Mid-Year Review of the Indian Economy 2005-2006

M. Govinda Rao

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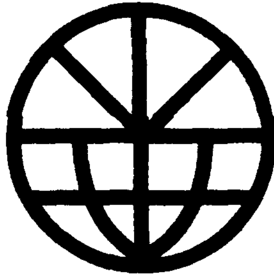

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M. Govinda Rao

SHIPRA

India International Centre, New Delhi

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Preface

Dr. M. Govinda Rao, Director, National Institute of Public Finance and Policy, New Delhi, made the mid-year assessment of the Indian economy at the India International Centre for the period 2005-2006. His presentation was followed by the observations of two invited Discussants, Dr Kanhaiya Singh, Fellow, Macroeconomic Monitoring & Forecasting Division, National Council of Applied Economic Research, and Ms Mythili Bhusnurmath, Editor, *Financial Express.* Dr Saumitra Chaudhuri, Economic Advisor, ICRA (Investment and Credit Rating Agency) and Member of the National Economic Advisory Council, chaired the half-day seminar. The Centre is thankful to Dr M. Govinda Rao for his distinguished presentation; to the two Discussants, Dr Kanhaiya Singh and Ms Mythili Bhusnurmath, for their insightful comments; and to Dr Chaudhuri for sparing time to chair the seminar.

A perceptible and desirable change in perspective of the annual mid-year review in the past couple of years had already been noted by Dr Ajit Mozoomdar last year. Dr Rao's survey documented the state of the economy mid-year but moved on to cover the reform process underway in the country, its success and limitations, analysing in detail the fiscal and taxation regimes, and the need for a more efficient operationalisation of these schemes in order to maximise returns. Ensuring better returns would by itself not ensure resources passing on to the weaker regions of the country. The policy of public expenditure in India also needs to be reviewed and reformed so that it can provide the essential framework for a more equitable channelling of resources. Dr Rao has moved away from making a static documentation of the state of the Indian economy mid-year, adding to his presentation an analysis of the policy of public expenditure in India, so as to give an idea of the direction from which change must come.

Dr Rao's emphasis on fiscal consolidation, tax reforms and regional disparities received overall acceptance.

The chair, Dr Saumitra Chaudhuri, raised a teaser in his

winding up remarks by observing that the speaker had referred to the paradox of the current fiscal deficit and its lack of effects on growth, which had continued its path upwards. In 1997-2002, Dr Chaudhuri noted, the situation had been the reverse, as then the fiscal deficit was accompanied by very low growth rates. Perhaps a fixed fiscal deficit was not the sole culprit in the perennial lagging growth in states like Bihar, Uttar Pradesh and Madhya Pradesh. The more advanced states, e.g. West Bengal and Punjab enjoy a fiscal flexibility that allows them to squeeze a lot of money out of small savings loans, etc., and they are hence allowed to borrow much more, whereas in states like Bihar, Uttar Pradesh and to some extent Madhya Pradesh, the quality of public service delivery is very poor, due to their fixed fiscal deficit. Hence the equation of fiscal deficit with low growth was not always logical.

Dr Ajit Mozoomdar, whose support to this annual event of the Centre has been constant and committed, felt that since the study was by Dr. Govinda Rao it actually had very little sectoral data, but in recompense very interesting and detailed discussion on fiscal consolidation, tax reforms and regional disparities. He felt that although the speaker correctly concentrated on what might be called the equity issue and the political implications of lack of balanced distribution, but it ought to be noted that the differential rates of growth of the regions are another factor presenting constraint on overall growth. The agricultural sector too functions as a constraint on growth, not just agriculture in general, but the rate of growth in the agriculture of the lagging regions. Another major factor is the rise in the price of oil, which in the recent past had been more or less absorbed or adjusted. This should not lead to complacency as it would be unrealistic to think that a 50 per cent increase in the price of crude can be totally absorbed by India or any other oil importing country, without somehow affecting its growth prospects.

The Centre is thankful to the economists, planners, administrators and journalists who attended the seminar for their sustained interest in the pace and pattern of national economic growth, and to Shri D. Kumar of Shipra Publications for bringing out this volume.

Bela Butalia
Editor

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Introduction

Economic Outlook

The performance of the Indian economy continues to defy conventional wisdom and presents interesting paradoxes. The continued growth momentum with stable prices despite persisting high public sector deficits is still to be explained satisfactorily. Despite soaring crude oil prices and no indication of their reversal in the near future, the economy continues to be buoyant and the price level continues to be relatively stable. Indeed, a part of the reason for this has to be found in the fact that the government has not fully adjusted the ex-refinery prices of petroleum products. Despite the poor state of infrastructure, particularly the constraints posed by the availability of quality power, transportation bottlenecks, woefully inadequate urban infrastructure, poor governance and ineffective regulatory systems, the economy and, in particular, the manufacturing sector has shown robust performance. Most importantly, the prevailing political climate is clearly unfavourable to pursuing reforms in several areas, and in fact, it has adversely impacted on governance and encouraged competitive populism. Despite this, the economy continues to perform buoyantly. Indeed, India continues to be a 'functioning anarchy' as J. K. Galbraith characterised it, but only with more robust economic performance.

The economy during the first quarter of the year has shown buoyant performance and recorded overall growth of 8.1 per cent as compared to 7.6 per cent for the corresponding period last year. Unlike in the past when the principal source of growth was the service sector, the growth during the first quarter of 2005-06 was in both manufacturing and service sectors. In fact,

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The author is grateful to Mr. Saumitra Chaudhury for extremely useful comments on the draft of the monograph. Thanks are also due to H. K. Amar Nath and Pinaki Chakraborthy for statistical assistance.

income from the manufacturing sector grew at a phenomenal 11.3 per cent in the quarter as compared to 7.9 per cent for the corresponding period last year and the services sector continues to perform well, the star performers being the trade, hotels, transport and communication sectors growing at 12.4 per cent. The primary sector, however, continues to be stagnant; it grew at 2 per cent during the quarter as compared to 3.8 in the corresponding period in 2004-05.

The impressive economic performance of the economy even in the wake of some adversities has created an aura of optimism that the economy has reached a higher growth trajectory on the eve of the Eleventh Plan. However, even in the past, there were periods of high growth. In fact, the economy recorded an overall growth of 8.5 per cent in 2003-04 followed by 7 per cent in 2004-05. Coming in its wake, the 8.1 per cent growth in the first quarter of the current year is creditable. The expectation of overall growth rate of about 7 per cent for the current fiscal year, therefore, may be realistic. However, it would be too early to surmise this as a trend and there are downside risks which need to be noted.

Policy Initiatives

On the policy analysis front, there have been four significant developments during the first half of fiscal 2005-06. The Report of the Twelfth Finance Commission (TFC) has provided a framework for fiscal adjustment at both central and state levels towards fiscal consolidation by 2008-09. The Mid-term Review of the Tenth Plan has underscored the shortfall in achieving the targeted growth and underlined the need to hasten the reform process to accelerate growth and enhance human welfare. Third, implementation of some important programs of the Common Minimum Program (CMP), particularly, the passing of the Rural Employment Guarantee Act, seeks to place more fiscal challenges, though their impact on enhancing the entitlement, capabilities and empowerment of the poor has to be seen in the years to come. Finally, the way in which the country coped with unprecedented disasters like the Tsunami and then the earthquake in Kashmir, and the way in which the rest of the country reached out to the affected areas has strengthened the bonds of unity and

demonstrated the confidence and dynamism of the country in facing natural calamities.

On the reform front, however, the climate continues to be one of uncertainty. There are few areas where clear directions are visible. On the fiscal front, the introduction of the value added tax by 21 states is a silver lining and revenue performance of these states after the reform has raised hopes of other states following suit. Many states have enacted fiscal responsibility legislations and others are likely to follow suit. At the central level, however, the progress has been at a snail's pace. The climate of uncertainty continues as regards disinvestment, foreign direct investment, labour laws and small scale industries reservation. Similarly, infrastructure sectors continue to be a cause for worry. There are also concerns about low investments and poor performance of agricultural sector and even more important, stagnation in large parts of central and northern India accentuating regional disparities.

Risks

While the economy has continued to show buoyant performance, there are serious risks lurking in the horizon. The near normal monsoon has assured robust agricultural revival and the favourable industrial climate continues to impart vigour in manufacturing as well as in the services sectors. The world economic growth, although is not expected to be as robust as that of last year, continues to be reasonably buoyant. On the down side, however, there are risks associated with unprecedented increase in oil prices within a few months. In combination with the effect of large persisting public sector deficit, this could decelerate growth and bring about greater instability.

Infrastructure constraints could further add to the risk. In fact, it is perceived that India has the worst economic infrastructure among all important emerging market economies (Acharya, 2004). In particular, the poor state of electric power, roads, ports, airports and urban infrastructure have placed significant constraint on economic growth. While the progress in National Highway Development Programme has helped to improve connectivity in major trunk routes, the condition of state highways and rural roads continues to be pathetic.

The poor performance of agriculture is a matter of concern. As over 60 per cent of the population resides in rural areas, productive employment generation mainly depends on the growth of agriculture and rural non-farm employment which again, bases itself on agriculture one way or another. According to the Mid-Term Review of the Tenth Plan unemployment rate in the economy according to the current daily status would have increased from 8.87 per cent in 2001-02 to 9.11 per cent in 2004-05 which implies that total employment increased slower than labour force growth during the period (India, 2005a; p.3). Another worrisome feature of growth in India is the increasing regional inequalities and the risks it poses to the federal fabric of the country. Yet, as mentioned above, Indian economy has shown paradoxes and despite the growth costs, these risks are unlikely to dampen the dynamism of the economy in the short and medium term. The economy is expected to continue its buoyant performance at higher growth trajectory seen during the first three years of the Tenth Plan.

On the whole, Indian economy presents a picture of cautious optimism. While the performance of the economy during the first three years of the Tenth Plan shows that a growth rate of 7-8 per cent is feasible if the immediate constraints are eased, favourable environment is created and risks are mitigated. These would, however require the government to undertake reforms in policies and institutions.

Plan of the Monograph

Thus, acceleration of reforms in several areas, making investments in stagnant sectors and regions and improving institutions of governance hold the key to taking the economy to the growth trajectory comparable to China. Undertaking these reforms in the prevailing political environment is a major challenge. The prospects of taking the economy to a higher growth trajectory depends on expeditiously carrying out reforms. This monograph reviews the recent developments in critical areas of the economy. The focus of the monograph is on fiscal reforms at central and state levels with a view to accelerate growth and reduce inter-state disparities. These are most difficult times for reforms and undertaking the right type of reforms is a major challenge in a coalition regime. Chapter

2 reviews the macroeconomic developments in the economy in greater detail to identify the achievements, opportunities and challenges. In chapter 3, the fiscal developments are analysed and some of the recent initiatives to restore fiscal balance is examined. Chapter 4 analyses the problems with the tax system in India and focuses on the reform areas in the medium and long term. Chapter 5 examines the issue of regional disparities and identifies the policy and institutional changes required to deal with the problem. The final chapter summarises the major conclusions.

Macroeconomic Dimensions and Prospects of the Indian Economy

Growth Prospects

The Indian economy has attracted the attention of world community as never before. In his address to the National Development Council (NDC), the prime minister stated, 'Rare are moments of history when a nation suddenly captures the imagination of the world.' Indeed, India is the latest poster child for its efforts to showcase the burgeoning middle class, free its markets and open its borders for trade and investment. It is heralded as a success story of globalisation for its acceleration in growth and high technology exports. Surely, economic performance during the last two decades, although nowhere near the potential, has been impressive.

In 2004, global growth rate has seen the 28 year peak at 5.1 per cent (Table 2.1). Despite disappointing economic performance in Europe, the better-than-expected recovery in the United States and continued buoyancy in China, India and other countries in the emerging markets have helped to accelerate the growth of the world economy. However, in 2005, the growth of the world economy is expected to decelerate to 4.3 per cent. There are doubts about realising even this growth rate as the continuing high price of oil, expectation of interest rate increase in the United States, and continued sluggish performance of the Japanese economy pose the risks.

A sector-wise analysis of growth shows that, during the fiscal 2004-05, there was sharp deceleration in the growth of the economy from 7.6 per cent in the first quarter to 6.4 per cent in the third, but in the fourth quarter it bounced back to 7 per cent, recording an overall growth of 6.9 per cent during the fiscal year (Annexure table 1). The recovery in the fourth quarter was possible despite deceleration of over two percentage points in the manufacturing sector from 8.8 per cent in the third quarter to 6.7 per cent in the fourth. Within the secondary

sector, it is worrisome to see that each of the subs-sectors showed growth deceleration of over two percentage points in the fourth quarter. The recovery was led by the agricultural sector, which recovered from the negative growth (-0.5 per cent) in the third quarter to record 1.8 per cent in the fourth. The services sector continued to be buoyant and grew at 9.3 per cent as compared to 8.9 per cent in the third.

Table 2.1: World Economic Outlook and Projections–Growth Rate of GDP

(Per Cent)

Country/Continent	2003	2004	2005*	2006*
World Output	4.0	5.1	4.3	4.4
Advanced Economies	2.0	3.4	2.6	3.0
Newly Industrialised Asian Economies	3.1	5.5	4.0	4.8
Other Emerging Markets and Developing Countries	6.4	7.2	6.3	6.0
China	8.3	8.5	8.5	8.0
India	7.5	7.3	6.7	6.4

Note: * Current projections
Source: *World Economic Outlook,* International Monetary Fund, April 2005.

The latest estimate of GDP at constant prices for the first quarter presented in Table 2.2 reinforces the optimism. The aggregate GDP accelerated to 8.1 per cent in the first quarter and this is significantly higher than not only that of the previous quarter (7 per cent) but also that of the first quarter of 2004-05 (7.6 per cent). Acceleration in the growth over that of the previous quarter was seen virtually in every sector of the economy except 'Community, Social and Personal Services'. Even in comparison with the growth rate in the first quarter last year (2004-05), the growth rates in all the sectors were higher except, 'agriculture', 'mining and quarrying' and 'community, social and personal services'. The sharpest acceleration in growth over the previous quarter was in electricity, gas and water supply from 2.6 per cent in the previous quarter to 7.9 per cent in the first quarter of 2005-06. The manufacturing sector growth accelerated to 11.4 per cent from 8.6 per cent recorded in the previous quarter and 7.9 per cent in the corresponding period last year. The highest growth

in the first quarter of the current fiscal year, however, was in trade, hotels transport and communication sectors.

A notable feature of economic growth in India is that the acceleration in the growth has been led by the services sector, particularly since the 1997-98 (Acharya, 2001). The trend has continued and during period, 1998-2005, almost 70 per cent of the growth in GDP in the economy was contributed by the services sector (Table 2.3). The contribution of the primary sector to overall growth of the economy has been low and widely fluctuating, depending on the vagaries of the monsoon. The performance of the secondary sector has not been impressive and nor has it been uniform over the years. Instead, the share of the services sector has shown a steady increase, to create a lop-sided growth pattern.

The slow growth in the manufacturing and agricultural sectors is also a reason for the slow growth of employment in the country, particularly at the lower end of the labour market for unskilled and semi-skilled labour. The relatively slow growth in the output of real sectors in the economy has tended to transform the economy from an agrarian society directly to a services-predominated one and the lopsided growth pattern has been a matter of concern. This pattern of growth, to a considerable extent, has been attributed to the pattern of reforms (Panagariya, 2004). In sectors and activities in which liberalisation has been effective, growth acceleration has been significant. These include, trade, hotels, transport, communication services, financing, insurance, real estate and business services.

By all accounts, the Indian economy is expected to continue its buoyant performance during 2005-06. The projections vary from one source to another, but only marginally. The NCAER has projected the growth rate of GDP in 2005-06 at 7.19 per cent. The CMIE estimated the growth rate at 6.8 per cent, the Economic Advisory Council to the Prime Minister projected it at 6.9 per cent. The forecast by the Confederation of Indian Industry (CII) is 7.3 per cent. The IMF projection of growth for the (calendar) year is placed at 6.7 to 7.1 per cent. In terms of different sectors, agriculture is expected to grow at 3.3 per cent,

Table 2.2: Quarterly Estimate of GDP for the First Quarter (April – June)

(at 1993-94 prices)

Industry	Gross Domestic Product in the First Quarter of			Percentage Change Over		
	2003-04	2004-05	2005-06	First Q in 2004-05 over 2003-04	Last Q in 2004-05 over previous Q	First Q in 2005-06 over 2004-05
Agriculture, Forestry & Fishing	70,930	73612	75068	3.8	1.8	2.0
Mining & Quarrying	7645	8170	8434	6.9	2.5	3.2
Manufacturing	56,982	61,458	68,409	7.9	8.6	11.3
Electricity, Gas & Water supply	8,000	8,489	9,160	6.1	2.6	7.9
Construction	17,992	18,896	20,383	5.0	4.1	7.9
Trade, Hotels, Transport & Communication	82,117	91,553	1,02,917	11.5	11.1	12.4
Financing, Insurance, Real Estate & Business Services	44,126	47,202	51,133	7.0	7.7	8.3
Community, Social & Personal Services	40,971	44,337	47,031	8.2	7.2	6.1
GDP at Factor Cost	3,28,764	3,53,717	3,82,534	7.6	7	8.1

Source: Central Statistical Organization (C.S.O), Government of India.

industry at 7.61 per cent and services at 8.55 per cent. Indeed, indications are that good rainfall and its reasonable even spread is likely to lift the agricultural growth rate. The manufacturing sector continues to be buoyant so far and the boom in the services sector is likely to continue.

Table 2.3: Contribution to GDP Growth by Different Sectors

(Per cent)

	Agriculture	Industry	Services	Total
1997-98	-14.42	24.88	89.55	100.00
1998-99	25.26	15.96	58.78	100.00
1999-00	1.35	21.32	77.33	100.00
2000-01	1.35	21.32	77.33	100.00
2001-02	25.95	16.98	57.07	100.00
2002-03	-42.19	44.10	98.10	100.00
2003-04	24.26	21.25	54.48	100.00
2004-05	3.61	29.86	66.53	100.00
Tenth Plan	3.64	28.91	67.45	100.00
1998-05	6.84	23.92	69.24	100.00

Source: Estimated from the National Accounts Statistics, Central Statistical Organisation.

Has India Reached a Higher Growth Trajectory?

The projected growth of 7 per cent during 2005-06 comes in the backdrop of 8.5 per cent growth in 2003-04 and 6.9 per cent growth in 2004-05. Thus, the average annual growth rate for these three years works out to 7.5 per cent. This buoyant economic performance has given considerable room to speculate that this in fact is a long-term trend and there has been an upward shift in the growth trajectory. It is therefore, argued that achieving 8 per cent growth during the 11th Plan is within the realm of feasibility. Such an optimistic view is well articulated among others by Kelkar (2004) and Rodrick and Subramanian (2004).[1]

1. The main theme of Rodrick and Subramanian (2005) paper is to argue that the shift to a new growth trajectory in India took place in India in the 1980 and not after comprehensive reforms were initiated in the 1990s. However, there is considerable literature demonstrating that the growth shift in the 1980s occurred mainly due to fiscal expansion and as such, was not sustainable. For a detailed critique of Rodrick and Subramanian, see Srinivasan (2005).

The arguments for the optimistic prediction are rooted in demographic factors, increase in the savings ratio, productivity growth and change in the quality of institutions. These have been discussed in detail in Acharya (2004) and will only be summarised here. The demographic argument to create a long-term shift in the growth trajectory comes from the fact the India has a relatively young population and a declining fertility and these will ensure a rapidly increasing work force and declining dependency ratio. However, this may not translate into productivity growth unless augmentation of labour supply is accompanied by commensurate increase in the demand for labour.

On the issue of increase in savings and investment, it is true that both have shown sharp increases in 2002-03 and 2003-04. It is seen that the savings ratio increased sharply from 23.4 per cent of GDP in 2001-02 to 26.1 per cent in 2002-03 and further to 28.1 per cent in 2003-04. Similarly, Gross Domestic Capital Formation (GDCF) as a ratio of GDP increased from 22.6 per cent in 2001-02 to 24.8 per cent in 2002-03 and further to 26.3 per cent in 2003-04. The sustenance of this however will depend on reversing the public dissavings, removing the infrastructure constraints and prevention of financial crowding out of private investments.

The major plank of the argument, however, is that there has been a significant increase in the rates of productivity growth. While Rodrick and Subramanian start with the total factor productivity growth (TFPG) of 2.5 per cent increasing over time to 5 per cent, Kelkar's estimate increases from the initial 2 per cent doubling over the next 20 years. Unfortunately, it would be too risky to rely on TFPG for growth forecasts as it has problems in properly accounting for various inputs which are derived as residuals and as such their trend is difficult to explain. Therefore, it would be safe to presume that while the economic environment for 2005-06 could produce 7 per cent growth, it is too early to predict that the Indian economy has reached a higher growth trajectory.

On the quality of institutions, however, the weight of opinion is that there has actually been a decline. Much of the comparison with China made in the past underlined the fact that India had better market institutions including a well

functioning stock exchange, financial system and inexpensive labour and yet, the growth performance of India has been nowhere near China's. A part of the reason is that India's advantage has actually been exaggerated. China has developed the market institutions rapidly and relative labour market flexibility in China is an additional advantage. As far as general institutional climate is concerned, despite Transparency International moving India by two places from 90 to 88 in corruption rankings, the problem admittedly is serious. The large number of clearances that a manufacturer is required to obtain is only a part of the problem. The dividing of the country into several tariff zones due to the taxes on inter-state exports (central sales tax) and inter-local body imports (octroi), restrictions on the movement of goods from one state to another, the operation of rent control acts and land ceiling acts are some of the oppressive laws which not only create micro level inefficiencies but also open wide vistas for rent seeking. Removing many of these can unleash the creative power without having serious political difficulties.

In an environment where there are a number of impeding factors constraining economic growth, sustaining high rates of growth we have seen during the last three years is possible only when systematic reforms are implemented. Fiscal reforms are important to raise the levels of savings and investment in the economy, minimise microlevel inefficiencies and enhance infrastructure investments. Reforms in the agricultural sector should enable the flow of larger investments to the sector besides enhancing its productivity. Similarly, unless reforms are undertaken to impart greater flexibility to labour markets and remove additional fiscal and regulatory protection given to small-scale enterprises, investments and technology will not flow into manufacturing. Launching the economy into a higher growth trajectory will require accelerating the pace of reforms.

Prospects of the Real Sector

Prospects of agricultural growth

The performance of the Indian economy during the first half of the fiscal year has continued to be buoyant. As mentioned earlier, despite its delayed appearance, the monsoon has been

near normal in most parts of the country. Until end September this year, 32 of the 36 meteorological subdivisions received normal or excess rainfall and it was deficient in only 4 subdivisions. In other words, 65 per cent of the districts received excess or normal rainfall. Although in the latter regions the floods could have damaged the 'kharif' crops, the 'rabi' output is likely to be substantially higher than last year. On the whole, foodgrains output is expected to increase significantly and this bodes well for the capacity of the economy to stabilise prices besides increasing the growth rate. On the other hand, there are worries on the coarse cereals and even more, on oilseeds as substantial portions of the areas under oilseeds cultivation were either damaged due to unprecedented floods or received deficient rainfall. This could substantially increase edible oil imports to add to the woes caused by high import bill of crude oil.

The major problem constraining the growth of agriculture is the low level of public as well as private investments. Fiscal compression has significantly constrained public investment in irrigation, watershed development, rural connectivity and research and extension services. Private investment in agriculture has stagnated due to low productivity and lack of incentives. Considerable augmentation of investment in post-harvest technology and agro-processing industries is needed to ensure growth of employment and increase in value addition. Not surprisingly, the GDP from the primary sector grew at less than 2 per cent as against the target of 4 per cent during the Ninth Plan and has averaged less than 1.5 per cent in the first three years of the Tenth Plan. The situation may not drastically change in the Eleventh Plan as the investment in farm infrastructure required to generate higher growth has just not taken place.

With the entry of some corporates into the agricultural sector, although in a small way, and application of information technology for accessing information on weather and markets (prices), diversification and modernisation of the sector is likely to make further progress. The entry of ITC, Bharati Telecom, Hindustan Liver and other actors in this area is likely to increase contract farming and improvement in productivity. However, the overall impact of this may be negligible as much remains to be done to create enabling legal and regulatory environment for contract farming by the states.

Savings and investment

A significant recent trend in the Indian economy is the sharp increase in the savings rate, from only 23.4 per cent in 2001-02 to 26.1 per cent in 2002-03 and further to 28.1 per cent in 2003-04. A clear increase of almost five percentage points in just two years is truly a remarkable achievement. Investment rate, in contrast, has stagnated at about 22-23 per cent right from 2000-01 and actually lower than the estimate for 1995-96 (26.1). Analysis shows that the largest contribution to increase in savings came from the sharp reduction in the public sector dissavings from 2.7 per cent of GDP in 2001-02 to 0.3 per cent in 2003-04. Similarly, household sector savings increased from 22.6 per cent of GDP in 2001-02 to 24.3 per cent in 2003-04 and much of the increase was in physical savings, which increased from 11.4 per cent in 2001-02 to 13 per cent in 2003-04. On the investment side, the private corporate investment remained broadly at the same level of 4.5 per cent whereas, the marginal increase in household's investment from 11.4 per cent in 2001-02 to 13 per cent in 2003-04 was matched by decline in the public sector investment from 6.2 per cent to 5.4 per cent during the period. In terms of components of gross domestic capital formation (GDCF), the investment in fixed capital formation remained at about 22 per cent whereas the working capital investment or change in inventory has remained at 0.1 to 0.4 per cent.

The sharp increase in savings has raised questions on the accuracy and reliability of the estimates. Chaudhuri (2005) in his careful analysis of the data argues that there is not much scope for overestimating the savings. Surely, reduction in the public sector dissavings mainly caused by the improved fiscal performance of the government sector since 2001-02 has increased the level of savings. As revenue deficits have tended to decline further even in 2004-05 and promise to decline even more in 2005-06, the prospects of savings rate increasing further are real. The good news from this is that investment in India is not constrained by availability of resources.

On the investment side, there are reasons to believe that private corporate sector capital formation and to some extent, public sector capital formation is underestimated and to that extent, physical savings of the household sector is

overestimated. Thus, there could indeed be some overestimation of aggregate savings rate and underestimation of GDCF. The rate of absorption of savings too has improved as, from the current account surplus situation that prevailed since 2001-02, the first quarter of 2005-06 has seen deficit of about 1-2 per cent of GDP and a good part of this is attributable to increase in non-oil imports. Chaudhry (2005) estimates that this scenario increases the financial resources available for investment by about 30 per cent.

Prospects of industrial growth

The industrial sector, after continuing buoyancy until July has shown signs of deceleration. The general index of industrial production in June stood at 212.5, which was 11.7 per cent higher than the previous month. However, in August, the index of industrial production (IIP) increased at just 7.4 per cent as compared to the 8.6 per cent last year. In other words, during April-August, 2005, IIP rose by 8.8 per cent as compared to 8 per cent during the corresponding period last year. Within the industrial sector, the manufacturing sub-sector index grew at 9.8 per cent, but both mining and electricity sub-sectors showed sharp deceleration.

The performance of infrastructure sector, during April-August however, has been worrisome. The sector recorded a growth of 4.4 per cent during the first half of the year which is about one percentage point lower than the last year for the corresponding period. The sluggish performance was particularly seen in crude oil in which it has recorded a fall of 4.9 per cent as against the growth of 4.3 per cent last year. A similar trend was seen in petroleum refining. Equally of concern has been the deceleration in electricity generation. The sector recorded the growth rate of 4.7 per cent during the first half of 2005-06, as compared to 7.8 per cent recorded for the corresponding period last year.

As mentioned above, the manufacturing sector continues to show buoyant performance with near 10 per cent growth. This is also seen from the sharp increase in the bank credit to the commercial sector. The bank credit to the commercial sector up to July this fiscal year recorded an increase of 5.9 per cent and on a year-to-year basis it works out to a phenomenal 28.3

per cent. The increase in non-food credit registered an increase of 6.6 per cent this year until July and on a year-to-year basis it works out to 34.5 per cent. The bank rate in July 2005 stood at 6 per cent which was the same as the last year. There was not much difference in the prime lending rate (PLR) as well. Thus, the benign interest rate has continued and is expected to continue during the financial year, though the coming months may see it harden.

Unprecedented floods in Mumbai in August this year, the poor performance of the infrastructure sectors and the sharp increase in oil prices could change the industrial climate during the course of the year. The most worrisome trend is in the electricity sector. The poor performance of the sector has posed serious constraint in the growth of other sectors and despite several models of reform adopted so far, none seems to have produced the desired results. On the one hand, the supply of electricity has just not kept pace with the sharply increasing demand and on the other, transmission and distribution of electricity continues to be plagued with problems of obsolete equipments and more importantly, theft of energy. Much hope was placed in the privatisation experiment in Delhi, but this has not led to expected improvements by way of reduction in distribution losses or simply, theft of electricity. Thieves and dacoits seem to find Delhi a fertile ground for their operations and have taken comfortable refuge in the city!

The stock market behaviour

After relative stagnancy for several years, the sharp rise in the stock prices in India has attracted considerable attention. What is of concern is the high degree of volatility. In April, the Sensex was barely at the 6,000 mark, but on October 4, it had touched the highest value of 8,822, although later in October, it had declined to less than 8,000. In fact, the second week of October has seen a sharp decline and the Sensex shed over 1,000 points in just a week, but in the third week, it fell by over 800 points. Similar movement was seen in the National Stock Exchange (NSE) index as well. Nevertheless, on the whole, during 2005, the stock prices had gained by 29 per cent on top of 13 per cent gain during 2004. Such a boom in the Indian equity market has buoyed investor sentiments.

A close examination of the share price movement shows that the movement of share prices in Indian equity markets at 29 per cent during 2005 is in line with what is seen in many emerging markets. Some of the emerging markets actually had much higher increase in their stock prices, and this includes Russia (62 per cent) South Korea (31 per cent) Czechoslovakia (38 per cent) South Africa (30 per cent) though the increase in the Sensex was higher than in Poland (25 per cent), Argentina (21 per cent) and Brazil (20 per cent).

The analysis shows that the movements of share prices are also in line with the fundamentals. By mid-September, the Price to Earnings Ratio (P/E), was 17.5 per cent up from 15.6 per cent at the end of March 2003, but comparable to end December 2004 (17.1%). It may also be pointed out that the P/E in India is actually lower than in many of the emerging markets. It is also important to note that the increase in prices has little to do with Foreign Institutional Investments (FII). In contrast to the FII inflow in February, March, July and August which stood at $ 1.65 billion per month on an average, it was much lower at $.0.97 billion in September.

The external sector

On the external front too, the buoyancy has continued in the first half of the fiscal year. The exports during April to July this year recorded a growth of 19.5 per cent which was higher than the corresponding increase last year by 35.6 per cent, buoyed partially by the growth of textile exports in the post-quota regime. Although there was considerable confusion in the first quarter of the year due to poor statistical information system on the exports of garments from India, by the end of the second quarter, it was clear that there has been considerable buoyancy in exports. Of course, India has not been able to take as much advantage of abolition of quota as China did and that is mainly due to its own lack of preparedness in changing the policy regime on labour laws to enable large-scale labour intensive manufacture of garments as has been done by China and Vietnam.

Alongside exports, imports too registered phenomenal growth of 38 per cent during the first half of the fiscal year. This has helped to move from the position of current account

surplus in the last quarter of 2004-05 to the deficit position in the first quarter of 2005-06. With continuing buoyancy of export of invisibles, the external payments continue to be met. Despite large fiscal deficit, the widening trade deficit may not precipitate a crisis, but nevertheless, there is no room for complacency. The cushion of surplus in non-oil trade that existed for three years until 2003-04 is no longer available, and although the trade deficit of $.6.5 billion during April–June could be met by the flow of invisibles, the situation can get worse over time. The recent pressure on the value of the rupee vis-à-vis the U.S dollar is a case in point.

Nevertheless, for the current fiscal, with the continuing surge in foreign exchange reserves, the payment position is likely to remain comfortable. By end September, exchange reserves excluding gold and SDR were estimated at USD 143 billion. This is also the reason for the overall stability in the exchange rate. The rate appreciated against pound sterling, Euro and Yen but depreciated against the US dollar in June as compared to May of this year. However, by October, with increasing current account deficit, the value of the rupee had seen some erosion against all currencies, and particularly against the dollar. On the whole, the exchange rate is expected to be stable during the year.

Money supply, interest rate and prices

Until July 8, 2005, money supply increased by 5.4 per cent, which is marginally higher than the last year (3.9 per cent) for the corresponding period. On a year-to-year basis, the growth rate of money supply works out to 14 per cent as compared to 15.3 per cent for the previous year. The analysis of different components of growth in reserve money (Table 2.4) shows that the predominant growth was in bank credit to the commercial sector which increased by 5.9 per cent in the first three months of the financial year and this works out to 28.3 per cent on a year-to-year basis. A considerable part of this, of course, is for personal credit for vehicles and housing and credit to industry constitutes only about one-third. Nevertheless, acceleration in credit reflects the investment climate in the economy. This essentially reflects the robust growth of the commercial sector during the period.

In fact, the growth of credit by commercial banks shows a healthy trend and with persisting fiscal deficit, this may put pressure on the interest rates. The incremental gross bank credit increased in the first quarter by 6.6 per cent (inclusive of foreign exchange conversion 6.8 per cent) and on a year-to-year basis, this works out to 32.9 per cent. The comparable figure for the last year was 21.6 per cent. The growth of non-food credit during the first quarter of the current year was 6.6 per cent which, on a year-to-year basis works out to a healthy 34.5 per cent.

Table 2.4: Growth of Money Supply Until July 8, 2005.

(Per cent)

Source of Money Supply	**2004-05**	**Up to July 8, 2005**	**Year to Year**
Net Bank Credit to Government	0.4	1.2	1.1
Non-RBI Credit to Government		-0.4	1.9
Bank Credit to Commercial sector	22.8	5.9	28.3
Net Foreign Exchange Assets of the Banking Sector	23.3	-3.4	8.0

Source: Reserve Bank of India.

The monetary policy statement for the year assures the continuation of the present environment. It is cautious and keeps the options open when it states that the policy is, "Provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability" (p. 22). Thus, if the inflationary threat becomes real, the government may intervene by increasing the interest rate. As for the present, the government has restrained from increasing the bank rate, but has increased the Reverse Repo Rate by 25 basis points two times during this year (April 29 and October 25). Thus since last October, the Reverse Repo Rate has been increased by 75 basis points from 4.5 per cent to 5.25 per cent. Thus, the spread between the Repo Rate and Reverse Repo Rate has been reduced from 150 to 75 basis points. The cash reserve ratio (CRR) continues to be placed at 5 per cent.

Despite the healthy growth of borrowing by the commercial sector and persistence of large fiscal deficits, the bank rate continues to be benign at 6 per cent, the same as last year.

There is not much of a difference in the prime lending rate as well (PLR). The call money rate this year at 4.01-6.05 per cent, however, is higher than last year (3-4.5 per cent). The continuation of benign interest rate regime, however, will depend on the outlook for inflation, investment demand and growth prospects in the next year. Surely, there is a possibility of interest rates hardening marginally later in the year.

There has been considerable deceleration in the prices during the current fiscal year until September, though the next few months may see their upward movement, partly to reflect fully the increasing price of oil, and partly due to high seasonal demand. The wholesale price index, the index that is usually used to measure the price trends in the country, quickened to an annual average of 4.62 per cent by the week ending October 8, from the lowest level in three years in August this year. The information on consumer price index, the more relevant one from the viewpoint of measuring cost of living, is available only until end May of the year and it shows the increase by just about 3.7 per cent on a year-to-year basis. The RBI predicts an increase of 5 to 5.5 per cent in wholesale prices for the current fiscal, but that could be an underestimate. The major risk factor here is the price of petroleum products and even the partial increase in the price of petroleum products implemented recently has not yet worked itself out. To the extent the international price increase has been absorbed by the government through lower taxes and losses in petroleum companies, the fiscal deficit position will also worsen which could also put pressure on the prices.

Not surprisingly, the RBI has cautioned, '...Inflationary situation needs to be watched closely and there could be no room for complacency on this account' (RBI, 2005). While the prevailing situation continues to be optimistic, the downside risks are real and if these create a situation of increase in prices, interest rates may have to be increased. The possibility of substantial increase in interest rates is remote, but if alongside inflation, recession, however mild, sets in, even marginal increases in interest rates could adversely affect the sentiments.

Economic and Political Risks

While the above description provides reasonably optimistic growth prospects of Indian economy, it is important to understand that there are serious risks lurking on the horizon. These risks may undermine the optimistic expectations and it would be prudent to take them into account in making the assessment. Some of the risks are real and could dampen economic growth or increase prices or impact on the external sector. While the policy makers have internalised the lessons from the crisis of 1991 to reduce possibility of a short-term liquidity crisis to meet external obligations, and the macroeconomic management of the 1990s has minimised the short-term debt, the significant inflow of portfolio capital seen in recent times could adversely impact on the sentiments to create some volatility (Acharya, 2001). It is therefore important to take note of these risks.

Fiscal imbalances and growth costs

The most important risk comes from the persistence of large fiscal and revenue deficits at both central and state levels. As mentioned earlier, the buoyant growth performance of the economy with stable prices in the wake of persisting large revenue, fiscal and primary deficits, is a paradox. Indeed, the deceleration in the growth for three years during 1999-2000 to 2002-03 raised considerable concern about the adverse impact of fiscal deficits on growth. However, the acceleration in the growth rate to average about 7.5 per cent in the next three years including the current year, has led to a measure of complacency. It is extremely important to guard against this complacency as the fiscal imbalances indeed entail high growth costs.

Indeed, the macroeconomic relationships are such that fiscal imbalance spills over into savings–investment imbalance and balance of payments problem. The extent to which macroeconomic and external variables will be impacted will depend on the resilience and flexibility of these variables. The 1991 crisis was mainly due to the build up of public spending-led growth fuelled by high and persisting fiscal deficits in the

second half of the 1990s, though the trigger for the crisis was the sharp increase oil prices and consequently, the import bill following Iraq's invasion of Kuwait. This was exacerbated by the withdrawal of NRI deposits and refusal of the international lenders to roll over the credit to precipitate into an external payments crisis. Domestically this led to sharp decline in the growth of the economy and increase in prices. However, contrary to expectations, despite large and persisting fiscal imbalances for over eight years, the country has continued to be stable and free from any external crisis.

This relative price stability despite large fiscal imbalances can be attributed to a number of factors. First, the macroeconomic management of the economy in the 1990s truly absorbed the lessons of the 1991 crisis. In particular, the short-term high cost external debt was substantially reduced to avoid any possible payments crisis. Second, the landmark agreement between the RBI Governor and the Union Finance Secretary in 1994 to avoid monetisation of fiscal deficits in the future avoided an important automatic route for money supply. Third, continued restriction on capital account convertibility avoids any possible speculations on flight of capital.

Although, it is tempting to argue that the impressive growth performance of the economy belies prophets of doom, persisting fiscal imbalances have had significant growth costs. High levels of fiscal deficit not only increase the debt-GDP ratio, but also reduce savings and investment and consequently, economic growth. In India, increasing revenue deficits and declining returns from public enterprises have contributed to large and increasing public sector dissavings in the economy. The Gross Domestic Capital Formation and savings- investment imbalance in the public, private household and corporate sectors since 1991 is presented in Table 2.5. It is seen that while the public sector had to depend on large drawals from the household sector savings for its investments throughout, steadily increasing part of the household sector's drawals were required to meet public sector dissavings. In 2004-05, the government dissavings amounted to 4.1 per cent of GDP. In fact, large public sector dissaving has placed severe constraint on the ability of the government to meet increasing infrastructure investment requirements.

Another way in which large fiscal deficits adversely impact on growth is by crowding out private investments. Pre-emption of large volumes of savings for public consumption and investment places pressure on interest rates, resulting in the financial crowding out of private investments. Of course, the prevalence of excess liquidity with the commercial banks and more than statutorily required volume of investments in government securities have often been cited as evidence against the existence of financial crowding out in Indian financial system. There are problems with this interpretation, however. First, the large enterprises have preferred to access international finance due to lower interest rates and as far as the small scale sector is concerned, despite excess liquidity, the commercial banks do not lend to this sector as they see high risk in lending to them. As the RBI has put 3 per cent cap above the Prime Lending Rate for lending to the small-scale sector and as commercial banks see the risk premium higher than this, the sector is starved of credit even as commercial banks have excess liquidity. Furthermore, to a bank manager it is preferable and he scores high in accountability when he uses his lendable resources to invest in government securities than when he takes the risk of lending to the small-scale sector.

The large and persisting public sector deficits have not only reduced domestic savings, but have led to inefficient transformation of savings into capital formation (Buiter and Patel, 2005). The gross fiscal deficits which reached 9.4 per cent in the crisis year, 1990-91 declined to 6.4 per cent in 1996-97 following fiscal adjustment, but increased sharply thereafter following the pay and pension revision. In subsequent years, it hovered around 9-10 per cent of GDP (Table 2.5). The estimates for 2004-05 and 2005-06 show some improvement, but this depends on the realisation of a large increase in revenues and compression of expenditures taken into account in these estimates. Commensurate with large fiscal deficit, the outstanding debt of the central and state governments increased from about 64 per cent in 1990-91 to over 82 per cent in 2004-05. What is even more worrisome, increasing proportion of fiscal deficit is being used to finance current expenditures of the government. The ratio of revenue deficit to fiscal deficit increased from 45 per cent in 1990-91 to 70 per cent in 2003-04. The estimates for 2004-05 and 2005-06 show substantial

Table 2.5: Selected Fiscal Indicators for India

Year	Per cent of Gross Fiscal Deficit to GDP	Per cent of Gross Primary Deficit to GDP	Per cent of Revenue Deficit to GDP	Per cent of Revenue to Fiscal Deficit	Out-standing Debt of Centre and States	Per cent of Develop-ment Spending to GDP
1990-91	9.4	5.0	4.2	44.7	64.4	17.1
1995-96	6.5	1.6	3.2	49.2	61.2	13.9
1996-97	6.4	1.3	3.6	56.3	59.8	13.5
1997-98	7.3	2.1	4.1	56.2	61.9	13.7
1998-99	9.0	3.7	6.4	71.1	63.0	13.8
1999-00	9.5	3.8	6.3	66.3	66.0	14.2
2000-01	9.6	3.6	6.6	68.8	70.4	14.8
2001-02	9.9	3.7	7.0	70.7	75.8	14.6
2002-03	9.5	3.1	6.6	69.5	80.0	14.6
2003-04	8.4	2.0	5.8	69.0	81.1	14.9
2004-05)*	8.3	2.2	4.1	49.4	82.0	14.9
2005-06 **	7.7	1.7	3.4	44.2	81.3	13.7

Note: *: Revised estimates; **: Budget estimates.
Source: *Handbook of Statistics on the Indian Economy,* Reserve Bank of India.

decline in this ratio, but actual realisation of this depends on the achieving the revenue and expenditure estimates as mentioned above.

The finance minister, in his budget speech has indicated that due to the generous recommendations of the Finance Commission, he has had to take a 'pause' as far as fiscal deficit target of the Fiscal Responsibility and Budget Management Act (FRBMA) is concerned. This, in fact, is not fair to the commission, for, it also recommended the discontinuation of the centre's lending to states. Given the fiscal deficit target, this provided substantial fiscal space to the central government as the estimated central lending to the states in the previous year was 0.7 per cent of GDP. Although the Commission's recommendation was for gradual implementation, the recommendation was implemented with immediate effect and that provided an additional cushion to the central government. In other words, the identical level of fiscal deficit in the budget estimates (4.3 per cent of GDP) for 2005-06, and revised estimate for 2004-05 is not really comparable. In 2004-05, this included on-lending to the states to the tune of 0.7 per cent of

GDP whereas in 2005-06, the practice on on-lending has been stopped on the recommendation of the TFC.

Although the budget estimate of fiscal deficit for 2005-06 looks overly ambitious, the progress in revenue collection and expenditure implementation up to end September shows that the target may be achieved. This is because recent trends in tax collections show considerable buoyancy. Since 2002-03, central government tax revenues have registered annual growth of over 20 per cent on average. In 2005-06, the gross tax revenue of the centre is targeted to increase by over 21 per cent over the revised estimate of 2004-05. The collections till October this year show spectacular increase in the revenue from service tax (66 per cent), customs (21 per cent), and corporation tax (26.6 per cent) whereas Union excise duty has continued to be stagnant (7.6 per cent). The personal income tax collection has grown at 15.8 per cent. With some effort, the improved tax administration and information system should enable the targeted revenue collections in 2005-06 in the case of direct taxes. However, there are still serious question marks regarding excise duties though even customs revenue is likely to achieve the target. However, conforming to the budget estimates of deficit will critically depend on the government's ability to withstand populist pressures for give-aways.

An important consequence of fiscal pressure and the attempt at adjustment was to compress expenditures on physical and social infrastructure in the country. The public sector domestic capital formation reached the peak in 1986-87, at 11.2 per cent, but declined steadily thereafter to 9.5 per cent in 1989-90, 7.7 per cent in 1995-96 and 6 per cent in 2004-05 (Buiter and Patel, 2005). Similarly, the ratio of development expenditures to GDP declined from 17.1 per cent in 1990-91 to 13.5 per cent in 1996-97 before crawling back to 14.9 per cent in 2003-04. In 2005-06, it is expected to be 13.7 per cent. A notable issue however, is that with significant increase in the cost of providing social services after the pay revision, in real terms the decline has been even more than what these figures indicate. Although these expenditures are not entirely on infrastructure, it would not be incorrect to infer that public investment in infrastructure along with maintenance expenditures on them have been cut to the bone. This has had

and will continue to constrain the availability of infrastructure such as power, irrigation, roads, railways, ports and airports.

It is argued that while persisting revenue deficit is a serious problem and fiscal reforms should focus at correcting them, the recent growth history has shown that the country can live with high fiscal deficits and yet have high growth and therefore, one need not unduly be concerned with it. In particular, the argument has come from prominent Keynesians who maintain that focus on reducing the fiscal deficit could crowd out the much needed outlay on fresh investments as well as spending on the maintenance of physical infrastructure. This could constrain growth by creating infrastructure bottlenecks.

It is certainly true that investment in infrastructure must be augmented to sustain high growth. Some infrastructure sectors are commercially viable. By creating the enabling environment to invest in these infrastructures, it is possible to augment them. The problem, however, is that in the past, much of the investment in these were undertaken by the public sector and as the cost recoveries from them have been abysmal, a strong interest group has been created for continuing public investment in them. Thus, almost 65 per cent of the power supplied in the country is not charged and on the remaining, the cost recovery is below the average cost. Obviously, there is a lot of political opposition to private participation in providing these services. Nevertheless, given the resource constraints, it is important to undertake reforms to create enabling environment for private investment in commercially viable infrastructures such as power and highways.

The focus of public investment in infrastructure should be the non-commercial infrastructures. The resources needed for the purpose will have to come by raising more resources and releasing resources from unproductive areas. It is also necessary to spend the resources to complete the existing projects rather than taking up new ones. In some areas, increasing investments will have to come through public private partnerships. In fact, in many areas where private partnership is possible, creation of climate of proper pricing is stuck up in a political logjam.

Further recourse to financing even the infrastructure expenditures through additional fiscal deficit has serious

dangers. Analysis has shown that with the debt-GDP ratio approaching 80 per cent and, in recent years, average interest rates turning out to be higher than the growth rate of the economy, the fiscal situation has tended to be unsustainable and correctives are called for. Of course, it is difficult to quantify with any precision what the optimal fiscal deficit is. But the quest for the optimal should not result in a macroeconomic crisis. While it is important to ensure adequate investments in infrastructure, this has to come about more by phasing out revenue deficits and forging public-private partnerships in infrastructure spending rather than indulging in unsustainable borrowing as mentioned above.

High fiscal deficit over the last seven years has delayed the progress in external liberalisation, particularly the progress towards further liberalisation of capital account. Given that the country needs a large volume of direct foreign investment in a variety of areas, capital account liberalisation is an important step that needs to be taken. However, when the fiscal deficit is so large and persisting, the risk to the currency from speculative movements and contagion is much more and it is necessary to trod cautiously.

Persisting fiscal imbalances will continue to pose high growth costs. While it is admitted in the Mid-term Appraisal of the Tenth Plan (India, 2005), that achieving the targeted growth of 8.1 per cent is well beyond the realm of feasibility, even achieving the 7-8 per cent target for the remaining two years of the Tenth Plan seems to be ambitious unless the pace of reforms in critical areas is accelerated.

Increasing oil prices and attendant risks

Another important risk faced by the economy is the sharply increasing price of crude oil. The average price of 'Brent' crude per barrel in 2004 was just about US$ 38; after rising sharply until mid-October, 2004, it receded thereafter only to rebound again to touch a peak of US$ 70 in September and is currently hovering around US$ 65 per barrel. Oil imports in India constituted 26.4 per cent of total import bill in 2003-04 and therefore, such a sharp increase in the oil price poses serious risk both to manufacturing and overall economic growth as well as to the price situation. With severe cut down in supply from

the US-Gulf of Mexico region due to the hurricanes 'Katrina' and 'Rita', the prospects of substantial reduction in the price of oil during the year do not seem to be bright. Although the severity of the latter was much less than originally expected, the two hurricanes have created severe disruption in the supply of oil. The losses of oil wells in Bombay High due to the accident will only add to the import bill to widen the current account deficit during the year. The difference in the price per barrel between $30 and $60 translates into a trade loss of a whopping 2.5 per cent of GDP in India.

An interesting paradox, however, is that the increase in oil prices no longer evokes the same response in terms of increasing general price level and reducing the GDP in India as in the past. A part of the reason for this has to be found in the fact that the government has not passed on the entire increase in oil prices to consumers. A part of the cost was borne by ONGC in terms of lower than international price to the crude oil produced by it, and a part of this has been absorbed by lowering customs and excise duties. The more intensive utilisation of natural gas has also helped to supplement other efforts to combat the oil price increase. This has helped to dampen the effect on prices and has not created recessionary trends in manufacturing.

The above does not mean that there are no costs or risks associated with oil price increase. The IMF estimate shows that on an average in the global economy, a US$ 5 increase in the price of crude oil reduces the GDP growth by 0.3 percentage point. It also contributes to increase in prices. It will also take two or three years before the total effect of oil prices unfolds.

In India, the cost was mainly in terms of lower tax collections and lower profits of public sector owned oil companies. The implication of this to the fiscal and revenue deficit is obvious. At a time when efforts are on to restructure the public finances of the centre and states, increasing oil prices come as a major blow. The central government collects about 40 per cent of its revenue from customs and excise duties from petroleum products. A significant portion (12 per cent) of corporation tax is also collected from oil companies. At the state level, about 42 per cent of sales tax accrues from these products. While in part this shows the lopsided tax system and excessive

taxation of this group of commodities as they are mainly in the public sector and are not prone to evasion and avoidance which needs to be corrected in the medium term, the short-term implications of oil prices to fiscal deficit is ominous. This has created additional difficulties in conforming to the targets set in the FRBMA.

Faltering infrastructure

The Mid-term Appraisal of the Tenth Plan states, 'infrastructure inadequacies in both the rural and urban areas are a major factor constraining India's growth.' This is as much due to substantial compression of outlay on the creation and maintenance of infrastructure as due to poor efficiency of the infrastructure facilities. The infrastructure unfriendly fiscal correction may be inferred from the fact that while the fiscal deficit in 2004-05 as a ratio of GDP continued to be as high as it was in 1990-91, the ratio of revenue deficit to fiscal deficit which was 45 per cent in 1990-91 increased to 71 per cent in 2001-02 before declining marginally to about 65 per cent in 2004-05. In other words, aggregate capital expenditure of central and state governments as a ratio of GDP declined from 5.9 per cent in 1991-92 to 4.5 per cent in 2002-03.

Providing world class infrastructure is an important pre-requisite to impart competitiveness to the domestic industry. In an open economy, it is important to provide quality infrastructure to enable the domestic manufacturers to compete effectively in the world market. The critical infrastructure facilities relate to electricity and transport including railways, roads, ports and airports. The World Competitiveness Yearbook, 2003 points to the fact that the standard of infrastructure provided in India is much below that of China, Malaysia, Thailand and Mexico among the major competitors. On a 10 point scale for infrastructure for distribution of goods and services, India scores only 3.8 whereas the index for China is 5.4 and for Malaysia, it is 8.0. The situation is particularly bad in the case of power, railways, ports and airports, posing serious supply bottlenecks in the economy as these are the sectors which contribute to significant growth.

Despite the many constraints, the performance of infrastructure sectors in the first quarter of 2005-06 has been

good. Power generation during the quarter was higher than the corresponding period last year, but well below the requirements despite a significant proportion of consumption of the manufacturing sector depending on its own generation rather than on the public utilities. There has been a slow-down in the contracts given for the upgradation of highways, though it has picked up again in the last couple of months. The growth in railway freight traffic in the first two months of the current fiscal is less than 2 per cent over the corresponding period last year. The petroleum sector, as mentioned earlier, has suffered a major loss of offshore production facility in Bombay High due to fire and the growth in natural gas too has not been very high. The handling of both cargo and passengers has shown a significant increase in virtually all international as well as many domestic airports, because of the adoption of a more open sky policy and the entry of a number of budget airlines. In fact, most airports at metros are 'bursting at the seams' and the existing infrastructure is woefully inadequate to cater to fast increasing requirements.

There is a tendency to showcase the performance of the infrastructure sectors by comparing with the performance in a previous period or with the targets set. This could be a little misleading for it does not indicate the extent to which infrastructure has constrained the growth of the economy. The relevant comparison should be to compare the actual with the requirements. The fact that most manufacturers have made large investments in the generation of power to free themselves from the utilities and the outages, that they have to significantly depend on the road transportation for the movement of goods and that the movement of coal from the pit-heads continues to be constrained for want of wagons, demonstrates that inadequate spending on infrastructure has been a binding constraint. Despite the infinite capacity of the Indian system to extract an 'extra mile from a seemingly empty tank', infrastructure constraints will become increasingly binding.

Political economy of policymaking

Much of the mainstream literature is in the tradition of 'common good doctrine' and assumes that the government is a

benevolent entity, playing its role to maximise the welfare of the community. The departure from this has come mainly in the public choice literature in the tradition of 'self-interest doctrine' in which individual economic agents within the government maximise their respective gains and this does not result in maximising the welfare of the community. Thus there are models of government in which governments can be monoliths in the hands of bureaucrats leading to bureaucratic capture and in this, even though elections are a part of the landscape, they are mere illusions without much significance (Niskanen, 1971). In the interest group capture models the governments, in effect, are producers and suppliers of rents (Olson, 1982, Landes and Posner, 1975). There are also models in which governments are treated as leviathans maximising their surplus (Brennan and Buchanan,1980). Of course, it is possible to have competitive governments (Breton, 1995), but in the prevailing political and economic conditions, it is difficult to envisage competitive behaviour among different economic agents within the governments in India.

There is considerable literature explaining fiscal outlook on the basis of elections and political cycles. In the Indian context, Sen and Vaidya (1996) find that the pre-election year revenue deficits of the central government are significantly higher. Rajaraman's (2004) analysis of primary revenue and primary fiscal deficits for all levels of government for the period 1951-2000 shows that election year response has become more marked during the last 30 years, showing an upward push of about 0.7 per cent of GDP in the primary revenue deficit and 0.8-0.9 per cent in the primary fiscal deficit.

In India, three important political factors have cast a dark shadow on reforms in policies and institutions. These have impacted on both fiscal adjustment and more generally, economic growth. The first is the end to single party rule and the emergence of government with coalition of parties at the centre as well as in some of the states. Second, the emergence of regional parties in power in many of the states and their participation at the centre as pivotal members of the ruling coalition impacts on policies and the pattern of resource allocation (Rao, 2004). Third, there has been a marked decline in the time horizon of political parties and politicians. In the

last Parliamentary elections, less than 30 per cent of the sitting members got re-elected and this shows that the probability of re-election is not very high and this can impact adversely on both policies and their implementation.

The impact of a coalition government on the medium-term growth prospects has to be seen by the difficulties it faces in initiating policy reforms. The critical dependence of the coalition government on the left parties implies that many of the important reform initiatives such as on disinvestment and privatisation, labour reforms, reforms to open the economy in foreign direct investment (FDI) in many of the sectors of the economy are all on hold. This could have important implications for efficiency in resource allocation besides adversely impacting on the volume of FDI and growth of the economy.

These political economy factors place severe constraints on economic growth due to their impact on the type of policies and implementation mechanisms. One important consequence of the coalition politics is 'competitive populism' in the policies followed. The emphasis is on adopting policies that are immediately gainful to various constituencies of the coalition partners rather than those that would improve the medium and long-terms prospects of accelerating growth and reducing poverty. A close scrutiny of many of the programmes in the Common Minimum Programme (CMP) demonstrates the preference of the political parties in the coalition to adopt policies which are likely to provide immediate popularity, though many of them are likely to absorb a lot of resources and add to fiscal woes (Acharya, 2004). This would also imply that on the fiscal front, there will be give-aways through various exemptions and concessions and in the expenditure side, adoption of various populist policies can result in redirection of resources from infrastructure spending to various populist schemes. There has already been considerable controversy on the merits in adopting the Rural Employment Guarantee Scheme (REGS). There is additionally a Bharat Nirman Yojana which could also involve significant resource costs. Acharya (2004) analyses the possible dangers of implementing the Common Minimum Programme (CMP) of the United Progressive Alliance (UPA) government.

Tasks Ahead

Sustained growth in the medium and long term depends on overcoming the constraints and risks pointed out above. While the policy frame under a coalition regime has to be evolved by the leading party in the coalition by identifying those reforms which are growth accelerating and yet politically acceptable, other issues would require building a consensus among the coalition partners. In fact, right from the 1991, the reform programme had to be sustained by building consensus and admittedly, the progress has not been as fast as desired. The task of building consensus is not easy in the prevailing environment and this is the most important challenge in furthering the reform process.

Despite the shortcomings detailed above, it is encouraging to see the economy achieve higher growth during the last three years. As already mentioned, the last three years have seen that with a little effort and luck, the growth rate for the Tenth Plan period may reach 7 per cent. Admittedly, India does not have a saving and investment rate of 40 per cent unlike China and cannot aspire for double digit growth unless the investment rate is increased from the present level of 23 per cent. Such a growth scenario is not outside the realm of feasibility in the longer term, but in the immediate context, the challenge is to sustain the growth at 7-8 per cent. This would call for extension and deepening of reforms in several areas. Reforms in policies and institutions need to be immediately intensified to both augment investments and increase productivity of these investments.

It is admitted that the growth of employment in the 1990s has been slow and has lagged behind the addition to the labour force. The Mid-Term Appraisal of Tenth Plan, using the sectoral growth rates and employment elasticities, shows that unemployment rates for the country, based on the current daily status of employment, have increased from 8.87 per cent in 2001-02 to 9.11 per cent in 2004-05, which implies that employment increased at a slower rate than labour force growth. Again, the Mid-Term Appraisal also speaks of lower-than-targeted decline in poverty.

Agricultural reforms

An important reason for the slow growth of employment and reduction in poverty has to be found in the relative stagnancy of the agricultural sector, which directly or indirectly supports about 60 per cent of the population living in rural areas. People-based development necessarily involves acceleration in the growth of the agricultural sector. As against the targeted annual growth of 4 per cent during the Tenth Plan, the actual growth rate recorded during the first three years of the plan was just about 1.2 per cent. Equally important are the wide fluctuations in agricultural output, underlining the dependence on monsoons. Reversing this trend is not possible unless the investment in the sector is substantially augmented and incremental capital out ratio (ICOR), which more than doubled during the Ninth Plan, is halved. This would call for speedily completing the ongoing irrigation works and development of minor irrigation works, improving market access, investments in food processing, value addition in infrastructure and modernisation of post harvest technology, revamping and modernising extension systems and adoption of improved systems of farming wherever feasible.

Manufacturing sector reforms

While the services sector has performed well in the wake of external liberalisation, the performance of the manufacturing sector has been relatively stagnant. This has raised questions as to whether the country will ever become a significant industrial power and whether it is more appropriate for India to simply leapfrog from agrarian to a service economy and modify its strategy accordingly. Such pessimism, however is not warranted for the manufacturing sector has continued to show buoyant performance during the last year. In fact, while the sector has grown at 8.6 per cent during the last quarter of 2004-05, it has accelerated further to 11.2 per cent in the first quarter of 2005-06. While it may be difficult to maintain the growth in the wake of rising crude oil prices and infrastructure constraints, this has shown that it is possible to increase the contribution of the manufacturing sector to overall growth of the economy from the 28 per cent during the first three years of the tenth plan. This, however, would require both larger

investments and improvement in productivity growth. Provision of world class infrastructure, reform of labour laws, rationalisation of tax laws to minimise distortions, removal of entry and exit barriers, further de-reservation of items for manufacture by the small-scale sector, privatisation of not only the loss making units but also those units in which the governmental presence is not required and creating conditions for the entry of foreign direct investment are some important initiatives that are required soon, if India has to emerge as an important industrial power.

Regional disparities

There are serious concerns about increasing regional inequalities as the states with better access to markets and with more developed market-based institutions have been able to take better advantage of the economic reforms than those without. Some of the poorest and most populous states belong to the latter category though it is not the richest states that have grown faster. The more affluent states of Punjab and Haryana, though, continue to be relatively more affluent, have grown at lower rates during the 1990s than some of the middle income states. The predominance of the agricultural sector and its relatively lower growth has been an important factor limiting their growth. On the other hand, the poor and more populous states of Bihar and Uttar Pradesh suffer from lack of institutions for the functioning and development of a market economy and government's initiative in providing social and physical infrastructure have been woefully inadequate. Much of the market based reform has bypassed these states.

A number of factors have contrived to exacerbate regional inequalities. Besides the legacies of past policies and investment pattern, there are important issues pertaining to intergovernmental transfers. In addition to poor institutions supporting the functioning of the market, poor capacities of these state governments to provide social and physical infrastructure and the inability of the fiscal transfer system to offset their fiscal disabilities are some of the important factors accentuating inter-state disparities. Besides, there are serious questions of governance in these states which has resulted in low productivity of even the low levels of expenditures made.

Widening regional disparities is a matter of concern in a federal polity and needs to be addressed quickly not only to ensure inclusive development but also to ensure harmonious law and order situation and preserve the unity and integrity of the country. The response to prevailing situation has been ad hoc such as the introduction of Bihar package and various anti-poverty interventions including the EGS. These are not going to address the issues of governance or issues of accelerating long term growth. It is important to augment infrastructure and initiate policy and governance reforms within a rule based context.

Fiscal reforms

The most important issue that needs to be addressed to ensure sustainable growth in the country is fiscal reforms. These reforms are necessary to ensure macro stability, remove the growth constrains, accelerate the pace of external liberalisation, but also to minimise the microeconomic inefficiencies of the prevailing tax and expenditure systems. The micro level inefficiencies have caused relative price distortions, divided the country into several tariff zones and have reduced revenue productivity.

Four specific issues relating to fiscal developments need emphasis. First, the persisting fiscal imbalance and growing indebtedness has been a major drag on the acceleration of growth in the country and needs to be addressed soon. Second, the fiscal adjustment attempted so far, howsoever little, has been infrastructure unfriendly. While aggregate fiscal deficit-GDP ratio has continued to hover around 9 per cent, over two-thirds of the fiscal deficit now is used to finance current government expenditures whereas in 1991-92, this was just about 20 per cent. Thus, the quality of fiscal deficit has shown a decline over the years. Third, while a substantial part of the fiscal deterioration was triggered by the pay and pension revisions after 1997-98, decline in tax-GDP ratio by over two percentage points during the period 1991-92 to 2001-02 also contributed to the outcome. This is mainly due to the inability of domestic trade taxes to compensate the loss of revenue from customs duty reduction. Instead, even the Union excise duties as a ratio of GDP showed a decline by one percentage point

during the period. Since, 2002-03, however, tax performance at the central level has been buoyant, the revenues rising by about 20 per cent on average during the last three years. Despite this, fiscal imbalance continues to plague the macroeconomic outlook of the country. Any fiscal restructuring plan initiated should address the issue of both improving revenue productivity and compressing unproductive expenditures. Fourth, some of the recent developments may ease the intensity of the problem and it is necessary to guard against complacency. The reduction in the effective interest rates following the debt swap scheme improved revenue buoyancy due to reforms in the tax administration at the centre and introduction of value added tax, and the more generous recommendations of the TFC at the state level have provided some fiscal space for both central and state governments. These have prevented short-term crisis situations. At the same time, the structural problems of central and state finances have not been addressed and the short-term relief should not be taken as a long-term trend. It is particularly important to be guarded against the pressures of competitive populism arising from the coalition politics.

There are two important developments on the fiscal restructuring front. First, the passing of Fiscal Responsibility and Budget Management Act (FRBMA) at the central level and by many states has shown the governments' intention to undertake fiscal adjustment. At the same time, it would be futile to think that the problem of fiscal imbalance can be solved and fiscal discipline inculcated simply by passing legislations. Legislation is a neither a necessary nor a sufficient condition for fiscal discipline, but it can be useful in the short term. Second, the TFC has worked out a detailed fiscal restructuring plan involving both revenue augmentation and expenditure compression for both central and state governments. It needs to be seen whether the central and state governments adhere to the path of fiscal rectitude as laid down by the TFC.

Fiscal Imbalances and Consolidation Attempts

Introduction

Persisting fiscal imbalance in India has been a major macro-economic concern for policy makers. In the early 1990s, the aggregate fiscal deficit relative to GDP was above 9 per cent and the revenue deficit was a little over 4 per cent. The first few years of the reform beginning 1991 saw genuine improvement in the fiscal situation and revenue; primary as well as fiscal deficits showed a marked decline. However, the pay and pension revision following the implementation of Fourth Pay Commission recommendations put the issue beyond the realm of control and as the states followed the central government in pay revision, the fiscal situation worsened. The sharp import duty reduction following the trade policy reform and the inability of domestic trade taxes to compensate the revenue loss further contributed to the deterioration. Thus, despite fiscal adjustment for a decade and a half, sizeable revenue, fiscal and primary deficits continue to persist. Even as the memory of the build up of fiscal expansion creating unprecedented crisis in 1991 has not faded, attempts to impart fiscal discipline at central and state levels are yet to meet with the desired degree of success.

The high and persisting fiscal deficits relative to GDP constrain economic growth by adversely impacting on savings and investment in the economy. It could also spill over into a balance of payments problem. Fiscal deficits also cause increase in indebtedness and when they persist, they can cause a vicious cycle of spiralling deficits and debt to create the problems of debt sustainability and solvency. This also blunts fiscal policy as a countercyclical tool. The lessons of fiscal expansion in the latter part of the 1980s culminating in the unprecedented balance of payments crisis in 1991 clearly point towards the dangers of persisting fiscal deficits.

Persisting fiscal deficits of over 9 per cent of GDP for the last eight years have raised serious questions of sustainability and solvency of debt once again. Important concerns also relate to the cost to economic growth arising from its adverse effects on saving and investment, financial crowding out and infrastructure-unfriendly adjustment, to the extent it is carried out. There are also questions as to whether the overemphasis in containing fiscal deficits has not hurt the economy by compressing infrastructure expenditures and whether one should allow higher deficits to allow larger capital outlay. It is important to note that fiscal stress has substantially reduced the capacity of the central and state governments to provide social services as well as physical infrastructure effectively (Acharya, 2004).

Continued buoyancy of the economy even in the wake of large and persisting fiscal imbalances has led to some measure of complacency regarding the urgency of fiscal adjustment itself. The important point is that unlike the fiscal imbalances leading to economic crisis in 1991, the build up of fiscal deficits and debt since the mid 1990s has not led to the external payments problem. The important difference in the new situation may be noted. First, although Indian public debt has risen steadily since the mid 1990s, it remains below the levels reached in 1991 when the foreign exchange rate crisis broke. Further, the present composition of debt is different from that of 1991. The ratio of external public debt is modest and there is considerable insurance from the build up of gold and foreign exchange reserves. The domestic debt is rupee denominated.

However, there is no room for complacency. For three consecutive years since 2001-02, the interest rate was consistently higher than the growth rate of the economy in both nominal and real terms signalling unsustainable situation (Rangarajan and Srivastava (2003, 2005). Although with the easing of interest rates the problem has receded, the problem remains and continued fiscal imbalance could cause vicious cycle of deficits, debt and debt servicing and push the debt-GDP ratio to unsustainable levels. Nevertheless, it would be safe to conclude that the danger of serious external payments problem in the present situation can be ruled out.

A more worrisome consequence of fiscal imbalance arises

from its cost to economic growth. First, large and persisting fiscal imbalance causes reduction in the overall savings rate as a significant portion of household savings are used up in public consumption rather than investment. Second, an important source of growth cost is the compression of expenditures on creation and maintenance of infrastructure. Inadequate allocation to maintenance results in low productivity of existing infrastructure and deceleration in capital expenditures causes huge time and cost overruns which again, reduces the productivity of capital expenditure. Thirdly, there is a cost to growth in maintaining large food stocks and foreign exchange reserves as an insurance against possible price increases arising from fiscal expansionism.

What are the factors responsible for the fiscal deterioration? How much of the fiscal imbalance is due to deceleration in revenues and to what extent it is attributable to profligate spending? To what extent is the problem structural and how have political economy factors impacted on them? How much of the problem is attributable to the central government and how much of it is due to states? Detailed analysis is necessary to understand the problem and identify the policy and institutional reforms to deal with the structural problems. It is also necessary to analyse the feasibility and likelihood of implementing the fiscal restructuring plan recommended by the TFC and the possibility and likelihood of achieving fiscal balance through the recently legislated fiscal responsibility acts at central and state levels.

The Problem

Magnitude and quality of deficits

The fiscal deterioration was in terms of both magnitude of imbalance and its quality. The aggregate fiscal deficit as a ratio of GDP, after declining from 9.4 per cent in 1990-91 to 6.4 per cent in 1996-67, increased to over 9 per cent in 1998-99 and hovered at around 9-10 per cent thereafter (Table 3.1; Figure 3.1). At the same time, revenue deficit increased steadily from 4.2 to 7 per cent in 2001-02 before marginally declining to about 6 per cent in subsequent years. Similarly, the primary deficit increased from 1.1 per cent in 1996-97 to 3.4 per cent in 2002-

03. The estimates of all three measures of deficits for 2004-05 and 2005-06, however, show substantial improvements. While the direction of the trend seems to be correct, the magnitude of the decline will be known only after the actual revenue and expenditure estimates are available.

Table 3.1: Fiscal Indicators of Central and State Governments

(Per cent of GDP)

Year	Gross Fiscal Deficit	Gross Primary Defict	Gross Revenue Defict	Per cent of Revenue to Fiscal	Development Expenditure	Total Liabilities
1990-91	9.4	5.0	4.2	44.7	17.1	64.4
1995-96	6.5	1.6	3.2	49.2	13.9	61.2
1996-97	6.4	1.3	3.6	56.3	13.5	59.8
1997-98	7.3	2.1	4.1	56.2	13.7	61.9
1998-99	9.0	3.7	6.4	71.1	13.8	63.0
1999-00	9.5	3.8	6.3	66.3	14.2	66.0
2000-01	9.6	3.6	6.6	68.8	14.8	70.4
2001-02	9.9	3.7	7.0	70.7	14.6	75.8
2002-03	9.5	3.1	6.6	69.5	14.6	80.0
2003-04	8.4	2.0	5.8	69.0	14.9	81.1
2004-05*	8.3	2.2	4.1	49.4	14.9	82.0
2005-06**	7.7	1.7	3.4	44.2	13.7	81.3

Note: * Revised estimates; **Budget estimates

Source: *Indian Economic Statistics 2003-04*, Ministry of Finance, Government of India.

Figure 3.1: Fiscal Imbalances of the Central Government

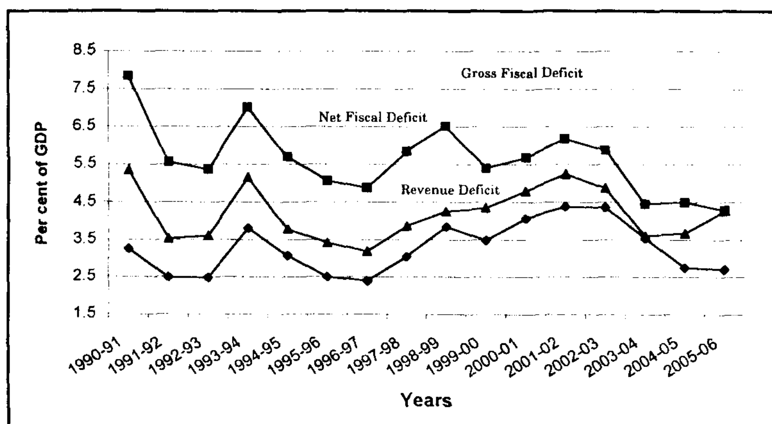
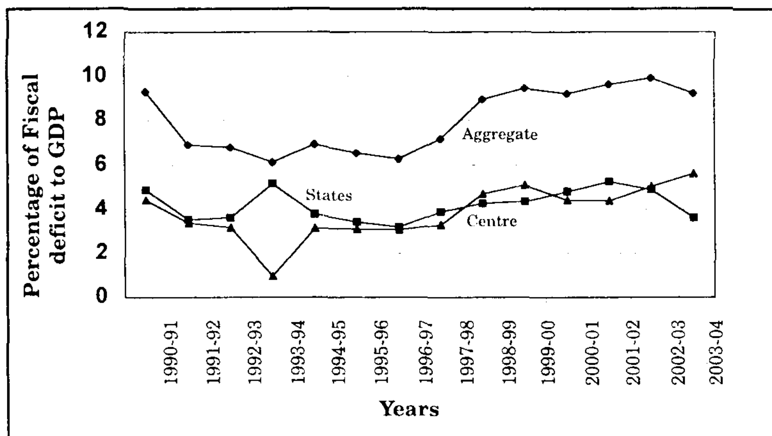


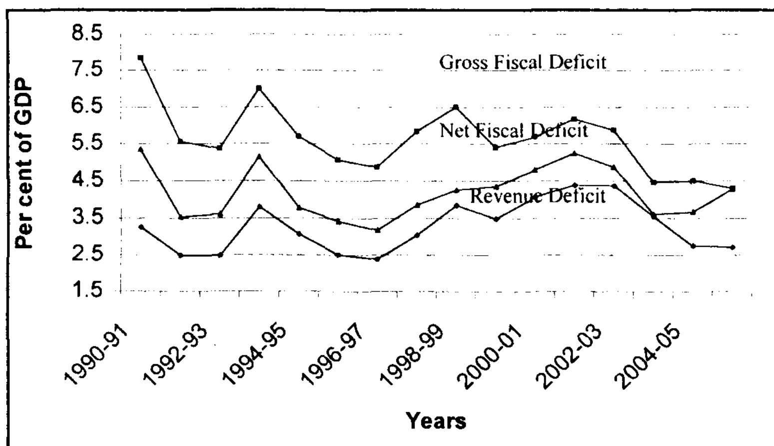
Figure 3.2: Fiscal Deficits: Centre and Aggregate



The problem of fiscal imbalance deficit is seen not merely in terms of increasing magnitude of fiscal deficits, but also in its declining quality. Thus, the share of revenue deficit in fiscal deficit increased from 50 per cent in 1995-96 to 67.5 per cent in 2002-03. Similarly, the ratio of capital expenditure to GDP declined by over two percentage points from 5.3 per cent in 1990-91 to almost 3 per cent in 2004-05. These numbers do not completely reflect the magnitude of the fiscal problem. There are substantial contingent liabilities incurred through special purpose vehicles and public enterprises and for the states alone, this is estimated at 7.2 cent of GDP in 2000-01, up from 4.4 per cent in 1996-97 (World Bank, 2004; p. 5). Besides, the uncovered losses incurred by state electricity boards itself worked out to about 1.4 per cent of GDP in 1999-2000.

Fiscal imbalance is as severe for the centre as it is for the state governments (Figure 3.2; Table 3.1). It is seen that at both the levels, the fiscal deficit declined until 1996-97 (except in 1993-94), but increased thereafter. In the case of the central government, the increase was continuous until 2001-02, but thereafter has shown a marginally improvement. In the case of states too, the sharp increase in the increase in fiscal deficit beginning 1997-98 following the pay revision levelled off in 2000-01, but increased thereafter sharply to reach the level close to 6 per cent of GDP in 2003-04.

Figure 3.3: Fiscal Imbalances of the Central Government



Fiscal imbalance of central government

It is instructive to examine the magnitude of fiscal deficit at the central and state levels separately, though they are interlinked through the intergovernmental transfer system. In the case of the central government, it is useful to look at net fiscal deficit as a good part of its borrowing until 2004-05 was for on-lending to the state governments. This practice, however, has been discontinued from this year on the basis of the recommendation by the TFC. There are also other adjustments in the revenue and fiscal deficit numbers needed to make it comparable over time and this includes adjustment for transfer of RBI profits, disinvestment proceeds and adjustment after the creation of small savings fund. Although these adjustments are not carried out in the estimates presented here, the fiscal deficits presented in Figure 3.3 are on a net basis after adjusting for lending to states.

The net fiscal deficit of the central government which was close to 5.4 per cent of GDP in 1990-91 declined steadily to 3.1 per cent in 1996-97, but thereafter increased to 5.3 per cent in 2001-02 before levelling off at 3.7 per cent in 2004-05. However, the budget estimates place the net fiscal deficit for 2004-05 at 4.5 per cent. The finance minister, in his budget speech, had indicated that he would switch the pause button regarding the

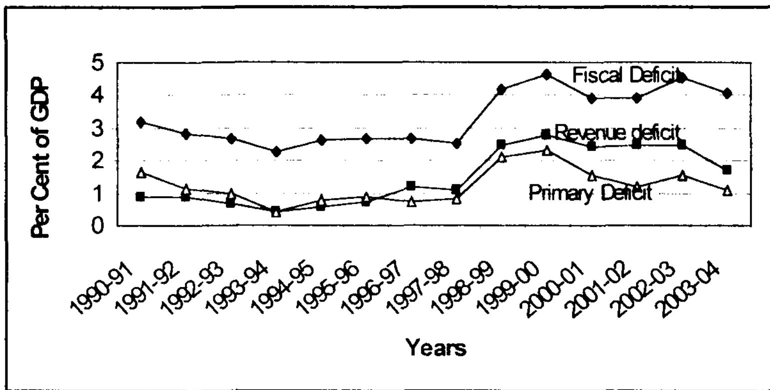
application of FRBMA during this year and the fiscal deficit would be 4.3 per cent of GDP, only a marginal reduction from the previous year. In fact, what he was referring to was the gross fiscal deficit. The fiscal deficit netted for lending to the states of about 0.7 per cent of GDP in 2004-05 works out to 3.7 per cent.

Fiscal deficit trend closely follows the trend in revenue deficit (Annexure Table A3.1; Figure 3.3). The revenue deficit declined from 3. 2 per cent of GDP to 2.5 per cent until 1997-98, but thereafter increased to 4.4 per cent in 2001-02 and subsequently declined to 2.75 per cent in 2004-05. It is estimated at 2.7 per cent in 2005-06. As the central government attempted to contain fiscal deficit even in the wake of increasing revenue deficit, the capital expenditure had to be compressed from 5.6 per cent if GDP in 1990-91 to 1.9 per cent in 2005-06. In other words, the central budget seems to have virtually abdicated its role in financing infrastructure. Thus, and infrastructure spending overwhelmingly depends on private financing.

Fiscal imbalance at the state level

As mentioned above, the problem of fiscal imbalance is equally serious at the state level (Figure 3.4). The aggregate revenue deficits of the states relative to GDP was less than one per cent in until 1996-97, but increased sharply to 2.8 per cent in 1999-2000 following the effect of pay revision. In subsequent years, there has been an attempt at containing the revenue deficits and it is estimated at less than 2 per cent in 2004-05. The increase in fiscal deficits essentially follows the revenue deficit path. It was around 2-3 per cent until 1997-98, but increased sharply to 4.6 per cent in 1999-2000 before showing a marginal decline to 3.9 per cent in 2001-02, but increased thereafter to about 4.5 per cent in the subsequent year. Thus the levels of revenue and fiscal deficits subsequent to pay and pension revision are substantially higher. This has led to the debt-GDP ratio of states increasing from about 19 per cent in 1990-91 to about 29 per cent in 2003-04.

Figure 3.4: Fiscal Imbalances in States



Fiscal trends in individual states

The fiscal imbalances in individual states tell much the same story. The trends in revenue and fiscal deficits as a ratio of GDP averaged for the three years 1993-96 and 2000-03 are summarised in Table 3.2. Analysis of the trends brings out a number of features. First, in every single state, there has been a deterioration in both revenue and fiscal deficits by varying magnitudes. Second, a large part of the deterioration in fiscal deficit has come about due to deterioration in revenue deficits. While the aggregate revenue deficit of the states increased by over 2.4 percentage points, the fiscal deficit increased by 2.1 percentage points. Thus, the share of revenue deficit in fiscal deficit increased from 24 per cent in 1993-96 to 62 per cent in 2002-03. Third, the deterioration in both revenue and fiscal deficits was more in special category states, though these states have received 90 per cent of their plan assistance as grants, as against the non-special category states which received only 30 per cent of the assistance as grants. Fourth, there is no association between the per capita income levels of the states and their fiscal imbalances as measured by revenue and fiscal deficits. Contrary to the general impression, these deficits are not higher in poorer states. The correlation coefficient between revenue deficit and per capita GSDP in non-special category

Table 3.2 : Trends in Revenue and Fiscal Deficits in States

	Average Revenue Deficit		Average Fiscal Deficit		Ratio of Increase in Revenue Deficit in Fiscal Deficit	Increase in Revenue Deficit	Fiscal Deficit
	1993-96	2000-03	1993-96	2000-03	2000-03	1993-2003	1993-2003
Andhra Pradesh	-0.5	-2.03	-3.16	-4.57	44.42	-1.53	-1.41
Bihar	-1.83	-1.87	-2.85	-4.52	41.37	-0.04	-1.67
Gujarat	0.1	-4.66	-1.82	-5.74	81.18	-4.76	-3.92
Haryana	-0.75	-1.32	-2.5	-3.69	35.77	-0.57	-1.19
Karnataka	-0.07	-2.21	-2.71	-4.37	50.57	-2.14	-1.66
Kerala	-1.18	-4.17	-3.32	-5.13	81.29	-2.99	-1.81
Madhya Pradesh	-0.61	-2.05	-2.16	-3.94	52.03	-1.44	-1.78
Maharshtra	-0.09	-3.09	-2.16	-4.12	75.00	-3.0	-1.96
Orissa	-2.0	-4.91	-4.63	-7.84	62.63	-2.91	-3.21
Punjab	-1.88	-4.53	-4.37	-6.14	73.78	-2.65	-1.77
Rajasthan	-1.09	-3.87	-4.51	-6.05	63.97	-2.78	-1.54
Tamil Nadu	-0.71	-2.5	-1.99	-3.75	66.67	-1.79	-1.76
Uttar Pradesh	-1.77	-2.98	-4.04	-5.07	58.78	-1.21	-1.03
West Bengal	-1.53	-5.47	-3.18	-7.31	74.83	-3.94	-4.13
Major States	-0.86	-3.19	-2.93	-4.97	64.19	-2.33	-2.04
Special States	1.96	-2.53	-3.64	-7.04	35.94	-4.49	-3.4
All States	-0.72	-3.15	-2.96	-5.08	62.01	-2.43	-2.12

Source: *Report of the Twelfth Finance Commission*, Ministry of Finance, Government of India, 2005.

states is -0.070 and between fiscal deficit and per capita GSDP is 0.237 and both are not significant at 5 per cent level.

The levels of revenue and fiscal deficits and their changes over the period, 1993-06 to 2000-03 are presented in Table 3.3. Notably, Orissa, Punjab and West Bengal are the states with very high revenue and fiscal deficits. In West Bengal, the revenue and fiscal deficits are not only high but are increasing at fast rates. This shows that the state has allowed the fiscal situation to drift continuously. In Gujarat and Kerala, while revenue and fiscal deficits are high, they have restrained the increases to moderate rates. In the former, the high revenue deficits also show increasing trend, but in the latter, the increase is moderate.

The problem of high revenue deficits in Kerala is structural–traditionally large outlay on social services has high revenue deficits, but attempts at fiscal restraint have limited the increases in revenue deficits to moderate rates. In Gujarat, the problem of deficits is partially due to the exogenous shock–adverse impact on revenues and large relief measures required to be taken following the earthquake in January 2001. This is also reflected in the fact that in Gujarat, while the revenue deficit is very high, fiscal deficit is in the middle range. It also falls in the fast increasing category because of the sharp increase in the revenue expenditures following the earthquake. However, the fiscal deficit in the state is in the middle range and has been increasing at a moderate rate.

In terms of containing deficits, the performances of Tamil Nadu and Haryana have been impressive. The fiscal deficits of both the states are in the low category and in the latter, revenue deficits are also low. In both the states the revenue deficits show slow increases whereas, the increase in fiscal deficit in the former was low and in the medium range in the latter. Thus, in terms of deficit containment, these two states seem to have done better than others.

Apart from a reasonably impressive performance of Bihar, Haryana and Uttar Pradesh in containing fiscal deficits, it must also be noted that the fiscal performance of the middle income states of the southern region was found to be better than other states. Even among them, as already mentioned, the revenue deficit in Kerala was very high and its fiscal deficit was in the

medium range. In other states in the south, the revenue deficits were in the middle range and were increasing at low rates. In Karnataka and Tamil Nadu, fiscal deficits were low, but increasing at medium rate whereas in Andhra Pradesh, it was in the middle range but increasing at a low rate.

Table 3.3: Classification of States According to Level of Deficits and Their Changes

Classification of States According to Revenue Deficits (1990-93 to 1999-2003)

	High >4%	Medium >2% <4%	Low <2%
Increasing at high rate >3% of GSDP)	Gujarat	West Bengal	Maharashtra
Increasing medium rate Increasing between 2 and 3 per cent of GSDP >2<3	Kerala Orissa Punjab	Karnataka Rajasthan	
Increasing at low rate <2		Andhra Pradesh Madhya Pradesh Tamil Nadu Uttar Pradesh	Bihar Haryana

Classification of States According to Fiscal Deficits

	High >6%	Medium >4.5% <6%	Low <4.5%
Increasing at high rate >3%	Orissa West Bengal	Gujarat	
Increasing at medium rate (Between 1.5 and 3 per cent of GSDP.	Punjab Rajasthan	Kerala	Karnataka Madhya Pradesh Maharashtra Tamil Nadu
Increasing at low rates (less than 1.5 per cent of GSDP)		Andhra Pradesh Bihar Uttar Pradesh	Haryana

Source: Based on the information given in Twelfth Finance Commission Report.

The most striking finding is that in the low income states of Bihar, Uttar Pradesh and Madhya Pradesh, both revenue and fiscal deficits are at moderate or low levels and they were increasing at medium or slow rate. It would however, be misleading to conclude from this that the severity of fiscal strain in these states is less. A more plausible explanation is that these states have tried to contain the deficits by reducing outlay on social sector and infrastructure spending. It is precisely for this reason, it is important to look at different dimensions of fiscal stress rather than draw conclusions on the severity merely by analyzing the deficits. We will return to this later in the section.

One important dimension of fiscal stress is the quality of the deficits itself. A summary measure of this is the ratio of revenue to fiscal deficits in the states. This indicates the ratio of borrowing used for current spending by states. The analysis shows that (Table 3.2) in Punjab and West Bengal not only were the size of fiscal deficits very high (more than 6 per cent of GSDP), but also that the revenue deficits constituted more than 70 per cent of the fiscal deficits. The quality of deficits was poor also in the medium deficit states such as Gujarat and low fiscal deficit state of Maharashtra. In contrast, Haryana had the lowest ratio of revenue to fiscal deficits. Thus, it was the best state both in terms of the size of fiscal deficit and its quality. In Karnataka, Madhya Pradesh and Tamil Nadu, the ratio of revenue deficit in fiscal deficit was in the middle range.

The relatively low levels of revenue and fiscal deficits and low ratios of revenue to fiscal deficits in some of the low and middle income states, notably, Bihar, Madhya Pradesh and Uttar Pradesh cast serious doubts on the usefulness of taking merely deficit measures to assess the severity of fiscal stress in the states. As argued earlier, fiscal severity is multi-dimensional and depending on the political environment, the governments tend to respond to the challenge. While many states may allow the deficit situation to drift, a number of other solutions are also possible such as: (i) increase revenues from own sources; (ii) use the bargaining power and clout with the central government and try to get more grants under additional plan assistance and central sector and centrally sponsored schemes; (iii) reduce non-committed expenditures mainly the

capital and maintenance expenditure for which there are no strong constituencies, but also on social expenditures for which the constituencies are weak; (iv) create off budget liabilities to conceal the real deficits. In none of these cases is the deterioration in the states' finances likely to be seen when fiscal severity is measured in terms of only the deficits.

Thus, there is no significant correlation between revenue and fiscal deficits on the one hand and per capita GSDP on the other. As mentioned earlier, in terms of deficits, the performances of the two poorest states, Bihar and Uttar Pradesh are impressive. By the same token the performance of two high income states of Punjab and Gujarat and the middle income state of West Bengal are dismal. The correlation coefficient between average revenue deficit-GDP ratio and per capita GSDP for the period 1999-2003 was 0.07 and between fiscal deficit and per capita GSDP was 0.236. This, however, does not mean that the fiscal stress in poorer states is lower.

The important point to note is that different states respond differently to fiscal stress. The low income states seem to take the option of cutting down expenditures, particularly developmental expenditures[1] to contain their deficits. The evidence of poorer states containing their deficits by cutting developmental expenditures may be seen from the fact that per capita development expenditure in 2002-03 in Bihar at Rs. 1075 was lower than the average of non-special category states (Rs. 2035) by 48 per cent and in Uttar Pradesh (Rs. 1187) it was lower by 42 per cent (Table 3. 4, Figure 3.5). In fact, West Bengal also tried to contain the deficits by cutting expenditures, but the tax-GSDP ratio in the state was so low that in spite of reducing expenditures, it has continued to be the most stressed state in terms of revenue and fiscal deficits. It is seen that while revenue and fiscal deficits in these states were not related to per capita GSDP, per capita expenditure was significantly lower in states with low per capita GSDP with a significant correlation coefficient of 0.813. At the same time, the tax-GSDP ratios were higher in states with higher per capita GSDP with a significant correlation coefficient of 0.777.

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1. The developmental expenditure in the Reserve Bank of India's classification is defined as revenue and capital expenditures on economic and social services.

Table 3.4: Important Fiscal Performance Indicators in States

State	Average per Capita GSDP (Rs)	Per cent of Revenue Deficit to GSDP	Per cent of Fiscal deficit to GSDP	Per cent of Revenue to fiscal defict	Average per capita Development (Rupees)	Per cent of Tax to GSDP
	1999-02	2000-03	2000-03	2000-03	2002-03	1999-02
Andhra Pradesh	18869	-2.03	-4.57	44.42	2531.32	7.27
Bihar	6539	-1.87	-4.52	41.37	1075.81	4.24
Chattisgarh	13710	*	*	*	2040.24	6.38
Goa	56599	-2.44	-4.68	52.14	9207.14	6.80
Gujarat	22708	-4.66	-5.74	81.18	2985.95	7.74
Haryana	26256	-1.32	-3.69	35.77	2778.35	7.78
Jharkhand	11717	**	**	**	2412.73	4.85
Karnataka	20703	-2.21	-4.37	50.57	2688.97	8.18
Kerala	22824	-4.17	-5.13	81.29	2762.29	7.81
Madhya Pradesh	13340	-2.05	-3.94	52.03	1859.41	5.49
Maharashtra	26994	-3.09	-4.12	75.00	2714.31	7.49
Orissa	11234	-4.91	-7.84	62.63	1702.88	5.16
Punjab	28030	-4.53	-6.14	73.78	2494.46	6.73
Rajasthan	15059	-3.87	-6.05	63.97	1982.60	6.14
Tamil Nadu	22587	-2.5	-3.75	66.67	2568.32	8.63
Uttar Pradesh	10798	-2.98	-5.07	58.78	1187.42	5.45
West Bengal	17377	-5.47	-7.31	74.83	1512.49	4.22
Non-Spl. Cat. States	**17022**	**-3.19**	**-4.97**	64.19	**2034.27**	**6.7**

Assam	12288	-1.9	-3.73	50.94	1690.84	4.29
Arunachal Pradesh	16579	1.76	-12.7	-13.86	8536.36	1.21
Himachal Pradesh	24762	-7.28	-11.41	63.80	6179.03	5.04
Jammu and Kashmir	18132	-1.82	-8.28	21.98	4411.32	3.92
Manipur	17264	-2.46	-6.06	40.59	4008.70	1.14
Meghalaya	16035	0.84	-5.28	-15.91	4050.00	3.25
Mizoram	21245	-9.07	-17.79	50.98	9390.00	0.79
Nagaland	20469	-2.12	-7.97	26.60	4659.09	1.17
Sikkim	20929	11.3	-3.42	-330.41	11233.33	4.04
Tripura	18974	-0.61	-7.2	8.47	4300.00	2.12
Uttaranchal	16998	***	***	***	3219.54	5.88
Spl. Cat. States	**16238**	**-2.53**	**-7.04**	35.94	**3474.96**	**3.1**
Total	**16978**	**-3.15**	**-4.08**	77.21	**2125.24**	**6.54**

Note: * Included with Madhya Pradesh. ** Included with Bihar. ***Included with Uttar Pradesh.
Source: *Report of the Twelfth Finance Commission*, Ministry of Finance, Government of India, 2004.

The fiscal performance indicators presented in Table 3.4 explain the reasons for the large deficits in West Bengal and Punjab. These states have large deficits and these states stand out in terms of their poor resource generation through taxation. Among the non-special category states, West Bengal at only 4.2 per cent of GSDP has the lowest tax ratio. This should be contrasted with the tax ratio in states with similar per capita GSDP such as Andhra Pradesh (7.3), Karnataka (8.2), Kerala (7.8) and Tamil Nadu (8.6). The ratio in West Bengal was also lower than average of non-special category states by 1.5 percentage points. Similarly, Punjab, despite being a state with highest per capita GSDP among the non-special category (excluding the small state of Goa), has the tax-GSDP ratio of only 6.7 per cent which is equivalent to the average of the states and substantially lower than not only other similar high income states such as Haryana (7.8), Gujarat (7.7) and Maharashtra (7.5) but also to that of the middle income states cited above.

Another important inference from the analysis is that the low deficits in states such as Bihar, Uttar Pradesh and Madhya Pradesh should not be taken to mean that they do not have fiscal problems. Their deficit is less because they do not spend adequately on development. The problem of low resource base and poor revenue effort is reinforced by large and growing expenditure on committed items such as wages, salaries and pensions and debt servicing. The fiscal stress in these states has displaced spending on developmental items, thereby jeopardizing the future growth prospects in them.

More recent trends, however, point towards some improvement in the fiscal situation in states. The debt swap scheme has reduced their interest payments. On the whole, the Report of the TFC has been generous to the states, particularly in giving equalisation grants and debt relief. The TFC has recommended the restructuring of central loans to states in which the existing high cost loans have been consolidated and made repayable in 20 years bearing an interest rate of 7.5 per cent provided the state pass the Fiscal Responsibility Legislations. This has considerably eased the burden of states' interest liabilities to the centre in future. Furthermore, the TFC has also recommended the debt write off of central loans repayable in the next five years and the extent of write off is

linked to the absolute reduction in revenue deficits.

Another important policy initiative relates to the introduction of reforms towards levying the value added tax (VAT). On April 1, 2005, twenty-one states switched over to the VAT system in which tax paid on the inputs and at previous stages of transaction is set off against the tax payable on the sales. Despite a number of shortcomings in the policy design and implementation, the reform is an important landmark on the fiscal geography of the country and the trends in revenue in recent months have shown that there will not be serious loss of revenue. Having seen the success of VAT in these states and with greater pressure from manufacturers, other states are likely to follow. This policy initiative is likely to not only improve revenue productivity, but also reduce distortions.

Although the fiscal situation in the states is not alarming at present, complacency in this regard is misplaced. The improvement in states' finances has come about due to lower interest payable on their loans due to the debt swap scheme and debt restrucring and additional resources flow recommended by the TFC. The structural problems affecting the state finances continue and unless these are addressed, permanent improvement in the states finances will not occur. This would require policy and institutional reforms to change the structure of incentives to improve revenue productivity and compress unproductive spending. The issue of expenditure profligacy and poor delivery systems particularly in states where the standards of public services are poor are critical to enhancing the overall productivity of the economy.

Causes of Fiscal Imbalances at Central and State Levels

There are a number of studies including the recent Report of the Finance Commission that have examined the causes of fiscal imbalances at central and state levels in considerable detail and therefore these are only summarised here.[2]

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2. A number of papers relating to fiscal imbalances in the country are included in Heller and Rao (Forthcoming). For a detailed account of trends in fiscal imbalances, see (India, 2005. World Bank, 2005, On State finances, see, Rao (2000).

At the central government level, an important reason for persisting fiscal imbalances is the steady decline in the tax-GDP ratio from 10.3 per cent in 1990-91 to 8.2 per cent in 2001-02, mainly due decline in revenue from customs and excise duties relative to GDP. A detailed analysis of the tax revenues of the central and state governments is presented in the next chapter. Combined with increase in the pay and pension revisions, large and increasing interest outlay due to increasing indebtedness as well as rising interest rates until 2002-03, and continued proliferation of subsidies and transfers arising from the competitive populism of coalition politics, the central government could not contain its revenue and fiscal deficits.

Similar is the story in regard to the states' fiscal behaviour. There has been a significant deceleration of revenues in the 1990s as compared to the previous decade. Although as ratio of GDP, the tax revenues of the states taken together did not decline, this was inadequate to meet the growing expenditure requirements arising from massive increase in salary and pension outlays, interest payments, subsidies and transfers and power sector losses. In addition to these, central transfers too declined during this period as mentioned above.

The recent trend in tax revenues however, is more encouraging. Since 2002-03, central government tax revenues have shown significantly higher buoyancy on an average. The growth rate of tax revenues during the last three years was over 20 per cent. In 2005-06, the gross tax revenue of the centre is targeted to increase by 21 per cent over the revised estimate of 2004-05. The revenue collections till September showed spectacular increase in the revenue from service tax (65 per cent), customs (24 per cent), and corporation tax (28.6 per cent) whereas Union excise duty has shown a low growth (6.5 per cent). Overall, central tax revenues are likely to register a growth rate of over 20 per cent for the fourth consecutive year. The problem, however, is in containing the expenditures at the budgeted levels. The pressure of competitive populism is likely to escalate expenditures as more allocation will be demanded by coalition partners to implement the common minimum programme (CMP) of the ruling coalition.

In the case of states, however, the revenue collections from VAT have shown encouraging results obviating the need for

substantial compensation by the centre. Revenue from stamps and registration fees too has shown significant increases in tandem with buoyancy in real property transactions and lowering of rates on them. In line with the buoyancy of the economy, revenue productivity of state excise duties and taxes on transport too have also improved.

On the expenditure front, however, the recent trends are not very encouraging. The implementation of Common Minimum Programme of UPA government would involve considerable spending. While additional spending on education and health care particularly in low income states is necessary to achieve the Millennium Development Goals, it is important to ensure better governance and delivery systems in these states to ensure that outlays translate into outcomes. With massive outlays proposed for the implementation of National Rural Employment Guarantee Act, the improvement in the delivery systems is more important now than ever before.

Recent Initiatives

The importance of fiscal consolidation becomes clear in the context of the 8 per cent growth target set for the Tenth Plan. The Plan assumes that in order to achieve the growth target the investment rate of 28.4 per cent would be required assuming that the incremental capital output ratio will decline from the prevailing 4 to 3.55. Such levels of investment would surely require generation of a larger volume of savings and investment both in the private and public sector and this can not be achieved without fiscal consolidation.

The governments at both central and state levels have taken some initiatives to arrest the deteriorating trend in the fiscal situation. Apart from swapping the high cost with low cost debt to reduce the interest burden, the recent attempts at improving the fiscal situation include the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) and making a reference to the Twelfth Finance Commission to recommend restructuring public finances of the centre and states to restore fiscal balance, achieve macroeconomic stability and debt reduction for equitable growth. The FRBMA sets the targets for revenue deficit-GDP ratio to be reduced to zero and

fiscal deficits to be brought down to 3 per cent by 2007-08, which has been since shifted to 2008-09. The TFC has reiterated the core strategy indicated in the FRBMA, of reducing public dissavings and increasing public investment in infrastructure. As considerable work has been done both in the report of the task force appointed to implement the FRBMA and the TFC to provide policy direction to achieve the targets, it is useful to analyse the quality and feasibility of the reforms recommended by the Finance Commission and whether and to what extent the budgetary proposals in 2005-06 further the cause of achieving fiscal rectitude at the central level.

As mentioned earlier, even if it is not for pure macroeconomic stability, growth considerations call for urgency in fiscal adjustment. From this perspective, the enactment of FRBMA to set the targets and the path of fiscal adjustment is important. Accordingly, the fiscal deficit of the central government is set to be brought down to 3 per cent and the revenue deficit is set to be phased out by the terminal year of adjustment 2008-09. The restructuring plan presented to the Parliament lays down the path of adjustment until 2007-08 which has since been postponed to 2008-09. Accordingly, the revenue deficit of the centre is set to be brought down each year by about half a percentage point from 2.5 per cent of GDP in 2004-05, to zero by 2008-09. Similarly, fiscal deficit is expected to be reduced from 4.3 per cent in 2004-05 by about a quarter percentage point every year to reach 3 per cent in 2008-09. In a more elaborate exercise, the TFC too has worked out the sustainable levels of aggregate fiscal deficit at 6 per cent of GDP of which the targets for the centre and states is set at 3 per cent each by 2008-09. These are consistent with the targets of the FRBMA. The Commission has also emphasized the need to reduce the ratio of primary deficit to GDP in order to reduce the debt-GDP ratio for reasons of sustainability. Once the sustainable level of debt-GDP ratio is achieved, the task of the adjustment process is to stabilise it at that level.

Thus, clearly, sustainable levels of deficits and debt cannot permit continuation of existing trends and significant fiscal restructuring is unavoidable. The Finance Commission details the plan for fiscal restructuring. Accordingly the overall saving rate should be increased from the 24 per cent of GDP in 2004-

05 to 26 per cent in 2009-10 and investment rate should be increased from 24.5 per cent to 27.5 per cent during the same period. Interestingly, the latest data shows that the saving rate has already exceeded the level indicated by the Finance Commission and is estimated at 28.1 per cent in 2003-04 although the investment rate continues to be around 23 per cent.

In regard to fiscal parameters, the TFC mandates that the aggregate fiscal deficit as a ratio of GDP should be brought down from the 8.9 per cent to 6 per cent in 2009-10 and revenue deficit should be eliminated completely from the 2004-05 level of 4.5 per cent. During the period, the capital expenditure should be increased from 5.6 per cent of GDP to 6.6 per cent. In terms of the adjustment for the central government, the target is to eliminate the revenue deficit by 2008-09 and reduce fiscal deficit to 3 per cent and this, as mentioned above, is consistent with the targets set by the FRBMA.

What is the required magnitude of fiscal adjustment in the revenue and expenditure sides? According to the Finance Commission, more than 60 per cent of the adjustment has to come from the revenue side and the remaining, by containing expenditures (Table 3.5). Thus, the tax-GDP ratio is stipulated to increase by two percentage points and the overall revenue-GDP ratio by three percentage points. The expenditure-GDP ratio is set to decline by 1.7 percentage points, but the primary expenditure-GDP ratio is set to increase, as capital expenditure as a ratio of GDP is targeted to increase by one percentage point. Almost the entire reduction in the revenue expenditure is expected to be achieved by reducing interest payments from 6.1 per cent to 4.5 per cent.

In terms of centre's revenues and expenditures, gross tax revenue is targeted to increase from 9.7 per cent in 2004-05 to 10.9 per cent in 2009-10, the non-tax revenues are supposed to remain at 2.2 per cent of GDP, revenue expenditure is set to decline from 11.9 per cent to 10. 2 per cent mainly by reducing interest payments from 4.2 per cent of GDP to 2.8 per cent. Capital expenditure is set to increase by 0.5 percentage point to GDP. Overall this adjustment is expected to reduce the outstanding liabilities from 53 per cent to 43.7 per cent.

In the case of the states, according to the plan, the revenue deficit should decline by two percentage points to GDP and the

Table 3.5: Finance Commission's Plan for Sustainable Fiscal Adjustment in India

Fiscal Variables	Centre		States		Aggregate	
	2004-05	2009-10	2004-05	2009-10	2004-05	2009-10
Gross Tax Revenue	9.7	10.9	5.9	6.8	15.6	17.6
Net Tax Revenue	7.2	7.9				
Own non-tax Revenue	2.2	2.2	1.2	1.4	2.5	3.4
Interest Payment	4.2	2.8	2.9	2.0	6.1	4.5
Total Revenue Expenditure	11.9	10.2	13.6	13.2	22.6	21.0
Capital Expenditure	3.0	3.5	2.6	3.1	5.6	6.6
Revenue Deficit	2.5	0	2.0	0	4.5	0
Fiscal Deficit	4.5	3.0	4.5	3.0	8.9	6.0
Primary Deficit	0.3	0.2	1.6	1.0	2.8	1.5
Interest Payments/ Revenue Receipts	44.5	28.0	24.9	15.0	33.7	21.6
Outstanding Liabilities	53.0	43.7	30.3	30.8	80.8	74.5

Source: Report of the Twelfth Finance Commission.

adjustment in fiscal deficit is equivalent to that of the central government-from 4.5 per cent of GDP to 3 per cent. The adjustment calls for increase in the tax-GDP ratio by about 0.9 percentage point, non-tax revenues are expected to increase only marginally by 0.2 percentage point, and the revenue expenditure-GDP ratio is expected to decline by about 0.4 percentage point. As interest payment is estimated to decline by almost 0.9 percentage point the states actually can increase their non-interest revenue expenditure by about 0.5 percentage point and primary expenditures by almost one percentage point.

How are these adjustments supposed to be achieved? The Finance Commission is rather silent about it except to state that the states should transform their sales tax systems into VAT. Of course, there are omnibus suggestions that tax administration should be improved, user charges should be levied on a variety of services and this should be determined by an autonomous regulatory body, subsidies should be contained, salary expenditures as a percentage of GDP should be rolled back to the level that prevailed in 1996-97, the management of public expenditures should be guided by economy, efficiency and effectiveness of expenditures to focus on outcomes rather than expenditures. Indeed such

'motherhood' statements can be found in all the Finance Commission Reports since the Ninth Finance Commission.

The TFC, despite its claims about incentivising the transfer systems, goes essentially by the gap filling approach. Of course, it tried to normativise the gap by making upward adjustment to the tax–GSDP ratios up to 25 per cent of the shortfall, but considering tax-SDP ratio as a measure of taxable capacity when there are many factors other than income that determine the taxable capacity this method is questionable. Further, the capacity to raise revenues is not a linear function of the capacity variables and there is also significant inter-state tax exportation. The incentive scheme for debt restructuring does impart some incentives and certainly superior to the scheme recommended by the previous Finance Commission, but like in the previous case, the extent of benefit is too small to make a significant difference to the structure of incentives.

Is the predicted scenario by the TFC within the realm of feasibility? The question is pertinent because, right from the Ninth Finance Commission, one of the terms of reference was to recommend fiscal restructuring to ensure that revenue deficits are not only eliminated but surplus is created in the revenue account for public investment. Indeed, all Finance Commissions since the ninth recommended the fiscal restructuring program, but neither the centre nor the states cared to heed. In the event, the actual outcomes were in wide variance with normative projections and the transfer system recommended by each of the commissions, instead of resolving horizontal and vertical fiscal imbalances with necessary fiscal system to generate the projected surpluses, ended up merely distributing deficits between the centre and states!

The budget for 2005-06 reinforces the above apprehension. While the magnitude of fiscal adjustment recommended by the commission does not look infeasible, the problem comes from the compulsions of coalition politics. The Finance Minister had to provide an outlay of Rs. 25,000 crore for the implementation of the National Common Minimum Program (NCMP) and the Finance Commission has not factored in the NCMP in its recommendations. In fact, as the years pass by, considerable additional amount will have to be provided for the implementation of NCMP. The Finance Minister has already

pressed the 'pause' button for fulfilling the obligations under the FRBMA. This he has done even after taking advantage of the additional cushion provided by stopping the practice of borrowing for on-lending to the states. Although the TFC has recommended this to be implemented in a phased manner, the Finance Minister has implemented the recommendation with immediate effect, leaving several questions to be answered on the states' ability to borrow from the market, hand holding required in respect of 'weak' states and the modalities to be followed to make the markets work. In other words, even though the Finance Minister has claimed that he has only pressed the 'pause' button, in effect, there is a slippage to the tune of 0.75 per cent, which is the amount the centre used to borrow to on-lend to the states, but now simply retains itself.

This clearly gives a wrong signal and widens the credibility gap. Even before the ink of the FRBMA is dry, the centre itself is caught in the web of non-compliance. Indeed, the TFC has recommended that the tates too should enact the Fiscal Responsibility Act to phase out their revenue deficits and limit fiscal deficits. The states will surely take a clue from the centre's 'pause'. The critical issue is, like in the past, the TFC's recommendations, despite their 'acceptance' may find non-compliance and the term of reference to restructure the finances of the centre and states. At the end, the interest in the Finance Commission recommendations for both central and state governments seems to be merely to find out the volume of devolution and grants. Once these are known, neither the centre nor the states seem to care for what the Finance Commissions recommend. Hopefully, the terms of reference on relating to the restructuring central and state finances will not continue to the next Finance Commission as well.

Towards Fiscal Consolidation

India's fiscal situation needs immediate attention. The persisting severe imbalance needs to be addressed because high growth and low interest rates will not take care of the long-term problem of debt sustainability nor would it mitigate the risks of a crisis in short and medium term (Singh and Srinivasan, 2005). Similarly, having high reserves, large stocks of foodgrains and a conservative monetary policy may not be

an adequate insurance against the crisis of confidence. It is also important to realise that fortunes of fiscal and financial sector are inextricably intertwined. Furthermore, moving forward in liberalising the capital account is feasible only when the fiscal problem is reined in. As argued above, persisting fiscal imbalances have involved significant growth costs in recent years and the prospect of achieving the 8 per cent growth during the Eleventh Plan will critically depend on the ability to rein is the fiscal problem. It is also important to focus not merely on fiscal deficits but the policy frame should also take into account the contingent liabilities.

Can fiscal responsibility legislations bring about the change in fiscal discipline? A careful analysis shows that legislations are neither a necessary nor a sufficient condition for fiscal discipline, but they can be useful in the short run to raise public awareness about the need for achieving fiscal consolidation and forge a political consensus on fiscal reforms. It is important to note that what is needed is the imparting of fiscal discipline and in a regime of coalition parties with a shorter time horizon this can not be legislated (Buiter and Patel, 2005). The experiences across the world on the effectiveness of legislations to contain deficits have been mixed and the jury is still out. In any case, it appears, in the prevailing political environment, that the FRBMA may still be a useful instrument to prevent fiscal profligacy and mobilise resources in the short term.

To achieve fiscal consolidation, it is necessary to deal with structural factors having an impact on the finances of the central and state governments. This involves the reform of both policies and institutions. There are reform issues which need immediate intervention, while others will have to be dealt with in the medium and long term. There are some-factors, particularly political economy factors, where choice may have to be exercised to undertake politically acceptable and yet economically less harmful options. While changing political incentives in the short or even the medium term may not be feasible, the success of reforms will depend upon finding bundles of reforms that can create winning coalitions of acceptance.

The reforms will have to be undertaken both to improve revenue productivity of the tax system and reduce unproductive expenditures. This would involve reforms in policies and their

implementation as well as altering the institutional framework in which policies are calibrated to change the structure of incentives towards improving revenue productivity and compress unproductive spending. These reforms will have to be carried out at both central and state levels.

Tax reforms at central, state as well as local levels are critical not only to enhance revenue productivity but also to minimise distortions. In the short term, improvement in tax administration and enforcement including the creation of proper information system could enhance revenue productivity as it has done in the last three years. There will also be gains from simplification of the tax system, and broadening of the tax bases by removing various exemptions and concessions. In the medium and long term, however, much more fundamental reforms need to be calibrated to evolve a comprehensive income tax to include income from all sources including from agriculture and a co-ordinated system of consumption tax such as the comprehensive Goods and Services Tax (GST) recommended by the Kelkar Task Force (KTF). This would require changing the assignment system in the Constitution and forging the consensus between the centre and states and therefore, can be accomplished only in the long term. The problems with the tax system in India and the direction for reforms are discussed in the next chapter.

On the expenditure side, the most important issue is the need to compress unproductive expenditures while safeguarding spending on social services, and creation and maintenance of social and physical infrastructure. A number of studies have been conducted at the NIPFP to estimate the volume and composition of implicit and explicit subsidies and the need to phase out non-merit subsidies, but the problem remains.[3] Much has been written about the cost and efficacy and on the distortions caused by the food and fertilizer subsidies, subsidies in the irrigation and power sectors and

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3. The first study detailing the concept and methodology of estimating implicit and explicit subsidies was done in 1991 when the reform process was initiated (Mundle and Rao, 1991 and Rao and Mundle, 1993). Subsequently, a number of studies were conducted by the NIPFP and two white papers were presented in the Parliament, the last one being in 2005.

transport subsidies. These subsidies not merely allocate large expenditures and are poorly targeted, but also cause distortions in resource allocation.

Another notable policy issue is the need to contain pressure to appoint another pay commission in the near future. The World Bank study has brought out the fact that Indian public-private sector wage differentials are among the highest in the world (Glinskaya and Lokshin, 2004). Although senior government officials may still be paid lower than private sector salaries, most class 3 and class 4 employees, accounting for an overwhelming proportion of the workforce, are paid substantially higher than the market wages. Restraint on raising the wages is an important policy component of achieving fiscal consolidation. The World Bank study has also shown that the size of civil service in India is small by international standards.

The most serious long-term policy issue calling for attention is the assessment of the future cost of the pension system. While some demographic factors such as larger proportion of population joining the workforce will ease the problem, others like increasing longevity of life will precipitate it. Increasing the retirement age may ease the problem, but it reduces opportunities for the younger entrants to the workforce. Analysis shows that the cash flow deficit of Employees Provident Fund schemes, which is a defined-benefit scheme, is likely to grow to almost one per cent of GDP in the next few decades, even with the existing coverage. Some of the states have introduced parametric reforms such as use of longer periods for the calculation of benefits, lower limit for commutation of pensions, higher discount rates. a more realistic set of life-tables to commute pensions and reduction in leave encashment limit. Another important parametric change suggested is to index pensions only to prices and not to real wages. The implementation of these reforms will depend on the political will of the ruling party, whether it is at the centre or the states. Nevertheless, it is extremely important to create proper information system on the existing and past employees, and their age profile and build an accurate model for forecasting the future liabilities and simulating reforms.

The number of government employees as percentage of population in India at 1.2 is significantly lower than in OECD

countries (7.7 per cent). Despite this, there is considerable excess employment of Class 3 and Class 4 employees at both central and state levels. However, in sectors such as education and healthcare, there is considerable understaffing. The pupil-teacher ratio in primary schools in some parts of Uttar Pradesh is 70:1 and in Bihar the ratio is 90:1 (World Bank, 2005). Even in a relatively better administered state like Karnataka, the Karnataka Administrative Reforms Commission found that excess employment was as much as 45 per cent in the Irrigation Department, 73 per cent in Public Works and 53 per cent in Mines and Geology.

Reform of public enterprises is an area that is politically sensitive and yet must be undertaken. The issue is not merely confined to the loss-making enterprises. All public enterprises that cannot be rationalised in terms of market failure arguments should be privatised. Even those that continue to be under the public sector need to be corporatised. The prime example of the enterprises that needs to be corporatised is Railways. Unless the public enterprise route to dispensing patronage is dispensed with, the drain on the exchequer will continue.

Improvement in the infrastructure is a key to reducing the ICOR. While the reforms in telecommunication and highways have seen considerable success, they have eluded other areas. In the case of electricity, 34 per cent of the power distributed is not billed at all. And the remaining 64 per cent is not billed at much lower than the long-run marginal cost. The reform in electricity distribution has virtually stalled as every player is waiting for someone else to succeed. There are bottlenecks with railways as not enough investment is made in renewal of the tracks, laying the new tracks, gauge conversion and maintenance of the existing infrastructure. Another important infrastructure that needs to be augmented is irrigation. Compression of capital expenditures has had adverse effects on timely completion of most of the major projects. These need to be completed to improve productivity in agriculture and reduce its volatility and dependence on monsoons. More importantly, it is necessary to focus on small and medium irrigation projects, and significant investment needs to be made in rainwater harvesting to ensure sustainable development of agriculture. Much needs to be done to augment the capacity of ports and airports.

The list of fiscal reforms is not complete unless we also refer to institutional reforms. Besides improvement in administrative, legal and governance systems and institutions relating to fiscal policy design and implementation, particular attention must be drawn to the working of intergovernmental institution systems. Clear delineation of the roles of Planning and Finance Commissions is one such area. The former should be entrusted with the task of planning for infrastructure and assisting the poorer and disadvantaged states to access funds from the market for infrastructure development. This should also help to get rid of the spurious distinction presently made between plan and non-plan budget. The task of making grants should be entrusted to the Finance Commission, which should have a competent permanent secretariat to implement the recommendations and undertake continuous research in critical areas of intergovernmental fiscal relations.

Reform of the transfer system should deal with general and specific purpose transfers rather than plan and non-plan transfers. The methodology employed to determine general purpose transfers should avoid perverse incentives that exist in the prevailing scheme. The centrally sponsored schemes should be consolidated within an overall ceiling and a system introduced to monitor them at both central and state levels. The technically competent permanent secretariat of the Finance Commission should be able to monitor the centrally sponsored schemes and keep a proper information system to administer them. At the state level too, it is necessary to have a system of managing and monitoring grants and keeping of a proper information system for the purpose.

The TFC has recommended that the practice of central lending to states should be stopped and the states should be allowed to access funds from the market in due course. To make successful transition, it is necessary to develop the primary market for government securities and evolve mechanisms and institutions for credit rating of the states and the system of assisting poorer and disadvantaged states. As already mentioned, the Planning Commission could assist the disadvantaged states through concessional assistance in the transitional period until their infrastructure is developed to comparable levels. This could be on the lines of International

Development Assistance (IDA)-type of loans given by the World Bank to low income countries.

Reforms are also necessary in the accounting and budgeting systems to ensure greater internal and external accountability and to create sufficient checks and balances in budget implementation. Moving over to multi-year budgeting, introduction of accrual accounting, removal of personnel deposit accounts (PDA) for disbursal of funds, computerisation of treasury and strengthening its functioning are some of the other reforms needed in this area. The recent introduction of outcome budget at the centre is only the first step in monitoring the outlays into outcomes. This only shows the direction from expenditures to input purchases and does not track the outputs and outcomes. Considerable work needs to be done in expenditure tracking to understand the transformation of expenditures into outcomes. Again, as over 55 per cent of the total expenditures are incurred at the subnational level, and the states provide most of the excludable public goods including social services, the initiative for expenditure tracking and outcome budget will have to be prepared at state and local levels.

Tax System Reform in India:
Achievements and Challenges

Introduction

The tax policy in India, evolved within the framework of public sector based, heavy industry dominated and import substituting industrialisation strategy, has some salient features. First, it was directed to raise resources for large and increasing requirements of public consumption and investment irrespective of the efficiency implications it entailed. Second, the objective of achieving a socialistic pattern of society on the one hand and exercising control over oligopolistic rents generated by the system of licences, quotas and restrictions on the other, necessitated steeply progressive tax structures in both direct and indirect taxes. Third, pursuit of multiplicity of objectives and the resulting complications in the tax system have not only impacted adversely on efficiency and horizontal equity, but also opened up large avenues for evasion and avoidance of taxes. Fourth, all of the above required not only differentiation in tax rates in arbitrary ways but also legitimised selectivity and discretion in tax policy and administration. This provided enough scope for the special interest groups to influence tax policy and administration. Fifth, the influence of special interest groups, the changing priorities and the lack of an information system and scientific analysis led to ad hoc and often, inconsistent calibration of policies. Finally, poor information system was both the cause of selective application of the tax system as well as its effect.

Not surprisingly, the tax system in India has been characterised by narrow base, multiple rates and complicated structure requiring close interaction between taxpayers and

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This chapter draws heavily on the recently written paper with my co-author, Dr. Kavita Rao entitled, 'Trends and Issues in Tax Policy and Reform in India' for the India Policy Forum, 2005.

collectors. With significant discretion given to the tax officials and leaving the taxpayers at the mercy of the tax collectors, there is considerable scope for rent seeking and tax evasion. Poor information system and long judicial process has only added to the problem. Not surprisingly, the tax system that was evolved was complicated, distortionary with low revenue productivity. The revenue productivity declined as economic growth in the country since the mid-1990s was propelled by growth of services and the tax system failed to garner revenues from the increasing income from this sector.

The low and declining revenue productivity of the tax system is an important cause of fiscal imbalances in India and therefore, reforming the tax system to improve revenue productivity has to be an important component of the strategy for fiscal consolidation. Although the recent trends show encouraging signs, structural issues related to tax policy need to be addressed.

The issue of tax reform gains significance in a globalising economy. In India, there has been a sharp decline in revenues following the reduction in tariffs, and as the broad-based domestic consumption tax is with the states, tariff reduction could not be calibrated along with enhancing revenues from domestic trade taxes. In the event, not only that there has been a significant loss of revenue, but domestic trade taxes continued to cry for reforms. With further reduction in tariffs planned, the issue of compensating revenue loss is still germane and in the context of persisting fiscal imbalances may even be a constraining factor. It is also necessary to note that the need for reforms is equally urgent to minimise both efficiency and compliance costs of the tax system in an open economy.

Paradigms of Tax Reforms

The thinking on what constitutes the best tax system and an implementation strategy to achieve it have undergone considerable change over the years mainly due to the changing role of the state in development and the internationalisation of economic activities (Bird and Oldman, 1990, Gillis, 1989, Boskin and McLure,1990). Design of tax policy and reform of an existing tax regime can be two distinctly different exercises, not always generating the same set of results. It is possible to

argue that the objective of tax reform should be to chart the course for taking a given tax regime to the one 'optimally' designed. However, the history of the existing system, as well as political and administrative constraints, could place limits on such a transition path.

One important school of thought, which focuses on the design of a tax system, is the Optimal Taxation. This school of thought recognizes the difficulties of achieving the first best and emphasizes the need to minimize the deadweight losses in exploring the second best solutions. Here, one can distinguish two key approaches. The first is based on the assumption that omniscient and benevolent governments, attempts to minimise the excess burden of raising given amount of revenue. In this, optimal consumption tax rate is related to direct and cross-price elasticities of demand. In the special case when the compensated cross price elasticities are zero, the optimal tax rate is inversely proportional to the direct compensated price elasticity of demand (Ramsey Rule). However, as the tax structures designed on these principles would involve taxing necessities, the need to address distributional concerns becomes paramount (Stern, 1987). Incorporating distributional considerations into this paradigm brought in discussions of optimal income tax, applications of which interestingly do not support sharply progressive tax structures.

The second approach recognizes that the government typically lacks the information on compensated price elasticities and is subject to lobbying when it evolves the tax system with multiple rates. Associated with the names of Harberger (1989, 1990) and Hatta, this approach leans more heavily towards taxing consumption at uniform rates across goods. While efficiency (and distribution weights) is clearly desirable in the design of tax policy, administrative capacity, attention to local institutions and political realities are equally, if not more, important. The principal concern is to adopt the system that will minimise tax-induced distortions and which is administratively feasible and politically acceptable.

The best practice approach essentially is an extension of the second approach. It favours the design of the system essentially to raise maximum revenue at minimum costs. There are three types of costs associated with any tax system and

these are collection costs, efficiency costs associated with the tax and compliance costs. Thus, the thrust of most tax-policy advice within this approach is to enhance revenue productivity of the tax system while minimising administrative costs, relative price distortions and compliance costs. Therefore, the emphasis of most tax policy advice in developing economies is to broaden the tax base, lower the rates and reduce rate differentiation in both direct and indirect taxes. Adoption of uniform tax rate has been an important feature of practical approaches to tax reform (Rao, 1992). A broader base requires lower rates to be levied to generate a given amount of revenues. Lower marginal rates not only reduce disincentives to work, save and invest, but also help to improve tax compliance. The broad based and uniform rates of taxation, thus, avoid an arbitrary array of tax differentials determined more by special interest group politics than pursuit of economic efficiency and a mechanism for ensuring stability and simplicity in the tax system.

The introduction of value added tax (VAT) is an important component of recent tax reform packages in most of the countries, especially in the context of declining emphasis on import tariffs.[1] Keen and Ligthart (2002) show that in small open economies any revenue neutral tariff cut accompanied by price neutral destination based VAT will enhance both net revenue and welfare. While, this result is contested, especially in the context of developing economies with significant informal sectors, the debate does not extend to cases where VAT seeks to replace a cascading type of sales tax or broad-based excise duty. Further, in India a complete replacement of revenue from international trade taxes by VAT may not be possible and even if it were, the revenue may not accrue to the central government in a federal set up like India where the states have the power to levy sales tax (Rajaraman, 2004).

In many countries, reason for levying the VAT has as much, if not more, to do with replacing the cascading type sales taxes, which are often confined to the manufacturing stage than to substitute import duties as a source of revenue. In many cases the expansion of the tax base accompanying the VAT both due

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1. For the most recent review of literature and analysis of VAT in the context of trade reform, see Bird (2005).

to coverage of the tax to post manufacturing stages and self-enforcing nature of the tax has enhanced revenue productivity. This has also helped to improve the information system for tax administration.[2] Thus, as argued by Bird (2005), 'One may criticise VAT in both theory and practice, and much more such analysis and criticism in not only to be expected but also welcomed. In the end,. . . VAT almost certainly works better both in theory and practice in most countries than any feasible alternative.'

Apart from concerns of efficiency, tax policy has often been guided by the need to pursue the objective of redistribution though over the years this has been substantially moderated. Most policy analysts in the 1950s and 1960s assigned redistribution a central focus in tax policies. In fact, in the 1950s and the 1960s, the marginal rates of personal income taxes were set at confiscatory levels and even in countries such as U.S.A and the U.K. the marginal tax rates were over 90 per cent. However, three important factors have led to moderation in the pursuit of redistribution. First, experiences have shown that highly progressive tax systems have done little to reduce inequality in developing countries as they are actually neither progressive nor comprehensive[3] (Bird and Zolt, 2005). The empirical studies in the U.S. (Pechman, 1985) and Chile (Engel Eduardo et al., 1999) have shown the extent of income redistribution and reduction in inequality achieved by the tax systems was insignificant. Second, the redistributive tax system can impose additional costs to the economy, and that includes

2. Rajaraman (2004) cites the estimates of the IMF study (Ebrill etal. 2001) to show that countries with higher per capita GDP tended to gain, but the poorer countries tended to lose by introducing the VAT. Besides the usual problems with cross-country regression estimates which both the papers point out, it must be noted that a properly calibrated VAT with its information on turnovers can improve income tax. In Thailand for example, the introduction of VAT replacing the manufacturers' sales tax in 1991 at a uniform rate of 7% which was actually less than the revenue neutral rate (10%), led to full revenue recovery. What was surprising was that it also increased the income tax by 25%. (India, 1995).
3. See. Harberger, 2004 and Bird and Zolt (2005).

administrative costs, compliance costs, economic efficiency costs and political costs. Third, the focus of equity in fiscal policy itself has shifted from 'reducing the incomes of the rich' to 'increasing the incomes of the poor' and in this, the alternative approach of using expenditure programs for poverty alleviation are more attractive (Harberger, 2003; Bird and Zolt, 2005).

Tax policy stands on the tripod of 'architecture', 'engineering' and 'management'. 'Architecture' provides the design of the tax system to be achieved and this is guided by the objectives of tax policy. 'Engineering' provides the mechanics and these are given by the nature of institutions and systems involved in tax collection. 'Management' provides implementation strategy and action and this inter alia, depends on the political support and vision, nature of administration and information system. All the three legs of the tripod are interdependent. The reform of the tax system involving both its structure and operations is a continuous process and has to be calibrated constantly. A complementary action in this regard is the building of a proper information system.

Evolution of Indian Tax System

Reform of central taxes

Systematic and comprehensive attempts to reform the tax system at the central level started only after market based economic reforms were initiated in 1991. The Tax Reforms Committee (India, 1991) laid out a framework and a roadmap for reform of the tax system, both direct and indirect. The analytical basis for the reform in the new millennium was provided by task force reports on the reform of direct and indirect taxes (India, 2002) and the report of the task force on the implementation of the Fiscal Responsibility of Budget Management Act, 2003 (India, 2004). In many ways the reform since 1991, with emphasis on simplicity and efficiency, makes a marked departure from the past. In fact, the task force reports build on the recommendations of the TRC.

Recommendations of the Tax Reform Committee (TRC)

Indeed as Bird (1993) states, '. . .fiscal crisis has proven to

be the mother of tax reform'. Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practices, the TRC adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms. There are three parts in the report. In the first interim report, the committee sets out the guiding principles of tax reform and applies them to important taxes, namely, taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report was concerned mainly with the much-neglected aspect of reforms in administration and enforcement of both direct and indirect taxes. The second part of the report dealt with restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations are to broaden the base, lower marginal tax rates, reduce rate differentiation, simplify the tax structure and undertake measures to make the administration and enforcement of the tax more effective. The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT, and (iii) increase the relative contribution of direct taxes.

The important proposals put forward by the TRC included reduction in the rates of all major taxes, i.e., customs, individual and corporate income taxes and excises to reasonable levels, maintain progressivity but not such as to induce evasion. The TRC recommended a number of measures to broaden the base of all the taxes by minimising exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerisation of tax returns, and a thorough revamping and modernisation of the administrative and enforcement machinery. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and it should be extended to the wholesale level in agreement with the states, with additional revenues beyond the post-manufacturing stage passed on to the state governments.

In the case of customs, the TRC recommended the tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. The tariff rate was to vary directly with the stage of processing of commodities, and among final consumer goods, with income elasticity of demand (higher rates on luxuries). At hindsight, it is easy to criticise the excessive rate differentiation (seven rates) and according a degree of protection depending on the stage of processing. Thus, Joshi and Little (1996, p. 74) state, '...this is a totally unprincipled principle, for it has no foundation in economic principles' as in addition to continued complexity, the proposed tariff structure creates very high differences in effective rates and provides higher degree of protection to inessential commodities.

By all accounts, there has been considerable simplification and rationalisation of the tax system at the central level in 2005 although these reforms are neither uniform nor consistent and the system is far from being perfect (Acharya, 2005). There are still areas requiring reforms and these will be discussed later. While the above description gives a broad account of the history of tax reform, it is important to understand the evolution of the tax structure in respect of each of the major taxes. The following provides the evolution of each of the major central taxes, namely, personal income tax, corporation income tax, union excise duties and customs.

Reform of direct taxes

Individual income tax

In the case of personal income tax, following the recommendation of the TRC, tax rates were considerably simplified to have three slabs beginning with a rate of 20 per cent, a middle rate of 30 per cent and the maximum rate of 40 per cent in 1992-93. The financial assets were excluded from wealth tax and the maximum marginal rate was reduced to one per cent. Further reduction came in 1997-98 when the three rates were brought down further to 10-20-30 per cent. The rates have remained stable since 1997-98, but there have been some changes in the tax brackets. The surcharge initially levied at 5 per cent of the tax payable in 2002-03 was discontinued in 2003-04, but a separate surcharge of 10 per cent of the tax payable was imposed on all tax payers having taxable income

above Rs. 8.5 lakhs, which was raised to Rs. 10 lakhs in the budget of 2005-06. Further, all taxes are topped up by 2 per cent education cess from 2004-05 onwards.

As regards the exemption limit, it was raised to Rs. 50,000 in 1998-99 and with generous standard deduction, exemption of dividend and interest on government securities up to specified limits, the threshold in effective terms increased substantially. The 2004-05 budget did not raise the exemption limit but provided that those with income less than Rs. 100,000 need not pay the tax, but retained the existing tax brackets. The 2005-06 budget raised the exemption limit itself to Rs. 100,000, abolished standard deduction and made marginal changes in the tax brackets. The exemption limit for women was increased to Rs. 135,000 and for senior citizens, Rs. 185,000. The savings in superannuating schemes up to Rs. 100,000 was made deductible from the taxable income.

The important feature of the 2005-06 budget was the levy of the 'fringe benefits tax'. A number of expenses by the company, which provide indirect perquisites to the entire group of employees, but are not directly assignable to any single employee, are identified and these are taxed through a Fringe Benefits Tax to be paid by the employee at 30 per cent. These include a pre-determined proportion of a wide range of expenses by the company, including entertainment, conference, employee welfare, sales promotion including publicity, conveyance, tour and travel, including foreign travel expenses, use of telephone. While in principle there cannot be anything against this levy, it provides uncertainty to the tax regime and implementation problems threaten to increase litigation rather than revenue.

In the case of corporate taxation too, the basic rate was brought down to 50 per cent, and rates applicable to different categories of closely held companies were unified at 55 per cent. Following the recommendations of TRC, the distinction between closely held and widely held companies was done away with and the tax rates were unified at 40 per cent in 1993-94. In 1997-98, when personal income tax rate was reduced, the company rate was brought down to 35 per cent and the levy of 10 per cent dividend tax was shifted from individuals to companies. The subsequent years have seen lack of direction in the measures adopted. The dividends tax rate was increased

to 20 per cent in 2000-01, reduced again to 10 per cent in 2001-02 along with reversal to the classical system of taxing it in the hands of the shareholders and the policy was reversed once again in 2003-04 with the levy of the tax on the company.

On the issue of taxing dividends however, there have been frequent changes and lack of direction. In 1997-98, the 10 per cent dividend tax was shifted from individuals to companies. The rate was increased to 20 per cent in 2000-01, reduced again to 10 per cent in 2001-02 and the tax was shifted back to the shareholders. The policy was reversed once again in 2003-04 with the levy of the tax on the company. In the 2005-06 budget, the corporate income tax was reduced to 30 per cent on domestic companies. A surcharge of 10 per cent (without any conditions regarding installed capacity increases) is also chargeable. The depreciation rate, however, has been reduced to 15 per cent in the case of general plant and machinery, but initial depreciation is set at 20 per cent, thereby reducing the overall benefit of reduction in corporate income tax rates.

The most important reform in recent years is in tax administration. Expansion of the scope of tax deduction at source (TDS) is one of the significant measures to reach the 'hard to tax' groups. Further, every individual living in large cities covered under any one of the six conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel, and subscriber of a telephone connection) is necessarily required to file a tax return. While the issue of permanent account numbers (PAN) has been simplified by outsourcing it to the UTI Investors' services Ltd., the work on Tax Information Networking (TIN) has been outsourced to the National Securities Depository Ltd. (NSDL). Strengthening the information system through the TIN, its processing and matching the information from various sources on a selective basis is an important initiative, that is likely to improve tax compliance.

A noticeable trend is that while until the mid-1990s tax reforms were calibrated on the basis of a consistent theoretical framework, some of the subsequent changes were ad hoc. The prime example of this is that of introduction of the MAT instead of phasing out tax preferences. Levying company tax at a rate higher than the highest marginal rate of personal income tax

is another example. Similarly, the levy of securities transactions tax ostensibly to create an audit trail in April 2004 and cash withdrawal tax at 0.1 per cent on all cash withdrawals above Rs. 25,000 from current accounts of commercial banks in April 2005 are other examples. Finally, the levy of fringe benefits tax also falls in this category. These measures however, are retrograde. The former securities transaction tax hinders the development of the stock market and discriminates against investments in shares. The cash transaction tax puts enormous inconvenience to small and medium sized firms, which have to withdraw large amounts of cash even to pay the salaries of its employees. The fringe benefits tax creates ambiguities, creates problems in implementation and opens up avenues for large scale litigation

Reform of indirect taxes

Union excise duties

Although the Indirect Tax Enquiry Report (India, 1977) provided a detailed analysis of the allocative and distributional consequences of Union Excise Duties, its recommendations were not implemented until 1986-87. The rationalisation recommendations included conversion of the specific duties into ad valorem, unification of rates and introduction of input tax credit to convert the cascading type manufacturers' sales tax into a manufacturing stage value added tax (MANVAT). Interestingly, there was virtually no preparation and the introduction of MODVAT was a 'learning by doing' process. This was a strange combination of taxation based on physical verification of goods with provision of input tax credit. The coverage of the credit mechanism too was confined initially to items from select chapters having one-to-one correspondence between inputs and outputs. By 1996-97, however, it covered majority of commodities in the excise tariff and incorporated comprehensive credit. Nowhere else in the world can one find the VAT as complicated in its structure, as difficult in its operations and as incomplete in its coverage. Not surprisingly, the revenue from the tax relative to GDP declined after its introduction.

The TRC recommended simplification and rationalisation, particularly gradual unification of rates and a greater reliance

on account based administration. In 1999-00, almost 11 tax rates were merged into three with a handful of 'luxury' items subject to two non-vatable additional rates (6 and 16 per cent). These were further merged into a single rate in 2000-01 to be called a Central VAT (CenVAT), along with three special additional non-vatable excises (8 per cent, 16 per cent and 24 per cent) for a few commodities. The base of the tax was also widened by taxing some exempted commodities at 8 per cent. The credit mechanism was extended to the small scale sector on payment of 60 per cent of the tax due. This option however has been withdrawn from the budget of 2005-06.

Customs duties

Even in 1990-91, the tariff structure was highly complex varying from 0 to 400 per cent. Over 10 per cent of imports were subject to more than 120 per cent. Wide ranging exemptions granted by issuing notifications made the system complex and was a reflection of the influence of various special interest groups on tax policy. In 1991-92, all duties above 150 per cent were brought down to this level to be called the 'peak' rate. This was subsequently brought down in stages to 15 per cent in 2005-06 for non-agricultural goods. Along with the removal of quantitative restrictions on imports and exchange rate depreciation, the change in the tariffs constituted a major change in the foreign trade regime in the country.

The number of major duty rates was reduced from 22 in 1990-91 to 4 in 2003-04. Of course, some items are outside these four rates but 90 per cent of the customs duty is collected from items under the four rates. At the same time, a special additional duty (SAD) was imposed on the rationale that if the commodity was domestically produced and sold on inter-state sale, it would have attracted the tax rate of 4 per cent. This was however, abolished in January 2004 and reintroduced subsequently in 2005-06, with a maximum rate of 4 per cent and called CVD. Thus, the direction of reforms was not always consistent, but over the years, the attempt has been to reduce the rates and reduce their dispersion. However, the pattern of tariffs with the rates varying with the stage of processing has continued and this has caused very high effective rates on assembling of consumer durables and luxury items of consumption.

Service Tax

The central government levied tax on three services, namely, non-life insurance, stock brokerage and telecommunications in 1994-95. The list was expanded in succeeding years to include over 80 services as at present. The rate of tax was also increased from 5 per cent to 8 per cent in 2003-04 and further to 10 per cent in 2004-05. The Expert Group on Taxation of Services (India, 2001) recommended the extension of the tax to all services with a small exempted list and a negative list of services, along with the provision of input tax credit for both goods and services and subsequently, integration with the CenVAT. These reforms eventually were to evolve a manufacturing stage VAT. However, the tax continues to be levied on selective services, though, the recommendations pertaining to the extension of input tax credit for goods entering into services and vice versa has been implemented.

State level tax reforms

Tax reforms at the state level were not coordinated with those at the centre. While individual state governments tried to appoint committees from time to time and reform their tax structures, there was no systematic attempt to streamline the reform process even after 1991 when market oriented reforms were introduced. Most of the reform attempts were ad hoc and were guided by exigencies of revenue rather than attempts to modernise the tax system. In some cases, even when systematic studies were done, the recommendations were hardly implemented.[4] The pace of tax reforms in the states accelerated in the latter half of the 1990s with increasing pressures on their budgets and, in some cases, due to the conditions imposed by multilateral lending agencies or to meet the targets set by the medium-term fiscal reforms facility.

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4. The NIPFP carried out several studies on the tax systems in various states since 1980 and this included Assam, Bihar, Kerala, Madhya Pradesh, Punjab and Tamil Nadu. Uttar Pradesh had a tradition of appointing a tax reform committee every five years. Sometimes, the studies were repeated after some years. These recommendations continue to be pertinent suggesting that very few have been translated into policy.

The major landmark in co-ordinated tax reform at the state level was in simplifying and rationalising the cascading type sales tax system since the beginning of this decade and the introduction of value added tax in 21 states from April 1, 2005. This reform is critical from the viewpoint of efficiency, for, these taxes contribute over 60 per cent of the states' tax revenues. Besides, in order to evolve a co-ordinated consumption tax system in the country, it is important to calibrate the reforms in the sales tax systems alongside reforming the central excise duty regime.

A systematic discussion on evolving a co-ordinated consumption tax system in the country was initiated in the Report on Reform of Domestic Trade Taxes in India prepared by the NIPFP (1994). It examined alternative models for a co-ordinated consumption tax system for India and studied the feasibility of (i) centralising sales taxes and unifying the levy with excise duties; (ii) giving the states the power to levy all domestic indirect taxes with a corresponding reduction in tax devolution; and (iii) evolving an independent dual VAT at central and state levels with no credit to be paid for the payment of the central taxes by the states and vice versa.

A number of arguments were put forward for replacing the prevailing state sales tax system with the destination based VAT. The pre-retail sales tax levied in most states rendered the tax base narrow. The multiplicity of rates made the tax system complex. The taxation of inputs and capital goods contributed tó cascading, vertical integration of firms and opaqueness. In an imperfect market characterised by mark up pricing, the taxes on inputs and capital goods resulted in the tax on tax, and mark up on the tax, with consumers paying much more than the revenues collected by the government. Inter-state competition in providing liberal tax incentives, besides distorting resource allocation, involved significant cost to the exchequer in tax expenditures. The tax on inter-state sale combined with input and capital goods taxation have caused significant inter-state tax exportation from richer to poorer states and the country was divided into several tariff zones. As a part of the dual VAT design therefore, the NIPFP study group recommended the levy of a separate destination based, consumption type retail stage VAT in place of the existing sales

taxes by the states. The Finance Ministers' Committee set up subsequently also recommended the adoption of VAT in 2003, which was eventually implemented by 21 states in April 2005.

Although characterised as adoption of VAT, the reform in April, 2005 only extends the sales tax up to the retail stage with credit allowed for taxes paid on purchases for all intra-state sales. Inter-state sales tax, i.e., Central Sales Tax, will continue to be levied in the same form in the initial years of the introduction of the new tax. It is proposed to phase out the inter-state sales tax in the next two years. In this sense, the reform is only a transitional measure. The salient features of the VAT levied in the states from April, 2005 are summarised in the following:

(i) The tax is levied at two rates, namely, 4 per cent and 12.5 per cent (except for bullion and specie and precious metals, which are taxed at 1%). Basic necessities (about 75 items) are exempted. Most items of common consumption, inputs and capital goods (about 275) are taxed at 4 per cent and all other items are taxed at 12.5 per cent. Petrol and diesel (which contribute about 40 per cent of sales tax) are kept outside the VAT regime and a floor rate of 20 per cent sales tax will be levied on them.

(ii) The facility of tax credit covers both inputs/purchases as well as capital goods for manufacturers as well as dealers. As regards capital goods, credit for taxes paid can be availed against sales over three years.

(iii) The tax credit mechanism operates in full only in the case of intra-state sale. In inter-state transactions, the exporting state is supposed to give input tax credit for purchases made locally, against the collection of CST. The tax credit of CST in the importing state, or other mechanisms of zero-rating of inter-state sales, will be extended after two years when the CST in its present form will be phased out. In the mean time, information system for inter-state trade will be built up and ICICI Infotech has been contracted to undertake the task.

(iii) The central government has agreed to compensate any loss of revenue during the first three years of introduction of the tax at rates of 100 per cent, 75 per cent and 50 per cent respectively. The loss will be calculated by estimating the

difference between the projected revenue from sales tax on the 2004-05 base and the actual revenue collected. The projected revenues will be estimated by applying the average of the best three years' growth rates during the last five years.

(iv) Tax incentives given to new industries by different states could be continued so long as it does not break the VAT chain. Many states propose to convert tax holidays into deferment of the tax.

(v) All dealers with turnover above Rs. 500,000 are required to register for VAT. However, the states may levy a simple turnover tax not exceeding 2 per cent on those dealers up to Rs. 5 million turnover. They do not have to keep detailed accounts of their transactions. But, these small dealers will not be a part of the VAT chain and no credit will be available for the taxes paid on purchases from these dealers. They may, however, voluntarily register as regular VAT dealers.

Altogether, the commitment to implement VAT has come from 18 states and 5 union territories from April, 2005. Haryana had already implemented the VAT from April, 2004, but with three main rates (4%, 10% and 12%). Eight states including Gujarat, Madhya Pradesh, Tamil Nadu and Uttar Pradesh have stayed out of the system.

Issues of design and implementation

Two sets of problems on the design need to be highlighted. The first is the ad hoc manner of introduction of the tax, lack of preparedness in many states and lack of firm decisions on the design and structure even after a few months of its introduction. Education and awareness programmes for the dealers and the public at large have been largely inadequate in many states. Some states started off the new regime without the rules and forms in place. Even the tax officials are not clear about many issues. In short, this switchover can in no terms be called a planned switchover. Second, there are some shortcomings in the design of the tax which are summarised below:

(i) The difference of 8.5 percentage points between the tax rates on inputs and outputs (4% and 12.5%) tends to reduce tax compliance. In fact, it is inappropriate to specify a lower rate on inputs in a VAT system because, in any case, full credit is available for taxes paid on inputs used in the production against the tax payable on final product. A manufacturer might

prefer to pay the input tax at 4 per cent, suppress his sale and evade the tax on the final product as the difference between the tax payable on the outputs and the tax paid on inputs is large. The large tax differential also encourages large scale lobbying to shift more items from the higher rate to the lower rate category. In fact, from the viewpoint of better tax compliance, it would have been better to choose rates like 4 per cent and 10 per cent.

(ii) It would have been better to stipulate the two tax rates as floor rates rather than uniform rates. The only condition should have been that no state should levy the tax at more than two rates. This would have provided a degree of autonomy to the states and potentially reduced the need for compensation.

(iii) The application of VAT on maximum retail price (MRP) at the first point on pharmaceuticals and drugs in West Bengal and Maharashtra. The rationale for this is that there cannot be value addition at subsequent stages once MRP is taken as the base. This goes against the principle of VAT — of collecting the tax at different stages of value added with credit given to the tax paid at the previous stage. Further, this would put in place two different mechanisms for taxation within the same state, as also for a given dealer, a complication both for administration and compliance.

Trends in Indian Tax Revenues

The trends in tax revenue in India show four distinct phases (Table 4.1; Figure 4.1). In the first, the tax-GDP ratio steadily increased from 6.3 per cent in 1950-51 to 16.1 per cent in 1987-88. The second phase started with the recession caused by the severe draught of 1987 and was marked by stagnation in revenues until the end of the decade. The third phase was marked by decline in revenues following the economic crisis of 1991 and subsequent tax reforms, particularly reduction in tariffs. Thus, the tax ratio declined from 15.8 per cent in 1991-92 to 13.4 per cent in 1997-98 and fluctuated around 13-14 per cent until 2001-02. The subsequent period has seen increase in the tax ratio by over one percentage point to 15.2 per cent in 2003-04. The tax level, however is yet to reach the level that prevailed before tax reforms were initiated in 1991.

Table 4. 1: Trends in Tax Revenue in India

(Per cent of GDP)

	Centre			States			Total		
	Direct	Indirect	Total	Direct	Indirect	Total	Direct	Indirect	Total
1950-51	1.8	2.3	4.1	0.6	1.7	2.2	2.3	4.0	6.3
1960-61	1.7	3.5	5.2	0.6	2.0	2.7	2.3	5.5	7.9
1970-71	1.9	5.1	7.0	0.3	3.1	3.4	2.2	8.2	10.4
1980-81	2.1	7.1	9.2	0.2	4.4	4.6	2.3	11.5	13.8
1985-86	2.0	8.3	10.3	0.2	5.0	5.3	2.2	13.3	15.6
1987-88	1.9	8.7	10.6	0.2	5.2	5.4	2.1	14.0	16.1
1990-91	1.9	8.2	10.1	0.2	5.1	5.3	2.2	13.3	15.4
1991-92	2.4	8.0	10.3	0.2	5.3	5.5	2.6	13.3	15.8
1995-96	2.8	6.5	9.4	0.2	5.2	5.4	3.0	11.7	14.8
2000-01	3.3	5.8	9.0	0.2	5.4	5.6	3.4	11.2	14.6
2001-02	3.0	5.2	8.2	0.2	5.4	5.6	3.2	10.6	13.8
2002-03	3.4	5.4	8.8	0.2	5.7	5.9	3.5	11.1	14.6
2003-04*	3.8	5.4	9.2	0.2	5.8	6.0	4.0	11.2	15.2
2004-05#	4.3	5.6	9.9	Na	na	na	na	na	na

Note: * Actual for the centre and revised estimate for states. #Revised estimates for centre.
n.a: not available.

Source: *Public Finance Statistics, 2003-04*. Ministry of Finance, Government of India.

The decline in aggregate tax ratio since 1987-88 was due to decline in central taxes. The tax ratio at the state level was virtually stagnant at about 5.5 per cent from the mid-1980s until 2001-02 and thereafter increased marginally to 6 per cent in 2003-04. In contrast, the central tax ratio declined by over two percentage points since 1990-91, and after 2001-02, recovered to the pre-1991 level in 2004-05 (revised estimates).

Trends in central tax revenue

Interestingly, motivation for comprehensive tax reform at the centre was the economic crisis. However, unlike most ad hoc reforms undertaken in response to economic crises, the tax

Figure 4.1: Trends in Direct and Indirect Taxes

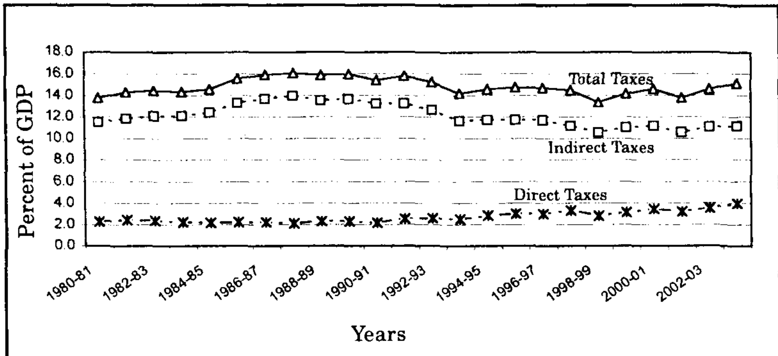
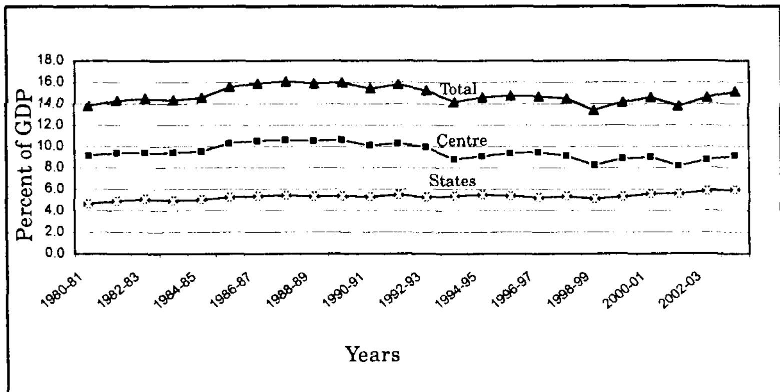


Figure 4.2: Trends in Tax Revenue—Centre and States



reform package introduced in India was systematic and the direction of reforms has continued. However, despite reforms and contrary to expectations, the central tax-GDP ratio has declined after reforms from 10.3 per cent in 1991-92 to 8.2 per cent in 2001-02, before it recovered to about 10 per cent in 2004-05.

The disaggregated analysis of the trends in central tax revenue presented in Table 4.2 (Figure 4. 3) shows that sharpest decline in the tax-GDP ratio was in indirect taxes. The revenue-GDP ratio from customs duty declined from 3.6 per cent in 1991-92 to 1.8 per cent in 2004-05. Similarly, central excise duty declined from 4.3 per cent to 3.3 per cent during the period. Interestingly, the revenue from both the taxes relative to GDP declined until 2001-02, and has stabilized at that level thereafter. It is expected that while the customs may continue to decline as tariff levels are further brought down, the tax ratio from internal indirect taxes are likely to increase if reforms towards improving the coverage of service tax and its integration with CenVAT is undertaken and significant improvement in tax administration is achieved.

The revenue from direct taxes-GDP ratio, however, more than doubled from 2 per cent in 1991-92 to 4.3 per cent in 2004-05. The increase was seen both in personal income and corporate income taxes, the tax-GDP ratio in the latter increasing by more than three times from 0.9 per cent in 1991-92 to 2.7 per cent in 2004-05. The revenue from personal income tax during the period increased from 0.9 per cent to 1.6 per cent.

The steady increase in the tax-GDP ratio in direct taxes has resulted in increase in its share in total taxes. In 1991-92, direct taxes constituted less than one-fifth of the total tax revenue of the central government. In 2004-05, it increased to 44 per cent and in 2005-06, it is estimated at 48 per cent. Commensurately, there has been a decline in the share of indirect taxes, from 80 per cent in 1991-92 to 56 per cent in 2004-05. The customs duties which constituted 36 per cent of central tax revenue in 1991-92 contributed just about 18 per cent in 2004-05 while the share of central excise duty share declined from 43 per cent to 33 per cent.

The decline in the share of customs revenue is certainly to be expected when the tariff rates are sharply brought down in

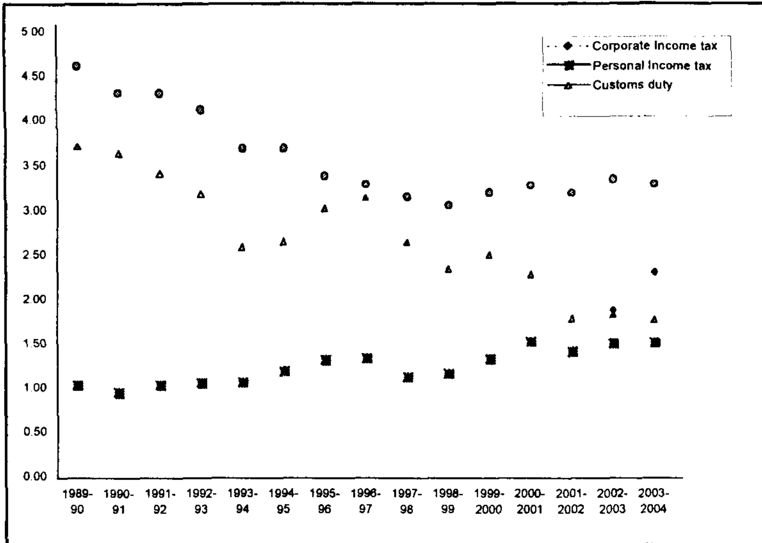
Table 4.2: Level and Composition of Central Tax Revenue

	PIT	CIT	Direct Tax	Customs	Excise	Indirect	Total	GDP
				Per Cent of GDP				
1985-86	1.0	1.1	2.1	3.6	4.9	8.8	10.9	100
1990-91	0.9	0.9	2.0	3.6	4.3	8.2	10.1	100
1995-96	1.3	1.4	2.8	3.0	3.4	6.5	9.4	100
2000-01	1.5	1.7	3.3	2.3	3.3	5.8	9.0	100
2001-02	1.4	1.6	3.0	1.8	3.2	5.2	8.2	100
2002-03	1.5	1.9	3.4	1.8	3.3	5.4	8.8	100
2003-04	1.5	2.3	3.8	1.8	3.3	5.4	9.2	100
2004-05	1.6	2.7	4.3	1.8	3.3	5.6	9.9	100
2005-06	1.9	3.1	5.0	1.5	3.5	5.5	10.5	100
				Per cent of Total Tax Revenue				
1985-86	9.2	10.1	19.3	33.0	45.0	80.7	100	
1990-91	9.3	9.3	19.2	35.9	42.6	80.8	100	
1995-96	14.0	14.8	30.2	32.1	36.1	69.8	100	
2000-01	16.8	18.9	36.2	25.2	36.3	63.8	100	
2001-02	17.1	19.6	37.0	21.5	38.8	63.0	100	
2002-03	17.0	21.3	38.4	20.7	38.1	64.5	100	
2003-04	16.3	25.0	41.3	19.1	35.7	61.3	100	
2004-05*	16.6	27.1	43.9	18.4	32.9	56.1	100	
2005-06#	17.9	29.9	47.9	14.4	32.8	52.1	100	

Note: * Revised Estimates; # budget estimates

Source: Estimate of Revenues, Central Budget (various years).

Figure 4.3 Percentage of Central Taxes to GDP



the wake of external liberalisation. In fact, the decline could have been even faster but for the hesitancy on the part of the Finance Ministry to reduce the tariffs due to the demands of the domestic industry. The declining trend in customs revenue is likely to continue. In fact, it was expected that increasing imports due to liberalisation will offset the effect of rate reduction, i.e. rate reduction being offset by base expansion. However, although imports have shown a significant increase after liberalisation (Panagariya, 2005), it was not enough to balance the revenues. One reason for this could be the large scale exemptions. Although the coverage of exemptions has not been expanded in a major way, the expansion in the base that should have accompanied a reduction in the rates of tax was not accomplished through reduction in the exemptions.

The declining trend in excise duties throughout the 1980s was due to the fact that the rate structure, assumed when input tax credit was allowed, was perhaps not revenue neutral. Continued exemption of the small scale sector and increase in the turnover limit to define the small scale up to a turnover of Rs. one crore, widespread use of area based exemptions are other important reasons for the decline in the excise duties.

Equally, if not more important is the fact that due to the poor information system, it was possible to claim excessive input tax credit. Further, since 1997-98 over 75 per cent of the increase in the GDP is attributable to the growth of the service sector, while the manufacturing sector has been relatively stagnant, implying an automatic reduction in the ratio of taxes on manufacturing base as a percentage of total GDP.

In contrast to indirect taxes, the revenue from direct taxes has shown a steady increase. Revenues from both personal income tax and corporate income tax have increased over the years. The major reason attributed for the increase is the improved tax compliance arising from reduction in marginal tax rates. There are no rigorous studies, though the increase in revenue from personal income tax since 1996-97 is attributed to improved compliance arising from reduction in marginal tax rates. Of course, there is some independent evidence on the improvement in tax compliance since 1991 (Das-Gupta and Mookherjee, 1997, Das-Gupta, 2002).

The recent trends in central tax revenues show a significant increase in revenue productivity, particularly in the case of direct taxes. During the period, 2001-02 to 2004-05, aggregate tax revenue has increased at the average rate of 17.8 per cent and the increase in direct taxes during this period was 24 per cent. It is seen that the gross central tax-GDP ratio increased from 8.2 per cent in 2001-02 to almost 9.85 per cent in 2004-05 and is expected to increase to about 10.6 per cent in 2005-06. Much of the increase has come about in direct taxes and its share in total central taxes increased from just about 19 per cent in 1990-91 to 44 per cent in 2004-05 and is expected to increase further to 48 per cent in 2005-06.

The budget estimate of gross central tax revenue for 2005-06 at Rs.369,293 (excluding Union Territory taxes) is 21 per cent higher than the revised estimate for the previous year and considerable apprehension was expressed in some quarters about the possibility of achieving it. Given the political difficulties in containing unproductive expenditures, the ability of the government to conform to the deficit targets will critically depend on its increase in tax revenues. The trends in revenue collections till September, however, are encouraging. The gross total tax collections have increased by 21 per cent. Much of the increase, however, has come about in the revenue from service

tax (65 per cent), customs (24 per cent) and corporation tax (28.6 per cent). However, the personal income tax including the fringe benefit tax has shown only a modest increase of 18.6 per cent as against the budgeted 30 per cent increase. The trend in union excise duties, has been extremely disappointing. The April - September increase in the revenue from the tax was just about 6.5 per cent higher than the collections in the previous year, despite the surge in manufacturing activity. This is substantially lower than the budgeted increase of 20.7 per cent and is indeed a cause for worry.

Trends in state tax revenue

In Table 4.3 one can see the trends in states' tax revenues. It is seen from the table that the revenue from state taxes as a ratio of GDP was virtually stagnant throughout the 1990s fluctuating around 5 to 5.7 per cent. In fact, from 1994-95, the tax ratio shows a decline to bottom out at 5.1 per cent in 1998-99, the year in which the states had to revise the pay scales exacerbating their fiscal problems. In subsequent years, there has been a steady improvement in the tax ratio to touch 6 per cent in 2003-04.[5]

Of the different state taxes, sales tax is predominant and constitutes about 60 per cent of total state tax revenues. Therefore, not surprisingly, the overall trend in states' tax ratio follows closely the trends in sales tax revenue. The revenue from sales tax after reaching a low of 3.1 per cent in 1998-99, has increased marginally to 3.5 per cent in 2000-01. It has remained at that level thereafter. Any attempt to improve the revenue productivity of states' tax system, therefore, is inextricably intertwined with the reform of sales tax system and in this respect, the recent reform of moving towards a destination based VAT is extremely important.

State excise duty is a sumptuary tax on alcoholic products. In regard to this tax, there has always been a problem of balancing regulatory and revenue considerations. The major components of the tax come from arrack and country liquor on the one hand and 'India Made Foreign Liquor' (IMFL) including

5. The tax ratios however do vary significantly across states, with the southern states of Kerala, Karnataka and Tamil Nadu on average, recording higher levels than the other states.

Table 4.3: Trends in State Level Taxes

(Per cent of GDP)

Year	Direct taxes*	Sales Tax	State Excise duty	Stamps and registration	Taxes on transport	Other indirect taxes	Total Indirect taxes	Total taxes
1985-86								
1990-91	0.2	3.2	0.9	0.4	0.5	0.3	5.1	5.5
1991-92	0.2	3.4	0.9	0.4	0.5	0.4	5.4	5.7
1992-93	0.2	3.2	0.9	0.4	0.5	0.3	5.1	5.5
1993-94	0.2	3.3	0.9	0.4	0.5	0.3	5.2	5.5
1994-95	0.2	3.3	0.8	0.5	0.5	0.3	5.3	5.5
1995-96	0.2	3.0	0.7	0.5	0.4	0.5	5.2	5.4
1996-96	0.2	3.2	0.7	0.5	0.4	0.3	5.1	5.2
1997-98	0.1	3.2	0.8	0.5	0.4	0.3	5.2	5.4
1998-99	0.1	3.1	0.8	0.4	0.4	0.3	5.0	5.1
1999-00	0.1	3.2	0.8	0.4	0.4	0.3	5.2	5.3
2000-01	0.2	3.5	0.8	0.4	0.4	0.4	5.4	5.7
2001-02	0.2	3.4	0.8	0.5	0.5	0.4	5.4	5.7
2002-03	0.2	3.5	0.8	0.6	0.5	0.3	5.7	5.9
2003-04	0.2	3.6	0.8	0.5	0.6	0.3	5.8	6.0

Source: Finance Accounts of States.

beer on the other. The duty is collected by way of licence fee on the sale/auction of vends and taxes on the consumption of liquor. The problem in regard to country liquor has been the brewing and consumption of illicit liquor and this has not only caused loss of revenue, but has been an important health hazard. As regards IMFL, the Karnataka Tax Reforms Committee estimated that the actual evasion of the tax may be as high as three times the actual revenue collected (Karnataka, 2001). The way to deal with this problem has more to do with strengthening the tax administration and information system and less to do with the structure of the tax.

The principal source of stamp duties and registration fees is from the sale of immovable property. Given the high marginal tax rates, the most important problem afflicting this tax is undervaluation of the value of the property transacted. In fact, development of organised market for urban immovable property transactions is hindered by the high rate of stamp duties and registration fees and other policies such as rent control act and urban land ceiling act. Many of the states which reduced the rates have found the typical working of the 'Laffer curve' phenomenon and have started reforms to reduce the rates in this direction. In Karnataka for example, the tax rate was reduced from 16 per cent in 2001-02 to 8 per cent in 2002-03 and witnessed 30 per cent growth of revenue from stamp duties in the next year.

Another important state tax is on transport comprising of motor vehicles tax and passengers and goods tax. For administrative convenience, many states have merged the latter with an additional motor vehicles tax. Also the motor vehicles tax on private non-commercial vehicles has been converted into a life-time tax by adding up ten years' tax or by adopting a similar formula. The reform in this area has to separate the motor vehicles tax from passengers' and goods tax and the latter should eventually become a part of the state VAT rather than a separate tax. Similarly, the taxes on entertainment, electricity duty and luxury tax on hotels and restaurants should also be merged with the VAT.

At the local level there are two taxes of some significance. These are the taxes on property and in some states, Octroi levied by urban local bodies. The major problem with urban

property taxes, like in the case of registration fees is undervaluation. Alternative models of reform–of using the capital value or rental value for valuing the property have been suggested. The ultimate reform depends on the development of an organised property market. In most cases the recommendations suggested have been to use the guided value determined in some independent manner. As regards Octroi, this check-post based levy is not only impeding internal trade and violating the principle of common market, but is also a source of corruption and rent seeking.

Analysis of the Trends and Economic Impact of the Tax System

This section seeks to raise a number of questions like: Has tax compliance improved over the years in response to reduction in marginal tax rates? What other factors influence revenue productivity of the tax system? What are the efficiency and equity implications of the tax system?

Personal income tax

The increase in revenue productivity of personal income tax is attributed to the improvement in tax compliance arising from the sharp reduction in marginal tax rates in 1991-92 and 1996-97. While the analysis of the relationship between the effective tax rates for different income classes and income tax collections as a proportion to GDP may not give a clear picture due to the small size of the sample, such an exercise does give a flavour of the sign of the coefficient. Interestingly, the relation appears to be negative, which shows that decline in the tax rate is associated with an increase in the tax-GDP ratio from the tax, suggesting some applicability of the Laffer curve. While it is clearly difficult to attribute increase in revenue productivity solely or even mainly to reduction in marginal tax rates, Das-Gupta and Mookherjee (1997) draw some tentative conclusions on the improvement in overall performance of the tax system. In a more recent analysis Das-Gupta (2002), based on 16 different structural, administrative and institutional indicators, concludes that the performance of the tax system has shown improvement: tax compliance has indeed improved after the reduction in marginal tax rates.

In a more recent analysis Bhalla (2005) estimates the aggregate revenue elasticity at -1.43 per cent and concludes that the 1996-97 tax cut was a huge success in increasing revenues. The paper provides an estimate of compliance by comparing the data published by the income tax department, the coverage of which, by itself is narrow, with those from other sources, particularly the NCAER to establish that the number of people recording incomes within any given bracket for income tax purposes, is significantly lower than the numbers recorded by other surveys. There are problems with this approach – especially for proprietary firms and individual businesses as also association of persons, where the distinction between expenditures of the firm and expenditures of the individual for personal needs can be hard to make.[6] Nevertheless, the paper helps to focus on the need for some informed debate and analysis in this area.

The important point is that it is not appropriate to attribute improvement in revenue productivity of the personal income tax since 1996-97 solely or even mainly to reduction in the marginal rate of tax. The information presented in Table 4.4 shows that the main reason for the increase in revenues is the extension of the scope of tax deduction at source (TDS). The proportion of TDS to total revenue collections declined from 42 per cent in 1990-91 to 22 per cent in 1994-95, but increased to 50 per cent following the expansion in the scope of TDS in 1996-97 and further to 67 per cent in 2001-02. In 2003-04, it was 64 per cent. Thus, the improved compliance is largely to do with greater effectiveness of TDS as a tool for collecting taxes.

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6. The income tax act provides for some deductions in the case of business and traders. The deductions include expenditure on travel and entertainment. Further, expenses on telecommunications too are a case in point. While any income tax return would show some or all of these expenses as business expenses, in most other consumer surveys these would figure as personal expenses. Given that the proportion of these expenses to total income is likely to be higher in the 'middle', and given the higher possibility of this group of agents being in the 'middle', it appears that this definitional issue itself could induce the pattern observed in the paper.

Table 4.4: Contribution of TDS to Revenue, Personal Income Tax

	Tax Deduction at Source (%)	Advance Tax (%)	Gross Collections (Rs crore)	Refunds (Rs crore)
1990-91	41.75	36.00	6188.37	827.74
1991-92	48.22	33.29	7523.97	794.79
1992-93	42.91	33.45	9060.79	1165.44
1993-94	19.65	51.77	14106.25	4045.96
1994-95	22.18	56.87	17178.72	3357.76
1995-96	22.21	50.01	22949.61	6462.48
1996-97	50.87	27.30	20042.48	1808.49
1997-98	50.87	24.10	19270.19	2169.60
1998-99	52.44	23.59	22411.98	2171.83
1999-00	53.69	24.58	28684.29	3029.79
2000-01	63.22	20.89	35162.61	3398.63
2001-02	67.10	19.23	35358.00	3354.00
2002-03	65.55	20.26	42119	5253
2003-04	64.03	20.04	48454	7067

Source: Report of the Comptroller and Auditor General (Direct Taxes) Government of India, (various years).

Interestingly, although it is tempting to attribute this to extension of TDS to interest, dividends, payments to contractors and insurance commission, the increase has come about mainly in TDS in salaries (Table 4.5). The TDS in salaries in 1992-93 constituted only 25 per cent of total TDS, and it increased to 50 per cent in 1999-2000 and thereafter declined to 41 per cent, as TDS from payments to non-residents and others and payments to contractors increased substantially. It is also seen that the substantial increase in 1996-97 in TDS and corresponding decline in the Advance Tax is accompanied by a sharp increase in the refunds as well. However, even after adjustment for refunds, the share of TDS in total receipts continues to remain high and increasing.

Thus an increase in the tax revenue has more to do with the rapid growth of the organised sector, financialisation of the economy, administrative measures on extending the TDS than improved compliance arising from the reduction in marginal rates of tax. The extension of PAN to cover larger number of potential taxpayers, combined with expanded use of PAN on the one hand and the building the tax information network

Table 4.5: Contribution to TDS

(per cent)

	1992-93	1997-98	1999-00	2000-01	2001-02	2002-03	2003-04
Salaries	25.15	42.05	50.43	48.99	47.82	44.56	41.23
Interest	40.15	25.25	25.85	19.91	21.39	18.37	16.63
Dividend	5.90	3.41	1.99	1.20	0.81	3.00	2.21
Winnings in lotteries and races	1.02	0.66	0.78	0.29	0.23	0.37	0.41
Payments to contractors	11.85	17.90	19.83	14.92	13.06	13.83	17.56
Insurance Commission	1.21	0.97	0.93	0.72	1.05	1.05	1.01
Payments to Non-residents and others	14.71	9.77	0.18	13.98	15.64	18.83	20.94
Total	99.99	100.00	100.00	100.00	100.00	100.00	100.00
Total TDS Collections (Rs Crore)	6,210	13,788	18,546	28,213	30,672	36,568	42,955

Source: Report of the CAG of India, Direct Taxes, various issues.

(TIN) on the other are expected to advance this cause further, by generating an extensive and reliable database. This however does not make out a case for increasing the marginal tax rates, since such increases would be associated with significant efficiency costs on the economy which are then sought to be corrected/mitigated through exemptions and concessions of various kinds.

There has been a significant increase in the number of non-corporate income tax assessees over the last decade. In fact, during the period from 1999-00 to 2003-04 alone the total number of personal income tax assessees increased from 19.6 million to 28.8 million registering a growth rate of over 10 per cent per year (Table 4. 6). Interestingly, the highest growth was seen in the income range of Rs. 0.2-0.5 million (38.4 per cent) followed by those above Rs. 1 million (16 per cent). The important thing to note is the number of tax payers in the country are still small considering the growing 'middle class'. Again, although the taxpayers with income above Rs. 1 million are growing, they still constitute a small number as well as proportion to the total. There were only about 100,000 taxpayers in this group constituting about 0.3 per cent of the total taxpayers.

Table 4.6: Income Range-wise Income Tax Assessees

Taxable Income Range (Rs. million)	Number of Taxpayers Million			Percent of Taxpayers in the Range to Total Number of Taxpayers	
	1999-00	2003-04	Growth Rate	1999-00	2003-04
Less than 0. 2	18.75	26.55	9.1	95.8	92.08
0.2 – 0.5	0.49	1.80	38.4	2.50	6.24
0.5 – 1	0.26	0.37	9.2	1.32	1.28
Above 1	0.06	0.01	16.0	0.30	0.36
Search and Seizure Assessments	0.015	0.012	(-) 5.43	0.08	0.04
Total	19.59	28.83	10.2	100	100

Source: *Report of the Comptroller and Auditor General for the year ended March, 2004*, Government of India, 2005.

It is important to understand the impact of reduction in the marginal tax rate and reduction in the number of rate categories since 1991-92 on the overall progressivity of the tax system. Given that the reform involved sharp reduction in the marginal tax rates, the effective rate declines as the level of income increases. It would be tempting to conclude from the above that progressivity has declined and overall equity in the tax system has worsened over the years. Such a conclusion would be inappropriate for, what this shows is that between income tax payers, the progressivity has declined. Surely in 2003-04, as many as 29 million people pay income tax as compared to about 3.9 million in 1989-90 and the tax paid by them now has doubled from less than one per cent of GDP to almost 2 per cent of GDP. The increase in the number of taxpayers indicates improvement in horizontal equity since more people with similar incomes now probably pay the tax and the fact that larger proportion of incomes are subject to tax now represents improvement in vertical equity as well.

Corporate income tax

Of the four major taxes considered, the revenue from the corporation tax grew at the fastest rate during the 1990s. As a ratio of GDP, the revenue from the tax increased by three times from 0.9 per cent in 1990-91 to 2.7 per cent in 2003-04, despite significant reduction in the rates. The reforms were mainly in terms of doing away with the distinction between closely held and widely held companies, reduction in the marginal tax rates to align it with the top marginal tax rate of personal income tax, rationalising tax preferences - investment allowance and depreciation allowance to considerable extent. In addition, the introduction of MAT has also contributed to the revenues.

It would be instructive to analyse the contribution of different sectors to corporation tax. The contribution of manufacturing sector from the prowess database accounts for two-thirds of the corporate tax collections (Table 4.7). The analysis shows that the manufacturing sector contributed 40 per cent of the corporation tax in 2004-05. Within the manufacturing sector, the petroleum sector contributed the highest (12.5 per cent) followed by chemicals (6.5) and basic metal industry (6.1). In contrast, the contribution of textiles was just about 0.5 per cent. In fact, in 1994-95 industries such as

Table 4.7: Sectoral Contribution to Corporate Income Tax (CIT) Collections

(Per cent)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Mining	2.41	5.20	10.55	11.47	12.88	18.66	22.45	18.27	21.97	13.92
Manufacturing										
Food Products	6.75	3.69	2.96	3.88	4.55	4.77	4.76	3.67	3.43	3.46
Textiles	1.92	0.83	0.81	0.72	0.56	0.55	0.64	0.37	0.47	0.52
Leather	0.04	0.04	0.04	0.04	0.05	0.11	0.07	0.02	0.02	0.03
Paper and Wood	1.61	2.29	0.78	0.53	0.44	0.75	0.89	0.94	0.58	0.74
Petro products	11.75	12.21	7.55	5.50	9.42	6.28	4.97	7.46	11.13	12.48
Chemicals	17.21	13.98	8.67	7.58	6.89	5.74	5.41	5.43	6.00	6.46
Rubber and Plastics	0.87	0.63	0.70	0.64	0.93	0.80	0.51	0.47	0.61	0.50
Non-metallic minerals	1.20	1.82	0.82	0.53	0.46	0.38	0.57	0.40	0.30	0.48
Basic metals and products	3.84	4.70	4.32	3.08	3.60	4.45	4.22	2.95	2.86	6.09
Machinery	13.34	9.90	8.68	6.40	6.35	5.75	3.51	3.92	3.63	3.88
Transport equipment	8.80	10.84	9.41	6.37	5.65	4.61	2.41	3.06	3.96	5.31
Total: Manufacturing	67.33	60.93	44.74	35.27	38.9	34.19	27.96	28.69	32.99	39.95
Electricity gas and steam	0.34	1.70	1.70	8.80	11.49	7.51	9.09	6.49	5.57	1.91
Construction	2.44	1.73	1.38	1.17	1.38	1.27	1.17	0.97	0.89	1.31
Wholesale and retail trade	3.29	2.27	3.31	3.41	2.23	1.89	3.00	2.94	3.03	2.99
Hotels and restaurants	1.15	1.37	0.97	0.62	0.53	0.35	0.38	0.23	0.21	0.21
Transport services	0.36	2.27	2.12	2.07	1.39	1.42	1.91	1.50	1.49	1.27
Post and telecom	10.07	7.91	6.13	5.95	7.58	4.29	5.72	6.35	2.61	6.50
Financial intermediation	11.89	15.95	28.34	30.39	22.37	28.54	25.83	32.01	28.67	29.74
Real estate	0.01	0.03	0.03	0.02	0.01	0.02	0.01	0.02	0.02	0.03
Computer, R&D and other Business services	0.67	0.60	0.64	0.72	1.06	1.46	2.19	2.21	2.13	1.79
Social services	0.04	0.05	0.09	0.13	0.19	0.39	0.31	0.32	0.40	0.40
Proportion of Total CIT Collections	50.06	62.16	77.39	80.82	64.54	62.21	61.95	72.62	80.38	65.09

Source: Prowess database.

chemicals, machinery, transport equipment contributed an overwhelming proportion of corporation tax, but their share declined sharply over the years.

Another important issue examined here refers to the contribution of the public sector enterprises. Curiously, the contribution by public enterprises has shown significant increase since 1991. In fact, the share fell from 23 per cent in 1990-91 to 19 per cent in 1994-95, but increased thereafter to constitute about 38 per cent in 2002-03. Thus, over 50 per cent of the increase in corporation tax was collected from public enterprises (Table 4.8). This is partly due to the fact that public enterprises do not undertake elaborate tax planning to minimise the taxes, unlike the private sector.

Table 4.8: Contribution of Public Sector Enterprises to Corporation Tax

Year	Tax provision by public enterprises (Rs. Crores)	Total Collections (Rs. Crores)	Percent of tax by public sector to total
1990-91	1229.3	5335	23.04
1991-92	1674.11	7853	21.32
1992-93	1804.37	8899	20.28
1993-94	2109.93	10060	20.97
1994-95	2581.46	13822	18.68
1995-96	4186.66	16487	25.39
1996-97	5192.51	18567	27.97
1997-98	5634.11	20016	28.15
1998-99	6499.00	24529	26.50
1999-00	7706.25	30692	25.11
2000-01	9313.62	35696	26.09
2001-02	12254.32	36609	33.47
2002-03	17429.95	46172	37.75

Source: *Public Enterprises Survey*, Government of India (various years).

Union excise duties

Declining tax-GDP ratio of union excise duties is truly a matter of concern as this has been a constraint in reducing the import duties further. The reforms in union excise duties rather than improving the revenue productivity have led to its decline over the years. Although during the last few years the revenue-GDP ratio from the tax has been stagnant at 3.3 per cent, it is significantly lower than the ratio in 1991-92 (4.1 per cent).

Not only that the revenue productivity of union excise duty has declined over the years, even the composition shows increase in revenue concentration, particularly towards commodities which would be used in further production. Independent operation of excise and sales tax systems and confining the tax to goods and to the manufacturing stage alone does not remove cascading, and final products in the manufacturing stage are not necessarily final consumer goods.

The commodity wise revenue collections from union excise duty presented in Table 4.9 bring out some interesting features with implications on both efficiency and equity of the tax system. One of the most important features of the union excise duties is the commodity concentration. Just five groups of commodities, namely, petroleum products, chemicals, basic metals, transport vehicles and electrical and electronic goods together contribute to 75 per cent of total revenue collections. It is normally expected that over the years, with diversification in manufacturing, the commodity concentration in excise duty should reduce. Contrarily, the commodity concentration has only increased over the years with a single group, petroleum products, contributing to over 40 per cent of the union excise duty collections, with more than a three times increase in share over a 13 year period.

Another important feature of excise revenue collections is that an overwhelming proportion of the duties are collected from commodity groups which are in the nature of intermediate products, used in the production of goods or services which are not subject to excise duty. Besides petroleum products, a significant proportion of which are used in transportation of goods and persons involved in or related to other manufacturing, the taxes on all goods serving as inputs to service providers, especially of services used as inputs to manufacturing activities, contribute to cascading and adds to the production cost. Transport vehicles and related industries are another such industry. These are a source of significant inefficiency in the system. This also makes it difficult to speculate on the distribution of tax burden in terms of different income classes as it is difficult to speculate on the effect of the tax on different manufacturing enterprises and its effects on employment and incomes.

Table 4.9: Revenue from Union Excise Duties by Commodity Groups

	1990-91	1995-96	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Food products	4.01	3.55	4.80	4.38	4.53	3.67	3.57	3.24
Tobacco Products	8.29	8.07	7.95	6.74	6.74	6.57	5.90	5.58
Minerals and ores	8.38	8.68	7.18	6.66	6.24	5.99	5.76	6.24
Petroleum Products	**13.93**	**12.39**	**22.46**	**29.56**	**32.91**	**38.32**	**40.37**	**40.99**
Chemicals	**11.15**	**14.42**	**11.14**	**9.79**	**10.17**	**9.86**	**9.31**	**8.86**
Plastics and articles thereof	2.50	4.04	4.21	3.66	2.28	2.38	2.39	2.52
Rubber products	4.93	4.62	2.90	2.65	2.16	1.96	1.79	1.27
Leather and wood products	0.56	0.43	0.23	0.20	0.20	0.17	0.15	0.15
Textiles and garments	10.78	8.54	6.25	5.20	4.84	4.68	4.62	3.73
basic metals	**9.62**	**14.53**	**11.43**	**11.15**	**10.42**	**9.18**	**9.84**	**11.24**
Electrical and electronic goods/tools	**16.11**	**11.88**	**10.47**	**9.47**	**8.81**	**8.18**	**7.77**	**7.82**
Transport vehicles	**8.39**	**7.35**	**8.46**	**8.79**	**8.90**	**7.17**	**6.97**	**6.63**
Miscellaneous	1.35	1.51	2.51	1.76	1.81	1.88	1.57	1.73
Total	100	100	100	100	100	100	100	100

Source: Central Excise Data

A striking feature of the excise duty collections is that like in the case of corporation tax, a predominant proportion, almost 42 per cent of revenue, is paid by the public sector enterprises (Table 4.10). This component, however has witnessed wide fluctuations from year to year, mainly because their production value depends on administered prices or import price in the case of crude oil. It reached the highest share of 53 per cent in 1999-2000, but it declined to almost 30 per cent in 2001-02. In other words, the revenue from excise duties, which constitutes an important source of revenue for the central government, is vulnerable to pricing and output decisions of public enterprises and international prices. This constrains the public enterprises from calibrating an independent pricing policy.

Table 4.10: Contribution of PSEs to Excise Revenues of GOI

	Public enterprises	Total collections	Share of PSEs
1990-91	9655.69	24514	39.39
1991-92	9815.15	28110	34.92
1992-93	12179.9	30832	39.50
1993-94	12527.11	31697	39.52
1994-95	16414.07	37347	43.95
1995-96	17044.41	40187	42.41
1996-97	22192.87	45008	49.31
1997-98	21719.61	47962	45.29
1998-99	23131.67	53246	43.44
1999-00	32941.53	61902	53.22
2000-01	20824.38	68526	30.39
2001-02	31202.78	72555	43.01
2002-03	34610.32	82310	42.05

Sources: *Public Enterprises Survey*, Various Issues, and Budget of GOI, various years
Notes: Tax Provision relates to the provision made for Corporate Tax

Customs Duties

The most important and in many ways far-reaching reform was of customs tariffs. Since 1991, imports subject to quantitative restrictions constituted 90 per cent of total imports, and these restrictions have been virtually done away with. The import weighted tariff rates have been reduced from 72 per cent in 1990 to 15 per cent at present. The peak rate of import duty too has been brought down from over 150 per cent in 1991 to less than 20 per cent at present (Virmani et al. 2004).

From the viewpoint of efficiency, continued varying of the duty rate according to the stage of production is a matter of concern. The rates on raw materials and intermediate goods continue to be lower than those on consumer goods and capital goods. The import tariff reduction has continued to be guided by this 'unprincipled principle' (Joshi and Little, 1996), and even the KTF's recommendations were in conformity with this logic. This approach retains the focus on greater protection for 'final use industries' as compared to inputs and intermediate goods, a continued reliance on the self sufficiency model of development as against a comparative advantage model.

Table 4.11 presents the commodity group-wise collection of customs from 1990-91 to 2003-04. Interestingly, despite liberalisation, almost 60 per cent of the duty is collected from just three commodity groups, namely, machinery (26.6 per cent), petroleum products (21 per cent) and chemicals (11 per cent). Furthermore, over 75 per cent of the duty is collected from either machinery or basic inputs and intermediate goods. Thus, the fear that liberalisation would lead to massive inflow of consumer goods is unfounded. This also implies that further reduction in the duties and greater uniformity in the structure of duties would benefit the economy. A detailed study by Virmani et al. (2004) shows that uniform reduction in tariffs has had favourable effects on production, exports, employment and capital and these gains are different across different sectors.

The commodity group composition of import duties also shows a significant increase in the proportion of import duties collected from machinery from 19.5 per cent in 1990-91 to 26.6 per cent in 2003-04. This has happened despite providing exemption to the plant and machinery imported for several project imports. This implies that external liberalisation is leading to adoption of more modern machinery and technology in the production process and this would have a favourable effect on the productivity growth. The other item that has shown increase in revenue importance is food products. In contrast, revenue from iron and steel and other basic metals has shown a substantial decline over the years and this may be due to the fact that these items have, over the years, become more competitive and therefore, it is perhaps more attractive to buy them in the domestic market rather than importing them.

Table 4.11: Composition of Revenue from Customs Duties

(Per cent)

	1990-91	1995-96	1996-97	2000-01	2001-02	2002-03	2003-04
Food items	2.49	2.43	2.25	5.42	10.64	8.76	6.36
Tea/coffee	0.12	0.04	0.04	0.05	0.06	0.09	0.04
Beverages	0.08	0.13	0.07	0.09	0.22	0.16	0.10
Minerals and ores	1.38	0.74	0.52	1.34	1.55	1.80	1.74
Petroleum products	19.39	23.39	28.54	23.16	16.14	19.50	20.93
Chemicals	12.34	11.86	11.19	10.35	11.41	11.19	11.12
Of which:							
Pharmaceutical products	0.06	0.07	0.05	0.21	0.30	0.44	0.29
Plastics	6.36	4.86	4.71	2.99	3.14	3.07	3.10
Rubber	1.38	1.32	1.48	1.39	1.40	1.30	1.33
Paper	1.04	0.65	0.74	0.70	0.71	0.69	0.89
Textiles	2.16	1.26	0.94	0.97	0.85	0.96	1.40
Cement products etc.	0.20	0.19	0.14	0.19	0.21	0.23	0.26
Ceramics	0.58	0.52	0.45	0.69	0.78	0.75	0.98
Iron and steel	10.24	6.63	5.15	3.81	3.78	3.72	4.64
Other basic metals	4.28	4.95	4.38	2.12	2.30	2.17	2.50
Machinery	19.49	20.84	18.81	23.55	24.80	26.36	26.58
Transport equipment	3.29	4.04	4.69	3.94	3.96	3.37	4.14
Others	15.20	16.16	15.90	19.25	18.06	15.87	13.90
Total	100	100	100	100	100	100	100

Source: Central Board of Excise and Customs, Ministry of Finance, Government of India.

Towards Further Reforms in the Tax System

Tax reform is an ongoing process and in India, in particular, with the fiscal imbalance looming large, reforms to improve the long-run revenue productivity will have to continue. The reforms will have to be in the tax systems, involving the tax structure, administration as well as institutions. The strategy of reform will have to address both the immediate issue of enhancing revenue productivity to achieve fiscal consolidation and facilitate rationalisation of customs duties as well as long-term issues of minimising distortions. The reforms will have to adopt a strategy of sequencing the reforms both to appropriately address short term and long-term issues and to calibrate reforms in the wake of political compulsions.

In the last few years, there has been considerable focus on the reforms of the tax system at the central level with the tax system being studied by various study groups and task forces. The Advisory Group on Tax Policy and Administration for the Tenth Plan (India, 2001) and the Kelkar Task Force (KTF) reports on Direct and Indirect Taxes (India, 2002) and more recently the KTF on the implementation of the FRBM Act (India, 2004) have comprehensively examined the tax system and made important recommendations.

Reform of central taxes

Short and medium term issues

The short reform strategy has to focus on enhancing the revenue productivity of the tax system. Essential components of the strategy comprise broadening the base, simplifying the tax system and improvement in tax administration and enforcement. While these could also have a favourable impact on the reducing distortions, focus is to improve the tax system towards enhancing revenue productivity.

A major problem that has haunted the tax system and reduced the tax base is the wide ranging exemptions, deductions and generous tax preferences. In the case of corporation tax, the important tax preferences were investment allowance and depreciation allowance. In addition, tax incentives were also provided for locating in backward areas. In the case of individual income tax, the major drain to the

exchequer is provided by the exemption to agricultural incomes, exemption given to charitable trusts and wide ranging incentives given to savings and housing. Similarly, in the case of excise duties, exemption given to firms having turnover up to Rs. 3 crores has enormously eroded the tax base. This has also provided additional protection to small scale enterprises, led to splitting of the businesses with adverse consequence on employment and competitiveness to domestic industry. Similarly, wide ranging exemptions for various items and project imports has eroded the tax base considerably. In addition to these, there are exemptions given to export industries and certain types of industries (software), industries located in export processing zones and special economic zones. It is important to review them both to broaden the base of the tax and to reduce distortions and inequity.

In a recent study, Bagchi, Rao and Sen (2005) closely examine and estimate the cost of selected tax incentives. They identify selected exemptions and concessions within the central tax statutes and estimate the associated revenue cost. The incentives taken up for estimating tax expenditures are : (i) Tax holidays: SEZs and area/region based incentives; (ii) exemptions from income tax: incomes of charitable institutions and gifts to charities; (iii) exemptions from excise and customs for small scale industries, specific commodities; and (iv) exemption from the base of agricultural income. The important findings of the study are summarised below:

(a) Special Economic Zones (SEZs): It appears that this incentive in both direct and indirect taxes is for the promotion of exports. In fact, the provisions within indirect taxes are meant to correct for any domestic taxes that the export good may have suffered and hence should not be treated as incentives. Within direct taxes, it is interesting to note that while most of these provisions are either being phased out or limited by a sunset clause, a new set of provisions have been introduced through the SEZ Act, 2005, without placing any limits. The act provides for incentives to both exporters setting new plants in the identified SEZ as well as to promoters of the SEZ, where the latter could be private entities as well.

The paper argues that the case for providing incentives to exports was located in an environment of protection and

controlled economy, a description which does not apply to the Indian scenario any more. Further, incentives of these kinds can potentially be neutralized by the importing country through the levy of anti-dumping duties, thus undermining both the gains from such an incentive regime and reducing the revenue potential within the economy. Further, research on SEZs provides evidence to suggest that the tax considerations figure rather low in the factors influencing the choice of location of exporting firms. Greater emphasis was desired on better infrastructure and better governance of the zones. The paper estimates that revenue cost of all export incentives within direct taxes in the range of Rs 10,000 crore.

Sector/region specific tax holidays

As an attempt to promote industrialisation in the north-eastern states, a package of incentives was designed and implemented in 1997. The scheme was to last for 10 years–any new unit which commenced production during this period could avail of both income tax and excise concessions for a period of 10 years. This scheme was subsequently extended to cover Sikkim, Jammu and Kashmir and finally, in 2003, Himachal Pradesh and Uttaranchal. Some other extensions of such areas based holidays include those for approved housing projects and for private hospitals in rural areas. The paper argues that the region specific tax holidays are objectionable on grounds of economic efficiency, administration and implementation problems in addition to the difficulty of ensuring the units would remain in the said region even after the incentive period has elapsed. A study of the impact of the incentives provided to the north-eastern states concludes that the policy failed to induce large-scale investment–most of the investment was characterized as low investment, low value added, low employment. Poor connectivity to mainland, inadequate infrastructure and security concerns limited the choice of location to two states, Assam and Meghalaya, which commanded 91 per cent of total investment in these states. Further, with identical packages provided to Uttaranchal and Himachal Pradesh, the incentives to the north-east stand completely undermined. The paper estimates that revenue loss on account is about Rs. 200 crore annually until the next two years, and could be substantially higher thereafter.

(c) Incentives for Housing: Investment in housing gets concessional treatment in individual income tax. The interest paid on housing loan is deducted from the tax base and on principal repaid, there is a tax concession available. Concession is given also for developing housing projects. Using the information on the magnitude of housing loans extended by the banks and the non-bank financial institutions, the cost of the first component of the above incentives is estimated at Rs 6,000 crore. Further, given the size of the housing sector in GDP, the second component is estimated at Rs 8,000 crore.

(d) Exemption of income of charitable trusts: While the rationale for exemption of the income of charitable institutions or allowing deduction for donations to charities is not in question, the tax treatment of charities has been a constant source of worry for tax administrators. The widespread feeling is that the exemption is misused widely to promote private gains. The paper builds a case for evolving an exhaustive definition of charitable purposes, and proposes that a clear notion of philanthropy be defined for institutions to qualify as charitable. Based on the estimates provided in Shome committee report and a study of 100 trusts carried out by the committee set up by the CBDT, the paper assesses the revenue cost at Rs 8,000 crore for the current year.

(e) Agricultural Income: Exclusion of agricultural income from the tax base for income tax, apart from offending horizontal and vertical equity, provides an avenue for evasion. The paper argues that the prevailing context does not warrant a general exemption of agricultural incomes. Corporatisation and commercialization of agriculture, on the one hand and expansion in the R&D activities through the development of new varieties of seeds on the other have changed the face of the sector, allowing for a new look at the treatment of this sector. The paper points out that to exempt the small and marginal farmers, the income level of Rs 1 lakh (Rs. 100,000) can be taken and this is effectively ensured when farmers with an average farm size up to 8 acres are exempted. Given that the power to tax agricultural income now rests with the states, the paper proposes a tax rental arrangement in which the centre could levy and collect the tax and returned to the states on the basis of origin. Alternatively, the states could be allowed

a 'piggyback' on the entire national personal income tax, as a revenue augmenting measure. On a conservative basis, the paper estimates the revenue loss from agricultural exemption at Rs. 10,000 crores. This does not take into account the amount of revenue lost as a result of evasion of the tax, through misrepresentation as agricultural income in the present regime.

(f) Exemption of Small Scale Industries (SSI): The SSI sector accounts for approximately 35 per cent of total exports and 40 per cent of value added from industry. This sector receives a number of concessions ranging from interest subsidy to tax concessions and preferences in government procurement. In terms of tax concessions, SSI units are defined as units with a turnover less than Rs 4 crore in any given year. As per the present excise taxation law, qualifying units are entitled to an exemption of up to Rs 1 crore (Rs. 1 million) in the subsequent year. The paper argues that while there may be a case for providing protection to the very small or tiny units, there is need to provide an environment where these units grow out of this stage and become competitive over time. Towards this end, it is argued that the limit for small scale industries should be rolled back to Rs 50 lakh–this would be in tandem with the thresholds being implemented within the state VAT regimes as well as with the thresholds in the personal income tax act. Based on the available information on the size of the sector as well as composition derived from the SSI survey, the paper estimates the revenue loss from this exemption at Rs 12560 crore.

(g) Commodity specific exemptions: With indirect taxes, there are some commodity specific exemptions, important among them are excise exemptions on textiles and printing industry. The paper estimates the revenue foregone in the case of printing industry alone in the range of Rs 2,400 crore. Taking into account the other exemptions, an estimate of Rs 4,000 crore of revenue foregone from commodity specific exemptions does not seem unreasonable.

On the whole, the concession from the exemptions and concessions listed above amount to Rs. 54560 crores. These are very conservative estimates and in actual practice the cost could be much higher. The details of the cost are given in Table 4.12.

In the case of individual income tax, in addition to dealing with exemptions and incentives mentioned above, in the longer

Table 4.12: Revenue Cost of Selected Exemptions and Concessions

Export incentives	Rs 10000 crore
Area Based exemptions	Rs 2000 crore
Charities	Rs 8000 crore
Agricultural incomes	Rs 10000 crore
Housing	Rs 8000 crore
Small scale industries	Rs 12560 crore
Commodity based exemptions in excise and customs	Rs 4000 crore
Total Revenue Cost	Rs 54560 crore

term, it may be more appropriate to move over to a single rate of tax as in many of transitional economies. This has significant administrative advantages. In the case of corporation tax, the tax rate needs to be aligned with the marginal tax rate of personal income tax. In regard to taxation of dividends, the most satisfactory solution is to have partial integration of the tax with income tax. Another issue in the context of corporate income tax is the differentials between the rates applicable to domestic and foreign companies. Part of the rationale for having some differential rests in the form of the dividend tax, payable by domestic companies alone. The rationalisation should deal with both the aspects together.

With regard to import duties, the reform will have to move in the direction of further reduction and unification of the rates. As most non-agricultural tariffs fall between zero and 15 per cent, a uniform tariff of 10 per cent would considerably simplify and rationalise the systems (Panagariya, 2005; Acharya, 2005). Equally important is the need to get rid of a plethora of exemptions and concessional treatment to various categories including project imports. In fact, a minimum tariff of 5 per cent could be introduced as a first step in rationalising the duty to bring it in line with the above recommendation.

Wide ranging exemption is a problem also with excise duties. Besides the exemptions for small scale industries, area based exemptions and exemptions for exports discussed earlier, exemption for project imports have significantly eroded the tax base. This has also imparted selectivity and discretion to the tax system. On the rationalisation of the rate structure, it is important to convert the remaining items subject to specific duties to ad valorem, and unify the rates towards a single

CenVAT rate. The next step is to fully integrate the CenVAT with the taxation of services. This would require the extension of the service tax to all services excluding a small list of exemptions and a small negative list as recommended by the Expert Group on Service Taxation (India, 2001) headed by the first author. This would help in assessing the potential from service taxation. At the next stage, the taxes on services could be unified with the CenVAT to evolve a manufacturing stage value added tax on goods and services.

(ii) State level tax reforms: The most important step in the short term tax reform at the state level is to complete the reform of sales tax system to evolve a proper VAT. The first step involve in this is that the VAT principle should be extended to the sales tax system in all the states. The second step is to repeal the 'Goods of Special Importance Act' to remove the restrictions posed by the 'declared goods'. Third, the centre should return the sales tax powers on sugar, textiles and tobacco to the states. Fourth, the states should be given power to levy taxes on services and in respect of services of all-India nature, the rules of division of revenue will have to be worked out. Fifth and the most important is the extension of input tax credit mechanism not only to intra-state trade but also inter-state trade by introducing appropriate zero-rating mechanism. This would require building up a proper information system on inter-state transactions, which has been initiated. More importantly, more advanced states which have got used to exporting the tax burden to the poor consuming states would not be willing give up the power. It is in this context that the central government should work out a grand bargain in which the states will receive the power to levy service tax and VAT on additional excise duty items in return for giving up power to levy the central sales tax (CST). Analysis shows that bargain will fully compensate every state for the loss of revenue from losing CST (Rao, 2002).

Long term reform issues in the tax system

Evolving coordinated consumption tax system: Long term reform issue should focus on evolving a co-ordinated direct and indirect tax system for the country. The objective is to raise revenues for the development of the country and at the same time, evolve the tax system which minimises distortions. The

system should enable fiscal autonomy to different levels of government while ensuring a common market. It should minimise all the three costs associated with the tax system: collection costs, resource allocation costs and compliance costs.

This implies that on the direct taxes front, in addition to some of the major issues of reform indicated in the short term, there is a need to levy the tax on the global concept of income. In other words, given the changing scenario of better organisation and corporatisation of the farm sector and the need to integrate all incomes for tax purposes requires a re-look at the assignment system. The principle of separation will have to give way to concurrent jurisdictions. This implies that both the central and state governments should have powers to levy taxes on individual incomes, and the tax should be levied on all incomes including agricultural incomes. At the same time, to have a co-ordinated tax system and to minimise collection and compliance costs, the central government will levy the tax and the state governments will piggyback on the central levy. This will also deal with the problem of vertical fiscal imbalance in the country, and the transfer system can focus on horizontal imbalances and ensuring minimum standards of meritorious services.

Similarly, it is important to evolve a co-ordinated indirect tax system in the country. This is necessary to ensure distribution of the burden of taxation fairly between different sectors and between goods and services, improve the revenue productivity, minimise relative price distortions and above all, ensure a common market in the country without placing any impediments on the movement of factors and products. This involves co-ordinated reforms at central, state and local levels.

In this context the idea of GST put forward by the Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act (India, 2004b) too would require constitutional amendment to enable the centre to levy the VAT up to the retail stage. The grand bargain with the states would have to be done to ensure a coordinated levy. At present, the effective rate of union excise duty approximately works out to about 8 per cent of the retail consumption and the effective rate of sales tax on final consumption of taxable goods and services works out to about 10 per cent. The grand

bargain could ensure a negotiated settlement on the taxes to be levied at both central and state levels. Along with the levy of VAT at the state level, it is important to integrate many of the taxes presently in existence such as entertainment tax, electricity duty, passengers and goods tax and luxury tax on hotels. Also there is no case for turnover taxes, surcharges and additional taxes.

An important aspect from the viewpoint of efficiency in resource allocation is the continued cascading of the tax on petroleum products. These are kept outside the CenVAT system. They are also not a part of the VAT system in states. These contribute to over 40 per cent of the revenues of both the taxes. Considering the use of these items for intermediate consumption, the extent of cascading and relative price distortion will continue to be high.

The local level indirect tax reform relates to the abolition of octroi. There is no place for octroi in any modern tax system. The problem however, is of finding an alternative source of revenue. In every country, property tax is a mainstay of local body finances and reform in this area should help in raising revenue productivity. Yet, this may not suffice. In this situation, a better option is to allow the local bodies to piggyback on the VAT collections in urban local body jurisdictions. This will avoid cascading of the tax and minimise tax spillovers by the urban local bodies to non-residents.

Reform in tax administration

In India, until recently, focus of tax reform attempts was on 'what to do' and much less on 'how to do'. Administrative dimension has been in the periphery rather than the centre of tax reform (Bird, 1989). The TRC did emphasise the need to reform tax administration to some extent but it is the Kelkar Task Force on Direct and Indirect taxes that has brought the administrative dimension to the centre of reform process.

Not surprisingly, the poor state of tax administration has been a major reason for low levels of compliance and high compliance cost. A major aspect of poor tax administration is the virtual absence of data on both direct and indirect taxes even at the central level. Not only that this rendered proper analysis of taxes to provide adequate analytical background to

calibrate changes in tax structure, but also it made proper enforcement of the tax difficult. Thus the changes in the tax structure had to be made in an ad hoc manner. Given the complexity in the tax structure and poor information system, the tax system often acquired the character of negotiated payments (India, 1993, 2002a,b). The consequence of this has been the high compliance cost. The only estimate of compliance cost by Das-Gupta (2004a, 2004b) of both personal income and corporation tax shows that in the case of personal income tax it is as high as 49 per cent of personal income tax collections and in the case of corporate tax, between 6 and 15 per cent of the tax paid, with the bulk being legal costs of compliance. While these estimates should be taken with a note of caution as the author himself has reservations on the adequacy and quality of the sample analysed, the important point to note is that the compliance cost in Indian income taxes is extremely high.

High compliance cost combined with poor state of computerisation and information system has led to continued interface of taxpayers and tax officials, negotiated payment of taxes, corruption and rent seeking and low levels of tax compliance. An important indication of the poor state of information system is seen by the fact that even as the coverage of TDS was extended over the years, there was virtually no information system to check whether those deducting the tax at source file the returns and pay the tax. As the CAG report for 2003-04 states, of the 6.26 lakh returns to be filed by TDS assessees, only 4.99 lakh returns were filed. In other words, more than 40 per cent of the TDS assessees did not file the returns. Even this is a vast improvement from the previous year when almost 80 per cent of the TDS assessees did not file the returns.

The fact that tax administration was the soft underbelly of the tax system and is a critical element in improving tax policy and revenue productivity has been underlined for long (Das-Gupta and Mookherjee, 1998). The Chelliah Committee (India, 1993) devoted considerable attention to this issue and the ideas of building a tax information network go back to the recommendation of this committee. The Kelkar Task Force on direct and indirect taxes rightly brought these issues to the fore with greater emphasis once again.

The recent initiatives on building the computerised information system in direct taxes follow from the recommendations of the KTF. The Central Board of Direct taxes (CBDT) outsourced the function of issuing permanent account numbers (PAN) and with this has facilitated the compiling of information on all taxpayers. The Tax Information network has been established by the National Securities Depository Limited. The initial phase has focused on ensuring that TDS assessees do in fact file the returns, and matching and cross-checking the information from banking and financial institutions to ensure that the taxes paid according to the returns are in fact credited into government accounts in the banks. The Online Tax Accounting System (OLTAS) was operationalised in July 2004. This has helped expedite the number of refunds from 2.6 million in 2002-03 to 5.6 million in 2003-04. The Permanent account Numbers issued has increased to 36 million by late 2004. Large companies such as Infosys Ltd could now upload one disk for filing the TDS of their employees instead of filing large number of separate TDS returns. In short, in the last four years, the direct taxes have shown annual growth rate of over 20 per cent per year and the contribution of improved information system in this has not been insignificant.

Similar initiatives have been taken in regard to indirect taxes as well. The customs e-commerce gateway (ICEGATE), Customs Electronic Data Interchange System (ICES) have helped to improve the information system and speed up the clearance processes. In 2003-04, ICES handled about 4 million declarations in automated customs locations which constituted about 75 per cent of India's international trade. The technical assistance from Canadian International Development Agency (CIDA) has helped the excise department to establish and build capacity in modern audit systems and computerised risk assessment for detailed audit. This is a step towards building up expertise in areas requiring significant technical expertise. Both the direct and indirect tax departments could gain from building up expertise through functional specialisation in such identified areas requiring technical and focused expertise.

These initial steps in building computerised information system are the basic requirements for tax administration. The second phase of the TIN has been initiated and when

completed, this should help not only in better administration and enforcement of the tax but also in planning the policy changes in regard to the tax system. Computerised information system will help to put together data from a variety of relevant sources and help in better administration and enforcement of the tax and improve the tax compliance. It will also help in significantly reducing the compliance cost as it will avoid the need to interact with tax officials. An important constraint for this is the fact that many of the senior officers are not familiar with computers and there is natural hesitancy and often unwillingness on their part to adapt to new technology. There have to be several orientation workshops to initiate them in the 'management of change' situations.

Another critical element in tax administration is the networking of the information from various sources. As mentioned earlier, systems have to be evolved to put together information received from various sources to quantify the possible tax implications from them in a legally acceptable manner to improve tax enforcement. In the first instance, the information networking should get the data from various sources such as banks and financial institutions on various assessees. In the second, CBDT and CBEC should exchange information to ensure a measure of consistency between the returns filed by the two departments. In the third, it is necessary to exchange information between central and state taxes. It is only through a properly organised and computerised information system and returns that will it be possible to enforce the tax and improve tax compliance.

Concluding Remarks

The foregoing analysis shows that there has been a significant progress in tax reforms particularly in tax administration in recent years and that has helped to recover the tax-GDP ratio close to the levels that prevailed prior to significant reduction in customs. This, however, is only the beginning and considerable distance in reforming the tax system is yet to be covered. In other words, the tax system reform including reform in administration is a continuous exercise for improving revenue productivity, minimizing distortions and improving equity.

It is important to note that reforms should be undertaken at central, state as well as local levels. A major objective should be to minimise distortions and compliance costs. In fact, the sub-national tax system should be such that the principles of common market are not violated. It is also necessary that domestic trade taxes on goods and services should be calibrated in a co-coordinated manner in the spirit of co-operative federalism. Coordinated calibration of domestic and external trade taxes to ensure a desired degree of protection to domestic industry and the desired burden of consumption taxes to the community is also necessary.

Broadening the base of both central and state taxes and keeping the tax structures simple and within the administrative capacity of the governments is an important international lesson that has to be taken in calibrating further reforms. Phasing out small scale industry exemptions, minimizing exemptions and concession to industries in the services sector, minimizing discretion and selectivity in tax policy and administration are all important not only for the soundness of the tax system but to enhance its acceptability and credibility.

Although the customs duties have been significantly reduced, India is still one of the highly protected economies. Further reduction in tariffs as also further unification and rationalization is necessary. This would certainly entail loss of revenue and there has to be corresponding improvement in the revenue productivity. The reforms in converting the prevailing sales taxes into the destination based consumption type VAT by the states initiated in April 2005, will have to be carried out with vigour and completed within the next years. This would require complete phasing out of the central sales tax. Finalizing the mechanism to relieve taxes on inter-state transactions and building a proper information system for the purpose is, therefore, extremely important, both to improve revenue productivity and to improve the efficiency of the tax system.

The most important reform is in tax administration. It is important to reiterate that 'Tax Administration is Tax Policy' (Cassenegra, 1990). Making a transition to information based tax administration, online filing of tax returns, and compiling and matching information is extremely important. It is also important to note that there must be a large taxpayer unit

which not only compiles information, ensures its collation and matching, but also assists these taxpayers without delay and helps them to reduce their compliance costs.

In the TFC's scheme of fiscal restructuring, states' tax revenue is expected to increase from 5.9 per cent in 2004-05 to 6.8 per cent in 2009-10. Much of this increase is expected from the introduction of VAT at the state level. Although the expert opinion has been that despite shortcomings in the design of the VAT system that was introduced from April1, 2005 in 21 states, the reform would be revenue neutral in the short term and would improve revenue productivity over medium and long term. The central government has, however, provided the insurance against the loss of revenue to the states by promising to compensate them for the loss. However, the trends show that outgo on this account is not likely to be large.

Public Expenditure Policy
Trends and Reform Issues

Introduction

Output and price effects of public expenditures depend on the level and composition of expenditures, the level of capacity utilization in the economy and the method of financing the expenditures. Further, public expenditure financed from borrowing could drive up the interest rate and crowd out private investment. On the other hand, public investment in infrastructure can create generalised externalities and crowd in private investment. Similarly, the output and price effects of public expenditure depends on whether it is tax financed or bond financed, and if it is the latter, whether it is done merely by drawing the household savings or by increasing the money supply.

There is considerable literature dealing with the output and price effects of public spending policy under different capacity utilisation and methods of financing (Balakrishnan, 1997; Buiter and Patel, 1997, 2005). Analysis suggests that public borrowing crowds out private investments. (Srinivasan, 2000). Considering the high growth cost of the deficits discussed in chapter 3, it is generally agreed that the prudent fiscal policy calibration in India in the present context warrants compressing public expenditures alongside increasing revenues.

The burden of expenditures compression in the initial years of reform fell on infrastructure spending. Since 1997-98, with pay and pension revision adding to increase in expenditures and in later years increase in debt feeding back into expenditures through increased interest payments, expenditures escalated sharply. This chapter analyses recent trends in the level and composition of public expenditures at central and state levels, the impact of the attempts to compress them, political economy issues in public expenditure policy and the possible effects of changing composition of expenditures.

Trends in Aggregate Expenditures

The analysis of trend in aggregate expenditures since 1990-91 reveals two distinct phases (Table 5.1). In the first, serious attempt at fiscal adjustment saw a steady decline in the expenditures relative to GDP from about 29 per cent in 199-91 to 25 per cent in 1996-97. Of this about 1.5 percentage point compression was made in revenue expenditures and capital expenditure was reduced by 2.5 percentage points. It is also seen that the burden of expenditure compression was borne mainly by the central government. The reduction in expenditures at the state level was by one percentage point, which was broadly equivalent to the reduction in the central transfers to states. At the central level, however, there was four percentage point reduction in expenditures relative to GDP. Of this, one percentage point reduction was in central transfers to states. Thus, the burden of fiscal adjustment in the first phase was borne mainly by the central government and an overwhelming proportion of adjustment was done by compressing capital expenditures.

The second phase of expenditures began with the pay and pension revision in 1997-98. The full effect of pay revision was seen only in 1998-99. With the revision of pay scales in the states, their parastatals and aided institutions in the next two years, the expenditures continued to increase. As increasing expenditures had to be financed from borrowing, the increase in indebtedness at both central and state levels fed back to expenditures through increasing interest payments. As interest rates increased and states resorted to borrowing from costly sources such as small savings and public provident funds, interest outlay increased further. Thus, there was a sharp increase in expenditures from 25 per cent of GDP in 1996-97 to 28.5 per cent in 2000-01 and further to 30.6 per cent in 2003-04. Aggregate revenue expenditure relative to GDP increased from 21.6 per cent in 1996-97 to 24.8 per cent in 2000-01, before levelling off. In the last two years, attempts have been made to contain revenue expenditures and it is expected to be about 24 per cent, partly because of the lower interest payments.

Table 5.1: Trends in Public Expenditures

Year	Centre			States			Total		
	Revenue	Capital	Total	Revenue	Capital	Total	Revenue	Capital	Total
1990-91	12.93	5.59	18.52	12.62	3.40	16.02	22.79	5.91	28.71
1991-92	12.60	4.46	17.06	13.20	3.33	16.53	22.86	5.60	28.46
1992-93	12.39	4.00	16.38	12.86	3.09	15.95	22.28	4.86	27.13
1993-94	12.59	3.92	16.51	12.73	2.94	15.67	22.27	4.80	27.08
1994-95	12.06	3.81	15.87	12.68	3.27	15.95	21.10	4.84	26.94
1995-96	11.77	3.23	15.01	12.21	2.74	14.95	21.5	4.05	25.55
1996-97	11.62	3.08	14.69	12.35	2.47	14.82	21.57	3.54	25.11
1997-98	11.84	3.40	15.24	12.26	2.73	14.98	21.91	3.86	25.77
1998-99	12.43	3.61	16.04	12.64	2.66	15.30	22.92	3.73	26.65
1999-00	12.86	2.53	15.39	13.48	2.73	16.21	24.01	3.89	27.90
2000-01	13.30	2.29	15.58	13.95	2.66	16.62	24.77	3.73	28.50
2001-02	13.27	2.68	15.95	13.86	2.75	16.61	24.63	4.11	28.74
2002-03	13.75	3.03	16.78	13.62	3.45	17.07	25.02	4.50	29.52
2003-04	13.12	3.96	17.08	13.42	5.29	18.71	24.30	6.38	30.63
2004-05*	12.43	3.86	16.29	13.53	5.27	18.81	23.99	6.47	30.47
2005-06**	12.94	1.97	14.91	12.92	3.54	16.46	23.54	5.21	28.75

Note: * Revised estimates; ** Budget estimates

As mentioned earlier, the burden of fiscal adjustment in the initial years of reform in the early 1990s was seen in the compressing of capital expenditures. Capital expenditure declined steadily from 5.9 per cent of GDP in 1990-91 to 3.5 per cent in 1996-97 and fluctuated around 3.5 to 4 per cent until 2002-01. Thereafter, due to concerted attempts by both central and state governments, the ratio increased marginally to 4.5 per cent in 2002-03. In 2003-04, it increased sharply to 6.4 per cent and is expected to remain at that level in the subsequent two years.

Another way to examine expenditure trends is to analyse it in terms of development and non-development expenditures. Development expenditure is defined as spending on social services and economic services and that includes both current and capital expenditures on them. It is seen from the table that, development expenditures relative to GDP was reduced from 17 per cent in 1990-91 to 13.5 per cent in 1996-97. Interestingly, revision of emoluments resulted in significant escalation of expenditures on social services and consequently, its share increased to 14.7 in 2000-01 and remained broadly at that level thereafter. However, notably, increase in development expenditures after the pay revision reflects mainly increase in the cost of service provision and not in the standards of services provided. As a ratio of total expenditures, development expenditure showed a steady decline from 60 per cent in 1990-91 to 54 per cent in 1996-97 and declined further even in the face of revision of emoluments to constitute 48.7 per cent in 2003-04.

In contrast, non-development expenditures remained at about 11 per cent of GDP from 1990-91 to 1996-97, even as developmental expenditures were compressed during the period. After the pay revision, they rose to 13.8 per cent of GDP in 2002-03 and remained broadly at that level thereafter. In other words, non-development expenditures increased from 40 per cent of the total in 1990-91 to 46 per cent in 1996-91 and further to 51 per cent in 2004-05.

Trends in Central Government Expenditures

As mentioned earlier, in the initial years of fiscal adjustment, the central government reduced the expenditures

Table 5.2: Developmental and Non-developmental

	Centre			States			Combined		
	Dev	Non-Dev	Total	Dev	Non-Dev	Total	Dev	Non-Dev	Total
1990-91	10.31	8.68	18.99	11.14	3.97	16.02	17.09	11.42	28.71
1991-92	9.08	8.45	17.53	11.42	4.16	16.53	16.75	11.07	28.46
1992-93	8.75	8.10	16.85	10.77	4.29	15.95	15.79	11.06	27.13
1993-94	8.43	8.56	17.00	10.40	4.42	15.67	15.02	11.67	27.08
1994-95	8.18	8.14	16.31	10.30	4.89	15.95	14.85	11.78	26.94
1995-96	7.11	8.30	15.41	9.66	4.66	14.95	13.92	11.39	25.55
1996-97	6.88	8.20	15.09	9.65	4.54	14.82	13.55	11.32	25.11
1997-98	7.29	8.40	15.69	9.54	4.71	14.98	13.73	11.71	25.77
1998-99	7.88	8.63	16.52	9.45	4.97	15.30	13.77	12.39	26.65
1999-00	6.67	9.19	15.85	9.67	5.69	16.21	14.17	13.28	27.90
2000-01	6.67	9.45	16.12	10.08	5.69	16.62	14.77	13.29	28.50
2001-02	7.01	9.48	16.50	9.54	6.08	16.61	14.62	13.55	28.74
2002-03	7.48	9.85	17.33	9.27	6.17	17.07	14.59	13.77	29.52
2003-04	7.08	8.82	15.90	9.93	6.02	18.71	14.92	13.35	30.63
2004-05*	7.10	8.60	15.71	9.90	6.14	18.81	14.93	13.56	30.47
2005-06**	6.49	8.86	15.35	9.18	6.04	16.46	14.33	13.47	28.75

Note: * Revised estimates; ** Budget estimates
Source: *Handbook of Statistics on Indian Economy*, Reserve Bank of India,

relative to GDP from 19 per cent in 1990-91 to 15 per cent in 1996-97 (Table 5.3). The pay revision impact was to increase it to 16.5 per cent in 1998-99 and it remained at broadly that level until 2002-03, when it rose to 17.3 per cent. As pay revision increases revenue expenditures, its share in the total increased from 70 per cent in 1990-91 to 77 per cent in 1998-99, and further to 85 per cent in 2000-01. Commensurately, the share of capital expenditure in the total fell from 30 per cent in 1990-91 to less than 15 per cent in 2000-01 before marginally recovering to 23 per cent in 2003-04. As much of this was in economic services, it shows decline in expenditures on physical infrastructure. As a ratio of GDP, the decline was from 5.7 per cent in 1990-91 to 3.7 per cent in 2004-05. It is budgeted to be even lower at 2.2 per cent in 2005-06.

Within revenue expenditures, the sharpest increase was in interest payments which increased from 20.4 per cent of the total in 1990-91 to 30 per cent in 2000-01. The decline in the interest rates and the scheme adopted to substitute high cost loans with low cost loans brought down the share of interest payments to 25 per cent in 2004-05. The outlay on subsidies relative to total expenditures continued to fluctuate around 8-11 per cent throughout the period. Thus, despite much talk about reducing subsidies, there was little success in compressing outlays on it. One item that the central government could compress in the course of fiscal adjustment is the grants to states. As a share of total expenditures, grants were reduced from 14 per cent in 1990-91 to 9.4 per cent in 2003-04. These are expected to be marginally higher at about 11 per cent in 2004-05.

In terms of developmental and non-developmental categories, deterioration in the volume as well as quality of expenditures over the years is clear. The total central government expenditures relative to GDP declined from 19 per cent in 1990-91 to 16 per cent in 2004-05, and this was mainly due to decline in developmental component. The latter declined from 10.6 per cent to 6.8 per cent of GDP or 56 per cent to 44 per cent of the total expenditures (Table 5.4). This trend points to the adverse impact of expenditures on both physical and social infrastructure. Within development expenditures, spending on economic services as a ratio of total expenditure

Table 5.3: Trends in Central Government Expenditures

	Revenue Expenditures					Capital Exp	Total Exp	Per cent of GDP
	Defense	Interest	Subsidies	Grants to States	Total			
1990-91	10.33	20.42	11.55	13.88	69.82	30.18	100.00	18.99
1991-92	10.27	23.87	11.00	14.11	73.86	26.14	100.00	17.53
1992-93	9.88	25.34	8.83	14.88	75.60	24.40	100.00	16.85
1993-94	10.56	25.90	8.18	15.73	76.25	23.75	100.00	17.00
1994-95	10.22	27.41	7.37	12.38	75.97	24.03	100.00	16.31
1995-96	10.57	28.07	7.10	11.82	78.45	21.55	100.00	15.41
1996-97	10.45	29.59	7.71	11.42	79.07	20.93	100.00	15.09
1997-98	11.28	28.29	7.99	10.62	77.71	22.29	100.00	15.69
1998-99	10.69	27.88	8.45	8.96	77.49	22.51	100.00	16.52
1999-00	11.82	30.28	8.22	9.76	83.57	16.43	100.00	15.85
2000-01	11.44	30.50	8.24	10.88	85.33	14.67	100.00	16.12
2001-02	10.50	29.66	8.61	11.42	83.21	16.79	100.00	16.50
2002-03	9.85	28.51	10.53	10.86	81.96	18.04	100.00	17.33
2003-04	9.17	26.33	9.39	9.39	76.83	23.17	100.00	15.90
2004-05*	8.60	24.89	9.20	11.28	76.33	23.67	100.00	15.71
2005-06**	9.45	26.04	9.22	13.52	86.81	13.19	100.00	15.35

Note: * Revised estimates; ** Budget estimates.

declined from 23 per cent in 1990-91 to 18.5 per cent in 1996-97 before crawling back to the 24 per cent in 2004-05. Considering that during the period total expenditure itself showed a decline relative to GDP, this implies a sharp decline. The direct expenditures incurred by the centre on social services, however, increased from 3 per cent in 1990-91 to 6 per cent in 2004-05 mainly due to pay revision. Some portion of decline in development expenditures was actually in the transfers given to states. As a large proportion of the transfers are to finance social services in the states, this has adversely impacted on the outlay n social services at the state level.

An important component of expenditures of the central government is subsidies and transfers. The important explicit subsidies of the central government are on food, fertilizer and exports. The estimate of explicit subsidies presented in Table 5.3 indicates that in the initial years of fiscal adjustment there was a concerted attempt at containing them. Thus, as a ratio of total expenditure, subsidies declined from over 11 per cent

Table 5.4: Trends in Central Government Expenditures: Developmental and Non-Developmental Categories

	Developmental expenditures			Non develop-mental expendi-ture	total expendi-ture	Percent of total expendi-ture to GDP
	Social services	Economic services	Total			
1990-91	3.11	23.35	55.69	44.31	100.00	18.99
1991-92	3.20	21.25	53.24	46.76	100.00	17.53
1992-93	3.27	21.41	53.40	46.60	100.00	16.85
1993-94	3.40	19.44	51.08	48.92	100.00	17.00
1994-95	3.65	21.09	51.51	48.49	100.00	16.31
1995-96	4.29	19.65	47.36	52.64	100.00	15.41
1996-97	4.81	18.53	46.86	53.14	100.00	15.09
1997-98	5.10	19.07	47.83	52.17	100.00	15.69
1998-99	5.25	19.47	49.14	50.86	100.00	16.52
1999-00	5.78	20.45	43.33	56.67	100.00	15.85
2000-01	5.43	22.03	42.81	57.19	100.00	16.12
2001-02	4.18	22.32	43.99	56.01	100.00	16.50
2002-03	5.33	25.12	44.57	55.43	100.00	17.33
2003-04	5.06	22.93	41.46	58.54	100.00	15.90
2004-05*	5.74	23.87	43.62	56.38	100.00	15.71
2005-06**	6.43	26.53	43.55	56.45	100.00	15.35

Note: * Revised estimates; ** Budget estimates.

in 1990-91 to about 7 per cent in 1995-96, before increasing again to about 10.5 per cent in 2002-03. They remained at over 9 per cent of the total expenditures thereafter. Inability to contain subsidies is a major shortcoming in the fiscal adjustment programme.

The subsidies comprise not merely explicit subsidies, but also implicit subsidies in terms of unrecovered costs of providing various social and economic services, as for example when the governments provide 'excludable' public services on which, in principle, it is possible to charge prices, but are provided at lower than average cost because they are merit goods. While such subsidies for merit goods are legitimate, subsidising goods with very little merit can be justified only for redistributive reasons. The recent analysis of central government subsidies by NIPFP (2004) following the methodology adopted first in Mundle and Rao (1991) for 2002-03 shows that the total implicit and explicit subsidies constitute 4.3 per cent of GDP of which 2.8 per cent of GDP, or two-thirds, is non-merit subsidies (Table 5.5). Almost 90 per cent of the non-merit subsidies accrued in economic services. The problem with this is not only that they impose heavy cost on the exchequer; this 'tragedy of commons' provides motivation and incentive for the special interest groups to lobby and ensure poor cost recovery in respect of even the non-merit goods provided and often becomes the motivation for retaining the supply of such services in the public sector. In fact, the analysis shows that complete cost recovery in respect of non-merit goods could reduce the fiscal deficit of the central government by almost by one-half. The government has given a lot of importance to phasing out subsidies in its pronouncements as shown by the putting out of the White Paper in the Parliament, but in terms of actions taken, progress has not been impressive.

Trends in State Level Expenditures

The analysis of state level expenditures in terms of revenue and capital categories presented in Table 5.5 shows that fiscal adjustment initiated in 1991 resulted in the compression of states' expenditures. Total expenditures of the states relative to GDP declined from 16.5 per cent in 1991 to 14.8 per cent in

Table 5.5: Central Budgetary Subsidies 2002-03

	Cost (Rs crore)	Subsidy (Rs crore)	Recovery Rate (%)	Subsidy as Percentage of		
				Revenue Receipts	GDP	Fiscal Deficit
Social Services	20805.21	20306.05	2.4	8.76	0.82	14
Merit	12177.6	12117.07	0.5	5.23	0.49	8.35
Non -Merit	8627.6	8188.97	5.08	3.53	0.33	5.64
Economic Services	142352.42	84606.59	40.57	36.51	3.43	58.32
Merit	24374.9	23700.58	2.77	10.23	0.96	16.34
Non -Merit	117977.52	60906.01	48.37	26.28	2.47	41.98
Merit	36552.5	35817.65	2.01	15.46	1.45	24.69
Non-Merit	126605.12	69094.98	45.42	29.81	2.80	47.63
Total	163157.62	104912.64	35.7	45.27	4.26	72.32
Memo Items						
Revenue Receipts	231748					
GDP	2469564					
Fiscal Deficit	145073					

Source (Basic Data): *Finance Account of the Union Government and National Income Accounts*, CSO.

1996-97, but following the pay revision in 1998-99, it increased sharply to 16.2 per cent in 1999-2000 and further to 18.8 per cent in 2004-05, following sharp increase in interest payments.

The reduction in central transfers on the one hand and increasing expenditures on wages, and salaries, pensions and interest payments on the other led to compression of states' capital expenditures. Thus, as a ratio of total expenditures, capital expenditures declined from 21 per cent in 1990-91 to 16.6 per cent in 2001-02. In other words, capital expenditure was truly considered a residual.

Table 5.6: Trends in State Expenditures: Revenue and Capital

Year	Per Cent of Revenue Expenditure to Total	Per Cent of Capital Expenditure to Total	Total	Per Cent of Total Expenditure to GDP
1990-91	78.8	21.2	100.0	16.02
1991-92	79.9	20.1	100.0	16.53
1992-93	80.6	19.4	100.0	15.95
1993-94	81.2	18.8	100.0	15.67
1994-95	79.5	20.5	100.0	15.95
1995-96	81.7	18.3	100.0	14.95
1996-97	83.3	16.7	100.0	14.82
1997-98	81.8	18.2	100.0	14.98
1998-99	82.6	17.4	100.0	15.30
1999-00	83.1	16.9	100.0	16.21
2000-01	84.0	16.0	100.0	16.62
2001-02	83.4	16.6	100.0	16.61
2002-03	79.8	20.2	100.0	17.07
2003-04	71.7	28.3	100.0	18.71
2004-05	72.0	28.0	100.0	18.81
2005-06	78.5	21.5	100.0	16.46

The analysis of expenditure trends presented in Table 5.6 shows reduction in the share of developmental expenditures in the total by almost 17 percentage points from 70 per cent in 1990-91 to 53 per cent in 2003-04. The decline in the share of development expenditure was particularly sharp after 1997-98 when the pay revision substantially increased non-development expenditures and the subsequently, as the large and increasing deficits fed back to expenditures through increased interest payments, the displacement of development expenditures by non-development expenditures continued.

Table 5.7: Trends in State Level Expenditures

	Developmental Expenditure			Non-developmental Expenditure			
	Total	Economic Services	Social Services	Total	Interest Payments	Adm. Services	Pensions and Misc. Gen. Services
1990-91	69.57	36.68	32.89	30.43	9.50	7.70	3.94
1995-96	64.66	32.09	32.57	35.34	12.35	7.54	7.23
1996-97	65.10	32.82	32.28	34.90	12.61	7.37	6.67
1997-98	63.68	31.45	32.23	36.32	13.20	7.48	6.58
1998-99	61.76	28.69	33.07	38.24	13.47	7.42	6.88
1999-00	59.67	26.86	32.81	40.33	14.39	7.51	7.99
2000-01	60.64	27.90	32.74	39.36	14.89	7.32	8.20
2001-02	57.43	26.43	31.00	42.57	16.57	7.13	8.68
2002-03	54.33	25.19	29.13	45.67	16.68	6.51	8.70
2003-04	53.08	27.88	25.20	46.92	15.64	5.42	7.40
2004-05*	52.63	26.34	26.29	47.37	14.92	5.41	7.77
2005-06**	55.79	26.30	29.48	44.21	16.27	7.01	9.52

Note: * Revised estimates; ** Budget estimates.

The compression of development expenditures has seen the reduction in the expenditures on both economic and social service, as a ratio of both GDP and total expenditures. Between the two categories, the reduction of expenditures on economic services was more than that of social services, as the latter has the large salary component and increase in the pay scales did increase expenditures on these services in an absolute sense. Thus, the expenditure on economic services which constituted 37 per cent of the total in 1990-91, declined steadily to 26 per cent in 2004-05. The decline in social services during the period was from 33 per cent to 26 per cent.

The two fastest growing items of expenditure are interest payments and pensions and miscellaneous services. As a ratio of total revenue expenditures, the former increased by over five percentage points from less than 10 per cent in 1990-91 to about 15 per cent in 2004-05. Similarly, the ratio of pensions and miscellaneous services in total revenue expenditures doubled from less than 4 per cent in 1990-91 to about 8 per cent in 2004-05.

Within the revenue account, wages and salaries constitute a substantial proportion. In 2002-03, in seven of the 14 major states, wages and salaries constituted more than 25 per cent of total revenue expenditure. In the four low income states of Bihar, Orissa, Madhya Pradesh and Rajasthan, it constituted more than 30 per cent and in the special category states, the share varied from 27 per cent in Uttaranchal to 51 per cent in Assam. Even in the high income states of Punjab and Haryana, the proportion of salaries constituted more than 30 per cent.

At the state level, explicit subsidies are few. However, much of the 'excludable' public services are provided at the state level and implicit subsidies constitute a significant proportion of total expenditures. As a proportion of GDP, the aggregate unrecovered costs on social and economic services as a ratio of GDP constituted almost 11 per cent and the non-merit subsidies at the state level constitute 5.2 per cent (Table 5.8). If these non-merit subsidies are fully recovered, they can phase out the fiscal deficits entirely.

The important public services with large component of non-merit subsidies include power, irrigation, water supply and sanitation, industry, higher education and housing. The specific

Table 5.8: Salary Expenditure in States 2002-03

States	Per Cent of Revenue Exp.	Per Cent of GSDP	Per Capita Exp.	Employees per 1,000 Population
Major States				
Andhra Pradesh	16.95	2.72	572	7.08
Bihar	39.64	8.98	568	5.40
Goa	21.50	4.12	2533	24.71
Gujarat	10.25	1.56	423	3.91
Haryana	37.03	4.96	1517	14.97
Karnataka	26.99	4.20	936	11.56
Kerala	20.71	3.75	937	10.90
Madhya Pradesh	36.26	6.40	846	7.98
Maharashta	14.86	2.02	602	6.98
Orissa	38.90	8.78	1040	11.20
Punjab	36.42	6.22	1797	na
Rajasthan	31.10	6.20	906	10.40
Tamil Nadu	26.40	4.35	1070	na
Uttar Pradesh	23.27	4.16	446	4.11
West Bengal	19.69	2.74	556	5.36
Smaller States				
Arunachal Pradesh	39.20	20.60	3613	36.79
Assam	51.27	9.98	1332	15.92
Chattisgarh	33.29	5.89	860	
Himachal Pradesh	38.83	12.42	3222	29.14
Jharkhand	49.83	7.34	993	
Manipur	47.89	18.42	2763	
Meghalaya	47.07	13.05	2396	21.05
Mizoram	43.03	22.18	5327	
Nagaland	47.64	13.61	3491	
Sikkim	41.08	23.32	5256	43.19
Tripura	49.99	14.85	3008	30.20
Uttaranchal	27.18	7.13	1146	

policy reforms in these sectors will have to be calibrated after a detailed analysis of subsidies in these sectors in each of the states. This is because it is important to identify whether the subsidies are due to uneconomic pricing of these services or poor quality of services provided, in which case increasing the price is not a solution. In Karnataka, such a detailed study was undertaken to help design and implement policies (Rao, 2002). In addition to these unrecovered costs from non-merit services there are implicit subsidies from tax incentives or 'tax expenditures' which are not easily quantifiable.

Table 5.9: Subsidies Estimates: All States 1998-99

	Cost (Rs. Crore)	Subsidy (Rs. Crore)	Recovery Rate (Per Cent)	Subsidy as Percentage of Revenue Receipts	GSDP	Fiscal Deficit
Social Services	77983	76135	2.37	44.06	5.42	104.78
Merit 1	30220	29957	0.87	17.34	2.13	41.23
Merit 2	26381	25942	1.67	15.01	1.85	35.7
Non Merit	21382	20236	5.32	11.71	1.44	27.85
Economic Services	85931	79789	7.15	46.17	5.68	109.81
Merit 1	1282	1273	0.68	0.74	0.09	1.75
Merit 2	27410	25643	6.45	14.84	1.83	35.29
Non Merit	57239	52873	7.84	30.6	3.77	72.77
Total Merit	85294	82815	2.91	47.92	5.9	113.98
Total Non Merit	78621	73109	7.01	42.31	5.21	100.62
Total	163914	155923	4.88	90.23	11.11	214.62

Source: Srivastava D. K. et al. (2002), *Budgetary Subsidies in India,* NIPFP, New Delhi (pp. 31)

Reforming Expenditure Policies and Implementation Issues

Reforming expenditure policy and implementation systems and institutions is important not only to achieve fiscal consolidation but also to create social and physical infrastructure, particularly those that are not of a commercial nature. Fiscal adjustment undertaken since 1991 has been infrastructure unfriendly and has considerably crowded out development expenditures. The fiscal restructuring plan recommended by the Finance Commission to achieve fiscal consolidation requires that the revenue expenditures of central and state governments relative to GDP should be compressed by 1.7 percentage points to 21 per cent by 2009-10. At the same time, according to the plan, capital expenditures should increase by one percentage point from 5.6 per cent in 2004-05 to 6.6 per cent in 2009-10. It is important to ensure that the implementation of the fiscal restructuring plan does not result in reducing productive expenditures.

Our analysis has shown that a significant reason for fiscal deterioration is the sharp increase in the emolument of

government employees following the implementation of Fourth Pay Commission recommendation. The recent World Bank study has brought out that the public sector wages were 2.33 times the private sector wages in 1999-2000, and the difference over time has increased for, in 1993-94, the difference was lower at 1.92 times. This implies that there is no case for appointing another Pay Commission in the near future.

An important recommendation of the Pay Commission while increasing the scales of pay was to restructure the employees to weed out the surplus and to make the departments responsive and functional. Unfortunately, while the governments, at both central and state levels, enhanced the emoluments they did not undertake any rationalisation measures to identify surplus employment and transfer this to the deficit departments, if necessary, after training. Sometimes comparisons are made to show that relative to population, the number of government employees is less in India as compared to say, even China (Glinskaya and Lokshin, 2004). Such comparisons are inappropriate for, in countries such as China the number of government employees include those in state enterprises involved in commercial activities. Even within India, the comparison between the states has to take account of the fact that in some states school teachers' are considered as government employees, in some others, the salary paid to even the private school teachers is disbursed from the budget as grant-in-aid. In any case, the issue of identifying surplus personnel in various departments has not been done by the state governments. It is only when surplus personnel are identified and then retrained to work in deficit departments, that fresh recruitment should be undertaken. Further, instituting a good information system on the present and past government employees is extremely important to assess the present and future liabilities of the government.

Infrastructure spending in poorer states has suffered badly during the last decade and a half. In particular, the response of the poorer states to fiscal problems has been to keep the deficits relatively at low levels by phasing out those expenditures for which constituency is not strong and naturally, the adjustment process has been infrastructure unfriendly. Special efforts are necessary to improve infrastructure,

particularly power, medium and small irrigation and road connectivity to achieve balanced regional development. At the central level, the benefits of opening up of the economy are possible only when the capacity of ports and airports is augmented and they are made more efficient. Recent events have shown the consequences of neglecting urban infrastructure in Mumbai, Chennai and Bangalore when unprecedented floods resulted in enormous human sufferings. Significant additional spending on these infrastructure facilities will have to be undertaken to sustain growth in the country.

In a polity ruled by coalition governments, it would be unrealistic to expect that spending plans will be formulated and implemented according to the long-term vision of the economy. Competitive populism will continue, often in the name of the poor. It is important to institute a system to ensure that spending on such anti-poverty programs are targeted, systems of checks and balances are instituted and expenditure tracking exercises are undertaken periodically to assess whether the benefits have accrued to the intended. The government has recently committed itself to provide 100 days of guaranteed wage employment to at least one member of the family under the Rural Employment Guarantee Act in two hundred of the poorest districts in the country. It is important to focus on asset creation as much as providing employment to the poor in such programs.

One major problem that has adversely affected the implementation of large projects is the inadequate provision of resources as there is pressure to take up more and more projects every year. Often, the spending departments simply spend the money merely to use their appropriation. Prioritising the projects for funding and switching over to multi-year budgeting in respect of large capital works would help to avoid cost and time over-runs. It is also necessary to do away with plan and non-plan distinctions in the long term and expenditure planning should be done in a holistic manner.

Most states have now embarked on treasury computerisation, but some of them still need to undertake reform in them. This should also help them to institute a proper information system to monitor the progress of expenditures in respect of each of the projects and programs. Furthermore, good

information system should also obviate the need to continue with the practise of administering expenditure implementation by using personal deposit accounts in major spending departments such as public works and irrigation, which has been subject to much abuse.

The reforms in public expenditures will have to cover both policies and systems. It should not only ensure proper prioritisation but also should help to implement the programs efficiently. Thus, reforms should encompass not only the policies to prioritise expenditures towards productive programs, but also should help to ensure better management and control over them. These reforms are imperative to enhance both allocative and technical efficiency in expenditure policies. The need to institute systems to ensure efficiency in spending is extremely important in an era of coalition politics than ever before.

Regional Policies, Resource Flows and Regional Equity in India

Introduction

Transition to the market results in changes in resource allocation between sectors and regions. With economic liberalisation and opening up of the economy, the states with more developed market institutions and infrastructure access the market opportunities better and grow faster than others. In a federal democratic polity, accentuating inter-state disparities cause economic and political tensions which need to be redressed. Further, accelerating growth, enhancing employment opportunities and reducing poverty in the country during the Eleventh Plan requires focusing attention on lagging regions.

In India, despite the adoption of a planned development strategy, regional disparities have continued to increase over the years. Prior to independence, the colonial interests determined the pattern of investment. What is worrisome is that even after independence, despite the thrust given to balanced regional development, inter-state inequalities have continued to accentuate. Among the large non-special category states, the poorest state of Bihar right from the 1950s continues to have the dubious distinction of having the lowest per capita income and Punjab has continued to have the highest.

There has been considerable research on the determinants of differences in growth between regions and why inequalities in the standards of living between persons, regions and nations have continued to persist and even accentuate.[1] Despite the insights gained on the growth process, much remains to be understood about the dynamics of the interaction between resources, policies and institutions in different regions in a country. Endowment of resources, infrastructure availability and volume of investments can provide only a partial

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1. For a recent review of the studies, see Krishna (2004)

explanation to the differences in levels of incomes and their growth rates. The impact of the type of policies pursued and the responsiveness of the institutions are equally, if not more, important for they impact on both the volume of investments, efficient use of resources and productivity growth.

This chapter does not go into the dynamics of the growth process in different states, but deals mainly with the pattern of resource flows and speculates on its impact on the pattern of growth in India. Although admittedly, the volume of investment is not the only factor determining the differences in growth rates, it is an important determinant. Therefore, it is useful to examine whether, in general, the regional policies and the pattern of resource flows in India have helped to offset the fiscal disabilities of the poorer states to enable them to provide comparable standards of infrastructure–physical and social, to place them on a level playing field in the race for development.

This chapter analyses regional policies as well as policies and institutional issues relating to central transfers to states. It attempts to identify some sources of invisible transfers in India and speculates on the pattern of resource flows from such transfers. Centralized planning entails controls on both production (quantities) and prices. Besides, price-quantity controls introduced in foodgrains as a part of supply management in a scarcity-ridden economy have continued despite the economy achieving surpluses. The regime of administered prices and regulated supply augmentation too has significant inter-state resource allocation implications. It is important to analyse the overall impact of these implicit and explicit channels in order to examine whether the fiscal disabilities of poorer states are adequately offset through the transfer systems so that poorer states are enabled to provide the basic infrastructure necessary to place them on a level playing field in terms of receiving private investments.

Of course, providing adequate transfers to enable the states to provide basic physical and social infrastructure does not necessarily result in ensuring comparable levels of social and physical infrastructure in the poorer states. First, there is considerable backlog in infrastructure in these states and catching up will require a considerably larger volume of

investments. Second, the productivity of public expenditures in these states in terms of transforming outlays into outputs and outcomes is significantly lower than in more advanced states. Among other reasons, poor governance and accountability in these states reduces their productivity.

Regional Income Inequalities in India

There are data deficiencies in regard to the income measure of economic performances of states in India. The most obvious measure is the State National Product (SNP) or the equivalent of Gross National Product (GNP) for the country. Such data, however, do not exist for the states in India and the analysis will be based on the estimate of Gross State Domestic Product (GSDP) and in some cases Net State Domestic Product (NSDP). The omission of net factor income from outside the state in income calculations is a major shortcoming. Even GSDP/NSDP data are not strictly comparable across states, as they have been estimated by the State Statistical Bureaus of respective states, but using a common framework.

Table 6. 1: Growth Performances of States

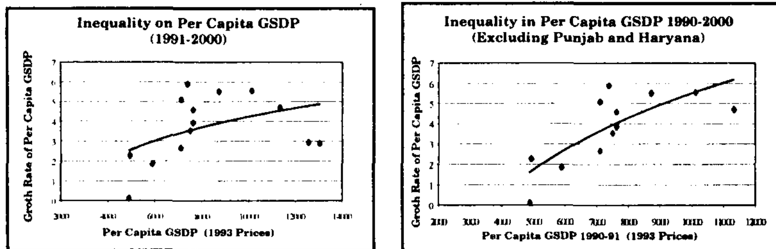
State	Growth Rate of GSDP		Growth Rate of Per Capita GSDP	
	1980-91 (1981 Prices)	1990-2001 (1993 Prices)	1980-91 (1981 Prices)	1990-2001 (1993 Prices)
Andhra Pradesh	5.65	5.44	3.39	3.92
Bihar	4.66	2.87	2.45	0.12
Gujarat	5.08	7.35	3.04	5.56
Haryana	6.43	5.06	3.89	2.94
Karnataka	5.29	7.56	3.25	5.89
Kerala	3.57	5.82	2.15	4.58
Madhya Pradesh	4.56	4.78	2.12	2.67
Maharashtra	6.02	6.83	3.63	4.7
Orissa	4.29	3.75	2.42	2.28
Punjab	5.32	4.85	3.35	2.89
Rajasthan	6.6	6.07	3.91	3.54
Tamil Nadu	5.38	6.62	3.88	5.52
Uttar Pradesh	4.95	3.95	2.57	1.86
West Bengal	4.71	6.84	2.44	5.1
All States	5.26	5.82	3.02	3.83
All India	5.55	6.1	3.32	4.08

Source: *Domestic Products of States of India,* EPW Research Foundation, Mumbai, 2003.

The growth rates of GSDP in the states since 1980-81 are presented in Table 6.1. It is seen that, on the whole, the growth rate in the 1990s accelerated by about half a percentage point over that of the previous decade. Further, much of the acceleration was seen in the high income states of Gujarat and Maharashtra and middle income states of Karnataka, Kerala, Tamil Nadu and West Bengal. In contrast, the growth rate decelerated in Bihar, Orissa, Rajasthan and Uttar Pradesh. The analysis shows positive correlation between the level of per capita GSDP in the initial year and growth rates of per capita GSDP (Figure 6.1) and this indicates a steady increase in inter-state inequalities. The correlation coefficient between the level of per capita incomes and their growth rates was 0.472 during 1980-91, but declined to 0.331 during the next decade. The scatter also shows Punjab and Haryana as the outliers during 1990-2001 and when these two observations are omitted, the correlation coefficient increases to 0.721 for the period 1990-2001. The economic liberalization and opening up of the economy during the 1990s seems to have benefited the states with a stronger industrial base and better access to markets than the states which are predominantly agricultural.

Figure 6.1 : Inter-State Inequalities in Per Capita GSDP

Correlation Coefficient: 0.3310 Correlation coefficient: 0.7213.



Thus, inter-state disparities in India even among the non-special category states are not only high, but also have shown an increasing trend. In 1980-81, the per capita GSDP of the richest state, Punjab (Rs.2,674) was about 2.9 times that of the poorest, Bihar (Rs.919). The average position in 1999-2002 is that the difference increased to 4.3 times with per capita GSDPs of the two states respectively at Rs.28,039 and Rs.6,539.

It is also seen that per capita income levels have tended to diverge sharply after market based reforms were initiated (Rao et al., 1999). As inter-state differences in the ability to raise revenues increased over the years, and as federal transfers did not entirely offset the fiscal disabilities of the poorer states, the coefficient of variation in per capita expenditures also increased over the time period (Rao, 1998).

Not surprisingly, the trend noted above has resulted in steady increase in inter-state inequalities as measured by the Gini coefficient (Table 6.2). The Gini coefficient was estimated for per capita GSDP at constant prices for the 1981 series up to 1995-96 and for the 1993 series from 1993-94 to 2000-01. Interestingly, the Gini coefficients estimated for per capita GSDP at 1981 series shows a sharp increase after 1991-92. However, the estimates for the 1993-94 series are lower, though they too show an increasing trend (Figure 6.2).[2]

Table 6.2: Gini Coefficients of State-wise Per capita GSDP

Years	GSDP (1981 series at 1980-81 Prices)	GSDP 1993-94 Series at 1993-94 Prices
1980-81	0.167	
1981-82	0.168	
1982-83	0.171	
1983-84	0.163	
1984-85	0.173	
1985-86	0.181	
1986-87	0.182	
1987-88	0.182	
1988-89	0.19	
1989-90	0.19	
1990-91	0.191	
1991-92	0.206	
1992-93	0.209	
1993-94	0.215	0.201
1994-95	0.22	0.201
1995-96	0.236	0.209

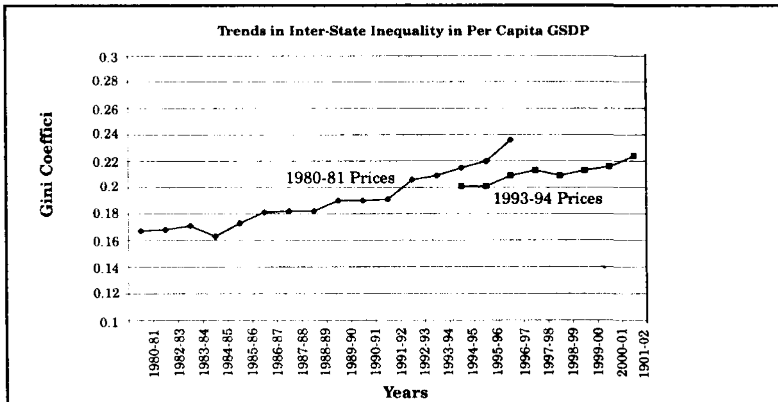
2. There are several recent attempts to record this trend, the prominent one being Ahluwalia (2000). These estimates use the GSDP estimates at 1981 base year which shows much sharper increase in inequalities during the 1990s. See also Rao, Shand and Kalirajan (1999).

1996-97	0.213
1997-98	0.209
1998-99	0.213
1999-00	0.216
2000-01	0.224
2001-02	0.262
2002-03	0.227

Source: *Domestic Products of States of India 1960-61 to 2000-01*, EPW Research Foundation, Mumbai. 2002.

Another interesting feature of the pattern of growth is that, the relative positions of the lowest and highest per capita income states have not changed. Per capita income in Bihar continues to be the lowest and Punjab continues to hold the top spot among the non-special category states (excluding the small state of Goa). Bihar, in fact, is the only state in 2002-03 having per capita incomes in four digits. In fact, the average per capita income for three years, 1999-2001, in Uttar Pradesh, the second poorest state after Bihar, was higher by 65 per cent! In the case of Bihar, in particular, per capita GSDP has staidly deteriorated in relation to that of the all-India average, while the position of Punjab has improved, particularly after the mid-1990s. Thus, there has been increasing divergence in the per capita income levels between the states with the lowest and the highest per capita NSDP. The index of per capita NSDP (all-India: 100) which was 60 in Bihar in 1980-81 declined to 35 in 2000-01 whereas the index in Punjab increased from 171 to 263 during the same period.

Figure 6.2 : Trends in Inter-State Inequality in Per Capita GSDP



Redressal of Inter-State Disparities: Regional Policies

In a centrally planned economy, investment planning and its regional spread is determined by the government and therefore, given the endowment of natural resources and nature of institutions, the pattern of regional growth and inter-regional distribution of incomes is largely determined according to regional policies. However, in a mixed economy the distribution of private sector investment is also important.

In India the main components of regional policies are the distribution of the central government's own investments, direction to financial institutions to provide credit accessibility to the poorer regions and directing credit to the agriculture and small-scale industries which dominate the economic activities in poorer regions. It is difficult to draw implications on the incidence of the central government's budgetary spending in the absence of a detailed empirical analysis and therefore, is assumed to be neutral here. In what follows, some broad implications of regional policies in impacting on the regional distribution of incomes are brought out.

During the first three five year plans, there was a concerted effort at directing investments to poorer states. As those were also well endowed with rich deposits of coal, bauxite and other mineral resources, large investments were made in steel plants in Bihar, Madhya Pradesh and Orissa. Substantial investments were also made in heavy industries and this included heavy electricals in Bhopal and the aircraft industry in the Sunabeda in Orissa. However, the concern at accelerating industrial growth and the policy of taking over of sick private industries resulted in the spread of investments which is different from what was originally envisaged.

Thus, despite pronouncements on regional equity, the spread of central government investment has not ensured regional equity. It is evident from Table 6.3 that low per capita income states with population share of 45 per cent accounted for only 29 per cent of the total investments in central government enterprises and 41 per cent of the total employment generated in central enterprises. In fact, the income share of these states was equal to the investment share. Similarly, the share of employment in central enterprises was lower than their population shares by 4 percentage points. In

Table 6.3: Inter-State Allocation of Investments in Central Government Enterprises

(Per cent of total)

	Population Share	GSDP Share	Investment Share	Employment Share
Goa	0.14	0.44	0.07	0.12
Punjab	2.41	3.97	1.56	1.72
Maharashtra	9.57	15.09	19.38	12.80
Haryana	2.08	3.24	2.34	1.29
Kerala	3.15	4.09	2.75	2.77
Gujarat	5.00	6.86	7.04	3.26
Tamil Nadu	6.16	7.94	6.92	5.42
Karnataka	5.23	6.34	5.32	5.11
Andhra Pradesh	7.53	8.66	7.63	6.34
West Bengal	7.91	8.40	5.28	13.48
High Income States	**49.19**	**65.02**	**58.30**	**52.31**
Rajasthan	5.58	4.98	2.77	1.91
Chhattisgarh	2.05	1.71	2.17	6.40
Madhya Pradesh	5.97	4.67	4.97	6.77
Jharkhand	2.67	1.79	4.11	15.32
Orissa	3.64	2.42	5.65	4.18
Uttar Pradesh	16.42	10.38	7.18	5.48
Bihar	8.20	2.99	1.87	1.17
Low Income States	**44.53**	**28.94**	**28.72**	**41.23**
Arunachal Pradesh	0.11	0.11	0.39	0.12
Assam	2.63	1.89	4.73	3.26
Himachal Pradesh	0.60	0.91	2.93	0.68
Jammu and Kashmir	1.00	1.03	1.98	0.55
Manipur	0.23	0.23	0.04	0.06
Meghalaya	0.24	0.23	0.03	0.12
Mizoram	0.08	0.11	0.06	0.06
Nagaland	0.19	0.25	0.19	0.06
Sikkim	0.06	0.07	0.28	0.06
Tripura	0.32	0.39	0.27	0.12
Uttaranchal	0.84	0.83	2.07	1.35
Special Category States	**6.28**	**6.04**	**12.98**	**6.46**
Total	**100.00**	**100.00**	**100.00**	**100.00**

Source: *TFC Report and Public Enterprise Survey* Vol-1, 2003-04

contrast, the above average income states with 49 per cent of population accounted for 58 per cent of the investments and 65 per cent of the income generated in the country. Thus, the

investments in central enterprises has not attempted to achieve balanced regional allocation of investments. The story of Bihar is even more telling. The poorest state with about 8.2 per cent of population received only about 2 per cent of the accumulated central government investments until 2003-04 and these accounted for just about 1 per cent of employment in central enterprises.

Even the investments made in the poorer regions have not had the desired impact on their regional economies. Investments in industries such as coal and steel were basically intended to promote both backward and forward linkages and as these have a strong resource base, they had significant backward linkages to exploit their mineral resources in these states. However, the introduction of freight equalisation policy–the policy of subsidising the freight charges to ensure uniform price for the outputs of these industries–denied any forward linkages from the investments in these enterprises, besides imparting inefficiency in the overall investment pattern in the country. Consequently, investments in these central enterprises contributed to further impoverisation of these regions. Although this policy has been given up, it is not possible to reverse the investment decisions that have already been made.

Another important initiative taken by the government of India was to expand the network of bank branches to rural areas and poorer regions, particularly after the nationalisation of the major commercial banks in 1969. However, relative density of commercial banks in poorer regions continues to be lower than in middle and high income states. Furthermore, the expansion of banking network has served to transfer household savings of poorer states for investment in more affluent states. In Table 6.4 we can see the credit deposit ratios in the 14 major states in descending order of their ratios as seen in 2004-05. The interesting inferences drawn from the table are: (i) By and large although credit-deposit ratios were higher in the more developed states, there are important exceptions. Punjab, Haryana and Gujarat are high income states, the ratios in these states were much below average. (ii) The credit-deposit ratios were generally higher in states with relatively more manufacturing activity. Thus, states such as Tamil Nadu and Maharashtra had much higher credit deposit ratios as

compared to Punjab, Haryana, Uttar Pradesh and Bihar. The ratios in the last two states were abysmal and in part, this reflects poor governance in these states. (iii) The relative position has changed very little from 1980. Exception to this are the cases of Kerala, Gujarat and West Bengal, which have moved down in their rankings substantially. (iv) The ratios have shown a steady decline in every state (except Maharashtra) indicating that commercial banks, as a policy tend to employ their resources increasingly to other ways of earning their incomes including investment in government securities. The decline has been particularly sharp in the two poorest states of Bihar and Uttar Pradesh. These states have the low credit-deposit ratios and it has been showing sharp declines.

Table 6.4: Credit-Deposit Ratios by State

	1980	1995	2001	2004
Tamil Nadu	0.94	0.91	0.91	89.63
Maharashtra	0.79	0.70	0.85	81.35
Andhra Pradesh	0.74	0.76	0.63	67.63
Karnataka	0.75	0.68	0.59	62.89
Rajasthan	0.68	0.46	0.48	57.24
Gujarat	0.58	0.47	0.49	112.97
Madhya Pradesh	0.56	0.53	0.47	47.71
West Bengal	0.60	0.54	0.44	49.32
Kerala	0.68	0.45	0.43	47.30
Haryana	0.72	0.47	0.42	47.90
Orissa	0.59	0.54	0.41	54.26
Punjab	0.43	0.41	0.41	43.38
Uttar Pradesh	0.42	0.35	0.28	33.21
Bihar	0.41	0.33	0.24	25.58
Average	0.65	0.58	0.57	63.42
Coeff. of Var.	0.22	0.27	0.32	0.37
Coeff. of Var. (SDP)	0.32	0.40	0.36	0.41
Corr$^{n.}$ with per capita SDP	0.11	0.18	0.59	0.48

Source: RBI Bulletins, National Accounts Statistics, and Indian Census. Figures for Bihar, Madhya Pradesh and Uttar Pradesh in 2001 include Jharkand, Chhattisgarh and Uttaranchal respectively.

Intergovernmental Transfers

At the outset, it must be mentioned that the objective of intergovernmental transfers is not equalisation of incomes across states although such transfers would have important

implications on the states' levels of incomes and their changes over time. While equity is the predominant objective of general purpose transfers, this does not necessarily translate into equalisation of per capital incomes among states. Indeed any scheme of transfers designed to equalise incomes suffers from severe disincentives.

In the literature, the equity case for intergovernmental transfers is made to ensure horizontal equity – or equal treatment of equals – to enable citizens with comparable incomes to have a given level of public service at the standard tax effort. This proposition translates into a scheme of offsetting fiscal disabilities arising from low revenue capacity and high unit cost of providing public services for reasons beyond the control of recipient governments. The transfers made to offset the fiscal disabilities have to be necessarily unconditional. In addition, it may also be necessary to provide specific purpose transfers to ensure minimum standards of specified services in each State because of externalities or merit goods reasons. Such transfers are specific purpose transfers preferably with matching contributions. In either case, the scope of equalisation is confined to public services and not per capita incomes.

This however, does not mean that the transfer system will not help in converging incomes across states in India. Indeed, if fiscal disabilities of poorer states are completely offset, they would be enabled to provide comparable levels of social and physical infrastructure. This, of course, provides only the necessary condition for equalising infrastructure; sufficient condition has to be found in ensuring that the outlays in these states transforms into outputs and outcomes.

Volume and composition

Central transfers constitute a significant part of state finances as shown in Table 6.5. In per capita terms at constant (1981-82) prices, central transfers to the states increased by over 2.5 times from Rs.77 in 1975-76 to Rs. 194 in 1993-94 and declined marginally thereafter owing to fiscal compression. It is also seen from the table that until 1993-94, growth of transfers was faster than both the centre's and the states' own revenues. In the latter half of the 1990s, however, these transfers have decelerated to grow slower than both central and

state revenues and the share of transfers in States' expenditures has shown a steady decline.

Table 6.5: Trends in Central Transfers to States

Years	Per Capita Transfers (1993-94 Rupees)	Percentage of transfers to GDP	Percentage of transfers to Central Revenues	Percentage of transfers to state Revenues	Percentage of transfers to state Expenditure
1975-76	198.2	3.67	31.8	38.64	44.8
1980-81	272.2	4.84	34.8	43.81	47.5
1985-86	381	5.55	40.98	45.62	46.42
1990-91	449.9	4.66	39.06	38.37	30.85
1995-96	465.3	4.28	35.55	38.60	31.06
1996-97	490.5	4.28	35.40	39.97	31.83
1997-98	570.7	4.86	38.90	44.91	35.33
1998-99	456.0	3.73	32.25	37.69	26.29
1999-00	486.4	3.79	30.23	36.46	25.05
2000-01	562.7	4.29	34.89	40.41	29.22
2001-02*	571.9	4.22	35.01	38.59	28.10
2002-03	573.4	4.13	32.24	35.21	25.11
2003-04	637.4	4.30	34.90	36.02	26.68

Note: * Revised estimates. ** GDP estimated to increase by 13% in current prices.

Source: Indian Economic Statistics/ Public Finance Statistics. Ministry of Finance, Government of India.

A notable feature of the federal fiscal arrangements in India is the existence of multiple channels of transfers. First, there is a constitutional mechanism to devolve tax shares and give grants through the Finance Commission. Second, the Planning Commission gives grants and loans for implementing development plans. Finally, various ministries give grants to their counterparts in the States for specified projects (central sector and centrally sponsored schemes).

The important economic and fiscal indicators of the states presented in Table 6.6 bring out several notable features. First, there are wide inter-State variations in revenues in both per capita terms and as a ratio of Gross State Domestic Product (GSDP). Second, these variations indicate differences in revenue capacity, and partly, differences in efforts. Third, in the case of non-special category States, the fiscal dependence on

the Centre is not only high but also varies inversely with per capita income. While the above average per capita GSDP states could finance 57 per cent of their expenditures from own sources of revenue, the corresponding percentage for the below average per capita GSDP states was 37 per cent. Fourth, financing larger proportion of poorer states' expenditures through the transfers is an indicator of the equity in the transfer system. But, this does not go far enough. Per capita total (Rs. 4380) as well as development (Rs. 2705) expenditures in above average per capita GSDP states were higher than the below average income states (at Rs. 1511 and Rs. 2577) by 45 per cent and 42 per cent. Thus, large differences in per capita expenditures exist despite equalization;

Central Transfers to States and Inter-State Equity

Strict adherence to economic rationale would require that transfers be designed to offset revenue and cost disabilities. However, actual transfer systems fall short of this ideal, as historical and political factors are also important in determining them. However, the extent to which economic objectives of intergovernmental transfer policy are met are important and needs to be analysed. In what follows, an attempt is made to analyse the equity implications of Central transfers to States in India.

Analysis of central transfers shows a fair degree of inter-State redistribution. Central transfers vary inversely with the level of per capita NSDP (Figure 6.3). The cross-section income elasticity of aggregate transfers in 2002-03 was - 0.54 (Table 6.6). However, equalization in the transfer system was entirely due to the redistribution in Finance Commission transfers. The elasticity of Finance Commission transfers with respect to GSDP in 1997-98 was -0.80. In contrast, Plan grants and grants for centrally sponsored schemes did not achieve significant equalization. Although by and large, the transfer system may be considered equitable, the absolute value of elasticity is low. On an average, per capita transfers were higher by 0.54 percent when the per capita SDP were lower by one per cent. This shows that although the transfer system on the whole has an equalising impact, but not entirely designed to offset fiscal disabilities.

Figure 6.3: Equalization in Central Transfers to States (2002-03)

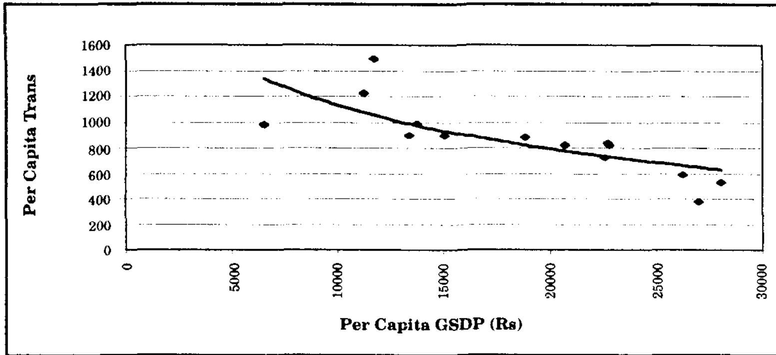
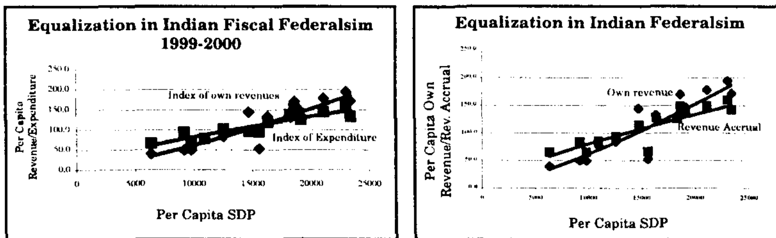


Figure 6.4



Despite the somewhat progressive distribution of intergovernmental transfers, per capita revenue accruals and therefore, per capita expenditures across States continue to be significantly higher in States with higher per capita SDP as may be inferred from Figure 6.4. Thus, the distribution of per capita revenue accruals as well as per capita expenditures across the States has a positive slope when they are plotted against per capita SDP. It is also seen that the slope of revenue accruals, which includes the Central transfers, is only marginally different from that of states' own revenues.

The important point is that the transfer system as a whole is equitable, mainly because Finance Commissions' tax devolution formula gives very high weight to the income disadvantage factor. However, the degree of equalisation is not very high because, general purpose transfers of both Finance

Table 6.6: Some Economic and Fiscal Characteristics of States

	Population (Millions) 2002-03	Average Per capita GSDP 1999-2002	Poverty Ratio 1999	Per Capita Own revenues 2002-03	Own revenue-GSDP ratio 2002-03	Per capita central Transfers 2002-03	Per capita develop-ment expendi-ture 2002-03	Per capita Total expendi-ture 2002-03	Per cent of own revenues in Exp. 2002-03
Andhra Pradesh	77.8	18869	15.77	2075	10.2	881	2531	3962	52.4
Goa	1.4	56599	4.4	9186	15.9	1371	9207	13314	69.0
Gujarat	52.2	22708	14.07	2505	10.4	835	2986	4600	54.5
Haryana	22.1	26256	8.74	3326	12.4	588	2779	4429	75.1
Karnataka	54.1	20703	20.44	2141	10.0	823	2689	4005	53.5
Kerala	32.3	22824	12.72	2436	10.5	821	2762	4809	50.7
Maharashtra	99.9	26994	25.02	2707	9.8	378	2714	4494	60.2
Punjab	25.0	28030	6.16	2875	9.9	530	2494	5117	56.2
Tamil Nadu	63.7	22587	21.12	2523	11.1	727	2568	4131	61.1
High Income States	**428.7**	**23336**	**17.91**	**2511**	**10.4**	**689**	**2705**	**4380**	**57.3**
Bihar	86.4	6539	42.6	358	5.6	982	1076	1912	18.7
Chattisgarh	21.5	13710	NA	1527	10.5	992	2040	2904	52.6
Jharkhand	27.9	11717	NA	1160	9.9	1493	2413	3437	33.7
Madhya Pradesh	62.4	13340	37.43	1250	9.2	895	1859	2737	45.7
Orissa	37.6	11234	47.15	1019	8.7	1225	1703	3001	34.0
Rajasthan	58.6	15059	15.28	1334	8.6	897	1983	3295	40.5
Uttar Pradesh	172.3	10798	31.15	852	7.7	763	1187	2111	40.4

West Bengal	82.3	17377	27.02	1006	5.4	829	1512	3043	33.0
Low Income States	**549.1**	**12067**	**29.64**	**948**	**7.6**	**914**	**1511**	**2577**	**36.8**
Non-Special cat. States	**977.7**	**17022**	**25.97**	**1633**	**9.3**	**816**	**2034**	**3367**	**48.5**
Assam	27.3	12288	36.09	963	7.6	1526	1691	2836	33.9
Arunachal Pradesh	1.1	16579	33.47	1027	5.7	9045	8536	12036	8.5
Himachal Pradesh	6.2	24762	7.63	1716	6.4	4187	6179	9634	17.8
Jammu and Kashmir	10.6	18132	3.48	1237	7.0	5429	4411	7843	15.8
Manipur	2.3	17264	28.54	530	3.0	5243	4009	6861	7.7
Meghalaya	2.4	16035	33.87	992	5.7	4379	4050	6104	16.2
Mizoram	1	21245	19.47	800	3.9	9410	9390	13520	5.9
Nagaland	2.2	20469	32.67	477	2.3	5877	4664	8405	5.7
Sikkim	0.6	20929	36.55	4133	19.2	10983	11233	15317	27.0
Tripura	3.5	18974	34.44	806	4.0	4569	4300	6794	11.9
Uttaranchal	8.7	16998	NA	1606	9.2	2094	3220	4645	34.6
Special Cat. States	**65.9**	**16238**	**22.56**	**1151**	**6.9**	**3351**	**3475**	**5605**	**20.5**
All States	**1043.62**	**16978**	**26.1**	**1603**	**9.2**	**976**	**2125**	**3509**	**45.7**

Note: Revenues and Expenditures are net of Lotteries; GSDP – Gross State Domestic Product.

Source: 1. Reserve Bank of India Bulletin, December 2000

2. Public Finance Statistics, Ministry of Finance, Government of India, 1994-95.

Table 6.7: Equalization in Fiscal Transfer System in India – 2002-03

1. Major States	Finance Commission		Plan Transfers			Total Transfers
	Tax Devolution	Total Transfers	State Plan Schemes	Centrally Sponsored Schemes	Total Plan Transfers	
Intercept	13.9855*	13.9918*	7.3504*	8.1765*	8.7939*	11.9334*
	(9.5600)	(8.8145)	(3.3882)	(2.3465)	(3.4016)	(8.0616)
Coefficient	-0.7999*	-0.7960*	-0.2722	-0.3737	-0.3544	-0.5375*
	-(5.3244)	-4.8829)	-(1.2217)	-(1.0444)	-(1.3348)	-(3.5356)
'R^2	0.669*	0.6300*	0.0060	0.0060	0.0495	0.4340*

Note: Estimated by employing the functional form: Ln G = a + b Ln Y+ Î
Where, G denotes different types of per capita transfers, Y represent per capita GSDP, a and b represent parameter estimates and Î is the error term.
* Significant at 1 per cent level.

and Planning Commissions are not designed to offset fiscal disabilities per se. As contradictory criteria are employed in the transfer system, fiscal disabilities are not entirely offset (Rao and Jena, 2005).

Intergovernmental Transfers in India: Implicit Transfers

The foregoing analysis demonstrates that even when there is a constitutional mechanism to effect formula based transfers, the political system may not allow evolving a simple, equitable, objective and rule-based system of transfers. Even if such a system is developed, there can be a number of implicit and invisible ways in which the more powerful States can impact on resource transfers in their favour to offset the effect of explicit transfers. Besides the pattern of distributing central government's own expenditures and its regional policies in terms of locating Central public enterprises, we can identify at least three important sources of resource transfers which are: (i) inter-state tax exportation, (ii) subsidised lending by banking and financial institutions to the private sector. This includes lending by All India Financial Institutions[3] (AIFI) at below market interest rates subsidised by the refinancing facility extended by the Reserve Bank of India, and priority sector lending by commercial banks for specified activities like agriculture and rural development, industrial promotion, small scale industry and exports; and (iii) subsidised borrowing by the States from the Central government and the banking system. The main source of inter-regional transfers from lending to the governments comes from the stipulation to the banking system on the extent of their lendable resources to be held in government bonds at regulated interest rates (Statutory Liquidity Ratio), stipulation on the quantum of assistance to

3. All India Financial Institutions refer to All-India Development Banks (Industrial Development Bank of India, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Small Industries Development Bank of India, Industrial Reconstruction Bank of India, SCICI) and specialized financial institutions (RCTC, TDICI), TFCI) and investment institutions (LIC, UTI, GIC).

be given to the 'priority sector', and the distribution of seignorage or the profits of Reserve Bank of India through the refinancing facilities given to AIFI. We discuss the three sources of invisible transfers in some detail.

Inter-state tax exportation

Inter-state tax exportation arises from the levy of origin-based cascading type sales taxation along with the taxation of inter-state sale of goods. The sales taxes levied by the States are predominantly on the basis of origin, at the stage of manufacture or import. They also levy taxes on raw materials, intermediate inputs, and capital goods. In addition, inter-State sale is also taxed subject to the ceiling rate of 4 per cent[4]. In an economy where there is only a limited internal and external competition the tax is fully shifted forward, input taxes cascade on to inter-state sales tax and consequently, effective tax rate on inter-state sales would be much higher than the four per cent nominally levied. This results in the exportation of the tax burden from more affluent producing States to the consumers in poorer consuming States. When the exports of more developed States are larger than their imports, and the proportion of final goods in their exports too is higher as in the Indian case (Rao and Singh, 2005), the residents of poorer States end up paying taxes on larger volumes of imports and at higher effective tax rates.

Data on inter-state trade is not available and it is difficult to accurately arrive at the estimate of inter-state tax exportation. A comparison of consumption shares and sales tax shares, however, shows that the high incomes states collect much higher share of sales taxes than their consumption shares[5]. While this can not be entirely attributed to tax exportation and a part of this could indeed be due to lower tax effort in poorer states, the large and systematic difference points towards significant perverse transfer of resources through inter-state tax exportation.

4 The ceiling rate is applicable only when the transaction takes place between the registered dealers. If the sale is from a registered dealer, in the exporting state to a non-registered dealer in the importing state the ceiling rate applicable is 10 per cent.

5 For details, see, Rao and Singh (2005), Ch. 9.

Regional transfers from subsidised lending by financial institutions

The pursuit of planned development strategy required the use of controls on prices and quantities. Important among these has been the distribution of credit to the specified activities in the private sector by the banking and financial system at below market interest rates. This includes credit given by the banking system to 'priority sector' activities such as agriculture, small-scale enterprises and exports, and refinancing facilities provided by the All India Financial Institutions (AIFI) at subsidised rates. Priority sector lending constituted about a third of total bank credit in 1995-96, and the subsidy element in these advances is significant. For example, interest rate on priority sector borrowing in 1993-94 was 5.5 to 6.5 per cent as compared to the SBI long term lending rate of 19 Per cent. The quantum of subsidy implicit in the assistance given by All India Financial Institutions was significant in earlier years, as much of the profits of the Reserve Bank of India (seignorage) were used to provide a refinancing facility to these institutions, but the subsidy has declined since 1992-93 as the centre has been appropriating the profits of the RBI entirely.

A detailed analysis of the priority sector credit and the financial assistance given by the AIFI shows that the distribution of both sources of lending is disproportionately in favour of high income states. In the aggregate, these states with just about 19 per cent of population received 35 per cent of priority sector lending given to agriculture, small enterprises and exports and, their share of assistance from AIFI was 43 per cent. In contrast, the low income States with almost 44 per cent of population received just about than 15 per cent of priority credit and 22 per cent of assistance from AIFI. Thus the distribution of subsidized credit by the banking system and AIFI has been to confer disproportionate benefits to more advanced States.

Invisible transfers from subsidised lending to states

The most important source of implicit transfers, however, is subsidised lending to the states. Loans from the central government alone contribute to almost 68 per cent of states' liabilities, a bulk of which was given for plan purposes under

the Gadgil formula. The market borrowings constitute another 22 per cent, which is subscribed mainly by the banking system as to fulfil the Statutory Liquidity Ratio (SLR) requirements[6]. The extent and nature of intergovernmental transfers from this source depends upon the pattern of inter-state allocation of when loans to state governments or public enterprises run by the states are rescheduled and written off, implicit transfers do arise. Providing periodic relief such as the bail out to the State Electricity Boards by providing a one time settlement of their dues to Central Public Sector Undertakings is a case in point. The states that gained from more from the scheme were the ones who had more accumulated defaults. This type of bail out involves implicit transfers to states.

Implicit transfers are also involved in lending to states at below market rates. In the past, this practice resulted in significant implicit inter-state transfers Rao (1997). However, as the practice of central lending itself is being given up based on the TFC's recommendations, this source of implicit transfers is being phased out.

The sources of implicit transfer pointed out above are not the only ones and it is difficult to say whether they are the important ones. The transfers arise whenever there are controls on prices and quantities. The determination of procurement price, so long as it is higher than the market price enables resource transfers in favour of foodgrain surplus states. The same is the case with cotton. So long as there are restrictions on imports and the prices get determined by a government fiat rather than the market forces, implicit transfers are inevitable.

Concluding Remarks

The increasing inter-state disparities have accentuated after the market-oriented reforms were undertaken in 1991. The important point, however is the trend towards accentuating disparities existed even before liberalising reforms, but surely,

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6 At present, the SLR stipulation requires the commercial banks to keep 25 per cent of their demand and time liabilities in eligible assets like Central and state government bonds. In fact, the financial sector reforms brought down the SLR from 38.5 per cent in 1991-92 to 25 per cent in 1996-97.

the states with better infrastructure and market institutions took advantage of the liberalised environment much better than those without. The fear is this trend of increasing disparities will accentuate further in the years to come and is likely to pose severe strains and tensions on Indian federalism and therefore, this is a priority area for policy.

In Conclusion

Prospects of the Economy in 2005-06: A Cautiously Optimistic Outlook.

The Indian economy has continued its buoyant performance in the first half of the fiscal year 2005-06 despite several problems and constraints. Both manufacturing and service sectors have shown a buoyant performance in 2004-05, and the trend has continued in the first quarter of 2005-06 to record GDP growth of 8.1 per cent. The near normal monsoon and continued good performance of manufacturing and service sectors has led to optimistic expectations and the economy is estimated to grow at over 7 per cent in 2005-06 as well. What is important is that the growth of the economy during the year is all-round, i.e. in the primary, secondary as well as service sectors of the economy.

The optimistic expectation on the Indian economy is not confined to the growth performance alone. Other important macroeconomic variables too have shown creditable improvement. Despite persisting of fiscal imbalances, steep increase in oil prices and supply shortages in some areas (onion), there are no immediate dangers to macroeconomic stability. The Reserve Bank of India predicts the inflation rate of 5 to 5.5 per cent for the year. The favourable environment for the manufacturing sector growth has continued and the commercial sector's demand for credit has shown a sharp increase. Although interest rates may harden in the latter part of the year, good performance is likely to continue. Commodity exports continue to be buoyant and along with continued good performance of software exports, will provide enough cushions in the external payments front, despite the large outflows due to increasing price of crude oil and emergence of current account deficit. Interestingly, the savings rate in the economy has reached a level of 28 per cent and with improvements in

the public finances of the central and state governments, the level of public savings as well as overall saving rate is likely to increase further in 2004-05 and 2005-06. The GDCF rate, however, continued to be stagnant until 2003-04, at 23 per cent. Therefore, what is needed to accelerate growth is more efficient intermediation of savings into investment.

It would, however, be a mistake to be complacent and ignore the weaknesses and risks in the economy. The persisting fiscal imbalance may worsen if the expected revenues are not realised and competitive populism leads to expenditure profligacy and softening of budget constraints at subnational levels. Although the performance of the revenues of the central government hitherto have been buoyant, the signs are ominous as far as expenditures are concerned.

Another major risk factor is that infrastructure bottlenecks will bind the growth performance and there is no immediate solution in sight for this. The important sectors presenting the binding constraint include power, transport, including ports and railways and urban infrastructure. Although investment in highways receded under the new government, the recent months have seen spurt in activity in awarding contracts in this area. In part, the infrastructure bottleneck is the consequence of the pattern of fiscal adjustment and given the tight fiscal space for both central and state governments, much of the increase in investments in this area will have to come from the private sector. Of course, public sector investment in infrastructure has to be stepped up, but this has to come about mainly by containing unproductive expenditures.

An important external shock that has added to the risk is the sharp increase in the international price of crude oil. The effect of this has not been felt by the economy entirely as a part of the increase in the price of crude oil has been absorbed in terms of lower profits of oil companies and lower taxes on petroleum products. This is not going to be a permanent solution as reduction in profits and lower tax revenues will only increase deficits. When the price increase has adjusted itself, it could have serious repercussions not only on fiscal outcomes, but may also have direct adverse impact on the growth of the manufacturing sector.

Has the Indian Economy Achieved a Higher Growth Path?

The Indian economy has shown buoyant performance consecutively for the third year and this has raised the expectations that the economy has accelerated to a higher growth trajectory. Many observers feel that achieving 8 per cent growth of the economy during the 11th Plan period is within the realm of feasibility. The return to buoyant performance by the manufacturing sector, continued buoyancy of the services sector, sharp increase in savings rate, creditable performance of exports are some of the factors cited in support of this claim. It is also suggested that there has been a significant productivity growth in Indian manufacturing and demographic as well as institutional factors support higher growth. The fact that the Indian economy has recorded creditable performance despite several adversities has supported this claim. Indeed, the performance of the economy has defied conventional wisdom and despite severe fiscal imbalances, sharply increasing oil prices, poor political climate for reforms, it continues to be buoyant.

The potential of the economy to grow at fast rates was demonstrated in the past as well and it would be erroneous to surmise from this that the economy has reached a higher growth trajectory. It must be noted that the growth performance has continued to be lopsided with about 70 per cent of the growth being contributed by the services sector. If the economy has to grow at 8 per cent during the 11th Plan, agriculture should grow by at least 4 per cent. In fact, the growth target for agriculture in both the Ninth and the Tenth Plan periods was 4 per cent. While in the Ninth Plan period the actual growth of GDP recorded in the sector was 2 per cent, the average growth during the first three years of the Tenth Plan is just 1.5 per cent. Continued stagnation in agriculture will not only drag the overall performance of the economy, but will also result in jobless growth and stagnation in the material living conditions of the majority of people in the country.

The year has seen the revival of the manufacturing sector but, it would be too optimistic to presume that the climate will continue. Although the bank rate has not been changed so far, the increase in the Reverse Repo Rate by 75

basis points over the last one year is a clear indicator for the hardening of interest rates during the course of the year. Also, continued compression of public spending on infrastructure could place a binding constraint on growth. The effect of oil price increase when it has fully worked itself out could also place additional constraints on the growth of the manufacturing sector.

Reforms Agenda

The recent experience provides many lessons. The reforms have been the most effective in the services sector and therefore, the economy has consistently performed well in this sector right from the middle of the 1990s. To achieve faster inclusive growth balanced between different sectors, regions and involving the majority of the people, it is important to undertake wide-ranging reforms.

Much has been written on the reforms to be undertaken in various sectors and one cannot offer any new perspective on this except to repeat the critical areas requiring reforms in the short and medium term. Wide ranging reforms to free the agricultural sector from the shackles of various controls on the movement and sale of agricultural products, larger volume of investments in irrigation, particularly small and medium projects, creating enabling conditions for contract farming through a proper promotional and regulatory framework, promoting agricultural extension by agricultural universities directly collaborating with the farmers to create demonstration farms to adopt advanced farm practices, ensuring adequate credit to the farmers at reasonable rates of interest are some of the measures. The reform measures suggested here are politically not very sensitive and with some effort it should be possible to undertake them.

On the manufacturing side, reforms are required both to enhance the flow of investments and to improve productivity. Making the manufacturing sector competitive in the international market is critical to enhancing growth in this area. This requires, significant improvement in infrastructure sectors through various reform measures to enhance their performance standards and direct larger volume of investments to the sector by enhancing public spending and enabling greater

private participation. In areas such as power supply, policy and institutional reforms will have to continue. There are other important measures such as reducing rigidities in labour laws, further de-reservation in small-scale industries and further liberalisation for the participation of foreign direct investments which can help to augment investments and improve productivity in the Indian industry. Indeed, excessive protection given to 7.5 per cent of the workforce has placed serious constraints on expanding employment opportunities to the rest.

Fiscal reforms are critical to accelerating growth with stability. The fiscal restructuring plan drawn up by the TFC for the central government, in fact, conforms to the framework specified in the FRBMA and if the central government provides the leadership by adhering to the plan it will have the moral authority to persuade the states to follow suit. This would require reforms both in the revenue and expenditure sides. Reforms in the tax system are necessary not only to improve revenue productivity but also to remove microlevel inefficiencies. The important tax reforms suggested in the paper include rolling back many of the exemptions and tax preferences, continued improvements in the tax administration and information system and further reforms leading to the levy of full-fledged VAT. The objective of the last measure should be to create an unhindered common marker in the country.

Critical areas of infrastructure augmentation include railways, power, urban infrastructure, ports and airports. The railways sector has been used for the distribution of political patronage by successive ministers in office, and this has led to poor commercial performance and lack of resources for reinvestment on renewal of the exiting structures and expansion of the system. A time has come to corporatise the sector and remove the political control over it. Similarly, the monopoly status provided to the Airports Authority of India has done little to ensure adequate investments in the sector. A complete overhaul of the policies relating to this sector are called for to meet the fast growing requirements.

These are only some of the important reforms needed to launch the economy to higher growth trajectory. These will not only accelerate the growth of the economy but bring in greater balance in the growth between different sectors, regions and

ensure greater employment opportunities. If the reforms indicated above are implemented, the economy can grow consistently at 8 per cent, even 10 per cent during the Eleventh Plan. The critical question is whether the special interest groups will allow the reforms to be carried out and whether it will be possible to create an enabling environment to unleash creative energies to improve the living standards of the people?

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Comments on the Review by the Discussants

Kanhaiya Singh

Dr. Govind Rao presented a very elaborate piece of work, covering an enormous number of issues confronting India's economy with particular emphasis on fiscal management, instead of limiting itself to presenting the economic progress during the first half of the financial year and the likely short-term outlook. In my opinion a mid-year review also means review of the reform process and Dr Rao has rightly touched upon such needs. I would like to take this discussion further as it appears that there is stagnation in the reform process. For this purpose, I have picked up some of the macro issues for discussion rather than concentrating on all the issues that Dr Rao touched upon.

Dr Rao, while presenting a cautious and optimistic outlook for 2005-06, feels it would be erroneous to surmise that the economy has reached a higher growth trajectory. He has stressed on the need for achieving a 4 per cent growth rate in agriculture to sustain a high overall economic growth. Therefore, a large volume of resources needs to be diverted to agriculture and infrastructure, particularly power. At the same time he has also suggested to strictly adhere to the FRBM, liberalise the FDI regime and to de-reserve the SSI sector. In the short-run, Dr Rao is concerned about the increasing oil prices and tends to support the RBI policy stance of raising policy rates, which he feels will not have much impact on investment.

To the question whether India has attained higher trajectory of growth, I feel that one of the ways to judge the sustainability of the high growth trajectory is to assess the resilience of the economy in responding to various shocks over a reasonably long period. In a recent work Singh and Bery (2005) have made interesting

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observations on the growth experience of India during 1950-2004. After breaking the periods into decades and recalling the episodes of shocks and policy regimes, they conclude that the trend growth rate during the 1980s and 1990s has shifted upwards systematically as compared to the previous decades. In fact, 1990s witnessed more shocks in terms of number and severity than any of the previous decade and yet they finished with the highest trend growth and least variability. The decade began with an external payments crisis and suffered from episodes of droughts, the East Asian Crisis, the Kargil War, and economic sanctions. The resilience was tested in the years following the 1990s decade; during the first half of 2000 it suffered two episodes of drought with severity as high as any of the droughts during the pervious decade. But, this time, unlike in the previous episodes, the economy could very well avoid nose-diving. This resilience has very well been sensed by the stock market. Beginning 2003, the movements in the stock market and increases in the level of operations of Foreign Institutional Investments (FIIs) reveal the confidence in the Indian economy. Therefore, the belief that there is no shift in the trajectory appears to me a bit pessimistic.

There are several factors contributing to this development including the changing structure of the economy, macroeconomic management, increasing integration with the global economy, more freedom to the private sector, and the reduced variability in the global economy. However, this also reflects on how important reforms are to sustain economic growth.

As regards developmental issues and problems of short vision, in our view, the key worry now is not about growth but the short vision. Due to several reasons, one tends to believe we have a short vision. We imagine and plan growth but do not believe it will happen and therefore end up making congested layouts. When we say layouts, these mean a host of issues. For example, we cannot see the kind of roads that are being developed in China to give passage to something big that was in the offing. One has to provide facilities for all the big things, which have to come along with growth. That kind of future vision does not show up at the micro level when we come to grassroot facilities. We never thought that affluence would bring more cars, which will require space for driving and parking. We now have lots of cars, but no roads or parking space. We have started facing the problems now, but still when we plan big and medium size cities, leaving aside small cities, we do not imagine such things coming up. We have lots of domestic

carriers, but no airport to handle them and still we have taken several years in realising some thing needs to be done, and yet the right decision is still not visible. Our vision is so short that all the time we think in terms of creating incremental facilities in bits and pieces, as the demand comes up. Construction of a huge network of high capacity cement concrete roads in China is a testimony of their awareness about the costs of frequent repairs and loss to the private sector in plying poor roads, which is extremely high and which costs dearly in terms of competitiveness of the economy as a whole. We fail to realise that.

Another example of short vision is the power sector. We are fully aware that public sector cannot meet the energy demand, yet we fail to give way to the private sector for mining coal freely. Probably we lack confidence in our regulations and hesitate to reform. Installing a captive power plant remains fraught with enormous problems. On the one hand public utility cannot supply the required quality and quantity of power and on the other when a private sector installs one of its own, we impose conditions such as the obligation to buy first from the electricity boards. Then there are taxes on the captive power generated. A captive power plant by default is an integral part of the production facility and therefore we argue against taxation of captive power and for its promotion. We want to reform the power sector, yet even after several years of effort, models of privatisation have not been worked out. It appears that the problem is less with the selection or availability of models but more with hesitation of the bureaucracy to relinquish control and the lack of political will to seek user charges and to allow a fair game.

Such short vision can be sighted in several other issues, be it FDI-related reforms, privatisation of profit-making public sector companies, investment in infrastructure or giving much needed freedom and boost to the industrial sector. It is no secret that the services sector in India has grown because it escaped the repression and wraths of government interventions, yet we are not ready to extend similar freedom to the manufacturing sector.

We also need to worry about the absorptive capacity of the economy leading to building of reserves (a costly but necessary evil). The services sector led growth has poor capacity to absorb capital and generates lesser employment in the formal sector. On the other hand, we conjecture that the industry-led growth alone could absorb more capital, produce more employment and generate resources for development of other sectors including agriculture.

The agriculture sector is fragmented, with the holdings size getting smaller and smaller, leading to capital constraints in most of the agriculture-intensive states. To increase the growth potential of the agriculture sector, public sector investment is required. But the agriculture sector is not able to create its own resource base as it has remained so far an untaxed sector. Therefore, resources for public expenditure in agriculture need to be generated through higher tax revenue from other sectors.

It is observed that the states with higher level of industrialisation have a higher ratio of fiscal self-reliance, which allows them to allocate higher resources for economic activities including those related to agriculture, infrastructure and services sector. Therefore, we argue that the growth of the industrial sector must be the paramount consideration in policy formulation. It is important to note that a larger industrial sector will provide larger base for collection of indirect taxes, but first, its own expansion would require the rate of taxation to come down.

The frequently referred tax to GDP ratio is a misleading concept in a country like ours, where the taxed sector constitutes only a small fraction. The agriculture and services sectors, which constitute about two-thirds of the GDP, are hardly taxed. The indirect tax, at 10 per cent of GDP, and the direct tax rate at 4 per cent of GDP, appear to be low, but the sectors through which these taxes are collected are highly disadvantaged. The indirect tax is collected through the industrial sector, which works out to be more than 40 per cent of the industrial sector's GDP. With this baggage the private sector manufacturing is expected to compete globally. One may view this issue in the light of a general equilibrium framework and argue that it is not one sector but the whole backward linkage that is taxed and it should not matter as to where the taxes are collected. But, in practice it does matter when it comes to competing globally or achieving economies of scale in the domestic market. The precise reason behind the advent of the system of VAT was to eliminate such distortions. We are still far behind in implementing such a regime with a uniform low level of VAT. There is no system in place to avoid domestic taxes being exported.

Another important aspect of reforms to improve industrial activities is the preference for the small-scale sector and the labour laws. Reforming the small-scale sector and the labour laws are also issues related to a long-term vision of the economy. In the short run it may be politically inconvenient to touch these issues but

avoiding them has had long-term adverse implications. The suggestions made by Dr. Rao on reforming the labour laws and the SSI sector are often re-iterated in several forums. While almost fully agreeing with the need for the labour law reforms and de-reservation of the SSI, one would like to go beyond. In fact, the very concept of giving preferences and incentives to the small-scale sector is ill founded. The claims of major contribution by the SSI to exports are misleading. It is the product and its price that makes it export competitive. It does not matter whether it is made in a small or a big set up. On the contrary, with bigger establishments, it could be more competitive. It may be noted that we are not talking here about tiny units. Yet, the scale of operation of SSI operations is too small, when we actually compare it with what is small in competing countries like China. Factories with less than 1,000 workers are considered small in China.

It is also misleading to announce de-reservation of items from the list of reserved items for manufacturing in SSI. How does such de-reservation matter in realising economies of scale if all the benefits to SSI remain intact for such products? Small increases in the limits of SSI operation. such as those from 3 crores or 5 crores, remain inadequate and create more complications than solving the problem. A better way could be to either eliminate all the benefits given to the SSIs or increase the operational limits in terms of manpower and capital to much higher levels.

Certainly, many may not agree on the rigidity of labour laws, but our own experience of working with industry in both the public and private sector manufacturing units clearly suggests it to be problematic. Even from the welfare point of view, the actual beneficiaries are not well identified. The union leaders extract rent from both labour as well as management and keep the production process on tenterhooks. The organised union is a formidable force backed by political interests and makes it impossible for any manufacturer to exit in case he/she find it uneconomical to run the establishment or even reduce the level of employment in order to reduce short term losses. It is completely irresponsible to think that labour laws are not a problem. Not only this, the current state of multiple laws applicable to the factories such as factory act, boilers act, pollution control, environmental control, all make life miserable for new entrepreneurs. The key problem with several of these laws is that they are based on 'do's' and not on don'ts. We should have a composite negative list of 'don'ts' for each type of industry and strictly penalise the violators rather than making

'dos' obligatory for giving permission to operate; permission to operate should be based on a guarantee of self-compliance and affidavit of penalty against violations.

Fiscal reforms and public expenditure preoccupy our minds. We worry about fiscal exuberance because it consumes private surplus and part of capital inflows. It has to be efficient and sustainable which Dr. Rao has very elaborately explained. Do deficits help growth? There is no clear evidence. However, at the state level, some states with increasing fiscal deficit are also growing faster. Statistical evidence supports the view that there is a significant positive relationship between economic growth and growth in the fiscal deficit across states. In a recent work Bhide and Singh (2005) have analysed the time series components of the combined budget of the centre and the state to see the effects on private investment, consumption and export and conclude, among others things, that the fiscal policy geared towards direct taxes for generating revenue rather than indirect taxes is likely to generate greater output effect. In the long run, the impact of direct taxes is significantly positive on capital formation and significantly negative on final consumption expenditure as predicted by the classical model. In the case of merchandise exports, direct tax has significant positive effect both in the long term as well as the short term, while indirect taxes have negative effects. Thus there is a case to shift towards increasing dependence on direct taxes as compared to indirect taxes for raising resources.

The so-called 'capital expenditure' in the government budget or the 'development expenditure' does not promote investment spending by the private sector. But expenditure by the state governments is found to have a significant long-term impact on these two activity variables. The state government expenditure has a negative long-term impact on private final consumption expenditure and a positive impact on private capital formation. This is an important result in the sense that it both agrees and disagrees with both the classical and the Keynesian frameworks. On the one hand, while the state government expenditure stimulus leads to private investment as predicted by the Keynesian model, the long-term wealth effect tends to dampen consumption decision. The impact of the state level variables is larger than that of the central government. These results point to the need to examine more carefully the case for shifting greater spending responsibilities to the state level. Therefore, there is a case to

emphasize fiscal decentralisation including the promotion of Panchayati Raj institutions.

During the discussions questions have been raised about repression and distortions in the financial sector through priority sector lending. Financial sector reforms have done good service in the urban areas and the cost of capital has gone down substantially but the same results have not percolated to the rural areas. The pressure of priority sector lending has been eased out in many ways, particularly by changing definitions. Take the case of housing loans. Previously it used to be 5 lakhs, but now it has increased to 15 lakhs. This effectively means provision of loans for houses with market price in excess of 20 lakh. Now, the question is: how many houses in the rural sector or in the semi-urban or small towns are built with 20 lakhs and does such finance create distortions in the financial market? Who are the people who are buying such houses, or in other words, who are the people actually taking these loans? Clearly, housing loans are getting concentrated in the urban areas and the banks are now after such borrowers to meet their priority sector obligations. If priority sector obligations are met like this, then where are the actually needy people, for whom the priority sector was intended, going to get the loans from? On top of that, the rate of interest for priority sector borrowers are significantly higher than for the large borrowers? Only after government intervention have the agriculture sector loans been disbursed at 9 per cent, but the interest rates for other small borrowers are much higher and banks use these returns to subsidise the large borrowers.

Private participation in the financial sector is a recent phenomenon and it is still localised in the urban areas. In order to bring competition in rural banking significant reforms are needed to bring the private sector to the rural areas. Such reforms include issue of property rights, land rights, crop insurance and formation of self-help groups as alternatives to tangible collaterals.

In summing up, one can say that the pace of reform must not be allowed to slow down, but India still has to travel a long distance to make itself competitive and formidable.

Mythili Bhusnurmath

I find myself in almost complete agreement with practically all that Prof. Rao has elaborated, which also makes my task that much more difficult.

Perhaps a couple of points require further discussion. The most significant thing pointed out by Dr. Rao, which perhaps we don't take seriously enough, is the inter-state disparities. It is a fact that post-reform, inter-state disparities have grown. And I don't think we pay enough attention to the consequences that, one day, may blow up in our face as a result of this.

The trickle down effect takes far too long, and I really don't know whether Indians, despite their fabled patience and willingness to put up with things with their fatalistic attitude, will be willing to wait that long. So I worry about inter-state disparities and specially since Dr Rao is aof the view that these have gone up post-reform. And while it is good that he has raised the issue, I do wish he had discussed it a little further in terms of possible solutions, particularly because he points out that it is not money that really determines outcomes. Moreover, despite efforts to transfer resources to the poorer states, these haven't delivered. Had they done that, the disparities would not have increased.

But part of the problem also arises because of the fact that with reforms, it was the states that were more advanced, which had better institutions, better infrastructure, that were able to benefit most whereas the others were not. Anything that is done to further liberalise the economy will, in fact, increase these disparities rather then reduce them, because the poorer states are not in a position to capitalise on the advantages that opening up confers on them. So what is the way out?

If transfers have not really helped, if opening up is only going to make things worse, what do we do? Is there a way out at all? The observation that disparities have grown is also buttressed by Dr Rao's observation that the special states, where the deterioration in both the fiscal and the revenue deficit is worse than that of other states, received almost 90 per cent of their plan assistance in the form of grants, rather than loans. Despite that, they weren't able to improve their position.

I would like to refer you to Table 6.3 on page 156. It shows that the poorer states do seem to have got a higher share of the

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central investment, relative to their share in the gross domestic product. If that is so, if the poorer states have got a relatively better treatment from the centre, that means transfers have been weighted in favour of the poorer states. Still the disparity has widened, so what do we do? If it is lack of governance, which definitely is a factor, then how does one improve things?

This is something that people have talked about in the past as well. Can you declare a financial emergency in states like Uttar Pradesh and Bihar, and can the centre take over, and try and improve matters? That's going be a very difficult decision. I don't think it will go down well with our polity. And yet these things do need to be discussed at a greater length. One possibility that Prof. Rao has mentioned, one possible reason he has touched upon for the widening inequality, is the fact that the poorer states also tend to be the more agrarian ones. And perhaps to the extent that agricultural reform hasn't happened, to the extent it has happened in the secondary and the tertiary sectors, one could cite that as a possible factor.

Fortunately, there is now an awareness that something needs to be done on the agriculture front as well, so if reforms take place on that front it may in some ways go towards bridging the gap between the rich and the poor states.

Another thing Dr Rao referred to is the differences in inter-state disparity, where he talks about revenues per capita and the share of the states' gross domestic product. He says these are partly due to the differences in the revenue capacity and he says partly due to the differences in efforts at raising taxes. Now where there is a difference in terms of income, maybe one can do something. But where it is a question of the states just not putting in enough effort in raising taxes, and you use that as also to go into your calculations of how much you need to transfer to them, then that in fact incentivises them to not really do anything much about raising taxes. So is there some way where we can differentiate how much of their disparity is because of poorer incomes and how much is because they just don't want to levy taxes on their populations? Can they be incentivised by compensating them only for their lower incomes and penalising them for not doing enough to mobilise revenue through taxes? Is it possible?

Unfortunately there seems to very little correlation between the economic and the fiscal performance. It is in the more prosperous states like Punjab, that the deterioration in fiscal performance has been the worst. States like West Bengal, which

earlier were not doing so badly, show a marked slippage in their performance. So is there something in the Indian system that induces more prosperous states to do less, induces the middle income states to say well there is always the centre we can turn to, particularly in these days of coalition politics where regional parties do become more important.

Another point that I thought worth discussing was the issue of savings being in excess of investments. While it is very good that the savings ratios have picked up, what is distressing is that most of the savings have not gone into financial assets. And increasingly over the last few years particularly, the major part of it has gone into physical assets. Now that is a very worrisome thing because investment in gold doesn't fetch you anything. What we do need to see is more investment in financial assets. But if you look at the ratios, they warn that the investment in the stock market for instance has come down drastically. This is possibly a result of the poor regulations that India has had in the past. It is sufficiently distressing, and I think the government does need to think whether there are any other kinds of instruments, particularly in the bond market, that can bring it more to life. Can you do something about it to ensure that savings (I am talking here about the household sector), go towards financial investments, so that they can be used for more productive investment? I think that perhaps needs to be debated a little bit more.

Another thing that I think needs to be flagged is that most of the correction in the fiscal deficit that the government is pinning its hopes on is in terms of increase in the tax GDP ratio. And while it is true there is scope, given the fact that India's tax GDP ratio is not even back to where it was at the beginning of the reform period, India's track record on this front has not been too good. On the expenditure front, it was stated that the government's hopes have been almost entirely on interest savings, and not really on cutting the wasteful expenditure, particularly in subsidies. So I think this is a little distressing, because and the government has benefited in the past from lower interest rates, not only through the direct saving on its own interest burden, but also because public sector banks made much higher profits thanks to lower interest rates. So the higher dividend that they got from public sector banks also benefited the government. That is not going to continue for very long. Interest rates have reversed, and it is a fact that they will no longer be the kind of savings that one had in the past. So unless the government think in terms of cutting its

wasteful expenditure, in terms of cutting subsidies, etc., one is not going to see much improvement in the fiscal deficit.

Linked to this is what Prof. Rao calls the marked decline in the time horizon of political parties. This is what I think is a very distressing thing, because it means every political party is going to take a very short term view, and the moment you take a short term view, that is an invitation for disaster. Some of this could change by having fiscal rules like the fiscal responsibility act, but then what happens if, as has happened in our context, the finance minister casually announces that he is going to press the pause button, and nobody really questions him in Parliament? Then what purpose does it really serve? In the case of the European Union also there is the Growth and Stability Pact and many governments especially, France, Germany and Italy, were found to be fudging numbers. But if you have a system where the Parliament does not even discuss the budget, where the finance minister can just say, oh well I am going to press the pause button, that's it, then what purpose does it really serve? I think we need to discuss that as well.

We also talk of incentivising the states. We've had MOU's in the past, and now we had the finance commission suggesting various ways of incentivising the states. It hasn't really worked very well because though you do need a carrot and stick approach, I think what happens is that there is always the question of political economy. How much do you apply the stick in the case of a state where the ruling party may be a key member of the coalition government in the centre? So, these *are* issues and to pretend that they don't arise at all and the entire thing is decided purely academically on the basis of economics is a little naïve. I think we need to discuss that also.

We talk of incentivising the states, and possibly, it is perhaps possible because the centre does hold considerable power over them. But what do we do about the centre? Is there any way of the incentivising the centre at all? Unless the politicians themselves feel sufficiently responsible and as I said that does not seem to be happening.

There is also this issue of whether India can leapfrog from an agrarian to a service economy, bypassing the manufacturing stage that other economies have done, or been through. I think this is a debate that surfaces periodically. I would just invite all of you to look at one of the recent issues of the *London Economist* that talked about how there is a complete blurring of the sharp divide between manufacturing and services. So a lot of what used to be regarded

as manufacturing earlier is now regarded as services. Do we then need to get so worried about the fact that manufacturing doesn't seem to have been growing that fast? I think what we do need to worry about more is the fact that a pretty large section of our population, more then 60 per cent is depending on a smaller and smaller share of agricultural income.

Agricultural income is just about a little over 20 per cent of India's GDP. But the share of people dependent on agriculture has not declined significantly. That is more worrisome as it means that more and more people are being squeezed into a smaller and smaller share of the GDP pie. What is important is that we need to move people away from agriculture or rural livelihoods into non-farm kinds of employment. If we can do that, it really doesn't matter whether it is to services or to manufacturing, because increasingly manufacturing has also become very capital-intensive. One really does not have the kind of job opportunities. The idea that blue collar employment can increase and that services don't employ that many, I don't think is entirely correct because if one looks at the entire BPO sector, the people one is employing over there are just college kids, some of them are graduates, but not all. In a lot of smaller towns, two-tier, three-tier cities like Bulandhshahr and Meerut, one finds people getting employment in these so-called services sectors. I don't think the services net growth per se is that bad a model. But whether it can work or not, we still have to wait and watch.

Now I'll come to a couple of issues where I am not in complete agreement with Prof. Rao. He talks of the high fiscal deficit constraining capital account convertibility. I agree with him, yes, that possibly is a factor, but I am not so sure that lack of capital account convertibility has done us much harm, because as far as non-residents and foreigners are concerned, there is complete capital account convertibility. And even for residents- I think all of us are now allowed to take pretty large amounts of money out of the country. The problem is that most of us really don't have that kind of money to take out of the country! So I am not so sure capital account convertibility needs to be an issue.

On the issue of the oil price hike, yes, Dr Rao does refer to the fact that the oil price hike was not allowed to go through. The price effect was not passed entirely, and some amount of it will be seen on the fiscal front either by way of a higher oil pool deficit, whatever you call it–oil pool bonds, or whether in terms of lower profits of the oil PSUs. But I think another factor that perhaps

very few people have discussed is that because the price effect was not allowed to go through, the demand compression that would have been a natural corollary of a price hike has not occurred in the case of petroleum.

On the issue of credit-deposit (CD) ratios, I think perhaps more importance has been given to the CD ratios than warranted for the simple reason that the way CD ratios are constructed are not reflective of the ground realities. Take the case of the POSCO Investment in Orissa. I don't think POSCO would be looking for bank loans, but to give an example, if it were to look for a bank loan, typically that advance would be booked at the industrial advances branch, maybe in the Mumbai branch of the State Bank of India. So in the Bombay main branch it would go towards Maharashtra's CD ratio, though actually the advance has been made in Orissa.

Moreover, if you accept that banks are commercial entities and are not instruments to achieve ends of social justice, than it is little unfair to expect banks to lend in a state where prospects are poor. The whole idea of financial sector reform was to move away from that concept where you use banks to achieve social ends. If there are any social ends to be achieved, it is better it is done directly through the budget, rather than by distorting the financial structure and expecting banks to do it. What happens, if a bank lends to a project which is not viable, then obviously ultimately it will not get the money back. And since these are public sector banks and ultimately it is the taxpayers money that goes to bail them out, it creates a whole lot of distortions in the interim period. So it is far better to do it directly through the budget, I feel.

There was reference to the centre and the states having concurrent powers to tax. This will take care of the vertical imbalance to some extent and the finance commission can take care of the horizontal balance to ensure that there is minimum meritorious service. My only dilemma is how do I ensure minimum meritorious service in a state like Bihar or Uttar Pradesh? One can ensure transfer of money, but how does one ensure that it translates into minimum meritorious service. Unless the people of the state demand that service and unless there is sufficient accountability from the politicians, that is going to be pretty difficult.

I think I entirely agree with Dr Rao on the way he has ended his paper, with a poser: will the government heed his warning that the fiscal situation needs immediate attention because neither the

low interest regime of the past nor high growth alone is going to take care of the issue of debt sustainability, nor will it mitigate the risk of a short term crisis? I think that needs to be taken very seriously.

So far we have got along fairly well and that is really the problem. Nothing concentrates our minds so much as a crisis. Fortunately or unfortunately for us, we have somehow managed to get by without a very major crisis, and then that kind of makes us believes things can continue like that for ever. They clearly can't. I think all of us need to chew on that very, very carefully.

Annexure

Table A.1: Growth of GDP in the Tenth Plan: Quarterly Estimates

		2002-03					2003-04					2004-05			
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4
A. Agriculture, forestry & fishing	**-7.0**	**-0.6**	**-4.0**	**-12.5**	**-8.0**	**9.6**	**0.1**	**7.2**	**18.2**	**10.4**	**1.1**	**3.8**	**0.0**	**-0.5**	**1.8**
B. Mining, manufacturing, Electricity and Construction	**6.6**	**5.3**	**7.3**	**6.9**	**6.8**	**6.6**	**5.8**	**6.4**	**6.4**	**7.7**	**7.7**	**7.1**	**8.2**	**8.8**	**6.7**
1. Mining & quarrying	9.0	11.9	10.2	7.6	7.0	6.4	4.5	4.1	5.9	10.7	4.5	6.9	4.7	4.5	2.5
2. Manufacturing	6.5	4.3	7.0	7.1	7.6	6.9	6.1	6.9	7.0	7.6	9.2	7.9	9.6	10.5	8.6
3. Electricity, gas & water supply	3.1	3.6	3.1	4.1	1.5	3.7	3.0	1.1	3.0	7.6	5.5	6.1	9.1	4.4	2.6
4. Construction	7.3	6.7	9.1	7.0	6.6	7.0	6.6	8.4	6.5	6.6	5.2	5.0	4.6	7.2	4.1
C. Services	**7.91**	**8.13**	**8.59**	**7.48**	**7.56**	**9.06**	**7.82**	**10.7**	**9.85**	**7.95**	**8.94**	**9.49**	**8.06**	**8.91**	**9.27**
1 Trade, hotels, transport & Communication	9.8	9.3	10.3	8.9	10.6	11.8	8.0	10.4	13.5	14.6	11.4	11.5	12.3	10.8	11.1
2. Financing, insurance, real estate & Business Services	8.7	9.4	9.6	8.5	7.4	7.1	6.4	7.2	7.3	7.6	7.1	7.0	5.5	8.2	7.7
3. Community, social & Personal Services	3.9	4.6	4.6	3.8	3.0	5.8	9.0	14.9	5.2	-2.9	5.9	8.2	3.0	5.6	7.2
GDP at factor cost	**4.0**	**5.2**	**5.8**	**1.6**	**3.8**	**8.5**	**5.5**	**8.8**	**11.0**	**8.4**	**6.9**	**7.6**	**6.7**	**6.4**	**7.0**

Note: Q1: April-June, Q2:July-September, Q3: October-December, Q4: January-March
Source: http://mospi.nic.in/t1_1996_2003q2.htm

Table A.2: Savings and Investment in Indian Economy

Year	Savings				Net Capital Inflow	Gross domestic Capital Formation	Errors and Omissions	Gross Capital Formation			
	House holds	Corporate	Public	Total				House holds	Corporate	Public	Total
1971-72	10.7	1.6	2.8	15.1	1.0	16.0	-0.9	7.5	2.5	7.0	16.9
1975-76	11.7	1.3	4.2	17.2	-0.1	17.1	-1.9	7.0	2.6	9.4	19.0
1981-82	12.6	1.5	4.5	18.6	1.5	20.1	-2.3	6.9	5.4	10.1	22.4
1986-87	14.5	1.7	2.7	18.9	2.0	21.0	-2.2	7.0	5.0	11.2	23.2
1991-92	17.0	3.1	2.0	22.0	0.5	22.6	0.6	7.4	5.7	8.8	21.9
1995-96	18.2	4.9	2.0	25.1	1.7	26.9	0.4	9.3	9.6	7.7	26.5
2000-01	21.6	4.1	-2.3	23.5	0.4	23.8	1.2	11.3	5.1	6.3	22.6
2001-02	22.6	3.6	-2.7	23.4	-0.8	22.6	0.4	11.4	4.6	6.2	22.2
2002-03*	23.3	3.8	-1.1	26.1	-1.3	24.8	2.1	13.0	4.3	5.4	22.7
2003-04#	24.3	4.1	-0.3	28.1	-1.8	26.3	3.3	13.0	4.5	5.6	23.0

Note: * Provisional estimates. # Quick estimates.

Source: Handbook of Statistics on the Indian Economy.

Table A.3: Fiscal Indicators of Central and State Governments

Year	Gross Fiscal deficit			Gross Primary deficit			Revenue deficitPer			Developmental cent of revenue to fiscal	Per cent Expenditure			of total liabilit-ies to GDP
	Centre	States	Total	Centre	States	Total	Centre	States	Total	deficit	Centre	States	Total	
1990-91	7.85	3.30	9.4	4.07	1.78	5.0	3.26	0.93	4.2	44.7	10.3	11.1	17.1	64.4
1995-96	5.07	2.65	6.5	0.86	0.80	1.6	2.50	0.69	3.2	49.2	7.1	9.7	13.9	61.2
1996-97	4.88	2.72	6.4	0.53	0.85	1.3	2.39	1.18	3.6	56.3	6.9	9.6	13.5	59.8
1997-98	5.84	2.90	7.3	1.53	0.93	2.1	3.05	1.07	4.1	56.2	7.3	9.5	13.7	61.9
1998-99	6.51	4.27	9.0	2.04	2.20	3.7	3.85	2.51	6.4	71.1	7.9	9.4	13.8	63.0
1999-00	5.41	4.72	9.5	0.75	2.39	3.8	3.49	2.78	6.3	66.3	6.7	9.7	14.2	66.0
2000-01	5.69	4.28	9.6	0.93	1.81	3.6	4.08	2.56	6.6	68.8	6.7	10.1	14.8	70.4
2001-02	6.20	4.23	9.9	1.47	1.47	3.7	4.41	2.61	7.0	70.7	7.0	9.5	14.6	75.8
2002-03	5.89	4.15	9.5	1.11	1.30	3.1	4.38	2.24	6.6	69.5	7.5	9.3	14.6	80.0
2003-04	4.47	4.40	8.4	-0.03	1.47	2.0	3.56	2.22	5.8	69.0	7.1	9.9	14.9	81.1
2004-05*	4.48	3.84	8.3	0.43	1.03	2.2	2.74	1.39	4.1	49.4	7.1	9.9	14.9	82.0
2005-06**	4.34	3.07	7.7	0.49	0.42	1.7	2.74	0.70	3.4	44.2	6.5	9.2	13.7	81.3

Note: * Revised estimates; **Budget estimates

Source: Indian Economic Statistics 2003-04, Ministry of Finance, Government of India.

Table A 4: Fiscal Performance of the Central Government

	Direct	Indirect	Total	Total Revenue	Rev. Exp	Cap. Exp.	Revenue Def	Prim. Def	Fiscal Def.	Loans to States	Net FD	Net PD
1990-91	1.94	8.19	10.12	9.66	12.93	5.59	3.26	4.07	7.85	2.50	5.35	1.57
1991-92	2.35	7.96	10.31	10.11	12.60	4.46	2.49	1.49	5.56	2.03	3.53	-0.54
1992-93	2.42	7.55	9.97	9.91	12.39	4.00	2.48	1.22	5.37	1.76	3.61	-0.54
1993-94	2.36	6.45	8.82	8.78	12.59	3.92	3.81	2.74	7.01	1.86	5.16	0.88
1994-95	2.66	6.45	9.11	8.99	12.06	3.81	3.07	1.35	5.70	1.92	3.78	-0.57
1995-96	2.83	6.54	9.36	9.27	11.77	3.23	2.50	0.86	5.07	1.65	3.42	-0.79
1996-97	2.84	6.57	9.41	9.23	11.62	3.08	2.39	0.53	4.88	1.70	3.18	-1.17
1997-98	2.67	5.97	9.14	8.79	11.84	3.40	3.05	1.53	5.84	1.97	3.87	-0.44
1998-99	2.68	5.58	8.26	8.59	12.43	3.61	3.85	2.04	6.51	2.25	4.26	-0.22
1999-00	2.99	5.88	8.87	9.37	12.86	2.53	3.49	0.75	5.41	1.06	4.35	-0.31
2000-01	3.27	5.76	9.03	9.22	13.30	2.29	4.08	0.93	5.69	0.89	4.80	0.05
2001-02	3.03	5.16	8.20	8.82	13.21	2.67	4.39	1.47	6.18	0.93	5.25	0.54
2002-03	3.36	5.39	8.76	9.35	13.72	3.02	4.37	1.10	5.87	1.00	4.88	0.11
2003-04	3.79	5.39	9.18	9.52	13.06	3.94	3.54	-0.01	4.46	0.86	3.61	-0.87
2004-05	4.33	5.56	9.89	9.73	12.48	3.87	2.75	0.43	4.50	0.83	3.67	-0.40
2005-06	5.03	5.50	10.53	9.99	12.70	1.93	2.71	0.49	4.30	0.02	4.28	0.47

Note: * Revised estimates; **Budget estimates

Source: *Indian Economic Statistics 2003-04,* Ministry of Finance, Government of India.

Table A 5: Combined Revenues

	Total Tax Revenue	Direct Taxes					Indirect Taxes							
		Corporate	Personal Tax	Tax on Agricultural Income	Other Taxes	Total	Custom	Union Excise Duties	State Excise Duties	Stamps and Registration Fee	Sales Tax	Taxes on	Other Taxes (includes Service Tax)	Total
1980-81	13.80	0.91	1.05	0.14	0.17	2.27	2.37	4.52	0.62	0.30	2.82	0.50	0.39	11.53
1981-82	14.32	1.17	0.88	0.16	0.25	2.45	2.55	4.40	0.71	0.31	3.03	0.47	0.39	11.87
1982-83	14.47	1.16	0.83	0.14	0.26	2.39	2.72	4.28	0.76	0.32	3.04	0.54	0.42	12.08
1983-84	14.36	1.14	0.77	0.14	0.19	2.24	2.54	4.66	0.76	0.30	2.97	0.51	0.39	12.13
1984-85	14.59	1.04	0.79	0.17	0.18	2.17	2.87	4.54	0.79	0.29	3.01	0.50	0.41	12.42
1985-86	15.56	1.03	0.90	0.17	0.14	2.25	3.43	4.66	0.79	0.32	3.17	0.51	0.45	13.32
1986-87	15.92	1.02	0.93	0.15	0.12	2.21	3.69	4.65	0.82	0.33	3.23	0.53	0.46	13.71
1987-88	16.08	0.97	0.90	0.14	0.10	2.11	3.87	4.64	0.85	0.36	3.30	0.54	0.41	13.97
1988-89	15.88	1.05	1.02	0.16	0.10	2.31	3.75	4.47	0.78	0.36	3.26	0.53	0.42	13.56
1989-90	15.98	0.97	1.04	0.16	0.12	2.30	3.71	4.61	0.83	0.39	3.24	0.49	0.41	13.68
1990-91	15.43	0.94	0.95	0.14	0.14	2.16	3.63	4.31	0.88	0.37	3.22	0.47	0.38	13.27
1991-92	15.80	1.20	1.03	0.13	0.19	2.55	3.41	4.30	0.88	0.42	3.37	0.47	0.41	13.25
1992-93	15.26	1.19	1.06	0.10	0.25	2.59	3.18	4.12	0.88	0.40	3.23	0.47	0.40	12.66
1993-94	14.19	1.17	1.06	0.10	0.20	2.53	2.58	3.69	0.86	0.42	3.30	0.47	0.35	11.67
1994-95	14.60	1.36	1.19	0.12	0.18	2.85	2.65	3.69	0.77	0.49	3.28	0.45	0.42	11.75

1995-96	14.75	1.39	1.31	0.01	0.30	3.01	3.01	3.38	0.73	0.50	3.01	0.44	0.67	11.74
1996-97	14.62	1.36	1.33	0.01	0.30	3.00	3.13	3.29	0.65	0.46	3.23	0.42	0.43	11.62
1997-98	13.99	1.31	1.12	0.01	0.37	2.82	2.64	3.15	0.75	0.47	3.23	0.45	0.48	11.17
1998-99	13.38	1.41	1.16	0.01	0.24	2.82	2.34	3.06	0.78	0.43	3.07	0.40	0.49	10.56
1999-00	14.18	1.58	1.32	0.01	0.22	3.14	2.50	3.20	0.78	0.44	3.24	0.43	0.45	11.03
2000-01	14.61	1.71	1.52	0.00	0.20	3.43	2.28	3.28	0.76	0.45	3.50	0.41	0.51	11.18
2001-02	14.55	1.60	1.40	0.00	0.20	3.20	1.77	3.95	0.76	0.49	3.39	0.50	0.50	11.35
2002-03 (RE)	15.62	1.81	1.51	0.00	0.18	3.51	1.84	4.32	0.79	0.55	3.53	0.52	0.56	12.12
2003-04(BE)	15.81	1.86	1.59	0.00	0.19	3.64	1.78	4.25	0.80	0.55	3.59	0.56	0.65	12.17

2011

2013

The mid-year review of the Indian economy for 2005-2006 presents the economic scenario with cautious optimism. The return to buoyant performance of the manufacturing sector, the continuing buoyancy of the services sector, the sharp increase in the savings rate and the creditable performance of exports present an optimistic picture of the Indian economy. Despite the severe fiscal imbalance, sharply increasing oil prices and a poor political climate for reforms, the economy has registered a growth of over 8 per cent in the first half of the current year.

The high performance of the economy consecutively for three years despite several constraints has given the impression that the economy has reached a higher growth trajectory. Such an assessment, however, would be premature and the review highlights several risks which have dragged the economy such as the continuing fiscal imbalance, infrastructure bottlenecks, perverse incentives and governance problems. Nevertheless, achieving 8 per cent growth during the Eleventh Plan is within the realm of feasibility, but that is possible only if the pace of reforms is accelerated. Restoration of fiscal balance, improving infrastructure, addressing labour laws, small scale industry dereservation, improving the efficiency of the financial sector, creating an enabling environment for investment and productivity increase in agriculture and addressing the problems of lagging regions are some of the measures needed for sustained high growth.

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