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Relating rule of law and budgetary allocation for tourism: Does per capita income growth make a difference for Indian states?

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ABSTRACT

This paper contributes to the inadequately explored empirical literature on tourism for Indian States. It investigates how the rule of law influences federal budgetary allocation for tourism at the state level. Theoretically speaking, the impact of rule of law on budget allocation for the states can be positive or negative, if the prevailing rule of law affects tourism prospects. The centre can transfer more funds to boost tourism and income if state is affected by local unrest, or offer less support to push state for maintaining order. Employing dynamic panel estimates we show that such allocation for tourism responds negatively when rule of law worsens in a state. However, the estimated marginal impacts of rule of law on budget allocation show that the decline in budget allocation is smaller for richer states. From a policy perspective, these results suggest that rule of law and budgetary provisions for tourism are complementary.

1. Introduction

A vast set of studies have explored the relationship between economic growth and tourism, both from theoretical and empirical perspectives (Antonakaki et al., 2015; Chou, 2013; Figini and Vici, 2010; Brau et al., 2004; Brau et al., 2007; Hazari and Sgro, 1995; Lanza and Pigliaru (1995), to mention a few). Apart from cross country analysis, many studies have studied the relationship between tourism and economic growth for specific countries (Dritsakis (2004) for Greece; Balaguer and Cantavella-Jorda (2002) for Spain; Oh (2005) for Korea; Gunduz and Hatemi-J (2005) for Turkey; Tosun (1999); Proença and Soukiazis (2005) for Portugal, Jaforullah for New Zealand (2015), Singh et al. (2010) for countries in West Indies, etc.). Indeed, research on the determinants and impact of tourism has attracted a lot of attention in the last two decades. A number of studies has explored factors that cater to tourism demand and determinants of tourism flows. Studies like Song and Li (2008) and Crouch (1994) point out that income, the price of tourist goods and services, the cost of transportation and exchange rates, etc. are significant determinants of demand for tourism. However, from the perspective of policymakers in a given country nothing much can be done about these factors to promote tourism any further, as these factors are determined from a bigger and considerably complex system involving hundreds of countries where each is small in the global service market. Consequently, this reduces the choices in favor of promoting tourism to a handful of instruments. Other studies focussing on the determinants of international tourist flows (for example, Kulendran and Divisekera, 2007; Lee and Kwon, 1995; Crouch, 1996; etc.) have stressed that per capita income at origin, relative prices and relative exchange rates are important factors, because these influence choice of destination.

Building on these strands of literature, we explore factors that affect tourism prospects for a set of Indian states over time. Importantly, we explore if the prevailing rule of law facilitates or inhibits growth of tourism and how the federal (central) government reacts to that via budgetary allocation for tourism related activities in each state. It seems that there is a serious dearth of empirical studies based on state-level tourism data for India, and almost nothing that discusses this particular relation, despite the fact that a large country often shows continuous or sporadic disturbances in different parts, often political, such that tourism is affected negatively. Among the very few aggregative studies for India, Prayag and Das (2017) recently provides an analysis of tourism based on both geographical and historical perspectives, although predominantly with the help of descriptive statistics only. Earlier, Sharpley and Sundaram (2005), Shinde (2010) provided explanations for religious tourism in their paper, but the empirical rigor and theoretical basis, both

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remained fairly weak. However, Mishra et al. (2011) employs time series analysis to show evidence of a long run unidirectional causality from tourism activities to economic growth. Doubtless, the tourism industry in India has become important and viable[1] over the past couple of decades making it an important source of revenue and employment.[2] Thus, from the perspective of policymakers, it is important to understand the growth dynamics of tourism and what can make the tourism industry better to sustain the economic impetus it offers. Political and other disturbances at the state level could affect the whole sector through various spill over effects across regions. In this context, we delve into a very specific research question that relates to budget allocation for tourism for the states in India.

Clearly, all constituent states in the country do not have equal tourist attractiveness, but even if they do, the revenue generating potential at the state level is often constrained by lack of infrastructure as well as paucity of dedicated funds for promotion of tourism. Therefore, the tourism-led outcomes may show significant divergence even if the tourist attractions are uniformly distributed, which is of course unrealistic to assume. In addition, the states may show varying levels of quality of governance and provision of infrastructure that could accentuate such divergence. The specific discussion on this matter is scant and therefore, we aim to contribute to a better understanding of the other factors that might influence tourist-related outcomes.

As briefly mentioned earlier, budgetary allocation for tourism at the state level could be substantially affected by the prevailing rule of law. Since tourism could be used as an instrument to promote economic prosperity for a given state which lags behind in terms of industrial and other prospects, the budgetary outlay may be a driver of such growth, provided the rule of law is conducive to tourism related activities. In order to explore possible relations between rule of law and promotion of tourism, including the budgetary grants flowing from the central government to respective states, we engage with the state level income and the rule of law, the latter defined by a set of important parameters.

How can the rule of law affect the budgetary allocation for tourism? A recent literature duly discusses the institutional implications of the 'rule of law'. The rule of law is usually thought of as a political or legal matter, but admittedly quite specific to contexts and countries. In fact, Dani Rodrik is of the opinion that he might have been the pioneer in using the term rule of law without really knowing what it meant (The Economist, 2008). Nonetheless, the available definitions and indices of rule of law seem to cover a lot of ground in terms of what constitutes an ideal state. These include, positive aspects such as, the public confidence in the police force and judicial system, popular observance of the law, a tradition of law and order, strength and impartiality of the legal system, the extent to which a well-functioning and accountable police force protects citizens and their property from crime and violence; and negative aspects such as the prevalence of petty crime, violent crime, organized crime, riots, political disturbances, etc. (see World Governance Indicators, 2014 for further details). Some studies, in this context, have documented that a worsening rule of law can have a detrimental impact on tourism for countries (Yap and Saha, 2013; Sharpley and Ussi, 2014). We discuss shortly about the modalities of budgetary transfers in India, from centre to states, and recast our contribution along two lines – (i) the role of institutional practices and outcomes with regard to transfers in federations, and (ii) the development targets of budgetary transfers, whether direct and purposive or molded by complex agendas.

This helps us to address the following question: does a rich state face a similar budgetary reallocation vis-à-vis a poor state, in the face of a deteriorating rule of law? Based on our empirical analysis, we find that central budget allocation responds negatively when the rule of law worsens in a respective state. However, by estimating the marginal impact of rule of law on the budget allocation, we find that the decline in budget allocation is smaller (and/or non-significant) for a richer state as compared to a poorer state, despite equivalent decline in the rule of law.

Section 2 offers the analytical motivation and section 3 describes the data. Section 4 discusses the empirical methodology and section 5 discusses the benchmark results. In section 6, we offer the robustness analysis and section 7 concludes.

2. Analytical motivation

We argue that the available estimates even if few, could be related to useful analytical structures for wider tractability. For example, different states within a country may have differing comparative advantages regarding tourist attractions. For example, all states or locations are unlikely to have important sites, monuments, natural beauty, etc. It should lead to unequal revenue generating potential and could be responsible for divergence in income and growth, if revenue from tourism is significant. More crucially, the lack of comparative advantage could be a function of poor infrastructure and paucity of dedicated budget for promotion of tourism despite presence of important sites. In addition, the states may show varying levels of quality of governance and the quality of rule of law that cannot generally be a function of tourism related prospects, unless tourism is the main source of income. Could budgetary allocation affect this steady state in any possible way?

In a federal system of centre-to-state fiscal transfers, as in India, it is possible to address the tourism related disparities between states by reallocating budgetary support under the category of tourism. This is not a conjecture, as fiscal devolution often makes use of such avenues to address growing regional disparities, particularly when direct and discretionary transfers are rule-bound and determined by constitutional arrangements. The Finance Commission of India (currently 14th round, follows Article 280 of the Constitution of India and is convened by the President of India) is empowered to look into the vertical and horizontal distribution of funds from the centre to the states. The fiscal transfers are strongly governed by a formula devised by the Finance Commission of India. This formula dictates how much a state should receive as income transfers from the central government. The sector-wise and category-wise transfers within the total receivable for a fiscal year are, however, decided as per requisitions and negotiations between state departments and central departments within respective ministries and were also vetted by the Planning Commission of India (presently, Niti Aayog), earlier.

It is easy to see that while rule-bound transfers cannot be manipulated, the sector-wise grants can be altered according to two main criteria: the plan expenditures and the non-plan expenditures. The plan expenditures, as a legacy of the planning mode of governance adopted in India since independence (formally beginning in 1951 and following other centrally planned economies, mainly, erstwhile USSR) include revenue and capital expenditures granted to each and every state under sector-specific plans. The allocations are for infrastructure, irrigation, rural development, and tourism, for example. The non-plan expenditures are mainly aimed at running the activities of the government, including judiciary, police and general administration of the state, etc. Even by a simplistic deposition such as this, it is easy to see that re-ordering of priorities for one head could cut short allocations for something else. If a larger amount is expended towards infrastructure suitable for development of tourism in a state, say, the allocation for new equipments for the police department may go down. In this example, the worsening of law and order can affect the equilibrium, and overall welfare outcomes can be ambiguous. We do not know of any attempt that has tried to

[1] According to the 2012-13 budgetary statistics, service trade accounts for 64.8% of the gross domestic product in India registering a growth of 6.5% over the previous financial year. Of the service trade in general, the category of 'trade, hotels and restaurants' contributed 25.1% in 2012-13 registering a rise from 14.6% in 2000-01 (Ministry of Tourism, 2013). Furthermore, by the broader category of tourism (Ministry of Tourism, 2013) the number of foreign tourist arrivals between 2008–09 and 2012-13 has gone up by 25% (5.28 million in 2008-09 to 6.65 million in 2012-13). Subsequently, the foreign exchange earnings from tourist arrivals in India as a whole went up by 49.9% during the same period, from US $ 11832 million to US$ 17737 million.

[2] According to India Tourism Statistics at a Glance 2015, by the Ministry of Tourism, Government of India, the country's share of global tourists is still well below 1%, but has increased from 0.39 in 1999 to 0.68 in 2015.

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