General Elective Economics 4th Semester Public Finance

Part B: Issues from Indian Public Finance

Unit 1: Current Issues of India's Fiscal and Monetary Policy

Reading 3: Economic Survey 2018-2019 Volume 2
Chapter 3 Monetary Management and Financial Intermediation

MONETARY DEVELOPMENTS DURING 2018-19

During 2018-19, the growth rate of monetary aggregates reverted to their long-term trend after experiencing unusual behaviour in 2016-17 due to demonetisation and again in 2017-18 due to the process of remonetisation. Reserve Money (M0) as on March 31, 2019, recorded a growth of 14.5 per cent over the previous year. On the component side, the expansion in M0 was mainly driven by Currency in Circulation (CiC). From the sources side, expansion in M0 during 2018-19 was contributed mainly by net RBI credit to the government as against driven by net foreign assets in the previous year. Increase in net RBI credit to government was mainly from the recourse to open market operations (OMOs) undertaken during the year. Among other sources, RBI's claims on banks increased, indicating tight liquidity conditions (this issue is further discussed in next section). Net foreign assets also contributed to M0 expansion albeit at a lower magnitude vis-à-vis previous year. Expansion in M3 during the year was broad-based, contributed by both currency and deposits. Deposits with the banking system, both demand and time, recorded acceleration in their growth leading to an increase in aggregate deposits by 9.6 per cent in 2018-19. The money multiplier (M3/M0) declined for two successive years in 2017-18 and 2018-19. Tightening of bank capital and regulatory norms may have contributed to the declining money multiplier.

LIQUIDITY CONDITIONS AND ITS MANAGEMENT

Liquidity situation moved in the deficit zone in the last two quarters of 2018- 19 as well as in first quarter of 2019-20. The banking system faced huge shortage of liquidity for the first time in the fiscal between September 15 and 26. The RBI then announced open market operations (OMOs) of ₹ 30,000 crore. This move did ease liquidity temporarily but the liquidity shortage has been persistent. There were three key factors which have led to this situation of liquidity tightening. First, the growth in bank credit has improved in last two quarters of 2018-19, however growth in bank deposits remained tepid. Second, growth in currency in circulation also accelerated during this period. Third, and the most significant, the RBI had to draw down its foreign exchange reserves in excess of $32 billion in 2018-19 to smoothen exchange rate volatility. The frequency of OMOs have increased considerably since September 2018. In view of the need to inject durable liquidity given the prevailing liquidity conditions, the RBI conducted twenty-seven OMOs. the RBI increased the Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) effective October 1, 2018, which supplemented the ability of individual banks to avail liquidity from the repo market against high-quality collateral. Furthermore, it was decided to reduce the statutory liquidity ratio (SLR) by 25 bps every calendar quarter until it reaches 18 per cent of NDTL to align the SLR with the liquidity coverage ratio (LCR) requirement. Accordingly, effective from the quarter commencing January 2019, the SLR was reduced to 19.25 per cent of NDTL and further to 19.00 per cent of NDTL in April 2019. Moreover, the RBI decided to augment its liquidity management toolkit and injected rupee liquidity for longer duration through long-term foreign exchange buy/sell swaps. Tightness in liquidity has a significant impact on short-term as well as long term interest rates. tight liquidity in the recent past has led to increase in spread of treasury bills (t-bill) and Goverment security (g-sec) rates over the repo rate. Availability of durable liquidity has a big impact on the market borrowing cost of the government.

DEVELOPMENTS IN THE G-SEC MARKET

During 2018-19, the 10-year benchmark g-sec yields were volatile and closely tracked the movement in oil prices, domestic liquidity and rupee exchange rate. Yields softened towards the end of September reflecting the measures taken for containing rupee volatility along with expectations of lower market borrowings by the central government in second half of 2018-19.

BANKING SECTOR

The performance of the banking sector (domestic operations), Public Sector Banks (PSBs) in particular, improved in 2018- 19. The Gross Non-Performing Advances (GNPA) ratio of SCBs decreased from 11.5 per cent to 10.1 per cent between March 2018 and December 2018. Their Restructured Standard Advances (RSA) ratio declined from 0.7 per cent to 0.4 per cent. The Stressed Advances (SA) ratio decreased from 12.1 per cent to 10.5 per cent during the same period. GNPA ratio of PSBs decreased from 15.5 per cent to 13.9 per cent between March 2018 and December 2018. SA ratio of PSBs decreased from 16.3 per cent to 14.4 per cent during the same period. Capital to risk-weighted asset ratio (CRAR) of SCBs increased due to improvement of CRAR of Public sector banks (PSBs). SCBs' return on assets (RoA) decreased during the same period.

CREDIT GROWTH

Growth in non-food bank credit (NFC), which remained sluggish in last few years, showed improvement in 2018-19. The average NFC growth in 2018-19 improved to 11.2 per cent vis-à-vis 7.7 per cent in 2017-18. Bank credit to large industry and services segments were the main drivers of overall NFC growth in 2018-19.

NON-BANKING FINANCIAL SECTOR

Non-Banking Financial Companies (NBFCs) bring in diversity and efficiency to the financial sector and makes it more responsive to the needs of the customers. In the recent past, the NBFCs have played increasingly important role in resource mobilization and credit intermediation, thereby helping commercial sector to make up for low bank credit growth. the NBFCs experienced difficult times in 2018-19 in the aftermath of the ratings downgrades and default of Infrastructure Leasing and Financial Services (IL&FS) Group. Immediately after the IL&FS crisis, NBFCs faced severe liquidity crunch as mutual funds (MFs) stopped refinancing the loans of NBFCs. Government intervention through immediate measures helped improve the flow of resources from the banking sector to NBFCs. the flow of resources from the banking side has contracted since November 2018. The GNPA ratio of NBFC sector deteriorated to 6.5

per cent as in December 2018 from 6.1 per cent in March 2018. The RoA of the sector stood at 1.4 per cent in December 2018 compared with 1.6 per cent in March 2018. The RoE decreased to 6.1 per cent in December 2018 from 7.0 per cent in March 2018.

DEVELOPMENTS IN CAPITAL MARKET

The has been a significant decrease in resource mobilization through public issue and rights issue of equity compared to the previous year. 123 companies mobilized ₹ 16,087 crore through public equity issuance and 21 rights issues which raised ₹ 2,149 crore. Resource mobilization through issuance of debt public issue rose quite significantly during 2018-19. Overall, total public issue declined by 50 per cent in 2018-19.

During 2018-19, Indian corporates preferred private placement route to gear up the capital requirement. There were 416 issues which raised ₹ 2,17,632. Out of the 416 issues, there were 12 qualified institutional placement (QIP) allotments and 404 preferential allotments. the resource mobilization through issuance of corporate bonds private placement stood at ₹ 5,79,425 crore in 2018-19.

The cumulative net assets under management of all Mutual Funds (MFs) increased by 11.4 per cent.

There was a net outflow of ₹ 5,499 crore by Foreign Portfolio Investors (FPIs) in 2018-19. Total cumulative investment by FPIs decreased to ₹ 2,48,154 crore as on March 31 2019. the notional value of offshore derivative instruments (including ODIs on derivatives) decreased to ₹ 77,287 crore.

S&P BSE Sensex, the benchmark index of Bombay Stock Exchange (BSE), closed at 38,673 on March 31, 2019, witnessing an increase of 17.3 per cent from its closing value of 32,969 as on March 31, 2018. In addition, Nifty 50, the benchmark index of National Stock Exchange (NSE) closed at 11,624 on March 31, 2019, witnessing a gain of 14.9 per cent from its closing value of 10,114 as on March 31, 2018. In 2019-20, the Sensex crossed 40,000 for the first time on 3rd June and closed at 40,268. As on 10 June, 2019, the Sensex closed at 39,785 whereas Nifty closed at 11,923.

INSURANCE SECTOR

The potential and performance of the insurance sector are generally assessed on the basis of two parameters, viz., insurance penetration and insurance density. The measure of insurance penetration and density reflects the level of development of insurance sector in a country. While insurance penetration is measured as the percentage of insurance premium to GDP, insurance density is calculated as the ratio of premium to population (measured in US$ for convenience of international comparison). During the fiscal 2017-18, the gross direct premium of general insurers (within India) was ₹1,50,660 crores as against ₹1,28,130 crores, in 2016-17 registering 17.6 per cent growth. Motor, health and others segments of insurance helped the industry report this growth. Life insurance industry recorded a premium income of ₹4,58,810 crores as against ₹4,18,480 crores in the previous financial year, registering a growth of 9.64 per cent. While renewal premium accounted for 57.68 per cent of the total premium received by the life insurers, new business contributed the remaining 42.32 per cent.

INSOLVENCY AND BANKRUPTCY CODE 2016: RESOLVING CORPORATE STRESS IN A CHANGED PARADIGM

The Insolvency and Bankruptcy Board of India (IBBI) – the regulator, was established on October 1, 2016. The Insolvency and Bankruptcy Code (IBC) was enacted on May 28, 2016. The Government moved quickly to operationalize the IBC. On June 1, 2016, the National Company Law Appellate Tribunal (NCLAT), the Principal Bench of NCLT at New Delhi, and 11 benches of NCLT – two at New Delhi and one each at Ahmedabad, Allahabad, Bengaluru, Chandigarh, Chennai, Guwahati, Hyderabad, Kolkata, and Mumbai were constituted. The IBC seeks to achieve resolution of corporate debtors (CDs) in distress and failing that, its liquidation in a time-bound manner under the non-intrusive oversight of the National Company Law Tribunal (NCLT).

The first case under the IBC was admitted by NCLT on January 17, 2017, in just over a month from the operationalization of the IBC, and the first insolvency resolution plan was approved on August 2, 2017. The Banking Regulations Act, 1949 was amended on May 4, 2017, to enable the RBI to direct banks to take defaulting borrowers into insolvency. The RBI constituted an Internal Advisory Committee which recommended the filing of cases under the IBC in all accounts with fund and non-fund based outstanding amounts greater than ₹5,000 crore, with 60 per cent or more classified as nonperforming by banks as of March 31, 2016. As on February 2019, that is, within 27 months of operationalization of the IBC, as many as 14,000 applications had been filed for initiation of CIRPs under the IBC. As on March 31, 2019, NCLT had ordered the commencement of CIRP of 1,858 CDs.

These cases have been filed across various sectors. 42 per cent of cases filed are from the manufacturing sector covering industries like steel, fast moving consumer goods (FMCG), chemical products, electrical machinery, basic metals, etc.

920 (50 per cent) cases were filed by Operational Creditors (OCs), 738 (40 per cent) were filed by FCs and 200 (10 per cent) were filed by Corporate Debtor.

A key objective of the IBC is the maximization of the value of assets of the CDs and consequently value for its stakeholders. A critical element towards achieving this objective is the transparent and credible determination of the value of the assets of CD to facilitate comparison and informed decision making. The Code and the regulations framed thereunder assign this responsibility to the 'Registered Valuer' (RV). The Central Government designated the IBBI as the 'Authority' under section 247 of the Companies Act vide notification dated October 18, 2017.

Two sets of amendments were introduced in the IBC, one in November 2017 and the second in June 2018. The former introduced Section 29A, prohibiting persons with certain disabilities from submitting a resolution plan. The latter introduced changes to make the IBC easier to operate by reducing the threshold for decision making by the committee of creditors from 75 per cent to 66 per cent in specified matters and to 51 per cent for routine decisions. This amendment also entailed the recognition of home buyers as FCs. The 2018 amendment was based on recommendations of the Insolvency Law Committee (ILC) set up by the Government in November 2017. The ILC has since been reconstituted as a Standing Committee. law. Since December 2016, the IBBI has introduced 25 amendments in various regulations to streamline the resolution and liquidation processes responding real-time to the market situation.

The NCLTs and NCLAT continue to play an important role as adjudicating and appellate authorities respectively for IBC.

The IBC has made a significant impact on the way the default of debts is viewed and treated by promoters and management. It has initiated a cultural shift in the dynamics between lender and borrower, promoter and creditor. The IBC has paved the way for Operational Creditors, mostly SMEs and small vendors to use the IBC as a recovery tool. Before enactment of the IBC, the recovery mechanisms available to the lenders were through Lok Adalat, Debt Recovery Tribunal, and SARFAESI Act. These mechanisms are recovery focused as compared to the IBC which aims at the turnaround of the debtor while maximizing returns for the creditors. Predictably, these earlier mechanisms have resulted in an average recovery of 23 per cent to lenders as against nearly 43 per cent under the IBC. One of the key objectives of the IBC is to allow companies to be liquidated swiftly to maximize value if resolutions cannot be reached.

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Reading 3: Economic Survey 2018-2019 Volume 2
Chapter 2 Fiscal Developments

CENTRAL GOVERNMENT FINANCES

Trends in Receipts: Central government receipts can broadly be divided into non-debt and debt receipts. The non-debt receipts comprise of tax revenue, non-tax revenue, recovery of loans, and disinvestment receipts. Debt receipts mostly consist of market borrowings and other liabilities, which the government is obliged to repay in the future. High growth in non-debt receipts have been targeted, driven by robust growth in net tax revenue and non-tax revenue. According to the provisional actual figures, it is lower than the estimated due to the reduction in net tax revenue.

Tax Revenue: Estimated growth in Gross tax revenue (GTR) was 16.7 percent, but the provisional actuals are lower. Direct taxes have grown by 13.4 per cent owing to improved performance of corporate tax. However, indirect taxes have fallen short of budget estimates by about 16 per cent. This is largely due to shortfall in GST revenues. GTR as a proportion of GDP has declined by 0.3 percentage points in 2018-19. Indirect taxes have fallen by 0.4 percentage points of GDP primarily due to shortfall in GST collections. This has been partly offset by 0.1 percentage points increase in direct taxes. Better tax administration, widening of TDS carried over the years, anti-tax evasion measures and increase in effective tax payers base have contributed to direct tax buoyancy. Widening of tax base due to increase in the number of indirect tax filers in the GST regime has also led to improved tax buoyancy. Going forward, sustaining improvement in tax collection will depend on the revenue buoyancy of GST.

Non-Tax Revenue: Non-tax revenue consists mainly of interest receipts on loans to States and Union Territories, dividends and profits from Public Sector Enterprises including surplus of Reserve Bank of India transferred to GOI, and external grants and receipts for services provided by the Central Government. These services include fiscal services like currency, coinage and mint, general services such as Public Service Commission and police, social services like education and health, and economic services like irrigation, transportation and communication. As per the Provisional Actual figures for 2018-19, receipts from non-tax revenue have exceeded the budget estimate of ₹ 2.45 lakh crore. Non-tax revenue constitutes about 1.3 per cent of GDP in 2018-19.

Non-Debt Capital receipts: Non-debt capital receipts mainly consist of recovery of loans and advances, and disinvestment receipts. The share of recovery of loans has declined over the years following disintermediation of loan portion of Central assistance to States consequent to the recommendation of the Twelfth Finance Commission, and States allowed to borrow directly from the market. During 2018-19, ₹ 1.03 lakh crore of non-debt capital receipts including ₹ 0.85 lakh crore from disinvestment have been realised.

Trends in expenditure: The composition of government expenditure is on defence, salaries, pensions, interest payments and subsidies account for more than sixty per cent of total the expenditure. Expenditures on salaries, pensions and interest payments are, by and large, committed in nature and have limited headroom for creation of additional fiscal space. Subsidies have seen significant moderation through improved targeting. Government has been able to contain fiscal deficit at 3.4 per cent of GDP through compression of Government expenditure. As per cent of GDP, total expenditure fell by 0.3 percentage points in 2018-19 PA over 2017-18, with 0.4 percentage points reduction in revenue expenditure and 0.1 percentage point increase in capital expenditure. As a proportion of GDP, both capital expenditure and non-defence capital expenditure register a rise of 0.1 percentage point in 2018-19. Expansion in capital expenditure on roads, railways and others has been met without compromising defence capital expenditure. Major subsidies comprising of food, fertiliser and petroleum have continued their downward trend. From 2013-14 to 2018-19, the total budgetary expenditure of the Central Government has declined by 1.7 percentage points of GDP, with a decline of 1.6 percentage points in revenue expenditure and 0.1 percentage points in capital expenditure.

Transfer to States: Transfer of funds to States comprises essentially of three components, such as, share of States in Central taxes devolved to the States, Finance Commission Grants, and Centrally Sponsored Schemes (CSS), and other transfers. Total transfer of States have risen between 2014-15 and 2018-19.

Central Government Debt: Total liabilities of the Central Government include debt contracted against the Consolidated Fund of India, technically defined as Public Debt, as well as liabilities in the Public Account. Total liabilities of the Central Government as a ratio of GDP, has been consistently declining, particularly after the enactment of the FRBM Act, 2003. This is an outcome of both fiscal consolidation efforts as well as relatively high GDP growth.

STATE FINANCES

The State budgets expanded considerably in 2017-18 RE over 2016-17 on account of increase in revenue expenditure. Capital expenditure consists of capital outlay and loans and advances by the State Governments. The loans and advances by the State Governments declined sharply in 2017-18 due to reduction in loans and advances by States for power projects and food storage and warehousing. On the revenue front, States own tax and non-tax revenue displayed growth in 2017-18 which is to be maintained in 2018-19 as well. States have budgeted for fiscal deficit of 2.6 per cent of GDP in 2018-19.

GENERAL GOVERNMENT FINANCES

The combined liabilities of Centre and States have declined to 67 per cent of GDP as on end-March 2018 from 68.5 per cent of GDP as on end-March 2016. The fiscal deficit of General Government is further expected to decline.

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Part A: Public Finance Theory
Unit 4: Working of Monetary and Fiscal Policies
Reading 1: Case and Fair, Principles of Economics, 10th Edition, Chapter 24 (pp 478-486)

You must be familiar with the concepts discussed below. But for the understanding of the what entails as fiscal policy it is necessary to start from the basics.

We are first going to determine equilibrium output/income for the economy as a whole and then look at how the fiscal policy affects this equilibrium output in the economy.

$Y_d = Y - T$……..(1)

where Y_d is the disposable income, Y is total income and T is Taxes

Y_d excludes taxes paid by households but includes transfer payments made to households y the government. This T does not include income taxes (taxes depending on income), such taxes are called lump-sum taxes.

So, whatever is left to the households is either consumed or saved. Thus we can write
$Y_d = C + S$………(2)

Combining (1) and (2) we get,
$Y - T = C + S$…….(3)

Adding T on both sides we get

$Y = C + S + T$……..(4)

This can be interpreted as income being divided into consumption(C) and savings (S) of the household and payment to the government by the household(T)

We can also write the planned aggregate expenditure(AE) of the economy as the sum of consumption spending by households(C), planned investment by business firms(I) and government purchases of good and services(G).
$AE = C + I + G$………(5)

Please note, the G we have defined here is the government spending on goods services.
Government also receives taxes from the households which is a source of income for the government.

In this context we can introduce how the government uses the income and allocates it into different sectors of the economy. The allocation of the income, alternatively the expenditure of the government, is called the Budget. A Union Budget is an estimation of revenue and expenditure of the Central government during a financial year. Depending on the feasibility of these estimates, budgets are of three types:
Balanced Budget: A government budget is said to be a balanced budget if the estimated government expenditure is equal to expected government receipts in a particular financial year. Advocated by many classical economists, this type of budget is based on the principle of "living

within means." They believed the government's expenditure should not exceed their revenue. Though an ideal approach to achieve a balanced economy and maintain fiscal discipline, a balanced budget does not ensure financial stability a balanced does not ensure financial stability at times of economic or deflation. Theoretically, it is easy to balance the estimated expenditure and anticipated revenues but when it comes to practical implementation, such balance is hard to achieve.

Surplus Budget: A government budget is said to be a surplus budget if the expected government revenues exceed the estimated government expenditure in a particular financial year. This means that the government's earnings from taxes levied are greater than the amount the government spends on public welfare. A surplus budget denotes the financial affluence of a country. Such a budget can be implemented at times of inflation to reduce aggregate demand.

Deficit Budget: A government budget is said to be a deficit budget if the estimated government expenditure exceeds the expected government revenue in a particular financial year. This type of budget is best suited for developing economies, such as India. Especially helpful at times of recession, a deficit budget helps generate additional demand and boost the rate of economic growth. Here, the government incurs the excessive expenditure to improve the employment rate. This results in an increase in demand for goods and services which helps in reviving the economy. The government covers this amount through public borrowings (by issuing government bonds) or by withdrawing from its accumulated reserve surplus.

Let's look at each component of equation (5),
We know, consumption to be function of income of the households. It is taken to be a specific linear function, such as,

$C = a + bY$……(6)

Where, b is the marginal propensity to consume, Y is the aggregate income
We are going to modify the above equation to includes taxes.

$C = a + bY_d$……..(7) , replacing Y with Y_d to include taxes into the consumption function

⇨ $C = a + b(Y-T)$…….(8)

We take planned investment to be fixed at I

Determination of Equilibrium Output/Income
In equilibrium Aggregate income should equal the aggregate output in the economy.

Hence, we can write $Y = C + I + G$……………(9)
For given values of C, I and G we can find the equilibrium output/income
Please refer to example given in pp 480-481 for understanding the calculation of equilibrium output/income.

The graphical representation of the equilibrium output is given in pp 481(fig. 24.2)
Equilibrium can also be achieved through the saving/investment approach.
By definition, $AE = C + I + G$ and $Y = C + S + T$
And we know in equilibrium $AE = Y$

Thus, $C + I + G = C + S + T$

⇨ $S + T = I + G$

For given values (Table 24.1) we can find at what values of S +T (in equilibrium) we get a corresponding Y. This gives the equilibrium output income.

Multiplier Effects

Till now we have taken G and T to be constant. But any change in these is going to change the equilibrium output. Intuitively, it makes sense that the government can control and change G and T through fiscal policy. If they do change, how is it going to change the output. This can be seen through multiplier effects.

Government spending multiplier: it is the ratio of change in income (ΔY) to a change in government spending (ΔG). In other words, an autonomous increase in government spending generates a multiple expansion of income.

We know from equation (9) $Y = C + I + G$

As G increases, Y should also increase. But the question is will it increase the same amount as the increase in G or less or more.

Any change in Y will increase consumption, since Y_d increases gives, taxes are assumed to not have changed.

From equation (8) we know b to be MPC and MPC is a positive number greater than 0 and less than 1, which captures the proportion (or percentage) of disposable income, $(Y – T)$, that goes for consumption spending. The rest of income that is not consumed is saved.

Thus,

$MPC + MPS = 1$

Where MPS is the marginal propensity to save.

Putting (8) into (9) we get,

$Y = a + b(Y-T) + I + G$

Or, $Y = a + bY – bT + I + G$

Or, $Y – bY = a + bT + I + G$

Or, $Y(1-b) = A$, where $A = a+ bT+ I+G$

Or, $Y= [1/(1-b)]A$

Thus the multiplier is $1/(1-b)$, b= MPC and 1-MPC= MPS

Notice that since MPC is less than 1, then 1/(1—MPC) will be greater than 1. Also, the higher MPC, the higher the multiplier.

If G is the component of A that changes, then the government spending multiplier GM is given by the multiplier we derived above :

1/(1—MPC) = GM

So any change in government expenditure will be inversely dependent on marginal propensity to save.

I have attached a pdf for the tax multiplier derivation.

The intuition of balanced budget multiplier is easy to follow. Balanced budget is the where the estimation of expected expenditure equals expected revenue. The multiplier takes care of when changes in taxes equal to change in government spending. Thus it gives the multiplier to be equal to 1.

Please refer to the example and diagrams given in the readings.

General Elective Economics 4th Semester Public Finance

Part B: Issues from Indian Public Finance

Unit 1: Current Issues of India’s Fiscal and Monetary Policy

Before we go into the reading for this Unit, I would like give a background into the Indian Public Finance System. Till now we have learned the theory of Public finance. Unit 1 of Part A discusses the need for Public Sector in an economy. This part of the course focusses on the issues that exist in the Indian Public Finance System. One of the functions of the Central government in India is presenting the Union Budget in the month of February for the next financial year. As we know the government earns revenue from various sources and then it spends it as expenditure for the benefit of the country.

According to Article 112 of the Indian Constitution, the Union Budget of a year, also referred to as the annual financial statement, is a statement of the estimated receipts and expenditure of the government for that particular year.[1]

Union Budget keeps the account of the government's finances for the fiscal year that runs from 1st April to 31st March. Union Budget is classified into Revenue Budget and Capital Budget.

Revenue budget includes the government's revenue receipts and expenditure. There are two kinds of revenue receipts - tax and non-tax revenue. Revenue expenditure is the expenditure incurred on day to day functioning of the government and on various services offered to citizens. If revenue expenditure exceeds revenue receipts, the government incurs a revenue deficit.[2]

Capital Budget includes capital receipts and payments of the government. Loans from public, foreign governments and RBI form a major part of the government's capital receipts. Capital expenditure is the expenditure on development of machinery, equipment, building, health facilities, education etc. Fiscal deficit is incurred when the government's total expenditure exceeds its total revenue.[3]

The accounts of Government are kept in three parts: -

1. Consolidated Fund of India:

All revenues received by the Government by way of taxes like Income Tax, Central Excise, Customs and other receipts flowing to the Government in connection with the conduct of Government business i.e. Non-Tax Revenues are credited into the Consolidated Fund constituted under Article 266 (1) of the Constitution of India. Similarly, all loans raised by the Government by issue of Public notifications, treasury bills (internal debt) and loans obtained from foreign governments and international institutions (external debt) are credited into this fund. All expenditure of the government is incurred from this fund and no amount can be withdrawn from the Fund without authorization from the Parliament.

2. Contingency Fund of India:

[1] https://economictimes.indiatimes.com/definition/Union-Budget

[2] https://economictimes.indiatimes.com/definition/Union-Budget

[3] https://economictimes.indiatimes.com/definition/Union-Budget

Art 267(I) of the constitution provides that "Parliament may by law establish a Contingency Fund in the nature of an imprest to be entitled the Contingency Fund of India into which shall be paid from time to time such sums as may be determined by such law, and the said Fund shall be placed at the disposal of the President to enable advances to be made by him out of such Fund for the purposes of meeting unforeseen expenditure pending authorisation of such expenditure by Parliament by law under Article 115 or Article 116

3. Public Account:
In the Public Account constituted under Article 266 (2) of the Constitution, the transactions relate to debt other than those included in the Consolidated Fund of India. The transactions under Debt, Deposits and Advances in this part are those in respect of which Government incurs a liability to repay the money received or has a claim to recover the amounts paid. The transactions relating to `Remittance' and `Suspense' shall embrace all adjusting heads. The initial debits or credits to these heads will be cleared eventually by corresponding receipts or payments. The receipts under Public Account do not constitute normal receipts of Government. Parliamentary authorization for payments from the Public Account is therefore not required.[4]

The same procedure is followed for the state governments ae well. In any developing economy the type of budget that is practised is the Deficit Budget, which means the expenditure of the government is always more than the revenue. Now, we have one union budget and state budgets. If all these budgets practise deficit budget, then how does the system work? And how much does revenue each state gets? Etc.
To define the financial relations between the Centre and states, Finance Commission was established in under the Article 280 of the Constitution of India by the President of India. The First Finance Commission was in 1951. Till date fourteen Finance Commission have submitted their reports. We can currently following the recommendations of the Fourteenth Finance Commission, which was for the time period 2015-2020. The Fifteenth Finance Commission was constituted on 27 November 2017 against the backdrop of the abolition of Planning Commission (as also of the distinction between Plan and non-Plan expenditure) and the introduction of the goods and services tax (GST), which has fundamentally redefined federal fiscal relations.[5]

Thus, the report of these finance commission should be able to answer our questions. The core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them, lay down the principles determining the distribution of these taxes among States. Its working is characterised by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism. Its recommendations are also geared towards improving the quality of public spending and promoting fiscal stability.[6]

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[4] The explanations for the various accounts are from https://ccaind.nic.in/govt_accounts.asp
[5] https://fincomindia.nic.in
[6] https://fincomindia.nic.in

The first reading of the Unit are the recommendations given by the Commission on how the centre and state should move forward keeping in mind what have been achieved so far.
The second reading of the Unit focusses on the Goods and Services tax reform in India. This needs to be focus for us because earlier some of the taxes were directly collected by the states themselves. Now with the GST reforms, allocation of revenue from the centre to the state changes, it is important to understand the system under which it is being operated now.
The last reading is from the current economic survey and the chapters in focus for us are the current scenario and the finances of both state and the centre with the monetary managements.

Reading 1: Report of the Fourteenth Finance Commission, Chapter 14(pp 178-201)
While studying this particular reading focus on the recommendations given by the commission given in pp 201 to 203 along with the bold lettered lines. As your read this you'll find some abbreviated letters. The most important of them is the FRBM, which means Fiscal Responsibility and Budget Management Act. It intends to bring transparency and accountability in the conduct of the fiscal and monetary actions of the government.
The rules set targets for the phased reduction of the fiscal deficit to acceptable levels. It requires the government to limit the fiscal deficit to 3% of the GDP by 31 March 2021 and the debt of the central government to 40% of the GDP by 2024-25, among others. The Act provides room for deviation from the annual fiscal deficit target under certain conditions.
The government is also required to provide the Parliament details of fiscal indicators such as fiscal, revenue and primary deficit as a percentage of GDP, tax and non-tax revenues as a percentage of GDP, and central government debt as a percentage of GDP.[7]

[7] https://www.livemint.com

General Elective Economics 4th Semester Public Finance

Part B: Issues from Indian Public Finance

Unit 2: Goods and Services Tax

Introduction

GST is an Indirect Tax which has replaced many Indirect Taxes in India. The Goods and Service Tax Act was passed in the Parliament on 29th March 2017. The Act came into effect on 1st July 2017; Goods & Services Tax Law in India is a comprehensive, multi-stage, destination-based tax that is levied on every value addition.
Goods and Service Tax (GST) is an indirect tax levied on the supply of goods and services. This law has replaced many indirect tax laws that previously existed in India. GST is one indirect tax for the entire country.
Under the GST regime, the tax is levied at every point of sale. In the case of intra-state sales, Central GST and State GST are charged. Inter-state sales are chargeable to Integrated GST.
GST is a comprehensive, multi-stage, destination-based tax that is levied on every value addition. GST has mainly removed the Cascading effect on the sale of goods and services. Removal of cascading effect has impacted the cost of goods. Since the GST regime eliminates the tax on tax, the cost of goods decreases.
There are 3 taxes applicable under this system: CGST, SGST & IGST.

- CGST: Collected by the Central Government on an intra-state sale (Eg: transaction happening within Maharashtra)
- SGST: Collected by the State Government on an intra-state sale (Eg: transaction happening within Maharashtra)
- IGST: Collected by the Central Government for inter-state sale (Eg: Maharashtra to Tamil Nadu)

GST regime also brought a centralised system of waybills by the introduction of "E-way bills". This system was launched on 1st April 2018 for Inter-state movement of goods and on 15th April 2018 for intra-state movement of goods in a staggered manner. Under the e-way bill system, manufacturers, traders & transporters are now able to generate e-way bills for the goods transported from the place of its origin to its destination on a common portal with ease. Tax authorities are also benefitted as this system has reduced time at check -posts and help reduce tax evasion.

Reading 1: A Sarvar Allam, GST and the States : Sharing Tax Administration, Economic and Political Weekly, Vol. 51, Issue No. 31, 30 Jul, 2016

Woes to the Manufacturing States

As mentioned earlier, GST is a destination-based tax. So, if a state manufactures a good but it is sold in another state, the tax will be collected by the state which sells the final product. The means that there will an outflow of tax revenue along with goods and services produced there, to states that consume the goods and services. This does not provide with any incentive for manufacturing states.

In terms of revenue neutral rate (RNR) which is a structure of different rates established in order to match the current revenue generation with revenue under GST. But states cannot have a uniform RNR that will match their present own tax revenue trend, as manufacturing and consumption levels vary from state to state. Therefore, the proposed RNR, that is, the standard rate of state GST is not going to neutralise the effects of GST on the revenue collection of all manufacturing rates.

The Union government for a specific period have assured for revenue loss compensation, but it is doubtful that the proposed GST would launch the manufacturing states in the revenue trajectory they are travelling now, especially after the booster runs out. With no independent powers of taxation manufacturing states may be left helpless.

Lopsided Tax Reforms

It was only the indirect reforms which have gone through major changes even before the GST reforms such as, Modified VAT (MODVAT) and Central VAT (CENVAT) in central excise, VAT in Sales Tax, allowing cross credit of CENVAT between goods and services, rationalisation of custom duties and reduction of Central Sales Tax. But no such reforms have been attempted in direct taxes.

A Direct Tax Code (DTC) was proposed to unify and simplify direct tax laws. The draft bill was released in August 2009 with a revised bill released in March 2014, including the draft General Anti Avoidance Rules. But in February 2015, since most of the provisions of the proposed DTC have already been integrated into existing tax law, the finance minister concluded that there was no merit in going ahead with the DTC.

Low Direct Tax Revenue Growth

India’s tax-GDP ratio is at 16.6 % which is below the emerging market economy and OECD countries averages of 21 % and 34 % respectively. Contribution of direct taxes to total tax revenue have fallen from 2009-10 to 2015-16 and direct tax-GDP ratio too declined from 2007-08 to 2015-16.

Thus, there has been a decline in the efficiency of income tax collections, whereas the compliance in indirect taxes is steadily increasing. This can be attributed to growth in service sector which is also a contributor to increase in income tax collections.

Regressive Indirect Taxes

Indirect tax is more distributive and GST would make it completely a consumption tax. Since this tax is paid by the consumer on goods and service, it is then a ‘spending tax’ or ‘expenditure tax’, which is similar to an income tax. Indirect tax is built into the price, which cannot be avoided. Since majority of the population- poor and lower middle class- consumes such goods and services daily, they tend to pay more indirect tax than the middle class and the rich. While, people in higher income groups easily avoid paying their income tax dues. This makes the indirect tax regressive in nature due to the imbalanced compliance between indirect and direct taxes.

Purpose of Tax Reform

Tax reform is an important aspect of public finance management, as taxation is used as an instrument of attaining certain social objectives, namely, redistribution of wealth and thus reducing inequalities. Taxation is not only to raise the revenue required to meet the growing expenditure on administration and social services but also to reduce the inequalities of income and wealth. Fiscal prudence demands a matching reform in direct taxes along with the introduction of GST to achieve fair, equitable, elastic and progressive tax regime.

Direct Tax Reform

Income tax law in India remains one of the most complicated tax laws. Such complications have only increased the cost of compliance for the assessees and cost of administration to the government.

Since the consumption tax of GST is much nearer to income tax, assessees of income may be given a tax rebate of a certain percentage of GST paid by them on their consumption of taxable goods and services.

Share the Direct Tax Base with States

When both the centre and states agree to share the indirect tax base, which is essentially a consumption or expenditure tax, the direct tax base can also be shared between the two. This would widen the direct tax base and improve the level of compliance as income earners are monitored by both agencies with reference to their consumption of goods and services.

Examples of such practices can be found in major economies, such as , European Union (EU), direct taxation remains the sole responsibility of member states. Member countries have taken joint measures to prevent tax avoidance and double taxation. In Canada, both federal and provincial governments impose income tax on individuals. The federal government charges the bulk of income taxes, with the provinces charging a somewhat lower percentage, except in Quebec, where it has its own income tax system. In the United States of America, the federal government, most states, and some local governments levy income tax.

Need for Public Interest in Tax Reform

Tax reforms should not be aimed only at increasing production. Instead, the reforms should be aimed at augmenting revenue to assure alleviation of poverty and creating a more equitable society.

General Elective Economics 4th Semester Public Finance

Part B: Issues from Indian Public Finance

Unit 2: Goods and Services Tax

Reading 3: Jayanta Roy Chowdhary, “Balancing Federal Fiscal Relations”, August 2017 issue of Yojana

To guard themselves against the failing of GST the states were able to get the Centre to bring in cess which is to be divided among states to compensate any loss in revenues. Conceptually, the GST should broaden the tax base. The tax-GDP ratio could increase to 16 percent from the current 10 percent. But there exist an uncertainty about the revenue outcome from GST implementation as addressed by RBI in a report on state finances. India’s public debt, which is a sum total of central and state debt, as a percentage of GDP already stands at a very high percentage of 67. According to debt to state GDP ratio of as many as 17 Indian states increased in the past year. Under such circumstances, inability to meet the states’ demands may see the states going on the warpath against the Centre.

According to officials 45 percent of Indirect Taxes are not covered by GST and the states will have ultimate right to tax them and even increase taxes on them. States need to have some measure of financial independence. The need to build a financial cushion which would see them working actively to retain these items of taxation in their portfolio.

The bias will be more pronounced in the Centre’s favour with the implementation of the GST. The states will loose their ability to raise resources to address problems unique to them. the state of Tamil Nadu, which opposed many clauses of GST, said that it had implemented wide ranging social sector reforms on the back of cash generated from its taxes.

GST Amendment Act effectively transfers the power of taxation to an unelected body, the GST Council. It was set up by the Act, takes on the power of deciding tax rates from both the Parliament and State Legislatures and have to be implemented across the country. GST council remains the Supreme Legislative body in determining tax rates on all goods and services across the country and not directly or indirectly elected Members of Parliament and State legislatures, like an educated super-body elected by Electors, without any direct responsibility to citizen voters.

Entry taxes by municipal bodies, entertainment tax levied by local bodies, stamp duties, products such as alcohol and fuels, and electricity cesses are still not covered by GST, which can be increased or decreased giving more financial independence. Whereas for states, they are bound by the decisions of GST Council as far as most of their revenues are concerned.

In India, the Centre not only enjoys sole rights over direct taxes, a portion of which it may give to the states, but it also enjoys the exclusive right to nearly half of the GST proceeds. This is unlike to when compared to other countries, such as Canada.

In case, states eventually decide to seek a fiscal arrangement which is less straight-jacketed they could then choose the Australian model where 75 per cent of all taxes are raised by the federal or commonwealth government and distributed through a very sophisticated mechanism.