

FISCAL POLICY STRATEGY STATEMENT

A. FISCAL POLICY OVERVIEW

1. The Interim Budget 2009-10 was presented in the background of the uncertainties prevailing in the world economy which was hit by three unprecedented crises in the same financial year. The details of the extraordinary economic circumstances have been enumerated in the Fiscal Policy Strategy Statement and Macro-Economic Framework Statement presented along with the Interim Budget 2009-10. The prevailing situation now as well as during the presentation of the Interim Budget is in sharp contrast to the conditions at the time of presentation of the Union Budget 2008-09 in February 2008 when the Indian economy was riding on a high and impressive growth trajectory registering about 9 per cent of average growth during 2004-08. This performance coupled with significant improvement in fiscal indicators during the regime of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 inspired confidence in the medium to long term prospects of the economy. The process of fiscal consolidation during these years 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 declined from 4.4 per cent to 1.1 per cent of GDP. The gradual reduction in fiscal deficit coupled with higher rate of growth of GDP helped the total liabilities (net of MSS) to GDP ratio of the Central Government improve from 69.1 per cent in 2002-03 to 56.5 per cent in 2007-08.

2. 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 gross tax to GDP ratio from 8.8 per cent in 2002-03 to 12.6 per cent in 2007-08.

3. However to mitigate the adverse effects of petroleum price rise, rise in prices of other commodities and the huge crisis in the global financial system during 2008-09, the Government had to explore suitable fiscal as well as monetary policy options. During the first half of the financial year 2008-09, the focus of the monetary as well as fiscal policy was more on 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 which together with the fiscal measures contributed to the softening of domestic prices. Headline inflation fell below 5 per cent in January 2009 and is now placed at (-) 1.3 per cent in June, 2009. However, the fiscal measures undertaken through tax concessions and increased expenditure on food, fertiliser and petroleum subsidies along with increased salary bills for implementing the Sixth Central Pay Commission recommendations significantly impacted the deficit position of the Government.

4. The global financial crisis in the second half of the financial year shifted the focus of fiscal policy to providing growth stimulus. The moderation in growth of the economy and the impact of the fiscal measures taken to stimulate growth has been reflected in lower gross tax revenue receipts at Rs.6,09,705 crore as per the provisional accounts of 2008-09 against B.E.2008-09 of Rs.6,87,715 crore. Additional budgetary resources provided as part of stimulus package including increase in plan outlay from Rs.2,43,386 crore in B.E. 2008-09 to Rs.2,82,957 crore in R.E.2008-09 and various committed liabilities of Government including rising subsidy requirements, implementation of Sixth Central Pay Commission recommendations and Debt Waiver and Debt Relief Scheme for Farmers contributed to increase the fiscal deficit to 6.2 per cent of GDP in 2008-09 (provisional accounts) as compared to 2.5 per cent of GDP in B.E.2008-09.

5. The Country is still facing a 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 mandated deficit for

the year as per the FRBM Rules. This could have resulted in an adverse impact on the growth of the economy in the absence of investments, thereby putting at risk the revival of the economy in the prevailing situation. The second option was to increase public expenditure, even with lower revenue receipts, and stimulate economy by creating demand and maintain the growth trajectory. The Government preferred the second option of undertaking fiscal measures to increase public expenditure in order to boost demand and increase investment in infrastructure sector. The above decision of the Government was guided on the principles of insulating the vulnerable sections of society and sectors of economy from the impact of economic downturn and at the same time ensure revival of the economy with higher growth. These measures are expected to spur growth and restore revenue buoyancy in medium term and provide the required fiscal space to revert to the path of fiscal consolidation.

B. FISCAL POLICY FOR 2009-10

6. The General Budget 2009-2010 is being presented in the backdrop of signs of moderation in the rate of decline in global economy. However, it is still early to predict complete revival as the recovery may remain sluggish with further risks towards the downslide. In the given scenario, the Government has to continue with the policy of increased public expenditure to boost demand and create infrastructure. The impact of three fiscal stimuli have started showing results. The growth rate of 6.7 per cent in GDP makes India the second fastest growing economy in the World during 2008-09. The measures taken by Government to counter the effects of the global meltdown on the Indian economy have resulted in 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 for 2008-09 and 2009-2010. The revenue deficit and fiscal deficit in 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 with emphasis on structural fiscal reforms and prudent fiscal management at the earliest, with improvement in the economic situation.

Tax Policy

Indirect taxes

7. In recent years, tax policy has been guided by the need to increase the tax-GDP ratio and achieve fiscal consolidation. In these years, the tax-GDP ratio improved significantly from 9.2 per cent in 2003-04 to 12.6 per cent in 2007-08. This has been achieved through rationalisation of the tax structure (moderate levels and a few rates), widening of the tax base, and reduction in compliance costs through improvement in tax administration. The extensive adoption of information technology solutions and re-engineering of business processes has also fostered a less intrusive tax system and encouraged voluntary compliance. These measures have resulted in increased buoyancy in tax revenues till 2007-08 and helped in fiscal consolidation. However, the process of consolidation slowed down in 2008-09, especially in the case of indirect taxes, as a result of certain policy interventions necessitated by the need to sustain the growth momentum in the wake of some unforeseen developments in the global and domestic economy.

8. The first half of 2008-09 saw a sharp surge in the international prices of crude petroleum and other commodities (food items, edible oils, metals etc.) leading to severe inflationary pressures on the economy. The inflationary pressures were contained through a slew of fiscal measures, including reduction of import duties and imposition of export duties on a host of items.

9. The onset of the global financial crisis in September, 2009 led to a reversal of trends with de-growth in export markets and domestic slowdown. A dip in industrial and manufacturing growth and the prognosis of an impending crisis prompted the Government to announce three fiscal stimulus packages in quick succession on 7th December, 2008, the 2nd January, 2009 and 24th February, 2009.

10. Owing to the policy interventions for inflation management and subsequently for providing a stimulus to growth, Government had to forego substantial revenues from excise and customs duties. Consequently, despite the buoyancy of direct tax revenues and service tax collections, the fiscal consolidation process received a setback. On the positive side, however, the results of these proactive measures have begun to show- with some sections of manufacturing and services exhibiting preliminary signs of recovery. It is expected that this will reflect in recovery in growth of tax receipts in the later part of 2009-10 and enable a return to the path of fiscal consolidation by moving closer to FRBM targets.

11. Thus, as a policy direction, while continuing on the path of simplifying and rationalizing the tax structure and improving the tax-GDP ratio, it has been considered necessary to continue (and also enhance in some cases) fiscal support to certain labour intensive and employment oriented sectors, which continue to be beleaguered owing to falling demand in domestic and export markets.

12. It is also proposed to integrate the tax on goods (cenvat) and the tax on services, and finally move to a common Goods and Service Tax (GST). In as much as the policy so far has sought to achieve convergence of rates, this would facilitate the introduction of GST by 1st April, 2010, as already announced by the Government. This shift to GST is expected to significantly improve buoyancy from indirect taxes, owing to the opportunity it provides for further convergence and moderation of rates and a substantial expansion in the base which would extend beyond manufacturing all the way to retail.

Central Excise

- To provide continued fillip to the manufacturing sector and accelerate its recovery, the reduction in ad valorem excise duty rates to 8%, effected in two phases as part of the fiscal stimulus packages announced on 7.12.2008 and 24.2.2009, is being continued.
- To mitigate the problem of credit accumulation (which arose in some cases as a result of the cenvat cuts implemented as part of the recent fiscal stimulus packages, owing to deeper cuts on finished goods as compared to their raw materials), excise duty rate has been increased from 4% to 8% in the following cases:-
 - ◆ Manmade filament yarn and fibre (polyester, nylon, acrylic and viscose)
 - ◆ Textile intermediates (DMT, PTA, acrylonitrile and polyester chips)
 - ◆ Natural fibres and yarns such as silk, wool, coconut etc on optional basis
 - ◆ Spun yarn, woven man made or blended fabrics, and industrial fabrics on optional basis
- In order to converge towards a mean cenvat rate, excise duty rate has been increased from 4% to 8% on certain finished goods and consumer goods
- To provide some relief to automobile manufacturers, who are careworn owing to falling demand in domestic and export markets, the specific excise duty component on large cars and utility vehicles of engine capacity 2000 cc and above has been reduced from Rs.20,000 to Rs.15,000.

Customs

- In the wake of global slowdown, to provide a level playing field to domestically produced goods against imports, the peak rate of customs duty on non-agricultural goods has been retained at 10%.
- Customs duty concessions have been provided on specified inputs and capital goods for exporters in sectors such as leather, textiles, and synthetic footwear.
- To promote indigenous manufacture of LCD televisions, customs duty has been reduced on 'panels', which is a primary cost-contributing component for LCD TVs.
- To provide a level playing field to domestic manufacturers of set top boxes, customs duty exemption has been withdrawn, and 5% duty imposed.
- To mobilize some revenues, the specific rates of Customs duty on gold and silver have been increased.

Service Tax

- To widen the tax base, service tax has been imposed on the following services:-
 - ◆ Transportation of non-essential goods through railways.
 - ◆ Transportation of specified goods through coastal shipping and inland shipping.
 - ◆ Legal consulting, advice and technical assistance provided by a corporate law firm to a corporate.
 - ◆ Cosmetic or plastic surgery, excluding restorative surgery
- The service tax rate is being continued at 10 per cent.

Direct Taxes

13. During the FRBM period there has been a structural change in the composition of Centre's tax revenue. While the Centre's tax-GDP ratio has increased by 2.3 percentage points to 11.5 per cent in 2008-09 from 9.2 per cent in 2003-04, the direct tax-GDP ratio has increased by 2.6 percentage points to 6.4 per cent in 2008-09 from 3.8 per cent in 2003-04. Further, the share of direct taxes in Centre's tax revenues has also increased to 55.5 per cent in 2008-09 from 41.4 per cent in 2003-04. This structural change has been brought about by a multi-pronged strategy comprising of the following elements :-

- (i) Minimizing distortions within the tax structure by expanding the tax base and reducing the tax rates to moderate levels;
- (ii) Improving the efficiency and effectiveness of the tax administration so as to substantially increase deterrence level to encourage voluntary compliance; and
- (iii) Providing quality taxpayer services by re-engineering business processes in the Income-tax Department through extensive use of modern technology, viz., e-filing of returns, e-payment of taxes, establishing a Centralized Processing Centre, issue of refunds through ECS and refund bankers, computer aided selection of cases for scrutiny and an effective taxpayer information system.

14. The medium term strategy for direct taxes is to consolidate the achievements of the past and accelerate this process of change. The policy proposals in the Union Budget 2009-10, are intended to achieve this objective.

15. The important policy initiatives are:-

- (i) Partly neutralizing the erosion in the tax base on account of various tax incentives by increasing the Minimum Alternate Tax (MAT) rate to 15 per cent from the existing level of 10 per cent. Also expanding the MAT base by plugging leakages on account of innovative accounting practices;
- (ii) Further rationalization of the Personal Income Tax (PIT) rate structure by enhancing the threshold exemption limits and removing the surcharge on PIT;
- (iii) Introducing a new package of presumptive taxation to encourage voluntary compliance by small businesses;
- (iv) Reducing the distortionary impact of profit-linked tax incentives by introducing investment-linked tax incentives for specified new businesses by allowing full expensing for capital expenditure;
- (v) Rationalization of various tax incentives to ensure better targetting and also preventing any misuse;
- (vi) Removing uncertainty in tax liability of foreign Investors by providing for a fast-track alternate dispute resolution mechanism;
- (vii) Streamlining the provisions relating to tax deduction at source for improving compliance and efficiency;
- (viii) Rationalizing the tax treatment of the New Pension System (NPS) for enabling the establishment of a much needed social security system in India;

- (ix) Enabling the tax administration to communicate with the taxpayers by making use of latest information technology tools;
- (x) Enhancing levels of transparency in the functioning of the tax administration by introducing the system of allotting and quoting a unique computer based Document Identification Number (DIN) in respect of all correspondence sent from or received by the Income-tax Department. This will help in proper record management and in tracking taxpayer grievances.

16. These Initiatives will enable us to sustain the healthy buoyancy in direct taxes.

Contingent and other Liabilities

17. 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 in 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 2.7 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).

18. 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 in the previous financial year 2008-09. Further, IIFCL have been authorised to raise additional Rs.30,000 crore on the same basis as per requirement during 2009-10. 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 0.69 per cent 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 necessitated 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

19. 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.

20. In order to provide 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 during 2008-09. The gross and net market borrowings (including dated securities and 364- day Treasury Bills) of the Central Government during

2008-09 amounted to Rs.3,18,550 crore and Rs.2,42,316 crore respectively as against Rs. 1,88,205 crore and Rs. 1,09,504 crore during 2007-08. The weighted average maturity of dated securities issued during 2008-09 was 13.8 years as compared to 14.9 years during 2007-08. The Central Government is continuing with the policy of elongating maturity profile of dated securities as well as building up a sound yield curve. The Government has been issuing securities with maximum 30-year maturity. The weighted average yield of dated securities issued during 2008-09 was 7.69 per cent and was lower than 8.12 per cent during 2007-08.

21. In consultation with RBI, after the presentation of the Interim Budget 2009-10, the Government has announced a market borrowing programme of Rs.3,98,552 crore (gross) and Rs.3,08,647 crore (net) for 2009-10. Of this, Rs.2,07,364 crore (net) is scheduled to be raised during the first half of the current financial year. The borrowing calendar will undergo revision to take care of changes arising on account of the General Budget presented now. The gross and net market borrowings (including dated securities and 364- day Treasury Bills) of the Central Government during 2009-10 (up to June 30, 2009) amounted to Rs.1,96,000 crore and Rs.1,53,361 crore respectively as against Rs. 65,550 crore and Rs. 33,144 crore during 2008-09 for the same period. The weighted average maturity of dated securities issued during 2009-10 (up to June 30, 2009) was 11.88 years which was 15.74 years during 2008-09 for the same period. The weighted average yield of dated securities issued during 2009-10 (up to June 30, 2009) was 6.93 per cent which was lower than 8.42 per cent during 2008-09 for the same period.

22. During the year 2009-10, the financing of fiscal deficit is estimated to be done without taking recourse to short-term borrowings through Treasury Bills or cash or cash draw down. However to take care of temporary mismatch between receipts and expenditure, the Government will have to take recourse to ways and means advances from RBI. In the last quarter of 2009-10, depending on the prevailing liquidity with the Government suitable adjustment in the size and composition of the borrowing programme may be required.

23. 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.88,773 crore mainly reflecting the change in policy, unwinding of MSS through buy-back of Rs.47,544 crores and de-sequestering of Rs.12,000 crore. This was part of the Government decision to de-sequester Rs.45,000 crore from MSS for using it in financing increased fiscal deficit during 2008-09 and 2009-10. As only Rs.12,000 crore was de-sequestered during 2008-09, of the balance Rs.33,000 crore the option of de-sequestering MSS to the tune of Rs. 28,000 crore was opted (up to June 30, 2009) during 2009-10 to augment the liquidity with the Central Government. The outstanding amount in MSS as on June 24, 2009 is Rs. 23,273 crore consisting of Rs.18,773 crore of dated securities and Rs.4,500 crore of T-bills.

24. 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.

25. Central Government has stopped playing the role of financial intermediary for State Governments for domestic market borrowings. The trends in the current year show 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.

26. The Government has set up the 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. However, 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

27. 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. As part of process reform, all new expenditure proposals will have to report on how the proposal under consideration will enhance the goals of equity or inclusion, innovation and public accountability. The government has outlined in the President's address to the joint session of Parliament in June 2009 that an area of major focus would be reform of governance for effective delivery of public services. Following initiatives are being taken by the Government to achieve the above mentioned objective:

- Establishing mechanisms for performance monitoring and performance evaluation in government on a regular basis;
- Strengthening public accountability of flagship programmes by the creation of an Independent Evaluation Office at an arm's distance from the government which will concurrently evaluate the impact of these programmes and place it in public domain;
- Putting up a public data policy to place all information covering non-strategic areas in the public domain which will help citizens to challenge the data and engage directly in governance reform.

28. Initiatives have also been taken to evenly pace the plan expenditure during the year and also to avoid rush of expenditure at the year end which results in poor quality of outcomes. 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. 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.

29. 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.

30. 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.

31. 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

32. 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 upto 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. 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 (-) 1.3 per cent in June 2009. Similarly the intervention of the Government has ensured that the economy grew at 6.7 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. But there cannot be any fiscal profligacy. Most of the countries are actually looking at increasing stimulus for the current financial year in order to provide boost to aggregate demand. Without putting at risk the revival process, the Government will look at exit strategies as soon as there is improvement in economic conditions.