



Does fiscal federalism prevent or provoke secessionist conflicts? *The Autonomy-Equalization Conundrum and the promise of concessionary federalism*

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ABSTRACT

Does Fiscal Federalism Prevent or Provoke Secessionist Conflicts? This article shows that both insufficient fiscal equalisation and excessive redistribution can provoke contestations – especially when economic grievances of low- and high-income states coincide with national minorities. Fiscal federalism must strike a balance – empowering low-income states without expropriating high-income states – to prevent these contestations from escalating into conflicts. The challenge is twofold: First, designing a policy framework that discourages the perverse incentives associated with high levels of equalisation and autonomy. This may be recommended by Independent Fiscal Institutions (IFIs). However, this is not sufficient, because political incumbents – influenced by their incentives and self-interest – might resist these recommendations. Therefore, the second level challenge lies in making these recommendations work. One way is to establish institutionalised mechanisms of inter-governmental negotiations which can reveal interdependencies and facilitate (a) continuous dialogue – enabling parties to align their incentives with economists’ recommendations and recognise their common interests where they had previously perceived conflicting ones, and (b) reciprocal concessions – encouraging parties to relax their dominant strategies. Intergovernmental councils with predefined principles for contestations and mandatory outputs (agreed-upon concessions) can yield an equilibrium where no party has a unilateral incentive to deviate, encapsulating the essence of negotiated cooperation and concessionary federalism.

KEYWORDS

Federalism; diversity accommodation; regional disparities; equalisation; autonomy; India; Europe; concessionary federalism; negotiated cooperation

Introduction

Policymakers in federal systems face the challenge of designing interventions to address economic disparities and ethnic diversity. In addition to explicit policies aimed at promoting equality and social inclusion – such as anti-discrimination laws, affirmative action and targeted social welfare schemes – fiscal policy¹ is an important, though often overlooked, tool in fostering accommodation. Fiscal constitutions can promote perceptions of economic justice, especially among ethnic minorities and territorial communities by allocating resources to support such groups and regions (Besley and Persson 2011; Claus 2012;

Roe and Addison 2004). Governments can utilise two fiscal policy instruments – fiscal autonomy and fiscal equalisation – as tools to manage ethnically or economically driven conflicts. The impact of fiscal autonomy and equalisation policies on (in)equality between regions and groups is well-documented (Boadway 2004; Tullock and Buchanan 1962; Musgrave 1959; Oates 1972). There has also been extensive research on how these policies address internal conflicts arising from economic inequality or ethnic differences in multiethnic states (Bird and Ebel 2006; Rode et al. 2018; Roe and Addison 2004; Sorens 2016). However, the task of designing fiscal policies to mitigate regional disparities and accommodate diversity is challenging because it involves competing interests and complex trade-offs (e.g. balancing equity and efficiency; diversity and solidarity; minority rights and national identity). The contrasting perspectives – nationalist versus sub-nationalist and federalist versus autonomist (Lluch 2012) – can result in federal contestations.² When self-rule and shared rule (intergovernmental coordination) mechanisms are weakly institutionalised, policy outcomes become susceptible to abuses of the bargaining power asymmetries. In such cases, federal contestations – such as demands for adjustments in fiscal arrangements – occur in an ad hoc manner rather than within a well-defined institutional framework. To address these challenges a new research agenda focusing on the incentives and constraints within fiscal policy frameworks, political processes and institutions is required.

This article addresses the challenge of developing a framework that combines fiscal autonomy (independent revenue-raising powers – fiscal self-rule) and fiscal equalisation (revenue sharing or intergovernmental grants – fiscal shared rule), in a way that moderates disparities and promotes cohesion. Economic theories of secession indicate that perceptions of economic injustice among minority-dominated regions can ignite conflict (Bakke and Wibbels 2006; Collier and Hoeffler 2004; Gurr 2011; Madiès et al. 2018; Sambanis and Milanovic 2014; Sorens 2012). For example, secessionist conflicts can arise when natural resource-rich minority-dominated regions perceive that they are not receiving a fair share of the natural resource extraction from the region – as seen in Aceh, Indonesia, and Baluchistan, Pakistan. Similarly, extensive fiscal equalisation and limited autonomy in affluent, minority-populated regions can ignite demands for greater autonomy – for example, the Basque and Catalonia in Spain, Flanders in Belgium, and Croatia and Slovenia in former Yugoslavia. Since it is not economic inequality between individuals but rather inequalities between territorially defined identity groups that significantly increase the risk of conflict, a focus on reducing interregional inequality can prevent conflicts (Fearon and Laitin 2003; Stewart 2002).

Therefore, the question arises: Can fiscal autonomy or equalisation moderate perceptions of economic injustice and prevent conflict? The previous studies on this question are contradictory. Some studies show that fiscal autonomy prevents conflict (Bibbee 2007; Cederman et al. 2015; Garcia-Milà and McGuire 2007) while others find that it drives conflict by increasing incentives to secede (Bakke and Wibbels 2006; Rode et al. 2018). Similarly, researchers argue that fiscal equalisation can both induce and prevent conflict (Cubel 2014; Lecours and Béland 2010; Sorens 2016).

To address these complexities, we proceed in the following steps. *First*, we identify the existence of different perspectives on fiscal policies (a national and a subnational perspective) *and* show how these create divergent policy preferences, based on the divide between rich and poor states, as well as between minority and majority nationality

dominance within these states. Internal conflicts arise when economic and ethnic grievances coincide and national policy frameworks, political processes and institutions fail to address the underlying ethnic-economic tensions and accommodate diversity. *Second*, we present the ‘Autonomy-Equalization Conundrum’, highlighting that both an excess and an inadequacy of either fiscal autonomy or equalisation can lead to tensions and conflicts within a federal system. *Third*, we argue that while a balanced autonomy-equalisation framework is a necessary condition for conflict resolution, it alone does not provide sufficient conditions. This is because in a highly politicised environment where competing interests dominate, even a well-balanced policy framework – whether constitutionally embedded or recommended by independent experts – can fail to work. In other words, political objectives can override institutional and legal frameworks, undermining their intended effectiveness (Gardner 2016). Therefore, the sufficient condition occurs when intergovernmental coordination mechanisms ensure that strategic concessions – such as granting targeted financial benefits, increasing shares in natural resource extraction, political accommodation, or addressing identity-related concerns – are negotiated and transacting parties enforce them as contracts. *Fourth*, we recommend a path to conflict resolution: Combine the technical expertise of Independent Fiscal Institutions (IFIs) with the political processes of intergovernmental negotiations. *Independent Fiscal Institutions* define the context-specific optimal range of fiscal autonomy and equalisation within which political negotiations must take place. *Institutions of intergovernmental negotiations* facilitate (a) continuous dialogue – enabling parties to recognise their common interests where they had previously perceived conflicting ones, and (b) reciprocal concessions – encouraging parties to relax their dominant (extreme) strategies. This approach allows contestations to evolve into negotiated solutions within a concessionary federal framework. Sharma (2021)

Finally, we situate fiscal federal dynamics within the broader set of determinants of secessionism through a case study that captures the full spectrum of identity-economic-political interactions. India, representing all key state types – low-/high-income and majority/minority nationality – provides such a comprehensive context. This case allows us to examine the complete causal chain and understand how the intersection of identity-based and economic grievances ignites separatist tendencies; how political institutional failures to address these grievances escalate the situation into violent conflict; and how resolution may be achieved when the central government negotiates concessions – while conflict persists when negotiations fail, or secessionist leaders remain uncompromising.

Why do some wealthy regions oppose fiscal equalisation while others don't?

The puzzle of perspectives, perceptions, and policy preferences

Social Identity Theory (Tajfel 1978) highlights that group affiliations influence individual perceptions and collective responses. Following this we argue that economically similar regions view the national government's policies through the lens of their regional or ethnic identities. Accordingly, high-income regions (with GDP per capita higher than the national average) dominated by national minorities oppose equalisation policies (Béland, Lecours, and Tombe 2022; Sambanis and Milanovic 2014). For instance, regions such as South Tyrol, Lombardy, and Veneto in Italy (Baldini and Baldi 2014; Lecours 2021), and

Flanders in Belgium (Swenden 2010; Swenden and Jans 2006; Vampa and Gray 2021), demand greater autonomy.³ Catalonia in Spain actively seeks secession (Boylan 2015).

Conversely, high-income, majority-nationality regions, generally see advantages in a centralist state because of their political and economic influence over central government (Bardhan and Mookherjee 2000; Rodden 2010). Although low-income regions (with GDP per capita below the national average) often outnumber high-income ones and are over-represented in legislatures, leading to demands for redistribution (Garrett and Rodden 2003), high-income regions dominated by majority nationalists can still use their influence to channel development resources in their favour (Biswas, Marjit, and Marimoutou 2010; Kramon and Posner 2013; Sharma 2017). Such regions may support fiscal equalisation not only in exchange for concessions on other policy issues, reflecting their bargaining power, but also as part of a broader political compromise (Rodríguez-Pose and Gill 2005). Several studies highlight the influence of normative beliefs, such as a strong sense of national unity (for example Germany) or the recognition of the imperative to prevent secessionist conflict (as seen in Canada), in explaining why high-income, majority nationality regions might refrain from opposing equalisation and may even actively support it (Bird and Tarasov 2004).

Thus, the majority nationality-dominated wealthy regions may have strategic reasons for supporting fiscal equalisation. For example, in India wealthy regions like Gujarat, Haryana, and Maharashtra, which are dominated by the national majority, do not oppose fiscal equalisation. This contrasts with regions like Punjab and Tamil Nadu, where minority nationalities like Sikhs and Tamils perceive fiscal equalisation as an unfair policy (Kohli 1997). In Spain, Catalonia, with its strong Catalan identity, aggressively pursues fiscal autonomy and resists the fiscal equalisation mechanisms that redistribute wealth (Griffiths, Guillen Alvarez, and Martinez i Coma 2015; Lecours 2021). On the other hand, Madrid, with its strong pan-Spanish identity, is much less opposed to equalisation, even though it seeks to preserve and defend its fiscal autonomy.

Likewise, relatively low-income regions (with GDPs per capita below the national averages) may have mixed opinions on fiscal autonomy and equalisation depending on their nationality status. National majority regions generally favour equalisation rather than having to rely on their fiscal capacity. These regions do not initiate autonomy movements or secessionist conflicts because they simply seek to uplift the region's economic status within the framework of national solidarity, rather than preserving their territorial identity (Stauffer 2001). For instance in India, there has been no secessionist movement in Bihar, a low-income, mineral-rich state in India – despite harbouring grievances typical of a low-income resource-rich state – because Bihar is part of the Indian majority nationality. The state seeks 'special category status' implying high levels of unconditional grants rather than seeking full-scale autonomy (The Hindu 2023).

In contrast, regions where relative deprivation and national minority identities converge – although not averse to financial equalisation – typically seek greater autonomy to manage their resources and make fiscal decisions that allow them to bear the costs associated with preserving their distinct identity and culture (Sambanis and Milanovic 2014). These minority-dominated regions, despite their low-income status, view autonomy as a pathway to effectively address their developmental challenges (Rodden 2002; Rodríguez-Pose and Ezcurra 2010) – especially in cases where they are resource-rich and feel exploited due to limited governance autonomy over these resources (Collier and Hoeffler 2004; Madiès et al. 2018).

For instance, India's Assam faced a separatist movement because of the Assamese distrust of the central government's extractive activities. The movement's slogan, 'Tej dim, tel nidi' (we will give blood, not oil), highlighted their dissatisfaction with the inadequate compensation for the state's resource contributions (Baruah 1999). However, the government of India made several concessions and brought the separatists into mainstream politics. Aceh in Indonesia (Aspinall 2009) and Baluchistan in Pakistan (Ahmed 2020) are also examples of minority-dominated regions that possess abundant natural resources yet have a low level of income. While Baluchistan is still struggling to achieve self-governance, the separatist struggle in Aceh ended when the central government accorded it significant autonomy. In Canada, Quebec, with its unique sense of identity and culture (Béland and Lecours 2014; Gagnon 2004), seeks greater control over natural resources, including hydroelectric power. Similarly, Scotland – driven by its strong cultural identity, distinct legal system, and political differences from the rest of the UK (Greer 2012; Keating, Cairney, and Hepburn 2012) – pushes for greater autonomy in economic policies and control over natural resources, such as oil in the North Sea.

These complex interactions bring to the forefront a puzzle that remains embedded in the political economy literature on secessionism: why do secessionist sentiments arise in some high- or low-income regions but not in others? (Bakke and Wibbels 2006; Collier and Hoeffler 2004; Gurr 2011; Madiès et al. 2018; Sambanis and Milanovic 2014; Sorens 2012). Drawing on observations from multiple real-world cases, supported by insights from the literature summarised above, we contend that secessionist sentiments are triggered by the intersection of economic, and ethnic grievances. We term this phenomenon the '*Ethno-Economic Overlap*', or simply, the '*Overlap Thesis*' defined as follows:

The economic grievances of states with high or low-income levels may be similar, but secessionist sentiments emerge only when economic concerns coincide with identity-based grievances (Figures 1 and 2). Such sentiments escalate into violent conflict when political institutions fail to accommodate these grievances.⁴

We present a matrix categorising the loyalty or secessionist tendencies of groups within a nation based on two axes: income and identity.

Low Income, Majority Nationality States fall into the top-left quadrant. They generally support equalisation measures. Examples include Mezzogiorno in Italy, Andalusia in Spain, The Maritimes in Canada, and the Indian states of Bihar and Uttar Pradesh.

Low Income, Minority Nationality States fall into the top-right quadrant. They seek greater autonomy over their resources while also welcoming unconditional equalisation grants. Examples include Northern Ireland (1968–98) and Scotland in the U.K. (since 1999), Sicily in Italy (1943–47), and the Indian states of Assam, Nagaland and Kashmir. The UK government ensures equitable public spending in Scotland, Wales, and Northern Ireland compared to England through the Barnett Formula (King and Eiser 2017). Sicily, recognised as an autonomous region, receives financial transfers from Italy's central government (Alber and Valdesalici 2023). Similarly, Assam, Nagaland, and Kashmir receive support from India's fiscal equalisation mechanisms (Sharma 2024).

High Income, Majority Nationality States can be placed in the bottom-left quadrant. While preferring to retain a major part of their own generated revenues, they are not against fiscal equalisation for low-income states. Examples include Maharashtra and Gujarat in India, Madrid in Spain, and Alberta in Canada.

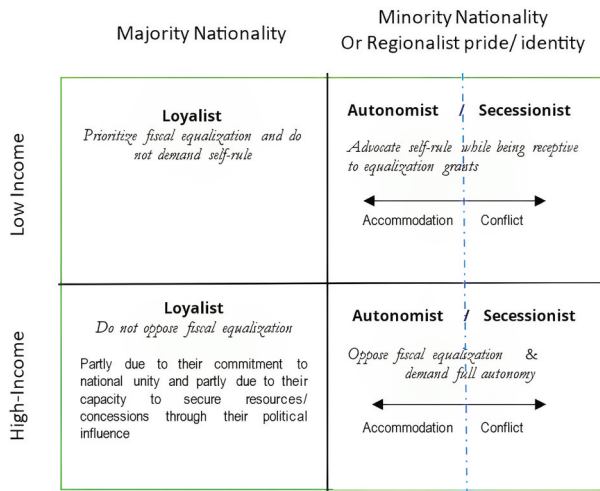


Figure 1. The overlap thesis. The convergence of economic grievances and identity issues precipitates autonomist or secessionist aspirations. These aspirations escalate into violent movements when political institutions are perceived as non-accommodative, extractive and exclusionary.

Finally, the *high-income minority-nationality states* fall into the bottom-right quadrant. They oppose equalisation measures and have autonomist ambitions, which could escalate to conflict if they perceive the political system as discriminatory and equalisation policies as confiscatory. For example, Punjab and Tamil Nadu in India, South Tyrol in Italy, and Catalonia in Spain.

Based on these insights, the puzzle of perspectives in fiscal federalism can be conceptualised as a multi-layered framework of conflicting or complementing interests, particularly when addressing the balance between national solidarity and subnational autonomy. These overarching perspectives each with its unique subcategories have been summarised in Figure 2.

National governments often advocate for greater revenue centralisation to ensure uniformity in the provision of public services, to implement federal spending priorities and to achieve a second-best unitary outcome in a decentralised setting (Boadway and Tremblay 2006). This perspective supports fiscal equalisation and federal spending to achieve broader national goals. Competing with this perspective are the subnational perspectives on the principles of fiscal organisation and the design of fiscal federal institutions. This perspective supports subnational fiscal autonomy to fortify the vitality of decentralised decision-making (Bird 2000). However, as detailed in preceding sections, subnational governments base their policy stance on their income and nationality status. The next section deals with this dilemma of designing fiscal federal systems that cater to the diverse aspirations of different regions.

When does fiscal federalism address conflicts? When does it aggravate them?

Two generations and two perspectives on fiscal federalism

What design of fiscal federalism optimally addresses conflicts arising from the overlap of economic disparities and identity-based grievances? Should the design of fiscal federalism enhance the central government's fiscal capacity to redistribute resources across regions? Or should the focus be on constraining central authority while bolstering the fiscal autonomy of subnational units? The dilemma of fiscal federalism – in addressing secessionist conflicts – lies in crafting a framework that combines elements of both fiscal autonomy and equalisation in a way that can address regional disparities and accommodate diversity without tipping towards extremes of centralisation or fragmentation.

Intergovernmental interactions, bargaining among political incumbents and the normative judgements of policymakers and practitioners, influence the selection of fiscal instruments within a federal system (Kincaid and Stenberg 2011; Oates 2005; Sharma 2012). As it happens, contrasting perspectives in policy debates imply that fiscal federalism often becomes a political competition between different levels of government, each with divergent interests in fiscal organisation and institutional design (Sharma 2012). There are two opposing perspectives on fiscal federalism: the theory of public finance, advocated by Richard Musgrave, and the theory of public choice, pioneered by James

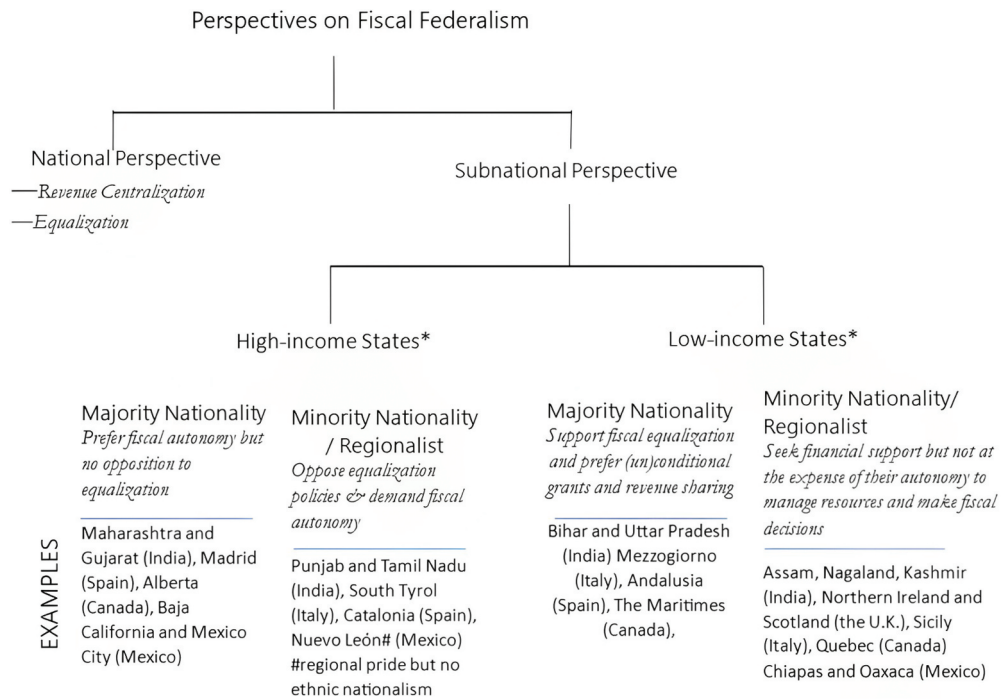


Figure 2. Perspectives on fiscal federalism. *Note: The terms “low-income” and “high-income” are relative to the national average and do not reflect low or high income on a global scale.

Buchanan. The public finance perspective aligns with those favouring national coordination in fiscal structures, while the public choice perspective resonates more with advocates of subnational autonomy.

From a public finance perspective, fiscal constitutions are strategically designed to enable national governments to pursue welfare maximisation through redistributive programmes, addressing fiscal externalities and regional disparities, and ensuring baseline public service levels through fiscal equalisation, revenue sharing, and intergovernmental transfers. Richard Musgrave (1959), the father of modern public finance, who coined the term 'fiscal federalism' assumed that government – a benevolent social planner – would act as custodians of the public interest and would introduce appropriate policy measures to correct public goods problems. His prescription, therefore, was to grant significant fiscal and regulatory powers to the central government for stabilisation, redistribution and provision of federal merit goods. Furthermore, since the distortionary cost of raising an additional unit of tax revenue (the marginal cost of raising tax revenue) is higher at the subnational level than at the federal level, the prescription for the national government was to raise more revenue through centralised taxation and then transfer part of the surplus to the subnational governments. The presence of horizontal fiscal disparities creates the need for even more revenue centralisation to empower the redistributive equalisation mechanisms. This is the *first-generation theory* of fiscal federalism. This literature cautions that an emphasis on subnational fiscal autonomy may raise concerns for equitable wealth distribution and national economic efficiency, potentially leading to 'moral hazards' due to tax base mobility and the perceived tax price of welfare benefits at the subnational level (Boadway 2004; Boadway and Shah 2007).

On the other hand, from the public choice perspective, fiscal constitutions are viewed as mechanisms to restrain the expansive power of central governments, often perceived as monopolistic and prone to rent-seeking behaviour. Buchanan, in his ground-breaking 1962 work *The Calculus of Consent*, laid the intellectual foundation of this perspective – which is the 'Leviathan view' of the public sector as a monolithic agent seeking its own aggrandisement (Tullock and Buchanan 1962). This view emphasises the virtues of limiting the influence of the central government. It sees intergovernmental transfers as mechanisms leading to unnecessary expansion of the public sector, fostering wastefulness and even regional divergence (Kessler and Lessmann 2010). This literature warns that prioritising fiscal equalisation can undermine the autonomy and accountability of subnational governments, leading to perverse incentives for recipient regions (Brennan and Buchanan 1980; Pola 2016). This includes phenomena like soft budget constraints, where regions may over-rely on central government funding (Kornai, Maskin, and Roland 2003; PISAURO 2001), and fiscal illusion, where the true cost of public spending is hidden from taxpayers (Rodden and Wibbels 2002; Smart 2005). Therefore, this perspective advocates for fiscal autonomy and intergovernmental competition. For instance, the 'Market Preserving Theory' of Federalism (MPF), which emerges from the *second generation of fiscal federalism*, advocates for high fiscal autonomy for subnational governments while hardening their budget constraints (Oates 2005; Weingast 1995). MPF downplays equalisation grants, emphasising fiscal autonomy's role in enhancing long-term regional convergence through market forces. Nevertheless, its applicability in countries with large economic disparities is questioned, as is its appropriateness in the European context grounded in solidarity principles (Hueglin 2017; Wong and Bhattasali 2002).

Table 1. Two Perspectives on Fiscal Federalism.

Public Finance Perspective	Public Choice Perspective
Fiscal autonomy, in the absence of equalization programs, widens regional inequalities.	Fiscal autonomy encourages regional convergence, whether or not 'equalization' programs are in place.
Fiscal autonomy promotes political instability (as it increases incentives to secede).	Fiscal autonomy promotes political stability (as it reduces the net payoff from a secession).
Fiscal equalization promotes political stability (as it pacifies the grievances of low-income states).	Fiscal equalization promotes political instability (as it increases the costs of heterogeneity).

While both perspectives on fiscal federalism – focusing on own source revenues and intergovernmental transfers – have merits, the ideal solution does not lie at either extreme. Any dichotomy in policy-making risks pushing fiscal constitutions towards extremes, sparking internal contestations and conflicts (Table 1). For example, while full equalisation can create a soft-budget constraint problem, providing perverse incentives to the recipient states to indulge in inefficient spending (Wildasin 1997), no equalisation policy can create inefficiently inflexible hard budget constraint (HBC) that can discourage socially efficient investments (Besfamille and Lockwood 2008). Similarly, while the goal of subnational fiscal autonomy is commendable for enhancing self-rule properties and enabling local accountability (Oates 2005; Rodden, Eskeland, and Litvack 2003; Weingast 2009), it cannot be pursued to an extreme. Full autonomy is not optimal because there are spatial inequalities and constraints on subnational governments' (SNGs') abilities to raise their own revenues – partly due to the openness of subnational economies and mobility of tax bases. Therefore, intergovernmental transfers play a role in approaching, if not entirely achieving, the ideals of perfect fiscal mapping as outlined by Breton (1965) or fiscal equivalence as proposed by Olson (1969).

The Autonomy-Equalization conundrum

The 'Autonomy-Equalization Conundrum' encapsulates the trade-offs that arise within a federal system when trying to address regional disparities while respecting demands for regional autonomy. Figure 3 presents a complex flow of outcomes based on how a central

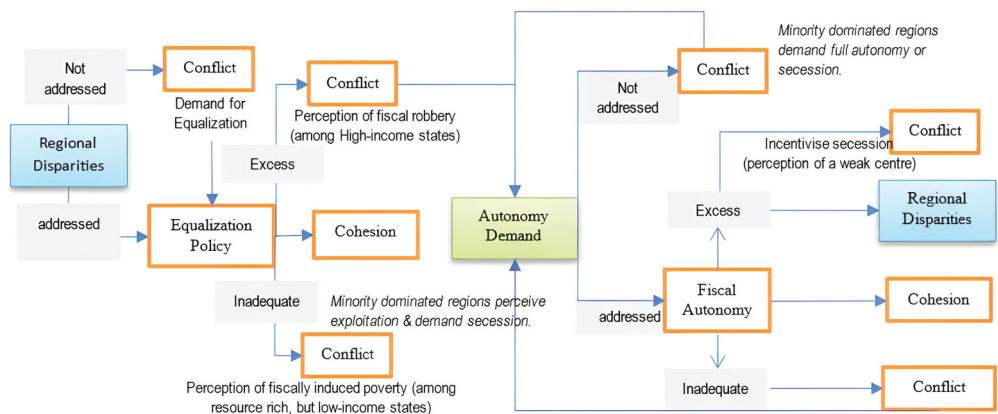


Figure 3. The Autonomy-Equalization Conundrum.

government responds to regional disparities and demands for autonomy. Regional disparities – stemming from historical, geographical, and systemic biases – create a demand for fiscal equalisation (Sorens 2016; Ter-Minassian 1997). In response, a well-designed equalisation policy – that recognises the unique needs and contributions of each region – can foster cohesion (Bird and Tarasov 2004; Boadway and Flatters 1982; Sharma 2012). However, a deviation from ‘optimality’ will trigger or exacerbate conflict. For instance, if equalisation is seen as inadequate, low-income states – particularly those rich in natural resources – may perceive their poverty as ‘fiscally induced’. Inadequate compensation or lack of control over natural resources may trigger secessionist sentiments and conflict (Ahmed 2020; Aspinall 2009; Baruah 1999).

On the other hand, if equalisation swings to the other extreme – it breeds resentment among high-income states (Béland, Lecours, and Tombe 2022) because they feel that their fiscal contributions are used to subsidise inefficiency, relax fiscal discipline and soften budget constraints in poorer regions (Rodden, Eskeland, and Litvack 2003). In such cases, greater fiscal autonomy – the embodiment of a region’s right to self-determination – can reduce conflict. Autonomy can also decrease the incentives to secede by providing regions with a sense of sovereignty within the larger federal structure (Bibbee 2007; Garcia-Milà and McGuire 2007).

However, sub-optimally high fiscal autonomy not only risks widening the disparities between regions (Boadway and Shah 2009) and incentivising a ‘race to the bottom’ (Zodrow and Mieszkowski 1986) but also may inadvertently lay the foundation for secessionist sentiments, particularly in the context of territorially defined minorities (Lustick, Miodownik, and Eidelson 2004; Mozaffar and Scarritt 1999; Siroky and Cuffe 2015). This is more so when regions believe the central government cannot effectively sanction them and the disgruntled regions have the resources for a successful secession (Collier and Hoeffler 2004).

Therefore, the balance of fiscal autonomy and equalisation is critical; inadequacies or excesses in either can precipitate internal conflicts.

Conflict Re(In)ducing federalism? Intergovernmental concessions in a balanced policy environment

Setting fiscal incentives right through a balanced policy environment

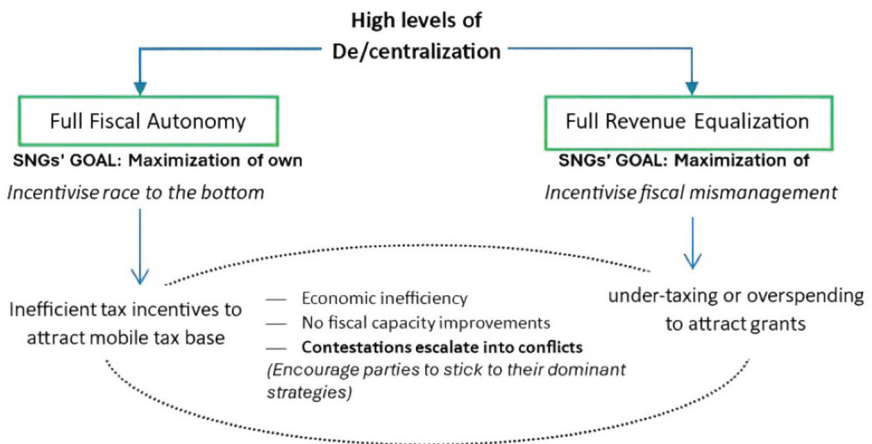
Fiscal federalism literature suggests that a context-specific optimal mix of equalisation and autonomy must be maintained to ensure federal stability (Lecours and Béland 2013; Sharma 2012). This however is a challenging task. It involves understanding the elasticity of regional responses to fiscal policies – how regions will react to changes in equalisation grants and autonomy provisions (Sharma 2012). It also involves calculating the marginal utility and marginal cost of one unit increase or decrease in fiscal transfers *versus* fiscal autonomy under different policy regimes.

Independent (non-partisan) Fiscal Institutions (IFIs) or autonomous fiscal councils – the most recent institutional innovation to foster the quality of the public debate on fiscal policy (Beetsma et al. 2019) – can guide the calibration of fiscal autonomy and equalisation measures in specific contexts. Although identifying context-specific policy mixes is a formidable task to be undertaken by expert bodies – depending on the state of the

national economy and the extent of regional disparities – a broad suggestion as to what that would entail is in order because this is the first step towards fostering sustainable cooperation.

It is clear that when implemented beyond a certain limit, either policy instrument (subnational tax autonomy or equalisation transfers) can lead to reduced efficiency, create perverse incentives for irresponsible behaviour, and cause tensions within the federal system. Weingast, Shepsle, and Johnsen (1981) and Wildasin (1997) studied the irresponsible behaviour associated with intergovernmental transfers, and Dillinger and Webb (1999) and Prud'homme (1994) highlighted the irresponsible behavioural patterns typically associated with subnational tax autonomy.

High Revenue De/Centralization



Optimum Vertical Fiscal Asymmetry (VFA) adequately addressed with Transfers

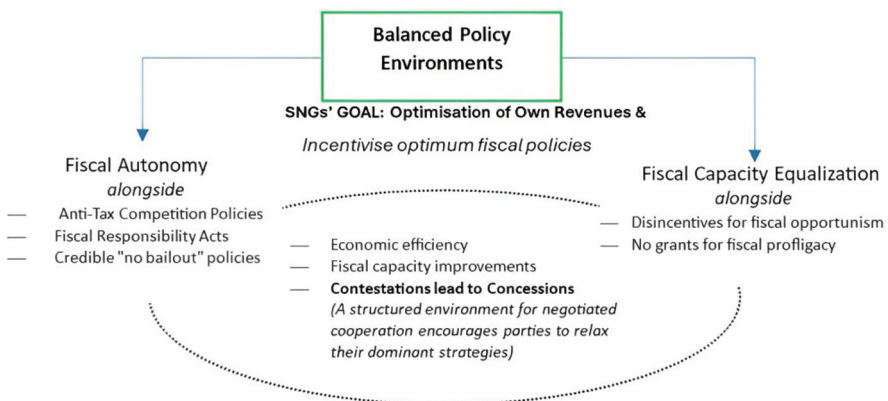


Figure 4. Subnational fiscal policy goals and outcomes under different policy environments. Note: Optimum Vertical Fiscal Asymmetry (VFA) adequately addressed with Transfers refers to a condition where there is no vertical fiscal imbalance or vertical fiscal gap, also termed as vertical fiscal difference (Sharma 2012).

These bodies of literature suggest that SNGs in systems granting high subnational fiscal autonomy may rationally choose to under-tax mobile tax base, to attract businesses or wealthy individuals or under-provide market-promoting public goods and services (education, healthcare, and infrastructure), thereby neglecting positive externalities (Figure 4).

Conversely, in the systems where SNGs are dependent on federal transfers, they may rationally indulge in overborrowing, overspending, rent-seeking, and corruption, thereby creating negative externalities. To address these challenges, a combination of fiscal autonomy at the margin and a well-designed equalisation system, with a credible no-bail-out policy, is essential (Bucovetsky and Smart 2006; Köthenbürger 2005; Rodden 2005).

In this system, SNGs retain a reasonable degree of independent revenue-raising power and the equalisation system does not create perverse incentives. For example, if a region adopts self-serving revenue-maximising strategies – such as race to the bottom to attract a mobile tax base – the system punishes this behaviour by reducing its equalisation grants. On the other hand, if a region strategically engages in revenue-diminishing behaviour such as fiscal profligacy and mismanagement, the system does not reward this behaviour by increasing grants. This balanced approach incentivises responsible fiscal behaviour across regions (Figure 4).

Thus, an optimal policy mix of fiscal autonomy at the margin and a well-designed fiscal equalisation system can avoid efficiency losses, due to perverse incentives associated with either financial dependency or full fiscal autonomy. In terms of the design of equalisation policies, the systems which focus on equalising the ‘fiscal capacity’ to provide comparable levels of public services at comparable levels of taxation (such as those in Canada, Australia, and Germany) create better incentives than those which focus on filling the actual revenue-expenditure gaps (for example India, Pakistan, Malaysia, South Africa, Mexico). The latter system incentivises lower revenue-raising efforts and higher spending to qualify for more grants.

While the task of finding and recommending optimal revenue-expenditure assignments and autonomy-equalisation policy mix may be entrusted to an independent agency, the challenge lies in making those proposals work in the presence of contrasting perspectives based on national/regional politics, majority/minority nationalities and views on the economic role of different levels of government.

Setting political incentives right through concessionary federalism: a Game-Theoretic approach

Having an expert body to recommend incentive-compatible autonomy-equalisation policy mixes is a necessary condition but not sufficient for conflict resolution. While it creates a structured framework for negotiated cooperation by defining the ‘boundaries of contestations’ or power struggles, political incumbents – driven by personal or partisan interests – may override or ignore these recommendations and even evade constitutional limits (Gardner 2016; Levinson 2011). The answer to the puzzle of an ‘optimal’ policy framework lies in politics, which determines resource allocation, addressing who receives what, when, and how (Lasswell 1936).

Therefore, the sufficient condition is the entrenchment of robust institutions for inter-governmental negotiation and shared governance. The first design element of such

empowered intergovernmental councils must be ‘binding inputs’ – such as IFI recommendations or constitutional principles – that define the framework within which contestations and negotiations occur. The second element should be ‘binding outputs’ (Schnabel 2020) so that no party deviates from agreed-upon concessions, which are enforceable as contracts. Note that binding outputs risk creating inefficiencies or being disregarded by parties unless they are rooted in binding inputs – predefined principles agreed upon a priori – that set clear limits beyond which no party will go. When these foundations – based on expert recommendations – are in place, sustained interactions can reduce opportunistic behaviour and allow optimal and sustainable solutions to emerge. Thomas Schelling (1956) demonstrates that if parties take a long-term perspective and interact repeatedly, their common interests may be sufficiently strong to sustain cooperation. Fourçans and Thierry (2001) present a game-theoretic model illustrating that ‘infinite interactions’ among stakeholders can act as a deterrent against strategic behaviours detrimental to collective welfare.

Overall, a continuous process of intergovernmental negotiations can reveal interdependencies and help parties align their incentives with economists’ recommendations. Designing an optimal fiscal federal system is like composing a symphony, balancing autonomy and equalisation to resonate with each country’s unique socio-political and economic fabric.

To illustrate this using a Game Theoretic approach, we model interactions between three players: the National Government (NG), High-Income States (HIS), and Low-Income States (LIS). The objective is to identify a Nash Equilibrium, reflecting a set of strategies from which no player has an incentive to deviate unilaterally.

Since the rules of the game matter for the outcome, the nature of the fiscal constitution, which sets the rules for the players, is the starting point. The National Government seeks to implement the given fiscal constitution. However, contestations from states may compel the NG to reform or revise the fiscal constitution depending on the bargaining powers, the credibility of threats, and the costs of non-cooperation as articulated by the interacting parties.

To illustrate, we assume two extreme scenarios:

- (1) The fiscal constitution provides for high revenue centralisation along with a system of fiscal equalisation.
- (2) The fiscal constitution provides for a high level of revenue decentralisation and fiscal autonomy.

Scenario I: high revenue centralisation

Stackelberg competition phase

NG (Leader) decides to implement a centralised fiscal constitution, benefiting Low-Income States (LIS) through an equalisation scheme. This incites grievances among High-Income States (HIS), which resent contributing to the equalisation fund. HIS then make an extreme demand for full autonomy, threatening conflict if their demand is not conceded. LIS do not support such a high autonomy framework, as it would force them to rely solely on their resources and revenue generation capacity. NG faces a critical decision: suppress the HIS demands or concede to HIS and alienate LIS – both of which could lead to conflict. So, the

compromise formula would be to offer a balanced equalisation-autonomy framework – that would include targeted concessions to address the cultural and identity-related concerns of territorial minorities in both Low-Income States (LIS) and High-Income States (HIS).

Coordination game phase

Since national cohesion is the NG's highest priority, conflict situations are as costly for the NG as it is for HIS. Therefore, both players (HIS and NG) enter into negotiations, making agreements in intergovernmental forums based on (a) trade-offs between their own and the other player's utilities, and (b) the extent to which a player's non-cooperative move can result in lower utility for the other player(s). If one player steadfastly holds to its extreme position, negotiations break down and the cycle of conflict and repression initiates.

Employing 'backward induction and look-ahead analysis', one can infer that if HIS is put in a situation to accept or refuse the balanced solution with concessions, HIS will likely accept because concessions offer a better payoff than initiating conflict with the likelihood of suppression and defeat. Assuming this rational behaviour, the NG insists HIS to participate in a balanced equalisation framework with concessions and get its second-best payoff. This is a state of equilibrium because if NG holds this strategy fixed, LIS will be satisfied and HIS cannot gain by switching its strategy from participation to conflict.

Scenario II: high revenue decentralisation

The intergovernmental dynamics are reversed in a system where revenue decentralisation and fiscal autonomy are prioritised. High-Income States (HIS) are content with this system, but Low-Income States (LIS) resent disparities and prefer a strong equalisation system to support their needs. LIS then make an extreme demand for full equalisation – a system HIS would resent because it would require them to subsidise LIS. NG will handle LIS's demands similarly to HIS's demands in the centralised system by negotiating tailored concessions while balancing their needs for equalisation and autonomy.

Three-player game: concessionary federalism as an equilibrium strategy

Assuming a situation where both HIS and LIS are territorial minorities and advocate for their contrasting perspectives, while NG aims to reconcile these differences to establish cohesion and stability, Nash equilibrium – where the strategies of all players are best responses to each other – can emerge if the players' strategic priorities, competing utilities, and concessions are negotiated in an institutionalised forum for intergovernmental coordination.

The concessionary approach to conflict resolution embodies a paradigm of reciprocal concessions aimed at achieving a joint agreement between the central and subnational governments. The core principle is that the concessions are designed to ensure that any utility loss experienced by the negotiating parties in one dimension is at least partially offset by gains in another (Sharma 2021). In the context of contestations, the central government's balanced policy mix along with strategic concessions, provides a better payoff than the potential gains from engaging in conflict.

NG values peace, cohesion, and stability, yet it poses a credible threat of counter-insurgency in the event of a secessionist conflict – historically, secessionist insurgencies rarely succeed. HIS and LIS understand the cost of conflict and likely suppression. Since concessions offered by the NG are seen as strategic and authoritative, rather than a sign of weakness, SNGs accept concessions as trade-offs for supporting NG’s policies.

The outcome is that HIS retains autonomy at the margin – maintaining profitability without losing all surplus – and receives targeted concessions related to the cost of preserving its identity and culture, making participation in the equalisation framework acceptable. LIS is content with NG’s equalisation framework due to additional concessions, such as control over natural resources or accommodation of their distinct identity. LIS also recognises that an efficient economy – achieved through optimal fiscal capacity equalisation rather than full revenue equalisation – leads to higher growth and expands the distributive pie. NG is content because HIS and LIS reciprocate by committing to the national policy framework. Thus, no party has a unilateral incentive to deviate from this state of equilibrium.

When is equalization perceived as empowering and when as expropriating?

Carrots for some can become sticks for others— insights from India

In this section, we will further substantiate the view that suboptimal equalisation policy designs incite contestations which can escalate into conflicts. However, targeted concessions in addition to an optimal autonomy-equalisation policy mix can effectively resolve disputes or end violent conflicts. Crucially, these concessions are most impactful when the national government (NG) acts from a position of power – yet this power disparity is exercised in an institutional setting which prevents the abuse of bargaining asymmetries by all players. This dynamic ensures that the NG’s moves are neither perceived as signs of weakness or coercive abuse of power, but rather as strategic and authoritative measures aimed at promoting cohesion and stability.

Before using the case examples from India to understand what makes equalisation policy contentious, we briefly highlight the federal systems which come closer to the ideal of an efficient policy mix. As illustrated in the previous section, contrasting models of federalism – those that value self-rule versus those that prioritise shared-rule – can both achieve optimal outcomes, provided these dimensions of the federal system are strongly institutionalised, as seen in Canada (institutionalised self-rule) and Germany (institutionalised shared-rule).

In Canada, the equalisation system operates within the context of extensive provincial fiscal autonomy, as provinces have access to broad-based tax sources. Given this substantial fiscal autonomy, the equalisation system does not take the form of revenue sharing – either horizontal or vertical. Instead, equalisation transfers are unconditional transfers from the federal government to provinces whose revenue-raising capacity is below average capacity. This structure ensures that equalisation does not incentivise fiscal laxity or profligacy among recipient provinces (Boadway and Shah 2009; Cameron and Simeon 2002; Sharma and Valdesalici 2020).

Unlike the Canadian system, where provinces have autonomy over broad-based taxes, tax collection for broad-based taxes in Germany is a shared responsibility between federal and state governments. This system makes revenue-sharing mechanisms essential for subnational financing. Additionally, Länder whose fiscal capacity remains below average receives contributions from wealthier states and vertical transfers from the federal government (Beramendi 2014; Gunlicks 2003). The Länder's limited fiscal autonomy is compensated by their participation in federal legislation through the Bundesrat (Federal Council) and control over certain own-source revenues like property taxes and specific business taxes, allowing for fiscal discretion (Sharma and Valdesalici 2020).

The above two systems show different ways to approximate optimal arrangements in contrasting contexts with institutionalised self-rule or shared rule. Institutionalised self-rule and shared-rule mechanisms prevent abuses of bargaining power by promoting competition, negotiation and renegotiation. Problems arise when neither self-rule nor shared rule is adequately institutionalised, as observed in the Indian federal system (Sharma and Swenden 2022).

Methodological approach and case selection

This article develops three propositions that explain the causal mechanism from grievances to secession: (a) secessionist sentiments arise when perceptions of economic injustice coincide with identity-based grievances (b) fiscal federalism, specifically fiscal autonomy and equalisation policies, influence perceptions of economic (in)justice, and (c) these grievances escalate into conflict if political-institutional framework fails to address them.

To illustrate and substantiate these propositions, we adopt a case study approach with India as a single, bounded unit containing multiple embedded cases (Table 2). India is an ideal case selection because it encompasses all four types of states – high/low-income and majority/minority-identity combinations – within a single country. The cases illustrate how the theoretical propositions operate in real-world contexts and set the stage for systematic empirical research to rigorously test these propositions. We use process tracing within low-income and high-income states to examine covariational patterns between income-identity overlaps and secessionist tendencies. The Method of Agreement is applied to identify common factors – identity grievances, economic injustice, and insufficient political accommodation – that drive secessionist violence. The Method of Difference highlights how the lack of these factors, along with effective political accommodation, results in a non-secessionist outcome.

Evidence from India

India is a federal system characterised by (a) significant regional economic disparities and income inequalities, and (b) a tendency towards centralisation. The national government exercises considerably more fiscal power relative to their constituent states, resulting in the latter's dependency on federal transfers. In this unique context of disparity and diversity, vertical and horizontal contestations arise which may or may not escalate into secessionist movements. Table 2 provides a snapshot of high- and low-income states across both minority and majority nationality groups. While majority-nationality states

Table 2. Income, identity, and secessionism: a comparative case study of Indian states.

Variables	Low-income, minority nationality—secessionist		Low-income, majority nationality—loyalist		High-income, minority nationality—secessionist		High-income, majority nationality—loyalist	
	Assam	Kashmir	Bihar	Uttar Pradesh	Punjab	Tamil Nadu	Haryana	Maharashtra
Per Capita Income (% of the national average)	Low (73.7%)	Low (77.2%)	Low (32.8%)	Low (50.8%)	High (106.7%)	High (171.1%)	High (176.8%)	High (150.7%)
Identity	Minority (ethnic)	Minority (religious)	Majority	Majority	Minority (religious)	Minority (linguistic-cultural)	Majority	Majority
Autonomist or Secessionist sentiment	Yes	Yes	No	No	Yes	Yes*	No	No
Secessionist violence/Insurgency	Yes (1979–1992)	Yes (1987 onwards)	No	No	Yes (1980–1992)	No	No	No
Financial Concessions	Yes	Yes#	Demand greater financial assistance beyond revenue-sharing (partially granted); Bihar demands Special Category Status (not granted)	Demand greater financial assistance beyond revenue-sharing (partially granted); Bihar demands Special Category Status (not granted)	Demand greater fiscal autonomy or fiscal reciprocity (allocations based on fiscal contributions) (Not granted)	Demand greater fiscal autonomy or fiscal reciprocity (allocations based on fiscal contributions) (Not granted)	No demand	No demand
Political accommodation/Concessions	Yes	Yes#	n.a.	n.a.	Yes	Yes	n.a.	n.a.
Military Suppression	Yes	Yes	n.a.	n.a.	Yes	No	n.a.	n.a.
Resolution of Secessionist Conflict	Yes	No	n.a.	n.a.	Yes	Yes	n.a.	n.a.

Source: Author (PCI data from Economic Advisory Council to the Prime Minister (EAC-PM), 18 September 2024); n.a. not applicable.

*Pre-independence secessionist sentiment in Tamil Nadu—rooted in linguistic and social justice issues—weakened post-1947, faded by 1963, and shifted to integrationist after 1967; Autonomist sentiment grew as the state's economy grew rapidly relative to northern states after the mid-1970s.

#On 5 August 2019, the Modi government nullified the special constitutional privileges and protections granted to J&K under Article 370 and Article 35(A). Additionally, the Special Category Status (SCS), aimed at providing preferential central funding, was also withdrawn. Furthermore, the region was downgraded from a state to a union territory. As concessionary approaches and counterinsurgency have failed, the punitive measures are aimed at disincentivising local support and foreign patronage to militants (Sharma 2024).

generally do not oppose central government policies, regardless of income level, minority-dominated regions have experienced secessionist movements.

Secessionist dynamics in low-income states

Assam

Fiscal equalization and financial concessions facilitate negotiations and peace.

Assamese hold a strong cultural identity and feel insecure about internal migration from other Indian regions and unauthorised immigration from Bangladesh. Therefore, there has been an anti-foreigner sentiment in Assam. At the same time, Assamese attributed their lack of prosperity – despite Assam's resource wealth – to the central government's economic policies. This combination of identity-based and economic grievances resulted in a sense of alienation. However, the Assam movement started when political processes not only failed to prevent illegal migration, rather it was found upon a court inquiry in April 1979 that 45,000 illegal migrants had been added to the voter list in the Mangaldai parliamentary constituency. This triggered widespread anti-foreigner protests in Assam, marked by civil disobedience and violent clashes with Bengali immigrants (Kimura 2013).

The Assam Movement continued under the banners of the All-Assam Students' Union (AASU) and the All Assam Gana Sangram Parishad (AAGSP) until 1985 when the Rajiv Gandhi Government negotiated a settlement with both groups. This agreement, known as the Assam Accord, was signed on 15 August 1985, formally concluding the Assam Movement (Pisharoty 2019). Prafulla Mahanta, then AASU President, transitioned into mainstream politics, founding the Asom Gana Parishad (AGP), which won the 1985 Assembly elections (Mitra and Singh 2018). However, the AGP government struggled to implement key provisions of the accord, notably the deportation of illegal immigrants. Additionally, it failed to secure greater autonomy or financial compensation from the central government. This period was also marked by a decline in law and order, coupled with an unprecedented rise in the prices of essential goods and escalating unemployment.

Against this backdrop, the militant United Liberation Front of Asom (ULFA) emerged, claiming to represent Assamese interests in response to perceived government failures. In the late 1980s, ULFA shifted the focus towards economic grievances, framing Assam's lack of development as a consequence of exploitation by the Indian state. The organisation mobilised local sentiment around the gap between Assam's development potential and its economic realities, deepening local resentment towards the central government (D'Souza 2012; Kikon 2019; Walter 2022).

As ULFA's armed struggle for an independent nation intensified, the Government of India imposed President's rule in the state and responded with a two-pronged approach. First, in 1991, it designated Assam as a Special Category State, which allowed the state to receive development funds as grants instead of loans. At the same time, the government used military force to decisively suppress the armed conflict, effectively combining incentives with strong measures – a classic carrot-and-stick strategy. When, in January 1992, most of the ULFA members surrendered and entered into negotiations with the Indian Government under the ULFA-S banner, the Government pledged to

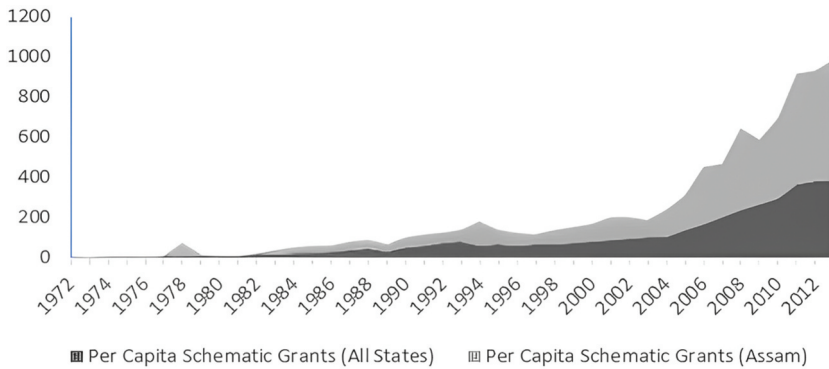


Figure 5. Per capita grants (INR) for Centre's welfare schemes. *Source:* Author's calculation based on RBI data on State Finances: A Study of Budgets, various years

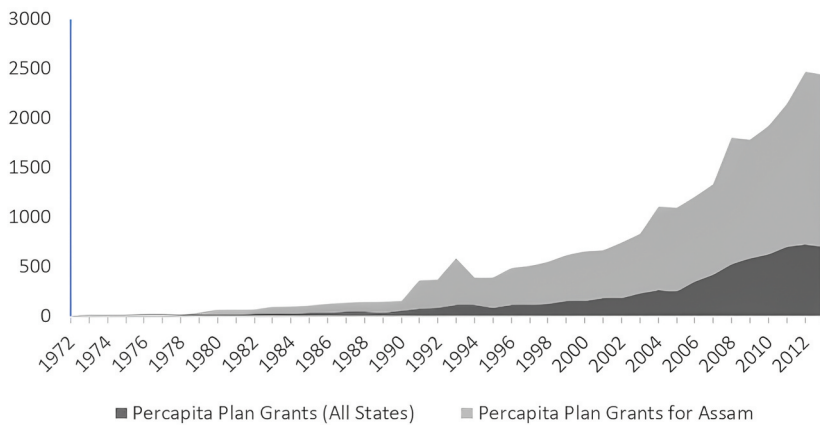


Figure 6. Per capita grants (INR) for state plan schemes. *Source:* Author's calculation based on RBI data on State Finances: A Study of Budgets, various years

modernise education in Assam, strengthen the state's economy, and allocate a larger share of royalties from oil, plywood, and tea to the state (Baruah 2005).

The strategic application of fiscal federalism successfully addressed the core grievances centred around economic exploitation and inadequate compensation for natural resource contributions. The 'special category' status meant the state got more grants and fewer loans from the government – the mix changed from 30% grants and 70% loans to 90% grants and 10% loans. The designation of Assam as a special category state enabled it to secure a larger share of plan grants as well as schematic grants from the Planning Commission in subsequent years (Figures 5 and 6). Consequently, the share of assistance for the state's plan jumped from 41.86% of total grants to 65.22% (State Finances: A Study of Budgets, RBI, 1991 and 1996). In addition, the oil royalty rate was revised in 1993 from INR 61 per metric ton of crude oil to INR 539.20 and on 1 April 1996, to INR 609.95

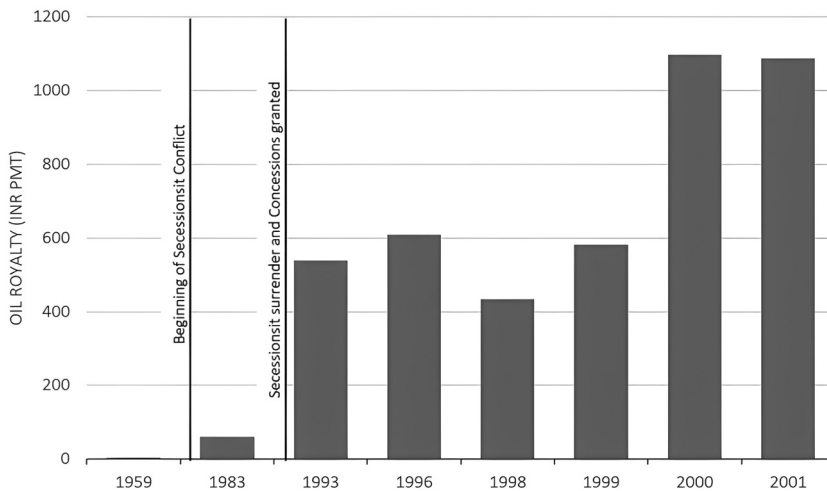


Figure 7. Oil royalty rate (INR per metric ton). *Source:* Author's calculation based on Lok Sabha Starred Question No. 59, dated 3.3.2005

(Figure 7). Overall, a conditional concessionary approach was used to address the grievances of secessionist forces and bargain peace for Assam.

Kashmir

Symbolic concessions— pre-emptive or reactive—work in the short run

Kashmir's experience demonstrates that *pre-emptive* political concessions can *prevent* the emergence of secessionist sentiments. Following Jammu and Kashmir's accession to India in 1947, the state enjoyed a unique level of legislative and administrative autonomy through Article 370 (Noorani 2011). It was expected that the autonomy granted to Jammu and Kashmir under Article 370 would empower Sheikh Mohammad Abdullah, the first elected Prime Minister of J&K, to address historical inequities.⁵ Indeed, Abdullah's government initiated land reforms under the Big Landed Estates Abolition Act of 1950, transferring land ownership to tillers without compensating Hindu landlords (Para 2018). This, however, triggered a significant backlash from Kashmiri Pandits and Hindu groups, such as the Jammu Praja Parishad. Intervention from the central government eventually led to Abdullah's dismissal and arrest on 9 August 1953, on charges of subversion (Abdullah 1993; Tremblay and Bhatia 2020).

Abdullah's arrest catalysed discontent among the Kashmiri population. However, to address local concerns regarding the state's distinct identity within India, the government of India granted another concession in 1954 in the form of Article 35 A which prevented outsiders from buying property, settling, or accessing local government jobs and scholarships in the region. Sheikh Abdullah's release in April 1964, and re-arrest in 1965 reignited old tensions. In that context, the National Liberation Front (NLF), was founded by Maqbool Bhat in 1965 to liberate Jammu and Kashmir from Indian control. While the

militant organisation was trying to gain local support, the Indian government approved yet another financial concession for J&K in 1969–70. It granted the state a ‘Special Category Status’ thereby, entitling it to substantial financial support along with tax exemptions, excise duty reductions, and development grants to promote infrastructure growth. This approach of granting substantial concessions likely contributed to regional stability and maintained relative calm until the late 1980s.

When symbolic concessions aren’t enough— financial outcomes and institutional effectiveness matter

From 1953 to 1975, a series of state-led administrations in Jammu and Kashmir were widely perceived as corrupt extensions of the central government, rather than autonomous representatives of local interests. Sheikh Abdullah’s return to power in 1975 was similarly marked by corruption and authoritarian practices. His son, Farooq Abdullah, who became Chief Minister in 1982, was also accused of prioritising cronyism over equitable development (Bose 2009; Ganguly 1999).

Overall, elite capture prevented policy benefits from reaching the economically marginalised population within the Kashmir Valley (Sharma 2024). Despite substantial fiscal allocations, rural poverty remained widespread, and economic development was uneven and concentrated within a narrow elite. This alienated the rural Muslim population from the local elite.

Muslim youth in the Kashmir Valley sought a democratic path to address their grievances. In the 1987 state assembly elections, Kashmiri youth rallied behind the Muslim United Front (MUF) – a new political alternative to the ruling National Conference–Congress alliance. However, the elections were rigged to secure a National Conference–Congress victory. The widespread perception of a stolen election eroded Kashmiris’ faith in Indian democracy. It became clear that the institutions of self-governance delivered procedural rather than substantive democracy and failed to provide genuine political inclusion. Thus, the rigged 1987 elections catalysed the rise of militancy, as disenfranchised Kashmiri youth turned to separatist organisations. Overall, institutions matter – not just for their symbolic significance, but also for what they do.

Secessionist dynamics in high-income states

Punjab

Fiscal equalization fuels discontent. Identity-based grievances and secessionist sentiments in Punjab emerged in the context of India’s partition, long before the violent secessionist movement began in the 1980s. A perception of cultural domination consolidated after independence, due to the actions of the national majority community such as campaigns advocating for Hindi and Sanskrit in Punjab (G. Singh 2000). As Punjab’s prosperity peaked during the 1970s, these actions intensified the sense of alienation among the Sikhs (Brass 1994). However, the roots of Punjab’s economic grievance can be traced to the perception that the central government’s fiscal equalisation policies are disproportionately disadvantaging the state despite its significant contributions to national revenue.

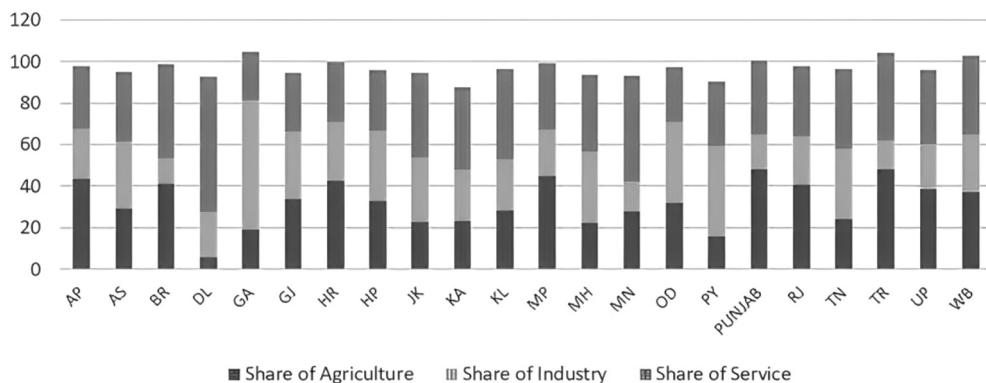


Figure 8. Average percentage share of three sectors in states' net domestic product from 1970 to 2020. Source: *State Finances: A Study of Budgets*, Reserve Bank of India, various years

Punjabis perceived that the Central government was penalising the state for its high-income status by denying it a proportionate share in central taxes relative to its contribution, and by thwarting its industrial growth through the industrial licencing regime. The central government argued that allocating a larger revenue share or more industries to Punjab – a state enriched by the Green Revolution – would aggravate regional disparities. Consequently, this policy stance led to a situation wherein Punjab's industrial sector's share in its GDP remained low compared to many other major Indian states (Figure 8). Punjab's experience shows how the central government's economic, industrial and fiscal policies can exacerbate separatist sentiments in a minority-dominated region. The state's perception of being unfairly treated in revenue sharing and industrial development – especially against its contribution to the national economy as India's agricultural powerhouse – fuelled demands for greater autonomy (P. Singh 2008). In 1973, the Akali Dal party's articulated Punjab's grievances through the Anandpur Sahib Resolution (ASR). In September 1981, the Akali Dal again presented a gamut of grievances to the central government. The grievances covered economic, religious, political, and social issues, but negotiations faltered as Prime Minister Indira Gandhi dismissed all demands. As a consequence, Akali Dal lost its control over the economically disadvantaged Sikh-Jats who under the leadership of an extremist leader Bhindranwale plunged Punjab into a secessionist violence spree characterised by daily killings of Hindus throughout the 1980s.

When negotiated concessions fail

On 24 July 1985, the Punjab Accord between Rajiv Gandhi and Harchand Singh Longowal, an Akali Sikh leader, was signed. The government conceded to most of the demands. However, the extremist faction within the Sikh movement rejected the deal, as they sought an independent Khalistan (Chima 2010). Consequently, religious militants assassinated Longowal, the Sikh signatory. Thereafter, militancy in Punjab entered a second, deadlier phase. Between 1986 and 1987, Punjab's Director-General of Police, Julio Ribeiro,

led the police force in a vigorous crackdown on Sikh militants, adopting a 'bullet for bullet' policy. Following 1987, K.P.S. Gill, Punjab's new Director-General of Police, implemented an even more stringent approach. He launched Operation Black Thunder in May 1988 and Operation Rakshak in November 1991, following a 'catch and kill' policy for alleged militants. Consequently, the secessionist movement was effectively crushed.

The central government's decisive victory over Sikh militants in Punjab diminished its incentive to offer concessions, resulting in none of them being granted. However, the case of Punjab illustrates the vital role of 'effective' institutions in pacifying Sikhs, even in the absence of formal accommodations for their demands. The political and economic decentralisation that occurred in the 1990s played a significant role in reshaping the perceptions. This period marked the transition from one-party dominance at the Centre to a multi-party coalition system and the termination of the centralised command economy paradigm. Elections in Punjab also became more competitive, with free and fair processes allowing Sikhs to contest and win elections, subsequently forming governments. Therefore, strong trust in democratic institutions in general and the integrity of the electoral process in particular prevented the resurgence of militancy.

From the fiscal federalism viewpoint, the recommendations of the Tenth Finance Commission, submitted on 26 November 1994, for the period 1995–96 to 1999–2000, played a role. The Commission, which submitted its report on 26 November 1994, for the five years from 1995–96 to 1999–2000 accommodated state demands for increased shares in central taxes. The Commission proposed an 'Alternative Scheme of Devolution', which expanded the range of shareable taxes from only two central taxes to all central taxes thereby ensuring that states could share the aggregate buoyancy in all central taxes. This allowed states like Punjab to have more access to central funds. Although Punjab's relative share from the divisible pool transfers remained low, the overall growth in the share partially compensated the state for its low share in taxes, providing some degree of financial relief.

Tamil Nadu

The case of Tamil Nadu illustrates how a separatist movement can be accommodated within a federal structure. Before India's independence, Tamil nationalists, led by the South Indian Liberal Federation (also known as the Justice Party), advocated for an independent Dravidian nation. By 1944 the Justice Party transitioned into Dravidar Kazhagam (DK), a social party that feared that an independent India under Congress leadership would solidify Brahmin-Bania power structures, and marginalise South Indian, non-Brahmin communities (Washbrook 1989). After independence, a faction led by C.N. Annadurai split from DK in 1949 to form the *Dravida Munnetra Kazhagam (DMK)*, which focused primarily on cultural, linguistic (anti-Hindi imposition), and caste-related grievances (anti-Brahminism). The DMK prioritised achieving greater autonomy within the Indian Union while downplaying the idea of secession (Narendra 1999).

In the 1950s and 1960s, the Indian government effectively accommodated and integrated Tamil nationalism within the Indian Union through key policies: (a) the *States Reorganization Act of 1956*, which formally recognised Tamil Nadu's linguistic identity, and

(b) the *Official Languages Amendment Act of 1967*, which designated English as an associate language alongside Hindi, reinforcing India's commitment to linguistic diversity.

Most importantly, the DMK embraced electoral politics and rose to power in Tamil Nadu in 1967. Had the central government obstructed the DMK's political ascent, Tamil nationalism could have taken a more confrontational path. However, the democratic accommodation of former separatists helped in addressing regional aspirations. Notably, Tamil Nadu's political landscape has shown limited signs of elite capture, contrasting sharply with the situation in Kashmir. Tamil Nadu has invested heavily in education, infrastructure, population control and the empowerment of marginalised communities (Kalaiyarasan and Vijayabaskar 2021). This approach has contributed to regional stability, as disenfranchisement and economic injustice are frequently underlying drivers of militant movements. As Tamil Nadu's growth story unfolded in the 1990s, it began to perceive that India's revenue-sharing scheme penalises the state for its efficiency, fiscal discipline, and investments in human development and infrastructure (Nilakantan 2022). However, with the identity-economic overlap significantly weakened and robust channels available for expressing dissent and gaining political power, there is no secessionist movement in Tamil Nadu.

Conclusions

The empirical and theoretical literature provides limited evidence of a definitive link between conflict and any specific – political, economic, psychological or identity-based – variable. This is because the rise and resolution of secessionist conflict is shaped not by isolated general determinants but by a unique, interconnected sequence of events – a causal chain with multiple interactions at each stage, from grievances to rebellion to reconciliation or secession. However, the role of fiscal policy remains underemphasised in much of this literature.

We show that the relationship between fiscal equalisation and the rise of secessionist sentiments follows a U-shaped pattern. Both insufficient and excessive equalisation can provoke contestations, albeit in different regions and for different reasons. Insufficient equalisation sparks contestation in low-income regions, while excessive equalisation triggers resentment in high-income regions. Therefore, an optimal policy mix that combines an incentive-compatible fiscal equalisation system with fiscal autonomy at the margin can ensure equity, efficiency and peace.

However, we observe a nuanced dynamic: not all high- or low-income states respond uniformly to autonomy or equalisation policies. Much depends on whether they are inhabited by national minority identities – who, irrespective of their income levels, perceive national fiscal policies as unjust. Thus, centre-state contestations over fiscal policies take on a secessionist dimension only when the aggrieved state is inhabited by a national minority, a phenomenon I term the Ethno-Economic Overlap Thesis.

Furthermore, the case studies show that while the ethno-economic overlap sets the stage for conflict, the secessionist sentiments escalate into violence only when institutional failures to address economic and identity-based grievances push the situation to a tipping point (also see Sharma (2024) for the Twin Catalyst Thesis). However, in each case, concessionary approach – whether pre-emptive or reactive – serves as a tool for conflict resolution with varying degrees of success. The case of Assam shows that targeted

concessions prompt secessionist leaders to weigh the economic and social costs of continuing insurgency and facing counter-insurgency measures against the benefits of accepting concessions.

However, as demonstrated in the case of Kashmir, secessionist tendencies may persist even after substantial concessions if these benefits fail to improve people's lives due to elite capture or systemic corruption. This underscores a vital point: while symbolic concessions provide temporary relief, only tangible outcomes can maintain long-term stability. Even self-governance – under a regionalist party – may fail to contain secessionist sentiments if (a) it does not result in meaningful socio-economic improvements and (b) the party manipulates electoral processes to maintain power. Tamil Nadu and Punjab are the cases that prove the rule: transparent, competitive elections that allow corrupt leaders to be replaced can prevent secessionist resurgence.

While this study identifies overlapping identity-based and economic grievances as primary drivers of secessionist sentiments, a deeper analysis of the causal pathways leading to violent conflicts reveals three critical areas that policymakers must prioritise—(a) crafting balanced policy frameworks to disincentivize fiscal mismanagement, opportunistic behaviour, and elite capture of resources; (b) building responsive institutions to strengthen public trust in democratic participation; and (c) establishing empowered intergovernmental councils with clear negotiation frameworks (binding inputs) and the authority to enforce mutually agreed concessions (binding outputs).

This article recognises that Centre – state contestations are not inherently problematic. Indeed, the Madisonian concept of 'contestational federalism' can serve as a federal safeguard. However, when such contestations remain unresolved and exceed their optimal threshold – often due to ineffective intergovernmental coordination – they risk escalating into conflict.

To prevent contestations from escalating into violent conflicts, this article advocates an institutionalised 'concessionary federalism' framework that fosters continuous dialogue and reciprocal concessions between national and subnational leaders. Negotiated solutions secure public approval when the negotiating parties are perceived as legitimate representatives, grounded in the integrity of electoral processes (Norris 2014). Finally, we invite further case research in different contexts and large-N analyses to test and refine the theoretical frameworks and hypotheses advanced in this article.

Notes

1. Fiscal policies aim to maintain macroeconomic stability, supply public goods, correct market failures, and redistribute income. Redistributive spending, such as social safety nets and transfers, alongside investments in public goods that benefit low-income households (such as health, education, public transport, sanitation, and digital infrastructure) are key in reducing inequality (Heshmati and Kim 2014). For instance, the Nordic countries, through progressive taxation and comprehensive public services and social spending, have achieved significant equality and social inclusion (Brandal, Bratberg, and Thorsen 2013). In federal systems, fiscal autonomy and fiscal equalisation are integral to achieving these objectives. Fiscal equalisation passively corrects horizontal disparities among regions, while fiscal autonomy actively empowers subnational governments to tailor taxation and spending to local

priorities. Both policies risk adverse incentives unless complemented by well-designed policy frameworks and oversight mechanisms.

2. Centre – state contestations are not inherently problematic; rather, they signify the vitality of a robust federal system – provided there are institutional mechanisms to channel these contestations towards constructive resolution and cooperation. When such institutions accommodate contestations, both national and subnational governments able to recognise and respect each other’s legitimate authority (Sharma and Swenden 2022). Historically, James Madison introduced the concept of ‘contestational federalism’, as a federal safeguard against excessive centralisation (Walker 2017).
3. Autonomy becomes a compromise solution when the issues driving the desire for independence are addressed, making secession seem costly or undesirable. In South Tyrol, extensive autonomy agreements, like the 1972 second Autonomy Statute, diminished the appeal of secession (Alber 2021). Lombardy and Veneto have also shifted focus from secession to negotiating for greater autonomy (Zampano 2017). Similarly, in Belgium, the increased autonomy for Flanders reduces its motivation for secession (Swenden and Jans 2006).
4. Sharma (2024) outlines a two-stage sequence of triggers leading to violent conflict. The Ethno-Economic Overlap represents the first stage, where economic marginalisation politicises insecure minorities. The contestations escalate into conflict when institutions fail to address these grievances. Together, this framework is termed the Twin Catalyst Thesis.
5. The Hindu Dogra rulers of Kashmir (1846–1947) historically privileged the small Pandit minority in administrative and economic roles, leaving the Muslim majority politically marginalised and economically disadvantaged (Rai 2018).

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Notes on contributor

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