mechanism, a constitutional body called the Finance Commission, makes recommendations on three areas: the share of the divisible pool of the Union government's taxes that is to be devolved to the States,[1] grants made by the Union government to the States to meet their revenue deficits, and certain other grants to States and local governments. The Finance Commission is intended to be an expert body that makes recommendations based on its independent analysis and consultations with diverse stakeholders. However, the commission is constituted by the President and is mainly staffed by civil servants whose careers can be shaped by the government of the day. The second mechanism through which funds flow from the Union government to the States comprises grants made under various Union government schemes. These are decided entirely by the Union government based on its political and governance objectives.

This paper contributes to the understanding of India's multi-level, polycentric structure of politics and governance by considering fiscal transfers from the Union government to subnational governments since 2014–15.[2] The 2014 general election marked the advent of India's fourth party system, in which the Bharatiya Janata Party (BJP) enjoys dominance at the Union government level but lacks such a position in most States. To the extent the distribution of power is a constant-sum game, the dominant party typically has an incentive to pursue myriad forms of centralization. In this light, it would be advantageous for the BJP to consolidate power with the Union government so it can implement its political agenda, maintain its central dominance, and pursue power at sub-national levels. Among the most consequential tools at its disposal is the centralization of fiscal resources. Indeed, one would predict that the BJP-led Union government would look to centralize fiscal resources at the Union level to further its political objectives. However, as described later in this paper, we do not find unambiguous evidence of such centralization; changes in transfer patterns suggest a nuanced picture with aspects of both centralization and decentralization.

This, we suggest, is a puzzle. While the dominant party at the Union level has strong incentives to centralize fiscal resources, fiscal transfers to States have increased—even as centralization has transpired in other ways. Exploring this puzzle can help understand the workings of vital political economy processes, institutional mechanisms, and policy frameworks that shape intergovernmental fiscal transfers in India in three ways.

1 The divisible pool comprises gross tax collection minus cesses and surcharges and the cost of tax collection.
2 Union territories without legislatures are not considered in this paper.

First, there is a constitutional scheme for fiscal transfers that includes certain governance imperatives. Although these imperatives are interpreted differently at different times—as exemplified by the changes in the scale and composition of fiscal transfers over time—they provide the legal framework within which decisions are taken. Analysis of fiscal transfers in the fourth party system can help us understand how these constitutional provisions have been interpreted in recent years, and which factors have shaped these interpretations.

Second, certain unelected institutions with constitutionally mandated powers and responsibilities also shape policies. In this case, the Finance Commission is the primary institution of interest, but other institutions have also played a part in shaping transfers. These include the erstwhile Planning Commission and the Goods and Services Tax (GST) Council. These institutions enjoy varying degrees of independence under the law, but they also interact with multiple stakeholders. Thus, their decisions may be shaped by a variety of factors, including professional standards, views of peer groups, decision-making procedures, political pressures, and more.

Third, the political realities of multi-level governance in India can also shape outcomes. If a union is seen as an outcome of a bargain between the States and the Centre, the changing dynamics of the bargain would also shape decisions on fiscal transfers. If, for example, States are able to act collectively to demand an increase in transfers from the Union government, it would likely impact decisions on this matter.

This paper proceeds in nine parts. Following this introduction, Part II provides a brief overview of India's four party systems, while Part III introduces India's system of fiscal federalism. Part IV presents an overview of India's constitutional arrangement for fiscal transfers. Part V examines the historical connection between economic and political decentralization, with special attention paid to the two most recent Finance Commissions. Part VI summarizes our key takeaways on the operations of the Finance Commission and its distinguishing features. Part VII considers how the Finance Commission has been able to maintain its independence despite changes in India's party system. Part VIII seeks to explain why the Union government did not significantly reduce non–Finance Commission grants to the States. In Part IX, we provide brief concluding remarks.

THE EVOLUTION OF INDIA'S PARTY SYSTEM

One of the most visible trends in India's political economy in recent years is the transformation of its party system. Since 1947, India has had four distinct 'party systems', to borrow the term first employed by Yogendra Yadav in 1999.[3] Each party system has had a unique distribution of power across parties at the Union level and in the States.

The 'first party system' roughly coincides with the period from 1947 to 1967. During this two-decade stretch, the Congress Party occupied a hegemonic position, drawing on the enormous reservoir of goodwill it enjoyed thanks to its role as the vanguard of the Independence movement. As political scientist James Manor has remarked, the Congress was not only the most important political party in India, but it was also arguably the most significant political institution in the country.[4] That is not to say there was not robust political competition across the board but, due to the Congress's strengths and the

3 Yogendra Yadav, "Electoral Politics in the Time of Change: India's Third Electoral System, 1989–99," *Economic and Political Weekly* 34, no. 34/35: 2393-99.
4 James Manor, "How and Why Liberal and Representative Politics Emerged in India," *Political Studies* 38 (1990): 20-38.

opposition's fragmentation, the Congress comfortably secured parliamentary majorities and controlled power in most of India's electorally critical States.

The 1967 elections ushered in the start of the 'second party system'. The Congress Party lost several critical State elections that year, conclusively ending its era of total dominance. While the party would continue to enjoy power at the national level, this too came under increasing threat before eventually unraveling. In 1977, after twenty-one months of Emergency rule under Indira Gandhi (during which many constitutional freedoms were suspended in draconian fashion), fresh elections were called and the Congress was decisively thrown out of office. Opposition rule would only last two years, but the moment was a harbinger of things to come. The Congress came back to power in 1980 and controlled the Union government until 1989, when it gave way to the first of several coalition governments.

The quarter-century from 1989 to 2014 comprised the 'third party system', or the era of coalition government. During this period, no single national party was strong enough to claim an outright parliamentary majority; instead, governments consisted of large, multi-party coalitions. The Congress Party's pole position was threatened by the rise of the BJP, a new party formed in 1980 and the successor to the Jan Sangh. While the BJP gained popularity during this period and led governments in 1998 and 1999, it was only able to do so in alliance with many smaller parties. Similarly, politics at the State-level was deeply contested and saw a sharp rise in the number of parties fighting elections. In many States, regional parties asserted themselves in new ways, displacing the Congress Party as the so-called default party of governance.

The era of coalitions would end in 2014, giving way to what has been called India's 'fourth party system'.[5] This new system, which continues today, is analogous to the second party system in many ways. The BJP has expanded its reach in the States but has no monopoly on power there. Indeed, after controlling an all-time high of twenty-one states in 2017 (on its own or with its National Democratic Alliance [NDA] allies), the NDA's tally sits at sixteen at the time of writing in April 2023. However, it enjoys a commanding position in national politics, buoyed by the unmatched popularity of Prime Minister Narendra Modi. In 2014 and again in 2019, the party notched single-party majorities in the Lok Sabha, India's lower house of Parliament—the first time in more than three decades that such a feat was achieved and the first time in India's history that a non-Congress party secured a majority of seats. In the Rajya Sabha, India's upper house of Parliament, the NDA controls 110 of 245 seats at the time of writing.

CENTRALIZATION IN THE FOURTH PARTY SYSTEM

As the dominant party, the BJP has many incentives to centralize power with the Union government. Centralization may be pursued vertically (vis-à-vis the States) by increasing the power of the Union government over the States or horizontally (vis-à-vis independent constitutional bodies and the Parliament) by reducing checks and balances on the executive's powers.[6]

To the extent that the pursuit of political power is a zero-sum game between the sub-national governments and the Union government, it is in the BJP's interest to concentrate power in the Centre. Similarly, it has incentives to exercise more control over constitutional bodies or to avoid their

5 Milan Vaishnav and Jamie Hintson, "The Dawn of India's Fourth Party System," Carnegie Endowment for International Peace, September 5, 2019.

6 If we consider a more expansive notion of politics, centralization may also be pursued by exerting more influence over civil society organizations and private capital.

interference to ensure that they do not thwart the government's priorities. Further, since the opposition directly participates in Parliament, and even enjoys a numerical advantage in the Rajya Sabha, the BJP also has a strong incentive to limit Parliament's oversight over the executive and to minimize its powers to delay or obstruct legislation.[7] It can then use these powers to secure electoral victories and implement its ideological agenda. Indeed, since returning to power in 2014, the BJP has re-centralized power in numerous ways.

First, the party has made the Rajya Sabha less relevant by using the so-called money bill route beyond its constitutional remit. The Constitution defines money bills as those pertaining 'only' to taxes, government borrowings, and government spending. Money bills must be introduced in the Lok Sabha; the Rajya Sabha can only recommend amendments, which the lower house can accept or reject. Therefore, the upper house possesses, at best, an advisory role on money bills. Since the BJP-led alliance lacks a majority in the Rajya Sabha, classifying a bill as a 'money bill' allows it to bypass the chamber entirely, avoiding the arduous task of building a coalition of support for its legislative initiatives. This workaround serves to undermine the power of the States in influencing central legislation—a key tenet of Parliament's constitutional design. In recent years, the BJP passed several key laws—such as the Aadhaar Act in 2016, amendments to the Reserve Bank of India Act, amendments to the Payment and Settlement Systems Act, and amendments to the Foreign Exchange Management Act—by classifying them as money bills, even though they appeared to run afoul of the Constitution's strict definition.

Second, the Union government has unilaterally redrawn the boundaries and powers of State governments. In August 2019, Parliament abrogated Article 370 of the Constitution, which had long granted the State of Jammu and Kashmir (J&K) a semblance of constitutional autonomy. At the same time, Parliament bifurcated the State and demoted the constituent pieces to Union Territories. In 2021, Parliament passed a law redistributing power away from the elected State government in New Delhi, placing these powers in the hands of the Lieutenant Governor—the Central government's chief representative in the national capital region. These decisions effectively undermined State powers and further concentrated authority at the Centre.

Third, the Union government has tried to expand its intervention in certain areas traditionally under the jurisdiction of State governments. For instance, in 2020, Parliament passed three agrarian reform bills intended to liberalize the farm sector. Historically, agriculture policy has been left to the States. However, the Centre moved the legislation by asserting its authority to regulate matters of inter-State commerce—a maneuver previous governments had shied away from.

Fourth, the BJP has strategically branded nationwide welfare policies in ways that afford most of the credit to the Union government. After coming to power, the Central government initiated a bevy of welfare schemes, orchestrated by the Prime Minister's Office (PMO) but implemented by State and local governments. Each of these programmes bore the prefix 'Pradhan Mantri' (Prime Minister) to signal to citizens that these benefits flowed directly from the country's chief executive to the masses. As some commentators have noted, the Union government now gets much more credit for the schemes than the State governments, even when the latter is implementing and co-financing the schemes.[8]

7 This incentive is especially heightened in the case of the Rajya Sabha where the BJP-led NDA lacks an outright majority and must bring other parties on board if it is to pass legislation.

8 Yamini Aiyar and Neelanjan Sircar, "Understanding the Decline of Regional Party Power in the 2019 National Election and Beyond," *Contemporary South Asia* 28, no.2 (2020): 209-222

Fifth, executive dominance appears to have weakened the so-called referee institutions that promote government accountability and level the playing field for incumbents and challengers.[9] These institutions include constitutional bodies such as the Election Commission and the Supreme Court. The curbing of these bodies seems to have resulted from a mix of deference, neglect, and interference.

We do not mean to imply that attempts at vertical and horizontal centralization have always succeeded. Some of these attempts—for example, the agrarian reform bills—failed. However, these five examples demonstrate that several consequential attempts have been made to achieve centralization. It seems logical to expect, therefore, that the party system might exert a strong influence on fiscal policy, especially the distribution of fiscal resources from the Union government to the States. After all, one of the most prized benefits of holding power is the ability to wield the purse strings. As Otto von Bismarck famously remarked, 'He who has his thumb on the purse has the power.'

FISCAL TRANSFERS SINCE 2014–15

Before examining the link between political and fiscal centralization, we briefly summarize recent developments in fiscal transfers (see Table 1 for details). In 2015, the Fourteenth Finance Commission (FC-XIV) recommended major changes in transfers to sub-national governments, namely increasing the devolution of tax revenues to the States. Following the implementation of its recommendations, the devolution of the Union government's tax revenues to the States rose from 27.1 percent in 2014–15 to 34.8 percent of gross tax revenues in 2015–16. Non-devolution transfers fell from 27.1 percent of gross tax revenue in 2014–15 to 22.5 percent in 2015–16 to partly offset this rise in devolution. All told, overall transfers from the Union government to sub-national governments rose from 54.2 percent to 57.3 percent of gross tax revenue. As Table 1 shows, the States' share in Union government taxes rose steadily to 38.4 percent in 2018–19, while other transfers remained at about the same level, taking total transfers to 60.2 percent of gross tax collection.

Table 1: Devolution and transfers from the Union government to sub-national governments (as a percentage of Union government's gross tax revenue, excluding GST compensation cess)

Year	Devolution of States' share in taxes	Transfers to J&K from 2020–21	Finance Commission grants	Other transfers (excluding loans in lieu of GST compensation)	Total
2015–16	34.8		5.8	16.7	57.3
2016–17	35.4		5.6	16.4	57.4
2017–18	36.3		5.0	17.2	58.5
2018–19	38.4		4.7	17.1	60.2
2019–20	34.0		6.5	19.4	59.8

9 Milan Vaishnav, "Backsliding in India? The Weakening of Referee Institutions," in Rachel Beatty Riedl, Kenneth Roberts, Thomas Pepinsky, and Valerie Bunce, eds., *Global Challenges to Democracy: Cross-Regional Perspectives* (forthcoming).

Year	Devolution of States' share in taxes	Transfers to J&K from 2020–21	Finance Commission grants	Other transfers (excluding loans in lieu of GST compensation)	Total
2020–21	30.6	1.6	9.5	16.5	58.2
2021–22	34.5	1.3	8.0	17.4	61.1
2022-2023 (Revised Estimates)	32.6	1.5	5.9	20.2	60.3
2023-2024 (Budget Estimates)	31.8	1.1	5.1	21.0	59.0

Source: Authors' calculations based on figures from the budget documents of the Ministry of Finance, Government of India. Most the numbers are from the statement on "Transfers of Resources to States and Union Territories with Legislature", which is usually the third statement of "Budget at a Glance," https://www.indiabudget.gov.in/doc/Budget_at_Glance/bag3.pdf.

The gross tax revenue of the Union government fell from 11.2 percent in 2017–18 to 10 percent of GDP in 2019–20. This was likely due to the decline in India's gross domestic product (GDP) growth rate from 6.8 percent in 2017–18 to 3.7 percent in 2019–20. One of the many ways in which the Union government responded to the situation was to squeeze devolution to the States by increasing Central cesses and surcharges, especially those on petroleum products. Cesses and surcharges are outside the divisible pool shared with the States and, thus, accrue only to the Centre. As a result, in 2019–20, the States' share in the Union government's gross tax revenue fell to 34 percent. However, since other transfers rose to 25.9 percent of gross tax revenue, overall centre-state transfers remained roughly stable.

The COVID-19 pandemic pushed India's public finances into a crisis, as revenue receipts fell while demand for additional expenditures rose. Although the States were allowed to increase their fiscal deficits, the Union government undertook much of the additional borrowing to finance the fiscal support needed during the crisis. In 2020–21, the Union government's fiscal deficit was 9.2 percent of GDP while the States' was 4.1 percent of GDP. Facing a fiscal crunch, the Union government intensified its strategy of raising taxes from duties on petroleum products. However, since this was accomplished by raising cesses, the States did not receive a share of these resources. Further, following the recommendations of the Fifteenth Finance Commission (FC-XV), devolution to the States was reduced by 1 percentage point to account for the demotion of Jammu and Kashmir from a State to two separate Union Territories. As a result, the States' share in the Union's government's gross tax revenue fell to 30.6 percent (or about 32.2 percent if one includes transfers to the two new Union Territories, J&K and Ladakh)—still above the pre-FC-XIV share but much lower than in previous years.

Other transfers to sub-national governments rose to a whopping 31.7 percent of gross tax revenue of Union government in 2020–21. However, that year, two new components were introduced that were dramatically different in nature from other types of recent fiscal transfers. First, in both 2020-21 and 2021-22, State governments were given loans to make up for the GST compensation shortfall. Second, the Union government made 50-year interest-free loans to State governments for capital expenditure to aid in the economic recovery. Interest-free loans for such a long period are essentially grants.[10] Therefore,

10 Assuming a 6 percent average interest rate, the present value of the amount to be repaid 50 years later is about 5 percent of the total amount.

these should be included in transfer calculations while the loans in lieu of GST compensation shortfall should not be included. Calculations given in Table 1 excludes the latter. All told, non-devolution transfers accounted for 26 percent of the Union government's gross tax revenue in 2020-21.

In 2021–22, devolution to the States rose to 34.5 percent of gross tax revenue (35.8 percent if one includes the transfers to J&K and Ladakh). In that year, excluding loans in lieu of GST compensation shortfall, non-devolution transfers totaled 25.4 percent of the Union government's gross tax revenue. Total transfers, including those to J&K and Ladakh, were about 61.1 percent of gross tax revenue. This increase in devolution seemed to suggest that the pre-2019–20 pattern of transfers might be restored. In 2022–23, based on revised estimates, devolution fell to 32.6 percent of gross tax revenue (34.1 percent including transfers to J&K and Ladakh). Non-devolution transfers were 26.1 percent of gross tax revenue. Total transfers were 60.2 percent of gross tax revenue. Looking ahead, the budget for 2023–24 has envisaged devolution of 31.8 percent of gross tax revenue (32.9 percent including transfers to J&K and Ladakh) and 26.1 percent of gross tax revenue for other transfers. If this comes to pass, total transfers will be about 59 percent of gross of tax revenue (including transfers to J&K and Ladakh).

All told, the increase in transfers in 2015–16 following the implementation of FC-XIV's recommendations remained stable from 2015–16 to 2018–19, as did the composition of transfers. Since then, however, there have been significant changes in fiscal transfers. The composition of transfers has shifted towards more non-devolution transfers and new types of purpose-specific transfers have been introduced. This can arguably be considered centralizing, because the purpose-specific transfers give less flexibility to the sub-national governments. However, there has not been any decline in total transfers from the Union government to sub-national governments. In looking at the big picture, the overall story that emerges is one of considerable resilience in transfers despite a variety of fiscal crises plaguing India during this period.

To fully understand this phenomenon, we turn now to a detailed examination of India's system of intergovernmental fiscal transfers.

INDIA'S FISCAL FEDERALISM

As alluded to above, India's system of fiscal federalism demonstrates a severe vertical imbalance; while the Constitution assigns most major powers of taxation to the Union government, sub-national governments are responsible for a majority of expenditures. This imbalance has arguably become even more pronounced following the establishment of the GST in 2017, which created a nationwide indirect tax on the supply of goods and services.[11] The impact of the GST on India's federal structure is complicated. On the one hand, by enabling India to operate as a single market, the GST enhances a key aspect of market-preserving federalism—that States can compete with one another with fewer frictions over inter-State trade. On the other hand, the GST increases the powers of the Union government over taxation. The Union government has a one-third voting share in the GST Council, while the States hold the remaining two-thirds. Decisions must be taken by a three-fourths majority. Therefore, the Union government needs to sway about 60 percent of the States to advance a proposal.

11 The GST replaced existing multiple taxes levied by the central and state governments, but further vested taxation powers at the center. Under the GST, revenue from intra-state transactions is shared equally between the center and the states. However, for inter-state transactions, the central government collects revenues and distributes the state's share to the state where the good or service is being purchased. Former chief economic advisor to the Government of India Arvind Subramanian has called the measure a "voluntary pooling of sovereignty in the name of cooperative federalism" because the states are willingly sharing taxation powers it once monopolized with the union government. See "One Nation, One Tax," *The Economist*, August 6, 2016.

States also face a hard budget constraint, as they are required to stay within the fiscal deficit limits, while the Union government has more flexibility. There is a fiscal responsibility law that is supposed to define the hard budget constraint for the Union government. Experience shows that the government has been easily able to change the deficit limit - although this is subject to Parliamentary approval, that is not difficult to obtain as it only requires approval by the Lok Sabha, where the government enjoys a clear majority. So, fiscal transfers from the Union government to sub-national governments are quite consequential for the latter.

There are two mechanisms by which the Centre transfers resources to the States to remedy this imbalance. First, the Constitution dictates the convening of a Finance Commission every five years to distribute tax revenue and make grant allocations to the States. Second, the Union government creates and implements a raft of Central sector and Centrally sponsored schemes (CSS) in which Union government ministries provide funds to States for the implementation of development priorities identified by the Centre. Under the Constitution, the Union government is empowered to make grants for any public purpose even if that purpose is a State subject. These are usually for the purpose of schemes that are either entirely funded by the Union government or co-funded by the State governments. These grants are entirely within the remit of the Union government to decide; therefore, the Union Government enjoys *de jure* discretion to redesign these transfers as it sees fit.

From 1950 until its abolition in 2014, the Planning Commission—a body created by executive order—allocated a significant share of Central resources to the States. This mission created obvious overlaps with the Finance Commission, which was resolved to some degree with the decision (from the Fourth Finance Commission onwards) that the Finance Commission would focus on the non-plan requirements of States.[12] With the abolition of the Planning Commission in 2014, this channel is no longer operative. Now, these transfers are decided by the relevant ministries along with the Ministry of Finance, presumably with the Prime Minister's Office (PMO) playing a key role given its participation in the budget-making process.

Finance Commission

The primary institution for intergovernmental fiscal transfers is the Finance Commission. According to its constitutional mandate, the Finance Commission is tasked with evaluating the state of finances of the Union and State governments, recommending the distribution of tax proceeds between them and among the States, and outlining the principles governing grants to aid State revenues out of the Consolidated Fund of India (CFI). Grants-in-aid are funds provided by the Central government to the States to finance essential development activities. Article 280 of the Indian Constitution stipulates that the President shall convene a Finance Commission two years after the commencement of the Constitution and at the expiration of every fifth year thereafter (or earlier, if deemed necessary). The Finance Commission consists of a chairman and four other members. Article 280(3) authorizes the commission to make recommendations to the President along three lines:

(1) the distribution and allocation of the net proceeds of shareable taxes between the Union and the States as well as between the States;

12 Manish Gupta and Atul Sarma, "The Role of Finance Commissions in Intergovernmental Fiscal Management," *Economic and Political Weekly* 62, no. 6 (2022): 43-50.

(2) the principles governing grants-in-aid of the revenues of States out of the CFI; and

(3) any other matter the President refers to the commission 'in the interests of sound finance'.

Subsequently, with the Seventy-Third and Seventy-Fourth Amendments mandating devolution to the third tier of government, the Finance Commission was authorized to make recommendations needed to augment the consolidated fund of a State to supplement resources required by panchayat and municipal governments based on recommendations advanced by State finance commissions.

To date, India has had fifteen Finance Commissions. The most recent one submitted its final report in November 2020 and its recommendations govern fiscal transfers through 2026. After a Finance Commission's report is finalized, it is tabled in Parliament. Once Parliament accepts its findings, its recommendations for tax sharing and grants are considered statutorily mandated annual transfers from the Union government to the States. [13] The recommendations relating to distribution of Union taxes and duties and grants-in-aid are implemented by an order of the President. Other recommendations made by the Finance Commission, as per its terms of reference, are implemented by the Union government's executive order.

Broadly speaking, the history of Finance Commissions can be divided into two phases. During the first phase, which includes the first ten commissions, the Union government only shared two taxes with the States: net proceeds of income tax and Union excise duties. The share devolved to States from these two categories of taxes varied over the course of the first ten commissions. The States' share of net proceeds of income tax steadily increased from 55 percent during the First Finance Commission (FC-I) to a high of 85 percent during the Seventh Finance Commission (FC-VII), remaining at that level until the Tenth Finance Commission (FC-X) recommended the share to be 77.5 percent. States' share of Union excise duties fell from 40 percent during FC-I to 20 percent in the Third Finance Commission (FC-III) and remained at that level through the Sixth Finance Commission (FC-VI). During the Seventh Finance Commission (FC-VII), States' share in net proceeds of Union excise duties was raised to 40 percent and it hovered between 40 percent and 47.5 percent until FC-X.[14]

Beginning from the Eleventh Finance Commission (FC-XI), all Union taxes were made shareable with States (with certain exemptions specified under Articles 268 and 269) via an amendment to Article 270 of the Constitution. This change was formally accomplished through the Eightieth Amendment to the Constitution and marked an important shift. The States could now rely on a share from a broader pool of Central taxes, enhancing the certainty and predictability of flows. According to scholars Manish Gupta and Atul Sarma, FC-XI devolved 29.5 percent of all shareable Union taxes to the States.[15] This share rose to 30.5 percent and 32 percent during FC-XII and FC-XIII, respectively. As discussed earlier in this paper, it was raised to 42 percent during FC-XIV.[16] FC-XV decreased this number to 41 percent, after accounting for Jammu and Kashmir becoming two Union Territories rather than a State.

13 Indira Rajaraman, "Continuity and Change in Indian Fiscal Federalism," *India Review* 16, no. 1 (2017): 66-84. There are examples of the central government ignoring Finance Commission allocations even after their acceptance by Parliament. As these transfers are considered statutory obligations, this has been the exception, rather than the rule. See Indira Rajaraman and Debdatta Majmudar, "Equity and Consistency Properties of the Twelfth Finance Commission Recommendations," *Economic and Political Weekly* 40, no. 31 (2005): 3413-20.

14 Gupta and Sarma, "The Role of Finance Commissions in Intergovernmental Fiscal Management."

15 Gupta and Sarma, "The Role of Finance Commissions in Intergovernmental Fiscal Management."

16 Reddy and Reddy note that the tax devolution of 42 percent recommended by FC-XIV is not strictly comparable with the devolution recommended by previous Finance Commissions because FC-XIV "considered the entire revenue account of States–and therefore normal Plan assistance and other assistance for State Plans was subsumed under tax devolution." See Y.V. Reddy and G.R. Reddy, *Indian Fiscal Federalism* (New Delhi: Oxford University Press, 2019): 74.

Though not the only institution tasked with this role, the Finance Commission is arguably the most significant body charged with making policy for intergovernmental funding transfers. For instance, Indira Rajaraman finds that flows governed by the Finance Commission accounted for roughly 60 percent of total Central transfers to the States in the immediate pre-liberalization era (1985–1990).[17] That share rose, hovering around 70 percent after the implementation of the recommendations of FC-XIV starting in 2015–16. This was an important shift in the historical pattern of India's fiscal federal system, as it signaled the end of a system that relied heavily on discretionary (as opposed to formula-based) transfers.[18]

Since the onset of the fourth party system, two Finance Commissions (FC-XIV and FC-XV) have presented their recommendations on the distribution of fiscal resources. Intriguingly, there is little evidence of centralization in either case, contradicting the trend observed in so many other policy areas. For instance, FC-XIV (which technically was constituted prior to the current government's first term) greatly expanded the degree of fiscal decentralization by increasing States' share in the divisible pool from 32 to 42 percent. Although the BJP government did try to counter this devolutionary thrust by increasing cesses and surcharges outside of the divisible pool, it only succeeded in doing so at the margins. Further, the government's non–Finance Commission grants to the States decreased only marginally during FC-XIV's implementation period. So, overall transfers did increase significantly (albeit not as much as envisaged by FC-XIV).

More recently, despite much controversy over its terms of reference—which many interpreted as an effort to tilt the scales in the direction of the Centre—FC-XV's recommendations have largely adhered to the framework adopted by its predecessor. Despite the government's ability to craft the commission's terms of reference and pick its members, it did not reverse the prevailing push towards decentralization.

To understand why political centralization has coincided with higher fiscal transfers, it is important to consider the interplay between the Union government and the Finance Commission, as well as the incentives driving non–Finance Commission transfers from the Union government to the sub-national governments. Some skeptics might question the premise that the Finance Commission, an independent constitutional body, can be influenced by the nature of the party system. However, it is worth noting that similar charges have been levied against other independent apex bodies, including the Election Commission and the Supreme Court.

THE INTERPLAY BETWEEN POLITICS AND ECONOMICS

There is ample reason to hypothesize that the patterns of India's fiscal federal relations might closely track the distribution of political power in the party system. There are at least four reasons for suspecting such a link.

First, the government of the day can set the terms of reference of the Finance Commission. The President can use their power to recommend any task in the pursuit of 'sound finance' to the Finance Commission. In other words, the government in power can craft the terms of reference in a way that constrains the Finance Commission's room to maneuver. Thus, a party system with a strong centre may further constrain the institution.

17 Rajaraman, "Continuity and Change in Indian Fiscal Federalism."

18 Earlier work by Indira Rajaraman reveals that the non-statutory flow of funds from the center to the states was larger than the statutory flow for the first two decades after 1950 and then accounted for roughly half of all flows for the next three decades. See Indira Rajaraman, "The Political Economy of the Indian Fiscal Federation" *India Policy Forum* 4 (2007): 1-51.

Second, the government (via the President) appoints the Chairman and four members of the Finance Commission; it can stack the deck in its favour through the appointments process. The government not only has full discretion in naming individuals to serve as members, but it also staffs the secretariat that does much of the commission's behind-the-scenes work. Through both channels, the government can influence the findings of the commission's final report.

Third, there is also the possibility of standard-issue political pressure on the Finance Commission. Especially when the party system is dominated by a single party with a clear majority, the executive tends to loom large in policymaking matters. The government can leverage this stature and the tools at its disposal to influence the commissioners. Indeed, as FC-XV was deliberating, many eyebrows were raised when the commission's Chairman held a closed-door meeting with the Prime Minister. Although there was no outwardly visible evidence of external pressure or favour trading, the meeting raised the possibility that the PMO could place its thumbs on the scales.

Fourth, the Union government could choose to accept a Finance Commission's recommendations and then undermine their implementation—a pattern that has been observed. For instance, the Union government accepted FC-XIV's recommendation to increase the share of untied funds devolved to the States from 32 to 42 percent of the divisible pool. However, as Yamini Aiyar and Louise Tillin have argued, the Centre chose to levy special revenue cesses that are segregated from the divisible pool and thus not shared with the States.[19]

Fifth, the Finance Commission is staffed mostly with career civil servants who serve in the commission for some time and then go back to their respective cadres, which are controlled by the Union government. Even though some of them serve under the audit and accounts bureaucracy which in principle operates at an arm's length from the executive, the government could still influence the Finance Commission's staff to protect its own interests. Even officers from the audit and accounts bureaucracy serve in positions in the government, in regulatory agencies and other public sector organizations.

The process through which the Finance Commission arrives at its recommendations involves extensive consultations with the Union government as well as State governments. These consultations are held individually with each government behind closed doors. The States have a stronger incentive to seek a greater share of the pool of devolved tax collection and advocate for more revenue-deficit grants than to seek an increase in the overall devolution. This pits the States against one another in a zero-sum game. While some likeminded States might act collectively to seek better outcomes for themselves, individuals States typically have quite distinct circumstances. This makes it difficult for States to cooperate and pursue collective action through their consultations with the Finance Commission.

Actual Patterns of Central-State Transfers

Table 2 outlines transfers from the Union government to the States since FC-III (1962 onwards) with periods demarcated based on Finance Commission tenures. These data need to be interpreted carefully as some changes over time may be due to changes in classification or definitions. However, prima facie, the numbers indicate a trend towards an increasing share of revenues shared with the States. The cumulative impact is that the states' share of tax revenue has almost doubled (although there is evidence

19 Yamini Aiyar and Louise Tillin, "'One Nation,' BJP, and the Future of Indian Federalism," *India Review* 19, no. 2 (2020): 117-135.

of some degree of reversal in the period immediately after each major increase or decrease). Notably, the table also indicates certain discrete time periods in which major shifts have transpired.

There were significant increases in tax devolution during the Fifth Finance Commission (FC-V) and FC-VII, and then again with FC-XIV. Devolution remained more stable between FC-VII and the Thirteenth Finance Commission (FC-XIII). However, there were many changes to Finance Commission grants. One noticeable pattern is that big shifts in devolution correspond with shifts in grants—partly to offset the impact of the change in devolution. FC-V and FC-VII, for instance, saw large increases in devolution, but grants fell. Overall, Finance Commission transfers and total transfers remained stable between FC-VII and FC-XIII. Then came FC-XIV, which led to the largest increase in both Finance Commission transfers as well as total transfers.

Table 2: Transfers from the Union Government to State Governments (as a percentage of Union government's gross tax revenue, excluding GST compensation cess)

	Years covered	Tax devolution	FC grants	Total FC transfers	Other transfers (excluding GST compensation)	Total transfers (excluding GST compensation)
FC-III	1962–66	15.0	4.4	19.4	12.9	32.4
FC-IV	1966–69	17.9	6.7	24.6	15.2	39.8
FC-V	1969–74	23.4	4.1	27.5	16.3	43.9
FC-VI	1974–79	19.9	6.8	26.7	13.4	40.1
FC-VII	1979–84	26.9	2.4	29.2	17.4	46.6
FC-VIII	1984–89	25.1	3.1	28.3	19.0	47.3
FC-IX	1989–95	26.9	4.3	31.2	18.4	49.6
FC-X	1995–2000	27.4	3.0	30.4	14.9	45.3
FC-XI	2000–05	26.9	5.1	32.0	14.9	46.9
FC-XII	2005–10	26.4	5.1	31.5	15.8	47.3
FC-XIII	2010–15	28.3	4.7	32.9	16.7	49.6
FC-XIV	2015–20	35.8	5.5	41.3	17.4	58.7

Sources: The estimates for FC-III to FC-XIII are from Gupta and Sarma (2022). The estimates for FC-XIV are the authors' calculations based on numbers extracted from the budget documents and from CMIE's Economic Outlook. The denominator (Gross Tax Revenue), devolution, and FC grants are from the Union Budget documents, and the other transfers are obtained by deducting the FC grants from the total transfers from Centre to States given in the CMIE's Economic Outlook database.

A cursory glance at the States' share in the Union government's tax collection suggests prima facie evidence of some correspondence between political shifts and economic (de)centralization. For instance, the States' share of gross tax revenue was relatively muted during the first four Finance Commissions—a period of Congress Party dominance—remaining below 20 percent throughout. The States' share rose above that threshold for the first time under FC-V (1969–74), which coincides with the Congress Party's decline in the States and the dawn of the second party system. Another sharp increase is discernible during the period of FC-VII (1979–84), which happens to correspond with the brief Janata interregnum between 1977 and 1979 when a diverse group of regional interests teamed up to displace the unpopular Congress Party in the aftermath of the Emergency. However, between 2015 and 2020, FC-XIV's recommendation to dramatically increase the States' share of gross tax revenue challenges this pattern of fiscal decentralization tracking political decentralization. FC-XV, which operated fully in the fourth party system, appears to further underscore this shift.

Appearance or Reality?

Despite outward appearances, Finance Commission transfers have no simple one-to-one correspondence with changes in the party system.

FC-V unfolded against the backdrop of slowing economic growth, rising prices, and lower tax revenue collection. FC-V did not increase the overall share of taxes devolved to States but adhered to the formula recommended by FC-IV. So, why did the States' share increase? The answer seems to be in the change in tax collection. The share of customs collection, which was not shared with the States, fell between the Fourth Finance Commission (FC-IV) and FC-V, while the excise duty increased on account of price inflation in certain commodities. In fact, almost the entire increase in the tax-to-GDP ratio between these periods was due to higher excise duty collection. This change also seems to have led to an increase in the States' share of gross tax revenue.

Under FC-VII, however, there was a significant change to the vertical distribution of resources: 85 percent of income tax and 40 percent of excise duties were transferred to States, a sizeable jump from 80 and 20 percent, respectively, under FC-VI. Since excise duty accounted for about half of gross tax collection, this represented a sharp increase. Indeed, the Finance Minister's 1979 budget speech touted the fact that FC-VII increased devolution of Central taxes and duties to States, adversely affecting the Centre's fiscal position. A 1978 editorial in Economic and Political Weekly commented that FC-VII 'broke new ground' in Centre-State relations by increasing the volume of devolved funds to the States.[20] For the first time in many years, the State and Union Territories' combined plans were larger than the Central Plan. And, as the headline numbers suggest, devolution recommended by FC-VII relied much more heavily on tax devolution than grants-in-aid.[21]

Comparing FC-V to FC-VII provides an interesting contrast. While FC-V coincided with the shift from the first to the second party system, its recommendations largely endorsed the status quo position established by the previous Finance Commission. On the other hand, FC-VII—which operated under the second party system—recommended a major increase in devolution. Until then, whenever Finance

20 "More for the States," *Economic and Political Weekly* 13, no. 48 (1978): 1957-1958.

21 According to an editorial in *Economic and Political Weekly*, the "greater weightage given to the tax share in the scheme of devolution has also the very important consequence of protecting the resource transfer to the states from being eroded by inflation." Because states' tax share is fixed (as a percentage of total tax receipts), "the states benefit from the likely buoyancy in the receipts from these taxes in a period of rising prices." See "More for the States."

Commissions had recommended increasing the share of income tax, they had also recommended reducing the share of excise duty. FC-VII was the first to recommend increasing the share of both income tax and excise duty, nearly doubling the States' share in the latter.

Even though FC-V was constituted at a time of transition, the party system was still characterized by a dominant party at the Union government level. That party's interests were not aligned with fiscal decentralization. On the other hand, FC-VII was formed and operated while India's first non–Congress Party government was in power. Coming after a period of extreme centralization during the Emergency, the Janata Party had made decentralization a major plank of its election manifesto.

To be clear, we are not arguing that those Finance Commissions were doing the government's bidding. Rather, given the structural imbalance in India's fiscal system, public finance analysis often leads to recommendations for more decentralization. The Janata Party government may have created the space for such recommendations to be made and accepted.

From FC-VII to FC-XIII, there were no major changes in the transfers as a percentage of gross tax revenues, but there were small changes in devolution and grants. Interestingly, most of the third party system—coinciding with the era of coalition politics from 1989 to 2014—went by without any major changes in fiscal transfers. This was a time when regional parties achieved greater bargaining power as no government could be formed without their support. Still, as a collective, States did not manage to secure a major increase in transfers from the Union government. This shift finally occurred in FC-XIV, which was formed during the final years of the third party system and saw its recommendations formally implemented during the fourth party system.

Finance Commission XIV: Recommendations

After 2014, as the party system was dramatically redrawn in favour of a centralized Union government, fiscal federalism underwent a dramatic shift towards increased transfers to sub-national governments. This not only runs counter to expectation, but it is also at odds with what has transpired in other policy domains.

FC-XIV recommended that the share of untied funds devolved from the Centre to the States via the divisible pool be increased from 32 percent to 42 percent. As economist V. Bhaskar has noted, 'the change in the quantum of vertical devolution is more transformational than incremental'.[22] The move was widely hailed as an inflection point for decentralization. For years, States had argued for greater flexibility in financing from the Centre, hoping to invest in areas of specific concern for their State as opposed to a general one-size-fits-all approach. When the Modi government accepted FC-XIV's recommendations, it seemed the States' wishes had been granted. Indeed, some analysts argued that FC-XIV had placed the States at the 'forefront of the development agenda' and provided them with 'substantial freedom to pursue their development agenda'.[23]

According to Aditya Bihani, the overall funds transferred by the Centre, the share of untied funds grew (from 61 to 74 percent) while tied funding declined (from 39 to 26 percent) between 2014–15 and

22 V. Bhaskar, "Stance on Devolution and Grants," *Economic and Political Weekly* 50, no. 21 (2015): 36-40.
23 Bhaskar, "Stance on Devolution and Grants."

2015–16.[24] What the States lost out in terms of cuts to Central schemes, they more than made up for it in untied transfers via tax devolution. Former Finance Secretary Ajay Narayan Jha largely concurs with the notion that FC-XIV represented a structural break.[25] The share of statutory transfers from the Centre to the States via the Finance Commission stood around 64 percent in the decade between 2005 and 2014, but rose to around 75 percent in the aftermath of FC-XIV.[26]

How does one explain this confluence of events? For starters, it is worth noting that FC-XIV was established by the previous Congress-led United Progressive Alliance (UPA) government. That government handpicked its members, drafted its terms of reference, and was in power during most of its deliberations. In some sense, the Modi government was presented with a fait accompli. Whether it supported or opposed the recommendations, it had very little room to maneuver.

However, observers have noted that the Modi government did try and undermine the spirit, if not the letter, of FC-XIV's recommendations. Due to the imposition of special cesses, whose proceeds accrue to the Centre and exist outside of the divisible pool, Aiyar and Tillin note that States' share of gross tax revenue hovered around 35 percent between 2015–16 and 2018–19 (based on revised estimates).[27] States have long argued that the Finance Commission should include all proceeds from cesses and surcharges in the divisible pool, but successive commissions have said that they are hamstrung by constitutional provisions governing the composition of the divisible pool.[28]

Does this mean, as some analysts have implied, that the decentralizing impulse of FC-XIV was wholly snuffed out by the present government?[29] We respectfully disagree. Table 1 clearly shows that the impact was only marginally neutralized. First, the actual devolution increased by 7.5 percent of gross tax revenue. This change was the highest increase on record. Second, the Finance Commission's grants-in-aid also increased as a percentage of gross tax revenues. This increase occurred because of a slowdown in gross tax collection, especially indirect taxes, after the implementation of the GST.[30] FC-XIV had forecasted that grants-in-aid would amount to 5.07 percent of gross tax revenues, but the actual Finance Commission–recommended grants-in-aid during this period were 5.5 percent of gross tax revenues. Overall, the Finance Commission–recommended transfers stood at 41.3 percent of gross tax revenues—an increase of 8.4 percentage points over FC-XIII's period of implementation. FC-XIV had projected the total Finance Commission-recommended transfers to be about 42.3 percent of gross tax revenues.

In sum, only about one-ninth of the impact of FC-XIV was neutralized (an 8.4 percentage point real increase as opposed to the 9.4 percentage point projected increase). This happened against the backdrop of a slowing economy, a comprehensive reform of indirect taxes, and other challenges to revenue collection that have created incentives for the Union government to increase its own resources. Finally, if one considers the increase in non–Finance Commission transfers, the overall increase in transfers was quite close to that projected by FC-XIV. Reductions in spending on CSSs never transpired. Despite the tabling of a NITI Aayog task force of chief ministers on reforming CSSs, the government opted not to

24 Aditya Bihani, "Studying the Impact of Fourteenth Finance Commission (FFC: 2015-20) Recommendations on Fiscal Decentralization and the Consequent Impact on Social Sector Expenditure—a National and State-wise Analysis" Working Paper, n.d.

25 Ajay Narayan Jha, "Continuity with Change: Approach of the Fifteenth Finance Commission." *Economic and Political Weekly* 61, no. 33 (2021): 40-47.

26 Reddy and Reddy peg the share of Finance Commission transfers to the states at 78 percent in 2016-17, with a corresponding drop in non-statutory transfers. See Reddy and Reddy, *Indian Fiscal Federalism*, 237.

27 Aiyar and Louise Tillin, "'One Nation,' BJP, and the Future of Indian Federalism."

28 Reddy and Reddy, *Indian Fiscal Federalism*.

29 Aiyar and Tillin, "'One Nation,' BJP, and the Future of Indian Federalism."

30 Since the FC-XIV's recommendations on grants-in-aid are in nominal terms, grants increased as a percentage of GDP.

follow its lead. Indeed, the persistence of numerous CSS under twenty-eight broad headings without meaningful consolidation implies that the Centre still wields considerable policy discretion.[31] In addition, the Centre simultaneously increased the cost-sharing component for CSSs to be borne directly by the States. The transfers other than those made following Finance Commission's recommendations also rose, as shown in Table 2. FC-XIV had expected these transfers to fall to partly compensate for the increase in FC-recommended transfers.

Finance Commission XV: Design

In many ways, FC-XV presents an even bigger puzzle than FC-XIV. FC-XV was appointed in November 2017, meaning it took place—from start to finish—during the Modi government's tenure. The government hand-selected the Chairman (N.K. Singh, a former BJP politician) and the members of the commission, decided which career officials would staff the commission secretariat, and authored its terms of reference. Indeed, the government's carefully worded terms of reference signaled its intent to reverse the decentralizing thrust initiated by FC-XIV. Economist V. Bhaskar recounts multiple ways in which FC-XV's terms of reference broke new ground.[32] Consider the following five examples.

First, the terms of reference stated that FC-XV was to determine whether the Finance Commission should provide any revenue deficit grants to the States. Many read this as a signal from the government that the commission should completely discontinue the practice of providing grants to plug States' revenue deficits. According to Bhaskar, 'such a directive untenably interferes in the working of the finance commission'.[33] Economists Y.V. Reddy and G.R. Reddy note that this directive could be construed as ignoring Article 275(1) of the Constitution, which provides for grants-in-aid of State revenues.[34] Such guidance was unprecedented in the history of Finance Commissions.

Second, according to the terms of reference, FC-XV was asked to consider the impact of FC-XIV on the fiscal situation of the Union government. Because FC-XIV recommended a significant enhancement of devolution to the States, the Union government wanted the new commission to evaluate its past performance. According to Reddy and Reddy, this was the first time that a Finance Commission was directed to review the recommendations of the previous commission.[35]

Third, the terms of reference required FC-XV to examine the impact of the 'continuing imperative' of the New India 2022 initiative's targets on the Union government's finances. These commitments represent key political priorities for the Modi government. It is noteworthy, however, that the terms of reference do not mention the impact on State finances, given that States are also responsible for significant expenditures on New India programmes. Furthermore, if the requirements of Union government schemes are given special priority, then the priorities of States implicitly take a back seat.

Fourth, the terms of reference asked FC-XV to investigate the possibility of creating a separate fund for defence and internal security. This direction raised concerns that FC-XV was being asked to segregate

31 Reddy and Reddy, *Indian Fiscal Federalism*.

32 V. Bhaskar, "Challenges Before the Fifteenth Finance Commission." Economic and Political Weekly 53, no. 10 (2018): 39-46; Reddy and Reddy write that FC-XV's TOR "seem to not just reverse some of the recommendations of the previous Commission but give greater discretion than ever before to the Union Government." See Reddy and Reddy, Indian Fiscal Federalism, xxvi-xxvii.

33 Bhaskar, "Challenges Before the Fifteenth Finance Commission."

34 See Reddy and Reddy, Indian Fiscal Federalism, 245. This raised the ire of state governments because they feared that the elimination of revenue-deficit grants would give the union government significant discretionary powers not stipulated in the Constitution.

35 Reddy and Reddy, Indian Fiscal Federalism.

funds from the divisible pool—which is shareable with the States—for the purpose of expenditures under the sole supervision of the Union government.

These (and other) facets of FC-XV's terms of reference created significant controversy. Individually and collectively, they indicated that the Union government was hoping to persuade FC-XV to reverse the impacts of FC-XIV.

Finance Commission XV: Recommendations

Despite these pressures, FC-XV's recommendations did not recommend a sea change from FC-XIV. Most significantly, FC-XV did not roll back devolution to the States. Accounting for the newfound Union Territory status of Ladakh and J&K, FC-XV recommended that 41 percent of the divisible pool be provided to the States in untied transfers—essentially the same share as recommended by FC-XIV. FC-XV demurred on the allocation of divisible pool resources for defence and security. Further, FC-XV recommended a significant increase in grants to State and local governments.

According to Ajay Narayan Jha, a member of FC-XV, the commission maintained its continuity with FC-XIV for several reasons.[36] First, any sudden change in vertical devolution could potentially destabilize State finances since many erstwhile 'plan' funds had been subsumed into vertical Finance Commission transfers after the Planning Commission's abolition. Continuity allowed for stability and predictability—important factors given the impacts of the COVID-19 pandemic.

Second, FC-XV was convinced that States deserved budgetary flexibility. The unconditional nature of Finance Commission transfers via tax devolution afforded them options. Whether this flexibility was fully exploited by the states in how it executed its own budgeting is the subject of academic debate[37].

Third, the commission also concluded that States' ability to tap into higher tax revenues when the economy is buoyant provides them with a higher upside. During a downturn, the Union government can act as primary shock absorber.[38] FC-XV appeared reluctant to disrupt this equilibrium.

IS THE FINANCE COMMISSION AN OUTLIER?

FC-XV operated during a time when a dominant party seems to have prioritized reducing fiscal transfers. From our interviews with members and officials of FC-XV we learnt that in the first memorandum that it submitted to the Commission, the Union government had suggested a major reduction in devolution to the States. On the flip side, certain states had expressed their opposition to any reduction in the Finance Commission-recommended transfers.[39] However, as discussed earlier, it is not easy for the states to act collectively because each state is more focused on achieving a higher share from the pool of resource transfers than on advocating for more transfers in the aggregate. So, it seemed likely that the FC-XV would significantly reverse the impact of FC-XIV. But FC-XV did not do so.

36 Ajay Narayan Jha, "Continuity with Change."
37 For a skeptical view, see Bihani, "Studying the Impact of Fourteenth Finance Commission."
38 Ajay Narayan Jha, "Continuity with Change."
39 "Four Southern States in Sync, Allege North Bias in Tax Sharing," Hindustan Times, April 11, 2018.

How and why has the Finance Commission, particularly FC-XV, been able to maintain its independence, push back on central imposition, and sidestep the terms of reference to achieve continuity with past precedent? Political economy principles and recent experience with institutions in other domains suggest that the changing nature of the party system would likely have a direct impact on the Finance Commission's recommendations. Interviews with officials involved in FC-XV and a review of the history of Finance Commissions suggest several possible reasons why this impact is mitigated.

First, the Finance Commission enjoys a clear constitutional mandate. Article 280 provides it with a concise institutional remit—albeit with some room for uncertainty, given that the President can refer certain matters to it if they are deemed to be in the 'interests of sound finance'. While the government of the day establishes the commission's terms of references, selects its members, and provides it with staff, its formal role stops there. Once the commission submits its report, Article 281 states that 'The President shall cause every recommendation made by the Finance Commission under the provisions of the Constitution together with an explanatory memorandum as to the action taken thereon to be laid before each House of Parliament.'

Second, the substance of the government's demands ran counter to the history of the institution, so much so that it would have been a major loss of reputation to recommend a significant reversal in devolution without a sound basis. The Finance Commission has historically been viewed as an important, technocratic body that stays above the fray of normal politics. That does not mean that its recommendations do not have political implications or are divorced from political worldviews, but rather that there are limits to partisan machinations colouring its work or its recommendations. Over time, this perception has created boundaries beyond which governments have not been willing to transgress. There is a norm that the core recommendations of the Finance Commission having to do with tax devolution and grant finance, once tabled, are accepted by the Union government.[40]

Increasing fiscal transfers to sub-national governments is a natural trend flowing from the imbalance in the Constitution, where resource-raising powers have been disproportionately given to the Union government and the expenditure responsibilities largely rest with the States. Technical analysis based on public finance principles usually leads to recommendations deepening decentralization. In other words, improvement in efficiency may require greater decentralization of fiscal resources. The politics of the day can mitigate this trend on the margins, ensure the status quo, or allow greater devolution, but it is very difficult to justify a large reversal of fiscal decentralization on analytical grounds. The commission could have considered moderating grants-in-aid, but our interviews suggest the pandemic made that a very difficult proposition.

Third, the Finance Commission's own culture and independence has created a certain *esprit de corps* that infuses its work. Our discussions with previous Finance Commission staff revealed bureaucratic norms among officials who worked in the commission; they are career civil servants who conduct the assessments of revenues and expenditures based on established methodologies and present them to the commission members. Thus, it was not easy for the members to simply change the conclusions. This established technocratic nature of the exercise acts as a point of resistance; permanent civil service sometimes acts as a bulwark against political pressure.

40 Reddy and Reddy, *Indian Fiscal Federalism*.

Fourth, the Finance Commission's staff and members typically come from a relatively small pool of technical experts that form the hub of India's public finance community. The close-knit and compact nature of this community could also create incentives for commission members to avoid social sanctioning by maintaining their methodological independence. There is a body of public finance knowledge, which is produced and utilized by this community. This community includes civil servants who mainly work on public finance as well as economists who specialize in public finance. This is an important point – the Finance Commission is not an institution known to the masses. However, for the purpose of its legitimacy, the reputation within this small community seems to be consequential.

Fifth, the Finance Commission is an example of what Devesh Kapur calls 'episodic delivery'.[41] Kapur notes that the Indian state performs better in activities that are episodic in nature and do not require a continuous presence like public goods delivery (such as health, education, or policing). Where delivery is episodic, exit is automatic once the specified, time-bound activities the institution oversees are complete. The Election Commission of India and Finance Commission are both examples of institutions that work in this way. When a Finance Commission is appointed, it carries out its work, delivers its report, and then immediately disbands until the next commission is established several years down the road.[42] This design feature allows the commission and its staff to work in a mission-driven mode that is temporally concentrated and jurisdictionally limited.

Sixth and perhaps the most important factor is that the Finance Commission does not require active support from the government for the successful implementation of its recommendations. Active government support implies serious application of institutional capacity and political judgement in a manner that cannot be fully specified by the commission in advance. This independence is a key variable that informs the rational choice exercised by the institutions.

The Finance Commission releases a report with specific recommendations on tax devolution and grants-in-aid. The latter are in nominal rupee terms, while the former is framed in terms of the percentage of the divisible pool of taxes. The government does not have any way to significantly alter the grants-in-aid. It can, of course, alter the devolution by shrinking the divisible pool (as it has done). However, there are limits to this strategy. For instance, cesses and surcharges cannot conceivably contribute a majority of tax collection, as such a composition would cause economic distortions and complexities in the tax system. Further, the possibility of imposing cesses on commodities such as petroleum products depends on the price of crude oil which is determined by the markets.

For comparison's sake, contrast the Finance Commission's position with that of the Supreme Court. The Supreme Court deals with a variety of cases, including complex political questions related to social justice, national integrity, and security. In cases involving substantive policy changes, it typically relies on active support from the Union government to support and implement its decisions. If, however, the government is hostile, it can find ways to undermine the court. Scholars have argued that the Supreme Court can make a difference on complex matters such as social justice issues only under certain conditions, one of which is that administrators and officials crucial for implementation are willing to act and see court orders as useful.[43] In the American context, Robert Dahl famously argued and showed

41 Devesh Kapur, "Why Does the Indian State Both Fail and Succeed?" *Journal of Economic Perspectives* 34, no. 1 (2020): 31-54.

42 However, as Reddy and Reddy note, technically the Finance Commission could function as a continuous body. The Commission would only need to be formally reconstituted before its expiry after five years. See Reddy and Reddy, *Indian Fiscal Federalism*, 12.

43 Gerald N. Rosenberg, *The Hollow Hope* (Chicago: University of Chicago Press, 2008).

how ‘the policy views dominant on the [U.S. Supreme] Court are never for long out of line with the policy views dominant among the lawmaking majorities of the United States’.[44] Dahl saw a lawmaking majority as ‘a majority of those voting in the House and Senate, together with the president’. Such a majority is usually enjoyed by a dominant party.

Consider a situation where the government wants a decision that an independent institution does not agree with. In a dominant party system, if the decision requires support from the government, the institution will know that it is futile to act independently because the outcome would not materialize. However, if dependence on government support is low, the institution can act independently or at times against the government's wishes even in a dominant party system. In a coalition setup, there is rarely a situation where the institution should not consider acting independently. Even if the institution is dependent on government support, it can inflict some political costs on government power by naming and shaming or gaining support from the opposition. If government support required for the implementation of decisions is low, it would almost always be rational for the institution to act independently. These dynamics are summarized in Figure 1.

Figure 1. Determinants of institutional independence in a situation of major policy disagreement

		Party system at Union government level	
		Dominant party	Coalition
Requirement of active government support for successful implementation	High	Does not act independently	May act independently
	Low	May act independently	Acts independently

Of course, Figure 1 is a simplification. If the disagreement is on a low-priority matter for the government, the institution could consider acting independently. Similarly, even in a coalition government, if the institution has reason to believe that the coalition is very likely to undermine the decision, it may not act independently. The reputational capital of the institution is also a key variable in the decision to act independently. An institution with substantial reputational capital can inflict more serious costs on an elected government, even in a dominant party system. The Reserve Bank of India (RBI) has behaved this way. The Union government had to withdraw certain amendments to the 1934 RBI Act that would have curtailed its powers because the RBI was able to mobilize public pressure.[45] The substance of the

44 Robert A. Dahl, “Decision-making in a Democracy: The Supreme Court as a National Policy-maker,” *Journal of Public Law* 6 (1957): 279-295.
45 “Govt Withdraws PDMA, RBI Bill Provisions from Finance Bill,” *Business Standard*, May 1, 2015.

disagreement also matters. If the conflict concerns a major reversal of an important position that is also publicly known, the institution could find it difficult to justify the decision in its own ranks. It may also risk losing face in the public eye, which would negatively impact its reputational capital.

Seen together, these factors paint a picture of the Finance Commission as an institution with a reputation and culture of independence in analysis and recommendations, with the exercise of independence bolstered by the fact that the institution's work involves episodic delivery of recommendations and that it does not require active support from the government to have its recommendations implemented effectively.

This complicates the framing of an electorally dominant government influencing unelected institutions to have its way. The example of the Finance Commission can contribute to an understanding that in a democracy, institutional legitimacy and independence can, to some extent, be constructed outside of the electoral processes. This is not a legalistic argument; the mere enshrining of independence in the constitution does not automatically create independence. Legitimacy and independence can be achieved and sustained by an institution's actions, and power can then be exercised. This exercise of power in turn may feed back into legitimacy and independence.

NON–FINANCE COMMISSION GRANTS TO THE STATES

A final aspect of this puzzle of fiscal transfers is why the Union government did not reduce the amount of non–Finance Commission grants it makes to the States. As discussed, such grants are fully decided by the Union government. If the Union government had so desired, it could have drastically cut these grants to neutralize the impact of FC-XIV's recommendations. The increase in total transfers is close to the recommended transfers because non–Finance Commission grants were not reduced.

Grants to States are mostly given for schemes that the Union government designs and wants the States to implement, with or without co-financing. Article 282 of the Constitution allows the Union government to incur expenditures even on matters that are mapped to the States in the Seventh Schedule. Over time, the Union government has designed and financed many schemes in areas that are State subjects. These schemes range from education and health to rural employment and housing.

Such schemes are politically consequential for the Union government. Reducing the amount of non–Finance Commission grants to States means risking the continuity of these important schemes. For instance, implementation of the housing scheme—Pradhan Mantri Awas Yojana—requires active support from the relevant State government. Any decision to cut funding for the scheme could be weaponized by opposition parties and State governments against the Centre. Thus, instead of reducing the grants, the BJP-led Union government adapted in at least two ways.

First, it worked to receive the lion's share of credit for these schemes, even if they were implemented and co-funded by State governments. There is continuing contestation between the Centre and the State governments (and perhaps also local governments as well) over who should get credit. The National Election Studies, carried out by the Centre for the Study of Developing Societies' Lokniti Programme, track which tier of government receives more credit for these schemes. Their data show

how, until 2014, State governments used to get much of the credit even for schemes that the Union government fully or mostly funded. In 2019, this situation reversed; the Centre began receiving more credit for the schemes.[46]

This reversal came about in two ways. The schemes were rebranded (e.g., the Indira Awas Yojana became the Pradhan Mantri Awas Yojana), while new technology, BJP, and Sangh Parivar cadres were used to communicate directly with the beneficiaries.[47] The Union government also increased the share of States' contributions to CSSs—in most cases, by double. This change allowed the Union government to further leverage its resources while also taking more credit. The increased contributions meant that part of the additional resources, per FC-XIV's recommendations, had to be made available to co-fund these schemes. These measures may have ensured that the Centre reaped the political benefits without having to risk making politically controversial decisions.[48]

Second, as the COVID-19 pandemic hit and the Indian economy shrunk in 2020–21, the need for a quick and sustained recovery became quite acute. A key element of the Union government's fiscal strategy for growth was to undertake capital expenditure to crowd in private investment. However, the Union government realized that this strategy required implementation through State governments. So, it devised a plan to give interest free loans to the States for a long period of time. This has emerged as a large component of non–Finance Commission transfers to the States. This argument also applies in other areas where fiscal transfers are made to sub-national governments. In most areas, the Union government needs the implementation support from sub-national governments.

CONCLUSION

As this paper makes clear, political shifts in the party system have not always been accompanied by corresponding shifts in the fiscal balance of power between the Centre and the States. At a time of renewed central dominance with a dominant ruling party, fiscal transfers to sub-national governments have increased and sustained albeit with some signs of centralization at the margins through change in composition of transfers, with more purpose-specific transfers being made.

Unlike many other institutions with *de jure* independence, India's Finance Commission has also maintained a degree of *de facto* independence and institutional resilience, despite apparent efforts by the Union government to influence its work. Understanding the Finance Commission's unique position in directing fiscal transfers between the Centre and the sub-national governments is key to understanding this disjuncture and the lessons it holds for India's institutional landscape more generally.

Further, the resilience of non-Finance Commission transfers also shows the complex interdependence between the Union government and the sub-national governments, with political contestations co-existing and interacting with the imperatives for efficiency through decentralization. This has significant implications for understanding the future of Centre-state relations.

46 Jyoti Mishra and Vibha Attri, "Did Welfare Win Votes?" *Seminar* 720, August 2019.

47 Aiyar and Sircar, "Understanding the Decline of Regional Party Power."

48 This kind of adaptation can also be seen in more detailed review of expenditure decisions. For instance, there was a big decline in grants in 2018-19, the year before the general election, because resources were used for direct cash transfers.

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