

On the optimal size of states

-Karthik Muralidharan

The Telengana announcement and the subsequent proliferation of additional statehood demands is a good time to consider some of the broader theoretical issues in determining the optimal size of states. The work of Alberto Alesina (Harvard) and Enrico Spolaore (Tufts), on the optimal size of nations (*The Size of Nations*, MIT Press, 2005) provides some useful principles for thinking about the optimal size of states in the Indian context.

The basic idea is that there are powerful economic trade-offs between the benefits and costs of size. There are five main benefits of size in the context of nations. First, there are economies of scale in national defense. Second, there are economies of scale in the provision of public goods such as law and order, judicial systems, and administration of social programs which can make the per capita cost of administration smaller in larger states. Third, the presence of barriers to trade across borders means that larger nations have bigger domestic markets which provide the minimum market size needed for capital-intensive investments to be viable. Fourth, larger jurisdictions can offer more spatial insurance against natural disasters (both through internal migration and through redistribution from the unaffected areas). Fifth and finally, larger jurisdictions can better coordinate on policies that have spillovers across geographic areas (such as water resources, crime, and public health).

Countering these benefits is one major cost of greater size, which is the difficulty of accommodating an increasing number of diverse preferences with one set of policies for the entire state. A related downside is the administrative challenge of aggregating information and preferences effectively in a larger state. Thus, the extent of shared identity, history, and preferences are key determinants of the extent to which jurisdictions can grow without the costs of managing diversity overwhelming the benefits of size.

The political institution of federalism is designed to get the best of both worlds by assigning to the higher level of government the roles that benefit the most from economies of scale while assigning to lower levels of government the roles that require greater accommodation of diversity. However, the same trade-offs laid out above (except for defense) apply to the discussion of optimal state size within a federal structure such as India.

Applying these principles to the question of state size, we see that an increase in regional consciousness at the sub-state level would be equivalent to an increase in the cost of managing intra-state diversity and may suggest that the optimal size of states is becoming smaller. As states get more involved in large-scale social protection programs like the NREGA and RSBY, it may be desirable to increase investment in state capacity to deliver services effectively and one way of doing this may be to create new state administrations with more manageable jurisdictions. Smaller states can also experiment more easily with innovations in governance and service delivery, which can be replicated across states if found to be successful.

However, these advantages come with potentially serious costs. While barriers to inter-state trade have come down over the past two decades, inter-state trade is still not completely frictionless and the creation of more states (especially land-locked ones) can have negative effects on economic activity if accompanied by restrictions (even minor) of movement of goods and people across state borders. Problems of law-enforcement (such as Naxal violence) increasingly spill over across state boundaries, and creating additional states will increase the costs of coordinated action across states. Similarly, the creation of more states would further complicate inter-state cooperation on already intractable issues such as sharing of water resources.

Finally, theory and evidence both suggest that underdevelopment of regions is mostly due to historical (local institutions, land tenure systems, etc) and geographical factors (distance to coasts, soil quality, etc.) and less due to systematic neglect (particularly in democratic systems). The creation of additional states in underdeveloped areas may help to better target central transfers, but is unlikely to be a panacea for development as the example of Uttarakhand, Jharkhand, and Chattisgarh have shown. The 73rd and 74th amendments provide enough of a mechanism for ensuring local participation and locally-driven development, and better implementation of the provisions of these amendments would perhaps improve state capacity in backward areas more than the act of creating a new state. Of course, the threat of secession of backward areas into new states may be the trigger needed for further decentralization at the state level, but the constitutional provisions needed for this already exist through the 73rd and 74th amendments.

The framework of costs and benefits of size is useful for thinking about the trade-offs associated with smaller states, but does not address the question of how decisions about statehood demands should be made in practice. While increased sub-state identity consciousness may suggest that there is strong demand for additional states, it is often likely that successful political entrepreneurs can mobilize support for causes (including statehood) for short periods of time that may not persist. However, since the demand may also be truly broad-based and genuine, it is important to establish a process that can incorporate technical, administrative, and political inputs into the final decision.

One possible approach would be to have a constitutional body (such as the Finance Commission) assess the economic merits of individual statehood proposals on a case by case basis and make independent recommendations with respect to each case. The individual proposals could then be voted on in a referendum across voters from the region that would constitute the new state, with a super-majority (of say 60%) required for the statehood proposal to pass. The super-majority requirement would ensure that a permanent decision is not taken on the basis of volatile and potentially fleeting sentiments.

Implementing a version of the proposal above would ensure the availability of technical inputs on the merits of individual statehood claims, followed by a democratic process that would be the basis for the final decision. Establishing such a process would also increase transparency and insulate decision making from short-term political considerations.

Karthik Muralidharan is an assistant professor of economics at the University of California, San Diego and a research affiliate of the NBER, and J-PAL (MIT)