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Economic Bulletin
March 2005

Volume III, Number 2

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India Resident Mission

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India: Key Economic Indicators

Variables	Unit	Reporting Date	Current	Percentage Change ¹
GDP at Factor Cost (1993-94 prices)	Rs. Billion	April-December 2004	11,140	6.7
● GDP in Agriculture	Rs. Billion	April-December 2004	2,312	0.3
● GDP in Industry	Rs. Billion	April-December 2004	3,032	8.0
● GDP in Services	Rs. Billion	April-December 2004	5,796	8.8
Industrial Production – General (1993-94=100)	Index	April-February FY2004	202.1	8.1
Industrial Production – Manufacturing (1993-94=100)	Index	April-February FY2004	211.6	8.7
Wholesale Price – All Commodities (1993-94=100)	Index	FY2004	187.2	6.4
● Primary Articles	Index	FY2004	188.4	3.2
● Manufactured Articles	Index	FY2004	166.2	6.2
Consumer Price (Industrial Worker) (1982-83=100)	Index	April-February FY2004	519.0	3.8
Broad Money (M3)	Rs. Billion	18 March 2005	22,653	13.1
RBI's Credit to Commercial Sector	Rs. Billion	18 March 2005	13.9	-32.0
RBI's Credit to General Government	Rs. Billion	18 March 2005	-282.1	-
Consolidated Fiscal Deficit / GDP	%	FY2003	9.4	-
Domestic Public Debt	Rs. Billion	FY2003	21,252	13.6
Exports	\$ Billion	April-December 2004	57.5	33.0
Imports	\$ Billion	April-December 2004	85.8	47.4
Trade Balance / GDP	%	April-December 2004	-5.7	-
Current Account Balance / GDP	%	April-December 2004	-1.5	-
International Reserves	\$ Billion	25 March 2005	135.1	27.3
External Debt	\$ Billion	end-December 2004	120.9	7.2
External Debt to GDP Ratio	%	end-March 2004	17.8	-
Debt Service Ratio	%	end-March 2004	18.3	-
Foreign Exchange Rate, Spot	(Rs./\$)	31 March 2005	43.8	0.8
Nominal Effective Exchange Rate (1985 =100)	Index	April-December 2004	35.6	-0.04
Real Effective Exchange Rate (1985=100)	Index	April-December 2004	76.7	0.4

¹Percentage change over the corresponding reporting date a year ago.

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	– Dr. M. Govinda Rao, Director, National Institute of Public Finance and Policy, New Delhi	

I. Federal Budget FY2005

1. The Finance Minister of India presented the federal budget for FY2005 to Parliament on 28 February. As had been expected, this budget marks a major milestone in the revival of growth-promoting fiscal reforms. At the same time it is an inclusive budget, focusing on the rural sector and social services in line with the ruling coalition Government's Common Minimum Program (CMP). The FY2005 budget also marks a major change in federal fiscal relations vis-à-vis the States, based on the recommendations of the Twelfth Finance Commission. Most of the growth oriented fiscal reform measures are on the revenue side. Indirect tax rates and direct tax liabilities have been significantly reduced; the tax base has been expanded, especially by expanding the coverage of service taxation; and a slew of exemptions have been abolished. These exemptions had been earlier identified by several committees as one of the major factors accounting for India's porous tax system and a relatively low tax:GDP ratio of only 16%. Equity concerns have been mainly addressed through the expenditure budget. The allocation of resources for agriculture and rural development, including water resource management, has been significantly increased. There is also a large increase in the budgeted expenditure on education, health and anti-poverty programs. The expenditure budget has also addressed key growth constraints through a large increase in the allocation for road transport and power infrastructure. Despite this the total increase in federal expenditure has been contained at 1.7% (Table 1). This has been possible mainly because of a sharp reduction in federal loan assistance to the States, based on the recommendations of the Twelfth Finance Commission. Henceforth, States will have to access the capital market for their borrowing requirements.

2. These fiscal consolidation measures notwithstanding, the fiscal deficit of the federal government for FY2005 remains high at 4.3% of GDP, with a revenue deficit of 2.7%, as compared to 4.5% and 2.7% respectively for FY2004. This implies a large consolidated fiscal deficit of about 8.8% after factoring in the deficits of State

Governments. The federal fiscal and revenue deficit estimates also fall short of the corresponding targets of 4.0% and 1.8% under the Fiscal Responsibility and Budget Management (FRBM) Act. The Finance Minister explained that this is mainly on account of a large reduction in the Federal Government's receipts from recoveries of loans from the State Governments, a consequence of the expiry of the Debt Swap Scheme in FY2004 and also the rescheduling of federal loans to the States. However, the Finance Minister affirmed that the government will still meet the FRBM targets by FY2008.

Table 1: Budget at a Glance

(Rs million)

	FY2003		FY2004		FY2005		FRBM Target
Revenue Receipts	263878	(9.6)	300904	(9.7)	351200	(10.0)	
Tax Revenue (net)	186982	(6.8)	225804	(7.3)	273466	(7.8)	
Non-tax revenue	76896	(2.8)	75100	(2.4)	77734	(2.2)	
Capital Receipts	207490	(7.6)	204887	(6.6)	163144	(4.6)	
Recoveries of loans	67265	(2.5)	61565	(2.0)	12000	(0.3)	
Other Receipts	16953	(0.6)	4091	(0.1)	—	—	
Borrowings & Other Liabilities	123272	(4.5)	139231	(4.5)	151144	(4.3)	
Total Receipts	471368	(17.2)	505791	(16.3)	514344	(14.6)	
Revenue Expenditure	362140	(13.2)	386069	(12.5)	446512	(12.7)	
of which							
Interest Payment	124088	(4.5)	125905	(4.1)	133945	(3.8)	
Capital Expenditure	109228	(4.0)	119722	(3.9)	67832	(1.9)	
Total Expenditure	471368	(17.2)	505791	(16.3)	514344	(14.6)	
Revenue Deficit	98262	(3.6)	85165	(2.7)	95312	(2.7)	(1.8)
Fiscal Deficit	123272	(4.5)	139231	(4.5)	151144	(4.3)	(4.0)

Note: Figures in parentheses are % of GDP. FRBM refers to Fiscal Responsibility and Budget Management Act.

3. Among other less encouraging features of the budget, there is no attempt to cut down on subsidies, nor have any major policy initiatives been announced with regard to disinvestment in public enterprises, liberalization of foreign direct investment, or liberalization of labour laws. However, on balance, the budget has been very well received by most stakeholders, including the Left parties, that are important partners

in the ruling coalition, as well as the business community. In a strong positive market response to the budget, the Sensex stock index rose by 114 points within a single day to a peak level of 6713 points. Some highlights of the tax and expenditure proposals follow.

4. On the indirect taxes side, the objective is to reduce customs tariffs to levels comparable to ASEAN countries. Accordingly, most customs duties have been reduced from 20% to 15% or 10%, and in some cases even 5%. One outlier is cut flowers, for which customs tariffs have been raised from 30% earlier to 60% now, presumably as a protection measure for a fledgling agri-business. In the case of excise duties, the Central VAT (CENVAT) on products like polyester filament yarn, tyres and air conditioners has been reduced from 24% to 16% to bring them in line with the 16% CENVAT rate that applies to most products. Surcharges on items like tea and edible oils have also been removed, and the CENVAT on imitation jewellery has been reduced from 16% to 8%. However, the CENVAT on motor vehicles and aerated drinks has been retained at 24%. Also, surcharges on cigarettes and some other tobacco products have been raised, with the realizations being earmarked for allocation to health expenditure. Another important tax measure is extension of the service tax to a number of services which were hitherto untaxed. The Finance Minister also announced that a VAT to replace the States' sales tax, a major tax reform measure that has been postponed several times in the past, will finally become effective from 1 April 2005.

5. On the direct taxes side, the income slabs for the four tax rates of 0%, 10%, 20% and 30% have been adjusted upwards, such that a 0% tax rate is now applied to all income upto Rs100,000,¹ while the maximum marginal rate of 33% (inclusive of a surcharge), will apply to incomes exceeding Rs1 million. A provision has been made to exempt all savings upto Rs100,000 from taxation. Barring this, most other tax exemptions and rebates, including the standard deduction, have now been abolished. The corporate income tax for domestic companies has also been revised downwards

¹ This exemption limit is Rs125,000 in the case of women and Rs150,000 in the case of senior citizens.

to 33% (inclusive of surcharge) to align it with the highest personal income tax rate. However, foreign companies will continue to be taxed at the rate of 41% (inclusive of a surcharge) as before. It is important to note that the adjustment of income tax slabs is quite progressive. As will be evident from Table 2, the reduction in the tax burden at the lower end of taxable incomes amounts to about 9.5% of income, whereas at the upper end of the income range the reduction in tax burden amounts to only 5.2% of income. One controversial proposal is the introduction of a 0.1% tax on all cash withdrawals exceeding Rs10,000 from banks. This is ostensibly aimed at curbing India's large 'black economy' or tax-evading transactions, that are largely conducted in cash rather than by checks and bank-to-bank transfers. A proposal to tax some employee perquisites has also attracted much criticism. Unfortunately, agricultural income continues to be entirely exempt from taxation.

Table 2: Change in Personal Income Tax Liabilities

(Rs)

Taxable Income	Existing Tax Liability	New Tax Liability (FY2005 Budget)
50,000	Nil	Nil
55,000	Nil	Nil
60,000	Nil	Nil
75,000	Nil	Nil
100,000	Nil	Nil
150,000	19,380	5,100
200,000	34,680	15,300
300,000	65,280	40,800
500,000	126,480	102,000
750,000	202,980	178,500
800,000	218,280	193,800
850,000	233,580	209,100
855,000	238,680	210,630
1,000,000	307,428	255,000

Source: Computation in 'The Hindu' newspaper of 1 March 2005

6. A major highlight of the Finance Minister's expenditure proposals is a dramatic increase of nearly 42% in resources allocated for the rural sector, including agriculture, water resource management, and other rural development programs (Table 3). This cluster also includes a safety net type rural 'employment guarantee' scheme. This is in

Table 3: The Expenditure Budget

(Rs million)					
	2004-05	2005-06	% growth	% of Total Expenditure	
				2004-05	2005-06
1. Agriculture, Water Resources and Rural Development	236438	335684	41.98	4.67	6.53
2. Education	132287	183370	38.62	2.62	3.57
3. Health	86793	106871	23.13	1.72	2.08
4. Urban Development	23263	24042	3.35	0.46	0.47
5. Poverty Reduction and Social Welfare	85509	114428	33.82	1.69	2.22
6. Infrastructure *	182464	214379	17.49	3.61	4.17
6.1 Energy	35670	36690	2.86	0.71	0.71
<i>of which</i>					
6.11 Power and Atomic Energy	47954	59571	24.23	0.95	1.16
6.12 Petroleum & Natural Gas	35670	36690	2.86	0.71	0.71
6.2 Transport *	92470	149103	61.24	1.83	2.90
<i>of which</i>					
6.21 Roads and Bridges	85660	139464	62.81	1.69	2.71
6.3 Telecommunications	54324	28587	-47.38	1.07	0.56
7. Fertilizer Subsidy etc.	157953	163988	3.82	3.12	3.19
8. Food Subsidy etc. and Public Food Distribution	261416	265901	1.72	5.17	5.17
9. Commerce	22000	24200	10.00	0.43	0.47
10. Textile Industry Development	16058	20083	25.06	0.32	0.39
11. Posts	16497	17731	7.48	0.33	0.34
12. Defence	899220	969520	7.82	17.78	18.85
13. Home Affairs	143916	170158	18.23	2.85	3.31
14. External Affairs	38850	39280	1.11	0.77	0.76
15. Department of Economic Affairs	1783081	1682000	-5.67	35.25	32.70
16. Department of Expenditure	63737	70739	10.99	1.26	1.38
17. Department of Revenue	27165	79692	193.36	0.54	1.55
18. Science and Technology	29611	36516	23.32	0.59	0.71
19. Environment and Forests	12070	13882	15.01	0.24	0.27
20. State Plans & Union Territories	569232	357688	-37.16	11.25	6.95
21. Others	270355	253286	-6.31	5.35	4.92
Total Expenditure	5057914	5143438	1.69		

* Excluding the Railway expenditure, which has a separate budget

keeping with the commitment of the Government in its CMP to shift the focus of development programs to the rural sector. There is a similar enhanced allocation of over 38% for education, and over 23% for health, that will be partly funded through an earmarked cess and a tax surcharge. The allocation for direct poverty reduction programs and social welfare has been similarly stepped up by around 34%. These enhanced

allocations are again in line with the commitment to inclusive social development in the CMP. The third notable feature on the expenditure side is the very large increase in expenditure on roads and bridges (63%) and power (24%). These are recognized as two key infrastructure constraints for maintaining a high growth rate in India. Interestingly, there is a large reduction in the allocation for telecommunications and only a small increase for hydrocarbon infrastructure. While these are also key infrastructure sectors, they have now been mainly left for development by the private sector. This is also partly the case for ports, airports and civil aviation. The Finance Minister has asserted that the expenditure allocations are to be linked to specific outcomes in the respective sectors. This is the first time that public expenditure is being linked to performance targets. Also, a beginning has been made towards gender budgeting, and the Finance Minister has indicated that this will be taken forward in future budgets.

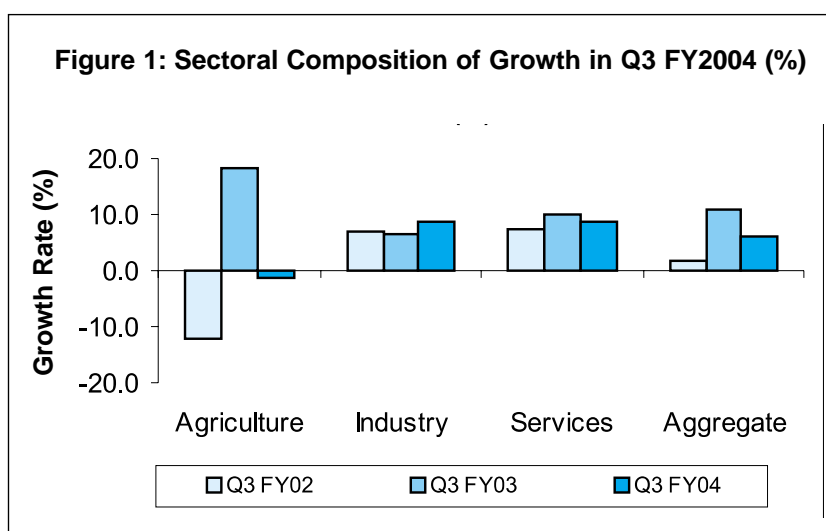
7. The reduced allocation for telecommunications is one of the factors that has made it possible to contain the increase in total expenditure in FY2005 to less than 2% compared to FY2004, despite the huge increase in expenditure on rural development, social development, and transport and power infrastructure. However, the main factor that accounts for the very limited increase of total expenditure is the sharp reduction of 37% in federal loan assistance to States, in keeping with the recommendations of the Twelfth Finance Commission. Henceforth, State Governments will have to access the capital market directly for their borrowing requirements. One disappointing feature of the expenditure budget is that it makes no attempt to cut any of the major subsidies like food and fertilizer.

8. The Finance Minister's budget speech is an occasion for announcing other important economic policy initiatives that are not directly related to the budget. The Finance Minister has announced several such initiatives for reform of the banking sector, rural finance, and financing for small and medium enterprises. He indicated that the required road maps and legislation for these initiatives will follow. However,

no significant initiatives have been announced for public enterprise reform and disinvestment, liberalization of foreign direct investment, or liberalization of labour laws. These omissions notwithstanding, the budget has been very well received by most stakeholders.²

II. Growth Performance

9. GDP grew at 6.2% in the third quarter (October-December) of FY2004,³ down from an average of 7.0% during the first two quarters. This is also substantially lower than the 11.0% growth recorded during the third quarter of FY2003 (Figure 1). This is mainly attributable to a slowdown in agricultural growth and the rising international price of oil. The government has projected a growth of 6.9% for the year as a whole, while ADB has maintained its projection of 6.5%. As noted in the previous issue of this Bulletin, the consensus forecast has converged around this figure (Table 4).



Source: Compiled from www.mospi.nic.in/stat_pr.htm

² For an expert assessment of the FY2005 budget and the Report of the Twelfth Finance Commission see the Special Feature by M. Govinda Rao in this issue.

³ Year ending 31 March 2005.

Table 4: Projections of Overall Growth (%)

Agency	FY2004
ADB	6.5
Government of India	6.9
Reserve Bank of India	6.0-6.5
International Monetary Fund (IMF)*	6.4
Economic Intelligence Unit (EIU)	6.9
National Council of Applied Economic Research (NCAER)	6.6
Centre for Development Economics-Delhi School of Economics (CDE-DSE)	6.6
Investment Information and Credit Rating Agency (ICRA)	6.5-6.7
Credit Rating Information Services of India Limited (CRISIL)	5.5-6.0
Centre for Monitoring Indian Economy (CMIE)	6.2
Consensus Forecast	6.4-6.5

* The projections are for the calendar year.

III. Sectoral Performance

10. Agricultural growth was negative in the third quarter (October-December) of FY2004, which follows -0.8% growth in the second quarter of the year. This is a sharp decline from the strong 18.2% growth recorded during the corresponding period in FY2003.⁴ This decline is attributed to the shortfall in monsoon rainfall as well as deficient post-monsoon precipitation. As a result, *kharif* (summer) foodgrain production is estimated to have declined to only 102.9 million tons in 2004 as compared to 112.1 million tons in 2003. Despite a marginal increase in *rabi* (winter) foodgrain production, total foodgrain production is projected to decline by 2.7% in 2004. For the year as a whole, ADB has projected total agricultural growth at 0.6%.

11. Industrial growth accelerated to 8.9% in the third quarter of FY2004. Consolidated industrial growth for the first three quarters of the year was higher at 7.9% as compared to 6.2% during the corresponding period in FY2003. Monthly data for January 2005 show that industrial growth remains high at 9.3%. In the manufacturing sector, consumer goods, capital goods, and basic goods production have all continued to grow at high rates. Growth of production in individual product groups is shown in Table 5. The recent CII-ASCON survey shows that 77 out of 134 manufacturing sectors registered

⁴ The agricultural year in India runs from July to June, and is thus different from the financial year.

more than 10% growth in production during the year. Broad-based manufacturing growth was supported by strong growth in key infrastructure industries such as cement, electricity, coal and petroleum refined products. ADB has projected industrial growth of 8.0% for the year as a whole. Such robust industrial growth has led to a strengthening of business confidence.⁵

Table 5: Sectoral Performance: Manufacturing (% growth)

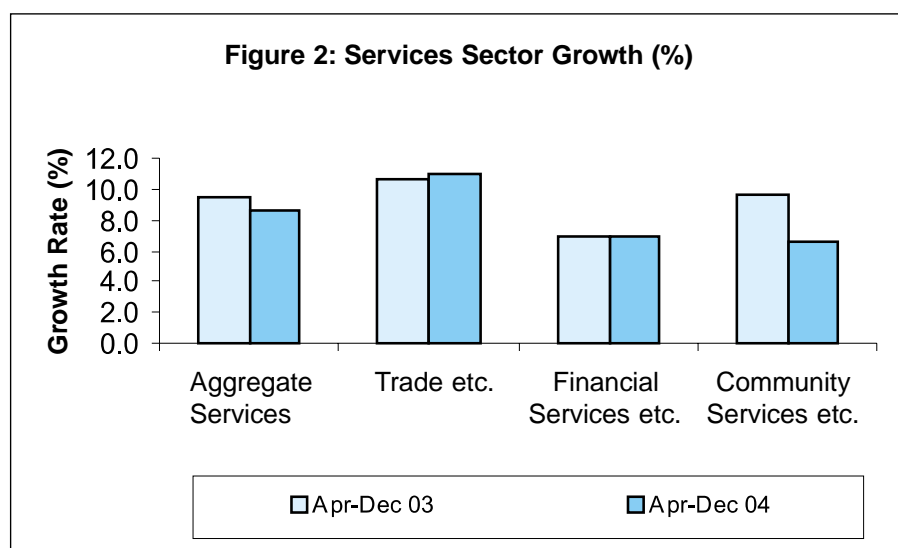
Increasing Output				Declining Output			
Sector	2002-03	2003-04	2004-05@	Sector	2002-03	2003-04	2004-05@
Machinery (except Transport Equipment)	1.8	15.2	19.6	Wood & Wood Products	- 17.8	6.8	- 8.5
Other Industries	-0.5	6.5	17.3	Food Products	10.7	- 0.2	- 0.6
Textile Products	15.6	-3.8	16.5				
Chemicals & Allied Products	4.0	8.2	15.3				
Beverage, Tobacco etc.	27.3	9.4	10.0				
Paper & Paper Products	5.6	15.9	8.5				
Cotton Textiles	-2.4	-3.3	7.3				
Metal Products	6.4	3.4	6.6				
Leather Manufactures	-2.9	-4.3	5.2				
Basic Metal	9.2	9.1	4.9				
Transport Equipments	14.9	17.0	3.5				
Jute and Mesta	8.4	-4.2	3.3				
Man-made Fibers etc.	3.8	6.2	2.9				
Rubber, Plastic etc.	4.9	4.5	1.5				
Non-metallic Mineral Products	5.0	3.7	1.2				
Overall Manufacturing	6.0	7.2	8.7				

Note: @ April-February 2004-05

Source: Compiled from www.mospi.nic.in/stat_pr.htm

⁵ As measured by the NCAER business confidence index. See NCAER (2005).

12. The services sector continued to grow at a high rate of 8.6% during the first three quarters of FY2004 (Figure 2), led by 11.0% growth in ‘trade, hotels/restaurants, and transport and communication’. Growth of ‘financial and business services, and real estate’ and ‘community, social and personal services’ has been lower in the range of 6-7%. Overall, services sector growth is expected to exceed 8.0% in FY2004.

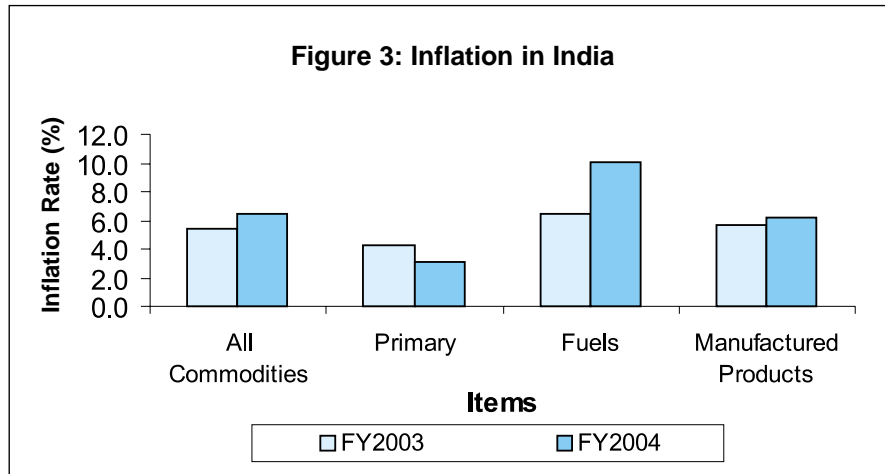


Source: Compiled from www.mospi.nic.in/stat_pr.htm

IV. Money and Inflation

13. Money supply (M3) growth was 13.1% as on 18 March 2005. This is significantly lower than the monetary policy target of 14% for the year as a whole.⁶ On the price front, the Wholesale Price Index indicates an inflation rate of 6.4% for the period April 2004–February 2005 (Figure 3). This was mainly on account of the high price of oil and rising prices of iron and steel. However, inflationary pressures have eased since December 2004. Also, inflation based on the Consumer Price Index for Industrial Workers has remained moderate at 3.8% during the period April 2004–February 2005.

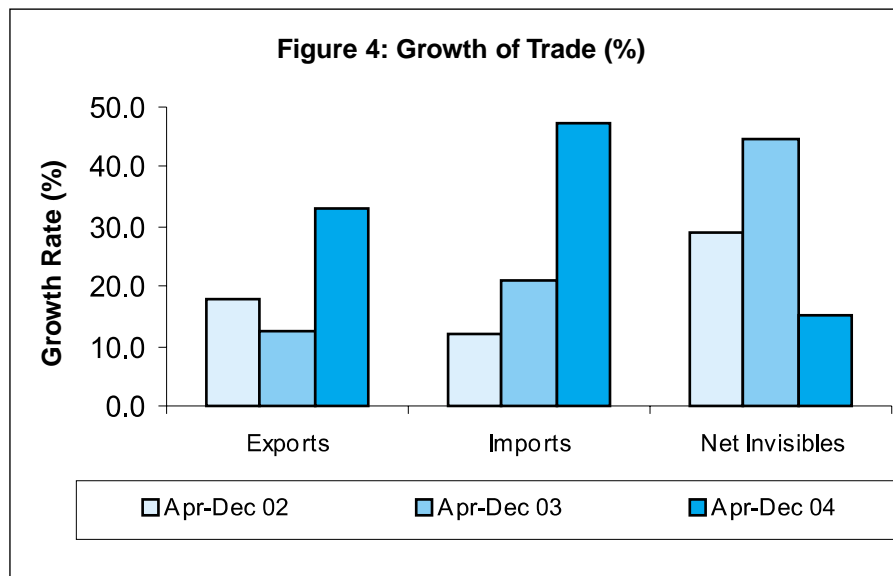
⁶ Mid-term Review of the Annual Policy Statement 2004-05 of Reserve Bank of India, October 2004.



Source: Compiled from <http://www.eaindustry.nic.in>

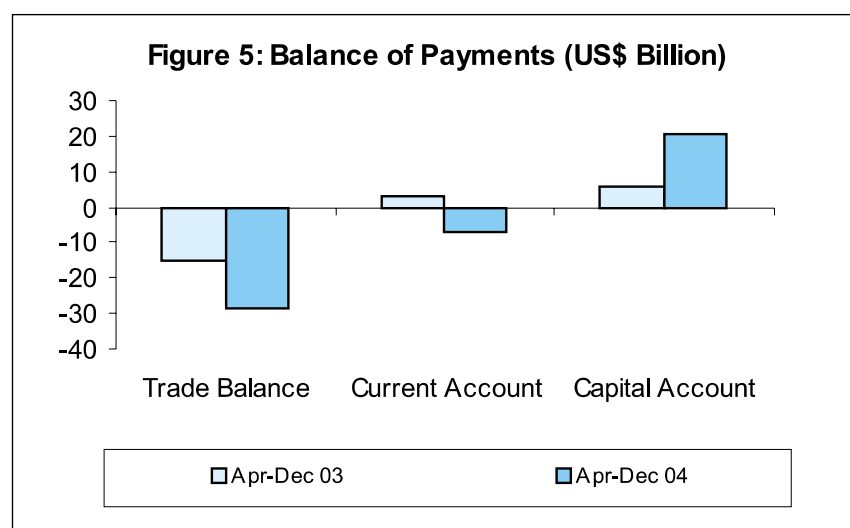
V. Balance of Payments and Foreign Exchange Reserves

14. India's trade expanded rapidly through FY2004. Merchandise exports grew by 33.0%, while imports grew by 47.4% during the first three quarters of FY2004 (Figure 4). The merchandise trade deficit accordingly rose to \$28.4 billion during this period, compared to \$15 billion during the corresponding period in FY2003. Unfortunately,



Source: Compiled from www.rbi.org.in

the earlier high growth of net invisibles earnings slowed down in FY2004. The larger trade deficit, combined with slower growth of net invisible earnings, reversed the current account balance from a surplus of \$10.6 billion in FY2003 to a deficit of \$7.4 billion during the first three quarters of FY2004 (Figure 5). The slowing down of net invisible earnings growth and consequent deficit in the current account is a potential risk factor for India's balance of payments which bears close monitoring.



Source: Compiled from www.rbi.org.in

15. On the capital account, net capital inflows jumped to \$20.7 billion during April-December 2004, up from \$5.9 billion during the corresponding period of FY2003. This sharp increase in net capital flows was largely on account of a quantum jump in net external assistance and net external commercial borrowings. However, there was not much increase in foreign investments, direct or portfolio. Net FDI amounted to only \$2.2 billion. Overall, with the surplus on capital account exceeding the current account deficit, foreign exchange reserves rose to \$135.1 billion as of 25 March 2005, providing a coverage of over 103.5% for the external debt stock.

VI. Near-Term Outlook

16. The near term economic outlook is promising. The economy is expected to grow in the range of 6-7% during the period FY2005 to FY2007. Growth is forecast at 7.0% in FY2005, 6.1% in FY2006, and 6.6% in FY2007.⁷

17. These projected growth fluctuations reflect an expected recovery in agricultural production in FY2005, combined with a downturn in the industrial business cycle. This is likely to lead to a lagged slow down in overall growth in FY2006. The anticipated downturn in the industrial business cycle in FY2005 is based on the reported cost-smoothing behavior of firms. The latest NCAER Business Expectation Survey reports that firms are upbeat about capacity utilization in FY2004, though they are not optimistic about demand off take. The survey indicates that the proportion of firms accumulating large stocks in FY2004 has increased significantly, especially in consumer goods industry. Firms that have accumulated excess inventories in FY2004 are likely to slow down production in FY2005 when costs are expected to be higher.

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⁷ These forecasts are based on an 'alternate leading indicators' technique that has performed better in 'within sample' root mean squared error tests compared to the Beveridge-Nelson univariate technique used for forecasts in earlier issues of this bulletin. These new growth forecasts are marginally higher for FY2005 compared to the earlier forecasts. For a detailed discussion of these alternate forecasting techniques and their performance, see Mundle et al. (2005).

Special Feature

The FY2005 Budget, the Twelfth Finance Commission, and Fiscal Consolidation*

Dr. M. Govinda Rao

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Dr. M. Govinda Rao is Director, National Institute of Public Finance and Policy, New Delhi, India. He is also a Member of the Prime Minister's Economic Advisory Council. He was earlier Director of the Institute for Social and Economic Change, Bangalore, and Fellow, Research School of Pacific and Asian Studies, Australian National University, Canberra, Australia. He has also served in various advisory capacities and these include Chairman, Expert Group on Taxation of Services (2000-01); Chairman, Technical Experts Committee on VAT; and Adviser, Financial and Fiscal Commission, Republic of South Africa. He is also a Member of the Taxation Policy Group in the United Nations Development Program's Initiative for Policy Dialogue led by Prof. Joseph Stiglitz. Dr. Rao's research interests include public finance and fiscal policy, fiscal federalism and State and local finance. He has been a consultant for the Asian Development Bank, UNDP, and World Bank in several countries including Cambodia, China, Laos, Pakistan and Vietnam. He has published a large number of technical articles in professional journals and eight books on various aspects of public finance. His most recent books include, *Political Economy of Federalism in India* (with Nirvikar Singh), Oxford University Press, 2005; and *Sustainable Fiscal Policy for India: An International Perspective* (edited with Peter Heller), Oxford University Press (forthcoming).

* The views expressed in this article are the author's personal views. These are not necessarily shared by the Asian Development Bank.

The FY2005 Budget, the Twelfth Finance Commission, and Fiscal Consolidation

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1. In India, achieving fiscal consolidation has turned out to be elusive even 14 years after the fiscal adjustment program was initiated. In the initial years of reform beginning 1991, particularly until the mid-1990s, there was a sharp improvement in fiscal balance measured in terms of revenue, primary and fiscal deficits. However, the subsequent period has seen worsening fiscal imbalance in terms of quantity, and even more so in terms of quality. Recent attempts at fiscal rectitude include enactment of the Fiscal Responsibility and Budget Management Act (FRBMA) and a reference to the Twelfth Finance Commission (TFC) to recommend measures for restructuring public finances of the Federal Government and States to restore fiscal balance, reduce debt and achieve macroeconomic stability for enabling equitable growth. The FRBMA set targets for the revenue deficit-GDP ratio to be reduced to zero and the fiscal deficit to be brought down to 3% by 2007-08, which has since been shifted to 2008-09. The TFC has reiterated the core strategy indicated in the FRBMA, i.e., reduction of public dissavings and increasing public investment in infrastructure. As considerable work has been done both in the report of the task force appointed to implement the FRBMA and the TFC report to provide policy directions to achieve these targets, it is useful to analyze the quality and feasibility of the reforms recommended by the TFC; and also examine to what extent the budgetary proposals for FY2005 will help accomplish fiscal rectitude at the federal level.

Fiscal Imbalance in India: Quantitative and Qualitative Aspects

2. Persisting fiscal imbalance in India has been a major macroeconomic concern for policy makers. The remarkable downward inflexibility of fiscal deficits and sustained growth of revenue and primary deficits have worried successive Finance Ministers. Despite their good intentions and efforts, they have had little success in achieving anything tangible. Thus, the consolidated fiscal deficit of federal and State Governments as a ratio of GDP, after declining from 9.3% in 1990-91 to 6.3% in 1996-97, increased to over 9% in 1998-99

and remained at around 9-10% thereafter (Table 1, Figure 1). At the same time, the revenue deficit has shown a steady increase from 3.6% in 1996-97 to 6.7% in 2002-03 and the primary deficit increased from 1.1% to 3.4% during the same period. Thus, the share of revenue deficit in fiscal deficit, a negative indicator of the quality of fiscal deficit, increased from 50% in 1995-96 to 67.5% in 2002-03.

3. There are a number of studies, including the recent report of the TFC, that have examined the causes of fiscal imbalances at federal and state levels in considerable detail.¹ These are briefly summarized here. The deteriorating trend is a phenomenon seen in both federal and state finances, but the magnitude of deterioration has been much larger in the latter. Thus, while in 1990-91, the shares of the federal government in total fiscal, revenue and primary deficits were 71, 78 and 58% respectively, in 2002-03, they declined to 59%, 65% and 32% respectively.

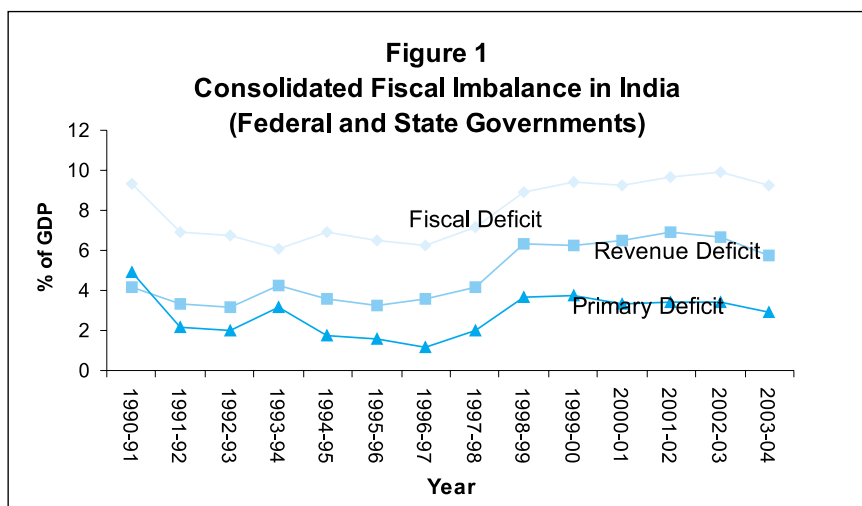
**Table 1: Consolidated Fiscal Imbalance in India 1990-2004
(Federal and State Governments)**

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Ratio of Revenue Deficit to Fiscal Deficit
1990-91	9.3	4.16	4.91	44.73
1991-92	6.9	3.36	2.19	48.70
1992-93	6.78	3.16	1.99	46.61
1993-94	6.12	4.21	3.17	68.79
1994-95	6.92	3.61	1.79	52.17
1995-96	6.52	3.24	1.56	49.69
1996-97	6.26	3.56	1.14	56.87
1997-98	7.16	4.15	2.00	57.96
1998-99	8.95	6.35	3.63	70.95
1999-00	9.45	6.27	3.78	66.35
2000-01	9.21	6.48	3.33	70.36
2001-02	9.63	6.88	3.45	71.44
2002-03 (RE)	9.91	6.69	3.44	67.51
2003-04 (BE)	9.22	5.76	2.91	62.47

Note: RE: Revised estimates; BE: Budget estimates

Source: Indian Economic Statistics 2003-04, Ministry of Finance, Government of India.

¹ A number of papers relating to fiscal imbalances in the country are included in Heller and Rao (forthcoming). For a detailed account of trends in fiscal imbalances, see India (2005). On state finances, see Rao (2000).



4. The sharp deterioration in states' finances can be attributed to a variety of factors. Revision of pay and pension of government employees was a major reason for fiscal deterioration. The public services provided by the states are more wage intensive and hence the revision has had a more adverse effect on state finances. Another major reason for fiscal deterioration was the increasing interest burden. Large borrowings for current consumption and low productivity of capital expenditures have resulted in the inability of both federal and state governments to generate additional resources, triggering a vicious cycle of debt and interest payments. In the states, an additional contributory factor is the fact that although over 65% of their plan expenditure is in the revenue account, they receive 70% of plan assistance as loans. On the revenue side too, there has been a significant deceleration in the tax revenue of the states in the 1990s compared to the previous decade. This may be attributed, among other reasons, to the service sector dominated growth in the latter part of the 1990s and exclusion of consumption of services from the tax base of the states. The poor and declining condition of power sector finances has had a significant impact on both states' finances and their contingent liabilities. The long gestation periods in irrigation projects and the creation of special purpose vehicles to finance them have further added to the problem. Finally, increasing explicit and implicit subsidies due to competitive political populism, which is a direct outcome of India's coalition politics, have had the most negative impact on the fiscal situation in the country.

5. It is curious that despite persistence of aggregate fiscal deficit of about 9-10% of GDP for the last 7 years, the macroeconomic situation has remained stable. This has raised a question as to whether the size of the fiscal deficit matters at all. There are also questions about the optimal sizes of deficits. Some have even advocated that in a situation where growth is constrained by infrastructure bottlenecks, resulting from declining capital expenditures over the years, the macroeconomic environment justifies significant increases in capital outlay financed by fiscal deficits. Despite large drawals of household savings for government consumption and investment year after year, the banking system has continued to have excess liquidity and interest rates have remained benign. Therefore, it is argued that increasing government expenditure to overcome infrastructure bottlenecks, financed through fiscal deficits, would be a feasible and a viable option to further improve growth prospects in the country.

6. The above interpretation, however, is misplaced. Although fiscal imbalance in the country has not led to any immediate macroeconomic crisis, it has entailed significant growth costs. It is true that fiscal deficits have not exerted significant upward pressure on interest rates in the recent past. The pressure on interest rates was less after the mid 1990s mainly because the ratio of corporate investment to GDP declined from 9.6% in 1995-96 to 4.8% in 2002-03 and the savings-investment gap in the sector declined from 4.6% to 1.4% during the period. This order of decline in corporate sector demand for lendable resources from the financial sector certainly eases the pressure on interest rates. At the same time, the small scale manufacturing sector which is starved of resources could not access funds from the financial system at lower interest rates due to the high risk perception regarding loans to the sector, and the premium attached to it by the financial system. Risk averse managers in the financial sector prefer to invest in government paper rather than make investments in the market. Consequently, the sectors that needed financial resources the most, could not access them at low rates of interest despite high liquidity in the banking system. Thus, it would be incorrect to presume that the large and persisting fiscal deficits during the last seven years were costless. Besides pre-emption of household savings to the tune of almost 6-7% of GDP for government consumption, fiscal deficits have diverted investment resources away from precisely sectors such as small scale industries, which needed these

resources the most at a time when they had to modernize their technology to meet the challenges of globalization. Also, there are inter-generational equity considerations of creating a liability for the future without creating commensurate assets.

Restructuring Plan of the Finance Commission

7. The importance of fiscal consolidation becomes clear in the context of the 8% growth target set for the Tenth Five Year Plan. The Plan states that in order to achieve this growth target an investment rate of 28.4% would be required, assuming that the incremental capital output ratio will decline from the prevailing 4 to 3.55. Such levels of investment will surely require generation of larger volume of savings and investment, both in the private and public sector, and this cannot be achieved without fiscal consolidation. Thus, macroeconomic stability and long-term growth considerations both call for urgent fiscal adjustment.

8. From this perspective, enactment of FRBMA to set the targets and path of fiscal adjustment is important. The fiscal deficit of the federal government is set to be brought down to 3% and the revenue deficit is set to be phased out by the terminal year of adjustment 2008-09. The forecast presented to the Parliament lays down the path of adjustment until 2007-08, which has since been postponed to 2008-09. Accordingly, the revenue deficit of the federal government is set to be brought down each year by about half a percentage point from 2.5% of GDP in 2004-05, to zero by 2008-09. Similarly, the fiscal deficit is expected to be reduced from 4.3% in 2004-05 by about a quarter percentage point to reach 3% in 2008-09. In a more elaborate exercise, the TFC too has worked out the sustainable levels of aggregate fiscal deficit at 6% of GDP, of which the targets for the federal government and states is set at 3% each by 2008-09. These are consistent with the targets of the FRBMA. The TFC has also emphasized the need to reduce the ratio of primary deficit to GDP in order to reduce the debt-GDP ratio to a sustainable level. Once the sustainable level of debt-GDP ratio is achieved, the task of the adjustment process is to stabilize it at that level.

9. Clearly, debt sustainability cannot be ensured under existing trends and significant fiscal restructuring is unavoidable. The TFC details the plan for fiscal restructuring. The overall saving rate should be increased from 24% of GDP in 2004-05 to 26% in 2009-10,

and the investment rate should be increased from 24.5% to 27.5% during the same period. As regards the fiscal parameters, the consolidated fiscal deficit as a ratio of GDP should be brought down from the 8.9% to 6% in 2009-10 according to the TFC, and the revenue deficit should be eliminated completely as compared to the 2004-05 level of 4.5%. During this period, capital expenditure should be increased from 5.6% of GDP to 6.6%. For the federal government, the target is to eliminate the revenue deficit by 2008-09 and reduce fiscal deficit to 3%. As mentioned above, this is consistent with the targets set by the FRBMA.

10. What is the magnitude of fiscal adjustment required on the revenue and expenditure sides? According to the TFC, more than 60% of the adjustment has to come from the revenue side and the balance by containing expenditures (Table 2). Thus, the tax – GDP ratio is stipulated to increase by two percentage points and the overall revenue-GDP ratio by three percentage points. The expenditure – GDP ratio is set to decline by 1.7 percentage points, but the primary expenditure-GDP ratio is set to increase as capital expenditure as a ratio of GDP is targeted to increase by one percentage point. Almost the entire reduction in the revenue expenditure is expected to be achieved by reducing interest payments from 6.1% to 4.5%.

11. Regarding the federal government's revenues and expenditures, gross tax revenue is set to increase from 9.7% in 2004-05 to 10.9% in 2009-10, and non-tax revenues are supposed to remain at the same level at 2.2% of GDP, revenue expenditure is set to decline from 11.9% to 10.2%. This reduction is expected to be achieved almost entirely by reducing interest payments from 4.2% of GDP to 2.8%. Capital expenditure is set to increase by 0.5 percentage points of GDP. Overall this adjustment is expected to reduce the outstanding liabilities from 53% to 43.7%.

12. In the case of the states, according to the TFC plan, the revenue deficit should decline by two percentage points of GDP and the adjustment in fiscal deficit is equivalent to that of the federal government – from 4.5% of GDP to 3%. The adjustment calls for an increase in the tax – GDP ratio by about 0.9 percentage point, non-tax revenues are expected to increase only marginally by 0.2 percentage point, and the revenue expenditure – GDP ratio is expected to decline by about 0.4 percentage point. As interest payment is estimated to decline by

almost 0.9 percentage point, the states can actually increase their non-interest revenue expenditure by about 0.5 percentage point, and primary expenditures by almost one percentage point.

Table 2: Finance Commission's Plan for Sustainable Fiscal Adjustment in India

Fiscal Variables	Centre		States		Aggregate	
	2004-05	2009-10	2004-05	2009-10	2004-05	2009-10
Gross Tax Revenue	9.7	10.9	5.9	6.8	15.6	17.6
Net Tax Revenue	7.2	7.9				
Own non-tax Revenue	2.2	2.2	1.2	1.4	2.5	3.4
Interest Payment	4.2	2.8	2.9	2.0	6.1	4.5
Total Revenue Expenditure	11.9	10.2	13.6	13.2	22.6	21.0
Capital Expenditure	3.0	3.5	2.6	3.1	5.6	6.6
Revenue Deficit	2.5	0	2.0	0	4.5	0
Fiscal Deficit	4.5	3.0	4.5	3.0	8.9	6.0
Primary Deficit	0.3	0.2	1.6	1.0	2.8	1.5
Interest Payments/ Revenue Receipts	44.5	28.0	24.9	15.0	33.7	21.6
Outstanding Liabilities	53.0	43.7	30.3	30.8	80.8	74.5

13. How are these adjustments supposed to be achieved? The TFC is rather silent about it, except stating that the states should reform their sales tax systems to adopt VAT. Of course, there are omnibus suggestions that tax administration should be improved, user charges should be levied on a variety of services and this should be determined by an autonomous regulatory body, subsidies should be contained, salary expenditures as a percentage of GDP should be rolled back to the level that prevailed in 1996-97, the management of public expenditures should be guided by economy, efficiency and effectiveness of expenditures to focus on outcomes rather than expenditures. Indeed such 'motherhood' statements can be found in all the Finance Commission Reports since the Ninth. The Report of the TFC, despite its claims about incentivising the transfer system, essentially adopts the gap filling approach followed by earlier Finance Commissions. The TFC has tried to normalize the gap by making upward adjustment of the tax –SDP ratios up to 25% of the shortfall, but there are serious questions in considering tax-SDP ratio as a measure of taxable capacity when there are many factors other than income that determine the States taxable capacity. The capacity to raise revenues does not linearly change with the size of these

factors, and there is significant inter-state tax exportation. The incentive scheme for debt restructuring is certainly an improvement over the scheme recommended by the previous Finance Commission. But once again, the extent of benefit is too small to make a significant difference to the structure of incentives facing a state.

Feasibility and Compliance Issues

14. Is the scenario predicted by the TFC within the realm of feasibility? The question is pertinent because, right from the Ninth Finance Commission, one of the terms of reference was to recommend fiscal restructuring to ensure not only that revenue deficits are not only eliminated but that a surplus is created in the revenue account for public investment. Indeed, each of the Finance Commissions since the Ninth had recommended fiscal restructuring programs, but neither the federal government nor the states cared to undertake the measures needed. In the event, the actual outcomes were in wide variance with normative projections. The transfer system recommended by each of the Commissions, failed to resolve the horizontal and vertical fiscal imbalances or achieve the fiscal consolidation necessary to generate the projected surpluses. Instead, successive Finance Commissions ended up merely distributing deficits between the federal government and the states!

15. The budget for 2005-06 reinforces the above tendency. While the magnitude of fiscal adjustment recommended by the Commission does not look frightening, and can certainly be achieved, the real challenge comes from the compulsions of coalition politics. The Finance Minister had to provide an outlay of Rs250 billion for the implementation of the National Common Minimum Program (NCMP), and the Finance Commission has not factored in the NCMP in its recommendations. In fact, as the years pass by, considerable additional amounts will have to be provided for the implementation of NCMP. The Finance Minister has already pressed the “pause” button for fulfilling the obligations under the FRBMA. This he has done even after taking advantage of the additional cushion provided by stopping the practice of borrowing for on-lending to the states for Plan assistance. Although the TFC has recommended that this be implemented in a phased manner, the Finance Minister has implemented the recommendation in one shot with immediate effect, leaving several questions to be answered on the states ability to borrow from the market, hand holding required in respect of “weak” States, and the modalities to be followed to

make the markets work. In other words, even though the Finance Minister has claimed that he has only pressed the “pause” button, in effect, there is a slippage to the tune of 0.75%, which is the amount the federal government used to borrow to on-lend to the states, but now simply retains for itself.

15. This clearly gives a wrong signal and widens the credibility gap. Even before the ink of the FRBMA is dry, the federal government itself is caught in the web of non-compliance. Indeed, the TFC has recommended that the states too should enact Fiscal Responsibility Act to phase out their revenue deficits and limit fiscal deficits. The states will surely take a clue from the federal government’s “pause”. The critical issue is that, like in the past, the TFC’s recommendations may remain unimplemented, despite their “acceptance”, and the terms of reference to restructure the finances of the federal and state governments may remain unfulfilled. In the end, the interest in the Finance Commission’s recommendations, for both federal and state governments, seems to be merely to find out the volume of devolution and grants. Once these are known, neither the federal government nor the states have an interest in following what the Finance Commissions recommend. Hopefully, the terms of reference relating to restructuring federal and state finances will not have to be repeated for the next Finance Commission as well.

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