

# Chapter 6

## Fiscal projections under reforms scenario

In the earlier chapters we have emphasised that the fiscal correction during the adjustment period must necessarily be revenue driven, the policy initiatives must be front-loaded and have also indicated at length the package of policy measures which will enable the country to achieve the targets laid down in the Fiscal Responsibility and Budget Management Act, 2003.

The overall emphasis in designing the reform package is to establish a world-class non-distortionary, transparent and sustainable fiscal system which will inspire confidence in all stakeholders: both citizens and foreign investors and enable us to launch a frontal attack on impoverishment, illiteracy and morbidity.

In Section 3.3, it was argued that in the baseline scenario, GDP growth will be slower owing to the fiscal problems. Under the reforms scenario, the opposite effects come into play.

If the fiscal system is re-engineered in the fashion described in this report, there would be a two fold impact. First, India would put its fiscal house in order, achieve a declining Liabilities/GDP ratio, and inspire confidence in the eyes of domestic and foreign investors. Second, tax reforms would unleash the Indian economy, by removing tax-induced

**Table 6.1 GDP at market prices under reforms scenario**

Year	(Rs. crore)	
	GDP	Growth (%)
2003-04	27,72,194	
2004-05	31,04,857	12.00
2005-06	34,77,440	12.00
2006-07	39,03,426	12.25
2007-08	43,91,354	12.50
2008-09	49,62,303	13.00

distortions which have resulted in inefficient organisation of production.

Table 6.1 shows projections for GDP under the reforms scenario. While nominal GDP growth was expected to slow down from 12 per cent per year in 2005-06 to 11.25 per cent per year in 2008-09 under the baseline scenario, GDP growth is instead expected to accelerate to 13 per cent per year in 2008-09 under the reforms scenario.

### 6.1 RATIONALE OF PROJECTIONS UNDER REFORMS SCENARIO

In this section, we articulate the rationale of how the proposed reforms of the previous chapter will impact on various components of revenue and expenditure.

### 6.1.1 Personal income tax

The package of measures recommended for personal income tax focus on eliminating the bias against savings and altering the economics of compliance by further liberalising the personal tax rates through broad basing the tax slabs. While there would be revenue loss at existing levels of compliance, the same can be reasonably expected to increase during the adjustment period resulting in an improvement in the PIT-GDP ratio from 1.45 in 2003-04 to 2.26 in 2008-09. Further, these revenue outcomes will be achieved with greater progressivity and economic efficiency.

The proposals of this report in regard to personal income tax are projected to directly generate a revenue loss of Rs.11,243 crore at existing levels of compliance. However, cross-country experience and empirical research on taxpayer compliance behaviour in India suggest that compliance will be significantly improved when tax rates are reduced and tax laws are simplified and rationalised.

Given the typically skewed distribution of taxpayers, we could reasonably expect to recoup 60% of the revenue loss in the first year (2005-06) through improved compliance. In 2006-07, this is projected to increase to 110%, and grow further to 115% in 2007-08, and stay at that level thereafter.

Discussions with field-level tax officials show that the current initiatives for modernisation of tax administration, such as the TIN and other initiatives proposed in this report, will yield a substantial positive impact on compliance from 2005-06 onwards. We assume that this will give improvements in tax revenues, over and above all other issues, by a factor of 2.5% in 2005-06, 5% in 2006-

07, 7.5% in 2007-08 and 10% in 2008-09.

As Table 6.2 illustrates, *all classes of taxpayers will benefit significantly from these proposals*. The estimates shown in this table are highly authoritative as they are based on an empirical analysis of around 1 million income tax returns spread over three years. These calculations are hence far more credible as compared with specific illustrations which are sometimes used in these debates.

The new savings incentive designed on a EET method will promote long-term savings and enhance the long term debt servicing capability of the Central Government. Similarly, the rationalisation of the tax treatment of zero-coupon bonds will provide the necessary finances for infrastructure and also increase bond supply in the debt market to fulfill the potential increase in demand for long term bonds in view of the rationalisation of savings incentives.

### 6.1.2 Corporation tax

The proposals of this report in regard to corporate tax are projected to directly generate a revenue gain of Rs.6,698 crore at existing levels of compliance. However, cross-country experience and empirical research on taxpayer compliance behaviour in India suggest that compliance will be significantly improved when tax rates are reduced and tax laws are simplified and rationalised.<sup>1</sup>

Discussions with field-level tax officials show that the current initiatives for moderni-

<sup>1</sup> See *Tax rates, tax compliance and tax revenues: India, 1988-2004*, Surjit Bhalla. This paper can be accessed at <http://www.oxusresearch.com> on the world wide web.

**Table 6.2** Impact of proposed personal income tax reforms on individual taxpayers

This table shows the projected impact upon a typical taxpayer of the proposed personal income tax policy reforms, simulated on a randomly chosen dataset of roughly 1,000,000 taxpayers, using their income tax filings. In each income range, the averages of all records in this dataset are reported in the table. For example, the results show that for a salaried taxpayer with an income between Rs.100,000 and Rs.150,000, the proposed changes would yield a reduction in income tax payment of Rs.3,272.

Income range	Salaried taxpayers			Non-salaried taxpayers		
	Existing	Post-reform	Benefit	Existing	Post-reform	Benefit
0-40,000	Nil	Nil	Nil	Nil	Nil	Nil
40,000-50,000	Nil	Nil	Nil	Nil	Nil	Nil
50,000-60,000	Nil	Nil	Nil	382	Nil	+382
60,000-80,000	Nil	Nil	Nil	2,196	0	+2,196
80,000-1,00,000	1,638	406	+1,233	5,452	0	+5,452
1,00,000-1,50,000	8,941	5,669	+3,272	10,697	4,016	+6,681
1,50,000-2,00,000	22,915	14,696	+8,219	23,522	14,136	+9,386
2,00,000-3,00,000	43,370	27,708	+15,663	44,830	29,928	+14,903
3,00,000-4,00,000	75,705	46,975	+28,731	76,855	51,334	+25,521
4,00,000-5,00,000	106,652	69,831	+36,821	108,923	77,634	+31,289
5,00,000-10,00,000	185,731	134,648	+51,084	188,671	149,645	+39,026
Above 10,00,000	734,591	660,812	+73,779	1,177,511	1,088,594	+88,917

sation of tax administration, such as TIN, RIN and other initiatives proposed in this report, will yield a substantial positive impact on compliance from 2005-06 onwards. We assume that this will give improvements in tax revenues, over and above all other issues, by a factor of 3% in 2005-06, 6% in 2006-07, 8% in 2007-08 and 9% in 2008-09.

An empirical analysis of the proposed package of reforms relating to corporate tax, using the CMIE database, is shown in Table 6.3. This suggests that these reforms may be expected to increase the corporate tax-GDP ratio from 2.27 in 2003-04 to 4.20 in 2008-09. While the rate reductions while eliminate the differential in tax regime across forms of organisations, it will also reduce the marginal rates for small and medium enterprises.

Therefore, the ex-ante cost of equity capital will reduce and so will the weighted average cost of capital. As a result, investment decisions at the margin will

become profitable.

Further, the reduction in depreciation rates will eliminate the bias against labour without adversely affecting the internal accruals for replacement and modernisation. To the extent credit for CENVAT on capital goods is also proposed to be allowed in the year of acquisition, this should further augment internal accruals. Investment in capital assets will be motivated by profitability and not driven by tax considerations. Entrepreneurs will now be motivated to improve efficiency in the use of capital assets.

Detailed calculations which take into account the revenue impact of the twin proposal - to reduce corporate tax rates and to reduce depreciation rates - are contained in Table 6.3. These are essentially static calculations, and do not reflect the most important aspects of the proposed reforms, which are the improved economic efficiency and administrative effectiveness. These revenue

**Table 6.3** Estimates of revenue impact of proposed changes to corporate income tax rates and depreciation rates

This table shows the projected impact of the proposed corporate tax policy reforms, on corporate tax revenues, simulated using the 2,952 non-banking profit-making firms and the 65 profit-making banks observed in the CMIE Prowess dataset.

Element	2952 profit-making non-banking firms	65 profit-making banks	Total
1 Profits before tax in 2002-03	109460	23150	132610
2 Tax paid at 2002-03 rate (36.75 per cent)	25245	7008	32253
3 Tax paid at 2003-04 rate (35.875 per cent)	24644	6841	31485
4 Taxable base	68694	19069	87763
5 Book depreciation as per CMIE database	41917	2682	44599
6 Deferred tax as per CMIE database	5628	192	5820
7 Excess of tax depreciation over book depreciation	15314	522	15837
8 Total tax depreciation	57231	3204	60436
9 WDV of assets	228925	12818	241743
10 Tax depreciation at 15 per cent	34339	1923	36261
11 Reduction in tax depreciation	22893	1282	4174
13 Taxable base before depreciation	125925	22274	148199
14 Adjusted taxable base	91586	20351	111938
15 Tax at 30 per cent	27476	6105	33581
16 Net gain in revenue from sample companies	2832	-736	2096
17 <b>Net gain in revenue (in per cent)</b>	<b>11.22</b>	<b>-10.50</b>	<b>8.5</b>
18 Gross corporate collection in 2003-04 (excluding regular collections)	62550	9000	71550
19 <b>Net increase in revenue</b>	<b>7017</b>	<b>-945</b>	<b>6072</b>

projections should therefore be considered conservative.

### 6.1.3 Union excise duties

In the earlier chapters we have pointed out the disappointingly low buoyancy, of 0.75, in the case of union excises in the baseline scenario. The proposed reduction in rates and the change in CENVAT credit system for capital goods will reduce revenues. However, this is projected to be overcome through base expansion to the retail stage, on account of comprehensive taxation of services.

We have also assumed an increase in revenues through improved compliance, owing

to the modernisation of the tax administration, by a factor of 5% in 2005-06, 10% in 2006-07, 12.5% in 2007-08 and 15% in 2008-09.

The overall impact of these changes is projected to bring the buoyancy of excise up to 0.98, which would stabilise the excise tax to GDP ratio. This increase is modest in the light of the average buoyancy for central tax revenues.

The combined revenues from both union excises and service tax will therefore increase from 3.6 per cent of GDP in 2003-04 to 5.44 per cent of GDP by 2008-09. With a standard rate of 12 per cent, the GDP-efficiency of the proposed GST by the centre

**Table 6.4** Projection of service tax revenues

Estimated revenues from 51,651 service sector firms with turnover above Rs.10 lakh, at 12% of gross value added less interest payments in 2002-03 (Table B.9)	26,035
Extrapolation of the above to 2003-04 by a factor of 10%	2,604
Estimated additional revenues from transport services not covered by CMIE dataset (assuming 90% coverage for Railways, 100% for Air, 50% for water transport and 50% for road transport)	8,670
Estimated additional revenues from construction services not covered by CMIE dataset (assuming 70% coverage)	12,987
Estimated additional revenues from urban dwelling services not covered by CMIE dataset (assuming 40% coverage)	3,859
<b>Total</b>	<b>54,155</b>
Less: existing service tax revenues	8,300
<b>Additional revenues in 2003-04 from 12% service tax</b>	<b>45,855</b>

is 0.45, which is consistent with international experience.<sup>2</sup> These revenue estimates from this source are therefore reasonable and achievable, particularly given the tremendous IT and telecommunications capacity found in India.

#### 6.1.4 Service tax

Table 6.4 shows the rationale behind the projections for service tax, focusing on the potential revenues for 2003-04. This uses the results from Appendix B. Projections from 2003-04 till 2005-06 are made assuming

<sup>2</sup>The average efficiency across countries is estimated to be 0.4. However, most countries with a modern VAT and tax administration have higher efficiency ratios.

a buoyancy of 1. The buoyancy is assumed to go up to 1.28, being the average buoyancy of central taxes under the baseline scenario. This reflects the broad-based improvements in tax reforms, simplification and administration. However, for the first year (2005-06), a more modest projection is made, which is 15% below these calculations, to account for the difficulties of first-time implementation.

Our recommendations to extend service tax to all services except a small negative list will remove the numerous distortions in the goods and services tax which we have alluded to earlier. The revenues from this undertaxed sector will grow from 0.45 per cent of GDP in 2004-05 to 2.14 per cent in 2008-09. The impact of integrating the service tax with the union excises on goods is extensively documented in the subsequent chapter.

#### 6.1.5 Customs

Customs revenues are projected to decline from 1.78 per cent of GDP in 2003-04 to 1.03 per cent of GDP in 2008-09. These are comparable estimates, which show the sum of customs and CVD collections.

The decline is primarily on account of reduction in customs tariff rates, on the lines proposed in the previous chapter. The revenue loss on account of these rate reforms have been fully factored into the projections of this chapter.

**Table 6.5** Additional resource mobilisation (ARM) by tax source

These incremental values (ARM) when added to the revenue projections under the baseline scenario, yield the revenue projections under the reforms scenario. In all cases, it is assumed that the full set of policy reforms proposed in this report are implemented in 2005-06, and that policies stay unchanged thereafter. The growth in all cases comes from normal trend behaviour, and incremental growth every year owing to improvements in tax administration and behavioural changes.

(Rs. crore, differences compared with baseline)				
Tax	2005-06	2006-07	2007-08	2008-09
Personal income tax	-3,148	4,902	8,831	13,042
Corporate tax	9,773	15,884	22,668	29,696
Union excise duties	2,594	13,150	17,624	22,816
Service tax	44,890	61,650	72,190	85,082
Customs	-8,302	-13,697	-15,067	-16,574
Total	45,807	81,890	106,246	134,062

### 6.1.6 Summarising the impact of proposed reforms on all tax components

Table 6.5 summarises the projected numerical impact of all the policy proposals of this report on tax revenues, using the imputation strategies outlined above.

### 6.1.7 Summarising basis for projections for baseline and reforms scenarios

Tables 6.6 and 6.7 show, in tabular form, a comparison of the assumptions used in the baseline scenario and the comparable values used in the reforms scenario.

## 6.2 MAJOR ECONOMIC FEATURES OF THE REFORMS SCENARIO

### 6.2.1 Tax projections for reforms scenario

Estimates of Central Government tax revenues by sources, in the post-reform scenario, are presented in terms of levels in Table 6.8.

The buoyancy of gross tax collections, under these projections, works out to 1.65, and imply a 20.3 per cent per year average growth in gross tax collections. The highest growth is seen in service tax. Customs growth is projected to stagnate, given the reforms envisaged in terms of cutting tariffs. Excise buoyancy works out to 0.98 in the reforms scenario, as opposed to the sluggish performance of excise collections in the baseline scenario.

Tax projections, under the reforms scenario, are expressed as per cent to GDP in Table 6.9. Gross tax collections are projected to go up from 10.08 per cent of GDP in 2004-05 (BE) to 12.96 per cent of GDP in 2008-09, an increase of 2.88 percentage points.

As emphasised above, the trajectory of revenue gains has been defined under the assumption that the tax reforms are implemented at the start of 2005-06. While the proposed reforms are front-loaded, their impact is smeared over the years from 2005-06, 2006-07 and 2007-08. As emphasised in the earlier chapter, increases of a similar magnitude has been registered by many countries which have undertaken similar comprehensive tax reform. Therefore, even

**Table 6.6** Revenue assumptions underlying baseline versus reforms scenarios

	Baseline	Reforms
<i>GDP</i>	Growth rate of 12 percent in 2004-05 and 2005-06, 11.75 percent in 2006-07, 11.5 percent in 2007-08 and 11.25 percent in 2008-09.	Growth rate of 12 percent in 2004-05 and 2005-06, 12.25 percent in 2006-07, 12.5 percent in 2007-08 and 13 percent in 2008-09.
<i>Tax revenue</i>		
Income tax	Estimated average buoyancy of 1.69	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 1.84
Corporate tax	Estimated average buoyancy of 1.98	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 2.19
Union excise duty	Estimated average buoyancy of 0.5 for Non-POL and 1 for POL. The overall buoyancy is estimated at 0.75	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 0.98
Customs	Estimated average buoyancy of 0.54	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 0.06
Service tax	Estimated average buoyancy of 1.77	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 5.39
Education cess	2 percent of all taxes	Maintain the ratio of education cess to all other central taxes in the year 2004-05
<i>Non-tax revenues</i>		
Interest income	Reduction of 5 percent per annum	Reduction of 7.5 percent per annum over 2004-05
Dividend	Annual growth rate of zero percent.	Annual growth rate of 2.5 percent.
Other non-tax revenue	Annual growth rate of 5 percent.	Unchanged

though the task is daunting, it is not out of reach.

One of the important consequences of the tax driven fiscal correction is that it will substantially improve the fiscal health of state governments. An increase of 2.88 per cent of GDP in gross tax revenues of the centre will result in a direct improvement of State revenues of about 0.9 per cent of GDP, going by existing sharing formulas. This will in turn help states to overcome their revenue deficit and put a halt to increasing debt burden.

The reforms projections envisage that cus-

toms collections will drop from 1.72 per cent of GDP in 2004-05 to 1.03 per cent of GDP in 2008-09, reflecting India's convergence to ASEAN levels of customs tariffs. Tax collections from the services sector are projected to rise sharply, from 0.45 per cent of GDP in 2004-05 (BE) to 2.14 per cent of GDP in 2008-09.

### 6.2.2 Fiscal projections for reforms scenario

Table 6.10 shows the full projections for the reforms scenario, measured in crore rupees.

**Table 6.7** Expenditure assumptions underlying baseline versus reforms scenarios

	Baseline	Reforms
<i>Non-plan expenditure</i>		
Interest payments	Weighted average interest rate of 8.25 percent	Unchanged.
Defence expenditure	Annual growth rate of 8.73 percent after adjusting for the one-time additionality in 2004-05 for capital expenditure.	To be marginally increased in 2005-06 and thereafter stabilised at 2.3 percent of GDP.
Subsidies		
Food	Reduction of 5 percent per year	Unchanged.
Fertilizer	Annual growth rate of 5 percent.	Unchanged.
Others	Petroleum subsidy to be phased out after 2006-07	Unchanged.
Grants, loans to States, UTs	Annual growth rate of 6 per cent	Annual growth rate of 5.5 per cent. Pending finalisation of the details of the program, a sum of Rs.5,000 crore in 2006-07, Rs.7,500 crore in 2007-08, and Rs.10,000 crore in 2008-09 have been additionally provided for the Backward States Grant Commission under this head.
Other non-plan exp.	Annual growth rate of 6 percent.	Annual growth rate of 5.5 percent.
<i>Plan expenditure</i>	12.82 percent increase per annum	Accelerated annual growth rate of 15 percent after 2004-05.
<i>Capital expenditure</i>	To maintain the ratio of capital expenditure to total expenditure at the 2003-04 level	To steadily increase capital expenditure, so that in 2008-09 it is about 0.5 percent of GDP higher than the baseline projection for 2008-09.

**Table 6.8** Reforms scenario tax projections (Rs. crore)

This table shows tax projections, under the reforms scenario, expressed in crore rupees. It may be compared against Table 3.2 which shows the corresponding baseline scenario.

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09	Growth 0405-0809	Buoyancy
Direct taxes	103,400	137,000	160,883	209,070	260,565	320,405	25.38	2.06
Income tax	40,269	50,009	55,310	74,744	92,130	112,042	22.71	1.84
Corporation tax	62,986	86,846	105,573	134,326	168,436	208,363	27.03	2.19
Indirect taxes	151,523	175,823	217,481	254,867	285,735	320,343	16.15	1.31
Excise	92,379	107,699	110,491	130,941	146,357	163,507	12.10	0.98
Customs	49,350	53,500	46,980	45,342	48,221	51,269	0.77	0.06
Service tax	8,300	14,000	60,010	78,584	91,157	106,326	66.54	5.39
Gross tax collection	254,923	312,823	378,363	463,937	546,301	643,287	20.34	1.65
Education cess	0	4,910	5,939	7,282	8,575	10,097		
Total gross taxes	254,923	317,733	384,302	471,219	554,875	653,384	20.71	1.68
GDP at market prices	27,72,194	31,04,857	34,77,440	39,03,426	43,91,355	49,62,231	12.35	



**Table 6.9 Reforms scenario tax projections: Per cent to GDP**

This table shows tax projections under the reforms scenario, where all values are expressed as per cent to GDP. It may be compared against Table 3.3, which shows corresponding values under the baseline scenario.

Financial Year	(Per cent to GDP)					
	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
Direct taxes	3.73	4.41	4.63	5.36	5.93	6.46
Income tax	1.45	1.61	1.59	1.91	2.10	2.26
Corporation tax	2.27	2.80	3.04	3.44	3.84	4.20
Indirect taxes	5.47	5.66	6.25	6.53	6.51	6.46
Excise	3.33	3.47	3.18	3.35	3.33	3.30
Customs	1.78	1.72	1.35	1.16	1.10	1.03
Service tax	0.30	0.45	1.73	2.01	2.08	2.14
Gross tax collection	9.20	10.08	10.88	11.89	12.44	12.96
Education cess	0	0.16	0.17	0.19	0.20	0.20
Total gross taxes	9.20	10.23	11.05	12.07	12.64	13.17

The projections envisage a small revenue surplus of Rs.7,429 crore in 2008-09. Table 6.11 shows the same information, expressed as per cent to GDP.

Gross tax revenues are projected to rise from 10.23 per cent of GDP to 13.17 per cent of GDP, an increase of 2.94 percentage points. Given the assumptions about stable nominal disinvestment proceeds, 'Other receipts' are projected to drop from 0.13 per cent of GDP to 0.08 per cent of GDP. Total receipts are projected to be 14.3 per cent of GDP in 2008-09.

Interest costs are projected to drop from 4.17 per cent of GDP to 3.54 per cent of GDP. Defence expenses are projected to be stable at 2.3 per cent of GDP from 2006-07 onwards. Subsidies are projected to steadily drop to 0.8 per cent of GDP. Grants and loans to States and Union Territories are projected to rise to 0.96 per cent of GDP.

Plan expenditure is projected to rise from 4.69 per cent of GDP in 2004-05 to 5.13 per cent of GDP in 2008-09. The decline in total

expenditure is projected to be concentrated in revenue expenditure. Capital expenditure is projected to go up from 2.97 per cent of GDP to 3.27 per cent of GDP.

This fiscal planning effort projects a small revenue surplus in the terminal year 2008-09. It should be highlighted that this is a small revenue surplus, so there is little 'slack' available in this set of projections. The improvement in the revenue deficit in every year, and the terminal year values, conform to the requirements of the FRBM Rules.

The fiscal deficit is projected to drop to 2.8 per cent of GDP in 2008-09. The drop in the fiscal deficit in every year conforms to the requirements of the FRBM Rules.

Figure 6.1 compares the baseline scenario against the reforms scenario on the revenue deficit. Under the baseline scenario, some progress on the revenue deficit (as per cent of GDP) is expected. However, the revenue deficit is expected to be quite substantial in 2008-09. In contrast, the reforms scenario delivers a trajectory through which the

**Table 6.10** Fiscal projections under reforms scenario (Rs. crore)

This table shows fiscal projections under the baseline scenario, expressed in crore rupees. It may be compared against Table 3.5, which shows corresponding values under the baseline scenario.

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
GDP	27,72,194	31,04,857	34,77,440	39,03,426	43,91,354	49,62,231
Gross tax revenue	254,923	317,733	384,302	471,219	554,875	653,384
Revenue receipts	263,027	309,322	357,066	420,758	482,441	554,712
Tax revenue, net to centre	187,539	233,906	282,969	347,713	410,191	483,014
Non-tax revenue	75,488	75,416	74,097	73,045	72,250	71,698
Capital receipts	164,626	168,507	161,131	155,001	153,525	154,835
Recoveries of loans	18,023	27,100	16,895	12,225	12,089	12,089
Other receipts	14,500	4,000	4,000	4,000	4,000	4,000
Borrowings and other liabilities	132,103	137,407	140,236	138,776	137,436	138,746
Total receipts	427,653	477,829	518,197	575,759	635,966	709,548
Non-plan expenditure	306,146	332,239	350,768	383,216	414,542	454,910
Interest, debt servicing	124,555	129,500	141,545	152,997	164,333	175,769
Defence	60,300	77,000	77,981	89,779	101,001	114,131
Subsidies	44,707	43,516	44,497	43,924	39,883	39,672
Grants, loans to States,UTs	15,850	19,576	20,653	26,789	35,762	47,729
Other non-plan expenditure	60,734	62,647	66,093	69,728	73,563	77,609
Plan expenditure	121,507	145,590	167,429	192,543	221,424	254,638
Total expenditure	427,653	477,829	518,197	575,759	635,966	709,548
Revenue expenditure	362,887	385,493	418,394	462,559	496,760	547,283
Capital expenditure	64,766	92,335	99,803	113,199	139,206	162,265
Revenue Deficit	99,860	76,171	61,328	41,802	14,319	-7,429
Fiscal Deficit	132,103	137,407	140,236	138,776	137,436	138,746

revenue deficit is projected to go to zero by 2008-09, and revenue surpluses can then be obtained thereafter.

Figure 6.2 shows projections for the Debt/GDP ratio under the baseline scenario. Under the baseline scenario, this ratio is projected to worsen slightly in the coming few years. In contrast, the reforms scenario is projected to deliver a sharp improvement in the Liabilities/GDP ratio.

This is consistent with the framework observed in advanced countries, where the Liabilities/GDP ratio only declines in normal

years, thus giving fiscal space for debt issuance when faced with emergencies. This also sets the stage for achieving the lower Liabilities/GDP ratios which are found with countries which have high credit ratings, which would pave the way for higher investment flows for the country.

The fraction of interest payments to revenue receipts (Figure 6.3) is a valuable indicator of fiscal stress. It shows the fraction of revenue receipts which have been pre-empted merely to meet interest payments. This ratio had risen to as high as 53.4 per cent in 2001-02;

**Table 6.11** Fiscal projections under reforms scenario (Per cent to GDP)

This table shows the full set of fiscal projections under the reforms scenario, expressed as per cent of GDP. It may be compared against Table 3.6, which shows corresponding values under the reforms scenario. All the values in the table are consistent with the FRBM Act and with the FRBM Rules.

	(Per cent to GDP)					
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
	(RE)	(BE)				
Gross tax revenue	9.20	10.23	11.05	12.07	12.64	13.17
Revenue receipts	9.49	9.96	10.27	10.78	10.99	11.18
Tax revenue, net to centre	6.77	7.53	8.14	8.91	9.34	9.73
Non-tax revenue	2.72	2.43	2.13	1.87	1.65	1.44
Capital receipts	5.94	5.43	4.63	3.97	3.50	3.12
Recoveries of loans	0.65	0.87	0.49	0.31	0.28	0.24
Other receipts	0.52	0.13	0.12	0.10	0.09	0.08
Borrowings and other liab.	4.77	4.43	4.03	3.56	3.13	2.80
Total receipts	15.43	15.39	14.90	14.79	14.48	14.30
Non-plan expenditure	11.04	10.70	10.09	9.82	9.44	9.17
Interest, debt servicing	4.49	4.17	4.07	3.92	3.74	3.54
Defence	2.18	2.48	2.24	2.30	2.30	2.30
Subsidies	1.61	1.40	1.28	1.13	0.91	0.80
Grants, loans to States,UTs	0.57	0.63	0.59	0.69	0.81	0.96
Other non-plan exp.	2.19	2.02	1.90	1.79	1.68	1.56
Plan expenditure	4.38	4.69	4.81	4.93	5.04	5.13
Total expenditure	15.43	15.39	14.90	14.75	14.48	14.30
Revenue expenditure	13.09	12.42	12.03	11.85	11.31	11.03
Capital expenditure	2.34	2.97	2.87	2.90	3.17	3.27
Revenue Deficit	3.60	2.45	1.76	1.07	0.33	-0.15
Change	0.80	-1.15	-0.69	-0.69	-0.74	-0.48
Fiscal Deficit	4.77	4.43	4.03	3.56	3.13	2.80
Change	-1.15	-0.34	-0.40	-0.47	-0.43	-0.33

i.e., more than half of revenues were taken up in merely paying interest.

The baseline scenario is projected to roughly deliver a stable ratio. However, the reforms scenario is projected to deliver sharp improvements in this ratio, going down to levels near 30 per cent by 2008-09. The continuation of revenue surpluses beyond is likely to give further reductions in this ratio in the following years.

Under the reforms scenario, the change in

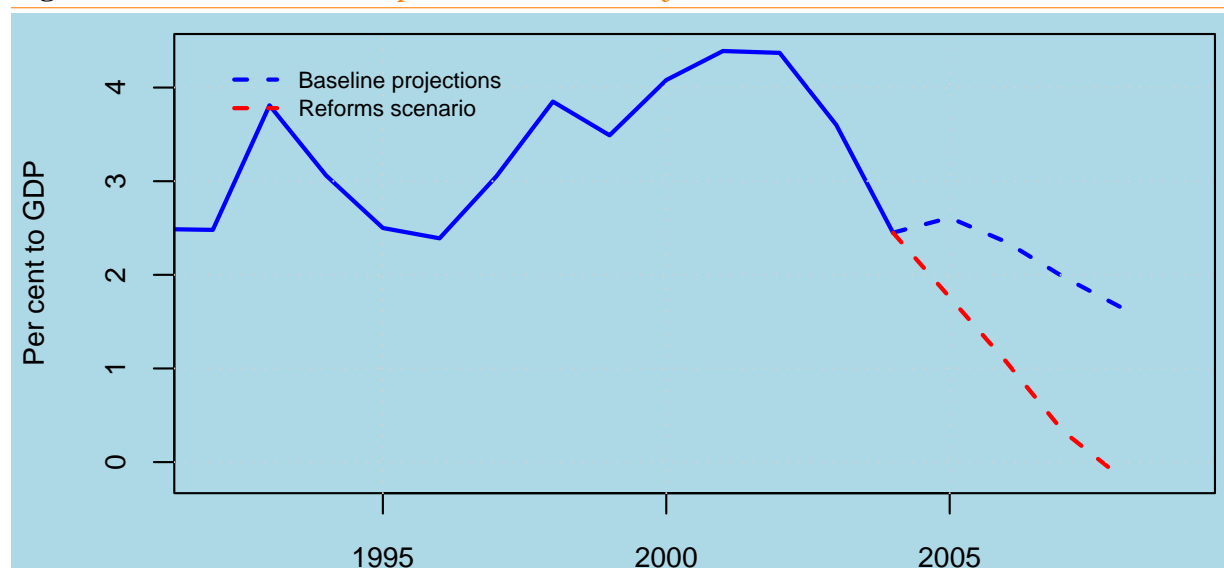
outlook on the Debt/GDP ratio, and on the fraction of revenue receipts used up to pay interest obligations, will send a sharp signal about India's fiscal consolidation from 2006-07 onwards, when progress will be manifestly visible.

The discretionary expenditure of government is the non-interest part of total expenditure. This is the resource base that is available to expenditure policy, which can be utilised to produce public goods and also fund

**Table 6.12** Comparing baseline and reforms scenarios

This is the data that underlies Figures 6.1, 6.2, 6.3 and 6.4.

Parameter	2004-05	2005-06	2006-07	2007-08	2008-09
<b>Liabilities/GDP</b>					
Baseline	68.51	68.85	69.09	69.07	68.92
Reforms	68.51	67.89	67.11	66.25	65.44
Difference		<i>-0.96</i>	<i>-1.98</i>	<i>-2.82</i>	<i>-3.48</i>
<b>Revenue deficit to GDP</b>					
Baseline	2.45	2.61	2.35	1.98	1.66
Reforms	2.45	1.76	1.07	0.33	-0.15
Difference		<i>-0.85</i>	<i>-1.28</i>	<i>-1.65</i>	<i>-1.81</i>
<b>Interest / revenue receipts</b>					
Baseline	41.87	44.50	44.01	42.90	41.48
Reforms	41.87	39.64	36.36	34.06	31.69
Difference		<i>-4.86</i>	<i>-7.65</i>	<i>-8.84</i>	<i>-9.79</i>
<b>Non-interest expenditure to GDP</b>					
Baseline	11.22	10.62	10.33	10.01	9.83
Reforms	11.22	10.83	10.83	10.74	10.76
Difference		<i>0.21</i>	<i>0.50</i>	<i>0.73</i>	<i>0.93</i>

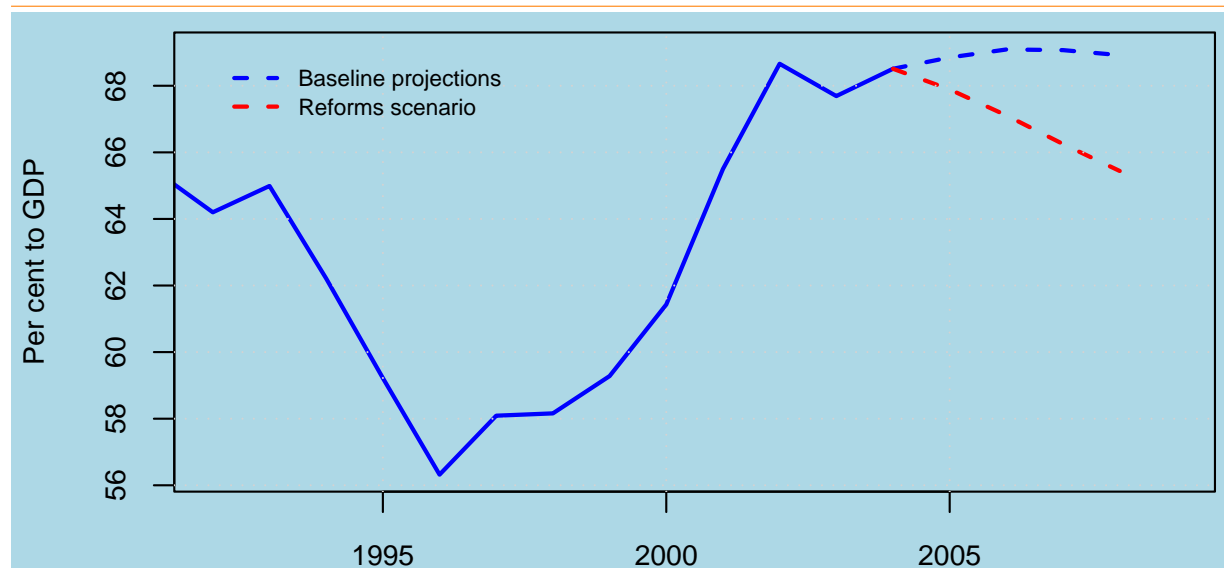
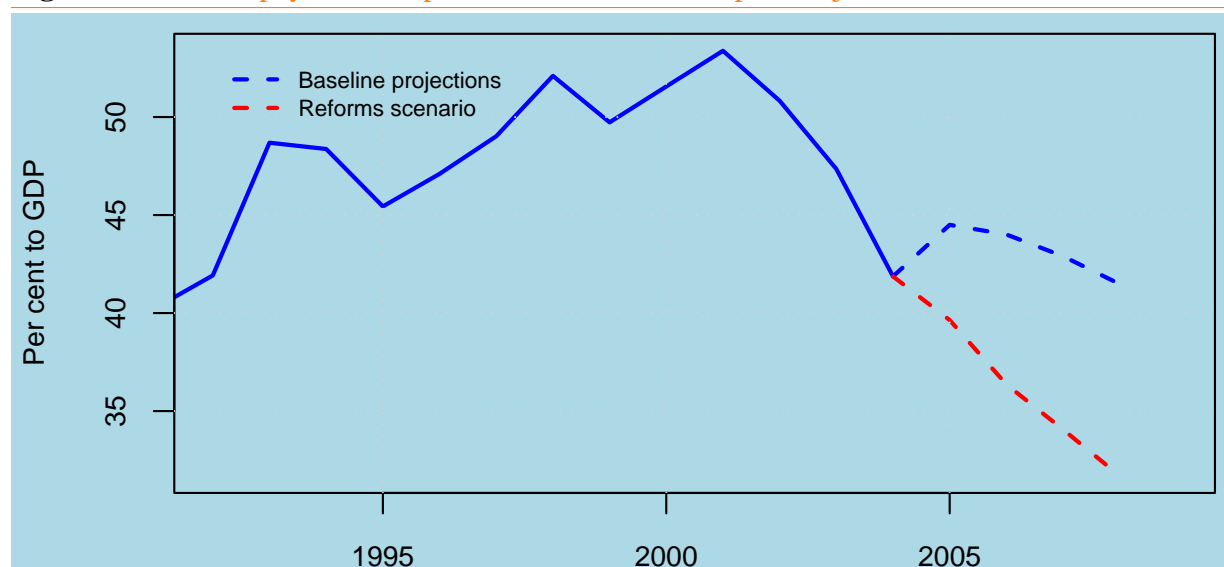
**Figure 6.1** Revenue deficit as per cent to GDP: Projections under reforms scenario

subsidies. The historical experience, and projections, for this (expressed as per cent to GDP) is shown in Table 6.4.

Under the reforms scenario, discretionary expenditure of government is projected to fall

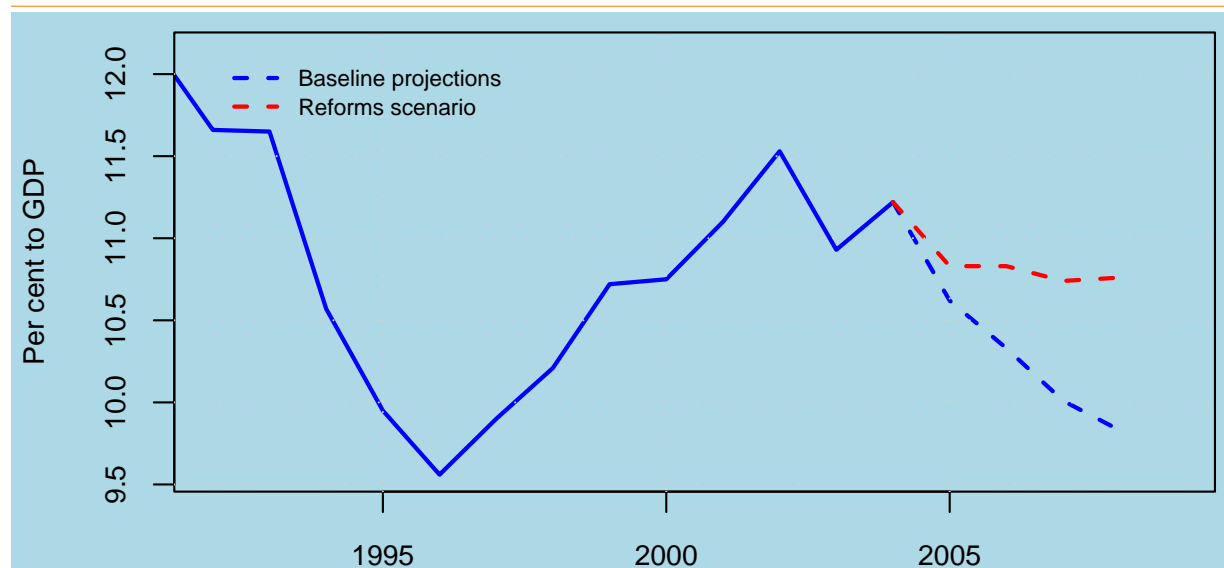
steadily to levels below 10 per cent by 2008-09. The reforms scenario is projected to deliver a stable value of roughly 11 per cent of GDP.

The numerical values underlying these

**Figure 6.2** Liabilities as per cent to GDP: Projections under reforms scenario**Figure 6.3** Interest payments as per cent to revenue receipts: Projections under reforms scenario

graphs are summarised in Table 6.12. The table highlights the fact that the reforms scenario improves upon the baseline projections on each parameter in each of the four years. In 2008-09, the Debt/GDP is projected to be lower by 3.48 percentage

points; the revenue deficit is projected to be smaller by 1.81 percentage points of GDP; interest payments as a fraction of revenue receipts will be smaller by 9.79 percentage points, and the discretionary expenditure of government will be larger by 0.93 percentage

**Figure 6.4** Discretionary expenditure as per cent to GDP: Projections under reforms scenario

points of GDP.

### 6.3 SENSITIVITY OF PROJECTIONS TO SHOCKS

In this report, both baseline and reforms scenarios have been conducted assuming that all the years from 2004-05 till 2008-09 will be 'normal' years. In practice, some years will be better than normal and some years will be worse than normal.

One of the years could prove to be like 2002-03, with a sharp drop in output caused by a bad monsoon. One of the years could prove to be like 2003-04, with above-8 per cent GDP growth. The domestic and global business cycle constitute important sources of uncertainty for both revenue and expenditure projections. For example, the buoyancy of corporate tax collections in recent months has clearly been shaped by the strong profit growth of the companies of India in 2003-04.

The FRBM Act has set requirements which have to be met, regardless of these fluctuations in the macroeconomy. This highlights the need to have 'safety factors' in policy decisions, through which the FRBM targets will be successfully achieved, even if some difficulties are encountered along the way.

The policy proposals of this report, and the associated reforms scenario projections, have a little slack in two respects. First, the revenue deficit in 2008-09 is -0.15, i.e. there is an outperformance when compared with the target of 0. Second, the bulk of the task of eliminating the revenue deficit is projected to be completed by 2007-08, where the revenue deficit is projected to be 0.33 per cent of GDP.

At the same time, these 'safety factors' constitute relatively little space in coping with a downturn in the economy. This underlines the need to embark on front-loaded reforms, so as to reap the benefits in 2005-06 and 2006-07.

#### 6.4 NEED FOR CARE IN EVALUATING ALTERNATIVE POLICIES

Medium-term fiscal planning differs considerably from the traditional budgeting exercise. The fiscal projections shown for the reforms scenario are derived using complex calculations from the reforms proposed. When alternative policies are considered, they have complex implications for the medium-term scenario, which need to be factored into policy analysis.

For example, if the corporate tax reforms proposed in this report are implemented, while leaving the depreciation rate at 25% instead of reducing it to 15%, the consequences flow as follows. Corporate tax collections will prove to be lower. Hence, every year, the revenue deficit will be larger. This will lead to a larger build-up of debt. This will, in turn, feed into interest payments, which further changes the revenue deficit in following years.

This highlights the need for new ways of analysing, crafting and executing fiscal policy. Medium term fiscal planning needs to be adopted as the new conceptual framework, in order to successfully achieve the fiscal consolidation, meet the targets set by the FRBM Act, while avoiding hurting economic growth or resorting to inefficient policies on taxation or expenditure. This will be a lasting contribution of the FRBM Act to strengthening India's fiscal institutions.

