

Evolution and Issues in Indian Public Finances

**Presentation to Trainee Officers of
IES and ISS**

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Scheme of Presentation

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1. Public Finances in Pre-Independent India till 1935

■ Four main sources of revenue:-

- Revenue from Government owned lands and forests and tribute from native States politically dependent on the British Indian Government. Rent from ryotwari and zamindari lands, sale proceeds of forest produce, royalty from working mines.
- Export of opium and its retail vending
- Income from commercial activities like railways, post and telegraphs
- Judicial fees

■ In 1913 land revenue accounted for 34.4 per cent of the total revenue. Land revenue was considered to be not a tax but only the price of exploiting natural resources belonging to the State. Other taxes like, excise, customs, stamp duties and salt tax accounted for 47 per cent of the revenue.

■ Defence alone accounted for over 34 per cent of total expenditure.

Provincial Revenues

- Provincial governments are assigned fixed shares of revenue collected by them under certain heads.
- Revenue from opium, salt, customs, post and telegraphs and railways are entirely imperial.
- Land revenue, irrigation, stamps, excise and forests are divided between the imperial and provincial governments as per provincial settlements.
- Provincial settlement did not improve the economy of provinces. It led to horizontal imbalances among the provinces.

Government of India Act, 1919

- Based on the Montague-Chelmsford report, the Government of India Act, 1919 was enacted. The main features of the Act are:
 - It introduced for the first time by bicameralism and direct elections in the country.
 - The provincial budgets were separated from the central budget and the provincial legislatures were empowered to enact their own budgets.
 - The provincial subjects were divided into “Reserved” and “Transferred” and the Governor in Council will control the reserved subjects.
 - Transferred subjects include local government, education, public works and excise. The sources of revenue of provinces included receipts from provincial subjects, a share in the income tax and taxes on specific items.
 - Finance, land revenue, famine relief, irrigation and waterways, mines, electricity, etc., were included in the reserved subjects.

2.Changes introduced by Government of India Act,1935

- It is the beginning of the evolution of federal provincial relations.
- It provided for 3 Lists-The Central and provincial governments had exclusive powers to legislate on subjects listed in List I and List-2, respectively. List-III did not contain any subject relating to taxes.
- The distribution of resources can be broadly classified into i) taxes collected and retained by the Centre, ii) taxes collected by provinces and retained by them, iii) taxes collected by the Centre but assigned to provinces, iv) taxes collected by the Centre but shared with provinces and v) grants-in-aid.
- The provinces were given the right to borrow and manage their budgets.
- The revenues of the provinces were not commensurate with the subjects assigned to them.

3. Adoption of Indian Constitution in January 1950 and consequent changes in the management of Indian public finances

- The Constitution clearly demarcates powers and responsibilities of the Union and the States and these are listed in the Union List and the State List respectively. Over the subjects listed in the Concurrent List, the Centre has overriding powers.
- The important taxes assigned to the Union are income tax other than on agricultural income, duties of customs including export duties, duties of excise on petroleum products and corporation tax.
- The important taxes assigned to the States are land revenue, taxes on agricultural income, taxes on lands and buildings, taxes on mineral rights, duties of excise on alcoholic liquors for human consumption, opium, taxes on consumption of sale of electricity, taxes on the sale of petroleum products, taxes on vehicles, taxes on professions, rates of stamp duty not specified in the Union List.
- The local bodies are not entrusted with any taxes except those assigned to them by the States.

- To address the vertical imbalances between the Union and the States and the horizontal imbalances across the States, the Constitution provides for the appointment of a Finance Commission within two years from the commencement of the Constitution and thereafter at the expiration of every fifth year or earlier.
- The mandate of the Finance Commission is to recommend
 - a) the distribution between the Union and the States the net proceeds of union taxes and the allocation between the States of their respective shares
 - b) principles which should govern grants-in-aid to States and
 - c) measures needed to augment the Consolidated Fund of the State to supplement the resources of panchayats and municipalities on the basis of recommendations of the State Finance Commissions.

- The Constitution initially provided for the sharing of the proceeds of income tax and to a limited extent the proceeds of union excise duties. Following the recommendations of the Tenth Finance Commission, the Constitution was amended facilitating sharing of all Union tax revenue with States in 2000.
- The 14th FC was a game changer by increasing the tax devolution to States from 32 to 42% of net tax revenue of the Centre. This was meant to make the transfers more untied, while keeping the total transfers at the same level.
- As per the Award of the Fifteenth Finance Commission (2020-26), the States' share in Central taxes is fixed at 41 per cent of the net proceeds of central taxes.

Horizontal Distribution-Approach of Finance Commissions

- In the criteria for inter se distribution of State share of income tax adopted by the first seven Finance Commissions, there was no element of equity.
- The Third Finance Commission introduced for the first time the element of equity in the distribution of state share of union excise duties.
- From the Seventh Finance Commission onwards, equity became an important criterion in the devolution formula.
- The Eighth Finance Commission recommended a uniform criteria for devolution of the income tax as well as Union excise duties.

Criteria and Weights assigned for Horizontal Devolution – Fifteenth Finance Commission

Criteria	Weight (%)
Population	15.0
Area	15.0
Forest and ecology	10.0
Income distance	45.0
Tax and fiscal efforts	2.5
Demographic performance	12.5
	100.0

- The Constitution also provides for procedures in financial matters such as, preparation of annual financial statement, appropriation bills, supplementary, additional or excess grants and auditing of accounts by the C&AG.

Per Capita Tax Devolution of XV-FC (2021-26)

State	Per Capita Tax Devolution (2021-26) (Rs)	State	Per Capita Tax Devolution (2021-26) (Rs)
General Category		Special Category	
Goa	111692	Arunachal Pradesh	537877
Chhattisgarh	56336	Sikkim	268738
Madhya Pradesh	45662	Mizoram	192036
Odisha	45579	Nagaland	121409
Jharkhand	42350	Meghalaya	109101
Bihar	40819	Manipur	105773
Uttar Pradesh	37930	Tripura	81504
Rajasthan	37138	Himachal Pradesh	51114
West Bengal	34819	Uttarakhand	46813
Andhra Pradesh	34485	Assam	42343
Punjab	27521		
Telangana	25373		
Karnataka	25217		
Kerala	24342		
Gujarat	24311		
Tamilnadu	23885		
Maharashtra	23750		
Haryana	18216		

Source: Fifteenth Finance Commission Report

4. Introduction of Central Planning in 1951 and its impact on public finances

- With the introduction of Central Planning in 1951 , a new classification of expenditure has emerged, i.e., plan and non-plan. The Constitution provides for classification of expenditure into capital and revenue.
- The first five year plan stated that “Judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part to play”. Thus, deficit financing which in our context meant RBI credit to Government was assigned a place in the financing of the Plan.
- The ad hoc Treasury Bills thus emerged as a mode of financing Central Government's deficit in mid-1950's.

5. Reforms in public finances- Tax Reforms

Direct Taxes-Income Tax

- Till 1970, changes in direct taxes were mostly ad hoc. In 1973-74, the personal income tax had ten slots with rates rising from 10 per cent to 85 per cent. With the sur charge of 15 per cent on incomes above Rs. 2 lakh, the highest rate was 97.5 per cent.
- The peak income tax rate was brought down to 77 % in 1974-75 and further to 66 % in 1976-77. In 1992, the number of income tax rates were brought down to 3 (20, 30 and 40%).
- In 1997-98, the tax rates were further reduced to 10 , 20 and 30%. In 2017-18, the then existing rate of taxation for individual assesses with income between Rs 2.5 lakh and Rs 5 lakh was reduced from 10 to 5%.
- In 2020-21, a new optional personal income tax system was introduced with 5 slabs (5, 10,15,20, 25 and 30%. To simplify the tax system and lower tax rates, around 70 of over 100 income tax deductions and exemptions were done away with. A taxpayers gets to choose between the old and new regimes at the beginning of a new financial year and get taxed accordingly.

Direct Taxes- Corporation Tax

- In the case of corporation tax, distinction was made between widely held and closely held companies, with the tax rate on widely held companies ranging from 45 to 65%. However, there were too many exemptions.
- The basic corporate tax was reduced to 50% and the applicable rate to different categories of closely held companies were unified at 55% .
- Following the recommendations of the TRC, the distinction between closely held and widely held companies was done away with and the tax rates were unified at 40% in 193-94.
- In 1997-98, the corporate tax rate was further reduced to 35% and the 10% tax on dividends was shifted from individuals to companies.
- In 2005-06, corporate tax on Indian companies was reduced to 30%.
- The Finance Act, 2020 had abolished the Dividend Distribution Tax and moved to the classical system of taxation wherein dividends are taxed in the hands of the investors. The dividend income shall be chargeable to tax at normal tax rates as applicable in case of an assessee.

Indirect Taxes- Union Excise Duties

- In the initial years after independence excise duties were levied on a few raw materials and intermediate goods. It was only in 1975-76, the tax was extended to final goods. The system was completed with some goods subjected to specific and others to ad valorem duties with 24 slabs. The tax ranged from 2 to 100%. The result was cascading.
- In India, a reform was attempted in 1986 when the principles of VAT were introduced in the Union excise duties (UEDs) through the so-called Modified Value Added Tax (MODVAT).
- To begin with, this was applied to a few select commodities but was extended overtime to a large number of commodities. The taxation was based on a strange combination of physical verification of goods with a provision of input tax credit.
- There was gradual unification of rates and in 2000-01 three rates were merged into one to be called CENVAT with 3 additional excises of 8,16 and 24% for a few commodities. Greater reliance on account-based administration of tax.

Indirect Taxes- Introduction of Service Tax

- Prior to July, 1994 only the manufacturing sector was subject to indirect tax in the form of Central Excise.
- Considering that services sector constitutes a significant part of the GDP, Service Tax was imposed in 1994 for the first time on telephone services, services relating to non-life insurance and services provided by Stock Brokers.
- Service tax has been extended overtime to cover all services with the exception of a few items in the negative list.

Indirect Taxes-Customs Duties

- Till the 1990s, tariffs were very high and there were restrictions on imports. The tariff structure ranged from 0 to 400%. More than 10% of imports were subject to 120% tariffs. There were wide ranging exemptions.
- In 1991-92, all duties on non-agricultural goods were reduced to 120%. Over the next four years, the peak rate was reduced to 50% and then to 40% in 1997-98, 30% in 2002-03, 25% in 2003-04 and finally to 15% in 2005-06. There were relaxations in quantitative relaxations.
- Rates were reduced from 22 in 1990-91 to 4 to in 2003-04. a few items were kept outside these 4 rates but 90% of revenue came from the commodities subject to 4 rates.
- At present custom duty rates range from 0 to 100%, with a special additional duty of 4% and a countervailing duty ranging from 0 to 12% on goods that received tax benefits or subsidies in the country of manufacture. This duty prevents undue advantage of these goods over locally produced goods.
- Under the Liberalised Remittance Scheme, all resident individuals, including minors, are allowed to freely remit up to USD 2,50,000 per financial year (April – March) for any permissible current or capital account transaction or a combination of both.

Indirect Taxes- Introduction of GST in 2017

- Introduction of GST in 2017 is a landmark reform in the system of indirect taxes. By subsuming a large number of Central and State taxes into a single tax, GST is intended to mitigate the ill effects of cascading or double taxation in a significant manner.
- GST is estimated to reduce the overall burden of taxation by 25 to 35 % and will make Indian products competitive. It is expected that because of its transparent and self policing nature, administration of the tax will be easier.
- Currently, taxation powers between the Centre and the States are clearly demarcated. The assignment of concurrent jurisdiction of the Centre and the States for the levy of GST required a major Constitutional amendment (122). The taxes are being levied as dual GST concurrently by the Union (CGST) and the States (SGST).
- An integrated GST (IGST) is being levied on inter state supply of goods and services and this is being collected by the Union and apportioned between the Union and the States.
- Currently there are 4 rates of GST 5%, 12%, 16% and 28%. In addition a cess is being levied on demerit goods to provide compensation to States which may lose revenue owing to the implementation of GST for a period of 5 years.

Indirect Taxes- Introduction of GST in 2017

- The central taxes subsumed under GST are central excise duty, additional duties of excise, additional duties of customs, special additional duties of customs, service tax and cesses and surcharges insofar as they relate to supply of goods and services.
- The State taxes subsumed under GST are State VAT, central sales tax, purchase tax, luxury tax, entry tax, entertainment tax, taxes on advertisements, taxes on lotteries and gambling and States cesses and surcharges insofar as they relate to supply of goods and services.
- GST applies to all goods and services except alcohol for human consumption.
- GST on five specified petroleum products, crude, petrol, diesel, aviation turbine fuel and natural gas would be applicable from a date to be recommended by the GST Council.
- Tax payers within an annual turnover not exceeding Rs.20 lakhs are exempted from CGST and SGST.
- Exports are zero rated. There is input tax credit on CGST and SGST.

Part-6: Other important reforms in public finances.

- The ad hoc Treasury Bills, introduced in the mid-1950s which were meant to be temporary, gained a permanent character. It became an attractive source of financing Government expenditures.
- Ad hoc Treasury Bills were created automatically to finance Central Government deficit without any limit. The system contributed to rapid monetary expansion and the budget deficit became very large.
- Considering the ill effects of ad hoc treasury bills and their automatic monetization by the RBI, reforms were introduced to eliminate them in a phased manner.
- Limits on creation of ad hoc Treasury Bills operated between 1994-95 and 1996-97.
- Through a transition period of two years beginning April 1, 1997, ad hocs were eliminated and the new system of Ways and Means is introduced; but, overdraft above Ways and Means would be permissible beyond certain number of working days, though at a cost.
- Full fledged system of Ways and Means and Overdraft became operative from April 1999.

Part-6: Other important reforms in public finances.

- Another major reform is the enactment of FRBM Act in 2003 by the Centre. The FRBM Act mandated elimination of revenue deficit by 31 March 2006, prohibiting government borrowings from the Reserve Bank of India three years after enactment of the bill, and reducing the fiscal deficit to 2% of GDP (also by 31 March 2006). Further, the Act mandated reduction of government liabilities to 50% of the estimated GDP by year 2011.
- As per the recent amendment to the Act in 2018, the Central Government shall,-
 - a) take appropriate measures to limit the fiscal deficit upto three per cent. of gross domestic product by the 31st March, 2021;
 - (b) endeavor to ensure that- (i) the general Government debt does not exceed sixty per cent.; (40% of GDP for the Centre and 20% of GSDP for States) by the end of financial year 2024-2025;
 - (c) not give additional guarantees with respect to any loan on security of the Consolidated Fund of India in excess of one-half per cent of gross domestic product, in any financial year,
 - (d) endeavor to ensure that the fiscal targets specified in clauses (a) and (b) are not exceeded after stipulated target dates.

Part-6: Other important reforms in public finances.

- The 12th FC recommended debt relief to States subject to each State enacting a fiscal responsibility legislation prescribing specific annual targets with a view to eliminating the revenue deficit by 2008-09 and reducing fiscal deficits based on a path for reduction of borrowings and guarantees.
- Following these recommendations almost all the States enacted FRBM Acts in 2005.
- The 15th FC recommended an indicative deficit and debt reduction for the Union Government. It recommended phased reduction of revenue deficit from 5.9% of GDP in 2020-21 to 2.8% of GDP by 2025-26. reduction of fiscal deficit from 7.4% to 4.0 % of GDP and total liabilities from 62.9% to 56.6% of GDP in the same period.
- For the States the Commission recommended increase in the revenue surplus from 0.1% to 2.5% of GSDP, reduction of fiscal deficit from 4.5% to 3.0% of GSDP and total liabilities from 33.1% to 32.5% of GSDP by 2025-26.

Part-6: Other important reforms in public finances.

- Following the recommendations of the 12th FC, the practice of Centre lending to States was dispensed with. Subsequently, the system of passing on assistance for externally aided projects has been modified. Instead of 60:40 grant loan ratio, external assistance is now being passed on back to back basis.
- Because of the accountability problems, the system of direct transfers to implementing agencies in the States under the CSS has been dispensed with. Now CSS grants are being routed through the State treasuries.
- The Central planning has been dispensed with the replacement of Planning Commission by NITI Aayog in 2015.
- The classification of expenditure into plan and non-plan had resulted in unintentional ill effects. The focus on higher plan outlays resulted in cutting down maintenance expenditure which is classified under non-plan. In 2017-18, the classification of expenditure into plan and non-plan had been dispensed with.
- A system of dedicated bank account for each CSS has been introduced to ensure that States release their share of CSS in a timely manner.

Part-6: Other important reforms in public finances.

- In the beginning of a financial year, the Ministries/Departments will release not more than 25% of the amount earmarked for a State for a CSS for the financial year.
- Additional Central share (not more than 25% at a time) will be released upon transfer of the stipulated State share to the Single Nodal Account and utilization of at least 75% of the funds released earlier (both Central and State share).

Part-7: Structure of Indian Public Finances-Union and states

Percentage share of Direct And Indirect taxes-Centre and States						
(₹ Crore)						
Year	Centre (gross)		States		Combined	
	Direct As % of Total	Indirect As % of Total	Direct As % of Total	Indirect As % of Total	Direct As % of Total	Indirect As % of Total
1950-51	35.9	64.1	38.3	61.7	36.8	63.2
1960-61	27.7	72.3	32.6	67.4	29.8	70.2
1970-71	20.6	79.4	21.9	78.1	21.2	78.8
1980-81	21.1	78.9	12.3	87.7	16.5	83.5
1990-91	19.2	80.8	10.8	89.2	16.3	83.7
2000-01	36.3	63.7	11.4	88.6	27.0	73.0
2006-07	48.8	51.2	15.4	84.6	37.2	62.8
2007-08	52.8	47.2	15.2	84.8	40.5	59.5
2010-11	56.5	43.5	13.6	86.4	40.7	59.3
2020-21	47.8	52.2	13.0	87.0	33.7	66.3
2021-22	50.1	49.9	12.6	87.4	34.2	65.8

Notes : 1. Data for 2020-21 are Revised Estimates and data for 2021-22 are Budget Estimates.

2. States direct taxes, indirect taxes and total taxes exclude States' share in Central taxes as reported in Central Government Budget documents.

Also see Notes on Tables.

Source : Budget documents of the Government of India and the State Governments.

Fiscal indicators of Centre, States and Combined

Year	Centre		States		Combined	
	Revenue Deficit As % of GDP	Fiscal Deficit As % of GDP	Revenue Deficit As % of GDP	Fiscal Deficit As % of GDP	Revenue Deficit As % of GDP	Fiscal Deficit As % of GDP
1950-51	-0.5	0.6	-0.02	0.7	-0.5	0.8
1960-61	-0.3	3.4	-0.14	2.1	-0.4	4.7
1970-71	-0.3	3.0	0.04	2.0	-0.3	4.2
1980-81	0.5	6.0	-0.61	3.0	-0.1	7.5
1990-91	3.2	7.8	0.89	3.2	4.1	9.2
2000-01	4.0	5.6	2.58	4.1	6.5	9.3
2006-07	1.9	3.4	-0.58	1.8	1.3	5.2
2007-08	1.1	2.6	-0.88	1.5	0.2	4.1
2010-11	3.3	4.9	-0.04	2.1	3.3	7.0
2020-21	7.3	9.2	1.99	4.7	9.3	13.3
2021-22	4.6	6.8	0.50	3.5	5.4	9.7

Note : (-) sign represents revenue surplus

Source: Economic Survey of India 2022-23, RBI-Handbook of Statistics on Indian Economy

Outstanding liabilities of Centre, State and Combined

(Rs. In crore)

	Centre	States	Combined
Year	As % of GDP	As % of GDP	As % of GDP
1980-81	40.6	16.3	45.4
1990-91	54.6	19.1	60.9
2000-01	60.4	27.8	75.0
2006-07	62.0	29.2	75.4
2007-08	59.9	27.1	72.7
2010-11	53.2	24.0	66.9
2020-21	63.2	31.0	89.3
2021-22	59.5	29.6	84.8

Source: Economic Survey of India 2022-23, RBI-Handbook of Statistics on Indian Economy

Structure of Taxes-Centre and States

(Rs. In crore)

	Centre			States	
	2021-22			2020-21	
Tax Revenue (Net)	1804793		I. Tax Revenue (a+b)	1767105	100%
Tax Revenue (Gross)	2709315	100%	a) States Own Tax Revenue	1171878	66.3% (100%)
of which			Of which		
Corporation Tax	712037	26.3%	Land Revenue	12184	1.0%
Income Tax	696243	25.7%	Stamps and Registration	126679	10.8%
Customs	199728	7.4%	VAT/Sales Tax	284902	24.3%
Union Excise Duties	394644	14.6%	State Excise	172794	14.7%
GST	698114	25.8%	SGST	463232	39.5%
Others	8594	0.3%	Others	105671	9.0%
			b) Tax devolution from Centre	595227	33.7%
Non-Tax Revenue	365112		II. Non-Tax Revenue	819517	
Total Revenue	2169905		Total Revenue (I+II)	2586622	
<i>Source: Union Budget Documents and RBI State Finances-Study of Budgets</i>					

Expenditure Pattern-Centre and States

(Rs. In crore)

	Centre		States
	2020-21		2020-21
Revenue Expenditure	3083519	Revenue Expenditure	2957844
of which Interest Payments	679869	General Services	1037852
Capital Expenditure	426317	of which Interest Payments	387028
		Social Services	1167386
		Economic Services	665611
		Grants-in-aid	86995
		Capital Expenditure	413687
		General Services	23744
		Social Services	111553
		Economic Services	278390
<i>Source: Union Budget Documents and RBI State Finances-Study of Budgets</i>			

8. Issues and way forward

- Tax-GDP ratio of the Centre has remained stagnant at about 10.5% of GDP. This is much lower than the tax-GDP ratios in developed countries (Australia 30.4%, Germany 36.4%, USA 28.3%, UK 32.7%)
- Only 8.13 crore people paid income tax in the AY 2020-21 out of a population of 136 crore (6%).
- Revenue foregone on account of tax concessions is estimated at Rs.11.10 lakh crore in 2020-21
- Higher dependence on indirect taxes, which are regressive in nature.
- Fiscal and revenue deficits of the Centre exceeding the FRBM targets by a huge margin. In 2022-23 (RE), revenue deficit accounts for 48.7% of fiscal deficit.
- Interest payments alone account for 41% of the net revenue receipts and 31% of revenue expenditure of the Centre. Establishment Expenditure accounts for 28% of revenue receipts and 21% of revenue expenditure. Major subsidies account for 14% of revenue receipts and 11% of expenditure.
- With such preemption, there is hardly any maneuverability in budget making.
- Capital expenditure constitutes around 20% of total expenditure.

8. Issues and way forward (contd)

- Growing trust deficit between the Union and States on account of:-
 - CSS
 - Cesses and surcharges
 - Treating off-budget borrowings as State borrowings, if they are serviced from the Budget.
 - At the aggregate level, States' own tax revenue subsumed under GST is 47% while the Centre's revenue subsumed is only 31%. Thus, the States have yielded more fiscal space and tax autonomy.
 - The vote of the Central Government shall have a weightage of 1/3rd of the votes cast and the votes of all the State Governments taken together shall have a weightage of 2/3rd of the total votes cast in the GST Council. Centre has almost has a veto power.
 - States have no representation in the GST Council Secretariat.
 - Some States will suffer revenue loss with the termination of GST compensation
- One of the maladies of Indian public finances is the off-budget borrowing guaranteed by the Centre and the States. These are not accounted for in the calculation of fiscal deficit and outstanding liabilities.

Way Forward

- Fiscal discipline at all levels-Fiscal Councils
- Widening of tax base and plugging the loopholes in tax collections
- Check on freebies
- Better targeting of subsidies
- Proper maintenance of assets already created.
- Timely completion of on-going capital works to avoid cost overruns.
- Recovery of user charges
- Better enforcement of contracts to attract FDI.

Thank You