STATEMENT EXPLAINING DEVIATIONS IN MEETING THE OBLIGATIONS OF THE GOVERNMENT UNDER THE FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT, 2003

Section 7(3) of the Fiscal Responsibility and Budget Management Act, 2003 [FRBM Act] mandates that no deviation is permissible in meeting the obligations cast on the Central Government under the Act, without the approval of Parliament. The Budget Estimates 2005-06 do not comply with the stipulations regarding minimum annual reductions in the Revenue Deficit and the Fiscal Deficit prescribed in the Rules framed under the Act. Hence, this Statement is placed before both the Houses of Parliament explaining the circumstances that have led to such deviation; explaining whether such deviation is substantial and relates to actual or potential budgetary outcomes; and detailing the remedial measures the Government proposes to take.

2. Under the FRBM Act and the National Common Minimum Programme, the Government is committed to elimination of revenue deficit by 2008-09, and I re-affirm this commitment. The fiscal drag due to government deficits continues to hold back full achievement of potential economic growth. Prudent fiscal policy, therefore, requires raising non-debt resources commensurate with the aspirations for higher levels of public expenditure on social and physical infrastructure; employment guarantee; rural development; and education and health. As I will explain in succeeding paragraphs, our efforts in this direction have encountered some difficulties, which we will overcome soon.

3. It may be recalled that in a front-loaded fiscal correction path, Government had targeted the revenue deficit to be 2.5 per cent of GDP in BE 2004-05 as against 4.1 per cent of GDP in BE 2003-04 and 3.6 per cent of GDP in RE 2003-04. The targeted reduction was significantly higher than the minimum 0.5 per cent of GDP contemplated in the FRBM Rules because we wanted to cover as much ground as we could towards our goal of eliminating revenue deficit by 2008-09. I am happy to inform the House that we hope to bring down the revenue deficit in the current year from 3.6 per cent of GDP in RE 2003-04 to 2.7 per cent of GDP in RE 2004-05. This is a reduction of 0.9 per cent of GDP, i.e., a decline of Rs.14,552 crore in the revenue deficit. Though short of the ambitious Budget target, this is not an insignificant achievement considering the difficulties that we have faced in the current year. These difficulties include time taken in the passage of the Finance Bill, the cumulative impact of the post-budget duty concessions given to ease the impact of inflation on the “Aam Aadmi”, increase in fertilizer subsidy, additional funds for rural telephone network and Tsunami relief.

4. Large and unprecedented rise in prices of crude oil, surge in liquidity due to continuing inflow of foreign exchange and rising consumption demands have raised inflationary pressures and 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. Late and inadequate rainfall affected the Kharif output and there was colossal loss to life and property in the Tsunami disaster.

5. Some of these factors will adversely impact on the next year’s Budget as well. However, the single biggest fiscal impact for the Central government - though not unwelcome, I hasten to add - has come in the form of the award of the Twelfth Finance Commission (TFC) for the period 2005-10. The States’ share in Union Taxes has been increased by 100 basis points. A quantum jump has been provided in grants-in-aid to

States from Rs.58,588 crore under the award of the 11th Finance Commission for 2000-05 to Rs.142,640 crore in 2005-10. 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 outstanding borrowings of the Central Government and also a special debt write-off scheme for States linked to fiscal reforms. These recommendations will put a substantial fiscal burden on Central finances. It may be recalled that the last major fiscal impact on Central 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 Finance Commission's award on Central finances, although almost double that of the Pay Commission, will have a highly beneficial effect on State finances. We are all aware of the precariousness of State finances and the dire need of promoting fiscal reforms in the States. Therefore, in the broader national interest, we have accepted the award in keeping with the high traditions of accepting the devolution package recommended by the TFC in the spirit of cooperative federalism.

6. However, it must be placed on record that 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. The TFC has assessed the Centre's expenditure requirements in 2005-06 to be Rs.476,797 crore, whereas the Budget 2005-06 places it at Rs.514,344 crore, an increase of Rs.37,547 crore. The Revenue expenditure under Plan is placed at Rs.115,982 crore in the Budget against Rs.75,389 crore assessed by the TFC. Similarly, expenditure on subsidies is placed at Rs.47,432 crore in the Budget against Rs.38,530 crore assessed by the TFC. I have made a provision of Rs.5,000 crore as compensation to States on account of the shortfall in revenue that may arise due to the implementation of State Level Value Added Tax w.e.f. 01.04.2005. Similarly, the requirement of Defence Services has far exceeded the assessment of the TFC.

7. Gross tax revenue and non-tax revenue are placed at Rs.370,025 crore and Rs.77,734 crore, respectively in the Budget against the TFC's assessment of Rs.343,703 crore and Rs.70,135 crore, respectively. The revenue improvements fall short of increased expenditure requirements leading to the increase in deficits.

8. It is the TFC's vision that the Centre and the States eliminate revenue deficit 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 is seriously compromised. Ceteris paribus, the TFC recommendations will lead to deterioration of about 0.75% of GDP in the Central Government's revenue deficit and that is more than the minimum annual reduction required to achieve the targets under the FRBM Act. Therefore, it is not feasible for the Central Government to achieve the minimum annual deficit reduction during 2005-06 as envisaged under the FRBM Act.

9. It appears, by comparing growth rates across the globe, that our economy has weathered the oil shock. However, the oil price increases have knocked off nearly 1% of the potential economic growth that would have been achieved had the oil prices remained stable. The oil shock has affected both the fiscal sector as well as the real economy. Another setback which has been somewhat masked by better performance in manufacturing and services sector is the low agricultural growth this year. But for the twin effects of oil shock and monsoon deficiency, the growth would have been as good as in the year before. At present, the fiscal management has been made even more difficult by the build-up of inflationary pressures as the foreign exchange inflows continue to increase liquidity and fuel prices are still volatile.

10. It may be argued that the Central Government could still meet the deficit reduction targets by financing increased expenditure commitments under the NCMP through enhanced taxation. But that would have meant literally killing the proverbial goose. The need of the hour is to increase disposable income, spur demand and generally give a boost to the economy. The scope for further step up in the tax mobilization is circumscribed by the need to sustain the growth momentum. Keeping this wider objective in sight, the pursuit of deficit reduction targets will need to be moderated in the short term.

11. As a remedial measure, the Government is focusing its efforts on restructuring of tax administration as well as expenditure management. A paradigm shift is on the anvil. The multi-pronged strategy includes speeding up the e-governance in tax administration, institutional reform by way of proposed setting up of National Tax Tribunal and expansion of the tax base.

12. The Budget 2004-05 had assumed an annual growth of 25% in the tax revenue largely relying on liquidation of tax arrears. The expectations have not been fully met. We have to be content with about 20% growth which is still higher than the growth recorded in earlier years. We are well aware of the delays in resolution of tax disputes, build-up of arrears and resultant uncertainties which have been a major source of complications in revenue budgeting with final outcomes not conforming to optimistic Budget estimates. I have therefore decided to err on the side of caution and assume a somewhat more realistic growth of 22% in tax revenues next year. While efforts will continue for liquidation of tax arrears, no significant credit has been taken in the Budget estimates for disputed arrears. This has resulted in an increase in the revenue deficit in the Budget.

13. On the expenditure front too, we have some systemic problems to deal with. The deficiencies in the delivery mechanism frustrate the good and sincere intentions behind Government's plans and schemes. A large number of Ministries/Departments usually release funds to a large number of implementing agencies - State Governments, Autonomous Bodies, District level agencies and NGOs. Quite often, the funds released by the Central Government remain for long with intermediaries and may even be temporarily diverted for unintended purposes resulting in accumulation of substantial "unspent balances" with implementing agencies. Government is keen that the funds reach the ultimate beneficiaries as speedily as possible rather than remaining in the pipeline with the long chain of intermediaries, including State Governments. While the House approves the expenditures for specified objectives, there is avoidable delay in meeting those objectives. The Government has tightened the fiscal discipline in this regard. The Ministries have been advised to keep a close watch on the position of unspent balances available with the State Governments and implementing agencies, and insist upon furnishing of utilization certificates for funds released earlier, wherever due under the Rules, before releasing more funds. The Government is also keen to restrain the tendency to 'park' Government funds and make undue advance payments merely to avoid lapse of the budgeted amounts. This calls for revamping public expenditure management and for accounting reforms. Based on the accepted recommendations of the TFC, we are requesting the Comptroller and Auditor General of India to suggest a roadmap for accounting reforms. Several specific measures on tax administration and expenditure administration have been spelt out in the Fiscal Policy Strategy Statement appended to the Budget.

14. To conclude, I would like to assure this august House that the Government's commitment to the NCMP target of elimination of revenue deficit by 2008-09 remains intact. "Sweet are the uses of adversity" said Shakespeare. The Government needs some time to revamp tax and expenditure management. The remedial measures proposed in tax administration, accounting reforms and the system of release of budgeted funds will necessarily have a gestation period, but the Government is keen to reclaim the ground lost temporarily in this battle against deficits and no effort will be spared towards meeting this objective.