Economic Development in India

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Abstract

This paper examines India's federal system in the context of prospects for India's future economic growth and development. After a brief review of India's recent policy reforms and economic development outcomes, and of the country's federal institutions, the analysis focuses on the major issues with respect to India's federal system in terms of their developmental consequences. We examine the impacts of tax assignments, expenditure authority and the intergovernmental transfer system on the following aspects of India's economy and economic performance: the quality of governance and government expenditure, the efficiency of the tax system, the fiscal health of different tiers of government, and the impacts on growth and on regional inequality. In each case, we discuss recent and possible policy reforms. We make comparisons with China's federal system where this is instructive for analyzing the Indian case. Finally, we provide a discussion of potential reforms of aspects of India's federal institutions.

Introduction

India's recent growth story is now much analyzed, and quite well understood. Despite some temporary controversy over the relative impacts of economic reforms in the 1990s and 2000s – hesitant and piecemeal in the first of those decades, deeper and more systematic in the subsequent period – the new consensus is not very different from the old, namely, that an overall shift in economic policy toward greater reliance on the market for resource allocation, including greater openness to the global economy, has been an important factor in increasing India's average growth rate from its previous low levels. This recognition of the role of market competition does not diminish the Indian government's past importance in building physical infrastructure and human capital, and in providing stability and safety nets. Nevertheless, the reform of India's governance is one of two major strands of current policy debates, the other being areas where further "liberalization" of the economy is needed.

Debates about India's governance include old concerns about corruption, affirmative action (e.g., the continuing controversy over quotas in higher education) and social safety nets (e.g., the National Rural Employment Guarantee Scheme), as well as newer worries about growing regional inequality. Managing the public finances appropriately has been an obvious part of the reform story, since fiscal consolidation has been a problem since the mid nineties. Within the broader context of governance, issues of federalism and decentralization have been addressed in a somewhat piecemeal fashion. Thus, the need for fiscal consolidation has focused considerable attention on the states' situations in this regard, and the central government, central bank, and central Finance Commission have all made efforts to ameliorate aspects of the states' fiscal crisis. At the same time, the decentralization to local governments, put in motion by the 73rd and 74th amendments to the Constitution, has been proceeding unevenly, and with mixed success. States have made various kinds of efforts to attract investment, done various deals with multilateral agencies, and wrestled with potentially major tax reforms, all the while struggling with fulfilling their constitutional responsibilities to constituencies such as the rural poor.

Underlying all the developments in economic policymaking, and concerns about governance, therefore, is the working of India's federal system. It is important to understand what this system is, what it does, and how it has been changing in response to the forces put in motion by India's renewed struggle to fulfill its "tryst with destiny" by substantially improving the well-being of all its citizens in a tangible manner. In particular, many of India's fiscal federal institutions evolved in the context of a planned economy, with the state playing a dominant role and that of the private sector and markets heavily circumscribed, and largely closed to the outside world. Economic liberalization with state control receding and markets coming into their own, and globalization together require a comprehensive reassessment of these institutions (Rao, 2006). This context, therefore, motivates the following analysis of the role of India's 1 federal system in its economic development.1 This analysis also leads toward some specific policy suggestions for institutional reform.

Our discussion of the performance and impact of India's federal system will also bear on general theoretical issues that have surfaced in considering the economic performance of federations. For example, China's economic success has partly been traced to de facto features of its federal system (Montinola, Qian and Weingast, 1995).2 Since China is now a commonly used benchmark for India in economic performance, we will also make some explicit comparisons with China in this paper. The key theoretical construct that we will explore in this comparison is "market-preserving federalism" (MPF; Weingast, 1993). MPF is defined by five conditions: (1) a hierarchy of governments with delineated authorities (the basis of federalism); (2) primary authority over local economies for subnational governments; (3) a common national market enforced by the national government; (4) hard subnational government budget constraints; and (5) institutionalized allocation of political authority.

Quality of Governance and Government Expenditure

In federal systems such as India's, general issues of quality of governance become intertwined with the features and operation of the hierarchy of governments. The MPF perspective is that, given basic good governance, what matters especially is restricting inefficient government interference in the market, and the right kind of federal institutions can be important in achieving this.15 From this viewpoint, certain kinds of decentralization of governance may be complementary to market-oriented reforms that redraw the boundary between government and market. The framers of India's Constitution opted for a relatively centralized, 'quasifederal' system because of concerns about unity, stability, and inequality. At the same time, the adoption of planning and the articulation of ostensibly comprehensive and economy-wide development plans led to centralization of economic decision-making. Implicit in these choices was the assumption that the central leadership (politicians and bureaucrats) would be more skilled and more honest than state and local politicians. Initially, therefore, state governments functioned basically as "corporate divisions" of the central ruling party, with local governments having little or no role to play in political or economic decision-making. The size and cultural homogeneity of India's major states, combined with the constitutional decentralization of key government expenditure responsibilities, created a tension that was finally resolved only in the 1990s, with the emergence of explicit political coalitions at the center as the norm of national governance.

The latest national legislation (the Electricity Act of 2003) may ultimately help in this sector, where coordination of regulation across governments is clearly required, though not all states have followed through with their own reforms. The unbundling of transmission, generation and distribution at the level of the SEBs, which is taking place in some states, will also help to wring out efficiencies through competition and consequent restructuring, though in some initial cases, the privatization has been poorly designed and implemented. Unfortunately, even nearly five years after its enactment, the implementation of the legislation is incomplete (particularly with respect to unbundling) to varying extents across states.

Efficiency of the Tax System

The issue of which level should have the power to tax services illustrates a broader issue addressed by the Eleventh Finance Commission, which made a general recommendation to give the states more power to tax, to reduce the vertical fiscal imbalance. This approach takes some pressure off the fiscal transfer system, allowing states that can obtain internal political support to more flexibly tax their own constituents for delivering benefits to them. Another possible example of such a tax reassignment would be to allow states to piggyback on central income taxes.34 With tax sharing no longer applied to specific tax "handles", but to tax revenues in total, this change would give states more flexibility at the margin, where they properly should have it. While states are already assigned the right to tax agricultural income, as noted earlier, their use of this tax is minimal, and the separation of agricultural income merely promotes tax evasion. Piggybacking, combined with a removal of the distinction between nonagricultural and agricultural income,35 would represent a change in tax assignments that could increase efficiency as well as reduce the states' fiscal problems. While services taxation and VAT represent the two most important aspects of subnational tax reform, the potential reform agenda is much deeper. The World Bank study of state finances suggests attention to the professions tax, state excise duties, stamp duties and transport taxes, as well as to state-level tax administration. Ultimately, while the technical aspects of policy and administrative reform are relatively well understood, the real issue is how institutional reform can be achieved through the political process. Our perspective is that the tax reform process at the subnational level has proceeded through a combination of cooperative and competitive federalism. The central government has played an agenda setting and coordination role in this process, and the states have managed to reach some level of agreement on coordinating tax rates and policies through bargaining by representatives of the executive branch. Strengthening and institutionalizing this process of bargaining could lead to a smoother reform process. The competitive aspects of federalism enter indirectly, through competitive benchmarking, sometimes spurred by individual states that initially go it alone (as in the case of Haryana with the VAT). The center can also play a role in brokering agreement by offering incentives in the form of compensation for lost revenue from a tax reform. Although this might create some short-term moral hazard, if compensation is capped, it will not lead to long run distortions. One idea that has not been explicitly tried is that of Rao (2000), who suggested that packages of tax reforms (e.g., VAT plus service taxes) be implemented, in ways that would compensate a lost source of revenue for states with a new one.

This idea may still be useful in implementing changes to tax assignments that reduce vertical imbalances, tax evasion, and distortionary taxes (e.g., consolidating the power to tax all income with the center, but allowing states to piggyback on central income taxes.) Finally, all of the issues that have been raised in considering center-state tax reform apply to local governments. Their tax bases are inadequate, and property and land tax systems need to be developed and implemented more effectively for decentralization of expenditure authority to the local government level to make some headway. In doing this, the political process that governs reform needs to be given attention, including developing institutions that will allow local governments to share information, benchmark, and coordinate where possible and desirable. Paralleling our suggestions for center-state tax coordination, small piggybacking taxes can also be introduced at the local level at the point of last sale to replace octroi.

Impacts of Federal System on Growth and Equity

For decades, a major debate has proceeded with respect to the proper role of government vis-à-vis the market in determining resource allocation, as well as how this determination interacts with non-material aspects of society. The last two decades have seen a shift toward acknowledging that market institutions are superior for many aspects of resource allocation, including those which impact growth, as well as those which affect static efficiency. While the debate is not settled in the minds of some, as evidenced by various policy discussions and actions in India, the more relevant issues really lie elsewhere. First, there is more room for disagreement with respect to how equity concerns should be handled, since this introduces normative considerations that tend to get tangled up with positive analyses of the impacts of government policies. Even here, though, we have considerable theoretical guidance and consensus on which policies may work best to achieve societal equity objectives, whatever those objectives may be. In comparison to this more settled literature on government-market boundaries, there is less work on, and perhaps less understanding of, the effects of the organization of governmental structures on economic activity and performance. Modern theories of federalism are an important subcategory of theories of the economic impacts of governance, with the concept of MPF being an example of an attempt to unify our understanding in a normative ideal for federalism. In this context, there is a clear link from some aspects of federal structures to their economic consequences, and these are captured in the MPF rubric. In particular, the benefits of an internal common market, just as is the case for international trade, are easily understood in terms of the theory of competitive market exchange. The rationale for decentralization of expenditure authority for local public goods has also been developed, in terms of political competition to satisfy constituents' wants effectively. The assignment of revenue authorities, coupled with a system of intergovernmental transfers, creates some more interesting theoretical issues.

In addition to redesigning the formulaic part of the intergovernmental transfer system to directly improve marginal incentives, one can also argue that reducing the magnitude of transfers can decrease the scope for political influence effects that distort subnational behavior, and also improve subnational political incentives – constituents of subnational jurisdictions can more clearly identify the Wicksellian connection between their costs and benefits in voting on taxation. Since there is no reason for centralizing expenditure decisions more than the status quo, reducing transfers requires further decentralization of tax authority. This can be done through allowing subnational jurisdictions to piggyback on some of the same tax bases that are used for center-state tax sharing, as we have argued in Section 4. For example, allowing states and local governments to impose income tax surcharges would not only improve their marginal retention, but it could reduce the need for tax sharing. This would also allow the focus of Finance Commission transfers to be more clearly on horizontal equalization for the poorest states. In general, the greatest weakness of local government reform as conceived and implemented so far has been the failure of tax assignment to match expenditure assignment. The poor functioning of the State Finance Commissions could be partly addressed by increasing the power to tax of the local authorities. In this latter case, some expenditure authorities also need to be decentralized more fully, since local government autonomy in this dimension remains constrained by state and central decisions with respect to investment projects and social insurance programs.

Conclusions

Most observers of the Indian economy agree that economic liberalization and systemic reforms since 1991 have contributed to sustaining a growth rate averaging more than 6% a year since, and that growth at about the same rate in the 1980s, led by fiscal profligacy and rapid accumulation of domestic and foreign debt, but without significant and systemic reforms, was not sustainable. The balance of payments crisis of 1991 that led to systemic reforms was the inevitable consequence of irresponsible macroeconomic policies of the eighties. The current debate on India's growth prospects center around issues of governance and of deepening, widening and accelerating reforms. The working of India's federal system is central to this debate.

In little Section we offered some reform proposals. First is to create a Fiscal Review Council (FRC), which could be the existing Inter State Council constituting itself as FRC, for joint review of state and central fiscal policies and plans. Second is for two reforms in intergovernmental transfers: one, that the Center assume sole responsibility for what are now called Centrally Sponsored schemes, and the other, to reconstitute the Planning commission into a Fund for Public Investment. These proposals are meant to create a politically credible means of pushing ahead with reforms which each state individually does not find politically feasible to implement and to ensure greater efficiency and equity in the process of allocation of public funds for investment. Lastly, we made some tentative suggestions as how to limit and improve the efficiency of subsidies and to link entitlements and rights of citizens more clearly to the Directive Principles of State Policy in the Constitution.

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