

*SABER Research Project Conference on
Efficiency of Economic Policy Formation, Development and Implementation in
Key South Asian Economies
India International Centre, New Delhi
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*Public Finance and Taxation
Reforms in India*

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The Focus

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

Presentation sequence

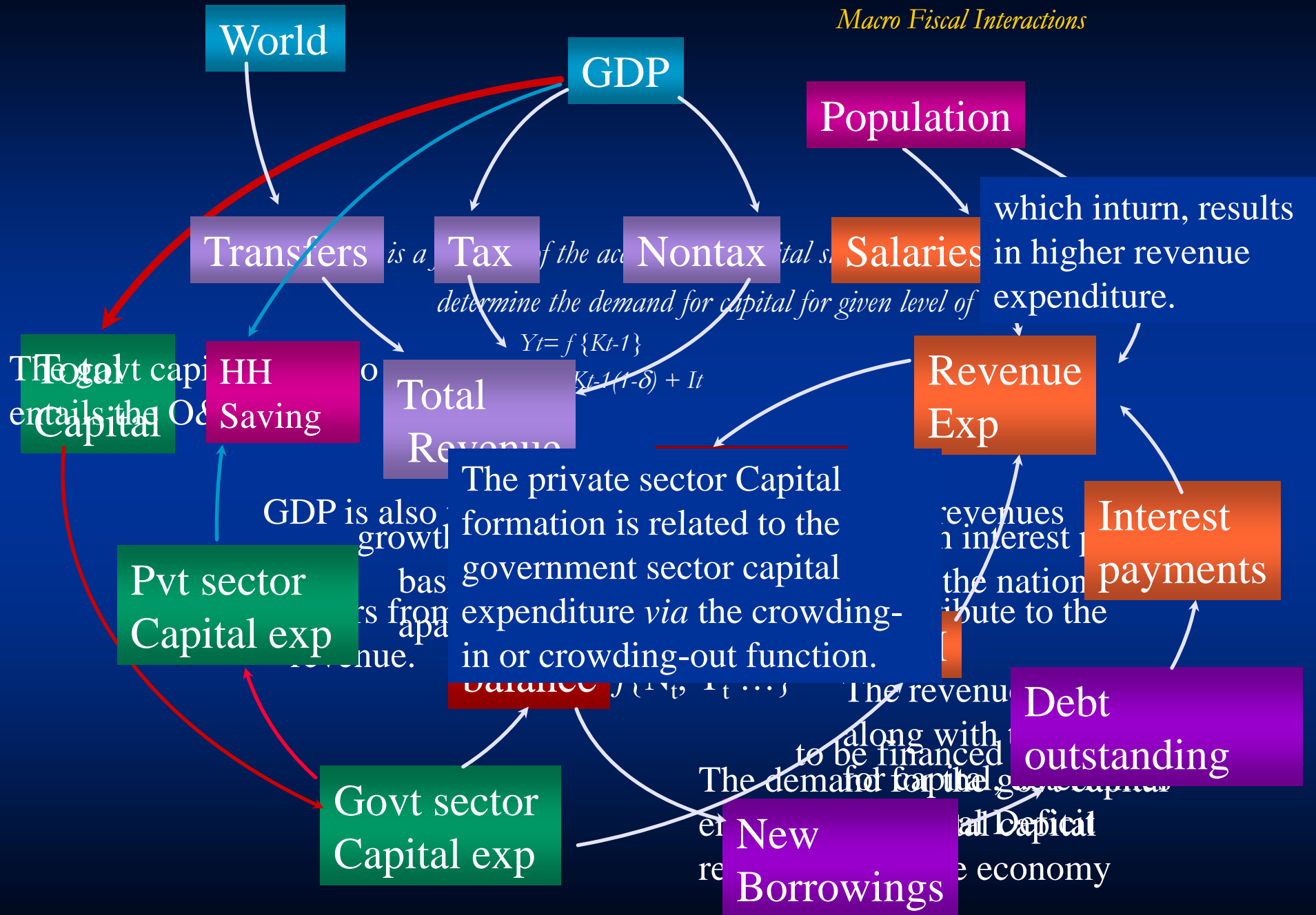
- *PFM and Development Strategy*
- *Land mark Reforms of 90s, paradigm change*
- *Trends in the Fiscal Components*
- *Analysis of the Tax Policy Evolution*
- *The Unfinished Agenda and likely Institutional hurdles.*

*Public Finance Management
& Development Strategy*

Nature of PFM

- *Development strategy options for India at the time Independence*
 - *Market orientation vs government intervention*
- *Choice towards the Mixed economic framework*
- *With bias towards heavy industry and dominant role for public sector*
- *Pronounced bias against foreign trade*
- *Socialistic pattern of development*
- *Federal Fiscal Sharing*
- *PFM not easy.*

Macro Fiscal Interactions



Key Requirements for mixed development strategy to work

- Need for Private-Public Macro Balancing
- Determining the respective areas of activities to achieve crowding in,
- Allocation of resources, avoiding crowding out
- Efficient government sector management
- Regulating the Private sector



Pre-90 Policy Stance: Problems

- *Development strategy too much centered on direct intervention of the state*
 - *in terms of providing direction, controls, regulation and even direct participation in economic activities.*
- *Inefficient, high cost and non-competitive industrial structure;*
- *Serious infrastructure bottlenecks*
- *Significant constraints on the availability of financial capital.*

*The Landmark Reforms of
90s*

The BoP Crisis of 1991: The fire-fighting

- *Cutting of Fiscal Deficit through special financing from IMF*
- *Trade and Industrial liberalization*
- *Tax Reform*
- *Crisis — catalytic for a paradigm shift in the tax policy*

Structural reforms since early 90's

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

Visible shifts in the economic Growth pattern

- *From a modest 3% till 70s to over 5.8% in later decades*



The Recovery path

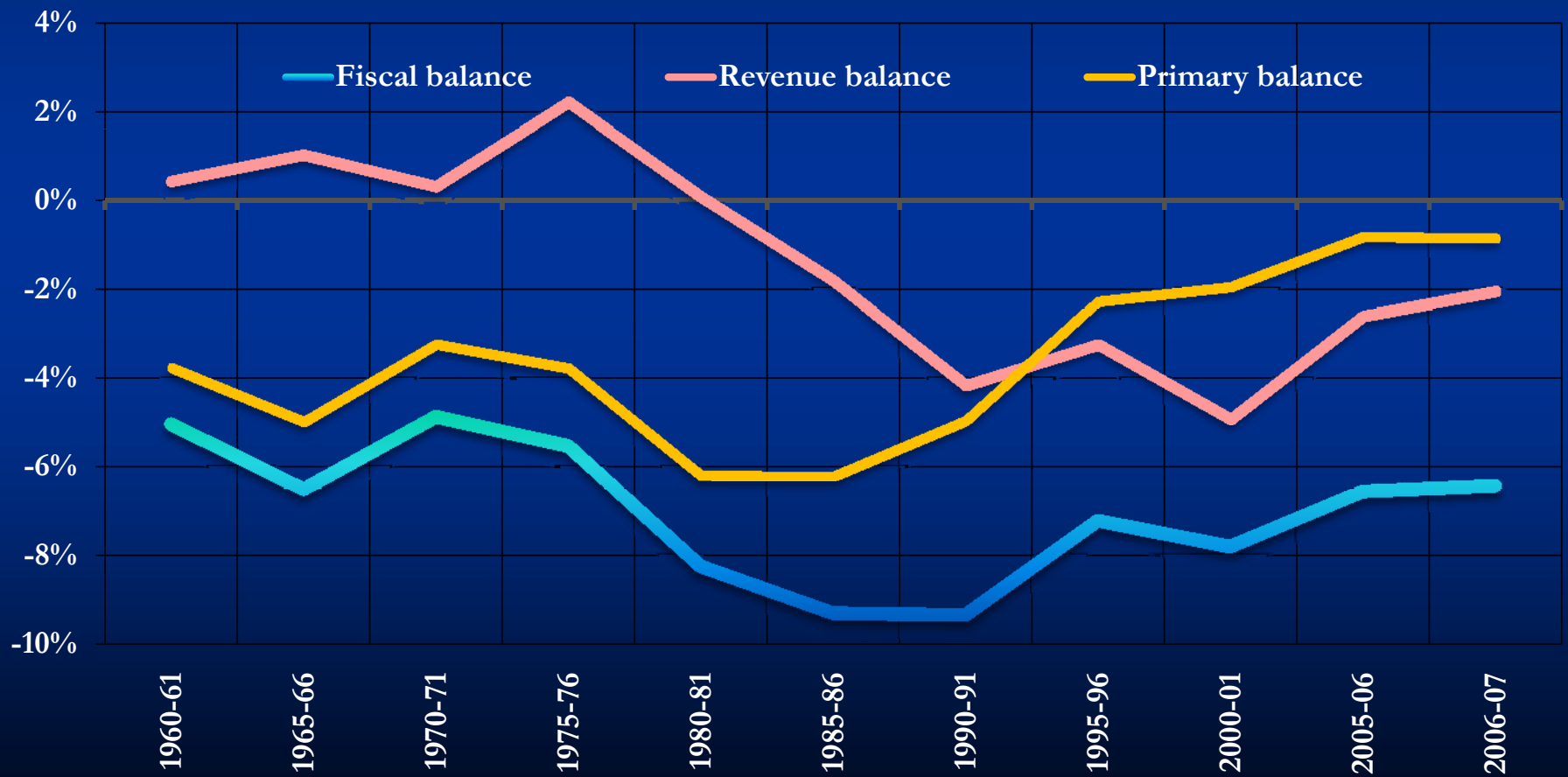
- *Real investment growth reaches 40% by 2000-01*
- *Growth in industrial investment touches > 50%*
- *Export growth touches >20%*
- *Increase in per capita GDP*
- *India the second fastest growing economy today .*

Trends in Fiscal Components

Continued Fiscal Downtrends: A Road Block to Development

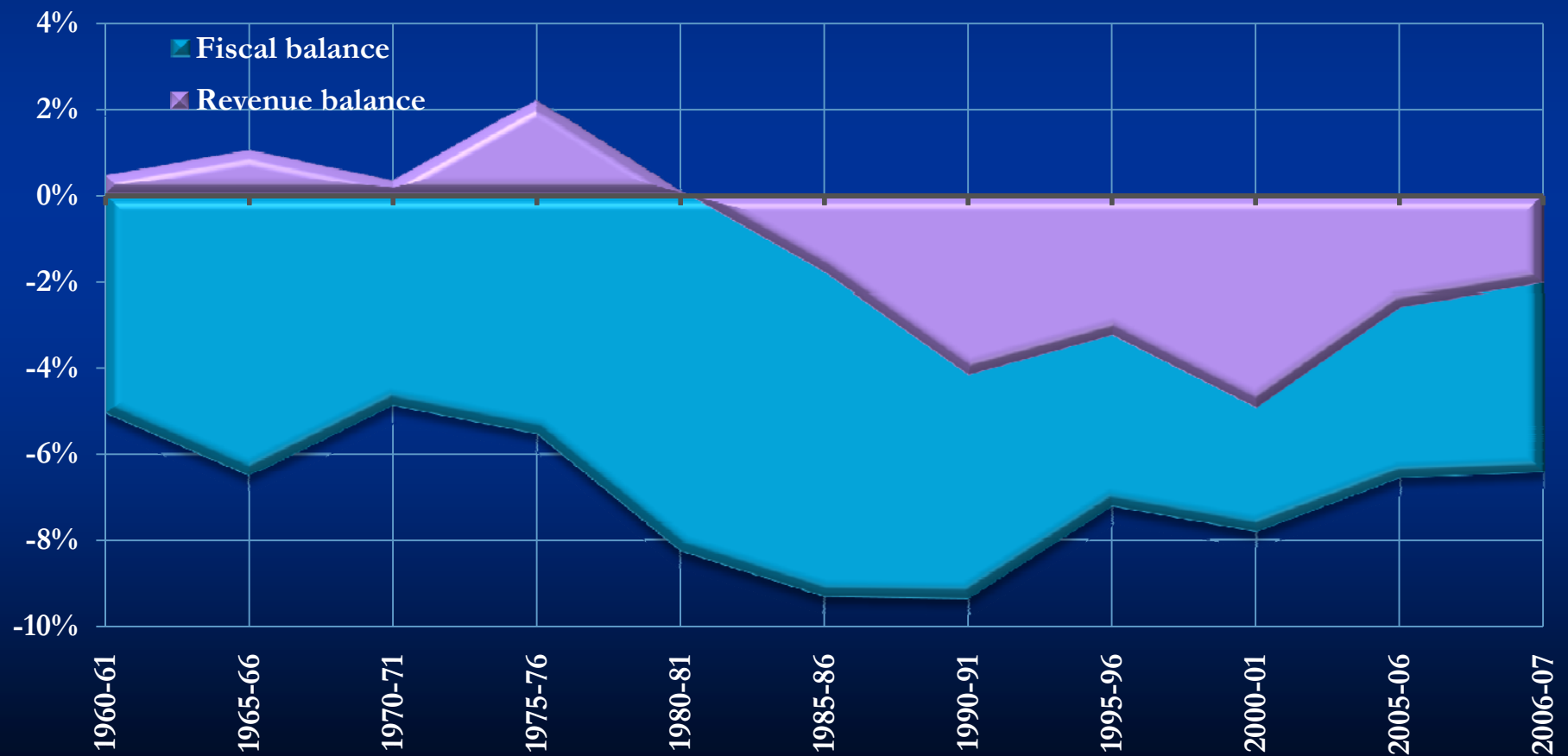
- *Narrow tax base*
- *Low, stagnant tax/GDP ratio*
- *Impact of the Pay Commission*
- *Rising interest burden*
- *Growing revenue deficit*
- *Growing fiscal deficit*
- *Declining capital expenditure*

High fiscal deficits (Centre & States)



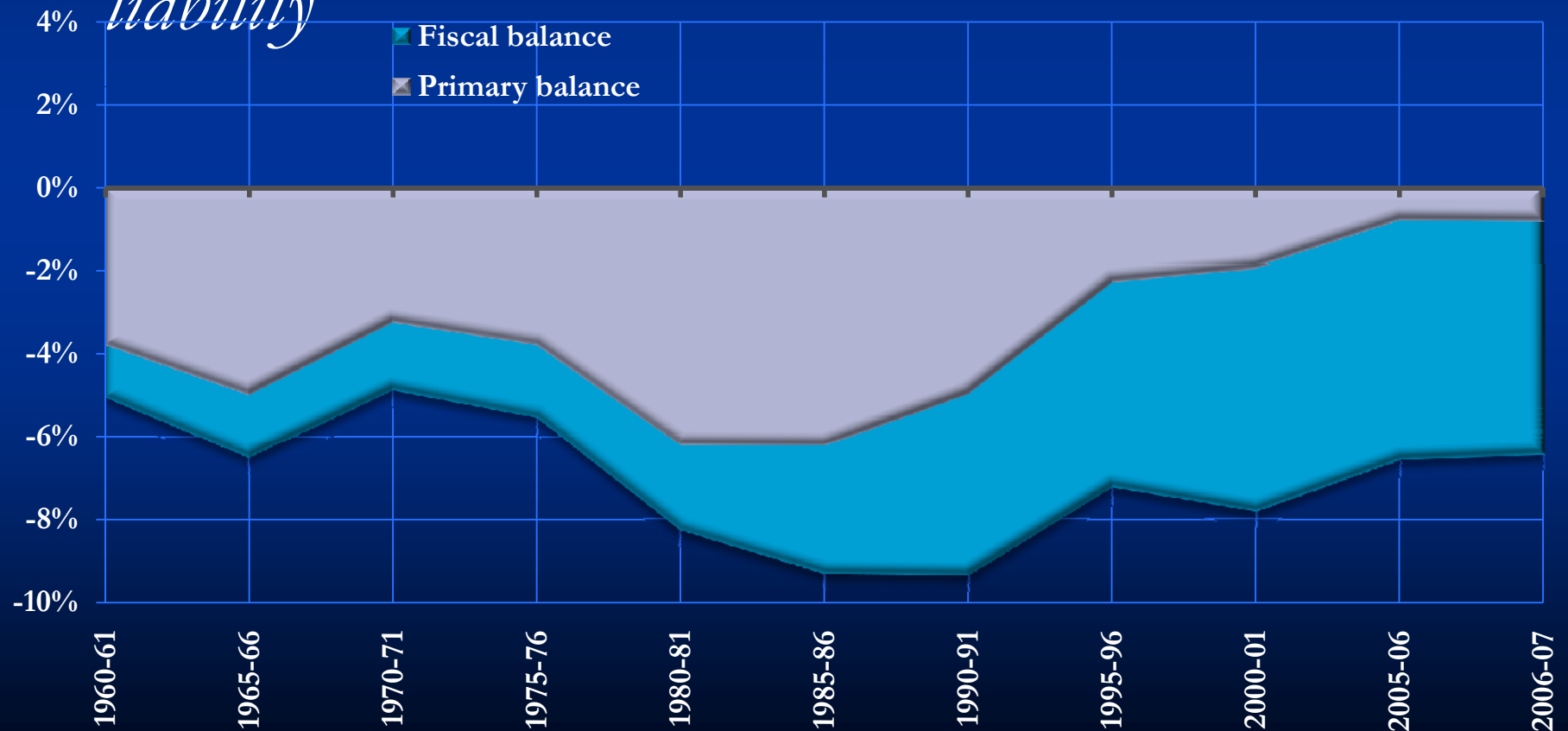
The Quality of Fiscal Deficit: A cause for worry

■ *Firstly, the fiscal deficit driven by revenue deficits.*

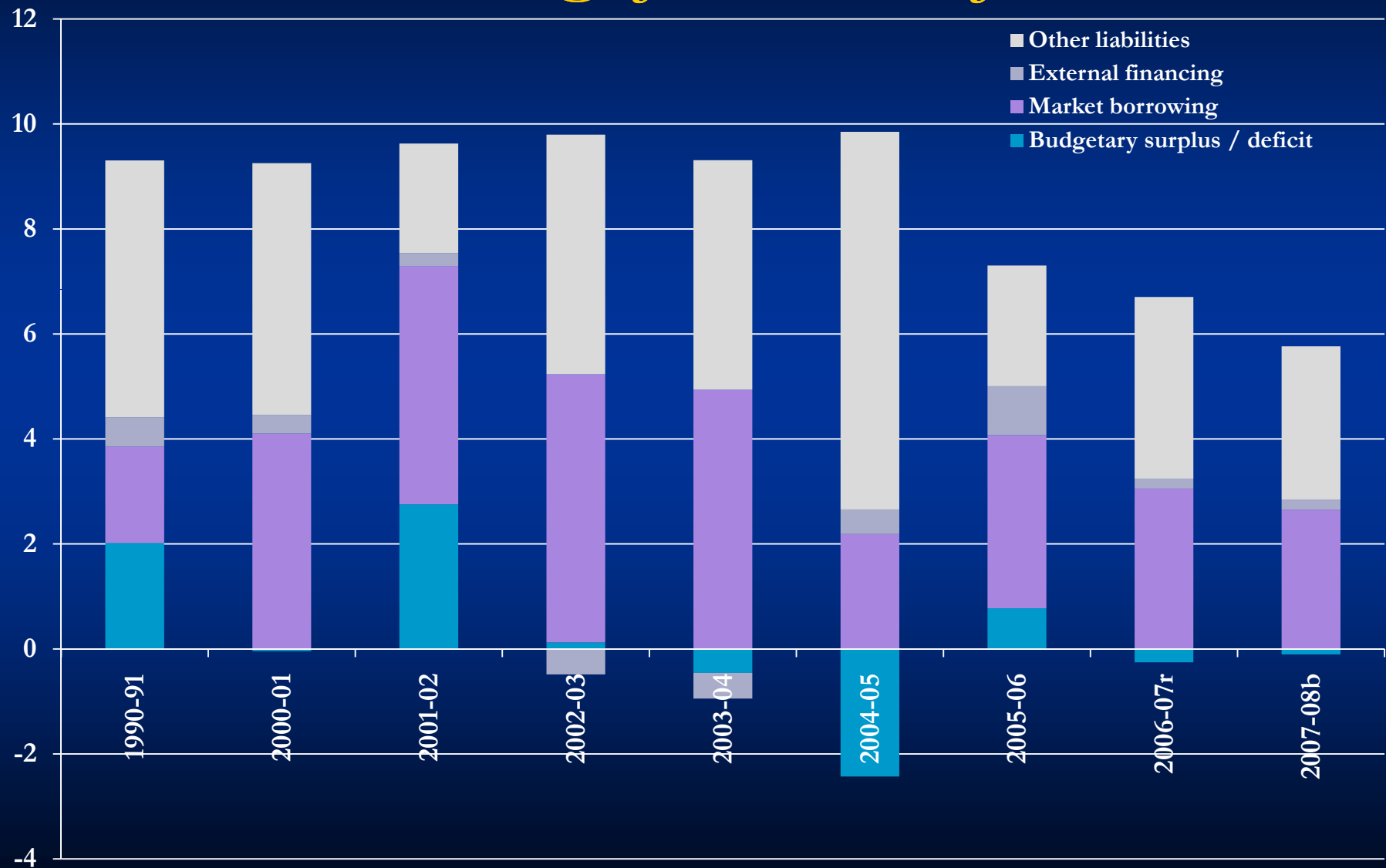


The Quality of Fiscal Deficit: A cause for worry

- *Secondly, a significant increase in debt service liability*



Financing of Fiscal Deficit



The Tax Policy Evolution

General

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

Tax policy constraints in pre-90s

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

The Resultant weaknesses

- *Anti-foreign trade regime — high customs and export duties*
- *High progressivity — personal income tax*
- *High tax rate differentiation — corporate tax, union excise, customs*
- *Plethora of exemptions, concessions, deductions, rebates and preferences*
- *Federal fiscal sharing further complicates*
- *Resulting tax complexity, difficult to manage*

Pre-90s Tax Reform under systemic constraints

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

- *The TEC (1954) – first comprehensive attempt after Independence*
- *Kaldor Committee (1956) – Expenditure tax and move towards integrated taxation*
- *DTEC (1971) – Reduction in income tax rates, and slabs*
- *ITEC (1977) – Moves in the direction of VAT introduction at the Central level*
- *The LTFP (1985) – advocated reduction of customs, rationalize excise – partially implented.*

*The Landmark Tax
Reforms of 90s*

The TRC (1991)

■ *Three reports –*

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

Basic principles underlying the recommendations

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

Major concrete recommendations

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

Major concrete recommendations

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

Major concrete recommendations

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

Implementation

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

The Aftermath of TRC Tax Reforms

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

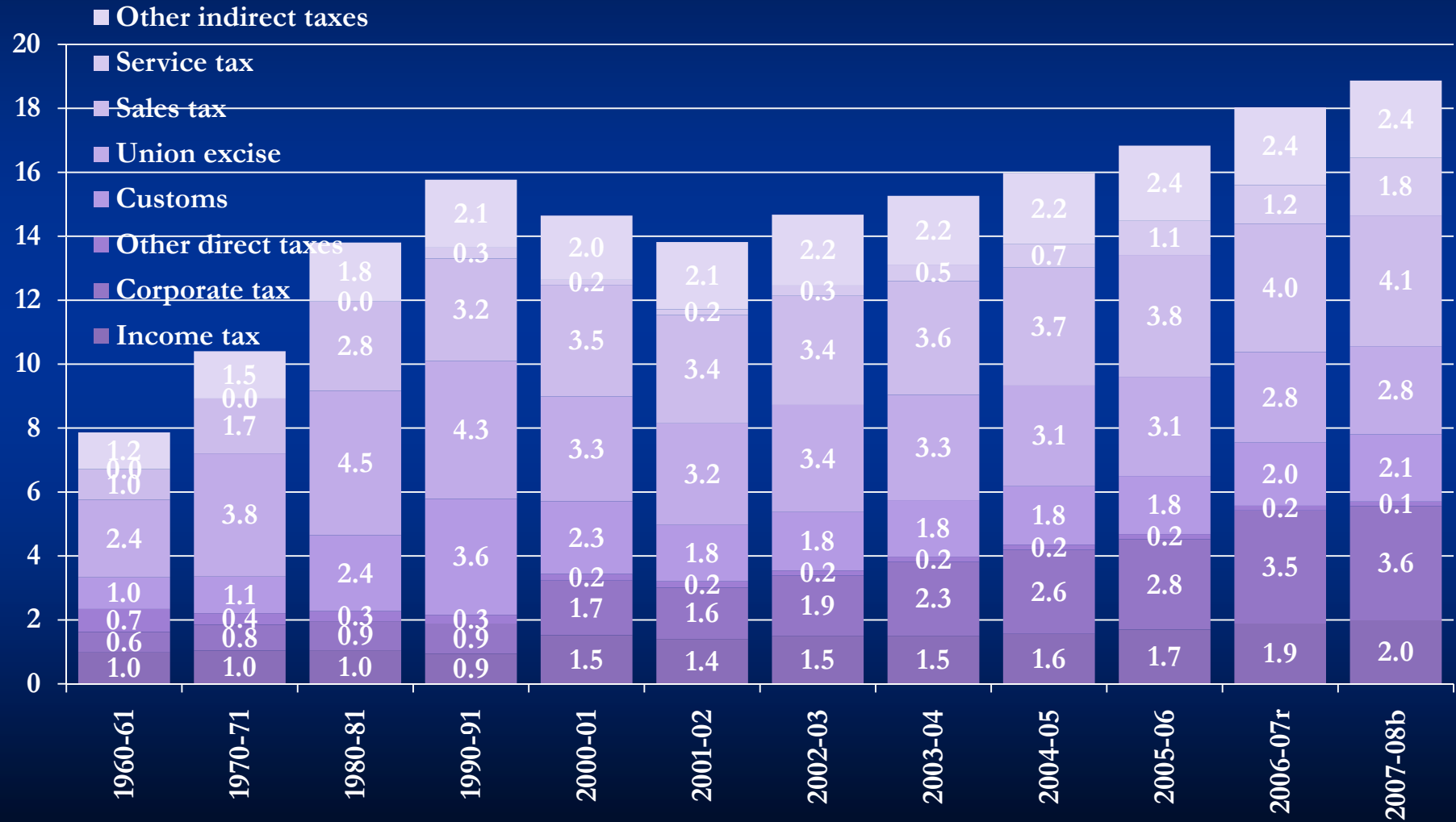
Economic performance in the 21 century

- *Striking till the Crises*
- *The Crises and their impact*
- *Rise in Petroleum price and other commodities — rising inflation*
- *The Financial Crisis*
- *Series of monetary and fiscal measures*

Combined Receipts and Disbursements of the

		1960- 61	1970- 71	1980- 81	1990- 91	2000- 01	2001- 02	2002- 03	2003- 04	2004- 05	2005- 06	2006- 07r	2007- 08b
I	Total Disbursements	15.4	17.7	24.9	26.8	26.1	26.5	26.7	27.1	26.1	25.9	27.0	27.3
A	Revenenu expenditure	9.9	12.5	16.5	21.6	23.0	23.5	23.8	23.6	22.1	21.9	22.6	21.9
	Interest payments	1.3	1.6	2.1	4.4	5.8	6.1	6.2	6.3	6.0	5.6	5.4	5.2
	Defence	1.4	2.3	2.5	1.9	1.8	1.7	1.7	1.6	1.4	1.3	1.2	1.1
	Subsidies	0.0	0.0	0.6	1.2	1.0	1.1	1.3	1.3	1.1	1.0	1.0	0.9
B	Capital expenditure	5.7	4.7	7.7	5.3	5.3	5.5	4.5	5.8	5.7	6.4	7.0	8.0
II	Total Receipts	10.0	12.8	16.4	17.6	17.0	16.5	17.3	17.9	18.4	19.2	20.3	20.5
A	Revenue receipts	10.0	12.8	16.4	17.6	17.0	16.5	17.3	17.9	18.4	19.2	20.3	20.5
	(i												
) Tax	7.9	10.4	13.8	15.4	14.6	13.8	14.5	15.0	15.7	16.4	17.7	18.1
	Direct	2.3	2.2	2.3	2.2	3.4	3.2	3.5	4.0	4.4	4.7	5.6	5.7
	Indirect	5.5	8.2	11.5	13.6	11.2	10.6	11.1	11.3	11.6	12.2	12.5	11.4
	(i												
	i) Nontax	2.2	2.4	2.6	2.2	2.4	2.7	2.8	2.8	2.7	2.8	2.6	2.4
	Interest receipts	0.0	0.0	1.2	1.1	0.8	0.7	0.7	0.7	0.6	0.6	0.4	0.4
	PSU dividends etc	0.4	0.2	0.2	-0.1	0.5	0.7	0.8	0.8	0.5	0.7	0.7	0.7
	Others	1.8	2.2	1.3	1.2	1.0	1.3	1.3	1.3	1.7	1.5	1.4	1.3
	Nondebt capital												
B	receipts												
III	Gross fiscal deficit	-5.3	-4.9	-8.4	-9.2	-9.1	-10.0	-9.4	-9.2	-7.6	-6.8	-6.7	-6.8

Tax Composition

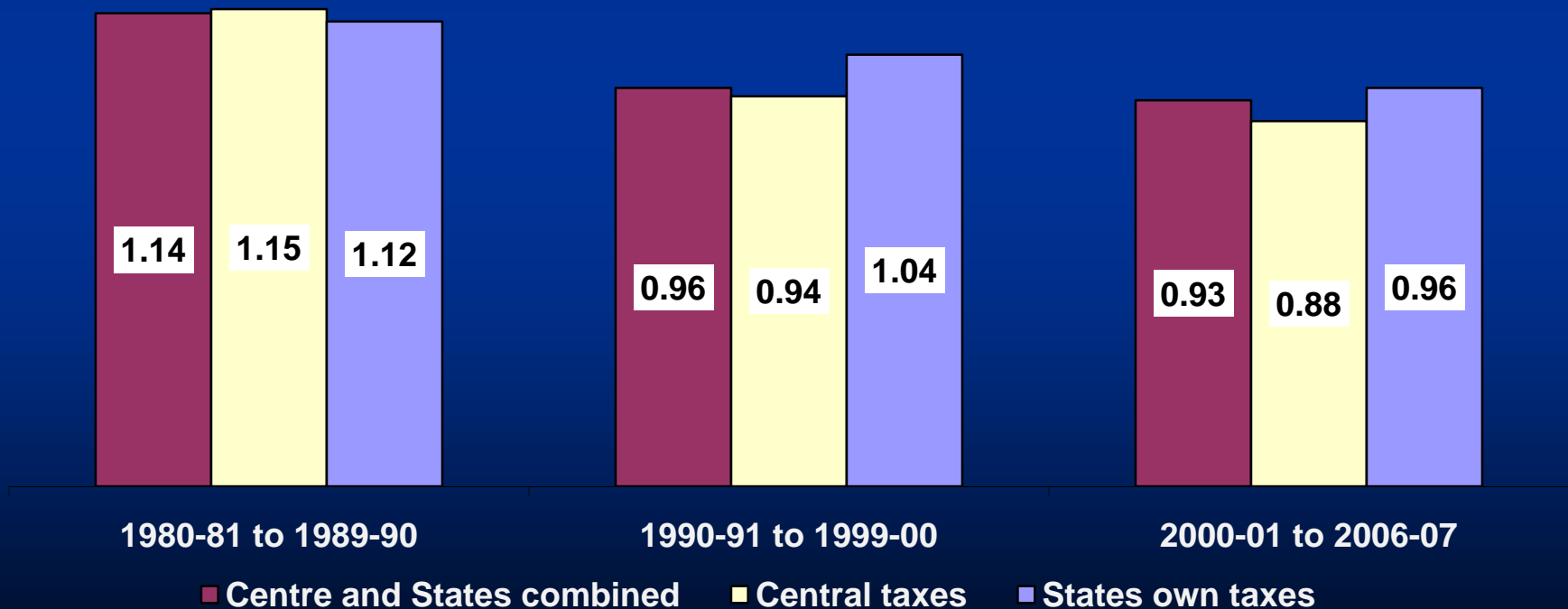


Shortfalls in Central Tax Collections

- *Tax collections below targets*
- *The drop affecting the flow of tax devolution to the States*

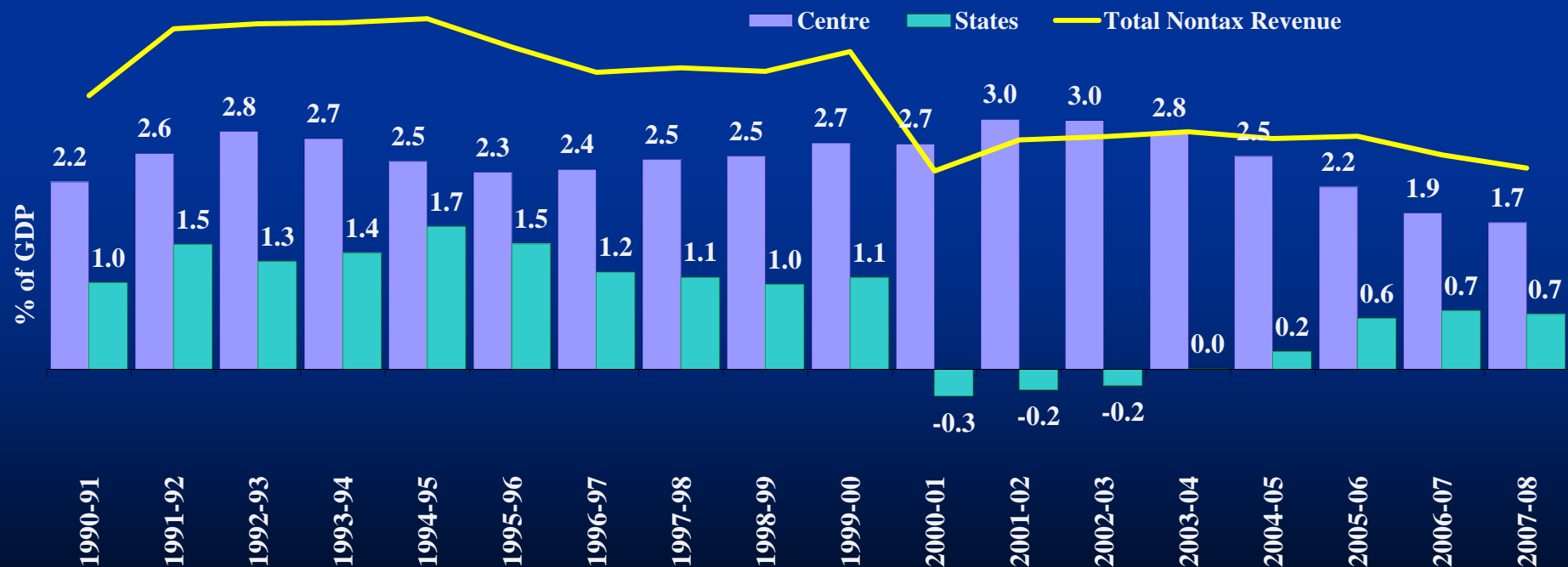
Tax buoyancy: Centre & States

- *Stagnation in tax/GDP ratio even prior to the present recession.*

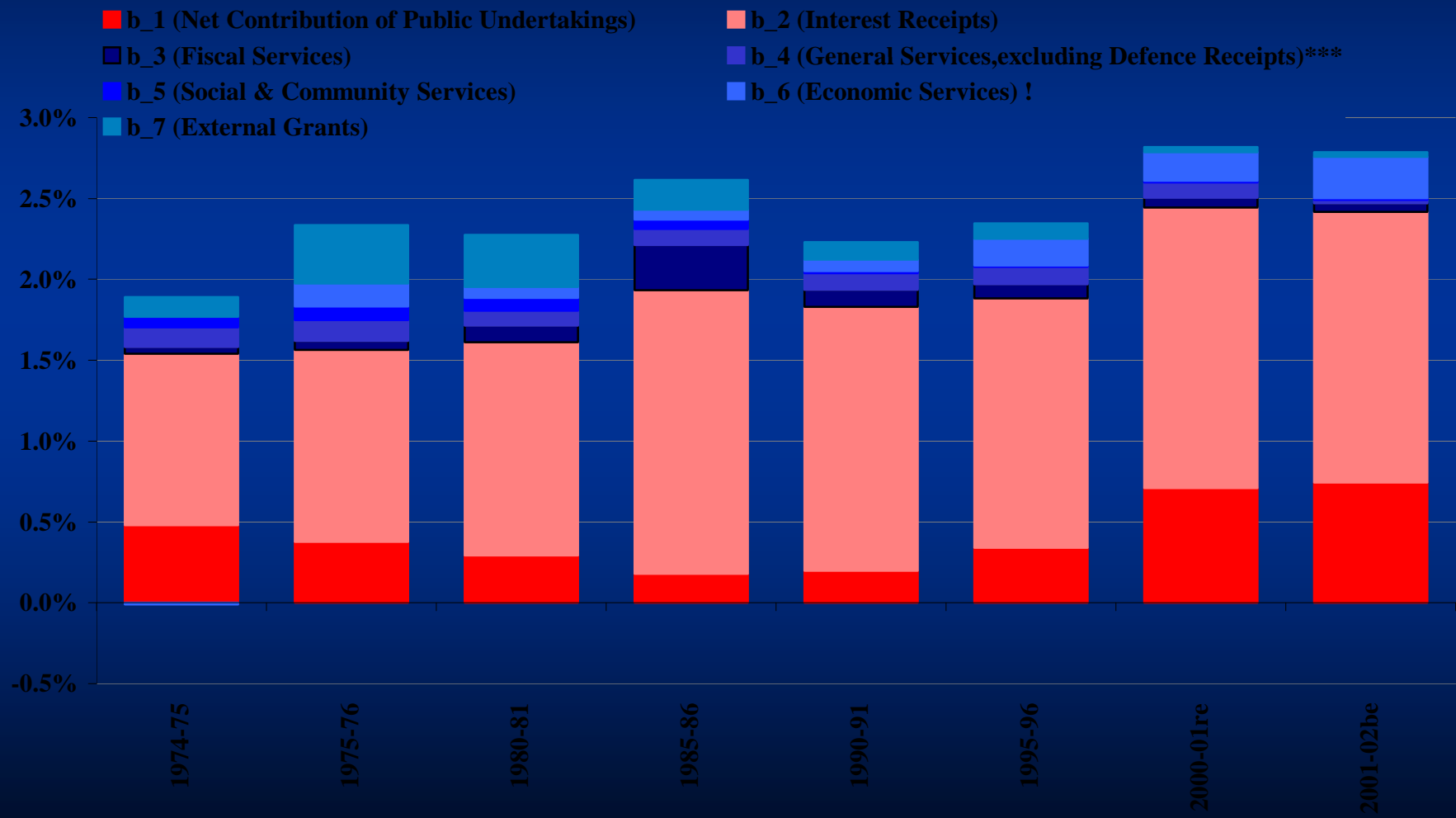


Stagnant Non-tax revenues

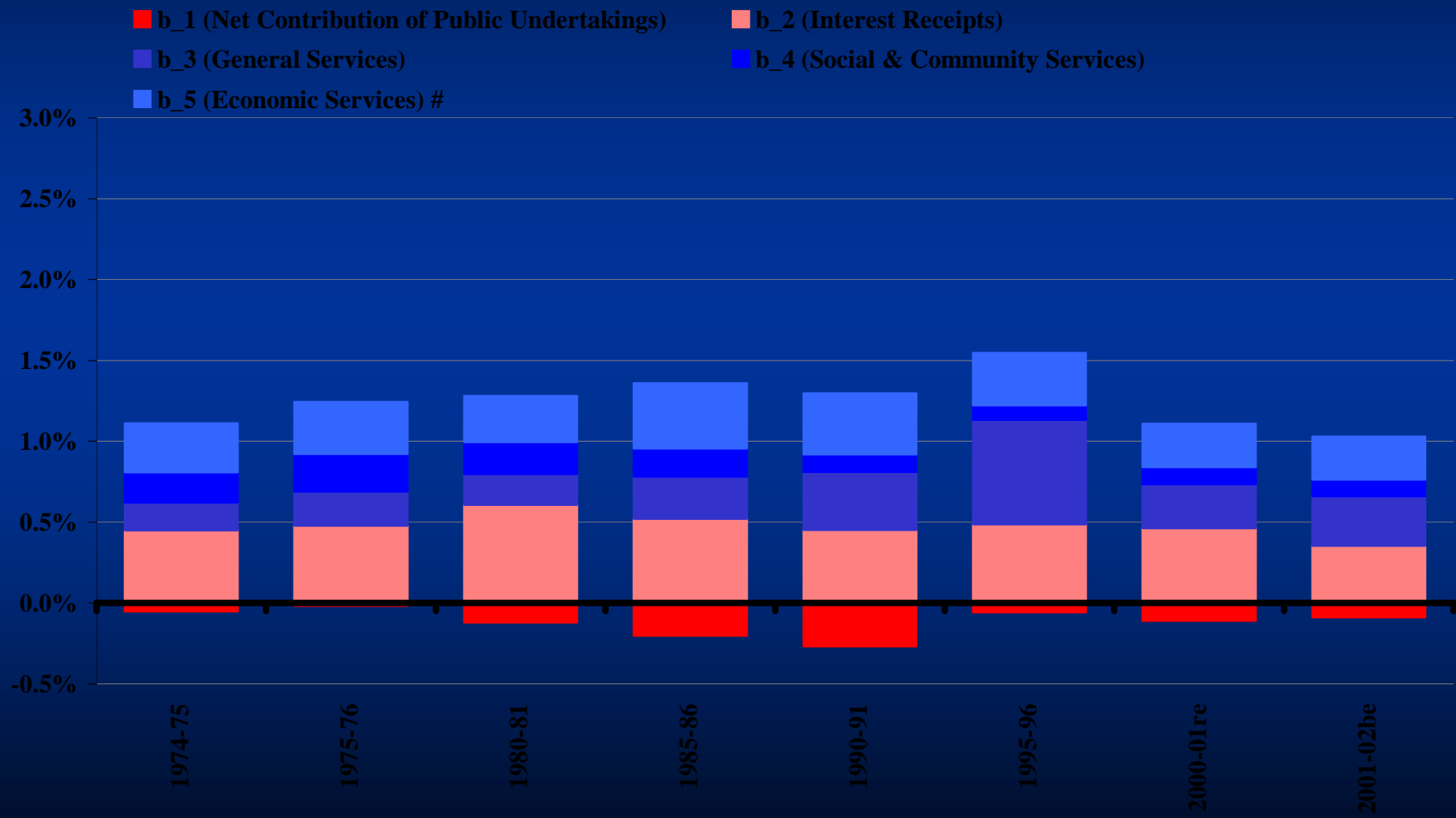
- *Non-tax revenues of the Centre increased during the 90s, but not adequate to neutralize the fall in tax revenue.*
- *Non-tax revenues of the States declined.*
 - *The upward trend in 1994-95 and 1995-96 was short-lived.*



Components of Non-tax Revenue: Centre



Components of Non-tax Revenue: States

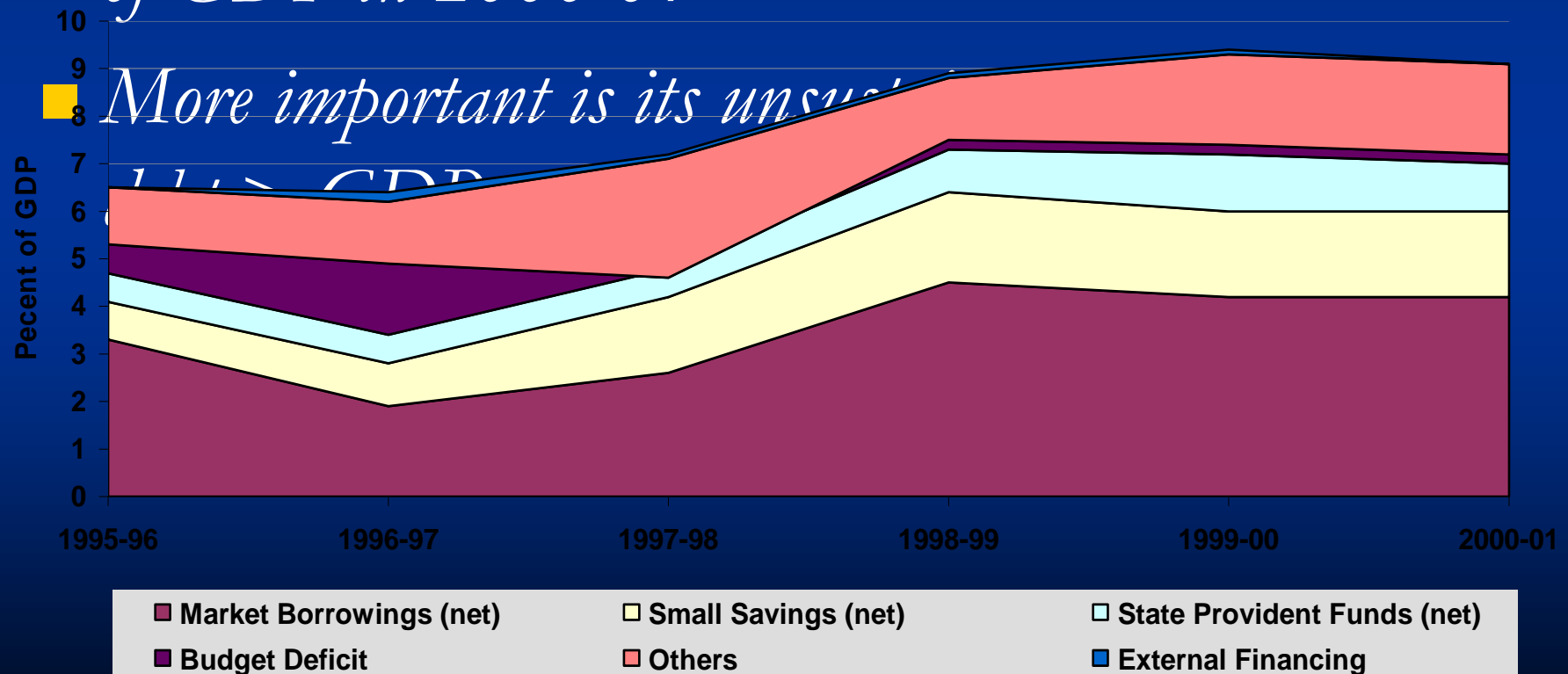


Factors Contributing to rising Central Government Expenditure

- *Rising interest expenditure*
- *Increases in defense expenditure*
- *Impact of 5th Pay Commission*
- *Rising fertilizer/ food subsidies*

Pattern of Financing the Fiscal Deficit in the late 90s

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

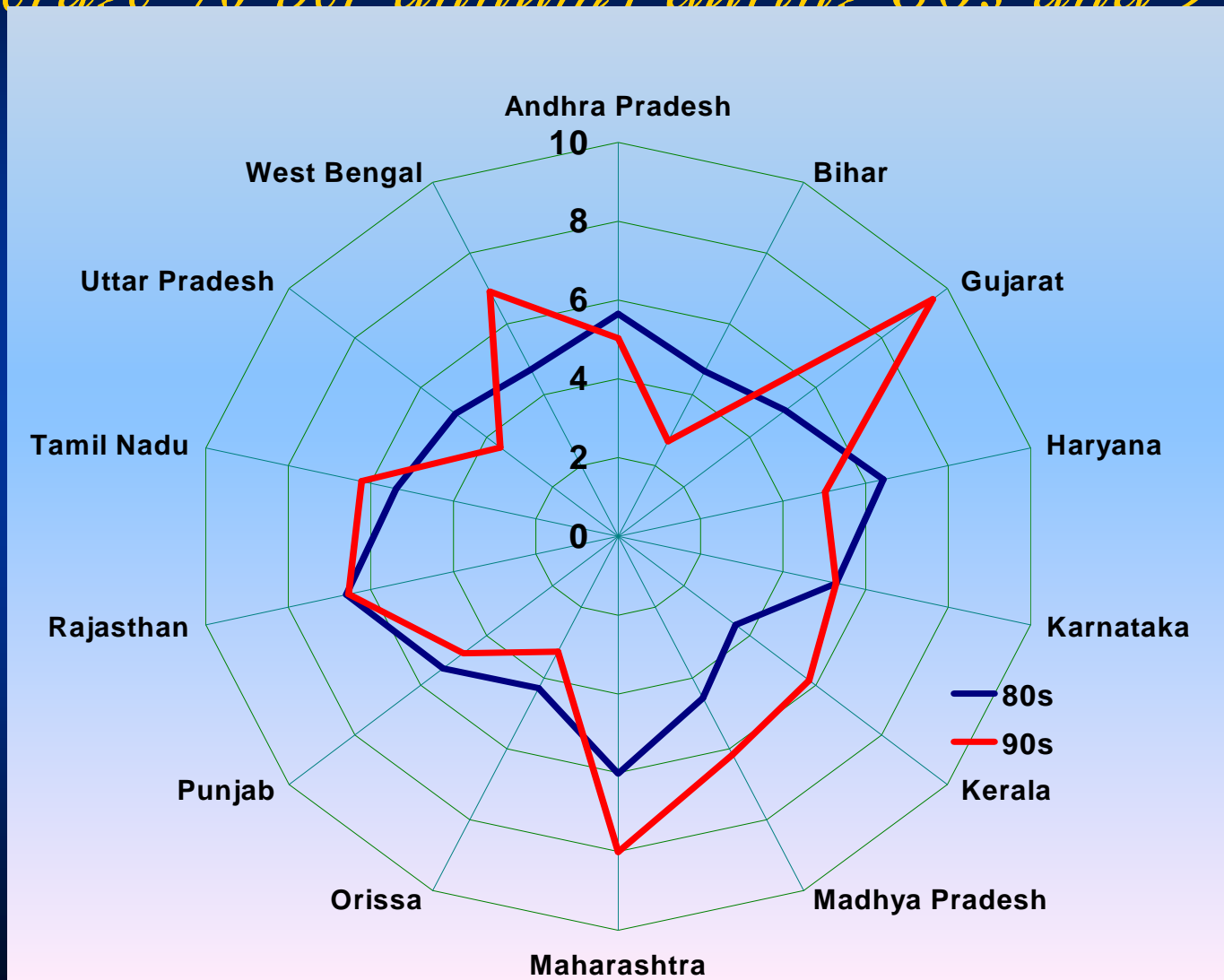


*Variations In Fiscal
Performance Across States*

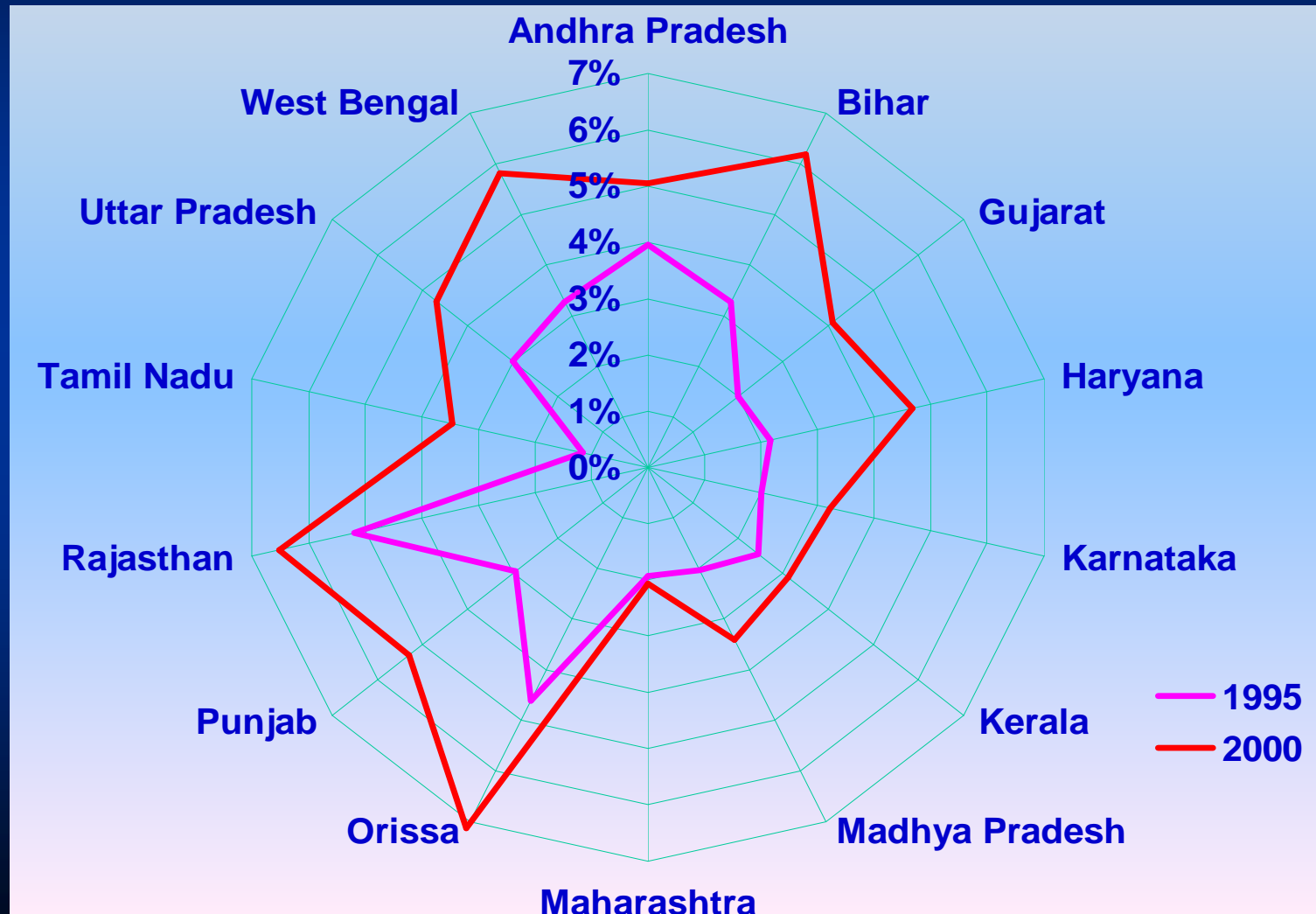
Structural Weakness of State Finances

- *Uncertainty and Variability in the federal resource transfers.*
- *Large electricity/irrigation/transport subsidies*
- *Inadequate generation of own resources*
- *Inefficiencies in expenditure*
- *Rising expenditures mainly due to rising wages and salaries, pensions, subsidies and interest payments.*
- *Constraint on investments in education, health, infrastructure, social security and welfare*

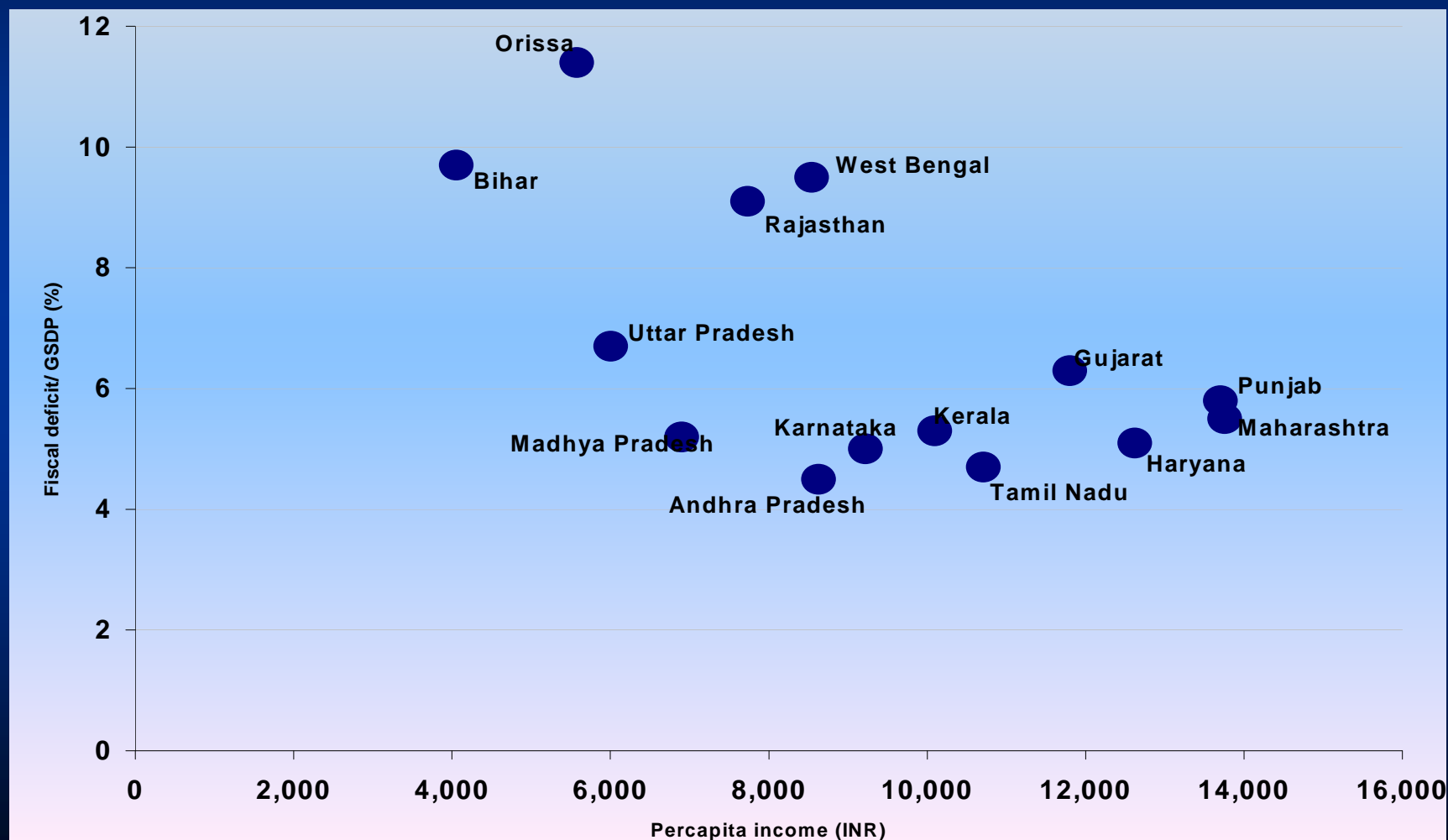
Increased Growth Dispersion Across States (average % per annum) during 80s and 90s



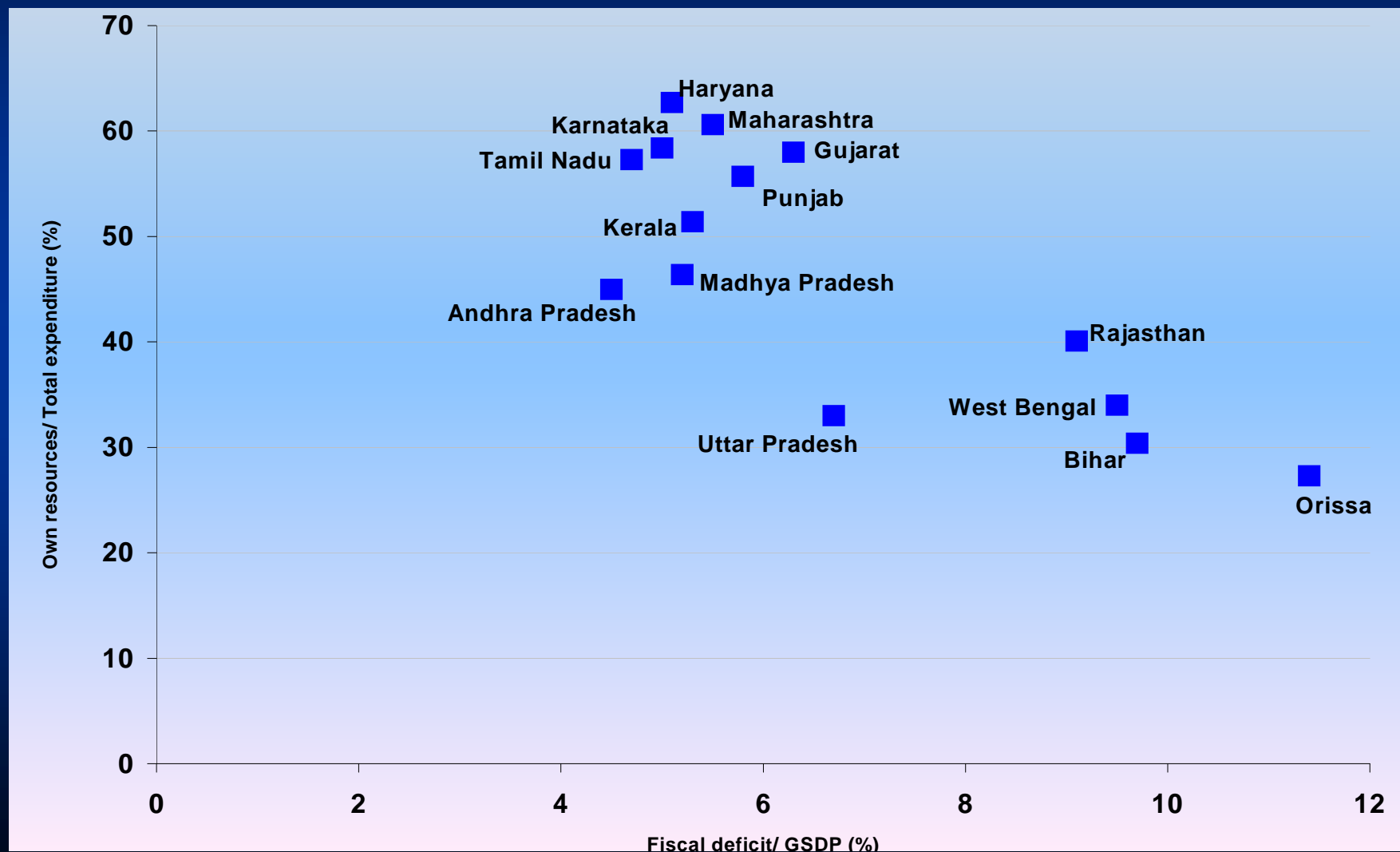
Trends in the Fiscal Deficit/GSDP ratio in 14 Major States



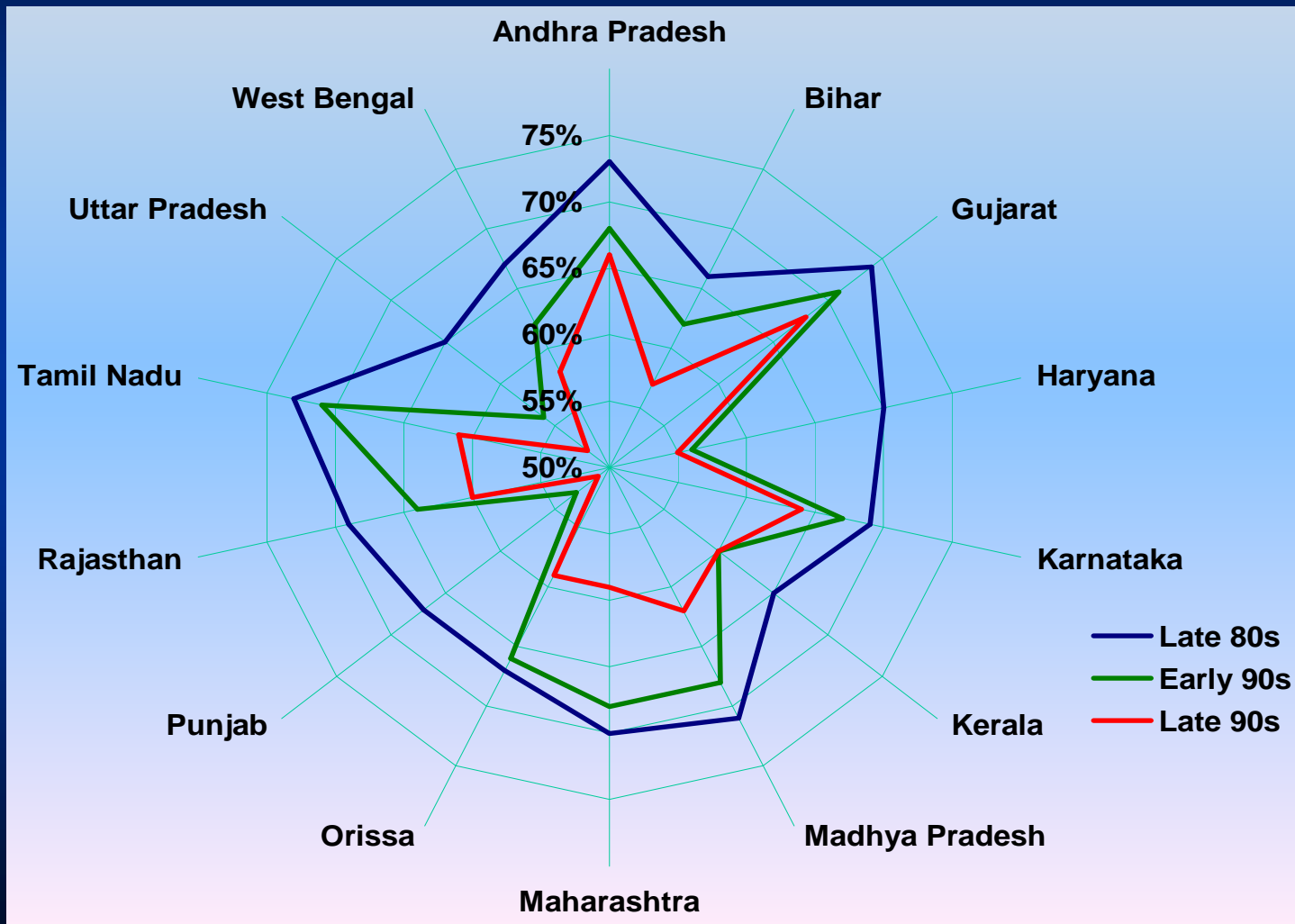
Per capita income vs fiscal deficit/ GSDP ratio in 14 major States of India



Own revenue/ Total expenditure & Fiscal deficit/ GSDP in 14 major States in India



Share of developmental expenditure in total: The Shrinking Trend in the in 14 major States



*States Efforts to overcome
fiscal constraints*

Fiscal restructuring at the States' level to focus on

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

Priorities for Further Reforms

Revenue side reforms

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

Expenditure side reforms

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

Thank You!

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