

India's Fiscal Policy

**Prescriptions, Pragmatics
and Practice**

Edited by
Supriyo De

Foreword by
Kaushik Basu



Fiscal policy has gained salience amid the challenges policymakers are facing in a post-crisis world. This book seeks to balance normative prescriptions on fiscal policy with its practical aspects in context of the Indian scenario. In doing so, it brings together views of leading experts from academic and policy spheres. It seeks to highlight the specificities of Indian fiscal policy and studies current issues like the impact of development expenditures, the GST, the challenge of reducing subsidies, and different aspects of political economy.

India's Fiscal Policy discusses rapid developments in the field following the fiscal stimulus of 2008, subsequent attempts at fiscal consolidation, and the formation of the NDA government. It focuses on policy and political considerations and adopts a wider approach for the analysis of fiscal policy by taking into consideration aspects such as the effectiveness and targeting of social expenditures, which are essential for a critical analysis of the Indian policy matrix.

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Supriyo De is Senior Economist at the World Bank, Washington D.C.

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Supriyo De is Senior Economist at the World Bank, Washington D.C. Prior to this he was Officer on Special Duty to the Chief Economic Adviser of India. He has a Ph. D. in Economics from the University of Sydney and was a recipient of the Endeavour International Postgraduate Research Scholarship. His research interests include analysis of sovereign credit ratings, macroeconomic impacts of remittances, fiscal policy in developing economies, endogenous growth theory, technology policy and intangible capital.

Foreword

Fiscal policy is one of those unusual subjects on which there are more people who hold an opinion than know what it means. More worryingly, political leaders get to shape it often with the most rudimentary notion of what it implies for the economy. Yet the importance of fiscal policy is immense. Wrongly done, it can stall growth, increase bureaucratic costs, fuel inflation, and cause income distribution to deteriorate. And, by the obverse, it can contribute to enhancing our well-being on all those dimensions if it is designed right.

I am especially sensitive to the importance of this subject because I learnt what I did by fire, when I joined the Ministry of Finance in New Delhi, in 2009, as Chief Economic Adviser to the government. Fiscal policy was my major concern during those nearly-three years that I spent in government, by virtue of the fact that a large part of the work in the Ministry of Finance is related to the Union Budget. I had acutely felt the need for more research and better books that connect the tomes of work on the theory of fiscal policy done in universities and specialized research institutes to the challenges faced by India. And the challenges were, and are, many. India's tax revenue collection is too small compared to its GDP. If this can be enhanced by another 50%, which is entirely within the realm of the possible, the country can have vastly better infrastructure—ports, railway, roads, power—and it could do much more to promote health, nutrition, education, among the poor, thereby closing some of the earnings gap and also promoting overall growth. India has systems of distributing food grain, health services and education to the poor but the organization is complex and plagued by fiscal leakages.

I am delighted to have in my hand a book which begins to deliver on precisely this need. **India's Fiscal Policy: Prescriptions, Pragmatics and Practice** edited by Supriyo De stands out for its effort to bring together the best of theoretical knowledge and ground realities of India between the covers of one book. It is also surprisingly topical. The book discusses at length the importance of the Goods and Services Tax (GST), and how it can be implemented well. The passing of the GST Bill by the Indian parliament earlier in 2016 was a landmark. If this is implemented well it can boost GDP not just by making the tax system

more rational but by cutting down the transactions cost of paying taxes, which imposes a major bureaucratic cost on business enterprises in India, especially ones that operate across the states. The GST can be a major nudge towards a single market.

The book also analyzes food security, land acquisition, the panoply of taxes and subsidies that the energy sector has to deal with, and many other important and topical subjects. Apart from having major distributional impact, these taxes and subsidies also have important implications for the environment and for pollution control, topics of great urgency for India. Over and above all this, the book begins with a primer on fiscal policy which can be extremely handy for not just economics students but those thrust into high office without sufficient advance notice.

My only complaint about the book is that I did not have it when I worked as Chief Economic Adviser in India.

Kaushik Basu
C. Marks Professor and Professor of Economics
Cornell University, New York
Former Chief Economist, The World Bank

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Introduction: Contours of the Indian Fiscal Policy Debate

Fiscal policy has gained salience amidst the challenges facing policymakers in the post-crisis world. As the title suggests, this book seeks to balance normative prescriptions on fiscal policy with its practical aspects in the context of the Indian scenario. In doing so, it brings together views of leading experts from academic and policy spheres. This book seeks to highlight the specificities of Indian fiscal policy (which are often not covered by conventional 'text book' approaches) to provide readers with a conceptual base as also bring them abreast with the most recent developments. Current issues like the impact of development expenditures, the challenge of reducing subsidies and political economy aspects are focussed upon. Considering rapid developments in the field, especially following the fiscal stimulus of 2008, subsequent attempts at fiscal consolidation and the formation of the NDA government, a fresh look into India's fiscal policy is warranted.

This book is different from others on the subject in terms of its focus on policy and political considerations, which have gained increasing importance in the Indian context. This is driven by the very obvious observation that divergences between prescribed fiscal policy options and actual practices, quite evident in most countries, are even more prolific in the Indian context. For instance, professional economists unanimously endorse a nation-wide goods and services tax (GST) and the need to curb subsidies. Yet, India's GST legislation process dragged on for many years while energy subsidies persist and food subsidy commitments were enhanced recently. These aspects are discussed threadbare in some of the chapters (Chapters 2–4). In debatable policy issues such as the separation of debt management from central banking, agreement and action seem to evade us forever (Chapter 6). It also adopts a wider approach for the analysis of fiscal policy by taking into consideration aspects such as political motivations and, the effectiveness and targeting of social expenditures, which are essential for a critical analysis of the Indian policy matrix (discussed in Chapters 5, 7 and 8).

This book proposes to cater to a large but often neglected readership – those who may not have a strong formal background in economics but need to grasp the essentials and complexities of India's fiscal policy; students of professionally oriented programmes such as Master of Business Administration or Public Policy/Administration, corporate executives including those in multinationals, staff at multilateral institutions and government officials.¹ It could also be used as a primer or supplementary material for undergraduate students of economics for public finance or macroeconomics courses.² This book, therefore, adopts a style that is bereft of jargon and explains the basic concepts required for an understanding of the subject. For the academic or industry economist, its utility would lie in its description of facts that are often not found collected in one place and also a focus on the most recent policy debates and dilemmas.

With purchasing power parity gross domestic product (GDP) of over \$7 trillion (constant 2011 international \$), India is the fourth largest economy in the world and home to around 1.3 billion people. India's per capita income (PPP-adjusted) at just over \$5,500 makes it a lower middle-income country as per the World Bank classification. Since liberalization of the economy in 1991, the country has witnessed phenomenal growth. On the eve of the Global Financial Crisis in 2007, India was growing at a scorching pace of over 8 per cent. The Indian economy weathered the crisis rather well with the growth rate slowing to only around 4 per cent in 2008 when the high-income economies were nearly stagnant. India's growth bounced back to just over 8 per cent in 2009 even as high-income countries shrank by over 3 per cent.³ The crisis and subsequent developments saw India become part of the G20, the group of large developed and developing economies that plays a key role in global economic governance. After a brief slowdown, it is projected to grow at around 7.6 per cent in 2015 and accelerate to 7.7 per cent in 2017.⁴ This gives India a salient place among global economies in terms of growth momentum.

Yet, vast challenges remain. India accounts for one third of the world's poor, a whopping 400 million people. Social and economic inequality abounds and is heightened by factors such as gender and caste. Regional divergences in terms of income and growth are also abundant. The poorest state Bihar has a per capita net state domestic product that is around one eighth of that of the rich states such as Goa and Delhi.⁵ Illiteracy, poor educational outcomes and slim employment opportunities threaten to derail a demographic dividend.

These dichotomies, rapid growth and persistent poverty, burgeoning opportunities available to the privileged few, great wealth amidst backbreaking poverty, shape the fiscal policy debate in India. The first manifestation of this is the tension between taxation and redistributive expenditures and subsidies. Furthermore, the underlying systems require substantial overhaul to cope with emerging challenges. Finally, the way the political debate is shaped tends to gravitate towards fairly irreversible outcomes that erode fiscal balances.

In its entirety, four main messages arise from this book. The first is the need to enhance revenues and refine the tax system, especially through the GST. Second, there is need for overhauling the architecture of some aspects of the fiscal landscape, such as fiscal federal relations and the debt management system. Third, effectiveness of allocated expenditures should to be enhanced through better targeting using devices such as direct cash transfers or improving outcomes in social sectors. Last but not the least, the political system has to evolve a mechanism through which redistributive urges are balanced against fiscal discipline considerations.

This book commences with this introductory essay followed by a chapter examining the trajectory of India's fiscal policy. The former places the Indian fiscal policy debate within the larger context of India's dynamic economy. The latter focusses on historical trends, fiscal discipline frameworks, responses to the global financial crisis and recent budgets. This part also deals with basic concepts in an approachable manner and prepares the reader for the more complicated arguments that follow.

The second chapter discusses the federal structure and evaluates the case for the GST. Indirect tax reform, the chapter avers, has been shackled by Constitutional provisions due to which neither the central nor state governments have the authority to levy taxes on a comprehensive base of all goods and services across all stages of production and supply. It finds that there is a case for the GST highlighting the cascading and frictional impacts of the current system. Furthermore, it argues that the federal transfer formula must cushion the fiscal implications of such a move on the states. The chapter also posits that there is an urgent need to review the totality of transfers from the central to state governments and local bodies.

The third chapter seeks to examine the vexing issue of the impact of energy subsidies on India's public finances. Political economy constraints that contribute to their persistence are discussed. It highlights that while in the oil sector, the aim is to protect consumers from the full impact of market-determined prices, in the

power sector, the politically important rural consumers drive the demand for subsidies. The renewable energy sector, on the other hand, has price distortions due to input capital subsidies. Consequently, this cocktail of subsidies impacts the fiscal balance at the state as well as the central level. It also makes the system complex, fairly opaque and prone to inefficiencies.

The contentious National Food Security Act, which is the largest welfare programme in the world to alleviate hunger and malnutrition, and its fiscal implications, is the focus of the fourth chapter.

Continuing with the theme of politically oriented economic policies in India, the fifth chapter highlights the nuanced shift towards rights-based legislations during the tenure of the Congress-led UPA government. The chapter argues that while the new Land Acquisition Act, 2013, and the National Food Security Act, 2013, were vanguards of the rights-oriented focus by legally empowering individuals and households to higher economic entitlements, the two legislations, were not bereft of political motives. The possible fiscal impacts of these developments are analysed. It reiterates the disturbing possibility that if the current land acquisition law makes cost of land-intensive development excessively high, it might actually lead to greater demand for fiscal incentives from industry for undertaking new projects. Furthermore, slowdown in real-estate transactions may hurt sub-national tax collections such as property taxes and stamp duties.

Practical aspects of debt management are the focus of the sixth chapter. It states that the main objective of debt management is to minimize the cost of borrowings over the medium to long run, consistent with a prudent degree of risk. The chapter reveals the arguments for a separate debt management office as well as the post-crisis rethinking of the issue of separation of monetary policy, fiscal policy and debt management. In balance, it finds that separation of debt management will help establish transparency, and assign specific responsibility and accountability on the debt manager.

Continuing with implementation aspects, the seventh chapter on direct cash transfers examines the possible benefits and risks of this attempt at better targeting of social expenditures. It posits that the main debate has been between direct cash transfers and in-kind transfers. It states that the deficiencies of the old in-kind food distribution system have been recognized for decades. Direct cash transfers can tackle leakages by removing 'duplicates' and 'ghosts'. This would reduce the fiscal bill, bring transparency and help in financial inclusion.

The final chapter continues with the analysis of public expenditures, this time in the context of the education sector. It traces trends in India's public educational expenditure, its effectiveness and implications. India compares poorly to other Brazil, Russia, India and China (BRIC) countries in terms of secondary school participation and youth literacy rates. The empirical literature on the socio-economic and demographic factors that influence household level decisions on education in India is discussed. The chapter finds that India's expenditure on social sectors such as education suffers from both inadequate allocation of budgetary resources and ineffective implementation on the ground.

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Notes

- 1 Across my career, I realized that this was a considerable chunk of decision makers. For instance, directly recruited generalists dominate the Indian civil services.
- 2 Indeed, I have received requests from academics teaching such courses to allow use of my Ministry of Finance working paper (on which the early part of this book is based) as part of their course material.
- 3 Data from World Bank World Development Indicators database.
- 4 "Global Economic Prospects: June 2016", The World Bank, Washington, D.C.
- 5 Data from Ministry of Statistics and Programme Implementation, India.

