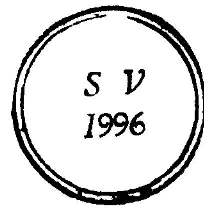

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LESSONS FROM INDIA

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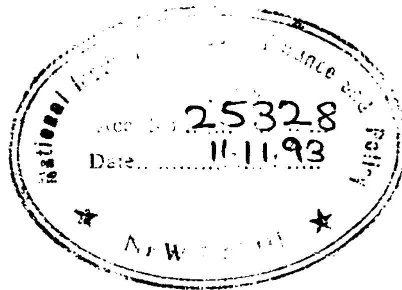

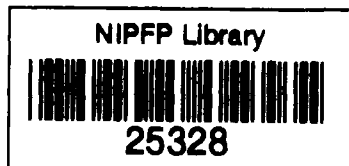

PUBLIC FINANCE AND ECONOMIC DEVELOPMENT: LESSONS FROM INDIA

**M. Govinda Rao*
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I. Introduction

Although the quest for rapid economic growth in India began with the introduction of development planning in 1951, it was only in the formulation of the Second Five Year Plan (1956) that the logic of the development strategy was fully articulated. This Nehru-Mahalanobis strategy of development emphasised "rapid industrialisation with particular emphasis on the development of basic and heavy industries". The fear of foreign domination arising from the colonial past and the feeling of export pessimism naturally led to the adoption of import substituting strategy and this social engineering could not be achieved without the public sector being assigned "commanding heights" in the economic activities of the country. This, in short, was a unique experiment of democratic centralised planning in the framework of a mixed economy.

The developmental strategy chosen at the time was influenced by both the philosophy of the times as well as the ground realities and constraints. The success of the Keynesian type of policies in fighting the Great Depression and more importantly, the achievements of Soviet industrialisation signified the importance of social engineering and centralised planning in allocating investments. The dominant opinion of development economists was that the problem of 'vicious circle of poverty' constrained the poorer countries in achieving transfer of surplus labour from the less productive agricultural sector to the more productive manufacturing sector (Nurkse, 1953). To achieve speedy industrialisation, large investments in social overhead capital to create generalised externalities were necessary and this could be undertaken only by the State (Rosenstein -Rodan, 1943).

The development strategy was also partly influenced by the structural constraints faced by the economy. The low levels of saving and investment, weak industrial base, lack of infrastructure, obsolete technology, scarcity of skilled manpower and virtual non-existence of a modern entrepreneurial class necessitated the State to take up the role of a catalyst to as well as an active participant in industrial progress.

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In this public sector dominated, heavy industry based industrialisation strategy, fiscal policy had to be designed to fulfill three important objectives namely, (i) raising the level of saving and capital formation, (ii) allocating the available resources in accordance with plan priorities; and (iii) achieving the desired state of redistribution.

Table 1

Growth Rates of Real GDP in Selected Countries

(per cent per annum)

Country	1965 - 1980			1980 - 1990		
	Total	Agriculture	Industry	Total	Agriculture	Industry
(1)	(2)	(2)	(3)	(4)	(5)	(6)
Bangladesh	1.7	0.6	1.5	4.3	2.6	4.9
India	3.6	2.5	4.2	5.3	3.1	6.1
China	6.8	2.8	10.0	9.5	6.1	12.5
Pakistan	5.2	3.3	6.4	6.3	4.3	7.3
Sri Lanka	4.0	2.7	4.7	4.0	2.3	4.6
Indonesia	7.0	4.3	11.9	5.5	3.2	9.0
Thailand	7.3	4.6	9.5	7.6	4.1	9.0
Turkey	6.2	3.2	7.2	5.1	3.0	6.2
Chile	1.9	1.6	0.8	3.2	4.2	3.4
Mexico	6.5	3.2	7.6	1.0	0.4	1.0
Brazil	9.0	3.6	10.1	2.7	2.8	2.1
Korea	9.9	3.0	16.4	9.7	2.8	12.2

Source: Ahluwalia (1993).

The achievements of four decades of planning have been significant in a number of respects, but in many others falls much short of the potential. Indeed, in contrast to the virtual stagnation in the preceding fifty years, the economy recorded the growth rate of 3.6 per cent in real terms during the First Plan (1951-56) and almost 4 per cent during the Second (1956-61). But this momentum could not be maintained and the long-term annual GDP growth rate hovered around just 3.5 per cent to be characterised as 'Hindu' rate of growth until the beginning of 1980s. Of course, the economy got into a higher growth path in the 1980s (5.3 per cent), yet, the performance was far below what was seen in many other countries. A comparison of GDP growth rates for India and other countries presented in Table 1 shows that during 1965-80, Indian growth performance was close to the bottom, better than only Bangladesh and Chile, and in the next decade (1980-90), its performance was in the middle range (Ahluwalia,

1993). Countries like China, Korea, Malaysia and Thailand with per capita income levels as much as or below India in the 1950s reached the income levels far higher by 1990.

The efficacy of the State-dominated, heavy industry-based strategy of import substituting industrialisation came into serious questioning when the country slipped into the worst economic crisis following the sharp rise in oil prices consequent to the U.S.-Iraq conflict in August, 1990. It may be noted that the economic crisis of such a magnitude occurred after a buoyant growth performance of the economy for about a decade. The diagnoses unambiguously point towards large and persisting fiscal imbalances as the principal cause of macro-economic and foreign trade account imbalance driving the economy to the crisis situation. This led to serious reconsideration of the role of the State vis-a-vis the market and to the questioning of the efficacy of a State dominated, import substituting development strategy. Given that fiscal policy is one of the principal instruments of intervention and as the persistent fiscal deficit was held to be the major cause of economic crisis, the emphasis naturally focused on the efficacy of public finance instruments in the developmental process. It is felt that instead of correcting the market failure, fiscal policy interventions in India have contributed to serious loss of efficiency and equity in the economy. In this background, it is important to review the performance of the application of public finance instruments in the developmental process of the economy so that the lessons drawn from the past experience can be used to beneficially reorient these policies. This paper attempts such an evaluation keeping in view the three developmental objectives of fiscal policy mentioned earlier namely, (i) raising the level of savings and investments (section 2), (ii) allocation of resources according to plan priorities (section 3) and, (iii) achieving the desired state of income distribution (section 4). In the final section, we summarise the lessons drawn from the Indian experience.

II. Public Finance and Saving and Investment

One of the significant achievements of the Indian economy has been to raise the levels of private saving and total investment within a relatively short period of time (Table 2). From just about 10 per cent of GDP in the early fifties, the investment levels increased steadily to form over 25 per cent of GDP in 1985-86 and thereafter, declined marginally to stabilise at around 23-24 per cent of GDP. It is notable that this increase in investment was financed not by foreign savings but by increasing domestic savings. The gross domestic savings increased from less than 10 per cent of GDP in the fifties to about 23 per cent of GDP in 1978-79, but thereafter stagnated at around 20-22 per cent of GDP. Thus, despite high levels of investment the resource gap did not exceed 2 per cent of GDP throughout the Sixties and the Seventies, though during the first seven years of the Eighties, it averaged around 4 per cent.

Table 2

Savings - Investment Gap in Indian Economy
(as percentage of GDP at current market prices)

	Household sector			Private corporate sector			Public sector			Total			% of public savings in total savings
	S	I	S-I	S	I	S-I	S	I	S-I	S	I	S-I	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
1950-51 to 1954-55	6.9	5.6	1.3	1.0	1.4	-0.4	1.7	3.1	-1.4	9.6	10.1	-0.5	17.7
1960-61 to 1964-65	8.1	5.1	2.9	1.7	3.6	-1.9	3.0	7.5	-4.4	12.9	16.2	-3.4	23.6
1965-66 to 1969-70	10.4	7.6	2.8	1.3	2.2	-0.8	2.4	6.8	-4.4	14.1	16.5	-2.4	17.3
1975-76	13.4	8.5	4.9	1.3	2.7	-1.4	4.2	9.6	-5.4	19.0	20.9	-1.9	22.4
1978-79	17.0	10.6	6.4	1.5	2.2	-0.6	4.6	9.5	-4.9	23.2	22.3	0.9	19.8
1980-81	16.1	9.7	6.3	1.7	2.8	-1.1	3.4	10.3	-6.9	21.2	22.8	-1.7	16.2
1985-86	15.2	8.1	7.1	2.1	5.6	-3.5	3.2	11.8	-8.5	20.4	25.4	-5.0	15.8
1989-90	17.8	8.9	8.9	2.7	4.3	-1.6	1.6	10.3	-8.7	22.2	23.5	-1.3	7.0
1990-91	18.4	9.8	8.6	2.6	4.5	-1.9	0.9	9.7	-8.8	21.9	24.0	-2.1	4.0

Source: National Accounts Statistics, Ministry of Planning, Government of India.

While the increase in the level of savings and investments is really a notable achievement, it is necessary to know whether this can be attributed to the efficacy of the government's fiscal policy. In fact, public finance policies can enhance the level of savings either by generating savings in the public sector or by encouraging private sector savings. Let us examine the efficacy of public finance instruments in enhancing the level of savings in either of the two ways.

a. Trends in Public Sector Savings: The most disturbing aspect of the Indian economy is the failure of the public sector in generating the level of savings required for its investments. The savings-investment gap in the public sector has shown a steady increase over the years (Table 2) and the drawals from the household sector to finance public sector investments increased steadily from 1.4 per cent of GDP in the 1950's to 8.8 per cent of GDP in 1990-91. The public sector savings constituted almost a quarter of gross domestic savings in the economy in the early sixties, but over the years it declined sharply to form an abysmal 4 per cent in 1990-91. As a proportion of GDP, public sector savings increased from 1.7 per cent of GDP in 1950's to 4.6 per cent in 1978-79, but thereafter declined to form less than one per cent of GDP in 1990-91 (Tables 2 and 3).

Table 3

Structure of Public Sector Savings as a Percentage of GDP

	1970-71	1975-76	1980-81	1985-86	1989-90	1990-91
	(1)	(2)	(3)	(4)	(5)	(6)
1. Government administration	1.4	2.8	1.9	-0.2	-2.5	-3.0
2. Public sector enterprises	1.7	1.7	1.5	3.4	4.1	3.9
a. Departmental	0.7	0.5	0.2	0.5	0.6	0.7
b. Non-departmental	1.0	1.2	1.4	2.9	3.5	3.2
3. Total gross savings (1+2)	3.1	4.5	3.4	3.2	1.6	0.9

Source: National Accounts Statistics (various issues), Central Statistical Organisation, Ministry of Planning, Government of India.

(i) Budgetary dissavings: The analysis of the composition of public sector savings (Table 3) brings out that the principal reason for the decline has to be found in the very high and increasing volume of budgetary dissavings. The budgetary dissavings emerged first in 1982-83, and thereafter steadily increased to form 3 per cent of GDP in 1990-91. The saving performance of public enterprises too leaves much to be desired. The level of savings remained virtually stagnant at a little over 1.5 per cent of GDP throughout the 1970's and thereafter, increased to 3.5 to 4 per cent of GDP, but considering the volume of investment made in the public sector[1] the saving levels were abysmally low and if capital consumption (depreciation) is taken account of, the savings became negligible (0.06 per cent).

A basic reason for the emergence of governmental dissavings is the outpacing of the rate of growth of resources by the expenditure growth. The government revenues in the 1980's grew at an average rate of 15.1 per cent per year and the growth of tax revenues was slightly higher at 15.6 per cent (Table 4). Yet, as the current[2] expenditure of the governments increased at over 18.3 per cent per year, the emergence of significant levels of dissavings was unavoidable. Consequently, rather than generating surpluses for investment in the revenue

1. The capital formation in the public sector in 1991-92 formed about 45 per cent of gross domestic capital formation. During the 1970's it was even higher, close to 50 per cent. The share of public sector enterprises in this was approximately 75 to 80 per cent.

2. The terms 'current' expenditure and 'revenue' expenditure are used interchangeably.

account as was the case until 1982-83, the situation deteriorated to a level wherein household savings amounting to almost 3 per cent of GDP had to be drawn merely to meet public consumption needs.

The emergence of fiscal imbalance has to be attributed to the high and accelerating growth of current expenditures (Table 5). The growth rate of per capita total current expenditures excluding interest payments increased from 4.4 per cent during 1974-75 to 1981-82 to 8.9 per cent during 1981-82 to 1986-87 and continued to grow at 7 per cent thereafter even as the growth of per capita aggregate expenditures decelerated to 3.4 per cent during the latter half of the eighties (Table 5). Interest payments in per capita terms (at constant prices) increased at over 13 per cent per year during the eighties and other items which recorded very high and accelerating growth rates were wages and salaries, and subsidies and transfer payments. In contrast, both per capita gross fixed capital formation of the government and capital transfers showed a sharp decline even in absolute terms. Our analysis shows that the decline was particularly severe in the infrastructural sectors like irrigation, energy and transport and communication. These trends have had adverse effects on both the growth potential of India as well as equity (Rao and Sen, 1993 and Mundle and Rao, 1992).

Table 4

Growth of Revenues and Expenditures

(per cent per annum)

	1970-71 to 1980-81	1980-81 to 1990-91	1970-71 to 1990-91
	(1)	(2)	(3)
1. Direct taxes	12.4	12.5	12.5
2. Indirect taxes	16.1	16.2	16.2
3. Total tax revenue	15.4	15.6	15.5
4. Non-tax revenue	14.2	13.0	13.6
5. Total revenue receipts	15.2	15.1	15.2
6. Capital receipts	18.0	20.6	19.3
7. Total receipts	15.8	16.5	16.1
8. Revenue expenditure	15.0	18.3	16.7
9. Capital expenditure	18.3	11.8	15.0
10. Total expenditure	15.9	16.6	16.3

Note: Growth rates have been estimated using the kinked exponential regression models. See, Boyce (1986).

Source: *Indian Economic Statistics*, Ministry of Finance, Government of India.

Table 5

Growth of Per Capita Government Expenditure in India (1981-82 Prices)

(Per cent)

	1974-75 to 1981-82	1981-82 to 1986-87	1986-87 to 1990-91	1974-75 to 1990-91
	(1)	(2)	(3)	(4)
1. Consumption Expenditure				
a. Compensation to employees	2.27	8.25*	6.39	5.28
b. Net government maintenance	4.30	8.09	2.60*	5.69
Total	3.03	8.20*	4.91*	5.43
2. Transfers				
a. Subsidies	11.78	10.90	10.38	11.23
b. Transfer to local bodies	2.24	4.96	12.39	4.58
c. Other transfers	5.39	10.37*	9.03	7.93
Total	6.96	9.96	10.00	8.60
3. Total current (1+2)	4.39	8.93	7.01	6.62
4. Gross fixed capital formation	1.99	12.47*	-7.05*	5.15
5. Financial outlay	3.42	7.97*	-9.78*	3.62
6. Total capital transfers and advances				
a. Local bodies	5.26	5.93	-1.19*	4.74
b. Others	2.51	1.12	-2.65	1.28
3. Total	2.81	1.77	-2.35	1.73
7. Total capital expenditure (4+5+6)	2.64	5.56	-5.05*	2.91
8. Total expenditure (3+7)	3.72	7.04*	3.37*	5.41

Note: Growth rates have been estimated by using kinked exponential regressive model. See, Boyce (1986).

* Significantly different from the previous period.

Source: Central Statistical Organisation.

As already mentioned, tax revenues have been reasonably buoyant during the entire period. Therefore, increasing governmental dissavings cannot be attributed to the lower revenue productivity of the tax system.[3] However, the growth rate of non-tax revenues have not only been relatively stagnant but have shown a decelerating trend. The non-tax revenues grew at an annual average rate of just about 13 per cent per year in nominal terms and this was even lower than the growth recorded during the Seventies. The principal reason for this relative

3. This is not to imply that there is no scope for tax reform, even with the specific objective of raising resources. Corporate income tax receipts, for example, show little increase in real terms when only the private sector is considered.

stagnancy was the low and declining cost recoveries on social and economic services provided by both Central and State governments (Table 6). The recovery rates (cost recoveries as a ratio of cost of providing public services) in the case of economic services declined from 55 per cent in 1977-78 to 41 per cent in 1987-88 and in the case of social services, the decline was from 6.3 per cent to 3.6 per cent. In fact, in higher education, the recovery rate was just about 2 per cent. The implicit subsidies arising from uneconomic pricing of public services as a proportion of GDP increased from 8.2 per cent of GDP to 15 per cent during the decade. Even in commercial sectors like power, irrigation, transport and communication, the volume of subsidy was significant. Inability to raise non-tax revenues by collecting users charges at the appropriate rate has been one of the major factors causing erosion of governmental savings.

Table 6

Subsidies in Social and Economic Services: States and Centre

	Recovery rate (Per cent)		Subsidies (Rs million)		Subsidy as percentage of total subsidy	
	1977-78	1987-88	1977-78	1987-88	1977-78	1987-88
	(1)	(2)	(3)	(4)	(5)	(6)
Economic Services						
1. Agriculture and allied services	35.93	20.49	12590	71170	15.97	16.02
2. Irrigation and flood control	25.77	20.27	9730	48150	12.34	10.84
3. Power and energy	45.77	32.29	3720	36190	4.72	8.15
4. Industry	39.11	16.81	6360	57350	8.07	12.91
5. Transport	69.55	74.30	11010	33610	13.96	7.57
6. Communication	114.85	68.58	-900	11310	-1.14	2.55
7. Other economic services	64.94	31.43	2350	17800	2.98	4.01
8. Total economic services	**54.69**	**40.74**	**44870**	**275570**	**56.90**	**62.03**
Social Services						
1. Education	2.75	1.30	20540	95850	26.04	21.58
2. Health	5.33	3.07	6840	29370	8.67	6.61
3. Water supply, sanitation and housing	14.39	5.82	3690	24300	4.68	5.47
4. Other social services	18.93	12.15	2920	19160	3.70	4.31
Total social services	**6.26**	**3.62**	**33990**	**168680**	**43.10**	**37.97**

Note: Includes data for fourteen major states and centre.

Source: Mundle and Rao (1992).

(ii) Declining savings of public enterprises: One of the reasons for the proliferation of subsidies is the poor financial performance of central and state level public enterprises and large budgetary support given to cover their losses year after year. At the central level in 1989-90, 244 public enterprises with Rs 844 billion capital employed made a net profit of Rs 38 billion. However, oil sector alone generated a profit of Rs 29 billion and the remaining enterprises together made a profit of just Rs 9 billion. A detailed analysis of the working of these enterprises further reveals that quite a good proportion of the losses have accrued not in the core-sector enterprises. The non-core sector industries of fertilisers, consumer goods, agro-based industries, textiles and construction services together made a net loss of Rs 8.5 billion. Although this partly reflects the government's taking over loss-making units in the private sector to protect the interests of labour, the fact that they have continued to function year after year without any form of restructuring has only contributed to inefficiency and decline in productivity. Nor can the problem be attributed entirely to such "loss swapping". The enterprises started by the government to produce consumer goods and services have also made losses in a number of cases.[4] Even the units making profits have done so in spite of poor physical performance, mainly due to the monopoly status in the market and charging administered prices. As many of these are in the nature of basic raw materials, intermediate and capital goods, this cost increases arising from their inefficient operation has contributed to the non-competitiveness of downstream industries. The situation is equally worrisome at the state level. The state electricity boards in 1990-91 made a net loss of 14.4 per cent of the capital employed and the losses in road transport corporations were over 12 per cent. Among the departmental commercial concerns, the losses on account of irrigation in 1987-88 worked out to Rs 52 billion. There were also several "promotional" corporations draining the exchequer to the tune of Rs 5 billion.

The above discussion brings to the fore a major weakness of the Nehru-Mahalanobis development strategy of not having a proper financial plan to correspond to the material balances exercise for major commodity sectors (physical plan). The implicit assumption was that, "...what was physically possible and desirable could also be rendered financially viable" (Chakravarty, 1987, p. 23). The inability to generate reasonable returns from the investment in public enterprises and effect cost recoveries from various 'quasi-public' and private goods directly provided by the government has turned out to be a major constraint in generating savings for reinvestment.

The large and persistent fiscal imbalances and governmental savings have been held primarily responsible for the economic crisis of 1990. The expanding expenditures created an excess demand situation, a part of which spilled over into imports. At the same time, declining public investments created infrastructural bottlenecks. Increasing resort to fiscal

4. For a more detailed analysis of public enterprises, see, Ahluwalia (1993).

deficits to finance public consumption and investment needs led to higher interest rates (including administered interest rates) and crowding out of private investments. The excess demand created by current public expenditure, and declining public and private investments together tended to create a stagflationary situation. The situation also warranted larger dependence on foreign savings and as noted earlier, during the period from 1981-82 to 1986-87, on an average, dependence on foreign savings was over 4 per cent of GDP in contrast to just about 1.5 per cent in the previous period. Further, as the household saving was pre-empted by the government at low interest rates by prescribing Statutory Liquidity Ratios (SLR) and as positive real rate of interest had to be given to the savers, the commercial banks indulged in serious irregularities in the securities market and these have resulted in further irregularities down the line, the discovery of which has affected the capital market significantly.

b. **Fiscal Incentives and Some Private Savings:** The second method of influencing the saving behaviour in the economy is through various fiscal incentives. Both personal and corporate income taxes were used to encourage household and corporate savings. The research on the subject, however, shows that while these have altered the after-tax rates of return in unintended ways and have thereby changed the choice of saving instruments, it is doubtful whether they have been effective in enhancing the level of total savings in the economy (Das-Gupta, 1989, Rakshit, 1987). At the same time, the various forms of tax incentives for savings have in fact contributed to the complications in the tax structure. The myriad tax incentives have in fact been used as loopholes to avoid taxes; subsequent attempts to close these have further complicated tax laws.

III. Fiscal Policy, Resource Mobilisation and Resource Transfers

An important objective of planning is to ensure that the available resources in the economy are utilised in accordance with plan priorities. In a mixed economy, this has to be achieved by transferring resources to make investments in the public sector and by influencing the allocative decisions of the private sector through various policy instruments, to correspond to the plan size and composition. In this section, we will examine to what extent the government has been effective in achieving these tasks and what have been the overall consequences of these measures on the economy.

The inability of the public sector to generate the savings required for investments necessitated the large scale transfer of resources from private to public sector. The mobilisation of resources and their transfer to the desired activities are crucial to successful plan implementation. But with major pressure groups influencing the pattern of resource mobilisation, achieving it in a cost-effective and non-inflationary manner has been difficult.

Table 7

Composition of Tax Revenue (1950-51 to 1991-92)

(Percentages)

	1950-51	1960-61	1970-71	1980-81	1985-86	1990-91	1991-92 (RE)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. Direct taxes	36.8	29.8	21.2	16.5	14.4	14.0	15.8
1.1 Corporation tax	6.3	8.1	7.8	6.6	6.6	6.1	7.1
1.2 Personal income tax	21.4	12.5	9.9	7.6	5.6	6.1	6.6
1.3 Other taxes	9.1	9.2	3.5	2.3	2.0	1.8	2.1
2. Indirect taxes	63.2	70.2	78.8	83.5	85.6	86.0	84.2
2.1 Customs	25.1	12.6	11.0	17.2	22.0	23.5	22.4
2.2 Union excise duties	10.8	30.8	37.0	32.7	30.0	27.9	27.0
2.3 State excise duties	8.0	4.1	4.3	4.5	5.1	5.7	5.5
2.4 Sales taxes	9.3	12.1	16.6	20.2	20.2	20.8	21.3
2.6 Others	5.6	7.1	7.1	6.7	6.3	5.7	5.5
3. Total taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0
4. Total tax as a percentage of GDP	6.7	8.3	11.0	14.6	16.5	16.5	16.8

Source: *Indian Economic Statistics*, Ministry of Finance, Government of India.

a. **Resource Mobilisation through Taxes:** Quantitatively, it must be stated that the tax system in India has largely fulfilled the role of mobilizing financial resources. The tax revenues over the years have grown steadily and as a ratio of GDP, increased from less than 7 per cent in 1950-51 to almost 17 per cent in 1991-92. However, difficulties in raising revenues through direct taxes on income and wealth have caused the spreading of the burden of development among the masses mainly through indirect taxes. In fact, the share of direct taxes declined from 37 per cent in 1950-51 to less than 16 per cent in 1991-92 (Table 7). At both central and state levels, revenue from indirect taxes presently constitute more than 80 per cent of tax revenue. Even within indirect taxes, the emphasis has been on easy and non-transparent means of tax collections. This has resulted in collecting taxes at the entry points by the centre, the states and by the local bodies. In the case of the centre, apart from the above reasons, the constitutional requirement that personal income tax and excise duty should be shared with the states has led them to concentrate on import duties as a revenue instrument. At the state level, the 'free-riding' behaviour of the states has resulted in rising inter-state tax exportation and this is aided by the constitution permitting the levy of taxes on inter-state sales. At the local level too, it is easy to collect taxes on the entry of goods into urban areas by erecting barriers. The

consequence of these has been to divide the country into several tariff zones with unintended effects on resource allocation and impediments to free movement of goods.

The practice of levying taxes in an easy and concealed manner ignoring the resource distortions it can cause is seen even in the levy of internal indirect taxes. In fact, there is a parallel regime of commodity taxes at all the three levels of government - manufacturing excises at the centre, sales taxes at the state level and octroi levied by the urban local bodies.[5] This has created an overlapping system of taxes and as a significant portion of revenues is derived from taxing inputs and capital goods at all the three levels, a highly distortionary tax system has evolved over the years rendering Indian manufactures non-competitive.

At the state level, there have been other types of distortions. In their eagerness to raise more revenues in the way least painful to their residents, the states have indulged in acute inter-state tax competition to attract trade and industry into their jurisdictions. We have already referred to the 'free-rider' behaviour of the states and the resulting tax exportation. The consequence of these has been to make minute differenciation in the sales tax rates not based on economic rationality but simply to 'free-ride' on other states. This has complicated the structure of taxes, opened up several avenues of tax avoidance and evasion and distorted the relative prices.

Table 8

Deficits as a Percentage of GDP

Year	Revenue Deficit (-)/ Surpluses	Budget Deficit (-)	Fiscal Deficit (-)
(1)	(2)	(3)	(4)
1971-72	-0.20	-1.72	-5.32
1975-76	+2.34	-0.46	-4.59
1981-82	+0.64	-1.58	-6.74
1985-86	-1.92	-1.31	-9.33
1986-87	-2.66	-3.13	-10.91
1987-88	-3.05	-1.65	-9.60
1988-89	-3.11	-1.29	-9.06
1989-90	-3.40	-2.34	-9.48
1090-91	-4.46	-2.16	-10.04
1991-92	-3.67	-1.46	-8.03
1992-93 (RE)	-2.70	-1.02	-6.83

Note: RE indicates Revised Estimates.

Source: *Indian Economic Statistics*, Ministry of Finance, Government of India.

5. Octroi is a tax on the entry of goods into a local area for consumption, use or sale.

b. **Borrowing and Fiscal Deficits:** Another method by which the government has been financing consumption and investment expenditures has been through borrowing. As a proportion of GDP, the fiscal deficit steadily increased from 4.6 per cent in 1975-76 to reach almost 11 per cent in 1986-87 and thereafter, stabilised around 10-11 per cent until the programme of stabilisation was initiated in 1991-92 (Table 8). In addition to the steady increase in fiscal deficit-GDP ratio, two important features in the trends in deficits must be noted (Table 8). First, an increasing proportion of fiscal deficit was incurred to meet growing revenue deficits or governmental dissavings. The revenue deficits which emerged for the first time in 1982-83 increased steadily to form 4.5 per cent of GDP in 1990-91. Second, an increasing proportion of the fiscal deficit has been monetised over the years. The monetised budget deficits increased from less than one per cent of GDP in the early 1960's to almost 4.7 per cent in 1986-87 and thereafter stabilised around 3-5 to 4 per cent until 1991-92. As a consequence of these trends, the ratio of outstanding public debt to GDP increased from 32 per cent in 1950-51 to about 65 per cent in 1991-92. With an increasing proportion of borrowing being used to meet consumption requirements and with the public investments not yielding commensurate economic returns, the vicious circle of growing deficits, rising debt, increasing interest costs and higher deficits was unavoidable. This self-propelling character has led governmental indebtedness to grow to unsustainable proportions (Chelliah, 1993, Buiter and Patel, 1992, Rangarajan, Basu and Jadhav, 1990). Further, pre-emption of funds from the nationalised banking sector for government consumption and investment has led to distortions in the capital and financial markets.

IV. Fiscal Policy and Redistribution

Economic activities in a mixed economy necessarily bring in inequalities in income and wealth.[6] The expansion of the public sector was intended, *inter alia*, to contain the concentration of wealth and incomes in the hands of a few persons and regions. But, in spite of the expansion of public sector investment, private sector's contribution to income generation was 75 to 80 per cent. To achieve the desired state of distribution of incomes, a number of other fiscal and non-fiscal measures were adopted. In the sphere of inter-personal incomes, the important redistributive fiscal measures were, levying of progressive taxes, encouraging small scale industries as they are presumed to be employment intensive and adopting long term and short-term poverty alleviation programmes by reorienting expenditure policies. To achieve balanced regional growth, the measures adopted consisted of equitable federal transfers and locating Central public enterprises in backward regions.

6. In terms of Myrdal(1957), the 'backwash effects' necessarily outweigh 'spread effects' in less developed economies in the context of regional development.

a. Fiscal Policy and Inter-personal Redistribution: For a long time, in bringing about vertical equity, the emphasis of fiscal policy in India was to reduce the incomes of the rich rather than on increasing the incomes of the poor. Until recently, apart from the highly progressive income tax with the highest marginal tax rates of 95 per cent, wealth tax was levied with the marginal rate going upto 8 per cent and the combined effect of the two on high income earners was confiscatory. Even after the marginal income tax rate was brought down from 95 per cent in the seventies to 54 per cent in the eighties, the combined incidence of the two taxes for the persons falling into the highest income bracket was nearly 70 per cent. Of course, since 1991-92, there has been a substantial rationalisation of the tax structure on the lines recommended by the Tax Reforms Committee (India, 1992).

With over 80 per cent of the revenue derived from indirect taxes, progressivity to the tax structure could be imparted only by making minute rate differentiation among commodities based on the judgments about their income elasticity of demand. Of course, the incidence studies done in a partial equilibrium framework show that the distribution of tax burden is moderately progressive (Ahmed and Stern, 1983; Jha and Srinivasan, 1988).

However, in a general equilibrium sense, it is doubtful whether the distribution of tax burden has been progressive, for various reasons. First, the highly progressive tax system created serious disincentives for income-earning activities and risk taking, and the consequent adverse effects on growth must have decelerated the growth of employment in the organised sector. The major consequence of the progressive taxes was widespread evasion and avoidance of income taxes. According to the best known study, the tax evaded income in 1985-86 constituted about 20 per cent of the reported GDP (Acharya and Associates, 1985). It is also seen that the number of income tax assessees in 1989-90 formed just about 0.05 per cent of population, which meant that all attempts at having a progressive distribution of the tax burden was confined to a miniscule proportion of population. The minute rate bracketing in the case of income tax to obtain a continuously progressive distribution of the tax burden, and excessive rate differentiation in the case of excises and sales taxes enormously complicated the structure of these taxes. Thus, while the efficacy of the tax structure to redistribute incomes is doubtful, it has certainly led to complications in the tax structure, caused allocative distortions by altering relative prices in unintended ways, and of course, led to the expansion of the illegal informal sector. These issues have been adequately addressed to in the report of the Tax Reform Committee. In particular, the Report has emphasised the need to expand the tax base to cover the income of the unorganised sector and hard-to-tax groups, though the progress in implementing these recommended measures has been limited.

A more important way in which redistribution is accomplished is by enhancing the incomes of the poor and that can be achieved by directing government expenditures to programmes which would directly benefit the poor or endow them with capital in the medium or

long term. Enhancing economic growth, and ensuring that its benefits trickle down to the poor, can complement the direct attack on poverty in a sustainable fashion. Indeed, there has been considerable expansion of direct poverty alleviation programmes in rural areas particularly since 1979-80 and despite the inefficiencies and leakages in these anti-poverty programmes, they have contributed to the reduction in the incidence of poverty over the years (Minhas, Jain and Tendulkar, 1991). However, the amount of money spent on these short-term relief measures in 1987-88 in per capita terms worked out to a mere Rs 25 in 1981-82 prices. Adding to this the money spent on primary education and health, the total redistributive package works out to a mere Rs 97 per capita which is less than 10 per cent of total expenditures. This is even lower than the per capita amount spent on interest payments (Rs 150), defence (Rs 100) and other general administrative services (Rs 148).

b. **Fiscal Policy and Balanced Regional Growth:** An important goal of planning in India was to bring about balanced regional development and reduce inter-regional disparities in the levels of living. To achieve this, fiscal policies can be employed in two ways: first, by allocating centre's own investments in the public sector on the desired lines, and second, through a well-designed policy on federal transfers to the states so that each state, howsoever deficient, is enabled to have given normative levels of social and economic infrastructure at a standard tax-price (effective tax rate). Our analysis shows that the spread of central government's own investments in public enterprises have not adequately taken account of inter-regional disparities (Table 9). Over 24 per cent of the gross block of capital in Central public enterprises was located in high income States as on 31st March, 1990 though these States had the population of only 18.8 per cent of the total. In contrast, in the low income States with 43.3 per cent of total population, the capital stock of Central public enterprises was just 34.1 per cent and the direct employment generated in these enterprises was only 42 per cent of the total employment generated by the central public enterprises.[7] Nor were the federal transfers designed to offset the fiscal disabilities of the poorer states. Although the Finance Commission's transfers were progressively distributed, this was not adequate to offset their inherent disabilities and consequently, the plan expenditure during the seventh plan (like the earlier plans) had a regressive distribution (Table 10). The average per capita plan outlay in the high income states was 66 per cent higher than the all-state average and that of low income states lower by 12 per cent. In the event, it is not surprising that the states with higher infant mortality and low life expectancy at birth had lower per capita spending on health services, states with lower literacy rates had lower expenditure per child (5 years to 11 years) on elementary education and states with low per capita income from the industrial sector had low per capita allocation on economic infrastructure like energy, irrigation, transport and communication. It is, therefore, not surprising that the regional disparities have continued to persist in India.

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7. Typically, in poorer states, a sizable part of the employment generated does not benefit the residents of that state due to the lack of necessary skills among locally available workers.

Table 9

Statewise Distribution of Capital Stock (Gross Block) and Employment in Public Sector Enterprises as on 31.3.1990

(Percentage)

	Population*	Gross Block	Employment
	(1)	(2)	(3)
High Income States	18.77	24.1	13.93
Punjab	2.38	0.74	1.01
Haryana	1.96	0.79	0.79
Maharashtra	9.02	17.58	9.81
Gujarat	4.91	4.99	2.32
Middle Income States	31.34	25.31	32.38
Karnataka	5.42	2.28	5.24
West Bengal	7.88	6.25	17.51
Andhra Pradesh	7.68	10.07	4.34
Tamil Nadu	6.76	5.21	3.83
Kerala	3.60	1.50	1.46
Low Income States	43.33	34.13	42.31
Rajasthan	5.30	1.51	1.72
Madhya Pradesh	7.67	11.10	12.48
Uttar Pradesh	16.28	7.76	6.17
Orissa	3.76	5.26	3.27
Bihar	10.32	8.50	18.67
Special Category States	5.23	7.47	3.61
Union Territories	1.33	8.99	7.77
Others and Unallocated	-	4.92	1.56
Total	100.0	100.00	100.00

* Mid-year estimates.

Source: 1. *Public Enterprises Survey*, 1989-90 (Vol. 1), Ministry of Programme Implementation, Government of India.

2. Office of the Registrar General, Government of India.

Table 10

Per Capita Federal Fiscal Transfers and Plan Outlay in the States

(Rupees)

States	Per Capita SDP average (1982-83) Rs.	Index of taxable capacity 1984-85	At constant (1981-82) prices					
			States own resources for the plan before statutory transfers	Statutory transfers, shared taxes and FC grants	Non-plan loans	States own resources for the plan after statutory transfers	Central plan assistance including centrally sponsored schemes	Plan outlay
					Actuals	Actuals	Actuals	Actuals
(1)	(2)	(3)	(4) (7 - 6 - 5)	(5)	(6)	(7) (9 - 8)	(8)	(9)
High Income States	**3340**	**146.30**	**-134.24**	**321.43**	**534.83**	**722.02**	**533.18**	**1255.20**
Punjab	4013	169.18	-459.28	280.45	318.05	139.23	1131.83	1271.06
Maharashtra	3384	142.75	229.72	316.24	509.77	1055.73	233.52	1289.25
Haryana	3043	151.11	-175.07	344.39	570.99	740.31	463.18	1203.49
Gujarat	2919	122.16	-132.35	344.62	740.53	952.79	304.20	1256.99
Middle Income States	**2206**	**112.82**	**-271.46**	**439.65**	**255.78**	**423.96**	**227.88**	**651.84**
Karnataka	2461	117.68	-49.98	389.70	112.04	451.76	213.36	665.12
West Bengal	2230	76.09	-421.11	483.04	278.40	340.34	140.56	480.90
Kerala	2144	117.66	-521.60	440.26	380.98	299.65	308.19	607.84
Tamil Nadu	2142	138.64	-186.56	439.21	316.60	569.25	229.51	798.76
Andhra Pradesh	2053	114.04	-178.07	446.02	190.87	458.82	247.77	706.59
Low Income States	**1689**	**50.06**	**-265.69**	**472.19**	**171.11**	**377.60**	**287.94**	**665.55**
Madhya Pradesh	1860	58.14	-139.69	422.13	227.32	509.75	200.00	709.76
Rajasthan	1820	67.46	-380.23	389.99	291.74	301.50	421.77	723.27
Orissa	1728	37.72	-250.75	582.07	126.74	458.07	310.56	768.63
Uttar Pradesh	1713	54.14	-256.19	440.86	143.54	328.21	272.18	600.39
Bihar	1323	32.85	-301.61	525.89	66.20	290.49	235.21	525.70
14 States' Average	**2345**	**99.97**	**-211.92**	428.94	261.35	**478.36**	**276.90**	755.27

Source: Column 1 and 2: *Second Report of the Ninth Finance Commission*, (Ministry of Finance, Government of India, 1990.

Other columns: Finance/Planning Departments of the State Governments.

V. Fiscal Policy for Development: Lessons from Indian Experience

The broad review of public finances and Indian economic development attempted above has brought to the fore many interesting lessons on development policy. In comparison with the socioeconomic environment that prevailed before independence, the achievements after independence are certainly notable. Surely, the adoption of planned strategy has hastened the developmental process in the economy and the public finance instruments have played a crucial role in this task. Yet, one cannot help the feeling that the rigidities imposed by the development strategy have constrained the economy from reaching its full potential and the Indian performance compares poorly with the experiences of the countries of the South East Asian region and China. The major difference in the strategies must be found in the role of the state . The review of successful developmental experiences of these countries shows that the state in these countries undertook to (i) monitor the competition in markets by enforcing property rights through an effective system of regulation, (ii) assisted and encouraged entrepreneurial competition to produce and to export, and (iii) provided adequate social and economic infrastructural facilities. In contrast, controlling the allocation of resources by the state acting as a direct participant in the production-distribution network and directing the private sector allocation through various policy instruments has curbed entrepreneurial competition in India and this has not served the cause of either growth or equity. Governmental intervention in India has been to a large extent negative in nature, -- preventing various activities rather than encouraging them. Such negative intervention should have been reserved only for activities causing harm to the society, but were indiscriminately used through widespread controls.

The problem with the Indian developmental strategy is not the lack of internal inconsistency of the plan models. Of course, many of the assumptions made in the plans were not fulfilled in practice and there were serious problems of implementation. The most important problem, however, was the basic assumption that the State is a benevolent entity and relentlessly works towards maximizing the welfare of its citizens. In a democratic polity which is relatively stable, electoral competition leads to the emergence of coalitions or special interest groups. The individuals with a common agenda having organisational abilities disproportionate to their numerical strength form interest groups for collective action and they work to influence policies to enhance their share of benefits from public services while trying to minimise their share of payments to the services consumed. The interest group action can be from the sellers of goods and services to the government (contractors or government employees) and their successful action results in enhancing the cost of public service provision. The interest groups may also attempt to influence policies and their implementation to direct the benefits in their favor and this is typically done by enhancing allocation to quasi-public goods, subsidies and transfers benefiting identifiable groups. In the Indian context, low and declining cost recoveries, declining importance of direct taxes, increasing resort to inflation tax and passing on the burden

to the unenfranchised sections by taking recourse to heavy borrowing can be easily explained by the above phenomenon. The low and declining efficiency of public enterprises too can be traced to this phenomenon. On the expenditure side too, sharp increases in wages and salaries, subsidies and transfers and declining expenditures on infrastructural facilities can be attributed to this phenomenon. These trends come out sharply during periods of hard budget constraint (Rao and Sen, 1993).

The above observation leads to the conclusion that the issue is not whether there should be more or less of state intervention but the quality of intervention. Unhampered interest group action can lead to overexpansion of the activities beneficial to them, but this may be achieved by displacing socially productive expenditures on social and economic infrastructure having a strong complementarity with the private sector. The success of the South East Asian economies must be attributed to the positive role the state has taken in enforcing the property rights and complementing the market by providing goods and services with high degree of externalities including spending on human resource development.

Indeed, even within the given constraints it is possible to bring about certain improvements to improve efficiency and growth in the Indian economy. For example, making the tax system simple and transparent will help in directing the burden on the targeted sections; higher cost-recoveries on public services and targeting the subsidies and transfers to the intended groups can also improve efficiency and accountability. Detailed studies on equity and efficiency implications done in the general equilibrium framework, and public debates on the results of such studies can help in choosing the right set of policies. This can help in reorienting the government expenditure benefits to more encompassing groups. More importantly, the multilateral lending institutions can play a crucial role in prescribing the right set of policies (not 'omnibus' policies) suiting the objective conditions prevailing in the country.

An important aspect of fiscal policy relevant to any developing country like India, but often ignored in economic analyses, is the implementation and administration of the set of policies decided upon. Tax administration is hampered by a substantial non-monetised sector, and low levels of literacy causing lack of proper account keeping and lower tax compliance. Underdevelopment manifests itself in the administrative machinery also; there is only a limited use of modern technology and modern management practices. Vestiges of feudalism and years of subjugation have made sections of the population completely passive; they do not fight for what is rightfully theirs. These make it easy for dominant groups and opportunist classes to hijack benefits meant for the poor; their designs succeed because of almost insurmountable difficulties in adopting selection procedures like means testing. The only sure way to target benefits under these circumstances is to build in as much self selection as possible. The institutional set-up also comes in the way of efficient administration. For example, tax disputes often take twenty years to be decided, as the courts are overloaded. Under these circumstances,

simplicity is not only a virtue, it is a necessity. For the same reasons, a certain degree of stability in the tax regime is also required. But neither of these qualities mark Indian public finance. The federal structure further complicates the fiscal scenario, because different levels of government, and different units of government at the same level do not necessarily work with a unity of purpose. These problems are, however, not unique to India, and can probably be tackled through a judicious mixture of perseverance, ingenuity, and advice from those who have successfully dealt with similar problems.

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