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Fiscal Sector Reforms in India

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ABSTRACT *Fiscal sector reforms play an important role in overall macroeconomic framework in India. Fiscal sector reforms helps to raise the rate of saving and investment which further enhances the productivity of government expenditure. Fiscal sector reforms in India include tax reforms, expenditure reform and systematic reform in government borrowing process. The core objective of this paper is to discuses fiscal sector reforms in India. The concluded that major purpose of the fiscal reforms programme was to achieve reduction in the size of the deficit and debt in relation to GDP.*

KEYWORDS : Fiscal System, Fiscal sector reforms, FRBM Act

1. Introduction

The fiscal trend of 1970s suggests that this was a period of moderate growth in public expenditure in line with revenue flows. Thus the fiscal situation of central government remained comfortable till 1980. But there was a significant deterioration in the fiscal situation in 1980's, especially by the second half, which was marked by high and persistence fiscal deficits accompanied by large fiscal deficits. This large fiscal deficit had some spill-over effects on the external sector which was reflected in the widening of current account deficit in the early 1990s. Therefore, Indian policy makers realized the need to start the process of fiscal reforms as a part of economic reform measures in 1991-92. Fiscal sector reforms were the integral and the most critical part of the macro-economic stabilization and reforms programme taken by the government after 1991 crisis.

2. Fiscal System in India

Fiscal system refers to the mechanism through which financial resources i.e. revenue and capital resources for the government and its bodies are obtained channeled and the scale and pattern of allocation of such resources is determined. Indian fiscal system is based on Constitution of India which is federal in character. The Constitution makes elaborate and complex arrangement relating to the distribution of revenue, expenditure and the power of borrowing between the central and state government. The Indian Constitution has assigned the powers of the central and state government into three lists: a union list, a state list and a concurrent list. Union list consists of 97 items on which the parliament has exclusive power to legislate, including items like defence, atomic energy, defence production, foreign affairs, railways, national highways, marine, shipping and navigation, airways, post and telegraphs, currency and foreign exchange, foreign and interstate trade, important industries, institution of national importance etc. The state list consists of 66 items and the states individually have the exclusive authority to legislate on items, including items like public order, police, and administration of justice, public health, education, agriculture, forest, fisheries, and the other industries. Concurrent list consists of 47 items which include commercial and industrial monopolies, labour disputes, social security, charity and social legislation like marriage and divorce and social planning etc. on which both the governments can legislate.

Amongst the sources of revenue of the government, taxation being the major sources, Article 265 of the Constitution specifically states that no taxes shall be levied or collected except by the authority of law. There is a clear demarcation of the taxation powers of the Union and the states in the Seventh Schedule of Constitution under Article 246. There are thirteen taxes which are listed in the Union List. Nineteen taxes are listed in the state list. Apart from the taxes levied and collected by the states, the constitutions has provided for the revenues for certain taxes on the union list to be allotted, partly or wholly to the states as listed in following categories:

a) Duties which are levied by the Union Government but are collected and appropriated by the states.
b) Taxes which are levied and collected by the Union, but the entire proceeds of which are assigned to states, in proportion determined by the Parliament.
c) Central Taxes on income and union excise duties are levied and collected by the Union but are shared by it with the States in a prescribed manner.
d) Proceeds of additional excise duty on mill-made textiles, sugar and tobacco which are levied by the Union since 1957 in replacement of state sale taxes on these commodities are wholly distributed among the States in a manner as to guarantee their former incomes from the displaced sales taxes.

In the case of distribution of expenditure powers, "the functions of the central government are those required to maintain macroeconomic stability, international trade and relations, and those having implication for more than one state.

So far as the borrowing powers of the centre government are concerned, it is regulated by Article 292 of the constitution. Article 292 of the constitution empowers the government of India to borrow upon the security of the consolidated fund of India, i.e. the resources of the centre; subject only to such limitations as Parliament by law may impose. The government of India can borrow internally as well as externally.

The constitution recognizes that because of its design, assignment of tax powers and expenditure functions would create imbalance between expenditure need and abilities to raise revenue between the centre and the state governments. The imbalance could be both vertical, among different level of governments, and horizontal, among different units within a sub national level (Rao and Sing, 2001). To correct this imbalance, the constitution provided for statutory fiscal transfers from the centre and the states through the instrumentally of the Finance Commission. The Finance Commission is constituted every five years to recommended allocations of centre taxes to the states.

3. Fiscal Sector Reforms in India

Under fiscal policy the government uses fiscal instruments to achieve desirable objectives. In other words, fiscal policy deals with instruments like taxation, expenditure and borrowing decisions of the government. Therefore, Fiscal position of the central government is determined through its taxation policy, growth and pattern of the public expenditure and process of public borrowing. Fiscal reforms thus encompass tax-reforms, expenditure reforms and reforms in the borrowing process of the central government.

Tax Reforms

In order to augment public revenue, the main focus has remained on taxation reforms. The first comprehensive attempt at reforming the tax structure was made by the Taxation Inquiry Commission (TEC) appointed by the Government of India under the chairmanship of John Matthai. The commission made several recommendations regarding income tax, some of which dealt with the broad structure while others related to matters like inclusion and exclusion of certain categories of income from taxation, grant of concessions to promote objectives of economic policy and so on. On March 2, 1970, the Government constituted the Direct Taxes Enquiry Committee with Justice K.N. Wanchoo as the chairman. The committee considered, inter alia, the problem of tax evasion and suggested various measures to fight the evil of tax evasion. To give effect to the recommendation made by the Committee, the government of India enacted the Taxation Laws (Amendments) Act, 1975.

The Indirect Taxation Enquiry Committee was set up by the Government of India on July 19, 1976, under the chairmanship of Shri L.K. Jha to review the existing structure of indirect tax system. The Committee recommended the introduction of Value Added Tax (VAT) at the manufacturing stage, called MANVAT, to tackle adverse effect of excise taxation. However, it was not implemented until 1986-87. A wide ranging and systematic effort to minimize the incidence of taxation was undertaken, through the introduction of Modified Value Added Tax System (MODVAT) in 1987. It was introduce in a limited manner on a few commodities and the coverage was gradually extended over the years. Further, the Government of India constituted a Committee of experts under the chairmanship of Raja J. Chelliah to examine the structure of direct and indirect taxes through its Resolution dated August 29, 1991. The Committee submitted interim report in December 1991 and final report in January 1993.

For the smooth and proper administration of the tax law and also to improve the tax collections, two task forces were setup by the Finance Minster in September 2002 under the chairmanship of Vijay Kelkar, Adviser to Minister of Finance and Company Affairs. The task force had given its recommendations on the aspects relating to direct and indirect taxes such as: (a) doubling the exemption limit for personal income tax, (b) abolishing taxes on equity capital gains and dividends received by individuals, (c) moving to dual rate structure in excise and custom duties, (e) abolition of minimum alternate tax. This was implemented in 2003-04.

For an efficient and harmonized consumption tax system in the country the Goods and Service Tax (GST) was introduce in 2010-11. GST is proposed to be comprehensive indirect tax levy on manufacturing, sales and consumption of goods as well as services at the national level. GST is aimed at giving India a world class tax system and improving tax collections. The changeover to GST will be a game-changing tax reform measure which will significantly contribute to the buoyancy of tax revenues, acceleration of growth and generation of many positive externalities.

Expenditure Reforms

Recognizing the gravity of the expenditure problem, a system of zero-base budgeting was initiated in the course of the formulation of the budgets of all central government departments for 1987-88 (Economic survey, 1986-87). To carry the process of reducing the growth in non-development expenditure, the government set up an Expenditure Reform Commission in 2000. The main Areas identified by the Expenditure Reform Commission included the creation of the national food security buffer stock and minimization of fertilizers subsidies through dismantling of controls in a phased manner.

The Eleventh Finance Commission examined the trends and composition of public expenditure of the central and state governments and suggests a number of measures to improve expenditure efficiency and to control budgetary deficits. According to Eleventh Finance Commission, alongside revenue augmentation, restructuring of public finances will requires structural changes on the expenditure side as well. While the thrust should be on compression, the composition of expenditure would need to be restricted in favor of priority sectors like elementary education, primary health care, water supply, sanitation, roads and bridges and other infrastructure. Items that would require a tight rein are salary and pensions, interest payments and subsidies. There has to be a radical change in the method of financing the plan expenditure as well.

After examining the trend and composition of expenditure at the levels of central and state governments, the Twelfth Finance Commission recommended its restructuring on the following lines. "In restructuring expenditures, there is needed to make reverence to basic objectives of government intervention in economic activities, as also to the basic objectives for assignment of responsibilities as between central and sub-national governments. It is also important to relate government expenditure to outcome in terms of quality, reach and impact of government services. This would be facilitated if government focuses more on their primary responsibilities rather than spreading resources thinly in many areas where the private sector can provide the necessary services.

Reforms in Borrowing Process

Under Article 292 the executive power of the centre extended to borrowing, either within or outside India, upon the security of the Consolidated Fund of India, within such limits, if any, as many from time to time are fixed by the Parliament. The government of India borrows heavily both internally and externally. The government of India announced the scheme of Special Bearer bond on January 15, 1981 to canalizing the unaccounted money for productive purposes. To mobilize private saving for public use, capital Investment Bonds were introduced on June 28, 1982. These bonds with a ten year maturity period carried an interest rate of 7 percent. For strengthening the fiscal position of the country, the system of ad-hoc Treasury Bills as a means of financing the budget deficit was discontinued. With effect from April 1, 1987, this system was replaced by a system of Ways and Means Advances (WMA). To provide short-term investment opportunity to financial institutions and others, the 182-days treasury bills were introduced.

After the fiscal crisis of 1991, the monetary policy of April 1992 heralded a new approach to internal debt management by introducing market operation in regard to absorption of Government of India dated rupee securities and longer term Treasury Bills and this was to be facilitated by overall reduction in the borrowing programme in 1992-93. These were in the line with the recommendation of the Chakravarty Committee and Narsimah Committee.

Another noteworthy reform in process of borrowing was the reduction of the differences between the interest rate on market borrowing and other internal liabilities i.e. small savings, provident funds etc. in 1993-94. Further in 1994-95, there was inclusion of loan in conversion of maturing treasury bills and Zero Coupon Bonds and increase in the rate of interest on 'other internal liabilities'.

4. Fiscal Responsibility and Budget Management Act (FRBM Act)

The deterioration of fiscal situation and high fiscal deficit of Government of India by the latter half of the 1990s renewed the urgency for improving public finances at both Centre and State level. Government of India set up Committee under chairmanship of Dr. E.A.S. Sarma in 2000. Based on the recommendations of the Sarma Committee, the government introduced the Fiscal Responsibility and Budget management bill in December 2000. In this Bill numerical targets for various fiscal indicators were specified. The Bill was referred to the Standing Committee on Finance of the Parliament. With the approval of the Parliament and clearance from the Standing Committee on Finance, the President of India gave his assent on the Bill on August 26, 2003. The Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act, 2003) came into force from July 5, 2004.

The Fiscal Responsibility and Budget Management Act-2004 is in place for around ten years now. Until 2007-08, the introduction of FRBM Act coincided with significant improvements in major fiscal indicators. Between 2003-04 and 2007-08, the central government fiscal deficit declined from 4.48 percent to 2.54 percent of GDP, achieving one-year in advance the medium-term target of 3 percent of GDP. More than two-third of fiscal adjustment over this period was due to revenue gains, with improvements in tax performance underpinned by rapid economic growth, strong corporate profits and improvements in tax administration as measured by effective tax rates. The rest of the adjustment came mostly from the declining interest payments (Simone and Topalova 2009). Although, there has been almost no correction on the expenditure side, the entire fiscal adjustment driven by enhanced revenue.

However, due to global financial crisis, this trend was suspended and the fiscal consolidation as mandated in the FRBM Act was put on hold in 2008-09. The crisis called for increase in the expenditure by the government to boost demand in the economy. As a result of fiscal stimulus, the government moved away from the path of fiscal consolidation. In 2009-10, the central government deficit reached a historical high leading to elimination of the fiscal improvement achieved since the introduction of the FRBM Act. Part of this widening can be attributed to fiscal measures undertaken since October 2008 to support economic growth in response to the global financial crisis as well as a deceleration in tax revenue due to the slowdown in economic activity.

5. Conclusion

Fiscal reform process was the key component of the economic reforms with the core objective to achieve a reduction in the size of the deficit and debt in relation to GDP. Fiscal reform process was initiated with the main focus on taxation reforms. Important tax reforms undertaken by the central government from time to time related to the reduction in marginal tax rate. Besides, the central commodity taxes i.e. union excise duty and custom duty also under what some changes. Efforts were initiated to curb expenditure growth through implementation of the recommendations of the Expenditure Reform Commission. Numbers of policy changes were also made to implement internal debt management policy by introducing market operation in regard to absorption of government of India dated rupee security and long term Treasury Bills.

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