FISCAL POLICY STRATEGY STATEMENT

A : Fiscal Policy Overview

1. Nearly two decades ago, Government adopted a fiscally expansionary policy coupled with gradual opening of the Indian economy so as to get out of the 3% average annual growth groove and move on to a higher trajectory. Consequent fiscal stress and balance of payment problems notwithstanding, the economy has actually been able to more than double the annual growth rate since then. The economic reforms initiated in 1991 have brought us to a stage where the country is now one of the fastest growing economies in the world. The fiscal stress, which peaked in the aftermath of the 5th Central Pay Commission and the economic slowdown, has since eased, mainly due to improvement in tax collections and softening of interest burden consequent upon increased liquidity from foreign exchange inflows.

2. Since 1991, fiscal policy has been focusing on tax reforms. These reforms focusing on indirect taxes in 1991 and direct taxes in 1997 have sought to reduce tax rates, simplify procedures, reduce litigation, cast the tax net wider, and generally increase voluntary compliance. These have yielded desired results especially in direct taxes, and helped to widen the tax base with very deep structural changes in the composition of tax revenue.

3. On debt and deficit management side, the fiscal policy changes since 1991 have aimed at greater reliance on market borrowing, developing retail market for gilt-edged securities, prudential management of external debt and budgetary disintermediation of external assistance flowing to Central Public Sector Undertakings. The financing of fiscal deficit is now almost entirely domestic. These measures have also been quite successful in meeting their objectives.

4. On expenditure side, the fiscal policy initiatives have not been as successful as a number of measures suggested by the 5th Central Pay Commission and Expenditure Reforms Commission are yet to be considered / implemented and those implemented have a long gestation period to bear fruit. However, the expenditure stress in 1997-98 and 1998-99 has since eased due to stabilization of salary and pension budget and softening of interest rates. There is some discernible moderation in growth of public expenditure, especially non-plan revenue expenditure, and inter-se Plan expenditure priorities need a fresh look, keeping in view NCMP objectives.

5. Lest the relative easing of fiscal stress in recent years leads to complacency about the potentially damaging impact of fiscal indiscipline on macro-economic parameters, the Parliament had passed a law in August 2003, the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, which has been brought into force on 5th July 2004. The Rules made thereunder have also been notified on that date. The fiscal stance is now oriented towards cutting down revenue deficit mainly through deeper tax reforms.

B : Fiscal policy for the ensuing financial year:

6. As indicated in the Macroeconomic Framework Statement, the Budget 2004-05 is being presented in the backdrop of a robust economic growth with a positive outlook for the economy tempered by the rising inflationary pressures and uncertainties in international capital and commodity markets.

7. Through the Budget 2004-05, the Government commits itself to pursuing fiscal policies designed to:-

- sustain, accelerate and broad-base economic growth with particular emphasis on increasing hitherto neglected investment in agriculture and in the rural economy;
- utilize the current favourable conditions to undertake next generation tax reforms for widening the tax base and reducing the revenue deficit from 3.6% of GDP in RE 2003-04 to 2.5% of GDP in BE 2004-05, more than the annual minimum target of 0.5% set under the statutory Rules made under the Fiscal Responsibility and Budget Management Act, 2003;
- assist the Reserve Bank of India in restraining the growth in money supply without damaging the medium/long term prospects of savings in the economy and without hurting the interests of the poor, the senior citizens and other fixed-income earners;
- reorient Plan expenditure priorities in line with the National Common Minimum Programme;
- restructure the subsidies, as contemplated in the National Common Minimum Programme, so that the benefits are not usurped by those not intended to be the beneficiaries of these subsidies;
- promote an integrated development perspective in areas of Food, Water, Energy, Transport and Communication that are vital to national well-being;
- prepare for a partnership with the States in moving towards a single national market through the introduction of VAT and allied dismantling of controls especially in agriculture;
- prepare for a partnership with the States in reforming and restructuring the fiscal institutions, which will get a further boost on the basis of the recommendations of the 12th Finance Commission;
- increase fiscal discipline, curb wasteful expenditure and enforce tax compliance;

8. While moderate inflation is conducive to sustaining the tempo of economic growth, it can cause all-round damage if it goes out of hand. Inflation hurts the poor the most through the “inflation tax”. High levels of domestic inflation in a situation of increasing openness across national borders imply serious trouble for fixed-income earners and damage the medium/long term prospects of savings in the economy. It will increase the pressure on interest rates and thereby cause increased burden on both Government and corporate finances, loss of competitiveness and eventually a slowdown in growth. In the short term, it will also exacerbate the problems in

management of external sector with hot money inflows rushing in to cash on arbitrage opportunities. Keeping these considerations in mind, the Government wishes to work closely with the Reserve Bank of India with the aim of restraining inflation. Accordingly, the Government will continue to issue Market Stabilisation Bonds to stabilise the markets and check inflation by absorbing excess liquidity caused by burgeoning forex reserves. The proceeds from these Bonds will not be utilized for financing public expenditure as that would defeat the very purpose for which these are issued.

9. While continuing with status quo ante in respect of interest rates on Small Savings, Government intends to protect the interests of senior citizens by introducing a new savings scheme with a higher interest rate. Government's policy will continue to be geared towards promoting long-term savings through interest rate and tax policy.

10. The specific fiscal policy measures are detailed below.

Tax Policy

11. The first generation tax reforms initiated in 1991 had focused on removing the classification disputes and simplification of procedures concerning central excise, and the second generation tax reforms initiated in 1997 had sought to lower direct tax rates and expand the tax base. It is opportune now to launch the third wave of tax reforms targeted at taxation of services and preparing the ground for introduction of VAT. Government intends to gradually move towards integrated taxation of goods and services and bring down customs tariff to levels prevailing in ASEAN countries. Sluggish growth in excise duties has been a weak point in the taxation system for some time past. Scope of service tax is sought to be widened and excise duties are now sought to be revamped, especially in preparation for introduction of Value Added Tax next year.

12. As a result of sustained direct tax reforms initiated in 1997, the share of direct taxes in total tax revenue has gone up from about 30% in 1996-97 to about 44% in BE 2004-05, largely due to substantial growth in corporation tax. The number of direct tax assessees has gone up from 1.25 crore in 1996-97 to nearly 3.4 crore now.

13. Effective zero-tax slab is sought to be increased for personal tax leading to reduction in tax liability for all low-income assessees without necessarily taking them out of the books of the taxation authorities. While it is true that the effective zero-tax personal income would hereafter be significantly higher than the per capita income, the divergence would not be so wide when we consider the per capita income in urban areas since personal income does not cover agricultural income and, for administrative reasons, it is not practicable to go in for itemized deductions towards higher cost of urban living.

14. A 2% cess on all major Central taxes and duties is sought to be imposed for financing universalisation of quality basic education, including cooked-meal for school children in accordance with the commitment under the NCMP.

15. In a major boost to development of capital markets, the long term capital gains tax is sought to be abolished. Instead, a modest levy on transactions in the securities is sought to be introduced.

16. Contributions to pension fund are sought to be exempted from tax during accretion stage and only to be taxed at the time of benefit-disbursement stage.

17. Tax concessions on interest income from NRI deposits are sought to be prospectively withdrawn since rising foreign exchange reserves are now posing liquidity management problems and such props have outlived their utility.

18. In view of significant implications for exports and employment, and the new international regime on Textiles and Clothing coming into force w.e.f. January 1, 2005, the taxation of the textiles sector is sought to be thoroughly revamped consistent with the policy objective of taxing the entire value addition chain.

19. Service tax net is being cast wider by bringing more services into it, expanding the scope of existing taxed services and removal of certain exemptions.

Expenditure Policy

20. Though it has been argued that public expenditure as a proportion of GDP is small in India by international comparison, the low tax-GDP ratio, debt build-up and high deficits constrain public expenditure. Further, it has been observed that greater emphasis on financial outlays rather than on outcomes has led to serious shortcomings in realising the developmental objectives.

21. The public expenditure policy inherent in the Budget seeks to reorient expenditure allocation priorities in two major areas. An additional amount of Rs.11,000 crore is sought to be allocated to meet the needs of defence and a lumpsum provision of Rs.10,000 crore has been made in BE 2004-05 for the thrust areas identified in the National Common Minimum Programme. Of this, Rs.6,000 crore is for new/restructured schemes of the Central Ministries/Departments and Rs.4,000 crore is for new/restructured schemes under State and UT Plans. These new/restructured schemes will subserve the objectives of the National Common Minimum Programme. Programmes/Schemes such as Food for Work Progamme, Sarva Shiksha Abhiyan, Mid-day Meal Scheme, Basic Health Care, Railway modernisation and safety, Accelerated Irrigation Benefit Programme, Drinking Water, Public Investment in Agriculture, Provision of Urban Amenities in Rural Areas (PURA), Science & Technology and Roads, etc. will also be accommodated.

22. The Government also intends to take up an intensive review of the operational aspects of the subsidies and restructure them so that the benefits are not usurped by those not intended to be the beneficiaries of these subsidies. Under NCMP, Government is committed to control inefficiencies that increase the food subsidy burden and to target all subsidies sharply at the poor and the truly needy like small and marginal farmers, farm labour and the urban poor.

23. Government intends to encourage States to approach the market directly rather than routing the State debt through Central Budget and to consider on-lending external loans to States on a back-to-back basis, i.e., on the same terms and conditions on which it is received by the Central Government.

Government Borrowings, Lending and Investments

24. There is no change in the policy stance regarding management of public debt – both internal and external. It continues to favour greater reliance on market borrowing for financing fiscal deficit; continuing to promote a benign interest rate regime; promote long term savings; develop a deep and wide retail market for Government securities; tap opportunities of debt swap and refinancing to reduce interest burden and allow similar opportunities to State Governments. Government lending is now mainly to State Governments as part of a set financing pattern (grant : loan ratios) of Plan transfers to States. Trend of loans to public sector undertakings is weakening since these undertakings are now being encouraged to borrow directly from the market on commercial terms. It is the Government's intention to move towards a similar arrangement for domestic loans to States. As far as external loans are concerned, Government intends to consider on-lending of external loans on the same terms and conditions on which these are received because under the Constitution only the Central Government can borrow abroad. These revisions will be carried out after extensive consultation with the Planning Commission and the States. The concerns regarding bunching of repayments in certain years are being addressed in fixing the maturity of new issues of Government securities.

Contingent and other Liabilities.

25. The Government believes in creating an investor-friendly environment through deepening the process of dismantling controls. With credit and infrastructure (energy, transport and communications) no longer being major hurdles for new investment as they used to be, the need for sops like Government guarantees to attract investment has substantially reduced. Hence, the Government would limit guarantees within a limit of 0.5% of GDP during 2004-2005, to be given mainly for external loans from multilateral agencies and as part of a package of measures for revival of sick public sector enterprises. Government will not give guarantee to any borrower not owned and controlled by it. In general, Government will discourage guarantees for normal commercial operations which needs to be secured through due diligence by lenders. The Government will also initiate a dialogue with the existing guarantee-holder lenders to arrive at a mutually agreed settlement to phase out the Government guarantee cover.

Pricing of Administered Goods

26. At present, no change is proposed in the policy regarding pricing of administered products. The situation regarding international crude oil prices is closely under watch and adjustments will be made as and when required with equitable sharing of burden between consumers, oil companies and Government.

Strategic priorities for the ensuing year

27. (i) Additional Resource Mobilisation is sought to be done through rationalization of the tax system, special drive for collection of tax arrears, broadening the scope of service tax, levy of tax on transactions in securities and 2% cess on Central taxes/duties, and surcharges for the purposes of the Union on personal and corporate incomes.

(ii) The expenditure management will focus on an intensive review and rationalization and convergence of Plan schemes, better targeting of subsidies and strict control on the growth of other non-plan expenditure.

(iii) Management of public debt will be done in a manner consistent with Government's commitment to reduce interest liabilities and elongate the maturity of dated securities; promotion of long term savings and widening the investor base through development of the retail gilt market.

Rationale for Policy changes

28. Raising effective zero-tax slab for personal income tax is designed to provide relief to a large section of low income earners.

29. Changes in the customs duty structure are broadly in line with the medium-term objective of moving towards tariff levels prevailing in ASEAN countries. Inclusion of 13 additional services within the service tax net is in line with the medium-term objective of removing the distortion caused by differential treatment of goods and services, and to bring within the tax net a sector with a rising share in GDP. Changes in excise duty structure are designed, inter alia, to serve the medium-term objective of moving towards a uniform rate, minimum exemptions and eventual integrated taxation of goods and services.

30. Initiative to gradually work towards disintermediation of State debt is designed to promote greater market-induced fiscal discipline as well as to prune the Centre's fiscal deficit. Better targeting of subsidies is in line with the medium-term objective of reducing subsidies by plugging leakages and inefficiencies and targeting them to the needy.

Targets for the ensuing year

31. In accordance with Rule 7 of the FRBM Rules, 2004, Government is committed to taking action as contemplated therein in case the outcome of the quarterly review of trends in receipts and expenditure at the end of the second quarter of 2004-2005 shows that –

(i) the total non-debt receipts are less than 40 per cent of Budget Estimates for that year; or

(ii) the fiscal deficit is higher than 45 per cent of the Budget Estimates for that year; or

(iii) the revenue deficit is higher than 45 per cent of the Budget Estimates for that year.

Policy Evaluation

32. Strong macroeconomic fundamentals have prevented occurrence of a fiscal imbalance-induced macro-economic crisis in India for many years. But, at the same time, it needs to be recognised that there is an opportunity cost in terms of growth foregone. At the core of the problem is the persistently low tax-GDP ratio. The tax-GDP ratio of the Central Government, which was 10.6 per cent in 1987-88, fell to a level of 8.8 per cent in 1993-94 and after more or less stagnating for years, rose to 9.3 per cent in 2003-04.

33. The guiding principles of tax policy are widening the tax base by reducing exemptions, incentives and concessions; reducing multiplicity of rates; lowering tax rates; shifting the incidence of the tax burden from production to consumption; moving away from the excessive reliance on manufacturing and taxing all value additions including from services; enhancing the neutrality between present and future consumption; enhancing the neutrality of the tax system to forms of business organisations and sources of finance; and reengineering business processess of tax administration to reduce compliance cost and overcome the culture of tax avoidance and evasion. The Government will endeavour to operationalise these principles.

34. The most significant aspect of fiscal policy enshrined in the budget is to reduce revenue and fiscal deficits largely through deeper tax reforms in the face of stagnant and even declining trend in other non-debt resources of the Government and long gestation period of expenditure reforms. Consistent with the philosophy of "reforms with a human face", the burden of fiscal correction will be shared more by those who can afford to do so. The success of direct tax reforms initiated in 1997 suggests that the prospects for fiscal correction are quite bright.