

51. The theory that there is a large domestic market for luxuries and that foreign capital and foreign debt should be used to develop industries for luxury production is very dangerous. This will put the country into a perpetual P.N. Mathur type black drain hole. We repatriated the prospective drain of British imperialism by settling the debts through settlement of sterling balances at the time of the end of the Second World War. Had the drain continued, India would not have grown after Independence at the rate it has. However, from the 60s onwards we have been continuously accumulating foreign debt and during the past few years we are increasing the stock of foreign capital in India. Whosoever *owns* the capital debt does not matter. The drain process will continue on an enlarged scale.
52. It is time economists start reconsidering the rationale of the present programme of structural adjustment and reform to the extent that we mortgage permanently the future of the young and unborn generations. To repeat we are now consciously generating a perpetual drain process. We have to call halt to this and recast our entire development and planning profile on a self-reliant, domestic savings based, austere, wage-goods productivity based, foundations.

## CHAPTER 2

# Tax Reform in India

Robin Burgess and Nicholas Stern

### I. INTRODUCTION

The total public revenues of the Indian Government have grown from around 8% of GDP at Independence to a proportion in the late 1980s of over 20% (see Table 1). This current proportion does not compare unfavourably with other countries at similar levels of income (See *Burgess and Stern*, 1992a). Nevertheless India faces a severe macroeconomic fiscal challenge since expenditure has grown from 10% of GDP to just under 30% and total debt from around 30% of GDP to around 60% in a similar period (see Tables 1 and 6). The challenge has several further dimensions in addition to the macroeconomic problems reflected in these figures. These are: microeconomic; administrative; political; federal; and strategic. The microeconomic tax structure is in many respects unsatisfactory, leading to misallocations of resources and impediments to growth. Administratively and politically there are fundamental problems with wide spread evasion and disrespect for the tax system, coupled with intrusiveness and fear of arbitrary enforcement. The balance between the centre and the states in India's federal structure is a delicate one, with significant political and constitutional stresses and constraints. And any tax policy should be consistent with

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India's change to a more open and market-oriented development strategy.

The purpose of this paper is to examine the emergence of the current problems in relation to the dimensions described, paying particular attention to the series of discussions, analyses, commissions and proposals which have accompanied their development. An understanding of the historical and structural background to India's severe fiscal problems should be a crucial impediment in the design of policy to overcome them. We shall therefore be looking backwards rather than making proposals for reform. There is little doubt that substantial reform in India's tax system should come, and preferably sooner rather than later. This is well recognised, both by those with responsibility for economic policy in India and by many commentators on the Indian economy. Proposals for reform are high on the agenda. The establishment of and excellent work by the *Chelliah Committee* (Reports of 1991 and 1992) are of great significance here. The paper should be seen as part of a contribution to the current reform discussion in its intention to assist understanding of how the difficulties arose, whilst throwing light on some of the problems which may emerge in future reforms and describing some earlier discussions and views of committees charged with reviewing the system and making recommendations for change. In accompanying and future papers we intend, to look more closely at some possibilities for reform.

In some respects, the fundamentals of India's tax structure have changed little since the Government of India Act in 1935 set out the basic assignments of revenues and responsibilities to the centre and the states. The assignments were subsequently embodied in the Indian Constitution of 1947. However, in terms of the relative importance of sources of revenue, there have been important changes. For example, land revenue has declined almost to the point of insignificance and the salt tax has been abolished, whilst excises, sales taxes and customs duties have increased greatly. Income taxes have declined in importance and play a relatively small role in total revenue. In response to pressures on revenue, it has been excises, sales and customs which have '*taken the strain*', and in the process a somewhat '*ad hoc*' structure has arisen with new goods being

brought into the tax net and rates on certain goods being increased in response to the pressures of the day.

In the next section (II) of the paper, we shall describe how the revenues from the most important taxes have developed since Independence, separating state and centre sources. In a number of important respects, India's pattern of revenue has evolved in ways different from those observed elsewhere. Excises play a relatively large role partly due to the nature of centre-state tax allocations. The role of customs declined as a proportion of total revenue, following development patterns described, for example, by *Hinrichs* (1966) for around 20 years from the early 1950s, but they then rose during the next two decades. The relative contribution of income taxes has stubbornly refused to show an upward trend.

Some of the factors which influenced the historical evolution of the tax structure are described in III. These include: growing government expenditure, particularly rising subsidies and defence expenditure; enhanced transfers to the states; emerging pressures of debt service; and development strategy. We shall argue, for example, that the growth of revenues is influenced by the incentives the collecting agent faces (centre or state) in terms of the share of taxes retained. We shall also see that the pattern of revenues is linked to the development strategies followed. The role for customs, for example, was limited by the degree of openness of the economy, which was partially restrained in the earlier stages by import-substitution strategies.

The fourth section (IV) of the paper is devoted to an account of the various previous reports and enquiries. There is a long tradition of distinguished Indian economists and public servants examining public policy matters, and taxation is no exception. It is striking that some themes such as the need to increase the role of the income tax have been constant, whilst others, for example, the desire to promote savings have declined, and others such as the problems of evasion have risen in importance. The final section contains concluding comments which look forward to problems of tax design and research on that design in relation to the historical experience reflected here.

## II. LEVEL AND STRUCTURE OF TAXATION IN INDIA

### 2.1 Introduction :

In this section, we aim to provide a quantitative picture of the level and structure of taxation in India over the period 1950-1989. In 2.2 we look at the level and structure of taxation for the country as a whole. Revenue performance in India is placed in international perspective through a brief comparison with the level and structure of taxation in other developing economies (see *Burgess and Stern, 1992a*). Comparison with expenditure trends in India over the 1950-1989 period also provides a rough measure of the adequacy of revenue generation.

The functioning of the tax system is complicated by the constitutional position of the federation whereby taxation and expenditure powers are divided between central and state governments. It is, therefore, appropriate to look at the public finances of these two entities separately. In 2.3 we examine central taxation and in 2.4, taxation by the states.

This brief quantitative section serves as raw material for discussions in the remainder of the paper. The observed level and structure of taxation may be seen as a result of interactions between the feasible set of tax instruments on the one hand and revenue requirements, administrative limitations, political considerations and the objectives of government policy on the other. This theme is taken up more fully in III where we examine some of the major factors which have influenced the evolution of tax structure in India. Accordingly, centre-state relations are examined in 3.2, trade and industrial policy in 3.3 and deficits and debts in 3.3. Finally, this section acts as a quantitative base for discussion of the history of Indian tax reform presented in IV

The bulk of data utilized in this section is extracted from various issues of the Government of India, **Indian Economic Statistics (Public Finance)** which cover the years 1950 to 1989. Aside from providing a lengthy time horizon, these statistics allow us to separate central and state public finances and provide relatively fine disaggregations of revenue headings at each of these levels. Data

from this source are presented in tabular form in Tables 1-6 and in diagrammatic form in Figures 1 to 13, which are appended to the paper.

### 2.2 Combined Centre and State Tax Revenue :

As can be seen in Figure 1 and Table 1 the growth of tax revenue in India has been quite impressive, rising from a meagre 6.7% of GDP in 1950-51 to 16.2% of GDP in 1988-89.<sup>1</sup> This growth partly reflects an increase in the role of the government. Increasing the revenue potential of the Indian state was consistently high within policy priorities and represented an integral part of the planning process (see III, IV and *Gupta, 1988*). By international standards the average level of taxation in India for 1987 (17% of GDP) is below the average for developing countries<sup>2</sup> as a whole for that year (18% of GDP), but compares well with the tax share exhibited by low-income developing economies<sup>3</sup> in 1987 (14% of GDP). Overall tax revenue performance in India for 1987 was low compared to the high-income developing countries<sup>4</sup> (19.8% of GDP) and the industrial nations<sup>5</sup> (31.2% of GDP).

Aside from increased tax effort by the government, several structural trends in the economy have combined to increase the level of taxation during the period 1950-89. First, there has been a decrease in the share of agriculture in GDP.<sup>6</sup> The increase in the size of the non-agricultural sector has contributed to a rise in tax collections as this sector is easier to tax, and because the agricultural sector in India has remained largely untaxed (putting to one side questions of how Government policy has influenced prices faced by the agricultural sector-see *Ahmad and Stern, 1991*). Also the less agricultural a country becomes the greater will be the demands on public services and hence the demands for additional revenue (see *Tanzi, 1988, 1991*). Second, the need to finance growing debt and deficits (see Figures 3 and 4) has generated calls to raise additional revenue through tax increases given the downward inflexibility of much of public expenditure (see 3.3). Third, a growing share of imports in GDP during the 1970s (see Figure 6) facilitated a higher overall tax ratio as imports provide a significant base for import duties as well as excises and sales taxes.<sup>7</sup>

An examination of revenue, however, cannot proceed sensibly without considering expenditure. As can be seen from Figure 3, the time series for total government expenditure (as a percentage of GDP) lies consistently above that for total government revenue for the period 1950-89. The rapid growth in expenditures reflected a number of desires and pressures including the establishment of a substantial government sector, problems of defence and a wish to subsidise certain sectors and activities. The overall deficit (expenditure less revenue) has been, on the whole, widening over this period, accelerating in the 1980s and accounting for roughly 10% of GDP in the late 1980s (see Figure 3 and Table 1). One consequence of these developments has been the accumulation of debt in the Indian economy. The share of debt in GDP has roughly doubled over the 1950-89 period from 30% in 1950 to over 60% in the late 1980s (see Figure 4, Table 6 and 3.2).

The implication then is that, although there has been a concerted attempt by various administrations to raise revenue in line with expenditure (see IV), such attempts have been broadly unsuccessful. There have been unwelcome consequences for macroeconomic variables such as debt and inflation, which accelerated towards the close of the 1980s.

We now examine the structure of combined government tax revenue in relation to the position of other developing and industrial nations in 1987 (see *Burgess and Stern, 1992a*) and in relation to the principles of public finance. We shall focus on principles deriving from the basic criteria of efficiency, equity and simplicity. In the next section we shall see that the dominant forces shaping the movements of Indian tax structures have been factors other than the simple principles of public finance.

On average, developing countries obtain the bulk of their revenue from (i) domestic taxes on goods and services (5% of GDP and 30% of tax revenue - partly from taxes on sales and partly from excises), (ii) foreign trade taxes (5% of GDP-mainly import duties) and (iii) income taxes (6% of GDP-mainly on corporations). In contrast, the three big sources of government revenue in industrial countries are (i) income taxes (11% of GDP and 36% of tax revenue

- mainly on individuals), (ii) domestic taxes on goods and services (9% of GDP and 28% of tax revenue - mainly on sales) and (iii) social security contributions (9% of GDP). It must be recognised that whilst these figures portray an average, there is a great deal of variation across countries in both the level of tax and non-tax revenue and the balance within and between them.

As can be seen in Figures 1 and 2 and Table 1, the structure of taxation in India is in a number of respects not far from the average developing country position, but there are important qualifications. In 1987, the bulk of taxation was obtained from (i) domestic indirect taxes (11% of GDP and 63% of tax revenue - mainly from excises and sales tax), (ii) customs duties (4% of GDP and 23% of tax revenue) and (iii) income taxes (2% of GDP and 12% of tax revenue). Compared to both developing and industrial countries there is thus a much stronger contribution from excises (6% of GDP and 34% of tax revenue). This arises in part from the constitutional arrangement whereby state governments are assigned exclusive power to levy sales taxes while the central government has had to rely on excises as its major instrument of domestic indirect taxation. As a consequence, excises became a major central tax instrument with a more extensive coverage than in most other countries. Taken together, excises and sales taxes account for more than half of total tax revenue in India. Earnings from customs are significant and are of a magnitude in line with the 1987 average for the developing economies, though clearly much higher than the average for the industrial countries, where they represent an insignificant revenue source. The share of income taxes, in both GDP and tax revenue, in India is relatively small compared to both developing and industrial countries (see *Burgess and Stern, 1992a, Table 3.2*). In sum, taxation in India is heavily dominated by indirect taxation (15% of GDP and 86% of total tax revenue) as opposed to direct taxation (2% of GDP and 14% of tax revenue).

Also interesting in this cross-sectional comparison are the dynamics of tax structure in India during the 1950-89 period, as shown in figure 2. Several trends are apparent here. First, there has been a definite decline in the relative share of direct taxation;



between 1950 and 1989 this fell from 37% to 14% of total tax revenue.<sup>8</sup> Over this period, the share of direct taxation in GDP was roughly constant (see Figure 1).<sup>9</sup> Second, the relative share of (state) sales taxes showed a roughly monotonic increase, rising from 9% of tax revenue in 1950-51 to 20% of tax revenue in 1988-89. Increases since 1970, however, have been marginal. Third, the relative shares of customs duties and union excises in total tax revenue show two distinct and opposing trends (see Figure 2). Between 1950 and 1970 the relative share of customs duties was falling (from 25% to 11% of tax revenue) whilst the share of union excises was rising (from 11% to 37% of total tax revenue). Between 1971 and 1988, both these trends were reversed: the relative share of customs duties rose (from 12% to 24%) while the relative share of union excises fell (from 37% to 28%).

If we confine our attention to the post-1970 period, and in particular to the 1980s (see Figure 2), recent developments in the tax structure in India are worrying as they run counter to the directions which would be suggested from basic public finance principles. Further, other developing countries have shown that tax reforms which do move in these directions can be carried through with some success. There are three groups of taxes which have been shown to be feasible in many contexts and which can be structured in a way which fits with the standard principles of public finance. This is not the place to work through these principles in detail (See, for example *Ahmad and Stern, 1991, Stern, 1984, or Newbery and Stern, 1987*) but generally speaking they point to the desirability of a mix of the personal income tax, domestic indirect taxes based on final consumption, and excise taxes directed to goods with external diseconomies. They indicate a minor role for corporation taxes (their justification being mainly as taxes on monopoly rents or foreign incomes) and import tariffs (their justification in theory resting on the existence of learning-by-doing, the infant industry argument). Thus the movements one generally sees in the process of development, i.e. from indirect to direct overall, trade taxation to domestic indirect taxation within indirect taxes, and from corporate to personal within direct taxes, are in accord with what theory would indicate. Generally speaking, as administrative problems become less dominant, basic economic principles can assert

themselves. It is largely administrative difficulties with other taxes that lead to the major role for import tariffs and corporate taxation in poor countries (and see III below).

The fall in the share of direct taxes in India is not in keeping, neither with these principles nor with historical trends observed elsewhere (see *Burgess and Stern, 1992a*). India has also seen a rising dependence on foreign trade taxes over the past two decades. What is particularly striking is that the role of foreign trade taxes did indeed decline in the 1950-70 period but was then reversed.

Increasing customs duties runs counter to the desire expressed in India's "New Economic Policy" to become better integrated into the global trading system. The rising role of customs is further illustrated in Figure 6 and Table 7, which compare imports as a fraction of GDP with customs revenue as a fraction of GDP. The post -1970 increase in the relative share of customs revenue as a fraction of GDP (see Figure 2) is partly explained by an increase in the share of imports in GDP. In the 1980s the fact that customs revenue rose in the face of a declining share of imports indicates that there had been a rise in customs rates both to generate additional revenue and to conform with protectionist government policy. As customs rates are substantially higher than domestic indirect tax rates, there is strong discrimination against imported goods (see *World Bank, 1990*). Given this tax structure, the task is not simply to raise it in a way which is consistent with the desire to raise economic efficiency and expand involvement in international trade.

### 2.3 Central Taxation :

In Figures 7 and 8, we examine the evolution of central taxes as a share of GDP and as shares of total central tax revenue by individual tax type (see Table 2 for original data). The main revenue generators over the entire period have been customs duties and union excises, and the pattern described in 2.2 is replicated. One notable point is that the central taxes which are shared with the states, i.e. union excises and personal income taxes, exhibit lower revenue growth, than customs duties, which are not shared. This is

particularly true of the 1970-90 period when pressures to generate additional revenue were most severe, as indicated by growing deficits and debt (Figures 3,4 and 5 and 3.3). Corporate income taxes which have not been shared since 1959, are an exception to this rule, and possible reasons for this are discussed below.

Within direct taxes, the two major revenue heads are the personal income tax and the corporate income tax, other heads such as land revenue have made only marginal contributions. The share of personal income taxes in total central tax revenues has declined from 33 percent in 1950-51 to 9 percent in 1988-89 (see Figure 8). This is no doubt in part due to the difficulties of implementing personal income taxes in low income developing economies – difficulties related to problems of income measurement, administrative capability, low literacy and poor accounting. An economic structure which is dominated by agriculture and small scale (often unregistered) enterprises makes it difficult to trace, and hence tax, incomes (*Burgess and Stern 1992a*). This trend, however, also indicates a preference to rely on easier to implement (but less equitable) taxes such as union excises and customs duties. Given the low importance and declining share of personal income taxes in India, it is somewhat difficult to perceive how this tax can act as a major instrument of redistribution as is claimed in much of the Indian tax literature.<sup>10</sup>

• This reasoning cannot be so easily applied to the low importance of corporate tax revenues as a share of total tax revenue (see Figure 8).<sup>11</sup> Corporations are, in principle, visible and easily taxable entities (at least relative to individuals) and, in low income countries where personal income taxation is highly problematic, they typically constitute the principal base of income taxation (see *Burgess and Stern, 1992a*). The trend shown in India is thus somewhat perverse and out of the ordinary and may be due to a number of factors. First, the limited presence of foreign companies in India, partly due to strict regulations on foreign investment and high rates of corporate taxation on foreign companies (higher than those applicable to domestic corporations), may have restricted the size of the contribution of the multinational sector. Second, the presence of a large public industrial sector, protected by the operation of licencing

and other measures which restrict the scope for domestic competition, limits the contribution of private sector enterprises. Third, it is likely that the political clout of the managers and owners of the large public and private sector corporations which dominate Indian industry, has been a factor in obtaining concessions from the Government with regard to corporate income taxation.

From Figure 13 it is clear that the centres' tax revenue has risen faster than the states' tax revenue (the latter series being flatter than the former). The expenditure series (as a percentage of GDP) for the centre and states shown in Figures 9 and 12, are of more similar slopes, though the centre series is steeper and both these expenditure series lie above the revenue series. The states have become increasingly dependent on transfers from the centre to meet their rapidly rising expenditures as is illustrated in Figure 12. This experience raises the question as to whether the weaker performance of the states in raising revenue and controlling expenditure is due to poor administration or lack of political will, perhaps associated with the belief that the centre will, ultimately, 'bail them out'.

#### 2.4 State Taxation :

The basic evolution in state tax structure is illustrated using shares of GDP of various taxes as well as their share of total state tax revenue in Figures 10 and 11 respectively (see Table 4 for original data). The only two headings that have illustrated monotonic growth, both as a proportion of GDP and tax revenue, have been sales taxes and the share in central taxation. Stamps, registration fees and other taxes, and state excise duties (mainly on alcohol) have contributed roughly constant shares of total tax revenue (see Figure 11).

Land revenue, which was the main state direct tax in 1950-51, contributing close to 20 percent of total state tax revenue, on the other hand declined rapidly in importance and by 1989-90 was contributing a meagre 2 percent. This development, which has been witnessed in many developing countries, seems to stem in large part from the political influence of landowners. Land taxation would

also be an especially visible tax and as such likely to be particularly fiercely resisted.

The rise in the share of central taxes in state revenue can be explained by the fact that these transfers are needed to fill the rising gap between state expenditures and state (tax and non-tax) revenues, as is illustrated in Figures 12 and 13. The centre-state revenue sharing theme is taken up in greater detail in 3.2.

### III. TAXATION AND PUBLIC POLICY

#### 3.1 Introduction :

Economic development changes the structure of the economy and the bases available for taxation. There is thus a dynamic relationship between development, base composition and tax policy. For a given set of available bases at a given time, the decision of where to direct tax effort will depend on such considerations as efficiency, equity, administrative capability, and political pressures. From this interaction a broad pattern of tax structure change during the development process emerges. Countries at early stages of development tend to depend on bases which are easy to tax, in particular, foreign trade (see *Hinrichs*, 1966). As development proceeds, administrative capability increases and the economy becomes more diverse; the 'handles' to which the revenue system may be attached become more numerous. There is, generally, a greater role for domestic indirect taxation and, in later stages, income and social security taxes (see *Musgrave*, 1959, 1969 and *Burgess* and *Stern*, 1992a). The development strategy pursued by a government will alter the pattern of evolution of the tax structure by influencing the growth of different bases and by favouring tax instruments whose effects on market functioning are in line with other aspects of government policy. For example, in a state pursuing policies designed to promote infant industries, import tariffs may be used both to protect the domestic economy and to generate revenue. Whilst it is notable that, broadly speaking, tax structure change worldwide has been in the direction of greater consistency with economic efficiency, there is a constant tension in tax policy between revenue requirements and efficiency (see *Burgess* and

*Stern*, 1992a). Mounting debt and deficits can lead to pressure to resort to taxes which are disruptive or distortionary but which nonetheless generate significant revenue at low collection cost (e.g. export taxes, import duties, and, implicitly, the inflation tax).

In this section, we would like to examine these tensions and influences in the context of India in order to provide a brief explanation of the patterns of changes in tax level and structure presented in II. An embedded political-legal factor, namely the division of tax powers between the centre and states, has been a basic determinant of tax structure in India up to the present day. Centre-state relations, in particular as regards tax assignment and revenue sharing, however, have introduced a number of disincentives and anomalies into the functioning of the tax system. These two aspects of centre-state relations are discussed in 3.2. In 3.3 we briefly examine how the inward looking development strategy pursued by successive Indian governments, in particular as regards trade and industrial policy, may have affected the dynamics of tax level and structure change. In 3.4 we look at how rising deficits and debt have greatly weakened the system of public finances in India and have led to a sacrifice of efficiency for revenue potential in the selection of tax instruments.

#### 3.2 Centre-State Relations :

Under the Government of India Act 1935, the British Government provided for strong financial control by the federal government together with important elements of provincial autonomy. It allocated tax instrument and expenditure responsibilities between the centre and states and also provided for grants to the provinces (see *Lizy*, 1990). After independence and at the time of the drafting of the Indian Constitution, the *Sarkar Committee* was established to examine centre-state financial relations. It recommended that 60% of the entire income tax revenue (including corporation tax) and certain other federal revenues be given to the states. It also suggested setting up a "Finance Commission" to deal with matters relating to the division of resources between the union and the states. The Finance

Commission would meet once every five years to discuss these issues.

The Constitution of India, 1950, set out broad principles for the allocation of taxation and expenditure responsibilities and also of grants-in-aid. Taxes on the union list, assigned to the centre, include personal income tax, corporation tax, wealth tax, customs duties and excises. Taxes assigned to the states include land revenue, agricultural income tax, sales tax and excises on alcohol. Expenditure responsibilities are also divided between the centre and the states – a union list that includes defence, railways, posts and telegraph, foreign and inter-state trade, and certain important industries, and a state list that includes public order, public health, education, agriculture and fisheries. A concurrent list, whose headings are under the jurisdiction of both the centre and states, includes industrial monopolies, social security and charities (see *Lakdawala, 1967, Bhargava, 1982 and Lizy, 1990*).

A problem of the Indian pattern of tax and expenditure assignment has been the inadequacy of the assigned tools, or of the willingness or ability of the states, to generate revenue relative to perceived expenditure needs. The Indian Constitution provides for the appointment of a Finance Commission every five years to recommend the transfer of resources from the centre to the states in order to bridge the expenditure-revenue gap. The Finance Commissions (the ninth of which reported in December, 1989) have two main responsibilities, they distribute the net proceeds of personal income and excise tax between the union and the states, and they establish the guidelines for the distribution of grants-in-aid of state revenues from the Consolidated Fund of India (see *Bhargava, 1982*).

It is clear from Figures 1,2,7,8,10 and 11 that the performances of different central and state taxes, with respect to tax revenue and GDP have been variable, with customs, excises and sales taxes constituting the main tax revenue generators for the economy (see II). The basic structure of the Indian tax system, in terms of the set of instruments employed, however, has changed little over the 1950-89 period and is, in essence, a legacy of the Indian

Constitution and the Government of India Act of 1935. This federal system of taxation has led to a number of difficulties, some of which are described below.

Examining Figures 1 and 2 and Table 1, it is notable that the taxes which have risen most strongly relative to GDP are those which are not shared, namely customs duties and sales tax. In looking at developments over time we should bear in mind a 'normal' pattern of relative growth in domestic tax revenues and decline in customs. The personal income tax, collected by the centre with the bulk (currently 85%) of revenue transferred to the states, has stayed in the region of 1% of GDP for the last 40 years, and below 1% for much of the 1980s, declining as a fraction of total tax revenue. Union excises, again collected by the centre with a large proportion (currently 45%) of revenues transferred to the states, have also declined as a proportion of tax revenue over the last twenty years. What these trends may imply is that, from the perspective of the central authorities, the fact that large proportions of excises and income tax are transferred to the states acts as a disincentive to the development of these revenue sources and tax collection. Discussions with the central tax reinforce this impression. These trends together with the discussions are strongly suggestive of the disincentive hypothesis i.e. lower shares in revenue for the centre for a source imply a lesser role for that source in revenue expansion and collection. These results are only suggestive – formal hypothesis testing would need a model of how taxes would have been set and collected under a different sharing regime. The construction of such a model in a convincing manner would encounter a number of difficulties, including the specification of the determinants of government behaviour. It is a task which is not attempted here.

The pattern of tax assignment, codified in the constitution meant that, for domestic indirect taxation, the Central Government had to rely on union excises. The growth of the domestic industrial base has been associated with an expansion both in the coverage and in the rates of union excises during the 1950-89 period. Most of that expansion, however, took place in the period to the mid 1970s after which there has been little or no expansion in revenue as a fraction



of GDP (and a declining share in total tax revenue). Excises are levied at a variety of rates, and the system has evolved in an *ad hoc* manner to become both unwieldy and overly complex. Also as a result of excise expansion, the tax bases of union excises and state sales taxes have become similar, leading to problems of both double taxation and cascading. The administration of these two taxes is, on the whole, not co-ordinated. These factors suggest that simplification reform to improve the coherence and efficiency of domestic indirect taxation is overdue (see *Burgess and Stern 1992b*).

Problems of centre-state financial relations have led to serious weaknesses and distortions in state-level taxation. We consider a number of these in turn (see also Rao, 1992). First, over the years, in response to revenue pressure, the state sales tax has become complicated and distorting. Increasing resort to taxing inputs has introduced a high degree of cascading. Second, inter-state competition has led to state-wise schemes for sales tax incentives for industrialisation with a resultant structure with little apparent logic in overall locational efficiency. Third, the imposition of Central Sales Tax (CST) at 4% on inter-state trade, which is origin based and distinct from the state sales tax, has in part segregated the states' economies into different tariff zones and substantially reduced the potential gains accruing from a common market.<sup>12</sup> There have also been problems of CST being evaded by the consignment method, whereby consignments between subsidiaries of the same company are not subject to CST. The introduction of the consignment tax to correct for this has been delayed, partly since the centre, with its obligation to facilitate flows between states, does not wish to see origin-based taxation reinforced in this way.

### 3.3 Trade and Industrial Policy :

The development strategies followed in India, as reflected, for example, in budget speeches or Government of India, *Economic Surveys* for the period 1950-1989, reveal interrelationships between tax structure and trade, and industrial policy and macro policy. Over this period, tariffs were justified on the grounds of generating revenue, protecting domestic industry and conserving foreign exchange. This congruence of objectives in part explains the

historically important role of tariffs in India. In this subsection we trace out the interplay between these factors and thus provide some partial explanation for the trends observed in II.

Trade policy for much of the 19th century was based on the principle of '*laissez-faire*', and industrial policy was centred on increasing the growth of external trade with Britain. The emergence and growth of large industries whose output was destined for the domestic market took place in the latter half of the 19th century, in particular in the areas of cotton textiles and steel. The First World War provided further impetus for the development of Indian industry (see *Bhagwati and Desai, 1970*).

A break from the policy of free trade came during the interwar years following the convening of the First Fiscal Commission in the UK (1921), which reported in favour of protectionist policy. These recommendations were adopted in British India, and Tariff Boards granted protection to a large number of Indian enterprises thus initiating a lengthy period of protectionism.<sup>13</sup> Aside from generating revenue, tariffs could be justified on the basis of protecting infant industry, and their share in total tax revenue expanded significantly. Tariffs were tightened during the Second World War to conserve foreign exchange.

Following Independence in 1947, there was a shift towards quantitative (e.g. quotas) restrictions which was reflected in a drop in customs revenue (see Figures 1, 2, 7 and 8). A conscious and systematic effort was made from the mid 1950s to promote self-reliance and balanced growth, and there was an ambitious programme of import-substitution-led industrialisation.<sup>14</sup> The period from 1951 to 1966 was characterized by a gradual replacement of trade taxes with taxes on (rising) domestic supply. Excises expanded rapidly whilst state sales tax capacity was gradually built up (see Figures 1, 2 and Table 1).

This period came to an end in 1966 with the devaluation of the rupee in response to a growing balance of payments problem which had arisen, in part, as the result of growing food grain imports exacerbated by the severe droughts of the mid 1960s.<sup>15</sup> In response

to revenue shortfalls, there was an expansion in the coverage and rates of both customs duties and excises and a tightening of import licensing. At the same time, the late 1960s and early 1970s saw a rapid expansion of a new package of development programmes were extended to the agricultural sector (associated with the so-called 'Green Revolution') so that by the early 1970s, dependence on massive food imports had vanished.

As can be seen from figure 6 and Table 7, these measures and events were associated with a sharp drop in import share in GDP between 1960 and 1970. Expansion in the use and rates of customs duties in the first half of the 1960s had maintained revenue from this source (see Figures 1, 2 and 6), however a drop in the share of imports between 1965-70 was sufficient to cause a drop in the share of customs revenue in total tax revenue (Figure 2) and GDP (Figure 1). By the early 1970s, imports and customs earnings had picked up (Figure 6 and Table 7).

It was only in the seventies that Indian exports started to expand more rapidly than previously, stimulated by a combination of factors including : the extension of subsidies and concessions to exporters, the creation of a diversified industrial base; the depreciation of the rupee against the currencies of India's major export markets; and a shift in the direction of exports towards less developed and centrally planned economies.

The 1973 oil shock and its aftermath gave a further boost to India's foreign exchange earnings as well as raising the cost of a major import. Indian firms secured contracts to build roads, airports, and the like, in the oil-rich middle-eastern countries. Substantial foreign exchange came from the direct export of labour (in the form of remittances from abroad). Transfer payments to India on private account rose from an average annual flow of Rs.49.9 crore during the Third Plan (1960-65) to Rs.917.3 crore in 1977-78 partly as a result of an increase in remittances (see *Datta Chaudhuri*, 1990). The rise in the international price of gold also had a favourable impact through the reduction in the smuggling of gold into the country. As a result of all these, for the first time in two decades the current account of the BOP showed a surplus (Rs.1319.9 crore in

1977-78). The country also had 20 million tonnes of food grain (see *Datta Chaudhuri*, 1990). It looked as though the two basic constraints on growth had been overcome. The economy, however, was not growing any faster.

In response to the favourable BOP position in 1977 direct import controls were relaxed on selected imports. This relaxation of trade policy was not accompanied by appropriate macroeconomic policy, and a continuously appreciating rupee, together with rising expenditure, led to a growing trade deficit. The 1979 oil shock, coupled with a domestic harvest failure, led to a serious recession and BOP crisis. The BOP showed a deficit of Rs.5967 crore in 1980-81. In order to bring the trade deficit under control and to meet rising public revenue requirements, tariff rates were increased, and quantity restrictions were replaced by tariffs. There was also a drive to step up import substitution in the field of crude oil and nitrogenous fertiliser. The policy was extended to non-ferrous metals, edible oils, heavy chemicals, iron and steel, and heavy electrical machinery. Thus the slow liberalisation of the trade regime that was attempted in the mid 70s (against the background of a more comfortable BOP and food grain situation) was temporarily halted in early 1982.

The period from 1977 to the end of the 1980s was one of rapidly accelerating deficit and debt levels (see Figures 3, 4 and 5 and 3.4). During this period there was a decreasing contribution of both direct taxes and union excises in total tax revenue (see Figures 2 and 8), and an increasing share of customs duties.

### 3.4 Deficits and Debt :

As can be seen in Figure 3, total Government expenditures have consistently outstripped total Government revenues in the period 1950-89. Since the financial crisis of the late 1970s (see 3.3), this gap has been widening rapidly (see Figure 3). Given that non-tax revenue has essentially remained constant and small as a fraction of GDP over the 1950-89 period, these deficits are in large part a reflection of the inability of tax revenues to keep pace with rising expenditures. Whilst expenditure control has not been all that

impressive, it is also true that expenditures have been strained by droughts and conflicts. If we examine Figure 3, for example, it is apparent that expenditures rose rapidly in the mid 1960s, associated with the combined effect of the Indo-Chinese Conflict in 1962, a severe drought in 1964 and the Indo-Pakistan Conflict in 1965. Though the budgets in these years did introduce measures such as new rates and a wider tax base for customs and duties, the response of revenue was nonetheless sluggish and clearly not commensurate with the expenditure jump, as reflected in the rise in the overall deficit during this period. Similarly, the congruence of the 1979 oil shock and drought in the early eighties was partly responsible for a rapidly increasing deficit in the 1980s (see Figure 3).

It would seem that rising deficits have had a significant impact on tax structure in that, under pressure, it has shifted towards 'easier options', as witnessed in the increasing reliance on import duties. These taxes, though distortionary, are capable of generating substantial revenue at short notice and with low administrative costs. By the close of the 1980s, there was also increasing reliance on the inflation tax as a means of deficit finance (see *Buiter and Patel, 1992*).

It is striking that deficits and debt increased most rapidly in the 1950s and 1980s, both of which, in their different ways, were somewhat ambitious in economic policy. The 1950s saw an emphasis on the rapid expansion of industry and, as can be seen from Table 3, capital expenditure by the centre rose in this decade by 3.5 percentage points of GDP whereas revenue expenditure by 1.7 percentage points. On the other hand the 1980s which brought some liberalisation saw a fall in the centre's capital expenditure and a sharp rise, of the order of 5 percentage points of GDP, in revenue expenditure.

An important consequence of the inability of tax revenues to finance rising deficits has been increasing resort to debt financing (see *Chelliah, 1991, 1992* and *Buiter and Patel, 1992*). As shown in Figures 4 and 5, both the level and growth of debt in the Indian economy has been high. The debt of the Government of India is mainly internal.<sup>16</sup> In the 1980s debt accumulation accelerated, a

number of analyses have indicated the non-sustainability of Indian public debt, and the projected insolvency of the state, if past trends in the public deficit are not reversed (see *Buiter and Patel, 1992*). These studies underline the fundamental role of tax and expenditure reform in stabilizing the Indian economy (see also *McKinnon, 1991* and *Aspe, 1992*, on this issue in other contexts). The basic problem here is that unless debt-financed expenditures generate sufficient returns, interest payments on debt enlarge the fiscal deficit. Indeed it is notable that interest payments headed the list of revenue expenditures for 1989-90 with a share of 29.1 percent of the total (see *Chelliah, 1992*).

*Chelliah (1991)* sets out the problem as follows :

"The fiscal crisis and the attendant exponential growth of public debt has arisen, not merely because of revenue expenditures running ahead of current revenues, but also because capital expenditures financed by borrowing have not been productive of adequate returns."

The option of further debt finance by borrowing does not seem viable in the medium term, and monetary expansion has proved inflationary. Tax reform, to increase revenue and fill the gap left by the reduced role of foreign trade taxes, and expenditure reform, to reduce unproductive outlays on subsidies and public sector enterprises, appear as urgent priorities (see *Chelliah, 1991, 1992*, and *Buiter and Patel, 1992*).<sup>17</sup>

#### IV. INDIAN TAX REFORM IN RETROSPECT

##### 4.1 A Broad Picture :

The 45 years since independence have seen total government (centre plus state) expenditure rise from around 9% of GDP (in 1950-51) to around 28% whilst total revenue (tax plus non-tax) has risen from 8% to just under 19% over the same period. The gap between the two grew from 1% to 5% over the 1950s, stayed at around 5 to 6% over the next two decades, and then rapidly rose from close to 6% at the end of the 1970s to over 10% in 1987-88 (see Figure 3 and Table 1 for sources and details). Correspondingly,

total debt (centre plus state) rose from 30% to over 40% of GDP in the 1950s and then from 40% in the mid 70s to 65% in 1987-88 (see Table 6 and Figure 4). The parlous state of India's public finance has been some time in the making and must be seen from a long-term perspective.

India's tax performance; in terms of both growth and share of GDP, does not compare badly with other developing countries (see *Burgess and Stern, 1992a*). The tax system itself, however, has seen little basic change since the Government of India Act of 1935, which established the federal system and provided the basic tax and expenditure assignments between the centre and states. There have been occasional modifications, some arising from tax enquiry commissions, such as the introduction of the Central Sales Tax in the mid 1950s following the *Mathai Committee*<sup>18</sup> recommendation of 1953-54. But these have largely been attempts to deal with problems that arose within the existing system. A significant move came in 1986 when a modified value-added tax (MODVAT) was introduced. The *Jha Committee*<sup>19</sup> had suggested a variant, but a more extensive version of such a tax (it was called MANVAT). The MODVAT provides a system of rebating central excise tax paid on inputs against central excise payments on output. The final *Chelliah* report (1992) also contains significant proposals to extend the domain of MODVAT. The basic structure of the tax system, however, has altered little and the recommendations of the 1988 *Sarkaria Commission*<sup>20</sup> on centre-state relations, such as those relating expending state resources and taxation powers, have had little impact.

The general picture is one where strong pressure from the expenditure side has put a greater strain on the revenue system than it can bear. The result has been growing deficits and debt on the macro front and a tax system which has generated substantial microeconomic distortions. Further, the tax system has become increasingly difficult to administer. Considerable evasion coupled with seemingly arbitrary enforcement procedures have reduced the credibility of the tax system in the eyes of many. The combination of the system's economic weaknesses, both macro and micro, and its unpopularity (even allowing for the fact that taxation is nowhere

loved) may generate a consensus that will make real reform a political possibility. It is notable that in the global history of tax reform, political and economic crises have often served as the motivating force behind deep structural changes in tax systems (see *Burgess and Stern, 1992a*).

In this section we examine some of the main features of this history, concentrating on the post-independence enquiries into the tax system (4.2) and discussing briefly the two most recent attempts at reform: that under the premiership of Rajiv Gandhi in the mid-1980s (4.3) and that of the current Prime Minister Narasimha Rao, over the last year (4.4).

These post-independence developments should be seen in historical context. When the *Taxation Enquiry Commission of 1925* reported, the Indian Princely States did not form a part of the structure of public finances of British India. They had separate budgets and sources of revenue, with maritime states, for example, imposing their own customs duty. Within British India, the revenue of the British India Provinces was dominated by land revenue, with liquor taxation constituting the second most important source. For the Central Government, customs dominated, with the income tax and the salt tax playing important but subsidiary roles.

By Independence, much had changed. The legal structure had been set by the Government of India Act of 1935,<sup>21</sup> which assigned taxation powers and expenditure responsibilities to the centre and states. Within the states of Independent India, sales tax had assumed considerable importance whilst the relative importance of land revenue had declined. For the centre, the salt tax had been abolished, and with the growth of manufacturing, excises were acquiring importance. Partition, and the loss of major cotton and jute areas, reduced the potential for export duties. It was in this context that the work of the first major post-independence *Taxation Enquiry Commission*, under *John Mathai*, began.

#### 4.2 Enquiries, Committees and Commissioners :

The *Mathai Commission* (1953-54) was the first of a number of enquiries into taxation in India since independence. The scope of



the *Mathai Commission* was comprehensive, and it examined the workings of the tax system as a whole. The *Mathai Commission* sought a progressive tax structure but at the same time was concerned about promoting saving and investment. It took the view that the disincentive effects of high marginal rates of taxation on richer income groups were in general exaggerated and suggested a ceiling on net personal income after tax (not exceeding approximately 30 times the prevailing average income per family). A principal task was to provide investible resources for the public sector whilst holding down any decrease in private investment. It thus saw the restraint of consumption as a major concern. It advised against a wealth tax (on grounds of administration), against a capital gains tax (adverse effects on investment), against a reintroduction of the salt tax (regressive) and against a gift tax.

On grounds of equity a reduction in the exemption limit for the income tax was proposed (from Rs.4,200 to 3,000 per annum) with a maximum marginal rate of 85% on income above Rs.1.5 lakh. On central indirect taxes the Commission saw little scope for increasing import duties but saw potential for increased rates and a broader base for excises. The Commission recommended a system of sales tax consisting of a low rate tax to be applied on the turnover of all small producers and retailers, and a higher rate tax to be levied at a single point for larger businesses<sup>22</sup>. Though the former tax is cascading, the objective was to reach as much business activity as possible, particularly in small unregistered businesses which are difficult to monitor. It was argued that taxation of inter-state sales should be the responsibility of the centre. The Constitution (Sixth Amendment) Act of 1956 gave the centre the power to tax inter-state trade and established the Central Sales Tax (CST). This gives the Central Government some control over levels of taxation of inter-state trade although the revenue from the tax goes to the state levying it. The Commission recommended the introduction of an agricultural income tax (which should be eventually integrated with the taxation of non-agricultural income) but did not see it as replacing land revenue.

*Nicholas Kaldor* prepared a paper on 'Indian Tax Reform' after spending the period January to March of 1956 in Delhi. It was

published by the Department of Economic Affairs of the Ministry of Finance in June 1956. This was at the beginning of India's most significant five-year plan, the second, which envisaged great strides in establishing heavy industry, predominantly in the public sector. He saw direct taxation as playing a central role in a new structure, perceiving the old structure as inadequate for the task at hand (it raised only around 7% of national income as revenue and with apparently little buoyancy). He saw the existing direct tax system as inequitable since it had the 'wrong base' (income as opposed to expenditure) and was open to manipulation, particularly by the better off. It was further inequitable in that it was based on very little information, thus taking inadequate account of the circumstances of tax payers.

He argued in favour of wealth taxation, capital gains taxation, a gift tax and a personal expenditure tax. These were all introduced soon after (capital gains taxation in 1956, a personal expenditure tax in 1957-58, and wealth taxation and the gift tax in 1958-59). However, very little revenue accrued from them, and the personal expenditure tax was abolished in 1962. He argued against high marginal rates of personal taxation on the grounds that they could not be easily administered and suggested a maximum rate of 45% (as against the current one of 92%).

Notwithstanding his espousal of broad bases and low rates on administrative (as well as incentive) grounds, *Kaldor* argued against those who saw his system as more "advanced" in character than that of even the most "developed" country. He argued that being an underdeveloped country did not imply a requirement for an underdeveloped tax structure. He argued further that the 1% of income earners who paid tax were on average just as capable of filing tax returns as the 70% of earners who paid income tax in the UK. *Kaldor's* confidence in the potential workability of his plans seems to have helped carry a number of them into the statute book although their effects in terms of revenue were nugatory.

A further major enquiry was that of the *Wanchoo Committee*<sup>23</sup> on direct taxes, which reported in December 1971. This reflected strongly a concern, which was increasingly expressed in the budget

speeches of the late 1960s, with widespread evasion and the related problem of the creation of black money. These difficulties were attributed to a range of factors including: high rates of taxation, the proliferation of controls and licences, 'harsh' treatment of business expenses, and ineffective enforcement. The committee recommended in favour of tough search and seizure procedures. It was against voluntary disclosure/amnesty/bearer bond schemes on the grounds that they would offend and discourage the honest taxpayer. The committee also recommended the reduction of marginal rates (in the case of the top income tax rate, from 97.75 to 75%) and argued that the beneficial effects of extra compliance were likely to offset, in revenue terms, any fall in revenue from the lower rate.

It also recommended a committee to look into the utility of various controls, permits and licences. A further recommendation was for the taxation of agricultural income to be brought into line with other income not only on equity grounds but also because of the scope it generated for tax evasion. The Raj Committee on the Taxation of Agricultural Wealth and Income followed the *Wanchoo Committee* and reported in October 1972. The *Dagli Committee* on controls and subsidies was established rather later and reported in May 1979.

The Committee under *K.N. Raj* noted that, whilst the power to tax agricultural income rested with the states, there was no constitutional impediment to the taxation of agricultural, as well as non-agricultural, wealth by the centre. They argued that it was inequitable that those deriving income and wealth from agriculture should make less than a 'fair contribution' relative to those deriving their income and wealth from other sectors, and further that the non-taxation of agricultural income created a loophole in the sense that non-agricultural income could be misleadingly attributed to agricultural sources. Both the Taxation Enquiry Committee reporting in 1925 and the *Wanchoo Committee* had pointed to the desirability of taxing agricultural income for the better-off farmers.

The argument about 'fair contributions' begs a number of questions. First, equity as a concept should be about the distribution

of welfare of burdens between individuals, households or groups, rather than production sectors. Second, calculating tax burdens and expenditure/subsidy receipts is a non-trivial matter, and one cannot simply look at one tax in isolation (and one should consider exchange rates and trade policy too; see *Lipton 1977*, for a discussion of an alleged 'urban bias'). Third, any tax or subsidy system tends to get capitalised in asset values so that changes result in windfall gains or losses rather than through greater sectoral post-tax profitability. Making due allowance for these points, however, there remain serious questions about both revenue concealment and efficiency aspects of omitting to tax agricultural incomes. Further, if properly designed, the effects on asset prices of changes in the system designed to tax agricultural income would not be regressive.

The *Raj Committee*, reporting in October 1972, recommended against basing any reform on land revenue, since the principles and procedures for assessment varied considerably both across states and within states. It proposed instead an Agricultural Holdings Tax (AHT). The base for this tax would be calculated from output norms from the last 10 years and average prices over the last three years. In this sense it would be based on potential rather than actual income. Taxing potential rather than actual income reduces disincentive effects (which at small rates of tax might in any case be small) but does shift a further element of harvest (and other) risk towards the tax payer.

Some allowances against an estimated gross potential output (which would itself take some account of land quality) would be made for cultivation expenses and irrigation thus arriving at rateable value. The Committee suggested the AHT should replace land revenue for all operational holdings of rateable value Rs.5,000 and above. In due course, and at the discretion of the states, it could be extended to holdings of rateable value above Rs.2,500. It was suggested that the rate should rise as follows: AHT on X,000 rupees would be at X/2% (for example 2% is a rateable value of Rs.4,000, 4% on Rs.8,000 and so on). Revenue estimates by the Committee were of the order of Rs.150-200 crore.

Nothing came of these proposals. The Government of Mrs Gandhi was facing an election in 1974-75 (although this was overtaken by the Emergency in 1975-77), and the *Janata* Government, which came to power in 1977, was quite strongly oriented towards agricultural groups. It is a moot point as to whether any Indian Government in the foreseeable future would want to take the undoubted political risk of such a highly visible tax for the benefit of a few hundred crores. Most Governments have shied away from land taxation in recent times, even though it has been historically of great importance, particularly in India<sup>24</sup> (see *Burgess and Stern*, 1992a, *Ahmad and Stern*, 1991, and *Skinner*, 1991, for further discussion). It is unfortunate since the efficiency, equity and administrative (measuring land is easier than measuring income, for example) advantages are strong. Nevertheless political considerations seem to have mitigated in favour of different, and perhaps less visible, forms of taxation.

The Indirect Taxation Enquiry Committee under *L.K.Jha* presented the first part of its report in October 1977. It desired to "pave the way for an integrated indirect tax system in the country which is more efficient, more equitable and better-oriented to further the objective of planned development". Major drawbacks of the existing system were identified as follows. First, it was a juxtaposition of existing systems, the cumulative effect of which was obscure. Its appraisal relative to basic criteria associated with equity and efficiency was very difficult and its performance relative to the criteria probably poor. Second, it suggested that the cascading of taxes associated with the taxation of the same product several times raised consumer prices by an amount greater than that which accrued by way of extra revenue. Third, the unwieldy system arising from the interaction of the different taxes caused administrative problems in pursuing economic policy, such as those associated with the calculation of duty drawbacks for export products. Fourth, the system of excises had appeared inelastic with respect to national income over the previous decade.

To deal with the problem of cascading in excise duties the Committee recommended an extension of the existing procedures for relief of input taxation, moving eventually to a VAT at the

manufacturing stage (MANVAT). A rationalised structure of import duties should consist of a basic levy, set to give a level of protection deemed necessary to particular products. In addition to this there should be a levy (called a countervailing duty) designed as a revenue element, and a discriminatory duty designed as a surcharge for discouraging imports. Countervailing duties should eventually be given the same treatment as excise duties on domestic products. Sales taxes should be single-point at the last stage with sales of inputs to registered manufacturers free of taxation. The ceiling on inter-state sales tax (CST) should be lowered from 4% to 1%.

The long-term goal described was essentially that of a central VAT up to the manufacturing stage with a final point retail sales tax by the states. As we have argued elsewhere (see *Burgess and Stern*, 1992b), this is a form of taxation for India which has a number of attractions as a long-term structure. This theme, with some modifications, was later taken up by the *Chelliah Committee*. In the meantime an advance in the direction of one aspect of its proposals occurred during the 1980s, namely the introduction of *MODVAT* in 1986. However, under revenue pressures customs grew rather than declined, state sales taxation was little changed.

The *Sarkaria Commission* on centre-state relations, which reported in 1988, examined and reviewed many of the inefficiencies and anomalies associated with the functioning of the current system. Its recommendations on reforming financial relations between the centre and states through such measures as devolution, enlarging the states resources, enlarging the divisible pool, and reviewing the role of the *Finance Commissions*, however, have in large part not been adopted due to political objections by the centre and/or states.

The *Chelliah Committee*, established by the Rao Government, delivered its interim report in December 1991 which served as input into the 1992 budget. The Committee focusses its attention on central taxes although it did make some suggestions for state taxes, particularly in the final report. With the rising problems of evasion and intrusiveness of the tax system, its emphasis was on acceptability, simplicity and administration. At the same time, it showed strong command of the economic principles behind



taxation, a feature which had not always been prominent in the work of earlier committees. Its increased emphasis on compliance and administration did not, however, lead to sharply differing conclusions from a number of its predecessors.

Its principal focus was on direct taxes, where broad bases and moderate rates were espoused. It might be argued that the personal income tax exemption limit, recommended at Rs.28,000, is rather high in relation to per capita income and would consequently narrow the tax base. The Committee saw compensation for the high limit in terms of better compliance expected on account of a simplified rate structure. The aim was to take 20% of the income of the potential income tax paying class through direct taxes. It estimated that only 30-35% of legally taxable income was being disclosed, and it was hoped that through the recommended measures the figure would be raised to 50-60%. It suggested a maximum marginal rate of 40% under a 3 rate structure (20%, 27.5% and 40%). A substantial rationalisation and reduction of exemptions was suggested as these lost considerable revenue and largely benefitted the rich. Increased usage of presumptive methods of taxation was recommended for 'hard-to-tax' groups.

On indirect taxes the *Chelliah* interim report recommended a move towards a VAT on a broad base to eventually replace central excise (apart from certain designated commodities). It suggested reductions in the general level of import tariffs, reduced spread of rates, a general simplification, and abolition of many concessions and exemptions.

In its budget, presented in February 1992, the government started to move in the direction of the report's recommendations. While direct tax changes saw a simplification of structure (in terms of both rates and slabs), there was a reduction import tariffs over a whole range of items (the estimated revenue loss was significant).

In the final report of the *Chelliah Committee*, presented in August 1992, the themes of tax reform that were given shape in the interim report were elaborated upon. Regarding the corporation tax, which was not covered in the interim report, the committee favoured the retention of the existing "classical system" of taxation with a

lowering of the tax rate for all domestic companies to 45% in 1993-94 and further to 40% in 1994-95. To attract foreign investment, the taxation of foreign companies should be made simple and transparent. In keeping with earlier *Taxation Enquiry Commissions*, the inclusion of agricultural income for determining income tax liability was favoured. In the field of excise taxation it was recommended that the coverage of VAT be extended beyond the manufacturing stage to the wholesale stage, but with the states returning the revenue from the wholesale stage. In the case of the sales tax it was suggested that this tax be converted into a form of state VAT within the manufacturing sector, although its comments here were very brief since its remit was central taxes. The broad thrust was towards reducing the role of customs as a revenue source, gradually replacing it with a more simple and rational system of domestic indirect taxation than that which currently apply. As regards direct taxes the aim was to improve compliance by reducing complexity and rates, differentiation, and removing concessions and loopholes.

India's tax committees and commissions have provided valuable advice since Independence. It is interesting how some themes have been ever present, for example the need to raise the contribution of direct taxes, whereas others have shifted with experience and economic conditions. The growing problems of evasion brought a much greater emphasis on acceptability, compliance and administration in the most recent report. The sanguinity as regards disincentive effects of high marginal rates which was expressed in the *Mathai* report of 1954 (although not shared by *Kaldor* in 1956) has been replaced by an emphasis on a broad base and moderate rates (a view which *Kaldor* would have endorsed, although he did not seem to appreciate the virtues of simplicity). The early emphasis on the need to encourage saving (*Mathai* and *Kaldor*) is still present but has been much reduced, consistent with the rise in the savings rate<sup>25</sup> from around 10% of GDP in 1950-51 to about 21% in 1988-89.<sup>26</sup>

What is striking is that the revenue system has generally moved away from, not only the patterns seen in other countries, but also from the patterns recommended by committees (which argued for an increased role for direct taxes and a reduced role for customs). The



low share of direct taxes would seem to indicate that the comparatively affluent sections of the Indian population have succeeded in side-stepping income taxation. This has been in large part by evasion but presumably also through their influence on political decisions.

### 4.3 The Rajiv Gandhi Reforms :

Rajiv Gandhi came to power soon after the death of his mother in October 1984 and won a commanding majority in the elections of December 1984. The budget speech of his Finance Minister, V.P.Singh, in February 1985 declared a new economic policy to improve the environment for industrial growth, including delicensing of some industries. There was also to be a long-term fiscal policy, coterminous with the 7th five year plan (covering the period 1985-90), and a major tax reform.

The main taxation proposals included the following. For personal income tax the exemption limit was to be raised from Rs.15,000 to Rs.18,000 whilst the highest marginal rate was to be lowered from 61.9% to 50%. There was also to be an attack on evasion. Concessions on indirect taxes designed to encourage priority areas were proposed and export duties were abolished on a number of goods. V.P.Singh's second (and last in this Parliament) budget in February 1986 continued the theme and announced reforms in the excise tax system in the direction of *MODVAT*. Subsequent budgets of the Rajiv Gandhi Government (in February 1987, 88, 89) were less innovative.

The early period of Rajiv Gandhi's Government was notable, as we saw in II, for its sharp rise in expenditure, rather than in tax revenue, and the widening of Government deficits. In retrospect the period cannot be really characterised as one of significant change in the public finances. It continued, one might even say pursued vigorously, what had become a history of widening deficits with (centre and state) expenditure rising from around 26% of GDP to around 31% between 1983 and 1988, whilst tax revenue increased by only two percentage points and non-tax revenue remained stagnant (see Table 1). During this time the tax structure did not

really change significantly, although the introduction of *MODVAT* was an important step.

What did change, however, was the attitude of the Government towards the private sector, profits and entrepreneurial activity. This was accompanied by an increasing desire to loosen the restrictive influence of the bureaucracy. India's growth during the late 1980s exceeded that achieved in the early 1980s, which itself was a period of high growth by historical standards. During the late 1980s however, government debt as a fraction of GDP was increasing more rapidly than at any time in post-independence history, contributing significantly to the crises of 1990 and 1991 which formed the background of the Rao-Singh reforms (see 4.4).

The change in attitude brought in by Rajiv Gandhi's government came in for substantial attack from some economic - political commentators (see 1985 issues of the *Economic and Political Weekly* for example) for abandoning the commitment to social justice and for promoting the interests of the better off. But probably both the protagonists and the critics of the reforms overestimated their effects relative to those of the deficits. The economy had been growing fairly rapidly in the early and mid-1980s and the increased budget deficits further boosted the economy into what was essentially demand-led growth, resulting eventually in serious inflation, as witnessed in the late 1980s and early 1990s. There is little that could be regarded as substantial reform of the public finances in the sequence of events that unfolded. An extended period of demand-led growth, however, has been unusual in India's economic history.

Many of the attacks echoed the opinion that increasing the share of direct taxation is the hallmark of progressivity (see e.g. Guhan, 1986, *Rakshit*, 1985, *Lakdawala*, 1985), and correspondingly that decreasing it constitutes a lack of concern for income distribution. The low compliance of tax payers (see the *Chelliah report*) and the low relative importance of direct tax revenues suggest that the effects of minor (or some non-minor) adjustments in direct taxation are unlikely to be of major significance in determining the overall progressivity of the tax and expenditure structures. The expenditure

side is of much greater importance here. This is certainly true of public policy in the U.K. for example, where, notwithstanding major contributions from direct taxation it has for long been the expenditure side which makes the largest contributions towards reducing inequalities (see U.K. Government, 1991 and *Atkinson*, 1989).

Between 1984-85 and 1985-86 income tax collections went up by 24.3% and corporation tax receipts by 22% (*Guhan* 1986). It had been argued that greater compliance was a principal goal of the income tax reforms-reduction of rates, raising of exemptions and the like - and such an outcome might be seen as vindication of the strategy. However, as *Guhan* argues, it is quite likely that much of this increase was due to immunity-cum-tax raids in 1985-86 as opposed to changing rates and bases. Indeed during Mrs. Gandhi's Emergency there was increased fear of strict enforcement and income tax receipts went up by 39% in 1975-76 over the previous year while there was no change in rates (*Guhan* 1986).

#### 4.4 The Rao-Singh Reforms :

P.V. Narasimha Rao was sworn in as Prime Minister on 21 June 1991, as leader of a minority Government. The new government, with Manmohan Singh as finance minister, won a vote of confidence in the Lok Sabha on 15 July and presented its budget on 24 July. On the same day it unveiled a new industrial policy. The government took office in the midst of an economic crisis. For a combination of reasons including the expansionary fiscal policy of earlier governments, the levelling of remittances from workers abroad and caution from foreign investors and non-resident Indians, the balance of payments was under severe pressure. These problems were exacerbated by the Gulf Crisis of 1990. In mid-January 1991, the country had only enough foreign exchange reserves to finance only 10 days import requirements. The fiscal problems have been emphasised at several points in this paper.

In the first week of July the rupee was devalued by 18-20% in two steps. This was followed by extensive changes in trade and industrial policy. The import licensing regime was dismantled

whilst industrial policy saw the removal of investment licensing and an increase in foreign equity limits in domestic industries.

A \$5.7 billion loan was negotiated with the IMF-which included an understanding on the observance of fiscal deficit ceilings. In line with the IMF conditions, fertiliser subsidies were cut. Also the growth in defence expenditure was held to 4% in nominal terms, a substantial real cut given double-digit inflation. The budget included a set of revisions in customs duties that were designed to reduce their relative role in revenue raising, encourage trade and subject domestic industry to greater international competition. Reductions in *ad-valorem* rates of customs duty to a maximum of 150% were announced (with the exception of alcoholic beverages and passenger baggage). To encourage technological development the list of capital goods items attracting fiscal relief on imports was expanded.

On excises, the *MODVAT* scheme, which allowed for the rebate of excise taxes on inputs, was expanded to cover man-made fibres. The duty rates on consumer durables such as refrigerators, motor cars and VCRs were increased. The special excise duty was increased from 5 to 10% with the exemption of some mass consumption goods such as tea and vegetable oil.

A primary objective was to increase the share of direct taxes, and the main route to this was to be via increased compliance. To this end there was to be an extension of withholding at source for interest income, a scheme for depositing undeclared wealth in the National Housing Bank (subject to 40% tax confiscation but without further penalty), and increased efforts on administration. At the same time some measures were announced to encourage investment in certain areas such as publishing, software and housing, and to encourage foreign investors' and non-resident Indians' investment in India. Broadly the strategy was to reduce and rationalise customs duties, increase excise duties (particularly on 'luxury goods') and raise direct taxes through better enforcement and compliance. In the autumn, the Government of India established the *Chelliah Committee* on tax reform, which, as we have seen, produced its interim report remarkably rapidly (by the end of the year).

The Budget for the year 1992-93 was presented, as usual, at the end of February, and proposed a number of important changes including the partial convertibility of the rupee. On personal income taxes the reform broadly followed the spirit of the *Chelliah report* in moving to just three tax rate slabs. The exemption limit was raised from Rs.22,000 to Rs.28,000. At the same time a number of tax deductions and exemptions were abolished. Revenue generated in this manner was estimated to be sufficient to cover the revenue losses arising from a higher exemption limit. However a number of measures recommended in the *Chelliah report* on direct taxation were not yet implemented, including the taxation of fringe benefits and the wider application of presumptive tax methods for 'hard-to-tax' groups.

On indirect taxes the measures again followed the spirit of the *Chelliah report* with a gradual reduction of customs duties to the maximum rate of 110% (with the same exceptions as previously). These restructuring measures were expected to result in a revenue loss from customs duties of more than Rs.2,000 crore. Excise duties would be moving to *ad valorem* rates wherever possible. Duties were raised on many items including watches, some plastics and metals, paints, cocoa and cigarettes. These measures were expected to raise in excess of Rs. 2,200 crore.

We see therefore that the *Singh* budgets have already involved substantial changes in taxation. Particularly noteworthy is the reduction of the role of customs revenue as part of the more efficient involvement with, and competition from, foreign trade. The tax system itself has not been radically changed in that the basic sources of revenue and bases remain much the same. But the orientation of tax policy has been altered and further steps are being actively debated.

## V. CONCLUDING COMMENTS

We have described in this paper the development of the tax structure in India and have linked this to features of the federal structure and development strategy. We saw that the wide deficits, which were central to the severe foreign exchange and inflation

problems of the late 1980s and early 1990s, have been developing over a long period. The growth in debt and deficits, however, were particularly associated with the two 'ambitious' decades of the 1950s and the 1980s. The former saw the launch of Indian planning and heavy industrialisation, and the latter initiated the attempt to make India more competitive internationally and less bureaucratic in industrial policy. Both were decades of rapid economic growth relative to other periods in Indian history.

The structure of Indian tax revenues appears to have been strongly influenced by the mechanics of India's federal arrangement. The two taxes which have not been shared (customs with the centre and sales with the states) have grown most strongly whereas the performance, in revenue terms, of those which have been shared (personal income taxes and excise duties) has been less satisfactory.

We have also examined the discussions and recommendations of various committees, identifying those themes which have been ever present and those that have risen in importance. Substantial reform is now urgent; this is well recognised and important progress, particularly through the work of the *Chelliah Committee*, has been achieved. We hope this paper will contribute to the discussions which are taking, and will take, place by providing a summary description both of some of the forces at work in generating current difficulties and of earlier attempts to design solutions.

In the context of the history described there are a number of issues which require close attention in further work. We highlight seven of the central ones here in the broadest of terms and hope to give a number of them closer scrutiny in our further work. Tighter administration should be a crucial feature of any advance but, for reasons of comparative advantage, is not one on which we focus. First, we have the political economy of the developments in the tax structure. Our focus in this paper has been on economic developments and some political and administrative responses to them at the official level. One must also investigate, however, the role of pressures and forces associated with different interest groups

in the economic and political developments on the fiscal front. There are usually gainers and losers in any tax reform even if it is broadly positive in terms of efficiency and growth. There are those who have a vested interest in the *status quo*. If reform is to be successful it is necessary to be aware of who these gainers and losers are, and where the vested interests lie. That is not, of course, to say that reforms must be designed so that none will lose and that all vested interests must be served. That would be to abandon the prospect of reform altogether and in that direction lies stagnation. Nevertheless the interests of stakeholders must be recognised if political and economic judgements are to be properly informed. Further, if support for reforms is to be mobilised, the gainers must understand, and be activated in favour of realising, their rewards. The potential losers usually recognise their position fairly rapidly and vociferously.

An analysis of those interests is closely related to a number of further topics in the following. Our second issue, in particular, concerns the difficulties that have arisen in the current tax system in terms of the various devices and strategies that have arisen to circumvent it, either legitimately or otherwise. In other words, one should examine the particular problems which have arisen in the existing system which a reformed structure might encounter and which it might be designed to solve or avoid. Here, particularly, there is important work initiated by the *Chelliah Committee* on which to build.

Third, any reform proposals should be subject to an examination of their implications for income distribution. Of great help here would be an analysis of how reforms are likely to affect households in different circumstances using data on household expenditure and income patterns. In this respect India is fairly well served by the richness of its sample survey information. Fourth, any reform proposals must be scrutinised carefully in terms of their impact on, and likely to be (and understandably so) very wary of any proposal which might be perceived as reducing their autonomy or revenue. Considered information on state-wise effects should be a crucial input into discussion and negotiation.

Fifth, reform proposals must have as a central element a move from trade to domestic taxation. The new Indian Government is seeking a greater involvement in the world economy and in its first two budgets has made substantial strides in removing tariffs and other impediments to trade. It is this goal of economic policy, which essentially concerns efficiency and growth, which should have particular priority in tax design in contrast, for example, to the predominance given to savings in some earlier discussions (important as that objective may be). A central task is to build domestic revenue sources as trade taxation is reduced since macroeconomic fiscal problems preclude the abandonment of one source in advance of its replacement by other.

Sixth, the tax and expenditure systems as they emerge should be consistent with perceptions, as they may change, of the appropriate role for the state. A withdrawal from extensive state involvement in production activities may have to be accompanied by an advancement in others, concerning for example, the infrastructure, education and health, and social protection, which promote and enable the private sector to function well and which protect the worst-off.

Finally, and above all, the reforms will have to meet the macroeconomic fiscal challenge. Without this the other objectives and concerns are likely to be overtaken by *forces majeures*.

#### NOTES

1. The growth of non-tax revenue has been less marked, with most years between 1950 and 1988 recording a figure of between 2 and 3 percent of GDP (see Table 1).
2. Defined as countries with 1987 GNP per capita below \$6000 (see *Burgess and Stern, 1992a, Table 3.2*).
3. Defined as countries with 1987 GNP per capita below \$360. For 1987, GNP per capita in India stood at \$311 (see *Burgess and Stern, 1992a, Table 3.2*).



4. Defined as countries with 1987 GNP per capita between \$1620 and \$6000 (see *Burgess and Stern*, 1992a, Table 3.2).
5. Defined as countries with 1987 GNP per capita above \$6000 (see *Burgess and Stern*, 1992a, Table 3.2).
6. The share of agriculture in GDP has decreased from 48% in 1960-61 to 30% in 1985-86 (see *Chandhok et al.*, 1990, Table 1.7 (c))
7. As Figure 6 and Table 7 demonstrate, the share of customs revenue in GDP has increased in the face of a falling share of imports in GDP in the 1980s. These revenue gains must be accounted for, both by an increase in customs rates and by a switch from quantitative to price/tariff controls (see 3.4).
8. Stagnancy and decline in the role of direct taxes in India is thought to largely reflect the difficulties of administering direct taxes relative to other tax instruments.
9. It is notable that all of the other major tax types showed a net increase in their share in GDP over the same period.
10. There is a growing realization worldwide that redistribution, if it is to take place, will have to come, in large part through expenditures (see eg. *Atkinson*, 1989).
11. These taxes exhibited a fairly constant share in total central tax revenues, standing at 10% in 1950 and 1989.
12. This is against the spirit of the Indian constitution which endorsed free movement of goods between the different states.
13. In practice a domestic producer was granted protection whenever it could be shown that the domestic output displaced more imports than it required, directly or indirectly, for its production (*Bhagwati and Desai*, 1970).
14. The protectionist element in this regime was reflected in the drop in imports as a share of GDP (see Figure 6 and Table 7).

15. Large imports of foodgrains had put the balance-of-payments (BOP) position under considerable strain since Independence. The maintenance of this strategy was made possible in the 1950s by the favourable climate of foreign aid that prevailed at that time.
16. Of the total public debt (centre and states), external debt accounted for about 10%. The proportion of central government deficit financed by net RBI credit rose from less than 16% in the early 1970s to nearly 1/3 during the latter half of the 1980s (*Chelliah*, 1991).
17. See *Chelliah* (1991, 1992) for some specific proposals to achieve debt and deficit reductions.
18. Government of India, **Report of the Taxation Enquiry Commission, 1953-54** (under the chairmanship of *John Mathai*), 1955.
19. Government of India, **Report of the Taxation Enquiry Commission, 1977-1978** (under the chairmanship of *L.K.Jha*), 1977, 1978.
20. Government of India, **Report of the Commission on Centre-State Relations** (under the chairmanship of *R.S.Sarkaria*), 1988.
21. The Indian constitution was to closely follow the division set out in the Government of India Act of 1935 (see, *Varma and Sinha*, 1981).
22. All dealers having a turnover exceeding Rs.5,000 a year should be liable to the multi-point tax. For the single point tax, the turnover limit should be relatively high, e.g.Rs.30,000 a year.
23. Government of India, **Direct Taxes Enquiry Committee (Final Report), December 1971** (under the chairmanship of *Wanchoo*), 1971.
24. Kumar, Table 12.4 for example, shows that in 1958-59, land revenue exhibited a 50% share in total revenue.

25. Gross Domestic Savings (households, private corporate sector and public sector).
26. Government of India, **Economic Survey 1991-92, Part II, Sectoral Developments**, Ministry of Finance, New Delhi, 1992.

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