

*Discussion of "The Political Economy of the Indian Fiscal Federation" – Mihir A. Desai*

The structure of fiscal federalism within developing countries can help dictate patterns of social spending and can interact with a variety of political economy considerations. In India, a vertical gap – the difference between revenues and expenditures at the state and federal level – of more than twenty percent of taxes has led to a labyrinthine set of arrangements by which revenues are distributed to states for expenditure at the state level. These solutions to the vertical gap have the potential to alter the nature of critical spending areas by states – such as health and education – and to be swayed by the nature of political currents.

Indira Rajaraman provides a detailed overview of fiscal federalism issues in India. Given the relative paucity of work in this area and the importance of the underlying questions, this is a welcome contribution. Her discussion of the federalism structure in India emphasizes the formulaic and non-formulaic nature of the correctives for the vertical gap. In particular, formulaic correctives to the vertical gap are implicitly considered favorable as they are assumed to lead to more steady allocations of expenditures at the state level. In addition to her overview of the arrangements, she makes a number of related claims. Most importantly, she claims that "increased political fractionalization in India over time has had a favourable upward impact on the formulaic share of total Central flows to states, and has therefore been favourable towards greater willingness by states to make steady expenditure commitments to provision of primary education and health." These are significant and surprising claims.

The first claim – that political fractionalization has increased formulaic allocations – is surprising as a simple political economy logic would suggest that fractionalization might lead to more discretion in the system. As fractionalization increases, politicians might search for more instruments by which to build coalitions, particularly those they can alter at their will. As such, increased discretion would accompany political fractionalization. It is hard to assess her claim that the opposite is the case without knowing the political economy mechanism by which this would operate. Similarly, the evidence to support this claim is complicated, as the author acknowledges, by the presence of a highly influential observation. It would be particularly helpful to know more about the period during which the simultaneous reduction in the bargaining margin and increase in political fractionalization occurred. Were there other factors that might have led to these simultaneous developments? At a minimum, it is difficult to conclude that a strong causal link exists given these considerations.

The second claim – that more formulaic allocations spurred by increased political fractionalization has been beneficial for health and education spending – is, unfortunately, untested. Health and education spending is presumed to be aided by steady allocations from the center to the states. This claim is complicated by the considerable variation in what might be termed formulaic or non-formulaic allocations. It would be useful to know if formulaic allocations were truly more stable as they are assumed to be in this analysis. As Rajaraman's discussion demonstrates, words like "statutory and "plan" in the Indian fiscal federation often do not in fact imply the stability that they usually do. Similarly, it is not clear that increased formulaic allocations necessarily lead to more health and education spending. Indeed, the figures demonstrate considerable variation in the bargaining margin with limited variation in the level of expenditure on health and education. As such, it is hard to know how to assess this claim.

These underpinning assumptions are problematic as reality might actually be quite different. Could it be that non-formulaic allocations foster competition between states to demonstrate more effective spending on health and education? In this case, more discretion at the center can lead to more effective spending and perhaps even more spending on health and education. In other words, would it really be ideal for states to face no uncertainty over their allocations? It would be useful to test this underlying assumption that stable allocations lead to more or better health and education spending. Similarly, increasing political fractionalization could indeed lead to more health and education spending but by the completely distinct mechanism of politicians seeking to sway votes in a more fractured political setting.

The structure of fiscal federalism is a critically important aspect of the Indian political economy picture and of the delivery of social services. Rajaraman's paper provides a comprehensive overview of the complex arrangements at work and takes some provocative, initial steps in what promises to be an important line of inquiry.