

MEDIUM TERM FISCAL POLICY STATEMENT

A. FISCAL INDICATORS – ROLLING TARGETS

(As percentage of GDP)

	Revised	Budget	Targets for	
	Estimates	Estimates	2007-08	2008-09
	2005-06	2006-07		
1. Revenue Deficit	2.6	2.1	1.1	0.0
2. Fiscal Deficit	4.1	3.8	3.4	3.0
3. Gross Tax Revenue	10.5	11.2	11.5	11.8
4. Total outstanding liabilities at the end of the year	65.7	65.7	64.4	63.1

Notes:—

1. "GDP" is the Gross Domestic Product at current market prices.
2. "Total outstanding liabilities" include external public debt at current exchange rates. For projections, constant exchange rates have been assumed.
3. Total outstanding liabilities are assumed to increase on account of estimated fiscal deficit and growth in small savings collections at the current rate of growth.

1. The medium term fiscal projections are in line with the commitment made in the Budget 2005-06 to resume the process of fiscal correction with effect from 2006-07 and achieve the FRBM goals by 2008-09. The deficit indicators in BE 2006-07 are consistent with the FRBM roadmap, which envisages an annual reduction of atleast 0.3 percentage points in fiscal deficit and 0.5 percentage points in revenue deficit.

2. During the current year, on account of Twelfth Finance Commission award and other relevant factors brought out in the Medium Term Fiscal Policy Statement presented along with Budget 2005-06, Government had projected Revenue Deficit during 2005-06 to be at 2.7 per cent, i.e. at the same level as RE 2004-05. Fiscal Deficit was budgeted to decline from 4.5 per cent in RE 2004-05 to 4.3 per cent in BE 2005-06. It is a matter of satisfaction that the Revenue Deficit and Fiscal Deficit at RE 2005-06 are estimated to be lower at 2.6 per cent and 4.1 per cent respectively. This improvement in fiscal position is being achieved largely on account of revenue receipts being on target and compression of non-plan expenditure. Demands for additional plan expenditure during the year, including the routing of EAP loans to States through the Consolidated Fund of India, have been met from savings within the BE 2005-06.

3. The Central Government has continued to follow prudent fiscal policy comprising (i) a balanced tax structure based on reasonable rates with minimal exemptions covering a wider class of taxpayers and (ii) an expenditure policy that aims to moderate growth in non-developmental expenditure and adequately provide for pressing social and infrastructure needs of a developing economy. The Central Government Tax:GDP ratio is estimated to increase from 8.3 per cent in 1998-99 to 10.5 per cent in RE 2005-06. The Non-Plan expenditure, as percentage of GDP has decreased from 12.2 per cent to 10.3 per cent during the same period, even as the Plan expenditure has increased from 3.8 per cent to 4.1 per cent even after discontinuation of Central loan assistance to State Plans with effect from 2005-06. The Government is convinced of the externality arising from pursuing a sound fiscal policy in terms of a high and sustainable rate of economic growth.

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4. The improvement in the fiscal position of the Central Government has been matched by State Governments also, supported as it has been by Debt Swap Scheme and TFC award providing for higher devolution of taxes and duties, larger quantum of grants-in-aid and debt restructuring package linked to enactment of fiscal responsibility legislation.
5. The Budget 2006-07 has been prepared within the policy framework indicated above.

B. Assumptions underlying the Fiscal Indicators

1. Revenue receipts

(a) Tax-revenue

6. The Gross Tax Revenue, States share and net Tax Revenue of Centre in BE 2006-07 are placed at Rs.4,42,153 crore, Rs.1,13,448 crore, and Rs.3,27,205 crore respectively, representing growth rates of 19.5 per cent, 19.5 per cent and 19.7 per cent respectively over BE 2005-06, with marginal variation being on account of rounding off.

7. Build-up of arrears of tax revenues arising from non-realization of disputed amounts and delays in resolution of disputes have been a matter of concern for all. The strategy to augment the tax collections and improve the tax:GDP ratio have, inter alia, aimed at liquidation of arrears of tax revenues and prevention of further accretions to the stock. In order to bring about greater transparency in respect of tax arrears, as envisaged by FRBM Rules, 2004 and recommendations of the Standing Committee on Finance (29th Report), Receipts Budget 2006-07 contains separate data indicating the following (i) statement regarding tax revenues raised but not realized, as on March 31, 2005; and (ii) arrears collection targets for 2006-07.

8. The fiscal indicators shown in Table in paragraph A assume gross tax revenue growth of 15 per cent per annum over 2007-08 and 2008-09. These estimates are based on normal tax buoyancy and do not envisage any significant Additional Resource Mobilisation (ARM) measures. Efforts in this regard would make available additional resources to fund higher outlays on expenditures.

(b) Non-tax-revenue

9. The non-tax revenues are estimated to increase marginally from Rs.74,335 crore in RE 2005-06 to Rs.76,260 crore in BE 2006-07. Interest receipts comprise the largest component of non-tax revenues and the receipts in this regard have been declining on account of the following major factors - (i) reduction in the lending rates on loans to State Governments and others; (ii) debt swap scheme enabling pre-payment of high cost Central Government loans; (iii) debt restructuring of Central Government loans to State Governments that enact fiscal responsibility legislation and reduction of the rate of interest thereon to 7.5 per cent; (iii) discontinuation of further Central Government loans to States as per TFC award; and (iv) prepayments by CPSUs, etc. taking advantage of soft interest rate regime. Similarly, receipts from dividends and profits may be impacted on account of progressive disinvestment in the CPSUs. The buoyancy in other-non-tax receipts is unlikely to be of a magnitude large enough to offset the above mentioned factors. Therefore, in the medium term, non-tax-revenues are expected to remain almost at current levels in absolute terms and thus, decline progressively as a proportion of GDP. A statement regarding the arrears of non-tax revenues, as enjoined by FRBM Rules, 2004 is included in the Receipts Budget, 2006-07.

(c) Devolution to States

10. The TFC has recommended that during 2005-10, 30.5 per cent 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, surcharges and cost of tax collection, will be

distributed to the States according to specified share of each State, as against the States' share of 29.5 per cent awarded by Eleventh Finance Commission applicable for the period 2000-05. TFC has also recommended that if the rental arrangement in respect of Additional duties in lieu of sales tax is terminated and States are allowed to levy sales tax (or VAT) on these commodities without any prescribed limit, the share of the states in net proceeds of shareable central taxes shall be reduced to 29.5 per cent.

2. Capital receipts

(a) Recovery of loans

11. Repayment receipts against loans extended earlier are estimated to decline over a period of time on account of gradual disintermediation by Central Government. Over time, State Governments, Central Public Sector Undertakings and Government servants have been encouraged to borrow directly from the market and not from the Central Government. In addition, State Governments have been allowed to prepay high cost loans amounting to Rs.1,03,652 crore over three-year period ending 2004-05. In respect of Central Government loans, TFC has awarded relief to State Governments in the form of debt consolidation and waiver subject to enactment of fiscal responsibility legislation and achievement of specified targets relating thereto. These measures are expected to impact recovery of loans further.

(b) Other non-debt capital receipts

12. Disinvestment proceeds through sale of Government stake in Central Public Sector Undertakings, etc. have been the main source of receipts under this head. However, it has now been decided that the sale proceeds of Government equity in PSUs will no longer be utilized to finance the fiscal deficit. Accordingly, a National Investment Fund (NIF) has been set up to which receipts from sale proceeds of equity in PSUs would be transferred. The NIF would be maintained outside the Consolidated Fund of India and would be professionally managed by selected Public Sector Mutual Funds to provide sustainable returns without depleting the corpus. The expenditure relating to transfer to NIF is included in the Demand for Grant pertaining to Department of Disinvestment, Ministry of Finance.

(c) Borrowings - Public Debt and Other Liabilities

13. The borrowing requirement of the Government is determined by the level of fiscal deficit, which essentially reflects the uncovered gap between expenditure and total non-debt receipts of the Central Government. This deficit is financed largely through domestic public debt and to a smaller extent through external debt and other internal liabilities. Over the years, share of other internal liabilities in financing the deficit has been coming down and the Government is financing major part of its deficit through resources raised at market determined interest rates.

14. Two items included in the domestic debt/liabilities of the Central Government are not related to the fiscal deficit - (a) Accretion to the National Small Savings Fund, which at present is transferred entirely to the State Governments through investment in Special securities issued for the purpose. The interest on such securities are borne by State Governments and utilized by NSSF to service the subscribers to NSSF. However, these are liabilities of the Central Government and are therefore, included as such. (b) Borrowings under Market Stabilization Scheme are raised by Government of India within the overall ceiling mutually agreed between GOI and Reserve Bank of India to assist the RBI in mopping up excess liquidity in the market. These receipts are sequestered in a separate account with RBI and are not available to GOI for expenditure. As such, these do not impact the fiscal deficit except to the extent of interest payment/discount on such borrowings.

3. Total expenditure

(a) Revenue account

Plan Revenue expenditure

15. Plan Revenue expenditure is estimated to increase from Rs.1,15,981 crore in BE 2005-06 to Rs.1,43,762 crore, i.e. an increase of 24 per cent. The increase is mainly on account of enhanced budgetary allocations for social sector, in particular elementary education and literacy (Sarva Shiksha Abhiyan and Mid-day Meal scheme), health and family welfare (National Rural Health Mission), rural employment, Integrated Child Development Scheme, agriculture, and for physical infrastructure including roads. Total Plan grants to States are estimated to increase from Rs.45,484 crore in BE 2005-06 to Rs.49,963 crore in BE 2006-07, representing an increase of 9.8 per cent.

Non-Plan Revenue expenditure

16. Non-Plan revenue expenditure is budgeted to increase from Rs.3,30,531 crore in BE 2005-06 to Rs.3,44,430 crore in BE 2006-07, i.e. an increase of modest 4.2 per cent. The major items of non-plan expenditure are detailed below.

(i) Interest payments

17. The interest payment expenditure is projected to increase from Rs.1,33,945 crore in BE 2005-06 to Rs.1,39,823 crore in BE 2006-07, showing an increase of 4.4 per cent. As a result, interest payments as percentage of Net Revenue Receipts of Central Government is estimated to decline further from 38.1 per cent to 34.6 per cent. The moderation in the rate of growth of interest payments has been achieved by prudent fiscal policy resulting in lower recourse to borrowings, coupled with sound debt management practices in an environment of benign interest rates. This process has assisted release of significant fiscal space to meet pressures of higher plan expenditure.

(ii) Defence Services

18. Total Defence Services expenditure is budgeted to increase from Rs.83,000 crore in BE 2005-06 to Rs.89,000 crore in BE 2006-07. The budgeted allocations for 2006-07 include Revenue expenditure component of Rs.51,542 crore, as against Rs.48,625 crore in BE 2005-06, i.e. an increase of 6 per cent. The capital outlays for Defence is budgeted at Rs.37,458 crore in BE 2006-07, up from Rs.34,375 crore in BE 2005-06, representing a growth of 9 per cent.

(iii) Major subsidies

19. The allocation for major subsidies, i.e. on food, fertilizers and petroleum products is estimated to decline marginally from Rs.46,098 crore in BE 2005-06 to Rs.44,532 crore in BE 2006-07 mainly due to decline in the food subsidy.

(iv) Non-Plan Grants to States

20. The Non-Plan Grants to States/UTs in 2006-07 are placed at Rs.35,361 crore, as against Rs.33,953 crore in BE 2005-06. The Central Government is committed to compensating the State/UT Governments for loss of revenue that may arise on implementation of the State level Value Added Tax (VAT), based on agreed norms. Keeping in view the generally robust growth in revenue collections on account of introduction of VAT, delays in claim by certain States in 2005-06, possibility of other

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States moving over to VAT, the provision of Rs.5,000 crore in BE 2005-06 is being reduced to Rs.2,500 crore in RE 2005-06 and being placed at Rs.3,000 crore in BE 2006-07.

(v) *Others*

21. The other major items of revenue expenditure are police, salaries, pensions, and other administrative expenditure. The moderation in growth of expenditure in respect of these items constitutes an integral component of prudent fiscal policy.

(b) Capital account

(i) *Loans and advances*

22. Loans and advances to State Governments had earlier constituted major component of loans and advances extended by Central Government. In regard to loans to State Governments, TFC has recommended disintermediation by Central Government, albeit with support to fiscally weak states, which are unable to raise resources directly. The Government accepted the recommendations and accordingly no provision was made for loans to State Governments or for pass-through of the EAP loans. However, the issue of pass-through of EAP loans without routing it through the Consolidated Fund of India was reconsidered and keeping in view the statutory provisions and the administrative arrangements, it was decided to continue with the arrangement of routing the EAP loans to States through the Budget, albeit on back-to-back basis for all fresh loans. As a result, provision of Rs.7,400 crore has been made for this purpose in RE 2005-06 and Rs.4,697 crore in BE 2006-07. As regards the domestic loans, the States are to raise such loans directly without budgetary intermediation of the Central Government. As regards the fiscally weak states, for 2005-06 it was decided that Central Government would assist them through the window of small savings transfers and intermediated market loans, if required. During 2005-06, no intermediation of the Central Government was, however, required by any State Government. No provision for the same has been made in BE 2006-07. However, Ways and Means Advances recoverable in the same year are envisaged to continue. Non-Plan loans are also extended to Central PSEs for various purposes, including budgetary support to meet gap in resources for payment of salary, wages and statutory dues.

(ii) *Capital outlay*

23. Capital Outlay on Defence Services at Rs.37,458 crore in BE 2006-07 constitutes the largest component of non-plan capital expenditure cumulatively estimated at Rs.46,833 crore [80 per cent]. The other non-plan capital expenditure of Rs.7,637 crore in BE 2006-07 includes Rs.3,840 crore for transfer of disinvestment receipts to National Investment Fund.

24. The share of capital outlay in Plan expenditure is Rs.28,966 crore in BE 2006-07, i.e. 16.8 per cent of the total plan outlay. The share of capital outlay in the plan expenditure in 2004-05 (Provisional Actual) was much higher at 33.8 per cent. The substantial decline in the share of capital outlays in plan expenditure is a matter of concern, even as it is realized that all developmental expenditure, especially those related to social sector such as education and health may not be of capital nature and that major part of expenditure of the Central Government relating to transfers for creation of physical assets such as rural roads and rural housing is not reflected in the Central Government accounts as capital expenditure. It may be mentioned that discontinuation of domestic loans to State Governments as per TFC award has been an important causative factor in decline of capital outlays in Plan expenditure. This concern would need to be addressed in the Eleventh Five Year Plan beginning 2007-08 so as to meet

the FRBM roadmap of elimination of Revenue Deficit consistent with Fiscal Deficit level of 3 per cent in FY 2008-09.

4. GDP Growth

25. The growth in GDP at factor cost at constant (1999-2000) prices is estimated at 8.1 per cent as compared to the growth rate of 7.5 per cent during 2004-05. The rate of growth of GDP at current market prices during 2004-05 (Quick Estimate) and 2005-06 (Advance Estimate) have been put at 13.1 per cent, pegging the GDP at current market price in 2005-06 at Rs.35,29,240 crore. For FY 2006-07, for the purposes of calculation of GDP, growth rate of 12 per cent has been assumed.

(c) Assessment of sustainability relating to

(i) the balance between revenue receipts and revenue expenditure

26. The revenue deficit is estimated to decline from 2.7 per cent in BE 2005-06 to 2.1 per cent in BE 2006-07. The improvement in the balance between revenue receipts and expenditure is a result of the increase in revenue receipts at 14.9 per cent outpacing the growth in revenue expenditure pegged at 9.3 per cent. The increase in revenue receipts amounting to Rs.52,265 crore is solely on account of increases in the tax revenues amounting to Rs.53,739 crore, offsetting a marginal decline of Rs.1,474 crore in non-tax revenues. Accordingly, the share of taxes in the revenue receipts of the Central Government is estimated to increase from 77.9 per cent in BE 2005-06 to 81.1 per cent in BE 2006-07. The increase in tax receipts is reflected in the Gross Tax:GDP ratio increasing from 10.5 per cent to 11.2 per cent in BE 2006-07. The decline in non-tax revenues is due mainly to impact of Debt Swap scheme and TFC award. The improvement in the tax resources has been achieved due to buoyant economy, broadening of the tax base, including expansion of the service tax net, phased rationalization of exemptions, plugging of loopholes and improvements in tax administration. The mix of such policy measures would need to be continued to sustain the buoyancy in tax collections. Special efforts would be required to expand the share of taxable sector of the economy through coverage of agriculture and services sectors. On the non-tax revenues, measures would need to be stepped up to realize the optimum potential of receipts from profit making PSUs, user charges on public goods and services, and allocation rights in respect of mineral and other resources like 'spectrum'.

27. The gains from buoyant revenue receipts have been complemented by moderation in growth in revenue expenditure and more specifically in non-plan revenue expenditure. This has been facilitated by deceleration in the rate of growth in the major components of non-plan expenditure, viz. Interest payments, subsidies and other general administrative expenditure. The decline in the interest payments have been possible due to lower fiscal deficits and lower average cost of financing such deficits, obtained through larger recourse to market borrowings under benign interest rate regime. The soft interest rates have also had salutary impact on the food subsidy through lower interest component therein. The pressures on subsidies, however, remain and would need to be watched under evolving global trends, specifically relating to energy prices and domestic concerns. The substantial hike in plan revenue expenditure is aimed at meeting the basic needs requirements and providing social and physical infrastructure including rural roads and electrification to unleash the untapped potential of the rural India. The dividend from these expenditures may not be direct in the short term but are certain to impact the government revenue balances in the medium and long term, if accompanied by proper delivery systems. The effort of the Government in this regard is reflected in the shift in emphasis from outlays to outcomes and presentation of Outcome Budget for the first time in August 2005.

28. The decline in capital expenditure of the Central Government, comprising mainly loans to State Governments, PSUs and others is at one level a positive signal of development of vibrant capital market in the country that has reduced the dependence of these stakeholders on financial intermediation by Central Government to raise resources to finance their expenditure requirements. This is expected to subject the schemes/programmes to more rigorous test of financial and commercial viability and the borrowing entities to greater market discipline. The TFC recommendation regarding disintermediation in respect of loans by State Governments is also premised on such expectation. The fiscal space vacated as a result of such disintermediation needs to be utilized for investment expenditure to augment the productive capacity of the economy and obtain commensurate benefits therefrom. Central Public Sector Undertakings (CPSUs) have also been meeting a large part of their capital expenditure through Internal and Extra Budgetary Resources (IEBR). The IEBR of CPSUs is estimated to increase by 25.1 per cent from Rs.98,085 crore to Rs.1,22,757 crore in BE 2006-07. This is also reflected in the repayment of loans by Government servants and others being higher than the fresh loans being taken by them in 2005-06 and BE 2006-07.

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

29. In BE 2006-07, the total Plan expenditure, commonly identified with developmental expenditure though not of the capital outlays, of Rs.1,72,728 crore is 116.2 per cent of the Fiscal deficit estimated at Rs.1,48,686 crore. This implies a confirmation of healthy trend of plan expenditure exceeding the fiscal deficit achieved in 2004-05 (103.3 per cent) for the first time since the beginning of the economic reforms process. This achievement is made more creditable in view of the decision regarding disinvestments receipts being transferred to NIF and not being reckoned as resource for the purpose of deficit calculation. However, reliance on debt financing to meet large component of developmental expenditure is expected to continue over the medium term. Emphasis is required to be paid to modalities of raising such debt, which result in minimum 'crowding out' of private investments so as to achieve sustained and broad based economic growth, cause least market distortions and at the same time make available funds to the Government in line with market rates of interest. In this regard, it is important to note that FRBM Act envisages discontinuation of participation of RBI in the primary government securities market, except under specified circumstances with effect from April 1, 2006.

30. One of the major objectives of the FRBM Act is to bring about a qualitative change in the composition of total expenditure, by increased emphasis on capital expenditure and therefore, on asset creation resulting in augmentation of productive capacity with possibility of commensurate returns on such investments. In the medium term, with the progress of fiscal consolidation and availability of greater fiscal space due to reduced share of non-plan revenue expenditure, plan capital expenditure would need to be increased. The Eleventh Plan scheduled to commence from 2007-08 would provide the opportunity to undertake a comprehensive evaluation of the entire gamut of plan expenditure with the objective of consolidation of schemes to emphasize asset creation and their appropriate reflection in the books of accounts of the Central Government.

31. The process of fiscal consolidation has shown results over the last few years resulting in reduction in revenue and fiscal deficit from a high of 4.4 per cent and 5.9 per cent, respectively in 2002-03 to 2.6 per cent and 4.1 per cent, respectively in RE 2005-06. The task ahead in order to achieve the end-year FRBM targets is admittedly more challenging, especially the elimination of revenue deficit. The endeavour in this regard is expected to be facilitated by continued buoyancy in revenues on the back of higher growth trajectory and consolidating efforts in further containment of non-developmental revenue expenditure.