BOOK REVIEW

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POLITICAL ECONOMY OF POVERTY ERADICATION IN INDIA AND ESSAYS ON FISCAL REFORM

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Given the stature of the author, it is only befitting that the book has a foreword by Dr. C. Rangarajan. The book begins with a tribute to the author by Prof. Srivastava, who brings to the fore the magnitude and impact of the work of Prof. Chelliah in shaping India's economic policy. Prof. Chelliah has influenced policy making in India first via the platform of NIPFP, secondly as founding Chairman of the Madras School of Economics, and then as member of Tax Reforms Committee under Dr. L.K. Jha, as Chairman of the Tax Reforms Committee in 1991 and finally as member of Planning Commission. Besides his focus on tax policy, Prof. Chelliah's work on fiscal transfers, debt sustainability, environment and poverty have all been traversed in the tribute. In short, Prof. Srivastava unravels the spectrum of Prof. Raja Chelliah's multi-faceted contributions to fiscal policy in India.

The book is a collection of three essays: The three essays put together make interesting reading for students of economics and professionals who closely track changes in India's economic policy. For the policy maker it provides useful insights and a roadmap for action on the entire gamut of significant issues spanning poverty eradication, tax policy and intergovernmental relations.

Essay 1

This essay empirically validates the perception that regional disparities in growth rates, poverty levels and indicators of social development are large and widening. There seems to be a concentration of poverty and backwardness in a group of States that account for 50% of the population. The author argues that unless there is a significant change in approach and special attention is paid to the group which he calls 'Low Growth States', the problem of regional disparities cannot be tackled.

A historical-institutional detour is provided to contextualize the reform process in India. According to the author some governments in the Indian federation have become 'captives of backwardness'. In a largely backward society which has adopted Parliamentary Democracy, "backwardness" itself becomes an important factor affecting the political system and the way governments act.

There can be no argument about these principles enabling the States to get on to a higher growth trajectory and reducing the yawning gap between the economic progress of the States of India. There is no dearth of literature on the issue of convergence or otherwise across States of India. However, the search continues with some nuances which could help us zero in on policy variables that would help reduce divergences. In a recent paper Karnik and Lalvani (2010) find a relatively lower importance of investment in physical capital for the growth processes as compared to the contribution of social sector capital (as measured by educational attainment in this paper). We have also found that the convergence rates in the presence of enrolment ratios were much higher. One unambiguous policy recommendation that flows from these results is that the relatively backward states should boost their investment in human capital if they are to catch up with the better off states.

The agenda for action that the author sets out involves the following:

1. Civil society action to usher in modernization on four fronts: (a) Universal Education (b) Scientific Outlook (c) Political Transformation leading to a law abiding society and (d) Ethical Transformation wherein society exhibits socially beneficial conduct and adherence to principles of justice and equality
2. Central government to undertake special additional investments in Low Growth States to accelerate rate of growth. This, the author argues could be in the nature of direct intervention by the Centre or via Special Purpose Vehicles in flood control or large scale irrigation and infrastructure (especially power and rural connectivity)
3. Promote family planning as this would facilitate achieving targets
4. Central government and National Civil Society groups should come forward to help the Low Growth States as this would be in the national interest and the interest of the poor in those states
5. The Central government should bring about substantial changes in the principles governing loans and grants to States

Thus, while the author's agenda for action set out by the author is comprehensive we would like to add a special focus to human development in general, and education in particular, by the backward states.

Essay 2:

This essay chalks out the principles which must underlie the system of intergovernmental transfers, examines the flaws in the existing system and appeals for reform. Once again the logical flow, clarity in thought process and comprehensiveness makes this essay educative.

The fundamental principles that the author emphasizes which must be satisfied when designing a transfer system are (a) It must preserve the autonomy of sub-national governments i.e. States should have the freedom to spend within their jurisdiction, raising the required resources (b) The link between the decision to spend and decision to raise resources should be maintained at the margin (c) Volume of transfers should not be determined on the basis of actual gaps in revenue and expenditure nor on gaps which are moderated by the Finance Commission as this would create the wrong incentives for fiscal discipline (d) The formulae for transfers should remain stable for a reasonable period of time so that budgets can be planned and (d) Additional transfers should be made to the weaker states to equalize fiscal capacity.

Having laid down the basic principles as listed above, the author undertakes an evaluation of the existing arrangements for central transfers to the States. To begin at the beginning the author draws attention *to problems with the Terms of Reference (TOR) of the Finance Commissions (FC)* itself where the federal principle of giving States autonomy finds no place. The TOR of the Fifth FC formally initiated the gap-filling approach, which required the Commission to judge the efficiency of expenditure and tax efforts of States. The author points out that objective measures to assess the above are almost impossible. Moreover, the TORs also required a re-drawing of the base year of the States when making normative estimates, which is politically problematic and amounts to imposing the decisions of the Commission on the States. Thus, only minor modifications could in fact be made.

Several other problems associated with TORs of previous Finance Commissions have been extensively discussed in the literature. This includes focus on the non-plan side of expenditure alone leading to multiple agencies involved with transfers, focus on stabilization and sustainability of finances, use of the 1971 population. The Thirteenth FC had the following tasks also included (i) analysing the impact of implementation of GST from 2010; (ii) "measures required to improve the quality of expenditures to obtain better outputs and outcomes"; (iii) management of ecology, environment and climate change consistent with sustainable development the implications of ecological management and climate change; and, (iv) measures needed to ensure commercial viability of irrigation projects and departmental and non-departmental public enterprises (Rao et. al. 2008, Pethe, 2008). A welcome addition to the TOR of the Thirteenth Finance Commission was a look at the 'quality' of expenditure. While there is a genuine problem in including a 'quality' measure, the Thirteenth Finance Commission incorporated this aspect by considering Infant Mortality Rate as an indicator of quality. While there may be a difference of opinion on the appropriateness of this measure, the fact that an output indicator has for the first time been incorporated in Finance Commission transfers marks an important progress towards re-orienting the focus towards output measures.

The essay goes on to list out the economic consequences and drawbacks of the FCs approach so far (a) By treating tax sharing and grants-in-aid on par the FCs have not paid enough attention to their function as adjudicating authority between central government and states on the sharing of taxes (b) The approach of the FCs gives wrong incentives to the State governments as regards the management of their finances since budgetary gaps are filled and neither overspending nor not tapping their tax potential is penalized (c) Base year that FCs use are actuals (with minor modifications) thus implying that moderation of States' projections are not of much avail (d) The link between decision to spend and decision to raise resources has not been retained even at the margin (e) States that spend more over their tax effort i.e. show greater budgetary needs also end up with larger transfers (f) The first FC had stated that design of transfers should be such that State governments must be responsible for balancing their budgets. This, however, has not happened (g) None of the FCs except the First even referred to autonomy of the States within the framework of broad national policy (h) Debt Relief given by the FCs softens the budget constraint.

Finally, the essay takes a re-look at the methodology employed for determining Finance Commission recommendations on sharing taxes and determining grants-in-aid. According to the author the fresh approach should incorporate all the relevant principles, the right incentives and equalization of fiscal capacity. The author lists out three broad principles that must underlie the reform agenda. First, the formula of the share of taxes to be transferred to states must be fixed for a longer period. Secondly, grants-in-aid should be de-linked to budgetary gaps and thirdly, the States must be allowed autonomy in budget making. In addition to this reform agenda the author also provides a roadmap comprising of four specific steps (1) Relative share of State and Centre should remain fixed for 15 years (2) Tax sharing should be mainly for closing vertical gap. Population figures of recent census should be used along with GSDPs of States with weight of 75:25 (3) Equalizing grants should be given on the basis of measures of relative deficiency in fiscal capacity following the Canadian, German or the Australian models (4) End the bailing out of the States in the form of Debt Relief. The 12th FC made a move towards this by directing states towards market borrowings. According to the author the borrowings from the small savings should be made into loans from autonomous Small Savings Trust which will receive funds from Centre and give loans according to rules that would be linked to capacity to repay. The financially weaker states should be provided with some help to get specified minimum level of funds at a reasonable rate of interest but this help should be for short duration of 10-15 years.

The essay ends with an appendix where the author discusses the positives and negatives in the tax sharing arrangements and intergovernmental transfers in Germany, Australia and Austria. Interesting lessons are drawn from each.

This essay is comprehensive in that it addresses all the important problems in the existing system of intergovernmental transfers, lays down the underlying principles that must govern an ideal transfer system and provides a roadmap for reform. The lessons to be drawn from some comparable federations hold the reader's attention.

Essay 3:

The third essay is an appraisal of the Kelkar Task Force's (KTF) recommendations on Direct Taxes. The author is supportive of the broad approach to reform of the income tax enunciated by the KTF which has the following constituents: A broad base with very few exemptions, simple structure with limited number of rates, moderate progression. However, the author disagrees with many of the specific recommendations of the KTF.

Personal Income Tax

As regards the tax base the author feels that the KTF recommendation that long term gains on sale of equity and dividends in the hands of the individual taxpayer be abolished is unjustified. He makes two recommendations in this context (a) Tax on dividends be continued but a simple imputation system be introduced at a designated rate (b) Long term capital gains on equity should continue as KTF's suggestion of its exemption would favour the rich.

On deductions and exemptions the author disagrees with KTF's argument that there is no strong case for standard deduction for salaried employees. He is of the view that standard deduction should continue and the maximum be fixed at 5% of salary inclusive of conveyance and subject to a ceiling of Rs. 20,000. Further, the KTF recommends that all incentives to save be abolished and the threshold level be raised to Rs. 1 lakh. The author is of the view that tax *incentives for savings* may be provided in the form of (a) Full deduction of contribution to pension (tax only withdrawal) (b) Full deduction for contribution to and individual retirement account (tax on withdrawal) and (c) Rebate to be given at 20% for contribution to LIC or PF.

According to the author the way to *reduce distortions and broaden* the base is to make all interest income taxable and also withdraw all tax free bonds.

As regards *housing loans* the author says that interest payments up to Rs. 1000 per month should be tax exempted and that the amount recommended by KTF is too generous.

Finally, on the rates of personal income tax the author is of the opinion that given the large inequalities that prevail, it would be appropriate to fix the top marginal rate at 35% but maintain the marginal rate of 30% for the large majority of taxpayers. Entry level above Rs. 1 lakh at the rate of 20% seems appropriate to the author. These rates are higher than what the FM announced in the budget speech 2010-11. Presently, the entry level income is tax exempt up to Rs. 1.6 lakhs and at the top end the highest marginal rate of 30% is applicable to income above Rs. 8 lakhs. Clearly, there is scope for making the existing tax structure more progressive when we juxtapose the existing tax structure with that suggested by Professor Chelliah.

Agricultural Income

The author does not agree with the KTF recommendation that the agricultural income above Rs. 1 lakh be brought under central income tax. Instead he recommends that agricultural incomes of non-agricultural assessees be added to their non-agricultural income and be subject to full taxation. The share of tax attributable to agricultural income could be handed over to the state from where it is collected. However, this would require greater effort on the part of income tax department but if this happens and the law is appropriately changed then the non-agricultural assessees will not be able to bring down their tax liability by showing part of their non-agricultural income as agricultural income.

Corporate Profit Tax

The author agrees with the KTF that the number of exemptions and concessions must reduce but feels some of them could continue. Specifically, he takes issue with the KTF recommendation of converting donations to rebates as he feels that the argument they make for doing so is flawed. Further, the author is of the opinion that the KTF recommendation of going back to claiming depreciation for individual assets, as against the existing system of block of assets, would entail extra compliance cost. The author is of the view that reduced taxable income on account of his suggestions could be addressed by keeping the rates somewhat higher i.e. at the existing 35% for domestic companies. Also, a ceiling of 50% could be placed on the depreciation.

Charitable Trusts

The author disagrees with the KTF recommendation to replace contributions as deductions to rebates as mentioned previously. Also, the KTF recommends that all charitable institutions must file income tax returns. The author, on the other hand feels that it would be sufficient if we require all registered charitable institutions who submit their audited accounts to the Registrar of Societies to do so to a designated income tax office and others should be asked to file their returns only if their gross income exceeds Rs. 10 lakhs.

Wealth Tax

The KTF recommended that Wealth Tax on unproductive wealth be abolished but the author feels that this is not justified and must continue as it is.

The overall view of Professor Chelliah in this essay is that while the broad direction of KTFs recommendations of widening the base and reduction of exemptions is acceptable, many of the detailed recommendations are not. Specifically, the author firmly believes that the abolition of taxes on wealth, on dividends in the hands of shareholders and on long term capital gains are unduly in favour of the rich.

Conclusion

This book by Professor Chelliah lives up to the high expectations that it raises. It is comprehensive in content as it traverses the ground of poverty and regional inequalities in the Indian economy and addresses two key fiscal issues viz., intergovernmental transfers and direct tax reform, addressing which would help all states rise to a higher growth trajectory and bridge in some measure the widening gap in economic development of the States.

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