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FISCAL SECTOR REFORMS AND ITS IMPLEMENTATION FOR ECONOMIC STABILIZATION

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Abstract

Fiscal reforms refer to changes in the fiscal sphere or fiscal policy. Fiscal policy is concerned with revenue and expenditure policies of the government. How to use the revenue and expenditure policies of the government so as to impact the aggregate level of demand for goods and services. The need for economic reforms in general and fiscal reforms in particular can best be understood if we examine the nature of the Indian economy in 1991. The fiscal crisis was a result of the fiscal profligacy of the Central and State government during 1980's. This contributed to a balance of payments crisis necessitating wide ranging economic reforms, of which fiscal reforms is the important one. The need for restoring fiscal balance by reducing fiscal deficits was widely recognized and a number of tax reforms and expenditure reforms were initiated. Tax reforms included expanding the tax base, reducing the rates leading to improved tax compliance and making the tax administration more efficient. These measures increased tax revenues considerably.

Key Words: fiscal reforms, fiscal deficits, tax reforms, expenditure reforms

Fiscal reforms are part of the economic reforms initiated in 1991. Fiscal reforms refer to changes in the fiscal sphere or fiscal policy. Fiscal policy is concerned with revenue and expenditure policies of the government. How to use the revenue and expenditure policies of the government so as to impact the aggregate level of demand for goods and services? This is the concern of fiscal policy. Keynes believed that revenue (especially taxation) and expenditure decisions – that is fiscal policy – should be used to stabilize the economy. The main fiscal instruments in this regard are – taxes (direct and indirect), expenditure, public debt, subsidies and the like. Fiscal reforms refer to changes in some of these so as to produce desirable effects on national income, production and employment. The need for economic reforms in general and fiscal reforms in particular can best be understood if we examine the nature of the Indian economy in 1991.

INDIAN ECONOMY ON THE EVE OF REFORMS:

In 1991, around the time of the Gulf War, India found herself in a deep economic crisis. A double digit inflation (16.7%), high interest rates, large fiscal deficits, huge subsidies (2% of GDP or 10.7% of Govt. expenditure), growing non-plan expenditure, a high current account deficit (3.1% of GDP), very low foreign exchange reserves ($1 Billion in July, 1991), enough to cover only two weeks of normal imports and large internal and external debts (India ranked as the countries, with the largest debt among all the developing countries).

Thus in 1991, India found herself in a deep macroeconomic disequilibrium. This was due to a number of causes – chief among them being the fiscal deficits, balance of payments and foreign exchange reserves.

The fiscal situation prevailing at the beginning of 1990's was characterized by high fiscal deficits and mounting debt accumulation, giving rise to inflation, financial repression and overall deterioration of the macroeconomic fundamentals of the economy.

Units the beginning of 1980's, the overall fiscal situation fiscal deficits. But during 1980's, the fiscal situation steadily deteriorated. In 1984-85, the overall fiscal deficit touched 7.7 per cent of GDP. It marginally increased to 7.8 per cent in 1989-90, reaching a new high of 8.5 per cent of GDP in 1990-91. The rising fiscal deficits and the monetization of a substantial part of it led to inflationary pressures and to a growing deficit in the current account of the balance of payments. This led to a serious balance of payments crisis towards the end of 1980's.

Revenue deficits, on the other hand, were a little over 2 per cent of GDP in the early years of 1980's. they, however, increased to 2.6 per cent of GDP in 1989-90 and 3.5 per cent in 1990-91. Increasing revenue deficit necessitated a substantial amount of borrowing for meeting the revenue expenditure. Though the central government tried to raise resources through taxation to met the situation it was not enough. The borrowing requirements of the Government continued to increase with 25 per cent of the overall fiscal deficit being met through the RBI route.

A serious implication of fiscal deficits is the meeting-debt burden, particularly the external debt. Interest payments accounted for about 24 per cent of the total expenditure of the central government in the early years of 1980's. Total outstanding debt of the central government stood at 59.5 per cent of GDP in 1989-90. The problem of debt burden had thus as summed a critical proportion.

The fiscal situation, prevalent at the beginning of 1990's, was thus characterized by sustained high fiscal deficits giving rise to inflation. The situation thus called for immediate correction, highlighting the need for economic reforms. This forced the government to recognize the need for swift – and radical changes in the fiscal system – not only to bring about macroeconomic equilibrium but also to lay the foundation for a long term structural reforms (or adjustment) programme.

FISCAL REFORMS AND FISCAL DEFICIT:

The economic crisis described above emphasized the need for initiating economic reforms in general and fiscal reforms in particular. A wide range of economic reforms were initiated in June/July, 1991 to tide over the crisis. Stabilization was necessary in response to the macro economic crisis. A stabilization programme concentrates on three important areas. I) Fiscal adjustment ii) Inflation Control and iii) Balance of Payments Adjustment. Among these, the first fiscal adjustment – is the important one, as it has a bearing on the other two. As the World Development Report (1988) observed: "A prudent fiscal policy can be defined as the one that maintains the public deficit at a level which is consistent with other macroeconomic objectives – controlling inflation, promoting private investments and maintaining external credit worthiness".

Fiscal consolidation has therefore become an imperative. It is needed for the success of India's economic reforms. A programme of fiscal consolidation to achieve the desired goals should, therefore, focus on reducing fiscal deficits to a sustainable level. The principal challenges was, therefore, to reduce fiscal deficit. In the light of this emphasis on reduction of fiscal deficits, it is necessary to understand the implications of a high, sustained fiscal deficit. Fiscal deficit is said to exist when the total expenditure of the government exceeds its total revenues.

i) The need for reducing fiscal deficit rests on the issue of sustainability. This is because fiscal deficits can be financed by borrowing either from domestic resources or external sources. Each of these methods, if carried beyond a point, can lead to a crisis. Printing of money, over and above the demand for money leads to inflation. Financing fiscal deficits by borrowing becomes unsustainable if the interest rate exceeds the GDP growth rate. In such a case, the economy may end up in a debt trap.

ii) To the extent government borrows, it preempts the available investible resources – it crowds out the private investment.

iii) A high fiscal deficit implies a large share of public resources are to be devote to debt servicing, thereby leaving a smaller part for desirable expenditure – expenditure on physical and social infrastructure.

iv) Continued fiscal deficits impact on interest and inflation rates, depending on how the deficits are financed. If the government borrows from the domestic market, it puts pressure on the interest rate. If the government finances the deficit by borrowing from the RBI, it fuels inflation.

v) Fiscal deficits (and larger revenue deficits) bring about enter – generational equity considerations – as they give the pleasure of spending to the present generation, they leave the pain to the future generations for servicing the debt.

vi) High fiscal deficits reduce the scope for flexibility in policy. Since deficits have to be eventually corrected, they may lead to a higher tax regime and/or a reduction in government expenditure both of which may affect incentives.

The attempts to reduce fiscal deficits centered round two things: i) tax reforms and ii) expenditure reforms.

TAX REFORMS:

Tax reforms are an important component of fiscal consolidation. The importance of tax reforms in relation to both fiscal stabilization and structural adjustment can not be over emphasized. Fiscal stabilization, in the ultimate analysis, can be achieved only through a buoyant revenue system.

In August 1991, the Government set up a high pawed committee, - Tax Reforms Committee (TRC) – under the chairmanship of Dr. RAJACHELLAIAH a noted public

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finance expert, to make recommendations for comprehensive reforms of the system of central taxes.

TAX REFORMS COMMITTEE:

The TRC was asked to examine the existing tax structure in the Country and make appropriate recommendations to make the system fair, broad based, elastic and more tax complaint. In view of this, the TRC identified its approach as; "the best results in terms of compliance, efficiency, and equity are obtained thorough a system of incorporating moderate rate on a broad base". The Committee felt that a good tax system is one which brings most of the revenue to the Government by way of direct taxes. As regards indirect taxation, it desired a system of taxation which was based on value added at every stage. The TRC advocated the adoption of a limited number of broad based taxes with moderate and limited number of rates and with very few exemptions and deductions.

DIRECT TAXES:

In formulating the proposals for reforming direct taxes, the TRC's approach was to build a fair by simple structure with

i) Reasonable tax rates

ii) Progressive Tax Rates, yet not leading to tax evasion and not adversely affecting the desire to work, save and invest, and

iii) Easy to enforce.

The Committee further felt that in order make to the Country's direct tax system more effective, it is necessary that tax rats be reduced in respect of all taxes.

Regarding Persona Income Tax, the TRC recommended a reduction in the top marginal rate to 40 per cent and adoption of a 3-tier slab system with an entry rate of 20 per cent and a top rate of 40 per cent (i.e. 20%, 30% and 40%). It also recommended abolition of tax concessions, rebates and allowances under various incentives for saving schemes.

It recommended the abolition of wealth tax and suggested a phased reduction of the corporate income tax to 40 per cent and abolition of surcharge on corporate tax.

Regarding indirect taxes, the TGRC's recommendations relating to indirect taxes, aimed at lowering the level of indirect taxes, rationalization and simplification of the indirect tax system and improving administrative efficiency. It suggested a phased reduction of inportduti4s (many of them above 200% in 1991) to range to 15 per cent to 30 per cent; reduction in the number of rates to 4 or 5 and abolition of exemptions and special treatments. It also recommended that the ultimate objective of Union Excise reform should be to make the excise tax system move towards a full-fledged VAT system.

Many of the recommendations of the TRC were carried out by successive Finance ministers starting with Dr. Manmohan Singh, the present Prime Minister.

A major recommendation of the TRC related to levy of a Service Tax, to start with, on a few selected services.

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Subsequently, the Government appointed some more Committee to pursue the process of tax reforms more vigorously and effectively. I) The Shome Committee (2001) to make appropriate recommendations on Tax policy and Tax Administration. Ii) Kelkar's Task Force a on Direct Taxes (2002) and iii) Kelkar's Task fare on Indirect taxes – the latter two Task force to r4ecommend. Measures for simplification and rationalization of direct and indirect taxes. Many of the recommendations of the committee were implemented in a gradual manner, beginning with 2005-06 budget. Thus the tax reforms process has been helped by the recommendations of the various expert Committees. The Direct Tax Reforms simplified the tax system, reduced exemptions and tax rates; expanded the tax based and ensured better tax compliance. Customs duties were reduced. Service tax was introduced which now covers about 104 services.

EXPENDITURE REFORMS:

Apart from tax reform, expenditure form is also needed to reduce fiscal deficits and restore fiscal balance. Expenditure reform is key to control fiscal deficit. The burden of fiscal deficit reduction crucially depends on public expenditure management.

In an attempt to contain expenditure, there is also a need to redirect public expenditure for the creation of productive assets. Plan expenditure and capital expenditure may be regarded as those which can create productive assets. But, a disconcerting feature of the expenditure compression policy of the GOI has been a reduction in capital expenditure – capital expenditure as a proportion of GDP is declining over the years.

While plan expenditure has to be increased, non-plan expenditure has to be reduced. Non-plan expenditure has been on the increase. In the context of fiscal reforms, it is important that non-plan expenditure be reduced. The other category of expenditure that needs attention in the context of expenditure reform is the revenue expenditure. Revenue expenditure is expenditure incurred for purposes other that the creation of public assets. Revenue expenditure as a proportion of GDP has been on the increase, while capital expenditure as a proportion of GDP has declined steadily in the post reform period. This needs to be corrected.

EXPENDITURE REFORMS COMMISSION (ERC):

An Expenditure Reforms Commission (ERC) was appointed in 2000 to suggest measure for rationalizing public expenditure. Among others, the ERC paid special attention to subsidies (major component of revenue expenditure) and made several suggestions for reducing them. The important recommendations of the ERC are the following.

1. Food subsidy should be reduced allowing it only to the population below the poverty line.

2. Fertilizer subsides which have grown over the years should be withdrawn in a phased manner. For this purpose, the control system should be dismantled over time. Fertilizer industry should be completely decontrolled.

3. The ERC also recommended downsizing the government.

Expenditure forms, compared to tax reforms. Is a difficult and sensitive matter and is on a slow track. Reduction of subsidies, to contain revenue expenditure and reduce revenue deficit, is an important component of expenditure reform with political ramifications.

FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT (FRBM ACT):

To bring about the fiscal balance effectively, it was thought better to enforce fiscal balance legally. India opted for this course of action in the year 2000, when a Committee on Fiscal Responsibility Legislation was constituted to examine the various aspects of the Country's fiscal system and recommend adrift legislation in Fiscal Responsibility of the Government (Central Government). Subsequently, the Fiscal Responsibility and Budget Management (FRBM) Bill was introduced in the Lok Sabha in December, 2000. One of the important objectives of the FRBM Bill was to make the Central Government responsible for ensuring inter-generational equity in fiscal management and long term macroeconomic stability for attaining a sufficient revenue surplus by eliminating fiscal deficit.

The original Bill recommended certain time table for the reduction of Revenue Deficit and Fiscal Deficit. However, a Parliamentary Standing Committee which has studied the original Bill made certain recommendations to changes in the time frame and also deficit reduction targets. A revised version of the original FRBM Bill was passed by the Parliament in July 2004. The FRBM Act became effective from July 5, 2004. The Act required the elimination of Revenue Deficit by 2008-09. This means from 2008-09 onwards, the Central Government will have to meet all its revenue expenditure from its revenue receipts only.The Act mandates a 3 per cent limit on Fiscal Deficit after 2008-09.Besides stipulation annual targets for the reduction of fiscal deficit and revenue deficit, the FRBM Act provides for greater transparency in fiscal operations.

After the enactment, the trends in the deficits of the Central Government indicate that the fiscal deficit and the revenue deficit are getting reduced as per the targets of the FRBM Act. The Revenue Deficit is supposed to be reduced to zero by next year 2008-09. But one more year is required for the elimination of revenue deficit.

FISCAL REFORMS AT THE STATE LEVEL:

In a federal country like India, Fiscal imbalances at the State level and the need to reform is equally important. Fiscal reforms at the state level are important because States raise more than 1/3 of the combined revenue of the Centre and the States. Central and State Governments revenues also account for more than 50 per cent of the total or combined revenue expenditure. In 1990-91, the fiscal deficit attributable to the States was substantial – 3.5 per cent of GDP. The share of States' Fiscal Deficit in the combined Fiscal Deficit of the Centre and the States was 35.1 per cent in 1990-91. Revenue deficits of the State Governments were substantial and increased during 1990's.

As already indicated, a number of fiscal reforms have been undertaken by the Central Govt. since 1991. In a federal set up, State level fiscal reforms are extremely important and should complement the efforts of the Central Government to evolve a healthy fiscal system.The Eleventh Finance Commission recommended creating a Rs. 10,607 crores incentive fund so that implement reforms would be eligible to draw funds from this incentive pool. It identified 15 States with revenue deficits and stipulated that each of these States should contribute 15 per cent of its revenue deficit grants to the Fund, with a matching grant from the Centre.

Each of these States should reduce their revenue deficits as a proportion of their receipts by at least 5 per cent annually between 2000-05. The States which do not follow the set Time-Table for reform would forego their share of withdrawals from the incentive fund for that financial year. Accordingly, the Government of India created an incentive fund of Rs. 10,607 Crores to encourage States to implement monitorable fiscal reforms. 13 State Governments have so far evolved and undertaken their own fiscal reform programme and also entered into an agreement with the Central Government in 1999-2000.

The Twelfth Finance Commission also recommended that each State Government should enact a Fiscal Reform Legislation (FRL) which would be a precondition for debt relief. To facilitate a Rule Based Fiscal Programme at the State level, the Reserve Bank of India constituted a Group to frame a model Fiscal Responsibility Bill. The Group submitted its report in January, 2005.

In accordance with this, States have also begun the process of fiscal consolidation in line with the Twelfth Finance Commission recommendations to complement the efforts of the Central Government. As recommended by the Twelfth Finance Commission and following the example of the Central Government, 26 out of 28 State Government have enacted the FRL's so far. Most of the FRL's have stipulated the elimination of the revenue deficit by March 31, 2010, so as to be in line with the targets recommended by the Twelfth Finance Commission.

The fiscal situation of the States has shown considerable improvement in the wake of FRL's. The enactment of the FRL's has provided a crucial impetus to the process of attaining fiscal sustainability. It has moved the rule based programme of fiscal reforms in the country further ahead.

FISCAL REFORMS: A CRITIQUE:

The need for economic reforms in June/July 1991 was acutely felt in view of the balance of payments crisis and the growing fiscal imbalances. The fiscal crisis was a result of the fiscal profligacy of the Central and State government during 1980's. This contributed to a balance of payments crisis necessitating wide ranging economic reforms, of which fiscal reforms is the important one. The need for restoring fiscal balance by reducing fiscal deficits was widely recognized and a number of tax reforms and expenditure reforms were initiated. Tax reforms included expanding the tax base, reducing the rates leading to improved tax compliance and making the tax administration more efficient. These measures increased tax revenues considerably. Expenditure reforms concentrated on the major subsidies-food, fertilizer and petroleum so as to rational is them. The FRBM Act and FRL's at the State level have taken the fiscal reforms further ahead and the progress of fiscal reforms so far is quite satisfactory.

However, while fiscal consolidation and fiscal adjustment are important, the quality of fiscal adjustment is as much important as its quantity. There is a view that drastic reduction in fiscal deficit has led to compression of Government's capital expenditure and a reduction in public investment. The latter is critical to the development of infrastructure-physical and social. An optimum fiscal adjustment programme should protect not only investment but also social expenditure and most social expenditure is incurred at the State level and (education and health). The quality of fiscal adjustment is a matter of concern as it has led to a decline in capital expenditure and expenditure on social services - this needs to be corrected.

The issue of fiscal adjustment should also be viewed in the context of India's democratic instuitions. At a more realistic level, India's fiscal crisis can be traced to the changing nature of Indian democracy-more demands on the State and political decay have led to a path of populist politics and fiscal excess which is not good for the future of democracy in the Country. This needs serious reflection and necessary correction.Further, fiscal deficit, which is a key variable in the fiscal reform programme, is not bad per se. The only question is its appropriate level. This depends on a number of factors – the level of savings, the existing stock of debt, and debt servicing burden, the rate of interest, the external payments situation, the degree of capital controls and most importantly, the use to which borrowed resources are put. This is an important point that should received proper attention in any fiscal reform programme.

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