# Chapter 7

# Impact of achieving FRBM targets

The FRBM Act is a milestone in India's economic history, in bringing about prudent fiscal policies. The implementation of this Act involves significant reforms to both revenue and expenditure.

This report proposes a paradigm shift in the tax system as the main means of achieving the FRBM Act requirements. This will give India a world class fiscal system. This tax system will be fair and equitable, and conducive to high economic growth. This chapter sketches the important consequences, and the impact upon the economy, of the policy proposals of this report.

## 7.1 World class tax system

The tax reforms proposed in this report seek to help India achieve a world-class fiscal system. This would be the most equitable tax system in India's post-independence period.

These reforms address the great degree of distorted behaviour that takes place today, in the portfolio formation of households, in the consumption versus savings decisions of households, in corporate financial structure, and in the industries where investment takes place. The attention of the companies of India should be on productivity and global competitiveness; not on tax planning. The removal of these behavioural distortions will improve the efficiency of resource allocation, and yield faster GDP growth.

A major distortion that will be addressed is the differential treatment of manufacturing versus services. The manufacturing sector, today, pays a disproportionate burden of total tax revenues, even though the services sector now exceeds half of GDP. By correcting this imbalance, with a uniform goods and services tax, the proposed tax reforms will bring neutrality between manufacturing and services. This will help spur a boom in investment in Indian manufacturing and agro-business, and particularly labour-intensive exports growth. This is likely to help in the creation of a large number of blue-collar jobs in the manufacturing sector including agro-processing industries and in rural areas, as has been observed in China.

The proposed tax reforms will have a major impact upon the economy in terms of the reduction of compliance costs. The present processes of recordkeeping and tax filing impose substantial costs upon both the taxpayer and government. These are deadweight costs for the economy. The proposed reforms would yield a sharp reduction in compliance costs, and thus free

up resources for productive uses.

Another key beneficiary of the tax reforms will be small and medium enterprises (SMEs), which today bear a disproportionate brunt of taxation owing to the regressive nature of exemptions and the regressive impact of costs of compliance. This is a key sector where labour-intensive and export-intensive growth needs to come about to sustain high growth in GDP and employment.

The proposed tax reforms will enhance equity. A complex tax system is inherently regressive, in that large entities are more able to engage in tax planning and tax avoidance. The compliance costs associated with a complex tax system also inherently have a higher incidence, as percent of income, upon individuals with smaller incomes and upon small firms. Simplifying the tax system inherently redresses this balance.

## 7.2 Impact on investment

The reforms proposed in this report will have a strongly positive impact upon investment at many levels, promoting 'investment-led' growth.

*Public capital expenditure.* Under the baseline scenario, capital expenditure was projected to drop from 2.5% of GDP in 2002-03 to 2.3% of GDP in 2008-09. There is a strong consensus amongst economists that public capital expenditure - if conducted through sound institutional mechanisms like NHAI - performs a valuable role in our growth process, and will actually 'crowd-in' private investment.

Under the reforms scenario, capital expenditure is projected to go up to 2.9% of GDP in 2008-09. This is a difference of 0.6% of GDP when compared with the baseline scenario. For a frame of reference, the capital expenditure of NHDP amounts to 0.3% of GDP, so 0.6% of GDP is large enough to support two programs of the size of NHDP.

*Improvement in credit rating.* The improvement in India's fiscal situation is likely to lead to an improvement of India's credit rating. This would spur foreign capital inflows into India, and thus help investment in the country.

*Impact on private investment.* A strong program of effective public investment is known to 'crowd in' private investment. The easing of the fiscal constraints faced by the government would help improve the provision of public goods, which would lead to an improved investment climate. The improvement in India's outlook owing to fiscal consolidation would improve the investment intentions of domestic and foreign investors.

## 7.3 Impact on manufacturing

The tax reforms proposed in this report would give a strong boost to Indian manufacturing. Through this, they would impact on investment in manufacturing and job creation. The impact on manufacturing takes place through the following elements:

- The CENVAT burden on manufacturing is proposed to go down from 16 per cent to 12 per cent. This is a direct reduction of the tax burden on manufacturing.
- Manufacturing firms are significant consumers of services. However, at present, they do not get CENVAT credit for the service tax that is embedded in their purchases of services. Under a single GST, manufacturing firms would get

credit for the GST that is embedded in their purchases of services.

- The manufacturing sector is a major exporter, particularly in areas like textiles and engineering goods. As highlighted above, a modern fiscal architecture sets the stage for integration into global production networks and an export orientation. The manufacturing sector would be the major beneficiary of this transformation.
- The proposed structure of GST plus state VAT would eliminate the existing situations where Indian firms actually face negative rates of protection.
- The proposed tax reforms involve a lower peak rate, which improves the post-tax returns on equity. They also better address the problems of dividend tax. Through these, manufacturing firms would face greater neutrality between alternative forms of financing and alternative forms of organisation. This would help firms design their organisational and financial structure based on pure efficiency considerations, with smaller tax-induced distortions.

## 7.4 Impact on exports

The rationalisation of taxation of goods and services would have an enormously positive impact on exports from the country.

A central feature of global production today is the phenomenon of breaking up production into long production networks that are spread all over the world.

The traditional vision of manufacturing consists of a long assembly line, starting from primary raw materials and ending in finished goods. However, in the last 40 years, this long assembly line has been broken up across multiple locations spread across the world, in the quest for the highest efficiency for each step in the overall production process.

Global production now takes place at highly specialised and highly efficient production centres. Raw materials get shipped to these centres, a small amount of value added takes place, and the products get shipped to another highly specialised and highly efficient production centre.

*This implies that the value added at any one location of production is relatively small when compared with the value of output.* Globally oriented firms tend to have high turnover but relatively low value added.

For these firms, distorted taxation can be a major factor affecting investment decisions. If revenues of Rs.100 are based on value added of Rs.20, then a distortion in taxation of Rs.2 works out to 10% of the value added. While a value like Rs.2 appears small when compared to a base of Rs.100, it should appropriately be compared with the value added and not the turnover. In this case, small mistakes in taxation can be large enough to make or break the viability of a proposed organisation of production.

In this situation, there is only one correct architecture for the fiscal system, illustrated in Figure 7.1, which consists of the following four elements:

1. *All imported goods should face a near-uniform and low tariff.*

   This avoids the anomalous rates of effective protection that can come about from apparently minor differences between customs duties.

2. *Imported goods should be charged a CVD at the point of entry, reflecting the domestic GST plus the state VAT.*

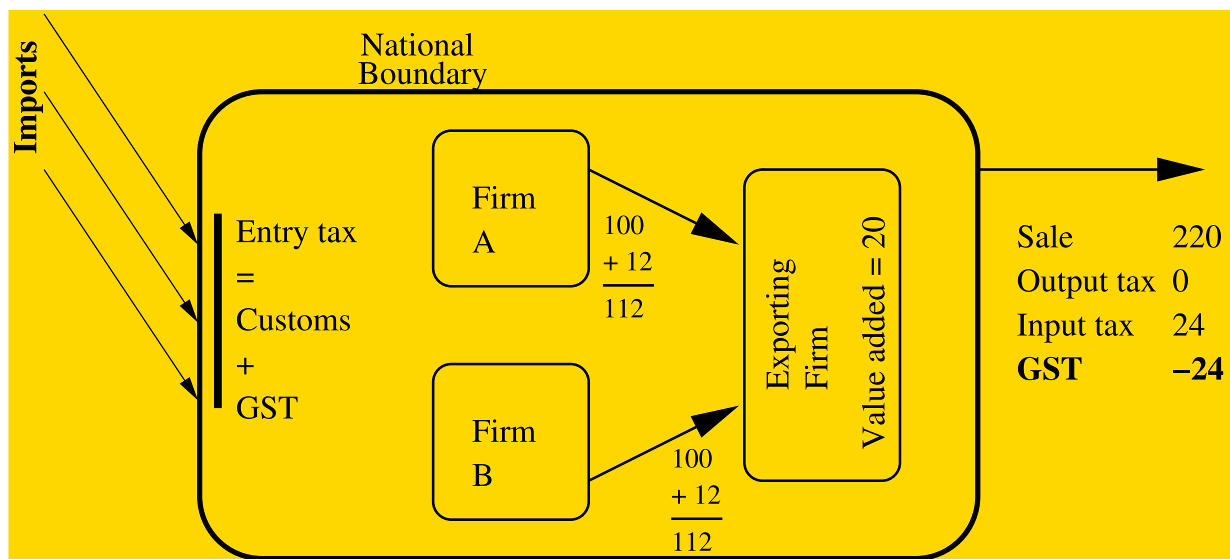
   This avoids situations with negative rates of protection.

3. *The domestic export-oriented factory should buy numerous goods and services domestically, but be able to clearly identify the GST and state*

**Figure 7.1** Treatment of imports and exports in a GST framework

The figure shows an example of the treatment of imports and exports in a GST framework.

- Imports are charged a combination of customs and GST. Imported goods would find their way across the economy at many levels in complex networks of production.
- Firm A and Firm B are each suppliers of goods and services to an exporting firm. Each of them sells goods/services worth Rs.100, which attracts a GST of Rs.12 at the rate of 12%.
- The exporting firm has a value added of Rs.20. The exported goods are worth Rs.220.
- Since exports are zero-rated in a GST, the output tax is 0. The input tax embedded in the raw material purchases are Rs.24. Hence, the GST applicable for the exporting firm is −24. Thus the GST embedded in exports is 'refunded' to the exporting firm.




*VAT that is embedded in the prices paid for all these.*

This is a much superior framework as compared with the present situation, where refunds that come back to firms are necessarily incomplete. In particular, at present, the services purchased by manufacturing firms at present contain a component of the service tax, but no credits are given reflecting this.

4. *As the product is leaving the country, the domestic factory should get back a refund of the GST and state VAT that is embedded in the goods that are leaving, which is the sum of all the GST and state VAT that has gone into the product, through a state of the art IT system without a human interface with the tax administration.*

This is a much superior framework when compared with the transactions costs involved in dealing with the export subsidy programs.

The business model of the hypothetical firm depicted in Figure 7.1 critically relies on the ability of the State to correctly know that the GST embedded in its production process is Rs.24, and for this GST to be refunded. If, hypothetically, there was a mistake in tax policy, and the GST payment to the exporter came out to only Rs.20 instead, then this apparently small difference of Rs.4 – which is merely 1.8% of the value of exported goods – looms large as 20% of the value added of this firm.

*For India to emerge as a major powerhouse in the evolving global economy, it is **crucial** to have this sound fiscal architecture comprising of near-uniform customs rates, well coordinated central and state GST, with efficient payment of credits at the point of export.* The tax reforms proposed in this report seek to achieve precisely this goal.

China is universally seen as a success story in export-oriented manufacturing which is integrated into global production networks. The modernisation of the tax system which took place in China, and was well in place by the early 1990s, was an integral part of the Chinese strategy for rapid export-driven and manufacturing-driven growth. These very elements – low and near-uniform tariffs plus an efficiently implemented GST – were in place in China by the early 1990s. They have helped pave the way for the massive expansion of Chinese exports which took place in the last decade.

The second aspect of the impact of the proposed tax reforms on exports lies in the SME sector, which tends to often involve labour-intensive firms and export-orientation. Dynamic export-oriented firms like Infosys all started out as SMEs. The existing complex exemption-ridden tax structure is regressive; it imposes smaller taxes on big companies, who are more equipped to pay the fixed costs of tax compliance and tax planning.

The tax reforms proposed in this report would make it easier for small and medium export-oriented firms to stay focused on issues of productivity and markets, instead of devoting resources to interacting with the tax system. For example, the existing system of duty drawback is limited to direct imports by the exporting firm. This distorts the structure of production in favour of excessively vertically integrated firms, and hurts efficiency. Small firms are disadvantaged since they would find it harder to import directly.

The tax reforms proposed in this report would hence have a powerful impact on exporting, at two levels. For the largest firms, they set the stage for thinking in terms of global production networks, and the establishment of very large factories that cater to the global market. They also free up small export-oriented firms from the existing regressive tax burden. In both kinds of firms, they serve to spur expansion into global markets, investment and hence job creation.

## 7.5 Impact on the financial sector

At present, the average tax paid by finance companies is disproportionately high, when compared with manufacturing, owing to the use of the existing depreciation treatment for tax planning by manufacturing companies. The proposed tax reforms of this report bring neutrality in this. Through this, the average tax burden on finance companies would go down.

For savers, the proposed tax reforms would largely eliminate the distorted portfolio formation that has come about in the quest for tax planning. Each individual and each household would form a better portfolio, in the sense of choice of risk and return, without tax distortions.

The financial sector would play a bigger role in the economy once the resource pre-emption of the government goes down. This would pave the way for greater growth in equity and debt financing for corporations.

The proposed tax reforms would bring about greater neutrality between equity and debt financing, and between alternative forms of organisation and fund management. This would yield a more efficient and vibrant financial system, which would be more focused on issues like productivity and information processing, as opposed to distorted behaviour motivated by tax considerations.

The present structure of risk and return across financial products in the system contains several anomalous products, with unusually high post-tax returns, owing to special exceptions embedded in the tax code. The reforms proposed in this report gradually phase out all these special cases. They usher in a single logically consistent EET system of taxation for the first Rs.100,000 of saving. Through this, the risk/reward profile present in the financial markets would attain a rational structure.

## 7.6 Impact on state finances

State governments are crucial to governance and development in the country. State finances would obtain an enormous boost, under the proposals of this report, through four channels:

1. The increase in Central gross tax revenues – of roughly 3 percentage points of GDP – would innately increase resource transfers to the States of roughly 1 percent of GDP.
2. States would benefit by the proposed extension of services as their tax base.
3. States would benefit by the proposed imposition of State VAT on imports, which would accrue to them.
4. Higher plan expenditure will be associated with larger resource flows to States through states and UT plans.

These benefits are, however, a part of a 'grand bargain' between the Centre and the States, as outlined above, which does require States to coordinate their fiscal reforms with this shift to the GST.

## 7.7 Impact on health and education

A major goal in Indian economic policy today is to improve outcomes on health and education. A substantial increase in expenditure, coupled with radical expenditure reforms in order to find new instrumentalities for achieving sound outcomes, is required in order to address this problem.

These expenditures would generally take place under state finances, and under the rubric of 'plan expenditure'. As argued above, the tax reforms proposed in this report would have an enormous impact on state finances. This will create the fiscal space for state governments to refocus their energies on the problems of local public goods like drinking water, primary education and public health. If these resources can be effectively delivered into the production of local public goods, while simultaneously re-engineering institutional mechanisms, then it can have a considerable impact on the health and education outcomes in the country.

## 7.8 Impact on prices

A successful fiscal consolidation has an impact on the outlook on prices, by removing the possibility of inflation when faced with acute fiscal stress.

The introduction of VAT has now taken place in numerous countries, and there is an ample international experience which can be drawn upon in order to envision the consequences. This event is known to be associated with a small one-time increase in prices, as the VAT ultimately falls upon final consumers. This is only a one-time effect.

This logic, however, applies only when VAT is introduced for the first time in a previously untaxed area. This effect does not necessarily apply when the VAT replaces existing distortionary cascading taxes. In some situations, the shift from cascading taxes to a VAT can actually lower prices.

Hence, it is useful to distinguish between three classes of goods, in envisioning the impact of the proposals of this report upon inflation:

**Unprocessed food, etc.** The GST proposal of this report does not envisage taxing food.

**Manufactured goods** Put together, the proposals of this report will give lower prices of manufactured goods, for three reasons: (a) The GST proposal of this report envisages lower rates for manufactured goods, as compared with the existing CENVAT rates, (b) The removal of cascading taxes will lead to lower prices, (c) The reductions in customs duties proposed in this report would yield lower domestic prices.

In previous discussions on the effect of introduction of the State VAT on prices, the tax rates which have been analysed were chosen in order to achieve revenue neutrality against the existing cascading sales tax. This report critically differs from that discussion, insofar as the proposed State GST, at the rate of 8% on goods, is not revenue neutral when compared with the sales tax on goods. Revenue enhancement, under the proposals of this report, are derived from the extension of the State GST to services.

**Services** This report proposes that GST exemption should be given to services such as medical services, school and college education, educational loans, home loans, etc. The GST proposal of this report will give a one-time increase in the prices of other services, though this effect will be offset to some extent by the extent to which services producers will be able to buy manufactured goods at lower prices.

In addition, at a macroeconomic level, to the extent that the VAT is a consumption tax, and generates a bias in favour of savings, there will be a negative effect on prices through a slight increase in the savings rate.

Hence, we may expect that there would be a one-time negative effect on the WPI, which focuses on goods, there might possibly be a one-time increase in the GDP deflator.

## 7.9 Impact on the expenditure/GDP ratio

Under the baseline scenario, the expenditure/GDP ratio is projected to go down from 15.4% of GDP in 2003-04 to 13.7% in 2008-09. This is a fairly sharp compression of expenditure, by 1.7 percentage points.

A major feature of the proposed reforms is the improvement in the Interest/GDP ratio. Under the baseline scenario, Interest/GDP was projected to go down from 4.5% of GDP in 2003-04 to 3.9% of GDP in 2008-09. Under the reforms scenario, this is projected to drop further to 3.5% of GDP. This reduction will alleviate fears about future debt dynamics, and alleviate the pressure on public expenditure that has come from the steadily escalating interest burden.

Under the reforms scenario, the expenditure/GDP is projected to be higher at 14.3%

in 2008-09. The impact of the reforms scenario on non-interest expenditure is stronger: these are projected to go up from 9.8% of GDP under the baseline scenario to 10.8% of GDP under the reforms scenario. The reforms scenario utilises the improvements in the tax system, and the reduced interest outgo, to deliver a higher non-interest expenditure/GDP ratio, while at the same time removing the revenue deficit.

At the same time, the level of non-interest expenditure of roughly 11% of GDP is consistent with the international experience for a modest level of government expenditure. Under the reforms scenario, the proposed tax reforms are primarily focused on eliminating the revenue deficit, and not on growing the size of government expenditure.

There is, of course, an enormously important parallel set of questions of expenditure reforms, so as to refocus and restrict expenditure to *efficient* production of *public goods*. This question is distinct from the problem of removing the revenue deficit, and putting government finances back in balance.

## 7.10 Impact on defence expenditure

Defence expenditure has been constantly compressed owing to fiscal stress. In the baseline scenario, defence expenditure was projected to drop from 2.3% of GDP in 2002-03 to 2.0% in 2008-09.

Under the reforms scenario, this process is proposed to be halted, and defence expenditure will be stabilised at 2.3% of GDP. In the terminal year, this difference of 0.3 percentage points corresponds to more than Rs.12,000 crore.

## 7.11 Reduced crowding out

The first and most direct impact of achieving the FRBM targets would be a reduction in GOI borrowing. However, in our proposed reforms scenario, part of this is reversed using a higher proposed scale of capital expenditure. Through this, the gross fiscal deficit, which is 4.0% in the baseline scenario, is smaller at 2.8% of GDP in the reforms scenario.

This difference - of 1.2% of GDP - is the reduction in government's claims on the savings of the economy. This would lead to lower interest rates for households and firms that seek to access equity and debt capital, and generate higher GDP growth.

## 7.12 Complementarity with other aspects of reform

The reforms to the fiscal system proposed in this report, which are narrowly motivated by the FRBM Act, should necessarily be seen in the larger context of the economic reforms agenda, across numerous areas, in the country:

- Agricultural reforms
- An active competition policy
- Financial sector reforms
- Infrastructure reforms
- Promotion of FDI
- Improved governance of PSUs
- Governance reforms
- Human resource development.

The fiscal reforms proposed in this report dovetail well with each of the above

initiatives. There are intimate synergies, and increasing returns to scale, in undertaking all these efforts as part of a coordinated effort to lift India's growth and obtain decisive progress on the elimination of mass poverty.

## 7.13 Impact on growth and employment

All these envisioned implications of the reforms proposals of this report add up to a scenario where India is likely to experience a considerable acceleration in GDP growth, and deliver high quality growth. The argument centrally rests on three elements:

- The first element lies in *removing tax-induced distortions*. The existing fiscal system has led to large-scale misallocation of resources. Tax reforms in India are likely to be expansionary through their impact on productivity. The behaviour of individuals and firms in India is greatly distorted by tax compulsions. In a simple, rational tax system, individuals and firms will make decisions based on economic principles, and considerations of efficiency and productivity, instead of being driven by tax planning.
- The second major factor is the issue of crowding out, i.e. the *pre-emption of financial savings by the government*. Tax reforms will free up greater resources for both equity and debt investment in the country. The fiscal consolidation will inspire confidence in the outlook for India, in the eyes of both domestic and foreign investors.

  In particular, the tax reforms proposed in this report will lower the cost of equity capital, and encourage entrepreneurship. They are consistent with a vision of investment-led growth for the coming five years.
- The third major factor is the *improved governance* made possible by easing the fiscal pressures upon government. This easing of resource constraints will greatly improve the quality and quantity of public goods that are provided. The growth implications of improved public goods, such as NHDP, is likely to be considerable.

In Section 3.3, it was argued that in computing the baseline scenario, there is a likelihood of slower GDP growth in the future owing to the fiscal problems. Under the reforms scenario, the opposite effects come into play, as shown in Table 6.1 which shows projections for GDP under the reforms scenario.

This difference in outlook, induced by reforms to the tax system, translates to *an improved GDP in 2008-09 of Rs.1,30,863 crore*. In other words, GDP in 2008-09 would be higher by Rs.1,30,863 crore if the fiscal system is reformed, as compared with the GDP that is likely to obtain in 2008-09 under present trends. This is an economically significant value, and highlights the materiality of embarking upon fiscal reforms.

Assuming a 60% labour share, an incremental Rs.78,518 crore of wage income would be injected into the economy in the year 2008-09 if fiscal reforms are taken up, which would impact on wages and employment. Higher GDP would have a powerful impact on poverty.

The proposals of this report are aimed at achieving success in meeting the goals defined in the FRBM Act. Fiscal consolidation will have far-reaching implications by giving fiscal flexibility to macroeconomic policy in the country. For example, when faced with monsoon shocks, or business-cycle fluctuations, there will be a possibility of having more activist fiscal policy.

On June 7, 2004, in his address at the first session of both Houses of Parliament after the elections to the 14th Lok Sabha, the President of India said:

> *Our people possess a vast pool of creative energies. They are eagerly waiting for the improvement in processes of governance for fuller utilisation of these energies for the task of nation building. All of us have an obligation to make the 21st century as India's century. India is destined to emerge as a major powerhouse of the evolving global economy and in the process also get rid of the chronic poverty, ignorance and disease which still affect large sections of our society.*

The reforms proposed in this report will help put India on this trajectory.