CHAPTER-I
INTRODUCTION

We live in an increasingly turbulent world with booms and busts, with inflation and deep recession and with growth and debt crisis. The socio-economic impact of the Great Depression of the 1930s becomes fresh in mind when we go through the literature. This was a period of breakdown of cross border financial obligations and collapse of banking system. Most currencies were inconvertible and countries had stringent restrictions over foreign investment. For the restriction and currency inconvertibility, capital movements across countries came to a halt. In the period of post war expansion (1940s), the government budgets in most countries rose steadily as they took greater responsibility for development, social services and started building up of a sound economic infrastructure for growth. Governments were unable to support their expenditure with revenues and were forced to inflationary tax increases or deficit financing.

Before the end of the World War-II, a concerted attempt was made to reinvent a new global economic order. J.M. Keynes, in his paper entitled “Shaping the Post War World: the Clearing Union”, (1940) circulated his proposal for the new economic order. In 1942, H.D. White publicized his vision of institutions those were intended to maintain exchange rate stability, macroeconomic stability and non discretionary trade relations among nations. White’s plan was accepted as the basis of Bretton Wood’s agreement and subsequent establishment of General Agreement on Tariff and Trade (GATT), with the basic premises that both variation in exchange rates and global capital movements should be closely watched and if need be controlled. Financial globalization slowed down significantly during the Bretton Wood Era. The Bretton Wood Era (1945-71) of fixed but adjustable exchange rates is known for limited capital mobility and autonomy in monetary policy (Das 2003). Bretton Wood’s system which was designed to offer the best protection against financial conflict and disorder and offer the best protection to the sovereign countries had its own limitations. The developing nations, with the oil shocks in the seventies, got into a financial crisis which affected their growth process.
Petrodollar which started flowing into international banks from the oil rich countries enabled these banks to become large-scale creditors for the foreign exchange starved developing nations. As the price of oil rose dramatically; Oil exporting countries in the Middle East deposited billions of dollars in profits they received from the price hike and US in European banks. Commercial banks were eager to make profitable loans to governments and state owned entities as well private companies in developing countries, particularly in Latin America. After the collapse of Bretton Wood Era, middle income developing economies began to open up for greater capital mobility, while keeping an autonomous control over their monetary policy. According to Mundell (2000), the era of financial globalization began with the oil shock of 1973 and collapse of Bretton Wood Era. The international liberalization of financial markets which gathered momentum in the 1980s evolved a qualitative jump in financial volatility and risk, as well as in the complexity and cost of the devices which are supposed to manage the risks.

By the early 1980s, several developing economies had accumulated large debts. Competitive pressure among mega banks together with lenders’ disaster myopia (Guttentag and Herrings 1984) led to a rapid build up of bank loan to Latin America. Some of the earliest international banks among them were born in Venice. The South Asia became forward venues for external capital flows during 1990s (Dymski 2002).

The 1980s have rightly been described as ‘decade of adjustment’ for a number of developing countries in Sub-Saharan Africa and Latin America. Global recession in the 1980s, the significant drop in debtor countries’ exports, combined with strong dollar and high global interest rates depleted the foreign exchange reserves that debtor countries relied upon for international financial transactions. The severe balance of payments crisis was sought to be overcome by resorting to loans from international monetary institutions like the International Monetary Fund (IMF) and the World Bank. The impact of such higher lending would be visible in sharp increases in the country’s debt service burden. Another reason for debtor countries’ failure in timely debt servicing was related to the floating interest rates that increased with global rates and put a greater burden on the debtor countries. Massive outward transfer of capital by private individuals in developing countries added to the problem.
During the second half of the 1990s, financial interdependence was no longer confined to mature democracies as more and more currencies became fully convertible to each other. Across the global economy, national finance policies came under increased scrutiny from international investors and rating agencies.

In banking and monetary sphere, there were significant changes in the 1990s. This included the establishment of European Bank of Reconstruction and Development in 1990, collapse of Thai Baht and its contagion effects on Korea and South East Asia in 1997 and the launching of Euro-single European currency in 11 countries in 1999 and the replacement of 12 Euro-area countries by Euro in 2002. Moreover, there were deep economic slumps in Japan, the European Exchange Rate Mechanism (ERM) crisis in 1992, debt crisis in Mexico and the replacement of General Agreement on Tariff and Tread (GATT) by World Trade Organization (WTO) in 1994. Besides, there was the Mexican debt crisis which had its impact on Latin American financial markets. The terrorist attack on USA on 9th September, 2001 had its devastating effects on the US economy.

The Washington Consensus, a phrase coined in 1989 by John Williamson describes a set of reforms which can be summarized as macro economic stabilization, micro economic liberalization and opening to the outside world. At that point of time, both mainstream economic theory and lessons of history appeared to suggest that it is the market system that makes the best use of an economy’s human and natural resources in terms of generating economic output in a competitive, open, global economy (Williamson 1999). The neoclassical theory is based on the recognition that the market economy has the advantage over alternatives and that it harnesses rather than fights the widespread human instinct of self-interest in the larger interest of economic development even though the neoclassical assumption are not universally valid and often need to be modified. The Washington Consensus was considered to constitute a standard reform package promoted for the crisis wrecked countries by Washington DC based institutions such as the IMF, the World Bank and International Finance Corporation (IFC) and supported by the US Administration. More important than all these changes was the collapse of the command economy in the Soviet Union and the East European countries. This in a way marked the triumph of capitalism and the wider acceptance of free market economy in the world. The policies are
sometimes described as neoliberalism or market fundamentalism. The recommendations include:

(a) Fiscal Policy Discipline;
(b) Redirection of public spending from subsidies towards broad based provision of key pro-growth, pro-poor services like primary education, primary health care and infrastructure investment;
(c) Tax reform - Broadening of tax base and adopting moderate marginal tax rates;
(d) Interest rates that are market determined and positive (but moderate) in real terms;
(e) Competitive exchange rates;
(f) Trade liberalization of imports, with particular emphasis on elimination of quantitative restrictions (licensing etc); any trade protection to be provided by low and relatively uniform tariffs;
(g) Liberalization of inward FDI (Foreign Direct Investment);
(h) Privatization of state enterprises;
(i) Deregulation - Abolition of regulation that impedes market entry or restricts competition, except for those justified on safety, environmental and consumer protection grounds and prudent oversight of financial institution and
(j) Legal security for property rights.


The appropriate policy in this context pioneered by the IMF and the World Bank was the package of stabilization measures. Emergence of macroeconomic imbalances in the 1980s and 1990s was generally taken as an opportunity to embark on extensive liberalization campaigns, alongside stabilization measures. The idea behind macro stabilization and fiscal corrections was that there would be a drop in demand leading to a reduction in current account deficit (more imports than exports) which the IMF believed was one of the major causes of financial crisis in debtor countries. The governments in these countries suffering from such crisis took the measures like reduction in demands by cutting public expenditures, devaluing the
country’s currencies and reducing money supply. The expenditure cut comprised drastic cuts in infrastructure (roads, bridges and dams), freezing state employees wages or shedding labour in the name of rationalisation, reducing consumer subsidies and cutting expenditure on health and education. The World Bank structural adjustment programme complimented stabilization efforts by seeking to increase economic efficiency, which, in turn, would increase the supply of goods and services. They two broad objectives that guided the world bodies were liberalization of domestic and foreign trade and privatization of large and inefficient public enterprises. The IMF and the World Bank averted the collapse of international financing system by resorting to case to case debt restructuring negotiations, popularly known as “muddling through” approach. The Brady initiatives in 1989 of US Treasury Secretary Nicholas F. Brady marked the change in US policy towards debt crisis. Brady bonds were introduced for swapping the debts of debtor countries.

The widespread acceptance of Washington Consensus was a reaction to the macroeconomic crisis that hit many of the Latin American countries like Mexico, Peru in the 1980s. Due to economic mismanagement and loss of access to foreign credit, many governments could no longer sustain high levels of public spending without igniting hyper inflation.

India was one of those countries that implemented market policies following Washington consensus. Other countries who joined are Argentina, Bolivia, Chile, Colombia, Costa Rica, Dominon Republic, Equador, EL Salvador, Guatemala, Honduras, Indonesia, Mexico, Morrocco, Nicaragua, Paraguay, Peru, South Korea, Thailand, Tunisia, Uruguay and Zambia. The World Bank began adjustment lending in 1980, which was lending conditional on implementing the new consensus on economic policies. The IMF expanded its portfolio of conditional lending at about the same time. The two institutions made 958 adjustment loans to developing countries between 1980-98.

**Fiscal Scenario in India:**

India was in deep debt crisis in the early 1990s. Public expenditure grew rapidly and states failed to generate adequate internal revenues. Since tax revenue was not adequate to meet the current account government expenditure, market borrowings were increasingly relied upon. The credit-rating and country-risk status of India was
very low not only due to economic problems like current account deficit, high debt service ratio, etc, but also for internal communal riots and terrorist activities in some states. The situation was so alarming that India was unable to get official loan or commercial loan from bilateral sources. So, the government of India was forced to swap 20 tonnes of confiscated gold in the Union Bank of Switzerland for a loan of US $200 million and mortgaged 47 tonnes of gold in the Bank of England for further loan of US $ 200 million. But, this meager amount was not sufficient to solve India’s debt problem. India had practically no option but to go to the IMF for loan. India borrowed Rs.3153 crore from IMF in January 1991 under Compensation Contingency Financing Facility (CCFF) and US $ 200 million in July, 1991. The IMF also sanctioned US $ 2.2 billion stand-by-loan paid in installment during 1991-92.

When a country resorts to external borrowing, there are various channels through which external economy and political factors influence the domestic policy of a developing country like India. Not only that, changes and fluctuations in international economic activities are transmitted and may impact the Indian economy in terms of

(i) business cycle
(ii) international network, and
(iii) loan conditionality

External forces including multilateral agencies seek to influence domestic policy more directly through loan conditionality. Devaluation, liberalization and privatization are often made obligatory conditions for loan from multilateral institutions like the IMF and World Bank to which most developing countries turn for assistance. This was the case with India. Loan conditionalities which India had to accept and implement were reflected in

(i) Devaluation of Indian Rupee, (ii) Liberalization of international trade, and (iii) Privatization of public sector undertakings were made obligatory by the IMF for which there were two strokes of devaluation of Indian Rupee on July 1 and 3, 1991 by which Rupee was depreciated by 21 percent against major currencies and consequent depreciation of Rupee against US $ under “free float” and proclamation of New Industrial Policy promoting liberalization and privatization including disinvestment of PSU shares on 6th August 1991.
Factors Responsible for Financial Crisis in India:

India’s financial crisis became acute due to:

i. Rising deficit of balance of payments and in public accounts.

ii. India's robust growth during the late 1980's had, if anything, overshadowed and exacerbated import growth and public overspending.

iii. The centralized, regulated economy chronically led by public enterprise losses staggered into more debt with no improvement in efficiency.

iv. The Soviet Union, India's friend, treaty partner for two decades, defense supplier, diplomatic supporter and major trading partner as well, tottered and in the summer of 1991 collapsed.

v. In 1990-91, India also experienced an uncomfortable situation in its foreign relations. The gulf crisis and the UN sanctioned war against Iraq, which resulted from Baghdad invasion of Kuwait in August 1990 put India in an impossible position as Iraq's Soviet mentor was distracted and disintegrating.

vi. By the spring of 1999, foreign exchange reserves dropped to 1.1 billion dollars approximate three weeks supply. By April, the margin had narrowed further and India faced real possibility of defaulting on its sovereign obligations. The would be guarantors of new credit, the bank of England and Japan demanded assurances that India would ship gold to secure new loans, a major humiliation to the Indian nation.

Fiscal Scenario of State Governments:

The analysis of state government finances during the period reveal that invariably almost all the states incurred more expenditure than the revenue they mobilize. Consequently, the states undertook borrowing from a number of sources to finance their resource gaps /GFD (gross fiscal deficit), mainly loans from the centre. The analysis in historical perspective since mid 1980 reveals (i) steady deterioration in revenue receipt – GSDP (gross state domestic product) ratio, (ii) stagnating social sector expenditure, (iii) inadequate investment for basic infrastructure sectors, (iv) preemption of high cost borrowed funds for financing current expenditure, (v) large
and persistent revenue gap and (vi) accumulation of high debt stock and debt service payments.

If we take the review period 1980-81 to 2003-04, this period can be subdivided into three major phases.

Phase-1 Revenue account surplus position (1980-81 to 85-86) was caused mainly due to growth in sales tax. Revenue expenditure remained at 12.8 percent of GSDP and revenue receipts remained at 13.2 percent of GSDP. GFD-GSDP ratios of all states except Punjab and Orissa were below four percent (Rajmal 2006).

Phase-2 Emergence of fiscal imbalance (1986-87 to 1997-98). This phase deals with sluggish revenue growth on account of low negligible user charges, dividends and profits coupled with stagnation of states’ share in central taxes. Revenue expenditure increased by two percent in terms of GSDP. Revenue receipt increased by one percent indicating deficit in revenue account.

Phase-3 Deepening and persistent fiscal imbalance (1999 to 2003-04). There was significant increase in expenditure due to 5th Pay Commission, growing interest payments on high cost borrowing, revenue growth remained sluggish due to low state tax GSDP ratio and decline in own non taxes and central transfers, particularly grants to states, revenue receipt – GSDP ratio decelerated by 0.8 percent while revenue expenditure GSDP ratio increased by two percent over previous phase. Interest payment and pension outgo absorbed as high as 37 percent of revenue receipts (varying from 26 percent in Madhya Pradesh to 58 percent in West Bengal). Total expenditure – GSDP ratio increased to around 21 percent. The persistent and large resource gaps resulted in vicious cycles of deficit, debt and debt service payments (ibid).

State of Orissa:

The ever increasing revenue expenditure, inadequate central devolution and absence of adequate revenue generation by state government commensurate with revenue expenditure aggravated the financial position of the state. This resulted in a transition from a position of overall surplus of Rs. 74.50 crore in revenue account of 1980-81 to the revenue deficit of Rs. 903.14 crore during 1997-98 constituting 2.76 percent of GSDP and 3.18 percent of NSDP (net state domestic product). With the
implementation of central revised scale of pay, the revenue deficit was hiked to Rs. 2,262.50 crore during 1998-99 (6.32 percent of GSDP and 7.34 percent of NSDP). The huge gap in revenue account was being met by borrowing on a large scale year after year. What became most disturbing was that in 1998-99, a gross borrowing of Rs. 2,093.34 crore excluding net accretion of Rs. 831.62 crore in the GPF (general provident fund) account was inadequate to meet the revenue deficit of Rs. 2,262.50 crore. The rapid deterioration in state finances constrained the ability of the state to provide quality infrastructure and to earmark adequate funds for investment in infrastructure and the social sectors to lift the human development indicators like infant mortality rate and literacy which were much lower compared to other Indian states.

**Institution of Economic Reforms at the National as well as State Levels:**

India’s economic reforms began in 1991 when a newly elected Congress government, facing an exceptionally severe balance of payments crisis, embarked on a programme of short term stabilization combined with a longer term programme of comprehensive structural reforms. Rethinking on economic policy had begun earlier in the mid-1980s by which time the limitations of development strategy based on import substitution, public sector dominance and pervasive government control over the private sector had become evident. But the policy response at the time was limited to liberalizing particular aspects of the central system without changing the system in a fundamental way. The reforms initiated in 1991 were different precisely because they recognized the need for a system change involving liberalization of government controls, a larger role for the private sector and greater integration with the world economy.

The broad outline of the reforms was not very different from the reforms undertaken by many developing countries in the 1980s. Indian approach to reforms, however was cautious and gradualist and they were implemented in a steady manner.

Economic reforms launched since June 1991 have been categorized in two broad categories, (1) major macroeconomic management reforms, and (2) structural and sector specific economic reforms. The reforms could be divided into (i) fiscal policy, (ii) monetary policy, and (iii) exchange rate management. The micro economic reforms included like industrial deregulation, infrastructure reforms,
finance sector strengthening, capital market deepening and agriculture. Important reforms in direct/indirect taxes recommended by the Tax Reforms Committee headed by Dr. Vijaya L. Kelkar were also complemented. To get fiscal assistance, the Eleventh Finance Commission set undertaking reforms as binding conditions. The policy initiatives were intended to prepare the states for Medium Term Fiscal Reforms Programme (MTFRP). Adjustment programme was also undertaken in the states. Major landmark in coordinate tax reforms were simplification and rationalization of sales tax system and introduction of VAT (Value Added Tax) from 1st April 2005 in place of existing cascading type sales tax (Rao et al 2005). Government of Orissa signed MOU with the Ministry of Finance, Government of India in April 1995, which stipulated a number of measures for reduction in non-plan expenditure and resource mobilization measures aimed at strengthening the fiscal position of the state. The state of Orissa also undertook a number of fiscal correction measures including expenditure rationalization and revenue generation measures so as to improve the fiscal situation of the state in subsequent years.

**Major Objectives of the Study:**

The objective of the study are as follows

1. To examine the trend of fiscal deterioration at the national and sub-national levels.
2. To assess the impact of Economic Reforms on the Indian economy.
3. To assess the impact of economic reforms at the sub-national level, particularly on state finances in Orissa.
4. To assess the impact of VAT implementation in the Indian states with special reference to Orissa.
5. To identify areas of economic reforms to sustain growth and suggest measures to augment revenue for the state from VAT.

**Major Hypotheses:**

1. That there was a disturbing fiscal deterioration in India both at the national and state levels;
2. That there has been a significant impact of reforms on the Indian economy;

3. That the impact of economic reforms has been felt at the sub-national level i.e. on the state economy of Orissa;

4. That there has been encouraging effect of VAT administration in augmenting the tax revenue of the state; and

5. That new areas of reforms can be identified and implemented to raise growth and generate additional VAT revenue for the state of Orissa.

**Methodology:**

The present study makes an attempt to evaluate / assess the outcomes of fiscal reforms including the implementation of VAT in India in general and in the state of Orissa in particular.

The study is mainly based on secondary sources of data. The main data sources are publications of various reports and official records of (i) Government of India, (ii) Government of Orissa, (iii) Reserve Bank of India and (iv) The literature on the topic available in the websites. The researcher consulted relevant books on Value Added Tax (VAT) by eminent economists and researchers. All efforts have been made in the course of this work to elicit accurate and relevant information on the matter from various stakeholders as mentioned above.

The time period chosen for the study is from 1980-81 to 2008-09. The period of study has been bifurcated into two sub-periods viz. (i) Pre liberalization and, (ii) Post liberalization. The study extensively makes use of per capita Net National Domestic Product (NNDP), growth in Gross State Domestic Product (GSDP), and the fiscal indicators such as fiscal deficit, revenue deficit, debt ratio in relation to GSDP. The study makes use of simple statistical tools like average, ratio, percentages, and coefficient of variations to express things scientifically. We have also made use of simple and cross tables showing correlation of variables, graphs and charts for better understanding of the tax matters.

One way of getting a measure of relative growth of tax revenue from VAT is the percentage growth over the preceding years. The growth in VAT collection has been measured comparing the tax revenue yield during Sales Tax regime and the
VAT regime beginning with 2004-05, the year when implementation of VAT started in the state. The study also makes a comparison of the gross Sales Tax and VAT collected in relation to GSDP during pre and post VAT periods.

The midpoint elasticity of gross sales tax during Sales Tax regime and VAT regime has been tested while comparing the percentage growth of GSDP and the percentage growth in gross Sales Tax collection in the respective periods. The efficiency and effectiveness of VAT has further been evaluated in terms of reducing compliance cost, increase in number of the registered dealers, increase in the use of government waybills, higher voluntary compliance in terms of payment of admitted tax as a percentage of VAT collection and the gradual reduction in arrear in VAT regime in comparison to the Sales Tax regime.

VAT promotes business and industry and reduces economic burden on common people. This can be adjudged from the design of tax rates in the VAT regime. For the purpose, the researcher examines as to whether the goods used as inputs in mining, construction, industry and the goods consumed more by people in low income group are grouped in low tax rate of four percent or at a higher rate of tax.

The impact of economic reforms has been assessed on the changes in Head Count Ratio (HCR) of poverty. Similarly, the growth in inequality among the Indian states has been evaluated in terms of Gini-coefficient in consumption expenditure distribution. The growth disparity between the Indian states is being assessed in terms of growth in GSDP and per capita GSDP across states and their variations expressed in terms of Gini-coefficient ratio.

**Organization of the Present Study:**

With a view to highlighting the main issues systematically, the content of the present study has been arranged in following order from Chapter-I to Chapter-IX. Chapter-I contains the statement of the problem explaining the need of the fiscal reforms and implementation of VAT as a part of the reform process and the beneficial extent of such reforms. It contains the objectives of the study, the hypothesis, the implications of study, and sources of data and the period of study. Chapter-II contains the review of literature containing gist of earlier work done in the area by the different researchers and policy makers. Chapter-III contains the socio economic profile of
Orissa. Chapter-IV embodies the analysis of economic reforms in India. Chapter-V contains the assessment of economic reforms in Orissa. Chapter-VI analyses the tax structure and the tax reforms evolution process in India. Chapter-VII contains implementation of VAT in the Indian states with special reference to Orissa, an assessment. Chapter-VIII embodies the need for further reforms and Chapter-IX contains the summary and conclusions and the limitations of the study.

**Rationale of the Study:**

India undertook major economic reforms in line with the terms and conditions that IMF and World Bank imposed for obtaining loans to come over the crisis-ridden situation during the 1980s and the early part of 1990s. In addition to structural reforms, major reforms in taxation area were also undertaken with the policy guidelines framed by the committee headed by Dr. Raja J. Chelliah. The most notable reform in indirect tax area was the paradigm shift to VAT replacing the complex and cascading Sales Tax system that prevailed in the Indian states. The Indian states embraced VAT on or after 01.04.2005. It is time that an attempt is made to assess on the impact of such reforms in Indian economy as well as on the states including Orissa which has been identified for the purpose.

**Sources of Data and Period of Study:**

The study is based on secondary database. Efforts have been made to look into the studies and contributions made by eminent economists in the field. The following publications of Government of India and Government of Orissa have been used for the study.

- Union Budget: Issues from 2001-02 to 2007-08
- Annual RBI Report on Currency and Finance, Various issues
- Handbook of Statistics – CSO, Government of India, various issues
- Handbook of Statistics on Indian Economy, RBI, 2005-06
- Economic Survey, Various issues – Ministry of Finance, Economic Division, Government of India
- Government of Orissa Budget from 2001-02 to 2009-10
The Time Period of Study:

Time period identified for the purpose of this study is from 1980-81 to 2008-09. This gives enough space to look at the financial crisis in India vis-à-vis the World situation that led to the emergence of Washington Consensus as a basis for reforms in the Latin American and the Indian economy. Since the reforms initiated at the national level were expected to be matched and strengthened by the implementation of similar reforms at the state levels, an attempt has been made to assess the reforms, particularly the impact of tax reforms and the introduction of VAT on the state economy of Orissa. The year 2000-01 is taken as reference year because the base year for national income has changed from this year. This helps us to make the comparison and test the hypothesis. It may be mentioned that the real reform process gathered momentum from 2003-04 onwards after the introduction of FRBM Act and rules and the period 2008-09 has been chosen at the other end to analyze the impact of economic reforms.

The period of study has been bifurcated into two sub-periods namely.

- Pre liberalization (1980-81 to 1989-90) and
- Post liberalization (1991-2009) for analyzing fiscal reform measures and their impact on the Indian economy. Given the change in the tax scenario after the introduction of VAT, a comparison has been made between 2001-02 to 2004-05 (the Sales Tax regime) and 2005-06 to 2008-09 (the VAT regime).
The objective behind dividing the study period is that it analyzes the responsiveness of fiscal reforms and the impact of the taxation reforms, which were vigorously initiated at the time of globalization after 1990s. Besides, as a part of tax reforms VAT has been introduced in most of the Indian states during with effect from 01.04.2005 and it has been considered necessary at this end to make comparison of growth of tax revenue in the Indian states after the introduction of VAT over the Sales Tax revenues collected in states during the Sales Tax regime for the same period back before the introduction of VAT and especially in the context of Orissa.

**Implications of the Study:**

Economic reforms, particularly the reforms in the fiscal sector in response to external influences and internal developments are expected to impact the pace of our economic development by influencing the process of desired changes in revenue collection, revenue spending, debt servicing and to that extent, the totality of our socio-economic activities. The study will indicate as to whether the implementation of fiscal changes and particularly the introduction of VAT into the Indian tax system have brought any quantitative jump in generating revenue for the states. This study may have implications for future tax planning, tax laws and procedures and tax administration. The findings of the study may also indicate whether the declared policy objectives of tax reforms have been achieved and what amendments, if any, are required to the existing arrangements in the wake of expanding economic activities both at the national and state levels.