Chapter - 4
4.1 INTRODUCTION

The Indian fiscal crisis was precipitated mainly by the growth of the public spending throughout the eighties that increased the budget deficit as a proportion of our G.D.P. At the turn of the decade into the nineties, serious action on the fiscal front was urgently needed to correct the fiscal imbalances. In the event, worsening fiscal deficits and Gulf War of 1990 brought the nation to the brink of international default. An increasing erosion of confidence in the government's ability to manage the economy led to a drying up of the market for external commercial loans in 1990-91. The period from August 1990 to May 1991 also saw a series of steep reductions in the international credit rating of India which had a flawless record of credit worthiness until then.

The state of our public finance had indeed reached crisis proportions by the end of the eighties. The public debt-to-GDP ratio increased through the eighties, going up to over 50 per cent at the end of the decade. As is now well known, the proximate reasons for this situation were the failure of the public sector to generate investible resources and the explosive growth of governmental current spending.

The two OPEC shocks of 1973 and 1979 hurt, but did not have a sustained impact on the budget deficit. 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 crisis was certainly 'home made'.

This was the context in which a newly elected government took office in June 1991 and set about the arduous task of launching a programme of economic reforms. 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 eighties which clearly pointed towards hastening 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 macro-economic 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, from 8.4 per cent in 1990-91 to 6.5 per cent in 1991-92. 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.

Part II of this chapter reviews tax reform measures taken by the government. Part III examines steps taken by the government to control unabated growth of expenditure. Part IV covers measures for reforms in public sector enterprises. Final part deals with management of monetary policy.
4.2 TAX REFORM MEASURES

Over the decades since the 1950s, the Indian taxation system became unduly complex, economically unjustifiable and unsatisfactory in many respects. Special exemptions and preferences abounded, nominal rates were high, evasion was widespread, and the burden across tax payers was often unfair.²

Revenue mobilisation has been high in India by developing country standards, and the tax/GDP ratio continued to rise in 1980s. However, tax increases were narrowly based and distortionary, mainly involving custom duties and union excise duties. Direct taxes contributed nothing to the increases, and personal taxes fell significantly as a share of GDP.

Customs duties are easy to collect, so there is an administrative factor involved, and same is true of excise duties. Many indirect taxes are set at a specific amount rather than as a percentage to avoid valuation problems. The personal income tax base has been kept narrow by pressure form organised sector employees for increases in the exemption level, together with difficulties in assessment and collection. Farmers have prevented any serious taxation of agricultural incomes by the states and the land tax has sharply declined as a source of revenue.

The thrust of fiscal management in 1991-92 was to meet the challenges posed by the unparalleled fiscal being faced by the country. Measures in the field of direct taxes were targeted at reversing the declining trend in the share of these taxes in total tax revenues and as a
proportion of GDP. The objectives of changes in indirect tax regime were: reducing excessive reliance on custom duties for additional resource mobilisation, ensuring price stability for essential commodities and goods improving the competitiveness of the industrial sector, particularly the export-oriented industries.\(^3\)

The budget also emphasised the need for rationalisation of the tax system including, reduction in the plethora of concessions, and also the need to bring the rates of income tax at various slabs of income to more appropriate levels.

Broadly, tax reforms are envisaged to:

* make excise rates more uniform,

* introduce a form of VAT,

* avoid high indirect taxes on capital goods because they are a serious obstacle to international competitiveness and should be lowered drastically,

* strengthen personal income tax by holding exemption limits constant in nominal terms to widen tax base,

* raise taxes on fringe benefits, housing and vehicles,

* rely more on income tax deduction at the source where appropriate, and

* broaden the tax base and increase revenue mobilisation at the state level.
Fiscal stabilization requires a reduction in the fiscal deficit. While some of this can be achieved by reducing low priority expenditure, much of the improvement has to come from higher tax collections. These are best achieved not by high taxation rates which encourage evasion, but by systems that are simple to administer, are set at moderate rates and have a broad base.

In its report the Chelliah committee has recommended far reaching changes in the tax system to remove loopholes besides making it more efficient from revenue raising point of view. The Chelliah committee recommended extensive reform in its Interim Report in August 1992. The government took several steps in this direction in the 1992/93 budget, accepting the approach and the broad lines of reform advocated in the Committee's Interim Report (1991a) and agreeing with the recommendations in the Committee's Final Report (1992a). The 1994/95 Budget proposals closely followed the recommendations of the committee, emphasising tax reforms aimed at simplifying the structure and continuing the process of shifting to moderate rates of taxation.

In respect of particular taxes the Chelliah committee has recommended the following:

* In order to make the country's direct tax system more effective it is necessary that the income tax regime has lower rates of taxation with a narrower spread between the entry rate and maximum marginal rate, and a minimum of tax incentives.
The system of subjecting the income of both partnership firms as well as the partners to taxation amounted to double taxation and this should be avoided.

Corporation tax rate for domestic companies being high should be lowered to 40 per cent and the surcharge should be abolished. Tax rates for foreign companies should also be lowered and the differential between the tax rates on domestic and foreign companies should be around 7.5 percentage points and in no case to exceed 10 percentage points.

The present tax treatment of long-term capital gains is not correct because the deductions allowed in computing taxable gain is not related to the period of time for which the assets have been held.

For levying wealth tax, distinction is to be made between productive and non-productive assets. By exempting productive assets such as shares, securities, bonds, bank deposits etc. from wealth tax the government can encourage investment in them.

The Chelliah Committee, which was asked to look into all aspects of customs duties, has recommended reduction in the general level of tariffs, a reduction in the dispersion of the tariff rates and a rationalisation of the system with abolition of numerous end use exemptions and concessions. It also suggested that the process of reform should be gradual, so as to moderate the impact of the adjustment both in terms of possible revenue loss and the pace at which industry is exposed to competition.
At present excise duty is levied on advalorem bases on some commodities and at specific rates on others. Over the years for administrative reasons, ad valorem duties have been steadily replaced by specific rates. Advalorem duties are preferable to specific duties as they ensure buoyancy in revenue. Underlining this fact the committee has recommended switching over to advalorem rates for a number of commodities.

The government has decided to implement the recommendations of the Chelliah Committee in a phased manner.

4.2.1 Indirect Taxes

Customs duties are to be further lowered to make key imported raw materials and capital goods available to Indian industry at reasonable cost and to reduce the high levels of protection to domestic industry. Reforms to the excise tax structure aim to promote growth of manufacturing output and employment; simplify tax administration and reduce the scope for misclassification, evasion and disputes; increase revenue elasticity; and pave the way for an eventual VAT.

4.2.2 Direct Taxes

The 1994-95 budget followed the basic approach to tax reform: simplify the system, apply moderate rates, place much greater reliance on broadening the base and improve administration.

4.2.3 Rate Reductions

Reductions in the peak rates of major taxes between 1990-91 and 2000-2001 are setout in Table B-1. It can be seen that among all these...
**TABLE : B-1**

PEAK RATES OF DIFFERENT CENTRAL GOVERNMENT TAXES DURING : 1990-91 to 2000-2001

<table>
<thead>
<tr>
<th>Year</th>
<th>Income tax Basic</th>
<th>Income tax Surcharge</th>
<th>Corporate Tax Basic</th>
<th>Corporate Tax Surcharge</th>
<th>Custom Duty (Peak rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>50</td>
<td>8</td>
<td>40</td>
<td>8</td>
<td>200</td>
</tr>
<tr>
<td>1991-92</td>
<td>50</td>
<td>12</td>
<td>40</td>
<td>15</td>
<td>150</td>
</tr>
<tr>
<td>1992-93</td>
<td>40</td>
<td>12</td>
<td>45</td>
<td>15</td>
<td>110</td>
</tr>
<tr>
<td>1993-94</td>
<td>40</td>
<td>12</td>
<td>45</td>
<td>15</td>
<td>85</td>
</tr>
<tr>
<td>1994-95</td>
<td>40</td>
<td>-</td>
<td>40</td>
<td>15</td>
<td>65</td>
</tr>
<tr>
<td>1995-96</td>
<td>40</td>
<td>-</td>
<td>40</td>
<td>15</td>
<td>50</td>
</tr>
<tr>
<td>1996-97</td>
<td>40</td>
<td>-</td>
<td>40</td>
<td>7.5</td>
<td>50</td>
</tr>
<tr>
<td>1997-98</td>
<td>30</td>
<td>-</td>
<td>35</td>
<td>-</td>
<td>40</td>
</tr>
<tr>
<td>1998-99</td>
<td>30</td>
<td>-</td>
<td>35</td>
<td>-</td>
<td>40</td>
</tr>
<tr>
<td>1999-2000</td>
<td>30</td>
<td>10</td>
<td>35</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>2000-2001</td>
<td>30</td>
<td>15</td>
<td>35</td>
<td>10</td>
<td>35</td>
</tr>
</tbody>
</table>

*Source : Government of India, Ministry of Finance, Budget Documents, Various Issues.*
taxes, the decline in the peak rate of customs duty has been phenomenal. It decline from 200 percent in 1990-91 to 35 percent in 2000-2001. The peak rate of income tax has also declined from 50 to 30 per cent. Including the surcharge on income tax, the effective rate of reduction has been from 54 per cent to 34.5 per cent. The effective rate of income tax increased to 56 percent in 1991-92 due to the increase in surcharge from per cent in 1990-91 to 12 per cent in the next year. In respect of corporate tax, the effective reduction has been from around 43 per cent in 1990-91 to 38.5 per cent in 2000-2001.

Even though the peak rate of income tax and corporation tax have declined substantially between 1990-91 and 2000-2001, decline in rates has been done in a phased manner. In the case of the income tax rate, reduction has taken place in four different time parts. First in 1992-93, when it was reduced from 50 per cent to 40 per cent. Second phase began in 1994-95 with the removal of surcharge which reduced the effective rate of tax even though the basic rate of 40 per cent continued till 1996-97. Third in 1997-98, when it was reduced from 40 per cent to 30 per cent, fourth phase began in 1999-2000 with the reintroduction of surcharge over the basic rate of 30 per cent which resulted in the increased effective tax rate, and the same has been continued in 2000-2001 with nominal increase in surcharge. In the case of corporate tax, the peak rate declined from 40 per cent to 35 per cent between 1990-91 and 2000-2001. In between there was an increase in the peak rate from 40 per cent in 1991-92 to 45 per cent in 1992-93 and this rate of 45 per cent remained till 1993-94 along with surcharge of 15 percent. Between 1994-95 and 1995-
In the subsequent two years there has been year-to-year reduction in the rate of corporate tax below 40 per cent (due to the reduction in surcharge to 7.5 per cent) and 35 per cent respectively. However, with the reintroduction of surcharge in 1999-2000, effective rate of corporate tax increased, which has been continued in 2000-2001.

**Recent Reforms**

Reform of the tax system has been an important element of structural reforms. The strategy has aimed at moving towards a simpler system of taxation with moderate rates, few exemptions and a wider tax base. The 1994-95 budget has continued to rely on these principles in direct taxes and undertaken major structural reform of indirect taxation.

In regard to both excise and customs, there has been a drastic cut in the number of end use notifications, which will greatly reduce the possibility of disputes and scope for discretion. Besides, the number of rate categories was sharply reduced, the peak rates were brought down and a significant switch over was effected from specific to advalorem duties to strengthen built revenue elasticity. The system of credit for taxes paid on inputs, called MODVAT, was extended to cover petroleum and capital goods.⁶

These changes in commodity taxation have brought MODVAT closer to a VAT type system, and will facilitate the introduction of a full fledged Value Added Tax. A modest beginning was also made in extending indirect taxation to services such as, telephones, non-life insurance and stock brokers.
In the budget of 1996-97, an effort has been made to tackle the phenomenon of zero tax companies having substantial book profits by bringing such companies under Minimum Alternative Tax (MAT). However, the companies in power and infrastructure sector or a sick industrial company or companies located in backward areas entitled to exemption under section 80 lA, have been kept out of the purview of MAT. The tax under MAT would in reality workout to about 12 per cent only. MAT has been now reduced to 7.5 per cent in the budget of 2000-2001.

The budget 1997-98 proposes two major innovations in the direct tax proposals i.e. (i) amendment of section 139 A of the Income Tax Act and (ii) the introduction of Voluntary Disclosure Scheme (VDS) to tap black money. Amendment of section 139 A proposes to widen the tax base by bringing the residents of larger metropolitan cities within the tax net on the basis of their lifestyle. To tap black money, under VDS, it is proposed that the disclosed amount either in the form of cash, securities or assets, whether in India or abroad, would be charged at the revised highest rate (30 per cent) of tax without any interest, penalty and action under the income tax, wealth tax and Foreign Exchange Regulation Act.

Regarding excise duty, the finance minister has proposed a gradual movement towards a mean rate of 18 per cent in order to reduce dispersion in excise rate in the budget of 1997-98 with this objective, three new rates have been introduced, namely, 8 per cent, 13 per cent and 18 per cent compared to the previous rates of 20 per cent and 10 per cent.
(except in the case of some petroleum products). The 1999-2000 budget undertook a major overhaul of indirect taxes by reducing the multiplicity of rates, rationalising the rate structure and drastically curtailing the scope for discretion by abolishing the power to grant ad-hoc duty exemptions. It reduced number of duty rates for excise from 11 to 3. The cap on MODVAT credit of 95 per cent of the admissible amount was lifted and restored to 100 per cent. Further, it also indicated government's intention to move towards a single rate and a full-fledged VAT in the medium term. In the budget of 2000-2001, the major measure on the tax side is the introduction of the single rate Central VAT (CENVAT). This has merged the prevailing three advalorem rates of 8, 16, and 24 per cent into a single rate of 16 per cent. At the same time special excise duty (SED) at three rates, which are not MODVATable has been introduced.

On customs, the peak rate has been reduced by five points. As far as personal income tax is concerned, there was no change in the rate except minimal increase in the surcharge. On these tax measures M. Govinda Rao argues that, "while there can be no dispute about the direction of reforms, this can not be considered significant to initiate the second phase of reforms. On the issue of personal income taxes, no change cannot be considered as a good policy always. It was possible to simplify the personal income tax system by abolishing surcharge and rationalise savings incentives."
4.3 MEASURES TO CONTROL PUBLIC EXPENDITURE

Government expenditure has risen faster than GDP all over the world during the last several decades. Basically there are three reasons for this: (a) advent of socialism, and mixed economy; (b) rise of welfare state, and (c) predominance of keynesian stabilization Policy.

In pure socialist countries the government does all the key economic activities. The share of government expenditure tends to grow with the degree of socialism in a mixed economy. In the welfare state the state takes the responsibility to provide education, health services, basic social infrastructure and social security. Keynesian stabilization policy with government expenditure as a key regulator of aggregate demand and supply provided the third impetus to the growth of public expenditure, especially in the industrial countries.

In the five decades of economic planning in India the share of government expenditure in GDP has increased from 10 per cent to about 35 percent. The growth has been more or less uniform in all decades. The share of government expenditure in GDP in India is five percentage points above the average of low-income countries.8

There had been an unsustainable increase in government expenditure. Budgetary subsidies, with questionable social and economic impact, have been allowed to grow to an alarming extent. The increasing difference between the income and expenditure of the government has led to a widening of the gap between the income and expenditure of the economy as a whole. This resulted in a huge fiscal deficit, which was
financed by the borrowing. As a result, internal public debt accumulated to about 55 per cent of GDP by 1990-91. The burden of servicing this debt also increased rapidly. Interest payments alone were about 4 per cent of GDP and constituted almost 20 per cent of the total expenditure of the central government.

The Budget for 1991-92 took some major steps to control the rapidly growing expenditure:

(i) Reduction in the Fertilizer subsidy by increasing the average prices of fertilizer by 30 per cent.

(ii) Abolition of subsidy on sugar distributed through the Public Distribution System (PDS).

(iii) Abolition of Cash Compensatory support for exports.

(iv) A 20 per cent increase in the prices of motor spirit, domestic LPG and aviation turbine fuel for domestic use.

After the budget for 1991-92 was passed, the government also imposed a 5 per cent cut on the expenditure provisions contained in the sanctioned budget estimates for 1991-92 of all ministries/departments.

4.3.1 Cutting Non-Plan Expenditure

Concept of Non-Plan expenditure as explained in the expenditure Budget is as follows:

"Non-plan expenditure is a generic term used to cover all expenditure of government not included in the Plan. It includes both
developmental and non-developmental expenditure. Part of the expenditure is obligatory in nature e.g. interest payments, pensionary charges and statutors to states. Part of the expenditure is an essential obligation of a state e.g. defence and internal security. Then, there are special responsibilities of the centre like external affairs, and currency and mint, and cooperation with other developing countries. Expenditure on maintaining the assets created in previous plans is also treated as non-plan expenditure. Similarly, expenditure on continuing services and activities at levels already reached in a Plan period is shifted to Non-Plan in the next Plan e.g. educational and health facilities, continuing research projects and operating expenses of power stations. Thus as more plans are completed a large amount of expenditure on operation and maintenance of facilities and services created gets added to Non-Plan expenditure, besides the interest on borrowings to finance the Plan.\textsuperscript{9}

4.3.2 Interest Payments

Interest payments which contributed most to the fiscal imbalance have continued to rise. According to Raja J. Chelliah, "The net interest payments by the government can be reduced by bringing down the gross interest payments or by increasing the income form the government's investments. It does not seem feasible to increase the latter. It is, therefore, necessary to find ways of reducing the gross interest payments by the government."\textsuperscript{10}

As a proportion of GDP, the central government's outstanding internal debt\textsuperscript{v} rose from 35.6 per cent in 1980-81 to 53.3 per cent in
1990-91. During the same period, gross interest payments on internal
debt, as a proportion of GDP, more than doubled, as they rose from 1.7
per cent to 3.7 per cent. Other measures of growth in gross liabilities
show more or less similar increase. As can be seen from Table: B-2, as a
proportion of the centre's total expenditure, these payments showed an
escalation from 10.5 per cent to 18.7 per cent during the same period; as
a proportion of the revenue account expenditure from 15.4 per cent to
26.1 per cent; as a proportion of revenue receipts from 18.1 per cent to
34.6 per cent and as a proportion of tax revenues from 24.6 per cent to
45.7 per cent. All funds borrowed by government need not be and are not
actually, deployed in investments, physical or financial. But the portion so
deployed, particularly that made in financial investments, does yield
returns, and that too directly in the form of interest receipts, dividends
and profits. In 1980-81 as much as 84.3 per cent of the interest paid on
the total public debt of the centre was recovered as interest receipts,
dividends and profits.11 Compared to that, the amount recovered in 1990-
91 worked out to 44.5 per cent. Thus, while the centre's debt mounted and
its gross interest obligations increased, correspondingly its recoveries
declined, which resulted in a greater burden on the general budget.
Between 1980-81 and 1990-91 the central government's revenue receipts,
as a proportion of GDP increased from 9.4 per cent to 10.7 per cent and
tax receipts from 6.9 per cent to 8.1 per cent During the same period,
annual growth registered in GDP was of the order of 5.5 per cent whereas
net borrowing (including borrowing from RBI) of the central government
increased from 6.6 percent to 8.6 per cent and gross interest obligations
### TABLE: B-2

**GROSS INTEREST PAYMENTS BY CENTRAL GOVERNMENT**

<table>
<thead>
<tr>
<th>Gross Interest as percentage of</th>
<th>1980-81</th>
<th>1990-91</th>
</tr>
</thead>
<tbody>
<tr>
<td>1- GDP</td>
<td>1.7</td>
<td>3.7</td>
</tr>
<tr>
<td>2- Total Government Expenditure</td>
<td>10.5</td>
<td>18.7</td>
</tr>
<tr>
<td>3- Revenue Expenditure</td>
<td>15.6</td>
<td>26.1</td>
</tr>
<tr>
<td>4- Current Revenues</td>
<td>18.1</td>
<td>34.6</td>
</tr>
<tr>
<td>5- Tax Revenues</td>
<td>24.6</td>
<td>45.7</td>
</tr>
</tbody>
</table>

increased from 1.9 per cent to 4 per cent of GDP. Obviously, the increase in the central government's receipts as well as in its tax receipts has been far below the increase in its gross interest obligations.

By targeting the fiscal deficit, government have sought to focus attention on containing public borrowing regardless of not only whether it takes the form of borrowing from households, or from banks or from the RBI but also what the funds raised in public borrowing could have been used for by the government. Strictly speaking when the proponents of the concept speak of the fiscal deficit, no distinction is drawn between covering the fiscal deficit through external public borrowing and through internal public borrowing. We shall, however assume for over purpose that the fiscal deficit, whatever be its magnitude, is covered through internal public borrowing. To emphasize reduction in public borrowing in order to reduce the fiscal deficit amounts to shifting the accent of fiscal policy from the mobilisation of current revenue receipts and the productive deployment of government expenditure. One can not rule out the possibility that a stage may arrive when blanket reduction in government spending may be called for.

Government has no other option except to effect reduction in the existing stock of debt. Since it is not possible to create a surplus in the account of balance of payments for reducing external debt, debt reduction has to confined to internal debt. The resources for this purpose can be raised by disinvesting in public sector enterprises and selling a part of vast real estate that the government owns in the country.
It will be appropriate at this point to refer to the paper written by E.D. Domar in 1944. This paper was no doubt, written in the context of the post-world war II fiscal policy in the US, but it is relevant to the current discussion in our country on fiscal policy. In this paper Domar argued that:

"When post-war fiscal policy is discussed, the public debt and its burden loom in the eyes of many economists and layman as the greatest obstacle to all good things on earth. The remedy is always the reduction of the absolute size of the debt or atleast the prevention of its further growth. If all the people and organisations who work and study, write articles and make speeches, worry and spend sleepless nights - all for fear of the debt - could forget about it for a while and spend even half their efforts trying to find ways of achieving a growing national income their contribution to the benefit and welfare of humanity and to the solution of the debt problem would be far greater".\textsuperscript{11}

4.3.3 Other Non-Plan Expenditures

In India, there is not much scope for raising tax revenue. Chelliah argued that 'neither it is feasible nor desirable to plan for a buoyancy in tax revenues of more than 1.1 or so'.\textsuperscript{12} Therefore, if fiscal deficit is to be brought down the growth of all the major categories of non-interest expenditure has to be slowed down considerably. In some cases it is both desirable and feasible to effect reduction in the expenditure. From this point of view subsidies, capital assistance to non-viable and inefficient enterprises, government's and defence expenditure have been specially mentioned.
The second largest component of non-plan expenditure is the allocation for the defence sector. No attempt at containing non-plan expenditure can succeed if defence is to be excluded. Containment of the growth of defence expenditure involves some security risk. Nonetheless, it is generally agreed that there is considerable scope to enhance the cost-effectiveness of the defence expenditure. In case this task is undertaken earnestly, then there is no reason why at least in the short-run, defence expenditure on revenue account can not be kept constant in real terms. Defence revenue expenditures have been more or less contained in 1999-92 over 1990-91. In this regard then Finance Minister Dr. Manmohan Singh in his first budget speech stated that:

"it is absolutely essential to ensure that a quest for economy in expenditure does not in any way compromise national security. We must, therefore, seek to limit expenditure without diluting the efficiency and effectiveness of our defence services".13

Unfortunately, the volume of subsidies has been accelerating with time mainly because of vested political interests. Over-protection through subsidies has prevented the potential competitiveness of the system from being realised. Beyond a point, however, the fiscal system cannot absorb such subsidies. In principle though the government decided to cut down subsidies, in practice it failed to do that. The government has reduced the export subsidy but is finding it difficult to cut down the fertiliser and food subsidies due to resistance from the big farmers' lobby. As far as food subsidy is concerned, it should be drastically pruned and in
any case should be provided to the lower strata of the society only. Export subsidies have been abolished with effect from 3 July 1991. The export sector is being adequately compensated through the adjustments in the exchange rate and the expansion of the Replenishment Licensing System which were implemented at the beginning of July 1991. So far as fertiliser subsidies are concerned, there was an increase of 40 per cent, on an average, in the price of all fertilisers except low analysis fertilisers such as calcium ammonium nitrate, ammonium chloride, ammonium sulphate and sulphate of potash were made free from price and movement controls in the budget of 1991-92. The sugar subsidy which was costing the exchequer about Rs. 350 crore per annum was indeed an aberration, which crept into the system from January 1990, when the increase in the levy price paid to producers was not matched by a simultaneous increase in the issue price for consumers in the public distribution system, government has decided that this subsidy should be abolished forthwith. Consequently, the issue price of sugar under the PDS was increased by 85 paise per kg. with effect from 24 July 1991. Subsidies on food distributed through PDS were reduced in recent budgets. Prices of petroleum products for domestic consumers also raised. The price of motor spirit, domestic LPG and aviation turbine fuel for domestic use was raised by 20 per cent. The price of other petroleum products, excluding diesel and kerosene for non industrial use was raised by 10 per cent.

In his budget speech of 1991 Finance Minister Dr. Manmohan Singh addressed the matter of cut in non-plan expenditure in this way:
"As a result of the major adjustments in the sphere of expenditure, which I have outlined in my speech, the budget estimate for total non-plan expenditure in 1991-92 stands at Rs. 79,697 crore. It is simply not possible to reduce interest payments in the short term. The provision for non-plan expenditure, excluding interest payments, in the current year represents a reduction of 4.9 per cent compared with the provisions in the revised estimates for 1990-91, and a reduction of almost 15 per cent in relation to what we would have had to provide this year, but for the specific correctives that are being introduced".14

As a part of the government's policy to supplement fiscal stabilization by structural reforms in economic policy and management, the government initiated steps to prioritise the activities and schemes both on plan and non-plan side to identify those which could be eliminated or reduced in size. In September, 1991 the government had also imposed a 5 per cent cut on the expenditure provisions contained in the sanctioned budget estimates for 1991-92 of all Ministries/Departments. Only a few items of expenditure, such as, statutory grants to state governments, block grants and loans for state plan schemes, interest payments and pension payments were exempted from the expenditure cut. The then Finance Minister had indicated on number of times that the burden of achieving reduction in fiscal deficit would fall heavily on expenditure side.

4.4 REFORMS OF PUBLIC SECTOR ENTERPRISES

The state dominated heavy industries based on Nehru-Mahalanobis strategy of protected industrialisation which India has
pursued since the mid-fifties, required not only a high rate of domestic savings and investment but also a large share for the public sector in total investment. However, the public sector's own savings performance has been quite disappointing. Though public sector savings have been less than public investment throughout the planning period, this gap widened considerably during the eighties. The share of public sector in gross domestic savings declined from over 20 per cent at the beginning of the decade to only 8 per cent by 1989-90. In plan financing, while the sixth plan (1980-81 to 1984-85) envisaged that over 46 per cent of the public sector plan outlay would be financed by own resources of the public sector, the actual contribution turned out to be only 37 per cent. Similarly, during the seventh plan (1985-86 to 1989-90) only 27 per cent of the public sector plan outlay was financed from own resources as against a target of over 41 per cent.

There were 246 central government public enterprises as on March 31, 1991, out of which 236 enterprises were in operation. These 236 enterprises yielded a net profit of Rs. 2368 crore in 1990-91, implying a rate of return of only 2.3 per cent on Rs. 101,797 crore capital employed. Of this, only 69 crores came from all the non-oil public enterprises put together. The record of the state level enterprises is worse. The departmental commercial undertakings of all states and union territories together reported a net loss of Rs. 1885 crore in 1990-91. Of the two major types of non-departmental undertakings, the State Electricity Boards reported a combined loss of Rs. 4169 crore while the
State Road Transport Corporation reported a loss of Rs. 470 crore. Thus, instead of generating a surplus, all public enterprises put together generated a net loss of some Rs. 4176 crore (Table A-12).

'Pervasive inefficiencies and poor financial performance in public sector enterprises have remained a major obstacle to industrial development and international competitiveness. Inefficiency and lack of dynamism have resulted from cost-plus pricing and distribution controls. Many public sector enterprises have been de facto monopolies, protected from competition. A soft budget constraint - easy access to budget funds and/or credit from the financial sector - has allowed sick PSEs to survive. Ambiguous relationships with government supervisory authorities were not conducive to efficiency. These enterprises have also been constrained by multiple objectives, lack of managerial autonomy and overstaffing pressures in relation to operational needs. They have constituted a serious drain on government resources'.

Reformists argue for a far more concrete exit policy and for reforms to be undertaken at the state level where public enterprises are even less efficient and less profitable than at the national level, and where the effect on limited resources is more serious. The reforms aim to increase efficiency and reduce the losses that so many public enterprises impose on the government budget. It is recognised that the budget not only should not support sick enterprises but it should not even provide the funds for their expansion. Rather, these should come from their own funds or from the capital market.
The 20th December 1991 speech by the Prime Minister elaborated policy on the public sector following the July 1991 new industrial policy.

'The mixed economy will continue but no further nationalisation will be resorted to; there will be no budgetary support to sick or potentially sick PSEs, with a view to eliminating it as soon as possible, but with 'sickness', hardship will be alleviated with the National Renewal Fund'.

The demand for reform of public sector enterprises seems to be more on pragmatic than ideological grounds. As the economic environment is being made more conducive to cost and quality considerations and attempts are being made to foster competition, pressures on performance orientation in the public sector are also mounting. The policy response in the form of public sector reforms by the central government, however, has been slow. Under structural reforms the government has decided to give greater managerial autonomy to public enterprises to enable them to work efficiently. In addition to this, two other key elements of the government's strategy for public enterprise reform are the promotion of increased private sector competition in areas where social considerations are not paramount and partial disinvestment of equity in selected enterprises.

In the area of public sector enterprises following steps were taken by the government.
The system of monitoring has been strengthened with Memorandums of Understanding. The MOUs are being claimed in official circles as major instruments of the rollback of state involvement in the running of the public enterprises by citing statistics such as the following: 'During 1990-91, 23 public enterprises signed MOUs with their administrative ministries, of which 14 were evaluated as excellent, 8 as good and 1 as poor. In 1991-92, 71 enterprises signed MOUs, while in 1992-93, 120 enterprises were identified for this purpose'. A more objective assessment of the situation, therefore, calls for a cleaner break with the old traditional culture of running the PSEs through back seat driving. The experience with the MOUs in the past has not been very positive. A change of attitude in the new era of liberalization may lead to some improvement in results in the years to come, but much more is needed than MOUs to distance the government from the actual running of the PSEs.

Some steps have been taken towards the marketisation of the PSEs. An important aspect of 'Marketisation' is corporatisation. A major example of corporatisation can be seen in the telecommunications sector. A beginning was made in 1986 by setting up a new corporate entity, i.e. the Mahanagar Telephone Nigam Ltd. (MTNL). The company made a profit of Rs. 1.4 billion in the very first year of its operation. This has now raised expectations.

The loss making sick PSEs have been brought under the ambit of Board for Industrial and Financial Restructuring (BIFR) which was already
facing numerous problems dealing with the sick private sector units. The government policy of marginal disinvestment of the equity of public sector enterprises has been dominantly governed by the compulsions of financing the fiscal deficits. The whole disinvestment approach is so incremental and so thinly spread that it fails to address the basic issue of how to improve the very low returns on the capital invested in the public sector. Not much has been done to bring about effective changes in the functioning of these enterprises. The approach of disinvestment is based on the assumption that the induction of private shareholders will alter the corporate culture in these enterprises and provide them a stronger commercial orientation in response to normal shareholder expectations. This is a tall assumption indeed.

The 1991-92 budget earmarked $ 67 million for the National Renewal Fund. The International Development Agency promised over $ 166 million during 1992-93 and the same amount in 1993-94. The NRF is expected to provide assistance to firms undertaking modernisation and technological upgrading of existing capacities to cover the costs of retraining and redeployment of employees. The fund would also provide compensation to employees affected by restructuring or closure of industrial units in both the private and public sectors. A social safety net would be provided for workers through allocating funds to finance employment generation schemes in the organised and unorganised sectors.

The willingness of the government to form strategic alliances has been demonstrated in the case of Maruti Udyog Ltd. an automobile
joint venture with Suzuki Motor Corporation of Japan. This unit was originally set up in the early eighties with Suzuki having a 40 per cent stake and the Government of India the remaining 60 per cent. Later, as part of the policy of encouraging foreign investors to increase their shareholding, Suzuki was allowed to increase its share holding to 50 per cent by purchase of fresh equity and also to acquire greater management control.

* On the whole the reforms of PSUs including privatization and phasing out of unviable units have not gathered as much momentum as had been hoped for. Disinvestment has been piecemeal and the funds so raised are being used to reduce budget deficits, rather than strengthen the PSUs. As Bimal Jalan points out:

'The sale of public sector enterprises would be of little help unless macroeconomic environment is improved and it is quite probable that if macroeconomic stabilization is successful, disinvestment of equity in public sector enterprises may not be necessary'.

Along with this, labour problems, political and bureaucratic interference have not been effectively reduced. Since it is not possible to privatise a large component of the public sector, it would be advisable to reform it.

4.5 FINANCIAL SECTOR REFORMS

We are aware now that the economic reforms launched by the government in 1991 were designed to accelerate overall growth and help India realise its full productive potential. The experience of successful
developing countries indicates that rapid growth requires a sustained effort at mobilising savings and resources and deploying them in ways which encourage efficient production. Financial sector reform thus constitutes an important component of the programme of stabilization and structural reform. At the outset the government had recognised that financial sector reform was an integral part of the new economic policy. A high level committee headed by Mr. M.N. Narsimham was appointed to consider all relevant aspects of the structure, organisation, functions and procedures of the financial system. Following the committee's report in November 1991, the government embarked on a far reaching process of reform covering both the banking system and the capital market.

4.5.1 Reforms in the Banking System

At the time of the crisis in 1991, India had been successful in mobilising savings, but the financial system had been seriously weakened by government policies. Commercial banks operated at low margins due to obligations to provide credit at subsidised rates to government and priority sectors. Internal efficiency in commercial banks was low and administrative costs were high. Many of the problems stemmed from fiscal deficits and the RBI's attempts to counter the potential monetary effects of deficits by requiring commercial banks to hold extensive government debt at below market rates. Solutions depended to a large extent on regaining fiscal balance.

'A basic constraint on the efficient functioning of the banks has been the preemption of large proportion of bank funds at low rates of
interest for financing the fiscal deficits through the Statutory Liquidity Ratio (SLR) has already begun in the budget of 1992-93 when the average SLR of 38.5 per cent was lowered to 36 per cent. The budget for 1993-94 sets the goal of bringing it further down to 25 per cent at the end of three years but does not specify the phasing pattern.19

The process of fiscal stabilization is expected to reduce the government's demand for borrowed funds and will facilitate the process of lowering the SLR. The interest rate structure has also been simplified. One of the problems facing the banks in 1991 was that levels of statutory liquidity ratio and cash reserve ratio (CRR) had been progressively increased over the years: the SLR, because of the desire to mobilise increasing resources through so-called market borrowings to support the central and state budgets. In the case of the CRR, it was because of the need to counter the expansionary impact on the money supply of the large budget deficits. Together, the SLR and CRR stipulation directed a large proportion of bank resources into low income-earning assets, reducing bank profitability and pressuring banks to charge high interest rates on commercial sector advances. The SLR and CRR were in fact a tax on financial savings in the banking system encouraging distortionary flows in markets where this tax did not apply. The government decided to phase out this distortion. The SLR is to be reduced in stages from 38.5 per cent to 25 per cent, and the CRR is to be reduced to a level below 10 per cent.

The government initiated a number of short-term measures to improve the financial sector, and pave the way for future reforms:
A high level committee, the Narsimham committee on financial sector Reforms (1991), reviewed the structure, organisation, functions and procedures of the financial system.

Interest rates on term loans and on the bulk of debt instruments in capital markets have been decontrolled, and deposit interest rates have been increased.

Full statutory powers were given to the Securities and Exchange Board of India (SEBI) to regulate, promote and monitor Stock Exchanges in India.

The private sector is now allowed to establish mutual funds.

The central government has been strongly influenced by the findings and recommendations of the Narsimham committee on financial sector reforms (1991), and by the securities scam. The government has recognised the sector as being over-regulated and overgoverned. In this situation, the quality of the advances portfolio has deteriorated and a culture of non-recovery has developed in many parts of the banking system. A number of reform initiatives to cover bad debts and meet new capital adequacy norms were announced in 1994 and special arrangements are in train for the recovery of debt due to banks.

4.5.2 Reforms of the Capital Markets

In addition to banking system reform, it was also necessary to reform the capital market, a need which had been evident for some time. Stock exchanges, for example, are characterised by long delays, lack of
transparency in procedures, and vulnerability to price rigging and insider trading. To counter these problems the government moved to establish a Securities and Exchange Board of India in the 1987-88 budget. It was first established as a non-statutory board, with the intention of giving it statutory powers, but this did not happen until January 1992.

Recommendations for reforms in the capital market were made by the Narsimham Committee (1991) and a series of initiatives were undertaken in 1991-92 and 1992-93. 'The reforms are moving capital markets away from direct government control over volume and pricing of issues to a market-determined system regulated by an independent authority. The government has recognised that the process of reform in the capital market has only begun'.

Further reform is necessary to bring about speedier conclusions of transactions, greater transparency in operations, improved services to investors, and greater investor protection, while encouraging the corporate sector to raise resources directly from the market at an increasing scale. Modernisation of the stock exchanges to bring them into line with world standards in terms of transparency and reliability is also necessary if foreign capital is to be attracted on any significant scale. A number of Indian companies have been successful recently in raising funds abroad through Euro-Equity issues and foreign currency convertible issues.

Finally, we would like to stress here that nearly half of the gross fiscal deficit of the central government in 1990-91 was financed by the banking system (including the RBI). Through instruments such as the
mandatory cash reserve ratio and statutory liquidity ratio, the government has traditionally forced the commercial banks to hold a larger share of relatively low-yielding government liabilities in their asset portfolio than they would otherwise hold. In any event, the facts that important financial intermediaries such as the major commercial banks and the Life Insurance Corporation are in the public sector, and that the Reserve Bank of India does not have the autonomy of either the federal Reserve Bank of the United States or the Bundesbank of Germany, have meant that the central government has faced little external discipline to trim its fiscal scales for fear of being unable to finance its deficit at any inflationary cost. This means that the reform of the financial sector, including of the RBI, must be treated as an integral part of the fiscal reforms.

The foregoing review has dealt with only urgent issues in fiscal stabilization reforms. Such as the deficit, expenditure control, reform of the tax system, banking and financial sector reform, subsidies and public sector reforms. In India, the fiscal instability has been mainly caused by sharp rise in public expenditure. Therefore, reduction in the fiscal deficit is to be brought about by containing public expenditure. Although for the purpose of fiscal stabilization containment of the government expenditure should receive priority, some effort at additional resource mobilisation through tax and non-tax sources may also be necessary. The planning commission has stated:

'The required additional revenues may have to be generated by a judicious mixture of broadening the tax base, rationalising the tax rates
An area where there is considerable scope for revenue mobilisation is public services. User charges on publicly provided utilities such as irrigation, electricity, water, road transport and higher education are much below their cost of provision. Hence, unrecovered costs of public utilities are large and a kind of subsidy to the users. The government can justifiably raise user charges on public utilities like electricity, irrigation, transportation and water. But it has to be said in conclusion that fiscal policy is more than the mere arithmetic of budgets or even the formal process of financial management in government. To lose sight of the underlying political power relations which drive fiscal policy is to miss the central point about the roots of India's current fiscal crisis.
NOTES

i) A Tax Reforms Committee was constituted under the Chairmanship of R.J. Chelliah in 1991 to examine the tax structure in the country and make appropriate recommendations to reform it.

ii) MODVAT was introduced with effect from 1.3.1986. Under the MODVAT scheme credit of duty is allowed on inputs which are used either for producing excisable finished products or intermediate products.

iii) MAT applies where the total income of a company as counted under the Income Tax Act, after availing all eligible deductions, is less than 30 per cent of the book profit. The total income of such companies shall be deemed to be 30 per cent of the book profit and shall be charged to tax accordingly.

iv) It has been proposed that residents of large metropolitan cities, who satisfy two of the economic criteria, namely ownership of a four wheeler vehicle, occupation of immovable property meeting certain prescribed criteria : ownership of a telephone and foreign travel in the previous year should fall within the taxable slab and should voluntarily file their tax return.

v) The term 'internal debt' is used to cover the various liabilities of the Government which in official documents referred to as 'internal liabilities' including what is narrowly called 'internal debt'.
vi) While interest payments are shown in the official documents separately for internal and external debt, interest receipts, dividends and profits are not so shown. The practice so far followed in the official documents is to put out also figures of total net outgo on account of interest payments.

vii) In order to provide the export sector of the economy with access to importable inputs that enter into export production, at international prices, the import policy allows special import facilities for registered exporters.

viii) Corporatisation means creating institutions which are distinct from a government department and operate as separate entities enabling commercial approach to the activities of the public sector.
REFERENCES


