CHAPTER 10

SUMMARY AND CONCLUSIONS

Multi-Dimensional Role of Fiscal Policy with Emphasis on Growth : Lessons from East Asian Economies.

The present treatise essentially addresses itself to a study of fiscal policy of developing countries with special reference to India, with a view to its reform, so as to subserve as a more effective instrument for stimulating growth and achieving other objectives. The study analyzes the fiscal and economic policies on a macro – economic basis of the principal five ASEAN countries – Malaysia, Thailand, Singapore, Hong Kong and Indonesia - as well as Japan, South Korea and Taiwan, which have enabled them to make enormous progress, increase their exports, savings, investment, incomes, productivity and G N P, reduce levels of poverty and enhance per capita incomes and employment, and the conclusions that could be usefully drawn for application to India and other developing economies.

The study also deals with an analysis of the macro - economic aspects of the framework of fiscal policies and an examination of the existing tax structure in India, liberalization measures and rationalization of economic policies in general, and fiscal policies in particular. Union Budgets from 1990 - 91 to 1995 - 96 have been analyzed. Reform of fiscal policies has been discussed, and norms evolved. Besides, the Indian tax structure, both personal and corporate, has been evaluated, while canons of taxation for developing economies discussed. Two new canons of taxation based on empirical evidence have been advanced and their usefulness assessed.

The study also examines the role of the new theory incorporating Corporate Nucleus Capital (C N C) Super - Multiplier, advanced by the present research

scholar, as an instrument of fiscal policy, and how far the multiplier and accelerator principles increase its usefulness in promoting investment in the desired directions.

The role of the state needs to be considered. With the failure of centralized planning in Eastern Europe, and also the inability of command economies to successfully deliver, there has been a world - wide turnaround in favour of a 'market - friendly approach' and reduced state intervention. The functioning and operations of government should be confined to areas in which markets did not work; it should reduce its presence to the minimum in areas in which markets did or could operate. Economic growth postulates more productive use of assets and investment; and both in industry and agriculture, the most appropriate decisions flow from entrepreneurs competing with each other and facing international competition.

However, it must be recognized that the state too has a positive role; it must perform its traditional functions and provide economic and social infrastructure – power, communications, irrigation, education, health facilities and the like –, as also an adequate institutional framework conducive to the inflow of foreign investment and technology and promotion of growth. The East Asian economies' experience bears out that the state, particularly in South Korea, Taiwan, Singapore and Japan, played a significant role in growth. Developing economies must learn to maintain fiscal discipline; keep budgetary deficits within manageable limits so that they can be financed in a non - inflationary manner; and try to get their fundamentals right – controlled inflation, manageable external debt and generally stable exchange rates.

The Government of India, in formulating the fiscal policy, has not ignored the distribution aspect. It is now obvious that growth in G D P itself is not enough; conscious effort is necessary to ensure that the benefits of development percolate to the poorest sections of society. The Government's poverty alleviation

programmes and public distribution system, despite shortcomings in implementation, are steps in the right direction. Provision for social welfare schemes and social security to the people at large – indeed all transfer payments – can only take place if the state has sufficient revenues, and incomes and savings can be buoyant only if there is economic growth. Hence, growth and equity have to be pursued together as goals of fiscal and economic policy.

The maintenance of internal stability, which implies price - stability and a high level of employment, postulates an adequate level of aggregate demand, which depends upon the level of expenditure and receipts. Aggregate demand should be adequate to provide the purchasing power for the goods produced by a fully employed economy and should expand with economic growth. If there is excess of aggregate demand, there would be inflation; and if there is deficiency in demand, output would be less than the potential, with inadequate utilization of capacity.

Growth postulates capital formation, and budgetary policy has to ensure release of resources needed for development by curbing consumption through taxation or borrowings. Growth is stimulated by inflow of foreign direct investment and modern technology. Budgetary policy must needs create the right investment climate and provide incentives for the inflow of such capital for development. The system and level of corporate taxation should be such that it provided scope and incentives for corporate savings and transfer to reserves for ploughing back for industrial expansion. In India, taxes on corporate and personal incomes need to be reduced further in line with the world trend, so as to maintain a healthy investment climate, conducive to capital formation and inflow of foreign investment capital with modern technology.

It is seen from Harrod - Domar growth model that g or the growth rate is equal to s/v that is the savings rate divided by the incremental capital output ratio (I C O R). It follows that growth can be stimulated in the economy either

by increasing savings rate or by reducing I C O R, or by effecting a combination of the two. Both macro - economic and micro-economic measures are necessary to effectuate an increase in the growth rate. The ratio of savings to G D P has declined from 23.7 per cent in 1990 - 91 to 21.4 per cent in 1993 - 94. The economy can achieve higher growth rate of 7 per cent or more provided the savings rate can be increased to above 26 per cent, foreign aid is available at about 2 per cent and I C O R is maintained at 4:1 or brought down further to 3.5:1. The savings rate in 1994 - 95 has increased to 24.4 per cent of G D P.

I C O R can be reduced below 4:1 in the nineties inter alia through (a) efficient allocation and utilization of resources according to pre - determined priorities; pragmatic budgeting, efficient implementation and effective monitoring; decentralization and implementation of projects in rural areas by panchayats; (b) optimization of productivity of existing capital stock and labour; (c) improvement in quality of public expenditure and curtailment of current and non - plan expenditure and non productive investment; (d) modernization and technological upgradation of plants; (e) increase in agricultural productivity and extension of Green Revolution to backward states.

The dominant considerations in effecting tax reforms in the East Asian economies have been those of economic growth and international competitiveness. Since these economies relied considerably on external linkages, they almost engaged in 'tax competition' and introduced tax reforms to maintain international competitiveness in this field. The lesson is clear. Developing countries must adopt levels of taxation which compare evenly if not favourably with the tax rates in other developing countries who are vying with each other to attract foreign direct investment. The tax system must not only stimulate resource mobilization, but also create an investment climate that is conducive to economic growth on a sustained basis with low levels of inflation.

It is remarkable that private savings in India are in alignment with those

in East Asian economies, but while public savings here have decelerated to about one per cent, those in the East Asian countries vary between 7 and 18 per cent. Increase in public savings and reduction in fiscal deficit have become imperative to sustain public investment in infrastructure – economic and social – as also higher levels of private investment, ameliorate poverty, and emulate the East Asian economies in achieving high growth rates.

Fiscal policy should place increasing emphasis upon human capital accumulation, that is, general skill levels of individuals which increases their productivity and also facilitates absorption of modern technology, which accompanies foreign direct investment and is an engine of growth. The spectacular growth of the East Asian economies has shown that primary and secondary education is by far the largest single contributor to the H P A E's growth rates.

Within the overall budgetary allocation for education, it is a public policy decision whether funds are to be allocated more for primary and secondary education or for higher education; and even in respect of the latter, choice exists with regard to the flow of resources to engineering and technology or liberal arts and humanities. Fiscal policy has an important role to play in determining not only the overall volume of funds, but also in channelizing these funds in the manner best calculated to maximize human capital accumulation and development.

Fiscal policy has an important role in achieving the objective of maintenance of technological excellence and competitive capacity. There should be rational allocation of budgetary funds between military research and industrial and scientific research. Deductions from taxable income should be permitted for tax purposes in respect of expenditure, including capital outlay on machines, for industrial and scientific research. Adequate funds and incentives for import of state-of-the-art technology and for upgradation and modernization of machines should be improved. Fiscal policy should encourage import of technology and inflow of foreign capital required for developing export industries so as to stimulate

exports, as in the East Asian countries.

Infrastructure is fundamental to growth. The availability of power, coal transport, communication *et al* must always remain way ahead of the progressive demands of growing industry. The World Bank rightly describes infrastructure as representing, if not the 'engine', then the 'wheels' of economic activity. Infrastructure and growth are linked both ways : growth depends upon infrastructure and infrastructure depends upon resources generated by growth. Fiscal policy has an important role to play in the development of infrastructure. Besides providing incentives like tax holidays, capital subsides *et al,* Government may provide guaranteed return on capital employed to encourage foreign capital, as has been done by the Government of India, in certain cases, to invest in power projects.

Allocative efficiency of resources increases if infrastructural services are efficiently delivered, which requires (a) commercial management, (b) competition and (c) shareholders and beneficiaries' active involvement. Privatization of existing power projects could reduce budgetary allocation (for losses) and deficit, and increase efficiency, output and profits. Infrastructure such as roads, transport, communication facilities *et al* developed by industry should be encouraged through investment allowances for tax purposes.

Control of inflation is essential for equity and growth. Inflation is the most insidious form of taxation and its redistributive effects are inequitable and regressive. India must eschew deficit financing, and opt for balanced budgets. The cumulative inflation that has occurred during the last three decades has very considerably eroded the purchasing power of money and resulted in great human misery. The theory that mild inflation upto 5 per cent per annum aids development has lost its relevance, considering that the East Asian economies have developed rapidly while maintaining macro - economic stability.

The economies of East Asia, during the period 1960 - 90 achieved remarkably high sustained growth in G D P and per capita incomes on the basis of export-led growth and a manufacturing revolution. The remarkable feature of their development was that rapid growth was accompanied by increase in human welfare, life expectancy, education and housing, and decline in absolute levels of poverty.

The East Asian experience has demonstrated the compatibility of growth and equity. The widely accepted theory of conflict between growth and equity – emphasized by eminent economists like W. Arthur Lewis and Nurkse – is no longer acceptable. The case of Taiwan, Thailand and other countries has conclusively proved that economic growth and equitable distribution are not only compatible but reinforce and strengthen each other. Shared growth is now a major objective of fiscal policy. The acceptance of the tenet that growth and equity have both to be pursued in tandem is almost irreversible; and modern fiscal policy has to enlarge its role and incorporate these developments. We have endeavoured to do so in this study.

The eight East Asian economies (including Japan), had certain common characteristics which distinguished them from other developing economies and also accounted for the greater portion of their growth : (a) higher rates of growth of physical capital amounting to an average 20 per cent of G D P between 1960 and 1990, accompanied by higher rates of domestic savings; (b) higher initial standards of human capital, which were further increased through education as also acquisition of technical skills; (c) higher rates of productivity growth through technological upgradation; (d) stimulated rate of increase of manufactured exports, with their share of World exports of manufactures increasing from 9 per cent in 1965 to 21 per cent in 1990; (e) greater increase in production and productivity in agriculture. The East Asian economies achieved high rates of savings and investment and also an impressive level of tax collection. Incentives and fiscal policy played an important role both in actually stimulating capital formation,

and also in creating an environment conducive to inflow of foreign investment capital.

The economies adopted low tax rates and varied tax policies to increase investment by increasing retained earnings of companies; Hongkong provided for a simple tax structure with low tax rates (presently 20 per cent maximum personal tax rate and 17.5 per cent corporate tax rate); Korea, Taiwan, Malaysia and Thailand provided complex tax structure, but with several tax incentives for promoting investment. Some of them facilitated investment by reducing its cost by adjusting tax, tariff, and exchange rate policies to hold down the relative price of capital goods. They allowed accelerated depreciation through investment, modernization and other capital allowances.

To ensure maintenance of macro - economic stability and low inflation, fiscal policies avoided inflationary financing of budget deficits. Singapore and Taiwan ran sustained budget surpluses. Borrowing funded investment rather than consumption. East Asian governments cut expenditures and increased revenues in a growth - oriented framework, to attain low deficit targets. While Indonesia, Singapore and Thailand evolved balanced budget laws, Japan and Korea followed custom and practices in this regard. The contrast with the budgetary position in India is all too evident. We have revenue deficit being financed by capital budget; borrowing is used to finance consumption year after year, leading to huge interest charges and further deficits.

Since 1985, tax laws in Singapore permitted annual capital allowance of 33.33 per cent of the capital expenditure incurred for a period of three years. This implied that the entire cost of plant and machinery was written off in this period. In Malaysia, an investment tax allowance of 60 per cent of the cost of qualifying capital expenditure was being given. 70 per cent of the statutory income could be utilized to set off the allowance, and the balance 30 per cent was subjected to company tax. Unutilized allowance was carried forward to subsequent years.

Reinvestment allowance for modernization was permitted. A company modernizing production facilities, diversifying into related products or expanding production capacity was given an allowance of 40 per cent of capital expenditure as deduction from income in Malaysia.

East Asian economies attuned their fiscal and monetary policies so as to achieve low inflation and competitive exchange rates. They improvised low fiscal deficits, positive real interest rates, high quality of fiscal adjustment and undervalued currencies. They liberalized exchange rate policies and devalued their currency from time to time to promote exports. Rapid total factor productivity growth was stimulated through greater access to technology obtained through manufactured exports, particularly in Japan, South Korea and Taiwan. Fiscal and monetary incentives in the form of subsidies and credits were provided to boost exports. They also provided high and variable protection to domestic industries, while liberalizing trade and reducing tariffs.

State intervention differed from country to country and with varying degree of success. It was most marked in South Korea and Singapore, and least in Hong Kong. Such intervention was largely successful in regard to directed credit and aggressive export promotion through subsidies, favoured access to foreign borrowing and foreign exchange. The emphasis on securing foreign markets imposed strong discipline on industries and encouraged efficiency. However, state intervention in regard to promotion of specific industries did not generally succeed (heavy chemicals industry in South Korea to wit). Most economies encouraged domestic and international competition – which increased efficiency – and kept their markets open. The regimes on the whole were 'market - friendly' and encouraged the private sector to perform and grow.

Fiscal Policy Reforms in India

There was a structural fiscal deficiency in India in that the capital budget financed part of the revenue budget; and an increasing portion of borrowed

funds was being used for meeting current expenditure which did not generate income. Fiscal deficits ranged between 5 to 8 per cent, while internal and external indebtedness had reached 67.7 per cent of G D P (1994 - 95 BE). Revenues were buoyant. They increased from Rs.57,576 crores in 1990 - 91 to Rs.1,03,762 crores in 1995 - 96 (BE). But the enormous increase of Rs.46,186 crores was absorbed to the extent of Rs.30,529 crores by increase in interest. The total increase in expenditure amounted to Rs.47,453 crores. The *White Paper on the Economy* stated that while the Centre's tax revenue increased by about 17 per cent per annum on average basis, its revenue expenditure increased by 18.4 per cent annually during the eighties.

The Government was making efforts to reduce or contain non - plan expenditure particularly subsidies, defence and administrative and other expenditure, but practical difficulties and resistance from farmers were being experienced. Effective utilization of money was important. It should be ensured that money reached target groups.

A pragmatic fiscal policy is one in which all the elements comprising the budget including deficits are consistent with the macro - economic objectives of controlling inflation,securing allocative efficiency, providing incentives for private and foreign investment and growth, promoting equity and social justice, and maintaining external sector viability and international credibility.

India should eschew deficit financing and opt for balanced budgets on account of the following factors : (1) The vicious circle of high interest charges, deficits and borrowings has to be broken. (2) Revenue account deficit needs to be converted into surplus and compression of government expenditure is imperative. (3) Fiscal deficit has to be brought down to between 2 to 3 per cent of G D P. (4) Despite favourable monsoons for several years, inflation ranges between 5 to 10 per cent which needs to be checked. (5) The vast accumulation of internal and external debt needs to be scaled down. The present levels of

accumulated debt are unsustainable and would lead to a debt trap.

On the basis of experience in India, East Asian economies and other developing countries, certain norms for fiscal policy have been evolved.

(1) Budgets should be framed within a broad disciplinary macro-economic framework on the basis of perspective fiscal planning, and expenditure and outlays should be in accordance with the broad economic and social goals of the government. Fiscal deficits should be within 2 to 3 per cent of G D P; and if inflation is utilized as a tool for promoting growth, inflation should not exceed 3 to 5 per cent per annum. Fiscal control and discipline should cover not only the Centre's own budgeting, but should also extend to public enterprises and the States.

(2) Current account should always have a surplus, which could be utilized for meeting part of the capital budget.

(3) Fiscal deficits should be limited to amounts which can be financed without (a) inflationary growth of money supply and (b) inordinate increase in domestic and external borrowings, leading to high indebtedness and interest charges and current account (B O P) deficits.

(4) Quality of fiscal adjustment is as important as quantity thereof in controlling fiscal deficits. Quality of fiscal adjustment implies that in order to cut deficits, public savings through cut in expenditure and increase in revenues should take place. Deficits should not be reduced by cutting outlays on investment, infrastructure and social expenditure, as was done during the first two years of Indian reforms programme. Such cuts were restored in subsequent budgets.

(5) The budgetary exercises should cover five-year periods and fiscal deficits and their mode of financing chalked out. Thus the borrowings programme would have to be framed on a five-year perspective basis. Borrowings, should not be utilized for consumption, as the debt then becomes dead weight and amortization

and interest payment present great difficulty. Borrowings, both domestic and foreign, should have viability. Returns on investment out of borrowings should cover interest and amortization of debt.

(6) Maintenance of healthy investment climate and incentives for capital formation in private sector and conducive to inflow of foreign capital and technology are crucial to growth. Rapid export growth and outward orientation and globalization of the economy are imperative.

(7) Flexibility of economy and flexibility in policies, as also eternal vigilance against the possibility of exogenous shocks are vital. Concessional aid during crisis has a catalytic effect; aid giving agencies should realize this.

(8) Exultation, reckless spending and imports should be avoided during favourable conditions. Sick public enterprises cannot be indefinitely financed out of the budget. Proceeds of privatization should be utilized not for reducing current account or budgetary deficits but to reduce accumulated debts.

(9) An I M F Study of 101 developing economies, as also *The East Asian Miracle,* have shown that growth and measures for macro-economic stability are positively related. Hence the two aspects should be integrated in the budget.

(10) As the East Asian economies have shown, growth is possible with greater equality in income distribution. This needs to be incorporated in fiscal policy.

(11) Increase in public savings and reduction in fiscal deficit is imperative to (a) sustain investment by public sector in infrastructure and higher levels of private investment; (b) maintain public investment in education, health, housing and other social infrastructure to reduce poverty; (c) reduce aggregate demand and inflationary potential and (d) obviate eventual imbalances in external sector.

(12) Severe monetary restraint is not a remedy for fiscal indiscipline. It leads to financial crunch for industry and high interest rates, consequent upon which industrial production and growth may be adversely affected.

Incentives constitute an important instrument of fiscal policy. Certain incentives like investment allowance, modernization allowance and backward areas tax rebate are necessary in that they stimulate industrial and regional growth and induction of state-of-the-art technology; yet in general, incentives should have a limited role in the fiscal policy framework, and low nominal basic tax rates and a broad base are preferable to too many incentives spread over the tax system. Transparency and accountability should characterize incentives.

Internal and external debt of the Central Government exceeded Rs. 6,15,000 crores in 1994-95 (BE). While external debt as percentage of G D P is on the decline as a result of reforms programme, the domestic debt position is unsustainable and may lead to an internal debt trap. In India, the current account has a deficit financed by the capital account; interest in 1995-96 (BE) absorbs more than 50 per cent of revenues; there is a vicious circle operating: high interest charges, large deficits, heavy borrowings leading to further annual increase in interest and deficits. This circle has to be broken basically by reducing fiscal deficit and borrowings.

Accumulated debt needs to be reduced in India so that interest charges are reduced. (1) 80 per cent of total additional interest payment to R B I on treasury bills should come back as additional dividend by R B I to Government. (2) Proceeds of sale of P S U shares should be utilized for reduction in debt. Privatization of certain saleable loss-making concerns should also be undertaken to reduce debts and deficits.(3) The Government holds vast amount of real estate including land; part sale thereof upto say Rs. 5000 crores a year would help in reducing indebtedness. (4) Smuggled gold forfeited may also be sold and proceeds utilized for reducing debts and interest charges, and moneys saved could be used for increasing social welfare and building infrastructure for growth.

The macroeconomic crisis in 1991 occurred principally due to four factors: (1) fiscal imbalances; (2) expenditure grew faster than revenues and part of

borrowings were used for consumption; (3) adequate return flow of funds to the budget from capital expenditure by the government and money made available to public enterprises did not take place; and (4) increasing interest charges occurred. If the current trend of high fiscal deficits was not reversed, Indian public debt would become unsustainable. Besides, money creation beyond prudent limits resulted in inflation; large foreign borrowings caused excessive indebtedness, current account deficits were caused by reduced exports and high level of imports leading to loss of foreign reserves.

The objectives of the Government's macroeconomic reforms programme have been to dismantle the extensive network of controls and increase the role of the private sector; adopt outward-oriented trade policies, open up the economy to trade and foreign investment and impart a thrust to global integration; restrict government intervention and activities to sectors in which the private sector was not prone to operate; and effectuate liberalization of the financial sector.

The Government achieved spectacular success in its short-term crisis management and macro-economic stabilization programme. Inflation was reduced from 17 per cent in June 1991 to about 7 per cent in December 1995; foreign exchange reserves increased from $ 1.2 billion in June 1991 to $ 18 billion in the same period; exports increased by about 20 per cent in U.S. dollar terms in 1993-94 and the tempo of increase had been subsequently maintained. Devaluation in mid-1991 had proved to be a success. Foreign investment inflow amounted to about $ 4 billion in 1993-94, signifying restoration of international confidence.

During the last four years,considerable fiscal adjustment had taken place. The fiscal deficit had been brought down from 8.4 per cent of G D P in 1990-91 to 5.5 per cent in the 1995-96 Budget, but much more needed to be done. The persistence of high fiscal deficits was a major threat to macro-economic stability. A further reduction of fiscal deficit by 2 percentage points to 3.5 per cent of G D P is necessary for the realization of the Government's objective of

achieving growth of 7-8 per cent of G D P per annum with inflation at about 5 per cent.

Despite a slowdown in growth during 1991-92 (G D P increase 1.1 per cent) and 1992-93 (5.3 per cent), there had been a remarkable revival in G D P and industrial production was buoyant averaging over 10 per cent in the first three quarters of 1995-96, which portended an increase in G D P. Employment was expected to increase by about 8 million in 1995-96 as against 3 million in 1991-92.

The weaknesses of the reforms programme may be indicated. Quality of fiscal adjustment was not satisfactory as cut in fiscal deficit in the first two years (1991-93) of Reforms had been effected by reducing development expenditure including expenditure on social and economic infrastructure. During the three subsequent budgets, however, the cut in expenditure on social welfare programmes had been restored. Despite buoyant revenues, fiscal deficit due to high interest charges, subsidies, funds for public enterprises, defence and general expenditure was high, although subsidies had been partly reduced subsequent to devaluation. Non-plan expenditure and on populist schemes continued to be high, although increase in such expenditure in an election year (1996), was perhaps inevitable. Infrastructural shortages were developing.

Progress in the field of privatization, as also autonomy and restructuring of public sector undertakings, and their regeneration for industry needed a thrust. However, a National Renewal Fund for displaced labour had been set up. The private sector was facing problems in adjusting to the new economic environment due to increasing competition by foreign firms and reduced protection, depressed stock market and liquidity crunch due to a restrictive anti-inflationary monetary policy and high interest rates.

The forecasts for the economy in 1995-96 were: growth in G D P 6.2 per cent; industrial production 10 per cent; inflation around 8 per cent; increase in

exports and imports 20 per cent and 25 per cent respectively, with deficit on current account exceeding 1.5 per cent of G D P; employment was likely to increase by 8 million; foreign investment inflow, which was 4.9 billion US $ in 1994-95 may be lower due to depressed stock market (affecting portfolio investment), political uncertainty and slowing down of macro-economic reforms. Fiscal deficit targeted at 5.5 per cent may actually turn out to be 6 per cent, which was on the higher side.

The key to the success of the structural adjustment programme was control of fiscal deficit, both at the Central and State levels. If the Central Government was able to effectuate a substantial reduction in fiscal deficit, it would be able to achieve price stability and enter a higher trajectory of sustained growth in a favourable macroeconomic environment. But the authorities must realize that monetary restraint was no substitute for lack of fiscal discipline.

Reform of Direct Taxation

The present scholar would advocate two new canons for stimulating growth in developing countries: (1) A certain percentage of incremental revenues every year should be utilized for reduction in taxes. Japan applied this principle during 1960-69 and achieved excellent growth. This was one of the principal contributory factors. (2) In developing countries, tax rebate (lower taxes) should be improvized for undistributed corporate incomes which are transferred to reserves and ploughed back into business. This would increase the incremental savings ratio of corporations and provide nucleus capital for industrial growth (vide C N C Super Multiplier, Section 7.6).

The triple benefit of low taxes has now become evident. The era of high taxes was over and taxes were being cut and simplified the world over. Lower taxes increased revenues due to stimulated activity, increased productivity and incomes; and cutting of costs by businessmen to maximize earnings. Since revenues increased with lower taxes, and G D P rose, there was triple benefit; (a)

taxpayers were responsively happy, (b) government revenues acquired buoyancy and (c) momentum of growth was accelerated. No finance minister could afford to ignore this triple benefit formula, at least not in the present fiscal world environment.

Empirical evidence shows that while the maximum marginal rate of personal tax in India was reduced from 56 per cent in assessment year 1990-91 to 40 per cent in 1995-96, the buoyancy in tax revenues, which was 1.1 for the period 1986-87 to 1990-91, increased to 1.5 in 1995-96 (B.E.). Similarly, in the case of corporate tax, with reduction in effective tax from 57.5 per cent for certain domestic companies to 46 per cent for all companies in this period, the buoyancy increased from 0.8 to 1.7. This vindicates the strategy advocated by the present scholar in 1991-92 (Kothari 1992 O U P).

The maximum tax rate needs to be reduced. We have suggested that the maximum rate of income tax should be brought down to 30 per cent and the progression should be smooth and even at all levels of income. Such rate should be applicable above Rs. 2 lakhs instead of Rs. 1.20 lakhs of income as at present. It would bring the system more in alignment with tax levels in other developing countries. After reduction in tax rate, a disclosure scheme may be formulated. Wealth tax on companies and gift tax needed to be withdrawn. Expenditure tax was an unmitigated failure. Estate duty had been withdrawn earlier.

Discrimination between foreign and Indian investors in regard to taxation of long-term capital gains has no justification. There should be only two rates for long-term capital gains: 10 per cent for individuals and 20 per cent for companies, while short-term capital gains may be taxed like normal income. Income from Units, dividend and bank interest may be taxed at one-half the normal tax rates for all categories of tax payers; and surcharge for companies in respect of capital gains withdrawn.

Fiscal administration should be rationalized and improved by resolving

principal problems facing the tax administration. Tax system should be compatible with the country's international position and level of taxation comparable with developing countries. Various suggestions for improving the tax structure have been made: (a) stability in tax structure; (b) transparency and openness; (c) developing trust and faith in assessee, protecting his rights and issuing refunds and rectification orders regarding appeals expeditiously; (d) development and adaptation of technology; (e)instituting a Tax Research Bureau for examining suggestions; (f) proper constitution of the Advisory Committee; (g) provision of a system of Appeals; (h) National Court of Direct Taxes not being necessary; (i) widening of tax base and efficient implementation of presumptive scheme of taxation; (j) conforming to Principle of Equality of burden based on ability to pay; and (k) other suggestions for improving tax laws and administration. Tax arrears could be reduced through compromises across the table as in the case of Bank's N.P.A.s. Rationalized scheme should be formulated and implemented.

Chelliah Committee had presented a pragmatic report and had closely followed the World Bank tax model; implementation of its suggestions should improve policy outcomes in India. There is a limit to collective savings; and if taxes are taken to levels which are confiscatory, people avoid payment and high evasion occurs. The modern trend is towards low taxes.

Despite rationalization and lowering of taxes, corporate taxes are still out of alignment with taxes prevailing in O E C D and East Asian economies. The latter are also vying with others for attracting foreign investment capital and sophisticated technology. The corporate tax rate in India should be determined between 30 and 35 per cent, particularly as we now have the classical system of taxation and shareholders do not receive credit for tax paid by the company as in the U.K. under the imputation system. The surcharge on corporate tax should be removed. For small companies with profits upto Rs. 5 lakhs, taxes should be even lower, say 25 per cent.

Corporate tax cut promotes investment. Taking into account the concept

and theory of C N C Super - Multiplier, reduction in corporate taxation has a multifold effect upon capital formation in the industrial sector. With the integrated effects of (1) C N C Super-Multiplier (2) Multiplier and (3) Accelerator, corporate tax cut of Rs. 100 crores may lead to additional investment in physical capital assets of about Rs. 675 crores, and additional revenue from excise and corporate taxes of about Rs. 108 crores.

Lower taxes result in higher revenue. The buoyancy in corporate taxes perceived in the Union Budget Estimates for 1995 - 96 bears out that a decline in corporate taxes has a stimulating effect upon work, production, incomes and corporate profits, leading to increasing revenues. Cost consciousness also increases, while tendency to avoidance is reduced. Cumulatively, it results in buoyancy in revenues.

Reform of Indirect Taxation

Indirect taxes provide 72 per cent of the revenues of the Centre and about 91 per cent of the revenues of the States. Indirect taxes yield the greater portion of taxes in developing countries; as per capita income rises, income tax and other direct taxes become increasingly important. In developed countries, direct taxes yield the major portion of taxes, while the contribution of customs and excise duties is proportionately less.

The ratio of taxation to G D P is about 15.5 per cent in India (1994 - 95) as compared to 29 per cent in USA and 38 per cent in UK (1983); this is largely due to agricultural incomes not being taxed, avoidance and evasion being rampant, and State taxes like land revenue being neither elastic nor progressive. The tax base is restricted, given the low incomes of large sections of the population. Besides there are numerous exemptions and deductions. There is need to rationalize the law and widen the tax base to augment revenues.

While MODVAT should be extended to areas not covered, the ultimate objective should be to move to a full-fledged value added tax (V A T) system.

Allocation of tax powers between the Centre and the States would have to be amended by constitutional amendment, with the consent of the states. Meanwhile, V A T principles should be incorporated in the present excise - cum - MODVAT system as far as practicable. Tax base should be widened, by including many currently exempted goods and some services. Certain service sectors such as share brokerage, telephone charges and insurance have already been covered.

Excise duties should be levied on ad valorem as distinguished from specific basis, so as to impart revenue elasticity to the tax structure through inbuilt mechanism. Where specific rates are continued, there should be inflation indexing of such rates. All commodity - specific and user - specific exemptions should be abolished.

Revenue productivity of the tax system is vital. While reducing customs duties, the revenue productivity aspect of the tax system should be kept in view. End-use specific exemptions should be eliminated, as also exemption from countervailing duty. The Government proposes to put most consumer goods on tariff - cum - O.G.L. import regime, and to rationalize customs and import policies for them.

In order to achieve globalization of the economy and increase the volume of foreign trade, customs duties on imports should be further reduced from about 50 per cent to 25 per cent. This would also induce Indian industry to increase efficiency, quality of production and competitiveness. Developing countries have already reduced their duty rates to 10 to 20 per cent for most commodities (except consumer goods).

Prompt action should be taken by the Government to counteract dumping. East Asian economies liberalized import duties, but provided protection to their developing industries on a discriminating basis to ensure their existence and well-being. Foreign exchange should be utilized for import of commodities of mass consumption which are in short supply like sugar, pulses, cotton, fertilizers,

oil *et al* with a low level of import duties, so as to maintain vital supplies and contain inflationary rise in prices.

Elitist consumption through excessive imports at low import duties (in C K D or other condition) of large automobiles, colour T Vs and V C Rs and low-technology items, should not be encouraged. Besides rendering reforms unpopular, such import also leads to unnecessary wastage of foreign exchange, which could be channelized for repayment of external debt – particularly high interest commercial debt. Effect of lower import duties on marginal industries is considerable. While reducing import duties, The Government must take into consideration the fact that liberalized imports may lead to closure of many marginal domestic industries or their takeover by foreign international companies. This has already happened in certain cases. Hence caution is necessary.

Sales tax has become a controversial subject. Uniform rates of taxation should be prescribed by all the States. Sales tax should be a single point levy charged at the final stage of sale to the consumer. Inter-State sales tax should be abolished. If a comprehensive national V A T is improvised, sales tax should be replaced by V A T. Until such time this is rendered possible, some more commodities as recommended by Tripathi Committee should be included in the list of items for replacement of sales tax by additional excise duty. Sales tax on raw materials and intermediate goods should be avoided, as it leads to cascading effect, and reduces competitiveness in export markets. Sales tax laws should be rationalized, rates made more reasonable and administration tightened up. As in the case of Central taxes, these measures would boost revenues due to greater turnover and reduced evasion and avoidance.

We have endeavoured to show that the modern fiscal policy in developing countries must transcend its traditional functions and mores and needs to be so formulated as to effectively contribute to the attainment of the various prerequisities of sustained growth. Properly designed and effectively implemented, fiscal policy can deliver the goods.