Chapter - 6
6.1 CONCLUSIONS

We have made an attempt in the foregoing chapters to examine the problem of fiscal stabilization in Indian economy since seventh plan (i.e. since 1985). The analysis of the foregoing pages shows that the origins of the fiscal crisis in the developing countries was in stagnant revenues coupled with uncontrolled expenditures, along with foreclosed foreign borrowings. As a result, governments had to rely on domestic sources of financing, which could result either in runaway inflation or pushed the economy into debt-trap or in a combination of both.

Chapter II tries to explain that most of the developing countries where there was a fiscal crisis, have registered a decline in the share of the direct taxes in general and that of income taxe in particular in total revenues. Simultaneously, higher rates of custom duties further reduced the buoyancy of the tax system in such countries. Thus, chapter-II concludes that experience of developing countries reveals that the emergence of the fiscal crisis was result of stagnant revenues along with rapid growing public expenditures and public debt. The fiscal crisis forced many countries to undertake fiscal stabilization programmes. Chapter II has surveyed some major issues that arise in the process to overcome the problem of fiscal stabilization. It also analysed possible effects of the fiscal stabilization measures, its quality and its sequencing. Finally, we can say, that the objective of fiscal stabilization cannot be achieved through shock therapy. However, good fiscal measures always took time in the restoration of fiscal stabilization.
During the seventh plan period (1985-90) the fiscal sector of the economy was possibly in the severest crisis in the post-independence era. All symptoms were almost similar as experienced by the developing countries, discussed in chapter-II. An analysis of chapter-III reveals that the government expenditure had been outpacing revenues since late seventies, leading the government to resort to substantial borrowings. The public debt reached to such a level that interest payments turned out to be the largest component of public expenditure. From 11.6 per cent in 1980-81 interest payments as a share of total expenditure increased to 21.4 per cent in 1990-91. Non-plan expenditure increased uncontrolled during the period in reference. In the realm of tax revenue, during the 1980s the ratio of total tax revenue to GDP had moved up from 9.93 per cent in 1980-85 to 11.20 per cent in 1985-90. A major problem with the tax system was that the share of direct taxes had virtually stagnated during the seventh plan period, it was 2.41 per cent in 1980-81 and averaged around 2.49 per cent of GDP in 1988-89. Thus the entire increase in the tax to GDP ratio has been brought about by exploiting indirect taxes. As it has been discussed in chapter-II in most of the economies where fiscal crisis incepted, direct taxes (which is considered most buoyant) as a ratio to GDP were either stagnant or on decline. India, also experienced the same trend along with high import duty.

It has also been recognized in the foregoing analysis that it is the progressive acceleration of government expenditure growth which has led to the emergence of a fiscal crisis despite a steady increase in the tax-GDP ratio during 1980s, which exceeded the long-term fiscal policy
targets in every year of the seventh plan period. The largest increase in the share of revenue expenditures over the period came about on account of increase in interest payments. Government expenditure in India during the seventh plan period grew at a rapid rate, faster than both GDP and government revenues, with low and declining level of cost recoveries. The analysis of the trends in public expenditure during the second part of the eighties have shown sharp increase in expenditures on quasi-public goods, subsidies and transfer payments. The increasing share of current expenditures and, particularly, those on wages and salaries, food and fertilizer subsidies and sharp reduction in the share of capital expenditures have also been evidenced. The foregoing analysis have shown that the public debt to GDP ratio increased throughout the eighties, going upto almost 59 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 enterprises to generate investible resources and the explosive growth of current expenditure of the government. In such a situation falling of the government into debt-trap was real. The failure of the public sector enterprises to generate profits have also contributed to the fiscal crisis, because these enterprises have dominated the provision of infrastructure and critical intermediates. Their inefficiency has led to downstream inefficiencies in a multiplier fashion. Then again, the restrictive trade and industrial licensing framework, for instance, led to serious loss of efficiency by reducing the scale of output, eliminating effective competition, creating bottlenecks, etc. which resulted in the reduction of returns, thereby affecting the GDP growth. In turn, the revenues raised
from the economy, for any given tax rates were adversely affected, and the necessity to undertake budgetary expenditures to support the creation of public sector jobs and for consumption, contributed to the fiscal deficit.

Gross capital formation out of budgetary resources, which comprised 40.1 per cent of total expenditure in 1980-81, had steadily gone down to 32.7 per cent by 1990-91. Two other features need to be mentioned in this context. First, gross capital formation out of budgetary resources, which grew at an average rate of 18.8 per cent in the early eighties, appears to have started to decline from 1986-87. Secondly, the rate of increase in gross capital formation turned negative in 1990-91. In the meantime the gross savings of the government had turned negative for the first time in 1984-85, and dissaving has been growing over the years.

The impact of the above trends resulted in the expansion of money supply. Alongwith the large revenue deficits there was large budget deficits during the seventh plan period. This in turn had contributed to a large monetised deficit. Money supply grew at an average annual rate of about 17.5 per cent during the seventh plan period. This contributed to the double digit increase in CPI inflation during 1990-91. Thus, foregoing analysis reveals that by the end of eighties, a severe problem of fiscal stabilizaiton emerged. All the indicators of fiscal imbalance were on rise throughout the eighties. During this period the gross fiscal deficit rose from 6.2 per cent of GDP in 1980-81 to 8.3 per cent in 1990-91, the revenue deficit registered similar trend and rose to 3.5 per cent of GDP in 1990-91 from 1.5 per cent in 1980-81. The fiscal imbalance, fuelled by the revenue and budget deficit and financed by the borrowings and the
decumulation of reserves, was accompanied by accelerated inflation to double-digit levels. Such a fiscal situation had become unsustainable.

To remove the deficit and bring fiscal stability, fiscal stabilization measures were introduced in 1991. The essential features of the central government's overall fiscal strategy for controlling the budgetary deficit comprises: expenditure compression, reduction in subsidies, reduced budgetary allocations to public enterprises, rationalised administered prices, and completion of tax reforms. An analysis of chapter-IV reveals that the government had reduced provision for subsidies in respect of fertilizers, food and export promotion. The provision of subsidy in respect of Public Distribution System (PDS) was difficult to eliminate, but could be restricted to the non-affluent. This however was more easily said than done; government in a democratic setup functioned under several compulsions and constraints. Even then government was making efforts to reduce subsidies through increases in prices of commodities supplied under the PDS. Reduction in interest burden postulated sizeable reduction in borrowings, and in order to tackle the problem at its roots, the budgetary strategy had to be revised: it was necessary to revert to the formulation of a surplus budget on revenue account. Another area of expenditure, in which effective cuts were proposed, was administration and grants. Thus, government in its fiscal stabilization measures had proposed to reduce expenditure both plan as well as non-plan.

With double digit inflation, and high budget and fiscal deficit and the precarious foreign exchange and current account position in 1990-91,
the fiscal stabilization programme was directed inter alia at drastically cutting the budget deficit and tightening monetary policy with the objective of reducing inflation and achieving external sector viability. Reforms in the public sector enterprises have also been introduced in the form of disinvestment and autonomy etc. The government needed to increase revenues in order to contain the fiscal deficit, as also to improve the ratio of taxes to GDP. Government proposed to implement various suggestions made by the Chelliah committee on tax reforms. In the field of direct taxes, the TRC recommended moderate direct tax rates with reduced tax deductions and exemptions, coupled with effective enforcement. Gradual reduction in both personal and corporate taxation was envisaged for the future. Customs tariff reform includes: gradual reduction in average tariff level, rationalisation of customs duties and import policies for consumer goods in a phased manner, and exemptions from countervailing duty eliminated. These measures were designed to ensure that the Indian economy becomes competitive and integrates with the global economy through freer trade. While MODVAT would be extended to all sectors, the ultimate objective was to move to a full fledged value added tax (VAT). Tax base should be widened to include exempt commodities and some services. A significant feature of tax reforms would be to move towards only one or two rates for raw materials and intermediate goods.

India's experience regarding impact of fiscal stabilization measures shows that efforts at restoration of fiscal stability proved difficult on account of certain factors as it has been experienced by various countries where IMF assisted fiscal stabilization programmes are in operation.
excise duties and raising that of direct taxes. The shift away from foreign trade taxes and excise duties appears to have taken place at the cost of overall revenue growth. The rise in the relative share of direct taxes has resulted partly from the decline in the revenue from customs and excise.

The foregoing analysis indicates towards the lack of success with expenditure reduction. There has been a sharp rise in interest payments. It is clear that the compensation has come not only from decreases in other items of current expenditure such as subsidies, defence and general administration, but also capital and plan expenditures. Throughout the 1990s, while capital expenditures as a proportion of GDP have fallen sharply, the revenue expenditures net of interest payments have stagnated. It is evident in the foregoing analysis that the ratio of capital expenditures to GDP has fallen from about 6 per cent in 1990-91 to 2.6 per cent in 1999-2000. Though, the ratio of net revenue expenditures which fell sharply between 1990-91 and 1996-97, has risen in recent times, but well below to its 1989-90 figure. Despite this the fiscal deficit is proving uncontrollable. If we use the older definition of the fiscal deficit, which included small savings transferred to the states, the fiscal deficit to GDP ratio which fell from 7.9 per cent in 1990-91 to 4.9 per cent in 1996-97, has since risen to 7 per cent in 1999-2000 and was expected to remain at around 6.8 per cent in 2000-2001.

Economic reforms have also meant a change in the way the government's deficit is financed. Till the early 1990s, a considerable part of the deficit on the government's budget was financed with borrowing
It is clear from the foregoing analysis of chapter-V, that the 1990s have witnessed a fall in the collection of tax revenue as a proportion of GDP. Between 1990-91 and 1999-2000, when there were substantial tax rates reductions the ratio of gross tax revenue to GDP declined from 10.8 per cent to 9.2 per cent. A remarkable feature of the centre's revenue trends in the reform years brought out by the foregoing analysis is the jump in the share of direct taxes of the total tax revenue from around 19 per cent in 1985-90 to 29 per cent in 1995-99, and was expected to reach at around 32 per cent level in 1999-2000. Acceleration of collections from corporation tax is particularly striking, from 9.6 per cent of the total revenue in 1985-90 to around 15.4 per cent in 1995-99, and stood at around 17.2 per cent in 1999-2000. Personal income tax has also shown greater buoyancy in the reform period, from 9.12 per cent of the total revenue during 1985-90 rose to around 14 per cent during 1995-99. The leap in revenue from direct taxes, however, has not been able to neutralise the decline that has taken place in the indirect taxes. Revenue from customs and excise, which together accounted for over 79 per cent during 1985-90 has declined to 66 per cent during 1995-99. Revenue from indirect taxes had started decelerating even before the reforms but the decline has been sharper in the reform period. There has been a noticeable shift in the tax structure at the centre. The two key aims of the reforms, viz., lessening the weight of foreign trade taxes and increasing that of direct taxes, are evidently materialising. The rise in the share of income tax has, however, not sufficed to make-up fully for the loss from the tariff reforms. In sum, reforms so far have succeeded in making a small dent on India's tax structure by reducing the weight of customs and
from the central bank against ad-hoc treasury bills issued by the government. The interest rate on such borrowing was, at around 4.6 per cent, much lower than the interest rate on borrowing from the open market. A crucial aspect of financial reform has been the reduction of such borrowing from the Central Bank to zero, resulting sharp rise in the average interest rate on government borrowing.

With the adoption of economic reforms, reform of public sector enterprises became inevitable. The new strategy essentially involved refocussing but not curtailing state activity and channelising resources and effort in high priority areas. In 1991-92 profit after tax to net worth was 3.9 per cent which rose to 10.2 per cent in 1997-98. This shows an improvement in the rate of return on capital employed in PSUs. Whatever limited progress has been achieved in initiating public sector reforms has largely been linked to the process of disinvestment. The foregoing analysis reveals that the goal has fallen short of expectations and the disinvestment strategy has itself been bogged down by controversies. During 2000-2001 non-tax revenue from dividends and profits from PSUs has exceeded the budget expectations. Thus, the shortfall in disinvestment has been partly offset by this increase. If this pattern continues for a longer period and an enhancement of revenue from disinvestment, it would be very important for retiring of public debt so that the fiscal deficit can be reduced significantly.

There is greater consensus that in the recent past the budgets of the central government were out of balance and now the restoration of fiscal balance is one of the most important task in the agenda of further
economic reform. There is not only a wide gap between revenue and expenditure resulting in deficits, the composition of expenditure is also quite out of line. Revenue structure needs to be altered to make it more broad based and equitable. Thus, a significant fiscal reform is needed for the restoration of the fiscal stability.

At the conclusion of this tour de horizon of problem of fiscal stabilization in the Indian economy we can say that, though the problem of fiscal stabilization has been sorted out to some extent, but a lot has to be done for consistent and long-term fiscal stability.

6.2 SUGGESTIONS

A few important points may however, be mentioned in the light of above discussion so as to make fiscal stability a long-lasting feature. The key objective of fiscal reform has to be a reduction in debt service payments. This has to be achieved by a progressive reduction in public debt and through higher revenues. The possibility of achieving higher revenues through increased rates of taxes is both undesirable and infeasible. Higher tax revenues can be achieved only through buoyancy and expansion of the tax base. Thus the main instruments for achieving a sustained fiscal balance are:

* The yield of income tax can be increased at least by broadening the base and strengthening the administration while at the same time ensuring that the main aim of the administration would be to collect increasing revenues without harassment that the exacting illegal payments will be drastically cut down. The base income tax can be widened by;
a) removing many exemptions that are unjustified and reducing the magnitude of some of the concessions,

b) bringing into the tax net a large number of income earners who are evading tax,

c) introducing such acceptable simplified procedures as the estimated income scheme, and

d) introducing a minimum profits tax on all business income other than income of professionals.

* Effort should be made to bring more companies into the group of tax filers. At the same time, the so-called zero tax companies can be made to pay some tax.

* There is agreement in principle that the base of excise duty must be broadened and the rates must be moderate. Multiplicity of rates is to be done away with.

* The VAT principle should be extended to the textile sector and the tax should be levied at the fabric stage also. For this purpose, the duty on artificial yarn of different kinds should be brought down and some simple way must be found to levy tax on the powerloom sector.

* The base of the services tax should be expanded. In order to minimise possible cascading effect, services which are generally used as major inputs should not be brought under tax and the rate of tax should be relatively low.

* With the rates of custom duties coming down, it would be necessary to subject at most all imports to some import duty. That would also
be economically a rational policy. The minimum rate could be 10 per cent and the maximum rate on goods other than consumer goods should be 30 per cent.

* At first, consumer goods requiring sophisticated technology may be permitted to be imported, then, gradually the imports of other consumer goods should be liberalised. The rate of duty on consumer goods may be kept 50 per cent to start with.

* It is generally agreed that government has overextended itself. Fortunately the economic reform programme has made many activities and the associated staff redundant. Apart from that, gradually the government sector should withdraw itself from the production of private goods.

* The central government should cut down the size of ministries and departments dealing with subjects which are mainly the responsibilities of the states.

* There is an agreement regarding the surplus staff in general administration and also in the administration of functional departments. There is also over-staffing of engineers in the public works department. This surplus staff must be identified and shed off.

* The share of interest payments must be brought down by limiting the fiscal deficit and by retiring some of the existing debt. Given the size of the debt, retirement would achieve only a relatively small reduction in the debt burden. However, through the sale of seized gold and some of the government lands and through disinvestment of PSUs
shares a sizeable amount could be raised and used for the retirement of debt.

* Subsidies have to be reduced mainly because the government cannot afford the luxury of providing wide ranging subsidies for production. Subsidies directly targeted at consumers from the vulnerable groups should be developed and implemented to safeguard the government's objective of income distribution. Carefully developed small projects that are practical and implementable, with a clear beginning and a fixed termination, are more likely to be successful than nationally announced mega projects short of sufficient funds and subject to wide misappropriation.

* Expenditure control mechanisms have to be given teeth. In particular, there should be full follow-up by government departments and resolution of problems after the completion of scrutiny by the CAG's reports.

* A clear position must be articulated to privatise existing public sector enterprises except those that may be regarded as strategic. This action is not only necessary for generating resources for retiring public debt but is also necessary for the long-term health of the enterprises generating themselves. We must adopt a new approach to public sector enterprises which recognises that privatising them would be the best way of making sure that the core of Indian industry grows, remains competitive and is enabled to compete internationally.

* The government must clarify the objectives of the process of privatisation and seek to forge a consensus. The objectives must be
both the strengthening of these enterprises to enable them to compete and grow, and to contribute to the restoration of fiscal health of the country. The return from privatisation must not be used for current expenditures. They should be explicitly used for retiring public debt so that the interest burden is progressively reduced.

* While it is difficult to prescribe a particular size for the public debt, it is possible to set up a monitoring unit with strong recommendatory powers for the containment of public debt. For example, such a writ set up within the RBI and headed by the governor of RBI could be given the final authority to cut off the government's ability to borrow except under specified contingencies. Such extreme measures as earmarked taxes or nonflouting of expenditure ceilings or cut off of the issuance of additional public debt are not warranted under ordinary circumstances. But they are necessary when a country's fiscal performance needs improvement in a hurry.

It may be concluded that viable fiscal stabilization may be restored, if the above suggestions are taken into consideration and implemented in an earnest and proper manner.