FISCAL POLICY STRATEGY STATEMENT

A. Fiscal Policy Overview

1. Managing fiscal discipline in the midst of competitive demands on public resources and tax expenditures vis-à-vis varied and often conflicting expectations of stake holders is a complex exercise. The last three years' fiscal results, particularly measured against the deficit targets, demonstrate the effectiveness of managing resources on the FRBMA compliant road map. It is reassuring that deficits have been contained within the mandated limits. The upswing in growth has appeared to have propelled the economy to 'take-off', and compared to pre-FRBMA period is more encouraging, as it has been accompanied with a reduction in fiscal deficit from a level of 5.9 per cent of GDP in 2002-03 to 3.7 per cent of GDP in RE 2006-07. During the same period, revenue deficit has declined from 4.4 per cent of GDP to 2.0 per cent of GDP. Tax-GDP ratio which was 8.8 per cent in 2002-03 is estimated to go up to 11.4 per cent in RE 2006-07. Annual growth in GDP, at constant (1999-2000) prices at factor cost in 2002-03 was 3.8 per cent. The advance estimate of GDP growth in 2006-07 is pegged at 9.2 per cent.

2. The improvement in deficit indicators has been achieved through improvement in tax-GDP ratio and measured increase in non-developmental expenditure, in the backdrop of moderate growth in non-tax revenue and increasing demand for investment requirements for social sector flagship programmes of the Government. The tax reforms, within the broad fiscal policy framework aimed at yielding benefits across the sectors and classes, during this period have laid the foundation for increasing tax-GDP ratio. Simultaneously, the tax-reform process, by increasingly rationalizing the tax rates and widening the tax base, has augmented the resources available to the Central Government and to the States through higher devolution. The improvement in the external sector, in terms of growth in exports, share in international trade, decline in external indebtedness, continue to be impressive. The process of fiscal consolidation on the FRBMA roadmap would need to be sustained to meet the mandated annual targets**.** Therefore, the revenue–led correction along with re-prioritized expenditure approach needs to be continued within the overarching goal of macroeconomic stability and inclusive growth. Such an approach seeks fundamental changes in the structure of government expenditure. Capital expenditure, has to be raised to promote infrastructural development and accelerate the pace of growth. The revenue expenditure needs to be directed at sectors such as health and education to make growth equitable and inclusive.

B. Fiscal Policy for the Ensuing Financial Year

3. Budget 2007-08 is being presented in the backdrop of continuing robust economic growth and a better than budgeted fiscal performance during 2006-07. A new industrial resurgence, increasing domestic savings, a pick-up in capital formation and a rapid growth in exports are the emerging opportunities for raising resources and sharing prosperity. Simultaneously finding the resources required to achieve the Eleventh Five Year Plan objectives amidst the global uncertainties is a challenge. Keeping inflation within an acceptable range and reducing the costs of financing government spending while also recognizing the need for inter-generational equity are challenges that the Government is confident of surmounting. Collectively these opportunities and challenges reinforce the need for continuity in the prudent mix of fiscal and monetary policy measures with no scope to slip on the annual deficit targets.

4. The fiscal policy, on the lines of earlier years is being guided by the National Common Minimum Programme while also internalizing the objectives and priorities of the Eleventh Five Year Plan. The emphasis is on increased spending on critical social sectors, such as rural employment, school education and literacy, higher education, health and family welfare, nutrition, drinking water supply and sanitation. Larger allocations for physical infrastructure facilities like rural roads, housing and rural electrification, is expected to accelerate growth potential of farm and non-farm sectors in the rural areas and better integrate them with the rest of the economy. As part of direct attack on poverty through guaranteed gainful employment, the coverage of the National Rural Employment Guarantee Scheme is expected to be expanded in a phased manner. The Scheme simultaneously creates rural infrastructure, especially for efficient water management and enhances the rural asset base. The successively increased provisions for education (Sarva Shiksha Abhiyan and Mid-day Meals) and health care (National Rural Health Mission) will allow all sections of society to contribute to economic growth and share its benefits. Backward Regions Grants Fund (BRGF) aims at focused development of backward areas to reduce imbalances and speed up development through untied grants covering 250 districts. In keeping with the recommendation of the Oversight Committee (OSC) on implementation of the reservations for the OBC communities, a National Mission for Education through Information and Communication Technology (ICT) is being launched. Provision has also been made in the Budget 2007-08 for meeting the requirement for enhanced number of students, on the basis of OSC recommendations. The 'Bharat Nirman' Schemes have been provided additional funds during 2007-08 as well.

5. Continuing buoyancy in tax collections are resulting in higher fiscal devolution to States and thus the externalities flowing from fiscal correction are increasingly shared with States. State Governments, are also gaining by staying the course of fiscal correction. Most States have adopted the progressive VAT system. Provisions have been made for VAT related expenditure including modernization of VAT administration as well. Towards the goal of introduction of GST, CST phase out is scheduled to start with reduction of CST rate from 4 per cent to 3 per cent. A suitable provision for compensation to State/ UT Governments for revenue loss due to proposed phasing out CST has been made in the Budget 2007-08.

Government's Strategy to Pursue Fiscal Consolidation

Tax Policy

6. Sound tax system, with moderate rates and a broad base, is an integral part of the prudent fiscal policy. The expansion in the tax base is sought to be achieved through expansion in the scope of taxes, specifically service tax, removal of exemptions and improvement in tax administration. With a decline in non-tax revenue receipts as a proportion of overall revenue receipts, the burden of fiscal corrections is expected to be mainly on tax revenues. However, the measures to increase the tax-GDP ratio must be harmonized with the overall growth objective. The strategy seeks to increase tax compliance, improve the efficiency of tax administration and with intense focus on recovery of arrears of tax revenues and prevent further build-up of such arrears.

Indirect Taxes

Customs

- Continuing the policy of bringing down the tariffs, the peak rate of customs duty for non-agricultural imports is being reduced from 12.5 per cent to 10 per cent.
- In order to make available input materials at competitive rates to domestic manufacturers, in January 2006, substantial reduction in tariffs for capital goods, non-ferrous metals and inorganic chemicals has been made. Import

duty on chemicals and plastics is now being reduced from 12.5 per cent to 7.5 per cent

- With these changes, simple average tariff for non-agricultural goods will get reduced from the present level of 12.2 per cent to about 9.4 per cent.
- To reduce price of edible oils, additional CV duty of 4 per cent is being removed. On sunflower oil, tariffs are being reduced by 15 percentage points.
- To promote gems and jewellery industry, tariffs on cut and polished diamonds is being reduced from 5 per cent to 3 per cent and on rough synthetic stones from 12.5 per cent to 5 per cent.
- All the existing exemption notifications have been reviewed and some exemption notifications are being withdrawn.
- To preserve country's mineral sources, and to mop up part of high profits, export duty is being imposed on iron ores and chromium ores.
- Exemptions from tariff to aircrafts are being restricted to Government imports and imports by scheduled airlines.

Excise Duty

- The policy of expanding the tax base, rather than increasing the rate and moving towards CENVAT rate is being continued.
- To give boost to food processing industry, excise duty on cheaper biscuits and food mixes is being reduced to nil.
- To provide clean drinking water, excise duty has been exempted on membrane technology based water purification systems. Existing duty exemption is also extended to specified pipes for water supply projects.
- Duty on cement is being reduced from Rs. 400 to Rs. 350 for cement of MRP (Maximum retail price) not exceeding Rs. 190 per bag of 50 kg. Cements of higher MRP will attract excise duty at Rs. 600/MT.
- As part of broadening tax base, certain exemptions are being withdrawn.

Service Tax

- Widening of service tax base and increase in compliance continues to show high buoyancy in service tax revenue collection during 2006-07 also.
- In line with the Government's declared policy of broadening the tax base, the scope and coverage of services leviable to service tax is being further widened by adding more services and expanding the scope of some of the existing services.

Higher and Secondary Education Cess

- To provide more funds for higher and secondary education, a cess @ 1 per cent of the customs duty, excise duty and service tax is being imposed.

Direct Taxes

7. The strategy to maximize direct tax collections is basically two-fold: – Firstly, minimising distortions within the tax structure by expanding the tax base and maintaining moderate tax rates. Secondly, improving the efficiency and effectiveness of the tax administration so as to enhance voluntary compliance through a higher deterrence level.

8. The Union Budget 2006-07 has managed to consolidate the landmark achievements of the Budget 2005-06 in the field of direct tax reforms. Some major tax concessions provided in the Income-tax statute were either eliminated or rationalized to broaden the tax base. For example, the exemption of income of infrastructure capital companies, earned by way of long term capital gains, dividends and interest, under section 10(23G) was eliminated. Similarly, the deduction available to co-operative banks under section 80P was also withdrawn. The erosion of tax base on account of various incentives to the corporate sector was partly neutralized by raising the Minimum Alternate Tax (MAT) rate from 7.5 per cent to 10 per cent of the book profit and also by including long term capital gains from transfer of securities chargeable to Securities Transaction Tax within the ambit of MAT.

9. The policy proposals in the Union Budget 2007-08 are intended to further consolidate the achievements made in the last two budgets. Some of the major proposals for widening the tax base are:-

i. Expanding the MAT base by bringing the profits of Software Technology Parks of India (STPI) units and Export Oriented Units (EOUs) within its ambit.

ii. Restricting the allowability of expenditure under section 36(1)(xii) only to notified corporations or body corporates.

iii. Extending the applicability of Tax Deduction at Source (TDS) provisions to payments made to contractors by individuals and Hindu undivided families engaged in business and having turnover above a specified limit.

iv. Restricting the non-chargeability of capital gain tax on sale of a long-term capital asset, by investing the same in certain bonds, to a maximum amount of Rs. 50 lakhs in a year.

v. Expanding the scope of Fringe Benefit Tax (FBT) by including any specified security or sweat equity shares allotted by the employer – under any Equity Stock Option Plan – to his employees either free of cost or at a concessional rate within its ambit.

vi. Fulfilling the commitment of the Government to provide and finance secondary and higher education, it is proposed to levy an additional surcharge called the "Secondary and Higher Education cess on Income-Tax" at the rate of one per cent of income tax and surcharge (not including "Education cess on income-tax").

10. Among other proposals are the further rationalization of the provisions of Fringe Benefit Tax, TDS, charge and payment of interest under direct taxes, etc. and streamlining of tax procedures. Besides, the rate of Dividend Distribution Tax (DDT) for domestic companies on distribution of profits to share holders is proposed to be increased alongwith specifying new rates for Money Market Mutual Funds (MMMF) and Liquid Funds (LF) on distribution of income to unit holders.

11. Modernization of tax administration for ensuring better taxpayer services has been a constant endeavour of the Government and electronic filing of returns (compulsory for corporates and optional for others from financial year 2006-07) amply demonstrates the commitment of the Government on this front. Further, the introduction of annexure-less returns for all categories of taxpayers is a noteworthy taxpayer service.

12. A key feature of all efficient tax administrations is an effective taxpayers' information system. Over the past few years, the Income-tax Department has gradually migrated to non-intrusive methods of collecting and collating information about financial transactions of taxpayers. While the Banking Cash Transaction Tax (BCTT) and the Annual Information Returns (AIR) are already in place, the electronic filing of returns by companies – as mentioned above – has added an entirely new dimension to the Department's information

bank. As more information about taxpayers becomes available, the Department would be able to hand out better taxpayers services while simultaneously targeting tax evaders.

Contingent and other Liabilities

13. Assumption of contingent liabilities by the Sovereign helps to leverage private investment in areas of national priority given the limited availability of long-term funds. FRBM Rules envisage a cap of 0.5 per cent of GDP on the quantum of guarantees that the Central Government can assume annually. Within the ceiling prescribed under the Rules, Central Government extends guarantees on loans from multilateral/bilateral agencies, bond issues and other loans raised by PSUs and public sector financial institutions. It has been decided to extend guarantees to the borrowings of India Infrastructure Finance Company to raise long-term funds to finance viable infrastructure projects facing difficulties in accessing long-term debt. With the growth of financial markets, developments relating to credit rating, project evaluation, availability of commercial guarantees and general stability in respect of economic policies, and with further widening and deepening of the debt markets, the requirements for government guarantees is expected to decline in a gradual manner.

14. The stock of contingent liabilities in the form of guarantees given by the Government has increased from Rs.1,07,957 crore at the end of 2004-05 to Rs. 1,10,626 crore at the end of 2005-06. The number of guarantees during the same period has declined from 505 to 492. The net accretion of Rs. 2,668 crore during the year 2005-06 amounts to 0.07 per cent of the GDP for that year.

Government Borrowings, Lending and Investments

15. The Central Government policy towards borrowings to finance its fiscal deficit remains unchanged. It emphasizes (i) greater reliance on domestic borrowings over external debt, (ii) preference for market borrowings over higher cost and market distorting instruments carrying administered interest rates, (iii) elongation of maturity profile of its debt portfolio and consolidation of the same and (iv) development of a deep and wide market for government securities to improve secondary market tradability. As part of policy to elongate maturity profile, Central Government has been issuing securities with maximum 30-year maturity. With a view to passively consolidating its securities portfolio, greater reliance is placed on re-issues rather than on fresh issues. The transition to FRBM Act mandated environment with effect from April 1, 2006 wherein recourse to borrowing from RBI under normal circumstances was prohibited, has been smooth. During the year, the borrowing programme has been conducted broadly in line with the half yearly indicative calendar. Recourse to Ways & Means Advances from RBI has been minimal and for most part of the year, Government account has been placed in surplus cash position. This is a matter of great satisfaction and encourages the Government to take the next step in the area of debt management.

16. The window of Market Stabilization Scheme to assist RBI in its monetary policy objectives continues to be retained in terms of the Memorandum of Understanding between the Central Government and RBI. In order to provide greater flexibility to RBI, the annual ceiling is being increased from Rs.70,000 crore in 2006-07 to Rs.80,000 crore in 2007-08.

17. Prudent management of debt reduces its carrying cost over medium term, both directly and indirectly by infusing greater liquidity in the debt market. Towards this end, Government has been following the strategy of passive debt management through re-issue of dated securities. It is now proposed to undertake active debt consolidation, through buyback of securities by auction, switch or bilateral transaction. During 2007-08, provision of Rs. 2,500 crore has been made for expenditure on prepayment premium on such buybacks. During the year the facility of ‘when issued’ trade has been introduced in respect of re-issues to enable better price discovery in the securities auction.

18. To provide greater focus on debt management, it is proposed to set up a Middle Office that would prepare the roadmap for setting up of autonomous Debt Management Office (DMO).

19. The role of Central Government as a financial intermediary for State Governments/UTs, CPSUs, etc. has been declining over a period of time. The decline is in line with the development of financial markets in the country and with the spirit of economic reforms that envisages greater market scrutiny and discipline on the one hand, and desirability of affording the freedom to States to choose as to how and from whom to borrow on the other.

20. The Government has set up National Investment Fund (NIF) to transfer the disinvestment proceeds in respect of Central Public Sector Undertakings (CPSUs) to be managed by professional fund managers. As such, these receipts will not be reckoned as resources for the purposes of financing the fiscal deficit. The income from investments under NIF will be used to finance social infrastructure and provide capital to viable Public Sector Enterprises without depleting the corpus of NIF.

Initiatives in Public Expenditure Administration

- The need to improve the quality of implementation and enhance the efficiency and accountability of the delivery mechanism has been well recognized. Emphasis has shifted from outlays to outcomes for ensuring that the budgetary provisions are not only spent within the year but also intended outcomes are actually achieved.
- With effect from financial year 2007-08, the Performance Budget and the Outcome Budget hitherto presented to Parliament separately by Ministries/ Departments are to be merged and presented in a single document. The document would indicate goals of the Ministry/Department, policy framework, budget estimates, scheme-wise analysis of physical performance and linkage between financial outlays and outcomes. Actual physical performance in the preceding year (2005-06), performance in the first nine months (up to December) of the current year (2006-07) and the targeted performance during the next year (2007-08) are included in the document. Guidelines have been issued detailing the manner in which Outcome Budget has to be prepared.
- In order to rationalize expenditure for augmentation of revenues all the Ministries/Departments have been asked to follow austerity measures. These measures promote fiscal discipline without restricting operational efficiency of the Government. The measures include ban on creation of posts, pruning of foreign travel expenditure, review of personnel policies relating to periodicity of transfers so as to avoid associated expenditure, increased use of information technology for e-procurement and e-payments, limiting the advances for schemes/projects, strict monitoring of the implementation of schemes/ programmes to avoid cost and time overruns.
- Guidelines on financial limits to be observed in determining cases relating to New Service/New Instrument of Service have been revised. These guidelines seek to rationalize the existing nature of transactions along with updating the financial limits.
- Monitoring of utilization certificates and unspent balances with the implementing authorities is being continued and taken into consideration while assessing fund requirements. 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. Quite often, given the poor fund management skills available with the implementing agencies, the return on

such parking of funds is lower than the cost of borrowed funds to the Central Government, resulting in a 'Pareto inferior' situation. Strict enforcement and discipline in this regard will continue.

- In a bid to improve transparency and accountability, Ministries/Departments are expected to release a summary of their monthly receipts and expenditure to general public (through their website, etc.) and in particular, disclose scheme-wise funds released to different States.
- In order to avoid recurrence of large scale unspent provisions in Demands for Grants, the Financial Advisers have been requested to study such cases and take appropriate measures.
- Evaluation and review of schemes have been undertaken as part of the exercise for launch of the Eleventh Five Year Plan. Some schemes have been merged or redesigned while some others have been discontinued.
- Continuing with initiative towards better cash management, the quarterly exchequer control based cash and expenditure management system has been extended from 14 (after the merger of Demands pertaining to Department of Health and Department of Family Welfare) to cover 23 Demands for Grants. The system, inter alia, involves preparing a Monthly Expenditure Plan (separately for Plan and Non-Plan Expenditure), which comprise Quarterly Expenditure Allocations (QEA), with the exchequer control being operative with respect to QEA.
- With a view to further fine-tune the cash management system, effective 2006-07, all Ministries/Departments have been advised to restrict the expenditure in the month of March to 15 per cent of Budget allocation, within the last quarter ceiling of 33 per cent. The 23 Demands for Grants covered under the Exchequer Control based cash management system are expected to formulate their MEP keeping the said restrictions in view. This restriction is expected to further reduce the rush of expenditure towards the end of the financial year and parking of funds.
- Non-tax Revenue receipts have been impacted by declining interest receipts from the States pursuant to the Twelfth Finance Commission award. The decline is expected to be partly off-set by higher receipts from dividends and profits from public sector undertakings, banks and other financial institutions due to improved performance on the strength of continued buoyancy in the corporate sector and from licence fee and other receipts from growing telecom and petroleum sectors. There is potential for further increase in the non-tax revenues from review of user charges and reduction in the operational losses of Commercial Undertakings.

Policy Evaluation

21. The FRBM period has been marked by sustained fiscal consolidation. The performance in RE 2006-07 shows an improvement over BE 2006-07 achieved mainly due to revenue receipts being higher than budgeted and measured growth in non-Plan expenditure. Budget 2007-08 aims to continue on the path of fiscal consolidation consistent with the objective of the Fiscal Responsibility legislation. Continuation of the policy measures already implemented in the domain of tax policies, expenditure management, etc. and further initiatives being launched in these areas form the basis of rolling targets included in the FRBM Statements. Fiscal policy measures to achieve the right economic environment to unleash the full potential of the Indian economy must essentially be a continuing challenge to be achieved and then sustained.