MEDIUM TERM FISCAL POLICY STATEMENT

A. FISCAL INDICATORS – ROLLING TARGETS

	Revised Estimates 2003-04	Budget Estimates 2004-05	Targets for 2005-06	2006-07
1. Revenue Deficit as percentage of GDP	3.6	2.5	1.8	1.1
2. Fiscal Deficit as percentage of GDP	4.8	4.4	4.0	3.6
3. Tax revenue (Gross) as percentage of GDP	9.2	10.2	11.1	12.1
4. Total outstanding liabilities* at the end of the year as percentage of GDP	67.3	68.5	68.2	67.8

***** *including external public debt at current exchange rates*

B. ASSUMPTIONS UNDERLYING THE FISCAL INDICATORS

1. Revenue receipts

(a) Tax-revenue

With the deepening of tax reforms, assuming an average annual nominal growth rate of 12 per cent in gross domestic product (GDP), gross tax revenue is expected to grow by an average 22 per cent per annum, based on an average annual growth of 26 per cent in direct taxes and 19 per cent in indirect taxes.

(b) Non-tax-revenue

Non-tax-revenues are expected to remain almost unchanged at current levels in absolute terms, and, thus, are set to decline progressively as a proportion of GDP

(c) Devolution to States

The recommendations of the 12th Finance Commission will have a significant bearing on the pattern of devolution to States (share in Central taxes and grants-in-aid) in the medium-term. The term of the 12th Finance Commission has been extended up to December 31, 2004. Hence, the above projections are based on existing percentage shares of States in Centre's divisible taxes. Besides, the cesses and surcharges do not form part of the divisible pool, and, thus, the 2 per cent cess proposed on major Central taxes has been included in the projections of net tax revenue of Central Government accordingly.

2. Capital receipts

(a) Recovery of loans

These receipts recorded significant variations from Rs.34,191 crore in 2002-03 to Rs.64,625 crore in 2003-04 RE and Rs.27,100 crore in 2004-05 BE, because of changes in the "Loans to States," which is the most significant component in the loan portfolio of the Central Government. Under State Debt Swap Scheme, the States are being allowed to prepay high-cost loans taken from Central Government in the past, with current low coupon bearing small savings transfers and additional open market borrowings. Most of the other loans are to Central Public Sector Undertakings that are loss-making. Hence, non-debt capital receipts on account of recoveries of loans are set to go down in years to come.

(b) Other receipts

As per the National Common Minimum Programme (NCMP), generally profit-making companies are not to be privatized and existing "navaratna" companies will be retained in the public sector. Budget 2004-05 assumes receipts of Rs.4,000 crore, mainly on account of simultaneous disinvestment of Government equity alongwith the maiden public issue of National Thermal Power Corporation.

(c) Borrowings – Public Debt and Other Liabilities

(i) The net borrowing requirement of the Central Government, which equals its fiscal deficit, is determined to a large extent by the level of gross budgetary support for Central, State and UT Plans. The balance of 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 the current levels of Budget support to Plan. It is the Government's endeavor to protect and enhance Budget support for the Plan in the process of fiscal correction mandated under the Fiscal Responsibility and Budget Management Act, 2003, by revenue enhancement and reduction in revenue expenditure.

(ii) Of the other components of Central Government's liabilities, two are significant: (a) accretion to the National Small Savings Fund which are now entirely invested in State Government securities, and (b) the Market Stabilization Bonds issued by Government to assist the Reserve Bank of India (RBI) in mopping up excess liquidity in the market with the continued build-up of foreign exchange reserves in recent years. While these liabilities are not reckoned in computing the Central Government's fiscal deficit, an unsustainable build-up in financial liabilities is not consistent with a prudent policy stance. Therefore, Rule 3(4) of Fiscal Responsibility and Budget Management (FRBM) Rules, 2004 seeks to cap the growth of total liabilities of the Central Government (including external debt at current exchange rate) as a proportion of GDP at 9 per cent for 2004-2005, 8 per cent for 2005-06, 7 per cent for 2006-07 and 6 per cent for 2007-08. Government is encouraging the State Governments to pass similar laws to contain the growth in deficit, debt and other liabilities.

3. Total expenditure

(a) Revenue account

(i) Interest payments

Projected growth in interest burden is based on the assumption of the continuation of a benign interest rate regime.

(ii) Major subsidies

These are assumed to decline in 2005-06 and 2006-07, consequent upon the Government's commitment under NCMP to control inefficiencies that increase the food subsidy burden, and to sharply target all subsidies at the poor and the truly needy, like small and marginal farmers, farm labour and the urban poor.

(iii) Others

Other major items of revenue expenditure are defence and police, salaries, pensions, and grants to States (directly as well as through agencies such as the District Rural Development Agencies), accounting for nearly 95 per cent of the total revenue expenditure.

These suffer from some rigidities. The Plan revenue expenditure is a function of set financing patterns (loan: grant : direct expenditure ratios), which have historically evolved and remained unchanged for long. While the medium-term projections do not envisage any major policy changes in revenue expenditure, non-plan expenditure is sought to be extensively reviewed and pruned by plugging inefficiencies and leakages and to keep it almost unchanged in real terms.

(b) Capital account

(i) Loans and advances

Non-plan loans and advances, which are mainly given to loss-making CPSUs, are projected to decline in real terms. The expenditure on Plan loans is also a function of set financing patterns (loan: grant : direct expenditure ratios in respect of state/UT Plans and equity : loan ratios in respect of CPSUs). No change in the financing pattern has been assumed at present.

(ii) Capital outlay

Non-plan capital outlay is a very small part of total expenditure, mainly for residential/ office buildings. This is projected to remain static in real terms. With reduction in revenue deficit, plan capital outlay is projected to grow in line with GDP.

4. GDP Growth

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

C. Assessment of sustainability relating to

1. Balance between revenue receipts and revenue expenditure

(a) The tax revenue as a proportion of GDP is targeted to increase from 10.2 per cent in BE 2004-05 to 11.1 per cent in 2005-06 and 12.1 per cent in 2006-07. Tax-GDP ratio needs to improve more than the targeted reduction in fiscal deficit-GDP ratio to make up for the shortfall in disinvestment proceeds and non-tax revenue.

(b) As indicated in the Macroeconomic Framework Statement, the economy has undergone a radical structural change since the seventies with the relative contributions of agriculture significantly decreasing and of services sector increasing correspondingly. Services sector, which has been an engine of growth for some time, holds great potential through IT-enabled services. 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 the services also start sharing the tax burden, as the production and distribution processes get constantly reengineered and the traditional distinction between manufacture of goods and of services start posing complicated tax administration problems. There is recognizable merit in looking at the whole value addition chain from the viewpoint of taxation. Government intends to expand the scope of taxation of services by not only bringing newer services within the tax net, but also by covering larger number of assesses under the services being taxed. A firmer legal basis for taxation of services has already been laid through the 95th Constitutional Amendment 2003.

(c) There are several developments negatively impacting the growth in non tax revenue. Interest receipts from States has been the single biggest item of non-tax revenue for years. With the States allowed to swap their high-cost loans with securities bearing lower interest rates, the interest rate on loans to States is coming down. Thus, interest receipts from States are set to decline. Besides, some large receipts of the one-off variety, such as licence fee from Telecom operators accrued in recent years. Further, RBI's surpluses have also displayed a declining trend in recent times.

(d) Under the statutory Rules framed under the FRBM Act, 2003, annual minimum target of reduction in revenue deficit is 0.5 per cent of current GDP. After careful consideration of rigidities in the profile and trends of expenditure on revenue account, both plan and non-plan, the bulk of the fiscal correction required to be carried out for meeting this target is sought to be achieved by improving the tax:GDP ratio. Fiscal deficit feeds itself into revenue deficit of the future by way of larger interest burden with increasing debt.

2. <u>The use of capital receipts including market borrowings for generating productive assets</u>

(a) In normal course, the Government borrowings are advisable only for financing productive investments. However, owing to continuing rigidities in expenditure, tax exemptions and a rather narrow base of revenues of Government, even recurring expenditures have been met by borrowings. This is what is reflected in the trends in revenue deficits.

(b) While in the early years after Independence, direct capital formation from the Central Budget used to be the norm, gradually, such capital expenditure has shifted to Central Public Sector Undertakings (CPSUs), States and other parastatals. This has changed 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 CPSUs 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 under which CPSUs were allowed to access external funding directly rather than through the Central Budget. For the past several years, the main form of incremental investment by Central Government has been "Loans to States" because of the pre-emption of nearly half of Government's net borrowings by current expenditures. Under FRBM Act, 2003, Government is committed to eliminating the revenue deficit by 2008, thereby releasing fiscal space for further investment.

(c) Loan recovery receipts, which are largely from States, are set to decline as the States are being allowed to prepay high-cost Central loans with current low coupon bearing small savings transfers and additional open market borrowings under the State Debt Swap Scheme.

(d) In the medium-term, capital receipts will continue to mainly bridge the resource gap on the revenue account and the residual 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, of outcomes rather than of new outlays, is needed, and will be carried out.

(e) One of the major objectives of the FRBM Act, 2003, is to effect a shift in the composition of total expenditure, in favour of capital expenditure. This will help achieve a higher growth trajectory. The elimination of revenue deficit and generation of revenue surpluses thereafter, will provide the Government the desired flexibility in enhancing capital expenditure.