MEDIUM TERM FISCAL POLICY STATEMENT

A. FISCAL INDICATORS – ROLLING TARGETS AS PERCENTAGE OF GDP

(at current market prices)

		Revised Estimates 2007-08	Budget Estimates 2008-09	Targets for	
				2009-10	2010-11
1.	Revenue Deficit	1.4	1.0	0.0	0.0
2.	Fiscal Deficit	3.1	2.5	3.0	3.0
3.	Gross Tax Revenue	12.5	13.0	13.5	14.0
4.	Total outstanding liabilities at the end of the year	63.8	59.6	55.7	52.3

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.*

1. This year (2007-08) is the fourth year of managing our economy with FRBM Act mandated goals as guideposts. Fiscal performance in 2007-08, in relation to the quantitative goals under the Act, is gratifying. Higher growth in revenue receipts relative to growth in revenue expenditure has resulted in reduction of revenue deficit. Driven by continuing fiscal correction, on the strength of revenue growth and reprioritized expenditure, the performance of fiscal deficit as well as revenue deficit in the revised estimates 2007-08 is poised to be better than the targeted level. Similarly the Tax:GDP ratio is set to exceed the budget estimates. Debt to GDP ratio too has remained within the budgeted target. The economy has entered into a positive loop of high growth and high tax receipts. The fiscal consolidation strategy is essentially revenue led as reflected in Tax:GDP ratio. However, some areas of concern relating to the fiscal correction remain. Such concerns mainly relate to quality of expenditure. Increased allocation in social sector, which is essentially revenue expenditure, has implications for Revenue Deficit, and is sought to be balanced by containment of other non-plan revenue expenditure.

2. On the strength of sound macro-economic management, continued fiscal consolidation and monetary stability, the deficit targets are likely to be over achieved as compared to budgeted level in 2007-08. Fiscal deficit is set to come down from 3.3 percent of GDP in budget estimates 2007-08 to 3.1 per cent of GDP in the revised estimates 2007-08. Similarly, the revenue deficit which was targeted to be brought down to 1.5 percent of GDP is now 1.4 percent of GDP. Tax:GDP ratio has improved from the estimated 11.8 per cent of GDP in budget 2007-08 to 12.5 percent of GDP in revised estimates.

3. Fiscal performance, in terms of the Fiscal Responsibility and Budget Management Act, 2003 (FRBM) mandated goals, during the last four years has disproved some initial apprehensions to a large extent. Budget management, as benchmarked to quantitative targets, is on track. The targets relating to fiscal deficit are set to be achieved as per the mandate, while those relating to revenue deficit would require to be rescheduled primarily on account of a virtuous shift in Plan priorities in favour of revenue expenditure intensive programmes and schemes and systemic rigidity in the short term containing non-plan expenditure in the short term, particularly arising from committed and obligatory expenditure like interest payments, pensions, salaries, defence etc. The robust economic growth and macroeconomic stability achieved during the past four years, generally resulted in higher than anticipated tax receipts and created fiscal space to meet increasing demand for resources. The ongoing reforms and fiscal correction initiatives would continue to be supportive of raising domestic demand and investment, both of which are the main drivers of growth in Gross Domestic

Product (GDP). The annual GDP growth that averaged around 8.7 percent is set to accelerate further in the range of 9-10 percent, as set out in the XI Five Year Plan. While meeting the spending requirements in consonance with the policy objectives, the tax reforms would continue to benefit the buoyant behaviour of tax receipts. The increased buoyancy in tax revenue, control of consumption expenditure, containing subsidies, generating resources for investment, improving physical infrastructure and creating human capital continue to be core focus areas in the medium term.

4. Going forward, the fiscal policy strategy is aimed at accommodating the spending priorities associated with interventions relating to inclusive growth, human capital development and critical infrastructure investment to achieve the growth objectives set out in the XI Five Year Plan document.

5. The FRBMA compliant road-map envisages an annual reduction of atleast 0.3 percentage points in fiscal deficit and 0.5 percentage points in revenue deficit. This condition is successfully being complied within the overall context of implementing the Act. The mandate is to eliminate revenue deficit and reduce fiscal deficit to not more than 3 per cent of GDP by 31st March 2009. In Budget 2007-08, Government had projected Revenue Deficit to be at 1.5 per cent, i.e., 0.5 percentage points lower than the RE 2006-07. Fiscal Deficit was budgeted to decline from 3.7 per cent in RE 2006-07 to 3.3 percent in BE 2007-08. The targets for Fiscal and Revenue Deficit as projected in BE 2007-08 are being bettered at 3.1 per cent and 1.4 per cent of GDP in RE 2007-08, primarily on account of higher tax growth rate that exceeds the GDP growth rate and to some extent on account of moderation in non-plan expenditure.

6. The gross tax-GDP ratio is set to increase from 11.8 percent in 2007-08 (BE) to 13.0 percent in 2008-09 (BE). Prudent fiscal policy has ensured continued improvements in the tax receipts, with direct tax component exceeding indirect taxes in 2007-08 (RE). Higher growth in direct tax collections, *interalia*, is a combined effect of a balanced tax structure based on reasonable rates with fewer exemptions, a wider coverage of taxpayers, better compliance and more efficient tax administration. The expenditure policy is aimed to contain non-developmental expenditure and provide adequately for priority spending on social development and infrastructure needs. Even though 80 per cent of Non Plan expenditure obligatory in nature, being expenditure on sovereign functions including on defence, interest payments, subsidies and transfers to States, Government is convinced on the need for creating further fiscal space through carefully calibrated fiscal consolidation in support of inclusive growth aligned with global trends. Government is also alive to the likely impact associated with surge in capital flows and increasing international commodity prices, particularly those of food, fuel and fertilizers.

7. The Budget 2008-09 has been prepared within the policy framework indicated above.

B. ASSUMPTIONS UNDERLYING THE FISCAL INDICATORS

1. <u>Revenue receipts</u>

(a) *Tax-revenue*

8. The Gross Tax Revenue, States share and net Tax Revenue of Centre in BE 2008-09 are placed at Rs.6,87,715 crore, Rs.1,78,765 crore, and Rs.5,07,150 crore respectively, representing growth rates of 25.5 per cent, 25.5 per cent and 25.6 per cent over BE 2007-08.

9. Growth in tax is driven more by direct taxes. Direct taxes which were 43 percent of gross tax revenue in 2004-05 have gone up by 53 percent in BE 2008-09. Rising income tax collections and improved tax compliance have *interalia* impacted the Tax:GDP ratio. The procedural reforms aimed at expanding tax base, improving efficiency in tax collections, while also providing certain concessions in order to encourage investments are at the core of the remarkable performance in tax collections. Exemptions to promote physical infrastructure, research and development in industry, development of North-Eastern region, exemptions to investment in bonds issued by a notified State Pooled Finance Entity on behalf of urban local bodies, incentives to certain investment relating to Commonwealth Games are a case in point. The coverage under Service tax is expanding. Now it covers more than 100 services.

10. The fiscal indicators shown in Table in paragraph A are based on normal tax buoyancy and do not envisage any significant Additional Resource Mobilisation (ARM) measures. Efforts in this regard would continue to make available additional resources for finding higher outlays on expenditures.

(b) Non-tax-revenue

11. The non-tax revenue (NTR) is set to increase from Rs. 82,550 crore in BE 2007-08 to Rs. 95,785 crore in BE 2008-09 registering a growth of 16.0 per cent. Receipts from dividends and profits constitute the largest component of NTR at Rs. 43,204 crore in BE 2008-09, as compared to Rs. 33,925 crore in BE 2007-08. Better performance of Central Public Sector Undertakings (CPSUs) particularly in power, coal, steel and telecommunication sectors is expected to yield higher returns along with transfers from financial institutions. Consequent to Govt. of India acquiring RBI's stake in SBI, the dividend is expected to flow thereon to Govt. of India. Interest receipts also constitute a substantial component at 20 per cent of NTR in BE 2008-09. However, interest receipts from States are likely to decline in the medium term, mainly due to Centre's disengagement from financial intermediation on the recommendation of the Twelfth Finance Commission on lending to States except for loans under externally aided projects. More specifically, the following factors, continue to cause the downward trend in interest receipts for some more time: (i) reduced lending rates on the loans; (ii) incentive linked restructuring of debt of State Governments that enact fiscal responsibility legislation; (iii) prepayments of loans by CPSUs etc. that took advantage of earlier soft interest rate regime. The buoyancy in other sources of NTR is unlikely to be of a magnitude, that is large enough to offset the above-mentioned factors. Therefore, NTR which constituted 1.8 per cent of GDP in BE 2007-08, is estimated to decline to 2.0 per cent of GDP in BE 2008-09. In BE 2007-08, the same is set to go further down to 1.78 per cent of GDP. In the medium term, NTR is expected to marginally improve in absolute terms but show a progressively declining trend as a proportion of GDP.

(c) Devolution to States

12. The TFC has recommended that during 2005-10, 30.5 per cent of the net proceeds of shareable taxes, will be distributed to the States according to specified share of each State. TFC has also recommended that if the states are allowed to levy Sales tax (or VAT) on sugar, textiles, tobacco, the share of the States in the net proceeds of shareable Central Taxes shall be reduced to 29.5.

2. Capital receipts

(a) Recovery of loans

13. Repayment of receipts against loans extended earlier are estimated to decline over a period of time on account of twin reasons of gradual disintermediation by Central Government and the debt consolidation that has taken place. Over time, State Governments and Central Public Sector Undertakings 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. The repayment of loans from PSEs is also impacted on account of defaults from PSEs that are either sick or under revival through BIFR.

(b) Other non-debt capital receipts

14. 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 is in Public Account and funds would be invested through professionally managed selected Public Sector Mutual Funds to provide sustainable returns without depleting the corpus proceed, and to be used for the sick units as well as for social sector spending as per policy.

(c) Borrowings — Public Debt and Other Liabilities

15. 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 or through cash draw down. 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.

16. Two items included in the domestic debt/liabilities of the Central Government are not related to the fiscal deficit. These are Net accretions to NSS and Borrowing under Market Stabilization Scheme. Net accretion to the National Small Savings Fund, to the extent of 80 per cent to 100 per cent is transferred to State Govt. as per their option with effect from 1.4.2007, through investment in State Government special securities issued for the purpose. However, these are liabilities of the Central Government and are therefore, included as such. On the other hand, borrowings under Market Stabilization Scheme are raised by Government of India within the overall ceiling mutually agreed between Government of India and Reserve Bank of India (RBI) 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 Government 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

17. Plan Revenue expenditure is estimated to increase from Rs.1,74,354 crore in BE 2007-08 to Rs.2,09,767 crore in BE 2008-09, i.e. an increase of 20.3 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, Agriculture, Integrated Child Development Scheme, National Social Assistance Programme, Accelerated Irrigation Benefit Programme, Special Plan Assistance to States, and for physical infrastructure including roads. Total Plan grants to States are estimated to increase from Rs.65,027 crore in BE 2007-08 to Rs.81,452 crore in BE 2008-09, representing an increase of 25.3 per cent.

Non-Plan Revenue expenditure

18. Non-Plan revenue expenditure is budgeted to increase from Rs.3,83,546 crore in BE 2007-08 to Rs.4,48,352 crore in BE 2008-09, i.e. an increase of modest 16.9 per cent. The major items of non-plan expenditure are detailed below.

(i) *Interest payments*

19. The interest payment expenditure is projected to increase from Rs.1,58,995 crore in BE 2007-08 to Rs.1,90,807 crore in BE 2008-09, showing an increase of 20.0 per cent. This increase is mainly due to high requirement for interest on market loans, Market Stabilization Scheme, and interest on Special securities issued to Oil Marketing Companies, Food Corporation of India and Fertilizer Companies. As a result, interest payments as percentage of Net Revenue Receipts of Central Government is estimated to decline from 32.7 per cent to 31.6 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. This process has assisted release of significant fiscal space to meet pressures of higher plan expenditure.

(ii) *Defence Services*

20. Total Defence Services expenditure is budgeted to increase from Rs.96,000 crore in BE 2007-08 to Rs.1,05,600 crore in BE 2008-09. The budgeted allocations for 2008-09 include Revenue expenditure component of Rs.57,593 crore, as against Rs.54,078 crore in BE 2007-08, i.e. an increase of 6.5 per cent. The capital outlays for Defence is budgeted at Rs.48,007 crore in BE 2008-09, up from Rs.41,922 crore in BE 2007-08, representing a growth of 14.5 per cent.

(iii) *Major subsidies*

21. The allocation for major subsidies, i.e. food, fertilizers and petroleum products is estimated to be Rs.66,537 crore in BE 2008-09 as against Rs.50,987 crore in BE 2007-08. The main reasons for increase in subsidies is higher input cost, increase in costs of fertilizers, enhanced minimum support price and increase in carrying

costs of food grains. Further, interest subsidy under export promotion and interest subvention also add to revenue expenditure.

(iv) *Non-Plan Grants to States*

22. The Non-Plan Grants to States/UTs in 2008-09 are placed at Rs.43,294 crore, as against Rs.38,403 crore in BE 2007-08, signifying an increase of 12.7 percent. The Central Government continues its commitment to compensate 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 and phase out of CST, a provision of Rs. 5,793 crore has been made in BE 2008-09 for this purpose, as against BE of Rs.5,495 crore in 2007-08.

(v) *Others*

23. 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*

24. 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. As regards the domestic loans, the States are to raise such loans directly without budgetary intermediation of the Central Government.

(ii) *Capital outlay*

25. The total Capital expenditure is set to increase from Rs.82,621 crore in BE 2007-08 (excluding Provision of Rs.40,000 crore for transfer of RBI's stake in SBI) to Rs. 92,765 crore in BE 2008-09. Of this, total non-plan capital expenditure is Rs. 59,146 crore as against Rs. 51,875 crore (excluding Provision of Rs.40,000 crore for transfer of RBI's stake in SBI). Defence Capital Outlay constitute the largest component of non-plan capital expenditure at Rs. 48,007 crore in 2008-09. The other non-plan capital expenditure is Rs. 11,139 crore.

26. The plan capital expenditure has increased from Rs.30,746 crore in BE 2007-08 to Rs. 33,618 crore in BE 2008-09 registering an increase of 9.6 percent. The share of plan capital outlay in BE 2008-09 constitute about 13.8 percent of Gross Budgetary support of Rs. 2,43,386 crore. As a percentage to GDP, plan capital expenditure stands at 0.63 percent in BE 2008-09 as against 0.66 in BE 2007-08.

4. GDP Growth

27. The growth in GDP at factor cost at constant (1999-2000) prices for 2007-08 is estimated at 8.7 per cent as compared to the growth rate of 9.6 percent during 2006-07. The growth rate at current market prices during the 2006-07 (Quick Estimates) and 2007-08 (Advance estimates) have been put at 15.8 per cent and 13.2 percent respectively. The growth rate for 2008-09 has been assumed at 13.0 percent. For the years beyond 2008-09 a trend growth of 13.0 percent has been assumed, and the fiscal targets as indicated in Table-A have been set accordingly. With the advance estimates of GDP at current market prices in 2007-08 being Rs. 46,93,602 crore, GDP at current market prices for 2008-09 is pegged at Rs.53, 03,770 crore.

(c) Assessment of sustainability relating to

(i) *the balance between revenue receipts and revenue expenditure*

28. The revenue deficit is estimated to decline from 1.5 percent of GDP in BE 2007-08 to 1.0 per cent in BE 2008-09. The improvement in the balance between revenue receipts and expenditure is a result of the increase in revenue receipts at 25.5 per cent outpacing the growth in revenue expenditure pegged at 18.0 per cent over that of BE 2007-08. The increase in revenue receipts amounting to Rs.1,16,513 crore is solely on account of increases in the tax revenues amounting to Rs.1,03,278 crore. Accordingly, the share of taxes in

the revenue receipts of the Central Government is estimated to increase from 83.0 per cent in BE 2007-08 to 84.1 per cent in BE 2008-09. The increase in tax receipts is reflected in the Gross Tax:GDP ratio increasing from 11.8 per cent to 13.0 per cent in BE 2008-09. The better than budgeted performance of tax revenue is mainly due to buoyant economy on the one hand and the liberal, equitable and efficiency inducing tax reform measures on the other. Such measurers include broadening of the tax base, expansion of the service tax net, phased rationalization of exemptions, plugging of loopholes and improvements in tax administration. The continuity and further progress in the mix of such reform measures would have to be continued in order to sustain the momentum in tax collections. Special efforts would be required to further expand the share of taxable sector of the economy through coverage of agriculture and service sectors. On the non-tax revenues, measures would need to be stepped up to realize the optimum potential of receipts from profit making PSUs, rationalization of user charges on public goods and services, and allocation rights in respect of mineral and other resources like 'spectrum'.

29. Buoyant revenue receipts in 2008-09 BE at 25.5 per cent over BE 2007-08, exceeds the growth in revenue expenditure at 18 percent in BE 2008-09 over that of BE 2007-08. More specifically, the growth in non-plan revenue expenditure at 17 percent is lower than the growth in revenue expenditure. Whereas the growth in plan revenue expenditure stands at 20.3 percent. This has been achieved despite pressure of various obligatory commitments like interests, pensions, salaries, defence, police, subsidies and transfers to states. Particularly, the increase in interest payments is due to higher amount required for payment of interest to meet costs of Market Stabilization Scheme, market loans and interest on special securities issued to Oil Marketing Companies, Food Corporation of India, and Fertilizer Companies. Such payments are substantially higher, and thus leave very narrow space for reducing the revenue expenditure. Therefore, the reduction in revenue deficit as per FRBM Road map has to be assessed in the backdrop of significant growth in major components of non-plan expenditure. Furthermore, the pressures on subsidies, however, remain due to volatility in commodity prices including those of energy prices. The substantial hike in plan revenue expenditure in BE 2008-09 at 20 percent over that of BE 2007-08 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 rural India. These allocations are likely to generate employment in rural areas while also providing better connectivity and improved quality of life particularly through enhanced access to health and education facilities. The Government is emphasizing on the outcome from the outlays and is keen to ensure spending discipline by implementing agencies.

30. Capital expenditure of the Central Government continues to decline largely on account of disintermediation of loans to State Governments and they can directly access the market now. This shift, at one level signals a positive development of vibrant capital market in the country and at the same time reduced dependency of State Governments on financial intermediation by Central Government. This approach also encourages rigorous test of financial and commercial viability of the projects/schemes being implemented by the borrowing entities through greater market discipline. The fiscal space being created 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 there from. 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 18.46 per cent from Rs.1,65,053 crore in BE 2007-08 to Rs. 1,95,531 crore in 2008-09.

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

31. In BE 2008-09, the total Plan expenditure, commonly identified with developmental expenditure of Rs.2,43,386 crore is about 182.6 per cent of the Fiscal deficit estimated at Rs.1,33,287 crore. This implies a confirmation of healthy trend of plan expenditure exceeding the fiscal deficit achieved in 2007-08 (135.9 per cent) for the third time since the beginning of the economic reforms process. 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, deepening and widening of debt market, which result in minimum 'crowding out' of private investments so as to achieve sustained and broad based economic growth, while at the same time, enabling Government to raise resources to finance its expenditure requirements.

32. During the FRBM mandated regime, sustained efforts on the part of revenue administration yielded the revenue to match ambitious targets. Thus, on the strength of buoyant tax performance, and institutional improvement in conjunction with measure to reasonably rationalize expenditure, the fiscal performance is on course. One of the core objectives of the FRBM Act is to induce a qualitative change in the composition of expenditure. The change is to be in favour of capital expenditure and against increase in revenue expenditure. However, the virtuous shift in Plan expenditure towards the social sectors, will be treated as revenue expenditure as per extant accounting/budget definitions. In other words, all grants from Central Government to States and other entities are treated as revenue expenditure without regard to their end-use in asset creation. In this background, and to expand the fiscal space, the medium term fiscal consolidation efforts would have to focus on containing the growth in revenue expenditure within the growth in revenue receipts. This is sought to be achieved through reduced share of non-plan revenue expenditure, while also increasing plan capital expenditure. Measures in this direction would have to include limiting subsidies and reducing interest burden. However, both these are subjected to global economic factors like volatility in commodity prices and interest rate fluctuations.

33. The process of fiscal consolidation has shown good results over the last four years in terms of (i) reduction in revenue deficit from a high of 3.6 per cent in 2003-04 to 1.4 per cent in RE 2007-08 and fiscal deficit from a high of 4.5 per cent to 3.1 per cent, in RE 2007-08. The task ahead in order to achieve the end of the year revenue deficit target is more complex and challenging. Though the endeavour in this regard is expected to be facilitated by continued buoyancy in revenues on the strength of a higher growth trajectory, the risk of volatility in international prices, fluctuating interest rates and the global growth trends will certainly influence our approach to the management of revenue deficit in accordance with the revised revenue deficit targets in the medium term.