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Taxation as an Instrument of Fiscal Policy in India

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ABSTRACT

Taxation is a fundamental tool for fiscal policy, which is the use of government spending and to influence the economy. Governments use taxation as a means to achieve various economic and social objectives such as generating revenue which are used to fund public services and government activities, income redistribution as a social welfare program, and also to address environmental concerns by discouraging activities that contribute resource depletion. Taxation has also been used as a tool to combat inflation. The article examines the careful balance between achieving economic objectives, promoting fairness, and addressing social and environmental concerns. Through a comprehensive analysis, this article aims to contribute to the understanding of the intricate dynamics between taxation and fiscal policy, offering insights that are relevant to policymakers, legal practitioners, and scholars in the field of taxation law.

Keywords: *Taxation Law, Fiscal Policy, Government.*

I. INTRODUCTION

India has a federal tax structure, expressly empowering the Central Government, State Government and local bodies to levy and collect taxes under the Constitution of India, 1950. As tax is one of the major sources of revenue for the government, the Constitution of India, 1950 divides the power of levying and allocation of taxes, as fund on various public activities, between the Centre and State[2].

After the Second World War and the Great Depression, fiscal policy's true significance, impact, and meaning became clear. The best and most widely accepted definition among experts is that fiscal policy is *"the government's policy with regard to the level of government purchases, the level of transfers, and the tax structure."*[3]

Another definition of fiscal policy is *"changes in government spending and taxation intended to achieve macroeconomic policy goals"* (such as growth, employment, investment, etc.).

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[2] Supriyo De, (2012) *Fiscal policy in India: Trends and Trajectory*, Working Papers. Available at: https://ideas.repec.org/p/ess/wpaper/id4751.html (Last accessed on 14th October 2023).

[3] *Id.*

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Therefore, it is pertinent to say that the fiscal policy can be considered as the utilization of taxes and government spending. The impact of fiscal policy on the macroeconomy in India was later analyzed, by various experts.[4]

After the Independence, India's economy was deemed to be planned. Due to the government's significant development obligations, both foreign currency and large sums of rupees were required. India experienced ongoing problems managing the cash needed to fulfil its five-year plans since neither significant amount of foreign money nor domestic resources could be mobilized. (As a result of decreased tax revenues, weaker banks with excessive private ownership, minimal savings rates, etc.)

The government began to pursue deficit financing by the late 1960s, and from the 1970s onward, India started to actively pursue larger fiscal deficits, relying more on increased deficit financing with each passing year. The deficit financing in India is divided into three phases[5] which are discussed below:

a) **The First Phase (970) -** The deficits were presented as budgetary deficits during this time because there was no concept of deficit financing. Important elements of this stage were:

i. Attempting to borrow money from both within and outside of the economy but failing to reach the goal.

ii. To emerge as an economy with surplus revenues, a concerted effort was undertaken to boost tax collections and control revenue expenditures in the 1950s. But tax evasion, an increase in corruption, a stagnant level of living, and a neglected social sector were witnessed by the government majorly.

iii. Significant borrowings from the Reserve Bank of India (RBI) and, eventually, from the nationalizing banks, the government utilized their funds to finance their goals. In addition to increasing the government's interest costs, this caused a financial collapse in the years that followed as banks ceased to become independent.

iv. Creating massive Public Sector Undertakings (PSUs) with larger revenue

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[4] Jyoti Kumar, *Indian Fiscal Policy and its problem*, JCECS, Vol. 03, No. 01. Available at: https://www.google.com/url?sa=i&url=https%3A%2F%2Finspirajournals.com%2Fuploads%2FIssues%2F1367844960.pdf&psig=AOvVaw33686c5wV5Ku7FOK3vlW6_&ust=1703671043439000&source=images&cd=vfe&ved=0CAgQrpoMahcKEwjAq6us66yDAxUAAAAAHQAAAAAQBA (Last Accessed on 21st November 2023)

[5] Kumar Rajiv & Alamuru Soumya, *Fiscal Policy Issues for India after the Global Financial Crisis,* ASIAN DEVELOPMENT BANK INSTITUTE, Working Paper No. 249 (2008-2010). Available at: https://www.adb.org/sites/default/files/publication/156104/adbi-wp249.pdf. (Last Accessed on 14th October 2023).

expenditures (such as salaries), which raised further revenue expenditure of governments at the time of paying Pensions and Provident Funds.

v. Even after using all the afore-mentioned methods, India was unable to make the necessary amount of investment.

b) **The Second Phase (1970-1991)** - This is regarded as the time of deficit financing, which was followed by weak economic foundations and finally culminated in a serious financial crisis by the years 1990–1991. The major highlights of this phase are as follows:

i. India saw the nationalization policy and simultaneous revival of an increased emphasis on expansion of the PSUs.

ii. The overall amount of capital and revenue spent by the government rose due to upcoming PSUs.

iii. Existing PSUs were receiving their fair share of the economy's benefits; the excessive growth in the number of illogical jobs increased the cost of salaries, pensions, and PFs; many of them had already begun to generate significant losses by this point; the public sector did not prioritize profit; there was a dearth of profit and loss analysis, and the PSUs had no relationship between their need for labour and the available labour force.

In the end, the officers were not held accountable for profit or loss, making them institutionalized hubs for corruption and sites of purposeful losses, etc.

iv. Governments failed to control population growth and provided large-scale employment since the cost of various subsidies had continued to rise, making them unmanageable and highly irrational. Self-employment programmes were not implemented, or, to put it more precisely, it was politically acceptable to implement piecemeal wage-employment programmes under various titles.[6]

v. Planned development remained extremely centralized and lacking in any space for local aspirations, which led to the emergence of radical and extremist organizations and the ensuing law-and-order issue as well as excessive spending on them. The result was a taxed police force and a slow-moving court system.

vi. Governments sought to finance their plans through investments in PSUs that were not driven by the profit incentive; the deficit financing of PSUs was not supported

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[6] Supriyo, s*upra note* 2.

by basic economics. Most of the plan on expenditure ultimately proved to be non-economic.

c) **<u>The Third Phase (1991 onwards)</u>-** This began with the International Monetary Fund's (IMF) conditionalities being met as the process of economic reforms was launched (controlling fiscal deficit was one among them). The economy required reform as it transitioned from the government to market control, and public finance also needed some sanity.

   The government's top aim after the economic reform process was to encourage private sector investment and make them available with sufficient funding so that the private sector can make investments in the economy.

   To make the private sector receive investable capital, the government needed to lessen the "crowding out" of funds from the banking system. Also starting in the early 1990s, the government took several steps, including reducing spending by the governments (federal and state), increasing its own tax and non-tax income, bolstering and developing financial markets, etc.

II. Objectives of Indian fiscal policy

Indian taxation system serves to achieve a variety of objectives in order to be considered as an instrument of fiscal policy. It is providing a method to make economic resources available by spending on public works which further generates maximum employment. It aims to provide economic equality and fair distribution of income and wealth amongst people of India.

Taxes are not merely a way to raise money and support the economy. It also plays a significant part in establishing institutions, markets, and democracy by holding the government responsible to its taxpaying citizens.[7]

It promotes good governance. In emerging economies, a lack of tax structures is a significant factor for ineffective governance and a high reliance on financial aid, just as high tax burdens in wealthy nations may impede progress. A proper tax structure enables citizens to hold governments accountable for their actions and frees developing nations from feeling beholden to assistance donors.[8]

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[7] Gyöngyi Végh & Hans Gribnau, *Tax Administration Good Governance*, EC TAX REVIEW, 2018-1, pg. 48-60. Available at: https://www.researchgate.net/publication/326235752_Tax_Administration_Good_Governance (Last Accessed on 18th October 2023).

[8] Ben Dickinson, Tax and Good Governance, OECD Journal: General Papers, Volume 2010 Issue 1. Available at: https://read.oecd-ilibrary.org/economics/tax-and-good-governance_gen_papers-2010-5kgc6cl2zv0q#page2 (Last Accessed on 16th November 2023).

III. Issues and challenges in Indian fiscal policy

As stated previously, the fiscal policy of India not only talks about levying but also allocation of taxes as expenditure within the country for its economic development. These include debt or surplus management, investment or disinvestment strategies, tax policies, and spending guidelines.[9] An economy's comprehensive framework is closely related to the overall economic strategy of a nation. The Indian government's before making the budget face the following challenges:[10]

- ***Disequilibrium between Government Revenues and Current Expenditures:*** There has long been an imbalance between government revenue and current spending. It has been noted that there is a rising trend in the imbalance between revenue and expenditure.
- ***Not so Buoyant and Responsive***: According to the non-plan current expenditure's propensity to increase considerably more quickly than tax revenues, expenditures appear to be more susceptible to inflation than revenues. This indicates that the Indian tax system hasn't been sufficiently flexible and responsive to income increases.
- ***Black or Unaccounted Money***: Despite the recent economic expansion, both the proportion of direct taxes in overall tax income and their share of the Gross National Product have decreased. This demonstrates the tax system's glaring inability to both capture extra revenue and lessen the concentration of income and wealth. India's fiscal strategy continues to be mostly affected by tax evasion.
- ***Low Returns on Public Investment:*** In addition to the issue of the tax system's lack of stability, there is also the issue of public investment's low returns.

IV. Fiscal policy in India through the lens of taxation

As the prospects for macroeconomic stability are threatened by ongoing fiscal imbalances and rising levels of public debt, the fiscal policy takes centre stage in policy discussions. Timely and appropriate fiscal policy action may stimulate growth by ensuring that scarce resources are used effectively. Without significant inflation or intergenerational transfers of the burden of public debt, a well-designed fiscal strategy could aid in accelerating the growth of an economy like India. The federal structure and democratic system of India pose fiscal policy issues that

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[9] William J. McCarten, *The Challenge of Fiscal Discipline in the Indian States,* 2003. Available at: http://web.worldbank.org/archive/website01061/WEB/IMAGES/INDIA.PDF (Last Accessed on 10th December 2023).

[10] Peter S. Heller & M. Govinda Rao, *A Sustainable Fiscal Policy for India - An International Perspective*, Reserve Bank of India Occasional Papers Vol. 28, No. 1, 2007. Available at: https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/82936.pdf. (Last Accessed on 25th October 2023).

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are recognized theoretically and are shared by other federal democracies. Since the start of the 1990s, India's economy has expanded quickly despite significant and rising fiscal imbalances and debt levels.[11]

It would be very interesting to investigate whether India has managed to balance sustained expansionary fiscal policies with comparatively stable macroeconomic conditions. The fundamental goal of economic policy in the 1950s and 1960s was to accelerate economic growth through increased public investment and comprehensive economic planning.[12] Taxation was utilized as a tool to curb private spending and investment and to shift funds to the government, allowing it to make significant public investments to boost the economy. Additionally, tax policy was designed to achieve the following economic goals:

- *promoting employment through the provision of tax incentives for new investment;*
- *reducing inequality through progressive taxes on income and wealth;*
- *relieving pressure on the balance of payments through an increase in import duties; and*
- *stabilizing prices through a tax rebate in excise duties on consumer goods*.[13]

The goal of fiscal policy throughout the 1970s was to increase fairness and social justice, and both taxes and fiscal policies were used to achieve that aim. As a result, income tax rates were increased to extremely high levels. The government's spending grew over time to include increased subsidies in addition to its dedication to a sizable amount for development spending. In 1980s, the public finances were in a state of disorder, with the fiscal pattern disrupting the relationship between the economy and the budget. This led to constantly larger deficits that appeared to be difficult to solve.

India's monetary policy framework has seen a substantial shift since the early 1990s. This

includes changes in its aims, operational organization, tools, and communication. This transition occurred at the similar time when several laws and policies were changing around the world, which led to the adoption of inflation. The tax system in India underwent systematic and comprehensive changes only after the beginning of market-based economic reforms in 1991. The changes in direct tax incorporated the implementation of computerized systems, simplifying the tax administration process, diminishing exemptions and concessions, and

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[11] Mohan Rakesh, The Role of Monetary Policies, RBI Monthly bulletin, Dec. 2008. (Last Accessed on 21st October 2023)
[12] *Id.*
[13] Heller S. Peter and Rao Govinda, *A sustainable Fiscal Policy for India*, RBI Occasional papers, Volume 28, No. 1, Summer 2007 (Last Accessed on 5th November 2023).

rationalizing tax rates. The corporate income tax has undergone significant changes. The differentiation between privately held and publicly listed enterprises no longer exists. There have been substantial changes made to the indirect tax structure as well. Historically, both domestic excise taxes on manufactured commodities and customs taxes on imports were known for their high levels and large range of rates. In addition to reduced rates, the tax has also been progressively diminished.

Continuing growth and financial stability while maintaining India's fast economic process is the major problem relating to fiscal policy. Since the early 1990s, fiscal and monetary policy have generally been successful in putting the economy on a path of faster growth. Wide-ranging fiscal reforms were implemented during this time and are now beginning to show results in the form of greater revenue mobilisation, spending restraint, a decrease in the fiscal deficit, and the beginnings of a decline in the debt to GDP ratio[14].

The achievement of revenue buoyancy through tax compliance and rationalisation in the field of fiscal policy needs to be strengthened. Since a significant part of self-employed people continue to be exempt from paying taxes. More focus currently needs to be placed on further strengthening and modernizing tax administration than furthering tax policy improvements. This would make it possible for tax income to continue shifting from indirect taxes to direct taxes, promoting higher economic efficiency.

On the expenditure side, it has been a challenge to keep the subsidy burden under check, though its growth as a share of GDP has been restrained.[15] The assumption of a large reduction in these subsidies soon is not suited to the current global context of high oil, food, and fertiliser prices.

Currently, the outlook for medium-term changes in the prices of food and energy on the global market is not positive. Public action in these areas must therefore take expectations for the medium term into account. Smoothing out the costs of such essential items of common consumption is justifiable if excessive prices are thought to be just transitory. Since providing such subsidies over an extended period of time is likely to become unsustainable, it may be preferable to focus on helping individuals who are less fortunate and less able to handle these price rises directly rather than trying to keep prices low overall. If the demand for these subsidies continues, the recent practise of issuing bonds to pay for them is furthermore untenable. Consequently, the expected rise of economic development acceleration is likely to increase the government's expenditure as a proportion of GDP, which would be aligned with the historical

[14] *Id.*
[15] RBI, Available at: https://rbi.org.in/scripts/BS_SpeechesView.aspx (Last Accessed on 28th October 2023)

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trend seen in countries as their per capita incomes grew.[16] The primary challenge of Indian fiscal policy is how to manage a rise in public expenditure while maintaining fiscal consolidation and continuing to decrease fiscal deficits.

Hence, it is imperative to continuously adapt monetary management to meet the demands of a rapidly growing globalised economy. This calls for constant instrument and management system improvement, especially given that Indian monetary and exchange rate policies are anticipated to be increasingly influenced by global events. Financial depth and rising monetization are often seen as a country experiences fast growth from low-income levels. Consequently, the increase in monetary aggregates deviates from their previous association with the development of real GDP. The objective of monetary policy is to regulate this expansion while upholding price and financial stability.

V. Recommendations

Taxes have an impact on the economy because they determine the amount of money government must spend in particular sectors and the amount of money each person should spend. For example, tax reduction is one way the government can encourage consumer spending. Families gain more money from a tax cut, which the government hopes they will spend on products and services to boost the economy.

As an instrument of fiscal policy, spending is used to direct government funds to industries in need of an economic boost. As with taxes, the government hopes that these monies will be spent on other products and services by whoever receives them.

- **Balancing Act Between Tax Rates and Public expenditure:**

The aim is to strike a balance between tax rates and government spending. For example, promoting a slow economy with tax cuts or increasing expenditure- a strategy known as expansionary fiscal policy- may lead to rise inflation. This is because a rise in consumer demand coupled with an increase in the amount of money in the economy might lead to a drop in the value of money, meaning that it would cost more to buy the same item.

Consider that the economy has stalled. There is a rise in unemployment, a decline in consumer spending, and firms are not making big profits. A government may choose to increase the economy by reducing taxes, so giving consumers more spending money, while increasing government spending by purchasing services from the market (such as building roads or schools). By funding these services, the government generates employment and incomes, which

[16] *Id.*

in turn stimulate the economy. Pump priming is the process of pumping money into the economy by cutting taxes and increasing government spending, leading to a temporary reduction in unemployment rates.

Consumer demand rises when there is more money in the economy and less taxes to pay. Consequently, this brings businesses back to life and reverses the cycle from inactivity to activity. But if there are no limitations on this process, however, the increase in economic productivity may go beyond a very narrow line and lead to an excess of money in the market. This extra supply reduces the value for money and raises prices (because of the increase in demand for consumer products). As a result, inflation therefore exceeds a reasonable level. Therefore, modifying the economy through fiscal policy alone can be a challenging, but not impossible, and can be used as a means of achieving economic aims.

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