Financing for Development*

N K Singh

Introduction

Financing for development is a broad issue because the resources needed for multifaceted and inclusive development is a collective effort of many stakeholders. No doubt, public outlays, which have a direct and catalytic impact, need to be financed by the central and the state governments. The financing needs of the general government, therefore, significant as they are, must be consistent with the overall macroeconomic stability. This means debt sustainability and manageable fiscal deficits. A significant stakeholder in the process is the corporate sector: large, small, medium, and micro industries. Their development plans, ambitious as they may be, need savings after a significant foreclosure to meet the needs of the government, both central and state. External capital and borrowings need the terms and conditions of debt to be acceptable. Project viability needs low-cost and long-term debt, both from internal and external sources. Enhancing total factor productivity implies incremental improvements in capital output ratio and harnessing nascent technology. The multiplier effects of digital technology in all our economic activity patterns will alter the culture of innovation. Harnessing demographic dividend necessitates investing in human capital – education and health. And, a burst of innovation alters the productivity curve of the economy. These are integral to the development dynamics.

The decision of the International Monetary Fund (IMF) to revise India's potential growth forecast to six percent from 6.25 percent citing the pandemic is "a gross underestimation for

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Professor S K Goyal Lectures

Professor S K Goyal
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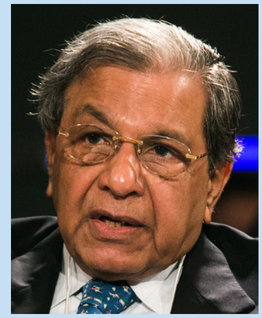
The Professor S K Goyal Lecture Series has been instituted by ISID in the memory of its founder, Late Professor Surender Kumar Goyal. Prof S K Goyal leaves behind a rich legacy in development research and institution-building. Prof Goyal's intellectual journey spanned a wide range of themes including industrial and trade policies, planning, public sector, monopolies, foreign capital, and corporate governance. Prof Goyal led preparation of a report on the issues relating to bank nationalisation in India laid the foundation for the historic bank nationalisation in 1969. As Honorary Economic Adviser of the Industrial Licensing Policy Inquiry Committee (1967–69) he realised the fact that the statistical system of the day was not geared to meet the requirements of a planned economy. He assembled a group of young scholars at the Indian Institute of Public Administration (IIPA) where he was a Professor of Economic Administration. Thus the Corporate Studies Group (CSG) was born. He inspired the scholars at the CSG and impressed upon the need to undertake empirical research with clear policy connotations. The CSG was institutionalised as the ISID in October 1986. ISID came under the fold of ICSSR in 1987–88 and moved to its own campus in Vasant Kunj Institutional Area in New Delhi in 2006. Along with institution building, Prof Goyal made strenuous efforts to unravel the phenomenon of MNCs and the need to take a pragmatic rather than dogmatic view of their contributions, by host developing countries.

2021-22." Calculation of the growth potential has always been problematic. Various statistical techniques and structural models are used to determine the trend in the cyclical part of the gross domestic product (GDP). One of the main structural methods is the Hodrick-Prescott filter, which extracts a trend reasonably in line with the evolution observed in output, is smooth, and does not change too much from year to year. This is dependent on the smoothness, given that the basic production factors – labour and capital – are relatively inertial and that new technologies are slow to spread. This makes contemporary estimates of potential output more problematic.

The Finance Commission, over the medium term, projected a nominal GDP growth of 11.5 percent, implying a real GDP growth of around seven percent. No doubt, this also would be an underestimation because for sustained GDP growth we need to significantly accelerate growth in real terms to meet the inescapable obligation of financing large public outlays, both physical and social infrastructure. For long-term poverty elimination, there is a need to ensure that those who escape poverty do not go back into it because of exogenous factors like the pandemic; this is contingent on significantly enhanced public outlay. A rising curve of public outlays, if not matched with enhanced savings, can be debatable of how much is it starving the private sector to finance their investments. There is an inevitable choice between not crowding-out private investment and crowding-in effect through investments that enhance opportunities for private investment. The line of distinction between the crowd-out and the crowd-in needs careful calibration based on a number of evolving factors. At any rate, financing a sustained seven percent real growth in GDP numbers consistent with macroeconomic stability also requires restructuring of resource mobilisation endeavours.

Tax Revenue

Even before the pandemic, resource availability has been a persistent challenge for many federations across the world. Although tax revenue has been rising over time, India's general government revenue as a percentage of GDP is the lowest among the BRICS countries – below the OECD average – given the smaller portion of the population that pays income and property taxes.



Mr N K Singh is a renowned politician and economist. He chaired the 15th Finance Commission and is currently the President of the Institute of Economic Growth. Until recently, he was a member of the Rajya Sabha. As one of the country's top bureaucrats, he has handled important portfolios such as Secretary to the Prime Minister, Expenditure and Revenue Secretary, and Member, Planning Commission. He was also the principal interlocutor with multilateral institutions during India's balance of payments crisis. His autobiography *Portraits of Power: Half a Century of being at the Ringside* (2020) has received wide acclaim.

The tax revenues of the union and the states pre-pandemic were around 17 percent of the GDP, and have remained constant since the early 1990s. The cesses and surcharges earmarked by the union government have also increased over time to about 15 percent of gross revenues. There is a need to raise India's tax ratio from both macroeconomic and redistributive perspectives; this is essential for enhancing fiscal space.

International experience suggests that comprehensive tax reforms can be implemented without imposing higher burdens on the poor with great progressivity in the tax structure. The move towards a goods and services tax (GST) is a step in the right direction.

In respect of GST, first and foremost it must be recognised that this was a path breaking reform. While it commenced in the 1990s, and was in discussion with international organisations in multiple ways – moving from integrated VAT to integration of variable and differentiated excise matrix of states, its formal enactment had to await broader consensus in 2017. It is only under the leadership of the Prime Minister, assisted by the late Finance Minister Arun Jaitley, that a consensus was reached with the states on GST. The recent revenue data are very encouraging making up on lost time. Nonetheless, there are some serious medium-term challenges.

First, the inverted duty structure with multiple rates and the balance in the structure of intermediates and final products have important revenue implications. As pointed out, "One of the important reasons for the higher than 50 percent input tax credit could be the inverted duty structure for many items. This can be corrected even without the weighted effective tax rate going up, with a salutary impact on net revenue collections of the general government."

Second, on compliance, the issues of fake invoice, and recalibrating the technology platform by overcoming technical glitches can bridge the yawning gap between realisation and potential.

Third, the issue of a revenue neutral rate (RNR) is a challenging one. As per the Fifteenth Finance Commission Report, "A change in tax structure can be said to be revenue neutral if the modified tax is able to realise revenue comparable to the original tax regime, relative to the tax base." From this point of view, the revenue neutrality of GST stands compromised, i.e. the average GST rate which is currently around 11 percent needs a fundamental change. The task force appointed by the Thirteenth Finance Commission suggested a RNR of 12 percent; IMF suggested 11.6 percent; the National Institute of Public Finance and Policy (NIPFP) suggested 17 percent; and, the former Chief Economic Advisor suggested a rate of 15 percent. The Fifteenth Finance Commission proposed a model where GST would be recalibrated over the medium term, including broad banding of rates. However, the goal has remained elusive. Nonetheless, compressing 12 and 18 percent into a rate consistent with the RNR will make a fundamental difference.

Fourth, in respect of streamlining the customs duty structure, three important steps will be useful. The following mix of customs policies for positive gains is recommended:

- Broad banding industrial finished products
- Broad banding intermediate industrial products and industrial raw materials
- Continuing with zero rating of imports to facilitate global value chain-related exports
- Streamlining and reducing non-tariff barriers.

Fifth, the overall issue of direct tax, particularly personal income tax. It is a strange area of a very skewed tax realisation. As per the Fifteenth Finance Commission Report, "Out of the 5.53 crore individuals that filed returns in this segment, 40.5 percent did not pay any tax. Another, 53.2 percent, whose annual income averaged ₹5.6 lakh, paid a tax of ₹22,538 each on an average, which means an effective tax rate of only 4 percent. Their contribution to tax collections accounted for about 21 percent. The remaining 6.3 percent accounted for about 79 percent of tax collections under personal income tax. This skewed picture emerges because of the plethora of exemptions and deductions, lack of effective surveillance and also the structure of tax slabs and rates."

Undoubtedly, having opted for moderate tax rates, there is a need to move forward in implementing the recommendations relating to personal income tax by way of reviewing exemptions under different tax law; expanding coverage of provisions relating to tax deduction at source (TDS) and tax collection at source (TCS) to capture more transactions, which leave behind an audit trail; and, closer co-ordination between agencies involved in TDS and TCS. Credible steps have been taken to improve the settlement and realisation of huge stock of disputed tax demand efforts. This requires creating a mind-set of departmental resolution, assigning of powers for freeing up tax litigation, and strengthening adjudicatory institutions.

Sixth, there are other issues relating to stamp duties where the higher the stamp duty, the greater the propensity to undervalue property – both stamp duty reforms and property tax reforms are the flipside of the same coin.

Seventh, with regard to corporate taxes, India's corporate tax rate compares very favourably to other competing destinations. In September 2019, the base rate was slashed to 22 percent from 30 percent for those domestic companies which do not avail of exemptions. But this steep reduction in tax rate did not yield tangible results. Hence, the Finance Commission has made some important recommendations which over a five-year timeframe will more than compensate for the revenue lost on account of reduction in 2019 given the lags and expected response of new investments.

Eighth, in respect of profession tax, the current figure of ₹2,500, fixed in 1988, came through a constitutional amendment. This is unscientific and has no basis. It is an important source of revenue to the three-tier institutions and requires necessary constitutional amendments which defreeze this and index it to inflation.

This has been calculated "from the implicit GDP deflator for each year. By this method, the upper ceiling of annual profession tax of ₹2,500 fixed in 1988 at 1988 prices works out to around ₹18,000 at 2019–20 prices." Freeing up profession taxes from the unscientific changes introduced through a constitutional amendment will go a long way in improving the finances of local bodies and state governments.

In summary, we suggest the following five steps:

- Undertake revenue administration reforms in parallel with tax policy changes;
- Broaden the base for both direct and indirect taxes by reducing exemptions and improving compliance;
- Shift focus to indirect taxation through the value-added tax, with simplification and greater efficiency being the key drivers of revenue gains;
- Sustain the revenue increase through administration reforms in key compliance areas, including risk-based audits, filing and reporting; and,
- Build revenue from local government property taxes.

This must be seen in the broader context not only of the stagnant revenue to GDP for a decade, but also the inability to meet the financing requirements compared to other peer group countries. The Finance Commission had requested the IMF for a detailed study, which came to the somewhat startling conclusion that the large gap in tax collections is more than five percent of GDP compared to its potential.

Public-Private Partnership

Public-private partnership is a concept where, for multiple reasons, the expected blend between private capital, managerial practices, and innovations being harmonised with projects financed or to be financed through public outlays has unfortunately been a mixed experience. There is no doubt about some very notable successes where such partnerships have benefitted all stakeholders, most importantly, the consumers themselves. There are others where the private sector has complained of excessive bureaucratisation, absence of autonomy, and an onerous compliance culture. Very often, many such arrangements are pejoratively referred to as 'sweetheart deals' where large public investments have not been able to secure expected rate of returns. The issue of assignment of risk, risk mitigation, and insurance against emerging exogenous or sudden risks beyond force majeure has eluded consensus. There was a proposal to have a legislative framework by a committee headed by the eminent economist Dr Vijay Kelkar, who came to similar conclusions. The needs of the economy are multiple and growing. A legal architectural framework on PPP will add enormous value. Emerging issues like, for instance, retrospective amendment of contracts based on emerging technologies have stymied entrepreneurial instincts and large private capital flows. The broad issue of risk mitigation, modalities of mitigation, and the modes of financing options need greater consensus.

Energy Transition

There is a need to focus research on emerging challenges such as energy transition. India provided great leadership at the 2019 United Nations Climate Change Conference, also known as COP25, which resulted in the Solar Alliance. Since then, we are on track to fulfil our nationally determined contribution of reducing emissions intensity by 33–35 percent of GDP by 2030. Prime Minister Modi's recent call for 'One Sun, One World, One Grid' has international resonance and moral appeal. Nonetheless, an orderly energy transition.

An orderly energy transition may cast a huge burden on the financial resources of the union and the states; however, it is inescapable. India's per capita emission is among the lowest and has a long way to go before it approximates, leaving aside the developed countries. India may be the third largest emitter of greenhouse gases below the US and China, but our per capita income is one-tenth of US and one-third of China, with far lower power consumption of 972 kilo hertz per person, which is eight percent of US and perhaps 20 percent of China. Yet, addressing the issues of poverty, improving life quality, physical and social infrastructure, and improving human resource skills will inevitably require cleaner sources of energy by a factor of even six to seven times.

The issue of an appropriate carbon tax, which overcomes issues like carbon arbitrage, has been in recent focus. A recent article in the *Financial Times* by the Director General of World Trade Organisation, Ngozi Okonjo-Iweala, recalls the

Stern-Stiglitz Commission on Carbon Pricing between $50 and $100 per tonne of CO_2 as a carbon tax. Who is to bear the burden of this tax? How is the tax to be realised and transferred in a manner that does not cripple our exports through non-tariff barriers? Continuing to use trade as an important engine of growth needs meeting orderly financing arrangements for enabling our transition to the new energy economy.

At the same time, reducing fossil fuels drastically to enhance solar power to, say, 5,600 GW by 2070 is an issue. The human resource and livelihoods of those engaged currently in fossil fuel production like coal have a huge economic cost. Simultaneously, adapting to energy changes, mitigating its impact and building an energy resilient infrastructure is equally costly. Public outlays alone have serious fiscal constraints. Garnering private capital is competitive as also access to newer technologies. We would need multiplicity of actions to enhance our domestic resource capability. For the international community and multilateral development banks, readapting their lending norms in imaginative ways, creating insurance buffers private capital, and risk mitigation is central to this exercise.

Conclusion

Inevitably, improving our revenue performance by implementing some of the measures mentioned above would be central to this objective. Our development challenges, however, are becoming increasingly more complex. A new architecture to buttress public-private partnership would be inescapable. Harnessing the resources of multilateral development institutions both for providing additional capital and, more importantly, in risk mitigation for crowding in private capital is a challenge. This is an area where availability of public and private capital and using multilateral institutions imaginatively is the forward path. Financing development needs resolving legacy issues. It equally means addressing new emerging challenges. To achieve the goals, a multifaceted approach is the path forward.

Finance for development must be viewed in the broader context of what development means. Einstein had very correctly said, "All that is valuable in human society depends upon the opportunity for development accorded the individual." Development must accord opportunities to individuals. It is about transforming lives of people, not just transforming economies.

ISID Policy Briefs

- **Speical Economic Zones and India's Industrialisation: Opportunities, Challenges, and The Way Forward**, #22-01, January 2022.
- **Harnessing Industry 4.0 for India's Development: Opportunities and Challenges**, #21-04, December 2021.
- **Making the TRIPS Agreement Work Effectively for the Public Health Challenges**, #21-03, October 2021.
- **Reigniting Sustainable Growth of MSMEs in the Aftermath of Covid-19 Pandemic**, #21-02, September 2021.
- **Competitive Manufacturing as a Growth Driver: Some Policy Lessons for India**, #21-01, June 2021.

ISID Institute for Studies in Industrial Development
An institution of Indian Council of Social Science Research (Ministry of Education)
4 Vasant Kunj Institutional Area, New Delhi - 110070, India