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A Review of India's fiscal policy architecture

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Abstract

We investigate the macroeconomic effects of fiscal policy using a Bayesian Structural Vector Autoregression (B-SVAR) approach. We identify fiscal policy shocks via a partial identification scheme, but also: (i) include the feedback from government debt; (ii) look at the impact on the composition of output; (iii) assess the effects on asset markets; (iv) use quarterly data; and (v) analyse empirical evidence from the US, the UK, Germany and Italy. The results show that government spending shocks, in general, have a small effect on Gross Domestic Product (GDP); lead to important 'crowding-out' effects; have a varied impact on housing prices and generate a quick fall in stock prices. Government revenue shocks generate a mixed effect on housing prices and a small and positive effect on stock prices. The empirical evidence also suggests that it is important to explicitly consider the government debt dynamics in the model.

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Introduction

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 policy approaches used by economic managers to steer the broad 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 composed of several parts. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. 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.1 This tends to influence other economic variables. On a broad generalisation, 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.

This essay examines the trajectory of India's fiscal policy with particular focus on historical trends, the development of fiscal discipline frameworks, the recent experience of fiscal response to the global financial crisis and subsequent return to a fiscal consolidation path. The initial years of India's planned development strategy were characterised by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector driven industrialization process and also cover social welfare schemes. Indirect taxes were a larger source of revenue than direct taxes. However, growth was anaemic and the system was prone to inefficiencies. In the 1980s some attempts were made to reform particular sectors and make some changes in the tax system. But the public debt increased, as did the fiscal deficit. Triggered by higher oil prices and political uncertainties, the balance of payments crisis of 1991 led to economic liberalisation. The reform of the tax system commenced with direct taxes increasing their share in comparison to indirect taxes. The fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legalisations were instituted at the central level and in most states. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and moderate inflation prevailed. The global financial crisis tested the fiscal policy framework and it 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.

India's fiscal policy architecture

The Indian Constitution provides the overarching framework for the country's fiscal policy. India has a federal form of government with taxing powers and spending responsibilities being divided between the central and the state governments according to the Constitution. There is also a third tier of government at the local level. Since the taxing abilities of the states are not necessarily commensurate with their spending responsibilities, some of the centre's revenues need to be assigned to the state governments. To provide the basis for this assignment and give medium term guidance on fiscal matters, the Constitution provides for the formation of a Finance Commission (FC) every five years. Based on the report of the FC the central taxes are devolved to the state governments. The Constitution also provides that for every financial year, the government shall place before the legislature a statement of its proposed taxing and spending provisions for legislative debate and approval. This is referred to as the Budget. The central and the state governments each have their own budgets.

The central government is responsible for issues that usually concern the country as a whole like national defence, foreign policy, railways, national highways, shipping, airways, post and telegraphs, foreign trade and banking. The state governments are responsible for other items including, law and order, agriculture, fisheries, water supply and irrigation, and public health.

Some items for which responsibility vests in both the Centre and the states include forests, economic and social planning, education, trade unions and industrial disputes, price control and electricity. There is now increasing devolution of some powers to local governments at the city, town and village levels. The taxing powers of the central government encompass taxes on income (except agricultural income), excise on goods produced (other than alcohol), customs duties, and inter-state sale of goods. The state governments are vested with the power to tax agricultural income, land and buildings, sale of goods (other than inter-state), and excise on alcohol.

Besides the annual budgetary process, since 1950, India has followed a system of fiveyear plans for ensuring long-term economic objectives. This process is steered by the Planning Commission for which there is no specific provision in the Constitution. The main fiscal impact of the planning process is the division of expenditures into plan and non-plan components. The plan components relate to items dealing with long-term socioeconomic goals as determined by the ongoing plan process. They often relate to specific schemes and projects. Furthermore, they are usually routed through central ministries to state governments for achieving certain desired objectives. These funds are generally in addition to the assignment of central taxes as determined by the Finance Commissions. In some cases, the state governments also contribute their own funds to the schemes. Non-plan expenditures broadly relate to routine expenditures of the government for administration, salaries, and the like.

While these institutional arrangements initially appeared adequate for driving the development agenda, the sharp deterioration of the fiscal situation in the 1980s resulted in the balance of payments crisis of 1991, which would be discussed later. Following economic liberalisation in 1991, when the fiscal deficit and debt situation again seemed to head towards unsustainable levels around 2000, a new fiscal discipline framework was instituted. At the central level this framework was initiated in 2003 when the Parliament passed the Fiscal Responsibility and Budget Management Act (FRBMA).

Taxes are the main source of government revenues. Direct taxes are so named since they are charged upon and collected directly from the person or organisation that ultimately pays the tax (in a legal sense).2 Taxes on personal and corporate incomes, personal wealth and professions are direct taxes. In India the main direct taxes at the central level are the personal and corporate income tax. Both are till date levied through the same piece of legislation, the Income Tax Act of 1961. Income taxes are levied on various head of income, namely, incomes from business and professions, salaries, house property, capital gains and other sources (like interest and dividends).3 Other direct taxes include the wealth tax and the securities transactions tax. Some other forms of direct taxation that existed in India from time to time but were removed as part of various reforms include the estate duty, gift tax, expenditure tax and fringe benefits tax. The estate duty was levied on the estate of a deceased person. The fringe benefits tax was charged on employers on the value of in-kind non-cash benefits or perquisites received by employees from their employers. Such perquisites are now largely taxed directly in the hands of employees and added to their personal income tax. Some states charge a tax on professions. Most local governments also charge property owners a tax on land and buildings.

Indirect taxes are charged and collected from persons other than those who finally end up paying the tax. For instance, a tax on sale of goods is collected by the seller from the buyer. The legal responsibility of paying the tax to government lies with the seller, but the tax is paid by the buyer. The current central level indirect taxes are the central excise, the service tax, the customs duty and the central sales tax on inter-state sale of goods. The main state level indirect tax is the post-manufacturing sales tax. The complications and economic inefficiencies of this multiple cascading taxation across the economic value chain are discussed later in the context of the proposed Goods and Services Tax.

Conclusion:

The fiscal expansion associated with budget composition matters for the length of the crisis since all fiscal variables, such as public consumption, public investment, income taxes and goods service taxes, would lead to a reduction of the duration of the crisis. Furthermore, the result suggests that the government may undertake such measures as expenditure-based or revenue-based fiscal expansion in order to reduce the duration of the crisis. The result also suggests that income tax cuts are a more effective tool than government consumption, public investment and goods and service taxes in shortening the length of the crisis in those countries. A decrease in the income tax by 1% would shorten the length of the crisis by around two months, which is not the case with public consumption, public investment and goods and service taxes.

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