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Public Finance in India in the Context of India's Development

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M. Govinda Rao

National Institute of Public Finance and Policy
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Abstract

The paper analyses important issues in Indian public finance in the context of the India's economic development. Given the predominance of working population and with children in the age group 0-14 constituting over 40 per cent of the population, government finance has a critical role not only in protecting life and property but also in creating physical infrastructure to expand economic activities to generate employment opportunities and in providing social infrastructure to empower them to get productively employed. The analysis public spending, however, shows that spending on education and healthcare is woefully inadequate and expenditures on interest payments, subsidies and transfers have crowded out spending on physical and social infrastructures.

The reasons for the above phenomenon have to be found in the low levels of taxation apart from lopsided priorities. Based on the 98 country average behaviour, the paper shows that the tax–GDP ratio in the country is lower by 2-3 percentage points for its level of per capita GDP. The reasons for the low tax ratio have to be found in the exemption to agricultural incomes, widespread tax preferences due to multiple objectives loaded into tax policy, tax abuse by multinationals and poor tax administration.

The low tax collections are also the reasons for the persistence of large deficits and debt. Despite passing the FRBM Act to follow the rule based fiscal policy, containing the government deficits and debt has continued to be a major challenge and the targets are diluted, new concepts created and repeatedly postponed. The paper argues that there is a strong case for creating a fiscal council by amending the FRBM Act and it is should be appointed by the Parliament and should be reporting to it as recommended by the Fourteenth Finance Commission. This is in contrast to the Fiscal Review Committee's recommendation according to which the Fiscal council should be appointed by the Finance Ministry and should report to it.

Keywords: Taxation and subsidies General.

JEL Classification Codes: H20

1. Introduction

This paper deals with the effectiveness of public finance in India. The objectives of public finance are to ensure macroeconomic stability, achieve the desired state of distribution, provide public services to accelerate growth and development.

Fiscal policy has both macro and microeconomic aspects.

The important objectives of public finance are allocating resources for the provision of public services and to ensure growth and development, ensure macroeconomic stabilization and bring about the desired distribution of incomes (Musgrave, 1959).

The basic (or minimalist) role of public finance is to provide 'public goods' which markets fail to provide. In addition, the government is requited to ensure optimal provision of services with significant generalised externalities which are called merit goods. The classic case of public goods is ensuring protection of and property rights to the people. Mancur Olson's story of a Chinese warlord provides an interesting argument for the basic public finance function (Olson, 1993). In the early twentieth century, a considerable part of China was infested with roving bandits and this anarchic environment was not conducive for economic growth because there was no incentive for saving and investment. However, when a stronger among the roving bandits decided to provide security to the people in return for a share of their incomes, there was a transition from "roving banditry" to "stationary banditry" or dictatorship. This provided incentives for saving, investment and growth as the stationary bandit ensured safety and security and right to property which was a precondition for growth. However, since the nature and quality of the growth was determined by the stationary bandit, it was not "encompassing" and therefore, the provision of public services under participatory democracy encompassing growth is possible. The important point is that ensuring security and protection of property rights is a basic public good and this can be provided only by the government.

In a democratic polity, however, the governments have to play a much larger role than Olson's stationary bandit (however benevolent). Besides ensuring protection from external aggression and internal strife and ensuring property rights, they are required to provide social and physical infrastructure. The governments have the task of redistributing incomes and alleviating poverty. Finally, after the Great Depression, and influenced by the Keynesian economics, public spending was assigned a central role in raising the level of aggregate demand to ensure full employment financed by, if necessary, borrowing from the Central bank of the country.

Thus, the role of public finance is inextricably linked to the role of the State. From merely ensuring safety, security and property rights, governments have expanded their activities to providing a variety of public services with externalities, ensuring social security and redistribution. The expansion, however, has been a subject matter of considerable debate. Many liberals like Richard Musgrave consider that, "… the expansion of the public sector has been a necessary and constructive development" and "…a sound and strong public sector is needed along with the market to let society thrive". In contrast, the public choice proponents led by James Buchanan argue that dispute arises when the state expands to areas "…beyond the realm of boundaries of the protective state into a productive or tax-transfer state".[1] While the expanded role of the state in economic activity is predicated on the assumption of a benevolent government maximising welfare of its citizens, public choice proponents contend that it ignores the problems of governance and the influence of special interest groups.

Despite consternation by public choice theorists viewing government as an abusive and ever growing Hobbesian Leviathan (Brennan and Buchanan, 1980), there are several reasons for the state to embrace a much larger than the minimalist role public choice proponents would recommend in a country like India. In India, in particular, state intervention through public finance policy has to play a very important role besides ensuring safety and security of the people and protecting their property rights. These include the need to overcome large social and physical infrastructure deficit, provide correctives to missing and imperfect markets, introduce measures to reduce acute inequalities and poverty, and provide correctives to widespread information asymmetry.

The working age population in India numbers over 800 million constituting 63.5 per cent of the total. Children in the age group 0-14 constitute about 40 per cent of the population. Almost 135 million people are estimated to be added to the working age during 2011-2020. The large working age population can translate into a demographic dividend only when that is productively employed. This calls for a significant government intervention in providing healthcare, education and skill development. Interventions are needed also to provide externalities in terms of market development, irrigation, storage and price support in agriculture to deal with market imperfections and supply volatility. Similarly, generalised externalities have to be ensured to manufacturing and service sectors though competitive levels of infrastructure.

Calibrating the public finance policies to enable the government to play a catalytic role in the development of the economy raises a number of issues. This paper analyses public finances in India from that perspective. The second section deals with an overview of public finance and the level and composition of public expenditures. The financing of public spending through tax policies is discussed in Section 3. The compulsions of spending and inability to finance it through taxes have led to the government resort to large deficits and accumulation of debt with threat to macroeconomic stability. This has also led to the adoption of rule based fiscal policy. These issues are discussed in Section 4. The concluding remarks are presented in Section 5.

2. Overview of Indian Public Finances and Public Spending

The role of government in terms of the share of public expenditure in GDP has remained remarkably stable varying from 25 to 28 per cent since 1991. In 1990-91, it was 26.7

[1] There is a fascinating account of the two contrasting views in the book summarising the debate between Buchanan and Musgrave in a week-long symposium held at University of Munich. See, Buchanan and Musgrave (1999).

per cent and remained so even after twenty years. However, if a shorter period is taken, it is seen that public expenditure-GDP ratio declined from 25.8 per cent in 2000-01 to 24.4 per cent in 2007-08 before increasing to 28 per cent in 2015-6 (Table 1). Similar trends are seen in the case of central and state government expenditures. Central government expenditure which was about 11 per cent of GDP in 2000-01 increased to 12.4 per cent 2009-10, but thereafter declined to 10.6 per cent in 2015-16 (Table 2). A major part of the increase after 2008-09 was in revenue expenditures mainly due to the pre-election decisions to revise the pay scales of government employees, the farm loan waiver and expansion of the rural employment guarantee from 200 districts to the whole country in 2008-09. There was also large subsidy outgo to oil marketing companies due to sharp increase in the international price of crude oil and political difficulties in increasing the administered price of distillates.

The analysis of public spending in India shows that allocation to essential social services and physical infrastructure is low by international standards. On health and family welfare, the government expenditure is a measly 1.4 per cent in 2015-16 as against the norm of 3 per cent (Table 2). According to Human Development Report, 2013, even in the least developed countries public health expenditure was 1.7 per cent of GDP in 2010. Not surprisingly, out of pocket expenditure on health by households is five times the public spending and this is one of the important causes of immiseration of the poor. The government has not been able to ensure even the basic preventative healthcare services such as water supply and sanitation. Only 44 per cent of households (31 per cent of rural households) have access to piped water supply and 47 per cent of households (31 per cent rural households) have access to toilets.

The situation is not very different in the case of education. Relative to GDP, expenditure on education in 2011-12 was just about 3.5 per cent and this is much lower than not only the norm of 6 per cent, but also the spending in countries with comparable levels of development. The low levels of expenditures on education and healthcare explain the government's failure to provide adequate health and education infrastructure.

Competitiveness of domestic producers depends on the quality of physical infrastructure available, but the trend in public spending on this is not very different. The capital expenditure by the Central government as a ratio of GDP has, in fact, declined from about 4 per cent in 2003-04 to 1.8 per cent in 2015-16. Inadequate spending on infrastructures such as roads, railways, ports, power, irrigation and urban development has posed binding constraints on accelerating growth and reducing poverty. The aggregate capital expenditure of the state governments increased during the period from a little over 0.5 per cent to about 3.2 per cent during the period.

In contrast, spending on subsidies and transfers has shown a substantial increase over time. At the Central level alone, explicit subsides as a ratio of GDP more than doubled from 1.2 per cent in 2000-01 to 2.5 per cent in 2012-13, and declined thereafter to 1.8 per cent as the price of crude oil in international markets declined. In addition, over the years, there has been significant increase in transfers such as for employment guarantee and food security, national housing scheme, apart from periodic loan waivers and recapitalization of banks to meet capital adequacy norms from time to time. At the state level too, there have been a proliferation of various subsidies and transfers, besides nutritional schemes and food subsidy. These include setting up of subsidised canteens, giving away of television sets, laptops, and even food processors and grinders. More recently, there has been a spate of loan waivers in different states. Thus, the focus of policy seems to be appeasement rather than long term policy of ensuring employability and increasing productivity.

There is certainly a case for subsidies in cases where externalities are involved. Providing certain amount of subsidy for non-renewable energy, for example, can make generation of solar or wind energy viable and can help to expand generation, promote more research to bring down the costs and reduce dependence on fossil fuels. However, input subsidies given for production can create distortions in its use. Further, it would be preferable not to clutter the policy of subsidising with redistribution. The latter objective is better achieved through direct transfers rather than consumption subsidies. Further, giving subsidy in the explicit form is preferable to keeping the administered prices low or providing tax concessions.

Public spending on social and physical infrastructures, besides low allocation is beset with poor productivity. Many infrastructure projects are marked by time and cost overruns. The governments habitually take on too many projects for which they cannot provide adequate funding resulting in the thin spread of resources and cost and time overruns. Often, public – private partnership projects for which government provides viability gap funding take inordinately long time for want of land acquisition and disputes. The Central government intervenes through specific purpose transfers in activities like Sarva Shiksha Abhiyan (SSA) for elementary education and National Health Mission (NHM) for health. The objective of specific purpose transfers is to ensure minimum standards of such meritorious public services. However, a detailed analysis shows that there are 28 specific purpose transfers resulting in the thin spread of resources. Multiple objectives and too many interventions within SSA and NHM have resulted in the lack of flexibility and poor targeting (Rao, 2017). Further, while enrolment in elementary education has improved, the learning outcomes are poor as pointed out by Annual Status of Education (ASER) reports. Similarly, the transfer system has not helped to ensure minimum standards of preventative healthcare throughout the country. A clear indicator of the poor outcomes in both education and health sector is overwhelming dependence of even the not so well to do sections of population on the private sector for these servicers. Surely, we need both higher allocation and better quality of spending on these services.

Another important development in public spending is the intrusion of Central governments into several state subjects through various central schemes. This is an important political economy development. With coalition governments at the Centre having regional parties as pivotal members of the coalition, there is considerable pressure to initiate programmes with immediate and direct benefits to the people even if it is in the State List. At the same time, there are states ruled by regional parties unfavourable to the parties ruling at the Centre.

Table 1: Public Finance In India (Per cent of GDP)

	Tax Revenues	Non-Tax Revenues	Total Revenues	Revenue Expenditure	Capital Expenditure	Total Expenditure	Revenue Deficit	Fiscal Deficit	Primary Deficit
1990-91	15.40	2.20	17.60	21.6	5.30	26.90	4.20	9.40	5.00
2000-01	14.50	2.30	16.80	23.1	2.90	26.00	6.40	9.30	3.40
2005-06	15.90	2.70	18.60	21.4	4.00	25.40	2.50	6.40	0.80
2007-08	17.50	2.80	20.30	20.3	4.70	25.00	0.10	4.00	-1.00
2008-09	16.30	2.40	18.70	22.9	4.00	26.90	4.20	8.20	3.20
2009-10	15.50	2.20	17.70	23.8	4.20	28.00	5.70	9.40	4.50
2010-11	16.30	3.40	19.70	22.9	7.20	30.10	3.00	6.80	2.30
2011-12	16.43	2.85	19.28	23.14	4.44	27.58	3.17	7.80	1.99
2012-13	17.02	2.86	19.88	22.99	4.18	27.17	3.48	6.90	2.28
2013-14	16.50	3.26	19.76	22.66	4.15	26.81	3.27	6.70	1.80
2014-15	15.75	2.54	18.29	21.13	4.11	25.24	3.34	6.50	2.00
2015-16	16.89	3.70	20.59	22.83	5.28	28.11	2.71	7.20	2.67
2016-17	17.16	4.40	21.57	23.39	4.97	28.36	1.96	6.30	1.67

Note: The Estimates for 2015-16 are actuals for the Union Government and Revised estimate for State governments. Similarly, the data for 2016-17 related to revised estimates of the Union government and budget estimates of the State governments.
Source: 1. Public Finance Statistics, Ministry of Finance, Government of India.
2. Budget Documents of the Union and State governments.

The Central government, in order to take the credit and claim ownership of the programmes closer to the people, designs programmes and gives grants to the state governments for implementation. Prior to 2014-15, the Centre was giving grants directly to various implementing agencies bypassing the states. In 2011-12, the grants to the states amounted to 10.5 per cent of central expenditures and those given directly to spending agencies amounted to 8.4 per cent. Since 2014-15, however, all grants ate channelled through states' budgets.

From the viewpoint of regional equity, the distribution of state level expenditures is extremely important. The analysis shows that inter-state differences in per capita spending on social and economic services are not only high but also have been increasing over the years. Even as the growth rates of development expenditures in low per capita income states have been increasing at a faster rate than those in advanced states since 2003-04, per capita expenditures on these services have continued to diverge. In 2014-15, for example, per capita development expenditure in Bihar, the lowest per capita income state at Rs. 5579 was only 66 per cent of the average of per capita expenditures on these services in general category states. In fact, per capita developmental expenditure in Haryana, a large state with the highest per capita GSDP was 2.4 times that of Bihar. This means that if the unit cost of providing these services is identical, the standards public services on developmental heads for citizens in Haryana would be 2.4 times those of Bihar. Similar differences are seen in the case of individual sectors such as education, healthcare and economic services (Panagariya, Chakraborty and Rao, 2014). The reason for this has to be found in the sharp inter-state differences in the capacity to raise revenues and the inability of the transfer system to offset fiscal disabilities. Given the staggered demographic profile of these states, reaping demographic dividends in the future would require significant improvement in the public service levels in these states.

The important point to note is that much remains to be done to achieve developmental objectives through public expenditure policy. Both low allocations to social services and physical infrastructure and poor quality of spending have severely constrained the effectiveness of the instrument. Inability to increase tax revenues and proliferation of expenditures on subsidies and transfers has crowded out capital expenditures relative to GDP resulting in its steady erosion. The inadequate and poor quality of public spending on education and healthcare has constrained the empowerment of the poor with human development and has led to increased inequalities in human development. The strategy of poverty alleviation is marked by the attempt to make the poor dependent on doles rather than expanding employment opportunities and empowering the poor with skills to take advantage of the opportunities.

3. Tax System in India: Trends and Issues

The tax policy is a major instrument through which the resources are transferred from the private sector to the government for financing public services. However, whenever taxes are imposed, distortions are inevitable as they affect the incentives to save, invest and undertake risks. A good tax system is supposed to raise the required revenues by minimising the collection cost, the compliance cost and the cost in terms of the distortions it creates. The best practice approach to tax reform is to have a broad base, low rate, minimum rate differentiation and a simple and a transparent tax system. While the taxes must have progressive distribution, excessive emphasis on redistribution could be counter-productive. The focus of policy should shift from reduction inequality to reducing poverty and this is better achieved through public spending policies.

Table: 2: Public Expenditure in India								
	1990-91	2000-01	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
I. Non-Dev Expenditures								
(i) Interest Payments	4.27	5.21	4.51	4.62	4.60	4.78	4.82	4.90
(ii) Defence	2.63	2.11	1.98	1.96	1.83	1.81	1.79	1.82
`(iii) Other Adm. Services	7.43	3.35	7.69	7.89	7.80	6.91	8.23	7.71
Total I: Non-Dev Expenditures	14.32	10.67	14.18	14.47	14.23	13.50	14.83	14.43
II. Dev. Expenditures								
(i) Education	3.19	2.89	3.42	6.66	7.17	3.35	3.38	3.45
(ii) Healthcare	1.24	1.15	1.31	1.46	1.29	1.27	1.42	1.42
(iii) Total Social Services	5.28	4.84	6.36	6.66	6.61	6.34	5.25	6.89
(iv) Total Economic Services	6.86	7.92	6.51	6.13	5.79	6.45	8.07	6.42
Total : Dev. Expenditures	12.14	12.76	12.87	12.79	1.24	12.79	13.32	13.30
Total Expenditures	26.90	23.44	27.05	27.26	26.64	26.29	28.15	27.73
Revenue Expenditures	21.6	23.1	22.9	23.1	22.99	22.66	21.13	22.83
Capital Expenditures	5.3	2.9	7.2	4.44	4.18	4.15	4.11	5.25
Total Central Government Expenditure	12.6	10.4	13.01	12.84	12.11	11.91	10.73	10.58
Total State government Expenditure	14.3	13.0	14.04.	14.42	14.53	14.38	17.42	17.16

Note: During the period 2010-11 to 2013-14, the central transfers through independent agencies are taken as central expenditures. In other years, these transfers are made to the State governments.
Source: Public Finance Statistics, Ministry of Finance, Government of India (relevant years).

Table 3: Per Capita Expenditures in Large Non-Special Category States 2014-15 (In Rupees)

States	Per Capita Education Expenditure	Per Capita Health Expenditure	Per Capita Development Expenditure	Per Capita Total Expenditure	Per Capita GSDP
Andhra Pradesh	3265	1099	18588	24410	106263
Bihar	1501	327	5579	8136	33954
Chhattisgarh	3519	863	13202	17005	87354
Gujarat	2801	1005	12486	17446	141405
Haryana	3555	840	13579	20030	165728
Jharkhand	1666	463	7772	10903	62091
Karnataka	2894	921	13987	19482	144869
Kerala	3854	1244	11376	22549	155005
Madhya Pradesh	2163	622	9564	13073	63323
Maharashtra	3394	762	11383	16822	152853
Odisha	2340	732	10740	14356	71184
Punjab	2623	813	8932	17153	126606
Rajasthan	2691	896	11355	15291	84837
Tamil Nadu	3331	997	12995	20062	146503
Telangana	1904	700	12469	16461	141979
Uttar Pradesh	776	262	4667	5802	59450
West Bengal	2505	754	8290	13465	94711

Source: Finance Accounts of the State Governments, Comptroller and Auditor General, Government of India.

The tax system in India, despite several rounds of reforms, has not been able to generate the required revenues. The tax-GDP ratio was 15.8 per cent in 1991-92 when economic reforms were initiated and the ratio of central taxes to GDP was 10.2 per cent. After a decade of reforms, the tax-GDP ratio declined to 13.4 per cent in 2001-02 mainly on account of the decline in central taxes by two percentage points to 8.2 per cent (Rao and Rao, 2006). The revenue from both import duties and excise duty declined respectively by two and one percentage points and with revenue from income taxes increasing by one percentage point, the overall decline in the central government's tax ratio was limited to two percentage points. While the general experience of liberalization in developing countries is to recoup the revenue loss from reducing import duties by introducing the value added tax, such an option could not be explored in India as the power to levy sales taxes rested with the states and state level reforms could not be coordinated with that of the Centre (Rao and Rao, 2011).

Another round of tax reforms was initiated after 2004-05. The creation of tax information network and expansion of the base of service tax at the Central level and replacement of the cascading type sales taxes with the value added tax in 2005-06 by the States. Consequently the tax-GDP ratio increased from 14.6 per cent in 2003-04 to 17.5 in 2007-08. A bulk of this increase, almost 2.6 percentage points was due to increase in income tax revenue relative to GDP from 2.7 per cent in 2003-04 to 6.3 percent in 2007-08. In fact, revenue from income taxes registered an average growth of more than 30 per cent during this period. At the state level, the replacement of cascading type sales taxes with multiple rates with a value added tax with only two rates considerably simplified the tax system, reduced distortions while increasing the revenue productivity. After 2007-08, however, the tax ratio declined to 15.5 per cent in 2009-10 partly due to the stimulus given in terms of reduction in excise duty and service tax rates in the wake of global financial crisis. It gradually recovered to 17 per cent in 2016-17.

How does revenue productivity of the Indian tax system compare by international standards? Bird and Zolt (2003) show that in 2000, the average tax ratio for the middle income countries (per capita Income ranging from USD 1000 to USD 17000) was 22 per cent. In comparison, the ratio in India has been lower. After reaching 17.5 per cent in 2007-08, the ratio declined to 15.5 per cent in 2009-10 and has been hovering around 16.2 to 16.5 per cent since.

To analyse the level of under-taxation in India, an attempt is made to estimate the tax-GDP ratio that the country should raise based on cross-country relationship between tax ratio and per capita income in a regression model, based on the data for 98 countries by combining information from both IMF (Government Finance Statistics) and OECD for the year 2010. The estimated equation was of the form:

$$T/Y = Ln(Y/P) + Rn/R + \in$$

Where, T/Y denotes tax-GDP ratio, Y/P represents per capita GDP, and Rn/R represents the share of revenue from natural resources in total revenues. Tax revenue data is sum total of the tax revenue being generated at different levels of government(s) in a country. While Y/P represents the ability of the people to pay taxes, Rn/R takes into account the fact that the need to raise tax revenue is lower in countries which derive substantial revenue from natural resources. It is seen that we have not included a constant term in the equation as at zero values of independent variables, the tax revenue too has to be zero.

Two alternative sets of equations are estimated, one by taking per capita nominal GDP according to purchasing power parity and another by using simple dollar exchange (USA) values (Table 4).

Table 4: Regression Equations with Tax – GSP Ratio Regressed on Per capita GDP N= 98			
1. Per Capita GDP in PPP			
Tax GDP ratio	**Coefficient**	**t-stat**	**Adjusted R Square**
Log (per capita income in PPP $)	2.642	23.89	0.88
Revenue share of rent from natural resources in GDP	- 0.303	-3.21	
2. Per Capita GDP in Dollar Exchange Rate			
Log(per capita income in $ terms)	2.781	26.05	0.897
Revenue share of rent from natural resources	-0.261	-3.0	

The predicted values of tax-GDP ratios for India are obtained by substituting the values of independent variables in the equation using per capita GDP in PPP terms. The predicted value for India based on the estimates presented in table 2a are 19.95 with the 95 per cent prediction confidence band ranging from 18.42 to 21.49 per cent. Thus, the current tax GDP ratio in India is much lower than even the predicted lower bound based on the international experiences. Similarly, the predicted value of tax-GDP ratio derived from the equation using per capita GDP at dollar exchange rate in place of the purchasing power parity value for 2010 is 18.16 per cent.

Thus, it is seen from the cross-country estimates, (i) the tax – GDP ratio increases with the level of per capita incomes, (ii) India's tax-GDP ratio of 17 per cent is lower than the average of Lower Middle Income group of 17.8 per cent and much lower than the predicted estimate for India from the regression at 19.95 per cent and much lower than the average predicted value for the group at 21.46 per cent (Table 5), (iii) the revenue productivity of the Indian tax system has not only been low but has not shown any perceptible increase over the years, despite increases in per capita incomes.

Table 5: Average Tax GDP-ratio across income group of the countries			
	Number of Countries in our sample	**Tax GDP ratio**	**Predicted Tax GDP ratio**
High income	36	29.03	26.26
Upper middle	24	23.84	23.03
Lower middle	24	17.83	21.46
Lower income	14	12.11	16.22

Surely, the country which aspires to accelerate its development has to substantially augment its public spending on physical infrastructure and human development. It must be noted that public spending in India has been static over the years hovering around 26-28 per cent and investments in physical and social infrastructure has been severely constrained by stagnant revenues, proliferating subsidies and transfers and limits on borrowing placed by the fiscal responsibility and budget management (FRBM). It is therefore, important that efforts must be made to increase the fiscal space by increasing the tax-GDP ratio at least to the average levels.

b. What ails the Indian tax system?[2]

The most important factor for the low revenue productivity of the Indian tax system has to be found in the narrow tax bases. There are a variety of reasons rendering the tax bases narrow and these include (i) the fragmented Constitutional assignment, (ii) wide ranging tax preferences, (iii) multiplicity of objectives assigned to tax policy resulting in complications in the tax laws wide avenues for evasion and avoidance and large and increasing amounts held in disputes, (iv) tax abuse by multinational companies resulting in base erosion and profit shifting and (v) poor capacity of tax administration including the information system to effectively administer and enforce the taxes.

Inability to levy a comprehensive income tax in India, in part, lies in the constitutional assignment itself. The assignment of the tax on incomes from agriculture to the States has resulted in the Union government levying tax only on non-agricultural incomes. The States do not levy the agricultural income tax except the income from plantation crops. Even the corporates making investments in agricultural sector do not have to pay the tax. The study by Rao and Sengupta (2011) for 2008-09 estimates the potential from taxing agricultural incomes at 0.6 per cent of GDP. The exemption to the agricultural sector prevents the levy of comprehensive income taxation and provides easy avenue for the evasion and avoidance.

The second important reason for the narrow base of taxes is a plethora of exemptions, concessions and deductions given in direct and indirect taxes. A close look at the number of objectives pursued by the tax system is enough to understand the complications and its ineffectiveness in achieving the multiple objectives. Besides raising revenues, the tax system is required to achieve objectives such as incentivising savings, promoting exports, achieving balanced regional development, promoting investments in infrastructure, expanding employment, promoting scientific research and development, encouraging cooperatives and charitable activities. Similarly, the excise duty is supposed to provide preferential treatment to small scale industries by keeping the threshold high, promoting backward area development. Incorporation of all these objectives in tax laws creates enormous avenues for evasion and avoidance and no one can be sure how much of these objectives are achieved if at all.

Since 2006, Government of India has been publishing estimates of revenue foregone from various tax concessions in the budget. For 2014-15, the budget estimates of the revenue foregone was at a staggering Rs. 5,89,285 crore. Of this, Rs. 3,01,688 crore was on account of customs and Rs. 1,84,764 crore on account of excise duties. These estimates bring out a glaring shortcoming in the tax system constraining the revenue productivity. The revenue lost on account of special economic zones for 2014-15 was estimated at Rs. 20376 crore from the corporate tax alone. The revenue cost of area based incentives for

[2] This section is based substantially on Rao and Kumar (2017) and Rao (2015/16).

2014-15 was estimated at Rs. 17,284 crore from excise duty and almost Rs. 8000 crore in the case of corporation tax. The revenue forgone on account of tax concession to infrastructure industries works out to Rs. 22,230 crore. There are also customs duty reductions in the case of items like fertilizers. A close scrutiny of these tax preferences could easily result in enhancing the ratio of tax to GDP by at least one percentage point.

The fourth important factor eroding the base is the way in which multinational operate in the country. Base erosion and profit shifting (BEPS) by multinational companies is a worldwide phenomenon. They indulge in a variety of ways to indulge in tax abuse. Creating a web of complex subsidiaries and shifting the profits to subsidiaries located in low tax jurisdictions and taking advantage of the tax treaties is one of the common methods employed. Manipulating prices in related party transactions or what is usually called transfer pricing to reduce the tax liability is another. Although there are “arm’s length pricing rules” to deal with transfer pricing issue, it is difficult to apply it in practice when intangible assets are involved and these include trade names, goodwill, and brand recognition as well as intellectual property, such as patents, copyrights, brands and trademarks and business methodologies. Multinational companies also act as intermediaries in product sales and distribution, make loans and interest payments to one another and charge fees to one another for activities such as management services, treasury services and investment services to reduce the tax liability.

Tax avoidance by multinational companies, as mentioned above, is a global phenomenon.[3] Overwhelming evidence of this even in developed countries has led the OECD and, in more recent times the G-20 countries to demand the OECD to bring out proposals for reform. It brought out an Action Plan in September 2013. In the meantime, the international Commission for the Reform of International Corporate Taxation (ICRICT) in its report has made a number of recommendations to deal with this pernicious practice (ICRICT, 2015).

In Indian context, there is considerable anecdotal evidence to show that the multinational companies have been indulging in abusive tax practices. Patnaik and Shah (2011) in their study showed that the effective corporation tax rate on multinational companies was significantly lower than domestic companies. Rao and Sengupta (2012), in their more detailed study using the prowess database, show that during the period 2006-2011, effective interest rate paid by the multinational companies were higher and amount of tax paid per unit of borrowing was lower. The paper also cites specific instances of the multinational companies indulging in tax abuse.

The problem is compounded by the fact that while the multinational companies have access to enormous resources which they use in hiring the best accountants and lawyers, the tax administrations in most developing countries is hamstrung by low resources

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[3] A recent study by United Food and Commercial Workers International Union estimates the assets stashed by Walmart in tax havens at US$78 billion. It has 78 subsidiaries or branches of which more than 30 were created after 2009. More than 90 per cent of these assets are owned by subsidiaries in Luxembourg and the Netherlands. The former, even without a single store in Luxembourg reported US$ 1.3 billion as profits in 2010. (http://www.bloomberg.com/news/articles/2015-06-17/wal-mart-has-76-billion-in-overseas-tax-havens-report-says

as well as administrative capacity. The general anti-avoidance rules (GAAR), after repeated postponement, is being implemented from 2017-18. While it is legitimate for the countries to demand a fair share of their taxes, it is also important that they should build capacity in their tax administrations to draft their laws better, have more competent staff and apply the laws more evenly. Of course, information exchange among the countries may help, but the countries should have the capability and intention to use the information better to enforce the laws. Surely, no country should expect others to draft and enforce the tax laws for them.

Finally, Indian tax administration does not evoke the confidence and trust that a modern tax administration should. There have been a number of reports on the reform of the tax administration beginning with Report of the Tax Reforms Commission (1991). The careful studies by Das-Gupta and Mukherjee (1998), and more recently the Reports of the Tax Administration Reforms Commission (India, 2014, 2015) have dealt with various aspects of the reform of tax administration in detail. The issue is one of implementation of the reforms.

The important problems of tax administration in India has to deal with (i) lack of autonomy; (ii) low morale of tax administrators arising from low prospects of progression in the careers of administrators; (iii) organizational problems of separation of direct and indirect tax administration and lack of coordination, effective communication and information exchange between them; (iv) area-wise rather than functional divisions and lack of functional specialization including developing intelligence system; (v) poor information system and limited use of technology for tax administration; (vi) perverse incentive from setting targets to tax administrators and judging their performances based on the fulfilment of the targets; (vii) Poor capacity to forecast revenues; (viii) lack of clarity in tax laws and wide discretion to tax officials and build-up of huge amount of revenues; (ix) adversarial attitude of the tax administration towards taxpayers and essentially considering them as tax evaders rather than agents who collect the tax from the people on behalf of the tax departments. While the problems with both the organizational set up and the functioning of the tax administration are well known, there have been few attempts to address them.

One of the consequences of unclear tax laws and poor administration has been the build-up of huge tax arrears. At the end of 2013-14, the amount of tax arrears from various taxes amounted to over 5.1 per cent of GDP. Almost 86 per cent of this is held up in disputes. In fact, about 47 per cent of the arrears have accumulated in disputes up to 2 years and the arrears held in disputes up to 5 years work up to 76 per cent of the arrears.

4. Indian Public Finance: Deficits and Debt

Persistence of large fiscal deficits in India has led to huge build-up of debt. At over 75 per cent of GDP, India's debt is significantly higher than comparable estimates for middle income countries (58 per cent). While generally, public spending financed by borrowing is necessary, it is important to see that it leads to additional economic activity. There is considerable controversy on the desirability of financing public expenditures by borrowed funds. The Ricardian equivalence theorem posits that fiscal deficits do not have impact on interest rates and growth because the government's dissaving is matched by household's decision to have higher savings to meet additional tax liabilities in the future. In the real world situation, however, that is not likely. For the Ricardian equivalence theorem to hold, it is necessary to meet the strong assumptions that the individuals in the economy have the foresight, know the discount rates equivalent to government's discount rates on spending and have very long time horizons for evaluating present value future tax payments (Rangarajan and Srivastava, 2011).

Therefore, there must be limits to borrowing as a source of financing public spending. In normal times, the golden rule is that all current expenditures for paying salaries, interest, maintenance of capital assets, subsidies and other transfers should be financed from current revenues from tax and non-tax sources and capital expenditures could be financed from borrowing. This is only a broad rule to ensure that borrowed funds are used to finance expenditures which would accelerate the growth rate of the economy at least equivalent to the interest rate on the borrowing. While it is not possible to give a general rule on the optimal level of deficits and debt, borrowing can be resorted to so long as it leads to net increase in employment and incomes.

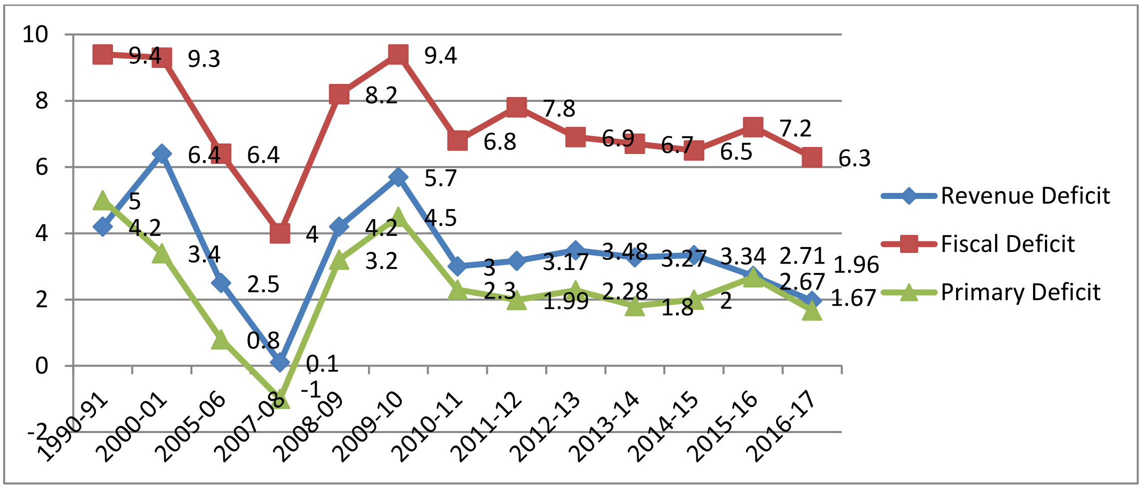
Excessive borrowing to finance public spending can have severe adverse implications. First, as already mentioned, excessive draft on household sector's financial savings would put upward pressure on interest rates and crowd out private investments. Second, high volume of debt results in high interest payments which pre-empts public spending on productive activities. Third, borrowing now will have to be repaid later through higher taxes and therefore, involves a burden on the future generation. Fourth, high deficits could lead to balance of payment problems. For these reasons credit rating agencies attach high risk perception to countries with high levels of deficits and debt resulting in higher borrowing international costs. Therefore, in many countries, fiscal rules are legislated to contain the levels of deficits and debt.

In India, there have been concerns about the deficits and debt for long and the economic crisis of 1991 was mainly attributed to lax fiscal policy. As Little and Joshi (1994; p. 215) state, "…the crisis of 1990/91 and 1991/92 is wholly attributable to the lax fiscal policy of the preceding years. The rapid growth of debt, ….together with political instability that delayed effective response to the gathering storm, made it impossible to finance the balance of payments deficit". The fiscal problem resurfaced in 2001-02 when the consolidated fiscal deficit was 10.3 per cent of GDP, primary deficit was close to 3 per cent and revenue deficit was about 7 per cent. With the outstanding liabilities of the government estimated at 72.5 per cent of GDP and interest payment claiming 35 per cent of the total revenue receipts, there were serious questions on debt sustainability. With the primary deficit hovering at around 2-3 per cent of GDP, there were a number of years during this period, when the debt–GDP ratio showed a steady increase (Buiter and Patel, 2006). This led the Central government to pass the Fiscal Responsibility of Budget Management Act (FRBMA) in 2003 and this was followed by all the States enacting fiscal responsibility legislations based on the recommendation of the 12th Finance Commission. Of course, the Twelfth Finance Commission provided significant incentives to the States by linking write off and rescheduling of central government debt with passing of the fiscal responsibility legislations and reduction in the fiscal deficits for the period 2004-2009. The Commission set the targets to phase out the revenue deficits at both Central and state levels and contain the fiscal deficit at 3 per cent of GDP each at Central and state levels. The 13th Finance

Commission reset the fiscal deficit targets at 3 per cent for the central government and 3 per cent of GSDP for the States (2.4 per cent of GDP) to be achieved by 2014-15.

The subsequent period, from 2004-05 to 2007-08 saw significant fiscal consolidation at both C State levels (Figure 1). At the State level too significant consolidation was achieved, thanks to the 12th Finance Commissions generous incentive scheme of writing off of a half of the outstanding Central loans on enacting the fiscal responsibility legislations. Buoyed by sharp acceleration in the growth of revenues, fiscal deficit to GDP ratio at the Centre declined from over 6 per cent in 2001-02 to 3 per cent in 2007-08. As mentioned earlier, the introduction of the tax information network combined with high growth rate of GDP during the period, resulted in the income tax revenue as a ratio of GDP increasing by two percentage points from 3.7 per cent of GDP in 2003-04 to 6.3 per cent of GDP in 2007-08. In addition, revenue from service taxes increased by more than half a percentage point. However, the Central government could not adhere to its target of completely phasing out the revenue deficit. In contrast, the states together were able to phase out the revenue deficit and even have a revenue surplus of half a per cent of GDP by 2007-08. They were also able to contain their fiscal deficit to 1.5 per cent in 2007-08. Thus, by 2007-08, relative to GDP, the consolidated fiscal deficit GDP was just about 4.5 per cent as against the target of 6 per cent, revenue deficit was just about half a per cent and there was a primary surplus of one per cent.

Figure 1: Fiscal Imbalances in India 1991-2017



The states in the aggregate have been able to achieve the targets, partly due to the generous debt write off and rescheduling based on the recommendations of the 12th Finance Commission (which correspondingly increased Centre's liability). However, the central government's fiscal position changed drastically after 2008-09 mainly due to the sharp increases in subsidies and transfers. The expansion of rural employment guarantee scheme from 200 districts to the whole country, introduction of farm loan waiver and the implementation of pay commission recommendations in the 2008-09 budget increased the expenditures of the central government significantly. In addition, sharp increase in international price of crude oil which hit the all-time high of USD. 165/barrel in July 2008, and the government's reluctance to increase the prices of distillates, resulted in the additional subsidy bill of about 2.5 per cent of GDP. Consequently, Centre's revenue deficit increased from 1.1 per cent in 2007-08 to 4.5 per cent in 2008-09 and fiscal deficit increased by over five percentage points from 3.1 per cent to 8.2 per cent. The problem was further exacerbated by the decline in centre's tax-GDP ratio by more than two percentage points to GDP from 11.8 per cent in 2007-08 to 9.6 per cent in 2010-11. Consequently, the consolidated revenue and fiscal deficits in 2008-09 increased to 4.4 per cent and 10.6 per cent respectively. Thus, there was a significant slippage in achieving fiscal consolidation at the central level.

In the event, the FRBM targets set for the Union government were breached by a variety of ways. There were pauses in the attempts to reach the targets in some years, off-budget liabilities were created to camouflage the deficits and targets were reworked from time to time as the original target was found infeasible. In the case of revenue deficit targets, a new concept of "effective revenue deficit" was created. Furthermore, although the automatic monetisation of the deficit was stopped, from time to time the RBI had to inject liquidity to the system through open market operations to accommodate government borrowing. The Fourteenth Finance Commission reiterated the targets at 3 per cent of GDP for the Union government and 3 per cent of GSDP for the States with some leeway (25 basis points) to states with low debt to GSDP ratio and interest payments to own revenue ratio. Subsequently, the Union Finance Minister in his 2016-17 budget speech announced the setting up of the FRBM Review Committee. The mandate of the Committee included (i) the review of FRBM targets; (ii) examination of the range rather than a point estimate of fiscal targets; and (iii) exploring the possibility of linking fiscal expansion or contraction to credit contraction or expansion.

The 12th Finance Commission (India, 2004), while fixing the fiscal deficit target at 6 per cent of GDP had explained the rationale. Given that only in the household sector savings- investment balance is positive, only the financial sector savings of the household sector are available for investment in corporate and government sectors. As the household sector's transferable saving was about 10 per cent of GDP and an acceptable level of current account deficit of 1.5 per cent, after meeting the aggregate fiscal deficit of the Union and States at 6 per cent and the requirement of the public enterprises of 1.5 per cent, the private sector would be left with the saving of about 4 per cent for its investment. Thus a target of 6 per cent of GDP would leave enough borrowing space to the private sector and will avoid financial crowding out. In fact, over the years, household sector's financial saving has declined and the latest available estimate is that it is just about 7.8 per cent. Thus, in the present scenario, the combined fiscal deficit of 6 per cent (3.5 at the Union and 2.5 at the State level), and with the public enterprises requiring 1.5 per cent, there is hardly any borrowing space left for the private sector investment. In the event, even as the Ministry of Finance wants the RBI to reduce the interest rates, the RBI has been reluctant to do so for good reasons. Added to this is the problem of twin balance sheets – that of overhang of the debt by the private sector and huge volume of non-performing loans of commercial banks. These have resulted in both lack of demand for viable investment projects by the corporates and the reluctance to lend by the commercial banks.

Calibration of efficient fiscal policy has three important pre-requisites. First, the budget forecast must be realistic and not aspirational. This is necessary for efficient execution of spending particularly in a federal country. Second, transparency in budgeting requires that costs of all new programmes and policy announcements – both in the short and in the long term - are properly estimated and included in the budget. In Indian context, schemes are announced without making proper estimate of the expenditure involved. There are also various pre-election announcements and the costs of these are not known until they are implemented. The estimates put out on the revenue forgone on account of various tax concessions need to be made on a much more scientific manner. Despite recommendations by the previous commissions to make an estimate of asset and liability positions of the government, not much seems to have been done. There is no reliable estimate of contingent liabilities arising from various public private partnership projects. Third, it is important to closely monitor the fiscal targets to ensure their compliance.

The 13th Finance Commission (India, 2009), while recommending the revised roadmap for fiscal consolidation underlined the need for making the FRBM process more transparent and comprehensive and sensitive to exogenous shocks and introduction of mechanisms to improve monitoring and compliance. In the case of the States, the Commission noted that while the incentive linked conditions were effective in improving the fiscal health, the independent review provided in the FRBM legislations of many state governments significantly contributed to improving credibility and transparency of the actions taken by these State governments. Therefore, the Commission recommended the setting up of an autonomous body to conduct an independent review of FRBM compliance including the fiscal impact of policy decisions on the FRBM roadmap to be presented along with the annual budget and medium term strategy. The committee was supposed to report to the Ministry of Finance and over time evolve into a full-fledged Fiscal Council (India, 2009; Para 9.65). The Commission concluded, "…As the size and complexity of the Indian economy expands, it is imperative that such an institution be developed to assist the government in addressing its fiscal tasks in a professional, transparent and effective manner." (para 9.66).

Deficit bias in the government budgets has been found to be a major case of government failure in most democracies and therefore, attempts have been made to provide checks and balances by creating institutions to make the governments behave. Worldwide experience has shown the preference to finance expanding expenditures by borrowing due to myopic view of the policy makers and in particular, electoral budget cycles. This is aided further by the lack of transparency and fiscal illusion. Not surprisingly, the world over, there have been a movement towards rule based fiscal policy. The policy in this regard includes legislating fiscal responsibility with numerical fiscal targets and the requirement to prepare and place a medium term fiscal framework in the Parliament. More recent attempts to provide checks and balances on this include the creation of an independent fiscal institution to review and monitor the conduct of fiscal policy.

Therefore, the idea of a Fiscal Council is sound, but if it has to be appointed by the Finance Ministry and will be reporting to the Finance Ministry, it will cease to be independent. Therefore, the Fourteenth Finance Commission (India, 2014) recommended that an independent Fiscal Council should be established through an amendment to the

FRBM Act by inserting a new section mandating the establishment of an independent Fiscal Council to undertake ex ante assessment of budget proposals and to ensure their consistency with fiscal policy and rules. The Council is supposed to be appointed by and reporting to the Parliament and should have its own budget. The functions of the Council include ex ante evaluation of the fiscal implications of the budget proposals which include evaluation of the realism of the forecasts and its consistency with the fiscal rules and estimating the cost of various proposals made in the budget. The ex-post evaluation and monitoring of the budget was left to the Comptroller and Auditor General. In the light of the above, there are questions about the independence of the Fiscal Council if it is appointed by the Ministry of Finance and will be reporting to it.

The Fiscal Review Committee (India, 2017) re-iterated the need to have a prudent fiscal management and rein in the deficits. The important recommendations of the Committee include (i) taking debt as the anchor and fiscal deficit as the instrument to achieve this. The debt to be reduced to 60 per cent of GDP in 2023 from the present level of about 70 per cent and the Central and State targets respectively fixed at 40 per cent and 20 per cent. This is supposed to be achieved by containing the fiscal deficit at 3 per cent of GDP in the first three years and 2.5 per cent in the next two years and containing the fiscal deficit at the state level at 2.5 per cent. The target is based on the available information on the household sector's financial saving and available foreign funds and equal sharing of the available funds between the government and enterprise sectors. The revenue deficit should be progressively reduced each year by 0.25 percentage point to reach 0.8 per cent in 2023 which will improve the quality of adjustment in terms of the ratio of revenue deficit to fiscal deficit from 66 per cent prevailing at present to 32 per cent. (ii) The Committee did not recommend fixing the targets in terms of a range nor did it favour linking deficit changes to coincide inversely to credit expansion and contraction. (iii) The Committee specified the circumstances for deviating from the target as overriding considerations such as natural calamity or war, far reaching structural reforms with fiscal implications and a sharp decline/increase in the output by 3 percentage points in four successive quarters for a 25 basis point deviation; and (iv) setting up of an institution "Fiscal Council" to forecast, review and monitor the conduct of rule based fiscal policy.

The recommendation on the Finance Ministry setting up the Fiscal Council has to be viewed with skepticism. This recommendation is similar to the one made by the 13th Finance Commission. The idea is to have an independent Fiscal Council and if it has to be appointed by the Ministry of Finance and reporting to it, it will cease to be independent. It is therefore, appropriate that the Council should be appointed by the Parliament and should report to it as recommended by the Fourteenth Finance Commission. Of course, if there is a political will to rein in the deficits and debt, there is no need for an independent monitor and if there is no will, the monitor can do precious little. The appointment of the Council is not a silver bullet. Yet, an independent Council will help to raise the public awareness of the government's fiscal stance and in that sense, an important checks and balances mechanism.

5. Concluding Remarks

Policies relating to public finance can play an important role in accelerating growth and promoting human development, they can be effectively employed to and reduce poverty. Besides ensuring safety and security of the people and protecting their property rights and creating enabling environment for growth, they can be employed to reduce poverty by endowing capital to those who do not have access to physical assets through education, healthcare and skill development. This enables the poor to participate and gain from the growth process through productive employment and income earning opportunities. Such a policy is particularly important to reap demographic dividend in an economy with a large proportion of the people in the working age and a considerable proportion of them with very low education and skill levels. However, public spending has to be financed either from taxation or borrowing. Each of these sources can have important implications for resource allocation, growth and equity.

However, there are a number of inhibiting factors constraining the public finance policies. The tax system is marked by not only low revenue productivity but also unintended distortions. Narrow bases due to various tax preferences given, widespread avoidance of evasion of taxes and poor administrative capacity have constrained revenue productivity. The assignment of agricultural income tax to the states and taxes on non-agricultural income to the centre has created an important avenue for avoidance and evasion. The strong farm lobby has ensured that the states do not levy the tax on agricultural income and this makes detection of misclassification of non-agricultural income difficult to detect. The corporate sector has been successfully reducing the effective tax liability by using various tax preferences to reduce the effective tax payments. The multinational companies by routing the investment through tax havens have been successful in avoiding the tax and there is considerable evidence of using transfer pricing mechanism for the purpose.

Ensuring competitive levels of physical and social infrastructure as well as alleviating poverty and income redistribution is achieved mainly through public expenditure. With interest payments pre-empting over 28 per cent of total revenues and wages and salaries and subsidies and transfers proliferating, allocation to physical infrastructure and human development has suffered. Here again, special interest group politics has led to proliferation of implicit and explicit subsidies and transfers and these, besides distorting the factor and product markets have crowded out productive expenditures on physical infrastructure and human development. Erosion of capital expenditure over the years has constrained realising the growth potential. Inadequate allocation to education and healthcare combined with poor quality of spending has made it difficult to reap the demographic dividends. The declining time horizon of political parties has led the governments to focus on short term political gains by providing doles to the poor in preference to empowering them with education and skills and improving their productivity.

Large and persisting deficits and debt has been a bane in India. The problem has re-emerged after 2008-09 and the attempts to achieve fiscal consolidation have not been successful. While the states have been, with some exceptions, able to adhere to the fiscal rules, the Central government has breached the rules with impunity with adverse effects on investment, growth and inflation. Large draft on household sector's financial savings by the government for public spending has put pressure on interest rates, adversely impacted on economic growth and put pressure on balance of payments. The large and persisting deficit has also reduced the policy space for calibrating monetary policy by the Reserve Bank of India.

The experience of fiscal adjustment brings to the fore the need for a robust institutional arrangement to monitor fiscal rules both for the centre and states. Absence of an independent mechanism to monitor and enforce and to ensure Parliamentary accountability is a major shortcoming. There is perhaps a need to have an independent and expert Federal Council monitoring the fiscal rules and reporting to the Parliament. Some countries have set up Fiscal Councils to monitor the adherence to fiscal and submit periodic reports to the legislatures. While this could help in raising awareness of the problem, ultimately, it is the political will that is necessary for stable and sustainable public finance policy in India.

As stated by Richard Musgrave, governments, like markets do not act with perfection. It is not surprising that political factors have constrained the realization of objectives of growth, redistribution and stabilization to the desired extent. It is important to institute checks and balances to contain the influence of vested interests through policies and institutions aligned to achieve the objectives, wider dissemination of knowledge and information and establishing legislative accountability.

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M. Govinda Rao, is Emeritus Professor, NIPFP
Email: mgovinda.rao@nipfp.org.in

National Institute of Public Finance and Policy,
18/2, Satsang Vihar Marg,
Special Institutional Area (Near JNU),
New Delhi 110067
Tel. No. 26569303, 26569780, 26569784
Fax: 91-11-26852548
www.nipfp.org.in