Three decades of India's Fiscal and Financial Transformation

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Three decades are but a speck of time in the history of a nation, yet the last three decades have been truly momentous for India's transformation from a poor underdeveloped country to an economic powerhouse to reckon. The fiscal landscape of India today is unrecognizably different from that of 1986, when V P Singh, Finance Minister in the Rajiv Gandhi Government rose to present his Budget on February 28. Economic growth rate of 4.5% then was little better than the Hindu rate of growth, and fiscal deficit was nearly 12% of the Gross Domestic Product (GDP).

While attempting "to create a dynamic country that is equal to any other country in the world", Mr Singh reduced the number of income tax brackets from 8 to 4, and the marginal tax rate from 66% to 50%. Side by side, to reduce the cascading effect of taxes on the final price of goods, MODVAT was introduced allowing set-off of duty paid on raw materials against the duty on final products. These were probably the first major tax reforms after independence. But it was still the era of dictatorship of the Planning Commission, the extra-constitutional politically-appointed body of so-called 'experts' that decided how resources were to be deployed for development. and the License Permit Raj architecture of the command and control economy was in full blossom, and under its tyranny, economy was getting throttled by extensive regulation, protectionism and a public sector supposed to dominate the 'commanding heights of the economy', but actually defined by cronyism, patronage, pilferage and inefficiency. In such a centralised planned economy, growth and productivity were the ultimate casualties, and market - the driver of growth in a modern economy, was not allowed to flourish. The result was a forced impoverishment of the nation that earned the nickname of "Sick man of Asia". Even though Mr Singh ended by asserting "his faith in new India", that faith would be short-lived. Crisis was already knocking at the door, and would take the nation perilously close to becoming a failed state only five years later when it would have to be brought back from the brink of an impending disaster.

Since the mid-eighties, the country had been sinking deeper and deeper into an economic quagmire, primarily because of the continued worsening of its balance of payments position, triggered by an overvalued currency. Gulf War exacerbated the crisis by swelling the import bills and dwindling our scarce forex reserves. Nehruvian economics of deficit financing led to escalating fiscal deficits which rose to 8.4 percent of GDP by 1990-91. Inflation ranged over 12%, and internal debt alone rose to 53 percent of the GDP, while external debt increased to US$ 72 billion from only US$ 20.5 billion in 1980, making India the third largest debtor nation after Brazil and Mexico. By June 1991, with foreign exchange reserves had fallen to only $ 600 million, or only two weeks equivalent of imports, and the prospect of defaulting on its external balance of payment obligations was looming ominously over the nation.

To escape the humiliating prospect of sovereign default, a desperate Government had to secure an emergency loan of $2.2 billion from the IMF by pledging almost its entire stock of 67 tons of gold reserves as collateral. To complete the humiliation, IMF insisted on physical transfer of this gold, and RBI had to airlift 47 tons of gold to the Bank of England and the remaining 20 tons to the Union Bank of Switzerland. While this gold was being transported to the airport, the carrier van broke down, creating widespread

panic. As a chartered plane ferried the precious cargo to London during the last 10 days of May 1991, an outraged nation and its hapless leaders were jolted out their deep slumber after 44 years. The Chandra Shekhar government that presided over this crisis collapsed shortly afterwards, and on 21st June 1991, P V Narasimha Rao took over as Prime Minister, with Dr. Manmohan Singh as his Finance Minister.

On July 24, Dr Singh presented his first budget, an epoch making budget that marked a complete break from the disastrous legacy of Neruvian socialism. As he finished his budget speech quoting Victor Hugo that "no power on earth can stop an idea whose time has come" and asserting that the emergence of India as a major economic power in the world happens to be one such idea, India had already changed. It had finally freed itself from its directionless past by recognising that it was the market and not the Government that should drive the economy.

That budget simplified the taxation system remarkably by introducing only three income tax brackets chargeable at 20%, 30% and 40%, and began the rationalisation of indirect taxes by pruning the peak customs duty from 220 per cent to 150 per cent. But far more important was the introduction of a New Industrial Policy that freed industry from controls by abolishing industrial licenses, allowed private sector into practically every economic activity, restructured public sector by reducing government control, facilitated foreign direct investment (FDI) and gave free access to foreign technology. These reforms would usher in a competitive industrial climate built around the private and not the public sector to create wealth and job for millions, and attract financial capital from outside with consequent built up our foreign exchange reserves. The net result would a near double digit economic growth and consequent fall in poverty from nearly 50% in 1991 to about 20% today, saving at least 300 million people from the clutches of poverty.

A Tax Reforms Committee (Chelliah Committee) set up soon afterwards submitted its report in January 1993, recommending radical simplification of the direct tax structure and rationalisation of indirect taxes. Following its recommendation to widen the tax net, in the 1994-95 budget, a service tax was introduced on only three services, whose number increased to 119 by 2011-12. Today barring only a few items in the "negative list", all services are taxable and their total contribution today is about 15% of the total tax revenue. The 1997 budget of Mr P Chidambaram further brought the income tax rates down to 10%, 20% and 30%, a level that has not changed since. The reforms boosted revenue, increased demand and accelerated growth. They also corrected the imbalance in the structure of revenue by raising the share of direct taxes in gross tax revenue from 19% in 1990-91 to 54% in 2015-16.

But fiscal consolidation is not only about quantity, significant qualitative improvements were effected in better management of deficits and debt, through the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) in 2003, imposing limits on Government borrowings, debt and deficits, requiring fiscal deficit to be reduced to 3% of the GDP by 2008-09 and forcing greater transparency of fiscal operations of the Government through statutory disclosures. The 12th Finance Commission (2005-10) forced the states to enact their own FRBMAs, to reduce their own deficits and debt, and by 2010, all states had enacted these legislations. This brought the state finances back to rails and helped them emerge out of the vicious debt traps they were inevitably falling into. Most states were thus able to generate revenue surpluses which financed their capital outlay, boosting significantly the productive

capacities of their economies. The higher growth that we see today is a cumulative result of all these measures.

However, many of these gains were frittered away by short-sighted political decisions. The five-year-plans that allocated resources inefficiently was one, another was the unabated proliferation of the centrally sponsored schemes whose number rose to 360 during the 9th plan (1997-2002). All these followed from the faulty Nehruvian economic model which was perhaps singularly responsible for India's poverty. Fortunately all there have now been corrected. The spectre of a Planning Commission no longer haunts Indian economy, and the number of centrally sponsored schemes have also been slashed to only 28.

Of all the reforms initiated by the present Government, the enactment of the Constitution (122nd Amendment) Bill, 2014 introducing the Goods and Service Tax to replace a plethora of indirect taxes, making India a unified common market is perhaps the most significant, though it will be awhile before the results can be expected. India of 2016 is totally integrated in the global economy and indeed it is an economic force no one can ignore in the world. Stagnation and despair of the 1980s are things of the past, today it is about aspiration and growth. We have indeed left our dismal past well behind us.