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ANALYZING THE IMPACT OF MAJOR FEDERAL POLICY REFORMS ON SOCIO-ECONOMIC OUTCOMES 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.

KEYWORDS Economic outcomes, development, Indian Economic Reforms, Government

INTRODUCTION

Environmental protection is one of the biggest problems confronted by humanity at present. Ever increase in population and per capita consumption are depleting the natural resources as well as the environment. Moreover, industrialization, urban concentration and modern forms of agricultural methods are polluting the water, soil and air resources all over the world. The natural environment is becoming hazardous and toxic for the endurance of future populations. The rising emissions of greenhouse gases (GHG) are affecting the blue planet and estimations of "United States Development Authority" and "Organization for Economic Cooperation and Development" reveal the rise in earth temperature by 2 centigrade by the end of 2050. It will have more adverse effects on the earth. Global warming is causing melting glaciers and polar ice with two to three times higher as compared with last century while loss of biodiversity is unpredictable and unforeseen. There is a sharp increase in saline soils by 50% up to 2050, resulting in land deterioration in every country.

Environmental challenges are not specific to geo boundaries, and steps taken by a single country alone are not sufficient to protect the global environment. The green and sustainable economy requires a basic transition of social, economic, and energy systems. Environmental and economic policies are important for the green economy along with improvement of prevailing institutions for effective implementation and monitoring of policies. Environmental involvement are essential economic policies eventually employed in a wider institutional setting. To achieve the objectives of environmental policies, the political process directing policy adoption plays a central role in conjunction with the nature of institutions, social and cultural discourse, industrial structure, distribution of resources. While the role of institutional quality and governance is overlooked by the quantitative models.

LITERATURE REVIEW

Eberhard Weber et.al (2012) The paper elaborates on changing economic paradigms in India over the past six decades that finally led to structural adjustment in 1991. The paper investigates how economic reforms failed to resolve social challenges in India. From the mid-1960s, when Congress dominance in independent

India was challenged for the first time economic crisis and political instability have been closely related, at times bringing the country close to a civil war. Today however, India is seen as doing very well, despite increasing unemployment, enormous subsidies and masses of extremely poor people living surrounded by increasingly affluent middle classes. In the past economic crisis and political instability were closely related. Urban based industrialization had often caused resistance that mainly came from rural India at various junctures in India's recent economic history. Removing poverty, and here in particular rural poverty, would allow India's economy to further expand. However if social polarization further widens, if masses of poor remain excluded from economic success, social dissatisfaction will further enhance insecurity and violence intensifying political instability and insecurity of the entire Asian region.

Dr. Mukesh Kumar Mishra et.al (2015) Building on fragile economic growth and regaining public trust requires greater oversight, increased innovation and comprehensive structural reform. More remains to be done to strengthen regulation in order to deal with the risks of contagion and government and other fail institutions. As forecasts of India GDP performance continue to be revised downwards, new policy initiatives and a reduction in global trade restrictions are essential perhaps the most important policy to improve the Indian economic outlook would be an approach to medium-term deficit reduction that would provide a path to sustainable national debt levels.

Gupta and Singh (2011) examined the socio-economic impacts of India’s Goods and Services Tax (GST) reform, focusing on its effects on business compliance and revenue generation. They concluded that while the reform simplified the tax structure, it required robust implementation to achieve equitable socio-economic benefits.

Sharma (2013) analyzed the effects of the Right to Education (RTE) Act on access to quality education in rural India. The study highlighted the policy’s role in improving enrollment rates but also identified challenges such as teacher shortages and infrastructure deficits.

Bose (2014) investigated the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) and its impact on rural employment and poverty alleviation. The study emphasized its contribution to empowering marginalized communities but noted inefficiencies in fund allocation and program monitoring.

Rao and Iyer (2015) explored the impact of the National Food Security Act (NFSA) on food accessibility and nutritional outcomes. Their research revealed that while the policy significantly improved food security for vulnerable populations, logistical challenges limited its effectiveness in certain regions.

BACKGROUND: INDIA’S ECONOMIC PERFORMANCE AND FEDERAL SYSTEM

India has been one of the fastest growing economies in the world since it began to reform its economic policies toward greater openness and greater market orientation Table 1 summarizes India’s overall growth performance since 1951. There is, perhaps, a weak consensus that market-oriented reforms played an important and positive role in supporting India’s good growth performance over the last 25 years. Relatively less well studied have been the parallel developments in governance that have accompanied and interacted with economic policy reform. At the same time, the nature of governance in India itself shapes the kinds of policy reforms that are politically feasible, and the pace at which they occur. Furthermore, a key aspect of India’s governance is its federal system, which is often crucial in determining how economic reforms filter down to affect the daily lives of the population.

TABLE 1: AVERAGE ANNUAL GROWTH RATES FOR INDIA

	GNP at constant prices	NNP at constant prices	NNP per capita at constant prices
First Plan (1951-56)	3.7	4.4	2.6
Second Plan (1956-61)	4.0	3.8	1.7
Third Plan (1961-66)	2.8	2.6	0.4
Three Annual Plans (1966-69)	3.9	3.9	1.6
Fourth Plan (1969-74)	3.4	3.1	0.8
Fifth Plan (1974-79)	5.0	4.9	2.6
Annual Plan (1979-80)	-5.0	-6.0	-8.2
Sixth Plan (1980-85)	5.4	5.4	3.1
Seventh Plan (1985-90)	5.5	5.5	3.3
Two Annual Plans (1990-92)	3.2	3.1	1.0
Eighth Plan (1992-97)	6.6	6.7	4.5
Ninth Plan (1997-2002)	5.5	5.3	3.3
2002-03	4.0	3.6	2.0
2003-04	8.6	8.7	7.1
2004-05	7.3	7.2	5.5
2005-06 (P)	9.6	9.6	7.9
2006-07 (Q)	9.7	9.7	8.1
2007-08 (R)	9.0*	9.4	7.8

India is a constitutional democracy, now comprised of 28 states and seven "Union Territories" (UTs), the latter including the National Capital Territory (NCT) of Delhi. The states, Delhi and the UT of Pondicherry have elected legislatures, with Chief Ministers in the executive role. The other UTs are governed directly by appointees of the center. Each state also has a Governor, nominally appointed by the President, but effectively an agent of the Prime Minister. There are directly elected parliamentary-style governments at the national and state level, as well as nascent directly elected government bodies at various local levels. These subnational elected bodies with explicit constitutional authorities are the essential feature of de jure federalism. Overlapping political authorities at the central and state levels have been dealt with through intra-party bargaining in the initial post-independence years,6 and, more recently, through explicit bargaining and discussion. The Inter-State Council (ISC) was created in 1990, and has become a forum where some political and economic issues of joint concern can be collectively discussed, and possibly resolved. The ISC includes the Prime Minister, state Chief Ministers, and several central cabinet ministers as members. While the ISC is merely advisory, it has formalized collective discussion and approval of important matters impinging on India's federal arrangements, including tax sharing and inter-state water disputes. In other cases, committees composed of state finance ministers have provided a means for reaching collective agreement by the states.

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.

Table 2: Criteria and Relative Weights for Tax Sharing

Criterion	Weight (%) 11th FC	Weight (%) 12th FC
1. Population (1971 Census)	10	25
2. Income (Distance Method)*	62.5	50
3. Area	7.5	10
4. Index of Infrastructure	7.5	0
5. Tax Effort**	5.0	7.5
6. Fiscal Discipline***	7.5	7.5

Beginning with the static issue of horizontal equity, the Indian case is one where the impacts of Finance Commission transfers are definitely equalizing across states. This goal was built into the transfer formula from the first commission, and analysts such as M. Govinda Rao have estimated the equalizing effects for various cross-sections and time periods, as an elasticity of transfers with respect to per capita income. Rao has also shown that including Planning Commission transfers weakens the equalizing effect. This is so despite the inclusion of some equalizing criteria in the Planning Commission's formulas, which were introduced in 1969. In any case, the existence of ministry-based transfers, and even more so of implicit transfers through subsidized and directed loans, debt relief and restructuring, tax exportation, targeted public investment, and administered pricing (particularly the freight equalization scheme) makes it very difficult to estimate the overall degree of horizontal equalization that takes place within India's federal structures.

Focusing on Finance Commission transfers alone, one can note that there has been a slight decrease in horizontal equalization in the Twelfth Finance Commission's recommendations, versus its predecessor (Rao and Jena, 2005; Howes, 2005). This was, of course the result of explicit changes that put less weight on per capita income, thereby reducing the horizontal equalization achieved through the formula. Rao and Jena calculate the exact differences in tax devolution as a result of the TFC's formula change. Howes shows that incorporating grants (which were targeted at the poorer states) reduces this in equalizing effect, but does not remove it. While India's states receive about half of their revenues through explicit transfers from the center (about 30% of the center's own revenues), these transfers represent about 5-6% of average state GSDP. In total, therefore, the states receive transfers that are small relative to their overall economies. Nevertheless, this process of apparent backing off from formal horizontal equalization takes place against a background of increased regional income inequality.

Some of the impact of different components of the formula can be assessed by recalculating shares without one component or another (keeping the relative weights on other components constant). In particular, since the fiscal discipline and tax effort measures are very highly correlated with each other and with population (simple unweighted correlation coefficients greater than 0.98), excluding them has very little impact on the major states (with the exception of West Bengal, which has recently been a consistent poor performer on these criteria). On the other hand, excluding the "area" component has two kinds of effects. Because this variable is proportional to area for larger states, but is truncated at a fairly high value for small states (presumably to capture both fixed costs of administration and higher costs associated with lower population density), excluding it actually helps the poorest state of Bihar. The very small states are the biggest beneficiaries of including this component, but that includes high income states such as Goa and Punjab.

Overall, it is not at all obvious what impact a change in behavior (e.g., tax effort or fiscal discipline) has on a state's share, nor whether the incentive effects are sufficient to induce changes in behavior, though one can perform the former calculation. For example, if Chhattisgarh's tax effort measure had fallen to that of Madhya Pradesh (about 0.9% of GSDP lower, so a substantial decline of close to 15% of tax revenue), the penalty in terms of the reduction in transfers (neglecting second order effects from recalculating relative shares) would have been about 0.9% of the overall formulaic transfers to the state. It is difficult to say whether this would be a deterrent, but the size of the penalty is an order of magnitude smaller than the tax reduction, and it seems unlikely that any state's behavior would be driven by the incentives built into the formula. In the absence of good empirical models of state level fiscal behavior, even after over 50 years of Finance Commissions, we can only speculate.

Understanding the growth impacts of intergovernmental transfers requires some modeling of how subnational governments can affect their tax bases. Careaga and Weingast (2001) use a model in which government decision-makers can either capture rents, or increase their jurisdiction's income, and hence its tax base. From this perspective, the marginal subnational retention rate of all taxes levied on the subnational tax base comes into play. Weingast (personal communication) observes that in the United States in the 19th century, the marginal retention rate of a state was nearly 100%. Qian and Weingast (2005) calculated this figure for China during the high growth phase of reform, 1981-92, and estimated the average marginal retention rate for a province at 89%, with 68% of the provinces having marginal retention rates of 100%. On the other hand, they report a similar calculation by Zhuravskaya for Russian cities, which came up with a retention rate is around 10%. Finally, Careaga and Weingast (2001) calculate this percentage as 23.3% for Mexico in 1995.

For the Indian case, this kind of calculation has not been seriously attempted.56 Note that the idea here is to look at the overall tax revenue of a state, without prior assumptions about assignment. A simple calculation might be as follows. If a state receives one-third of all taxes assigned to the center, and all of the taxes assigned to the state, and the latter and former made up equal shares of the state's revenue, then its marginal share of the extra tax revenue generated by growth would be 50%. This assumes that tax rates could not be adjusted, and that all tax revenues have the same income elasticity. The complication in this calculation would be the impact of the Finance Commission's equalization formula.

FUTURE REFORM AND PROSPECTS

India's constitutional provisions on center-state economic relations were largely based on prevailing circumstances that were seen to demand a strong central government and this led to many unitary features in the constitution of 1950. These circumstances no longer prevail. While the constitution mandated the appointment of a Finance Commission every five years to manage intergovernmental fiscal transfers, an extraconstitutional body, the Planning Commission, was set up in 1950 at the center (with state planning commissions and boards following later), to implement the belief of the ruling Congress Party leadership in central planning (modeled after the Gosplan of the Soviet Union) and a dominant role for the state in economic management. The Planning Commission became a major player in center-state economic relations and has been making transfers to states in support of their five-year plans, as well as overseeing some other transfers by central ministries. The Soviet Union collapsed in 1991, while central planning as a mode of articulating and implementing a development strategy had gone out of fashion even earlier. Thus, the role of central planning needs urgent rethinking in the contemporary Indian context, in which markets are allowed to play a far greater role in the economy.

Besides emphasizing state control over the economy, the Indian development strategy from the 1950s to the mid-1980s was extremely inward-oriented, with acrossthe-board import substitution, implemented though a plethora of controls that drove the investment pattern of the public and private sector. Foreign investment was actively discouraged and foreign borrowing was basically from concessional loans of multilateral development banks and bilateral foreign aid. The economy has moved away from this dysfunctional strategy with much greater openness to external competition and active pursuit of foreign investment (direct and portfolio). This shift was also accompanied by reforms in the financial sector, along with making the rupee convertible for current transactions.

With the economy getting more integrated with the world economy both in trade in goods and services and in finance, domestic fiscal and monetary policies (and also public investment in social and economic infrastructure, to the extent that the public sector continues to be the supplier of infrastructure services), have to be consistent with foreign sector policies, particularly with respect to the exchange rate and capital flows. Evidence from other federations (e.g. Argentina) suggests that the political economy conflicts of federalism in the fiscal arena, themselves rooted in faulty institutional design, can trigger an external payments/exchange rate crisis. As Indian policy makers are considering a road map for making the rupee fully convertible, they have to ensure that fiscal aspects of India's current federal system do not pose such a threat and undertake appropriate actions to reform the system, if necessary, for this purpose.

Some reforms may require rewriting the constitutional provisions regarding center-state fiscal relations. While there have been several successful examples of this process in the 1990s, constitutional amendments do require considerable thought and debate and can take a longer time to accomplish. However, there are several reforms that can be considered for implementation, which do not require constitutional change.

CONCLUSION

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 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. We discussed in Section 1 conventional theories of federalism and their relevance to India's vibrant, resilient but imperfect democracy. In Section 2, we explored the background to India's economic performance, its federal system and alternative perceptions of the contribution policy reforms to the growth experience since the 1980's. The strong unitary features of India's constitution adopted in 1950 and the creation of the Planning Commission, also in 1950, set the framework for economic policy making until the reforms of 1991. The role of the constitutionally mandated Finance Commissions, (twelve have reported thus far) on center-state fiscal relations are elaborated in this section.

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