CHAPTER-1

INTRODUCTION
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1.1 The Problem:

In recent years many countries have adopted economic programs aimed at adjusting their economies because of the large macroeconomic disequilibria characterized by inflation, balance of payments difficulties, and increasing debt obligations. By and large, adjustment has aimed at reducing the rate of inflation, improving the balance of payments, and promoting economic growth. Adjustment requires many policy changes, including devaluation, opening of the economy, financial reforms, reduction of excessive regulations and removal of price controls. All these adjustment programs adopted by countries (whether supported by the IMF or the World Bank or undertaken without outside support) have required that substantial attention be paid to the fiscal situation. The reason for this is obvious. In countries facing major macro-economic difficulties, the public finances are often in substantial disequilibrium. A reduction of the disequilibrium becomes a necessary condition for improving the macroeconomic situation. The need for fiscal reform is now widely recognized but at the same time it has been experienced that the fiscal reform is very difficult. In fact, it has been found to be the most difficult of the various policy changes required in adjustment programs. The difficulties are partly political, partly institutional, and partly conceptual. Dealing with fiscal deficits remains today one of the most difficult problem for the majority of developing countries. For many, growing fiscal deficits led to money creation as the main source of financing followed by increasing inflation, an erosion of the tax base, and even larger fiscal imbalances. Even counties that contained their fiscal deficits usually did so at great costs mainly by indiscriminate expenditure cutting.

According to the World Bank, Country Economic Memorandum (CEM) on India, economic crisis which triggered the reform process in 1991 itself was diagnosed as the consequence of the severe fiscal imbalance that afflicted the economy throughout the 1980s, a detailed review of achievements and challenges of fiscal adjustment efforts is opportune. Fiscal reforms must therefore be analyzed from the perspective of whether and to what extent they have helped to achieve economic growth.
The Indian economy has undergone a gradual transformation during the post-independence period. The pace of such transformation, however, being relatively rapid since the last decade. The structural transformation that occurs in the Indian economy over the decade is the consequence of the development process witnessed since the beginning of planning in 1951. This is reflected in the growth rate and in the changing sectoral composition of the GDP. With the Indian economy shifting to a high growth path during the 1980s it was evident that the economy has emerged from a phase of stagnation, which has set in since the mid-1960s. However, the impressive growth performance of the 1980s was also associated with steady deterioration in a number of macroeconomic indicators.

In the early 1991, a major economic crisis surfaced in India. Most economists are now conceived that the crisis in the economy was the worst that this county had experienced since independence. However, the situation is much less unstable than it was two decades ago. Over the past two decades, the Government has followed a policy of macroeconomic stabilization and has introduced certain structural reforms. So far these policy measures have not shown any spectacular results and whether in future these neo-liberalization measures will ensure economic growth with equity cannot be said a priori.

The problems of the economy which assumed crisis proportions in 1991 did not develop suddenly. The origin of the crisis is directly attributable to the careless macro-management of the economy during the 1980s which led to large and persistent macroeconomic imbalances. The strategy of development, notwithstanding its limitations, cannot be blamed for this crisis. The widening gap between the revenue and expenditure of the Government resulted in growing fiscal deficits which had to be met by borrowings at home. Further, the steadily growing difference between the income and expenditure of the economy as a whole resulted in large current account deficits in the balance of payments which were financed by borrowings from the abroad. The internal imbalance in the fiscal situation and the external imbalance in the payments situation were closely related, through the absence of carefulness in the macro-management of the economy. The fiscal situation, which had been under mounting pressure throughout 1980s, assumed crisis proportions by the beginning of the 1991-92. The twin crises were reflected through an unmanageable balance of payments crisis and a socially intolerably high rate of inflation that were building up in the 1980s and climaxed in 1990-91. The Gulf crisis in the late 1990s sharply
accentuated macroeconomic problems. There was also political instability in the
country at this juncture. All these developments together eroded international
confidence in the Indian economy and as a result, this country’s credit rating in the
international capital market declined steeply. However, it has to be recognized that the
problems of the economy did not assume crisis proportions abruptly. These problems,
in fact, were very much there for years destroying the capacity of the economy to cope
with any internal or external shocks. The two OPEC shocks of 1973 and 1979 hurt, but
did not have a sustained impact on the economy. The external shocks administered by
the loss of remittances and the expenditures incurred to rescue workers in the aftermath
of the invasion of Kuwait in August 1990 certainly accentuated the fiscal crisis at the
end. But the crises was certainly ‘home made’.

This was the context in which a newly elected Government took office in June
1991 and set about the difficult task of launching a programme of economic reforms.
The Government initiated a programme of macroeconomic stabilization and structural
adjustment with the support of the IMF and the World Bank. To some extent the
urgency was derived from the gravity of the crisis because the day of reckoning could
not be postponed any further. There was also the performance record of the 1980s
which clearly pointed towards speeding up the pace of structural reforms while setting
the fiscal house in order without any loss of time. Fiscal stabilization was begun with a
view to bringing about macroeconomic stabilization. The regular budget for 1991-92
took a bold step in the direction of correcting the fiscal imbalance. It envisaged a
reduction in the fiscal deficit by nearly two percentage points of GDP. This magnitude
of fiscal correction can be considered unprecedented in as much as only eight months
of the current fiscal year remained to accomplish the task. The budget laid stress on
fiscal stabilization being supported by essential reforms in economic policy and
management. While it contained proposals for raising additional revenue, most of the
reduction in fiscal deficit was sought to be achieved through reduction in non-plan
expenditure.

The reform process was comprehensive. The initial reforms focused on fiscal
reforms, policy paradigm shift from physical control regime to the one relying more on
market forces and trade related reforms. Subsequently reforms were extended to cover
financial sector and to put in place law and regulatory framework compatible with a
market system. The full impact of the reform measures edges into view over a long
span of time (Sarma,A. & Gupta,M.,2002). In India, over the last several years, public
debate with respect to fiscal policy reforms has proceeded at three distinct levels:

- at the *microeconomic level*, where discussion has centered on the base and
  structure of tax rates and the distribution of Government expenditures across
  alternative end uses,

- at the *administrative level*, where concern has been expressed with respect to
  the quality of Government expenditures, the delivery of its services and the
  inefficiencies inherent within its tax collecting bureaucracies, and

- at the *macroeconomic level*, where attention has focused on the size of the
  Government’s fiscal deficits (and its various counterparts) and the implications
  this carries for real interest rates, inflation, investment and
  growth(Mishra,V.,2001).

Fiscal Reforms at the Centre Covered:

I. Tax Reforms,

II. Expenditure Reforms,

III. Restructuring of PSUs,

IV. Coordination between Monetary and Fiscal Policies, and

V. Institutional Measures.

The structuring of the tax system constitute a major components of fiscal
reforms with the aim of augmenting revenues and removing anomalies in the tax
structure. The main focus of the reform was of simplification and rationalization of
both direct and indirect taxes drawing mainly from the recommendation of the Tax
Reform Committee headed by R.J Chelliah in 1991. Since the rates were very high and
structure of indirect taxes was highly complex, it was considered undesirable to
augment revenues merely by raising tax rates. The Committee had recommended
adoption of a small number of simple broad-based taxes with moderate and limited
number of rates and with very few exemptions and reductions. Accordingly, the tax
rates were significantly rationalized and progressively brought down to the levels
comparable to some of the developed economies. The concern with tax rationalization
has been reflected in the appointment of a number of Committees to review the tax
system in the last few years.

Since 1991 several efforts have been made through the annual budget process
to achieve tax reforms. These have focused on: expanding the tax base by including
services (not previously taxed); reducing rates of direct taxes for individuals and corporations; abolishing most export subsidies; lowering import duties (covered below by us under structural reforms relating to trade policies/external sectors); rationalizing sales tax and reducing the cascading effect of central indirect taxes by introducing a modified value-added tax (MODVAT) and later on value-added tax (VAT); rationalizing both direct and indirect taxes by removing unnecessary exemptions; providing for tax incentives for infrastructure and export-oriented sectors, including setting up special economic zones; and simplification of procedures and efforts for improving the efficiency of the tax administration system specially through computerization.

The Central Government has included a lot of measures to curb built-in growth in expenditure and to bring about structural changes in the composition of expenditure in successive budgets during 1990s. These included subjecting all ongoing schemes to zero-based budgeting and assessment of manpower requirements of government departments. These measures, by and large, focused on downsizing government and reducing its role and administrative expenditure. The process also involved review of all subsidies with the view to introducing cost-based user charges wherever feasible, review of budgetary support to autonomous institutions and encouragement to PSUs to maximize generation of internal resources. Further, as an institutional arrangement, the Government also constituted an Expenditure Reforms Commission (ERC) to look into areas of expenditure correction. The ERC constituted to suggest measures for rationalizing public expenditure and made the following important recommendations which are at different stages of implementation:

i. Food subsidy should be reduced and should be allowed only to population below the poverty line. For this purpose, the State Governments should identify below poverty line population.

ii. Fertilizer subsidies which have grown over the years should be withdrawn in a phased manner. This will require dismantling of the control system over time to make fertilizer industry completely decontrolled.

Since there is excess staff in the Government, for optimizing the Government staff strength, a cut of 10 percent on the staff strength as on January 1, 2000 should be carried out by the year 2004-05. There should be complete ban on creation of new posts for two years.
The public sector was originally intended to be the engine of self-sustain economic growth. It was also conceived to hold the commanding heights of the economy. In order to fulfill these roles, it was necessary for the public sector to generate adequate investible surpluses. No doubt public sector contributed significantly to the expansion of the industrial base. However, it has failed to generate sufficient internal resources for its further expansion and, as a result, has now become major constraint on economic growth. Under structural reforms the Government has decided to give greater managerial autonomy to public enterprises to enable them to work efficiently. On careful consideration it becomes clear that managerial autonomy is of great importance to improve the performance of the public enterprise. During the reform period there has been a distinct change in the public perceptions in favour of reducing the size of public sector and improving private participation. Hence, a two-pronged strategy was adopted by the Central Government-reduction in budgetary support to the PSUs and privatization of PSUs.

Another objective of the reform process has been to improve fiscal-monetary coordination. This involved steps to ensure wider participations in the Government securities market so as to facilitate elimination of automatic monetization and pre-emption of institutional resources by the Government. During the 1990s, the RBI undertook a series of steps towards widening Government securities market.

In the second half of the 1980s, when the Government had pursued expansionary fiscal policies to support growth from the deficits contributed to the foreign exchange crisis in 1991 which then prompted the far-reaching economic reforms. The combined deficit then declined until 1996-97, but increased again in the following years. Net dis-savings of general Government peaked in 2001. The Government was then absorbing almost half of the nation’s saving in order to finance its own consumption outlays. In addition, the Government was borrowing to finance its investment, capital transfers and loans to state-owned enterprises. As a result, the borrowing requirement (fiscal deficit) of State and local Governments had reached nearly 10 percent of GDP by 2001 and public debt was rising significantly. In order to end this unsustainable situation, the Central Government enacted legislation to improve fiscal discipline. After close to three years discussion, the Fiscal Responsibility and Budget Management (FRBM) Act was adopted in August 2003. This Act sets a medium-term target of achieving a balance between current revenue and current spending (i.e a zero-revenue deficit) by 2008 and limits the overall fiscal
deficit for the Central Government to 3 percent of GDP. By 2006 the Central revenue
deficit had only been reduced to 2 percent of GDP, but the fiscal deficit has been
reduced by 3.5 percent of GDP. The 2007 budget confirms the faster adjustment of
fiscal deficit, which is only slightly greater than the target for 2008 incorporated in the
FRBM Act. However, the revenue deficit is expected to be 1.5 percent of GDP,
indicating that a very sharp reduction would be necessary to meet the target of the
FRBM for this balance. In effect, the Central Government has not been able to stem
the increase in current expenditure as much as had been planned and, consequently, the
hope – for increase in the extent of investment, which would have raised the fiscal
deficit relative to the current deficit, has not materialized. The FRBM Act also
improved the transparency of budgetary policy. The Act provides that the Government
has to lay three documents before parliament every year: one with an assessment of
economic prospects, another with its strategy with regard to taxation and expenditure,
and the final one giving a three-year rolling target for the revenue balance and the
overall balance.

Fiscal reforms were the integral and perhaps the most critical part of the
macroeconomic stabilization and reforms initiative taken by the Government after the
1991 economic crisis. The fiscal consolidation measures taken immediately after the
crisis situation yielded significantly positive results in terms of reduction in fiscal
deficit, control in expenditure and marked changes in the fiscal system particularly in
the financing pattern of the deficits through reduction in monetization. However, the
continued structural imbalances in terms of falling tax buoyancy, nature of fiscal
correction in terms of reduction in investment expenditure, increased interest burden
owing to borrowing at market related rates, impact of enhanced salary of Government
employees, compulsions of increased defence expenditure etc. were some of the major
factors which reversed the situation such that at the end of the decade the combine
fiscal deficit of Centre and States was almost at the same level as was at the beginning
of the reform measures. The emerging situation has led economists to suggest that the
second generation of reforms should constitute a program of action aimed at
preventing another major economic crisis and should stimulate rapid economic growth
in the country during the new century. Infact, in the strategy outlined by the Finance
Minister in his budget speech in February, 2000, declaring the next 10 years as ‘India’s
decade of development’ one of the elements is to establish a credible framework of
fiscal discipline. Many economists in their surveys have even warned that unless
substantial fiscal consolidation is achieved continued fiscal deficits pose India’s greatest risk to future destabilization (Deshmukh, H., Chaudhari,K., Powar,Y., Pa:har,A & Shejwal,A,, 2006).  

1.2 Review of Literature:  

Tripathi,R.N (1966) in his study of tax structure in developing countries shows that the high rates of taxes on commodities with a high income elasticity of demand are quite effective in siphoning a substantial proportion of increase in output into the resources of the public sector needed for development financing and a stiff rate of commodity taxes on luxury articles tends to introduce an element of progressiveness in an otherwise predominantly regressive tax structure in developing countries.  

Chelliah,R.J (1969) in his study of fiscal policy attempted to analyze the fundamental problems of fiscal policy in less developed countries, the basic structure of public finance with emphasis on tax structure and fiscal policies, against the background of planned economic development. The greater part of his work is carried on with special reference to India. He has also observed that the fiscal policy appropriate for a country will depend, apart from many other factors, on the stage of its development and on the social grounds.  

Jain,M.M (1969) is of the view that the Indian tax structure was found to be highly buoyant with respect to income. Analysing the tax yields through log linear functions for the period 1955-56 to 1965-66, he found that while the buoyancy co-efficients were greater than unity for both direct and indirect taxes, indirect taxes had a much higher co-efficient than direct taxes, reflecting the tax efforts which were largely in the form of commodity taxes or taxes on transactions. However, a tax-wise analysis showed corporation tax to have the highest co-efficient of buoyancy. The built-in flexibility of the tax system was also found to be high which is attributed to the additional taxes imposed during the Second and Third Five-Year Plans.  

Musgrave,R.A (1969) in his study of fiscal policy has examined the essential characteristics of fiscal system in the content of certain key features of economic life. His study deals with the adoption of fiscal systems to the requirement of centrally planned and decentralized market economy. He also examined the interaction between fiscal systems and economic development and compared the tax structure of a number of highly developed countries. In his study he also raised the issues like fiscal
centralization versus decentralization, the formulation of a budget plan, the impact of
government forms on fiscal behaviour, social security and transfer systems, and the
structure and management of public debt.

Shaws, G.K (1981) in his study of the concept of fiscal policy in developing
countries suggested a relatively homogeneous body of fiscal instruments applicable to
such countries and perhaps more important that public finance and fiscal policy in
developing economies constitute an academic discipline distinct from its counterpart in
the more advanced economy. Both notions are certainly false, the former being
contradicted by the greater diversity in conditions pertaining to third world countries
when compared with the more integrated advanced economies, whilst the latter
encounters the objection that policy objectives, fiscal instruments and both political
and administrative constraints are in principal the same.

Gowda, K.V (1987) in his work has criticized the long term fiscal policy
(LTFP) that it has placed exclusive reliance not on fiscal policy with all its various
segments. It does not touch on expenditure policy, monetary policy, debt management
and international economic policy but on tax policy. In his study he explains how fiscal
policy instruments are to be integrated with all other instruments of macro-economic
policy in order to realize the desired results and underlines the complications of
pursuing fiscal policy in isolation.

On the issue of tax elasticity, Shome (1988) found the tax system to be lacking
the design that would automatically yield higher tax revenue with growth in gross
domestic product. He felt that in the event of low tax elasticity, even the discretionary
measures may fail to evoke the desired response in the form of improvement in tax-GDP
ratio. According to him, the improvement in tax elasticity would call for expansion of
coverage, a regular adjustment in rates on inflation and reasonable progressivity in the
system as a whole. Removal of various exemptions in income tax would be critical for
improving elasticity. For tax on goods and services, a broad-based general sales tax or
value added tax would yield a higher elasticity.

Singh, S.K (1988) has examined the nature of the fiscal crisis in India and
evaluated long term fiscal policy (LTFP) as a response to this crisis. The study
explains that since 1975-76, the tax ratio has kept pace with the expenditure ratio
resulting in the long run imbalance between Government revenues and expenditures.
This gap which widened during the Sixth Plan became much larger during the Seventh
Plan. Thus, the Central Government has to borrow even to meet its current
His analysis indicates that the LTFP, as a response to the challenging problem of fiscal crisis, has failed to offer any clear direction in two vital areas, namely, (i) how to restrain the increase in non-plan expenditure on revenue account, and (ii) how to augment the surpluses of PSUs. Finally, he has warned that without proper advance in these areas the fiscal crisis will persist.

Rakshit, M (1991) in his work has studied the fiscal roots of macroeconomic imbalance in India, and found that during 1980, fiscal imbalance assumed alarming proportions due to widening gap between revenue and expenditure. In his work he has discussed macro-economic adjustment programme introduced by the government to resolve the fiscal crisis. Finally, he raises a number of important issues regarding viability of fiscal management.

Buiter & Patel (1992) found the state of Indian public finance to be perilous. They observed the rising trend in public debt as ratio to GNP and also in monetized deficit. This disturbing trend, as they find, started in 1970s but accelerated significantly in 1980s. They also make it clear that this deterioration cannot be explained in terms of some external shocks like OPEC I and OPEC II (when oil prices were increased substantially in early 1970s and late 1970s) and 1990 Iraqi occupation of Kuwait and subsequent war. They blame public sector for the crises. Far from being a channel for mobilizing national saving and stimulating domestic capital formation, the public sector has become a drain on nation’s investable resources. Public consumption growth has steadily outpaced the growth of current revenue.

Mundle & Rao (1992) have analyzed the nature of fiscal crisis in India in 1990 and related issues in the growth and composition of public expenditure, the tax system and mobilization of tax revenues and non-tax revenues. They have shown that the fiscal imbalance was mainly a reflection of the increasing gap between revenue receipts and revenue expenditure. There was a spurt in spending mainly on account of interest payments, subsidies, plan and non-plan grants to State Governments, defence and failure of public sector undertakings etc. on the other hand, the growth of tax and non-tax revenues was stagnated. Finally, they have endorsed the fiscal stabilization measures initiated in 1991.

Buiter & Patel (1993) basically updated their earlier analysis (Buiter and Patel 1992) and extends the period of it upto 1992-93. They concluded that considering the magnitude of the crises the fiscal correction measures were insufficient. Debt-GDP ratio would continue to rise. They calculate that a permanent increase of primary
surplus to about 4.5 percent of GDP is required for the stabilization of debt-GDP ratio, which demands both revenue enhancement and expenditure control. To achieve this, it recommends the widening of tax base for both direct and indirect tax. On expenditure side they emphasized the pruning of Government wage bill, food and fertilizer subsidies and subsidies to public sector enterprises. They opine that currently implemented food subsidies normally benefit other than those who are subject to malnutrition or under-nourishment. Therefore, target-oriented subsidies should be used as anti-poverty instrument.

Chhibber & Mansoor Dailama (1993) argue for a need for a broader approach to the relationship between fiscal policy and private investment in developing countries. Such an approach needs to emphasize the role of fiscal policy and stabilization, the competitiveness between public and private investment and the taxation of income from capital. While these issues have long been recognized in the literature in the context of both developed and developing countries, they have assumed particular urgency and importance in the context of the ongoing liberalisation and privatization trends evident in most developing countries.

Cornia & Stewart (1993) reviewed changes in the fiscal policy of developing countries undergoing economic adjustment during 1980s. Macro choices in the areas of overall taxation, government expenditure and fiscal deficit are first examined. It appears that although a few countries managed to combine raising government expenditure per head and a falling budget deficit thanks to increase in the ratio and/or to overall growth, in the majority of the countries analyzed, traditional fiscal policy emphasizing rapid reductions in budget deficit through expenditure reductions compounded the negative effects of falling incomes on the welfare of the poor. Finally, they concluded that the main elements of fiscal policy approach are aiming at protecting the poor during adjustment.

De Melo Martha (1993) has proposed the use of a sustainable deficit concept to estimate the minimum fiscal adjustment required in a high debt country. The sustainable deficit is defined to be compatible with a sustainable debt, which the borrower is willing and able to service. His work provides empirical estimates of the need for fiscal adjustment in a small group of high debt countries in the mid 1980s. Their experience is compared to that of small group of low debt countries to distinguish the differences in the adjustment required and its determinants during this
period. The results illustrate the extent to which the appropriate size of fiscal deficit depends on the macro-economic content.

Faini, R. & Jaime (1993) take a look at the evidence of fiscal adjustment in developing countries. They found that, while on an average, developing countries were successful after 1985 in cutting their primary deficits, rising interest costs and stagnant fiscal revenues implied limited progress towards reducing fiscal imbalances. Most of the improvement on the fiscal front was achieved by cut in capital expenditures. Then they have focused on issues such as the size of fiscal adjustment, the macroeconomic impact of deficit reduction and choice between expenditure cut and tax increases.

Gulati (1993) has dealt with some questions concerning the growing burden of internal public debt in India. These questions that have lately been raised with a stridency not noticed before focus on reducing the fiscal deficit, a term that hardly ever figured in the lexicon of fiscal policy in India.

Kapila, U (1993) in her analysis of public finances of India has shown that the fiscal policy situation which was under strain throughout the 1980s, reached a critical situation in 1990-91. Throughout the 1980s, all the indicators of fiscal imbalances were on the rise. The unabated growths of non-plan expenditure and poor returns from investments made in the public sector have been the main contributory factor in the fiscal crisis. Government initiated the fiscal stabilization and intended to continue it. She has also suggested that for the realization of the fiscal stabilization, it is imperative to restrain the rise of expenditures. Fiscal discipline is also necessary on the part of PSEs to hasten the process of fiscal correction.

Mookherjee, D (1993) has analyzed the fiscal stabilization reforms in the Indian economy. In this work he has highlighted that at the term of the eighties into the nineties, serious action on the fiscal front was urgently needed to correct the macro-economic imbalances. The principal instruments of fiscal stabilization in 1991-92 were plan expenditure and subsidies on exports and fertilizers. Disinvestment of equity holding in central public sector enterprises also provided a cushion. Initially government succeeded in its determined effort at fiscal stabilization and brought the fiscal deficit down.

Mundle & Hiranya Mukhopadhyay (1993) in their study have analyzed the impact of alternative fiscal policies on macro-economic performance of the Indian economy. The most important lesson emerged from their work is that in reducing the deficit, greater revenue mobilization would be preferable to expenditure compression.
This should be attempted through tax reform rather than raising rates. There are, however, limits to how far tax reforms can raise the buoyancy of tax revenue. Hence, fiscal correction will have to depend in part on public expenditure compression. They have shown that in the post reform period expenditure on almost all items except interest payments have been cut in real terms. However, the sharpest cuts have fallen on those items of expenditure which ought to be protected.

Tanzi, V (1993) has observed that fiscal reform has proven difficult to implement for political, institutional and conceptual reasons. In his work he has discussed the determination of the correct size of the fiscal adjustment needed, the problems in measuring fiscal disequilibrium, the desired fiscal measures and the sequencing of the required fiscal reforms. Finally, he argues that fiscal reform require time to be successful.

Taylor, L (1993) has attempted to study fiscal policy issues that arise during macroeconomic stabilization in developing countries. His work is based on the study of stabilization episodes in eighteen countries. He has observed that the effects of fiscal stabilization and adjustment on income distribution are less clear cut and stabilization programme should take into account specific country conditions.

Thirsk, W.R (1993) has observed that many countries have overhauled their tax systems during the past decade. His work reviews the profile of a typical developing country tax system prior to recent wave of reforms. A detailed description of tax reforms in several developing countries is presented. Comparisons across countries indicate an emerging consensus on the desirable characteristic of a tax system: neutrality and the adoption of a more uniform system of taxation, the progressive abandonment of special tax distinctions and exemption and simple tax design.

Bagchi & Stern (1994) noted that the early results of fiscal policy were quite striking. Breaking out of the stagnation of the preceding fifty years Indian economy grew about 4 percent per annum in the first two plan periods. Per capita income grew at 1.8 to 2 percent. But this momentum was not maintained. What was more, financing of public sector proved increasingly difficult, leading to larger and larger recourse to market borrowing and deficit financing (borrowings from the central bank) with all their attendant consequences. Before the decade of 1980s had drawn to a close it was evident that the Government budgeting in India was in a crisis. Apparent reason for the imbalance in Indian public finances was not other than the faster growth of
Government expenditure than the revenues. Thus, a fiscal correction was inevitable. Although the move towards fiscal adjustment in India was discernible in the pronouncements made as part of long term fiscal policy announced in the mid 1980s, a comprehensive fiscal reforms programme at the Central Government level was initiated only at the beginning of the 1990s as part of the economic adjustment programme initiated in 1991-92. The fiscal reforms were aimed to achieve a reduction in the size of fiscal deficit and debt in relation to GDP and were affected through rationalization of tax structure expenditure pruning, restructuring of PSUs and better coordination between monetary and fiscal policies.

Shand Ric & Kalirajan (1994) in their study indicated that the reforms implemented in India since 1991-92 have been yielding the anticipated positive results. Though the reform process has been gradual, it is becoming increasingly clear that sustainability is not in question. The study concludes that Indian economy may be evolving a new paradigm of growth which could be relevant to other developing countries with similar structural linkages.

Bhattacharya (1995) in his work has evaluated the factors responsible for fiscal imbalance in 1990 and analyzed the performance of fiscal stabilization measures. He has shown that the basic problem of the fiscal stabilization in India was that the government expenditure was rising faster than the government income. As a result all the measures of deficit such as fiscal deficit, revenue deficit, primary deficit, etc. have rising trends. Finally, he suggested that the fiscal deficit should be reduced by slowing down growth of non-plan and wasteful expenditures on the one hand and improving direct tax revenue and surplus of public enterprises on the other.

Ghosh & Sen (1995) have observed in their study that during 1980s not only the revenue receipt have been rather inelastic but the expenditure accounts particularly of the non-plan outlays have also gone up quite rapidly. This has been termed by them as the main cause of the fiscal imbalance. They have also suggested that it requires to be attended with policies to reduce the non-plan expenditure drastically.

Rao, Sen & Ghosh (1995) have analyzed in their study that after 1980-81, expenditure growth was higher than that of revenue receipt. Within total expenditure, revenue expenditure grew at rates higher than that of capital expenditure. Growth of revenue expenditure was particularly sharp in the case of interest payments, subsidies, wages and salaries, while those on maintenance of capital assets lagged behind. So fiscal imbalance becomes inevitable by the end of 1980s. The analysis also points
towards the difficulty in achieving fiscal equilibrium in the short and medium term context. So long as the interest groups succeed in securing a large and increasing share of expenditures on categories beneficial to them compression of fiscal deficit become difficult.

Nayak (1995)\(^2\) in his work has revealed that in the fiscal sector, government expenditure had been far outpacing revenues for more than a decade, leading the government to resort to substantial borrowings, both internal and external. As a result interest payments become largest expenditure head of the Central Government budget. Non-essential expenditure continues to grow unabated. He has also observed that the tax to GDP ratio is already reasonably high and the prospect of increasing it further appears to be limited at least in the short run. So, there is not much choice left and expenditures have to be cut in several vital areas.

Mcdermott, John & Wescott (1996)\(^3\) in their study tried to use the fiscal expansion and consolidation experiences of the industrial countries over the period 1970 to 1995 to examine the interplay between fiscal adjustments and economic performance. A key finding is that fiscal consolidation need not trigger an economic slowdown, especially over the medium term. Fiscal consolidation that concentrates on the expenditure sides, especially transfers and government wages, is more likely to succeed in reducing the public debt ratio than tax-based consolidation. Also, the greater the magnitude of the fiscal consolidation, the more likely it is to succeed in reducing the debt ratio.

Chakraborty (1997)\(^4\) has attempted to examine whether lowering the rates of direct and indirect taxes in recent years has resulted in higher tax mobilization. The study concludes that compared to indirect taxes, direct taxes were more buoyant during the post-reform period. It has been observed by the author that generally reduction in tax rate cannot make a tax more buoyant instantly. There is a time lag involved.

Shome (1997)\(^5\) attempts to assess the state of fiscal stabilization in the post-reform period. He has shown that after an initial improvement in the fiscal deficit, the government faced difficulty in controlling the fiscal deficit-GDP ratio. The tax-GDP ratio also declined and the Central Government passed down certain expenditure responsibilities to State governments, thereby managing to reduce the expenditure-GDP ratio to some extent. His work focuses on the performance of the fiscal sector and the direction for future policy imperatives.
Mohan (2000) has analyzed trends in State and Central Government revenues and expenditures and suggested ways to climb out of debt trap. He has observed that rapid economic growth is the only solution to the problem of poverty and such growth is not possible without significant fiscal correction. The key objective of fiscal reform has to be a reduction in public debt service payments.

Rao, M. Govinda (2000) advocated that there have been major changes in tax systems in several countries over the last two decades for a variety of reasons. The objective of his study is to analyze the evolution of the tax system in India since the early 1990s. He describes and assesses the introduction of new forms of direct and indirect taxes, their revenue and equity implications and the successes achieved in their implementation. He concludes that after eight years of reforms, improving the tax system remains a major challenge in India.

Rakshit (2000) is a critique of the whole approach of fiscal policy pursued during 1990s. He points out that adverse effects of it could be found in many macroeconomic variable like declining aggregate capital formation and stagnant saving, low agricultural growth alongside sharp fluctuations in food output, deceleration of industrial growth during second half of 1990s and ultimately the rise in fiscal deficit itself. He also argued that not only deficits, but revenue and expenditure also need to be redefined for the specific purposes as they generate different effects on different macro variables. For example, he favors the expenditure and health to be taken out from revenue expenditure and receipts from disinvestments cannot be equated with tax revenue as former reduces the future non-tax receipts. He thus argues that ‘Fiscal Gap’ rather than fiscal deficit is the better measure for measuring sustainability of public debt. It is also critical of the shift in financing the deficit towards high interest borrowing instruments.

Kopits, G (2001) assesses the potential usefulness of fiscal policy rules for India in the light of rapidly growing international experience in this area. As part of his assessment, he explores various design options and institutional arrangements that seem relevant for India in the context of the Fiscal Responsibility and Budget Management Bill. He also outlines preparatory step for successful implementation.

Karnik, A (2002) has addressed the question that can fiscal policy play a key role in the revival of the economy? He argued that the problem is that this question has had to be posed in the context of deteriorating fiscal balances of the Centre and the States, whose combined deficit is today slightly worse after 10 years of reform. The
States’ gross fiscal deficit has deteriorated significantly. It is absolutely necessary, therefore, for the Centre to be fiscally prudent, which will be a signal to the states of the Centre’s seriousness in regard to fiscal management. A contrary signal will undermine any restraint that the Centre can bring to bear on the States.

Peter, M., Kerr, I. & Thorpe, M (2002) in their study said that the tax reforms of recent years in India are based on Chelliah’s recommendations of simple broad-based taxes with a moderate and limited number of rates. The reduction in direct tax rates in the economy has not only increased revenue collection but also accelerated economic growth. Their aim is to investigate the effect of India’s tax policy on private capital formation. A time series analysis of data for the economy for the period 1950-51 to 1994-95 reveals that a one percent increase in the direct tax ratio has led to a reduction of 0.12 percent in the ratio of private capital formation to GDP. They also examine whether there is any gain in opting for an expenditure tax to promote savings and capital formation in the economy. The major problem facing the Indian direct tax system is evasion of income taxes. They concluded that an expenditure tax is powerful tool to combat evasion.

Sarma, A. & Gupta, M (2002) in their paper show that the year 1991-92 was one of the toughest years for the Indian economy. All the macroeconomic indicators became adverse. The overall economic growth slumped to a mere 1.1 percent. The gross fiscal deficit stood at 8 percent of the GDP and the revenue deficit on the current account at 3.5 percent in 1990-91. Prices shot up to 17 percent, an all time high level. In the external sector, the balance of payments with as little as $1.1 billion foreign exchange reserves or barely enough to meet two weeks’ import bill became precarious. The shortage of foreign exchanges apart from inducing import squeeze for industrial production led the country by June 1991 to face a hard option of defaulting on international commitments such as debt servicing or accepting IMF structural adjustment and stabilization programme. The new government decided to adopt in June 1991 programme of macroeconomic stabilization to restore viability to fiscal balances and the balance of payments and to contain prices. At the same time it undertook a far reaching programme of structural reforms involving bold initiatives in external trade, exchange rate, industrial policy and so on, higher growth trajectory through infusing efficiency and international competitiveness. It also aimed at integrating the Indian economy with the global system and enhancing its robustness through wider access to better technology and benchmarking with the global
performer. The reform process was relying more on market forces and trade related reforms. Subsequently reforms were extended to cover financial sector and to put in place law and regulatory framework compatible with a market system. The full impact of the reform measures edges into view over a long span of time. Nevertheless, a decade since the introduction of the reform process is a long enough period to make visible the results of the reform measures. It is in this background that this paper addresses itself to a vital area of reforms, viz, fiscal reforms. It attempts to evaluate the impact of fiscal reforms on the public finances of the Union and State governments. The paper starts with the outcome of the reform process as reflected in different measures of balances and then proceeds to examine the performance of the process variables that determine the aggregate balances. To form a view of the effectiveness of fiscal reforms, they have examined the performance of some of the important fiscal variables in an intertemporal context. To be more specific, they have compared the performance of fiscal variables in the post-reform decades with that of the proceeding decades.

Bhattacharya, B. & Sabyasachi, Kar (2004) examined the nature of relationship between aggregate economic growth and fiscal and external balances in the Indian economy. Acceleration in aggregate GDP growth can lead to worsening of fiscal deficit which is to be financed by other sources. Investment and productivity capital is further prerequisites for acceleration of GDP. This study examined the interlinkages between the production sector, the fiscal and external sectors.

Lahiri, Ashok & Kaman (2004) in their study examine the sustainability of fiscal deficits, the differences between monetary versus debt financing of fiscal deficits, the increasing importance of revenue deficits. According to them high fiscal deficits are not exclusive to India but high sustained deficit are quite unique, especially in the content of relative stability of the external balance of payments. The authors allude to two factors to explain sustainability: that the interest rate has been more or less consistently below the rate of growth of nominal GDP and the deficit has been mostly financed domestically rather than through external savings.

Mohan,R (2004) in his paper examines the trends in Central finances over a three decadal period beginning from the 1970s. It is found that there is lack of buoyancy in all the major sources of revenue of the Central Government. This calls for devising new methods of revenue mobilization. There are political economic limits to the premise that direct taxes with its simplified rate structure and administrative
reforms will make good the losses from the cuts in customs duty revenue. The analysis of the issues involved would require an examination of the influence of dominant classes on the State. Very recently however, the thrust of the tax reform seems to be on introduction of a Central value-added tax (VAT). Total expenditure of the Central Government as a proportion of the gross domestic product (GDP) has not increased during the 1990s when compared to the 1980s. But the composition of expenditure has shifted more towards revenue expenditure. An emphasis on expenditure allocation with targeting at a detailed level and innovative tax reforms aimed at more revenue mobilization are necessary to achieve qualitative fiscal correction, but this is often stymied for political economic reasons. Procrustean fiscal correction aiming merely at deficit targeting is not a very desirable method. His study finds that the main problem in achieving fiscal consolidation at the Central level is falling revenue and tax receipts during the 1990s.

C.Rangarajan (2004)\(^{46}\) Chairman of the Twelfth Finance Commission, Government of India, emphasized on current fiscal situation, fiscal deficit and its adverse impact on the economy. Raising debt results in raising interest payments, fall in the growth rate of development expenditure, serious implications of balance of payments and low investment. Debt-GDP ratio is needed to be reduced and tax-GDP ratio has to be picked up considerably by introducing VAT. Raising revenues for accelerated flow of development expenditures are leading to improved socio-economic growth.

Raju, S (2004)\(^{47}\) in her study examined that deficits measure the excess of government spending over revenues and reflect the fiscal health of an economy. Fiscal consolidation has been the focus of the reform process initiated in 1991-92. Fiscal reforms have seen tax reforms, rationalization and restructuring of the tax structure to augment revenues as well as expenditure management which in turn can influence deficit containment. Interdependence between revenues and expenditures can lead to ambiguous impact on deficit and the efforts to contain the deficit. Our results indicate bi-directional causality between total government expenditures and tax revenues and revenue receipts. Instantaneous causality is observed for all variants of revenue.

Rakshit, M (2005)\(^{48}\) has attempted to examine some analytics and empirics of fiscal restructuring in India. The study concluded that TFC’s focus on growth as a key element of its fiscal reform strategy is well taken. Also eminently sensible are its recommendation for performance budgeting; doing away with the distinction between
plan and non-plan expenditure; and transparency including elimination of all hidden subsidies. However, the major weakness of the strategy consist of not dovetailing demand management policies in a developmental programme; ignoring the saving-generating impact of investment in an economy where rural and informal sectors are characterized by considerable underutilization of resources even while the formal sector may not have much slack; treating education, health and other social sector expenditures as current; and absence of optimality considerations in respect of allocation of expenditures, and of alternative modes of their financing, taking into account their short- and longer-term effect on growth, equity and government finances.

Bagchi, A (2006) is of the view that deficit reduction has had the adverse fallout for public spending on health and education in several states, forcing shrinkage of the public sector’s involvement in the social sector. Policy-makers are now seeking an escape route by getting the fiscal and revenue deficit targets relaxed. While there can be valid arguments against inflexible targets, abandoning the discipline underlying fiscal responsibility legislation, as has been suggested, is questionable. For, at base, the fiscal problems of democracies have their origin in the short time horizon of governments and their penchant for promising the moon to electorate while showing an extreme reluctance to tax.

Kochhar, K (2006) examines both the evolution of India’s fiscal imbalances since the early 1990s and the key developments in major macroeconomic variables— inflation, external balances, interest rates, and growth— in order to assess the macroeconomic implications of the growing fiscal imbalances and rising public debt-GDP ratio reflects a weakening in revenue mobilization, persistent deficits at both the Central and State levels and narrowing of the gap between the real interest and growth rate. Deficits of the States have become increasingly large relative to that of the Central Government. After exploring why fiscal imbalances have not led to serious macroeconomic problems, she then explores their hidden costs on the economy in terms of the foregone potential for even higher economic growth than that has recently been experienced. In effects, by its high fiscal deficits, productive public expenditure has been crowded out, the scope for further structural reforms and liberalization has been constrained, and room for macroeconomic policy manoeuvre has been narrowed. Kochhar argues that time is running out for India to address these fiscal imbalances in a way that does not result in enhanced vulnerability to macroeconomic crisis. She
advocates stronger revenue mobilization efforts and a reorientation of expenditure away from subsidies and toward physical and social infrastructure projects.

Rao, M, Govinda & Singh, Nirvikar (2006) examine recent and potential reforms in India’s fiscal federal system. They summarize key federal institutions in India, including tax and expenditure assignments, and mechanisms for Centre-State transfers. They discuss the institutional process by which reforms can and do take place, including the role of academics, political influences, and especially institutions such as the Finance Commission. In contrast to the past, recent Commissions have played a greater role in articulating an agenda for fiscal federal reform, which then proceeds through political bargaining. This change has taken place in the context of, and been influenced by, broader economic reform in India.

Gurria, A (2007) examines areas of government spending, taxation and fiscal federalism where further reforms are desirable to reduce economic distortions and improve the provision of public services. As to government spending, it finds that a large share is used to subsidize commercial undertakings, agriculture and food distribution and that there is much room to improve the quality of spending and target it better to reduce poverty. On taxes, which have undergone major reforms since the early 1990s, it points to the large number of loopholes and suggests that a broadening of the tax bases would allow further reductions in tax rates and make the system simpler and more efficient. Reforms of indirect taxes should focus on creating a common market within India so that goods can move between States without border controls. India’s federal structure has led to a well-developed system of tax-sharing and transfers, both through constitutionally empowered bodies and delivered through the annual budget. Overall, this transfer system has worked well; moving resources towards the poorest States, but the system has become very complex and, in the past, weakened fiscal discipline. Furthermore, it has not been able to create an effective local government system; this would be important for improving accountability and responsiveness to citizen needs as three-quarters of the population live in States with over 50 million inhabitants.

Mohan, R (2008) in his paper shows that the performance of the Indian economy in recent years has attracted increasing international interest. His paper focuses on the role of fiscal and monetary policies in the evolution of the Indian economy over the years, with particular attention being given to the reforms undertaken in these policies since the early 1990s. The coordination of fiscal and
monetary policies has been crucial in the sequencing of the economic reform process carried out since the early 1990s. Monetary policy aims to maintain a judicious balance between price stability and economic growth. With the opening up of the Indian economy and the spread of financial sector reforms aimed at functional autonomy, prudential strengthening, operational efficiency, and competitiveness of banks, considerations of financial stability have assumed greater importance in recent years alongside the increasing openness of the Indian economy. The biggest challenge facing the conduct of fiscal and monetary policy in India is to continue the accelerated growth process while maintaining price and financial stability. Therefore, the self-imposed rule-based fiscal correction at both the national and sub national level has to be consolidated and carried forward. The existence of a high level of fiscal deficit also contributes to the persistence of an interest rate differential with the rest of the world, which then also constrains progress toward full capital account convertibility. The success achieved in revenue buoyancy through tax rationalization and compliance has to be strengthened further.

1.3 Objective of the Study:

The need for comprehensive fiscal reforms in India was apparent during the late 1980s, as there was rapid deterioration in Government finances. During this period, the expenditure of the Central Government rose much faster than its revenue leading to a steep rise in the Centers’ fiscal deficit to GDP ratio. The sharp increase in revenue deficit of the Central Government and the emergence of such deficits in State finances happened to be the most worrisome developments in the fiscal scenario during the 1980s.

Economic and fiscal reforms undertaken from the early nineties brought fresh air and released clogged up economic energies. Growth rates accelerated and the economy went through a major structural shift in the composition of output. The poverty ratio fell tangibly in the high growth years. If there is one vulnerable part of these otherwise sound developments, it is the disarray in the fiscal scenario. Comprehensive economic and fiscal reforms were initiated in the early nineties leading to a substantial rise in the overall growth rate by the mid-nineties. The nineties witnessed momentous changes in the macroeconomic scenario of India in terms of economic growth, changes in the sectoral composition of output, public finances, and the overall policy environment that characterized and influenced the macroeconomic
outcomes. Towards the close of the decade, reforms appeared to have slowed down even as industrial recession seriously beset the economy for three consecutive years towards the end of the decade. Several events in the latter part of the nineties clouded the gains from the fiscal reforms of the initial years, leading the public finances of the Centre as well as the States to exhibit chronic imbalances showing themselves up in the form of large revenue and fiscal deficits. Important among these was the revision of salaries of Central and State Government employees in the wake of the recommendations of the Fifth Central Pay Commission. A second reason was a substantial rise in the nominal and real interest rates, with low inflation rate. A third reason was the onset of recession that led to a fall in Government revenues relative to GDP and large fiscal imbalances, with Government expenditures adjusting much less than revenues. The new crisis led to new responses. The Centre and many State Governments emerged with fiscal responsibility legislations and medium term adjustment programmes.

India’s fiscal policy is a key part of its overall economic history and central to its growth prospects. Fiscal reforms, particularly those relating to taxation constituted the core of economic reforms in the early stages. Fiscal reforms that have been carried out so far and those that are forthcoming can be studied under the following broad heads:

i. Revenue side reforms consisting of
   a) Taxation reforms at the Centre and State level, and
   b) Reforms affecting non-tax revenues.

ii. Expenditure reforms affecting
   a) Subsidies,
   b) Salaries of Government employees, and
   c) Pensions.

iii. Reforms related to managing fiscal imbalance including fiscal responsibility legislations.

iv. Public sector reforms including disinvestment and power sector reforms.

v. Budgetary reforms.

In this study entitled “Fiscal Reforms in India-Policy Measures and Performance” an attempt has been made to analyze the fiscal sector reforms with following objectives:
i. To ascertain the adequacy as well as efficacy of fiscal policy in dealing with the issue of economic crisis of the country.

ii. To examine the reasons of the fiscal reforms started by the Government of India.

iii. To discuss various fiscal measures initiated by the Government as a part of reform process.

iv. To analyze the effectiveness and performance of the fiscal measures in correcting the fiscal imbalances.

v. To suggest appropriate measures for improving fiscal scenario of the country.

1.4 Sources of Data and Methodology Used:


The methodology used for evaluating fiscal sector reforms is based on different statistical tools. In order to study the year-wise growth in the variables, percentage growth rates have been calculated. It is a simple measure to get a look at the year-wise increase and decrease in the variables under study. The formula used is current year value minus last year’s value, the whole divided by the last year’s value. The compound annual growth rate (CAGR) is used to calculate the growth over the period of time. The CAGR is a number that represents a steady level of growth from the initial value to an ending value as it determines the average of year to year growth rate for time series data. For calculating CAGR the years have been coded as 0,1,2,3, and so on. The coded years have been taken as the independent variable and the natural log of the variable under study is taken as the dependent variables for obtaining the regression coefficients. The beta coefficient is processed further by taking the inverse
and natural log and subtracted by one and then multiplied by 100, which finally yield
the value of CAGR. In addition, averages, standard deviation and coefficient of
variation have also been used to analyse different variables to get meaningful results.

ANOVA, in general, is used to test whether the differences among the variables
for more than two periods are significant or not. It is based on a comparison of two or
more estimates of the population variance. One estimate is obtained from variance
among the sample means and the second estimate is obtained from variation that exists
within samples. This ratio is referred to as F-ratio. If the value of calculated F-ratio is
less than the critical value or table value at the particular degrees of freedoms and
significant level then we accept the null hypothesis or else we reject it. In this study
ANOVA has been used to check the hypothesis as to whether there is any significant
difference in the value of variables between three periods at 5 percent level of
significance. The first period relates to the period before reforms (prior reform period),
i.e from 1980-81 to 1990-91. The second period is the first generation reform period i.e
from 1991-92 to 1999-2000. And the third period is second generation reform period
i.e from 2000-01 to 2007-08.Given the objectives of the study, the above statistical
tools have been used in order to obtain meaningful results.

1.5 Scheme of the Study:

The whole study is organized into six chapters. First Chapter introduces the
main theme of the study, explaining about statement of the problems along with review
of literature, objectives of the study, sources of data and methodology used, and
limitations of the study. It is an introductory chapter of the study.

Second Chapter presents an overview of fiscal policy and its role in economic
development of the country. It deals with the role of fiscal policy in resource
mobilization, allocation efficiency, equity and economic stability. Finally, it deals with
the nature of India’s fiscal policy.

Third Chapter explains rationale, reasons as well as objectives of fiscal
reforms. It also includes the RBI’s perspective on fiscal reforms, quality and
sequencing of fiscal reforms in India. Further, it also explains various policy measures
of fiscal reforms such as tax reforms, expenditure reforms, and restructuring of PSUs
etc. in India.

Four Chapter deals with the fiscal reforms in India. It describes in detail about
the tax and expenditure reforms. It examines the trends and composition of both tax
and expenditure during given period of the study. In addition, it also explains findings and recommendations of the tax reforms Committees which have been set up in the country from time to time.

Five Chapter analyses the performance of fiscal reforms and effectiveness of policy measures in correcting fiscal imbalances. For evaluating the performance of fiscal reforms various parameters such as total receipts and expenditure, real GDP growth, tax-GDP ratio, expenditure-GDP ratio, debt-GDP ratio, deficit indicators, BOPs indicators, and inflation have been undertaken. The chapter also deals with the concept and measurement of fiscal gap. In addition, it also incorporates major problems as well as challenges of fiscal reforms in India.

Six Chapter of the thesis provides summary and conclusion of the study and some specific suggestions regarding fiscal reforms for correcting fiscal imbalances in the country.

1.6 Limitations of the Study:

This study is strictly limited to the secondary data available and concentrates mainly on the Government and official data. The study is limited to the period of twenty eight years from 1980-81 to 2007-08. However, for the purpose of analyzing the performance of fiscal measures, the entire period of the study has been divided into three sub-periods:

- First phase (P1)- 1980-81 to 1990-91 (Prior reform period)
- Second phase (P2) - 1991-92 to 1999-2000 (First generation reform period)
- Third phase (P3) -2000-01 to 2007-08 (Second generation reform period)

In addition, in this study fiscal reforms and problems of the Central Government have only been discussed and analyzed. The study does not cover the fiscal reforms and scenario of the Indian States. Lastly, given different fiscal measures, in this study emphasis has been given on taxation reforms and expenditure management as fiscal instruments for dealing fiscal reforms.
References:


