FISCAL POLICY STRATEGY STATEMENT

A. FISCAL POLICY OVERVIEW

1. The Union Budget 2008-09 was presented in the backdrop of impressive growth in the Indian economy which clocked about 9 per cent of average growth in the last four years. This striking performance coupled with significant improvement in fiscal indicators, during the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 regime definitely put the country on a higher growth trajectory inspiring confidence in the medium to long term prospects of the economy. The process of fiscal consolidation during these years has resulted in improvement in fiscal deficit from 5.9 per cent of GDP in 2002-03 to 2.7 per cent of GDP in 2007-08. During the same period, revenue deficit has declined from 4.4 per cent to 1.1 per cent of GDP. In tune with the philosophy of equitable growth, the process of fiscal consolidation was taken forward without constricting the much-required social sector and infrastructure related expenditure. This improvement in the state of public finances was achieved through higher revenue buoyancy, driven by efficient tax administration and improved compliance which is evident from increase in the tax to GDP ratio from 8.8 per cent in 2002-03 to 12.5 per cent in 2007-08.

2. Riding on the path of fiscal consolidation, the Union Budget 2008-09 was presented with fiscal deficit estimated at 2.5 per cent of GDP and revenue deficit at 1 per cent of GDP. However after the presentation of the Union Budget in February 2008, the world economy was hit by three unprecedented crises – first, the petroleum price rise; second, rise in prices of other commodities; and third, the breakdown of the financial system. The combined effect of these crises of these orders are bound to affect emerging market economies and India was no exception. The first two crises resulted in serious inflationary pressure in the first half of 2008-09. The focus of the monetary as well as fiscal policy shifted from fuelling growth to containing inflation, which had reached 12.9 per cent in August, 2008. Series of fiscal measures both on tax revenue and expenditure side were undertaken with the objective of easing supply side constraints. These measures were supplemented by monetary initiatives through policy rate changes by the Reserve Bank of India, and contributed to the softening of domestic prices. Headline inflation fell to 4.39 per cent in January, 2009. However, the fiscal measures undertaken through tax concessions and increased expenditure on food, fertiliser and petroleum subsidies along with increased wage bill for implementing the Sixth Central Pay Commission recommendations significantly altered the deficit position of the Government.

3. The global financial crisis in the second half of the financial year which heralded recessionary trends the world over, also impacted the Indian economy causing the focus of fiscal policy to be shifted to providing growth stimulus. The moderation in growth of the economy and the impact of the fiscal measures taken to stimulate growth can be seen reflected in the estimates for gross tax revenue which stand reduced from Rs.6,87,715 crore in B.E.2008-09 to Rs.6,27,949 crore in R.E.2008-09. Additional budgetary resources of Rs.1,50,320 crore provided as part of stimulus package and various committed liabilities of Government including rising subsidy requirement, provision under NREGS, implementation of Central Sixth Pay Commission recommendations and Agriculture Debt Waiver and Debt Relief Scheme for Farmers contributed to the higher fiscal deficit of 6 per cent of GDP in RE 2008-09 as compared to 2.5 per cent of GDP in B.E.2008-09.

4. The Country is facing difficult economic situation, the cause of which is not emanating from within its boundaries. However, left unattended, the impact of this crisis is going to affect us in medium to long term. The Government had two policy options before it. In view of falling buoyancy in tax receipts, the Government could have taken a decision to cut expenditure and thereby live within the estimated deficit for the year. The second option was to increase public expenditure, even with reduced receipts, to stimulate economy by creating demand and maintain the growth trajectory which the country was witnessing in the recent past. The Government took the second option of adopting fiscal measures to increase public expenditure to boost demand and increase investment in infrastructure sector. Ensuring revival of the higher growth of the economy will restore revenue buoyancy in medium term and afford the required fiscal space to revert to the path of fiscal consolidation.

B. FISCAL POLICY FOR THE ENSUING FINANCIAL YEAR

5. The Interim Budget 2009-2010 is being presented in the backdrop of uncertainties prevailing in the world economy. The impact of this is seen in the moderation of the recent trend in growth of the Indian economy in 2008-09 which at 7.1 per cent still however makes India the second fastest growing economy in the World. The measures taken by Government to counter the effects of the global meltdown on the Indian economy, have resulted in a short fall in revenues and substantial increases in government expenditures, leading to a temporary deviation from the fiscal consolidation path mandated under the FRBM Act during 2008-09 and 2009-2010. The revenue deficit and fiscal deficit for R.E.2008-09 and B.E.2009-2010 are, as a result, higher than the targets set under the FRBM Act and Rules. The grounds due to which this temporary deviation has taken place, are detailed in the Fiscal Policy Overview above and also in the Macro-economic Framework Statement being presented in the Parliament. The fiscal policy for the year 2009-2010 will continue to be guided by the objectives of keeping the economy on the higher growth trajectory amidst global slowdown by creating demand through increased public expenditure in identified sectors. However, the medium term objective will be to revert to the path of fiscal consolidation at the earliest, with improvement in the economic situation.

Tax Policy

Indirect Taxes

6. During the first half of the fiscal year, the global spurt in commodity prices (crude petroleum, food items and metals) led to increases in domestic prices of essential items and industrial inputs, putting a severe inflationary pressure on the economy. Hence, the Government took several measures after the presentation of the Union Budget 2008-09, particularly on the Customs side, to contain the rising inflation, as detailed below:-

Customs

- On 21.3.2008, to curb the inflationary trends in the economy arising out of a rise in prices of food items, a sharp reduction was effected in the import duty rates on various food items such as semi-milled or wholly milled rice (70% to nil) and crude and refined edible oils (from 40%-75% to 20%-27.5%). On 01.04.2008, a further reduction was effected in the import duty rate- on all crude edible oils duty was reduced to nil, and on refined edible oils duty was reduced to 7.5%.
- Export duty of Rs.8,000 PMT was imposed on exports of Basmati rice with effect from 10.5.2008.
- With effect from 10.5.2008, import duties on crude petroleum was reduced to nil and on petrol and diesel to 2.5% (earlier 7.5%). Customs duty on other petroleum products was reduced from 10% to 5% on 04.06.2008.
- Import duties were reduced to nil on many iron and steel items as well as on specified inputs for this sector (zinc, ferro-alloys, metcoke) on 29.4.2008. Further, in order to increase the domestic availability and bring about moderation in prices, export duties were imposed on many items in the iron and steel sector @ 15% ad valorem on pig iron, sponge iron, iron and steel scrap, iron or steel pencil ingots, semi finished products and HR coils/sheets, etc.
- On 08.07.2008, raw cotton was also fully exempted from customs duties so as to contain the prices of raw cotton and augment the domestic supply.

Excise

- With effect from 04.06.2008, excise duty on unbranded motor spirit (MS) was reduced from Rs.6.35 per litre to Rs.5.35 per litre and on unbranded high speed diesel (HSD), excise duty was reduced from Rs.2.6 per litre to Rs.1.6 per litre.

In the post-October stage, while the inflationary pressures on the economy were subdued, the global meltdown and resultant slowdown of the Indian economy required review of the existing policy in favour of maintaining the growth momentum and retaining export markets. As such, the following policy changes were effected which would be reviewed in the ensuing financial year in the light of the macro-economic situation particularly the growth of the manufacturing sector:-

Excise

- With effect from 07.12.2008, a fiscal stimulus package was implemented.
- As part of this package, Government implemented an across-the board reduction of 4 percentage points in the ad valorem rates of excise duty on non-petroleum items, with a few exceptions. Thus the three major ad valorem rates of Central Excise duty viz. 14%, 12% and 8% have been reduced to 10%, 8% and 4% respectively.
- The specific rates of duty applicable to cement and cement clinker were also reduced proportionately.

Customs

- Export duties on iron and steel items were withdrawn w.e.f. 31.10.2008.
- Aviation turbine fuel was fully exempted from basic customs duty for the benefit of the aviation industry w.e.f. 31.10.2008.
- In addition, to provide a level playing field to the domestic industry, some customs duty exemptions provided earlier to combat inflation, on iron and steel items, zinc and ferro-alloys, were withdrawn w.e.f. 18.11.2008.
- As an incentive to the infrastructure sector, the CVD and Special CVD exemption granted to imports of cement has been withdrawn w.e.f. 2nd January, 2009 to provide a cushion to domestic cement industry and boost demand.
- In the power sector, customs duty on naphtha used for generation of electricity by electrical generating stations has been fully exempted w.e.f. 2nd January, 2009 till the end of this financial year.

Service Tax

- The refund of service tax paid by exporters on various taxable services attributable to export of goods has been further extended to include clearing and forwarding agents services.
- The upper limit of refund of service tax paid by exporters on foreign commission agent services has been enhanced from 2% of FOB value to 10% of FOB value of export goods.
- Drawback benefit can now be availed of simultaneously with refund of service tax paid in respect of exports.
- In order to mitigate the genuine hardships of goods transport agencies, eight specified services which are provided to goods transport agency have also been fully exempted from service tax.

Direct Taxes

7. Over the last five years, widespread reforms have been ushered in the area of direct taxes. The reform strategy comprises the following elements: -

- Minimizing distortions within the tax structure by expanding the tax base and rationalizing the tax rates.
- Enabling the tax administration to provide quality taxpayer services and also enhance deterrence levels. Both these objectives reinforce each other and have promoted voluntary compliance.
- Re-engineering business processes in the Income-tax Department through extensive use of information technology, viz., e-filing of returns; issue of refunds through ECS and refund bankers; selection of returns for scrutiny through computers; e-payment of taxes; establishing a Centralized Processing Centre and an effective taxpayer information system.

These measures have substantially enhanced the direct tax revenue productivity from 3.81 per cent of GDP in 2003-04 to an estimated 6.35 per cent of GDP in 2008-09. Further, the share of direct taxes in the Central tax revenues is now significantly higher than the share of indirect taxes resulting in a substantial improvement in the equity of the tax system. Therefore, the reform strategy in the medium term is to consolidate the achievements of the past.

8. Since there is no change in the tax base and rates, the prospects of growth in direct tax collection in the ensuing financial year will remain unchanged vis-a-vis the revised estimate for the financial year 2008-09.

Contingent and other Liabilities

9. The FRBM Act mandates the Central Government to specify the annual target for assuming contingent liabilities in the form of guarantees. Accordingly the FRBM Rules prescribe a cap of 0.5 per cent of GDP in any financial year on the quantum of guarantees that the Central Government can assume in the particular financial year. The Central Government extends guarantees primarily on loans from multilateral/bilateral agencies, bond issues and other loans raised by various Public Sector Undertakings/Public Sector Financial Institutions. The stock of contingent liabilities in the form of guarantees given by the government has reduced from Rs.1,07,957 crore at the beginning of the FRBM Act regime i.e. 2004-05 to Rs.1,04,872 crore at the end of 2007-08. As a percentage of GDP, it has reduced from 3.4 per cent in 2004-05 to 2.3 per cent in year 2006-07 and further to 2.2 per cent for the year 2007-08. The disclosure statement on outstanding Guarantees as prescribed in the FRBM Rules, 2004 is appended in the Receipts Budget as Annex 3 (iii).

10. Assumption of contingent liability in the form of guarantee by the sovereign helps to leverage private sector participation in areas of national priorities. In the current situation, wherein a large number of infrastructure projects are being cleared for implementation under the Public Private Partnership (PPP) mode, difficulties are being faced in reaching financial closure due to the current uncertainties in the global financial market. Within the given fiscal constraints and with a view to supporting financing of above mentioned PPP projects, the India Infrastructure Financing Company Limited (IIFCL) has been authorized to raise Rs.10,000 crore through Government guaranteed tax free bonds, by the end of 2008-09 and additional Rs.30,000 crore on the same basis as per requirement in the next financial year. The capital so raised will be used by IIFCL to refinance bank lending of longer maturity to eligible infrastructure projects. This initiative of the government is expected to result in leveraging of bank financing to PPP programmes of about Rs. one lakh crore. The likely assumption of contingent liability in the form of guarantee for 2008-09, including the above mentioned Rs.10,000 crore for IIFCL, will amount to Rs.36,606 crore which will be 0.67 percentage of GDP during 2008-09, higher than the target of 0.5 per cent of GDP set under the FRBM Rules. This deviation has been necessiated in the larger interest of re-invigorating the economy in the background of the current economic scenario, to stimulate demand and increase investment in infrastructure sector projects. In the medium term while this may not have a potential budgetary impact, the additional demand thus created will help restore the economy to its higher growth path and contribute to higher revenue buoyancy which has shown a slump in the current financial year due to moderation in the growth in economy.

Government Borrowings, Lending and Investments

11. The Government policy towards borrowings to finance its deficit continues to remain anchored on the following principles namely (i) greater reliance on domestic borrowings over external debt, (ii) preference for market borrowings over instruments carrying administered interest rates, (iii) elongation of the maturity profile and consolidation of the debt portfolio and (iv) development of a deep and wide market for Government securities to improve liquidity in secondary market.

12. In the first half of the current financial year, the government borrowing was in line with the indicated auction calendar decided upon in consultation with the Reserve Bank of India. However, due to the need to provide the fiscal stimulus to counter the situation created by the effects of the global financial crisis, the borrowing calendar of the government had to be revised in the second half of the current financial year. The gross and net market borrowings (dated securities and 364- day Treasury Bills) of the Central Government during 2008-09 (up to February 9, 2009) amounted to Rs.2,40,167 crore and Rs.1,68,710 crore respectively. As part of policy to elongate maturity profile, Central Government has been issuing securities with maximum

30–year maturity. The weighted average maturity of dated securities issued during 2008-09 (up to February 9, 2009) was 14.45 years which was marginally lower than 14.90 years during the corresponding period of the previous year. The weighted average yield of dated securities issued during 2008-09 (up to February 9, 2009) was 7.91 per cent and was lower than 8.12 per cent during the corresponding period of last year.

13. Consequent to the transition to the FRBM Act mandated environment, recourse to borrowing from RBI under normal circumstances is prohibited. During the year 2008-09 (up to February 7, 2009) the Central Government resorted to ways and means advance to meet the temporary mismatch in receipts and expenditure for 77 days as compared with 91 days a year ago. The daily average utilization of ways and means advance by the Central Government was Rs.7,383 crore as compared with Rs.14,498 crore a year ago. The Central Government also availed of Overdraft (OD) for 24 days up to February 7, 2009. The daily average of OD was Rs.11,233 crore as compared with Rs.6,381 crore a year ago.

14. The outstanding balance under Market Stabilization Scheme (MSS) on 1st April, 2008 was Rs.1,70,554 crore. Notwithstanding fresh issuance of Rs.43,500 crore during 2008-09, the outstanding balance under the MSS declined to Rs.1,05,773 crore mainly reflecting the change in policy and unwinding MSS through buy-back of Rs.47,544 crores. This was done in order to ease liquidity in the system in the backgrounds of the additional borrowing plan during the second half of 2008-09 to finance the increased deficit.

15. In order to have prudent management of debt and greater focus on carrying cost as well as meeting secondary market liquidity, the government has set up a Middle Office which in due course will merge with the proposed Debt Management Office.

16. Central Government has stopped playing the role of financial intermediary for State Government for domestic market borrowings and the trends in the current year shows that this transition has been very smooth resulting in reduction in cost for the State Governments while at the same time bringing in a sense of market discipline.

17. Government has set up National Investment Fund (NIF) to which the disinvestment proceeds from Central PSUs are being transferred. This fund is being managed by professional fund managers. The receipts in the Fund are not reckoned as resources for the purpose of financing the fiscal deficit. The income from investments under NIF is used to finance social infrastructure and provide capital to viable public sector enterprises without depleting the corpus of NIF.

Initiatives in Public Expenditure Management

18. The focus has shifted from financial outlays to outcomes for ensuring that the budgetary provisions are not merely spent within the financial year but have resulted in intended outcomes. Initiatives have been taken to evenly pace plan expenditure during the year and also to avoid rush of expenditure at the year end which results in poor quality of expenditure. The practice of restricting the expenditure in the month of March to 15 per cent of budget allocation within the fourth quarter ceiling of 33 per cent is being enforced religiously. The quarterly exchequer control based cash and expenditure management system which inter alia involves preparing a Monthly Expenditure Plan (MEP) continues to be followed in select Demands for Grants. The emphasis is on right pacing plan expenditure by ensuring adequate resources for execution of budgeted schemes. At the same time, steps have also been taken in the form of austerity instructions to reduce expenditure in non-priority areas without compromising on operational efficiency. This has resulted in availability of adequate resources from realised receipts for priority schemes.

19. Delays in receipts of utilization certificate are broadly indicative of poor implementation strategy, diversion of funds or delay in utilization of funds for intended purposes. Monitoring of utilization certificates and unspent balances with the implementing authorities is reviewed at the highest level in the Ministry of Finance. Necessary control mechanisms have been put in place with the help of the office of the Controller General of Accounts (CGA) to avoid parking of funds and to track expenditure.

20. A central monitoring, evaluation and accounting system for the 1258 centrally sponsored schemes and central sector schemes of the Government has been instituted under the Central Plan Schemes Monitoring System. All sanctions issued by the Central Ministries under these schemes are now identified with a unique sanction ID that enables the tracking of release as per their accounting and budget heads across the different implementing agencies. This central system is hosted on the e-lekha portal of the CGA.

21. In addition pilots are currently underway in the States of Punjab, Karnataka and Uttarakhand for testing a system for expenditure filing and direct payment to beneficiaries under the schemes. The results of the pilot would form the basis of designing comprehensive IT based Decision Support System and Management Information System for all the centrally sponsored schemes and central sector schemes. This initiative assumes special significance in the light of the significant increase in the social sector spending by the Government.

22. The application software COMPACT has been extended to all civil ministries of the Government and expenditure data is being uploaded on a daily basis by the Pay and Accounts Offices on e-lekha. This is a significant step towards faster and accurate compilation of the accounts for the Government of India and will lead to the development of a core accounting solution. The monthly and annual Finance and Appropriation Accounts are regularly updated on the CGA website: www.cgaindia.gov.in.

C. POLICY EVALUATION

23. The process of fiscal consolidation during the FRBM Act regime has created necessary fiscal space to undertake much needed social sector expenditure and provide for higher infrastructure outlays. The performance up to 2007-08 was heartening. Fiscal deficit was brought down from 4.5 per cent of GDP in 2003-04 to 2.7 per cent in 2007-08. Similarly, revenue deficit was reduced from 3.6 per cent of GDP in 2003-04 to 1.1 per cent in 2007-08. The government was steadfast in following the fiscal consolidation path which is reflected in the deficit estimates of B.E.2008-09. However, subsequent to the global meltdown, there was a compelling need to adjust the fiscal policy to take care of exceptional circumstances through which the economy has been passing. The result of the fiscal measures taken by the Government for containing inflation has been positive as is evident from headline inflation dropping from high of 12.9 per cent in August 2008 to 4.39 per cent in January 2009. Similarly the intervention of the Government has ensured that the economy grows at a healthy rate of 7.1 per cent in a difficult year when most of the developed economies are facing recession. The fiscal consolidation process has to be put on hold temporarily. The process of fiscal consolidation will be back on track once there is an improvement in economic conditions.