Indira Gandhi
National Open University
School of Social Sciences

BECE-002
Indian Economic Development: Issues and Perspectives

Block

3

FISCAL AND MONETARY ISSUES

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BLOCK 3 FISCAL AND MONETARY ISSUES

Introduction

The present block, the third in the course, is on Fiscal and Monetary Issues. The block consists of four units.

Unit 9 is on Monetary Policy. Beginning with an outline of the Indian financial system, it describes the different instruments of monetary policy which are employed to achieve the twin objectives of ensuring the required money supply for economic expansion and controlling inflation. In the light of fast changing global economic environment, it also discusses the emerging challenges before the monetary authority in India.

Unit 10 discusses the issues of fiscal federalism. Outlining the scientific principles on which devolution of financial powers are determined between the centre and the states, it discusses the methods of fiscal adjustment available to deal with the situations of fiscal imbalances bound to prevail in a federal system of governments functioning at different levels. The role of the Finance Commission, and its contrast with that of the Planning Commission, is also discussed in this context.

Unit 11 deals with role of fiscal system in economic development. Addressing the broad theme of taxation and expenditure, it describes the different aspects of India's tax structure. The issues of public expenditure and public debt are also discussed.

Unit 12 is on Fiscal Reforms. Beginning with an outline of the fiscal crisis that prevailed in the beginning of 1990s in India, the unit first presents the steps taken by the government in constituting several committees and their recommendations on the reform measures needed to be instituted in the country. The extent of implementation of these recommendations and the relationship between budgetary outlays and the intended outcomes is also discussed.

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UNIT 9 MONETARY POLICY

Structure

9.0 Objectives
9.1 Introduction
9.2 Indian Financial System
9.3 Monetary Policy in India
9.4 Tools of Monetary Policy
9.5 Foreign Exchange Management Act
9.6 Mutual Funds
9.7 Venture Capital
9.8 Evaluation of the Monetary Policy in India
9.9 Emerging New Challenges Before the Monetary Authority
 9.9.1 Changing Global Economic Environment
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 9.9.4 Inelasticity of Domestic Supply
9.10 Let Us Sum Up
9.11 Key Words
9.12 Suggested Books for Further Reading
9.13 Answers/Hints to CYP Exercises

9.0 OBJECTIVES

After going through this unit you will be able to

- outline the features of the Indian financial system;
- elaborate the major dimensions of the monetary policy pursued in India;
- discuss the different tools employed by the central bank to achieve its goals of monetary policy in the country;
- distinguish between the FERA/FEMA Acts;
- outline the importance of new financial instruments like Mutual Funds and Venture Capital; and
- discuss the limitations of monetary policy pursued in India in terms of an evaluation of the same.

9.0 INTRODUCTION

The objective of monetary policy is to achieve a desired expansion of the economy by facilitating the availability of money supply needed for the process. This needs to be done in such a way that it imposes no undue inflationary pressures on the economy. The two objectives of ensuring the required money supply for economic development and checking inflation are, to an extent, mutually conflicting in their nature. In view of this, it is important to examine the effectiveness of tools that are employed to control inflation. Institutionally, the role of formulating and implementing the different policy measures needed in this direction is discharged by the central bank of the country which in case of India is the Reserve Bank of India (RBI). The unit deals with the different dimensions of India's monetary policy. It begins by providing an account of the main features of the Indian financial system. It then elaborates on the two major objectives behind the implementation of monetary policy in the country. The major instruments or tools used in achieving the objectives of controlling inflation are discussed next. The provisions of the Foreign Exchange Regulatory/Management Acts and some new financial market's developments in the form of Mutual Funds and Venture Capital are subsequently discussed. An evaluation of the monetary policy pursued in India is finally provided to equip the learners with its strengths and limitations.

9.2 FEATURES OF INDIAN FINANCIAL SYSTEM

The Indian financial system comprise of a wide array of institutions broadly classifiable into: (i) credit institutions, (ii) investment institutions, (iii) savings institutions, (iv) merchant banking institutions, and (v) support service institutions. We will mainly focus here on the first i.e. the credit institutions as they are not only more spread out in terms of their reach but also concerns the lives of almost all sections of the society. The credit institutions comprise of two major segments viz. ***commercial banks*** and ***specialised financial institutions***. Both these segments have their participants in each of the three sectors viz. the public sector, the private sector and the co-operative sector. Commercial banks are engaged in the crucial function of mobilising savings and extending credit to economically viable enterprises. The specialised financial institutions, on the other hand, are development banks set up for the promotion of specific sectors of the economy like agriculture, industry, trade, housing, tourism, etc. The structure of financial institutions is well diversified and the diversification trend is gaining further momentum with the institutions entering new fields like leasing, venture capital financing, technology development, etc.

Besides the above range of institutions which come within the purview of the regulatory framework of the government or the Reserve Bank of

India (RBI), there is also a huge unregulated segment. This mainly comprises of private money lenders like: indigenous bankers, semi-cooperative institutions, traders and commission agents, etc. As per one estimate, the unregulated segment in India caters to the needs of nearly 40 percent of the credit needs of the farm and the non-farm enterprises including households. The main reason for the popularity of such institutions is the low transaction costs for both the borrowers and the lenders. The transaction cost is low for the lenders as the creditworthiness of borrowers is judged mainly on the basis of familiarity and personal knowledge. It is also low for the borrowers because the lenders do not insist on securities as in the case of commercial banks. Thus, although the interest rates are higher than in the formal financial sector institutions, the low transaction costs partly compensate for the high interest rate.

A question is to what *extent* and with what *efficiency* the financial system is serving the needs of the country. To the extent that informal lending practices hold such a large share, with its exploitative ill-effects for the large illiterate poor borrowers in rural areas, there is a need for reforms in the banking operations to implement innovative institutionalised credit practices. There are examples of banking practices in other countries where the bank officials go out to seek potential borrowers to facilitate the financing of viable economic enterprises. Such officials are suitably rewarded for their initiatives. The contact between the official of the bank and the borrower is maintained in a continuous manner aimed at ensuring the proper utilisation of the credit provided and the successful running of the enterprise financed. Such proactive practices are yet to make inroads in the commercial banks in India. In other words, the financial system has not been able to improve its efficiency by reducing the transaction costs of the borrowers nor has it been able to progressively ensure the investment and productive efficiency of the enterprises it finances, particularly in the 'micro enterprises' sector. A second dimension is to see the extent of reach of the banking system into the household savings mobilisation. Data on this aspect reveal that the gross savings of the household sector mobilised by the banking sector in India has risen marginally from 10.0 percent of GDP in 1965-66 to 17.9 percent in 2007-08. A third dimension is in respect of 'financial technology' which is underdeveloped in India as compared to many advanced countries of the world. Improvements in this area would enhance the ability of the borrowing units and the financial sector units to better withstand the possibility of output volatility through upswings and recessions. With increased integration into the globalised trading and financial systems, India's financial system needs to be strengthened to enable it to withstand asset price shocks. Policies should be geared to take quick remedial measures.

Unlike the credit institutions, the presence of other four type of financial institutions (viz. investment, savings, merchant banking, and support services institutions) is generally restricted to the two sectors viz. public and private sectors. Investment banking has become prominent more

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recently with organisations like LIC, GIC, UTI, etc. from the public sector also entering into this sector. Post offices have gained in acceptance as saving institutions with attractive schemes. Merchant banking institutions are specialised bank departments or subsidiaries. Private sector banking received a boost with the introduction of New Economic Policy. The private sector banks have their presence largely in the urban areas confined mainly to the metropolitan cities. In terms of major indicators like business per employee, profit per employee, establishment expenses, etc. private sector banks have much better performance indicators. For instance, in terms of profit per employee, in 2005-06, the figures were Rs. 2 lakhs for the SBI group of banks, Rs. 0.78 lakhs for the other nationalised banks, and Rs. 9.23 lakhs for the private sector banks. However, two major criticisms against the private sector banks are that they ignore the rural areas and promote high-street banking which cater to the upper sections of the society. The overall share in total deposits is 75 percent for public sector banks and 20 percent for private sector banks.

The basic elements of a suggested strategy for restructuring of the financial system to improve its efficiency are the following:

- formulation of a sound criteria for appraisal, selection and monitoring of enterprises and projects that seek financial assistance from the system;
- effective legal and regulatory framework to ensure sound and healthy functioning of the financial system;
- a policy framework that ensures operational autonomy to the constituent units of the financial system; and
- generation of competitive impulses in the financial system.

Check Your Progress 1

1. What are the major types of institutions governing the Indian financial system? What proportion of total credit, the unregulated segment of financial operations is estimated to cater and why?

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2. What are the basic elements of a strategy suggested to improve the financial system in India?

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9.3 MONETARY POLICY IN INDIA

The objective of monetary policy of India has been one of controlled monetary expansion. This approach has aimed at ensuring the required money supply for all legitimate economic activities while at the same time ensuring that it is not available so freely to create inflationary pressure. It is argued that in a developing economy, money supply must be expanded sufficiently to match the growth of real national income. While it is difficult to say the exact relationship that the rate of increase in money supply bears on the growth in national income, it is generally agreed that increase in money supply has to be slightly higher than the projected rate of growth of real national income. This is because the income elasticity of demand for money, for India, is found to be 1.4 i.e. any change in income generates a 1.4-fold change in the demand for money. A second factor viz. the price elasticity of demand for money also influences the desired change in the money supply for a country. The value of price elasticity of demand for money (which measures the extent to which the demand for money changes in response to a given change in prices) is estimated as close to 1 for India i.e. any change in prices is accompanied by an exactly equal change in the demand for money.

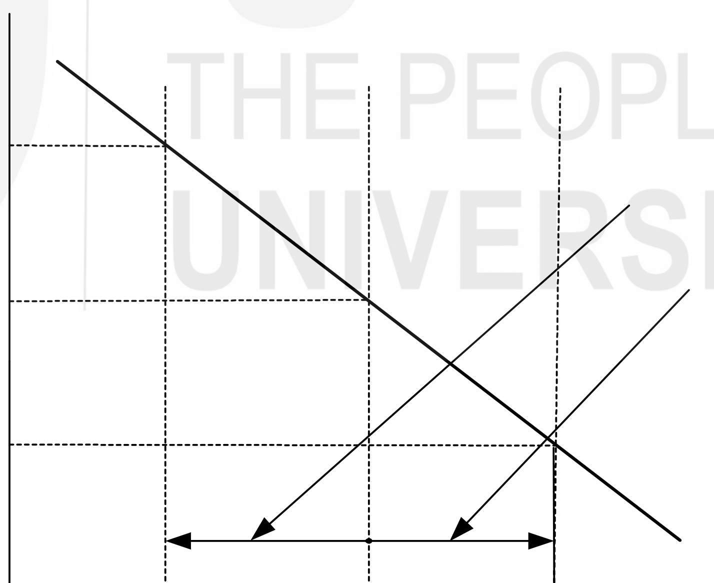
While ensuring the required money supply for meeting the growth stimulus in the economy, a distinction needs to be made between primary credit needs and secondary credit needs. All growth anticipated or growth promotive need for investment, such as the credit needs for promotion of legitimate economic activities, come under primary credit. A second most popular need for credit arises when in the annual budgets of central and state governments, free sanctions in the name of subsidies and loan waivers are announced. The money required for meeting such budgetary announcements also needs to be met by the monetary authority in the country. There is also the huge financial need by way of 'budgetary deficit' which refers to the gap between the revenue income and revenue (i.e. government) expenditure. The financial or the credit need of such economic and non-economic types is what may be termed as secondary credit. Many types of expenditure are thus not only non-productive (some of them like loan waivers are clearly negative expenditure) but are also unrelated to the growth process in the economy. The objective of controlling the supply of money, to an extent, aims at restraining such secondary expansion of credit. Imposing a check on the secondary expansion of credit poses a constraint because the private sector credit needs are not wasteful as most of it is needed for the legitimate requirements of production and trade. Further, even in case of private sector credit needs ensuring efficient spending for the actual purpose to which the credit was meant requires effective monitoring. The fulfilment of the objective of controlling secondary credit needs therefore — **one,** a careful choice of instruments of monetary policy designed to regulate the flow of credit, and, **two,** an effective credit planning and implementation system. We therefore now turn our attention to the tools of monetary policy.

9.4 TOOLS OF MONETARY POLICY

The essence of monetary policy being either to increase or decrease the supply of money circulating in the economy, it is immediately clear that the impact of any tool or instrument used should alter the '*monetary base*' in the economy in the desired direction. Thus, if the government wants to reduce the money supply, it can do so by issuing **bonds**. With the money in circulation used up to purchase the bonds, the monetary base would shrink. Again, at a time when the objective is to increase the money supply, the government can propose to take back the bonds by which the monetary base is expanded with the supply of money induced into the market while purchasing back the bonds from the public. The example used to illustrate the achieving of a change in the monetary base i.e. disburse/collect bonds falls under what is more generally called as '***open market operations***'. Such open market operations, as defined by the RBI, more generally refer to 'the purchase and sale by the central bank of a variety of assets such as foreign exchange, gold, government securities and company shares'.

Characteristically, the open market operations are anti-inflationary. This can be graphically illustrated (Figure 9.1) by the influence that a change

Figure 9.1: Interest Rate Determination



in the monetary base makes on the rate of interest prevailing in the economy. Consider the situation where the market is in equilibrium at the rate of interest OR corresponding to the level (or quantity) of money supply OM. If the central bank makes open market sale of securities, the supply of money in the market shrinks to the level OM_1. Consequently, the demand for credit would increase, resulting in an increase in the rate of interest to the level of OR_1. Conversely, if the central bank purchases securities, the money supply would increase to

the level OM_2. The rate of interest too, with the increase in money supply causing a reduction in the demand for credit, would fall to the level OR_2. The change in the supply of money associated with or brought about by a change in the rate of interest, vis-a-vis the open market operations, would be effective when the government policy permits the prevailing of 'market related or determined rates of interest'. Alternatively, in a situation where the monetary authority is able to mandate specific interest rates (on loans, savings/fixed deposits, etc.), a raise in the interest rates would result in a contraction of money supply as higher interest rates encourage savings and discourage borrowing.

Apart from the open market operations, there are other instruments (or tools) which the central monetary authority can employ to influence the desired change in the money supply. One of the most important among these is the '*bank rate*' (BR) policy. The bank rate refers to the 'standard rate' at which the central bank (RBI) buys or rediscounts bills of exchange or other commercial papers. More generally, bank rate is taken as the rate at which the RBI extends advances to the commercial banks. In some countries (e.g. U. K.) the bank rate has been substituted by minimum lending rate (MLR). By increasing the bank rate (or the nominal interest rate) a contraction in the monetary supply can be achieved.

Another prominent instrument used is the specification on the level of '***variable reserve requirement***' (VRR). More particularly, VRR is used to control credit. By changing the ratio of reserves, the RBI influences the volume of credit that banks can advance. There are two components of VRR viz. the ***cash reserve ratio*** (CRR) and the ***statutory liquidity ratio*** (SLR). CRR refers to the portion of total deposits of a commercial bank which it has to keep with the RBI as cash reserves. The SLR, on the other hand, refers to that portion of total deposits which a commercial bank has to keep with itself in the form of cash reserves. Increasing or decreasing the SLR, like the CRR, either decreases or increases the availability of funds with the banks to advance credit thereby complementing the objective of the central bank to influence the volume of money supply in the economy.

Still another instrument which has acquired significance in the recent times is what has come to be known as the '***liquidity adjustment facility***' (LAF). The LAF is an indirect instrument. It operates through overnight ***fixed repo*** and ***reverse repo*** rates. Repo rate is the rate at which banks borrow short-term loans from RBI. Reverse repo rate is the rate at which banks park their short-term surplus funds with the RBI. Since October 2005, repo rate has been changed frequently, along with changes in the reverse repo rate. Frequent changes in the repo rate indicate that the global factors are being accorded greater weight in the determination of monetary policy contours than ever before. This is in sync with the authorities' efforts to push for further opening up of the economy with the proposed introduction of capital account convertibility (see Unit 21).

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Apart from the four tools mentioned above viz. open market operations, bank rate, CRR and the SLR, there are other instruments like Refinance Policy, Selective Credit Control and Moral Suasion. The ***refinance policy*** refers to the system of refinance provided by the RBI to the commercial banks for certain credits extended by them (e.g. concessionary agricultural and rural credit). As an instrument of credit control its effectiveness depends upon commercial bank's liquidity position. With time, the dependence of commercial banks on the RBI having reduced greatly, the effectiveness of this policy as an instrument for credit control has also reduced. ***Selective credit controls*** (SCCs) are designed to curb excess of advancing in select areas/cases without affecting other types of credit. For instance, (i) ceiling on the amounts of credit for certain purposes and to any one borrower, (ii) discriminatory rates of interest charged on certain types of advances, (iii) prohibiting banks from entering into any particular transaction, (iv) giving directions on the purposes for which advances may not be made by the banks, (v) laying down maximum amount up to which guarantees may be given by a commercial bank, etc. Practices followed under *moral suasion* includes periodic urging by the RBI to the commercial banks to exercise control over credit in general and certain advances in particular. This method has been found quite useful with the RBI having successfully built up good informal relations with the banks.

Market Stabilisation Scheme (MSS)

The MSS was launched by the RBI in April 2004. There was a certain background due to which the MSS was introduced. While intervening in the foreign exchange market, the RBI had been releasing rupees for buying dollars. The rupees so released added to liquidity in the system raising inflationary pressures. To mop up this excess liquidity, the RBI used its huge stock of government securities. But over a period of time, this stock of securities held with RBI came down substantially. It was in this context that the MSS was launched as an additional channel to reduce liquidity. Under the MSS, the government issues T-Bills (treasury bills) in addition to its normal borrowing requirements. The amounts raised under the MSS will be held in a separately identifiable cash account entitled Market Stabilisation Scheme Account.

The MSS is thus basically a monetary management tool. The MSS will curb short-term volatility in the forex market. It is also expected to fine tune the structural balance in the money market and enable the RBI to maintain a grip over short-term interest rate.

9.5 FOREIGN EXCHANGE MANAGEMENT ACT (FEMA)

Foreign exchange is linked with country's trade policy. The focus of India's trade policy followed since the 1980s show that it first followed a policy of import liberalisation and subsequently (in the 1990s) shifted

to a policy of export orientation. Prior to the 1980s, the then prevailing Foreign Exchange Regulation Act (FERA, 1973), focused on conservation of foreign exchange. The FERA had strict provisions to deal with contravention of its stipulations. This led to harassment of bonafide companies and individuals earning unpopularity. With the process of liberalisation begun in 1991, foreign investment in various sectors were permitted. This resulted in increased flow of foreign exchange leading to rising foreign exchange reserves. With a view to managing the increased flows and reserves, FERA was repealed and in its place, the Foreign Exchange Management Act (1999) was made effective from 1st June, 2000. The approach of FEMA thus fundamentally differed from that of FERA principally in two respects viz. (i) from conservation to management, and (ii) from control to facilitation. In light of this, while offences under FERA were treated as criminal, those under FEMA are treated as civil.

Provisions of FEMA provides for free transaction on current account subject to the guidelines by the RBI. Enforcement of FEMA is entrusted to a separate directorate which undertakes investigations on contraventions of the Act. Provisions of FEMA are grouped under four heads. Important provisions under each of the four heads, having a bearing on promoting economic development through foreign investment with enabling provisions to ensure the curtailing of inflationary trends from such transactions, are outlined below.

I Regulation for Current Account Transaction

- Any person can sell or draw foreign exchange to or from an authorised dealer (if such sale or withdrawal is a current account transaction) except for certain prohibited transactions like remittance of lottery winnings, remittance of interest income on funds held in Non-Resident Special Rupee (NRSR) account scheme, etc. Besides these cases, there are certain other transactions, for which specific RBI approval will be required. For instance, Reserve Bank approval is required for importers availing of Supplier's Credit beyond 180 days and Buyer's Credit irrespective of the period of credit. Authorised dealers are permitted remittance of surplus freight/passage collections by shipping/airline companies or their agents, multimodal transport operators, etc. after verification of documentary evidence in support of the remittance.

II Regulations Relating to Capital Account Transactions

- Foreign nationals are not allowed to invest in any company or partnership firm or proprietary concern which is engaged in the business of Chit Fund or in Agricultural or Plantation activities or in Real Estate business (other than development of townships, construction of residential/commercial premises, roads or bridges) or construction of farm houses or trading in Transferable Development Rights (TDRs). Listing of permissible classes of Capital account

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transactions for a person resident in India and also by a person resident outside India has been provided in the regulations.

- Detailed rules and regulations are provided on borrowing and lending in Foreign Currency as well as Indian Rupee by a person resident in India from/to a person resident outside India either on non-repatriation or repatriation basis.

- Authorised dealers are now permitted to grant rupee loans to NRIs against security of shares or immovable property in India, subject to certain terms and conditions. Authorised dealers or housing finance institutions approved by National Housing Bank can also grant rupee loans to NRIs for acquisition of residential accommodations subject to certain terms and conditions.

- General permission has been granted to Indian company (including Non-Banking Finance Company) registered with Reserve Bank to accept deposits from NRIs on repatriation basis subject to the terms and conditions specified in the schedule. Indian proprietorship concern/firm or a company (including Non-Banking Finance Company) registered with Reserve Bank can also accept deposits from NRIs on non-repatriation basis subject to the terms and conditions specified in the schedule.

III Regulations relating to export of goods and services

- Export proceeds are required to be realised within a period of 6 months from the date of shipment. In the case of exports to a warehouse established abroad with the approval of Reserve Bank, the proceeds have to be realised within 15 months from the date of shipment. An enabling provision has been made in this regulation to delegate powers to authorised dealers to allow extension of time. Export of goods on elongated credit terms beyond six months requires prior approval of Reserve Bank.

IV Other Regulations

- A person resident in India to whom any foreign exchange is due or has accrued is obligated to take reasonable steps to realise and repatriate to India such foreign exchange unless an exemption has been provided in the Act or regulations made under the general or special permission of Reserve Bank.

- Any foreign exchange due or accrued as remuneration for services rendered or in settlement of any lawful obligation or an income on assets held outside India or as inheritance, settlement or gift to a person resident in India should be sold to an authorised person within a period of seven days of its receipt and in all other cases within 90 days of its receipt.

- Any person who has drawn exchange for any purpose but has not utilised it for the same or any other purpose permissible under the provisions of the Act should surrender such foreign exchange or unutilised foreign exchange to an authorised person within a period of 60 days from the date of acquisition. Where, however, exchange was drawn for travel abroad, the unutilised exchange in excess of the limit up to which foreign exchange is permitted to be retained, should be surrendered to an authorised person within 90 days from the date of return of the traveller to India if unspent exchange is in the form of foreign currency notes and within 180 days if it is in the form of travellers cheques.

- The Reserve Bank has specified the limit for possession and retention of foreign currency by a person resident in India. There is no restriction on possession of foreign coins by any person. Any person resident in India is permitted to retain in aggregate foreign currency not exceeding US$ 2000 or its equivalent in the form of currency notes/bank notes or travellers cheques acquired by him from approved sources.

- The Reserve Bank has granted general permission to any person to receive any payment: (a) made in rupees by order or on behalf of a person resident outside India during his stay in India by converting the foreign exchange into rupees by sale to an authorised person; (b) made by means of a cheque drawn on a bank outside India or a bank draft or travellers cheques issued outside India or made in foreign currency notes directly, provided the cheques, drafts or foreign currency is sold to an authorised person within seven days of its receipt; (c) by means of a postal order or postal money order issued by a post office outside India.

- Reserve bank has also granted general permission to a person resident in India to make payment in rupees: (a) for extending hospitality to a person resident outside India; (b) to a person resident outside India for purchase of gold or silver imported by such person in accordance with the provisions of any order issued by Central Government under the Foreign Trade (Development and Regulation) Act, 1992 or under any law or rules or regulations in force.

Check Your Progress 2

1. Distinguish between primary credit and secondary credit ?

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2. Mention the different tools that are employed to achieve the objectives of monetary policy in India. Which one of them is characterised as anti-inflationary and why?

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3. How are selective credit controls (SCCs) designed to curb excess of advancing in select areas/cases?

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4. In what respects the two Acts, FERA & FEMA, basically differ ? What are the three principal heads under which provisions of FEMA are listed ?

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9.6 MUTUAL FUNDS

A mutual fund is an investment financial institution which collects and invests the money collected by the public through open offers of public deposits. The investment is made in a wide array of assets in the market. The fund is managed by professionals due to which the returns on investments are usually much higher than those on the bank deposits. It thus gives an alternative to small investors who can make a choice or distribute their investment between bank deposits and market investment. The liquidity in mutual funds is, however, less than the bank deposits as there is usually a lock-in period within which the investor cannot sell and encash the investment made in the fund. The experience of mutual funds in India is four decades old of which for the first two decades the Unit Trust of India was the leading pioneer in this field. During the last two decades, however, there is a multiplicity of companies which have entered the mutual fund market. The average return on investment in MFs has been in the range of 15 to 25 percent which is higher than the domestic inflation rate and the risk-less return offered by the banks combined. In the light of this, it is no surprise that presently nearly *25 percent of household savings in India are cornered by the mutual*

funds (MFs). This is higher than the corresponding shares in the developed markets of western countries viz. 11 and 16 percents in UK and USA respectively.

Rationale for Mutual Funds: The rationale for the mutual funds can be stated both from the individual investor's as also from the capital market's side. In case of individual investor there is higher return by way of dividends and capital appreciation. Risk of loss is reduced as the funds are managed by well informed professional managers. It is also reduced due to diversification of portfolio in terms of companies and industries. Further, since the returns are automatically invested, the scope for capital appreciation is enhanced. As the savings and investments of a large number of investors are pooled the advantage of economies of scale accrue. The individual investor is spared of the ordeal of having to self-decide and then go through the process of investment. Thus, from the individual investor's angle mutual funds are very much advantageous.

From the point of view of capital market, if the foreign investors are also investing, due to increased volume of trading operation the liquidity for the domestic market players is enhanced. Such competition with a market regulator surely, and to an extent even otherwise, would automatically demand a higher investor discipline by way of increased disclosure, improved information flow, etc. In other words, problems of information asymmetry is reduced. This also contributes to improvement in economic fundamentals. Stability in returns on investment over long term, which is the hallmark of mutual funds, has the potential to counter the imbalance due to speculative tendencies witnessed commonly in active capital market. The benefits for both the individual and the capital market are thus significant.

Strengthening the Mutual Funds: Some suggestions that have been made by researchers to strengthen the mutual funds market are: (i) improve the transparency by specifying the ratio of fund deployment between different market instruments; (ii) make explicit, on the basis of professional judgement or assessment, the likely period of highest yield to distinguish between short term gain and long term gain; (iii) disclose the gain or loss due to inter-scheme transfer of investments by the fund managers in order that the investors are better informed; and (iv) put in place a separate comprehensive legislation, on the lines of UTI, to overcome the various shortcomings stated above.

9.7 VENTURE CAPITAL

Venture capital (VC) is a type of private equity capital provided to high-potential growth companies in the interest of generating a return at a later time point. Venture capital investments are generally made in exchange for shares in the invested company. Typically, such investments come from institutional investors. There are also dedicated investment

firms which pool together such capital to invest in enterprises that are normally risky for standard capital markets or bank loans. Such an investment firm (or sometimes a person) is called a Venture Capitalist. The pooled investment is known as a 'venture capital fund' (VCF).

Venture capital has been used as a tool for economic development even in many developing countries with not so well developed financial markets. In such countries, venture capital is known to play a role in facilitating access to finance for small and medium enterprises (SMEs) which in most cases would not qualify for receiving bank loans.

In India, the union budget for 1999-2000 stressed the difficulty to access credit from the capital market for technology demonstration/development particularly for the SMEs. Stressing the need for higher investment in venture capital activity, it suggested the need to create a suitable environment for allowing the VCF to play a major role in providing capital for the SMEs. Taking the cue from this, the Security Exchange Board of India (SEBI) initiated a process of interaction with industry participants to identify the issues and areas for the development of VCF industry in India. Towards this end, SEBI appointed a committee on Venture Capital in July 1999. Examining the impediments to the growth of VCF, the committee suggested several measures to facilitate the growth of venture capital activity in India. The thrust of the committee's recommendations was to facilitate through an enabling regulatory, legal, tax and institutional environment the creation of a pool of 'risk capital' to finance idea-based entrepreneurship. Among its other specific recommendations the following are note worthy: (i) the existing provisions of the IT Act should be reframed to provide automatic income-tax exemption to VCFs registered with SEBI; (ii) mutual funds, banks and insurance companies should be permitted to invest in SEBI-registered VCFs; and (iii) the investment criteria should be redefined to permit investment by VCFs primarily in the equity or equity related instruments which should be convertible into equity by way of subscription to initial public offers (IPOs).

Regulation by RBI for venture capital funds are that a SEBI registered VCF investor can invest in Indian venture capital undertakings according to the rules and regulations issued by RBI from time to time.

9.8 EVALUATION OF THE MONETARY POLICY IN INDIA

Monetary policy has an advantage (compared with the fiscal policy) in terms of the shorter time lag between its perceived 'action needed' and 'action taken' time points. Reduction in the different rates/ratios (BR/CRR/SLR/RR) are made applicable with immediate effect. Such changes are also made any time of the year. But these advantages are not realised optimally as evidenced by the 'inflationary rise in prices' which

have frequently taken place. Main reasons for the instruments of monetary policy to be ineffective are the following.

Higher Proportion of Non-Banking Credit: A substantial proportion of credit extended is by the non banking institutions (NBIs). This segment is not affected by the changes in the bank rate and ratios. The linkages between the banks and the NBIs are not well developed. Further, the banks have largely tapped non-deposit resources by way of call money market and participation certificates. The call money rates are generally beyond the purview of the RBI.

Limitations of Monetary Instruments: The frequent changes in the rates of monetary policy instruments are resented on the ground that they create an environment of uncertainty for productive investment. Further, with the greater integration of the Indian financial sector with the global financial system, RBI's monetary management has to take due note of global trends. It has also come to be realised that change of interest rates to curtail credit (i.e. increasing the interest rates) favour the unproductive sectors relatively more, hurting the interests of equity and growth. The effectiveness of the monetary policy instruments is thus clearly constrained in the changing environment prevailing in the globalised context.

Influence of New Financial Institutions: Institutions like mutual funds, venture capital companies and the public offers floated in the open market (to raise capital) have an abundant influence in effecting the overall liquidity in the economy. Recall that the mutual funds account for nearly 25 percent of the total household savings in the economy. Thus, the new financial institutions together account for a significant proportion of overall liquidity besides leading to a high degree of disintermediation. The effect of RBI's interventions is insignificant in these segments of the financial system.

High Currency-Deposit Ratio: The banking habit among large proportion of vast rural segments is still weak which has kept the currency-deposit ratio high. Influence of RBI's monetary policy instruments touches only the deposit segment. This contributes to the ineffective monetary regulation in the economy.

Preferential Rediscount Facilities, Selective Application of Credit Constraints and Weak Statistical/Monitoring System: The RBI has still maintained the many preferential rediscount facilities for encouraging the extension of credit by banks to promote certain sectors like agriculture, small industry, export finance, etc. There is also the special consideration that segments like small farmers and artisans in rural areas should be shielded from credit curbs. Further, there is a lack of the required sound statistical and monitoring system to ensure that the preferential segments are duly benefiting by such policies. These preferences and gaps have rendered the task of monetary policy restrictive in their reach and influence.

Rigidity in Policies and Growing Fiscal Needs: Credit policy for a particular year is traditionally based on the developments in the previous year in regard to money supply and price trends. As opposed to this, the need of the hour is a switch over to an assessment of the credit needs of the ensuing year based on the growth in real output envisaged. The increasing monetisation of the budget deficits also conflicts the objectives of fiscal and monetary policies. To overcome this situation, it is necessary that the monetary authority must have a reasonable degree of flexibility for the creation of reserve money. However, there are exogenous factors (e.g. movements in the foreign exchange assets) affecting the determination of the reserve money requirement.

The above factors point out to the need for strengthening the institutional arrangements governing the functioning of the monetary authority. It is in this context that the Sukhmoy Chakravarty Committee pointed out to the need for bridging the mismatch between the responsibilities of the RBI to supervise and control the monetary system on the one hand and the authority needed to do so on the other. That leads us to have a look on the question of RBI autonomy.

9.8.1 RBI Autonomy

An important ingredient for the success of financial liberalisation is the autonomy of the RBI. There are two basic tenets of the concept of autonomy. **One**, the monetary policy is conceived to be an arm of the overall economic policy. The stability and functioning of the banking system which is important for improving its effectiveness in serving the needs of the economy is unarguably an important economic policy objective entrusted to the central bank (i.e. the RBI). **Two**, there has to be a clear distinction between ownership of the central bank by the government and the regulation of the monetary and financial system by the central bank. This distinction is normally blurred and the impression remains that ownership also confers on the government the right to regulate the monetary system.

In the context of the sweeping changes now taking place in the financial landscape as also the global trends, there is a compelling need for giving undisputed authority to the RBI as an independent professional institution to not only watch over the financial integrity and stability of the system but also ensure its orderly development. For instance, the RBI can be given an opportunity to form its views which the bank can put across to the government at an early stage right at the time of formulation of the policy. Also, the inputs need not just be on monetary policy but may be on broader economic and fiscal policy too. With such a role and responsibility vis-à-vis autonomy extended to RBI, it would be more effective in discharging its function in place of its present nature of function focusing more on liquidity management and inflation control.

9.9 EMERGING NEW CHALLENGES BEFORE THE MONETARY AUTHORITY

The conduct of monetary policy is faced with a number of emerging challenges. They can be outlined as below.

9.9.1 Changing Global Economic Environment

Recent developments in the global economy have aggravated the challenges that monetary authorities face. An important challenge faced is brought about by the new environment characterised by increased financial globalisation. This renders economies vulnerable to changes in internal demand, volatility in capital flows and exchange rate shocks. Monetary policy formulation thus becomes much more interdependent than before across economies and has to factor in developments in the global economic situation, the international inflationary situation, interest rates, exchange rate movements and capital flows. As a result, while domestic developments continue to dominate, global factors are also gaining more importance. Massive cross-border capital flows, globalisation of financial markets and advances in information technology have combined to significantly alter the choice of instruments of monetary policy, operational settings and transmission mechanisms.

9.9.2 Multiplicity of goals

There is also a multiplicity of goals in the rapidly integrating economies like: (i) a fixed exchange rate; (ii) free capital movement; and (iii) an independent monetary policy. This has been identified as an 'impossible trinity'. Management of this trinity necessarily implies constant trade-offs on the domestic circumstances, global circumstances and expectations. It calls for greater coordination among the policy circles. There is considerable fuzziness in reading underlying macro-economic and financial developments, obscured signals from price behaviour and the required clarity in the monetary authority's observance of the performance of the real economy. Consequently, dealing with the impossible trinity has become more complex than before.

9.9.3 Challenges originating from other sectors

Monetary policy has also to contend with the following challenges originating from other sectors.

a) Fiscal imbalances remain large by international standards which needs to be managed in a non-disruptive manner;

b) The enduring strength of foreign exchange inflows complicates the conduct of monetary policy. In the event of demand pressure building up, increases in interest rates may be advocated to preserve and sustain growth in a non-inflationary manner. High interest rates,

however, increases the possibility of further capital inflows and potentially reduce the efficiency of the monetary policy;

c) In India, levels of livelihood of a large section of the population are inadequate to withstand sharp financial fluctuations which impacts real activity. As such, monetary policy has to take into account the effect of these segments of the economy from volatility in financial markets, often related to shifts in capital flows.

9.9.4 Inelasticity of domestic supply

Limitations of the elasticity of aggregate supply domestically, impose an additional burden on monetary policy particularly in the short term. While open trade has expanded the supply potential of several economies, it does not seem to have had any significant short term salutary effect on supply elasticities. Persisting supply shocks to prices of commodities and services are sensitive to inflation and can exert a lasting effect on inflation expectations. The burden and the dilemmas in the event of structural supply problem are thus greater due to its persistent effects on inflation. Managing such structural problems while keeping inflation low and stable without disturbing the growth momentum is an important challenge to monetary policy in the period ahead.

Check Your Progress 3

1. What are the two major dimensions from which the rationale for mutual funds are pointed out ? What suggestions have been made to strengthen the mutual funds in India?

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2. Distinguish between Venture Capital (VC) and Venture Capital Fund (VCF). Which segment of economic enterprise is basically supposed to benefit from the VCs in the developing countries?

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3. What were the specific recommendations of the committee set up in 1999 to promote the growth of the VCFs in India ?

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4. What are the main reasons identified for the ineffectiveness of the monetary policy instruments in India ? Mention the one single but major deficiency pointed out by the Sukhmoy Chakravarty Committee as needing to be removed to improve the effectiveness of monetary policy instruments in India ?

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9.10 LET US SUM UP

Beginning with an outline of the Indian financial system, the unit has explained the objectives of monetary policy and the instruments/tools used in meeting out these objectives. Some new institutions like mutual funds and venture capital funds which have come to occupy a prominent place in the financial system of the country are then outlined. A distinction between the foreign exchange regulation Act (FERA, 1973) and the foreign exchange management Act (FEMA, 2000) is then presented. The specific provisions of the latter instituted to liberate and promote the budgetary needs of achieving the high growth objectives are also spelt out in detail. The limitations of the monetary policy instruments and the underlying factors that continue to prevail rendering the policy instruments ineffective are finally outlined.

The tools/instruments applied to achieve the objectives of monetary policy are expected to yield results in quantitative as well as qualitative terms. Quantitatively, it should be such as to aid the process of economic development without hindering the process by a short fall of money required. Qualitatively, it should not result in undue inflationary pressure which is possible if the utilisation of money earmarked for a purpose is used efficiently for it. Ensuring this, however, requires a strong data base and monitoring mechanism besides the appropriate standards of autonomy for the implementing body. The authority vested with the responsibility of implementing the monetary policy objectives should, therefore, be ideally empowered to monitor the utilisation of funds made available for different purposes. This is possible with the establishment of institutional mechanisms on which there is scope for improvement in the Indian context.

9.11 KEY WORDS

Financial technology : Is defined as a mechanism consisting of a spectrum of financial assets with wide-

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ranging variety of liquidity, risk, maturity, yield, etc.

Investment banks/ institutions : Are institutions which 'underwrite' (i.e. guarantee) the sale of stock and bond issues, trade for their own accounts, make markets, and advice corporations on capital market activities such as mergers and acquisitions.

Merchant banks : Traditionally, merchant banks were engaged in trade financing. In the modern day context, these banks refer to banks which provide capital to firms in the form of shares rather than loans.

Retail banking : The term includes financial services like: payments, savings products, credits and insurances for individuals or small and medium sized enterprises. Retail banks differ from commercial banks in terms of their broadly decentralised distribution network, providing local and regional outreach by their socially responsible approach to business and society.

Savings institutions : Activities of retail banking which includes offering savings products and savings schemes operated under the national postal systems.

Current account and capital account : The two terms are used in the context of balance of payment (BoP). BoP is a statistical statement that summarises transactions between residents and non-residents during a period. The BoP comprises of three heads viz. *current account,* the *capital account, and* the *financial account*. Together, these accounts balance in the sense that the sum of the entries is conceptually **zero**. In particular, the 'current account' transaction refers to the 'goods and services' account. The 'capital account' refers to the transfer of capital goods (e.g. machinery transferred to or from abroad). The *financial account* records transactions that involve financial assets and liabilities that take place between residents and non-residents.

Call money market : Market in which brokers and dealers borrow money to satisfy their credit needs, either

to finance their own inventory of securities or to cover their customers' margin accounts.

9.12 SUGGESTED BOOKS FOR FURTHER READING

L M Bhole (2006): *Financial Institutions and Markets*, Tata McGraw-Hill Publishing Company Limited, New Delhi.

I C Dhingra (2009): *The Indian Economy – Environment and Policy*, Sultan Chand & Sons, New Delhi (Twenty Third Revised Edition).

Ruddar Datt, K.P.M. Sundharam (2006): *Indian Economy*, Sultan Chand & Sons, NewDelhi (Fifty-fourth Edition).

S.K. Misra, V.K. Puri (2006): *Indian Economy*, Himalaya Publishing House, Delhi, (24th Revised and Updated Edition)

9.13 ANSWERS/HINTS TO CYP EXERCISES

Check Your Progress 1

1. See Section 9.2 and answer.
2. See Section 9.2 and answer.

Check Your Progress 2

1. See Section 9.3 and answer.
2. See Section 9.4 and answer.
3. See Section 9.4 and answer.
4. See Section 9.5 and answer.

Check Your Progress 3

1. See Section 9.6 and answer.
2. See Section 9.7 and answer.
3. See Section 9.7 and answer.
4. See Section 9.8 and answer.

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UNIT 10 FISCAL FEDERALISM

Structure

10.0 Objectives
10.1 Introduction
10.2 Devolution of Functions
10.2.1 Allocation Function
10.2.2 Distribution Function
10.2.3 Stabilisation Function
10.3 Distribution of Revenue Powers
10.4 Fiscal Imbalance
10.4.1 Vertical Fiscal Imbalance
10.4.2 Horizontal Fiscal Imbalance
10.5 Methods of Fiscal Adjustment
10.5.1 Divisible Pool Method
10.5.2 Supplementary Levies
10.5.3 Federal Grants
10.6 Fiscal Federalism in India
10.6.1 Division of Functions
10.6.2 Revenue Powers of the Centre
10.6.3 Revenue Powers of the State
10.6.4 Division of Borrowing Powers
10.6.5 Fiscal Imbalances in India
10.7 Finance Commission
10.8 Finance Commission Vs Planning Commission
10.9 Fiscal Transfer by the Finance Commission
10.10 Resource Transfer by Planning Commission
10.10.1 Plan Assistance-State Plan Schemes
10.10.2 Gadgil Formula
10.10.3 Centrally Sponsored Schemes
10.11 Let Us Sum Up
10.12 Key Words
10.13 Some Useful Books
10.14 Answers/Hints to Check Your Progress

10.0 OBJECTIVES

After going through this unit, you will be able to:

- explain the concept of fiscal federalism;
- discuss the different revenue sharing arrangements between the Central and State Governments;
- state the types of fiscal imbalances and describe the different fiscal adjustment methods; and
- explain the role played by the Finance Commission and the Planning Commission in allocating resources to establish fiscal balance.

10.1 INTRODUCTION

Fiscal functions are carried out by the different tiers of a government in a country. The number of tiers of government involved in the fiscal functions differ from one country to another depending upon the federal structure of the government. For instance, the USA, India and Australia have a three-tier federal structure, while Holland and Switzerland have a two-tier federal structure. Each of these different tiers of government must, therefore, have a clearly demarcated functional devolution and fiscal powers based on sound principles. ***The theory and practice of the devolution of powers and functions among the different tiers of government involved in the fiscal operations is what is called as 'fiscal federalism'.*** In other words, fiscal federalism provides a framework for the devolution of functions between the national and the sub-national governments along with a framework for sharing the revenue collected among the different tiers of governments. In this context, the present unit, inter-alia, discusses: (i) the principles on which the devolution of functions and revenue sharing is based; (ii) the types of fiscal imbalance that arises in the process and methods by which fiscal adjustment are sought to be established; and (iii) the institutional arrangements that exist in India to recommend the norms for effecting fiscal transfers and allocate the budgetary resources among the states in the federal system.

10.2 DEVOLUTION OF FUNCTIONS

10.2.1 Allocation Function

The task of ensuring the welfare of its people requires a government to devise a system by which the allocation of public goods and services are efficiently made. An important question, in this context, is which tier of government should provide which type of services. A widely followed principle, in this respect, is that of '***benefit incidence***'. Benefit incidence is a method of computing the distribution of public expenditure across different demographic groups, such as women and men. The procedure

involves allocating per unit public subsidies (for example, expenditure per student for the education sector) according to individual utilisation rates of public services. Further, according to the benefit incidence principle, if there is a function whose benefit is nation wide, such a function is to be entrusted to the national government, while if the benefit of a function is regional or sub-regional in character, such a function should be entrusted to the State or local governments. Thus, services like defence, scientific exploration, etc. whose benefit incidence reaches the whole nation, should be provided by the Central government. On the other hand, public goods like law and order, supply of water, electricity, sanitation, etc. whose benefit incidence is spatially limited to the State and local areas, should be provided by the State and local level governments.

It is, however, to be noted that many public goods and services are required at each level of government. Therefore, these should be provided not only by the Central government, but also by the State and local governments.

10.2.2 Distribution Function

Distribution of services, and therefore the resources to be raised by levying taxes for providing the services to the people, is another important fiscal function. The function of distribution is assigned to the Central government. An important question in this context arises as to whether the distribution function can be effectively carried out by the sub-Central (State and local level) tiers in a government. If this function is to be carried out by the sub-Central governments, it may lead to distortions in the mobility of labour leading to increase in inequality. For instance, suppose there are two regions A and B. Region A has a higher concentration of poor people who favour a high degree of redistribution of factors of production. On the other hand, region B has a relatively larger proportion of rich people who favour low or no redistribution. In such a situation, all high-income people residing in region A and opposing distribution, would like to shift to region B. As a result, the degree of equalisation would become less (i.e. inequality would increase in region A) as larger number of poor people would reside in region A.

Another reason for the distribution process by the State and local level governments becoming a failure is that these tiers may choose to implement the distribution process for reasons of politico-administrative factors. However, this does not mean that the sub-Central governments cannot altogether render the distribution function. It also does not mean that the Central government is always more capable and effective in discharging the distribution function. It only means that the Central government may have a greater reach and act in the national interest than the sub-Central governments in many cases.

10.2.3 Stabilisation Function

In a federal country, macro economic issues like unemployment, inflation, money supply, etc. are to be dealt by different levels of government. The process of aiding macro economic adjustment is known as '***stabilisation***'. Stabilisation function cannot, however, be entirely entrusted to sub-central governments as they do not have adequate instruments to deal with such macro-economic issues without giving scope for economic distortion. Moreover, in most of the federations, it is the exclusive prerogative of the Central governments to deal with the 'external sector'. In view of this, in almost all the federations the Central government performs the function of stabilisation by using the tools of monetary and fiscal policies. Thus, while the Central government has an absolute advantage in rendering the redistribution and stabilisation functions, lower layers of government can render the function of delivery of goods and services more effectively. In the light of this, while functional responsibilities have been distributed between different layers of government (in several federations including India) on the basis of the principle of benefit incidence, functions like defence, space exploration, navigation, railways, etc. have been entrusted to the Central government. Likewise, functions like law and order, water supply, education, health, sanitation, agriculture, etc. are entrusted to the lower tiers of governments.

Once the functional division takes place, each tier of government need financial resources to discharge their respective functions. So what is equally important is the distribution of revenue or tax powers.

10.3 DISTRIBUTION OF REVENUE POWERS

Generally, powers for levying taxes (i.e. revenue powers) with a narrow base are given to the State or local governments while those with a broad or national base are retained by the Central government. For instance, in India, sales tax, State excise, motor vehicle tax, property tax, profession tax, etc. are given to the sub-Central government, whereas taxes with broader base like income tax, corporation tax, customs duties, wealth tax, etc. are entrusted to the Central government. Such a distribution is, however, made not arbitrarily but is guided by economic and scientific principles.

The division of revenue powers are generally made on the basis of the three important principles: (i) ***efficiency***, (ii) ***suitability***, and (iii) ***adequacy***. The fiscal resources provided through revenue powers to each tier of government should correspond to the requirements that arise due to the functional responsibilities entrusted to each government. The sub-principles, within the broad ones stated above, which are also considered for the division of revenue powers between the Centre and the States, are often referred to as the 'Principles of Federal Finance' [or Adarkar's Principles]. These include the need for: (i) independence

and responsibility, (ii) adequacy and elasticity, (iii) equity and uniformity, (iv) accountability and productivity; and (v) ease of integration and coordination. In most of the federations including India, even though the above principles are followed, situations of fiscal imbalance arises quite often. We, therefore, now turn to know about the types of fiscal imbalance and methods of its adjustment.

10.4 FISCAL IMBALANCE

When the revenue powers are divided between two or more tiers of government in a federation, in general, the Central government is entrusted with more financial resources. This is because due to its functional responsibilities like defence, space research, etc. there is always a greater demand for its expenditure requirement vis-à-vis its revenue resources. This is to say that some of its functions are required to be discharged more in the national interest than the interest of a regional dimension which warrants greater revenue powers for it. The fiscal imbalance among the States would arise because of inadequate revenue resources in comparison to their respective expenditure commitments. Such non–correspondence between the revenue resources and expenditure requirements among the states in a federation is known as Fiscal Imbalance. The fiscal imbalance may be classified into two types: (i) Vertical Fiscal Imbalance, and (2) Horizontal Fiscal Imbalance.

10.4.1 Vertical Fiscal Imbalance

The fiscal imbalance due to the difference between the revenue resources and expenditure commitments of the Central government, and those of the State governments *put together* is called as the Vertical Fiscal Imbalance. It is natural that the federal governments of any country have vertical fiscal imbalance irrespective of their development status.

10.4.2 Horizontal Fiscal Imbalance

Horizontal fiscal imbalance arises due to the non-correspondence between the revenue generating potential/efficiency of the different state governments within the federal structure vis-à-vis their respective expenditure commitments. This type of fiscal imbalance arises due to the differences in the endowment (or availability) of the natural resources, even if the revenue powers and expenditure responsibilities are uniform. Thus, horizontal fiscal imbalance also exists in federations across the countries irrespective of their state of development. As fiscal imbalance of both the types exist in all the federations of the world, a uniform system of fiscal adjustment has been developed to reduce the fiscal imbalances. We will study more about this in the subsequent section of the unit. But before that, we will attempt to answer the following questions.

Check Your Progress – 1

1. What are the three type of functions on which the devolution of functional responsibilities are determined in a federal government system? Briefly explain writing a line on each one of them.

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2. What are the broad and specific principles on which the 'distribution of revenue powers' are determined?

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3. Briefly outline (in 50 words) the concept of vertical fiscal imbalance.

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4. What is horizontal fiscal imbalance? Briefly explain in about 50 words.

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10.5 METHODS OF FISCAL ADJUSTMENT

In order to reduce the fiscal imbalances of both vertical and horizontal types, fiscal adjustment is made through fiscal transfers, from the Central government to State and local governments. Fiscal transfers are also used as instruments to reduce regional inequalities of income and wealth in the federation. The important types of fiscal transfers or methods of fiscal adjustment are briefly explained below.

10.5.1 Divisible Pool Method

As per this method, either a fixed percentage of net revenue from all the taxes or identified select taxes is pooled for the purpose of distribution across the federating states on the basis of a criterion. In view of this, this method of fiscal transfer is also known as ***distributive pool or shared tax revenue method***. Certain issues like: (i) which taxes are to be shared, (ii) what percentage of each of the pooled taxes should be shared, and (iii) how to distribute the pooled revenue across the competing states, etc. are decided separately. As said above, there is a uniform practice in all the countries with regard to these issues. In some countries these are mentioned either in the Constitution of the country, while in others, these are decided by independent agencies. They may also be decided by mutual agreements like the five-yearly agreements in Canada. If the shareable taxes, percentage of share and the criteria for inter se distribution are written in the Constitution, it leads to fiscal rigidity. So, in several federations, including India, these are decided by an independent agency. The agency in India which discharges this function is known as the Finance Commission about which we will study later. The most important advantages of the divisible pool method are the following:

i) It keeps the supremacy of the Central Government while upholding the fiscal autonomy of the States;

ii) Simple to administer, it enables the distribution of the financial resources equitably and efficiently among the States; and

iii) It expands the resources of the States as the revenues from the shareable taxes expand.

However, logical and rational distribution of percentage of shareable taxes and the criteria of distribution are often difficult to arrive at. Any arbitrariness will lessen the importance of this fiscal device.

10.5.2 Supplementary Levies

This is a levy imposed by a tier of government over and above the basic rate of tax of the same tier or that of the other tier. The financial resources thus mobilised will be used either for a specific or general purpose of the State. This device is also simple, administratively efficient and carries all the advantages of the divisible pool method.

10.5.3 Federal Grants

An important fiscal adjustment method is the grant-in-aid. As these are mostly provided by the federal government to the States to reduce both the vertical and horizontal fiscal imbalances, these are also known as 'federal grants'. Federal grants are broadly categorised as (i) conditional grants and (ii) unconditional grants. Conditional grants are further divided into conditional matching grants and conditional non- matching grants.

Conditional grants

If the 'grantor' insists on any conditions while providing the grant to the 'grantee', either with reference to its eligibility or in its use, the grant is known as a 'conditional grant'. For instance, the grantor could insist upon the grantee to contribute a lump sum or a fixed percentage of the total grant amount. Such a grant is known as *conditional matching grant*. If the grant is made with conditions for its use but without any contribution, it is known as *conditional non-matching grant*.

Unconditional grants

If the grantor provides grants to the grantee without stipulating any conditions, either with reference to its eligibility or its use, the grant is known as unconditional grant. These are also known as ***general purpose grants***. These grants are as good as revenue from tax and non-tax sources to the States. The States always favour this type of grant to conditional grants as they enjoy more fiscal autonomy though this type of grant, although fiscal irresponsibility is not ruled out. These grants are provided in several federations like USA, Australia, Canada, etc. including India.

In almost all federations, fiscal transfers from the Central government to the State or local governments are made in the form of shared tax revenue or grants or both. In India also, powers of revenue collection and functions have been distributed between the Centre and the States right from the adoption of the Constitution. Fiscal adjustments have been made in the form of shared tax revenue, and grants and loans have been transferred from the Centre to States and Union Territories. The two agencies responsible for fiscal transfers from Centre to States are the Union Finance Commission and the Planning Commission. Before we proceed to read about these organisations, let us first know about the fiscal management system as it obtains specifically in India. But first we will answer the following questions.

Check Your Progress – 2

1. Briefly outline the Divisible Pool Method of fiscal transfer.

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2. Distinguish between the methods of conditional and unconditional grants of fiscal transfer.

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10.6 FISCAL FEDERALISM IN INIDA

The various aspects relating to fiscal federalism in India are discussed under four heads viz. (i) division of functions, (ii) revenue powers of the centre, (iii) revenue powers of the states, and (iv) division of borrowing powers.

10.6.1 Division of Functions

The fiscal powers and functional responsibilities in India have been divided between the Central and State governments following the principles of federal finance. The division of functions is specified in the Seventh Schedule of the Constitution in three lists viz. the Union List, the State List and the Concurrent List. The Union List contains 97 subjects of national importance, such as defence, railways, national highways, navigation, atomic energy, and posts and telegraphs. Sixty six items of State and local interest, such as law and order, public health, agriculture, irrigation, power, rural and community development, etc. have been entrusted to the State governments. Forty seven items, such as industrial and commercial monopolies, economic and social planning, labour welfare and justice, etc. have been enumerated in the Concurrent List. The concurrent list is one in which both the Centre and the States can make legislation. However, in case of a conflict or tie, federal laws prevail.

10.6.2 Revenue Powers of the Centre

The Central government has been given powers in respect of taxes on income other than agricultural income, customs duties, excise duties on tobacco and other goods manufactured or produced in India, corporation tax, taxes on capital values, estate duty in respect of property other than agricultural land, terminal taxes on goods or railway passengers carried by railway, sea or air, taxes other than stamp duties on transactions in stock exchanges and futures markets, stamp duty in respect of land, etc.;

taxes on sale or purchase of news papers and on advertisements published therein; and sale, purchase and consignment of goods involving inter-State trade or commerce. In fact, the Central government does not get revenue from all the above taxes. These revenues can be divided into four categories on the basis of levy, administration and the accrual of revenue as follows.

i) Taxes that are levied, collected and retained by the Central government: e.g. Corporation Tax, Customs Duties;

ii) Taxes that are levied and collected by the Centre but shared with the states: e.g. the net proceeds from Income Tax under Article 270 and the net proceeds from Union Excise Duties under Article 272, respectively;

iii) Taxes that are levied and collected by the Centre but whose net proceeds are assigned to the States: e.g. all the eight items under Article 269 of the Constitution such as Estate Duty, Taxes on Railway Passenger Fares and Freights and Consignment Tax, etc.; and

iv) Taxes levied by the Centre but collected and appropriated by States, such as excise duties on medicinal and toilet preparations, etc.

10.6.3 Revenue Powers of the State

The State governments have been given exclusive tax powers in respect of land revenue; taxes on agricultural income; duties in respect of succession to agricultural land; estate duty in respect of agricultural land; taxes on land and buildings; excise duties on goods containing alcoholic liquors for human consumption; opium, Indian hemp and other narcotic drugs; taxes on the entry of goods into local areas; taxes on the sale or purchase of goods other than newspapers; taxes on vehicles, tolls; taxes on professions, trades, callings and employment; capitation taxes, taxes on luxuries including taxes on entertainment, amusements, betting and gambling; and rates of stamp duty in respect of documents other than those specified in the Union List.

10.6.4 Division of Borrowing Powers

The borrowing powers have also been clearly mentioned in the Constitution. Under Article 292, the Central government is empowered to borrow funds from within and outside the country as per the limits imposed by the Parliament. According to Article 293(3), the States can borrow funds within the Country. Article 293(2) empowers the Centre to provide loans to any State subject to conditions laid down by Parliament. A State, in practice, cannot raise any loan without the prior permission of the Centre or if there is any outstanding loan from the Centre to the State or an outstanding loan for which the Centre has given a guarantee.

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10.6.5 Fiscal Imbalances in India

The Constitutional fiscal arrangement shows that fiscal imbalances were deemed inevitable as most of the powers for elastic taxes are given to the Central government. Further, as said before, the division of powers and functions itself leads to vertical federal fiscal imbalance while the differences in the endowment position of natural resources across States cause horizontal federal fiscal imbalance. Visualising the fiscal imbalances, the Constitutional makers provided a mechanism of fiscal adjustment by way of fiscal transfers from the Central to the State Governments. This provision in the constitution was made under Article 280 by way of setting up of a Finance Commission for every five years or earlier, if the President of India feels it necessary. Let us now know more about the Indian Finance Commission.

10.7 FINANCE COMMISSION

The Finance Commission, to be constituted every five years, consists of a Chairman and four other members to be appointed by the President of India for a term. The Constitution has not mentioned the qualifications of either the Chairman or its members; they are to be determined by the Parliament. The Parliament can also lay down the manner in which they shall be selected. That is the reason why the Chairmen of the Finance Commissions have been reputed politicians, former justices, economists, technocrats and reputed public personalities (Table 10.1).

Table 10.1: Chairmen of the Successive Finance Commissions

Finance Commissions	Chairman	Year of Appointment
I	Shri K.C. Neogi	1951
II	Shri K. Santhanam	1956
III	Dr.A.K. Chanda	1960
IV	Shri P.V. Rajamannar	1964
V	Shri Mahavir Tyagi	1968
VI	Shri K.Brahmananda Reddy	1972
VII	Shri J.M. Shelath	1977
VIII	Shri Y.B. Chavan	1982
IX	Shri N.K.P. Salve	1987
X	Shri K.C. Panth	1992
XI	Dr. A.M. Khusro	1998
XII	Dr.C. Rangarajan	2004
XIII	Dr. Vijay Khelkar	2007

10.7.1 Functions of the Finance Commission

Article 280(3) speaks about the functions of the Finance Commission. The Article states that it shall be the duty of the Commission to make the recommendations to the President as to:

i) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation among the states of the respective shares of such proceeds;

ii) to determine the quantum of grants-in-aid to be given by the Centre to States [Article 275(1)] and to evolve the principles to govern the eligibility of the state for such grant-in-aid;

iii) Any other matter referred to the Commission by the President of India in the interest of sound finance. Several issues like debt relief, financing of calamity relief of states, additional excise duties, etc. have been referred to the Commission invoking this clause.

The Commission shall determine its procedure and shall exercise such powers in the performance of its functions, as the Parliament may, confer on it by law. The President shall place the Report of the Commission together with an Explanatory Memorandum before each house of Parliament. In practice, the recommendations of the Finance Commission are accepted by the Government of India for the distribution of shared tax revenue, as well as for grant-in-aid.

10.8 FINANCE COMMISSION VS PLANNING COMMISSION

Though the Constitutional makers envisaged channelling of fiscal transfers by the Finance Commission only, the Government of India created a parallel commission, the Planning Commission, within just 50 days from the adoption of the Constitution (in March,1950). The Planning Commission, originally meant for formulating and evaluating Five Year Plans, started channelling fiscal resources for Plan purposes. The contrast between Finance Commission and Planning commission is given in Table 10.2.

Several eminent scholars, academics and administrators are of the opinion that there exists duality and overlapping of functions between the Finance Commission and Planning Commission. The Planning Commission, which is a non-statutory body and an arm of the Central government makes fiscal transfers in the form of Plan loans and Plan grants to states. Referring to this issue, P.V. Rajamannar, Chairman of the IV Finance Commission had observed that 'there is no provision in the Constitution for constituting a body like the Planning Commission'. Right from the first Finance Commission onwards, the Finance Commissions confined themselves to the non-plan revenue account only, while the entire plan needs have come within the purview of the Planning Commission. In the beginning of the plan period, the fiscal resources transferred by the Finance Commission were relatively larger than that of the Planning Commission.

Table 10.2: Finance and Planning Commissions

	Finance Commission	Planning Commission
1.	It is temporary and appointed for every five years or even less.	It is a permanent body.
2.	Chairman is appointed for a term.	Prime Minister is the chairman.
3.	Makes devolution and grants-in-aid for non-plan purposes.	Provides resources for Plan purposes only.
4.	A non-political semi–judicious and independent agency.	A political body and an arm of the government.
5.	Provides non-plan or statutory grants under Article 275(1).	Provides plan or non- statutory grants under Article 282.

But slowly the Planning Commission has overtaken and overridden the Finance Commission. In other words, the Planning Commission has emerged as an important authority determining the scope and pattern of central assistance to States. Referring to this, the Third Finance Commission observed that: 'a general weakness of federal-state financial relations, more particularly in the field of devolution, is that the federal assistance tends to be discretionary in character, not necessarily on principles of uniform application. To safeguard the position of the States, our Constitution provides for the assessment of the needs of the states as well as the measure of assistance to be afforded and the form in which this should be given, be determined by an independent Commission……. But this role and function of the Finance Commission, as provided in the Constitution can no longer be realised fully due to the emergence of the Planning Commission as an apparatus for national planning'. Successive Finance Commissions also observed the overlapping roles of the two Commissions as both the agencies make separate assessments of the needs of the states. To rectify the situation, several States as well as economists have suggested either to widen the role of the Finance Commission (from the existing Non-Plan Revenue Account to both Revenue and Capital Accounts of the budgets of the state governments) or to transform the Planning Commission itself into Financial Commission. However, some of the Finance Commissions did not agree with the view of making the Finance Commission a permanent body. For instance, the Eighth Finance Commission opined that there is no such need and instead suggested to establish a secretariat on a permanent basis in the Ministry of Finance to extend assistance to the Finance Commissions. Notwithstanding the controversy regarding the relative roles of the two agencies, the gross transfers channelled through both these agencies (in absolute terms) have increased overtime. However, although the total quantum of fiscal transfers have been increasing, as a percentage of total receipts of the central government, the proportion has declined over the different plan periods. For instance, the resources transferred from the Centre to States as a proportion of

total expenditure of the States during 1951-52 to 1955-56 was as high as 42.7 per cent. But this percentage declined to around 30 per cent around 1970s (e.g. 1970-71: 31.5%). While it remained around the 30 percent share till the 1990s, it declined to below 30 percent level in the post-2000 years (e.g. 2000-01: 26.1%; 2004-05: 27.5%) . The trend indicates that the fiscal dependence of the states on the centre has been declining in relative terms although the total (gross) transfers have increased. It also might be indicative of the fact that the fiscal profligacy of the states have been improving.

The most important objective of fiscal transfers, however, is not only to reduce vertical and horizontal fiscal imbalance, but also to achieve horizontal equalisation across states. This depends largely on the criteria of inter se distribution of fiscal transfers (both by the Finance Commission and Planning Commission). So in what follows an account of the criteria of fiscal transfer followed by successive Finance Commissions and the Planning Commission is provided.

10.9 FISCAL TRANSFERS BY THE FINANCE COMMISSION

One of the first terms of reference of a Finance Commission is to recommend a percentage share of the shareable taxes and the principles or criteria of its distribution among the States. The two type of taxes, whose net proceeds are to be divided between the Union and the States according to Article 270 and 272 of the Constitution are, the Income tax (IT) and the Union Excise Duties (UEDs).

Trends in Percentage Share: With regard to Income Tax, by the time the First Finance Commission was appointed, 50 per cent of the net revenue had been assigned to the States. The First Finance Commission increased the States' share to 55 per cent and over the period the share reached 85 per cent. Sharing of Union Excise Duty revenue is possible only through an Act of Parliament. The First Finance Commission recommended that 40 per cent of the net proceeds of the duties on tobacco, matches and vegetable products be given to the States. Successive Finance Commissions not only increased the coverage of shareable excise duty items but also increased the states' share.

Criteria of distribution: The other important aspect is the criteria adopted by the successive Finance Commissions for the inter-state distribution of the revenue from Income Tax (IT) and Union Excise Duties (UEDs). For a long period, the 'population' factor was used for the distribution of the net revenue from Income Tax while a criteria of 'backwardness' was adopted for the distribution of net revenue from Union Excise Duties. The two different criteria adopted for the distribution of these two sources of revenue have been subjected to a lot of criticism. The main argument was that while the objective of transferring revenues to states by the Centre through shared tax revenue

is the same, there is no rationale for adopting two different criteria in case of IT and UEDs.

Alternative Scheme of Devolution: The Tenth Finance Commission made a significant departure from the then existing criteria by recommending 29 per cent of gross tax revenue of all taxes of the Central Government instead of a share from the two taxes of Income Tax and Union Excise Duties. This recommendation of devolution, known as ***Global sharing*** (meaning sharing of all taxes), was accepted by the Government of India in 2000 with a modification. The modification relates to the word 'net revenue' instead of 'gross revenue' as recommended by the 10th Finance Commission. The XI Finance Commission increased this share to 29.5 per cent while the XII Finance Commission further raised it to 30.5 per cent.

Grants-in-Aid: Article 275(1) deals with grants-in-aid. According to this Article, grant-in-aid are to be given to the States in need of assistance and the amount of grant-in-aid and the principles for judging the eligibility of states for these grants-in-aid are to be determined by the Finance Commission. These grants recommended by the Finance Commission are generally known as 'statutory grants' or 'non-plan grants'. Though the First Finance Commission stated a number of principles like (i) budgetary needs, (ii) tax effort, (iii) economy in expenditure, (iv) standards of special services, and (v) broad purposes of national importance, almost all the successive Finance Commissions followed a single criterion of 'budgetary needs' of the States. The grants given on the basis of budgetary needs are known as ***revenue-gap grants*** (or deficit grants). Besides the revenue-gap grants, several Finance Commissions have given grants for upgradation of essential social and administrative services. For instance, the 12th Finance Commission recommended grants for health and education, maintenance of roads and bridges, buildings, forests, heritage compensation, State specific needs, and calamity relief besides the traditional revenue gap grants. It was opined by several academics that the objective of horizontal equalisation could not be achieved by the award of grants-in-aid mainly because the Commissions did not take into account the net fiscal needs, but took into account only the budgetary needs.

Other Important Recommendations: Besides shared tax revenue and grants-in-aid, the successive Finance Commissions have been recommending various fiscal matters like calamity relief, debt relief and grants to local governments, etc. We will now take a brief look at each of these below.

Assistance for Calamity Relief: When States experience natural calamities they need to undertake relief operations incurring huge expenditure. The successive Finance Commissions have been extending financial assistance in the form of loans and grants. For instance, the Ninth Finance Commission adopted an innovative scheme in which a

Calamity Relief Fund (CRF) was to be established in each state to which Centre and States are to contribute in the ratio of 75:25. The Eleventh Finance Commission suggested establishment of a National Calamity Contingency Fund (NCCF) with a corpus of Rs. 500 Crores. A special levy had to be imposed and credited to this Fund whenever a national calamity of rare severity occurred. The NCCF continues under the Twelfth Finance Commission recommendations also.

Debt Relief: States have been reeling under debt burden for several decades during the plan period. Several Finance Commissions recommended debt relief in various forms like rescheduling, moratorium, etc. The Tenth Finance Commission recommended a scheme of debt relief linking it to fiscal performance in terms of reduction of revenue expenditure. The Eleventh and Twelfth Finance Commissions continued the debt relief scheme with some modifications, the main theme being reduction of revenue expenditure by the States.

Assistance to Local Bodies: The 73rd and 74th Constitution Amendment Acts envisage the Panchayats and Municipal bodies as institutions of self-government. Considering the need to transfer some resources to enable them to function more effectively, the Tenth Finance Commission, for the first time, recommended an amount of Rs. 1000 Crores, and Rs. 4000 Crores to Panchayats and municipalities, respectively. This grant amount was increased to Rs. 2000 Crores to Panchayats and Rs.5000 Crores to Municipal bodies by the Twelfth Finance Commission. These grants have contributed to improving the financial position of the local governments in India.

Ceiling on Aggregate Resources: For the first time, the Eleventh Finance Commission felt the need to put a cap on the total resources transferred to the states from the Centre on the ground that such a measure would help in encouraging the States to augment their own revenues. Suggesting that all transfers must be taken in their totality, it suggested a ceiling of 37.5 per cent on total resource transfer from the Centre to the States. The Twelfth Finance Commission slightly enhanced the ceiling to 38 per cent. The States were, however, critical of such a ceiling on the ground that it would inject fiscal inflexibility into the State finances.

Equalisation: It is important to know about the impact of Finance Commission transfers on equalisation. Equalisation here refers to both (i) vertical equalisation and (ii) horizontal equalisation. There are indications that the implementation of the Alternative Scheme of Resource Transfer, as recommended first by the X Finance Commission, and subsequently also by the XI and the XII Finance Commissions, has reduced the vertical fiscal imbalance considerably. However, the expected reduction in regard to horizontal fiscal equalisation has not been achieved. This is attributed to the undue weightage given to

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population factor and considering the 'budgetary needs' instead of the 'net fiscal needs' of States for transferring the shared tax revenue and the grants-in-aid to the states.

10.10 RESOURCE TRANSFER BY PLANNING COMMISSION

The Planning Commission has been transferring both plan grants and plan loans according a new dimension to the Indian fiscal federalism. The Planning Commission has been allocating grants and loans for: (i) state plan schemes, (ii) centrally sponsored schemes and (iii) central sector schemes. It transfers resources through itself as well as through different ministries or Departments. The loans and grants recommended through different ministries/grants are known as '***discretionary transfers***'. These transfers, also known as non-statutory transfers, have increased substantially over and above the Finance Commission transfers over the years. Thus, the Central government through the Planning Commission, has been influencing the development process at the state level.

10.10.1 Plan Assistance-State Plan Schemes

The Planning Commission has been providing budgetary resources to bridge the gap between the State-generated resources and the approved Plan outlay since the advent of Five Year Plans. There were no objective criteria to distribute the Plan assistance for State Plan Schemes until 1969. The Planning Commission used to approve the state Plan Schemes providing scheme-wise pre-determined loans and grants to states. This type of plan assistance provided by the Planning Commission was referred to as '***Schematic Pattern of Assistance***'. This pattern of assistance carried lot of arbitrariness failing to achieve the 'equalisation' objective. Consequent upon the demand by several States in the National Development Council in 1968, the Central Government constituted a committee under the chairmanship of D.R. Gadgil, the then Deputy Chairman of the Planning Commission, to evolve a objective criteria to distribute plan assistance among the states and Union Territories.

10.10.2 Gadgil Formula

The Gadgil Formula (Table 10.3) was adopted for the distribution of plan assistance for State Plan Schemes since the Fourth Five Year Plan (1969-70). The same formula was adopted for the Fifth, the Sixth and the Seventh Five Year Plans with minor modifications. A new formula was adopted since the Eighth Five Year Plan (known as the Mukherjee Formula: Table 10.3). The uniform application of the objective criteria for the distribution of plan assistance injected an element of equalisation in fiscal transfers in India.

Table 10.3: Objective Criteria for Determining Distribution of Plan Assistance

Gadgil Formula		Mukherjee Formula	
Criteria	**Weight (%)**	**Criteria**	**Weight (%)**
Population (1971)	60	Population	55
Per Capita Income	10	Per Capita Income	25
Tax Effort	10		
Continuing Commitments on Major & Medium Integerated Multi-purpose Projects (IMP)	10	Special Development Problems	15
Special Problems	10	Progress in Fiscal Management	5
IV, V, VI, & VII Five Year Plan and 1990-91 Annual Plans.		VIII, IX, X, & XI Five Year Plans.	

The Gadgil Formula was modified by withdrawing the 10% weightage given to the on- going schemes (i.e. continuing commitments) and adding it to the per capita income. This was further revised in October 1990 as 55 per cent for population, 25 per cent for per capita Income, 5 per cent for fiscal management and 15 per cent for special development problems. According to the Gadgil Formula the total plan assistance provided to a Non-Special Category State should be uniform in the loan-grant ratio of 70:30. Such a ratio, in the assistance amount provided to the special category states, was to be 90:10. Fiscal transfers through the Planning Commission since the adoption of the Gadgil Formula have become more equalising compared to the previous periods.

10.10.3 Centrally Sponsored Schemes

Besides the central assistance for State Plan Schemes, the central government has been providing loans and grants to Plan schemes known as 'Centrally Sponsored Schemes' and 'Central Sector Schemes'. These schemes are sponsored by the Central Ministries and hence the expenditure on these schemes is a part of the Central Plan for which provision is made in the Central Government Budget. The schemes are, however, implemented by the States because they are in the sectors of State competency. Programmes such as Drought Prone Area Programme, Small Farmers Development Agency, etc. are in this category. Over decades, the number of such schemes has increased to more than 200. The States have been demanding that these schemes should be limited to a small number and to most needed areas, and the resources thus saved should be placed in the general pool of central assistance for states. The increasing number of centrally sponsored schemes and Central Sector

Schemes have become one of the irritants in Centre–State fiscal relations in India.

The resources transferred through the Planning Commission for State Plan Schemes, for Central Sector Schemes and Centrally Sponsored Schemes have been increasing substantially over the plan periods. But the States prefer more resources transferred through the Finance Commission than through the Planning Commission as the former is more objective and equalising. It might, therefore, be preferable to channelise more resources, both for plan and non-plan purpose, through the statutory body – The Finance Commission – with the task of plan formulation and evaluation being left to the Planning Commission to focus upon.

Check Your Progress – 3

1. State the similarities and the distinguishing features between the Finance Commission and the Planning Commission.

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2. Write a note on the Alternative Scheme of Devolution of central taxes.

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3. What are the major components considered for assigning weights for determining the distribution of Plan assistance by the Planning Commission?

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10.11 LET US SUM UP

Devolution of powers and functions between the Central and sub-Central governments is inevitable in almost all the countries. The devolution, even when made on the basis of economic and scientific principles, lead to vertical and horizontal federal fiscal imbalances. Fiscal adjustment, to be achieved through shared tax revenue, grants and loans become necessary in all such cases for optimal realisation of developmental objectives through planning.

Visualising the need for federal fiscal transfers to reduce vertical and horizontal fiscal imbalances in India, the constitution-makers made provision for transferring resources from the Centre to the States. For this, they made provision for the setting up of a Finance Commission to make recommendations. Besides the Finance Commission, the Planning Commission, a non-statutory body, was also set up to allocate resources to the States. The resources determined and transferred through these Commissions have substantially contributed to reducing the vertical fiscal imbalance. However, horizontal equalisation has not been achieved to the extent desired. One reason for this is said to be the undue weightage given to the population factor. This has been rectified, in the transfer of resources by the Planning Commission, by giving prominence to other factors like per capita income, progress in fiscal management, special development problems, etc.

10.12 KEY WORDS

Fiscal Imbalance : Non-correspondence between revenue and expenditure of a government or across governments.

Vertical Fiscal Imbalance : Non-correspondence between revenue and expenditure commitments of the central government vis-à-vis the non-correspondence between revenue and expenditure commitments of the federating units put together.

Horizontal Fiscal Imbalance : Non-correspondence between revenue and expenditure commitments across state governments in a federation. This type of fiscal imbalance arises due to the differences in the endowment of natural resources, given the uniform revenue powers and expenditure responsibilities.

Divisible Pool : Also Known as Distributive Pool, it refers to a fixed percentage of net revenue from select identified taxes (or all taxes) pooled

for the purpose of distribution across the federating states on the basis of a criterion.

Grantor : A level of government providing grants to other level(s) of government.

Grantee : A level of government receiving grants from other level(s) of government.

Finance Commission : A statutory, independent, semi judicious non-political body to be set up by President of India for every five Years (or earlier) under Article 280 of the Constitution.

Planning Commission : A non-statutory agency constituted by the Central Government. Initially, set up to formulate and evaluate Five Year Plans, the commission has been transferring financial resources besides undertaking evaluation of progress in the implementation of projects/ schemes.

Gadgil Formula : A Formula named after D.R.Gadgil, the then Deputy Chairman of the Planning Commission. Central assistance for state Plan Schemes has been distributed among states since 1969-70 on the basis of this formula. Slight modifications were made subsequently.

Global Sharing : The Tenth Finance Commission in its 'Alternative Scheme' proposed a percentage share of gross revenue from all central government taxes instead of a share from Income Tax and Union Excise Duties alone. The Government accepted this recommendation and implemented by making an Amendment in the Constitution.

Calamity Relief Fund : It is a fund recommended by the Ninth Finance Commission with regard to financing of relief expenditure of states that arise due to natural calamities. The Fund will be at the disposal of the state governments. It is contributed by both the Centre and States in the ratio of 75:25. The fund is being continued since then till today.

10.13 SOME USEFUL BOOKS

Bhargava, R.N.: *The Theory and Working of Union Finance in India*, Chaitanya Publication House, Allahabad.

Lakdawala, D.T.: *Union-State Financial Relations*, Bombay, Lalwani Publications, 1977.

Thimmaiah, G: *Federal Fiscal Systems of Australia and India*, Associated Publications, New Delhi, 1976.

Sudarsana Rao, R: *Grants-in-Aid and Economic Development in India,* Chug Publications, 1986.

Singh, S.K.: *Public Finance in Theory and Practice*, S. Chand & Co.

Reports of Finance Commission, Govt. of India, New Delhi.

10.14 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress – 1

1. See Section10.2 and answer.
2. See Section 10.3 and answer.
3. See Section10.4.1 and answer.
4. See Section10.4.2 and answer.

Check Your Progress – 2

1. See Section 10.5.1 and answer.
2. See Section 10.5.2 and answer.

Check Your Progress – 3

1. See Section10.8 and answer.
2. See Section10.9 and answer.
3. See Section10.10.2 and answer.

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UNIT 11 TAXATION AND EXPENDITURE IN INDIA

Structure

11.0 Objectives

11.1 Introduction

11.2 Role of Fiscal System in Economic Development

11.2.1 Objectives of Budgetary Policy

11.2.2 Limitations of Budgetary Policy

11.3 Union Finances

11.3.1 Components of Union Budget

11.3.2 Concept of Deficit

11.3.3 Trends in Union Budget

11.4 State Finances

11.4.1 Results of Reform Measures

11.5 Local Finance

11.5.1 State of Finances

11.6 India's Tax Structure

11.6.1 Main Aspects of India's Tax Structure

11.6.2 Evaluation of the Tax System

11.7 Growth of Public Expenditure in India

11.7.1 Size of Public Expenditure

11.7.2 Classification of Public Expenditure

11.7.3 Causes of Growth in Public Expenditure

11.7.4 Need to Cut Public Expenditure

11.8 Public Debt in India

11.8.1 Growth of Public Debt

11.8.2 Problems of Public Debt

11.8.3 Evaluation of Debt Policy

11.9 Let Us Sum Up

11.10 Key Words

11.11 Some Useful Books

11.12 Answers or Hints to Check Your Progress Exercises

11.0 OBJECTIVES

After reading this unit, you will be able to:

- explain the role of fiscal system in the process of economic development vis-a-vis the objectives and limitations of budgetary policy;
- identify the different concepts of budgetary deficit and its importance;
- discuss the trends in union revenue and expenditure over the period of 1950s to 2008;
- explain the situation in regard to state and local finances;
- bring out the basic features of Indian tax structure making an evaluation of the same;
- outline the causes for rapid growth in public expenditure in India; and
- discuss the problems associated with public debt and the related policy framework.

11.1 INTRODUCTION

As reviewed in the preceding unit (unit-10), in the federal system of finance that obtains in India, three tiers of government operate with independent areas of responsibility and sources of revenue. These three tiers are (i) the Union government, (ii) the State government, and (iii) the Local government. In this unit, we first review the state of finances of each of these tiers of government. We then analyse the trends in their aggregate tax revenue and expenditure patterns. We finally make an evaluation of the trends of public debt and discuss the associated policy issues.

11.2 ROLE OF FISCAL SYSTEM IN ECONOMIC DEVELOPMENT

The essence of a fiscal system is contained in the management of finances of the State. This includes: (i) assessment of the requirements of the State's finances, (ii) modalities of raising revenue and (iii) supervision & control over the allocation of revenue and its efficient expenditure to realise the objectives of the State. Two major features of the fiscal system are therefore of: (a) raising revenue, and (b) incurring of expenditure by the government. The statements relating to these two are integrated in a document popularly known as the **budget**. A budget (whether of union or state or any other tier of government), shows the relationship between the estimated financial receipt (and actual receipt

for the previous year) and its disbursement (and actual expenditure for the previous year). The relationship is shown separately for the various departments/programmes/schemes of a government. A budget is therefore regarded as an important instrument of economic planning and policy.

11.2.1 Objectives of Budgetary Policy

In a developing economy, the budgetary policy (i.e. fiscal policy) has to perform an important role. Broadly, they are expected to achieve the following objectives:

i) promote the growth of the economy by making productive investment both in the public and the private sectors;

ii) mobilise maximum resources for investment keeping in view of the returns on those investments so as to ensure the growth of marginal and average rates of savings in the economy;

iii) promote a measure of economic stability needed to realise the maximum growth of the economy; and

iv) redistribute the national output to ensure balanced regional development.

11.2.1 Limitations of Budgetary Policy

A number of factors can be identified which limit the effectiveness of realising the budgetary policy objectives in a developing economy. Among these, the more important are:

a) the rigidity and narrowness of the base of the tax structure posing difficulties for the establishment of a well-knit and integrated tax policy framework;

b) the lack of a sound and reliable data base on income, expenditure, savings, investment, employment, etc. making it difficult for public authorities to formulate a rational and effective budgetary policy; and

c) a lack of administrative machinery required to collect the revenue and ensure its effective spending.

11.3 UNION FINANCES

In making an analysis of the finances of the Government, the annual budgets provide the required basis. In this section, we take a brief look at: (i) the components; (ii) the concepts of deficit in budgets; and (iii) the trends in the Union Budgets of India.

11.3.1 Components of Union Budget

The budget of the Central or Union Government is divided into two parts: (i) revenue budget (or account), and (ii) capital budget (account).

Revenue budget covers those items which are of a recurring nature.

Capital budget covers those items which are concerned with acquiring and disposal of capital assets. Each account has a receipts side and an expenditure side. **Receipts in** the revenue budget consist of those items that carry no repayment liability (e.g. tax revenue, revenue surpluses etc.). Receipts in the capital budget consist largely of internal and external borrowings net of repayment; they also include recovery of loans and advances and some other receipts such as by sale of assets.

On the expenditure side, revenue expenditure is divided into two categories: development expenditure (or plan expenditure) and non-development expenditure (or non-plan expenditure). Development expenditure consists of expenditure on social and community services such as education and health, and on economic services, such as agriculture, industry, power, transportation and communication. Non-development expenditure consists of expenditure on administration and defence, and also payment of interest on public debt. Broadly speaking, revenue expenditure is expenditure on maintenance of existing levels of services. Capital expenditure, on the other hand, is concerned with acquiring of capital assets i.e. for the expansion of the level of services. Ideal fiscal management requires that revenue surplus should be available to finance capital expenditure.

11.3.2 Concept of Deficit

There are three type of deficits in any budget viz. (i) Revenue deficit, (ii) Budgetary deficit, and (iii) Fiscal deficit.

Revenue deficit is the difference between the revenue receipts and the revenue expenditure.

Budgetary deficit is = (Revenue receipts + Capital receipts) - (Non-Plan expenditure + Plan expenditure).

Fiscal deficit = (Revenue receipts + Non-debt capital receipts) - Total expenditure (i.e. total of plan and non-plan expenditure). It indicates the total borrowing requirements of Government from other sources to meet the total estimated expenditures of the government.

Fiscal deficit is further split (or decomposed) into primary deficit and interest payments by Government. Primary deficit is also further split into revenue deficit and capital deficit. Primary deficit on revenue account would therefore equal revenue deficit less interest payments. Primary deficit on capital account would correspondingly equal capital expenditure less loan repayments.

These relationships can be brought out clearly with the help of the following data (Table 11.1) relating to the union budget for 2006-07 and 2008-09.

Table 11.1: Union Budget Data- 2006-07 & 2008-09

(Rs. Crores)

	2006-07	2008-09
1. Revenue Receipts	434,387	602,935
2. Tax Revenue	351,182	507,150
3. Non tax Revenue	83,205	95,785
4. Capital Receipts (5+6+7)	149,000	147,949
5. Recovery of Loans	5,893	4,497
6. Other Receipts	534	10,165
7. Borrowing & Other Liabilities	142,573	133,287
8. Total Receipts (1+4)	583,387	750,884
9. Non-Plan Expenditure	414,527	507,498
10. On Revenue Account of which	373,991	448,352
11. Interest Payments	150,272	190,807
12. On Capital Account	41,336	59,146
13. Plan Expenditure (14+15)	169,860	243,386
14. On Revenue Account	142,418	209,767
15. On Capital Account	27,442	33,619
16. Total Expenditure (9+13)	584,387	750,884
17. Revenue Expenditure (10+14)	516,409	658,119
18. Capital Expenditure (12+15)	68,778	92,765
19. Revenue Deficit (17-1)	82,022	55,184
20. Fiscal Deficit {16– (1+5+6)}	143,573	133,287
21. Primary Deficit (20-11)	-6,699	-57,520

Conventionally, government deficits have been measured in terms of budgetary deficits. But in recent times, the focus has shifted to fiscal deficits. The shift of focus to the fiscal deficit internationally is mainly due to the shift in emphasis on macroeconomic principles of fiscal management.

11.3.3 Trends in Union Budget

The trends in Union Budget for the period 1956 to 2008 are presented in Table 11.2. Measures of revenue and fiscal deficit expressed as

Table 11.2 : Overall Budgetary Position

(Rs. Crores)

	Deficit (-) or Surplus (+) under Revenue Account	Deficit (-) or Surplus (+) under Capital Account	Total Budgetary Deficit
II Plan (1956-61)	+220	-1,156	-936
III Plan (1961-66)	+1,018	-1,791	-773
Annual Plans (1966-69)	+413	-1,177	-764
IV Plan (1969-94)	+411	-2,433	-2022
V Plan (1974-79)	+2,672	-6,328	-3656
VI Plan (1980-85)	-9,158	-1,629	-10,787
VII Plan (1985-90)	-46,905	+9,557	-37,348
VIII Plan (1992-97)	-1,45,875	+1,07,680	-38,195
IX Plan (1997-02)	-3,87,704	+3,87,704	-
X Plan (2002-07)	-4,79,354	+4,79,354	-
2007-08	-63,488	+63,488	-
2008-09	-55,184	+55,184	-

Source: Union Budgets

percentage of GDP at current market prices for the period 1991-2008 are presented in Table 11.3. The broad trends flowing from the data therein are as follows:

1. Till the end of the 1970s (or the end of V plan period), the Union Government used to have larger surpluses under the revenue account (Table 11.1). In other words, the centre was reasonably successful in keeping the revenue expenditure under check, record a surplus in revenue account and use that surplus to support capital budget. The reversal of the trend since the early 1980s suggests that the centre has been unable to control the steep increase in conventional expenditure or a diversion of funds (i.e. non-developmental expenditure), which could have financed the creation of tangible assets via developmental expenditure.

2. Well till mid-1990s, the Government used to have a deficit on the capital account. But, since the mid-1980s, surpluses have appeared on the capital account (Table 11.2). The share of capital expenditure in the total expenditure has, however, declined from 37 percent during 1980-85 to 12.35 percent in 2008-09. This is due to declining revenue surpluses which has consistently decreased right through the VI Plan Period (1980-85 : Rs.- 9158 crores) to the X Plan Period (2202-07 : Rs. - 4,79,354 crores).

3. Revenue deficit as a proportion of fiscal deficit stood at 41.7% in 1990-91 (Table 11.3). It rose to 79.7 percent in 2003-04. Subsequently, this proportion came down to 62.4 percent in 2004-05 and continued to decline to reach the level of 44.3 percent in 2008-09. Thus, the fiscal deficits which were driven by large revenue deficits is showing an improvement with the continued decline of revenue deficit as a proportion of GDP since 2003-04.

Table 11.3: Measures of Deficit of the Central Government

(as percentage of GDP at current market prices)

Year	Revenue Deficit	Gross Fiscal Deficit	Cot. 2 as a% of Col.3
1	2	3	4
1990-91	3.47	8.33	41.7
1991-92	2.64	5.89	44.8
1992-93	2.63	5.69	46.2
1993-94	3.81	7.01	54.4
1994-95	3.07	5.71	53.8
1995-96	2.52	5.10	49.4
1996-97	2.40	4.90	49.0
1997-98	3.04	5.82	52.2
1998-99	3.82	6.47	59.0
1999-2000	3.46	5.36	64.6
2000-01	4.05	5.65	71.7
2001-02	4.40	6.19	71.1
2002-03	4.40	5.91	74.5
2003-04	3.57	4.48	79.7
2004-05	2.49	3.99	62.4
2005-06	2.58	4.09	63.1
2006-07	1.94	3.50	55.4
2007-08	1.52	3.30	46.1
2008-09	1.35	3.05	44.3

Source: Union Budgets

The above trends indicate a violation of the principles of sound public finance that 'consumption must be financed by current income'. Consumption financed through borrowing, while only postponing the inevitable adjustment, makes such consumption unsustainable in the long term.

Risks of High Fiscal Deficit: There are several risks with high fiscal deficits. These are:

a) Fiscal deficits, spilled over, could lead to macroeconomic instability particularly if the government resorts to deficit financing (i.e. borrowing beyond a limit and printing of new currency);

b) High fiscal deficits imperil national saving rates, thereby reducing overall aggregate investment. This further jeopardises the sustainability of high growth. Low levels of public investment renders poor physical infrastructure incompatible with large increases in national domestic product. Thus, without an increase in the scale and rate of growth of infrastructure investment, economic growth rates remain moderate as has been the experience with India;

c) The continuing large fiscal deficits, even if they do not spill over, lead to macro-economic instability in the short run requiring higher taxes to cover the burden of internal debt. High tax rates will place the country at a significant disadvantage relative to other fast-growing countries by reducing the competitive strength of the domestic producers;

d) Larger fiscal deficits have adverse effects on balance of payment (BoP) too. Aggregate excess demand representing a shortage of domestic supplies spills over as current account deficit (CAD). External loans raised to finance the CAD, ultimately leads to a BoP crisis; and

e) With large fiscal deficits, even an independent monetary management cannot sustain a low interest rate regime. This, therefore, impinges on a necessary condition for macroeconomic stability that 'real interest rate must be lower than the GDP growth rate'.

There is therefore an international consensus that the fiscal adjustment is the first and foremost task. How to achieve this is an aspect covered in the next unit (Unit 12) under the theme of 'fiscal reforms'.

Check Your Progress 1

1. Outline in brief the objectives of budgetary policy in a developing economy like India.

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2. What are the major components of Union Budget In India?

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3. Differentiate between different measures of deficit.

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4. Explain in brief the principal budgetary trends in India.

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11.4 STATE FINANCES

Like in the Union budgets, there has been a growing volume of revenue deficits in the State finances too. In response, the union and the state governments have together formulated a strategy to address the fiscal problems confronting the states. This strategy has taken the form of a package of ***'advance financial assistance'*** which is provided by the centre along with an appropriate time-bound programme of a ***'medium-term fiscal reform'*** to be undertaken by the concerned state. The time-bound programmes comprise specific measures aimed at promoting the following:

i) Reduction in non-plan revenue expenditure through appropriate measures by downsizing the staff strength of the government wherever possible;

ii) Introduce Pricing/subsidy reforms to reduce the fiscal burden of the state on the one hand and improving the allocative efficiency on the other;

iii) Introduce institutional reforms to improve the efficiency in the delivery of public services;

iv) Reduction in the role of Government from non-essential areas through decentralisation, disinvestment and privatisation;

v) An Incentive Fund to be created for incentivising the implementation of fiscal reforms in states;

vi) A model fiscal responsibility legislation at the state level was formulated which has since been implemented by most of the states. The model provides a broad framework leaving it to the discretion of the states to work out the specifics; and

vii) A debt swap scheme was introduced to enable the states to prepay high cost debt by introducing current small savings and open market loan initiatives.

11.4.1 Results of Reform Measures

There has been a dramatic turn-around in the state finances following the implementation of the reforms measure. The gross fiscal deficit of the states has come down from a high of 5.1 percent of GDP in 2003-04 to 2.1 percent in 2008-09. The revenue deficit too has been replaced by revenue surplus amounting to 0.54 percent of GDP in 2008-09, from a deficit of 2.6 percent in 2000-01. This is attributed to the incentive structure provided by the Twelfth Finance Commission as indicated in the time-bound measures above. In addition, there has also been a large inflow of small savings, tax devolution and, finance commission grants.

While the overall economic buoyancy improved due to the central transfers by way of tax sharing, the interest payment obligations declined due to the debt-swap scheme introduced. Most states have now agreed to mirror the centre's fiscal correction plan by putting in place their own fiscal responsibility targets.

11.5 LOCAL FINANCE

Local government bodies in India consist of various tiers of Panchayati Raj Institutions (PRIs) in rural areas and municipal bodies in urban areas. With the enactment of the 73rd and 74th Constitution Amendment Acts, local governments have attained the statutory status of the third tier of the federal structure. Their areas of responsibility have been respectively laid down, for the rural and urban local government, in the Schedules XI and XII of the Constitution.

11.5.1 State of Finances

The important sources of revenue of PRIs are: (i) house tax, professional tax, taxes on property and vehicles, etc.; (ii) fees from remunerative enterprises like markets, slaughter houses, etc.; and (iii) state grants and loans. Overall, PRI's finances have been in poor shape, so much so that they have not been in a position to discharge many of their obligatory functions like provision of safe drinking water, sanitation and conservancy.

The major sources of revenue for urban local bodies are tax-revenue (65%), grants-in-aid (25%), and non-tax revenue. Over the years, the dependence of local bodies on government grants has increased. Local governments are themselves partly responsible for this as they (i) have

failed to administer property tax and octroi levies, (ii) could not maximise revenue from potential sources, and (iii) have failed to raise revenue from user charges.

Check Your Progress 2

1. Enumerate, in brief, the objectives of reforms in state finances.

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2. Mention in brief the results of measures undertaken to bring about reforms in state finances.

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3. Discuss in brief the state of local finance in India.

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11.6 INDIA'S TAX STRUCTURE

The Indian tax structure, like in any other country, has developed in response to many influences - social, political and economic. In analysing the tax structure, it is therefore useful to first of all note the properties of an ideal tax structure, which are as follows:

i) The distribution of tax burden should be ***progressive***.

ii) The tax structure should facilitate the use of fiscal policy for achieving ***stabilisation*** and ***growth*** objectives.

iii) The tax structure should improve ***efficiency of the market*** rather than distort it.

iv) Tax policy should be ***easy to implement administratively*** with a low cost of collection of taxes.

11.6.1 Main Aspects of India's Tax Structure

The principal aspects of India's tax structure can be briefly enumerated as follows:

1. **Increasing importance of tax revenue:** The tax revenue collected both by the Central and state Governments have increased from Rs. 460 crore in 1951-52 to Rs. 10,17,107 crore in 2008-09 registering an average annual growth of 13.9 percent (over the 59 years period). There has thus been a significant increase in tax revenue. However, looked at another way, the tax revenue which formed 88.6 percent of the total revenue receipts in 1951-52 declined to 84.1 percent in 2008-09. Two possible inferences that can be drawn from these figures are:

   a) The Central and State governments have been relying less on tax revenue to finance their expenditure; or

   b) Revenue from non-tax sources has been increasing at a faster rate.

The second of the above two inferences looks more plausible because, as noted above, the amount of taxes collected by the Central and State governments have risen appreciably over the years. Further, as stated below, the tax revenue as a percentage of national income has also been consistently rising.

2. **Tax revenue as a percentage of national income:** The total tax revenue as a percentage of GDP, has increased from 6.7% in 1950-51 to 19.2% in 2008-09. Although this is a good growth, this can be contrasted to the tax GDP ratio of developed countries which ranges between 25 and 45 percent. Again, while it is likely to give the impression that our tax effort is relatively low, it should not be ignored that in a low-income country like India, a tax GDP ratio of about 20 percent imposes quite a heavy burden on the majority of population. To understand this, we need to take a look at the 'structure of taxes' which is outlined below.

3. **Structure of Taxes:** These are classified into two types, viz. (i) direct taxes and (ii) indirect taxes. Direct taxes include taxes on income and property, whereas indirect taxes cover taxes on commodities and services. Important direct taxes are income tax, corporate tax and wealth tax. Important examples of indirect tax are VAT, service tax, excise duties, import duties, etc. Over the years, India's tax structure had come to rely more on indirect taxation. The underlying rationale was that since it is difficult to reach all the individuals, the alternative of pursuing a broad based indirect tax is preferable. However, following measures initiated in the direction of rationalisation and simplification of the tax structure, there has been a decline in the proportion of indirect taxes in the country. The trend has revealed that lower tax rates are compatible with higher tax realisation, given better tax administration and compliance.

4. **Shift in Relative Importance of Taxes:** As a consequence of the fact that indirect taxation had been increasing till the onset of 1990s, there occurred a shift in the relative importance of different taxes. For instance, corporate and income taxes which were the major source of the Union revenue during early 1950s, yielded place to excise duties and customs duties. Similarly, in the State tax structure, sales tax replaced land revenue as the major source of state revenue. The increasing importance of excise revenue and sales tax reflected the favourable changes in the economy following the progress on industrialisation and export promotion fronts. Other contributory factors for the relative shift in tax structure are: (i) the rise in domestic production and prices and (ii) extension of the tax coverage. While these developments took place up to the 1980s, with the onset of the reform in the 1990s, the relative importance of different taxes has been undergoing changes once again. For instance, the significance of personal income tax and corporate tax have been on the rise, whereas that of the customs and excise duties are on the decline.

5. **Progressive Tax Rate Structure:** The tax structure has been designed in such a manner that all *relevant ability indices* are considered. In particular, the direct tax structure has been made progressive by ensuring that as the base grows the yield will also increase. There has, therefore, been a gradual move towards presumptive methods of taxation in which factors like: (i) emergence of a service oriented economy, (ii) proliferation of small businesses, (iii) rapid industrialisation, (iv) increase in the number of taxpayers and, above all, (v) the need to device ways and means which could ensure revenue flows without much strain on the administrative set up are given due recognition. In the field of indirect taxes, on the other hand, duties have been so levied that commodities which are consumed by the relatively well-to-do classes are taxed more.

Taxation has thus been used as one of the main instruments to achieve the different socio-economic objectives of the country.

11.6.2 Evaluation of the Tax System

Evaluation of Indian tax system can be made along the following four criteria which are necessary to sub-serve the objectives of planned economic development: (1) adequacy and productivity, (2) efficiency, (3) equity, and (4) certainty.

1. **Adequacy and productivity:** Contrary to the earlier phase, tax system has exhibited a good deal of buoyancy in recent years. The tax revenue has been continuously increasing along with an increase in national income. However, the increase in tax revenue has not been adequate enough to meet the growing requirements of the developing economy.

2. **Efficiency:** Indian tax system falls short of the criterion of efficiency.

On account of complicated laws and rapid changes in their provisions, the tax system has lost the qualities of simplicity and certainty. As a result, on the one hand, this has led to massive tax evasion and avoidance. This has generated massive black money which, in turn, has given rise to serious distortions in the economic and socio-political set-up. On the other, the taxpayers have to incur high costs in paying up taxes.

3. **Equity:** Our tax system also falls short of the criterion of equity. Although our direct taxes are highly progressive, undue reliance on indirect taxes has more than counter-balanced that effect. Leaving agricultural income out of the tax net has been a source of additional inequity. Likewise, the proliferating unorganised industrial sector is providing complete tax haven.

4. **Certainty:** The scheme of taxes in India has been considerably fluctuating, resulting in frequent tampering with tax exemptions, incentives and concessions leading to uncertainty. Even the goals of taxation have been changing. For instance, at one time the goal was to have a large number of taxes, so as to widen the tax base, whereas currently, the goal is to reduce the multiplicity of taxes and duplicity of the laws. Again, at one stage, indirect taxes on commodity inputs were not only levied more but also extended widely. Presently, however, the goal of indirect taxes is to avoid the cascading effects of taxes. A more fundamental change in the tax perspective is the emphasis in the recent years on thrift, productivity and wealth accumulation as compared to the almost single most important goal of 'avoidance of concentration of income and wealth' pursued in earlier years. Adhocism pervades the sector of corporate taxation also. Although the reasons behind the changes are quite often laudable, the policy of frequent and sudden changes in taxes ought to give way to certainty so as to have stability in the tax administration system.

In short, many provisions in the tax laws have become redundant and need to be in tandem with the liberalised economic policies. In the current scenario, as suggested by Raja J. Chelliah, India's tax structure should be based on three cardinal principles; the tax system should be simple, moderate and fair. (For tax reforms in India, readers are guided to unit-12 of the course).

Check Your Progress 3

1. Enumerate in brief the salient features of Indian tax structure.

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2. Write a note on the structure of taxes in the Indian taxation system.

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3. Make a critical assessment, in brief, of India's tax structure.

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11.7 GROWTH OF PUBLIC EXPENDITURE IN INDIA

As stated earlier, India has a federal system of finance in which duties and functions of the central and state governments have been clearly distinguished. The constituents of the federal structure have been empowered to incur expenditure on the functions falling under their purview.

An analysis of the growth of public expenditure can be properly done under two headings: (i) size, and (ii) classification.

11.7.1 Size of Public Expenditure

The size of public expenditure in India i.e. the total expenditure of the central and state governments has grown from Rs. 983 crores in 1950-51 to Rs. 14,85,535 crore in 2008-09 or at an average annual growth rate of 13.5%. The growth of public expenditure has been at almost the same pace as that of revenue generation which also had grown at an average annual rate of 13.9% per annum over the period. Of course, all of this increase cannot be regarded as real, as a good part of it would be due to the rise in prices. But even if an adjustment is made for the rise in prices the fact remains that there has been a phenomenal increase in public expenditure. This fact can also be brought out in another way i.e. by relating public expenditure to GDP. Whereas GDP has increased at an annual average rate of about 4.2 percent during this period, the proportion of public expenditure in national income has gone up from 11.1 percent in 1950-51 to 28.0 percent in 2008-09. Compared to an average of 40 percent in public expenditure in industrialised market economies, once again, India's proportion of public expenditure is still low.

Plan Expenditure and Non-Plan Expenditure: The budgeted expenditure in a year is split into two parts, viz. (a) plan expenditure, and (b) non-plan expenditure.

Plan expenditure consists of budgetary provisions for schemes and programmes that have been included in the five-year plans in which the financial allocations between different heads are made on a five-yearly basis. Within the broad parameters of budgetary provision, annual allocations are made for different schemes and programmes.

Non-plan expenditure on the other hand, is a generic term which includes both developmental and non-developmental expenditure. Part of the expenditure is obligatory in nature e.g. interest payments, pensionary charges and statutory transfers to states. Part of the expenditure is on account of certain essential obligations of a state e.g. defence and internal security. Expenditure on maintaining the assets created in previous plans is also treated as non-plan expenditure. Likewise, expenditure on continuing services and activities from levels already reached in a plan period is shifted to non-plan in the next period e.g. expenditure on education and health services, continuing research projects, operating expenses of power stations, etc. Thus, as more plans are completed, a large amount of expenditure on their operation and maintenance of facilities and services created gets added to non-plan expenditure besides the interest on government borrowings to finance the plan. Therefore, as the plan size grows, expenditure under the non-plan category also grows. For instance, the non-plan expenditure of the Central Government amounting to Rs. 76,933 crore in 1990-91, increased to Rs. 5,07,498 crore during 2008-09. However, as a proportion of total expenditure, non-plan expenditure came down to 67.1 percent in 2008-09 from the 73.1 percent in 1990-91.

Non-plan expenditure has been the focus of considerable criticism from many quarters. Though much of the criticism comes from the premise that the non-plan expenditure is maintenance centred and to that extent not adding to further productive asset base, a more detailed study of non-plan expenditure shows that many of its constituent items are vital for the long-term development and social goals of the economy. The non-plan outlay may on analysis be therefore found to be as significant to the achievements of the plan as the plan outlay itself.

11.7.2 Classification of Public Expenditure

Public expenditure both at the centre and states can be classified into two categories, viz. (1) developmental expenditure, and (2) non-developmental expenditure.

Central expenditure: Developmental expenditure of the central government includes expenditure incurred under such heads as social and community services, economic services, grants-in-aid to states and Union Territory governments for developmental expenses. Non-

developmental expenditure of the central government includes expenditure incurred on defence, interest payments, etc.

State expenditure: Developmental expenditure of the state governments also include expenditure incurred on social and community services, and economic services. Non-developmental expenditure includes expenditure incurred under such heads as administrative services, fiscal services, appropriation to reserves, interest payments, pensions, etc.

The proportion of developmental expenditure in total public expenditure has shown a significant increase over the years. In 1950-51, developmental expenditure formed 36 percent of the total expenditure. In 2008-09, this proportion was estimated as 56 percent. This indicates the growing participation of the State in developmental activities of the economy. It should, however, be noted that the developmental schemes figure both under revenue and capital budgets. Although a larger proportion of developmental expenditure comes under capital budget, some parts of revenue budget such as subsidies do not directly pertain to developmental purposes although their indirect effects on development cannot be underrated.

11.7.3 Causes of Growth in Public Expenditure

The continuously rising public expenditure can be explained in terms of the Wagner's Law. According to the Wagner's law (hypothesised and empirically verified about 100 years ago by Adolph Wagner), there exists a causal relationship between government expenditure and economic development. The law specifies that: 'during the course of economic development, government expenditure increases more than proportionately with per capita community output'. In other words, the income elasticity of demand for government expenditure is more than one. The underlying explanation is that the very growth of the economy gives rise to such complexities that the government has to incur increasing expenditure to deal with them. Wagner distinguished three types of activities which cause an increase in government expenditure. These are:

i) Maintenance and enforcement of internal law and order;

ii) Participation in material production; and

iii) Provision of social services.

Each one of the above pushes up the expenditure for different reasons. The **first** one increases expenditure because government has to ensure the maintenance and improvement of the quality of services it provides. The **second** one increases expenditure because government has to create a climate conducive to economic growth by entering into material production which private sector would not undertake on its own. The **third** one pushes up expenditure because government alone has the ability to provide such services satisfactorily.

In addition, more recent research in this area has identified other factors like demographic changes, higher income elasticity of public goods, increasing cost of government production, etc. as responsible for growing public expenditure of the government.

All the above mentioned factors are interrelated suggesting that the sphere of government activity in developing economies like India is rising. The type of the mixed economy that India has adopted has opened up multiple avenues of government action ranging from direct participation in production (as an entrepreneur) to the exercise of regulatory and promotional measures (via taxes and subsidies). The objective of these activities would, therefore, range from the provision of social overhead capital to achieving of social and economic equality in the economy.

11.7.4 Need to Cut Public Expenditure

The ongoing reforms in the Indian economy underscore the need for scaling down the fiscal deficit. Theoretically, fiscal deficit can be reduced either by increasing revenues (i.e. the rate of growth of revenue generated) or by reducing government expenditures. In the present context, most of the reduction has to be achieved though the reduction of expenditure as the 'tax to GDP ratio' has already reached such a high level that it may not be desirable to raise it further.

The progress on this front in India has, however, not been encouraging as revealed by the facts that: (i) the government expenditure as a proportion of GDP has shown little change in the post-reform period, and (ii) the composition of spending is still skewed towards unproductive expenditures. Slow progress on both these fronts has rendered the task of maintaining macroeconomic stability more complicated.

11.8 PUBLIC DEBT IN INDIA

Among the non-tax sources the major source of government revenue is public debt. As per the current budgetary practices, there are three sets of liabilities which constitute central government public debt, viz. (1) internal debt, (2) external debt, and (3) other liabilities. The three sets of liabilities are as follows:

1. **Internal debt:** The internal debt is classified into: (a) market loans, (b) other long and medium term borrowings, and (c) short-term borrowings all of which are shown under the receipts side of the central budget. They include special securities and T-bills issued to RBI, state governments, commercial banks and other financial institutions.

2. **External debt:** Represents loans received from foreign government and bodies.

   Both the internal and external debt are secured under a fund called as the Consolidated Fund of India.

3. **Other Liabilities:** Includes other interest bearing obligations of the government such as: (i) post office savings deposits under small savings schemes, loans raised through post office cash certificates, etc. (ii) provident funds, (iii) interest bearing reserve funds of departments like railways and telecommunications, etc.

The obligations of 'other liabilities' are met by the Public Account, just as the internal and external debts are secured under the Consolidated Fund.

11.8.1 Growth of Public Debt

As a means of financing, the Government of India has made a liberal use of borrowing, both internal and external, as can be seen from Table 11.4. The figures of total indebtedness and its components are of staggering magnitude. But far more important than the magnitudes are the rate at which they are growing (12.5 percent average annual growth for total debt). Public debt as a proportion of national income has increased from 12 percent in 1980-81 to 42 percent in 2008-09.

Table 11.4: Public Debt of the Government of India (As at the end of the year)

(Rs. in Crores)

Year	Internal Debt	External Debt	Total Public Debt
1950-51	2,022	32	2,054
1960-61	3,978	761	4,739
1980-81	30,864	13,479	44,343
1990-91	2,83,033	31,525	3,14,558
2000-01	8,03,697	65,945	8,69,642
2008-09	19,72,532	11,23,675	20,95,207

11.8.2 Problems of Public Debt

The growing size of public debt in India has given rise to the problem of debt management. The important objectives of debt management in the context of planned development of Indian economy are as follows:

1. Promote savings and provide more funds for investment in the public sector without impinging on the private sector's need for funds; and

2. Ensure large borrowing and other debt requirement without sacrificing the objective of price stability.

The first objective requires a debt policy capable of tapping funds from all possible sources in the economy. Varied instruments of resource mobilisation should be employed to suit the requirements of different types of savers/investors. The policy should be flexible so as to offer

terms, such as the interest rates and maturities, suitable to the conditions prevailing in the money and the capital markets.

The second objective requires that the loan operations of the government should support the objective of maintaining the price stability in the economy. In other words, these operations should have the aim of minimising the incidence of inflation.

11.8.3 Evaluation of Debt Policy

Government of India's debt policy can be evaluated on the basis of the two objectives defined above. The public debt policy has been successful in terms of the first objective as evidenced by the growth of public debt which has contributed to the resource availability of the government to meet its plan and non-plan expenditures. This is all the more creditable in view of the limited sphere of organised money market, an all-round scarcity of funds and competing claims for these funds by both the public and private sectors. It is, therefore, a commendable achievement that along with the dated loans, quite a good contribution has been made by the small savings sector.

In terms of the second objective, the policy has exhibited certain weaknesses. The rate of return on public debt has been quite low. Though this has helped the government in keeping the interest rate in check, it has prevented the expansion of the government securities market. The phenomenon has added to the inflationary pressures in the economy, making the investment in government securities less attractive. For a public debt policy to be anti-inflationary, contribution to the public debt should come from genuine savings adding to the productive capacity of the economy.

Check Your Progress 4

1. Distinguish between plan expenditure and non-plan expenditure.

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2. Distinguish between developmental expenditure and non-developmental expenditure.

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3. Examine in brief the trends in public debt in India.

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11.9 LET US SUM UP

Two major functions of a fiscal system are: (a) raising of revenue, and (b) incurring of expenditure by the government. In a federal system of governance, different governments operate at different levels. India's Constitution provides for (i) a union government, (ii) governments at state level, and (iii) local authorities. The state of finances at different levels of government has been precarious, resulting in fiscal imbalances and other distortions in the economy. Tax revenues have failed to keep pace with the ever-rising expenditure requirements of the government. There is an imperative need to bring speedy reforms in the fiscal administration of the country. This is the theme to which the subsequent unit of the course (unit 12) addresses.

11.10 KEY WORDS

Budget : Shows the relationship between estimated financial receipt and expenditure (i.e. its disbursement)

Revenue Budget : Covers those items which are of a recurring nature

Capital Budget : Covers those items relating to acquiring and disposal of capital assests

Revenue Deficit : Is the difference between the revenue receipts and revenue expenditure

Fiscal Deficit : Indicates the total borrowing requirements of government from other sources to meet the total expenditure requirements of the government

11.11 SOME USEFUL BOOKS

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Ishwar C. Dhingra, *The Indian Economy–Environment and Policy*, Sultan Chand, 2009.

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11.12 ANSWERS OR HINTS TO CHECK YOUR PROGESS EXERCISES

Check Your Progress 1

1. See Sub-section 11.2.1 and answer.
2. See Sub-section 11.2.2 and answer.
3. See Sub-section 11.3.2 and answer.
4. See Sub-section 11.3.3 and answer.

Check Your Progress 2

1. See Sub-section 11.4.1 and answer.
2. See Sub-section 11.4.1 and answer.
3. See Sub-section 11.5.1 and answer.

Check Your Progress 3

1. See Sub-section 11.6.1 and answer.
2. See Sub-section 11.6.1 and answer.
3. See Sub-section 11.6.2 and answer.

Check Your Progress 4

1. See Sub-section 11.7.1 and answer.
2. See Sub-section 11.7.2 and answer.
3. See Sub-section 11.8.1 and answer.

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UNIT 12 FISCAL REFORMS

Structure

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12.0 OBJECTIVES

After reading this unit, you will be in a position to

- explain the situation which warranted the implementation of fiscal reform measures in the Indian economy;
- discuss the various initiatives of the government by way of important commissions set up and implementing their recommendations;
- explain the importance of prudent expenditure management in maintaining fiscal balance;
- discuss the provisions of Fiscal Responsibility and Budget Management Act, 2004;

- explain the relevance of matching budgetary outlays with their effective implementation or outcomes; and
- discuss the fiscal reform initiatives of the state governments in India.

12.1 INTRODUCTION

The term 'fiscal' refers to government revenues especially those raised by levying taxes. The term 'reforms' refers to strong rectification measures needed for restoring the balance in any situation which ordinarily does not respond to 'normal measures'. 'Fiscal reforms', thus, refers to the changes in the fiscal sphere brought about by the fiscal policies of the government. The fiscal policy is concerned with the revenue and expenditure policies of the government. The objective of fiscal policy is to use the same as the principal instrument to promote the aggregate demand for goods and services in the economy. The important fiscal instruments are taxes, government expenditure, public debt and subsidies.

You are aware that government expenditure in several sectors of the economy, particularly in the social sectors like education and health, are vital for the development of the economy. Also, in the context of a developing country with significant proportions of the population belonging to the poor and weaker sections, it becomes necessary for the government to subsidise many essential goods and services. In discharging these responsibilities, the government will be effectively aided if the revenues generated by the government are able to establish a healthy balance with its expenditure obligations involved in providing different services. However, when this balance is disturbed, due to what is called as 'fiscal profligacy', the anomalies that sets-in leads to a situation of 'fiscal imbalance'. The present unit deals with the situation faced by the Indian government, in the early 1990s, which warranted the implementation of 'fiscal reforms' in order to restore its fiscal health. In order to appreciate the issues involved, we will begin by familiarising ourselves with the meaning of some important concepts used in this context.

12.2 CONCEPTS AND DEFINITIONS

In the context of fiscal reforms for establishing macro economic stabilisation, controlling *key deficit variables* assumes importance. We will familiarise ourselves with the various deficit indicators and understand their implications.

FISCAL DEFICIT: It is the difference between the total government expenditure and total revenues and non-debt capital receipts. It is a measure of the total resource gap – i.e. the excess of total government expenditure over its revenue receipts and grants. This is thus a measure of the government's indebtedness. This measure of deficit has been adopted by the IMF as the Principal Policy Target, in evaluating the performance of countries seeking assistance.

REVENUE DEFICIT: It is the difference between revenue expenditure and current revenues. Thus, a Revenue Deficit arises, if revenue expenditure exceeds current revenues. It is measured to ascertain whether the recurrent expenditure of the government on account of public consumption and current transfers are fully met out of current revenues.

BUDGET DEFICIT: It is the difference between all receipts and all expenditure (both revenue and capital).

PRIMARY DEFICIT: This is equal to fiscal deficit minus interest payments.

MONETISED DEFICIT: Important from the policy point of view, monetised deficit tells us the increase in Net RBI Credit to the Central Government. The overall budgetary deficit derived in the budget does not accurately reflect the size of the monetised deficit. The monetised deficit indicates the quantum of additional money created as a consequence of credit extended to governments.

We will now proceed to examine the fiscal situation which came to prevail in the Indian economy rendering implementation of reforms imperative.

12.3 FISCAL SITUATION BEFORE REFORMS

The need for tax reform was considered even during the 1950s. From 1950s to 1990s, a number of Committees and Commissions were set up to suggest tax reforms aimed at reducing tax evasion and augment government revenues. However, the implementation of these recommendations was adhoc. Also, until the beginning of 1980s, the overall fiscal situation was under control with low revenue deficits and marginal overall fiscal deficits. But during the 1980s, the fiscal situation steadily deteriorated. In 1984-85, the overall fiscal deficit touched 7.7% of the GDP. It marginally increased to 7.8% in 1989-90 reaching a further high of 8.3% in 1990-91. The rising fiscal deficits and the monetisation (i.e. borrowing from the RBI which leads to creation of more or additional money) of a substantial part of it, led to inflationary pressures and to growing deficit in the current account of the balance of payments. In order to understand how this happened we must first know the relationship between the current account deficit and the balance of payment deficit.

The current account shows the external trade position of a country. It comprises of two sub accounts viz. the exports/imports of goods and the exports/imports of invisibles. The invisibles include: services, remittances and investment income. If imports of goods exceed exports, there will be a trade deficit. The trade deficit can be covered by the service inflows. However, if the service inflows are less than the trade deficit there will be *current account deficit* (in the balance of payments).

Thus, a current account deficit in the balance of payments of a country represents the extent of net liability of the country to the rest of the world. The relationship between the two deficits i.e. the fiscal deficit and the current account balance of payments deficit can be expressed in the form of a economy wide *financial balance identity* as follows.

Current Account Deficit = Income - (Consumption + Investment + Govt. Expenditure)

= Fiscal Deficit + (Private Saving – Investment Gap)

In symbols we can write the above as: $\mathbf{X - M = Y - (C + I + G)}$
$\mathbf{= (T - G) + (S - I)}$

where X stands for exports, M stands for imports, Y stands for National Income, C stands for total consumption, I stands for total investment, G stands for total government expenditure, (T – G) stands for total revenue collected by taxes less total governmental expenditure incurred and S stands for total savings in the economy.

The economic condition in the Indian economy resulting from the growing fiscal deficits on the one hand and the current account deficit in the balance of payments on the other, led to a serious balance of payments crisis towards the end of 1980s. Further, increasing revenue deficits (which had touched 3.5% of GDP by 1990-91) necessitated a substantial amount of borrowing for meeting the revenue expenditure. This resulted in increasing addition to unproductive debt with the interest burden on the general budget beginning to increase significantly. Though the central government tried to raise resources through taxation to meet the situation, it was not enough. The borrowing requirements of the government continued to increase with 25% of the overall fiscal deficit being met through the RBI route.

A serious implication of fiscal deficits was thus the mounting debt burden, particularly the external debt. Interest payments constituted about 24% of the total expenditure of the central government in the early years of 1980s. Total outstanding debt of the central government stood at 59.5% of GDP in 1989-90. The problem of debt burden had thus assumed a critical proportion by the end of 1980s. The fiscal situation prevalent at the beginning of 1990s, was thus characterised by sustained high fiscal deficits and mounting debt accumulation giving rise to inflation, financial repression and overall deterioration of the macro economic fundamentals of the economy. Plagued by these situations, and in consequence thereof, the Indian economy in 1990-91 was characterised by the following features:

a) High inflation –16.7% in August, 1991.

b) High interest rates.

c) Large fiscal deficits – 8.3% of GDP.

d) Higher trade tariffs – import duties ranging from 75% to 350%.

e) Control of capital inflows and outflows.

f) High subsidies – (amounting to 2% of GDP or 10.2% of government expenditure with growing non-plan expenditure).

g) Higher Current Account Deficit – 2.6% of GDP.

h) Very low foreign exchange reserves, enough only to cover one weeks' imports.

i) Large internal and external debts.

The situation called for immediate correction highlighting the need for economic reforms. This forced the government to recognise the need for swift and radical changes in the fiscal system, not only to bring about macro economic stability but also to lay the foundation for a long term Structural Reforms (or Adjustment) Programme.

12.4 FISCAL DEFICIT AND FISCAL REFORMS

The economic crisis described above emphasised the need for adopting economic reforms in general and fiscal reforms in particular. A broad ranging programme of economic reforms were initiated in June/July 1991 to tide over the crisis. The observation of World Development Report (1988) is relevant in this regard: 'a prudent fiscal policy can be defined as one that maintains the fiscal deficit at a level that is consistent with other macro economic objectives viz. controlling inflation, promoting private investments and maintaining external credit worthiness'. A programme of fiscal consolidation to achieve the desired goals should therefore focus on reducing fiscal deficit to a sustainable level. The principal challenge was, therefore, to reduce fiscal deficit. In the light of this emphasis laid on reduction in fiscal deficit, it is timely to know the dangers of high fiscal deficits. These are:

i) The need for reducing fiscal deficit rests on the issue of sustainability. This is because fiscal deficits can be financed by borrowing either from domestic sources or external sources. Each of these methods, if carried out beyond a point, can lead to a crisis. Printing of money, over and above the demand for money leads to inflation. Financing fiscal deficits by borrowing becomes unsustainable if the *interest rate exceeds the GDP growth rate*. In such a case, the economy may end up in debt trap.

ii) Even if high fiscal deficits are sustainable, they may *crowd out* investment, thereby affecting growth. Hence high fiscal deficits are not desirable, even though they may be sustainable.

iii) High fiscal deficits significantly reduce the scope for flexibility in policy. Since deficits have to be eventually corrected, they may lead to high tax regime, and/or reduction in government expenditures, affecting incentives.

Thus, fiscal deficits are detrimental to growth as they:

i) Crowd out private investment;

ii) Set-in inflationary pressures;

iii) Increases foreign indebtedness and

iv) Raise externality risk.

The above factors therefore emphasise the need for fiscal prudence. The quality of fiscal adjustment is equally important in the sense that the deficit should be reduced by *raising public savings and not by reducing public investment.* Public savings should be raised gradually and consistently along with protection of social expenditure and improvement in the efficiency of the tax structure. Fiscal consolidation thus means stress on domestic resource mobilisation of which taxation is an important component. Therefore, the policy instruments for fiscal correction and reduction of fiscal deficits are to focus dually on: i) *tax reforms* to increase revenues and ii) *expenditure reforms* to improve the efficiency of public expenditure. We will therefore first focus on Tax Reforms.

12.5 TAX REFORMS

Tax reforms are an important component of fiscal consolidation. As budding economists, you would have by now recognised the importance of tax reform in relation to both fiscal stabilisation and structural adjustment. Fiscal stabilisation, in the ultimate analysis, can be achieved only through a buoyant revenue system. Increase in the productive efficiency and lowering of costs, which are the central objectives of tax reform programme, hinge on the characteristics of the tax structure to a significant extent. The Government set up a high powered committee in August, 1991, under the chairmanship of Dr. Raja J. Chelliah, a noted Public Finance Expert, to make recommendations for a comprehensive reform of the system of central taxes. It was called the Tax Reforms Committee.

12.5.1 Chellaiah's Tax Reforms Committee, 1991

The tax reforms committee (TRC) was tasked to examine the existing tax structure in the country and make appropriate recommendations to reform in order to make the system fair, broad based, elastic and more tax compliant. The TRC identified its approach thus: 'as is well known, the best results in terms of compliance, efficiency and equity are obtained through a system of incorporating moderate rates on a broad base'. The

main approach of the committee was therefore to make the tax system simple, efficient and transparent and at the same time productive in terms of revenue generation. The committee also felt that a good tax system was one which brings most revenue to the Government by way of *direct taxes*. As for indirect tax, taking simplicity and transparency into account, the committee desired a system of taxation that was based on value added at every stage.

The TRC advocated the adoption of a limited number of simple broad based taxes with moderate and limited number of rates and with very few exemptions and deductions. In reforming the country's tax system, the TRC observed that the alarming scale of tax evasion in India was due to ***high tax rates, complex procedures of filing returns, administrative lapses, inefficiency and corruption***. With this approach, the TRC made recommendations for the reform of Direct Tax and Indirect taxes in the country as follows.

Recommendations of TRC: Direct Taxes

In formulating its proposals for reforming direct taxes, the TRC's approach was to build a fairly simple structure with:

1) Reasonable tax rates;

2) Progressive Tax rates, yet not leading to tax evasion and not adversely affecting the desire to work, save and invest; and

3) Easy to enforce.

The most important tax recommendations of the Committee are that in order to make the country's direct tax system more effective, it is necessary that tax rates are reduced in respect of all taxes. With this in view, the recommendations of the TRC relating to direct taxes were as follows.

Personal Income Tax

i) The Committee recommended a reduction in the top marginal rate to 40% and adoption of a 3-tier slab system with an entry rate of 20% and a top rate of 40% (i.e. 20%, 30% and 40%).

ii) Aggregation of minor's income, other than wage income, with the income of the parents.

iii) Abolition of tax concessions, rebates and allowances, under various incentives for saving schemes.

Wealth Tax: The TRC opined that the Wealth tax has failed to achieve any of its objectives i.e. reducing inequalities and helping the enforcement of income tax through cross checks thereby preventing further concentration of economic power. It therefore recommended

the abolition of wealth tax on productive assets. Only unproductive assets and socially undesirable forms of wealth was recommended to be taxed.

Capital Gains Tax: The TRC suggested a moderate flat tax rate on long term capital gains after due indexation for inflation.

Corporate Income Tax: The TRC recommended that the rate of tax be fixed at the same level as the top marginal rate of personal income tax and a uniform rate be applied to all domestic companies. It suggested a phased reduction of the corporate tax to 40% and abolition of surcharge on corporate tax.

Recommendations of TRC: Indirect Taxes

In general, TRC's recommendations relating to indirect taxes aimed at lowering the level of indirect taxes, rationalisation and simplification of the indirect tax system and improving administrative efficiency. The specific recommendations in respect of the major central indirect taxes are indicated below:

Import Duties

i) It recommended a drastic overhauling of the system by suggesting a merger of the regular and auxiliary duties;

ii) A phased reduction of extra-ordinarily high rates of import duties (many of them above 200% in 1991) to a range of 15% to 30% for manufactures and 50% for certain agricultural items by 1997-98;

iii) Reduction with the renewal of rates to 4 or 5; and

iv) Abolition of exemptions and special treatments.

The Committee suggested that the process of the reform should be gradual, so as to moderate the impact of the adjustment, both in terms of possible revenue loss and the pace at which the industry is expected to compete.

Union Excise Duties

i) The TRC recommended that the ultimate objective of Union Excise Reform should be to make the excise tax system move towards a full-fledged Value Added Tax (VAT) system i.e. graded conversion of the Union Excise Tax into a genuine VAT.

ii) VAT is to be levied at only 3 rates – 10%, 15% and 20% for general commodities.

iii) For non-essential commodities, the rates should be 30%, 40% and 50%.

iv) Reduction in the number of commodities enjoying exemptions.

Besides the above, the TRC suggested far reaching reforms of the system of tax administration, simplifying the assessment and computational procedures so as to reduce the cost of compliance.

Implementation of the TRC Recommendations on Direct and Indirect Tax

Many of the recommendations of the TRC were carried out by successive Finance Ministers, starting with Dr. Manmohan Singh, the present Prime Minister. In respect of Direct Taxes, the progress of implementation of TRC recommendations so far has been as follows:

i) The direct tax structure has been greatly reformed;

ii) Personal Income tax has been restructured with lower tax rates, (10%, 20% and 30%), fewer scales, a higher exemption limit and reduced saving limit tax exemptions;

iii) There is now only one rate of separate income tax for all domestic companies (30%);

iv) Wealth tax on all assets, other than those termed as unproductive assets, has been abolished;

v) Taxation of capital gains has been restructured so that only capital gains of price increases would be taxed; and

vi) Shift in the structure of taxes towards direct taxes (direct taxes to GDP ratio has increased to 5.7%).

Implementation of the TRC recommendations in respect of indirect taxes is as follows:

a) Import duties have been reduced;

b) The peak level of customs duty has been reduced to 10%;

c) Reforms in the Excise Duties have been guided by the need to simplify the rate structure to: (i) give some relief to articles of mass consumption, (ii) help the domestic capital goods industry so as to increase its competitiveness, (iii) reduce capital costs, assist industries suffering from depressed demand conditions and (iv) provide relief to small-scale industries;

d) Till December 2005, VAT has been adopted by 25 states and Union Territories, uniformly across all the states. A 3-rate structure – 4%, 2.5% and 1% is adopted.

Service Tax

In addition to the reforming of the existing direct and indirect taxes, the TRC also referred to Service Tax.

The power to levy a tax on services in general is not mentioned either in the Union list or State list. However, by virtue of entry 97 in the Union list which gives power to the Centre for levy and collection of 'any tax not mentioned in either of these lists' (i.e. the State list or the concurrent list), it is clear that the Union Legislatures is competent to levy indirect tax on services.

The TRC suggested that, to begin with, a few selected services should be subjected to tax. It suggested that i) advertising services, ii) services of stock Brokers, iii) services of automobile insurance, iv) services of insurance of residential property, personal effects and jewellery, and v) residential telephone services, be taxed.

In 1994-95 budget, a 5% union service tax on 3 services – namely telephone, general insurance and stock brokerage was introduced. The number of services liable for taxation was raised from 3 in 1994-95 to 6 in 1996-97 and from then on gradually to 100 in 2007-08. The service tax rate is 12% of the value of taxable services. The service tax has been a buoyant source of revenue in recent years, as it helped widen the tax net.

Besides the TRC Report's recommendations and its implementation, the Government of India subsequently appointed some more Committees to pursue the process of tax reform more vigorously and effectively. Let us examine the recommendations of these committees.

12.5.2 Shome Committee, 2001

The Planning Commission constituted an advisory group headed by Dr. Parthasarathi Shome to make appropriate recommendations on Tax policy and Tax Administration. The 5-member group submitted an Interim Report in February, 2001 and Final Report in May, 2001. The Report is known as The Report on Tax Policy and Tax Administration (for the 10th Plan).

The major recommendations of the advisory group are:

i) Maximum marginal rate of personal Income tax should be retained at 30%. Tax incentives should be abolished and tax concessions should be given in the form of tax credit rather than as deductions from income;

ii) Corporate tax should be reduced to 30% to bring it in line with the existing level of maximum marginal rate of income tax;

iii) Regarding the union excise, two rate structure of 16% together with a higher rate should be introduced. Moreover, services should be

integrated as early as possible with the central value added tax (CENVAT) to arrive at a full-fledged VAT at the centre;

iv) The median Tariff Rate should be reduced to 15% by 2004-05. Exemptions in respect of customs duties should be removed. Also, there is no need for so many export promotion schemes by way of exemptions and entitlements;

v) States should reform their sales taxes and introduce broad based VAT by April 2002;

vi) The ultimate goal should be to have a harmonised VAT for both the centre and the states; and

vii) State excises should be rationalised further and its revenue potential fully tapped.

12.5.3 Kelker's Task Force, 2002

In September 2002, two task forces were set up under the chairmanship of Vijay Kelkar, the then Advisor to the Ministry of Finance and Company Affairs to recommend measures for simplification and rationalisation of direct and indirect taxes. The Task Forces submitted their Final reports to the Government in December, 2002. These two Task Forces have made several important recommendations on improving tax administration to make it simple and effective.

Recommendations of the Task Force on Direct Taxes

The Committee has argued that a tax system should balance the requirements of: a) equity, b) ease of collection, and c) fostering the efficiency in resource allocation. The Committee, in the interests of efficient tax administration, has opined that a fairer tax structure should comprise of: a) low rates of taxation, b) few nominal rates, c) a broad base, d) minimal tax exemptions and incentives, e) no surcharges, and f) clearly articulated exemptions.

Personal Income Tax

a) Regarding personal income tax, the task force recommended an increase in exemption limit to Rs. 1 lakh for the general categories of tax payers and Rs. 1.5 lakhs for widows and senior citizens.

b) Only 2 slabs of tax rates – 20% upto income of Rs. 4 lakhs and 30% for income above Rs. 4 lakhs.

c) elimination of standard deduction and tax incentives under Sections 88, 80c and interest income under section 10.

Corporate Income Tax

On Corporate Income Tax the task force recommended:

i) Reduction in tax rate to 30% for domestic companies and to 35% for foreign companies;

ii) Reduction in general rate of depreciation for plant and machinery to 15% from existing 25%;

iii) Elimination of the Minimum Alternative Tax (MAT);

iv) Long term capital gains be aggregated with other incomes and subjected to taxation at the nominal rates; and

v) Abolition of wealth tax.

Recommendations of the Task Force on Indirect Taxes

Customs Duty

i) Multiplicity of levies to be reduced to 3 – i.e. basic customs duty, additional duty of customs and anti-dumping duties.

ii) Substantial duty reduction (0%) on items like life saving drugs and equipment, sovereign imports and imports by RBI; 10% duty on raw materials, inputs and intermediate goods and 20% duty on consumer goods (by 2004-05), 5% duty on basic raw materials like coal, 8% duty on intermediate goods, 10% duty on finished goods other than consumer durables and 20% on consumer durables by 2006-07.

iii) Duty reduction to the level of 5-10% should start after the introduction of state level VAT.

iv) A duty of 8% on crude oil and 15% on petroleum products from 2004-05.

v) A higher duty up to 150% - on certain agricultural products.

vi) All exemptions should be removed except in the case of life saving drugs, goods of security and strategic interest, goods for relief and charitable purposes and international obligations.

Central Excise Duty

i) All levies should be reviewed and replaced by only one levy: CENVAT.

ii) Zero % excise duty on life saving drugs and equipments, security items, food items and agricultural products; 6% for processed food products and matches; 14% standard rate for all items not mentioned against other rates; 20% on motor vehicles, air conditioners and aerated waters.

iii) A uniform rate of 16% on all fibres and yarns.

iv) All exemptions to be removed on the textile sector except for handloom woven fabrics and certified as khadi.

v) Duty exemption in respect of small scale sector to be extended to only small units with a turnover of Rs. 50 lakhs.

vi) Uniformity in all state legislations and procedures relating to VAT.

vii) Extension of service tax in a comprehensive manner leaving only a few services by including them in a negative list.

To Recapitulate:

Main Recommendations on Direct Taxes Relate to

i) Raising the exemption limit of personal income tax;

ii) Rationalisation of exemptions;

iii) Abolition of concessional treatment to long term capital goods;

iv) Reducing rates of corporate tax; and

v) Abolition of wealth tax.

Main recommendations on Indirect Taxes relate to

i) widening of the tax base;

ii) removal of the exemptions;

iii) lowering the tax rates; and

iv) expansion in the coverage of service tax.

A number of these recommendations were adopted in 2005-06 budgetary provisions subsequently. Thus, the tax reform process has been helped by the recommendations of the various expert Committees as explained above. Reforms in the direct tax system simplified the tax system, reduced exemptions and tax rates, and expanded the tax base providing for better tax compliance. Customs duties were reduced. Service tax was introduced and now it is extended to cover about 104 services. Thus, most of the tax reforms measures recommended were adopted.

Check Your Progress 1

1. Mention the conditions which led to the implementation of fiscal reforms becoming imperative.

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2. What are the dangers of high fiscal deficit?

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3. What was the basic approach of the Tax Reform Committee towards evolving a simple direct tax structure?

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4. Mention the main recommendations of Kelker's Task Force on direct and indirect taxes?

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12.6 EXPENDITURE REFORMS

Apart from tax reform, expenditure reform is also needed to reduce fiscal deficits and restore fiscal balance. Expenditure reform is key to control fiscal deficit. Expenditure management is an integral part of expenditure reforms. The burden of fiscal deficit reduction crucially depends on public expenditure management. In the effort to contain expenditure, there is also a need to reorient public expenditure for the creation of productive assets. In this context, it is necessary to distinguish between three types of expenditures viz. plan expenditure, non-plan expenditure and capital expenditure. ***Plan expenditure*** refers to expenditure on developmental programmes leading to creation of assets. ***Non-plan expenditure*** refers to expenditures on defence, interest payments, subsidies, etc. which do not add to capital assets. In light of this, while plan expenditure has to be increased, non-plan expenditure should be reduced. ***Capital expenditure*** is the expenditure incurred for the creation of assets like land, building, machinery, equipments and the like. Thus, plan expenditure and capital expenditure are the two types of expenditure on which there should be greater focus. However, in the case of Indian economy, plan expenditure has been around 4 to 4.5% of GDP (it was 4.5% of GDP in 2002-03, 3.9% in 2005-06, 4.1% in 2006-07, 4.4% of GDP on 2007-08). The non-plan expenditure, on the other hand, was increasing at an average annual rate of about 15% in

the initial years of the present decade (i.e. 2000s). As a proportion of GDP, it was about 10% of the budget for 2007-2008. As stated before, in the context of fiscal reforms, it is important that non-plan expenditure is reduced.

A disconcerting feature of the expenditure compression policy of the Government of India bas been a reduction in capital expenditure. Capital expenditure as a proportion of GDP is declining over the years; 1990-91 (4.4%), 2002-03 (3%), 2006-07 (1.7%). It is important to note that in any expenditure reform program, expenditure compression should not be at the expense of social expenditure like education and health. There is a view that the fiscal reforms have lead to a decline in the social sector expenditure. For instance, in the post-reform period, total government expenditure on education declined as a proportion of GDP from 3.2% in 2000-01 to 2.8% in 2007-08. As a proportion of total expenditure, expenditure on education declined from 11.3% to 10.2% during this period. The total expenditure on health in India is less than 1% of GDP (0.99%) and that on social services was only 6.2% of the total expenditure in 2004-05. Again, expenditure on agricultural infrastructure, especially irrigation, was a mere 0.09% of total expenditure in 2004-05 and 0.06% in 2007-08. Since social services and agriculture are priority sectors identified by the government, reduction of expenditure in these sectors is a matter of concern.

The other category of expenditure that needs attention in the context of expenditure reform is the Revenue Expenditure. ***Revenue expenditure is expenditure incurred for purposes other than the creation of assets of the Government***. Revenue expenditure consists of pay and allowances, interest payments, grants to the States and the Union Territories and subsidies. Trends in the Revenue expenditure shows that as a proportion of GDP, it has been in the range of 11% to 14% over the period 1991-2008 [1990-91 (13%), 1997-98 (11.8%), 2006-07 (12.4%), 2007-08 (11.9%)].

Thus, we see that in the post reform period, revenue expenditure has been high at over 10% of GDP, while capital expenditure has declined steadily as a proportion of GDP till 2006-07. The axe of fiscal reforms has thus fallen heavily on capital expenditure. This needs to be corrected. On the other hand, revenue expenditure which is not only high but also increasing needs to be arrested. Expenditure reform programme should therefore pay attention to these components.

12.6.1 Expenditure Reforms Commission, 2000

An Expenditure Reforms Commission (ERC) was appointed in 2000 to suggest measures for rationalising public expenditure. The ERC paid special attention to subsidies (a major component of revenue expenditure) and made several suggestions for reducing them. The important recommendations of the ERC are the following.

i. Food subsidy should be reduced by allowing it only to the population below the poverty line. For this purpose, the State Governments should identify the population below the poverty line, in their respective States.

ii. Fertiliser subsidies which have grown over the years should be withdrawn in a phased manner. For this purpose, the control system should be dismantled over time. Fertiliser industry should be completely decontrolled in course of time as a result of the implementation of this recommendation.

iii. The ERC also considered down sizing the government. It found that there is excess staff in the government. For optimising the government staff strength, it suggested a cut of 10% on the staff strength as on January, 1, 2004, to be carried out by the year 2008. There should be complete ban on creation of new posts for two years.

Expenditure reform, compared to tax reforms, is a difficult matter and is therefore understandably on a slow track. Reduction of subsidies, to contain revenue expenditure and reduce revenue deficit, is an important component of expenditure reform. This is discussed in more detail in the next section.

12.6.2 Rationalisation of Subsidies

In the case of expenditure reform, the containment of the growth of non-plan expenditure is a major concern. As said before, non-plan expenditure mainly refers to maintenance expenditure like salaries including: (i) expenditure on defence, (ii) interest payments and (iii) subsidies. Since 1980s, there has been uncontrolled growth in non-plan expenditure. The containment of the growth of non-plan expenditure is a major issue having implications for expenditure and fiscal deficit reduction.

The major component of non-plan expenditure are: i) defence expenditure, ii) interest payments and iii) subsidies. These three, together account for more than 70% of the non-plan expenditure. Of these three, defence expenditure is a charged item, and for security reasons, cannot be interfered with. Interest payments being contractual obligations also cannot be avoided. Therefore, the only item of non-plan expenditure, in the reduction of which some scope and discretion exists, is subsidies. Any plan for expenditure reform or expenditure reduction should therefore pay attention to subsidies.

Over the years, subsidies have increased continuously. Budgetary subsidies - i.e. subsidies which were provided for in the central government's budget – were very negligible at the beginning of 1970s but increased to 2.3% of GDP at the end of 1980s. They are on the decline but still account for more than 1% of GDP. Pruning of subsidies has been a crucial component of fiscal reforms initiated in 1991-92.

When economic reforms were initiated in 1991 – three subsidies – food, fertiliser and export development subsidies – were considered as the major subsidies, accounting for 1.7% of GDP. These three subsidies accounted for more than 75% of all subsidies in the 1990s. In the beginning of 1991, export development subsidies were abolished as part of the reform programme. Hence, the most important explicit subsidies, that remain are food and fertiliser subsidies, which together account for more than 1% of GDP (and 80% of total subsidies). In recent years (i.e. from 2002-03), petroleum subsidy is added to the list. Today, ***food, fertiliser and petroleum*** subsidies are the major subsidies which are to be considered for any fiscal reform programme. In 2002-03, expenditure on these three subsidies was Rs. 40,716 crores. It increased to Rs. 52,935 crores in 2006-07 and is budgeted at Rs. 51,247 crores in 2007-08. However, as a proportion of GDP, subsidies declined from 1.7% in 2002-03 to 1.2% in 2006-07 and further to 1.1% in 2007-08 budget. Though as a proportion of GDP, major subsidies have declined during the last 5 years, they are still at a higher level, accounting for 8% of total expenditure. Let us now look briefly at the nature of these three subsidies and the need for their rationalisation

Food Subsidy

Food subsidy is aimed at ensuring supply of food grains to the consumers, especially the poor, at affordable prices. Public distribution system (PDS) was introduced to provide food grains at cheaper rates and to insulate the vulnerable sections from higher prices in the market and also to ensure minimum nutritional status to them. PDS is highly subsidised in India and this has put a severe fiscal burden on the central government.

Subsidy on the PDS arises from the difference between the issue price and the economic cost of Food Corporation of India (FCI) – procurement and operational costs. The economic cost of FCI is going up due to i) regular hikes in procurement prices and ii) increasing costs of storage and distribution. While these are rising, the issue prices are deliberately kept low in order to supply food grains at lower prices. Thus, the gap between the two is increasing over the years and hence food subsidy is going up.

Many studies have shown that food subsidy is badly targeted and most of it goes to the not so poor. Food subsidy is justified on the ground that it is aimed at poverty relief, but in reality the poor have not benefited much from it. Further, a major part of the subsidy goes to covering the costs of the inefficient and corrupt FCI. In addition, there are leakages from the PDS, in the form of losses in storage and transportation and diversion to the open market. In view of this, there is a need for rationalisation of food subsidy and a targeted PDS (i.e. targeting only the poor and vulnerable sections of the population). This will help the real poor people and also reduce the burden of food subsidy.

Fertiliser Subsidy

Fertiliser subsidy is the other component of major subsidies. Government introduced this subsidy in 1977, with the primary aim of making fertilisers available to the farmers at affordable prices. This is aimed at encouraging more fertiliser use in agriculture, increasing agricultural production and attaining food self sufficiency. The fertiliser subsidy has two main components. A part of the subsidy goes to the farmers. The other part goes to the fertiliser production units.

The second component is aimed at ensuring fertiliser producing units a fair return and attract investments in the industry to increase the production of fertilisers. A Retention Pricing System (RPS) was introduced in 1977 towards this end. The excess of the cost of production (retention price) and distribution (transportation and distribution) costs over the controlled price is regarded as a subsidy and paid to the production units. In actual working, it is found that fertiliser subsidy is not reaching the poor farmers. 50% of the subsidy is going to the inefficient and high cost domestic fertiliser industry. The fertiliser producing units have not shown any inclination to reduce the cost of production in view of the RPS. Further, the fertiliser pricing policy of the government of India has resulted in imbalance in the use of different fertilisers [viz. nitrogen (N), phoperous (P) and potassium (K)]. This has, in fact, led to excessive use of urea relative to other fertilisers. This has had an adverse effect on the environment affecting the quality of the soil. Likewise, nitrogen is heavily subsidised and therefore it is used in excess relative to other fertilisers.

Petroleum Subsidy

From 2002-03 onwards, petroleum subsidy is regarded as a major subsidy. The Government of India gives petroleum subsidy for domestic LPG and PDS kerosene. Kerosene is distributed through PDS, as it is supposed to be poor man's cooking fuel, at a heavily subsidised price. But, half of it is used to adulterate diesel and petrol, in view of its relative cheapness. In Bengal and Bihar, much of it is smuggled to Nepal and Bangladesh to be sold at a profit.

The subsidy on kerosene and LPG is financed by huge cross subsidy on petrol. This is highly distortionary in nature. It is, thus, clear that these subsidies - food, fertiliser and petroleum subsidies – while imposing heavy fiscal burden on the government, are responsible for distortions in the working of the price and delivery mechanisms, in addition to leakages. There is therefore every need for their rationalisation.

12.6.3 Reform of the Subsidy Regime

There have been several suggestions for the reform of the subsidy regime to make it efficient and less burdensome. In May 1977, the Finance Minister placed before the Parliament, a discussion paper, entitled

'Government Subsidies in India'. This discussion paper was based on a detailed study conducted by the National Institute of Public Finance and Policy (NIPFP), New Delhi. Outlining the rationale for the reduction of subsides, the study stated that 'the existing regime is not tangibly progressive, as on an average, nearly half of the fertiliser subsidies accrues to the producers/suppliers rather than the farmers. Similarly, a significant portion of the food subsidies does not filter through to the consumers but are absorbed in costs of handling and storing food grains'. Taking the stand that these subsidies are the cause of inefficient and wasteful use of resources, the study indicated the lines on which the subsidy regime is to be reformed.

As explained in the earlier section, the Expenditure Reforms Commission (ERC) also suggested that food grains subsidy should be reduced and should be allowed only to the population below the poverty line. It also suggested that fertiliser subsidy should be withdrawn in a phased manner and that the present control systems be dismantled. At a meeting of the Planning Commission in December, 2007, The Prime Minister expressed concern that the current subsidy regime has become untenable as it is contributing to fiscal deficit and inefficiency in public expenditure. Observing that 'over rupees 1 lakh crore would be spent this year alone, he said that too much money is being spent on financing subsidies in the name of equity, with neither equity objectives nor the efficiency objectives being met'. He emphasised the importance of restructuring subsidies so that only the really needy and the poor benefit and all leakages are plugged.

The position is, however, very critical requiring political will and commitment. Better targeting of subsidies, plugging leakages and improving the delivery mechanisms are the much needed measures in this regard.

12.7 FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT (FRBM) ACT, 2004

To bring about the fiscal balance effectively, it was thought better to enforce fiscal balance legally. India opted for this course of action in the year 2000 with the constitution of a committee on Fiscal Responsibility Legislation to examine the various aspects of the country's fiscal system and recommend a draft legislation on the Fiscal Responsibility of the government (central government). Subsequently, the Fiscal Responsibility and Budget Management (FRBM) Bill was introduced in the Lok Sabha, in December, 2000.

The FRBM bill had stated its important objectives as follows:

i) to make the central government responsible for ensuring inter generational equity in fiscal management and long term macro economic stability for attaining a sufficient revenue surplus by eliminating fiscal deficit;

ii) to remove fiscal impediments in the effective conduct of monetary policy;

iii) to ensure prudent debt management consistent with the fiscal sustainability through limits imposed on the central governments' borrowings, debt and deficits; and

iv) to ensure greater transparency in the fiscal operations of the central government.

The original bill recommended certain time-table for the reduction of revenue deficit and fiscal deficit. A diluted version of the original FRBM Bill (in terms of targets and time frame) was passed by the Parliament in July, 2004. The FRBM Act became effective from July 5, 2004. The Act required the elimination of Revenue Deficit by 2008-09. This means from 2008-09 onwards, the central government will have to meet all its Revenue Expenditure from its Revenue Receipts only. Any borrowing would only be to meet capital expenditure, repayment of loans, lending and fresh investment.

The Act mandates a 3% limit on Fiscal Deficit after 2008-09. This is a reasonable limit that allows significant leverage to the government to build capacities in the economy without compromising fiscal stability. Besides stipulating annual targets for the reduction of fiscal deficit and revenue deficit, the FRBM legislation provides for greater transparency in fiscal operations. For formulating annual targets and drawing up the framework for fiscal policy, a taskforce headed by Dr. Vijay Kelkar was constituted by the central government. By providing for quarterly review of fiscal situation and regulating direct borrowing from the Reserve Bank of India, the FRBM Act makes an effort to control expenditure through fiscal discipline.

The FRBM legislation has now made it mandatory for the Finance Minister to make an annual statement to Parliament on the fiscal situation, explaining any deviation in meeting the fiscal obligations cast on the centre. Following the enactment of the FRBM Act, the trends in the deficits of the central government have begun to decline as indicated in Table 12.1.

The trends indicate that the fiscal deficit and revenue deficit are getting reduced as per the targets set by the FRBM Act. The revenue deficit was, however, supposed to be reduced to zero by the year 2008-09. The trends indicate that by 2009-10, the government might be able to achieve the zero percent revenue deficit.

The Approach Paper to the Eleventh five year plan has incorporated the fiscal parameters relating to Fiscal Deficit broadly within the FRBM Act. The Approach Paper recognises the importance of meeting the FRBM Act targets, which would have a salutary effect on the overall credibility of policy. Adherence to the FRBM targets is critical to

TABLE 12.1: Trends in the Deficits of the Central Government

(% of GDP)

Year	Fiscal deficit	Revenue Deficit	Primary Deficit
2003-04	4.5	3.6	0.0
2004-05	4.0	2.5	-0.1
2005-06	4.1	2.6	0.4
2006-07	3.4	1.9	-0.2
2007-08 (RE)	3.1	1.4	-0.6
2008-09 (BE)	2.5	1.0	-1.1

Source: *Economic Survey 2007-08*

ensure budgetary sustainability and macro economic stability. The FRBM Act is thus an important step in the direction of reducing fiscal deficit over a period of time as the targets laid down in the Act enable the government to formulate its tax, expenditure and debt policies so as to be able to meet the targets.

12.7.1 Fiscal Reforms at the State Level

We have so far discussed the fiscal reforms at the level of the central government. In a federal country like India, fiscal imbalances at the state level and the need for its reform is equally important. Fiscal reforms at the State level are important because States raise more than 1/3 of the combined revenue of the centre and the states. Central and state governments' revenues also account for more than 50% of the total or combined revenue expenditure. In 1990-91, the fiscal deficit attributable to the states was substantial at 3.5% of GDP. The share of states' fiscal deficit in the combined fiscal deficit of the centre and states was 35.1% in 1990-91. Revenue deficits of the state governments were substantial and increasing during 1990s.

As we have seen, a number of fiscal reforms have been undertaken by the central government since 1991. In a federal setup, state level fiscal reforms should complement the efforts of the central government to evolve a healthy fiscal system. The Eleventh Finance Commission recommended creating a Rs. 10,607 crores incentive fund so that the states that implement reforms would be eligible to draw funds from this incentive pool. It identified 15 states with revenue deficits and stipulated that each of these states should contribute 15% of its revenue deficit grants to the fund, with a matching grant from the centre. Each of these states should reduce their revenue deficits as a proportion of their receipts by at least 5% annually between 2000-2005. The states which do not follow the set time-table for reform would forego their share of withdrawals from the incentive fund in that financial year. Accordingly,

the government of India created an incentive fund of Rs. 10,607 crores to encourage states to implement monitorable fiscal reforms. Thirteen state Governments have so far evolved and undertaken their own fiscal reform program and also entered into an agreement with the central government in 1999 – 2000.

The Twelfth Finance Commission also recommended that each state government should enact a Fiscal Reform Legislation which would be a precondition for debt relief. To facilitate a rule based fiscal program at the state level, the Reserve Bank of India constituted a group to frame a model fiscal responsibility bill. The group submitted its report in January, 2005. In accordance with this, states have begun the process of fiscal consolidation in line with the Twelfth Finance Commission's recommendations to complement the efforts of the central government. Almost all the states have since enacted their fiscal reform legislations.

The fiscal situation of the states have shown considerable improvement in the wake of Fiscal Reform Legislations. In fact, the State's performance in this regard may be considered even better than the performance of the central government in terms of FRBM targets. The aggregate revenue deficit of the States was 0.1% of GDP in 2006-07 (R.E). The states are expected to have a revenue surplus of 0.3% of GDP in 2007-08.

The enactment of Fiscal Reform Legislations has provided a crucial impetus to the process of attaining fiscal sustainability as reductions in revenue deficit and fiscal deficit are critical for redrawing the maintaining level of the states debts. The enactments by most of the states has ushered in a rule based fiscal policy framework at the state level. This has moved the process of fiscal reforms in the country further ahead.

12.8 BUDGET OUTLAYS AND OUTCOMES

Each budget announces some programmes allocating money for its implementation. The actual amounts spent on a program usually are below what is budgeted reducing the desired effect of the programme. Thus, expenditure would increase consequent to inefficiency in expenditure. There is a growing concern about the efficiency of government expenditure and about effectively utilising public resources. This led to a discussion, in recent years, about the relation ship between outlays and outcomes. The Twelfth Finance Commission (TFC) addressed this problem in its report making a distinction between outcomes and outputs thus: 'the conventional budget exercises have focussed on allocation of resources to different heads without taking into account how these government expenditures get translated into outputs or outcomes.

Outputs are the direct result of government expenditure and outcomes are the end results. For example, in the case of education, opening a

new school or appointing a new teacher is an output and reduction in the rate of illiteracy, as a result of this, will be considered as outcome.

A critical part of the budgetary reforms, the TFC Report notes: 'must include information on the relationship between expenditure and the corresponding performance in producing real results'. This is necessary for the management of public expenditure to be guided by economy, efficiency and effectiveness. It must be noted, however, that relating outlays to output or outcome is complex as it is difficult to establish a one-to-one correspondence between outlays on the one hand and outputs or outcomes or the other. For example, upgrading educational standards depends not only on expenditure on education but also on a number of other variables such as quality of teaching, attitudinal factors and the like. Further, the relationship between outlays and outcomes is not always linear; if the amount spent is doubled, it may in some cases yield more than twice the benefits.

In view of this debate, the central government has taken the initiative in output budgeting. In presenting the budget for 2007-08, the Finance Minister has presented the outcome budget to the parliament. This is a welcome step as ultimately, the effectiveness of expenditure on various programmes has to be judged by the outcomes (the final results) and not by the outlays (i.e. amounts spent).

Check Your Progress 2

1. What are the two components of productive expenditure? Which of the two results in asset creation?

 ....

 ....

 ....

 ....

Fill in the blanks:

2. An expenditure reforms programme should not be at the cost of ……
 ………..……………….

3. The three major components of non-plan expenditure are: ....,
 ……….........…., ……………....……..

4. Which are the three commodity fronts on which reduction of subsidies needs to be focused? ……………………, ……………………., …………………..

5. What is the relationship between budgetary outlays and outcomes? Which of the two needs to be especially focused upon and why?

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12.9 LET US SUM UP

The need for economic reforms in June/July, 1991 was acutely felt in view of the balance of payment crisis and the growing fiscal imbalances. The fiscal crisis, was a result of the fiscal profligacy of the central and state governments during 1980s. This contributed to a balance of payment crisis necessitating wide ranging economic reforms of which fiscal reforms is the important one. The need for restoring fiscal balance by reducing fiscal deficits was widely recognised and a number of tax reforms and expenditure reforms were initiated. The tax reforms, introduced in the light of the Chelliah's tax reforms committee and Kelker's committee included altering the tax structure of direct taxes by expanding the tax base, reducing the rates leading to improved tax compliance and making the tax administration more efficient. The indirect tax system is also reformed by reducing import duties and reforming the excise duties towards a VAT system. A new tax, service tax, was introduced covering about 104 services as on date. All these increased tax revenues considerably. Expenditure reforms have concentrated on the major subsidies in the areas of food, fertilisers and petroleum so as to rationalise them. The FRBM Act, which stipulated targets for the reduction of fiscal and revenue deficits is a major feature of fiscal reforms. Progress in the enactment of similar legislations in the states, in line with that at the centre, is in line with the targets as fiscal legislations at state level are a crucial part of the overall fiscal reforms.

12.10 KEY WORDS

Fiscal Deficit : difference between the total government expenditure and total revenues and non-debt capital receipts.

Revenue Deficit : difference between revenue expenditure and current revenues.

Fiscal Profligacy : higher governmental spending, particularly unproductive spending, like subsidies including inefficient utilisation of resources due to unrealised outcomes and time-overruns on projects resulting in increased expenditure.

Fiscal Imbalance : difference between government revenue and government expenditure.

12.11 SUGGESTED READINGS

Ruddar Datt & K.P.M Sundharam, *Indian Economy*

Vijay Joshi and I.M.D Little; *Indian Economic Reforms* 1991-2001, Oxford University Press, 1996.

Govt. of India, Ministry of Finance — Discussion Paper: Government Subsidies in India, May, 2007.

12.12 HINTS/ANSWERS TO CYP EXERCISES

Check Your Progress 1

1. See Section 12.3 and answer.
2. See Section 12.4 and answer.
3. See Section 12.5.1 and answer.
4. See Section 12.5.3 and answer.

Check Your Progress 2

1. Plan and Capital expenditure. Of the two, capital expenditure is asset creative.
2. capital expenditure.
3. defence, interest, and subsidies;
4. food, fertiliser and petroleum.
5. See Section 12.8 and answer. Ensuring the desired 'outcomes' is more important as our experience of developmental failure suggest that they are on account of not realising the intended outcomes and not due to the required budgetary allocations.

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