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FISCAL POLICY IN INDIA: PAST REFORMS AND FUTURE CHALLENGES

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ABSTRACT/RÉSUMÉ

Fiscal policy in India: past reforms and future challenges

This paper examines varies areas of India´s fiscal policy, in particular fiscal discipline, the structure of government spending, the tax system and fiscal federalism. It describes reforms over the past decades which, as part of the overall economic reform agenda, helped lifting the Indian economy to a higher growth path. It also discusses where further reforms are desirable to further reduce economic distortions and improve the provision of public services. It finds that after high fiscal deficits have often been recorded during the past two decades, after the adoption of the Fiscal Responsibility and Budget Management Act in 2003, fiscal discipline has significantly improved. As to government spending, it argues that, given the large share which is used to subsidise commercial undertakings, agriculture and food distribution, there is much room to improve the quality of spending and to target it better to improving infrastructure and reducing poverty. It describes the tax system which has undergone major reforms since the early 1990s. Nonetheless, there are still many exemptions and loopholes which suggest that a broadening of the tax bases would allow further reductions in tax rates and make the system simpler, fairer and more efficient. The paper also suggests that reforms of indirect taxes should focus on creating a common market within India so that goods can move between states without border controls. Finally, on fiscal federalism it finds that India's federal structure has led to a well-developed system of tax-sharing and transfers, both through constitutionally empowered bodies and delivered through the annual budget. While overall, India´s fiscal federalism has worked well moving resources towards the poorest states, it has become very complex and there are still some features which weaken fiscal discipline of the states. Furthermore, a major drawback is the lack of an effective local government system, most notably in rural areas and strengthening the local level would be important for improving accountability and responsiveness to citizens' needs as three-quarters of the population live in states with over 50 million inhabitants.

This Working Paper relates to the 2007 OECD Economic Survey of India (www.oecd.org/eco/surveys/india).
JEL classification: H1, H2, H5, H6, H7.
Keywords: Fiscal policy, Government spending, Taxation, Fiscal Federalism, India

La politique budgétaire en Inde : réformes passées et challenges pour l'avenir

Nous examinons dans ce document différents aspects de la politique budgétaire indienne, notamment la discipline budgétaire, la structure des dépenses publiques, le système fiscal et le fédéralisme budgétaire. Nous décrivons les réformes mises en œuvre au cours des dernières décennies, qui, dans le cadre du programme global de réformes économiques, ont contribué à rehausser la trajectoire de croissance de l'économie indienne. Nous nous demandons également si de nouvelles réformes sont souhaitables pour réduire encore certaines distorsions économiques, et améliorer la prestation des services publics. Nous parvenons à la conclusion qu'après deux décennies fréquemment marquées par de volumineux déficits budgétaires, la discipline budgétaire s'est sensiblement améliorée à la suite de l'adoption de la Loi de responsabilité et de gestion budgétaires de 2003. S'agissant des dépenses publiques, nous estimons que, dans la mesure où une grande partie des fonds est utilisée pour subventionner des entreprises commerciales, l'agriculture et la distribution de produits alimentaires, les autorités disposent de marges de manœuvre considérables pour améliorer la qualité des dépenses et mieux les cibler, en vue d'améliorer les infrastructures et de faire reculer la pauvreté. Nous décrivons également le système fiscal, qui a fait l'objet de réformes de fond depuis le début des années 90. Il n'en demeure pas moins caractérisé par un grand nombre d'exonérations et de lacunes, ce qui laisse à penser qu'un élargissement de l'assiette des impôts permettrait de réduire davantage leur taux, tout en rendant le système fiscal plus simple, plus équitable et plus efficient. Nous estimons par ailleurs que les réformes des impôts indirects devraient être axées sur la création d'un marché commun en Inde, de manière que les biens puissent circuler entre les États de l'Union sans contrôle à leurs frontières. Enfin, s'agissant du fédéralisme budgétaire, nous parvenons à la conclusion que la structure fédérale de l'Inde a débouché sur un système étoffé de partage des recettes fiscales et de transferts, reposant sur des organismes constitutionnels ou s'inscrivant dans le cadre du budget annuel. Globalement, le fédéralisme budgétaire indien a bien fonctionné et permis de redistribuer des ressources aux États les plus démunis, mais il est devenu très complexe et présente encore des caractéristiques qui nuisent à la discipline budgétaire des États. En outre, un de ses inconvénients majeurs réside dans l'absence de système d'administration locale efficace, en particulier dans les zones rurales. À cet égard, il serait important de renforcer le niveau local d'administration pour responsabiliser davantage les autorités et les rendre plus attentives aux besoins des citoyens, dans la mesure où trois quarts de la population vivent dans des États de plus de 50 millions d'habitants.

Ce document de travail est lié à l'*Étude économique* qu'a consacrée l'OCDE à l'Inde en 2007 (www.oecd.org/eco/etudes/inde).
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FISCAL POLICY IN INDIA: PAST REFORMS AND FUTURE CHALLENGES

By Richard Herd and Willi Leibfritz[1]

Introduction

India's fiscal system has been reformed significantly since the early 1990s, in particular in the area of taxation. This has, together with other fundamental economic reforms, contributed to a remarkable transformation of the Indian economy leading to significantly higher economic growth and – for the first time since Independence – a decline in the absolute number of people living under the poverty line (see OECD, 2007). This paper describes fiscal reforms over the past two decades and examines a number of fiscal policy issues, such as the development of deficits and debt levels, government spending, taxation and fiscal relations between the different levels of government. It identifies areas where additional reforms could help to further reduce economic distortions and improve the provision of public services. It first looks at fiscal consolidation which has been addressed with some delay but has made progress more recently. It then analyses government spending and spending areas where reform has progressed, as in the pension system, or where additional controls are needed, as with subsidies and public-sector wages. This is followed by a description of the main elements of the tax system, which has been significantly improved during the past and suggestions for further reform. The last section examines India's system of fiscal federalism and recent and possible additional reforms to this system.

The strengthening of fiscal rules is bearing fruit

In India, government saving (net of depreciation) has been persistently negative since the early 1980s implying a significant use of private savings to finance current government spending. In the second half of the 1980s, when the government had pursued expansionary fiscal policies to support growth from the demand side, the central and state governments ran large deficits averaging together 8% of GDP. These deficits contributed to the foreign exchange crisis in 1991 which then prompted the far-reaching economic reforms. The combined deficit then declined until 1996-97, but increased again in the following years. Net dis-savings of general government peaked in FY 2001. The government was then absorbing almost half of the nation's saving in order to finance its own consumption outlays (Figure 1). In addition, the government was borrowing to finance its investment, capital transfers and loans to state-owned enterprises. As a result, the borrowing requirement (fiscal deficit) of state and local governments had reached nearly 10% of GDP by 2001 and public debt was rising significantly.

In order to end this unsustainable situation, the central government enacted legislation to improve fiscal discipline. After close to three years discussion, the Fiscal Responsibility and Budget Management Act (FRBM) was adopted in August 2003. This Act sets a medium-term target of achieving a balance between current revenue and current spending (*i.e.* a zero-revenue deficit) by 2008 and limits the overall fiscal deficit for the central government to 3% of GDP. By 2006 the central revenue deficit had only been reduced to 2% of GDP, but the fiscal deficit had been reduced to 3.7% of GDP (Table 1). The 2007 budget confirms the faster adjustment of the fiscal deficit, which is only slightly greater than the target for 2008 incorporated in the FRBM Act. However, the revenue deficit is expected to be 1.5% of GDP, indicating that a very sharp reduction would be necessary to meet the target of the FRBM for this balance. In effect,

1. Richard Herd is Head of the country desk for India and China in the Economics Department of the OECD and Willi Leibfritz was, at the time of writing, Head of Country Studies Division 3 in this department. This paper draws on material originally produced for the *OECD Economic Survey of India,* published in October 2007. The authors would like to thank A. Dean, C. Heady, K.L. Prasad, R.C. Srinivasan and V. Koromzay for valuable comments and the Indian authorities for providing important information. Special thanks go to Thomas Chalaux for technical assistance and to Nadine Dufour for technical preparation.

the central government has not been able to stem the increase in current expenditure as much as had been planned and, consequently, the hoped-for increase in the extent of investment, which would have raised the fiscal deficit relative to the current deficit, has not materialised.

The FRBM Act also improved the transparency of budgetary policy. The Act provides that the government has to lay three documents before Parliament every year: one with an assessment of economic prospects, another with its strategy with regard to taxation and expenditure, and the final one giving a three-year rolling target for the revenue balance and the overall fiscal balance. Quarterly progress reviews have to be placed before Parliament. The second quarter review is the most important because a statement of the remedial steps that will be taken to offset any shortfall from targets has to be provided to Parliament. The government now also publishes its asset register annually, so permitting the calculation of a net asset position for the government. Its revenue account, though, does not account for capital consumption. Estimates of the revenue foregone through exemptions and concessions from standard tax rates are now also published annually, and the central government has made a first step towards accrual accounting by publishing the outstanding amounts of tax and non-tax revenue.

During 2005, 23 state governments introduced similar legislation and, by the middle of 2006, only three states – West Bengal, Sikkim and Jharkhand – had not introduced such laws, mandating a fiscal deficit of 3% of state GDP. To some extent, this move reflected the incentivisation process of the Finance Commission, a body established by the constitution to advise on the sharing of tax revenues between the centre and the states. Standardised and rapid accounting procedures are still lacking at the state level and are almost non-existent at the municipal level with most local authorities not even using a double-entry accounting system.

States have also reduced their fiscal deficits after the severe financial pressures that they faced at the beginning of this decade. These pressures were the result of a failure to adjust other expenditures after large centrally-determined pay and pension increases at the end of the 1990s. With increased outlays funded from borrowing that amounted to nearly 40% of income, outlays on wages, pensions and interest increased to almost 70% of current revenues on average in the period 2000-03. The process of consolidation started in 2004 and has continued since then with the states planning to almost eliminate (on average) their revenue deficit in 2006 and reduce their fiscal deficit of 2½ per cent of GDP (Table 1). The increases in the states' own tax revenues has been helped by a significant increase in transfers from central government which came in the form of higher shared taxes, increased grants and write-offs of interest due to the central government.

The process of consolidation is far from uniform across the states. In 2005, the remaining revenue deficit of the states was concentrated in just four states (Jharkhand, Kerala, Uttaranchal and West Bengal) where the fiscal deficit still amounted to between 35% and 60% of state government revenues, with similarly large revenue deficits for three of them. Indeed, these four states accounted for the whole of the revenue deficits of states – small deficits elsewhere were offset by surpluses in a number of states. As a result, debt levels of these four states continued to increase, rising from 37 to 47% of state GDP between 2000 and 2005 – a particularly high burden given that their total revenue from taxation and transfers from central government amounted to just 14% of their GDP.

Table 1. Government budget balances

Per cent of GDP at market prices, fiscal years starting 1st April

	2001	2002	2003	2004	2005	2006	2007
General government accounts							
Revenue	16.3	17.0	18.1	18.4	19.0	. .	. .
Expenditure	23.5	23.2	22.8	21.9	22.5	. .	. .
Net saving	−7.2	−6.3	−4.6	−3.6	−3.5	. .	. .
Net capital formation							
Administrative units	1.8	1.8	1.6	1.7	2.4	. .	. .
Departmental enterprises	0.1	0	0	0	0.2	. .	. .
Net capital transfers and other	0.7	0.8	0.7	0.5	0.5	. .	. .
Total above	2.6	2.6	2.3	2.3	3.1	. .	. .
General government balance	−9.7	−8.9	−6.9	−5.7	−6.6	. .	. .
Budgetary accounts							
Current balance							
Central	−4.4	−4.4	−3.6	−2.5	−2.6	-2.0	-1.5
State	−2.6	−2.2	−2.2	−1.2	−0.5	0.0	. .
Central + State	−7.0	−6.7	−5.8	−3.9	−3.1	-2.1	. .
Financial balance (excludes net lending)							
Central	−5.7	−5.8	−4.8	−4.2	−4.1	-3.6	-3.1
States	−4.0	−3.7	−4.1	−3.1	−2.9	-2.5	. .
Central + State	−9.7	−9.5	-9.0	−7.7	−7.0	-6.1	. .
Fiscal deficit							
Central	−6.2	−5.9	−4.5	−4.0	−4.1	-3.7	-3.3
State	−4.2	−4.2	−4.5	−3.5	−3.2	-2.6	. .
Central + State[1]	−9.9	−9.6	−8.5	−7.5	−7.4	-6.3	. .

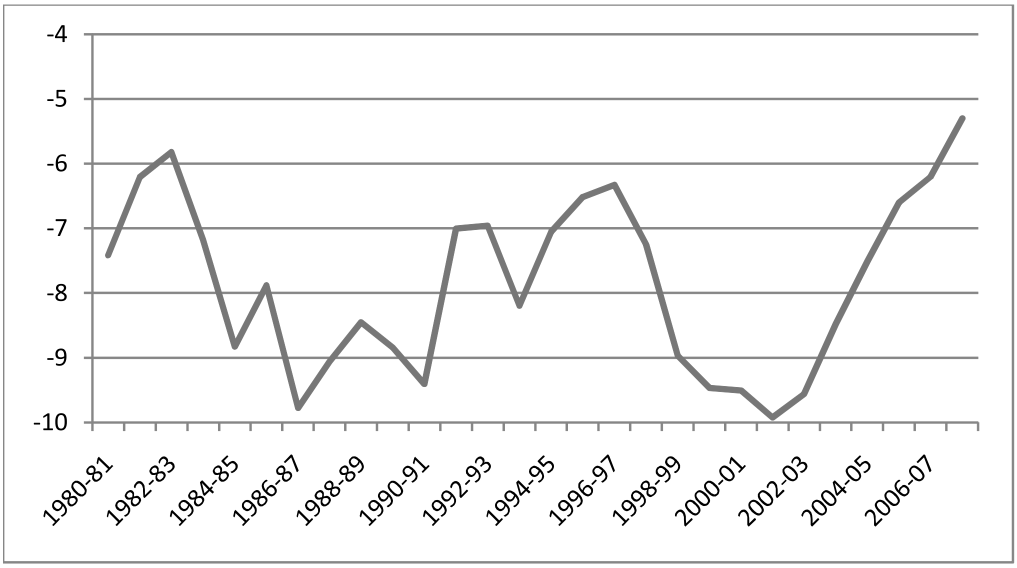
Note: 1. The combined fiscal deficit of state and central governments is not the sum of their respective deficits as the two levels of government follow different accounting principles. Central government counts repayment of loans by state governments as part of capital income. On the other hand, state government governments do not count as capital expenditure, repayments of loans from central government. The discrepancy has to be allowed for when consolidating the two deficits. In addition, state governments express their deficits relative to state GDP. The sum of the estimates of state GDP exceeds national GDP which a reason why the aggregate deficits when expressed as a share of GDP is not the sum of two individual deficits for central and state governments expressed as shares of national and state GDP, respectively.

Source: Reserve Bank of India, State Finances, Ministry of Finance, Public Finance Statistics, Economic Survey and Budget Documents, Central Statistical Organisation: National Accounts Statistics.

The current FRBM targets have provided a marked check to the growth of public debt. The combined fiscal deficit of state and local governments has fallen to 6.3% of national GDP and should reach 5.7% of national GDP in fiscal year 2008, if deficit targets are met, slightly less than might be thought given that the both levels of government are aiming for a 3% deficit (see footnote one of Table 1 for an explanation of the differences). The current consolidation compares favourably with the past. In the second half of the 1980s when the government had pursued expansionary fiscal policies to support growth from the demand side, the combined deficit of the centre and of states amounted to between 8-10% of GDP, and these high deficits contributed to the foreign exchange crisis in 1991 which then prompted economic reforms. The combined deficit then declined until 1996-97, but increased again in the following years and in 2002 it peaked at 10% of GDP (Figure 1).

Figure 1. Evolution of the combined fiscal balance of the Centre and the States

In percent of GDP

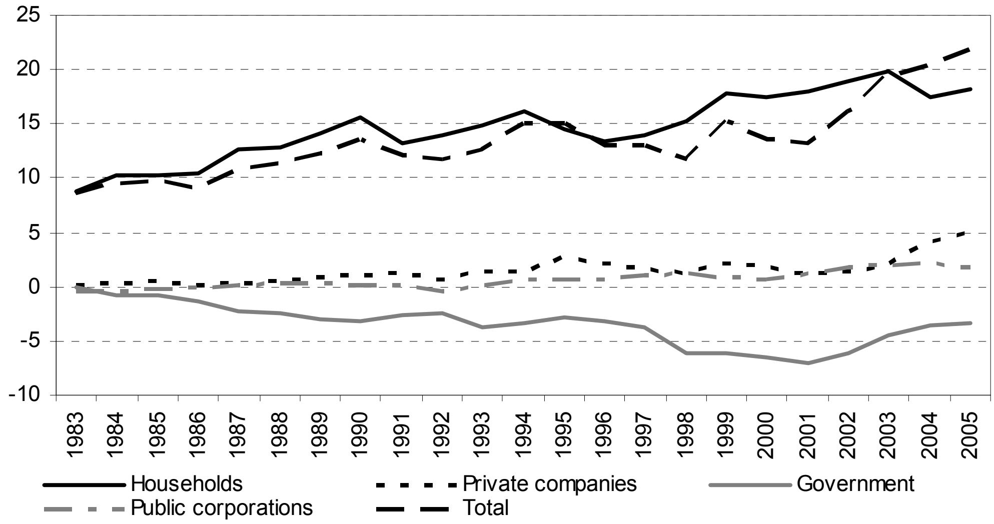


Source: Ministry of finance, Government of India.

The current consolidation is clearly positive for economic growth. In the past, increases in interest payments have crowded out other government spending including public investment which led to the built-up of infrastructure bottlenecks. In addition, the government was absorbing a large part of private saving for government consumption. As a result of consolidation, government interest payments are declining as a share of GDP and government investment is rising again. The reduction in government dis-saving also contributes to the increase in national savings (Figure 2).

Figure 2. India's national net savings rate and its components

Per cent of GDP at market prices

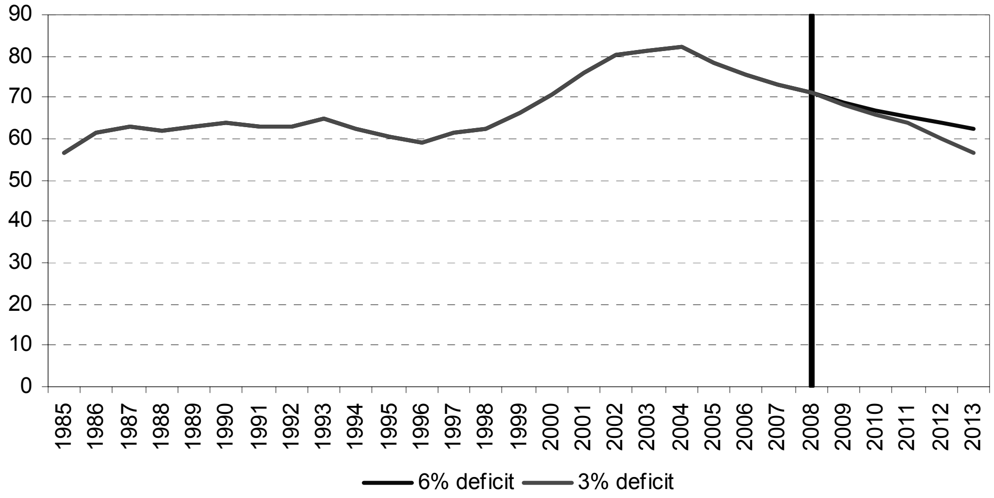


Source: Central Statistical Organisation, National Account Statistics.

The combined liabilities of the states and central government have fallen from a peak of 82% of GDP in 2004 to 76% in 2006 and are likely to fall a further 6 percentage points by 2008. Assuming medium-term annual growth of nominal GDP of around 13% and interest rates of no more than 8%, then current fiscal targets would result in a further gradual decline of the debt to GDP ratio (Figure 3).

Figure 3. Government debt

Past development and scenarios on the assumptions that the combined fiscal deficit is maintained at 6%, or alternatively, reduced to 3% of GDP by 2013



Source: Reserve Bank of India, various national sources and OECD projections.

Some risk factors remain

While fiscal consolidation is clearly visible both at the level of the Centre and of States, there are also some risks. *First,* a small part of the improvement in revenues in FY 2006 and FY 2007 reflects the economic boom and was cyclical as actual GDP was growing faster than potential GDP[2]. As a result, the actual deficit declined faster than the cyclically adjusted (structural) deficit and in a future cyclical downturn this will be reversed. *Second*, the recommendations by the Sixth Pay Commission may lead to another hike in public wages and overall government spending. In the public sector, pay is set in a two-stage process. Each year, there are small pay increases. In addition, about once per decade there is a Pay Commission established at the central level to establish the appropriate level and structure of salaries and make recommendations on personnel management. The last Commission, in 1996, recommended a 30% pay hike that boosted government pay by over 1% of GDP, relative to pay recommended by the previous Pay Commission a decade earlier. This Commission recommended compensating the pay increases by a reduction in the number of staff but this part of the recommendation was never implemented. A new Pay Commission has just been established. Although the risk of major increases in pay stemming from this Commission may be lower than in previous episodes as civil service wages have been indexed on inflation, following the merging of the basic pay scale and the "dearness" allowance, it still exists. In general, such a large interval between Commissions carries the risk of pay differentials moving out of line with those in the market and so the interval between Commissions should be markedly reduced. *Third,* while the budget constrained has been hardened by the FRBMA in those states which

2. Between Fiscal Year 2003 and 2007, actual GDP increased by 39% while potential GDP grew by 36%.

adopted such legislation, some features of the Indian fiscal and financial system continue to work in the opposite direction and reduce the flow of savings to private investment. This is, in particular, the case for the obligation of states to borrow 80% of the proceeds of the National Small Savings Fund (NSSF) (see below). *Fourth,* the provision of infrastructure by the private sector (through Private-Public-Partnerships, PPPs) is gaining in importance. While this helps narrowing infrastructure bottlenecks, there is also the risk of contingent liabilities as the government provides guarantees or may even without guarantees may be forced to bail-outs if some projects turn out to being not viable on a commercial basis. It is therefore important to careful select and monitor such projects. The OECD´s "Principles for Private Sector Participation in Infrastructure" provides guidelines for governments to minimize such risks (OECD, 2007*b*).

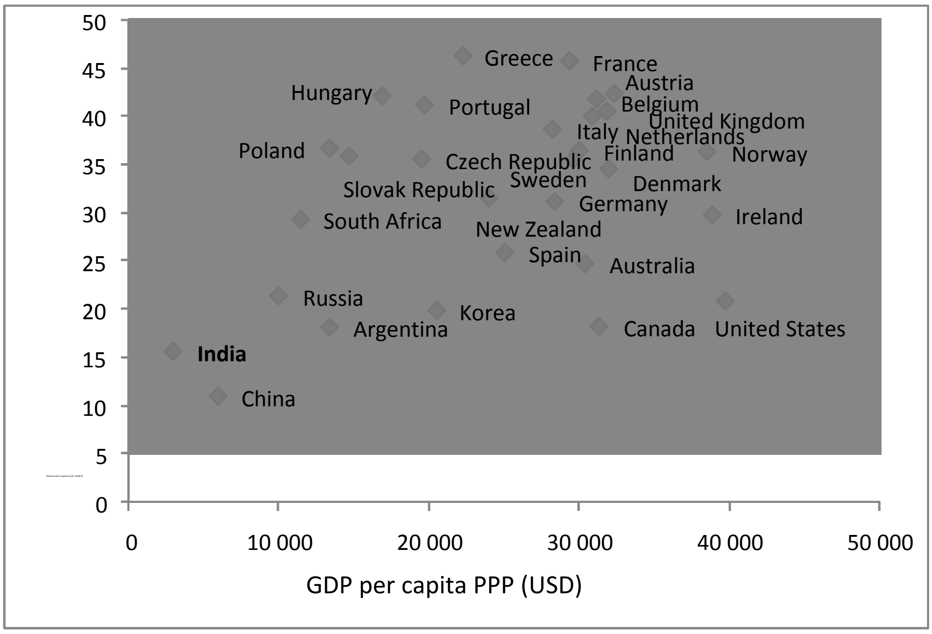
Are fiscal targets ambitious enough?

While a gradual decline in the debt to GDP ratio indicates a sustainable fiscal position, the general government's balance sheet reveals a further deterioration of the government's net asset position as government borrowing continues to exceed the level of net capital formation. Currently, net capital formation by the general government sector (including departmental enterprises such as the post office and state road transport agencies) amounts to 2½ per cent of GDP, with a further small and declining amount of capital transfers. Part of these transfers represent infusions of capital to loss-making enterprises. They should be considered as a form of subsidy rather than capital formation. Consequently, if governments wished to restrict their borrowing to a level that covered net investment, a fiscal deficit of no more than 3% (at current levels of investment) for both levels of government, rather than the current 6% deficit, would be needed. It would ensure that government debt returns to the level of the mid-1990s by 2013.

Improving the quality of government spending

India´s level of government spending is less than in all OECD countries with the exception of Mexico where spending is some 5 percentage points of GDP below that in India (Figure 4). One reason for the relatively low spending level is the absence of a broad-based social security system. The level of general

Figure 4 Government spending and per capita income: an international comparison



Source: World Development Indicator (WDI).

government expenditure (national accounts definition) rose only slightly from just under 23% to just over 25% of GDP in the decade to 2003. The increase in public spending in the decade to 2003 was driven by increases in interest payments, which rose from 4 to 6% of GDP, while investment expenditure remained constant at just 1.6% of GDP. Total outlays on salaries, pensions to retired staff and interest amounted to just over half of total outlays in 2003. Since 2003, current spending by central government has expanded at a measured pace, almost 2 percentage points below the growth of GDP.

Reducing subsidies and improving their efficiency and transparency

Achieving the government's higher growth target requires greater investment. In part, that could be achieved by holding the growth of government expenditure below that of revenue and thereby increasing saving and private investment. However, some restructuring of public expenditure might also be possible. All levels of government have devoted a significant amount of resources to subsidising economic activities. Measuring the extent of subsidies is complicated. One approach to measuring subsidies is to use the definition of national accounts, which is similar to that used in the budget. With this definition, subsidies paid by all three levels of government amounted to 3.1% of GDP in FY 2003, markedly higher than most OECD countries and about seven times higher than in China and Brazil (Figure 5).

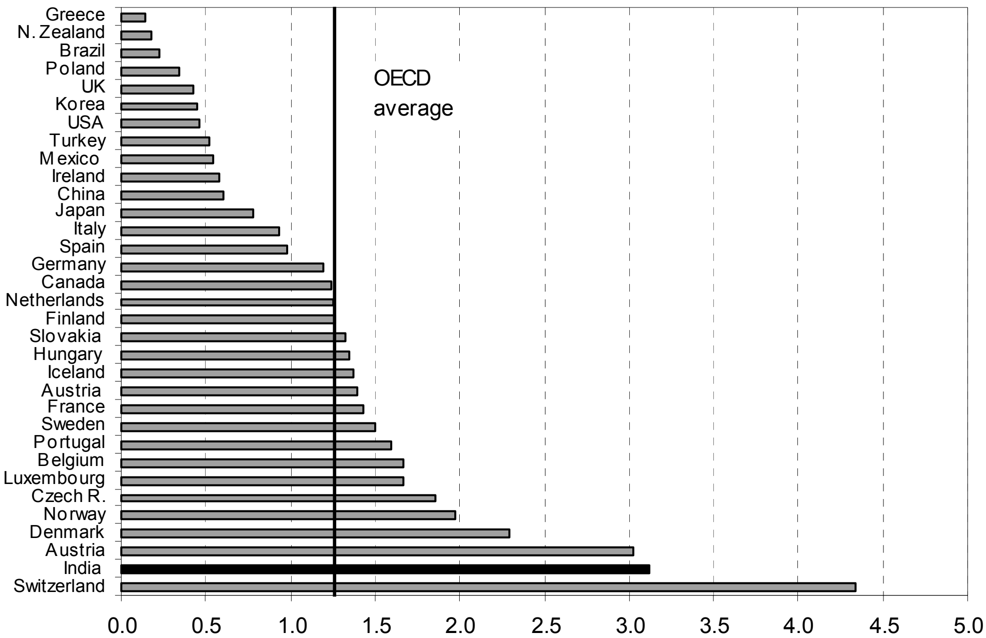
These direct measures of subsidies understate their full amount as they only measure cash flows and not the opportunity costs which arise from the government providing goods and services below cost. Estimating the opportunity cost of the provision of subsidised economic services (excluding education, healthcare and labour market services, which are generally provided by government), central government outlays on subsidies were more than double the explicit subsidies measured in the budget and the national accounts in 2003 (Government of India, 2004). At the state government level, in 1998 the total subsidy was four times greater than the budgetary estimate due to the large implicit subsidies to agriculture, irrigation, power, water and sanitation, and road transport (Rao, 2003). No update is available for total state subsidies, but it seems likely that this broad measure of total subsidies for both state and central government exceeded 8% of GDP in 2003. In addition to subsidies, there are considerable cross-subsidies in India. These occur in many of the sectors where the state is a monopoly provider. Examples are electricity, railway transport, kerosene, road passenger transport and telephone calls. In total these cross-subsidies amounted to 2.3% of GDP in 1999 (Ahluwalia, 2000).

The high subsidy outlays as a percent of GDP also biases the structure of total government spending (Figure 6). In India, around two-thirds of total government outlays (excluding interest but including loans) is on functions other than general administration and defence. One-half of this is spent on support to commercial undertakings and subsidies for food and the agricultural sector. Three-quarters of the transfers to enterprises go to electricity, gas, water and communication enterprises, either in the form of outright subsidies or as capital transfers to cover losses and/or finance expansion. A large part of the total sum spent on the enterprises is provided as loans. However, given that most of the state-owned utilities are loss-making, such loans do not represent a source of future income for the government but rather a source of future subsidy payments. Additional structural reforms are necessary to ensure that government-owned units can reduce losses while at the same time improving service delivery (OECD, 2007*a*).

Aside from subsidies and transfers to public utilities, a considerable part of the subsidies on food, fertilizers and kerosene result in the waste of public money due to faulty delivery. Given the proportion of families living below the poverty line, the government has put into place a programme to ensure that low income families are able to purchase a number of basic products at subsidised prices through a network of "fair price shops". Overall, expenditure on food and agricultural subsidies was equivalent to 1.6% of GDP, of which food subsides amounted to 0.8% of GDP in 2004, double their level of 1990. Analysis of the programme shows that it is bedevilled by poor administration and corruption (Planning Commission, 2005). Nationwide, over one-third of the grain distributed through the system is diverted

Figure 5. General government budgetary subsidies

2003, per cent of GDP



Source: OECD Economic Outlook database, Central Statistical Organisation and national sources.

either by the shopkeepers or through the existence of "ghost" ration cards. The beneficiaries of this diversion are officials in state governments and the Food Corporation of India and wholesale and retail dealers. In addition, one-fifth of the grain goes to people wrongly included in the programme, bringing the total loss to 58%. In two of the poorest states, Bihar and Uttar Pradesh, the loss rises to 98% and 80% respectively (*op. cit.*). For fertilizers, only 68% of the subsidy is estimated to accrue to farmers, with the bulk being paid to large farmers in irrigated areas (Ministry of Finance, 2004).

The wide dispersion of performance across states in the efficiency of delivering food subsidies suggests a number of possibilities for reform. In particular, the two states with the highest delivery of subsidies to the targeted population have innovative schemes in place. In Andhra Pradesh, a coupon system has been introduced that allows rationed goods to be drawn in smaller quantities which reduces the probability of undrawn rations being diverted to the market, while in Tamil Nadu, target households are allowed to trade their excess rations against other rationed commodities (sugar and kerosene). Both of these schemes point to the possibility of establishing a food stamp system, especially if the beneficiaries can be publicly verified at the village level but the Tamil Nadu Government found that even food stamps, imposed transaction costs and so withdrew the scheme.

As mentioned above, in addition to the direct on-budget subsidies, the government also grants subsidies through fixing the prices of products of the public enterprises below shadow market prices (most often there is no market price and as a result the prices adopted are based on international parity-import or export – mostly of the former variety). This is particularly the case with liquefied petroleum gas (LPG) and kerosene.[3] Kerosene is distributed through the public distribution system and it is estimated that about 38%

3. Three methods are used to finance the off-budget subsidies: first, the state-owned domestic oil producers are obliged to make a payment to the state-owned oil marketing companies while the latter have to bear the cost of the subsidy from their profits on gasoline and diesel sales. In addition, a small direct budgetary

of the total deliveries are diverted to the black market, where prices are three times higher. For LPG, while the market price is 45% higher than the subsidised price, the overall subsidy is larger and largely accrues to higher income urban residents. Finally, the budget has been deprived of higher profits from the state-owned marketing companies by the failure to allow regulated prices for gasoline and diesel to rise in line with world market prices and prevalent tariffs (at a cost of 0.5% of GDP); the budget was further hit by reductions in tariffs on oil imports that may have cost the exchequer 0.3% of GDP in 2005.

The subsidy system is essentially directed at helping people who live below the national poverty line, but some people are unable to find sufficient work to purchase even subsidised goods and so the government has introduced an employment guarantee scheme. This programme aims to provide 100 days work to people in 330 districts of the country, with an estimated cost of 0.3% of GDP for this system. The programme is not restricted to people below the poverty line and some simulations suggest that a significant part of the benefit will accrue to households above the poverty line. (Murgal and Ravallion, 2005). This programme is innovative but previous programmes of a similar nature have proved difficult to implement at the local level. Many analysts have suggested that the various poverty alleviations programmes are subject to considerable risk of money not being used for its prescribed purpose (Saxena and Ravi, 2006). Indeed the Planning Commission concluded that "in the absence of acceptable levels of governance, it would be preferable to eschew targeted programmes in favour of more generally applicable schemes" (Planning Commission, 2002). The government is aware of its experience with similar schemes, such as food for work and drought relief, that reveal waste, leakage and corruption caused by weak monitoring systems and lax accountability mechanisms (Rangarajan, 2005). The employment guarantee programme, though, does represent a step to providing a form of social safety net for the rural population that could be effective, though costly, in terms of reducing poverty, if efficiently administered. Indeed, the objective of the programme is to provide a safety net rather than reduce poverty.

In general, the efficiency of government administration is reduced by the relatively small number of higher skilled staff. The structure of the bureaucracy is heavily skewed in favour of lower grades reflecting the legacy of the colonial era. The structure should be oriented to recruiting more skilled staff with competitive pay scales and markedly reducing the use of paper-based transactions. At present the central government has placed severe restrictions on recruitment of lower grade staff which could yield considerable savings going forward were it fused with a reengineering of business processes (see OECD, 2007).

The public pension system is presently being modernised

The government has acted to ensure that the liabilities of the public pension system are contained. Public pension payments rose from 1.1% to 2.0% of GDP between 1990 and 2005. If such an increase had continued, payments might have reached 2.3% of GDP by 2009 (Chidambaram, 2007). As from 2004, however, the government closed the existing defined benefit scheme to new entrants who, instead, will contribute to a two-tier defined contribution system. This is beginning to help ease pressure on expenditure which may grow at a slower pace over the period till 2009 when pension outlays are expected to be only 1.7% of GDP.[4] Contributors will be able to decide between three different investment strategies. The system separates management, record keeping and fund management into separate operations. Government

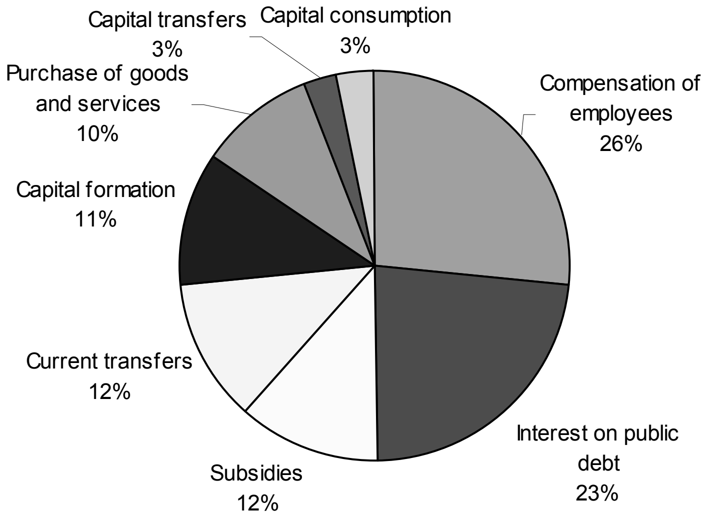
subsidy is paid to the oil companies. Finally, the government issued "oil" bonds to marketing companies. These bonds were granted to companies and there was no expenditure item in the budget for this grant. In total, in FY 2005 and 2006 off budget subsidies amounted to 90% of the total subsidy. Excluding the oil bonds subsidies amounted to 0.8% of GDP

4. Earlier government reports have suggested that there is considerable uncertainty surrounding pension projections due to the weakness of the underlying data on pension payments (Ministry of Finance, 2001).

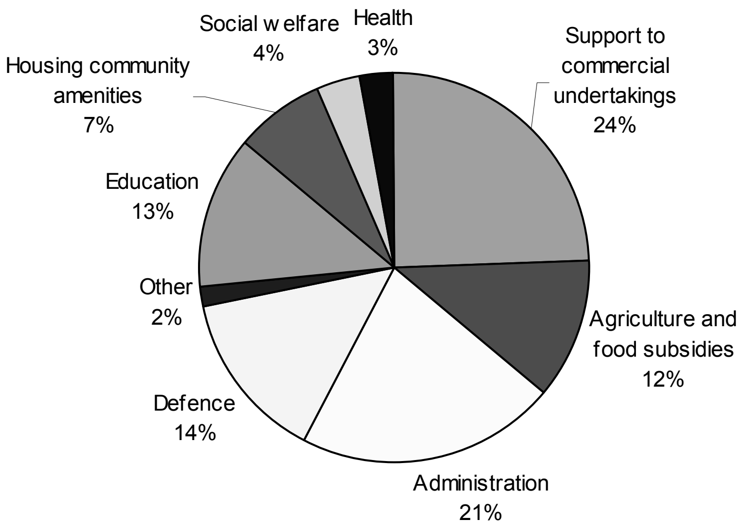
Figure 6. Government spending by type and function in 2003

Per cent of total government spending

By type of spending



By functional area



Source: National Account Statistics, 2006.

employees will pay 10% of their salary to the "tier one" account and this will be matched by the government. They will also be able to contribute to a "tier two" account on a voluntary basis. Withdrawals can be made from this tier but it will not attract tax concessions. Three years after its announcement, the system has not yet been fully implemented due to delays in passing the bill for a pension fund regulator. Nonetheless, contributions have been accumulating and four fund managers will be appointed, but no private sector fund managers will be allowed. State governments have also followed these reforms with 19 states, covering 82% of the population, having adopted the system by January 2007. West Bengal and Kerala are the principal states that refuse to implement the scheme at the state level.

Once the record-keeping system has been put in place, private sector employees will be eligible to join the system. They can deposit funds in the first tier of the system but there will be no matching contribution from the government as will be the case for public employees. As for civil servants, at retirement the individuals will have to use a fixed proportion of the funds in their accounts to purchase annuities with the remainder being taken as a cash sum. Once working, this system will provide the first universally available pension for private sector workers. Previously less than 3% of the private work force was eligible for pensions.

Conclusions

Public expenditure is neither high in relation to GDP nor in relation to the needs of the economy and citizens for public services. However, there is ample evidence that spending could meet a number of the government's goals in a more efficient manner. The high proportion of expenditure that is devoted to the support of public sector enterprises is one area where considerable economies could be made through lessening the need for such transfers by making the recipient enterprises more efficient and improving governance (OECD, 2007). Similarly, the use of subsidies appears to be excessive and costly in relation to the presumed goal of reducing poverty. These subsidies have other goals but these too need careful evaluation to ensure that money is being spent effectively. As yet, it is too early to evaluate the National Rural Employment Guarantee programme, but major efforts will be required to ensure that the problems seen by previous programmes do not re-occur. More broadly, there appears to be a need to improve the monitoring and control of public expenditure. The public distribution for food and fuels, in particular, seems to need considerable reform. Reform of spending has been undertaken in some areas. The move to a defined contribution retirement saving system is to be welcomed, even if it has been slow in implementation. It could form the basis of a much wider retirement security programme to cover people working in the private sector.

India's tax system has been fundamentally reformed

Since the early 1990s, India´s tax system has undergone a landslide change from a highly interventionist system towards more neutrality. In the decades before, taxes were – together with licenses and other regulations – the main tool to allocate resources according to central economic planning towards priority sectors and at the same time redistribute income which accrued in protected markets. As a result, effective tax rates varied widely across sectors and incomes which created inefficiencies and led to large-scale tax evasion.

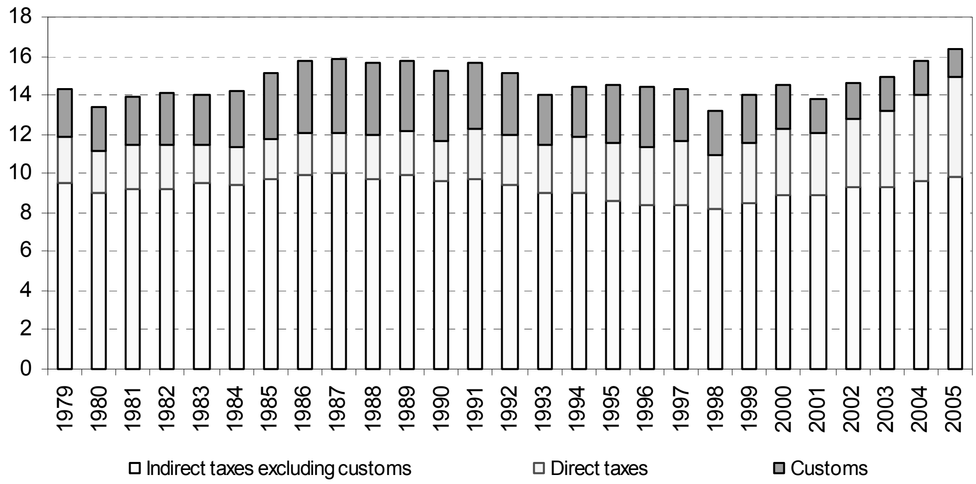
During the first three to four decades after Independence India´s tax system was characterized by highly redistributive income tax rates, high import tariffs, a multitude of excises besides the sales tax and at the same time many exemptions and preferential treatments which aimed at channelling resources towards priority sectors. This system turned out to be inefficient and unfair and also led to widespread tax evasion.[5]

5. The British economist Nicholas Kaldor reviewed in 1956, at the request of the Indian government, India´s direct tax system. He described it as inefficient and inequitable because of its narrow tax base and the lack

In the second half of the 1980s, under Prime Minister Rajiv Gandhi, tax reform ranked high on the policy agenda and steps were taken to rationalize the tax system. At the beginning of the 1990s, fundamental reforms were undertaken in the area of taxation in a manner that enhanced the efficiency of the economy. Marginal tax rates for individuals and companies were reduced significantly, building on the cuts that had been introduced in the previous decade. Furthermore, during the 1990s economic distortions stemming from indirect taxes were reduced by converting excises on manufactured products into a form of value-added tax while the tax base was gradually widened by the introduction of a service tax. In 2005, the cascading system of state sales tax on goods was also switched to a value-added tax. The reforms of tariffs and excises considerably lowered tax revenues from these sources but was partially offset by an increase in direct tax revenues as the tax base increased, perhaps linked to the reduction in direct tax rates. Overall, these reforms reversed the temporary increase in revenues that had occurred in the second half of the 1980s due to tariffication (Figure 7). By the second half of the 1990s, the combined tax ratio of the centre and the states was, at around 14% of GDP, a similar rate to that in the first half of the 1980s prior to reform, but with much lower marginal tax rates. After 2002, with the upswing in the economy and the introduction of the service tax, the tax-GDP ratio increased again, and is now exceeding the peaks reached in the late 1980s, even though all marginal tax rates are appreciably lower than in the second half of the 1980s.

Figure 7. Evolution of taxation since 1980

Per cent of GDP at market prices



Source: Public Finance statistics.

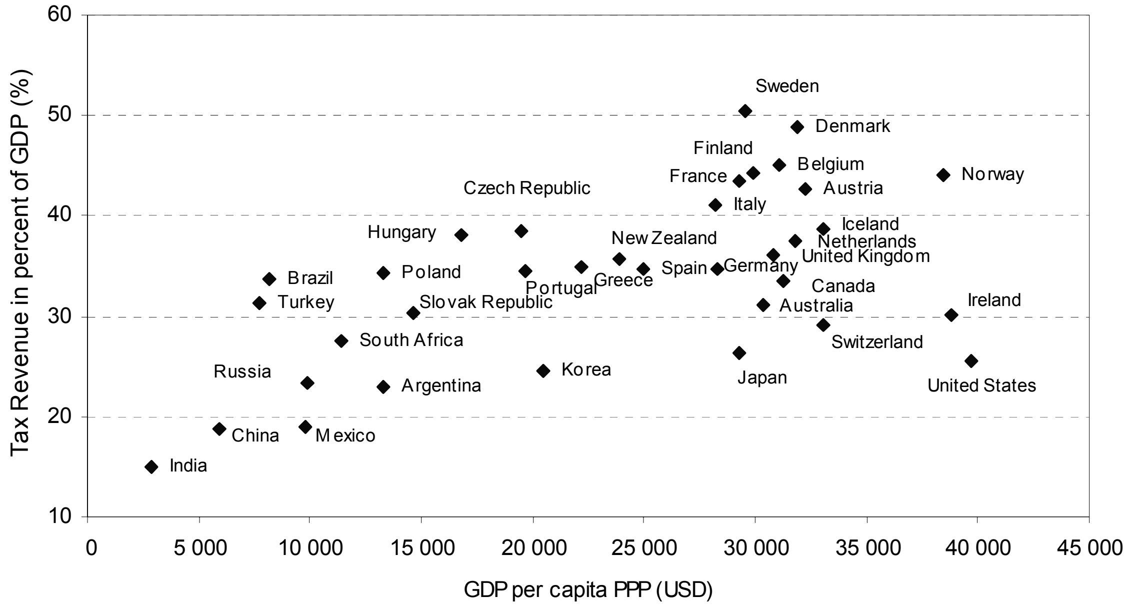
of comprehensive reporting on property income and property taxation. According to him, high marginal tax rates and loopholes contributed to pervasive tax evasion. He recommended a significant cut in the maximum marginal income tax rate from (at the time) 92% to no more than 45% and stated that "it is far better to have a fool-proof system of taxation with a moderate tax schedule, than a system which has the appearance of high progressivity but which cannot be effectively or impartially administered". He proposed a broadening of the direct tax base through the introduction of a tax on wealth, the taxation of capital gains, a gift tax and a progressive personal expenditure tax (Sury, 2006 p.161). Following his recommendations, the government revived the taxation of capital gains and introduced a wealth tax, a gift tax and also a progressive personal expenditure tax, although the latter was short-lived as it did not create enough revenues. The proposal to significantly reduce marginal income tax rates was, however, not implemented and only twenty years later in the 1970s, marginal tax rates were somewhat reduced to combat tax avoidance and evasion.

India is a low tax economy in international comparison…

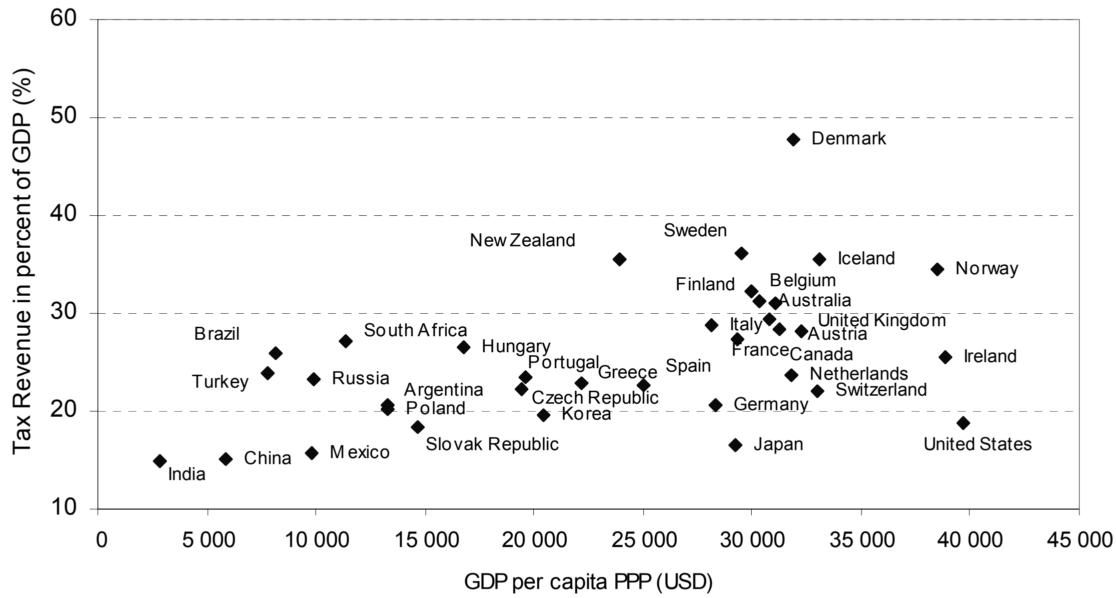
Tax revenues in India are low compared with both OECD countries and a number of developing countries (Figure 8, Panel A). Two factors have resulted in this low tax ratio. First is the absence of a system of social transfers (for health, pensions and unemployment) covering the whole population, given that the current systems only cover employees of larger companies and the government. The second was the ability of central and state governments to use borrowing to cover almost one-third of total spending in

Figure 8. The relationship between the ratio of tax to GDP and per capita incomes: an international comparison

Panel A: including social security contributions, 2004



Panel B: excluding social security contributions, 2004



Source: OECD *Revenue Statistics,* Ministry of Finance, *Indian Public Finance Statistics*.

the 1990s – a policy that was financially possible only because interest rates were low relative to the growth of GDP. If social security contributions are excluded from the comparison, then India's tax level is similar to that in China, Japan, Korea, Mexico and not much lower than in the United States (Figure 8, Panel B). Several forces are pushing towards an increase in the average tax burden, notably the need to reduce the deficit and the desire to introduce a basic social safety net.

… relying on indirect taxation…

Indirect taxation accounts for the bulk of government revenues (Table 2). Indirect taxes are levied both by the central government and the states according to demarcation lines established in the Constitution. The Constitution allows the central government to impose taxes on the production of goods and the provision of services, but not on the sale of goods at later stages, with the exception of inter-state sales. State governments have the power to tax sales of goods within their state at all stages. Only the federal government is allowed to tax inter-state sales of goods and to impose tariffs on international trade. It also imposes a countervailing duty on imports designed to ensure that imports pay the same central VAT as domestically produced goods.

Table 2. Structure and amounts of taxation, FY 2005

	Tax yield				Tax rates		
	% GDP			% total taxes	Number	Low- High	Commonest rate
All taxes	16.6			100	n.a.	n.a.	n.a.
State government	6.0						
Indirect taxes		6.0	36.3				
State sales/VAT taxes[1]		3.8		22.9	3	1-12.5	12.5
Other state indirect taxes		1.4		8.7	n.a.	n.a.	n.a.
Other state taxes		0.8		4.7	n.a.	n.a.	n.a.
Central government	10.4						
Indirect taxes		5.4	32.9				
Excise taxes[2]		3.4		20.8	5	0-24	16
Tariffs		1.5		9.1	25	0-182	35
Service taxes		0.5		3.0	1	12	12
Direct taxes		5.0	30.2				
Corporation tax[3]		3.1		18.9	3	40-42	42
Income tax		1.9		11.3	3	10-33	10

1. From 2006, state sales tax became a state VAT.
2. Also known as central VAT (CENVAT).
3. Including dividend withholding tax or capital gains tax.

Source: Ministry of Finance, Indian Public Finance Statistics, various national sources.

The main indirect tax at the state level is the VAT, which was introduced in April 2005 and replaced the sales taxes. The state VAT only taxes goods, but does allow input tax credit. The new VAT is a significant step forward in achieving tax neutrality as it avoids the cascading of taxation and reduces incentives to vertically integrate production systems. However, the state VAT does not tax services. It is destination based, so that all exports to another state are zero-rated. The central sales tax (CST) is levied on inter-state sales of goods; but payments cannot be offset against the state VAT as yet and revenues accrue to the exporting state. As from April 2007, this tax was reduced from 4% to 3% and will be further reduced and finally eliminated in the coming years. The central government will compensate exporting states for this tax cut by transferring the revenue from the tax on certain services (see below) and has promised to compensate further if there is a sufficient shortfall in revenues.

The central government also taxes the production of goods through central excise taxes. This tax is known as the central VAT (or CENVAT). Within the good-producing sector, there is no cascading effect as goods' producers can offset input tax against output tax. However, distributors cannot offset the tax against their payment of state VAT and so it effectively becomes an excise tax. The central government also levies a tax, known as a countervailing duty, on imports that is set at the same rate as the excise tax on domestic production. In addition, the centre levies a service tax (of 12%) on the sale of a growing number of services.

The emphasis on the taxation of consumption has to a large extent resulted from the difficulty of taxing income when there are a large number of potential tax payers with low incomes, with a large proportion not being literate. The collection costs are also likely to be lower for indirect taxes than for direct taxes given that, even though there is a large number of small shops and manufacturers, the total number of tax points is much lower than total employment. Thus, the parameters of the income tax system have always been set to ensure that the vast bulk of the population is kept outside the income tax system. For example, after the threshold for paying personal income tax was raised to almost four times the average yearly wage in 2005, the number of taxpayers fell to 12 million from 26 million (less than 2% of the population aged 15 and over). More tellingly, the exemption limit is equal to the average salary of a male graduate working in an urban area. Perhaps surprisingly, in view of the many anecdotes on the difficulty of raising tax from the unorganised sector of the economy, the total yield of income tax from the self employed was greater than that from wage-earners in 2004 (Kelkar, 2004). With the increasing computerisation of government records, cross-matching of data files is improving the extent of compliance and it would be less costly to include more workers in the personal income tax net.

Table 3. Implicit tax rates on main macroeconomic aggregates

Per cent of tax base

	1999	2000	2001	2002	2003	2004
Consumption	18.3	19.0	17.7	19.2	19.2	20.7
Capital	9.1	8.6	9.6	11.1	11.6	13.2
Labour	2.2	2.0	2.1	2.1	2.4	2.8

Note: The methodology follows that of Carey and Tchilinguirian (2004). Consumption is the sum of private consumption and government consumption of goods and services. Capital income is sum of net operating surpluses for all sectors of the economy. For self-employment, capital income has been imputed and labour income computed by residual. Rates for 2004 have been estimated in the absence of data for factor incomes in that year.

Source: OECD calculations.

Given the dominance of indirect taxes, the effective tax burden (as measured by tax revenues as a percent of an estimated macroeconomic tax base) is much higher on consumption than that on labour. The effective rate on consumption has been rising in recent years with the progressive introduction of the service tax and by 2004 had reached nearly 21% when measured on a tax-exclusive base. By contrast, the tax rate on labour income is low at less than 3%, while the tax rate on capital was higher, at above 13% in 2004 (Table 3). It is noticeable that there are large differences in the apparent tax rates on different types of capital (see below). The corporate sector pays relatively high taxes on capital whereas the unorganised sector pays very low tax on capital – in part because of the low level of capital employed per individual tax unit so keeping much of the capital in untaxed units. While the gap between the effective tax rate on consumption and labour incomes is larger than in OECD countries, it is similar to that in China, Korea

Thailand and Sri Lanka (Poirson, 2006). However, overall capital taxation appears to be similar to that in Korea and Thailand but markedly higher than in China.

… with exemptions and distortions in all tax areas

Even though the tax system is – after all the reforms – not very onerous, there are numerous deductions and exemptions that result in considerable distortions to economic activity. Such tax breaks are a significant remaining element of government intervention in the economy. They are very widespread and affect nearly all central government taxes. Significant tax breaks were also offered by states but these have diminished considerably with the introduction of the value added tax.

Personal and corporate income tax

Revenues from both the personal and the corporate income tax have increased in recent years. The reason is that cuts in statutory rates have to some extent been accompanied by base broadening. Tax compliance also improved, eased by lower tax rates and reinforced by more efficient tax administration, in particular the increased scope of deduction at source. Nonetheless, both the personal and the corporate income tax yield relatively little revenues. In 2005-06 revenues from the personal income tax amounted to only 1.9% of GDP and the corporate income tax yielded 3.7% of GDP. While the revenue yield from corporate taxation is almost the same as in the median OECD country, the yield from income taxes is only one-fifth. With rising incomes of firms and individuals, revenues from corporate and personal income taxes should further increase in the future. However, the various exemptions and tax incentives as well as the large informal sector will continue to restrain revenues from these taxes.

Table 4. Personal income tax rates, 2006-2007

Per cent

Income brackets	Marginal tax rates	Marginal tax rates and surcharges[1]
Below INR 100 000 (USD 2 210)	Nil	Nil
INR 100 000 – 149 999 (USD 2 210 – 3 320)	10	10.2
INR 150 000 – 249 999 (USD 3 320 – 5 530)	20	20.4
INR 250 000 – 999 999 (USD 5 530 – 22 110)	30	30.6
INR 1 000 000 and above (USD 22 110)	30	33.66

1. Includes the surcharge of 10% for incomes above INR 1 000 000 and the education surcharge of 2% on all rates.

Note:

- The basic exemption is INR 135 000 (USD 2 980) for women and INR 185 000 (USD 4 080) for taxpayers above the age of 65.
- The average daily wage income was INR 120.2 in 2004, equivalent to about INR 36 000 (almost USD 800) on a yearly basis.

Table 5. Corporate income tax rates

Per cent

	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007
Basic tax rate	35	35	35	35	35	30
Surcharge	13	2	5	2.5	2.5	10
Total tax rate[1]	39.55	35.7	36.75	36.59	36.59	33.66
Companies not registered in India	48	48	42	41.82	41.82	41.82

1 An education surcharge of 2% was introduced from 2004 onwards.

Exemptions to income tax are most noticeable in the area of saving and capital incomes. The treatment of savings is so favourable that it is often exempted from taxation at all three stages: *i.e.* at the time of the initial saving, during the period when the funds are invested and finally when the investment is liquidated (so-called Exempt-Exempt-Exempt or EEE tax treatment). While the use of consumption as a base for taxation has a number of theoretical attractions, the Indian system goes well beyond a consumption tax base because there is no taxation of dis-saving. Thus, a deposit made in an approved financial instrument (such as a one-year post office deposit) could be made out of pre-tax income and on maturity be re-invested generating a new reduction in taxation. Few of the tax-favoured saving schemes are treated on the classical system of exemption of contributions and holding income and then taxation at withdrawal that approximates a consumption tax (EET). Moreover, there is little empirical evidence that similar, favourable, tax treatment results in increased saving in the OECD area (de Serres, 2004).

There are a few other tax breaks that favour particular categories of taxpayers. Women and senior citizens are allowed higher exemption limits that together lowered tax revenues in 2004 by 7%. A further small tax break is extended to farmers. This source of income can only be taxed by state governments under the current constitutional arrangements but, in practice, they choose not to tax such incomes. In fact, given the current level of tax exemptions few farmers would have incomes sufficient to pay any income tax. However, this exemption does appear to result in some taxpayers deliberately misclassifying normal income as agricultural income, perhaps lowering the income tax yield by as much as 2% (Kelkar, 2004).

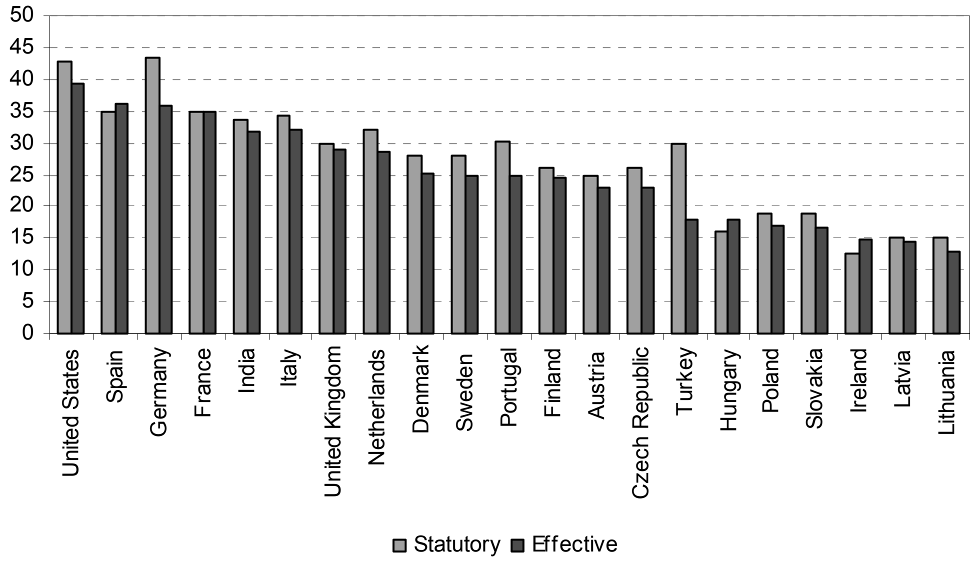
Despite the significant rate cuts during the reform period, the statutory tax rate for corporations is at the high end in international comparison. At the same time, there are many exemptions and special treatments that substantially lower the actual tax rate paid by corporations. At 33.66%, in 2006, the corporate tax rate was exceeded in only a quarter of all countries in the world, with the un-weighted worldwide average corporate tax rate (for retained earnings) being 27%. The distortion between the tax treatment of interest and dividends was markedly reduced in 1997 when dividend taxation was limited to 10% in excess of corporate taxation, through a withholding tax of 10% paid by the company. Dividends are not subsequently taxed in the hands of the shareholder. Consequently, there was only slight saving in the combined tax bill of the company and the shareholder if finance is switched from equity to debt. The 2007 budget has, however, increased the withholding tax to 15%. The total tax on dividends will thus be almost one half greater than that on interest which is only taxed under the personal income tax system.

Over the complete lifetime of an investment project, there is very little difference between the statutory rate and the effective tax rate. This effective tax rate allows for factors which affect the tax base, in particular the difference between tax depreciation and economic depreciation. In the case of India, this rate is only slightly lower (at 31.7%) than the standard rate and is relatively high in comparison to other countries (Figure 9).

However, these calculations refer to standard model firms and do not consider the numerous exemptions and loopholes. In particular, significant tax breaks have been given to firms located in Special Economic Zones (or similar areas) where exports are subject to a lower than standard tax rate (or no tax at all). The largest of these tax breaks has been given to firms located in Software Technology Parks or to the

Figure 9. Statutory and effective standard tax rates across countries

2005 (India, 2006), tax rate as % of corporate income



Source: Centre for European Economic Research (ZEW), Germany.

firms that have developed the power and telecommunication infrastructure for these parks. In the new Special Economic Zones (SEZs), tax concessions similar to those in software parks have been introduced: a tax holiday for five years and a 50% reduction for the next ten years, followed by halving the tax rate on export sales for the next five years. While widening the tax breaks in SEZs, the 2007 budget effectively lowered some of the concessions given to IT companies in software parks. It brought companies within the scope of the minimum alternative tax.[6] A number of IT companies have unused foreign tax credits and so the impact may be limited.

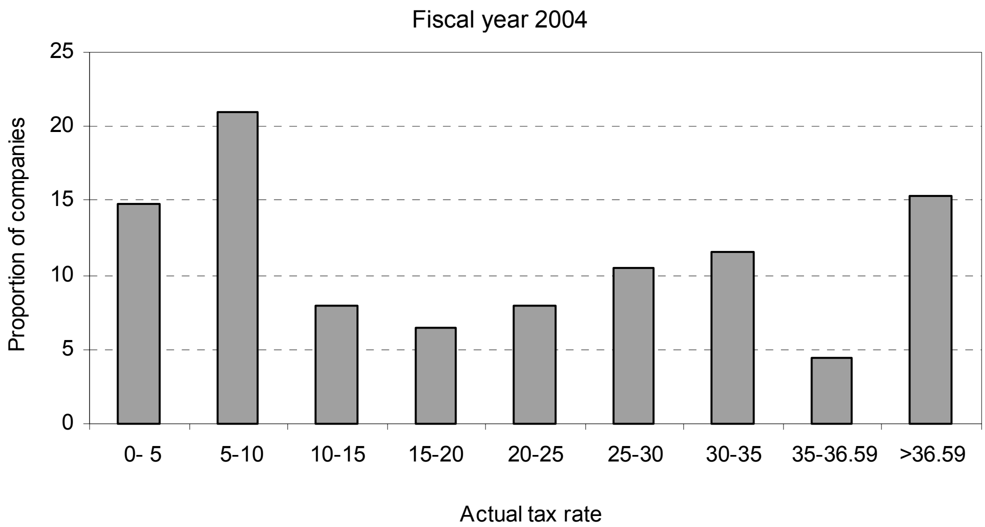
The fiscal cost of these concessions is substantial, lowering tax yields by almost one half. Based on a random sample of firms, the Ministry of Finance estimates that, on a static basis (*i.e.* ignoring the fact that behaviour is altered by the tax concessions), the concessions reduce the corporate tax yield by 47%, lowering the average corporate tax rate in 2004 to 19% against a legislated tax rate of 36.59% in that year (Ministry of Finance, 2006). However, companies are able to use these concessions to a varying extent,

6. The minimum alternative tax allows for the computation of corporate tax on the basis of the profit calculated by a company rather than the profit calculated for the tax authorities. This method of calculation is only used when the tax bill of the company is zero.

with the result that there is a large variation in the effective tax rate across companies, with only a small minority of companies paying the standard rate of taxation (Figure 10).

The cost of these concessions has been evaluated against the basic tax legislation but this may not be the appropriate base for evaluating tax expenditures. In the case of corporate taxation, depreciation allowances are not revalued to take into account inflation, so raising tax payments. There is also discrimination against groups of companies with subsidiaries. These structures are not allowed to file consolidated tax returns, so that it is possible that a group of companies can make a loss but continue to pay corporate taxes. In addition, the dividend withholding tax cannot be reclaimed on intra-group dividend payments, leading to cascading taxation.

Figure 10. Distribution of companies by average corporate tax rate



Source: Ministry of Finance, *2006 Budget Documents*.

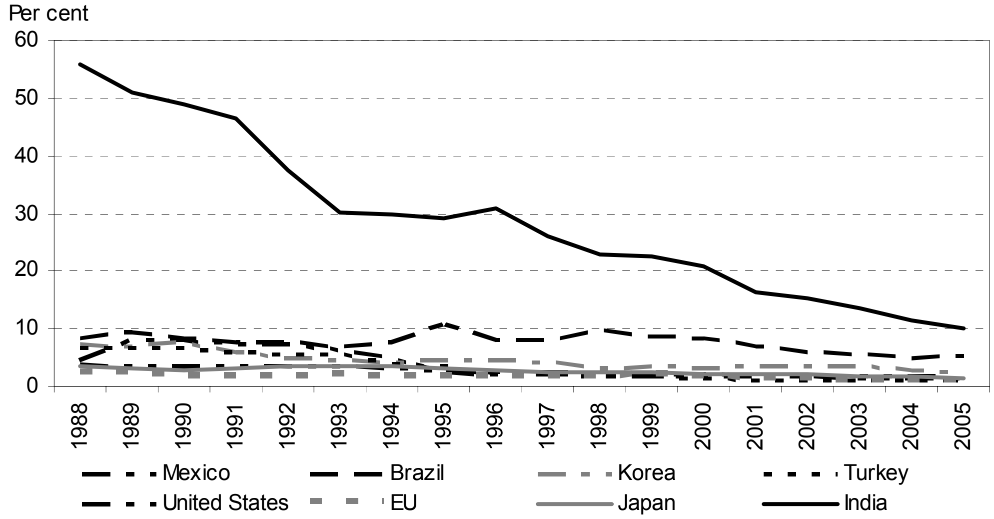
Indirect taxation

Tariffs

Reducing trade barriers was an important part of the policy reform agenda during the past 15 years. After the reforms of the second half of the 1980s, quantitative import restrictions and licensing were abandoned for capital goods and intermediate products but retained for consumer products, until negotiations with major trading partners led to their eventual abolition at the end of the decade. More importantly, import tariffs were progressively reduced to 35.5% (simple average) and 29.8% (import weighted basis) by 1999, but were still the third highest amongst the seventy countries for which data is available (Government of India, 2001*a*). Moreover, the pattern of tariffs was such that, in effective terms, intermediate products were more protected than final products. Despite the major fall in tariffs, the ratio of import duties to total imports was still 22% by the end of the decade (Figure 11).

Tariff reductions were resumed in 2001 when the government committed to reducing tariffs to the level of ASEAN countries. The highest standard tariff rate was reduced from 35% in 2001 to 10% by 2007, bringing a commensurate fall in the ratio of tariff revenues to the total value of imports. Nonetheless, India continues to belong to the group of countries with relatively high level of Most Favoured Nation (MFN) import tariffs. As with other countries, there are numerous derogations from the standard tariff. These often take the form of regional tariff arrangements (as in Turkey and Mexico) but in the case of India the

Figure 11. Evolution of tariffs relative to import value
(Including domestic taxes levied on imports for India)



Source: OECD Revenue Statistics, Public Finance Statistics.

exemptions are mainly domestic. Taking account of these derogations, the ratio of import duties to the value of imports was well below the standard tariff (at 10% and half that once domestic taxes on imports are removed from the total) but was nonetheless still well above the levels seen in ASEAN countries. Detailed analysis of the tariff revenues shows that product, industry or end-use based exemptions lowered the yield of tariffs, in a static sense, by 62% in 2004. The extent of the subsidy varies considerably across products. The revenue shortfalls from current concessions and exemptions are estimated at 18.5% of import values (Table 6). This shows that there is potential for cutting tariff rates further and at the same time reducing the dispersion of tariff rates which would increase economic efficiency and contain or prevent revenue losses.

Table 6. Tariff revenue foregone as the result of concessions and exemptions

	Revenue foregone	Value of imports	Foregone revenue relative to imports
	billion INR		%
Agricultural products	108.9	206.1	52.8
Ores and fuels	139.9	1639.1	8.5
Chemicals	82.7	516.5	16.0
Organic raw materials	40.1	203.7	19.7
Filaments, clothing, textiles, footwear	49.5	54.8	90.2
Precious stones, jewellery, ceramics	153.6	956.3	16.1
Metals	89.6	268.5	33.4
Non-electrical machinery and tools	89.4	448.5	19.9
Electrical machinery	123.9	401.9	30.8
Vehicles	20.0	194.6	10.3
Other manufactured products	30.8	135.8	22.7
Total (excluding arms and munitions)	923.8	4 995.3	18.5
Simple Mean (chapter level)	. .	. .	24.3
Standard deviation	. .	. .	28.4
Coefficient of variation	. .	. .	117%

Source: Ministry of Finance, Statement of Tax Expenditures, (2006), Ministry of Commerce and Industry, Department of Commerce, Export Import, data bank, Tradestat 6.0.

Domestic indirect taxes

As mentioned above, the domestic indirect tax system has also been reformed significantly and has been made more neutral. Nonetheless, there remains considerable cascading of taxes and unequal tax treatment of different firms. It is discriminatory in design because of the separation of the taxation of goods from that of services which also makes taxation complex and facilitates tax avoidance. Taxation also cascades because the central VAT on goods becomes an excise tax once the taxed item leaves the production sector, though there is a mechanism, a the central level to set-off central taxes on inputs of goods and services against taxes on outputs. The central excise taxes are subject to numerous derogations both for particular goods but also for small industries and for firms in certain geographic areas. Overall, these exemptions lower the excise tax yield by one-quarter (1% of GDP). Despite the exemptions, the indirect tax burden on goods is much larger than on services, though the extent of service taxation is being continually widened. The central sales tax on cross-border sales favours the producers within a given state at the expense of other states. Moreover, there are physical border controls between states which are costly and are barriers to the creation of a uniform internal market, but necessary to prevent tax evasion through false reporting of intra-state sales as inter-state sales.

The government intends, in partnership with the states, to introduce a nation-wide goods and services (value-added) tax by 2010. A nation-wide GST would be a major step to creating a barrier-free common internal market. A first step in this direction has been taken with an agreement between state finance ministers and the central government to progressively phase out the central tax on interstate sales. A desirable second step would be for the central government to unify the three taxes that resemble a value added tax into one central goods and service tax. This would involve merging the countervailing duty on imports, the central VAT (CENVAT) and the services tax into one tax preferably with a unified rate. At the same time, the scope of the service tax would need to be widened. In addition, the nation-wide IT system that now covers 700 000 firms and is designed to ensure that income tax can be deducted at source should be broadened so that it can also handle VAT transactions.

There are various reform options which would allow the elimination of controls at state borders so that taxation would no longer be a barrier to the development of a more dynamic internal market. Achieving this requires eliminating state entry taxes (and octroi which still exists in some municipalities) and also further reforming the VAT system as this currently also requires physical controls at state borders.

One option for further VAT reform is to tax goods and services without allowing any tax rebates for inter-state sales and collect the revenue centrally, but then redistribute the VAT yield using a formula. This system exists in most federal OECD member countries but suffers from two major drawbacks: first, agreeing on an adequate revenue distribution between the centre and states and between states is politically difficult. Second, as the VAT rate has to be set nationwide, states lose a major part of their tax autonomy – though in the case of India states have given this up by agreeing to set the same standard VAT rate of 12½ per cent (There are three other rates for certain products: 0%, 1%, 4%).

Another option would be to establish a dual VAT where both the central and the state level set their own rates on the same tax base. Individual states could then set different VAT rates (perhaps within limits). Operating a dual VAT system with a unified federal rate and different rates across states and without border controls would be facilitated by a federal VAT that did not exempt interstate exports (i.e. in line with current treatment for the central government VAT on goods and the service tax). The states' VAT would continue the current treatment of exempting interstate exports. This system ensures that the VAT chain is maintained for interstate trade (through the federal VAT) which would facilitate tax enforcement.

Among OECD countries, a dual VAT system where both the centre and the provinces levy VAT on the same tax base but with different rates exists in Canada in the province of Québec, which set its own VAT rate, on which the central VAT rate is added. However, in this system, sales between states, which only bear the federal VAT, are taxed less than sales within a state, which bear both the federal and the state VAT, there is still a risk of fraud with goods being declared as exports to other states although they are consumed within the originating state. The VAT chain is still intact, so efficient auditing is needed to limit such fraud. In the system used in Québec fraud appears to be contained, but in the European Union, which uses a destination-based system for cross-border sales, fraud is a significant problem (Nam *et. al* 2001; IMF, 2007).

The risk of fraud could be further reduced by imposing – in addition to the ordinary federal VAT – a federal surcharge on interstate exports, as suggested by McLure (2000). This surcharge would serve to neutralize the states' VAT exemption of interstate exports while yielding no net revenues to the federal government as a corresponding tax credit would be granted to the importer (see Box 1 for details).

Box 1. A multi-level VAT system designed to avoid cross-border fraud

The current state level VAT system is a destination-based tax so that exports to other states (or other countries) are zero-rated. The federal government imposes a central sales tax (at a rate of 3% from April 2007) on inter-state sales with the revenues accruing to the exporting state. This system results in goods produced and consumed in the same state being taxed less heavily than goods imported from another state. The government's objective is to move to a nationwide goods and service tax on VAT lines.

Various suggestions have been made to simplify VAT systems with respect to trade within federal countries or economic unions such as the EU. The proposal for a dual VAT seems to be particularly interesting for India as it allows states to preserve their fiscal autonomy by setting different VAT rates. With a VAT, different rates are possible across states without that being a deterrent to investment or production in that state since the VAT is essentially a tax on consumption in a given area and not a tax on the value-added in the same area. As with a destination based VAT, it ensures neutrality between producers inside and outside a given state.

The main change to the current system in India would be first to widen the national base of the VAT to include all goods, services and imports. Then the states' VAT base would need to be widened as well and a federal VAT on the same tax base as the state tax would have to be introduced. The existing central VAT on goods, the service tax, the countervailing duty on imports and the central sales tax would all be rolled into the federal VAT. The federal VAT would be imposed both on intra-state sales and inter-state sales and so it would not be rebated when the good moved from one state to another. As a result, the self-policing nature of VAT would be preserved on inter-state sales.

The possibility of fraudulent claims would still, however, persist as the state tax would be rebated on cross-border sales and so there is an incentive to declare sales as an export, even if they are subsequently fraudulently sold in the same state. If the system were to also include a "compensating VAT" on cross-border sales, as suggested by McLure (2000) who modified earlier proposals made by Bird and Gendron (1998) and others (as quoted by McLure), then fraud could be minimised. Such a system allows the operation of a destination-based VAT without controlling trade at state borders.

Under such a system, the federal government would impose an additional surcharge (the compensating VAT) on inter-state sales in order to ensure that no exporter receives a rebate. It would be set at the level of the highest state VAT. As a result of this additional tax, the tax burden on goods leaving the state is similar that on goods sold within the state of origin, so eliminates the incentive for false declaration of intra-state sales as exports to another state. As the importer receives a tax credit for the compensating VAT paid by the exporter, this compensating VAT does not yield net revenues to the government. The operating of the current VAT system and of our reform proposal (with hypothetical tax rates) is illustrated in Tables 7 and 8.

Conclusions

From the above description of the past reforms and current system, it is clear that the tax system has been modernised considerably. Nonetheless, there is still a large potential for making the system more efficient. Eliminating exemptions and loopholes for both direct and indirect taxes would level the playing field, reduce distortions and make the system simpler for both tax payers and the administration. For example, for tariffs, the direction should be to introduce a revenue-neutral reform that markedly reduces the dispersion of tariffs ideally aiming for one tariff rate, but certainly a limited number or rates on all non-agricultural goods. For direct and indirect taxes (excluding tariffs) there are also various ways to make them more business-friendly without reducing tax revenues.

Creating room for further cuts in direct tax rates by broadening the bases

The internationally high statutory tax rates on corporations together with the existence of large tax expenditures suggest that there is scope for some further reduction in the corporate tax rate. Such a reform has started in the 2005-06 budget by the alignment of the depreciation rate for tax purposes with replacement life value. The goal could be to allow companies to unify the tax treatment of depreciation with the accounting treatment, making the tax base for corporate profits the same as profits declared in their accounts. This would remove discretion from the tax authorities and result in assets being valued at the company level. Just abolishing accelerated depreciation and various area and industry specific allowances would permit the tax rate to be lowered to just below 25%, and perhaps even lower if accounting depreciation were used for tax purposes. Reducing such special incentives and exemptions for firms, allowing group taxation (subject to single shareholding of group as well as individual units), and unifying the taxation of retained and distributed earnings would not only improve economic efficiency but also make the direct tax system fairer and simpler and thus easier to administer.

A major issue with tax exemptions is to what extent existing export-related tax allowances should be ended (covering the old type of special economic zones, export processing areas and most importantly software technology parks) and whether the generous tax holidays for companies established in the new special economic zones (SEZs) should continue. Given the relatively high effective average corporate tax rates for domestic and foreign firms that operate outside SEZs, and which do not have access to any special concessions, such tax holidays will certainly provide a big incentive for domestic firms to establish production facilities in SEZs when they wish to expand their export operations. They will also provide a considerable incentive to foreign firms to come to the SEZs, especially as infrastructure will be better and labour regulations less onerous. The cost of these concessions will have to be balanced against the employment gains. The actual cost of the concessions is not yet known and official estimates vary considerably. Overall, there would appear to be considerable advantages for ending all of the above-mentioned tax breaks and unifying the accounting and tax treatment of depreciation. With a far-reaching reform, the tax base would broaden significantly so that the standard corporate tax rate could probably be lowered to about 20% without creating revenue losses This would bring India’s statutory and effective corporate tax rates closer to the levels which exist in a number of other emerging economies.

In line with the treatment of corporate taxation, the objective for the personal income tax should also be to make it as neutral as possible. The first priority should be to move the taxation of saving schemes to a base where only the income accumulated during saving is exempt from tax. Then, consideration should be given to reducing age and gender related allowances, or at least replacing them by a tax credit. Finally, the centre should come to an agreement with states to allow the taxation of agricultural income by the centre with the revenue raised being transferred to states. These changes would generate significant revenue which should be used to reduce the top marginal rate to, perhaps, 20% in line with the proposed corporate tax rate.

Reforming indirect taxes to create a common market for goods and services within India

The current structure of indirect taxation is complicated and still involves considerable cascading of taxation. The government has announced a target of moving to a nationwide goods and services tax by 2010. This will allow a consolidation of the whole indirect tax system, by abolishing the central VAT, the service tax and countervailing duties on imports. A path has not yet been established. One possible route would be to move to a national VAT with central revenue collection and redistribution of the tax yield according to a formula. Another option is to establish a dual VAT system, with a state and central component. This would enable states to set their own rates for taxing local consumption thereby allowing states the autonomy to adjust revenues to their expenditure needs and would also provide revenue to the centre. If the federal part of the tax was levied without a rebate on cross-border sales, then fraud could be contained, especially with an effective auditing system. If an additional federal surcharge on interstate sales was added, then the possibility of fraud would be almost eliminated. Creating a unified GST in such a way would be a major achievement and would greatly simplify of the indirect tax system. GST would also be a significant contribution to the creation of a common and efficient domestic market of goods and services, as it could be operated without physical border controls.

Table 7. The current VAT system and cross-border trade

	Transactions: Sales entirely in State B	Transactions: Sales in both State A and State B	Calculation of tax paid on an intra-state sale and an inter-state sale: All sales entirely in State B – State B VAT (8%)	First sale in State A, final sale in State B: State A VAT (8%), State B VAT (8%)	First sale in State A, final sale in State B: Federal tax on inter-state sales (3%)	First sale in State A, final sale in State B: Total tax
First sale						
Purchase	0	0	0	0	0	0
Sales	100	100	8	8	0	8
Value added	100	100				
Net tax			8	8	0	8
Intra-state sale or cross-border sale both with no value-added						
Purchase	100	100	-8	-8	0	-8
Sales	100	100	8	0	3	3
Value added	0	0				
Net tax			0	-8	3	-5
Final sale						
Purchase	100	103	-8	0	0	0
Sales	200	203	16	16.24	0	16.24
Value added	100	100				
Net tax			8	16.24	0	16.24
Total value added	200	200				
Total tax			16	16.24	3	19.24

Source: OECD (based on McLure, 2000).

Table 8. Illustrating the operating of VAT: Reform options with a dual VAT

		Calculation of tax paid in intra-state sale and an inter-state sale						
	Transactions	All sales within State B where VAT is 8%			First sale in State A where state VAT is 6% and final sale in State B where VAT is 8%			
		State tax (8%)	Federal tax (10%)	Total tax	State tax (6% and 8%)	Ordinary federal tax (10%)	Compensatory federal tax (8%)	Total tax
First Sale								
Purchases	0	0	0	0	0	0	0	0
Sales	100	8	10	16	6	10	0	16
Value added	100							
Net tax		8	10	16	6	10	0	16
Intra-state or cross-border sale with no value added								
Purchases	100	-8	-10	-16	-6	-10	0	-16
Sales	100	8	10	16	0	10	8	18
Value added	0							
Net tax		0	0	0	-6	0	8	2
Final sale								
Purchases	100	-8	-10	-16	0	-10	-8	-18
Sales	200	16	20	32	16	20	0	36
Value added	100							
Net tax		8	10	16	16	10	-8	18
Total value added	200							
Total tax		16	20	36	16	20	0	36

Source: OECD (based on McLure, 2000).

Improving fiscal federalism to limit borrowing and increase responsiveness to local needs

In a country as large and diverse as India, which is a union of 28 states and seven centrally administered territories, an efficient means for transferring resources from the central government to states is needed. This is so for efficiency reasons as the centre is unlikely to be able to match local demands for public services in a country with nearly 1.1 billion inhabitants[7]. But it is also important for equity reasons. Amongst the twenty major states, per capita income is three and half times higher in the richest three states (including the national capital territory) than in the poorest three states and the latter three contain 28% of the total population of the country. This section looks at the distribution of powers between central and state governments and at mechanism for revenue sharing as well as borrowing controls. It points to the apparent neglect of local authorities that have only been formally recognised in the constitution since 1992, which created a three-tier system in rural areas and municipal governments in urban areas, although some decentralisation below the state level existed long before with municipal bodies in the major cities that are over three centuries old.

The powers of central and state governments

The constitution gives the centre considerable powers over states in certain exceptional situations. The union parliament has the power (with qualified majority) to redraw the boundaries of a state (though this requires the consent of the States concerned) and to create new states. The powers have been exercised three times in the past two decades. The union also has the power to take over the administration of a state in certain circumstances and promulgate “President’s Rule” (Article 356), although judicial rulings in recent years and differences in the party composition of the lower- and upper-house have made it more difficult to exercise such powers recently. Moreover, a deliberate choice was made at independence that the recruitment and initial training of the senior civil and police employees should be undertaken by the central government which also has joint control with the states over their subsequent careers. Such personnel rotate rapidly through state and central government postings – typically at any point in time more than 50% of staff members have been in their current post for less than one year and less than 20% for more than two years (Singh and Bhandarkar, 1994 and Mishra, 1997).

The Constitution splits the powers of jurisdiction to legislate into three sectors: areas reserved to centre, areas reserved to states and areas of joint jurisdiction (the concurrent list), with any unspecified areas assigned to the centre or states. Areas with large externalities like defence, foreign affairs, international trade and macroeconomic management are the responsibility of the centre while law and order, public health, sanitation, schools, irrigation, agriculture, fisheries, industries, land rights, local government and others with state-wide effects are assigned to the states. In practice, however, the centre has often intervened in areas of states’ responsibility. Functions which create benefits across States and with significant effect on development (such as economic planning, energy, parts of education, health and family welfare) are undertaken concurrently with states. Supervision of a number of major economic activities (including national highways and airways) are assigned exclusively to the union. A number of activities are assigned to urban local governments, some of them concurrently with the state government (such as secondary and adult education, housing and land use, electricity distribution and industrial and commercial estates).

7. India has 21 official languages in use across the States with more than 1 600 mother tongues, or regional dialects. Only about three percent of India´s population speak English as a second language, but these individuals basically lead India´s economic, political and social life.

As well as assigning duties, and hence expenditure, to the centre and to the states, the constitution also gives the right to levy specific taxes to either the central or state governments, while any unspecified taxes can be levied by the central government. The tax assignments have been described above in the section on taxation. Furthermore, the constitutionally mandated quinquennial Finance Commission *de jure* decides on the arrangements for revenue sharing between the centre and the states (see below).

The extent of fiscal devolution to state governments

The overall pattern of finance shows that state governments receive a much higher proportion of total tax revenues than in federal countries in the OECD area (Table 9). The share of taxes assigned exclusively to state governments is larger than in other federal countries and this is accentuated both by the tax sharing arrangements and the extent of grants. However, this does not necessarily reflect a greater degree of autonomy of Indian states relative to states or provinces in other federations. In particular, the comparison is biased by the very low level of social insurance taxation and expenditure in India. In nearly all OECD federal countries, social insurance taxation is a significant portion of total taxation and is nearly always raised by the federal government, thereby reducing the share of the tax revenue flowing to states.

States in India are not very efficient in creating non-tax revenues with many of their commercial enterprises returning a loss, in contrast to central government enterprises. As a result, the states have a significantly lower share of spending than their share of the total tax revenue of central and state governments. Overall, the states share of spending is about 10 percentage points lower than their share in tax revenues.

Table 9. Tax and revenue structure of state governments in selected federal countries

2002, percentage of total central and second tier government tax revenues

	States own tax revenue	States shared tax revenue	States total tax revenue	Grants from central to state governments	States tax and grant revenue	*Memorandum items*	
						Earmarked grants	Revenue excluding earmarked grants
Australia	15.9	13.4	29.3	9.5	38.8	8.5	30.3
Austria	1.7	8.1	9.7	8.8	18.5	6.9	11.6
Belgium	15.3	8.7	24.0	2.8	26.8	2.6	24.2
Canada	38.2	0.6	38.8	8.8	47.7	1.4	46.3
Germany	3.2	20.2	23.4	6.2	29.7	n.a.	n.a.
Mexico	2.4	0	2.4	46.1	48.5	26.4	22.1
Switzerland	29.1	3.1	32.2	18.5	50.7	14.2	36.5
United States	22.4	0	22.4	13.3	35.2	13.3	21.9
India	**39.4**	15.8	55.2	12.1	67.3	12.1	55.2

Note: The data refer to provinces in Canada and Lander in Germany.

Source: OECD fiscal federalism network, Ministry of Finance, *Indian Public Finance Statistics*.

The flow of funds from the centre to the states occurs through three channels. *First*, the Finance Commission recommends the proportion of central government taxes that should be transferred to states. These recommendations are generally followed and these transfers represent the bulk of financial flows to states. *Second*, the Planning Commission grants central assistance to either projects or schemes that are included in state planning documents that it has to approve. *Finally*, The Planning Commission also administers more than 200 schemes for selected areas of government expenditure that were originally designed by ministries. The Auditor General suggested that these schemes are often very poorly managed (Saxena, 2006). Moreover, it is often the case that funds allocated for these schemes by the Planning

Commission are not fully utilised by a large number of states due to problems of the delivery system at the state level. Central government ministries administer these schemes, which are designed to ensure that state governments follow the policy directions of central government in areas outside its jurisdiction (Table 10).

Transfers through the Finance Commission have increased, but the share of earmarked grants has also increased, which may lower efficiency. The latest (12th) Finance Commission raised transfers to states for the period 2006 to 2010, with the states' share of central taxes being increased from 29.5% to 30.5%, while earmarked grants jumped by 143% (on average compared with the previous five-year period). It also recommended that central government should stop lending to states. Shifting from central loans to transfers is a welcome move (see below). The growth of earmarked grants within the transfer system runs counter to the experience in a number of OECD countries where block grants were found to be more efficient than earmarked grants**.**

The redistributive impact

The system of grants and tax sharing essentially provides for horizontal redistribution of income between states. The amounts which are distributed to states in the form of tax sharing and grants (in both the Finance Commission and the Planning Commission routes) are determined by formulae that differ. In deciding on the distribution of shared taxes, the Finance Commission places most weight on income redistribution and less weight on the size of the state – whether measured by population or area. In the case of the Planning Commission, the weights are almost exactly reversed, with the added twist that the population structure is always based on the 1971 census, so as not to reward states that failed to implement effective family planning programmes. The Planning Commission distributes only part of its grants according to its distribution formula; the states classified as “general category” states receive less than half of their grants from the Planning Commission according to the formula while the “special category” states receive only 10% according to the formula and 90% as discretionary grants; “special category” states, with two exceptions, are physically isolated areas in either the north-eastern or north-western borders of India with strategic importance as well as poor infrastructure..

Table 10. Central transfers to states by type of programme

	1998	1999	2000	2001	2002
	Per cent of total assistance to states				
Tax sharing	60.0	59.3	58.0	55.7	56.5
Assistance to state plans	22.2	21.6	18.1	17.3	18.7
Other central schemes	11.9	11.0	9.2	14.2	14.8
Non-plan schemes	5.9	8.1	14.7	12.9	10.0
	Per cent of GDP				
Tax sharing	2.2	2.2	2.5	2.3	2.3
Assistance to state plans	0.8	0.8	0.8	0.7	0.8
Other central schemes	0.4	0.4	0.4	0.6	0.6
Non-plan schemes	0.2	0.3	0.6	0.5	0.4

Source: Nirmal (2004).

Within the general category of states, the distribution of the totality of central grants is highly redistributive. Before redistribution, poorer states have a slightly lower own tax revenue relative to state GDP than higher income states. After redistribution, there is a strong negative correlation between tax and grant revenues of states relative to state GDP and the income level of the states (Figure 11). Part of this lower own tax revenue might be the result of disincentive effects with poorer states making less efforts to create own revenues as they rely heavily on central transfers. Indeed, for the special category states, such disincentives may be significant as their tax effort is markedly lower than average while their total grant income represents, on average, 40% of state GDP – though it is possible that the tax base of these states is lower than average relative to state GDP.

Despite this high degree of redistribution of tax revenues, there remain marked differences in total current revenues across states. Although the current mechanism has reduced the coefficient of variation of tax revenues by a factor of almost two, the extent of inequality in revenues still remains more than double that in a number of OECD federal countries. However, given the scale of income differentials and the size of the poorer states, equalisation of per capita revenue would be difficult to achieve and would also create additional disincentives for creating own revenues. For example, moving to a degree of equality similar to that seen in Canada would require implausibly large transfers to a number of states (Bihar, Jharkhand, Madhya Pradesh, Rajasthan, Uttar Pradesh and West Bengal), that would be equivalent to half of the income currently remaining for the central government after grants and transfers. Nonetheless, within the group of low income states, the transfers received by Bihar and Uttar Pradesh are relatively low as compared to the transfers to the special category states.

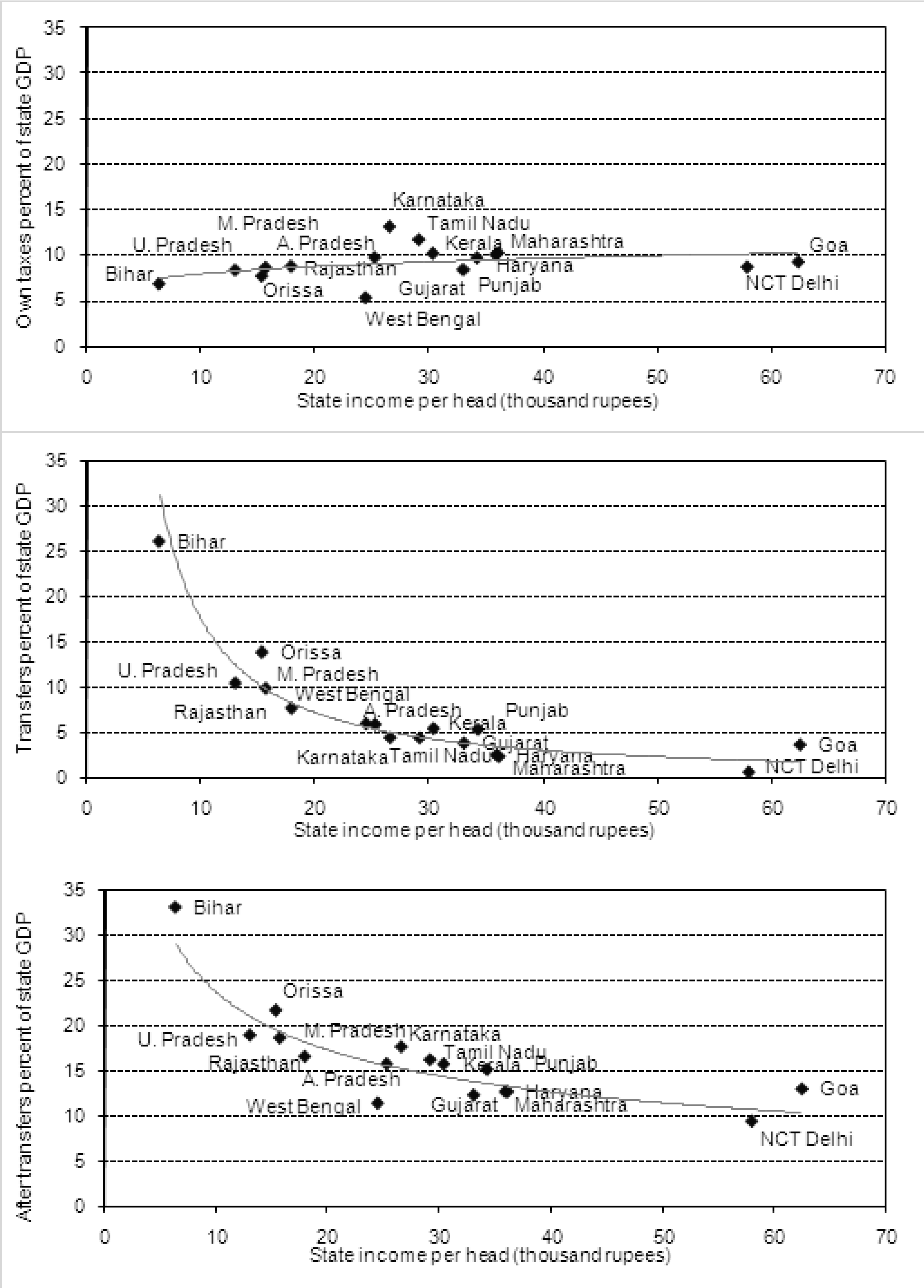
Part of the redistributive impact of central transfers may have been counter-balanced in the past by other elements of fiscal policy, but these offsets are now coming to an end. Horizontal redistribution was partially offset by exporting part of the tax burden from richer states to poorer states through the origin nature of inter-state sales tax with taxes accruing to the (richer) exporting states while being paid by citizens in poorer importing states (Rao, Shand and Kalirajan, 1999). The progressive ending of the inter-state trade tax will eliminate this tax export. Furthermore, vertical redistribution from the centre to states was lessened by the high interest rates charged by the Planning Commission for loans that largely offset the grant element of such transfers in the past. This policy was ended in 2006 and states are now allowed to borrow from the market where interest rates tend to be lower than for borrowing from the central government. Some states have been unable to access the market and continue to rely on the National Small Savings Fund.

Some studies have suggested that political economy factors, such as proportion of ruling party members coming from a particular state, have also affected the distribution not only of earmarked grants but also (with a lag) of the formulae-based Finance Commission transfers (Rao and Singh, 2002; Biswas and Marjit, 2000). Nonetheless, despite such influences, there is a significant progressive redistribution mechanism at work, even if these fiscal transfers have been unable to prevent a further widening of income inequalities across states in the past decade.

Controlling debt

Formally, the centre has the power to limit states' borrowing as states have to obtain the permission of central government for any borrowing; only if a state were not indebted to the centre, which has never been the case, could it borrow in the market without facing central government controls. India's legal arrangements for the control of state-level borrowing differ from those in a number of other federal systems (Table 12). In India, there is no national legal restriction on the ability of states to borrow to finance consumption expenditure, nor is there any nationally set ceiling on the overall debt of the states. The absence of such constraints is compounded by the absence of national laws that explicitly limit the central government guarantee of state borrowing and forbid the bailout of states that default on debt. Moreover, the law does not forbid states from guaranteeing loans. On the other hand, nearly all states have now introduced Fiscal Responsibility Acts that aim to eliminate revenue deficits, broadly equivalent to not using borrowing to finance consumption.

Figure 11. State tax and grant income before and after central transfers, 2005[1]



1. Correlation and t-statistics calculated using regressions on logged variables.

Source: Reserve Bank of India and OECD calculations.

Table 12. Rules governing borrowing by lower level governments in selected federal systems

	Australia	Brazil	Canada	India
Constitutional rules mandate balanced operating budgets	no	no	no	no
Statutory rules mandate balanced operating budgets	yes	no	yes	no
Penalties on state officials that violate balanced budget rules	yes	no	yes	no
States prohibited from borrowing other than for within year purposes	no	no	no	no
Ex-ante registration of state borrowing with central government required	yes	yes	no	yes
National policy places ceiling on the outstanding long-tern debt of a State	yes	yes	no	no
National policy expressedly provides that state borrowing is only backed by the full faith and credit of the issuing state	yes	no	yes	no
Explicit and credible ban on bailouts of states at risk of defaulting on debt by national government	yes	no	yes	no
National policy prescribes rigorous accrual accounting standards for states	no	no	yes	no
State pension schemes required to operate on actuarially sound fully funded basis	yes	no	yes	no

Source: Reserve Bank of India (2006) and national sources.

Despite its general power to limit states' debt, the central government does not appear to have used this power to a significant degree. Furthermore, in the past, numerous factors have softened states' budget constraint:

- The centre provided large loans to states to finance their deficits and sometimes these loans were later converted into grants.

- Furthermore, states were obliged to borrow most of the savings which are accumulated in the postal national savings fund (the Small Savings Scheme), a regulation that undermined fiscal consolidation and was particularly expensive for states.[8] They are now required to borrow only 80% of the funds raised by this scheme in their state (see below).

- In addition, states also borrow from public enterprises and have also received overdrafts from the Reserve Bank of India.

8. States are supposed to absorb 80% of accumulated savings of the savings fund of its jurisdiction. This scheme collects private households saving which is subsidized through income tax relief and also through offering returns above market rates. As the borrowing State has to bear the interest rate subsidy, its borrowing from this fund is more expensive than borrowing from the market.

- Past fiscal slippages by the central government also had a negative signalling effect on fiscal discipline of states and local authorities (contagion effect).

- Some features of the transfer system have weakened fiscal discipline as transfers by the Finance Commission were partly based on (initial or projected) expenditure-revenue gaps of individual states ("gap-filling" grants) rather than on normative indicators, thus rewarding states with relative poor fiscal management.

- Infrastructure projects are also often financed by newly created corporations which borrow from the market with State guarantees, thus creating contingent liabilities. Contingent liabilities also emerge through other State guarantees as well as through unfunded pension liabilities, although the recent pension reform is limiting the growth of these liabilities and will eventually eliminate them.

Given the factors that have contributed to a weakening of the budget constraint at the level of the states, their debt rose from 22% to 33% of GDP between 1990 and 2003, with the ratio of debt to total current revenue of the states rising from 1.8 to 2.9 in the same period and interest payments increasing from 13% to 26% of revenue. The main reason for this relatively modest increase was the fact that, in the 1990s, nominal GDP growth was higher than nominal interest rates, which compensated for the effect of the primary deficit on the debt ratio and resulted in a stable debt ratio between 1990 and 1998 (Rangarajan and Srivastava, 2003).[9] However, the dangers of relying on such a combination were seen between 1999 and 2003 when the interest rate-growth differential moved against the states and debt rose sharply.

The central government has now obliged the states to go to the market for new borrowing. It has stopped acting as a direct intermediary for borrowing by the states and has ended the requirements that central grants covering state investment projects should only cover 30% of total outlays with the rest covered by state borrowing. This absence of lending to states only covers expenditure through the Consolidated Fund of the government. The central government continues to lend to states through the Public Account which manages the postal savings system.

The postal savings system has played a key role in financing public sector deficits and, as designed, needs a significant reform. The states have privileged access to these funds through the National Small Savings Fund (NSSF) where all postal savings are held. Since 1999, each state government is obliged to borrow all of the cash raised in its geographic area and all pay the same interest rate which is set administratively. These postal savings attract significant tax concessions and also benefit from the administrative setting of interest rates above market rates and also from the backing by the full faith of the union government. States are charged a rate of 9.5% against their average market borrowing rate of 7.9%. Loans are unconditional and so can permit continued borrowing when access to markets might be difficult. Indeed, West Bengal – with a high debt burden – expects to finance its deficit entirely through this form of funding. States in this position are then vulnerable to any slowdown in the growth of deposit in their area. Indeed, such a slowdown is partly the cause of the recent fiscal problems in Kerala.

The obligation to borrow from the National Small Savings fund also places a burden on fiscally responsible states. In 2005, for states such as Tamil Nadu, Karnataka, Haryana, Punjab and the National Capital Territory almost one-third of the inflow of funds from the NSSF was in excess of their overall borrowing requirements. So these states were obliged to increase balances held with the central government by a similar amount. As the rate on the balances with the central government is well below

9. The change of the ratio of debt to GDP is affected by two factors: the debt to GDP ratio increases if there is a primary deficit (*i.e.* if government non-interest spending exceeds revenues) and if the interest rate on government debt exceeds the growth rate of nominal GDP.

that on the NSSF loans, the states make a significant loss on the transaction and are locked into a 25-year loan from the NSSF.

A reform of the NSSF mechanism is required to install greater fiscal discipline at the level of states. The increase in postal savings has amounted to 2.7% of GDP on average between 2002 and 2005 and represented one-quarter of the total acquisition of financial assets by the household sector. Even with the current FRBM targets for states, postal savings provide almost total finance for their deficits. This goes against another one of the desirable reforms of the FRBM Act, namely that the central government should cease lending to the state governments and instead oblige them to borrow on financial markets. In any case, if, over the medium-term, government borrowing were to be used only to finance net capital formation, then the flow of funds from postal savings would exceed the requirements of states.

Reform should take action on a number of fronts. The interest rates on the different saving products should be aligned with market rates on an automatic basis with a sufficiently large margin to pay for the costs of collection and administration. The tax privileges accorded to this type of saving should be ended and states should be freed from the obligation to borrow from the fund. Even if all these reforms were implemented, a fundamental problem will continue with this type of intermediation by the central government. The deposits with the post office are effectively guaranteed by the central government but the assets are not central government loans, exposing the central government to a credit risk. One solution would be for the NSSF inflows to be used to fund the central government deficit, so removing the credit. An alternative would be for the fund to lend money in the commercial bond market.

The latest Finance Commission has lessened the extent of moral hazard in its grants and transfers. It recommended that states should introduce Fiscal Responsibility legislation that would involve balancing their revenue budgets and limit their overall fiscal deficit to 3% of state GDP. It further recommended that states that achieve specified targets for the reduction of revenue deficits should receive grants in the form of debt relief. Perhaps unfortunately, it tied the amount of the grant to the amount of maturing debt due to central government in a given period, thus tending to reward the highly-indebted states, *i.e.* the worst performers in the past more than the good performers. Nonetheless, it is unclear at this stage, if poorer states which face particularly serious fiscal strains and also have high infrastructure needs will be able to meet these fiscal targets. The Finance Commission has also reduced the extent of the grants for states deemed to be in need of assistance (where the moral hazard problem appears to be most prominent). This form of grant is now very small, accounting for less than 7½ per cent of tax sharing transfers. Moreover, from 2007 onwards no general category state will be receiving this form of grant which will be made only to the north-eastern and north-western special category states. However, the obligation of states to borrow 80% of the proceeds of the "Small Savings Fund" was not removed and continues to undermine the intended hardening of state's budget constraint as well as the flow of savings to private investment.

A further weakness in the control of state borrowing is the difficulty of obtaining consistent and timely data on the overall fiscal performance of state governments. The states do not use accrual accounting, nor is there a standardised form of accounts across states, with the result that states are able to switch expenditure between current and capital expenditure, notably for the payment of subsidies to loss-making state enterprises. Overall data for the budgets of all states are only available with a nine month delay, with the result that nationwide data for actual spending in a given fiscal year is not available until 21 months after the end of that fiscal year when they are presented by the Reserve Bank of India.

Local bodies remain underdeveloped

While the basic principles of the vertical and horizontal distribution between the central government and states appear to work reasonably well, there is inadequate account taken of the needs of local government. This is a particularly important deficiency in a country where the median population of a general category state was 62 million in 2005. The constitution recognised only in 1992 the existence of local government [Districts, Taluks (Blocks), villages in rural areas (Panchayats) and municipal corporations in urban areas] and specified a number of services that should be in the domain of local authorities and also assigned taxes. More than a decade later, progress in developing an effective third tier of local government has been very limited. This is particularly the case in rural areas where there was no history of functioning institutions to build on, in contrast to urban areas where there has been a long history of municipal corporations. Even to the extent that they do function, the rural authorities have little autonomy and their own tax revenue is almost non-existent. Municipal authorities scarcely do better, raising less than one-sixth of the level of own taxation seen in federal countries in the OECD area. Moreover, the autonomy of municipalities to set their own tax rates is often strictly limited while the value of the property tax base is often adversely impacted by state-level rent control laws. There is somewhat less of a difference in total local revenues from taxes and grants as a per cent of state and central taxes with some other federal OECD countries. Nonetheless, the overall tax and grant income of local bodies is only around 1½ per cent of GDP, which is about one-third that seen in the federal OECD countries shown in Table 13.

The low level of municipal taxation is clearly associated with a low level of provision of basic local services. The provision of a piped water supply, a sewage disposal system and effective waste disposal are three key municipal services to which could be added an adequate road network and street lighting. Access to the first three basic services in urban areas varies enormously across different states in India (Figure 13). The average access across all states is 24% but the coefficient of variation is 50% with the range of individual indicators being from zero (provision of sewage disposal in urban areas in Bihar) to 79% (provision of piped water in Rajasthan). The variation of access to provision of basic services across municipalities is closely related to the average income of municipal authorities which shows considerable variation across states. In part this variation is due to the municipal income per capita being related positively to average incomes of the state in which they are located. This suggests that part of the problem of low income for municipal authorities is the failure of lower income states, which receive large transfers, to treat local authorities in their jurisdiction in the same way as they are treated by central government.

Indeed, it would appear that the mechanism put in place to ensure revenue sharing at the state level, at the time when the constitution was amended to formalise the role of local authorities, has never functioned in the way that was envisaged. In part this reflects poor availability of basic accounting data. Few municipalities have kept double-entry accounts and even fewer use them on an accrual basis. But the problem appears deeper. The constitution envisages that each state should create a Finance Commission to regulate revenue sharing. They appear to be viewed as a constitutional formality, with recommendations often being ignored. According to the 12th National Finance Commission, “the delays in their constitution, frequent reconstitution, delays in reporting and reporting action taken and the qualifications of those serving on the commissions have in many cases defeated the very purpose of the institution”.

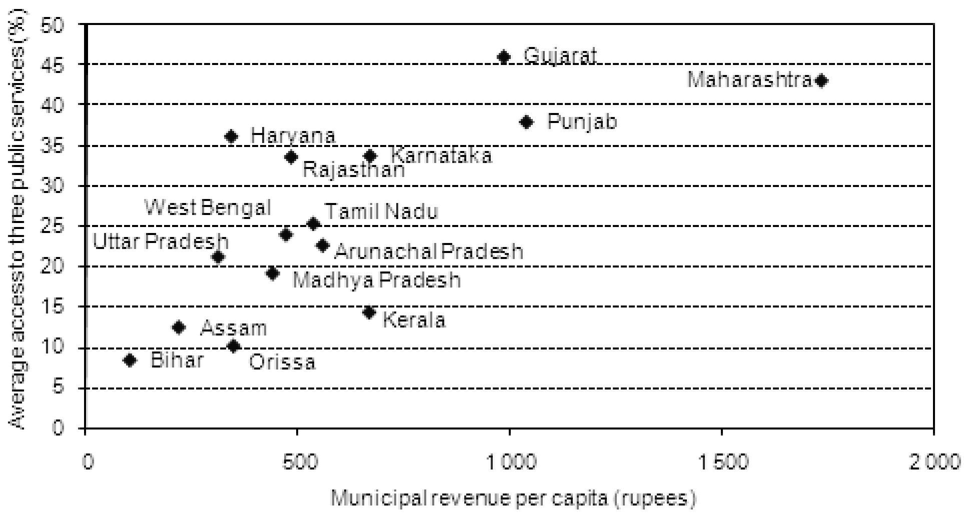
Table 13. Tax and grant revenue of local level government in selected federal countries

	Local taxes				
	Total	Tax sharing	Own taxes	**Grants**	**Total tax and grant revenue**
	% state and central taxes				
Australia	3.1	0.0	3.1	0.7	3.8
Austria	10.6	5.9	4.7	2.1	12.7
Belgium	5.3	0.0	5.3	1.8	7.1
Canada	9.4	0.0	9.4	9.7	19.1
Germany	7.5	1.8	5.7	7.6	15.1
Switzerland	19.3	0.0	19.3	8.7	28.1
Simple average of above	9.2	1.3	7.9	5.1	14.3
India (municipalities)	2.1	0.7	1.5	4.7	6.8
India (rural)	2.2	2.0	0.3	0.9	3.1
India (total)	4.4	2.6	1.7	5.5	9.9
	% of GDP[1]				
Australia	0.9	0.0	0.9	0.2	1.2
Austria	4.2	2.3	1.9	0.8	5.0
Belgium	2.3	0.0	2.3	0.8	3.1
Canada	2.9	0.0	2.9	3.0	5.9
Germany	2.5	0.6	1.9	2.5	5.0
Switzerland	4.9	0.0	4.9	2.2	7.1
Simple average of above	3.0	0.5	2.5	1.6	4.6
India (municipalities)[2]	0.6	0.2	0.4	1.2	1.8
India (rural)[1]	0.6	0.6	0.1	0.3	0.9
India (total)	0.6	0.4	0.2	0.8	1.4

1. GDP is measured at market prices.
2. It has been assumed that the distribution of GDP at market prices between rural and urban areas is the same as that of the distribution of net domestic product at factor cost.

Source: OECD Fiscal Federalism network, 12th Finance Commission, Indiastat.com.

Figure 13. Access of urban population to basic services and municipal revenue per capita, by state
Average % of population with access to piped sewage, waste collection and internal water supply, 1999



Source: Mathur and Thakur (2004), National Sample Survey (1999).

Conclusions

A major achievement of India's federal system is that it has preserved the political cohesion between the states, which is a main challenge in a country of this size and with its ethnic, religious, linguistic and economic diversities. Nonetheless, there remains much room for improving the operation of India's fiscal federalism. Given the various weaknesses of the current system there is much agreement that reforms are needed and a reform path seems clear.

The first stage would be to set clear objectives for the system, which are lacking at the moment. The current tax sharing arrangements and transfer systems appear to be rather complex and not very transparent. However, designing an efficient system is notoriously difficult given the tradeoffs between the efficiency and equity objectives, and the need to make political compromises. Nonetheless, making the different functions of the transfer systems explicit, such as reducing fiscal imbalances between the different levels of government (vertical equity), supporting the financing of spending with positive externalities (efficiency) and redistributing resources in favour of poorer states and regions (horizontal equity), would increase transparency and help to improve the system. The multiplicity of channels for directing funds to states could also be simplified in order to give an overall view of the extent of redistribution.

There are large differences in state government revenues and, on this basis, it could be argued that the transfer system should be more redistributive. Here an explicit redistribution objective might help, such as those adopted in Canada and Australia. However, relying on redistributive transfers alone will not be sufficient to achieve economic catching-up of poorer states. They will also need to implement structural reforms that improve framework conditions for the private sector, which is the main driver for growth in all OECD countries as well as in the more successful Indian states.

Future reforms should also aim in particular at eliminating those elements of the fiscal system which undermine economic developments and spending efficiency and create problems of moral hazard. Experiences in federal OECD countries show that it is possible to provide states with relatively high tax autonomy, including indirect taxes, without creating barriers to interstate trade. The move to reduce the central sales tax on interstate trade is thus welcome. International experience also shows that appropriate safeguards are needed to achieve fiscal discipline at all levels of government. In India, recent reform efforts aim to harden the budget constraint for the centre and for states, but more needs to be done. In particular, States should be freed from the obligation to absorb private savings which are accumulated in the Small Savings Scheme.

Reforming the system of fiscal federalism along these lines remains a major political challenge. But the benefits of such reforms could be huge. A more efficient indirect tax system would help to create an internal market for goods and services within the country and improve the efficiency of public spending, while more fiscal discipline would help to sustain high growth. This would – if accompanied by market-oriented structural reforms – further raise living standards in India as a whole, as well as in poorer regions, and would thus help to achieve the government's objective of sustainable and inclusive economic growth.

Box 2. Policy recommendations for improving the fiscal system

Improve fiscal discipline

- Align the interest rates of the small savings fund on those of the market, end tax advantages and the obligation for states to borrow from the National Small Savings Fund (NSSF).

Improve spending efficiency

- Lower subsidies especially for fertilizers and fuel and reduce the extent of leakages from the Public Distribution System.

- Set objectives for private sector employees joining the New Pension Scheme and allow private fund sector managers in the New Pension Scheme.

Reduce tax distortions

- Reduce the extent of exemptions for corporate taxation, agricultural incomes, excise taxes and tariffs.

- Move to a system of taxation on long-term saving that balances tax exemption on initial saving with taxation on withdrawal.

- After exemptions have been reduced, lower standard rates of taxation.

- In the context of the move to a General Sales Tax by 2010, introduce a two-tier state and central VAT, abolishing service tax and central excise taxes. and countervailing duty.

Improve fiscal federalism

- Unify formulae used for transfers to states by the Finance Commission and the Planning Commission.

- Improve the administration of central government schemes for transfers to states.

- Strengthen the role of local government.

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