Resources for Equitable Growth

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I. Introduction

Confronted with demands for increased expenditure on programmes to accelerate employment growth, alleviate poverty and address the worst forms of human deprivation, a common refrain has been: "Where will the money come from?" Several notions are implicit in this rhetorical question (which is often not really looking for an answer). The first is the idea that surplus resources in the system available for allocation to such expenditures are limited. The implicit perception is that, if the government seeks to tax away a larger part of available surpluses to finance social expenditures, it would create disincentives for private investment and thereby adversely affect growth. The second is the view that, if we take the current tax-GDP ratio as given (which it is not) or at least given in the short to medium term, it would be wrong on the part of the government to increase social expenditures of various kinds by resorting to borrowing. The decision to legislate the Fiscal Responsibility and Budget Management (FRBM) Act to force the government to reduce to pre-specified levels the revenue and fiscal deficits is the obvious result of such a view. Finally, underlying the above question is the view that the government should not use supportive financial policies to ensure the flow of resources to finance activities in sectors that can ensure a more equitable path of development. Such intervention is opposed on the grounds that it leads to financial repression, low or distorted interest rates, low savings and a misallocation of that savings. Based on such a perception, financial liberalisation has dismantled and is dismantling many of the measures instituted in the past to ensure the flow of finance to sectors such as agriculture, small scale industry and traditional manufacturing.

The prevalence and influence of this perspective has had two consequences: the first is that even when there is a recognition of the urgency of adopting and implementing certain kinds of social policies such as provision of social security to unorganised workers, the policy is not advanced with confidence or is even abandoned, for fear of a "drain on the exchequer". The second is that even when policies are adopted they are implemented tardily or not at all, because of the fiscal conservatism that grips most sections of government. There is reason to believe that the Approach Paper to the XIth Five Year Plan is trapped between a degree of fiscal conservatism and the recognition of the need for "inclusive" growth. As a result, many of the objectives it identifies are likely to remain unrealised unless the prevailing fiscal mindset is changed and the FRBM Act modified or repealed. In the circumstances, this paper seeks to examine the effects of each of the three perceptions underlying fiscal conservatism delineated earlier, questions their validity and offers some alternatives.

II. Mobilising resources for development

The idea that surpluses are limited challenges what was for long considered sound economic judgment. In the 1950s and 1960s, economists concerned with development had concluded that national savings and government revenues in most developing countries were as low as they were not because these countries were poor, but because their governments had failed to adequately tax the rich in their countries. This meant that tax revenues of the government were lower than warranted. Further, since these richer sections allocated a significant share of their incomes to consumption that would be considered non-essential at the levels of average income recorded in these countries, savings rates were also below their potential.

There is no reason to believe that this is untrue in India today. The fact of the matter is that despite the government's efforts to widen the tax net and improve tax collection, the tax-GDP ratio in India is still low by international standards, including those of many developing countries. As Table 1 indicates India's performance in terms of this indicator is well below that of many similarly placed developing countries.

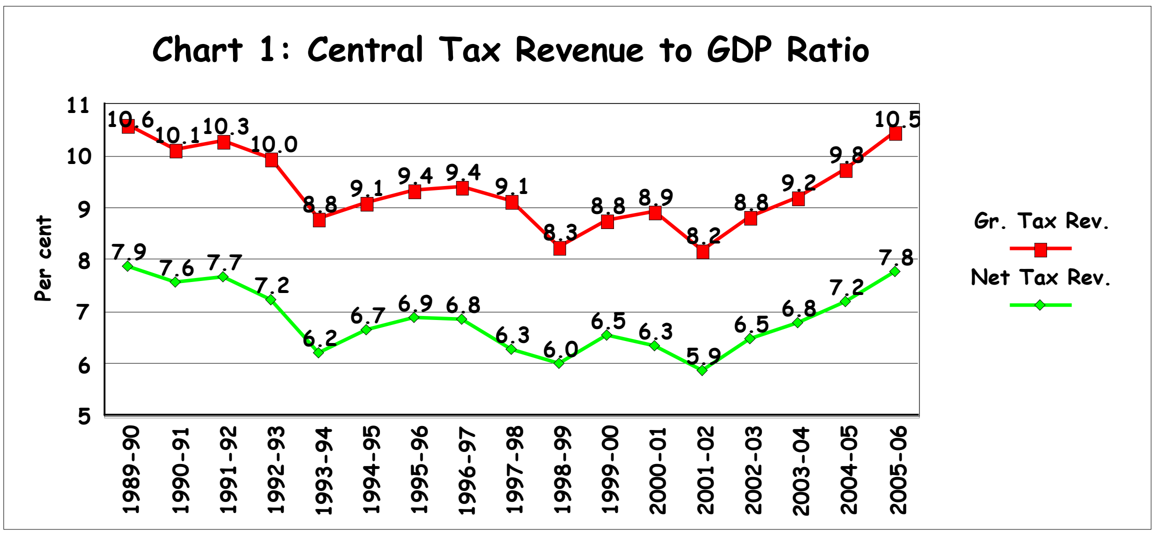
Table 1: Tax-GDP Ratios of Selected Countries (%)

	2000	2003	2004
Kenya	19	-	-
Korea, Rep.	16	-	-
Mexico	12	-	-
Sri Lanka	15	-	-
Bangladesh	-	8	8
China	7	9	-
India	9	9	10
Pakistan	10	11	10
United States	-	10	10
Germany	12	11	11
Indonesia	-	12	12
Venezuela, RB	13	12	-
Argentina	-	13	14
Peru	12	13	13
Philippines	14	13	12
Singapore	16	13	12
Colombia	-	14	14
Thailand	-	15	16
Chile	-	16	16

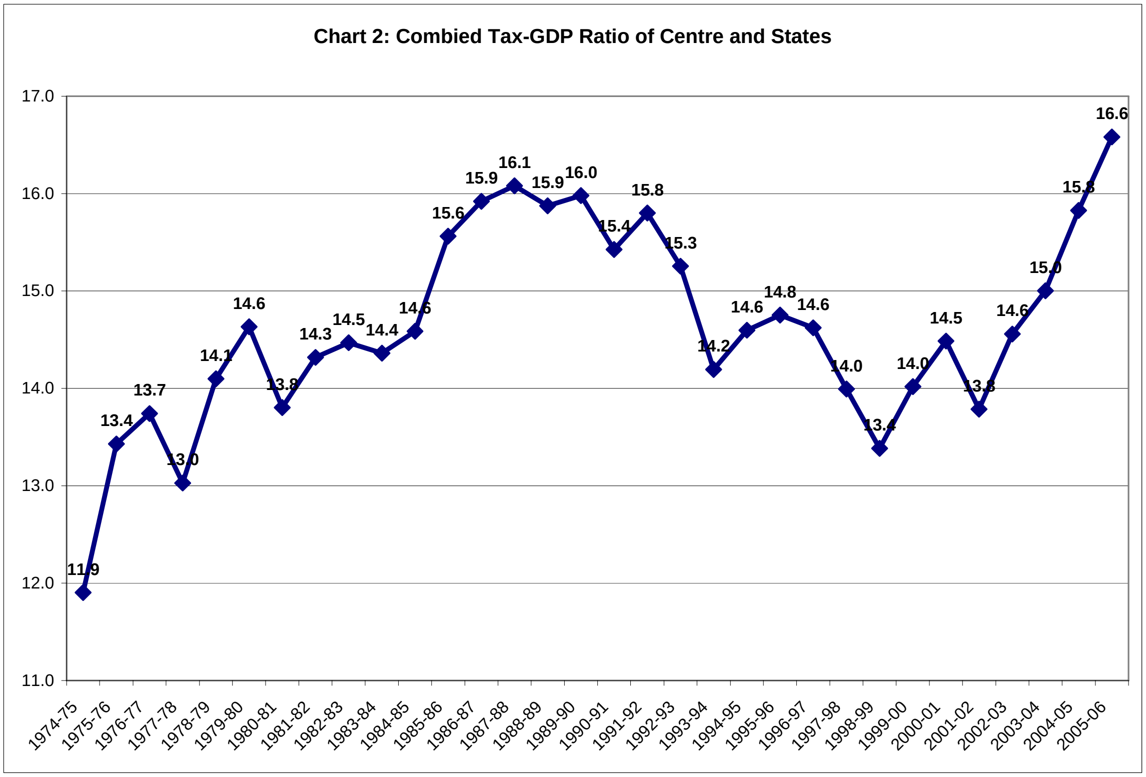
Malaysia	14	18	-
Ghana	-	20	22
Sweden	20	20	-
France	24	22	22
Finland	25	23	23
Norway	28	27	29
United Kingdom	29	27	27

Source: World Bank, World Development Indicators Online

Moreover, the Central tax-GDP ratios in India have been declining till recently. And despite the increase in the ratio in recent years, their 2004-05 values were at around the same level they were at in 1989-90 (Chart 1). Fortunately, because of a renewed tax effort by the states, the combined tax revenue to GDP ratio of the Centre and the States has performed better (Chart 2). But we are still short of desirable levels.



This failure to significantly improve the tax to GDP ratio, in a period when there has been a widening of the tax net through various means, is largely due to the tax concessions provided during the years of liberalisation. What is more, even when corporate profits and managerial salaries are reported to be rising sharply, taxes do not appear as buoyant. An important reason for this is that while inequality increases, marginal tax rates have come down sharply during the liberalization years. In 1985-86, the marginal rate of taxes on personal income was brought down from 62 to 50 per cent and the corporate tax rate from around 60 to 50 per cent. In the budgets of the early 1990s, especially those of 1992-93 and 1994-95, the marginal rates were further reduced to 40 per cent. Today, they stand at around 33 per cent.



Along with this decline, there have been specific tax give-aways that have eroded revenues, especially in areas where returns in recent years have been substantial. A striking example is the income earned from equity investment. There are two principal ways in which income is garnered through such investment: dividends and capital gains. Both have them have benefited from recent tax concessions. To start with, on the grounds that corporate incomes are already taxed so that taxing shareholder dividend income would amount to a form of double taxation, it was decided in 1999-2000, that dividends paid-out to share holders should be made tax free. Being controversial, this decision was reversed in the budget for 2002-03, only to be reinstated again in the Budget for 2003-04.

What has been the fall-out of this exemption? An extremely revealing analysis by B.G. Shirsat (*Business Standard*, July 14 and 22/23, 2006) of 1,050 major dividend-paying, listed companies has found that dividends paid out during the three years ending 2005-06 amounted to Rs. 29,532 crores. Since the beneficiaries of these dividends are likely to be in the highest marginal tax bracket, if this dividend income had been subject to tax, the revenue earned by the government over these three years would have been an additional Rs.10,000 crore (if we assume that the dividend pay out rate would have been the same even if the tax was effective). This is by no means a small sum.

What is noteworthy is the inequality in the distribution of this tax benefit. It is known that a miniscule proportion of the domestic population invests in equity. But even among them the distribution of dividend and therefore the benefit of the tax exemption is highly skewed. Of the close to Rs.30,000 crore of dividends paid out by these companies, Rs.14,000 crore or around 45 per cent accrued to the promoters of the companies themselves. In fact, small or so-called "retail" shareholders received a relatively small share of this benefit. Over ninety per cent of the shareholders holding up to 500 shares each received just over Rs.4000 crore of dividend income, while public shareholders with equity holding in excess of 500 shares garnered Rs.7,575 crore as dividends. A significant amount of the dividend paid to public shareholders went to foreign investors. Foreign institutional investors (FIIs) received Rs.12, 808 crore of dividend income during this period and investors in GDRs and ADRs, NRI investors and other overseas bodies received Rs.4,567 crore. In sum, a combination of promoters, high net worth domestic investors and foreigners were the main beneficiaries of the dividend tax hand out.

There remains the argument that the exemption of dividends from taxes was not a hand out but the redressal of an unjust scheme of double taxation. Even if this is accepted, there remains the fact that there is a high degree of inequality in the distribution of incomes in the country, which the accrual of record dividend incomes seems to aggravate substantially. If the idea was for the government to garner a fair share of the surplus for social and capital expenditures, then the removal of the tax on dividends should have been accompanied by an increase in the marginal corporate tax rate. The fact that the government has not chosen to resort to such an increase only strengthens the perception that it has failed to tax a section of the rich adequately and effectively.

Additionally, if we take account of the fact that the expansion of corporate revenues and profits has not been accompanied by an expansion in employment that can make a difference to the backlog of unemployment and underemployment in the country, then the need for the government to garner surpluses to finance employment promoting schemes is obvious. The failure to garner a share of the surpluses is a failure to ensure broad-based development.

The evidence on unwarranted benefits to investors in equity does not end here. It is visible in the case of the other form of return from equity holding—capital gains—as well. The budget for 2003-04 also decided that, "in order to give a further fillip to the capital markets", all listed equities that were acquired on or after March 1, 2003, and sold after the lapse of a year, or more, were to be exempted from the incidence of capital gains tax. Capital gains made on those assets held by the purchaser for at least 365 days were defined for taxation purposes as long term gains. Long term capital gains tax was being levied at the rate of 10 per cent up to that point of time.

An analysis of share price movements of 28 Sensex companies found that if we assume that all shares purchased in 2004 were sold after 365 days in 2005, the total capital gains that could have been garnered in 2005 would have amounted to Rs. 78,569 crore. If these gains had been taxed at the rate of 10 per cent prevalent earlier, the revenue yielded would have amounted to Rs. 7,857. That reflects the revenue foregone by the state and the benefit accruing to the buyers of these shares. It is indeed true that not all shares of these companies bought in 2004 would have been sold a year-and-one-day later. But some shares which were purchased prior to 2004 would have been sold during 2005, presumably with a bigger margin of gain. And this estimate relates to just 28 companies.

In sum, the stock market alone has become the site for tax-exempt gains of a magnitude which suggest that a more appropriate tax policy relating to dividends and capital gains could have yielded substantial revenues for the government. This is only one area. There are many more such which the government should look to when looking for money to finance crucial expenditures. There is enough money to tap from sources which should be tapped. And there are far too many good purposes that such money can serve.

What needs to be done

Besides stopping all further tax concessions and plugging loopholes that encourage tax evasion and avoidance, there are a number of measures that the government can resort to substantially increase the tax GDP ratio. The first and most obvious, which the government is conscious of, is to collect the large arrears on past tax payments that remain to be collected. Even though tax collections vis-à-vis budget estimates have improved in the recent past (as also the tax to GDP ratio), the problem of tax arrears remains a major problem area for India (Tables 2 & 3).

Table 2: INCOME TAX INCLUDING CORPORATION TAX COLLECTED AND REMAINING UNCOLLECTED

Year	Tax collected			Tax remaining uncollected		
	CT	IT	Total	CT	IT	Total
1	2	3	4	5	6	7
2000-01	35,696	31,764	67,460	24,402	32,029	56,431
2001-02	36,609	32,004	68,613	42,538	47,639	90,177
2002-03	46,172	36,866	83,038	35,057	32,581	67,638
2003-04	63,561	41,387	1,04,948	37,631	50,386	88,017
2004-05	82,677	49,259	1,31,936	39,204	83,977	1,23,181

Source: CAG Report No. 8 of 2006 (Direct Taxes), Page 24; Figures are in Rs crores

Table 3: YEARWISE DETAILS OF ARREAR DEMAND OF EARLIER YEARS (UPTO 2003-04)

		Corporation tax	Income tax	Interest	Others	Total
1	2	3	4	5	6	7
1	Over 1 year but less than two years	9,074.96	7,982.81	6,075.04	1,903.44	25,036.25
2	Over 2 years but less than 5 years	3,990.74	4,218.06	8,303.65	1,625.55	18,138.00
3	Over 5 years but less than 10 years	1,871.65	7,923.03	2,566.64	1,432.18	13,793.50
4	Over 10 years	450.30	352.22	748.69	243.30	1,794.51
Total		**15,387.65**	**20,476.12**	**17,694.02**	**5204.47**	**58,762.26**

Source: CAG Report No 8 of 2006 (Direct Taxes), Page 25; Figures are in Rs crores

The break up of cases contributing to these arrears figures as of 2004-05 provides an interesting picture (Table 4). It is clear that the arrears for non-company cases (referring to individual income tax) is highest in the range of Rs. 1 crore each, which indicates that the maximum tax arrears are still with the richest sections of Indian society. This is significant given the fact that income tax collections formed only 1.5% of GDP with a tax buoyancy of only 1.51.[1]

Table 4: AMOUNT WISE DETAILS OF GROSS ARREARS AND NET ARREARS (UPTO 2004-05)

	Company cases			Non-company cases			Total		
	No. of cases	Gross arrears	Net arrears	No. of cases	Gross arrears	Net arrears	No. of cases	Gross arrears	Net arrears
1	2	3	4	5	6	7	8	9	10
Upto Rs.1 lakh in each case	25,94,275	3,280.64	948.51	41,61,813	2,286.43	6,27.81	67,56,088	5,567.07	1,576.32
Over Rs.1 lakh to Rs.10 lakh in each case	19,443	4,535.47	529.02	5,9507	1,214.36	496.28	78,950	5,749.83	1,025.30
Over Rs.10 lakh to Rs.1 crore in each case	9,388	4,159.83	957.36	12,826	2,660.60	1,131.47	2,2214	6,820.43	2,088.83

Source: CAG Report No. 8 of 2006 (Direct Taxes), Page 26; Figures are in Rs crores

* Net arrears comprise gross arrears minus arrears not fallen due, amounts claimed to have been paid pending verification, amount for which instalments were granted and amount stayed/kept in abeyance

The government has begun an effort to mop up a substantial part of these arrears and there is reason to believe that the recent increases in the tax-GDP ratio are in large part due to this, rather than the collection of new taxes. This suggests that as an interim revenue generation measure the government must strengthen this effort with greater focus on recovering the huge income tax arrears so that a substantial part of the Rs. 1,15,000 crore available under this head is collected as a one time revenue. That would also ensure that any future pile up of tax arrears would be curbed.

A second initiative, the importance of which was discussed above, is the reinstatement of the long-term capital gains tax on traded shares and units of Mutual Funds and the increase of the short-term capital gains tax from 10 to 20 per cent, for both domestic and foreign investors. As noted by Amaresh Bagchi: “Since much of economic power accrues to asset owners in the form of rise in asset values, a tax system that fails to tax capital gains remains gravely deficient and creates a strong bias in favour of the rich. Not taxing capital gains also offends efficiency in that it discriminates in favour of activities like speculation, which beget large gains quickly, as against risk taking in ordinary

[1] All figures are averages for 2000-01 to 2004-05, quoted from TABLE 2.4 of CAG Report No. 8 of 2006 (Direct Taxes), Page 18.

business…exempting long-term gains from only listed equities, as is now proposed, offends not only fairness but also efficiency by discriminating against the unorganised corporate sector and unincorporated enterprises — the small and medium sector — where the bulk of our economic activities take place. In sum, there is no good reason to exempt long-term capital gains from taxation, and that too selectively for gains from listed equities, or for taxing short-term gains at a rate lower than applicable to other incomes, as has been proposed now. It will grievously damage the income tax base and offend both equity and efficiency. Can the transaction tax be a substitute for a tax on capital gains? The answer plainly is "no"…[it] can in no way replace the income tax any more than a sales tax can." (Business Standard, 21.07.04). Even in the US most investors pay capital gains tax at the rate of 15% with some categories of assets inviting capital gains tax of as much as 25% to 28%.

Parallel to this, to discourage speculation arising from similar taxation of short-term and long-term investors, as well as to collect additional revenue, the government must increase the rate at which the Securities Transaction Tax is imposed. Budget 2004 had proposed a rate of 0.15% for the STT, to be paid by the buyers in all segments of the market (equities, bonds, government securities, and derivatives). Due to protests from market players and intermediaries, the rates were reduced. It was decided that 0.075 % STT would be charged both on the buyer and the seller for equities in the case of delivery-based transactions, a paltry 0.015 % for day traders, 0.01 % for the derivatives segment, and nil for bonds and government securities. The Government lost hundreds of crores because of this dilution of the STT brought about under pressure from the speculators and brokers. The STT for day traders was increased from 0.015 % to 0.02 % cent in Budget 2005. Experience has shown that the argument that such a tax would result in a stock market collapse was wrong, with the stock indices surpassing all previous highs even after the STT had been introduced. However, if the objective of the STT is to reduce market volatility and encourage long-term investments in the stock market, there is no good reason why the rates of the STT should not be the same for all kinds of stock transactions, be it delivery-based or non-delivery based, especially since more than half of the total trading volume in the Indian stock market is non-delivery based (day-trading). A flat rate of the STT should be fixed at least at 0.10 % for both delivery-based as well as non-delivery based transactions. There is no good reason to exempt bonds, derivatives and government securities transactions from the STT and the same rate should apply to them as well. The proposed rate of STT, along with the proposed 15% capital gains tax, can together contribute an additional Rs. 5000 crore to the exchequer.

The surge in capital flows into the country and the excessive accumulation of reserves (resulting from central bank intervention aimed at preventing a sharp appreciation of the rupee) has encouraged the government to substantially ease access to foreign exchange for both current and capital account transactions. It is well known that much of the spending of foreign exchange is undertaken by a fraction of the population at the top end of the income spectrum. In return for this freedom to access to foreign exchange from the national pool, the Government should consider imposing a nominal tax on all foreign exchange outflows. This can be done easily by levying a nominal 0.5% tax on all purchases of foreign exchange in India with an exemption limit of $5000. Overseas aid and debt repayments made by the Government should of course be exempted. The Government can also exempt items of essential imports from its purview. This small tax would not only generate substantial revenue but also provide some protection against capital flight. This would also discourage capital flight through overinvoicing of imports.

A fourth measure would be to rationalize Corporate Tax Exemptions. Despite having a scheduled corporate tax rate, which is comparable with developed countries, the effective tax rate for the private corporate sector in India continues to be low due to myriad exemptions. Corporate taxes formed 62.27% of total direct tax collection in 2004-05, amounting to a total of Rs. 82,680 crores. However, the effective tax rate for the private corporate sector in India is quite low (despite scheduled rates being comparable with developed countries) because of tax concessions.

Table 5: Comparison of actual tax receipts with budget estimates

YEAR	BUDGET ESTIMATES	ACTUALS	SURPLUS(+) / SHORTFALL S(-)	% OF SURPLUS/SHORTFALL
2002-03	48,616.00	46,172.35	(-) 2,443.65	(-) 5.03
2003-04	51,499.00	63,562.03	(+) 12,063.03	(+) 23.43
2004-05	88,436.00	82,679.58	(-) 5,756.42	(-) 6.51

Reprinted from CAG Report No 8 of 2006 (direct Taxes), Page 16; Figures are in Rs crores

Table 5 shows that actual receipts of corporate taxes have been consistently lower than budget estimates mainly because of the high level of concessions given to and refunds of corporate taxes in India. While the compound annual growth rate of corporate assessees has been 3.28 for the period 2000-01 to 2004-05 the corporate tax/GDP ratio has only increased from 1.71% to 2.66% (based CAG Report No. 8 of 2006 (Direct Taxes), Tables 2.4 & 2.8. pages 18 and 21).

Although some steps were taken in Budget 2005 to do away with some of the corporate tax exemptions, the corporate tax rate itself was slashed at the same time. This was avoidable and needs to be redressed. Further, the various tax exemptions that exist today need to be rationalised. The Government should urgently review the tax incentives under Section 80IA and 80IB of the Income Tax Act. Currently, 100% profits are exempted from taxation for a period of 10 years for infrastructure projects like Highways and Ports, provision of telecommunication services, development, operation and maintenance of Industrial parks and Special Economic Zones and generation, transmission and distribution of Power. The rate of deduction as well as the period of the tax concession can be reduced for these infrastructure projects as well as for industrial undertakings set up in the industrially backward states. Moreover, exemptions that have been allowed for sectors like Housing, Shipping, Hotel, Oil Refining etc. should be phased out.

Fifth, the existing set of export incentives also needs to be reviewed. An estimate made by the Revenue Department suggested that total duty foregone on account of export incentives was Rs. 39,704 crore, which was 13.6% of total export revenue in 2003-04

(Business Standard, 08.08.04). The multiplicity of export incentive schemes has also led to their misuse. The Government should immediately phase out schemes like the DEPB and EPCG besides curtailing revenue losses on account of Drawbacks and Advance Licence. Moreover, the tax incentives provided to the SEZ units under the SEZ Act 2005 also need to be revisited. Since SEZ units enjoy customs and excise duty exemptions any way, the case for providing 100% exemption from tax on profits for the first 5 years and 50% for the next 5 years does not seem to be justifiable. The Exim Policy of Government also allows duty concessions to the SEZ units for conditional sales to the Domestic Tariff Area (DTA), which clearly discriminates against exporters outside the SEZs. Such concessions should be phased out.

Sixth, it is necessary to broaden the base for the Service Tax. Although the Services sector accounts for 52% of India's GDP, tax mobilization from this sector is a small proportion of total tax revenue. The increase in the rate of the Service Tax to 10% in Budget 2004-05 and the broadening of the Service Tax net in 2005-06 were steps in the right direction. However, Service Tax collection has been disappointing.

Table 6 clearly shows that actual collections have been lower than budget estimates, mainly because of problems in collection. A CAG report states that "Measures taken by the Department to bring unregistered service providers into tax net proved ineffective and inadequate. Audit identified 2492 unregistered service providers in 45 commisionerates with an estimated loss of revenue of Rs.40.96 crores." (Paragraph 5.7, CAG report No. 7 of 2006 (Indirect Taxes), Section-3 SERVICE TAX).

Table 6: The Service Tax Scenario

Year	No. of Services covered	Budget Estimates	Revised Budget Estimates	Actual Receipts	Difference between actual receipts and budget estimates	% variation
2000-01	26	2200	2200	2612	412	18.73
2001-02	41	3600	3600	3302	(-)298	(-)8.28
2002-03	51	6026	5000	4122	(-)1904	(-)31.60
2003-04	58	8000	8300	7890	(-)110	9_01.38
2004-05	71	14150	14150	14196*	46	0.33

Source: CAG report No. 7 of 2006 (Indirect Taxes) , Section-3 SERVICE TAX, amounts in Rs. Crores.

The problem is mainly twofold. On the one hand, there is a high level of tax evasion in this sector by all units under the ambit of service taxes. This is substantiated by the figures provided in Table 7. Moreover, there are serious shortcomings in terms of identifying service providers who are to be taxed. Table 8 provides the position based on the CAG report on 46 commissionerates it audited.

Table 7: NUMBER OF CASES AND AMOUNT INVOLVED IN DEMANDS FOR SERVICE TAX OUTSTANDING FOR ADJUDICATION/RECOVERY as on MARCH 2005

Number of Cases		Amount	
More than five years	Less than five years	More than five years	Less than five years
648	35719	2.97	2532.05

Source: Reprinted from CAG report No. 7 of 2006 (Indirect Taxes) , Section-3 SERVICE TAX, amounts in Rs. Crores

M. Govinda Rao of the NIPFP has quoted estimates by a Government appointed Expert Group to show that the size of the tax base in respect of some key services like transportation and storage, post and telecommunications, banking and financial institutions was likely to be almost Rs 70,000 crore in 1999- 00 (EPW, October 20, 2001). He had suggested broadening the Service Tax base to cover all services except those in well-defined negative and exemption lists. The Government should move fast in this direction. While drawing up the exemption list, the Government should be cautious in avoiding further concessions for sectors, which already enjoy the benefits of tax incentives, like the Information Technology Enabled Services.

Table 8: POSITION OF ALLOTMENT OF PAN BASED SERVICE TAX CODE

Number as on 30th September 2004

Manpower Recruitment Agency			
No. of Commissionerates	No. of Service Providers	No. of Service Providers not allotted STCNs	% of non-allotment
46	5538	2998	54
Security Agency			
46	3900	2614	67

Seventh, the rate of the Wealth Tax should be increased from the current 1% to 3%. In rural areas, the base for Wealth Tax is very low since agricultural land is exempted from being a taxable asset. The Government should consider the imposition of a land ceiling beyond which Wealth Tax exemption should not be granted. Moreover, a tax on conversion of agricultural land for non-agricultural purposes may also be considered. Further, India does not have any inheritance tax, while almost all developed countries do. The Government should consider imposing a progressive Inheritance Tax with a base level of 1% and an exemption limit of Rs. 15 lakhs.

The base of the Wealth Tax should also be broadened. It is evident from the collection of only Rs 265 crore on account of Wealth Tax in 2004-05 that a lot of scope remains to improve upon the collection efficiency as well. It has been noted that this is another area where there are huge arrears but the Central government has taken no positive steps to recover them or try to increase resource generation from the same. As can be seen from Table 9, there are substantial arrears, because of which the percentage of actual collections to arrears have remained below 20% over the last five years. It is also interesting to note that government Budget estimates have remained constant over the period at Rs. 145 crores despite knowledge of huge arrears and an increase in income levels of the richer section of Indian society. It is to be noted that the fall in arrears of Rs. 250.18 crores between the periods 2003-04 and 2004-05 was mainly due to reduction of demand on account of verification, reconciliation and rectification of assessments. Actual cash collection was a meagre Rs. 13 crore.

It emerges from Table 10 that the percentage of pending wealth tax assessments to total assessments is very high because of laxity of the income tax department to complete assessments in this category. The fact that the total number of assesses for the 2004-05 has decreased from the previous years is also to be noted.

Table 9: BUDGET ESTIMATES, ACTUAL WEALTH TAX COLLECTION & ARREARS OF WEALTH TAX DEMAND

Year	Budget estimates	Actual collection	Arrears of wealth tax demand	Percentage of actual collection to the arrears of wealth tax demand
2000-01	145.00	131.73	844.10	15.6
2001-02	145.00	135.36	1,361.04	9.9
2002-03	145.00	153.88	2,122.17	7.3
2003-04	145.00	135.83	1,397.88	9.7
2004-05	145.00	145.36	1,147.70	12.7

Source: CAG Report No 8 of 2006 (direct Taxes), Page 75;
Figures are in Rs crores

Table 10: WEALTH TAX ASSESSEES,
ASSESSMENTS DUE FOR DISPOSAL AND COMPLETED

Year	No. of wealth Tax Assessees	No. of wealth tax assessments due for disposal	No. of wealth tax assessments completed	No. of wealth tax assessments pending	Percentage of pending wealth tax assessments to total assessments due for disposal
2000-01	2,02,171	1,16,406	66,313	50,093	43
2001-02	1,51,676	1,18,530	78,982	39,548	33
2002-03	1,27,766	1,28,186	1,03,976	24,210	19
2003-04	1,35,085	1,09,777	82,702	27,075	25
2004-05	1,01.801	57,475	32,310	25,165	44

Reprinted from CAG Report No8 of 2006 (direct Taxes), Page 76

The government should immediately expedite the process of collecting Wealth Tax and increase the tax rate from the current 1% to 3% with immediate effect. The government should consider imposition of land ceiling beyond which wealth tax exemption should not be granted for rural areas. Moreover, a tax on conversion of agricultural land for non-agricultural purposes may also be considered.

Collection of custom duties too is afflicted by similar problems. Barring 2004-05, customs duty collection has been below budget estimates consistently from 2000-01. The increase in 2004-05 was mainly due to increase in collection of import duty on petroleum products, non-ferrous metals, chemicals and iron and steel.

Table 11: Customs Duty Collections

Year	Budget estimates	Revised budget estimates	Actual receipts	Difference between actual receipts and budget estimates
2000-01	53576	49781	47542	(-)6034
2001-02	54822	43170	40268	(-)14554
2002-03	45193	45500	44851	(-) 342
2003-04	49350	49350	48629	(-)721
2004-05	54250	56250	57610*	(+)3360

Reprinted from CAG Report no 7 of 2006 (Indirect Taxes), Section 1, CUSTOMS;
All figures in Rs crores
*Figure is provisional

There has been a noticeable decrease in import duties over the period mainly because of consistent lowering of import duties by successive Central governments over the period. As a result, import duty as a percentage of total imports has decreased consistently over the period, as shown in Table 12. This is a clear case of import leakage for the economy in a situation where the Government complains of being resource constrained.

Table 12: VALUE OF IMPORTS AND IMPORT DUTY COLLECTED
2000-01 to 2004-05

Year	Value of Imports	Import duties	Import duty as percentage of value of imports
2000-01	228307	46569	20.40
2001-02	243645	39406	16.17
2002-03	296597	44137	14.88
2003-04	353976	48002	13.56
2004-05	490532	55807	11.38

Reprinted from CAG Report no 7 of 2006 (Indirect Taxes), Section 1, CUSTOMS; all figures in Rs crores

Table 13: CUSTOMS DUTY FOREGONE UNDER EXPORT PROMOTION SCHEMES AND DUTY DRAWBACK SCHEME

Year	Advance licence & others	DEPB	EPCG	EPZ/ SEZ	EOU	Duty drawback	Total
2001-02	7890	5661	2008	2064	4219	2957	24799
2002-03	7462	6831	3026	1106	4820	4520	27765
2003-04	10812	11692	3399	1320	9422	3059	39704
2004-05	11741	10076	4681	3457*	8266	2812	41033

Reprinted from CAG Report no 7 of 2006 (Indirect Taxes), Section 1, CUSTOMS; all figures in Rs crores

* includes DFRC/DFCEC

A disturbing feature of customs duties is the loss of revenues due to export incentives under the different schemes like DEPB and EPCG, besides revenues losses from Drawbacks and Advance Licence.

As can be seen from Tables 13 & 14, duty forgone has increased consistently over the period from 2001-02 to 2004-05 under the various schemes. This has had very adverse effects on total custom duty revenues. A major problem in this regard has been the misuse of the multiplicity of export incentives which has led to unscrupulous practices.

Table 14: Customs Duty Foregone

Year	Customs duty collected	Total duty foregone under export promotion schemes	Duty foregone as a percentage of customs receipts
2001-02	40268	24799	62
2002-03	44851	27765	62
2003-04	48629	39704	82
2004-05	57610	41033	71

Reprinted from CAG Report no 7 of 2006 (Indirect Taxes), Section 1, CUSTOMS; all figures in Rs crores

It can be seen that total duty foregone as a percentage of total custom duty collection has been increasing over the period of time. The fall in the figures for 2004-05 is because of the increase in custom collection in the year as explained before.

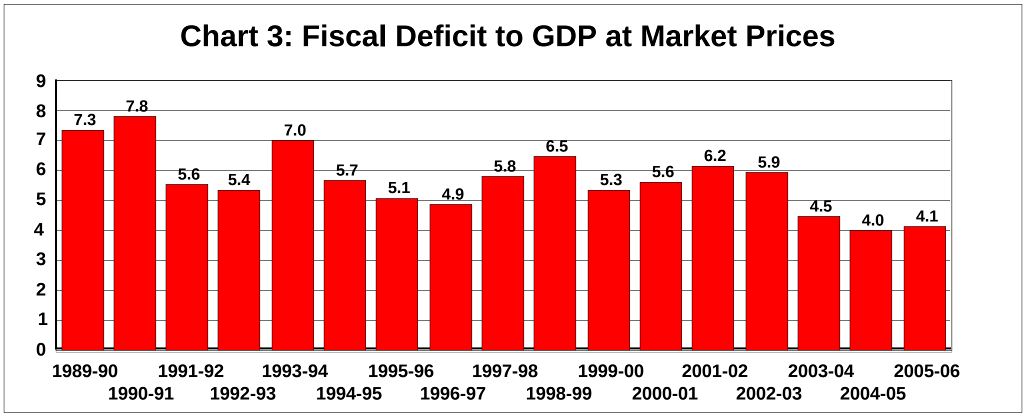
While import concessions must be seriously looked into, the Government should immediately phase out schemes like DEPB and EPCG besides curtailing revenues losses on account of Drawbacks and Advance Licence.

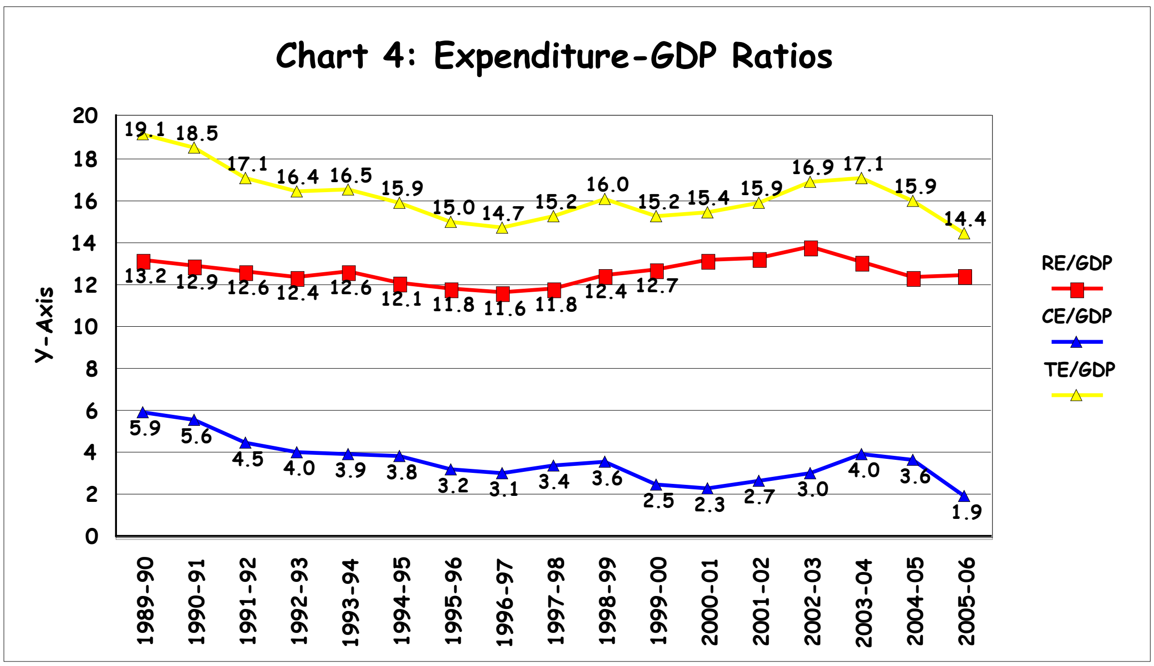
Finally, there is need to increase VAT/Sales Tax Rate on items of luxury consumption. A Schedule of luxury items, which are consumed only by those who are very rich, like diamond jewellery, luxury cars etc. should be drawn up by the Government. Consumption in places like Five-Star Hotels should also be included. This Schedule of luxury consumption items should invite a higher rate of sales tax/VAT. A large number of shopping malls are currently operating in India and many more are likely to come up in the near future. These large organized retailers earn huge profit margins because of economies of scale. Small unorganized retailers find it difficult to compete with them. A surcharge on the sales tax/VAT payable at shopping malls should be levied, which besides generating revenue, would also help in creating a level playing field for small retailers.

Measures such as these can make a substantial difference to the tax revenues of the government, mobilising enough resources to finance social expenditures and support sectors such as agriculture and unorganised manufacturing and services that are crucial from an employment and poverty alleviation point of view. While an exact estimate of total resources that can be mobilised from these suggestions is not possible here, the fact of the matter is that the Central Government has various means of generating resources for the forthcoming 11th Plan that it has overlooked or ignored in the approach paper. The current discourse of generating resources from outside sources is self defeating as it would lead to a debt build up that would handicap future efforts at undertaking welfare programmes.

III. Rethinking Deficit Reduction

While the government is working to realise these goals on the tax front, it can substantially step up expenditures by abandoning fiscal conservatism. In actual fact, however, it has internalised the ideology that there is need to limit and even reduce the size of the fiscal deficit. This is clear from the fiscal deficit to GDP figures in Chart 3. With a low and, for quite some time, declining tax-GDP ratio, this implies a substantial curtailment of expenditures. As Chart 4 shows, capital expenditures as a ratio of GDP have been on the decline for quite some time now. And more recently this trend is visible in current expenditures as well. The impact on growth and social provision cannot but have been adverse.





The argument that fiscal deficits are inherently problematic in macroeconomic terms relies on three types of mechanism. First, it is argued that a fiscal deficit can be inflationary, or that it will cause external deficits, and is therefore destabilising. Second, it is suggested that large fiscal deficits will "crowd out" more desirable private investment by reducing the investible resources available to the private sector and raising the interest rate on borrowing. Third, it is argued that, even if fiscal deficits do not cause inflation, they lead to the accumulation of public debt and the mounting of future interest obligations of the government, and therefore are not sustainable.

Consider the first argument, that fiscal deficits are inflationary or lead to balance of trade deficits. In fact, both of these results – inflation or external deficit – emerge from an excess of aggregate demand *ex ante* being greater than aggregate supply. But the size of the fiscal deficit, which shows only the net demand arising from the government sector, does not necessarily tell us anything about aggregate excess demand. It is possible to have any combination of public or private surplus or deficit, which would then lead to very different outcomes with respect to both inflation and external deficits.[2] It is quite possible for a large public deficit to be entirely financed by a voluntary private sector savings surplus, as was the case in Italy for more than a decade from the mid-1980s, when fiscal deficits of as much as 9 per cent of GDP were met by positive private savings-investment balances of equal proportions. Similarly, there can be large balance of payments deficits or higher inflation in countries with low, zero or positive fiscal accounts, when the private sector spends more than it earns - this was the case in many Southeast Asian economies before the crisis, and is currently true of the United States economy. In fact, in the 1990s one of the more interesting features of some "emerging economies" in the developing world was the association of strict fiscal discipline and low public deficits with large external deficits which were the result of private profligacy permitted by economic liberalization.

The "crowding out" argument is based on two assumptions: that the demand for borrowed funds from the government will cause a rise in prevailing market interest rates, and that a rise in such rates will in turn depress private investment. In fact both assumptions are problematic. Interest rates are administered by the government through the central bank; insofar as they rise this reflects policy choices made by the government, such as when such a move is seen as required for attracting foreign savings. In financially liberalised economies interest rates tend to rise not because of demand for credit from the State but because of the need to attract and maintain investor confidence, and these higher interest rates can be compatible with substantially lower levels of the fiscal deficit as a share of GDP. Also, when investors' expectations about future profitability are bullish – for example because of substantial infrastructure investment by the State which would give rise to positive demand and supply linkages with private industry – investment would increase despite higher interest rates.

The third issue concerns the possibility of large fiscal deficits leading to the undesirable build up of public debt. It is true that borrowing to meet current expenditures should be controlled, although even this is not always wrong - as for example in a recession. However, there is nothing necessarily wrong with borrowing to meet investment requirements. Indeed, there is a strong case for a fiscal deficit composed entirely of public capital investment, as long as the social rate of return from such investment exceeds the rate of interest. There are many crucial areas (for example in physical and social infrastructure) where public investment is absolutely necessary since the presence of externalities means that the private sector is not likely to invest at socially optimal levels. If the focus had been on a reduction of the revenue deficit, then it might have made some sense, but emphasising the fiscal deficit as distinct from the revenue deficit, means negating the crucial role of the government as an investor. If these investments are

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[2] Thus, the standard identity for an open economy :

Private Investments – Private Savings + Government Deficit = Current account deficit,

can allow for a government deficit which does not involve a current account deficit if the private sector saves more than it invests by the same amount. It can similarly allow for the opposite situation in which a surplus on the government account is associated with a current account deficit if the private sector account is in deficit, i.e. private investment is greater than private savings by more than the amount of the government surplus.

socially productive, then they should also involve higher government revenues in future, because of the growth they would generate.

In addition to all this, there is a basic problem with making expenditure cuts the essential means of public deficit reduction. Quite obviously, a reduction in the revenue deficit, or in the fiscal deficit, can be brought about in a number of different ways besides expenditure cuts, the most obvious method being an increase in direct tax revenue. Indeed in any developing economy where glaring poverty coexists with offensive opulence, increased revenue from direct taxes is urgently called for anyway as a means of reducing inequalities. But policies of liberalization or the new-style economic reforms invariably underplay or even completely disregard this avenue of deficit reduction and emphasise cuts in investment and welfare spending.

So the theory underlying such expenditure cuts is completely invalid. In addition, the fiscal deficit which is invoked to legitimise such cuts in the first place gets aggravated because of other policies associated with the liberalization package. Since inviting direct foreign investment becomes an overriding objective of economic policy, the rates at which they are taxed gets reduced in competition with other countries. This, for reasons of symmetry, means that direct tax rates on the rich as a whole are lowered. Since customs duties are cut as part of the import liberalization package, and excise duties, again for reasons of symmetry, cannot be raised as a consequence, indirect tax revenues too suffer. This is aggravated by the sluggishness in output growth rate that cuts in government expenditure may engender, which reduces actual tax collections even at given tax rates. Meanwhile, financial liberalization effectively leads to higher interest rates on government borrowing, resulting in a larger interest burden on the government, which in turn adds to its expenditure. Two features are particularly significant in this process : first, the removal of interest rate caps and other such restrictions in the credit market; and the recourse of the government to more expensive open market borrowing as part of the decision to reduce and then do away with borrowing directly from the RBI.

Thus this strategy, which officially aims to restrict the fiscal profligacy of the State, actually contains within itself processes which work to aggravate further the fiscal situation, through lower taxes on the rich and higher interest rates.

Overall, therefore, the economic reform has had damaging consequences for the fiscal position of the central government. Through the 1990s, while capital expenditures as a proportion of GDP[3] fell sharply and revenue expenditures net of interest payments stagnated, the government's effort to hold down the fiscal deficit was essentially unsuccessful. As Table 15 shows, the ratio of capital expenditures to GDP fell from 5.9 per cent in 1989-90 to only 2.3 per cent in 2000-01. Despite a slight recovery after that, it has since declined to 1.9 per cent in 2005-06. Few would disagree that this was unfortunate and should be reversed. Not only were plan targets scaled down, but there were huge shortfalls in public investment relative to targets during most of the years of the decade. This shortfall was most evident in crucial sectors such as agriculture and rural

1 [3]GDP figures used here are from the 1993-94 series of the CSO for the years 1989-90 to 1998-99 and the 1999-00 series figures for 1999-00 to 2005-06.

development, industry and minerals, for which the actual expenditures were often as much as 40 per cent less than the planned outlay.

Table 15 : Expenditure-to-GDP Ratios (Per cent)

	RE/GDP	IP/GDP	CE/GDP	Net RE/GDP
1989-90	13.2	3.7	5.9	9.6
1990-91	12.9	3.8	5.6	9.1
1991-92	12.6	4.1	4.5	8.5
1992-93	12.4	4.2	4.0	8.2
1993-94	12.6	4.3	3.9	8.3
1994-95	12.1	4.4	3.8	7.7
1995-96	11.8	4.2	3.2	7.6
1996-97	11.6	4.3	3.1	7.3
1997-98	11.8	4.3	3.4	7.5
1998-99	12.4	4.5	3.6	8.0
1999-00	12.7	4.6	2.5	8.1
2000-01	13.2	4.7	2.3	8.5
2001-02	13.2	4.7	2.7	8.5
2002-03	13.8	4.8	3.0	9.0
2003-04	13.1	4.5	4.0	8.6
2004-05	12.3	4.1	3.6	8.2
2005-06	12.5	3.7	1.9	8.8

Note: RE = Revenue expenditure
CE = Capital expenditure
IP = Interest payments
Net RE = RE – IP

Source : RBI Handbook of Statistics, various issues

However, the really disconcerting feature of the fiscal deficit since the early 1990s was not that it did not get reduced as was intended. Rather, the main problem by the end of the decade was that the dominant proportion of it was due to a deficit on the revenue account of the government, rather than capital expenditure which would presumably lead to future growth. The revenue deficit, which stood at 3.5 per cent of GDP in 1990-91, peaked at 4.0 per cent in 1993-94 and has remained well above 3 per cent in subsequent years till 2003-04. So the government had to borrow large sums to finance even its current expenditure. After closing the option of accessing low-interest Treasury Bills, the government had to borrow at relatively high interest rates from the open market, which substantially increased its interest burden. Nor did the government manage to curb other forms of revenue expenditure.

The other way in which the expenditures of the State were sought to be cut was through a curtailment of general government expenditures. While there was little attempt to curb extravagance or profligacy on the part of Ministers and senior bureaucrats, productive capital expenditure was severely curtailed. This adversely affected not just the state of infrastructure but also overall investment and growth in the economy because of the strong linkage effects between public and private investment. In addition, there has been public pressure on the State to reduce its employment and level of economic activity as well as periodic declarations of official commitment to downsizing government.

However, this goal of reducing public employment is itself highly problematic. All societies require fairly extensive public employment, not only to provide public goods which would otherwise not be in the private interest to produce at all, but because of essential public services which are crucial for both productive activity and for the welfare of the people. In fact so far the Indian state has failed quite dramatically in providing a range of public goods and services to the majority of people. Whether in the areas of basic transport and infrastructure development, or adequate housing or sanitation, or universal access to minimum health facilities and educational opportunities, it is more than evident that the gap between public need and actual availability is huge and growing.

Therefore most citizens, knowing the poor state of public services, would agree that the country needs far *more* people employed in areas such as public health, sanitation and education, not less. The share of employment accounted for by government in India is much smaller than in both developed and developing countries that offer better public services to its citizens. Thus, more rather than less government employment is required, in order to provide essential goods and services through the public space. And the incomes generated by such employment would contribute not merely to more welfare and better human development indicators, but to aggregate demand as well, providing a part of the economic stimulus required in the domestic market. This is not to deny that there may be overmanning in some government departments at Delhi and the state capitals, warranting some redeployment of the existing labour force. But the need to redeploy an existing public labour force and use it more effectively is not sufficient reason to argue that total government employment is too high. That would amount to condemning much of India’s population to social services that are even worse than their currently poor levels.

What those advocating such downsizing tend to forget is that the issue involves much more than justified concern about the fate of the workers who lose their jobs in this process. It also tends to involve a genuine loss of efficient functioning as the remaining workers are forced into additional workload and insecure contracts. International experience, from countries as far apart as England and Brazil, suggests that the costs of obsessive downsizing of the workforce can be severe and even socially damaging. Thus, in Britain, the reduction of staff strength in the privatized railway system has been associated with a near collapse of the system, with many more accidents, inordinate delays, frequent unannounced changes of schedule and apparently a much more surly workforce which is made to work longer and more intensely without security of contract. In mid-2001, the private rail network company actually went into receivership, effectively requiring a quiet renationalisation by the British state simply to keep the trains running. Similarly, the downsizing which followed the Latin American privatization of several important public utilities has implied not just job loss but also declining safety precautions and reduced effectiveness of services, as those workers who have remained in employment have found themselves unable to match the delivery levels associated with the earlier higher employment. An even more extreme case comes from the United States, where (after the terrorist attacks of September 11, 2001) a new law has been passed which would increase public security at airports and effectively renationalise such security services, after an earlier phase of downsizing and privatization which many observers have balmed as being responsible for the poor security conditions that prevailed.

Quite apart from these supply-side considerations, there is the obvious Keynesian point to be made, that public employment is also necessary because it creates purchasing power which is important even from the point of view private growth. Keynes famously argued that in an economy with unutilised capacity, even a completely “unproductive” activity such as simply getting workers to dig holes and then fill them again would serve a positive economic purpose because it would increase effective demand, and therefore production, by a multiple of the wages paid to such workers. [4] While this simple point tends to be forgotten today, that does not make it any less relevant. Seen in the current macroeconomic context, of declining growth rates in all sectors, low aggregate employment generation and huge wastage of the country’s human resources, the goal of public sector downsizing of employment thus becomes even more dubious.

The Structure of the Fiscal Deficit

Fiscal reform was not concerned only with reducing the size of the deficit, but also with the manner in which any given level of the deficit should be financed. In this regard, fiscal reform involved a sharp reduction of the "monetised deficit" of the government, or that part which was earlier financed through the issue of short-term, *ad hoc* Treasury Bills to the Reserve Bank of India, and its subsequent elimination. [5] Until the early 1990s, a considerable part of the deficit on the government's budget was financed with

[4] Consider, for example, a case where, in a context of unemployment and unutilized capacity, an increase in public employment increases wage incomes by Rs. 100. If these wages are then spent on consumptions goods, generating a multiplier process which leads to increased economic activity of say, Rs. 300, then there is a large net gain to society. Even if the original R s. 100 were spent on some completely unproductive activity, society would still have a net gain of Rs. 200 compared to the earlier situation.

[5] This was more or less “successfully” implemented in a two stage process, involving initially a ceiling on the issue of Treasury Bills in any particular year, and subsequently the abolition of the practice of issuing Treasury Bills and substituting it with limited access to Ways and Means advances from the central bank for short periods of time.

borrowing 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. The reduction of such borrowing from the central bank to zero resulted in a sharp rise in the average interest rate on government borrowing.

The reduction, in fact the elimination, of *ad hoc* issues, was argued to be essential for giving the central bank a degree of autonomy and monetary policy a greater role in the economy. This in turn stemmed from the premise that monetary policy should have a greater role than fiscal manoeuvrability in macroeconomic management. The shift away from borrowing from the central bank was advocated on three grounds. First, that such borrowing (deficit financing) is inflationary. Second, that it undermines the role of monetary policy by depriving the central bank of any autonomy. And, third, that it undermines much needed fiscal discipline by providing ready access to credit to the government at a low rate of interest. We need to consider each of these in some detail.

The notion that the budget deficit, defined earlier in India as that part of the deficit which is financed by borrowing from the central bank, is more inflationary than a fiscal deficit financed with open market borrowing, stems from the idea that the latter amounts to a draft on the savings of the private sector, while the former merely creates more money. In a context in which new government securities are ineligible for refinance from the RBI, and the banking system is stretched to the limit of its credit-creating capacity, this would be valid. However, if banks are flush with liquidity (as has been true of the Indian economy since at least 1999), government borrowing from the open market adds to the credit created by the system rather than displacing or crowding out the private sector from the market for credit.

But more to the point, neither form of borrowing is inflationary if there is excess capacity and supply side bottlenecks do not exist. Since inflation reflects the excess of ex ante demand over ex ante supply, excess spending by the government financed through either type of borrowing, is inflationary only if the system is at full employment or is characterised by supply bottlenecks in certain sectors. In the latter half of the 1990s, the Indian industrial sector was burdened with excess capacity, and the government was burdened with excess foodstocks and high levels of foreign exchange reserves. This suggests that there were no supply constraints to prevent "excess" spending from triggering output as opposed to price increases. Since inflation was at an all time low, this provided a strong basis for an expansionary fiscal stance, financed if necessary with borrowing from the central bank. So in the late-1990s and early 2000s context a monetised deficit would not only have been non-inflationary, but it would also have been virtuous from the point of view of growth.

This brings us to the second objection to a monetised deficit, namely, that it undermines the autonomy of the central bank. This demand for autonomy, which is a central component of IMF-style financial reform, assumes that once relieved of the task of financing the government's deficit, the RBI would be "free" to use monetary policy as a device to control inflation, manage the balance of payments, and influence growth. The two interrelated means to realising these objectives are seen as controlling liquidity and influencing interest rates.There are strong grounds for scepticism regarding the efficacy of this policy. At this point it is relevant to note that the decision to eliminate the practice of monetising the deficit hardly affected the fiscal situation. Fiscal deficits remained high, though they were financed by high-interest, open-market borrowing. The only result was that the interest burden of the government shot up, reducing its manoeuvrability with regard to capital and non-interest current expenditures. As a result the Centre's revenue expenditures rose relative to GDP, even when non-interest expenditures (including those on subsidies) fell, and the fiscal deficit continued to rise.

Indeed, while many complain that the current fiscal problem stems from the burden placed by past accrual of public debt, the more significant problem is actually that of higher interest rates on public borrowing. These have contributed to a situation which, by the turn of the decade, was perilously close to that of Ponzi finance[6], in which the government borrows simply in order to pay interest.

This is especially important because macroeconomic circumstances during many of the years of reform cried out for deficit financed spending. In a context where growth in the commodity producing sectors was sluggish and where there was inadequate progress on the poverty reduction front, the budget should have been treated above all as means to trigger growth and alleviate poverty. The obsession with the fiscal deficit and expenditure reduction amounted to downplaying these more fundamental objectives.

An obvious lesson from that experience is that if the government had not frittered away resources in the name of stimulating private initiative, if it had continued with earlier levels of monetising the deficit and also dropped its obsession with controlling the total fiscal deficit, especially at the turn of the decade and after when food and foreign reserves have been aplenty, the last decade would have in all probability been a decade of developmental advance. Yet the policy choices made ensured that neither was this achieved, nor were the desired targets of fiscal compression met. It is evident that the failure of the government to realise its objective of reining in the fiscal deficit was a result of this type of economic reform rather than of abnormal expenditures.

Fiscal responsibility

In the 1990s, legal restraints on government fiscal behaviour became something of an international fashion. As in much else in the world at the moment, this fashion was set by the United States, where in the mid-1980s the Balanced Budget and Emerging Deficit Control Act (Gramm-Rudman-Hollings Act) required a steady decline in the federal government’s deficit to zero within a stipulated and fairly short time frame. Such a provision is extreme by any standards (although some countries have pursued balanced budget policies without legal stipulation) and few other countries have opted for such an extreme measure. [7] Governments putting such firm constraints on fiscal policy have to reckon with the possibility of deep and severe recession/deflation as a corollary to such fiscal conservatism. That is why other such legislation as has taken place elsewhere has

[6] “Ponzi finance”, named after a financial confidence trickster who operated in Europe during the 1920s, refers to the situation in which cash payments on debt are met by increasing the amount of debt outstanding. For obvious reasons, such a process is unsustainable.

[7] In any case, the special circumstances of the United States allowed its economy to expand despite the more conservative fiscal stance, on the basis of an asset market boom which generated a consumption splurge, and led to large private investment-savings deficits financed by the rest of the world’s savings. Quite obviously, these conditions could not be replicated elsewhere for such a long period of time..

generally been more circumspect, allowing a little more flexibility to governments and emphasising that deficits can change over the course of the cycle in any case. Even the IMF, long one of the most vociferous opponents of large government deficits, increasingly recognises that fixed and rigid limits are neither feasible nor desirable and has recently allowed quite large deficits in some countries under its supervision.

Nevertheless, in some countries, most strikingly in the European Union, there have been similar, and self-imposed, restrictive constraints on fiscal policy in the 1990s. The Stability and Growth Pact, which was part of the Maastricht Treaty, declared that there should be a limit of 3 per cent for the total fiscal deficit to GDP ratio and a limit of 60 per cent for the public debt to GDP ratio. This was also made a condition for joining the European Monetary Union in January 1999. Just before that, it was interesting to see how suddenly a number of countries that had been showing much higher levels of the government deficit to GDP ratio (such as Italy, France and Germany) managed to get to the required level. There is more than a suspicion of widespread "creative accounting" that allowed this sudden decline in these countries.

The urge to have legal limits on government deficits and public debt stemmed from the greater political clout of finance in all these countries, as the financial groups that benefited from government borrowing also sought safeguards to make sure that these debts were sustainable and would be repaid. It is still very much the fear of adverse investor reaction, which would be most severely expressed by open capital flight, which dominantly drives the obsession to contain fiscal deficits across the world.

This is the background to the Fiscal Responsbility and udget Managemnt Act. The declared justification for this Bill came from the Report of the Committee on Fiscal Responsibility Legislation, which was submitted in July 2000. The premise underlying this report was that the fiscal deficit is the key parameter affecting all other macro-economic and growth variables, and that its control is absolutely necessary for the realisation of all economic objectives of the government. In addition, fiscal consolidation is seen as necessary to lower interest rates and therefore to encourage higher private investment. In fact this argument cannot be justified either by newer theoretical work or by recent international experience, which actually point to very different causal relationships. Let us consider each of these assumptions in turn.

First is the argument that lower fiscal deficits lead to higher and more sustained growth. This need not be the case, since if the deficit is dominantly in the form of capital expenditure, it contributes to future growth through demand and supply linkages. Also, since there is a strong positive correlation between public and private investment, which is now accepted even by institutions like the World Bank, more such public spending would stimulate more overall investment and thus growth. The "crowding in " effects of public investment are now generally acknowledged to dominate over "crowding out" effects in developing countries in particular. Indeed, the deflationary effect of lower fiscal deficits is one that is widely and openly recognised by most governments even in Europe, although they may be forced to try and curtail their deficits because of other reasons such as financial sector pressure. So reducing deficits may well have depressing effects on economic activity.

Second, it is wrong to argue that large fiscal deficits necessarily lead to higher inflation. As discussed earlier in this paper, inflation is caused by the ex ante excess of aggregate demand over aggregate supply, which may come from public or private sectors, and is reflected in either inflation or current account deficits in the balance of payments, or some combination of both.

Third, external vulnerability now has less to do with the observance of fiscal rectitude, and more to do with the degree of financial openness of the economy as well as a range of perceptions of international finance. Thus, countries can face external crisis and capital flight because of large current account deficits led by private profligacy in the context of trade and capital account liberalization, or because other areas are suddenly seen as more profitable by financial investors, or even just because of geographical proximity to another country in crisis. It is true that international finance generally declares large fiscal deficits as undesirable, but that has not prevented mobile capital from flocking to economies thay are growing on that basis, or from avoiding economies with low or stagnant growth which are marked by severe fiscal discipline. [8] This in turn means that the argument that fiscal rectitude is sufficient to enable low interest rates in a world of relatively open capital markets, cannot be sustained. In fact, while it is true that finance in general dislikes large fiscal deficits, it is quite prepared to tolerate them if they are associated with higher economic activity. Also, since finance may respond negatively to other factors, in periods of speculative capital outflow it becomes necessary to raise domestic interest rates to ward off further capital flight, whatever the condition of the public exchequer.

All this suggests that the axiomatic basis of the legislation on fiscal responsibility that was proposed in India was flawed in the extreme. But these questionable assumptions were used to suggest a time-based framework of very severe fiscal tightening. Thus, the final bill states that the government should commit itself to taking “appropriate measures to eliminate the revenue deficit and fiscal deficit and build up adequate revenue surplus”. The only contingencies which would allow higher revenue or fiscal deficit were described as “the grounds of unforeseen demands on the finances of the Central Government due to national security or calamity”. Presumably, economic recession, high poverty or low employment generation (for example) would not qualify as adequate reasons.The strict constraints of the proposed legislation, of eventual limits of 2 per cent of GDP for the fiscal deficit and zero for the revenues deficit, were far more stringent and restrictive than even the European Union’s infamous Maastricht criteria, which allow 3 per cent of GDP for the fiscal deficit and 60 per cent of GDP for the public debt. [9] Also, there was no concession made for the cyclical nature of deficits (the fact that fiscal deficits tend to increase during the downswing and decrease during the upswing) or for estimating a “structural deficit” which would take account of this. This made it even more rigid and inflexible than similar fiscal responsibility legislation in other countries, and totally constrained the ability of the government to respond to downturns in

[8] Witness the high state of “investor confidence” in South Korea in 1999 and 2000, even though the fiscal deficit was around 6 per cent of GDP, because the expansionary fiscal stance was seen as contributing to a recovery in economic activity after the 1997-98 crisis.

[9] They were even more stringent than the recommendations of the Committee on Fiscal Responsibility Legislation, which also suggested fiscal deficit limits of 3 per cent of GDP.

economic activity through a more reflationary fiscal stance. This would essentially leave domestic economic agents, including industry, completely unprotected by fiscal policy during a recession.

The truth is that such restraining measures are both unwarranted and unnecessary, and when fully implemented they would actually be substantially detrimental to the material interest of most of the Indian people. This is because such measures would not only force deflation on the economy, but also involve reductions in public expenditure to meet these very severe criteria, so that public expenditure which is important and necessary for growth and welfare would not be made. A misleading feature about such legislation, is that typically the assumptions and conclusions are presented as technocratic necessities rather than blatant political choices. But in fact, such decisions about overall expenditure, its distribution and deficit control, are deeply political and reflect the choice of favouring certain economic groups in society - especially finance - over all other citizens and even at the cost of denying all citizens their basic economic rights.

IV. The consequences of financial liberalisation

Indian finance is currently in the midst of a transition driven by changes in the financial and banking policy regime of the government. Among the outcomes of the change in regime are the end of social and development banking, growing evidence of financial exclusion, an incipient process of financial consolidation and concentration, and signs of increasing financial fragility.

The shift in regime is justified on four grounds. The first is that the practice of pre-empting bank resources and directing them to chosen sectors at controlled interest rates leads to financial repression that is not conducive to growth and development. The second is that excessive regulation has prevented the development and diversification of the financial sector needed to facilitate growth at higher levels of development. The third is that the banking sector that had evolved under a regime which considered it an instrument to achieve varied development goals is now populated by non-competitive agents (burdened with non-performing assets) that survive because of state support and is incapable of "efficiently" mobilising savings and channelling them to the best possible uses. Fourth, that, while changes in technology and the inevitable process of globalisation are transforming the nature of finance, the financial institutions that were dominant under the old policy regime are unable to restructure themselves to face up to the new situation.

Arguments of this kind present the change in banking and financial policy as being motivated by the need to correct the inadequacies and failures of the earlier regime. Nobody can hold that the banking system as it evolved in the post-Independence period was perfect and flawless. However, it would be a travesty of the truth to hold that the sector is a moribund structure which is not contributing to development and is surviving on life support from the government. On the contrary, there is evidence to suggest that it is the change in financial policy currently underway that is eroding the role of the banking sector as an instrumentality for more rapid and broad-based development. In fact, there is evidence to suggest that the change in banking policy is one among the contributors to the agrarian distress and rural decline that has culminated in a wave of farmers' suicides in different parts of the country. The change also seems to be worsening the difficulties being faced by domestic banks and creating new ones, leading to an increase in fragility. Finally, there is a danger that banking "reform" is paving the way for a decline of domestic control over banking operations as a result of international takeovers, with attendant adverse implications for economic sovereignty.

From the point of view of this paper what is important is that, following the reforms, the credit deposit ratio of commercial banks as a whole declined substantially from 65.2 per cent in 1990-91 to 49.9 per cent in 2003-4, despite a substantial increase in the loanable funds base of banks through periodic reductions in the CRR and SLR by the RBI starting in 1992. It could, of course, be argued that this may have been the result of a decline in demand for credit from creditworthy borrowers in the system. However, three facts appear to question that argument. The first is that the decrease in the credit deposit ratio has been accompanied by a corresponding increase in the proportion of risk free government securities in the banks major earning assets i.e. loans and advances, and investments. Investment in government securities as a percentage of total earning assets for the commercial banking system as a whole was 26.13 per cent in 1990-91. But it increased to 32.4 per cent in 2003-04. This points to the fact that lending to the commercial sector may have been displaced by investments in government securities that were offering relatively high, near risk-free returns.

Second, under pressure to restructure their asset base by reducing non-performing assets, public sector banks may have been reluctant to take on even slightly risky private sector exposure that could damage their restructuring effort. This possibly explains the fact that the share of public sector banks in 2002-3 in total investments in government securities of the scheduled commercial banks was very high (79.17 per cent), when compared with other sub-groups like Indian private banks (13.41 per cent), foreign banks (5.7 per cent) and RRBs (1.74 per cent).[10]

Finally, with all banks now being allowed greater choice in terms of investments, including corporate commercial paper and equity, even private banks in search of higher profitability would have preferred investments in securities and financial paper of different kinds rather than conventional lending. The observed rise in investments by banks would be partly due to bank preference for credit substitutes.

Priority sector lending

The effect of neoliberal banking reform on credit delivery to the priority sectors has also been adverse as expected. The process of directing credit to what were "priority" sectors in the government's view was facilitated by the nationalization of leading banks, since it would have been difficult to convince private players with a choice of investing in more lucrative activities to take to a risky activity like banking where returns were regulated. Nationalization was therefore in keeping with a banking policy that implied pre-empting banking resources for the government through mechanisms like the statutory liquidity ratio (SLR), which defined the proportion of deposits that need to be diverted to holding specified government securities, as well as for priority sectors through the imposition of

[10] Bank group-wise Liabilities and Assets of SCBs in Statistical Tables relating to Banks in India, RBI, 2002-3.

lending targets. An obvious corollary is that if the government gradually denationalizes the banking system, its ability to continue with socially-motivated and inclusive banking and with policies such as directed credit and differential interest rates would be substantially undermined.

"Denationalization", which takes the form of both easing the entry of domestic and foreign players as well as the disinvestment of equity in private sector banks, forces a change in banking practices in two ways. First, private players would be unsatisfied with returns that are available within a regulated framework, so that the government and the central bank would have to dilute or dismantle these regulatory measures as is happening in the case of priority lending as well as restrictions on banking activities in India. Second, even public sector banks find that as private domestic and foreign banks, particularly the latter, lure away the most lucrative banking clients because of the special services and terms they are able to offer, they have to seek new sources of finance, new activities and new avenues for investments, so that they can shore up their interest incomes as well as revenues from various fee-based activities.

As a result, since 1991 there has been a reversal of the trends in the ratio of directed credit to total bank credit and the proportion thereof going to the agricultural sector, even though there has been no known formal decision by government on this score. At the same time, attempts have been made in recent years to dilute the norms of whatever remains of priority sector bank lending. Thus, while the authorities have allowed the target for priority sector lending to remain untouched, they have widened its coverage. At the same time, shortfalls relative to targets have been overlooked.

In agriculture, both direct and indirect advances to agriculture were clubbed together for meeting the agricultural sub-target of 18 per cent in 1993, subject to the stipulation however that "indirect" lending to agriculture must not exceed one-fourth of that lending sub-target or 4.5 per cent of net bank credit. It was also decided to include indirect agricultural advances exceeding 4.5 per cent of net bank credit into the overall target of 40 per cent. The definition of priority sector itself was also widened to include financing of distribution of inputs for agriculture and allied sectors with the ceiling raised to Rs. 5 lakh initially and Rs. 15 lakh subsequently. Further, financing of distribution of inputs for allied activities such as dairy, poultry and piggery up to Rs. 5 lakh were also made eligible for treatment as indirect agricultural advances. Finally, the scope of direct agricultural advances under priority sector lending was widened to include all short-term advances to traditional plantations including tea, coffee, rubber, and spices, irrespective of the size of the holdings.

So far as small scale industries were concerned, the authorities extended the coverage for priority sector lending by re-defining it in terms of the level of investments in plant and machinery together with an increase in working capital limits. Initially, the SSI sector included those industries whose investment and machinery did not exceed Rs. 35 lakh. In the case of ancillary units, the investment limit was Rs. 45 lakh. In May, 1994, these limits were raised to Rs. 60 lakh and Rs. 70 lakh respectively. This has gone up to Rs. 3 crore in some cases. All advances to SSIs as per the revised definition were to be treated as priority sector advances which indirectly encouraged term finance loans.

Apart from this, there were also totally new areas under the umbrella of priority sector for the purpose of bank lending. In 1995-96, the Rural Infrastructural Development Fund (RIDF) was set up within NABARD and it was to start its operation with an initial corpus of Rs. 2000 crore. Public sector banks were asked to contribute to the fund an amount equivalent to their shortfall in priority sector lending, subject to maximum of 1.5 per cent of their net credit. Public sector banks falling short of priority targets were asked to provide Rs. 1000 crore on a consortium basis to the Khadi and Village Industries Commission (KVIC) over and above what banks were lending to handloom co-operatives and the total amount contributed by each bank was to be treated as priority sector lending. The outcome of these new policy guidelines could not but be that banks defaulting in meeting the priority sector sub-target of 18 per cent of net credit to agriculture, would make good the deficiency by contributing to RIDF and the consortium fund of KVIC.

Another method to avoid channelling of credit to priority sectors has been to ask banks to make investments in special bonds issued by certain specialised institutions and treat such investments as priority sector advances. In 1996, the RBI asked the banks to invest in State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs), NABARD and the National Housing Bank (NHB). Investments made by banks in special bonds issued by these agencies were also to be treated as priority sector advances. The changes thus made in the policy guidelines on the subject of priority sector lending were obviously meant to enable the banks to move away from the responsibility of directly lending to the priority sectors of the economy.

It is in the light of this that the trends in priority sector lending during the post liberalisation period of 1991-2004 needs to be understood. Priority sector lending as a proportion of net bank credit, after reaching the target of 40 per cent in 1991, had been continuously falling short of target till 1996. It has subsequently been in excess of the target for the reasons specified above, and stood at 44 per cent in 2004, which was mainly due to the inclusion of funds provided to RRBs by their sponsoring banks that were eligible to be treated as priority sector advances. Advances to agriculture on the other hand declined from 16.4 per cent of net bank credit in 1991 to 15.4 per cent in 2004, well below the target of 18 per cent of net bank credit. Within the category of agricultural advances, the growth of indirect finance has been much faster than direct finance to agriculturists. Indirect finance to agriculture includes lending to various intermediary agencies assisting the farmers as also investment in special bonds issued by NABARD and the Rural Electrification Corporation (REC). It also includes deposits placed by banks in RIDF.

In sum, the principal mechanism of directed credit to the priority sector that aimed at using the banking system as an instrument for development is increasingly proving to be a casualty of the reform effort. And methods are being found to conceal this trend by window-dressing the evidence of achievement with regard to priority sector lending.

Credit to the rural areas has also been affected by financial and monetary policy reform in the form of relaxation of rules with regard to foreign institutional investment and enhanced "autonomy" for the central bank ensured through reduced lending to government. Faced with large FII inflows in recent years the RBI has been forced to buy up foreign exchange to prevent undue appreciation of the rupee. The resulting accumulation of foreign exchange assets with the central bank has been sought to be sterilised through retrenchment of government securities held by it. Since reserves are invested in liquid financial assets like US Treasury bonds, that yield extremely low rates of interest, the substitution of such assets for government securities in the assets of the central bank reduces its "profitability". As a consequence funds available for low cost lending through NABARD to institutions like the regional rural banks have dried up, reducing resources available for lending in the rural areas.

Credit to Agriculture and Small-scale Industries

The functioning of the system of credit delivery by scheduled commercial banks, the largest component of the financial sector in India, is a good example of the extent and nature of the neglect of agriculture, small-scale industries and small borrowers, the correction of which is most crucial (Shetty 2004). A large-scale study undertaken by the EPW Research Foundation on sector-wise, state-wise and district-wise spread of commercial banking in India (including Regional Rural Banks) for 32 years from 1972 to 2003 has yielded extremely significant information in this regard. The neglect of the informal sectors since the 1990s appears glaring when juxtaposed against the achievements made in the 1970s and 1980s after bank nationalization.

The share of agriculture in total bank credit had steadily increased under impulse of bank nationalization and reached 18 per cent towards the end of the 1980s, but thereafter the achievement has been almost completely reversed and the share of the agricultural sector in credit has dipped to less than 10 per cent in the late 1990s—a ratio that had prevailed in the early 1970s. Even the number of farm loan accounts with scheduled commercials banks has declined in absolute terms from 27.74 million in March 1992 to 20.84 million in March 2003.

Similarly, the share of small-scale industry accounts and their loan amounts in total bank loans has fallen equally drastically. The number of accounts has dropped from 2.18 million in March 1992 to 1.43 million in March 2003, and the amount of credit as a percentage of the total has slumped from 12 per cent to 5 per cent, that is, less than one-half of what it was three decades ago, that is, in the early 1970s.

Bias against Small Borrowal Accounts

The neglect of agriculture, small-scale industries and other informal sectors is reflected in the sharp bias against small-sized borrowers. A distinct feature of the credit delivery record in the 1990s has been the persistent and drastic decline in the number and amounts of small loan accounts. The number of small borrowal accounts with credit limit of Rs 25,000 or less had reached 62.55 million in March 1992, but it was followed by a steep downward trend to reach 36.87 million—a loss of nearly 26 million accounts or 60 per cent by March 2003. Correspondingly, their credit outstanding as a proportion of total bank credit has fallen from over 25 per cent in the late 1980s to 5.4 per cent in March 2003.

This had important implications for borrowers in rural areas and those engaged in agriculture. In 1993 agriculture was the main occupation of 42.4 per cent of borrowers who had availed of credit under this facility. The distribution of this category of accounts by population groups showed that 49.2 per cent of the credit below Rs. 25,000 was availed of in the rural areas basically for agricultural activities as against only 14.6 per cent in urban areas.

When reporting data collected through its Basic Statistical Returns (BSR), the RBI has periodically revised the ceiling credit limit for what it defines as Small Borrowal Accounts (SBAs). The cut-off point, which was set at Rs. 10,000 at the time of inception of the BSR in 1972 was revised upwards to Rs. 25,000 effective from June 1984 and Rs. 2 lakh effective from March 1999 (March 2002 in the case of Regional Rural Banks). Even in 2001, by when the cut-off limit had been raised to Rs. 2 lakh, nearly two-fifths of the small borrowal accounts (38.8 per cent) were from agriculture, which accounted for 32.1 per cent of the credit outstanding in such accounts. The change in the nature of banking activity is partly reflected in the fact that personal loans accounted 30.9 per cent of SBAs and 36.7 per cent of outstanding credit. The average outstanding loan per small borrowal account was the lowest for agriculture at Rs.17,435 while it was Rs.23,284 for transport operators, Rs. 20,719 for industry and Rs.25,004 for personal loans.

It must be noted, however, that even in 2001 about two-fifths (39.3 per cent) of the small borrowal accounts were sanctioned under various loan schemes of the Government and claimed about one-third (30.5 per cent) of the amount outstanding. The Integrated Rural Development Programme (IRDP) was the largest loan scheme forming about one-sixth (16.6 per cent) of the small borrowal accounts and accounting for 6.9 per cent of the amount outstanding. Accounts under the Prime Minister's Rojgar Yojna (PMRY) were fewer in number (2.4 per cent) with a 4.2 per cent share in the amount outstanding. Thus the collapse of the share of credit provided through small borrowal accounts during the 1990s would have adversely affected rural development and employment generation.

V. Conclusion

In sum, the period since 1991 has witnessed not only the a loss of potential revenues for the government and a revision of the proactive policy aimed at accelerating employment growth, promoting agriculture and small industry and improving public provision of a host of social services, but also a curtailment of the flow of funds to sectors crucial from the point of view of employment generation and poverty alleviation. The effects of this are already visible, but are likely to cumulate in a period when GDP accelerates, led by services. The resulting increase in inequality is not just against a strategy of “inclusive growth and unacceptable from a welfare point of view, but can have dangerous social and political consequences. The evidence is, therefore, clear. The declared aims of the Planning Commission’s Approach to the XIth Plan, all of which require substantially increased public expenditure in physical infrastructure and social sectors in particular, simply cannot be met within the confines of the restrictive fiscal rules that have been adopted. The further need to ensure more egalitarian access to productive credit is also critical, for both equity and efficiency considerations. The need to rethink policies of resource generation and financial regulation and direction, is therefore urgent.