INDIA: PRIMARY ASPECTS OF A MEDIUM TERM FISCAL STRATEGY

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Foreword

India is facing difficulties in controlling her consolidated fiscal deficit of the Centre and states combined, even as the public debt burden increases. There is an urgent need to address fiscal issues with the objective of fundamental reform at all levels of government. With that in mind, what action might government take to reduce the fiscal deficit in terms of GDP?

In the discussion paper, Parthasarathi Shome presents a profile of India's recent fiscal developments, demonstrating that India's fiscal stance has worsened during the last decade, and especially so during the second half of the decade. He suggests several necessary steps to bounce back from the fiscal difficulties of the nation. Such action comprises tax and expenditure measures both at the central and state levels, as well as the possibility of increased decentralisation. He justifies the need for reform by demonstrating that, for likely scenarios regarding government's cost of borrowing, its primary deficit--fiscal deficit net of interest payments--must be brought down in a consistent manner if a meaningful public debt policy is to be developed with an eye towards reducing its burden on posterity.

The paper was presented at an ICRIER workshop where the participants included selected policymakers and representatives from chambers, academia and the media. The session was chaired by Dr. Shankar Acharya. The presentation of the paper was followed by a lively discussion amongst all the participants.

The paper and the proceedings of the workshop are presented here with a view to creating a better understanding of salient issues underlying India's current fiscal stance and to point towards the direction for appropriate reform.

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Executive Summary of Discussion Paper

India has faced an upward trend in her consolidated--centre and states combined--fiscal deficit in terms of GDP in recent years. Her public debt has accumulated to 73 percent of GDP. If she is unable to contain it, it is likely that the prevailing average interest rate on debt servicing, 9.7 percent, will increase, in turn affecting economic growth. In order to obviate this, the primary fiscal deficit--deficit net of interest payments--has to be reduced in terms of GDP. Several measures are possible, consisting of restructuring central government tax and expenditure, reform of state level taxes and pervasive subsidies, and further decentralisation.

1. Recent fiscal performance

Over the last decade, the decline in revenue performance in terms of GDP of the central government has been driven by tax revenue. On the whole, an increasing interest burden has coexisted with diminishing expenditure, both Plan and non-Plan. The fiscal deficit of the central government has shown no clear declining trend over the 1990s, while the quality of the fiscal deficit has been worsening.

A perspective on the declining quality of the centre's fiscal stance may be gleaned from Graph 1. Non-Plan expenditure has exceeded total receipts (as well as, of course, gross tax revenue) during the decade. Since 1995/96, interest payments have been higher than Plan expenditure. And within Plan expenditure, Plan capital expenditure has remained below Plan revenue expenditure since 1991/92.

Since 1997/98, a further worsening of the centre's fiscal deficit to GDP ratio has occurred. Even if we regard interest payments as a legacy of the past and look at other items of non-Plan expenditure, we find that there has been a rise in non-interest non-Plan expenditure. Further, the rise has exceeded the secular decline in Plan expenditure. It becomes more disturbing when one considers that the expenditure trends have been accompanied by a renewed decline in tax revenue.

States have suffered a revenue decline in terms of GDP over the past decade. This reflects a steady decline in tax revenue. It is noteworthy that non-tax revenue improved until 1994/95, but then declined to earlier levels. A steep rise in states' expenditures is accounted for entirely by revenue expenditures (both interest payments and administration costs) at the cost of productive expenditure (whether defined as capital or as development expenditure) which has experienced a marked decline.

The quality of the fiscal stance of states is revealed in Graph 2. Revenue expenditure has exceeded total receipts during the last decade. And, as in the case of the centre, the interest burden of states has increased. Indeed, capital expenditure has remained below interest payments since 1995/96.

Further, as in the case of the centre, there has been a renewed worsening in states' fiscal performance in most recent years, intensifying the overall trend of the past decade. A major component has been a decline in non-tax revenue in terms of GDP since the mid-1990s.

In sum, the fiscal performance of the centre and the states worsened over the past decade, both in terms of the level and quality of the fiscal deficit, and it has been exacerbated more recently. The effect has been an increase in their combined fiscal deficit by about 1 percent of GDP, approaching 10 percent of GDP in 1999/2000. Appropriate tax and expenditure policies, therefore, need to be identified and implemented to improve India's fiscal performance.

It may be helpful to develop certain in-house analytical tools at the Ministry of Finance that would be able to make better fiscal projections and prepare policymakers to take appropriate corrective action in good time. Such a framework need not be overtly complex, yet, should be representative of the major channels of operation and be relevant in the determination and impact of fiscal sector variables. Its success would, of course, depend on timely input of data into the system. For its appropriate management, a Fiscal Policy Office might be set up in the Ministry of Finance in line with experiences of developed and emerging market economies.

2. Centre's tax reform

While bringing down customs tariff rates to internationally comparable levels remains a challenge, a greater challenge remains in terms of streamlining the exemptions from the CCCN code. An examination of the customs tariffs structure reveals the wide scope and extreme complexity of exemptions. It results in non-transparency in administration, economic distortions and poor revenue productivity. Therefore, customs tariff reform remains quite incomplete.

While there has been palpable progress in restructuring the central excise rate structure as well as in reducing distortions by minimising taxation of inputs, existing leakages from the tax base through exemptions pose a major problem. Cleaning up exemptions would raise revenue productivity and improve the quality of tax administration. A major medium term challenge remains the coordination of central excises (CENVAT) with a state level VAT, with the objective of structuring a national VAT.

Under the individual income tax, tax incentives should be given mainly in the form of tax credit. Incentives under Section 80L should be removed, and those under Section 10 should be streamlined. The investment ceiling for tax credit under Section 88 should be appropriately raised reflecting any cost of living increase and different asset-wise ceilings should be consolidated.

The corporate income tax structure needs to be improved to enable expansion of the number of taxpaying companies. Only with an expansion of the tax base can the corporate tax rate of 35 percent be brought down to the top individual income tax rate of 30 percent, which is desirable.

Consumption of services, which comprise the fastest growing as well as the largest sector of GDP (Diagram 1), remains essentially untaxed, even though a beginning has been made by the centre. It is imperative to introduce comprehensive taxation of services at the central level at the earliest. It should also be seriously considered for appropriate assignment at the levels of states and local bodies.

In the area of tax administration, there are significant aspects of tax administration that need to be strengthened. In Direct Taxes (CBDT), administration should be restructured in favour of functional departmental classifications such as Returns, Assessment, Audit, Legal/Judicial, Penalties and Arrears, as opposed to linking individual tax officials to all functions for a list of taxpayers. This will minimise the tax official - taxpayer link. Computerisation has to be hastened and electronic filing has to be introduced. In Customs and Excises, computerisation has helped administration but continuing exemptions have rendered administration opaque, exacerbating the tax official - taxpayer nexus. The planned enlargement of the number of taxpayer registrations must be matched by release of staff from rudimentary and routine functions such as Summary Assessment in the case of Direct Taxes and procedural cases in Customs and Excise. Such release should be followed by appropriate training of lower level staff for new functions.

3. States' tax reform

Some states are moving ahead with their own VAT reforms pertaining only to intrastate sales. These attempts are not as yet coordinated fully among states and may conflict with agreements on the floor rates of their sales tax regimes. It is important to address the issue of a state level VAT that includes interstate trade. This will obviously require close coordination among states. Such coordination should be facilitated by guidance from the centre.

Interstate trade taxation should be based on the destination principle: since the VAT is a consumption tax, the destination (or importing) state should receive the revenue. This will imply a move away from the prevailing origin principle in which the exporting state keeps the revenue. To compensate states that loose revenue from this shift, the centre could consider selected services to be assigned to states for taxation. Once destination based interstate sales taxation is accepted in principle under a state level VAT, its administration structure has to be devised.

There is no doubt that the centre is already providing some guidance to the process towards VAT introduction. Given the complexity of the process, however, it needs to take a clear position as to what role it will play in further facilitating a state level VAT. The centre has to: (1) urge states that have been slow so far in conceptualising an appropriate VAT for themselves to take appropriate action and provide them expert assistance; (2) play a technical role to help design a harmonised state level VAT in terms of rate structure and base which is yet to take shape, though states themselves have initiated discussions amongst themselves; (3) help reform interstate sales taxation since no state level VAT can function appropriately without covering interstate sales in the VAT structure; and (4) work out its own role in the administration of the state level VAT on interstate sales, either in the form of supporting a clearing house mechanism, or itself administering the VAT on interstate sales for the states. Otherwise, interstate rivalries in taxation with unwarranted consequences on the consolidated fiscal deficit could result. The Ministry of Finance should consider setting up a VAT Office itself or encourage states to cooperate to establish one.

A national VAT--comprising the centre and the states--must remain the final objective.

4. Expenditure policy

In accordance with the Pay Commission and Expenditure Commission recommendations, the Ministry of Finance should propose a definitive strategy to reduce non-Plan expenditures. Its wage bill should be reduced through reduction in government employment by a tenth as a first step, going upto a third in the final analysis, in reflection of latest Expenditure Commission and Pay Commission recommendations.

Subsidy reforms should be directed towards: reduction in their size; making them of finite duration; using them for strict economic objectives; making them transparent; and administering them through final goods, with a view to maximising their reach towards the target population at minimum cost. Recovery rates, even for non-merit services are low. An increase in user charges in agriculture, irrigation, industries, power and transport would substantially mitigate pressures on the fiscal deficit.

In line with Expenditure Commission recommendations regarding fertilizers, the Retention Price Scheme should be dismantled by early 2001 and replaced by a more decontrolled system such that manufacturers compete with imports at a reduced protection level. In case of food subsidy, central government should provide subsidy directly to states and allow the latter freedom to procure either from the Food Corporation of India or other sources. Any stock above a pre-determined buffer stock being a producer subsidy, should be phased out.

Regarding Plan expenditures, the obscuring of various types of expenditures under the Plan category must be eliminated to make the nature of expenditures transparent. The oft-repeated premise that the Plan and non-Plan categorisation should be replaced by the internationally prevalent current and capital nomenclature cannot be overemphasised.

The expenditure profile of states would improve significantly if they were able to rein in the growing subsidy element by increasing user charges in the provision of electricity, road transport and irrigation.[1] The largest drain on the states' financial system has been

[1] To some extent, the bunching of particular expenditures in the case of states, reflecting various factors, has the impact of making the situation appear to be even worse. For example, the Fifth Pay

the losses of State Electricity Boards reflecting low tariffs, low levels of operational efficiency, and leakages.

5. Fiscal deficit and decentralisation

The performance of individual states in terms of their fiscal deficit to GDP ratios has not changed much over the past decade, poor performers remaining below the better performers (Graph 3). This indicates that the centre's revenue sharing and redistribution across states have not necessarily encouraged states to improve their performance. Many states complained bitterly about the Eleventh Finance Commission's formula for revenue sharing which was perceived to provide little disincentive for poor fiscal performance.

There is an empirical relationship between: (1) higher decentralisation and higher economic growth (Diagram 2); and (2) higher decentralisation and lower fiscal deficit (Diagram 3). Therefore, with the objective of reducing the consolidated fiscal deficit of general government, further decentralisation should take place in the form of amplified tax assignment to states. This would provide greater freedom to states to collect their own revenue. While this would imply a smaller revenue sharing pool of the centre, in its redistribution, the centre should give higher weight to the income criterion, in order to protect poorer states.

6. Sustainability of public debt

There is a clear upward trend in the public debt to GDP ratio pertaining to the centre and states over the last two decades (Graph 4). This is explained by the trend in the fiscal deficit to GDP ratio of the centre and states during the last decade (Graph 5), whose steepness has increased since 1994 (Graph 6). In all realistic scenarios of public debt policy, either a reduction in the primary deficit or a generation of surplus is necessary. Clearly, a perspicacious fiscal policy is needed to prevent the burden of public debt on future generations from growing.

If public debt is to be amortised completely in 5-20 years, severe pressures on the primary balance--fiscal balance net of interest payments--will ensue. Of course, if disinvestment in public enterprises progresses with some success, the proceeds could be utilised to amortise public debt.[2] In the absence of any such indication, however, the debt sustainability simulations do not assume any role of disinvestment proceeds in retiring public debt. Thus, even at a low 8 percent interest rate, for example, the primary deficit would have to be in surplus while, currently, the average interest rate on public debt is 9.7 percent.

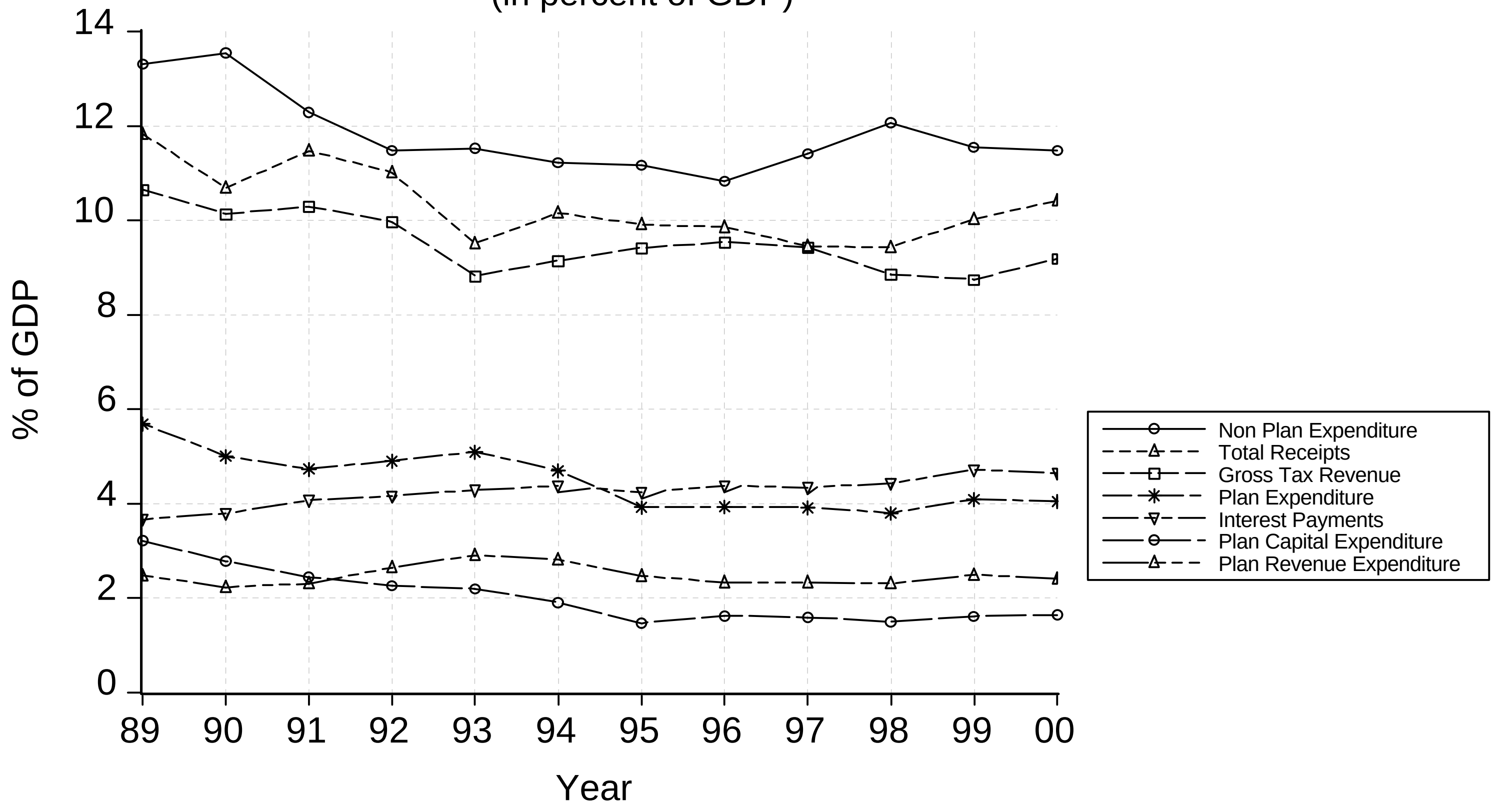
Commission's round of pay increases from January 1, 1996 was implemented by the central government with a 16-month lag, and by the state governments with a 28-month lag. This resulted in a greater bunching in the case of state governments. On the other hand, it must be remembered that it is not obligatory for states to follow the Pay Commission's recommendations.

[2] In fact, such one-shot proceeds should not be treated as revenue to be included in the fiscal budget.

If a less severe goal of reducing the public debt to GDP ratio is specified, say to 60 percent in the next 10 years, then too a primary surplus is needed. But if the goal is extended to 15 years, then a primary deficit could be accommodated, though at a lower level than the current one. If the goal is diluted to freeze the prevailing debt to GDP ratio, then a primary deficit of 1.3 percent of GDP at the prevailing 10 percent interest rate, and a primary deficit of 0.65 percent of GDP at a 11 percent interest rate, can be accommodated.[3] The prevailing primary deficit to GDP ratio is 0.86 percent. Therefore, in the former case, a higher than present primary deficit in terms of GDP could be accommodated. But all indications are that public debt cannot be serviced in the future at prevailing rates and that the average interest rate is likely to rise. In such a realistic case, the present primary deficit in terms of GDP would need to be reduced. Thus, all reasonable scenarios indicate the need for an immediate reduction in the primary deficit even under the soft objective of freezing the public debt to GDP ratio.

[3] Currently, the average interest rate on public debt is 10 per cent. Consultations indicate that it is likely to rise in the near future. Further, on the one hand, the public sector has been able to borrow at low rates reflecting financial repression in the past. As improvements take place in India's financial architecture, this is expected to change. On the other hand, if the fiscal deficit is controlled, there is likely to be a downward pressure on the average interest rate.

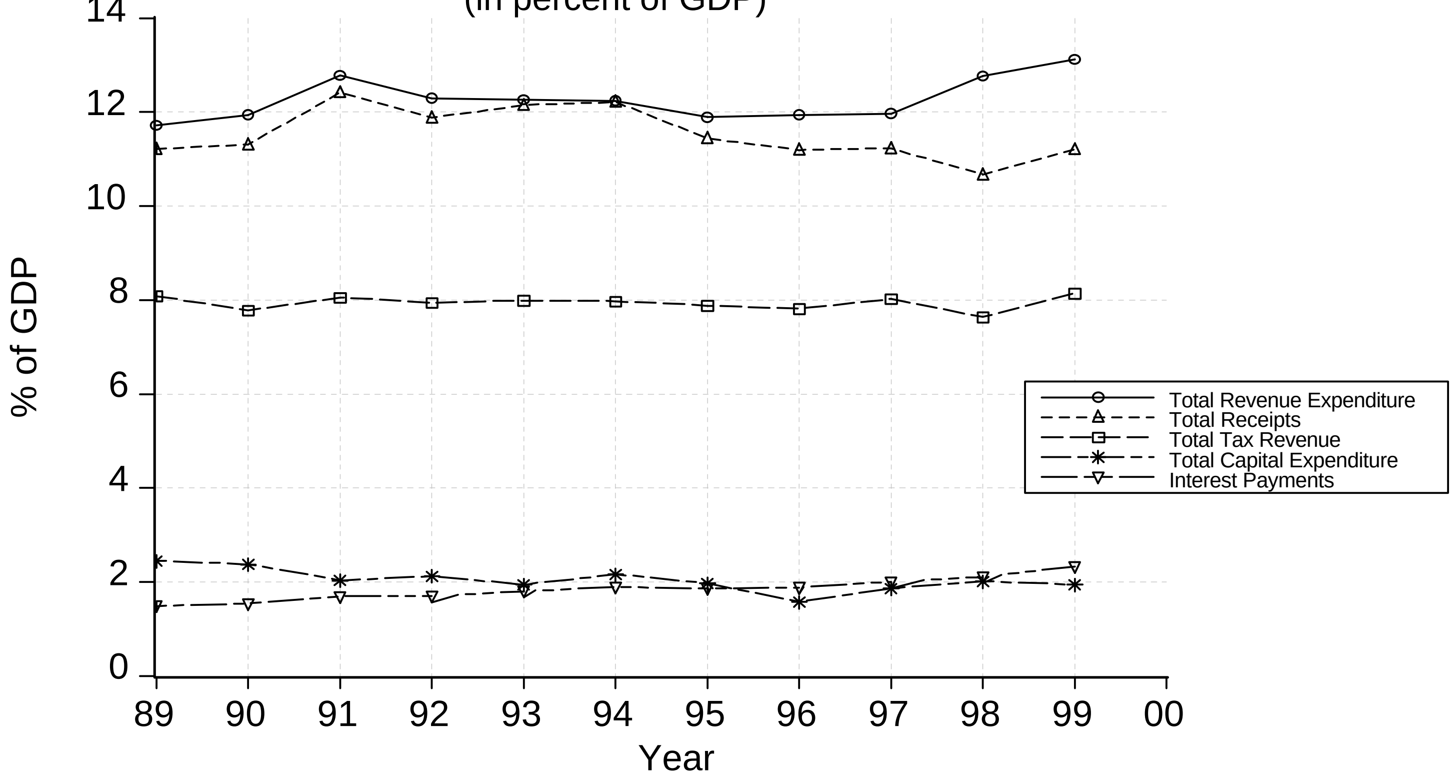
Graph 1. India: Selected Fiscal Indicators of Central Government
(in percent of GDP)



Sources: Economic Survey, Ministry of Finance, 1999/2000.; Union Budget, Ministry of Finance, various issues.

*89 indicates 1989/90, and accordingly for future years

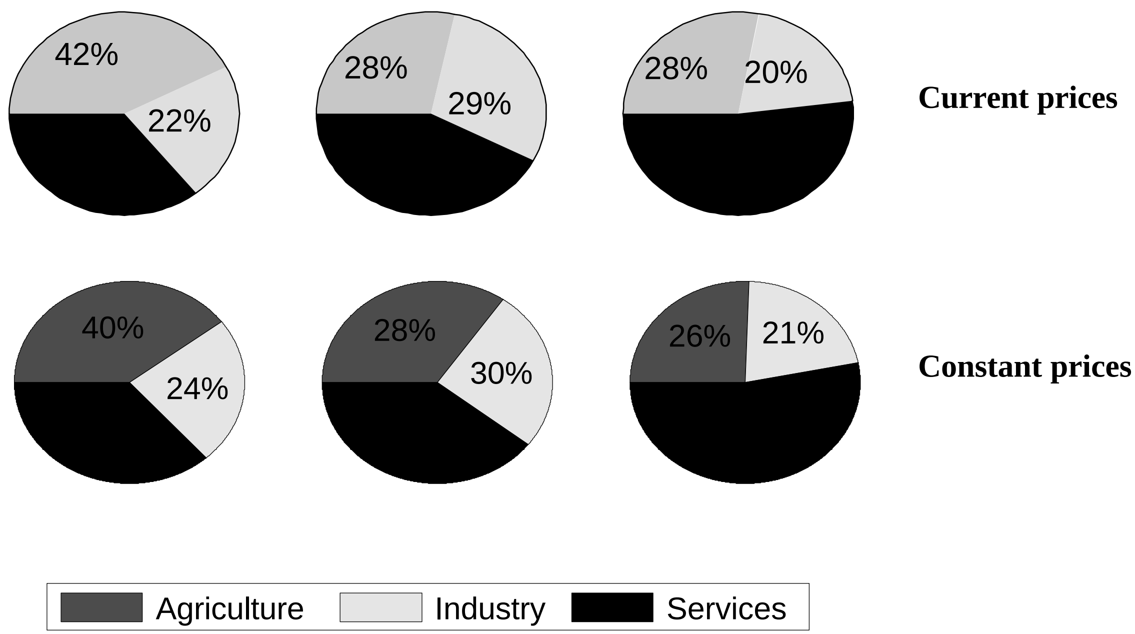
Graph 2. India: Selected Fiscal Indicators of States
(in percent of GDP)



Sources: Economic Survey, Ministry of Finance, 1999/2000.; Union Budget, Ministry of Finance, various issues.

*89 indicates 1989/90, and accordingly for future years

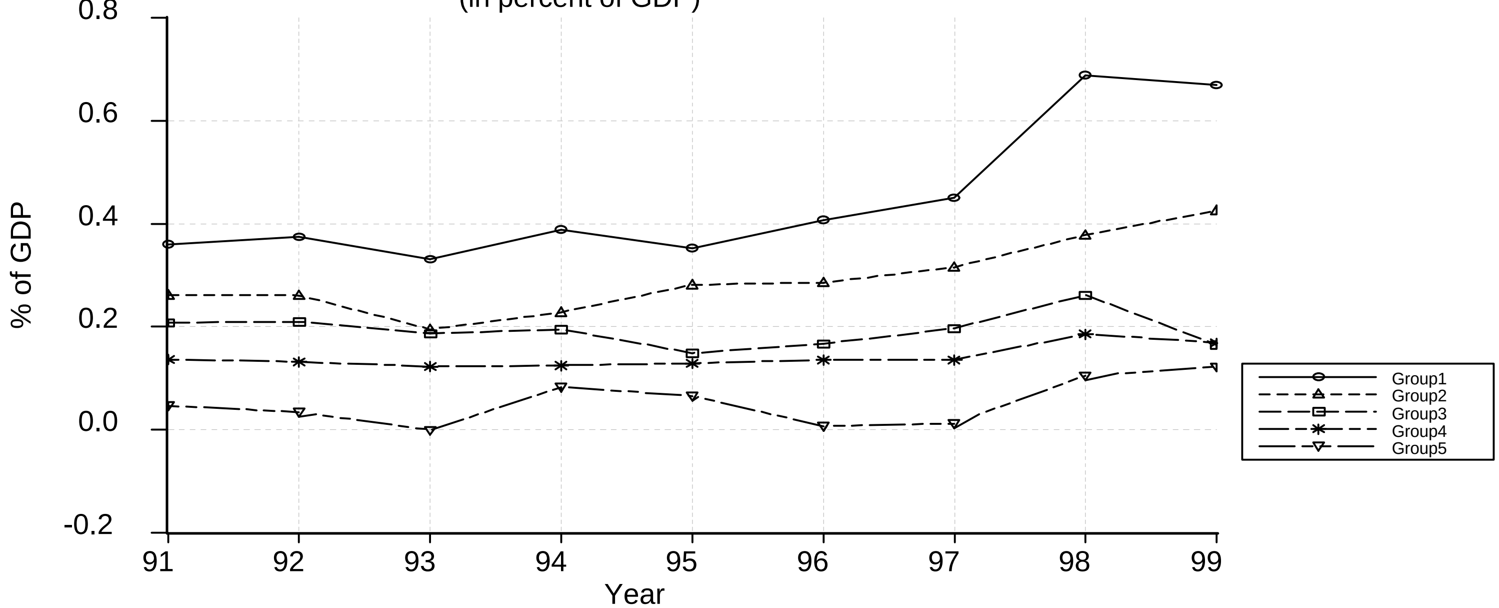
Diagram 1. India: Changing Sectoral Composition of GDP
(at current and constant prices)



1/ It may be observed that the services sector has grown at a faster pace in both current and constant prices.

2/ In 1990/91, the agriculture to industry ratio was approximately the same in terms of current and constant prices (28/29 and 28/30 respectively). However, in 1999/2000, the ratio in terms of current prices became higher (28/20) than in constant prices (26/21). This implies that prices in industry increased more slowly than in agriculture.

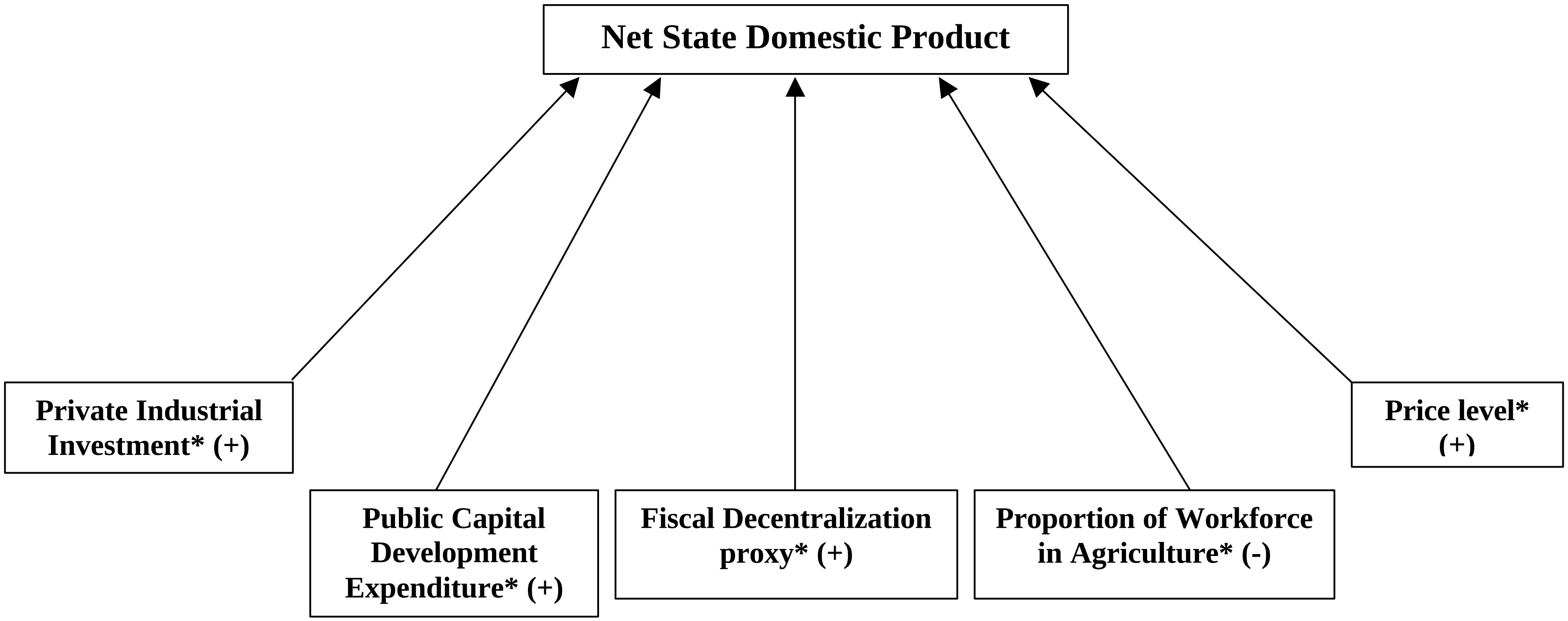
Graph 3. India: States' Gross Fiscal Deficit
(in percent of GDP)



Sources: Economic Survey, Ministry of Finance, 1999/2000; State Finances, RBI, various issues.

* 91 indicates 1991/92, and accordingly for future years.
**States have been grouped reflecting their fiscal deficit to GDP ratio for 1998/99 (given that 1999/2000 are Budget Estimates).
The composition of the groups is as follows:
Group1.........Uttar Pradesh, West Bengal (above 0.5 percent).
Group2........Gujarat, Maharastra, Rajasthan (between 0.3 to 0.5 percent).
Group3........Andhra Pradesh, Bihar, Madhya Pradesh, Punjab,Tamilnadu (between 0.2 to 0.3 percent).
Group4........Haryana, Karnataka, Kerala, Orissa (between 0.1 to 0.2 percent).
Group5........Assam (below 0.1 percent).

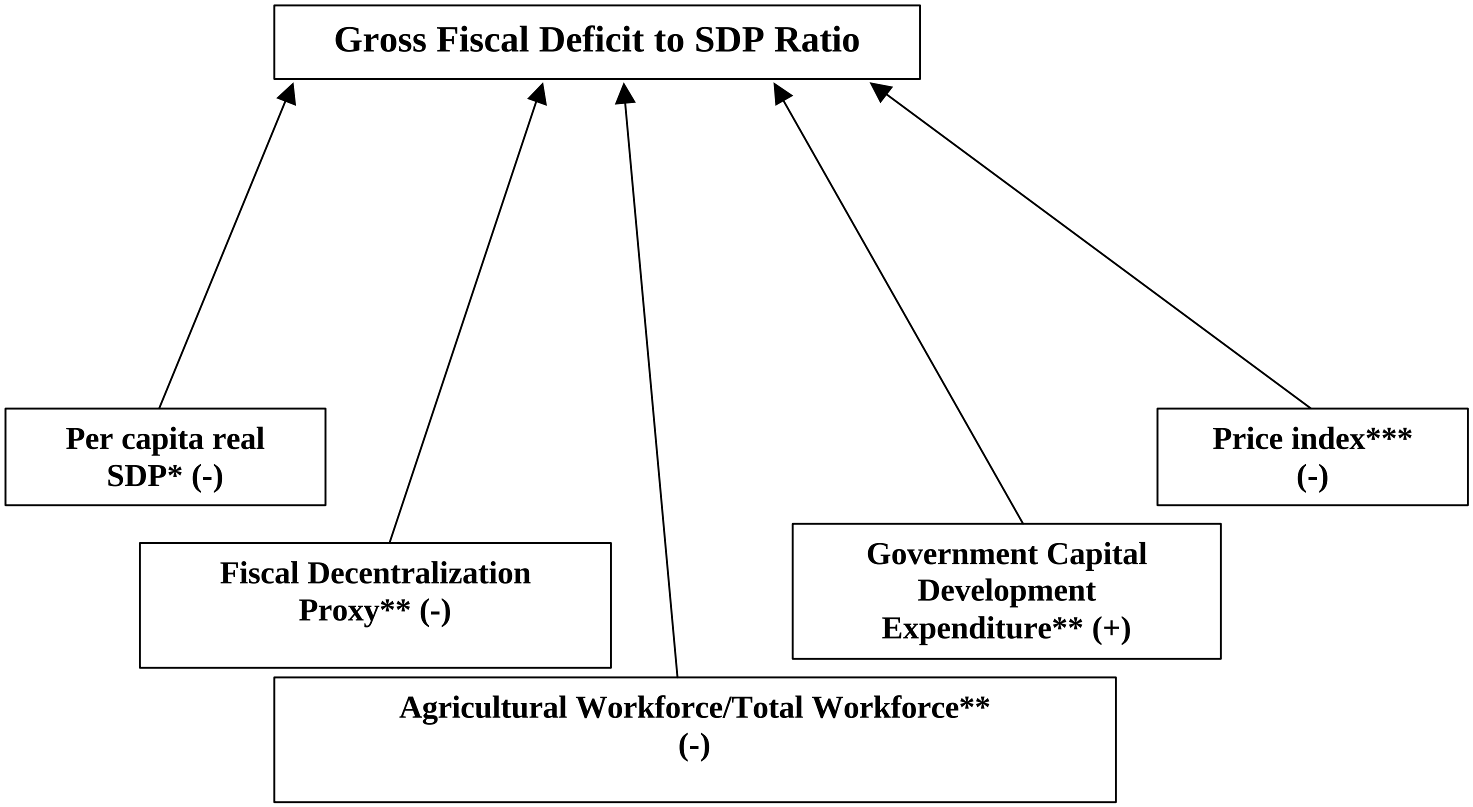
Diagram 2. India: Effect of Fiscal Decentralization on Economic Growth 1/



* variable was found to be significant at 1 percent level.

1/ Fiscal decentralization proxies are based on total expenditure, development expenditure, non-development expenditure, capital expenditure and revenue expenditure respectively. For example, in case of development expenditure, the decentralization proxy is defined as: (development expenditure of state ‘i’) divided by (development expenditure of centre + development expenditure of state ‘i’)

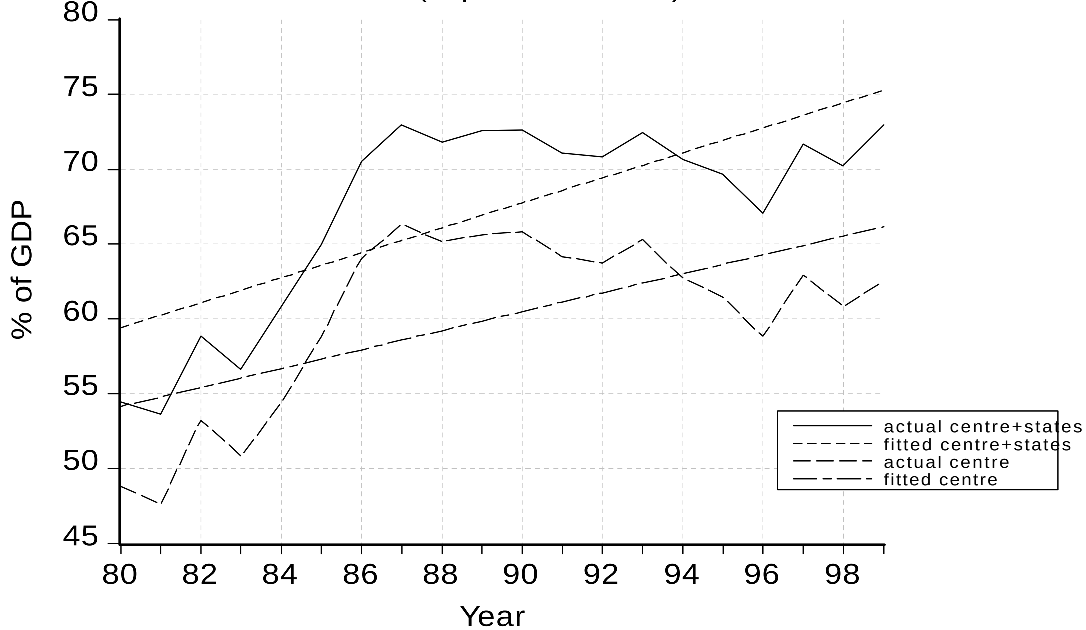
Diagram 3. India: Effect of Fiscal Decentralization on States' Fiscal Deficit 1/ 2/



* indicates significant at 1 percent ** indicates significant at 5-10 percent *** indicates not significant.

1/ Fiscal decentralization proxies are based on total expenditure, development expenditure, non-development expenditure, capital expenditure and revenue expenditure respectively. For example, in case of development expenditure, the decentralization proxy is defined as: (development expenditure of state 'i') divided by (development expenditure of centre + development expenditure of state 'i')

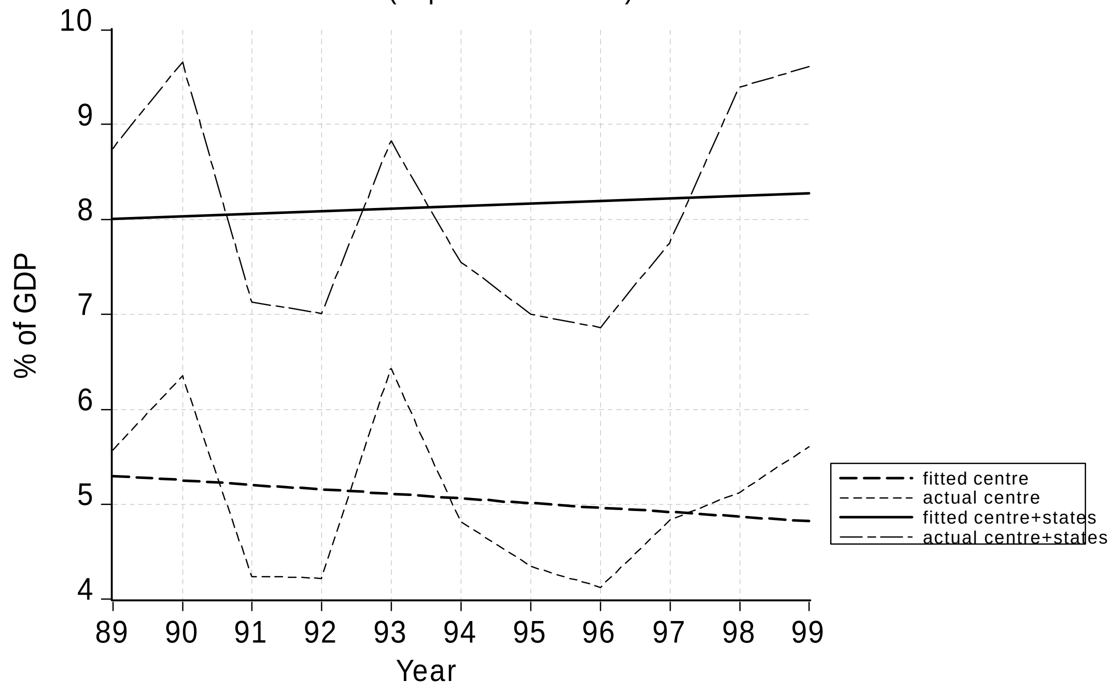
Graph 4. India: Total Public Debt of Centre and Total Public Debt of Centre plus States
(in percent of GDP)



Sources: Economic Survey, Ministry of Finance, 1999/2000; Indian Public Finance Statistics, Ministry of finance,various issu

*80 indicates 1980/81, and accordingly for future years.
**Figures for 1998/99 and 1999/2000 are Revised and Budget Estimates Respectively.
***The fitted values in the Graph are based on the trend regression of the actual variables.

Graph 5. India: Gross Fiscal Deficit of Centre and Gross Fiscal Deficit of Centre plus States
(in percent of GDP)



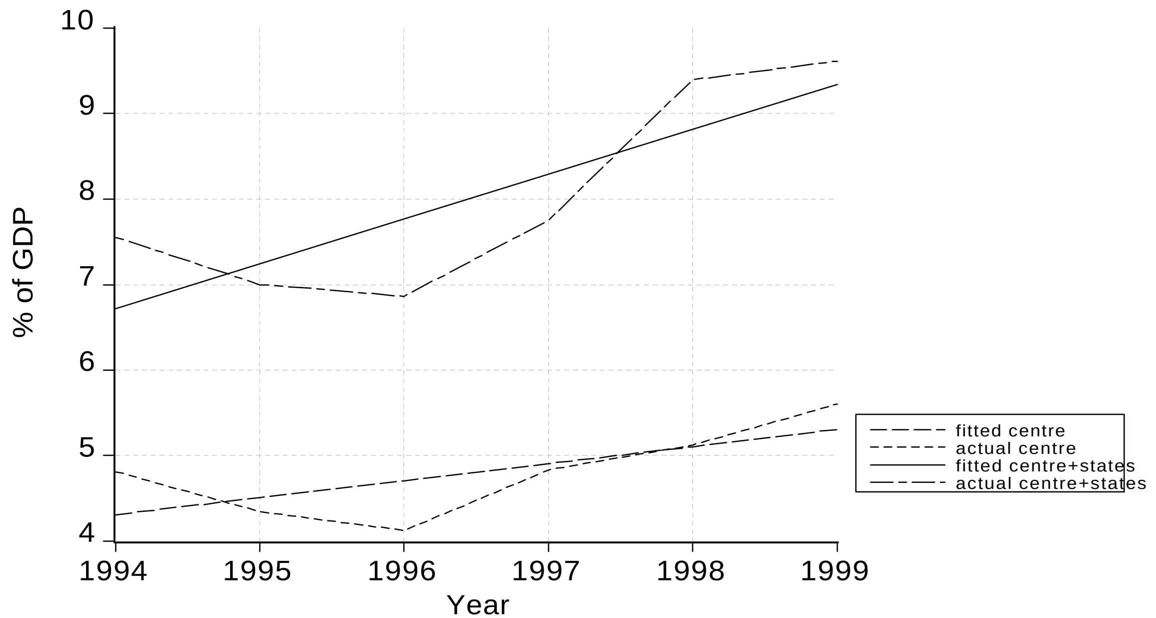
Sources: Economic Survey, Ministry of Finance, 1999/2000; Indian Public Finance Statistics, Ministry of Finance, various
Union Budget, Ministry of Finance, various issues

* 89 indicates 1989/90, and accordingly for future years

**1999/2000 is Revised Estimate for Centre and Budget Estimate for States

***The fitted values in the graph are based on the trend regression of the actual variables.

Graph 6. India: Gross Fiscal Deficit of Centre and Gross Fiscal Deficit of Centre plus States
(in percent of GDP)



Sources: Economic Survey, Ministry of Finance, 1999/2000; Indian Public Finance Statistics, Ministry of Finance, various iss
Union Budget, Ministry of Finance, various issues

*1994 indicates 1994/95, and accordingly for future years.

**1999/2000 is Revised Estimate for Centre and Budget Estimate for States

***The fitted values in the graph are based on the trend regression of the actual variables.

Discussion Paper*

1. Introduction

The 1990s were a decade of ostensible change in India's fiscal stance. With the onset of economic liberalisation coupled with economic austerity in 1991, attention focussed on the fiscal deficit in relation to GDP. The ratio was brought down significantly over the next two years by Manmohan Singh, then Finance Minister. Customs tariff reform was stepped up and distortions in domestic excises were minimised through crediting of taxes paid on inputs in the process of production.[4] In 1997, P. Chidambaram, then Finance Minister, introduced fundamental changes in the income tax structure mainly by scaling back rates of both individual and corporate income taxes. Coupled with meaningful tax administration measures, income tax revenue subsequently accelerated beyond most predictions.[5] Yashwant Sinha, Finance Minister in subsequent governments, has attempted to maintain liberalisation as an anchor, together with an overall conservative fiscal stance.

Yet, it would not be wrong to say that India is currently facing a mix of complex fiscal problems, pertaining not only to the central government but also at the level of state governments. These manifest themselves in: (a) an apparent inability of the central government to rein in its fiscal deficit, (b) a rise in state governments' fiscal deficits resulting in a consolidated general government (centre and states combined) fiscal deficit of almost 10 percent of GDP, and (c) their unwelcome implications for the medium term sustainability of public debt. These challenges have received somewhat belated official recognition and concern in the 1999 Annual Report of the Reserve Bank of India and the

* Reserve Bank of India Professor, ICRIER. I am grateful to Bhaskar Datta, Indian Statistical Institute, New Delhi for sharing his data on Indian states and for valuable advice, and to Sunil Ashra, Fellow, and Smriti, Research Associate, both of ICRIER, for assisting with data, estimations and simulations. At various stages of preparation of the paper and its presentations, I have received helpful comments from Shankar Acharya, Isher Ahluwalia, Montek Singh Ahluwalia, Surjit Bhalla, Prithviraj Chavan, Martin Feldstein, N.N. Jha, N.J. Kurien, Amit Mitra, Sudhir Mulji, T.N. Ninan, Pronab Sen, Jagdish Shettigar, Vishvjit Prithvijit Singh, and D.K. Srivastava. However, opinions expressed are mine and should not be attributed to others unless specifically mentioned. Comments are welcome at parthoshome@hotmail.com

4 See Shome (1997a) for a detailed discussion of India's fiscal stance during this period.

5 See Shome (1997b) for a summary of the revolutionary changes in the tax structure emanating from the 1997/98 Union fiscal budget.

2000 Economic Survey of the Ministry of Finance.[6] A succinct presentation of fiscal trends of the centre and the states during the 1990s is attempted in Section II of the paper.

The objective of this discussion paper is to delineate the major areas that need to be addressed to rein in the consolidated fiscal deficit. They include, first, ways to fill existing gaps in tax reform at the centre, including cutting back exemptions and taxing the consumption of services appropriately. These are considered in Section III of the paper. Second, at the state level, while states have agreed to levy floor rates for the sales tax, appropriate legislation for a value added tax (VAT) needs to be introduced and, in many of them, a list of irrational taxes has to be abolished. State level taxation issues are considered in Section IV of the paper. Third, expenditures of the centre have to be rationalised and motivation may be derived from the recently published recommendations of the Expenditure Commission, which are considered in Section V. Fourth, the matter of the impact of decentralisation from the centre to the states on economic growth and on the fiscal deficit has assumed importance. This has implications for the quantum of funds that should be available for distribution by the centre and the funds that states should be free to collect. In a sense, some of these concerns have been reflected in the controversy over the criteria used by the Eleventh Finance Commission to distribute central funds since they are increasingly perceived as providing disincentives for fiscal correction by poorly performing states. These perspectives are addressed in Section VI. The medium term implications of the prevailing fiscal performance on the sustainability of public debt of general government, are analysed in Section VII. Concluding remarks are made in Section VIII.

2. Fiscal Performance in the 1990s

i. Trends in the central government

Certain clear trends appear upon examination of the centre's fiscal performance in terms of GDP (Table 1)[7]. The first three conclusions pertain to the last decade[8] while the fourth relates to the most recent period.

(1) In terms of GDP, **total receipts** (net of states' share) have fallen from 10.8 percent in 1989/90 to 9.2 percent in 1999/2000 over the decade. Similarly, **gross tax revenue** fell in terms of GDP from about 10.7 percent to 8.7 percent.

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6 In the annual Indian Bankers Association's Sir Purshotamdas Thakurdas Memorial Lecture at the Reserve Bank of India in December 1996, Shome (1996) highlighted the issue of a rise in public debt resulting from an increase in the consolidated fiscal deficit.

7 First, from 1999/2000, transfer of small savings to the states and Union Territories was removed from the Ministry of Finance's definition of the fiscal deficit. For comparability, the entire series in Table 1 has been adjusted accordingly. Second, the published GDP series uses a new base from 1993/94. For consistency, this series has been appropriately adjusted for previous years. Note that Table 1 illustrates the fiscal deficit calculations under the different definitions.

8 Similar conclusions apply for comparisons beginning in the mid-1980s. For illustration, see Mohan (2000) and Shome (1996).

Conclusion: Clearly, the decline in revenue performance has been driven by tax revenue.

(2) In terms of GDP, **total expenditure** declined from over 19.2 percent to 15.6 percent between 1989/90 and 1999/2000. The decline could be explained by both **Plan expenditure** and **non-Plan expenditure.** Of the latter, only interest payments increased significantly; others such as defence and subsidies actually underwent a decline except in the most recent years.

Conclusion: On the whole, over the last decade, an increasing interest burden has coexisted with diminishing expenditure, both Plan and non-Plan.

(3) Reflecting mainly high expenditure levels, the **fiscal deficit** was high in the 1980s, in the range of 7-8 percent of GDP (not shown in Table 1). The financial crisis of 1990/91 and the ensuing reform reduced it to well below 6 percent in the following two years of fiscal tightening but the policy was not sustained[9]. Especially since 1997/98, the size of the fiscal deficit has become difficult to tame.

Conclusion: The fiscal deficit of the central government has shown no clear declining trend over the 1990s.

(4) **Since 1997/98**, a renewed worsening seems to have taken hold. For example, having recuperated somewhat between 1993/94 to 1996/97, another declining tax revenue trend seems to have begun in 1997/98. Major components of non-Plan expenditure have also increased since 1997/98. These factors are reflected in the fiscal deficit figures that have increased markedly in terms of GDP since 1997/98, approaching 6 percent in 1999/2000.

Conclusion: A worsening of the fiscal deficit to GDP ratio since 1997/98 reflects: (a) a renewed decline in tax revenue since then; and (b) a resurgence in the rise of non-interest non-Plan expenditure. The latter, coupled with the continuing rise in interest payments, has exceeded the secular decline in Plan expenditure.

9 It would be below 5 percent of GDP under the new definition of GDP from 1999-2000. This is shown in Table 1.

Table 1
India: Fiscal Position of the Central Government
(in percent of GDP)

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000 (RE)	2000/01 (BE)
TOTAL RECEIPTS	11.83	10.68	11.47	11.01	9.50	10.15	9.90	9.85	9.44	9.42	10.02	10.41
REVENUE RECEIPTS	10.80	9.67	10.09	9.90	8.78	9.02	9.32	9.27	8.83	8.48	9.23	9.33
(Centre's share)												
Gross Tax Revenue	10.65	10.13	10.29	9.96	8.82	9.14	9.41	9.53	9.42	8.85	8.74	9.18
Non-Tax Revenue	2.88	2.11	2.44	2.68	2.56	2.34	2.39	2.39	2.52	2.54	2.73	2.63
TOTAL CAPITAL RECEIPTS	1.03	1.01	1.38	1.11	0.71	1.13	0.58	0.58	0.61	0.94	0.79	1.08
TOTAL EXPENDITURE	19.17	18.53	17.03	16.37	16.51	15.92	15.08	14.76	15.31	15.85	15.62	15.51
NON-PLAN EXPENDITURE	13.31	13.54	12.29	11.48	11.52	11.22	11.16	10.83	11.41	12.06	11.54	11.48
of which,												
Interest Payments	3.66	3.78	4.06	4.15	4.28	4.36	4.23	4.37	4.33	4.42	4.70	4.64
PLAN EXPENDITURE	5.68	4.99	4.73	4.89	5.08	4.69	3.92	3.93	3.90	3.79	4.08	4.04
FISCAL DEFICIT (new definition)*	5.57	6.35	4.24	4.22	6.43	4.81	4.34	4.12	4.83	5.12	5.60	5.10
FISCAL DEFICIT (old definition)**	7.34	6.22	5.40	4.72	7.01	5.77	5.18	4.91	5.87	6.43	6.99	6.57
FISCAL DEFICIT(Min of Finance)***	7.30	6.22	5.40	4.72	7.01	5.71	5.10	4.90	5.87	6.45	5.60	5.10

Sources: Ministry of Finance, Union Budget, various issues.
Economic Survey, Ministry of Finance, 1999/2000.
and Appendix Table 1.
* From 1999-2000, transfer of small savings to the states and union territories was removed from the concept of fiscal deficit. The entire series has been adjusted accordingly
** The series is presented according to the old definition.
*** The Ministry's series combines the old definition upto 1998-99, and the new definition from 1999-2000 onwards.

ii. Trends in states' fiscal performance

(1) The fiscal performance of the states over the last decade is depicted in Table 2. During the period 1989/90 to 1998/99[10], **revenue receipts** fell from 11 percent of GDP to 10.5 percent, while **tax revenue** fell from 8.1 percent to 7.6 percent. Thus there was a worsening in performance by 0.5 percent of GDP in both instances.

Conclusion: States have suffered a revenue decline in terms of GDP reflective entirely of tax revenue decline.

(2) **Revenue expenditure** increased from 11.7 percent to 12.8 percent of GDP. Of this increase of 1.1 percent of GDP, interest payments increased by 0.5 percent of GDP; the other obvious component that climbed up was salaries and wages. **Capital expenditure** fell by 0.4 percent of GDP (Table 2). Defined alternatively, total non-development expenditure increased by 1.1 percent of GDP while total development expenditure fell by 0.3 percent of GDP (Appendix Table 2).

Conclusion: The steep rise in states' expenditures is accounted for entirely by revenue expenditures--both interest payments and administrative costs--at the cost of productive expenditure--defined either as capital or as development expenditure--which has experienced a marked decline.

(3) The **states' fiscal deficit** has risen from 3.2 percent of GDP to 4.3 percent over the last decade. This could be interpreted as reflective of: (1) an equal rise in revenue expenditure; together with (2) a decline in revenue matched by a decline in capital expenditure.

Conclusion: The quality of states' fiscal performance--reflecting both revenue and expenditure factors--worsened significantly over the last decade.

(4) In the very **recent years from 1997/98**, states' fiscal performance has worsened further, just as was the case for the central government. This manifests itself in a rise in the states' fiscal deficit to GDP ratio, to 3 percent in 1997/98, and then steeply to 4 percent in 1998/99. The worsened 1998/99 situation is caused by a renewed decline in the tax revenue to GDP ratio and a steep rise in the revenue expenditure to GDP ratio.

Conclusion: As in the case of the centre, there has been a renewed worsening in states' performance in most recent years, intensifying the overall trend of the past decade.

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[10] Only budget figures are available for 1999/2000 for the states. These are, therefore, not included.

Table 2
India: Fiscal Position of State Governments
(in percent of GDP)

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (RE)	1999/2000 (BE)
TOTAL RECEIPTS	11.22	11.31	12.42	11.88	12.15	12.22	11.44	11.20	11.23	10.67	11.21
REVENUE RECEIPTS	11.00	11.04	11.91	11.63	11.87	11.70	11.15	10.76	10.87	10.48	11.07
Tax Revenue	8.08	7.78	8.05	7.94	7.99	7.97	7.88	7.81	8.02	7.64	8.14
Non-tax Revenue	1.04	0.97	1.40	1.21	1.30	1.62	1.51	1.16	1.10	1.00	1.08
NET CAPITAL RECEIPTS	0.21	0.26	0.51	0.26	0.28	0.52	0.30	0.44	0.36	0.20	0.14
TOTAL EXPENDITURE	14.17	14.31	14.81	14.42	14.21	14.41	13.85	13.52	13.82	14.78	15.07
Revenue Expenditure	11.72	11.94	12.78	12.30	12.27	12.25	11.89	11.94	11.97	12.77	13.13
of which,											
Interest payments	1.48	1.53	1.68	1.69	1.79	1.89	1.85	1.88	2.00	2.10	2.32
Capital Expenditure	2.44	2.37	2.03	2.12	1.94	2.16	1.97	1.57	1.85	2.01	1.94
Gross Fiscal Deficit	3.18	3.31	2.89	2.79	2.40	2.74	2.66	2.74	2.92	4.27	4.01

Sources: Indian Public Finance Statistics, Ministry of Finance, various issues.
and Appendix Table 2.

Finally, in sum, the overall fiscal performance of the centre and the states worsened over the decade, and has been exacerbated in very recent years. The overall impact has been an increase in their combined fiscal deficit by about 1 percent of GDP, approaching 10 percent of GDP in 1999/2000. Appropriate tax and expenditure policies need to be identified to improve India's fiscal performance.

iii. Absence of a macro-fiscal framework

It is not the intention of this paper to point out how different actual turnouts have been when compared to budget projections, but the differences have been significant. Perhaps to no small extent this reflects the lack of a system of long term forecasting at the Ministry of Finance. The Five Year Plan prepared by the Planning Commission does provide a broad framework for the conduct of fiscal policy. However, medium-term macroeconomic (and fiscal) forecasts are rarely used as a basis of fiscal policy planning and budgeting at the Ministry. For this some basic analytical macro-economic tools should be developed at the Ministry of Finance that could be developed into a model at a later stage in reflection of crucial variables, important parameters, and binding constraints of the macroeconomy.

In any fiscal model, however simple, to be specified for India, certain features of the Indian economy would have to be incorporated such as: (1) a macroeconomic balance; (2) a tax equation with the scope of buoyancy and elasticity considerations; (3) an expenditure equation that allows reduction or expansion; (4) if possible, a representation of non-financial public sector operations; (4) private investment and constraints thereof; and, if possible, a recognition of private sector investment in infrastructure; (5) foreign trade and international finance; (6) foreign investment; (7) labour market; (8) price controls; (9) a monetary equation; (10) financial sector characterisation; and (11) a poverty constraint. Ahluwalia (1999) has listed some of these criteria for considerations in such a context.

Interestingly, there is a wide availability of models, though their relative sectoral focus--agriculture, industry, services--may be diverse, their approach--structuralist, monetarist, financial--may be different, and their objectives--price determination, fiscal deficit, exchange rates--may differ in emphasis. Table 3 provides a simple comparison of some of these models. Appendix I summarises the conceptual basis and workings of selected models.

While no single model may be suitable for the Ministry's purposes, a lot could be gleaned from many of them to help construct an analytical framework based on meaningful macroeconomic relationships, for the Ministry's forecasting needs. Such an analytical framework has the following advantages: (1) relationships between instruments and targets become transparent; (2) links between policy measures and associated trade-offs become clear; and (3) the policymaker's--Minister of Finance--qualitative assessment in the budget speech is transformed into a model subject to feasibility tests.

Table 3
A Comparison of Models

		Pandit, 1994 (Structuralist – Keynesian)	Manohar Rao, 1999 (Financial Programming)	Balakrishnan, 1991 (Structuralist)	Jadhav, 1994 (Neo-classical-Structuralist)
I	**Output (Q)**	**(Sectoral)**	**(Single Sector)**	**(Dual Sector)**	**(Single Sector)**
		Q_{agr} – supply constrained	Q is assumed to follow Harrod – Domar type growth path	Q_{agr} – Supply/weather constrained	Q - supply determined and real govt. development expenditure also affects it
		$Q_{infrastructure}$ – resource constrained Q_{manuf} – demand/supply constrained Q_{others} – demand determined		Q_{manuf} –demand determined	
II	Price (P)				
		P_{agr} – market clearing P_{others} – Cost determined & money also affects it		P_{agr} – determined by Q_{agr} & government's procurement price policy P_{manuf} – Cost plus pricing	P depends on real GDP(-), inflation rate (+), money supply(+), and lagged real money supply(-)
III	Money (M)				
		$M \rightarrow Q$ $Q \rightarrow M$ $M, Q \rightarrow P$ M affects Q and is also influenced by it. Rate of interest also influences P	M exogenous Velocity (v) is influenced by rate of interest	M endogenously determined by real sector developments	M affects only P but not Q
IV	Sectors				
		1. Agriculture 2. Manufacturing 3. Infrastructure 4. Economic Services 5. Govt. Administration & Defence	1. Monetary sector 2. External sector 3. Real sector 4. Financial sector Interaction between these sectors determines the equilibrium outcome in these sectors and output growth, inflation, reserves and interest rate	1. Agriculture (Food) 2. Manufacturing	1. Real Sector 2. Government Sector 3. Financial Sector 4. Price Determination

Conclusion: An analytical structure should be developed at the Ministry of Finance for the purpose of forecasting. The mechanism could comprise a Fiscal Policy Office that should be set up in line with experiences of developed and emerging market economies. Success would depend on timely input of data into the system. Eventually a model may be developed that is not overtly complex, yet, is representative of the major channels of operation and variables relevant in the determination of the economy's macroeconomic equilibrium, while incorporating, in some detail, the fiscal sector components.

3. Remaining Gaps in the Centre's Tax Reform

There is no doubt that fundamental changes in the centre's tax structure were introduced in the 1990s. Customs duties were scaled back, individual and corporate income tax rates were significantly reduced, and a rationalisation of the excise tax structure eliminated the distortionary inclusion of inputs from the tax base, and reduced the number and level of rates. Table 4 summarises the prevailing central tax rate structure and indicates how it has changed in recent years. However, an important lacuna remained in that, though in line with international movements in tax reform, the measures have not been accompanied, by and large, by expansion in the tax base.

i. Prevailing central tax structure

Today, **individual income tax** rates--at 10, 20 and 30 percent--are among the lowest in the world. The **company income tax** rate--at 35 percent--is also not high (though it remains to be aligned with the highest individual income tax rate[11]). **Customs duties**, while remaining high by international standards at a top rate of 40 percent, have nevertheless been significantly reduced since 1991/92 when the highest rate was 300 percent. The number of customs tariff rates was reduced significantly; the structure was rationalised in that input tariff rates were made significantly lower than output tariff rates, and the rates themselves were markedly lowered, so that the average tariff rate was reduced from 55 percent to 25 percent over the 1990s.[12] And union **excise duties**--at a central rate of 16 percent--are not high even with the complementary rate of 24 percent for selected goods. The average rate has declined markedly since 1986 when credit for input tax was initiated (Government of India, 1985) and progressively expanded in subsequent years to cover all commodities presently. The resultant tax to GDP ratio trends are depicted in Appendix Table 1.

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[11] Otherwise there is likely to be tax induced non-corporatisation of enterprises.

[12] It is noteworthy that, in 1999, the average nominal customs tariff rates in East Asia were 0 percent in Hong Kong and Singapore, 9.5 percent in Indonesia, 10.2 percent in Malaysia, 10.7 percent in the Philippines, and 17 percent in Thailand. The average effective rates (customs tariff revenues as a percent of the value of imports) were 5 percent in Indonesia, 4 percent in Malaysia, 14.4 percent in the Philippines, and 7.4 percent in Thailand in 1995.

Table 4. India: Tax Structure

DIRECT TAXES			
Individual Income tax	**2000/01**	**1992/93**	**Bracket**
Bracket (Rs. Per annum)	Rate(in percent)	Rate(in percent)	(Rs. Per annum)
upto 50000	Exempted	Exempted	upto 12000
next 10000	10	25	Next 8000
next 90000	20	30	Next 20000
Above	34.5[1]	40	Next 20000
surcharge	10	55	Above
Company Income Tax	**2000/01**	**1992/93**	
Domestic Company	35	45, 50	
Foreign company			
Royalties required from Indian concern and fees for technical services	50,30,20	50, 30, 20[2]	
Dividend and interest income.	20		
Capital Gains Tax	**2000/01**		
Individuals[3]	20 + Surcharge[4]		
Companies[3]	20 + Surcharge[4]		
INDIRECT TAXES			
	2000/01	**1995/96**	
Union Excise Duties	8,16, 24	5,10,15,20,25,30,35,40,50	
CENVAT	16		
Higher Income consumer goods	24		
Intermediate goods	16		
Basic goods & low income consumption goods	8		
MODVAT on all inputs and capital goods(exception HS Diesel Oil & Petrol)			
Cigarettes	Special Duties		
	2000/01		
Customs Duties			
Range of rates	5, 15, 25, 35		
Special additional duty on all products except petroleum products.			
	2000/01		
MAT(Minimum Alternate Tax)	10 reduced to 7.5		
Reduction in exemption on export income by 20%			

Source: Indian Budget Documents, 1999/2000 & 2000/01.

1) 30%+10% surcharge.
2) Respectively, between 1961-76,1976-97 and after 1997.
3) Under sections 115ACA and 115ACB it should be less then 10% + Surcharge.
4) Depending on income tax rate applied.

Despite these fundamental changes in the overall rate structure, by and large the tax base has not been enlarged. This pertains to both (a) existing tax incentives in the income taxes and exemptions in the indirect taxes; and (b) omission in a feasible expansion of the tax base through the taxation of the consumption of services. Also, though there have been successful recent administrative attempts in expanding the number of income tax registrations from 10 million in 1997 to 18 million in 2000, a major strengthening of tax administration itself is needed. These aspects are taken up separately.

ii. Possible reductions in existing incentives and exemptions in Union taxes

Despite the all-round reduction in tax rates, the tax base has not expanded in structural terms. In the early design of tax policy, exemptions tended to assume an important role, whether they be in the area of customs tariffs, the VAT, excises, individual income tax or the corporate income tax. Even smaller taxes such as the capital gains tax, wealth tax, gift tax, and inheritance tax at the central level, or the property tax, motor vehicles tax, professions tax and the like at the state level, were typically replete with exemptions reflecting the perception of the tax instrument as useful for attaining various social and economic goals. Not only was the number of taxes affected by exemptions very large, but the conditions under which the exemptions were applicable were very complex. This problem with the overall tax structure continues at present.

Apart from the economic distortions they cause, exemptions give tax administrators unwarranted discretion in interpretation of the law or executive statutes. Fiscal transparency would improve when such reliefs are scaled back thereby simplifying the tax structure. Tanzi (1997) has emphasised the "control over the provision of tax incentives to particular investors" by "government officials" as a "major instrument that makes corruption possible," making arms length transactions difficult and increasing unwarranted discretion in the hands of officials. In more complex structures, "several officials have such a discretion over a single decision" (pp.17-18).

The **customs tariffs** remain burdened with exemptions with such a wide coverage detail that they have a toll on the efficacy of administration. In any standard publication of the Customs Tariffs Structure containing some 1150 pages, there are 406 pages describing 121 General Exemptions, some of which are (a) further alphabetised and/or (b) divided into Lists. In addition, each of the 99 Chapters of the Customs Classification (CCCN), includes Exemptions Notifications. This is further compounded by separate Exemptions Notifications under the Additional Duty, Special Duty, and Special Additional Duty. The complexity in interpreting the exemptions may only be imagined, adding to the discretionary power of lower level tax administrators [13]. In addition, the

[13] To take a specific example, there is a customs tariff exemption that allows a lower duty to the import of resin that is used to manufacture shoe soles. However, since resin has many uses, it may be quite difficult to convince appraisers in the customs department as to the purpose of the resin imported based on the purchase invoice or technical literature (from, say, company publications or the internet). In instances such as this, appraisers may demand to see manufacturers' statements certifying the use. These may be difficult and time consuming to obtain and perplexing for the manufacturer to issue. When imported goods are waiting on the docks to be cleared and the importer has to pay considerable

economic distortions created can be expected to easily override the seeming simplification in the nominal tariff structure achieved over the last decade. It is worthwhile noting that, in order to eliminate such problems, Chile has introduced a single tariff and eliminated exemptions.

Conclusion: While bringing down customs tariff rates to comparable East Asian levels remains a challenge, a greater challenge remains in terms of streamlining the exemptions from the CCCN code. Until this is achieved, customs tariff reform remains quite incomplete.

In the area of domestic consumption and production taxes, the central excises and state sales tax rates alike had been fine-tuned to various objectives including social considerations, assumed elasticities of demand[14], or purely revenue considerations. They were again replete with exemptions and incentives, often reflecting populist measures or tax competition among states. Though the rate structure was improved as described above, the leakages in the tax base have not been plugged.

In any standard publication of the **central excises** running some 720 pages, 220 pages are devoted to exemptions. Though the Exemptions number about 70, they are divided under 259 Entries, 52 Conditions and 7 Lists, with numerous items under each List. For textiles alone, there are 90 exemptions; for exports, 20; for small scale industries, 5; and for contracted work ("job work"), 4. Apart from these categories, exemptions are given for particular items.[15] Apart from the overall number, their descriptions tend to render their scope and applicability more complex. For example, exemptions are made conditional, such as "for use in leather industry", or the exemption is required to be "strictly interpreted" or "liberally given", thereby adding to the discretion of junior officers such as appraisers, superintendents and assistant commissioners. Many of these exemptions are obviously given for merely populist motives. They result in a simple tax becoming structurally unsound--causing distortionary resource allocation--and unduly complex to administer (Mukhopadhyay, 2000).

Conclusion: While there has been palpable progress in restructuring the central excise rate structure as well as in reducing distortions by minimising taxation of inputs, existing leakages from the tax base through exemptions pose a major problem. Cleaning up exemptions would raise revenue productivity and improve the quality of tax administration.

In the case of the **income tax**, it would not be wrong to claim that, with lower rates, tax administration has become simpler. The administration's resources can be spent in alternative investments such as modernisation through computer use including the

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and progressive demurrage charges, they are likely to be in no position to wait. Eventually, the probability of the matter getting resolved on an informal basis obviously becomes high.

14 The lower is the variation in demand to price changes, the higher is the tax rate that can be charged.

15 To give an illustration of their extent, these include aerated water, tooth powder, soap, chemical agents, nipples for feeding bottles, pencil sharpeners and blades thereof, small diesel engines, pens and ball point pens and parts thereof, particle boards made of cement, jute, bagasse and so on.

possibility of electronic filing, more careful data processing, and production of better statistical information. However, one negative ramification of the early high marginal tax rates that has been difficult to remove from the income tax structure is the continuing high incidence of exemptions, allowances, deductions and incentives. This is because these perceived as using a tax policy instrument to achieve particular social or development goals.

In the case of the **individual income tax**, the incentives that erode the tax base the most relate to savings. They are provided in the form of tax credit on savings (Section 88 of the Income Tax Act) and as partial deduction of income (Section 80L) or exemption (Sections 10(11) and 10(15)) from savings in specified assets. In addition, tax relief is allowed under specific schemes as (1) deduction of savings from taxable income (Section 80CCC); (2) exemption from long term capital gains tax (Section 54E); and (3) exemption from payment of gift tax. In general, assets in incentive schemes are totally exempt from wealth tax. Total tax relief is subject to certain ceilings of course.

A **tax credit** gives equal relief to all taxpayers irrespective of their marginal tax rate. An exemption or income deduction, however, gives higher relief to a saver with a higher marginal tax rate. Thus the higher tax subsidy for the richer relate mainly to deductions under Section 80L and exemption under Section 10(11) and 10(15).[16] There is no rationale for this. Some of these ideas were already considered by an Expert Group to Review Existing Fiscal Incentives for Savings of Ministry of Finance (Government of India, 1997a).

Conclusions: (1) Tax incentives should be given mainly in the form of tax credit. (2) Incentives under Section 80L should be removed, and those under Section 10 should be streamlined. (3) The investment ceiling for tax credit under Section 88 should be appropriately raised reflecting any CPI increase and different asset-wise ceilings should be consolidated.

While **corporate income tax** revenue has shown a healthy buoyancy in the current year, there is no doubt that the tax structure needs improvement if the incidence of zero tax companies and the resultant inequity is to be minimised. The current base of the Minimum Alternate Tax (MAT) which is book profits, can be easily manipulated by the taxpayer to generate zero tax while honest taxpayers are hit with a higher effective rate than before. Thus an appropriate mechanism for minimum contribution has to be devised and alternatives are being studied by the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan at the Planning Commission. Another anomaly that needs to be corrected is the corporate income tax rate which, at 35 percent, is higher than the highest individual income tax rate of 30 percent. This tends to lead to noncorporatisation of potential corporates. But clearly the corporate income tax rate cannot be brought down to 30 percent and equalised to the top individual income tax rate unless base erosion of the corporate tax is reduced.

[16] Since the gift tax and long term capital gains tax are flat rate taxes, exemptions pertaining to them do not favour the higher marginal rates.

Conclusions: (1) The corporate income tax structure needs to be improved to enable expansion in the number of taxpaying companies. (2) Only with an expansion of the tax base can the corporate tax rate of 35 percent be brought down to the top individual income tax rate of 30 percent, which is desirable.

iii. Taxation of the consumption of services

Reflecting that services were not conceived as a taxable event at the time, India's constitutional fathers did not mention services specifically when they assigned taxes to different levels of government. Services, therefore, fell in the residual category which is the responsibility of the centre. Over the last decade, the **service sector has grown** rapidly, currently representing more than half of GDP (Diagram 1). The need to target the service sector for taxation emanates also from the following change.

The top panel in Diagram 1 shows GDP in current prices while the bottom panel uses constant prices. In terms of current prices, industry share in GDP has declined over the last decade in current prices while that of agriculture has remained the same. In terms of constant prices, however, the decline in industry is less and agriculture's share has declined only slightly. This implies that industrial prices have not kept pace with agricultural prices. Given that agriculture is not directly taxed and that the share of nominal GDP accounted for by manufacturing has shrunk, there is little alternative but for **services to fill the gap in taxable base** in order to maintain--leave alone increase--the overall tax to GDP ratio of general government.

The Ministry of Finance had attempted to address how to tax this growing sector by contracting a study (NIPFP, 1995). However, the introduction of taxation of a set of haphazardly selected services in 1997 led to a national strike and a resultant setback. It then instituted an expert group in 1998 that produced a report (Government of India, 1999), and a second advisory group in 2000 that is currently undertaking a study. Meaningful **implementation is yet to come** even as the service sector is growing phenomenally.

Further, any medium term consideration of the issue does not end here. There are many services that are better addressed for taxation purposes at the state and even municipal levels. When the introduction of a VAT is being seriously considered by the states, an issue that will be addressed below, an aspect that assumes importance is how to reform the taxation of interstate trade at the level of states. Some states are likely to loose revenue in the process and **assigning taxation of services**, at least selectively, to states may be one way to accommodate their loss. Indeed, many states are becoming quite restive about the matter. In addition, the need for resources at the local government level resultant of the 73rd and 74th Amendments to the Constitution, would tend to imply that some services might also be assigned to Urban Local Bodies and Panchayats for taxation[17].

[17] This needs to be considered especially given the difficulties of property taxation both for administrative reasons as well as judicial opinions limiting ratable value of taxable property (in light of the link between property taxation and ratable value).

Appendix Table 3 provides some detail of the various services that are typically taxed under the VAT in a number of countries. **Brazil is a case in point** from which India can draw important lessons in the area of service taxation. Brazil was one of the first countries to introduce a comprehensive VAT on both goods and services in the mid-1960s. Given its federal structure in which the states have an important fiscal role, the VAT was primarlity assigned to states (ICMS). Services under the VAT were also assigned mainly to the states. Municipalities were assigned selected services that typically cater to the local market such as hotels and restaurants, and laundry and dry-cleaning (Shome and Spahn, 1997). An alternative would be to allow concurrent taxation of services by different levels of government. They would presumably end up taxing those services that they are able to administer adequately.[18]

Conclusions: (1) Consumption of services, which comprise the fastest growing as well as the largest sector of GDP, remains essentially untaxed. (2) It is imperative to introduce comprehensive taxation of services at the central level at the earliest. (3) It should also be seriously considered for appropriate assignment at the levels of states and local bodies.

iv. Strengthening of tax administration

In any developing country, tax laws themselves may be extremely well designed and detailed. Yet, given that tax **administrators apply the tax law** in the field, it is only to be expected that the intent and nature of tax administration give the final tone and flavour to the tax policy mix that is actually implemented. Thus unless the accompanying tax administration is able to handle those laws in terms of having the appropriate staff to interpret and implement them, the field level reality of the actual incidence of the tax system may be quite different from the original objectives (Faria and Yucelik, 1995).

India is no exception. It appears that, while at top levels of both tax administrations viz. Customs and Excise (CBEC), and Direct Taxes (CBDT), there is a growing realisation of the **need for reform**, actual implementation at the field level has much room for improvement. The CBEC and CBDT are receiving significant bilateral international technical assistance in improving tax administration but the process has been slow. Thus many of the recommendations of the Working Group on Tax Policy and Tax Administration (Government of India, 1997c) remain valid. While the impact of a complex tax law on the efficiency of tax administration has been mentioned already, improvements in the **structure of tax administration** are addressed below.

In the case of **direct taxes**, most reforming countries have opted for a functional division of their tax administration, thus creating independent departments for the handling of returns, assessment, audit, judicial/legal procedure (that covers

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[18] The model of concurrent (or "piggyback") taxation is prevalent in the United States in the case of the income tax. It functions quite efficiently.

interpretation), disputes and arrears. Usually, there is also a large taxpayer unit that administers taxpayers above a specified threshhold in order to facilitate their control. In India, this is not the case since tax administration does not, by and large, reflect functional departmental classification. The same official tends to be assigned for accepting returns and for assessment, if not for audit, of a taxpayer. Thus, in effect, a tax official is assigned charge of a list of taxpayers tending to create a taxpayer-tax official nexus, that should be avoided at any cost in a modern tax administration.

When particular functions are scrutinised, many lacunae appear. In **Summary Assessment** (accepting returns), first, it appears that there is excessive manpower carrying out this rudimentary function. In addition, arguable interpretations of fact and law are imparted under prima facie adjustments, leading to controversial additions. Requests by taxpayers for rectification need to be dealt with with greater promptness and efficiency**.** In **Scrutiny Assessment** (generally known as assessment), the manner in which legal provisions are applied--with questionable additions and disallowances in individual taxpayers' cases--tends to give rise to litigation, whose long run benefits are yet to be established. In the process, even the bias in favour of revenue by officials--sometimes leading to a disregard to the canons of taxpayer rights and fair interpretation of the law--is not achieved. The result of a **Revenue Audit** (audit) often becomes a guessing game; here, the problem worsens with the involvement of the judiciary and the tendency of the CBDT to await the verdict of the highest court, a process which takes several years. Public perception of other aspects such as lack of responsiveness to correspondence, lateness in **refunds**, and **amnesties** every five years or so, is also quite low.

Clearly there is a need to **reform direct tax administration** through: (1) reorganising tax administration; (2) developing better records management; (3) establishing a tax assessment research and guidance cell; (4) establishing a refunds monitoring and research cell; (5) developing an effective information system; (6) computerisation; and (7) a reorientation in training systems. Some of these matters are being addressed by the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, Planning Commission.

Customs administration poses its own problems though, through increasing computerisation, some improvements are apparent in major centres. As already indicated, however, significant problems emanate from classification issues. To give one example, instructions under Section 151A by the CBEC on classification and valuation are not uniformly interpreted, especially in the absence of any requirement that officers below the CBEC--including Commissioner (Appeal)--are bound by them. Other problem areas continue to be: undervaluation of imports on the one hand and, on the other, slow clearance of cargo; frequent remanding of cases that comprise harrassment to taxpayers on the one hand and, on the other, bureaucratic impediments for commissioners to hire lawyers for speedy disposal of cases; a buildup of pending cases (that could be reduced by speedy disposal of cases pertaining to lower value); unclear guidelines for prosecution that could be launched even before the case is established by adjudication; and, last but not least, a recognised officer-clearing agent nexus.

Excise administration has certainly improved over the years as the nature of administration has progressed from a physical control to an accounts based system. A deep belief seems to have lingered that the drop of excise revenue reflecting MODVAT credit has been compounded by fraud. However, investigations have tended to indicate that about 5 percent of the total offences booked are due to fraud, a large majority being procedural. Paradoxically, a large proportion of the staff is routinely engaged in administering such procedural cases that are caused by exemptions and an unclear concept of input for the purpose of **MODVAT credit**, leading to interpretation problems. The sooner the excise base structure is cleaned up as already discussed, the sooner staff can be released for more advanced responsibilities that emerge from moving to the accounts based system.

Conclusions: There are significant areas in which tax administration needs to be strengthened. In the area of Direct Taxes, administration should be restructured in favour of functional departmental classifications such as Returns, Assessment, Audit, Legal/Judicial, Penalties and Arrears. Computerisation has to be hastened. In Customs and Excises, computerisation has helped administration but continuing exemptions have rendered administration opaque, exacerbating the tax official - taxpayer nexus. The planned enlargement of the number of taxpayer registrations must be matched by release of staff from rudimentary and rountine functions such as Summary Assessment in the case of Direct Taxes and procedural cases in Customs and Excise, followed by appropriate training.

4. Agenda for Subnational Tax Reform

States have a multiplicity of taxes, for example, on entertainment, lottery, professions, liquor, motor vehicles, entry to a region, and on general sales.[19] On average, about half their tax revenue comes from the **sales tax.** However, they have experienced only unitary buoyancy in the sales tax in recent years (Appendix Table 2). In early 2000, states agreed to impose **floor rates of 4, 8, 12 and 16 percent** for different groups of taxable commodities. This was clearly a step forward inasmuch as their tax bases had been eroded over the last decade due to severe tax competition. This step is only a first, however, in state level tax reform.

Tentatively, **states have agreed to introduce a VAT** on April 1, 2002. This is not the place to eulogise a VAT since much has been written on it. Suffice it to say that the VAT makes collection of a retail sales tax considerably simpler. The retail sales tax has to be collected only when a retailer sells to the final consumer. This is what states in the United States do. Indeed, if this could be done without much tax evasion, there would be no need to institute a VAT. But in a developing country such as India where retail transactions are mainly small scale, sales tax collection merely at the retail stage would lead to low revenue productivity. A scheme such as a VAT that attempts to collect the same revenue

[19] With the reform of the sales tax, many of the smaller taxes are expected to be restructured. These are not examined here.

in a greater number of steps is certain to be more successful, provided its design is structurally sound (Shome, 1995).

i. Existing VAT experience

A VAT attempts to collect the retail sales tax at different stages of production and distribution while maintaining an in-built system of verification, since any input tax paid can be deducted from output tax only on the basis of an invoice. Designing a VAT appropriately should amplify the taxable base and improve revenue performance. For this reason, more than **100 countries have introduced a VAT**. Appendix Table 4 provides some details regarding VAT introduction in selected countries. Most of them, however, have done so at the central level which is not difficult. India too has progressively done so at the central level. The challenge lies in introducing a state level VAT in a federal nation such as India. Brazil has done it and Canada is attempting to do so (Bagchi, 1997).

Though there is a tentative agreement among Indian states to introduce a VAT in 2002, it must be recalled that they have made similar agreements in 1995 and 1997, and nothing came of them. Indeed, after the 1995 agreement, a few states such as Andhra Pradesh, Kerala, Maharashtra, and West Bengal seriously considered or introduced the VAT on a selective basis. In general the experiment failed. The failure of **past experiments** can be explained simply. First, they were applied on a few items rather than on all items under the sales tax (for example, 18 items in Andhra Pradesh and steel in West Bengal). A VAT, which is based on subtracting all taxes paid on inputs when an entrepreneur pays tax on output, cannot be expected to efficiently distinguish among those commodities that are VATable and those that are not. Second, the VAT was applied on large businesses that had turnovers above too high a threshold (as in Maharashtra) which limited the credit that could be taken for input tax paid. So it was unpopular. And no calculations for appropriate tax rates were made to maintain revenue neutrality. Thus there was a revenue collapse. No wonder states became cautious in the immediate post-1997 period regarding the VAT (Shome, 1997c).

ii. Obstacles to new reform

It is heartening, therefore, that many states are once again seriously considering the **introduction of a VAT** through their own tax reform committees or expert groups, though others are lagging behind. **Two lacunae remain**, however. First, given the floor rates agreed to by the states, it would be **difficult to design a VAT** that is single rated or even double rated, by any particular state. For example, a VAT structure of, say, 6 percent and 12 percent would conflict with a floor rate of 16 percent. Thus, states need to come to an agreement regarding new floor rates in case any particular state introduces a VAT before others. Otherwise, renewed tax competition cannot be ruled out.

Second, when a comprehensive VAT is introduced by states, the **treatment of interstate trade** under such a VAT has to be resolved. It is clear that the central Ministry of Finance has to remain intrinsically involved and that states by themselves, given their diversity, cannot be expected to conclude on the matter. Indeed, in 1996, the Ministry of

Finance constituted a Group of Officials and Experts to Study the Problem of Taxation of Inter-State Sales, comprising experts, state finance secretaries and sales tax commissioners. Its report (Government of India, 1996) made specific recommendations regarding how to proceed, step by step, to a *destination* based taxation of interstate sales from the prevailing *origin* based structure.[20] This would involve a division of revenue from the 4 percent tax on interstate trade between the *origin* and the *destination* states, with an increasing share for *destination* states. The states seem to be in agreement at present that the tax rate would be sequentially reduced from 4 percent to 0 percent. However, considerations for revenue compensation to loosing states remain to be addressed. The Ministry of Finance should certainly be weighing these aspects carefully.

In the absence of any reform of the taxation of interstate trade, **states are focussing on intra-state sales** only. This is not a VAT by international standards. Further, it can lead to serious trade diversion. For example, if Madhya Pradesh introduces a VAT with input tax credit allowed only for inputs bought within the state, any entrepreneur would tend to reduce imports from other states. In a chain of such tax induced distortionary behaviour, the entrepreneur would face difficulties in selling his product outside his state. This is because entrepreneurs in other states would not get input tax credit in their own states on the tax they may pay in Madhya Pradesh. This should choke any common market properties among states. In order to successfully install a state level VAT, therefore, the central Ministry of Finance has to assume a lead role in reaching agreement among states on a *destination* based interstate sales taxation.

Once such an agreement is reached, an appropriate **administrative structure for interstate sales taxation** has to be devised. One alternative would be to create a clearing house mechanism. Here, when state A exports to state B, state A collects the tax to facilitate administration, and passes the revenue to the **clearing house**. At the end of a specified period, an accounting of interstate trade determines the distribution of revenue among states. The central government could be given charge of the pool or the states could set up their own management structure. A second alternative would give the **central administration direct responsibility**. Here, sales tax returns of all states would have one column for intra-state sales and a second column for interstate trade. The tax payable on the second column would be submitted to the centre.[21] At the end of the year, the central tax administration would distribute the revenue to the importing states as indicated from the tax returns.

At present, these aspects are not being adequately considered. In their absence, any **VAT focussed only on intrastate trade** remains a relatively rudimentary exercise. Indeed, it may lead to new types of distortions and inequities. It will require new bookkeeping from taxpayers without giving them benefits of a full-fledged VAT. Its revenue productivity cannot be safeguarded. Such a VAT may, therefore, suffer the same

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[20] In an *origin* based system, revenue accrues to the state that exports a good to another state. In a *destination* based system, revenue accrues to the importing state. Since the VAT is a tax on consumption, it should necessarily be based on the latter principle.

[21] The tax payable on the first column would be submitted to the state tax administration.

fate as the earlier VAT experiences among selected states, unless they are willing to quickly move forward to include interstate trade under the VAT. In the absence of a resolution, a buoyant revenue base for states, based on a comprehensive interstate VAT, cannot be structured.

Without **intensive central involvement**, the issue of interstate sales taxation is unlikely to be resolved. In sum, the centre needs to take a clear position as to what role it will play in facilitating a state level VAT. The centre has to: (1) urge states that have been slow so far in conceptualising an appropriate VAT for themselves to take appropriate action and provide them expert assistance; (2) play a technical role in designing a harmonised state level VAT in terms of rate structure and base which is currently not happening among states; (3) help reform interstate sales taxation since no state level VAT can function appropriately without including interstate sales in the VAT structure; and (4) work out its own role in the administration of the state level VAT on interstate sales, either in the form of supporting a clearing house mechanism, or itself administering the VAT on interstate sales for the states. Otherwise, it could result in interstate rivalries in taxation with unwarranted consequences on the consolidated fiscal deficit. The Ministry of Finance should consider setting up a VAT Office with the objective of addressing these issues.

iii. **Objective of a national VAT**

Only in the long run can a **national VAT**--comprising an amalgamation of the CENVAT at the central level and a state level VAT that incorporates interstate trade--be envisaged. That remains a distant goal, but it must remain the final objective.

Conclusions: (1) Some states are moving ahead with their own VAT reforms pertaining only to intrastate sales. These attempts are not coordinated among states and may conflict with agreements on the floor rates of their sales tax regimes. (2) It is important to address the issue of a state level VAT that includes interstate trade. This will obviously require close coordination among states. Such coordination should be facilitated by guidance from the centre. (3) Interstate trade taxation should be based on the destination principle: since the VAT is a consumption tax, the destination (or importing) state should receive the revenue. This will imply a move away from the prevailing origin principle in which the exporting state keeps the revenue. To compensate states that loose revenue from the shift, the centre could consider selected services to be assigned to states for taxation. (4) Once destination based interstate sales taxation is accepted in principle under a state level VAT, its administration structure has to be devised. The centre will have to play a significant role in its administration. The Ministry of Finance should consider setting up a VAT Office to facilitate the process. (5) A national VAT--comprising both the centre and the states--must remain the ultimate goal.

5. Expenditure Policy

With fiscal deficit targets in focus, and tax rates already lowered to internationally comparable rates, expenditure levels need to be sustained and restructured. The broad areas to **improve the quality of expenditures and reduce their scope** are generally known (Government of India, 1997b):

(1) The central government should scale back activity from expenditures that comprise the primary responsibility of states, the main area being agriculture. (2) It is well known that a wide array of schemes under various Ministries could be closed down without any noticeable impact on their assumed beneficiaries. An updated list of schemes should be drawn up by the office of the Expenditure Secretary and allocations made on zero-based budgeting. (3) Administration costs--especially the wage bill--must be reduced. (4) Subsidies must be restructured and user charges increased. (5) Expenditure categories must be subjected to evaluation techniques (for example, have expenditures on family planning yielded expected results). (6) Departmental undertakings such as posts and telegraphs and railways should run on their own without budgetary allocations--through reducing costs and restructuring charges. And (7) a freeze on investment and lending to commercially oriented public enterprises, requiring them to borrow on commercial terms, should improve their operations as well as reduce budgetary allocations. These measures should improve the quality of expenditure as well as reduce them in terms of GDP. In what follows, selected areas in which an immediate beginning needs to be made are discussed.

i. Non-Plan expenditures of the centre

The degrees of freedom in streamlining expenditure are curtailed by interest payments and defence expenditures that must be met. Other non-Plan expenditures that may be targeted are mainly subsidies and public administration. There is no dearth of analysis on either issue but a revisit and some elaboration may be useful here.

The wage bill: The need to cut back on wages and salaries was emphasised by the **Fifth Pay Commission**. In 1997 it recommended the usual quinquennial baseline salary adjustments *pari passu* with a **stepwise scaling back of government employment** by a third. The latter has not been implemented in substantial measure, however. Instead, the central government's salary adjustment was mirrored by state governments, adding to the fiscal pressure on general government. At this moment, even local bodies are being heard to demand salaries on similar scales as their corresponding state governments. The matter of reducing government employment seems to have remained a political one. Nevertheless, the recommendations of the Pay Commission continue to be pertinent.

The scaled back recommendations of the more recent **Expenditure Commission** (Government of India, 2000) to: (1) secure a cut of 10 percent of the staff as on 1.1.2000, to be carried out by 2004/05; (2) freeze creation of posts for two years; and (3) create a surplus staff cell to be made eligible for liberal voluntary retirement at the cost of being discharged (in line with the Pay Commission recommendations), may be a more realistic objective to be set for government policy.

Conclusion: In accordance with the Pay Commission and Expenditure Commission recommendations, the Ministry should propose a definitive plan to reduce government employment by a tenth as a first step, going upto a third in the final analysis, and delineate their implications for reducing expenditure.

Subsidies: Only if they give rise to substantial externalities do goods and services qualify for subsidies. Then they are termed **merit goods**. Such subsidies--that can be priced even if imperfectly--usually pertain to vital areas such as health, education and environment. Other subsidies, particularly in **non-merit areas**--agriculture, irrigation, industry, power and transport--tend to be justified on grounds of long term growth, redistribution or, simply, promotion of particular activities. These are likely to be based on noneconomic factors, and their costs and benefits are usually not adequately weighed. Non-merit subsidies have accounted for 11 percent of GDP--4 percent for central and 7 percent for state subsidies--with an average recovery rate of 9 percent, or a subsidy element of 91 percent (Srivastava and Sen, 1997).[22] They analysed the extent of subsidies and identified those components that should be curtailed. More recently, the Expenditure Commission has delineated selected subsidies that should be scaled back.

Another aspect of subsidies is that, in contrast to those given to final consumption or production, subsidies on inputs are undesirable since they are more easily dispersed to the non-target population.[23] Many **input subsidies** are, nevertheless, given in India for example, to fertilisers, feedstock, electricity, diesel and irrigation. Low user charges, reflected in low recovery rates, lead to excessive demand for scarce resources such as power and water, or in an inducement to use scarce inputs such as diesel and fertilisers. Indeed, costs and subsidies have moved in tandem in recent years. It becomes obvious that these need to be cut back and their recovery rates improved. An **increase in recovery rates** through revised user charges would mitigate the pressure on the fiscal deficit because excessive demand for scarce resources would be curtailed.

Conclusions: Subsidy reform should therefore be directed towards: (1) reduction of their size; (2) making them of finite duration; (3) using them for strict economic objectives; (4) making them transparent; and (5) administering them through final goods, with a view to maximising their reach to the target population at minimum cost. Recovery rates, even for non-merit services are low. An increase in user charges in agriculture, irrigation, industries, power and transport would substantially mitigate pressures on the fiscal deficit.

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22 For merit and non-merit goods combined, the extent of subsidy was 13-14 percent of GDP, with an average recovery rate of 11 percent.

23 Even where subsidies are on final consumption such as food subsidy, targeting remains poor and leakages--reflecting inefficiencies in procurement, storage and distribution--are extensive. These make any equity objective difficult to realise.

The recommendations of the **Expenditure Commission** (2000) are along the above lines:

(1) On the input oriented **subsidy on fertilisers**, the Retention Price Scheme (RPS) results in high costs and excess payments to industry. The goal of reform should be to bring price charged to farmers to import parity price, while protecting small farmers' real incomes and obviating any slump in food production. Nevertheless, the entire control system should be dismantled in a phased manner over five years--beginning with the dismantling of RPS on February 1, 2001. This should be replaced by a more decontrolled system of groupwise concessions--comprising selected incentives to manufacturers--such that they can compete with imports at a small protection level. The number of groups would be phased down from five to two over the five year period to minimise government support.

(2) On **food subsidy**, the Expenditure Commission has recommended higher efficiency, first, through the central government's providing the subsidy amount directly to states and allowing the latter freedom to procure either from the Food Corporation of India or other sources; second, by treating any stock above a pre-defined buffer stock as a producers' subsidy that should be phased out; and, third, by reducing the FCI's overhead costs. While the Commission welcomed the targeting measure already instituted by government[24], no further measures were suggested.

ii. Plan expenditure of the centre

An examination of the composition of Plan expenditure reveals that, first, it has had a **downward trend** in terms of GDP over the last decade (Graph 1). This aspect is generally known. However, second, Graph 1 also reveals that the revenue/current component had been lower than the capital component of Plan expenditure until 1991 when the trend reversed. Since then, Plan **revenue expenditure** has remained above Plan **capital expenditure** and the gap has widened.

Conclusion: The obscuring of various types of expenditures under the Plan category must be eliminated to make the nature of expenditures transparent. The premise that the Plan and non-Plan categorisation should be replaced by the internationally more prevalent current/capital nomenclature cannot be overemphasised.

iii. Subsidy elements in states' expenditure

It is generally believed and argued that rapid industrial growth depends upon the availability of adequate infrastructural facilities. This is usually in the form of adequate provision of electricity, road and rail transport, and telecommunications. In the same manner, agricultural growth depends upon rural infrastructure such as assured irrigation, land development, rural electrification and a good rural road network. In India **states suffer from infrastructural deficiencies** in differing degrees. The poorer states lag

[24] The measure is the allocation of 20 kg per month per family below the poverty line at half economic cost.

farther behind. Some of these needs could be met by the private sector except that it has a limited role in the less developed states. Here public investment, either by the central government or the state government, becomes crucial.

Despite arguments in favour of subsidies, their cost to the government exchequer has been estimated to be upwards of 10 percent of GDP, coupled with providing disincentive to performance (Srivastava and Sen, 1997). Further, **non-tax revenue** including from user charges **has declined** in states since the mid-1990s. The major state level subsidies comprise cheap or free electricity to farmers, subsidised road transport rates, and inadequate rates charged by the irrigation departments. An increase in user charges in these areas could reduce **the burden of subsidies** significantly. Perhaps only the low user charges for education and hospital services could be construed as subsidies for final consumption with a redistributive motive. Nevertheless, they require close examination.[25]

The largest single drain on the states' financial system has been the losses of the **State Electricity Boards** (SEBs) which increased from about 10 percent to 18 percent of the total states' Plan Expenditure from 1992/93 to 1998/99. The reason, beside the low tariffs, for these huge losses has been very low levels of operational efficiency. The transmission and distribution losses amount to about 23 percent in the official estimates which is itself quite high, but the actual figure is possibly much larger (for example, it is estimated to be about 46 percent in case of Orissa). Most of this large loss is theft, often with the connivance of the staff in the distribution segment. **Privatization of the distribution** may be the simplest way to eliminate these huge losses of the system as a whole including the consumers. These aspects have been delineated in some detail by Ahluwalia (2000).

Conclusion: The expenditure profile of states would improve significantly if they were able to rein in the growing subsidy element by increasing user charges in the provision of electricity, road transport and irrigation. The largest drain on the states' financial system has been the losses of State Electricity Boards reflecting low tariffs, low levels of operational efficiency, and corruption. The subsidy element in higher education and hospital services may be construed to be for final consumption with a redistributive motive; but it nevertheless requires careful examination.

6. Fiscal Deficit and Decentralisation

As in the case of the centre, the fiscal performance of the states, as discussed earlier, has been worsening. In terms of GDP, Graph 2 demonstrates: (1) there is an inability of total receipts to meet even total revenue expenditure; (2) the gap between the two is growing; and (3) there is a declining trend in capital expenditure which has remained

[25] Even for consumption subsidies, pricing policy based on cross-subsidization, for example of the Railways--subsidising passenger traffic at the cost of freight traffic--may work against the redistributive motive. In this case, the interest of backward states is affected adversely as it increases the cost of rail freight to these regions. This, for example, has made it cheaper for the coastal power plants in the south to import coal rather than transport it from the mineral rich backward states of the country.

below even interest payments since 1996/97. When individual states are examined, a **variation in states' fiscal performance** is detected. Indeed, Graph 3 indicates that grouping various states according to their 1998/99 fiscal deficit to GDP ratios yields the same ordering among the states over the entire decade.[26] This indicates that, central revenue sharing has not improved behaviour in terms of states' fiscal deficit to GDP ratios. The matter becomes controversial when Finance Commission recommendations are perceived to exacerbate such differences.[27] Thus, one fallout of the Eleventh Finance Commission Report (2000) was that various states that consider themselves to be better fiscal managers complained bitterly that the formulae used by the Commission to redistribute central funds would provide little incentive for profligate states to improve fiscal performance.

Indeed, there is an appearance of a dilemma for the central government. On the one hand, a crucial economic role of any central government in a federal country such as India has to be **redistribution of resources** from developed to underdeveloped regions. Indeed, between the Tenth and Eleventh Finance Commissions, the income criterion--"Distance"-- has been given greater priority (Table 5). On the other hand, the results of that very distribution are increasingly perceived to provide little encouragement in reducing the **consolidated fiscal status of the states**.

Table 5
India: Finance Commissions: Relative Weights for Distribution

	Eight	Ninth		Tenth	Eleventh
	Income	UED[1]	Income	Inter se	Inter se
Population	25	29.94	25	20	10
Distance[2]	50	40.12	50	60	62.5
Inverse Income	25	14.97	12.5	--	--
Poverty/ Backwardness	--	14.97	12.5	--	--
Area	--	--	--	5	7.5
Infrastructure	--	--	--	5	7.5
Tax Effort	--	--	--	10	5
Fiscal discipline	--	--	--		7.5
Total	100	100	100	100	100

Source: Various Finance Commission Reports.
1) Union Excise Duty. 2) Distance from nation's per capita income.

Ongoing research (Shome, 2000b), based on data on the 14 major states, indicates the following. (1) **Decentralisation**[28] of expenditure--both development and non-development--from the centre to the states over the last two decades **has led to higher**

[26] To an extent, the groupings may be affected by exogenous factors such as the absorptive capacity of Assam (leading to a low fiscal deficit) or a high level of small savings in West Bengal (leading to a high fiscal deficit) since this source of financing, in effect, has to be absorbed).

[27] See also Ahluwalia (2000) and Kurian (1999, 2000) for an analysis of variations in economic and fiscal performance of states.

[28] Decentralisation was defined in various ways, focussing on the share of a state's expenditure in a particular category (such as development expenditure) in the total (i.e. the centre plus that state's expenditure on the same category). See Diagrams 2 and 3.

economic growth (Diagram 2).[29] (2) Estimates reveal that, over the last decade, decentralisation in the case of development expenditure has also led to lower fiscal deficit of states (Diagram 3) while, in the case of non-development expenditure, the result is statistically insignificant. (3) A significant negative relationship is found between decentralisation--irrespective of the definition--and the central fiscal deficit.

Given the **negative relationship between decentralisation and fiscal deficit**, and with the objective of reducing the latter, it is well worthwhile considering a policy review in centre-state fiscal relations. To take advantage of the likely negative impact on the fiscal deficit as a result of decentralisation, the overall revenue transfer (as a percentage of gross central tax revenue) from the centre to the states might be reduced. This will leave greater room for the states to collect their own revenue, giving them more responsibility to handle their own affairs.[30] Nevertheless, the share of the central pie (albeit a smaller one) that goes to the poorer states should be increased in order to make redistribution among states the main focus of revenue sharing from the centre to the states. [31]

Conclusions: (1) Tax assignment to states should be amplified with the objective of decentralisation. (2) A lower proportion of central tax revenue should be shared with states. (3) Income redistribution should be given higher weight in revenue sharing. (4) Given the empirical relationship between higher decentralisation and lower fiscal deficit, the consolidated fiscal deficit of general government will likely decrease.

7. Sustainability of Public Debt

Previous sections have delineated fiscal trends for the centre and states in macro terms as well as the details of their tax and expenditure policies and intergovernmental relations. It is clear that the resultant public debt to GDP ratio, of centre and states combined, has risen over the decade--standing at 73 percent of GDP at present-- so that the issue of its sustainability becomes relevant. India's foreign debt is a small fraction of central public debt--about 5 percent--and states cannot borrow directly abroad.[32] Hence

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[29] Other explanatory variables were private industrial investment, public capital development expenditure, and price level that affect growth positively, and proportion of workforce in agriculture that affects growth negatively. See Diagrams 2 and 3.

[30] This would be consistent with assigning services to be taxed by states.

[31] It is worth pointing out, however, that the "distance" criterion used by the Eleventh Finance Commission is a surprisingly rudimentary one, given the ample availability of information on poverty in the case of India. The formulation of this criterion should be improved by considering the proportion of the country's poor living in a state, the percentage of poor in a state's population, the proportion of poor living in the urban areas and in the rural areas, and the proportion of rural to urban population.

[32] Public debt refers to total debt of centre and states. It includes internal debt and other liabilities--small savings and provident funds--and external debt on the part of the centre. It includes market loans and bonds, ways and means advances from the Reserve Bank of India, provident funds, etc., and loans from banks and other institutions.

foreign debt does not yet pose a problem of similar intensity as in Latin America or East Asia.

i. Upward trend of public debt to GDP ratio

Graph 4 plots the path of **public debt to GDP** ratio over the last two decades for the centre, and for the centre and states combined.[33] It also fits a trend regression of the actual variables. The **upward trend** in both instances is amply clear. Graphs 5 and 6 attempt to examine **what lies behind this growth**. Graph 5 plots fiscal deficit over the last decade and fits trend regressions. While it reveals a slightly declining trend for the centre, it is clear that it is more than countered by states, so that the combined trend is rising. In fact, the declining trend for the centre is not really meaningful since the trend is influenced by two very high numbers for early years in the series (1990 and 1993). Further, during more recent years--since 1994--Graph 6 indicates that fiscal deficit trends of both the centre and combined centre and states have been rising. These fiscal deficit trends tend to explain the upward trend in the public debt to GDP ratio of Graph 4.

ii. Tests for debt sustainability

The sustainability of public debt is usually discussed in terms of the direction in which the primary deficit--fiscal deficit net of interest payments--should move. The current primary deficit in India is 0.86 percent of GDP and action needed for various public debt policies will have to be measured against this benchmark.

Three criteria are tested for the sustainability of India's public debt. (1) Debt should be zero at a specified future period n. (2) The debt to GDP ratio at a future period n should be reduced to a specified fraction of today's (t) ratio. (3) The debt to GDP ratio for the future is fixed at today's ratio. The formulae used are well known in the literature and have been recently discussed in La Pittus (2000). They are summarised in Appendix II. Reflecting prevailing macroeconomic indicators, initial assumptions made are that the nominal rate of growth of the economy, g, is 12 percent; and the average nominal rate of interest on public debt, i, is 10 percent.[34] This combination, with the nominal growth rate being higher than the nominal interest rate, provides a leverage for debt sustainability. Though the average interest rate has declined over the last three years, ongoing studies tend to indicate that interest rates on public debt have hit bottom and are most likely to increase in the future. As interest rates catch up with growth rates, as is likely to happen with further debt issuance, this leverage will be lost, and further correction would be

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[33] Usually, the public debt to GDP ratio is considered. Conceptually, however, if the burden caused by amortisation of public debt is the issue, then one should ideally use non-subsistence GDP as the benchmark since only this part of GDP could be utilised for amortisation. For India, the ratio of public debt to non-subsistence GDP would be much higher than the public debt to GDP ratio. In a cross-country comparison, India's public debt burden would rank among the highest.

[34] The rate of nominal growth of 12 percent is in line with prevailing conditions. The current average interest rate on public debt is 9.7 percent, calculated as: interest payments of the centre and states divided by the public debt as defined above.

needed. In the simulations, therefore, three interest rates--10, 11, and 12 percent--have been tested.

The results of the various simulation exercises are shown in Table 6. In Case 1, since **public debt is targeted to reduce to zero**, it reflects the most severe criterion. Whether this is attempted in 5 years or 20 years, the requirement is for the primary balance (PB) to be in surplus. At the prevailing 10 percent interest rate, reducing the public debt to zero in 20 years will require an average primary surplus of 1.93 percent of GDP. As the interest rate rises, say to 11 percent, a greater surplus of 2.05 percent of GDP is needed, and so on. Even with a lower interest rate of 8 percent, **a primary surplus is needed** to amortise public debt (though this is not illustrated in the Table 6).

Case 2 (a) is a less severe objective in that the **public debt to GDP ratio** is targeted to reduce over a specified period of time. The current ratio being 73 percent, it is targeted to reduce to a range (60, 50, and 40 percent) over a 5 - 20 year period. Even in the case of a **reduction to 60 percent**, it is obvious that such a reduction in a 5 -10 year period will require a primary surplus; the same reduction in 15 years **requires a reduction in the current primary deficit** to 0.67 percent of GDP, from the prevailing 0.86 percent. The same requirement in 20 years will, however, allow a higher primary deficit in terms of GDP than presently, reflective of the continuance of the positive gap between growth and interest rate. However, this is only one such instance among all possibilities in Case 2 and is an unlikely case. Needless to say, to bring down the debt/GDP ratio to below 60 percent, a requirement for a primary surplus requirement becomes effective.

Case 2(b) simply assumes a more realistic interest rate of 11 percent. Immediately, there is no instance in which a higher than current primary deficit is feasible. In fact, all public debt policies necessitate a primary surplus.

Case 3 is the least rigid in that it just requires the **public debt to GDP ratio to be frozen** at current levels. In such a case, at a 10 percent interest rate, **a primary deficit can be accommodated** at 1.3 percent of GDP which is higher than the present level. This reflects the assumption of a continuance in the positive (growth - interest rate) gap which is likely to be untenable in the medium term. At a higher interest of 11 percent, the primary deficit needs to be reduced to 0.65 percent of GDP and, at a 12 percent interest rate, the primary balance must be zero.

Table 6. India: Simulations of Public Debt Sustainability: Primary Balance Requirement (PB/Y) 1/

PB/Y actual = -0.86 **Dt = Rs. 1155717 crores,** **Yt = Rs. 1583516 crores g = 12%**

1. Debt should be zero at period n at specified interest rates

	i = 10%	**i = 11%**	**i=12**
n=20	1.93	2.05	2.16
n=15	3.13	3.28	3.44
n=10	5.49	5.68	5.87
n=5	12.30	12.50	12.70

2. Debt/GDP at period n is a given fraction δ of current period (t) debt/GDP

D/Y - actual for 1999/2000	73	73	73
D/Y - desired	60	50	40
δ	0.82	0.69	0.55
(a) at i=10%			
n=20	-1.39	0.14	1.67
n=15	-0.67	0.89	2.46
n=10	0.17	1.94	3.71
n=5	1.76	4.38	7.01
(b) at i=11%			
n=20	0.14	1.49	2.84
n=15	0.54	1.98	3.41
n=10	1.13	2.80	4.47
n=5	2.49	5.04	7.59

3. Debt/GDP in future is fixed at today's (t) debt/GDP of 73%

	i = 10%	**i = 11%**	**i = 12%**
PBt/Yt	-1.30	-0.65	0.00

Sources: Appendix Table 1 and Indian Public Finance Statistics, Ministry of Finance, various issues
1/ Formulae for Cases 1,2 and 3 appear in Appendix II
Note: PB/Y is the primary balance in terms of GDP, D/Y is the public debt in terms of GDP.

Therefore, **in all realistic scenarios, the current primary balance has to be reduced** for a sustainable public debt and, in many instances of a healthy public debt policy, a primary surplus needs to be generated. In general, these results are in line with those of earlier studies (Buiter and Patel, 1992; and Rajaraman and Mukhopadhyay, 2000) which also found that the behavior of India's public debt cannot be sustained in the long run without a reduction in the primary deficit.[35] Though this should not be considered an adequate objective, it indicated that the overall public debt scenario in India is not unmanageable if meanigful measures are taken soon enough.

Conclusions: (1) There is a clear upward rising trend in the public debt to GDP ratio pertaining to the centre and states. This is explained by a similar trend in the fiscal deficit to GDP ratio, whose steepness has increased since 1994. (2) If public debt is to be amortised completely in a 5-20 year period, severe pressues on the primary deficit will ensue. Even at 8 percent rate of interest, for example, it will have to be in surplus while currently, the average interest on public debt is 9.7 percent. (3) If a lower goal of reducing the public debt to GDP ratio is specified, say to 60 percent in the next 10 years, then too a primary surplus is needed. But if the goal is extended to 15 years, then a primary deficit could be accommodated though at a lower level than the current one. (4) If the goal is diluted to require freezing the prevailing debt to GDP ratio, then a primary deficit of -1.3 percent of GDP at a 10 percent interest rate, and a primary deficit of -0.65 percent of GDP at an 11 percent interest rate, can be accommodated. In the former case, a higher than the prevailing -0.86 percent primary deficit to GDP ratio becomes acceptable, but an average interest of 10 percent cannot be expected to last into the future. In the more realistic latter case of 11 percent interest rate, the present primary deficit of 0.86 percent of GDP needs to be reduced in terms of GDP.

In sum, in realistic scenarios of growth rate - interest rate combinations, the primary deficit to GDP ratio has to be reduced or a surplus generated for the sustainability of public debt. Clearly, a perspicacious fiscal policy is needed to contain the public debt to GDP ratio--and its burden on future generations--from growing. Even more restrictive policies are needed to reduce the ratio.

8. Concluding Remarks

India has faced an upward trend in her consolidated fiscal deficit to GDP ratio in recent years. The **burden of public debt is also high**. However, there are practical and meaningful measures that could arrest these trends. Thus India is at a crossroads. If she is able to successfully implement a menu of available options, the fiscal stance will certainly improve. If she is unable to do so, the fiscal problem will worsen and the burden on the next generation--through accumulation of public debt, high interest rates,

[35] Since then the debt/GDP ratio of the centre had decreased and the average interest rate diminished somewhat. However, the outlook at this point has changed as mentioned above.

diminished private sector activity, and lower growth--would become untenable. In order to obviate this, the **primary fiscal deficit**--deficit net of interest payments--**has to be reduced** in terms of GDP.

The measures that are possible are several. On the side of central taxation, **exemptions and incentives must be rationalised** and minimised. State level taxation should **spearhead a VAT** with central guidance. **Services should be brought** under the tax net. On the expenditure side, the **wage bill must be reduced**. **Food subsidies** must be better targeted and their operations made more efficient. **Fertiliser subsidies must be reduced**. Unproductive expenditure hidden under the **Plan category must be streamlined**.

In the medium term, greater decentralisation in the form of **higher tax assignment to states** (leaving a smaller central pie to be shared with states) might be attempted. At the same time, revenue sharing should **give greater weight to receipts by poorer states**. Since there is a relationship between lower fiscal deficit and higher decentralisation, these modifications in centre-state relations should **reduce the consolidated fiscal deficit** while protecting the poorer states.

Appendices

Appendix I: Description of Selected Macro Models

Among the narrower approaches, Balakrishna (1991), in his model, specifies the agricultural and manufacturing sectors in some detail with the objective of explaining inflation in a structuralist model with inter-linkages between agricultural and non-agricultural prices both directly and through wages and salaries. And Joshi and Little (1994) have used a monetarist approach to price determination, demonstrating a stable relationship between money, production and prices.

Among simultaneous equations models, Pandit (1994), Jadav (1994), and Manohar Rao have delineated detailed macro models. Pandit (1994) specifies agriculture, manufacturing, and infrastructure sectors and intersectoral relationships. Output is affected by the availability of credit. Price determination incorporates money and interest rates, though money supply is not fully controlled given fiscal operations. A more recent version has been utilised in Pandit, Krishnamurty and Mahanty (2000).

In the same vein, Jadhav's (1994) model postulates channels of operation in the Indian economy using a monetarist approach with some structural elements. His model is especially interesting for fiscal considerations. An initial government deficit raises money supply which determines the price level and nominal income (given real income). The higher price level affects government receipts and expenditures differently. Since the effects of inflation are likely to be stronger on expenditures than on receipts, and if expenditures adjust faster than revenues, the government deficit tends to widen further, setting in motion a self-perpetuating process. However, higher real development expenditure promotes economic growth which moderates inflation caused by the initial increase in money supply. This dampens inflation induced deficits. The actual evolution of government deficit, money supply, inflation and economic growth, and other model variables is determined by the relative strengths of the various postulated relationships.

Manohar Rao (1999) suggests an integrated system of national accounts—based on a framework of income and flow-of-funds accounts—for an appropriate macroeconomic appraisal, forecasting and policy conclusions for the economy. The flow-of-funds identities combined with behavioral relationships between variables included in the accounting framework can be combined to construct and utilise a quantitative model of economic processes involving the accounts that define the economy.

Chand and Shome (1997) address the issue of poverty alleviation in a macro-model. They integrate the poverty alleviation objective into a financial programming framework. In consequence, the assessment of trade-offs between competing objectives is facilitated. Simulations demonstrate how such an integrated approach can reduce poverty and improve the balance of payments although at a cost, temporarily, of a higher fiscal deficit and inflation. Indian data are now being applied to the model.

Appendix II: Criteria for Public Debt Sustainability
Debt should be zero at period n at specified interest rates (Solvency)

$$\overline{PB} = \frac{D_t * (1+i)^n}{\sum_{j=1}^{n} (1+i)^{n-j}}$$

where
PB = Primary balance
Dt = Public debt
i = Interest rate
g = Rate of growth of nominal GDP

Debt/GDP at period n is a given fraction δ of current period (t) debt/GDP
(Stabilizing or reducing the debt to income ratio)

$$\frac{PB}{Y_t} = \frac{D_t}{Y_t} * \frac{[(1+i)^n - (1+g)^n * \delta]}{\sum_{j=1}^{n} (1+i)^{n-j}}$$

Debt/GDP in future is fixed at today's (t) debt/GDP
(Freeze change in debt to income ratio)

$$\frac{PB_t}{Y_t} \gtreqless \frac{\alpha * (i-g)}{(1+g)}$$

Where α is the share of debt in income (D/Y) at (t-1).

Source: La Pittus (2000).

Appendix Table 1: India: Fiscal Position of the Central Government

(in percent of GDP)

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000 (RE)	2000/01 (BE)
TOTAL RECEIPTS	11.83	10.68	11.47	11.01	9.50	10.15	9.90	9.85	9.44	9.42	10.02	10.41
REVENUE RECEIPTS (Centre's share)	10.80	9.67	10.09	9.90	8.78	9.02	9.32	9.27	8.83	8.48	9.23	9.33
Gross Tax Revenue of which,	10.65	10.13	10.29	9.96	8.82	9.14	9.41	9.53	9.42	8.85	8.74	9.18
Corporation Tax	0.98	0.94	1.20	1.19	1.17	1.37	1.39	1.36	1.41	1.51	1.54	1.84
Taxes on Income (other than Corp. Tax)	1.03	0.95	1.03	1.05	1.06	1.19	1.32	1.34	1.90	1.19	1.37	1.45
Customs	3.72	3.63	3.40	3.17	2.58	2.65	3.03	3.15	2.71	2.73	2.46	2.46
Excise	4.62	4.31	4.30	4.12	3.69	3.70	3.40	3.31	3.15	3.27	3.14	3.27
Net of States Share	7.91	7.56	7.65	7.22	6.22	6.68	6.93	6.88	6.31	5.94	6.50	6.70
Other Taxes	0.30	0.30	0.37	0.43	0.31	0.23	0.27	0.37	0.26	0.25	0.24	0.18
Non-Tax Revenue	2.88	2.11	2.44	2.68	2.56	2.34	2.39	2.39	2.52	2.54	2.73	2.63
TOTAL CAPITAL RECEIPTS (net of borrowings) of which,	1.03	1.01	1.38	1.11	0.71	1.13	0.58	0.58	0.61	0.94	0.79	1.08
Loan Recovery	1.03	1.01	0.92	0.85	0.72	0.63	0.55	0.55	0.55	0.60	0.65	0.62
Other Receipts of which Disinvestment	0.00	0.00	0.46	0.26	-0.01	0.50	0.03	0.03	0.06	0.33	0.13	0.46
TOTAL EXPENDITURE	19.17	18.53	17.03	16.37	16.51	15.92	15.08	14.76	15.31	15.85	15.62	15.51
NON-PLAN EXPENDITURE of which,	13.31	13.54	12.29	11.48	11.52	11.22	11.16	10.83	11.41	12.06	11.54	11.48
Interest Payments	3.66	3.78	4.06	4.15	4.28	4.36	4.23	4.37	4.33	4.42	4.70	4.64
Defence Expenditure	2.97	2.71	2.50	2.35	2.54	2.30	2.27	2.17	2.33	2.26	2.49	2.69
Subsidies	1.62	2.14	1.87	1.60	1.48	1.28	1.13	1.20	1.29	1.41	1.32	1.04
Others	5.05	4.90	3.86	3.38	3.23	3.28	3.52	3.09	3.19	3.97	3.02	3.10
Pay Commission									0.28			
PLAN EXPENDITURE	5.68	4.99	4.73	4.89	5.08	4.69	3.92	3.93	3.90	3.79	4.08	4.04

Contd…./-

FISCAL DEFICIT (new definition)*	5.57	6.35	4.24	4.22	6.43	4.81	4.34	4.12	4.83	5.12	5.60	5.10
FISCAL DEFICIT (old definition)**	7.34	6.22	5.40	4.72	7.01	5.77	5.18	4.91	5.87	6.43	6.99	6.57
FISCAL DEFICIT(Min of Finance)***	7.30	6.22	5.40	4.72	7.01	5.71	5.10	4.90	5.87	6.45	5.60	5.10
GDP at market price	484720	568240	654468	749029	859220	1009906	1181961	1361952	1515646.00	1762609	1944607.14	2181862.75

Sources: Ministry of Finance, Union Budget, various issues.
Economic Survey, Ministry of Finance, 1999/2000.

Note: 1. The GDP for 1999-2000 is computed using the nominal GDP growth of 8.9 percent (real GDP growth of 5.9 percent plus the rate of inflation, WPI, of 3 percent) given in the Economic Survey 1999-2000.
2. GDP growth for the year 2000-01 is assumed to be 12.2 percent (computed from Union Budget 2000-01)

* From 1999-2000, transfer of small savings to the states and union territories was removed from the concept of fiscal deficit. The entire series has been adjusted accordingly
** The series is presented according to the old definition.
*** The Ministry's series combines the old definition upto 1998-99, and the new definition from 1999-2000 onwards.

Appendix Table 2: India: Fiscal Position of State Governments

(in per cent of GDP)

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (RE)	1999/2000 (BE)
TOTAL RECEIPTS	11.22	11.31	12.42	11.88	12.15	12.22	11.44	11.20	11.23	10.67	11.21
REVENUE RECEIPTS	11.00	11.04	11.91	11.63	11.87	11.70	11.15	10.76	10.87	10.48	11.07
Tax Revenue	8.08	7.78	8.05	7.94	7.99	7.97	7.88	7.81	8.02	7.64	8.14
Direct Taxes	1.05	0.92	0.96	0.97	1.08	1.04	1.14	1.15	1.34	1.01	1.06
Indirect Taxes	7.03	6.86	7.09	6.97	6.91	6.93	6.74	6.66	6.68	6.63	7.08
of which,											
General Sales Tax	2.96	2.90	3.03	2.89	3.00	3.13	2.86	3.08	2.99	2.94	3.17
Non-tax Revenue	1.04	0.97	1.40	1.21	1.30	1.62	1.51	1.16	1.10	1.00	1.08
NET CAPITAL RECEIPTS	0.21	0.26	0.51	0.26	0.28	0.52	0.30	0.44	0.36	0.20	0.14
of which,											
Recoveries of Loans and Advances	0.21	0.26	0.51	0.26	0.28	0.52	0.30	0.42	0.36	0.17	0.13
Disinvestment	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.03	0.02
TOTAL EXPENDITURE	14.17	14.31	14.81	14.42	14.21	14.41	13.85	13.52	13.82	14.78	15.07
Revenue Expenditure	11.72	11.94	12.78	12.30	12.27	12.25	11.89	11.94	11.97	12.77	13.13
of which,											
Interest payments	1.48	1.53	1.68	1.69	1.79	1.89	1.85	1.88	2.00	2.10	2.32
Rev Exp (Non-Development)	4.45	4.65	4.86	4.87	4.94	5.38	5.45	5.11	5.36	5.61	6.22
Rev. Exp. (Development)	7.04	7.10	7.72	7.18	7.16	6.69	6.43	6.67	6.43	6.89	6.67

Contd…/-

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (RE)	1999/2000 (BE)

Capital Expenditure	2.44	2.37	2.03	2.12	1.94	2.16	1.97	1.57	1.85	2.01	1.94
of which,											
Non-Development	0.01	0.00	0.01	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01
Development	1.65	1.62	1.54	1.42	1.44	1.73	1.56	1.29	1.50	1.47	1.47
Total Development Exp.	8.69	8.72	9.26	8.60	8.60	8.42	7.99	7.96	7.93	8.36	8.14
Total Non-Development Exp.	4.46	4.65	4.86	4.87	4.94	5.39	5.45	5.12	5.37	5.63	6.23
Gross Fiscal Deficit	3.18	3.31	2.89	2.79	2.40	2.74	2.66	2.74	2.92	4.27	4.01
GDP at market prices*	484720	568240	654468	749029	859220	1009906	1181961	1361952	1515646	1762609	1944607

Sources: Indian Public Finance Statistics, Ministry of Finance, various issues.

*Taken from Economic Survey, Ministry of Finance, 1999/2000.

Note:

1. The GDP for 1999-2000 is computed using the nominal GDP growth of 8.9 percent (real GDP growth of 5.9 percent plus the rate of inflation, WPI, of 3 percent) given in the Economic Survey 1999-2000.

2. GDP growth for the year 2000-01 is assumed to be 12.2 percent (computed from Union Budget 2000-01)

Appendix Table 3: VAT: Cross-Country Treatment of Selected Services

Country	Laundry	Hotel/ Restaurant	Amusement	Telecommuni -cations	Repair/Maint. Movable Goods	Leasing Movable Goods	Freight/ Storage	Advertising Admin	Professional/ Legal	Medical	Particulars
ASIA											
China People Rep.	T	T	T	T	T	T	T	T	T	T	Business Tax on services
Indonesia	S	X	S	S	S	S	S	X	S	X	Integrated + Devt. Tax
Japan	S	S+	S	S	S	S	S	S	S	X	Integrated +Excise Tax
Korea Republic of	S	S+	S+	S	S	S	S	S	X	X	Integrated +Excise Tax
EUROPE											
Belgium	S1	L,S1	X,L	S	S	S	S	S+	X,S	X	
France	S	L,S	L,S,X	S	S	S	S	S	X	X	Integrated
Germany Federal Rep.	S	S	X,L	S	S	S	S	S	S	X	Integrated
Italy	S	L	S	X,L	S	S	S	S	S	X	Integrated
Netherlands	S	L	L,S	X	S	S	S	L,S	L,S	X	Integrated
United Kingdom	S	S	S	S	S		S	S	S	X	Integrated
Hungary	S	Z,S	X,Z,S	Z	L	S	L	S	X,S	Z	Integrated
Turkey	S	S	S	S	S	S	S	S	S	Z	Integrated
WESTERN HEMISPHERE											
Argentina	S	S	X,S	S	S	S	S	S	S	S	Integrated
Brazil	T+	T+	T+	T	T	T	X+	T	X	X	State/ municip excise taxes
Canada	S	S	S	S	S	S	S	S	S	X	Integrated
Chile	S	S	S	S	S	S	S	S	X	X	Integrated
Colomubia	X	S+S	X,S+	L	S	X	X	X	X	X	Services taxed selectively
Mexico	S	S	X,S,H	S+	S	S	S	S	S	X	Integrated + Excise Tax

S=STANDARD RATE, H=HIGH (ABOVE STANDARD), T=TAXED SEPARATELY, Z=ZERO RATE, L=LOWER RATE, X=EXEMPT, SI=INTERMEDIATE RATE, S+=STANDARD PLUS AN EXCISE RATE

Appendix Table 4: VAT: Cross-Country Selected Features

Country	Year Vat Intro	Vat Form	Stage	Tax base	No. of Rates at Intro	Rates Current Number	VAT Principle	Method of Calculation
ASIA								
China People's Republic of	1984	Production	Manufacturing	Selected Industrial Goods	12	12	Destination	Substraction
Indonesia	1985	Consumption	Wholesale	G&S	1	1	Destination	Credit
Japan	1989	Consumption	Retail	G&S	1	1	Destination	Credit
Korea Republic of	1977	Consumption	Retail	G&S	1	1	Destination	Credit
EUROPE								
Belgium	1971	Consumption	Retail	G&S	3	6	Destination	Credit
France	1968	Consumption	Retail	G&S	4	6	Destination	Credit
Germany	1968	Consumption	Retail	G&S	2	2	Destination	Credit
Italy	1973	Consumption	Retail	G&S	3	4	Destination	Credit
Netherlands	1969	Consumption	Retail	G&S	2	2	Destination	Credit
United Kingdom	1973	Consumption	Retail	G&S	1	1	Destination	Credit
Bulgaria	1991	Consumption	Retail	G&S	2	2	Destination	Credit
Hungary	1980	Consumption	Retail	G&S	2	2	Destination	Credit
Turkey	1985	Income Type	Retail	G&S	1	5	Destination	Credit
Western Hemisphere								
Argentina	1975	Consumption	Retail	G&S	1	1	Destination	Credit
Brazil	1967	Consumption	Retail	G&S	1	2	Origin/Destination*	Credit
Canada	1991	Consumption	Retail	G&S	1	1	Destination**	Credit
Chile	1975	Consumption	Retail	G&S	2	1	Destination	Credit
Columbia	1975	Consumption	Retail	GS taxed selectively	3	2	Destination	Credit
Mexico	1980	Consumption	Retail	G&S	1	3	Destination	Credit

G&S = Goods & Services

*States use origin principle, though some rate accommodations are made to approach the destination principle.

**Not all provinces have as yet, opted for the VAT.

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Summary of Discussions

The first issue of focus was the burden of public debt. Dr. Shankar Acharya emphasised that the burden of public debt may be looked at from the profile of government's increasing interest payments to GDP. Dr. Pronab Sen pointed out that, nevertheless, if government is able to control the fiscal deficit, then there would be a downward pressure on interest rates. In his reply, Dr. Shome indicated that, unless this actually occurred, any exercise to estimate the sustainability of public debt must keep the deficit as *ceteris paribus*. Further, it is anticipated that the average interest rate paid on public debt will rise from the present 10 percent approximately. Shri Vishwajit Prithvijit Singh added that, if one looks at actual experience, the role and scope of infrastructure bonds, millennium bonds and the like, with the sole intention of financing the fiscal deficit, are likely to continue. Thus the interest burden may be expected to keep rising unless there is a will to implement reform. Shri Jagdish Shettigar agreed that one element affecting the deficit is the interest rate. He indicated that it would be worthwhile exploring non-fiscal tools such as disinvestment to amortise public debt. Shri Prithviraj Chavan added that he found the public debt situation to be alarming.

The second issue was expenditure, in particular, the impact of implementing the fifth Pay Commission's recommendations. Dr. Shankar Acharya began the discussion by indicating that the post 1997/98 increase in expenditure ratios can be substantially attributable to the consequences of implementation of Pay Commission recommendations. This was subsequently replicated by the states though it was not legally required for them to do so. Dr. Pranab Sen also emphasised the impact of implementation of the Pay Commission's recommendations, held every ten years. He added that this leads to a bunching of expenditures which looks worse for states. This is because, while the Centre revised salaries with a 16 month lag, the states did so with a 28 month lag. The entire backlogged adjustment shows up in one year and renders the fiscal stance to appear to be lumpy and bunched together.

The third issue was that of central taxes. Shri Prithviraj Chavan indicated that exemptions remained an issue with central taxes such as customs and excises as well as direct taxes. Further, there are many leakages occurring in reflection of present tax administration practices. Dr. Amit Mitra raised several issues. First, the 1997/98 tax cuts had raised revenue and resulted in 13 million more taxpayers. Second, it is feasible to increase the base by including farmers. Third, services should be taxed comprehensively. Fourth, there had been little tax collection from presumptive taxation so far since the margin of payment has been low.

The fourth issue was decentralisation and the role of the states. Dr. Shankar Acharya indicated that a sizeable increase in the expenditure function of the states, to be passed down from the Centre, would possibly require a constitutional amendment, rather than being simple and straight forward. Shri Vishwajit Prithvijit Singh added that, if a state were managing its fiscal affairs well, it could be expected to have a lower debt burden. Shri Prithviraj Chavan made several points regarding the fiscal conduct of states. Because of their debt burdens, states are having to cut back on development expenditures, for example, Maharashtra has cut back on education expenditures by 27 percent. They are giving out guarantees without sufficient backing. Their pension costs are overtaking salary bills. Given the poor expenditure stance, fundamental reform is needed on this front. At the same time, revenue aspects must be addressed. The value added tax (VAT) needs a blueprint at the level of states. There remain too many exemptions from the taxes of states. Dr. Mitra added that it should be pondered why states should not be allowed to tax income as in the United States where both the federal and state governments are empowered to tax income. Further, though services are not directly mentioned in the constitution and thus falls in the residual category that belongs to the Centre, there is no reason why the Centre should not share services as a tax base with the states.

The fifth issue was the political economy of reform. Shri Vishwajit Prithvijit Singh was of the opinion that a political consensus was needed for implementation of economic policies. For example, he pointed towards the electricity subsidy suffering from leakages to the privileged, including to industrial units. Any correction simply based on economic policy, would lead to unrest. On the other hand, he charged that development budgets lie unspent by the Centre, but is then used up to cover the fiscal deficit. Shri Jagdish Shettigar said that it was time for political parties to shed the guise of opposition on economic matters, when the nation's well being is at stake. All parties should come together to agree on matters of common economic interest. Shri Vishwajit Prithvijit Singh responded by saying that, in Parliament, the opposition has desisted from attempting to block economic matters that could affect the general population and that opposition had emerged from within the ruling coalition itself. Shri Prithviraj Chavan added that corrections on the petroleum front were breached by the prevailing government itself.

Last but not least, the sixth issue was the size and role of government. Shri Sudhir Mulji was of the opinion that the fiscal deficit was irrelevant and that Keynesian policies were needed to jumpstart the economy. Shri T.N. Ninan added that, playing the devil's advocate for example, if the real problem was the real interest, why not print money to fund the deficit. Shri N.N. Jha cautioned that downsizing government was the answer. Disinvestment continues to remain a quandary. Since 1991, Rs. 19,000 crore had been raised from disinvestment but now an appropriate sequencing policy was needed. Shri Jagdish Shettigar also supported disinvestment.

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