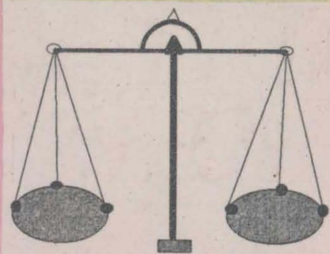
FISCAL POLICY
PUBLIC POLICY
& GOVERNANCE

Edited by

Parthasarathi Shome

Symposium held
in commemoration of
20th Anniversary Year
5-6 December 1996
New Delhi



National Institute of
Public Finance and Policy
New Delhi

FISCAL POLICY
PUBLIC POLICY
& GOVERNANCE

Edited by

Parthasarathi Shome

Symposium held
in commemoration of
20th Anniversary Year
NATIONAL INSTITUTE OF
PUBLIC FINANCE AND POLICY
5-6 December, 1996
New Delhi

CENTAX PUBLICATIONS PVT. LTD.
1512-B, Bhism Pitamah Marg, [Opp. Sachdeva
P.T. College of Defence Colony],
New Delhi-110003, (India).

Copyright © 1997 National Institute of Public Finance and Policy, New Delhi, India.

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without permission in writing from the publisher.

Requests for permission to make copies of any part of the work should be mailed to:

Programme Development Officer
National Institute of Public Finance and Policy
18/2 Satsang Vihar Marg, Special Institutional Area, New Delhi 110067, India.
Fax: (91-11-) 6512703, 6852548
Telephone : (91-11) 6512702, 669303

ISBN : 81-7566-023-6

Price : Rs. 400
US $ 18

Cover & layout design by

S.B. Maan, NIPFP

Printed in India at Kapoor Art Press, New Delhi.

P. Chidambaram,
Minister of Finance, Government of India,

"Behind the velvet glove, there is a firm fist. I will come down very very heavily on tax evaders and go to the extent of launching prosecution."

in Parliament on May 9, 1997 regarding the newly announced voluntary income disclosure (amnesty) scheme.

Preface

The success of the symposium that commemorated the twentieth anniversary year of the National Institute of Public Finance and Policy was the result of many individuals working together and with purpose. The presence of and commemorative lecture by Shri P. Chidambaram, Minister of Finance, for the inauguration, underlined its importance. Dr. Vito Tanzi, Director, Fiscal Affairs Department, International Monetary Fund, delivered the keynote address and participated in all the technical sessions of the symposium. Dr. Raja J. Chelliah and Dr. Amaresh Bagchi, the two ex-Directors of NIPFP, also lent their presence, recalling the Institute's glorious history. The presence of international and national dignitaries and well wishers added substance to the proceedings.

My senior colleagues poured over various alternatives for the focus of the symposium together with me, donating as much time as was necessary to arrive at one that was topical, relevant and timely, as the nation finds itself at a crossroads and anticipates the beginning of a new millennium. In turn, the authors of the various papers made their contributions utilising a diverse set of approaches to the issue at hand. It should be mentioned, however, that the opinions expressed in the papers belong solely to the respective authors and not necessarily to NIPFP or any other individual, institution or government unless otherwise mentioned. I have rarely used the editor's scissors, except mainly to remove individual references where unneeded in a scholarly work.

The discussants supplemented the presentations by authors with their own incisive analyses of the papers. The chairman of each session helped maintain the flow of discussion. They were Dr. Shankar Acharya, Chief Economic Adviser, Government of India; Dr. Raja J. Chelliah, Professor of Eminence, NIPFP; Dr. Suresh Tendulkar, Director, Delhi School of Economics; and Dr. Ramaswamy Aiyer, Research Professor, Centre for Policy Research. The full house during all sessions and the openness with which exchanges took place during question-answer sessions that followed the formal presentations, demonstrated the interest in, if not the urgency of, the topic of the symposium.

The support provided by NIPFP staff, divided into various task forces to successfully accomplish different aspects of much needed background work as well as frontline responsibilities, sometimes under very demanding circumstances, was exemplary. Finally, the workload that Messrs. S.B. Maan and R. Parameswaran carried in order to complete the preparation of the manuscript on time was extraordinary. Their contribution is deeply appreciated.

Parthasarathi Shome

New Delhi.
May 1997.

Contributors

Pawan K. Aggarwal
Fellow, National Institute of Public Finance and Policy, New Delhi

Balveer Arora,
Professor & Chairman, Centre for Political Sciences, Jawaharlal Nehru University, New Delhi

Amaresh Bagchi
Professor Emeritus
National Institute of Public Finance and Policy, New Delhi

Sanjay Baru,
Editor, Editorial Page
The Times of India, New Delhi

Surjit Bhalla
President, OXUS Research and Investment, New Delhi

Sumon K. Bhaumik
Senior Economist
National Institute of Public Finance and Policy, New Delhi

Nilima Chandiramani
Senior Lecturer, Bombay University
Mumbai

Raja J. Chelliah
Chairman, Governing Body
National Institute of Public Finance and Policy, New Delhi

P. Chidambaram
Minister of Finance
Government of India, New Delhi

Bhaskar Dutta
Professor, Indian Statistical Institute
New Delhi

Subhashish Gangopadhyay
Professor, Indian Statistical Institute
New Delhi

A.K. Ghosh
Formerly, Financial Adviser, Ministry of Defence, Govt. of India, New Delhi

B.V. Kumar
Formerly, Member, Central Board of Excise and Customs, New Delhi

N.J. Kurian
Advisor, Planning Commission
New Delhi

Kuldeep Mathur
Director, National Institute of Educational Planning and Administration, New Delhi

Om Prakash Mathur
Senior Adviser, National Institute of Public Finance and Policy
New Delhi

Pulin Nayak
Professor, Delhi School of Economics, University of Delhi, Delhi

Indira Rajaraman
Professor, National Institute of Public Finance and Policy
New Delhi

Kanwarjit Singh
Commissioner, Income Tax
Income Tax Department
New Delhi

Parthasarathi Shome
Director, National Institute of Public Finance and Policy
New Delhi

D.K. Srivastava
Professor, National Institute of Public Finance and Policy
New Delhi

Vito Tanzi
Director, Fiscal Affairs Department, International Monetary Fund, Washington D.C.

Contents

Preface
Contributors

INTRODUCTION 1

CHAPTER 1 1
Fiscal Policy, Public Policy and Governance
(Editor's Remarks) *Parthasarathi Shome*

CHAPTER 2 10
Economic Policy Goals, Ideology and Governance
(Commemorative Lecture) *P. Chidambaram*

CHAPTER 3 15
Corruption, Governmental Activities and Policy Instruments—Brief Review of the Main Issues
(Keynote Address) *Vito Tanzi*

CHAPTER 4 27
Governance : Weaknesses, Their Causes and Remedial Steps (Inaugural Speech) *Raja J. Chelliah*

PUBLIC POLICY AND GOVERNANCE 36

CHAPTER 5 36
Discussion of papers by *Subhashish Gangopadhyay*

CHAPTER 6 43
Towards a Bill of Economic Rights : Public Policy and Governance in the 21st Century
Surjit Bhalla

CHAPTER 7 60
Coalition Governments and Policy Distortions : the Indian Experience
Bhaskar Dutta

CHAPTER 8 83
Economic Crime, Corruption and the Destabilization of Developing Countries
Sumon K. Bhaumik and B.V. Kumar

TAX POLICY AND ADMINISTRATION 92

CHAPTER 9 — 92
Discussion of papers by *Pulin Nayak*

CHAPTER 10 — 99
Tax Evasion and Tax Administration: A Focus on Tax Deduction at Source
Parthasarathi Shome, Pawan K. Aggarwal and Kanwarjit Singh

CHAPTER 11 — 128
Presumptive Taxation and Governance
Indira Rajaraman

CHAPTER 12 — 169
Property Tax Policy and Local Governance
Om Prakash Mathur

EXPENDITURE CONTROL AND FISCAL MANAGEMENT—THE FEDERAL DIMENSION 187

CHAPTER 13 — 187
Discussion of papers by *N.J. Kurian*

CHAPTER 14 — 196
Budget Processes and Expenditure Management in India
D.K. Srivastava

CHAPTER 15 — 230
Effective Budgetary Control for Expenditure Management and its Ramifications for Public Policy and Governance
A.K. Ghosh

CHAPTER 16 — 273
Fiscal Management—The Federal Dimension
Amaresh Bagchi

INTER-DISCIPLINARY APPROACHES 298

CHAPTER 17 — 298
Discussion of papers by *Sanjaya Baru*

CHAPTER 18 301
Federal Governance for India's Multi-Tiered Polity: Some Transformative Options
Balveer Arora

CHAPTER 19 312
Challenge of Good Governance: India in the Post-Economic Reform Period
Kuldeep Mathur

CHAPTER 15 332
Indian Legal System—Perspectives and Problems
Nilima Chandiramani

Fiscal Policy, Public Policy and Governance:

(Editor's Remarks)

1

Parthasarathi Shome

Increasingly, it is becoming apparent that efforts at economic policy improvements, such as in the area of fiscal policy, are being made in vacuum since more fundamental changes that are imperative in the environment within which such measures are being introduced, are not occurring. These relate to public policy and rules of governance which are the issues that are probably foremost in the minds of the polity today. The focus of this symposium reflects this concern.

A nation may be able to survive many crises over a long period as long as there is a critical mass of support behind its governance. However, there may come moments in a nation's life when only great transformations can save it for, otherwise, that underlying foundation may imperceptibly slip away. India, I am confident in saying, is at such a crossroads. A catharsis, celebrating the 50th anniversary of the 1947 one and transporting the country to the next century, is present. Some of its aspects are discussed below.

First, as democracy in India matures, expectably fiscal federal issues assume ever-increasing importance. As that happens, different areas in the country tend to become more diverse in their economic destinies as more and more decisions are left to states and local governments. They experience widely divergent rates of economic growth as well as population growth.[1] If the economic rationale for a fiscally federal nation state is mainly redistribution of income since an economic union could be devised even outside of it, the Central government has to carry out its redistributive role in an ever transparent manner. While the Finance Commissions have provided regularity and stability to this effort, they are progressively coming under the criticism of partiality (see Bagchi, 1995). Improvements in the prevalent redistribution mechanisms are, therefore, vital.

---

[1] Population policy has to be resuscitated from its deep slumber and put back into the heart of policy making at the Centre.

Second, there seems to be a significant rise in corruption in all walks of life.[2] One could argue that decentralisation leads to greater corruption since it lessens state control and monitoring. However, corruption seems to have already enveloped the administrative structure of the Centre corroding the rules of governance perceptibly. It is not at all clear, therefore, that a fiscally federalist state would be more corrupt than a centrist one. Corruption may take many pernicious forms with government—in its legislative, executive, and judiciary branches —functioning with the cooperation of vested interests in the private sector. That corruption may have something to do with the fear of the counterfactual is also obvious. The change in the rules of appointment of the judiciary freeing it from the control of the executive branch's powers of appointment has clearly had the benefit of a new judiciary taking determined action on the control of corruption. Similar changes are necessary in the other branches of Government. More fundamentally, an entirely new social contract will have to be developed if there is to be a system in place comparable to the transformed economies in the rest of the world.

Third, and in continuation of this premise, the inherited rules of executive branch appointments may have outlived their purpose. Executive decision making in government should be based on a combination of administrative, technical and professional skills. Otherwise, they tend to become mainly and merely decisions based on directives received from above—the legislative branch—and on fear spread below—the private sector. In the modern world, government has increasingly become non-intrusive, imperceptibly playing the role of a facilitator or catalyst, flowing in with a particular administration and formed from the professional private sector, and flowing out with the termination of that administration. If permanent tenure is what the executive branch enjoys it also creates fertile ground for corruption which takes visible and invisible forms (see Tanzi, 1995). Only strong and non-discretionary penalties—defined meaningfully, carrying some teeth and bearing down on both receiver and giver—can make initial dents on the problem while societal values modify and reform over time.

Fourth, an economy performing under strict administrative and structural controls perpetuates rent seeking and rent generation. Therefore, liberalisation as an option is better. It would be better for keeping corruption under check if liberalisation is of the variety that makes the

[2] And this is surely not just the case here. For an international perspective, see Mauro (1997).

system more transparent. For example, even a system based on the ideology of socialism, despite its lofty ideals, may attempt to micromanage too many objectives; it then becomes opaque and gridlocked and generates rents for particular players at the cost of efficiency of the system and adverse equity of its members.[3] Further, while socialism as a concept having been inserted into the Constitution through an Amendment, has always hung in the Indian air, its maturation in terms of land reform or other redistribution measures such as the Public Distribution System has either been selective or ineffective.

That does not mean that liberalisation is a panacea for solving all lacunae of socialism. In fact, liberalisation is fraught with difficulties which raise their heads with unpreparedness in facing possible ramifications of the liberalisation process. In *taxation*, liberalisation requires full preparation for detecting if arms length rules—market based pricing among parent corporations and their subsidiaries—are appropriately utilised, or transfer pricing practices—multinationals minimising overall taxation by inappropriate pricing among their branches and subsidiaries—are not indulged in by multinationals operating in the country. In *health*, there must be a regulatory policy that is effective in minimising "junk food" imports or the like that are well known in the West to include questionable carcinogens and cause obesity directly through high fat content and indirectly through the feeding of steroids into live meat forms. The same applies to *environment*. Hazardous materials and waste—banned from their own countries—are and will be exported without compunction by Western business into developing countries. In reciprocity, the chances of quick enrichment will encourage individual operators in India to flout regulations and carry on international business. Discussions of these matters in the West are conducted only by the "radical" NGOs like Greenpeace which are usually relegated to the fringes of the public view and debate; and, to begin with, even they are mainly concerned about their own environment (as they may be expected to be). Developing countries tend to become cheap dumping grounds for the West and India has already revealed signs of succumbing to the same. In *research*, liberalisation would rightly bring in more ideas from abroad but the likelihood of theft of results for the West's own commercialisation through abducted proprietorial rights over research results and morally wrong patenting will be much increased as has already

[3] LeGrand (1982), studying the impact of the British goals of the Atlee Plan whose stated goal was redistribution, concluded that in all objective public expenditure areas — transport, housing, education and health — the opposite resulted. Shome (1983) has a review.

been evinced. In *trade*, new nontariff barriers based on environment, child labour and other constructed standards by the West against developing country imports will mushroom. In *factors of production*, pressure will be put by the developed countries in favour of export of their capital while closing their boundaries to the import of all—even professional—labour from developing countries. The lesson is that multinationals are not charitable institutions; indeed, they are likely to be rather uncharitable. Nor are their parent governments mere grantors; rather, they are likely to be seekers. Despite these factors, gains from opening up the economy could appear like gains from international trade. That is what has to be culled out if liberalisation is to result in benefits to the Indian economy.

The expectation is that despite all the moral hazard that liberalisation will bring, it should still be better than the current system that generates undersupply because of inefficient use of resources and poor products because of dated technology. But liberalisation will serve better if, and only if, India can transcend its lack of preparedness to adequately face other nations and multinationals and deal with them with a practical yet firm set of rules, regulations and manner of conducting business. All this will have to be developed. Indeed, underneath, many of the current practices of contracting for and approval of business undertakings would have to be redesigned such that rumours of cutbacks and commissions catering to individual gains do not reappear. Yet again, full knowledge of and facility with multinational business practices in the context of law and taxation will have to be inculcated by a lot of Indians. For example, multinationals are pressing to be allowed to import legal advisors from abroad. Indians will have to quickly learn to withstand their strategy, approach and nature of advice. If appropriate preparatory action cannot be taken by Indians, it would be fair to say that liberalisation will fail, and characteristically, India will shy back into her earlier shell and to slogans of socialism with its concomitant basis of bureaucratic controls.[4]

Fifth, and in continuation of the fourth, India cannot be truly prepared for liberalisation until it can develop a clean set of rules with which it itself operates. Blaming the West for our own predicaments is a dated strategy. The world sees itself as too advanced and too complex to listen to complaints of this kind. Countries, far behind India at one time in terms of per capita GDP, have pulled themselves up despite seemingly opposing manoeuvres by the West to rush past India, to achieve incomes

---

[4] An interesting, alternative and critical viewpoint on the process of liberalisation is found in Nayyar (1995).

several times higher. In India, today, the private sector could be said to be little better than being thrown into a cat and mouse game with administrators and politicians, who consider themselves more masters than public servants. On the other hand, would the private sector itself be willing to progressively redeem itself and allow punishment to be imposed on the erring few? Would Indian entrepreneurs be willing to face such possibilities if left free to go about their business of generating employment and wealth? The answer here should be in the affirmative if India is to face the demands of liberalisation.[5]

The tentacular effects of tax evasion in India are well known. To quote Jalan (1996), "Tax evasion is not only a revenue and a moral problem. As the potential and propensity for tax evasion vary across sectors, it has pervasive economic effects on demand and supply of various kinds of goods and services, savings and investment. Off-market and unrecorded transactions, outside the legal framework of contracts and regulations, become much more attractive. Savings and investment tend to flow to sectors where evasion is easier and where potential for evaded incomes is high. Similarly, skilled personnel are likely to gravitate towards those occupations and professions where the ratio of incomes that do not have to be declared, legally or otherwise, to taxable incomes is high. All these effects of a distorted tax system are visible in India. There is no shortage, for example, of supply of savings for investment in real estate, where tax evasion is rampant and monetary returns are large. On the other hand, the demand for private investment by farmers in irrigation may be strong, but there is no equivalent supply response. The supply of highly trained doctors or teachers for public hospitals or universities is limited, but there is no shortage of doctors in private practice or teachers in private tuition. Similar examples can be found in virtually all sectors of the economy." (pp.60-61).

Indeed, there is no choice with the prevailing international milieu in which many countries have done the necessary by successfully cleansing their own erring systems. Argentina closed down factories and retail outlets for infractions in VAT returns. It publicly posted lists of importers whose declarations had to be reassessed by customs officials. Peru drastically cut down the number of tax administrators, replaced them with officials with an average age of little more than 30, and put in place a salary structure multiple times the earlier one. Korea successfully matched most invoices

[5] One reader of an earlier draft has commented that this would need a cultural revolution.

between each seller and corresponding buyer when introducing the VAT. The United States routinely put tax evaders behind bars irrespective of their social standing. Mexico introduced a minimum income tax based on gross assets as a presumptive method, netting a whopping increase of one per cent of GDP in corporate tax revenue. Argentina did the same (see Shome, 1995). In the absence of such cleansing, India too would sink back into extra-institutional decision making based on the whims and fancies of politicians. The few progressive geographical areas would increasingly question the efficacy of vast and increasing subsidisation of the majority by the minority which cannot be maintained simply by greater cabinet and like representation from successful areas in an otherwise bankrupt economy, in debt and without ethical standards.

For success, new ideas amenable to quick change even at the cost of initial mistakes must replace "business as usual". In the *legislative* branch, the lack of manoeuvrability of the last Government (United Front, comprising thirteen disparate parties) was underlined by the fact that it had to depend on most parties other than the main opposition party for its existence, and by April 1997, it fell after only ten months in operation because of sudden and inadequately explained withdrawal of support from another party (Congress) outside it.[6] Thus, the Government's select economically meaningful measures reflected, on the one hand, a certain self-generated strength but their truncated nature betrayed, on the other, the obvious misalignment and even internal discord within it. The subsequent resurrection with a new Prime Minister, hopefully, will not be too ephemeral. All this also increasingly demonstrates, however, that the parliamentary form of government is beset with obstacles in an emerging fiscally federal state and that the efficacy of a presidential form of government demands close and urgent examination. In the *judiciary*, the backlog of cases is so monumental that the Indian case has become a perennial citation for the rest of the world. Here independent tax courts, commercial courts and the like must be considered. Only that will put in place a dynamic judiciary and firm up some of the pathbreaking measures that it has recently taken to challenge the lack of action in the other branches. In the *executive* branch, civil servants are rarely complemented by professionals with specialised training and, instead, are moved from one specialised department to another. There is little effective interaction or involvement with researchers. Fundamental reform is necessary, therefore,

[6] It is chastening that the main opposition party (Bhartiya Janata Party) was stopped, by almost all parties, from obtaining parliamentary support after forming a Government earlier which lasted a mere thirteen days.

to allow the infusion of specialised knowledge from different professions into the executive branch. In terms of professional research itself, various research and related institutions continue to be created even though there seem to be far too many of them. Under the assumption that they exist to enhance the stock of intellectual capital, often this process is veritably thwarted, however, by making it well nigh impossible to develop a framework that would accommodate researchers with recent high quality training, or familiarity with international trends. New ideas tend to get stifled as a result.

The argument that new ideas tend to get stifled could be generalised across professions, whether politics or economics, socialists or rightists, development or market enthusiasts. Work output based on dated techniques by international standards and administration by a stifling and changeless hierarchy are often justified on grounds of reverence to elders who become synonymous with wise, with all the pampering and paraphernalia that such position commands, even if at great direct and social cost. The fact that the world's "learning curve" is rapidly changing with a high rate of obsolescence is virtually ignored. The result is that there is a falling out from the more dynamic and pace-setting real world, with the country tending to enshroud itself in intellectual autarchy. Only a fundamental change that opens the way for a new and younger generation to impact on policy making can resurrect the country's ability to keep up with the rest of the world. Peculiarly, but thankfully, there is a general feeling in the present atmosphere that this is possible, but many complementary actions would also have to occur. The emergence and activitism of non-governmental groups, the cautious optimism of the new generation, and the stream of innovative ideas that are breaking through the firmness of stagnancy are playing to that intuition.[7]

The above issues cannot all be considered in a technical context in one setting. In what follows, concerns in public policy and governance, as related to selected fiscal policy issues, are addressed. As NIPFP celebrated

[7] One commentator, Amaresh Bagchi, was not so sanguine. I quote him lest, if I summarise, the spark in his language should suffer: "The optimism of the new generation, though cautious, may not take the country forward unless some way is found to resolve the conflicts simmering particularly in North India over 'caste' and the distrust of each other among the constituent units of the federation. Ultimately, it is the awareness of the people that can take the country out of the present mess and that cannot come without education. Tensions generated by inequalities (inter-personal and inter-regional) that accompany growth in the initial stages also need to be kept in view."

its twentieth anniversary year, the nation prepared for its fiftieth anniversary. It seemed fit to bring to the social science readership, a collection of papers focussing on broad aspects of the governance problem which is accepted as paramount today. Since the understanding—leave alone eradication—of the problem must be centred not just on an economic approach but also on related disciplines such as political science, sociology and law, an attempt was made to bring together papers from various fields.

In what follows, each Section is preceded by a discussion of the various papers which appear in it. Section I on "Public Policy and Governance" explores issues such as the relationship between policy outcomes and the nature of governments; the impact of crime and corruption on the stability of countries, as well as guidelines on public policy as we approach the next century. Section II on "Tax Policy and Administration" explains that good governance is crucially dependent on sound tax policies and effective tax administration. The papers presented in this section dwell on the key constraints in the existing tax policies and systems of administration, explore the possibilities and potential of such options as presumptive taxation and tax deduction at source, and suggest ways to simplify administrative procedures. It also addresses the problem of local governance and the role property taxation could play in it. Section III on "Expenditure Control and Fiscal Management—The Federal Dimension" deals with the overall context of an overgrown government and its fiscal management. This section is devoted to an indepth scrutiny of the system of control and management of government expenditure which evinces rising magnitudes, falling efficacy, pervasive leakages and considerable waste. Issues like soft budget constraints, myopic and partitioned processes of formulating budgetary demands for spending, budgetary mispredictions, inadequate ex-post scrutiny and weak corrective feedbacks are discussed with a view to identifying such reform measures as can muster a greater mileage out of each budgeted rupee. The practice of providing free social and economic services and its primary and other implications are also discussed in the fiscal federal context. Section IV on "Inter-disciplinary Approaches" is a window into the recognition of public policy and governance as the outcome of not only economic forces, but also the overall legal framework and political environment. In recognition of these factors, this section throws some light on possible impediments to the channels and mechanisms in the process of efficient governance, such as legal obstacles or multi-level structures of institutions of governance, as well as alternative forms of government such as democracy or otherwise.

References

Bagchi, Amaresh (1995), "Tenets of Tenth Finance Commission : A Critique", *Economic and Political Weekly*, Vol.XXX, Nos. 31 and 32, August 5-12.

Jalan, Bimal (1996), *India's Economic Policy : Preparing for the Twenty-first Century*, Viking Penguin India, New Delhi.

LeGrand, Julian (1982), *The Strategy of Equality*, George Allen & Unwin, London.

Mauro, Paolo (1997), *Why Worry About Corruption*, Series on Economic Issues No. 6, International Monetary Fund, Washington, D.C., February.

Nayyar, D. (ed.) (1995), *Industrial Growth and Stagnation*, Oxford University Press, Bombay.

Shome, Parthasarathi (1983), "Review of J.Le. Grand, *The Strategy of Equality*", London: George Allen and Unwin, 1982, pp. 208, in *Public Finance Quarterly*, April.

_______ (1995), "Recent Tax Policy Trends and Issues in Latin America", in Andre Lara Resende (edited), *Policies for Growth: The Latin American Experience*, International Monetary Fund, Washington, D.C.

Tanzi, Vito (1995), "Corruption, Government Activities, and Markets", *Finance and Development*, International Monetary Fund-World Bank, Washington, D.C., December.

Economic Policy Goals, Ideology and Governance

(Commemorative Lecture)

2

P. Chidambaram

I am happy to be here this morning on this occasion to commemorate the 20th anniversary of the National Institute of Public Finance and Policy. Twenty years is a short period in the life of an institution but long enough to make a mark and indicate the kind of contribution that an institution can make to sensible policy making in the public domain.

I have come here to listen. I shall not, therefore, deliver a long lecture. I can also take refuge on the fact that since Parliament is in session, I cannot even utter the word 'policy'. In recent years, there has been a greater degree of convergence among economists and administrators that we require a set of policies which will impart stability to the economy and which will impart a certain dynamism that is required for growth. The central concern of economic policy making, in my humble view, should be the fiscal deficit. This requires paying attention to both augmenting resources as well as controlling expenditure. Many scholars have told me that the effort to control expenditure will yield only marginal results; that unless various institutions and organs of the state are thoroughly overhauled, control of expenditure may not yield results adequate to contain fiscal deficit. They have also told me that the burden, therefore, has to fall on augmentation of resources.

It is tempting to make radical suggestions but one has to remember that we are working under a written Constitution and there are clear divisions of taxation power between the Centre and the states. One, therefore, has to work within the limits laid down by the Constitution. Every now and then I turn to the Seventh Schedule of the Constitution to see if there is any tax that we have missed or any source that we could tap. Frankly, there are very few. Noted politicians easily say that we should tax agricultural incomes. The entry in the Constitution says that you can tax income other than agricultural income. The power to tax agricultural income is with the states. I give that just as an example. It is, therefore, increasingly clear to me, that while we can look at new and innovative taxes and also try to sustain them, under the residuary power of taxation which

is vested in Parliament, the only effective way to augment resources is to widen the tax base.

There is enormous tax evasion in this country. Sometimes it is disguised as tax avoidance but, from the collectors' point of view whether it is evasion or avoidance, the result is the same: the tax does not come to the state. Take the Minimum Alternate Tax (MAT) which has been severely criticised in some quarters. The incidence of MAT will be felt only in the assessment year beginning 1st April 1997! Surely it cannot account for poor corporate performance last year. MAT is a tax which corporates who have large profits and declare such profits to the shareholders and declare dividends, yet who do not pay any tax to the state, have to pay. Firstly, MAT falls on a corporate; secondly, he must have large profits; thirdly, he must declare those profits by adopting a pattern of depreciation which allows him to declare such large profits. And he must have a chartered accountant who is able to disclose that he has made a loss, to the tax collector. Such a company, according to me, is a very successful company and if we extract 12.9 per cent from that company, it should wear it as a badge of success. Why should that company hide the fact that it is a successful profit making company which declares large dividends to its shareholders when the government is asking it to pay 12.9 per cent of its profits as tax?

Why I give MAT as an example is that, while we can innovate with taxation, the real way to augment tax resources is by widening the tax base. Here we run into enormous difficulties. There is very little data base in this country; whatever there is, it is totally fragmented. There is no way in which we can integrate these data bases. I have asked my people a simple question: if a person owns a house and a car and a telephone, or possesses two of these three characteristics, is it not fair to assume that he must have an income which should be subject to income tax? At a meeting of the Chief Commissioners I gave out these figures—the number of telephones in Delhi, the number of houses in Delhi. They run into lakhs. Yet there are only 5 lakh people who are assessed to income tax in Delhi. I think on any Sunday if you walk through Karol Bagh or South Extension you will find hundreds of shoppers who obviously have to pay tax. But they do not pay tax. How do we augment the tax base? This is the real issue.

I would urge all of you to bestow some attention on widening the tax base. The wider the tax base, I can assure you, the quicker it will be and the easier it will be for the government to bring down tax rates. If we

can double the number of income tax assessees in this country we can move much more rapidly towards reducing income tax rates. The two are closely linked. The demand for reduction of tax rates will depend only upon how quickly we are able to widen the tax base.

The same is true of excise and customs—less so in customs but more in excise. A couple of days ago, a Commissioner of Excise who has done good analytical work gave me some very interesting data. In his Zone, 44 per cent of companies contribute 80 per cent of excise revenues—a little over 80 per cent in fact; 56 per cent of companies contribute only less than 20 per cent of excise revenues. The small scale industry (SSI) exemption has become a tax shelter. SSIs must have some exemption. But that has become a device by which one can avoid paying even a certain minimum amount of tax. It has also resulted in fragmentation of production and of productive capacities. How do we widen the tax base in excise which is a major source of revenue for the government? These are questions which we must be concerned with.

It seems to me that we have not yet drilled into the consciousness of policy makers and administrators that the availability of resources at any point of time is finite. People assume that resources are infinite; the capacity of government to borrow is infinite; and the capacity of government to monetise its deficit is infinite. It is not. There are severe limits. If you yield somewhere, you have to pay a price somewhere else. If you yield on the question of, say, borrowing or on the question of monetisation, it shows up somewhere else. It shows up either as high interest rates or it shows up as high inflation and then it hurts everyone.

Today as far as containing inflation is concerned, at least in 1995-96, and to some extent in 1996-97, the entire burden is falling on monetary policy. We are not able to do enough on the fiscal side to contain inflation because the demands are so great. We are now in the middle of an exercise of drawing up the next Five Year Plan. Some snatches of the discussions have appeared in the newspapers. I think the Member-Secretary, Planning Commission, very aptly described it: as it is a dharma of the planner to ask for more, it is a dharma of the Finance Ministry to plead for less. The point I wish to make is, even for planners, the fiscal deficit must be the central concern, and planning must recognise that government does not have an infinite capacity to borrow, either domestically or externally.

The country can grow only to the extent it has savings, can attract foreign savings, and has an efficient capital output ratio. We must raise savings; we must keep India attractive for foreign savings; and we must become more efficient. These appear to be old-fashioned virtues, but it is old-fashioned virtues which have made new "Tigers". We need to imbibe these old-fashioned virtues. I think it is possible to raise domestic savings. It is possible to raise savings particularly in the public sector and in the government sector. The Common Minimum Programme of our Government says that the public sector cannot be allowed to dissave. That is a very pregnant statement. One must have the courage to follow up and take the steps by which that can be translated into policy. The public sector cannot be allowed to dissave. Similarly, we must keep India attractive for foreign savings to come here as foreign direct investment.

A single minded drive towards certain measurable goals is what is missing in India. The Chinese have such a goal. Malaysians have such a goal that they want to make their country a developed country by 2020 and drop the tag of a developing country. Indonesia has such a goal. We *must* keep for ourselves some measurable goal. And we must become more efficient. Unless we improve efficiency, even if our savings go up or we attract more foreign savings, it will not translate into real growth. I would urge, therefore, NIPFP and others to work on a set of measurable goals which we can achieve, say, by the year 2000 and, again, goals which we can achieve by 2010, and goals which we can achieve before 2020. For good reasons I do not think beyond 2020.

I would suggest that by the year 2000, a measurable goal that we must achieve is a 7.5 per cent real GDP growth rate on a sustainable basis. We must, therefore, have in place policies and instruments which will ensure that we have a 7.5 per cent GDP growth rate every year. An economist friend of mine three or four days ago left a very sobering thought with me. She told me that I could no longer take credit for a 6.5 per cent growth rate because that is already there now. To achieve 6.5 or 6.6 per cent is no big achievement because the economy seems to have matured into a 6.3–6.4 per cent rate of growth. So at the end of the year if you turn up and say that you have achieved 6.3 or 6.4 per cent, that is no big success. I think that is very sobering but, by 2000, we must be able to say that we can achieve, on a sustainable basis, a 7.5 per cent growth rate. By 2010 we should be able to say that we have a per capita income of at least US$ 750 and, by the year 2020, we should set for ourselves a goal of a per capita income of at least US$ 1200. We must also set for ourselves a goal of a

fiscal deficit of less than 4 per cent of GDP by the year 2000 and then bring it sharply down to, say, 3 per cent by the year 2005. May be that is too long a time table. But we *must* set for ourselves some measurable goals because I think we allow year after year to pass by without goals against which we can measure our success. We seem to be happy with good monsoon and we rue when there are bad monsoons, but we must set for ourselves measurable goals.

I think governance will become easier if we can make these goals widely accepted and widely looked forward to. Governance is becoming more complex because the polity is fragmented. For every reformer, you will find an anti-reformer. For every measure of reform, you will find some opposition. The task is difficult enough to put together a government which commands majority, because the people seem to elect, for a variety of reasons, parties and individuals who do not share a basic ideology or basic philosophy. In fact it is sometimes more comfortable to go back to the age of ideology when at least you knew that 350 individuals of one ideology could get elected—even if it was an imperfect ideology, atleast some ideology linked them. Today one can never say what will happen to a bill or what will happen to a measure. It is quite possible that someone in your own constituency will stand up and say that we don't agree. So, given the fragmented polity, it is even more necessary to find *some* convergence on a few economic issues, particularly issues concerning fiscal policy and public policy.

I think that is enough for the commemorative speech. I think commemorative is too high sounding a title. I have made a few introductory remarks just to show that we support the work you do, and that we will continue to support the work you do. We are respectful listeners of your advice, even if we don't follow them always, and we want you to continue to work for the government. We want independent institutions like NIPFP to continue to be a guide, critic, and counsellor of government, and I wish you many many more years of useful work. Thank you.

Corruption, Governmental Activities and Policy Instruments—Brief Review of the Main Issues

(Keynote Address)

3

Vito Tanzi

I. Introduction

In recent years a lot of attention has been paid to the problem of corruption. The newspapers of countries where there is a free press have been reporting, almost daily, stories related to this topic. More importantly, in some countries, governments have fallen, whole political classes have been replaced and prominent politicians have lost their positions or, in some case, have gone to jail. It was not always so. If we go back a decade, we find much less frequent mentions of corruption. Then, most observers, including economists, were generally ignoring this phenomenon.

In spite of the recent attention, corruption is not a new phenomenon and references to it can be found as far back as thousands of years. It is, thus, difficult to understand why, all at once, everyone seems to be interested in the topic.

Corruption has been and can be defined in many different ways each lacking in some respect. However, like an elephant, even though it may be difficult to describe, it is generally not difficult to recognize. In most, though not in all, cases different observers would agree on whether a particular behaviour or action reflects corruption. Perhaps the simplest definition is that it is the abuse of public power for private benefit. From this definition it should not be concluded, however, that corruption cannot exist in private sector activities. Especially in large private enterprises where the managers may not be the same as the owners, this phenomenon can also exist. In this definition, a public official who uses his position to derive benefits for himself or for his family and friends, or even for his political party or tribe, is engaging in an act of corruption.

It is a controversial issue whether cultural factors play a role in the existence and prevalence of corruption. The soon-to-be-published 1997 *World Development Report* by the World Bank, which deals with the

economic role of the state, affirms categorically that cultural factors do not play a role in corruption. I disagree with that conclusion because, as I have argued in some of my writing, there are particular characteristics of some cultures which, while meritorious and even noble in themselves, may create a more fertile ground for corruption. This is, for example, the case with close interpersonal relationships which are much more prevalent in some cultures than in others. Such relationships create a warm and friendly environment which makes living in these societies more pleasant but, at he same time, it creates a contiguity which exposes public sector employees to pressures to bend rules to help friends and family members. In certain circumstances such pressures may be hard to resist.

Regardless of cultural factors, however, human behaviour universally responds to positive and negative incentives. Thus, when incentives exist that increase the returns to acts of corruption, some individuals will become corrupt, regardless of culture. By the same token, when effective controls are in place, and when acts of corruption are severely punished, corruption will tend to decrease, regardless of culture. This implies that more attention should be paid to the incentive structure that exists within public sector institutions, including the level of wages. There are now examples of countries that were relatively corrupt in the past but where corruption has been much reduced through determined action on the part of the government.

II. Instruments and Effects of Corruption

Corruption affects and distorts what should be arms' length, or objective and unbiased, relationships between government officials and private sector individuals. Because of corruption, some individuals succeed in getting favourable treatment by public officials in their economic activities. Such a treatment can either reduce the costs for the economic activities in which these individuals are engaged or create new opportunities for them not available to others. Through the payment of a bribe or through some other favour, an individual can influence the decision of a government official or can have the official bend a rule in his favour. At times, of course, the initiatives may start with the official who may offer a special treatment in exchange for a payment. In all these cases, corruption will change the competitive equilibrium that exists in the market.

Corruption may also occur when a government official demands the payment of a bribe to make decisions that the officials should make in any

case. For example, it was recently reported that in New York City some elevator inspectors required bribes from the owners of buildings to validate that the elevators were in good working order. Apparently, without the bribe they would simply refuse to give such a seal of approval even when there was nothing wrong with the elevators. It is also conceivable that under particular circumstances, government officials may create or invent additional rules and regulations explicitly with the objective of providing themselves with more instruments for extracting payments from individuals. In some cases, there is no written or publicly available version of these rules. The asymmetry of information in such cases makes it impossible for the private individuals to ascertain whether, in fact, the regulation claimed by the public officials is a legitimate one.

Recent attention toward corruption has been promoted by the globalization of economic activities and of information. With increasing frequency globalization is placing individuals from countries less tolerant of, or less used to, corruption into contact with those from countries where corruption is a more common phenomenon. This is, for example, the case with foreign investment or with public projects where foreign companies compete for the projects. The fact that some industrial countries make the payment of bribes to foreigners business expenses deductible for tax purposes while others (the United States) do not, has intensified international interest in corruption related to foreign countries and has led to calls to standardize the tax treatment of bribes. Recent attention has also been promoted by the growing trend in the world toward more open societies with increasingly free and active presses. Thus, behaviour that was not reported in the past, or did not attract attention, is now closely scrutinized. Recent attention to corruption has also been stimulated by the growing concern for economic efficiency and competitiveness on the part of policymakers because corruption reduces the ability of countries to compete internationally.

Corruption is made possible by the monopoly power that the existence of government rules and regulations confers on some government officials. In some countries most economic activities need the authorization or the approval of some public sector official. Often several officials with different jurisdictions must authorize an activity.

The instruments that make corruption possible are many. Important but by no means exhaustive examples are the following:

(a) regulations or licenses needed to engage in particular activities, such as driving a car, opening a shop, importing, running a business, and so on;

(b) land zoning and other similar official decisions, which, at the discretion of some public official, may determine whether, for example, a piece of land can be used only for agriculture or for high rise buildings, thus sharply affecting the market value of that land;

(c) access to the provision of goods and services supplied by the government at below market prices, such as fertilizers, electricity, telephones, foreign exchange, credit, places in good schools;

(d) control over decisions regarding procurement contracts;

(e) control over decisions regarding public investment contracts;

(f) control over the provision of tax incentives to particular investors;

(g) control over hiring and promotions within the public service; and so on.

In all of these cases, some government official has an element of discretion in making a decision which may have important economic consequences for some individuals. In some cases several officials have such a discretion over a single decision.

The literature on corruption has centred on a basic and, perhaps, debatable assumption, namely that the more involved is the government in economic activity and decisions, the greater is the potential scope for corruption. This assumption is particularly realistic when the government role is not played just through spending and taxing but is carried out through the use of regulations, authorizations, and other quasi-fiscal activities. In particular, the less transparent and clear are the laws and the regulations, and the greater is the discretion of government officials in interpreting and applying them, the greater is the potential for corruption. Thus, *clarity* and *discretion* are key factors. In some countries regulations are not even published so that private individuals are not able to challenge the public officials who claim a given regulation in support of particular actions.

Economists generally believe that too rigid rules may lead to inefficient economic systems, thus reducing growth. Because of this consideration, a few economists have argued that corruption may actually increase the efficiency of economies by rendering the rule more flexible. Countries of Southeast Asia are mentioned as examples because the economies of these countries have grown at very fast rates in spite of the existence of significant corruption in some of them. These economists have argued that corruption can be the oil that makes the economic mechanism operate more smoothly.

In theory at least, corruption could increase efficiency when the rules are in fact too rigid and stifling and when the bribes to be paid are predictable rather than random. In such circumstances, the economic agents who want to start new activities and get around the rigid rules know whom to contact to get the desired decision; they know the size of the bribe to be paid; and they have confidence that the public official who has been bribed has the power and the incentive to comply with the terms of the implicit agreement. In other words, he will not renege on the promise and no other official will appear who will put obstacles on the activities of those who pay the bribe. In this case, corruption is less damaging to economic efficiency and growth as compared to corruption that is random and uncontrolled as it seems to be in Russia today. Some economists have viewed the former type of corruption as a kind of neutral tax which increases the cost of economic activity, but does not distort much the allocation of resources. It just removes, for a fee, an obstacle to the presumed good allocation of resources.

While there may be some truth in the above argument, its practical importance is often exaggerated. It assumes that economic activity is damaged by the existing and unchanging rules so that the bypassing of these rules, through the payment of bribes, removes an obstacle to growth but does not do any other damage. The problem is that corruption is often like a cancer, it starts in one specific area, perhaps the area where the rigid rule is, and soon it begins to spread to other areas. Eventually, most activities may become affected. Then it stops being a proportional tax and begins to be more like a distortionary tax levied with uneven and random rates. When this happens, corruption is no longer just oil for the mechanism but it distorts decisions in ways that at times can be very damaging to the economy. For example, it may encourage expenditure in unproductive investments, because of the bribes or "commissions" that some public officials can get from those who undertake the projects. Furthermore,

corruption may itself encourage the creation of opaque rules and regulations, thus increasing the range of possibilities for which public officials can get bribes. When regulations are creating the possibilities of increasing incomes for some government officials, more regulations may be created or more government officials may join the corrupt ones in using existing regulations to get a piece of the action.

Corruption reduces in many ways the ability of the government to pursue its basic functions. It distorts the allocative, distributional, and stabilization roles of the government. The effect of corruption on the allocative role is somewhat obvious. In the public finance literature, that role is justified in terms of the need for the government to correct for market failures or imperfections. However, corruption itself creates market imperfections by the differential treatment that individuals receive when some of them have been able to bribe a public official while others have not. For example, in some countries corruption has led to the creation of monopolies when those who benefited from it were given exclusive rights to engage in some activities.

The distributional role is distorted because those who benefit from corruption, either as corruptors or as corrupted, are often better placed and better connected than those who do not. The very poor do not have the means to bribe somebody and are too uneducated to be in the strategic government positions where public officials have the power to elicit bribes. Furthermore, they are more likely to be abused by public officials.

The stabilization role is negatively affected because corruption tends to decrease government revenue and to increase government spending, thus contributing to the enlargement of the fiscal deficit.

The reduction in revenue occurs when corruption contaminates the tax and customs administrations, so that some of the payments made by taxpayers end up in the pockets of tax inspectors or customs officials. In some countries major revenue from customs duties has been lost when customs officials assisted in smuggling activities or when they diverted the collected customs duties toward their pockets. Revenue is also reduced when proceeds from the sale of state-owned natural resources, such as oil, are diverted away from the government treasury.

Corruption increases government spending when, because of bribes, useless spending (such as unproductive investments) is promoted or when

individuals receive payments from the government to which they are not entitled. This is the case of ghost workers, phoney disabled workers, and abusive recipients of government subsidies. In some countries major government spending went to pay rebates on fake exports.

Recent, empirical literature has pointed to a negative correlation between corruption and growth, while some of the more speculative literature of earlier years had hypothesized a positive connection between corruption and growth. The reason why some economists now believe that corruption retards growth is because of its negative impact on some of the economic variables that promote growth. For example, recent empirical work by Paulo Mauro of the IMF, done using cross-sectional data, has shown that corruption decreases total investment and expenditure in education. Because these variables are important contributors to economic growth, corruption can be assumed to decrease a country's rate of growth. In fact, Mauro has estimated the probable reduction in the growth rate that can be attributed to the impact of corruption on these variables.

However, corruption may affect economic efficiency in other indirect ways. For example, unproductive public investment may replace more productive investment even when the total is not affected; incompetent officials may move up to positions where their poor decisions are damaging to economic activity; promotions within the civil service may not be based on merits thus leading to the discouragement of good people; public projects may be completed in a sloppy way; and so on. There have been stories of countries where projects such as the building of new roads have been so shabbily done that the road had to be redone in a few years. There have even been reports of countries where expenditure for operation and maintenance was intentionally reduced so that the infrastructure would deteriorate at a faster rate to the point where it would require major new investment, thus providing opportunities to get "commissions" from those who would undertake the project.

III. The Measurement of Corruption

In recent years, various estimates of corruption have become available. Because there is no way of measuring corruption directly and quantitatively, the estimates available are based on surveys whereby some relevant individuals are asked to rate the extent to which economic decisions within a particular country are contaminated by corruption. Examples of these indexes are available from *International Country Risk Guide, Business*

International, Transparency International, World Competitiveness Report, and *Political and Economic Risk Consultancy.* All these indexes tend to be highly correlated among themselves which may mean that they contain some element of truth. However they should be used with a great deal of caution because they are based disproportionately on the opinions of certain classes of individuals who may base their opinions on what happens in some sections of the economy such as foreign investment.

Perhaps, the best known index is the one that has been made available by *Transparency International,* a non-profit organization, with headquarters in Berlin, created by a former World Bank employee. *Transparency International* rates 54 countries with an index that ranges from 0 to 10. Zero means totally corrupt; ten means that there is no corruption. The index is "an attempt to assess the level at which corruption is perceived by people working for multinational firms and institutions as impacting on commercial and social life". As the description implies, it is not a fully presentative index. The *Transparency International* index is highly correlated with per capita income and with indexes of "economic freedom". Thus, as countries become richer, they generally become more free, especially economically speaking, and less corrupt. In other words, the government becomes less intrusive in the daily economic activities of the citizens even though the level of taxation and spending is higher in rich countries. Interestingly enough, some of the least corrupt countries (those of Northern Europe) are also among those with the highest share of taxes or public spending in GDP. The World Bank has been working on a more comprehensive index of corruption. However, because of sensitivities, it is unlikely that this index will become publicly available.

IV. Steps to Reduce Corruption

Governments should not be fatalistic about corruption. With a well focused and determined effort, corruption can be reduced, although attempting to bring it to zero may not be an optimal policy. At some point, the social benefit from reducing corruption further may not justify the pecuniary or social cost of doing so. For example, it may require excessively high public sector wages or major legal or organizational changes. The optimal theoretical level would be reached where the marginal social cost of reducing it further would be equal to the marginal social benefit from the reduction. This level is likely to be higher than zero. In many countries corruption is well above the "optimal" level so that there is ample justification to try to reduce it.

The war against corruption must be fought on at least four fronts: (a) commitment by the country leadership; (b) reduction of the demand for corruption by the private sector; (c) reduction of the supply of corruption by the public sector officials; and, finally, (d) increasing controls and penalties for acts of corruption.

Commitment by the leadership: The war against corruption must start with an explicit commitment by the leadership of the country (president, prime minister) that it wants a clean government and is willing to pay the price to achieve it. To be believable, this commitment must be accompanied by visible action. Leaders should not only declare that they are against corruption, but they should be seen as not tolerating any form of corruption, whether it involves family members, political associates, or other members of government. They must be particularly vigilant and strict especially *vis-a-vis* those closest to them who use their positions or their special relationship with the leaders to extract rents from the private sector.

In some countries, political leaders have not been considered personally corrupt or, at least, no acts of corruption have been traced to them, but they have, at times, tolerated, (or, at least, have closed their eyes to) questionable practices by family members, political allies, and members of their government. These sins of omission are as important in creating perceptions as sins of commission. The fight against corruption requires that neither of these sins be committed. A country where the political leadership is now showing a strong determination to follow this rule is Malaysia, where a powerful political figure was recently asked to leave the government when evidence became available that he was engaged in acts of corruption. On the other hand, in some countries when high level political figures (such as ministers) were accused of corruption, they were just moved to other high level government jobs. In a particular country, a minister who was widely believed to be corrupt was put in charge of a commission to fight corruption.

Reducing the demand for corruption: Corruption exists mainly because government officials find themselves in positions from which, through their decisions, they can influence significantly the activities of some individuals. As a consequence, particular individuals, such as investors, businessmen, importers, taxpayers or even plain citizens, can benefit from a decision that is favourable to them. In countries where governmental intervention in the economy is carried out mainly through broad, general and indirect policy tools such as monetary policy, fiscal policy, and exchange rate policy there

is much less scope for corruption. Unfortunately, in many countries government intervention in the economy transcends the use of general policy tools, and is carried out through regulations, authorizations, tax incentives, and other tools that require direct contacts between specific individuals and public officials and require decisions by public officials which are tailored for specific individuals or enterprises. Such intervention creates a strong demand for acts of corruption.

An important reason why corruption seems to be more prevalent in developing and transition economies, than in industrial countries, is that in the former the role of the state is carried out substantially through the use of rules and regulations and less through spending and taxing. As countries become richer and acquire the ability to raise the level of taxation, and as markets develop more fully, the role of the state comes to be played more through taxing and spending and less through regulations. However, when in a country individuals are required to obtain permits or authorizations (and often from several or even many different offices) to import, obtain foreign exchange, borrow, export, invest, benefit from tax incentives, open a shop, start a new activity, and so on, it is inevitable that somewhere along the line a bribe will be offered (or asked) to get the desired decision. The bribe may provide a license denied to others; or it may provide a license more speedily; or it may reduce the cost of complying with existing regulations (as for example those related to health standards), or it may provide a tax incentive or subsidized credit and foreign exchange.

Thus, the fight against corruption must start with the pruning of the regulatory framework, at both the national and local level, to eliminate redundant or unnecessary regulations. This exercise may also reveal that some needed regulations are not in place. The fight must continue with an attempt to make the regulations that are retained clear and more transparent to reduce the possibility of conflicting interpretations. Also, if possible, strict time limits should be set by which a given request must be accepted or rejected in order to reduce the chance that public officials may invite bribes by simply sitting on requests. The deregulation of economic activities which is characterizing the economic policy of many countries should in time lead to a reduction in the demand for acts of corruption.

Reducing the supply of corruption: The widespread involvement of the government in the economy, especially when carried out with non-neutral and non-general instruments, creates conditions which lead some individuals to want to bribe public officials. In other words, it increases the demand size

of the corruption equation. However, as the saying goes, it takes two to tango. An act of corruption is much like tango because it involves two sides —one that offers a bribe and one that accepts it. It is conceivable that two countries could have the same instruments for governmental intervention, and thus the same demand for acts of corruption, but one might end up with much more corruption than the other. The reason might be that the willingness of the public officials to accept bribes could be very different. In this case, one reason for the difference might be the relative level of public sector wages and the status of a civil service job.

Recent empirical work carried out within the IMF has supported what one could believe intuitively, namely that there is a correlation between the level of wages in the public sector and the level of corruption. Countries that have low corruption tend to be those where the status of a civil service job is high and these jobs are relatively well paid. In this case, there is less pressure on the public employees to accept bribes (to make ends meet) and there is a higher cost to them associated with losing their government job. In some countries, however, public employees are paid so little that they are pushed, or even expected, to get additional income, either by having second jobs or by compromising their integrity. In these countries, the low levels of wages are often also accompanied by little differentiation in salaries across the ranks which creates additional pressures for some employees and especially for those with more discretion on decisions.

Although the level of wages is far from being the only factor that determines the supply of acts of corruption, it is a very important one so that a country that sets the objective of reducing corruption must be willing to revise the salary structure for its public sector employees. Countries that over the years have made significant progress against corruption, such as Singapore and Hong Kong, compensate well their public sector employees. In Singapore, for example, ministers are among the best paid in the world. This indicates that the fight against corruption is not a costless one.

Increasing controls and penalties: So far we have discussed three lines of action in the war against corruption, namely the commitment by the leadership, reducing the demand for corrupt acts, and reducing the incentives on public officials to accept bribes. The fourth line of action must be related to the establishment of better controls and heavier penalties. The controls would be aimed at increasing the chance that a corrupt act will be discovered and punished. The heavier penalties would make it more costly

for those who engage in corruption to continue to do so. There is now an extensive literature that started with work by Gary Becker that supports this approach, with respect to crime in general.

Countries could create the equivalent of a Criminal Investigation Bureau (as in Singapore and Hong Kong) that should be a high profile and politically independent unit staffed with well paid and highly motivated personnel charged with investigating reports of corruption. This bureau should go after corrupt officials and also after those who attempt to bribe the officials and should have the power to recommend adequate penalties (including dismissal) for those who are caught in acts of corruption. It is clear that the effectiveness of such a bureau will depend on its political independence, its integrity, its resources, and the extent to which the results of its investigation bring effective punishment on those who are caught. In this context, the role for the judiciary is important. A criminal investigation bureau cannot be effective if its actions are not followed by other institutions who have the responsibility to punish those who are found to have committed acts of corruption.

V. Concluding Remarks

In this discussion, we have considered various issues related to the fascinating and serious problem of corruption. We have discussed factors that create an environment where corruption becomes common, and we have outlined major steps to reduce corruption. It should be realized, however, that to some extent corruption is a reflection of society. Non-democratic societies, without a free press and an independent judiciary, are less likely to be relatively free of corruption. At the same time, we have evidence of democratic societies where corruption is still a major problem. But all societies can do a lot to scale down the problem. The costs of not doing so are becoming progressively higher in a globalizing world. But the fight against corruption must be carried out on many fronts. There are no magic solutions for this problem.

Governance : Weaknesses, Their Causes and Remedial Steps

4

(Inaugural Speech)

Raja J. Chelliah

I am glad that the topic, Fiscal Policy, Public Policy and Governance, has been chosen as the theme of the symposium commemorating the 20th Anniversary Year of the Institute. In our country today when, after many mistakes and experiments, we seem to have discovered and accepted the right economic policies to promote growth with stability, problems of governance have come to the fore and deficiencies therein are tending to nullify policies or render them ineffective and thus threaten to thwart progress.

In the traditional normative theory of public economics, a benevolent state with effective means of implementation of policies was implicitly assumed and on that basis the fiscal economist proceeded to study and analyse the effects of alternative policies on the behaviour of economic agents and of the economy as a whole. Recommendations on policy were based on such an analysis. This statement can be considered an over-simplification, if account is taken of developments in the literature in more recent decades. Increasing attention has been paid to the behaviour of bureaucracies; tax administration considerations have come to play a role in the determination of sound tax policies and transaction costs are no longer ignored.

However, official economic doctrine in India has not been modified to take account of the serious problems of governance that have arisen over the years in our country. Nor have any systematic studies of tax administration's impact on the effectiveness of tax policy or of transaction costs been undertaken. One also notes that Planning Commission documents do not reflect any significant change in the nature of policies or strategies in the light of the revealed weaknesses and deficiencies in governance except for tackling delays, cost over-runs, inadequate cost recoveries, etc. Even if the experts in the Planning Commission are no longer convinced about the beneficial effects flowing from large increases in public expenditure without systemic changes, political leaders still seem to

believe that much good is coming out of larger and larger allocation of public funds to key areas even within the existing system of governance. Surely, much larger funds need to be allocated to priority sectors such as education and health but, at the same time, some of the serious weaknesses in governance need to be speedily removed.

I shall first try to enumerate the major weaknesses of governance arising from certain characteristics of the government as a performing institution in India which impinge on, and distort, fiscal policies. Next, I shall try to explain briefly how these weaknesses have arisen and in what ways they distort fiscal policies. In the last section, I shall indicate the most urgent steps to be taken to ensure that fiscal policies can be more effectively pursued and will have the intended effects.

I. Major Weaknesses of Governance

Over-staffing and Tendency for Further Increases in Government's Staff Strength

The size of the staff of the government has grown so large at the level of the Central government as well as at the level of each State government that it has become virtually impossible for the leaders to exercise effective control over the generality of government servants. Hence, the low degree of effectiveness of government administration and slack implementation of policies. In terms of more direct economic costs, if we assume that the extent of surplus staff is 20 to 25 per cent, the over-staffing amounts to providing subsidy to 20 to 25 per cent of government's servants in the form of employment without work. It could be argued that the subsidy is being shared among all the government servants.

Leakages from Government Expenditure

Leakages from government expenditure are not an uncommon phenomenon as it is found to exist in most countries. But in India, as in some other developing countries, the phenomenon of leakage is substantial and pervasive and the total of leakages seems to form a fairly large proportion of public expenditure. Two categories of leakages can be distinguished: the first category consists of (a) kickbacks on large contracts, (usually defence and PSU contracts), (b) siphoning off funds allocated to construction, (c) 'cuts' on all kinds of purchases, and (d) maintenance of fictitious muster roll in respect of contractual employment of labour. The second category consists

of practices by which all facilities and means bought and maintained to provide public goods and services are illegally (that is, against rules) put to private use of the government servants concerned. Such practices are so pervasive and common that they do not now seem to be considered in any way improper and are accepted as matters of legitimate privilege. Illegally putting to private use of automobiles, telephones, xerox machines, postage and services of Group "D" employees are good examples.

Illegal Exactions

The cost of over-employment in the government sector and of all kinds of leakages from public expenditures is ultimately borne by the taxpayers. These exactions from the taxpayers are made indirectly. Another prominent feature of governance in India is the direct illegal exaction of money from the public by various categories of government servants. The illegal exaction or acceptance of money is usually called a bribe. In most cases there is some element of coercion in such exactions. It is commonly stated that there are two types of bribes. The first type of bribe is taken for performing a function which the government servant concerned is expected to perform as part of his duties such as issuing licences or registering a document or granting an approval according to rules and laws. The second type of bribe is taken for doing a favour to the briber in contravention of the law. Wherever opportunities exist tax as well as other administrators are found to practise this trade of two kinds. In effect then the citizens have to pay two types of taxes - legal taxes which go into the government treasury and illegal taxes that go into the pockets of government servants (some of these payments cannot be strictly considered taxes because the payers receive in return some favours in contravention of the law).

Remuneration and Performance

It has already been pointed out that too large a size of government staff has meant lack of adequate control and hence ineffectiveness has crept in. In addition, trade unions of government servants have more or less succeeded in ensuring that, except for lateral entries at selected levels, all advances and promotions should be primarily based on seniority. Periodic evaluation of performance is rather perfunctory. An adverse report is apparently given only very rarely. None in government service can be fired for non-performance or poor performance of duty. The general level of efficiency is understandably low because the incentive for good performance is weak. It must, however, be pointed out that there are a sufficient number of

motivated and conscientious people in government service who keep the system going. They are as good an example of conscientious public servant as one can find anywhere else. But too large a proportion of government servants have come to perform much below par.

II. How the Weaknesses have Arisen

The characteristics of the governmental structure and operations are quite similar to the basic features of a feudal order. When India became independent, Indian society was still basically a feudal society permeated by the feudal culture. The British had done little to change the structure because it was in their interests to preserve it. The feudal values and attitudes could have changed with the development of capitalism—as 'Marx' had shown—accompanied by fast growth and the spread of education. However, state socialism was imposed on the feudal sub-structure. As a result, the entire public sector has been developed as a rent-seeking mechanism with services being only a secondary goal. (Feudalism was preserved in the private sector also with the restrictions imposed on competition).

Second, labour laws were enacted which gave undue protection to the organised labour with a large part of it in the public sector. Organised labour itself formed, and still forms, a small part of the total labour force but the laws protecting them influenced in shaping their attitudes and thus affected the functioning of the government sector.

Third, representative democracy in an economy with a low rate of growth but with a fairly high rate of growth of population (which in turn could be attributed to the relative neglect of education and health) generated pressures for providing employment through over-staffing in the public sector. The type of planning process adopted with the current part of plan expenditure under any given plan automatically becoming an addition to the non-plan expenditure in the succeeding plan periods, also led to a steady increase in staff.

Fourth, controls, licences and complicated procedures developed under the planning system created ample opportunities for demanding speed money as well as a 'return' for granting approvals, issuing licences, accepting tax returns, etc. Given the very large size of the government and the enormous scope of its activities in the context of a feudal setting, it was inevitable that the lives of the common people and their economic activities

would come in contact with a host of government officials and would be subjected to undue scrutiny and harassment.

Fifth and finally, high rates of taxes, complicated provisions in the tax laws and the total neglect of tax administration by the senior civil servants, leaders of the government and the planners, and the perpetuation of archaic methods of administration, all led to the building up of a parallel illegal tax system whose yield went into the pockets of tax collectors.

III. IMPACT OF GOVERNANCE

- Lack of accountability and pervasive inefficiency obviously made every policy initiative yield far less than its full potential beneficial effect. This, in effect, means that the cost of performing almost every service went up.

- In the service oriented public expenditure programmes leakages result in the intended beneficiaries receiving very little of benefit. In the capital formation oriented programmes leakages mean either higher cost per unit of real investment or lower quality.

- The above-mentioned weaknesses of governance in many cases lead to distortions in the allocation of resources. For example, it has been alleged that engineers in the irrigation department prefer to start new projects under the plan, instead of completing the old projects or maintaining them better, because new posts of senior engineers can be created to look after the new projects. Politically, the proposals for new projects could receive ready support because a larger number of voters can be pleased. It is well known that funds allocated to irrigation have been spread too thinly in most parts of the country.

- Because of the existence of the various kinds of leakages, budgetary figures over-state the volume of provision of public goods. On the other hand, the total payment of taxes to the government sector is under-stated because part of the money is taken illegally. The actual public expenditure (incurred for the benefit of the citizens) is to be reckoned as being total budgetary expenditure minus leakages minus the subsidy in the form of expenditure on the provision of government employment without work. On the other hand, the total payments by the people to the government for its services are

to be reckoned as the total of legally collected taxes plus illegal exactions by all types of government servants from the public.

The legal tax ratio (taking the Centre and the States together) is now around 16% of GDP, amounting to Rs. 1,70,000 crore. If a reasonable assumption is made that illegal exactions by all categories of government servants amount to between 15 and 20 per cent of the legal tax ratio, then the total tax burden on the public could be taken to be between 18.4 and 19.2 per cent of GDP, that is to say, that the citizens are paying between Rs. 25,500 crore and 34,000 crore more than the tax revenue shown in the records.

We are all arguing for a rise in the legal tax ratio which has come down from 17 per cent of GDP in 1989-90 to 16 per cent in 1994-95. But perhaps the illegal tax ratio has risen in the meanwhile, judging by the spate of scams that are being unearthed. None will dispute the statement that money is being illegally collected with impunity by a proportion of various categories of government servants today. We can more easily raise the legal ratio, if we can take steps to reduce the illegal tax ratio. Indeed, I would say nothing would cheer the general public more than the elimination or a drastic reduction of the arbitrary, arrogant and illegal exactions of money by government servants for whose salaries they are already contributing taxes. In this connection I would strongly suggest that reforming tax administration should be a major plank in the government's reform agenda.

The total salary bill of the government sector amounts to around Rs. 64,000 crore. If 20 to 25 per cent of the staff is taken as surplus, the subsidy on the provision of employment without work can be reckoned at Rs. 12,800 to 16,000 crore.

Total capital formation of the government sector, excluding defence capital outlay, amounts to Rs. 24,500 crore. Of this about 66 per cent is accounted for by construction. That comes to Rs. 16,200 crore. Leakage of 30 per cent of this amount will be equal to Rs. 4860 crore or roughly Rs. 5000 crore (Leakage out of construction expenditure of non-departmental public enterprises is not included here).

Thus, total public expenditure is unnecessarily inflated by Rs. 21,000 crore, which is about 10 per cent of public outlay excluding loans. Surely, when we talk of reducing fiscal deficit, priority attention should be given to cutting down drastically this unjustified imposition on the public.

IV. Remedial Steps

It is generally felt that the deplorable weaknesses in the system of governance in our country can only be remedied through a movement of moral regeneration backed up by sufficient pressure by the enlightened public. Certainly the moral aspect and the exercise of civic responsibility are important. However, as social scientists, we should base our recommendations on an analysis of the social and institutional forces operating in a given society. Institutional and structural changes are required in addition to moral exhortation. I suggest below some of the major changes that we should try to bring about together with the priority areas for policy action.

- The area of governmental action, i.e., the scope of governmental activities should be narrowed down substantially; in particular the government should withdraw from the business of production of private goods which are of no significance either from the social or strategic point of view.

- Wherever the government is in the business of production of private goods, i.e., where public enterprises operate, they should operate in competition with private enterprises and must be made fully autonomous. All autonomous public enterprises should have substantial private share-holding.

- There should be further liberalisation and reduction in the number of controls. There should be delicencing of all industries except defence and strategic ones.

- Governmental procedures and procedures for obtaining various types of approvals should be simplified. Strict time limits should be set for grant of approvals. For all construction on government account, there should be a system of tendering and bidding by various construction agencies. The public works department itself should be one of the bidders. In course of time that department should be pruned and should be put in charge only of maintenance; construction can be taken out of its purview.

- With the reduction in the scope of government activities, avoidance of duplication of functioning by the Centre and the State governments and procedural changes, the size of the surplus staff in

several government departments can be gradually brought down by not filling up vacancies and redeployment of staff. Of course, there would have to be increase in staff in some social sectors like education. What is intended to be achieved is only elimination of surplus staff.

- In consultation with the unions of government employees, a system of reward and punishment related to quality and performance must be introduced.

- There has to be further rationalisation of the tax system including the system of stamp duty. All the checkposts acting as hindrance to the flow of trade and providing an opportunity for graft should be abolished. A special programme designed to modernise and improve tax administration should be taken as a matter of priority. Corrupt tax officials and tax evaders should be punished equally severely.

V. CLOSING REMARKS

Let me close by posing a few theoretical questions to the fiscal economists assembled here. Economists normally make a distinction between private goods and public goods. Public goods are those that cannot be produced and sold under the market exchange relationship because the principle of exclusion cannot be applied to them. As such, people will not reveal their preferences for public goods and a price cannot get established in the market. It is also argued or assumed that a public good will be consumed in an equal amount by all. Defence and maintenance of internal law and order are considered pure public goods. We generally take many other government services such as enforcing certain minimum standards, registering documents, etc., as public goods.

But in India, even "law and order" has been converted into a private good. When one goes to file a First Information Report (FIR) to register a matter with the authorities, often a payment is demanded to register the case. Should we say that a public good is converted into a private good in all such cases? How come this happens? Is this due to the extraordinary ingenuity of the Indian public servants? Or is there a weakness in the economists' definition of public goods? Parallel payments arise only because there are private benefits to be obtained. What we can say is that Indian Government servants have succeeded in converting what are generally regarded as public goods into non-merit private goods. In the light of our

experience, it seems that Indian economists should try to arrive at a more satisfactory definition of public goods.

Second, we should reconsider the definition of taxes. Taxes have two special characteristics: one, they are payments without *quid pro quo*. Two, they are compulsory payments for those who fulfil the conditions laid down in the law. Thus, there is an element of coercion. The illegal tax payments satisfy the condition of coercion, but they are usually rewarded with *quid pro quo* benefits. However, since the use of the coercive power of the State is involved these payments cannot be classified as user charges.

I would suggest that a thorough study of the kinds and quantum of illegal taxes being collected should be undertaken in order to get an idea of the total tax burden on the community. Meanwhile, I shall plead that the term illegal tax ratio should be brought into use.

Public Policy and Governance

Discussion of Papers by Surjit Bhalla, Bhaskar Dutta, Sumon K. Bhaumik & B.V. Kumar

5

Shubhashis Gangopadhyay

Modern researchers of corporate law, or company law as it is called in India, emphasise the importance of a single point objective. They maintain that, the only objective of such a body of laws governing the behaviour of corporations, should be that of maximising the value to shareholders. They argue that such maximisation will encourage efficient projects to be undertaken and, hence, realise the right amount of investment required for sustained growth. This focus, on the shareholders alone, is in spite of the fact that a corporation is an organisation of diverse groups, like labour, management, suppliers, consumers, local residents where the production points are situated, etc., all with very diverse interests.

The basic reason for this is a simple one. Corporate decisions are ultimately taken by managers and a large part of the laws govern *their* behaviour in an attempt to regulate the behaviour of corporations. If managers are given a multidimensional objective, and asked to look after the interests of every single group in the organisation, the entire managerial activity is trivialised. Why? Simply because, invariably, an action by the manager that is not pure fraud, will benefit at least some group(s) in the organisation and will, therefore, win the support of that (those) group(s) for the managers' actions. Thus, maximisation of shareholder value, necessary for investment, may not be achieved, leading to inefficient project choices.

One may wonder, why do I refer to corporate governance and company law when discussing papers in a session entitled *Public Policy and Governance.* Well, one of the authors, namely Bhalla, refers at the very beginning of his paper, to corporate governance and its correspondence to governance in general. I am simply subscribing to the same view and setting the framework in which the papers can be discussed. This allows me to set up a common theme for papers with such diverse topics as a *bill of rights, coalition governments,* and *crime and corruption.* Also, the papers are too well written and, were equally well presented, for me to add any further explanation about what they contain.

To finish the analogy between corporate governance and public policy, let me list some of their common aspects. In corporations, shareholders are principals and managers their agents. In public life, under a democracy, the voters are the principals and the parliamentarians, or the lawmakers, their agents. The managers choose the projects; the politicians, and/or their parties, choose the policy regimes. We want managers to choose efficient projects. This is their fiduciary duty. What do we want politicians to do? This is where the analogy seems to become strained, or even, break down. Can we say that as far as governance, or public policy is concerned, one can think of a uni-dimensional objective?

One way of looking at this problem is to go back to corporations. Various corporations undertake various projects. How can all of them be efficient? Well, they can. Some managers can handle steel projects, others chemicals, some financial companies, and so on. Yet, the goal is the same, that of maximising shareholder value. If Bhalla is to be believed, and I agree with him, then currently, the considered wisdom is that governments should maximise growth. Thus, all aspects of the government, namely the various ministries, should strive towards this single objective. Just as the common framework of the corporate institution (as defined by the company law) is to ensure that differently talented managers can all pursue a common goal, the institution of public policy and governance should also try to achieve this one goal of sustained growth.

If achieving growth, and economic efficiency, is what governance is all about, the obvious next question is how to get there. Bhalla's paper tries to figure this out. He considers the following candidates as explanators of growth: good bureaucracy, low fiscal deficit and overall economic freedom. He maintains that it is the latter which effectively gets translated into a high and sustained economic growth in a society. It is this conclusion that makes the correspondence between corporate governance and public policy so significant.

In financial markets, institutions must be developed so that the market for managers is efficient. Since managers have private information, not available to the small investors, the latter need to be convinced that managers will not be undertaking opportunistic actions that are to the disadvantage of the small investor. The laws governing corporate behaviour are meant to do this. In practice, these institutions can work in various different ways. In the US and the UK, which follows the so-called *outsider* system, a well-functioning stock market, with low costs of information,

strictures against insider trading, and the separation of commercial banking from investment banking all help in improving the efficiency of the outsider system. In Germany, the stock market is not very developed. Managers, therefore, cannot be disciplined by movements in stock prices. There, it is the banks and financial institutions, with access to company boards through the strength of their equity shares in companies and through the institution of proxy voting, who perform the role of monitors. The basic approach is to ensure that project managers do not become too entrenched and there is free entry and exit of managerial talent.

Bhalla's point is that for sound governance, as measured by economic well-being, economic freedom is a must. In other words, much like the body of corporate laws, the institutions safeguarding economic freedom must be developed. An economic bill of rights will disallow short-sighted policy makers from undertaking populist, or opportunistic actions that undermine the powers of economic decision-making of the less vocal political minority. For instance, when the government issues production licenses to some and not to others, it is restricting the feasible actions of those agents who have not obtained permission to produce! When the government introduces differential commodity taxes, it discriminates one group against another. The institution of government can be allowed to collect revenue, but it has to maintain some degree of unanimity, and uniformity, in the type of agents it collects from.

The main point is that while democracy is a good starting point, it is not enough; just as, developing a stock market requires more than constructing stock exchange buildings. Managers are elected by majority shareholders, and politicians are elected by majority voters. But once chosen as managers, various stock market regulations prevent managers from taking minority shareholders for granted. Elected politicians also need to be controlled after they win office. The bill of economic rights will play this role.

All of this may appear as a trivialisation of the most solemn concept of governance. One way I justify these analogies is to say that having been trained in economics, I am more at home working within that framework. Secondly, the part of governance I am interested in, and can comment upon, is that involving commercial law and the institutions governing economic actions.

Moreover, for those deeply involved in the philosophical issues of governance, and those convinced of the economist's ability to narrow down the focus of broad ideas to a simple economic agenda, Dutta's paper should be an eye-opener. In this paper he shows how deliberate policy distortions can be traded against electoral support, by elected politicians, what we have described as opportunistic behaviour by them. It is an excellently argued paper, though I must say that my knowledge of econometrics is very limited. (I must confess that I had similar problems with Bhalla's paper!)

Continuing with the issue of corporate governance, a large body of literature has tried to test whether certain (financial market) institutions encourage managerial myopia. What Dutta investigates in his paper is, whether or not, a similar question can be posed for the political managers of the country. His argument works best in unstable coalition governments. With unstable coalition governments, each constituent party tries to win concessions for its own vote bank, in the (expected) short duration that it is in power. Without Bhalla's bill of economic rights of citizens, this gets translated into populist policies, favouring one group against the other. In the long run, of course, this leads to an inefficient economic structure, resulting in losses to everybody. Hence, this can be termed as leading to myopic behaviour.

The conclusions of Dutta's paper ties up very well with something I had mentioned in the beginning, regarding the objectives of the manager. What happens in a coalition government is similar to what can happen in a company board which has representatives from various groups, like labour, main creditors, government, etc. Since each such board representative is looking after the interests of its own group, it can lead to certain actions by the management, who are answerable to the board, which lead to depletion of shareholder value. This possibility will be aggravated if the diverse board representatives are sufficiently powerful to force outcomes they like and block those they do not want. In political governments, this happens with what Dutta calls unstable coalitions. Loosely put, an unstable coalition is one where a defecting small party can destroy the majority of the ruling coalition.

Bhowmick's presentation, and Kumar's paper, points to an important aspect that I have not touched on so far. So far I have been implicitly assuming that once the laws, and institutions are set up, everything else follows. However, institutions and laws make sense, or are treated as being credible, only if they are enforced. A law stipulates the actions that agents

must take under certain conditions. If they do not comply, then they have to be punished. In most commerce, this punishment is in the form of economic costs, making the deviation from the stipulated action less profitable compared to compliance. By definition, this means that there has to be a system of enforcement. This is necessitated by the fact that laws come in handy whenever contracts are not self enforceable. If they were, rational agents would not need to be coaxed into these actions by the arm of law. It is here that the concept of corruption becomes important.

Corruption is essentially a breach of contract by the officials. Thus, if the licensing authority grants permits by deviating from the guidelines and procedures set up in the original policy, then it goes against the stated purpose and, hence, is a breach of trust reposed on the authority by the general public. It becomes corruption when the authority undertakes the deviant behaviour because of personal benefits from this action. Good governance is not simply ensuring that one has decision makers who understand and can follow guidelines, but also the development of institutions that punish those who do not. The costlier it is to develop these institutions, the easier it will be for corruption to flourish.

Bhowmick's presentation does an excellent job in setting this problem in the theoretical literature and then, applying the various models to actual realities and experiences in India. What I will, therefore, try to do is add a little bit to the discussion by talking about the costs of enforcement in law.

Let us take a look at contractual law. Suppose that the courts made only one law: enforcement of all voluntarily signed contracts. In other words, the legal institution of the country did not specify which contracts agents are allowed to sign, but commit to ensure that no party to any contract reneged on the agreement. Observe that, courts only come in when there is a dispute. Thus, ex post, both parties may want to nullify the agreement. In that case, the courts should not step in. Only if one party complains that some other party is not keeping to the agreement, should the court come in. In such situations, very few contracts will be broken, and the courts will seldom be called upon to act, keeping the costs of governance low. This is because, being voluntarily signed, there will be few incentives for breach. If, for some reason, breach does happen, courts will swiftly move in to prevent it. This sort of a society, will be a fully *enabling* system.

Contrast this with the other extreme where, the court specifies, or mandates, what contracts can be signed and what cannot. The tenancy law in many parts of India is an example of this; it specifies the agreement between landowners and tenants. The problem with this is that it precludes contracts that are tailor-made for agents with different needs, or preferences. Consequently, there is more reason to breach these contracts by at least one party. This implies too many disputes, long queues in courts, and a general delay in court dispensation of so-called justice. This discourages people from viewing courts as a system of redressal, with the associated high time costs. Invariably then, people operate outside the legal system, encouraging corrupt practices. The Indian system, with its plethora of laws, guidelines, and mandatory restrictions (like tenancy laws) has resulted in corruption having become a way of life.

Should we then move to the enabling system? Yes, but not fully. An advantage of the *mandatory* system, where every contract is pre-specified, is its low contract costs. Relatively uninformed agents do not have to undergo the costs of writing complicated contracts, since the courts have already written these for them, and they only have to sign on the dotted line. So, while the ex post costs are high, the *ex ante* costs are low. In the enabling system, the ex post costs are low as there is very little dispute resolution required, but the ex ante costs are high.

The way out is to have a mix of the two. This is called the enabling system with *standard form* contracts. Those who are relatively uninformed and have high contracting costs, sign the standard forms; those who are informed and find it beneficial to deviate from the standard form, sign their own contracts. The courts commit to enforce all signed contracts, the standard ones as well as the non-standard ones. Thus, there can be a standard tenancy contract, as well as those that deviate from it and are voluntarily signed by the contracting parties.

Observe that the basic point I am trying to make here is that economics thrives on differences across agents. If they are straight-jacketed into similar modes of trade, welfare is reduced and they attempt to break out of these straight-jackets. These straight-jackets are the umpteen mandatory restrictions on free trade and commerce in India. Once again then, Bhalla's economic freedom becomes an issue. A fully enabling system tries to realise this, but glosses over the issue of transaction costs (of writing contracts when people are relatively uninformed). The enabling system with standard forms, for countries like India, may be more suited. Will it

stop all corruption? No; however, it will prevent corruption from being as pervasive as it is now.

I will stop here and hope that we take an objective view of the problems raised in the papers. The economic model for analysing these issues gives a consistent framework in which to study them. These are serious issues and can be tackled only with less emotion and more objectivity.

6

Towards a Bill of Economic Rights: Public Policy and Governance in the 21st Century

Surjit S. Bhalla

I. Introduction

Governance—of the corporate and public sector variety—has become a popular topic for research in recent years. Especially since the fall of the Berlin Wall, the role of the state has come under increasing scrutiny—and the state's past behaviour under increasing attack. Policy makers, and policy making organizations like the World Bank, are now fighting a rear-guard battle for existence. Apart from past performance, technological change has also overtaken well meaning policy makers or policy politicians (hereafter referred to as policians). Increased globalization has rendered many a policy—from fiscal and monetary policy in the West to exchange controls in the backward South—impotent. A re-examination of the role of the state, its accountability, and future policy direction is the subject of this paper.

The analysis consists of five parts. Section II deals with the definition of governance—what is meant by it and are there any clues about the definition to be obtained from the parallel issue in the corporate sector. The question of measurement of governance is also taken up in this section—how does one identify good governance and what constitutes bad governance? For example, an exchange control policy might be advocated for considerations of "better" economic growth or "better" institutional development. A noble goal and therefore its introduction may mean "good" governance. But what if such a policy gives rise to large scale corruption? How therefore is the policy to be assessed?

Section III discusses popular academic prescriptions for improving governance e.g. get good management (*The* remedy in corporate sector) or good bureaucrats, and/or lower fiscal deficits (any Washington consensus policy maker). The record of these prescriptions is examined and shown to be wanting—for either affecting governance *per se*, or affecting economic growth.

Section IV revives the Hayekian concept of economic freedom (see, in particular, Hayek(1945). It is suggested that economic freedom, and an associated bill of economic rights, form the basis of the modern interaction between citizens and the state. Empirical evidence of the important role of economic freedom in enhancing economic growth, and significantly decreasing corruption, is offered. These results suggest that the provision and enforcement of economic freedom may be the yardstick by which governance is measured, in India and elsewhere. Section V concludes.

II. Definition of Governance

It is interesting to note that the dictionary has very little to offer by way of a definition. The Webster's 1979 edition has this definition: governance n: government, while the Oxford dictionary goes a bit further: governance: the act or manner of governing. Clearly the recent academic and heated discussion have greater substance to them than a never-ending circularity.

There are hints towards an appropriate definition from the advocacy of governance in the corporate sector. Here, the terms good management and accountability keep occurring. Of the two, "good management" can be dispensed with as one facing an identification (and Identity?) problem. Accountability seems to bring a desirable element into the discussion—the act of governing is not independent of its premises or its consequences—there are rights and wrongs and there are rewards and punishment for good and bad governance.

After starting with a good definition, most discussion of corporate governance seems to have missed the point. For example, in the corporate sector, (and here one is talking of only publicly held firms) there is the convenience of an actively traded stock price. If an individual perceives that a corporate entity is behaving "badly", he/she can sell the stock of that firm. Contrastingly, if the firm is fulfilling the ideals of governance, the choice of buying the stock is open. (Note that disapproval of a firm because it pollutes or employs child labour is not so much a matter of accountability as of law). Since the accountability is with reference to the stockholder, the stock price acts as a perfect indicator of performance. Indeed, to look for other indicators is to go hunting for matches *after* the fire has been lighted. Unfortunately, the option of using price as an indicator of **public sector** performance (and here the term public sector is used to refer to the *non-corporate* public sector) is not available. The reason is straightforward—government services are meant to reflect a social profit rather than a

monetary profit. But how is social profit to be measured ? Unlike corporate governance, therefore, there are genuine issues relating to public sector governance.

One indicator of performance is already available—elections. The electoral process provides for a referendum on government policies, and as such, is a mechanism for approving good governance (re-electing the incumbent) or disapproving bad governance (rejecting the incumbent). While useful, elections are too infrequent and cover too many areas to be useful.

III. Existing Measures of Public Governance

Economists have not been idle in their search and have come up with two indicators of governance—good management and a fiscal surplus. The arguments for the former are that enlightened governance will lead to higher economic growth, *ceteris paribus*. This is a significant advance over the tautological definition presented in the dictionary. Further, there is an explicit measure by which governance can be assessed.

Wade proceeds to discuss good public management in the context of the high-flying East Asian economies. He cites the high level of education, and corresponding low corruption, of the managers of the public sector as one large cause for their success.

There are two problems with Wade's measure of governance, and his conclusion. The first is particularly relevant for India. While the Indian Administrative Service (IAS) has been widely criticized for its inefficiency, there are few who would argue that the IAS does not constitute the Best and the Brightest that India has to offer. India has not appeared on any analysts good governance radar screen, so one has to conclude that recruiting good people into the bureaucracy is **not** a sufficient condition for good governance. But is it a necessary condition, as Wade seems to assume?

The analysis of whether it is appropriate to assume that good governance is only possible through having in the government stable good managers is beyond the scope of this paper. However, what can be examined is whether good governance contributed to the higher growth rate of the East Asian economies.

Any analysis of the success of the East Asian economies (as measured by a higher growth rate) is plagued by the Confucian fallacy. (Bhalla(1992, 1996)). Briefly, the gist of this fallacy is as follows: (I) it is a fact that the East Asian economies grew at a rate about 3-5 % higher than an average (and most) developing countries for the period 1960-1996. (ii) With this higher growth as a dependent variable, almost any "causative" factor of growth that is relatively common to the East Asian counties (EAC) and relatively uncommon to the other countries will show up as an important determinant. Inadequate attention to identification has meant that analysts have "found" *several* important explanators for the East Asian "miracle". (See Bhalla(1996) from which the discussion below is taken). A brief description of each explanation follows:

Authoritarianism

Excepting Hong Kong and Japan, the EAC countries have had non-free political regimes through most of the development period, 1960-90. It is an observed reality that all these countries have grown at growth rates above 5.5 per cent, 1960-90. Thus, some casual observers have conjectured that perhaps the discipline of authoritarianism is a pre-requisite for growth now and freedom later.

Land Reform

A more equal initial distribution of land (wealth) made agricultural productivity grow which fuelled growth in the urban centres. Four countries—Japan, Korea, China and Taiwan(China)—had land reform in their early development period, and so land reform or income equality can misleadingly show up as an important cause of high economic growth.

Managed Growth

This is one of the most popular explanations. The premise is that government involvement in the private sector helps facilitate rapid growth. The assumption is that many more winners than losers are picked by the bureaucrats. Support for this argument is obtained from the robust empirical observation that all EAC countries (except Hong Kong) had managed government.

High Saving Rates:

A "taste" for higher savings, and investment, has made rapid growth

possible. All EAC countries (except Korea in the sixties) have had significantly higher savings, investment, and growth.

Education

The new growth theory's emphasis on externalities to education has revived interest in the explanation that EAC countries grew well because in the early sixties they had significantly higher levels of education. Bhalla(1992) examines a sample of sixty-eight developing countries for which education data were constructed . These countries had an average education level of the labour force of 2.5 years in 1960, compared with 4.7 years for the EAC countries and 2.3 years for the non-EAC countries.

Female Education

As argued by World Bank's World Development Report, 1991 (WDR 1991—Chapters 2 and 3), Bhalla-Gill(1991) and Gill-Bhalla(1992)) the more important externality is not of higher levels of education but rather that of higher levels of *female* education. In 1960, the average level of female education was 1.9 years, with EAC countries registering 3.9 years and non-EAC countries 1.8 years. Bhalla-Kharas-Nabi(1993) advance the argument that female education and increased female participation in the urban labour force was an important explanator of the Malaysian growth experience. Indeed, they suggest that export led growth was often a case of female-led growth.

Confucianism

The reasoning is based on culture—the Confucian countries grew faster because of their cultural philosophy. This view has many followers, and many still evaluate Japanese success (both past and expected future growth) in these non-economic terms.

One can add other arguments to the list. The fact remains that for each study that suggests a particular factor as one explaining the East Asian miracle, there are other studies providing a different explanation. The jury therefore is still out, and the notion that good governance results from smart and well meaning bureaucrats remains to be verified.

The second popular measure of public sector accountability is the fiscal deficit i.e. the smaller the fiscal deficit, the "better" the public governance.

In recent years, this notion has not only gained the status of conventional wisdom, but also the stature associated with being "politically correct". The reasoning is as follows; politicians cannot be relied upon to do the right thing. Therefore, the only way to force accountability on them is through control of the fiscal deficit. If the deficit is narrowed, then almost by definition if not by magic, bad expenditures will be curtailed, and only good governance remain.

Controlling the fiscal deficit is deemed to have an additional advantage towards governance—it can lead to higher growth. Before presenting the empirical evidence, it would be useful to examine heuristically how controlling the deficit helps reduce "bad" expenditure. This remedy has mostly been imported from the West, as well as the recent fashion to have a balanced budget amendment. In the West, bad expenditures are considerably less than most developing countries; in addition, political pressures to *cut* taxes are paramount. In theory, therefore, it can be expected that as the deficit is narrowed, bad governance will get squeezed out.

In theory, in developing countries, one should *not* expect bad governance to be squeezed when the fiscal deficit is reduced. This is because with modernization and development, the tax base in LDC's is increasing significantly over time. Each year, policy measures are announced to increase the tax base, and often times even the tax rate is raised. These measures have the active support of academics and policy makers who are strongly advocating a reduction in the fiscal deficit. The "bad" politicians, rather than the good governance policians, have thus a way out—they can even increase bad expenditures because of the availability of extra funds. Thus, *a priori*, one should not expect the same, (or any) increase in governance to take place with deficit reduction in LDC's as has been observed in developed countries (DC's). To get an analogous response as in the DC's, policy makers should be arguing for a decrease in taxes, and tax rates, along with a decrease in the fiscal deficit. Unfortunately, such recommendations are rare, and such studies virtually non-existent.

There would, however, be some justification to the deficit reduction recommendation if declines in deficits were accompanied by an increase in economic growth. Note that this result runs counter to conventional Keynesian economics where deficits, *ceteris paribus*, are expected to increase economic growth. So if economic growth does respond positively to deficit reduction, then this would constitute good support for the low deficits

equals good governance relationship. The thread of reasoning is as follows—with low deficits, government is responsive, bad expenditure is not being financed by controlled interest rates, bad public sector units are not being subsidized etc, and high economic growth results.

While complicated models can and have been built on the relationship between deficits and economic growth, the model reported below is a simple reduced-form policy model. The purpose of the model is illustrative and meant to document whether the levels and changes in fiscal and current account deficits are related to growth in developed and/or developing countries. Two time-periods are chosen: 1981-1990 and 1991 onwards. *A priori*, one would expect that higher fiscal deficits (positive values of fiscal deficits are fiscal surpluses) lead to lower economic growth, and higher current account deficits have an ambiguous relationship i.e. such deficits may either be due to higher consumption or investment. Separate regressions are run for the developed, and developing countries. (Table 1) Data from over 70 countries are used for the time-period 1981-1995. High inflation countries were excluded from the analysis. All data are from the IMF's *International Financial Statistics*.

The results not reported in Table 1 are that the coefficients are unstable if different variables (e.g. money supply growth, real interest rates) are brought into the equation. Nevertheless, the following results emerge:

- Data for developed countries suggest that the level of fiscal deficit is not related to growth in the eighties and *negatively* related to growth in the nineties. The change in the fiscal deficit is positively associated with growth in both time-periods. In the nineties, a movement from 3 % to 2 % in the fiscal deficit leads to an increase in growth rate by about a quarter per cent per annum. Current account deficits show a similar pattern for both periods—the level has a positive effect and the change a negative effect. In net terms, a movement from 2 % to 3 % deficit in the current account has a mildly negative effect on growth.

- Data for developing countries suggests that the lower the fiscal deficit, higher the growth. Improvement in the fiscal situation helps growth in the eighties, but has a negative sign, and zero significance, in the fiscally conscious nineties. The current account deficit variables change signs and significance for the eighties and nineties. A one per cent improvement in the current account (e.g. movement from 5 per cent deficit to 4 per cent deficit) is associated with a decline in the growth rate of about a quarter per cent per year.

Table 1
Growth and Deficits in Developed and Developing Countries

	Constant	*Fiscal Deficit (%GDP)*	*Change in Fiscal Deficit*	*Current Account Deficit (% GDP)*	*Change in CA Deficit*	*R2 (adj)*	*No. of obs. (pooled country-years)*
Developed Countries (1982-90)	2.72 (14.88)	-.015 (-.46)	.239 (2.99)	.082 (2.27)	-.307 (-4.87)	.18	169
Developed Countries (1991- latest)	1.43 (4.00)	-.136 (-2.05)	.452 (5.46)	.132 (1.54)	-1.041 (-4.98)	.40	75
Developing Countries (1982-90)	5.50 (11.40)	.135 (1.56)	.450 (2.85)	.172 (1.82)	-.467 (-4.23)	.17	150
Developing Countries (1991- latest)	4.75 (8.95)	.384 (3.15)	-.079 (-.39)	-.137 (-1.11)	-.253 (-1.81)	.20	72

Notes : The figure in parenthesis denotes the t-statistic corresponding to each variable

The above pooled cross-section time-series analysis can be questioned on the ground that it adds a lot of the intra-country variation. Further, the results are different for developed and developing countries. Consequently, non-econometric evidence from two developing countries, India and Mexico, as well as USA and Europe are offered.

✡ *India: pre-1991 and post-1991*

Prior to the crisis year, fiscal deficits averaged 8.5 % , the exchange rate was over-valued by at least 50 per cent, tariff rates were among the highest in the world, exports had been in a continuous decline since the early fifties, and government intervention was present in extreme form in every aspect of an Indian's consumption or production choices. The reforms came and while the most noise was made about fiscal deficits, it is likely that the most important reforms pertained to opening up the Indian economy. The exchange rate vis-à-vis the US dollar, which had remained unchanged in real terms from 1955 to 1990, was devalued by 20 per cent in mid-1991—and today is almost half the level of 1990-91. Quantitative controls were substantially reduced, and peak tariffs while still inordinately high at 50 per cent, have come down from the "commanding heights" levels of 150 per

cent and more. The economic growth rate is on a potential path of 6.5—9.5 per cent, inflation to the surprise of all fiscalists is down to around 6 per cent, and manufacturing productivity growth is approaching double digits. And little of this changed face of the Indian economy has to do with fiscal deficits being brought down from around 8 to around 6 per cent.

☼ *Mexico—Not the Fiscal Deficit*

Mexico provides another example of the futility of using a decline in fiscal deficits as an explanator of good governance. This example is particularly relevant because minimization of the fiscal deficit was an explicit policy goal of the Mexican government. And the goal was over-achieved —before its full blown crisis in late 1994, Mexico enjoyed fiscal *surpluses* for the previous four years. It had low and stable inflation rates and not so high interest rates. And it was the darling of people who know best—the lemmings of Wall Street. But the palatial grandeur was not enough to prevent the devaluation crash that followed—a highly predictable crash because Mexico's problem was structural and non-fiscal in nature—its exchange rate was over-valued by at least 50 per cent.

☼ *USA*

Fiscal deficits have been a major policy issue in the US since the Reagan induced fiscal explosion in the early eighties. Various attempts were made to contain these deficits—from the Gramm-Rudman amendment in the mid-eighties to the recent ill-fated attempt at a balanced budget amendment. US fiscal deficits peaked at 4.5 per cent in 1992 and this year should fall to a low of 1.5 per cent.

Regardless of the lags chosen, neither growth, inflation, or real interest rates have been much affected by the increasing and decreasing trend in deficits in the US. *Economic growth*—steady trend of 2 to 2.5 per cent per annum. *Inflation*—at less than two per cent over the last fifteen years with sharp movements up and down affected by oil prices and not much else. A statistic which surprises many is that the US producer price index (PPI—equivalent to our less accurately named wholesale price index) averaged *less* than 2 per cent during the fiscal explosion decade 1982-1992. *Real long-term interest rates*—in a range of 2 to 4.5 per cent, again with little relationship to fiscal deficits or the change in such deficits. Real interest rates are closely related to economic growth prospects in US and elsewhere, but as just mentioned, there is little relationship of the important macro

variables with fiscal deficits, or with the earlier mantra, money supply growth.

☼ *Europe*

Perhaps the most influential policy document in Europe in the last decade has been the Maastricht treaty which mandates that fiscal deficits will have to be lower than 3 per cent of GDP. Analogous to India, and with similar "socialism" policy goals, Western Europe has had a strong tradition of high fiscal deficits *and* distorted economies. The politician needed to be curtailed and therefore policy makers focused on the fiscal deficit. The fiscal gods have disappointed—not much has been achieved in terms of reduction in fiscal deficits, or much else. Germany, France, Netherlands and Austria (the hard-core fiscalists) are all estimated to have deficits above 3.3 per cent in 1996 and 1997. Spain and Portugal will both have deficits higher than 4 per cent and higher than their respective deficits in 1988.

The real problems in Europe lie elsewhere—in the labour market. This market, not unlike India's, suffers from "structural" problems which is a euphemism for heavy and unproductive unionization and protection of inefficient workers. There is little that can be done for the shockingly low Western European growth rates until the important issue of labour rigidities is tackled.

☼ *US—Again*

There was much political and market fanfare about how interest rates would come down in the US if the balanced budget amendment was to pass. The amendment did not pass, and long-term interest rates hovered around six per cent in early 1996. A few months later, news of robust economic growth quickly propelled real interest rates about 1 per cent higher. Fiscal deficit news continued to be golden —in 1996, fiscal deficits in the US will remain below 2 per cent, among the lowest in the world. The decline since 1994 is about 2 per cent, yet the growth rate is higher and inflation about the same—in complete contradiction of the forecasts based on fiscal deficits

IV. Provision of Economic Rights—A New Indicator of Governance

The lack of a good indicator of governance notwithstanding, the issue of accountability is a serious one, especially so in developing countries where

the state plays a large role. There should be some *direct* methods by which the performance of the state can be assessed—and analogous to the private sector, its "price" either driven up or down. Elections have been ruled out as too infrequent and too indirect, the fiscal deficit as ineffective in developing countries, and recruitment of good bureaucrats as being a non-sequitur. Bad governance in the long run does lead a state to bankruptcy (e.g. Russia and eastern Europe, Argentina, India (1990-91), Mexico (1994) etc.), but often the punishment of elected officials is too late for the citizens.

There is a way by which the state can be disciplined in a fair and disciplined manner. The analogy is with political rights. If the state violates such rights, there is a legal recourse—the constitution—by which the citizens can hold the state accountable. Civil rights of an individual are also well protected by the constitution. One needs to ask—why are economic rights not so protected by the constitution, at least in India and other developing countries?

This begs the question—what are economic rights? Some definitions are offered below. But it is useful to anticipate those definitions by re-evaluating the definition of governance. A definition noted as obsolete by Webster's dictionary may be relevant—"moral conduct or behaviour: discretion". The last word—discretion—is almost sufficient to indicate both what constitutes bad governance and what should constitute a bill of economic rights.

It is worth identifying as to what ails the public sector—or more directly, what economic actions of the state citizens are most upset about. These reactions/evaluations are universal.

- The state imposes "unfair" taxes, and/or unrealistic taxes. These can range from a 97 % marginal tax rate a la Mrs. Gandhi, to taxing inputs to a computer—keyboard, floppy disk drive, mouse—at differential rates, as is presently the case in India.

- The state unfairly discriminates against exporters relative to importers, or agriculture vs. industry, or the manufacturing sector vs. the services sector etc.

- By imposing unfair and sometimes draconian laws, the state is guaranteeing the emergence and "flowering" of large scale corruption.

It has reached close to unbearable magnitudes in countries like India, Pakistan, Nigeria etc.

- Another form of state action that guarantees large scale corruption is a government monopoly (deliberately) accompanied with inappropriate pricing. What really gives the game away is the claim by politicians that they are subsidizing items like telephones, access to internet, air travel, higher education, sophisticated medicine etc. in order to help the poor. Another form of state action that has little rationale is controls on individual action e.g. exchange controls, import controls etc. These controls infringe on one individual's right at the expense of another.

These examples can be multiplied several times over. That economic rights/freedom is on an equal par with political rights/freedom was pointed out as early as the mid-forties by Hayek (1945) and re-iterated again by Friedman (1962). But the post-war period has been a full bloom period for those that have argued about the virtues of state knowledge and state action. It took the fall of the Berlin Wall, and state bankruptcy consequences of inordinate state involvement in the economic affairs of the individual, to question the role of the state. While the notion of economic freedom is not still politically correct today, there is a more than a reasonable chance that it will be correct, with a vengeance, tomorrow.

The above violations of economic freedom serve as pointers to its definition.

Economic freedoms generally reflect rights provided by a free (competitive) environment e.g. property rights, external and internal openness (right to buy and sell goods to whomever one wishes and at prices the competitive market determines); rights to set up investments without a licence, rights to foreign travel, rights to hire and fire (with due process); rights of domestic and international movement of labour and capital etc.

Omitting the freedom to immigrate, labour freedom means the right to work anywhere in national boundaries and at wages the impersonal market determines, rather than the "face-less" bureaucrat. Capital freedom means the freedom to obtain the highest return on one's capital either domestically or abroad -hence, negative real rates of interest domestically would suggest a need for freedom to transfer one's capital abroad. Produce freedom implies a right to sell abroad at favourable prices, or to import from abroad if import products are cheaper.

Several variables exist to proxy for different components of economic freedom e.g. nature of property rights (land ownership, urban land ceilings, patent rights etc.), high trade taxes, unionization, licensing procedures, capital market controls, minimum wages etc. Each constraint on market behaviour (excepting that of monopolists and actions that ignore externalities) constitutes an infringement of economic freedom.

The above definition(s) of economic freedom point to several components of the bill of economic rights. The amount of economic freedom allowed to the citizenry can be used as a basis for evaluating governance—and on deciding which laws can be deemed illegitimate. What gives the concept of economic freedom greater potency is the fact that on both a heuristic and empirical basis, it can add substantially to economic growth and welfare. It is a well accepted proposition of economics that removal of controls can only increase welfare, not decrease it. It may be the case that according to the welfare function of the *planner*, a situation without controls is worse. But the planner's welfare function is the one that is in question when one is talking about governance.

Several possible variables that can theoretically measure economic freedom have been outlined above. One useful proxy for economic freedom is the black market premium on a country's *official* exchange rate. This variable was first used as an explanator of growth by Scully-Slotje(1991), World Bank (1991) and Bhalla(1992)). This variable can be thought of as a proxy for freedom to move financial capital across borders. Such data are available on an annual basis from the *Pick's Currency Yearbook*. Black market premia can reflect distortions in the exchange rate. It can also reflect the presence of exchange controls and controls on imports—all variables connected with economic rights.

Perhaps the most convincing reason to use the black market premia as a measure of **economic freedom** is because it accurately reflects aspects of *economic control* prevailing in the economy. This was first elaborated upon by Hayek (1944, p.92, italics mine):

"*The extent of control over all life that economic control confers is nowhere better illustrated than in the field of foreign exchanges.* Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most Continental countries has taught thoughtful people to regard this step as the decisive advance on the path to

totalitarianism and the suppression of individual liberty.....Once the individual is no longer free to travel, no longer free to buy foreign books or journals, once all the means of foreign contact can be restricted to those of whom official opinion approves or for whom it is regarded as necessary, the effective control of opinion is much greater than that ever exercised by any of the absolutist governments of the seventeenth and eighteenth centuries."

Bhalla(1992,1996) reports results using the black market premia in the context of a "new" growth model. Some of the variables considered in the context of a simultaneous equation model were: initial level of education, initial per capita income, relative prices of domestic traded goods to international goods, political freedom, share of investment in GDP, initial level of inequality, price of equipment investment etc. The black market premium variable was introduced as a "crude" dummy variable—the bottom 25 per cent of countries (sample of 68 countries for the time-period 1973-1988 or 1960-1988) are classified as zero and the remainder as 1. In effect, this meant that those countries with a long run black premia annual average below 6 per cent were thought to have "no" exchange controls.

Of all the variables reported above, the most significant, and robust, coefficient was that pertaining to the black market premia. (See Appendix I for some results) The coefficient was consistently between -1.5 and -2.0 suggesting that a country grows at approximately 1.75 % **less each year** if it has exchange controls. The fact that lack of controls means less arbitrage by the administrators (read corruption) is an additional benefit to the removal of controls.

What economic freedom implies is that the citizens have a right to express their economic desires in anyway they choose too. As long as this freedom does not encroach on another individual's freedom, it should not be interfered with. Note that this definition of economic freedom does not imply either zero taxation, or even a reduced role of the state. There are several public goods that a state has to provide—taxation is needed to finance that expenditure. Further, and especially for developing countries, there is the very important issue of poverty and its removal. The notion of economic freedom presumes that the individual has income and/or assets with which he/she can choose consumption or production possibilities. Part of the definition of economic freedom is that an individual has the (economic) ability to make choices; consequently, the provision of basic needs is the responsibility of the state. The state has a further important role

as an umpire/regulator, as one providing equal opportunities, and as one facilitating a level playing field, and as one protecting individual rights—political, civil **and** economic.

V. Conclusions

This paper has attempted to survey some issues relating to the difficult concept of governance. Evidence on different aspects of governance was presented, and it was suggested that the best way for ensuring governance was to introduce into the constitution a bill of economic rights.

If policy makers delay the provision of economic rights in countries like India, they must realize the explicit trade-offs they are making. For uncertain and questionable gains (see below), the obstruction of economic freedom means that corruption is being officially and explicitly encouraged. The distinction between a drug-dealer who makes possible a crime on the part of another individual is not that far-fetched a parallel from policians who make large scale corruption inevitable.

Policians offer well conceived and noble reasons for delaying economic reform and increasing accountability. There is the argument that the polity is not well prepared for the change, that it will drown in the sea of change unless the state protected them from their own freedoms. Or the argument that the individuals do not know any better while the well managed state has individuals dedicated to improving welfare and **knowing** what policy is good, what policy bad, and what policy has which particular consequence. Intellectual support for these notions is derived from various sources—most importantly, from the notion that "institutional development" is necessary before change can be introduced. In other words, you have to be first imprisoned and taught the rules of behaviour before being released into the cruel world. This view ignores the likely possibility that institutional development is much more endogenous than commonly assumed, and much less exogenous than commonly believed.

References

Bardhan, Pranab. 1993. "Symposium on Democracy and Development", *Journal of Economic Perspectives*, Summer.

Bhalla, Surjit S. 1992. "Free Societies, Free Markets and Social Welfare", mimeo, World Bank, Aug. 1992. Final Revision, Feb. 1994.

_______ 1996. "Freedom and Economic Growth: A Virtuous Cycle?", in Axel Hadenius, ed., *Democracy's Victory and Crisis: Nobel Symposium 1994*, Cambridge University Press.

_______ and Indermit S. Gill, 1991. "Social Expenditure Policies and Welfare Achievement in Developing Countries", background paper for the *World Development Report* 1991, World Bank, Washington, D.C.

_______, Homi Kharas and Ijaz Nabi. 1993. "Female-led growth", World Bank, mimeo, July.

Dasgupta, Partha. 1990. "Well-Being and the Extent of Its Realisation in Poor Countries", *Economic Journal*,(Supplement),100.

_______ and Martin Weale. 1990. "On the Measurement of Well-Being", mimeo, June.

Dreze, J. and Amartya Sen. 1990. *Hunger and Public Action*, Oxford University Press. Oxford.

Friedman, Milton. 1962. *Capitalism and Freedom*, University of Chicago, Chicago.

Gastil, Raymond D. 1987. *Freedom in the World*, Freedom House Inc, New York.

Gill, Indermit S. and Surjit S. Bhalla. 1992. " Externalities in New Growth Theory: The Importance of Female Human Capital", paper presented at the Western Economic Association Meetings, San Francisco, July 9-13.

Hayek, Friedrich. 1944. *The Road to Serfdom.* University of Chicago Press. Chicago.

Hayek, F. A., *The Fatal Conceit: The Errors of Socialism*, edited by W.W. Bartley III, University of Chicago Press, 1988.

Persson, Torsten and Guido Tabellini, 1994. "Is Inequality Harmful for Growth?", *American Economic Review*, June.

Sah, Raaj K. 1991. "Fallibility in Human Organizations and Political Systems", *Journal of Economic Perspectives*, Spring.

Scully, Gerald W. 1988. "The Institutional Framework and Economic Development", *Journal of Political Economy*",vol. 96, #3.

_______ and Daniel J. Slottje. 1991. "Ranking economic liberty across countries" Public Choice, 69.

Wade, Robert. "The Role of Government in Overcoming Market Failure: Taiwan, Republic of Korea and Japan".

World Bank, 1991. *World Development Report 1991.* Washington,D.C.

______, 1993. *The East Asian Miracle: Economic Growth and Public Policy.* Policy Research Report, July. Washington, D.C.

7

Coalition Governments and Policy Distortions : The Indian Experience

Bhaskar Dutta

I. Introduction

Much of the recent policy discussion in India implicitly assumes a framework in which a benevolent government or social planner will optimally choose policy instruments in order to maximise the welfare of the representative individual, with the availability of resources posing as the main constraint. This *normative* view of government behaviour is, of course, an important tool of analysis. However, it can often be a sterile exercise if it ignores completely the institutional constraints and rigidities in which policy-making occurs. The presence of these constraints makes it important to analyse the *positive* theory of government behaviour, or in other words to explore what governments actually do.

I am most grateful to Sanghamitra Das and Bharat Ramaswami for numerous discussions and invaluable advice. Thanks are also due to IRIS University of Maryland for financial support.

The recent *public choice* literature discusses various political features which crucially influence government behaviour, and which drive a wedge between what governments *actually* do and what they are *advised* to do by economists. Typically, political power is dispersed, either across different wings of the government, or amongst political parties in a coalition, or across parties that alternate in power through the medium of elections. The desire to concentrate or hold on to power can result in inefficient economic policies.

For instance, lobbying by various interest groups together with the ruling party's wish to remain in power often results in policy distortions being exchanged for electoral support.[1] Several papers also emphasise the presence of *political cycles* in economic policy formulation. In the aptly named *opportunistic* models, policymakers are interested solely in maximising their probability of surviving in office, so that the resulting

[1] See Bardhan (1984) for an illuminating account of this process in the Indian context.

character of government is very far away from the benevolence assumed by more traditional normative theories of government behaviour.[2] In contrast to opportunistic models, *partisan* models specify that political parties are almost exclusively concerned with furthering the interests of their *own* support groups[3]. Again, the conclusions which follow from this class of models are very different from the *benevolent government* models.

In this paper, I focus on *government instability*, which can be another cause of economic distortions, and is also of particular relevance in India today. Unstable coalitions or governments that are not likely to remain in power for an extended period of time are liable to introduce policy distortions for at least two reasons. First, such governments obviously have very short time-horizons. This has important implications for economic policy in general and budgetary policy in particular. If political power alternates rapidly and randomly between competing political parties or groups of parties, then each government will follow *myopic* policies since it assigns a low probability to being relocated. Hard policy options whose benefits flow after a long gestation lag are unlikely to be adopted by such a government. Instead, it may spend indiscriminately in order to satisfy the short-term needs of its support groups. This will result in a legacy of high debt to its successor. Although this may constrain the actions of the next government, the current government does not care about the priorities of the next government.[4]

The second route through which the rapid turnover of governments may induce policy distortions is relevant in the case of coalition governments. The shorter is the expected duration of such governments, the more difficult it will be for the members of the ruling coalition to agree on policies. Of course, the more heterogeneous the parties in the ruling coalition, the greater will be the lack of co-operation. Each party in the ruling coalition may then try to promote populist policies in order to exploit its own narrow interests. The most likely casualty of all this will be fiscal discipline since government expenditure will be excessive.[5]

[2] Nordhaus (1975) was amongst the first to develop this class of political cycle models.

[3] See Alesina (1987).

[4] Alesina and Tabellini (1990) construct a model along these lines.

[5] Roubini and Sachs (1989) analyse the pattern of fiscal deficits in OECD countries. They find a clear tendency for larger deficits in countries characterised by short average tenure of government and by the presence of many political parties in a ruling coalition.

Of course, *all* coalitions are not unstable. For instance, the Left Front government in West Bengal has been one of the most stable governments in India, and has been in office for almost *four* full terms since 1977. The Left Front again serves as a counter-example to the received wisdom which asserts that the larger the number of parties in the coalition, the more unstable it is likely to be. Similarly, Kerala has witnessed some coalition governments containing a relatively large number of constituent parties. The average duration of these governments has tended to exceed the duration of coalition governments in other states.

This provides the motivation to propose a model of instability of coalitions. Section 2 provides a brief description of the experience of coalition governments in the major states in India. On the basis of this experience, I suggest that the crucial factor determining instability of a coalition is the number of *pivotal* members in the coalition. A constituent member is defined to be pivotal if its departure from the coalition converts the coalition from a *winning* to a *losing* coalition. In order to test the hypothesis that the instability of a coalition increases monotonically with an increase in the number of pivotal members in the coalition, I use data on the *duration* and *nature* of state governments in India after the general elections of 1967. The regression exercise, whose results are reported in section 2, confirms the hypothesis. The exercise also reveals that the presence of *defectors* in a coalition increases instability since defectors are more likely to switch from one party to another. Moreover, governments that are formed from *minority* coalitions with support from individuals or groups from outside also prove to be more fragile.

In view of the principal result in section 2, a coalition is labelled *unstable* if it contains at least *two* pivotal members. In section 3, I examine the pattern of fiscal policies followed by 15 major states between 1967-68 and 1992-93 in order to see whether there are any obvious policy distortions associated with coalition governments in India. Two sets of exercises are carried out. First, the data for all the states are *pooled*, and regressions are run on the pooled data in order to see whether unstable coalition governments are more profligate, are less inclined to raise resources and whether they are more liable to run up revenue deficits.[6] Adjustments are made for factors such as size of the state economy and population by deflating with the state domestic product. Moreover, state-specific factors are

[6] The dependent variable is taken to be *revenue* deficit rather than the overall deficit since each state has greater control over its revenue deficits. Central largesse (or its absence!) can have an undue influence on a state's overall deficit.

also accommodated by using state dummies. The results show that unstable coalition governments *do* have a *significantly higher* proportion of revenue expenditure to state domestic product, as well as a *significantly lower* proportion of revenue surplus to state domestic product. There is, however, no statistically significant relationship between the prevalence of unstable ruling coalitions and any of the other policy variables.

In the second set of exercises, the relationship between the prevalence of unstable coalition governments and possible policy distortions is tested separately for individual states. The exercise is restricted to states which have had unstable coalition governments for some period in each of at least *four* years[7] (out of the 26 financial years between 1967 and 1993). Although Kerala satisfies this requirement, it was excluded because it has not had *single-party* (or coalitions with one only one pivotal party) in four years. Four other states fit into this category. The regression results show that in two of the four states, revenue expenditure, as a proportion of state domestic product, has been significantly higher in years in which unstable coalitions have been in power. In a couple of states, the state's non-tax revenue as a proportion of state domestic product has been significantly lower during the rule of unstable coalitions.

So, there is some evidence to support the hypothesis that unstable coalition governments are guilty of greater levels of fiscal indiscipline. And, of course, there are other potential costs associated with governmental instability which are not captured in government budgets. For instance, weak governments are unlikely to pass politically unpopular legislation if the benefits cannot be captured immediately. The failure of the present central government to reform labour laws so as to permit firms to restructure their labour force is an obvious example. The huge subsidies on water, food, electricity and urban transport are also symptoms of weak governance.

This raises the obvious question as to whether anything can be done to minimise the possibility of occurrence of unstable coalitions. Section 4 contains some tentative suggestions about reform of the electoral system. In particular, I point out a need to take a second look at the system of the plurality rule. Some form of proportional voting system along with the stipulation that parties must get a minimum percentage of the total valid votes cast in order to gain representation in the legislature may well lead to a distribution of seats in the legislatures which will bring forth more stable governance.

[7] Of course, the choice of four is arbitrary!

COALITION GOVERNMENTS IN INDIA

The Indian experience with coalition governments started after the elections in 1967, which marked a watershed in Indian politics. The Congress party suffered a sharp setback in both the Parliamentary as well as the state assembly elections, and Opposition parties and coalitions came to power in 6 major states. One consequence of the Congress setback was a vastly different pattern of party representation in many of the state assemblies. There was a marked tendency towards *multipartism* or *fragmentation* of legislatures with a proliferation of small parties and successful Independent candidates. The fragmentation of legislatures has often resulted in loose and unstable alliances since commonality of ideology or purpose is more difficult to ensure amongst a large number of groups.

An early consequence of multipartism was the formation of coalition governments of very short duration. Indeed, between the elections in 1967 and July 1968, as many as 10 governments were formed in the four states of Bihar, Uttar Pradesh, Punjab and West Bengal. The first non-Congress government in Bihar consisted of all the non-Congress parties, but without any Independents. The government lasted barely 11 months before it was brought down by a no-confidence motion. This was replaced by a Minority government, which included *defectors*, and was also dependent on the support of the Congress party. Another government of the same type (Minority government along with defectors) took over before the imposition of President's Rule in June 1968.

A similar pattern was witnessed in Punjab. In Uttar Pradesh, a Congress government was formed immediately after the elections. But, it lasted for less than a month when Charan Singh defected along with several other Congress legislators. The new government formed by Charan Singh himself survived for less than a year, and President's Rule had to be imposed in February 1968. In West Bengal, the so-called United Democratic Front, which was essentially a motley group of almost all the non-Congress parties, managed to stick together for just 8 months. Its successor, a minority government constituted by defectors supported by the Congress party lasted for 3 months.

The Indian electorate's initial experience with coalition governments was not a particularly happy one. This may have been one reason why the pattern of state governments changed in the *seventies* and *eighties*, with single

party governments ruling in almost all states.[8] Although there have been stray cases of coalition governments in some states, Kerala and West Bengal are the only states which have had several spells of coalition governments during this period. Over the last few years, there has again been an increase in the incidence of coalition governments.

Of course, factionalism *within the same party* can be as disruptive as inter-party competition for power. This disruption has taken two forms. First, in several cases, the leader of some faction in the Congress party has walked out of the Congress after being denied the Chief Ministership or enough Cabinet positions for members of his group. This has sometimes precipitated the collapse of Congress governments.[9] Second, and more frequently, it has resulted in a change in the Chief Minister, with the same *party* remaining in power. To the extent that Chief Ministers have to follow the "party line", this is less disruptive as far as policies are concerned. That is why this paper defines a *change* in government to mean a change in terms of the party or parties in power.

In particular, a *government* will be identified with the party (or parties) which constitute the Cabinet.[10] So, when it comes to calculate the *duration* of a government, the following conventions will be adopted:

(a) A change in the Chief Minister does not constitute a change in government unless this is accompanied by a change in the composition of parties supporting the administration.

(b) If a party switches from being a supporter to being an active member (that is joins the Cabinet), then this will be taken to be a new government.

(c) A *new* government will be said to take over after each election, even if the same party or coalition commands majority support.

Of course, this is not the only possible approach. For instance, Brass (1977) adopts a different definition. Brass defines a government as an

[8] In this analysis, I naturally assume that the Janata party is a single party since its constituent parties formally gave up their individual identities.

[9] For instance, Charan Singh's departure from the Congress in 1967 brought down the government lead by C.B. Gupta.

[10] In the actual measurement of duration of governments, some anomalies crop up. For instance, while heading the government in Haryana , Mr. Bhajan Lal defected en masse and joined the Congress in the mideighties. Although the identity of the government obviously changed, I have *not* treated this as a change in government.

administration whose Chief Minister has been sworn in by the Governor and who remains in office without any inter-election resignation. So, a government which undergoes a formal resignation and a new swearing-in ceremony after an election, but with the same Chief Minister, is counted as a single government. However, if a Chief Minister *resigns* between elections and reconstitutes the government after the elections, then Brass assumes that a change in government has taken place. The principal difference between the definition advocated by Brass and the one adopted here is that Brass identifies a government with its Chief Minister, whereas this paper stresses the identity of the ruling party(s). The identification of governments with parties seems more appropriate since changes in policies are more likely when there is a change in the ruling party or coalition. A second (but less important) difference is that this paper identifies a government with the "current" legislature, since (c) above specifies that the duration of a government ends when a new legislature is formed.

Brass (1977) notes that there is a clear difference in mean duration between single-party governments and coalition governments.[11] His results provide a partial corroboration of the hypothesis relating instability of coalition governments to the degree of fragmentation of legislatures. The greater the extent of fragmentation in the legislature, the more likely is it that a large number of relatively equal-sized parties will bargain with each other to form ruling coalitions. So, this also increases the number of possible ruling coalitions. This, in turn, makes it more likely that a small party or party faction (or perhaps a group of Independent candidates) can defect from one ruling coalition to another, a process which is not unfamiliar in the Indian context.[12] Also, it is likely that the larger the number of equal-sized parties in the legislature, the greater will be the number of parties in the ruling coalition. If parties in the coalition have no ideological affinity to one another (perhaps not a bad assumption in the Indian context), then the possibility of conflicts will increase with the number of such parties.

Despite the plausibility of a positive association between fragmented legislatures and instability of ruling coalitions, the actual *correlation* between the Rae measure of fragmentation (F_R)[13] and duration of coalition

[11] Brass analyses the duration of coalition governments in Indian states between 1952 and 1977. His analysis involves explanatory variables relating to the structure and composition of the legislature, the structure of parties in the coalition, and the degree of institutionalization of the party system.

[12] Indeed, Brass remarks that coalitions containing Independents and defectors were more unstable.

governments turns out to be low in several empirical studies.[14] This may be because F_R does not capture the *specific* characteristics of fragmentation which influence coalitional instability. As I have remarked earlier, the reason why greater fragmentation causes more instability is that it increases the number of parties in the ruling coalition. However, the correlation between F_R and the number of parties in a ruling coalition may be low.

That is why it may be preferable to use a *direct* approach which is built on the number of parties in the ruling coalition. Define a *winning* coalition to be any group of parties which together commands the support of a majority in the legislature. A coalition T is called a *minimal* winning coalition if T is a winning coalition, and moreover no *proper subset* of T is a winning coalition. So, if T is a minimal winning coalition, then all members of T are *pivotal* in the sense that if any member of T defects, then the remaining subset of T ceases to be a winning coalition. In other words, any pivotal member can bring about the collapse of a government by defecting from the coalition.

Given any coalition T, let p(T) denote the *number* of pivotal members in T. I will also call p(T) the *index of instability* of coalition T. The hypothesis to be tested is that the stability of a ruling coalition T *decreases* with an increase in p(T). This is related, but *distinct*, from the hypothesis which links stability to the number of members in a winning coalition. Obviously, the two hypotheses coincide when T is a minimal winning coalition. However, there are instances where ruling coalitions have not been minimal winning coalitions. For instance, although the Left Front in West Bengal has a large number of parties, the Marxist Communist party, the CPI(M), had an absolute majority of seats in the four elections held since 1977. So, the CPI(M) was the only pivotal member in the Left Front coalition. Hence, the index of instability of the Left Front ministries takes on the value of 1. Parties other than the CPI(M) were relatively powerless because any threats by them to leave the coalition would not bring about a collapse of the government. Obviously, single-party majority governments also have the same index of instability.

In the Left Front coalitions, the CPI(M) held an absolute majority on its own. However, the index of instability of a winning coalition could be *unity* even if no single party in the coalition holds an absolute majority

[13] F_R was introduced in Rae (1967) and is based on the Herfindahl - Hirschman index of industrial concentration.

[14] Apart from Brass (1977), see also Taylor and Herman (1971).

of the seats. For instance, the ruling coalition which was formed in Kerala immediately after the elections in 1967 contained as many as 6 parties. The major party in the coalition was the CPI(M) with 52 seats in a house of 133 seats. No party other than the CPI(M) was pivotal. Note that the CPI(M) itself did not have a majority of the seats. So, in general, coalitions whose combined seats are well in excess of the threshold needed to constitute a majority in the legislature are relatively immune against defections by small parties in the coalition.

The use of p(T) as an index of instability involves an implicit assumption. It is being assumed that only the threat of *individual* parties to deviate from the ruling coalition need be taken into account. Consider, for instance, the ruling coalition in Kerala after the 1967 elections. As I have pointed out, the CPI(M) was the only pivotal party in that coalition. But, since the CPI(M) was not a majority party on its own, the other parties in the coalition could *combine* and engineer the collapse of the government. And, indeed, this is what happened in 1969 when the CPI, the other Communist party, left the coalition along with some of the other parties and formed a minority government. However, the organization of *joint deviations* involving several parties may be just as unlikely as mutual cooperation in order to sustain a multi-member coalition.[15] Hence, the use of p(T) as an index of instability may not be a bad approximation after all.

Brass (1968, 1977) had earlier commented on the key role of Independents and party defectors in creating instability. Since a defector has switched parties at least once in the past, he or she is more likely to do so again in the future. Hence, coalitions which depend on defectors for survival are liable to be unstable. Brass had also pointed out that the duration of minority governments was less than that of majority governments, although the difference was not significant. The present paper uses the presence of defectors, minority governments and the instability index of the ruling coalition as the principal variables in the analysis of stability of coalition governments.

Table 1 exhibits the frequency distribution of duration of state governments during the period 1967-1995. Majority governments without defectors or those who have not been removed by the central government have been classified according to their index of instability, which is denoted IS in the table. The table does not report the index of stability of Minority

[15] It is worth pointing out that the CPI(M)-led coalition lasted for 2 years and 7 months before the CPI could organize a successful revolt!

governments or a government containing defectors.

Table 1
Pattern of State Governments

Type of Govt.	*Duration (in months)*					
	60+	*48-59*	*36-47*	*24-35*	*12-23*	*< 12*
IS=1	30	17	8	17	9	15
IS=2	1	1	1	1	2	3
IS=3		2			5	2
IS=4	1				1	
IS=5	1				1	6
IS=6+				1		8
D				1	2	7
M				1	2	5
R			2	6	4	3
DM						3
RD						1
RM						1

Note: D refers to government containing or supported by defectors, M refers to a minority government, R refers to a government removed by the Governor (or Central government), while DM refers to a government which is both D and M. RM and RD have similar interpretations.

Of the 96 governments[16] which have an index of instability of 1, as many as 47 survived for 4 years or more. The table also shows that 15 governments with an index of instability of 1 lasted less than 12 months. However, in 8 of these cases, the relatively short duration of the government is partly due to the fact that the government was of the D, M, or R category. The average life of coalition governments clearly decreases with an increase in an increase in IS.[17] It is also noticeable that minority governments as well as those containing defectors have a much shorter life span.

In order to explain the pattern of duration, the following procedure was followed. The duration of different governments was classified into 6-monthly intervals. Let L denote this variable. So, L takes on the value 1 for a government which lasted upto 6 months, 2 for a government which lasted upto 12 months, and so on. Finally, the maximum value of L is 10

[16] Out of these, 5 are actually coalition governments in West Bengal. The first is the United Front Ministry which was in office between February 1969 and March 1970, while the other four are the Left Front governments since 1977.

[17] An outlier is the instance of the coalition with IS =5 in the 60+ months category. This is the government in Kerala which lasted from march 1971 to April 1977.

for governments whose duration was at least 55 months. The reason for making this transformation is that it is difficult to come up with a model which can distinguish between a government whose duration is (say) 7 months from one whose duration is 8 months. Since Table 1 suggests that IS , D, M and R all have a significant influence on the observed pattern of duration, these are used as explanatory variables. In addition, it is also observed that the average duration of coalition governments in Kerala is longer than that of governments in other states. This observation suggests the use of a dummy for coalition governments in Kerala. Several regressions were run with this set of explanatory variables, using different functional forms. I report below the results of one such exercise.

$$\ln L = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 \qquad (1)$$

Here, x_1 denotes the index of instability of government. x_2 represents the value of (D+M), where D (respectively M) takes on the value 1 if the government contains defectors (respectively is a minority government) and 0 otherwise, while x_3 equals 1 if the government was removed from office by the central government or by the governor, and 0 otherwise. Finally, x_4 is the dummy variable equalling 1 for coalition governments in Kerala, and 0 otherwise. The estimated equation is:

$$\underset{(24.9)}{\ln L = 2.15} - \underset{(6.19)}{0.22}\, x_1 - \underset{(6.11)}{0.75}\, x_2 - \underset{(4.07)}{0.59}\, x_3 - \underset{(2.28)}{0.53}\, x_4 \qquad \bar{R}^2 = 0.47 \qquad (2)$$

The terms in parentheses are the t-values, while $\bar{R}^2$ is adjusted for degrees of freedom. They indicate that all the coefficients are significant. The regression result supports the initial hypothesis regarding the influence of the number of pivotal parties in the ruling coalition on the duration of the coalition since an *increase* in IS *decreases* the life of the coalition. The result also corroborates Brass' earlier observations regarding the relationship between defectors and duration of coalitions.[18] Notice, however, that (2) indicates that once the other factors (that is, IS and the presence or absence of defectors) have been controlled for, there is a *significant* difference between the duration of minority and majority governments. This conclusion is different from the corresponding result of Brass, who did not find any significant difference between the duration of majority and minority governments.

---

[18] Note that D and M are statistically significant variables even when they appear separately in the regression equation.

UNSTABLE COALITIONS AND FISCAL POLICIES

In this section, I examine whether unstable ruling coalitions are guilty of fiscal indiscipline.[19] Of course, as I have remarked earlier, fiscal indiscipline is only *one* source of policy distortion associated with coalition governments. It is however an important indicator of the kind of governance associated with different political institutions. Governments which practise fiscal discipline are more likely to adopt policies which bring long-term benefits even if they are politically costly in the short-run.

A conceptual problem in analysing discipline of state governments in India is that the states have less than complete control over their resources. The Constitution classifies the expenditure responsibilities of the central and state governments into three categories. While some are exclusively subject to the jurisdiction of one or the other, others are within the concurrent jurisdiction of both. The Constitution also sets forth the respective taxation powers of the two tiers of government. However, as Bagchi, et.al. (1995) remark, "....states' taxation powers are inadequate in relation to their expenditure responsibilities and this imbalance is growing over time". The Constitution also specifies resource transfers from the centre to the states through various mechanisms. Unfortunately, the centre has often been accused of manipulating tax rates to its own advantage. The importance of discretionary grants to states has also been growing over time. Moreover, successive central governments have been accused of bias in the dispensation of such grants.

In order to mitigate the effects of the states' dependence on the centre as far as possible, the paper focuses on variables such as *revenue expenditure*, *own tax revenue*, *own non-tax revenue* and *surplus (or deficit) in the revenue budget*. It can be argued that these are variables over which the state governments have relatively greater control, subject to the constraints imposed by the Constitution. Certainly, there are no *legal* barriers in increasing non-tax revenues by raising charges for services provided by the state. The wide variation in tax effort (measured by ratio of own tax revenue to state domestic product) amongst states implies that some states are more efficient in raising resources than others, although all states face similar constraints in so far as powers of taxation are concerned. If states can differ in tax effort, then it is possible that differentials in tax effort are partially explained by factors such as the nature of the government.

[19] An early contribution on the impact of political factors on fiscal policies of different state governments is Govinda Rao (1979).

A question may be raised about the extent of control exercised by the *current* state government over the level of its revenue expenditure. This is because the current state government "inherits" some items of expenditure which are obligatory. For instance, centrally-sponsored schemes have become an increasingly important source of funding for the states, but the subsequent recurrent expenditure has to be borne by the states. Similarly, the payment due to debt servicing, which has been growing in magnitude, is obviously an item of committed expenditure. However, there is no reason to believe that there is any systematic relationship between the ratio of committed expenditures to total revenue expenditure and the *type* of state governments. So, any possible result on excessive revenue expenditure by unstable coalition governments need not be biased on this account.

In order to neutralise the effects of factors such as size of population and state income, all the variables of interest are deflated by the state domestic product (SDP). I denote by E , T , N , and S the ratios of revenue expenditure, own tax revenue, own non-tax revenue and surplus in the revenue budget respectively, to the SDP. Data on these variables is used for each of the 26 financial years between 1967-68 to 1992-93, and for all the 15 major states which are listed in the Appendix.

Since the main purpose is to analyze whether unstable ruling coalitions have any effect on the levels of E, T, N and S, I need to find a proxy for the type of government in a state in each financial year. Of course, there have been many instances in which the type of government has changed midway through the year. The following procedure was adopted. A dummy variable, denoted *c*, was used to represent the presence or absence of unstable ruling coalitions during any year in any particular state. The variable c is defined to take the value of *one* if there was an unstable coalition (that is, one with *at least two pivotal parties*) for at least *two months* of the relevant (financial) year and relevant state, and *zero* otherwise. An alternative procedure which was used only for a couple of individual states looks at the IS-values of all governments which have been in office for at least two months in a financial year, and then picks the *maximum* IS-value from this list. Of course, the cut-off mark of two months as well as the choice of the maximum IS-value are necessarily ad hoc and arbitrary.

There are some states which have not had *any* experience of coalition governments. Some of the other states have had coalition governments on a couple of occasions. Due to insufficient variation in the values of the

explanatory variable, the impact of coalition governments on fiscal policy was not estimated *separately* for these states.[20] However, in order to include *all* experiences with coalition governments, the data for all the 15 states and 26 years was *pooled*. Regressions were run on the pooled data in order to see whether unstable coalitions have any significant effect on any of the fiscal variables of interest. Not surprisingly, there was significant *time trend* in all the variables. Thus, the basic equation estimated on the pooled data was:

$$y = \alpha + \beta \ln t + \gamma c \tag{3}$$

where y denotes the values of the dependent variable (E, T, N or S) , while c is the dummy for type of government. An alternative specification (used for S) was :

$$S = \alpha + \beta_1 t + \beta_2 t^2 + \gamma c \tag{3'}$$

The basic equation was modified in order to allow for inter-state differences. To accommodate differences in state intercepts, equation (3) is modified to :

$$y = \alpha + \Sigma_j \alpha_j x_j + \beta \ln t + \gamma c \tag{4}$$

where x_j (j = 1, 2,...,14) takes value *one* for state j and *zero* for all states other than j.[21] So, $(\alpha+\alpha_j)$ is the intercept for state j , j not being West Bengal, whose intercept term is just α. A corresponding modification was made to equation (3μ).

In order to allow differences in both state intercepts and state slopes, the estimated equation was :

$$y = \alpha + \Sigma_j \alpha_j x_j + \beta \ln t + \Sigma_j \beta_j z_j + \gamma c \tag{5}$$

where x_j as in equation (4), while z_j (j = 1, 2,...,14) takes value ln t for state j and zero otherwise. Again, West Bengal is taken to be the reference state, so that the slope for West Bengal is β, while it is $(\beta + \beta_j)$ for state j.

[20] In the case of Kerala, there was a converse problem since there were only a couple of years in which Kerala had a government with only one pivotal party!

[21] Since data for 15 states is being pooled, only 14 dummies are necessary. West Bengal was taken to be the "reference" state.

The states of Bihar, Orissa, Punjab and Uttar Pradesh are of particular interest because they have experienced *both* unstable coalition governments and single-party (or stable coalition) governments in several years. Separate regressions were run for each of these states, using some version of equation (3).

Table 2
Regression Results (All States Pooled)

Dependent Variable	*Explanatory Variables*						
	Constant	*t*	t^2	*ln t*	*c*	n_i	R^2
S	-1.82 (5.74)	0.34* (9.40)	-0.01* (11.22)		-0.16 (0.74)	9	0.40
E	3.82 (6.85)			3.54* (25.31)	1.14* (2.83)	10	0.69
ln T	1.13 (34.57)			0.25* (30.33)	0.002 (0.11)	7	0.86
ln N	-0.20 (2.65)	0.12* (8.68)			-0.13* (2.24)	14	0.52

Note: (i) n_i refers to the number of state intercepts which are significant at the .01 level in the regression equation.
(ii) * indicates significance at the .01 level.
(iii) terms in parentheses are the t values.

The results of the regressions on the pooled data are given in Table 2.[22] The most interesting feature of the regression exercise is the evidence that unstable coalitions *do* have significantly higher levels of revenue expenditure than other types of government. This corroborates the basic hypothesis that unstable ruling coalitions will tend to overspend since they have relatively short time horizons. There is also support of the hypothesis that unstable coalitions are not very enthusiastic about raising nontax revenues. Notice that the coefficient of c in the regression equation for N is negative and significant. But, the type of government does not seem to have any influence on tax effort. It is also apparent that the explanatory power of the regression model is low as far as S is concerned. An explanation for this phenomenon could be that transfers received from the central government have some influence on the state's size of revenue surplus or deficit. Since the size of these transfers have nothing to do with whether a particular state government is an unstable coalition or not, it is not surprising that the index of instability of the government does not have a significant influence on the size of revenue surplus.

[22] The introduction of dummies to accommodate differences in state slopes makes only marginal differences in the estimated equations. So, Table 2 only reports values corresponding to equation (4).

Tables 3-5 describe the regression results for the states of Bihar, Uttar Pradesh and Punjab. The results for Orissa are not reported here since the explanatory power of the regression equations was uniformly poor. A possible reason for this may lie in the fact that the pattern of governance in Orissa has been slightly different. The election in 1967 brought the coalition of the Swatantra and the Jana Congress into office. Unlike the coalitions in other states, the coalition in Orissa demonstrated remarkable stability, continuing in office for almost 4 years. After a brief spell of President's Rule, another coalition succeeded the Swatantra-Jana Congress coalition, but lasted for slightly over a year. There were also a couple of spells of minority governments in Orissa during the seventies.

Bihar and Uttar Pradesh are two states which have had long experience of coalition governments. In both states, various coalition governments were in power between 1967-68 and 1971-72. There were also several spells of President's Rule during this period. Single-party majority governments were in office between 1972-73 and 1989-90. Finally, both states elected coalition governments to power. Several coalition governments have been in power in Punjab, but only during the first four years.

Table 3
Regression Results (Bihar)

Dependent Variable	*Explanatory Variables*					
	Constant	*ln t*	*t*	*c*	*IS*	$\bar{R}^2$
S	2.85	-0.60		-3.18		0.53
		(1.77)		(5.28)		
E	-0.47	5.51*		4.86*		0.85
		(11.94)		(5.92)		
E	-1.98	5.88*			0.86*	0.77
		(9.08)			(3.94)	
ln T	1.07	0.16*		0.05		0.74
		(8.23)		(1.54)		
ln N	-0.05		0.06*	-0.30*		0.81
			(9.33)	(2.90)		

Note : * indicates that coefficient is significant at the .01 level.

The strongest corroboration of the basic hypothesis is provided by Bihar. Unstable coalition governments have incurred a *significantly* higher revenue expenditure, a result which is consistent with that obtained in the regression exercise with the pooled data. Most interestingly, the *index of instability* also has a significant influence on revenue expenditure. In other words, the more unstable the ruling coalition (that is, the larger the number of pivotal parties) the greater is the proclivity for excessive expenditure!

Table 3 also shows that unstable coalitions collect a smaller volume of non-tax revenues. The strength of the relationship between unstable ruling coalitions and fiscal indiscipline is strong enough to carry over to the case of S - it turns out that unstable ruling coalitions also have a lower surplus (or larger deficit) in their revenue budgets. Notice, however, that unstable coalitions *do not* have lower tax effort.

Table 4
Regression Results (Punjab)

Dependent Variable	*Explanatory Variables*				
	Constant	*ln t*	*t*	*c*	$\bar{R}^2$
E	2.76	3.65*		2.84	0.58
		(4.59)		(1.57)	
Ln T	1.40	0.23*		0.14*	0.85
		(8.89)		(2.33)	
S	3.34		-0.20	-1.85*	0.52
			(5.18)	(2.27)	

Note : * indicates that coefficient is significant at the .01 level.

Table 5
Regression Results (Uttar Pradesh)

Dependent Variable	*Explanatory Variables*				
	Constant	*ln t*	*t*	*c*	$\bar{R}^2$
E	2.35	4.27*		2.72*	0.87
		(12.91)		(4.43)	
ln T	0.94	0.26*		0.05	0.79
		(9.88)		(1.08)	
S	1.95		-0.10	-1.27**	0.52
			(3.47)	(2.68)	
ln N	0.87		-0.02*	-0.13**	0.42
			(4.30)	(2.01)	

Note : * indicates that coefficient is significant at the .01 level.
** indicates significance at the .05 level.

The results for Uttar Pradesh are qualitatively similar to that of Bihar, the only difference being that the *index of instability* of ruling coalitions has no significant influence on any of the fiscal variables. Thus, unstable coalitions have higher revenue expenditure, collect a smaller volume of non-tax revenues, and have lower surplus in the revenue budget. However, Punjab follows a somewhat different pattern. Here, tax effort is significantly *higher*, although the revenue surplus is lower under unstable ruling coalitions.

Electoral Systems, Fragmented Legislatures and Unstable Governments

The preceding discussion suggests that unstable ruling coalitions do induce policy distortions. Analysis of the duration of different types of governments suggests that government instability is more likely to prevail in fragmented legislatures since the latter are unlikely to produce majority governments. Since the pattern of representation in legislatures is an outcome of the electoral system, there is a clear need to take a close look at different electoral systems.

Conventional wisdom amongst political scientists suggests that *plurality rule* is most likely to produce majority governments. Indeed, the so-called *Duverger's Law* states that single-member district electoral systems in which winners are decided by simple plurality, the system prevalent in India, is most likely to produce *two-party* systems. Unfortunately, Indian electoral experience does not fit this general pattern. Legislatures are increasingly fragmented, and the explosion in the number of small parties and Independent members increases the probability of unstable coalitions.

An alternative to the plurality rule is the family of *Proportional Representation* (PR) systems. PR systems are used in different countries. The *unmodified* PR system is considered to be more *favourable* to small parties and minority groups, thus increasing the tendency towards fragmentation. However, the PR system can be modified by specifying that only parties which get (say) 5% of the total valid votes cast in all the constituencies can get representation in the legislature. Since this restriction will immediately eliminate all Independent candidates and most of the smaller parties, there is no a priori reason to expect the modified PR system to result in a more fragmentation legislature.

Simulation exercises were carried out in Dutta (1995) to compare the *actual* pattern of representation in state legislatures with the hypothetical pattern which would result if the plurality rule had been replaced by a member of the PR system based on the *Droop* quota, *and if the pattern of voting had remained unchanged.* Of course, any change in the electoral system would have resulted in different responses from both parties as well as voters. So, the hypothetical representation produced by the PR system is an *approximation* to the pattern of representation which would have resulted if Indian states had actually used this system. Nevertheless, some regularities revealed by the simulation exercise are quite interesting.

The particular member of the PR family which was compared to the plurality rule in the simulation exercise is the "largest remainders" formula using the *Droop quota*. As in all quota systems, the first step is to calculate a quota of votes that entitles parties to a seat. A party gets as many seats as it has quotas of votes. Any seats which remain after all full quotas are exhausted are given to those parties having the largest numbers of unused votes. The Droop quota divides the total number of valid votes by the number of seats plus one. So, it is represented by $Q_D = V/(n+1)$, where Q_D is the Droop quota, V is the total number of valid votes cast, and n is the number of seats to be allotted.

The "inputs" into the simulation exercise were the aggregate vote shares of the different parties in 12 major states between 1967 and 1992. While Dutta (1995) compared various characteristics of the pattern of representation in these state legislatures, I will report here only the results about the number of pivotal parties in ruling coalitions.

The focus of attention here is on the stability of *legislatures*. In other words, the principal objective is to evolve a measure which will enable one to judge the potential of any particular legislature to produce stable governments. The approach taken here is based on calculating the number of pivotal members in a coalition which is *likely to form*. In order to do this, some assumption has to be made about what sets of parties would actually have formed alliances. This involves the specification of a set of *permissible* coalitions. I have assumed here that the SSP, BJS and its later reincarnation the BJP, CPIM, Swatantra and the Congress (O) would not form an alliance with the Congress. I have chosen this specification because these are the national parties which have *never* joined a coalition government with the Congress in any state. Hence, a permissible coalition cannot contain the Congress along with any of these parties. Having specified the set of permissible coalitions, the index of instability (IS) of the legislature is taken to be the *minimum* number of pivotal members amongst the set of permissible coalitions.

Tables 6 and 7 give the values of IS under plurality rule and *the PR rule where parties obtaining less than 5% of the total votes cast are denied representation*. The tables show that there is no reason to believe that plurality rule leads to a higher degree of stability in comparison to proportional rule. In several states and at different points of time, the simulated value of IS has been lower than the actual value. Table 8, which shows the *differences* in the two sets of values, exhibits a clear pattern. The actual level of IS is lower than the simulated level *only* in legislatures

which had a majority party under the plurality rule, and where the use of the proportional rule would have resulted in the absence of a majority party. Correspondingly, in legislatures where the value of IS was high under the plurality rule, the proportional rule would have produced a more stable legislature. This is because legislatures with a high value of IS have a relatively large number of parties even in the smallest permissible winning coalition. This implies the presence of several small parties. The proportional rule with the 5% cut-off mark essentially eliminates the smaller parties, thereby producing a higher level of stability according to IS.

Table 6
Values Of IS Under Plurality Rule
(District Magnitude = Entire State)

	I	*II*	*III*	*IV*	*V*	*VI*	*VII*	*VIII*
AS	1	1	2	1	1	1		
AP	1	1	1	1	1	1		
BIH	3	3	1	1	1	1	3	
GUJ	1	1	6	1	1	2		
HAR	1	1	1	1	2	1	1	
KAR	1	1	1	2	1	1		
MAH	1	1	2	1	1	2		
MP	1	1	1	1	1	1		
OR	2	3	2	1	1	1	1	
PUN	2	3	1	1	1	1	1	
RAJ	4	1	1	1	1	2		
UP	3	2	1	1	1	1	2	1

Note: The periods refer to the successive rounds of elections held in the various states between 1967 and 1992.

Table 7
Values Of IS Under Proportional Rule
(District Magnitude = Entire State)

	I	*II*	*III*	*IV*	*V*	*VI*	*VII*	*VIII*
AS	1	1	2	1	1	2		
AP	1	1	2	1	1	1		
BIH	2	2	3	1	2	1	2	
GUJ	1	1	2	1	1	2		
HAR	1	1	1	1	1	1	2	
KAR	1	1	2	2	1	1		
MAH	1	1	2	1	1	2		
MP	1	1	1	1	1	1		
OR	2	2	2	1	1	1	1	
PUN	1	1	1	2	1	2	1	
RAJ	1	1	1	1	1	2		
UP	1	2	2	1	1	1	2	2

NOTE : The periods refer to the successive rounds of elections held in the various states between 1967 and 1992.

Table 8
Difference In Actual and Simulated Values of IS
(District Magnitude = Entire State)

	I	*II*	*III*	*IV*	*V*	*VI*	*VII*	*VIII*
AS	0	0	0	0	0	1		
AP	0	0	1	0	0	0		
BIH	-1	-1	2	0	1	0	-1	
GUJ	0	0	-4	0	0	0		
HAR	0	0	0	0	-1	0	1	
KAR	0	0	0	1	0	0		
MAH	0	0	0	0	0	0		
MP	0	0	0	0	0	0		
OR	0	-1	0	0	0	0	0	
PUN	-1	-2	0	1	0	1	0	
RAJ	-3	0	0	0	0	0		
UP	-2	0	1	0	0	0	0	1

Note: A negative number indicates that the actual stability of the legislature is *less* than the stimulated stability.

This pattern suggests that PR system may produce more stable ruling coalitions in situations where the plurality rule is unlikely to produce majority governments. Since this situation seems to conform to the ground realities of the current Indian situation, the properties of the PR systems (relevant in the Indian context) should be studied more carefully.

References

A. Alesina, 1987. Macroeconomic Policy in a Two-Party System as a Repeated Game, *Quarterly Journal of Economics*.

_______ and G. Tabellini, 1990. A Positive Theory of Fiscal Deficit and Government Debt, *Review of Economic Studies*.

A. Bagchi, J.L. Bajaj and W. Byrd (ed.), 1992. *State Finances in India*, Vikas Publishing House, New Delhi.

P. Bardhan, 1984. *The Political Economy of India's Development*, Basil Blackwell, Oxford.

P.R. Brass, 1968. Coalition Politics in North India, *American Political Science Review*.

_______ 1977. Party Systems and Government Stability in the Indian States, *American Political Science Review*.

L.C. Dodd, 1976. *Coalitions in Parliamentary Government*, Princeton University Press.

B. Dutta, 1995. Electoral Systems and Fragmentation : The Indian Experience, mimeo.

W. D. Nordhaus, 1975. The Political Business Cycle, *Review of Economic Studies*.

D. Rae, 1963. *The Political Consequences of Electoral Laws*, New Haven, Yale University Press.

M. Govinda Rao, 1979. Political Stability and Taxation in India, *Public Finance*.

N. Roubini and J. Sachs, 1989. Political and Economic Determinants of Budget Deficits in the Industrial Democracies, *European Economic Review*.

M. Taylor and V.M. Herman, 1971. Party Systems and Government Stability, *American Political Science Review*.

APPENDIX

List of States

Andhra Pradesh (AP)
Assam (AS)
Bihar (BIH)
Gujarat (GUJ)
Haryana (HAR)
Karnataka (KAR)
Kerala (KER)
Madhya Pradesh (MP)
Maharashtra (MAH)
Orissa (OR)
Punjab (PUN)
Rajasthan (RAJ)
Tamil Nadu (TN)
Uttar Pradesh (UP)
West Bengal (WB)

Economic Crime, Corruption and the Destabilization of Developing Countries

Sumon K. Bhaumik
B.V. Kumar

I. INTRODUCTION

The economic reforms in India were introduced as a response to an economic crisis which was manifested by a precariously low level of foreign exchange reserves. Abatement of corruption was arguably not an overt rationale justifying the paradigm change. Interestingly, however, in the aftermath of the reforms, reduction of rent seeking activities (and corruption in general), as a consequence of the end of the *licence raj*, received substantial attention from the media and social scientists alike. The new paradigm, involving fewer permits and licenses, was hailed by all (vocal) sections of the economy.

This reaction is hardly surprising. Since independence in 1947, policies and programmes of the central and state governments were shaped such that the core sectors including infrastructure were reserved for the public sector, and the pillars of the economy were controlled by the central government. The people were fed on slogans of "socialism" which was manifested through administered prices of essential commodities, poverty alleviation programmes and the system of subsidies. The bureaucracy, which thrives within any economy that is governed with the use of controls (as opposed to incentives), shackled the system and vested interests and pressure groups burgeoned within the economy. The most evident consequence of this controlled regime was corruption which, in turn, led to distortions in economic decisions, thereby compromising the efficiency of the economy. Rent seeking became the order of the day.

Clearly, rent seeking is perceived as distortionary in the sense that it leads to loss of efficiency in the economy. In particular, economists have argued that if rent seeking is deemed profitable then people will allocate resources in a way that will enable them to be in a position to partake in

rent seeking (Krueger, 1974). The resultant allocation of resources can be inefficient in the Pareto sense. We must note here that the inefficiency arises not only out of the misallocation of resources, including human capital, but also because of the fact that if expected rents are high then people are willing to wait (i.e., refuse other job opportunities) till they get to the desired position.

However, while a discussion about Pareto efficiency might seem to be somewhat abstract, there are more practical reasons to ensure that corruption is minimized. For example, it is argued by MNCs that despite reforms red tapism in the Indian bureaucracy is pervasive and that the resultant delay involved for sanctioning of projects is substantial. The MNCs presumably have to incur significant expenditure to submit project proposals, and the problem is exacerbated by high time costs. This assertion underscores a wariness on their part in so far as investment in India is concerned. In an attempt to quantify relative corruption, on a scale of zero (absolutely corrupt) to ten (very little corruption), Mauro (1995) concluded that there is a significant and negative correlation between corruption and the state of economic development of a country.[1] He accorded high point to developed countries on the aforementioned scale: a perfect 10 each for the United States, Canada, Australia and France, and 8.75 for Japan. Developing countries, on the other hand, received much lower points on the scale, with India (with 5.25) emerging marginally superior to Bangladesh (with 4), Ghana (with 3.66) and Egypt (with 3.25).

The implications of this, in so far as India is concerned, are grave. There is general consensus about the fact that corruption lowers private investment and hence reduces growth rates, and that is a sobering thought given that the government desires foreign direct investment to the tune of USD 10 billion annually. The magnitude of the problem becomes clearer when we take into account the fact that at least one potential investing country, the United States, has stringent laws which aim at dissuading entrepreneurs to use unfair means to obtain contracts or tenders. Under the Foreign Corrupt Practices Act, the United States government can penalize any company partaking in corrupt practices to secure contracts in foreign countries upto USD 5 million in fines. The relevant employees of the company can be imprisoned for upto 5 years.

---

[1] In other words, there is a very high and *positive* correlation between the points accorded to a country on the Mauro scale, and its state of development.

II. Corruption in Post-Liberalization India

The Indian liberalization process remains an exercise in contradictions. The professed policy of the Government of India, is to carry forward the economic reforms to their logical conclusion. However, *de facto*, clearances have to be obtained from the Government of India (Foreign Investment Promotion Board), before a multinational corporation can invest into any industry/sector. There are delays in the decision making process and, as exemplified by the so-called telecom scam, there is little transparency in the process involving approval of project and/or finalization of global tenders. Considerable expenditure has to be incurred by the multinational corporations and their Indian partners to submit project proposals or global tenders, and this cost is further enhanced by delays in the decision making process. It is widely believed that the delays are deliberate ploys on the part of the powers that be to coerce the companies into a rent seeking arrangement before the relevant projects are cleared or tenders approved. In the era of competition, India has *competitive corruption.*

What forms do corruption take? The episodes involving several banks and the so-called Harshad Mehta scam, as well as the switching of shares at the Bombay Stock Exchange are, by now, common knowledge.[2] There are, however, other forms of corruption which do not catch the fancy of the masses as easily, namely, over invoicing of projects. Industrial firms advertise ambitious projects and woo the investors by generating expectations of high returns. At the same time, the project cost is inflated significantly through over invoicing of resources like land and capital goods, as well as services like managerial skills and external consultancy. The resultant surplus of the exhibited cost over the actual cost can then be siphoned away by the promoters concerned, and can yield significant *profits* even after accounting for their investment into the project as directed by the guidelines of the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI). In one such case, the initial (estimated) project cost of Rs. 8 million (USD 230,000) was inflated into Rs. 180 million (USD 5.15 million) and foreign exchange to the tune of USD 2.57 million was siphoned out of the country through over invoicing of imports.[3]

[2] Although the term *common knowledge* has been used here in the literary sense of the words, the Indian paradigm permits its use as defined in the game theory literature!

[3] The example cited here, as well as those cited elsewhere in the paper have been taken from the following sources: (1) Janaki Raman Committee Report, Reserve Bank of India, 1992, (2) Report on the Functioning of the Banking System, 1992, (3) case histories from the Directorate of Revenue Intelligence, (4) Economic Times, and (5) report of the Bank of England on the collapse of Barings.

Other, equally innovative, schemes are also in effect. For example, on the basis of the guidelines given by the RBI, scheduled banks extend credit to exporters upto 60 to 80 per cent of the contractual value against a firm export order. It leaves the door open for a bent exporting to enter into "contracts" with its cronies based abroad, and obtain insurance cover from the Export Credit and Guarantee Corporation (ECGC). Such companies often enter into sub-contracts with supporting manufacturers to show that they are serious about executing the contract. Suppose that the "contract" is valued at USD 125,000. The exporting firm can then obtain credit upto USD 100,000 from his bankers, by way of a cheque. The interest rate associated with this form of bank credit is nominal: 13.5 per cent for 90 days, 15.5 per cent for between 90 and 180 days, and 18.5 per cent for more than 180 days.

The firm can, in turn, discount the cheque with a money changer and receive USD 99,000 in cash. Instead of utilizing the money for procuring the goods ostensibly required for the export "contract," the firm can enter the market for short term loans (repayable within 140 days at 30 per cent interest per annum) as a lender. Before the payment of the loan becomes due, the firm can export goods valued/invoiced at (say) USD 150,000 and ship the same either on collection or delivery against documents basis. It also extends credit to the overseas buyers ranging from 30 to 90 days, as per RBI norms. The firm is then in a position to obtain USD 135,000 from its bank, after discounting of the export invoice under the Bill Discounting Scheme. It can thus pay back its loan worth USD 100,000, and reenter the short term credit market as a lender. In other words, the arbitrage opportunities, apart from the opportunities from over and under invoicing (in violation of the Foreign Exchange Regulation Act), provide more incentive for corruption and misuse of export schemes than for export and foreign exchange earning.

While perverse incentive mechanisms provide encouragement in favour of corruption and rent seeking, perhaps a bigger contribution to these problems is made by the lack of accountability which, in turn, arises out of the lack of adequate monitoring on the part of the authorities. Nowhere is this hypothesis more valid than in the case of the capital market. With the increasing autonomy of the RBI and the SEBI, and with the formulation of regulations which aim at reducing the information asymmetry between the firms and the investors, and at increasing the transparency of the trading system, the activities of the firms, the investors and the intermediaries are increasingly becoming rule bound.

II. CORRUPTION IN POST-LIBERALIZATION INDIA

The Indian liberalization process remains an exercise in contradictions. The professed policy of the Government of India, is to carry forward the economic reforms to their logical conclusion. However, *de facto*, clearances have to be obtained from the Government of India (Foreign Investment Promotion Board), before a multinational corporation can invest into any industry/sector. There are delays in the decision making process and, as exemplified by the so-called telecom scam, there is little transparency in the process involving approval of project and/or finalization of global tenders. Considerable expenditure has to be incurred by the multinational corporations and their Indian partners to submit project proposals or global tenders, and this cost is further enhanced by delays in the decision making process. It is widely believed that the delays are deliberate ploys on the part of the powers that be to coerce the companies into a rent seeking arrangement before the relevant projects are cleared or tenders approved. In the era of competition, India has *competitive corruption.*

What forms do corruption take? The episodes involving several banks and the so-called Harshad Mehta scam, as well as the switching of shares at the Bombay Stock Exchange are, by now, common knowledge.[2] There are, however, other forms of corruption which do not catch the fancy of the masses as easily, namely, over invoicing of projects. Industrial firms advertise ambitious projects and woo the investors by generating expectations of high returns. At the same time, the project cost is inflated significantly through over invoicing of resources like land and capital goods, as well as services like managerial skills and external consultancy. The resultant surplus of the exhibited cost over the actual cost can then be siphoned away by the promoters concerned, and can yield significant *profits* even after accounting for their investment into the project as directed by the guidelines of the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI). In one such case, the initial (estimated) project cost of Rs. 8 million (USD 230,000) was inflated into Rs. 180 million (USD 5.15 million) and foreign exchange to the tune of USD 2.57 million was siphoned out of the country through over invoicing of imports.[3]

[2] Although the term *common knowledge* has been used here in the literary sense of the words, the Indian paradigm permits its use as defined in the game theory literature!

[3] The example cited here, as well as those cited elsewhere in the paper have been taken from the following sources: (1) Janaki Raman Committee Report, Reserve Bank of India, 1992, (2) Report on the Functioning of the Banking System, 1992, (3) case histories from the Directorate of Revenue Intelligence, (4) Economic Times, and (5) report of the Bank of England on the collapse of Barings.

Other, equally innovative, schemes are also in effect. For example, on the basis of the guidelines given by the RBI, scheduled banks extend credit to exporters upto 60 to 80 per cent of the contractual value against a firm export order. It leaves the door open for a bent exporting to enter into "contracts" with its cronies based abroad, and obtain insurance cover from the Export Credit and Guarantee Corporation (ECGC). Such companies often enter into sub-contracts with supporting manufacturers to show that they are serious about executing the contract. Suppose that the "contract" is valued at USD 125,000. The exporting firm can then obtain credit upto USD 100,000 from his bankers, by way of a cheque. The interest rate associated with this form of bank credit is nominal: 13.5 per cent for 90 days, 15.5 per cent for between 90 and 180 days, and 18.5 per cent for more than 180 days.

The firm can, in turn, discount the cheque with a money changer and receive USD 99,000 in cash. Instead of utilizing the money for procuring the goods ostensibly required for the export "contract," the firm can enter the market for short term loans (repayable within 140 days at 30 per cent interest per annum) as a lender. Before the payment of the loan becomes due, the firm can export goods valued/invoiced at (say) USD 150,000 and ship the same either on collection or delivery against documents basis. It also extends credit to the overseas buyers ranging from 30 to 90 days, as per RBI norms. The firm is then in a position to obtain USD 135,000 from its bank, after discounting of the export invoice under the Bill Discounting Scheme. It can thus pay back its loan worth USD 100,000, and reenter the short term credit market as a lender. In other words, the arbitrage opportunities, apart from the opportunities from over and under invoicing (in violation of the Foreign Exchange Regulation Act), provide more incentive for corruption and misuse of export schemes than for export and foreign exchange earning.

While perverse incentive mechanisms provide encouragement in favour of corruption and rent seeking, perhaps a bigger contribution to these problems is made by the lack of accountability which, in turn, arises out of the lack of adequate monitoring on the part of the authorities. Nowhere is this hypothesis more valid than in the case of the capital market. With the increasing autonomy of the RBI and the SEBI, and with the formulation of regulations which aim at reducing the information asymmetry between the firms and the investors, and at increasing the transparency of the trading system, the activities of the firms, the investors and the intermediaries are increasingly becoming rule bound.

Accountability, indeed, is perhaps the single most important curative process for the malaise that is corruption.

III. Incentives, Information, and Corruption

Interestingly, whether or not corruption is good in a system that is otherwise sluggish has been a bone of contention among economists. Some have argued that corruption and rent seeking, which we can henceforth call bribery for the sake of simplicity, can be of help to investors if bribes can ensure them whatever good or service they want to possess (Leff, 1970). Economists have also shown that in the presence of bribery, delivery of services is not delayed in the long run so as to extract a higher bribe (Lui, 1985). On the contrary, after bribery is permitted, those that accept the bribe have an incentive to speed up the system. The intuition offered for the result is that if the queue moves sluggishly even after bribes are "permitted," people will not have an incentive to be in the queue.

But the problem lies with the fact that corruption coexists with uncertainty. The honest entrepreneurs face the uncertainty that their projects might not be approved by corrupt officials. At the same time, when officials are able to enter the market for corruption freely, and when each official or department sets its own bribes without harmonizing its actions with others, there is a positive probability that the action taken by a corrupt official or department will not be complemented by other officials and departments (Shleifer and Vishny, 1991). Hence, dishonest entrepreneurs too face uncertainty. It is a stylized result in Economics that investment is suboptimal in the presence of uncertainty (Dixit and Pindyck, 1994).

Typically, economists argue that the solution to the problem of corruption lies in changing the incentive structure of the organization, namely, the government. This is attained by changing the payoff structure in a way which makes honesty either a dominant strategy or at least the best response of the potentially corrupt officials to the action adopted by those overseeing their jobs. Methodologically, this typically involves the use of principal-agent models the outcome of which are the optimum contracts that the principal (i.e., the monitoring agency) can offer while satisfying the so-called participation and individual rationality constraints. In brief, this implies that in equilibrium the agent (i.e., the potentially corrupt individual) will enjoy a level of welfare which is higher than his welfare with all other possible contracts, and is also higher than his reservation level of welfare.

The problem lies in the fact that effecting an alteration of the payoff structure of the corrupt government officials is not easy. Even if we rule out formation of coalition by officials and the executive, we have to take into consideration the fact that if an official remains honest then the benefits accruing to the society as a result of his actions are largely external to him, and hence he has little incentive to be honest. This problem is aggravated by the weak link between an official's performance and his pecuniary and non-pecuniary perks. At the same time, the career paths of government officials are typically independent of their reputation. Together, these make it extremely difficult for some principal to offer contracts to these officials that are consistent with honest behaviour. In other words, unless an official is pathologically honest or unless there is strict monitoring together with stiff penalties, honesty might not be the best strategy for an official.

One can also argue that a government official is endowed with superior information about various policies and regulations (Tirole, 1994). Bribe, in that case, is a price for that information which interest groups are willing to pay. One way, therefore, to ensure that the officials are not tempted to serve the interest of these groups is to reduce the stake that the groups have in the regulatory decision. In the extreme case, the regulatory decision may itself become moot. The Indian policy regime aimed at delicensing several economic activities is an example of such a policy. Alternatively, policies can aim at reducing the discretionary element of regulations and make it rule bound. Note that the latter policy is in serious conflict with the interests of the officials. For example, in a slightly different context, it has been argued that one reason as to why many LDCs import state of the art technology as opposed to appropriate technology is that it is easier for officials to ascribe values to new technology and hence make resource allocations that are inconsistent with the true value of the technology (Shleifer and Vishny, 1991).

The immediate policy implication of such an analysis is that the expected negative payoffs of corrupt officials, in the event they get caught, have to be increased. This can be done by increasing the frequency or intensity of monitoring and/or the penalties handed out if the official is adjudged guilty of corruption. Since monitoring is typically expensive, the classical policy prescription is to impose the maximum level of penalties possible (Becker, 1981). Later research, however, has shown that if monitoring is expensive, it is optimal for enforcement agencies to have low level of monitoring for relatively smaller acts of corruption (Mookherjee and Png, 1994). In fact, these research endeavours have proposed that a threshold

be created below which no enforcement is effected. This *de facto* legalization of minor offences, together with stiff penalties for higher offences, has been deemed an optimum strategy for monitoring agencies. The latter policy is stylized. The implicit logic of the "legalization" policy is that stiff penalties for any minor offence will provide the incentive to all corrupt individuals in the neighbourhood to move to higher offences (which have higher expected payoffs).

The importance of monitoring in abatement of corruption cannot be overemphasized. It has been argued in the literature that if offences are under-reported and if investigation is costly, both of which conditions are satisfied in the Indian context, then efficient enforcement of laws includes monitoring as well (Mookherjee and Png, 1992). Indeed, monitoring, coupled with graduated fines, can provide sufficient disincentive to those involved in petty corruption. Hence, costly investigation can be reserved for higher forms of corruption. In India, on the other hand, the emphasis has traditionally been on prolonged and costly investigation of the activities of firms and individuals against whom there is *prima facie* evidence of corruption, and a virtual absence of monitoring (and accountability) on a day-to-day basis.

IV. The New Face of Corruption

While corruption among government officials is a widely debated topic, of late the issue of corruption and monitoring has assumed importance even in the context of the private sector. The issue was brought to the fore by the FERA violation charges levied against ITC Limited. If true, it is quite to safe assume that it is not the only example of corporate corruption, and the methods involved are numerous: over invoicing projects, rigging share prices, packing credit, money laundering through banks, switching of shares, and private placement of shares to name a few.

The importance of monitoring is further enhanced by the fact that in cases of corporate corruption, there is often no incentive for "insiders" to abate corruption. This issue has been debated significantly in the wake of the ITC scandal, with reference to the "inaction" of the financial institutions which sat on the board of the company. If managers are simply inefficient, and the inefficiency adversely affects the profitability of a company, then the (core) shareholders are expected to act so as to replace the incumbent management. Indeed, this is often used as the rationale for privatization. However, if managers are corrupt, and if the corruption is

sustainable in the long run in the absence of monitoring-investigation then the effect of the corruption on the company's profitabilty can be positive, and hence there will be no conflict of interest between the owners and the managers. Hence, in the presence of sustainable corruption, it can be perfectly rational for a profit or value maximizing investor to turn a blind eye to managerial corruption. Monitoring and investigation renders corruption potentially unsustainable and hence alters this "win-win" paradigm for the investors and managers.

In so far as the private sector is concerned, monitoring and investigation can deter corruption not only with the threat of penalties but perhaps also with that of potential takeover. As highlighted by the ITC case, credible charges of corruption arising out of monitoring-investigation can lead to fall in the market price of the equity as the future of the company becomes uncertain. If the fundamentals of the company are sound, and managerial corruption is perceived as the sole reason for the fall in equity value, then the equity may be considered a bargain in the market, having a positive *alpha*. There is, therefore, an increased possibility of takeover by a rival firm or investor. While this form of market discipline usually plays a role in discouraging managerial inefficiency, it is perhaps safe to hypothesize that it can also potentially deter managerial corruption. However, the monitoring-investigation regime will then have to be supplemented by favourable takeover laws, a proposed legislation which evoked a heated debate in the recent past.

V. Conclusion

At the end of the day, one has to grapple with a profound question. The discussion has highlighted the importance of monitoring, and various caveats concerning the same. However, while the legislative arm of the government can decide on appropriate changes in institutional and penalty structures, and the judiciary can decide whether or not to convict someone, it falls upon the executive to monitor corruption with the help of its agencies. However, today the executive stands somewhat discredited in the wake of multiple scandals both at the state and the federal levels. The problems facing the country at large are twofold. First, the replacement of a "corrupt" executive is a costly and cumbersome process. Second, since election results indicate not only disenchantment with a particular government but also changes in the tastes and ideologies of the masses, it is difficult to overcome the agency problems faced by the members of the executive (Tirole, 1994). Who, therefore, will monitor the monitor?

References

Becker, G., 1981. *A Treatise on the Family*, Harvard University Press.

Dixit, A. K. and R. S. Pindyck,1994. *Investment Under Uncertainty*, Princeton University Press.

Krueger, A. O., 1974. "The Political Economy of a Rent-Seeking Society," *American Economic Review*, 64(3):291-303.

Leff, N. H., 1970. "Economic Development through Bureaucratic Corruption," in A. Heidenheimer (ed.) *Political Corruption: Readings in Comparative Analysis*, New York: Holt, Rinehart & Winston.

Lui, F.T., 1985. "An Equilibrium Queuing Model of Bribery," *Journal of Political Economy*, 93(4):760-781.

Mauro, P., 1995. "Corruption and Growth," *Quarterly Journal of Economics*, 110: 681-712.

Mookherjee, D. and I.P.L. Png, 1992. "Monitoring vis-a-vis Investigation in Enforcement of Law," *American Economic Review*, 82(3):556-565.

_______, 1994. "Marginal Deterrence in Enforcement of Law," *Journal of Political Economy*, 102(5):1039-1066.

Shleifer, A. and R. Vishny, 1991. "Corruption," *Quarterly Journal of Economics*, 106.

Singh, N., 1985. "Monitoring and Hierarchies: The Marginal Value of Information in a Principal-Agent Model," *Journal of Political Economy*, 93(3):599-615.

Tirole, J., "The Internal Organization of Government," *Oxford Economic Papers*, 46: 1-29, 1994.

Usher, D., 1987. "Theft as a Paradigm for Departures from Efficiency," *Oxford Economic Papers*, 39:235-252.

Tax Policy and Administration

9

Discussion of Papers by Parthasarathi Shome, Pawan K. Aggarwal & Kanwarjit Singh, Indira Rajaraman, Om Prakash Mathur

Pulin Nayak

We have here three valuable contributions that address the question of tax policy and administration from three distinct perspectives. Yet there is one unifying theme, which is that sound tax policies and effective tax administration are the essential prerequisites to good governance. The first paper makes a strong case for introducing presumptive taxation in the sphere of direct taxes, and in particular personal income taxes, to significantly push up the direct tax to GDP ratio in India. The essential burden of the argument rests on the premise that if the information costs of ensuring perfection by adopting the theoretically ideal base of actual income is impossibly high, then presumption could be first best (p.31). The second paper addresses the question of the "reform" of property taxes which is the principal source of revenue for local governments. In particular it is seen that the annual rateable value (ARV) system has enough flexibility to allow for reform measures that may make it responsive to shifts in the real estate market. The final paper examines the interrelationship between tax administration and the phenomenon of tax evasion. In this context the paper goes on to make a case for widening the scope for tax deduction at source (TDS) combined with a suitable penalty structure to improve tax compliance. We shall now proceed to examine each of the papers in turn.

Tax Evasion and Tax Administration: A Focus on Tax Deduction at Source

We first take up the paper which deals with the vital issue of trying to combat tax evasion by adopting tax deduction at source (TDS) or withholding taxes. Even though a comprehensive reform of the direct tax system has already been in place for about 5 years, with the top marginal tax rate set at 40 per cent, tax evasion continues to be a vexing problem. While it is true that in the post 1991 period the yield of the direct tax system has definitely improved, we are still very far from realising the potential that may be legitimately expected.

The literature as tax evasion is quite substantial and there is an influential strand that looks at the problem of tax evasion from the point of view of the tax payer as a decision under uncertainty where the tax payer chooses the optimal level of concealment of income so as to maximise his expected utility. The extent of evasion is seen to be a function of the individual assessee's attitude towards risk, the probability of detection function and the nature of the penalty function, in the event of detection. Quite already, *ceteris paribus*, a tighter regime characterised by a higher probability of detection and more severe penalties would involve additional greater tax compliance. But this would involve additional costs, both in terms of a more efficient detection apparatus as well as a more powerful enforcement machinery. One additionally has to contend with the fact that more resources put into the detection and enforcement machinery may not automatically increase the efficiency of the system if one allows for corrupt tax administrators.

There are a number of aspects of tax administration that the paper takes note of which are useful to summarise:

(1) Penalties should be realistic. The higher they are, the less likely that they would be applied.

(2) Penalties must be implemented expeditiously.

(3) The structure of penalties must include possible (jail term) or incarceration.

(4) As regards tax amnesties the overall agreement seems to be that amnesties are counter productive because they may even encourage tax evasion in the long run aside from being iniquitous.

The paper then goes on to make a strong case for incorporating or widening the scope of tax deduction at source (TDS). The advantages are several:

(1) Tax and income flows are concurrent or parallel.

(2) Compliance is improved and enforcement costs are reduced.

(3) The government has a better cash-flow position.

(4) Among those within the TDS net, the tax burden is shared more equitably.

The main disadvantage of the TDS are—

(i) inability to capture large taxpayers, and most importantly,

(ii) it presupposes a large information network with a body of trained personnel to run the system. This also calls for computerisation of the tax system.

(iii) A number of aspects remain untapped under the TDS, for e.g., perquisites.

The incomes covered under the scheme of TDS include, principally,

(i) salaries
(ii) fees for professional or technical services
(iii) interest and dividends
(iv) rents from real estate
(v) Capital gains of non-residents.

The contribution of TDS in gross collection of income tax increased from about 23% in 1980-81 to 37% in 1989-90 and it stands at around 31% as of now.

There is no gainsaying that TDS or withholding would lead to greater tax yield. But for this there has to be an adequate infrastructure by way of computerisation and trained personnel for cross verification of TDS claims.

Among the suggested strategies are—

(i) access to bank accounts by the tax administration and

(ii) full application of legal penalties.

Presumptive Taxation and Governance

The next paper under review confines itself to adopting presumptive taxes in the sphere of direct taxation. Even though the ratio of direct taxes to GDP has moved up somewhat in the post 1991 period and today stands at

around 3 per cent, this is much lower than the figure of about 5.5% for all developed countries for 1989 as reported in a paper by Burgess and Stern (1992). This paper argues that there is substantial scope for governing more direct tax revenues by adopting presumptive taxation.

The notion of presumptive taxation rests on the identification of objectively measurable indicators specific to each sector of economic activity and the use of these to establish the potential tax base of the assesses. This method assumes importance when there is widespread concealment of income on the part of particularly the self employed and the hard to tax groups thereby reducing the revenue potential of the traditional or regular income tax system. Recognising the seriousness of the problem of evasion in developing countries, Musgrave (1987) was led to conclude that "a more realistic approach is needed, using presumptive taxation, applied outside and in lieu of the regular framework of income and sales taxation, as well as estimated tax bases, applied within the context of the regular tax system". Elsewhere in the same paper Musgrave goes on to say: "Small taxpayers, involving five employees or fewer, may be reached most effectively by a presumptive tax, imposed in lieu of the regular income and sales tax." Musgrave emphasises that the presumptive tax ought to be computed conservatively so as not to exceed the amount that would be payable under the regular tax, and it leaves the taxpayer free to demonstrate that a lesser liability is called for.

This paper argues, quite rightly, I think, that the imposition of the Rs. 1400 flat tax (under section 115K) on small business, whether or not presumptive tax, has really been non starter. This has been applicable for non-tax paying retail traders with a turnover ceiling of under Rs. 5 lakhs. The revenue yield has been marginal, in 1995-96. It is placed at 0.23% of total income tax.

Secondly the present MAT (minimum alternative tax) on corporate book profits is not really a presumptive tax. An asset-based corporate MAT could, on the other hand, be regarded as a presumptive tax and its revenue potential might have been more substantial.

The paper then goes on to argue for the use of production indicators for presumption, for example, the asset base of the enterprise, or floor area of consulting premises. It is contended that consumption indicators are to be shunned because they are capricious or even inequitable. It is not clear to me why consumption based norms are inherently likely to be inequitable.

The paper then goes on to make an examination of two sectors, services and agriculture. As regards services it is seen that the evasion has been widespread: the average net income of even rural legal practitioners fell above the taxable threshold for the year 1983-84. It is suggested that a legal enterprise with at least one hired worker is worthy of consideration for a presumptive levy. Kansal's 1990-91 survey of medical practitioners referred to in the paper, also shows large scale evasion.

As regards agricultural income tax, it is clear that the Raj Committee's agricultural holding tax (AHT) is nothing other than a presumptive tax on land.

It is suggested that there is substantial scope for garnering additional revenues making use of presumptive tax.

While the above argument is unexceptionable it would be worthwhile to first fully utilise the scope of regular income especially by (i) improving the information system and computerisation and (i) have better trained personnel.

Property Tax Policy and Local Governance

We turn our attention now onto the question of property tax. Some of the most critical inadequacies of the pattern of development we are experiencing pertain to the woeful level of provision of municipal services. These include water supply, sewerage, garbage collection, provision of street lighting and the like. The principal source of revenue in the hands of local authorities is property taxes which account for about 40 to 50 per cent of local government finances in developing countries. They account for some 25-28 percent of the total municipal expenditure. Property taxes account for about 2.6-2.8 per cent of all taxes raised in the country and it constitutes less than a mere quarter percentage point of GDP. Quite clearly if local governments have to govern at all, let alone govern effectively, the resources available in their hands have to be substantially bolstered.

Since property taxes are determined by State governments, there is wide variation in the application of this tax across states. The tax is obligatory in some states and optional in some others, and there are many municipalities that do not levy any property tax at all. However the mainstay of the property tax system across the country is assessment on the basis of the annual rateable value (ARV) of land and buildings. The ARV

is defined to be the gross annual rent which a property may reasonably be expected to be let out from year to year. The ARV is a hypothetical rent which is held as a proxy for the market rent of the concerned property. Most state municipal legislations have provisions for revaluation of ARVs once every 3 to 5 years, and alterations of assessments in the interim if additions and alterations are made to the property. In practice, however, changes in ARVs are brought about tardily and often not at all. There are a number of deductions and rebates allowed on the ARVs that have reduced the yield of the property tax. Further there are several categories of properties, which, even though making heavy demands on municipal services, stand exempted from the payment of property taxes. Finally the presence of rent control requires that property tax be levied on the basis of standard rent or fair rent. All of these have contributed to substantially narrowing the base of the property tax system. In certain studies the assessment to market rent ratio is seen to be as low as 25 to 35 per cent.

Quite clearly there is a strong case for increasing the yield of property taxes in the country. Towards that end, the paper makes a case for adopting a modified method of determining ARV with reference to certain attributes that may possibly be: plinth area, land area, location, type of construction, type of use and age. Such a system has already been adopted in Andhra Pradesh and also Patna city with beneficial results.

Finally, summarising, it cannot be denied that there is a substantial scope for deploying presumptive taxes on income, property taxes as well as TDS to bolster tax revenues. As regards presumptive taxes there is of course a case for exploiting the regular system to the fullest before we think in terms of employing the presumption route. In order to work out a well calibrated presumptive direct tax system the information system has to be substantially stepped up but then if that is the case then one may as well employ the regular tax system to the fullest. Nobody can really seriously take exception to bolstering the property tax system or the system of TDS.

Adopting of the measures suggested here would make the system more efficient as well as more equitable. While good governance must mean more efficient resource allocation one cannot underestimate the importance of fairness as an inseparable part of good governance.

In the discussion that followed one important point that emerged was that we have considered here three distinct approaches of bolstering tax revenues. What is however important to remember is that the total tax

burden on individuals ought not to be excessive. In other words, one may well think in terms of garnering additional tax revenues in terms of individual taxes such as personal income tax and property tax but there should be some judgement in terms of the totality of the tax burden that a person is likely to incur. It needs to be ensured that the total incidence is not too excessive or burdensome.

10

Tax Evasion and Tax Administration : A Focus on Tax Deduction at Source

Parthasarathi Shome
Pawan K. Aggarwal
Kanwarjit Singh

I. Introduction

It has been argued that, in developing countries, "tax administration *is* tax policy" (Bird and Casanegra, 1992). In reality, this is true in every country, whether developing or developed, since it simply implies that the legal tax structure takes real form only upon implementation. This is in fact a mere truism, but it carries with it the benefit of stressing that a tax structure is meaningful to the extent that it can be administered. No amount of finessing a tax law or refining its economic attributes will help if it is not adequately administered. Many countries suffer from a gap between intention and implementation, and developing countries do so especially.[1] If tax administration cannot match the tax law that is deemed to be simple, with broad coverage and scope and economically neutral, then distortions in resource allocation would result and it is likely that tax evasion would ensue. The relation between tax administration, on the one hand, and governance and public policy, on the other, is thereby established.

While public finance as an area of scientific inquiry has had a long history, matters relating to tax administration have not been subject to it until recently. For example, in the seminal introductory treatise on public finance by Musgrave (1959), there was scant mention of tax administration. Only rather slowly, as well structured tax policies in many developing countries failed to yield the projected tax revenues did constraints imposed by tax administration come into view. And, as the need for tax revenues increased in response to large government expenditure programmes catered

[1] Similarly, laws for pollution control may be quite rigorous and wide in scope. Yet lack of implementation may result in a very high level of pollution in particular spatial areas such as cities and industrial zones. This has increasingly been the perception in India.

to address social imbalances and the building of massive infrastructure, the need to streamline tax administration so that a given tax structure could yield more revenue, received attention. Improvement of tax administration thus became the mainstay in a wave of tax reforms carried out in the 1980s in East Asian "tigers" (see Tanzi and Shome, 1992) as well as in Latin American countries (see Shome, 1995), even as tax structures themselves were simplified and multiple objectives of tax systems scaled back in an attempt to render the systems more amenable to successful implementation.

While many appropriate and innovative tax administration measures seem to have been taken by a wide range of countries, it further became obvious that their success varied over a period of time as well as from country to country. In India as well, tax administration reform became a focus of attention in the 1990s, especially as economic liberalisation and concomittant economic growth opened up possibilities and incentives for tax avoidance and evasion. Economic activities, which traditionally had remained undertaxed or out of the tax net, began to grow speedily, thereby reducing the overall revenue intake in terms of GDP. While an awareness of the urgent need to make fundamental improvements in tax administration has set in, comprehensive restructuring and innovations in tax administration are yet to be undertaken or put in place.

In what follows, Section II explores some of the broad determinants of tax evasion, including weaknesses in tax administration. Section III delineates selected tax administration mechanisms that have been utilised to break tax evasion. Section IV discusses the current Indian experience, primarily pertaining to the mechanism of tax deduction at source, which has become an important tax administration tool to combat tax evasion. Section V concludes.

II. Tax Evasion : Determinants, Means and Effects

Even though tax evasion has been present ever since there have been taxes--even Chanakya and Pluto wrote about it--there had been little discussion in modern economic literature on this phenomenon until very recently.[2] Tax evasion, corruption, and the underground economy are being analysed using the theory of constrained maximisation under uncertainty, game theory,

[2] See Tanzi and Shome (1993) for a detailed coverage of recent literature and a discussion of methods to control tax evasion. This section draws from some of the concepts developed there.

probit analysis, catastrophe theory, and the like,[3] though the assumptions and results of these approaches are restrictive compared to the real life phenomenon of, and need to curb, tax evasion whose practice and methods of control are, typically, far more complex. Similarly, the size of the underground economy and the extent of tax evasion have also been estimated for various economies (for example, see Tanzi (1983) for the United States, Acharya (1985) for India, Aguirre and Shome (1988) for Mexico, and Shome et.al.(1995) for Colombia). Thus it is not the dearth of analytical interest or the lack of curiosity regarding how large the problem is that limits its solution. The solution lies, rather, in a well rounded approach for a comprehensive understanding of the determinants, means and effects of tax evasion. Only then a practicable strategy for its eradication might be devised.

Determinants of Tax Evasion

Tax evasion is determined by a mix of a country's economic structure, tax structure and social milieu. Thus, there is no doubt that tax evasion can be linked more easily to a developing country's economic structure. For example, small taxpayer units are typically more prone to tax evasion than large enterprises. Also, lower the monetisation harder it is to detect evasion. Tax structures are likewise linked to tax evasion. For example, a value added tax or a first point tax such as customs duties or production excises is likely to be subject to less tax evasion than a retail sales tax or final point tax, partly explaining the use of the former taxes among the developing countries, even though some of them may be rather distortive for resource allocation. Incomes (such as salary, interest and dividends) which are easily identifiable at the origin are relatively less prone to tax evasion than others. Service professionals (restaurateurs, doctors, lawyers, architects), real estate developers, independent contractors and agricultural entrepreneurs can evade taxes more easily than others. A tax structure that is complex or is perceived to be unfair by the public is likely to result in higher tax evasion. A weak and inefficient tax administration spurs evasion.

Tax evasion is not just an individual phenomenon as theoretical models seem to suggest,[4] but has a social determinant as well. An individual

---

[3] See 1993 conference proceedings of the International Institute of Public Finance, Berlin.

[4] The seminal work in this area in which the problem of tax evasion is seen from a taxpayer's point of view is by Allingham and Sandmo (1972). Here the decision to evade tax is tantamount to buying a lottery, based on the expected gains and losses

tax evader in a predominantly honest society has to be much more careful of social censure and the reach of the law than one in a society in which tax evasion is accepted more openly. Public perception about efficiency of government spending also influences tax evasion. Stronger the public perception about wasteful public spending higher would be the inducement for evasion.

Means and Agents of Tax Evasion

Tax evaders employ various means of operation. These include: non-reporting or underreporting income, sales or wealth, overreporting expenses, fragmenting income to reduce tax liability, maintaining illicit financial accounts, and claiming excessive tax credits. Tax evasion is not confined to personal income tax payers. Companies, through "transfer pricing", "tax farming", or inappropriate exchange rate transactions (where exchange restrictions apply) also may avoid or evade taxes.

Ramifications of Tax Evasion

Tax evasion affects the horizontal and vertical equity of the tax system adversely. It affects the efficiency of the production structure inasmuch as some taxpayers evade taxes and others cannot. It lowers the revenue intake from the statutory system, and tends to convert the statutory system into an unrealistic one to safeguard revenue objectives. It affects public attitude towards government because there is always the presumption that collusion exists between tax evaders and the tax administration. Thus, the distance between tax evasion, on the one hand, and faults in the tax administration, on the other, is usually considered to be short.

Recently, many authors have taken to address the issue of tax evasion directly. To quote Tanzi and Shome (1993): "Tax evasion prospers when society condones it. In a society that does not condone tax evasion, the phenomenon remains isolated and concerns relatively few individuals. When society condones it, however, the phenomenon becomes much more widespread. Citizens at large should have a responsibility to prevent tax evasion. Since tax evasion is often facilitated by the acquiescence of some citizens in the tax-evading behaviour of others, laws should penalize not just the tax evaders but also those who collaborate either passively or actively in tax-evading activities. For example, in many countries, the tax evasion

---

associated with the decision, and intended to maximise the taxpayer's utility or satisfaction.

of professionals, such as doctors or independent contractors, is facilitated by their requests that customers pay them in cash or accept invoices that underestimate the payment. In addition, those who govern must obey the tax laws. When a country's leadership engages in tax evasion or similar activities, it sends an unmistakable signal that noncompliance is acceptable."

As the incidence of tax evasion and the awareness of its existence increase in a society, a critical mass of support to attack it emerges. The pressure then is not only on the tax evaders but equally on reestablishing the confidence in the tax administration. These may occur at rare moments of catharsis in a country's economic history. It is currently occurring in India. In Italy, recently salaried workers have publicly demonstrated against professionals who escape the tax net. Many such instances may be cited from other country experiences.[5] In India, the impact has been on both individual and corporate income taxpayers, as well as on manufacturers and businesses that have been caught misusing input tax credits against VAT contributions. It is apparent, and hoped, that such matters have taken on an impetus of their own, over and beyond any untoward intervention to obviate it. The tax administration should also face increasing challenges to clean up procedures and instil transparency while, at the same time, ensure taxpayer rights as well as improve revenue productivity.[6]

III. TAX ADMINISTRATION AND TAX EVASION

The efficacy of tax administration defines the prevalence of tax evasion. If a tax administration is viewed as a monopoly firm maximising revenue given a budget constraint, its allocation of resources among competing functions becomes an important determinant for the extent of tax evasion that remains in the system. If resource allocation has been optimised within a tax

[5] Authors such as Richupan (1987), Cowell (1990) and Webley and others (1991) have reviewed these aspects.

[6] There is clearly a silver lining in the clouds. To quote *The Times of India,* November 23, 1996, on the text of a speech by Mr. H.D. Deve Gowda, ex-Prime Minister, on November 22, 1996, to Central Bureau of Investigation officials, "The Prime Minister said collective and determined effort was required on the part of the political, executive, judicial, administrative and legislative wings to deal with the cancer of corruption. 'Standards of probity and rectitude will have to be upheld by all', he added". There seems to be emerging a general atmosphere congenial to a clean up; its full emergence and, subsequently, its sustainability remain important questions. To continue from the same speech, "'Let us touch our conscience, instead of finding fault with each other'" (p.7). Mr. Gowda is no longer at the helm. The new mood is yet to emerge.

administration, then further revenue generation would not be feasible by reallocating resources among assessment, collection and audit functions. In an imperfect world, this never happens and the scope of improvement always remains. If there are reasons to believe that there is collusion between tax administrators and tax evaders, then the scope for improvement is greater.

Resource Availability and Cost Effectiveness of Administration

There is quite a large variance among countries in the amount of resources devoted to tax administration, both as a proportion of GDP and total tax collection. A low share is not necessarily good. For example, collecting mainly from large taxpayers would minimise administration costs. Indeed, there is a general bias among tax administrators to focus on large taxpayers, without adequate monitoring of the increase in the taxpayer net over time. This is not to say that setting up special units to track large taxpayer behaviour is a poor idea; but to ignore the enlargement of the universe of taxpayers consistently, is. Such neglect tends to bypass or vitiate the objective of tax policy which constructs a tax structure to include the widest possible universe of taxpayers. The complacence with which tax administrators often endorse the view that the application of tax laws to the bigger taxpayers should suffice in the (never-ending) shortrun might, therefore, result not only in frustration among tax policy makers but in a cynical affirmation of the saying "tax administration *is* tax policy".

It is noteworthy that the cost of tax administration in India has been generally low compared to many developed countries in proportion to overall revenue collected. For all direct taxes , it has been less than 1.7 per cent of revenue collected. It has been around 0.4 per cent for corporate tax and around 3 per cent for income tax other than corporate tax. Indeed the rate of increase of resource availability to the tax administration has been one of the lowest among government expenditure categories. There clearly seems, therefore, both on cross sectional and trend bases that an increase in resource availability is called for if effectiveness and efficiency are to be improved.

A tax administration may find it less costly to collect those taxes which are easy to collect, say an entry tax such as octroi. Or it may be cost effective to focus mainly on the large urban areas and ignore smaller municipalities or panchayats. Such narrow and selective focus would,

however, sacrifice both neutrality and equity. It is, therefore, important to reaffirm that simply minimising cost of tax administration may not comprise optimal strategy. Ignoring a broader perspective of the universe of taxpayers, therefore, has the seed embedded in it of causing inequities and, consequently, of tax evasion.

Compliance Costs of Taxpayers

A good tax administration should also concern itself with compliance costs of the taxpayer–lost time, stress, visits to the tax office, standing in queues, charges by accountants and lawyers–associated with a given tax payment. In some countries, and especially for particular taxes, these costs can be enormous, rendering it worthwhile for taxpayers to develop strategies to evade them. In India, the general perception and the findings of various field-based research projects, many of which are being carried out at the National Institute of Public Finance and Policy (NIPFP), point in this direction.

Compliance costs are also likely to be high when tax laws get complicated, and this would tend to exacerbate tax evasion. Establishment of large tax departments by corporations that have to depend on tax advisers to meet tax obligations is a clear sign of high compliance costs. The flip side is the likelihood that these advisers also find ways to minimise tax burdens through legal tax avoidance schemes in order to make the entire operation (or department) cost effective. On occasion, they may even resort to tax evasion. In Latin America, prior to reform, often even small enterprises were found to have large tax departments to work through a jungle of tax laws and regulations. In India, this problem has been well recognised and the Minister of Finance saw fit to establish a committee of experts to simplify an otherwise complicated company tax law, and to make its recommendations prior to the 1997-98 budget formulation. The committee submitted its report in early 1997.

Good public relations of a tax administration are certain to reduce compliance costs to taxpayers. The behaviour of tax officials especially at lower levels, the availability of forms, adequate dissemination of information and information campaigns, taxpayer services in terms of assistance in form filling, adequate manpower to ease the pressure of queues especially at tax filing periods, and punctuality in sending refunds are important tenets of good public relations. The Indian tax administration experience may perhaps be faulted on many of these grounds and adequate measures are

urgently needed to address them. Indeed, a successful tax administration is one which is "invisible" while providing all desirable services mentioned above. The more a tax administration makes its existence felt in the daily productive life of a taxpayer–say through search and seizure measures–the less effective it is likely to be in the regular flow of tax compliance. Thus such extraordinary measures should be reserved for very selective occasions.

Role and Forms of Penalties

While tax administration should not be too demonstrative, it should nevertheless, make sure that the law is fully implemented and resist political pressures, if any, to do otherwise. For example, penalties should be fully applied. There are, however, certain caveats that must be kept in mind. First, the levels of penalties should be realistic for, the higher they are, the less likely that they will be applied. For, if they are too high, it is unlikely that an individual will be singled out when many others may be assumed to go free. Second, the penalties must be implemented expeditiously. It is clear that this does not happen in India since, in the absence of independent tax courts, the process of final determination of penalties may and does take years sometimes so that the sting of corrective measures is often lost. Similar has been the case in Italy and Tunisia. Third, the structure of penalties must include the possibility of irrevocable incarceration. In India, jailing for tax evasion has been rare if not nonexistent imparting, until recently, little fear of severe punishment for an offence. The Internal Revenue Service of the United States regularly acts to put tax evaders behind bars, however high their influence may reach. Other reforming countries are following suit. This could be a lesson for India. Fourth, there is indeed a role for innovative forms of penalties to curb evasion. In Argentina, for example, businesses that fail to make timely or correct VAT declarations are closed immediately for three days (see Duran and Gomez-Sabaini, 1994) after the 1990 tax reform. In 1990, 700 taxpayers were penalised this way. In 1992, the number rose to 12,000. Similarly, names of trading houses and businesses whose customs declarations have to be modified by the Customs Department are openly displayed on notice boards in the Department.[7] These methods have had a perceptible deterrent effect on the evasion of indirect taxes.

[7] The third and fourth aspects mentioned here should not be confused with demonstrative measures such as the instrument of search and seizure which is sporadic (albeit carrying with it the quality of briskness). They are policies that should be carried out consistently and with tenacity.

Limitations of Tax Amnesties

Amnesties have been used by developed and developing countries alike in order to clear the books on tax evasion. Yet amnesties may actually encourage tax evasion at least in the long run. They thus have an adverse impact on the equity of the system. Their revenue intake is also typically marginal. To quote Stella (1989): "...while in general it may be correct to impose a reduced penalty on individuals who voluntarily disclose tax evasion, short-lived amnesties of the type most frequently observed in practice are unlikely to generate significant revenue when judged against the potential danger of reducing future tax compliance" (p.i). Specifically analysing Argentina, Colombia, and India in the 1980s, Uchitelle (1989) concludes: "...most of the programs have not led to a widening of the overall tax base, and many have failed to produce even very large one-time revenue gains" (p.53).

Thus, sporadic policies such as tax amnesties and search and seizure methods do not help contain tax evasion meaningfully. It is unfortunate that another tax amnesty was announced in India in the 1997-98 budget, which seems to have become a regular repetitive feature. As in earlier cases, it is unlikely to yield significant revenue or, by itself, to enable the ushering in of a clean slate from which to launch the future.

Policies that are put in place and applied on a consistent basis such as implementing the full extent of the law including jail, closure of businesses, and public posting of names of individuals with malintent, are more effective. Specific tax administration mechanisms such as presumptive taxation for better assessment, tax deduction at source (TDS) for better collection, and computerisation for improved information systems and better coordination, are also available which are often utilised to curb tax evasion. These are examined next.

Presumptive and Minimum Taxes

Many countries attempt to minimise tax evasion by using presumptive taxation methods, for example, by assigning presumptive incomes based on standard of living such as the value or existence of residence and automobiles owned by individual taxpayers. India introduced a scheme in the 1997-98 budget whereby an individual who meets any two of four specific criteria in the previous fiscal year—ownership of immovable

property, automobile, or phone, and having taken a trip abroad—is required to file a tax return. The practicability of the scheme is yet to be tested.

For businesses, value added may be presumed on the basis of sales or floor space used. Similarly, many countries impose a minimum income tax contribution on businesses based on gross assets (Ecuador, Mexico, Peru), turnover (selected Francophone African countries), book profits (India), and alternative income calculations to facilitate and yield a minimum contribution (the United States, Canada and some Nordic countries). Some of these methods are better than the others in terms of promoting efficiency or maintaining equity but all of them have the same objective of minimising tax avoidance and, perhaps, tax evasion. Currently there is a debate in India whether the prevailing Minimum Alternative Tax (MAT), reintroduced in the 1996-97 budget after its removal a few years back, should take any other form such as being based on gross assets, or be removed. The paper by Rajaraman in this volume addresses the issue of presumptive taxation in particular.

Tax Deduction at Source (TDS) or Withholding Taxes

If the 1960s and 1970s firmed up the conceptual basis of taxation in the Haig-Simon tradition, the late 1980s (with continuation in the 1990s) began to question the feasibility and some of the administrative implications of the tax structures that emerged from purist concepts of equity, efficiency and stabilization as objectives. Those objectives based on equal tax treatment of equals (horizontal equity) and unequal treatment of unequals (vertical equity) as well as of neutral treatment of different economic activities, generally led to the basis of global taxation with a progressive rate structure. All sources of income were to be grouped together, that is, globalized, and taxed under the same rate schedule, assuring equity as well as stabilization over the business cycle.

In its implementation, global taxation has to relegate to self-declaration of many sources of income. Even after the tax collection process, auditing turned out to be cumbersome and often infeasible. Slowly, withholding taxes (at source) at low rates began to be introduced. Though not final taxes (whose rates were higher), withholding taxes assured a minimum tax contribution from income sources such as wages and interest.

A further stage has arrived in which withholding taxes are being levied at higher rates and as final taxes, mainly for administrative reasons.

Conceptually correct global taxation seems to have given way to a more administratively feasible means of taxing all major sources of income. The opinion seems to be forming that withholding taxes are able to subject all sources of income—such as wages, interest, dividends and payments to small suppliers—to taxation, at least in a minimum way, while several sources of income are liable to escape taxation altogether, if taxes were applied on a global basis. In that sense withholding, rather than the declarations method (which is more difficult to control), is increasingly seen as being more able to approach the objective of global taxation.

Today there seems to be overwhelming evidence that TDS reduces tax evasion. In the United States, for example, the difference in tax evasion between independent contractors, for whom there is no TDS, and dependent workers who are subject to TDS, is very high. Nevertheless, as a tax administration mechanism, TDS has both advantages as well as disadvantages.[8] Any TDS system, unless it is designed to minimise these inherent flaws, will fail to facilitate tax administration or improve revenue collection ostensibly. Therefore, familiarisation with both advantages and disadvantages of TDS systems is important lest the expected benefits from TDS functions be lost. Among the advantages may be mentioned: (1) the intent of the law is more conveniently fulfilled since the tax flow should parallel income flow more closely than without TDS; (2) since tax is collected prior to receiving income, compliance is improved and enforcement costs are reduced; (3) because of improved cash-flow, government's day-to-day borrowing needs are eased; (4) among those within the TDS net, the tax burden is shared more equitably; and (5) since tax collection responsibility is shared by the collection agents, tax officers can devote more time and resources to other functions of tax administration such as expanding the universe of taxpayers, audit and scrutiny, and so on.

Among the disadvantages may be mentioned: (1) the inequity implied in the inability to capture potentially large taxpayers in the TDS net, and the relatively lower success in withholding tax on certain forms of income such as dividends or professional and self-employment income; (2) for a developing country in particular, the inadequacy of trained tax administrators may be further deepened by the addition of the TDS function needing extra staff, infrastructure and processing particularly to

[8] The discussion on TDS draws upon Shome Parthasarathi, Pawan K. Aggarwal and Kanwarjit Singh, "Evaluation of the System of Tax Deduction at Source in India", New Delhi, National Institute of Public Finance and Policy, 1996. (mimeo)

check bogus tax deduction claims, or short deductions and short payments to the exchequer; (3) the possible excessive burden on the taxpayers in terms of obtaining TDS certificates from deductors, filling additional (and often complicated) tax forms, followed by long waits for refunds; and (4) the burden on deductors implied by the free service of withholding carried out for the tax department even when it may be difficult to obtain the necessary withholding forms and even while they may be subject to two scrutinies (audits) by the tax department: the usual as well as an additional one specifically for TDS.

Despite the above mentioned disadvantages, there exists strong support for TDS because of its ability to mitigate opportunities for non-compliance. In an early paper on the U.S., Vitez (1983) found that, "There is no question but that the withholding and information reporting system operates as a most persuasive stimulant of voluntary compliance" (p.191). More recently, using responses to a questionnaire from 27 U.S. participants, Martinez-Vazquez, Harwood and Larkins (1992) provide experimental evidence to claim that, rather than contributing to tax compliance, "the main role of withholding, besides being an efficient collection device, may be to lessen the opportunities for evasion" (p.168).

Based on a comprehensive survey of the Canadian TDS system, Li (1995) has argued that "withholding should be given a greater role in the Canadian income tax system...(it) is more effective in reducing tax evasion than other enforcement measures because it restricts opportunities for non-compliance...(it) can also improve tax equity and generate additional revenue without requiring the introduction of any new taxes...a broad-based withholding regime would result in additional compliance costs; however, those costs would be greatly outweighed by the benefits" (p. 554). Soos (1990), after a review of several country experiences--Australia, Egypt, Indonesia, Ireland, Japan, Pakistan, the Philippines, United Kingdom, and the United States--concludes that "a carefully structured system for withholding on business income reduces tax evasion by self-employed individuals and promotes other tax policy objectives" (p.109).

The types of income which should be subject to TDS depends on the particular circumstances of a country with respect to: (1) the prevalence of tax evasion; (2) departure from horizontal equity (wage and salary earners paying a higher proportion of income in taxes than the self employed or those earning rent, royalties or interest) and vertical equity (large businesses not being subjected to adequate taxation); (3) the size of potential revenue

from untapped income sources; (4) the extent of small taxpayers who may be tapped for revenue purposes; and (5) the availability of additional infrastructure to the tax administration as well as to the deductors for carrying out the extra responsibilities connected with TDS, or the ability to transform available infrastructure suitably and quickly enough to undertake TDS functions efficiently, for example to ensure accurate deductions and prompt refunds. Section IV of this paper is focussed on the TDS system in India: its current operations and possibilities for improvement.

Computerisation

It is generally agreed now that computerisation is an essential element for the control of tax evasion. As economic activity expands beyond its traditional scope into far-reaching markets across large geographical spaces, the exchange of information becomes increasingly important. This is simply not feasible without comprehensive computer networks. For example, cross controls between the information available to the income tax administration, the customs and excise administration, social security institutions at the central government level, as well as state level tax administrations, can play an important role in checking tax evasion. The assignment of a permanent account number (PAN)[9], to be used in this cross control, is important since it facilitates the use of computers. Tax reform in even some small resource poor countries such as Bangladesh and Sri Lanka has proceeded pari passu with adequate computerisation of the tax administration. By contrast, both the assignment of PAN and the overall computerisation of tax administration in India has been slow despite both the availability of specialised technical assistance as well as adequancy of funds.

IV. THE INDIAN EXPERIENCE

Large scale evasion of taxes in India is a well known phenomenon. To quote Jalan (1996): "Tax evasion is not only a revenue and moral problem. As the potential and propensity for tax evasion vary across sectors, it has pervasive economic effects on demand and supply of various kinds of goods and services, savings and investment. Off-market and unrecorded transactions, outside the legal framework of contracts and regulations, become much more attractive. Savings and investment tend to flow to sectors where evasion is easier and where potential for evaded incomes is high. Similarly, skilled personnel are likely to gravitate towards those occupations and professions where the ratio of incomes that do not have to

[9] Sometimes also called tax identification number (TIN) or other names.

be declared, legally or otherwise, to taxable incomes is high. All these effects of a distorted tax system are visible in India. There is no shortage, for example, of supply of savings for investment in real estate, where tax evasion is rampant and monetary returns are large. On the other hand, the demand for private investment by farmers in irrigation may be strong, but there is no equivalent supply response. The supply of highly trained doctors or teachers for public hospitals or universities is limited, but there is no shortage of doctors in private practice or teachers in private tuition. Similar examples can be found in virtually all sectors of the economy"(pp.60-61).[10] If the middle income class in India comprises about 300 million individuals, with an average household size of six, and under the assumption that there are 1.5 earning members per household, there should be 75 million taxpayers. In fact, possibly there are only about 10 million income tax payers (the taxpayer list is not updated regularly, however). Thus, only a small proportion of the potential universe of income taxpayers could be said to be in the tax net.

In the past, a number of amnesties had been offered to unearth black money. The amnesty schemes with varied characteristics were offered during the years 1951, 1965, 1975, 1980, 1985-87, 1991 and 1997. These amnesties provided taxpayers immunity from interest, penalty, investigation or prosecution in exchange for disclosures of incomes which did not suffer tax. The black economy continues to exist despite these amnesty schemes. Acharya et.al.(1986) estimated the size of the parallel economy at 18 per cent of GNP and income evading tax at 186 per cent and 243 per cent of income assessed to tax in 1975-76 and 1980-81 respectively. The amount of taxes in arrear has been snow-balling from year to year. For direct taxes, it was Rs.9,890 crore, Rs.12,809 crore and Rs. 22,699 crore on 31 March of the years 1993, 1994 and 1995 respectively. These facts indicate the severity of the problem of evasion as also the degree of ineffectiveness of tax administration in enforcing the tax laws.

The taxpayers' perception is that the income tax department (henceforth Department) has little interest in identifying or punishing defaulters. They believe, there is corruption within the Department which is combined with less than satisfactory taxpayer service. On the other hand, compliance by non-salaried taxpayers towards the bottom of the tax brackets is more or less voluntary. Tax evaders are perceived to be roaming around

[10] It could be argued, of course, that the supply of professionals to the private sector is stronger because of higher income earning possibilities, rather than being linked to greater opportunities for tax evasion.

freely after defrauding the nation. The Department has not been able to pay adequate attention to this group of taxpayers. Only about 1 per cent of the taxpayers with declared income assessable to tax not exceeding Rs. 1,20,000 are subject to scrutiny. On the other hand, , not only are refunds delayed, the costs of obtaining refunds from the Department are excessive at least to small taxpayers. At times, the system results in harassment of honest taxpayers, sometimes through frustrating litigation (which may sometimes be intended or motivated). The Department lacks infrastructure for attending to correspondence from taxpayers with expected promptness and efficiency.

It, perhaps, would not be an exaggeration to state that a comprehensive reform of tax administration is overdue. Not only should the Department provide clean and efficient administration, it should be visibly clean and efficient. Only this would boost the image of the Department paving the way to a greater degree of compliance. Various enforcement strategies including taxpayer awareness programmes, an efficient and clean taxpayer service programme, greater reliance on TDS, presumptive and minimum taxes, a comprehensive audit plan covering all categories of taxpayers, an adequate penalty structure combined with computerisation can go a long way in checking non-compliance and financial indiscipline. It is heartening that during the 1997-98 budget deliberations on May 9, 1997, in Parliament, P. Chidambaram, Finance Minister, alerted would-be taxpayers regarding the newly announced voluntary income disclosure (amnesty) scheme, "Behind the velvet glove, there is a firm fist. I will come down very very heavily on tax evaders and go to the extent of launching prosecution" (*The Times of India*, May 10, 1997).

Tax Deduction at Source

TDS has become one of the major tools in the hands of the Department for the purpose of collection of income tax. India attempts to have a very broad coverage under TDS including not only salary and interest but also self employment income from various sources. The scope of TDS has been enlarged, particularly in the late 1980s, and it has continued in the 1990s. TDS is creditable against the final tax liability of resident taxpayers, while it is final in the case of non-resident taxpayers. The scheme applies to company as well as non-company taxpayers, as also to residents and non-residents.

The incomes covered under the scheme of TDS include: salaries, fees for professional or technical services, interest, dividends, rent from real estate, capital gains of non-residents, and commissions from insurance and sale of lottery tickets. The winnings falling in the ambit of the scheme are those from lotteries, crossword puzzles or horse racing. The repurchase value of financial instruments to which the scheme applies relate to units of UTI or mutual funds for which income deduction has been availed of in the year of investment. Similarly, withdrawals from some such other savings schemes like National Savings Scheme are subject to TDS. A brief description of the structure of the scheme is given in Box 1. It indicates incomes covered by TDS, the threshold limits, if any, the dates from which covered and the relevant section of the Income Tax Act 1961.

On the whole, TDS is not only fully operational, but the growing experience with it is also helping to improve the existing systems of assessment, verification and refund. The scope of TDS is likely to increase further. Indeed, it is desirable that it be so. The contribution of TDS in income tax revenue however, has declined in the 1990s even as its coverage has widened. The share of TDS in gross collection of income tax increased from about 23 per cent in 1980-81 to about 37 per cent in 1989-90 and declined subsequently to about 31 per cent in 1994-95 (Table 1). The trends of rise or decline in the shares of TDS in gross and net collections of income tax are found to be similar. The trends in the shares of TDS in gross/net collection of income tax from companies and non-companies have also been found to be similar (Tables 2 & 3).

The system of income tax collection also gives rise to large refunds. The ratio of total refunds to gross (net) collection of income tax has varied between 11 and 22 (13 and 28) per cent (Columns 5, 8, and 9 of Table 1). The refund-to-collection(gross) ratio of companies was found to vary between 14 and 29 per cent whereas for non-companies it did not exceed 14 per cent.

Deficiencies in Implementation

The decline in the share of TDS revenue could partly be due to deficiencies in the operation of the scheme. This suggests that an efficient implementation of an enforcement strategy is necessary to realise its full potential. Therefore, in order for TDS to mature into a revenue productive and equitable system of deduction with broad coverage, a major improvement in its implementation has to be effected. The deficiencies in the operation of TDS include:

Box 1
Structure of Income Tax Deduction at Source in India
(Financial Year 1996-97)

	Nature of payment (Subjected to TDS with effect from)	*Section of Income Tax Act 1961*	*Rate of deduction (per cent) for*			
			Non-companies		*Companies*	
			Residents	*Non-residents*	*Domestic**	*Foreign*
	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1.	Salary and wages (from the beginning)	192	**	**	NA	NA
2.	Interest: (from the beginning)					
	a. On Securities[1]	193	10[2]	20	21.5	55
	b. On other instruments	194A,195	10[2]	20/30[3]	20	20
3.	Dividends	194, 195	20[2]	20	21.5	20
4.	Winnings from lottery and crossword puzzle (1.4.72)	194B	40	40[4]	40[4]	40[4]
5.	Horse Races (1.4.78)	194BB	40[4]	40[4]	40[4]	40[4]
6.	Insurance commission (1.4.73)	194D	10[5]	NA	21.5[5]	NA
7.	Commission on sale of lottery tickets(1.10.91)	194G	10[6]	10[6]	10[6]	10[6]
8.	Rent (1.6.94)	194I	15/20[7]	15/20[7]	20[8]	20[8]
9.	Fees for professional services[9] 1.7.95)	194J	5[10]	NA	5[10]	NA
10.	Fees for technical services[11] (1.7.95)	194J, 195	5[10]	30	5[10]	30/50[12]
11.	Royalty[13]		20	30	21.5	30/50[12]
12.	Income in respect of units of a Mutual Fund specified under Section 10(23D) of:					
	a. Residents (1.7.95)	194K	15[14]	NA	20[14]	NA
	b. Non-residents (1.7.95)	196A	NA	20[15]	NA	20
13.	Income of foreign financial corporations/offshore funds from units (referred to in Section 115AB) purchased in foreign currency (1.10.91) or long term capital gains arising from transfer thereof (1.6.93)	196B	NA	NA	NA	10
14.	Income of a non-resident from bonds/shares (referred to in Section 115AC) purchased in foreign currency (1.6.92) or long term capital gains arising from transfer thereof (1.6.93)	196C	NA	10	NA	10

	Nature of payment (Subjected to TDS with effect from)	*Section of Income Tax Act 1961*	*Rate of deduction (per cent) for*			
			Non-companies		*Companies*	
			Residents	*Non-residents*	*Domestic**	*Foreign*
	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
15.	Income of foreign institutional investor from securities (other than those covered U/S 115AB) (1.6.93)	196D	NA	NA	NA	NA[16]
	a. Short-term capital gains		NA	NA	NA	NA[17]
	b. Long-term capital gains		NA	NA	NA	20
	c. Other					
16.	Income of a non-resident by way of long-term capital gains		NA	20	NA	20
17.	Payment on account of repurchase of units under notified equity linked schemes by Mutual Fund or UTI (Referred to in Section 80CCB) (1.4.91)	194F	20[18]	20[18]	NA	NA
18.	Payment in respect of deposits under National Savings Scheme or deferred Annuity Plan of LIC (Referred to in Section 80CCA(2)(a)) (1.10.91)	194EE	20[19]	NA	NA	NA
19.	Payments (referred to in Section 115BBA) to non-resident sportsmen (not citizens of India) or sports associations (1.11.89)	194E	NA	10	NA	10
20.	Payment to contractors (1.4.72)	194C(1)	1 or 2	NA[20]	1 or 2[20]	NA
21.	Payment to sub-contractors (1.4.72)	194C(2)	1[21]	NA	1[21]	NA
22.	On receipts from the buyer of[22]	206C				
	a. Liquor for human consumption (other		15/10[23]	NA	15/10[23]	NA
	than Indian-made foreign liquor) and tendu leaves		15	NA	15	NA
	b. Timber obtained under a forest lease		5	NA	5	NA
	c. Timber obtained by any mode other than under a forest lease		15	NA	15	NA
	d. Any other forest produce not being timber					
23.	Any other income		20	30	21.5	55

Notes:
* From domestic companies, a surcharge at the rate of 7.5 per cent on the tax computed at the specified rates is also charged.
** Deduction of tax is made as per the applicable rate schedule.
1. These comprise government securities, debentures or other securities issued by or on behalf of any local authority or a corporation established by a Central. State or local Act and any debentures issued by a company, which are listed on a stock exchange in India.
2. Provided the amount payable during the financial year exceeds Rs. 10,000 in the case of banking companies, cooperative societies, Unit Trust of India, specified Mutual Funds and housing finance companies (effective from 1st October, 1996), and Rs, 2,500 in other cases.
3. The 20 per cent rate is applicable to only non-resident Indians provided investment is made in convertible foreign currency.
4. Provided the amount exceeds Rs. 2,500 in the case of horse races and Rs. 5,000 in other cases.
5. Provided the amount exceeds Rs. 5,000.
6. Provided one time payment exceeds Rs. 1,000.
7. Provided the amount payable in a year exceeds Rs. 1,20,000 and is payable by a person other than an individual or a Hindu Undivided Family (HUF). The rate is 15 per cent on rent payable to individuals or HUFs, and 20 per cent on rent payable to others.
8. Provided the amount payable in a year exceeds Rs. 1,20,000 and is payable by a person other than an individual or a Hindu Undivided Family (HUF).
9. Professional services means services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or internal decoration or advertising or such other profession as is identified by the board for the purposes of Section 44 AA or for this Section. According to rule 6F corresponding to Section 44AA(3), the section covers 'film artists' which are defined to include actors, directors, cameramen, etc.
10. Provided the amount payable in a financial year exceeds Rs. 20,000 and is payable by a person other than an individual or HUF.
11. Technical services means managerial, technical or consultancy services.
12. The rate of 50 per cent applies to payments in respect of agreements made before March 31, 1976.
13. Royalty means consideration for (i) imparting with right or information relating to a patent, invention, model, design, secret formula or process or trade mark or similar property; (ii) imparting of information concerning technical, industrial, commercial or scientific knowledge or, experience or skill; (iii) transfer of rights of copyright, literary, artistic or scientific work; and (iv) rendering of services in connection with activities (i) to (iii).
14. Provided the annual payment exceeds Rs. 10,000.
15. In the case of a non-resident Indian or a non-resident HUF, no tax is to be deducted if the units have been acquired out of funds in an NRE account or by remittance of funds in foreign currency.
16. Taxable at the rate of 30 per cent but no tax deduction at source (TDS).
17. Taxable at the rate of 10 per cent but no TDS.
18. Provided the payee is an individual or HUF.
19. Provided the payment in a financial year is likely to exceed Rs. 2,500 and is not made to heirs of the taxpayer.
20. Provided the payment in a financial is likely to exceed Rs. 20,000. In the case of advertising the rate is 1 per cent and otherwise 2 per cent.
21. Provided the payment in a financial year is likely to exceed Rs. 20,000.
22. The tax so deducted has to be paid to the credit of the Central Government within seven days, and issue a certificate of TDS to the buyer within ten days from the date of debit or receipt of the amount. A person collecting tax from such buyers has to file half yearly returns for the period ending on 30th September and 31st March.
23. 10 per cent is applicable with effect from October 1, 1996.

Table 1
Collections of Income Tax and Tax Deduction at Source

Year	Deducted at source (TDS) (Rs.Crore)	Gross collections (Rs.Crore)	Total refund (Rs.Crore)	Net collections (Rs.Crore)	TDS as %age of		Refunds as %age of		
					Gross collections	Net collections	Gross collections	Net collections	TDS
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1980-81	745	3185	368	2817	23.39	26.45	11.55	13.06	49.40
1985-86	898	3889	653	3236	23.09	27.75	16.79	20.18	72.72
1986-87	1496	6829	867	5962	21.91	25.09	12.70	14.54	57.95
1987-88	2276	7703	1078	6625	29.55	34.35	13.99	16.27	47.36
1988-89	2704	9794	1150	8644	27.61	31.28	11.74	13.30	42.53
1989-90	4350	11754	2031	9723	37.01	44.74	17.28	20.89	46.69
1990-91	4083	13463	2773	10690	30.33	38.19	20.60	25.94	67.92
1991-92	5976	17991	3409	14582	33.22	40.98	18.95	23.38	57.04
1992-93	6210	21164	3654	17510	29.34	35.47	17.27	20.87	58.84
1993-94	7283	24566	5387	19179	29.65	37.97	21.93	28.09	73.97
1994-95	9604	30537	4686	25851	31.45	37.15	15.35	18.13	48.79

Source: The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981, 1990 and 1995.

- Certain kinds of payments that both the employers and employees decide not to disclose or disclose as non-taxable reimbursements and perquisites, remain untapped in the operation of TDS.
- Declarations filed for receiving payments of interest, dividends etc. without TDS remain unscrutinised. A sample check in Karnataka revealed substantial revenue potential in scrutiny of such declarations.
- The contribution of tax deductors to non-compliance due to lack of knowledge about the provisions of TDS has not been insignificant.

Table 2
Collections of Income Tax and Tax Deduction at Source from Companies

Year	*Deducted at source (TDS) (Rs.Crore)*	*Gross collections (Rs.Crore)*	*Total refund (Rs.Crore)*	*Net collections (Rs.Crore)*	*TDS as %age of*		*Refunds as %age of*		
					Gross collections	*Net collections*	*Gross collections*	*Net collections*	*TDS*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*
1980-81	NA	NA	NA	NA	NA	NA	NA	NA	NA
1985-86	386	2370	450	1920	16.29	20.10	18.99	23.44	116.58
1986-87	425	3676	531	3145	11.56	13.51	14.45	16.88	124.94
1987-88	830	4137	704	3433	20.06	24.18	17.02	20.51	84.82
1988-89	841	5151	745	4406	16.33	19.09	14.46	16.91	88.59
1989-90	1685	6176	1462	4714	27.28	35.74	23.67	31.01	86.77
1990-91	1500	7275	1945	5330	20.62	28.14	26.74	36.49	129.67
1991-92	2348	10467	2614	7853	22.43	29.90	24.97	33.29	111.33
1992-93	2321	12103	2489	9614	19.18	24.14	20.57	25.89	107.24
1993-94	2772	14106	4046	10060	19.65	27.55	28.68	40.22	145.96
1994-95	3811	17179	3358	13821	22.18	27.57	19.55	24.30	88.11

Source : The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981, 1990 and 1995.

Note: NA: Not available. (The earliest year for which the breakup of tax deducted at source by corporate and non-corporate entities is available is 1985-86.)

- In the context of collection of tax on purchase price of specified goods, the interpretation of purchase price (to be taken as inclusive or exclusive of 'bid money') has created many problems.

- Decentralisation of assessment and TDS jurisdictions in some of the regions have put excessive compliance burden on the deductors because, with decentralisation, they are required to deal with two officers where enquiries overlap.

Table 3

Collections of Income Tax and Tax Deduction at Source from Non-Companies

Year	*Deducted at source (TDS) (Rs.Crore)*	*Gross collections (Rs.Crore)*	*Total refund (Rs.Crore)*	*Net collections (Rs.Crore)*	*TDS as %age of*		*Refunds as %age of*		
					Gross collections	*Net collections*	*Gross collections*	*Net collections*	*TDS*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*
1980-81	NA	NA	NA	NA	NA	NA	NA	NA	NA
1985-86	513	1519	203	1316	33.77	38.98	13.36	15.43	39.57
1986-87	1071	3153	336	2817	33.97	38.02	10.66	11.93	31.37
1987-88	1446	3566	374	3192	40.55	45.30	10.49	11.72	25.86
1988-89	1863	4643	405	4238	40.12	43.96	8.72	9.56	21.74
1989-90	2666	5578	569	5009	47.79	53.22	10.20	11.36	21.34
1990-91	2583	6188	828	5360	41.74	48.19	13.38	15.45	32.06
1991-92	3628	7524	795	6729	48.22	53.92	10.57	11.81	21.91
1992-93	3888	9061	1165	7896	42.91	49.24	12.86	14.75	29.96
1993-94	4510	10460	1341	9119	43.12	49.46	12.82	14.71	29.73
1994-95	5793	13358	1328	12030	43.37	48.15	9.94	11.04	22.92

Source: The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981, 1990 and 1995.

Note: NA: Not available. (The earliest year for which the breakup of tax deducted at source by corporate and non-corporate entities is available is 1985-86.)

- There is no comprehensive system for identifying non-filers from amongst those who are not on the Department's register, as also from those on the register.
- Also, there is no system of preparing a comprehensive list of potential deductors. There is a significant gap between the number of tax deductors on the register and the tax deductors who actually file the annual returns.
- Many of the Central and State government offices, local authorities, autonomous bodies and other institutions do not file any annual

returns. Since the persons responsible are also Central or State government employees, the remedial action taken is at best lukewarm.

- There is a lack of an efficient system for monitoring payment of TDS. Verification of TDS with that paid to the government account is done entirely on the basis of copies of challans furnished by the tax deductors.

- Checking the correctness of calculations in the tax returns is carried out only on a selective basis. Sample exercises done in Delhi and Karnataka indicated significant potential for raising additional revenue through proper checking of annual returns.

- Low priority is assigned to the work of TDS. For internal management, the Central Board of Direct Taxes (henceforth Board) calls for quarterly reports of TDS as against monthly reports in the case of assessments and arrear reductions. Further, there is no requirement for indicating the number of tax payers covered in the statements.

- Efforts at educating the tax deductors with a view to improving compliance with the provisions of TDS were reported only in Mumbai. More educational programmes are, therefore, needed.

- Vital information is omitted in the statements filed by deductors. Permanent Account Numbers (PANs) of some of the persons from whom tax has been deducted at source are not reported in the TDS returns, partly due to delay in allotting PANs.

- Ensuring changes in the legal and procedural requirements to ensure efficiency in issuing refunds is an important pre-requisite for efficient operation of the scheme of TDS.

- There is a lack of computerisation. The work of monitoring TDS is being done more or less manually except in Karnataka. Tax accounting (challan processing) or cross-verification have not been fully computerised either (see below for further details).

With these improvements, TDS is likely to become an even more important instrument in the hands of the Department for influencing compliance with the tax laws. An improvement in implementation of TDS can result in further increase in (i) its share in total collection of income tax, and (ii) total collection of income tax itself. However, the Indian experience illustrates that TDS as an enforcement strategy is helpful only where

income is identifiable at its origin. Where income is not easily identifiable at its origin, other enforcement strategies such as minimum and presumptive taxes would need to be deployed.

Extending the Coverage of TDS

There is room for enlarging the scope of TDS. But this should be done only after the pre-conditions such as setting an efficient refund system and an adequate infrastructure for cross-verification of TDS claims are satisfied. After that, TDS could be extended to activities in which black money is invested or to some other activities which can be easily tapped. Some of the activities which could be considered for this purpose are transfer of property and transactions of shares.

Compensation for Cost of Compliance

Dependence on the deductors has been on the rise due to resource constraints in the Department. In order to encourage deductors to provide necessary support to facilitate the work of the Department, it would be desirable to pay them a nominal fee for their services. It could be fixed as a small fraction of TDS. Alternatively, the deductors may be allowed to retain the tax deducted/collected for a longer period (say about a month) before depositing it to the government account. This will also provide some operational flexibility to the deductors in complying with their obligations regarding the tax laws.

Computerisation

The state of computerisation in the Department is unsatisfactory though it embarked upon computerisation in 1985. Out of 36 computer centres which were to be developed all over the country, 35 were made operational by 1988 and the last became operational in 1990. The systems installed at these computer centres could handle only two applications: tax accounting (challan processing) and allotment of PAN that too in batch mode rather than on-line. Even these applications could not be carried out efficiently due to lack of adequate skilled manpower. To a large extent, verification of tax credit claims has been done on the basis of copies of challans (which could be misused) provided by taxpayers instead of computer based statements emerging from processing of challans on computers. This has been so, because of delays in preparing such statements and sending them to the concerned officers. After the introduction of a decentralised system

of allotment of PANs, some taxpayers were able to obtain more than one PAN making detection of their defaults difficult. This indicated the need for a comprehensive computerisation plan combined with a centralised system of allotment of PANs.

Recently, the Department has initiated a comprehensive overall computerisation plan with a view to augment the possibility of providing an efficient and clean tax administration. The applications planned to be run on the computer cover all areas of the Department. These include:

a. PAN allotment system (PAN)
b. Assessee information system (AIS)
c. Tax accounting system (TAS)
d. Assessment information system (AST)
e. Tax deduction at source information system (TDS)
f. Individual running ledger account system (IRLA)
g. Enforcement information system (EFS)
h. Resource management system (RMS)
i. Management information system (MIS)
j. Judicial reference system (JRS)

The regions as well as applications are scheduled to be covered under the comprehensive plan in phases. In phase-I, the Chief Commissionerates of Chennai, Delhi and Mumbai are covered. The regional computer centres at Chennai and Delhi were made operational in January 1995 and at Mumbai in February 1995. The main focus of these computer centres has been on allotment of new PANs and developing assessee information systems which are vital for efficient tax administration. Allotment of PANs has been centralised for better monitoring of taxpayers, but the process has been slow. Other computer applications are at nascent stages of development. Comprehensive computerisation at the remaining 33 centres would be undertaken in phase-II only after all applications are installed and stabilised at the above mentioned three centres. Only then would systems configurations for the remaining centres begin.

At the remaining 33 centres, therefore, until a comprehensive plan of computerisation is implemented, each Chief Commissioner could be encouraged to modernise the existing system by utilising locally available resources to implement TDS functions as has been done at Bangalore. In Bangalore, a substantial degree of efficiency has been achieved in the operation of TDS through local efforts at computerisation. Budgetary

support could be extended promptly as it is bound to be translated into greater revenue gains even in the short run. Some norms regarding the nature of hardware and software to be utilised to ensure compatibility at the all India level could be issued by the Board.

Concluding Remarks

Tax evasion is a complex phenomenon; it is old and pervasive, afflicting various economic activities and both developing as well as developed economies. Many tax administration instruments have been employed over the years in a cross-section of countries to combat tax evasion, with varying degrees of success. These instruments may be specific and short run in scope, such as amnesties or search and seizures, or may comprise long run collection mechanisms such as tax deduction at source or presumptive taxation. Long run instruments are better employed to obviate tax evasion.

There needs to be formulated and implemented a comprehensive strategy against tax evasion if there is to be success in containing it. Such strategies should include the full application of legal penalties rather than the mere employment of search and seizure methods. Indeed, ephemeral, sporadic or sudden actions simply tend to impinge on taxpayer rights, through encroachment on private property and, occasionally, even physical ill-treatment of the tax payer. This leads to the growth of organised resistance by tax payers. Instead, meaningful, sustained instruments comprising a determined strategy to control tax evasion have to be installed from the collection to the penalty stage, while fully preserving taxpayer rights, yet obviating political intervention to protect particular individuals or institutions.

In India, there is scope to improve tax compliance through proper implementation of enforcement strategies, beginning from the collection stage such as tax deduction at source combined with a suitable penalty structure. Regarding penalities, the process of sanctioning penalties should be expedited. Serious offences should be subject to severe punishment such as jailing the defaulters. Penalties in the form of closure of businesses for a few days, intended to impart decisive action against the defaulters—found successful in Argentina—should be attempted in India to discourage non-compliance.

Focussing on the instrument of TDS in India, this paper noted that its scope has expanded considerably through the 1980s and 1990s and that

there is room for further expansion especially for activities which are likely to generate black money. However, such expansion should be carried out only after various improvements are made in cross-verification, in the refunds systems and in computerisation. Now, despite the installation of some computer systems, much of TDS functions are being carried out manually for lack of adequate infrastructure and skilled manpower. Perhaps this is one reason why the share of TDS in overall income tax revenue has declined in recent years. It also indicates an increased incidence of refunds, in turn reflecting the urgent need for a well designed enforcement strategy. Within this strategy, however, two aspects must be safeguarded. First, the role of the tax deductor, performing a free service for the Department, should be more clearly spelled out especially in terms of an adequate compensation. And, second, taxpayer rights should be fully protected.

References

Acharya, Shankar N., and others (1986), *Aspects of the Black Economy in India*, National Institute of Public Finance and Policy, New Delhi.

Aguirre, C.A. and P. Shome (1988), "Mexican Value-Added Tax: Methodology for Calculating the Base", *National Tax Journal.*

Allingham, M.G., and A. Sandmo (1972), "Income Tax Evasion: A Theoretical Analysis", *Journal of Public Economics,* Vol.1, No.3/4.

Bird, Richard M. and Milka Casanegra de Jantscher (eds.) (1992), *Improving Tax Administration In Developing Countries*, International Monetary Fund, Washington, D.C.

Cowell, Frank A. (1990), *Cheating the Government: The Economics of Evasion,* Cambridge: MIT Press.

Duran, Mana, and Juan C. Gomez-Sabaini (1994), "Lecciones sobre Reformas Fiscales en Anntina: 1990-93", paper presented at the sixth Comision Economica para Aerica Latina y el Caribe (CEPAI) seminar, Santiago, Chile, January.

Jalan, Bimal (1996), *India's Economic Policy : Preparing for the Twenty-first Century*, Viking Penguin India, New Delhi.

Li, Jinyan (1995), "Withholding Tax on Domestic Interest and Dividends", *Canadian Tax Journal*, Canadian Tax Foundation, Vol.43, No.3.

Martinez-Vazquez, Jorge., Gordon B. Harwood and Earnest R. Larkins (1992), "Withholding Position and Income Tax Compliance: Some Experimental Evidence", *Public Finance Quarterly,* Vol.20, No.2.

Musgrave, Richard (1959), *The Theory of Public Finance : A Study in Public Economy*, McGraw-Hill, New York.

Richupan, S. (1987), "Determinants of Income Tax Evasion: Role of Tax Rates, Shape of Tax Schedule, and Other Factors", in *Supply-Side Tax Policy: Its Relevance to Developing Countries*, ed. by Ved P. Gandhi, International Monetary Fund, Washington, D.C.

Shome, Parthasarathi (1995), "Recent Tax Policy Trends and Issues in Latin America" in *Policies for Growth: The Latin American Experience,* ed. by Andre Lara Resende, International Monetary Fund, Washington, D.C.

_______, et. al. (1995), *Comprehensive Tax Reform: The Colombian Experience,* Occasional Paper No. 123 (edited), International Monetary Fund, Washington, D.C.

Soos, Piroska (1990), "Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues", *University of California, Davis Law Review,* U.S.A., Vol.24, No.1.

Stella, Peter (1989), "An Economic Analysis of Tax Amnesties", *IMF Working Paper No. 89/42,* International Monetary Fund, Washington, D.C.

Tanzi, Vito (1983), "The Underground Economy in the United States: Annual Estimates, 1930-80", *IMF Staff Papers,* International Monetary Fund, Vol.30.

______ and Parthasarathi Shome (1992), ""The Role of Taxation in the Development of East Asian Economies", Chapter 2 in *The Political Economy of Tax Reform,* ed. by Takatoshi Ito and Anne O. Krueger, University of Chicago Press, Chicago.

______ and Parthasarathi Shome (1993), "A Primer on Tax Evasion", *IMF Staff Papers,* Vol.40, No.4, International Monetary Fund, Washington, D.C., December.

Uchitelle, Elliott (1989), "The Effectiveness of Tax Amnesty Programs in Selected Countries", *Quarterly Review,* Federal Reserve Bank of New York, Vol.14.

Vitez, Thomas G. (1983), "Information Reporting and Withholding as Stimulants of Voluntary Compliance", *Income Tax Compliance: A Report of the ABA Section of Taxation Invitational Conference on Income Tax Compliance,* American Bar Association, USA.

Webley, P., and others (1991), *Tax Evasion: An Experimental Approach,* Cambridge University Press, Cambridge.

11

Presumptive Taxation and Governance

Indira Rajaraman

I. Introduction

What is presumptive taxation? It is important that the perimeters of the presumptive label be established right at the outset for two reasons. One is that in the public mind the flat tax of Rs.1400 introduced in 1992 and withdrawn in 1997 is (mistakenly) taken to be synonymous with presumptive taxation. The second is that there is in existence a widely-circulated proposal for estimating the taxable income of individuals on the basis of consumption indices, also termed a presumptive scheme. The poor revenue yield from the Rs. 1400 flat tax tarred the label that it (wrongly) carried with the brush of revenue insignificance, and regressivity, since it pursued the small when the big so demonstrably continued to evade the tax net. The second has wrongly transferred to the label the fear of capricious application that the particular scheme proposed invites. Both have served to marginalise presumptive approaches when, in fact, these could play a central role in the reform of economic policy and governance, and would make the tax system more rather than less equitable.

The author thanks Mr. V.K. Bhatia, Mr. K.D. Gupta and Mr. T.R. Satish Chandran for very valuable suggestions, data and information; Miss Deepa Sankar for assistance with literature review; and Mrs. Promila Rajvanshi for secretarial assistance. The paper incorporates material from previous published work by the author.

Presumption is an alternative to taxation based on self-declaration. There are three features that distinguish presumptive approaches:

1. Assessment of taxability independently of self-declaration.

2. The identification of objectively measurable indicators specific to each sector or economic activity and the use of these to establish not

merely taxability, but also the taxable income generated per unit of the chosen indicator/s.

3. The need for robust survey-based norms linking taxable income to these observed indicators.

It can be seen that neither the flat Rs. 1400 tax nor the consumption indicator-based scheme satisfies these three criteria. Later sections of this paper will cover these schemes in greater detail, in particular the revenue failure of the first, and the reasons why consumption-based presumption could be damagingly inequitable.

Presumption need by no means be confined to direct taxation. Because of the immense possibilities it offers in terms of simplification of assessment and consequent reduction of harassment, it is actually used (optionally) in some states for the (first-point) sales tax; an example is the 1993 amendment of the Haryana General Sales Tax Act to permit taxation of brick output on the basis of kiln capacity.[1] This paper will however concentrate on direct taxation because indirect taxation in the country is already under review for the possible introduction of a destination-based VAT, and because the use of presumption in the context of a VAT is an administrative matter deserving of separate examination.[2]

Why is presumption a governance issue? Without making any attempt to define good governance, which could draw one into considerations of whether this can at all be objectively established independently of the perceptions of the governed, it certainly seems possible to identify those features that make governance in developing countries like India especially difficult:

1. Governments exist in a state of what may be defined as chronic revenue-hunger, deriving from the need to provide infrastructure, public goods and social safety nets, not all of which can be effectively privatised.

[1] The Union Budget 1997 has announced a proposal to amend excise legislation whereby excise may be levied on production capacity in place of underreported production actuals as a means of curbing evasion.

[2] See also Ahmad-Stern, 1984, for an excellent treatment of possibilities of welfare-improving indirect tax reform for India.

2. Even where a banking system exists in the sense of an intermediary between the depositor and the ultimate lender, most transactions are not routed through the banking system. This removes the only possible information base for the verification and monitoring of economic activity, except in certain limited sectors of the economy.

3. Tax compliance is impossible to enforce in the absence of an information base for cross-checking of self-declaration.

Whole sectors of the economy function perfectly well within the cash system, even those requiring large payments, such as the construction sector, the movie industry, or jewellery manufacturing. Even if the threat of taxation were to be withdrawn altogether, which removes the cost of engaging with the banking system, the non-intermediated sector is likely to stay out until institutional reforms and competition in the financial sector lower the transaction costs of the banking system as it presently functions.

The difficulties of enforcing compliance in the presence of revenue-hunger gives rise to the following:

1. A narrow tax base, defined by the perimeters of information availability.

2. A deepening of the tax burden on the narrow tax base, driven by revenue-hunger but justified most often by appeals to the need for progressivity in the rate structure.

3. Avoidance-seeking by sectors trapped and subjected to high rates within the net, resulting in large numbers of exemptions and general legislative complexity.

4. Taxpayer harassment resulting from the attempt to fulfil revenue collection targets in the face of base erosion through both legal avoidance and illegal evasion.

5. A dependence on revenues through easily available avenues, even those known to be distortionary, such as checkpoint levies on movement of goods within the country.[3]

[3] These still contribute 3-4% of the tax revenues collected by the states.

The fiscal reform begun with the implementation of the recommendations of the Chelliah Tax Reforms Committee has made many strides towards disentangling the complex of conditions listed above.

The process of reducing tax rates and flattening the rate structure of the personal income tax, already begun in the mid-seventies, has been carried further; the maximum marginal rate after Union Budget 1997 is 30%, as compared to 85% in the early seventies with an additional surcharge. The corporate tax rate on domestic companies at 35% is higher than the maximum marginal rate on individual incomes after the latest round of rate cuts, but taxation of dividends in the hands of shareholders has been eliminated at the same time.[4]

However the tax base has yet to be substantially widened. The total number of assessees on the rolls, aggregating across individuals and corporations, and including also those paying the flat tax of Rs 1400, is 12.2 million, in a population of over 930 million. Out of this, the number of "ineffective" assessees is estimated at 1.6 million, leaving 10.6 million effective assessees. Out of this, the number actually filing income tax returns in 1995-96 (including returns pertaining to past years) was 8.1 million.

This figure does not include those with tax deducted at source (TDS) who do not file a return. There are no estimates readily available of the numbers covered through the TDS channel, nor needless to add, of the breakdown of these into those also filing returns and those not filing (this is necessary since all withholding in India is provisional, not final). Thus to say "less than 1% of our total population pays personal income tax" is a trifle misleading, since the total number paying income tax aggregated across TDS and those filing returns is not known. This number when it is known must be related not to the total population but to the total labour force, and in the case of India, to that subset of the labour force in non-agricultural occupations, a figure of 115 million,[5] since taxation of agriculture under the Constitutional allocation of fiscal authority rests with

[4] There is however an additional tax on corporate entities at 10% on distributed profits.

[5] Obtained by application of the non-agricultural share of main workers, 33.08% as estimated in the 1991 Census, to labour force projections of the Eighth Five-Year Plan (347 million as on 1 April 1996).

the states.[6]

A major attempt at base-broadening was made in Union Budget 1995, with the introduction of TDS provisions on payments for professional and technical services including transport and advertisement contracts, and with the resurrection of some others.[7] However, the bulk of the rise in the share of direct taxes from 2% of GDP in 1990-91 to 3% occurred prior to this base-broadening thrust (see table 1). It is commonly attributed to improved administration of pre-existing TDS provisions,[8] although this attribution is not supported by the figures, since TDS collections as a percentage of total collections gross of refunds has held steady in the neighbourhood of 30% since 1987-88.[9]

The rise in direct tax collections from 1991 to 1995 is more likely to be a result of the few attempts that have been made to limit exemptions.[10]

---

[6] When the income tax was first introduced in British India, agricultural incomes were not exempt. The income tax was then withdrawn, and when reimposed permanently in 1886 did exempt agriculture (Ahmed-Stern, 1991:16). Although agricultural properties were subject to the wealth tax levied by the Central Government from 1.4.1970 until 1.4.1981, this was in practice paid only by the small number of taxpayers that paid income/wealth taxes on non-agricultural income or property. Land is reported to have been valued at ten times the Product Index Unit, a rough measure of normal production per acre by quality (Ahmed-Stern, 1991:254), but if true this would have been merely a convention without any legislative backing.

[7] TDS on interest payments by banks introduced in 1991 and withdrawn in 1992.

[8] Responsibility for collection of non-salary TDS was concentrated under one head, and separated from the work of assessment of filed returns. Such separation of responsibility had been in place all along for TDS on salaries.

[9] A jump from 22% in 1986-87, before the reorganisation described in the preceding footnote.

[10] The more important among these include:

- Sections 71 and 74/1991 : Denial of set-off of capital loss against any other income.
- Sections 23 and 24/1992 : (i) Withdrawal of deduction from house property income in respect of new residential units; (ii) Denial of set-off of negative income from house property against other incomes.
- Section 64/1992 : Provision for clubbing of minor's income with the income of the guardian.

The following exemption removals would not have contributed towards revenue increases prior to 1995:

contd...

This gives some idea of the revenue gains possible with a more frontal attack on exemptions, even with no further expansion in the tax base. Exemptions can however prove to be adhesive. Presumptive approaches can play an important role here, as a substitute for the politically difficult task of removing exemptions. Presumptive asset-based minimum taxes on the corporate sector for example have proved particularly effective in the developing world as an alternative (hence, minimum alternative taxes, or MATs) to direct assaults on avoidance through elimination of exemptions, or on evasion through closer ex-ante monitoring or ex-post raids. A presumptive MAT does not eliminate corporate tax avoidance or evasion altogether, but caps the advantage from such practices by placing a floor on tax payable.

Table 1

Central Tax Collections (Gross/GDP %)

Year	*Income tax*	*Corporate tax*	*Direct taxes*	*Customs*	*Excise*	*Indirect taxes*	*Total*
1990-91	1.00	1.00	**2.06**	3.85	4.54	**8.69**	**10.75**
1991-92	1.09	1.27	**2.49**	3.61	4.54	**8.43**	**10.92**
1992-93	1.12	1.26	**2.57**	3.37	4.33	**8.01**	**10.58**
1993-94	1.14	1.26	**2.53**	2.77	3.96	**6.92**	**9.46**
1994-95	1.27	1.46	**2.94**	2.83	3.96	**7.03**	**9.97**
1995-96	1.42	1.51	**3.05**	3.25	3.73	**7.00**	**10.05**

Source: *Indian Public Finance Statistics 1995* and NIPFP, 1996 upto 1993-94; CBDT for 1994-95 and 1995-96. The 1995-96 figure for indirect taxes is provisional. Actuals for 1996-97 were not available at the time of writing.

Notes: These figures are gross in the sense of collections before distributing states' shares, but net of refunds.

[10] *contd...*

- Section 10(15A)/1995 : Restriction of income-tax exemption on payments made by Indian companies for acquiring aircrafts on lease from abroad, to the amount of lease rent only.
- Section 40A(3)/1995 : Disallowance in respect of cash payments above Rs. 10,000, to be restricted to 20 per cent of such payments.

However a number of new exemptions have been introduced at the same time, such as Section 35(1)/1991 granting 100% deductions in respect of contributions to educational institutions; Section 80G/1991 granting 50% deductions on donations to the Rajiv Gandhi Foundation; and many others.

A proposal for a presumptive asset-based corporate MAT for India, based on the experience of other countries which have implemented such a tax, has been detailed elsewhere and will not be repeated here (Rajaraman-Koshy, 1996). A presumptive MAT has never been tried in India. What has been tried before, and was reintroduced in the Union Budget of 1996, is a minimum tax on corporate book profits (termed a MAT, but not asset-based). As a tax on declared profits, there is no element of presumption in this levy. An asset-based levy by contrast involves presumption of income generation from the asset base. A presumptive levy is in that sense quite distinct from a property tax which is a levy on ownership of wealth independent of the income generated therefrom. As the experience with MAT96 shows, any levy minimum or otherwise on declared income immediately generates incentives to minimise that income. Many companies have turned to using the accelerated depreciation provisions under Income Tax Law instead of the depreciation rates under Company Law for computation of book profits. It is expected that markets will adjust quite easily to looking at cash profits rather than book profits when assessing corporate performance. The revenue gain from a presumptive MAT would have been more robust.[11]

Exemption removal or by-passing through a MAT in sectors like the corporate sector already within the tax net does nothing towards extending the net to cover presently untaxed sectors. Although expanding TDS provisions is very definitely a necessary component of this, provisional withholding does carry the administrative burden of processing refund applications. The revenue contribution of TDS to gross direct tax collections was 31.5% in 1994-95, but at the same time refunds that year amounted to as much as 15.4% of gross collections. These refunds are not attributable entirely, or possibly even largely, to TDS. But they give some idea of the extent of revenue-unproductive processing with respect even to the small number of filed returns. It is in this context that there is a need to use all available mechanisms for enlarging the income tax base.

This paper will focus on presumption as a way by which to expand the direct tax base in untaxed sectors of the economy. Even after the growth

[11] The yield from MAT96 has not been insignificant, however, at an estimated Rs. 2,500 crores (0.2% of GDP); the yield from an asset-based MAT on the other hand would have been nearer 1% of GDP (see Rajaraman-Koshy, 1996:1949).

in the post-1991 period of 1% in direct tax collections at the Centre as a percentage of GDP, the present figure of 3.0% of GDP is much lower than the Burgess-Stern average of 5.5% for all developing countries, based on IMF data for 1989. Tax reforms in many developing countries have improved the direct tax/GDP ratio still further, so that the present day average would be higher still. Unless steps are taken very urgently to confront the information problem in presently untaxed sectors of the economy, there will be no equitable way by which to increase the tax/GDP ratio to levels prevalent in other countries in the developing world. As can be seen from table 1, the ratio to GDP of indirect tax revenues from customs and excise has fallen by more than the improvement on the direct tax front so that overall, the ratio of Central tax revenues to GDP has fallen by three-fourths of one per cent.

Section II examines issues that arise in the identification of presumptive norms and indicators. The section endorses the use of production indicators, and argues against the use of consumption indicators. The section also outlines the nature of the spadework that is required if presumption is to be used for the expansion of the tax base in services, small business and agriculture.

Section III examines the (now withdrawn) Rs. 1400 flat tax, and the lessons to be drawn from its revenue failure.

Section IV examines such data as are presently available for a quantification of the shortfall in taxation of income from services.

Section V examines the history of the failure to tax agricultural incomes, in particular the non-acceptance of the Raj Committee's Agricultural Holdings Tax, a presumptive scheme proposed more than 25 years ago. The issue of the level of governance at which an agricultural tax is ideally levied is also examined in this section.

Finally, section VI examines the all-important issue of whether presumption is a second-best option in the presence of an information constraint; or whether it could be a first-best option even in the absence of an information constraint.

Section VII presents conclusions.

II. Presumptive Indicators And Norms

A first requirement before presumptive taxation can be contemplated is supportive legislation, whereby survey-based occupation-specific presumptive indicators and norms can be used as benchmarks, independently of or as a corrective to self-declaration. Under the present legislative framework, income tax administrators find themselves unable to use any external benchmarks in assessment of filed returns, because of the ease with which the use of these can be legally challenged. A Committee of Experts set up to rationalise and simplify income tax legislation makes no recommendations in respect of presumption other than a standard deduction for self-employed professionals with gross receipts under 10 lakhs to cover expenses and depreciation (Ministry of Finance, 1997:24). It is important to emphasise that the use of presumption does not involve any departure from the principle of taxation according to ability to pay. In the words of one expert, "The essence of the presumptive method is to assume that taxable income is related in relatively fixed ways to some factor (or factors) which can be more easily verified than income itself" (Bird 1970:89). The shift is not one of principle, but one of the basis of measurement.

a. Production Indicators

Production indicators consist of one or a few key inputs indicative of the scale of activity of the taxable entity. Presumptive norms establish the link between tax liability and observable entity-specific indicators. Credible presumptive norms require that indicators be chosen specific to each sector or occupation, and that the norms themselves be established on survey or other objective evidence. A levy that is not arrived at on some such objective basis does not earn the presumptive label.[12]

The type of indicator selected determines the form of presumption chosen. There are three possibilities:

i. ***Estimation, based on flow indicators:*** One class of indicators consists of measures of entity-specific flows at either the output or input ends of the

[12] For example, the presumptive schemes in Francophone Africa are judged to have failed because of an insufficient basis of prior sectoral study (Baldet, 1991: 26).

activity. This approach retains actual activity as the basis for taxation, and departs from conventional income taxation only in that actual income is estimated independently of self-declaration.

ii. *Capacity-based presumption, based on stock indicators*: A second class of indicators consists of stock measures of income-generating capacity, in terms of what is possible with average or normal effort rather than as a frontier, without any reference whatever to actual current flows. The indicator may be either the aggregate asset-base of the enterprise measured in financial terms, or a physical measure of one or a few key assets indicative of scale of operation. Where the asset-base is embodied human capital as in the case of self-employed professionals, the indicator could be some proxy measure such as type and level of formal qualification, in conjunction perhaps with years of professional experience. Or it could be a physical index like the floor area of consulting premises, if this is established by means of occupation-specific surveys to be a robust indicator of income generated.

iii. *Flat presumption:* A third type of presumption, where no entity-specific information of either the flow or stock varieties can be accessed, is based on an income average across enterprises. This type of flat presumption results in a uniform levy per enterprise. What distinguishes this from a licence or other such flat fee and qualifies it for the 'presumptive' label is that there should be an explicit underlying exercise based on survey or other evidence establishing average taxable income for the activity in question.

The terms presumption and presumptive norms will be used quite generally in this paper to cover all three. In the case of capacity-based or flat presumption, any levy specified in absolute terms must be indexed to inflation.

Criteria that come into play in the selection of indicator are ease of observation; difficulty of concealment, falsification, or substitution; and stability in relation to income. The same indicator may be more easily amenable to concealment and therefore less suitable for some occupations than for others. It is necessary therefore to select indicators on an occupation-specific basis, but it is possible nevertheless to list some properties of quite general validity.

- *Prevention of avoidance/evasion:* In general, the class of stock indicators used for capacity based presumption carries lower substitution and concealment possibilities than flow indicators, although this may be more true of immoveable assets like land than moveable assets like livestock (Bird, 1970: 90). Some flow indicators like electricity and water consumption also carry low substitution possibilities, and may be easily observed if information routinely collected for other purposes, such as utility billing, can be easily transferred for use by the tax administration (although there always remains the possibility of usage of these inputs through unmetered channels).

Within the class of flow indicators, turnover is in general more easily concealed (Ahmed-Stern, 1991: 277), than inputs.[13] Within the class of inputs, the indicators chosen must not bias factor or input choice. The most pernicious estimation indicator to use, especially in labour-abundant developing countries, is labour usage, which invites a change in labour contracts away from direct employment.[14]

- *Physical or value specification of indicator:* In the class of asset indicators, valuation is unavoidable where presumption is based on total assets, but where a single asset like land is used, specification in physical terms avoids valuation problems. Schemes of the sort suggested by Allais, 1977, for expropriable self-declaration are ingenious,[15] but hard to administer.

[13] This is why in the French occupation and region-specific norms, issued in what are called "monographies", coefficients are provided for generating turnover from input usage; no attempt is made to measure turnover directly.

[14] In the earlier Israeli system of occupation-specific tachshivim, the tachshiv for small-scale shoe manufacturers for example, which was based initially upon the number of cobblers employed, meant that work in-house was discontinued and contracted out instead to former employees; the tax base was subsequently modified.

[15] Checks are introduced by making public the declared values by type of asset and location, without reference to the individual making the declaration; with a provision that any asset on the published list could be purchased by the tax administration at 140% of the declared price, and by any member of the public at 150% of the declared price. The taxpayer has the option not to sell the asset by paying 5% of the declared value to the tax administration, and an additional 5% in case the purchase offer is from a member of the public, to the person making the offer (Allais, 1977, as reported in Sadka-Tanzi, 1993: 67).

- *Asset ownership or asset operation:* Asset ownership as a base of presumptive taxation places the burden of tax liability upon the owner. This would be shiftable in an asset-leasing transaction in accordance with elasticity parameters. If the price elasticity of supply of leased land is lower than that of demand, as is plausible, the levy will be largely borne by the supplier, and the equilibrium quantum leased will decline. Presumption based on asset ownership is likely therefore in the presence of the assumed elasticity configuration to be detrimental to leasing, which in the case of agricultural land may be an objective independently desired; most reported cases of presumptive taxation especially as applied to agriculture are based on ownership.[16] In general, however, the choice of asset operation (or occupancy in the case of housing) rather than ownership as the tax indicator will be more neutral in its impact on leasing and factor flows, and is preferable for that reason.[17]

b. Consumption Indicators

It is always better to base presumption on production indicators rather than consumption indicators. Consumption patterns are not sufficiently uniform or stable that one or a few non-concealable items of consumption can be related to total income in a way that is presumptive rather than capricious. Even in the Israeli tax system which uses an eclectic mix of all possible indicators to establish tax liability, the use of consumption indicators was minimised because they involved "so many conjectures as to become almost wholly unreliable as independent support for an assessment of income" (Wilkenfeld, 1973: 154).

It must be mentioned that in France there is a provision for assessing taxability based on external signs of wealth (Rajaraman-Singh:Chap. IV), as a supplement to the conventional income tax based on self-declaration, rather than as a replacement. Under this provision, income can be imputed independently of self-declaration on the basis of fixed factors for ownership of consumer durables like cars, yachts and private aircraft; ownership of race horses; other indicators of ability to pay such as expenditure on hunting

[16] The Raj Committee recommended operated acreage as the base for an agricultural tax, whereas the revised Bagchi scheme recommended owned land (see section V).

[17] See also Bird, 1970:95, for recommendation of operation over ownership.

rights or on resident domestic servants; and on the rental value of principal and secondary residences. These income factors are treated as independent and additive, and if there is a minimum of 5 elements yielding a sum greater than a stipulated absolute threshold for two consecutive years and is 1/3 more than reported income, a tax may be levied on the basis of 'External Signs of Wealth'.

Any tax based like the French system on ownership of consumer durables or rental values of housing is bound to fail in India, where benami ownership of real estate, vehicles and so forth is the rule rather than the exception, and where property values are already seriously underestimated because of property taxation. The proposal by Sathe, 1996, for consumption-based presumption suggests four possible types of consumption indicators: domestic electricity consumption and ownership of telephones, cars and TV sets. Of these, electricity consumption alone is feasible, in the sense of providing a readily available data base. The set of those consuming electricity will also contain within it those owning the other three suggested indicators.

If electricity were freely available with no supply constraints, actual consumption would measure desired consumption. But when electricity is supply constrained, and in particular when this constraint is not uniform across the country, to take the electricity bill in a region where electricity is supplied for twelve hours a day would understate incomes there as compared to regions where electricity is supplied for eighteen hours a day. Furthermore, these supply shortfalls are not stable over time. Assuming for the moment that the supply shortfall problem can be taken care of through some region-specific adjustments (what the Sathe proposal calls multipliers), credible presumptive norms must be based on survey or other objective evidence. A levy that is not arrived at on some such objective basis does not earn the presumptive label.

The same indicator such as an electricity bill can serve as both a consumption or as a productive indicator, depending on the context in which it is used. For a small scale business, an electricity bill can serve as an excellent production indicator of its scale of operations. For a household, on the other hand, as any survey would establish, an electricity bill of, say, Rs. 1000/- month would cover such a wide range of incomes as to make it impossible to identify any single stable multiplier.

Any attempt to use multipliers not based on surveys or other such objective evidence would be rightly rejected by taxpayers as unjust. Such multipliers would also be legally untenable. A service tax on the electricity bill is one matter; that is a valid indirect tax. An indefensible multiplier applied to an electricity bill to obtain the presumptive income of the consumer is quite another. Even if the law were to be altered to permit taxation based on consumption indicators, unstable multipliers will not stand up to legal scrutiny. It is vital that presumptive taxation should not mean whimsical or capricious taxation.

c. Presumptive Norms

Presumptive schemes for the hard-to-tax sectors - small business, agriculture and services - cannot be immediately implemented in our country. However the process of developing occupation-specific presumptive norms can be immediately begun. Norms for determination of taxable income from easily observable entity-specific indicators will enlarge the tax base by making possible identification of potential taxpayers from among non-filers, and by strengthening the verification and monitoring capabilities of the tax administration. Once norms have been developed for an occupation, these should be used as benchmarks in the selection of cases for scrutiny and in the process of scrutiny for all enterprises irrespective of income level.

Presumption does not imply arbitrary income determination. It offers a way by which the correctness of declarations can be objectively judged and the taxability of those presently outside the tax net can be objectively established. Its application increases administration efficiency and is revenue productive. It also limits the area of discretion of the administration with consequent reduction in taxpayer harassment.

Prior to field survey there should be no pre-judgement of which indicator/s, and by extension which form of presumption, whether estimation of actual income from input or output indicators, or capacity-based potential income, would be most suitable for the activity in question. The survey should collect information on all inputs, both fixed as well as variable inputs by type and quantity, as well as on the type and quantity of outputs. Existing information bases on usage of inputs like water and electricity should be used, in the process of identifying suitable indicators,

as these are readily available at little incremental cost. The appropriate indicator can only emerge after all possible indicators are examined for stability in relation to taxable income.

It is vital, for the preservation of intra-occupational equity, that the norms be stratified by important occupation-specific parameters that make for differences in taxable income. On the assumption of constant returns to scale, we have

$$(z/K)_i = \alpha + \Sigma\, ß_i d_{ij} + f(y_i) + e_i \quad \text{for the ith taxable entity,}$$

where

z/K_i : actual income per unit capital endowment (or other capacity indicator);

d_{ij} : a set of dummy variables for qualitative exogenous factors like location, $j = 1,...n$;

y_i : effort; and

e_i : the error term.

It is only in those professions where the levy is stratified with respect to all significant exogenous factors, of which regional location is only one, and where the systematic component of actual income is large vis-a-vis the stochastic component, that presumption can be intra-occupationally equitable, and be perceived to be so. In practice, since the effort variable y is difficult to observe or proxy, the empirical basis for any levy based on potential income is a simple average across all levels of effort, with intercept dummies for location and other exogenous variables influencing income.

Although the need for stratification has been prescribed in the context of capacity-based or flat presumption, it applies equally to the use of flow indicators for estimated taxation. It is essential that any use of presumptive norms should not violate notions of justice as perceived by the taxpayer. This will be more a function of equity *within* than across professions. An unstratified levy will be perceived as grossly unfair, if incomes are seen to any degree as a function of exogenous factors unrelated to personal effort.

A straightforward application of income determination based on presumptive norms, except where prescribed books of accounts are not

maintained, is bound to face strong legal challenge as in the case of the now deleted Section 44AC.[18] The existing practice in France and Israel for using these norms as a benchmark in selection of cases for scrutiny and in the process of scrutiny is, therefore, recommended where books of accounts are maintained. After gaining experience with application of the norms an attempt could be made to identify a smaller sub-set of indicators on the basis of which it could be prima facie concluded whether the income crosses the taxable threshold or not. Information regarding such a sub-set of indicators collected from non-filers through surveys could then be used for identifying potential taxpayers.

An activity that must be immediately begun, and carried out in parallel with the development of norms, is the task of listing practitioners of the selected occupations. A number of sources can be used ranging from registration lists with State and local authorities to voluntary membership lists of professional and trade organisations. A comprehensive listing serves two functions. It provides a frame from which to select the sample for the determination of norms. It also serves subsequently as a means by which to ensure compliance through either the presumptive or conventional routes.

Computerisation is necessary for the maintenance of occupation-specific listings. This can be worked in with the on-going project of computerisation of tax administration, in parallel with the development of norms.

III. THE RS. 1400 FLAT TAX

The 1992 flat tax of Rs. 1400 on small business (section 115K) has now been deleted in Union Budget 1997. It was widely referred to as a presumptive tax, and indeed in popular perception was synonymous with the term, although the presumptive component in it was deleted after one year of its introduction. Introduced for all non-tax paying retail traders above the taxable income threshold but under a turnover ceiling of Rs. 5 lakhs, there was initially an explicit presumption of taxable income at 7% of turnover, with all those eligible and opting for the scheme deemed to be at the turnover ceiling. At the rates of income tax then prevailing, this worked out to a tax liability of Rs. 1400. Subsequently, the presumption with respect to turnover was dropped, and the applicability of the scheme was directly stipulated at that level of taxable income on which income tax payable worked out to Rs. 1400. Along with this the occupational coverage of the

[18] For an account of this, see Rajaraman-Singh, 1995: Chap. III.

scheme was widened. The stipulated income has been steadily raised from its initial level of Rs. 35,000 to keep pace with increases in the taxable income threshold, in steps to Rs 37,000, Rs 42,000 and in 1995 to Rs 47,000. Income from financial assets or sources such as manufacturing not covered by Section 115K, upto Rs. 5000 was taxed at 20%; higher income from such sources disqualified the recipient from eligibility for the scheme. The turnover ceiling defining eligibility remained unchanged at Rs 5 lakhs until it was raised in the Finance Bill of 1995 to 6 lakhs, although turnover had ceased to play a role in the determination of taxable income.

Thus, the scheme as it functioned for much of its life had no presumptive elements in it, and was merely a simplified voluntary option for those outside the tax net at or below a stipulated taxable income, at which income those opting for the scheme were deemed to be. For those at lower levels of income, the higher tax liability under the scheme was offset by a simplified compliance procedure. For those above, to whom the scheme did not technically apply, there was the added inducement of a lower tax liability with a low probability of detection. Despite these advantages, the total number of new tax entrants numbered around 2 lakhs at the end of the two-year period for which the scheme was initially introduced, as compared to the expectation of 10. The scheme was continued, and coverage rose to 3.60 lakhs the next year, but fell again in 1995-96 to 2.50 lakhs (see table 2; figures for 1996-97 are not available).

TABLE 2
Revenue Yield from Rs. 1400 Flat Tax (Section 115K)

Year	*No. of taxpayers*	*Revenue (Rs. crores)*	*Total income tax revenue (Rs. crores)*	*Share of 115K in total income tax (%)*
1992-93	1,16,644	16.47	7888	0.21
1993-94	1,95,600	27.53	9123	0.30
1994-95	3,56,322	49.96	12162	0.42
1995-96	2,51,824	35.39	15463	0.23

Source: CBDT.

Notes: 1. The revenue under the scheme in all years slightly exceeds the figures obtainable by application of the flat levy to the number of taxpayers reported.
2. Total income tax revenue is net of refunds.

The principal difficulty lay *not with the small numbers opting for what was a voluntary scheme, but with the lack of any reference lists on the basis of which compliance could be enforced through either the simplified scheme*

or through conventional accounts-based self-declaration. There would have been an inducement to comply only if not opting for the voluntary scheme implied follow-up through the conventional assessment stream. The same problem afflicted the estimation scheme for construction contractors and the capacity-based presumption for truck owners introduced in 1994 (sections 44 AD and AE), also voluntary options. Estimates of revenue collections under these schemes are unfortunately not available.

What is important in all these schemes is that taxes should be paid through either of the two channels, not that collections through the simplified channel should necessarily record increased receipts. But as things stand, these "presumptive" (whether or not they actually deserve that label) schemes have imparted a negative connotation to presumption for two reasons: they are perceived as revenue-unproductive, and as regressive because they go after the small when the big so demonstrably continue to evade the tax net. This is most unfortunate because presumption actually offers a way by which to enforce compliance among the big and thus to improve the progressivity of direct taxes.

Because of the configuration of the Rs. 1400 levy whereby the scheme targeted potential taxpayers whose tax liability remained constant as assessed at conventional rates, and was not a flat presumptive levy, the requirement of indexation did not directly apply, but it does in the case of the capacity-based levy on trucks, which is specified as an unindexed absolute per truck.

IV. TAXATION OF SERVICES

The only possible *nationwide* source of information on value added and incomes in services are the periodic surveys conducted by the Central Statistical Organisation as a part of the national accounts estimation exercise. The latest published survey is for the year 1983-84 (CSO, 1987), which is the basis for the current series on national accounts. A more recent survey was conducted in 1991-92, but the data continue to be in process.

Table 3 presents the 1983-84 survey figures, separately for enterprises with and without hired workers, of average gross income per enterprise, per operating partner, and per hired worker, for five service groups at NIC two-digit level (there is no information at further levels of disaggregation, and net income figures are not provided for enterprises not hiring workers). The figures fail the plausibility test. The average annual gross income per

enterprise with hired workers in recreation-providing services including motion picture production (NIC code 95), of Rs. 21330 in 1983-84, is quite simply ridiculous. Likewise the figure of Rs. 9690 per private medical enterprise with hired workers is not even remotely credible.

TABLE 3

Income of Commercial Enterprises in the Service Sector 1983-84

NIC Code	*Services*	*Number Sample Enterprises*	*Estimated Number of Enterprises*	*Average Workers Per Enterprise*		*Gross Average Income (Rs. 10^3)*		*Average Wage Per Hired Worker (Rs. 10^3)*
				Owners/ Partners	*Hired*	*Per Enterprise*	*Per Partner*	
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*
96	Personal: laundries;	7980	818264	1.54	-	3.29	2.14	-
	barbershops; photographers; etc.	935	76865	1.24	1.66	7.50	6.05	3.28
95	Recreation: including motion	566	52301	2.11	-	2.83	1.34	-
	picture production; distribution and projection; theatrical and cultural services	320	36045	1.59	7.14	21.33	13.42	2.35
93	Medical (non-	2010	206602	1.06	-	6.05	5.71	-
	governmental. excluding veterinary)	1272	122848	1.09	2.84	9.69	8.89	3.19
83	Legal	868	67268	1.02	-	9.07	8.89	-
		306	39571	1.13	2.56	32.62	28.87	9.21
82	Business and real estate	1474	123999	1.27	-	4.04	3.18	-
		592	44395	1.28	2.24	13.66	10.67	4.31

Source: Government of India, Ministry of Planning, Central Statistical Organisation (1987), Department of Statistics, *Enterprise Survey, 1983-84: Report on Service Sector,* Statements 3.1.3, 3.3.3 and 3.5.3, New Delhi.

Notes: 1. For each occupation, the first row of figures is for "own account enterprises (OAE)" not hiring any workers; the second for enterprises hiring one or more workers. The samples were independently selected, and a separate canvassed, for each of these two strata.

2. Gross rather than net income per enterprise is given here because figures for neither depreciation nor assets are available in the source publication for OAEs and non-OAE medical enterprises. Although, the definition of operating surplus is given as total receipts minus total expenditures defined to *include* additions to fixed assets, the figures suggest that in practice this was not done, and that only recurring expenditures were (correctly) subtracted.

Comparable nationwide averages are not available from any other source. However, region-specific surveys can give some idea of the magnitude of under-estimation in the CSO figures. A survey of incomes of non-government medical practitioners in 1990-91 in the Delhi region (Kansal, 1992), updated to 90-91 prices, reveals an underestimation factor of roughly 20 for those practising in clinics, and more than 50 for those running nursing homes, as compared to the CSO urban average (across all enterprises, including those not hiring workers). The two surveys are of course not directly comparable on several counts; the Kansal survey was confined to Delhi and covered just allopathic practitioners, whereas the CSO coverage was nationwide and extended across practitioners of all, including indigenous, systems of medicine. Even so, the comparison gives some indication of the magnitude of underestimation involved.

If it is assumed that the degree of underestimation is uniform across occupations, a ranking of occupations by income from the CSO figures could possibly be justified. Of the five occupation groups, the legal profession is at the top of the rankings for both income per enterprise, and income per hired worker. For enterprises with hired workers, the absolute annual income of legal enterprises, even at the appalling degree of underestimation of the survey, was well above the taxable threshold of Rs. 15000 in 1983-84, but it must be remembered that the figures in table 3 are of gross income.

Table 4 provides estimated net income of enterprises with hired workers. A similar calculation was not possible for enterprises not hiring workers, for which depreciation figures are not reported; but these had a gross income falling below the taxable threshold in any case. For enterprises hiring workers, it can be seen that the disparity between rural and urban net income is not very wide, and that the average net income of even rural legal

practitioners fell above the taxable threshold for the year. That such a finding should come out of a survey that seriously under-estimates incomes is in itself a matter of considerable significance, and suggests at the very least that in terms of priority, legal service enterprises large enough to have at least one hired worker are worthy of consideration for a presumptive levy.

TABLE 4

Average Income and Tax Liability of Legal Enterprises: 1983-84

	No Hired Workers	*Hired Workers*		
		Rural	*Urban*	*Total*
Number Sample Enterprises	868	6	300	306
Estimated Number Enterprises	67268	635	38936	39571
Partners/Enterprise	1.02	1	1.14	1.13
Hired Workers/Enterprise	0	1	2.59	2.56
Gross Income/Enterprises (Rs. 10^3)	9.07	27.70	32.71	32.63
Net Income/Enterprises (Rs. 10^3)	-	26.61	29.97	29.92
Tax Payable (Rs. 10^3)	-	3.31	4.49	4.47
Tax Rate	-	12.45%	14.98%	14.95%
Total Potential Tax Revenue (Rs. 10^3)	-	2104.39	174803.17	176961.51

Notes: 1. Legal enterprises are defined as those rendering legal services such as by advocates, barristers, solicitors, pleaders, mukhtiars, etc.

2. The only way to obtain net income from the gross figure was by deducting reported depreciation, since fixed assets as recorded in the survey included land, and no break-up of the aggregate is provided in the published figures. Depreciation was recorded in the survey as provided for by the responding enterprise, and may or may not have corresponded to income tax norms (the implicit depreciation percentage of fixed assets was 9.31% for rural enterprises, 8.40% for urban). No depreciation or asset figures were recorded for enterprises not hiring any workers.

3. Tax payable is calculated at the slab rates for individuals prevailing in 1983-84 (at 25% between 15,000 and 20,000, 30% upto 25,000 35% upto 30,000) as applied to enterprise income. Where enterprise income was split by partner, there was in 1983-84 a corresponding levy on the enterprise at the rate for registered firms, an adjustment that cannot be made without data on the distribution of enterprises by number of partners. In any case, the average number of partners per enterprise is not much above one.

Clearly a serious examination of this issue calls for better figures and more possibilities of stratification than merely by rural/urban location alone. But taking the 1983-84 survey figures as they stand, table 4 presents a primitive calculation of presumptive tax liability. Applying the individual tax rate schedule of 1983-84 to average net income per enterprise (the

average number of partners per enterprise was 1 in rural areas, and 1.14 in urban areas),[19] yields a presumptive levy of Rs. 3314 per rural enterprise, and Rs. 4490 per urban enterprise, at implicit rates of 12.45% and 14.98% respectively. An undifferentiated levy on average income across all enterprises, rural and urban, works out at Rs. 4472, at implicit rates of 16.81% and 14.92% on rural and urban enterprises respectively. This underscores the need for any presumptive levy in practice to include as many parameters of stratification as possible so that systematic factors explanatory of variations in income are taken care of.

Using the estimated number of legal enterprises from the survey, the revenue yield from a presumptive levy works out at roughly 17.7 crores of rupees. This compares with a figure for total tax collections of Rs. 13.5 crores from legal services for AY 1984-85, at an implicit tax rate of 26.52% from 13156 non-company assessees. This estimate is from a sample of 34.38 lakh non-company assessees above the taxable limit for AY 1984-85 from *All-India Income-tax Statistics.* The report of the Comptroller and Auditor General shows a total of 36.86 lakh non-company assessees above the taxable limit as on 31 March 1985. Applying this correction factor to actual collections from legal services in assessment year 1984-85 yields a total of 14.5 crores. This is a 22% shortfall below the potential of Rs 17.7 crores, which in turn is based on a survey that is known to have hopelessly under-estimated figures of income from service enterprises. Even if the survey had been accurate, actual collections should have exceeded the yield from a levy based on average income, given the progressive rate schedule.

Any respectable presumptive income scheme will have to be based on a survey as reliable as Kansal's on a nationwide basis. The Kansal survey suggests three distinct strata for medical practitioners, with there clearly being a fourth stratum of those practising indigenous medicine and therefore not covered in the Kansal survey: those without surgical post-graduate qualifications; those with surgical post-graduate qualifications; and those operating nursing homes. There is also a location element in income earned even within the Delhi region. The Kansal survey is merely suggestive of the types of stratification that will be necessary, but cannot prejudge the issue.

[19] The justification for why individual rates were applied to enterprise income, even though the number of partners per enterprise was slightly greater than one in urban areas, is that in the event of a sharing of income and separate taxation of partners, the firm itself would have been subject to taxation at the rate for registered firms. An assumption that all firms would have been taxed on this basis would bias upwards the estimate of revenue yield.

It remains to be seen whether the 1991-92 service enterprises survey of the CSO, when the findings are made available, will provide a more credible base for a presumptive tax calculation than the woeful underestimates of 1983-84. The schedules are roughly the same, except that for the first time there is provision for recording whether the enterprise is registered with the relevant authorities. There is provision, as in 1983-84, for detailed recording of facilities operated by medical establishments, and it is to be hoped that these data will not remain unpublished, as happened with the earlier survey.

The second critical information requirement is the need for listings of establish-ments and practitioners. Kansal's 1990-91 survey of medical practitioners in Delhi found only a voluntary fee-based membership listing with a professional organisation. *Unless this critical information requirement is tackled on an emergency basis, there does not exist even a frame on the basis of which a sample to determine average potential income can be selected.*

V. AGRICULTURAL TAXATION

a. The Appropriate Level of Governance

A conventional income tax on agricultural income based on self-declaration supported by books of accounts is not possible in general, except in the context of large-scale organised operations like plantations. It is especially difficult in the context of small-scale operations in developing countries, because of the difficulties of verification and monitoring of large numbers of petty cash transactions. Any broad-based taxation of agricultural incomes must therefore necessarily be presumptive in character, based on an objective assessment of taxability. In the case of agriculture, the most obvious production indicator is land cultivated.

Stratification with respect to differences in the productive capacity of the land is essential, most basically with respect to presence or absence of irrigation. This distinction is based on productive capacity, and would apply uniformly to all irrigated land whether privately or publicly irrigated. A stratified land-based levy is not designed to take the place of user charges for publicly-provided irrigation, or other public works.

An alternative approach could be based on rental value or on an equivalent capital sum. This is the approach adopted in property taxation

of urban land or structures by urban local governments, but it is difficult to apply in the agricultural context, where the number of sale or rental transactions are too sparse to provide reliable location-specific values.

Thus, through a combination of precept and practice, there is a mainstream consensus that taxation of agriculture can most effectively be attempted through a presumptive income-based tax on land calibrated in physical rather than value units, stratified by crop, region and irrigation status, with provisions for catastrophe exemption and for periodic updating of the yield and cost norms used (Rajaraman, 1995: 1112). It is particularly important that what appears to be physical stratification should not be valuation-based. The principal reason for the failure of the Uruguayan 1967 experiment with a presumptive land-based agricultural tax, for example, was that soil quality classifications in terms of fractions or multiples of the national average, were based on easily challenged valuation records (Tanzi, 1991).

An area-based tax eliminates having to deal with the valuation problems mentioned above, or those that arise when there are structures or improvements on land that are not yield-enhancing, or when land value rises in response to location factors unrelated to potential income from use for agricultural purposes. Clearly, an area-based land tax will have to be indexed to product-price inflation and to productivity increases; a valuation-based land tax is on the other hand implicitly indexed to asset-price inflation, which is different from the income concept that basically underlies the tax. There are however successful instances of valuation-based systems, such as in Chile, where income was presumed at 9% of land value until 1954, 10% thereafter. Land values were updated with reference to an index based on agricultural commodities, which was a clever way of leaving relative values unchanged, and which seems to have been legally robust. There are other systems in place such as in Costa Rica (5% of immovable property value in agriculture and stock-raising) and in Colombia (10% of the value of livestock and land excluding superstructures, subsequently reduced to 8% with the extension of the levy to the non-agricultural sector), although the details of the updating mechanisms are not known.

The most often cited and most successful practise of presumptive land-based taxation of agriculture is the French 'forfait' which is based on land calibrated in physical units. The forfait leaves room for negotiation with, and reference to the books maintained by, the taxpayer, within the parameters of the presumptive norms (Rajaraman-Singh, 1995). Variants of

this system are practised in Francophone Africa, although it is not known with what degree of revenue success.

In 1972 a Committee on Taxation of Agricultural Wealth and Income (the Raj Committee) was appointed to suggest methods by which taxation of agricultural wealth and income could be used more effectively for raising additional resources for development, for reducing economic disparities and for efficient use of existing resources.

The Raj Committee found two basic defects in the pre-existing land revenue system:

1. The incidence of land revenue in relation to the productivity of land was not uniform over the country, because of the different land revenue systems in force historically in different parts of it; and

2. land revenue was assessed at a flat rate per hectare and hence was not progressive.

The Raj Committee's principal recommendation was the replacement of land revenue with a progressive schedular agricultural holdings tax (AHT) on agricultural income, defined to include income from livestock, fisheries, poultry and dairy farming, to be levied like the land revenue by State governments. Although the Raj Committee had detailed consultations with State governments, its recommendations were not adopted. The Haryana State government made an effort to implement a form of AHT, but the Haryana version was quite different from the system recommended by the Raj Committee. At the present time, Haryana has repealed even the land revenue, the only state to have done so (Rajaraman, et. al., 1996).

The land revenue, the only universal (with exceptions) levy on agriculture in India, is presumptive in conception. The survey and settlement procedures on the basis of which land revenue rates are determined show a basic design related to the yield from land, stratified by number of crops, soil and irrigation. However rate revisions have not kept apace with crop yields. The period between rate revisions (called "settlements") is either statutorily fixed at thirty years or in practice is as long as that. Since land revenue is a specific levy unindexed to inflation, it is not surprising that it has dwindled to revenue insignificance over the years. In 1994-95, the most recent year for which estimates are available, it accounted for 1.84% of aggregate revenues raised by state governments; and

0.7% of total tax revenues aggregating across Centre and States. At the turn of the century, land revenue contributed 50 per cent of total tax revenues of the country (Ahmed-Stern 1991:15).

There is a schedular state-level agricultural income tax, independently of land revenue, which despite the fact of being levied in only eight states,[20] and on plantation crops alone,[21] yields one-fifth as much as land revenue, which is levied on almost all agricultural land in the country. The lack of interest of state governments in restructuring land revenue is due far more to the fact of it being a tax shared with panchayats as to the political difficulties of taxing agriculture.

For any restructured land revenue to succeed it has to be levied at the panchayat level of governance, and the revenues must be retained locally for improvement of agricultural infrastructure. This will have three positive outcomes.

1. It will break the present stalemate whereby revenue sharing reduces the collection incentive of the levying authority (the State government) , and non-jurisdictional sharing (i.e. not by origin of collection) robs local governments of a staked in improved collections. The reason for formula sharing is of course to introduce a redistributive component, but it is best if such objectives are achieved through independent and transparent grants.

2. It will help harden the budget constraint at local level, if the restructured land revenue is made obligatory at specified minimum rates of levy.

3. The compliance resistance to enhanced agricultural taxes will be lower with the reduction in distance between government and the governed, and the greater potential voice for the average taxpayer in the uses to which tax revenues are put.

The lack of national uniformity which was seen by the Raj Committee to be a principal defect of land revenue is thus a matter of no

[20] Assam, Bihar, Karnataka, Kerala, Maharashtra, Orissa, Tamil Nadu and West Bengal.

[21] The set of plantation crops has a common core across the states, with some variation at the fringes; in Karnataka, for example, it includes cardamom, coffee, linaloe, orange, pepper, rubber and tea, but excludes arecanut and coconut, which are included in Kerala.

consequence. Quite aside from the Constitutional division of fiscal authority, an agricultural tax will be possible to enforce only by that level of governance closest to the farmer, where the link between compliance and improved local services can be clearly established. The progressivity issue, the second concern of the Raj Committee, is relevant only in contexts where land redistribution is not directly possible.

Even where, as is recommended in this report, the power to levy agricultural taxes is given to the panchayat level of governance, the maintenance of land records must remain the rightful preserve of State governments. This is especially important in India where there are no formal titles to land ownership other than the land records maintained by the State government through village-level functionaries.[22] This arrangement will have to remain in place for the foreseeable future, so that local records are not corruptible by local power structures. The colonial land surveys of over a century ago upon which the present land revenue structure continues to be based was necessitated because of the corruption of land records by powerful local chieftains.

b. Computation of Taxable Rateable Value of Agricultural Holdings (Raj Committee):

The Raj Committee proposal for a presumptive tax on land is deserving of close examination nevertheless, to see what, other than enforcement considerations, made it infeasible.

The AHT was a tax on the Taxable Rateable Value of an agricultural landholding. The tax liability under the AHT was:

AHT = (X/2) % of the Taxable Rateable Value of the Holding;

where "X": the TRV in units of a thousand rupees. This formula was recommended for the purpose of building in progressivity in the rate structure, and on a continuous scale, since X permitted non-integer values. Thus, the rate applicable on a holding with a taxable rateable value of Rs. 8,800 was 4.4%. For $X/2 < 0.24$, the Committee recommended a nominal tax of Re. 1/holding. Thus, the AHT threshold was a TRV of Rs. 480.

Norms of yield per hectare of different crops were to be prepared each year for each district/tract, based on yields of the previous ten years,

[22] I am indebted to Mr. T.R. Satish Chandran for pointing this out.

and these yield norms were to be valued at the relevant average harvest prices of the preceding three years to obtain the value of the gross output of different crops.

The excess of gross output per hectare over paid-up costs was termed the rateable value of the crop. Thus, for the ith crop:

$$RV_i = [\ 1\text{-}f_i\ ]\ GO_i$$

where

RV : Rateable value/hectare.
GO : Gross output/hectare.
f : Fraction of gross output that goes out as paid-out costs.

The Committee did not recommend that field surveys be conducted for the determination of paid up costs, assuming perhaps that standard cost of cultivation surveys provided a ready source of information. However, these surveys are not available at the level of regional disaggregation recommended by the Committee, nor do they have comprehensive crop coverage. Paid up costs were defined to include only material and labour costs actually paid out by the farm operator for current cultivation. The imputed cost of family labour was treated as part of the income of the family.

For each district/tract, there would be a schedule of RV_i of land per hectare for all i. Grouping of crops into crop groups was suggested[23], with each such group given a single rating in terms of rateable value. The schedule was to be prepared afresh each year and included in the legislation of the year in question.

The assessable RV of the agricultural holding was obtained by deducting expenses of irrigation from the above schedule of crop-specific rateable values, actual expenses in the case of irrigation from public sources, and imputed at 20 percent of the RV for irrigation from private sources. Thus, for the jth holding:

$$ARV_j = 0.8 \sum_i [\ RV_i\ ]\ H_i \text{ for privately irrigated land}$$

[23] Although the criterion for grouping is not clear. The report suggests either rateable value, or crops showing a "high degree of local concentration". The latter need not necessarily be similar in terms of rateable value.

$$ARV_j = \sum_i [RV_i] H_i - \text{[water charges for publicly irrigated land]}.$$

where

ARV_j : Assessable rateable value of jth holding.

H_i : Number of hectares devoted to ith crop.

From this a further 20%, subject to a maximum of Rs. 1000 (termed the 'Development Allowance'), was to be deducted to obtain the taxable RV of the holding. Thus,

$$TRV_j = 0.8 [ARV_j], \quad \text{where } 0.2 [ARV_j] < \text{Rs. } 1000$$

$$TRV_j = ARV_j - 1000, \quad \text{where } 0.2 [ARV_j] \geq 1000$$

Thus, the TRV threshold of Rs 480 implied an ARV threshold of Rs 600. The development allowance was meant to cover costs of soil conservation, digging of wells, other maintenance and depreciation.

Bagchi, 1978 suggested that the AHT could be modified and made administratively simpler, while retaining its essential character, if:

1. A uniform RV was specified for each area/tract with respect to the *gross value of output of only one or two major crops grown in that area*, without taking account of the variety of crops grown;
2. Paid out costs were estimated at a flat 30% of gross value of output for all crops.
3. Norms were fixed on the basis of averages of output for five years (instead of the ten year average suggested by the Raj Committee), and the corresponding assessments kept in force unchanged for a period of five years, barring radical alterations in the productivity of the land, or when prices change by more than a specified percentage;
4. The basis was ownership holdings instead of operational holdings;
5. Milder progressivity were attempted, with 2.5% on the first Rs 3500 ARV (net of paid-up cost) of a holding, 5% on the next Rs 3500, 8% on the next Rs 3500, and 10% on the rest (although this rate

structure is actually more progressive upto an ARV of Rs. 20,000), and a flat rate of 8% on companies, trusts etc. whose beneficiaries are unknown.

Perhaps the single most critical requirement of any scheme for agricultural income taxation is the need to adjust for variability in agricultural yields, spatially (idiosyncratic) and over time (non-idiosyncratic). A yield threshold is a necessary element of such a scheme, covering extreme downside variability at the very least, but the AHT had no such provision. The rateable value threshold of Rs. 480 was defined with respect to the holding, and served essentially as an exemption by size of holding since the yield figures on the basis of which the threshold was calculated was obtained from standard crop averages unadjusted for idiosyncratic yield failure. The Bagchi scheme had both an exemption by size of holding (1 hectare irrigated; 2 hectares irrigated) and a threshold specified in terms of rateable value (Rs. 5000) which, as in the case of the Raj Committee translates into a threshold in terms of holding size with no provision for idiosyncratic yield failure. Since the Raj/Bagchi approaches were heavily dependent on yield averages, an attempt was made to strengthen those averages by using yield series extending five or ten years into the past. For non-idiosyncratic yield shortfalls covering an entire region, the Raj scheme provided for discretionary suspension of liability to pay the AHT "on a liberal basis", with crop failure defined as "less than half the norm established on the basis of average output of the earlier ten years" (Raj Committee, 1972:34). The Bagchi scheme also carried a provision for "full or partial remission, as may be required, in exigencies like floods and drought" (Bagchi, 1978:1635). Neither of these provisions takes care of idiosyncratic crop failure.

The annual assessment recommended by the Raj Committee was seen to be an administrative difficulty with its implementability. However, a move to quinquennial assessment would only exacerbate the inequity inherent in a comprehensive levy of that type applicable aggregatively across crops with average yields.

An alternative scheme under preparation at NIPFP suggests annual assessment limited to those farms growing any of a few designated crops. Information will be required only in respect of whether a particular farm falls in any year above a specified yield threshold, or below it, with assessment at a pre-determined rate of levy per acre applying above the threshold. More ambitious systems could be devised, with perhaps a second rate of levy per acre for a yield slab above the minimum, but that would carry a higher information cost.

Inter-crop equity will be ensured by a two-stage procedure, whereby the selection of crops forwarded by the local bodies for consideration accords with the local ordering in terms of profitability, and the technical survey following defines a further threshold based on objective evidence. There cannot be any national uniformity in this respect nor indeed should such uniformity be sought. Since the purpose of this tax is to enable public provision of productivity enhancing improvements to agricultural infrastructure, failure to implement the tax can only be a local decision with implications that, in the first instance, will be local rather than national.

VI. Presumption: First Or Second Best?

There are two approaches, somewhat orthogonal mutually, to the theoretical treatment of presumption. If the theoretically ideal base of taxation is income actuals, accurately measured and reduced by individual-specific corrections for ability to pay, presumption becomes a second-best, carrying the cost of divergence from the horizontal equity ensured by the perfect income tax. But when the information costs of ensuring perfection are impossibly high, i.e., under certain values of the relevant parameters, presumption could be first-best (section VI.1). An alternative approach sees an efficiency advantage to presumption based on potential income, i.e. capacity-based or flat, over taxation of income actuals, whether estimated through presumptive norms or based on self-declaration, deriving essentially from neutrality with respect to the work-leisure choice. Although well-known,[24] it is restated in section VI.2.

a. Presumption As a Second-best:

If the ideal measure of ability to pay is the individual's gross income reduced by individual-specific itemisable deductions, presumption becomes a second-best option which trades off the accuracy of tax-base measurement against the cost of that measurement. Slemrod-Yitzhaki, 1994, identify the parameters governing the optimal presumptive tax, where it is presented as an option to be exercised by the taxpayer. The particular tax considered is the standard deduction, which in the US is an alternative to the claiming of itemised deductions. The optimal level of the standard deduction becomes that which equates at the margin the benefit, in terms of the saved resource cost of claiming and verifying itemised deductions, and the cost, which is the social price of the divergence from the horizontally equitable ideal on

[24] Sadka-Tanzi, 1993 trace the ancestry of the idea to a 1938 book by Luigi Einaudi titled *Miti e Paradossi della Giustizia Tributaria* (Torino: Giulio Einaudi).

account of taxpayers opting for the standard deduction. The model can be operationalised if the joint distribution of incomes and itemisable deductions, and the costs of collection including compliance costs borne by the taxpayer are known.

Although the social price placed upon divergences from ideal horizontal equity is not objectively measurable, the model can be solved for it on the assumption that the given level of presumption, the standard deduction in this case, is optimal. Slemrod-Yitzhaki, 1994, do this with US income-tax data, on the assumption that there is zero evasion. The introduction of evasion could alter the result. Specifically, as is frequently the case in developing countries, the enforcement of income tax is possible only among salary recipients because of information availability. (Das-Gupta, 1994, models the hard-to-tax as those with a large number of independent income-generating transactions, as contrasted, with a salaried employee who has in effect a single income generating transaction). The introduction of presumption in such a context would actually constitute a move towards, rather than away from, horizontal equity.

Another way of stating the same thing is that, for a typical developing country, the resource costs for a zero-evasion enforcement of the horizontally ideal tax are so high, that the costs of departure from that ideal through presumption are negligible by comparison at any reasonable valuation of the social price of divergence from the ideal.

b. Efficiency Advantage of Taxing Potential Income: Work/Leisure Neutrality:

The potential income approach prescribes a flat absolute liability per unit capacity, or per entity in the case of flat presumption, with a marginal tax rate with respect to incremental actual income (from the presumptive source) of zero.

Formally, using the notation and model developed by Sadka-Tanzi, 1993:

If $z = yn$; where z: actual income; y: effort index; n: normal income;
then $n = z$ for $y = 1$; and $dz/dy = n$
Thus normal income, n, is what actual income, z, is at normal effort ($y = 1$); n is also the marginal productivity of effort in terms of actual income.
The consumer maximises utility, u:
$u = u(x,y)$; where x: consumption; and y: effort index;

$du/dx > 0$; $du/dy < 0$; $d^2u/dx^2 < 0$; $d^2u/dy^2 < 0$;
subject to $x = z - T$; where T = total tax payable.
Thus, consumption, x, equals total post-tax income.

If actual income, z, is the tax base:
$T = T_A(z); \Rightarrow T = T_A(ny);$
Thus, $x = ny - T_A(ny);$
$\Rightarrow dx = [n - \partial T_A/\partial y]\, dy$

Whereas, if normal income, n, is the tax base:
$T = T_N(n)$, where the presumptive taxation function T_N can incorporate any desired degree of progressivity with respect to potential income;

Thus, $x = ny - T_N(n)$
$\Rightarrow dx = n\, dy$

Thus, taxation of potential income does not reduce the pre-tax marginal productivity of effort. By contrast a conventional, or estimated, levy based on actual income lowers the marginal reward of effort. A corollary of this is that the optimal tax on actual income is not necessarily progressive, whereas the optimal tax on normal income is necessarily progressive (Sadka-Tanzi, 1993: 69).

Implicit in the Sadka-Tanzi actual income function is a production function with an exogenously given endowment of capital, which is activated only by effort; $z = 0$ when $y = 0$. If K is the exogenously given endowment of capital, tangible and intangible,
$z = pq = p\,[f\,(Ky)]$, where p is price and q quantity of output. On the assumption of a constant returns to scale function, we have
$z/K = p\,[g\,(y)]$.
Thus, normal income is that income per unit endowment of K at $y = 1$. K is the occupation-specific asset indicator. The total tax liability of an entity is determined by its scale of operation in terms of units of K.

Presumption can also be applied without occupation-specificity, on total assets aggregated in value terms. A special case of this is the minimum asset-based levy on corporations (with offset against actual income tax, and therefore not an 'add-on'),[25] based on a minimum presumptive rate of return. A presumptive levy, even as a minimum, carries an efficiency

[25] Any levy that is additional to an income tax based on actuals cannot involve presumption regarding income.

incentive, where a minimum add-on does not. Until the prescribed benchmark rate of return is attained, the incremental tax on income actuals is zero. Firms or individuals earning rates of return on assets below the minimum presumed pay an implicit tax on income actuals at a rate higher than the prevailing nominal corporate income tax rate, which increases the greater the performance shortfall.[26] The Mexican design carries an incentive even for returns in excess of the minimum and for the accurate reporting thereof.[27]

Any minimum levy on businesses, whether presumptive or add-on, raises the marginal effective rate of tax (MERT), and therefore depresses investment incentives. However a recent study of this effect, explicitly incorporating uncertainty, establishes through simulation that the MERT increases much faster with uncertainty within conventional corporate taxation than with the introduction of a minimum levy (Estache-van Wijnbergen, 1992). This is because the conventional corporate tax gives the government an equity share only of positive profits and not of losses (unless losses can be indefinitely carried forward). The minimum tax is merely an additional put option on the equity share giving further downside cover. If the enhanced revenues from a minimum corporate levy can contribute significantly to macroeconomic stability, and hence to stability of corporate profits, there could be an overall fall in the MERT, even though the direct impact of the minimum tax increases the MERT (Estache-van Wijnbergen, 1992: 15-19).

Corporate minimum taxation can also be turnover-based. A turnover base, however, when applied at a flat rate across all sectors of industry, lacks the economic justification of an asset based tax. The rate of return to capital, adjusted for differences in risk, should in principle be equated across sectors by capital flows, unless impeded by entry barriers. By contrast, there is no theoretical justification for uniformity in the share of taxable income in total turnover across sectors.

Among the class of studies that commend the efficiency properties of presumption, mention should be made of Erbas, 1993, which recommends presumption as suitable for global rather than just selective sources of

[26] They may do so even at the minimum rate of return, if tax loopholes reduce taxable income much below book profits. In that case, firms may have to earn more than the minimum rate of return in order to fully exhaust the crediting provision against the minimum asset-based levy.

[27] Through a carryback provision; see Rajaraman, 1995:1109.

income. Following from this recommendation, Erbas investigates whether presumptive taxation of global income would contribute to macroeconomic instability because its *ex ante* determination robs it of the automatic stabilizer property of standard progressive taxation. The results of such investigations are so closely a function of model specification that it is impossible to reach an unqualified conclusion; within the Erbas framework of rational expectations, presumptive taxation actually works out to be more conducive to macroeconomic stability under certain values of the relevant parameters.

VII. Conclusions

This paper argues that presumptive taxation is one way, though not the only one, by which the process of fiscal reform currently under way in the country may be further advanced. The paper confines itself to the possible uses of presumption in the sphere of direct taxation alone.

Revenue from direct taxes collected at the Centre in 1995-96 amounted to 3% of GDP, up by 1% as a result of reform efforts since 1990-91. This is lower than the 1989 average for all developing countries of 5.5%, as estimated by Burgess-Stern on the basis of IMF data. The corresponding average today for those countries would be higher still as a result of tax reform in the nineties. Clearly there remains much room for further reform in India, on the basis of successes achieved by other developing countries operating within similar institutional constraints.

Direct taxes are paid through either filed returns or tax deduction at source (TDS). The number of filed returns in 1995-96, aggregating across corporate and individual assessees, was a mere 8.1 million, out of a total non-agricultural labour force of 115 million. The number covered additionally through TDS is not known.

A prior requirement before any possible expansion of the tax base is computerisation, so as to enhance the capability of the tax administration to process larger numbers. Alongside that, the tax base can be widened by any, preferably all, of the following, not mutually exclusive, ways:

1. Expansion of coverage under TDS provisions; at all times, however, expansion of coverage should not divert administrative attention from ensuring compliance under pre-existing TDS provisions.

2. Elimination of exemptions; this will bring previously exempt sectors into the tax net, and for those sectors already within, it will simultaneously expand the taxable income base and reduce the time taken to process each return.

3. Presumptive indicators and norms, to cover sectors and occupations entirely or partially beyond the reach of TDS; and as an alternative to the elimination of exemptions, which can be politically difficult in the presence of powerful lobbies.

Lack of information is the principal difficulty facing tax administration in developing countries, whether for identification of potential assessees, or for independent verification of self-declaration with respect to filed returns. It is this vacuum that can be filled by the identification of occupation-specific presumptive indicators, and survey-based norms linking those indicators to taxable income. Most of all, there is a need for legislation making possible the use of such norms (the latest Expert Group set up to examine income tax legislation has not seen fit to make any recommendations in this regard, other than a minor amendment to allow a standard expense deduction for self-employed professionals). Good governance consists in the recognition of, and accommodation to, the institutional limitations of functioning within the developing country context, rather than in the pretence that those limitations do not exist.

Additionally, presumptive norms enable reduction of costs of collecting revenues at both the taxpayer and collection ends; and can help reduce taxpayer harassment. Above all, by aiding in base expansion and reduction of evasion, and by providing an avenue for containment of avoidance where exemptions are impossible to remove, presumption makes the tax system more equitable. Capacity-based presumption also has efficiency properties, resulting essentially from neutrality with respect to the work/leisure choice, which make it a first-best, rather than merely a second-best in the presence of the high information costs of equitably enforcing the ideal tax based on self-declaration.

This paper has consciously refrained from providing estimates of the total direct tax potential in India, but very creditable attempts have been made by others (Haindl, 1996). Instead, the paper has focused on the directions in which to proceed in services and agriculture, two sectors which lie largely outside the tax net. Detailed suggestions for an asset-based presumptive corporate tax, together with revenue estimates, have been made elsewhere (Rajaraman-Koshy, 1996).

For services, the principal recommendation is that the approach should be occupation-specific. The national income statistics on the services sector are so hopelessly underestimated that no sensible occupation-specific estimates are possible of potential revenue; but even at those levels of underestimation, the legal profession emerges as undertaxed by 22%.

For the agriculture sector, the principal suggestion is for a crop-specific enhancement of the land revenue, to be levied at the panchayat-level of governance, with the revenues from both the land revenue and the selective crop-based enhancement to be retained at local level for improvements to agricultural infrastructure. It is recommended that the levy should be on land calibrated in physical rather than value units; indexed to inflation; with a built-in provision for adjustment to yield failure, both idiosyncratic and non-idiosyncratic. The Raj Committee's Agricultural Holdings Tax, which was a presumptive scheme although not so labeled, was based on yield averages with no yield threshold. There was only a threshold in terms of size of holding, and no systematic exemption provision for idiosyncratic crop failure. A scheme is under preparation at NIPFP applicable to selected crops with specified yield thresholds. Inter-crop equity will be ensured by a two-stage procedure, whereby the selection of crops forwarded by panchayats to the State government for consideration accords with the local ordering in terms of profitability, and the field survey to be conducted by the State government defines a final subset based on the survey results. There cannot be any national uniformity in respect of the crops selected, nor indeed should such uniformity be sought.

Presumptive taxation based on production indicators does not involve any departure from the principle of ability to pay. It is not caprice, and it is not a quick fix. Presumption based on consumption indicators on the other hand could be a quick fix, but will imply a capricious departure from the principle of ability to pay. The spadework required to establish legally robust presumptive norms based on production indicators is considerable. Once done, however, the incremental expenditure of time and effort on processing of returns will be greatly reduced.

Finally, the paper examines the causes for the failure of the Rs. 1400 flat levy, which was not a presumptive tax, although so labeled. The fundamental failure lay with the lack of listings of potential assessees. Unless steps are immediately taken to plug this information vacuum, no presumptive scheme can succeed either.

References

Ahmad, Ehtisham and Nicholas Stern, 1984 "The Theory of Tax Reform and Indian Indirect Taxes" *Journal of Public Economics* 25(3); 259-98.

________, 1991 *The Theory and Practice of Tax Reform in Developing Countries* (Cambridge University Press).

Allais, Maurice, 1977 *L'Impot sur le Capital et la Reforme Monetaire* (Paris:Hermann).

Bagchi, Amaresh, 1978 "Agricultural Holdings Tax: A Modified Scheme" *Economic and Political Weekly* XIII: 38 (23 September); 1631-1648.

Balasubramanian, R. 1996 "Agricultural Taxation in India" *Fiscal News* VI:9-10 (Sept-Oct); 33-60.

Baldet, J. et.al., 1991 "Current Tax Issues in CFA Countries" (Proceedings of a Seminar, IMF, Fiscal Affairs Department, Washington, D.C. 1991); unpublished.

Bird, Richard M. 1970 *Taxation and Development: Lessons from Colombian Experience* (Cambridge, Mass: Harvard University Press)

________, 1974 *Taxing Agricultural Land in Developing Countries* (Cambridge, Mass: Harvard University Press).

Burgess, Robin and Nicholas Stern, 1992 *Taxation and Development* (London: London School of Economics, DEP 42), unpublished.

Central Statistical Organisation, 1987 *Enterprise Survey, 1983-84: Report on Service Sector* (New Delhi: Department of Statistics, Ministry of Planning, Government of India).

Das-Gupta, A. 1994 "A Theory of Hard-to-Tax Groups" in Werner W. Pommerehne, *Public Finance and Irregular Activities* (Proceedings of the 49th Congress of the International Institute of Public Finance, Berlin 1993); 28-39.

Erbas, Nuri S., 1993 "Presumptive Taxation: Revenue and Automatic Stabilizer Aspects" (Washington,D.C.: International Monetary Fund, FAD WP/93/69), August; unpublished.

Estache, Antonio and Sweder van Wijnbergen, 1992 "Evaluating the Asset Based Minimum Tax on Corporations: An Option-Pricing Approach" (Washington: World Bank Policy Research Working Papers WPS 892), April; unpublished.

Government of India, 1972 *Report of the Committee on Taxation of Agricultural Wealth and Income* (chaired by Dr. K. N. Raj).

Haindl, Erik, 1996 "Revenue Productivity of Direct Taxes in India" (New Delhi: National Institute of Public Finance and Policy), November; unpublished.

Kansal, S.M., 1992 "An Evaluation of the Contribution of 'Other Services' Sector to the Gross Domestic Product of India" (New Delhi: Indian Statistical Institute Technical Report No. 9201), February.

Ministry of Finance, Government of India, *Tax Reforms Committee (chaired by Prof. Raja Chelliah): Interim Report* (December 1991) and *Final Report, Part I* (August 1992), and *Part II* (January 1993).

_______, *Indian Public Finance Statistics 1995.*

_______, *Economic Survey: 1995-96.*

_______,1997 *Report of the Expert Group to Rationalise and Simplify Income-Tax Law.*

National Institute of Public Finance and Policy, 1996 *Report of the Working Group on Tax Policy of the Steering Group on Financial Resources for the Ninth Five Year Plan (1977-78 to 2001-02).*

Office of the Registrar General and Census Commissioner, *Census of India 1991* Series-1 (India), Part II-B(i); Vol. 1: *Primary Census Abstract.*

Rajaraman, Indira, 1995 "Presumptive Direct Taxation: Lessons from Experience in Developing Countries" *Economic and Political Weekly* XXX:18-19 (6-13 May); 1103-1124.

_______ and Kanwarjit Singh, 1995 *Report on Presumptive Direct Taxation* (New Delhi: National Institute of Public Finance and Policy), February; unpublished.

_______, O.P. Bohra and V.S. Renganathan, 1996 "Augmentation of Panchayat Resources" *Economic and Political Weekly* XXXI:18 (4 May); 1071-1083.

_______ and T. Koshy, 1996 "A Minimum Alternative Asset-Based Corporate Tax for India *Economic and Political Weekly* XXXI:29 (20 July); 1941-1952.

Rao, C. Bhujanga , 1996 "Agricultural Taxation and Subsidies in India: Issues and Review" (Ahmedabad: Indian Institute of Management) unpublished; June.

Sadka, Efraim and Vito Tanzi, 1993 "A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation" *Bulletin for International Fiscal Documentation* February; 66-73.

Sathe, Vasant, 1996 *Presumptive Direct Taxes for Economic Independence* (New Delhi); unpublished.

Shome, Parthasarathi, 1995 "Recent Tax Policy Trends and Issues in Latin America" in A.L. Resende (ed.,) *Policies for Growth: The Latin American Experience*, International Monetary Fund, Washington, D.C.

Slemrod, Joel and Shlomo Yitzhaki, 1994 "Analyzing the Standard Deduction as a Presumptive Tax" *International Tax and Public Finance* 1:1; 25-34.

Sultan, K. M., 1993 "A Study on Enlarging the Scope of Presumptive Taxation" (New Delhi: Central Board of Direct Taxes); unpublished.

_________, 1994 *Restructuring of the Economy in India and its Impact on Direct Taxes* (New Delhi: Directorate of Income Tax; Tax Payers Information Series 19).

Tanzi, Vito, 1991 *Public Finance in Developing Countries* (Elgar).

_______ and Milka Casanegra de Jantscher, 1989 "The Use of Presumptive Income in Modern Tax Systems" in Aldo Chiancone and Ken Messere, ed., *Changes in revenue structures: Proceedings of the 42nd Congress of the International Institute of Public Finance, Athens 1986* (Detroit: Wayne State University Press); 37-51.

Wilkenfeld, Harold C., 1973 *Taxes and People in Israel* (Cambridge, MA: Harvard University Press).

12

Property Tax Policy and Local Governance

Om Prakash Mathur

I. Introduction

Property taxation is perhaps the most widely-used source of revenue for local governments throughout the developing and developed world. Virtually all local governments depend to some extent on property taxation for meeting their expenditure responsibilities. Although comparative data on property tax revenues are sparse, the World Bank estimates that property taxes account for 40-50 per cent of local government finances in the developing countries.

The theoretical framework of property taxation is relatively simple in that this tax serves no other socioeconomic objective except to raise revenues for providing municipal services.[1] Because of its simplicity, property taxes have come to be associated with a number of advantages, these being—

- The object of taxation, i.e., the property, is immobile at least in the short run, and therefore, taxation of property is difficult to avoid or even shift.
- A tax on property provides no *direct* competition to other taxes that are typically held by the Central and State governments.
- It allows the application of the benefit principle because local services are, in some degree, capitalized into property values.[2] Property taxes are one way to allow owners and occupants to contribute towards the cost of local services.

---

[1] That property taxes can be used for achieving land-distribution and land-use goals can not be denied. However, these are long term considerations and have little significance in the short-run. See Roy W. Bahl (1979).

[2] While tax is for benefit conferred on a property, it can not be claimed that property taxes are determined on a *quid pro quo* principle.

- It is relatively stable in times of economic slowdown. Also, the effects of price movements on property taxes are minimal.
- It can be responsive to economic growth provided it is accompanied by good property tax policy and administration.
- It causes only minor distortions in resource allocation.[3]

Given these theoretical and practical advantages, it is surprising that property taxes have not been adequately mobilized for raising resources in the country. Indeed, these do not form a part of the country's tax policy, nor has the "reform" of these taxes been considered an integral part of any tax policy. The result is that property taxes, despite their being the primary revenue source of municipal governments, remain minor taxes in terms of revenue yields. In 1990-91, property taxes are estimated to have generated only about Rs.1425 crores of revenue, forming 2.6 per cent of the total tax revenues of the Central and State governments, and 0.25 per cent of the gross domestic product (GDP). These shares have changed little over the years, notwithstanding an extraordinarily large increase in land and property values.

Table 1
Revenue Significance of Property Taxes (1990-91)

*Estimated yield from property taxes (Rs. crores)**	*Property tax yield as a % of GDP*	*Property tax yield as a % of total tax revenues*	*Property tax yield as a % of total municipal revenues*
Rs. 1425	0.25%	2.6%	40-45%
Property tax yield as a % of total municipal expenditure	*Per capita property tax yield (Rs.)*		
25-28%	Rs. 65		

*Source: Based on the data of 293 municipalities spread over seven States namely—Andhra Pradesh (54), Assam (21), Gujarat (63), Kerala (57), Maharashtra (33), Punjab (33) and West Bengal (32). NIPFP (1994), *Redefining State-Municipal Fiscal Relations*, New Delhi.

[3] R.J. Bennet summarizes the advantages of property taxation: "It undoubtedly has strong advantages in being cheap and easy to administer; it allows easy definition of the tax base, and relates local taxation to services that result from the distribution of property. Indeed, the property tax has been recognized as the fundamental means of relating revenue burdens to geographical distribution of benefits". See, Bennet (1980).

In several States, the revenue significance of property taxes is even lower than portrayed above. In West Bengal, for example, the per capita annual property tax yield is estimated to be only Rs. 24, and in Andhra Pradesh, it was estimated to be Rs. 55 (1991-92). Even in Bombay where the real estate prices are among the highest in the world, the total annual rateable value was placed Rs. 436 crores, and property tax yields at Rs. 266 crores (1993-94).[4] This highly uneven performance of property taxes in the different States is essentially explained in terms of the diversity of tax domain between municipal governments, as defined in the State municipal acts, the efficiency with which it is used, and the legal and statutory framework within which municipal governments are able to operate and exercise their tax powers. These figures also reflect property taxes suffering from the problems of narrow base (exemption of a large number of properties from payment of property taxes), persistent undervaluation, high tax rates, and most of all, poor enforcement. These issue will be brought out in some detail in the next section of the paper.

Table 2
Inter-State Variation in Per Capita Property Tax Yields

State	*Per capita property tax revenue (Rs.)*
Andhra Pradesh	55.4
Gujarat	68.7
Kerala	54.9
Maharashtra	117.3
West Bengal	24.1

Source: NIPFP (1994), *Redefining State-Municipal Fiscal Relations*, Vol. 1. New Delhi.

II. Property Tax System in India: Practices, Performance and Problems

A property tax system is generally described in terms of tax-base definitions, rebates, exemptions, rates, property valuation, tax liability, notification, tax collection, enforcement, appeals, and disputes. For reasons of simplicity, these components of the system are grouped in two parts, namely: those that are related to valuation and assessment, and those which are related to collection. Such a division has been found to be common in countries that have developed and implemented strategies for property tax reform.

[4] See NIPFP (1996).

Property taxes in India owe themselves to Entry 49 in List II of the Seventh Schedule of the Constitution of India which provides for the levy of taxes on lands and buildings. Taxes on land and property are, however, levied by municipal governments in accordance with the procedures laid down in the State municipal acts. The procedures lay down the tax bases, rate structures, rebate and exemption policies and measures for dealing with payment delays and defaults. The autonomy of municipal governments in formulating property tax policy is severely limited, and allowed at best in fixing the tax rates within certain ranges and often in designing collection strategies. Since property tax policies are determined by State governments, there is a large scale diversity in almost every sphere of property taxation. Thus, for instance, a tax on land and property is an *obligatory* tax in some States and an *optional* tax in others, with the result that a number of municipalities have opted not to levy any property tax at all.[5] Diversity is particularly sharp in the structure of tax rates.

There are several forms of assessing properties for taxation purposes. A tax on property may be levied on its rental value; in this, the annual value form is seen as an attempt to tax the *flow* of income from properties. The main advantage of the annual value is that it is based on the income concept and is easier to comprehend. This system yields good results where the size of the property rental market is large. Tax may be levied on the capital value, i.e., the value that a property may derive if it is sold in the market (*stock* of capital). This system works well in situations where property sale and purchase transactions are common. Site value tax (STV) is yet another form of taxation prevalent in some countries. It is a form of property tax under which the value of land alone is taxed. The rationale of STV is that increases in land values are attributable to public investment in developing the area and not due to an individual's effort.

Assessment of property taxes in India is based on the annual rateable value (ARV) of land and buildings taken together in all States, except in Andhra Pradesh where the State Municipal Act provides for the use of ARV for rented properties and capital valuation for owner-occupied properties.[6] Annual rateable value is defined as the gross annual rent at which a property

---

[5] According to Zakaria Committee (1963), 35 per cent of local bodies in Gujarat, 18 per cent in Madhya Pradesh, 38 per cent in Punjab, and 40 per cent in Uttar Pradesh did not levy any property tax. Recent data on this aspect is not available.

[6] Andhra Pradesh has recently shifted the assessment method by using what is called the "area basis" for determining the annual rateable values. It will be referred to later in the paper.

may reasonably be expected to be let out from year to year. It is a hypothetical rent which is held as a proxy for market rent of the property concerned. It is not the actual rent transacted, but is the expected or the notional rent of the property. In the State municipal acts of Himachal Pradesh and Madhya Pradesh, however, ARV is derived on the basis of the actual rent charged; in Maharashtra, Punjab and Haryana, the statutory provision is that only if a property is let out at a higher rent than is "reasonable", the actual rent is to be treated as the basis for calculating the ARV. In the case of buildings which fall under the purview of rent control provisions, annual rent is taken as equal to the "standard rent" fixed by law.

There are provisions for revaluation in all State municipal legislations in the annual rateable values. Most State municipal acts require that revaluation occur once in three to five years. In the interim, assessment can be altered only if additions or alterations are made to the property. No adjustments in assessed values are made even if such changes *actually* occur and are known to the assessor. This has introduced large scale inequities into the tax base and retarded the growth yield.

Annual rateable value is subject to at least six different kinds of deductions and rebates, these being—

- rebate to owner-occupied houses
- rebate for repairs and maintenance
- depreciation as per the age of the building
- rebate on early payment
- vacancy remission

The Andhra Pradesh Municipal Corporation Act, for example, provides that the annual rental value of lands and buildings shall be deemed to be the gross annual rent at which these may reasonably to be let from year to year, less a *deduction* at the rate of 10 per cent for buildings aged upto 25 years, and 20 per cent for buildings aged above 25 years. The Act also provides for a rebate of 40 per cent of the annual rental value in respect of residential properties occupied by the owner. Similarly, in Madras, the annual value is adjusted for owner-occupied buildings (25%), repairs and maintenance (maximum of 10%), semi-permanent structures (maximum of 20%), age of the building (30% depreciation), and for unspecified special

concessions.[7] Most of the rebates and deductions have assumed a discretionary character, and are negotiated between the tax assessors and tax payers, and constitute a major source of corruption at the local level.

A general feature noticed in almost all the statutes governing municipalities is the stipulation making it obligatory for a municipality to refer the fixation and alteration of tax rates to State governments. Some of the notable exceptions to this general rule include the municipal statutes of Andhra Pradesh, Kerala, Maharashtra and Tamil Nadu where the municipal bodies, *provided they are not indebted*, have powers to alter the rates of the tax at their discretion within the limits prescribed under the statues. Municipal Corporation have somewhat greater autonomy in this respect.

This common feature notwithstanding, significant variations are observed over the rate structure provisions in different States. Some States stipulate the maximum and minimum of rates of taxes as percentages of annual rental or capital values; in others, one-side limit or no limit is prescribed. The Karnataka Municipal Act, 1964 fixes the maximum ceilings on the rates of component taxes as also the minimum limit on the rate of the aggregate of all those taxes. In Kerala, on the other hand, minimum limits on rates of component taxes are laid down; similarly, no limits are prescribed in respect of water tax with the stipulation that the aggregate rate of all property taxes should vary within a specified range of the annual value. In addition, property tax is envisaged to be levied at a fixed proportional rate of the annual value. Provision also exists for the levy of tax according to progressive rates, the rates of the tax increasing alongwith the annual value of the property concerned. Thus, under the Calcutta Municipal Act, 1951, the rate structure applicable to different annual rateable values of properties are as follows:

Table 3
Rate Structures as provided for in the Calcutta Municipal Act, 1951

Annual Rateable Value (ARV)	*Tax Rate (% of the ARV)*
Less than Rs. 1.000	15.5
Rs. 1,000—3,000	18.5
Rs. 3,000—12,000	22.5
Rs. 12,000—15,000	27.5
Rs. 15,000 and above	33.5

[7] Actual depreciation of a building aged "n" years is calculated using the following formulae: $P=A[(100-r)/100]^n$ where A= total cost of construction of building: r=rate of depreciation per anum, n=age of building; and P=the final depreciation value of the building. The amount of depreciation is then equal to (A-P), subject to the minimum of 10 per cent of A.

Thus, these are four different categories of rate structure prevalent in the country:

- consolidated rate instead of several imposts on the same tax base
- statutory specification of the maximum and minimum of the rate
- progressivity in the rate structure
- discriminatory rate structures to properties according to their use, location and other factors.

Exemption from local property taxation constitutes an important ingredient of a property tax system, and is prevalent in all countries. The underlying objectives in granting exemptions are social justice, high administrative and collection cost particularly from low tax-yielding properties, and compensation to those properties that provide, directly or indirectly, welfare services having characteristics of merit or public goods. In India, exemption from property taxation is a *Constitutional obligation* where, under article 285 properties of the Union are exempted from all taxes imposed by either a State government or any authority within a State; and it is a *statutory obligation* where the State government and municipal government properties are exempted from payment of property taxes. Exemption is also allowed by the decision of the municipal councils themselves. Thus, the New Delhi Municipal Act, 1994 vests the Municipal Committee with the power to exempt in whole or in part any person from payment of taxes on grounds of poverty, and also to exempt any class of property from payment of property taxes. Since the exemption is *exemption from payment and not from levy*, the entire exercise for the levy of tax, i.e., issuance of notice, determining the rateable value, and inviting objections has to be done but no Demand Notice is issued to the extent of exemption granted. More generally, the following categories of properties stand exempted from payment of property taxes:

- residential properties whose annual rateable values are below the prescribed minimum
- Central and State government properties and also, selectively, properties of other levels of governments
- residential properties whose annual rateable values are below a prescribed minimum
- charitable organisations
- places of worship

- properties used for sheltering the destitutes, orphanages, and similar organisations run on philanthropic lines
- ancient monuments
- charitable hospitals and dispensaries
- burial and cremation grounds
- recognised educational institutions including hostels, libraries and playgrounds

Efficient tax collection is one of the most important constituents of property taxation. Here too, the municipal legislations lay down detailed procedures for issuance of assessment notice, period within which the tax is required to be paid, mode of payment, and actions under the law for defaulting on tax payment. Thus, the payment modes include payment at the office of municipality, payment to tax collectors, and payment at banks. In a few areas, provisions exist for tax pass books as well. There exists no penalties for delayed payment; however, properties can be attached, sold or auctioned in case of default on payments.

Major problems have arisen over the years in the implementation of this system of property taxation. This paper focuses on four problems relating to (i) those which are associated with the annual rateable value as the method of assessment, (ii) the wide range of rebates that are provided to the tax payer, (iii) the exemption policy, and (iv) the tax collection strategy. It is important to point out that several Committees and Commissions have examined local taxation issues and as has often been pointed out, apart from a few exceptions, they have reached the same conclusions and made similar recommendations yet few of their major recommendations have been put into practice.

Much of the discussions on property taxation in India have taken place on the merits and demerits of assessment based on the annual value of property. The concept of annual rateable value as prescribed in the State municipal acts corresponds closely with the view of the English Court which as described the problems of measuring the rental value:

> "The rent prescribed by the statute is a hypothetical rent, as hypothetical as the tenant. It is the rent which an imaginary tenant might be reasonably expected to pay to an imaginary landlord for the tenancy of this dwelling in this locality, on

> the hypothesis that both are reasonable people, the landlord not being extortionate, the tenant not being under pressure, the dwelling being vacant and available to let, not subject to any control, the landlord agreeing to do the repairs, and pay the insurance, the tenant agreeing to pay the rates, the period not too short nor yet too long, simply from year to year."[8]

Given this description which also represents the Indian system of property taxation, it is not surprising that the entire process of calculating ARVs has turned into a highly ad-hoc and discretionary exercise. More than this, divergence between the assessed annual value and market rents of properties has grown over the years, and led to large scale stagnation and inequity into the system. Though assessment to market rent ratio studies are rarely carried out, available evidence suggests the existence of large scale underassessment. A survey by the World Bank in Calcutta has estimated the assessment to market rent ratio at about 50 per cent for central commercial properties and 7.5 per cent of outlaying industrial estates. Nath and Schroeder (1984) report assessment ratios in the 25 to 35 per cent range in Delhi and Madras. Revaluation—a mechanism to bridge the divergence between the annual value and market rents—has, for instance, not been carried out in Hyderabad for twenty years, even though the rules prescribe it to take place every four years. Such revaluation lags are common in India. Quite apart from the political and administrative problems that lead to infrequent reassessment, the main reasons identified for such divergence are (i) legally available reductions in annual value, (ii) rent controls, and (iii) assessment difficulties, particularly for non-residential properties. It is this divergence between the assessed annual values and market rents that has been identified as the principal problem in using the ARV as the base for property taxation.

The presence of rent control confounds the notion of what constitutes a market rent. Rent control constraints are said to severely limit both the level and growth of assessed value. In practice, the problem of assessment under rent control has been dealt with in different ways. For example, Bombay and Delhi have had long-standing rent control acts and all assessed properties are subject to rent control according to the ceilings prescribed in the acts. In Bombay, the concept of 'standard rent' or 'fair rent' plays an important role in the taxation of properties. The Bombay Rents, Hotels, and Lodging House Rates (Control) Act, 1944, for instance, defines "standard rent" in relation to any premises as:

[8] Adopted from Rakesh Mohan (1983).

(a) Where the standard rent is fixed by the Court and Controller respectively under the Bombay Rent Restriction Act, 1939 or the Bombay Rents, Hotels and Lodging House Rates (Control) Act, 1944, such standard rent;

or

(b) When the standard rent is not so fixed subject to provision of Section 11,

i. The rent at which the premises were let on the first day of September, 1940;

ii. Where they were not let on the first day of September 1940, the rent at which they were last let before that day;

or

iii. Where they were first let after the first day of September 1940, the rent at which they were first let. Notwithstanding anything contained in this paragraph the rent of the premises referred to in sub-section (1A) of Section 4 shall, on expiry of the period of five years mentioned in that sub-section, not exceed the amount equivalent to the amount of net land and buildings and all the outgoings in respect of such premises

or

iv. In any of the cases specified in Section 11, the rent fixed by the Court.

It is clear from the above text that once the standard rent has been fixed, it remains unchanged for the life of the property. This position applies even when the actual rent transacted by mutual agreement between the landlord and tenant is higher than the standard rent. This has had the effect of freezing the rateable value of the properties falling under the rent control acts. Various Court judgments over the years have also ruled that the municipalities can not assess the annual value of any property at a value greater than the standard rent.

Studies on municipal finances have singled out the adverse effects of rent control on property tax yields. The Zakaria Committee (1963) and the Rural-Urban Relationship Committee (1996) suggested that property assessments should be delinked from rent control. The oft-repeated assertion that rent controls actually benefit low income tenants or that they have substantial income distribution effects have also not been sustained by studies. The result of continuing with rent controls is the considerable opportunity cost in terms of property tax revenues forgone. Rakesh Mohan (1974) estimated that Bombay's property tax revenues could have been 50

per cent higher in the absence of rent controls. A similar estimate of property tax loss was made for Calcutta. Gains from rent control to low-income families, if at all these accrue, are achieved by sacrificing large revenues.

The fiscal effects of rent control on municipal governments are substantial, and have led to inequities in property taxation. Thus, two types of properties, bearing taxes on two different bases have appeared: (i) properties whose ARVs are determined on market value basis, and (ii) properties whose assessments are determined by the Rent Controller. The inequities in the two assessments have widened over time in that the former are periodically revised and the latter remain stagnant and outdated. The principal effect of this is that rental assessment in most municipal areas which are subjected to rent control acts, is that the total property taxes remain stationary. Even in the case of properties not under the rent control acts, the full rent is not revealed in the ARV for various administrative and other factors, with the result that the entire property tax system suffers from underassessment.

In addition, some non-fiscal effects emanating from the current ARV practices have also come to attention, especially relating to the adverse effects of rent control acts on property rental market, and on the quality of the rental housing market which has dipped over the years, with virtually no investments having been made in housing upgradation and improvement.

In sum, the inadequacies of ARV as the basis of assessment are as under :

- ARV is not amenable to capturing the price rise in land and buildings.
- ARV is not comprehensive. In the case of premises covered by the rent control acts, rents are virtually frozen and therefore, there is no tax yield from those properties.
- ARV system provides no incentive to optimum utilization of land. In so far as the rental value system does not take into account the appreciated value of land, it offers no incentive to the land/property owner to build as much as is permissible under the building bye-laws.

- It has given rise to land speculation, and distortions in the property market.

As indicated earlier, property tax system in India allows exemptions to different categories of properties from payment of property taxes. These typically include government properties, charitable, religious and educations institutions, and also, often, property owners in certain income categories. This exemption discriminates in favour of tax-exempt organisations leading to a mix of land use that may be different from that which may exist under equal treatment of all properties.

An indication of the scale of exemption and the degree to which it can affect the property tax is available from Delhi where, of an estimated 15.3 lakh properties within the jurisdiction of the Corporation, only about 6.4 lakh properties have been brought under property tax assessment. The fact that only 41.7 per cent of the total estimated properties are assessed speaks of the narrow tax base, and provides important clues to the existing untapped potential of property taxes even under the existing set of rules and regulations governing the taxation of properties. Needless to say that, such large exemptions also explain the very high rates of property taxation within the country, leading to major tax avoidance, leakages, underassessment and corruption.

Collection of property taxes presents a formidable problem as collection costs are often high and collection efficiency low. Although firm data on property tax collections are unavailable, property tax collection ratios are no more than 50-60 per cent. Data problems notwithstanding, these low rates of collection are a good indication of the situation. The source of the problem lies with inadequate collection procedures, with an inadequate set of penalties necessary to enforce the tax, and with the lack of inducements necessary to stimulate collection.

In Bombay, the discrepancy between demand and collection of taxes has widened over the years. During the years 1992/93 to 1993/94, property tax demand increased by 74.7 per cent but the collection during the same period increased by only 53.3 per cent. It has led to large uncollected amounts. What is important is that the collection efficiency or the proportion of collection to demand has remained stagnant. In Delhi too, the proportion of tax payers making payment compared to the total number of bills issued is very low. The South Zone of Delhi accounts for only 68.5 per cent of the total tax payers making payments; the North Zone reported

only 63.5 of the tax payers making payments towards property taxes. The net result of this inefficiency is in large property tax arrears which amounted to over Rs. 75 crores at the end of November 1994. It excluded those tax payers which had arrears of less than Rs. 10,000.

The overriding factor in the existing administrative system lies in the maximum rights for the taxpayers. It has a high priority in a long-established legal tradition. The procedures designed to secure the rights of taxpayers are, however, invariably misused to the extent that the levying of property taxes has been turned into a negotiation process where corruption is common and where appeal procedures result in tax reduction.

The property tax system thus stands fully choked in each of its components or sub-components. If an estimate is made of the *lost income* on account of the inability of the annual rateable value to capture the market rents, of the large scale rebates, of exemptions which result in an extremely narrow tax base, and the effect of rent control on the annual rateable values, it will be phenomenal. Giving values to the lost income is a hazardous exercise, but the fact that (i) assessment to market rent ratios are in the range of 50-60 per cent, (ii) rebates are substantial, (iii) only about 30 per cent properties are under property tax assessment, and (iv) most cities lose 50 per cent of income on account of the rent control acts, would add up to a loss equal to approximately 150-175 per cent of actual collections on property tax account. In Delhi, it is estimated that property tax actual yields are only about 14-15 per cent of the potential, without any adjustment to the rate structure or any other change in the present-day system.

III. THE ANDHRA PRADESH INITIATIVE

The past few years have seen in the country improvements in property tax policies and administration; for example, Bihar and Andhra Pradesh have introduced reform in property tax assessment which have resulted in significant revenue increases. Delhi has modified its Rent Control Act which has also had its impact on the property tax revenue. In addition, Tamil Nadu, Hyderabad and Ahmedabad have carried out marginal improvements in property tax administration which too have led to greater mobilisation of resources.

The reform efforts of property tax assessment revolve around standardization so that objectivity is ensured to the advantage of the

assessors and the tax payers. Standardization implies setting up of certain measurable norms in the assessment, irrespective of the basis of assessment. Most of the cases relating to assessment of properties have in the past, struck down by the courts on the grounds of inequity and arbitrariness. The challenge therefore, in the recent reform efforts was to evolve a system which could withstand the rigors of law, and at the same time, be feasible from the administrative standpoint.

An important innovation that has taken place in the country is in respect of the method of assessment by using instead of the actual, 'reasonable' or 'standard rent', a set of area based indicators, combining such characteristics as location, type of construction, nature of the use of building and age of building for the calculation of ARVs. The Andhra Pradesh government has adopted this method as it, *prima-faci*, seemed to possess such advantages, i.e., objectivity in assessment, procedural simplicity, standardized methodology, and better clientele appreciation and cooperation. The Andhra Pradesh property tax reform was driven by the following objectives:

- To evolve a scientific method in the assessment and levy of property tax by incorporating in it the principles of equity, objectivity, fairness and simplicity.

- To provide relief to the residential buildings of owner-occupied, weaker sections and aged buildings.

- To delink the operation of Rent Control Act from the assessment of property tax.

- To make tax administration efficient, transparent and effective in the levy of property tax.

- To improve buoyancy in the property tax revenues.

The new method of property assessment involved determination of annual rental value with reference to their location, type of construction, plinth area, age of buildings, and nature of use to which the property was put. For this purpose, the entire municipal area was divided into convenient territorial zones for purposes of assessment of tax, taking into account such factors as the availability of civic amenities, access to markets, to educational institutions, banks, postal services, and medical institutions. Buildings were classified according to the type of construction and according to use. Surveys were undertaken to ascertain the prevailing rents.

It constitutes in recent times the most important initiative to eliminate the arbitrariness that the system of estimating the ARV suffered from. The approach is effectively a formula for property valuation where a property is defined by a vector of attributes. Hence, conceptually, what has been tried in Andhra Pradesh and also in Patna city is that the value of a property has been determined as a discrete function of six attributes:

V = f (plinth area; land area; location; type of construction; type of use; age)

where f (.) is a linear combination of these attributes[9]. As a result of the introduction of approach, the property tax yields in Andhra Pradesh and Patna city have increased substantially. In Andhra Pradesh, the increase in property taxation has been capped so as not to place unreasonable burden on tax payers, while in Patna city, the rate of tax has been significantly reduced so as to endure its acceptability. What is significant is that the Courts too have found the new system sustainable on grounds of its being simple, transparent and reasonable, as may be seen from the following extract[10]:

> "The merit of the Assessment Rules, 1992, is that they rid the house-owners of the harassment and the constant threats of revision of annual rental value by the concerned officials of the corporation. The earlier system of taxation left too much discretion in their hands. Now, the only thing that has to be ascertained is the carpet area of the house, the rest is determined by the Rules and the notifications. There is no question of the revision of annual rental value periodically on the ground that the rental value has gone up. A new system, with all good intentions is being tried out—a system designed in the interest of the body of house owners-tax payers as well as the corporation. May be, this is the trial and error method. Unless found to be offending the Constitutional or a statutory provisions, it must be allowed to be worked. One should start with the presumption that the corporation knows what is the better method of

[9] This system is really a hedonic formulation of property values. While the approach is conceptually simple, it is not obvious that it would not suffer from discretionary arbitrariness. As in the valuation of land, the key problem would lie in the delineation of locations. However, despite this, the approach is transparent, simple and reasonable.

[10] It is significant that the issue of whether or not the new system is compatible with the rent control acts has not been considered in the Court of Law.

classification. It has chosen to divide the Municipal corporation area with reference to roads for valuation of holdings. It is difficult for the court to substitute its opinion for that of the corporation nor can any one guarantee that if the municipal corporation area is divided on the basis of zones it will be a perfect classification and would eliminate all complaints and grievances of differential treatment. It is because of the inherent complex nature of taxation that a greater latitude and a larger elbow room is conceded to the legislature—or its delegate, as the case may be—in such matters"

IV. Conclusions

There are several conclusions here. One is that the structure of property tax and its administration and enforcement are part of one integrated system and can not be dealt with separately. Any attempt to reform the structure without ensuring that the new structure will be efficiently administered will be partial, and yield at most short-run rather than sustainable gains. A second conclusion is that the annual rateable value (ARV) system has enough flexibility to allow for changes that can make it responsive to shifts in the real estate market. The Andhra Pradesh and Patna models have demonstrated that ARV can be worked out taking into account a number of variables, and that the same can be made more transparent by giving publicity to rate structures for different locations and geographical areas.

A third conclusion is that the discretionary elements particularly in gaining rebates and exemptions are unjustified and have no place in any property tax system. It needs to be recognized that property tax is not a tax on rental income; it is a *local* tax, consisting of a general tax and various service taxes, payment of which is distributed among property-owners according to the value of the property. Across-the-board rebates do not change the distribution of the tax burden; the same results can be achieved by lowering the tax rate. A fourth and final conclusion is that direct contracts between the tax payers and tax assessors should be replaced by the introduction of indirect system of property tax payment. Such systems are currently being experimented, and need to spread out to gain wider acceptance.

The Constitution (Seventy-fourth) Amendment Act, 1992 places longer responsibility upon municipal governments to undertake not only

those functions that have traditionally been performed by them but also those which are related directly to economic growth and development and income distribution. The Amendment also provides for the setting up of State Finance Commissions which, in accordance with its provisions are required to determine the principles for tax assignment to municipal bodies, for tax sharing, and grant-in-aid systems. The Amendment has provisions for the strengthening of local democracy, participation, and effective governance. The Amendment assumes that these components are not isolated or independent provisions but are inextricably linked with each other. Effective local governance is thus as much dependent on participation as on the fiscal strength and fiscal discipline of municipal governments.

Property taxes provide to municipal government perhaps the most important source of revenue. As the municipal governments stretch their horizon and undertake larger responsibilities it will be necessary for them to undertake major reform of property taxes in a comprehensive manner, and optimally use them for provision of infrastructure and services.

Any reform process must recognize that property tax policy formulation is the responsibility of State governments, and the execution of policy that of the municipal governments. A prerequisite for reform is thus a political will by all levels of governments and acceptance by the tax payers. A concomitant step will demonstrate how *all* could gain from property tax reform. The State governments could reduce grants to municipal governments. The municipalities could increase revenues on property account and may secure greater autonomy in rate-setting. The tax payers could have lower tax rates due to the repealing or reduction of rebates and exemptions.

References

Bahl, Roy W. (1979), *The Taxation of Urban Property in Less Developed Countries*, The University of Wisconsin Press.

Bennet, R.J. (1980), *The Geography of Public Finance*, pp 290.

National Institute of Public Finance and Policy (1994), *Redefining State-Municipal Fiscal Relations*, New Delhi.

_______ (1996), *Potential of Property Taxes in Major Indian Cities*, New Delhi.

Mohan, Rakesh (1974), "Indian Thinking and Practice Concerning Urban Property Taxation and Land Policies". Princeton University, Discussion Paper 47. Princeton.

_______ (1983), "Indian Thinking on Property Tax Reform", in A. Datta, *Property Taxation in India*. Indian Institute of Public Administration, New Delhi.

Nath, Shyam, and Larry Schroeder (1984), "Property Tax Growth in Metropolitan Cities in India", *Nagarlok*, 16. No. 2, pp 33-44.

Expenditure Control and Fiscal Management—The Federal Dimension

13

Discussion of Papers by D.K. Srivastava, A.K. Ghosh, A. Bagchi

N.J. Kurian

One of the sessions in the symposium on Fiscal Policy, Public Policy and Governance held at the National Institute of Public Finance and Policy (NIPFP) during 5-6 December, 1996 in connection with the commemoration of the 20th Anniversary year of the Institute was on Expenditure Control and Fiscal Management and the Federal Dimension. Within the overall context of an over-grown Government and its fiscal management, this session was expected to be devoted to an in-depth scrutiny of the system of control and management of government expenditure which has been exhibiting rising magnitudes, falling efficiency, pervasive leakages and considerable wastage. The symposium was expected to deliberate on issues like soft budget constraints, myopic and partitioned process of formulating budgetary demands for spending, budgetary mis-prediction, procurement inefficiencies, inadequate ex-post scrutiny and weak corrective feed-backs and to identify reform measures to correct these shortcomings.

Three papers have been presented in the session. They are (i) Budget Process and Expenditure Management in India by Dr. D.K. Srivastava; (ii) Effective Budgetary Control for Expenditure Management and Its Ramifications for Public Policy and Governance by Dr. Amiya Kumar Ghosh and (iii) Fiscal Management - the Federal Dimension by Dr. Amaresh Bagchi. The three papers together covered all the issues expected to be discussed in the session and as such, they have complemented each other. While Srivastava attempted a conceptual and theoretical interpretation of the empirical aspects of budgetary control and management in India, Ghosh concentrated on aspects of effective budgetary control in the context of Indian budgetary process with special reference to defence expenditure and Bagchi concentrated on the federal dimensions of the fiscal management. Broadly, one can characterise the first paper as a conceptual paper, the second as an applications paper and the third as an issues paper. The three papers together have covered a vast canvas of fiscal issues drawn heavily from the institutional and empirical aspects of public expenditure management in the Indian context based on their respective rich and varied experiences in these areas.

Size and growth of Government of India

Though the premise of this session is an over-grown Government one can very well argue that the share of Government expenditure in India in terms of GDP or the share of Government employees in the total population is not necessarily too much as compared to developed countries. Even if we take Governments at all levels in India, they account for less than 30 per cent of the total GDP while the OCED average is around 40 per cent. A number of core activities/services which are truly in the domain of Government are either neglected or provided inadequately. These include a number of public goods including primary education, primary health, sanitation, water supply and law and order. At the same time, it should be conceded that the Government has been expanding in several wrong directions and has been taking up several activities which truly belong to the private sector or the market. Further, Government expenditure has been notorious for its ineffectiveness and wastages due to inefficiencies at all levels and leakages of various kinds.

Till the early 80s, the growth in Government expenditure has been in tandem with the growth in revenues and as such, Governments at the Centre as well as in the States have been, by and large, able to meet the current expenditure from the current revenues. Broadly, borrowings of the Government were being used for capital formation. In the early 80s, the revenue expenditure overtook the revenue receipts, resulting in revenue deficits, both at the Centre and in the States. Initially, revenue deficits were only on the plan account but by the late 80s, revenue receipts were not even enough to cover the non-plan revenue expenditure. By early 90s, the situation deteriorated even further to the extent that a significant share of the borrowing had to be used for meeting the revenue gap. In the wake of stabilisation and the structural adjustment policies initiated in June, 1991, attempts were made to arrest the fast growth of expenditure. The experience of the last five years is that while the Centre has succeeded in containing the growth in expenditure, there was no such success in the case of States. In the case of the Centre, however, the reduction in the growth of overall expenditure was mainly on account of the reduction in capital expenditure. As a result, while the fiscal deficit has come down, the revenue deficit as a percentage of GDP has not come down; revenue deficit remains more or less at high levels.

Factors inducing escalation of expenditure

A number of factors responsible for escalation of Government expenditure have been identified by the three authors in their respective papers. They can be broadly classified as : (i) soft budget constraint; (ii) fragmented approaches to budgeting; (iii) spending without earning, (iv) creating commitments by under-provisioning; (v) lack of transparency, (vi) systematic errors in prediction/forecasting.

Soft budget constraint has been the bane of Indian budgetary process. Supplementary budget is the major villain in this context. Supplementaries are a rule rather than an exception. A hard budget constraint, such as those faced by individuals and private enterprises could discipline the decision-making units in the Government and force them to be responsive to price signals in the economy. Only a hard budget could generate substitution effects that are crucial for economic efficiency. However, the spending agencies in the Government perceive budget constraints as soft and lobby for increased budget allocations rather than reallocate resources in the face of changing relative prices and other cost-escalating changes.

In general, decentralised decision making and a bottom-up approach have several merits in the context of planning, programming and implementation of development projects. This, however, may not be the case with budget making. Fragmented approaches to budget making invariably lead to over- estimation/padding and over-spending. This is because the spending agencies take into account the full benefit from the spending programmes but consider as cost only that part which falls on them. Thus, policy makers in a decentralised budgetary process systematically over-estimate the net marginal benefit of increasing public spending. In contrast, centralisation of budget formulation enable a comprehensive view of the revenues and expenditure as compared to the compartmental view of individual spending agencies.

As in the case of private individuals , public agencies also become spent-thrift if they are not responsible for generating incomes which they are spending. The resources are perceived to be coming from a common pool. As Dr. Bagchi characterises: the 'tragedy of the commons' is one of the major factors escalating the public expenditure. This is especially true in the Indian context where most of the social and economic services are provided free of cost. Since the spending Ministries/Agencies are not called upon to earn their existence through their spending programmes, there is no restraint on their propensity to demand more.

Another major problem with the budgetary process is the committed expenditure which is the result of under-provisioning in earlier periods. Often one comes across a situation where a project requiring massive resources for its completion is included in the budget with a very insignificant provision. This will lead to commitments in the following periods as well as cost escalation due to inordinate delays. Indeed, one of the major reasons for low productivity of capital and high incremental capital output ratios in the public sector of the Indian economy is this kind of under-provisioning.

The budgetary process is generally shrouded in secrecy and suffer from lack of transparency. As a result the perceived benefits of spending are often over-estimated by the interested parties. The spending requirements, on the other hand, are under-estimated.

Further, as Dr. Srivastava notes, clever budget formulators often employ subtle techniques like strategic use of budget projections, under-estimation of interest rates, over-statement of effects of proposed budgetary changes, creation of various funds and extensive use of transfers to and from these funds and strategic use of multi-year budgeting to increase the opacity of the budget.

The tendency of systematically under-estimating the growth of public expenditure is inbuilt into the budgetary process. As a rule, every year, the revised budget is significantly higher than the budget estimates and further often the final budget figures or accounts are still higher than the revised estimates. However, almost invariably one year's budget estimate is related to the revised estimates of the preceding year or the actual expenditure of the previous years. This comparison of un-comparables invariably gives the impression of a growth in expenditure significantly lower than the real growth.

The Present System of Public Expenditure Management

The existing system of control and management of Government expenditure had been evolved in the context of entirely different expenditure criteria prevalent in an earlier era. The traditional control mechanism devised to monitor and control expenditure has become rather ineffective in the present context. As compared to regulatory and maintenance expenditure during pre-plan period, the present emphasis on developmental expenditure has given an altogether different thrust to Government expenditure. Indeed,

the expenditure management and control system is so weak and ineffective that often accountability is conspicuous by its absence in the system.

Several modern techniques of public expenditure control have been developed in the post-war era in developed countries. Some of these techniques have been borrowed and introduced half-heartedly in our context. However, most of them have failed miserably. Examples are: performance budgeting, work study and planning, programming and budgeting system (PPBS). A major drawback of the existing system of public expenditure management is its ineffectiveness in ensuring that spending is effective and it results in expected outputs. Most of the expenditure monitoring is restricted to ensuring that money is spent.

Reasons for ineffective/wasteful spending

One of the major drawbacks of our budgeting process is that spending follows budget cycles over-riding all other considerations. 'The rule of lapse' implied in the annual budget implies that unless expenditure is incurred before the financial year end, the money will lapse. This results in immense waste in the system. Often, it is noticed that even in activities like agriculture, anti-poverty programmes and other areas where the spending cycle has to be necessarily related to the monsoon cycle and lean season requirements, the all pervasive budget cycle introduces serious distortions in spending which are usually bunched in the last quarter and especially in the month of March. A second reason for wasteful spending is excessive categorisation and fragmentation of expenditure. As per Indian Constitution, expenditures are to be either revenue or capital. But in the context of developmental activities we have further classified expenditure into developmental and non-developmental. With the introduction of a planning process, we have even further classified expenditure into plan and non-plan. As a result we have 2x2x2=8 categories of expenditure. Of course, out of these eight categories, two, namely, plan non-development revenue and plan non-development capital are redundant. However, we still have six types of expenditure in our accounting system. Indeed, Tenth Finance Commission had come down heavily on the 'artificial' distinction between plan and non-plan expenditure and recommended that this should be done away with. If we closely examine the classification of capital and revenue expenditure in our budget, we notice that this classification is also artificial to some extent. For example, all grants are treated as revenue expenditure while all loans are treated as capital expenditure. However, grants for rural works, soil conservation, minor irrigation etc., contribute to capital formation, while loans to the public sector enterprises for meeting

their losses and loans for natural calamities do not contribute to capital formation. Again, all grants given to the States are not spent on revenue items just like not all loans are spent on capital expenditure.

Stages of Budget Making

Dr. Srivastava has very succinctly discussed the various stages of budgetary process in our country. It starts with proposals for Demands for Grants by various spending agencies six months in advance of the financial year and generally the approach is incremental. The concept of zero-based budgeting is still alien to our system. This results in padding of expenditure all through at the stage of budget proposals. The Budget Division in the Department of Economic Affairs in the Ministry of Finance coordinates the budget related work. The regular budget is usually presented before the end of February by the Finance Minister. The Parliamentary process usually lasts for 10 to 12 weeks. After the presentation and general discussions the Demands for Grants of the different Ministries are taken up for detailed discussion. As per the information furnished by the Reference Wing of Lok Sabha Secretariat , only a small fraction of the total demand for grants is taken up for detailed discussion during the entire budget session and the rest of the demands for grants are passed without any discussion in Parliament. However, a few years ago, the Standing Committee system was introduced which implies that groups of Parliamentarians responsible for different Ministries go into the details of the Demands for Grants of different Ministries. However, its effectiveness is yet to be evaluated. The ex-post control of expenditure by the Constitutional Institution of Comptroller and Auditor General generally goes into the expenditure details and their reports are presented to the Parliament. However, a major limitation of the auditing process is that it is strictly based on the accounts and hardly any provision is there to ensure that the expenditure is justified in terms of the outcome or results. As long as accounts are consistent (even if false), the chances of getting caught by the audit process are minimum.

Ex-post control of expenditure is also exercised by Parliament through a number of Committees such as (a) the Estimates Committee (b) the Public Accounts Committee and (c) the Committee on Public Undertakings. Depending upon the personality of the Chairman and the homework done by him and the members, these Committees can be of varying levels of effectiveness. In the past there were several instances when these Committees used to send shivers down the spines of senior bureaucrats and the heads of public undertakings . Of late such instances are far fewer.

Need for an Expenditure Policy

The absence of an expenditure policy to guide the public expenditure management in India is the prime reason for uncontrolled growth in public expenditure. The mechanism of determining the expenditure level has been through the annual budgets. Budget-making and budgetary control system in India has practically remained unchanged for more than a century. Budget is formulated on an incremental basis keeping in view the trends in expenditure. Though an attempt was made in the 1980s to introduce the principle of zero-based budgeting, this was scrapped subsequently. Though none of the authors in the symposium highlighted the importance of zero-based budgeting, this principle has the potential to play a significant role in curbing unproductive public expenditure. Many of the on-going schemes and staff in position in Central Ministries and Departments may not survive the test of zero-based budgeting.

The annual budget cycle militate against proper planning of public expenditure over a long period which is essential for major schemes. As noted earlier, the rush for spending in March due to the 'rule of lapse' results in considerable wastage. Multi-year fiscal planning and allowing funds to be carried forward without lapse is essential for effective implementation of projects which require longer periods for completion.

Another major weakness in our public expenditure management is the problem of obligatory expenditure due to commitments of earlier years. For control of obligations it is necessary to take into account the total requirements of expenditure on a project over several years. Knowing future spending commitments is particularly important for projects which require several years for completion. Dr. Ghosh has highlighted the problem by citing examples from Defence and Irrigation sectors in his paper. The phenomenon of lack of control over commitments is particularly striking in the context of irrigation projects in India. According to Economic Survey (1994-95), at the start of the Eighth Plan, the total cost of completion of spill over irrigation projects was a staggering amount of Rs.40563 crore. The projects pending completion included those started in the First and Second Five Year Plans in the 1950s. Since adequate resources for completion of these projects could not be provided in the Eighth Plan, many of these projects will be spilling over to the Ninth Plan. The time and cost over-runs resulting from this imposes enormous costs on the economy and society. This highlights the need for multi-year fiscal planning to accommodate the obligatory expenditure of irrigation projects.

A totally neglected aspect of expenditure policy in India has been the linkage between expenditure and income generation. The duality between spending and meeting the cost of expenditure has been touched upon by Dr. Ghosh and Dr. Bagchi in their respective papers. The cost recovery from most of the services, both economic and social, provided by the governments at the Central and State levels meet only a small proportion of the cost of supply. While purely public goods and merit goods are to be necessarily supplied free of cost, there is a vast range of economic and social services provided by the governments, where recovering of cost partially or fully is possible and justified. Higher education and specialised health services are examples of such cases. Indeed, those who can afford to pay are often willing to pay for services, provided the quality is adequate.

Devolutions from the Centre to the States

A neglected item in the literature on public expenditure management is accountability in the context of intergovernmental fiscal relations. This is especially true as far as fiscal federalism is concerned. According to Dr. Bagchi, fiscal federalism in India suffers from absence of accountability and incentive for fiscal management. He further contends that this is responsible in no small measure for the fiscal problems in the country. He argues that the Centre-State fiscal relations need radical restructuring for improving the fiscal management in the country.

The deterioration of Central and State revenue surpluses over the last two decades has been revealing. Till the mid-seventies, Centre as well as all the States were having revenue surpluses after meeting revenue expenditure - both Plan and non-Plan. From the second half of the 1970s onwards some of the States developed revenue deficits off and on, on the Plan side. By the early 1980s this had become a regular feature for some of the States. Centre also started developing revenue deficits on the plan side. By the second half of the 1980s, a few States found that their revenue receipts including the Central grants are not sufficient to meet their non-plan revenue expenditure. By early 1990s this had become a regular feature for a number of States. Further, the Centre also found itself in a similar situation. That is, Centre's total revenue receipts could not cover its non-plan revenue expenditure. In other words Centre and States have to use their capital receipts to meet part of the non-plan non-developmental revenue expenditure. The situation has not improved in the post-reform period since 1991. Indeed, the situation has worsened in the case of a number of States and possibly for the Centre over the past five years. The single- most important reason for this sad development is the fiscal profligacy on the part of the Centre and the States.

Both Dr. Bagchi and Dr. Srivastava argue that the existing system of devolution via Finance Commission, Planning Commission and Central Ministries contribute significantly to: (i) the increase on fiscal profligacy on the part of the State governments; (ii) unwarranted growth in the debt burden of the State governments; and (iii) extreme fiscal dependence of special category States on the Centre. The gap filling approach followed by the Finance Commission has been negating the virtues of fiscal prudence on the part of the States. The unplanned expansion in plan expenditure has been ballooning the non-plan committed expenditure at the end of each Five Year Plan. The fast growth of devolution under Centrally Sponsored Programmes through Central Ministries over the past 15 years is a reflection of Central activism in subject matters which are principally in the domain of the States. This has resulted in significant fiscal indiscipline and wastage.

Budget Processes And Expenditure Management In India

14

D. K. Srivastava

I. Introduction

Government expenditures in India, habitually overrunning voted appropriations with an undue reliance on supplementary demands and ex-post approvals, are initiated as 'demands for grants' under the myopic perceptions of individual ministries and departments paying scant attention to an overall resource constraint. The synoptic view of the Ministry of Finance, in its role as a coordinator of individual spending claims, may also be conditioned by the perception of a "soft" budget constraint.

With short-term revenue-response to tax reforms being sluggish, government expenditure has to bear the burden of fiscal adjustment if fiscal deficit is to be contained. Public expenditure has already slipped several rungs from its deified heights in the heady days of planning and control. The gush of public spending, funnelled through porus administrative conduits, is a mere trickle by the time it reaches the intended targets. With huge government funds locked into investment in public sector enterprises, giving back meagre returns, and a steadily increasing interest-cost of borrowing, it is evident that government spending must be curtailed, restructured and better targeted. While expenditure policy itself needs to be recast, it also needs to be serviced by an improved system of expenditure management and control, which happens to be undergoing significant changes elsewhere in the world (see, e.g., von Hagen and Harden, 1996 and Premchand, 1994) also, an outstanding effort being the U.S. National Performance Review (1993), the Report being tellingly entitled "From Red Tape to Results: Creating a Government That Works Better and Costs Less". It contains some 1200 recommendations (see Leonard, Cook and McNeil, 1995, for a review).

The author would like to thank Dr. P. Shome, Shri Saumen Chattopadhyay and Shri T.S. Rangamannar for their help with ideas and materials. Thanks are also due to Shri Satish Kamath and Shri R. S. Tyagi for adept computational and secretarial assistance, respectively.

The outline of this paper is as follows. Section II provides a theoretical and empirical perspective to such features of the budget process as have a bearing on the unwarranted growth of public expenditure and its low efficacy. In Section III, successive stages in expenditure-related budget processes in India are analysed. Section IV looks at the legal and institutional aspects of management of government expenditure in India. In Section V, the interface between the Central budget and the State governments is analysed. Section VI, similarly looks at the interface between the Central budget and the public enterprises. Policy implications are drawn in Section VII. The analysis focuses on the Central government. Budget procedures and practices, and the institutional framework and legal provisions at the State level, in general, mirror those at the Centre, and therefore, subject to similar deficiencies and weaknesses.

II. EXPENDITURE GROWTH AND MANAGEMENT: A THEORETICAL AND EMPIRICAL PERSPECTIVE

a. Growth in Public Expenditure : Theoretical Perspectives

A number of alternative theoretical perspectives are available in the literature that attempt to explain the growth, which is often sub-optimal, of public expenditure, e.g., Wagner's law of increasing State activity [a more-than-unity income elasticity of demand for public expenditures (Musgrave and Peacock, 1957)], the Peacock-Wiseman hypothesis (1965) (discrete increments in the threshold for tolerance of tax-burden) and determinants' analysis which identifies expenditure-augmenting factors such as growth of population, wage-and sex composition, and urbanisation (Bird, 1972, Burkhead and Miner, 1971, Pryor, 1968). The public choice literature explains the growth of public expenditure, metaphorically seen as the Leviathan, in terms of collusive and self-promoting behaviour of politicians and bureaucrats [Downs (1957), Buchanen (1967), Breton (1974), Niskanan (1971), Tullock (1976), Brennar and Buchanen (1977), Mueller (1989)]. A variant of this tradition sees growth in public expenditure and its changing composition in terms of the operation of pressure groups [Olson (1982); Bardhan (1984)] such as agriculturists, industrial capitalists, and professionals and bureaucrats, etc. Niskanen (1971) argues that bureaucrats derive direct utility from the size of their bureaus (i.e., Departments/Ministries) that leads to sub-optimal increases in public expenditure. More recently, works by Niskanen (1978), Tridimus (1992), Craigwell (1991) and Ashworth (1995) have investigated the empirical relationship between budgetary deficits and government expenditure growth. Ashworth, using cointegration analysis and

positing an error-correction mechanism (with U.K. as an example) contends that deficit financing is a long-run phenomenon but with a critical short run role in explaining the dynamics of government expenditure. Alesina and Perotti (1995) emphasize the role of political and institutional factors in explaining why large public debts have been incurred by some countries and not others, and why this phenomenon has appeared in the last 20 years and not before. They find that pertinent features of electoral systems, party structure, government fragmentation and political polarization have had an important role to play in the onset of this phenomenon. Specific features of budget processes (estimation procedures, formulation of demand for funds, scrutiny, etc.) also have a bearing on high growth-low-performance government expenditure. Some of these features are noted below.

b. Synoptic-Hierarchical Vs. Fragmented-Collegial Approaches to Budgeting

Von Hagen (1992), Alesina and Perotti (1995, 1996), and Von Hagen and Harden (1996) have put forward the proposition that budget procedures and budget institutions have a major influence on fiscal outcomes. It is argued [e.g., von Hagen and Harden (1996)] that increased 'centralisation' of the budget processes can help in controlling the bias towards excessive spending. 'Centralisation' refers to all those processes of budget formulation and spending that strengthen a macroscopic and comprehensive view of the budget as compared to the compartmentalized and particularistic view of the spending Ministries. Their theoretical model rests on a consideration of externalities in the context of a 'common pool' problem of government budgeting. While public spending is targeted at individual groups, regions or locations, the tax burden of financing the spending programme is well dispersed over the taxpayers. Policy makers, representing the spending agencies, take into account the full benefit from expanding the spending programme, but as costs they only consider that part which falls on their constituencies. Thus, policy makers systematically overestimate the net marginal benefit of increasing public spending. This "common pool" problem is akin to that exploitation of a common resource by uncoordinated private parties.

Evidence from EC countries is cited by von Hagen and Harden (1996) to indicate that countries characterised by stronger centralising features in the budget process are also the countries with a relatively higher degree of fiscal discipline pertaining to spending, deficits and debt. A comparable study of the budget process for 28 Latin American States was

carried out by Alesina, et.al. (1995). They also find that cross-country differences in public sector deficits can be explained by differences in the degree of centralisation of the budget process.

In a more recent contribution, Alesina and Perotti (1996) argue that more hierarchical procedures are associated with more fiscal discipline. They outline hierarchical procedures as those that attribute "more power to the treasury than to spending Ministers in intra-government negotiations" and those that "limit the role of the parliament in amending the budget proposed by the government". Several years ago, Prest (1962, p. 134) had perceptively observed: "On these grounds, therefore, one must make a very strong plea for a budgetary system which enables revenue to be looked at as a whole, and expenditure to be looked at as a whole rather than one which breaks down each side into a number of pieces or one which matches specific items of revenue with specific items of expenditure".

c. Soft Budget Constraints

An examination of the growth of public expenditures and their poor performance in the context of some of the erstwhile socialist experiments led Kornai [1980, 1986] to formulate his theory of the "soft budget" constraint. A hard budget constraint, such as those faced by individuals and private enterprises, forces decision making units to be responsive to the price signals in the economy, thereby generating substitution effects that are crucial to economic efficiency. On the other hand, when the budget constraint is soft, and is perceived to be soft by the spending agencies, i.e., departments as well as public enterprises, they pay greater attention to lobbying for increased budget allocations, rather than exploring the possibilities of input - substitution and resource - reallocation. In the presence of a soft-budget constraint, the compulsion to adjust demand to changes in relative prices is weakened. A perfectly soft-budget constraint would imply a zero response to price changes. When a large number of government departments and public enterprises operate under the perception soft-budget constraints, the overall efficacy of public expenditure declines due to weak responses to price signals because incentives to improve quality and competitiveness of products, and to reduce costs and introduce new products or innovations are weakened. Lower expenditure efficiency in these units is accompanied by a greater demand for increasing the draft on the general budget.

The implication of a soft budget constraint is explained in Diagram 1. Let the vertical axis represent the budget allocation in terms of the Y

good and let X be another good (input). Suppose the price (budget) line initially was AB. Let input X becomes costlier as indicated by the price line AC. In the context of a hard budget constraint this would also have been the new budget line. But, the spending agency perceives that its budget allocation is stretchable to the extent of enabling it to buy P at the new set of prices. The initial combination of inputs was at P. The increase in the relative price of X, would imply its lower use, if the substitution effect obtains. But, the spending agency insists on buying the combination at P. Its effective budget-line, at the new prices becomes A^1 C^1. The agency remains at point P. But, if substitutions had been generated, with an allocation of OA^1, it should operate at a higher indifference curve, or conversely attain the same isoquant as at P with lower a budgetary allocation.

Some idea as to the existence of a soft-budget constraint in the departments/ministries of the Central government can be obtained by considering empirically the 'stretchability' of the constraint reflected in the excess of actual expenditures over the corresponding budgeted and approved magnitudes. This indicates that most adjustments, in the context of unforseen events including price and wage increases, are in the form of increases in expenditures.

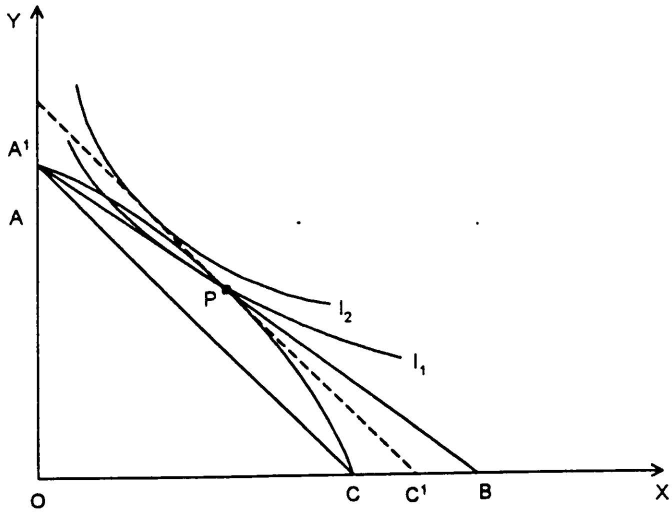
A coefficient of 'upward flexibility of government expenditure' may be defined as:

$$f_i = \left(\frac{A_i - P_i}{P_i}\right) \times 100$$

where A = actual expenditure, P = budgeted expenditure, and the subscript i refers to the relevant expenditure category.

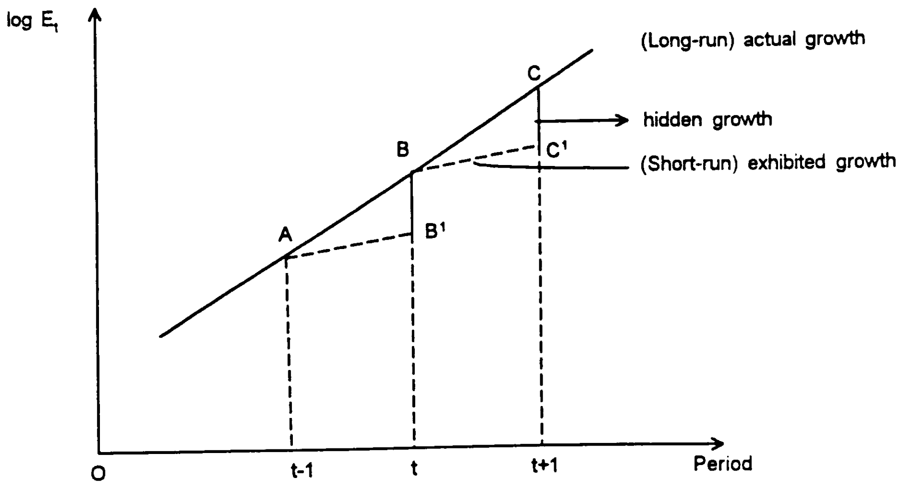
In Table 1, the values of the estimated coefficients averaged over the period 1975-76 to 1993-94 (i.e., average of annual figures) are given for some of the key expenditure aggregates for the Central government.

This implies that in all the major expenditure aggregates, the spending agencies have been able to spend more than what was budgeted for them. In capital expenditure, the upward revision has been about 10 per cent of budgeted amounts, and in revenue expenditure, this ratio is about 5 per cent.



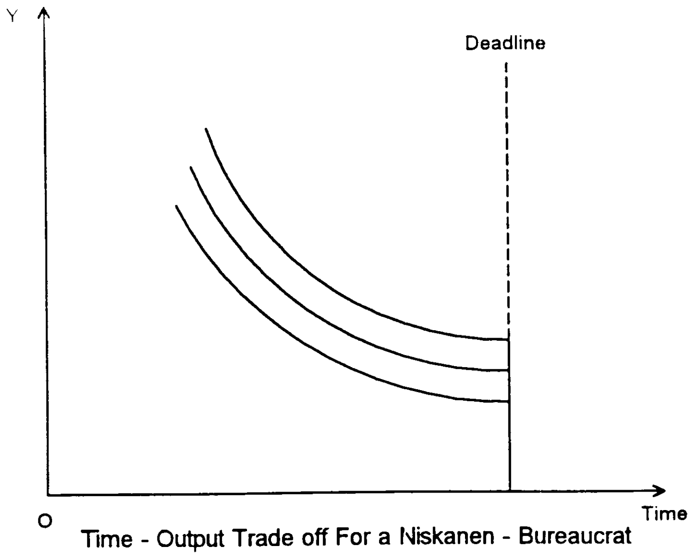
Inefficiency Due to a Soft Budget Constraint

Diagram 1



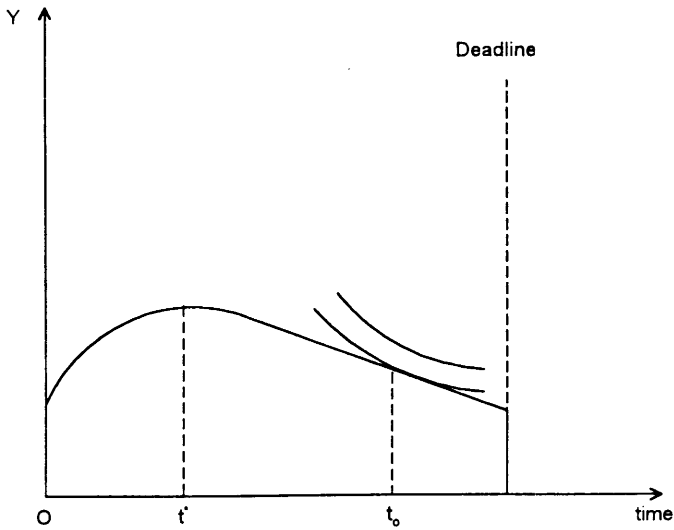
Expenditure Growth : Exhibited vs Hidden Components

Diagram 2



Time - Output Trade off For a Niskanen - Bureaucrat

Diagram 3a



Decision - lags and Expenditure Inefficiency

Diagram 3b

Table 1
Estimates of Coefficients of Upward Flexibility of Central Government Expenditure Aggregates (Annual Average 1975-76 to 1993-94)

Expenditure	*Value of Coefficient (Per Cent)*
Non-Development Revenue Expenditure	4.37
Development Revenue Expenditure	6.67
Total Revenue Expenditure	4.75
Non-Development Capital Expenditure	10.21
Development Capital Expenditure	2.85
Total Capital Expenditure	9.52
Total Expenditure	6.28

Source: Computed from Data from Indian Economic Statistics (Public Finance), various issues.

d. Transparent Vs. Opaque Budgeting

The "transparency" of the budget and budget procedures is also crucial for better fiscal outcomes. The real balance of the budget, both current and future can easily be "hidden" in the "complexity" of the budget. Alesina and Perotti observe (1996, p. 16): "Politicians have incentives to 'hide' taxes, overemphasize the benefits of spending, and hide government liabilities, equivalent of future taxes. Politicians have little incentive to produce simple, clear and transparent budgets". Techniques by which the opacity of the budget are often increased include (i) strategic use of budget projections, (ii) underestimation of interest rates, (iii) overstatement of the effects of proposed budgetary changes, (iv) keeping various items off the budget with a "creative" use of the budget of other public organisations not incorporated in the national budget, (v) creation of various funds, and extensively using transfers to and from these funds, and (vi) strategic use of multi-year budgeting by announcing more-than-one-year adjustment plans, and extending the adjustment horizon year after year.

e. Systematic Errors in Budgetary Prediction of Expenditures

An expenditure system that is managed on the basis of poor forecasts (budget estimates) is bound to be inefficient as noted by Prest (1962, p. 139) more than three decades ago: "... the general principle that no government can hope to execute its economic policies successfully if its budgetary forecasting is wildly inaccurate seems clear enough". Poor expenditure forecasts are less understandable than those for revenues, because expenditures are themselves approved amounts, and entirely under the control of the spending agencies. Several studies in India, beginning the early work of Mahesh Chand (1962), and subsequent studies by Asher (1978), Chakravarty and Verghese (1982), Bhattacharya and Anita (1988), and

Pattnaik (1990), among others have evaluated the quality of budget estimates in India in terms of forecast accuracy and have rated them as quite deficient. In particular, expenditures are systematically underestimated. In a more recent work on this issue (Srivastava and Prasad, 1996), the systematic bias in expenditure projections (for Centre and States taken together) was estimated using more recent data (1975-76 to 1992-93). It was observed that in 15 out of the 18 years in the sample, aggregate expenditure was underestimated.

A regression of the prediction error ($e_t = P_t - A_t$) on its own past value (e_{t-1}) indicated a significant relationship, pointing out that systematic factors are responsible for the prediction error, which ought to identified and taken care of in the estimation exercise. The estimates of β in $e_t = \beta e_{t-1}$, for aggregate expenditure was 0.602 with an estimated t-value of 2.856, indicating that the coefficient was significantly different from zero at 1 per cent level of significance. In the prediction-realization diagram, the estimated line

$$A_t = \underset{(1.75)}{1632.84} + \underset{(114.463)}{1.012\, P_t} \qquad \bar{R}^2 = 0.99 \quad DW = 2.05$$

would lie consistently above the 45° line of perfect forecast (LPF) as is evident from the magnitude of the coefficients. A similar picture emerges for the sub-aggregates of expenditure, although the degree of underestimation differs between categories.

Underestimation of expenditure, in fact, serves as a strategic device, because it enables the government to understate growth in expenditure, thereby making the passage of the budget easier through the Parliament, and enhance its acceptability to the general public, as discussed in the next section. Budgetary underestimation of expenditure has emerged as the long-term tendency. In more recent years, this tendency appears to have been reversed because considerable attention is being paid to meeting fiscal deficit targets and any shortfall in revenues lead to adjustments on the expenditure side.

f. Budgetary Dynamics of Expenditure Growth: Exhibited and Hidden Growth

Government expenditure is driven upwards by systematically underprojecting its growth. The presentation of the budget exhibits certain growth-rates for relevant expenditure aggregates. The projected growth follows from a comparison of revised estimates of expenditure for the year immediately preceding the budget year, and the budget estimates for the current year. The 'exhibited' growth can be calculated as

$$\left(\frac{P_t - R_{t-1}}{R_{t-1}}\right) \%$$

where P refers to the budget estimate for year t, and R_{t-1} indicates the revised estimate for period t-1 for the relevant expenditure category.

On the other hand, the actual (long-run) growth can be estimated on the basis of actual expenditures. In Table 2, estimates of long-run (per annum) growth of expenditure aggregates for the Central government over the period 1976-77 to 1994-95 are given along with the average yearly 'exhibited' growth rate, estimated as the average of annual growth-rates based on relevant budget and revised estimates.

Table 2
Estimates of 'Exhibited', Long-Run, and Hidden Growth in Expenditure

Expenditure Category	*Per Cent Per Annum*		
	Average Annual 'Exhibited' Growth	*Average Per Annum Growth of Actual Expenditure*	*Hidden Growth*
Revenue Expenditure	10.11	17.13	7.02
Capital Expenditure	2.31	13.73	11.42
Total Expenditure	7.56	16.12	8.56

Source: Computed from Data from *Indian Economic Statistics* (Public Finance), various issues.

It is evident that the actual growth-rate exceeds the pronounced or the exhibited growth rate. This process of estimation dynamics drives government expenditure upwards and represents another aspect of budget opacity. In Diagram 2, this phenomenon is explained. While expenditure actually grows along the line ABC, in the budget estimates for the concerned period, it is projected as growing along AB^1. After two years when the actual figures become available, it would turn out to have grown along AB. By this time, nobody would be interested in the hidden component of expenditure growth indicated by B^1B.

g. Time and Deadlines in Decision-Making

In the decision-making hierarchy of government, time per se has little value. There is no penalty for delayed decisions and no premium for timely decisions. The result is that decisions are steadily postponed until deadlines arrive.

Time itself is an important input in economic processes which are characterised by extensive linkages. If inputs are not procured in time, the related output is delayed which may set off a domino-kind effect upsetting the subsequent chain of outputs or related decisions. Delay in decisions is often strategically used as a 'message' by rent-seeking decision-making units in governmental hierarchy indicating the need for such action on the part of the private parties (contractors, firms, suppliers) as would induce a favourable and quick decision. The greater is the inefficiency of the system, the larger is the average time of governmental decisions. If an aggregate output function for governmental services is plotted against average decision time, it would rise upward initially (too quick a decision may also be sub-optimal). The position of the government would be far to the right of the optimal decision-time (t^* in Diagram 3b).

If a deadline is relevant, most of the decisions would be bunched close to the deadline. The phenomenon of "march" spending is well-known in departments/ministries.

The preference map between output Y (i.e., basket of government services) and time (t) would look as depicted in Diagram 3a. Time is a strategic variable for the decision unit (a Niskanen bureaucrat); by using more (average) time in taking decisions they can maximise personal utility (higher rewards in rent-seeking, lower incidence of mistakes for which they may be accountable). But against this, they have to set-off loss of output (for which they may be directly or indirectly held responsible). However, if a deadline is applicable, all indifference curves would merge into the deadline when the value of time becomes infinity. Juxtaposing the indifference map with the output curve (as a function of average decision time), it becomes evident that most decisions would be bunched in the inefficient part of the output function.

h. Excessive Categorisation

In the Constitution, a distinction is made only between revenue and 'other' (i.e., capital) expenditures. But over time, expenditure categories pertaining to developmental and non-developmental and Plan and non-Plan, have evolved. This excessive partitioning of expenditures adds to the opacity of budgetary handling of government expenditures. Excessive emphasis on Plan expenditure has underemphasised the maintenance of capital assets as an objective. The Tenth Finance Commission (Report, p.

64) observes: "... the present artificial distinction between Plan and non-Plan expenditures, which runs across revenue and capital budgets ... be replaced by the simpler and conventionally well recognised distinction between revenue and capital".

III. Successive Stages Of An Expenditure Budget

The budget of a given year t, gets initiated in period (t - 1), gets implemented in period t, and is subjected to ex-post accounting, evaluation and performance checks in period (t + 1) and beyond. These steps may be divided into four successive stages, *viz.*, Government Stage (G), Parliamentary Stage (P), Implementation Stage (I), and Stage of Ex-Post Control (E)(see, e.g., Alesina and Perotti, 1996). These stages may alternatively be called as budget formulation, approval, implementation, and follow up stages.

For the budget of a given year, therefore, different stages are traversed through in a number of years, preceding, as well as succeeding it. Conversely, in any given year, budgetary activities pertaining to the budgets of the previous year(s), current year, and the succeeding year occur concurrently. A stage-wise, year-wise schematic representation of the budgetary process is given below:

Stage-Wise and Year-Wise Path of a Budget

Budget of ↓	*Stage in* →	*Year*		
		t - 1	*t*	*t + 1*
t - 1		P, I	E	E
t		G, P	P, I	E
t + 1			G, P	P, I

G = Government stage; P = Parliamentary stage; I = Implementation stage;
E = Stage of ex-post control.

The budgeting activities are crowded in a year. Ex-post stage of many of the previous budgets may occur simultaneously in a given year. Maximum parliamentary attention is paid to the consideration of the current budget. The government is also concerned relatively more with the passing

and implementation of the current budget. The ex-post budget control activities, pertaining to the previous years, keep accumulating, and the degree of attention progressively declines as the concerned budget recedes in time.

a. Government Stage (G)

In this stage, individual spending Ministries and Departments formulate their spending plans that are forwarded to the Ministry of Finance for screening and integration into the main budget. The government finalises the budget in the confines of the Ministry of Finance. Because of the secrecy associated with the budget, tax plans are zealously guarded and expenditure plans are also under wraps. Discussions at the cabinet level often only relate to the general policy issues. Specific magnitudes of expenditure remain with the Ministry of Finance.

The government stage of the budget for period t, gets started in period (t - 1) and can be divided into several sub-stages. The process gets initiated by the issue of the 'Budget circular' (mid-September in period t - 1) from the Budget Division of the MOF (Department of Economic Affairs). The circular is addressed to the Ministries/Departments and other relevant authorities (e.g., Comptroller and Auditor General of India). Different ministries, through their financial advisers, furnish estimates of expenditure to the budget division which embarks upon the process of compilation and coordination of estimates of expenditure of different ministries. Discussions take place between Secretary (expenditure) and the financial advisers of the ministries, after which each ministry forwards estimates of expenditure for the forthcoming budget as well as revised estimates for the current budget, also explaining departures of actual expenditures from budgeted amounts. Between September to February, the government stage passes through the following steps: (i) issue of budget circular giving general guidelines and calling for submission of estimates; (ii) preparation of estimates of expenditure by different ministries; (iii) discussion with Secretary (expenditure), finalisation of individual estimates of expenditure, compilation and coordination, and finalisation of specific demand for grants for each ministry/departments.

b. Parliamentary Stage (P)

The current budget is presented to a joint session of Parliament under normal circumstances towards the end of the previous financial year (usually

in the last week of February). The budget session of Parliament extends into the current year. Discussions may continue until May. Thus, the parliamentary stage of the budget comprises a period running from the end of February to May. From the presentation to the passing of the Appropriation Bill, the process takes about two months. For Supplementary demands, the Parliamentary stage, in fact, continues through the financial year.

The parliamentary stage consists of (i) presentation of the budget (annual financial statement) by the Minister of Finance, preceded by a separate budget presented by the Minister of Railways; (ii) debate on revenue and expenditure proposals; (iii) specific discussion of individual demands for grants; (iv) replies to debates by individual Ministers and the Minister of Finance; (v) voting by Parliament; and (vi) passing of appropriation bills.

The relative position of the ruling party in the Parliament, has an important bearing on the formulation of the expenditure budget. The closer is the majority of the party, and the greater is the dependence of the ruling party on its allies in the Parliament, the more difficult it is to bring about expenditure discipline. In particular, expenditure programmes with clear benefits for localities represented by the MPs who are supporting the ruling party are more likely to be taken up. Von Hagen (1992) observes that the more "serious" is the possibility of a parliamentary defeat on the budget "the more it is in government's interest to propose a budget that can be expected to find a solid majority in Parliament". The introduction of the MP's Local Area Development Scheme in India at a time when the ruling party was finding parliamentary survival quite difficult, and its subsequent continuation in the wake of a difficult parliamentary position of the ruling coalition is a clear example of the inverse relationship between expenditure discipline and weak parliamentary position of the ruling party.

c. Implementation Stage (I)

The implementation stage starts after the appropriation bills have been passed by the Parliament. Once the appropriations are voted and approved by the Parliament, spending authorities are authorised to draw the necessary amounts and spend. The MOF communicates to each spending ministry its respective budget allocation (usually by the end of May). The necessary information is then transmitted to Heads of Departments and offices, and controlling and disbursing officers giving details of sanctioned amounts in each case. The appropriated amounts must be spent during the current

financial year. All funds voted by legislature, i.e., initial budget grants as well as supplementary grants lapse at the end of the financial year. That is why the implementation stage is peaked with "March" spending. Within the financial year, subject to specified rules, there is a possibility of reappropriation between expenditure heads. General restrictions provide that reappropriation cannot be done (i) between voted and charged items of expenditure, and (ii) for meeting expenditure on a new service or new instrument of service not provided for in the budget. Expenditure of each spending ministry is overseen by its financial adviser who prepares monthly and quarterly reports on expenditure incurred. He also transmits monthly accounts to the CAG for the preparation of consolidated accounts for the government.

c1. Supplementary Budgets

Supplementary budgets are needed when the forecasts on the basis of which the original budget was prepared go wrong in the wake of unanticipated increases in prices, exogenous shocks, and other unforeseen events. Supplementary budgets do not get the same public or parliamentary attention as the main budget and can often serve to increase the opacity of the budget. The better is the forecasting framework on which the main budget is based, the lesser would be the need for supplementary demands.

c2. Cash Flow Management

Bottlenecks in the flow of cash increase inefficiency. Flows of cash receipts and expenditure peak at different times and have seasonalities of their own which are not synchronous. There is no existing mechanism for producing cash forecasts. The financial advisers of departments/ministries usually put forward a mechanically sub-divided (1/12th of annual figures) forecast. The requirement of short-term borrowing could be minimised, and releases of loans and grants from the Central Treasury could be synchronised with cash requirements of the spending agencies, if a proper mechanism of cash-flow management is brought in place. Hitherto, the Central government relied on the mechanism of ad hoc treasury bills for shortfalls in cash inflows relative to outflows. This system has been replaced, effective 1997-98 with a system of ways and means advances on which the Central government will have to pay interest. There would, therefore, be an incentive to better manage the cash flows, because mismatches would now carry a cost.

d. Ex-Post Approval, Verification and Control (E)

All expenditures appropriated in a budget for period t must be actually incurred in that period. All budgetary processes in period (t + 1) that relate to the budget of period t, are therefore ex-post. If any amounts have been spent in excess of appropriations, these must be approved by the President and Parliament. Further, a detailed process of verification and scrutiny is undertaken by the Comptroller and Auditor-General of India, and various Parliamentary Committees, such as the Estimates Committee, Public Accounts Committee, etc. These exercises should normally be completed within one year, but in practice, they take much longer.

i. Authorisation of Excess Expenditures. At the end of the financial year, all voted amounts lapse. On the other hand, if there has been excess expenditure, it requires ex-post approval. This approval is given under Article 151 of the Constitution whereby excess of actual expenditure over sanctioned grants, as brought out in the audit reports of the CAG, are regularised.

ii. Ex-Post Control by CAG. The Comptroller and Auditor General of India is required under Articles 149, 150 and 151 to prescribe the format in which the accounts of the Union and the States are to be kept. As such, the classification of the heads and sub-heads is prepared by the CAG. The CAG under Article 151 is required to present a report relating to the accounts of the Union (and similarly for the States) which is then laid before each House of Parliament. The report of the CAG amounts to the issuance of a "certificate" which reads as follows: "These accounts have been examined under my direction in accordance with the requirements of Articles 149 and 151 of the Constitution of India and the Comptroller and Auditor General's Act, 1971 on the basis of the information and explanations that my officers required and have obtained, and according to the best of my information as a result of the receipts and disbursements for the purpose of the Union for the year ... subject to the observations in my Report on the accounts of the Union..." It is these "observations" of the CAG, which summarise the objections and irregularities in expenditures in relation to voted and charged expenditures in the budget. The traditional auditing is regulatory in nature. But, observations are also included that comment on the economy and efficacy of public expenditure programmes.

iii. Parliamentary Control in Ex-Post Stage. At the ex-post stage, the Parliament also exercises control over expenditures through a number of

committees. Some of the important financial committees of Parliament are (i) estimates committee, (ii) public accounts committee, and (iii) the committee on public undertakings.

The public accounts committee is the primary body concerned with an ex-post examination of the expenditures incurred. It examines whether expenditures approved by Parliament have been properly spent within the scope of the concerned demand. It also examines cases that involve losses and financial irregularities. The reports of CAG that are presented to the Parliament are examined in detail by the PAC. The committee on public undertakings performs a similar function in respect of these undertakings. It examines the CAG reports on expenditures incurred by the public undertakings in the more general context of autonomy and efficiency of public undertakings and evaluates their performance as business enterprises.

iv. Performance Budgeting for Ministries and Departments. Conventional budgeting in India is now supplemented by Ministry/Department-wise performance budget[1] that now cover most of the developmental expenditures of the concerned ministries. These budgets are prepared by the ministries and departments dealing with developmental activities. The idea behind such a document is to provide a link between financial allocations in a budget and physical/real achievements by the concerned spending agency in terms of functions, programmes and activities.

Under a performance budget, governmental operations are divided into functions, programmes and activities/projects. A function refers to a major division of the work of the government such as education, health, agriculture, etc. Programmes refer to broad categories within a function that identify end-products or accomplishments in respect of the objectives of a function. Activities constitute the collection of homogenous types of work in a programme. Projects generally refer to activities that are of a capital nature. For example, education is considered a function, elementary education is considered a programme, and training of elementary teachers is taken as an activity. The construction of a school building is taken as a project.

The primary concern in a performance budget is to bring out the end-objectives associated with the monetary allocation in the budget. It relates the costs of providing a service and the results and accomplishments in financial as well as physical terms. The performance budget can thus serve in the role of an internal management tool. The Report of the study

Team on Financial Management (1967, p. 162) list the following objectives to be served by performance budgeting:

i. to correlate the physical and financial aspects of every programme on activity;

ii. to improve budget formulation, review and decision-making at all levels of management in the government machinery;

iii. to facilitate better appreciation and review by legislature;

iv. to measure progress towards long term objectives as envisaged in the Plan; and

v. to bring annual budgets and development plans close together.

Performance budgets are lengthy documents. They relate to individual ministries, and each report is so lengthy that legislators find little time and interest to discuss the performance budgets in Parliament. Other limitations of this process are that (i) while it enables a quantitative and financial evaluation of programmes and activities, it does not permit a qualitative evaluation; and (ii) its usefulness is limited in respect of governmental activities the results of which are not measurable in a precise manner (e.g., research, police, law and order).

IV. Legal and Institutional Aspects

a. The 'Funds' of the Government of India

The Government of India maintains its accounts under the aegis of three 'Funds', *viz.*, the 'Consolidated Fund of India' [Article 266(1)], the 'Contingency Fund of India' (Article 267), and the 'Public Account of India' [Article 266(2)].

i. Consolidated Fund of India. All revenues received by the Government of India, all loans raised by it by issue of treasury bills, loans or ways and means advances, as also repayment of loans, accrue to the Consolidated Fund of India (CFI). Expenditures out of CFI are divided into two categories. Under Article 112(2), estimates of expenditures embodied in the annual financial statement are to be shown separately for (i) the sums

required to meet expenditure described by the Constitution as expenditure **charged** upon the CFI; and for (ii) the sums required to meet 'other' expenditure from the CFI. The expenditure charged upon CFI are listed in Article 112(3). Sums so charged upon CFI are not submitted to vote by Parliament, but may be discussed. 'Other' expenditures are submitted in the form of demands for grants to the House of People. It is provided under Article 113(3) that, subject to the provision Articles 115 and 116, no money shall be withdrawn from the CFI except under appropriation made by law. No amendment can be proposed with respect to a Bill pertaining to a demand for grant [Article 114(2)] which has the effect of either varying the **amount** or altering **its destination**. In other words, the Parliament can either accept a demand for grant or reject it, but it cannot modify it.

If the amount authorised by law is "found to be" insufficient, or some need, not contemplated in the budget has arisen, a supplementary demand is to be presented to the Parliament [Article 115(1)(a)], and if any money has been **spent** on any service in **excess** of the amount granted, a demand for such excess is presented for the approval of Parliament [Article 15(1)(b)]. These provisions indicate that initially budgeted demands can be supplemented and ex-post adjustments can also be made.

Further exceptions are provided in Article 116 that provides that the House of People shall have power (a) to make any grant in advance in respect of estimated expenditure for a **part** of any financial year, pending the completion of the procedure prescribed in Article 113 pertaining to the presentation of the budget (vote on account), and (b) to make a grant for meeting an unexpected demand upon the **resources** of India which is not provided for in the budget due to the indefinite character of the service, and (c) to make an exceptional grant that forms no part of the current service of any financial year.

ii. Contingency Fund of India. The Contingency Fund of India is in the nature of an imprest, placed at the disposal of the President, the constitutionally provided corpus of which is Rs. 50 crore. This was temporarily raised to Rs. 840 crore in 1994-95 for financing the expenditure arising out of the implementation of the MP's Local Area Development Scheme. Any expenditures authorised by the President from out of the Contingency Fund of India are subsequently put up for Parliamentary approval, and an equivalent amount is withdrawn from the CFI, so as to replenish the Consolidated Fund.

iii. Public Account of India. All other public moneys received by or on behalf of the Government of India are credited to the 'Public Account of India' under Article 266(2) of the Constitution. Here, the government acts as a mere banker. Transactions relating to provident funds, as also the small saving collections are kept in the public account. These are moneys meant to be repaid. Parliamentary authorization for payments from the public accounts is not required. In a few cases, a part of the revenue of the government is set apart in separate funds for expenditure on specific objects like sugar development, replacement of depreciated assets of commercial undertakings, etc. These amounts are withdrawn from CFI with the approval of Parliament and kept in the Public Account for expenditure on the specific objects. The actual expenditure on these objects is, however, a gain submitted for Parliamentary approval.

b. Voted Vs. Charged Expenditures

There are two types of expenditures from out of CFI: those that are voted and appropriated, and those that are "charged". Principal items of expenditures that are charged on CFI are interest payments, grants-in-aid to State governments under Article 275(1), payment of States' share of Union excise duties, repayments of internal and external debt of the Central government, and loans and advances to State governments. The Constitution also provides that the salary and allowances of the President and other expenditure relating to his office, salaries, allowances and pension of the Chairman and Deputy Chairman of the Council of States, the Speaker and Deputy Speaker of the House of the People, Judges of Supreme Court, and Comptroller and Auditor General of India, are to be charged up on the CFI and not voted by Parliament.

Over the years, the component of expenditure charged on CFI has grown substantially and out of the total disbursements from the CFI, only about **one-third** is subject to a vote by Parliament. For 1994-95 (RE), out of a total disbursement of Rs. 392388.77 crore from the CFI, Rs. 253064.60 crore was charged, representing about 65 per cent. Of this, servicing of past debt (interest payments + repayments) accounted for 54 per cent, payments to State governments for 10.2 per cent (grants-in-aid and share in Union excise duties and loans and advances), and all other items including the salary and allowances of President, Judges of Supreme Court and Comptroller Auditor General of India, accounted for the remaining 0.8 per cent. It, therefore, appears that more than half of the disbursements from out of the Consolidated Fund of India is really under the 'control' of the

fiscal 'history' (of debt), nearly one-tenth under the recommendations of the Finance Commission, and only one-third is subject to the on-line discretion of the members of Parliament, present and voting.

c. Demand for Grants and the Principle of Guillotine

The estimates of expenditure included in the annual financial statement and required to be voted by Lok Sabha are submitted, under Article 113, in the form of Demand for Grants. Generally, there is one demand for grant in respect of each Ministry or Department. However, large ministries have more than one demand for grant. A demand for grant includes total provisions required for a service, revenue as well as capital, grants to be given to the State and Union territory governments, and loans and advances relating to that service. Where the provision for a service is entirely for expenditure charged on the CFI (e.g., interest payments), a separate appropriation as distinct from a demand, is presented for that expenditure and is not required to be voted. Where expenditure on a service includes both 'voted' and 'charged' items of expenditure, the latter are also included in the demand for that service, but the 'voted' and 'charged' provisions are shown separately in that demand.

Each Demand first gives the totals of 'voted' and 'charged' expenditures as also the 'revenue' and 'capital' expenditures included in the Demand separately and also the grand total of the amount of expenditure for which Demand is presented. This is followed by the estimates of expenditure under major heads of account. The break-up of the expenditure under each major head between 'Plan' and 'non-Plan' is also given. The amounts of recoveries taken in reduction of expenditure in the accounts are also shown. A summary of Demand for Grants is given at the beginning of this Document, while details of 'New Service' or 'New Instrument of Service' such as formation of a New Company, undertaking a new scheme, etc., if any, are indicated at the end of the document.

There are about 100 demand for grants in one Central budget. For example, the 1996-97 budget contained 101 demands for grants. The distribution of these according to ministries is summarised in Table 3. A few ministries (e.g., finance, defence) account for a large proportion of the total amount. Discussion on the demand for grants in the Lok Sabha has to be completed in the budget session. These discussions take place under tremendous pressure of time and usually a very limited number of demands are actually discussed in the Lok Sabha. As the budget session draws to a

close, the principle of 'guillotine' is applied implying that demands are passed without any discussion or scrutiny in the Lok Sabha. Table 4 presents information indicating the proportion of demands that are actually discussed and those that are guillotined for the period 1990-91 to 1996-97. The proportion of undiscussed demands has been increasing over time. In 1996-97, only 6.5 per cent of the total demands were discussed.

Table 3
Demand for Grants: Relative Importance of Different Ministries/Departments

Ministry/Department	*Demand Numbers*	*Total Number of Demands*	*Amount (Rs. Crore)*	*Percentage to Total*
Agriculture	1 - 4	4	4589	2.24
Chemical and Fertilisers	5 - 6	2	7461	3.64
Defence	15 - 21	7	31339	15.31
Finance	24 - 36	13	106383	51.97
Health and Family Welfare	39 - 41	3	2840	1.39
Home Affairs	42 - 46	5	5754	2.81
Human Resource Division	47 - 50	4	5714	2.79
Industry	51 - 54	4	2077	0.99
Law, Justice & Company Affairs	58 - 61	4	583	0.28
Planning & Programme Implementation	67 - 69	3	1014	0.49
Rural Areas and Emp.	71 - 73	3	8713	4.26
Science and Technology	74 - 76	3	1017	0.50
Surface Transport	78 - 80	3	2340	1.14
Union Territories Without Legislature	97 - 101	5	1039	0.51
All Others		38	23835	11.64
Total	1 - 101	101	204698	100.00

Source: Expenditure Budget, 1996-97, Vol. 2, Government of India.

V. Central Budget And The State Governments

The interface between the Central government budget and the State governments is concerned with three outflows, *viz.*, tax devolution, grants and loans. There are two main inflows, *viz.*, interest paid by the State governments on Central government loans, and repayment of these loans.

Both in terms of the constitutional provisions, and the way fiscal federalism has evolved in India, as overseen by Ten Finance Commissions, and successive versions of resource transfer formulae followed by the Planning Commission, States draw a substantial portion of their budgetary

resources, both on revenue and capital accounts from the Central budget. The Centre collects specified taxes and devolves them on to the State governments; it borrows and on-lends to the States, and it gives grants to the States from the totality of its funds. The fiscal deficit of the system as a whole cannot be reined in without considering the fiscal system as a whole, i.e., the integrated budget of the Union as well as the State governments and the Union territories. In other words, any mechanics of fiscal correction that merely revolves the fiscal deficit around between different tiers of government cannot remedy the situation.

Table 4
Demands for Grants Discussed and Those Guillotined: Central Budgets 1990-91 to 1996-97

(Rs. in Crore)

Budget Year	*Total Amount of Demand for Grants*	*Demands Discussed and Amount Involved*	*Amount of Demand Guillotined*	*Column (3) as Percentage of Column (1)*
	(1)	*(2)*	*(3)*	*(4)*
1990-91	94707	34908 (Agriculture, Defence, External Affairs, Home Affairs, HRD, Industry, Labour, Water Resources and Welfare)	59799	63.0
1991-92	113422	28819 (Industry, Agriculture, Food, Rural Development, Defence)	84603	74.6
1992-93	119087	12760 (HRD, Rural Development, Food, Agriculture Civil Supplies and Public Distribution, Labour, Commerce)	106327	89.3
1993-94	130323	28112 (Defence, Home Affairs, Agriculture)	102211	78.4
1994-95	157420	3815 (Water Resources and HRD)	153605	97.5
1995-96	172152	28935 (Commerce and Defence)	143217	83.2
1996-97	204698	13302 (Rural Areas and Employment, Agriculture)	191396	93.5

Sources: 1. *Lok Sabha Bulletins of Budget Sessions.*
2. *Expenditure Budget (Part II)* of various years.
Compiled by Reference Wing (LARRDIS) of the Lok Sabha Secretariat.

Resource transfers, in the form of tax-revenue sharing, grants and loans take place between the Union government and the States. It is a one-way transfer from the higher to the lower tier, although resources flow both

The mechanism of borrowing and the attendant servicing of debt is such as to encourage current borrowing. To the extent, a State can get assistance from the Planning Commission, it gets a loan that would have an attached grant element. For every rupee borrowed by a (non-special category) State for a State Plan Scheme, a grant element of 42.86 per cent (i.e., 3/7) would be attached. All committed expenditure and interest liabilities would become part of legitimate revenue expenditure in the future for which the Finance Commission would make an equivalent transfer under the gap-filling approach. For repayments, the State would ask for a relief, and going by the approach taken by most Finance Commissions, it may expect to get some. Hence, there is every incentive for a State to increase its current expenditure by borrowing, so that in future it can finance its expenditure by transfers from the Centre. These linkages between the Finance and Planning Commission transfers are indicated in the Box given below.

The Case of a Revenue Deficit State: Implication of a Gap-Filling Approach	
Current estimate of revenue expenditure by FC	$E_t = R_t + 0_t$
Additional expenditure by State financed by borrowing	Z_t
Actual revenue expenditure in period t	$E_t + Z_t$
Interest liability on additional borrowing	rZ_t
Projected expenditure in period t+1, applying a growth-rate, g	$(1 + g)(E_t + Z_t) + rZ_t$
Gap on revenue account in period (t + 1)	$(1 + g)(E_t + Z_t) + rZ_t - (1 + g) 0_t$
Transfer in period (t + 1)	$(1 + g)(E_t + 0_t) + (1 + g + r) Z_t$ $= (1 + g)(R_t) + (1 + g + r) Z_t$

E_t = Revenue expenditure; R_t = Fiscal transfer from Centre;
0_t = Own revenues in period t.
Period t, and t + 1 are Considered by Successive Finance Commissions

Thus by increasing expenditure beyond that estimated by the Finance Commission, a State can increase the fiscal transfer received by it from the Finance Commission in a subsequent period, by a multiple of the initial borrowing, over and above normal growth in the magnitude of the transfer in the earlier period. Growth in overall public expenditure, and

public debt is at least partly due to the mechanism and institutions handling resource transfer between the Centre and the States. The key features of this mechanism may be identified as below:

(i) a partitioned approach to resource transfers being handled by

- (a) Finance Commission (devolution + statutory grants + special purpose grants + debt relief);
- (b) Planning Commission (plan grants + loans); and
- (c) Grants by Administrative Ministries.

Since each body effectively looks at only a part of the overall transfers, a synoptic view of the overall expenditure, revenue and deficit status of the State governments is taken by no one. This partitioned approach weakens the possibility of a 'centralising' or synoptic view of the country's finances.

VI. PUBLIC ENTERPRISES

The public enterprises consider the resources of the government (Central or State) as fungible with their own. As such they perceive a soft budget constraint. This makes them reluctant to take up efficiency-augmenting options.

a. Interface With the Budget

Budgetary support to public enterprises is given in the form of equity and loans. Correspondingly, the inflows generated by past investments and loans, are in the form of dividends, interest payments and repayments. Thus, the interface between the Central budget consists of outflows in the form of investment in equity and loans, the former is voted and appropriated and the latter is charged on the Consolidated Fund of India. Most loans to the public enterprises are plan loans but non-plan loan are also given to them. Public enterprises are listed under the Ministries/Departments and expenditures on them from the budget are part of the demand for grant of the concerned ministry.

b. Performance of Public Enterprises

The share of Central government in total investment (equity + loans) in the 246 Central public sector enterprises (as on March 31, 1995) was nearly 50 per cent, amounting to Rs. 86122 crore. Its share in equity holdings was

about 96 per cent, and that in loans was 26 per cent. Excluding enterprises under construction, the average annual return on government equity investment (in 1994-95) was only 2.36 per cent. The number of loss-making public enterprises (in 1994-95) according to cognate groups are given below along with the total number of enterprises in that group: steel (5/9); minerals and metals (4/13); coal and lignite (4/9); power (1/4); petroleum (0/14); fertilizers (3/8); chemicals and pharmaceuticals (11/21); heavy engineering (9/15); medium and light engineering (11/24); transport equipment (6/12); consumer goods (15/19); agro-based industries (2/4); textiles (13/14); trading and marketing services (8/18); transportation services (3/11); contract and construction services (7/10); tourist services (5/9); telecommunication services (0/2); and industrial development and technical services (1/10); and financial services (1/9). Most public sector units in sectors like consumer goods, textiles, contract and construction services and tourist services are loss-making units. These are not sectors which require investment through public enterprises. Except for the petroleum sector, and enterprises in industrial development and technical consultancy services, and financial services, the performance of public enterprises is dismal. If we exclude enterprises in these sectors, the rate of return on equity for the rest is only 1.5 per cent (1994-95).

c. Public Enterprises and the Central Government

In its 52nd Report (3rd Lok Sabha), the Estimates Committee stressed the need for setting up a centralised coordinating unit which could also make continuous appraisal of the performance of public enterprises. In 1965, the Bureau of Public Enterprises (BPE) was set up. BPE was later constituted as an independent administrative unit in the Ministry of Finance, Department of Expenditure in 1969. In 1985, BPE was transferred to the Ministry of Industry. In May 1990, BPE was conferred the status of a full-fledged Department and is now known as the Department of Public Enterprises (DPE) in the Ministry of Industry.

DPE is a nodal agency for all PSEs. It assists in policy formulation, providing guidelines on performance improvement and evaluation, financial accounting, and personnel management. It also collects, evaluates and maintains information pertaining to several areas in respect of PSEs. It also provides an interface between the Administrative Ministries and the PSEs. The DPE has Five Constituent Divisions: Financial Policy Division, Management Policy Division, the MOU Division, the Administration and Coordination Division, and a permanent Machinery of Arbitration.

The Estimates Committee, in their 73rd Report (1959-60) had recommended that a comprehensive report on the working of all public enterprises (other than departmentally run public undertakings), should be submitted to Parliament every year indicating government's total appraisal of the working of public enterprises. Such annual reports are being presented to Parliament since 1960-61 in the form of Public Enterprises Survey. Currently, this survey consists of 3 volumes. In volume 1, a macro appraisal and analysis of the performance of public enterprises is given in terms of broad physical and financial parameters. In volume 2, an analysis of the performance of these enterprises in different sectoral groups is given. In volume 3, enterprise-wise analytical data consisting of summarised balance-sheet, profit and loss account, and important management ratios are given.

In 1985, the "committee to review the policy for Public Enterprises" (known as Arjun Sengupta Committee) recommended the adoption of "Memorandum of Understanding" (MOU) as a "performance contract" between an administrative ministry and the public sector undertaking. The committee visualised the MOU as an effective interface between the Government and the PSE management for ensuring operational autonomy to the management with corresponding accountability for results so as to minimise day-to-day government interventions. MOU defines clearly the respective roles of the PSUs and the Government so as to bring a proper balance between autonomy and accountability.

An MOU has the following components: (i) corporate mission, (ii) corporate objective, (iii) performance criteria, (iv) targets, (v) criterion weights, and (vi) composite score. A performance criterion has five levels of targeting, *viz.*, excellent, very good, fair, average and poor. The performance budget targets of the Ministries/Departments are required to be placed under the "very good column". The performance criteria is assigned a weight on a scale ranging from 0 to 4 in a manner such that the sum of the weights of all criteria add to 1. The weight attached to a particular criterion depends on the subjective assessment of its relative importance by the ministry/department.

In 1993-94, 101 PSUs signed MOUs with their respective administrative ministries/departments. The performance evaluation of 101 public enterprises which signed MOUs during 1993-94 has been completed and PSE have been placed according to their performance in five broad groups: Excellent (44 PSEs), Very Good (30 PSEs), Good (13 PSEs), Fair (7 PSEs), Poor (6 PSEs), Two out of the 101, were not evaluated.

Thus, more than half of the Central PSEs are yet to be brought into the ambit of MOUs. Whether the MOUs would lead to an improvement of PSE performance cannot be empirically verified as yet. There is considerable opacity in the interface between the Central government and the PSE. Loans given to them, and interest due are often written off subsequently. Subsidies given by the government like those based on retention prices often encourage inefficiency in these enterprises. Low dividends given on equity imply a subsidy which is not clear while looking at explicit data on subsidies in the budget.

The proposal that the PSE enterprises should declare minimum dividends[2] would at least make the budgetary support to PSEs more transparent, should they require additional support, after paying out the dividends.

VII. A Framework Of Remedial Measures

The deficiencies and weakness of the system of expenditure management in India are summarised below.

Accordingly, remedial measures that are urgently called for are listed below.

a. Macro Aspects

At the macro level, procedural changes that strengthen a synoptic view of the budget, and effectively alter expenditure related choices down the stream, are required. For this purpose:

i. A fiscal adjustment period (say, five years) should be announced during which the time profile of the fiscal-deficit target should be fixed.

ii. Given the fiscal-deficit, all adjustments should be made in the expenditure side of the budget in response to any short term variations on the revenue side.

iii. Medium-to-long-term expenditure priorities should be fixed and, accordingly Ministry/Department-wise expenditure growth ceilings should be announced and communicated to each agency-head, before agency-wise budget exercises begin. Procedures are required to

convert the bottom-up system of budgeting to top-down budgeting during the adjustment period.

Deficiencies in Expenditure Management in India: A Summary	
Formulation Stage:	Piecemeal approach, centralising - synoptic features weak; overstated demands; perceived soft-budget constraints.
Implementation Stage:	Long decision-lags, expenditure bunching close to deadlines; excess of actual expenditure over budgeted amounts; poor coordination between intergovernmental units.
Approval (Legislative) Stage:	Most demand for grants remain undiscussed; perfunctory approval; an overwhelming proportion of expenditure 'charged' on the CFI and not subject to voting.
Ex-Post Stage:	Delayed evaluation (extremely long-time-lags); loss of interest; poor follow-up of punitive aspects; poor corrective feedback.
Overall Perspective:	Poor budgetary forecasting (systematic underestimation); understatement of expenditure growth; opacity in expenditure-related processes; partitioned approach to handling Centre-State fiscal transfer; built-in incentive for borrowing-based expenditure.

b. Outlook Changes

Expenditure agencies, *viz.*, the administrative departments need to bring about a transformation in their outlook and values. In the maize of rules, regulations, more and more detailed legislation, and additional layers in the organisational and procedural structures, the real target of the expenditure, *viz.*, the consumer or customer is totally lost. In the NPR Report (U.S., 1993), it has been perceptively observed: "The major cultural change sought is to shift the focus of government activities from process and inputs to a focus on the government's customers and outcomes to be achieved ... The present culture is largely framed by the civil service ... (which) tends to treat these processes as ends in themselves".

Putting people first would call for a completely different approach to management of government services. Each Department should be asked to evaluate the quality of interface with people, in terms of such parameters as average length of queues, average waiting time, conditions of waiting,

follow-up mechanism for complaints, and procedural formalities . The government may even charge a higher price for a better quality of service and differentiate service charges according to quality, urgency, etc. As Michael Barzley (quoted in Leonard, et.al., 1995) has observed "The Central challenge of organisations is to channel human energies into thinking about and doing socially useful work".

c. Stage-Wise Reforms

Budget Formulation

i. All agencies should be supplied with good forecasts of macroeconomic trends - relating to economic growth, interest-rate and price changes. Agencies prepare budget demands much before the time they would actually spend the amount, hence, information and perspective provided by a sound forecasting exercise would be highly useful. Government priorities should also be announced in advance.

ii. Budget caps should be announced for the forthcoming year well in advance and communicated. Accordingly, the agency-heads can allocate the share to the sub-agencies and individual offices and departments who will adjust their budgets according to relevant ceilings.

Budget Approval

The legislature should get greater time to discuss all demands. Such discussion should explore the quality and performance of past appropriations approved by the Parliament. The device of guillotine should be used only marginally.

Budget Implementation

i. Instead of annual appropriations, appropriation can be approved on a multi-year or no-year basis. This would end the phenomenon of "march spending". The doctrine of lapse should itself be allowed to lapse. At the same time, within the budget year time-markers should be introduced, like every quarter, and expenditure targets for each of these should be specified.

ii. Provide field officers and frontline managers, with greater flexibility and incentive to achieve results.

iii. Cash-flow management should be completely computerised; the transmission and receipt of funds should be managed by modern day information technology.

Budget Follow-Up

i. Audit follow-up is crucial for sound management. Methods need to be evolved to monitor the status of audit recommendations. In particular, audit comments need to be evaluated and a corrective plan needs to be activated. Further, evaluation of adequacy of action taken and special attention to key recommendations is called for. Responsibility in the context of audit follow-up action should be clearly spelt out for agency/department/enterprise.

ii. Follow-up of recommendations of Parliamentary committees entrusted with the task of examining the use of public funds is equally important.

Notes

1. The Estimates Committee of the Lok Sabha had in its 20th Report (1958) suggested the adoption of performance budgets. In its 60th Report and its 73rd Report, the Committee reiterated its recommendation for the adoption of performance budgeting in India. In its report submitted in 1967, the study team on Financial Administration, examined the issue at length, and strongly recommended the adoption of performance budgeting. A cell was established in the budget division of MOF to oversee its adoption. By 1975 almost 2/3rd of Central government's development expenditure was covered by the system of performance budgets. The concept of performance budgeting evolved through the First (1949) and Second (1955) Reports of the Hoover Commission in U.S.A. Sometimes a conceptual distinction is drawn between a programme budget and a performance budget. The concept of programme budgeting has been further refined into Planning, Programming, Budgeting (PPB) systems.

2. The Department of Expenditure, Ministry of Finance, Government of India issued an Office Memorandum entitled "Guidelines on Expenditure Management: Fiscal Prudence and Austerity" on June 17, 1996 which envisaged that PSE should be persuaded to declare a minimum 20 per cent dividend on share holding. This was a reiteration of a similar D.O. issued in August, 1995. In case a 20 per cent dividend on share holding was not possible, at least 20 per cent of dividend pay out on post tax profits (30 per cent for oil, petroleum and other infrastructure industries) should be ensured.

References

Alesina, Alberto and R. Perotti (1995), The Political Economy of Budget Deficits, *IMF Staff Paper*, March 1-31.

______ (1996), Budget Deficits and Budget Institutions, *IMF Working Paper*, WP/96/52.

Asher, M. G. (1978), Accuracy of Budgetary Forecasts of Central Government 1967-68 to 1975-76, *Economic and Political Weekly*, Vol. 13, No. 8.

Ashworth, John (1995), The Empirical Relationship Between Budgetary Deficits and Government Expenditure Growth: An Examination Using Cointegration, *Public Finance/Finances Publiques*, Vol. 50, No. 1, 1995.

Bardhan, Pranab (1985), *The Political Economy of Development in India*, Oxford University Press, New Delhi.

Bhattacharya, B.B. and K. Anita (1988), Budget Forecasts of Central Government Revenue and Expenditure - A Test of Rational Expectations, *Economic and Political Weekly*, Vol. 23, No. 26.

Bird, R.M. (1972), *Growth of Public Spending in Canada*, Canadian Tax Foundation, Toronto.

Brennen, G. and J. Buchanan (1977), Towards a Tax Constitution for Leviathan, *Journal of Public Economics*, Vol. 48, No. 4.

Breton, Albert (1974), *The Economic Theory of Representative Government*, Chicago Aldine Publishing Co.

Brooks, Richard C. and D.B. Pariser (1995), Audit Recommendation Follow-Up System: A Survey of the States, *Public Budgeting and Finance*, Vol. 15, No. 1, September.

Buchanan, J.M. (1967), *Public Finance in Democratic Process* (Chapel Hill: University of North Carolina Press).

Burkhead, J. and J. Miner (1971), *Public Expenditure*, Macmillan, London.

Carlsen, F. (1995), Why is Central Regulation of Local Spending Decisions So Pervasive? Evidence From a Case Study, *Public Budgeting and Finance*, Vol. 15, No. 1, September.

Chakravarty, T.K. and W. Verghese (1982), The Government of India's Budget Estimation: An Analysis of the Error Components, *RBI Occasional Papers*, Vol. 3, No. 2.

Chand, Mahesh (1962), A Note on Underestimation in the Indian Central Budget, Indian *Journal of Economics*, Vol. 43.

Craigwell, R. (1991), Government Deficits and Spending in Barbados: An Empirical Test of the Buchanen - Wagner Hypothesis, *Public Finance/Finances Publiques*, Vol. 46, pp. 373-81.

Downs, Anthony (1957), *An Economic Theory of Democracy*, Harper and Row, New York.

Gore, Al (1993), *From Red Tape to Results: Creating a Government That Works Better and Costs Less*, Government Printing Office, p. 15, Washington.

Kornai, J. (1980), *Economics of Shortage*, Vols. A and B, Amsterdam, North Holland.

_______ (1986), *The Soft Budget Constraints*, pp. 3-30, Kyklos.

Leonard, B., Joe Cook and Jane McNeil (1995), The Role of Budget and Financial Reform in Making Government Work Better and Cost Less, *Public Budgeting and Finance*, Vol. 15, No. 1, pp. 4-18, September.

Mueller, D. (1989), *Public Choice II*, Cambridge University Press, New York.

Musgrave, R.A. and A.T. Peacock (1958), *Classics in the Theory of Public Finance*, Macmillan, New York.

Niskanan, W.A. (1971), *Bureaucracy and the Representative Government*, Aldine - Atherton, Chicago.

_______ (1978), Deficits, Government Spending and Inflation: What is the Evidence?, *Journal of Monetary Economics*, Vol. 10, pp. 139-62.

Olson, M. (1983), *The Rise and Decline of Nations*, Yale University Press, New Haven.

Pattnaik, R.K. (1990), Fiscal Marksmanship in India, *RBI Occasional Papers.*

Poterba, J.M. (1994), State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics, *Journal of Political Economy*, Vol. 102, No. 4, pp. 799-821.

Premchand, A. (1994), Changing Patterns in Public Expenditure Management: An Overview, *IMF Working Paper*, WP/94/28.

Prest, A.R. (1962), Public Finance in Developing Countries, ELBS and Widenfield and Nicolson.

Pryor, F.L. (1968), *Public Expenditures in Communist and Capitalist Countries*, George Allen and Unwin, London.

Srivastava, D.K. and A.R. Prasad (1996), *On the Predictive Quality of Budget Estimates in India,* NIPFP (mimeo).

Tridimus, G. (1992), Budgetary Deficits and Government Expenditure Growth: Toward a More Accurate Empirical Specification, *PFQ*, Vol, 20, pp. 275-97.

Tullock, G. (1976), *The Vote Motive,* Institute of Economic Affairs, London.

Von Hagen, Jurgen (1992), *Budgeting Procedures and Fiscal Performance in the EC*, Commission of the European Communities, Directorate for Economic and Financial Affairs, Economic Papers, Vol. 96.

_______ (1996), Budget Processes and Commitment to Fiscal Discipline, *IMF Working Paper,* WP/96/78.

Effective Budgetary Control for Expenditure Management and its Ramifications for Public Policy and Governance

15

Amiya Kumar Ghosh

I. Introduction

It is now a well-recognised fact that the long-term growth in public expenditure in India has been well above the growth of non-debt receipts, both at the Centre and in the States. During the period from 1974-75 to 1990-91, aggregate government expenditure at current prices increased at the rate of 16.3 % per year and the growth at constant prices (1981-82 as base) was 8.2 %. In per capita terms, the expenditure at constant prices increased by over 2.7 times from Rs. 366 in 1974-75 to Rs. 975 in 1990-91 (Rao, Sen and Ghosh, 1995). Per capita government expenditure at constant prices increased at the rate of 6 % per year. This exceeded the growth of per capita GDP and the growth of revenue receipts. The per capita GDP, during this period, increased by only 2.5 % per year.[1] Per capita revenue receipts, in constant prices, grown at only 4.6 % per annum.

The Central Government expenditure, as a percentage of GDP, has declined on the average in the 1990s compared to the 1980s, at the same time figures relating to the States have increased (Shome, Sen and Gopalakrishnan, 1996). The outcome of these basic trends has been the recourse to the rising net borrowing, both internal and external, which has now reached 67 % of GDP. This has led to rising debt-service burden and the composition of rising Central Government expenditure over a ten-year period has undergone a major qualitative change. The rising interest payments have squeezed Central Plan expenditure, which used to be 26 % of total Central Government expenditure in 1985-86 RE, and was only 11 % in 1995-96 RE.

While the rate of increase in expenditure is well documented and is causing serious concern to policy makers for last several years, nothing much has been done by way of policy measures to contain the expenditure. No doubt, attention has been focused on containing the fiscal deficit to

---

[1] ibid.

certain pre-determined figures, in which, the Central Government has succeeded to some extent. But the effect has been to severely curtail the capital expenditure. The revenue expenditure continues to increase in an uncontrolled fashion. In fact, the character of fiscal deficit has changed for the worse due to the inability of the Central Government to control the revenue expenditure and consequently the revenue deficit. In 1990-91, the fiscal deficit of Rs. 44,632 crore was made up of Rs. 18,562 crore of revenue deficit and Rs. 26,070 crore deficit on capital account (other than borrowings). Thus, the revenue deficit constituted 41.58 % of the fiscal deficit, while the deficit on capital account represented 58.42 %. As per 1995-96 BE, the fiscal deficit of Rs. 57,634 crore was composed of Rs. 35,541 crore of revenue deficit and Rs. 22,093 crore deficit on capital account. Thus, the revenue deficit constituted 61.67 % of the fiscal deficit, while the deficit on capital account represented 38.33 % of the fiscal deficit — a reversal of the position compared to 1990-91 situation. It is clear that rising revenue deficit, in view of the policy to keep the fiscal deficit within a pre-determined percentage, is putting a squeeze on capital expenditure, which in turn, is affecting development expenditure.

The basic lacuna appears to be the absence of an expenditure policy to guide expenditure management. The mechanism of increase in expenditure has been through the annual budgets.

PREVAILING BUDGETARY CONTROL SYSTEM

Budget-making and budgetary control system in Government of India has remained unchanged for several decades. It is formulated on an incremental basis, keeping in view the trend in expenditure, as also provision required for obligational expenditure. The budget is prepared on the basis of what is expected to be actually received and paid during year, including arrears of the past years — not for the liabilities incurred within the year but for payment in that year. In other words, budget is nothing but an estimate of cash receipts and cash payments. It is prepared on an annual basis with the 'unspent' amount lapsing at the end of the year. This was the procedure followed in the last so many decades.

The system of Budgetary Control operates through the following three stages:

i. initial distribution of budget grants;
ii. watching expenditure against allotments; and

iii. re-appropriation.[2]

The process of budgetary control starts from the distribution of budget grants. *But how are the amounts provided under each grant arrived at and on what principles are the amounts under each grant distributed under various budget heads?*

Since the basic control would emanate from the process through which amounts under each budget head is arrived at, not giving sufficient importance to this vital aspect would also mean that expenditure control cannot be effective. And that it cannot be more than an arithmetical control to see that the amounts provided under each budget head, is not exceeded by the expenditure incurred.

But what about the purpose for which this expenditure is incurred? What about the 'output' aspect? The present budgetary control system in India, is not geared even to ask this question.

Principles of expenditure and budgetary control, as far as Defence Services are concerned, is contained in *Financial Regulations*, Part 1, Vol. 1, edition 1983. Describing the control system as a whole, it states: 'The principles upon which the control. internal audit and account of defence expenditure are conducted are minute scrutiny of the estimates, a careful examination of all demands for money or stores before supply, a strict control over the application of funds and stores to the service for which they are supplied, a concurrent check and internal audit of the account of such expenditure when rendered' [Rule- 106 (iii)].

The present budgetary system is based on objects of expenditure, viz., pay and allowances, travelling, stores, works, capital expenditure, miscellaneous expenditure, etc. Though, attempt was made to introduce performance budgeting in the 1970s, it has remained a device for exhibition of expenditure in terms of programmes and projects, as a parallel exercise, without affecting the budgetary process and the management techniques (Ghosh, 1992). In Defence, however, this window dressing was not done.

When object classification was introduced in the beginning of this century in various countries, it was treated as a major improvement in the budgetary technique. It served to establish control over expenditure and it limited the discretion of the officials. It was a big step forward in budgeting

[2] Procedure followed in regard to the Budgetary Control over Defence Expenditure, Appendix C, *Defence Services Estimates,* 1995-96, Govt. of India.

since it helped in the establishment of the government accounting system, which could be linked with the budget.

The object classification focuses attention on the accounting aspect of government operations in terms of things bought. This is called input-oriented budgeting or 'line item' budgeting. There are obvious advantages of object classification. The most important of which is accountability. Funds cannot be allocated except for the objects specified. An object classification below the department level establishes a pattern of accounts that can be controlled and audited. In the lower administrative levels of financial management, object classification of expenditure has lot of validity and would continue to remain so. In fact, there is a definite case for introducing more code heads for micro level control.

But the accountability ensured by object classification, particularly at higher level of financial administration (who has responsibility for achieving certain goals for the organisation), is a narrow view of accountability (Ghosh, 1996a). It doesn't provide basis for measuring performance of a government unit or progress of a particular programme.

'Value for money' has become the most important concern for public sector expenditure management all over the world. This has led to reforms in budget management. It is this concern which leads to the need for consistent planning, for clarity of objectives and for review of performance against objectives.

WIDER CONCEPT OF ACOUNTABILITY

This concern for value for money has also led to wider concept of accountability, which focuses attention on management of resources, to make best use of resources, people and money, to achieve desired goals.

Interestingly, wider concept of accountability has been incorporated in General Financial Rules (GFR) of the Government of India as one of the canons of financial propriety by an important amendment in the late 1980s, as per recommendation of an important committee.[3] The committee stated that the principles, which should govern selection and procurement of an item on Government account, should be derived from the broad principles of canons of financial propriety and should not emphasise merely the financial value of the tender. While recommending re-formulation of the

[3] Government of India (1985).

principles of financial propriety under Rule 6 of GFR, the committee stated that the important thing to highlight is that the accountability of a public servant, who decides on the procurement of any item on government account, is total and indivisible. While taking any purchase decision, he has to be guided, at all times, by public interest and Standards of Financial Propriety and whether the offer being accepted, is the most appropriate one.[4] The suggested amendment was accepted and incorporated in Rule 6 of GFR dealing with canons of financial propriety.

However, this has remained only on paper and has not been concretised by laying down of detailed procedure regarding purchase on government account. And as recent instances of impropriety is coming to light, it is felt that this has been followed more in breach than in compliance.

But the concept of wider accountability for obtaining the best value for money, goes beyond this as this has to address itself to the basic objective of public expenditure. This would involve reform of the budgetary system itself.

NEW CONCEPT OF BUDGET MANAGEMENT

Let us see how a budget is conceived in a country where reforms in expenditure management have taken place. For example, in a comparatively recent publication of Ministry of Defence, UK, the Budget is defined as a statement for expenditure to be incurred and/or capital to be employed, 'to attain a defined set of objectives and targets, set down in a Management Plan during that period, and for which an organisation and/or individual is accountable.'[5] And a Budget Cycle is defined as, 'A unified management cycle, incorporating planning, budget setting, control, performance monitoring and review.'

These definitions are in tune with present philosophy of expenditure management in many countries where budgetary reforms have taken place during last two decades. It underlines the need for:

a. management plan;

b. a plan having clear set of objectives and targets;

c. allocation and deployment of resources for attainment of the objectives as part of the budgetary process;

[4] ibid., p. 20.

[5] Government of the United Kingdom (1990).

d. performance monitoring and evaluation to see how far the objectives have been attained; and

e. managers to be individually accountable for the attainment of the objectives laid down as a part of budgetary control cycle (Ghosh, 1996b).

In our budgetary process, there is no mechanism for review of programmes, projects and activities with a view to making allotments to them. Hence, there is no output orientation at all.

It is also necessary to recognise that the area of expenditure over which the government can exercise effective control, viewed in the context of any particular year, is in practice, much smaller than the total of its expenditure; much of which is virtually predetermined. In any single year, a government can be in a position to reduce only a minor portion of its expenditure. Interest on national debt is a contractual obligation. Payment obligations arising out of various purchase contracts of the past years are similarly binding. Pay and allowances are not only fixed obligations but are constantly rising because of pay revision and DA payments. Pensions are committed expenditure. The Central Government also has commitments on payments of grants to states and union territories. Thus, the area of operation for control of expenditure, viewed in the context of any one fiscal year, is fairly restricted.

Improvements in public expenditure management in countries who have given concentrated attention in this area in the past three decades, have emphasised, among other reforms, the need for multi-year fiscal plans and allocations with clear guidelines for various parameters.

NECESSITY OF REVIEW OF BUDGETARY CONTROL SYSTEM

With an enormous increase in government expenditure, particularly during the last two decades, we have to take a second look at some of the tenets of financial and budgetary control system mentioned above. On the basis of experience of expenditure management in Defence, following points will be mentioned to establish the necessity of review of the budgetary control system even without bringing in the output orientation [Ghosh (1996a), pp.25-26].

1. The existing presumption is that while pay and allowances (which is about 31 % of Defence Budget) represent more or less obligatory

expenses, the expenditure in other categories can be controlled against budget provisions. As far as Defence Services Estimates are concerned, this presumption is no more true. Almost 75 per cent of the expenditure under capital expenditure is on account of the obligations already incurred in the past years by way of contractual obligations, debt payment obligations or deferred payment obligations.

For 'Stores' (which account for 38 % of the budget) under revenue expenditure, payment on account of past obligations, may account for 65-70 per cent of the total allocations made. For construction Works, it is a still higher percentage. Therefore, control of obligational expenditure becomes as important part of budgetary control as cash management. In fact, in view of the large percentage of committed expenditure in the Defence Budget, without control of commitments, cash management under certain heads may pose serious problem. Supplementary budgets may be the only way out. But the problem would recur.

2. Many defence projects have a large gestation period, and some take several years to complete. It is, therefore, possible to make large commitments for projects and programmes for the future years by making small down payments in the current year, as the budgeting is on a cash basis. Therefore, control has to be exercised on various projects and programmes with a view to seeing that the cash flow under each of the programmes undertaken can be accommodated within the annual expenditure budget sanctioned by the Parliament.

3. Commitments have to be controlled in future years with reference to some cash out-go ceiling. The programmes and projects to be undertaken will take time to fructify. However, it may not be possible to accommodate the committed expenditure without some indication of the amounts that would be made available under each head of expenditure in the next few years. If the cash out-go ceiling are indicated for next three to four years then the sanctioning of fresh projects or undertaking of new activities can be tailored to the likely available fund. In the present yearly budget with no indication about future budgets, and since the budgeting is on cash basis, large commitment can be made without making sure that future budget would be able to accommodate them.

With extended time horizons and with clear fiscal directives it is possible to control our expenditure upwards or downwards by taking appropriate actions spread over several years.

4. With almost 30 per cent of the expenditure under Defence Services Estimates made in the month of March, 'the rule of lapse' is a ready-made rule for wastage. There is a rush of expenditure, and every attempt is made not to surrender any funds but if possible to slightly overspend, to give the proper signal for the next years' allocation. Priorities get totally topsy-turvy and money gets spent even on low priority items.

Interestingly, even in the pre-Second World War years with conservative financial rules, there were exceptions to this 'rule of lapse'. This was done with clear recognition that strict adherence to this rule would militate against any planning of expenditure and may lead to waste. As Wattal put it long back,

At the same time it must be recognised that this "rule of lapse" prevents planning of expenditure over a long period which is sometimes necessary for big schemes, for no legislature can or will be committed to voting funds in advance. It also sometimes leads to what is known as "the rush of expenditure in March". Officers in their eagerness to spend the money allotted to them sometimes authorise expenditure which they would not have done if they were permitted to utilise the savings in the succeeding financial year (Wattal, 1950). He went on to add that to mitigate the undesirable consequences of the rule of lapse, several funds had been built up at the Centre and in the provinces (in pre-war years) such as Defence Reserve Fund, the Road Development Fund, etc. 'Unspent' balances in these funds did not lapse at the end of the year but were available for expenditure in succeeding years.

Of the points mentioned above, I shall like to elaborate a little on the commitment aspect of the expenditure. As our budget is prepared on a cash basis, it does not bring out the commitment aspect. Unfortunately, there is no formal mechanism for control of commitments in our financial system, apart from the information that is made available to the expenditure authority at the time of making further commitments. As the information regarding commitments already made and the likely cash out-go from them, neither systematically collected and updated nor is it used as input before the sanction for fresh expenditure is given, large commitments get made on

the basis of limited cash outlay in the current financial year [Ghosh (1996a), p.39]. There is no legislative requirement for getting authorisation for total obligational payments. The financial rules also do not make it absolutely incumbent on the spending authority to get the commitment profile duly certified by the accounting authorities before making fresh commitments. In the US Federal Budget, for example, commitments are controlled through the concept of Budget Authority (BA). BA is the permission granted to an agency or department to make commitments to spend money for signing of contract for purchase of an item. Outlays (O) are the actual dollars that either have been or will be spent on a particular activity. Outlays are the direct result of BA, that is, commitment to spend, either this year or future years. The figures for both BA and O are essential because many activities of the Federal Government are not completed in a single fiscal year. The total cost of a federal activity will be known in USA through BA and what will have to be spent this year as O.

By looking beyond this year's spending requirements to the overall cost of the activity, the President and the Congress can know the future spending commitments they are making, as well as the cash required immediately (Collender, 1995).

Imperative Need for Control of Obligational Expenditure

From the budgeting point of view, according to my own experience, it is most important to control the commitments or obligations. Even limited goals of expenditure control would not succeed ultimately if future commitments are not controlled as the defence budget has grown basically to meet obligatory expenditure. The traditional technique of budgeting with its emphasis on expenditure control during the year makes no attempt to control the commitments for future years [Ghosh (1996a), p.45].

In USA, for example, while 'outlays' or cheques drawn on the Treasury in a particular year is meaningful when related to the total Government budget or the GNP in USA for expenditure control, the Total Obligational Authority or TOA figure is taken as a more meaningful figure. Outlay will always lag behind TOA. Outlays for procurement for example in a particular year are substantially determined by past decisions rather than current ones.

Herschel Kanter gives an illustration of how outlays get spread over several years for obligations made (Kanter, 1982). This is shown in the following table.

Outlays Per Dollar of Toa* for Selected Budget Categories

Categories	*YEAR*				
	1	2	3	4	>4
Shipbuilding	.03	.13	.14	.14	.55
Aircraft	.10	.40	.30	.10	.10
Missiles	.30	.55	.14	.01	-
Research and Development	.59	.34	.05	.01	.01
Military personnel	.98	.02	-	-	-
Other operating costs	.83	.14	.03	-	-

* Total obligational authority.

In case of defence expenditure in India, for construction Works programme, the normal expenditure pattern is 10:40:40:10, which sometimes tends to extend to five to six years with not more than 5 per cent expenditure in the first year. The pattern for shipbuilding and aircraft manufacture is not very different from what has been depicted in Table 3.2. Therefore, if no check is imposed on total obligations, outlays of various projects when added together may exceed the budgetary provisions. This is not a hypothetical apprehension and such a situation has been faced in the Min. of Defence in the past under certain programmes. Thus, it is absolutely imperative to have indicative budgets and fiscal guidelines for five years, within which various programmes of the Defence Services are to be accommodated.

For the control of obligations also, it is necessary to keep in view the total flow of expenditure on an activity or programme over several budget years. Knowing future spending commitments is particularly important for activities that take several years to complete, for example, the procurement of an aircraft carrier, the development of a naval base, the procurement of any weapon system, making substantial additions to the force levels, and the procurement of an aircraft and subsequently its weapon system. In these cases, particularly shipbuilding, the outlay in the first year will be relatively small, as we saw from an earlier illustration. Unless the total obligation or commitments are kept in view, in such a case, the expenditure in future years can neither be predicted nor controlled.

This phenomena of lack of control over commitments is not peculiar to Defence alone. For example, in a report on irrigation and flood control, prepared by the Comptroller and Auditor General of India (1989), brought out that the number of projects which were pending completion (in 1989) for more than fifteen to twenty years, had swollen to 57, out of which 4 were from the First Plan period, 5 from the Second Plan and 16 from the

Third Plan period. The estimated cost of 181 not completed projects were Rs. 35,353 crore, out of which cost spilling over to the Seventh Plan period was Rs. 26,270 crore. The C&AG report observed the major distortion had taken place in the Fifth Plan when 73 major and 331 medium irrigation projects were taken up at an estimated cost of Rs. 8,136 crore. When the Fifth Plan started in 1974, there were as many as 93 major and 165 medium projects in hand, with a spill over cost of Rs. 2,902 crore. The Fifth Plan investment was Rs. 2,442 crore, which was not even adequate for completion of on-going schemes. The undertaking of several projects without looking into the total commitment aspect, is the principal reason for their non-completion and time and cost overrun. The Economic Survey, 1994-95 stated that at the start of the Eighth Plan, there were various projects which were carried forward from previous plans. The total spill over cost of these projects have been estimated at about Rs. 40,563 crore (*Economic Survey,* 1994-95, p. 126).

Need for Multi-year Fiscal Planning

For control of obligational expenditure in future years, it is absolutely necessary to project the expenditure in future years on the basis of some norms and then plan the expenditure on that basis. This is one basic step for control of expenditure over a period of time. The control in expenditure cannot be brought about on the basis of year to year incremental budgeting. Multi-year fiscal planning along with manpower planning is the key to better expenditure management and control. But the planning and budgeting cannot be independent exercises. The budgeting has to be clearly based on multi-year fiscal planning.

The other important point is that the public expenditure decision cannot be taken piece-meal. If the government did not examine together as alternatives, the competing expenditure plans of various departments of the government for a series of years and if it did not examine at the same time, what resources might be available for public expenditure in future then surely, public expenditure would grow in an uncontrolled manner nor would the objectives for which the expenditures are incurred be achieved. If the projects remain incomplete because of over commitment of funds in several projects, or because all the aspects of the projects have not been considered together for funding then the objective of the expenditure would remain unfulfilled. In UK, Plowden Committee was set up to look into these aspects of public expenditure management which submitted its report in 1961. This committee recommended undertaking regular surveys of public

expenditure as a whole over a period of years ahead and in relation to 'prospective resources'. Expenditure decisions, involving substantial funds, were to be made in the light of these surveys. The UK Government excepted the recommendations of the Plowden Committee and public expenditure decisions were put on a systematic basis by the establishment of a Public Expenditure Survey Committee (PESC). The main features of the public expenditure survey system were:

a. a forward costing of 'existing policies' governing expenditure to be made annually by a committee of senior officials—the PESC—with the identification of proposals for future spending by the department;

b. this was done at 'constant prices';

c. the estimates covered up to four-year period.

After the completion of the survey, ministries have to take decisions. The Chancellor of Exchequer put forward his own proposals for levels of public expenditure in relation to his judgement of the validity of the survey report.

The Plowden Committee recommendations have received a good deal of attention in the context of problems of expenditure management. Unfortunately, in India, there has not been in-depth examination of the issues raised the Plowden Committee report or the experiences arising out of the implementation of the Report. Attention was drawn to some of the issues raised in the Task Force Report submitted to the Ministry of Defence in April, 1992 (Ghosh, 1992). Apart from the techniques followed in PESC, there were certain *innovations* (Clarke, 1978)[6] in the public expenditure management, which should not be lost sight of. The following, which are of particular relevance to us, deserve attention:

1. *classification of all public expenditure as one entity*, divided into programmes which represent coherent subjects for Ministerial consideration and each within the responsibility of one Minister;

2. collective decisions by Ministers on public expenditure and resource allocation;

[6] As stated by Sir Alec Cairncross, Richard Clarke was the driving force behind the creation of the PESC and the system control that went with PESC.

3. inclusion of time beyond, say, two years ahead in the arrangement for public expenditure planning and control;

4. relationship of future expenditure to future resources.

As stated by Sir Richard Clarke, the above are 'indispensable innovations: and it would be surprising if they failed to survive as part of permanent apparatus.'[7] The first innovation was the foundation which enabled the ministers to discuss programmes such as education, health, roads, which could not be formerly discussed as programmes at all, or be subject for ministerial choice and decision. In a sense it could be stated to provide the basis for programme budgeting.

One major problem of technique in public expenditure control in UK, which came into focus in the mid-70s was the absence of an effective cash budgeting system as controls were sought to be made in 'real' terms. This led the an inflationary situation. The cash limit system was introduced in 1974-75 to remedy this defect. It had the following features (Henley, et.al., 1990):

1. cash limits are set for as many Central Government programmes as possible for the next financial year;

2. they are set in current prices, with an allowance for inflation;

3. the cash limits are regarded as firm, not to be raised save in exceptional circumstances.

From 1983 onwards, the public expenditure survey itself, was made in cash terms, the previous years' cash figures for various services being the starting points. We should draw appropriate lessons from the experience of the other countries engaged in reforms in public expenditure management. The experience mentioned above, underline the need for perspective budgets for decision-making purposes [Ghosh (1996a), p.48].

The Administrative Reforms Commission which submitted its report in 1968, made an extremely important recommendation in this regard. They advocated a system of a forward-looking budget or *Perspective Budget for each service and activity*. 'A system of forward looking Budget should be attempted for each service and activity wherein requirements of manpower

[7] ibid. p. 151.

and materials for a few years should be ascertained in advance. The budget so framed should be reviewed every year with a view to facilitating the formulation of financial requirements of each year' (Government of India, 1968).'

We should pick up the thread where we left off in the late 1960s, as also take account of the experiences of other countries undertaking budgetary reform. for introducing a proper system of expenditure management.

NEED FOR COLLECTIVE DECISION-MAKING ON ISSUES AFFECTING EXPENDITURE POLICY

One of the important recommendations of Plowden Committee related to the need to strengthen the hand of the Chancellor of Exchequer by establishing *collective ministerial responsibility for public expenditure*. Sir Richard Clarke states that of the conclusions reached by the Plowden Committee, *this was the one to which they attached the most importance*; otherwise there was the danger of leaving it to the Chancellor alone to withstand the pressure. 'In a process of piece-meal decisions with no central review by ministers collectively' (para 67). The committee's first concern was with the fundamental question of how government can best determine their policies affecting public expenditure. For the level of public expenditure, ultimately, follows from them. The first conclusion was that the traditional system which made this point, the sole responsibility of the Chancellor of Exchequer, subject to the collective assent of the Cabinet with no central review by ministers collectively, was no longer likely to be effective in curbing expenditure or keeping it within the prospective resources available.

In the aftermath of the recent agitation on the bonus issue by the P&T and Telecom employees following the declaration of bonus by the Railway Ministry, the need for collective decision-making on such important policy issues affecting levels of expenditure in future has been brought home. We cannot delay this matter further. The collective decision-making process by the ministers on issues affecting public expenditure must be institutionalised. The Finance Minister cannot bear the responsibility alone. Further, regular ministerial appraisal of public expenditure as a whole, over a period of years ahead, and in relation to prospective resources, is a must. Decisions involving substantial future expenditure should be taken only in the light of such appraisals. At the same time, there should be maximum

stability of decisions on public expenditure so that considerations of long-term economy and efficiency throughout the public sector have the opportunity to develop.

NEED FOR VIEWING EXPENDITURE AS A WHOLE

The change in the concept of public expenditure from thousands of individual transactions to 'expenditure as a whole' and allocation of resources on long-term basis carries with it wide implications for the relation between the Finance Ministry and the departments. This aspect of the recommendation of the Plowden Committee did not receive as much attention as it deserved but is very striking. They concluded that the relationship between the departments and the Finance Ministry (Treasury) should be one of joint working together in a common enterprise. The primary responsibility of a Department was to conduct its policy effectively within the limits laid down by the government. The department is itself responsible for efficiency with which it does its work. The Permanent Secretary, as Accounting Officer was fully responsible for the financial management. The committee observed that it is important that these responsibilities should be clearly understood, fully accepted, and reflected in the Department's relations with the Treasury.

Secretaries of various departments of Government of India are also the Chief Accounting Officers, following the UK pattern. But, in their budget formulation, projection of expenditure and expenditure management, do they fully understand the responsibility which arises out of the concept of working together in a common enterprise? If it was so, we would have avoided wide differences between budget projections by various department and what was ultimately allotted to them in the budget by the Finance Ministry and the plethora of supplementary budgets, which have become a chronic feature of our budgetary system.

To take the example of budget projection of Ministry of Defence for the year 1996-97 BE, the Standing Committee on Defence of the Eleventh Lok Sabha, in its report on the Demands for Grants indicated that the Ministry of Defence had projected to the Ministry of Finance a total requirements of funds of Rs. 31,925. 61 crore for 1996-97 for the BE stage (Government of India, 1996, para 20). The service-wise break-up of the projected amount and the amounts ultimately provided in the budget, are shown in the following table.

(Rs. crore)

	Army	*Navy*	*Air Force*	*Other Deptts.*	*Total*
Projected	16656.66	4413.30	8758.74	2096.91	31925.61
Provided	14590.67	3914.09	7387.13	1906.58	27798.47

Thus, the amount allotted by Ministry of Finance is less than the projected amount by Rs. 4,127.14 crore, which means that it is short by almost 13 % of the projected amount. This kind of wide difference between the projected amount and what is ultimately provided is a new phenomena. This means, there is no shared perception, among the bureaucrats, about the 'affordability' aspect. This also means that pressure would get mounted on the Ministry of Finance to enhance the allocation. The following quotation from the report of the Standing Committee on Defence, will indicate the directions in which things would be moving: 'During evidence, the Committee were informed that the Ministry of Defence needed enhancement of funds by Rs. 4,106.61 crore over Budget Estimates for 1996-97 for meeting various revenue and modernisation requirements. It was also stated during evidence that the Ministry of Finance had assured the Ministry of Defence that they may be providing additional funds between Rs. 1000 to Rs. 1500 crore during the current year to meet the foreseen shortfalls on the revenue side and that the extra burden arising out of the recommendations of the Fifth Pay Panel would also be met. The committee are not satisfied with this assurance. Keeping in view the emerging security scenario and for reasons cited in the Report subsequently, the Committee desire that the entire amount projected by the Ministry of Defence may be allocated in the Defence Budget, 1996-97' (para 24).

The MoF is clearly isolated in its effort to curb the expenditure. The concept of joint responsibility may not work when question of allocation of resources for major spending departments are discussed at the highest policy making body.

The PMO does play a part in the final allocation of resources to major spending departments, particularly when, difference in perceptions between the spending department and MoF is rather large.

In the present pattern of governance where PMO is holding, in reality, key position as arbiter in all administrative matters, it may be worth while to institute a small budget office, headed by a professional, in the PMO to advise the PM on the reasonability of the demands projected when the difference in perception, between the spending department and the MoF,

is comparatively large—say where MoF feels necessary to impose a cut of more than 5 % over the projected amount. This office can perform other functions also, like taking initiative in the introduction of new management techniques in the various departments in the management of resources, keeping a watch on the economy and efficiency aspects of fund utilisation by various departments. Normally, the MoF should be looking into these two aspects but it is not any more in a position to do so. Efficiency in public expenditure is too important a matter and cannot be left unattended.

As pointed out above, an unequal battle is being fought for allocation of scarce resources in which MoF has to fight a lone battle to correct the malady of fiscal imbalance and to provide funds to meet the competing needs.

We are, evidently, in an era of 'soft budget'. What happened to defence budget in 1995-96 would amplify the point. The approved BE was Rs. 25,500 crore, as against the projection of Rs. 26,000 crore by MoD. One could have at most hoped for another Rs. 500 crore in RE, if at all, to make it equal to the initially projected amount. The actual increase given in RE, however, was Rs. 1,379 crore, which represented 5.41 % increase over the BE figure of 1995-96 and was Rs. 879 crore more than the projection initially made by the MoD (Ghosh, 1996b).

Thus, availability of funds in a particular year for a major spending ministry like Defence, *appears to be an elastic concept. It would expand to the extent concerted pressure can be generated to get more funds.*[8]

The Budget Estimates, which are presented with lot of fanfare to the Parliament in the form of Annual Financial Statement under Article 112 of the Constitution, has lost its sanctity. Recently, *The Economic Times*, in its editorial, in the context of postal and telecom strike for bonus hike on the pattern of Railways, argued the case for 'hard budgets'. It writes: 'The Union budget is not a budget in any proper sense, but a starting point for negotiations between the finance Ministry and the other ministries about expenditure entitlements. This must change and every ministry be made to realise that once the budget is passed, it cannot get a penny more than what it allows.'[9]

---

[8] *ibid. p. 9.*

[9] *The Economic Times*, Editorial, dated 25-10-96.

This is unlikely to happen unless populism ends and political patronage at the expense of the State's exchequer ends. This really calls for change in style of governance.

Better Expenditure Management can Start When Era of Supplementary Budget Ends

One important facet of good governance would be to give back the sanctity to the allotments as contained in the Budget Estimates. The Budget Estimate, therefore, requires to be meticulously prepared, taking into account various contingencies. Once passed, it should be treated as sacrosanct. The era of supplementary budget must end. This would not only help in bringing back financial discipline, but would also lead to better expenditure management. This is because one can determine in advance availability of funds for the current year and plan expenditure on that basis. Any hard decision required to be taken, in the light of fund availability, would be taken, as there would be no other option. This, in turn, would lay the basis for reasonable projection for future years. Better planning would come about by establishing firm nexus between planning and budgeting.

So long there is no finality of a budget, no beginning can be made for planning and better expenditure management, as the basic motivation for them would be missing. Future projections also cannot be made as the RE figure can differ considerably from the BE figure, particularly as RE figure has been conventionally been the basis for next year's BE. If BE = RE, one has to then make projection on the basis of BE figure itself.

If the spending authorities cannot make reasonable future projections regarding fund availability, neither the Long-term Equipment Plan nor the Indicative Budgets, for which we have argued above, can be formulated. In the absence these, obligational expenditure cannot be controlled (Ghosh 1996b).

Appropriation Accounts

Appropriation Accounts present a telling picture of the malaise which has affected our budgetary control system. The Appropriation Accounts are prepared every year indicating details of amounts on various specified services actually spent by Government vis-à-vis those authorised by the Appropriation Acts. Five different Appropriation Accounts pertaining to different sectors of activities, viz., Civil, Defence Services, Postal Services, Telecommunication Services and Railways are presented to the Parliament.

These Appropriation Accounts exhibit the total sanctioned grant/appropriation, actual expenditure and savings/excess for the grant/appropriation as a whole during the financial year.

An overall summary of Appropriation Accounts (Civil) of sums expended during the year ended 31 March, 1995 compared with the several sums authorised in the schedule appended to the Appropriation Acts, 1994 passed under Articles 114 and 115 of the Constitution of India, is given in the table below.

The Report of the Comptroller and Auditor General of India for the year ended 31st March, 1996 comments that the overall savings of Rs. 45,149.02 crore was three times the supplementary grant of Rs. 14,116.71 crore and constituted 12.93 per cent of the total provision of Rs. 349,161.19 crore, as compared to 7.13 per cent of the total provision of the last year.

(Rs. crore)

	Original grant/ appropriation	*Supplementary grant/ appropriation*	*Total*	*Actual expenditure*	*Savings*
Grand total	335044.48	14116.71	349161.19	304012.17	45149.02

Source: Report of the C&AG on Appropriation accounts, p. 32.

According to the provisions of the Financial Rules, no expenditure should be incurred which might have the effect of exceeding the total grant or appropriation authorised by Parliament by law for a financial year even after obtaining supplementary grant or an advance from the Contingency Fund. C&AG's, however, observed that in the revenue section, there was an excess of about Rs. 46.62 crore over the authorised sums in five grants.

The manner in which the supplementary grants are obtained, amounts are surrendered and excess made over the sanctioned grant further strengthens the point that the budget has lost its sanctity. If the budgetary mechanism does not function as a control mechanism then it is axiomatic that the expenditure cannot be controlled. If we decide to have a control over the expenditure, the institution of budget and budgeting has to be given its due place of importance. This is a central point of governance in the business of expenditure management.

DYNAMICS OF BUDGET AND EXPENDITURE CONTROL

To understand the dynamics of a budget and expenditure control, it is not enough to compare the actual expenditure figures from year to year and draw conclusions about inevitability or otherwise of the growth of expenditure. To get an insight into the possibilities of control of expenditure of a department and steps to be taken in this regard, it is also necessary to see by how much the revised estimate figure of the current financial year ultimately varies from the budget estimate. We can take the instance of BE and RE figures of MoD to get an idea of this phenomena. Contrary to the general impression, when viewed in this way, the defence expenditure shows a lot of resilience from year to year [Ghosh (1996a), p.152].

To appreciate this point, we can look at the two-way percentage changes: one, from the previous financial year's Revised Estimate (RE) to the current financial year's Budget Estimate (BE); and two, from the current year's BE to the current year's RE, for the years from 1985-86 to 1995-96, as given in the table below.

Dynamics of Defence Budget

Year	*Budget Estimate (Net) (Rs. crore)*	*% age increase of BE over previous year's RE*	*Revised Estimate (Net) (Rs. crore)*	*% age increase of RE over same year's BE*	*Actual Exp. (Net) (Rs. crore)*
1	2	3	4	5	6
1985-86	7686	-	7862	2.29	7987.49
1986-87	8728	11.02	10194	16.80	10477.46
1987-88	12512	22.74	12000	(-) 4.09	11967.49
1988-89	13000	8.33	13200	1.54	13341.02
1989-90	13000	(-) 1.52	14500	11.54	14416.17
1990-91	15750	8.62	15750	0.00	15426.48
1991-92	16350	3.81	16350	0.00	16347.04
1992-93	17500	7.03	17500	0.00	17581.79
1993-94	19180	9.60	21500	12.10	21844.73
1994-95	23000	6.98	23544	2.37	23245.00
1995-96	25500	8.31	26879	5.41	

From this table it will be seen that the defence budget does not get finally determined just at the budget estimate stage in January-February of each year when the demands for grants are finalised. The table shows that in five years out of eleven, the RE figures show a significant variation over the budget estimates of the same financial years. In three years, viz., 1986-87,

1989-90, and 1993-94 the RE figures show more than a 11 per cent increase over the BE figures of the respective financial years. This increase is more than what the Defence Ministry often got from one year to the next in terms of budget estimates; as if two budget estimates got determined in the same year in these three years. In another year, i.e., 1987-88, the RE showed a significant fall of 4.09 per cent over the BE figure.

One notable point that stands out is that in three successive years of 1990-91, 1991-92 and 1992-93, the RE figures did not deviate from the BE figures at all.[10] In these three years, the increase, in percentage terms, of BE over RE of the previous financial years, were quite modest. That this performance in expenditure control could be repeated for three successive years is supportive of the point that given the will, both on the part of the MoD and MoF, the expenditure in Defence can be controlled and kept within the amounts provided in BE. The same conclusion is drawn when it is seen that in 1987-88 at the RE stage, the MoD could manage with Rs. 512 crore less than the amount approved at the BE stage and the actual expenditure was still less. So, basically, it is the question of political will, backed up by total bureaucratic support that can contain the expenditure within the amounts allotted at the BE stage.

Thus, expenditure control is greatly a matter of will, followed by control through detailed exercises and constant monitoring of expenditure against allotment in collaboration with various functionaries.

The dynamics of a budget can be seen from another angle also, viz., the way the expenditure progresses quarter by quarter. The following table will show quarter-wise expenditure booking in percentage terms in respect of defence services estimates for years 1994-95 and 1995-96.

(in percentage terms)

Years	*Quarters*			
	I	*II*	*III*	*IV*
1994-95	13.18	25.32	18.57	42.93
1995-96	11.92	26.07	21.58	40.43

'March-Rush' Syndrome

It would be seen that the percentage of expenditure booked in the Fourth Quarter of the above two years is double the percentage booked in the Third Quarter. In the first Quarter, the expenditure booked is quite low.

10 ibid. p. 154.

This shows that the expenditure is not planned properly. The higher percentage booking in the last quarter is accounted for by the 'March-rush' syndrome. About 30 % or more of the total expenditure is booked in the month of March alone. This syndrome is tailor-made for wastage and expenditure on non-priority items in order to somehow exhaust the funds. This is the undesirable consequence of the 'rule of lapse'. The rule of lapse prevents planning of expenditure over a long period, which is necessary for big schemes. If the departments were permitted to utilise the savings made in a particular year in the succeeding financial year then the expenditure would be made more wisely. It may be necessary to create Reserve Funds to be credited with savings of a particular year which could be utilised in subsequent years. In order to control the March-rush situation, the government may consider laying down a rule that not more than 15 % of the allotted amount in the budget could be spent in the month of March.[11] And the balance to be credited to the reserve fund. As we have mentioned above that there was a Defence Reserve Fund, Road Development Fund and other reserve funds to avoid the March-rush situation.

The phenomena feverish activity at the end of the financial year is not peculiar to India alone. The rule of lapse of the unspent funds, at the end of financial year, is the main reason for it. It is also been recognised world over that this practice leads to inefficiency in the utilisation of funds. The urge to somehow spent the amounts allocated is explained to some extent through the budget-maximising behaviour of the bureaucrats. The senior bureaucrats are afraid that subsequent budgets would definitely be reduced unless they spent all their allocation before the end of the fiscal year.[12] The problem is further compounded by the fact that often the additional funds are made available, through supplementary budgets, in the month of January, when it is extremely difficult to plan for spending it in an efficient manner. The recourse taken may then be to make down payments for future supplies and thereby entering into large committed expenditure for future years. This puts pressure on budget of future years. The rules of budgeting should, therefore, be changed in that:

a. as suggested above, not more than 15 % of the allotted amount can be spent in the month of March;

b. creation of a reserve fund; and

---

[11] ibid. p. 272.

[12] ibid.

c. no supplementary provision to be made after the month of November when the trend of expenditure for first six months of the financial year is available.

MICRO-ISSUES OF BUDGETING

Necessity of budgetary control through restructuring of budget code heads and detailed allocations and proper MIS

For controlling expenditure under various budget heads, it is necessary to establish personal accountability for control and monitoring of expenditure so that the expenditure is contained within the allocated amounts.

There are various code heads under which allocation of budgets are made. Starting from major heads, it goes up to detailed heads of expenditure. Control of expenditure is mainly done through budgetary allotment under detailed heads of expenditure. The code heads are designed in such a way that they help in providing MIS for monitoring and control of expenditure. For better budgetary control, time to time, additional code heads are proposed by spending authorities.

In the context of defence expenditure management, an interesting proposal was received from Naval Headquarters in November, 1989, for restructuring of code heads for better budgetary allocation and monitoring of expenditure on 'Stores' under Minor Head 110. The interesting point is that the aim of this proposal was to achieve accountability of various Directorates for expenditure under the Stores heads. This was to be achieved by indicating the specific Directorates, responsible for controlling and monitoring the expenditure, against each code head. The proposal was, 'The Directorates indicated against each code number should be allocated budgets separately for each code and authorised to incur expenditure under the codes directly and exclusively controlled by them. No one else would be entitled to book expenditure against these codes. They would, consequently, be responsible for containing expenditure within the budget allocations made for their codes and furnish explanation in case expenditure exceeds such allocation.'[13]

The proposal was made in the context of severe resource crunch that was facing the Defence Services and was expected to continue for several

[13] Letter of Controller of Logistic Support, Naval Headquarters, Vice Admiral R.S. Sharma to the Controller General of Defence Accounts, dated 7th Nov., 1989.

years. The Chief of Naval Staff had specifically directed, 'Accountability under various heads of expenditure should be clearly specified and thereafter, specifically monitored. Ambiguity on this account is particularly acute in respect of the minor head 110 for "Stores".'

'The above serious lacuna in respect of the Stores,' it was suggested, 'can best be removed through restructuring the code numbers for various heads 110.'

The should be no ambiguity about the officer responsible for exceeding an allotment if expenditure is to be controlled. This is a very basic point. In our system of budgetary control, the personal accountability angle is missing. This has to be brought about and restructuring of budgetary code heads can help in this direction. This issue has been discussed in length and appropriate recommendation has been made in the Task Force Report, April, 1992, prepared by me and submitted to MoD.

There are further 'ambiguities', which needs to be tackled. At present Defence Stores are procured:

a. locally under local purchase powers delegated to the authorities concerned; and

b. centrally through the procurement agencies like DGS&D, Department of Defence Supplies, Army Purchase Organisation, High Commission of India, London, ISM, Washington, other foreign countries involving FFE, NER and direct purchase resorted to by officers delegated with the direct purchase powers.

Though so many agencies are involved in the Central Purchase of Stores, while formulating the Defence Budget, no clear cut allocations are made in respect of each of these agencies, laying down the limit up to which the procurements can be made by them during the year. This ambiguity is compounded by the fact that the indents placed by these agencies do not materialise in full during the same financial year and the liability is, therefore, carried over to succeeding year/years. No stock is taken of such commitments while formulating the following year's budget. This results in the absence of control of expenditure on central purchase (Ghosh, 1992, p. 89).

With a view to overcoming the lacuna, it was recommended in the Task Force Report that for stores procured Centrally by Service HQ allotment of funds to the indentor should be made *source of procurement-wise.* In the absence of such distinct allotments, no budgetary control was possible for Central purchase of stores. This allotment is to be made at the budget formulation stage itself for various code heads.

The Task Force Report also recommended that the amount provided for meeting the liabilities of the past years was also to be clearly indicated under the said code heads.

There is now a distinct realisation in the Service Headquarters, consequent on the recommendations of the Task Force Report that if the exercise of budgetary control has to be at all meaningful, precise and accurate data on committed liabilities must be available. More importantly, they laid stress on the point that such data on committed liabilities was required to be collected at the stage when liability was committed and monitored on a yearly basis till it was completely liquidated. Formats have been prescribed for collecting such data. The amount being allocated for meeting past liabilities must be clearly identified under the budget heads. To improve budgetary control, budgetary allocation for Army Ordnance Stores for 1995-96 was made on the basis of detailed heads, provided in the *Classification Handbook of Defence Expenditure and Receipts* [Ghosh (1996a), p. 242].

Thus, for proper budgetary control, even on a yearly basis, one should have two things: a) classification of expenditure object-wise in as much detail as possible with reference to spending authority, project or programme to which it relates and whether it pertains to payment on account of past obligation, for each of which there should be specific code heads for identification[14]; b) these code heads should be utilised for allotment of funds in the beginning of financial year which will help in control of expenditure object-wise, as the spending authority would know before the expenditure is incurred, about the balance amount left under a specific code head; it would also help in better planning with priorities in

[14] As computer is used for recording booking for expenditure, it would not be difficult to use additional code heads for identification of spending authorities, source of procurement, unit for which expenditure is incurred, project and programme to which it pertains and whether the expenditure relates to payment on account of past obligation or for fresh expenditure; a 13-digit code was found adequate for the purpose in the Task Force Report mentioned above.

view as specific allotments have to be made for detailed heads of expenditure with circumspection.

II

As we have mentioned in the above section, the present budgeting system is totally input-oriented. For using resources efficiently, it is necessary to specify the objectives which are to be achieved and identify the programmes which would help in achieving these objectives. As a corollary, various inputs should be allocated for implementing these programmes. If these links are not established then there is every possibility that the resource inputs would be wasted or would not achieve the desired objectives.

It helps the planners to think in terms of programmes. Programmes are to be viewed as a collection of 'activities'. If any relationship between input and output is to be established and any meaningful quantitative analysis be made then it should be in terms of these activities and ultimately in terms of the programmes of which these activities are the building blocks.

In saying this, we are only reiterating what was stated by the Team of Officers in their Report on Reforms in the Structure of Budget and Accounts as far back as in 1972, for introducing Performance Budgeting in the Government, as a follow up to the recommendations of the Administrative Reforms Commission. It stated: 'The objectives of a function are achieved by undertaking a number of programmes. For example the objectives of Public Health are achieved through programmes for control of diseases, drug control, prevention of food adulteration, etc. Hence, the third tier of classification, viz., minor heads should identify these programmes under each function. This will not only give a clear picture of what programmes Government is undertaking to further a particular function but also facilitate preparation of performance budgets. A programme would consist of a number of Schemes. For example, the programme 'control of diseases' under 'Public Health' will consist of schemes for malaria eradication, control of tuberculosis, etc. The fourth tier of classification will reflect the schemes undertaken under a programme. The third and fourth tier of classification will, thus, provide a link between budget outlays and development programmes and schemes and foster adoption of modern techniques for programme selection, monitoring and evaluation of performance, etc.'

The scope for economy on the basis of input analysis is limited. We may save a little on transport budget by restricting movements, or by defining rotational transfers, or restrict consumption of patrol per vehicle and so on.

It is only when we look at combination of 'inputs' through the programmes, review them and see whether they are worthwhile pursuing them or not or put a ceiling limit as to how much can be spent on a programme over a period, take a view as to which program or which activity should slow down or get deferred and which should be pushed, does the possibility of economy in real sense emerge. Multi-year planning with firm fiscal guidelines will ensure that correct programmes get the boost, while not so important ones, which are just carried on (because once started nothing seem to stop), get dropped.

To arrive at the cost of a programme one has to take into account all input costs serving the needs of a programme, viz., personnel cost, infrastructure cost, capital outlay required for the programme. For example, personnel cost by itself is not amenable to cost-benefit studies, except in the context of programmes they are supporting. The input costs are to be divided into various activities under the programme. All the activities being carried out should be reviewed constantly, to examine whether they are relevant and in keeping with emerging situation and this review process should be integrated with the budgeting process.

The budgeting should become a dynamic process of planning, reviewing, evaluating and allocating of resources rather than a passive process of watching and ensuring that expenditure did not exceed the allotments.

This, in effect means, introduction of programme budgeting. The Planning, Programming, Budgeting System (PPBS) ushered in Programme budgeting in the 1960s. Experience of the 1970s show that PPBS was not a panacea. However, some features of the system have lot of relevance for expenditure management and continued to receive substantial attention and more extended application in the 1970s. A major feature of the PPBS was the preparation of budget estimates over a multi-year period so that any action aimed at strengthening some programmes or abandoning them could be considered at length. It was expected that preparation of multi-year estimates would provide better perspective to the decision-makers on the financial implication of current policies. It would, therefore, show the extent

to which available resources were already committed to current policies.[15] Whether we adopt PPBS or not, it is absolutely necessary to have multi-year budgeting for planning and control of commitments, as suggested above. Even if we do not adopt Programme Budgeting, to get the best value for money in expenditure management, we have to think in terms of programmes and policy makers have to take decisions in terms of total programmes and not in piece-meal fashion. The programmes should be reviewed and evaluated as a part of the budgetary control process for making suitable allotments as also to correct any lacuna in the programmes.

If we plan programmes on the basis of cash ceilings, the fear of inflationary pressure generated because of programmes being conceived in terms of physical targets, would also be avoided. Programmes can also be tailored to the availability of funds if clear fiscal guidelines are available. Therefore, I see no conflict between programming and expenditure control. It should be a top-down approach, where cash ceiling indicated at the top level should percolate to lower level of functioning, who should, in turn, plan on the basis of cash ceiling indicated for three to four years.

In the Defence sector, the necessity of expenditure management, on the basis of programmes, is obvious and has been accepted all over the world. PPBS had its most fruitful application in the defence expenditure management. The need for introducing Programme Budgeting, at the earliest, in defence expenditure management in India, has been stressed in a recent book on the subject [Ghosh (1996a), Chapter 5].

Using the programme concept in various economic activity, as a part of budgetary process, would help in getting the best value for money. We can take a examples to illustrate firstly, how programme concept is important in resource management and secondly, how issues of public finance are inextricably linked with the issues of Public Policy and Governance.

Creation of additional irrigation potential is a pre-requisite for agricultural development. It is also important to utilise, promptly and efficiently, the full potential. The rate of growth of irrigation potential has been, on the average, 2.2 million hectares (mh) per year during the Seventh

[15] Premchand, A. (1994), *Changing Patterns in Public Expenditure Management: An Overview.* Paper prepared in response to an invitation from the sponsors of an international conference on 'Financial Management and Accountability in the Public Sector', Feb., 1994.

Plan. The utilisation of the irrigation potential did not match this growth. It was noted by C&AG, in an evaluation study of selected projects, that in some projects the extent of utilisation ranged from 30 to 40 %.[16] The *Economic Survey*, 1986-87, stated that the gap in potential and utilisation has increased from 7 mh at the end of the Sixth Plan (1984-85) to about 7.5 mh in 1985-86. A centrally sponsored Command Area Development (CAD) Scheme, has been under implementation since 1974-75 with the basic objective of reducing the gap between potential created and potential utilised. The programme envisages execution of on-farm development works like construction of field channels, land levelling, etc. But from the gap between potential and its utilisation, it is clear that the efforts made by CADS have not been very successful. We have not made much headway in this as we do not have a proper programme concept in our expenditure management in irrigation.

Factors affecting the utilisation of irrigation potential created was discussed in the Public Accounts Committee in 1983. The reasons for shortfall continues to be the same. They are[17]:

I. Difficulties faced by the farmers in levelling of lands, construction of field channels, water loss due to siltation and seepage on transmission;

II. In the case of Command Area Development Programmes the main reasons for shortfall were:

   a. reduction in Budget provision;

   b. lack of control of CAD authority on the department executing construction of field channels;

   c. unwillingness of farmers to provide land for CAD activities;

   d. low progress in land levelling because the farmers are not willing to level the land due to uneconomical nature of this activity.

In almost all the projects studied by the evaluation team of the audit, there was no indication in the project report as to the extent of land

[16] Comptroller and Auditor General Of India, *Performance Evaluation Series, Irrigation and Flood Control*, Dec., 1989.

[17] *ibid.*, p. 33-34.

levelling operation for efficient application of water. Clearly, the project has not been conceived in its entirety.

Investments in Major and Medium sector of irrigation projects rose from around Rs. 7,500 crores in the Sixth Plan to over Rs. 11,000 crore in the Seventh Plan and are expected touch Rs. 25,000 crore in the Eighth Plan. From the present indication, it is likely that the amount spent in the Ninth Plan would be much larger. The present system permits a project to claim as soon as its headworks and its main distribution systems have been completed (Vohra, 1996). The Major and Medium irrigation sector has never accepted responsibility for putting such potential to use by building of minor distribution systems and field channels. This task has, therefore, been neglected and lot of gap between potential created and potential utilised have arisen. As B.B. Vohra points out that in 1990 as many as 13.9 mh or around 55 % of the total potential, which was expected to be created by that year lay un-utilised. The cost of creating one hectare of potential in this sector is likely to cost Rs. 70,000 during the current plan. 'What this means is that the idle capacity which existed in this sector in 1990 is worth around Rs. 1,00,000 crore at current price levels.[18] Today's figures are bound to be even higher because the gap between "potential created" and "potential utilised" has appreciably widened since 1990.'

This was clearly a case where the programme concept needs to be reconsidered. The objective of programme should be redefined to make available irrigation water to the farmers in their field as the basic objective, and not just of creation of 'irrigation potential'. The activities pertaining to construction of field channels, land levelling, land consolidation should be considered as part of the total programme. The financing of these activities, by providing suitable incentives to the farmers, should also be part of the programme.

Instead of creating additional irrigation at high cost, it may be worthwhile to alter the programme concept and spend in such a way that the gap between the potential created and potential utilised is reduced. This may be a more cost effective method of programme management in the irrigation sector.

As need of the consumers of irrigation water, are to be met, so also the question of recovering suitable amounts for providing the service should also be linked. Generation of revenue cannot be dis-linked from the

[18] ibid.

expenditure, but should be viewed in its totality. The revenue is generated through betterment levies and water rates. In 1945, the irrigation works registered a net profit of Rs. 8 crore in undivided India after meeting working expenses. In 1947, it was reduced to Rs. 1 crore. In 1967-68, it showed a net loss of Rs. 58 crore. Thereafter, it has increasingly become negative. And in 1982-83, it had stood at Rs. 120.6 crore.[19]

For betterment levy, Irrigation Commission, in 1972, recommended that betterment levy laws enacted by the States be amended so that half the capital cost of irrigation projects is recovered from the beneficiaries. The recovery is to start three years after the irrigation is provided in an area and the period is not to exceed thirty years. State Governments were advised to implement this recommendation. Audit finding was that in some States there was no statutory provision for levy of betterment charges. In some non-finalisation of levy rates led to non-levy of the rates. Study of four projects in 1975-76 indicated that against Rs. 67.70 crore estimated to be collected only Rs. 3.33 crore were actually collected. In some States, levy has been discontinued.[20]

From time to time, mode of levy and collection of irrigation charges were studied and discussed by bodies like Irrigation Commission (1972), Central Water Commission (1975), Irrigation Ministers Conference (1975). The basic principles enunciated, remains valid even today. Important points are as follows:

1. the total receipt on account of irrigation rates should not be less than the annual cost incurred by the State for providing the service consisting of operation and maintenance charges and at least a portion of interest and depreciation on capital invested;

2. the rate should be related to crop and gross income;

3. water rate should be increased in a phased manner to realise additional resources from farmers who benefit from the projects.

Some of the audit findings were: there was no up-to-date record of areas which have come under irrigation; the departments failed to issue notification for levy of water rates, leading to non-recovery of water rates; huge delays were noticed in raising the demands for water rates (in some

[19] ibid., p. 46.
[20] ibid., p. 48.

cases between 8-12 years); it was seen that water rates as percentage of gross revenue was below 4 %; it was noticed that irrigation gross revenue receipts did not cover even the working expenses of many projects.[21]

Good governance in this case would be to levy the water rates properly and realise them. Good governance would also imply that expenditure in the irrigation sector should be linked to the benefit to be obtained by the farmers and revenues to be realised therefrom to meet the cost of the projects and service provided. Expenditure management cannot be put on a sound footing unless expenditure and revenue generation to meet the operational expenses as also the project cost gets linked for each project.

We also know the poor financial plight of the State Electricity Boards. The transmission and distribution (T&D) losses are increasing and as per one estimate have already exceeded 32 %. This is, primarily, due to under investment in transmission and distribution during the last fifteen years. The distribution system has been extended beyond capacity to cope with the rural electrification programme. The peak time losses are estimated to be as high as 48 % during the summer months (Roy, 1996). The consumption by agricultural pumps may exceed 100 billion units this year out of this around 55 billion units may be lost due to heavy pilferage and excessive T&D loss. The revenue loss on this account is estimated at Rs. 15,000 crore.

To mitigate power shortage, policy makers have planned to increase the installed capacity by 57,000 mw during the Ninth Plan period, involving a massive investment of Rs. 450,000 crore.[22] The solution to the power problems may not solely lie in adding large installed capacity. It can be solved to a great extent by improving the efficiency of operations and optimising the power system. The plant load factor (PLF) is an important indicator of operational efficiency of thermal power plants. Every one per cent improvement in national average PLF, makes available an additional 450 mw of installed generation capacity. 'The average PLF in capacity utilisation of thermal power plants of SEBs is much lower than the central PSUs, and is largely due to deficiencies in management and operation, lack of proper maintenance and non-availability of coal of proper quality. There are wide inter-state variations in the average PLF of thermal plants. Significant improvement in PLF of thermal power stations can be effected

---

[21] ibid., p. 50.
[22] ibid.

through medium-term measures like proper maintenance planning' (*Economic Survey*, 1994-95, p.137). This is clearly a management issue. The better expenditure management cannot be brought about only by the financial planners and budgeting techniques. Proper budgetary technique, combined with cost-benefit analysis and improvement in management ethos can bring about better value for money in expenditure management. That is why the essential link between planning, budgeting and management control requires to be recognised. Planning is a management function. Budget, as a finance function, provides essential link between management planning and management control. Therefore, model of planning, budgeting and management control has to be viewed in its totality with essential linkages, if we have to achieve efficiency in expenditure management [Ghosh (1996a), p.60].

As in the case of irrigation, the question of realisation of tariff for electricity supplied cannot be segregated from the issue generation of electricity. Agriculture and industry continues to be two most important consumers in terms of their relative shares, together consuming about 75 % of the electricity generated. SEB charges agricultural sector 21.70 paise per Khw and industry at 201.92 paise per Khw, i.e., ten times more. Power tariff charged for agricultural sector is one-fourth of the rate charged from the domestic sector. 'Unit revenue realisation from agricultural sector in none of the SEBs covers a reasonable fraction of unit average cost for the SEB, leading to heavy financial losses.'[23] The commercial losses of SEBs is showing an increasing trend and could be of the order of Rs. 7,100 crore in 1995-96. The *hidden subsidy* for agricultural and domestic sectors could be of the order of Rs. 13,307 crore in 1995-96. In terms of Section 59 of Electricity (Supply) Act, 1948, SEBs are required to earn a minimum rate of return of 3 % on their net fixed assets in service, after providing for depreciation and interest charges. During 1993-94, the rate of return reveals that even with subsidy, 7 SEBs are with negative rate of return. 'A minimum 3 % return on net fixed assets with minimum agricultural tariffs of 50 paise per unit may provide a working framework for fixing tariffs and achieving conservation of power.'[24] But there is still the problem of un-metered supply in which every body connives.

Thus, the issue of expenditure management is intimately linked with resource generation along with cultivating proper values.

---

[23] *Economic Survey*, 1994-95, Government of India, p. 138.
[24] ibid., p. 139.

In any funding scheme undertaken by the government, the ultimate objective has to be kept in view. If the philosophy behind the funding scheme is lost sight of then the basic purpose of funding would not be achieved. One has to take a policy view as to how much subsidy the government can give for higher education. This is important because students from middle and high income families are likely to benefit the most from the subsidised higher education. Since equity is an important component of good governance, a specific and well deliberated views are required to be taken as to the extent of the subsidy. The very low level of tuition fees in the IITs, which, it is understood, is being raised substantially from next year is a pointer to the fact.

Department of Education in consultation with the Department of Expenditure, evolved a new funding pattern for financing of IITs, IIMs, and Indian Institute of Science, Bangalore with a system of Block Grant, with a view to giving them stable financial support over a medium term of four to five years and at the same time encouraging them to raise their own resources. It was hoped with the introduction of the scheme, the era of steady increases of non-plan grants to these institution, on an annual basis by the government would come to an end. Government is to also help in the creation of corpus fund for each institute, by matching grant, where savings from the non-plan grant would be transferred by the institute. Though not spelt out, gradual attainment of self-sufficiency in the operational expenditure by the institutes should have been the central objective if aim was to cut down the extent of subsidy for higher technical education. Since this was the basic point, this should have received adequate attention and steps required for achieving of self-sufficiency laid down, while deciding upon the funding.

Higher education is not neutral in personal distribution effects. Some individuals and families gain future income streams, partly at the expense of others. Whether it is in general depends in the distribution of personal cost and personal benefits of higher education. 'It could be that the financing of higher education is quite regressive. It is plausible that it is regressive because it adds to the value of the human capital of those who attend college relative to those who do not go to college, because it increases the lifetime earnings of college graduates in part at the expense of others, and closely related, because higher education provides educational services predominately for students from middle and upper income families and a part of the cost of these educational services is paid for by taxes on poor families' (Schultz, 1968/76).

Investment in schooling, on the other hand, reduces inequality of distribution of personal income. The point is that investment in education cannot be dis-linked from the issue of equality and inequality in distribution of personal income and good governance would mean taking full note of the fact in deciding about investments in education sector.

Higher education is to be recognised as an industry. The students are to be regarded as consumers of the output of the institutes in terms of education and training. This would also provide basic rationale for full-cost pricing of higher education, combined with government provision of ample loan funds to students who do not have access to competitive loan terms in the private markets. The introduction of full cost pricing in higher education might help to increase the degree of competitiveness among the institutes and the universities. The student-consumers can exercise their preference on the basis of the cost and benefit. The logic of full-cost pricing should also lead to gradually moving out of the average cost fee to be charged to all students at a given institute. The relative cost and demand differences for different courses within a university/institute should lead to differential pricing on the basis of marginal cost principles (Tollison and Willet, 1973). The principles of giving scholarship should also be determined by relative attraction of different courses.

Some of these points are receiving attention in the deliberation of the Expert Committee of the Department of Education which is examining the implementation of the new funding pattern of IITs, IIMs and IISc. with a view to suggesting a revised scheme.[25] But much requires to be done.

The achievement of self-sufficiency in operational expenditure, within a defined time frame, has to be accepted as a goal, not only from the point of view of ensuring autonomy in the functioning of the institutes but also for reducing the element of subsidy to the students in pursuing higher technical and management education.

The corollary of this perception should be the projection of expenditure for next five years (Ninth Plan) and same for the revenue, with a view to reducing the gap between the two. This exercise has become necessary so that at the end of the Ninth Plan period the object of required degree of self-sufficiency is achieved. In projecting the expenditure, planning element automatically comes in, as the aim now is to keep the expenditure to the minimum. For revenue generation, the aim should be the opposite,

[25] The author is a member of the Expert Committee.

so that it increases in a perceptible manner by raising of fees, higher induction of students, vigorous pursuit of sponsored programmes, consultancy and by establishing closer linkages with industry who would be ready to finance relevant projects. The projected figure for expenditure and revenue for each institute can then become the norm for evaluating their performance each year. This would also call for micro planning where each department and each sphere of activity being treated as 'finance units' for groupings of income and expenditure for the purpose of control and planning. Thus, linking of expenditure and revenue in each spear of activity leads to better management and economical use of resources (Hungate, 1954). The philosophy of financial support for each group of activities, has also to be developed.

WHY EXPENDITURE SHOULD BE LINKED WITH RECEIPTS?

Every spending proposal costs money. This money most come from somewhere. If one has to follow the Wicksellian model of taxation then it would require that every proposal to spend money should explicitly state how the revenue should be raised. For example, a proposal might be made in the parliament that Rs. 500 crore should be spent for relief of those who have suffered from a cyclone in an area. That money would have to come from somewhere. Prudent budgeting would dictate that the opportunity cost of fund should be taken into account while agreeing to the proposal. If no other expenditure could be cut then the bill before the parliament should explicitly say that national debt be increased by Rs. 500 crore to pay for the disaster relief. If, however, expenditure could be cut in other area to pay for it then extent of amount of expenditure being cut for each area to pay for it should be explicitly stated in the spending proposal. Alternatively, taxes might be increased, in which case the legislation must state so explicitly. Or it could be combination of expenditure reduction in certain areas, raising of taxation and part borrowing, all adding up to Rs. 500 crore. Thus, legislation, would have to explicitly consider opportunity cost of all such spending which comes after the budget has been passed. Once this type of budget is established, expenditure then would require to stay within overall amount approved in the budget at the time of budget estimate. This proposal is not exactly Wicksellian in that the criterion of unanimity is not met. But it is Wicksellian in the sense that it requires, explicit accounting of costs and benefits of all spending proposals (Holcombe, 1994), before it is passed by the parliament. The true cost of government spending should not be hidden.

INABILITY TO SPEND CALLS FOR EVALUATION OF THE PROGRAMMES

The inability to spend allotted amount also calls for in-depth analysis of programmes as the overspending. This phenomena is seen in the Health sector. The anti-TB programme fighting one of the India's most serious health problems has been allocated Rs. 52 crore a marginal increase compared to the last budget (Sridhar, 1996). The more serious aspect is according to figures in the Annual Report of the Health Ministry that between 1992-93 and 1995-96, actual expenditure have fallen short of the budgeted outlays by more than 27%. Similarly, for blindness control programme in 1995-96 only Rs. 63 crore compared to the budget projection of Rs. 73 crore. Funds for programmes against Kala azhar, have been halved in 1996-97 from the 1995-96 level probably because of inability to spend the allotted amount. All these programmes require re-look to find out the reasons for inability to spend though the need exists. Is the concept of making the health system entirely doctor-based logical? Is not adequate support facilities for pathology and radiology equally important (Basu Ray, 1996)? But this would require trained group of para-medical staff. Does this scarcity lie here? And what can be done about? These are the questions which have to be addressed to, among others, if we have to look into the reasons for short fall of expenditure in some of the disease control programmes. Thus, the management aspects cannot be segregated from expenditure control aspects. It may call for decentralised resource management with lot of delegated powers. As recommended in one study of budgetary management (Ghosh, 1992, pp.10-11), it may be useful for better resource management to identify authority and responsibility centre along with budget centre concept. The objectives of authority centres will need to be reflected as targets of responsibility centres for which adequate funds have to be made available.

III

How a budget is managed is reflected in the Appropriation Accounts. Timely rendition of Appropriation Accounts and its scrutiny by the audit authorities, is an essential part of the budgetary control system. From the reports available, it is seen, in some of the State Governments rendition of Appropriation Accounts is inordinately delayed by some of the departments. In all the states in each district, there is a district treasury. The treasuries are the units of fiscal system and the points at which public accounts start. Into these treasuries are paid the receipts of the government and from them are disbursed payments on behalf of government. The initial accounts of all

receipts and payments in India, on behalf of Union and State Governments, are maintained at the treasuries. Treasuries are of two kinds—banking and non-banking. The collector or deputy commissioner of a district is in general charge of treasury and is personally responsible for its general administration, for correctness of its returns and punctuality of their submission but he takes no part in the daily routine of treasury business. The treasury officer is in immediate control of the treasury.[26] Treasury officer passes a payment order on each bill presented for payment at the treasury, *provided it is in order.* He has to satisfy himself and also the Accountant General that the claim is valid. He has to see that the claim is covered by general or special orders, that the voucher is in proper form and properly drawn up and is properly signed by proper officer. This general check is applied to all bills before they are paid at the treasury. The most important feature of this check is that it is applied before payment and that it secures no claims, not generally and prima facie admissible shall be paid at the treasury.[27] In matters of accounts and check at the treasury, the collector and the treasury officer under him is responsible to the Accountant General, whose instructions he is bound to carry.[28]

In reports relation to fodder scam in Bihar, C&AG's inspection report states that delay in rendition of accounts by the treasuries led to the suppression of information relating to excess expenditure. The report observed that in Bihar, over the years, the rendition of accounts by the treasuries, Public Works and the Forest Department has been inordinately delayed. This led to consequential delay of finalisation of the Annual Appropriation Accounts. Chronic delays in rendition of accounts have given rise to malpractices. The delay in receipt of accounts range from 5 -16 months. After lot of follow up action, four Appropriation Accounts could be finalised in one-and a half years and the excess expenditure by the Animal Husbandry Department could be highlighted (Mathew, 1996). As per the report, the Treasury Officers overlooked the impropriety in bill forms and passed a number of bills fraudulently on high amounts of allotment, even without the signature of the appropriate officer.

In view of the enormity of failures, the chronic nature of delays in rendition of accounts and the fact that the treasuries perform the most crucial role in the whole system of financial control, it calls for introspection. First the structure of financial control should be sound which

[26] An Introduction to Indian Government Accounts and Audit, Fourth Edition, 1971, issued by C&AG, para 106.
[27] ibid., paras 132-133.
[28] ibid., para 136.

can ensure that in view of internal controls no fraud can take place. Detection and prevention of fraud is part of the work in connection with scrutiny of expenditure and in our system it is entrusted to the officers of the spending department. Under the existing arrangements the certification as to the initial facts are left to the executive officers. Most of the frauds, therefore, can be checked or detected in the course of scrutiny by the executive officers. The executive officers must be fully alive to this responsibility. Only then one can talk of budgetary reforms and other kind of management reforms. If the basic structure of financial control shows weakness then that is required to be corrected first before other reforms can be talked of. Financial irregularities should call for exemplary punishment. The relationship between Accountant General and the treasury officer has to be re-looked: whether AG should play a more pro-active role than just reminding various authorities for rendition of accounts needs to be seriously considered. The need for strengthening the hands of the audit authorities in the context of what has happened in Bihar and may be happening elsewhere also needs to be seriously considered by a high level committee which should be constituted for the purpose.

Violation of canons of financial propriety can be infectious and if timely action is not taken, it may have serious consequences for financial administration. If financial control is not on a sound footing, if internal control system is not functioning properly then the era of better expenditure and financial management cannot be brought about.

The code of corporate governance is receiving a lot of attention. Report of the Cadbury Committee is being widely discussed for its application in financial management of companies in India. The Cadbury Report stressed the primary responsibility of the directors of the companies for maintaining adequate accounting records for financial transparency. The accuracy of such records depend upon a sound system of internal control and the auditors have to specifically report on this. Ultimately, it is the quality of management which is the crucial factor in ensuring proper internal control.

The extent to which the code of governance in the corporate world is applicable in the expenditure management of the Government, is a matter to be examined. The model of a corporate world was very much there in the mind of founding fathers of our financial administration system, which led to the laying down of the ground rules for determining the responsibility of executive authorities, paying authorities and audit

authorities in financial control. To substantiate this point, I shall like to quote from *An Introduction to Indian Government Accounts and Audit*, 1971: 'So far as its audit duties are concerned, the position of the Indian Audit and Accounts Department in relation to Government transactions is to a large extent similar to that of an "auditor" (of a company). In this context, Parliament / Legislatures may be regarded as the Shareholders of the "Government concern" and the Executive Government as its directors. The object of this concern is however not profit-making.'[29]

This model requires slight change in that the citizens and the tax-payers should be regarded as the shareholders of this giant concern. The Citizens as tax-payers must get value for money. The Government can be treated as a quasi-market. Citizens vote is the means by which his preferences are conveyed. Even if we accept the Downs' model, which is somewhat mechanistic, one can conceive of two stage political market theory. In the first stage voters choose men who are fitted to discharge the task of deliberation and discussion at the parliamentary stage, in the second stage, these officials are held accountable for their political acts by the need to seek periodic re-election (Maass, 1977).

Conceiving of a proper model of political process would also help in structuring our thought in designing a better public expenditure management system.

An analyst role should be to force an articulation of the objectives served and the conflicts between such objectives in public policy making. Issues and conflicts should not be concealed but openly discussed while taking decision in policy matters. Only then would the public interest be served.

[29] Issued by the C&AG, Fourth edition, 1971.

References

Basu Ray, Indranill (1996), "Still on the Sick Bed", *The Sunday Times of India*, September 8.

Clarke, Sir Richard (1978), *Public Expenditure Management and Control,* edited by Sir Alec Cairncross, published by The Macmillan Press Ltd.

Collender, Stanley E. Director, Federal Budget Policy Price Waterhouse (1995), *The Guide to the Federal Budget Fiscal 1995,* The Urbana Institute Press, Washington DC.

Ghosh, Amiya Kumar (1992), *Report of the Task Force on Accounting Classification and Budgetary Control in Defence Services (TFR),* April, pp. 5-7.

_______ (1996a), *India's Defence Budget and Expenditure Management in a Wider Context*, Lancer Publishers, p. 240.

_______ (1996b), *Scope for Meeting National Security by Effective Management of Available Funds.* Paper presented to the 'National Security Seminar–1996', organised by the United Service Institute of India. 28-29 November.

Government of India (1968), *Report of the Administrative Reforms Commission on Finance, Accounts and Audit,* 1968, pp. 16-17.

_______ (1985), *Geethakrishanan Committee Report,* Committee to Review General Financial Rules, General Treasury Rules and Accounts Codes. Second Report, December, p. 18.

_______ (1989), Comptroller and Auditor General of India, *Performance Evaluation Series, Irrigation and Flood Control*, December.

_______ (1994-95), *Economic Survey,* 1994-95, p. 138.

_______ (1995-96), Defence Expenditure, *Defence Services Estimates,* 1995-96, Appendix C.

_______ (1996), *Report of the Standing Committee on Defence*, 11th Lok Sabha, Demands for Grants, First Report, Government of India, August.

Government of the United Kingdom (1990), *Management Strategy, Part IV*, p. 276, glossary. A publication of the UK, Ministry of Defence.

Henley, Douglas, et. al. (1990), *Public Sector Accounting and Financial Control,* Chapman and Hall, London, pp. 59-60.

Holcombe, Randall G. (1994), *The Economic Foundation of Government,* Macmillan, p. 203.

Hungate, T.L. (1954), *Finance in Educational Management of Colleges and Universities*, Columbia University.

Kanter, Herschel (1982), "The Defence Budget Process", in *The Federal Budget Economics and Politics,* edited by Aaron Wildarsky and Michael J. Boskin, Institute for Contemporary Studies, San Francisco, California, 1982. Quoted in the book, *(IDBEM).*

Maass, Arthur (1977), "System Design and the Political Process: A General Statement", *Design of Water-Resource Systems,* Cambridge: Harvard University Press 1962, quoted by Peter O. Steiner in *The Public Sector and The Public Interest,* appearing in *Public Expenditure and Policy Analysis,* R.H. Haveman and J. Margolis, 1977.

Mathew, Mammen (1996), "Report by Mammen Mathew", *The Hindustan Times,* New Delhi, October 11.

Premchand, A. (1994), *Changing Patterns in Public Expenditure Management: An Overview,* paper prepared for an international conference on 'Financial Management and Accountability in the Public Sector', Feb.

Rao, M. Govinda, Tapas K. Sen and Madanmohan Ghosh (1995), "Uneven Growth of Government. Expenditure—An Analysis of the Trends Between 1974-75 and 1990-91", *Journal of Indian School of Political Economy,* vol. 7.

Roy, S.N. (1996), "SEBs Lose, Consumers Pay", *Economic Times*, New Delhi, November 11.

Schultz, Theodore W. (1968), "Resources for Higher Education: An Economists View', *Journal of Political Economy,* May/June, 1968, reprinted in *The Economic Approach to Public Policy (EAPP),* edited by Ryan C. Amacher et.al., Cornell University Press, 1976.

Sridhar, V. (1996), "Harmful Neglect, India's Disease Control Programmes", *The Frontline*, September 6.

Shome, Parthasarathi, T.K. Sen and S. Gopalakrishnan (1996), "Public Expenditure Policy and Management in India: A Consideration of the Issues", March 1996. Paper presented at a seminar on *Expenditure Management*, organised by Department of Expenditure, Ministry of Finance, Government of India.

Tollison, Robert D. and Thomas D. Willett (1973), "The University and the Pricing System", *Journal of Economics and Business,* Spring-Summer, reprinted in *EAPP.*

Vohra, B.B. (1996), "Flooded Funds, Meandering Projects", *Hindustan Times*, New Delhi, October 3.

Wattal, P.K. (1950), *The ABC of Indian Government Finance,* Government of India, p. 30.

Fiscal Management : The Federal Dimension of Developing Countries

16

Amaresh Bagchi

I. Introduction

Fiscal management has been in the forefront of public policy challenges in recent years. The motivation stems from the realization that "fiscal corrections" have been and continue to be poor in most countries, particularly among the developing ones. Carefully designed and elegantly articulated programmes of structural adjustment notwithstanding, government budgets continue to be in deficit and fiscal balance seems to elude policy makers everywhere. While budget imbalance in essence reflects the inadequacy of revenues in relation to the expenditures of the government, attention has tended increasingly to be focused on pruning expenditures since given their economic structure and the deficiencies of administrative machinery, it is felt that revenue levels are not easy to push up significantly in the short term and so fiscal correction must start from the expenditure side. Even where there is scope for expanding the revenues, spending must be reined in for the budget to be balanced on a sustainable basis. Fiscal management thus turns heavily on how efficiently public expenditure is managed. Hence the emergence of Public Expenditure Management or PEM in short, at the top of the structural adjustment programmes all over the world.

The author wishes to thank Sujata Data and T.S. Rangamannar for statistical assistance. Able Secretarial Assistance was provided by N. Natarajan.

Measures taken by India's Finance Minister in 1991-92 to restore the fiscal health of the economy as an integral element of the structural adjustment campaign also proceeded by imposing pretty severe cuts on the Central government's expenditures and, contrary to the general perception, growth of the expenditures of the Union government decelerated markedly

with the reforms. During the five years of reform (1991-92 to 1995-96) the compound growth rates of total expenditure of the Central government came down to 11.7 per cent per annum as compared to nearly 17 per cent in the preceding ten years. Fiscal deficit also contracted to 5.9 per cent of GDP in 1991-92, marking a clear contraction from 8.3 per cent that prevailed immediately before. The improvement turned out to be shortlived however. During the third year of reform (1993-94) fiscal deficit widened, measuring 7.4 per cent of GDP and has remained stubbornly at 6 per cent since then, defying all attempts to bring it down to less than 5 per cent.

Part of the blame for the failure can perhaps be laid on the revenue side of the budget as the growth and level of the Centre's gross tax revenue in terms of proportion of GDP suffered a decline with the initiation of the reforms, bearing the twin impact of tariff reduction and import contraction. But there was stickiness in the expenditures too particularly its major components viz. interest, defence and subsidies.

Persistence of deficits by itself does not reveal the shortcomings in expenditure management in all its aspects. While not many among the developing countries have succeeded in tackling their fiscal problem in terms of sustainable fiscal deficit. composition of public spending shows "egregious imbalances", evidencing adverse consequences for allocative efficiency and equity. In many countries government spending is marked by gross technical inefficiency in various forms, such as excessive staff growth, with the rolls carrying a large number of ghost workers and widespread moonlighting. In several cases there has been a collapse in the delivery of public services with investment and maintenance expenditures taking the brunt of the spending cuts.

To correct these deficiencies and inefficiencies, attention is usually drawn to the need for evaluating and improving the budgeting systems on the one hand and strengthening the financial management systems on the other. The latter, for which there is already an extensive literature centres around programmes that help to improve the efficiency of instruments of monitoring expenditures through computer-based information systems, better financial accounting, redesigning budget formats, restructuring of organisational responsibilities and strengthening public sector spending management capacity through training and so on. The National Performance Review drawn up for USA by its Vice President Al Gore provides a fine example of the attempt to improve government functioning by revamping the budget process, personnel policy, procurement process,

audit agencies, allocation of revenues and the devolution process.[1] However, these approaches though useful and necessary as providing building blocks for improving PEM do not really go to the root of the matter in that they do not provide a coherent analytical framework for evaluating the strengths and weaknesses of a PEM or fiscal management system nor do they provide a helpful methodology for relating changes in a given system to actual outcomes.

A major lacuna is insufficient attention to the incentives that makes for sound fiscal management and the relevance of the fiscal dimension in this context. This paper seeks to draw attention to this rather neglected dimension of fiscal management referring particularly to the Indian experience. It is contended that the system of fiscal federalism as it is operating in India suffers from a grave deficiency viz., absence of accountability and incentives for fiscal management and is this responsible in no small measure for the continuing fiscal problems facing the country. The paper argues that the Centre-State fiscal relations need radical rethinking if management of public finances is to improve in all respects. This is an issues paper highlighting some of the crucial areas of federal fiscal relations, in order to draw attention to the need for further research rather than presenting any definitive research results.

II. The Federal Dimension of PEM

Drawing attention to the deficiencies of PEM it has emerged in the Literature and also the structural adjustment programmes launched in recent years, a recent World Bank research paper suggests that expenditure outcomes need to be evaluated under three levels or categories, viz., *aggregate fiscal discipline* reflected in the aggregate level of spending and deficit, the *composition of expenditures* ("strategic prioritization for allocative efficiency and equity") and the *technical efficiency* of the spending programmes in implementation (Campos and Pradhan, 1996). The World Bank paper recommends a new approach to the problem underlining the vital role of institutional arrangements (viz., rules, norms and procedures) and explaining how they can undermine the budget process unless properly designed. Particularly emphasised is the crucial role of **incentives** in determining the allocation and use of resources in government. Drawing upon the theories of New Institutional Economics, the authors put forward suggestions for setting up "genetic institutional arrangements" that can help address some of the problems in PEM by linking the arrangements with relevant accountability and/or transparency mechanisms and thereby

correlate the "quality" of PE systems with expenditure outcomes in each of the three categories.

The most striking example of how institutional arrangements can make for effective accountability and transparency by binding the government to aggregate fiscal discipline is provided by New Zealand. In order that accountability starts visibly at the top, one of the radical steps taken in New Zealand was to link the contract of the post of its Central Bank government explicitly to inflation and that of the Minister of Finance to aggregate fiscal performance. Two developing countries (Thailand and Indonesia), it appears, have also achieved notable success in bringing about aggregate fiscal discipline as evidenced by low inflation rates together with rapid and broad-based growth.

The authors of the World Bank study identify three distinct but interrelated problems that have a bearing on the reforms of the three categories mentioned earlier. These are: one, what is called "the tragedy of the commons" (stemming from the citizens' tendency to view the budget as a common pool which can be drawn upon at no or little cost); two, informational and "vote cycling" problems that impede the strategic prioritization of expenditure programmes and three, information asymmetry and incentive incompatibilities within the government. Unquestionably, these are formidable problems which call for an institutional approach to tackle. But, as noted in the study, institutions alone cannot deliver the goods. For institutional arrangements to be effective they have to be **binding** and that in turn calls for mechanisms that make adherence or non-adherence to the prescribed rules transparent and make the government and its agents (ministries and officials) accountable.

While prioritization involves political decision the quality of which is determined by many factors (people's awareness level and information availability), technical efficiency in public resource use hinges critically on accountability. Accountability and incentive compatibilities form the key note of the institutional arrangements suggested in most studies on PEM (see for example, Premchand 1992).

One of the institutional factors that have a profound influence on accountability - but generally overlooked in the literature on PEM - is intergovernmental fiscal relations, in short, for a federal polity, the federal dimension.[2] This is surprising. For it should be evident to anyone watching the fiscal scene in a federal country (or even any country with a

decentralised system of governance but not very well defined system of intergovernmental fiscal relations) that the manner in which responsibilities for providing public services are assigned to and public resources are shared between different levels of government has a profound impact on the PEM and thus fiscal management in all its aspects viz., deficit control, prioritization of spending programmes, tapping of possible revenue sources and efficient use of what is available. Indian experience bears ample testimony to this prognostication.

III. The Indian Fiscal Scene

That fiscal management in India has gone awry and there is a chronic imbalance in the government's revenue and expenditure with expenditures running ahead of revenue has been evident for quite some time. But this was not the case in the beginning. Looking at the post-independence era, one finds that there was a time when government finances in India appeared to be in reasonably good shape. During the three decades spanning the 50s, to 70s rarely did the combined receipts and expenditures of the Centre and the States turn out a fiscal deficit of more than 5 per cent of GDP (Table 1). What is more, during the entire thirty years there was no deficit in the revenue (that is, current)[3] budget except for three years and even then the deficit did not go beyond 0.2 per cent of GDP. Since 1982-83, revenue deficit has been a recurrent phenomenon and since 1987-88 the revenue account has been turning out deficit of over 3 per cent (in the last three years it has been running at over 4 per cent of GDP). Earlier the Centre's budget used to have a small surplus in the revenue account except occasionally. Since 1979-80 deficits have been a regular feature of the Centre's revenue budget and the level of the deficit has steadily risen exceeding 4 per cent of GDP in 1993-94. Although the States' revenues have been chronically inadequate to meet their current expenditures - as their tax sources are limited - their current budget deficit did not exceed 1 per cent of GDP at any time and in fact the revenue account produced some surplus, though modest from time to time. Since 1987-88 the State budgets too have been in the red continuously although the deficit has not exceeded 1 per cent of GDP in any year so far. The picture however varies widely from State to State, with some States running revenue deficit of 2 per cent or more.

Table 1
Trends in Fiscal/Revenue Deficits or Surpluses as Per cent of GDP
(Centre, States and Combined)

	1950-51	*1955-56*	*1960-61*	*1965-66*	*1970-71*	*1975-76*	*1980-81*	*1985-86*	*1990-91*	*1991-92*	*1992-93*	*1993-94*	*1994-95 BE*	*1995-96 RE*
Fiscal Deficit(-)														
Centre	-1.27	-4.10	-4.49	-5.21	-3.26	-3.85	-6.53	-8.53	-8.34	-5.89	-'5.70	-7.45	-6.10	5.94
Sates	-1.12	-2.47	-2.64	-3.89	--2.14	-1.43	-3.20	-2.98	-3.39	-2.99	-2.84	-2.91	-3.00	-3.15
Combined	-1.88	-4.00	-5.54	-6.92	-4.59	-4.59	-8.09	-9.32	-9.88	-7.35	-7.19	-8.71	-7.95	-7.44
Revenue Deficit(-)/Surplus(+)														
Centre	+0.58	+0.40	+0.31	+1.22	+0.38	-1.13	-o.57	-2.12	-3.47	-2.64	-2.63	-4.08	-3.61	-3.00
States	0.02	0.44	0.15	-0.19	-0.04	+1.21	0.66	+0.21	-0.95	-0.92	-0.72	-0.43	-0.82	-0.87
Combined	0.56	0.03	0.48	0.90	+0.34	+2.34	+0.09	-1.91	-4.42	-3.55	-3.35	-4.52	-4.43	-3.97

Source: Indian Economic/Public Finance Statistics, Ministry of Finance - various issues.

Table 2
Expenditure Growth of the Centre and the States — 1980-81 to 1990-91 and 1990-91 to 1995-96

(% per annum)

	Revenue						*Capital*						*Total (Revenue plus capital)*	
	1980-81 to 1990-91			*1990-91 to 1995-96*			*1980-81 to 1990-91*			*1990-91 to 1995-96*			*1980-81 to 1990-91*	*1990-91 to 1995-96*
	P	NP	Total	P	NP	Total	P	NP	Total	P	NP	Total	-	-
Centre	16.6	17.9	17.7	19.2	13.2	14.3	9.6	26.2	15.3	3.0	10.9	4.4	16.9	11.7
States	17.8	16.9	17.1	14.8	15.5	15.4	11.1	6.6	9.3	11.7	5.3	9.8	14.9	14.3

Note: P stands for "Plan" and NP stands for "non-Plan.

To quote the Tenth Finance Commission(TFC), "From a revenue surplus the economy moved into a state of continuous deficit on revenue account in 1982-83". There was a time when the **non-Plan** revenue accountof the States as a whole produced a surplus large enough to meet the revenue expenditure requirements of the Plan and even cover a part of the capital requirements of the budget. The non-Plan revenue surplus started declining with the revenue component of the Plans getting larger and larger and since 1991-92, the non-Plan revenue account also has run into a deficit. To quote the TFC again, "That all States have had almost identical turning points seems to suggest that there are systemic factors underlying this deterioration rather than state specific reasons" (TFC Report, para 2.14). Fiscal deficit of the Centre was no doubt brought down by the Union Finance Minister in an attempt to stabilise the economy and as part of the structural adjustment programme but the axe fell more on the capital rather than revenue expenditures, which shows that PEM has sought to achieve success in one dimension of its objectives at the cost of the other two. While the annual growth rate of total expenditure decelerated from nearly 17 per cent in the previous decade to 11.7 per cent in the five years of reform, capital expenditure growth slumped to 4.4 per cent from 15.3 per cent (Table 2). In the case of the States, the deceleration in expenditure growth has been little more than marginal (from 14.9 per cent to 14.3 per cent).

Concerned at the persistence of the fiscal deficits particularly on the revenue account, and the need to generate budget surpluses to finance capital expenditures, and as mandated by their terms of reference, the TFC proposed a scheme of devolution of funds from the Union government which, in their estimate should be able to wipe out the deficits in the course of five years ending 2000 A.D. The TFC has also sought to incorporate fiscal management as a part of their devolution formula to induce better budget discipline. Budgets so far do not provide any indication that fulfilment of this goal is anywhere in sight. Unrealistic projections of revenue and expenditures are blamed by many for the outcome. It needs to be recognised that the roots of the matter go beyond "realistic" revenue-expenditure projections and or generous devolution dispensation. The problem lies in the absence of a binding accountability and effective incentives (and disincentives) for public revenue expenditure management (or mismanagement) and that has a lot to do with the system of federal finance as it has been operating in the country.

IV. ROLE OF FEDERAL RELATIONS IN FISCAL MANAGEMENT

That there can be serious problems in securing accountability in public expenditures because of incentive incompatibility in fiscal management in a multilayered system of governance is well recognised. The problem arises essentially from the mismatch that usually marks the assignment of functional responsibilities and fiscal powers among different levels of government. Governments at the lower levels are usually vested with more expenditure responsibilities than those above, reflecting the belief - strengthened by theory - that welfare is maximised, and so allocation and use of resources in the public sector is optimized, if governmental activities are lodged at levels of government closest to the people that can effectively discharge them. This is the efficiency or allocative argument for decentralization of which the normative case is best expounded in the decentralization theorem formulated by Oates (1972) and now enshrined in the "principle of subsidiarity".

The decentralisation theorem postulates that under a sufficiently decentralized system the level of public sector output would be Pareto-optimal because each level of government would possess complete knowledge of the preferences of its citizens and presumably seek to maximise their welfare, and would finance the same through benefit pricing - which in effect implies extending the market principle in determining the supply (both volume and content) of public goods in the economy (McLure, 1993). The trouble is that in the real world the benefit principle is not possible to go by in charging for public services universally for the simple reason that not all governmental activities provide measurable benefits to any identifiable individual. It is possible to apply the benefit principle even with a generalized tax if it is realized from the group of individuals enjoying the public goods or services in question (e.g. through a residence based personal income tax). But there are limits to which taxation on this basis can be practised. There are not many taxes with large revenue potential which can be exploited efficiently at the subnational levels. Efficiency considerations - mobility of tax bases and scale economies in collection - argue for raising taxes with mass bases and significant revenue potential at the higher, typically, national level. It is thus common to find that higher level governments raise more revenue than they need while the governments below spend more than they raise on their own - the gap being filled by transfers and grants.

However, as is well known, transfers, unless carefully designed, can have an adverse consequence for fiscal management in that by allowing politicians to spend money that they are not required to raise, that is by delinking spending and revenue raising decisions, they weaken accountability which is believed to be a strength of federal system of government. For they reduce the tax price of subnational public spending inducing distortions in choices resulting in overspending. When a substantial fraction of the revenue raised at the higher level is transferred, those at the helm may be less inclined to do their best to implement effectively the taxes or tap the revenue sources at their command. Dependence of lower level governments on transfers also undermines their ability to raise funds through borrowing and in any case raise their cost of borrowing (McLure 1993). Experience shows that unless accompanied with certain conditions like a clear and comprehensive contract between Central and subnational governments that spells out the powers and functions of the latter and lays down a hard budget constraint for them, decentralization can be inimical to stabilization (Tanzi, 1995). The problem simply is that it is not easy to maintain a system that relies heavily on transfers from higher level governments without impairing accountability or eroding subnational autonomy.

IV. FEDERAL FISCAL RELATIONS IN INDIA - THE WEAKNESSES

There is reason to think that fiscal management in India has suffered because of incentive incompatibility which in turn has originated *inter alia* from deficiencies in the federal fiscal relations as they have evolved in the last fifty years. The deficiencies consist primarily of the following:

- Large and widening vertical fiscal gap;
- Faulty design of transfers;
- Emergence of Planning Commission as an almost rival channel of transfers and the practice of government budgeting under "Plan" and "non-Plan";
- Shortcomings of the political system to exercise effective accountability on politicians and bureaucrats.

Large and Widening Vertical Gap

That the assignment of powers and functions to the Union and the States with tax powers concentrated largely in the Centre and responsibilities for

expenditures vested in the States larger than they could meet out of their own sources would create a vertical gap and require substantial devolution of funds from the Centre to the States was clear to India's Constitution makers. Accordingly, they provided channels for transfer of a part of the revenues that were to be raised by the Union government to the States. In order that the transfers did not erode the autonomy of the states, the Constitution stipulated the creation of a statutory body every five years to recommend the share of the States in the revenue from specified tax heads and their share *inter se* as also grants in aid of States in need of assistance. This was the genesis of the Finance Commission.

Going by budgetary outcomes (at least the overall balance between revenue and expenditures at the two levels), it is fair to say that the scheme of devolution evolved by the Finance Commission seemed to provide a solution to the vertical fiscal gap for at least the first two decades. But the gap widened over time. As Table 3 shows, since the beginning of the sixties the proportion of revenue expenditures of the States in the combined revenue expenditure of the Centre and the States has remained more or less at the same level around 55 to 58 per cent. But revenue from their own sources as a proportion of the States' revenue expenditure has declined from nearly 66 per cent in the early sixties to barely 55 per cent now (a fall of over 10 percentage points). The proportion of States' own source revenue in the aggregate revenue receipts of government at the two levels on the other hand has gone up only by 6 percentage points or so during this period. Compared with the position that prevailed in the early fifties, the proportion has declined (Table 4). The gap between the states' own revenue and their revenue expenditures is evidently met increasingly out of transfers from the Centre.

Table 3

Proportion of States' Revenue Expenditure in Aggregate Government Expenditure and of States' Own Revenue in their Revenue Expenditure

(Per cent)

Average for the period	States' revenue expenditure/ aggregate government expenditure	States' own revenue receipts/States' revenue expenditure
1960-65	55.56	65.57
1965-70	58.83	61.40
1970-75	59.46	58.62
1975-80	55.79	68.00
1980-85	58.17	60.21
1985-90	54.68	56.90
1990-95 @	57.57	55.13

Source: Government of India, Ministry of Finance, Public Finance Statistics

Note: @ 1994-95 figures are based on REs.

Table 4
States' Revenue Receipts as Proportion of Aggregate Revenue Receipts

(Percentage)

Years/Average	*States' Revenue Receipts/Combined Revenue Receipts of Centre and States*	*States' own Revenue Receipts/Aggregate Revenue Receipts of Centre & States*
1950-55	52.6	40.7
1955-60	57.1	38.7
1960-65	52.6	32.2
1965-70	56.1	37.1
1970-75	58.8	34.6
1975-80	58.1	34.7
1980-85	61.5	36.1
1985-90	61.1	35.7
1990-95	66.1	38.6

Source: Indian Economy/Public Finance Statistics, Ministry of Finance - various issues.

While the weight of the States' contribution to total government revenue has not gone beyond 38 per cent, accrual of revenue to the States as measured by the proportion of total revenue going to them (that is, own revenue together with transfers) in the combined revenue of the government at both levels has registered a marked increase during the last thirty years, from about 53 per cent in 1960-65 to about 66 per cent at present. Correspondingly, revenue accrual to the Centre has suffered a decline. Apparently, while the allocation of expenditure responsibilities between the Centre and the States has remained practically unchanged, the division of revenues has moved more towards the States evidencing a large vertical fiscal gap and growing dependence of the States on Central transfers on the one hand and persistent fiscal deficits at the Centre on the other.

Going by the index of subnational autonomy (defined as 1 - total transfers/subnational expenditures) India ranks among the lowest three countries among ten (next to Indonesia and Australia). In a study based on late 1980 figures India's index worked out to 0.45 as compared with 0.88 for USA and 0.89 for Brazil (Shah, 1994). The degree of dependence of the States may have increased since then. The extent of dependence of States on Central transfers is much greater in several cases than is indicated by the all States' average (as will be seen from Table 5). Transfers as a proportion of the State's revenue expenditures is over 50 per cent in the case of two large States, Bihar and Orissa and are 100 per cent in some of the special category States.

Table 5
Revenue Transfers as a Proportion of States' Revenue and of Revenue Expenditure

Sl. No.	*States*	*Transfers as % of States' Revenue*		*Transfers as % of States' Revenue Expenditure*	
		1993-94	*1994-95*	*1993-94*	*1994-95*
1.	Andhra Pradesh	37	42	38	47
2.	Bihar	60	59	55	52
3.	Goa	30	29	32	30
4.	Gujarat	24	22	24	22
5.	Haryana	16	9	16	8
6.	Karnataka	28	27	29	27
7.	Kerala	32	34	29	27
8.	Madhya Pradesh	42	45	40	44
9.	Maharashtra	22	19	22	19
10.	Orissa	60	60	56	54
11.	Punjab	22	15	18	14
12.	Rajasthan	44	43	42	41
13.	Tamil Nadu	32	29	29	26
14.	Uttar Pradesh	52	52	47	45
15.	West Bengal	42	39	39	35
Special Category States					
1.	Arunachal Pradesh	84	85	115	117
2.	Assam	71	69	81	70
3.	Himachal Pradesh	74	69	81	54
4.	Jammu & Kashmir	84	87	106	113
5.	Manipur	92	87	121	98
6.	Meghalaya	85	86	88	91
7.	Mizoram	93	93	111	99
8.	Nagaland	93	86	87	75
9.	Sikkim	81	39	96	42
10.	Tripura	90	91	90	96

Source: Compiled from data given in Finances of State governments (RBI Bulletin).

The States' dependence on transfers of this order and the decline in the revenue accrual of the Centre without a commensurate shift in its expenditure responsibilities has had two important consequences:

- Chronic budget problems of both the Centre and the States;
- Erosion of accountability and weakening of PEM.

That the shift in revenue accrual unaccompanied by any significant change in the assignment of expenditure responsibilities of the respective levels of government may have a direct bearing on the budget outcomes of both Centre and the States is indicated by the fact that the revenue budget of the Centre went into the red in 1979-80 and has been in deficit ever since. It was at about that time that there was a jump in the proportion of Centre's gross tax revenue devolving to the States following the recommendations of the Seventh Finance Commission. Expansion of the States' share in Central taxes helped the States to overcome the gaps in their revenue budgets in the late seventies and first half of the eighties but the improvement was shortlived. As noted earlier, since 1987-88, the revenue budgets of all States taken together have turned out deficits every year. It is worth mentioning that TFC found to their dismay that not a single State had projected a pre-devolution surplus in their revenue account and even the Centre had, for the first time, anticipated a pre-devolution deficit in its revenue account.

It would be overly simplistic to attribute these developments on the budget front entirely to inefficient federal fiscal relations in the country. But it may not be wrong to presume that the division of financial powers and functions that has emerged in practice has something to do with the deterioration and its chronic character. Unable to meet its revenue gap the Centre has resorted to borrowing and deficit financing on a massive scale leading to mounting interest burden and acute problems in balancing the budget. The States too are burdened with debt servicing liabilities of varying magnitudes constraining their ability to discharge their responsibilities efficiently. The attempt of the Centre to reduce its fiscal deficit has had an adverse impact on transfers to the States. Net transfers as a proportion of GDP as also a proportion of the States' revenue receipts have registered a decline (Table 6) with negative consequence for their spending on social sectors (Sen et.al, 1994). But as would be seen from Table 3, revenue accrual to the States has been on the increase.

Larger revenue accrual however has not helped to meet the revenue gap of the States. In some States the gap is probably wider than what is reflected in the budget because a part of their accrued liabilities remain unpaid (teachers' salaries and so on). This may be true of the Centre too (in as much as some of its liabilities are carried over from year to year and in the absence of accrual accounting does not show up in the budget). The deterioration in the State budgets has occurred despite the fact that their access to borrowing is practically controlled by the RBI and their ways and means advances are also subject strictly to specified ceilings. Despite repeated

admonition from the RBI, large deficits in the Centre's budget persist. There is a feeling that the Centre's revenue effort is inadequate while it has taken on more functions than what it could meet out of its revenues after transfer to States (The sharp fall in the States' share in public sector Plan outlay from 65 per cent in the first Plan to less than 40 per cent now provides a telling commentary on the directions in which functional responsibility sharing between the Centre and the States is moving). The transfer system too may have some serious deficiencies built into them.

Table 6
Net Revenue Transfers from Centre to States as Proportion of GDP/Revenue Receipt of States

(Rs. crore)

Year	*GDP at Market Prices*	*Total Revenue Receipt of States*	*Total Net Current Transfers to States*	*Net Revenue Transfers as Proportion of (%)*	
				GDP	*States' Revenue Receipts*
1952-53	9774	448	106	1.08	23.66
1960-61	16201	1026	389	2.40	37.91
1970-71	43163	3422	1079	2.50	31.53
1980-81	136013	15036	5658	4.16	37.63
1990-91	535534	62754	21745	4.06	34.65
1991-92	616799	77959	25959	4.21	33.30
1992-93	705328	87091	30315	4.30	34.81
1993-94	801032	101965	33905	4.23	33.25
1994-95 RE	945615	120248	35896	3.80	29.85
1995-96 BE	1078001	132994	40314	3.74	30.31

Source: Net current transfers are net of interest payments made to Centre by the States.
Note: Net Current Transfers are net of interest payments made to Centre by the States.

Multiplicity of Transfer Agencies and Faults in the Transfer Design

Looking at the operation of the transfer systems in India, Rao and Chelliah in their insightful *Survey of Fiscal Federalism in India* conclude: "On the whole it is felt that the design and implementation of intergovernmental transfer schemes suffer from a number of important weaknesses rendering the achievement of their objectives extremely difficult". The difficulties identified by the authors are; one, multiplicity of agencies (Finance Commission, Planning Commission and the Ministry of Finance) for the

flow of Central transfers with overlapping roles, resulting in duplication and waste. Two, faulty design of both general purpose and specific purpose transfers by the Finance Commission and the Planing Commission and three, adverse incentive effects of the faulty transfer system on the revenue and expenditure decisions of the States (and one might add, of the Centre too).

The deficiencies of the transfer design seem to be two fold, viz., the preponderance of tax devolution rather than grants-in-aid in the statutory transfers, and the absence of a clear conceptual framework for distributing the unconditional transfers, of which a good part flows from the dispensation of the Planning Commission.[4] For a long time the grants-in-aid part of the statutory transfers was used mainly to fill the revenue gaps of the States without any rigorous assessment of their revenue deficiency or cost disabilities. The Ninth Finance Commission had sought to correct this by adopting a normative basis. However, the normative principle is yet to find acceptance and get firmly established in the transfer formula of the Finance Commission. Equity seems to have overtaken efficiency in the design of the Finance Commission's transfers but the end result has not been commensurate with the objectives as better off States are left with much larger post-devolution surpluses than the weaker ones (Bagchi, 1995). The attempt to fine-tune the transfer formulae has made the system almost non-transparent. Specific purpose transfers on the other hand are smaller in dimension and are designed on an ad hoc basis even though transfers for Centrally sponsored schemes have emerged as a significant component of the transfers but neither these nor grants for the State Plans which too account for a good proportion of the transfers (see Table 7) are subject to any monitoring worth the name.

Faulty design of the transfer and absence of monitoring for even specific purpose transfers have adversely affected the incentives on revenue and expenditure decisions of the States (Rao and Chelliah, 1996). This may be seen from the fact that the States vie with each other in undertaking expenditure programmes which they cannot meet out of their own revenues while giving up (or not adequately exploiting) revenue sources at their command. The weight attached to tax effort in the formula guiding the FCs transfer or to fiscal management in the Plan transfers does not seem to have had any appreciable impact. Some of the potential revenue sources like farm incomes and urban land remain inadequately taxed. The subsidies provided

Table 7
Composition of Central Revenue Transfers to States

(Rs crore)

Year	States' Revenue Receipts	States' Total Receipts	Centre's Tax Devolution	Grants from the Centre				Total Grants	Total Revenue Transfers to States	Interest Payments to Centre	Net Current Transfers to States
				Statutory Grants	State Plan	CSS/CS	Other Grants				
1952-53	448	581	73 (68.9)	18 (17.0)			15 (14.2)	33 (31.1)	106 (100.00)	NA	106
1960-61	1026	1610	165 (42.4)	37 (9.5)			187 (48.1)	224 (57.6)	389 (100.00)	NA	389
1970-71	3422	4247	755 (56.4)	150 (11.2)			433 (32.4)	583 (43.6)	1338 (100.00)	259	1079
1980-81	15036	18515	3791 (57.9)	335 (5.1)	1109 (16.9)	962 (14.7)	350 (5.3)	2756 (42.1)	6547 (100.00)	889	5658
1990-91	62754	81172	14535 (54.0)	3394 (12.6)	3878 (14.4)	4657 (17.3)	455 (1.7)	12384 (46.0)	26919 (100.00)	5174	21745
1991-92	77959	96715	17197 (52.9)	3446 (10.6)	5651 (17.4)	5598 (17.2)	632 (1.9)	15327 (47.1)	32524 (100.00)	6565	25959
1992-93	87091	107782	20522 (53.8)	3853 (10.1)	7976 (20.9)	5692 (14.9)	115 (0.3)	17636 (46.2)	38158 (100.00)	7843	30315
1993-94	101965	120574	22240 (51.2)	4034 (9.3)	9757 (22.4)	6653 (15.3)	779 (1.8)	21223 (48.8)	43463 (100.00)	9558	33905
1994-95 (RE)	120248	149296	24843 (52.5)	4381 (9.3)	10754 (22.7)	6880 (14.6)	418 (0.9)	22433 (47.5)	47276 (100.00)	11380	35896
1995-96 (BE)	132994	164436	29388 (54.8)	5458 (10.2)	9211 (17.2)	7034 (13.1)	2571 (4.8)	24274 (45.2)	53662 (100.00)	13348	40314

Source: 1. Indian Economic Statistics (Public Finance), Ministry of Finance (various issues).
2. Indian Public Finance Statistics, Ministry of Finance (various issues).
3. Union Government's Finance Accounts (various issues).

Note: Figures in parentheses are percentages to total revenue transfers.

in the form of literally free supply of power and irrigation water to farmers account for substantial sums but the States have not felt compelled to curb them (there are though some signs now that with a slow-down in Central transfers this may change). Inability of the government at both levels to absorb funds made available by agencies like the World Bank point to poor quality of PEM in the country for which again some clue may lie in the faulty federal fiscal arrangements.

It is widely believed, that the transfer system has had a negative impact on the Centre's tax efforts too. When the bulk of the revenue from a tax is transferred to the States the Centre, it is thought, can have little incentive to maximise its effort to administer it (though the striking buoyancy in the income tax revenues in the post reform period weakens this argument). The practice of budgetary accounting under "Plan" and "non-Plan" with "Plan" expenditures acquiring an aura of superiority has led to the relegation of activities like maintenance to lower priority and encouraged launching of grossly underfunded projects. These have led to deterioration in the quality of public services and accumulation of budget problems leading almost to a debt trap for both Centre and many States.

Weak Political Accountability

Lastly, the competitiveness of India's avowedly pluralistic democracy with multiple pressure groups trying to have a dip into the common pool (the "tragedy of the commons") also has compounded the budgetary problems at all levels of government. The tendency of politicians to nurse their constituencies (or grab those of others by promises that burden the budget without adequate thought for their act) has contributed in no small measure to the fiscal problems at both levels of government. While in principle democracy with periodic free elections as are held in India should help to exert the pressure, for many complex reasons such as illiteracy, impediments to information flow and narrow loyalties of caste, community and so on, political accountability has not been as effective as could be expected.

Unless effective steps are taken in advance and the transfers from States to local bodies are appropriately designed, the 73rd and 74th amendment to the Constitution which confer statutory recognition to the urban and rural local bodies in India, may worsen the budget imbalances of the government further.

VI. Directions of Reform - Rethinking Centre-State Relations

Budget deficits have been a challenge for policy makers not only in developing countries like India but also in advanced industrial societies like USA and Canada. It is interesting to find that federal fiscal relations in these countries too are thought to have contributed to the deterioration that has marked their government budgets and weakened their economies in recent years. It is felt by many that for an enduring solution one has to rethink the role of federal and State governments and the assignment of their powers and functions.

For example, in a thought provoking paper, Alice Rivlin, the eminent public finance expert and a top adviser to the Clinton administration, has argued that the American economy would gain in many ways if federal spending programmes for education, housing, training and most other types of investment were devolved to the States. Such a move, she thinks would serve to clarify which level of government is accountable for performance in these areas and make it possible to achieve a surplus in the federal budget. To meet their added responsibilities, the States would have to find more effective ways of raising resources. For this purpose, she suggests a new approach to taxation, under "shared common taxes" whereby, with the support of the federal government, the States would move toward a system of more uniform taxation of business and consumption with one or more common taxes and sharing the proceeds on a formula basis (Rivlin, 1991). The "common shared taxes" Rivlin has in mind could be an existing tax like the present sales tax or a new tax such as the value added tax which can be adopted by an "interstate compact" to be operated with the acquiescence though not the participation of the federal government. The central idea is that federal functioning should be limited principally to international affairs, but would include strengthening the social insurance sphere, a stronger role in means-tested payments like a national welfare minimum and functions, of which the costs or effects spill over State borders. Regulating financial institutions and support for scientific research would, in this scheme, also be a federal responsibility. And so also would be the objective of running a significant surplus in the unified budget.

In Canada deficits appeared in the federal budget almost as a consequence of the federal government going into fields which in terms of the country's constitution fell within the provincial and not federal competence, viz., post-secondary education, health and welfare. The post-war boom in the Canadian economy and the large accretion to income tax revenue from a progressive and unindexed income tax helped to fund the

involvement which took the form of open-ended matching grants to encourage provincial spending in the proposed activities. With the end of the growth era, revenue fell off and the federal government ran into "unending deficits". As a remedy, some of the transfers which had assumed large proportions were capped and turned into general purpose or unconditional transfers (Bird and Duan-jee Chen, 1996). The Canadian federal fiscal arrangements are under severe strain and continuing federal deficits have triggered intense search for enduring solutions by rethinking federal-provincial relations (Banting et.al., 1994).

While the character of federal fiscal relations varies from country to country, being rooted in many factors such as history, racial composition of the population, and so on, the one lesson that emerges from the experience of even advanced countries with federal constitution is that fiscal management must pay attention to the long standing federal dimension if it is to succeed in its objectives.

The need to rethink the Centre-State relations in India has been underlined by experts and observers in India too. After surveying the entire gamut of Centre-State financial relations and noting the basic deficiencies of the system, Prof. Chelliah in a lecture delivered in 1991 had made wide-ranging suggestions for restructuring. His main recommendations were:

- In order that there is some stability in the level and pattern of transfers, the share of Centre's total tax revenue to be devolved to the States may be constitutionally fixed. The Finance Commission should be asked to fix the principles for the *inter se* distribution of the shared taxes among the States. In his view 25% of the Central tax revenue might be fixed as the share of the States.

- With tax devolution proportion fixed, the FCs would need to look only at the requirements of the backward or poorer regions in recommending grants-in-aid. In his calculations, to keep the grants at the same relative level as was prevailing then, the share of the States in the combined total revenue could be fixed at 60%.

- The capital transfers would be administered partly by the Planning Commission and would be given in the form of loans except for the Special Category States to whom it could be largely given as grant.

- A Loans Council should be set up to allocate public sector borrowing between the Centre and the States. A fraction of this could be given as subsidised loan from the Centre and the rest would be obtained though the market leaving *inter se* the distribution among the States to be divided on principles such as laid down in the Gadgil formula in consultation with the National Development Council or the Inter-State Council.

- In order that there is no overlap between its jurisdiction with the Finance Commission, the Planning Commission should look only at investment and not revenue expenditures.

With a view to correcting the disincentive effects of the present system on the Centre's tax effort and to impart a measure of stability in the level of devolution, TFC too has recommended a Constitutional amendment to fix the proportion of the Centre's tax revenue to be devolved to the States for fifteen years. To maintain devolution at its present level, the TFC has suggested that this percentage be fixed at 29.

Since the TFC's scheme leaves out the plan component of revenue expenditures, an alternative suggestion has been put forward for fixing the proportion of Centre's revenue to be devolved at 40% including the plan grants (Guhan, 1995).

Yet another suggestion has been that in order that Central transfers do not dampen the incentives for efficient fiscal management, while at the same time, their autonomy does not suffer, let each State's share be divided into two parts, one, "entitlement" and the other "conditional". The entitlement transfers should form the core and be given without any condition while the rest should be subject to fulfilment of specified conditions. The loans under this scheme would be negotiated like those given by the World Bank (Rao and Rao, 1996).

While the idea of fixing the share of the States in total Central revenues has an intuitive appeal, one has to take into account the fact that the division of spending responsibilities and revenue that has evolved over the years (the revenue part of which is sought to be frozen through a Constitutional mandate) is far from what might be regarded as sound or optimum from the angle of either efficiency or equity. Available data (some of which have been presented in the tables below) clearly reveal that there is a wide vertical fiscal gap and it has widened, necessitating larger and larger revenue accrual to the States. While there may be nothing intrinsically

wrong in this, the fact of the matter is that the present division of revenues is not based on a normative or careful assessment of the expenditure requirements of the Centre and the States and what they can raise by revising the powers at their disposal judiciously. The Finance Commissions have often felt obliged to take the existing situation as a *fait accompli* (and so have gone by the actuals at the start of their reference period as the base). Even granting that the gap as it has emerged reflects the relative revenue capacity and functional responsibilities of the two levels of government, the fact that the transfers have not been sufficient to bridge the revenue gap at either levels, clearly shows that there is something fundamentally wrong in the assignment of powers and functions between the Centre and the States. If the vertical gap is to be narrowed, either the Centre must shed more responsibilities to the States (by withdrawing from fields in which strictly speaking it has no competence), retaining for itself its basic responsibilities or more financial powers should be transferred to the States or both. It is possible to transfer more tax powers to the States without causing disharmony (e.g. by joint occupancy of certain tax powers like income tax and sales tax but with common base and common administration). If that seems impossible right now, there should at least be transfer of more functions to the States. Irrespective of whether the vertical gap gets reduced immediately, in the interest of efficiency the transfer pattern should be redesigned with a larger weight for grants in the statutory transfers and merging of Plan and non-Plan grants in one.

There is no doubt some merit in fixing the proportion of Central revenues to be devolved and giving a fraction of the grants-in-aid in the form of specific grants, with strict monitoring (so that there is no diversion as is currently believed to be taking place). But before the proportions are frozen at their current levels, it is necessary to take a look at the entire gamut of federal fiscal relations,[5] see whether the existing vertical gap can be left as it is and whether the plan grants also can be included in the percentage to be so fixed. Since, as has been argued, quite rightly, the Centre-State fiscal relations call for a paradigm shift (Rao and Rao, 1996a) it would be undesirable to fix a percentage on the basis of what has been obtaining in the recent past especially since the existing situation can scarcely be regarded as anywhere near optimal. It is salutary to remember as a member of the Tenth Finance Commission has observed, "...... the total system and both its Central and States' component are now in difficulty (Vithal, 1996).

While the need to reduce the vertical fiscal gap in the interest of accountability and sound fiscal management is generally acknowledged, what would be optimal gap for a given country remains an open question,

offering a challenging area for research. One of the earliest to go into this question in an analytical framework was Gordon (1983). More recently, Boadway and Keen (1995) have questioned the generally held belief that efficiency considerations lead to a positive vertical fiscal gap. Modelling the decisions of more than one level of government and the interaction between them in a game-theoretic framework, they show that pure efficiency considerations may plausibly point in exactly the opposite direction. The main reason for this possibility, they argue, is the existence of a "vertical fiscal externality" since where there is co-occupancy of the tax base, a typical state may neglect the impact of its tax decisions on the federal tax base. If the federal response is to be optimal the distortions of State decisions should be internalised through offsetting subsidy on the common tax base, and financing that may call for transfers from the States. The analysis abstracts from inefficiencies flowing from tax competition and so on at the State level and also the redistributive role of federal transfers. Moreover, the experience of confederate type pattern of federal fiscal relations, such as in China, USA (for some time) and erstwhile Yugoslovia does not seem to be very encouraging in promoting efficiency or fiscal stability (Mihaljek, 1993). However, the conclusions reached by the authors, if valid, may have a profound implication on optimal direction of federal-state transfers and need attention.

Given this background, lot more research and public debate are needed if efficiency of fiscal management in India is to improve appreciably. In any case, it should be recognised that the federal dimension is central to enduring fiscal correction and the ills that afflict Centre-State financial relations in India need to be addressed in a radical way instead of through palliatives that do not cure.

Notes

1. For a brief report on what the NPR contains, see Doraiswamy (1996).

2. There are of course exceptions. The recommendations of the National Performance Review referred to in foot note 1 above, for example, include, among other things, measures for "re-engineering and autonomy to States/local bodies".

3. The terms revenue budget and revenue expenditures are used interchangeably with "current budget" or "current expenditures".

4. For a discussion of the consequences of the preponderance of tax devolution in the transfers ordained by the Tenth Finance Commission, see Bagchi (1995).

5. See, for a critique of the proposal to pool central taxes for devolution, Bagchi (1996) and defence thereof (Rao and Rao, 1996b).

References

Bagchi, Amaresh (1995), "Tenets of the Tenth Finance Commission", *Economic and Political Weekly*, 5-12 August.

_______ (1996), "Pooling Union Taxes for Devolution", *Economic Times*, 2 August.

Banting, Keith G., D.M. Brown and Thomas J. Courchene (Eds.) (1994), "The Future of Fiscal Federalism" (Queen's University at Kingston).

Bird, Richard M. and Duan-jee Chen (1996), "Federal Finance and Fiscal Federalism: The Two Worlds of Canadian Public Finance" in *Essays on Fiscal Federalism and Federal Finance in Canada* (International Center for Tax Studies, University of Toronto).

Boadway, Robin and Michael Keen (1995), "Efficiency and the Optimal Direction of Federal-state Transfers", *IFS Working Paper.*

Chelliah, Raja J.(1991), "Towards a Decentralised Polity", *Fourth L.K. Jha Memorial Lecture.*

_________, M.G. Rao and T.K. Sen (1992), "Issues Before the Tenth Finance Commission", *Economic and Political Weekly*, 21 November.

Campos, Ed.and Sanjay Pradhan (1996), *Budgetary Institutions and Expenditure Outcomes* (World Bank Policy Research, Working Paper 1646).

Doraiswamy, P.K. (1996), "Red Tape Tangle: Clues from American Experience", *The Hindu*, 8 October.

Gordon, R.H. (1983), "An Optimal Taxation Approach to Fiscal Federalism", *Quarterly Journal of Economics* 98.

Guhan, S. (1995), "Report of Tenth Finance Commission", *Economic and Political Weekly*, 22 April.

Gulati, I.S. (1995), "Pooling of Central Taxes for Devolution", *Economic and Political Weekly*, 22 April.

McLure, Charles Jr. (1993), "The Brazilian Assignment Problem: Ends, Means and Constraints", Paper presented at *International Seminar on Fiscal Reform, Sao Paolo, Brazil*, September 1993.

Mihaljek, Dubravko (1993), "Intergovernmental Fiscal Relations in Yugoslavia, 1972-80" in *Transition to Market*, ed. by Vito Tanzi (IMF).

Oates, Wallace E (1972), *Fiscal Federalism* (Harcourt, Brace).

Premchand, A (1993), *Public Expenditure Management* (IMF).

Rao, M.G., and Raja J. Chelliah (1996), *Fiscal Federalism in India*, (ICSSR).

Rao K. Madhava and D. Subbarao (1996a), "Give Unto State, What is States'", *Economic Times*, 31 January.

_________(1996b), "Alternative Tax Devolution: A Defence", *Economic Times*, 24 September.

Rivlin, Alice M (1991), "Strengthening the Economy by Rethinking the Role of Federal and State Governments" *Distinguished Lecture on Economics in Government, Journal of Economic Perspectives*, Vol. 5, No. 2.

Vithal, B.P.R. (1996), "States Stressed in Stabilisation", *Business Standard*, 27 April.

Vithal, D (1995), "Alternative Approach to Devolution", *Economic and Political Weekly*, 7 October.

Tanzi, Vito (Ed.) (1995), "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects", *Paper presented at Annual World Bank Conference on Development Economics.*

Sen Tapas K., M.G. Rao and M. Ghosh (1994), "Implication of 1994-95 Budget for Growth and Stability", *Economic and Political Weekly*, 16-23 April.

Shah, Anwar (1994), "The Reform of Intergovernmental Fiscal Relations" (World Bank, Policy Research).

Inter-Disciplinary Approaches

Discussion of Papers by Balveer Arora, Kuldeep Mathur, Nilima Chandiramani

17

Sanjaya Baru

Reading through these three papers one is reminded of Karl Marx's famous theses on Feuerbach, one of which states that, "The philosophers have only interpreted the world in various ways; the point is to change it." The three papers, much like the presentations in the inaugural sesession as well as many other papers read here, reflect extreme unhappiness with the functioning of all our institutions of governance. While the focus of much that has been said here has been the State, mainly the executive and the legislature, and today we have a paper that finds even the judiciary wanting, one could critique other institutions of Civil Society as well, like the Media, the so-called "Fourth Estate" and academia. The vestiges of feudalism in the institutions of the State have been referred to, and one can find equally damning examples of feudalism and feudal servitude contributing to bad governance in academia and the private sector.

To be sure, feudal values and institutions, the weak development of meritocracy and the consequent lack of transparency in governance and constraints on competition lie at the root of the problem of misgovernance today. Indeed, more than a crisis of governance, we are faced with a deeper crisis, namely, a crisis of institutions, of their very legitimacy and survival.

The three papers presented this morning present a damning indictment of the executive, the judiciary and the legislature. However, the problem that has been analysed is neither of recent origin nor inherent to the system of parliamentary democracy we have adopted for ourselves. A similar critique of the judiciary could have been made two decades ago. Indeed, long before this Institute was set up, Indian social scientists had delved deep into each of these questions. Even on the subject of corruption, Gunnar Myrdal wrote a scholarly chapter in his three-volume book,"Asian Drama".

Hence, while I do not disagree with the broad conclusions of the three papers, it is not clear to me why any of the arguments presented here

are more relevant today than they were twenty years ago. If it is agreed that the problems have been with us for at least two decades, and one can cite from the literature on the political economy of Indian development that this is indeed so, then it must be asked what is new about our concern for good governance today?

Kuldeep Mathur's paper states at the outset that the question of good governance is being raised today in the context of economic liberalisation and "government failure". If development economics of the 1950s and 1960s, argued in favour of a wider role for the State in the context of "market failure", neo-liberalism today demands more space for the market in the context of "government failure". However, embedded in the neo-liberal view of "good governance" is the notion of an 'autonomous state', insulated from day to day politics, as Dr. Mathur puts it.

This is, indeed, so. Most of the World Bank's examples of good governance in the developing world are from Asia and are all non-democratic societies—South Korea, Hong Kong, Singapore. Mathur's mild assertion that the "capacity of a state to deliver good governance is not necessarily incompatible with democracy" deserves to be stated more forcefully, though this view deserves closer empirical verification since there are few high achievers on growth who have had democratic governments during the period of transition from low to high growth. He is right in qualifying that statement with the observation that "to a great extent this capacity depends on political agreement on what development is all about". It would have been interesting if Dr. Mathur had explored this question in greater detail. Why did the "consensus" of the mixed economy with liberal democracy crafted by Nehru break down? Why is the current economic agenda based on a fractured foundation and why, during the intervening years, did the transition take place from an India in which political consensus on economic policy was possible, to an India in which no such consensus is in sight? To me these remain the unanswered questions of Dr. Mathur's paper.

It is possible to tentatively suggest that the reason for the collapse of the policy consensus of the past is the increasing heterogeneity of the policy making elite. Is this to be viewed as the positive contribution of democracy to the evolution of our polity, or the price we pay for democracy. Are we condemned to remain an increasingly argumentative and fractious society, rejoicing in the glory of our political freedom but condemned to economic inefficiency? Or, is it possible to fashion an economic policy that can create a more efficient as well as humane society?

If such are the questions that Dr. Mathur's paper raises, Dr. Arora's addresses the more limited issue of the challenges facing federal governance in India. Dr. Arora approaches the issue as if the evolution of what he calls "cooperative federalism" has a historical and structural basis. It can be argued that the evolution of federal governance in India is the product of purely historical accidents. The authors of the Indian Constitution may have never visualised the possibility of Nehru living longer than Patel, of dynastic succession in which Nehru's demagogic daughter would turn out to be a clever politician capable of subverting the Constitution through executive fiat, and so on and so forth. Is the emergence of regional parties, and of coalition government at the Centre the product of historical and systematic forces, or a reaction to mindless, over-centralisation of authority? Could N.T. Rama Rao have unleashed the forces of Telugu regionalism if Mrs. Gandhi had not centralised the Congress party so much? Did regionalism emerge as a response to centralism, or the other way round? In short, were the institutions and instruments of federalism challenged by the federal units or subverted by central authority? Counterfactuals may beg the question, but to me it is not yet clear whether the crisis of Central governance is the project of the emergence of underlying social, political and economic forces, or whether it is merely a response to over-centralisation of authority, which was in turn the product of the Nehru-Gandhi family's desire to perpetuate themselves in power. Unless this question is answered, it will be difficult to accept Dr. Arora's assertion that centralism was a response to a concern with regionalism and inter-state rivalry.

Finally, Dr. Chandiramani's list of failures is once again an indictment of all our institutions, and as I said at the beginning, one can add to her list both the media and academia. Which institution has succeeded in meeting all the objectives? Which institution has not been subverted either by money power or political power? Who can disagree with Dr. Chandiramani's lament? But, there is a question that the discussion on good governance raises. Are we encountering a crisis of governance or is the very legitimacy of our institutions under threat today? Does the law of the land carry any conviction? Consider the example of taxation. How is it that even a foreign government like the British Raj was able to administer land revenue while our democratic government has not been able to administer sales tax? Is it merely a question of procedures or is the crisis deeper? How many institutions of the State and civil society have survived in tact over the last fifty years? Why is every one of our institutions faced with charges of corruption, mediocrity and misgovernance? It appears to me that at the root of the crisis of governance these papers address, lies a crisis of credibility of institutions and the absence of a shared vision.

18

Federal Governance for India's Multi-tiered Polity: Some Transformative Options

Balveer Arora

Political institutions associated with federalism occupy pride of place in an increasing number of diverse societies seeking unification within a single polity. It is also well established that federal institutions alter policy outcomes in significant ways (Pierson 1995). They influence policy strategies and preferences, create multiple institutional actors, and generate shared decision making dilemmas. Exploring the relationship between the market and democracy in a seminal essay, Charles Lindblom (1995:688) suggests that both face similar choices, "between coordination by central authority, on one hand, and by mutual adjustment among those to be coordinated on the other". While the market relies heavily, even excessively, on the latter principle, governments are generally mixtures of the two. The federal principle, however, incorporates a marked preference for structures and institutions of government based on mutual adjustment.

If federal democracy is seen as an attempt to combine self-rule and shared-rule (Elazar 1987), then the task of devising non-majoritarian institutions and practices of power-sharing assumes significance (Lijphart 1996, Linz & Stepan 1996). In a system marked by wide socio-economic disparities, securing the consent of even the losers in the public policy process is a formidable challenge for democratic ingenuity. Bridging the participation deficit through institutional innovation is only one part of the story; bringing about a new order through the politics of mutual adjustment is the real agenda.

I. Shared Rule and Mutual Adjustment

There is a strong centralist tradition which affirms that social order requires centrality. Mutual adjustment is viewed at best as a necessary evil, dismissed as being devoid of any "positive merit as a method of coordination with attributes of rationality" (Lindblom 1995:688). While retaining and endorsing the centralist assumption, the framers of the Indian Constitution

simultaneously incorporated significant elements of flexibility and accommodation (Mukarji and Arora 1992). It is noteworthy that most of the existing institutions and mechanisms of federal governance were crafted during a phase when the polity was on its centralising trajectory. The factors and reasons for this trend towards central hegemony are too well known to bear repetition (Chelliah 1991). The halting move towards more federal arrangements, despite the dominance of the Congress party at the Centre, is a notable legacy of the late-eighties.

Counter-Federalism and the Eighties Agenda

Federalism in India has always had a strong social base but weak institutional articulation. The demands for space and voice that emerged during the eighties find only a partial expression in the main Sarkaria Report, but are loud and clear in the second volume. In the search for adaptation to a more federal polity, two significant trends are discernible.

The primary reform agenda was to restore institutions neglected or damaged during the seventies. The issue of their further adaptation to a more federal polity remained unresolved, since they had been crafted when the social base of the polity was much narrower, and perhaps viewed as largely homogenous.

The limits of political centralism became all too apparent during the eighties (Arora 1992). Since the Centre was vested with key economic functions, its dominance in macro-economic management translated itself only top readily into hegemonic politics. Hierarchy and dependence characterised Centre-State relations. Institutional development was stunted as it remained within the narrow confines of the integration-disintegration paradigm. sub-central or sub-national institutions were viewed as possible agents of disintegration.

The emergence of regional or state-based parties and the consolidation of a non-Congress counter-federalism marked the decade. Bypassing established channels of official federalism, new modes of coordination were tried in 'conclaves', which laid the foundation for wider experiments in power sharing.

Reformatting Federalism

Extending the federal principle to meet new power-sharing demands can involve essentially five different facets:

- Boundary changes, and internal process within federations which may lead to the formation of new member states (Khan 1992). Other forms of boundary change such a secession are disallowed by most federal constitutions. The "politics of recognition" of identities plays a key role in sustaining unions at critical juncture (Taylor 1992).

- Multiplying tiers or levels, through the creation of intermediate structures (e.g., multi-state sub-central zones and agencies) or sub-state institutions for autonomous self-rule. This is not to be confused with spatial or sectoral disaggregation for more efficient management.

- Modifying the institutional format of intergovernmental relations. This is typically the area covered by reform agendas concerning Centre-State relations, and would include the roles of different bureaucracies, national (e.g., All-India Services) State and local.

- Asymmetrical variations, assigning differing powers and responsibilities to constituent units, can be either *de facto* or *de jure*, i.e., with legal-constitutional sanction. Special dispensations and status to meet specific requirements constitute a major application of the mutual adjustment principle so critical for the maintenance of diverse unions.

- Political practices of the consociational or other non-majoritarian types, where the tolerance and acceptance of diversity play a key role. Homogenising and assimilationist practices typically push threatened groups to seek boundary change (Stepan 1996).

In the sections that follow, we turn our attention to the institutional formats and political practices which have contributed to defining India's federal development in recent years, before looking at some transformative choices and initiatives.

II. Institutional Development: Experimenting With Formats

The simultaneous emergence of intensive multi-party competition, a multi-tiered institutional structure and accelerated economic liberalisation are arguably the principal defining features of the present decade. Earlier reform

ways in any given year due to payment of interest and repayment of past loans. There are virtually no direct inter-State transfers although it is not Constitutionally barred, and a State may make a grant to another State (or even to the Union government), under Article 282. There are three principal channels through which the resource transfers take place between the Union and the State governments: *viz.*, Finance Commission, Planning Commission and transfers through administrative Ministries. The Planning Commission provides assistance for State Plans that consists of grants and loans that are given in the ratio of 30:70 for the non-special category States, and in the ratio of 90:10 for the special category States.

Fiscal transfers from the Centre to the States are thus handled by fragmented approaches of these institutions which remain dysnchronised and unintegrated. The combination of the methodology of projections of expenditures and revenues based on their historical growth, and the gap-filling approach of the Finance Commission, and the treatment of committed liabilities generated by Plan transfers by future Finance Commissions sets up a dynamic that emits significant incentives for a State to increase its borrowing-financed expenditure as explained below.

The gap-filling formula of the Finance Commission implies that the aggregate fiscal transfer for a (revenue-deficit) State would be—

$$R_t = E_t - O_t$$

where R = Transfer, E = Revenue expenditure and O = Own revenue, which are all projected for period t, under the consideration of the Finance Commission, on the basis of historical data. A legitimate objective of a State could be to maximise its expenditure per unit of own revenue, by maximising the fiscal transfer (devolution plus grants) from the Centre thereby making citizens in the rest of the country pay relatively more for its own increase in expenditure. The higher is the transfer, and the lower is own revenue, the larger is the expenditure per unit of own revenue. There is an incentive for a State therefore to increase its current expenditure relative to own revenue, so as to ensure higher transfers in the future, since they are based on the past history of expenditures and own revenues. The ability of a State to increase its current expenditure depends on the current resource constraint. This can be relaxed to the extent that a State can borrow to finance its current expenditure.

agendas need to be reviewed in the light of these developments and consequent changes in the policy environment. From this perspective, three areas are significant: the problem of competing jurisdictions, the creation of a third tier and the consolidation of asymmetry as an institutional variable.

The redistribution and transfer of subjects from one list to another has been a constant feature of all federal reform blueprints, from the Administrative Reforms Commission to the Rajamannar Committee and the Sarkaria Commission. The underlying premise of separate jurisdictions is the coordinate authority format, with its emphasis on autonomy of units and minimization of overlaps. Involved here is a conception of intergovernmental relations which, in its pristine form, now appears to have been largely a legal reconstruction unrelated to ground realities of the time, from which it was supposedly derived. (Elazar 1987; Wright 1990).

Unravelling interlocking jurisdictions and minimising concurrences is a task that has grown in complexity over the years, as interdepencies have multiplied. What is more to the point is the politics of pre-emption, the race for exemption of contested policy spaces through which different levels of government seek to wield power in areas of common concern. The location of residuary powers continues to be a major bone of contention in this regard.

The emergence of third-tier federalism (Mukarji and Arora 1992; Mukarji 1995) has been viewed with either hope or scepticism. Given its patchy record of achievements and its largely unresolved jurisdictional and financial problems, the temptation to dismiss it as empty rhetoric is considerable. The mismatch between responsibilities and resources is rightly a cause for concern (Rajaraman 1996). Trends across states are uneven, and the mere listing of subjects transferred is patently no guarantee of empowerment. Yet, the evidence suggests a movement that is slowly gathering momentum (Oommen 1996), even though there are strongly entrenched pockets of resistance.

Unlike many other federal unions, India has not had major conceptual difficulties with asymmetrical arrangements. These are found not merely in the Constitution (articles 370 and 371) but also in laws relating to personal and corporate taxation and industrial development incentive structures. The main beneficiaries of these special status provisions are the small economically dependent states of the north-east. This type of

asymmetry has implications for institutional power-sharing formats which have not been fully worked out. While the equality of states principle has been rightly rejected for the Rajya Sabha, overrepresentation in forums of executive federalism could hamper their growth as effective power-sharing devices (Agranoff 1994; Watts 1994). Alfred Stepan (1966) suggests that "disproportionate representation" and "symmetrical scope" of the two Houses of the US Congress could be construed as a violation of formal democratic equality, perhaps not to be replicated elsewhere.

III. Political Parties And Practices

The fragmentation of the party system and the changed balance between national and regional parties have been viewed as ominous for the Union. Bemoaning the rise of regional parties, one editorialist cautions against the loss of policy cohesion: (ET 13 August 1996).

> *Naïve federalists think the rise of regional parties heralds a more federal India that will be more unified. They think, mistakenly, that the key problems of a regional party are with the Centre. In fact, these are often with neighbouring states.... National parties can restrain their state units. But the entire ethos of regional parties is to magnify local interests and ignore those of the rest of the country".*
>
> (Economic Times, 13 August 1996)

The tenacious belief that national parties are essential for smooth intergovernmental relations within a federal system, though widely held, is not based on irrefutable empirical evidence. In fact, the centralist ideologies of some of them (Arora 1989) have repeatedly brought the federal union to the brink of crisis. In a multi-tiered institutional system, the development of norms and conventions permitting split party control over different levels is essential.

Split Party Control and Federal Governance

The transition from uni-party to split-party control was consolidated during the eighties, with major implications for political accountability practices. The lack or absence of federal functioning within the Congress party further aggravated the problem. Efforts at arriving at a theory of delinked electoral mandates have not made much headway due to the persistent legacy of central interventionism (Sengupta 1966).

If viewed as temporary aberrations to be rectified at the earliest opportunity by whatever means available, split party control situations have a paralysing effect on institutions of governance at different levels. While interdepencies can be a source of strength for federal unions, the problem here is to determine the points in the structural interface where they could stifle state initiative (Radin and Arora 1995). In a multi-tiered system, this determination becomes more complex as the interface between central, state and local levels covers a wider range of jurisdictions, agencies and policies. Since political control over administration is an integral part of the democratic accountability framework, both conflation of levels through party channels and intervention through administrative networks are apt to generate political tensions unsuited to effective split party control. The importance of independence institutions in such a scheme of governance is further enhanced if prevailing political practices provide insufficient safeguards for neutral competence based policy making (Banerjee and Chandrasekaran 1996).

State-Based Parties and Competitive Federalism

Regional or state-based parties have traditionally been the building blocks for nation-wide parties in most federal systems (Manor 1995). In India, there has been a long-standing tension between national and regional parties, based on a mistrust of the sub-national and the local (Hegde 1991). Inter-state rivalry and competition have generally been viewed with unease: the sceptre of disintegration through internecine conflict has always loomed large. This strain of our political culture has favoured centralism and blocked the development of the politics of mutual adjustment.

Nowhere in this more evident than in the sphere of inter-state disputes over sharing of river waters. In the absence of politically acceptable conciliation mechanisms, central or judicial arbitration appear both unsatisfactory and inevitable. Since there is no mutual agreement, the disputes resurface periodically in ways that are wasteful of scarce national resources. Disruptions through inter-state and centre-state conflicts can be viewed as examples of "systemic downtime". Averting such occurrences or at least minimising their duration is a formidable challenge for federal governance.

IV. TRANSFORMATIVE INITIATIVES

If we accept that it is not in the general interest to have repeated interruptions in the regular functioning of public policy systems, then

initiatives to reduce "downtime" are called for. In this section we identify three such initiatives which could have transformative effects curbing central interventionism, reinforcing executive federalism and creating new institutional levels of popular participation.

Central Rule and Political Instability

As political "gridlock" situations multiply in the states, it is imperative to take a view on central intervention as a problem solving mechanism in this area. Notwithstanding the Supreme Court ruling in The Bommai, case the curbs on indiscriminate use of article 356 remain insufficient. Even if we accept that this provision can have a "creative potential" in certain exceptional emergency situations (Manor 1995), the paralytic effect on governance till a popularly elected ministry assumes office is undeniable (Guhan 1993). Despite the theory of uninterrupted democratic accountability, where Parliament supplants the State Assembly, major policy decisions do suffer. There is sufficient empirical evidence to suggest that, far from being a remedy, it is perhaps not even an adequate palliative.

It appears today necessary to drastically curtail the ambit of art. 356 so as to completely exclude the possibility of its continued and pernicious use to combat 'political instability'. The definition of "failure of constitutional machinery" needs therefore to be made more stringent to preclude its use to fabricate unprincipled majorities by dubious means. It is only when this alternative is no longer available that more stable and durable coalitions will be encouraged to emerge through the political process.

More Executive Federalism

Apex bodies arguably provide greater opportunities for negotiated settlement and compromise over a broader spectrum of issues. The institutionalisation of state participation in national policy making has so far favoured a sectoral approach. Negotiations are typically conducted in a conflict-management mode where central coordination, and eventually arbitration, play a dominant role. Accommodation across sectors is made difficult by the absence of effective apex institutions.

It is important to understand why bodies such as the Inter-state Council (whose second plenary meeting in October 1996 could well have been 'an empty ritual') and the National Development Council have not

lived upto expectations. Two possible reasons can be advanced here. Centralist parties, ever hopeful of regaining and wielding nation-wide power, have traditionally favoured internal party channels and been reluctant to endow such formal intergovernmental forums with real significance. The second reason concerns asymmetry in size and population of states, which has steadily increased over the last 25 years. The implications of asymmetry for executive federalism need to be worked out, to avoid 'disproportionate representation'. In the reassignment of roles to the Planning Commission and the NDC, the States should have a greater voice, and the contribution of an expert authority under art. 307 suggested by the Sarkaria Commission merits serious consideration.

Multiple Levels of Cooperative Federalism

Apart from third tier local democracies, a few other sub-state and multi-state initiatives deserve to be noted for their transformative potential. The various experiments with autonomous councils share common characteristics with other third tier institutions, including similar problems of empowerment. For historical reasons, the zonal concept has remained largely ineffective as a mechanism for federal coordination. Today it is primarily recommended and used for decentralising large organisations having a national spread. Apart from the special case of the North-Eastern Council which is moving towards becoming a policy making body of the Central government for the region, the other zonal councils have continued to languish for want of a driving force other than central initiative and their lack of roots in electoral democracy.

In recent years some new initiatives for achieving coordination and consensus in areas of common economic interest have emerged. These limited regional groupings—such as the SUNRISE cluster of north-eastern states, the CONCORD of seven northern states and the Western Economic Corridor—apparently seek to procure common market benefits to member States. Of recent origin, their achievements have yet to be assessed, alongside more traditional common interest lobbies such as the coastal states (on deep-sea fishing) or the oil-producing states. In political economy terms, the region as an entity awaits delineation.

V. In Lieu of Conclusion

We have argued here that India's experiment with federalism has now reached a point where there is great need to strengthen institutions capable

of assimilating the demands for space and voice in an increasingly competitive polity. Multiplicity of structures and multi-layered institutional arrangements need not be viewed as wasteful impediments. They strengthen systemic capabilities of recognition and response: addressing social and economic unrest before it becomes political upheaval. They play, therefore, a significant role in strengthening the roots of India's federal democracy.

In operational terms, "the determination of the extent of required and feasible decentralisation is crucial" (Chelliah 1991). We are rightly cautioned against mindless and counterproductive decentralisation (Tanzi 1995). When stability and coherence are endangered, there is a temptation to recentralise. Recourse to central facilitation might appear to be an attractive option when fragmentation and disorder appear imminent. Yet, as Lindblom points out, "often the remedy for unacceptable forms of mutual adjustment is some better structure for it, not a turn toward centrality" (1995:688). In sum, the options for both the economy and the polity are strikingly similar.

References

Agranoff, Rober (1994) "Accommodating Diversity: Asymmetry in Federal Systems" (mimeo).

Arora, Balveer (1989) "Centralist and Regionalist Parties in India's Federal Polity", in Zoya Hasan et.al. eds. *The State, Political Processes and Identity* (Sage).

_______(1992) "India's Federal System and the Demands of Pluralism: Crisis and Reform in the Eighties" in J. Chaudhuri ed. *India's Beleaguered Federalism: The Pluralist Challenge* (Arizona State U); reprinted in J. Sengupta ed. (1996).

_______(1995) "Adapting Federalism to India: Multilevel and Asymmetrical Innovations" in B. Arora and D.V. Verney eds.

_______(1997) "Federalism and Inter-governmental Relations : A Bibliographical Essay" in S. Bhatnagar and Pradeep Kumar eds. *Some Issues in Contemporary Indian Politics.* (Ess Ess).

_______ and Verney, Douglas V. eds. (1995) *Multiple Identities in a Single State: Indian Federalism in Comparative Perspective* (Konark).

Banerjee, Ajit M. and K.A. Chandrasekaran eds. (1996) *Renewing Governance: Issues and Options* (Tata McGraw Hill).

Chelliah, Raja J. (1991) "Towards a Decentralised Polity", *Mainstream*, May 25.

Elazar, Daniel J. (1987) *Exploring Federalism* (Alabama U.).

Guhan S. (1993) "Centre and States in the Reform Process" (Merton College Oxford, June, mimeo).

Hegde, Ramakrishna (1991) *Federalism: Reviving a Dying Culture* (Bangalore, Author).

Khan, Rasheeduddin 91992) *Federal India: A Design for Change* (Vikas).

Lindblom, Charles E. (1995) "Market and Democracy - Obliquely", *PS: Political Science and Politics*, December.

Linz, Juan J. and Stepan, Alfred (1996) *Problems of Democratic Transition and Consolidation* (Johns Hopkins).

Manor, James (1995) "Regional Parties in Federal Systems" in B. Arora and D.V. Verney eds.

Mukarji, Nirmal and Balveer Arora (eds.) (1992) *Federalism in India: Origins and Development* (Vikas).

Mukarji, Nirmal et.al. (1995) *People's Representatives and Bureaucracy: The Interface in Panchayati Raj* (ISS).

Oommen, M.A. (1996) *Panchayati Raj Development Report 1995* (ISS).

Pierson, Paul (1995) "Fragmented Welfare States: Federal Institutions and the Development of Social Policy" *Governance,* 8(4), October.

Radin, Beryl and Balveer Arora (1995) "National Bureaucracies in Federal Systems: The All-India Services" (CPR, mimeo).

Rajaraman, Indira et.al. (1996) "Augmentation of Panchayat Resources" *Economic and Political Weekly*, May 4.

Sengupta, Jayshree ed. (1996) *Economic Reforms, the Role of States and the Future of Centre-State Relations* (Observer Research Foundation).

Stepan, Alfred (1996) "Modern Multi-National Democracies: Transcending a Gellnerian Oxymoron" in John A. Hall ed. *Ernest Gellner and the Theory of Nationalism* (forthcoming).

Tanzi, Vito (1996) "Fiscal Federalism and Decentralization" (World Bank Conference on Development Economics, May, mimeo).

Taylor, Charles (1992) *Multiculturalism and the Politics of Recognition* (Princeton UP).

Watts, Ronald L. (1994) "The Theoretical and Practical Implications of Asymmetrical Federalism" (Berlin: IPSA World Congress, mimeo).

Wright, Deil S. (1990) "Federalism, Intergovernmental Relations and Intergovernmental Management: Historical Reflections and Conceptual Issues" *Administration Review*, March/April.

19

Challenge of Good Governance : India in the Post-Economic Reform Period

Kuldeep Mathur

I. INTRODUCTION

India is not an easy country to govern what with its size and heterogeneity. Politically the Nehruvian days of consensus are not going to return and as many observers of the current scene suggest the days of coalitions are here to stay. Two other features tend to add to the difficulties in governing the country. Political institutions, since 1970, have progressively shown their inability to respond to society's changing concerns. They have become inefficient and immune to social demands. Political leadership has also given its own push in this direction by undermining them in their eagerness to private profiteering and/or personal domination. This is as much true of governmental institutions as of political parties. The other major change has been political awakening among all sections of society including both prosperous and disadvantaged groups. The result is that people have become more politically aware, more assertive, better organized and more impatient with other social groups and with governments that do not respond adequately to their rising expectations and demands. And it is for these reasons that Manor (1995 : 347) argues that "this awakening has made India more difficult to govern at a time when political decay has seriously damaged the instruments of government".

Grateful thanks are due to my colleague J.B. Tilak for his comments on this paper.

It is for good reason then that the concern for good governance is catching attention of policy makers, political leadership and the people at large. The policies of economic liberalization introduced in 1991 have set the tone of urgency. Good governance is being related to the sustainability of market friendly reforms. While the topic of governance is not new to the development literature, its emphasis within the neo-liberal agenda envisions

a different kind of thrust. What was a focus on public administration and strengthening of state capabilities alone, it can now be summarized to include : "the use of political authority and exercise of control over a

II

The neo-liberal formulations on good governance have tended to build their case on how rulers extract resources and invest them. It is argued that rulers in many states tend to use resources for their own benefit to the detriment of development of their societies. The case of state failure is then based on how monopoly rents are created through the imposition of regulation and control over the economy. Political pressures dominate economic policy making and execution leading to misallocation of resources. Corruption and favouritism surround bureaucratic allocations of investment licenses, import licenses and the award of government contracts. A consequence of this system is that government machinery is increasingly used to serve personal interests. Such a state has been classified as a predatory state and the problem that is posed is how to create conditions that such a state moves on to become a development state in which resources are invested for the good of the society as a whole.

The key to the transformation of a predatory to developmental state is good governance and much of the discussion in the literature is on the identification of the features of development state which can be used for policy prescriptions. The reflections on the possible features of development state have been based not on the discussions concerning state theory and the proper content or definition of states in general, but on the empirical assessment that some East Asian countries are remarkably more successful than other Third World countries. (see Sorenson, 1993) Market led development is emphasized and the role of state is confined to the narrow context of creating or sustaining institutions that help the markets operate effectively. Many scholars have suggested that the state can perform this task successfully when bureaucratic and technocratic elite in charge of policy making are insulated from the pulls and pressures of everyday politics. Among the enabling conditions for this insulation Evans (1989; see also Evans, et.al. 1985) emphasizes Weberian characteristics of internal organization of the state. On the basis of Johnson's (1982) account of the golden years of MITI in Japan, he argues that Japan's startling post-war economic growth occurred in the presence of a powerful, talented and

prestige laden economic bureaucracy which also had the capacity to build networks with other social institutions that provided it with information and sufficient flexibility to deal with changing technical and market conditions. He has described this networked insulation of the top bureaucracy as the embedded autonomy of the state and regards it as the key to the success of Japan.

In sharing the thesis that a rationalized bureaucracy with relative insulation from society is a necessary condition for economic and political development, Levi (1988) elaborates the argument a little differently. She argues that among the pre-requisites of a development state are institutional arrangements and property rights that promote productive uses of resources and that minimize social waste. Crucial are efficient government regulations that reduce rent seeking on the one hand and provide incentives for growth, on the other. Of equal importance is compliance of these regulations by the citizens. The regulations enforce an appropriate property rights regime because it leads to assurance that it will be implemented fairly and enforced in a way that creates conditions of cooperation over a long period. But as she further adds, a good bureaucratic design is not a stand alone solution. Its effectiveness requires that it be a part of (what Evans calls embedded) a set of governmental institutions, market institutions and policies that together work to support political and economic development. Other social institutions also matter and an administrative apparatus incompatible with them is a design of ineffectiveness.

Most contributors to the discussion of the characteristics of a developmental state drew inspiration from this state centric model. The question of autonomy—freedom of action of elected and bureaucratic officials—was seen as a primary characteristic. The other was the capacity of state structures that emanated from a rationalized bureaucratic system. While these features were widely accepted, doubts about their actual developmental implications began to be raised on real life experiences. It was posited, for example, that Zaire's elite was strikingly unconstrained by any set of organized social interests and in this sense was relatively autonomous but did not work for societal growth and development. (Evans, 1989 : 571) Taiwan began as an oppressive regime but changed to a development state in a short period of time. The puzzle that Sorensan (1993) highlights is why some states enjoying high degree of autonomy do not exploit it in the service of development and why state actors do not choose to promote development in a consistent and efficient manner.

A more significant criticism of the state centric model has to do with the denial of political processes in development. Too much is made out of the developmental impact of bureaucratic and technocratic decision-making while other characteristics of such states are ignored. An important feature that Leftwich (1994) points out is that development states have all been de facto or dejure one party states for much of the past thirty years. The effect has been to concentrate very considerable and unchallenged political power at the top in these states, thus enhancing political stability and continuity in policy. Japan, South Korea, Taiwan or Singapore the leading examples of developmental states are also marked by a strong degree of cultural homogeneity and tendencies towards an authoritarian state. Keeping democratic politics out also means that somehow state is seen as outside society and developmental goals to be emerging out of its own predilections and not those of society—state is perceived as an actor and force independent of social dynamics. In the burgeoning literature on 'bringing the state back in', Skocpol (1985 : 20-21) argues that 'states conceived as organizations claiming control over territories and people, may formulate and pursue goals that are not simply reflective of the demands or interests of social groups, classes or society". This being so how far can we go to say that state interests different from those of society will always be pro-development? The empirical evidence points to divergent experiences.

Notwithstanding the nature and extent of these contradictions, a major item on the agenda of neo-liberal reform in many countries-democratic or not-is to lay heavy emphasis on strengthening state capabilities. Once again, building technical and professional capacities among bureaucrats is high on the agenda of aid giving agencies.

III

The second cluster of characteristics of good governance is related to the issues of participation and democratization. Attention is directed towards strengthening institutions of civil society and the argument is made that the people do not need dole and welfare which makes them grateful to politicians. They need empowerment—financial, legal and institutional. They need institutions which give them power to decide and legal rights to manage their enterprises. For the people dependent on local resources, democracy means participation in managing them.

The emphasis is on creating new institutions or sustaining the existing ones that will serve the interest of participation as well as development. The new literature on institutional economics points to some very important features of institutional failures that cause or prolong under development. North (1990) provides a basis for this understanding when he says that in a small, closed face-to-face peasant community transaction costs are low, but the production costs are high, because specialization and division of labour are severely limited by the extent of the market defined by the personalized exchange process of the small community. In a large scale economy complexities develop as the network of independence widens, the impersonal exchange process gives considerable scope for all kinds of opportunistic behaviour and the costs of transaction can be high. As impersonal exchange becomes more and more complex various kinds of assurances of what is demanded and supplied are required. Attributes of goods and services have to be clearly measured for proper exchange to take place and property rights enforced. All these activities have costs and are provided through institutions. These costs can be lowered if these institutions are effective. In western societies institutions have developed over time which reduce transactional costs and allow for productivity gains through improved technology : these institutions include defined property rights, formal contracts and guarantees, enforcement rules, etc. In the developing countries these institutions are either too weak or too predatory in their demands.

Enforcement of contracts and property rights cannot be taken for granted. It is (and always has been) the critical obstacle to increasing specialization and division of labour (North, 1990 : 33). It does not pose any problem when it is in the interest of the other party to live up to agreements. However, this may not be always so. Immense resources are then required to promulgate codes of conduct and create rules that can provide a framework of constraints. These rules can be formal or informal but at the formal level they are concerned with constitutions, statutes or contracts. Bureaucracy as an agent of state is an agent of enforcement of rules and its role is considerably simplified if informal rules are supportive of its actions. Otherwise, transaction costs tend to rise with more resources being diverted towards monitoring and regulating activities. There is now considerable literature on what is called transaction costs and the argument is that these costs need to be reduced for improved economic performance.

A significant focus of this literature has been on the detrimental impact of development on the institutional choices of rural communities.

The diversity of these choices was the bedrock of the "traditional" order. In face of the emergence of worldwide markets the efficacy of local community tended to be destroyed and they seemed to be powerless in putting up with new challenges. These local communities need to be strengthened to at least manage local resources and local affairs. This perception has given rise to two schools of thought: one is focussed on restoring to the local community a degree of control over its own fate and the other is on creating new institutions to handle tasks that emerged as the state showed its inability to handle them or as it receded to give greater space to market transactions (Nicholson, 1988). Finally, local institutions are also given importance for promoting the culture of democracy in a country and much used concept of self-governance is seen as a base of democratic institutions.

Apart from the focus on local level institutions, as referred to above, attention is also directed towards macro-level institutions that establish constitutional order in societies. These are also the institutions that help the market to function effectively. In reality an effective market is one which operates freely but within a structure of norms and legal institutions. Such institutions can be contract enforcing mechanisms and Basu (1992) has shown how market in housing in Delhi does not function well because contract enforcement is weak. Both the landlord and tenant know that law does not either establish or enforce contractual relationships with each other - either in fixing rents or in eviction of tenants. Hence distortions occur as there is no expected and predictable behaviour. Unrealistic rents, unoccupied houses, protracted litigations are the result.

Institutions can be seen as rules and as organizations. As rules, they are consensual arrangements, conventions, and codes of conduct that govern the pattern of individual and collective behaviour. They are norms of behaviour that are enforced through social practice or custom. What is important is that these rules bring order and predictability to human relationships. Institutions as rules are mutually agreed by people as acceptable behaviour. They are accompanied by sanctions-either some sort of reward for carrying out a prescribed action or some sort of punishment for carrying out a proscribed action. Every society develops such social rules that order relationships among individuals and in that sense they are institutions. Rules tend to become institutions overtime. They provide the ordering and predictability of human behaviour. James Coleman (1987) has termed this as social capital that provides the basis of cooperation in every society.

Social capital is viewed as emerging from the collection of norms, beliefs, attitudes and practices that govern relationships between individuals, and groups in a society. Social capital is high when people and groups relate to each other with respect, solidarity, trust and caring. In too many societies it is depleted and or has never been permitted to develop adequately. Suspicion, prejudice, rivalry, greed and hatred reflect low social capital. In his recent writings, Fukuyama (1995) has built on this idea of social capital and suggested that this key cultural characteristic fosters trust in societies and it is societies marked by trust that are industrialized and economically developed. Other societies low on trust quickly fall in the trap of state intervention which is seen as detrimental to development. The argument is that trust can dramatically reduce what economists call transaction costs - costs of registration, enforcement of contracts and the like and make possible certain efficient forms of economic organization that would otherwise be encumbered by extensive rules, contracts, litigation and bureaucracy.

Most of the institutions that help to create social capital evolve informally and over time. But there can be formal rules too created by society at any point of time. As North (1990 : 4) points out, institutions include any form of constraint that human beings devise to shape human interaction. This can range from a formally accepted constitution to conventions and codes of conduct.

But the crucial distinction is between institutions and organizations. Organization can be called a "decision mechanism". It is a device that constrains and guides individual choices. In this sense it is a social arrangement which has a form and function, and for its members meaning and legitimacy. To return to North (1990 : 5), organizations are groups bound by some common purpose to achieve objectives. Modelling organizations is analyzing governance structures, skills, and how learning by doing will determine the organizations success over time. More specifically, institutions as rules provide the basic way that people interact with each other and institutions as organizations focus on the structure in which this interaction takes place. There are formal rules that lay down how people function in an institution or organization. There are also informal rules that govern people's behaviour in an organizational setting. If the formal and the informal rules reinforce each other then organizations become more efficient and effective. When Fukuyama talks of trust or Coleman of the broad category of social capital, they are focusing attention on rules as institutions governing social interaction. The cost of enforcing

organizational rules rises considerably when social rules contradict or conflict with them.

Organizations exist because there are a set of working rules that define them. These working rules are of two types : (a) those that define an organisation vis-a-vis the rest of the world and (b) those that spell out the internal nature of the organisation (Bromley, 1989). The working rules are formally enforced by the institution but the costs of enforcement are low if the social rules reinforce them. This means that enforcement is not the only reason that people follow rules. People also follow rules because those in a community share a belief that rules are fair and they perceive that by following them they are pursuing their own interests.

The discussion of rules, institutions, conventories and customs etc. has given lot of insights on how community organizations can be institutionalized and civil society strengthened. It has also sought to identify the kind of interventions needed to create new institutions or sustain and nurture the existing ones. In these endeavours, the role of government would be that of support rather than of direct intervention. Lot of clarity on these issues has been gained from working on the management of common property resources where both privatization and centralized government control have been found to be unsatisfactory strategies. User organizations are being advocated and these organizations are seen distinct from statutory local government units.

The reason for the preference for user organizations lies in the perspective of theory of public goods. There is a special problem in the use of common property resources. The problem is that degradation of the resources takes place whenever many individuals use scarce resources held in common. This has come to be symbolised by the expression 'tragedy of the commons' in the article by Garrett Hardin (1968) which has become the standard frame for so much of the common property resources management debate (see Blair, 1996). He asks the reader to imagine a pasture "open to all" and examines the structure of this situation from the perspective of a rational herder. Each herder receives a direct benefit from his own animals and suffers delayed costs from the deterioration of the commons when his and others cattle over graze. Each herder is motivated to add more and more animals and bears only a share of the costs resulting from over-grazing. Herein lies the tragedy - each herder increases his herd, gains but all herders lose out when the pasture is in ruin. The well known Prisoner's Dilemma is a formalization of this into a game model. The difficulty of getting

individuals to cooperate and pursue joint welfare is elaborated by Olson (1965) whose argument rests on the premise that one who cannot be excluded from the benefits of a collective good once the good is produced has little incentive to contribute voluntarily to the provision of that good. He will choose to free ride and if all choose to be free riders then that collective good will not be produced.

Keeping these issues in background Ostrom (1991) raises the central issue of governance which is how best to manage natural resources held in common and used by many individuals. Or how to reduce free rider problem in the production and provisions of a public good. Government and bureaucratic intervention leads to heavy costs in controlling free rider problems, and privatization apart from destroying the nature of the good itself also carries similar costs. In any case both may not be able to resolve the problem of degradation. But these two alternatives taken in the extreme tend to dominate the thinking of most policy makers and academics. She argues for another alternative that is small enough to create rules of use and consumption and those of monitoring and enforcing them. She illustrates the need to search for new institutional alternatives by giving example of forest management in developing countries where the disastrous effect of nationalizing forests formerly owned by village communities has been well documented.

In the contemporary usage, the meaning of good governance seems to include two concepts. The first is that of improving state capabilities and creating conditions for its relative insulation from day to day political demands. The second is concerned with decentralization which allows for community institutions and organizations to function in a way that provides for greater participation and democratization in society. Strong state albeit with limited scope for effective bureaucracy rising above short term interests and institutional pluralism in a decentralized mode appears to be the broad vision of good governance.

IV

In the post independence period, India sought to shape a state that reflected both the concerns of good governance as being articulated in the current literature. First an effort was made to give a certain amount of autonomy to economic decision making by establishing a prestige laden Planning Commission. The problem of development was largely seen as a problem of correct policy formulation and design. This meant that the

issues that dominated the discussion were prioritization of investment allocations, trade and industrial strategy etc. The Nehru-Mahalanobis strategy that became the hallmark of the fifties and sixties assumed a 'developmental' state. The successive five year plans took it for granted that the rationale of the plans would be accepted and people will behave accordingly. If difficulties arose, they were seen as difficulties of implementation. The development policy was seen to be designed as technocratically correct and failures were seen as those of social and political constraints on implementation. Even in 1991, it was being written that 'the primary failure in several developing countries, including India, has been in implementation........' (Jalan, 1991 : 87).

This argument was carried further when Myrdal, tried to explain the feeble development record of Indian state by drawing a distinction between a 'soft' and 'strong' state. He argued that if Indian poverty was to be overcome what was needed was a strong state which could divest itself of the influence of special interests and enforce social discipline. (Myrdal, 1970).

The potential of being a "strong state" was seen in terms of the states' dominance in the economic sphere and "its ideological advantage as the presumed defender of collective interest and socialist purposes and as the enemy of private and partial gains". (Rudolph and Rudolph, 1987 : 13). Elaborating the notion of the state as a powerful "third actor" apart from capital and labour, the Rudolphs point out that the Indian state has sought over the decades of sixties and seventies to insulate itself from the exigent pressures of a mobilized society and suggest that the Nehruvian state of the 1950s provided a credible if partial embodiment of relative autonomy. Failure to effect structural changes in the Indian economy by such a state have, however, been well documented. This has been described as the fundamental paradox of the Indian political economy : the commitment to radical social change and yet an equal determination to avoid a direct attack on the existing structures (Francine Frankel, 1978 : 3-78).

The paradox does not remain a paradox when state is seen as completely subordinated to the pressures and pulls of various groups in society. Providing this dimension to the argument, Bardhan (1984) much later analysing the reasons of lack of investment in long term growth suggested that politicians preside over a dominant coalition with three main elements : the industrial bourgeoisie, the rich farmers and the bureaucracy. Each get a share of benefits of the development policies and the state is not capable to rise above their interests and work for development of society as

a whole. A plethora of subsidies and the syndrome of 'strong on regulatory law and weak on enforcement' is the result.

V

The capacity of the Indian state was further circumscribed by the nature and role of its bureaucracy. In the initial years of planned development much reliance was placed on the Indian bureaucracy to provide the necessary capability to the Indian state to work above the sectarian interests. The civil service was a legacy of the British and the British civil servants under the Raj had not only represented state interests but had been governed directly with a distant king emperor and a resident Viceroy who was hardly a political master. Exercising power in the best interests of the state, they were seen as relatively autonomous of the local interests. The doctrine of neutrality and impartiality was seen as their predominant behavioural trait and it was assumed that their successors moulded in the same tradition would withstand the parochial pressures on the state. As Nehru's coauthors and implementors, civil servants were the vanguard of the lobby for an industrial strategy collaborating in the creation of basic and heavy industry under the second and third five year plans. The national orientation and professional ethos, however, soon lost their gloss. Public sector undertakings could not be managed efficiently and profitably and civil servants enabled politicians to appropriate administration to partisan and personal ends.

While Indian bureaucracy is cited to have the Weberian characteristics it is not marked for creating a state with the autonomy to pursue developmental interests. The question is whether in a society which is extremely heterogeneous and conflict ridden and where the democratic process leads to political coalitions described by Bardhan (1984) and which are developmental upto a certain point of time, such insulation of policy making elites but networking with other economic and social institutions is possible. As Bardhan (undated) points out, in the Indian context of a plurality of contending heterogeneous groups, a close liaison and harmonizing of the interests of the state with private business would raise an outcry of foul play and strong political resentment among other interest groups (particularly among organized labour and farmers) which, unlike the East Asian politicians, the Indian politicians cannot ignore. The tightly integrated relationship of government with private business, which is the embedded autonomy, that Evans talks of, is very difficult to envisage in the

Indian case. There may be certain spheres of state action where this may be possible but these demand empirical investigation.

The Indian design of state intervention was usually engulfed by the characteristics of the larger administrative system and some successes in innovative institutional experiments occurred only because they could move away from its stifling stranglehold. As mentioned above, at the dawn of independence, India was among the very few countries of the Third World that had a strong and effective bureaucratic machinery in place. As a matter of fact the strength and coherence of its civil service was so striking that it was known as a steel frame. The Indian Administrative Service (I.A.S.) was moulded as a monolithic instrument and an image of elitism was deliberately built in to provide a sense of separation from the common society. This was supported by constant movement of officials from one position to another, and a few people, whirled about by rapid transfers, were pulled up by automatic promotions into higher and higher positions exclusively reserved for them at all levels of government. On the way they commanded handsome salaries and social status forever denied to others (Potter, 1986). The District Collector was head of the district and all other local offices were subservient to him. A direct line of command was established with Central/State authorities and the district officer was recognized as the kingpin of the system. Vesting so much power in a single individual also meant that higher levels of government came to depend on him for all information and advice in matters of his local area. In the social context, he could also be above the local politics because of the prestige and status that came to him in government hierarchy.

After independence, the same structure of civil service and district administration was maintained. Faith in the independence of the civil service was so great that no new organization or institutional design could be put on the ground which did not have the involvement of the civil service or the district collector. This all pervasive influence was felt in institutions that were sought to be given autonomy but were gradually pushed into becoming semi-autonomous and then operationally came under the purview of politicians and civil servants in "public interest", Public sector manufacturing or service units were among the initial victims and as the state expanded its role institutions in education or health or rural development followed suite.

The efforts at decentralization suffered this malaise and the ineffectiveness of Panchayati Raj institutions is well documented (see Narain,

1966; and for a brief review Mathew, 1996). The three levels of Panchayats from the District downwards had close association of the local administrators as formal functionaries and government reports have indicated how this association led to obstacles to democratization as well as decentralization. Bureaucrats were hesitant to part with power and colluded with ruling local groups in taking decisions with little participation. In any case, Panchayats were seen in a functional perspective - institutions to implement national development plans (For an elaboration of this argument see Mathur, 1996). When such an effort failed, the central government in its concern to implement certain development programmes by passed these democratic institutions and created their own bureaucratic agencies like District Rural Development Agencies (DRDAs) to implement poverty alleviation programmes. The significance of these institutions under the umbrella of the district administration was highlighted by the way the then Prime Minister Rajiv Gandhi went about to learn about the responsiveness of local administration to local needs. In an effort to discuss problems of district planning and Panchayati Raj, the Prime Minister met district collectors in capitals of several states. In these meetings, he repeatedly emphasized the primacy of the district collector in the district administrative system and as the embodiment of government at local level.

The recent 73rd and 74th amendments of the Constitution seek to advance the concept of local self governance by providing for regular elections, little possibility of superseding PR bodies by administrative fiat and assuring regular finances through statutory distribution by the decisions of State Finance Commission etc. Together with economic liberalization this constitutional amendment for Panchayati Raj has been hailed as a major initiative to change the character of governance in the country. In a Foreword to a recent publication (Banerjee and Chandrashekharan, 1996) Chidambaram, then Minister in Rao Government that initiated economic liberalization in 1991, has boldly stated that in taking these two initiatives, Government of India has virtually forced a re-examination of the issues relating to governance. However, the question remains whether the constitutional amendment by itself can create self-governing institutions. It must be remembered that police functions and enforcement of rules have been kept outside the purview of the panchayat institutions. States have also been reluctant to share power with local levels and similar is the story of relations between the centre and the states. The overarching administrative system has not loosened its grip too.

Designing ineffective instruments for development is further reflected in the role of state in regulating and promoting cooperative societies. Meant to be self-governing institutions where people came together to fulfil their economic needs, they have served the ambitions of local politicians and bureaucrats. The legal framework in the Cooperative Societies Act stalled the growth of a movement and the Registrar of Cooperative Societies became the instrument of perpetuating the hegemony of government and bureaucracy over the cooperatives. In a review of the government's role, Shah (1996) argues that rather than protecting cooperatives from petty, sectional interests, in numerous instances the law has been unabashedly used by politicians and petty bureaucrats to stifle their growth by superseding their boards, and suspending elections to their boards for decades. In a more strident indictment of the role of bureaucracy, Jain & Coelho (1996) demand the abolition of the cooperative department itself to nurture the co-operative movement in the country.

If little thought was given to structure state intervention to support Panchayats or cooperative institutions, even less effort was made to see that government's own innovative organizations in the rural development sector are embedded in a supportive environment. These institutions like Small Farmers Development Agency established in 1970 and later transformed into District Rural Development Agency in 1979 were established with the aim of keeping them outside the normal bureaucratic framework so that the implementation of poverty alleviation programmes would be more effective. The government documents provided their rationale through the use of such phrases that would have one to believe that the government is ardently committed to decentralization, semi-autonomous local organizations, local level planning locally prioritized schemes of assistance to remove poverty.

What happened? Effective decentralization did not take place, local accountability of these programmes was absent and the government stifled the operating agencies through its operating administrative policies. (see for elaboration Mathur, 1995). And these weaknesses were pointed out not by academic researchers alone but by the committees appointed by the government itself. But little was done. Urge for change and to help the local communities in creating opportunities remained more in government documents than what was felt on the ground. This gives strength to the view that in India there is greater effort to give an appearance of an innovative state than any devotion to development. When the institutions fail to perform, the blame is laid at the door of the rural society. Apparently formal establishment of an institution demonstrates commitment to

development and the failure in its performance demonstrates weaknesses in society—illiteracy, backwardness, social conflicts etc.

Clearly state intervention was not designed in a way that development organizations could grow. The systems of economic planning and those of mobilizing financial resources tended to reinforce central tendencies of the entrenched administrative systems. In a situation where a strong bureaucracy had sought to curb local initiative in order to gain social power and create a strong control and command systems, the vastly expanded state intervention merely entangled the individuals into increased socio-economic obligation toward the state. A kind of dependency syndrome held back the individuals and the communities from taking social and economic initiatives, wherever such initiatives received state support or left relatively alone like those exemplified in dairy cooperatives in Gujarat or sugar Cooperatives in Maharashtra, they have shown success. It must also be emphasized that without the Constitutional Amendment, state support in West Bengal has led to rejuvenation of their panchayat systems.

The perception that the state has the capability to provide supportive environment to sustain and nurture local institutions does not emerge only from the experiences of cooperatives in Gujarat and Maharashtra mentioned above. Innovative institutions are also coming up in common property resources management with or without active state involvement. Evidence is being documented in diverse fields as irrigation or forestry to show that when user groups are allowed to manage common property resources it is possible for them to exclude free-riders, monitor behaviour of their members and enforce rules to maintain the resources. (Ostrom, 1991; Poffenberger & McGean, ed. 1996; Chambers et.al., 1989). In an effort to reduce the conflict between state agencies and rural groups, joint Forest Management Committees are also being facilitated to emerge to respond to national needs and local resource requirements. The national guideline to support such committees envisages peoples' involvement in development and protection of forests. It states that one of the essentials of forest management is that the forest communities "should be motivated to identify themselves with the development and protection of forests from which they derive benefits". West Bengal government has taken lead in the matter and has formulated an official programme providing legitimacy to this grass-roots resource management. Encouraged by the extensive and generally successful experiences with JFM in West Bengal government, NGOs are making efforts to spread the experiment elsewhere in the country. Through increasing dialogue with participating communities, non-governmental organizations

and governmental agencies new ideas are emerging and local groups are being encouraged to work for themselves and in the process help develop and manage local resources. These are hopeful signs and greater support must be elicited from voluntary groups to accelerate the process.

VI

Some issues need to be highlighted at the end. The notion of good governance within the neo-liberal agenda leans heavily on the idea of state capability through relative autonomy emerging from insulation from day to day politics. Such a view of the state has been questioned conceptually and it has been suggested that good governance can only be the product of political contestation and negotiation within a society (Jayal, 1996). Capacity of a state to deliver good governance is not necessarily incompatible with democracy. To a great extent this capacity depends on political agreement on what development is all about. The 'success' of early years of planning can be attributed to some extent to the consensus that had emerged during the nationalist struggle about the role of state in development and it was possible to see the state as a powerful "third actor". The recent introduction of policies of economic liberalization has also taken place according to some because of the assertion of the state. For, how does one explain the fact that these policies were initiated by a minority government and crafted by a Finance Minister who did not have a political base. Kohli (1990) argued that Rajiv Gandhi who commanded an extraordinary majority in Lok Sabha had to abandon his liberalization programme (in spite of his personal commitment) because he found it impossible to maintain sufficient autonomy from powerful interests to push forward his reforms. But Narsimha Rao demonstrated an unwavering determination to sustain his efforts because of his capacity to insulate his commitment from these interests. This may not completely be a straight forward case of relative autonomy. One view is as Manor (1995) argues that limited and cautious reforms were introduced precisely because Rao did not have the capacity to face various powerful groups who were not touched adversely at all whether in reference to subsidies or taxes. Another view is that the reforms were really crisis driven and did not have any strategy behind them (Bhaduri and Nayyar, 1996). The reforms are faltering now because the sense of crisis is gone and the powerful interests are raising their heads and blocking any unwelcome change.

When so much has been written about Indian bureaucracy little more can be said about it. But one needs to point out that when reform is in the air, precious little has been done to change or reform it. As a matter of fact there seems little evidence that the expanding government activity has been curtailed (Ramachandran, 1996). In the financial year 1991-92, the salaries, including allowances and travel expenses of the central government employees stood at about Rs. 8000 cr. But in the year 1994-95 the figure rose to Rs. 16,221.59 cr. The finance ministry has estimated that this figure will further rise to Rs. 17,262.71 cr. in 1995-96. (Time of India, November 15, 1996).

In order to deepen democracy and create countervailing institutions that can strengthen civil society and counter bureaucratic influence as well, institutional pluralism needs to be promoted. We need to search for institutional alternatives and accept the idea that an array of diverse institutional arrangements are possible to take advantage of available opportunities. Cooperatives, joint committees between users and government, user associations are examples that provide opportunities for improved collective decision making. We must build upon the common understanding and the shared experience of people in their particular circumstances. These may require changes in legal and contractual arrangements, explicit codification of rights as well as attendant obligations and these tasks should be high on the agenda of improving governance.

References

Bardhan, P.K. 1984, *The Political Economy of Development in India*, Basil Blackwell, Oxford.

_______ (undated), The Nature of Institutional Impediments to Economic Development, (mimeo).

Basu, Kaushik 1991, Markets, Laws and Governments in B. Jalan (ed). *The Indian Economy Problems and Prospects*, Viking Press, New Delhi.

Bhaduri, Amit and Deepak Nayyar 1996, *The Intelligent Person's Guide to Liberalization*, Penguin Books, New Delhi.

Blair, Harry W. 1996, Democracy, Equity and Common Property Resource Management in the Indian Sub-Continent, *Development and Change*, Vol.27, No.3.

Chambers, Robert et.al. 1989, *To the Hands of the Poor : Water and Trees*, Oxford and IBH Publishing New Delhi.

Coleman, James, 1987, Norms as Social Capital in Raduitzky and Bernholz (eds.) *Economic Imperialism : The Economics Applied Outside the Field of Economics*, Paragon House, New York.

Evans, Peter B. 1989, Predatory, Development and other Apparatuses : A Comparative Analysis of Third World State, *Socio-logcal Forum*, 4.

_______ et. al. 1985, *Bringing the State Back In*, Cambridge University Press, Cambridge.

Fukuyauma Francis 1995, Social Capital and the Global Political Economy *Foreign Affairs*, September-October.

Frankel, Francine 1978, *India's Political Economy, 1947-79*, Princeton University Press, Princeton, N.J.

Hardin, G. 1968, The Tragedy of the Commons, *Science*, 162.

Jain, L.C. & Karen Coelho, 1996, *In the Wake of Freedom India's Tryst with Cooperatives*, Concept New Delhi.

Jalan, B. (ed) 1991, *The Indian Economy Problems and Prospects*, New Delhi, Viking Press.

Jayal, Neraja G. 1996, The Governance Agenda Making Democratic Development Dispensable (Mimeo).

Johnson, Chalmers 1982, *MITI and the Japanese Miracle : The Growth of Industrial Policy*, Stanford University Press, Stanford.

Leftwich 1994, Governance, The State and the Polities of Development *Development and Change*, Vol. 25.

Levi, Margaret 1988, *Of Rule and Revenue*, University of California Press, Berkeley.

Manor, James 1995, The Political Sustainability of Economic Liberalization in India in Robert Cassen and Vijay Joshi, *India : The Future of Economic Reform*, Oxford University Press, Delhi.

Mathur, Kuldeep 1995, Politics and Implementation of Integrated Rural Development Programme, *Economic and Political Weekly* XXX, 41 & 42, Oct. 14-21.

Mathur, Kuldeep 1996, Challenge of Decentralization Politics of Panchayati Raj, *Social Change*, forthcoming.

Mathew, George 1996, Panchayati Raj in India in Kuldeep Mathur (ed.) *Development Policy and Administration*, 1996 Sage, New Delhi.

Myrdal, G. 1970, *Asian Drama : An Inquiry into Poverty of Nations*, Twentyfirst Century, New York.

Narain Iqbal 1966, The Administrative Challenge of Panchayati Raj *Indian Journal of Public Administrative.*

North Douglas C. 1990, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge.

Nicholos Norman 1988, 'The State of the Art' in Ostrom D Feeny and H Pichmet (eds) 1988 *Rethinking Institutional Analysis and Development Issues, Alternative and Choices*, International Centre for Economic Growth, San Fransico.

Olson, M. 1965, *Logic of Collective Action*, Cambridge University Press, Cambridge.

Ostrom E. 1991, *Governing the Commons : The Evolution of Institutions for Collective Action*, Cambridge University Press, Cambridge.

Potter David 1986, *India's Political Administrators*, Claredon Press, Oxford.

Poffenberger, M and Betsy McGean (eds.), *Village Voices, Forest Choices : Joint Forest Management in India*, Oxford University Press, Delhi.

Ramachandran V. 1996, Restructuring Government Machinery in the Centre and the States in Banerjee & Chandrashekharan (eds) 1996.

Rudolph L.I. and Rudolph S.H., 1987, *In Pursuit of Lakshmi The Political Economy of the Indian State*, Orient Longman, Hyderabad.

Shah Tushaar 1996, Agriculture and Rural Development in the 1990s and Beyond Redesigning Relations between the State and Institutions of Development in Mathur (ed) 1996 op.cit.

Skocpol, Theda 1985, Bringing the State Back In in Evans et. al. 1985 op. cit.

Sorensen, George 1993, Democracy, Authoritarianism and State Strength, *The European Journal of Development Research*, Vol.5, No.1

World Bank 1991, Annual Conference on Development Economics Governance and the External Factor by Pierre Lavdel-Mills and Ismail Serageldin World Bank, Washington D.C.

20

Indian Legal System: Perspectives and Problems

Nilima Chandiramani

I. Introduction

We, the people of India, wrenched ourselves free from the foreign yoke, and constituted a sovereign and democratic republic. Later, by the Constitutional (42nd Amendment) Act, 1976, we made it a secular and socialist state. Our nascent state achieved substantial, even spectacular, successes in many fields of life—social, economic and political. These achievements were possible on account of the proper implementation of the constitutional mandate enshrined in the preamble and the directive principles of state policy. But there is still 'vast undone'. This is a challenge that faces us to-day.

Law is an important instrument for accomplishing this 'undone'. But, is our archiac legal system geared to lead the nation on its path of growth and development? Is the Westminster pattern of legislation in India capable of dynamic and prompt legislative action? Can our judiciary, still fed on outdated Indo-Anglican jurisprudence, bring about purposeful and active reforms? Is it possible for our executive, adopting the White-hall style of administration, to transform the socio-economic conditions in India? This paper (after discussing the goals of public policy and the instruments of governance under the Constitution) attempts to reflect on these questions and endeavours to suggest some solutions so that the legal system gets attuned to the needs of a pulsating India.

II. Goals of Public Policy

The Constitution of India has, through its preamble (Table 1) and directive principles (Tables 2, 3, 4 & 5), set the goals of public policy and governance. The behest of the constitution is to build, with the rule of law, a welfare society in which justice—social, economic and political—shall inform all institutions of our national life. The core of the commitment lies in Parts III and IV of the Constitution. Part III, containing the fundamental

rights, is based on the model of the American Constitution. These rights are justiciable. Part IV, dealing with the directive principles, is founded on the Constitution of Republic of Ireland. Directive principles are non-justiciable but are fundamental in the governance of the country—being in the nature of principles of public policy. They serve as moral restraints upon future governments and thus prevent the policy from being torn away from the idea which inspired the makers of the constitutional charter.

Table 1

Preamble

The Preamble to the Constitution, as amended in 1976[1] summarises the aims and objects of the Constitution—

"WE THE PEOPLE OF INDIA, having solemnly resolved to constitute India into a SOVEREIGN, SOCIALIST SECULAR[2] DEMOCRATIC REPUBLIC and to secure to all its citizens:

JUSTICE, social economic and political;
LIBERTY of thought, expression, belief, faith and worship;
EQUALITY of status and of opportunity; and to promote among them all;
FRATERNITY, assuring the dignity of the individual and the unit *and integrity*[3] of the Nation.

1. By the Constitutional (42nd Amendment) Act, 1976.
2. Inserted by the Constitutional (42nd Amendment) Act, 1976.
3. Inserted by the Constitutional (42 Amendment) Act, 1976.

Table 2

Directive Principles of State Policy

Part IV of the Constitution (Arts. 36-51) embody the directive principles of state policy. State is under a duty to follow these directions both in the matter of administration as well as in the making of laws.

The directive principles may be classified as below:

i. directives in the nature of ideals of the state;
ii. directives shaping the policy of the state; and
iii. non-justiciable rights of citizens.

Table 3[1]

Directives in the Nature of Ideals of the State

1. The State shall strive to promote the welfare of the people by securing a social order permeated by social, economic and political justice [Art. 38(1)]; to *minimise inequality in income, status, facilities and opportunities, amongst individuals and groups* [Art. 38(2)]. (Added by the 44th Amendment Act, 1978).

2. The State shall endeavour to secure just and humane conditions of work, a living wage, a decent standard of living and social and cultural opportunity for all workers [Art. 43].

3. The State shall endeavour to raise the level of nutrition and standard of living and to improve public health [Art. 47].

4. The State shall direct its policy towards securing equitable distribution of the material resources of the community and prevention of concentration of wealth and means of production [Art. 39(b)-(c)].

5. The State shall endeavour to promote international peace and amity [Art. 51].

1. Basu, D.D., *Introduction to the Constitution of India*, p.434.

Table 4[1]

Directives Shaping the Policy of the State

1. To establish economic democracy and justice by securing certain economic rights.
2. To secure a uniform civil code for the citizens [Art. 44].
3. To provide free and compulsory primary education [Art. 45].
4. To prohibit consumption of liquor and intoxicating drugs except for medical purposes [Art. 47].
5. To develop cottage industries [Art. 43].
6. To organise agriculture and animal husbandry on modern lines [Art. 48].
7. To prevent slaughter of useful cattle, i.e., cows, calves, and other milch and draught cattle [Art. 48].
8. To organise Village Panchayats as units of self-government [Art. 40].
9. To promote educational and economic interest of weaker sections and to protect them from social injustice [Art. 46].
10. *To protect and improve the environment and to safeguard forests and wild life* [Art. 48A]. (Added by the 42nd Amendment Act, 1976).
11. To protect and maintain places of historic or artistic interest [Art. 49].
12. To separate the judicial from the executive [Art. 50].

1. Basu, D.D., Introduction to the Constitution of India, p.434.

Table 5[1]

Non-justiciable Rights of Citizens

1. Right to adequate means of livelihood [Art. 39(a)].
2. Right of both sexes to equal pay for equal work [Art.39(d)].
3. Right against economic exploitation [Art. 39(e)-(f)].
4. *Right of children and the young to be protected against exploitation and to opportunities for healthy development, consonant with freedom and dignity* [Art.39(f)].
5. *Right to equal opportunity for justice and free legal aid* [Art. 39A] (Added by the 42nd Amendment Act, 1976).
6. Right to work [Art. 41].
7. Right to public assistance in case of unemployment, old age, sickness and other cases of underserved want [Art. 41].
8. Right to humane conditions of work and maternity relief [Art. 42].
9. Right to living wage and conditions of work ensuring decent standard of life for workers [Art. 43].
10. *Right of workers to participate in management of industries* [Art. 43A]. (Added by the 42nd Amendment Act, 1976).
11. Right of children to free and compulsory education [Art. 45].

1. Basu, D.D., Introduction to the Constitution of India, p.434.

III. INSTRUMENTS FOR GOVERNANCE

The Indian Constitution brought into existence three major organs of our democratic form of government. These instruments of governance are—the legislature, the judiciary and the executive. The legislature makes the law; the judiciary declares the law that is; and the executive enforces it. The distribution of powers among these three organs is made in such a way that each organ functions effectively and without exceeding its limits. Each has some checks, direct or indirect, on the other.

The rigid Montesquieuan separation of powers and an absolute balance between the different organs of government is almost impossible. The final say usually belongs to one of the organs. In England, the British Parliament is supreme under the English Constitution. There, the birth of democracy was due to a protest against absolutism of an autocratic executive. So the English political system placed faith in the good sense of the elected representatives of the people. It established "parliamentary supremacy". Under the British Constitution parliament can do anything and everything. No law made by the British parliament can be struck down as void by the courts. Even if the law is unjust and contrary to the principles of sound governance, the courts cannot nullify it nor correct the parliament.

In the US the supreme court is supreme. The drafters of the American Constitution had the painful experience that even a representative body could be tyrannical and exploitative. They wanted a law superior to the legislature itself. They established 'judicial supremacy'. In the US, the judiciary, being supreme, can nullify any law made by the legislature. One of her own judges, CJ Hughes, once said, "The Constitution is what the supreme court says it is", but he could have broadened that to include all laws. Hence the American judiciary can sit in judgement over the wisdom of any legislative policy as if it is a 'super-chamber' of the legislature or the 'Marshal'.

The Indian Constitution has blended and adopted the American system of judicial supremacy and the British principle of parliamentary supremacy. The Indian parliament cannot make a law which is beyond its legislative competence as declared by the Constitution. And the Indian judiciary is endowed with the power to declare a law as unconstitutional if it is beyond the legislative competence of parliament. To this extent our Constitution follows the American model rather than the English. But the powers of our judiciary vis-a-vis the legislature are weaker than in the US. The Indian judiciary has no power to question the wisdom of the legislative policy of parliament. If parliament has erred, the judiciary can and must draw the attention of parliament but the error can be rectified only by parliament itself. No person has expressed this better than Pandit Nehru : "No supreme court, no judiciary, can stand in judgement over the sovereign will of parliament representing the will of the entire community. It can pull up that sovereign will if it goes wrong but in the ultimate analysis where the future of the community is concerned no judiciary can come in the way."

IV. Legislative Flaws

Parliament makes and shapes the laws. But the law-making process, the law itself and the personnel leave much to be desired. The law-making process is highly complex and specialised. Even a small piece of legislation is too time-consuming and difficult to be handled by a large elected body like our Parliament. Hence the process of law-making in India has become terribly cumbersome, expensively dilatory and cumulatively disastrous. The slow, complicated and tedious Westminster methodology of law-making may be suitable for a small and homogeneous population but not for a large and heterogeneous country like India. The British too were disgusted with their out-dated method and a re-appraisal of the process was suggested by the Renton Committee. A critic of British law making has humourously said :

I'm the parliamentary draftsman,
I compose the country's law,
And of half the litigation,
I am undoubtedly the cause.

It is imperative that we reform and rationalise our methodology of legislation if we wish to bridge the gap between the legislative pace and the developmental needs of the country. The European and the Russian models of law-making have much to teach us. In these countries the Law Commission plays a pivotal role in law-making. The legislature in these countries merely lays down the guidelines for a specific legislation. The members of the Law Commission collect material; study it; consult experts and institutions; and draft the bill. The bill thereafter is quickly approved and passed by the legislature without much debate. In Canada the Law Commission, during the formulation and reshaping of laws, takes the laws to the public for a thorough airing. A Chairman of the Canadian Law Commission once said, "I want to stop turning people against the law ..... I want to turn them for it" (Journal of the Canadian Bar Association). Same is the case in Australia. There is no reason why the Law Commission in India cannot play a similar and active role in the process of Indian law-making.

It is no wonder that law-making in India has resulted in complicated and ill-drafted laws with litigative uncertainties. Most of our laws are wordy, pompous and dull. They are slaves to technicality and legalism. A classic example of a law that is overbearing and monotonous (even to students of law) is the Foreign Exchange Regulation Act—an important piece of economic legislation regulating, among other things, payments, dealings and transactions in foreign exchange. Its long-winding and never-ending sections run into pages. Worse still, it is topped with heaps of rules, regulations, notifications, orders and circulars which have rendered the law inaccessible and unfathomable to the people. Laws are made for the people. So should not the laws be comprehensible, readily ascertainable and reasonably clear?

Simple and clear laws are possible if the legislative drafting is simplified. Good legislative drafting requires specialised skill. Hence it is imperative that our legislators possess the necessary expertise in drafting. They must also possess the necessary vision. But it is pathetic that Indian legislators are not attuned to the developmental needs of the country. They are still ideologically grounded in Blackstone's England and Maxwell's interpretation. And above all they are totally baffled by the detailed and puzzling subject-

matter of the bills and the confusing legalese. And in absence of background information and critical assistance, the outcome is a foregone conclusion. This has been aptly stated by a British critic : "Many bills are now so long and complicated that it is just not possible for any MP, without a supporting team for briefing and research, to grasp the implication of all the clauses. Indeed, few MPs try. And those who do, sometimes get the wrong end of the stick in their haste to legislate." This equally applies to an Indian legislator! An illustration will clarify the point. In 1994, India ratified the GATT treaty. This necessitated bringing our patents and trade-marks laws (which are excellently drafted and in the interest of the nation and Indian industry) at par with the TRIPs requirement. Ironically, the Patents and the Trade-marks bills went even beyond the requirements of the TRIPs text. Fortunately, both the bills were defeated in the Rajya Sabha and referred to Select Committees. These ex-post facto committees and commissions, now frequent, reflect the ignorance and folly of our legislators and not their competence.

Sometimes the incompetency of the legislator in drafting the law defeats the very purpose of the law. The penalties prescribed under the Environment Protection Act, 1986 are vigorous and severe, when compared to the penalties prescribed for environment pollution under any other Indian law. But unfortunately, penalties under the former law are rendered ineffective and nugatory because the Act itself provides that if any act or omission constituting an offence punishable under it is also punishable under any other law, then the offender shall be punished under the other law and not under the Environment Protection Act [s. 24(2)]. And invariably some other law prescribing a much lesser penalty is applicable in most of the cases. Or take the case of the Urban Land (Ceiling and Regulation) Act, 1976. Its object is to prevent concentration of land in the hands of a few. But the exemptions granted under the Act have prevented it from achieving what it had set out to achieve. These exemptions have become avenues for locking up large areas of urban land and creating an artificial scarcity.

Not only is there a delay in making laws, but sometimes laws made, get aborted. No law nor any regulation, rule, notification or order of the government or any body is beyond court's jurisdiction. Any and all of these can be challenged in a court of law. If a stay is granted—and our courts are generous in granting it—years pass and the law becomes unproductive. In the past writ petitions, appeals and stays have sabotaged vital Indian legislation dealing with land reforms. One appeal is necessary, but two are too many, three become counter-productive and four ruinous to the legal

system. England, America or Russia do not know of so many appeals. It is imperative that the number of appeals is reduced and revision abolished. Instead a high quality judiciary charged with realism should be created; which, with ongoing judicial education, could do prompt justice in individual cases.

IV. JUDICIAL FAILINGS

Legislative delays are coupled with judicial delays. The oral arguments in our courts are not limited in duration. These endless arguments cause delay. In the US oral arguments are secondary in importance to briefs. The briefs are excellently packed and presented to the court. The court permits arguments only to clarify. Hence, the time for argument is often restricted. In the Supreme Court of US only one hour is allowed to each side to argue his case. But in other appellate courts a much shorter time is allowed. The mechanism for curtailing prolonged arguments is really interesting and worth mentioning. When the counsel has only 5 minutes left a white light on his lectern goes on. When the time for argument is complete, a red light goes on. And the Chief Justice may barely allow him to complete his sentence.

There is yet one another allegation against our judiciary. This is that instead of working in unison, it sometimes functions in isolation, even confrontation, with the legislature; thereby retarding the growth of the nation. Way back in 1921, Benjamin N Cardozo had cautioned, "To-day courts and legislature work is separation and aloofness ..... and move on in proud and silent isolation ....." This holds good even today. One has only to read the chronicle of constitutional amendments to know how the Indian courts began striking down enactments on the grounds of legal technicalities or constitutional niceties; and obstructing progressive legislations relating to economic regulations, labour, social-welfare measures and reform of land ownership. Parliament retaliated by rightly amending the constitution but wrongly creating a freezing chamber—the IX Schedule—where many laws have been stacked away to protect them from judicial attack. The judiciary was in the wrong and its judgments in Zamindari Abolition case (1951 AIR Pat 91), Golak Nath (AIR 1967 SC 1643), Bank Nationalisation case (1970 I SCC 248) and Abolition of Privy Purses case, were not in tune with public policy. In the Zamindari Abolition case, the first agrarian legislation was struck down by the Patna High Court as being violative of fundamental rights. But the barriers in the way of the Zamindari Abolition Act were removed by Parliament enacting the Constitutional (1st Amendment) Act, 1951. In Golak Nath's case the Supreme Court, overruling Shankari Prasad

(AIR 1951 SC 458) and Sajjan Singh (AIR 1965 SC 845), held that parliament has no power to take away or abridge the fundamental rights enshrined in the Constitution. Parliament answered back by passing the Constitutional (24th Amendment) Act 1971, nullifying Golak Nath and rehabilitating Shankari Prasad and Sajjan Singh. In Bank Nationalisation case the Supreme Court struck down the law for acquisition of banking undertakings on the ground that the 'compensation' was not sufficient. This case was instrumental for the passage of the Constitutional (25th Amendment) Act, 1972, which finally bid good-bye to the term 'compensation' in Article 31 and the word "amount" was substituted in lieu of it.

These and other instances of judicial interferences are not restricted to India. Even in the US when the Supreme Court threatened to electrocute the New Deal, an exasperated Roosevelt had complained, "The American Constitution is not what its plain terms declare but what these nine old man (of the Supreme Court) interpret it to be." On another occasion, he rebuffed the Court in the following words : " we have therefore reached the point as a nation where we must take action to save the Constitution from the Supreme Court and the Court from itself. We must find a way to take an appeal from the Supreme Court to the Constitution ......" In Russia, Lenin had exclaimed, " There are no more reactionary people in the country than judges." Prof Laski, referring to the obstructive tactics of the English judiciary, has said, "the judges spare no pain in attacking parliamentary decisions, which it is not their function to criticise."

The solution to judicial interference is not to down the judiciary or to create freezing chambers and lock up the laws. Will there be perfect government if courts did not come in the way? Has not the judiciary acted as a sentinel of public policy even when our laws have been defective and executive lethargic? Can anyone deny that the judiciary has played a magnificent role in environmental jurisprudence and the recent scam cases? And it must be noted that such unexpected jolts by the judiciary are often the result of imperfect legislation or an indifferent executive. What must be borne in mind is that whenever the legislature and judiciary work at crossroads the penalty is paid both in wasted effort of production and in the lowered quality of the product. Therefore whenever the intendment of the law maker misfires due to court's interpretation, the legislature and the judiciary must immediately mediate through some quick agency and avoid litigating till the very end. This agency should play the role of a creative go-between and establish a mutually responsible relationship between the two.

At the same time it is crucial for a judge, in a developing country like India, to be an activist. When challenged by change and readjustment, he must renovate and innovate. He is the one who can infuse life and blood into the legislative skeleton and create a living organism suitable to meet the needs of the society. If he cannot look forward then he must also not turn backwards. Atleast he can look sideways and around him, and become an instrument of transformation of Indian society as envisaged by the Constitution. According to M. C. Chagla, a judge must consider the public policy of the state and then consider the law in the light of that policy. It is the duty of the judge to help the legislature to satisfy the needs of the time and he should not set himself as a brake or clog against the progress of the nation. He must bear in mind the words of Lord Chancellor Hailsham, "..... if law is to last it must adopt because law of one age can be the injustice of the next."

V. EXECUTIVE FAILURES

The executive has also failed the country. After our independence we planned and programmed for change through the 5 year plans. Law is the guardian of any plan. Hence plan and law must be constant companions. The planner must realise that every plan that he formulates, or policy that he implements, or project that he undertakes, must be justified by law. Every taxation measure proposed must be according to the procedure prescribed by law; every organisation that is contemplated to be set up must be structured by law; and every policy decision for nationalisation or state monopoly needs the authorisation of law. And such a legislation has to be properly planned in advance if it is not to be challenged in a court of law. No belated or haphazard legislation can save the plan. Nor will any ad hoc or piecemeal legislation serve to achieve the developmental goals.

But our executive has never felt the need of a plan legislation. Our Planning Commission is conspicuous by the absence of a law member on it and our legislature has no knowledge of plan technology. Nor do the planning experts in the administration maintain any liaison with the law commission or any other organ in the legislative process. When the policy decision for creating PSUs was taken, the Indian jurisprudence was innocent about their limits of autonomy; parliamentary and government control; their structure, concentration and mode of function; recruitment and labour policy, etc. Hence, the failings of the Indian PSUs! No half-hearted and hastily made subsequent legislation by unequipped politicians or inexperienced draftsmen could help them. Similarly, while nationalising the

insurance and the banking sectors, the legal principles governing nationalisation, administration of these state monopolies and the penal restraints on managerial personnel for over-stepping their limits and for dereliction of duty was never considered. And to-day we are blaming these sectors for their inefficiency and corruption. Is not the planner to be blamed for his legal illiteracy and for having failed to plan an appropriate legislation to ensure their success? Before the state undertook gigantic power and hydro-electric projects, did the planner design an apparatus to deal with problems that could arise, so that nothing could come in the way of completion of these projects?

The executive has also failed us by its delays. Sometimes, laws made by parliament are not passed or if passed, not notified. The epoch making judgement of Justice Krishna Iyer in Bangalore Water Supply and Sewage Board (1978, 2 SCC 213) changed the complexion of the term 'industry' by bringing within its ambit universities, hospitals, charitable institutions, etc. But when the court pointed out the patent error in the Industries Dispute Act, parliament delayed in clarifying the law and the insensitive executive has yet to pass and notify the law. Kerala legislature long ago passed a bill to help the adivasis who were cheated of their lands, but this law was not brought into force. Many laws relating to land reforms, urban ceiling, civil rights were lying in suspended animation for a long time.

The greatest failure of our executive has been in the area of implementing laws. Implementation and enforcement of laws has become a bane of Indian legislation. Some of our vital economic, environmental and social-welfare laws have been rendered paper tigers or counterfeit currencies because of poor implementation. Some illustrations will clarify the point. Section 18(1)(a) of FERA imposes a restriction on the exporter. It ordains that no person can export goods from India unless he furnishes a declaration 'true in all material particulars' and supported by necessary evidence. And this restriction is deemed to be a restriction under the Customs Act, 1962—another vital piece of economic legislation whose primary purpose is collection of customs duties. Hence if the exporter violates the provision of section 18(1)(a) of FERA by furnishing an untrue declaration then he is deemed to have violated the provisions of the Customs Act. And this can entail confiscation of export goods under s. 113; and/or imposition of penalty under s. 114; and/or criminal prosecution under s. 135 of the Customs Act. Two Supreme Court judgements—Union of India v Rai Bahadur Shreeram Durgaprasad Ltd. (1971) 41 Co. cases, 864; and Becker Gray & Co. V. Union of India AIR (1971), 116—in which the court held

that incorrect or incomplete declaration is not a violation of s. 18(1)(a), are bad law today. Inspite of such effective provisions under both the Acts, the exporters, under the DEEC scheme, bring enormous amounts of foreign currency into the country's banking system as export proceeds for exports that are never made or for exports of a much lesser value; and thereby convert their black money into dollars. Since export income is free from income-tax, the black money gets laundered into white. Moreover, the scheme allows the exporter to have duty-free imports of raw material which results in the country losing crores of rupees which it would have earned by way of import duty. All this is because of the unsatisfactory implementation of the provisions of FERA and customs law. Similarly, it is the poor implementation of the Urban Land (Ceiling and Regulation) Act, 1976; and not the inadequate space in Indian cities, that has put such a high premium on urban property in India. The Act empowers the state to acquire land in excess of the ceiling in order to provide low-cost housing facilities. However, despite the government declaring as much as 250,000 hectares of urban land surplus under the Act, it has managed to acquire only 33,970 hectares and developed a mere 13,000 hectares.

Or take the example of environmental laws. The Indian environmental legislation is among the best ones in the world. Yet, developed and OECD countries find it economical to export their most ecologically dangerous industries and waste to India than to comply with stringent environment standards strictly enforced in their own countries. We are quick to ape these countries. Why can't the environmental authorities in India learn from these same countries the art of implementing laws? It is the laxity in implementing our laws that enabled Union Carbide to get away easily despite the Bhopal gas tragedy. Could the managing director of Boehringer Mannheim (India) Ltd. have escaped from India, after producing contaminated Comsat Forte tablets, if we had been prompt in enforcing our laws?

Yet another law that if not seriously enforced is the Dowry Prohibition Act—enacted to eradicate a social evil that plagues our society. The Act was been amended twice; corresponding changes were made in the allied laws such as I.P.C., Cr.P.C. and Evidence Act; and new offences such as 'harassment and cruelty' and 'dowry death' created. Notwithstanding all these efforts, dowry harassments and above all dowry deaths are on the rise. The reason is that the Dowry Prohibition Officers themselves scoff at the Act and regard it ornamental! How can such insensitive and heartless officials implement the law? Instances such as these can be multiplied to show that inadequate implementation has rendered our laws illusions.

VI. Conclusion

Our archaic legal system designed for the 19th century Indian conditions needs drastic metamorphosis. Attempt to transform it may be like an attempt to make a sheet of corrugated iron flat with a hammer. But this should not deter us because a progressive legislature making appropriate, clear and prompt laws; an active and foresighted judiciary; and a committed and sensitive executive, are the essentials of an effective legal system which can lead the country on its path to progress.

Readings

Austin, G. (1966), *Indian Constitution: Cornerstone of a Nation*, Clarendon Press, Oxford.

Basu, D.D. (1984), *Comparative Constitutional Law*, Prentice-Hall of India.

_______ (1994), *Introduction to the Constitution of India*, Ed. 16, Prentice-Hall of India.

Baxi, U. (1980), *Indian Supreme Court & Indian Politics*, Eastern Book Company, Lucknow.

_______ (1982), *The Crisis of Indian Legal System*, Vikas Publishing House, New Delhi.

Birkby, R.H. (1983), *The Court and Public Policy*, Congressional Quarterly, Washington.

Cardozo, B. (1921), *The Nature of the Judicial Process*, Yale University Press, New Haven.

Cox, A. (1987), *The Court and the Constitution*, Houghton Mifflin, Boston.

Edwards G. et.al., (eds.) (1985), *The Presidency and Public Policy Making*, University of Pittsburgh Press, Pittsburgh.

Friedman, L. et.al., (eds.) (1978), *American Laws and the Constitutional Order*, Harvard University Press, Cambridge.

Haines, C. (1959), *The American Doctrine of Judicial Supremacy*, University of California Press, California.

Indrayan, N.K. (1985), *Law and Public Opinion in India*, Deep & Deep Publications, New Delhi.

Jain, M.P. (1982), *Changing Face of Administrative Law in India and Abroad*, N.M. Tripathi, Bombay.

Krishna Iyer, V.R. (1972), *Law and the People*, People's Publishing House, New Delhi.

_______ (1975), *Social Mission of Law,* Orient Longman, New Delhi.

_______ (1980), *Justice and Beyond,* Deep & Deep Publications, New Delhi.

_______ (1981), *Law vs. Justice*, Deep & Deep Publications, New Delhi.

_______ (1982), *Law, Society and Collective Consciousness*, Allied Publishers Private Ltd., New Delhi.

Lloyd, D. (1953), *Public Policy,* University of London, The Athlone Press, London.

Mukherjee, T.P. (1996), *Customs Law,* 6th edition in 2 vols., Delhi Law House, New Delhi.

Sheth, D.K. (1993), *Treatise on FERA - Law and Practice*, vol. 1-2, edition 2nd, Bharat Law House, New Delhi.

FISCAL POLICY, PUBLIC POLICY AND GOVERNANCE

The country is at a crossroads at which issues in public policy and governance have reared their head as never before. There is increasing public awareness of the many aspects to the problem. Fiscal policy is one such aspect which is intrinsically linked to public policy and upon which the quality of governance manifests itself. This volume is a timely attempt to bring together various approaches—economic, political and legal—to this exigent issue that reigns paramount in the citizen's mind today. Not only are broader issues such as corruption and formation of government considered, but specific matters of taxation, expenditure and fiscal relationships among different levels of government are also addressed in order to bring to the reader a wide array of fiscal policy concerns.

Dr. Parthasarathi Shome is the Director of National Institute of Public Finance and Policy, 18/2 Satsang Vihar Marg, Special Institutional Area, New Delhi–110067.

MAIL YOUR ORDER TO

CENTAX PUBLICATIONS PVT. LTD.

1512-B, BHISM PITAMAH MARG

OPP. SACHDEVA P.T. COLLEGE DEFENCE COLONY

NEW DELHI - 110 003, INDIA ✆ : 469 3001 to 3004

FAX : 011-4635243, E-Mail : centax @ del 2. vsnl net.in