ABSTRACT

Fiscal policy is among the most potent instruments of economic policy. Through it the government creates and sustains the public economy consisting of the provision of public services and public investment, at the same time, it is an instrument for re-allocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability. Thus the fiscal policy must be geared to the sustenance and growth of the public economy and to help achieve the broader objectives of planning. This implies that the methods of raising resources for the public sector should be such as to influence the rest of the economy in beneficial ways and within the public economy itself resources must be used in the most efficient way.

Role of the government which was confined only to providing essential public service in the pre-war period has been extended to the sphere of social welfare and public sector investment for maintaining economic stability as well as promoting economic development in developing countries in the post-war period. Public debt which was intended to be used in emergencies has come to be justified for the purpose of economic stability and development, and subsequently it has been extended to the financing of the deficit. These expansions in the government operations have caused the size of the government budget to increase very fast. Therefore, high fiscal deficit become common phenomenon in many developing countries in the recent past.

There is general agreement among economists that runaway public expenditures as compared to nearly stagnant revenue receipts
played crucial role in the inception of fiscal imbalance in many developing countries as well as in India. Excessive borrowings and loss-making public sector enterprises added fuel to the fire. On account of these factors all the indicators of the deficit were on the rise by the end of eighties especially in India. S. K. Singh, M. Rakshit, S. Mundle et al., S. Gulati, U. Kapila, Datta and Sen, Ghosh and Sen, P. B. Nayak, M. G. Rao and others have shown in their studies that outpacing of revenues by public expenditure since early eighties lead the government to substantial borrowings, which further widened the gap between revenue and expenditure. According to them these consequential extensions and expansions have caused the problem of fiscal stabilization.

The study covers a period of fifteen years, from 1985-86 to 1999-2000. The choice of the period in reference is basically because a number of events took place in the fiscal area of the Indian economy during this period. In 1985-86 the government of India announced its Long Term Fiscal Policy (LTFP). It concerns with that part of fiscal management which relates mainly to direct and indirect taxation by the centre. In 1991-92 government of India announced its Fiscal Adjustment/Stabilization Programme in order to combat the deepening fiscal crisis. After that a number of important steps have been taken by the government to restore fiscal stabilization. These events generated interest to study the whole problem with a new approach.

To accomplish our endeavour required data have been taken from reports and periodicals published mainly by, Ministry of Finance, Reserve Bank of India, Central Statistical Organisation, and other departments/
offices of the Government of India. Besides these sources we have also taken data published by CMIE and the World Bank. In our study we have used both statistical as well as theoretical approach.

In our study, we have analysed the experience of the developing countries regarding fiscal instability and fiscal corrective measures. In our study we found that the factors responsible for the fiscal crisis in most of the developing countries were common in nature. Due to declining share of direct tax in the total tax revenue and the declining buoyancy of custom duties because of higher rates, the tax revenue remained stagnant as a proportion of GDP in the countries experiencing fiscal crisis. Stagnant revenues coupled with rapid growing public expenditure and public debt indicted as main culprits behind the creation of fiscal imbalance. In order to put their fiscal house in order, countries adopted fiscal adjustment/stabilization measures. Their experience reveals that fiscal stabilization cannot be achieved through shock therapy, good fiscal measures always took time.

Our analysis of the problem during seventh plan period shows that expenditures had been outpacing revenues for more than a decade, leading the government to substantial borrowings. Consequently interest payments become the single largest component of the expenditure of the central government. Our analysis have identified the problem related with the tax system. The problem was that the share of direct tax (which is considered most buoyant) had virtually stagnated during the entire eighties, it started out at 2.20 per cent of GDP in 1980-81 and stood at around 2.19 per cent of GDP in 1988-98. Thus whatever increase had been
in the tax revenue brought about by exploiting indirect taxes. On considering dis-aggregated figures for direct and indirect taxes during the seventh plan period, we find that performance of direct taxes has been far behind the targets. Indirect taxes, however, performed better, exceeding seventh plan projections by a significant margin. It was certainly a very unhealthy development. However, overall tax revenue performance during the seventh plan as compared to sixth plan seems to be satisfactory. Gross tax revenue of the central government as a proportion to GDP moved from 9.93 per cent during sixth plan period to 11.20 per cent during the seventh plan period.

During the seventh plan period government expenditures far exceeded the revenue receipts. During the period in reference public expenditure of the central government was 20.48 per cent of GDP. This was particularly due to sharp rise in expenditure on interest payments, defence, and food and fertilizer subsidies. Interest payments contributed most to this unabated growth of expenditure. From 9.6 per cent of the total expenditure in 1981-82 interest payments rose to 16.4 per cent in 1990-91. Thus our analysis of the problem during seventh plan period have shown sharp rise in expenditures on subsides, transfer payments, wages and salaries, food and fertilizer subsidies and sharp decline in the share of capital expenditure. This acceleration in the government expenditure has led to the emergence of severe fiscal imbalance.

We have also analysed the contribution of the public sector enterprises in the emergence of fiscal instability in Indian economy. Net profits of these enterprises have declined from Rs.3789 crore in 1989-90
to Rs. 2368 crore in 1990-91. The rate of return, as measured by the ratio of net profits to capital employed, declined from 4.5 per cent in 1989-90 to 2.3 per cent in 1990-91, the lowest since 1984-85. It is clear from our analysis that poor returns form investments made in the public sector enterprises had been one of the main contributory factors in the inception of fiscal crisis.

Since this fiscal deficit had to be financed by treasury bills and market borrowings, as a result the internal debt of the government increased rapidly from 42 per cent of GDP at the end of 1980-81 to 53 per cent of GDP at the end of 1990-91. The danger of the government falling into debt-trap was inevitable. During the seventh plan period government also relied partly on issuing of the treasury bills for the financing of the deficits. This in turn had resulted in huge monetized deficit. Consequently, money supply grew at an average annual rate of about 17.5 per cent during the period in reference. This contributed to the double digit increase in inflation by the end of 1990.

Thus it is clear from the analysis of the problem during seventh plan period, that throughout the eighties, all the important indicators of fiscal imbalance were on the rise. The state of our public finances had reached crisis proportions by the end of eighties. Evidently, a stabilization programme, reversing the growth in the budget deficit, revenue deficit, fiscal deficit, and tightening monetary policy was called for.

We have analysed the fiscal reform measures introduced in 1991-92. The immediate aim of fiscal reform was to improve the fiscal balance in order to eliminate the inflationary pressure emanating from the budget deficit. The other objectives of the fiscal reform were to stop
further accumulation of public debt, to reduce the level of subsidies in the economy, to direct government expenditure towards providing essential public services of a high quality, and to restore the government’s capacity to make strategic investments in infrastructure and human resources.

The government has recognised the link between compression of expenditures, tax reform and programme of fiscal stabilization. Fiscal stabilization requires a reduction in the fiscal deficit. While some of this can be achieved by reducing low priority expenditure, some of the improvement has to come from high tax collections. For this purpose government has introduced cuts in expenditure specially in regard to the emoluments and size of the bureaucracy, and subsidies to food and fertilizers. Also, government appointed a committee on tax reforms under the chairmanship of R.J. Chelliah. Government accepted the recommendations of the committee, emphasising tax reforms aimed at simplifying the structure and continuing the process of shifting to moderate rates of taxation.

Inefficiencies and poor financial performance in public sector enterprises have contributed to the fiscal crisis. The reforms aim to increase efficiency and reduce losses that so many public enterprises impose on the government budget. In addition to this, two other key elements of the government's strategy for public sector enterprise reform are the promotion of increased private sector competition and partial disinvestment of equity in selected enterprises. For the retirement of public debt the objective of the fiscal policy reforms was to use the proceeds from privatisation/disinvestment, so that the interest burden is
progressively reduced. Fiscal reforms have also recommended a sound management of monetary policy in the interest of financial stability, as many of the problems in the financial sector stemmed from the fiscal deficits.

Our analysis of the effects of fiscal correction measures on fiscal stabilization shows that government succeeded partially in the restoration of fiscal stabilization. Though the growth of expenditure has been controlled marginally, the tax revenue as a ratio to GDP declined during the reform period. Our analysis of the revenue implications of tax reforms shows that compared to indirect taxes, direct taxes were more buoyant during the nineties. Between 1990-91 and 1999-2000, when there were substantial tax rates reductions, the ratio of gross tax revenue to GDP declined from 10.8 per cent to 9.2 per cent. Among the different categories of taxes, customs and excise duties as a proportion of GDP declined sharply from 3.9 per cent to 2.6 per cent and from 4.6 per cent to 3.3 per cent respectively during the period in reference. However, there was an improvement in terms of direct tax to GDP ratio. Between 1990-91 and 1999-2000 yield of personal income tax and corporation tax as a percentage of GDP increased from 1.0 per cent to 1.4 per cent and from 1.0 per cent to 1.6 per cent respectively. This is the reason why even though the direct tax/GDP ratio increased during this period, growth in total tax revenue could not keep pace with the rate of growth of GDP. The analysis of the movement of tax rates and income elasticities of various taxes shows that generally reduction in tax rate cannot make a tax more buoyant instantly. There is a time lag involved. Average income elasticity
of total tax revenue declined from 0.91 during the period of 1991-92 to 1995-96 to 0.73 during 1996-97 to 1998-99. If the tax level in the pre-reform years is to be achieved, tax revenues have to grow with a rapid pace as compared to GDP. To be realistic, if the centre's revenue is to grow faster the pick up has to come from union excise and custom duties.

It becomes clear from examination of the data that total expenditure of the central government declined from an average of 19.66 percent of GDP in 1990-91 to 15.73 per cent in 1999-2000. While capital expenditures as a proportion of GDP have fallen sharply from 5.9 percent during 1980-81 to 1991-92 to 2.7 per cent during 1992-93 to 1999-2000 and revenue expenditures have marginally increased from 11.7 per cent to 12.2 per cent during the period in reference. Our analysis also shows that during the nineties plan expenditures have declined sharply as compared to non-plan expenditures. Interest payments now constitute the single largest component of expenditure of the central government. Our analysis suggests that rising expenditure on interest payments has dampened the pace of expenditure compression.

A few distinct trends have been drawn from the analysis of the effects of the reforms in public sector undertakings. In 1991-92 profit after tax to net worth in 237 central PSUs, was only 3.9 per cent, which rose to 8.9 per cent in 1998-99. Disinvestment in PSUs have fallen short of expectations during the reform period. It is also clear that reforms in the PSUs have not helped much in the reduction of fiscal deficit.

As far as financing of the government's deficit is concerned, till the early nineties a considerable part of the deficit was financed with
borrowing from the central bank. The interest rates on such borrowing were much lower than the interest rate on borrowing from the open market. Later, a gradual shift away from borrowing from the central bank to open market borrowing, resulting in a sharp rise in the explicit interest cost of the fiscal deficit. During the period between 1980-81 to 1991-92 share of market borrowing in financing of the gross fiscal deficit was 26.2 per cent, which rose to 49.7 per cent during the period of 1992-93 to 1999-2000. The study makes it clear that even putting an end to the practice of monetising the deficit has hardly affected the fiscal situation. Fiscal deficits remain high, though they are now financed by high interest open market borrowings. The only result is that the interest burden of the government tends to shoot up. Interest payments as a percentage of GDP have risen from 3.4 per cent during 1985-90 to 4.6 per cent during 1995-99. As a result revenue deficit of the central government has increased from 3.3 per cent of GDP in 1990-91 to 3.9 per cent of GDP in 1998-99.

To sum up, we can say that fiscal correction measures have not delivered the fiscal results as expected. In the recent past the budgets of the central government were out of balance. There was not only a wide gap between revenue and expenditure but the composition of expenditure was also quite out of line. Revenue structure needs to be altered to make it more broad based and equitable. The key objective of future's fiscal reform has to be a reduction in debt service payments. This has to be achieved by a progressive reduction in public debt and through higher revenues. Higher tax revenues can be achieved only through buoyancy and expansion of the tax base. The share of interest payment in total
expenditure may be brought down by retiring some of the debt. Through the sale of seized gold and some of government lands and through disinvestment in public sector undertakings, a sizeable amount could be raised and used for the retirement of the debt. Ensuring long-term fiscal health of the economy requires higher buoyancy in tax revenues and compression of non-essential expenditures. Apart from this the key solutions to India's fiscal predicaments are bold programmes for imposing user charges on all public services amenable to such charges, and the implementation of crash programme of privatisation. The fiscal health of the economy may improve swiftly, if this correction is made.