MEDIUM TERM FISCAL POLICY STATEMENT

A. FISCAL INDICATORS – ROLLING TARGETS AS A PERCENTAGE OF GDP (AT CURRENT MARKET PRICES)

	Revised Estimates 2006-07	Budget Estimates 2007-08	Targets for 2008-09	Targets for 2009-10
1. Revenue Deficit	2.0	1.5	0.0	0.0
2. Fiscal Deficit	3.7	3.3	3.0	3.0
3. Gross Tax Revenue	11.4	11.8	12.3	12.7
4. Total outstanding liabilities at the end of the year	64.4	61.4	58.6	56.0

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. On the strength of domestic consumption demand and increasing investment, the ongoing economic dynamism is turning out to be a virtuous cycle of economic growth in conjunction with consistent fiscal consolidation policies pursued by the Central Government, more particularly during the period after the Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) came into force. With annual real GDP growth at 9.0 per cent in 2005-06, as per Central Statistical Organisation's (CSO) Quick Estimates and 9.2 per cent in 2006-07 (CSO's Advance Estimates), the economy appears to have entered a phase of high growth. Staying the course and delivering on FRBM targets has proved to be critical for accelerating and sustaining the current growth momentum and generating resources for investment, and speedy development of physical and social infrastructure. An obligation to create an enabling environment to encourage State governments to stay the course of fiscal consolidation - essential for achieving overarching goal of macroeconomic stability - is also embedded in the Central Government's medium term fiscal policy.

2. Medium term fiscal projections are in consonance with the commitment made in Budget 2005-06 to resume the process of fiscal correction w.e.f. 2006-07 and achieve the FRBM goals by 2008-09. Supported by revenue growth as well as better management and re-prioritization of expenditure, performance in 2006-07 in relation to deficit targets is gratifying. The FRBM Rules envisage an annual reduction of at least 0.3 percentage points in fiscal deficit and 0.5 percentage points in revenue deficit. In BE 2006-07, Government had projected Revenue Deficit to be at 2.1 per cent of GDP i.e., 0.5 percentage points lower than the BE 2005-06. The Revenue Deficit estimates have shown improvement at 2.0 per cent of GDP at RE 2006-07. Similarly, Fiscal Deficit, which was budgeted to decline from 4.3 per cent of GDP in BE 2005-06 to 3.8 per cent of GDP in BE 2006-07 has shown further improvement at 3.7 per cent of GDP in RE 2006-07. This improvement has been possible due to high economic growth, increased revenues and prudent expenditure management practices.

3. Fiscal targets for the year 2007-08 and beyond are set to be FRBMA compliant. The law mandates the Central Government to eliminate its revenue deficit and reduce fiscal deficit to not more than 3 per cent of GDP by 31st March, 2009. Accordingly, the medium term fiscal targets in 2007-08, 2008-09 and 2009-10 reflect the legislative mandate on the one hand, and the optimism of continued growth as well as commitment to steadfastly pursue fiscal correction paying attention to the quality of adjustment while achieving the targets in quantitative terms. To this end, the strategy followed is essentially revenue led, with a focus on outcomes and improving the allocative efficiencies of public expenditure.

4. The Central Government's gross tax-GDP ratio, is estimated to go up from 11.4 per cent in RE 2006-07 to 11.8 per cent in BE 2007-08, with tax revenue likely to grow over 17 per cent. While such a growth in tax receipts seems impressive, it also concurrently creates a larger base to work on, and thus raises the 'performance bar' in terms of absolute tax revenue in every succeeding year. Sustaining such growth in tax revenues requires an increasingly efficient, liberal and equitable tax system. Balanced tax structure in terms of reasonable tax rates, fewer exemptions and wider tax base are the key policy tools in this regard. Comparative figures for non-Plan expenditure as a percentage age of GDP has declined to 6.5% per cent while Plan expenditure has increased to 4.4 per cent in 2007-08.

5. The Budget 2007-08 has been prepared within the policy framework indicated above.

B. Assumptions underlying the Fiscal Indicators

1. <u>Revenue receipts</u>

(a) Tax-revenue

6. The tax collections during the year have shown a higher buoyancy than anticipated in Budget 2006-07. The growth rate in tax assumed at BE 2006-07 was 19.5 per cent assumed over BE 2005-06. At RE 2006-07 over the same base, it is being revised upward to 26.4 per cent. Consequently, in RE 2006-07 the revised tax receipts on account of gross tax revenue, States' share after adjusting against expenditure, and net tax revenue to Centre are pegged at Rs. 4,67,848 crore, Rs. 1,20,377 crore and Rs. 3,45,971 crore respectively.

7. The tax-GDP ratio is set to increase from 11.4 per cent in RE 2006-07 to 11.8 per cent in BE 2007-08. Accordingly, the gross tax revenue, States' share after adjusting against expenditure, and net tax revenue to Centre are placed at Rs. 5,48,122 crore, Rs.1,42,450 crore and Rs.4,03,872 crore respectively yielding corresponding growth rates of 17.16 per cent, 18.34 per cent and 16.74 per cent. While substantial increase in tax receipts creates greater fiscal space to meet the Eleventh Five Year Plan expenditure requirements, there is also a potential risk that ambitious expansion in expenditure would put the progress of fiscal consolidation under undue stress.

8. The fiscal indicators shown in Table in paragraph A assume a gross tax revenue growth of 17 per cent per annum over 2008-09 and 2009-10 keeping in view the trend growth. The total outstanding liabilities are assumed decline as percentage of GDP. The increase in outstanding liabilities is on account of assumed persistence of gross fiscal deficit at 3 per cent in 2008-09 and 2009-10. The net small savings collections are assumed to grow at 10 per cent per annum during the same period. The exchange rate are assumed to remain unchanged for simplicity of projections.

(b) Non-tax revenue

9. The non-tax revenue (NTR) is set to increase from Rs. 76,260 crore in BE 2006-07 to Rs. 82,550 crore in BE 2007-08 registering a growth of 8.2 per cent. Receipts from dividends and profits at Rs. 33,925 crore in BE 2007-08, as compared to Rs. 27,500 crore in BE 2006-07, constitute the largest component of NTR. Better performance of Central Public Sector Undertakings (CPSUs) is expected to yield higher returns. The transfers from financial institutions, and dividends from CPSUs in power, telecommunications and petroleum sectors are also expected to increase during this period. Interest receipts also comprise a substantial component at 23.4 per cent of NTR in BE 2007-08. However, interest receipts are likely to decline in the medium term, mainly due to Centre's disengagement from financial intermediation on the recommendation of the TFC 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: (i) reduced lending rates on the loans; (ii) debt swap scheme that enabled State Government pre-pay high cost loans to Central Government; (iii) incentive linked restructuring of debt of State Governments that enact fiscal responsibility legislation; (iv) 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 2.23 per cent of GDP in BE 2005-06, was estimated to decline to 1.93 per cent of GDP in BE 2006-07. 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

10. Twelfth Finance Commission (TFC) award with incentive to promote fiscal reforms are enabling the State Governments to actively undertake fiscal correction with taxation reforms and expenditure management. The soft interest rate regime experienced in the recent past had also benefited the State Governments. By the middle of February 2007, twenty-five States have enacted their own FRBM laws. In so far as sharing of taxes are concerned 30.5 per cent of gross tax revenue from Central Taxes/Duties including Additional Excise Duty on sugar, tobacco and textiles in lieu of Sales Tax but excluding cesses, surcharges and cost of tax collection devolve to States, as against 29.5 per cent awarded by Eleventh Finance Commission. TFC has also recommended that if the rental arrangement in respect of Additional duties in lieu of sales tax is terminated and States are allowed to levy sales tax (or VAT) on these commodities without any prescribed limit, the share of the States in net proceeds of shareable central taxes shall be reduced to 29.5 per cent. States share of Taxes and Duties increased to Rs. 1,20,377 crore in RE 2006-07, and is projected to further increase to Rs. 1,42,450 crore in BE 2007-08 reflecting a 25.6 per cent increase over BE 2006-07 at Rs. 1,13,448 crore.

2. <u>Capital receipts</u>

(a) Recovery of loans

11. Repayment receipts against loans extended earlier are estimated to decline over a period of time on account of gradual disintermediation by Central Government. State Governments and Central Public Sector Undertakings (CPSUs) are encouraged to directly borrow from the market. 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 have had affect of reducing the debt stock. As such the recovery of loans are estimated to decline from Rs. 8,000 crore in BE 2006-07 to Rs. 5,450 crore in RE 2006-07 and further to Rs. 1,500 crore in BE 2007-08.

(b) Other non-debt capital receipts

12. A provision of Rs. 41,651 crore is made in BE 2007-08, of which Rs. 40,000 crore is the anticipated one-time receipt from RBI consequent to transfer of its stake in State Bank of India to Government. The balance of Rs. 1,651 crore is on account of receipts from sale proceeds of equity in Rural Electrification Corporation, Power Grid Corporation of India Ltd., National Hydro Electric Power Corporation. Provision is being made for transfer of the receipts into National Investment Fund (NIF) set up outside the Consolidated Fund of India, to be professionally managed by select Public Sector Mutual Funds for ensuring sustainable returns without depleting the NIF corpus.

(c) Borrowings - Public Debt and Other Liabilities

13. Borrowing is resorted to meet the uncovered gap between total expenditure and total non-debt receipts of the Central Government. Central Government policy towards borrowing to finance its fiscal deficit places greater reliance on domestic market borrowings over external debt. Thus, the Government finances major part of its deficit through resources raised at market determined interest rates. Central Government is taking several steps to moderate the carrying cost of debt and clean-up its debt/liability portfolio. Debt restructuring measures along with the policy of fiscal rectitude as prescribed under FRBMA is expected to moderate the overall public debt burden.

14. Some transactions are not related to fiscal deficit of the Government except to the extent of interest liabilities assumed on their account. These include Small Savings accretions transferred to State Governments and serviced by the State Governments but not utilized by Central Government, Special securities issued to Food Corporation of India and to Oil Marketing Companies and Borrowing raised under the Market Stabilization Scheme (MSS) to assist RBI in mopping up excess liquidity in the markets. MSS receipts are sequestered in a separate account with RBI and are not available to GOI for expenditure.

3. <u>Total expenditure</u>

(a) Revenue account

Plan Revenue expenditure

15. Plan Revenue expenditure is estimated to increase from Rs.1,43,762 crore in BE 2006-07 to Rs. 1,74,354 crore in BE 2007-08 registering an increase of 21.3 per cent. As a percentage of GDP there is a marginal increase from 3.6 per cent to 3.8 per cent during the same period. The increase is mainly on account of enhanced budgetary allocations in social sector, in particular school education, women and child development, health and family welfare (National Rural Health Mission), rural employment, Integrated Child Development Scheme (ICDS), agriculture, waste land development, drinking water and for physical infrastructure including roads. Total Plan grants to States and UTs are estimated to increase from Rs. 50,913 crore in BE 2006-07 to Rs.65,027 crore in BE 2007-08, representing an increase of 28 per cent.

Non-Plan Revenue expenditure

16. Non-Plan revenue expenditure is budgeted to increase from to Rs.3,44,430 crore in BE 2006-07, to Rs. 3,83,546 crore in BE 2007-08 i.e., an increase of 11.3 per cent. Five major items of non-Plan expenditure are detailed below.

(i) *Interest payments*

17. Expenditure on interest payments is projected to increase from Rs.1,39,823 crore in BE 2006-07 to Rs. 1,58,995 crore in BE 2007-08. This is an increase of 13.7 per cent. This is mainly on account of increase in outstanding debt stock, increase in the interest rates resulting interalia, in lower accrued interest on reissued dated securities and provision for interest payment on special securities issued to Oil Marketing Companies and Food Corporation of India. It also includes a provision of Rs. 2,500 crore for payment of premium on active debt consolidation which is expected to moderate the carrying cost of debt. Despite such an increase, the expenditure on interest payments as a percentage of net revenue receipts of Central Government is estimated to decline from 34.6 per cent in BE 2006-07 to 32.7 per cent in BE 2007-08 yielding increased fiscal flexibility in short term with potential to strengthen fiscal consolidation in the medium term

(ii) *Defence Services*

18. Total Defence Services expenditure is budgeted to increase from Rs.89,000 crore in BE 2006-07 to Rs. 96,000 crore in BE 2007-08. The budgeted allocations for 2007-08 include revenue expenditure component of Rs.54,078 crore, as against Rs.51,542 crore in BE 2006-07, while the capital outlay for Defence in BE 2007-08 is budgeted at Rs. 41,922 crore as against Rs.37,458 crore in BE 2006-07. The enhanced provisions take into account, normal growth in pay, allowances, maintenance expenditure and modernization plans.

(iii) *Major subsidies*

19. The allocation for major subsidies, on fertilizers, food and petroleum products is estimated to increase from Rs.44,533 crore in BE 2006-07 to Rs. 50,987 crore in BE 2007-08 registering a growth of 14.5 per cent. While the fertilizer subsidy is budgeted to increase by 30.1 percent, the subsidy on petroleum is budgeted to marginally decline from Rs. 3,080 crore in BE 2006-07 to Rs. 2,840 crore in BE 2007-08. However, these subsidies do not include special securities issued to Oil Marketing Companies .

(iv) *Non-Plan Grants to States*

20. The non-Plan Grants to States/UTs in BE 2007-08 are placed at Rs. 38,403 crore, as against Rs. 35,361 crore in BE 2006-07 signifying an increase of 8.6 per cent. A major component of these grants is in fulfillment of the Central Government's commitment to compensate the State/UT Governments from losses on account of implementing VAT and proposed phase out of CST. A provision of Rs. 5,495 crore has been made in BE 2007-08 for this purpose as against a BE of Rs. 3,000 crore in 2006-07.

(v) *Others*

21. The other major items of revenue expenditure like salaries, pensions, police and other administrative expenditure is expected to maintain normal growth rate. Moderation of expenditure in respect of these items constitutes an integral component of prudent fiscal policy.

(b) Capital account

(i) *Loans and advances*

22. Loans and advances to State Governments had earlier constituted major component of loans and advances extended by Central Government. In regard to loans to State Governments, TFC had recommended disintermediation by Central Government, albeit with support to fiscally weak States, which are unable to raise resources directly. The Government accepted the recommendations. Domestic loans have been 'disintermediated' and the States now raise loans directly. External loans continue to pass-through Central Government. Non-Plan loans are also extended to CPSUs for various purposes, including budgetary support for investments, restructuring/revival and Voluntary Retirement Scheme/Voluntary Separation Scheme.

(ii) *Capital outlay*

23. The total capital expenditure is set to increase from Rs.75,799 crore in BE 2006-07 to Rs. 1,22,621 crore in BE 2007-08 representing annual growth of 9 per cent (after adjusting for Rs. 40,000 crore for payment to RBI to transfer its stake in SBI to GOI). The non-Plan capital expenditure is Rs. 91,875 crore. Of this capital outlay on Defence Services constitutes the largest component at Rs.41,922 crore. The Other non-Plan capital expenditure accounts for Rs. 9,953 crore, excluding a provision of Rs.40,000 crore towards acquisition of RBI's stake in State Bank of India.

24. The plan capital expenditure has increased from Rs. 28,965 crore in BE 2006-07 to Rs. 30,746 crore registering an increase of about 6.1 per cent. The share of plan capital outlay in BE 2007-08 constitutes about 15 per cent of gross budgetary support of Rs. 2,05,100 crore as against 16.8 per cent of gross budgetary support of Rs. 1,72,728 crore in BE 2006-07. Discontinuation of domestic loans to State Governments, may have contributed to this decline in the capital outlay in plan expenditure. Seen in relation to GDP, the plan capital expenditure, which was 0.73 per cent of GDP in BE 2006-07, has declined to 0.66 per cent of GDP in 2007-08. Notwithstanding the fact that a major part of expenditure of the Central Government relating to transfers for creation of physical assets such as rural roads and rural housing is not reflected in the Central Government accounts as capital expenditure due to the existing method of accounting classification, the decline in the share of capital outlays is a matter of great concern.

4. GDP Growth

25. During the year 2006-07 annual real GDP growth (at constant 1999-2000 prices) is likely to attain a level of 9.2 per cent (Advance Estimates) as compared to the growth rate of 9.0 per cent during 2005-06 (Quick Estimates). The nominal growth rates of GDP at current market prices during the respective years are 15 per cent and 14.1 per cent. As such the GDP at current market prices for the year 2006-07 stands at Rs. 41,00,636 crore as against Rs. 35,67,177 crore in 2005-06. On the strength of the continuously ascending growth and also considering inflation expectations, the annual GDP growth rates (at current market prices) for FY 2007-08, and the following two years, for the purposes of calculating fiscal indicators shown in Table -A, have been assumed on a linear trend of 13 per cent. Thus the GDP for the year 2007-08 (at current market prices) is set at Rs. 46,33,719 crore.

(c) Assessment of sustainability relating to

(i) the balance between revenue receipts and revenue expenditure

26. Growth in revenue receipts is out pacing the growth in revenue expenditure. The improvement in the balance between revenue receipts and expenditure in BE

2007-08 is a result of the increase in revenue receipts at 20.5 per cent over that of BE 2006-07 and simultaneous containment of growth in revenue expenditure at 14.3 per cent. As such , the revenue deficit is estimated to decline from 2.1 per cent of GDP in BE 2006-07 to 1.5 per cent of GDP in BE 2007-08. Both the tax revenue as well as NTR contributed to such an increase in revenue receipts amounting to Rs.82, 957 crore. Increase in the tax revenue receipts (net to Centre) are placed at Rs.76, 667 crore, while the NTR are expected to increase by Rs. 6,290 crore. Such an increase in tax receipts is reflected in the upward movement of tax-GDP ratio, which stands at 11.8 per cent in BE 2007-08 as against 11.2 per cent in BE 2006-07. The improvement in tax receipts is due to combined impact of the buoyant economy and institutional reforms in tax administration. As a result of pursuit of a coherent policy of improving climate for investment, helping productivity and opening more sectors of the economy to competition, manufacturing and service sectors are increasingly influencing the economic growth and contributing to fiscal resources. Going forward, agriculture sector in conjunction with food processing, promises to offer new opportunities for growth and employment; the sector continues to be the key sector for ensuring livelihoods of a large number of Indians. Besides the impact of encouraging macroeconomic environment, measures such as broadening of the tax base, expanding the service tax net, rationalizing the exemptions, plugging of loopholes are contributing to enhanced tax collections. A revenue optimization policy along with a transparent tax payer friendly system is crucial to sustain the buoyancy in tax collections. Special focus would be required to expand the tax base by widening the coverage such that there is increase in share from non/under-covered sectors, while balancing the interests of vulnerable sections. On the non-tax revenues, measures would need to be stepped up to realize the full potential of receipts from PSUs, including the beneficiaries of restructuring/revival package. Flexibility to strike a balance between the diverse objectives of maximizing government revenue, accelerating investment for sectoral growth and optimizing consumer surplus has to be at the core of the efforts to rationalize the user charges on public goods and services, including fees/charges for allocation rights in respect of extractive industries and other resources like ‘spectrum’.

27. The gains from buoyant revenue receipts on the one hand and moderate growth in revenue expenditure on the other have contributed to the commendable fiscal performance. The pressures on subsidies, however, remain and would need to be watched under evolving global trends, specifically relating to energy prices and domestic concerns. The substantial hike in Plan revenue expenditure is aimed at meeting the basic needs requirements and providing social and physical infrastructure including rural roads and electrification to unleash the untapped potential of the rural India. Investments in Bharat Nirman and the Eight Flagship programmes in line with the National Common Minimum Programme are noteworthy in this context. Due to internal and external lag between conception and implementation as also between implementation and the final outcome, the impact of these expenditures would be visible in the medium term.

28. As regards capital expenditure, the emerging fiscal space on account of disintermediation of Central Government in extending loans to State Governments/ UTs needs to be utilized to augment the productive capacity of the economy and obtain commensurate benefits therefrom. Central Public Sector Undertakings (CPSUs) have also been meeting a large part of their capital expenditure through Internal and Extra Budgetary Resources (IEBR). The IEBR of CPSUs is estimated to increase by 34.5 per cent from Rs.1,22,757 crore in BE 2006-07 to Rs. 1,65,053 crore in BE 2007-08.

(ii) The use of capital receipts including market borrowings for generating Productive Assets.

29. In BE 2007-08, the total Plan expenditure, commonly identified with developmental expenditure of Rs.2,05,100 crore is about 135.0 per cent of the Fiscal deficit estimated at Rs.1,50,948 crore. This implies a confirmation of healthy trend of plan expenditure exceeding the fiscal deficit achieved in 2006-07 (116.2 per cent) for the second 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.

30. Compared to pre-FRBMA period, the process of fiscal consolidation has shown impressive results. The revenue and fiscal deficit declined from a high of 4.4 per cent and 5.9 per cent, respectively in 2002-03 to 2.0 per cent and 3.7 per cent, respectively in RE 2006-07. For the first time in the process of fiscal correction there will be a primary surplus of 0.2 per cent of GDP in BE 2007-08.

31. The task ahead in order to achieve the end-year FRBM targets is admittedly more challenging, especially the elimination of revenue deficit. The endeavor in this regard is expected to be facilitated by continued buoyancy in revenues on the back of higher growth trajectory. Improved cash management, containment of non-developmental expenditure, introducing innovative investment financing, targeting subsidies better, providing adequately for desired level of investment to strengthen the social and infrastructure, all remain an inalienable part of optimizing the benefits/externalities that flow from fiscal consolidation.