FISCAL POLICY IN INDIA: A REVIEW

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ABSTRACT

Fiscal policy is a policy of government’s actions and reactions. Every country does not want to grow only but develop also. In other words increase in National income and per capita income along with increased welfare of masses. For this the govt. Needs a sound fiscal policy which can help them to achieve desired objectives. This essay reviews the trends and trajectory of India’s fiscal policy with a focus on historical trends, fiscal discipline frameworks, and fiscal responses to the global financial crisis and subsequent return to a fiscal consolidation path. The initial years of India’s planning strategy were featured by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to finance the large public sector driven industrialization process and also cover social welfare schemes. However, growth was hampered and the system was prone to inefficiencies. In the 1980s some attempts were made to reform particular sectors. But the public debt increased, as did the fiscal deficit. India’s balance of payments crisis of 1991 led to economic liberalization. The reform of the tax system commenced. The fiscal deficit was controlled. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legalizations were instituted. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and moderate inflation prevailed. During the global financial crisis fiscal policy responded with counter-cyclical measures including tax cuts and increases in expenditures. The post-crisis recovery of the Indian economy is witnessing a correction of the fiscal policy path towards a regime of prudence. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.
Introduction
Fiscal policy is a part of economic policy of government which is related to government’s income and expenditure. It consists of four important instruments i.e. Taxation policy, Public debt policy, Public expenditure policy and Deficit financing. Fiscal policy deals with the taxation and expenditure decisions of the government. Monetary policy, deals with the supply of money in the economy and the rate of interest. These are the main policies used by economic managers to gear up required growth aspects of the economy. In most modern economies, the government deals with fiscal policy while the central bank is responsible for monetary policy. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy strategy. Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. This tends to influence other economic variables. On a broad generalization, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. If it draws down on its foreign exchange reserves, a balance of payments crisis may arise. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the “crowding out” of private investment. Sometimes a combination of these can occur. In any case, the impact of a large deficit on long run growth and economic well-being is negative. Therefore, there is broad agreement that it is not prudent for a government to run an unduly large deficit. However, in case of developing countries, where the need for infrastructure and social investments may be substantial, it sometimes argued that running surpluses at the cost of long-term growth might also not be wise (Fischer and Easterly, 1990). The challenge then for most developing country governments is to meet infrastructure and social needs while managing the government’s finances in a way that the deficit or the accumulating debt burden is not too great. Before beginning it is important to know that Fiscal Deficit = Total Expenditure (that is Revenue Expenditure + Capital Expenditure) – (Revenue Receipts + Recoveries of Loans + Other Capital Receipts (that is all Revenue and Capital Receipts other than loans taken)).

Objectives:
1. To study tools of fiscal policy.
2. To study trends of fiscal policy.
3. To study possible reasons of fiscal deficit.
4. To compare Centre and state fiscal deficit variation.

REVIEW OF LITERATURE
The opening chapter, ‘Fiscal Developments and Outlook in India’, by Indira Rajaraman focuses on the factors underlying the continued weak fiscal position during the previous one and half decades as well as the prospects of recent fiscal reforms. The author identifies that the impact of trade liberalization measures and their associated loss of tariff revenue remained the major factor underlying the weakened fiscal position since the early 1990s. Unlike other countries which undertook tariff rate reductions, India did not compensate the loss of revenue by a commensurate increase in domestic taxes. The author is of the view that buoyant growth in India is essential for fiscal reforms to be possible and this requires that the kinds of physical and social infrastructure should go up in both quality and quantity. The author finds two strands to the fiscal imbalance path in India. First, high interest rates on public debt which started rising sharply in the 1980s and details the political economy pressure that fuelled this rise. Second, non-interest fiscal indicators which worsened sharply in 1998 with the real wage hike introduced that year for government employees and pensioners raising the consolidated salary bill substantially. An econometric exercise investigates whether this event was endogenous to the political economy. The regression equations show an election year...
response, which has become more marked in the last 30 years. The author recognizes the importance of two major reforms, i.e., the reforms of the interest rates guaranteed under the NSSF and passage of the Fiscal Responsibility Legislation (a. IMF-NIPFP, Conference on Fiscal Policy in India, New Delhi, January 16-17 2004).

He had given a positive analysis, to examine the overall outcomes emerging from a complex set of institutions and motivations. He found that a system with large vertical transfers is inevitably subject to political pressures and unintended effects, implying a need to reconfigure the underlying tax assignments to achieve a better match with expenditure responsibilities at different levels of government. (Nirvikar Singh, and Garima Vasishtha, 2004)

Kumar and Soumya found that the need for fiscal consolidation and sustainability is one of the crucial macroeconomic issues confronting Indian economy. He attempted to understand India’s current fiscal situation, its likely future development, and its impact on the economy in the context of a weak global recovery from the current crisis. The impact of the global crisis has been channelized to the Indian economy through three distinct channels, namely: the financial sector, exports, and exchange rates. The other significant channel of impact is the slump in business and consumer confidence leading to decrease in investment and consumption demand. He has suggested refined objective of economic policy. It must be to maximize gains from global integration while ensuring a reduction in poverty and inequity. So he advised a better way of responding to the crisis is to start the “second round of reforms” that are now overdue. The focus must now turn to promote private investment, which can alone sustain rapid growth.

Empirical studies have demonstrated that most of the countries are trying to cut public debt and deficit financing. Imran Saleem has found that India is successful in doing that because India has got second highest propensity to consume for domestic production which in turn generated multiplier effect. Further he suggested making modifications in direct taxes and to enhance aggregate demand will reduce fiscal deficit. He also suggested generational model in which he advised to do more investment in public sector despite of the fact that deficit may rise. This investment will be further driven by multiplier and accelerator effect. But still this is not the sufficient and necessary condition for fiscal sustainability (jan2014).

She suggested for a stronger economy target investments to boost the economy, now and in the future, Improve fiscal planning to protect services and investments that promote long-term economic growth, Help struggling families meet basic needs and participate more fully in the economy, by reducing poverty, hardship, and income inequality; and Avoid ineffective strategies and gimmicks that can weaken the state’s economy. (Erica Williams 2014)

**Evolution of Indian fiscal policy till 1991**

India started planning after getting independent as it was required at that time around 1950. Exactly India commenced on the path of planned development with the setting up of the Planning Commission in 1950. That was also the year when the country adopted a federal Constitution with strong unitary features giving the central government primacy in terms of planning for economic development (Singh and Srinivasan, 2004). The forthcoming planning process laid emphasis on strengthening public sector enterprises as a means to achieve economic growth and industrial development. The resulting economic framework imposed administrative controls on various industries and a system of licensing and quotas for private industries. Consequently, the main role of fiscal policy was to transfer private savings to cater to the growing consumption and investment
needs of the public sector. Other goals included the reduction of income and wealth inequalities through taxes and transfers, encouraging balanced regional development, fostering small scale industries and sometimes influencing the trends in economic activities towards desired goals (Rao and Rao, 2006).

Tax policy was used via direct and indirect taxes for extracting revenues from the private sector to fund the public sector and achieve redistributive goals. The combined Centre and state tax revenue to GDP ratio increased from 6.3 percent in 1950-51 to 16.1 percent in 1987-88. For the central government this ratio was 4.1 percent of GDP in 1950-51 with the larger share coming from indirect taxes at 2.3 percent of GDP and direct taxes at 1.8 percent of GDP. Given their low direct tax levers, the states had 0.6 percent of GDP as direct taxes and 1.7 percent of GDP as indirect taxes in 1950-51 (Rao and Rao, 2006). The government authorized a comprehensive review of the tax system culminating in the Taxation Enquiry Commission Report of 1953. However, the government then invited the British economist Nicholas Kaldor to examine the possibility of reforming the tax system. Kaldor found the system inefficient and inequitable given the narrow tax base and inadequate reporting of property income and taxation. In indirect taxes, a major component was the central excise duty. This was initially used to tax raw materials and intermediate goods and not final consumer goods. But by 1975-76 it was extended to cover all manufactured goods. The excise duty structure at this time was complicated and tended to distort economic decisions. Some commodities had specific duties while others had ad valorem rates. The tax also had a major “cascading effect” since it was imposed not just on final consumer goods but also on inputs and capital goods. In effect, the tax on the input was again taxed at the next point of manufacture resulting in double taxation of the input. Considering that the states were separately imposing sales tax at the post-manufacturing wholesale and retail levels, this cascading impact was considerable. The Indirect Tax Enquiry Report of 1977 recommended introduction of input tax credits to convert the cascading manufacturing tax into a manufacturing value added tax (MANVAT). Instead, the modified value added tax (MODVAT) was introduced in a phased manner from 1986 covering only selected commodities (Rao and Rao, 2006).

The other main central indirect tax is the customs duty. Given that imports into India were restricted, this was not a very large source of revenue. The tariffs were high and differentiated. Items at later stages of production like finished goods were taxed at higher rates than those at earlier stages, like raw materials. Rates also differed on the basis of perceived income elasticity with necessities taxed at lower rates than luxury goods. In 1985-86 the government presented its Long-Term Fiscal Policy stressing on the need to reduce tariffs, have fewer rates and eventually remove quantitative limits on imports. If we compare graphically the composition of revenue then it is visible that share of indirect tax is increasing over time. In 1970-71, direct taxes contributed to around 16 percent of the central government’s revenues, indirect taxes about 58 percent and the remaining 26 percent came from non-tax revenues (Figure 1). By 1990-91, the share of indirect taxes had increased to 65 percent, direct taxes shrank to 13 percent and non-tax revenues were at 22 percent (Figure 2)
Government Expenditure:- Govt expenditure can be categorized into two categories: developmental and non-developmental expenditure. Developmental expenditure creates infrastructure and physical capital while non-developmental expenditure human capital that is pensions, scholarships etc are provided. As per "Indian Public Finance Statistics" report 2012-13 of the expenditure of Centre, States and General Governments covering the period 1990-91 to 2012-13(BE) attempts to examine the trends in developmental and non-developmental expenditure.
The composition of aggregate expenditure of both State and Central Governments shows that developmental expenditure increased steadily after the enactment of FRBM Act. However, there has been a modest stagnation in the share of developmental expenditure in the last two years. States have done well during the same period as compared to the Central Government in terms of raising developmental expenditure. Capital developmental outlay has increased for both the Centre and the States while the non-developmental revenue expenditure has gone down. These impressive and positive trends indicate that the quality of expenditure for Centre, States and General Government is on the path of improvement and this improvement is significant in the post-FRBM period compared to the pre-FRBM period. Developmental expenditure has three components; revenue developmental expenditure, capital developmental expenditure and developmental loans and advances. In a study of either the Central Government budget or State budgets both the quantity and the quality of public expenditure has always been an important issue especially while analyzing the impact of public expenditure on overall economic development. In judging quality of expenditure, experience of many developed and other emerging market economies indicate the use of a wide variety of measures. These measures include prioritization of expenditure, capping certain expenditure and greater transparency and accountability in measuring in public expenditure. On the lines of many countries which embarked on a massive effort in re-engineering government expenditure, the Government of India introduced the FRBM Act to both check public expenditure and to ensure its quality. While capping the expenditure or compressing public expenditure care should be taken that essential components of expenditure are not curtailed. Excessive public expenditure may lead to crowding out effect; but not getting the right size and the right composition of government expenditure may also negatively affect the objectives of inclusive and sustainable growth. On-developmental expenditure remains the dominant component of aggregate expenditure of the Central Government. Prior to the FRBM Act the share of non-developmental expenditure was continuously increasing; 2004-05 was a watershed year after which the share of developmental expenditure started increasing and share of non-developmental expenditure started declining (Chart-1). Similar trend has also been observed in revenue expenditure of the Central Government (Chart-2).

Chart-1 Decomposition of Central Government's Expenditure

![Chart-1 Decomposition of Central Government's Expenditure](image-url)
**Note:** Figure for 2011-12 is revised estimates and 2012-13 is budget estimates.

**Source:** Indian Public Finance Statistics Report 2012-2013

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**Chart 2:** Decomposition of State Governments' Expenditure

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**Note:** Figure for 2011-12 is revised estimates and 2012-13 is budget estimates.

**Chart 3:** Share of Direct and Indirect Taxes in Total Tax Revenue of Central Government

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**Note:** Figure for 2011-12 is revised estimates and 2012-13 is budget estimates

**Source:** Indian Public Finance Statistics Report 2012-2013
Chart-9 Share of Direct and Indirect Taxes in Total Tax Revenue of State Government

Note: Figure for 2011-12 is revised estimates and 2012-13 is budget estimate

Source: Indian Public Finance Statistics Report 2012-2013
## 4.3 FISCAL DEFICIT OF THE CENTRE AND THE STATES

<table>
<thead>
<tr>
<th>Year</th>
<th>Centre (' crore)</th>
<th>States (' crore)</th>
<th>Combined (' crore)</th>
<th>Centre (per cent of GDP)</th>
<th>States (per cent of GDP)</th>
<th>Combined (per cent of GDP)</th>
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<td>1990-91</td>
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<td>18558</td>
<td>53320</td>
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<td>30844</td>
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<td>45849</td>
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<td>2.81</td>
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<td>35909</td>
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<td>51643</td>
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<td>6.67</td>
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<td>1993-94</td>
<td>55257</td>
<td>20126</td>
<td>70310</td>
<td>6.20</td>
<td>2.26</td>
<td>7.89</td>
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<td>1994-95</td>
<td>48030</td>
<td>27350</td>
<td>70739</td>
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<td>2.62</td>
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<td>50253</td>
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<td>2.61</td>
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<td>37490</td>
<td>86650</td>
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<td>73204</td>
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<td>104717</td>
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<td>2000-01</td>
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<td>2002-03</td>
<td>145072</td>
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<td>3.89</td>
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<td>2003-04</td>
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<td>233452</td>
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<td>2004-05</td>
<td>125794</td>
<td>105130</td>
<td>233051</td>
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<td>3.24</td>
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<td>2005-06</td>
<td>146435</td>
<td>87608</td>
<td>237187</td>
<td>3.96</td>
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<td>2006-07</td>
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<td>79979</td>
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<td>2007-08</td>
<td>126912</td>
<td>75690</td>
<td>199375</td>
<td>2.54</td>
<td>1.52</td>
<td>4.00</td>
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<td>2008-09</td>
<td>336992</td>
<td>127320</td>
<td>459908</td>
<td>5.99</td>
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<td>8.17</td>
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<tr>
<td>2009-10</td>
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<td>194961</td>
<td>610851</td>
<td>6.46</td>
<td>3.01</td>
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<td>2010-11</td>
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<td>529594</td>
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<td>2.03</td>
<td>6.79</td>
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<td>2011-12(RE)</td>
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<td>212015</td>
<td>731957</td>
<td>5.82</td>
<td>2.36</td>
<td>8.16</td>
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<tr>
<td>2012-13(BE)</td>
<td>513590</td>
<td>219284</td>
<td>730319</td>
<td>5.06</td>
<td>2.16</td>
<td>7.19</td>
</tr>
</tbody>
</table>
NOTE: 1. GDP at current market prices based on CSO’s National Accounts 2004-05 series is used.
2. Combined fiscal deficit of the Centre and State Governments are adjusted for double counting.
4. The figures for the central govt. are exclusive of state’s share against small savings collection.

### Comparison of Centre and State Fiscal Deficit

<table>
<thead>
<tr>
<th></th>
<th>CENTRE</th>
<th>STATE</th>
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<tr>
<td>N</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>MEAN</td>
<td>249776.52174</td>
<td>88860.91304</td>
</tr>
<tr>
<td>S.D</td>
<td>212833.10837</td>
<td>61200.98871</td>
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<tr>
<td>CO-EFFICIENT OF S.D</td>
<td>.852</td>
<td>.688</td>
</tr>
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</table>

Higher Standard deviation in case of Centre indicates variations in expenditure in different time periods. Non-developmental expenditure remains the dominant component of aggregate expenditure of the Central Government. Prior to the FRBM Act the share of non-developmental expenditure was continuously increasing; 2004-05 was a watershed year after which the share of developmental expenditure started increasing and share of non-developmental expenditure started declining (Chart-1). Similar trend has also been observed in revenue expenditure of the Central Government (Chart-2). These brought higher SD in case of Centre.

### Possible causes of fiscal deficit:
Several reasons can be counted for fiscal deficit. Different researchers found the same reasons in one or the other way.

1. Payment of interest, increase in subsidies
2. Lok Sabha Secretariat Research and Information Division has come out with same causes of India’s financial woes such as more developmental expenditure being a welfare state and rise in crude oil prices and imports. Besides the sky-rocketing demand for gold in the economy is another cause for current account deficit. Interest payments on the external borrowings for financing developmental expenditure are a common reason. Defence expenditure due to security reasons and committed expenditure of pensions payments and interest payments has increased manifold aggravated the problem.

3. "India's high budget deficits are partly due to a large population and low per capita income levels. Low income levels limit the government's tax revenue base and at the same time drive socio-political pressure to increase government spending on subsidies and economic development," Moody's Investors Service said in the report titled: "Frequently asked questions on India's fiscal position and the forthcoming budget".

4. The figures for the central govt. are exclusive of state’s share against small savings collection.
**Results and conclusion:** Thus the paper deals with the fiscal policy and its tools. Data has been provided regarding revenue and expenditure of the government. Fiscal deficit has been compared and found that value of standard deviation is higher in case of Centre government as compared to state government indicating more variation in deficit. If we talk about the possible causes of fiscal deficit these are interest payments on borrowings, subsidies, defence expenditure, pressure of population and high demand for gold etc. High fiscal deficit can heighten inflation, remove effectiveness of monetary policy stimulants, increase the risk of external sector imbalances and can dampen private investment. It can also leads to debt trap for the economies. In short the two phases of fiscal policy stance immediately before the 2008 global crisis and thereafter are discernible in a longer period analysis. The gap between non-debt receipts and total expenditure (as proportion of GDP) reflects the extent of FD and depicts the shift of fiscal policy from consolidation to expansion during the two phases.

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