Public Finance and Taxation
Reforms in India

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The Focus

Review of the fiscal developments in India focusing on the policy changes and their impact
Presentation sequence

- PFM and Development Strategy
- Landmark Reforms of 90s, paradigm change
- Trends in the Fiscal Components
- Analysis of the Tax Policy Evolution
- The Unfinished Agenda and likely Institutional hurdles.
Public Finance Management & Development Strategy
Nature of PFM

- Development strategy options for India at the time of Independence
  - Market orientation vs government intervention
- Choice towards the Mixed economic framework
- With bias towards heavy industry and dominant role for public sector
- Pronounced bias against foreign trade
- Socialistic pattern of development
- Federal Fiscal Sharing
- PFM not easy.
The demand for capital in the government sector capital expenditure is a function of the accumulated capital stock which can be inverted and used to determine the demand for capital for a given level of income.

\[ Y_t = f\{K_{t-1}\} \]

\[ K_t = K_{t-1}(1-\delta) + I_t \]

The fiscal deficit, along with the demand for capital, determines the revenue balance to be financed by new borrowings.

\[ Ct = f\{N_t, Y_t \ldots\} \]

The revenue balance, along with the demand for capital, determines the revenue balance to be financed by new borrowings.

\[ \text{Revenue Exp} \]

Interest payments

\[ \text{Interest payments} \]

Debt outstanding

\[ \text{Debt outstanding} \]

The public sector capital expenditure also entails the O&M expenditure. The government sector capital expenditure is related to the private sector capital formation via the crowding-in or crowding-out function.

\[ \text{Pvt sector Capital exp} \]

\[ \text{HH Saving} \]

\[ \text{Total Revenue} \]

\[ \text{GDP} \]

\[ \text{World} \]

Transfers

\[ \text{Tax} \]

\[ \text{Nontax} \]

\[ \text{Salaries} \]

\[ \text{Revenue} \]

\[ \text{Exp} \]

\[ \text{Interest payments} \]

\[ \text{Debt outstanding} \]

\[ \text{New Borrowings} \]

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Key Requirements for mixed development strategy to work

- **Need for Private-Public Macro Balancing**
- **Determining the respective areas of activities to achieve crowding in,**
- **Allocation of resources, avoiding crowding out**
- **Efficient government sector management**
- **Regulating the Private sector**
Pre-90 Policy Stance: Problems

- Development strategy too much centered on direct intervention of the state
  - in terms of providing direction, controls, regulation and even direct participation in economic activities.
- Inefficient, high cost and non-competitive industrial structure;
- Serious infrastructure bottlenecks
- Significant constraints on the availability of financial capital.
The Landmark Reforms of 90s
The BoP Crisis of 1991: The fire-fighting

- Cutting of Fiscal Deficit through special financing from IMF
- Trade and Industrial liberalization
- Tax Reform
- Crisis – catalytic for a paradigm shift in the tax policy
Structural reforms since early 90’s

- Industrial licensing relaxed
- Market forces allowed to operate in many economic sectors
- Independent regulators in electricity/insurance/telecom
- FDI/domestic private investment allowed in electricity/insurance/telecom & many other economic sectors
- Beginning made in disinvestment of Central/State PSUs
Visible shifts in the economic Growth pattern

From a modest 3% till 70s to over 5.8% in later decades
The Recovery path

- Real investment growth reaches 40% by 2000-01
- Growth in industrial investment touches > 50%
- Export growth touches > 20%
- Increase in per capita GDP
- India the second fastest growing economy today.
Trends in Fiscal Components
Continued Fiscal Downtrends: A Road Block to Development

- Narrow tax base
- Low, stagnant tax/GDP ratio
- Impact of the Pay Commission
- Rising interest burden
- Growing revenue deficit
- Growing fiscal deficit
- Declining capital expenditure
High fiscal deficits (Centre & States)
The Quality of Fiscal Deficit: A cause for worry

Firstly, the fiscal deficit driven by revenue deficits.
Secondly, a significant increase in debt service liability.
The Tax Policy Evolution
General

- Tax structure guided by the economic and political structures and choices
- 90s mark a big change in the growth strategy. We touch upon
- Pre-90 tax policy stance
- Tax Reforms of 90s
- Post Millennium tax reform experience
- Future reform priorities
- Likely institutional bindings.
Tax policy constraints in pre-90s

- Need for raising resources for the public investment and government current expenditure requirements
- Adoption of socialistic pattern means need to maintain high progressivity
- Anti-foreign trade regime – high foreign trade related taxes
The Resultant weaknesses

- Anti-foreign trade regime – high customs and export duties
- High progressivity – personal income tax
- High tax rate differentiation – corporate tax, union excise, customs
- Plethora of exemptions, concessions, deductions, rebates and preferences
- Federal fiscal sharing further complicates
- Resulting tax complexity, difficult to manage
Pre-90s Tax Reform under systemic constraints

Constrained due to the nature of the development paradigm – only mild Reforms

- **The TEC (1954)** – first comprehensive attempt after Independence
- **Kaldor Committee (1956)** – Expenditure tax and move towards integrated taxation
- **DTEC (1971)** – Reduction in income tax rates, and slabs
- **ITEC (1977)** – Moves in the direction of VAT introduction at the Central level
The Landmark Tax Reforms of 90s
The TRC (1991)

Three reports —

- Broad principles for taxes on income and wealth, tariffs and taxes on domestic consumption in the Interim Report
- Tax administration and enforcement aspects - Part I of the Final report
- Restructuring the tariffs - Part II of the Final Report
Basic principles underlying the recommendations

- Base broadening,
- Lowering of marginal tax rates,
- Reducing rate differentiation,
- Simplifying the tax structure and
- Measures for more effective tax administration
- Revenue neutrality in the short term
- Revenue productivity in the medium and long term.
Major concrete recommendations

- Simple three-tier personal income tax structure,
  - with an entry rate of 20 per cent and a top rate of 40 per cent.
- Phased reduction of the corporate tax rate to 40 per cent,
- Abolition of the distinction between widely-held and closely-held companies,
- Abolition of wealth tax on all assets
  - except certain ‘unproductive’ assets.
Major concrete recommendations

- **Phased reduction of the high import duties (many above 200 per cent in 1991)** to a range of 15 to 30 per cent for manufactures and 50 per cent for certain agricultural items by 1997-98.
- **Restructuring of central excise to cover all manufactures,**
- **Reduction of multiple excise tax rates to three in the range of 10 to 20 per cent**
Major concrete recommendations

- Extension of MODVAT credit to all inputs including machinery.
- Selective excises at higher rates on luxury consumption items.
- Elimination of the numerous prevailing exemptions and tax preferences in both direct and indirect taxes.
- Far-reaching reforms of tax administration, including the deployment of modern information technology and online linkage of new tax identification numbers to a national network.
Implementation

- In different phases by different governments – Broad Thrust kept in tact
- PIT rates lowered
- Import duties cut
- Corporate distinction – widely held closely held abolished.
- Single CENVAT rate
- Service tax introduced
- Reduction in the exemptions and incentives
The Aftermath of TRC Tax Reforms

- **MAT**
- **Further lowering of CENVAT and customs**
- **VAT at the States level**
- **The FRBM**
- **Advisory Group on Tax Policy 2001**
- **The Kelkar Task Force Committee on Direct and Indirect taxes**
Economic performance in the 21st century

- Striking till the Crises
- The Crises and their impact
- Rise in Petroleum price and other commodities – rising inflation
- The Financial Crisis
- Series of monetary and fiscal measures
## Combined Receipts and Disbursements of the Central and State Governments (% of GDP)

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## Tax Composition

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### Years

- 1960-61
- 1970-71
- 1980-81
- 1990-91
- 2000-01
- 2001-02
- 2002-03
- 2003-04
- 2004-05
- 2005-06
- 2006-07
- 2007-08b
Shortfalls in Central Tax Collections

- Tax collections below targets
- The drop affecting the flow of tax devolution to the States
Stagnation in tax/GDP ratio even prior to the present recession.
**Stagnant Non-tax revenues**

- **Non-tax revenues of the Centre increased during the 90s,** but not adequate to neutralize the fall in tax revenue.
- **Non-tax revenues of the States declined.**
- **The upward trend in 1994-95 and 1995-96 was short-lived.**

![Graph showing non-tax revenues as a percentage of GDP from 1990-91 to 2007-08, with data for Centre, States, and Total Nontax Revenue.](image-url)
Components of Non-tax Revenue: Centre

- $b_1$ (Net Contribution of Public Undertakings)
- $b_2$ (Interest Receipts)
- $b_3$ (Fiscal Services)
- $b_4$ (General Services, excluding Defence Receipts)
- $b_5$ (Social & Community Services)
- $b_6$ (Economic Services)
- $b_7$ (External Grants)

Year-wise Breakdown:

- 1974-75
- 1975-76
- 1980-81
- 1985-86
- 1990-91
- 1995-96
- 2000-01
- 2001-02

Percentage Contribution:

- $b_1$: 2.5%
- $b_2$: 3.0%
- $b_3$: 2.5%
- $b_4$: 3.0%
- $b_5$: 1.5%
- $b_6$: 2.0%
- $b_7$: 0.5%
- $b_{10}$ (Total Non-tax Revenue): 1.0%
Components of Non-tax Revenue: States

- **b_1** (Net Contribution of Public Undertakings)
- **b_2** (Interest Receipts)
- **b_3** (General Services)
- **b_4** (Social & Community Services)
- **b_5** (Economic Services)

<table>
<thead>
<tr>
<th>Year</th>
<th>b_1</th>
<th>b_2</th>
<th>b_3</th>
<th>b_4</th>
<th>b_5</th>
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<td>1974-75</td>
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<td>1975-76</td>
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<td>1981</td>
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<td>1985-86</td>
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<td>1990-91</td>
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<td>1995-96</td>
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<td>2001-02</td>
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</table>
Factors Contributing to rising Central Government Expenditure

- Rising interest expenditure
- Increases in defense expenditure
- Impact of 5th Pay Commission
- Rising fertilizer/ food subsidies
Pattern of Financing the Fiscal Deficit in the late 90s

- **Indebtedness of the Centre and the States > 65% of GDP in 2000-01**

- More important is its unsustainability (growth of debt > GDP growth).

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The graph shows the pattern of financing the fiscal deficit in the late 90s, with a focus on the indebtedness of the Centre and the States exceeding 65% of GDP in 2000-01. The graph illustrates the contributions of various sources to the deficit, including market borrowings, small savings, state provident funds, and external financing, with a notable increase in the budget deficit over the years.
Variations In Fiscal Performance Across States
Structural Weakness of State Finances

- Uncertainty and Variability in the federal resource transfers.
- Large electricity/irrigation/transport subsidies
- Inadequate generation of own resources
- Inefficiencies in expenditure
- Rising expenditures mainly due to rising wages and salaries, pensions, subsidies and interest payments.
- Constraint on investments in education, health, infrastructure, social security and welfare
Increased Growth Dispersion Across States (average % per annum) during 80s and 90s
Trends in the Fiscal Deficit/GSDP ratio in 14 Major States

- Andhra Pradesh: 7%
- West Bengal: 6%
- Bihar: 5%
- Uttar Pradesh: 4%
- Tamil Nadu: 3%
- Karnataka: 2%
- Rajasthan: 1%
- Punjab: 0%
- Orissa: 0%
- Gujarat: 4%
- Haryana: 3%
- Maharashtra: 2%
- Madhya Pradesh: 1%
- Kerala: 0%
- Punjab: 0%
- Madhya Pradesh: 1%
- Maharashtra: 2%
Percapita income vs fiscal deficit/GSDP ratio in 14 major States of India

- Orissa
- Bihar
- West Bengal
- Rajasthan
- Uttar Pradesh
- Gujarat
- Punjab
- Maharashtra
- Madhya Pradesh
- Karnataka
- Kerala
- Tamil Nadu
- Haryana
- Andhra Pradesh
- Punjab
- Maharashtra

Percapita income (INR) vs Fiscal deficit/GSDP (%)
Own revenue/ Total expenditure & Fiscal deficit/ GSDP in 14 major States in India
Share of developmental expenditure in total: The Shrinking Trend in the in 14 major States
States Efforts to overcome fiscal constraints
Fiscal restructuring at the States’ level to focus on

- **Revenue mobilization**, through better tax collection and rationalizing taxes
- **Revising user charges** specially for power, water and transport
- **Better expenditure management**
  - for example, downsizing the Government by abolition/freezing of posts
- **Enhance expenditure efficiency**
- **Compressing non-Plan revenue expenditures**
- **PSU reforms**: Closure/ disinvestment
- **Infrastructure development**
- **Sector reforms**: Competition/ Regulation
Priorities for Further Reforms
Revenue side reforms

- Coordination of central excises (CENVAT) with a state level VAT
- Implement comprehensive taxation of services at the earliest.
Expenditure side reforms

■ Reduce non-Plan expenditures through containment of wage bill
■ Reform the subsidies (reduction in size, making them of finite duration, making them transparent and proper targeting.)
■ Review user charges in agriculture, irrigation, industries, power and transport.
■ Use the proceeds of disinvestment in public enterprise to amortize public debt.
Thank You!
References


3) Acharya, Shankar (2005) Thirty Years of
References

6) Stephen Howes and Rinku Murgai (Subsidies And Salaries: Issues In The Restructuring Of Government Expenditure In India)