UNIT 16 PUBLIC FINANCE AND FISCAL POLICY

Structure

16.0 OBJECTIVES

This unit is concerned with Public Finance and Fiscal Policy. After going through this unit, you will be able to:

- *explain* the concept of fiscal policy;
- *describe* the working of fiscal policy in India;
- *discuss* the finances of Union Government;
- *examine* the finances of State Governments;
- *analyse* the issues and concerns of India's fiscal policy, and
- *relate* the remedial measures for improving the financial health of the government.

16.1 INTRODUCTION

These days there is hardly any economy in the world which is not regulated by government budget decisions and public policy. The Government imposes taxes and spends on various public works and programmes. The Government also borrows and invests in various economic activities. There are many public sector undertakings producing various types of goods and services. All these activities of the government influence private production, employment, consumption, saving and investment. There are many people who believe that the Central and State Governments in India are overdoing their economic activities. They impose too much taxation. Public undertakings are run inefficiently. The Government is also borrowing too much. On the other hand, there are many who believe that the Government is not doing enough to promote growth and social justice. There is a lot more the Government could and ought to do: for instance, remove poverty and develop backward regions. As we go along this unit, we will review the role played by the Government in the Indian economy and you can yourself form your own views about the success and failure of the Government budget decisions.

16.2 CONCEPT OF FISCAL POLICY

Public Finance is a part of study of Economics. It borders on the fields of government and political science. Public finance is the study of the financial activities of governments and public authorities. It describes and analyses the expenditures of governments and the techniques used by governments to finance these expenditures. Public finance analysis helps us to understand why certain services have come to be supplied by government, and why governments have come to rely on particular types of taxes. There is both a normative and a positive side to public finance.

Fiscal policy aims at using its three major instruments – *taxes, spending and borrowing* – as balancing factors in the development of the economy. According to *Arthor Smithies* fiscal policy is a policy under which government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on the national income, production and employment. Fiscal policy consists of the use of taxes, government spending, and public debt operations to influence the economic activities of the community in desired ways and is concerned with the allocation of resources between the public and private sectors and their use for the attainment of stability and growth. Although the effects of fiscal policy are extensive, they are particularly measurable in areas such as employment, price stability, savings and investment, and the balance of payment. The prime aim of such a policy is to maintain a high level of employment without inflation.

16.2.1 Objectives of Fiscal Policy

Formulation of fiscal policy presumes the identification and clear recognition of the *institutional aspects of government finance, such as tax system, their incidence and shifting, budget formulation and execution and financial management*. The focus of budgeting is on the attainment of efficiency in the allocation of resources within the public sector and is influenced at each stage by the goals of fiscal policy. The changes in government income or expenditure have been designed to affect the level of activity in the economy as a whole. An understanding of the fiscal policy is essential for gaining proper perspectives on the different aspects of budgeting. In the recent years importance of fiscal policy has increased due to economic fluctuations. Fiscal policy is an important instrument in the modern time.

The budgetary fiscal policy can, play a key role in the process of economic development by *(i) mobilising additional resources, (ii) maintaining economic stability, (iii) allocating resources into socially necessary lines of development, (iv) reducing extreme inequality in income and wealth, and (v) providing the necessary incentives to the private sector for its healthy growth.* The fiscal policy thus has not one goal. It has a *multiplicity* of *goals*. Hence, they cannot be achieved by any one set of policies. A disaggregated approach will be needed. There may be conflicts between allocation and stabilisation goals. In the context of economic growth, the fiscal policy has to be so framed as to avoid an inflationary pressure in the economy.

16.2.2 Implications of Fiscal Policy

Fiscal policy is so wide-ranging that selection of a combination of differing objectives is both complex and controversial. Supply-side economists argue that economic activity is quite sensitive to changes in tax rates, particularly the highest marginal rates. In today's global economy, tax policy is not conducted in a vacuum. Taxes can influence the choices of both business and labour. The decisions that the government makes over fiscal policy can have important implications for business. What causes governments to ignore budget deficits in some circumstances and not in others? Business also need to understand what effect a change in fiscal policy is likely to have on aggregate demand. In recent decades, the ratio of government expenditure to GDP has increased in most countries. In many countries its present level can not be financed by ordinary sources of revenue. As a consequence, many governments have been compelled to borrow heavily. If a country borrows too much money, it has to pay a great deal of interest every year in order to service that debt.

The greatest obstacle to proper use of fiscal policy is that changes in fiscal policy are necessarily bundled with other changes that please or displease various constituencies. The same is true for a tax cut for some favoured constituency. The problem of making good fiscal policy in the face of such obstacles is, in the final analysis, ***not economic but political***. There are many practical limitations or drawbacks to the actual working of the fiscal policy. The objective of fiscal policy in modern society cannot be promoted in isolation. It has to be coordinated to monetary, credit and debt policies to be effective. The questions relating to the manner of financing deficit or disposing of surplus in a budget have close relationship with monetary and credit policies.

Monetary and fiscal polices can be best understood in the context of the events that shape them. Such an analysis can assist in choosing policies that improve rather than disrupt short- and long-term economic performance. Of particularly interest are the circumstances and policies surrounding the recent recession.

16.3 SIZE OF GOVERNMENT IN INDIA : COMBINED RECEIPTS AND DISBURSEMENT

The combined expenditure of Central, State and Union Territory Governments has increased more than 1947 times from Rs. 918 crores in 1950-51 to Rs. 17,88,195 crores in 2009-10. Aggregate tax revenue of the Centre, States and Union

Territories has also increased more than 1918 times from Rs. 627 crores in 1950-51 to Rs. 12,02,412 crores in 2009-10. *This, however, not a correct comparison because it does not adjust for inflation*. The combined expenditure of the Central, State and Union Territory Governments as a ratio to GDP has increased from less than 10 per cent in 1950-51 to around 32 per cent in 2009-10. The ratio of combined tax revenue of all governments to GDP has increased from 6.6 per cent to 16 per cent between these years. In India, current expenditures are assuming a larger proportion of government expenditure, mainly driven by consumption expenditures and transfer payments *viz.*, interest payments and subsidies. On the other hand, social sector expenditure comprising mainly, education, medical facilities, public health, family welfare and sanitation showed a steady deterioration, particularly in the 1990s. The deterioration in the allocations under social sector is sharper in the Centre than in States. Another adverse consequence of the deterioration in revenue/GDP ratio has been the discretionary cut back in public investment in productive sectors raising the issue of the *quality of fiscal adjustment* and this may have been an important factor underlying the resurfacing of fiscal pressures over the second half of the decade.

Taking the budgetary position of the central government and states together, one finds that the combined expenditure as a per centage of GDP rose from 26.8 per cent in the 1990s to 27.4 per cent in 2007-2008. The subsequent two years show a sharp rise in expenditures, with the budget estimates for 2009-2010 showing expenditure at almost 32 per cent of GDP. This has been a consequence of a sharp increase in public expenditure in the run up to the general elections of 2009-2010. Total receipts have also shown a similar increase from around 26 per cent to roughly 31 per cent from the 1990's to 2008-2009. Over 60 per cent of receipts are accounted for by revenue receipts (both tax and non-tax). The rest has come from capital receipts of which the two major components have been debt capital receipts (mainly borrowings) and disinvestment.

The share of the central government's capital receipts in GDP was just above 6 per cent until 2000-2001 and thereafter increased until 2003-2004. Since then, it declined reaching 3.6 per cent in 2007-2008. Debt capital receipts have been the major contributor to capital receipts. The contribution from disinvestment has been about 1-2 per cent of capital receipts in the post-reform period. Disinvestment was the highest in 2003-2004.

Check Your Progress 1

1) Explain the concept of fiscal policy

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2) What are the objectives of fiscal policy?

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3) Point out the importance of fiscal policy.

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4) Write three important features of size of government of India in relation to revenue and expenditure.

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16.4 FISCAL POLICY IN INDIA

The objective of economic policy during the *1950s and 1960s* was mainly to *increase the growth rate of the economy* through increasing public investment and overall economic planning. Taxation was used as an instrument for reducing private consumption and for transferring resources to the Government to enable it to undertake large-scale public investment in an effort to spur economic growth. Furthermore, taxation policy was geared towards achieving the economic objectives of: (i) promoting employment through grant of tax incentives to new investment; (ii) reducing inequality through progressive taxes on income and wealth; (iii) reducing pressure on balance of payments through increase of import duties; and (iv) stabilising prices through tax rebate in excise duties on consumption goods. *Fiscal policy during the 1970s* consciously focused on *achieving greater equity and social justice* and both taxation and expenditure policies were employed towards this end. Accordingly, income tax rates were raised to very high levels, with the maximum marginal rate of income tax moving up to 97 per cent and, together with the incidence of wealth tax, it even crossed 100 per cent. Over the years, in addition to the commitment towards a large volume of developmental expenditure, *the Government's expenditure widened to include rising subsidies*. Large interest payments on growing debt and downward rigidity in prices further contributed to increased current expenditure. Current revenues, on the other hand, were less buoyant leading to the emergence of *sizeable revenue deficits* in the Central government budget *from 1979-80 onwards*.

During the 1980s, Indian public finances were in a state of disarray with the fiscal pattern destabilising the relationship between the economy and the budget. This resulted in persistently large deficits which were seemingly intractable. *Considerable fiscal deterioration took place during the 1980s and eventually became unsustainable*, though the growth rate did rise significantly with enhancement in public investment in infrastructure. During this phase, expenditure of the Government was seen as an instrument having a bearing upon aggregate demand, resource allocation and income distribution. The Government sought to reduce its deficit through tax increases. Customs duties were hiked to augment revenue and to protect domestic industry. There was a *structural change in the government budgets during the 1980s*. The emergence of *revenue deficit* in 1979-80 in the Centre's Budget continued to enlarge during the 1980s, raising concerns over the rising public debt and interest payments and the consequent constraint on the availability of resources for meeting developmental needs. The 1980s witnessed a steady increase in market borrowings along with an increase in Reserve Bank's support to such borrowing, thus compromising monetary policy.

Broadly, during the first 30 years of independence, between 1950 and 1980, the fiscal deficits of both the Central and the State Governments were not excessive. There was a significant deterioration in the fiscal situation in the 1980s, accompanied by large and automatic monetisation of government deficits.

16.4.1 Fiscal Policy Reforms since the 1990s: Tax Structure and Policy

Taxation is perhaps the most controversial element of public policy. The Indian tax system, like that of any other country, has developed in response to many influences — political, economic and social. It has not been constructed by an *ideal* economist in line with the optimal requirements for a *good* tax structure. Indian tax structure over the years has been evolved by pressures from two contradictory forces: (a) revenue maximisation; and (b) social and economic reforms through taxation. Revenue maximisation has generally gained ascendancy over reform objectives in actual tax policy. The reform motive, however, has asserted in the recent years, though not always in a positive way. Tax receipts, which contribute the bulk of the central government revenues, fell sharply in the period following the introduction of the reforms in 1992. This was the result of the *rationalisation of the tax structure*. The tax reforms initiated since 1991 were part of the structural reform process after the 1991 economic crisis. *The Tax Reforms Committee (TRC)* concentrated on finding a suitable framework to reform both the direct and indirect tax structure. The committee recommended two major reforms on direct taxes — one was the simplification and rationalisation of the direct tax structure (*The Chelliah Committee,* 1992); the other was to introduce a *service tax to widen the tax base* (*The Chelliah Committee,* 1994).

The 1992 reforms radically altered the composition of tax revenue at the central level. Direct taxes as a per centage of GDP rose from 2.0 per cent in the 1980s to 6.5 per cent in 2008-2009. *Corporation tax* now is the major source of direct tax followed by income tax. Estate tax, wealth tax, gift tax etc. are very tiny amounts. These taxes are levied on richer income and wealth classes to bring equity in the tax structure. Agriculturalists pay only two types of direct tax: land revenue and agricultural income tax. Together, they now account for about 7 per cent of total direct tax revenue. *Direct taxes are, therefore, paid basically by non-agriculturists.* Revenue maximisation through indirect taxes has to be evaluated in relation to inflationary pressures generated by higher indirect taxes. In the recent years, there has been a reform in the indirect tax structure. Until recently, *indirect taxes*, particularly excise duties, were levied on most intermediate goods used as inputs. However, this rise in the proportion of direct taxes was offset by a reduction in central indirect tax revenues as a per centage of GDP from 7.9 per cent to 5.3 per cent over the same period. The government also *introduced a service tax in 1994* in line with the recommendations of the Chelliah Committee. Until then, the service sector had been totally left out of the tax net. Starting with three services, viz., namely telephone, stock broking, and insurance services, the coverage has progressively widened over the years with about 119 services having been brought within the ambit of taxation till 2011. Initially with a levy of taxes on three services of 5 per cent. The tax rate was revised to 10 per cent in 2004-05, 12 per cent in 2006-07, and further reduced to 10.3 per cent in 2009.

Collections from service tax have shown a steady rise from 1994–1995 (0.2 per cent of GDP) to 2008-2009 (1.1 per cent of GDP). However, in 2008-2009, they accounted for only 10.4 per cent of the total tax receipts of the central government. The government now intends to move to a *goods and services tax (GST) regime*, which will replace state-level VAT and CENVAT. This will mark a major step in unifying the tax regime across the country and do away with tax arbitrage that currently disturbs investment decisions. At the state level, fiscal health depends both on revenues from state taxes as well as constitutional and other transfers from the central government. These transfers are accounted for in a state's revenue receipts.

There is no doubt that fundamental changes in the centre's tax structure were introduced in the 1990s. *Systematic and comprehensive efforts to reform the tax system in India started only after market based economic reforms were initiated in 1991*. Centre's *tax reforms included*: (i) Customs duties were scaled back, (ii) individual and corporate income tax rates were significantly reduced, and (iii) a rationalisation of the excise tax structure eliminated the distortionary inclusion of inputs from the tax base, (iv) the number and level of rates reduced, (v) revamping of tax administration, and (vi) computerisation. Tax rates in respect of *personal income tax* were simplified considerably to *just three slabs* of 10, 20 and 30 per cent in 1997-98. The financial assets were excluded from wealth tax and the marginal rate was reduced to one per cent. The corporate income tax has also undergone significant changes.

The *indirect tax structure* has undergone marked changes during the last two decades or so. Both domestic excise duties that were levied on manufactured goods and customs duties on imports have undergone considerable simplification and rationalisation. Besides reduction in the number of rates, the tax has been progressively reduced. These were further merged into a single rate in 2000-01 to be called a *Central VAT (CenVAT)*, along with three special additional excises (8, 16 and 24 per cent) for a few commodities. The CenVAT rate of 16 per cent has now been reduced to 14 per cent. *Custom duties* have undergone far reaching reforms. The reform of custom duties started in 1991-92. The number of major duty rates was reduced from 22 in 1990-91 to 4 in 2003-04. There are some items outside these four rates, but *90 per cent of the custom duties are collected from items under the four rates*.

At the beginning of the economic reforms process in 1991-92, the ratio of direct and indirect taxes in gross tax revenue was 22.6 per cent and 74.8 per cent respectively. As part of the larger economic reforms, the reforms in the tax structure effected through a gradual and sequenced reduction in the rates of duties in both customs and excise together with the increase in the levels of income resulted in a gradual shift in the composition of taxes. As a result in 2004-05 – the year when the FRBM regime was operationalised – the ratios of direct and indirect taxes were 56.1 per cent and 43.3 per cent of gross tax revenue; in 2009-10, the ratios were 58.6 per cent and 39.5 per cent respectively.

16.4.2 Tax Preferences/Tax Expenditure

The main objective of any tax system is to raise revenues to fund Government expenditures. The amount of revenue raised is determined to a large extent by *tax bases and tax rates*. It is also a function of a range of measures – *special tax rates, exemptions, deductions, rebates, deferrals and credits – that affect the level and distribution of tax. These measures are sometimes called tax* *preferences*. They have an impact on Government revenue (i.e. they have a cost) and reflect the policy choices of the Government. Tax preferences may be viewed as subsidy payments to preferred taxpayer such implicit payments are referred to as *tax expenditures* and it is often argued that they should appear as expenditure items in the Budget. In this context, the basic issue is not one of tax policy but one of efficiency and transparency — *programme planning* requires that the policy objectives be addressed explicitly; and *programme budgeting* calls for the inclusion of such outlays under their respective programme headings. Tax expenditures are spending programmes embedded in the tax statute.

The importance of tax incentives in a tax system cannot just be brushed aside. It has to be appreciated and accepted as an established situation that a tax system cannot be totally free from such provisions. What is needed is a balanced well laid-out policy and to ensure that these benefits accrue only to those sections of taxpayers, who deserve and the economy as a whole benefits from these. There should be no *adhocism* in giving these and decisions in this regard should not be influenced by lobbying by some quarters at the cost of teeming millions in the country. Hence, the revenue loss, cannot be avoided what is needed is well-planning to achieve the objectives for which these are designed. Also, a study regarding areas where revenue loss occurs consequent to these should be made to find out whether the objectives sought to be achieved by foregoing tax is realised. The Income-tax Act, *inter alia*, provides for tax incentives to promote savings by individuals; exports; balanced regional development; creation of infrastructure facilities; employment; donations for charity and rural development; scientific research and development; and the co-operative sector. *Accelerated depreciation* is also provided as an incentive for capital investment. Most of these tax benefits can be availed of by both corporate and non-corporate taxpayer.

Revenue loss from exemptions and deductions. The total magnitude of tax revenue forgone due to exemptions/incentives/deductions in the central government tax system has been estimated (by the Finance Ministry itself) to rise from Rs. 4.14 lakh crore in 2008-09 to Rs. 5.02 lakh crore in 2010-11. A liberal estimate of the amount of additional tax revenue which could have been collected by the union government in 2009-10, if all exemptions/incentives/deductions (both in direct and indirect taxes) had been eliminated, stands at a staggering 8.1 per cent of GDP. Not all kinds of tax exemptions/incentives/deductions can be eliminated; however, there could be a strong case for removing those exemptions which are benefiting mainly the privileged sections of population. The income tax foregone for 2009-10 and 2010-11 for corporations was Rs. 72,861 crore and Rs. 88,263 crore; for non-corporate assesses Association of Persons, Body of Individuals (AOPs, Firms and BOIs) Rs. 4,845 crore and Rs. 436 crore; and for individuals Rs. 40,197 crore and Rs. 45,222 crore respectively. For the corporate sector because of such exemptions and deductions, the effective rate of tax was 23.53 per cent as against the statutory rate of 33.99 per cent. For non-corporate assesses (Firms, AOPs and BOIs, the effective rate of tax is 20.78 per cent vis-à-vis statutory rate. For individuals, the effective rate of tax in their cases has not been worked out because of (i) composition of taxpayers in the category of salary and non-salary taxpayers, and (ii) progressive rate of taxes.

16.4.3 Tax-GDP Ratio

Table 16.1 shows the overall tax structure in India. You can see that the tax-GDP ratio has recorded an impressive rise from 6.6 per cent in 1950-51 to 16.0 per cent in 2009-10. The rise is accounted for by the growth of the indirect tax-GDP ratio, which now stands at 10.03 per cent. Direct tax-GDP ratio has increased over the long-run and now stands at 5.97 per cent. *Direct taxes are increasing in importance*. The Indian experience also shows how long it takes for fiscal reform to be effective, and hence the importance of consistent policy over a long period. Although tax-GDP ratio in India is now fairly high, it is still lower than many other developing countries and most industrial countries. India is, therefore, not a very highly taxed nation, although the indirect tax burden on the common man is on the high side. As a part of reform of the taxation system, indirect taxes, excise duties as well as custom duties, were reduced substantially from their earlier high levels and this impacted the magnitude of indirect tax collections. The tax-GDP ratio reflects beneficial impact of the rationalisation of the direct tax structure on the revenues. Growth provides the base for rise in tax-GDP ratio of the country.

The combined ratio of tax to gross domestic product (GDP) of the central and state governments fell to a seven-year low of 14.73 per cent in 2010-11. Experts attributed it to larger expansion in the size of the economy, which is delivering a lower ratio despite a rise in tax proceeds. Total tax revenue increased 17.5 per cent to Rs. 11.6 lakh crore in 2010-11, compared to 7.9 per cent growth a year before. Despite this, the tax to GDP ratio fell, reflecting the combined effect of economic growth and inflation. This signifies that the economy is growing at a healthy rate. While the direct tax to GDP ratio was 5.84 per cent in 2010-11 (budget estimates), a four year low, the indirect tax to GDP ratio was 9.25 per cent. The break-up of the ratio into the Centre's and states' numbers reveal the Union Government tax-GDP ratio, after devolution of tax funds to states, was at an eight-year low of 6.8 per cent. Within this category, the direct tax-GDP ratio was 3.76 per cent and the indirect tax-GDP ratio was 3.02 per cent. These figures are not comparable with earlier years. While the structure of the economy has moved decisively in favour of services which *contribute the highest amount to GDP, but major part of it is unorganised; hence, they do not yield so much tax*. The rise in service tax-to-GDP has not been as sharp. On the other hand, the states' tax-GDP ratio is at a 12-year low of 5.25 per cent. Of this, the direct tax-GDP ratio was just 0.12 per cent during 2010-11. However, states do not have direct tax as their major source of revenue; the major bit comes from indirect taxes. After states switched to a value added tax (VAT) regime from one based on sales tax from April, 2005, the indirect tax-GDP ratio rose to 5.86 per cent during 2005-06. A year after, the ratio again rose to 5.98 per cent. After that, it has been steadily coming down. Their indirect tax-GDP ratio was at a 11-year low of 5.13 per cent. However, if the absolute indirect tax kitty is taken into account, states' revenues rose 87 per cent after they shifted to VAT. This is a staggering figure, compared to just 4.4 per cent annual in the preceding five years (*Business Standard*, August 19, 2011).

India compares very poorly with the tax-GDP ratios of developed nations. For instance, the tax-GDP ratio for the *UK* is 34.3 per cent, for *Germany* 37 per cent and about 24 per cent for the *US*. Despite the plethora of schemes to increase the tax base, tax-to-GDP levels are even below what they were in the pre-reforms period the tax-to-GDP ratio was 15.93 in 1989-90. Most of the decline has been due to the fall in the central tax collections, where the tax-to-GDP ratio has moved down by 2.42 per centage points from 11.9 per cent in 2007-08 to 9.48 per cent in the budget estimates for 2010-11. The fall has been marginal for the states' taxes. While industry accounts for about 28 per cent of GDP, excise duties account for 1.82 per cent of GDP; services comprise 58 per cent of GDP but the service tax-to-GDP ratio is only about one per cent. All of which underscores the urgent need for a *combined goods and services tax (GST)* (*The Financial Express*, August 20, 2011).

Table 16.1: Share of Tax Revenue in GDP (per cent).

	1950-51	1960-61	1970-71	1980-81	1990-91	2000-01	2009-10
1) **Central Taxes**	4.2	6.0	8.0	9.7	10.11	8.80	10.29
a) Direct	1.8	2.0	2.2	2.2	1.94	2.97	5.84
b) Indirect	2.4	4.0	5.8	7.5	8.17	5.83	4.45
2) **State Taxes**	2.3	3.0	3.8	4.9	5.29	5.55	5.71
a) Direct	0.6	0.7	0.3	0.2	0.22	0.16	0.13
b) Indirect	1.7	2.3	3.5	4.7	5.08	5.39	5.58
3) **Total Tax Revenue**	6.6	9.0	11.8	14.6	15.4	14.52	16.0
a) Direct	2.4	2.7	2.5	2.4	2.15	3.41	5.97
b) Indirect	4.2	6.3	9.3	12.2	13.25	11.11	10.03

Source: Government of India – Indian Public Finance Statistics (Various Issues)

16.5 EXPENDITURE PATTERN AND POLICY

Public expenditure is incurred to provide public goods and services. In national accounting, a distinction is made between government final expenditure on consumer and investment goods and services and transfer payments. Public expenditure may also be divided between *plan and non-plan*, *developmental and non-developmental*, *and revenue* and *capital*. One may also divide public expenditure *into civilian and defence* and also between ministries, sectors and so on. All these classifications are necessary to know specific effects of public expenditure on the economy. Finally, one may divide public expenditures by institution: Central Government, State Governments and Local Authorities. Relatively more expenditure of the Central Government may reflect greater centralisation in decision-making of expenditure.

At the central level, average government expenditure stood at 17.6 per cent of GDP in the 1980s. The share fell by 1.6 per cent immediately after the reforms, mainly because of the macro-economic stabilisation programme that followed the 1991 balance of payments (BoP) crisis. However, a sharp rise in salaries and pensions following the acceptance of the *Fifth Pay Commission* report in 1996-1997 pushed the expenditure level back to the 16-17 per cent level the following year. After the Fiscal Responsibility and Budget Management Act, 2003 (FRBM) was passed, central government's total expenditure fell from approximately 16 per cent to 14 per cent of GDP over the next two years. However, this expenditure control was achieved by cutting down capital expenditure sharply while revenue expenditure showed only a marginal decline. Thus, the composition of government expenditure, which has always been a matter of concern, remains unchanged with revenue expenditure accounting for about 80 per cent of total expenditures. Public capital expenditure as a per centage of GDP declined from an average of 6.2 per cent in the 1980s to 3.6 per cent in 2004-2005 and further to 1.8 per cent in 2008-2009. By contrast, revenue expenditure, which was 11.4 per cent of GDP during the 1980s, rose to 12.2 per cent in 2004-2005 and to 15.1 per cent in 2008-2009.

A major weakness of government finances has been the inability to curtail revenue expenditures. Fiscal stabilisation carried out in the 1990s included both extensive tax reform as well as expenditure reforms. The total expenditure of the Central Government has declined from 17.9 per cent of GDP in 1990-95 to 14.7 per cent in 2004-07. Both revenue and capital components of expenditure have declined during this period. Most importantly the share of capital expenditure in total expenditure declined sharply from 25.7 per cent in 1990-98 to 17.0 per cent in 2004-07, though this happened partly because of the cessation of loans from the central government to states, which were classified as capital expenditures. However, the decline in capital expenditure does suggest some moderation in public investment over the period, which has contributed to the lower than desirable growth in infrastructure investment since the mid 1990s.

Table 16.2 : Combined expenditure of the Centre and the States (Revenue and Capital) as a per cent of GDP.

	1990-91	2000-01	2009-10 (BE)
1) Developmental Expenditure (including loans and advances: gross)	14.7	12.0	14.5
2) Non-developmental expenditure (including Loans and advances: gross)	12.5	14.3	14.2
3) Total expenditure* (2+3)	27.2	26.3	28.7
Of which:			
i) Education, family welfare, medical and public health, and water supply and sanitation	4.4	4.3	4.6
ii) Agriculture and allied Services	2.1	1.7	2.2
iii) Defence	2.7	2.4	2.3
4) Total expenditure net of lending	26.8	25.9	28.7

*Excludes self-balancing item and transfer to funds

Non-developmental expenditures are those which do not contribute directly to economic development, like *defence and administrative expenses*. *Interest payments* and certain categories of subsidy are also included in non-developmental expenditures. Both developmental expenditure and non-developmental expenditure have risen faster. It is also noteworthy that defence expenditure increased substantially. Most of the increase in defence expenditure has grown after 1960.

As in the mid-1990s, the reason for the sharp rise in revenue expenditure in 2008-2009 has been the implementation of the recommendations of the *Sixth Pay Commission* Report and measures such as the *debt waiver on farm loans and subsidies*. *Interest payments*, which account for over 30 per cent of revenue expenditure, stood at about 4 per cent of GDP until 2004-2005. However, these came down to 3.6 per cent in 2005-2006 and continued at the same level until 2008-2009. This, however, was not really the result of a reduction in borrowings but rather an effect of softening of interest rates. The other major item of revenue expenditure has been *subsidies*. Budget data do not indicate the actual expenditure on subsidies because several subsidies are hidden in the production of intermediate goods and services and the quantum of subsidy at the stage of final consumption of goods or services is not clearly known. Explicit government budgetary *subsidies like those on food, fertilizers, and petroleum products* are only a small portion of the total subsidy.

Expenditures at the state level exhibit a trend similar to those at the central level. From an average of roughly 15.5 per cent of GDP in the 1980s and 1990s, the total state-level expenditures rose to nearly 18.0 per cent in 2009-2010. An increase in revenue expenditure also accounted for the rise in states' expenditure. Capital expenditure has shown a more fluctuating trend. In the immediate post-reform period, there was a sharp drop in states' capital expenditures. This was an unhealthy development, because by reducing capital expenditure to achieve fiscal balance, they had effectively compromised on building the infrastructure capacity needed to promote growth.

The relative shares of the Centre, on the one hand, and of States and Union Territories, on the other, in total public expenditure, have not varied much in the last three and half decades. *The Centre spends about 55 per cent and States and Union Territories together spend about 45 per cent*. The pattern of expenditures of the Centre and the States vary. The Centre spends all of the defence expenditure. States spend more on agriculture and rural development. The Constitution has allocated items of public expenditure into three categories: (a) exclusive to Centre – defence, external affairs, nuclear energy, etc., (b) exclusive to States, and (c) concurrent, in which both Centre and States can spend.

Check Your Progress 2

1) Point out the four important points of working of fiscal policy in India during pre-economic reform period (before July 1991).

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2) Explain the rationale behind fiscal policy reforms since July 1991.

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3) What do you mean by tax preferences/tax expenditure?

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4) Highlight the main features of tax GDP ratio in India.

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5) Distinguish between Development and Non-development Expenditure. Give three main heads of expenditure in each category.

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16.6 FISCAL IMBALANCE

As a result of the concerted efforts to restore fiscal balance through *tax reforms, expenditure management, institutional reforms and financial sector reforms in the first half of the 1990s*, there was significant reduction in the magnitude of fiscal deficit and the proportion of debt relative to GDP during the period 1991 to 1997. However, during the period 1997 to 2003, (i) there was a reversal in the trend of fiscal consolidation, (ii) the cumulative impact of industrial slowdown, (iii) *fifth pay commission* award, and (iv) a lower than expected revenue buoyancy culminated in fiscal deterioration. This deterioration in the Indian fiscal position happened at an inopportune time when there was fiscal improvement the world over and India was trying to globalise.

The structural transformation in the economy also impacted upon the tax revenue flows. The structural character acquired by revenue imbalances during the 1990s has been a critical factor underlying the rigidity of *fiscal imbalances* and explains as to why *fiscal correction* has not been durable during the 1990s. Thus, the *combined fiscal deficit* at the end of the decade was the same as at the beginning at around *nine per cent* of the GDP. The reduction in the fiscal deficit at the Centre which has also followed a *zig-zag* path has been off-set by a rise in the fiscal deficit of the States. Both plan expenditures and capital expenditures of the central government have fallen to levels of about 4 per cent of GDP or less now. *Interest payments now constitute the largest component of expenditure of the central government*. The key area for action in correcting this fiscal imbalance is related to rising debt servicing obligations of the central government. With the government running a revenue deficit since the early 1980s, *all government and public sector investment has come from resources borrowed by the central government*. In the presence of no returns from such investments, debt service payments are bound to become an increasing burden.

It has not been easy to undertake expenditure reforms. *Much of government expenditure is non-discretionary*. With increasing fiscal deficits, interest payments have formed a significant proportion of government expenditure. The government wage bill and pension obligations are also non-discretionary. Defence expenditures cannot probably be reduced. *Subsidies on food, fertilizer and oil have proved to be difficult to reduce*, despite various attempts at targeting them better. As a proportion of GDP, however, they are now lower than they were in the early 1990s, though there are now renewed pressures for higher subsidies because of the recent increases in the prices of each of these items. Overall, *the correction in total central government expenditure has essentially come from reductions in capital expenditure*.

The most important reform measure was the passing of the fiscal responsibility legislation in 2003. In the years following the enactment of the *Fiscal Responsibility and Budget Management Act*, the fiscal deficit declined from 4.5 per cent of GDP in 2003-04 to 2.6 per cent in 2007-08. In 2009-10, the fiscal deficit was 6.9 per cent (revised estimates). This increase could be partially attributed to the *fiscal stimulus package* of the Government of India. The health of the central government's finance did deteriorate on account of the *stimulus package*. The target fiscal deficit for the years 2011-12 and 2012-13 is 4.8 per cent and 4.1 per cent of GDP, respectively. If the recommendations of the *Thirteenth Finance Commission* are implemented and its suggestions are followed, then one can foresee an improvement in the state of the fiscal deficit. To begin with, the Commission recommended a '*calibrated exit strategy from the expansionary fiscal stance of 2008-09 and 2009-10*'. It has suggested that the revenue deficit of the Centre should be eliminated and the objective should be to have a revenue surplus 2014-15 onwards. In the context of *combined debt of the Centre and states, the Commission has suggested a target of 68 per cent of GDP to be achieved by 2014-15*.

Table 16.3: Deficit indicators of Centre, States and combined finances.

(Per cent of GDP)

Item	1980-85 (Avg.)	1985-90 (Avg.)	1900-95 (Avg.)	1995-00 (Avg.)	2000-04 (Avg.)	2004-07 (Avg.)	2009-10
Centre RD	1.0	2.4	3.0	3.1	4.1	2.3	5.1
Centre GFD	5.9	7.7	6.3	5.5	5.5	3.9	6.3
Centre PD	3.8	4.5	2.2	1.1	0.9	0.1	3.1
States RD	-0.4	0.2	0.7	1.6	2.4	0.5	0.7
States GFD	2.8	3.0	2.8	3.4	4.3	2.9	3.3
States PD	1.9	1.6	1.1	1.4	1.5	0.4	--
Combined RD	4.8	5.2	2.9	2.5	6.5	2.9	5.7
Combined GFD	7.2	8.9	7.8	7.7	9.4	6.8	9.5
Combined PD	0.6	2.7	3.7	4.7	3.1	1.1	--

RD: Revenue Deficit; GFD: Gross Fiscal Deficit; PD: Primary Deficit

Source: Handbook of Statistics on Indian Economy, 2006-07, RBI, Economic Survey, 2010-11.

16.7 FISCAL REFORMS AND FINANCES OF STATE GOVERNMENTS

State governments are responsible for most public expenditures for the provision of social services. Further, they are responsible for most infrastructure services except for telecommunications, civil aviation, railways and major ports. *They are also responsible for law and order*. Thus a deterioration in the state's ability to invest is very serious for human development and hence for internal security, in addition to the harmful effects on economic growth. In the case of state governments, capital expenditure fell during the late 1980s as well. But, just as in the central government, *the main problem lies in increasing debt service payments.* Similarly, other committed expenditures such as pensions have also been rising.

The decline in central transfers and the increase in the average cost of debt have adversely affected the fiscal scene in the states, particularly during the 1990s. Primary expenditure, which is net of interest payments, as a per centage of GDP showed a trend of a decline indicating the shrinking of the fiscal space of the states. If we exclude the other committed expenditures, viz., wages and salaries and pension payments, the residual of expenditure available for both operation and maintenance and much needed fresh investment for the provision of various publicly provided services under social and economic services is on the decline. All the *committed expenditures*, viz, interest, wages and salaries and pension constituted around 65 per cent of the total revenue receipts in 1994-95, which increased to more than 85 per cent in 2002-03. *Although, the aggregate fiscal scene depicts a gloomy picture of state finances in India in general, the severity of the fiscal crisis differs widely across states in terms of the levels and quality of the fiscal deficit, debt-servicing obligations, the level of the debt stock and the fiscal space.*

The four years from 2004-05 were a remarkably good period for the finances of State Governments. All this was, of course, facilitated by high economic growth, which proved to be the proverbial tide that lifted all boats. From 2008-09, there has been *a setback to the fiscal turnaround process*. The Reserve Bank of India's '*State Finances: A Study of Budgets*' shows that the number of States with revenue deficits increased from just four in 2007-08 to six in 2008-09 and 11 in 2009-10. Even for 2010-11, nine States are budgeted to have revenue deficits; the figure may well go up in the revised estimates. State debt has grown faster than output and many states have budgeted for revenue deficits. The picture is worse in States such as *West Bengal*, where interest payments, salaries and pension payments consume over two-thirds of revenue receipts, as against roughly a third in *Tamil Nadu* and *Maharashtra* or less than a fifth in *Chhattisgarh*. Reverting to the path of fiscal consolidation is important not only to create headroom for more purposive, growth-promoting investments, but also to complement the reforms already underway at the State-level.

At the state level, while individual State Governments appointed Committees from time to time to reform their tax structure, there was *no systematic attempt to streamline the reform process even after 1991* when market oriented reforms were introduced. The pace of tax reforms in the States accelerated in the latter half of the 1990s. A uniform *Value Added Tax (VAT)* has now been adopted by all the States in place of the existing sales tax. The Central Government has played the role of a facilitator for successful implementation of VAT. The initial experience with implementation of VAT has been encouraging.

It has been observed that economic liberalisation since the early 1990s has unleashed competition among sub-national governments, and this has brought to the fore the central role of incentives in ensuring sound fiscal practices at all levels of governments. Some of the important changes in sub-national fiscal policy worth highlighting in this context are: (i) the introduction of state level *Fiscal Responsibility and Budget Management (FRBM)* Acts to institutionalise rule-based fiscal control by 14 states; (ii) incentivising the system of transfers to fiscal performance by successive finance commissions, (iii) increasing reliance on state-specific discretionary transfers through memorandum of understanding (MoU) with the central government, (iv) sub-national adjustment lending based fiscal correction in selected states at instances of multilateral institutions, primarily the Asian Development Bank and World Bank, and (v) reforms related to macro-economic policy changes. The primary objective of state level fiscal reform programmes is to achieve fiscal consolidation through revenue enhancement, reducing and restructuring of expenditure, reducing subsidies and power sector loss and thereby overall fiscal restructuring and consolidation. The current system for the financing of investments by state governments in India is clearly unsustainable. *The problem has essentially arisen because of the lack of a link between borrowing and end use of expenditures in capital investment.* There has been a rise in the issue of state government guarantees for their public sector entities enabling them to borrow directly from the market. The budgeted gross fiscal deficit of the states as a per centage of total state gross domestic products is 3.2. That is twice the actual level of 2007-08.

The most important conclusion is that *the rule-based fiscal policy adopted by States improved fiscal discipline*. Therefore, the challenge before State governments is to *revert to fiscal consolidation*. The higher devolutions recommended by the *Thirteenth Finance Commission (FC)* will benefit State finances. Factors likely to have significant implications for fiscal consolidation at the States' level include implementation of *Goods and Services Tax (GST)*, States' own efforts towards mobilising non-tax revenues and prioritisation and rationalisation of expenditure. For credible progress towards fiscal consolidation, States need to amend their FRBM Acts. *The strengthening of State Finance Commissions* is *essential to ensure the allocation of resources to local bodies, keeping in view their developmental role for the purpose of inclusive growth*.

A comparative profile of debt accumulation of individual states shows that those with lower per capita income and a high level of fiscal deficits have a higher debt stock. A higher stock of debt implies a larger interest burden and consequently lower fiscal space available for primary expenditure. *It can be observed that in the post-economic liberalisation era in India, fiscal reforms at centre and the financial sector reforms have adversely affected sub-national finances*. Thus, in the past two decades, the sub-national fiscal space has been shrinking in the face of an increase in the cost of borrowing. Corrective measures are required to widen the fiscal space for developmental fiscal needs. The public debt continues to exhibit signs of unsustainability.

Given the general neglect of state finances, RBI is right to be concerned about the decline in the states' own tax revenues. The central bank is right to suggest that state governments need to: (i) augment their revenues through improved tax collections, (ii) measures to check under-valuation of property to improve collections under stamp duty and registration fees, and (iii) phase out exemptions under sales tax. Non-tax revenue can be a major source of budgetary receipts for the state governments if *proper attention is paid towards pricing of the services*. Its importance is now being realised in the context of bridging fiscal deficits of the states and the heavy financial requirements for upgrading and modernising basic infrastructure. On the non-tax front, the RBI report says, the states' *own non-tax* revenue, at around 10 per cent of the total revenue receipts, is low by international standards. The states have been advised to increase their reliance on non-tax revenues by: (i) levying appropriate user charges such as time-bound revision of water supply tariffs, introduction of user charges in health, education and veterinary services, and (ii) cost recovery from social and economic services.

What is needed is *political will at the state level*. Union Finance can play a leadership role by setting an example in fiscal responsibility that states can follow.

Table 16.4: Combined Fiscal Stance of the Central and State Governments (As a per cent of GDP).

	1980-1989	1990-1999	2000-2001	2009-2010 BE
Total Expenditure	28.8	26.8	28.3	31.9
Revenue Expenditure	20.7	22.3	24.6	27.1
Interest Payments	3.1	5.0	5.9	5.6
Capital Expenditure	8.1	4.5	3.7	4.8
Capital Outlay	-	-	-	4.5
Loans and Advances	-	-	-	0.3
Total Receipts	27.1	26.0	28.5	31.4
Revenue Receipts	18.9	18.1	18.0	21.6
Tax Revenues	15.0	14.6	14.5	17.5
Direct Taxes	2.5	3.2	3.8	7.4
Indirect Taxes	12.5	11.4	10.7	10.1
Non-Tax Revenues	3.9	3.5	3.5	4.2
Capital Receipts	6.2	7.9	10.5	9.8
Debt Capital Receipts	-	-	-	9.6
Non-Debt Capital Receipts	-	-	-	0.17
Disinvestment Proceeds	-	0.2	0.1	00
Revenue Deficit	1.8	4.2	6.6	5.5
Gross Fiscal Deficit	8.0	7.7	9.5	10.2
Gross Primary Deficit	4.9	2.7	3.6	4.6

Notes: BE: Budget Estimates
Source: RBI (various issues)

16.8 PUBLIC DEBT IN INDIA

The gap between government total expenditure and current revenue is financed almost wholly through various types of borrowings which add to the public debt. Public debt is outstanding Government borrowing at a point of time, usually calculated at the end of the financial year. Public debt is the stock corresponding to the flow of Government borrowing. Borrowings can be made from both *internal and external sources*. As Government borrowing increases, public debt rises. So long as the debt financing is kept within a limit there is no problem. Debt financing, however, beyond a limit, causes several problems. As the volume of debt rises, the burden of interest payment and repayment of debt increases, and a stage may come when the Government is unable to service the debt i.e., interest payments become a big burden. There are other problems of debt financing.

Between 1950-51 and 1990-91 the gross debt of the central (internal, external and other liabilities) has risen from Rs. 29 billion to Rs. 3114 billion, i.e. by 106 times. As a per centage of GNP, the increase has been from 32 per cent to 68 per cent. This growth is phenomenal.

The public debt as a ratio to GDP has risen phenomenally over time, and in particular in the eighties. There is no doubt that public debt is now matter of serious concern. The high level of fiscal deficits both at the Centre and the States led to debt accumulation over the period resulting in a rise in the debt to GDP ratio. The combined debt-GDP ratio of Centre and States was about 81.0 per cent during 2004-06. Following the impact of fiscal responsibility legislations at both the centre and the states, the combined debt-GDP ratio has come down to 73.8 per cent in 2007-08. Of the overall Central Government debt, about 92 per cent is internal debt and 8 per cent is external debt. Internal debt largely consists of market loans in the form of dated securities which are contracted through auction. Most of the dated securities (97 per cent) are fixed coupon and only the balance 3 per cent are floating rate bonds. The weighted average maturity of these dated securities is about 10 years while the weighted average interest rate is about 7.8 per cent per annum. The outstanding debt of State Governments is estimated at 26.3 per cent of the GDP for 2009-10. THFC has recommended limiting the combined debt of the Centre and States to 68 per cent of the GDP by 2014-15.

If debt is used for financing investment projects, then that would generate more income in future and the country would benefit. If debt is instead incurred for unproductive expenditure, say paying higher salary to defence and police and general administration personnel, then it does not generate any income and, consequently, creates a repayment problem. Until recently, the Government was using debt exclusively to finance capital expenditure. But in the recent years the Government has started using debt to finance its current expenditure. This is a clear violation of norms of prudent fiscal policy.

16.8.1 India's External Debt

External debt consists of bilateral loans or loans from international monetary agencies. *The growth of external debt is a far more serious matter than internal debt. External debt directly affects a country's balance of payments position, trade flows and currency valuation*. Since the very significant fiscal imbalance in the 1980s had also contributed to the 1991 balance of payments crisis. The fiscal crisis of 1990-91 was caused by the phenomenal increase in the external sector deficit. In fact external debt is all the more difficult since the principal amount and interest repayments keep accelerating with increasing debt as also due to currency devaluation. This in fact forms a vicious circle and the country falls into a debt trap which threatens its sovereignty in the long.

The major developments relating to India's external debt as at end-March 2011 are that India's short-term debt to total external debt ratio rose to 21.2 per cent in 2010-11, the highest in at least five years. The status report on external debt for 2010-11 showed that the short-term debt to foreign exchange reserves increased to 21.3 per cent. The rise in short-term debt is considered riskier as it needs to be repaid from foreign currency reserves in a shorter duration of time. However, the external debt to gross domestic product (GDP) ratio fell to 17.3 per cent in 2010-11. *The composition of external debt is worrying*. The increase in short-term debt to total external debt is not a welcome development because short-term external debt is considered riskier than long-term external debt. *However, India's* *external debt is not yet in the danger zone*. At the end of March 2011, India's short-term debt was $65 billion and India's total external debt stood at $305.9 billion. The share of commercial borrowing in total external debt has increased from 19.7 per cent at the end of March 2005 to 28.9 per cent at end-March 2011. The changing composition of debt in favour of commercial borrowing, however, is also an indication of a maturing market economy and the increasing role that the corporate sector is playing in sustaining the high growth rate.

India's debt indicators compare well with other indebted developing countries. According to the World Bank's latest Global Development Finance report, which contains external debt numbers for 2009, India's position was fifth, after China, Russia, Brazil and Turkey, in terms of absolute debt stock among the top 20 developing debtor countries. In terms of ratio of external debt to gross national income, India's position was the fifth lowest. Although external debt as a ratio to GDP is not very high, one must not underestimate it, because India's foreign exchange reserves and export earning capacity are also very low. The repayment of this moderate amount of external debt may also, therefore, be a problem in future. *One does not have to panic over the growth of debt as such. What matters ultimately is the use of debt.*

16.9 ISSUES AND CHALLENGES IN FISCAL POLICY FORMULATION

The fiscal situation in India is worrisome. The self imposed rule based *fiscal correction* at both the national and sub national levels has to be consolidated and carried forward. Achievement of the current objectives will still leave the combined fiscal deficit in India at around 10 per cent of GDP, and somewhat higher if the off budget items are also taken into account. The main challenges are:

i) In the fiscal policy area, the success achieved in revenue buoyancy through tax rationalisation and compliance has to be strengthened further. Large proportions of the self employed remain outside the tax net; thus continued *strengthening and modernisation of tax administration* now needs to be emphasised, relative to further reforms in tax policy in terms of relative emphasis. This would enable *further shifts in tax revenue toward direct taxes from indirect taxes*, thereby aiding greater economic efficiency. At the state level also, the move to *VAT* has provided *very significant tax rationalisation*, and emphasis now needs to be put on its administration. In this sphere, the next step of reform would, of course, be the proposed move towards a unified *Goods and Service Tax (GST)* regime encompassing the Centre and the States. The foundations of an efficient fiscal regime in India have, therefore, been achieved.

ii) *Rakesh Mohan* has observed that the *expenditure side*, containing the *subsidy* burden has proved difficult, although its increase as a proportion of GDP has been contained. The second issue on the expenditure side relates to the funding of public investment particularly related to *infrastructure*. The acceleration of economic growth to the next level is therefore likely to lead to an enhancement of government spending as a proportion of GDP, which would be consistent with the experience of other countries as their per capita incomes increased. This then is the main *challenge confronting Indian fiscal policy: how to provide for an enhancement in public expenditure while continuing fiscal consolidation and reducing fiscal deficits further*.

iii) It is clear from experience that the mere passing of the legislation will not bring about fiscal discipline. *First of all*, it is necessary for the government, *not just the Ministry of Finance, to take responsibility for fiscal discipline for stable macro-economic management and political motivation; no legislation can ensure this*. *Secondly*, it is necessary to evolve an institutional mechanism not only to monitor but also to ensure the *participation of all spending departments in implementation*. The experience with the implementation of the *Fiscal Responsibility and Budget Management Act (FRBMA)* has raised some important questions on its efficacy. *Without the government's willingness, institutions cannot ensure fiscal discipline*.

iv) Professor *TCA Anant*, has suggested that the expenditure cuts must come in those sectors/areas that do not constitute productive spending by the government. This is often harder than cutting expenditure in productive areas, i.e., public investment. This is because much of the *non-productive spending fulfills certain populist aims of the government*. A big deficit puts upward pressure not just on inflation but also on interest rates. That is a double whammy for growth, something the government must avoid. Even after taking out *interest payments and subsidies*, there would still remain a large lump of inflexible expenditure comprising salaries, pensions, and staff overheads. These might be declining as a proportion of GDP but that does not tell the whole story. In several states, in departments such as health and education which are staff-intensive, as much as 95 per cent is spent on the wage bill, leaving precious little for other things.

v) *The central government has resorted to a fiscal system of high fiscal deficits on a consistent basis over the last 30 years*. Non-productive committed current expenditures rise giving rise to higher and higher revenue deficits. This leads to yet higher and higher borrowing levels. The main sufferer in this process is government *capital expenditure* in both *social and infrastructure facilities*. The continued high levels of public borrowings also have an effect on the rest of the economy through prevalence of high interest rates. *The key objective of fiscal reform has to be a reduction in debt service payments*. This has to be achieved by a progressive reduction in public debt and through higher revenues. The emerging debt position is not a sustainable one. The policy implication is that India should strive to reduce primary deficit or achieve a primary surplus, raise the growth rate, and reduce the interest rate.

vi) The *Expenditure Commission* has delineated *selected subsidies* that should be scaled back. An increase in user charges in agriculture, irrigation, industries, power and transport would substantially mitigate pressures on the fiscal deficit. In other words, the governments of the centre and the states combined are borrowing resources amounting to a 10^{th} of national income every year: about a *half of these resources are being borrowed to defray current expenditures on items such as wages and salaries*. The current trend is such that before long almost all borrowing will essentially finance current expenditure leaving almost nothing for investment. A mere reduction in tax rate may not persuade people to pay tax unless there is fear that, tax evasion would be heavily penalised. *Higher tax revenues can be achieved only through buoyancy and expansion of the tax base*.

vii) It is also clear that the *problem is largely structural*. Much of the problem has arisen from the failure to correct the *structural problems of proliferating* *subsidies and transfers*. Despite fundamental changes in the overall rate structure, by and large the tax base has not been enlarged. *The tax base has not expanded in structural terms*. Even smaller taxes such as the *capital gains tax, wealth tax, gift tax, and inheritance tax at the central level, or the property tax, motor vehicles tax, professions tax and the like at the state level, were typically replete with exemptions reflecting the perception of the tax instrument as useful for attaining various social and economic goals*. Not only was the number of taxes affected by exemptions very large, but the conditions under which the exemptions were applicable were very complex. This problem with the overall tax structure continues at present. Though the rate structure was improved, the *leakages in the tax base have not been plugged*. There are significant areas in which tax administration needs to be strengthened. In the area of Direct Taxes, administration should be restructured in favour of functional departmental classifications. In Customs and Excises, computerisation has helped administration.

viii) We cannot forget the fact that out of the 120 crore population, only 3.36 crore pay taxes in India. One should not forget that even this number has been achieved only by lowering the tax rates, resulting in better compliance for the last several years. *The number of tax evaders, and the money invested in tax havens, increases because of the high tax rates only*. What we have to do now is to reduce tax rates and increase the tax base, enforce compliance and insist on penalties for evaders. We cannot compare India with France, Germany or the US, where the majority pay taxes and there is also a well-set social security system. *The need of the hour is to include more in the tax net, by reducing the tax rates and enforcing compliance*. This will definitely pay off by higher collection as well. However, we can think of a super tax for incomes above a substantially-higher threshold.

India is currently facing a *mix of complex fiscal problems*, pertaining not only to the central government but also at the level of state governments. These manifest themselves in: *(a) an apparent inability of the central government to rein in its fiscal deficit, (b) a rise in state governments' fiscal deficits resulting in a consolidated general government (centre and states combined) fiscal deficit of almost 10 per cent of GDP, and (c) their unwelcome implications for the medium term sustainability of public debt*. The key challenge involves balancing between public interventions and maintaining market confidence in the sustainability of public finances. This will involve focusing policy attention on *removing some of the structural bottlenecks* on raising the potential GDP growth rate. Essentially, this will imply efforts to improve the investment climate for both domestic and foreign investors, remove entry barriers to corporate investment in education and vocational training, improve the delivery of public goods and services, and expand physical infrastructure capacities, including a major effort to improve connectivity in the rural regions. Infrastructure is a key binding constraint on India's growth and the government should take up long-term projects to improve infrastructure facilities. The government also needs to step-up investment in *human capital development through increased spending in areas such as primary education, primary health, and research and development. Investment in human capital will help achieve inclusive growth, and furthermore such expenditures should be considered as part of capital expenditure rather than as revenue expenditure (which is how they are categorized now) since they yield a return in the long-term by way of inter-generational equity and economic growth*. These measures will constitute the package of second-generation structural reforms and will enable the Indian economy to climb out of the downward cyclical phase.

16.10 INDIA'S FISCAL POLICY (1950-2012): AN OVERVIEW

In this section, an attempt is made to analyse and examine how far the multiple objectives of Indian fiscal policy have been realised. Fiscal strategy or policy refers to the budgetary policy of the government in power. It includes tax policy, expenditure policy, public debt policy and any other policy which is implemented through the budget. In the wider sense of the term, it also includes related policies such as monetary policy in so far as it is interlinked with the public debt management policy of the government. After independence and with the advent of planning, fiscal policy was accepted as an important tool in the armoury of government to direct the allocation of national resources in the desired direction. In a developing economy like India, fiscal policy came to be used as a principal instrument of resource mobilisation and allocation. Besides, the objectives of fiscal policy came to be identified as promoting economic development, maintaining economic stability and achieving social justice. Achieving economic development implied certain specific policy measures. It encompassed diversion of increased income in the private sector (from going to private consumption) to savings in the public sector, an increase in public sector saving by the expansion of public sector activities and generating surpluses by public enterprises. Accumulation of capital by the government through the generation of public savings was a major objective of state capitalism conceived in Indian Planning. Fiscal Policy was used to achieve this objective. Economic stability in the Indian context implied mostly controlling inflation. Employment and output stability were taken for granted. Economic stability was supposed to be maintained by levying taxes, particularly indirect taxes, so as to reduce the real consumption or real demand. Thus, on the one hand, there was an attempt to divert increased income from consumption through direct taxes as well as high rates of indirect taxes, and at the same time public expenditure was proposed to be allocated in such a way as to create not only infrastructural facilities required for private and public sector production activity but also for creating productive capacity for goods required in the economy.

Social justice or equity was attempted to be achieved through progressive taxes like wealth tax, gift tax, capital gains tax, income tax, estate duty and so on. However there was not much transfer of payments to the poor in the form of negative income tax or in the form of unemployment and old age benefits. All that the government did was to formulate anti-poverty programmes which were introduced only during the Fourth Five Year Plan period. After realising the failure of the '*trickle down*' process several target group-oriented programmes were initiated which provided financial assistance, both subsidy and loan, to the small and marginal farmers, unemployed youth artisans, agricultural labourers, and to petty shop-keepers, to make them economically viable.

The initial years of India's planned development strategy were characterised by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector-driven industrialisation process and also cover social welfare schemes. However, growth was anaemic and the system was prone to inefficiencies. Indirect taxes were a larger source of revenue than direct taxes. The government authorised a comprehensive review of the tax system. *Kaldor* found the system inefficient and inequitable, given the narrow tax base and inadequate reporting of property income and taxation. *The Direct Taxes Enquiry Committee of 1991* found that the high tax rates encouraged tax evasion. In the 1980s, some attempts were made to reform particular sectors and make some changes in the tax system. But public debt increased, as did the fiscal deficit. Triggered by higher oil prices and political uncertainties, the balance of payments crisis of 1991 led to economic liberalisation.

The reform of the tax system commenced with direct taxes increasing their share in comparison to indirect taxes. In consonance with the tax reform plans, the sources of central government revenue shifted from indirect taxes towards direct taxes. The rising revenues from tax administration reforms and expenditure control resulted in the deficits being brought under control. The Planning Commission in the approach paper to the 12th Five Year Plan (2012-17), while projecting the Centre's fiscal resources, envisages an average fiscal deficit of 3.25 per cent of GDP for the entire plan period. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

The first-generation reforms consisted of rationalisation of the direct and indirect taxes levied by the Centre, broadening of their bases, and lowering of the statutory rates. It is very difficult to identify the level of tax rates which make tax payers honest without reducing the flow of tax revenue to the government. The second-generation reforms were the replacement of state sales taxes by the value-added tax (VAT). While these reforms resulted in improvement in tax compliance and provided a significant boost to tax revenues, they were limited to legislative changes and the rich dividends that could be reaped by having a modern, IT-savvy and taxpayer-friendly tax administration remain unrealised. A facilitative tax administration is dependent on simplicity of the tax laws, infrastructure for tax administration, harmonisation and integration of laws and procedures across the country.

India's tax-to-GDP ratio is 15 per cent (of which the Centre's share is 10 per cent). Before the financial crisis of 2008, it was 17.7 per cent (of which 12 per cent was central taxes). The problem in India is not with rates; it is with coverage. Hence the familiar criticisms — only 35 million pay income tax, a service economy which accounts for more than half of GDP delivers less than one per cent of GDP as tax, and so on. Perhaps reduced evasion comes with the better systems associated with a higher order of development. More people come into the organised sector, and evasion becomes more difficult because transactions leave a trace. That automatically raises the tax-GDP ratio, without tax rates having to go up. The other way is to use information networks to detect evasion. For instance, nearly half of the income tax collection comes from just two per cent of taxpayers (715,000 people who report a taxable income of Rs. 8 lakh or more). Yet, household surveys show that the number in that income bracket should be twice as large. If they could be traced, imagine what it would do to tax revenue.

The Fiscal Responsibility and Budget Management Act has not helped much in preventing the monetisation of fiscal deficit. Much of our fiscal deficit is made up of the revenue deficit, a perverse stimulus to consumption in an economy that needs investment. In its present form, the arithmetic and the analytics of the Union budget revolve around five deficit numbers: *fiscal, revenue, primary, monetised, and current account deficits*. All of them came to the fore ever since the budget was transformed into a fiscal policy document after fiscal stabilisation in 1991. The flaw is not just economic. It reflects a fundamental problem in the political strategy of the Government. Usually multiple objectives of public policy are contradictory, and the policy would serve one at the cost of others. Given the current global context and the domestic macro-economic situation, the budget needs to be reinvented as a public expenditure policy document. The emphasis should be on how the government intends to strengthen the legitimacy and effectiveness of policy-making in areas that are causing a systemic crisis. These done, the fiscal deficit along with its associates will take off itself on a sustainable basis.

Tax expenditure or revenue foregone on account of various tax concessions was an astounding Rs.4,82,432 crore, or more than the entire fiscal deficit for 2009-10 . Back in 1974, the late *Dr Amaresh Bagchi* had argued eloquently against tax sops. The same sentiment finds place in a research paper by the National Institute of Public Finance and Policy (NIPFP) which makes a strong case against riddling the tax regime with exemptions. The fewer the tax incentives, the less is the discretionary space available to tax administrators and less is the scope for corruption. If the objective is to have a transparent, efficient and feasible tax administration, then the tax structure should have low rates, a broad base, few exemptions and few incentives. Rather than allowing more concessions – whether by way of exemptions or rebates – what we need to do is rationalise the system of taxation so that the incidence of tax on income is same regardless of the source. Unfortunately, even as most economists decry tax exemptions and concessions in pursuit of a variety of objectives through tax policy, it is a fact that special interest groups in every country secure them under the guise of one social objective or another. *In India, the tax policy has been made to pursue a variety of objectives such as promoting savings, encouraging exports, enabling balanced regional development, creating infrastructure, promoting scientific research, encouraging employment, enabling gender equity, protect the elderly, promote small cars versus large and so on and so forth besides raising revenue and promoting equity*. Surely, these objectives are worthy, but they should be pursued through other policy instruments rather than loading the tax policy with them. Pursuit of multiple objectives through the tax policy complicates the tax system and provides enough scope for evasion and avoidance.

The most important initiative to change the sentiment is to *undertake fiscal consolidation measures*. In pursuance of objectives, both the Central and State Governments provided subsidy. Therefore, systematic reforms in tax system and expenditures, particularly in the subsidy regime, are unavoidable. The subsidy bill has been a major contributor to the slippage. Clearly, *tax expenditures in India are large and it is necessary to phase them out in the interest of revenue, efficiency and horizontal equity*.

The reforms for achieving simplicity in tax laws and their harmonisation are an ongoing process and the *goods and services tax (GST) is aimed at addressing this objective*. The GST, if based on the flawless design recommended by the 13th Finance Commission, could well be the 4G reform. Pending its implementation, governments should focus on archaic, inefficient and ineffective tax administration. Critical ingredients of a modern tax administration are automation and standardisation, quality taxpayers' services, avoidance of tax disputes and their quick resolution. The most pivotal reform among these is a more effective use of information technology. While India has made considerable progress in terms of computerisation, it is still very basic. The significant role that IT can play in comprehensive automation and integration of processes, minimising discretion by officials, data capturing and analysis for guiding policy decisions and for enhancing taxpayer services, has not been tapped in full measure. A stable and efficient tax administrative environment would also spur foreign investments, crucial for India's economic growth.

An important issue in calibrating tax reforms in a federal system is the need to coordinate the reforms at the national and sub-national levels. Tax harmonisation, both vertically among different levels of government and horizontally among governmental units within each of the sub-national levels, is important from the viewpoint of minimising the collection cost, compliance cost and distortion cost. However, the very principle of fiscal federalism entails the choice to the States to vary their public service levels and tax rates. The State tax system is beset with a number of shortcomings. The States have found it politically difficult to levy taxation of agricultural incomes, except in the case of a few plantation crops, and this has opened up avenues for evasion and avoidance of taxes on incomes. Every effort should be made to minimise rate differentiation from the viewpoint of reducing distortions in the economy. *But these are political decisions and compromises are unavoidable*.

The fiscal situation in the country surely is a cause for serious concern. Difficult situations warrant drastic remedial measures. Hopefully, the government will evolve a workable strategy and muster sufficient political will to implement harsh measures well before the policy paralysis comes into play due to electoral reasons. The fiscal arithmetic has gone terribly wrong. Of course, there is always scope for clever financial engineering to camouflage the size of the fiscal deficit. As such, *there are concerns about the quality of fiscal adjustment*. The problems of the Indian fiscal deficit are not of recent origin. Way back in the 1980s, Reports of Finance Commissions as well as those by the Comptroller and Auditor General (CAG) had emphasised the need for reining in government borrowing. It is argued that the government should have unfettered freedom to meet manifold exigencies such as increased food, fertilizer and petroleum subsidies.

Using fiscal strategy for promoting economic development with social justice and for maintaining economic stability, the Indian experience has not been a total success. No doubt, in the field of mobilising government savings, this strategy has achieved partial success. It has however failed, to a large extent, in the field of achieving economic equity and maintaining price stability. What is missing in the Indian fiscal strategy is a rational approach to the use of public expenditure and transfer payment for the promotion of the objectives of fiscal policy. The proliferation of subsidies has further widened the economic inequalities by benefiting relatively better-off sections of society, without promoting price stability. These are the lessons which have emerged from our past experience. Let us hope that our planners and fiscal policy makers will learn from past experience.

The monetary and social benefits from Government spending should be assessed at periodical intervals and accountability for any shortfalls in the achievements needs to be fixed. There should be adequate checks and balances to ensure that there exists a proper relationship between investment, production, exports, imports and revenue collections and there is no undue misrepresentation of facts by any agency involved. Usage of subsidies is one area requiring close surveillance and for this the Central Government should have special arrangement, even at a cost, to ensure that subsidy has the desired impact. Information technology should be put to optimum use to strengthen the database and initiate follow-up action. The Budget should aim at capturing all forms of economic activities, particularly under the unorganised sector, and bring them under the information system formally.

Fiscal responsibility is a bit like going to the temple: you want to be there, but there are so many immediate priorities that need attending to. The MGNREGA, Sarva Shikshya Abhiyan; Right to Education and the biggest impact is, of course, expected from the *Food Security Bill*. Ways and means advances (WMA) which is meant to be used for temporary mismatch in the receipts and expenditure of the government, has been used as a resource. This leads to monetisation of the fiscal deficit.

It could be concluded that fiscal dominance of monetary policy has resurfaced in the Indian context. There is an urgent need to free monetary policy from fiscal dominance to ensure price stability, financial stability and sovereign debt sustainability. *How does one get rid of the fiscal dominance of monetary policy*? It is certainly a difficult task as democracy has a built-in fiscal deficit bias. There is an inflexion point beyond which fiscal deficits militate against growth. Government borrowing is not bad *per se*, but excessive borrowing is. Thus, the following policy options could be considered. *First*, cap the total public debt as a proportion of GDP, including a cap on net market borrowing of the government. *Second*, revisit the public account borrowing, particularly, small savings. *Third*, the revised FRBM Act may include the quality of public expenditure. *Fourth*, the RBI and central government may consider appointing a working group under the institutional framework of Cash and Debt Management Committee to review the entire WMA System.

Check Your Progress 3

1) What do you mean by fiscal imbalance?

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2) Write a note on state of finances of state governments.

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3) Give three reasons for increasing burden of public debt in India.

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4) Point out major developments relating to India's external debt.

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16.11 LET US SUM UP

The fiscal sector consists of the income, expenditure and deficits of the government. As far as the income, expenditure and deficits in the revenue accounts are concerned, there have been very significant changes over the years 1970 to 2000. Both the revenue income and expenditure (as a per centage to GDP) exhibited increasing trends till the mid-1980s, after which they kept falling for the next ten years or so, and have again shown an upward trend after the mid-1990s. Another notable aspect is that till the mid-1980s, the revenue income and expenditure approximately moved together and this resulted in very low (and sometimes negative) values of the revenue deficit. After the mid-1980s, however, the expenditure has been significantly higher than the income leading to high and increasing revenue deficits during this period. The total expenditure (as a per centage of GDP) rises till the mid-1980s, fall for the next decade, and rises again after the mid-1990s. However, the fall after the 1980s is much sharper than that for the revenue expenditure, clearly implying a sharp fall in the capital expenditure during this period. As a result of the sharp decline in capital expenditure, the fiscal deficit shows a downward trend during this period. However, this trend is reversed in the latter half of the 1990s, as total expenditure rises steeply during this period.

A look at the trends and patterns over the last three decades (1980-2010), which span both the pre- and post-reform period, helps us understand the relationship between fiscal expansion and growth in the Indian economy. Along with high external borrowings, a sustained increase in the combined revenue expenditure to stimulate demand, particularly in the services sector, caused the fiscal deficit to rise during the 1980s. As a result, the combined public debt became 56 per cent of GDP on average, with interest payments at 14.6 per cent of revenue expenditure (3 per cent of GDP on average) accounting for a large portion of government revenue expenditure and creating a debt trap in the 1980s. During the first half of the 1980s, these revenue expenditures averaged 18.5 per cent of GDP. In the second half, they rose to an average of 22.4 per cent. The government introduced the *Fiscal Responsibility and Budget Management Act (FRBM)* to control the fiscal deficit. The trends in fiscal deficit were mirrored in the rising public debt levels. The concern now is that the high fiscal deficits suggest an increase in the public debt to above 75 per cent. It could be even higher if GDP growth slows down further. Another aspect of the fiscal scenario that has exhibited changing patterns is the mode of financing of the total expenditure. A debt financed growth strategy during the 1980s and resulted in high levels of debt-to-GDP ratios. This trend was reversed during the first half of the 1990s but there seems to be a return to the high deficit syndrome during 1995-2011.

16.12 EXERCISES

1) Examine the trends in the pattern of Public Revenue and Public Expenditure during the last 30 years.

2) What do you mean by Fiscal Imbalance? What steps have been taken by the Central Government to correct this situation?

3) Examine the various measures taken by the State Governments to improve their finances.

4) What measures will you suggest to improve the working of Fiscal Policy in India?

5) ‘The emerging debt situation is not a sustainable one’. Comment.

16.13 KEY WORDS

Revenue Budget : This consists of the revenue receipts of the government (tax revenues and other revenues) and the expenditure met from these revenues.

Tax Revenues : These comprise proceeds of taxes and other duties levied by the Union.

Non-tax Revenues : These receipts of government mainly consist of interest and dividend on investments made by government, fees and receipts for other services rendered by government.

Revenue Expenditure : This is expenditure for the normal running of Government departments and various services, interest charges on debt incurred by government, subsidies, etc. Broadly speaking, expenditure which does not result in the creation of assets is treated as revenue expenditure. All grants given to state governments and other parties are also treated as revenue expenditure even though some of the grants may be for creation of assets.

Capital Budget : This consists of capital receipts and payments. It also incorporates transactions in the Public Account.

Capital Receipts : The main items of capital receipts are loans raised by government from public which are called market loans, borrowings by government from Reserve Bank and other parties through sale of treasury bills, loans received from foreign bodies and governments and recoveries of loans granted by the Union government to state and Union territory governments and other parties.

Fiscal Deficit : The difference between revenue receipts plus non-debt capital receipts on one side and total expenditure including loans, net of repayments, on the other side.

Primary Deficit : The fiscal deficit minus interest payments.

Balance of Payments (BoP) : Statement of the country's trade and financial transactions with the rest of the world during the year.

Direct Tax : Tax levied by government on the income and wealth received by households and businesses.

Fiscal Policy : An instrument of demand management which seeks to influence the level of economic activity in an economy through the control of taxation and government expenditure.

Indirect Tax	:	A tax levied by government on goods and services.
Monetary Policy	:	The tool of macro-economic policy which involves the regulation of money supply, credit and interest rates in order to control the level of spending in the economy.
Public Debt	:	National debt and other miscellaneous debt for which the government is ultimately responsible. This would include the accumulated debt of nationalised industries and local authorities.
Tax Avoidance	:	Efforts to avoid paying tax by legal means.
Tax Evasion	:	Efforts to evade the payment of tax by illegal means.
Tax Base	:	The total pool which tax authorities can tap when levying a tax.
Value Added Tax (VAT)	:	A general tax applied at each point of exchange of goods or services from primary production to final consumption. It is levied on the difference between the sale price of output and the cost of inputs.
Good and Services Tax (GST):		The proposed GST will be a comprehensive indirect tax levy on the manufacture, sale and consumption of goods and services. The GST is likely to reduce indirect taxes paid on most of the books and services as it would avoid the cascading effect.

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16.15 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

i) See Section 16.2

ii) See Sub-section 16.2.1

iii) See Sub-section 16.2.2

iv) See Section 16.3

Check Your Progress 2

i) See Section 16.4

ii) See Sub-section 16.4.1

iii) See Sub-section 16.4.2

iv) See Sub-section 16.4.3

v) See Section 16.5

Check Your Progress 3

i) See Section 16.6

ii) See Section 16.7

iii) See Section 16.8

iv) See Sub-section 16.8.1

ANNEXURE 1

A Note about GST

Goods and Services Tax (GST) is going to replace CENVAT, state VAT, and service tax. The salient features of GST are the following:

A dual GST model with two separate components. Namely, the central GST (CGST) and state GST (SGST) will be introduced.

Both the central governments and states have to levy GST concurrently on all goods and services other than a small list of exemptions.

Cross-utilisation of input tax credit between CGST and SGST will not be allowed except in case of inter-state transactions (IGST).

GST will have a two-rate structure: a standard rate for most goods and a lower rate for necessities.

A combined rate of 12 per cent (8 per cent for states and 4 per cent for the central government) is seen to be revenue neutral.

The proposed GST will be a comprehensive indirect tax levy on the manufacture, sale, and consumption of goods as well as services at a national level. It will allow a single price for each product across the country. The GST is likely to reduce indirect taxes paid on most of the goods and services as it would avoid the cascading effect. Product prices, therefore, can be expected to fall and ensure growth in demand. In addition, the integration of goods and services taxes will improve tax collections and thereby help increase economic growth. It will also end the long-standing differential treatment of the manufacturing and services sectors. Apart from eliminating cascading effects, double taxation, and other issues, the introduction of GST will facilitate credit on uniform terms across the entire supply chain and across all states. The consensus GST rates may emerge to be 14 per cent. Even this will sharply bring down the incidence of indirect taxes in the economy and release new growth impulses.

Another tax reform that is likely to become effective from April 2012 is the *Direct Tax Code (DTC)* which is designed to greatly simplify the dual tax structure. The intension is to consolidate and comprehensively amend the existing Income Tax Act, 1961 and Wealth Tax Act, 1957 through a single legislation. DTC will achieve this by eliminating distortions in the tax structure, expanding the tax base, and improving tax compliance by introducing moderate levels of taxation. Initial analysis shows that most of these objectives are achievable.