

Dissection of a Bold Budget

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Barring adverse harvests or oil price movements, the 1993-94 budget is likely to increase the industrial growth rate, without significantly increasing inflation. The balance of payments situation may, however, deteriorate, resulting in downward pressure on the rupee, necessitating intervention by the RBI to stabilise the exchange rate. The resource mobilisation assumptions underlying the budget projections for 1993-94 appear to be slightly optimistic. Nevertheless, the likely increases in customs and excise revenues and direct tax receipts should cover the effects of the duty concessions. There is some uncertainty, however, about the ability of public enterprises to raise enough resources through market borrowings to implement plan outlays. In terms of the aim of longer term structural adjustment, the fiscal policy of the government appears to be successful in reducing government borrowing, but unsuccessful in stepping up investments, particularly in infrastructure. Detailed aspects of tax policy are appraised and some suggestions for administrative initiatives and for insurance market reform are offered.

I

Introduction

THE 1993-94 budget provides a clear signal of the government's resolve to continue the thrust of economic reforms initiated in July 1991. Its boldness has dispelled the notion that the momentum of economic reforms has slowed down in response to the political uncertainties of the past few months. It is also unprecedented in appearing to offer gains to almost all sections of Indian society, in contrast to the usual expectation of increased burdens imposed by the exchequer. Most surprising, it appears at first glance to simultaneously exercise fiscal restraint, and push forward structural adjustment reforms, both of which are usually associated with short-term costs on large sections of the population.

Among the important measures announced in the budget are the following: (i) a unified exchange rate, which removes a 7-8 per cent tax on exporters that financed a subsidy on official imports of oil, fertilisers and other essential commodities; (ii) a significant reduction in customs and excise duties; (iii) increased central plan outlay by 37 per cent; (iv) substantial increases in spending on infrastructure as well as social services such as education (38 per cent), health (60 per cent) and welfare (27 per cent); (v) substantial increases in plan outlays on agriculture (16 per cent) and irrigation and flood control (33 per cent), combined with the benefit of reduced duties on farm equipment; (vi) five-year tax holidays for investments in backward regions; and (vii) a cut in interest rates by one percentage point along with preferential treatment for export credits. At the same time the finance ministry expects to continue the downward trend of the fiscal deficit, bringing it to 5.1 per cent of GDP in 1992-93, and to keep it at roughly the same figure in nominal terms the following year.

Not surprisingly, the budget has evoked enthusiastic, even euphoric, responses from large sections of the population. It appears to be simultaneously deflationary, growth-oriented, export-oriented, and welfare-oriented, and thus come rather close to the economist's theoretical ideal of a Pareto improvement. By reacting to criticisms of neglect of inflation, agriculture and welfare in the past year and a half, as well as by offering significant gains to important interest groups such as industrialists, large farmers, professionals, the urban middle class and politically disturbed backward regions, the budget reveals the growing political maturity of the protagonists of the current reforms programme. Set in the context of the fiscal and foreign exchange crises faced by the country only one and a half years ago, and of double-digit inflation and industrial recession last year, this does seem remarkable.

The absence of a free lunch is a common belief of economists, particularly in the context of fiscal policy. The possibility of designing a policy that seems to offer something for nothing therefore deserves close examination. In order to probe the internal structure and consistency of the budget proposals, this paper addresses the following issues: (i) how major macro variables are likely to react in the next one year if budget proposals are implemented (Section II); (ii) how the government expects to mobilise the resources required for the next financial year, and how realistic these expectations appear to us (Section III); and (iii) how the government's fiscal policy performs with respect to the longer term aims of structural adjustment (Section IV). Following this, Section V discusses detailed aspects of the government's tax policy, and Section VI concludes with some suggestions for initiatives in related areas of public administration and reform of insurance markets. We hasten to add that our ap-

praisal of the three questions above is based on rough-and-ready calculations based largely on aggregate data available from the 1992-93 *Economic Survey* and the 1993-94 budget documents, so our estimates potentially admit considerable refinement.

II

Short-Term Macro-Economic Expectations

Taking the budgetary forecasts and measures proposed in the Finance Bill as given, how should major macro-economic variables react? We expect the industrial growth rate to pick up due to the effects of: lowered excise and customs duties; reduced interest rates; increased availability of credit via phased reductions in the statutory liquidity ratio of banks and ease of accessing the capital market; increased plan outlay of the government; and stimulation of exports following reduction in duties of capital and intermediate goods imports, apart from the transition to the unified exchange rate regime. Countering this will be the effect of increased competition from foreign producers owing to tariff cuts, but this is likely to be tempered by the deeper reduction in the duty on intermediate goods than for finished goods and exchange rate depreciation, both of which serve to increase effective rates of protection for domestic producers.¹ A second negative factor is the overall decrease in aggregate demand due to the fall in real central government expenditure.² On balance it is reasonable to expect industrial growth to at least revert back to the three or four per cent rate observed during the last quarter of 1992 and we would, in fact, expect a step up from this.

The impressive slowdown in the rate of inflation during 1992-93 has been due mainly to a slow-down in the foodgrains inflation rate. This is undoubtedly a result

of the good monsoon in 1992 as well as stepped up food imports and procurement. Since budgetary measures should stimulate aggregate supply and curb aggregate demand growth, the budget is clearly intended to be deflationary. The deflationary effect of cuts in custom and excise duties may, however, be limited in view of the fact that most of these pertain to consumer durables rather than items of mass consumption.

On the other hand, some inflationary pressure in the coming months can be expected from the recent increase in petrol, fertiliser and freight prices. The inflation rate in 1993-94 will additionally depend on the coming monsoon, on food procurement operations and on movements in world oil prices (which may increase from their currently depressed levels over the next few months). It will also depend upon the method employed to finance the costs of the transition to the unified exchange rate. To the extent that these are financed by further administered price increases, as government officials have disclosed, this will further add inflationary pressure.³ Finally, additional upward pressure can be expected if the exchange rate of the rupee depreciates to about Rs 35 per US dollar, as is expected in some circles. The budget should, therefore, end up with an overall inflationary effect. Nevertheless, barring a bad monsoon or unexpectedly adverse movements in oil prices or exchange rates, we would expect the increase in the inflation rate to be mild.

While budgetary projections imply that the overall inflation and industrial growth rates would be satisfactory in 1993-94 in the absence of adverse and unanticipated shocks, the prospect for the current account deficit is different. A rise in the level of imports can be expected, stimulated by the customs duty concessions and the rise in industrial growth. Indeed, customs revenue projections for 1993-94 in the budget imply an assumed growth of around 16 per cent in imports in rupee terms. On the other hand, export growth projections of the commerce ministry lie between 10 per cent and 15 per cent implying an increase in the trade deficit. The actual performance could be worse, if the current recession in the world economy continues, and if the exchange rate depreciation and tariff cuts serve to increase domestic profit margins faster than export profit margins. Based on estimates for April to December 1992 provided by the 1992-93 *Economic Survey*, the trade gap for 1992-93 is likely to be at least of the order of Rs 10,000 crore. The trade deficit may be countered to an extent by increased remittances and reduced hawala trades following the unification of the exchange rate. Nevertheless, it would not

be surprising if the current account deficit also worsens appreciably. *Economic Survey* estimates a current account deficit of Rs 21,000 crore for 1992-93.

Prospects for increases in direct foreign investment appear to have improved slowly over the past year, but there continue to be major uncertainties regarding whether this potential will indeed materialise within the coming year. The recent political turmoil in the country, the expectation of continued reductions in tariff walls over the next two or three years, the slow development of infrastructure and continued bureaucratic and legislative hurdles, particularly with the exit policy should continue to act as negative signals to potential investors. Even with the relatively optimistic assumption of inflows of \$ 2 billion per annum, continued pressure on the balance of payments is likely in 1993-94.

With the current free float of the rupee, a depreciation may therefore be expected in the next six to seven months, when import growth is especially likely to outstrip export growth and government import operations go into effect. Going by recent events, it seems likely that the Reserve Bank will intervene to try to limit depreciation beyond about Rs 35 per US dollar, resulting in a loss of foreign exchange reserves. As can be seen, much hinges on the success of the export-cum-foreign investment drive, which remains notoriously difficult to predict. If these do not pick up within the next year and a half, it may even prove difficult for the Reserve Bank to sustain a rate of Rs 35 per dollar. Any further depreciation will undoubtedly strain the inflation rate and limit the room for fiscal manoeuvres.

To summarise, while we expect industrial growth and the inflation rate to behave satisfactorily in the coming year in the absence of adverse weather or oil price shocks, there is likely to be increased uncertainty concerning the balance of payments situation and, consequently, about inflation rates in 1993-94. Taking these factors into account, we will assume a 5 per cent growth rate of real GDP and an inflation rate of 9 per cent for 1993-94 in calculations made below to assess the budget.

III

Resource Mobilisation Assumptions

A quick glance at the overall budget figures reveals a 40 per cent decline in the budgetary deficit in nominal terms, amounting to Rs 2,888 crore. This reflects an increase in receipts by Rs 9,485 crore as against an increased expenditure of only Rs 6,597 crore. The increased receipts of course include additional borrowing to

the tune of Rs 3,125 crore. Excluding borrowing, receipts increase by almost as much as expenditures, so that the fiscal deficit increases by a mere Rs 232 crore. In other words, increased expenditures (of Rs 6,597 crore) are expected to be financed essentially by increased revenue (of Rs 5,390 crore).

On the other hand, the announced policies would suggest at least four sources of a widening gap between revenues and expenditures: (i) increase in the cost of official government imports, arising from the transition to the unified exchange rate; (ii) reduced realisations from customs and excise duties; (iii) budgetary support for the substantial increases in the central Plan outlay; and (iv) increased non-Plan expenditure. Estimates for the latter three sources are readily available from the budget documents: the duty concessions are estimated to lead to a net revenue loss of Rs 3,981 crore (Rs 4,522 crore including the states' share) while the extra budgetary contribution for the increased Plan outlay is estimated at Rs 3,607 crore. Non-Plan expenditure is projected to increase by Rs 2,319 crore due solely to an increase in the net interest liability of the government (amounting to Rs 3,405 crore). Estimates of the higher government import bill are not so readily available, but pooling information from a number of sources yields a conservative estimate of between Rs 2,000 crore and 2,500 crore.⁴ The four sources therefore account for a total of between Rs 11,907 and Rs 12,407 crore. How does the government expect to neutralise a net revenue loss of this magnitude?

Government officials have disclosed that the budget estimates make no allowance for factor (i) above: insofar as oil prices harden, the government is likely to increase the administered price of petroleum.⁵ Of course, this still leaves open the question of how increases in other official import costs or debt service payments will be financed but essentially the same option is available. In other words, the inflation tax is expected to finance the cost of transition to a unified exchange rate policy. If the 1993 monsoon co-operates as in the last few years, this may still leave the year's inflation rate in single digits, but problems can be expected if the monsoons are unfavourable.

That still leaves Rs 9,907 crore of duty reductions and increased spending to be accounted for. This is almost exactly covered by the increase in tax revenues that would have taken place in the absence of duty reductions (Rs 9,910 crore after deducting states' share). We now review how reasonable these revenue projections appear.

Corporation and personal income taxes are expected to yield additional revenues of Rs 1,300 and Rs 1,200 crore respectively. So, in aggregate, these sources approximately cover the increase in non-Plan expenditure. The increase amounts to 14.3 per cent in nominal terms and (at a 9 per cent inflation rate) 5.3 per cent in inflation adjusted terms. With real GDP assumed to grow at 5 per cent, this appears to be reasonable. On the other hand, the revised estimates of direct tax revenue collections for 1992-93 appear to be over-optimistic, implying that the base year figure for the calculations above requires to be scaled down.⁶ Thus there is a likelihood of a shortfall in direct tax revenues.

If the accuracy of base period (that is 1992-93 revised) estimates is taken for granted, the projections for import and excise duties also appear to be reasonable, and perhaps even conservative, in that they seem to be based on reasonable assumptions about the elasticities of import demand for industrial production.⁷ For instance, the assumed growth of the import bill in rupee terms is only about 16 per cent. Certain exceptional items, however, are projected very optimistically: for example, the sale of confiscated gold and silver is expected to increase from Rs 71 crore to Rs 1,000 crore, and duties on baggage to increase from Rs 550 crore to Rs 1,500 crore! Both of these figures appear to be optimistic, so that a shortfall in customs duty collections of up to Rs 1,000 crore cannot be ruled out.

A further qualification to the resource mobilisation assumptions for customs duties ought, however, to be made, on the basis of achieved performance till February 1993 when this is compared with the revised estimates for 1992-93. There is a reported shortfall of Rs 1,800 crore during the first eleven months of 1992-93 in customs revenue collection relative to the target for this period based on the budget estimates for 1992-93. The revised estimates increase the customs target for the year by Rs 577 crore relative to the budget estimates. This means that achieving the revised estimates in the current year will require collections in March to be Rs 2,377 crore higher than normal.⁸ To the extent that this is unachievable, it will increase the required incremental collection for the next year. Nevertheless, it is evident that a large amount of the expenditure increase is expected to be financed by the Rs 3,478 crore net increase in customs and excise duties. This is clearly the key to the financing of the increased budgetary support to the plan.

On the non-tax side, public enterprises have not succeeded in raising bonds to targeted levels in the current year: this is true particularly for the Power and

Railways Finance Corporations, whose shortfall in market borrowing at the end of February (relative to yearly targets) amounted to an aggregate of almost Rs 1,900 crore.⁹ The prospects after the auction this March have deteriorated even further. This raises the question of the realism of the assumptions concerning the ability of public sector enterprises to raise market loans in the coming year, with consequent implications for the investment expenditures they can actually incur. This raises doubts, in turn, about both the centre's resource assumptions and the viability of the central Plan.

Overall, therefore, the assumptions underlying the budgetary revenue projections seem reasonable, though inflows from certain exceptional items appear over-optimistic. A shortfall of up to Rs 2,000 crore is possible, though not inevitable. There are greater doubts about the sustainability of the Plan outlays, however, arising from the limited ability of public enterprises to currently raise extra-budgetary resources.

IV

Structural Adjustment

We turn now to an appraisal of the government's fiscal policy in terms of the longer term objective of structural adjustment. The usual logic of such programmes necessitates the elimination of two fundamental imbalances (fiscal and external) that precipitate debt crisis in developing countries.¹⁰ While the current government has done much to remedy the external imbalance via currency, trade and foreign investment reforms, we are concerned here with its success on the fiscal front.

Fiscal crises have their genesis essentially in the government financing expenditures from borrowed funds at a cost which exceeds the rate of return on such expenditures. Such programmes are inherently unsustainable, as the burden of growing interest payments sooner or later precipitates a debt trap. It also generates pressures on the government to finance revenues via inflation, and tends to crowd out private investment.¹¹ Required fiscal reforms must therefore attempt a mixture of the following: reduced borrowing via increased tax effort and restriction of unproductive expenditures, and increases in the productivity of investment in the public sector and the economy as a whole.

We, therefore, focus on a few variables pertaining to the government's success on these fronts. Revenue and expenditure estimates are taken from the 1993-94 budget documents, and GDP and inflation projections from the *Economic Survey*.

The 'fiscal contraction' in operation since 1991 has certainly avoided any sense of an overt fiscal crisis, comparable to those faced periodically by certain Latin American countries such as Argentina, Bolivia or Mexico over the past two decades. As is well known, the fiscal deficit has fallen substantially as a percentage of GDP from a high of 8.4 per cent in 1990-91 to an estimated 5.1 per cent in 1992-93 and is likely to fall further during 1993-94. Table 1 indicates that since 1991-92, the government has successfully lowered its expenditures as a fraction of GDP, though not substantially in absolute (inflation adjusted) terms. Moreover, a progressively larger fraction of expenditures is being met from tax revenues, which have also grown as a percentage of GDP. The improved tax effort appears to be mainly in direct taxes, which typically bodes well for both growth and equity. This inference ought to be qualified, however, by the provisos for tax revenue projections for 1992-93 and 1993-94 that were discussed in the previous section.

A welcome feature within the overall expenditure compression is the slowing down of the rate of growth in government employment and wages. Employment is projected to be less than one per cent higher than it was two years ago. This has been accompanied by a small decrease (0.93 per cent) in the inflation adjusted aggregate wage bill.¹²

The consequence of these developments has been a reduction in the amount of borrowing by the central government, as indicated by Table 2. The decline in the proportion of GDP accounted for by borrowing is particularly impressive and bodes well for the interest burden on the budget in the medium term. The table also indicates that this has been achieved mainly by reducing domestic borrowing: the proportion of GDP accounted for by foreign borrowing has in fact increased substantially since 1991-92. The conclusion of reduced central government borrowing must, however, be qualified by two factors ignored by our analysis: the increased reliance of public sector enterprises on borrowed funds, and borrowings of state governments and union territories.

Fixed capital investment projections are not currently available for 1992-93 or 1993-94. To examine the government's effort in diverting expenditures towards more productive avenues, we therefore turn to Table 3. This reveals a striking fall in the central government's capital expenditures relative to its revenue expenditures since 1985-86, especially after 1991-92. To the extent this could have been caused by sharp growth in interest payments on the revenue account, we also examine the ratio of capital expenditures to non-interest revenue expenditures. This, too, reveals a

similar pattern. This pattern is also not accounted for by the role of subsidies (food, fertilisers, debt relief to farmers, etc), which current government has succeeded in reducing from the high levels prevailing between 1989-91.

Table 3 also reveals a substantial fall in the government's spending on infrastructure, as measured by expenditure on general economic services (which includes agriculture, rural development, irrigation, energy, industry, transport, communication, and science and technology). This is true not only in absolute inflation adjusted terms, but also relative to non-interest revenue expenditures and to GDP. The ability of various ministries to meet capital spending targets in this and the next year is also adversely affected by the need to find the resources to meet increased dearness allowance payments for a part of their staff from their budgetary allocations. Since the scope for cuts in revenue expenditure is typically limited, dearness allowance increase will typically imply reduced capital expenditure.

The inference of reduced government spending on economic infrastructure must be qualified by its effort to divert investment in some of these areas (such as power and communications) to the private sector. While we do not have access to data to appraise private investment in infrastructure, our impression is that substantial investments have not yet occurred to compensate for the reduced spending by the central government. It is possible that the corporation tax holiday for power projects in this year's budget will cause an acceleration in private investment though, as we discuss below, this is by no means certain.

The most disturbing aspect of the fiscal contraction is its impact on the centre's transfer of resources to the states. As compared to a revised estimate of central transfers to states (net of interest paid by states to the centre) of Rs 40,113 crore for 1992-93, the 1993-94 budget provides only Rs 39,799 crore for this purpose: a decrease of Rs 334 crore even in nominal terms. Furthermore, while an 18.4 per cent increase in budgetary support for the central Plan is provided, the increase in central assistance to states' Plans is a mere 3.8 per cent, well below the projected inflation rate. Since the bulk of expenditure on education, health, water supply, sanitation and nutritional schemes is incurred by the states, the cut in central assistance will have a severe impact on the ability of already cash-strapped poorer states to provide these basic social services. Furthermore, cuts in general transfers to states reduce their ability to finance matching contributions for central and centrally-sponsored schemes including the IRDP and employment under

the Jawahar Rozgar Yojna. The possibility of less than full utilisation of central outlays on social services cannot be dismissed. Consequently, the pro-welfare appearance of the central budget is partly illusory.

In summary, the government has succeeded in restricting its expenditures, in raising more resources via tax revenues, thereby allowing a reduction in domestic and aggregate borrowing. On the other hand, this has been accompanied by reduced spending on economic infrastructure, which will restrict productivity improvements in the economy, unless compensating increases in private investment appear soon in these areas. Further, decentralisation to states and an effective policy for enhancement of basic social services do not appear to be an integral part of the current reforms.

V

Structural Reform in Tax Policy

The 1993-94 budget is notable also for its lack of significant changes in direct tax policy, some of which were generally expected following the submission of the Chelliah Tax Reforms Committee (TRC). While the government has accepted the main views expressed by the TRC, it has decided to postpone the implementation of some of the proposed reforms.

(a) PERSONAL INCOME TAXES

(i) *Enforcement*: In the area of personal income taxes, a number of important reforms remain to be accomplished. The most important pertains to improvements in tax enforcement. In Das-Gupta, Lahiri and Mookherjee (1992) we have shown that counter to the upward trend in real income tax revenues during the last two decades, income tax compliance has actually fallen by a factor of at least 30 per cent. One important factor in explaining

this is the declining quality and quantity of scrutiny assessments over the past decade, resulting largely from the income tax department's obsession with disposal of pending assessments. Moreover, the overall level of compliance also seems particularly low, largely owing to the fact that the enforcement system is hopelessly out-of-date, and incapable of handling the growth in workload resulting from growth in the number of assessees in recent years. Another cause is the virtual absence of effort to prosecute tax evaders (most prosecutions launched are for reasons other than concealment of income), and the large number of routes available to large-scale evaders to obtain immunity from prosecution.

The TRC has made a number of detailed suggestions in regard to improvement of the enforcement system, and more comprehensive reforms in several areas are suggested in Das-Gupta, Mookherji and Panta (1992). These include introduction of a set of countrywide tax-payer identification numbers, introduction of third-party reporting rules, computerisation of returns processing and of tax collection operations, enhanced non-filer detection

TABLE 2: CENTRAL GOVERNMENT BORROWING

	Amount (Rs Crore)		GDP (Per Cent)	
	Total	Foreign	Total	Foreign
1985-86	13,129	1,150	7.07	0.62
1986-87	13,198	1,477	6.95	0.78
1987-88	13,875	1,891	7.19	0.98
1988-89	15,800	1,537	7.15	0.69
1989-90	15,268	1,582	6.17	0.55
1990-91	17,991	1,719	7.04	0.59
1991-92	13,518	2,487	5.43	1.00
1992-93	12,562	1,885	4.78	0.72
1993-94	12,903	2,156	4.64	0.78

Note: For explanation of 1992-93 and 1993-94 figures, see Table 1.

TABLE 1: CENTRAL GOVERNMENT REVENUES AND EXPENDITURES

	Expenditures		Tax Revenues			Direct Tax Revenues Per Cent GDP
	Amount (Rs Crore)	Per Cent GDP	Amount (Rs Crore)	Per Cent Expenditure	Per Cent GDP	
1985-86	41,798	22.5	16,777	40.1	9.04	2.30
1986-87	45,924	24.2	17,751	38.7	9.35	2.32
1987-88	44,615	23.2	18,310	41.0	9.50	2.25
1988-89	49,444	22.4	21,094	42.7	9.55	2.45
1989-90	56,651	22.9	23,384	41.3	9.44	2.40
1990-91	56,917	22.3	23,231	40.8	9.09	2.27
1991-92	51,115	20.6	22,968	44.9	9.24	2.69
1992-93	53,075	20.2	24,757	46.7	9.42	2.83
1993-94	51,907	18.6	26,194	50.5	9.41	2.84

Note: Tax revenues are net of states' share. 1992-93 revenue expenditure figures are based on Revised Estimates, and 1993-94 figures on Budget Estimates. GDP figures are estimated figures for 1992-93 in *Economic Survey*, and figures for 1993-94 assume 14 per cent growth in nominal GDP. Inflation rates are assumed to be 7.8 per cent for both 1992-93 and 1993-94.

efforts, improved co-ordination between intelligence and assessment branches, enhanced and improved allocation of manpower in the income tax department aimed especially at augmenting assessment operations, reforms in performance evaluation and target-setting for assessing officers, an improved selection system of cases for scrutiny assessment, simplification of appeals procedures, removal of provisions for obtaining immunity against prosecutions, and increased penalty/prosecution effort. The overall culture within the income tax department needs to be reoriented towards collection of revenues, and detection and punishment of tax evasion, rather than overcoming a workload problem with limited manpower. In addition, a serious attempt to introduce effective presumptive taxes to combat the problem of tax evasion ought also to be made. The presumptive tax provision introduced in the 1992 budget which was extended to additional categories of tax-payers this year is a non-starter since the Estimated Income Scheme recommended for simultaneous introduction by the TRC has not been implemented. This omission causes the presumptive tax scheme to have a major loophole. A large-scale effort in improving the enforcement system is long overdue, which we hope will be undertaken in the near future.

(ii) *Tax Structure*: The 1993-94 budget also avoided changes in rates of tax or the exemption limit for personal income taxes. The analysis in Das-Gupta, Lahiri and Mookherjee (1992) indicates that revenues and tax compliance are sensitive to both these factors: a 10 per cent cut in effective tax rates or in the (reveal value of the) exemption limit will tend to raise revenues by approximately 6-7 per cent. This result has the following implications: (a) it is desirable to index tax brackets for inflation: otherwise the progressivity of tax rates implies that inflation causes an increase in effective tax rates via 'bracket creep', with resulting erosion of revenues; and (b) it is desirable to resist the populist demand for increases in the exemption limit above the rate of inflation. In fact, if the exemption limit is raised by less than the inflation rate, this will result in gradual base-broadening and permit either further indirect tax cuts or reduced borrowing.

Besides the Estimated Income Scheme, taxation of perquisites and fringe benefits is a base broadening measure recommended by the TRC, but not yet implemented. The finance ministry has not even signalled its intention to introduce appropriate measures in the future. This constitutes an important shortcoming in direct tax reform efforts undertaken to date.

(iii) *Savings Incentives*: Following the removal of a number of major tax-shelter

incentives for savings in last year's budget, there was some expectation of a reversal this year. Our view is that, all factors considered, there is no strong case for such a reversal. This is based on the following considerations: (a) Given an exemption limit that exceeds four times the per capita income, and given the exclusion of agricultural income from tax, only a tiny fraction (less than 0.6 per cent of the population) is actually subject to income tax. If there is an argument for raising savings via increases in the net return rate to savers, raising deposit rates would appear to be a more uniform and transparent alternative to offering income tax concessions. (b) Savings incentives generate substantial revenue losses: Aggarwal, Bagchi, Das-Gupta, Pandey and Prasad (ABDPP) (1991) estimated that in 1986-87 deductions under Sections 80C, 80CC and 80L of the Income Tax Act resulted in a tax loss of Rs 953 crore, as against collections of Rs 2,978 crore, which amounts to a 25 per cent loss ratio. (c) Tax shelters for contributions to government savings schemes represent an extremely short-term way to encourage increases in government revenues, at the expense of revenues a few years hence. For instance, ABDPP analysed a hypothetical 8 per cent bond with a six-year lock-in which was rebatable under Section 88 of the Income Tax Act. This resulted in a gain in resources for the government for the first six years after its introduction, but thereafter leads the government to lose resources for the next 28 years on account of repayment obligations (despite a 3 per cent annual growth in the number of tax-payers), with the cumulative loss being 285 per cent of the initial gains. The scheme would lead to net revenue gains only from the 34th year. So such rebates really result in a drain on the budget in the medium-term, which is inconsistent with the objectives of structural adjustment. (d) Tax concessions are in-

equitable, since their benefit grows with the tax bracket of the concerned taxpayer. ADBPP estimate that for a person in the 40 per cent marginal tax bracket, the return on the NSC VIII is 22.3 per cent, as opposed to an apparent yield of 12.39 per cent. (e) And finally, there is no convincing empirical evidence that we are aware of that establishes that tax incentives promote aggregate saving. The tax shelters are usually directed towards contributions to public sector savings vehicles, and therefore create a bias against private borrowers. Extending the range of qualifying assets would be administratively difficult, though some progress in this direction has recently been made via the equity-linked saving schemes floated by mutual funds.

(b) CORPORATE INCOME TAXES

(i) *Corporate Tax Rates*: The 1993-94 budget belied common expectations that the corporate tax rate would be lowered, following the TRC recommendation, causing stock market values to subsequently decline. The government has, however, announced its intention to lower rates in the near future. We would defend this measure, on the grounds that it would, if anything, encourage the incentive to invest in new equipment this year. The write-off benefits from acquiring new equipment this year would be heightened owing to the continuation of the old rates, while the income flows from such investments are likely only from next year onwards, when the reduced tax rates are expected to apply.

(ii) *The Tax Base*: One alternative to corporate income tax cuts that is widely demanded in the business sector is a reintroduction of the investment allowance. The TRC has argued strongly for a tax system with low rates and a broad base, and has recommended the withdrawal of

TABLE 3: TRENDS IN INVESTMENT EXPENDITURES

	Capital Expenditures As Per Cent of		Subsidies As Per Cent of Total Revenue Expenditure	General Economic Service Expenditures		
	Total Revenue Expenditure	Non-Interest Revenue Expenditure		Amount (Rs Crore)	As Per Cent of Non-Interest Revenue Expenditure	GDP
1984-85	57.6	73.7	9.25	7,765	25.9	
1985-86	55.2	71.3	9.11	8,676	24.2	4.68
1986-87	54.0	70.2	8.66	9,350	23.9	4.93
1987-88	47.8	64.1	8.76	7,684	20.6	3.99
1988-89	46.2	63.3	9.77	8,171	20.2	3.70
1989-90	44.7	61.2	11.27	9,001	19.6	3.64
1990-91	43.2	60.0	11.54	7,491	16.5	2.93
1991-92	35.4	52.7	10.73	6,019	15.5	2.42
1992-93	31.3	49.8	9.71	6,440	16.4	2.45
1993-94	28.9	49.9	6.38	6,862	18.6	2.46

Note: See Table 1 for explanation of 1992-93 and 1993-94 figures.

several deductions in order to achieve base-broadening. Nevertheless, it is worth considering the investment allowance (as an investment promoting measure) in lieu of a corporate tax cut on its own merits. In a recent NIPFP study, Sarma and Sondhi (1989) calculate the additional investment attributable to the 20 per cent investment allowance (under the erstwhile Section 32A of the Income Tax) to be about 2 per cent of total corporate investment. They also calculate that one rupee of corporate investment induced by the allowance cost about Rs two in foregone taxes. Sarma (1990) calculated, furthermore, that the likely effect of the 10 per cent corporate tax cut which was combined with the withdrawal of Section 32A in the 1990 budget, would be to leave investment more or less unchanged (i.e., increase investment by 0.034 per cent), while resulting in a substantial gain in corporate tax revenue. Unfortunately, an analysis of the actual outcome of this package is not available. Nevertheless, from available evidence, a re-introduction of the investment allowance does not appear to be warranted.

The budget has also offered five-year tax holidays in an effort to stimulate investment in backward regions as well as in power projects. There is scepticism regarding the effectiveness of this measure owing to the fact that incomes from such investments are unlikely to be high in the first five years, as well as the absence of adequate infrastructure in backward regions. In another NIPFP study which examined the impact of the former Backward Area Development Allowance, Aggarwal and Sondhi (1991) concluded that incentive schemes are ineffective in accelerating flows of industrial investment to areas which lack necessary infrastructure.¹³ Thus the backward states tax holiday appears to hold out limited hope for accelerated industrialisation of backward states. On the other hand, by introducing the tax holidays as also number of lesser tax concessions in this year's budget, it is evident that despite protestations to the contrary, the finance ministry has not accepted the philosophy of taxes with low rates and broad bases with few exemptions. This does not augur well for the future of structural reform of the tax system.

(c) RATIONALISATION OF CUSTOMS AND EXCISE DUTIES

The government has also neglected one of the most important recommendations of the TRC pertaining to elimination of the myriad exemptions granted under the customs duty. This permits the continuation of rate structure distortions, discretionary privilege to government officials

makes the duty structure vulnerable to the pressures of special interest groups, and encourages rent-seeking activities. The TRC (in Chapter 10 of its Final Report, Part II) has recommended immediate rescinding of 72 exemption notifications in view of reduced customs duties (in addition to the withdrawal of a further 85 notifications over the next few years). While an overall verdict on rationalisation achieved, must await a more detailed analysis of the customs tariff, the 1993-94 budget has introduced some new notifications and end-use based concessions. The finance ministry has thus failed to provide proof of its commitment to base-broadening so far.

Another problem is that in some sectors (such as computer hardware) the duty rates on finished goods is lower than for intermediate goods and sub-assemblies and it is not clear whether this is deliberate or the effect of oversight. We hope that considerable simplification along the lines suggested by the TRC, where all goods are classified into four or five comprehensive duty-rate categories, will be forthcoming in the near future.

VI

Suggestions and Conclusion

An Annual Administrative Reforms Plan: The current spate of economic reforms has not so far accommodated any substantive initiatives in the area of public administration. Such initiatives are usually introduced in piecemeal fashion in the form of notifications and amendments throughout the year. We believe that the time has come for the government to attempt a more comprehensive approach to administrative reforms, analogous to its approach towards financial policies incorporated in the annual budget.¹⁴ We, therefore, propose that in the latter half of every year the government introduce a comprehensive Annual Administrative Reforms Bill in parliament accompanied by an appropriate policy paper. Some of the areas which deserve attention urgently are: (a) enforcement of direct and indirect taxes, (b) employment and manpower in government ministries, (c) reduction of delays in issuing clearances, (d) reforms in the financial sector, (e) inclusion of transparent accounting practices for government departments and public enterprises (such as the Basel norms for banks), and ensuring that accounts are up-to-date, (f) regulation of industries, (g) reform of managerial incentives in public sector enterprises, and (h) legal reforms to reduce the arrears in courts. Some of these will lie outside the ambit of the finance ministry, but concerned ministries could be required to pro-

pose reforms in their respective areas simultaneously and in a co-ordinated fashion. Such an approach may also serve to reduce the delays that occur between many announcements of new policies and the issuance of notifications bringing them into effect. In 1993, the government could take advantage of the recommendations by various expert committees in the recent past to give a push to the reform of tax administration, bank administration and financial regulation.

Reform of Insurance Sector: In his 1993 budget speech, the finance minister announced long overdue and welcome plans to constitute a High Powered Committee to examine insurance industry reform. However, it is not clear why the committee is to be asked to submit all its recommendations (as opposed to an interim report) within a mere six months. In order to make informed recommendations for the reform of the insurance industry, it is necessary that its current working be carefully examined. We suggest that the committee be asked to make recommendations after an in-depth examination of the working of the industry, which should include the following issues:

- (i) The extent of insurance coverage available and the cost to the insurer for major types of risks including: crop risk in agriculture; risks due to spoilage or damage during transportation or storage for both domestic and international business; foreign exchange risk to exporters and importers; fire and accident risk to both households and business; and health risk or risk of death.
- (ii) The actuarial basis (and monopoly pricing, if any) in the design of premium tables and the adequacy of design of insurance policies taking into account moral hazard, adverse selection and the demand for insurance.
- (iii) Overhead costs in different lines of insurance companies, including international business in comparison with costs in other countries.
- (iv) The quality and timeliness of customer service and grievance redressal procedures.¹⁵
- (v) The adequacy of infrastructure and quality of staff training in insurance companies.
- (vi) The spread of insurance coverage across rural and urban households and businesses, and the adequacy of marketing efforts of insurance companies.
- (vii) The adequacy of the existing regulatory framework and the extent of malpractices of various kinds.

In addition the committee should be asked to examine, (i) the reasons and remedies for the alleged lack of international competitiveness of Indian insurance companies; (ii) the question of

opening up selected lines of business to the private sector including multinational insurance companies; (iii) the identification of lines of insurance which should continue to be in the public sector or which should be subsidised; and (iv) the issue of partial or complete privatisation of public sector insurance companies.

In summary, the 1993 budget marks a decisive step forward in the reform of economic policy by removing a number of growth inhibiting distortions that have burdened the economy. By seeking to achieve significant changes in a few key areas pertaining to the external sector, it also signals the government's continuing commitment to the reforms programme in very clear terms. We wish, however, that the reforms had generated a greater thrust towards building up infrastructure, which would have further strengthened growth orientation in the medium-term. Greater attention to the finances of states would also help protect the economically weak from bearing much of the short term-costs of structural change.

Notes

- 1 According to the Tax Reforms Committee (1993) in its Final Report Part II, for most commodities negative tariff rates would be required to neutralise the increased nominal protection rates due to recent exchange rate depreciation.
- 2 In gross terms, central government expenditure is expected to rise by 5.3 per cent which is almost certain to be below the rate of inflation. Subtracting the major transfer payment, (net) interest, expenditures are projected to rise by a mere 3 per cent.
- 3 The next section elaborates on this issue.
- 4 *The Economic Times* (February 28) estimates a burden of Rs 2,500 crore on oil imports alone, to be offset by the existing Rs 1,000 crore surplus in the oil pool account, giving a net burden of Rs 1,500 crore. On the other hand, government officials disclosed at the post-budget press conference (*The Economic Times*, March 1) an official import bill of \$ 1.5 billion per annum, giving an estimated increase in the import bill of the order of Rs 1,400 crore assuming oil prices increase by \$18.5 per barrel from August 1993 onwards. This yields a smaller net increase of the order of Rs 400 crore on the oil account. Fertiliser imports are estimated at Rs 2,000 crore for the coming year (*The Economic Times*, March 1), while the debt service on external assistance alone amounts to Rs 6056 crore at an implicit exchange rate of Rs 24.7 per dollar (1992-93 *Economic Survey*, Table 5.17). Data on the government's food and drugs import bill was not available to us. Nevertheless, a 20 per cent increase in the fertiliser and debt service bill will yield an additional cost of Rs 1,693 crore.
- 5 See the report on the post-budget press conference in *The Economic Times*, March 1.
- 6 This assessment is based on the following considerations: (a) The ratio of advance to

total taxes has been around 0.6 between 1986-87 and 1991-92. The Revised Estimates (RE) for 1992-93 assume a ratio of 0.484. If advance tax figures given in the receipts budget are taken to be more or less correct and past trends hold, total collections will be below Rs 15,000 crore as compared to the RE of 17,500 crore for 1992-93. (b) The proportion of revenues collected up to September or December 1992 should exceed that in past years due to the increase in the first two instalments of the advance tax from 50 per cent to 60 per cent and due, possibly, to large, scam-related capital gains by public sector banks and companies—gains that will by now have disappeared. The factors have not been pointed out by the finance ministry when releasing interim figures on direct tax collections.

- 7 Assuming 5 per cent GDP growth, 9 per cent domestic inflation, no change in the rupee price of imports and an income elasticity of imports of 1.33, the import price elasticity implicit in the government's revenue projections is approximately the same as for 1992-93. Further, customs duty and excise duty buoyancies computed with data for 1980-81 to 1993-94 are, in fact, marginally lower than computations with data for 1980-81 to 1991-92.
- 8 See, 'Good Receipts Help Government Meet Targets', *The Economic Times*, March 3, p 1.
- 9 See, 'Railways, Telecom Sector Seek RBI Help to Sell Bonds', *The Economic Times*, March 5, p 1.
- 10 See, Sachs (1988) for an elaboration of this in the context of developing countries in general, and Mookherjee (1992) in the context of the Indian economy.
- 11 On the other hand, research in the Indian economy suggests that private investment has been stimulated by borrowing-financed public investment.
- 12 The assumed increase in the CPI for Urban Non-manual Employees is 8 per cent in 1993-94 following an estimated 13.1 per cent increase this year.
- 13 Their results indicate that industrial dispersal to designated backward areas with adequate infrastructure is encouraged—but it is not clear as to why such areas should be designated as backward in the first place.

- 14 For a more general discussion of this point of view, see, Mookherjee (1993).
- 15 In the Supreme Court judgment in *Peerless versus Union of India* [61, Company Cases, 628 (CHC), 1987], a member of the bench observed "When the activities of Peerless and the Life Insurance Corporation are considered juxtaposed, one is tempted to observe that Peerless is less harsh than the Life Insurance Corporation."

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