MEDIUM TERM FISCAL POLICY STATEMENT

A. FISCAL INDICATORS – ROLLING TARGETS

	Revised Estimates 2004-05	Budget Estimates 2005-06	Targets for 2006-07	2007-08
1. Revenue Deficit as percentage of GDP	2.7	2.7@	2.0	1.1
2. Fiscal Deficit as percentage of GDP	4.5@@	4.3	3.8	3.1
3. Gross Tax revenue as percentage of GDP	9.8	10.6	11.1	12.6
4. Total outstanding liabilities at the end of the year as percentage of GDP for the year	68.8	68.6	68.2	67.3

Notes:—

1. "GDP" is the Gross Domestic Product at current market prices as distinct from Gross Domestic Product at factor cost and "Total outstanding liabilities" include external public debt at current exchange rates.
2. There are two significant changes in the Budgetary practice with effect from Budget 2005-06 having a bearing on computation of fiscal indicators (i) No credit has been taken in BE 2005-06 for the sale proceeds of Government equity in Public Sector Enterprises (PSEs) because these are no longer to be reckoned as a resource for financing the Fiscal Deficit. Instead, these receipts will be credited into an 'Investment Fund', the income from which will be used to finance expenditure of Social Infrastructure and to provide capital to viable PSEs. (ii) No provision has been made in Budget 2005-06 for Loans to States and the Union Territories with Legislature. They will be raising required loans directly from the market without budgetary intermediation of the Central Government. (However, Ways and Means Advances recoverable in the same year will continue as before.) This has been done in line with the accepted recommendations of the TFC.

@ The Budget 2005 -06 includes a provision of Rs.5,000 crore as compensation to States on account of shortfall in revenue that may arise due to implementation of State Level Value Added Tax w.e.f. 01.04.2005. But for the inclusion of this estimated expenditure, which the Central Government feels will not be required to be incurred and is being included as measure of assurance to the States, Revenue Deficit would have been 2.6 percent of GDP.

@@ This would have been 4.6 per cent of GDP, had the disinvestment proceeds not been taken as a resource for financing the Fiscal Deficit.

1. The above projections for medium term fiscal outlook show substantial variation over the projections presented along with Budget 2004-05 due to several developments having significant budgetary implications that have taken place since the presentation of the last Budget.

2. Large and unprecedented rise in prices of crude oil, surge in liquidity due to continuing inflow of foreign exchange and rising consumption demand have raised inflationary pressures. The government had to reduce taxes and duties on POL products as well as key construction materials, and increase the payments of fertilizer subsidy, so as to mitigate the adverse effects of inflation on the vulnerable sections of the society. Post-budget duty concessions and increased subsidy burden adversely affected the fiscal outcome targeted in the Budget. Delayed and inadequate rainfall affected the Kharif output and there was colossal loss to life and property in the Tsunami disaster.

3. However, the single biggest fiscal impact for the Central Government, not unwelcome in national interest, has come in the form of the award of the 12th Finance Commission (TFC) for the period 2005-10. Under the award, the States' share in Central Taxes has increased by 100 basis points; and grants-in-aid to States have increased to Rs.142,640 crore for 2005-10 compared to Rs.58,588 crore under the award of the

11th Finance Commission for 2000-05. The TFC has further recommended re-scheduling of outstanding Central Loans for a fresh period of 20 years carrying only 7.5% interest, which is significantly lower than the average cost of borrowing (about 9.3%) of the Central Government and also a special debt relief scheme for States linked to fiscal reforms. These recommendations will put a large fiscal burden on Central finances. However, in keeping with the high traditions of accepting the devolution package recommended by the Finance Commission as an award; the spirit of cooperative federalism; the perilous position of State finances; and to promote fiscal reforms in the States, the Central Government has accepted it. It may be recalled that the last major fiscal impact on government finances arose in 1997-98 with the implementation of the Fifth Central Pay Commission recommendations, which had a cascading effect on both Central and the State finances. In contrast, the fiscal impact of the TFC's award, which is almost double the impact of the Pay Commission, will have a highly beneficial effect on State finances.

4. The TFC's generous package of increased resource flow to States is based on certain assumptions, which do not fully factor in the expenditure commitments of the Central Government arising out of the National Common Minimum Programme. It is the TFC's vision to achieve elimination of revenue deficit for the Centre and all the States by 2008-09. The States may possibly achieve fiscal stability through larger Central transfers and debt relief on Central Loans but then, correspondingly, the Centre's ability to adhere to the fiscal correction targets set under the FRBM Act has been impaired. Ceteris paribus, the TFC recommendations will lead to deterioration of about 0.75% of GDP in the Central Government's revenue deficit. Hence, the Budget 2005-06 does not project improvement in the Revenue Deficit position vis-à-vis the level achieved in 2004-05.

5. This is the backdrop of the fiscal scenario built in the Budget 2005-06 with implications for medium term as well.

B. Assumptions underlying the Fiscal Indicators

1. <u>Revenue receipts</u>

(a) Tax-revenue

6. The Gross Tax Revenue, States share and net Tax Revenue of Centre in BE 2005-06 are placed at Rs.370,025 crore, Rs.94,959 crore, and Rs.273,466 crore, respectively as against the estimate of Rs. 343,703 crore, Rs.91,376 crore, and Rs.250,728 crore, respectively projected by the TFC. In line with the progress already made, gross tax revenue is expected to grow by an average 22 per cent per annum.

7. A long gap between the time of actual collection of tax and the time when it becomes due, delays in resolution of disputes with tax assessees and resultant uncertainties have been a major source of complications in revenue budgeting with final outcomes not conforming to rather optimistic Budget estimates. It has, therefore, been decided that while efforts may continue for liquidation of tax arrears, no significant credit should be taken in the Budget estimates especially for disputed arrears.This has resulted in an increase in the revenue deficit in the Budget.

(b) Non-tax-revenue

8. Under the award of the TFC, Central loans to States contracted till March 2004 amounting to Rs.1,28,795 crore are to be consolidated and rescheduled for a fresh term of 20 years at an interest rate of 7.5 percent. This is subject to the enactment of fiscal responsibility legislation by the States. As against this, the average cost of borrowing of the Central Government is presently about 9.3 per cent. The acceptance of this recommendation implies an annual reduction in the interest receipts of Centre of about

Rs.4,250 crore. Notwithstanding this reduction, the non-tax revenue in BE 2005-06 is placed at Rs.77,734 crore, as against the estimate of Rs.70,135 crore projected by the TFC mainly on account of expectation of better dividend realization. In the medium term, non-tax-revenues are expected to remain almost at current levels in absolute terms and thus are set to decline progressively as a proportion of GDP especially in view of large investment needs of profit making Government companies

(c) Devolution to States

9. The TFC has recommended that during 2005-10, 30.5% of gross tax revenue from Central Taxes/Duties including Additional Excise Duty on sugar, tobacco and textiles in lieu of Sales Tax but excluding cesses and surcharges, will be distributed to the States according to specified share of each State. During 2000-05, the percentage of vertical devolution was 29.5%. Due to increase in percentage share as well as increase in absolute amount of gross tax revenue viz-a-viz the TFC projection, the States share in Central Taxes has gone up from Rs.78,617 crore in RE 2004-05 to Rs.94,959 crore in BE 2005-06 which is far in excess of the TFC's projections of Rs.91,376 crore. The share in Central Taxes given to States under the TFC award is also supplemented by grants for specific purposes. During 2005-06 the total amount of such grants to States is Rs.25,874 crore.

2. <u>Capital receipts</u>

(a) Recovery of loans

10. "Loans to States" is the most significant component in the lending profile of Central Government. Under the State Debt Swap Scheme, States are being allowed to swap their high cost loans taken from Central Government with fresh securities bearing lower interest rates. Upto December 2004, Rs.92,444 crore high cost Central Loans have been swapped by States with lower interest securities. Central loans to States contracted till March 2004 amounting to Rs.1,28,795 crore are to be consolidated and rescheduled for a fresh term of 20 years, under the award of the TFC. The acceptance of this recommendation implies an annual reduction in the loan recovery receipts of Centre. Notwithstanding this reduction, the recovery of loans in BE 2005-06 is placed at Rs.12,000 crore, as against the estimate of Rs.9,195 crore projected by the TFC mainly on account of the fact that this debt relief package is subject to States enacting Fiscal Responsibility Acts and also in expectation of improved recovery from Public Sector Undertakings. Non-debt capital receipts on account of recoveries of loans are set to go down in years to come.

(b) Other non-debt capital receipts

11. In a major policy change, it has been decided that with effect from Budget 2005-06, the sale proceeds of Government equity in Public Sector Companies will no longer to be reckoned as a resource for financing the Fiscal Deficit. Instead, these receipts will be credited into an 'Investment Fund', the income from which will be used to finance expenditure on social infrastructure and to provide capital to viable PSEs. Accordingly, BE 2005-06 assume no credit for these receipts whereas Rs.4,000 crore was the receipt estimated in BE 2004-05, and now placed at Rs.4,091 crore in RE 2004-05.

(c) Borrowings – Public Debt and Other Liabilities

12. The net borrowing requirements of the Central Government to finance the fiscal deficit are determined as a policy choice keeping in view the desirable level of gross budgetary support for Central, State and UT Plans. This is so because the Government's own resources (net tax revenue accruing to Centre after deducting States' share, non tax revenue and non-debt capital receipts like loan recoveries and disinvestment proceeds) left after meeting the needs of essential non-plan expenditure is insufficient to finance current levels of Budget support to Plan.

13. Of the other sources of Central Government's liabilities, two are significant: (a) accretion to the National Small Savings Fund, which is now entirely invested in State Government securities and (b) the Market Stabilization Bonds issued by Government to assist the Reserve bank of India in mopping up excess liquidity in the market arising out of continued build-up of foreign exchange reserves in recent years.These liabilities are not reckoned in computing the Central Government's fiscal deficit. Nevertheless, an unsustainable build up in financial liabilities is not desirable for various reasons. Enactment of fiscal responsibility laws by States pursuant to the recommendations of the TFC will assist in controlling unsustainable growth in deficit, debt and other liabilities. Government is also marshalling fiscal policy in aid of Reserve Bank of India for prudential regulation of foreign exchange inflows.

3. Total expenditure

(a) Revenue account

Plan Revenue expenditure

14. Total Plan Revenue expenditure is set to increase from Rs. 91,843 crore in BE 2004-05 to Rs.115,982 crore in BE 2005-06. The step-up follows increase in Budgetary provisions for expenditure commitments under the National Common Minimum Programme. Total Plan grants to States are set to increase from Rs.38,177 crore in RE 2004-05 and further to Rs.45,484 crore in BE 2005-06. In terms of sectors/programmes, major increases are in Rural Employment, Rural Roads, Rural Water Supply, Integrated Child Development Services, Reproductive and Child Health, Immunisation, Medical Education, Rural Family Welfare Services, Nutritional Support to Primary Education, Sarva Shiksha Abhiyan, Agricultural Research, National Horticulture Mission, Micro Irrigation, Space Research and Agro and Rural Industries. Increasingly, the Plan priorities will be reoriented to concentrate outlays in these areas by a consolidation of the expenditure portfolio.

Non-Plan Revenue expenditure

(i) *Interest payments*

15. Realizing the benefits of lower interest rates for Central and State Governments as well as corporate and retail borrowers, the Government intends to pursue policies for continuance of the soft interest rate regime. Projected growth in interest burden is based on this assumption. One of the positive features of the fiscal Policy pursued by the Government and the benign interest rate regime is that the share of interest payments in the total expenditure has declined and the interest burden as percentage of GDP and of total revenue receipts has also come down. The TFC envisaged that the Centre's interest payments should be brought down to 28% of revenue receipts. It may be seen that this percentage is estimated to go down from 42 per cent in RE 2004-05 to 38 per cent in BE 2005-06.

(ii) *Defence Services*

16. TFC had assessed the requirement of Defence (Revenue expenditure) to be Rs.46,346 crore whereas it is placed at Rs.48,625 crore in BE 2005-06 due to inescapable requirements. Total Defence Services expenditure is set to increase from Rs.77,000 crore in the current year to Rs.83,000 crore in Budget 2005-06.

(iii) *Major subsidies*

17. The total amount of major subsidies budgeted for 2004-05 was Rs.42,022 crore, which went up to Rs.45,015 crore in RE2004-05 due to the increase in fertilizer subsidy (in turn due to increase in prices of petroleum products used as raw material for production of fertilizers). For the same reason, it is set to rise to Rs.46,098 crore in Budget 2005-06. Surprisingly, the estimate made by the TFC placed the subsidy requirement in 2005-06

at a substantially lower level of Rs.38,530 crore. It is difficult to say at the present juncture how soon we can neutralize the impact of sharp increase in petroleum prices. While the efforts to target all subsidies sharply at the poor and the truly needy like small and marginal farmers, farm labour and the urban poor are continuing, medium term outlook does not appear to favour a severe compression in the subsidy bill. To improve efficiencies and cost control, food procurement is being gradually decentralized.

(iv) *Non-Plan grants to States*

18. As per the TFC's award, non-Plan grants to States in 2005-06 are placed at Rs.28,174 crore. In the subsequent years (2006-10), these grants will be about Rs.29,000 crore per annum. Besides, the Central Government is committed to compensating the revenue loss that may arise as a result of implementation of the State level Value Added Tax, based on agreed norms. In BE 2005-06, a provision of Rs. 5,000 crore has been made on this account. Total non-Plan grants to States are set to increase from Rs.14,828 crore in RE 2004-05 to Rs 33,953 crore in BE 2005-06.

(v) *Others*

19. Other major items of revenue expenditure are police, salaries, pensions, and administrative expenditure. However, the growth of other items of non-plan expenditures has been contained.

(b) Capital account

(i) *Loans and advances*

20. In the Fiscal Policy Strategy Statement in Budget 2004-05, it was mentioned that Government intends to encourage States to approach the market directly rather than routing the State debt through the Central Budget and to consider onlending external loans to States on a back-to-back basis, i.e., on the same terms and conditions on which they are received by the Central Government. TFC has responded favorably to these suggestions and formally recommended them to the Central Government. The recommendations have been accepted by the Government. Accordingly, no provision has been made in Budget 2005-06 for Loans to States and also for the two Union Territories with a Legislature. The States will be raising the domestic loans directly from the market without budgetary intermediation of the Central Government. In respect of external loans, special arrangements are being made. However, Ways and Means Advances recoverable in the same year will continue as before. Non-Plan loans and advances are mainly given for meeting inescapable needs of loss making Central PSEs. The expenditure on Plan loans is a function of set financing patterns (equity : loan ratios) in respect of CPSUs.

(ii) *Capital outlay*

21. Non-Plan Capital Outlay other than that on Defence Services is a very small part of total expenditure, mainly for residential/office buildings. This is projected to remain static in real terms. Plan capital outlay is projected to grow in line with GDP growth as increasingly higher share is allocated for these with reduction in revenue deficit.

4. GDP Growth

22. GDP at current market prices is assumed to grow annually by 12 per cent. This is expected to comprise of inflation within the range of 4 to 5 per cent and real growth within 7 to 8 per cent.

(c) Assessment of sustainability relating to

(i) *the balance between revenue receipts and revenue expenditure*

23. The tax revenue as percentage of GDP is targeted to increase from 9.8 per cent in RE 2004-05 to 10.7 per cent in 2005-06. Tax GDP ratio needs to improve well beyond the

targeted reduction in fiscal deficit to GDP ratio because increase in tax revenue has to make up for shortfall in disinvestment proceeds and non-tax revenue. As has been indicated in the Macroeconomic Framework Statement, the economy has undergone a radical structural change since the seventies with the relative contribution of agriculture significantly decreasing and of the services sector correspondingly increasing. Services sector has been an engine of growth for some time past and holds great potential. This marks the transition to an economy poised to overtake the backlog of development through IT-enabled services while continuing to modernize manufacturing with world-class technology. This transition has important implications for Fiscal Policy in general and Tax Policy in particular. So far, the manufacturing sector has borne the brunt of taxation with agriculture and services largely remaining outside the tax net. It is time that services also start sharing the tax burden. This is also due to the fact that the production and distribution processes are being constantly reengineered and traditional distinction of manufacturing of goods and services is posing tax compliance problems. There is recognizable merit in looking at the whole value addition chain from the viewpoint of taxation. The planned introduction of State level Value Added Tax w.e.f. 1st April 2005 marks one of the biggest tax reforms undertaken so far. Government intends to expand the scope of taxation of services not only by bringing newer services within the tax net but also covering a larger number of assessees under the services being taxed. In the long run this will be beneficial to both Central as well as State finances. It is in keeping with the expectation of a medium term gestation period for tax reform that the Government is confident of meeting the target of elimination of revenue deficit by 2008-09.

24. There are several developments negatively impacting on the growth in non tax revenue. Interest receipts from States have been the single biggest item of non-tax revenue for years. In recent years, States have been allowed to swap their high cost loans with loans/securities bearing lower interest rates. Upto December 2004, Rs.92,444 crore of high cost Central loans have been swapped by States with lower interest bearing securities. Central loans to States contracted till March 2004 amounting to Rs.1,28,795 crore are to be consolidated and rescheduled for a fresh term of 20 years, under the award of the TFC. Thus, interest receipts from States are set to decline in subsequent years. Besides, some large receipts had accrued in recent years such as license fee from Telecom operators etc. which are non-recurring in nature. With additional levies largely being recycled within the Telecom sector through the mechanism of Universal Service Obligation Fund, and the fiscal concessions extended to Bharat Sanchar Nigam Limited, the telecom sector’s contribution to the Central Government’s non tax revenue is unlikely to be very significant. There has been a decline in the transfer of surplus profits of the Reserve Bank of India and the profit making Public Sector Enterprises have large investment needs. Thus, the overall cumulative impact of these developments would be that non-tax revenue as a proportion of GDP is set to decline progressively and tax revenue will have to correspondingly increase to make for the short fall in non tax revenue.

25. Under the statutory Rules made under the Fiscal Responsibility and Budget Management Act, 2003, the annual minimum target of reduction in revenue deficit is 0.5% of current GDP. After careful consideration of the rigidities in the profile and trends of expenditure on the revenue account, both plan and non-plan, the bulk of the fiscal correction required to be carried out for meeting the revenue deficit reduction (and eventual elimination) is sought to be achieved by improving the Tax:GDP ratio. Principal constituents of the revenue expenditure portfolio are interest payments, defence and police, major subsidies, salaries, pensions, and grants to States, which together account for nearly 95% of the total. Fiscal deficit feeds itself by way of interest since persistence of fiscal deficit increases the interest burden, which further increases the revenue deficit and in turn the fiscal deficit.

26. In the normal course, Government borrowings are advisable only for meeting the needs of financing productive investments. However, owing to continuing rigidities, exemptions and a rather narrow base, the revenues of Government have not been able to keep pace with its needs of recurring expenditure leading to borrowings to finance such expenditures. This is reflected in the trends in revenue deficit. As interest payments constitute a very sizeable chunk of total revenue expenditure, persistence of high fiscal deficit, partly to finance revenue deficit, has cyclically accentuated the problem of further increases in revenue deficit and fiscal deficit.

27. The Government's investment policy needs to be seen in this context. Since the early years of Independence, the investment profile has considerably changed. While earlier, direct capital formation from Central budget used to be the norm, gradually the capital expenditure shifted to States, Central Public Sector Enterprises and other parastatals, changing the nature of Government investment from direct creation of physical assets to financial assets in the form of equity and loans. Equity investments have also progressively declined as the public sector enterprises gradually began to finance their capital expenditure by raising resources directly from the market. The process received a further boost when in 1993 the Government switched over to the policy of 'disintermediation' of external assistance to Central PSEs under which Central PSEs are now allowed to access external funding directly rather than through the Central Budget. These developments have contributed to a decline in capital expenditure/ investment of the Central Government. For the past several years, the main form of incremental investment by Central Government has been "Loans to States" partly due to the very nature of the development cycle, the disintermediation policy and the pre-emption of nearly half of Government's net borrowings by the need to finance current expenditures. From 2005-06, States and the two Union Territories with a Legislature will be expected to raise the loans directly without intermediation of the Central Budget. All these developments indicate a substantial decline in the Plan Capital expenditure of the Central Government, from Rs.47,714 crore in RE 2004-05 to Rs.27,515 crore in BE 2005-06, which is largely concentrated in areas of Roads, Railways, Power and Urban Infrastructure. Public Private Partnership is the new paradigm for Government-catalysed rather than fully Government-funded investment. To experiment with newer institutions in this area, the Government is setting up a Special Purpose Vehicle for arranging financing for critical infrastructure projects held up due to non availability of adequate resources. The Government will provide a guarantee to the SPV within the limits of the FRBM Act.

(ii) *The use of capital receipts including market borrowings for generating productive assets.*

28. As brought out above, the capital receipts of loan recoveries are set to decline following debt relief to States under the TFC's award. Upto December 2004, Rs.92,444 crore high cost Central loans have been swapped by States with lower interest securities. Central loans to States contracted till March 2004 amounting to Rs.1,28,795 crore are to be consolidated and rescheduled for a fresh term of 20 years, under the award of the TFC. The Central Government has used the proceeds of the debt-swap for redemption of special Central Government securities issued to the National Small Savings Fund.

29. As brought out above, no credit has been taken in BE 2005-06 for the sale proceeds of Government equity in Public Sector Enterprises because these are no longer to be reckoned as a resource for financing the Fiscal Deficit. Instead, these receipts will be credited into an 'Investment Fund', the income from which will be used to finance expenditure on social infrastructure and to provide capital to viable PSEs. In the medium term perspective, capital receipts will continue to mainly bridge the

resource gap on the revenue account and whatever is left will be used to finance Plan expenditure which has emerged as a proxy for public investment. Simultaneously, a review of the quality of investment, and of outcomes rather than of new outlays, is needed and will be carried out.

30. One of the major objectives of the Fiscal Responsibility and Budget Management Act, 2003, is to effect a shift in the composition of total expenditure, by increasing the share of capital expenditure that would help achieve a higher growth trajectory. The practice of capital receipts funding revenue expenditure, which began in the 1980s, needs to be reversed. The Fiscal Responsibility and Budget Management Act, 2003 has set an important target of eliminating revenue deficit by end March 2009 and of generating revenue surpluses thereafter, which when achieved would provide Government the desired flexibility in incurring capital expenditure.