

Chapter 2

The fiscal challenge

2.1 FISCAL DETERIORATION

The fiscal problem in India has steadily built up from the early 1980s onwards. Figure 2.1 depicts this transition for the revenue deficit, i.e. the gap between revenue receipts and revenue expenditure.

In the early 1980s, there was actually a revenue *surplus* for the states, and for the consolidated accounts of the centre and the states. Both deteriorated sharply through the 1980s. There was a sharp runup of the deficit in the late 1980s, which ended with the BOP crisis of 1991. This was followed by efforts at fiscal caution until 1997, after which the central revenue deficit deteriorated sharply.

Figure 2.2 shows the corresponding information for the gross fiscal deficit. The gross fiscal deficit of the centre peaked in 1986, after which it has dropped. However, the gross fiscal deficit of the states, which was stable at roughly 2% of GDP to 3% of GDP until 1996, rose sharply thereafter. As a consequence, the consolidated deficit of the centre and the states has attained all time highs in the recent period.

This worsening of the deficit came about through a combination of weak tax revenues, a sharp increase in the wage bill, rising

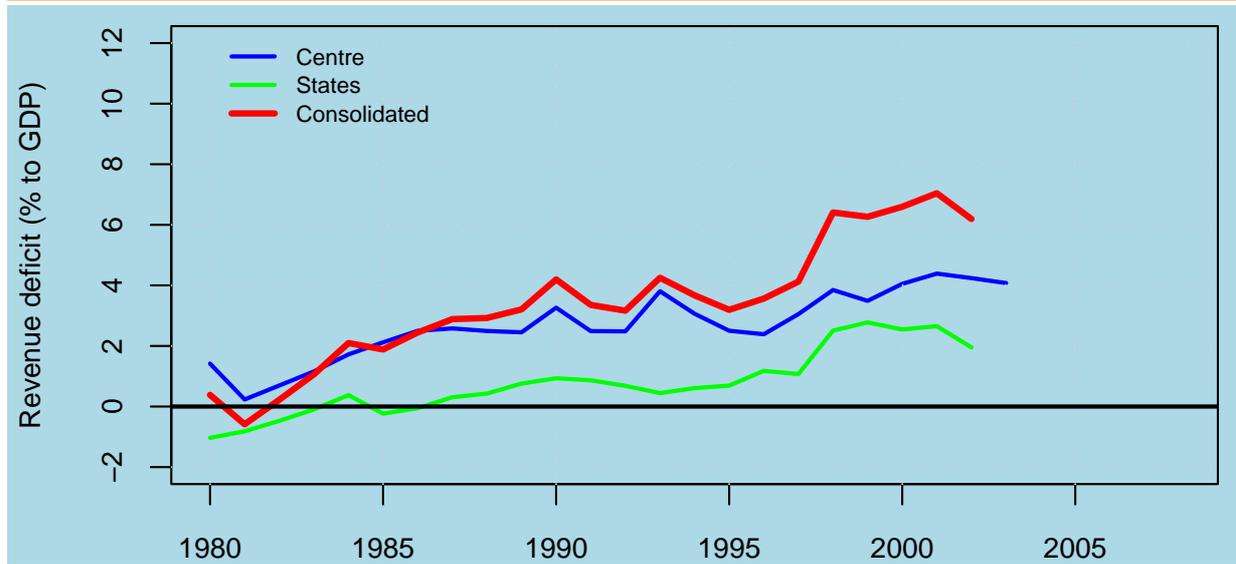
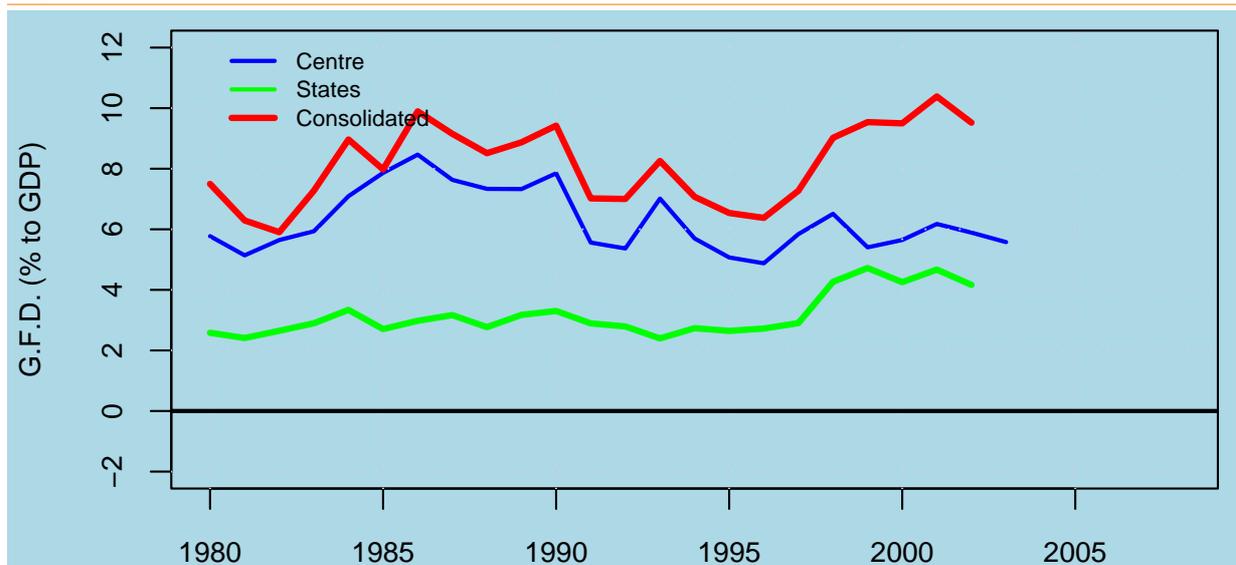
interest payments, and rising subsidies.

2.2 EVOLUTION OF TAX/GDP RATIO

The Central Tax/GDP ratio, measured using central gross taxes, peaked at 10.6% in 1987-88. It dropped sharply to 8.8% of GDP in 1993-94 and to a low of 8.3% in 1998-99. From this level, it rose to 9.3% in 2003-04.

For the purpose of comparison, we focus on the 51 major countries of the world who have a PPP GDP above \$100 billion. Figure 2.3 shows a graph of how the Tax/GDP ratio varies with GDP. India has one of the lowest levels of the Tax/GDP ratio in the world. This low Tax/GDP ratio has been a central feature of India's fiscal problem.

While India's fiscal system appears to have made little progress, when viewed through the Tax/GDP ratio, a great deal of qualitative progress has been made through tax reform, which has set the stage for a growth of the Tax/GDP ratio in a way that is consistent with rapid economic growth, and raising resources for financing public investment, producing public goods of adequate quality and quantity, and supporting enhanced spending on social programs in areas such as education and health.

Figure 2.1 Trends in revenue deficit**Figure 2.2** Trends in gross fiscal deficit

2.3 DIAGNOSING THE POOR PERFORMANCE ON TAXES

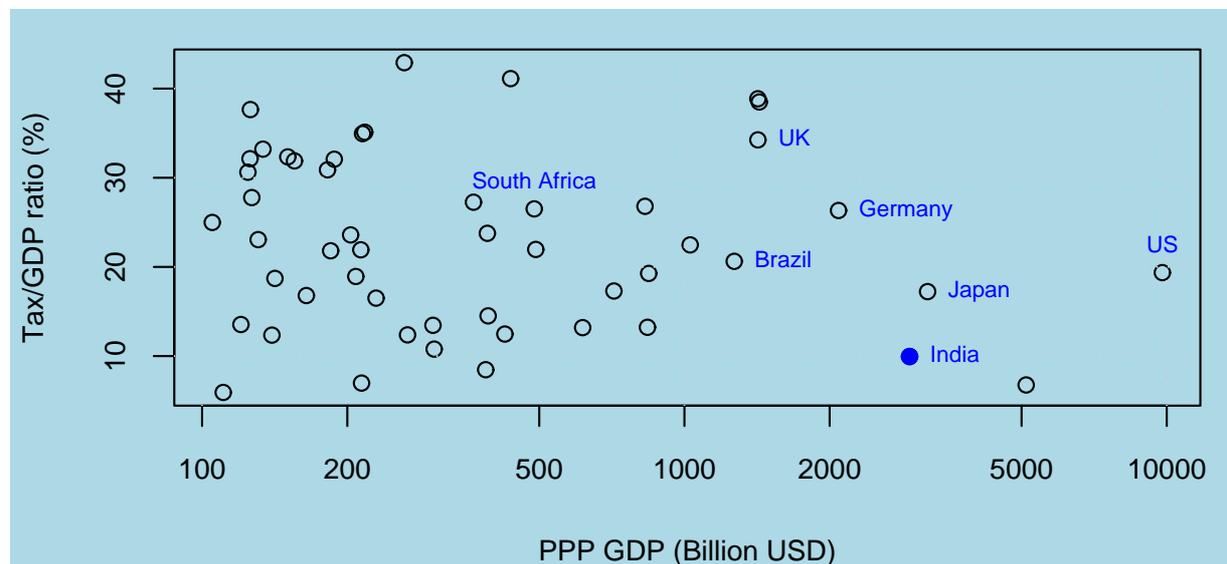
A sound diagnosis of the causes of the low Tax/GDP ratio, and of poor tax buoyancy (particularly in the case of excise) is a

necessary precondition for emerging with policy proposals in terms of improvements in tax policy and administration.

This question has been extensively studied and debated in recent years. The key elements at work appear to be as follows:

Figure 2.3 Variation of Tax/GDP ratio with GDP (across 51 large countries)

Information for India in this cross-country dataset reflects only Central taxes. In many countries, the Tax/GDP ratio as commonly reported includes the taxes associated with social security.



- The revenue base has been considerably diminished through exemptions.
- Manufacturing has been the focus of indirect taxation. The service sector is now larger than 50% of GDP. While taxation of services has commenced, the service tax accounts for less than 0.5% of GDP.
- Tax compliance is expensive, for honest citizens, and the probability of getting caught is low, for violators. This has led to an endemic culture of tax avoidance. India considerably lags the best international practice in exploiting information technology and new ideas in process design, in obtaining a frictionless and efficient tax administration which does not impose compliance costs upon honest citizens while faring well at spotting violators.

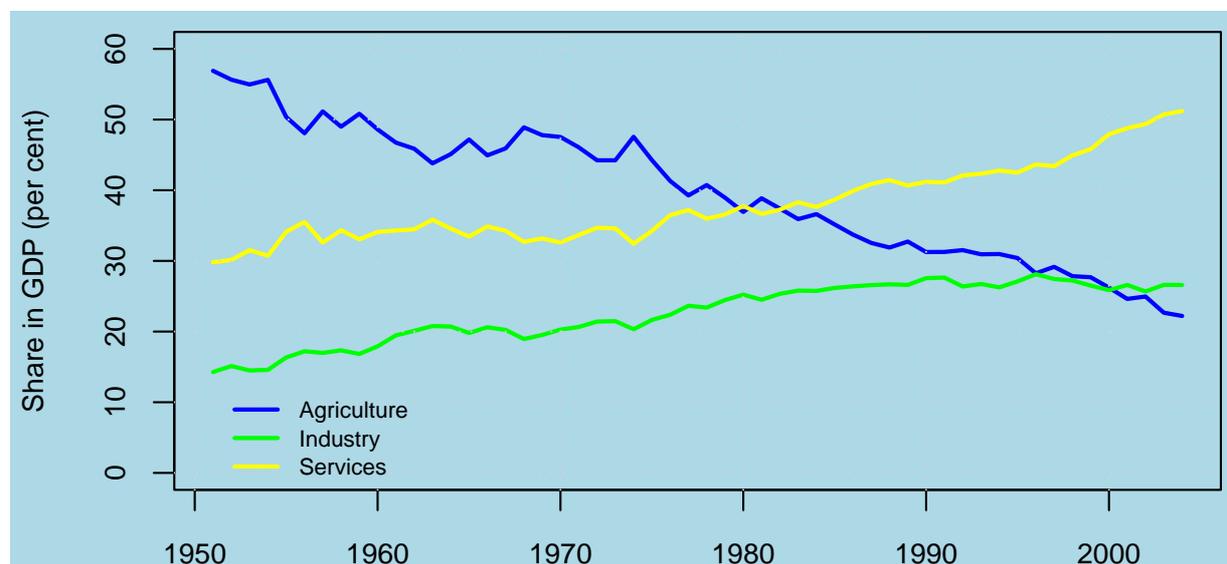
In public discussions, the main focus of diagnosing problems of the tax system has been on their impact on the tax-GDP ratio. However, an equally important dimension has been the *impact on GDP growth*. The pervasive structure of exemptions and spe-

cial clauses in the tax code has distorted resource allocation and adversely affected GDP growth. Firms and individuals should make decisions based on efficiency considerations and not tax considerations. Every decision influenced by tax considerations is a suboptimal decision from the viewpoint of maximising India's economic development.

The present tax system is regressive, since the richest individuals and firms are able to harness the energies of tax consultants and lawyers, which are devoted on exploiting the complex tax system. Millions of man-hours of high-skill individuals are presently devoted to this quest. The move towards a simple tax system will give a more fair distribution of the tax burden in the economy.

Figure 2.4 Evolving structure of GDP

The share of agriculture in GDP rose from 43.8% of GDP in 1963 to 47.6% of GDP in 1974. From that point onwards, agriculture has steadily become a smaller part of GDP. The share of industry rose till the mid 1990s. From the mid 1980s onwards, the largest component of GDP has been services.



2.4 THE COMPOSITION OF TAXES

Figure 2.4 shows the familiar evidence about the evolving structure of India's GDP. The share of agriculture in GDP has dropped sharply, particularly in the period after 1974. From the mid 1980s onwards, services has been the largest single component of GDP. While the share of manufacturing grew in the early years, this expansion of the share of manufacturing has been halted in recent years.

Figure 2.5 juxtaposes the taxation of manufacturing with the evolving composition of GDP. In the early years, taxation of manufacturing was sharply escalated, to a point where excise accounted for over half of the central tax revenue. While this share has reduced, the share of excise in tax revenue continues to far exceed the share of manufacturing in

GDP. While the services to GDP ratio is in the region of 50 per cent, the share of the service tax is below 0.5 per cent of GDP.

Figure 2.6 breaks down gross central tax collections into three components: Customs, taxation of goods and services, and Income tax applied upon both individuals and firms. The percentage contributed by each of these three is shown on the graph, and the three percentages add up to 100. The major tax reforms, which have taken place from 1987-88 onwards, are visibly manifested in this graph.

As recently as 1997-98, income tax was the smallest of these three components, where it made up just 26.7% of overall tax revenues. From this situation, we have a striking turnaround by 2003-04 (a period of just six years), where income tax was the largest of the three components. This reflects the

Figure 2.5 Evolution of GDP and tax composition

As this graph shows, in the early years after independence, taxation of manufacturing was sharply escalated, to a point in the early 1970s, where excise accounted for over half of the central tax revenue. Over the following years, the share of excise has declined to below 40 per cent, reflecting the processes of tax reform in the country. However, excise continues to contribute a disproportionate share of total tax revenues. In parallel, the services to GDP ratio has grown steadily to near 50 per cent. Services continue to contribute a negligible fraction of total tax revenue.

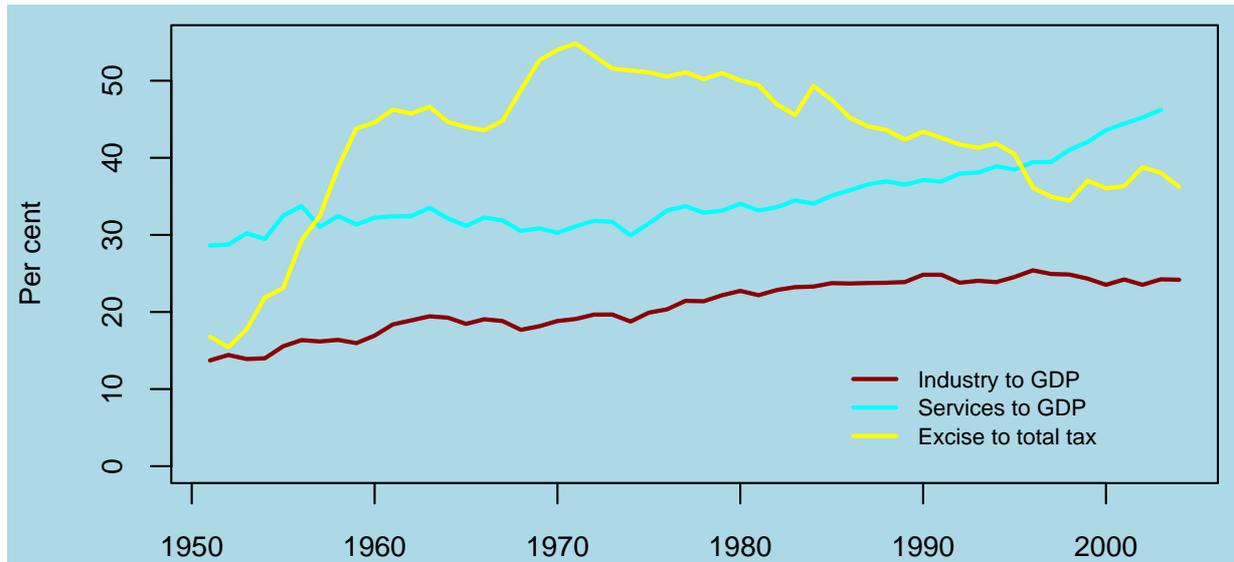
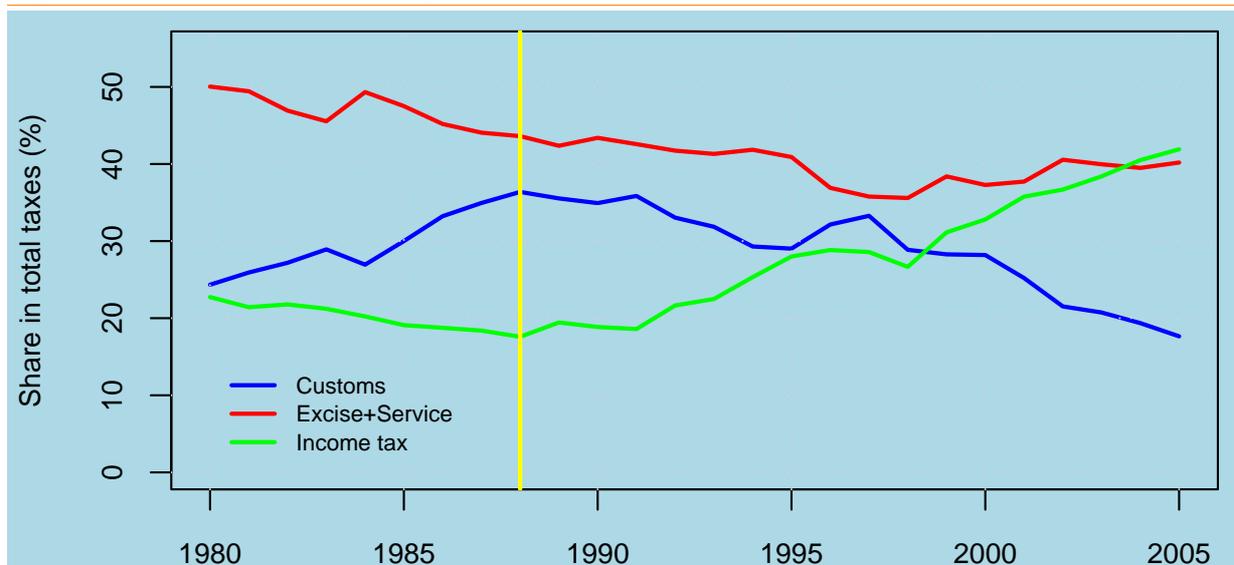


Figure 2.6 Evolution of tax composition (share in taxes)



important accomplishments of tax reform in this period.

It is interesting to observe that 1987-88, which was the year where the central Tax/GDP ratio peaked at 10.6%, was also the year where the proportion of customs tax revenues in the total tax collections peaked, at 36.4%, and the proportion of income tax collections was the lowest, at 17.6%.

Put together, excise and service tax - which reflect the taxation of goods and services - have stayed broadly constant from 43.6% in 1987-88 to 40.2% in 2004-05 BE.

Figure 2.7 re-expresses these same series as percentages to GDP, which is a particularly useful parametrisation when faced with medium-term fiscal planning.

Here also, 1987-88 stands out as the peak year of the traditional framework of tax policy, with a dependence on indirect taxes in general and on customs duties in particular. In that year, customs collections were 3.87% of GDP, excise was at 4.64% of GDP and income tax stood at 1.87% of GDP.

Compared with this starting point, sharp changes have come about. Customs duties have fallen to 1.79% of GDP. Excise has now been augmented by the service tax, and the combination yields 3.65% of GDP. Income tax has risen to a level of 3.75% of GDP. On income tax, the Tax/GDP ratio has risen steadily from 1991-92 onwards. In the case of excise and service tax, the poor performance of the Tax/GDP ratio appears to have bottomed out in 1998-99, where it dropped to 3.17%, and after that this ratio has risen to 3.65% of GDP in 2003-04.

2.4.1 The problem of customs

In the area of customs, the reforms process has obtained major progress in the period after 1991. As part of the removal of protectionist policies, and a move towards ASEAN levels of tariffs, there has been a sharp reduction in customs tariffs, and a consequent drop in the share of customs revenues. There has been a considerable effort on improving income tax collections, both for individuals and companies, through reduction of rates and rationalisation.

From 1987-88 onwards, the share of customs has consistently dropped, to a level of 17.6% in the 2004-05 BE, while income tax has risen sharply, from 17.6% in 1987-88 to 41.9% in 2004-05 BE.

In order to evaluate the international experience, Figure 2.8 shows the share of import duties as percent of total tax revenues in 2001, for the 51 countries with a PPP GDP of above \$100 billion. In this group, India stands out as having an extremely high share, at roughly 20%.

If we exclude the four countries labelled on the map, the remaining 47 countries have an average of 3.83% of tax revenues coming from import duties. China, which has had great success with exporting, gets only 2.76% of its tax revenues from import duties.

The data above *overstates* the extent of customs tariffs in India, since they report the sum of customs and of CVD. CVD is, primarily in lieu of domestic production or consumption taxation. If India had a single VAT, then the CVD would be at this VAT rate. In other countries, the VAT that is charged on imported goods at the point of entry is shown as VAT revenue, and not customs

Figure 2.7 Evolution of tax composition (percent to GDP)

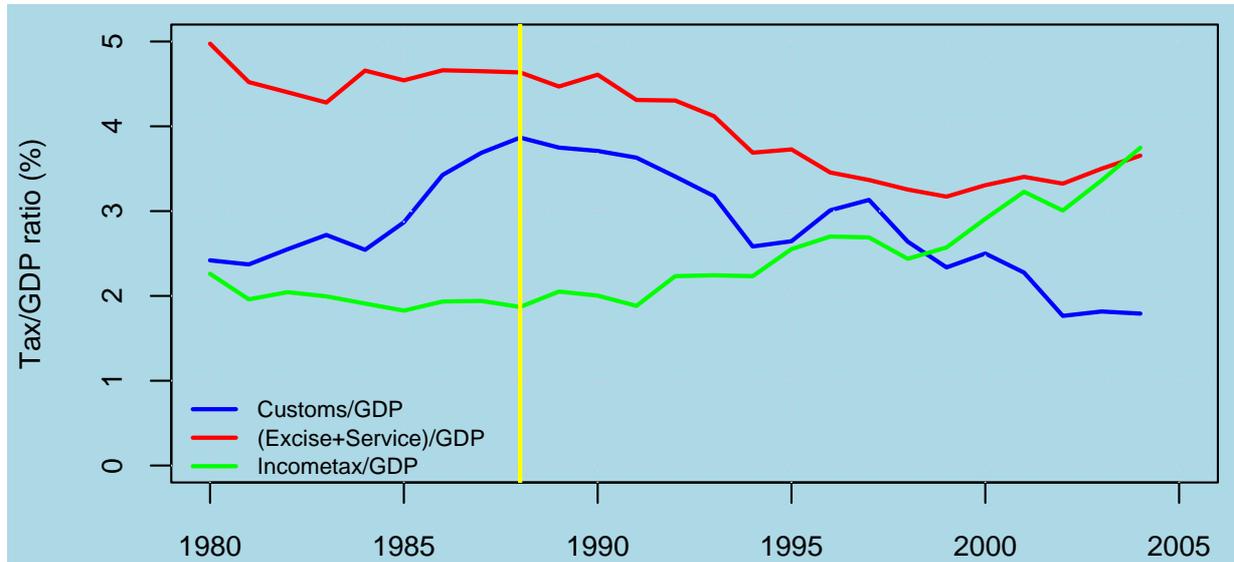
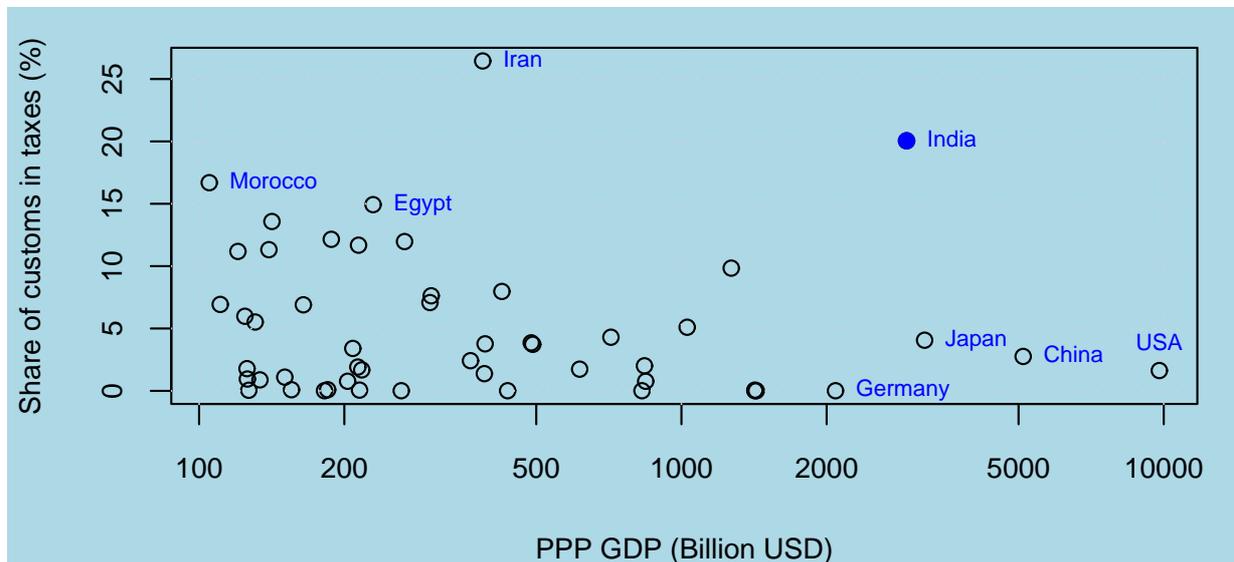


Figure 2.8 The share of import duties in taxes (across 51 large countries)

As emphasised in the text, Indian data for customs revenues are overstated to the extent that CVD on imports is conventionally classified as customs revenues. The normal international convention consists of classifying VAT on imports as VAT, and not as customs revenues. For this reason, the value seen for India here is overstated.



revenue. In India, this is conventionally lumped into customs, thus *overstating* the extent of taxation of imports.

As an example, in 2003-04 (RE), of the total customs collections of Rs.49,350 crore, collections on account of CVD (including

Table 2.1 Large countries with a high ratio of import duties to tax revenues (2001)

Rank	Country	Ratio
1	Iran	26.45
2	India	20.05
3	Morocco	16.69
4	Egypt	14.93
5	Chile	13.58
6	Algeria	12.15
7	Pakistan	11.97
8	Bangladesh	11.68
9	Venezuela	11.32
10	Peru	11.18
11	Brazil	9.84
12	Argentina	7.97
13	Colombia	7.62
14	Philippines	7.08
15	Nigeria	6.93

SAD) were Rs.20,451 crore, or 41 per cent. Similarly, in 2004-05 (BE), 35.7 per cent of the budgeted customs revenues come from CVD.

2.4.2 The problem of taxation of services

Inadequate taxation of services has been an important weakness of the tax system. The share of the services sector in GDP has grown sharply over time (see Figure 2.4). Yet, the focus of indirect taxes - through excise and customs - has been on manufacturing.

As of 2002-03, industry was 24.2 per cent of GDP, but excise tax collections were 38 per cent of central tax collections. Services were 46.2 per cent of GDP (Figure 2.4, Figure 2.5). Some of this anomalous taxation of manufacturing but not of services has been addressed by the introduction of the service tax. While service tax revenues have grown rapidly, service tax remains at unacceptable levels of below 0.5% of GDP.

Problems of allocative efficiency

The low tax rates prevalent for the fast-growing services sector have adversely affected the tax base. This has generated a bias in favour of higher tax rates on the manufacturing sector and on high import duties, in order to maintain the tax-GDP ratio. These high tax rates have adversely impacted compliance. By discriminating against the manufacturing sector, they have also adversely affected allocative efficiency.

At present, the bulk of indirect taxes is paid by consumers of goods and not services. This has tended to affect consumers' choice in favor of consumption of services. Further, the selective taxation of a few services that has come about through the 'service tax' has covered a small subset of the services sector, and distorted consumption of services in favor of untaxed services.

The Indian consumer is known to be remarkably sensitive to apparently small changes in relative prices. The goal of a rational tax system is to *empower households* to engage in undistorted decision making. Whether a household seeks to buy clothes or shoes or the services of a restaurant or a bank or a phone company: these decisions should be entirely cater to the needs and preferences of the household, without any distortions introduced by the tax system.

Problems of equity

The poor tend to consume necessities, with little value addition. The rich spend a larger fraction of their incomes on services. For example, the poor eat primary food and make do with simple clothing. The rich spend an ever-larger amount on the services of cooks

(e.g. restaurants, processed food) and tailors (e.g. readymade clothes, designer clothes, personal tailors). Therefore, a symmetric tax framework covering the services sector is desirable from the viewpoint of both horizontal and vertical equity.

Problems of tax administration

The selective taxation of a few services innately causes definitional ambiguities, giving rise to classification disputes. When some services are taxed and some are not, there will always be an attempt on the part of service provider to label their service as belonging to the non-taxable category. More importantly, the central VAT (CENVAT) only extends into manufacturing. Tax credits are not given for services purchased by manufacturers, or manufactures purchased by service producers. This serves to break VAT chains, distorts production through cascading taxation, and increases the likelihood of evasion.

2.4.3 Perspective on future improvements

There is a striking contrast between customs duties, and the other taxes, in terms of a perspective on tax reform.

In the area of customs, there was a time when shifting to a modern economic policy framework - i.e., without protectionism - was difficult since it would be associated with fiscal stress. For example, in 1987-88, customs tax revenues were as large as 36.4 per cent of Central tax collections, and reforms on customs duties were innately difficult. *That phase is now largely behind us*, since the customs revenues are now in the region of 17 per cent of tax collections. This

figure is itself inflated - owing to the inclusion of CVD in customs. In addition, lower customs duties would be associated with a lower *outgo* for government on account of duty drawback.

Thus, the difficult part of customs reforms is now behind us, and further reductions in customs duties are now not difficult to obtain. When customs rates go down in the future, the fiscal cost will hence not be a serious problem since (a) The CVD portion of what is shown as customs revenues will be unaffected, (b) As rates go down, duty drawback payments will also go down. However, medium-term fiscal planning efforts do need to undertake special efforts in overcoming the loss of revenue from customs in the years to come.

In contrast, in the case of income tax and excise, the reforms that have been achieved so far have been the relatively easy ones, since they have primarily involved cutting rates, which is politically popular. Service tax was introduced in a simple manner, as an excise on a few services, without integration into VAT chains. The challenges that lie ahead are now the more difficult areas, such as removing exemptions, modernising tax policy in the area of excise and service tax, etc.

2.5 MAJOR COMPONENTS OF REVENUE EXPENDITURE

Two of the major components in revenue expenditure are interest payments and subsidies. These components of expenditure can meaningfully be expressed in two ways: as per cent to GDP, and as per cent to revenue receipts.

Table 2.2 Growth of interest and subsidies

	Percent to GDP		Percent to revenue receipts	
	Interest	Subsidies	Interest	Subsidies
1982-83	2.1	0.9	23.1	11.1
1992-93	4.2	1.4	41.9	14.6
2002-03	4.8	1.8	50.8	18.8

In the case of interest receipts, the steady growth of the Debt/GDP ratio has led to a corresponding growth in interest payments. In recent years, the decline in interest rates has masked the earlier trend of rapidly growing interest outgo.

In the case of subsidies, there are important problems of measurement. The elements of expenditure which are classified as a 'subsidy' in budget documents are only a subset of the overall subsidies. There are also many other expenditures which are actually subsidies, i.e. narrow transfers to a few households or firms, without any public goods characteristics. Hence, the size of subsidies as seen using the standard budget data substantially understates the actual extent to which the expenditures of government are being devoted to transfers/subsidies instead of being deployed on producing public goods.

Another area where subsidies exist but are not explicitly reported is the issue of 'tax expenditure'. One of the important reasons for the low Tax/GDP ratio is the erosion of the tax base through a large number of exemptions. Such exemptions are fiscally identical to subsidies. That is, *tax revenues foregone are no different from explicit subsidies paid out.*

As an example, if the government loses Rs.1,000 crore on account of the tax exemption of a certain 'small savings scheme', that is identical to a framework where the exemption did not exist, but

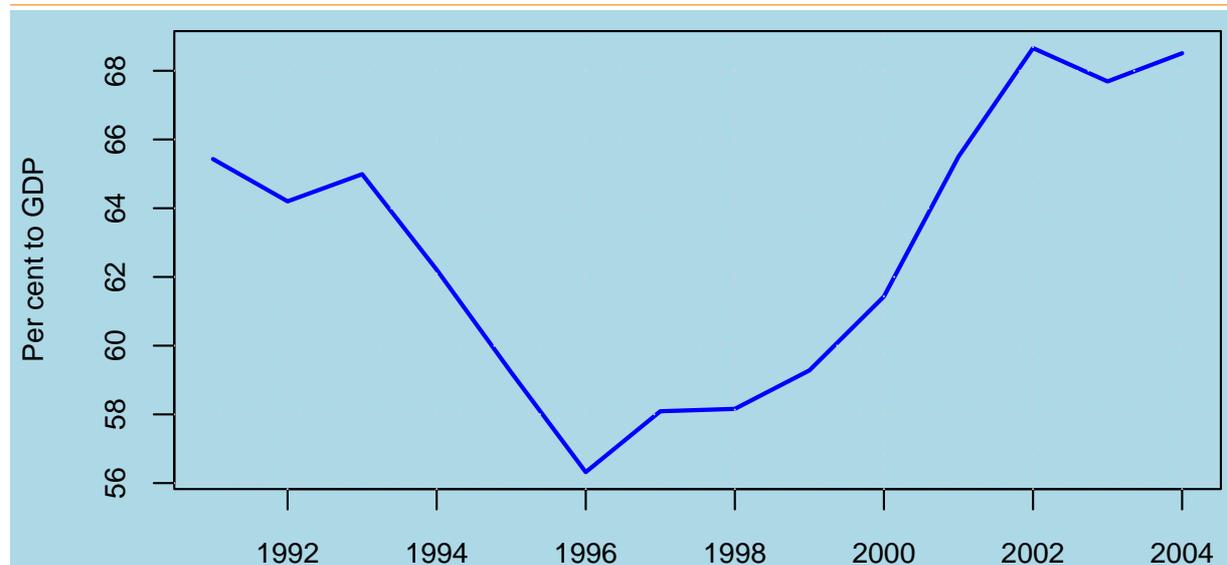
explicit cheques of Rs.1,000 crore were written by government to those individuals.

Table 2.2 summarises the experience with these components of expenditure over twenty years. In 1982-83, interest and subsidies added up to 34.2 per cent of revenue receipts. In 2002-03, this had doubled to 79.6 per cent. This has increasingly reduced the fiscal space available for the legitimate expenditures of government on the production of public goods. These numerical values understate the extent of this problem, to the extent that the full extent of subsidies is larger than portrayed by these statistics.

The essence of the challenge in terms of debt dynamics is the rising Interest/GDP ratio. This rose from 3.7 per cent of GDP in 1989-90 to 4.5 per cent of GDP in 1999-00. From this point onwards, interest payments have benefited from the sharp drop in interest rates, which has helped to contain the Interest/GDP ratio to 4.8 per cent in 2002-03. This sharp decline in interest rates is unlikely to be repeated in the future. Even under stable interest rates, in the absence of fiscal consolidation, the debt dynamics in the future could generate a higher Interest/GDP ratio.

2.6 FRBM

Figure 2.9 shows the evolution of the Debt/GDP ratio. While interest rates have fallen, and have generally been below

Figure 2.9 Historical Liabilities/GDP ratio

nominal GDP growth, persistent revenue deficits have been financed by new debt. This has led to an escalation of the Debt/GDP ratio. In particular, the fiscal deterioration has been particularly marked in the eight-year period from 1996-97 to 2004-05, where the Liabilities/GDP ratio worsened by 12.2 percentage points.

The persistent fiscal deficits, and the steadily growing Debt/GDP ratio, constitute the most important challenges affecting India's growth prospects. In response to this challenge, Parliament passed the Fiscal Responsibility and Budget Management (FRBM) Act, which was notified on August 26, 2003.¹ A central requirement of the FRBM concerns

¹The history of the FRBM may be summarised as follows. A committee headed by Dr. E. A. S. Sarma was setup in January 2000 in order to recommend draft legislation on fiscal responsibility. This report was submitted in July 2000. The bill was introduced in Parliament in December 2000, and enacted as law in August 2003, after a period of extensive discussion and analysis.

the revenue deficit in 2007-08: it requires that government undertake :

“appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by 31st March 2008 and thereafter build up adequate revenue surplus”

The original FRBM Bill had proposed that the revenue deficit would be eliminated by 2005-06. The Act, as passed by Parliament, modified this to be 2007-08. On 8 July 2004, the Finance Minister announced that an amendment to the FRBM Act would be proposed to Parliament, which would further amend this date to 2008-09. This report defines its target as being the elimination of the revenue deficit by 2008-09.

The Central Government is required to fix annual targets indicating the path of adjustment, and required policy measures, so as to eliminate the revenue deficit. Table 2.3 summarises the requirements that were proposed by the FRBM Bill, that were

Table 2.3 Requirements of the FRBM

Requirement	FRBM Act	FRBM Rules
<i>Revenue deficit</i>		
Date for elimination	31/3/2008	
Min. annual gain		0.5% of GDP
<i>Fiscal deficit to GDP</i>		
Ceiling		3% by 31/3/2008
Min. annual gain		0.3% of GDP
<i>Guarantees</i>		
Max. annual issuance		0.5% of GDP
<i>Total liabilities</i>		
		Incremental flow capped at 9 per cent of GDP in 2004-05; this ceiling to be reduced by 1 percentage point of GDP every year.
<i>RBI primary market purchases of GOI bonds</i>		
	Cease on 1/4/2006	

enacted as the FRBM Act (2003), and are in the FRBM Rules (2004). The full text of the FRBM Act and the FRBM Rules is presented in Appendix C of this report.

A minimum annual reduction of 0.5 per cent of GDP in the revenue deficit, and 0.3 per cent of GDP in the fiscal deficit, is required by the FRBM Rules. This is a floor, and for a credible adjustment path, the actual correction will need to be higher in the years in which the correction takes place. The Rules also provide for an end-period target, namely that by March 31, 2008, the fiscal deficit will be below 3 per cent of GDP.

Additional liabilities assumed by the Central Government are required - under the FRBM Rules - to go down progressively by at least one percentage point of GDP every year from a level of 9 per cent in 2004-05.

In addition, the FRBM embeds a series of improvements in the area of transparency and medium-term fiscal planning. It requires that three reports be placed before houses of

Parliament every financial year:

Macroeconomic Framework Statement This report shows the underlying assessment of growth prospects, and the underlying assumptions. It defines the macroeconomic backdrop under which the fiscal policies and projections are being made.

Fiscal Policy Strategy Statement This report specifies the policy measures pertaining to taxation, expenditure, subsidies, administered prices and borrowing.

Medium-term Fiscal Policy Statement This report specifies three-year rolling targets for prescribed fiscal indicators, and the underlying assumptions.

The FRBM Act requires that the Finance Minister conduct quarterly reviews of receipts and expenditure, and place the outcome of these reviews before Parliament. He is required to make a statement in Parliament explaining the reasons for deviations from the FRBM Act obligations, and remedial measures that are proposed to be taken in order to overcome these.