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365

**CENTRAL FINANCES IN INDIA -  
ALTERNATIVE TO PROCRUSTEAN  
FISCAL CORRECTION**

**R. Mohan**

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Special gratitude is due to Prof. K.P.Kannan, Director, Centre for Development Studies (CDS), Thiruvananthapuram, for encouraging me to take up a study on various issues in Centre State fiscal devolution. Thanks are due to Prof. E.T. Mathew and Prof. K.K. Subramanian, Honorary Fellows, CDS, Dr. N. Vijayamohanan Pillai, Associate Fellow CDS, Dr. Pinaki Chakraborty, Senior Economist- NIPFP, New Delhi, D. Shyjan, Rathi Kanta, Doctoral Scholars, CDS and Rajesh Puliyara, project associate CDS, for the valuable help rendered. I also acknowledge the participants of the seminar in CDS on 21/10/2004, in which this paper was presented, especially Dr. Raviraman, Dr.K.T.Rammohan and Ranjan Kumar Dash for the comments and suggestions. A special mention is also due to Prashant Krishnan, my son for his lively interruptions, while writing this paper.

## ABSTRACT

This paper examines the trends in Central finances over a three-decadal period beginning from the 1970s. It is found that there is lack of buoyancy in all the major sources of revenue of the Central Government. This calls for devising new methods of revenue mobilisation. There are political economic limits to the premise that direct taxes with its simplified rate structure and administrative reforms will make good the losses from the cuts in customs duty revenue. The analysis of the issues involved would require an examination of the influence of dominant classes on the state. Very recently however, the thrust of the tax reform seems to be on introduction of a Central Value Added Tax (VAT).

Total expenditure of the Central Government as a proportion of the Gross Domestic Product (GDP) has not increased during the 1990s when compared to the 1980s. But the composition of expenditure has shifted more towards revenue expenditure. An emphasis on expenditure allocation with targetting at a detailed level and innovative tax reforms aimed at more revenue mobilisation are necessary to achieve qualitative fiscal correction, But this is often stymied for political economic reasons. Procrustean fiscal correction aiming merely at deficit targetting is not a very desirable method. The study finds that the main problem in achieving fiscal consolidation at the Central level is falling revenue and tax receipts during the 1990s.

**Keywords:** Deficit targetting, tax buoyancy, revenue receipts.

**JEL Classification:** E62, E66

*“It is a mouldy fallacy that regardless of circumstances, the government must balance its budget every year. Why not in each month or week or hour?”*  
(Jacob Viner cited in Dalton 1954:215)

## **1. The Fiscal Situation of the Centre - Recent Trends**

The study of fiscal situation of the Centre forms the basis for the analysis of the larger aspects of devolution of funds from the Centre to the States and the fiscal situation of the States, as they are critically dependent on the position of the Central finances.

The Union Government embarked upon fiscal correction by targetting the indicator fiscal deficit (which measured the market borrowings of the Government) as a proportion of the Gross Domestic Product (GDP), in the wake of the balance of payments crisis of 1991<sup>1</sup> The emerging opinion was that the fiscal policy followed in the 1980s was profligate and fiscal correction by targetting the indicator fiscal deficit was called for. The earlier practice of automatic monetisation of budget deficits by issue of ad hoc 91-day treasury bills was phased out in the 1990s. In effect, the Centre resorted to the costlier route of market borrowings. The States' did not have the soft option of monetisation of

budget deficits even earlier. Though the States' had Ways and Means Advances and Overdraft facilities from the Reserve Bank of India, running of an Overdraft above a stipulated period resulted in stoppage of further facilities from the Reserve Bank of India. With the phasing out of automatic monetisation of budget deficits, and by entering into Memorandum of Understanding (MOU) with the Reserve Bank of India, the Centre imposed a harder budget constraint on itself.<sup>2</sup>

Another feature in the 1990s was that the tax-GDP ratio of the Centre as well as that of the States started stagnating or even declining. Though the real expenditure of the Centre and the States has not shown any significant rise in the 1990s, there has been rise of the revenue expenditure component of the total expenditure. After a decade of attempts at fiscal correction<sup>3</sup>, the important trends in Central finances can be summarised as 1) declining tax-GDP ratio 2) a rising component of revenue expenditure in total expenditure 3) interest expenditure becoming the single largest component of revenue expenditure and 4) a mild fall in total expenditure as a proportion of GDP in the 1990s as compared to the 1980s.

## **2. The Trends in Receipts of the Centre -1970-71 to 2002-03.**

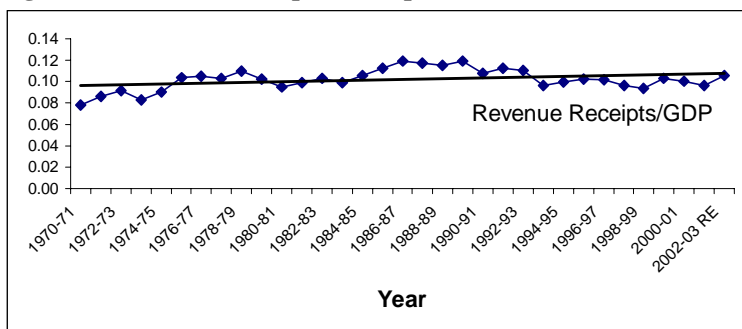
The time period selected for the study is 1970-71 to 2002-03. These three decades witnessed significant upward shifts in economic growth, changes in expenditure patterns, and tax reforms. This time period was also one of gradual liberalisation in internal and external sectors<sup>4</sup>. Our study aims to analyse the Central finances during this period and examine the possible impacts of these changes on receipts and expenditure of the Centre.

In this section, we analyse the trends in receipts of the Central Government and its components. We start with the examination of the receipts side.

### a) Receipts

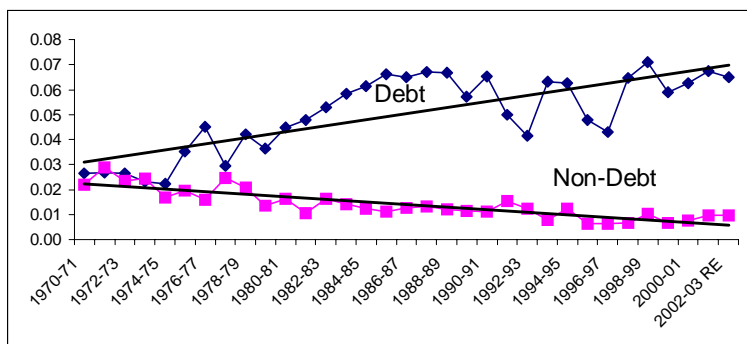
The receipts are broadly classified into revenue receipts and capital receipts. The former can be further classified into tax revenue and non-tax revenue and the latter into debt creating receipts and non-debt creating receipts. Let us look at the trends in revenue and capital receipts as a proportion of GDP.

**Figure1(a) Revenue Receipts as Proportion of GDP**



Source: Computed from The Handbook of Statistics on Indian Economy, Reserve Bank of India

**Figure 1(b). Debt Creating and Non-Debt Creating Capital Receipts as Proportion of GDP**

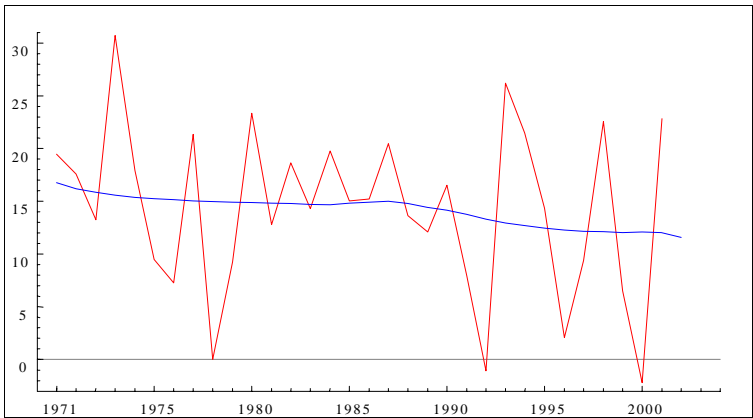


Source: Computed from The Handbook of Statistics on Indian Economy, Reserve Bank of India

The trend line of the revenue receipts shows an almost stagnant trend, with a downward movement since 1993-94. As substantial portion of the revenue receipts is tax receipts (nearly 85 percent) and this is clearly associated with the declining tax-GDP ratio during the 1990s.

The trends in debt creating capital receipts are increasing when compared to non-debt creating capital receipts<sup>5</sup>. Since 1991-92, the non-debt creating capital receipts includes proceeds of disinvestment also. The major component of non-debt creating capital receipts is recovery of loans. The increase in the debt creating capital flows imposes the committed burden of interest payments in the expenditure.

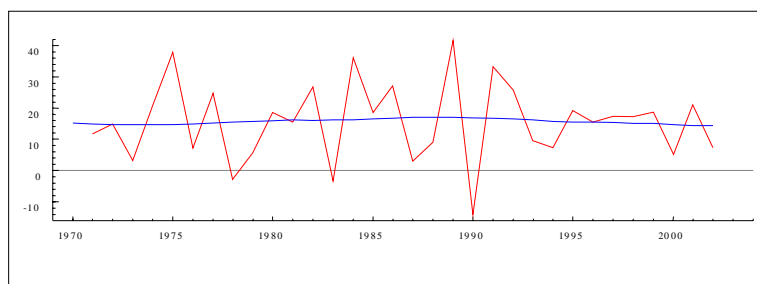
**Figure 2. Growth Rate of Tax Revenue and its Trend**



*Source:* Computed from The Handbook of Statistics on Indian Economy, Reserve Bank of India



**Figure 3. Trend Growth Rate of Non-Tax Revenue**



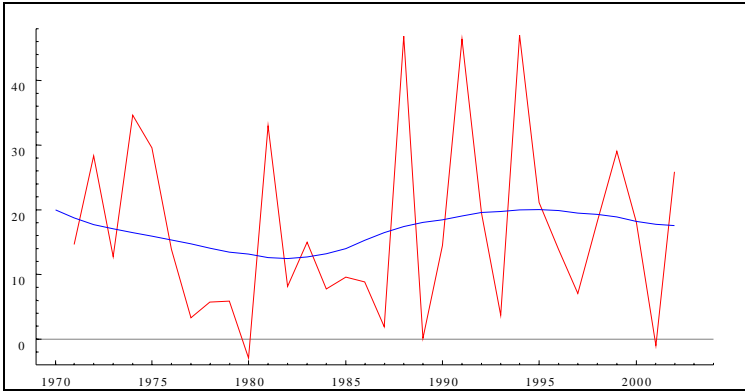
*Source:* Computed from The Handbook of Statistics on Indian Economy, Reserve Bank of India

The trend of the tax revenue growth of the Central Government has been showing a downward trend during the 1990s. The major components of tax revenue are direct and indirect taxes. The former mainly consist of Personal Income tax and Corporation tax and the latter consist of Excise and Customs duties. The trend of the Non-Tax revenue growth rate of the Centre has been stagnant throughout the period 1970-71 to 2002-03. The Non-Tax revenue consists of user charges for general, social and economic services and interest and dividend receipts from the public sector. The trend line indicates stagnation from these receipts<sup>6</sup>. Let us look at the components of the tax revenue, which forms 85 percent of the revenue receipts.

### ***Trends in components Tax Revenue***

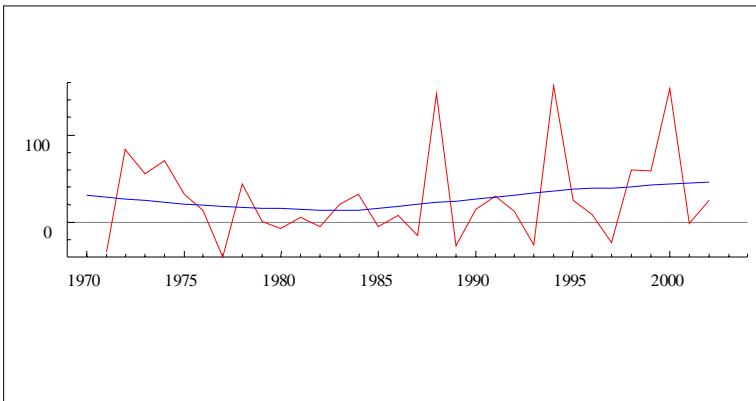
The downward trend in the growth rate of Tax revenue requires more analysis of its components, namely, the Customs Duty, Central Excise, Personal Income Tax and Corporation Tax.

**Figure 4. Trend Growth Rate of Direct Taxes 1970-71 to 2002-03**

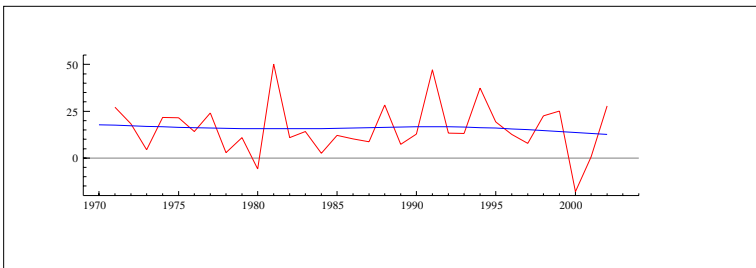


*Source:* Computed from The Handbook of Statistics on Indian Economy, Reserve Bank of India

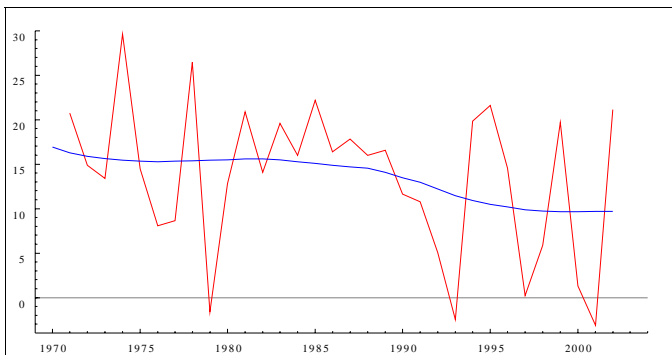
**Figure 4(a). Trend growth rate of Personal Income Tax 1970-71 to 2002-03**



**Figure 4(b). Trend Growth rate of Corporation Tax 1970-71 to 2002-03**

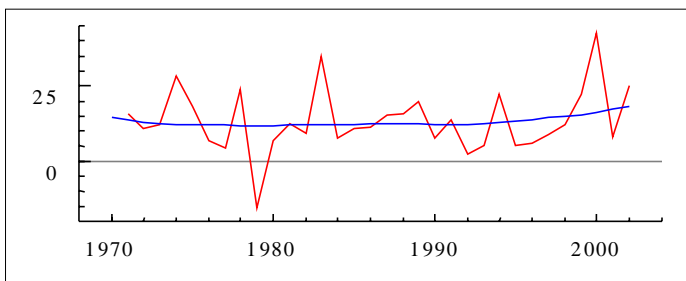


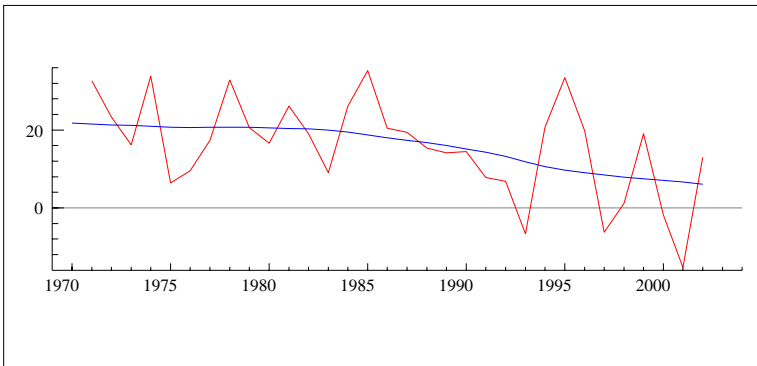
**Figure 5. Trend Growth rate of Indirect taxes 1970-71 to 2002-03**



*Source:* Computed from The Handbook of Statistics on Indian Economy, Reserve Bank of India

**Figure 5(a). Trend Growth rate of Excise Duty 1970-71 to 2002-03**



**Figure 5(b). Trend Growth rate of Customs Duty 1970-71 to 2002-03**

The trend growth rate of direct taxes shows an upward trend but it starts plateauing around early 1990s. The trend of Personal Income tax is upward while that of the Corporation tax shows a downward movement. The trend of the Excise duties shows an upward trend while that of Customs duties shows a downward trend. The time period under study was one of phased tax rate reduction and rationalisation of duties. The probable reasons for these upward trends in certain taxes could be reduction of rates and duty rationalisation. But on the whole, the trend of tax revenues show that it has not been responsive to these changes. There is also a downward trend in Corporation tax, despite rate reduction. This requires further analysis and could be due to the fact that a lot of exemptions and deductions do remain making the tax structure complicate.

To get a clearer idea, let us look at tax-GDP ratios and tax buoyancies. The tax-GDP ratio has shown a declining trend in the 1990s (Table 1). The rise in direct taxes-GDP ratio has not been able to compensate for the fall in indirect taxes-GDP ratio. India has one of the lowest tax-GDP ratios among the countries of the world (Report of the Task force on Implementation of FRBM Act, 2003:15-17 and Figure 2.3).

**Table 1. Decadal Tax-GDP Ratios**

Period	Tax/GDP Ratio	Direct Tax/ GDP Ratio	Indirect Tax /GDP Ratio
1970s	7.2	1.6	5.6
1980s	8.2	1.5	6.7
1990s	7.5	1.9	5.6

*Source:* Computed from Handbook of Statistics on Indian Economy, Reserve Bank of India

The emerging fact is that the tax revenue growth has not kept pace with the growth of the tax base, the Gross Domestic Product<sup>7</sup>. The reason for this is that the dominant sector of the GDP, the services sector, which constitutes more than 50 percent of the Gross Domestic Product (GDP), has not been brought adequately into the tax net. The Economic Survey 2002 described the emerging section of professionals in the services sector as a 'hard to tax group'. To tax this modern sector, more information gathering and information sharing needs to be done by the revenue authorities and this requires closer cooperation between Central Excise (which administers the service tax) and the Income tax departments<sup>8</sup>. Instead of the present system selectively taxing a few services, the CENVAT should integrate the services and manufacturing components in the manufacturing process (Rao 2001).

### ***Tax Elasticity and Tax Buoyancy***

In order to test the elasticity of tax revenue to GDP, we took the logarithmic transformation of tax revenue and GDP and tested for co-integration, the null hypothesis of no co-integration failed to reject<sup>9</sup>. It is apparently puzzling as this goes against the theoretical concept, because for any tax, the base is income or consumption. The consumption again is a function of income<sup>10</sup>. Though income or consumption is the economic base for taxation, what is defined by law can alter and narrow down this base. This is the possible explanation for no co-integration between GDP (the economic base) and tax revenue found here<sup>11</sup>.

**Table 2. Results of the Johansen-Juselius (JJ) Test of Co- integration**

Maximum Eigen Value test				Trace Test		
Null Hypothesis	Alternative	Statistic	95% C.V.	Alternative	Statistic	95% C.V.
P=0	P=1	8.3 (7.7)	14.1	P≥1	9.1 (8.5)	15.4
P= 1	P=2	0.8 (0.7)	3.8	P≥2	0.8 (0.7)	3.8

Note: Figures in Parentheses indicate the Statistic with small sample correction. C.V. = Critical values.

Since the variables are not co-integrated, we empirically test the association between growth rates (logarithmic first differences) of tax revenue and GDP, which is in effect testing for the significance of tax buoyancy. The result indicates that the association between growth rate of GDP and tax revenue is not statistically significant, which implies that the overall tax buoyancy is not statistically significant.

**Table 3. Association between Tax Revenue Growth and GDP Growth 1971-72 to 1999-2000**

	Coefficient	Std. Error	t-value	t-prob
Constant	17.831	3.591	4.965	0.0000
GDP growth	-0.221	0.239	0.923	0.364

$R^2 = 0.031$ ,  $DW = 1.93$

**Table 3(b) Residual Properties<sup>12</sup>**

Autoregression	2.643 (0.091)
ARCH	0.165 (0.687)
Normality	0.384 (0.824)
Homoscedasticity-1	1.241 (0.308)
Homoscedasticity-2	1.240 (0.308)
RESET	1.358 (0.254)

It can be seen that the combined tax buoyancy of direct as well as indirect taxes is not statistically significant. The revenue side of the Central finances has not been buoyant despite the GDP growing in a statistically significant manner during this time period.

The measurement of elasticity of Personal Income tax with the non-agricultural GDP is also attempted here<sup>13</sup>. Both the variables, i.e. logarithmic transformation of Personal Income tax and non-agricultural GDP have unit roots, i.e. they are non-stationary at levels. At first difference, they are stationary<sup>14</sup>. When tested for co-integration using the Johansen and Juselius (JJ) test, it is found that the null hypothesis of no-co integration fails to reject.

**Table 4. Results of the Johansen-Juselius (JJ) Test of Co-integration**

Maximum Eigen Value test				Trace Test		
Null Hypothesis	Alternative	Statistic	95% C.V.	Alternative	Statistic	95% C.V.
P=0	P=1	8.3 (7.7)	14.1	P≥1	9.1 (8.5)	15.4
P= 1	P=2	0.8(0.7)	3.8	P≥2	0.8 (0.7)	3.8

Note: Figures in Parentheses indicate the Statistic with small sample correction. C.V. = Critical values.

Since the variables are not co-integrated at levels, we are regressing the growth rate (logarithmic first differences) of Personal Income tax on growth rate of non-agricultural GDP.<sup>15</sup>

**Table 5. Association between Growth of Personal Income Tax and Non-Agricultural GDP 1971-72 to 1999-2000.**

	Coefficient	Std. Error	t-value	t-prob
Constant	11.55	6.67	1.73	0.09
Non-Agricultural GDP	0.27	0.41	0.65	0.52

Note: D-Non-Agricultural GDP = First Difference of Non-Agricultural GDP.  
R<sup>2</sup> = 0.015 DW= 1.93

**Table 5(a). Residual Properties**

Autoregression	0.681 (0.515)
ARCH	0.062 (0.804)
Normality	1.646 (0.439)
Homoscedasticity-1	0.020 (0.980)
Homoscedasticity-2	0.020 (0.980)
RESET	1.280 (0.268)

The coefficient of the growth rate of non-agricultural GDP is not statistically significant, implying that one unit increase in the growth rate of non-agricultural GDP is not significantly associated with the growth rate of Personal Income tax. This leads to the inference that the buoyancy of Personal Income tax in relation to its economic base, non-agricultural GDP is not statistically significant for the period 1971-72 to 1999-2000. The presumption is that growth of the economy should lead to more income generation and the buoyancy of Personal Income tax should have been statistically significant during the period when, the growth rate of GDP showed two statistically significant upward shifts, in the 1980s and the 1990s respectively. The reasons for the statistically insignificant buoyancy of Personal Income tax necessitate further study.<sup>16</sup> Possible reasons could be the existence of multiple exemptions and deductions in the Income Tax Act simultaneously with the cut in tax rates. The problems of non-compliance, evasion, insufficient collection of information, insufficient use of collected information and rent-seeking behaviour among some enforcement authorities are also there. To state in brief, the legal base<sup>17</sup> and administrative implementation are the two areas requiring analysis for explaining the non-buoyancy of tax revenues with regard to its economic base.

The report of the Kelkar Task Force on direct taxes also discusses the problem of non-compliance at middle income groups describing them as



the 'missing middle'.<sup>18</sup> The tests of buoyancy of other taxes, i.e. Corporate tax, Excise and Customs duty also indicate that the association between their growth rates and growth rate of GDP is not statistically significant.

### ***Political Economic Limits to Tax Reform***

As we have mentioned already, there has been significant cuts in tax rates during the 1990s. The customs duty has been reduced in a regularly phased manner. The maximum marginal rates of the direct taxes like Personal Income Tax and Corporation Tax have also been brought down. The general perception is that as the economy grows at a faster pace and the per capita income rises, the proportion of the indirect taxes in total tax revenue will come down and that of direct taxes will rise. It is not a matter of dispute that this has happened in India.<sup>19</sup> But the fact remains that the increase in direct taxes has not been enough to prevent the decline in tax-GDP ratio. In the given political economic constraints and influence of dominant classes of the society over the state, both at the policy making level and the cutting edge level,<sup>20</sup> it is quite possible that the limits to enhancing of revenue from direct taxes may be reached very fast. The limits are caused by power of the interest groups in retaining the multiple exemptions and deductions, non-payment by litigating the loopholes in the law, evading by manipulating the cutting edge level etc. These problems will be quite serious in enforcement of direct taxes, as it mainly affects classes having resources and power to fight for retaining benefits. The effect of dominant classes or organised groups successfully bargaining for concessions in the form of tax breaks can undermine the theoretical argument that direct taxes with progressive rates tax the rich more than the poor.

A pertinent point to be noted is that the balance of power of interest groups is a dynamic process, with new interest groups emerging to be the dominant ones. In the 1970s, the class of rich farmers grew to be a

powerful group (Bardhan 1984). In the 1990s, finance capital emerged to be a powerful interest group with transnational dimensions. Economic policies, and budgets are analysed with reference to their impact on the stock market. The opposition to the securities transaction tax introduced in the budget 2004 is an example. The successful bargaining of concessions by interest groups has hamstrung the revenue mobilisation potential as well as reallocation of expenditure.

Innovative tax reforms are necessary, rather than relying on direct taxes to bring continuously more revenue as the economy grows, since it has got political economic constraints. Some suggestions are making conspicuous expenditure a base for taxation, and deduction of tax at source at moderate rates on transactions as a final payment etc. Presently, for Tax Deduction at Source (TDS) in the Income Tax Act, 1961, income component is not the base, but the aggregate receipts. If the rates can be moderated and TDS made as a final payment, it can be a transaction-based tax covering a wider range of activities. But these will require a nation wide information network and effective exchange of information between various agencies like banks and taxation departments. Whether the proposed Value Added Tax (VAT) at the Central and State levels will improve the resource mobilisation efforts or lead to more problems like increase in cost of detection of tax evasion, problems in distribution of Centre-State fiscal powers etc. need to be evaluated in the light of the sector-wise proposals to levy Goods and Services Tax (GST) at the Central level by the task force on the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. These aspects require elaborate study and details of tax reforms are beyond the scope of this paper.<sup>21</sup> Suffice it to say that the need for more innovative tax reforms is to be recognised i.e. tax reforms should strategically tackle the power and influence of the interest groups by exploiting the contradictions and divisions among them.<sup>22</sup>

### ***Non-Tax Revenue***

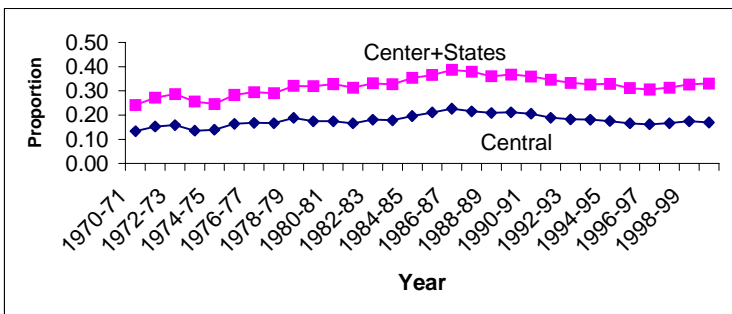
The trend of the non-tax receipts is stagnant for the period 1970-71 to 2002-03. Most of the studies recommend rise in user charges and thereby raising of more non-tax receipts. The question involved here is pricing of public goods and pricing of publicly produced private goods. There are economic, social and political constraints in pricing the utilities provided by the public sector. There are problems of operational inefficiencies and cost overruns in public undertakings, which, result in higher expenditure, and attempts to pass it on to the customer, will meet with resistance.<sup>23</sup> Wicksell (1896) discusses pricing in public utilities like railway, postal and telegraph administration etc., where an annual increase or decrease of some millions of passengers, ton-miles of freight, letters, telegrams etc. has little effect on annual costs and of course still less on the amount of fixed and working capital and on the interest payable thereon. If such enterprises were run on a fee principle and total production costs or at least general operating costs, they will have to spread over a relatively small number of service units and the unit price will be normally higher than the marginal cost, i.e. the additional cost occasioned by an additional unit of service. Such a pricing policy would allow the public sector to satisfy the demands of only those persons who rate its subjective value higher or at least as high as the fee is charged. The entire range of demand, which is less intensive than this objective level, must remain unsatisfied. Such a scenario may not be politically acceptable. There has to be a balance in pricing of public utilities, as they are meant for more utilisation by the public collectively.<sup>24</sup> There are also political economic constraints through the power of interest groups, which have an interest in underpricing public sector products. Raj (1973) analysed this from the perspective of intermediate regimes in the Indian case.<sup>25</sup>

In the case of public utilities, the thrust areas should be reducing operational inefficiencies (like transmission and distribution loss in power distribution, keeping administrative and establishment costs within limits and checking cost overruns. It is very doubtful whether user charges can be raised as a revenue gap bridging measure given the political economic constraints. Concentration should be on the cost side, e.g. time and cost overruns, so that reasonable user charges that become essential can be levied. Since it is a levy, which can be precisely measured, the opposition of the interest groups in measuring the consumption of utilities can be stronger than in taxation, the evasion of which is comparatively easier.

### 3. Trends in Expenditure of the Central Government

If we look at the share of total expenditure of the Central Government and that of the Central and State Governments together in the GDP, it can be seen that they have not risen abnormally. It has come down in the 1990s when compared to the 1980s. The size of Government measured by the total expenditure of the Centre and the States as a

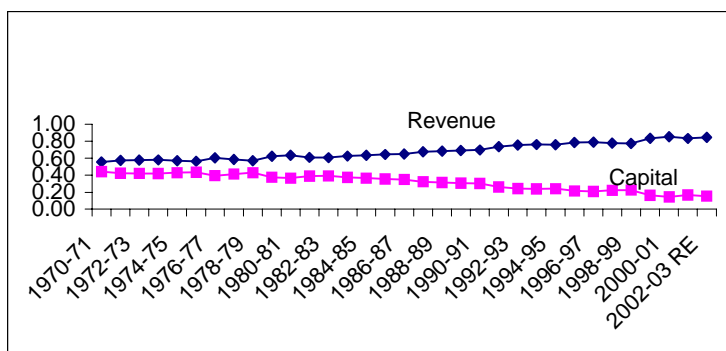
**Figure 6(a). Central and Centre and States Total Expenditure as Proportion of GDP**



Source : Computed from Handbook of Statistics on Indian Economy, Reserve Bank of India

proportion of GDP, over the period of three decades, has increased from 22 percent in 1970-71 to 32 percent in 1999-2000.<sup>26</sup> Compared to the OECD countries, this is relatively low. As far as the components of expenditure are concerned, the share of revenue expenditure has been rising throughout the period 1970-71 to 2002-03 and the gap between the revenue and capital expenditure proportions is widening in the 1990s. This is an indication of current expenditures growing at the expense of productive investment.<sup>27</sup>

**Figure 6 (b). Revenue and Capital Expenditures as a Proportion of Total Expenditure**



*Source:* Computed from the Handbook of Statistics on Indian Economy, Reserve Bank of India

A look at the composition of revenue expenditure reveals that interest is the major component of the revenue expenditure in the 1990s [Table 7 (a)]. Contrary to popular perception it is not subsidies and wages and salaries that have been rising, but interest payments. The proportion of wages and salaries to the Government Final Consumption Expenditure (GFCE) for the Centre, State and Local Bodies are given in Table 7. It can be seen from table 7 (b) that wages and salaries as a proportion of total expenditure of the Central Government has shown a 1 percent fall

in the 1990s as compared to the 1980s, while showing a similar rise as a proportion of revenue expenditure.

**Table 7. Wages and Salaries as a Proportion of Government Final Consumption Expenditure: 1970-71 to 1999-2000**

Period	Centre	State	Local Bodies
1970's	0.54	0.74	0.75
1980s	0.48	0.75	0.76
1990s	0.46	0.81	0.80

*Source:* Computed from National Accounts Statistics, EPW Research Foundation

**Table 7 (a). Proportion of Total Central Government Expenditure to GDP and its broad composition**

Period	Total Central Government Expenditure /GDP (%)	Revenue Expenditure as a proportion of total Expenditure (%)	Capital Expenditure as a proportion of total Expenditure (%)
11970s	16 (26) *	58	42
11980s	20 (32)	65	35
11990s	18 (31)	79	21

*Note:* \* The figures in parentheses indicate the combined expenditure of the Centre and the States as a proportion of GDP.

*Source:* Computed from Handbook of Statistics on Indian Economy, Reserve Bank of India.

**Table 7(b). Composition of Revenue Expenditure of the Central Government**

Period	Wages and Salaries	Interest	Defence	Loans and Subsidies
1970s	13 (22)	18 (11)	30 (17)	7 (4)
1980s	10 (16)	22 (14)	21(14)	14 (9)
1990s	11 (15)	35(27)	14 (11)	11 (9)

*Note:* (The figures in parentheses indicate the expenditures as a proportion of Total Expenditure)

*Source:* Computed from the Handbook of Statistics on Indian Economy, Reserve Bank of India

Notwithstanding the impact of the Fifth Pay Commission, the share of wages and Salaries in Government Final Consumption Expenditure has come down for the Centre, whereas it has gone up for the States and the Local bodies. This suggests that an increase in size of the States' bureaucracy independent of the Pay Commission<sup>28</sup> has accentuated the burden of wages and salaries, while this has not happened in the case of the Centre.

The proportion of loans and subsidies to revenue expenditure has also come down during the 1990s, though it is higher than it was during the 1970s. This indicates that there is scope for directing and targeting explicit and implicit subsidies.<sup>29</sup> The export subsidies have been eliminated and fertiliser subsidy has come down. Targetting food subsidy during the 1990s did not have the desired impact. Though issue prices for customers Above Poverty Line (APL) from the Public Distribution System (PDS) was raised, there was reduced off take from the PDS outlets and resulting in a rise of carrying cost subsidy of the Food Corporation of India (FCI). There was more producer subsidy than customer subsidy as there was increased procurement by the FCI at higher Minimum

Support Prices (See Report on Currency and Finance 2001-02, of Reserve Bank of India for a discussion.) But whatever is done for targeting subsidies, the major component needing attention is interest payments, which has risen, due to change in method of financing fiscal deficit.

### ***Increasing Interest Payments-Possible Reasons***

With declining tax-GDP ratios and statistically insignificant tax buoyancies, there has been more borrowing for meeting current expenditures. The increase in interest payments as a proportion of revenue expenditure, which has been quite marked since the 1990s is due to the conscious shift in policy in financing deficits, i.e. instead of resorting to monetisation of deficit by issue of ad hoc 91- day treasury bills at low interest rates by the Reserve Bank of India, the deficit is financed by market borrowings at higher rates of interest.<sup>30</sup> While the fiscal deficit is being increasingly financed by market borrowings at higher interest rates than being financed by ad hoc treasury bills, the spending is for current expenditure and not productive investment expenditure. At the same time revenues have not been buoyant.

There have been suggestions for increased monetisation of deficit [Naastepad (1999), Ramachandran et.al. (2001)]. But monetisation deficit by increased RBI credit to the Government has an added dimension in the present economic scenario with large foreign exchange reserves. Net RBI credit to the Government and the Foreign Currency Reserves are two main components of High Powered Money. A rise in these components can lead to increase in money supply and inflationary pressures. In the context of gradual opening up to foreign investments, especially portfolio investments, foreign exchange reserves cannot be said to be sufficient in terms of a specified period of import cover. The holding of higher reserves is considered necessary for meeting exigencies in the context of a more open external sector.<sup>31</sup> With this component of



High Powered Money at a necessarily higher level compared to the pre-reform period, the ability of the Government to monetise a higher proportion of deficit is limited. Hence the higher interest burden by resorting to increased market borrowing is a forced necessity as a consequence for having to maintain a higher foreign exchange reserve. To state in brief, the increasing proportion of revenue and total expenditure being preempted by interest expenditure is the result of conscious fiscal, monetary and external sector policies.<sup>32</sup>

The growth of revenue expenditures and revenue receipts has shown statistically significant increase during the three decades. The growth rate of revenue expenditure and revenue receipts rose during the 1980s and fell during the 1990s (Table 9 and Table 10). The fall in growth of revenue receipts has occurred when the overall all growth rates showed a statistically significant increase. Had revenue receipts increased during the 1990s, the fiscal situation of the Centre would have been better. The impact of the fall in growth of revenue receipts is reflected in the indicator, the fiscal self-reliance, i.e. the ability to meet revenue expenditure out of revenue receipts. This has come down from a position of surplus revenue receipts after meeting revenue expenditure in the 1970s to a position of revenue receipts not being able to meet revenue expenditure in the 1980s and the 1990s.

**Table 8. Fiscal Self Reliance of the Centre**

Period	Fiscal Self Reliance
1970s	1.05
1980s	0.85
1990s	0.74

*Note:* Fiscal self-reliance is measured as the ratio of revenue receipts to revenue expenditure.

*Source:* Computed from Handbook of Statistics on Indian Economy, Reserve Bank of India

**Table 9. Growth Rate of Revenue Expenditure of the Centre: Kinked Exponential Model: 1970-71 to 2002-03**

Period	Coefficient	Std.Error	t-value (t-Probability)
1970s	0.1451	0.002	48.49 (0.00)
1980s	0.1670	0.002	66.85 (0.00)
1990s to 2002-03	0.1289	0.002	54.39 (0.00)

$R^2 = 0.999$ ,  $\text{Adj } R^2 = 0.999$ ,  $\text{Root MSE} = 0.037$

**Table 10. Growth Rate of Revenue Receipts of the Centre: Kinked Exponential Model: 1970-71 to 2002-03**

Period	Coefficient	Std.Error	t-value(t-Probability)
1970s	0.1331	0.004	29.73 (0.00)
1980s	0.1459	0.003	39.01 (0.00)
1990s to 2002-03	0.1196	0.003	33.73 (0.00)

$R^2 = 0.998$ ,  $\text{Adj } R^2 = 0.998$ ,  $\text{Root MSE} = 0.056$

### ***Problem Areas of Central Finances- A Summary***

To summarise the major problem areas of Central finances for the three decadal period are, on the revenue side

- a) Decline in the trend growth of Tax Revenue and a stagnant trend in Non-Tax Revenue
- b) The non-buoyancy of direct as well as indirect taxes.
- c) Political economic constraints setting limits to tax reforms aimed at larger revenue mobilisation

And on the expenditure side

- a) Continuously increasing share of revenue expenditure in total expenditure
- b) Rising share of interest expenditure, in the 1990s which is the result of a conscious policy decision to finance fiscal deficit by market borrowings
- c) Fall in share of developmental expenditure in the total expenditure
- d) The changing composition in expenditure trends (of the Centre and the States) can become unhelpful in influencing economic growth in the future.

The prescription for this problem appears to be improving the tax buoyancy and meeting an increased proportion of current expenditure by revenue receipts rather than borrowing, which has become costlier than before due to altered methods of financing fiscal deficits and change in external sector policies. Any new proposal of revenue expenditure should be accompanied by a proposal regarding revenue source for meeting that.<sup>33</sup>

#### **4. Methods Employed for Achieving Fiscal balance**

The traditional argument is that budget should be balanced and expenditure should not exceed revenue. If expenditure exceeds revenue, budget is said to be unbalanced. That budgets should be balanced was often regarded, not only as an unquestioned percept of finance, but as a moral percept as well. It is enunciated by orthodox financial experts with a cold puritan pride (Dalton 1954).

Much emphasis has been laid on the proportion of fiscal deficit to GDP/SDP as a summary measure of fiscal consolidation.<sup>34</sup> Fiscal deficit

as officially measured by the Government of India is the difference between aggregate disbursements excluding debt repayments and aggregate receipts net of debt receipts. The major defect of this indicator is that fiscal deficit can be contained even while incurring more revenue deficit, by having a surplus in the capital account. In other words, spending for current expenditures through borrowings at the cost of cutting down productive investment can also lead to a smaller fiscal deficit. In fact, this has been happening through out the 1990s in India. Let us now look at three methods employed to make the fiscal deficit as a proportion of GDP lower.

### ***Accounting Methods***

There are definitional changes in fiscal deficit, which makes comparison of the ratio fiscal deficit/GDP over the years difficult. For example, borrowings from small savings by the States are not reflected in the Centre's fiscal deficit since 1999-2000<sup>35</sup>, which makes the official fiscal deficit to GDP ratio not comparable with that of the previous years.

### ***Utilising Disinvestment Proceeds***

One method employed to show a reduced fiscal deficit is to treat disinvestment proceeds as a revenue enhancing measure (Report on Currency and Finance, 2001-02, Reserve Bank of India: IV-19). This has been criticised by Dalton (1954), Mansoor (1993), Ize (1993), Gulati (1994) and Patnaik (2000). Dalton (1954) stated that when we consider the budget, some expenditure and revenue would have to be excluded. On the revenue side, the receipts which are in the nature of capital, such as the proceeds of sales of public property, or sums drawn out of reserves accumulated out of previous surpluses are to be excluded, for the diminution of public capital assets is equivalent to an increase in the deadweight public debt. Mansoor (1993) argued that government could spread risk more readily than private agents and can be less risk averse.

Under these circumstances, it may be expected that the governments would have to sell assets at a discount relative to the expected value of the stream of discounted earnings. The discount would have to be even greater, if one considers other uncertainties- or example, future changes in the regulation of prices, markets (including labour) and profits, possible modifications of the tax regime, and the prospect of renationalisation at below-market price. The above arguments suggest that even if the governments were able to devise ways of selling assets at market value, the prices would be below the expected discounted value of the stream of earnings as perceived by the government. Mansoor (1993) argued, "Even if all the proceeds of an asset sale were invested in financial assets, the expected future income stream would be lower than without asset sale. Put another way, the government would have to transfer some of its wealth to the private sector to compensate for its greater risk aversion and higher discount rate. Ize (1993) is of the view that accounting consistency implies that a public disinvestment should be treated symmetrically to a public investment. Revenues from the sale of public assets should thus be counted as a flow "above the line". From the perspective of fiscal stance, a disinvestment unless it is offset by an expansionary monetary policy- withdraws liquidity from the public. Disinvestment would lower the overall investment in the economy, because the private sector's demand for fixed capital is partially satisfied through the purchase of existing capital rather than through new investments. A policy through which the government finances its current expenditure through the sale of fixed assets may thus end up having an undesirable consequence on growth. Gulati (1994) visualised an extreme situation (stated as hypothetical) of government selling off equity in public sector undertakings but not utilising it for new public investments. In this case, the amounts raised by the government go to finance the current expenditure and it should actually be treated as raising the fiscal

deficit rather than reducing it. Patnaik (2000) opined that if the fiscal deficit is considered undesirable as it crowds out private investment, the same logic would apply to disinvestment, if the private purchaser borrows from the bank to purchase the equity of the public sector. The views discussed above show that reducing fiscal deficit by including disinvestment proceeds, as revenue cannot be treated as a desirable type of fiscal consolidation.

***Prescribing Legal Limits- Fiscal Responsibility and Budget Management Act of Centre and the States***

Emphasis on reducing fiscal deficit as a proportion of GDP as the Fiscal Responsibility and Budget Management Bill of the Centre and the States like Kerala<sup>36</sup> and the Eleventh Finance Commission report suggest, can result in Centre and States resorting to the soft option of cutting capital investment expenditure rather than the downward sticky revenue expenditure which is also championed by social and political interest groups.<sup>37</sup>

The fiscal consolidation is sought to be achieved through legislative measures like the FRBM Act, which sets limits for deficits to be adhered to in a time bound manner. The Central Act gives some flexibility with regard to achieving deficit targets. The deficit targetting approach of Fiscal Responsibility legislation in countries like the U.S. has not been successful. In fact tasks of revenue mobilisation and expenditure monitoring is effectively possible in the existing framework at the Governmental level with Parliamentary scrutiny. One has to wait and watch to opine whether a legislation separately setting deficit targets is going to make an additional contribution to improve fiscal situation.

It has to be noted that the FRBM Act 2003 not only targets fiscal deficit, but also revenue deficit. In accordance with the rules to the FRBM Act 2003, the Central Government has targetted to eliminate revenue

deficit by 2008-09. Fiscal deficit is an indicator of the borrowings by the government. The conventional argument is that higher borrowing by the government crowds out the available funds for private investment and also raises the interest rate thereby adversely affecting private investment. A higher fiscal deficit is also expected to spill over to external sector. This argument can be found in the report of the Eleventh Finance Commission Report (Chapter III, para 3.7, p. 19), Report on Currency and Finance 2001-02 and Srinivasan (2000). In the prevailing economic situation, none of these is empirically tested in favour of the conventional arguments.<sup>38</sup>

## **5. The Alternative Path to Fiscal Consolidation**

Contrary to the widely held perception, it is not 'spiralling' expenditure that has caused the fiscal problem at the Central level. In fact the proportion of total expenditure to GDP (of the Centre alone and Centre and States together) has declined in the 1990s when compared to the 1980s. But the revenue receipts of the Centre have not been buoyant when tested for a thirty-year period. The tax-GDP ratios have also declined during the 1990s when compared with the 1980s. This necessitates contemplation for measures to achieve revenue buoyancy, especially when the growth rate of the economic base of the taxes, i.e. Gross Domestic Product (GDP) has shown statistically significant upward shifts during the three decadal period starting from 1970-71. The fiscal consolidation at the Central level is of paramount importance as the consequential fiscal situation of the States' and assistance through loans and grants is critically dependent on the fiscal position of the Centre.

Fiscal consolidation should aim at collecting revenues from emerging sectors of the economy, targeting expenditure towards productive public and infrastructural investments, collect user charges from the beneficiaries and undertake social sector expenditure for the

benefit of development. It should not be a process of only deficit targetting. In the present circumstances, the focus should be on increased revenue mobilisation in an economy, which is having statistically significant growth rate of the economic base of taxation, the Gross Domestic Product.

It is difficult to predict whether the above suggestions as well as the revenue led consolidation<sup>39</sup> advocated by the Task force report on the implementation of the FRBM Act 2003, would become a reality, given the political economic constraints to tax reforms and expenditure management. The challenge lies in the ability of the government to strategically tackle these constraints with consensus among political parties. This is essentially question of political strategy for tackling economic problems. In other words, it is the art of balancing the fiscally desirable with what is politically feasible.

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## NOTES

- 1 The official view that causality runs from fiscal deficit to balance of payments crisis has been questioned by Rakshit (1991) and Balakrishnan (1997). Rakshit (1991) states that fiscal deficit does not represent the saving investment gap in the government and finds no empirical relationship between fiscal deficit and current account deficit.
- 2 We shall discuss later in this paper how this apparently hard budget constraint was in fact a soft budget constraint and did not help in achieving fiscal consolidation.
- 3 In the title of the paper we use the term 'Procrustean' Fiscal Correction. Procrustes is a Greek mythological character. He was a high way innkeeper who used to feed his guests with food and drinks. But when they were made to sleep in a bed, if he found that they don't exactly fit, their limbs would be cut or stretched. Cutting deficits to meet a target without regard to what expenditure is being cut can be termed as Procrustean.
- 4 In the seminar in which this paper was presented, there were comments that the period before and after liberalisation, say post and prior 1991 or post and prior mid-1980s cannot be compared for trends in receipts and expenditure. While it can be agreed to that there has been substantial internal and external sector reforms, the major sources of tax revenue of the Central Government has not been altered. But there have been considerable changes in the rate/duty structure, slabs, and share of revenue contribution of the taxes. It is to be noted that the three decadal period has witnessed gradual tax reforms. The 1980s saw a reduction of marginal rates of taxation from the 1970s and during the 1990s there was still further reduction of rates. The three decadal period also witnessed immunity schemes, introduction of MODVAT, submission of reports by tax reforms committees, administrative reforms in tax departments etc. There were also two significant upward shifts in the growth rate of the economic base of taxation, the Gross Domestic Product. To test the impact of these changes on trend growth rate of major taxes, tax elasticity and tax buoyancy, we have selected this time period of 1970-71 to 2002-03.
- 5 Non-debt creating capital receipts are recoveries of loans and disinvestment proceeds, whereas debt creating capital receipts are market borrowings, small savings and PF receipts.

- 6 The Report on Currency and Finance, 2001-02 of the Reserve Bank of India, states that the Non-tax revenue of the Central Government recorded an improvement from 2.1 percent in 1990-91 to 3.0 percent in 2001-02. An examination of the trend in Non-Tax revenues reveals that increase in dividend and profits and economic services fully account for the improvement in Centre's collection of Non-Tax revenue, as growth in other components remained stagnant during the reform period, according to the report. Much of the improvement in dividends and profits came from the profits of the Reserve Bank of India, which increased from Rs.210 crore in 1990-91 to Rs.10320 crore in 2001-02, there by raising its share from 1.8 percent to 15.2 percent of the Non-Tax revenue. The rise in profits is mainly due to earnings from deployment of foreign currency assets, conversion of 4.6 percent Treasury bills into marketable securities and discontinuation of the practice of crediting large sums to the National Industrial (LTO) fund. This makes it clear that but for the increased remitting of profits of the Reserve Bank of India to the Centre, the trend of Non-Tax Revenues would have shown a downward trend.
- 7 A more precise tax base would be Gross domestic Product minus the subsistence income, though many studies take the Gross Domestic Product (GDP) as the tax base.
- 8 This idea of sharing information finds a mention in the report of the Task force on the implementation of the FRBM Act, 2003.
- 9 When two variables are non-stationary, but integrated of the same order, for example  $I(1)$ , and if the residuals are stationary at levels,  $I(0)$ , then the variables can be combined in a co integrating relationship.
- 10 I am grateful to the anonymous referee for reminding me of this aspect.
- 11 See also Mundle and Mukhopadyaay (1993) for a discussion.
- 12 The residual properties indicate that the model is adequate. The statistic is given along with the probability in parenthesis. The null hypotheses are there is no autoregression, there is no Autoregressive Conditional Heteroscedasticity (ARCH), there is normality, there is no heteroscedasticity and the model is not misspecified (RESET). A low value of the statistic and the high value of the probabilities indicate that the null hypotheses fail to reject.
- 13 Agricultural GDP is excluded from the base for measuring elasticity, as agricultural income is exempt from Central income tax.

- 14 The Augmented Dickey Fuller Test was used for testing unit roots. There is a problem with this test as one of the variables, i.e. logarithmic transformation of Personal Income Tax has two structural breaks, but the logarithmic transformation of non-agricultural GDP has no structural break at 1 percent level, when tested using the Chow's test for structural break. An alternative method to test for unit roots when structural breaks are present is Perron's test. We are not attempting this here. The Report on Currency and Finance, 2001-02, Reserve Bank of India :IV-10 has shown a statistically significant relationship between personal income tax and GDP. But the variables are not taken in their log transformations, i.e. not in the double log model, usually used for obtaining co-efficients of elasticity. When tested for model adequacy, we find that the residual properties were not satisfied, rendering the coefficients obtained using Ordinary Least Squares (OLS) unreliable.
- 15 Growth rates are logarithmic first differences.
- 16 It is to be noted that our result of non-buoyancy of taxes is different from those in Currency and Finance, Reserve Bank of India 2001 and the Report of the Task Force on Implementation of the FRBM Act, 2003, which find significant tax elasticity to GDP. We find that those regressions involving time series variables do not satisfy the residual properties and hence the OLS estimators are not reliable.
- 17 The narrowing of the legal base as compared to the economic base is obviously due to political economic reasons, mainly the influence of various classes and groups in the society over the state.
- 18 Das Gupta and Mookherjee (1997: 166) have pointed out that the extent of tax evasion seems to be concentrated in the (annual) income range of Rs. 2 lakhs to Rs.4.5 lakhs. The extent of evasion in this range is as high as 90 to 95 percent. The evasion estimate falls sharply to about 30 to 40 percent in incomes above Rs. 5 lakhs on the upper end and to between 70 and 80 percent for those between Rs. 30000 and one lakh. With the lowering of marginal rates and thus decreasing progressivity in the tax rates since the second half of the 1990s, the main collection point is on the middle-income groups. It is perhaps this missing middle, a large proportion of them earning income in the service sector, that is accounting for the statistically insignificant coefficient of the buoyancy of Personal Income tax with its base, the non-agricultural GDP.
- 19 It is yet another matter that indirect taxation still plays a very important role in a federal set up like ours and its reforms deserve serious consideration, for example Service tax and VAT.

- 20 see Harris White (2003) for a discussion
- 21 For a brief discussion on the implementation problems of the recommendations of GST, see Venkitaramanan (2004)
- 22 For a discussion on this with regard to Rajasthan, see Jenkins (1999).
- 23 For a study of the plight of the power sector in India, which is a typical public utility supplied by the Union and the State Governments, see Kannan and Pillai (2001) and Report on Currency and Finance, 2001-02, Reserve Bank of India.
- 24 Wicksell (1896) states as a general rule that if a public enterprise is already in existence and thus a potential loss of original investment costs must be faced in any case, then the (theoretically) most economic method of covering costs will always be  $\text{Price} = \text{Marginal Cost}$ , that is additional costs occasioned by the last unit of service, leaving the general costs to be financed by taxes. If this cannot be economically done, that is no conceivable way of distributing the required total tax can command approximate unanimity, then the whole enterprise must be considered uneconomic and best be discontinued. Any loss of money or interest payments thereon might be shared according to the principle of equal (or proportionate) sacrifice. This in effect amounts to say that public borrowings to cover the total costs of enterprises is economically unfeasible and Government can consider discontinuing such enterprises by transferring them to cooperatives or private sector. This should be done for public enterprises producing purely private goods and making losses. It is a desirable sign that budgetary support to public enterprises has come down from 39.7 percent in the Seventh Plan period to 12.7 in the Eighth Plan period to 11.9 percent in 1998-99, of the resources of the public sector. But disinvestment has been attempted in the case of profit making public sector enterprises like the oil companies, which earn resource rents.
- 25 It needs to be mentioned here that the analysis of the Indian state as one dominated by an alliance of lower middle class and rich peasantry was criticised by Namboothiripad (1973). In his view, the Indian state was one dominated by big bourgeoisie and feudal landlords with lower middle classes and rich peasantry being their camp followers. An analysis of the intermediate regimes in the context of liberalisation has been made by Bardhan (1993). Intermediate regimes affecting state policies has also been discussed by Harris White (2003).



- 26 The size effect of government on economic growth may not be adequately captured by the total expenditure of the government as the size may not capture the difference between the regulatory role and the direct intervention. For a discussion, see Slemrod (1995).
- 27 However one needs to be careful in generalising this. Maintenance of capital assets falls in the category of revenue expenditure. Social sector spending falls in the category of revenue expenditure. As pointed out earlier, all capital expenditure need not be productive and all revenue expenditure unproductive. The increasing proportion of revenue expenditures, when the trend growth rate of revenue receipts is stagnating implies that there is borrowing for revenue expenditure and a rising revenue deficit and interest burden on debt.
- 28 Though we do not intend to state that the impact of pay revision consequent to the higher pay granted equivalent to the scales suggested by the Fifth pay Commission for the Centre has not adversely affected the State finances, it is sought to be emphasised that the adverse effect on State finances is due to the combined effect of the increasing trend in wages in salaries for the period 1970-71 to 1999-2000 and the rise in pay consequent to Fifth pay Commission.
- 29 The tax breaks for export income in the Income tax Act, 1961, (Section 80 HHC) are being phased out to be eliminated by 1<sup>st</sup> April 2005.
- 30 It is not proposed here that higher borrowing has led to higher rates of interest. In fact, there are arguments against this hypothesis. For a discussion, see Patnaik (2000). The higher interest payments are due to shift in policy from low cost borrowing through treasury bills to high cost market borrowings, where interest rates are already high. To state in other words, we do not attribute a causative relation or an association between higher government borrowing and rise in interest rates. This is however a testable proposition. The inability to generate resources to meet expenditure obligations is the major cause for borrowing.
- 31 Though we are not having full convertibility on capital account, there is gradual opening up of the external sector.
- 32 It should also be taken note of that since the latter half of the 1990s there has been softening of interest rates and comfortable foreign exchange position has enabled the Government to repay previously incurred high cost debt.

- 33 This was a proposal from Knut Wicksell in 1896. For a discussion, see Mueller (2003: 382)
- 34 The fact that the acceptability of this measure has been challenged deserves mention. Illustrative examples in the literature on this subject are Gulati (1994), Rao and Amarnath (2000), Srinivasan (2000, p.48). Even the Union Finance Minister's Budget Speech, 2003 has to a certain extent recognised this, by stating that revenue deficit is the main worry and not the fiscal deficit. Rakshit (1991) and Balakrishnan (1997) have examined the relationship between fiscal deficit and macro economic variables and found practically no relationship. Balakrishnan (1997) points out that fiscal deficit as a macroeconomic tool has weaknesses.
- 35 The Centre includes the portion of small savings borrowed by the States in a special fund. National Small Savings Securities Fund (NSSF) and treats the balance as its capital receipts. The interest due on small savings is however included in the expenditure.
- 36 Though the Central Act has not prescribed a target for the proportion of fiscal deficit to GDP on a yearly basis and leaves it to the Central Government, the Kerala Act has prescribed a target of 2 percent fiscal deficit to GDP ratio. Since it has been legislated, the achievement of targets becomes an obligation and indiscriminate cutting of expenditure including productive capital expenditure may happen.
- 37 Here we should take note of the fact that revenue deficit reduction and raising capital expenditure proportion have also been suggested by the EFC.
- 38 We are not entering into elaborate economic counter arguments to these propositions, which of course have been made by Rakshit (1991), Patnaik (2000), Chandrasekhar and Ghosh (2002), Fazzari (1994), Naastepad (1999) etc.
- 39 It is worth mentioning here that the Task force on the implementation of the FRBM Act 2003 discusses the arguments in favour of fiscal consolidation through revenue mobilisation than through expenditure reduction. The reasons mentioned in the report are 1) positive impact on State finances 2) raising taxes is less contractionary than cutting expenditure for the macroeconomy and 3) tax reforms spur GDP growth by removing the existing misallocation of resources.

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