

The Challenge of Fiscal Reform in India

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Abstract

This paper argues that the growth performance of the Indian economy, while commendable by the standards of the pre reform period, is not adequate to rid India of the bane of poverty in a short enough time period. Two reasons are identified for this inadequate growth performance viz., low rate of savings and investment and poor productivity of public sector investments. The paper then discusses the design of fiscal policy to help raise the rate of saving and investment and improve the productivity of public expenditures.

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“There are only three gems in the world – water, foodgrain and beneficial advice. Some misled men, however, think of pieces of stones as gems”

Kautilya in Arthashastra

I. Introduction

If, at this point in time early in the new millennium, one had to single out the most important task before economic administrators in India that task must be to raise the rate of economic growth. Once the reforms began, GDP growth rates did pick up for a while in the mid 1990s but have since settled down to the narrow band of 5.5 to 6.5%. There are fears now that this rate could fall even lower during 2001-02. At this rate, the Indian economy will take an unacceptably long time to get rid of its bane of poverty. In the post reforms period although poverty seems to have declined particularly in the urban sector, the rural sector picture remains considerably disappointing¹.

It is also important to remember that such growth as exists is largely driven by good performance of the services sector with a commensurate rise in the share of services in GDP (now standing at more than 50% of GDP). The share of manufacturing sector in GDP has been stagnant at a level slightly more than half that in China's. The Indian economy thus seems to have gone through a typical transition associated with economic development – the share of GDP originating in industry falling as the share of output from services rises - without the share of manufacturing sector in GDP ever reaching the level it has attained in major economies around the world. The aggregate growth performance, although impressive by India's past performance is simply inadequate to address some of the long standing problems the country faces and, more importantly, is unnecessarily below potential.

¹ See Dutt (1999) and Jha (2000), on this point.

The primary purpose of this paper is to assess some dimensions of the role that fiscal policy can play in stimulating the rate growth of the Indian economy. Clearly the appropriate design of fiscal policy is important since fiscal policy could act both as a stimulant as well as an obstacle for rapid economic growth. If tax and expenditure policies are geared towards encouraging savings and investment and the efficient use of capital fiscal policy can help stimulate economic growth. However, fiscal policy can hurt prospects for economic growth if, for example, profligate government machinery runs up successively high budget deficits and crowds out productive private investment.

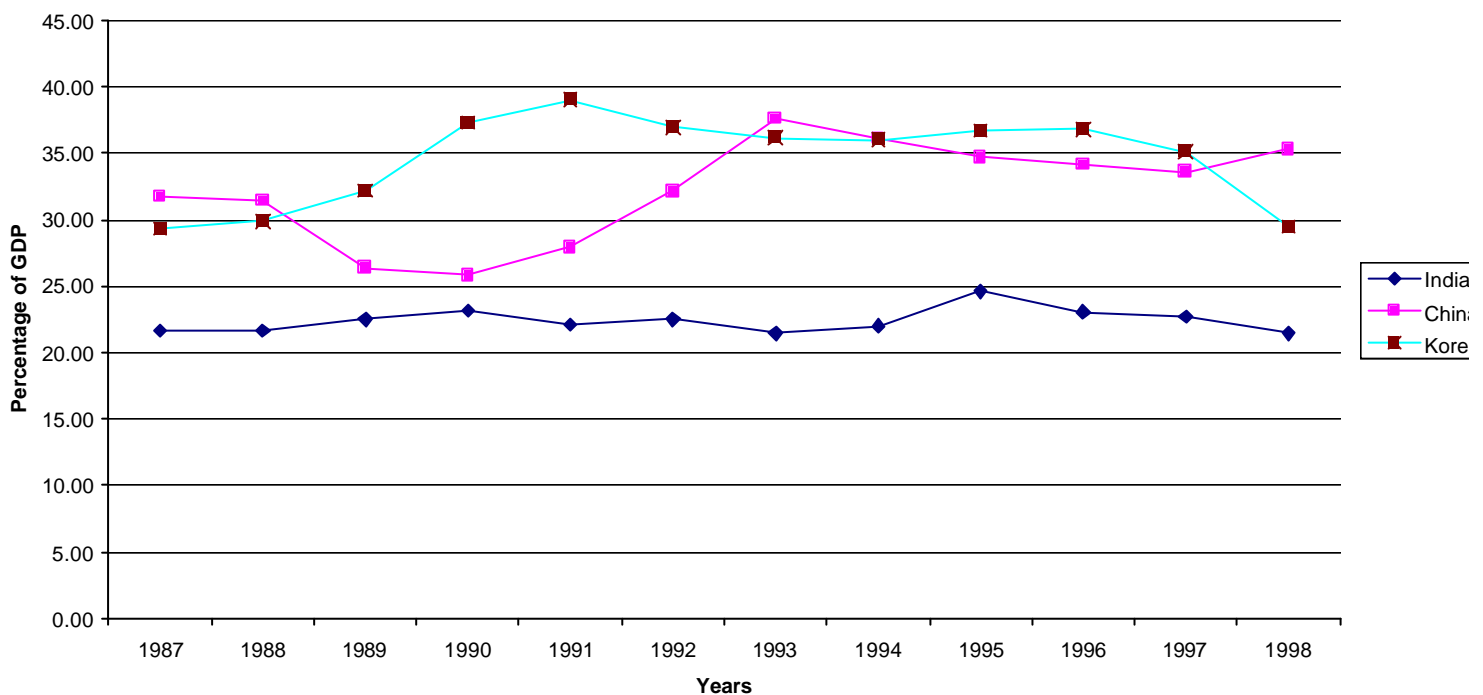
The plan of this paper is as follows. In section II I outline two dominant reasons for the inadequate growth performance of the Indian economy. Section III discusses some policy options at the central and lower levels of government to improve growth performance. Section IV concludes.

II. Two reasons for the inadequate growth performance of India

Several reasons have been discussed in the popular as well as the scholarly literature for the inadequate performance of the Indian economy. The most significant of these must be the low magnitude and poor performance of investment in India. So far as the former is concerned, an illustration is provided in Figure 1 where the Indian ratio of Gross Fixed Capital Formation to GDP is compared with that in China and Korea. Both these countries have had a better investment performance than India's. Since 1992 the Chinese investment to GDP rate has been higher by 10 percentage points or more than India's. The Korean investment to GDP rate has also been higher by 10 percentage points or more except for the "crisis period" since 1997. If one were to argue that the productivity of capital is approximately the same in China, India and Korea it should not surprise us that

the trend rate of growth rate in these economies has been higher than that in India. In fact the relative GDP growth performance of these economies has quite accurately mirrored the differences in investment rates with Indian GDP growth rates in India in the 1990s being 90% or lower of the GDP growth rates in China, for example.

Figure 1
Investment Rates in India, China, Japan and Korea



Stagnation in investments explains much of India's disappointing GDP

growth in recent years. Inadequate resources accompany weak demand for asset creation, as savings have tended to stagnate and even drop in the recent past. Unless the demand for asset (i.e. productive investment) is accompanied by a rise in resources (savings and FDI) India's GDP growth would stay well below the targeted 7%. The rate of gross capital formation fell from 26.9% of GDP in 1995-96 to 23.3% in 1999-00. This chopped

off almost one per cent from real GDP growth. At the same time domestic savings rate has dropped to close to 22% of GDP, entirely on account of government dis-saving and lower savings of the private corporate sector. That, coupled with meagre FDI inflows, deprives the economy of sufficient resources to augment investment.

According to some commentators, the industrial sector and manufacturing companies drove the first wave of asset creation in the mid-1990s. Now, corporates are focused less on asset creation and more on extracting value from past investments. Achieving the targeted 7% GDP growth would need investment of US\$140bn in 2002-03 US\$20bn more than expected given the current investment rate. A shortfall of US\$20bn would eventually cap GDP growth at the 6% level.

Where could this additional investment be absorbed? In terms of the sectoral picture, while infrastructure sectors have the potential to absorb large investment, obstacles in the policy framework persist. Telecom sector looks promising and to a lesser extent, roads. However, the power sector remains in deep trouble with no end in sight. The corporate sector does not seem to be in any position to absorb such large increases in investment.

In terms of domestic savings supply, the household sector looks the most promising. The cumulative asset growth rate for the household sector nearly doubled from 8.9% in the first half of the 1990s to 18.8% in the latter half. Thus policy efforts should be directed to increase household savings. Part of this would be through tax policies, discussed below and part through stimuli in critical sectors such as housing. FDI investment in India is still very poor in comparison both to China, other developing countries as well as in comparison to India's potential (Table 1). The fraction of gross

fixed capital formation financed by FDI is smaller in India than in smaller neighboring countries such as Bangladesh, Pakistan and Sri Lanka.

Table 1

US\$ million		FDI Inflows into select Asian economies 1989-2000					
Country	1989-94 average	1995	1996	1997	1998	1999	2000
Bangladesh	6	2	14	141	190	179	170
China	13951	35849	40180	44237	43751	40319	40772
Hong Kong	4164	6213	10480	11368	14776	24591	64448
India	394	2144	2591	3613	2614	2154	2315
Indonesia	1524	4346	6194	4677	-356	-2745	-4540
South Korea	869	1776	2325	2844	5412	10598	10186
Malaysia	3964	5916	7296	6513	2700	3532	5542
Pakistan	304	719	918	713	507	531	308
Philippines	879	1459	1520	1249	1752	737	1489
Singapore	4798	8788	10372	12967	6316	7197	6390
Sri Lanka	102	65	133	435	206	177	217
Thailand	1927	2004	2271	3627	5143	3562	2448
Vietnam	651	2336	2519	2824	2254	1991	2081
Sub total	33533	71517	86793	95208	85625	92823	131816
Region	35078	73639	89846	98507	86004	96224	137348
FDI Inflows as percentage of gross fixed Capital Formation in select Asian economies 1989-2000							
Country	1989-94 average	1995	1996	1997	1998	1999	
Bangladesh	n.a.	n.a.	n.a.	2.9	3.8	3.2	
China	7.9	14.7	14.3	14.6	12.9	11.3	
Hong Kong	14.8	14.6	21.7	19.8	29.9	60.2	
India	0.6	2.4	2.9	3.8	2.9	2.4	
Indonesia	4.0	7.6	9.2	7.7	-1.6	-11.0	
South Korea	0.8	1.0	1.2	1.7	5.7	9.3	
Malaysia	19.4	15.0	17.0	15.1	13.9	20.1	
Pakistan	3.7	7.1	8.9	7.3	5.7	6.5	
Philippines	7.5	8.9	7.8	6.2	12.7	5.1	
Singapore	30.3	31.2	29.7	35.3	20.6	26.1	
Sri Lanka	4.2	1.9	4.0	11.8	5.2	4.1	
Thailand	5.0	2.9	3.0	7.2	20.7	13.7	
Region	5.9	8.2	9.1	10.1	10.4	11.2	

Source: World Investment Report, 2001

Hence the first order of business in boosting the growth rate of the Indian economy has to be a boosting of the rate of investment. What role can fiscal policy play in accomplishing this? Addressing this question is one of the principal objectives of this paper. We will, however, not comment upon the measures needed to boost FDI.

Another prime candidate as an explanation for inadequate growth performance of the Indian economy is the (legendary) poor productivity of public expenditure in India. The seeds of such poor productivity are embedded in the very philosophy behind such expenditures. Public expenditure management systems in India have emphasized control and ignored achievement and have often served as avenues of easy and steady employment for many. As a consequence, government departments and programs have tended to expand uncontrollably irrespective of any rationale for their existence. Highly centralized² decision-making and control systems have left bureaucrats unable to take initiatives to secure improved results even when they wished to do so. Hence, the public service has settled into a low-level equilibrium, in which low expectations, the dead weight of bureaucracy, lack of incentives, accountability and political interference combine to generate low performance, high waste and corruption. In the Indian case, this is typified by a high incidence of failure of public expenditure across the board: from large-scale public sector white-elephant type investments to anti-poverty programs that do not reach the poor. Some of the public expenditure being addressed here belongs to the category of investment expenditure. This fact then reinforces the tendency for GDP growth rates to be below potential in India³. Later in this paper I explore some avenues

² Gordon and Wilson (2001) have argued that expenditure competition among state governments in a federal framework reduces waste and encourages efficiency.

³ It is implicitly assumed here that the productivity of private investment expenditure in India is comparable to those in rapidly growing economies of East Asia. This may not be an entirely valid assumption –

for reform of public expenditure in order to enhance its productivity.

III. Fiscal Policy for Higher Economic Growth

Mirroring the low rate of investment in India is her low savings rate. The highest that the savings rate of the Indian economy has ever attained is 25.46% of GDP compared to an excess of 30% in several East Asian countries. In only three years since the reforms began has the savings rate been in excess of 24% of GDP. Higher investment rates are possible only if the savings rate goes up substantially or foreign savings (current account deficits) are used in a big way to supplement domestic savings. The latter course of action is ruled out in view of the East Asian currency crisis of the late 1990s. As is well known countries like Thailand, Indonesia and others ran high current account deficits (accumulated foreign savings). But this led to a lack of confidence in their currencies amounting to a run, in some cases. Thus enhancing the growth rate of the Indian economy would necessarily call for higher domestic savings. In addition, fiscal policy can have a role in improving the productivity of investment.

Empirical evidence on the determinants of effects of savings among a panel consisting of both developed and developing countries (including India) presented by Loayza, Schmidt-Hebbel and Serven (2000) indicates that most important determinant of savings is the level of per capita income and the rate of growth of the economy. This effect is particularly strong in developing countries like India. Thus raising the rate of savings and the rate of growth of the economy becomes a circular issue- the higher the rate of savings the higher the rate of growth of the economy and the higher the rate of growth the higher the rate of savings at least at low absolute levels of per capita income.

however the paucity of investment coupled with the low productivity of public investment would appear to be sufficient explanation for inadequate growth in India.

Their results also point to the possibility of incomplete Ricardian Equivalence. In other words, a given rise in public savings is accompanied by a less than commensurate drop in private savings. Had Ricardian equivalence obtained, consumers would realize that any increase in public expenditure would be paid for by taxes and adjust private saving commensurately. This is of obvious policy significance in the Indian context.

Such empirical studies also point to the relevance of the gap between the real rate of return on savings and the discount rate. The role played by the characteristics of the credit market is crucial here. For instance, it has been discovered that savers who are liquidity constrained may be more sensitive to such differentials as opposed to those who do not face such constraints. As financial deepening takes place and fewer consumers remain liquidity constrained, this responsiveness may drop. However, it might also be the case that as consumers become less liquidity constrained they might become less risk averse and opt for investments with higher returns. This might help boost the rate of savings. Thus the impact of the tax structure on savings is of critical importance. A meaningful research agenda on stimulating saving must, therefore, concentrate on estimating effective tax rates⁴ (and implied net rates of return) for various sources of income as well as for different sectors. It would then be necessary to ensure the elimination of distorting differences in effective tax rates across sectors as well as assets.

Since the prime determinant of the saving rate appears to be the level and rate of growth of per capita income, all tax-induced distortions that create inefficiencies and lower the potential rate of economic growth should be eliminated. Thus there is urgent need for tax reforms. The basic tenets of tax reform are well known and far too elaborate for a complete analysis to be attempted here. (For a recent account see Jha (1999a)).

These are only briefly stated here and the performance of the Indian economy with respect to these is briefly assessed.

An important canon of tax reform is that as an economy develops reliance on indirect taxation, as a source of revenue should decline. This is because indirect taxes typically have an excess burden (or deadweight losses) associated with them (Jha 1998, chapter 13). Furthermore efficient indirect taxation (one that minimizes excess burden to the representative consumer, for example) can be quite regressive⁵. One can make indirect taxes more progressive by sacrificing some amount of efficiency but the extent of the redistribution possible through such means is quite limited (Sah, 1983).

This principle applies to indirect taxes that are differentiated and distortionary. If, however, indirect taxes can be levied on final consumption alone it would be possible to avoid the tax-induced changes in relative prices that characterize production taxes such as excise duties. Then, if consumer utility functions are weakly separable between consumption and leisure, a uniform tax on final consumption goods (say a VAT or, in the case of India, a properly harmonized state and central VAT) would approximate a lump-sum tax⁶. This would be a superior solution to distortionary commodity taxation. It is implicitly understood that a proper VAT would replace the existing indirect tax structure.

A related principle of tax reform is that the share of direct taxation in overall tax revenue should rise. Within direct taxation, reliance has to be shifted from corporate to income taxes. Since corporate profits are taxed at the level of personal income anyway, the rationale for separate corporate taxes is rather weak. There are only two arguments

⁴ Jha and Mittal (1990) present some evidence on this.

⁵ Efficient indirect taxation often calls for tax rates to vary inversely with the compensated elasticity of demand. This would make them "regressive".

in favor of corporate taxes: i) as a tax on foreigners' incomes and ii) as a tax on noncompetitive profits⁷. Within the sphere of income taxation, the rate and exemptions structures need to be rationalized. Tax reform theory advocates taxation of "full income" the Haig-Simons definition of which is "all increases in human and physical capital during a period of time". One cannot pick and choose the types of income one would like to tax. This canon has, of course, been grossly violated in the Indian case with several categories of income exempt from income taxation.

In line with the 'new' public economics of the Nobel laureates William Vickrey and James Mirrlees, the number of income tax brackets should be small, the degree of progression mild and the top marginal tax rate low. These have been adhered to in the Indian tax reforms program. However, an important canon of optimal direct taxation is also that there be few, if any income sources that are exempt from taxation. In the Indian case this has not been adhered to. Traditionally agricultural income has been tax exempt as are some sources of investment income. In addition, the ongoing process of globalization, which the economy is going through, creates its own avenues for tax exemptions.

Globalization has followed liberalization. Now firms and individuals are freer to adopt global strategies. However, national governments must, perforce, think in terms of domestic allocation of resources, the national account books, increasing the domestic rate of growth, protecting the domestic poor and so on. In this sense, the scope of activities of governments and those of the best and most dynamic firms and individuals are tending to

⁶ Separability of the utility function between goods and leisure would indicate that taxation of goods would have no implications for the labor-leisure choice.

⁷ In developing countries such as India, corporate tax rates are high essentially as a revenue raising measure. It is much harder to evade corporate as compared to income taxes.

divert from each other more than at any other time in the past. The future has much more of this in store. Thus increased liberalization of financial markets has improved the international allocation of savings and reduced the cost of capital. But it has also widened the opportunities for tax evasion and avoidance.

Globalization has provided several avenues for tax avoidance. The Economist (2000) reported, for example, that e-commerce amounted to about US\$150 billion in 1999, which would rise to more than US\$3 trillion by 2003. Surely, if India were to remain in the vanguard of the information technology revolution, a significant share of such e-commerce would originate in India.

Some have argued that it is best to leave out e-commerce from the tax net. It is a nascent industry, they argue, and taxing it would thwart its growth. Since India has discovered comparative advantage in IT, this reasoning is particularly valid for her. However, this argument is flawed. There is a rationale for zero customs duties on e-commerce in line with arguments for free trade, but not for zero taxes. If goods traded through e-commerce were not taxed whereas goods traded through ordinary channels are this would be inefficient as well as inequitable. A commodity that is sold in a bricks and mortar store and, therefore, subject to taxation would be deemed to be different if sold through e-commerce and escape taxation. Further, those buying through e-commerce are likely to be the more affluent sections of society. This exacerbates inequity. Furthermore, a policy of not taxing e-commerce would provide another avenue for tax evasion. There is U.S. evidence to suggest that sales over the Internet are quite responsive to the failure to collect taxes. Furthermore, given its projected phenomenal rate of growth, if e-

commerce is not taxed there will be sharp erosion of the tax bases of governments that primarily levy sales taxes.

It is well recognized that e-commerce presents some formidable challenges for tax administration. Both the origin as well as the destination principles of commodity taxation applied at the subnational level in a country such as India would find it hard to deal with e-commerce. With the physical location of both the buyer and the seller of the commodity in question irrelevant for the transaction, assigning tax liability would be hard. In addition, many goods (such as software) sold through e-commerce are directly downloaded and do not necessarily have a physical presence.

Given the vast scale of anticipated e-commerce transactions, it can safely be said that the smaller the scale of government, the greater would be the difficulty of taxing e-commerce. The central government with its reach throughout the country may find it easier to tax e-commerce than individual state governments, certainly local governments. This further centralization of tax authority and the continued need to further decentralize public expenditures would require the devolution of larger and larger funds to state governments. This would put greater stress on the structure of fiscal transfers necessitating a devolution plan that is transparent, fair and acceptable to all levels of government. This development is a further challenge to Indian federalism and requires urgent research attention from academics and policy makers⁸.

Another source of worry is the presence of tax havens. The OECD estimates, for example, that during 1985-94 the foreign direct investment by the G7 countries in some tax havens in the Caribbean and South Pacific increased more than five fold to more than

US\$ 200 billion – an increase well in excess of the growth of total outbound FDI. These concerns extend to transition and developing economies including India. In some such situations what has been called “a race to the bottom” may ensue with national and/or state governments using tax incentives competitively to attract FDI. Such incentives then interact dynamically with the existing avenues for tax evasion (for example because considerable segments of income are not taxed as in India) to reduce not just current tax revenues but the prospects for higher future tax revenues. In the face of this tax reform, particularly direct tax reform should have a considerable element of international cooperation. But all we have are independent action or bilateral treaties. Direct tax reform in India must take cognizance of this lacuna.

A related issue is that of the taxation of services. Services now constitute 52.3 per cent of GDP. Incomes from the service sector are taxed as income. However, whereas central excise and state sales taxes are levied on goods, services face very few indirect taxes. This is inefficient as well as inequitable. Inequitable because it discriminates between providers of goods and services; inefficient because it has the potential of creating several distortions thus increasing non-labor costs. It is not surprising, that the world over, growth in the most rapidly growing part of services (the so-called FIIRE sector of Finance, Insurance, Internet and Real Estate) creates the fewest jobs per unit of value added. It is for such reasons that major indirect tax reforms in recent times go under the rubric of *goods and services* tax reform. In the U.S., where state sales taxes have largely exempted services, there is evidence that the phenomenal growth of services is related to their non-taxation. A similar phenomenon is at work in India.

⁸ A further problem in the federal structure of India is the inadequate performance of the state governments with respect to tax effort. Jha et. al. (1999) discover that the higher the share of central financing of state

In terms of customs duties, tax reform theory calls for moving toward a free trade regime. These have typically involved replacing quantitative restrictions (broadly interpreted to include non-tariff barriers) with tariffs, reducing the mean and variance of tariffs and opening up domestic markets to foreign investment. In the Indian context some progress has been made in this regard, however, tariff levels in India are still much higher⁹ than Asian levels.

Since indirect taxes are regressive and distortionary it is natural to seek a reduction in their importance in overall tax revenues. For a developing country like India one could imagine that when per capita incomes are low the direct tax to GDP ratio would also be low. The per capita real Gross Domestic Product of the Indian economy as revealed by National Accounts Statistics has grown by about 2 per cent per annum between 1950-99, which would then imply that per capita output has grown by a factor of about 2.5 over the period 1950-99. However, despite this not unsubstantial performance, the tax/GDP ratio has actually fallen and the share of direct taxes stagnated at best. Customs duties have come down recently but nevertheless, India's tax mix was probably better at the dawn of independence than it is now. This is a serious indictment of tax design and administration in India.

Poor tax performance and inelastic revenue requirements have meant that fiscal deficits have been high in the Indian context. This is true of both the central as well as the state governments. The combined deficits of state and central governments have been high since the crisis year of 1991. Although the deficit of the central government fell in the early part of the structural adjustment period, some of this adjustment was done at the

government expenditures the lower is their tax effort.

expense of transfers to state governments¹⁰. This information is presented in Figure 2. In the mid to late 1990s the fiscal deficit of the central government fell whereas that of the state governments went up.

Bemoaning the fact that while the deficit of the central government fell that of the state governments increased, RBI (2000) noted:

"The fiscal outcome ... is essentially a reflection of the structural weakness of State finances. The revenue side is vulnerable to wide fluctuations either due to the constraint on the State Governments to generate adequate own resources or due to the variability in the vertical resource transfers, with the expenditures being inflexible to the revenue flows. This weakness often gets reflected in the form of the actual budgetary outcomes deviating from the initial projections of resources and expenditures. Such deviations bring to the fore the important issue of 'integrity of budgeting' or fiscal marksmanship of states."

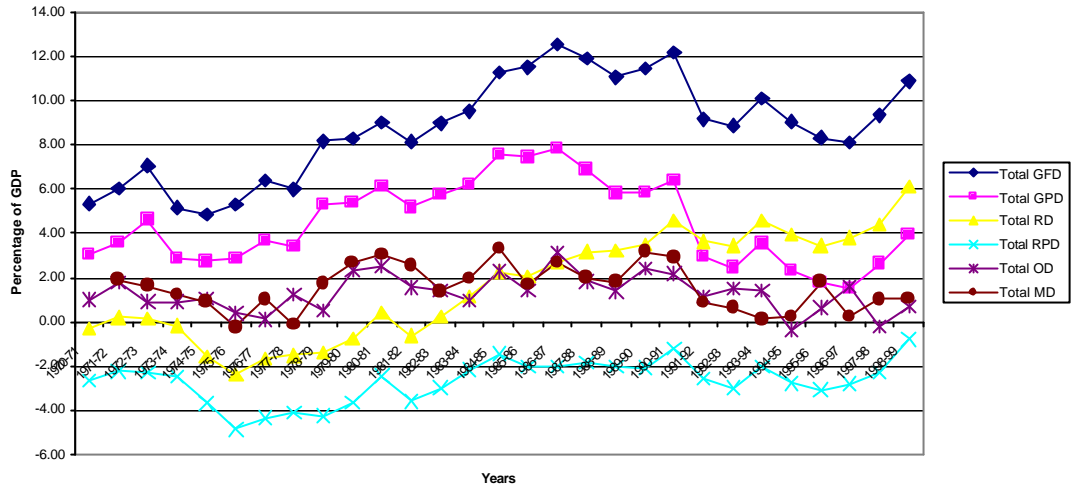
The high deficit of the state governments pushes up their borrowing requirements. Larger and larger portions of these borrowings are then used for consumption (servicing the debt) rather than for productive purposes. In 1999-2000 the total debt of state governments crossed its upper limit of 20% (as decreed by the Constitution of India) of GDP¹¹.

⁹ Although quantitative restrictions on imports were lifted on April 1, 2001 pursuant to India's agreements with the WTO, tariff levels have been raised in compensation.

¹⁰ Another major component of the adjustment was reduction in capital expenditures by all levels of government.

¹¹ In addition, the structure of transfers from the central to the state governments is not encouraging higher tax effort by state governments. See Jha et. al. (1999). Jha (1999b) examines sustainability of India's internal debt.

**Figure 2:
Combined Deficits of Central and State Governments**



(Figure 2 legend: GFD=gross fiscal deficit; GPD=gross primary deficit; RD=revenue deficit; RPD=Revenue Primary Deficit; OD=other deficit; monetized deficit).

Fitting a linear trend to the combined fiscal deficits of the state and central governments is a revealing exercise. There appears to be considerable serial correlation in this relation. When this is corrected for the trend is decisively upwards and is highly significant. In order to estimate the percentage trend rate of growth the estimated equation (corrected for serial correlation) for the log of the combined fiscal deficits of the central and state governments is reported below:

$$\text{Log GFD} = 1.7528 + 0.024162 \text{ Time}$$

10.6842[.000] 2.6657[.013]

R-Squared = 0 .79564 R-Bar-Squared = 0.77992

S.E. of Regression = 0.13209 F-stat. F(2, 26) = 50.6125[.000]

Akaike Info. Criterion = 15.7118 Schwarz Bayesian Criterion = 13.6608

DW-statistic = 1.8592

GFD is gross fiscal deficit of the central and state governments. Figures below a coefficient denote the corresponding t values with levels of significance in within adjacent square brackets. The time period covered by the estimation is 1970-98. This shows that there is a tendency for GFD to grow¹² by about 2.4% per year, on average. This is highly significant¹³.

India's performance with respect to external debt has not been very comforting either¹⁴. As Table 2 indicates, as of December 1998 India was the ninth most externally indebted country in the world.

Table 2

External Debt: India in Comparison with Other Major Debtors								
Country	Total External Debt (US\$ billion)	Debt to GNP (%)	Debt Service to Exports of Goods and Services (%)	Short term to Total Debt	PV of Total Debt	PV to exports Of goods and services (%)	PV to GNP	Indebtedness Classification
Brazil	232.0	31	354	11	119.9	347	28	Severe
Russia	183.6	69	207	10	165.2	166	45	Moderate
Mexico	160.0	42	110	17	155.7	121	44	Less
China	154.6	16	72	18	135.0	67	15	Less
Indonesia	147.5	173	254	14	144.7	238	84	Severe
Argentina	144.1	50	388	22	150.5	424	53	Severe
Korea	139.1	44	87	20	135.1	83	31	Less
Turkey	102.1	50	151	27	100.4	176	52	Moderate
India	98.2	23	144	4	84.3	147	20	Moderate
Thailand	86.2	77	125	27	85.3	116	58	Moderate
Philippines	47.8	70	109	15	45.3	102	57	Moderate
Poland	47.7	31	101	13	44.0	103	30	Less
Malaysia	44.8	65	62	19	47.3	54	55	Moderate

¹² As I have argued elsewhere (Jha (2001)) even this deficit is an underestimate. For instance, this deficit ignores the deficit on the "oil pool account" which by itself stood at 0.5% of GDP on March 1, 2001.

¹³ The monetised deficit has a tendency to fall over this time period.

¹⁴ As I have argued in Jha (2001) the current account deficit of India does not show a tendency to converge to a well-defined limit.

Venezuela	37.0	40	173	7	37.7	150	46	Moderate
Chile	36.3	48	181	21	36.8	179	53	Moderate
Indebtedness Benchmark	Severe: either PV/XGS>220 or PV/GNP >80		Moderate: either 132≥PV/XGS≥220 or 48≥PV/GNP≥80			Less: PV/XGS<132 and PV/GNP < 48		

Source: World Bank, **Global Development Finance 2000**

The composition of India's external debt is elaborated in Table 3. This shows the low proportion of short-term debt to total debt and underscores the prudence that Indian policy makers have traditionally exercised in the area of external debt. Also notable is the fact that loans available on concessional terms have declined significantly over time.

Table 3

India's External Debt Outstanding (US\$ billion)								
Categories	End March						End Sep	
	1991	1992	1995	1996	1998	1999	2000P	2000P
Long term Debt	75.26	78.22	94.74	88.70	88.49	93.29	94.40	93.36
Short term debt	8.54	7.07	4.27	5.03	5.04	4.39	4.04	4.50
Total Debt	83.80	85.29	99.01	93.73	93.53	97.68	98.44	97.86
External Debt – Key Indicators	(Ratios as percent)							
Total External Debt to GDP	28.7	38.7	30.8	27.0	24.3	23.6	21.9	20.7
Short-term to Total Debt	10.2	8.3	4.3	5.4	5.4	4.5	4.1	4.6
Short-term debt to Foreign Currency Assets	382.1	125.6	20.5	29.5	19.4	14.9	11.5	13.8
Concessional Debt to total Debt	45.9	44.8	45.3	44.7	39.5	38.1	38.5	37.5

P: Provisional

Source: **Economic Survey**, Government of India, February 2001

The overall picture then that emerges is one where there is considerable fiscal stress at all levels of government. Expenditures need to be harmonized and rationalized but the overwhelming need is to increase the tax/GDP ratio.

IV. Rectifying the Problem of Unproductive Public Investment

The second reason put forward in this paper for the inadequate growth performance of the Indian economy is the poor productivity of public expenditure. Although several issues are obviously involved here I will concentrate on two of these.

The first order of business has to be the targeting of public expenditure. From food subsidies to public production of intermediate and capital goods, there is considerable evidence of mistargeting of expenditures. Several authors, e.g. Jha et. al. (1999b) have commented on the mistargeting of major subsidy items such as food subsidies. The mistargeting of public expenditures in the design of anti poverty programs has been well documented by Gaiha (2000) and others. The deleterious effects of several industrial subsidies have been documented by Jha and Sahni (1993). Thus there is no gainsaying the fact that public expenditures in India whether these be at the central or state levels, on consumer or capital goods or public services need to be better targeted.

In addition to the question of targeting is that of proper design of public expenditure governance systems. In this context it is instructive to look at the experience of countries that have been able to put together a credible program of such reforms. Several OECD economies have been able to put into effect such public governance

reforms. In such countries economists, management theorists and politicians set about revitalizing the public sector during the 1980s, although there remains an underlying tension between the erstwhile control approach and the new approach emphasizing accountability.

Public expenditures are now based on a belief that markets provide a good benchmark for performance. Thus there have been attempts to not only withdraw the State from areas where the private sector can operate but also to find ways in which the market can intrude into areas that have traditionally been the preserve of the public sector.

As a result, there have been fundamental changes in the role of the state, its institutional structure and management systems. Six key elements of what has been called the New Public Management (NPM) agenda can be identified:

- * Sustained privatization of public enterprise, liberalization and the promotion of non-governmental service providers and, to some extent, a downsizing of state institutions have led to a redefinition of the role of the State. The State is now seen more as a facilitator than as a social engineer.
- * Administrative reforms have led to a separation of the policy and implementation functions. Creating executive government departments and decentralizing responsibility for the management of service delivery to departments closer to users have achieved this.
- * Bureaucratic controls on managers have been considerably reduced. This has afforded them greater autonomy in the application of resources and in the recruitment and remuneration of staff.
- * Setting out and monitoring performance targets, often through formal agency and

personnel performance contracts, have made incentives for government departments and personnel consistent with policy goals, and with introducing performance related pay.

* Competitive pressures are brought upon government departments through compulsory tendering, internal markets and benchmarking of performance between service delivery departments.

* Mechanisms have been put in place to ensure feedback from and accountability to the public, by creating opportunities for 'exit' (facilitating access to alternative private and public providers) and 'voice' (through, for instance, user surveys and the participation of representatives on management boards).

The NPM has entailed a fundamental change in the perceived purpose of public expenditure management systems. Whereas traditional administrative approaches emphasized expenditure control, in order to ensure compliance with procedures and legislatively mandated expenditure policies, as expressed in the annual budget, public expenditure management now emphasizes performance. This performance is assessed in terms of the goals of macro-economic stabilization and economy, efficiency and effectiveness in the use of public funds — the so-called SEEE criteria (Premchand (1993)).

Achievement of these goals requires having a broad managerial perspective, in which financial resources are jointly managed with other key resources as personnel and information, plans and decisions are resource-constrained rather than simply needs based and performance assessment contributes to planning and decision-making.

NPM also implies a wider institutional scope than has traditionally been the case, extending beyond the core functions of the ministry of finance to include expenditure

management at the departmental level, down to the point where citizens access public services. Concurrently, public expenditure management has also moved upstream, recognizing that policy decisions are expenditure decisions and that system performance can only be assessed in relation to policy goals.

In consonance with the focus on performance, public expenditure management systems are viewed as key instruments of governance. This requires that public expenditure management systems are not only transparent and accountable to the legislature, but also involve citizens in decision-making. Partly as a result of the abject failure of government to provide quality public services, since the 1980s LDCs, and India in particular, have seen a rapid expansion in the number of private sector and non-governmental organizations involved in the provision of, formerly, 'public' services. It is now common to find household spending on education and health exceeding State expenditures, even where governments claim to offer free services. Governments, recognizing their reduced capacity to provide services, have facilitated this process. In India, state governments have forged partnerships with local NGOs to improve coordination, provide support and ensure standards. International donors have contributed to this trend by channeling funds directly to NGOs. However, this process is not a structural transformation. By and large, the private sector and non-governmental organizations are seen as alternative service providers rather than an alternative mechanism for public service delivery, as proposed in NPM. Transforming this perception is a challenge to be addressed in any meaningful reform of public expenditure in India.

IV. Conclusions

This paper has outlined some pressing aspects of the research agenda that appear important at the beginning of the new millennium. The tax reforms program in India is considerably behind schedule. Fiscal imbalance is distorting central and state government expenditure patterns and impacting on growth. The basic factor causing this was identified as the low tax/GDP ratio in the Indian economy. It was argued that tax reform measures would improve the allocation of resources, thereby improving growth prospects and increasing the tax base and collections. These higher tax collections would ease the fiscal pressure on state and central governments thereby enabling them to undertake much needed expenditures of a capital nature as well as for poverty alleviation.

The paper has further argued that the rapid development of e-commerce while inevitable and welcome in its own right, has the potential of eroding the tax base of state governments. Given the anticipated large growth in e-commerce this problem is potentially of a serious nature and must be planned for. It was argued that lower levels of government would find it hard to levy sales taxes and hence more and more tax authority would have to be vested with the central government. Since decentralization of public expenditures would continue to be attractive, the role of fiscal transfers from the central to state governments is likely to become far more important in the future. This, then, becomes another critical area for policy research.

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