CHAPTER 3
Fiscal System and Fiscal Reforms in India

The framers of the Indian Constitution wanted to build a strong united India. The Commission on centre-state relations, 1988, observed, "In a country too large and diverse for a unitary form of government, the framers of the Constitution envisaged a system which would be worked in co-operation by the two levels of government - national and regional - as a common endeavour to serve the people." (Sury, 2007). So India has adopted federalism to actualize and uphold the values of national unity, cultural diversity, democracy, regional autonomy and rapid socio-economic transformation.

India is a classical federation with a constitutional division of the revenue powers and expenditure functions between the central government and state governments. The Constitution makes elaborate and complex arrangements relating to the distribution of revenue, expenditure and the power of borrowing between the central government and the state governments. The Indian Constitution has assigned the powers of the central government and state governments into three lists: a union list, a state list and a concurrent list.

Amongst the sources of revenue of the government, taxation being the major source, Article 265 of the
Constitution specifically states that no taxes shall be levied or collected except by the authority of law. Entries 82 to 92(b) of union list in the Seventh Schedule refer to the taxation powers of the central government. Entries 45 to 63 of state list in the same schedule specify the taxation powers of the state governments. Concurrent list does not contain any head of taxation which means the union and the states have no concurrent powers of the taxation. The Constitution (73rd and 74th Amendment) Act 1992 has conferred constitutional status to the structure and mandate of Panchayats and Municipalities, respectively.

Fiscal experts have mentioned time to time that no doubt, there is a clear-cut distribution of tax powers between the centre and state governments but there are some problems in this system. The division of tax powers based on efficiency considerations and scientific principles have created a gap in the revenue resources and requirements of the states as the elastic and productive sources of tax revenue fall in the jurisdiction of the union government (Bhargava, 1984). The Constitution assigns a number of important tax resources to the central government and a limited amount of tax resources to the states (Mohan, 2003). The states are allowed to levy taxes on the sale and purchase of goods (Entry 54 in the state list) but not on services (Singh, 2004). This besides providing avenues for tax evasion and avoidance has also posed
problems in designing and implementing a comprehensive (VAT).

In the case of distribution of expenditure powers, "the functions of the central government are those required to maintain macro-economic stability, international trade and relations, and those having implications for more than one state. The major subjects assigned to the states comprise public health, agriculture, irrigation, land rights, fisheries, and industries and minerals. The States also assume a significant role for subjects in the concurrent list, such as education and transportation, social security and social insurance." (Singh, 2004).

Some experts are of the view that more functions are assigned to the state governments so the amount required to spend is also more for the state governments. Rao and Singh (1998) observed that state and local governments have to incur expenditures on most quasi-public goods including many social services like education, preventive and curative health care, water supply and social security and welfare and economic services like building physical infrastructures. On the other hand, some experts are of the view that "the expenditure assignment of the government at the union, state and local levels is not based on the content of concentration of marginalized groups or population size." (Patel and Sapovadia, 2003).

So far as another important instrument of fiscal system i.e., the borrowing powers of the centre and state
governments are concerned, it is regulated by Articles 292 and 293 of the Constitution. Article 292 of the Constitution empowers the Government of India to borrow upon the security of the consolidated fund of India, i.e., the resources of the centre; subject only to such limitations as Parliament by law may impose. The Government of India can borrow internally as well as externally. States too are empowered to borrow under Article 293. According to this Article, a state cannot borrow outside India. The borrowing powers of the states are limited. Furthermore, if a state is indebted to the centre, it may not resort to further borrowing without prior consent of the central government. It is a knotty problem of the fiscal system that the Constitution has restricted the borrowing powers of the states.

The Constitution recognizes that because of its design, assignment of tax powers and expenditure functions would create imbalances between expenditure 'needs' and abilities to raise revenue between the centre and the state governments. The imbalances could be both vertical, among different levels of government, and horizontal, among different units within a sub-central level (Rao and Singh, 2001). To correct this imbalance, the Constitution provided for statutory fiscal transfers from the centre to the states through the instrumentality of the Finance Commission. The Finance Commission is constituted every five years to recommend allocations of central taxes to the states. It also forecasts the revenue and expenditure of the state.
governments and recommends additional assistance in the form of grants-in-aid to close the resource gap. In addition, the Planning Commission also gives assistance to the states on the basis of an established formula (Gadgil formula) and different central ministries give specific purpose transfers to states.

Under such a fiscal federation, the fiscal situation of both the centre and state governments remained comfortable till 1980. But there was a significant deterioration in the fiscal situation in 1980's, especially by the second half, which was marked by high and persistent fiscal deficits accompanied by large revenue deficits. This large fiscal deficit had some spill-over effects on the external sector which was reflected in the widening current account deficit in the early 1990s. Infact, there were two sources of external shocks which contributed the most to India's large current account deficit in 1990-91. "The first shock came from events in the Middle East in 1990 and the consequent run up in world oil prices, which helped precipitate the crisis in India. Second, the deterioration of the current account was also induced by slow growth in important trading partners." (Cerra and Saxena, 2002).

In the past also India had experienced macro-economic crisis in the mid-60s, in the mid-70s and in the mid-80s. It was mainly due to supply shocks, both internal and external. The economic crisis of the mid-sixties owed its origin to two successive droughts of 1965-66 and 1966-67
and the two wars: the Indo-China war of 1962 and the Indo-Pak war of 1965. The second major crisis occurred in the mid-seventies due to the combined effect of monsoon failures of 1972 and 1974, and the first external oil shock. The third major crisis occurred in 1979, again due to the combined effect of bad weather and the second oil shock" (Klein and Palanivel, 2000). It was only after the crisis of the early 1990s, when India’s foreign currency assets depleted rapidly to the extent that it could barely finance just two weeks of imports, India realized the need to start the process of fiscal reforms as a part of economic reform measures in 1991-92.

Fiscal sector reforms were the integral and the most critical part of the macro-economic stabilization and reforms programme taken by the government after 1991 crisis (JBIC Research Paper No. 11, 2001). The primary objective of the fiscal reforms programme was to achieve a reduction in the size of deficit and debt in relation to GDP.

Many least developed countries (Bangladesh, Malawi, The Gambia and the United Republic of Tanzania) also faced serious macro-economic difficulties during the 1980s, which included the growth of unsustainable fiscal deficits, and they implemented major tax and expenditure reforms as part of the stabilization and adjustment programme.

Moreover, an important feature of India’s reform programme, when compared with reforms undertaken by many other countries, is that it has emphasized gradualism
and evolutionary transition rather than rapid restructuring 'shock therapy'. The reform measures were initiated in the backdrop of a crisis but not a 'system collapse' (JBIC Research Paper No. 11, 2001).

The major structural change made during fiscal reforms programme was a step towards decentralization i.e., the conversion of two-tier structure into three-tier structure. With the 73rd and 74th Constitutional Amendments in 1993, roles and responsibilities of rural and urban local governments have been specified. A list of 29 functions to rural local bodies has been specified in a separate list. Another list of 18 functions has been specified for urban local bodies. These functions can be divided into 4 or 5 categories, viz. socio-economic schemes, beneficiary-oriented schemes, national policy schemes, infrastructure creating schemes and State or Centrally Sponsored Schemes (Gupta, 2007). This reform is a step towards strengthening the third layer of government in India.

Fiscal position of the government is determined through its taxation policy, growth and pattern of public expenditure and process of public borrowings. Fiscal reforms thus encompass tax reforms, expenditure reforms and systemic reforms in governments' borrowing process of the central government and fiscal reform initiatives of the state and local governments.
I. Fiscal Reforms of the Central Government

(i) Revenue Reforms

In order to augment public revenue, the main focus has remained on taxation reforms. No doubt, since independence a number of attempts have been made at improving the tax structure in the sphere of direct as well as indirect taxes. The first comprehensive attempt at reforming the tax system was made by the Tax Enquiry Committee in 1953 (Rao, 2000). This provided the backdrop for the Second five year Plan (1956-60), and was required to fulfill a variety of objectives such as raising the level of savings and investment, effecting resource transfer from the private to the public sector and achieving a desired state of redistribution (Rao, 2005).

A number of attempts have been made to remedy various aspects of direct taxes from time to time. As regards the personal income taxes, the most drastic and visible changes have been seen in reduction in personal and corporate income taxes. In the case of personal income taxes, the attempt to achieve the desired state of redistribution caused the policy makers to design the income tax system with confiscatory marginal rates. Tax evasion, low profitability of detection and the ineffective legal system that failed to impose penalty within a reasonable time period (Rao, 2005) led the Direct Taxes enquiry committee in 1971 to recommend significant reduction in marginal tax rates. On the recommendation of
the Direct Taxes Enquiry Committee, the highest marginal tax rate has been brought down to stimulate domestic demand from 77 per cent in 1974-75 to 66 per cent in 1976-77, to 50 per cent in 1985-86, to 40 per cent in 1992-93 and further to 30 per cent since 1997-98.

A new scheme called "one by six" was introduced to widen the tax net during 1998-99. "Under this scheme, a person possessing a house, a telephone, motor vehicle, spending on foreign travel, holding of credit card and membership of expensive clubs was liable to file an income tax return. This scheme was introduced in 12 districts in 1997-98 budgets and was extended to 35 districts in 1998-99, 54 districts in 1999-2000 and to 133 districts in 2000-01." (Gupta and Kaur, 2004). By 2003-04, it was applicable throughout the country. This scheme was abolished in 2005-06.

In Indian federal scenario, the mechanism of transfers from the centre to states also makes a significant impact on the resources of both these layers of government. The percentage share of gross revenue receipts of the central government transferred to the states reached to the peak level of 40.33 per cent during the award period of FC-IX (1989-95). However since 1979, 35 per cent to 40 per cent of gross revenue receipts of the central government of India are transferred to the state governments (Table 3.1). Central transfers dipped to around 35 per cent by FC-X and FC-XI. During the period covered by FC-XII, the percentage share
Table 3.1: Revenue Transfers from Centre to States as Percentage of Gross Revenue Receipts of the Centre

<table>
<thead>
<tr>
<th>Years</th>
<th>Transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>FC-VII (1979-84)</td>
<td>38.11</td>
</tr>
<tr>
<td>FC-VIII (1984-89)</td>
<td>37.86</td>
</tr>
<tr>
<td>FC-IX (1989-95)</td>
<td>40.33</td>
</tr>
<tr>
<td>FC-X (1995-2000)</td>
<td>35.79</td>
</tr>
<tr>
<td>FC-XI (2000-2005)</td>
<td>35.27</td>
</tr>
<tr>
<td>FC-XII (2005-10)</td>
<td>38.51</td>
</tr>
</tbody>
</table>

Note: These are revenue account transfers. Prior to FC-XII, Plan assistance also carried a loan component, which varied as a share of total assistance from 70 per cent for general category states, to 10 per cent for special category states. Prior to 1999-2000, there was also on-lending by the centre to states of net collections in small savings schemes.


of transfers rose to 38.51 per cent. However, the percentage share of gross revenue receipts of the centre to states during FC-X, FC-XI and FC-XII has remained less than that was during FC-IX. So, by reducing the share of transfers from gross revenue receipts the central government is trying to improve its own fiscal position. On the other hand, such a change is deteriorating the fiscal position of state governments.

The share of total transfers through different mechanisms has been shown in Table 3.2. Transfers through the Finance Commissions are predominant, accounting for about 60 to 70 per cent of total central
transfers to states and have shown variation over time. There has been an increase in the share of Finance Commission transfers from 60.13 per cent in the award period of FC-VIII to 69.38 per cent in the award period of FC-XI. It went down to 68.03 per cent in the award period of FC-XII. Within the Finance Commission transfers, there has been an increase in the share of grants, particularly in the periods covered by FC-XI and FC-XII. FC-XII felt that grants could be targeted better and that cost disabilities and distributive considerations could be addressed more effectively through grants than through tax devolutions (Report of Thirteenth Finance Commission, 2010-15). Accordingly, the Commission increased the share of grants in the transfers recommended by it.

**Table 3.2: Percentage Composition of Revenue Transfers from the Centre to States**

<table>
<thead>
<tr>
<th>Years</th>
<th>Finance Commission Transfers</th>
<th>Other Transfers</th>
<th>Total Transfers (4+7)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share in Central Taxes</td>
<td>Grants</td>
<td>Total Finance Commission</td>
</tr>
<tr>
<td>FC-VIII (1984-89)</td>
<td>53.48</td>
<td>6.65</td>
<td>60.13</td>
</tr>
<tr>
<td>FC-IX (1989-95)</td>
<td>52.98</td>
<td>8.48</td>
<td>61.46</td>
</tr>
<tr>
<td>FC-X (1995-00)</td>
<td>62.06</td>
<td>6.55</td>
<td>68.61</td>
</tr>
<tr>
<td>FC-XI (2000-05)</td>
<td>58.38</td>
<td>11.00</td>
<td>69.38</td>
</tr>
<tr>
<td>FC-XII (2005-10)</td>
<td>56.48</td>
<td>11.55</td>
<td>68.03</td>
</tr>
</tbody>
</table>

Note: As in Table 3.1

Other transfers have declined from 40 to 30 per cent of total central transfers to states. The share of plan grants declined to 28.55 per cent in 2005-10 from 35.91 per cent in the period of FC-IX. This is on account of a shift in the composition of plan grants as well as higher transfers through CSS (Centrally Sponsored Schemes). Thus, over the years, the importance of FC in devolution of resources to the states has increased and of Planning Commission has declined.

In line with the Long term Fiscal Policy (LTFP), significant reforms were also carried out in the area of corporate taxation which aimed at increasing the generation of internal resources, while simultaneously providing stimulus to industrial investment, growth and modernization. Corporate income tax has been substantially rationalized in real earnest in 1983-84, with removal of the step system of taxation of corporate income. By the year 1991-92, widely held (shares quoted in stock market) and closely held (family concerns) domestic companies were taxed at 51.75 and 57.5 per cent, respectively and foreign companies were taxed at 65 per cent. Following the recommendations of Tax Reforms Committee (TRC) 1991, the distinction between closely held and widely held companies was unified at 46 per cent in 1994-95. The tax rate on foreign companies was reduced to 55 per cent in 1994-95 (Economic Survey, 1994-95). However, the rates were progressively reduced in 1997-98 to 35 per cent in
case of domestic companies and 48 per cent in case of foreign companies. In 2002-03, the rate of tax for foreign company was further reduced to 40 per cent while the rate of tax for domestic company remained at 35 per cent. The corporate income tax for domestic companies was reduced to 30 per cent in 2005-06. Further, there has been no change in existing rates of corporate tax. Also, the dividend tax at the individual income tax level was abolished. However, to tackle the phenomenon of zero tax, an effort was made by bringing such companies having substantial book profits under Minimum Alternative Tax (MAT) in 1997-98. The rate under MAT was increased from 7.5 per cent of book profits in 2000-01 to 10 percent in 2006-07.

The Expenditure tax, which was levied on the recommendation of the Kaldor Committee in 1957-58 to curb consumption did not generate the expected revenues, it had to be withdrawn after three years. It was again enacted and came into force from November 1, 1987. The tax was charged on expenditure incurred in a hotel on accommodation, food, drink and other services. "The exemption granted to payments made in foreign exchange was withdrawn in 1992. However, in order to give boost to tourism sector and reduce the incidence of tax on hotel industry, the Finance Act, 2003 provided that Expenditure Tax should not be charged on expenditure incurred in a hotel after May 31, 2003." (Dhingra, 2005). With effect from June 1, 2003, Expenditure Tax was again abolished.
As regards the wealth tax rate, the highest wealth tax rate was reduced from 8 per cent in 1974-75 to 2.5 per cent in 1976-77 and further increased to 5 per cent in 1979-80. In 1985-86, it was again lowered to 2.5 per cent and made applicable to net wealth over Rs. 20 lakh. On the recommendations of the Tax Reforms Committee, 1991, wealth tax was charged at the flat rate of 1 percent with a basic exemption of value of Rs. 15 lakh on taxable items of wealth. With this, the scope of wealth tax was drastically reduced. In fact, the Task Force on Direct Taxes had recommended the abolition of wealth tax.

However, a major relief was provided in 2004-05 in the form of abolition of tax on long-term capital gains and reduction in tax on short-term capital gains from 30 per cent to a flat rate of 10 per cent on securities transactions. In 2005-06, a new tax i.e., fringe benefit tax was introduced which targeted at those benefits enjoyed collectively by the employees, and not attributable to individual employees, which were to be taxed in the hands of the employer. But fringe benefit tax was abolished after realization of its considerable compliance burden in 2009-10.

Indirect taxation has remained a major source of tax revenue in India. Therefore, measures were also taken in the area of indirect taxes to improve the efficiency of these taxes. However, on the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee in 1972. As the excise system had no
built-in-checks against evasion, it recommended the conversion of specific duties into an ad valorem, unification of tax rates and introduction of input tax credit to convert the tax into a manufacturing stage value added tax (MANVAT), but it was not implemented until 1986-87. Then, a wide ranging and systematic effort to minimize the incidence of taxation on inputs was undertaken, through the introduction of Modified Value Added Tax System (MODVAT) in 1987. It was introduced in a limited manner on a few commodities and the coverage was gradually extended over the years. As a result of simplifications and relaxations introduced in the MODVAT scheme, availment of MODVAT credit for payment of duty had gone up appreciably over the years.

Further after 1991, reform impetus on excise duties came with the implementation of the recommendations of the Tax Reforms Committee (TRC). In 1999-00, almost eleven major ad valorem duty rates were reduced to three, namely, a central rate of 16 per cent, a merit rate of 8 per cent and a demerit rate of 24 per cent. In order to bring further simplification in the rate structure, these were further merged into a uniform 16 per cent Central Value Added Tax (CENVAT) at production stage. Also, a special excise duty (SED) rates of 8 per cent, 16 per cent and 24 per cent continued on specified goods in 2000-01. This was further improved in 2001-02 with the reduction of three special excise duty rates to a single rate 16 per cent. In
2008-09, the general CENVAT rate on all goods and services was reduced to 14 per cent.

The tariff rates were extremely high by the middle of 1980s. The Long Term Fiscal Policy (LTFP) presented in the Parliament in 1984-85 emphasized the need to reduce tariffs, have fewer rates and greater uniformity and reduce and eventually eliminate quantitative restrictions on imports. However, for reasons of revenue and also to counter unfair competition from imports, the tariffs were raised and the weighted average rate increased from 38 per cent in 1980-81 to 87 per cent in 1989-90 (Rao, 2005). As a fiscal reform measure, there was drastic reduction in both the average and peak tariff rates to make Indian industry competitive in the long run in 1990-91. The peak rate of custom duty was reduced to 40 per cent in 1997-98 from 355 per cent in 1990-91 and lowered to 25 per cent in 1997-98 from 125 per cent in 1990-91. The peak rate of custom duty was further reduced to 35 per cent in 2001-02, to 30 per cent in 2002-03 and to 25 per cent in 2003-04. The average rate of custom duty was further reduced to the level of 15 per cent in 2005-06 with steeper reductions for capital goods and raw materials and corrections for inverted duty structures. This was done due to pre-announced commitment to align tariffs to the levels prevailing in the South-East Asian countries (Economic Survey, 2005-06). Further, the peak rate of custom duty was reduced to 10
per cent in 2007-08 with a few exceptions (Economic Survey, 2007-08).

The Tax Reforms Committee (TRC), 1991 recommended the introduction of selective tax on services. As the service tax was never visualized by the framers of the Constitution and policy makers, it does not find any place in the Constitution of India. As a result, it belongs to the central government. But in view of Gupta (2007), the entire proceeds from service tax should form part of the divisible pool as it is more buoyant in future than commodity taxes. However, the central government by invoking residency powers introduced a tax on services at the rate of 5 per cent since 1994-95 namely, non-life insurance, stock brokerage and telecommunications rate. In 2001-02, the coverage of service tax was extended to 15 new services at the rate of 5 per cent. It was extended to 10 new services including life insurance, insurance of auxiliary services, inland cargo handling, storage and warehousing etc. in 2002-03. However, subsequently life insurance was exempted from service tax. In 2003-04, service tax was raised to 8 per cent and the tax was imposed on 10 new services. Again in 2004-05, "Service tax has been extended to over 75 separate services and the revenue yield accounted for nearly 5 per cent of gross central revenues" (Acharya, 2005). This sustained expansion in service tax was due to the growing need to find alternative revenue resources in the face of the declining role of customs and excise revenues However, the
rate of service tax was raised to 10 per cent in 2005-06. The number of services liable for taxation was raised to 99 services in 2006-07 and then gradually to 100 services in 2007-08. The rate of service tax was further raised to 12 per cent in 2006-07 and was retained at this same rate in 2007-08.

A comprehensive indirect tax reform in the country is going to take place in April 2011 with the implementation of dual Goods and Services Tax (GST), levied concurrently by the centre as Central Level GST (CGST) and by the states as State Level GST (SGST). GST would be further improvement over the VAT. This new system, which is being steered by an Empowered Committee of State Finance Ministers and the central government will replace state level VAT and CENVAT. In case of Central GST, central excise duty, additional excise duty, service tax, additional custom duty (countervailing duty), special additional duty, surcharge and cesses would be subsumed with CGST which are at presently levied separately on goods and services by central government. In case of State GST, VAT/sales tax, entertainment tax, luxury tax, taxes on lottery, betting and gambling, state cesses and surcharges, and entry tax except for stamp duty, toll tax, passenger tax and road tax would be subsumed with SGST which are at present levied separately on goods and services by state government. This will mark a major step in unifying the tax regime across the
country and do away with tax arbitrage that currently disturbs investment decisions.

(ii) Expenditure Reforms

The fiscal position of the central government has been under stress since the mid-1980s as public expenditure has grown at a very rapid rate as compared to the growth rate of public revenue. Reflecting the fiscal stress, the expenditure for developmental activities, which are directly related to growth, has suffered. On the other hand, expenditure on non-developmental purposes, largely committed, has witnessed a steady rise. It was crucial to bring about improvement in the finances with a view to restructuring the expenditure in favour of developmental expenditure in order to enable higher growth. Therefore, successive central government budgets since 1990s have been contemplating a host of measures to curb built-in-growth in expenditure and to bring about structural changes in the composition of expenditure and effecting economy in non-plan expenditure.

The need to control public expenditure was realized even in 1979-80 and a Commission on public expenditure, the first in independent India, was set up by a resolution of the Government of India on May 29, 1979. But it was wound up on January 31, 1980 before it could submit its report.

With a view to restraining the growth of expenditure, a package of measures was taken by the central government in January 1984. Plan expenditure was to be reduced by 5
per cent including supplementary grants. Non-plan expenditure (excluding interest payments and transfers to states) was cut by 3 per cent (Economic Survey, 1983-84). It was expected that these measures would result in a reduction of about Rs. 800 crore in non-plan expenditure during that year.

Recognizing the gravity of the expenditure problem, a system of zero-base budgeting was initiated in the course of the formulation of the budgets of all central government departments for 1987-88 (Economic Survey, 1986-87). Efforts were made by the government to check the fiscal imbalances in 1990-91 and emphasis was laid on curtailing unproductive expenditure by undertaking a number of measures. These measures included monthly budgeting of expenditure in all the departments, cut in the expenditure on staff cars, electricity and telephone bills, and a complete ban on the purchase of new vehicles (Economic Survey, 1990-91).

The government initiated few measures on the expenditure front to correct the fiscal imbalance during 1991-92. Such measures mainly were reduction in the fertilizer subsidy by 30 per cent, abolition of Cash Compensatory Support for exports, abolition of subsidy on sugar. Further the government had also “imposed 5 per cent cut on the expenditure of all Ministries/Departments. Only a few items of expenditure, such as, statutory grants to state governments, block grants and loans for state Plan
schemes, interest payments and pension payments were exempted from the expenditure cut” (Economic Survey, 1991-92).

The problem of high rate of growth of non-developmental expenditure persisted for a long time, but the reforms on this front started very late with the beginning of the process of downsizing the government. The government abolished the four-secretary level posts through a process of merger and rationalization of central government departments with effect from April 1, 1999. To carry this process forward in a systematic way towards reducing the role and the administrative structure of the government, an Expenditure Reforms Commission was constituted on February 29, 2000. Areas identified by the Expenditure Reforms Commission included creation of a national food security buffer stock and minimization of fertilizer subsidies through dismantling of controls in a phased manner.

In 2000-01, government took number of measures to control growth in non-plan, non-developmental expenditure which included: a mandatory 10 per cent cut in the budgetary allocation for non-plan non-salary expenditure of all ministries/departments and autonomous institutions; a complete ban on purchase of new vehicles for one year; ten per cent cut in the consumption and allocation of funds for expenditure on petroleum oil and lubricants (POL) for staff cars; ban on creation of new posts for one year; ban on foreign travel for study tours, seminars, etc.
The measure to improve the quality of expenditure includes subjecting all existing schemes to zero-based budgeting and only those that were demonstrably efficient and essential were decided to be retained from 2001-02. “This was sought to be achieved by reviewing norms for creation of posts and fresh recruitment and introduction of voluntary retirement scheme (VRS) for surplus staff. The process also involved review of all subsidies” (Kapila, 2003).

Other important measures of expenditure reform undertaken were optimizing government staff strength through a ban on the creation of new posts for a period of two years and the redeployment of surplus staff in various government departments and autonomous institutions which have budgetary support through grants.

Also, the central government has brought about pension reforms by introducing a new pension scheme with effect from January 1, 2004 for central government employees recruited on or after that date (except Armed Forces, in the first stage) replacing the existing defined benefit pension system. "The central government has also initiated the process for bringing out legislation for the appointment of an independent pension regulatory authority, which can ensure proper investment of pension funds" (Srivastava, 2005).

In 2006-07, government took a series of initiatives for fiscal reforms like avoiding rush of expenditure through
releases in a time sliced manner and simplification of procedures (Economic Survey, 2006-07).

(iii) Reforms in Barrowings Process

The significant changes in the process of central government borrowings to meet the budgetary and temporary mismatches have also been part of the fiscal sector reforms. During 1976-77, long-term borrowings and debentures were excluded from the capital base and a new National Savings Annuity Scheme was introduced to promote small savings from April 1, 1976. To mobilise the savings for development purposes, National Development Bonds of Rs. 10/-, Rs. 100/- and Rs. 500/- were introduced from August 31, 1977.

For canalising the unaccounted money for productive purposes, the Government of India announced the Scheme of Special Bearer Bonds on January 15, 1981. To mobilise private savings for public use, Capital Investment Bonds were introduced on June 28, 1982. These bonds with a ten year maturity period carried an interest rate of 7 per cent. With a view to mopping up excess liquidity in the banking system as also to mobilise some resources for public investment, the government introduced the ‘National Deposits Scheme’ with effect from July 30, 1984. During 1984-85, for the first time long-dated securities with a maturity of 30 years were introduced with a coupon rate of 10.50 per cent. As the subscription to the deposits under the National Deposit Scheme since inception were placed at
Rs. 68.3 crore as on March 8, 1987 as against a target of Rs 500 crore, this scheme was discontinued by government with effect from April 1, 1987.

In order to strengthen fiscal discipline as a significant step, the system of ad-hoc treasury bills as a means of financing the budget deficit was discontinued. With effect from April 1, 1987, this system was replaced by a system of Ways and Means Advances (WMA). To provide short-term investment opportunity to financial institutions and others, the 182-days treasury bills were introduced.

After the fiscal crisis of 1991, a number of policy changes during 1992-93 to activate internal debt management policy were made. The monetary policy of April 1992 heralded a new approach to internal debt management by introducing market operation in regard to absorption of Government of India dated rupee securities and longer term Treasury bills and this was to be facilitated by overall reduction in the borrowing programme in 1992-93. These were in line with the recommendations of the Chakravarty Committee and Narasimham Committee.

The Government of India for the first time, offered to sell dated securities on an auction basis in June 1992. In addition to this, government introduced 364-days treasury bills and 91-days Treasury bills on an auction basis from April 1992 and December 1992, respectively. Moreover, auctions of repurchase agreements (REPOS) of dated securities were introduced from December 1992. However, it
was realised that these developments in the first place would have implications for monetized deficit. Moreover, they might lead to discipline in use of borrowed funds at relatively high rates of interest. Besides, they would import liquidity as well as flexibility to investors.

Another noteworthy reform in process of borrowing was the reduction of the difference between the interest rate on market borrowings and 'other internal liabilities' (small savings, provident funds, etc.) in 1993-94. Further in 1994-95, there was inclusion of loans in conversion of maturing treasury bills and Zero Coupon Bonds and increase in the rate of interest on 'other internal liabilities'.

In 1999-00, there was conversion of other liabilities into central government securities which led to the sharp increase in internal debt and corresponding decline in 'other internal liabilities'. Thereafter, the most notable outcome of external debt management has been the control over short term debt.

II. Fiscal Reform Programme for the States

The Constitution of India has made elaborate provisions for demarcation of functional responsibilities and finances between the central government and the state governments. It is often mentioned by experts that the arrangement of distribution of financial resources relating to taxes and non-taxes and power of borrowing is not equitable. "Most of the buoyant sources of revenue, such as
customs duty, corporation tax, etc, are in the purview of central government for the stated reason of administrative efficiency and the implicit desire to make the centre strong vis-à-vis the states. This has culminated in central government having a comparative advantage over the States in raising revenues. But the fiscal responsibilities in meeting huge expenditures remained with the state governments" (Jena, 2001). These factors have created acute problems for the fiscal adjustment in the states.

As the central government has continued with the reform process since 1991, the states have been slower in initiating the fiscal reforms. The fiscal position of the state governments has been under stress since 1980s. While the gross fiscal deficit was quite high, a very high proportion of the same resulted from the revenue deficit. The stress stemmed from the inadequacy of receipts in meeting the growing expenditure requirements. The low and declining buoyancies in tax and non-tax receipts, constraints on internal resource mobilisation due to losses incurred by state public sector undertakings, electricity boards and decelerating resources transfers from the centre had resulted in rising fiscal deficit of the state governments during mid-nineties.

The deterioration in the fiscal position of the states (and its peaking in 1998-99) was also reflected in the ways and means advances and overdraft position of the states with the Reserve Bank of India (RBI). “State governments
resorted to overdraft and Ways and Means Advances (WMA) much more frequently than prior to 1997-98. The central government was unable or unwilling to limit the borrowings of the state governments" (Sawhney, 2008). As a result, the debt of states had gone up. In order to remedy this situation, "several major states which were hesitant and lagging behind the central government in adopting the fiscal reforms have now come forward to initiate economic reforms with multiple goals to achieve" (Rao, 2005). It was in the late nineties that some reforms in the field of taxation, management of public expenditure, and borrowings were undertaken by only a few states. “Specific time bound fiscal reform programmes have, therefore been discussed in the National Development council on Feb 19, 1999 (represented by the Chief Ministers of States). It was felt that joint effort on the part of the central government as well as state governments is required to devise a medium term strategy for fiscal reforms programme for states.” (JBIC Research Paper No. 11, 2001).

The main objective of fiscal reforms programme for states was to progressively improve the ‘Balance on Current Revenues’ and reduce the revenue deficit in the medium term. Consequently, nine states entered to an agreement with the centre during 1999-00 and availed of assistance under Fiscal Reform Programme for the states introduced in April 1999. These states were: Punjab, Rajasthan, Himachal Pradesh, Manipur, Nagaland, Mizoram, Orissa, Sikkim and
Uttar Pradesh. In fact, "even states which were not facing with acute financial distress have recognised the need for prudent fiscal management and come forward to discuss their reform programme" (Singh, 2006), but the name of resource poor, heavily running into deficits, the state of Bihar was lagging behind. During the year 2000-01, thirteen states undertook their own Fiscal Reforms Programme. These states were: Punjab, Rajasthan, Himachal Pradesh, Manipur, Nagaland, Mizoram, Orissa, Sikkim, Uttar Pradesh, Madhya Pradesh, Assam, Andhra Pradesh and Jammu & Kashmir.

Measures initiated by the states are broadly grouped under revenue mobilization, expenditure containment, debt restructuring, and institutional reforms. In addition to states' own efforts, the central government has also taken initiatives to strengthen the reform process at the state level.

(i) Revenue mobilisation

There was no systematic attempt to streamline the reform process even after 1991 when market oriented reforms were introduced. Most of the reform attempts were ad hoc and were guided by exigencies of revenue rather than attempts to modernise the tax system (Rao and Rao, 2005). Even in 2000, Rao cautioned, "A good deal of progress has been made in the tax system reform of central government; progress in the case of state tax systems has not been commensurate" (Rao, 2000). Recognising the need
for strengthening state finances, “States have initiated measures towards enhancement/restructuring of various taxes within their fold, such as, land revenue, vehicle tax, entertainment tax, sales tax, betting tax, electricity duty, tax on trades, professional tax and luxury tax” (Kapila, 2003 and State Finances: A Study of Budgets of 2003-04).

With a view to harmonising inter-State taxes and ultimately switch-over to state level value Added Tax (VAT), states were guided to introduce, uniform floor rate during 2000. Infact, "Gujarat was the first state to implement the uniform floor rate for sales tax" (Upadhay, 2006). The most important reform initiative in the case of the states is the replacement of the cascading type sales tax with the state level VAT from April 1, 2003, "based on a blue print finalized by the empowered committee of State Finance Ministries" (Bernardi and Fraschini, 2005). Accordingly, VAT was introduced by all states/UTs by 2007-08. Uttar Pradesh introduced VAT on January 1, 2008.

After deliberations with the Empowered Committee of states regarding inconsistency of the Central Sales Tax (CST) with the concept of VAT, the roadmap for Central Sales Tax was finalized in 2007-08. This provided a gradual phase out by reducing the CST rate from its level of 4 per cent from April 1, 2007, by 1 per cent every year, to be finally phased out completely by March 31, 2010. The scheme finalized in consultation with the Empowered Committee of State Finance Ministers (EC) provides for new
revenue generating measures for states as the primary source of compensation. It also provides for meeting 100 per cent of the residuary losses to a state, if any thereafter, through the budgetary resources of the centre. This reduction of CST rate by 1 per cent every year was entailed to eliminate CST coincidental with the introduction of Goods and Services Tax (GST).

The introduction of GST would entail a restructuring of state VAT and central excise and as such involves a degree of coordination and due process of consultation with various stakeholders. The GST would facilitate greater vertical equity in fiscal federalism.

Besides this, states have also undertaken a few measures to enhance non-tax revenues by reviewing the royalties payable to them, including “those on major and minor minerals, forestry and wildlife, revision of tuition fees, medical fees, irrigation water rates and tariff on urban water supply” (State Finances : A Study of Budgets of 2003-04). Some states have also initiated measures towards “reviewing of user charges for power, water and transport; introduction of a new scheme of summary assessment by Maharashtra in April 2003; introduction of self-assessment scheme under Sales Tax and Entry Tax Act by Karnataka” (Dhanasekaran, 2006).

(ii) Expenditure Management

The state governments' measures to contain expenditure inter alia include restrictions on fresh
recruitment/creation of new posts, review of manpower requirements and cut in establishment expenses and reduction in non-merit subsidies through better targeting (Kapila, 2003).

Measures initiated by Orissa regarding expenditure restructuring include rightsizing the government by abolishing 24 thousand posts, introducing Voluntary Retirement scheme (VRS) for government employees, suspending CTC and surrender leave to employees.

Punjab has constituted the Public Expenditure Reforms Commission. On the other hand, NCT Delhi has set up on expenditure review committee to review non-plan expenditure (JBIC Research Paper No.11, 2001). To monitor the government's fiscal performance, Kerala government appointed the Kerala Public Expenditure Review Committee (PERC) in November, 2005. It put much emphasis on expenditure rationalization which aimed to prioritize productive expenditures.

Most of the state governments have taken initiative towards rationalization of expenditures. Measures towards containment of committed revenue expenditure included introduction of new pension schemes based on defined contributed system by the states. The states that have introduced the new pension scheme are Andhra Pradesh, Assam, Gujarat, Goa, Himachal Pradesh, Manipur, Rajasthan, Tamil Nadu, Uttar Pradesh, Chattisgarh,
Jharkhand, Madhya Pradesh, Bihar, Haryana, Karnataka, Maharashtra, Orissa, Sikkim, Uttranchal.

State governments have also undertaken measures regarding “identifying performance indicators to assess the quality of expenditure restructuring, conservation of resources by compressing non-plan revenue expenditure, introduction of Voluntary Retirement Scheme and introduction of zero-base budgeting” (Dhanasekaran, 2006). (iii) Debt Restructuring

After one decade of economic reforms, the issue of debt restructuring and reforms in borrowing process has attracted the attention of policy makers. To address the growing burden of states and to supplement the effort of states in the direction of evolving of Medium Term Fiscal Reform Programme (MTFRP), the central government formulated a Debt Swap Scheme in 2002-03. Under the Scheme, with the mutual agreed between the states and the centre, states were allowed to retire loans taken from the central government bearing a coupon rate in excess of 13 per cent. Up to Rs. 10,00,000 million of high loans contracted before April 1999 were to be replaced under the debt swap scheme by 2004-05. Subsequently, states replaced loans worth Rs. 1,37,660 million in the first year (2002-03), Rs. 4,45,660 million in 2003-04 and the balance of Rs. 4,16,680 million in 2004-05 (Bhargava,2007).

The states have taken several policy initiatives to stabilize their finances. To help retire debt repayments, the
states of Andhra Pradesh, Assam, Arunachal Pradesh, Goa, Maharashtra, Mizoram, Meghalaya, Tripura, Uttaranchal, West Bengal, Chhattisgarh, Gujarat, Kerala, Orissa, Punjab, Sikkim and Tamil Nadu have set up consolidated sinking funds. Fifteen states have legislated ceilings on guarantees i.e., Statutory Ceiling – Goa, Gujarat, Karnataka, Sikkim, West Bengal, Tamil Nadu, Nagaland, Andhra Pradesh, Assam and Manipur and Administrative Ceiling - Assam, Orissa, Punjab, Madhya Pradesh and Rajasthan. The states of Assam, Andhra Pradesh, Goa, Gujarat, Haryana, Jammu & Kashmir, Karnataka, Madhya Pradesh, Orissa, Sikkim, Tamil Nadu and Rajasthan have set up a Guarantee Redemption Fund.

(iv) Centre’s Initiatives

Recognizing the nexus between the centre and state finances, the central government also initiated measures to encourage fiscal reforms at the state level. The Eleventh Finance Commission (FC) recommended a monitorable fiscal reform programme for all the states which aimed at reduction of revenue deficit of the states. Subsequent to the recommendations of the Eleventh FC, the Government of India has drawn up the States’ Fiscal Reforms Facility 2000-01 to 2004-05 and an incentive fund of Rs. 10,607 crore was earmarked to encourage states to implement fiscal reforms programme. All 28 states have drawn up medium term fiscal reforms programme. The Twelfth FC discontinued this facility.
As a prudent fiscal reform measure in order to introduce fiscal discipline, the central government enacted a FRBM Act on August 26, 2003 and the Act and the rules were notified to come into effect from July 5, 2004. "The objective of this Act is to ensure reduction in deficits, prudent debt management consistent with fiscal sustainability through limits on borrowings, transparency in fiscal operations, and conduct of fiscal policy in a medium term framework" (Singh, 2005). So far 26 out of 28 states have enacted Fiscal Responsibility and Budget Management Acts till 2008-09. Sikkim and West Bengal are yet to enact Fiscal Responsibility and Budget Management Acts.

To link the states to fiscal responsibility, the Twelfth FC recommended a Debt Consolidation and Waiver Facility (DCRF) for states. This facilitates states to achieve targets of elimination of revenue deficit and containing fiscal deficit to gross state domestic product (GSDP) at 3 per cent well ahead of 2008-09. So far, debt consolidation has been done for 19 states namely, Andhra Pradesh, Assam, Bihar, Chhattisgarh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Orissa, Punjab, Rajasthan, Tamil Nadu, Tripura, Uttarakhand and Uttar Pradesh. Central loans in respect of these states have also been consolidated.
III. Fiscal Reform Initiatives for the Local Governments

The Constitution of India recognized the division of functions and sources of revenue only between the centre and the states. Entry 5 of list II (state list) of the Seventh Schedule mentioned local bodies as institutions created by state governments. Furthermore, the Directive Principles of the Constitution (Article 40) requires the strengthening of the units of local self government in the states, particularly Panchayati Raj Institutions (PRIs). However, little was done in this regard during the first three decades of independence. But the 73rd and 74th Amendments of the Constitution have accorded the local bodies’ lawful existence (Gupta, 2007). The 73rd Amendment Act relating to panchayats and the 74th Amendment Act relating to municipalities were come into force from April 24, 1993 and June 1, 1993 respectively. The changes made by 73rd and 74th Amendment Acts to the Constitution “is the beginning of a process of local government reform in India” (Singh and Srinivasan, 2002).

It may thus be concluded that Indian federal structure has changed from two-tier to three-tier administrative set up of centre, state and local governments with very high concentration of powers with the central government. In the Indian Constitution, there is division of the revenue powers, expenditure functions and the power of borrowing with the central and state governments. In the early 1990s, the
Indian economy suffered from a very acute macro-economic crisis the like of which it had never faced in the past. This crisis led to the deep structural imbalances in the fiscal system. This underlined the need for a comprehensive programme of fiscal reform. The central government started the reform process since 1991 but the states were slower and late by one decade in initiating the fiscal reforms. Important tax reforms undertaken by the central government relate to reduction in the highest marginal tax rate and in the basic rate of corporate tax. The main central commodity taxes, i.e., union excise duties and customs duties also underwent salient changes. In the case of customs duties, there were drastic reductions in the tariff rates across the rate categories including the peak rates. Reforms also entailed reduction in the rate categories and exemption regimes. However, in the case of Union excise duties, a wide ranging and systematic effort to minimise the incidence of taxation on inputs was undertaken through the introduction of Modified Value Added Tax which was further converted into a uniform rate 14 per cent CENVAT. To align tariffs to the level prevailing in the South-East Asian Countries, the peak rate of import duty was reduced. Other important reforms that have been brought about since 1991 are the introduction of service tax, abolition of securities transaction tax and fringe benefit tax (now abolished). Efforts have also been made to curb expenditure growth through the Expenditure Reforms Commission. Numbers of
policy changes are made to activate internal debt management policy by introducing market operation in regard to absorption of Government of India dated rupees securities and longer term Treasury bills. Another reform in borrowings' process was the reduction of the difference between the interest rate on market borrowings and other internal liabilities. So far states are concerned, all states have undertaken their own fiscal reforms programme. To supplement the effort of states in the direction of evolving Medium Term Fiscal Reform Programme, a Debt Swap Scheme has been formulated by central government. States reduced the rate categories in the case of sales taxes, reduced exemptions, and introduced floor rates. The states are also trying to contain expenditure by compressing spending with the help of enactment of their FRBMAs. To provide a statutory backing to the fiscal reforms, 26 states have implemented fiscal responsibility acts.