

# **Fiscal Policy in India: Trends and Trajectory**

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## Content

|  | Page No. |
|--|----------|
| Foreword   | 2        |
| Disclaimer and acknowledgements  | 3        |
| Abstract   | 3        |
| Introduction   | 4        |
| Basic concepts   | 5        |
| India's fiscal policy architecture   | 6        |
| Evolution of Indian fiscal policy till 1991                                      | 8        |
| Liberalization, growth, inclusion and fiscal consolidation (1991-2008)           | 14       |
| Crisis and return to fiscal consolidation: The maturing of Indian fiscal policy? | 20       |
| Conclusion   | 25       |
| References   | 26       |

## **Foreword**

In the rush to produce urgent policy documents and briefing notes that any government has to do, it is easy to let matters that may not be quite as urgent to go unattended. However, the not-so-urgent often includes matters of great importance for the long-run well-being of the nation and its citizenry. Research papers on topics of strategic economic policy fall in this category. The Economic Division in the Department of Economic Affairs, Ministry of Finance, has initiated this Working Paper series to make available to the Indian policymaker, as well as the academic and research community interested in the Indian economy, papers that are based on research done in the Ministry of Finance and address matters that may or may not be of immediate concern but address topics of importance for India's sustained and inclusive development. It is hoped that this series will serve as a forum that gives shape to new ideas and provides space to discuss, debate and disseminate them.

January 18, 2011

**Kaushik Basu**  
Chief Economic Adviser

## **Disclaimer and Acknowledgements**

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The views expressed in this essay are purely personal and do not necessarily express the views of the institutions the author is associated with. This is a technical, academic and research output.

## **Abstract**

This essay examines the trajectory of India's fiscal policy with a focus on historical trends, fiscal discipline frameworks, fiscal responses to the global financial crisis and subsequent return to a fiscal consolidation path. The initial years of India's planned development strategy were characterised by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector driven industrialization process and also cover social welfare schemes. However, growth was anaemic and the system was prone to inefficiencies. In the 1980s some attempts were made to reform particular sectors. But the public debt increased, as did the fiscal deficit. India's balance of payments crisis of 1991 led to economic liberalisation. The reform of the tax system commenced. The fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legalisations were instituted. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and moderate inflation prevailed. During the global financial crisis fiscal policy responded with counter-cyclical measures including tax cuts and increases in expenditures. The post-crisis recovery of the Indian economy is witnessing a correction of the fiscal policy path towards a regime of prudence. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

## Introduction

Fiscal policy deals with the taxation and expenditure decisions of the government. Monetary policy, deals with the supply of money in the economy and the rate of interest. These are the main policy approaches used by economic managers to steer the broad aspects of the economy. In most modern economies, the government deals with fiscal policy while the central bank is responsible for monetary policy. Fiscal policy is composed of several parts. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy strategy.

Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money.<sup>1</sup> This tends to influence other economic variables. On a broad generalisation, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. If it draws down on its foreign exchange reserves, a balance of payments crisis may arise. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the ‘crowding out’ of private investment. Sometimes a combination of these can occur. In any case, the impact of a large deficit on long run growth and economic well-being is negative. Therefore, there is broad agreement that it is not prudent for a government to run an unduly large deficit. However, in case of developing countries, where the need for infrastructure and social investments may be substantial, it is sometimes argued that running surpluses at the cost of long-term growth might also not be wise (Fischer and Easterly, 1990). The challenge then for most developing country governments is to meet infrastructure and social needs while managing the government’s finances in a way that the deficit or the accumulating debt burden is not too great.

This essay examines the trajectory of India’s fiscal policy with particular focus on historical trends, the development of fiscal discipline frameworks, the recent experience of fiscal response to the global financial crisis and subsequent return to a fiscal consolidation path. The initial years of India’s planned development strategy were characterised by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector driven industrialization process and also cover social welfare schemes. Indirect taxes were a larger source of revenue than direct taxes. However, growth was anaemic and the system was prone to inefficiencies. In the 1980s some attempts were made to reform particular sectors and make some changes in the tax system. But the public debt increased, as did the fiscal deficit. Triggered by higher oil prices and political uncertainties, the balance of payments crisis of 1991 led to economic liberalisation. The reform of the tax system commenced with direct taxes increasing their share in

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<sup>1</sup> The government’s exclusive right and privilege to print money is known as ‘seigniorage’.

comparison to indirect taxes. The fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legislations were instituted at the central level and in most states. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and moderate inflation prevailed. The global financial crisis tested the fiscal policy framework and it responded with counter-cyclical measures including tax cuts and increases in expenditures. The post-crisis recovery of the Indian economy is witnessing a correction of the fiscal policy path towards a regime of prudence. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

The paper is organised into seven sections. Section 1 is introductory in nature, Section 2 clarifies certain basic concepts and Section 3 outlines India's fiscal policy architecture. Section 4 delineates the fiscal policy developments from the period of planned development in the 1950s to the eve of the country's balance of payments crisis in 1991. Section 5 describes developments following economic liberalisation and the move towards fiscal consolidation till the global financial crisis in 2008. Section 6 traces the role of fiscal policy during the crisis and post-crisis recovery of the Indian economy. Section 7 concludes.

## **2. Basic concepts**

At the outset, it is important to clarify certain basic concepts. The most elementary is perhaps the difference between revenue and capital flows, be they receipts or expenditures. While there are various complex legal and formal definitions for these ideas, presenting some simplified and stylised conceptual clarifications is deemed appropriate. A spending item is a capital expenditure if it relates to the creation of an asset that is likely to last for a considerable period of time and includes loan disbursements. Such expenditures are generally not routine in nature. By the same logic a capital receipt arises from the liquidation of an asset including the sale of government shares in public sector companies (disinvestments), the return of funds given on loan or the receipt of a loan. This again usually arises from a comparatively irregular event and is not routine. In contrast, revenue expenditures are fairly regular and generally intended to meet certain routine requirements like salaries, pensions, subsidies, interest payments, and the like. Revenue receipts represent regular 'earnings', for instance tax receipts and non-tax revenues including from sale of telecom spectrums.

There are various ways to represent and interpret a government's deficit. The simplest is the revenue deficit which is just the difference between revenue receipts and revenue expenditures.

Revenue Deficit = Revenue Expenditure – Revenue Receipts (*that is Tax + Non-tax Revenue*)

A more comprehensive indicator of the government's deficit is the fiscal deficit. This is the sum of revenue and capital expenditure less all revenue and capital receipts other than

loans taken. This gives a more holistic view of the government's funding situation since it gives the difference between all receipts and expenditures other than loans taken to meet such expenditures.

Fiscal Deficit = Total Expenditure (*that is Revenue Expenditure + Capital Expenditure*) – (Revenue Receipts + Recoveries of Loans + Other Capital Receipts (*that is all Revenue and Capital Receipts other than loans taken*))

“The *gross fiscal deficit* (GFD) of government is the excess of its total expenditure, current and capital, including loans net of recovery, over revenue receipts (including external grants) and non-debt capital receipts.” The net fiscal deficit is the gross fiscal deficit reduced by net lending by government (Dasgupta and De, 2011). The gross primary deficit is the GFD less interest payments while the primary revenue deficit is the revenue deficit less interest payments.

### **3. India's fiscal policy architecture**

The Indian Constitution provides the overarching framework for the country's fiscal policy. India has a federal form of government with taxing powers and spending responsibilities being divided between the central and the state governments according to the Constitution. There is also a third tier of government at the local level. Since the taxing abilities of the states are not necessarily commensurate with their spending responsibilities, some of the centre's revenues need to be assigned to the state governments. To provide the basis for this assignment and give medium term guidance on fiscal matters, the Constitution provides for the formation of a Finance Commission (FC) every five years. Based on the report of the FC the central taxes are devolved to the state governments. The Constitution also provides that for every financial year, the government shall place before the legislature a statement of its proposed taxing and spending provisions for legislative debate and approval. This is referred to as the Budget. The central and the state governments each have their own budgets.

The central government is responsible for issues that usually concern the country as a whole like national defence, foreign policy, railways, national highways, shipping, airways, post and telegraphs, foreign trade and banking. The state governments are responsible for other items including, law and order, agriculture, fisheries, water supply and irrigation, and public health. Some items for which responsibility vests in both the Centre and the states include forests, economic and social planning, education, trade unions and industrial disputes, price control and electricity. There is now increasing devolution of some powers to local governments at the city, town and village levels. The taxing powers of the central government encompass taxes on income (except agricultural income), excise on goods produced (other than alcohol), customs duties, and inter-state sale of goods. The state governments are vested with the power to tax agricultural income, land and buildings, sale of goods (other than inter-state), and excise on alcohol.

Besides the annual budgetary process, since 1950, India has followed a system of five-year plans for ensuring long-term economic objectives. This process is steered by the Planning Commission for which there is no specific provision in the Constitution. The main fiscal impact of the planning process is the division of expenditures into plan and non-plan components. The plan components relate to items dealing with long-term socio-economic goals as determined by the ongoing plan process. They often relate to specific schemes and projects. Furthermore, they are usually routed through central ministries to state governments for achieving certain desired objectives. These funds are generally in addition to the assignment of central taxes as determined by the Finance Commissions. In some cases, the state governments also contribute their own funds to the schemes. Non-plan expenditures broadly relate to routine expenditures of the government for administration, salaries, and the like.

While these institutional arrangements initially appeared adequate for driving the development agenda, the sharp deterioration of the fiscal situation in the 1980s resulted in the balance of payments crisis of 1991, which would be discussed later. Following economic liberalisation in 1991, when the fiscal deficit and debt situation again seemed to head towards unsustainable levels around 2000, a new fiscal discipline framework was instituted. At the central level this framework was initiated in 2003 when the Parliament passed the Fiscal Responsibility and Budget Management Act (FRBMA).

Taxes are the main source of government revenues. Direct taxes are so named since they are charged upon and collected directly from the person or organisation that ultimately pays the tax (in a legal sense).<sup>2</sup> Taxes on personal and corporate incomes, personal wealth and professions are direct taxes. In India the main direct taxes at the central level are the personal and corporate income tax. Both are till date levied through the same piece of legislation, the Income Tax Act of 1961. Income taxes are levied on various head of income, namely, incomes from business and professions, salaries, house property, capital gains and other sources (like interest and dividends).<sup>3</sup> Other direct taxes include the wealth tax and the securities transactions tax. Some other forms of direct taxation that existed in India from time to time but were removed as part of various reforms include the estate duty, gift tax, expenditure tax and fringe benefits tax. The estate duty was levied on the estate of a deceased person. The fringe benefits tax was charged on employers on the value of in-kind non-cash benefits or perquisites received by employees from their employers. Such perquisites are now largely taxed directly in the hands of employees and added to their personal income tax. Some states charge a tax on professions. Most local governments also charge property owners a tax on land and buildings.

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<sup>2</sup> Economic theory indicates that the incidence of a tax depends on various factors. In the case of commodity taxes these include the respective elasticities of supply and demand.

<sup>3</sup> A capital gain (or loss) arises when a person sells off a capital asset. The gain (or loss) is the difference between the price at which the asset was purchased and the price at which it is sold and represents an appreciation (or fall) in value. Often an adjustment to the basic value of the asset is made to include factors like cost inflation or economic depreciation due to wear and tear.

Indirect taxes are charged and collected from persons other than those who finally end up paying the tax (again in a legal sense). For instance, a tax on sale of goods is collected by the seller from the buyer. The legal responsibility of paying the tax to government lies with the seller, but the tax is paid by the buyer. The current central level indirect taxes are the central excise (a tax on manufactured goods), the service tax, the customs duty (a tax on imports) and the central sales tax on inter-state sale of goods. The main state level indirect tax is the post-manufacturing (that is wholesale and retail levels) sales tax (now largely a value added tax with intra-state tax credit). The complications and economic inefficiencies of this multiple cascading taxation across the economic value chain (necessitated by the constitutional assignment of taxing powers) are discussed later in the context of the proposed Goods and Services Tax (GST).

#### **4. Evolution of Indian fiscal policy till 1991**

India commenced on the path of planned development with the setting up of the Planning Commission in 1950. That was also the year when the country adopted a federal Constitution with strong unitary features giving the central government primacy in terms of planning for economic development (Singh and Srinivasan, 2004). The subsequent planning process laid emphasis on strengthening public sector enterprises as a means to achieve economic growth and industrial development. The resulting economic framework imposed administrative controls on various industries and a system of licensing and quotas for private industries. Consequently, the main role of fiscal policy was to transfer private savings to cater to the growing consumption and investment needs of the public sector. Other goals included the reduction of income and wealth inequalities through taxes and transfers, encouraging balanced regional development, fostering small scale industries and sometimes influencing the trends in economic activities towards desired goals (Rao and Rao, 2006).

In terms of tax policy, this meant that both direct and indirect taxes were focussed on extracting revenues from the private sector to fund the public sector and achieve redistributive goals. The combined centre and state tax revenue to GDP ratio increased from 6.3 percent in 1950-51 to 16.1 percent in 1987-88.<sup>4</sup> For the central government this ratio was 4.1 percent of GDP in 1950-51 with the larger share coming from indirect taxes at 2.3 percent of GDP and direct taxes at 1.8 percent of GDP. Given their low direct tax levers, the states had 0.6 percent of GDP as direct taxes and 1.7 percent of GDP as indirect taxes in 1950-51 (Rao and Rao, 2006).

The government authorised a comprehensive review of the tax system culminating in the Taxation Enquiry Commission Report of 1953. However, the government then invited the British economist Nicholas Kaldor to examine the possibility of reforming the tax system. Kaldor found the system inefficient and inequitable given the narrow tax base and inadequate reporting of property income and taxation. He also found the maximum marginal income tax rate at 92 percent to be too high and suggested it be reduced to 45

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<sup>4</sup> The Indian financial year commences on the 1<sup>st</sup> of April of a calendar year and ends on the 31<sup>st</sup> of March of the next calendar year.

percent. In view of his recommendations, the government revived capital gains taxation, brought in a gift tax, a wealth tax and an expenditure tax (which was not continued due to administrative complexities) (Herd and Leibfritz, 2008).

Despite Kaldor's recommendations income and corporate taxes at the highest marginal rate continued to be extraordinarily high. In 1973-74, the maximum rate taking in to account the surcharge was 97.5 percent for personal income above Rs. 0.2 million. The system was also complex with as many as eleven tax brackets. The corporate income tax was differential for widely held and closely held companies with the tax rate varying from 45 to 65 percent for some widely held companies. Though the statutory tax rates were high, given a large number of special allowances and depreciation, effective tax rates were much lower. The Direct Taxes Enquiry Committee of 1971 found that the high tax rates encouraged tax evasion. Following its recommendations in 1974-75 the personal income tax rate was brought down to 77 percent but the wealth tax rate was increased. The next major simplification was in 1985-86 when the number of tax brackets was reduced from eight to four and the highest income tax rate was brought down to 50 percent (Rao and Rao, 2006).

In indirect taxes, a major component was the central excise duty. This was initially used to tax raw materials and intermediate goods and not final consumer goods. But by 1975-76 it was extended to cover all manufactured goods. The excise duty structure at this time was complicated and tended to distort economic decisions. Some commodities had specific duties while others had ad valorem rates.<sup>5</sup> The tax also had a major 'cascading effect' since it was imposed not just on final consumer goods but also on inputs and capital goods. In effect, the tax on the input was again taxed at the next point of manufacture resulting in double taxation of the input. Considering that the states were separately imposing sales tax at the post-manufacturing wholesale and retail levels, this cascading impact was considerable. The Indirect Tax Enquiry Report of 1977 recommended introduction of input tax credits to convert the cascading manufacturing tax into a manufacturing value added tax (MANVAT). Instead, the modified value added tax (MODVAT) was introduced in a phased manner from 1986 covering only selected commodities (Rao and Rao, 2006).

The other main central indirect tax is the customs duty. Given that imports into India were restricted, this was not a very large source of revenue. The tariffs were high and differentiated. Items at later stages of production like finished goods were taxed at higher rates than those at earlier stages, like raw materials. Rates also differed on the basis of perceived income elasticities with necessities taxed at lower rates than luxury goods. In 1985-86 the government presented its Long-Term Fiscal Policy stressing on the need to reduce tariffs, have fewer rates and eventually remove quantitative limits on imports. Some reforms were attempted but due to revenue raising considerations the tariffs in terms of the weighted average rate increased from 38 percent in 1980-81 to 87 percent in

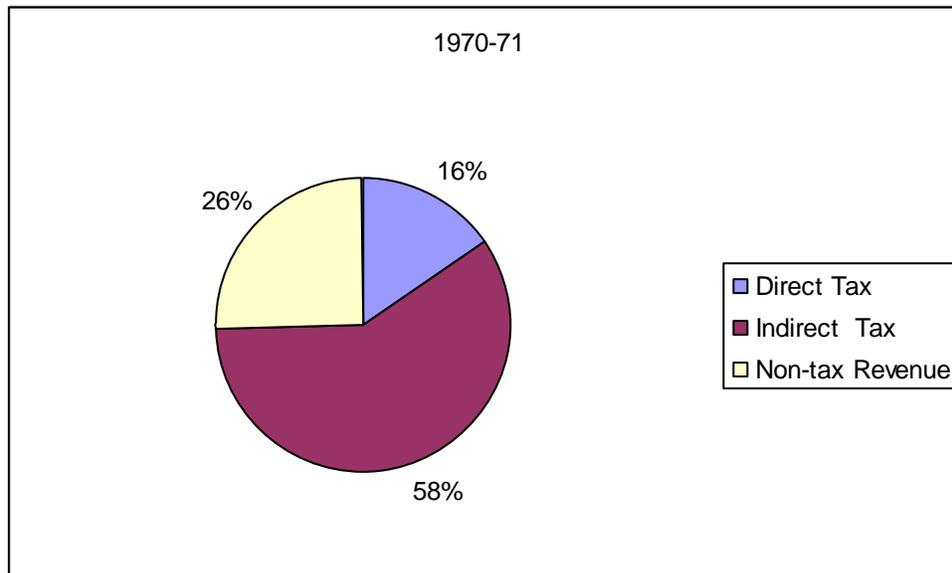
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<sup>5</sup> Specific duties are levied in terms of a certain amount for every unit, for instance a tax amount per litre of alcohol or per hundred cigarettes. Ad valorem taxes are based on the value of the article or service to be taxed at a certain rate. For instance a ten percent ad valorem sales or consumption tax rate would mean that if a good worth Rs. 100 were purchased, a tax of Rs. 10 would be paid.

1989-90. By 1990-91 the tariff structure had a range of 0 to 400 percent with over 10 percent of imports subjected to tariffs of 120 percent or more. Further complications arose from exemptions granted outside the budgetary process (Rao and Rao, 2006).

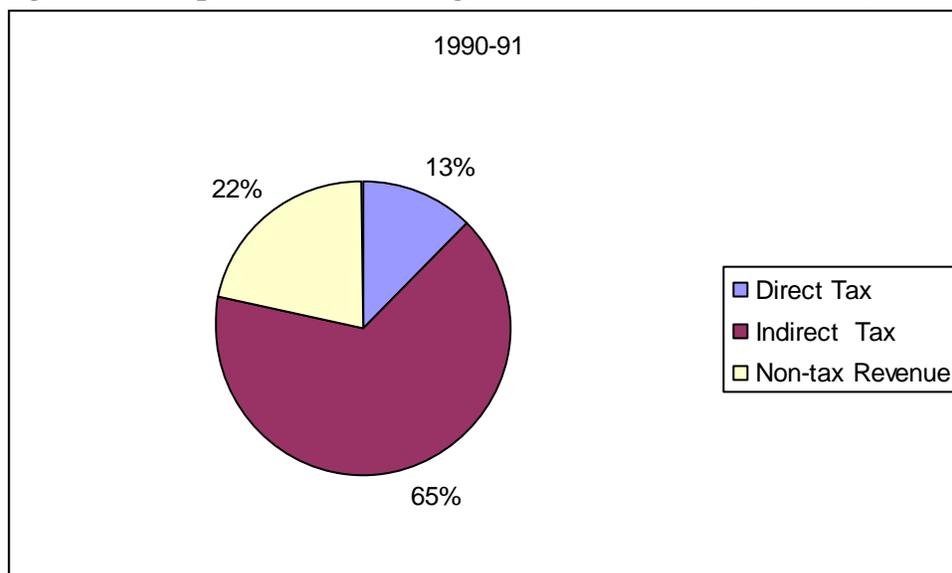
In 1970-71, direct taxes contributed to around 16 percent of the central government's revenues, indirect taxes about 58 percent and the remaining 26 percent came from non-tax revenues (Figure 1). By 1990-91, the share of indirect taxes had increased to 65 percent, direct taxes shrank to 13 percent and non-tax revenues were at 22 percent (Figure 2).

**Figure 1: Composition of central government revenues (1970-71)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 2: Composition of central government revenues (1990-91)**

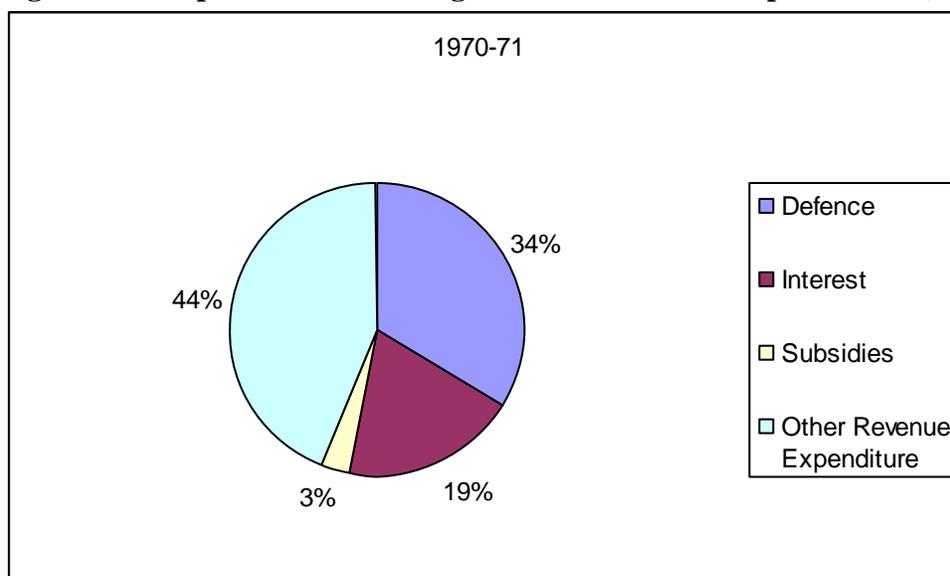


Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

India's expenditure norms remained conservative till the 1980s. From 1973-74 to 1978-79 the central government continuously ran revenue surpluses. Its gross fiscal deficit also showed a slow growth with certain episodes of downward movements (Figure 5). The state governments also ran revenue surpluses from 1974-75 to 1986-87, barring only 1984-85 (Figure 6). Thereafter, limited reforms in specific areas including trade liberalisation, export promotion and investment in modern technologies were accompanied by increased expenditures financed by domestic and foreign borrowing (Singh and Srinivasan, 2004). The central revenue deficit climbed from 1.4 percent of GDP in 1980-81 to 2.44 percent of GDP by 1989-90. Across the same period the centre's gross fiscal deficit (GFD) climbed from 5.71 percent to 7.31 percent of GDP. Though the external liabilities of the centre fell from 7.16 percent of GDP in 1982-83 to 5.53 percent of GDP by 1990-91, in absolute terms the liabilities were large. Across the same period the total liabilities of the centre and the states increased from 51.43 percent of GDP to 64.75 percent of GDP.

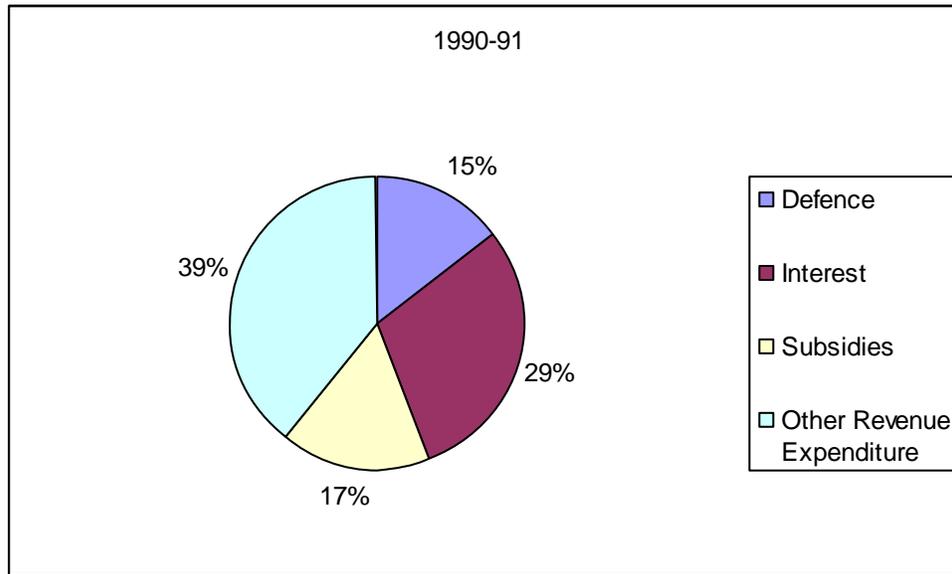
This came at the cost of social and capital expenditures. The interest component of aggregate central and state government disbursements reflects this quite clearly. The capital disbursements decreased from around 30 percent in 1980-81 to about 20 percent by 1990-91. In contrast, the interest component increased from around 8 percent to about 15 percent across the same period (Figure 7). Within revenue expenditures, in 1970-71, defence expenditures had the highest share of 34 percent, interest component was 19 percent while subsidies were only 3 percent (Figure 3). However, by 1990-91, the largest component was the interest share of 29 percent with subsidies constituting 17 percent and defence only 15 percent (Figure 4). Therefore, besides the burden of servicing the public debt, the subsidy burden was also quite great.

**Figure 3: Composition of central government revenue expenditures (1970-71)**



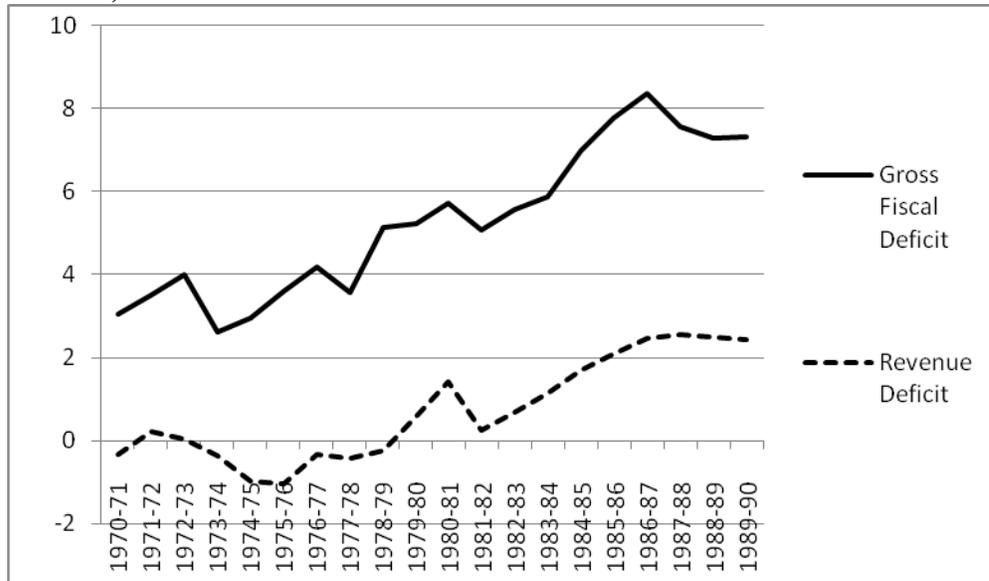
Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 4: Composition of central government revenue expenditures (1990-91)**



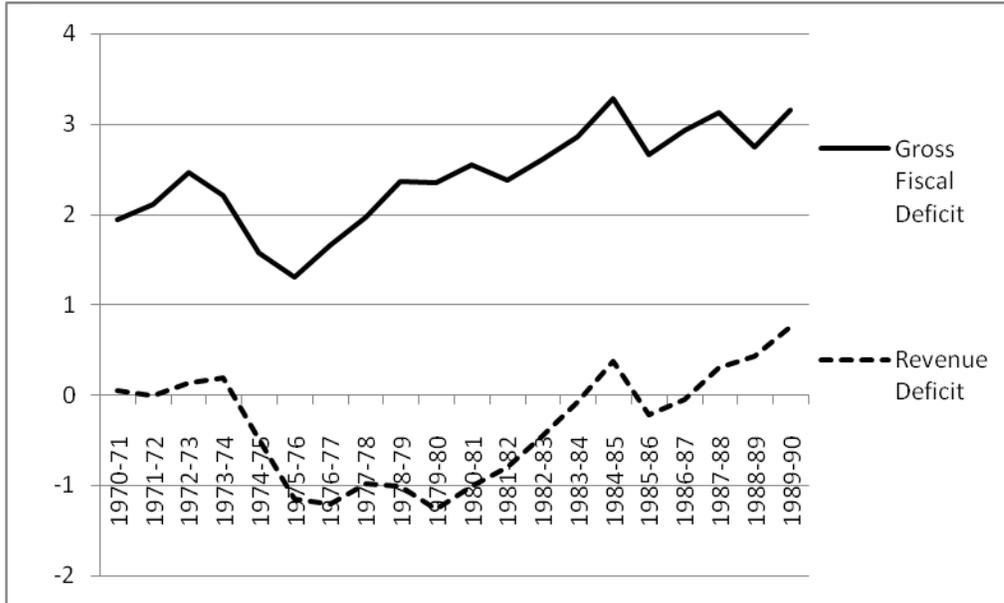
Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 5: Deficits of the Central Government as percentage of GDP (1970-71 to 1989-90)**



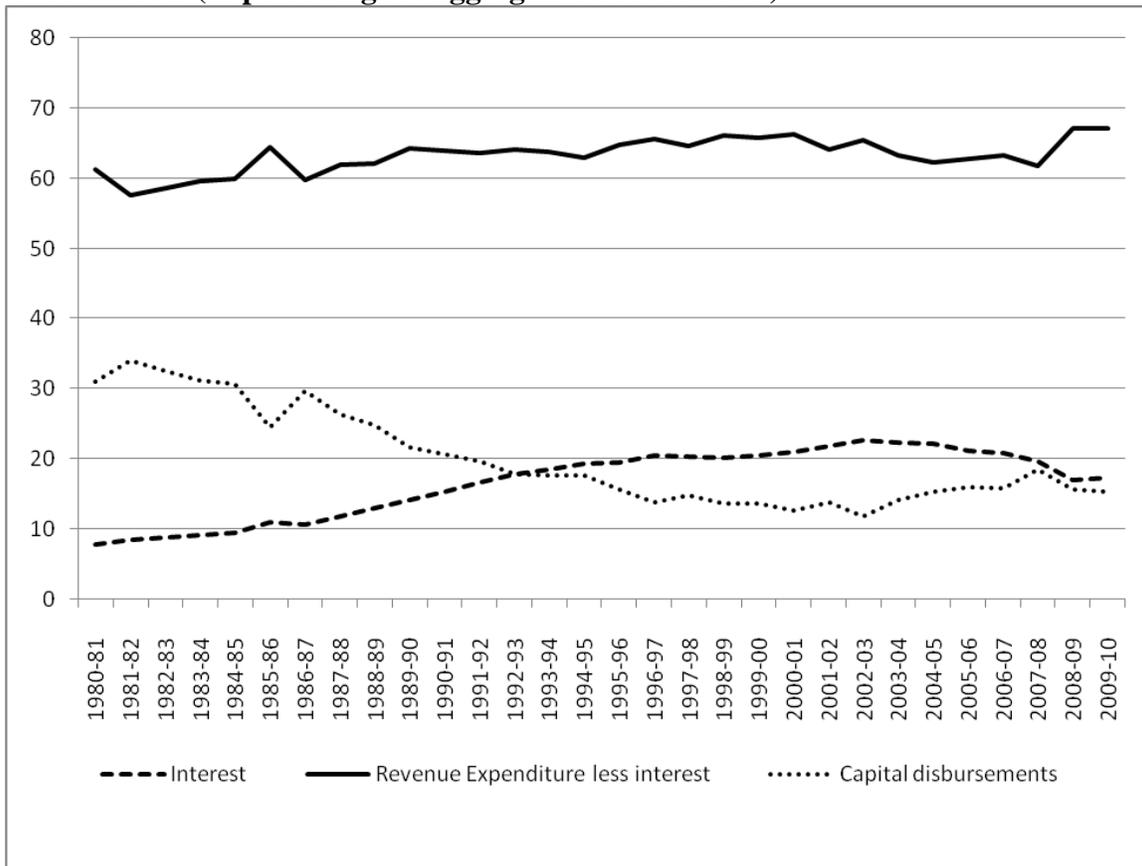
Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 6: Deficits of the State Governments as percentage of GDP (1970-71 to 1989-90)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 7: Composition of aggregate disbursements of Central and State Governments (as percentage of aggregate disbursements)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

While India's external debt and expenditure patterns were heading for unsustainable levels, the proximate causes of the balance of payments crisis came from certain unforeseen external and domestic political events. The First Gulf War caused a spike in oil prices leading to a sharp increase in the government's fuel subsidy burden. Furthermore, the assassination of former Prime Minister Rajiv Gandhi increased political uncertainties leading to the withdrawal of some foreign funds. The subsequent economic reforms changed the Indian economy forever.

## **5. Liberalization, growth, inclusion and fiscal consolidation (1991-2008)**

Following the balance of payments crisis of 1991, the government commenced on a path of economic liberalisation whereby the economy was opened up to foreign investment and trade, the private sector was encouraged and the system of quotas and licences was dismantled. Fiscal policy was re-oriented to cohere with these changes.

The Tax Reforms Committee provided a blue print for reforming both direct and indirect taxes. Its main strategy was to reduce the proportion of trade taxes in total tax revenue, increase the share of domestic consumption taxes by converting the excise into a VAT and enhance the contribution of direct taxes to total revenue. It recommended reducing the rates of all major taxes, minimizing exemptions and deductions, simplifying laws and procedures, improving tax administration and increasing computerisation and information system modernisation (Rao and Rao, 2006).

As a part of the subsequent direct tax reforms, the personal income tax brackets were reduced to three with rates of 20, 30 and 40 percent in 1992-93. Financial assets were removed from the imposition of wealth tax and the maximum rate of wealth tax was reduced to 1 percent. Personal income tax rates were reduced again to 10, 20, and 30 percent in 1997-98. The rates have largely remained the same since with the exemption limit being increased and slab structure raised from time to time. A subsequent 2 percent surcharge to fund education was later made applicable to all taxes. The basic corporate tax rate was reduced to 50 percent and the rates for different closely held companies made uniform at 55 percent. In 1993-94, the distinction between the closely held and the widely held companies was removed and the uniform tax rate was brought down to 40 percent. The rate was further reduced to 35 percent with a 10 percent tax on distributed dividends in 1997-98 (Rao and Rao, 2006).

Despite these reforms, the tax system continued to have preferential exemptions and deductions as tax incentives for various socio-economic goals including location of industries in backward areas, export promotion and technology development. This led to the phenomenon of 'zero-tax companies' whereby imaginative arrangements were used to leverage all these tax incentives with an intent to minimise tax liabilities. To counter this trend, the Minimum Alternative Tax (MAT) was introduced in 1996-97. It required a company to pay a minimum of 30 percent of book profits as tax. Further attempts to expand the tax base and increase revenues were the introduction of the securities

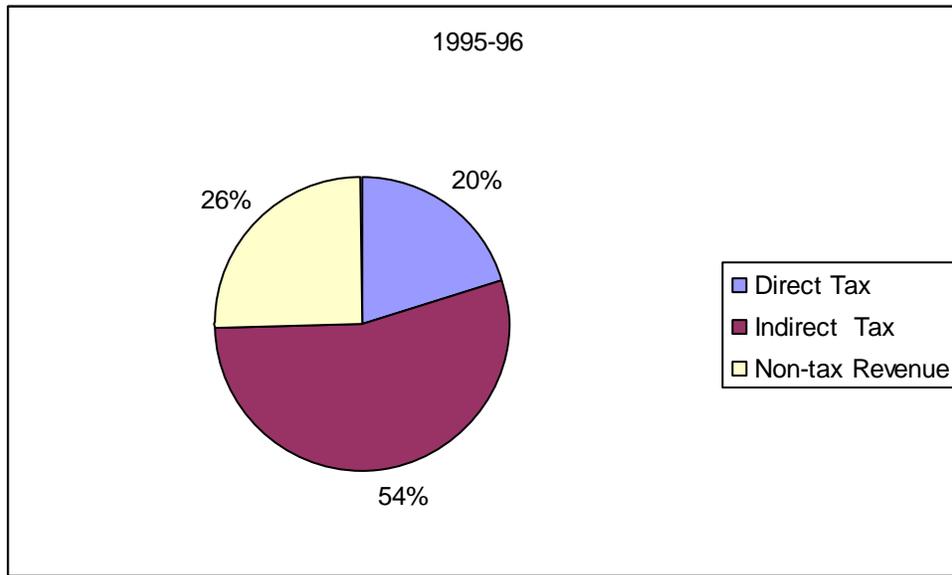
transaction tax (STT) in 2004 and the fringe benefit tax (FBT) in the budget of 2005-06 (Rao and Rao, 2006).

In indirect taxes, the MODVAT credit system for excise was expanded to cover most commodities and provide a comprehensive credit system by 1996-97. The eleven rates were merged into three with a few luxury items subject to additional non-rebatable tax in 1999-2000. In 2000-01, the three rates were merged in to a single rate and renamed as central VAT (CENVAT). There remained three additional excises of 8, 16 and 24 percent. In case of custom duties, in 1991-92 all duties on non-agriculture goods that were above 150 percent were brought down to this rate. The 'peak rate' was brought down to 40 percent in 1997-98, 30 percent in 2002-03, 25 percent in 2003-04, and 15 percent in 2005-06. The number of major duty rates was also brought down from 22 in 1990-91 to 4 in 2003-04. These four rates covered almost 90 percent of customs collected from items. This period also saw the introduction of the service tax in 1994-95, which was subsequently expanded to cover more and more services. Given that the Indian economy was having an increasingly large service component this increasingly became a major source of revenue. Eventually, provisions were made for allowing input tax credits for both goods and services at the central indirect tax level (Rao and Rao, 2006).

Despite the reforms in central taxes, even after the economic reforms of 1991, state government tax reforms were inadequate and sporadic. A major move in this direction was the coordinated simplification of the state sales tax system in 1999. This eventually led to the introduction of a VAT in 21 states in 2005. The value added tax gives credit to taxes paid on inputs and provides relief from cascading. Implemented at the retail level this replaced the cascading sales tax providing great relief to consumers and traders alike while enhancing the revenues of the state government. The administrative design of the VAT ensures reporting of inputs and outputs resulting in substantial reduction in tax evasion. The basic features of the tax include two rates of 4 percent for common consumption commodities and inputs and 12.5 percent for the others. Some essential items are exempted and precious metals are taxed at 1 percent. The credit system covers inputs and purchases as also capital goods for manufacturers as well as dealers. Credit for capital goods taxes can be availed over three years of sales. The tax credit operates fully only for intra-state sales (Rao and Rao, 2006). This is a major hindrance to the formation of a smooth nationwide market and is to be addressed by the proposed Goods and Services Tax (GST).

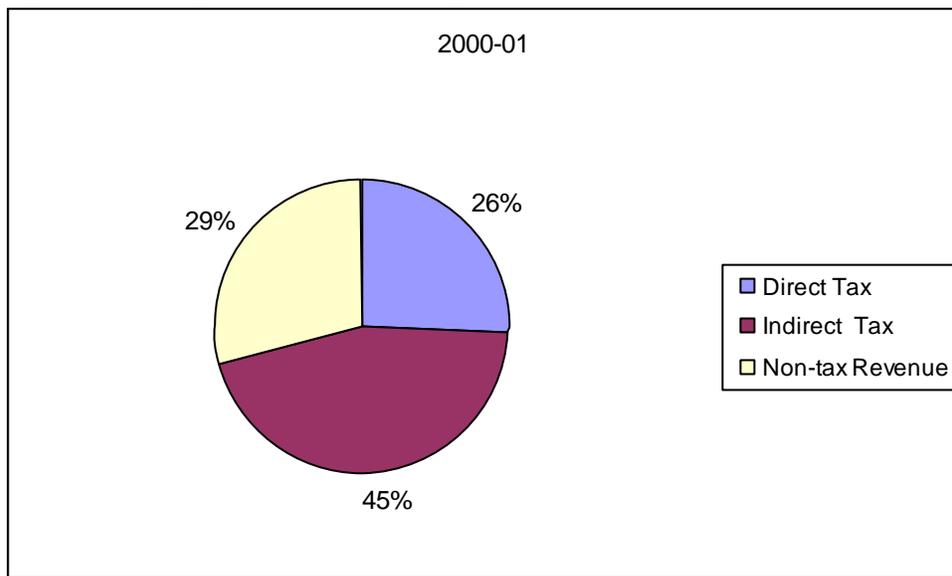
In consonance with the tax reform plans, the sources of central government revenue shifted from indirect taxes towards direct taxes. In 1995-96, about 54 percent of revenues came from indirect taxes while around 20 percent were from direct taxes (Figure 8). In 2000-01, the share of indirect taxes had gone down dramatically to around 45 percent while the contribution from direct taxes had increased to about 26 percent (Figure 9). By 2005-06, indirect taxes accounted for approximately 43 percent while the direct taxes share was about 35 percent (Figure 10).

**Figure 8: Composition of central government revenues (1995-96)**



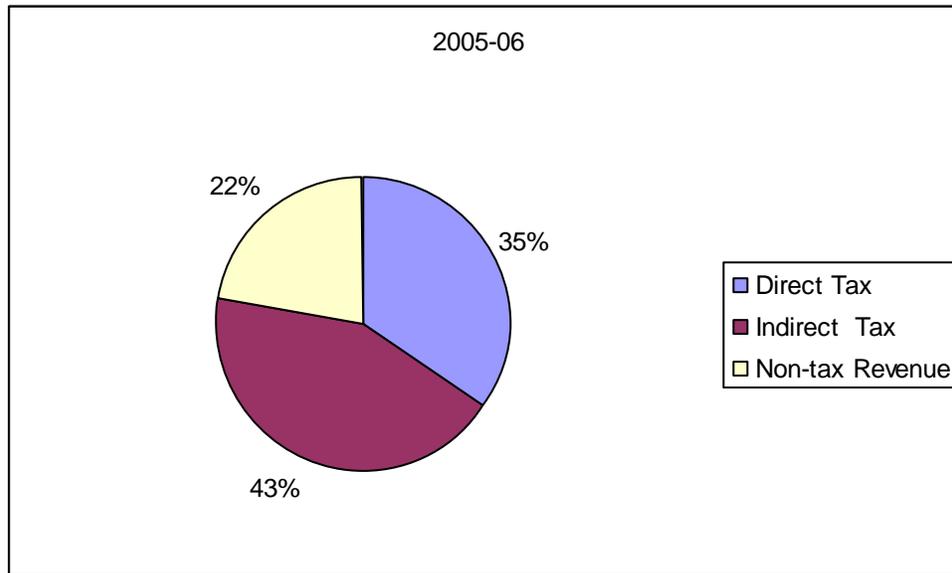
Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 9: Composition of central government revenues (2000-01)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

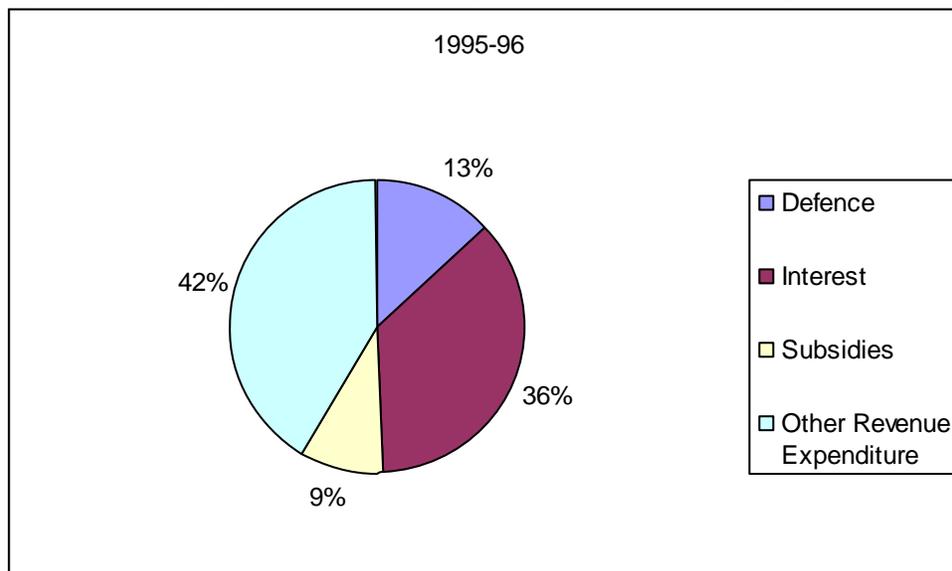
**Figure 10: Composition of central government revenues (2005-06)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

The post 1991 expenditure strategy focussed on reducing subsidies and cutting down on non-capital expenditures. However, the large debt burden meant that the interest component would take a long time to ebb. In 1995-96, of the central government's revenue expenditures, 9 percent went to subsidies, 13 percent to defence and 36 percent to interest (Figure 11).

**Figure 11: Composition of central government revenue expenditures (1995-96)**

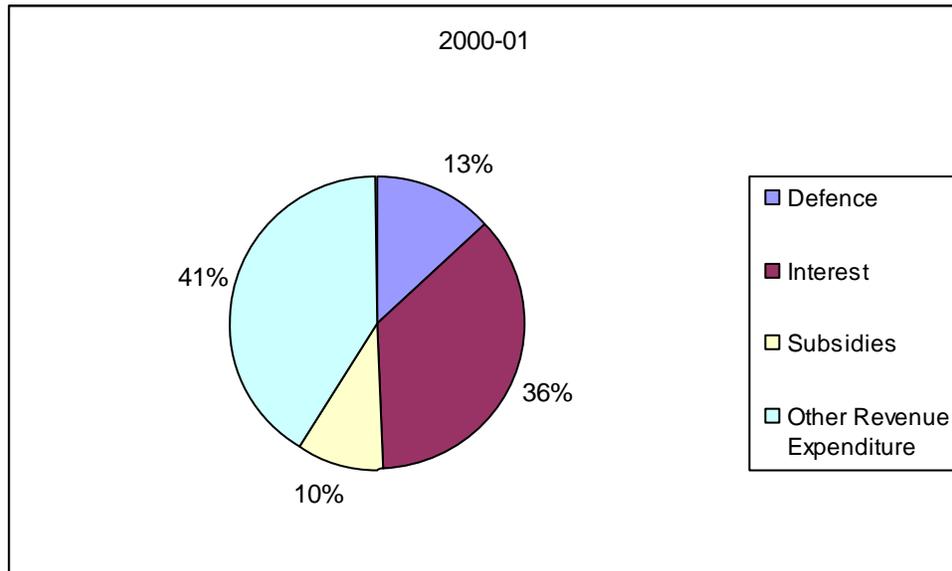


Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

Five years later in 2000-01, defence and interest remained at 13 percent and 36 percent, respectively, while subsidies increased slightly to 10 percent (Figure 12). This reveals that the composition of government expenditure generally does not change very fast. By

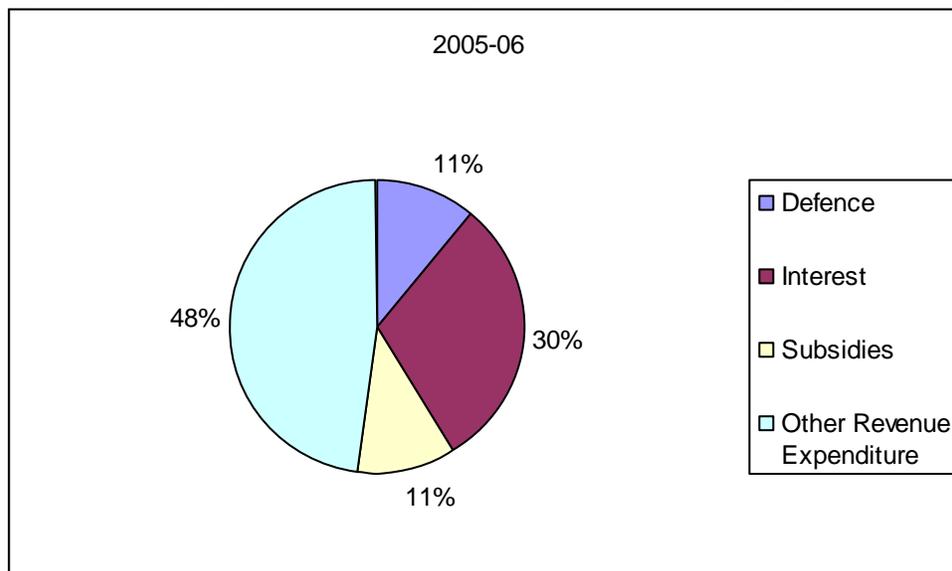
2005-06, the interest component had come down to 30 percent and defence and subsidies each took up 11 percent (Figure 13). As a component of aggregate disbursements of the central and state governments, the interest component continued to rise till around 2002-03 and then started to decline. Capital disbursements showed just the opposite trend falling till around 2002-03 and then rising till 2007-08 (Figure 7).

**Figure 12: Composition of central government revenue expenditures (2000-01)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 13: Composition of central government revenue expenditures (2005-06)**



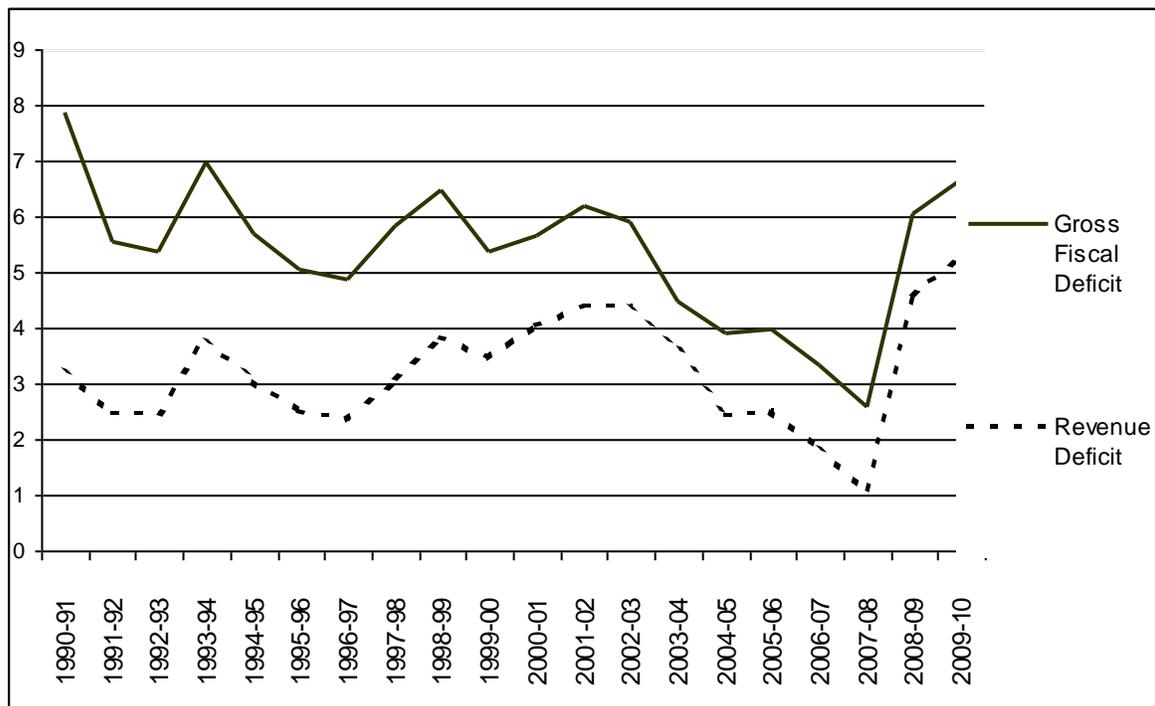
Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

The rising revenues from tax administration reforms and expenditure control resulted in the deficits being brought under control. The central government's revenue deficit went down to 2.37 percent of GDP in 1996-97 while the GFD was 4.84 percent (Figure 14).

The government was also more prudent about its external debt. The debt to GDP ratio went down to 4.3 percent of GDP in 1995-96 and reached a further low point of 2.99 percent in 1999-00. However, government debt and fiscal discipline again seemed to give way in the early 2000s. The central government's revenue deficit climbed up to 4.4 percent of GDP in 2002-03 while the GFD was at 5.91 percent of GDP. By 2003-04 the combined liabilities of the centre and the states were up at 81.09 percent of GDP from 70.59 percent in 2000-01. The external liabilities were however kept under control at only 1.67 percent of GDP in 2003-04.

It was obvious that a new fiscal discipline framework was urgently required. After around three years of discussions, the FRBMA was adopted in 2003. This Act gave a medium term target for balancing current revenues and expenditures and set overall limits to the fiscal deficit at 3 percent of GDP to be achieved according to a phased deficit reduction roadmap. The FRBMA enhanced budgetary transparency by requiring the government to place before the Parliament on an annual basis reports related to its economic assessments, taxation and expenditure strategy and three-year rolling targets for the revenue and fiscal balance. It also required quarterly progress reviews to be placed in Parliament. A large number of state governments also brought out their own fiscal discipline legislations (Herd and Leibfritz, 2008).

**Figure 14: Deficits of the Central Government as percentage of GDP (1990-91 to 2009-10)**

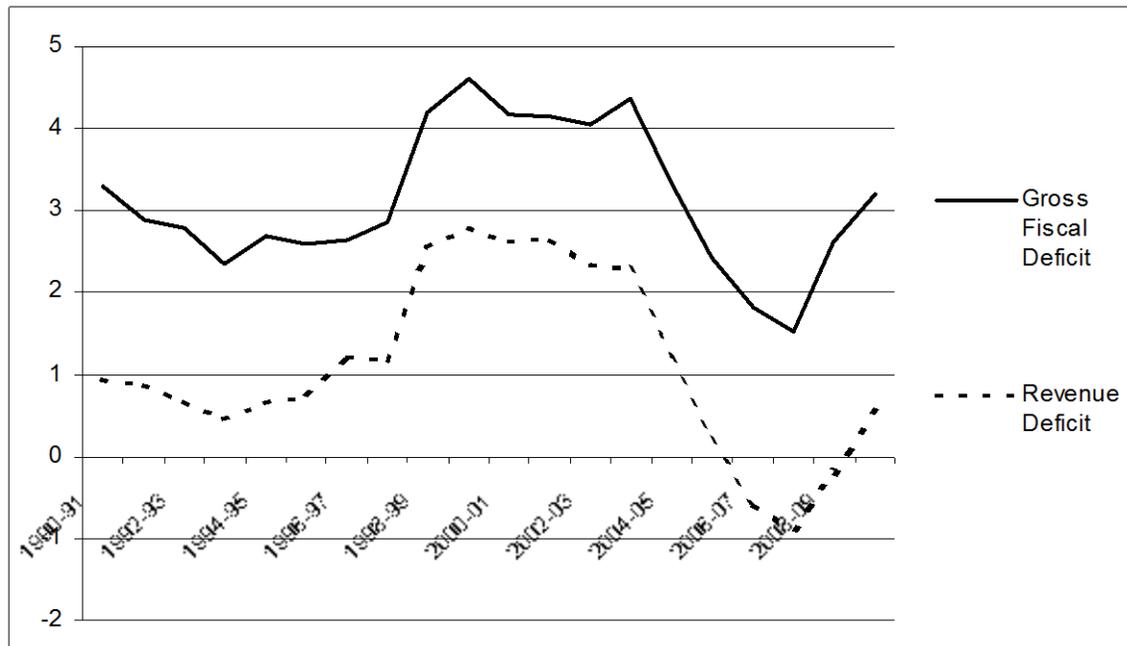


Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

These fiscal discipline legislations seemed to have had good impact at both the central and state levels. The year before the global financial crisis in 2007-08, the central government's revenue deficit came down to 1.06 percent of GDP while the GFD was

3.33 percent (Figure 14). The state governments achieved a revenue surplus of 0.58 percent of GDP and a GFD of 1.81 percent of GDP by 2006-07. Even in the year of the crisis, in 2008-09 they had a small revenue surplus of 0.19 percent of GDP and a GFD of 3.2 percent of GDP (Figure 15). This fiscal discipline fed into other economic variables in a positive manner. The aggregate disbursements of the central and state governments showed an increase in capital outlays from 11.87 percent in 2002-03 to 18.59 percent 2007-08. Inflation was moderate and growth was buoyant at 9.6 percent in 2006-07. This benign macroeconomic environment was disturbed by the global financial crisis.

**Figure 15: Deficits of the State Governments as percentage of GDP (1990-91 to 2009-10)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

## 6. Crisis and return to fiscal consolidation: The maturing of Indian fiscal policy?

The global financial crisis that erupted around September 2008 saw Indian fiscal policy being tested to its limits. The policymakers had to grapple with the impact of the crisis that was affecting the Indian economy through three channels; contagion risks to the financial sector; the negative impact on exports; and the effect on exchange rates (Kumar and Soumya, 2010). Somewhat serendipitously, the government already had an expansionary fiscal stance in view of a rural farm loan waiver scheme, the expansion of social security schemes under the National Rural Employment Guarantee Act (NREGA) and the implementation of revised salaries and compensations for the central public servants as per the recommendations of the Sixth Pay Commission. Furthermore, the parliamentary elections of 2008 also resulted in further government expenditures (Kumar and Soumya, 2010).

As the crisis unfolded, the government activated a series of stimulus packages on 7<sup>th</sup> December 2008, 2<sup>nd</sup> January 2009 and 24<sup>th</sup> February 2009. Actions included an overall central excise duty cut of 4 percent, ramping up additional plan expenditure of about Rs. 200 billion, further state government borrowings for planned expenditure amounting to around Rs. 300 billion, interest subsidies for export finance to support certain export oriented industries, a further 2 percent reduction of central excise duties and service tax for export industries (that is a total 6 percent central excise reduction). The impact of these measures is estimated to be around 1.8 percent of GDP in 2008-09. If the increase in public expenditure across the budgets of 2007-08 and 2008-09 is taken together it amounted to about 3 percent of GDP (Kumar and Soumya, 2010).

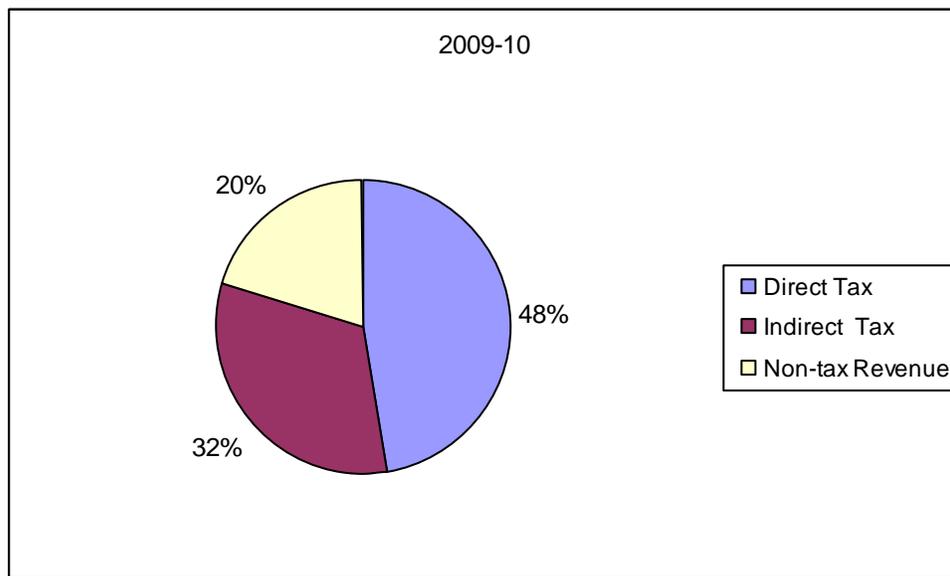
Given its inherent strengths like a strong and prudently regulated financial sector, a well managed capital account policy, large foreign exchange reserves, strong domestic consumption and effective fiscal policy interventions, the Indian economy weathered the financial crisis rather well. GDP growth declined to 5.8 percent (year-on-year) in the second half of 2008-09 compared to 7.8 percent in the first half. By 2009-10 India's GDP was growing at 8 percent (quick estimates (QE)). This increased to 8.5 percent in 2010-11 (revised estimates (RE)).

It was now important that the process of fiscal consolidation be reinstated. This was a delicate process where the fiscal tightening had to be achieved without prematurely choking off the growth process. The Thirteenth Finance Commission (13<sup>th</sup> FC) in its report was keenly conscious of the need to return to the path of fiscal prudence and provided a road map charting a set of desired fiscal deficit targets. The budget of 2010-11 adopted a calibrated exit policy targeting a fiscal deficit of 5.5 percent of GDP in 2010-11 from a level of 6.5 percent (inclusive of bonds in lieu of securities) in 2009-10 (Ministry of Finance, 2011).

In course of 2010-11 the non-tax revenues from auction of telecom spectrum (3G and broadband) resulted in higher than anticipated receipts. A conscious decision was taken to increase allocation to priority sectors while adhering to the fiscal deficit target. Ultimately the fiscal deficit for 2010-11 declined to a better than targeted 5.1 percent of GDP. This was also an improvement over the 13<sup>th</sup> FC roadmap target of 5.7 percent. The government's medium term fiscal policy statement as mandated by the FRBMA for the annual Budget 2011-12 projected continuing on a path of gradual adjustment at a pace faster than that prescribed by the 13<sup>th</sup> FC. The 2011-12 fiscal deficit target was set at 4.6 percent of GDP as against the 13<sup>th</sup> FC target of 4.8 percent. The rationale for this was that reducing the debt to GDP ratio at an accelerated pace would unlock more resources for use in developmental programmes instead of debt servicing (Ministry of Finance, 2011).

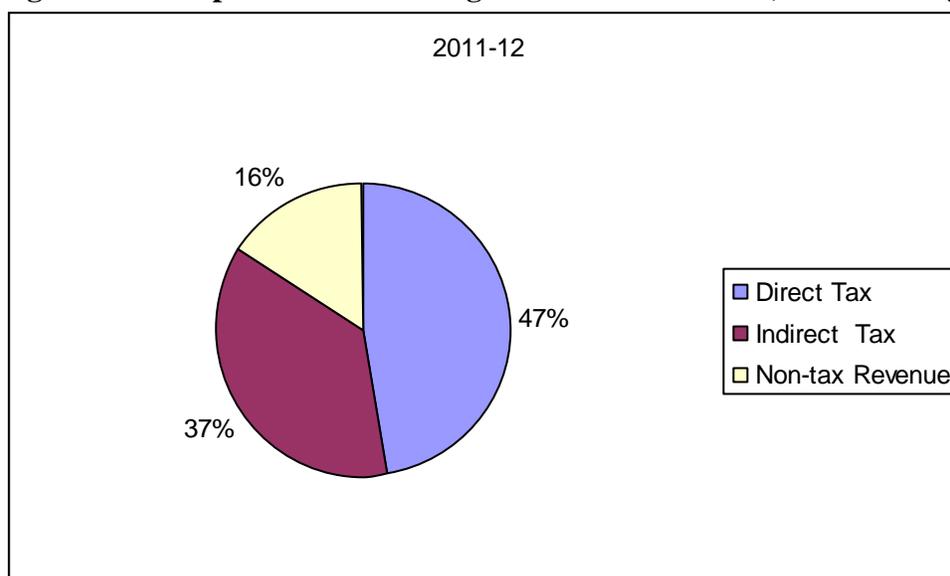
By 2009-10, direct taxes were contributing around 48 percent of revenues while the indirect taxes share was about 32 percent (Figure 16). In the Budget of 2011-12, the share of direct taxes was about 47 percent of the central government's projected revenue while the indirect taxes contribution was around 37 percent (Figure 17). The move to increase the share of direct taxes as envisaged in 1991 had therefore been achieved.

**Figure 16: Composition of central government revenues (2009-10)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 17: Composition of central government revenues (2011-12 Budget Estimates)**

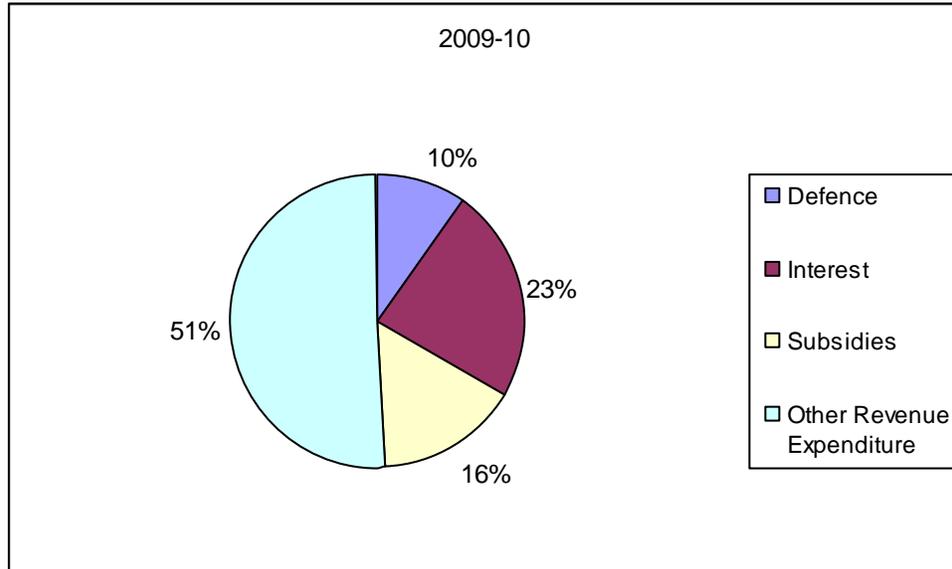


Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

In terms of tax policy, after the conscious slackening of the tax to GDP ratio in the wake of the crisis, a tightening was seen to be desirable. The Budget of 2011-12 aimed at dovetailing both direct and indirect tax policy with medium term objectives of fiscal consolidation and the proposed adoption of major new tax legislations; the Direct Tax Code (DTC) for direct taxes and the Goods and Services Tax (GST) in case of indirect taxes. In indirect taxes, among major proposals, the central excise merit rate was increased from 4 percent to 5 percent, branded readymade garments were subjected to excise duty of 10 percent, and few additional services were brought in under the service tax net. In the case of direct taxes, the personal income tax exemption limit was increased

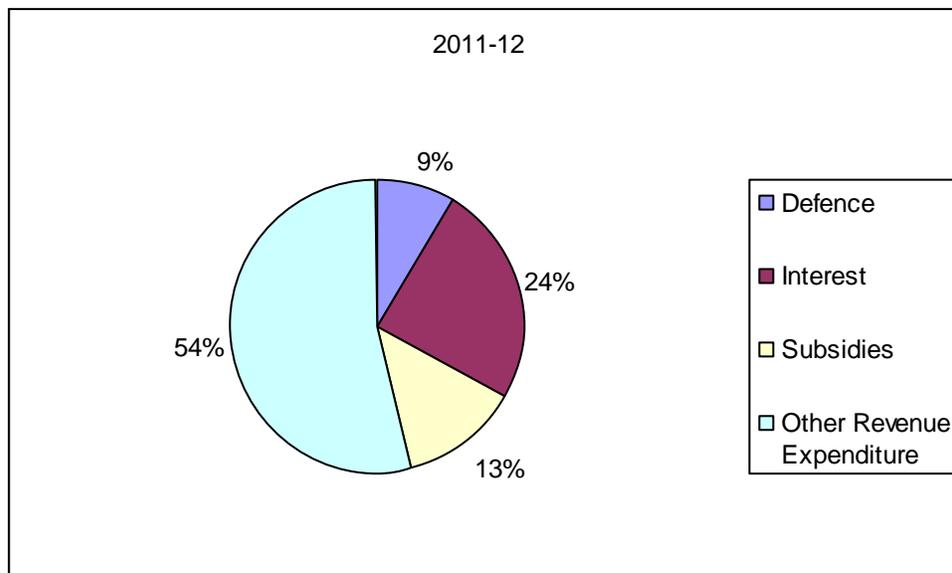
and the surcharge on corporate income tax for domestic companies was reduced from 7.5 percent to 5 percent resulting in the overall rate coming down from 33.2 percent to 32.4 percent. Certain changes were also made to the Minimum Alternate Tax (MAT) provisions to maintain revenue neutrality and preserve horizontal equity as far as possible (Ministry of Finance, 2011).

**Figure 18: Composition of central government revenue expenditures (2009-10)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

**Figure 19: Composition of central government revenue expenditures (2011-12 Budget Estimates)**



Data source: Database on the Indian Economy, <http://dbie.rbi.org.in> (Reserve Bank of India, 2011)

The government's expenditure management initiatives also seemed to have gathered momentum with a focus on outcomes rather than allocations. For this select departments are mandated to develop their 'Result Framework Document' with an emphasis on tracking measurable outcomes. In 2009-10, defence expenditures made up around 10 percent, subsidies 16 percent and interest 23 percent of revenue expenditures (Figure 18). The situation remained more or less the same in the Budget of 2011-12, revealing once again the largely slow changing nature of the composition of government expenditures. Of the government's projected revenue expenditures for 2011-12, defence constitutes 9 percent, subsidies 13 percent and interest 24 percent (Figure 19).

It now appears that fiscal prudence and the desire to limit the public debt through better revenue and expenditure outcomes has been fairly institutionalised in the Indian policy matrix. This is probably partly attributable to the anchoring role played by the FRBMA and the deficit reduction roadmaps put forward by the 13<sup>th</sup> FC. Despite the temporary deviation from stringent fiscal consolidation targets necessitated by the global financial crisis, Indian fiscal policy is being steered rapidly back to the path of prudence. The determination displayed by policymakers to set for themselves strict deficit reduction targets, often exceeding those mandated by the 13<sup>th</sup> FC appear to demonstrate that fiscal discipline is here to stay.

Recent developments indicate that policymakers have come to accept strict budgetary constraints, while attempting to maximise resources for developmental activities. The Planning Commission abundantly reveals this in its preparatory reports for the 12<sup>th</sup> Five Year Plan (2012-17). The approach paper to the plan while projecting the centre's fiscal resources assiduously envisages an average fiscal deficit of 3.25 percent of GDP for the entire plan period with the fiscal deficit projected to come down from 4.1 percent in 2012-13 to 3.5 percent in 2013-14. It is then expected to remain at 3 percent of GDP for the next three financial years. The gross budgetary support for the plan is kept realistic. It is projected to increase from 4.92 percent of GDP in 2011-12 to 5.75 percent by the end of the 12<sup>th</sup> Plan. Similarly, revenue targets are projected at conservative levels. Net tax revenue for the centre is expected to increase from 7.4 percent of GDP in 2011-12 to 8.91 percent in 2016-17. The gross tax to GDP ratio is projected to be 10.36 percent of GDP in 2011-12 rising to 12.3 percent by 2016-17. This is somewhat optimistic given that this ratio previously peaked at 11.9 percent in 2007-08. It appears that the planners are relying on critical tax reforms, especially the GST to deliver the much needed revenue boost. Since chances of large non-tax revenues like spectrum auctions are unlikely, such revenues are expected to fall from 1.4 percent of GDP in 2011-12 to 0.88 percent of GDP in 2016-17. Similarly, non-debt capital receipts (mainly proceeds from disinvestment) are expected to fall (Planning Commission, 2011).

Rather than rely on revenue performance alone, expenditure reforms with effective targeting of subsidies appears to be a major policy strategy. For the 12<sup>th</sup> Plan with regard to non-plan expenditure, defence expenditure is projected to fall from 1.83 percent of GDP in the base year (2011-12) to 1.56 percent in the final year (2016-17). Subsidies are forecast to decline from 1.6 percent of GDP in 2011-12 to 1.24 percent of GDP in 2016-17. They would still account for 18.8 percent of total projected non-plan expenditure

during the 12<sup>th</sup> Plan. The ability to control subsidies would hinge critically on global oil prices and the success of planned measures to target subsidies through improved delivery mechanisms. While the former is beyond the control of policymakers, the latter would then be a key focus area (Planning Commission, 2011).

Looking ahead, the government would probably focus on reforms on both the tax and expenditure fronts. With regard to tax policy, changes can be expected in terms of legislation as well as administrative reforms to improve efficiency. The main legislative proposals are the DTC and the GST both of which are in various stages of legislative consultation. The DTC seeks to simplify the tax code, revamp the system of tax deductions and remove ambiguities of law. The GST aims at bringing a fairly unified system of input tax credits across the value chain and at an interstate level. Currently the central excise and service taxes have limited credit facilities up to the manufacturing stage. The state VAT is not geared to provide interstate input tax credits. It is proposed to institute a dual GST structure with separate central and state GSTs. This would require a constitutional amendment to allow both the central and state governments to have concurrent jurisdiction over the entire value chain. Interstate GST credit and full credit for the central GST is envisaged. This would also require an advanced information technology (IT) infrastructure (Empowered Committee, 2009). IT is also likely to be further leveraged for improving the direct tax administration. Moves in this direction include increasing the number of Centralised Processing Centres (CPCs) that carry out bulk processing functions from one to four. The number of taxpayer help centres and web-based taxpayer interface facilities are also to be increased substantially (Ministry of Finance, 2011).

It also appears that there are moves to improve social expenditure outcomes and target subsidies in a better manner. With respect to energy related subsidies in particular, given the Integrated Energy Policy of 2009, the basic principle would be to equalise the prices of domestic energy with that of imported energy while targeting subsidies to the poor and needy (Planning Commission, 2011). Much of this would hinge on the adoption of new techniques and technologies including IT based identification systems as proposed by the Aadhar Unique Identification system.

## **7. Conclusion**

This essay traced the major developments in India's fiscal policy from the early stages of planned development in the 1950s, through the country's balance of payments crisis of 1991, the subsequent economic liberalisation and rapid growth phase, the response to the global financial crisis of 2008 and the recent post-crisis moves to return to a path of fiscal consolidation. India's fiscal policy in the phase of planned development commencing from the 1950s to economic liberalisation in 1991 was largely characterised by a strategy of using the tax system to transfer private resources to the massive investments in the public sector industries and also achieve greater income equality. The result was high maximum marginal income tax rates and the consequent tendency of tax evasion. The public sector investments and social expenditures were also not efficient. Given these apparent inadequacies, there were limited attempts to reform the system in the 1980s.

However, the path of debt-induced growth that was pursued partly contributed to the balance of payments crisis of 1991.

Following the crisis of 1991, the government charted out a path of economic liberalisation. Tax reforms focussed on lowering of rates and broadening of the tax base. There were attempts to curb subsidies and disinvest the government holdings in the public sector industries. While initially the fiscal deficit and public debt were brought under control, the situation again started to deteriorate in the early 2000s. This induced the adoption of fiscal responsibility legislations at the central and state levels. There were also reforms in the state level tax system with the introduction of VAT. Consequently there were major improvements in the public finances. This probably contributed to the benign macro-fiscal environment of high growth, low deficits and moderate inflation that prevailed around 2008. The global financial crisis brought an end to this phase as the government was forced to undertake sharp counter-cyclical measures to prop up growth in view of the global downturn. Measures included, excise duty cuts, fiscal support to selected export industries and ramping up public expenditure.

The Indian economy weathered the global crisis rather well with growth going down to 5.8 percent in the second half of 2008-09 and then bouncing back to 8.5 percent in 2009-10. In view of the recovery, a slow exit from the fiscal stimulus was attempted in a manner whereby fiscal consolidation was achieved without hurting the recovery process. Recent policy documents like the 12<sup>th</sup> Plan Approach Paper and the government's Fiscal Policy Strategy Statement of 2011-12 appear to indicate that the fiscal consolidation mindset is fairly well institutionalised in the country's policy establishment (Planning Commission, 2011; Ministry of Finance, 2011). This is partly reinforced by institutional structures like fiscal responsibility legislations and the regular Finance Commissions that mandate the federal fiscal transfer regime. In the future, it appears that the government would focus on tax reforms and better targeting of social expenditures to achieve fiscal consolidation while maintaining the process of inclusive growth.

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