

# Six Essential Questions in Indian Public Finance

Review article based on *Studies in Indian Public Finance* by M Govinda Rao

**Pranay Kotasthane\***

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## Introduction

The discipline of public finance assesses the quality and quantity of government income and spending. As a cross-cutting discipline, public finance offers insights across all public policy domains. Whether it is public health, defence, or scientific research, policies in each of these domains grapple with some common questions:

- Does a prevailing situation warrant a government intervention?
- If yes, should the government produce, finance, or regulate?
- What amount of spending is required, if the government decides to either produce or finance the good/service?
- What mechanism(s) should be used to spend government money in order to realise the policy objectives?
- How should government generate revenue to sustain a policy project?

The discipline of public finance addresses all these questions and more.

Despite its utility, public finance is an underappreciated discipline in Indian public discourse. Discussions on government schemes, budgets, and taxes often descend into ideological fistfights. Even serious debates over these issues dominantly use the framing of political economy, without including the analytical basis that public finance can offer.

For example, a prominent policy debate in the media at the time of writing this essay has been over what constitutes government “freebies”. Many opinions were written and debated after the Prime Minister’s speech criticising state governments for distributing freebies to win votes.<sup>i</sup>

Public finance can bring much-needed clarity to this debate. Analytically, “freebies” are a particular category of subsidies. The concept of a “subsidy” has been studied by public finance specialists, including in a landmark study co-written by the author of the present book (Rao and Mundle, 1991). Analysing the quantum of subsidies at the union and state levels, it showed that Indian governments were collectively spending almost 15% of GDP on subsidies. The study also crucially differentiated and enumerated subsidies on meritorious goods and services from those on non-meritorious goods or services. Despite the availability and relevance of such analyses, a public finance perspective on freebies was an exception rather than the norm in popular media debates on the issue.

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<sup>i</sup> Pranay Kotasthane is the Deputy Director of the Takshashila Institution and chairs the High-Tech Geopolitics Programme.

This lack of popular understanding makes *Studies in Indian Public Finance (SIPF)* a much-needed contribution. The author of this book, M Govinda Rao, is a doyen in the field of public finance. He has several important papers, journal articles, reports, and academic books on public finance issues such as taxation, fiscal federalism, and intergovernmental transfers. As a public policy practitioner, academic, public intellectual, and institution-builder, Rao brings a unique perspective to his writings.

*SIPF* is a *tour de force*, in which Rao explains India's public finance journey after independence. The introduction chapter succinctly presents twelve takeaways for the reader. In *Chapter 2*, the book discusses opposing answers to a long-standing question that motivates public finance: what is the ultimate role of the State? Chapters 3 through 8 focus on one central concept each in public finance, narrated through India's journey. *Chapter 9* throws light on the unprecedented impact of COVID-19 on government finances in India.

Throughout the book, Rao stays away from the types of strongly held opinions that dominate discussions on government schemes, tax policies, and federalism. Instead, he attempts to educate readers on the analytical foundations and empirical studies which they can then use to derive their own conclusions.

Given the book's foundational nature, this essay departs from the conventional book review article. In place of critically analysing all the claims and studies in the book, the essay applies insights from the book to contemporary questions in India's public policy. The purpose is to highlight key ideas in public finance from *SIPF*, and to impress upon readers that understanding public finance is a valuable skill regardless of the policy domain of their core interest.

To do this, the essay asks six questions, and tries to answer them using insights from the book. A caveat for such an essay is in order: the views on contemporary issues are this writer's, based on insights from *SIPF*. They might differ from the author's perspective on specific issues.

## Studies in Indian Public Finance in Six Questions

### Question 1: What do we know about the quantity and quality of India's public expenditure?

Every year, there is animated discussion around the union budget regarding public expenditure allocations across sectors. Often, these conversations lament what they see as anaemic expenditure levels in a chosen sector. *SIPF* offers a framework for analysing public expenditure levels in a holistic manner.

Consider the quantitative aspect of public expenditure first. One way to judge government size is to measure public expenditure as a proportion of overall economic activity. The higher this parameter, the bigger the government. In 2018, India's overall public expenditure as a proportion of its GDP stood at 27%. The US was at ~38%; Russia was at ~36%; Sweden was at ~49%; Pakistan was at ~21%. The Indian State is thus no outlier on this measure.

This parameter has been rising steadily for most countries ever since the "welfare State" became mainstream after the Second World War. There is a strong correlation between government spending and income levels — the more prosperous a country is, the higher the share of public expenditure in its economy. This observation is known in public finance literature as Wagner's Law.

While Indian public expenditure fits Wagner's Law in a cross-sectional analysis (i.e. when one compares multiple countries), it does not follow this law in a longitudinal analysis (looking at public spending in India over time). Over the last thirty years, the public-expenditure-to-GDP ratio has hovered

around 26%, despite the considerable rise in per capita income. Poor state capacity and resulting difficulties in raising additional resources for the government to spend are a prominent reason for this divergence (Rao and Kumar, 2017).

Another interesting quantitative highlight is state governments' prominent-yet-under-analysed role in India's public finance landscape. State governments spend nearly 60% of total government expenditure. Constitutionally, the crucial domain of social infrastructure (health, education, etc.) is the primary responsibility of the states, while physical infrastructure is assigned to the union government. Moreover, expenditure at the third tier of government is negligible, as many state governments have failed to decentralise fiscally. This middle-heavy nature of India's public expenditure system demands higher scrutiny of state budgets and performances.

Qualitatively, India's public expenditure is centred around current expenditure, to the detriment of "capital expenditure" – spending that can yield long-term benefits. Over the last three decades, expenditures on consumption, subsidies, and transfers have risen significantly, while the spending on basic public goods (defence, law and order, contract enforcement) has remained stable at 6% of GDP. Similarly, while children constitute nearly 35% of India's population, expenditure on social services that impact this age group continue to be low.

Overall, the long-term productivity of public expenditure seems to be reducing. The author highlights the importance of tying public expenditure on inputs to policy outcomes. He argues that it is possible to get better outcomes from the same level of spending through better accountability, intergovernmental transfer design, and the use of technology.

Rao also suggests that one way to improve the efficiency of public expenditure is to eliminate most subsidies and shift to a basic minimum income scheme. However, he does not detail such a programme's costs and implementation details. Another way to improve productivity discussed in the book is the strategic sale of all public sector enterprises in non-strategic areas.

## Question 2: Should India reintroduce wealth and inheritance taxes?

This question is a recurring theme in Indian public policy. Many a scholar advocates the usage of tax policy to contain rising inequality. The calls have only grown louder due to COVID-19. Most recently, the non-governmental organisation Oxfam International released a report titled *Inequality Kills: India Supplement 2022*. It argues:

"We call upon the government to redistribute India's wealth from the super-rich to generate resources for the majority by reintroducing the wealth tax and to generate revenue to invest in the education and health of future generations by imposing a temporary one per cent surcharge on the rich for health and education."  
(Oxfam India, 2022)

After reading *SIPF*, the reader would realise that these calls are trying to address a genuine problem with a sub-optimal solution. In the chapter titled *Tax Policy and Reforms in India*, Rao explains that "the most important objective of tax policy is to raise revenue by minimising the three costs associated with taxation: the cost of collection, cost of compliance, and cost of market distortion."

In this writer's view, a wealth tax in India would fail on all three counts. Measuring wealth is not easy. For instance, estimating the cost of the artwork owned by a wealthy family requires the tax authority to have expertise in valuing art. Thus, the administrative and compliance costs would be significant. Nor do

people have all their money in easily visible financial assets such as stocks. Some of the assets could be notional (such as equity in early-stage start-ups), other assets could be outside India, and still others in immovables, such as real estate. Complying with wealth tax regulations on these assets will not be easy.

Finally, such a tax will have distortionary costs, as people will transfer wealth (notionally) to relatives, take money out of India, and invest in assets that are difficult to value. A tax on capital will end up being a burden on labour if companies shift their operations out of India, thus denying employment opportunities to Indian workers. Thus, any calls for new taxes should first assess the three costs.

More broadly, *SIPF* informs us that the tax system is not an effective instrument for redistribution. The idea that changing tax rates can reduce income inequalities has a long history. This vision led to highly progressive personal income tax regimes, combined with high corporate taxes in India and countries such as US and UK. Empirical studies have pointed out that such “Robin Hood taxes” did not lead to a reduction in inequality. In Chile, raising tax rates had a regressive effect, leading to an increase in the Gini coefficient (Engel et al., 1999).

Gradually, many countries have realised that redistribution should be a goal of the expenditure side of the budget. Revenue-raising functions and policies should not be tasked with this goal at all. Broadening the base, lowering the tax rates for all individuals and companies, and getting rid of tax exemptions are more progressive than multiple tax slabs and high tax rates.

It’s not just redistribution: India’s tax policy is deployed for several other socially desirable objectives, such as “*industrialisation of backward regions, encouraging infrastructure ventures, promotion of small scale industries, generation of employment, encouragement to charitable activities and scientific research, and promotion of enclave-type development through Special Economic Zones (SEZs)*.” (Business Standard, 2013)

This multi-objective optimisation is addressed through various exemptions and rates, enabling evasion, rent-seeking, and corruption. Rao points out that this obsession with the tax policy is one of the primary reasons why India’s tax-to-GDP ratio is almost 2.75% points lower than its taxable capacity. In a memorable phrase that illustrates the problem with expecting too much from one policy instrument, Rao had likened India’s tax policy to kamadhenu (a mythical, miraculous cow which could fulfil all demands of her owner) in his earlier work (Economic Times BFSI, 2022).

### **Question 3: Is an imperfect Goods and Services Tax (GST) better than no GST?**

In recent years, the shoddy implementation of the GST has generated much debate. While the reform was touted as a ‘game changer’ initially, it has come under criticism for two reasons. First, teething problems on the technical side and multiple GST rates indicated poor planning and implementation. Second, others have argued that the GST takes away some of the state governments’ taxation powers, making it anti-federal.

*SIPF* has an excellent chapter that addresses the GST in detail. The author was the chairperson of an Expert Group on Taxation of Services that first recommended the adoption of GST as early as 2001. Hence, his views on this subject are illuminating. Rao highlights that unlike in other countries where such tax reforms were adopted to boost revenues, the reform in India was motivated by the need to “unify multiple trade taxes, reduce distortions, and harmonise the indirect taxes between the Centre and States”. On this objective, GST appears to have paid off.

Acknowledging that it is difficult to quantify some crucial gains from GST, the author suggests that the currently imperfect GST is much better than the pre-GST scenario for five reasons.

1. It has unified myriad consumption taxes, reducing administration and compliance costs compared to the pre-GST tax situation.
2. It harmonises domestic taxes, by merging union excise duties and states' sales taxes and taxing this merged base based on value addition.
3. It has eliminated various tax exemptions that state governments deployed to win over businesses as a substitute to market-friendly policies.
4. It has eliminated checkposts, that physically hindered the movement of goods across the country, in effect bringing down transportation-related costs.
5. Finally, it has led to a significant reduction in cascading of taxes (the effect of charging a tax on tax), increasing money in the hands of citizens.

The author also terms the creation of the GST Council an important innovation in fiscal federalism, “where both the union and State governments pass on their fiscal autonomy to levy important consumption taxes to a joint agency in the interest of tax harmonisation.”

The chapter also systematically identifies the current problems with the GST and recommends these solutions: simplify the tax regime, broaden the base, lower the rates, and include the currently excluded items into the GST. While the GST is a good starting point, without resolving these outstanding issues, GST's teething problems might grow into chronic defects.

#### **Question 4: What is the single-largest expenditure item in the union government budget?**

Neither defence nor subsidies, the single largest expenditure item in the union budget are interest payments, which account for one-fifth of the total expenditure planned this year. In FY19, before the pandemic, the aggregate public debt of all governments in India was about 72% of GDP, making India an outlier among emerging market economies. Only Brazil, Argentina, Pakistan, and Sri Lanka had a higher outstanding debt. The economic crash in Sri Lanka and the ongoing turmoil in Pakistan should prompt the question — how should India manage its public debt better?

That is the focus of Chapter 6, *Macroeconomics of Indian Public Finance*. The chapter starts with the implications of fiscal deficits and goes on to discuss India's experience with managing deficits and debt. Three insights are worth recalling here.

1. There is no optimal debt-GDP ratio for a government. Borrowing can be made sustainable over time if it is utilised for productive growth. However, if it is used for non-productive purposes, such as financing the day-to-day expenses of the government, increasing debts might eventually result in a financial crisis.
2. Increased government borrowing from the household sector's financial savings crowds out private investment – the backbone of any economy.
3. Today's borrowing results in tomorrow's taxes. Excessive borrowing has intergenerational effects, as it locks in future expenditures as interest payments.

India's 1991 balance of payments crisis highlights the need to monitor fiscal deficits and debt. The book has an illuminating section on how the Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2003. The FRBM Act put limits on deficits of state and union governments. This rule-based fiscal policy initially paid quick dividends, but got derailed in 2008-09, as expansionary fiscal policy took

centre stage. This situation has not improved since then. Since there are no penalties for breaching the FRBM targets, there have been regular slippages through the last decade. COVID-19 has pushed the deficit reduction plan further away into the future.

To tackle this situation, the author highlights a missing institution: an independent fiscal council. The Thirteenth, Fourteenth, and Fifteenth Finance Commissions have highlighted this institutional gap. While India has an institution (the Comptroller and Accountant General) to audit policies that are already in action, no institution conducts and publishes an independent financial evaluation of government policies *before* they receive approval.

The result is that tall promises of handouts often become government policies swiftly, without regard for fiscal sustainability or assessments of opportunity cost. A recent example is the One Rank One Pension (OROP) scheme, which was implemented in 2015 after appearing in the 2014 election manifestos of the major national parties. An independent fiscal council would have made the long-run costs of OROP explicit, thereby enabling a more informed discussion based on cost-benefit analysis, prior to the eventual policy decision.

An independent fiscal council is an institution that is supposed to do three things: evaluate the quality of budget forecasts (given the wide gap between budgeted estimates and actual expenditures); develop cost estimates of budgetary proposals *ex-ante*; and monitor adherence to fiscal rules. Rao argues that the global experience with such institutions is largely positive, and that it is time for India to build a credible and genuinely independent fiscal council.

### Question 5: What ails Indian Fiscal Federalism?

Fiscal federalism is a much-debated topic in India's policy discourse. After liberalisation, states in southern India have witnessed impressive growth, while many large states in the Gangetic belt have underperformed. This difference in the economic and demographic centres of gravity manifests as squabbling over the horizontal distribution of revenues between states.

Opinions keep reappearing, suggesting how some states are getting a raw deal in the Indian union, as they contribute far more to the union government's tax revenue collections while getting far less in return. *SIPF* has two chapters that deeply engage with such questions on Indian fiscal federalism.

The author presents various fiscal federalism theories, and an even-handed assessment of India's experience with fiscal federalism. As he explains, the wide disparity in incomes per capita between states—Haryana's per capita income is almost five times that of Bihar, for instance—makes some redistribution across states inevitable.

The states' exclusive focus on horizontal devolution seems to be misplaced, as the real problem lies in vertical devolution, i.e. how the tax resources are split between the union government and all states as a whole. The Indian union has a heavy 'centripetal bias', which allows the union government to corner more revenues to itself, and also apply those revenues to domains that are constitutionally under the State List.

The Fourteenth Finance Commission tried to change this by recommending a higher devolution of revenues to the states as a whole. While most commentaries suggest that the union government increased the devolution substantially, from 32% to 42%, following these recommendations, the author offers an important correction. As the commission's mandate covered the requirements of both plan and non-plan expenditure, in reality, the increase was from 39% to 42%. The union government partially neutralised even this modest 3 percentage point increase by increasing cess and surcharges, which are not shared with states.

In that sense, debates over India's fiscal federalism resemble the 'monkey and the two cats' fable. While states fight amongst each other, the union government can get away with 58% of the divisible pool resources, raising new cesses, and using a part of these funds to run centrally sponsored schemes that fall squarely in the states' constitutional domain. States need to cooperate with each other to reduce this centripetal bias.

### Question 6: How many centrally sponsored schemes should the union government run?

Centrally Sponsored Schemes (CSS) are programmes designed and significantly funded by the union government and implemented by state governments. CSS such as the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) or National Health Mission (NHM) occupy an outsized role in Indian public policy discourse.

The chapter *Intergovernmental Transfers in India* analyses these schemes in great depth and offers foundational insights. Conceptually, the union government transfers money to state governments in two ways: general purpose (GP) transfers and specific purpose (SP) transfers.

- GP transfers are not tied to any specific purpose; states are free to deploy these funds according to their priorities. Such transfers are now recommended by the Finance Commission. GP transfers are meant to “enable states to provide comparable levels of public services at comparable tax rates by offsetting their revenue and cost disabilities.” (Rao, 2017)
- SP transfers, as the name indicates, are funds that states need to spend on pre-determined subjects. SP transfers are meant to ensure a minimum standard of public services, which are considered 'merit goods', and have significant externalities across the country. MGNREGS and NHM fall under this category; conceptually, most CSS would fall under this category as well.

Analysing three primary CSS, the author finds that SP transfers have failed to meet their core objectives. Instead of focusing on a few meritorious public services, they became a vehicle for successive union governments to woo the electorate, by expanding their reach to spend on subjects Constitutionally allocated to the states.

This had led to thinly spread resources and poorly designed schemes. The net result is that SP transfers are less equalising than GP transfers, meaning that such transfers are not able to drive convergence of performance of various states on desired outcomes, as richer states end up getting more allocations per capita under these schemes. The chapter goes on to recommend design changes for SP transfers.

## Conclusion

These six questions and their answers based on *SIPF* illustrate the utility of public finance analyses and reasoning in making sense of contemporary policy debates. Additionally, the book has much more to offer on several other issues, such as subsidies, the post-pandemic fiscal situation, and a proposal to reimagine an institution that can help intergovernmental bargaining. *SIPF* is an excellent introduction to Indian public finance for any interested reader.

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## Notes

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<sup>i</sup> The Indian Express. 'Revidi Culture Dangerous, Must End: PM Modi Slams Politics of Freebies', 17 July 2022. <https://indianexpress.com/article/cities/lucknow/revdi-culture-dangerous-must-end-pm-modi-slams-politics-of-freebies-8033948/>.