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Political Alignment and Economic Growth in India

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Abstract

Political economy theories suggest that political alignment between different levels of the government should positively impact economic outcomes. In this paper, we hypothesize that political alignment leads to increased discretionary fiscal transfers from the higher to the lower level of government, which could positively impact economic outcomes. Over the period 1970-2022, we have collected data from over 140 State legislative assembly elections in India to generate our political alignment indicators. Using fixed-effects panel data regressions and a difference-in-differences (DID) approach, our main results suggest that if the State government in a particular State is politically aligned to the Central government, this leads to higher fiscal transfers to the respective State government in India. While part of the total Centre-State fiscal transfers is rule-based, our results show that the discretionary fiscal transfers to the respective State governments specifically increase with political alignment. Further, this effect is enhanced when the government at the Centre is a coalition government, and the government at the State is an important coalition partner for the Central government. We also find that States which exert a higher tax effort in collecting their own tax revenues get higher fiscal transfers from the Centre in general. Our results are robust to a variety of model specifications and controls. Lastly, using a 2SLS model, we further show that the increased discretionary spending on the politically aligned State government has a positive impact on economic outcomes in the Indian States. Thus, increased discretionary spending acts as a mediator for economic growth.

Keywords: Economic Growth, Fiscal Transfers, Indian states, Political Economy, Tax devolution