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An analysis of Fiscal Prudence in Germany and India

Study by

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Executive Summary

When monetary policies have not been deemed sufficient to dampen the cycles of an economy, especially during a downturn with the risk of an extended period of recession, fiscal stimuli have been the tools for governments to intervene and kick-start the economy by altering demand in the economy. This was seen in the face of the financial crisis of 2008-09 across the world. These measures added to fiscal unsustainability in national budgets and hence, led to arguments for fiscal consolidation with core Europe leading the way. But with the low-growth economic scenario faced by developing countries, fiscal consolidation may in fact cause more long-term harm than benefits. This debate is analysed in this paper in the context of fiscal policies in Germany and India – with Germany being representative of developed economies and exemplary fiscal consolidation implementation and India, representative of developing economies. The paper also attempts to identify the various policies that drove fiscal consolidation in both countries by looking at historical trends in government accounts and consequently, identifying low hanging fruit for further consolidation.

Foreword

Since the formation of the European Union, Germany has upheld the benefits of fiscal prudence and has insisted that all members of the union abide by the principle of aiming for a balanced government budget. Even when faced with an adverse economic situation, Germany has followed a policy of restricted government expenditure, prudent policies aimed towards fiscal consolidation, structural reforms and a balanced budget. These have borne fruit in recent times, when Germany was able to weather the financial crisis of 2008-09 in a much better way than other developed countries and emerged stronger. It is one of the few countries that enjoy a fiscal surplus and low unemployment rate. India, on the hand, has had a history of rising government expenditures and uncontained fiscal deficit, which has led to deterioration in government accounts. Following the financial crisis, India faced a low growth environment, increased fiscal deficit and high inflation, which has made it difficult for the government to undertake fiscal consolidation. An assessment of the contrasting economic situations of the two countries and an analysis of the effects of fiscal policies and reforms in the two countries provides lessons that the two countries could learn from each other's experience. This paper will highlight fiscal consolidation issues, identify areas for reform that could lead to fiscal stability over the long-term in India and will provide an overview of the investment climate of India.

Chief Executive and Director
ICRIER
Dr. Rajat Kathuria

Chapter 1 Introduction

Governments are equipped with monetary and fiscal tools to alter the economic cycle of boom and bust by either boosting demand or cutting supply. While the monetary tools are primarily the domain of Central Banks, the fiscal tools lie in the hands of government and policy-makers. Fiscal deficit is defined in this context as the difference between government revenues and expenditures. In recent times, when the downturn in economies has been severe and monetary policies have been unable to attain objectives of boosting growth among other goals[1], policy-makers have turned to fiscal tools to contain the extent of recessions. While the debate continues on the multiplier-effects of such measures and the timing of the same, these tools continue to be deployed in the hope of fulfilling economic objectives.

Furthermore, since fiscal deficits have an impact on the balance of payments[2], it becomes more important in terms of policy implications. Since the current account deficit/surplus is a component of the balance of payments accounts, this combined with the capital account determines the changes in reserves to maintain the equation; and when both act counter-productively to an economy, this may result in payment crises, debt defaults or other eventualities depending on the approaches taken by countries. When fiscal deficits are experienced by an economy, the build-up may negatively affect the growth prospects of the economy. This debate gives rise to fiscal prudence wherein economies seek to keep the fiscal deficit within a defined boundary by utilising fiscal tools available. What these boundaries may be is debatable. While some look towards a fiscal balance, others advocate 3-5 percent of deficit as sustainable while some may also advise a surplus. The process of reducing fiscal deficits is known as fiscal consolidation.

This paper attempts to identify the major fiscal policies that have historically had an impact. With debates and impacts being different arguably for developed markets and emerging markets, the paper tries to draw an analogy to these by looking at fiscal policy changes and its impact in Germany (as an analogue to developed markets) and similarly, undertake the same exercise for India (an analogue for developing markets). Further, the paper attempts to delve deeper - from the central to state and local government level - to identify the major fiscal policy changes, to better understand these fiscal policies and to analyse the impact of these changes. To conclude,

[1] These objectives differ for different countries but have similar underlying principles of economic growth, exchange stability, price stability and higher employment. Additional objectives may or may not be the same such as credit control, reduction in inequalities of income and wealth, creation and expansion of financial institutions, promotion of fixed investment, restriction of inventories, promotion of exports and food procurement operations, desired distribution of credit, promotion of efficiency and reduction of rigidity.

[2] Based on a paper by Douglas Bernheim, *Budget Deficits and the Balance of Trade,* national accounting can be shown to be $T-G = (X-M) + (I-S)$ where T= taxes, G= governmental goods, X= Exports, M= Imports, I= private investments, S= private savings which tantamount to Fiscal Deficit = Current Account Deficit + Difference between Investment and Saving (which can be termed as domestic borrowing or domestic debt)

the paper attempts to highlight a few policies that have had good and adverse outcomes as a basis to critically analyse the policies in the given economic scenario.

To sum up, this study looks at the following areas which have contributed to the current fiscal situation of both countries:

- Trends in Government Account for Germany and India – Combined, Federal, State and Local level
- Expenditure and Revenue components of the Government Account for both countries
- Financial relations between Centre and State
- Fiscal Policies which have had a significant impact on Germany – Pension reforms and Labour market reforms
- Fiscal Policies which have had a significant impact on India – Fiscal Responsibility and Budget Management (FRBM), Value Added Tax (VAT), Direct Tax Code (DTC) and subsidies
- Tax Administration
- Subsidies
- Debt

It should be noted that due to very different economic and social structures for both countries, comparisons are unlikely. However, due to similarity of the external debt, subsidies, federal relations between the 3 layers of government, lesser control on monetary policies provide substantial grounds for comparisons and mutual learning in some areas of interest. There are areas for improvement and learning within the tax administration as well. However, other areas provide less insight towards mutual learning on the fiscal front. On the monetary front, Germany's capital account convertibility, open economy and consistently higher country rating of AAA (S&P) against India's lack of capital account convertibility, somewhat closed economy and a rating of BBB- (S&P) render comparisons futile. To conclude, the paper points out the differences between the countries, identifies the advantages and disadvantages faced by various policies which have had significant impact on the economy and comments on the policies in the near future that need to be undertaken.

1. Introduction to the Global Financial Crisis and the Ensuing Policy Debate

The Global Financial Crisis (GFC) was precipitated by the collapse of Lehmann Brothers. While signs of deterioration in asset qualities were being seen earlier, the bankruptcy of Lehmann

Brothers marked a significant change in the availability of liquidity in the market. It escalated the underestimated systemic risks in the system giving rise to defaults, losses and lack of confidence in the markets. The GFC marked the start of recession in the advanced economies' rallying markets and the corrections seen pointed towards a more severe depression than the Great Depression. This effected extraordinary monetary responses to ensure liquidity in the global economy for the proper functioning of the financial markets and further led to fiscal policy responses as well. To address the spill-over effects of individual actions in a global, inter-connected financial system, coordinated fiscal stimulus packages were unleashed. The ensuing drop in growth rates and rising unemployment led even conservative countries such as Germany to stretch its balance sheet (Shome, 2012) to rescue failing banks and revive economic growth. These stimuli in addition to recapitalisation of banks, purchase of toxic assets by governments as well as deterioration in quality of assets placed many countries' sovereign fiscal position on a risky precipice. An explosion of sovereign debt in peripheral economies in the Euro zone has already been witnessed with subsequent erosion of the concept of 'risk-free sovereign bonds' leading to enormous bail-outs such as in Greece. The peak of the GFC and the subsequent 'sovereign crisis'[3] has intensified the debate over the kind of fiscal policies to be implemented - stimulus or austerity? (Corsetti, 2012). Supporters of fiscal stimulus argue that recapitalising banks and purchase of bad debt will ease the lending constraint and therefore boost aggregate demand. Whereas supporters of austerity argue that pumping more money into banks will only increase sovereign indebtedness when banks are already holding high cash reserves and are unwilling to lend. Also, sovereign bail-outs of distressed banks and financial institutions without an orderly mechanism would lead to moral hazards in the financial markets. Further, they argue that spending-based adjustments are less recessionary and will have positive impact on growth. Hence, they propose spending cuts along with easy monetary policy and appropriate structural reforms like liberalisation of goods and labour markets.

2. Germany and its Policies

Germany's fiscal prudence could be attributed to its institutions that impose fiscal discipline. These institutions create fiscal rules, ensure transparency in the budgetary process and hence, help manage fiscal deficit and public debt. The functioning of these institutions is based on four broad pillars: budgetary target, strictly limiting debt control, balancing the expenditures and an

[3] It has been termed by many that after the financial crisis originating in US due to the collapse of Lehmann, a subsequent sovereign crisis occurred in Europe where peripheral countries far exceeded the debt-to-GDP ratios which were set as norms to be part of EU due to manipulative accounting/non-disclosure as was the case of Greece - thus leading to concerns over the existence of monetary union. These economies were 'bailed-out' by providing loans by the rest of Europe primarily Germany in exchange for austerity measures to be undertaken in the early phases to bring fiscal imbalances in place. But the evolution of sovereign debt crisis across peripheral Europe has led to the notion that austerity and quick fiscal consolidation can choke growth leading to unintended consequences. Historically, fiscal consolidation has been backed by high growth. Implementation in a low growth environment creates natural political disincentives and economic rationale is required to evaluate the speed of austerity needed to sustain unhindered growth in the economy.

independent fiscal council (Bernadett and Gyöngyi, 2012). Germany has instituted a strong system to ensure fiscal discipline along these lines:

- First, the Golden Rule initiated in 1969 allowed deficit financing only for capital investment and strictly forbade financing current expenditure;
- Second, debt brake limits introduced during the GFC 2008-10, allowed the federal (Bund) and the state (Länder) governments to run cyclically-adjusted deficits with clear guidelines to reduce the deficit from 2011 onwards, and to strictly balance the budget from 2020 onwards, barring catastrophes and recessions;
- Third, The German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung), an independent academic body, is mandated to assess the macroeconomic situation and forecast public finances to ensure fiscal transparency and sustainability;
- Fourth, the federal government is also constitutionally constrained from making any large fiscal commitments i.e. the first Greek rescue package and the European Financial Stability Facility (EFSF) had to be upheld by the Constitutional Court that these initiatives were compatible with German Basic Law.

Germany's commitment to adherence of the provisions of the Stability and Growth Pact – Council Regulation, on strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies have had a prudent effect on the fiscal balance. The guiding principle of the federal government's fiscal policy has been a two-pronged strategy consisting of structural consolidation of public budgets, net of cyclical and temporary effects and strengthening Germany's economic growth potential.[4] In addition to the quantitative consolidation, the qualitative improvement of public finances has been a core driver of fiscal policy actions. The effectiveness and efficiency of government spending to be improved in all areas is an outlined objective pursued with the planned modernisation of the federal system of budgeting and accounting. These principles render Germany an ideal case study to understand fiscal policies undertaken and its implied effect on the economy since the German government does not have an independent monetary authority owing to the European Monetary Union. Going forward, it should be noted that Germany comprises of 3 layers of government: Federal, Lander and Commune. We use the terminology "General Government" to refer to all the three layers combined rather than just the Federal level of the government.

3. India and its Policies

India's public finances were prudent until the early 1980s as a response to a conservative fiscal policy. There was a surplus in revenue receipts of the central government over revenue

[4] Fiscal and Economic Policy, *German Stability Programme,* December 2008

expenditures which helped in financing of deficit on the capital account of the central government. Subsequently in the mid 1980s fiscal prudence was abandoned, resulting in sharp deterioration in the public finances of the Indian economy. The eruption of the balance of payment crisis in 1991 totally devastated the fiscal situation of the Indian economy. In response to the crisis, the government undertook a series of structural economic reforms, which are widely known as economic reforms of 1991 which brought down the fiscal deficit from around 9 percent in 1986-91 to 6.5 percent of GDP in 1992-97. However, the fiscal improvement after the economic reforms was discontinued during the late 1990s, as a mixed response to unstable coalition governments in India and eruption of the Asian crisis in 1997, which further debilitated the growth of the Indian economy. To break this trend and to bring fiscal prudence, the Indian government introduced the Fiscal Responsibility and Budget Management (FRBM) Act in 2004 at both the central and state government levels. This Act is similar to the Maastricht Treaty and Stability and Growth Pact (SGP) of the European Union, enacted in 1999, which aimed to bring down the central government fiscal deficit to 3 percent of GDP by 2008-09 with an annual reduction target of 0.3 percent of GDP per year. Further, the FRBM Act targeted a zero revenue deficit and primary surplus by 2008-09. The targets laid down in the Centre's FRBM Act and fiscal responsibility legislations of the states were achieved in 2007-08, a year ahead of schedule, except for the Centre's fiscal and revenue deficit targets, which were missed by a small margin.

These targets were mechanically achieved, compressing essential expenditure on infrastructure, health and education, while maintaining subsidies and loan waivers. However, the fiscal situation would not look that favourable if the off-budget bonds on oil and fertiliser are included in those years. In the run up to the elections, the Indian government could not adhere to the self-imposed rules on spending cuts, and this again widened the fiscal deficit (Buiter and Patel, 2010). The fiscal situation was reversed sharply in 2008-09 as the government undertook a number of measures to stimulate the economy in the wake of the global crisis along with uncontrolled expenditures. Thus, the need for fiscal consolidation and the achievement of fiscal sustainability continue to be the key macroeconomic issues confronting Indian policy makers. The fiscal situation is expected to improve now as the government has brought back its focus on fiscal consolidation in the 2012-13 Union Budget. Fiscal reforms in government expenditure have started to facilitate short-term fiscal consolidation. However, uncertainties remain on the revenue side of the government. For instance, the situation on long-pending direct and indirect tax reforms will only get clarity after the general elections in 2014.

4. Future of Fiscal Prudence & Consolidation

Moving the discussion to fiscal prudence, it has been revealed that fiscal risks and buffers required to protect economies from crises are much larger. For example, headline fiscal surpluses can mask large structural deficits during asset price booms, and contingent liabilities stemming from large internationally-connected domestic banks can dwarf reported public debts (IMF).

Earlier fiscal sustainability assessments were conducted on headline fiscal balances and debt ratios. In light of the crisis, this has been expanded to account for the underlying (structural) fiscal position, to also ascertain the probability of events that could threaten fiscal sustainability and the speed with which markets' perceptions of sovereign risks can change. The official debt ratio fails to reflect contingent liabilities which are often underestimated until they materialise (Irwin, 2012). This argues for a much lower 'safe' debt level than was thought necessary before the crisis (Ostry and others, 2010; Blanchard, Mauro, and Dell'Ariccia, 2013). On the other hand, some advanced economies considered safe havens (Japan and US) have been able to tolerate much higher debt ratios than previously thought (Mendoza and Ostry, 2008; Ostry and others, 2010). The crisis has prompted research into measures for fiscal space as Aizenman and Jinjarik (2010) do so by using debt-to-revenue ratio as a simple measure of fiscal space; while Bi and Leeper (2012) propose the notion of country-specific fiscal limits (defined as 'the point at which for economic and political reasons taxes and spending can no longer adjust to stabilise debt,') at which point, fiscal space runs out. Recent IMF research has developed a new definition of fiscal space as the distance between the current (or projected) debt ratio and the debt limit, the point above which the sovereign loses market access (Ostry and others, 2010; Ghosh and others, 2013). The debt limit is determined by the maximum primary balance (PB) that can be sustained both economically and politically (i.e. the fiscal limit) and the interest rate-growth differential (r-g), which is the difference between the real interest rate on public debt and the real GDP growth rate (IMF, 2011b).

While different debt targets will be appropriate for different countries, a target of bringing gross debt down to around 50 percent of GDP can be supported by some arguments (OECD Economics Department Policy Notes, No.11). For example, empirical estimates suggest that changes in the functioning of the economy occur around debt levels of 70-80 percent of GDP. Interest rate effects of debt seem to become more pronounced, discretionary fiscal policy becomes less effective because offsetting private saving responses become stronger and trend growth seems to suffer. The differential between the growth rate and the interest rate is also an important determinant of long-term sustainability, with higher interest rates on government debt relative to growth rates implying a need for more fiscal consolidation (OECD Economic Outlook). Based on a cross-country panel analysis, Alesina and Ardagna (1998) argue that frontloaded fiscal adjustment: (i) maximises debt reduction, since the earlier a country achieves a high primary surplus, the higher would be the cumulative primary surpluses and therefore the more debt reduction; (ii) minimises corporate and household uncertainties about (future) fiscal consolidation needs, which would otherwise weigh on private demand; (iii) boosts market confidence (especially in countries experiencing sovereign stress) and lowers government yields, with knock-on benefits for both fiscal indicators and private investment; and (iv) is associated with higher long-term growth and more durable debt reduction. But the choice of appropriate speed of adjustment has to weigh the costs (i.e. adverse short-run effects on growth) against the benefits (i.e. reduction in sovereign risk) of a faster adjustment. This is supported by the view

that excessive frontloading can hurt growth to the point that it undermines social and political cohesion, and weakens rather than strengthens market confidence (Cottarelli and Jaramillo, 2012). In such a scenario, the frontloading efforts might be self-defeating. According to Eyraud and Weber (2013), the initial level of debt-to-GDP ratio must already be high and the negative growth impact on the denominator of the debt-to-GDP ratio must be large enough to increase the debt ratio in the short run.

In light of these studies and research regarding the effectiveness of fiscal stimulus which was seen to be applied with vigour to economies worldwide, fiscal prudence has taken centerstage in debates among policy makers. A continued high fiscal deficit is viewed as unsustainable and hence, fiscal consolidation is another area of discussion to assess the need as well as the mechanism for implementing these changes in the weak growth environment being faced globally.

Chapter 2 Fiscal Situations

Fiscal policy plays an important role for macroeconomic stabilisation in Germany as well as in India. The large share of public (government) investment, production, and consumption in the economy confers on fiscal tools a considerable direct influence on the economy. Fiscal policy is a significant tool to the German government since it does not have its own monetary policy being a member of Eurozone. Similarly, it helps in fulfillment of multiple objectives in a developing country like India where means of earnings are less than ways of spending.

In the wake of the global financial crisis and Eurozone crisis, the role of government in management of public finances from fiscal stimulus to fiscal consolidation has turned out to be very pertinent. The Indian government announced many stimulus packages, which helped in stimulating domestic demand and thus growth. However, expansionary fiscal policy deteriorated the public finance of the government and caused the ratio of gross borrowing to GDP to reach approximately 10 percent in 2009-10 from 4.0 percent in 2007-08. Likewise revenue deficit[5] to GDP substantially rose to 5.7 percent in 2009-10 from a minuscule revenue deficit of 0.2 percent to GDP in 2007-08. With household sector's financial savings at just about 11 percent of GDP, there were fears that borrowing of this magnitude leaves very little savings available for the corporate sector. This exerted significant pressure on interest rates. Now, fiscal consolidation is a major goal for India; it is committed to achieving fiscal sustainability.

Germany has been known for following cautious and responsible fiscal and monetary policies with its main focus on price stability. However, the fiscally conservative countries like Germany found their balance sheet stretched in the wake of the global financial crisis (Shome 2012). Financial support was provided to financially distressed economies of the Eurozone in forms such as recapitalisation of banks and purchase of debt and equity in distressed financial institutions which resulted in substantial increase in fiscal deficit and public debt[6]. In Germany, fiscal deficit increased from 0.1 percent of GDP in 2008 to 3.2 percent in 2009 and 4.1 percent in 2010. Public debt increased from 66.9 percent of GDP in 2008 to 82.4 percent of GDP in 2010. However, Germany returned to a course of fiscal consolidation in 2011 and witnessed a sharp decline in fiscal deficit in 2011 itself and fiscal surplus the following year.

Nevertheless, runaway public debt has been a major concern for both academicians and policy makers in Germany as well as India. At this juncture, a detailed analysis of trends and patterns over the last three decades (1980-2012) that cover both the pre and post crisis period would help us understand the relationship between fiscal expansion and growth in both Germany and India.
In the following section, analysis of fiscal trends in Germany is based on annual time series corresponding to the calendar year (1 January to 31 December). The data is drawn mostly from

[5] Excess of revenue expenditure over receipts is termed as revenue deficit.
[6] Public debt and government debt are interchangeably used.

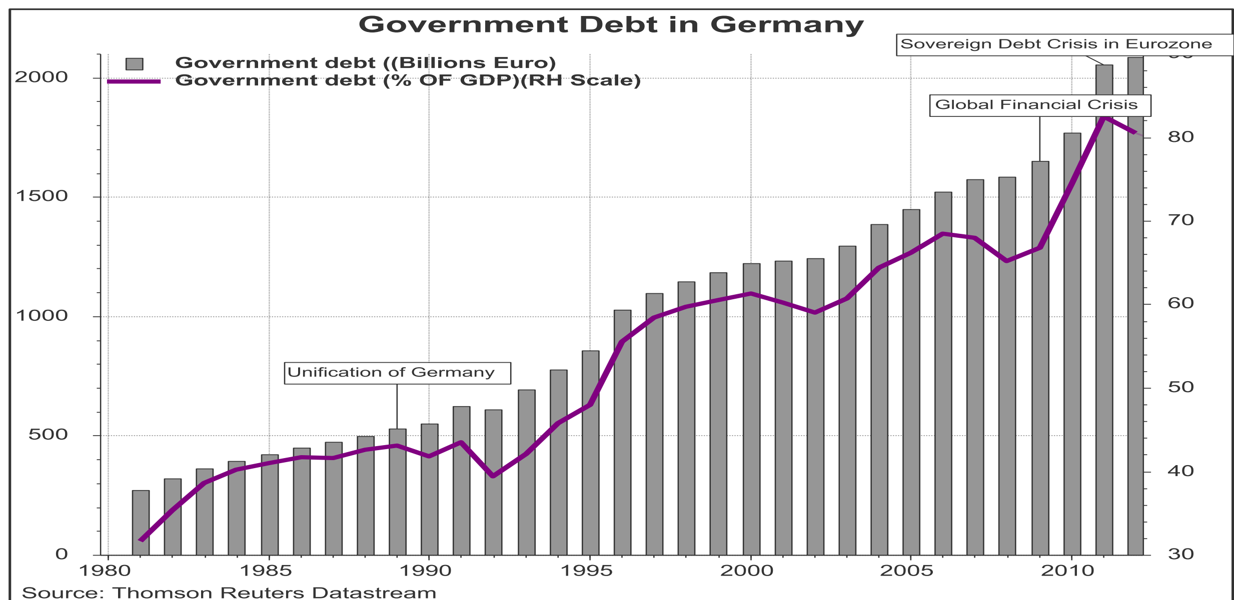
Bundesbank (Central Bank) of Germany and Datastream of Thomson Reuters. In the subsequent section, fiscal trends of India are discussed on the basis of annual time series corresponding to the fiscal year (1 April to 31 March). The data is drawn mostly from the Reserve Bank of India's Handbook of Statistics on Indian Economy and Annual Reports and National Accounts Statistics published by the Central Statistical Organisation (CSO).

1. Trends and Patterns of Fiscal Variables in Germany

Our period of study starts from the 1980s but to understand how large accumulation of public debt has been taking place in a fiscally conservative economy like Germany, we did not ignore trends and patterns of the past few decades.

After the traumatic experience of the hyperinflation of the 1920s and World War-II, Germany followed cautious and responsible fiscal and monetary policies focussing mainly on price stability. Public debt was also controlled and maintained at below 20 percent between 1950 and 1970. However, the oil shock of the 1970's after the formation of OPEC created disruption in the economy. The changes in the constitutional borrowing limits for the central government at the end of the 1960s, allowed the government to maintain macroeconomic equilibrium through public expenditure (Bundesbank 2010). The rise in public expenditure through borrowings increased public debt sharply; nevertheless it remained below 40 percent till the late 1990s. However, two major events: the unification of Germany in 1989 and the global financial crisis of 2007-08 resulted in sharp deterioration of the government balance sheet (Figure 2.1).

Figure 2.1 Government Debt in Germany



After the unification of Germany in 1989, centrally planned under-developed eastern Germany required substantial transfer of funds to finance deficits of the public social security system and for the development of public administration and bureaucracy (Hoppner 2004). The economic boom in the initial phase of the unification made the fiscal outlook look bright; policy makers underestimated the magnitude of fiscal challenge of unification (Bundesbank 1997). "Initial over optimistic forecasts claimed that unification only needed an initial "knock-on financing" which could be refinanced by increased tax revenues of the following expected unification boom. However, after it became clear that an independent and self-financing upswing of the eastern economy was not within reach, public finances had to fill the gap by infusing a massive amount of public transfers to the east" (Hoppner, 2004). Expenditure on social security has turned out to be a major factor that resulted in a large increase of government debt (Hagen & Strauch 1999).

Furthermore, since pension claims were tied to the retiree's wage rate, the higher conversion rate for wages and pensions resulted in higher social security demand. Additionally, the full extension of unemployment insurance also raised the social security expenditure. Public expenditure of the general government increased sharply from 43.1 percent of GDP in 1989 to 54.8 percent of GDP in 1995 (Figure 2.1). Part of the transfers were financed by raising taxes, however, a significant portion of it was financed through borrowing (Siebert 2004). Germany recorded a fiscal deficit of 9.5 percent of GDP in 1995, which culminated in a significant increase in public debt. Debt increased from 41.8 percent of GDP in 1989 to 55.6 percent of GDP in 1995 and 60.2 percent of GDP in 2000 (Figure 2.1). While analysing public debt i.e. general government debt, we realised that it would be meaningful to look at the distribution of debt among central (federal), states (Länder) and local governments (see Annexure 2).

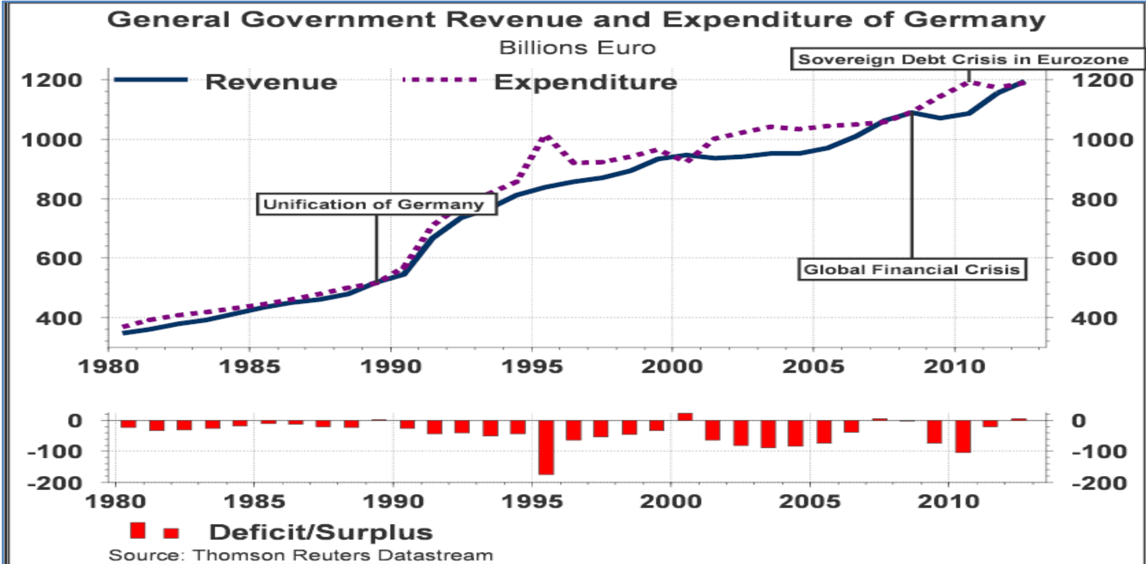
2. Inception of Euro and the Global Financial Crisis

With the formation of the Eurozone in 1999[7], Germany entered into a Stability and Growth Pact (SGP) to ensure fiscal discipline, with the aim for the general government to stay within the limits of government deficit and debt up to 3 percent of GDP and 60 percent of GDP, respectively. These limits were applicable to states (Länder) as well. However, limits were breached for three years in a row, starting from 2002. This was mainly a response to sluggish economic growth that declined by 0.4 percent in 2003 and grew marginally by 0.7 percent in 2004. The weak enforcement of the Pact was also argued as a cause for fiscal profligacy in Germany (ECB 2011). High growth rates in 2006 and 2007 and buoyant revenues as a response to an unprecedented boom in real estate markets helped to cover up the rising expenditures; and

[7] With the inception of the third stage of the Economic and Monetary Union (EMU) or introduction of a single currency in 1999, the founding fathers of the EMU introduced the institutional element in the form of the **Growth and Stability** Pact (GSP) to safeguard against fiscal profligacy, and for better economic coordination and management amongst Eurozone economies. The Pact was signed by 12 member states of the Eurozone including Germany. As per the GSP all the member states cannot run annual general government deficits and debt beyond 3 percent of GDP and 60 percent of GDP, respectively.

this resulted in an improvement of public finances. Moreover, a surplus in fiscal balance was witnessed in 2007 and subsequent negligible deficit in 2008 (Figure 2.2).

Figure 2.2 General Government Revenue and Expenditure of Germany



The improvement in fiscal balances prior to the crisis weakened amidst the global financial crisis, particularly from 2009 onwards. Large stimulus packages to revive economic growth, significant decline in government revenues, capital injections for weak banks, and purchase of debt and equity in distressed financial institutions (Table 2.1) resulted in substantial increases in fiscal deficit and public debt. Fiscal deficit increased from 0.1 percent of GDP in 2008 to 3.2 percent in 2009 and 4.1 percent in 2010 (Figure 2.2). Public debt increased from 66.9 percent of GDP in 2008 to 82.4 percent of GDP in 2010 (Figure 2.1).

Table 2.1 Financial Sector Support in Selected Advanced Economies (Percent of 2012 GDP, except where otherwise indicated) [1]

	Impact on gross public debt and other support	Recovery	Impact on gross public debt and other support after recovery
Belgium	7.6	2.50.6	5.1
Cyprus	10.0	0.0	10.0
Germany[2]	**12.8**	**1.9**	**10.9**
Greece	21.8	6.4	15.4
Ireland	40.4	5.7	34.7
Netherlands	15.6	10.7	4.9
Spain	7.6	3.1	4.5
United Kingdom	6.6	2.2	4.4
United States	4.6	4.6	0.0
Average	6.9	4.1	2.9
In $US billions	1752	1029	722

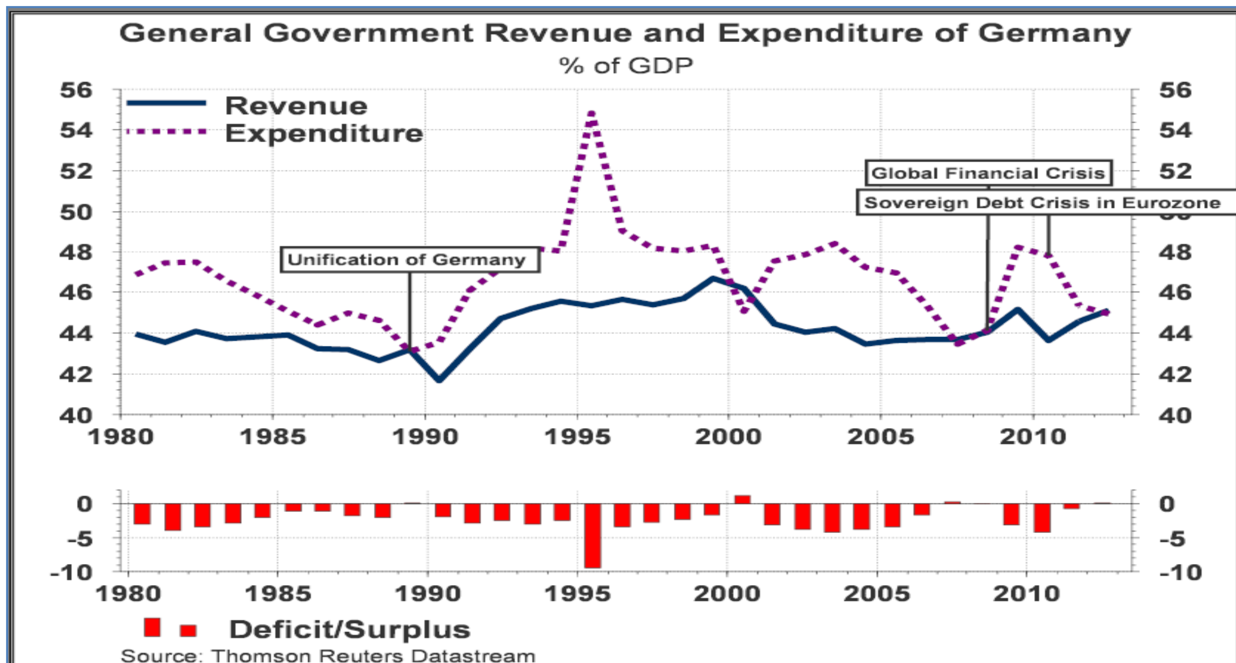
Source: Fiscal Monitor (October 2013)

Note: Fiscal outlays of the central government, except in the cases of Germany and Belgium, for which financial sector support by sub-national governments is also included.

[1] Cumulative since the beginning of the crisis—latest available data, up to August 2013.

[2] Support here includes the estimated impact on public debt of liabilities transferred to newly created government sector entities (11 percent of GDP), taking into account operations from the central and subnational governments. Since public debt is a gross item and not netted, this neglects the simultaneous increase in government assets. With this effect taken into account, the net debt effect amounted to just 1.6 percent of GDP, which was recorded as deficit.

Figure 2.3 General Government Revenue and Expenditure of Germany



3. Post-Crisis: Fiscal Rules and Consolidation

The global financial crisis underscored the need for strengthening the fiscal policy framework in the European Union. European fiscal rules were revised and few national rules were also envisioned to guard against future crises. Germany complied with all the European fiscal policy requirements. To begin with, Germany enshrined the debt brake into its constitution in 2009 and aligned with the principle of the Stability and Growth Pact (SGP). According to the Pact, the federal government must restrict its structural deficit to 0.35 percent of GDP by 2016 and the 16 *Länder* (states) must balance their budgets by 2020. These limits are said to have enhanced the credibility of the financial market of that country, lowered the risk premiums and hence, made it easier for public sector financing.

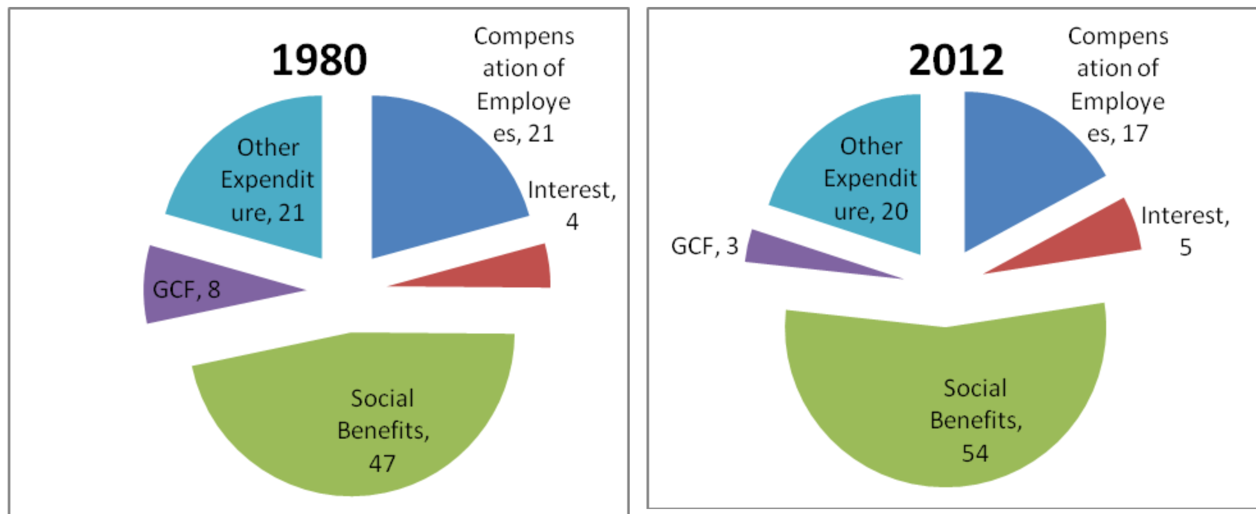
In 2011, the SGP was reinforced whereby a benchmark was introduced to reduce excessive debt-to-GDP ratio and a more rigorous system of sanctions was implemented. Specifically, payments made out of certain EU funds were tied to sustainable fiscal policies. Each member state of the Eurozone set its own medium-term budgetary objectives (MTOs) and Germany set the structural deficit at no higher than 0.5 percent of GDP. Further, a new Treaty on Stability, Coordination and Governance in the Economic and Monetary Union known as Fiscal Compact came into force in 2013. For this the national budgets of participating member states have to be in balance or in surplus. This goal will be fulfilled even if their annual structural government deficit does not exceed the threshold level of 0.5 percent of GDP. Also there is a mechanism of automatic correction that is put in place in the event of a deviation from the balanced budget. It is also in line with MTOs stated in the SGP. The Fiscal Compact will be operational at the constitutional level of member states within one year after the treaty is enforced, i.e., by 1 January 2014.

It is worthy to note that Germany was able to abrogate fiscal deficit in 2012 and recorded a surplus of 0.2 percent of GDP (Figure 2.3). The general government's structural balance – adjusted for cyclical and one-off effects – stood at 0.4 percent of GDP, reflecting a remarkable improvement in fiscal balance and accomplishment of the medium-term budgetary objective. Moreover, structural balance improved more than actual fiscal balance (taking both cyclical and non-cyclical effects). Fiscal corrections can be attributed to the momentum in profit taxes, moderate annualised pension increases, lower labour market spending, the phasing-out of the 2009 stimulus programme and low interest rates (Bundesbank 2013).

However, the slowdown in economic growth has become a major challenge for further improvement in the sovereign balance sheet of Germany. Weak balance sheets of financial institutions and sovereigns in peripheral Eurozone economies remain a concern for core economies, particularly Germany. Demand for more bailout from countries facing the banking and sovereign debt crisis will deteriorate the fiscal health of a slowing German economy. Recapitalisation of Spanish banks is still a contentious issue. If Germany and Finland fail to

persuade other members against the retroactive direct bank recapitalisation for Spanish banks, then the burden will fall disproportionately on Germany.

Figure 2.4 Proportion of Major Expenditures in Germany



Source: Thomson Reuters Datastream

Runaway debt cannot be entirely attributed to the global financial and Eurozone crises; some of it is certainly due to ageing of the population and the associated health and pension costs. Rising expenditure on social security is an important driver of public debt in Germany. In 1980, the expenditure on social benefits as a percentage of total expenditure was 47 percent; it increased to 56 percent in 2000 and remains around 54 percent in 2012(Figure 2.4). The increase has primarily been due to unification. However, like many advanced economies, the potential increase in social security expenditures because of an ageing population has become a major concern for Germany.

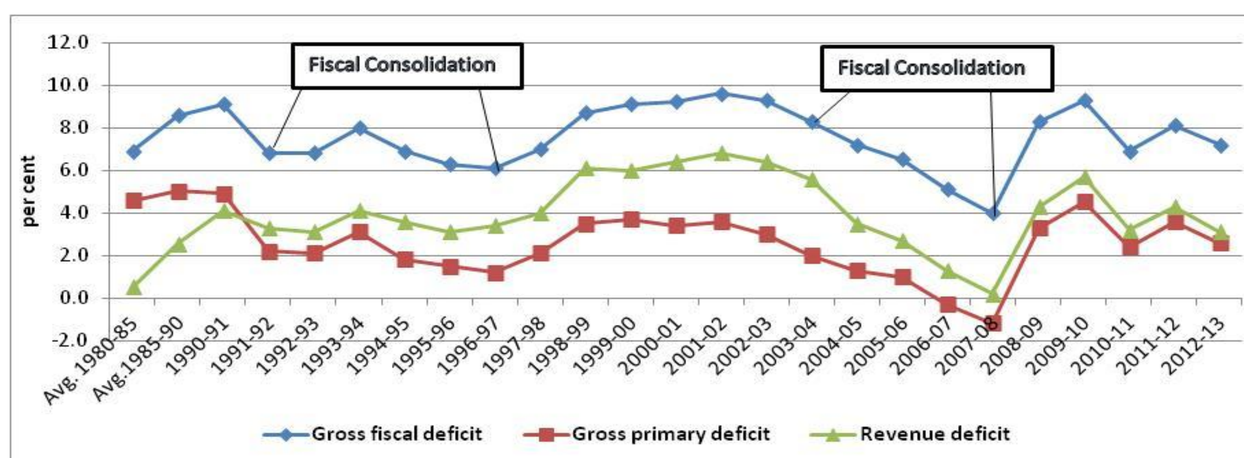
4. Trends and Patterns of Fiscal Variables in India

Until the early 1980s, India's public finances were prudent as a response of conservative fiscal policy. There was a surplus in revenue receipts of the central government over revenue expenditures which helped in financing of deficit on capital account of the central government. Subsequently in the mid 1980s, fiscal prudence was abandoned, resulting in sharp deterioration in the public finances of the Indian economy. It meant that the government had to borrow at home and abroad not just to finance its capital expenditures but also revenue expenditures. During the second half of the 1970s (1975-80), the average combined gross fiscal deficit of centre and states was a mere 5.4 percent of GDP[8] whereas it rose considerably to around 7 percent of GDP in the next five years. Furthermore, the public finance of the government

[8] Srinivasan (2000) Eight Lectures on India's Economic Reforms

deteriorated in the face of fiscal expansion of the 1980s. The average quinqennium gross fiscal deficit, in the period 1985-90, rose to 8.6 percent compared to 7 percent in 1980-85 (Figure 2.5). In 1990-91 when the Indian economy was hit by a balance of payment crisis, the gross fiscal deficit and current account deficit ballooned to a record high of 9.1 percent of GDP and 3 percent of GDP, respectively. High level of fiscal deficits was also mirrored in large accumulation of public debt. The average of five years of combined debt of the centre and states starting from 1980-81 stood at 52 percent of GDP while in the next 5 subsequent years, the average ratio rose unprecedentedly to 66 percent of GDP (Figure 2.6). Along with high external borrowings, weakening of the financial sector, an overvalued exchange rate and heavy-handed regulation of trade and industry were the other factors responsible for stimulating the balance of payment crisis.[9]

Figure 2.5 Fiscal Indicators of the Combined Centre and States (percent of GDP)



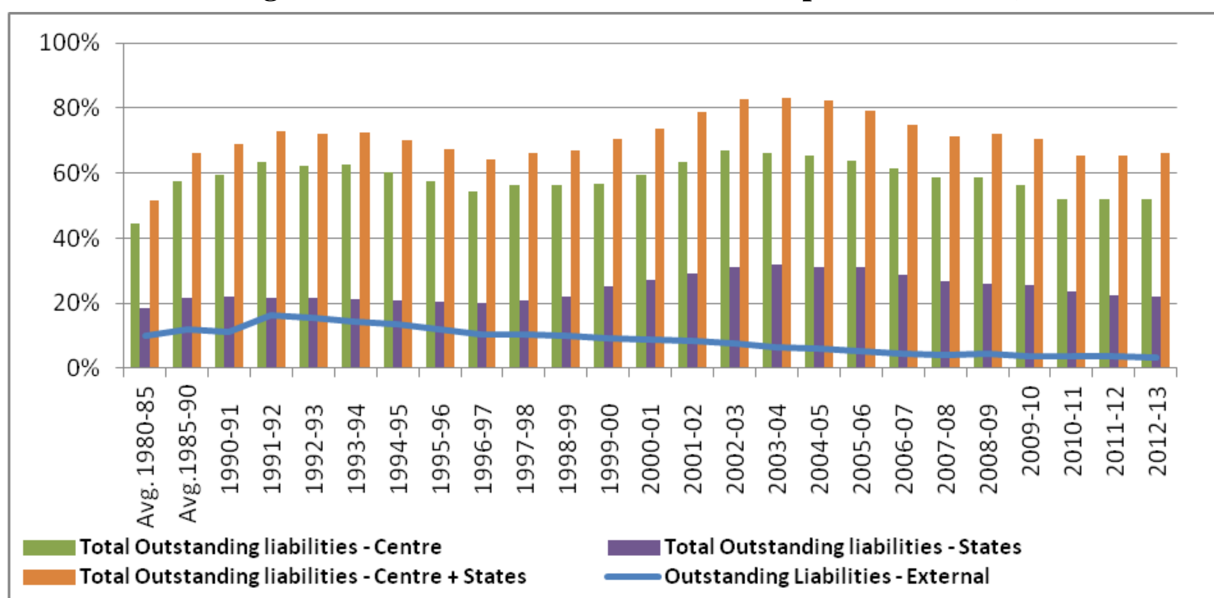
Source: Reserve Bank of India (RBI)

The government undertook a series of structural economic reforms, which are widely known as economic reforms of 1991, to face-off the balance of payment crisis. It included opening up international trade and investment, dismantling of industrial licensing, initiation of privatisation, abandoning of fixed-exchange rate, tax reforms and inflation-controlling measures. The fruits of economic reforms were visible primarily during 1992-97. The high growth rate of 6.5 percent in 1992-97 reflected in the improvement of the fiscal situation and external position of the Indian economy. The gross fiscal deficit was brought down to 6.5 percent of GDP in 1992-97 from around 9 percent in 1986-91. Similarly, primary deficit, the fiscal deficit less interest payments, fell sharply from 5 percent of GDP in 1986-91 to 2 percent in 1992-97. On the other side, revenue account of the combined centre and states experienced a sharp deterioration, as shown in (Figure 2.5). Of revenue receipts, tax revenues to GDP declined from 15.3 percent in 1991-92 to 13.9 percent in 1996-97. This happened possibly due to a concurrent reduction in import duties from 110 percent in 1992-93, to 85 percent in 1993-94, to 65 percent in 1994-95 and to 50

[9] Acharya (2002), Ahluwalia (2002), Joshi and Little (1996)

percent in 1995-96. Therefore, it suggests that improvement in the fiscal situation was attributed to a reduction in the combined capital expenditure to GDP by a significant 5 percentage points in 1992-97 from 7.3 percent in 1986-91.

Figure 2.6 Debt of the Centre and States (percent of GDP)



Source: Reserve Bank of India (RBI), Note: External liabilities of the centre are at current exchange rates.

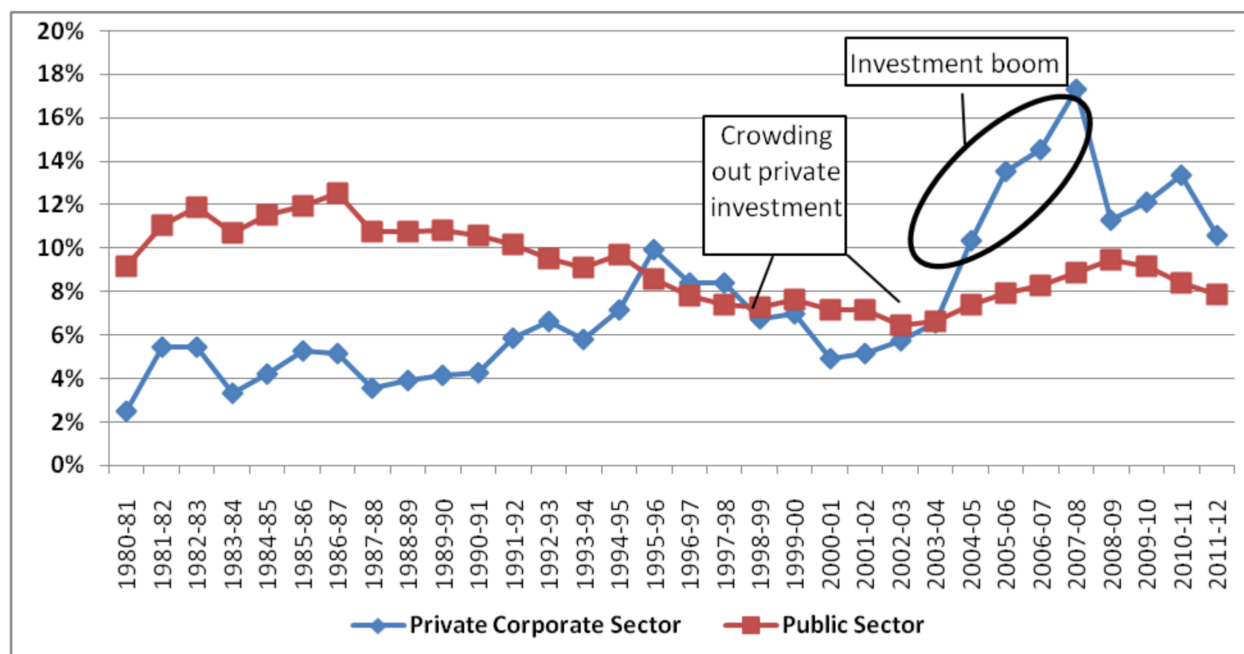
5. Poor Fiscal Performance during 1997-2003

The fiscal improvement after the economic reforms, particularly in 1992-97, was not sustained thereafter, due to a mixed response of unstable coalition governments in India for three years and the eruption of the Asian crisis in 1997 which debilitated the growth of the Indian economy. Moreover rise in salaries and pensions of central and state governments' employees on account of implementation of the Fifth Pay Commission recommendations caused massive increase in combined non-developmental revenue expenditure from Rs. 1.9 trillion in 1998-99 to Rs. 3.2 trillion in 2002-03. Furthermore, low tax revenue buoyancy as a result of faltering growth rate led to a sharp rise in revenue deficit as a share of GDP to more than 6 percent in 1998-99 and stayed at this level for the next four years. Similarly, deterioration in revenue account was mirrored in the fiscal deficit. It again attained a peak rate of 9.6 percent of GDP in 2001-02 as it had done so in the late 1980s (Table 2.2).

The impact of the sky-high fiscal deficit was totally reflected in the total government debt-to-GDP ratio during 1997-2003. Combined outstanding liabilities of the centre and states ballooned to 83 percent in 2002-03, from 67 percent in 1998-99. In particular, domestic liabilities of the central government rose by 27 percent in 2002-03 from 46 percent in 1998-99. Noticeably, India's total external debt-to-GDP declined throughout the aforementioned period and reached a

low level of 8 percent in 2002-03 (Table 2.2). This level of debt is quite low as per standards of other developing countries[10]. Surprisingly, outstanding liabilities of all states of India taken together experienced an upturn, and rose sharply to 31 percent of GDP by 2002-03 in comparison to 21 percent in 1997-98. The cost of rise in debt was paid for in terms of high real interest rates and crowding out of private investment, which averaged 7.6 percent of GDP in 1992-97, compared to 5.8 percent in 1998-2003 (Figure 2.7).

Figure 2.7 Gross Investment by Private and Public Sectors (percent of GDP)



Source: Reserve Bank of India (RBI)

Table 2.2 Deficit and Debt Indicators

	Average 1992-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Revenue Deficit	3.5	4	6.1	6	6.4	6.8	6.4
Primary Deficit	2	2.1	3.5	3.7	3.4	3.6	3
Fiscal Deficit	6.8	**7**	8.7	9.1	9.2	**9.6**	9.3
Combined debt of centre and states	69	**66.29**	67.11	70.47	73.67	78.79	**82.86**
States' debt	21	21.04	22.16	25.19	27.29	29.32	31.01
External debt	13	10.27	9.87	9.23	8.73	8.47	7.73

Source: Reserve Bank of India (RBI), Note: External debt is at current exchange rates.

[10] Joshi and Little (1998) India Macroeconomics and Political Economy 1964-1991

Despite the faltering fiscal performance of the Indian economy in 1997-2003, many significant reforms in the sector of telecom, finance, insurance and highway infrastructure took place from 1998 onwards. Furthermore, reforms in indirect tax to consolidate excise tax rates, improvement in tax administration by deploying modern information technology and reduction of high import duties which had been ushered in the beginning of 1990s were put in place at the end of the decade. The impact of these reforms was significantly visible in the next decade[11].

6. Golden Years of Growth and Fiscal Consolidation, 2003-2007

After sluggish economic growth in the second half of 1990, the Indian economy entered into a higher growth trajectory, achieved a continuous 8+ percent growth rate during 2003-2008, except for the year 2004-05. India faced a significant investment boom in the aforementioned period when the ratio of investment to GDP sharply rose from almost 25 percent in 2002-03 to 38 percent in 2007-08. This period also coincided with key fiscal reforms at both the central and state government levels. At the central level, the Fiscal Responsibility and Budget Management (FRBM) Act was enacted in 2004. The FRBM Act laid down fiscal targets for the Central government such as reduction of fiscal deficit to 3 percent of the GDP by 2008-09 with annual reduction target of 0.3 percent of GDP per year. Similarly, revenue deficit had to be reduced by 0.5 percent of the GDP per year, and by 2008-09 the deficit was to be wholly eliminated. The fiscal discipline imposed by the government helped in containing the deficit of the central government.

Table 2.3 Fiscal Position of Central Government in Post-FRBM Period (percent of GDP)

	Average 1998-03	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Gross Fiscal deficit	5.7	4.34	3.88	3.96	3.32	2.54
Gross Primary deficit	1.2	-0.03	-0.04	0.37	**-0.18**	**-0.88**
Gross Revenue deficit	3.9	3.46	2.42	2.50	1.87	1.05

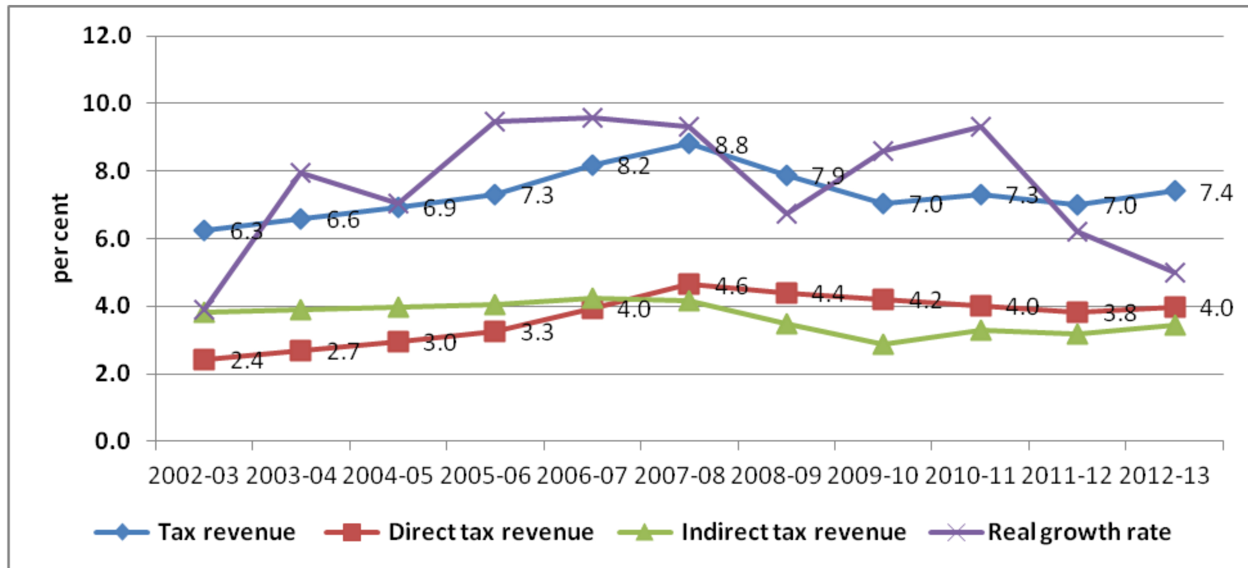
Source: Reserve Bank of India (RBI)

As shown in Table 2.3, fiscal deficit of the central government reduced markedly to 2.5 percent of GDP in 2007-08; it had reduced more than the FRBM target and that too before the prescribed time. Similarly, revenue deficit saw a continuous decline during 2003-2008 and touched 1 percent of GDP in 2007-08, though it was not completely eliminated. Decline in revenue deficits had been possible through lower revenue expenditure facilitated by major components such as interest payments, defence revenue expenditure and subsidies. Simultaneously, revenue receipts increased on account of higher tax receipts while non-tax revenue declined. Gross primary deficit turned into surplus in the above-mentioned period, barring 2005-06. However it is essential to mention here that there were other factors responsible for reining in fiscal deficit such as

[11] Callaghan, M et al (2014)

improvement in tax administration through information technology, increase in collection of direct tax revenues as a consequence of high growth rates and improvement in administration of tax[12].

Figure 2.8 Net Tax revenue [13] (Central Government) Indicators as a Proportion to GDP



Source: RBI

Coming to the State level FRBM Act, with the recommendations of the 12th Finance Commission (FC), many states enacted "Fiscal Responsibility Legislation (FRL)" during 2003-08. The 12th FC tried to motivate states to achieve fiscal consolidation through introducing Debt Swap Schemes and the Debt Consolidation and Relief Facility (DCRF) in the form of conditional debt restructuring and interest rate relief. After the endorsement of FRL, many states could achieve fiscal consolidation through reduction in revenue expenditure and improvement in revenue receipts. Implementation of state-level value added tax (VAT) in 2005 led to higher collection of states' own tax revenues since it avoided cascading of taxes. Continuous decline in revenue deficits and fiscal deficits facilitated states to reduce non-productive expenditure and increase allocations towards priority areas[14]. All the aforementioned favorable factors led to considerable progress in bringing down states' deficits until 2007-08 (Table 2.4).

[12] Callaghan, M et al (2014)
[13] We are referring to Central Government's tax revenue after devolving tax revenues to all states.
[14] State Finances : A Study of Budgets

Table 2.4 Fiscal Position of State Government in Post-FRL Period (as a percent of GDP)

	Average 1998-03	2003-04	2004-05	2005-06	2006-07	2007-08
Revenue Deficit	2.59	2.30	1.21	0.19	**-0.58**	**-0.86**
Gross Fiscal Deficit	4.24	4.38	3.32	2.44	1.80	1.51
Primary Deficit	1.79	1.46	0.66	0.16	**-0.36**	**-0.49**
States' own indirect tax	5.22	5.47	5.69	5.85	**5.98**	**5.43**
States' own total tax	5.38	5.63	5.84	6	**6.13**	**5.56**

Source: Reserve Bank of India (RBI) & Indian Public Finance Statistics 2012-13

The improvement in the fiscal situation of the central government as well as state governments improved the combined deficits of central and state governments. The burgeoning fiscal deficits during 1997-2003 registered a continuous decline in the post-FRBM period, 2003-08, and stood at 4 percent of GDP in 2007-08, the lowest ever since 1980. Similarly primary deficits turned into surplus for two consecutive years, starting from 2006-07 and revenue deficit stood close to zero in 2007-08 (Figure 2.5). These trends are discernible in public sector savings which rose to 5 percent of GDP in 2007-08 from marginal dissavings of 0.2 percent in 2002-03.

Consolidation in combined deficits of central and state governments mirrored in combined debt during 2003-08. The total outstanding liabilities of the general government were slashed from 77 percent of GDP in 2003-04 to 67 percent in 2007-08 and continued to decline thereafter because of high nominal growth rates. The proportion of sovereign debt[15] to GDP has been low, and hovered around 5 percent in the past 5 years.

7. Global Financial Crisis and Post-Crisis Fiscal Consolidation

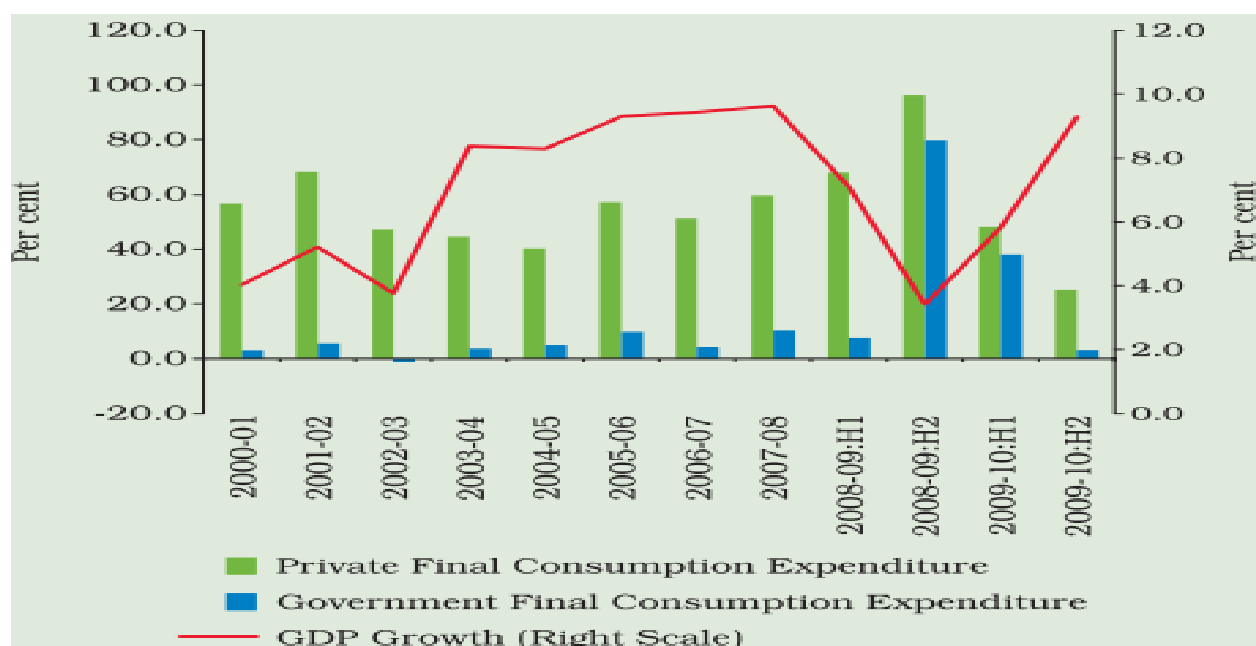
Fiscal consolidation during 2003-08 reversed in 2008-09 as a response to discretionary fiscal expansion of the government in the form of farm loan waivers, expansion of social security schemes under the National Rural Employment Guarantee Act (NREGA), increase in pay scale of government employees on the recommendations of the Sixth Pay Commission and subsidies for food, fertiliser and petroleum. Further, the onset of the global financial crisis (GFC) in the second half of 2008-09 forced the government to adopt an expansionary fiscal policy to safeguard the economy from spillover effects of the GFC. Fiscal measures were undertaken in the form of three fiscal stimulus packages: tax cuts, enhancing investment on infrastructure and increased expenditure on both investment and consumption.

Notably, the fiscal stimulus measures did not have to support the banking sector in India in the form of financial bailout or injection of capital as was done with the banks of the US and Europe. Its objective was to spur aggregate demand to minimise the effect of crisis through discretionary counter-cyclical fiscal policy. Nevertheless, there was an accommodative monetary policy in

[15] What we imply from sovereign debt is that proportion of total general government debt which is raised by a national government in the form of foreign currency.

place to stimulate private investment but due to loss in investors' confidence, monetary policy could not provide the required fillip to stop the falling aggregate demand. Thus fiscal expansion augmented aggregate demand and as a result the contribution of government expenditure to the incremental GDP at market prices surged from around 8 percent in the first half to 80 percent during the second half of 2008-09[16] (Figure 2.9). However, all the aforementioned factors deteriorated the finances of the government. To be precise, the central government's fiscal deficit shot up to 6 percent of GDP in 2008-09 against 2.5 percent in 2007-08 and even higher to 6 percent when the off-budget items like petroleum and fertiliser bonds were included (Table 2.3).

Figure 2.9 Relative Contribution of Government Consumption to GDP Growth



Source: Taken from "Report on Currency and Finance", RBI 2013

The expansionary fiscal stance continued in the next year, 2009-10, and helped in containing the economic slowdown in the short-term – this was reflected by a jump in the economic growth rate by around 2 percentage points from its previous period (Figure 2.9). Consequently, fiscal deficit of the central government sharply rose to 6.5 percent of GDP, the largest in the decade and this fuelled a debate on fiscal austerity vs. fiscal profligacy. One view is that fiscal expansion is necessary to revive growth and employment rather than focusing on reducing fiscal deficit. While the other view is that as huge public debt and deficit cause sovereign insolvency and raise sustainability issues, fiscal austerity could be the right move for fiscal consolidation. In terms of India, despite the fact that fiscal balances have continuously been deviating from the FRBM Act since the eruption of the GFC, the probability of a sovereign debt[17] crisis is very low. Unlike

[16] Report on Currency and Finance, RBI (2013)

[17] What is implied by sovereign debt is when a significant proportion of total debt issued by a national government is in the form of foreign currency.

many advanced economies most of the public debt in India is domestically held, primarily by public sector banks. High inflation also reduces the real debt value. Nevertheless, burgeoning fiscal deficits leave little room for expansionary monetary policy to stimulate private investment and revive growth and raise the dependence on short-term volatile capital inflows to finance current account deficit[18]. Due to large fiscal deficits and a high inflation rate, the RBI has followed a hawkish monetary policy stance, particularly during 2010-11 to 2011-12. It has primarily hurt the growth of private sector credit, weakened investment and thereby overall economic growth.

The government brought back its focus on fiscal consolidation in the 2012-13 Union Budget and targeted to achieve 5.1 percent fiscal deficit of GDP, which was revised to 5.3 percent in the mid-term review. To provide a roadmap for fiscal consolidation, a committee under the chairmanship of Dr Kelkar that was formed in the beginning of 2012, submitted its report on September 3, 2012. The committee recommended ways to augment more revenues as well as to curb wasteful expenditures. On the revenue side, medium-term fiscal consolidation measures include raising the tax-to-GDP ratio by implementing Direct Tax Code (DTC) and unified Goods and Services Tax (GST). Although, these critical tax reforms are already under the government's consideration, their schedule of the implementation is uncertain. In order to curb total expenditure, a combination of plan expenditure and non-plan expenditure was recommended. Cut in subsidy bill was strongly recommended since it constitutes around one-fifth of non-plan expenditure[19]. Subsidies on petroleum, fertliliser and food form around 90 percent of the total subsidies. Therefore to facilitate short-term fiscal consolidation, the government has taken steps on the expenditure side to curb its burgeoning subsidy bill by deregulating diesel, limiting the supply of subsidised cooking gas consumption and rationalising the fertiliser subsidy.

Going forward, there is a need for prudent fiscal consolidation since consumer price inflation has been high, more than what is within the comfort zone of the RBI. In this context, cuts in fuel subsidies may be inflationary in the short run. But given the persistent increase in current account deficit in the balance of payments from 1.3 percent of GDP in 2007-08 to 4.8 percent in 2012-13, it is imperative to keep fiscal deficits under check. In that case, it becomes necessary to pass on increases and adjust administered prices in the energy sector including coal and electricity[20].

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[18] Kelkar Committee Report 2012

[19] Total expenditure = Plan Expenditure + Non-Plan Expenditure. The former is spent on creation of productive assets through Centrally-sponsored programmes and flagship schemes, while the latter refers to all other expenditure such as defence expenditure, subsidies, interest payments, including expenditure on establishment and maintenance activities such as salaries.

[20] Macroeconomic and Monetary Developments, RBI (July 2013)

Concluding Remarks

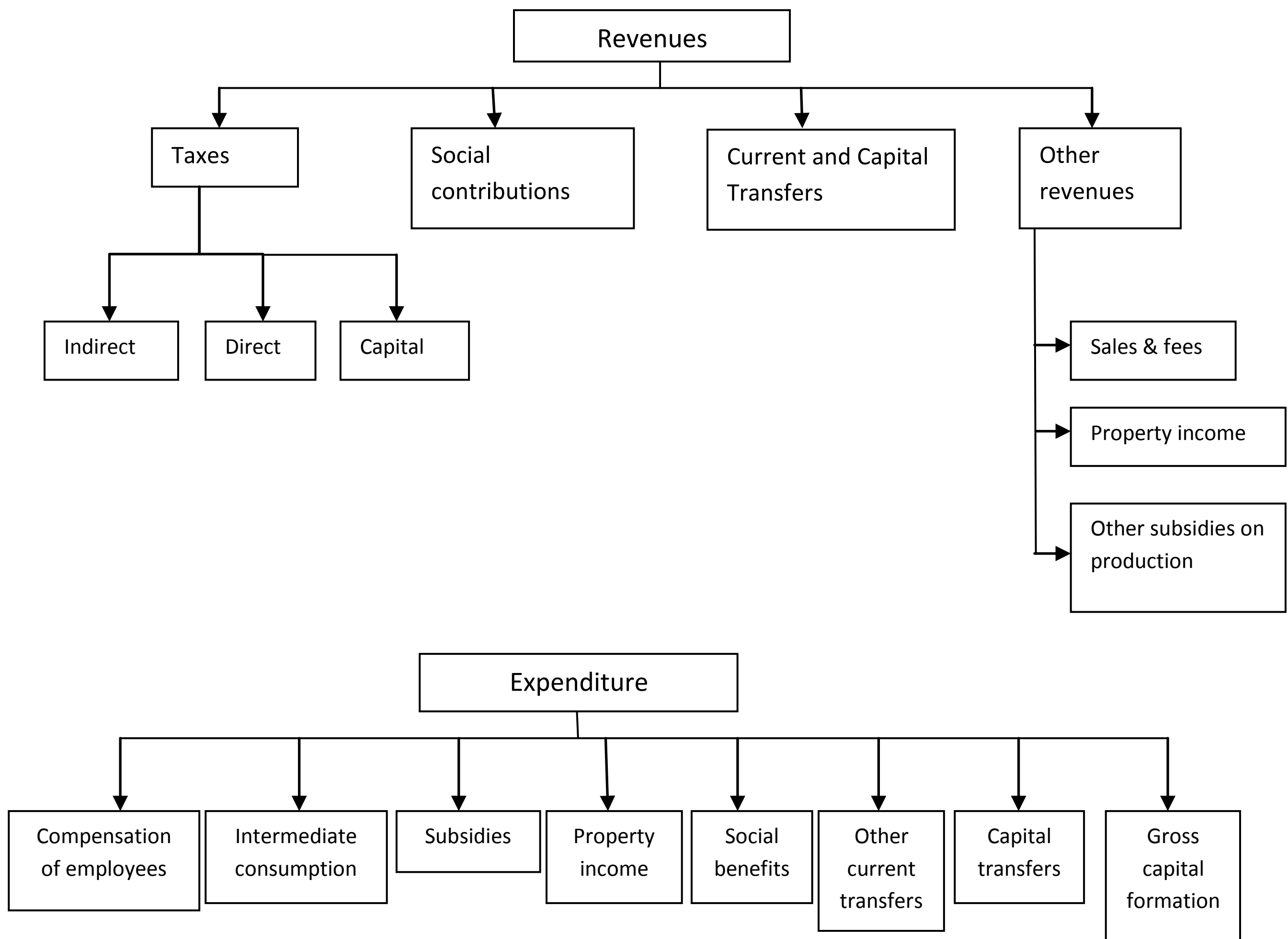
The high growth periods in both Germany and India prior to the onset of the global financial crisis witnessed remarkable improvement in public finance. During 2006-2008, Germany was able to limit the fiscal deficit, and moreover, exhibited a surplus in 2007. Similarly India had been able to contain the fiscal deficit, even a year ahead of the schedule as per recommendations by the FRBM Act. A notable feature was that both the economies had experienced an uptrend in their public debt-to-GDP ratio. However India's trend shows a decline in public debt to GDP ratio, particularly after the outbreak of the global financial crisis. Resilient growth rate and high inflation provided a cushion to India's debt to GDP ratio. But feeble growth prospects of the Indian economy in the near-term may pose some threat to sustainability of the debt.

Chapter 3 Government Budget

1. Government Budget of Germany

The Government Budget of Germany is divided into revenue and expenditure. Further breakdown of the revenue and expenditure is shown below based on the OECD statistics:

Figure 3.1 Classification of German Government Account



The trends for the major components of the budget are presented in Annexure 3.1 & 3.2.

Upon analysis of the revenue side of Germany from the data extracted from OECD Statistics, we find that there has been a significant shift in the taxation climate since 2000 as can be seen in Annexure 3.1. The conclusion from the revenue graphs is that Direct Tax has declined over time either due to decline in the rates or contraction of the revenue base. Furthermore, analysing the

expenditure statistics presented in Annexure 3.2, we see stable expenditure levels at Federal, Länder as well as Local levels but an overall reduction in the expenditure level as a whole. This reduction in expenditure resonates with the fiscally conservative stance of the government to maintain/aspire to achieve a balanced budget year on year. The shift in the taxation climate of Germany can be viewed in light of Tax Reform 2000 which was put in place aiming at a sustainable improvement in the conditions for investment and employment in Germany. The government afforded aggregate relief to taxpayers of ~DM 30 billion during the period of 1999 to 2002 under the Tax Relief Act. In addition, under the Tax Reform 2000, the government focused further relief of ~DM 62 billion up to 2005 on dependent employees, families and small and medium-sized business. Of this, ~DM 33 billion went to private households, DM 23 billion to small business and ~DM 7 billion to large-scale enterprises. Under the reform, the corporate income tax was reduced from 40 percent (on retentions) and 30 percent (on distributions) to a standard rate of 25 percent. The system of full imputation of corporate income tax was replaced by the half-income system. For unincorporated companies, relief was provided by allowing trade tax to be credited in a standardised form against the income tax liability. The post-reform tax charge on corporations in conjunction with trade tax amounted to 38.5 percent which is considered in the middle range by international standards. Further the basic rate was reduced in 3 stages up to 2005 from 22.9 percent to 15 percent, personal allowance was raised from DM 13,499 to DM 14,989, and the top rate of income tax was brought down from 51 percent to 42 percent. This reform explains the structural shift in government budgets during 2000-2001 with ever-decreasing ramifications till 2004.[21]

The remarkable change in the government budget of Germany which weathered the financial crisis of 2008 reasonably well and has been able to follow a conservative path to consolidation and turned its deficit into a surplus in the recent year needs deeper analysis of the major policy changes which were undertaken during the 2000s. Based on our survey of the academia in Germany as well as policy makers, the turnaround has been attributed to the Pension reforms and the Labour Market policies. These coincidentally took effect at the opportune time of the crisis from which the whole world was reeling, and somewhat to a lesser extent to the taxation climate change mentioned above.

2. Pension Reform in Germany

Since 1945, the German pension system espoused the principles of equivalence (a relatively strict link between contributions and benefits) and income maintenance based on the male breadwinner model. Since unemployment was low among elderly, the retirement policy was a

[21] Bundesministerium der Finanzen, *German Stability Programme,* 2001

success. Fiscal sustainability was not a big concern and contribution rates were adjusted accordingly to match the expenditures. [22]

Post the German unification, the fiscal aspects of the system arose. Reduction in the burden of state and stable future contribution rates gained center-stage. The 2001 Reister and 2004 Rurup reforms were attempts to fill the shortfalls in public benefits with increased occupational plans and individual savings. But this was effective in unionised sectors under collective agreements leading to the shift from an occupationally fragmented system that protects individuals from social exclusion to a sectorally fragmented system whose outcomes are subject to randomness and may breed poverty during old age. Germany also changed its social assistance law to secure a guaranteed basic income for low earners (Igor, 2010).

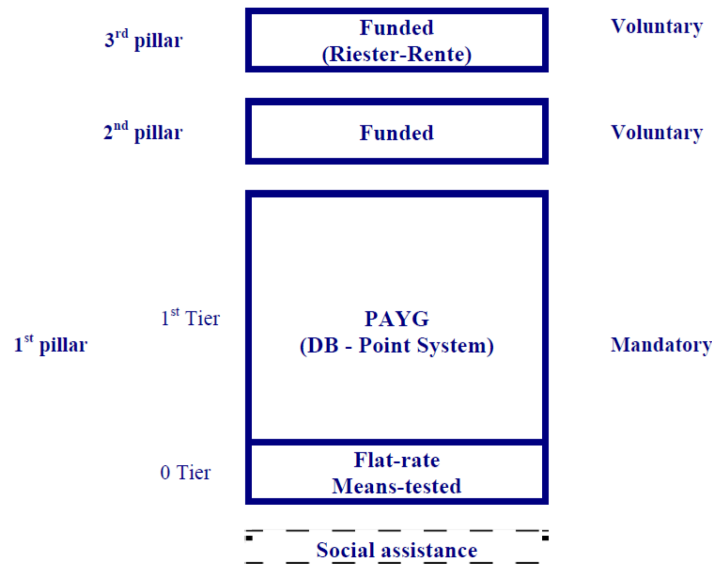
Box 3.1

Is the adjustment to the pension system fair?

The change to the pension system in addition to the extension of the retirement age to fix the problems associated with the demographic change in Germany has ramifications which are not the same for all groups of the population. The problem faced is that low-skilled and low-income workers are usually forced to exit early and are thus more likely to endure these permanent reductions leading to poverty in old age. Another problem is the differential treatment of periods outside work and atypical work contracts. Women are fairly well protected (during childbearing, child care and in case of divorce – as they split entitlements with the former spouse), as are disabled people. Unemployment, especially long-term, is not. Credits for apprenticeships and higher education have been drastically reduced. Atypical jobs are particularly discriminated: part-time jobs called mini- and midi- jobs are partly voluntarily insured and take up is minimal, false self-employment is on the rise and many do not save (Igor, 2010). This raises the issue of addressing poverty in old age and the state welfare system collapsing for the group who incur this for no fault of their own.

[22] Igor Guardiancich, *Current pension system: first assessment of reform outcomes and output,* May 2010, European Social Observatory

Figure 3.2 German Pension System



The 1st pillar consists of i) compulsory statutory pension insurance for blue- and white-collar employees (*Arbeiter- und Angestelltenversicherung);* ii) pension scheme for farmers *(Altershilfe for Landwirte)*; iii) insurance for civil servants and judges – tax-financed (*Beamtenversorgung)*; and iv) several professional schemes. Public pensions are contribution-financed, PAYG defined-benefit scheme. But the benefit calculation formula brings it very close to a defined contribution system (Igor, 2010).

The Actual Pension Value is valorized/indexed to gross wages but also depends on 2 factors: i) changes of the contribution rates to the statutory pension scheme and to subsidised voluntary occupational and personal pension schemes are taken into account (an increase of contribution rates will reduce the adjustment); ii) sustainability factor, which links the adjustments to changes in the system dependency ratio. These keep the contribution rate within defined limits. The increase in the rate was limited to 20 percent by 2020 and 22 percent by 2030. The statutory retirement age will increase stepwise (1 month per year until 2024 and 2 months per year afterwards) between 2012 and 2029 from 65 to 67 for both men and women. Flexible retirement is possible between 63 and 67, however it implies that the permanent benefits would be decremented by an amount equivalent to 0.3 percent per every missing month to the statutory retirement age, up to a maximum of 14.4 percent decrement. From 2012, an exception will be made for seniority pensions after 45 years of qualifying period which would be counted including employment, self-employment, care and childbearing up to age 10 count, but not unemployment periods and only till the age of 65. Deferring pension after 65 earns a 0.5 percent increment for each month of additional work and this extra income is unrestricted (Igor, 2010).

The 2nd pillar (voluntary and privately managed) consists of occupational funded schemes offered by a variety of sponsors and subsidised through tax rebates. German employers have to offer at least one type of occupational pension (*Entgeltumwandlung)* and have 5 different options: they can administer the scheme by themselves (*Direktzusage),* through insurance institutions (*Unterstutyungskasse, Pensionskasse or Pensionsfond),* they may take out a direct insurance with an insurance company for their employee (*Direktversicherung).* But the slow take up of occupational schemes is attributable to relatively tough regulations (Igor, 2010).

Box 3.2

The negative effects of privately managed occupational pensions

The problem with these schemes remains the same: that they expanded only in those sectors where collective agreements were negotiated and agreed upon with the help of trade unions (and often contributions are not even additional as other fringe benefits are diminished). Hence, socially inclusive retirement has now become much more fragmented than it used to be under pure state provision and depends on the sector and firm size. The employer and employee finance most plans jointly and hence, the coverage of employees under the plan is higher for larger firms than smaller firms. The trend is away from book reserves to out-of-company plans. This effectively leaves out a section of the population without a sustainable pension scheme to alleviate poverty during old age.

The 3rd pillar consists of voluntary, subsidised individual plans, which were strongly encouraged through the 2001 Riester and 2004 Rurup reforms. The *Riester-Rente*[23] serves the purpose to encourage low-income workers to additionally save. The government recommends that 4 percent of gross wages are to be invested into these plans (and provides tax subsidies or direct allowances on contributions). There are several conditions which make Riester less attractive: guaranteed rate of returns, low charges, and consumer information requirements. Everyone covered by public pensions can claim state support from Riester. Full-time careers and child credits are eligible, so Riester undermines the male breadwinner model. Unisex benefits were also introduced. For the self-employed, Rurup plans (tax free to a ceiling and protected against insolvency of the self-employed) continue but they are less flexible than insurance (Igor, 2010).

Due to the above-mentioned problems, in 2006, there were only 5.6 million Riester-Renten[24] covering 15 percent of eligible people, of whom many were high-income employees. The equivalence principle and the cuts in the redistributive elements imply that the reforms are

[23] It refers to a form of pension which was supposed to compensate for a parallel reduction in the German Statutory Retirement Insurance System ("*Gesetzliche Rente")*

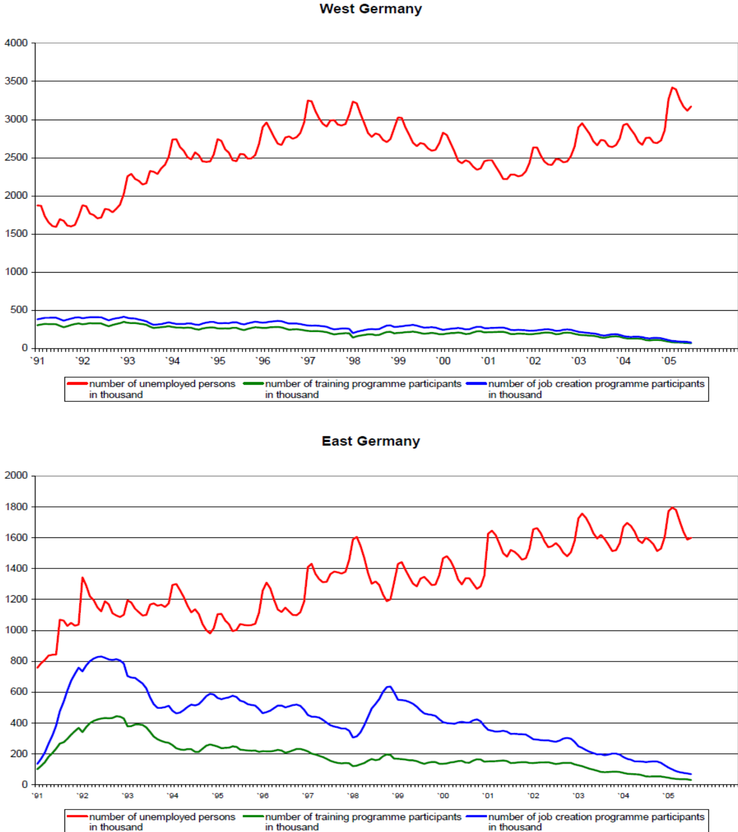
[24] Refers to the people qualified for the Riester-Rente (Riester Pension)

leaning towards an ever more flexible labour market. With the projected demographics and the dependency ratio projected as below by the Federal Statistical Office, Germany has the option to 2 different developmental paths: continue with a voluntaristic approach as in the United Kingdom and relegate its elderly poor to social assistance, or espouse the universalism of a Dutch or Danish public scheme and mandate additional private savings to low-income workers and atypical job holders.

3. Labour Market Reforms – Hartz Reforms in Germany

Since unification, labour supply increased by almost one-third but the East German labour force were not adequately trained to be employed in a competitive open market economy. The figures below show the development of unemployment and the number of participants in training and job creation programmes for West and East Germany during 1991 to 2005. The East German economy experienced rising unemployment and continuing dependence on federal subsidies and transfer payments from West to East (Jacobi and Kluve, 2006).

Figure 3.3 Unemployment and Active Labour Market Policies (ALMP) participation



Source: IAB Nurnberg

Before the Hartz reform, the active and passive labour market policy addressed issues of providing unemployment benefits to maintain the worker's social status during unemployment

rather than providing a safety net of last resort. All payments made to the individual were linked to his or her previous earnings. Unemployment benefits, paid for the first 6 to 32 months of unemployment, amounted to 67 percent of the last net income. Unemployment assistance paid thereafter without time limit still reached 57 percent of the last net income. The unlimited duration of unemployment benefit payments was an extraordinary feature – it led to higher replacement rates (the ratio of pension and wage levels) for long-term unemployed than in any other OECD country (OECD 2004). Replacement rates for short-term unemployed were still comparable. Unemployment benefits were financed by unemployment insurance contributions shared by employees and employers, while unemployment assistance was financed by taxes. The system combined generous benefit levels with high benefit reduction rates that taxed away most of the additional earned income of a benefit recipient. The incentives to take up a job were very low, especially for low skilled workers. The active labour market policy in the 1990s was characterised by training and job creation measures. Direct integration into regular employment played a minor role. Job search assistance and monitoring by the public employment agency was given low priority. Sanctions for low engagement in job search activities were rarely implemented lest there be costly lawsuits. Assignment to programmes was not based on a systematic profiling of each customer, but rather on caseworkers' discretion which eventually ended in shorter engagements and less productivity (Bonin, 2009 and Jacobi and Kluve, 2006).

As unemployment continued to rise in the 1990s, the social security system ran the risk of financial collapse and need for a comprehensive reform of the labour market policies. The debates (political and academic) criticised the benefit system for creating adverse work incentives and increasing long-term unemployment, deteriorating skills and thus worsening the mismatch on the labour market. The public employment services were blamed for operating inefficiently and being customer-unfriendly and failing to push jobseekers sufficiently to search for a job. The mix of active measures, focusing on training measures and public job creation schemes with long durations, was criticised for retaining participants out of the open labour market instead of integrating them (Jacobi and Kluve, 2006).

The pension reforms worked in tandem with the labour market reforms known as the *Hartz* reforms. This consisted of *Hartz I-IV* implemented gradually – Jan 1st 2003 (Hartz I and II), Jan 1st 2004 (Hartz III) and Jan 1st 2005 (Hartz IV). The reform strategy aimed at: (a) improving employment services and policy measures, (b) activating the unemployed, and (c) fostering employment demand by deregulating the labour market. The reform changed the institutional and legal framework that determines the rights and duties of the unemployed, the benefit system. Further, the employment protection was reduced in some segments of the labour market[25].

[25] Lena Jacobi and Jochen Kluve, *Before and After the Hartz Reforms: The Performance of Active Labour Market Policy in Germany¸* April 2006, Discussion Paper No. 2100, IZA

The Hartz reforms fundamentally changed the framework in which the measures operated and involved greater co-ordination of institutional arrangements, especially between active and passive policy measures. The biggest changes were in the job placement services and the benefit system while the deregulation of work measures was mostly in the temporary work sector. The aim of reforms was to improve the performance of placement services (keeping in mind that the connect between jobseekers and jobs was large and contributed somewhat to a higher unemployment) and policy programmes. This was accomplished by the introduction of market mechanisms and by streamlining the public employment services. Modernisation was implemented along the lines of New Public Management. Every employment agency was to fulfill quantitative goals (measurable) individually fitted to each type of agency while having a wider scope of discretion on the choice of policy mix. Employment offices were converted into customer-oriented one-stop-centres. Range of services provided was expanded from advising and counseling services to social services and administration of benefit payments.

Market forces improved the quality of services and broke up the informal and inefficient insider relationships between public employment management and private providers; introduction of the voucher system meant that each individual could choose an alternative private placement service if a public employment service was unable to place one in 6 weeks. The public employment service could also *outsource services* fully or partially by setting up a Personal Service Agentur (PSA) that acted like a temporary work agency for the unemployed. The reform also aimed at improving the *targeting* of active measures and the *allocation of measures and resources*. The statutory regulation of eligibility conditions was reduced leaving a wider scope for individually fitting clients to measures.

The clients were categorised into 4 types based on abilities, problems and potential labour market chances: Market clients (*Marktkunden)*, Clients for counseling and activation (*Beratungskunden Aktivieren),* Clients for counseling and support *(Beratungskunden Fordern),* and Clients in need of supervision (*Betreuungskunden).* Selection into training measures targeted cream skimming in order to choose those clients who would benefit most from the training (70 percent probability of finding a job after the measure). Accordingly, training providers had to produce a 70 percent success rate in order to be contracted by the employment agency. In contrast, job creation measures were re-designed for merely targeting the very hard-to-place unemployed. Hence, public employment would constitute market replacement and preserve employability for those who are not expected to find a way back into regular employment in the near future. Incentives for unemployed workers to take up public employment rather than regular employment were reduced as participants could no longer restore eligibility for unemployment benefits after completing the measure. The restrictive targeting of training and job creation schemes as well as the reduction of programme durations induced a further reduction of participants and spending for these measures. And lastly, in order to continuously optimise existing programmes on the basis of conclusive empirical evidence, a corresponding evaluation

mandate was implemented making it the first major reform in the history of the German welfare state that is accompanied by comprehensive scientific evaluation. Currently more than 20 economic and sociological research institutes are involved in the evaluation (cf. Bundesregierung 2006). The Hartz reform implemented the "Minijobs" and "Midijobs" – which exempted/reduced the social contributions since these jobs generated a low income. Temporary work was allowed in many industries including construction. Exemptions from restrictions on fixed-term contracts which were provided to employees aged 58 and over were expanded to those above 52 years (Jacobi and Kluve, 2006).

Based on the interviews conducted in Germany at official bodies as well as academic institutions, the effect of the financial crisis of 2008 was mitigated due to the coincidence of the effects of Hartz reforms taking effect. In addition, the government took steps to reduce the working hours, thereby decreasing the unemployment due to lay-offs. This led to continued employment which helped in the revival of the economy in recent times. One of the most significant accomplishments of the Hartz reforms was the reduction in turnaround time for connecting the unemployed to the right opportunities.

Given below is a summary of the effects of Hartz reforms as evaluated by the various research institutes from the data collected to evaluate the effectiveness of various policies implemented and their positive/negative effect on reduction of unemployment and increasing the employability of the hard-to-place workers.

Figure 3.4 Effects of Hartz Reforms

Measure	Evidence before	Evidence after	Reform effect
4a1. Placement Services			
General	(+)	(+)	(+) Introduction of one-stop-centres seems positive, but significance of effects unclear.
Placement voucher[a]	n/a	0	0 No significant effect on re-employment probability.
Assignment to private placement providers[a]	n/a	0	0 No significant effect on re-employment probability.
Placement via temporary work (PSA)	n/a	–	– PSA reduce the employment probability of participants.
4a2. Training	0 older studies / (+) more recent studies	+	+ Exit rate to employment increased, locking-in effects reduced.
4a3. Public job creation	–	(–)	– Measure remains detrimental after the reform. (+) Magnitude of negative effect decreases. Impact on "employability" unclear.
4b1. Wage subsidies to employers (Integration subsidies)	(+)	+	+ 20-50 percentage points higher probability of regular employment post-treatment. Extent of windfall gains unclear.
4b2. Start-up subsidies (Bridging allowance and "Me, Inc.")	(+)[b]	+	+ Subsidy significantly reduces risk of unemployment (decreasing over time). Some windfall beneficiaries exist.
4b3. Wage protection for elderly	n/a	0	0 No significant effect.
4b4. Employment with reduced social security contributions			
Minijobs	n/a	+	+ Reform caused large increase in employees in Minijobs (+1.8 Mio.). (–) Inflow from unemployment low. Incidence of intra-enterprise displacement cannot be ruled out.
Midijobs	n/a	(+)	(+) Modest effect on creation of Midijobs (+125,000). Incidence of intra-enterprise displacement cannot be ruled out.
4c1. Temporary work deregulation	n/a	+	+ 23,700 additional employees in temporary work 6 months after reform (short-term). Deregulation widely acclaimed.
4c2. Fixed-term contracts for elderly	n/a	0	0 No significant effect.

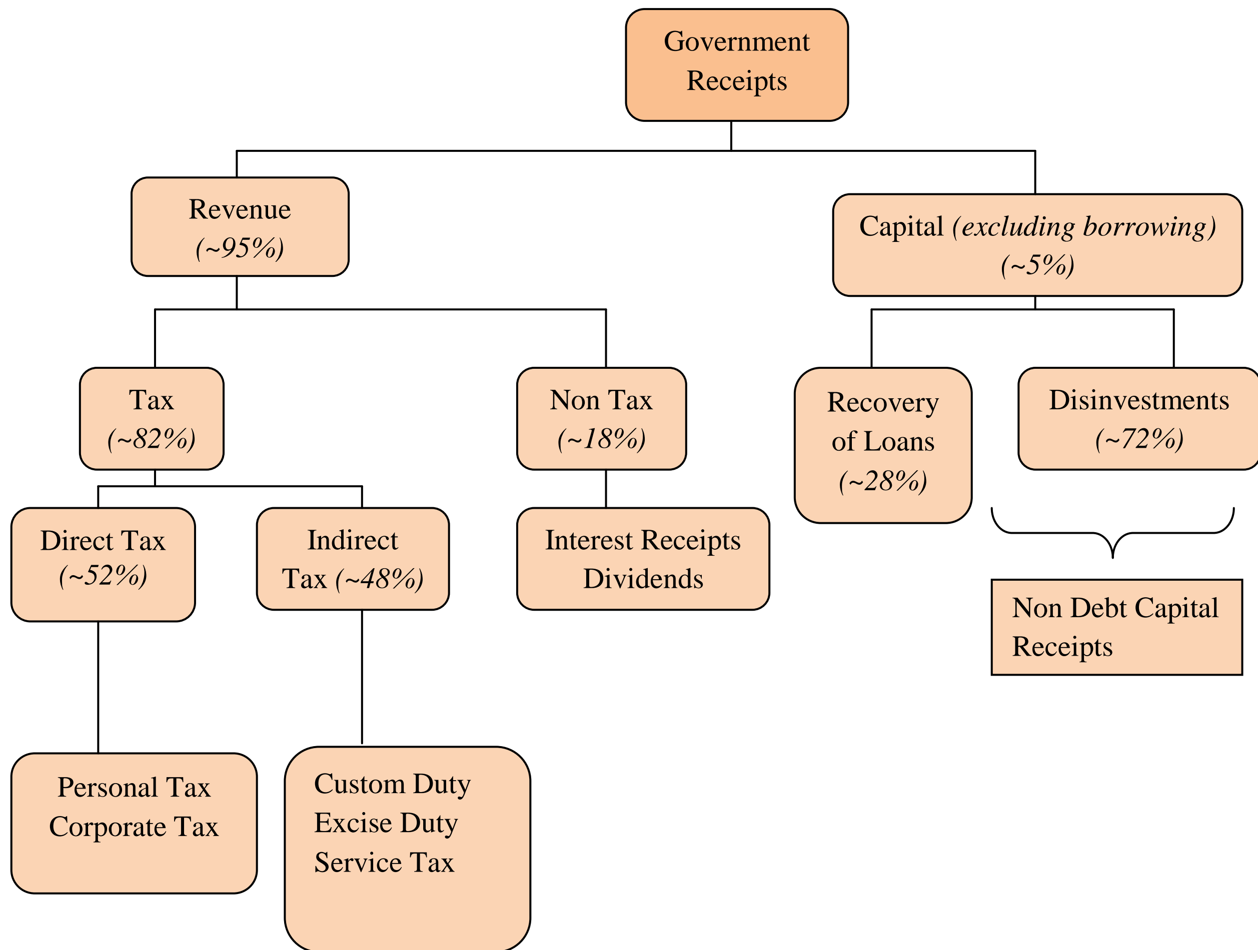
Notes: Labour market effects: + positive, (+) modestly positive, 0 zero, (–) modestly negative, – negative.
[a] Already since early 2002.
[b] Pre-reform evidence on bridging allowance only.

Source: Jacobi and Kluve, 2006

4. Indian Government Budget

The Indian Government account is divided into Government Receipts (revenue) and Government Expenditure. The Government Receipts are further categorised as Revenue and Capital and so on as shown in the figure below along with percent contribution as per data given in FY13 Budget Estimates in brackets:

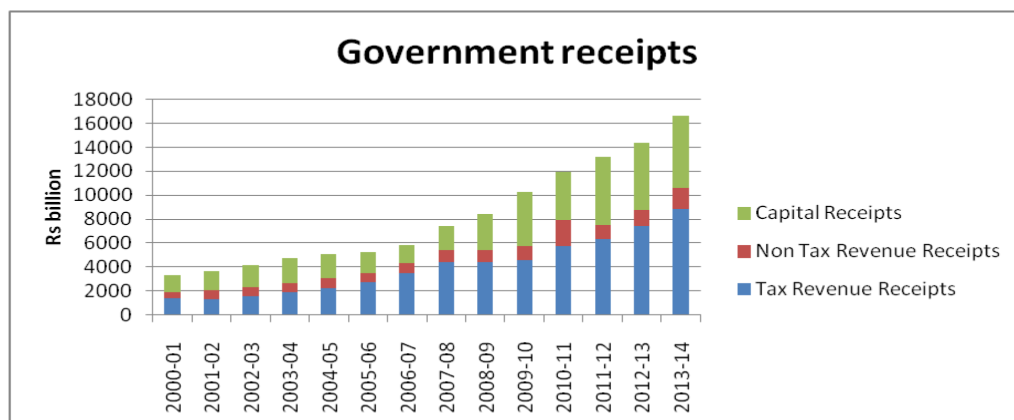
Figure 3.5 Classification of Indian Government Revenues



Source: IDFC, *Fiscal Deficit and its Component*

Looking at the trend of government receipts in absolute terms using budget released numbers, the following conclusions can be inferred.

Figure 3.6 Distribution of Central Government Receipts

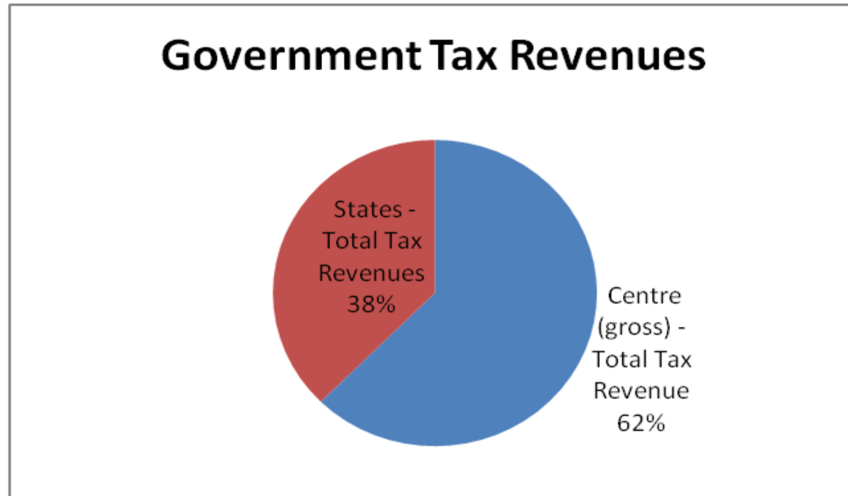


Source: Budget Documents

Tax has been the dominant share for Central Government Receipts and hence warrants further investigation.

The Tax revenue collection pie of the Central and State government is as below:

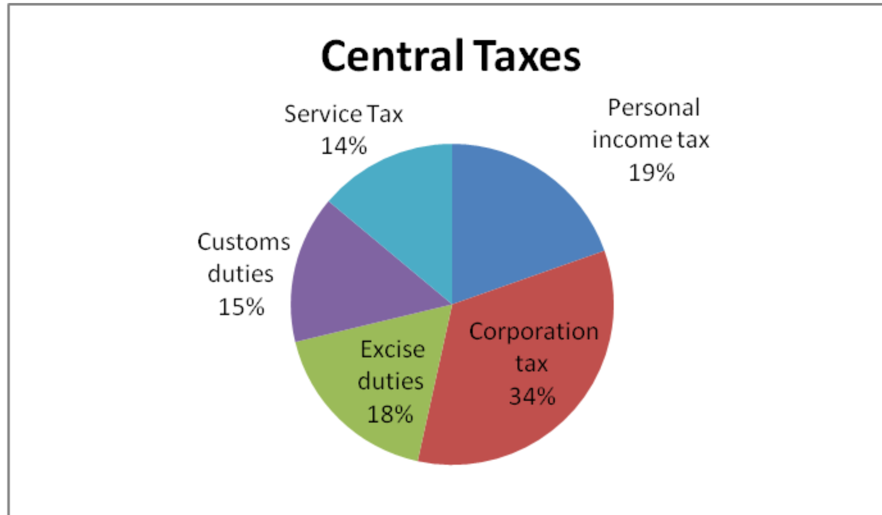
Figure 3.7 Distribution of Government Tax Revenues (2012-13)



Source: Budget Documents

The major contributors to central taxes are given below:

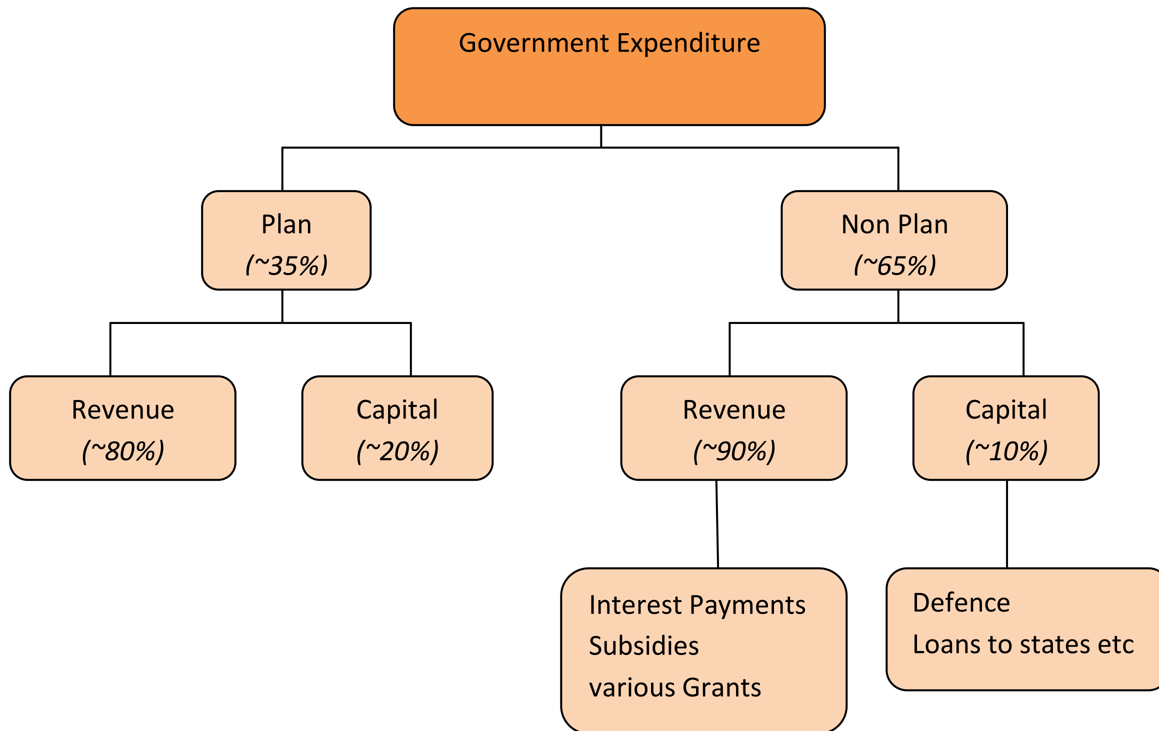
Figure 3.8 Components of Central Government Taxes (2012-13)



Source: Budget Documents

On the expenditure side, expenses are categorised as Planned and Non-Planned and then broken into further buckets as shown in the figure below, along with percent contribution as per data given in FY13 Budget Estimates in brackets:

Figure 3.9 Components of Central Government Expenditure



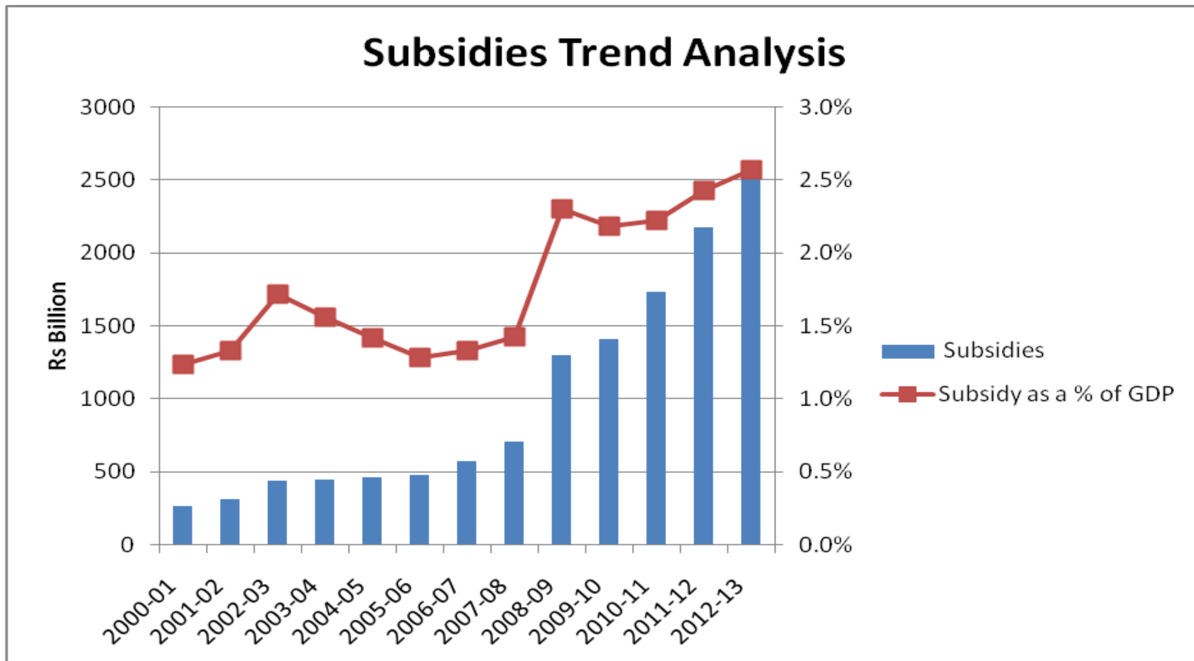
Source: IDFC, *Fiscal Deficit and its Component*

Plan expenditures are expenses on schemes and projects while Non-Plan expenditure is towards maintenance and support activities. Revenue expenditure is consumption expenditure by the government. Plan Revenue expenditures are expenses towards various schemes and services provided by the government while Non-Plan Revenue expenditure includes interest payments, subsidies and various grants. Interest payment forms ~37 percent of Revenue Non-Plan expenditure while subsidies (major ones include food, petroleum, and fertiliser) form ~22 percent of the Non-Plan expenses[26]. Hence, subsidies and interest payments require further analysis.

As can be seen from the chart below, subsidies have been increasing as a percentage of GDP.

[26] IDFC, *Fiscal Deficit and its Component*

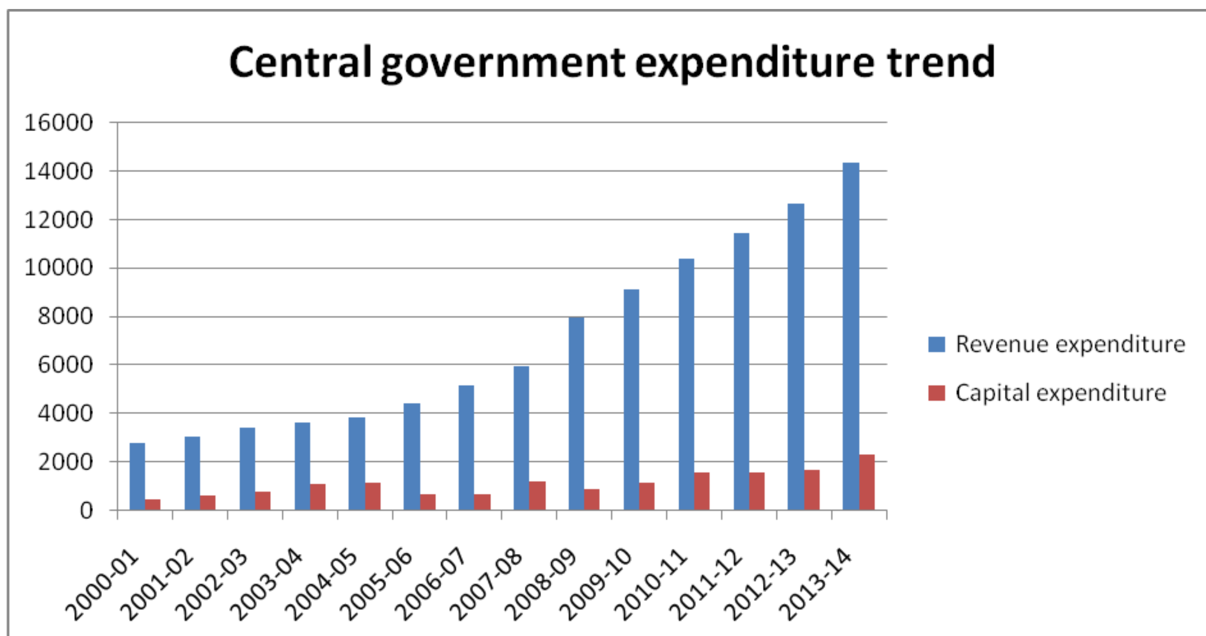
Figure 3.10 Subsidies Trend



Source: Budget Documents, RBI

Below is the trend of expenditure of the central and state governments:

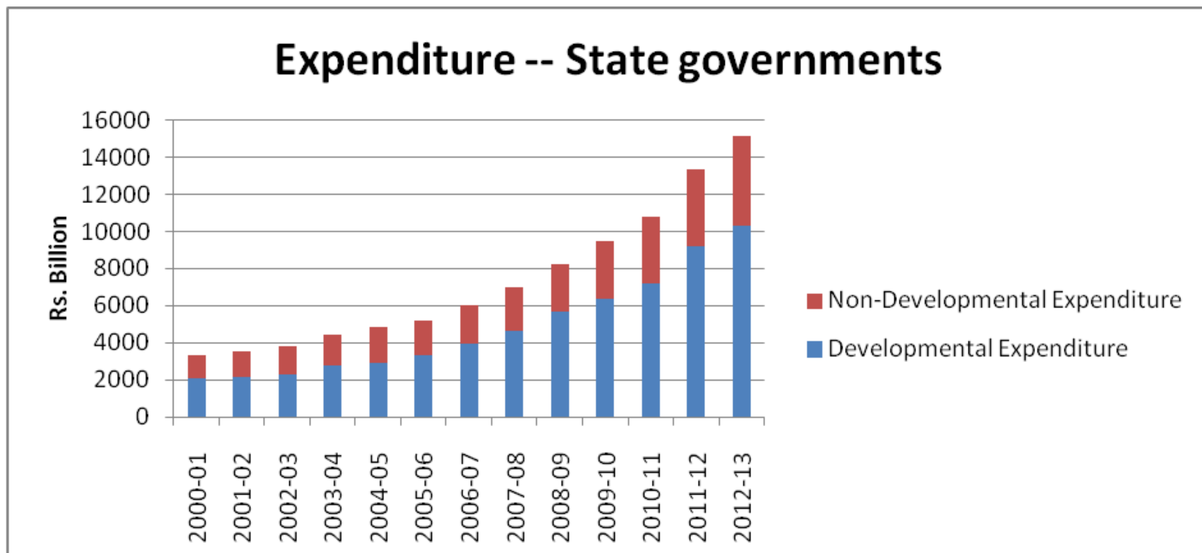
Figure 3.11 Central Government's Expenditure Trend (Revenue vs Capital)*



* 2013-14 Budget Estimates according to RBI, units are in Rs. billion

Source: Budget Documents

Figure 3.12 State Governments' Expenditure (Developmental vs Non-developmental)



Source: Budget Documents, RBI

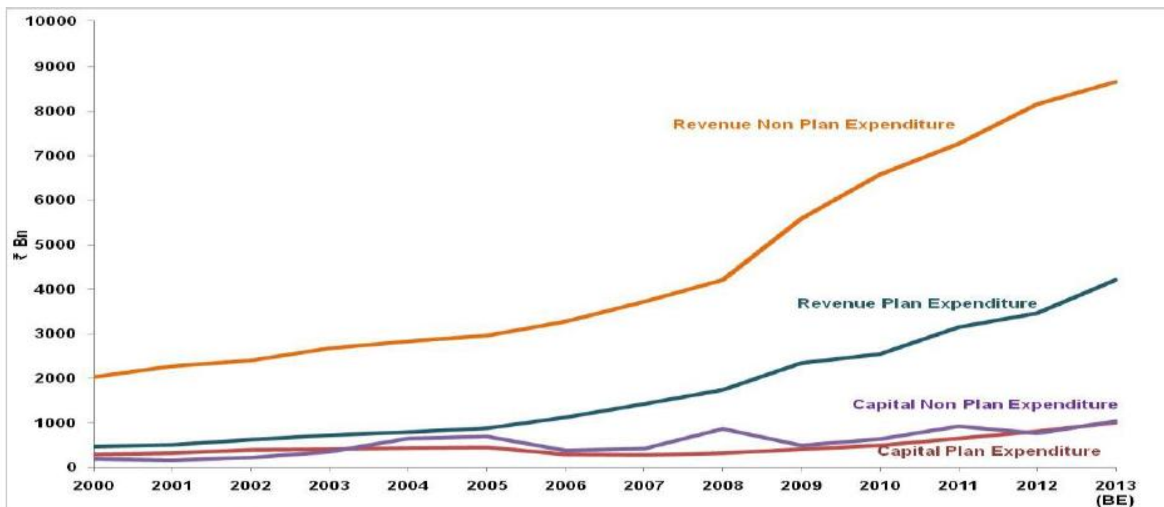
It can be seen that the growth of revenue expenditure for the central government has been drastic compared to the growth of capital expenditure. In fact, the CAGR for revenue expenditure has been 12.4 percent since 2000 while the capital expenditure has grown by 10 percent CAGR.

It widely accepted that fiscal deficit on the back of higher capital expenditure is preferred to deficit due to revenue expenditure. This is because in the former, the deficit creates assets for the government which will in future increase its receipts while the latter indicates that the government is using its receipts and is also borrowing to finance its consumption rather than investing. This in turn will hurt economic growth and add to government debt and increase interest payments. [27]

By looking at the figure below re-created by IDFC using the budget data released, it can be inferred that the Indian government is spending more on consumption rather than investing.

[27] IDFC – Mutual Fund, *Fiscal Deficit and its Component,* <http://tablet.idfcmf.com/FundDocuments/Fiscal-Deficit-and-its-Component.pdf>

Figure 3.13 Trend Analysis of Plan and Non Plan Expenditure of Central Government



Source: Budget Documents

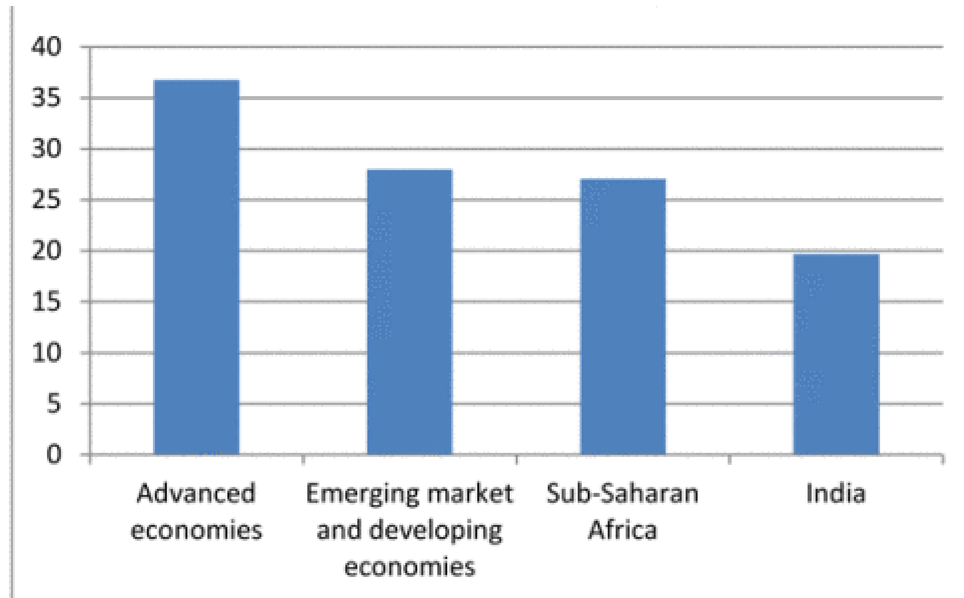
With this groundwork, we start by looking closely at the Indian Tax Administration – the organisation, structure, laws, use of technology, taxpayer information and lastly, important tax policies.

The power to levy, collect and administer taxes is divided among the three tiers of governments. The Union (federal) government handles income tax, wealth tax, securities transaction tax, customs, central excise, central sales tax and service tax; the state governments handle value added tax (VAT), excise on liquor and molasses, land revenue, stamp duty, motor vehicle tax (including driving licenses); and local government bodies like municipal corporations, municipalities and cantonment boards administer property tax, taxes on non-motorised vehicles (cycles, three-wheelers, rickshaws, animal-driven vehicles), fees on pets, etc.

We proceed by looking at the Tax Administration structure of India since tax collection forms the crux of many issues related to government revenue.

India has low revenue to GDP ratio in the world as seen by the graph below which re-emphasises the point of expanding the tax base as well as making the tax administration more efficient and widespread to reduce tax evasion.

Figure 3.14 General Government Revenues (percent of GDP, 2007-11)



Source: IMF WEO Database, www.imf.org

Chapter 4 Financial Relations between the Centre and States

There are many countries in the world that have significant subordinate levels of government such as Argentina, Australia, Brazil, Canada, Germany, India, Spain and the US. The subordinate levels of government have significant influence on the fiscal position of the country. For instance, their share accounts for 31 percent of total expenditure, 22 percent of total revenue and 66 percent of total investment in OECD countries, with the remainder being carried by respective central governments[28]. Germany has three levels of government – federation, Länder and municipalities. The constitution delineates the powers and duties between the Federation and the Länder in Germany by a law called Basic Law. The Basic Law clearly demarcates rules for expenditures and revenue responsibilities and legislative powers for the Federation and the Länder, but not for municipalities. Most of the legislative powers lie with the Federation whereas administrative tasks are in the hands of the Länder[29].

1. Financial relations between the Centre and States: Germany

Tax system and division of tax revenue among the Federation, Länder and municipalities in Germany

Germany is a federal state comprising the Federation and 16 federal states, called Länder. Länder represents an independent level of government which has its own rights and obligations. Municipalities or local government which constitute the third tier of the government are deemed to be part of the Länder, as per constitutional rules on public finance. Länder are considered independent in managing their budgets, in principle, as stated in the Basic Law. But, in practice, their autonomy is relatively heavily limited on the revenue side as well as the expenditure side. The independent tax powers of Länder and municipalities are very limited and can together raise around 11 percent of total tax revenue from their own tax sources. The collected total tax revenue among three levels of the government is broadly allocated into four phases:

1. **Vertical distribution of tax revenue:** By the constitution several particularly important taxes are allocated to the Federation, Länder and, to some degree, the municipalities.
2. **Horizontal distribution of tax revenue:** The tax revenue attributable to the Länder (consisting of all federal states) under vertical distribution is redistributed among the various individual Länder (16 federal states). Revenues collected from VAT, income tax and corporate tax are then redistributed among the individual Länder on the basis of some specified principle.

[28] Blochliger, H. et al. (2010). Sub-central Governments and the Economic Crisis: Impact and Policy Responses. OECD Economics Department Working Paper No. 72

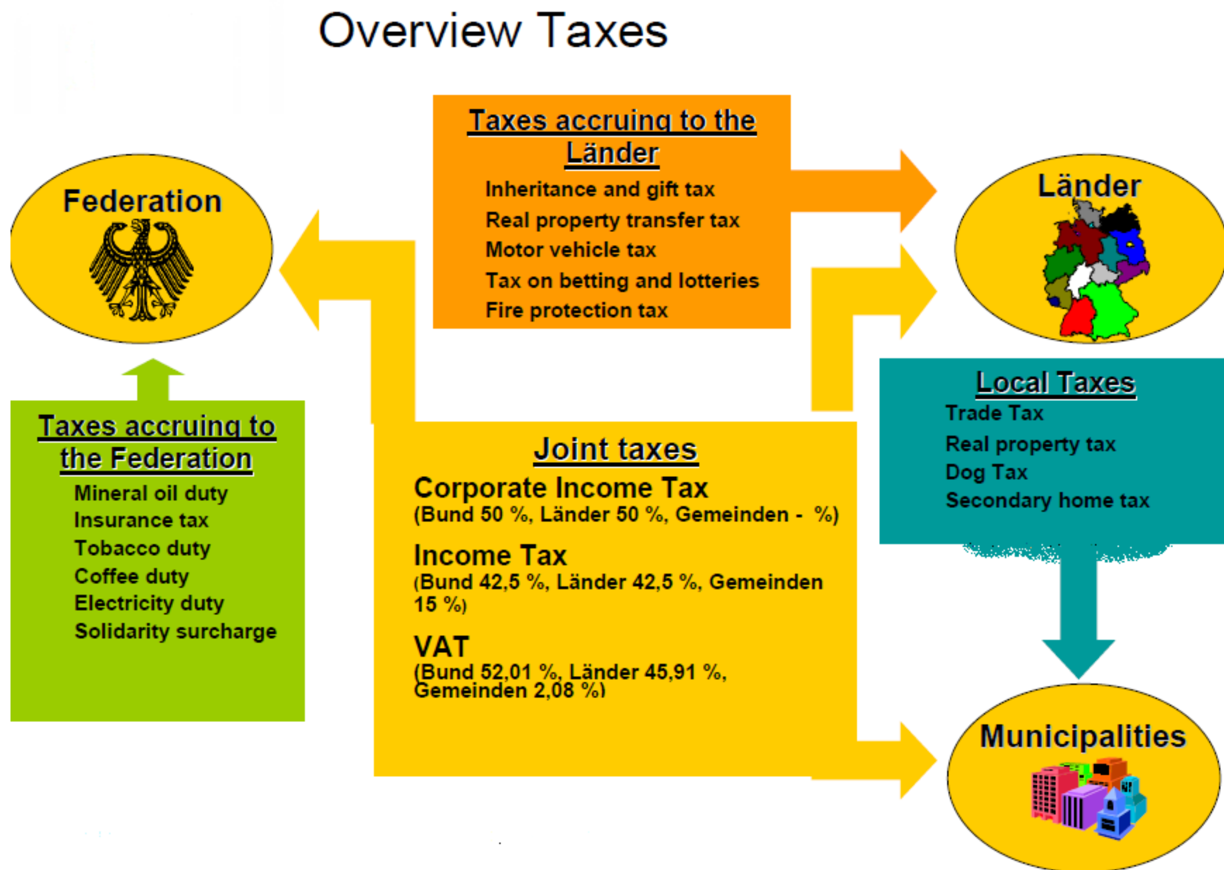
[29] There are exceptions, for instance, customs duties and the administration of waterways are federally owned.

3. **Financial equalisation:** In the third stage, rich Länder transfer funds to poor Länder to enhance financial equalisation amongst all federal states.
4. **Supplementary federal grants:** Taking forward the process of financial equalisation, the federal government makes grants to poor Länder to bring their funds at par with rich Länder.

There are certain specified principles on the basis of which the above-mentioned four stages are implemented. However, we are not going to explore all of these in depth, but will concentrate on the vertical distribution of tax revenue. The tax and finance system of Germany is extremely complex[30]. The interconnections amongst the three layers of the government are very strong; especially tax administration, and devolution powers are effectively descended to regional and local authorities. In the tax system of the federal republic of Germany, there are four categories of taxes, viz. Federal taxes, Länder taxes, Municipal taxes and Joint taxes. As shown in the following figure (Figure 4.1), federal taxes such as mineral oil duty, insurance tax, duty on electricity, etc. are levied and appropriated by the federal government, but collected by 16 Federal States. Likewise, inheritance tax, gift tax, real property transfer tax, etc. and trade tax, real property tax etc. are levied, collected and appropriated by the Länder and Municipalities respectively. However, there is a unique category of taxes called joint taxes - corporate income tax, income tax and VAT - wherein taxes are levied by the federal government but revenue is distributed among the three levels of the government. Further, they constitute the majority of the total tax revenue, around 72 percent in 2012 (Figure 4.2). Before we move to the devolution of tax revenues, it is worthy to note here that all taxes which are levied by the federal government are collected by the 16 Federal States' Ministry of Finance through their set up of 551 local tax offices[31].

[30] Hillebrand, Distribution of taxes by regional authorities
[31] OECD Library 2013, Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies

Figure 4.1 Distribution of Total Tax Revenue among Federal, Länder and Municipalities: Länder have little tax autonomy



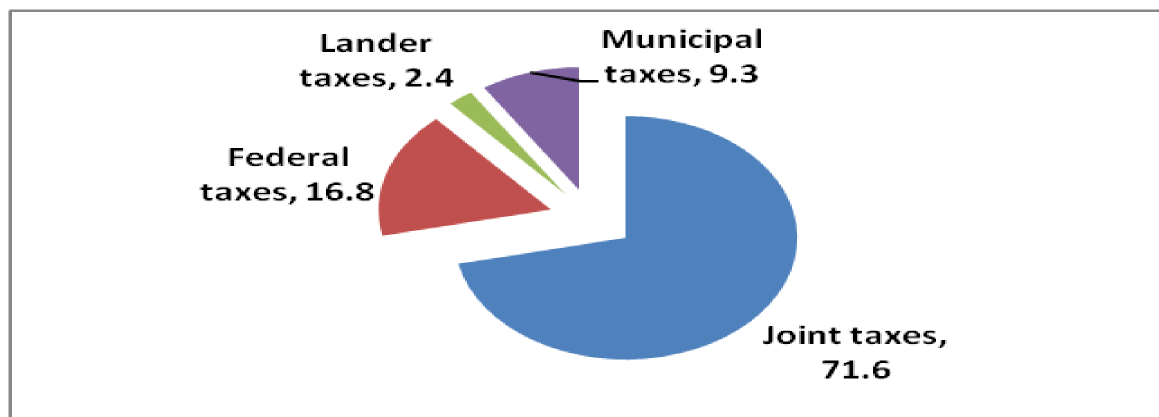
2. Devolution of Tax Revenues

Once the taxes are collected by the Lander and local governments, the redistribution takes place between different levels of the government. The German constitution makes sure that the devolution of taxes between Federation, Federal States and local authorities must align with their duties and functions. Therefore, in this kind of tax and finance regime, certain taxes or those called 'joint taxes' go into a common pool and are then divided among different levels of the government. For instance, the Länder are constitutionally entitled to 42.5 percent of the revenue raised on income tax, 50 percent of the revenue raised on corporation taxes and 53 (approx) percent of revenue raised on VAT. Länder's share on VAT varies from year-to-year. Municipalities which are primarily regulated by the Länder governments are entitled to 15 percent of the revenue raised on income tax and around 2 percent raised on VAT (Figure 4.1).

Apart from joint taxes which constitute around 70 percent of the total tax revenue, the remaining proceeds are allocated to the Federation, the Federal States and the municipalities as their own tax source. Länder have little tax autonomy. Their own share of tax totals 2-3 percent of total tax revenue. On the other hand, the main source of revenue of local governments' is grants that they

receive from the Länder government, on the part of financial equalisation mechanism. There is one interesting feature found in the devolution of taxes. Revenue generated from some of the Local Authority taxes such as trade tax and land tax are transferred to the Federation and Federal States[32]. The Municipalities own sources of tax revenue amounted to around 10 percent of total tax revenue of the general government (Figure 4.2).

Figure 4.2 Contribution of Total Tax Revenue by Federation, Länder and Municipalities as per 2012



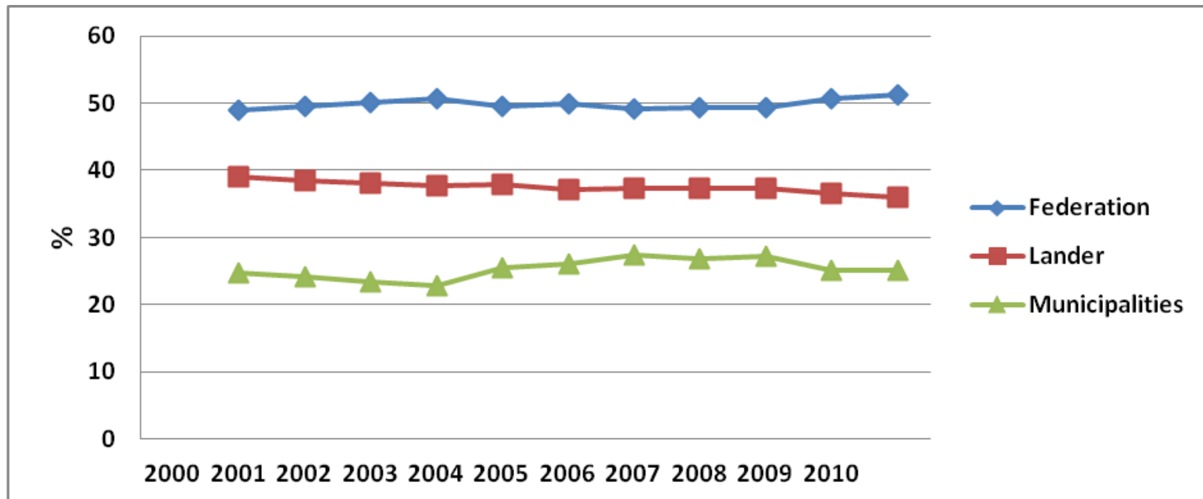
Source: Federal Statistical Office

3. Trends in Tax Revenue among Levels of Government

The apportionment of tax revenue among different levels of the government has remained almost constant over the past decade. The federation generates the highest tax revenue followed by the Länder and Municipalities (Figure 4.3). In the mid 2000s the Municipalities' share rose slightly from 25 percent in 2004 to 27 percent in 2008 while Länder's share declined from 38 percent to 37 percent. This shows that the role of the federation has remained dominant and generates around half of the total tax revenue in the economy.

[32] Hillebrand, Distribution of taxes by regional authorities

Figure 4.3 Share of Total Tax Revenue



Source: OECD Statistics

4. Financial Relations between the Centre and States: India

Like Germany, India too possesses a federal structure comprising 28 states wherein a distinction between the functions of centre (federal) and states (Länder) and their sources of revenue is clearly delineated under the Constitution of India. The major sources of tax revenues – income tax, corporate tax, union excise duties[33], etc. are under the purview of central government. These taxes are levied and collected solely by the central government. But it is worthy to note that revenues collected from income tax and union excise duties are shared by all States in a proportion suggested by the Finance Commission of India[34]. In other words, these taxes are called shareable taxes just as Germany has joint taxes. Rest of the collection from taxes is appropriated by the Central government. As of now, States are entitled to 32.5 percent of central tax revenue which roughly represents around 50 percent in Germany. The central government also makes transfers to the individual state to ensure equality amongst states. And total transfers to the states on part of the revenue account are capped at 39.5 percent of the Centre's gross tax revenue for the period of 2010-15, as per the recommendations of Thirteenth Finance Commission of India.

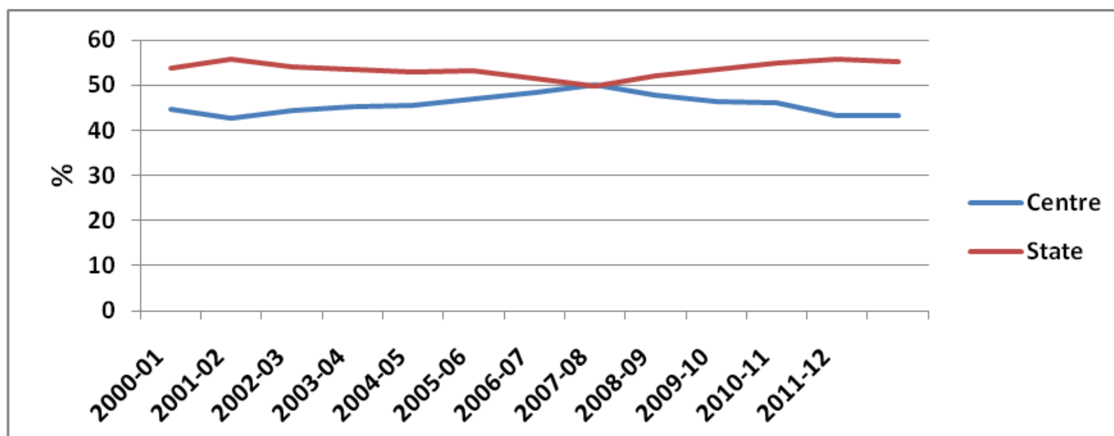
The centre and the state as a whole generate total tax revenue. The States' share has remained higher than the central government's over the past ten years, representing around 55 percent of

[33] Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparation.

[34] Finance Commission is constituted by the Constitution of India to define relations between centre and the states in terms of distribution of net proceeds of shareable taxes between them (vertical distribution) and the allocation of such proceeds among the states (horizontal distribution), to give recommendations on grants-in-aid given to the States by the Centre and recommendations on loans to states given by the Centre. The commission is appointed every five years and makes recommendations by submitting reports.

total tax revenue. However the relative share of the centre rose in mid 2000s, remained constant for a few years and declined thereafter (Figure 4.4). In India, there is no distinct data available at the local government level, as was the case with Germany.

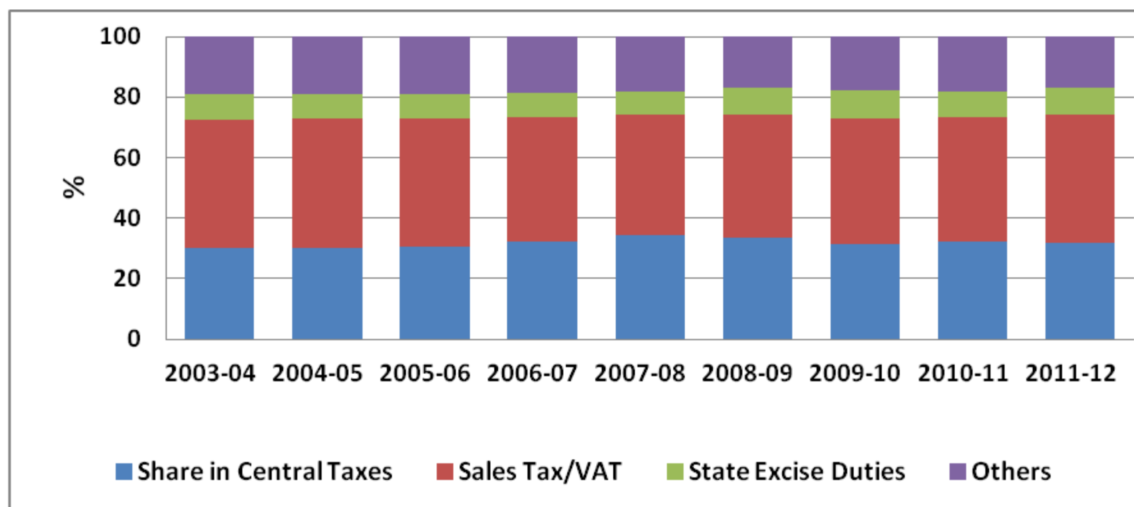
Figure 4.4 Pattern of Tax Revenues between Centre and State (in proportion to total tax revenue)



Source: RBI

Going forward, there are some taxes which are totally assigned to the state governments. They are fully responsible for designing of those tax rates, collection and appropriation. This category broadly includes taxes on sale and purchase of goods except newspapers, taxes on agricultural income, excise duty on alcoholic liquors and narcotics, taxes on sale and purchase of property, and so on. Most states in India have replaced Sales tax with Value Added Tax (VAT) from 1 April 2005. However other indirect taxes such as excise duty, service tax etc., have not been replaced by VAT. The benefit of VAT is that it gives credit to taxes paid on inputs at each stage of sale and therefore provides relief from cascading taxes. The standardised rate of VAT is 12.5 percent though it may vary from state-to-state. For instance, Assam, Jammu and Kashmir, and Karnataka charge VAT at 13.5 percent. Sales tax has continuously been the major source of tax revenue for states, and constitutes around 40 percent of total states' tax revenue (Figure 4.5). Central taxes shared by states (30 percent) have been the second highest source of states' tax revenue, followed by state excise duties (9 percent).

Figure 4.5 Pattern of States' Tax Revenue (in proportion)



Source: RBI

There is a third category of taxes wherein the Central government decides the rate of taxes but they are collected and appropriated by the states. These include stamp duties, excise duties on medical and toilet preparations containing alcohol or narcotics. There is another distinct category of taxes in which taxes are levied as well as collected by the centre, but their entire proceeds are transferred to the state governments, in proportion as determined by Parliament. These taxes include: Succession and Estate duty in respect of property other than agriculture land; terminal taxes on goods or passengers carried by railways, sea or air; taxes on railway fares and freights; taxes on transactions in stock exchanges; taxes on sale and purchase of newspapers, including advertisements published therein, taxes on the sale and purchase of goods other than newspapers, where such purchase takes place in the course of inter-state trade or commerce.

Coming to local governments, there are no separate taxes assigned to them as was in the case of central and state governments. Local governments are at the complete discretion of state governments. The constitution empowers the State governments to levy taxes on land and buildings which have been transferred to the local governments/ municipalities. But the autonomy of the municipalities is limited in determining the tax rates and enforcing the tax[35]. In addition, there is no discernible distinction in the roles of municipalities among various states. The limited autonomy of municipalities though varies from state to state.

Concluding Remarks:

The tax structure between federal, Länder and local governments in Germany is quite similar to that in India, whereby main taxes are in the hands of the federal government, their revenue is distributed between different levels of the government and grants are transferred from the centre

[35] Rao, January 2013, Property Tax System in India: Problems and Prospects of Reform

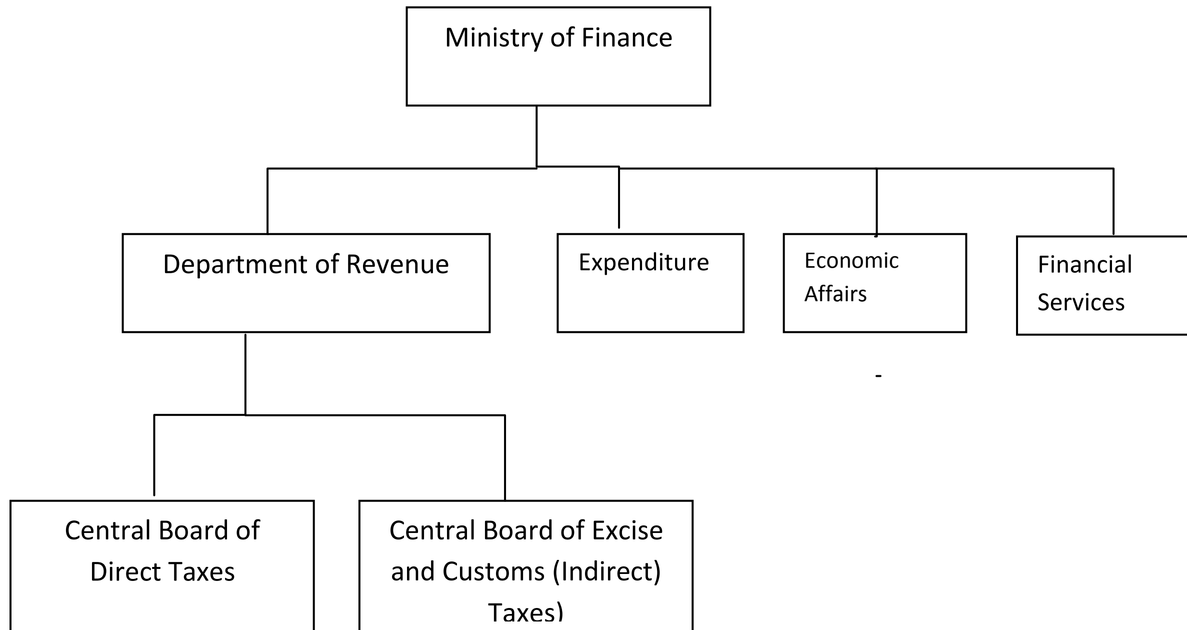
to the states to promote financial equalisation among different states as sources of revenues vary between the states. However, the division of tax revenue from the central to the local government is clearly demarcated in Germany which smoothens the functioning of a government. Furthermore, they have their own sources of tax revenue, and are not completely dependent on Länder. Whereas in India the local governments are not autonomous, and are mainly within the state's jurisdiction; there is no direct transfer of revenues to them from the central government and their own sources of taxes are limited. On the other hand, they are expected to undertake various functions viz. administration affairs of the rural regions, supply of clean drinking water, construction and maintenance of public utilities such as roads, parks, street lighting, and maintenance of public hospitals and schools, etc. despite inadequate sources of finance. If local governments in India are made autonomous and they have their own sources of revenue then perhaps better goods and services could be delivered by them[36].

[36] We are not suggesting that higher the financial resources, higher will be the work efficiency.

Chapter 5 Tax Administration

Structurally, the apex body administering levy and collection of taxes is divided in two – the Central Board of Direct Taxes (CBDT) and the Central Board of Excise and Customs (CBEC) for indirect taxes.

Figure 5.1 Structure of Tax Administration in India



Each field tax office operates on a cross-functional basis. The same Income tax officer or assessing officer along with his staff carry out the functions of receipt and processing of returns and payment, audit (scrutiny) of cases, enforced collections and recovery of taxes, surveys, etc. All matters related to taxation are handled on a cross-functional basis. The direct tax and indirect tax officers do not share any common databases. Further, there are separate directorates to handle cases of tax deduction at source (TDS), international taxes and transfer pricing and central charges (handling deep investigation cases) but all of these again function on a cross-functional basis.

The German Tax Department, also known as the Revenue Administration, is the public-sector body responsible for assessing and collecting taxes. The Tax Department in the Federal Republic of Germany is split between the central government and the federal states.

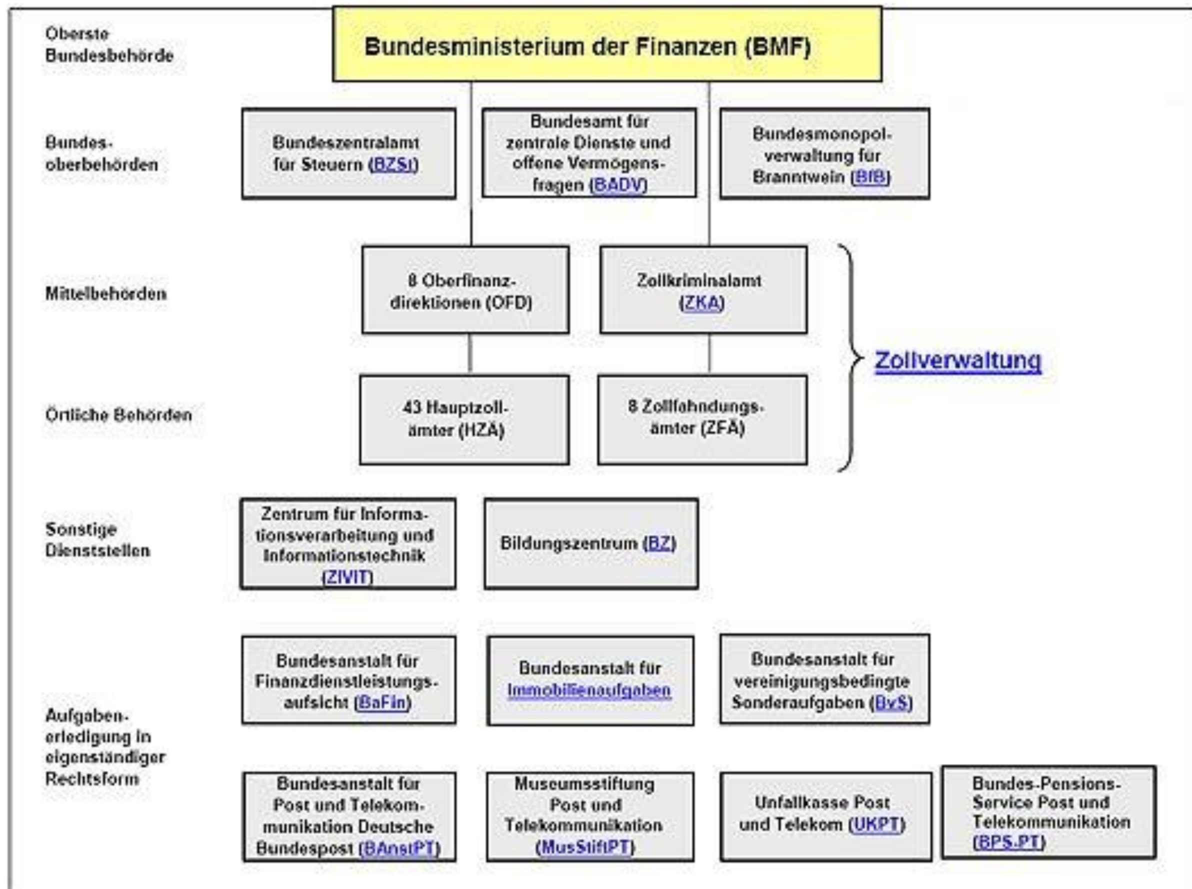
The Federal Ministry of Finance is the supreme authority of the Federal Revenue Administration. Subordinate to it are various senior authorities that perform specific functions for which the central government is responsible, such as the Federal Central Tax Office. Strictly speaking, the Federal Revenue Administration includes the Federal Ministry of Finance as the supreme federal

authority, the senior federal authorities, the medium-level authorities, local authorities and other departments such as the Data Processing and Information Technology Centre (ZIVIT)[37].

It also includes authorities and public sector bodies under the authority of the Federal Ministry (e.g. the Federal Financial Supervisory Agency).

Illustration: Summary of the department (as on 1 August 2006) is given below:

Figure 5.2 Organisational Structure, German Ministry of Finance



Source: Federal Ministry of Finance

The tax and finance system of the Federal Republic of Germany is extremely complex[38]. The Federal, State (Länder) and Local (Commune) authorities share a complex link of financial connections for the sharing/distribution of revenue collected between the various layers of governance which is expected in a Federal state with strong regional and local authorities.

[37] Federal Ministry of Finance

[38] Ernst Hillebrand, Director of the London office of the Friedrich Ebert Foundation, *Focus on Germany,* December 2006

However, the limitations of sources of revenue at the commune level have been a debate for some time now[39].

1. Institutional Structure of the Revenue Authorities

In order to allow the Revenue authorities[40] the flexibility of achieving the above objectives, they are being organised as a semi-autonomous or autonomous body with or without an external supervisory board, the head of which reports to a Government Minister. The rationale[41] for this is to ensure effectiveness and efficiency as a single purpose agency that can direct all its energy on the single task; as an autonomous body it will have the freedom to manage its affairs in a business-like manner without any day to day political interference and freedom from civil service regulation with respect to recruitment and fixing of salaries of its staff.

In India, both CBDT and CBEC have a number of the powers as listed above but they are subject to civil service rules in recruitment and in negotiating and fixing of salaries of staff. This limits their capacity in hiring and firing and retaining experts and specialists in accounts, industry and information technology. Even the proposal for opening of new tax offices, or expenses on infrastructure including on Information Technology infrastructure that has financial implications need approvals from the Department of Expenditure and Expenditure Finance Committee of Ministry of Finance.

In Germany, there is no separate autonomous or semi-autonomous revenue authority that is subject to budgetary control of Parliament and is subject to civil service regulation in recruitment and fixing salaries. Taxes are administered by the Federal Ministry of Finance through a number of Director Generals in the Ministry and a Federal Central Tax office for certain central functions; it also operates a Data Processing and Information Technology Centre (ZIVIT). All major taxes are administered separately by 16 State Ministry of Finance, which are subject to co-ordination and supervision by the Federal Ministry of Finance. Each State Ministry of Finance has their own IT operations.

2. Formal Advisory/Management Board between Ministry of Finance and Revenue Authority

Both India and Germany do not have any external supervisory body. Setting up of such a body with external officials as members to assist the Revenue Board both in India and Germany will help better the efficiency of the administration and provide supervision.

[39] Rodden, Jonathan, *Soft Budget Constraints and German Federalism,* World Bank
[40] Tax Administration in OECD and Selected Non-OECD countries: Comparative Information Series (2010)
[41] The Reform of Revenue Administration: A study for DFID, Delay, Devas and Hubbard, June 1998

3. Taxes handled by the Revenue Authorities

It has been recognised that there are advantages in a single autonomous revenue authority handling Income Tax, Corporation Tax, Excise and VAT. This is because almost all these taxes have a common taxpayer which allows not only seamless exchange of information, matching and cross verification of the turnover, expenses (in form of salaries, social security contributions and other payments) for audit purposes and third party information but they also have common ICT infrastructure and databases. This reduces the cost of compliance for the taxpayer since for all activities including registration, payment of taxes, filing of return, audit (scrutiny) as well as dealings in postponing payment of taxes by way of installments and so on, they only have to deal with a single authority.[42]

India has semi-autonomous bodies in the form of Central Board of Direct Taxes (CBDT) that deals with Personal Income Tax (PIT), Corporate Income Tax (CIT), Wealth Tax and Securities Transaction Tax (STT); while the Central Board of Excise and Customs (CBEC) deals with Central Excise, Customs, and Service Tax. The State Governments deal with VAT.

In Germany the levy and administration is complex as indicated in the next section.

4. Integration of Tax and Social Security Contribution

Separate bodies for collection of tax and social security contribution has not only raised issues of efficiency and effectiveness but has also added to the cost of compliance for businesses including employers who have to deal with separate collection bodies for almost identical functions. The International Monetary Fund Fiscal Affairs Department study[43] has revealed multiple benefits of integration of collection activities of tax and social security contributions.

As per the OECD survey[44], 18 countries including UK and Canada out of 49 countries surveyed have integrated social security contributions with their Tax Administrations.

In India, there are two organisations of government, namely, Employees Provident Fund Organisation (EPFO) and Employee State Insurance Scheme which cater to social security needs of 61.5 million low income persons employed in 660,546 organisations. Since these organisations must have at least 20 employees to be covered by the scheme, almost all of them must be registered with the Income Tax Department and must also be liable for indirect taxes

[42] OECD survey, OECD 2011, based on the model being followed in 44 of the 49 countries covered
[43] IMF Working Paper: Integrating Tax and Social Security Contribution Collection within a Unified Administration: The experience of Central and Eastern European Countries, Peter Barrand, Graham Harrison and Stanford Ross (December, 2004)
[44] Tax Administration in OECD and Selected Non-OECD countries: Comparative Information Series (2010)

like excise, service tax etc. Though the employees registered with EPFO have lower threshold of income and may not be liable for income tax, there could be a fair number of higher income employees who voluntarily register with EPFO and contribute to the fund. Bringing together the collection of contributions of EPFO to the combined revenue board would be advantageous to the two organisations as well as to the employers.

In Germany the tax set up does not deal with any aspect of Social Security Fund collection or administration and integrating it with their Tax Administration might yield lower costs of managing as well as provide leeway to enable changes to the social security fund in light of the ageing demographic.

5. Role of Ministry of Finance and the Revenue Authority in Tax Policy and Legislation

While in almost all countries, the Ministry of Finance handles the Tax Policy and Legislation work, the Revenue Authority implements and administers the tax laws. However, the Revenue Authority, especially HMRC (Tax Administration in UK), UK as well as the Canadian Revenue Agency carry out studies on the impact of the policy measures of the Ministry of Finance even before the same is proposed.

In India, the Tax Policy and Legislation Division of the CBDT and Tax Research Unit of CBEC also report to the Ministry of Finance on tax policy and legislation matters. There is no clear-cut delineation of the roles of the Tax Authority and Ministry of Finance which distorts the policy framing as well the drafting of the legislation. Often tax policy and legislations proposed by Tax Policy and Legislation (TPL) and Tax Research Unit (TRU) are more to meet certain legal hurdles and day to day working of Tax Administration issues without any regard for impact and equity.

Thus, in India, there is need for clear separation of the function of tax policy formulation and legislation from the execution of Tax Administration functions. While the Ministry of Finance must focus on formulation of Tax Policy and Legislation, the Revenue authorities (CBDT and CBEC) must be left to handle Tax Administration and execution and administration of the tax policy and legislation formulated by the Ministry of Finance.[45] However, the Revenue Authority must carry out research and analysis on the impact of various policy and legislation either already enacted or those prior to being proposed.

In Germany, tax policy is formulated only by the Federal Ministry of Finance but is administered directly by the Federal as well as by State Ministries of Finance. This presents non-

[45] This conclusion is based on analysing the separation of functions of Tax Policy and Legislation and implementation and administration of tax laws in other democracies such as US, Canada, UK, Australia etc.

separation of tax policy formulation and legislation and execution which should be separated as can be seen in other democracies.

6. Restructuring of Tax Administration and ICT Implementation

In order to improve operational efficiencies and effectiveness and to provide better service to taxpayers, while taking advantage of technological developments, a large number of Tax Administrations have moved away from the *tax type* organisational model with cross-functional working to *functional* working. A further development is in the form of *taxpayer segmentation*, where the taxpayer service, compliance and audit functions have been structured on the basis of taxpayer segments such as large taxpayers, medium taxpayers, salaried taxpayers, High Net worth Individuals, etc.

It has been seen that ICT implementation of the existing manual business processes as it is without carrying out functional reorganisation and business process reengineering, normally, does not provide any benefit either to the Tax Administration or the taxpayers. The inefficiencies and mistakes of a manual system often lead to a repeat of those mistakes and inefficiencies at a faster rate in the computerised environment. However, carrying out functional reorganisation and business process reengineering of the tax processes before ICT implementation has given great dividends to most of the successful Tax Administrations. Experiences have shown that Tax Administrations that have carried out functional reorganisation and business process reengineering based on best international practices before ICT implementation, including setting up of centralised processing centers for processing of returns and payment, have resulted in greater efficiency. This then frees valuable manpower resources for compliance activities like taxpayer service, audit and enforced collections.

Figure 5.3 Before Functional Alignment, BPR & ICT Implementation

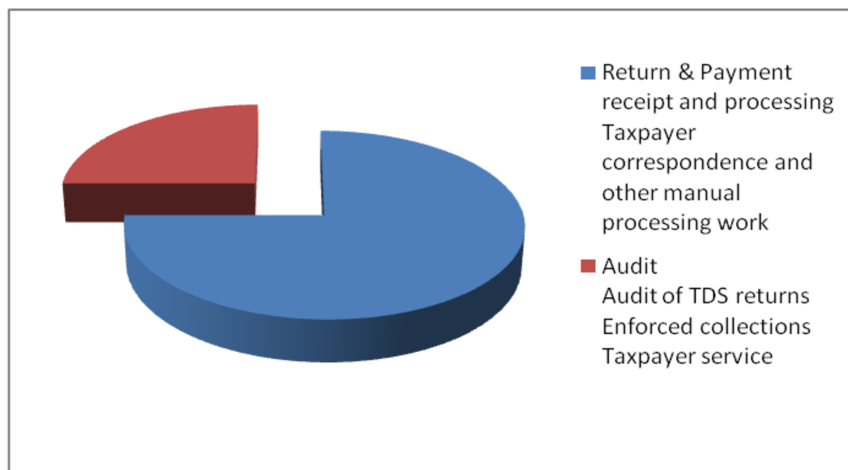


Figure 5.4 After Functional Alignment, BPR & ICT Implementation

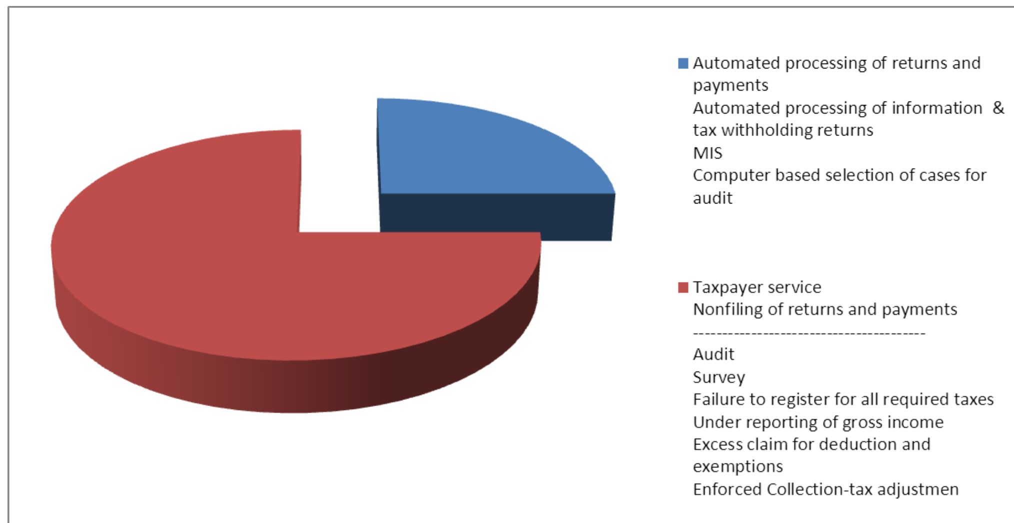
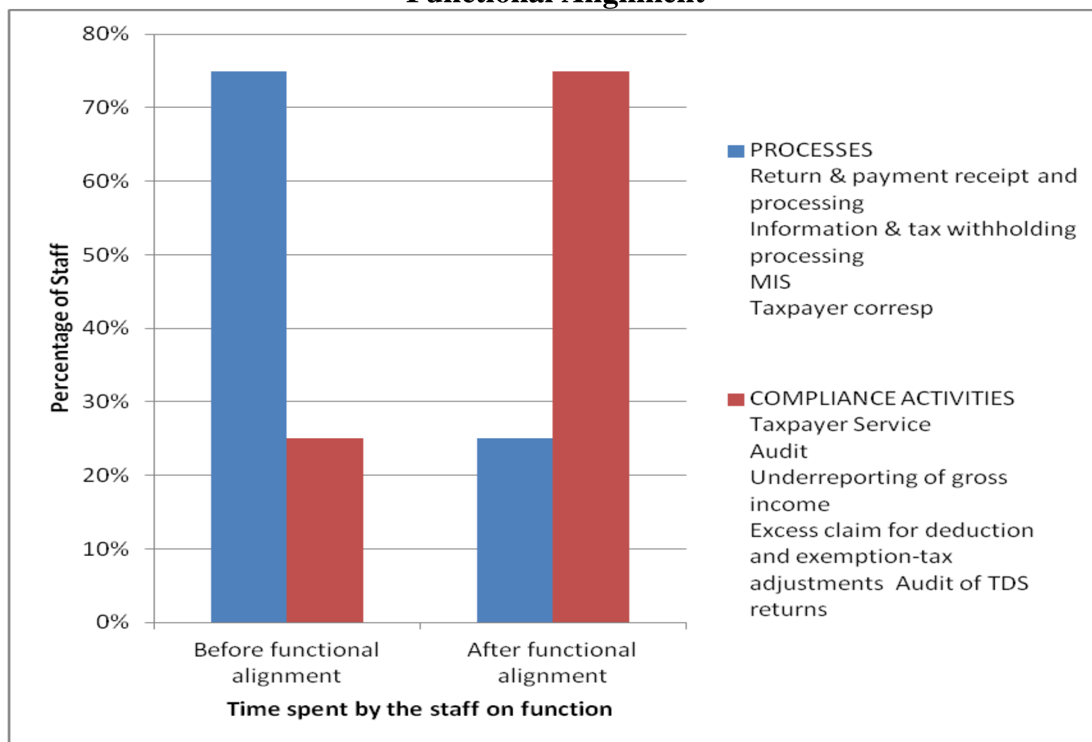


Figure 5.5 Percentage of Staff and Time Required for Various Processes Before and After Functional Alignment



Source: Parthasarathi Shome, *Indian Tax Administration,* pp. 35

Germany follows a functional system of working and has a dedicated processing centre, debt collection, appeals, tax fraud detection units, High Net worth Individual and Large Taxpayer Units. India can reorganise its tax administration through induction of ICT and administrative restructuring along the lines as it exists in Germany.

Looking at the technological implementation within the tax department in India, we find the following table presented in Shome (2012) comparing India to other developed countries:

Table 5.1 Comparison of ICT Implementation Effect on Income Tax Collection

	Australia	Canada	UK	USA	Brazil	India
Total PIT returns filed (in million)	13.6	26.7	8.6	147.2	52	29
Total PIT returns filed electronically (percent)	92	58	73	65	98	17
Total CIT returns filed (in million)	0.9	1.9	1.6	7	Separate figures not available	0.5
Total CIT returns filed electronically (percent)	92	21	16	25	Separate figures not available	n.a.

PIT: Personal Income Tax; CIT: Corporate Income Tax
Note: During the year 2011-12, 16.3 million (or 46.5 percent) out of a total 35 million returns were filed electronically. Data for all other countries are for the year 2009 or earlier.

The analysis of the statistics on returns filed vis-à-vis registered taxpayers and population in select countries is shown below:

Table 5.2 Statistics on Returns filed vis-à-vis Registered Taxpayers and Population in Selected Countries

	Australia	UK	USA	Brazil	India
Citizens (in million)	22.6	62.6	311[°]	196	1241
Number of returns filed (in million)	14.9[ϕ]	NA	237[°°]	52	36.3[ϕϕ]

From Shome (2012), pp. 248

The number of tax return filers in India appears very low compared to its total population.

The lack of utilisation of technological edge within the Tax Administration (TA) can be seen in the following table showing the number of IT Personnel vis-à-vis Total Tax Personnel in Selected Countries (Shome, 2012):

Table 5.3 Lack of Utilisation of Technological Edge in Selected Countries

	Australia	**US**	**Canada**	**Brazil**	**India**
Tax Staff	21,766	92,033	44,000	27,000	57,793
IT Staff	1733	7228	4408	9929	335

Note: Australia has outsourced its IT operations but still holds 8 percent IT staff

One of the main reasons for IT implementation being patchy and not universal in the department is that the existing manual processes in 1994-95 were computerised as is. This led to mistakes being repeated in the computerised environment.

Looking at the data, it is imperative that rather than immediate induction of ICT into the existing framework of tax administration in India, a restructuring along functional lines must be implemented and only then would the absorption of ICT into further fast-tracking the processes yield substantially optimal results.

Chapter 6 Subsidies

Subsidy plays a dominant role in framing the fiscal policy of an economy as it caters to the needs of a particular section of the economy where the market fails to distribute resources. Sometimes it entails additional expenditure burden on the government as there is no direct return to the government from the recipient. However, subsidies are justified in the presence of positive externalities where social benefits are higher than private benefits, therefore, higher consumption levels are required than what is provided by private optimum levels. In addition, they are required, sometimes, for redistribution of resources across the population[46]. However the financing of subsidies deserves special attention as it may cause an increase in borrowings of the government or increase in additional taxation.

1. An Analysis of Subsidies in Germany[47]

Definition of Subsidy in Germany

Subsidies refer to financial assistance given to the private sector enterprises and different sectors of the economy viz. food and agriculture, trade and industry, transport, housing, etc. The direct assistance to a recipient is referred to as direct subsidy. Indirect subsidies, which directly reduce the price of a specified good or service entitled for households, are also included. For instance, housing subsidies given to households indirectly helps in growth of the housing industry. In addition to financial assistance, tax concessions given to households, business enterprises, etc. are considered as part of subsidies. Therefore a subsidy is, precisely, the sum of financial assistance and tax benefits (or concessions).

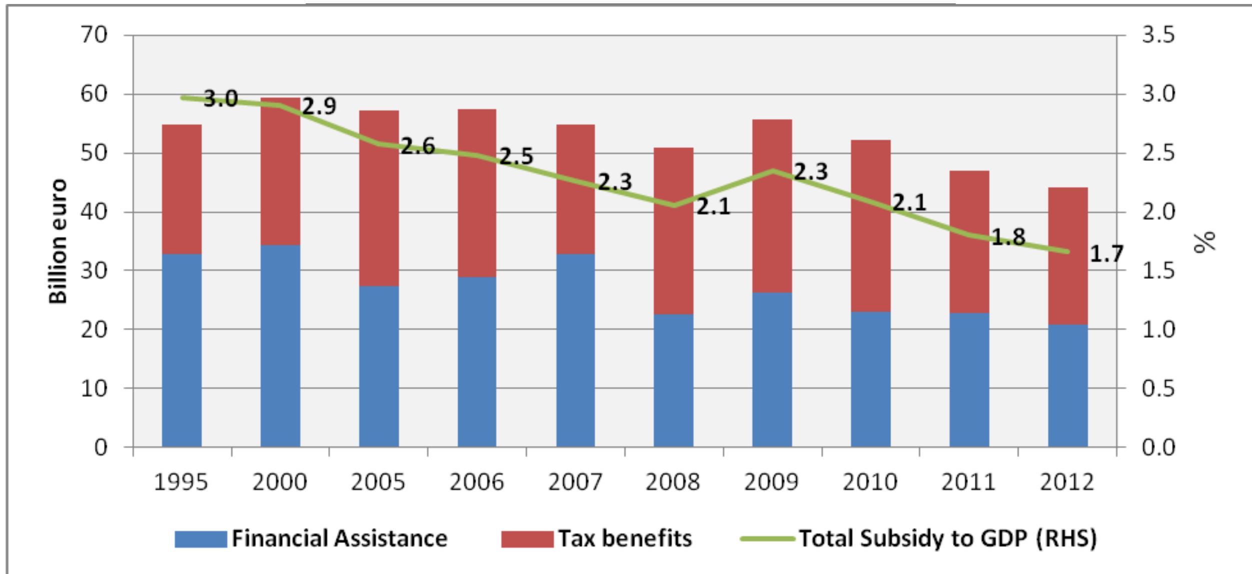
Magnitude and trend of subsidies in Germany

Subsidies count as one of the important expenditures of the general government of Germany and amounted to 44.2 billion euros in 2012 or 1.7 percent of nominal GDP. However, it is worthwhile considering that the level of subsidy has significantly dropped since the past decade, barring 2009 when fiscal stimulus was pumped in to stimulate the economy (Figure 6.1).

[46]R.A. and P.B. Musgrave, (1989), Public Finance in Theory and Practice, McGraw Hill.

[47] Note: It is mainly based on our discussions with Dr. Claus-Friedrich Lasser, a subsidy expert from Kiel Institute of the world Economy and biennial subsidy reports published by the federal ministry of finance of Germany.

Figure 6.1 Subsidy Trends in Germany



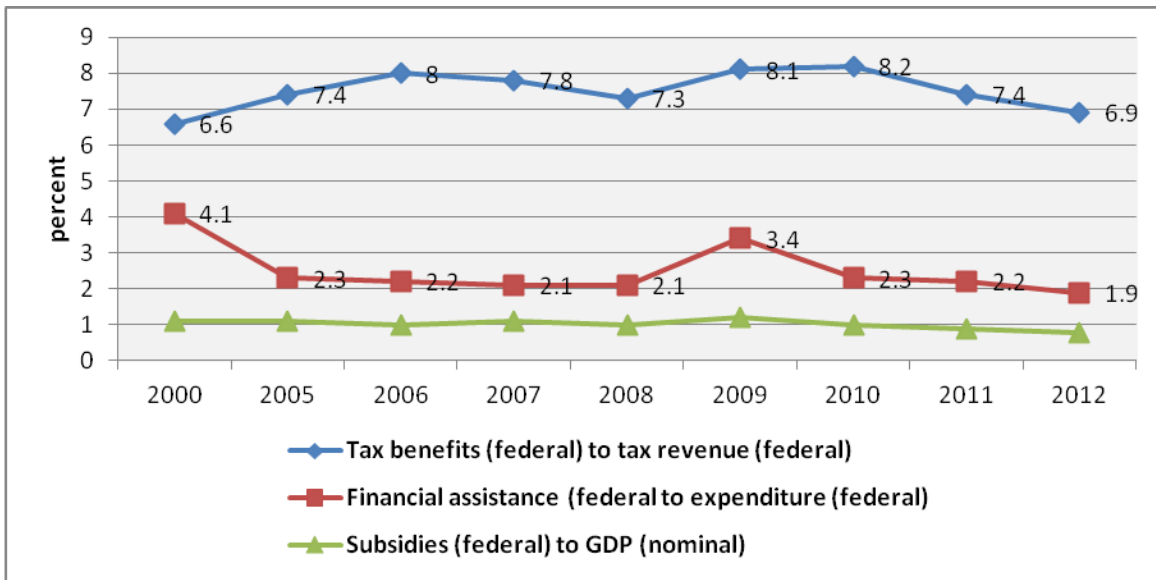
Source: Data is taken from 23rd and 24th Subsidy reports of the federal government

Federal Subsidies[48]

After the outbreak of the global financial crisis and since 2009, the proportion of federal financial assistance to federal expenditure continued to decline and attained an all time low of 1.9 percent after the year 2000. Likewise, tax benefits (federal) as a percentage of tax revenue (federal) also declined in the past 2 years but could not attain its lowest level since 2000 (Figure 6.2). It suggests that the proportion of tax benefits to financial assistance has been increased in the recent years. In addition, the proportion of federal tax benefits to federal tax revenue depicts loss of revenue that could be added to the government's kitty if no tax exemptions had been given. Further, large number of tax benefits makes tax administration very cumbersome and less efficient.

[48] The three layers of government viz. federal, Länder and municipal provide subsidies. However, our analysis is restricted to federal subsidies only because of data bottlenecks and lack of availability of information in English language.

Figure 6.2 Trends of Federal Subsidy in Germany

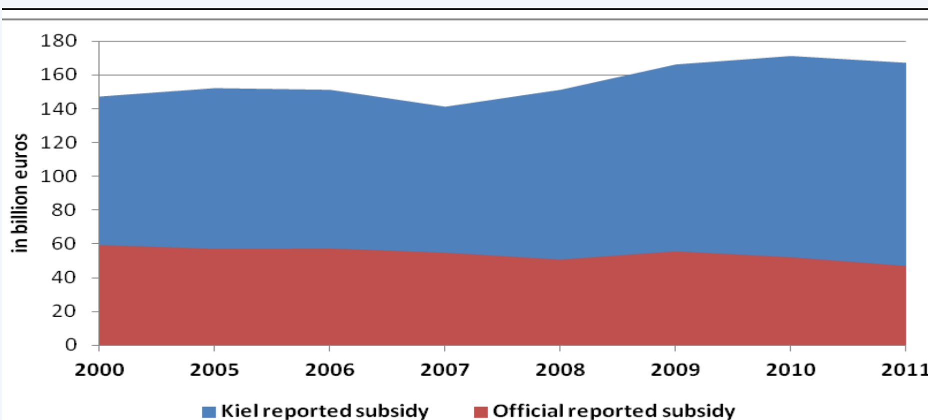


Source: Data is taken from 23rd and 24th Subsidy reports of the federal government

Box 6.1

Official Subsidy – A half truth

It is interesting to know that the official estimates of subsidies (calculated by federal government of Germany) represents less than one-third of subsidies calculated by Kiel Institute of World Economy[1]. The difference arises due to differences in definitions considered. The Federal government accounts for subsidies in a narrow sense while Kiel Institute accounts for it in a broader sense. The former does not include financial assistance granted to private or governmental non-profit organisations while the latter does. Subsidies in the narrow sense exhibit a declining trend (figure below) between 2000 and 2011 decreasing by 12.4 billion Euros to 47 billion Euros. In contrast, when transfers and grants to private and public non-profit organisations are included as subsidies in the broader sense, it increased in the same period by 18.8 billion Euros.



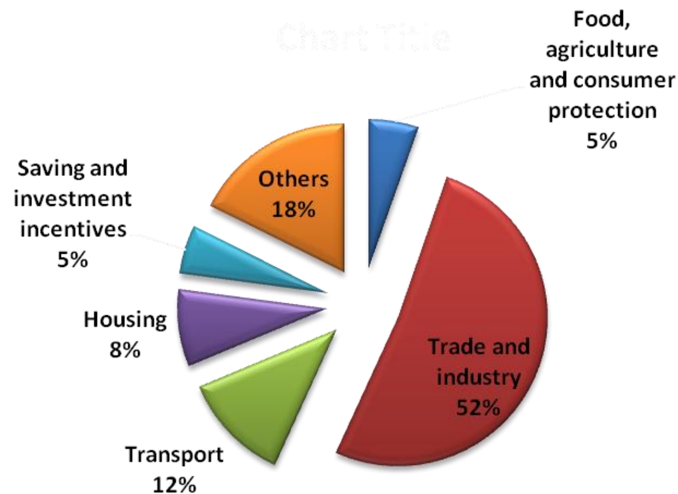
Notes: [1]The **Kiel Institute for the World Economy** (Institut für Weltwirtschaft, IfW) is an economics research center and a think tank which is located in Kiel, Germany.

Federal Subsdies (financial assistance + tax benefits) by Category

Coming to category wise subsidies, trade and industry[49] are highly subsidised and continue to account for the largest share of federal subsidies[50]. The sector underwent a massive jump in 2009 in the backdrop of the global financial crisis but thereafter its share declined to 52 percent in 2012 from 60 percent in 2009. This change largely happened on account of the termination of the car scrappage scheme that was there earlier to boost the demand for new cars [51]. Subsidies to the transport sector accounts for the second highest category followed by housing, food, agriculture and consumer protection, and saving and investment incentives (Figure 6.3).

Of the top ten direct subsidy payments or grants by the federal government, public rail passenger commuter transport is highly subsidised, with around one-half of total direct financial assistance to companies going to it[52].

Figure 6.3 Proportion of Federal Subsidies by Category in 2012



Source: 23rd Subsidy Report of the Federal Government

The top 10 tax benefits of the federal layer of the government are obtained from their federal budget while comprehensive analysis of subsidies of all federal, Länder and municipality layers of government is not available. However, some Länder publish their own subsidy reports (not all of them). Therefore, given the large share of states and municipalities in subsidies relative to the federal government (Figure 6.4), focusing only on the latter renders an incomplete picture.

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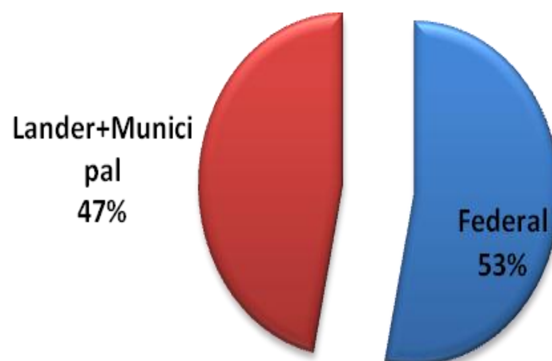
[49] Federal subsidies under trade and industry category include mining, energy efficiency and renewable sources, technology and innovation subsidies, assistance for specific sectors of the economy, regional structural measures and other measures.
[50] Federal subsidies exclude subsidies provided by Länder and Municipal governments.
[51] Department of Public Relations, Federal Ministry of Finance, 23rd Subsidy Report of the Federal Government.
[52] Claus-Friedrich and Rosenschon (2013), Table 4, P-33

Figure 6.4 Reported Total Volume of Federal, Länder and Municipal Subsidies in 2011



Box 6.2
Off-budget subsidies in Germany

There are many off budget subsidies in Germany though it is difficult to come out with concrete figures. For instance, public transport (bus, tram, etc.) sometimes makes heavy losses but is cross-subsidised within the firm by the profits generated from the energy part. In addition, currently the most intensely debated off-budget subsidy is the "Erneuerbare-Energien-Gesetz[1] (EEG) reallocation charge" by which electricity users are subsidising the suppliers of renewable energies (photovoltaic, wind, water, etc.) via discriminatory pricing in order to enable the country to quit nuclear power altogether and further expand the role of renewable energy in the electricity sector. The suppliers of renewable energies can send their produced current to the grid at a guaranteed price above the market price level. The difference to the actual sales price at the energy exchange has to be borne by electricity users via higher tariffs for the current they are using. In addition, "EEG reallocation charge" is around 25 per cent higher for homes and businesses as large energy-intensive producing manufacturing enterprises are exempted from it. Politicians fear that energy-

Note: [1]Renewable Energy Sources Act or Erneuerbare-Energien-Gesetz (EEG)

2. An Analysis of Subsidies in India[53]

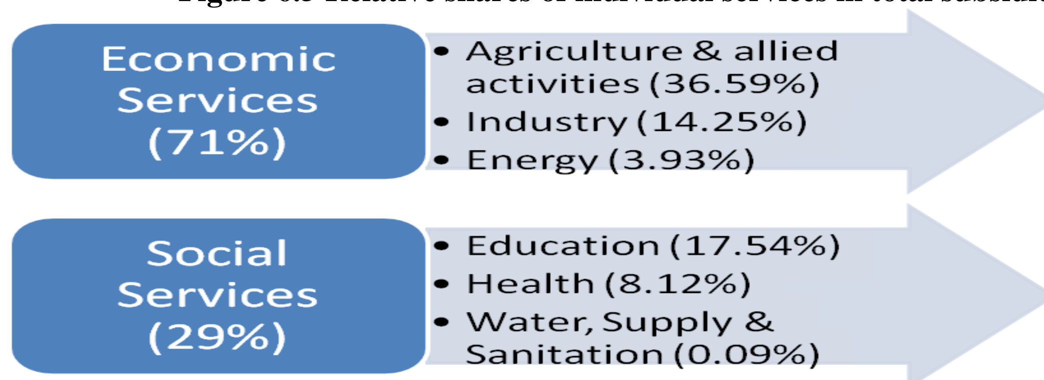
Subsidies constitute an important part of revenue expenditure of the central government of India. It is the one expenditure incurred by the government which has always been growing since the past decade. Expenditure on subsidies always shoots up whenever the economy goes through any financial turmoil. Notwithstanding this, subsidies have also grown rapidly in normal years as a

[53] Here we are analysing the central government's subsidy expenditure, excluding all states because of data bottlenecks.

result of populist policies in India. It is often contended that India spends relatively less on education, health, and infrastructure than it does on subsidies.

Subsidies in India are classified as depicted in the following flow chart. Economic subsidies comprise around two-thirds of total subsidies of which agriculture subsidies dominate (Figure 6.5). Since they constitute more than one-third of total subsidies, it is worthwhile to explore it further.

Figure 6.5 Relative shares of individual services in total subsidies[54]

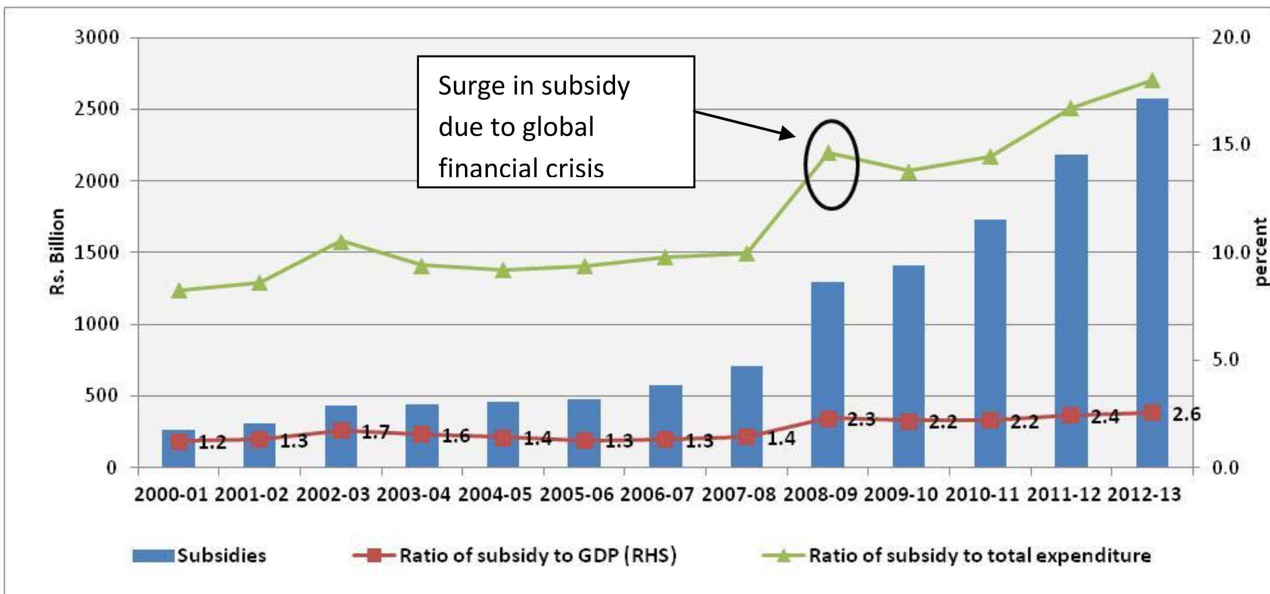


Trends in Subsidies

Central government subsidies have doubled to Rs 1.4 trillion in the aftermath of the global financial crisis in 2009-10 in two years (from 2007-08) and have continued to increase, amounting to Rs 2.5 trillion (or 2.6 percent of nominal GDP) in the previous fiscal, 2012-13. Similarly, its proportion to total expenditure, another measure of the relative size of subsidies, has increased to 18 percent in the previous fiscal (Figure 6.6). Nevertheless, these statistics do not provide a true picture of subsidies in India, refer to Box 6.3 for details.

[54] This is as per 2003-04 as the latest data is not available. Source: Finance Account of the Union Government and National Income Accounts, CSO

Figure 6.6 Trends in Central Government Subsidy in India



Source: RBI and Budget Documents

Box 6.3

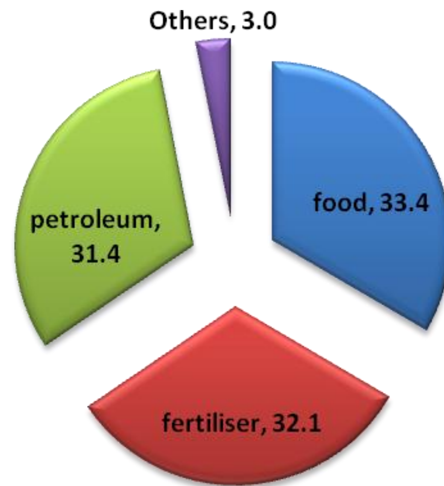
Explicit vs. Implicit Subsidies

The subsidies mentioned in Figure 6.6 are called explicit subsidies and clearly visible in the Government budget's account, but the actual level of subsidies – camouflaged under implicit subsidies- is not visible in the Government budget's account. The implicit subsidies are as a result of unrecovered costs of public provision of goods and services, not classified as public goods. As per estimates of the National Institute of Public Finance and Policy (NIPFP) total (explicit + implicit) subsidies accounted for 4.25 percent and 4.18 percent of nominal GDP in 2002-03 and 2003-04 respectively while explicit subsidies were about 1.8 percent and 1.7 percent of GDP respectively, hence the difference between these figures show the volume of implicit subsidies. Unfortunately estimates for implicit subsidies are not available for the latest years.

Major Subsides in India

The major central government subsidies for petroleum, fertliliser and food, form more than 90 percent of the total central subsidies (Figure 6.7). We will discuss them in detail in the following section.

Figure 6.7 Proportion of major subsidies as per 2011-12



Source: RBI and Budget Documents

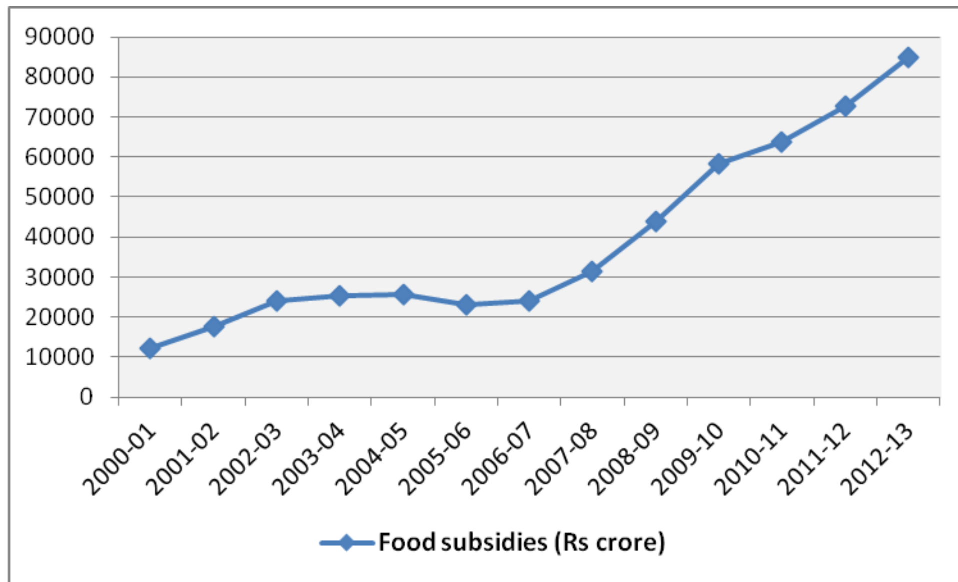
Food Subsidy

Food subsidies in India are considered to be one of the largest food subsidies in the world[55]. On one hand, it creates a social safety net to the poorer section of the society while on the other hand it increases the government budget deficit, and contributes to economic inefficiency.

The non-plan expenditure on food subsidy has constantly been showing an upward trend (Figure 6.8). The sharp rise in food subsidy since the beginning of the past decade has largely been attributable to the steep rise in minimum support/procurement prices, accumulation of large stocks of grains by FCI, rising economic costs of foodgrains, high offtake of foodgrains under targeted public distribution system and other welfare schemes and constant central issue prices (CIP) of foodgrains[56]. The high food subsidies are generally believed to be a result of malfunctioning of the FCI.

[55] Food subsidy in India
[56] (GoI, 2012e)

Figure 6.8 Food Subsidies in India



Source: Budget documents

It is worth noting that India's food subsidy bill is not going to remain around the 2012-13 level even though that in itself is a very high figure – the expectation is it would experience a sharp jump in following years as a result of the recent Food Security Act passed in September 2013.

Petroleum Subsidy

The prices of various petroleum products were controlled and regulated by the government of India before 2002-03. The government provided subsidy on four petroleum products viz. petrol, diesel, kerosene and LPG (cooking gas). These subsidies were not part of the annual budget and financed from something called the Oil Pool Account. This Oil Pool Account was funded from the surcharge on petroleum products and refilled when the international oil prices were low but the retail prices were not cut proportionally by the government. From April 2002, as part of continuing reform in the public sector, the government moved towards a market pricing mechanism, and dismantled the administered price mechanism. However, subsidies for kerosene and LPG were continued as these cooking fuels were considered important to help poorer households and therefore these two fuels were budgeted in the government's annual account. The downstream oil market companies[57] (OMCs) were allowed to fix petrol and diesel prices within a prescribed range. However the OMCs ended up making huge losses as the Indian retail prices of petrol and diesel was not in line with international fuel prices and also because the government did not raise the price of cooking fuels when international fuel prices rose sharply. As a result of

[57] Downstream oil market companies (OMCs) refer to those companies that are involved with the retailing and marketing of petroleum products such as petrol, diesel, etc while upstream OMCs are those companies which are involved in production and processing of crude oil from which petroleum products are obtained.

this, the downstream oil marketing companies started suffering losses pertaining to under-recoveries[58] by the end of financial year 2006-07. In other words, the government did not pass on the burden to consumers by raising retail prices of fuel while the downstream OMCs and upstream OMCs were left to bear the losses made through under-recoveries. However, the government issued oil bonds to ease the burden of OMCs and to help keep them in business. But this did not help OMCs to great extent. These bonds could not generate cash flows since they had low liquidity and the interest earned was also small. The government should have provided a cash subsidy rather than issue oil bonds. A Committee on Pricing and Taxation of Petroleum Products, headed by Dr Rangarajan stated in its February 2006 report, "The practice of issuing oil bonds is strictly inadvisable as it does not resolve the problem; it only postpones the resolution while compounding the economic and financial costs." However, this method did help in cutting down on-budget subsidies substantially (Figure 6.9). Refer to Box 6.4 for an explanation of off-budget subsidies in India.

Box 6.4

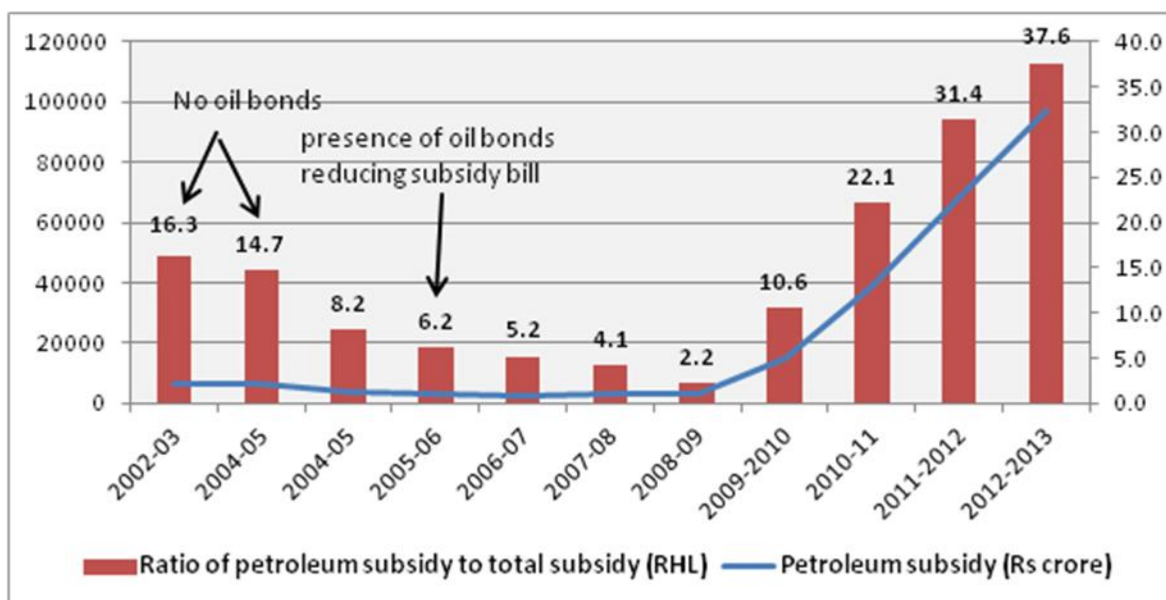
Off budget fuel subsidies in India

There are many off-budget subsidies in India as it was a case in Germany too. One significant off-budget subsidy arises when government guarantees loans undertaken by the public enterprises and borrower ceases to repay it back. In that case the government is obligated to repay and corpus becomes the budgetary liability. An important off-budget subsidy is marked under the Oil Pool Account[59] (or petroleum subsidy) that was not budgeted by the government. Further, the government issued oil bonds to the oil market companies (OMCs) rather than providing cash subsidy to ease their under-recovery burden, suggesting camouflaging of actual subsides. In addition to this, the corpus was not recorded as liability of the government and therefore was not reflected in the fiscal deficit.

[58] Under-recovery means the difference between the cost price and the realised price of petroleum products by the oil marketing companies.

[59] To understand the Oil Pool Account, kindly refer to our section on petroleum subsidies.

Figure 6.9 Petroleum Subsidy in India



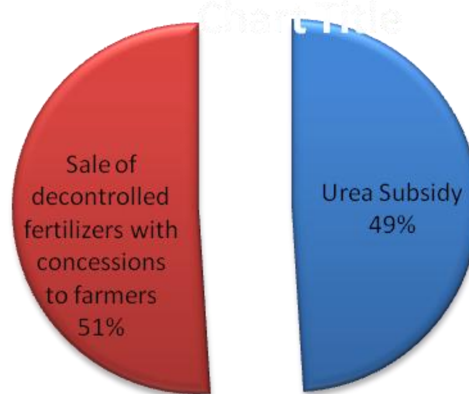
Source: Budget documents

Taking the agenda of reforms forward as well as stepping towards fiscal correction, the government completely deregulated the petrol prices in June 2010; partially deregulated diesel price in 2012 and limited the subsidised quantity of LPG consumption. But there is still there a long way to go to diminish the huge petroleum subsidy bill.

Fertiliser Subsidy

Fertiliser is a major input used in agriculture and its prices are directly and indirectly determined by the government. It is available to farmers as subsidised prices so that they can use it effectively and enhance their farm production. Of all fertilisers, urea is completely under government control and is highly regulated. It constitutes one-half of the total fertiliser subsidy bill (Figure 6.10).

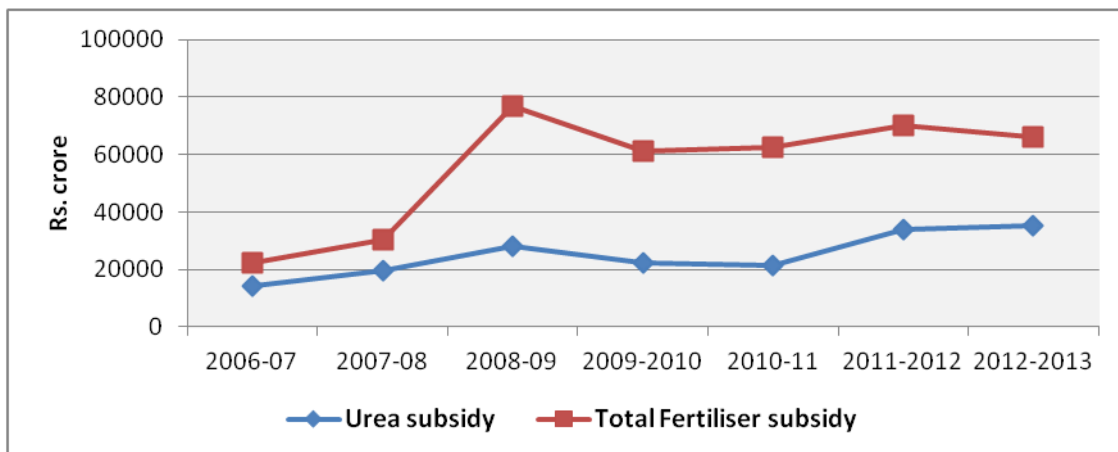
Figure 6.10 Fertiliser Subsidy in India, 2011-12



Source: Budget Documents

Moving ahead, the fertiliser subsidy has continuously been increasing (Figure 6.11). Likewise, the urea subsidy bill has also constantly been growing, barring a few years and its share in total fertiliser subsidy has significantly grown in recent years.

Figure 6.11 Trends of Fertiliser Subsidy in India



Source: Budget Documents

Not only do burgeoning fertiliser subsidies put a drag on the government budget, it also questions the real beneficiaries of fertiliser subsidy such as small vs. large farmers, well-developed vs. less developed regions, etc. It is generally believed that large farmers, who can afford non-subsidised fertilisers, are large recipients of subsidy. In addition, subsidy distribution is not pan India but is concentrated in a few states, namely, Uttar Pradesh, Andhra Pradesh, Maharashtra, Madhya Pradesh and Punjab. The inter-state disparity in fertiliser subsidy is still

high albeit it has declined over the years[60]. Furthermore, reduction in fertiliser subsidy or deregulating it is debatable as it is likely to have an adverse impact on farm production and consequently on the income of small and marginal farmers. This is because a rise in cost of input (fertiliser) causes higher cost of production and therefore makes it less viable for small and marginal farmers.

Concluding Remarks

There is a lot of discrepancy in official subsidies of Germany and the Kiel estimates of subsidy. The former exhibits a sharp decline in subsidy levels while the latter does the opposite[61]. Industrial subsidies (energy subsidies) continue to dominate in Germany. In recent years, subsidy in the form of tax benefits outweighs subsidy in the form of financial assistance, reflecting an increase in the number of tax concessions (or revenue loss). However, comprehensive data comprising Länder and municipal subsidies along with federal subsidy is not readily available. Thus, analysing only federal subsidies gives an incomplete picture.

Likewise in India, official estimates of subsidies do not account for off-budget subsidies. Subsidies on food, fertliliser and fuel form most of the total central government subsidies. These subsidies mainly facilitate consumption and do not play a major role in building up capital goods; therefore disbursing subsidies continues to face criticism. However, reforms have been initiated by the Government of India to minimise the subsidy bill and the government intends to reduce subsidies to 1.5 percent of GDP by 2017. The objective is not to eliminate subsidies but rather to have targeted subsidies that advance the cause of inclusiveness, and to have the subsidies contained within a pre-determined level of affordability[62].

[60] Sharma and Thaker (2009)
[61] Refer to Box 5.1 for details.
[62] Economic Times, http://articles.economictimes.indiatimes.com/2013-03-07/news/37532059_1_subsidies-12th-plan-gdp

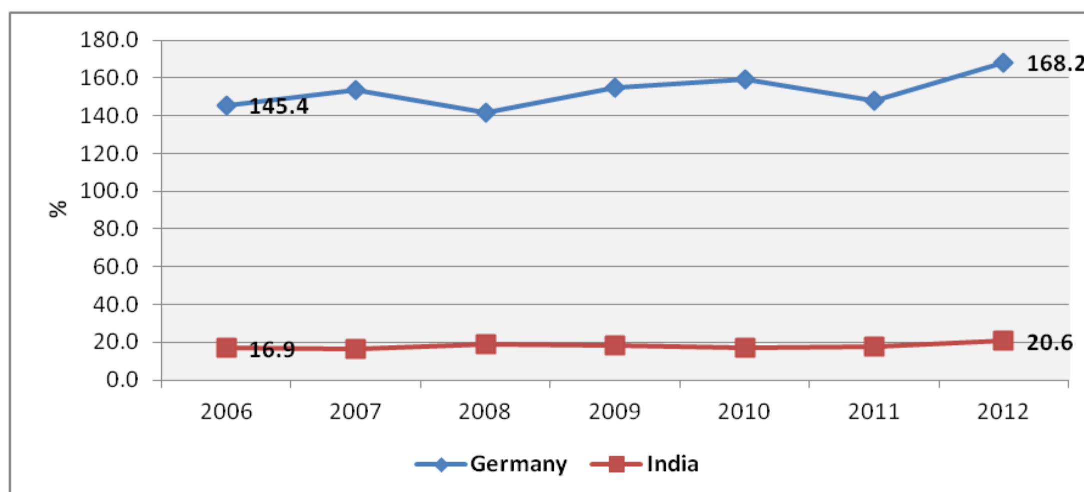
Chapter 7 Debt/Borrowings

Total Debt of a country can be decomposed into domestic debt and external debt. Any borrowings which are owed to creditors outside an economy, at a point in time, are considered as gross external debt while borrowings which are owed to creditors inside an economy, at a point in time, are referred to as domestic debt. And borrowers can be the government, corporations or private households. However, it is worthwhile considering that the proportions of domestic debt to GDP and external debt to GDP may vary from country-to-country. For instance, Germany's external debt is two-fold that of domestic debt whereas in contrast, India's is only one-fourth.

An Analysis of Germany and India's Borrowings from Abroad[63]

Germany's external debt stood at US$ 5716 billion at the end of December 2012 which was more than one and a half of its GDP or precisely amounted to 168.2 percent of GDP. The ratio of external debt to GDP has continuously been rising in the past six years, and rose significantly by 23 percentage points from 2006 to 2012 (Figure 7.1). On the other hand, India's ratio of external debt to GDP has exhibited an almost constant trend, and at the end of December 2012 stood at one-fifth of GDP. Prima facie, India's external debt seems to be in a comfort zone while Germany's external debt has grown alarmingly.

Figure 7.1 Gross External Debt as a Percent of GDP



Source: Quarterly External Debt Statistics, World Bank

Before making conclusions, it is prudent to consider other indicators to assess a country's financial circumstances. The level of external debt does not take into account the level of external assets which is an important factor in determining a country's ability to confront adverse shocks. Germany possesses high levels of external debt as well as external assets. Therefore it becomes pertinent to look at a country's international investment position (IIP) while evaluating

[63] It is to be noted that when external debt is mentioned in this chapter, it refers to gross external debt.

a country's financial strength. Net IIP is the difference between external assets and external liabilities. The positive (negative) net IIP position of a country indicates net lending to (net borrowing from) the rest of the world. The following figure (Figure 7.2) shows that Germany has always been a net creditor while India has been a net borrower. Germany's surplus of external assets over external liabilities as a percentage of GDP stood at 43 percent at the end of 2012 while India's deficit of external assets over external liabilities as a percentage of GDP was 15.3 percent. Although the ratio of India's external debt to GDP is not big, its net IIP is negative (Figure 7.3).

Figure 7.2 Net International Investment Position ratios (percent of GDP)

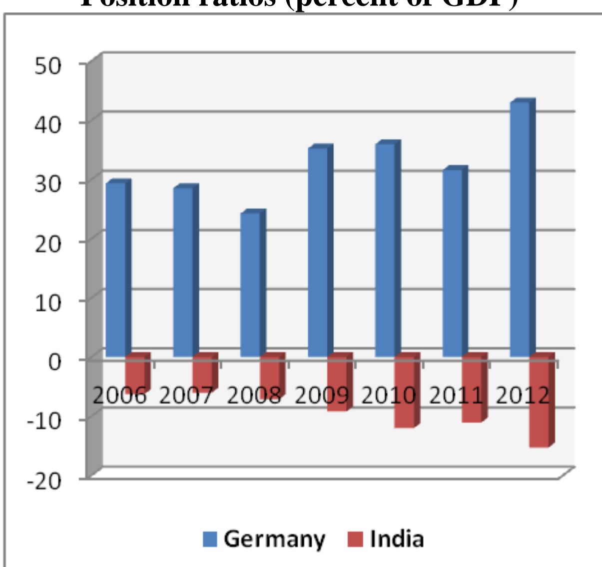
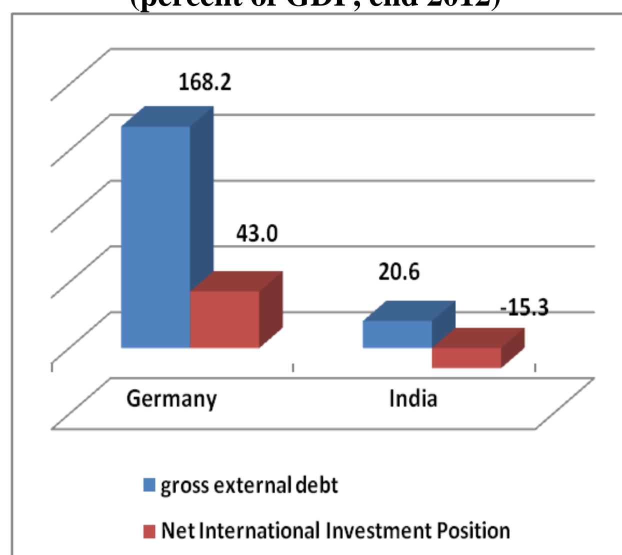


Figure 7.3: External Debt and IIP (percent of GDP, end 2012)

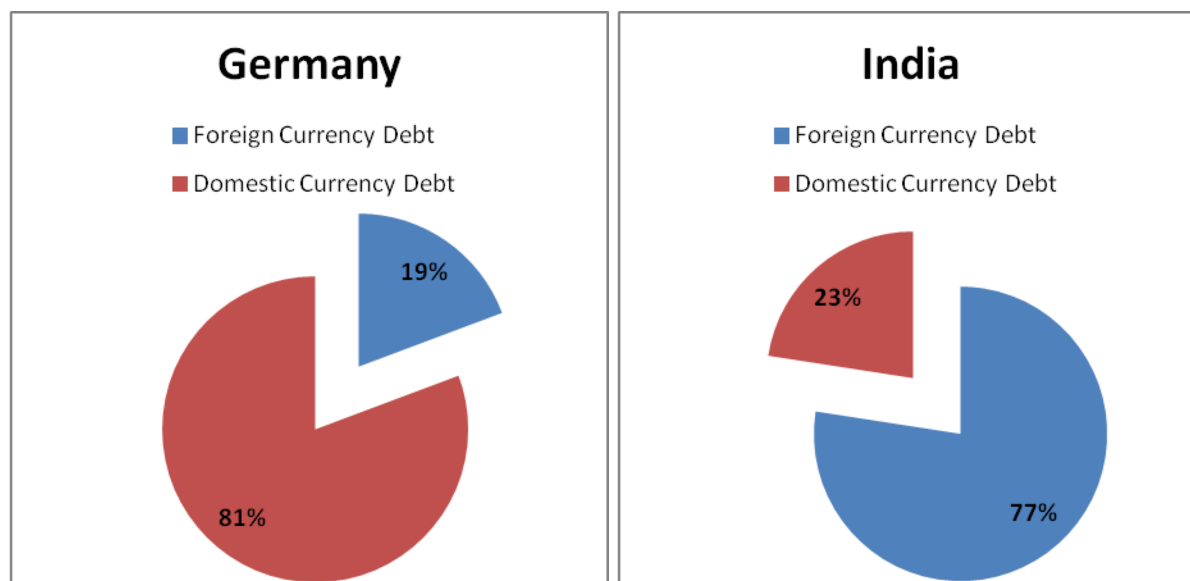


Source: Balance of Payments Statistics, IMF and Balance of Payments Statistics, IMF

Coming to currency composition of external debt, Germany's external debt shows dominance of euro-denominated debt. Domestic currency debt accounted for four-fifths of external debt at the end of 2012 (Figure 7.4). Prevalence of low interest rate as a response of credit easing policy of the European Commercial Bank (ECB) in the wake of the global financial crisis and the European debt crisis has further helped to stabilise the massive external debt. On the other hand, the currency composition of India's external debt shows continued dominance of foreign currencies, especially the US dollar accounting for 57.2 percent, at the end of March 2013[64]. Furthermore, external debt in terms of all foreign currencies represented three-fourths of total external debt at the end of 2012. Since India's external debt has remained within manageable limits, the dominance of non-rupee denominated debt is not considered problematic, at least in the short run.

[64] Department of Economic Affairs, Ministry of Finance, GoI (2012), India's External debt : A Status Report 2012-13

Figure 7.4 Currency Composition of External Debt: Domestic vs. Foreign at the end of 2012



Source: Quarterly External Debt Statistics, World Bank

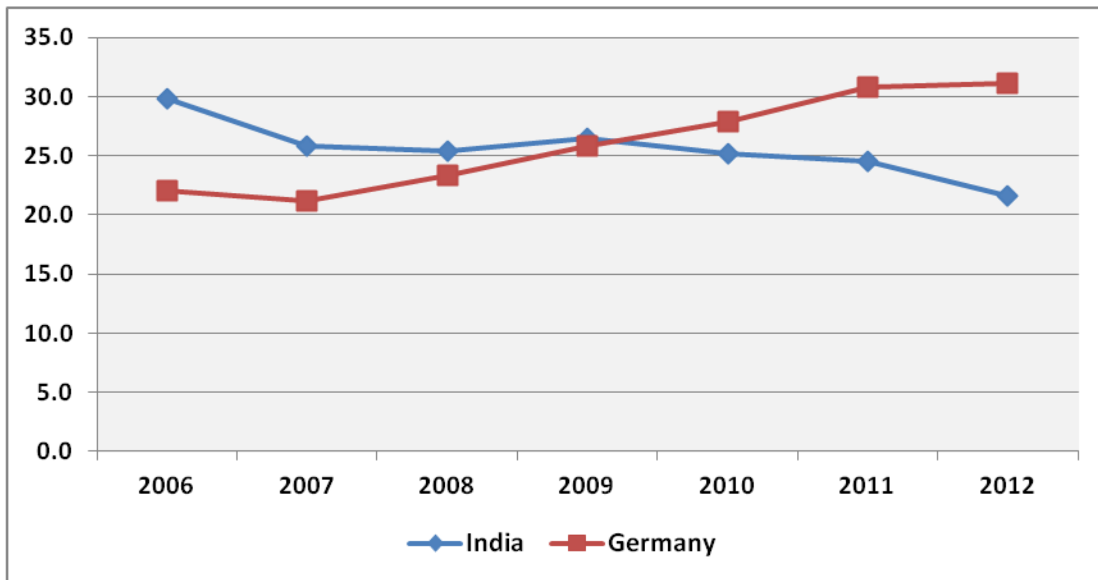
Going forward, sovereign (government) external debt came into prominence in the wake of the sovereign debt crisis in the Eurozone. This refers to the part of the external debt that is raised by the government itself. The peripheral economies of the euro area have the largest sovereign debt to GDP ratios because of their large exposure to international capital markets. However, in a developing country like India, the government primarily raises funds with long maturity periods from bilateral and multilateral institutions[65].

India's ratio of sovereign debt to external debt has declined continuously over the past few years, and stood at 22 percent at the end of 2012, down from 30 percent at the end of 2006 (Figure 7.5). Likewise, the share of general government debt[66] in GDP has been low and stood at 4.4 percent in December 2012 (Figure 7.6). In contrast, Germany experienced a surge between 2006 and 2012; the share of sovereign debt increased from 22 percent in 2006 to 31 percent in 2012 mainly on account of the global financial crisis and European debt crisis. Similarly, sovereign debt as a proportion of GDP has constantly increased over the years and risen by 60 percent from 2006 (Figure 7.6).

[65] Department of Economic Affairs, Ministry of Finance, GoI (2012), India's External debt : A Status Report 2012-13

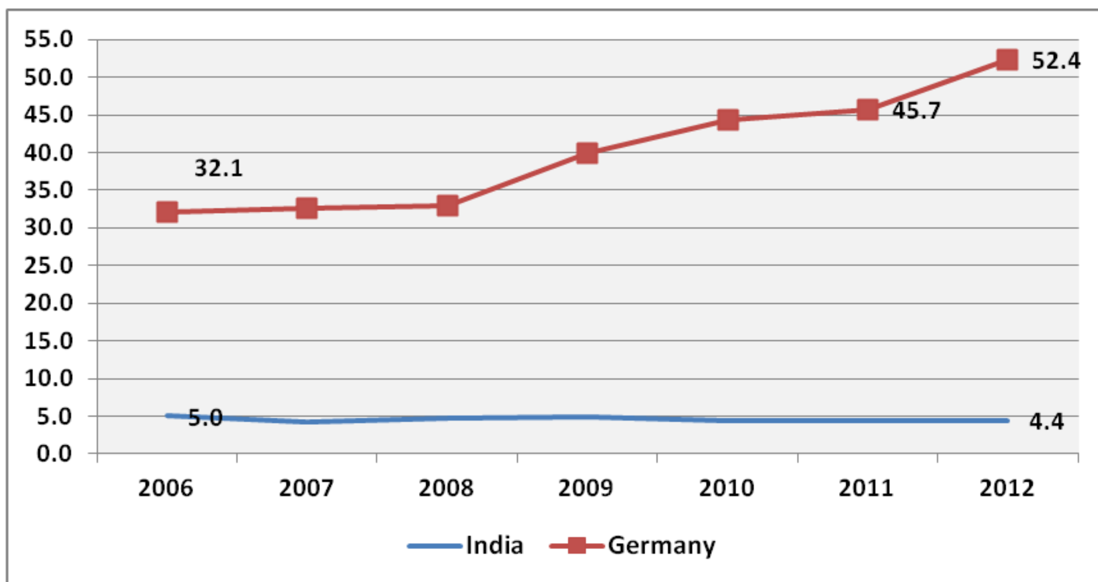
[66] Federal government debt and sovereign debt are used interchangeably.

Figure 7.5 Ratio of Sovereign External Debt to Total External Debt



Source: Quarterly External Debt Statistics, World Bank

Figure 7.6 Ratio of Sovereign Debt to GDP



Source: Quarterly External Debt Statistics, World Bank

Concluding Remarks

India's share of sovereign external debt to GDP is minuscule in comparison to Germany's. However, Germany enjoys a favorable position due to bonds being pre-dominantly denominated in Euros (or domestic currency) and having a surplus of foreign assets which is not the case in India. Moreover, it is further bolstered by the low interest rate environment which is expected to continue in the near future but will require redressal once the growth situation changes and ECB hikes interest rates.

Chapter 8 Conclusion and Forecasts/Guesstimates

Looking at changes in the Indian system, the implementation of the GST is awaiting review in Parliament, and the Minimum Alternate Tax is supposed to become wider in its coverage. GAAR has an announced an implementation date of April 1, 2016 and hence, is a change that is likely to happen. We outline these below.

1. Primer on Goods and Services Tax (GST)

The long-pending Goods and Services Tax (GST) is the most ambitious indirect-tax reform policy in India at this point in time. It aims to foster a common market in India by dismantling the fiscal barrier between states, reducing distortions and inefficiencies. GST is not a new tax but is a tax system that encompasses all indirect taxes, which include customs duties, VAT (or sales tax), services tax and the excise duty. It is a tax on goods and services with a comprehensive and continuous chain of set-off benefits from the producer and service provider's level, right up to the retailer level. It is essentially a tax only on value addition at each stage. Through a tax credit mechanism, this tax is collected on value-added goods and services at each stage of sale or purchase in the supply chain. The system allows the supplier at each stage to set-off the GST paid on the procurement of goods and services against the GST which is payable on the supply of goods or services. The final consumer will thus bear only the GST charged by the last dealer in the supply chain, with set-off benefits at all the previous stages.

There are some issues which keep on delaying the implementation of the GST. For instance, if GST is implemented, then interstate transactions would not be taxed through the Central State Tax (CST). The present CST would be reduced to zero. CST would be replaced by interstate GST (IGST). The centre would levy the IGST. IGST is based on the spirit of destination based VAT. The idea here is to make the interstate tax collections distributive across states and enable all states to have an equitable share. However, this will hamper the autonomy of the Indian states; some states, especially those with a strong manufacturing base are quite opposed to it as they will have to forego a huge amount of their own tax revenue. Though the central government is determined to compensate the states for loss in revenue, the proportion of compensation is still not clear and hence debatable.

Further, there is no consensus on taxes on petroleum products such as crude, motor spirit (including ATF), etc., alcoholic beverages and tobacco products. Taxes on sale of these goods are levied and collected by the states. States have unanimously agreed that all the above-mentioned taxes should not be subsumed in GST, if this happens, it would jeopardize the real ambit of the GST. However, the central government has to make its final decision based on the recommendation of the states.

In sum, the unified GST will definitely simplify the indirect tax system, which should have a positive impact on the Indian economy. But whether it will augment tax revenue is quite uncertain as it depends crucially on the final structure of the GST. And the final blueprint is likely to be finalised only after the general elections.

2. Primer on Minimum Alternate Tax (MAT)

MAT was introduced to tax companies making significant profits and declaring dividends to their shareholders but who effectively have no significant taxable income because of exemptions, deductions and incentives. The primary cause of introduction of MAT was not tax evasion but to add to the tax system a provision such that that no taxpayer with substantial income can avoid tax liability by using deductions, exclusions and other incentives. Such a situation arose due to different provisions under the Companies Act and the Income Tax Act. The expenses disallowed under the Companies Act are also disallowed under the Income Tax Act, but there are some expenditures which are disallowed under Income Tax but are deductible while calculating profits under the Company Act[67].

Table 8.1 Details on Minimum Alternate Tax

• *MINIMUM ALTERNATE TAX* - The following rate of minimum alternate tax shall be applicable for the assessment years 2012-13 and 2013-14.

	A book profit does not exceed Rs. 1 crore					*A book profit exceeds Rs. 1 crore*				
	IT	*SC*	*EC*	*SHEC*	*Total*	*IT*	*SC*	*EC*	*SHEC*	*Total*
Domestic company	18.5	-	0.37	0.185	19.055	18.5	0.925	0.3885	0.19425	20.00775
Foreign company	18.5	-	0.37	0.185	19.055	18.5	0.37	0.3774	0.1887	19.4361

Note - If book profit of a company for the assessment years 2012-13 and 2013-14 exceeds Rs. 1 crore, the minimum alternate tax cannot exceed the following : (Rs. 18.5 lakh + book profit - Rs. 1 crore) + EC + SHEC.

where EC: Education cess which is 2% of income-tax and surcharge
SHEC: Secondary and higher education cess which is 1% of income-tax and surcharge

Source: Income Tax, India

The trend has been to lower the corporate tax rate to set a narrow bandwidth of marginal tax payable by taxable companies and to expand the coverage of MAT to other sectors. This will reduce the leakage of tax avoidance due to exemptions/deductions and guarantee a tax liability. A further extension of MAT is the Alternative Minimum Tax (AMT) imposed on limited liability partnerships at 19.06 percent (i.e. 18.5 percent plus the 3 percent education cess) of the adjusted total income where the normal income tax payable is less than the AMT payable[68].

[67] http://www.caclubindia.com/articles/what-is-minimum-alternate-tax-mat--17597.asp
[68] Deloitte, *India Highlights 2013*

3. Primer on General Anti Avoidance Rule (GAAR)

The various methods applied to reduce tax liability are broadly categorised as Tax Evasion, Tax Avoidance, Tax Mitigation and Tax Planning. GAAR is to curb Tax Avoidance. It is a concept which empowers the Revenue Authorities in a country to deny the tax benefits of transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit. It is intended to target evaders, especially Indian companies and investors trying to route investments through Mauritius or other tax havens in order to avoid taxes. It was introduced in the 2012-13 Budget to check tax avoidance and is expected to be implemented from April 1, 2016. GAAR would apply to business arrangements with a tax benefit exceeding Rs. 3 crores. Investments made before August 30, 2010 will not be scrutinised and its provisions will apply to assessees that obtain tax benefits on or after April 1, 2015. It will apply to foreign institutional investors (FIIs) that have claimed benefits under any Double Tax Avoidance Agreement. Investments made by a non-resident by way of offshore derivative instruments or P-Notes through FIIs will not be covered by GAAR provisions[69]. The GAAR is expected to undergo significant easing of the rules in the face of stiff opposition and lobbying and hence, the final version is expected to be a watered-down version with a fair number of exemptions and exceptions so as to not tarnish the Indian economy as an investment destination.

The Indian system looks towards fiscal consolidation as an important milestone for the 13th Finance Commission although the effectiveness of the same is debatable on the back of a low-growth environment being seen in the current fiscal year. Inflation has continued to be untamed leading to less room for monetary policy effects. The Indian currency has been depreciating due to continuing fiscal deficit as well as outflow of capital largely prompted due to the announcement of tapering of Quantitative Easing (QE) 3. The Indian tax administration has a mammoth task of changing the organisational structure accordingly. It also needs to overhaul the Information and Communication Technologies (ICT) implementation, increase the revenue base and increase the coverage of taxpayers. MAT is expected to remain with increasing coverage across all sectors with the intent of lowering the marginal corporate tax rate but ensuring that tax avoidance is not permitted. Hence, entities generating taxable income are taxed at MAT to ensure tax collection. Investment in infrastructure and logistics remain one of the cornerstones the government needs to ramp up. India also looks towards diversifying its energy sources based on the import bill due to extensive fossil fuel usage. The government is moving towards reducing subsidies in the energy sector with the expectation that the subsidy will be removed completely for diesel; and is also moving towards deregulating control on urea pricing. Another matter of concern is the increasing revenue expenditure of the central government while investment expenditure growth is limited. This raises doubts on the sustainability of fiscal consolidation.

[69] http://archive.indianexpress.com/news/controversial-tax-evasion-targetting-gaar-to-come-into-effect-from-april-1-2016/1174763/0

Labour market reforms are not expected. The silver lining could be that the depreciating currency could boost Indian exports.

Furthermore, upon analysing the trends in the government budget and fiscal policies undertaken, we conclude that before the 2008-09 crises, direct tax revenue to GDP grew significantly as a response to high growth. Reforms in the tax administration were ushered to augment the growth environment and widen the tax base. While after the crisis, growth faltered which led to a fall in direct tax and cuts in indirect taxes as part of fiscal stimulus measures. A substantial increase in revenue expenditure was incurred to stimulate aggregate demand and therefore subsidies rose significantly. Further, sluggish economic growth post-crisis dampened tax collection. Thus, the growth-story has more or less explained India's fiscal trajectory.

Regarding the fiscal federalism in India, the Centre and States have a financially strained relationship due to the centralised process of tax revenue sharing as well as the process of how grants and loans are made. These issues are being debated and addressed in the 13th Finance Commission. The desire is to empower the States and ultimately, the panchayats to be the decision-making body for local development. Further, the local bodies need to be better resourced and should have a direct share in the central government's tax revenue as is the case in Germany.

The restructuring of the tax administration and a subsequent ICT implementation is greatly desired in India and is likely to increase compliance and widen the tax-base, coverage and reduce evasion. The restructuring of the tax administration can be evolved by studying the German and other developed nations' tax administration and adopting the best practices. Fiscal prudence is the call of the hour and significant learnings can be had from the German experience. Government expenditures – especially revenue expenditure – must be within conservative limits even during phases of low growth as demonstrated by the German policies. The off-budget subsidies are envisioned to be combined with the official estimates of subsidies and ultimately, reduce them within the preferable targets. Elimination is not the objective but rather to utilise subsidies within a pre-determined level of affordability to advance the cause of inclusiveness. Overall, to advance on a path of fiscal prudence, India must promote pro-growth policies and control revenue-expenditure within limits. These may be fostered by inculcating transparency in government budgets, simplification of tax rules, unification of indirect taxes across states and limiting special benefits to certain groups, thereby promoting a meritocratic environment. At the same time, it is necessary to augment low-level capital expenditures to sustain the higher growth rates.

Looking at policies in Germany, it can be expected that the pension and social welfare system is currently in balance and is equipped to cater to the needs till 2022 and will require further tweaking based on the changing demographics. This entails a building up of reserves in the

social welfare system or changing it based on contributions, in which case it shall not provide a safety net to all its citizens. In the near future, regular investment in infrastructure is expected with little changes to the pension system, subsidies or the labour market policies. In the long-term, Germany will need to look at its immigration policies to counter the ageing population. In terms of debt, Germany enjoys a favorable position with bonds denominated in Euros and having a surplus of foreign assets. This is further boosted by the low interest rate environment which is expected to continue in the near future but will require re-dressal once the growth situation changes and ECB hikes interest rates. The flight to quality[70] effect which Germany[71] enjoys in the Eurozone helps keep the interest rates low compared to the rest of the members. This phenomenon is expected to continue. On the tax administration front, Germany enjoys a relatively efficient system based on functional alignment and high ICT implementation. There are few changes which are suggested in the Tax Administration section which are present in other advanced economy's Tax Administration which is likely to improve the governance as well as streamline the process of tax collections further and provide further ease to taxpayers. In terms of subsidies and tax allowance, Germany has a very complex structure of subsidies which is unlikely to change in the medium-term since it is not the priority in debates about changes required to the system. The federal system which exists in Germany where the various interconnections between the different layers of the government is an area which has been cited as inefficient and limiting the powers of Länder and Commune government. One may see small changes being implemented in the government structure with more autonomy being transferred to Länder and Commune governments.

With vast differences in the geo-political as well as economic conditions between India and Germany, there are few best practices which can be shared between the nations. One of the most successful reforms in Germany – labour market reforms – can essentially be a good future goal in the Indian context. On fiscal prudence, debate has raged on the negative consequences of consolidation in terms of its speed and the existing economic condition. With a low-growth environment being experienced in India, consolidation has few takers and low-hanging fruits are few to implement the same without the negative consequences over the long-term.

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[70] The flight quality phenomenon has been much discussed. It refers to investor sentiments of liquidating riskier investments and buying assets which they perceive as less risky and of higher quality. For example, during the 2008 financial crisis, investors dumped the risky assets on their portfolio and bought US treasuries. In addition, they liquidated foreign investments to choose safer investments in the US. This perception of higher quality and safer assets leads to investors piling their holdings in a domestic market perceived of higher quality thereby, lowering the yields on those assets while pulling capital out of riskier assets which cause fire-sale conditions further pressuring the prices downwards into a spiral.

[71] Germany enjoys a similar effect in Eurozone wherein investors perceive German assets as less risky compared to other Eurozone countries. Hence, this has seen capital flow into Germany from other Euro area countries – even bank deposits due to the sovereign debt crisis triggered by Greece. The German bund yields dropped drastically due to this phenomenon. In 2012, the zero-coupon, 2 year bond was sold at a record low yield of 7 basis points while the 30 year bond yields fell to 2 percent (Financial Times, http://www.ft.com/intl/cms/s/0/78a8c2da-a4c8-11e1-9a94-00144feabdc0.html#axzz2rCnzPzAJ).

Annexure 2.1 Debt distribution: Central, State and Local Government

Trends in Centre's Debt Share

With the discussion of Germany's general government debt, it is important to know distribution of debt amongst different levels of government. Germany's general government debt is divided into central, state and local government. Central government's debt comprises the highest share (barring early 1950's) in general government debt followed by states and local government's share. The general government debt has surged broadly under three scenarios: oil price shocks of 1973, reunification of Germany in 1989 and global financial crisis from 2008 onward (Deutsche Bundesbank April 2010). However, the impact of these developments on individual governments was different. The share of dominant central government debt had risen disproportionately from 36 percent in 1950 to 65 percent in 2011. Oil price shocks led to a rise in the central share's debt by 8 percentage points to 47 percent between 1973 and 1977. Subsequently, the reunification of Germany in 1989 placed additional pressure on public finances, especially in improving infrastructure and social benefits in the east German states, causing a sharp rise in central share's debt, up from 54 percent in 1989 to 65 percent in 1996 (Figure 1). Thereafter the position of the central government improved on account of proceeds of 51 billion euros from the auction of UTMS mobile telephone, which was used to pay off government debt. However, recurring fiscal deficits resulted in debt accumulation and the global financial crisis deteriorated the balance sheet of the government. Central government debt rose to 1.03 trillion euros in 2009 and 1.27 trillion in 2011 as compared to 0.98 trillion in 2007.

Trends in States' (Länder) Debt Share

The federal states had the highest share in general government debt in 1950. It remarkably declined from around two-thirds in 1950 to one-fifth in the early 1960s. However, state government debts massively increased in the wake of the oil crisis, rising by 87 billion euro, in the following decade. The sharp upsurge in state government debts was expedited by budgetary reforms undertaken in 1969-72. Subsequently their share in government debt increased from 22 percent in the early 1970s to 31 percent in the early 1980s (see Graph). Thereafter, the debt share on average remained 31 percent and taking the global crisis into account, not much has changed as compared to previous years. Nonetheless, debt levels rose steeply in the wake of the global financial crisis and euro crisis in 2009 and 2011, respectively[73].

[72] In 1969 a new budget reform was set up for the first time for the federation as well as for Länder (states) of Germany. Under it, federation and states in their budget management have to take into account the requirements of macroeconomic equilibrium in terms of stable prices, high level of employment, equilibrium in the balance of payments, and constant and appropriate economic growth (Article 109(2) of basic law). A limit on borrowing was also imposed. It may not exceed the total of investment expenditure provided for in the budget (Article 115 of the Basic Law). (Bundesministerium der Finanzen, November 2008)

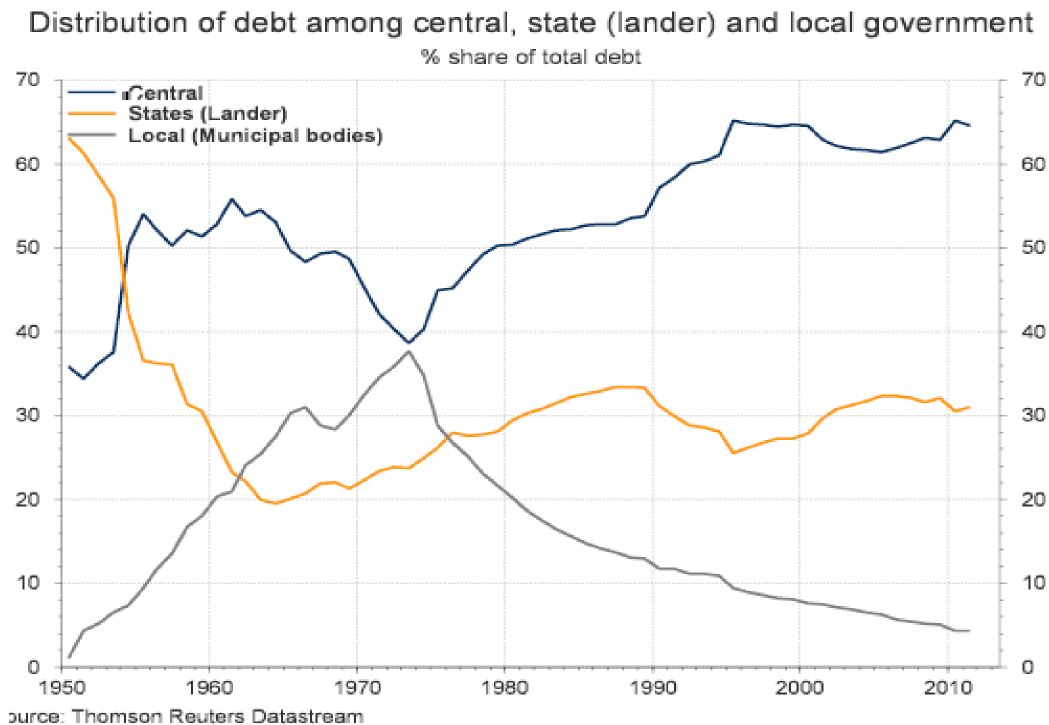
[73] Here we are not analysing developments in the individual federal states, focusing only in aggregates.

Trends in Local Government/ Municipal Debt Share

The local government debt as a share of general government debt was minuscule in 1950 and rose to a record level of 38 percent in 1973. Thereafter, it continuously declined while central and state governments saw acceleration in the debt as a response of the oil crisis and unification of Germany. Debt decelerated because of changes in local government budgetary rules which put a limit on borrowings of municipalities. However, it is relevant to note here that local government debt level has almost seen an uptrend but its share in general government debt has sharply fallen from 12 percent in 1990 to 4 percent in 2011, reflecting a significant rise in debt level of federal and state governments.

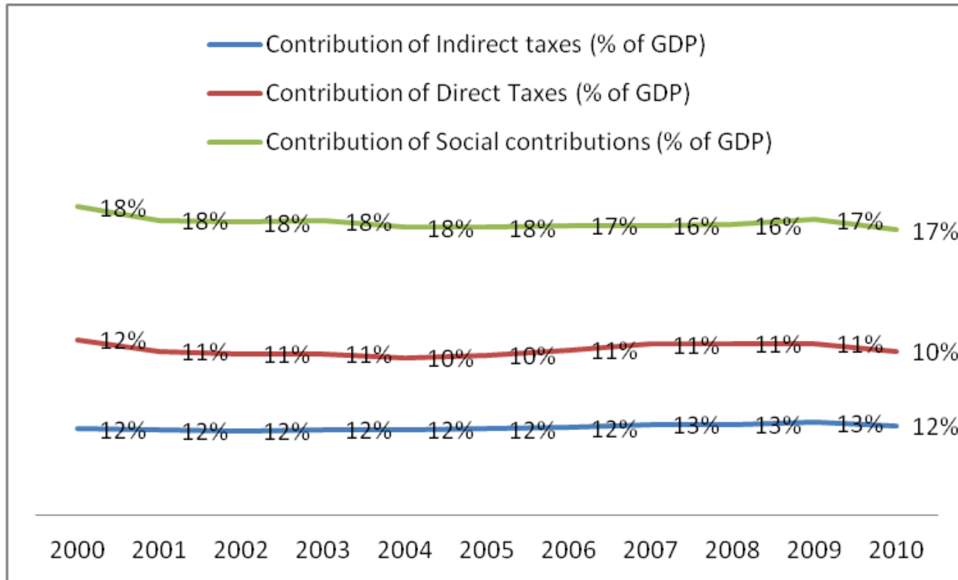
The German government has already introduced a new fiscal and economic surveillance system to augment sound public finances at all three levels of the government. It has embedded into the constitution a debt brake that states that the federal government must restrict its structural deficit to 0.35 percent of GDP by 2016. The 16 Länder (states) must exhibit a balanced budget by 2020. In other words, they are refrained to borrow from 2020 onward. Municipalities are prohibited from borrowing to finance the gap between expenditure and receipt, with the exception that they are allowed to cover short-term liquidity mismatches.

Distribution of Debt among Central, State (Länder) and Local Government



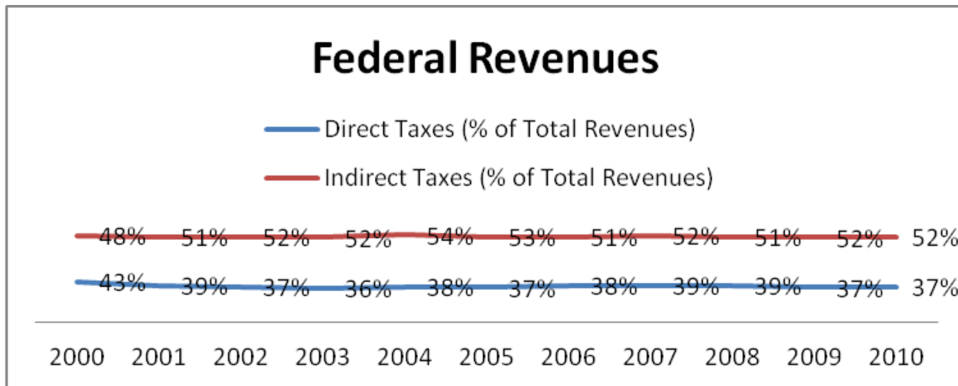
Annexure 3.1

Figure 1: Contribution of Major Taxes to Revenue in the Government Budget (Germany)



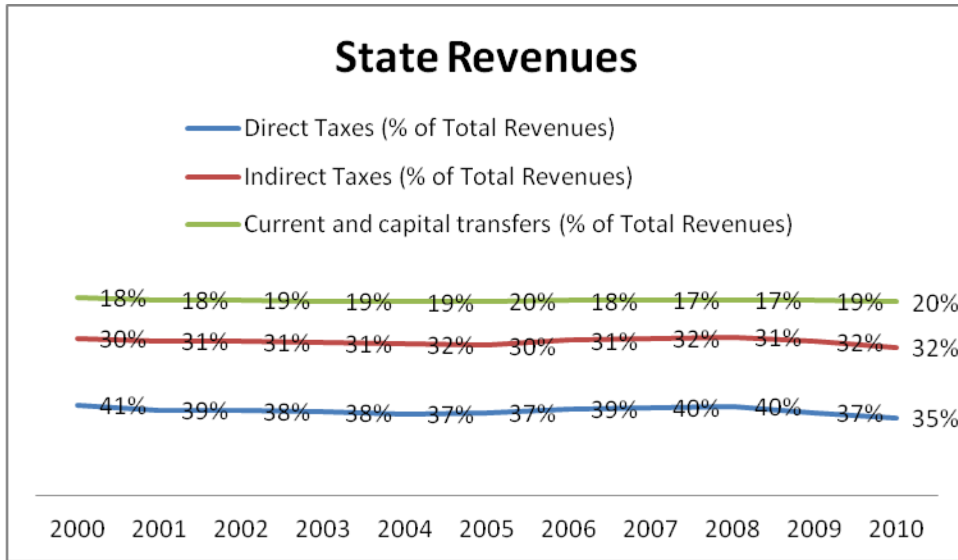
Source: OECD Statistics

Figure 2: Federal Government Revenues Trend (Germany)



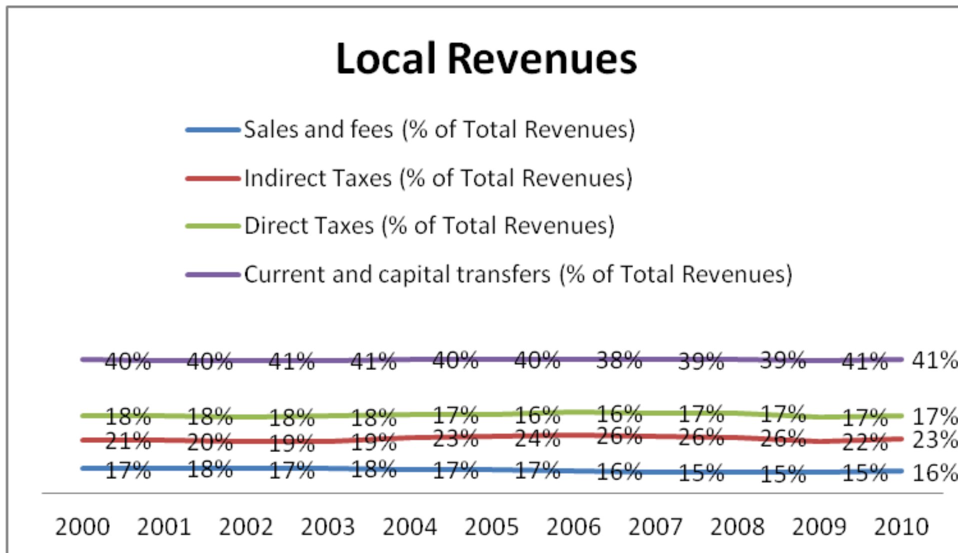
Source: OECD Statistics

Figure 3: State (Länder) Government Revenues Trend (Germany)



Source: OECD Statistics

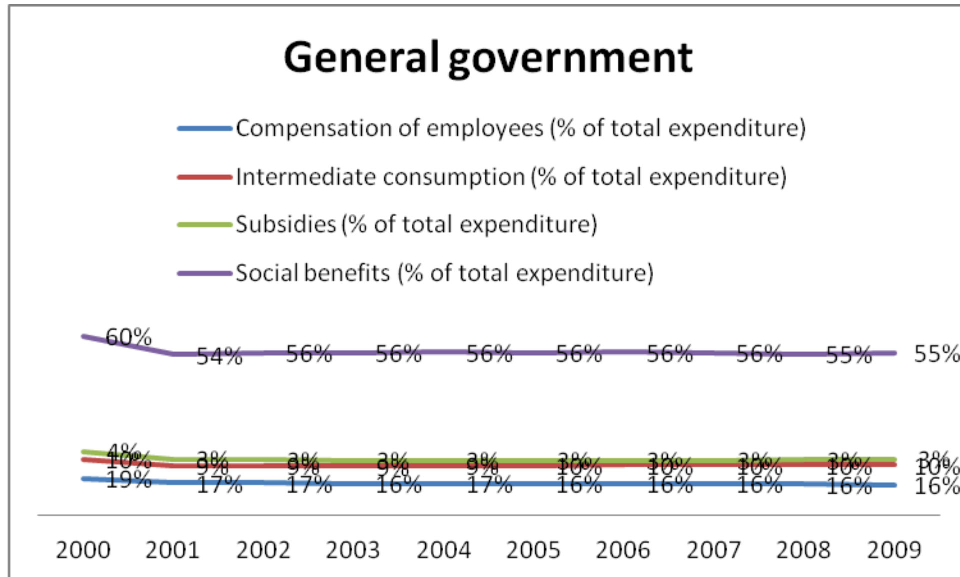
Figure 4: Local (Commune) Government Revenues Trend (Germany)



Source: OECD Statistics

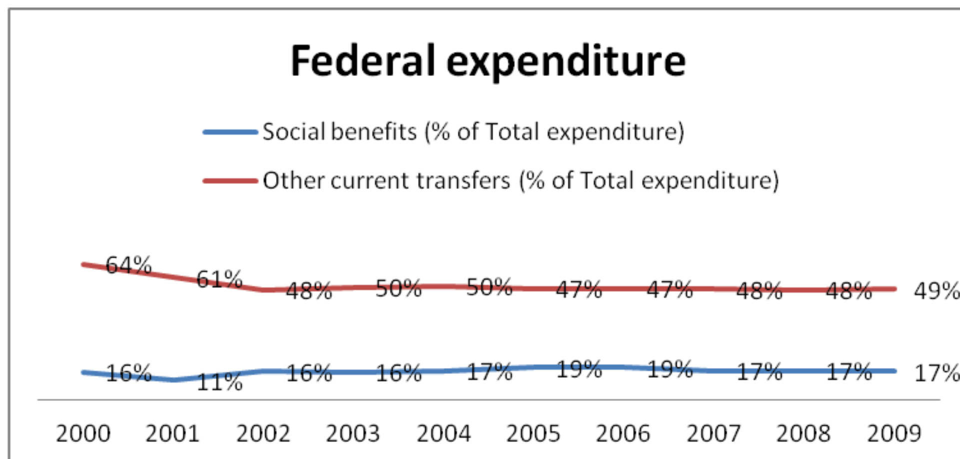
Annexure 3.2

Figure 1: General Government Expenditure (Germany)



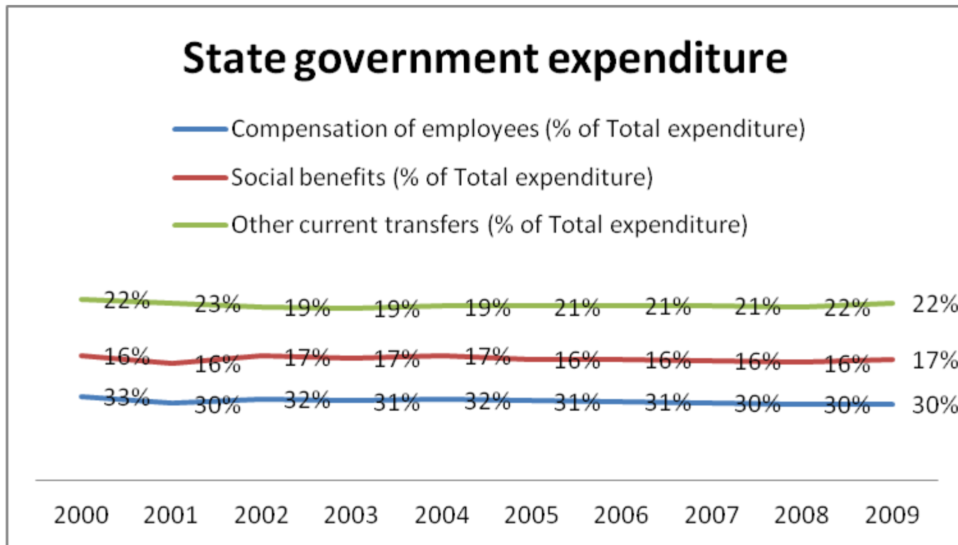
Source: OECD Statistics

Figure 2: Major Components of Federal Government Expenditure (Germany)



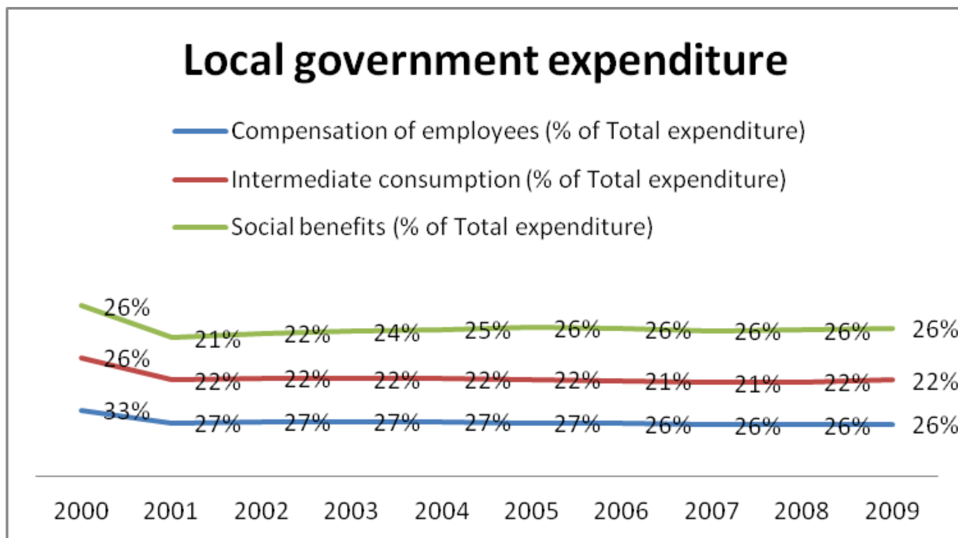
Source: OECD Statistics

Figure 3: Major Components of State (Länder) Government Expenditure (Germany)



Source: OECD Statistics

Figure 4: Major Components of Local (commune) Government Expenditure (Germany)



Source: OECD Statistics

Annexure 6.1

The 10 largest tax allowances in Germany in 2012	Billion Euro	Proportion to GDP
No VAT for Social security institutions, Hospitals, Diagnostic clinics, Nursing homes, care for elderly people and blind.	6.7	0.25
No VAT on Medical Services (invoices of doctors)	5.7	0.21
Lower VAT for cultural services and entertainment	4.1	0.15
Allowances for travelling to work	4	0.15
Tax allowances for Church tax	2.9	0.11
Allowance for private property and homes (first time buyers)	1.2	0.05
Energy tax allowance for producing certain types of energy	2.3	0.09
Allowances for overtime work (Sundays, public holidays and night work)	2.2	0.08
Energy tax allowance for manufacturing	2	0.08
Tax allowance for additional work (working in 2 jobs simultaneously)	2	0.08

Source: Kiel report or Reference 2, Table 2

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