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Fiscal policy issues for India after the global financial crisis (2008 - 2010)

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**Fiscal Policy Issues for India after
the Global Financial Crisis
(2008–2010)**

**Rajiv Kumar and
Alamuru Soumya**

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Abstract

The need for fiscal consolidation and sustainability is one of the key macroeconomic issues confronting Indian economy. This paper attempts to understand India's current fiscal situation, its likely future development, and its impact on the economy in the context of a weak global recovery from the current crisis. The impact of the global crisis has been transmitted to the Indian economy through three distinct channels, namely: the financial sector, exports, and exchange rates. The other significant channel of impact is the slump in business and consumer confidence leading to decrease in investment and consumption demand. The Indian government, to boost the demand, has announced several stimulus packages. However, there is not much room for further fiscal policy action as the consolidated fiscal deficit of the central and state governments in 2009–2010 is already about 11% of the gross domestic product (GDP). Any further increase in the fiscal deficit to GDP ratio could invite a sharp downgrading of India's credit rating and a loss of business confidence. The paper reviews the existing theories on the relationship between fiscal deficit and growth. It also analyzes the past trends and policy measures to understand the possible implications for economic recovery and long run growth in the Indian context. It also provides a long-term forecast of the fiscal deficit and public debt burden based on the past trends. Finally, the paper suggests a set of policy measures to get the Indian economy back on the path of sustained rapid and inclusive growth.

JEL Classification: H6, E62, H20

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1. INTRODUCTION

Given India's long history of running huge fiscal deficits, the sharp increase in its fiscal deficit over the last two years is a major concern for both academicians and policy-makers in India (Govinda Rao 2009; Rangarajan 2009). According to budget estimates for the fiscal year 2009–2010, the ratio of fiscal deficit to gross domestic product (GDP) (for the central and state governments but excluding off-budget bonds) in India is expected to be 10.2%. This follows a sharp rise in the fiscal deficit ratio from 4.2% in 2007–2008 to 8.9% in 2008–2009. This increase reverses all the fiscal gains made since 2003–2004. Likewise, the debt to GDP ratio would be 76.6% for the year 2009–2010, which is up from 74.7% in 2008–2009.

A higher fiscal deficit can be financed through domestic borrowing, external borrowing, or by printing money. Excessive domestic borrowing can put upward pressure on interest rates, while external borrowing may result in an external debt crisis. Printing money would invariably lead to high inflation. Food inflation in India is running at more than 18%, lending credence to an already strong argument for adopting an exit strategy from the existing stimulus programs. In the absence of such an exit strategy, there will be tremendous pressure for tightening monetary policy and raising interest rates, leading to an adverse impact on private investment, which remains sluggish.

The relationship between fiscal deficit and output growth is a much debated issue, both in general and in the Indian context. Indeed, the need for fiscal consolidation and the achievement of fiscal sustainability continue to be the key macroeconomic issues confronting Indian policy makers.

This paper attempts to understand India's current fiscal situation before and after the current global financial crisis, its likely future evolution, and its impact on the economy in the context of a weak global recovery from the current crisis. This paper is divided into five sections. The following section provides an overview of some insights from economic literature into the relationship between fiscal deficit, public debt, and growth. Section 3 presents trends and patterns of the Indian fiscal situation over the past three decades and discusses the major fiscal reforms that have been undertaken in recent years. In this section there is also detailed examination of the structural and cyclical behavior of fiscal variables. Section 4 discusses the impact of the current global crisis on fiscal balances in India. Finally, Section 5 includes the contours of a feasible exit strategy for restoring fiscal balance. Section 3 presents trends and patterns of the Indian fiscal situation over the past decades (1980–81 to 2009–10), and discusses the major fiscal reforms that have been undertaken in recent years and examines the structural/cyclical behavior of fiscal variables in detail. Section 4 discusses the impact of the current global crisis on fiscal balances in India. Finally, Section 5 includes the contours of a feasible exit strategy for restoring fiscal balance.

2. THE NEXUS OF FISCAL DEFICIT AND ECONOMIC GROWTH—THEORETICAL PERSPECTIVES

The impact of fiscal deficit on economic growth is a highly debated issue in economics. Apparently, there is no consensus among economists on this issue. One argument follows the concepts put forth by the economist John Maynard Keynes, and advocates that high fiscal deficits are not unusual for developing economies as governments use fiscal deficits to keep aggregate domestic demand at high levels in order to generate growth and employment. High fiscal deficits accelerate capital accumulation and growth (Krishnamurty 1984 and; 20012; Chandrasekhar 2000; Shetty 2001; Chelliah and Kavita Rao 2001; Murty and Soumya 2007). Those supporting the Keynesian approach argue that an increase in fiscal deficit due to public sector investment, especially in infrastructure, stimulates growth in the private sector. Increasing public investment in an appropriate policy framework,

therefore, gives the private sector adequate incentives to invest on a massive scale, resulting in overall economic growth. This is generally referred to as the positive “crowding in” impact of fiscal deficit.

Classical and neo-classical theory, on the other hand, postulate that high fiscal deficits created through higher public investment may displace private investment, or more generally expenditure. According to this argument, public investment-driven fiscal deficits “crowd out” private investment through an increase in the interest rate, especially if government borrowing is used to finance revenue deficit. It may also work through movements in the price level depending on how such investment is financed and the extent of capacity utilization in the economy. In general, public expenditure increases aggregate consumption in the economy, which leads to a reduction in aggregate savings. A reduction in aggregate savings results in higher interest rates, which in turn discourages private investment and overall economic activity in a closed economy.

In an open economy, higher public investment leads to higher capital inflows and a real appreciation of the currency, which results in lower net exports and, again, a reduction in economic activity. In either case, higher public expenditure appears to result in a reduction in overall economic activity. An implicit assumption in the above argument is that the economy is already at near full capacity level.

The efficacy of fiscal expansion has been questioned given the large fiscal deficits and the accumulation of a high debt to GDP ratio (Sundararajan and Thakur 1980; Easterly 2004). It has been argued that, apart from the problem of crowding out private investment, public spending is less efficient than the crowded out private investment, even if such spending is on investment. Therefore, controlling fiscal deficits spurs growth in the long run (Acharya 2001; Rangarajan 2009).

The Reserve Bank of India (RBI) has done significant research on the role of fiscal policy in reviving the Indian economy (RBI 2001). Research shows that an attempt to raise public consumption to revive aggregate demand will crowd out both private consumption and private investment with no long-run positive impact on output growth. Further, public investment in manufacturing appears to adversely affect private investment. However, government expenditure on infrastructure crowds in private investment. In addition, the level of fiscal deficit is also important because the positive impact of public sector infrastructure investment on private investment is predicated on the deficit remaining at the same or lower level. Despite differing opinions regarding the impacts of crowding out, RBI analysts mostly agree that excessive government consumption expenditure (especially on salaries, debt waivers, and subsidies) has a negative impact on growth. This is an issue of the political economy of government spending and the quality of fiscal adjustment, to which we return in later sections.

Another view that differs from both the classical, neo-classical, and Keynesian approaches is the neo-Ricardian approach. The neo-Ricardian argument is that the impact of an increase in public investment on the economy is neutral. Rational economic agents in the economy try to adjust their expenditure in relation to movements in public expenditure. Hence, there is no effect on the economy and overall savings remain unchanged. The empirical support in favor of the Ricardian view seems to be weak (Ball and Mankiw 1995; Elmendorf and Mankiw 1998). However, given that empirical studies support both the neo-classical and Keynesian views for India, no firm policy conclusion can be advanced.

Fiscal imbalances have remained a cause for concern in India in recent years. Despite impressive increases in the revenue productivity from direct taxes, there is a real fear that fiscal imbalances will worsen, causing interest rates to harden and crowd out private investment. A higher fiscal deficit essentially means the government must take more loans from banks, preventing the extension of loans to other borrowers and driving up interest rates at the cost of industry and individual borrowers. With a deficit of over 10% and the household sector’s financial savings at just about 11% of GDP, borrowing of this magnitude

leaves very little savings available for the corporate sector. This exerts significant pressure on interest rates. The excess demand created by large deficits could spill over to imports and create balance of payments problems as well.

Other concerns have been voiced about controlling public spending and fiscal deficit. On the one hand, the government has to raise public spending to boost the economy; on the other, the fiscal deficit has to be controlled to avoid its ill effects. The expansionary fiscal policy of the last two years, it has been argued, cannot continue and an exit strategy will have to be put in place in the forthcoming budget to ensure fiscal sustainability and greater flexibility in monetary policy operation, enhance the productivity of public spending, and avoid pressure on interest rates (Govinda Rao 2009; Rangarajan 2009; Kumar 2009).

Another argument is that focusing only on budget deficits can be misleading, because the problem of off-budget and contingent liabilities is also serious. Shifting liabilities off budget without reducing systemic risk does not improve matters. To achieve fiscal stability, attention needs to be given to optimal paths of public consumption, investment, taxes, and borrowing rather than only focusing on primary balances (Nirvikar Singh and Srinivasan 2004).

3. TRENDS AND PATTERNS IN FISCAL VARIABLES IN INDIA

A look at the trends and patterns over the last three decades (1980–2010), which span both the pre- and post-reform period, helps us understand the relationship between fiscal expansion and growth in the Indian economy. The first surge in India's economic growth rate came in the early 1980s, when it increased to above 5% from the average "Hindu" growth rate¹ of 3.5% in earlier decades. Unfortunately, this spurt was achieved by unsustainable fiscal expansion financed by domestic credit and external borrowing. Growth accelerated to 5.8% during the 1980s, but in the second half of the decade, fiscal and current account deficits widened significantly, causing serious macroeconomic imbalances and culminating in the balance of payment (BOP) crisis of 1991. These triggered the series of economic reforms that have been introduced, starting in 1991, to bring about macroeconomic stabilization and implement structural measures² to push up growth.

In the following section, we analyze fiscal trends in greater detail. The analysis is based on an annual time series corresponding to the fiscal year (1 April to 31 March). The data is drawn mostly from the RBI's *Handbook of Statistics on Indian Economy and Annual Reports and National Accounts Statistics* published by the Central Statistical Organization (CSO).

3.1 Deficit Indicators

The 1980s saw a sharp rise in the combined fiscal deficit of the central and state governments to 8% on average (see Table 3.1). Along with high external borrowings, a sustained increase in the combined revenue expenditure to stimulate demand, particularly in the services sector, caused the fiscal deficit to rise during the 1980s. As a result, the combined public debt became 56% of GDP on average, with interest payments at 14.6% of revenue expenditure (3% of GDP on average) accounting for a large portion of government

1 The "Hindu" rate of growth is a controversial expression coined by Raj Krishna used to hide the disastrous socialist policies followed by successive Indian National Congress governments. India's low annual growth rate of economy before 1991 was stagnant around 3.5%, and had been so since the 1950s.

2 Structural measures initially emphasized accelerating the process of industrial and import de-licensing simultaneously, with a switch to a flexible exchange rate regime, and then shifted to further trade liberalization, financial sector reforms, and tax reforms.

revenue expenditure and creating a debt trap in the 1980s. During the first half of the 1980s, these revenue expenditures averaged 18.5% of GDP. In the second half, they rose to an average of 22.4% with the bulk of the expansion coming under the heads of defense, interest payments, higher salaries (Fourth Pay Commission) and subsidies.

Studies by Srinivasan and Tendulkar (2003), Joshi and Little (1994), and others attribute the spurt in economic growth during the decade to demand-side factors. The flip side, however, was the spilling over of this into external balances. By 1990, the current account and fiscal deficits had risen to 3.5% and 9.4% of GDP respectively, leading to the BOP crisis of 1991 (Ahluwalia 2000, Arvind Panagariya 2004a and, 2004b; Balakrishnan and Suresh 2004; Nirvikar Singh and Srinivasan 2004). Containing this deficit was one of the key structural adjustments undertaken by the Indian government at the time. Economic reforms helped reduce the fiscal deficit, and the combined fiscal deficit fell to 6.3% of GDP in 1996–1997.

**Table 3.1: Finances of the Central and State Governments: Selected Indicators
(As % of GDP)**

| Year | Central | | | States | | | Combined | | |
|-----------------|---------|-------|-----|--------|------|------|----------|-------|-----|
| | GFD | GPD | RD | GFD | GPD | RD | GFD | GPD | RD |
| 1980–1989 | 6.7 | 4.1 | 1.7 | 2.8 | 1.7 | -0.1 | 7.9 | 4.9 | 1.6 |
| 1990–1999 | 5.9 | 1.6 | 3.0 | 3.1 | 1.2 | 1.2 | 7.7 | 2.7 | 4.2 |
| 2000–2001 | 5.7 | 0.9 | 4.1 | 4.2 | 1.8 | 2.6 | 9.5 | 3.6 | 6.6 |
| 2001–2002 | 6.2 | 1.5 | 4.4 | 4.1 | 1.4 | 2.6 | 9.9 | 3.7 | 7.0 |
| 2002–2003 | 5.9 | 1.1 | 4.4 | 4.1 | 1.2 | 2.3 | 9.6 | 3.1 | 6.6 |
| 2003–2004 | 4.5 | -0.03 | 3.6 | 4.4 | 1.5 | 2.3 | 8.5 | 2.1 | 5.8 |
| 2004–2005 | 4.0 | -0.04 | 2.5 | 3.4 | 0.7 | 1.2 | 7.5 | 1.3 | 3.6 |
| 2005–2006 | 4.1 | 0.4 | 2.6 | 2.5 | 0.2 | 0.2 | 6.7 | 1.0 | 2.8 |
| 2006–2007 | 3.5 | -0.2 | 1.9 | 1.9 | -0.4 | -0.6 | 5.6 | -0.01 | 1.3 |
| 2007–2008 | 2.7 | -0.9 | 1.1 | 1.4 | -0.6 | -0.9 | 4.2 | -1.3 | 0.2 |
| 2008–2009 RE | 6.1 | 2.5 | 4.5 | 2.7 | 0.7 | -0.1 | 8.9 | 3.5 | 4.4 |
| 2009–2010 BE | 6.8 | 3.0 | 4.8 | 3.4 | 1.4 | 0.6 | 10.2 | 4.5 | 5.5 |

GFD: Gross Fiscal Deficit
GPD: Gross Primary Deficit
RD: Revenue Deficit
RE: Revised Estimates
BE: Budget Estimates

Source: RBI, various issues.

A sharp increase in government salaries and pensions in the next year halted the process of fiscal improvement until 2003–2004 when the government introduced the Fiscal Responsibility and Budget Management Act³ (FRBM) to control the fiscal deficit. The Act required the Government of India to bring down its revenue deficit by 0.5% of GDP each year until it touched zero, and to reduce its fiscal deficit by 0.3% each year to a level of 3.0% of GDP. The targets were to be achieved by 2008–2009. Further, it set an annual limit of 9.0% on the union government's total liabilities and capped union government guarantees

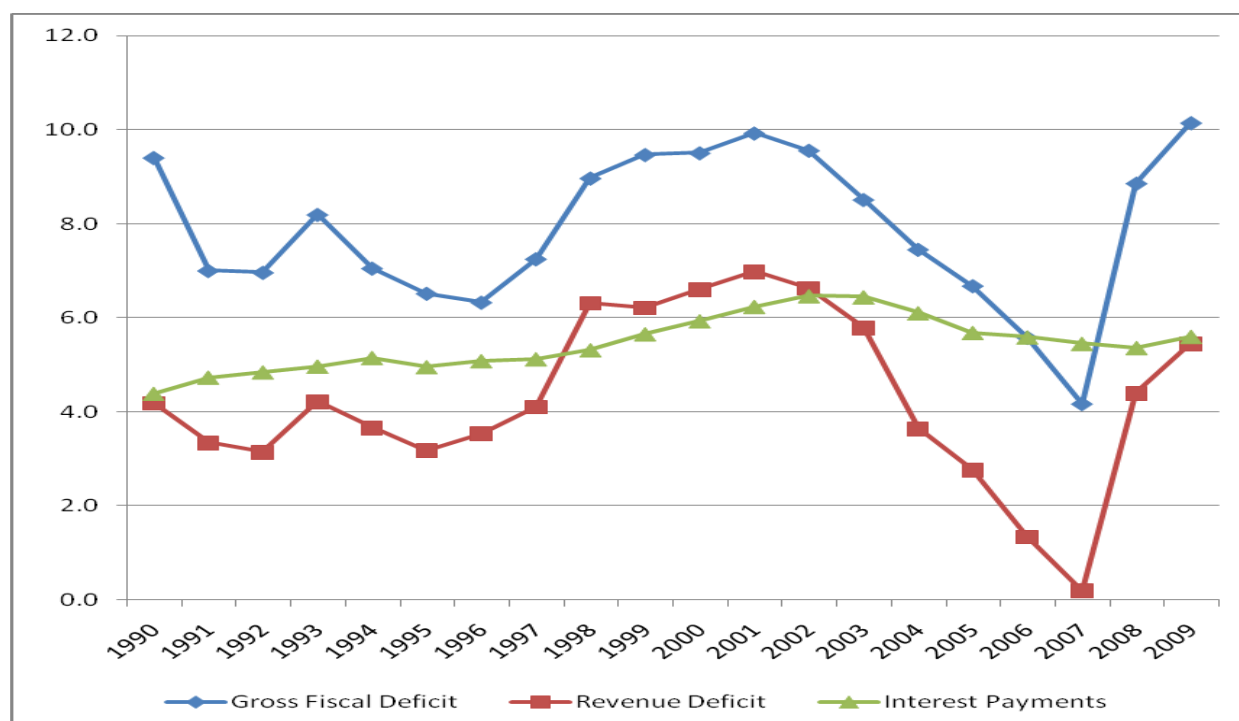
³ The FRBM Act was enacted by Parliament in 2003; later, Mr. Chidambaram, the finance minister in the UPA (United Progressive Alliance) government, notified the act on 2 July 2004.

for public sector units and state government loans at 0.5% of GDP. The targets laid out by the government's FRBM Act and state-level fiscal responsibility legislations were achieved in 2007–2008, a year ahead of schedule (except for the central government's revenue deficit target). The combined fiscal deficit came down to 4.2% of GDP in 2007–2008 (well below the prescribed 6.0%) and the primary deficit (fiscal deficit net of interest payments) turned into a surplus of 1.3% of GDP in 2007–2008.

However, there is a lot of disagreement among policy-makers about targeting a zero revenue deficit in India, for the reason that it sounds unrealistic to target a zero revenue deficit and a 3% fiscal deficit because this implicitly assumes that revenue expenditure does not contribute to growth. For a developing country, it may be argued that it is desirable to target a small revenue surplus to finance capital formation rather than target a zero revenue deficit. This means the government would be saving and contributing to capital formation (Chelliah 2000). Public finance experts like Dr. Chelliah have also questioned the wisdom of setting a 3% fiscal deficit target. He says, "... 3% is too low for a developing country as the government still has to spend large amounts of money on infrastructure investment, including social infrastructure such as hospitals and schools."

Figure 3.1 provides a synoptic view of fiscal trends from 1990–1991, the year in which India faced its economic crisis. There was a steady improvement in central and state finances from 2001–2002, when the fiscal and revenue deficits of the combined central and state governments had peaked at 9.9% and 7.0% of GDP respectively.

Figure 3.1: Fiscal Indicators of the Combined Central and State Governments (%GDP)



Source: RBI, various issues.

3.2 Debt Sustainability

The trends in fiscal deficit were mirrored in the rising public debt levels. The combined debt of the central and state governments, which averaged 56% of GDP in the 1980s, rose to an average of slightly over 63% in the 1990s and climbed further to touch a peak of 81.4% in 2003–2004 (see Table 3.2 and Figure 3.2). A notable feature was the drastic reduction in the share of the external liabilities to GDP from 6.7% (on the average) in 1980s to 1.7% in 2003–

2004⁴. After the introduction of the FRBM Act, public debt steadily declined until 2008–2009, when it stood at 74.7%. The concern now is that the high fiscal deficits of the past two years may suggest a long-term reversal of this trend. Budget estimates for 2009–2010 indicate an increase in the public debt to above 75% (about Rs 44,000 billion). It could be even higher if GDP growth slows down further.⁵ This also may reverse the downward movement in the public debt to GDP ratio in India, which has been achieved over the last few of years.

These trends also point to one of the main deficiencies in the FRBM Act, namely the failure to set a cap on public debt. There is little doubt that the FRBM Act put the country on a higher growth trajectory by reducing the fiscal and primary deficits, but a sound fiscal system also needs to have in place measures to control the debt to GDP ratio. We hope the next set of FRBM targets include policies towards reducing public debt.

The rise in public debt can be attributed to the sharp rise in the primary deficit (i.e. fiscal deficit minus interest payments). The basic rule is that the ratio of debt to GDP will keep rising if there is a primary deficit or if the interest rate on debt exceeds the growth rate of GDP. With the fall in the GDP growth rate because of the global financial crisis, concerns regarding the sustainability of such high levels of public debt have become stronger. Should economic growth slow down because of the crisis, debt servicing could pose a problem as interest rates decline only with a lag, which would result in a further deterioration in government finances. This may also point towards the need to adopt an early exit from the high fiscal deficit regime

⁴ Reinhart, Rogoff, and Savastano (2003) found inter alia that countries with a higher aggregate public debt to GDP ratio and higher share of external debt in the total public debt were more likely to default on their debt servicing (International Monetary Fund [IMF] 2003). In this respect, India has a major advantage of having a very low share of external debt in total public debt with external debt being only 5% of GDP.

⁵ ICRIER estimated GDP growth for the year 2009–2010 to be between 6.5–6.8% and inflation to be 4.0–5.0%. Therefore the nominal growth rate would be 10.50% as compared to 10.97% estimated by the Finance Ministry for the 2009–2010 budget.

Table 3.2: Debt Components of the Central and State Governments (As % of GDP)

| Year | Internal Debt (Central) | Internal Liabilities (Central) | External Debt and Liabilities (Central) | Outstanding Liabilities (Central) | Outstanding Liabilities (State) | Combined Outstanding Liabilities ⁶ (Central and State Public Debt) |
|-----------------------|-------------------------|--------------------------------|---|-----------------------------------|---------------------------------|---|
| 1980–1989 | 24.7 | 41.2 | 6.7 | 47.9 | 20.7 | 56.0 |
| 1990–1999 | 27.4 | 48.0 | 4.5 | 52.5 | 22.4 | 63.2 |
| 2000–2001 | 38.2 | 52.4 | 3.1 | 55.6 | 28.3 | 70.6 |
| 2001–2002 | 40.0 | 56.8 | 3.1 | 59.9 | 30.3 | 76.0 |
| 2002–2003 | 41.5 | 61.0 | 2.4 | 63.4 | 32.0 | 80.2 |
| 2003–2004 | 41.4 | 61.4 | 1.7 | 63.0 | 33.2 | 81.4 |
| 2004–2005 | 40.5 | 61.4 | 1.9 | 63.3 | 32.7 | 81.3 |
| 2005–2006 | 38.7 | 60.4 | 2.6 | 63.0 | 32.6 | 80.3 |
| 2006–2007 | 37.4 | 59.0 | 2.5 | 61.5 | 30.3 | 77.3 |
| 2007–2008 | 38.3 | 57.7 | 2.4 | 60.1 | 27.8 | 75.1 |
| 2008–2009 RE | 37.8 | 56.6 | 2.3 | 58.9 | 27.1 | 74.7 |
| 2009–2010 BE | 40.2 | 57.2 | 2.3 | 59.9 | 27.6 | 76.5 |
| RE: Revised Estimates | | | | | | |
| BE: Budget Estimates | | | | | | |

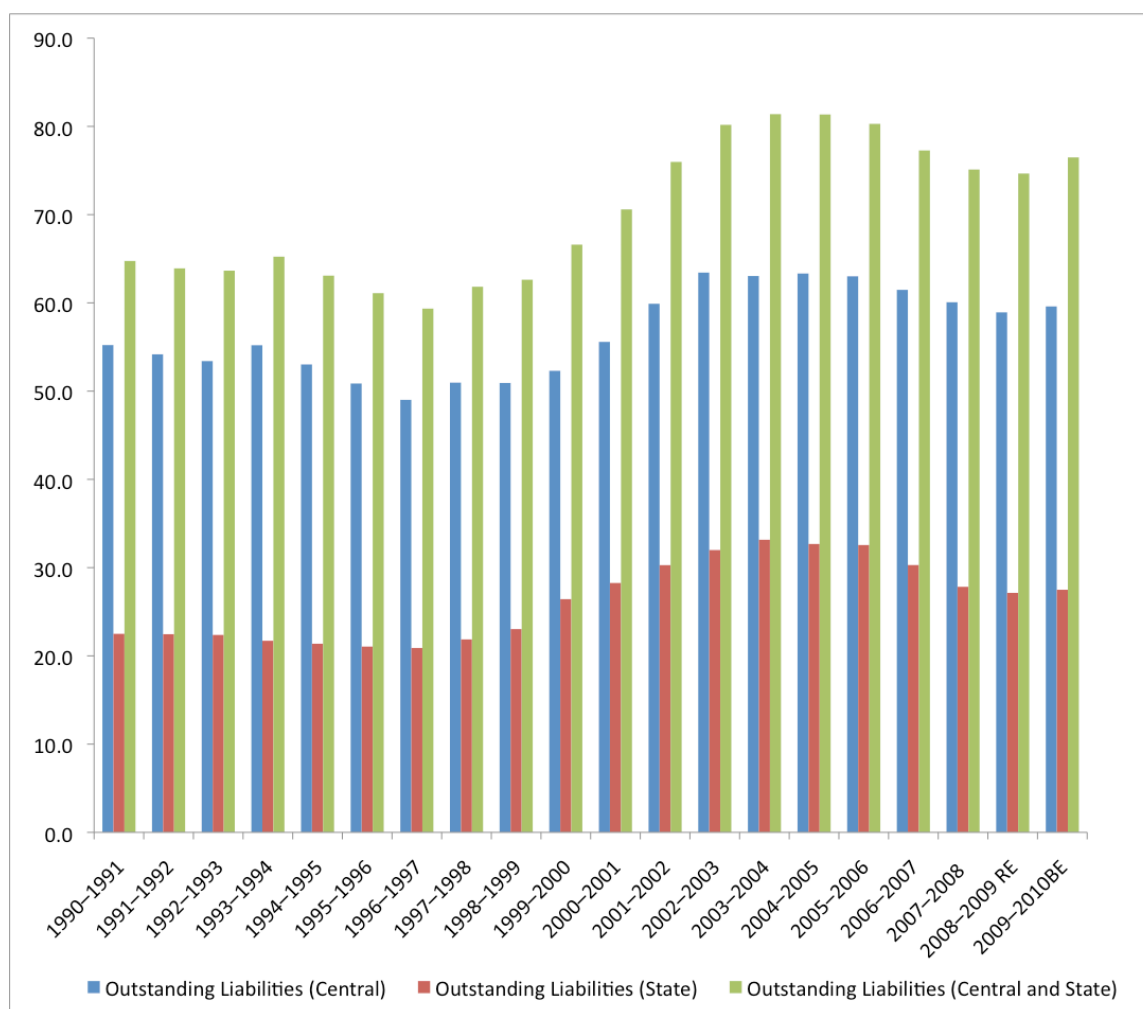
Source: RBI, various issues.

There is little consensus on what the ideal debt to GDP ratio for an economy should be. Internationally, the Maastricht Treaty has set the tolerable debt level at around 60% of GDP for the European Union countries. The Twelfth Finance Commission had recommended an even lower target of 56% over a period for India. To this end, it had also recommended that the ratio be brought down to at least 75% by 2009–2010.

If one goes by the budget estimates for 2009–2010, the government is quite clearly not going to be able to meet the target. The primary deficit, which as Rangarajan and Srivastava (2005)⁷ pointed out was the core variable that led to an increase in public debt to GDP ratio in the period 1951–2003, turned positive in 2008–2009. The gross primary deficit rose from -1.3% in 2007–2008 to 3.5% in 2008–2009 and is expected to rise further to 4.6% in 2009–2010. Since capital expenditure has been declining over this period, it is apparent that the main factor accounting for the rise in the gross primary deficit is increased revenue expenditures for both the central and state governments.

⁶ Outstanding liabilities (public debt) are comprised of the internal (market borrowings, RBI treasury bills, small savings and deposits, provident funds, and reserve funds) and external liabilities.

⁷ Rangarajan (2003) has found that during the 1970s and 1990s a negligible increase was seen in the debt to GDP ratio because nearly 100% of the impact of the primary deficit was absorbed by the growth-interest differential.

Figure 3.2: Debt of the Central and State Governments (As % of GDP)

Source: RBI, various issues.

3.3 Receipts and Disbursement of the Government

3.3.1 Central and State Governments' Expenditure

At the central level, average government expenditure⁸ stood at 17.6% of GDP in the 1980s (see Appendix 1). The share fell by 1.6% immediately after the reforms, mainly because of the macroeconomic stabilization program that followed the 1991 BOP crisis. However, a sharp rise in salaries and pensions following the acceptance of the Fifth Pay Commission report⁹ in 1996–1997 pushed the expenditure level back to the 16–17% level the following year—a level at which it stayed until the FRBM Act in 2004–2005.

After the FRBM was passed, central government's total expenditure fell from approximately 16% to 14% of GDP over the next two years. However, this expenditure control was achieved by cutting down capital expenditure sharply while revenue expenditure showed only a marginal decline. Thus, the composition of government expenditure, which has

⁸ Government expenditure consists of revenue and capital expenditures (mostly public investment). The major components of government revenue expenditure are interest payments on debt and subsidies.

⁹ Acharya (2001) describes the effects of the Fifth Pay Commission for government employees as "the single largest adverse shock" to public finances in the 1990s. His estimates indicate that compensation to employees (including pension) by central and state governments accounted for about half of the fiscal deficit increase of three percentage points of GDP during 1997–1999.

always been a matter of concern, remains unchanged with revenue expenditure accounting for about 80% of total expenditures.¹⁰

Public capital expenditure as a percentage of GDP declined from an average of 6.2% in the 1980s to 3.6% in 2004–2005 and further to 1.8% in 2008–2009. By contrast, revenue expenditure, which was 11.4% of GDP during the 1980s, rose to 12.2% in 2004–2005 and to 15.1% in 2008–2009.

As in the mid-1990s, the reason for the sharp rise in revenue expenditure in 2008–2009 has been the implementation of the recommendations of the Sixth Pay Commission Report and measures such as the debt waiver on farm loans and subsidies. Interest payments, which account for over 30% of revenue expenditure, stood at about 4% of GDP until 2004–2005. However, these came down to 3.6% in 2005–2006 and continued at the same level until 2008–2009. This, however, was not really the result of a reduction in borrowings but rather an effect of softening of interest rates.

The other major item of revenue expenditure has been subsidies. Budget data do not indicate the actual expenditure on subsidies because several subsidies are hidden in the production of intermediate goods and services and the quantum of subsidy at the stage of final consumption of goods or services is not clearly known (Radhakrishna and Panda 2006)¹¹. Explicit government budgetary subsidies like those on food, fertilizers, and petroleum products are only a small portion of the total subsidy.

Food subsidy as a percentage of GDP rose from 0.4% in 1990–1991 to 0.9% in 2003–2004. This has decreased since 2003–2004 and reached 0.6% in 2006–2007. However it started rising again in 2007–2008 (see Table 3.3)¹², partly due to enhanced food security measures with a higher subsidy for the poor. A part of this rise in subsidy is due to the high minimum support price for food grain procurement and the inefficient operation of the Food Corporation of India. This indicates scope for reducing subsidy without hurting the poor (Radhakrishna and Panda 2006). The government has recently taken some measures to make the food subsidy more target-group oriented by revamping the public distribution system and introducing differential prices for the poor and non-poor groups. Food subsidy has increased further and reached 0.9% of GDP in 2009–2010. Fertilizer subsidies have gradually increased to 0.7% of GDP in 2007–2008 and further shot up to 1.4% of GDP in 2008–2009, whereas petroleum subsidies were constant at 0.1% of GDP until 2009–2010.

¹⁰ The remaining 20% is the capital expenditure.

¹¹ Several studies have attempted to make a comprehensive estimate of implicit and explicit subsidies by central and state governments. All these studies pertain to the late 1980s and 1990s. The estimated figures are high at about 12–13.5% of GDP during the period (e.g., Mundle and Rao 1992; National Institute of Public Finance and Policy (NIPFP), 1997).

¹² The figures given in Table 3.3 are the subsidies that are included in the budget. There are off-budget subsidies given on food, fertilizer, and petroleum.

Table 3.3: Subsidies (As a % of GDP)

| | 2003–2004 | 2004–2005 | 2005–2006 | 2006–2007 | 2007–2008 | 2008–2009 RE | 2009–2010 BE |
|---|-----------|-----------|-----------|-----------|-----------|--------------|--------------|
| Subsidies | 1.6 | 1.5 | 1.3 | 1.4 | 1.5 | 2.4 | 1.9 |
| Food | 0.9 | 0.8 | 0.6 | 0.6 | 0.7 | 0.8 | 0.9 |
| Fertilizer | 0.4 | 0.5 | 0.5 | 0.6 | 0.7 | 1.4 | 0.8 |
| Petroleum | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| RE: Revised Estimates BE: Budget Estimates | | | | | | | |

Source: RBI, various issues.

More importantly, the growing practice of issuing special bonds to oil and fertilizer companies to support low consumer prices means that at least part of the subsidy burden is off the budget. While these subsidies do not appear in the budget, they do result in additional costs and risk for the government.¹³ Oil subsidies, which are included in off-budget bonds, not only affect the liquidity position but also change the fiscal position of the government itself. The off-budget expenditure incurred by the government has almost doubled to 1.80% of the GDP (Rs 970.19 billion) in 2008–2009 from 0.98% (Rs 403.61 billion) in 2006–2007.

Expenditures at the state level exhibit a trend similar to those at the central level. From an average of roughly 15.5% of GDP in the 1980s and 1990s, the total state-level expenditures rose to nearly 18.0% in 2004–2005 (see Appendix 2). While expenditures fell steadily for the next three years to 15.5% in 2007–2008 on account of the Twelfth Finance Commission measures, they rose again to 17.3% in 2008–2009. Budget estimates indicate that the level for 2009–2010 will climb back to the 2004–2005 level.

An increase in revenue expenditure also accounted for the rise in states' expenditure. Between 2004 and 2005, there was some reduction in revenue expenditure but the trend reversed in 2008–2009 and it is expected to touch a high of 14% in 2009–2010. Capital expenditure has shown a more fluctuating trend. In the immediate post-reform period, there was a sharp drop in states' capital expenditures. This was an unhealthy development, because by reducing capital expenditure to achieve fiscal balance, they had effectively compromised on building the infrastructure capacity needed to promote growth. There was a moderate increase in states' capital expenditure in the three-year period from 2002–2004 but it slipped again thereafter. However, it has since increased from 3.5% in 2007–2008 to 3.9% in 2008–2009.

3.3.2 Central and State Governments' Receipts

The persistent fiscal expenditures reveal that total receipts of both the central and state governments have remained consistently below total expenditures. Tax receipts, which contribute the bulk of the central government revenues, fell sharply in the period following the introduction of the reforms in 1992. This was the result of the rationalization of the tax structure. Total tax revenue as a proportion of GDP declined from 10.3% in 1990–1991 to the lowest level of 8.2% in 1998–1999. It was only in 2005–2006 that tax revenue touched the level it was at in 1990–1991 (see Appendix 1). Tax receipts rose to 12.6% in 2007–2008 but again declined to 11.8% in 2008–2009.

¹³ If heavy bond payments are made given the economic slowdown, budget deficits will rise significantly.

The tax reforms¹⁴ initiated since 1991 were part of the structural reform process after the 1991 economic crisis. The Tax Reforms Committee (TRC) concentrated on finding a suitable framework to reform both the direct and indirect tax structure. The committee recommended two major reforms on direct taxes—one was the simplification and rationalization of the direct tax structure (Chelliah 1992); the other was to introduce a service tax to widen the tax base (Chelliah 1994).

The Chelliah Committee (1992: 4) had, in its interim report, recommended that as a first step towards the rationalization of the personal income tax structure a three-rate slab structure should be introduced and later replaced by a two-rate structure. Further, the committee suggested reducing corporate income taxes. Both the recommendations were accepted and implemented in 1992. The maximum marginal rate of personal income tax was reduced to 40% from 56% in June 1991. Further, rates of corporate income tax, which were 51.8% for a publicly listed company and 57.5% for a closely held company, were unified and reduced to 46.0% in 1992. These rates were inclusive of a 15% surcharge.

The 1992 reforms radically altered the composition of tax revenue at the central level¹⁵. Direct taxes as a percentage of GDP rose from 2.0% in the 1980s to 6.5% in 2008–2009. However, this rise in the proportion of direct taxes was offset by a reduction in central indirect tax revenues as a percentage of GDP from 7.9% to 5.3% over the same period. The share of non-tax revenue¹⁶ in GDP at the central level fluctuated between 2.0–3.0% during 1980–2009 with the 3.0% recorded in 2001–2002 and lowest 1.8% observed in 2008–2009.

The government also introduced a service tax in 1994 in line with the recommendations of the Chelliah Committee¹⁷. Until then, the service sector had been totally left out of the tax net though the sector's contribution to GDP had risen to 36% by 1993–1994. Starting with three services, viz., namely telephone, stock broking, and insurance services, the coverage has progressively widened over the years with about 80 services having been brought within the ambit of taxation till to date. A few important services brought under the service tax net are banking and other financial services, management consultants, credit rating agencies, and market research agencies. Some important services that are still outside of the tax net are legal consultancy services, transport of goods by waterways, and cosmetic or plastic surgery. The rate imposed originally was a moderate 5% of turnover. This was, however, progressively increased to 12% and an additional education tax of 2% on service tax was imposed in 2006–2007. The 2008 crisis, however, forced a rollback in the service tax rate to 10% in February 2009. Collections from service tax have shown a steady rise from 1994–1995 (0.2% of GDP) to 2008–2009 (1.1% of GDP). However, in 2008–2009, they accounted for only 10.4% of the total tax receipts of the central government while the share of services in total GDP has gone up to 57%.

Major changes on the indirect tax side included a sharp reduction in import duties from extremely high levels to a range of 15–30% for manufacturers, reduction of multiple excise tax rates to three in the range of 10–20%, and extension of the then existing modified value added tax (MODVAT)¹⁸ credit to all inputs. In 2000–2001, the government converted the three excise duties into a single central value added tax (CENVAT), levied at the rate of 16%. Subsequently, state-level value added tax (VAT) replaced CENVAT in 2005–2006

¹⁴ The list of fiscal reforms mainly on taxation is given in Appendix 3.

¹⁵ Direct taxes contribute a negligible amount to state revenues.

¹⁶ Non-tax revenue includes interest receipts, income from property, etc.

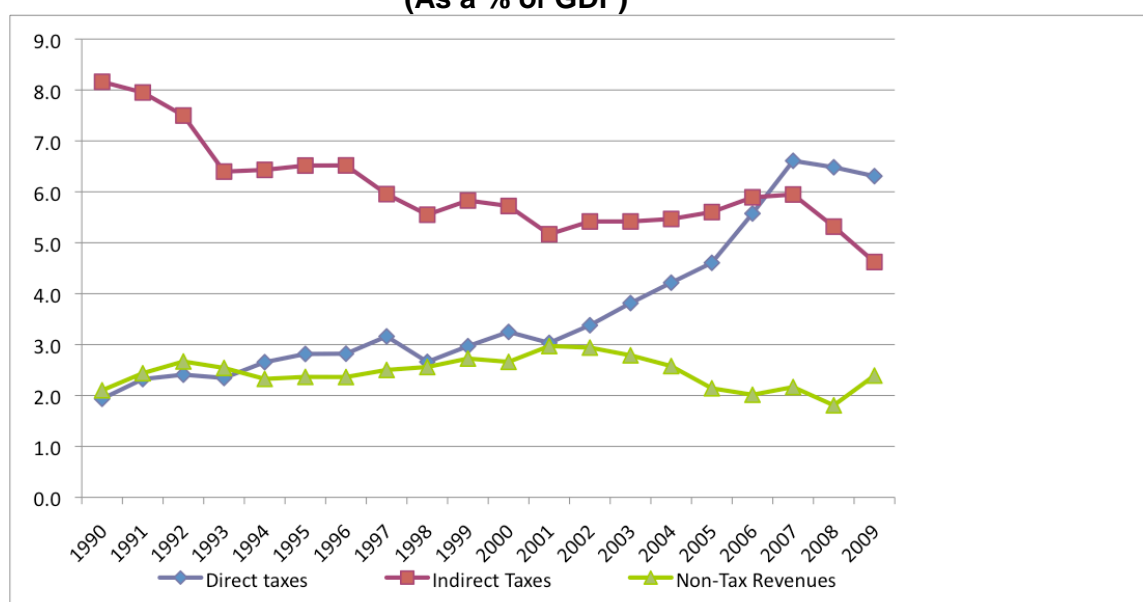
¹⁷ The objectives of levying a service tax are: (i) shrinking of the tax base as the share of industry in GDP decreases while that of services expands, (ii) failure to tax services distorts consumer choices and encourages spending on services at the expense of goods, (iii) untaxed service traders are unable to claim VAT on service inputs, which encourages businesses to develop in-house services, creating further distortions, and (iv) most of the services that are likely to become taxable are positively correlated with expenditure of high-income households and, therefore, service tax improves equity (Annual Report, RBI 2003–2004).

¹⁸ Under the MODVAT, a manufacturer can obtain credit for excise tax paid on capital goods and on inputs used in the manufacture of final products.

though initially only 20 states accepted the proposal. The acceptability of the VAT has gone up to 28 states to date. Four slabs of VAT have been uniformly applied across all states that adopted it—0.0% on necessities and primary goods, 1.0% on bullion and precious stones, 4.0% on industrial inputs and capital goods and items of mass consumption, and 12.5% on all other items. Necessities and primary products were left out of the ambit of VAT.

The government now intends to move to a goods and services tax (GST) regime, which will replace state-level VAT and CENVAT. The tax will be imposed on final goods and services with a two-rate structure. The GST, which is being steered by an empowered committee of state finance ministers, was expected to be launched in April 2010. Its introduction will most likely be delayed until October 2010. This will mark a major step in unifying the tax regime across the country and do away with tax arbitrage that currently disturbs investment decisions.

Figure 3.3: Direct and Indirect Taxes and Non-tax Revenues of the Central Government (As a % of GDP)



Source: RBI, various issues.

At the state level, fiscal health depends both on revenues from state taxes as well as constitutional and other transfers from the central government. There is a three-tier transfer mechanism in India. First, the Indian Constitution provides for mandatory transfer of revenue from central taxes on the basis of the recommendation of a Finance Commission that the central government is required to set up every five years. Each Finance Commission uses different criteria to transfer funds. Second, there are budgetary transfers made through the Planning Commission to implement plan projects¹⁹. Third, there are optional transfers through various union ministries and agencies. Fund transfers from the central government form a large part of revenue of the state governments. These transfers are accounted for in a state's revenue receipts. There are several issues related to the transparency of central government transfers and accounting problems. The discussion about these problems is beyond the scope of this paper.

A look at the revenue receipts of states shows that there was a steady improvement in the tax ratio during the study period. The revenue from states' tax receipts (including their share

¹⁹ The Planning Commission transfers resources on the basis of population, per capita income, tax effort, fiscal management, literacy, land reform, and other factors. The planning commission uses a formula where 30% of the transfers are in the form of grants and 70% as loans. States cannot accept grants without taking loans. Thus grants and loans are tied together.

in the central pool) as a ratio of GDP was virtually stagnant throughout the 1980s and 1990s at around 7.7% (see Appendix 2). There was some decline from 1994–1995 and the low point of 7.2% was reached in 1998–1999, the year in which the states had to revise their pay scales, which exacerbated their fiscal problems. The pay revision in 1997–1998 created more fiscal stress for state governments as revealed by the increase in their revenue deficit from 0.9% of GDP in 1990–1991 to 2.6% in 2000–2001. The extent of the stress on state budgets can be gauged from the fact that, since the mid-1990s, salaries and pensions account for 80–90% of revenue receipts in most states. However, the tax ratio has steadily improved from 7.8% in 2000–2001 and reached 9.6% in 2008–2009.

A major development at the state level is the adoption of VAT from 2005–2006. The VAT would help to remove the cascading tax burden. Tax revenue²⁰ is expected to rise as compliance improves under VAT. The state VAT has evidently helped tax revenues to increase from 8.6% in 2005–2006 to 9.6% in 2008–2009.

3.3.3 Combined Receipts and Disbursement

Taking the budgetary position of the central government and states together, one finds that the combined expenditure as a percentage of GDP rose from 26.8% in the 1990s to 27.4% in 2007–2008 (see Table 3.4). The subsequent two years show a sharp rise in expenditures, with the budget estimates for 2009–2010 showing expenditure at almost 32% of GDP. This has been a consequence of a sharp increase in public expenditure in the run up to the general elections of 2009–2010.

Total receipts have also shown a similar increase from around 26% to roughly 31% from the 1990's to 2008–2009 (see Table 3.4). Over 60% of receipts are accounted for by revenue receipts (both tax and non-tax). The rest has come from capital receipts of which the two major components have been debt capital receipts (mainly borrowings) and disinvestment.

The share of the central government's capital receipts²¹ in GDP was just above 6% until 2000–2001 and thereafter increased until 2003–2004. Since then, it declined reaching 3.6% in 2007–2008. As Table 3.4 indicates, debt capital receipts have been the major contributor to capital receipts. The contribution from disinvestment has been about 1–2% of capital receipts in the post-reform period. Disinvestment was the highest in 2003–2004, amounting to Rs 169.53 billion (0.6% of GDP). However, it did not pick up momentum till until 2007–2008²² where the disinvestment receipts were Rs 457.50 billion (about 1% of GDP)²³.

²⁰ The states receive about 30% of total tax collection from the central government from the shareable common pool according to the norms prescribed by the Finance Commission.

²¹ Capital receipts consist of debt and non-debt capital receipts of the central government. Disinvestment receipts are considered to be the important non-debt capital receipts from 1991–1992.

²² From 2005–2006 disinvestment proceedings of the government includes sale of 'land and property' and debt relief.

²³ With the setting up of National Investment Fund (NIF), all proceeds from disinvestment of Central Public Sector Enterprises (CPSEs) are required to be routed to it, which is maintained outside the Consolidated Fund of India. (Annual Reports, RBI).

Table 3.4: Combined Receipts and Disbursement of the Central and State Governments (As a % of GDP)

| | 1980 – 1989 | 1990 – 1999 | 2000 – 2001 | 2001 – 2002 | 2002 – 2003 | 2003 – 2004 | 2004 – 2005 | 2005 – 2006 | 2006 – 2007 | 2007 – 2008 | 2008 – 2009 RE | 2009 – 2010 BE |
|---------------------------|----------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------------|-------------------------|
| Total Expenditure | 28.8 | 26.8 | 28.3 | 28.6 | 28.7 | 28.9 | 27.6 | 26.8 | 26.9 | 27.4 | 31.2 | 31.9 |
| Revenue Expenditure | 20.7 | 22.3 | 24.6 | 24.5 | 25.1 | 24.6 | 23.2 | 22.5 | 22.6 | 22.4 | 26.3 | 27.1 |
| Interest Payments | 3.1 | 5.0 | 5.9 | 6.2 | 6.5 | 6.4 | 6.1 | 5.7 | 5.6 | 5.5 | 5.4 | 5.6 |
| Capital Expenditure | 8.1 | 4.5 | 3.7 | 4.1 | 3.6 | 4.3 | 4.4 | 4.3 | 4.3 | 5.0 | 4.9 | 4.8 |
| Capital Outlay | - | - | - | 2.6 | 2.7 | 3.1 | 3.6 | 3.7 | 3.8 | 4.7 | 4.4 | 4.5 |
| Loans and Advances | - | - | - | 1.2 | 0.9 | 1.2 | 0.8 | 0.6 | 0.5 | 0.4 | 0.4 | 0.3 |
| Total Receipts | 27.1 | 26.0 | 28.5 | 28.5 | 28.8 | 29.0 | 28.2 | 28.3 | 27.3 | 27.8 | 30.9 | 31.4 |
| Revenue Receipts | 18.9 | 18.1 | 18.0 | 17.5 | 18.5 | 18.8 | 19.5 | 19.7 | 21.2 | 22.2 | 21.9 | 21.6 |
| Tax Revenues | 15.0 | 14.6 | 14.5 | 13.8 | 14.6 | 15.1 | 15.7 | 16.3 | 17.5 | 18.5 | 18.1 | 17.5 |
| Direct Taxes | 2.5 | 3.2 | 3.8 | 3.6 | 4.1 | 4.6 | 5.0 | 5.4 | 6.5 | 7.5 | 7.4 | 7.4 |
| Indirect Taxes | 12.5 | 11.4 | 10.7 | 10.2 | 10.5 | 10.5 | 10.7 | 10.9 | 11.0 | 11.0 | 10.7 | 10.1 |
| Non-Tax Revenues | 3.9 | 3.5 | 3.5 | 3.8 | 3.9 | 3.7 | 3.9 | 3.3 | 3.7 | 3.7 | 3.8 | 4.2 |
| Capital Receipts | 8.2 | 7.9 | 10.5 | 11.0 | 10.3 | 10.2 | 8.7 | 8.6 | 6.0 | 5.6 | 9.0 | 9.8 |
| Debt Capital Receipts | - | - | - | 10.2 | 9.7 | 8.6 | 8.0 | 8.2 | 6.0 | 4.5 | 8.6 | 9.6 |
| Non-Debt Capital Receipts | - | - | - | 0.80 | 0.65 | 1.57 | 0.62 | 0.37 | 0.04 | 1.07 | 0.40 | 0.17 |
| Disinvestment Proceeds | - | 0.2 | 0.1 | 0.2 | 0.1 | 0.6 | 0.1 | 0.0 | 0.0 | 0.96 | 0.2 | 0.0 |
| Revenue Deficit | 1.8 | 4.2 | 6.6 | 7.0 | 6.6 | 5.8 | 3.6 | 2.8 | 1.3 | 0.2 | 4.4 | 5.5 |
| Gross Fiscal Deficit | 8.0 | 7.7 | 9.5 | 9.9 | 9.6 | 8.5 | 7.5 | 6.7 | 5.6 | 4.2 | 8.9 | 10.2 |
| Gross Primary Deficit | 4.9 | 2.7 | 3.6 | 3.7 | 3.1 | 2.1 | 1.3 | 1.0 | 0.0 | -1.3 | 3.5 | 4.6 |

Notes: RE: Revised Estimates; BE: Budget Estimates

Source: RBI, various issues.

3.4 Public Sector Savings and Investment²⁴

The deterioration in the fiscal position of the central and state governments has impacted public sector savings and investment. The share of nominal public sector savings in nominal output²⁵ averaged just above 3.5% in the 1980s (see Table 3.5). This had reduced to an average of 1.5% in the 1990s. Public sector savings deteriorated further in the period after reforms were initiated, turning negative (-1.8%) in 2000–2001. Though there was some improvement in 2002–2003, public sector savings turned positive again only in 2003–2004, a trend that was maintained until 2008–2009. They peaked in 2007–2008 reaching 4.5% of GDP. There was a sharp deterioration in 2008–2009 when public sector savings turned negative at -1.8%. Budget estimates for 2009–2010 indicate a further deterioration.

The 1980–2009 period also saw a rapid decline in public sector investment, especially in the infrastructure and agriculture sectors. The fall was particularly sharp after the 1991 reforms. Since state governments in India typically handle both agriculture and infrastructure,

²⁴ The public sector includes administrative departments, department enterprises, non-departmental enterprises, and quasi-government bodies. The data is available for quasi-government bodies from 1993–1994 only.

²⁵ The percentage share of public sector output in the total GDP was fluctuating between 20–30% in the 1980s and 1990s. It has been stagnant at just above 20% since 2005–2006.

declining public sector investment reflects in part the deterioration in the fiscal position of state governments.

Concern remains that high fiscal deficits would crowd out private investment by keeping interest rates high in the short-term. In the long term, the lack of critical investments would prevent the crowding in effect from becoming operative. A growing fiscal deficit will, therefore, adversely impact both the long and short-term growth prospects of the economy.

Table 3.5: Public Sector Savings and Investment²⁶ (As % of GDP)

| Year | Public Investment | Public Savings |
|-----------------------|-------------------|----------------|
| 1980–1989 | 10.6 | 3.7 |
| 1990–1999 | 8.5 | 1.5 |
| 2000–2001 | 6.9 | -1.8 |
| 2001–2002 | 6.9 | -2.0 |
| 2002–2003 | 6.1 | -0.6 |
| 2003–2004 | 6.3 | 1.1 |
| 2004–2005 | 6.9 | 2.2 |
| 2005–2006 | 7.6 | 2.4 |
| 2006–2007 | 8.0 | 3.3 |
| 2007–2008 | 9.1 | 4.5 |
| 2008–2009 RE | 6.9 | -1.8 |
| 2009–2010 BE | 6.9 | -2.0 |
| RE: Revised Estimates | | |
| BE: Budget Estimates | | |

Source: National Accounts Statistics, various issues.

3.5 Structural and Cyclical Behavior of Major Fiscal Variables

3.5.1 Relationship Between Gross Fiscal Deficit and Growth

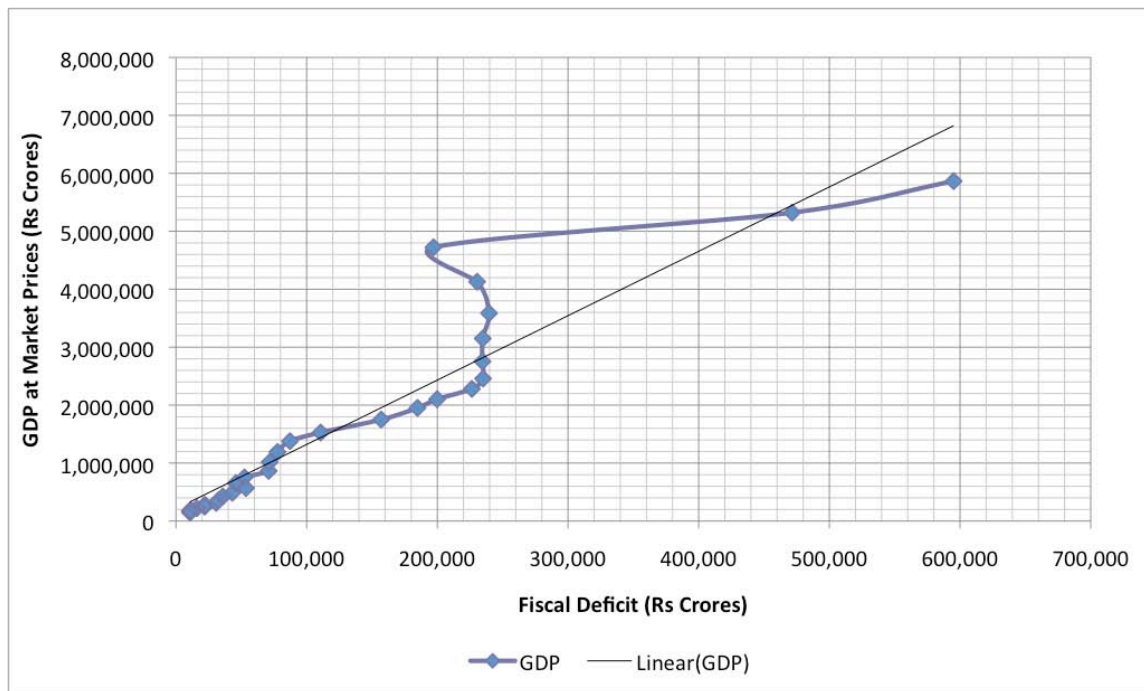
The relationship between the fiscal deficit and output growth has been of enduring interest for the Indian economy. In Figure 3.4, the annual data of the combined gross fiscal deficit (GFD) of both the central and state governments is plotted against GDP at market prices from 1980–1981 to 2009–2010 (BE Budget Estimates). Until 2002–2003, there appeared to be considerable long-run coordinate movement between these two series. This indicates that the relationship is structural rather than cyclical. However, for a short period over 2006–2007 and 2007–2008, fiscal deficit decreased as the output increased. This negative relationship could be attributed to the implementation and realization of FRBM targets. There is a sudden jump in fiscal deficit in 2008–2009 and 2009–2010 (BE), though output has grown at a slower pace²⁷, making the association between GFD and GDP horizontal in 2008–2009 and 2009–2010. Nonetheless, there is an upward linear trend exhibited throughout the study period implying a positive relation between fiscal deficit and output growth.

²⁶ The difference between public investment and public savings does not equal to fiscal deficit as the definition of public sector also includes non-departmental enterprises. Savings and investment of administrative departments and departmental enterprises are more directly related to fiscal deficit, and its impact on growth.

²⁷ The slower growth in output is due to current global crisis and the sudden rise in fiscal deficit is due to salary hike and debt waiver schemes, fiscal stimulus packages, and other fiscal factors.

Interestingly, we find different results altogether when gross fiscal deficit as a share of GDP is plotted. Figure 3.5 shows the gross fiscal deficit as a share of GDP. The relative growth of GFD to GDP exhibits cyclical behavior through the study period. The cycle does not seem to coincide with the electoral cycle but the peaks coincide exactly with the pay commission recommendations²⁸ and the troughs coincide with fiscal reforms²⁹.

Figure 3.4: Scatter Plot of Combined GFD and GDP

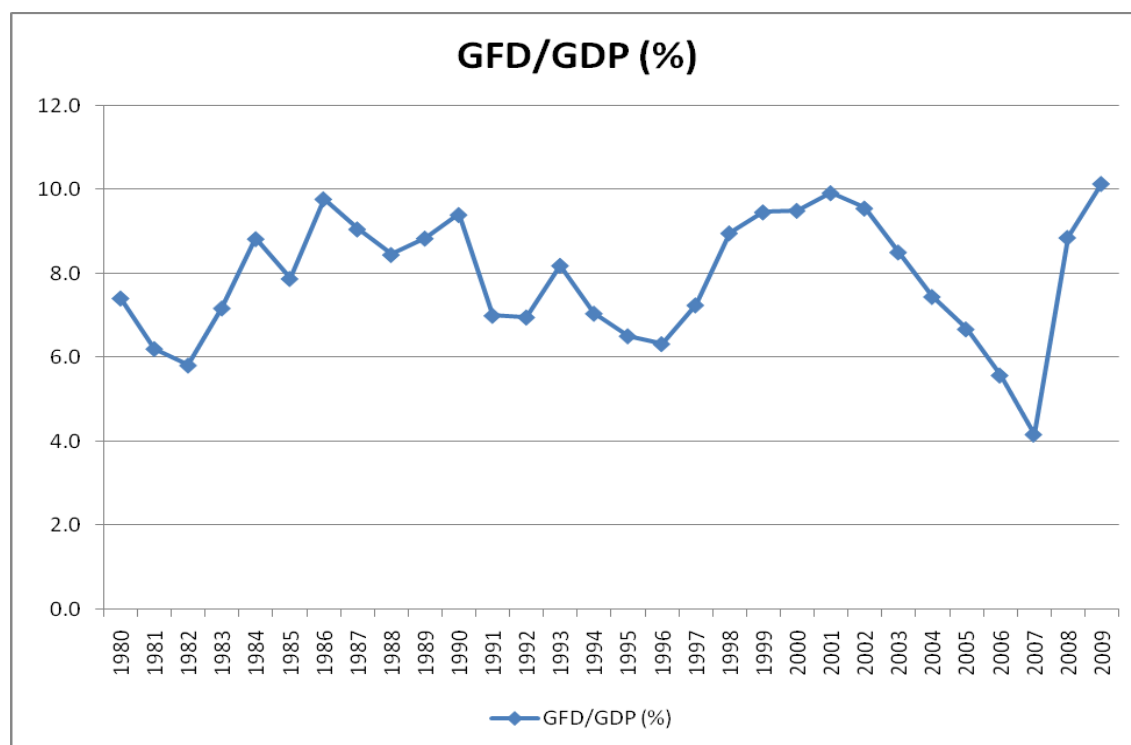


Source: RBI, various issues.

²⁸ Fourth Pay Commission in 1986–1987, Fifth Pay Commission in 1997–1998, and Sixth Pay Commission in 2008–2009.

²⁹ Economic reforms in 1991–1992, tax reforms in 1992–1993, and FRBM Act in 2004–2005.

Figure 3.5: Combined GFD as a Share of GDP (%)



Source: RBI, various issues.

As discussed earlier in the paper, the relationship between the size of fiscal deficit and GDP growth has been an intensely debated one. There are those who believe in its “crowding in” effect in a developing economy. Their view is contrasted by others who see a high fiscal deficit as pre-empting domestic savings and discouraging private investment, resulting in a “crowding out” phenomenon. We have tried to test the validity of these arguments, by trying to quantify the relationship between GDP growth and fiscal deficit taken as a percentage of GDP. We estimated the simple equation given below.

$$1. \text{Gr GDP} = 8.63 + 0.07 \text{Gr GCF} - 0.41 \text{GFD/GDPM}^{30}$$

$$(3.8) \quad (1.8) \quad (-1.5)$$

$$\bar{R}^2 = 0.17 \quad \text{DW} = 1.92$$

Equation 1 yields a negative correlation, though a weak one, between GDP growth and fiscal deficit as a percentage of GDP. This substantiates the argument made by several Indian economists (Govinda Rao 2009; Rangarajan 2009).

But the long run relationship between GDP and fiscal deficit, using the logarithm of both to avoid non-stationarity problem, is surprisingly a positive one as given by Equation 2.

$$2. \text{Log GDP} = 1.28 + 0.64 \text{Log GCF} + 0.19 \text{Log GFDR} + 0.39 \text{AR} (1)$$

$$(2.6) \quad (15.9) \quad (3.4) \quad (2.0)$$

$$\bar{R}^2 = 0.99 \quad \text{DW} = 2.1$$

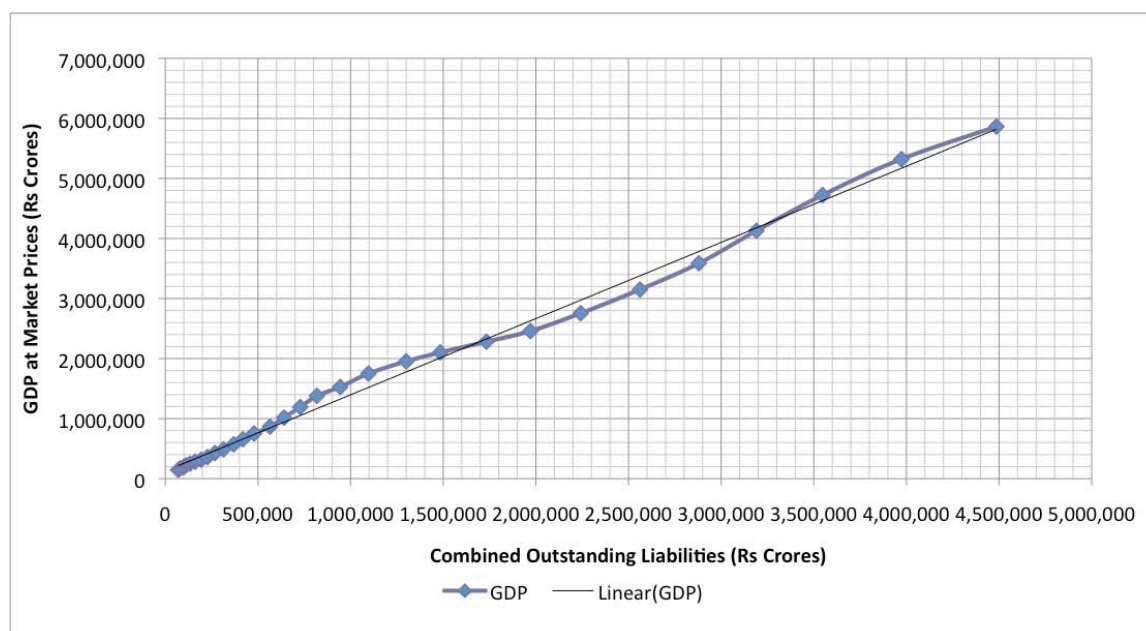
³⁰ GDP = gross domestic product at constant factor prices, GDPM = gross domestic product at current market prices, GCF = real gross capital formation, GFD = gross fiscal deficit, GFDR= gross fiscal deficit in constant prices, Gr indicates growth rate.

Apparently in conditions of unemployed resources and rising demand, an expansion in public expenditure, even when it increases the fiscal deficit, results in the positive impact of “crowding in” swamping the negative effect.³¹

3.5.2 Relationship Between Public Debt and Growth

Annual data on the combined outstanding liabilities and GDP at current market prices from 1980–1981 to 2009–2010 (BE) is plotted in Figure 3.6. The scatter graph below depicts trends that are similar to that in the case of the fiscal deficit throughout the study period, confirming the structural behavior of public debt over decades. It shows that there is a positive relation between GDP and public debt from 1980s. However, there seems to be a marginal downturn from 2007–2008 to 2009–2010, implying rising public debt has had a negative impact in recent years.

Figure 3.6: Scatter Plot of Combined Outstanding Liabilities and GDP



Source: RBI, various issues.

4. GLOBAL CRISIS AND INDIA'S FISCAL DEFICIT

The deviations seen in the structural relationship between the GDP and GFD in 2008–2009 and 2009–2010 can be attributed to the impact of the global economic crisis.

4.1 Global Financial Crisis

The sub-prime crisis that emanated from the United States (US) has led to liquidity and solvency problems all around the world. Even though India, like other developing countries, did not have direct exposure to the crisis, the effects have been felt through credit, exports, and exchange rate channels. India's engagement with the global economy has deepened since the 1990s, making it vulnerable to global financial and economic crises. The impact of the current global crisis has been transmitted to the Indian economy through three distinct channels, namely, the financial sector, exports, and exchange rates (Kumar 2009). However, four factors helped India to cope with the crisis and soften its impact. They are: (1) the

³¹ However, there appears to be a relatively high correlation between GCF and GFDR, which dilutes the validity of the long run equation.

robust, well-capitalized and well-regulated financial sector; (2) the gradual and cautious opening up of the capital account; (3) the large stock of foreign reserves, and (4) a greater dependence on domestic consumption as a driver of GDP growth. Consumption accounted for more than 70% of India's GDP and GDP growth was 7.3% during 2000–2007. India's GDP growth declined to 5.8% (year-on-year) in the second half of 2008–2009 from 7.8% in the first half. The growth improved to 6.1% in the first quarter of 2009–2010. ICRIER estimates the GDP growth rate for the Indian economy is likely to be between 6.5–6.8% in 2009–2010.

The contagion from the global financial crisis warranted appropriate monetary and fiscal policy responses to ensure enough liquidity in the economy, the orderly functioning of markets, and financial stability. Given the role of fiscal measures to fight the economic slowdown, the government's ability to raise resources for spending and the economy's existing fiscal health, there is need to study the viability of fiscal stimulus in India. In this section, we discuss the Indian fiscal response to the current crisis and attempt projections of fiscal deficit and public debt to check for their sustainability in coming years.

4.2 Trends in Fiscal Indicators in 2008–2009 and 2009–2010

As discussed above, India's fiscal situation improved significantly after the adoption of FRBM targets by successive governments since 2003–2004 until the global crisis hit the Indian economy in early 2008–2009. The high rate of GDP growth, which averaged 8.7% between 2003–2004 and 2008–2009, also contributed to revenue buoyancy and helped bring down both revenue and fiscal deficits.

The combined fiscal deficit in 2007–2008 was just about 4% and revenue deficit was very close to zero along with a primary surplus. However, the situation changed drastically in 2008–2009. The central budget in 2008–2009, announced in February 2008, seemed to continue the progress towards FRBM targets by showing a low fiscal deficit of 2.5% of GDP. However, the 2008–2009 budget quite clearly made inadequate allowances for rural schemes like the farm loan waiver and the expansion of social security schemes under the [National Rural Employment Guarantee Act](#) (NREGA), the Sixth Pay Commission award and subsidies for food, fertilizer, and petroleum. These together pushed up the fiscal deficit sharply to higher levels. There were also off-budget items like the issue of oil and fertilizer bonds, which should be added to give a true picture of fiscal deficit in 2008–2009. The fiscal deficit shot up to 8.9% of GDP (10.7% including off-budget bonds) against 5.0% in 2007–2008 and the primary surplus turned into a deficit of 3.5% of GDP (see Table 4.1). The combined public debt, however, declined marginally to 74.7% of GDP because of a nominal growth in GDP of 12.7%. The revenue deficit increased substantially to 4.4% in 2008–2009.

The huge increase in public expenditure in 2008–2009 of 31.2% that followed a 27.4% in 2007–2008 was driven by the electoral cycle with parliamentary elections scheduled within a year of the announcement of the budget. The budget's fiscal expansion helped compensate the effect of monetary tightening and push up domestic demand, especially in the rural sector. This prevented a collapse in domestic demand when Indian exports suffered a huge collapse starting November 2008 in the wake of the global crisis. Therefore, it is important to include fiscal expansion undertaken by the Indian government in February 2008 as a part of the fiscal stimulus undertaken in response to the post-Lehman Brothers crisis.

Budget estimates for 2009–2010 indicate a further worsening with the fiscal and primary deficits rising in the current year. Fiscal and primary deficits are expected to be 10.2% and 4.5% of GDP respectively and the debt³² ratio is likely to deteriorate to 76.6% of the GDP. This has raised the issue of India's fiscal stability and debt sustainability once again.

³² The total outstanding liabilities of the central government as per 2009–2010 (BE) is about Rs 3,400 billion (59.6% of the GDP) of which internal debt accounts for 67.0%. Adding the state governments' outstanding

**Table 4.1: Receipts and Disbursement of the Central and State Governments
(As a % of GDP)**

| | Combined | | | Center | | | States | | |
|-----------------------|-------------------|---------------------|---------------------|-------------------|---------------------|---------------------|-------------------|---------------------|---------------------|
| | 2007 – 2008 | 2008– 2009 RE | 2009– 2010 BE | 2007 – 2008 | 2008– 2009 RE | 2009– 2010 BE | 2007 – 2008 | 2008– 2009 RE | 2009– 2010 BE |
| Total Expenditure | 27.4 | 31.2 | 31.9 | 15.1 | 16.9 | 17.4 | 15.5 | 17.3 | 17.7 |
| Revenue Expenditure | 22.4 | 26.3 | 27.1 | 12.6 | 15.1 | 15.3 | 12.0 | 13.4 | 14.0 |
| Capital Expenditure | 5.0 | 4.9 | 4.8 | 2.5 | 1.8 | 2.1 | 3.5 | 3.9 | 3.6 |
| Total Receipts | 27.8 | 30.9 | 31.4 | 18.3 | 20.0 | 20.2 | 15.8 | 17.0 | 17.1 |
| Revenue Receipts | 22.2 | 21.9 | 21.6 | 14.7 | 13.6 | 13.3 | 12.9 | 13.6 | 13.4 |
| Tax Revenues | 18.5 | 18.1 | 17.5 | 12.6 | 11.8 | 10.9 | 9.3 | 9.6 | - |
| Non-Tax Revenues | 3.7 | 3.8 | 4.2 | 2.2 | 1.8 | 2.4 | 4.0 | 3.9 | - |
| Capital Receipts | 5.6 | 9.0 | 9.8 | 3.6 | 6.4 | 6.9 | 2.9 | 3.4 | 3.7 |
| Revenue Deficit | 0.2 | 4.4 | 5.5 | 1.1 | 4.5 | 4.8 | -0.9 | -0.1 | 0.6 |
| Gross Fiscal Deficit | 4.2 | 8.9 | 10.2 | 2.7 | 6.1 | 6.8 | 1.4 | 2.7 | 3.4 |
| Gross Primary Deficit | -1.3 | 3.5 | 4.6 | -0.9 | 2.5 | 3.0 | -0.6 | 0.7 | 1.4 |
| RE: Revised Estimates | | | | | | | | | |
| BE: Budget Estimates | | | | | | | | | |

Source: RBI, various issues

The measures taken by the government to counter the effects of the global meltdown on the Indian economy have resulted in a shortfall in revenues and substantial increases in government expenditures, leading to a temporary deviation in 2008–2009 and 2009–2010 from the fiscal consolidation path mandated under the FRBM Act. The revenue deficit and fiscal deficit in 2009–2010 BE are, as a result, higher than the targets set under the FRBM Act and Rules. The combined government expenditure was 31.2% of GDP in 2008–2009 and is expected to increase to 31.9% in 2009–2010 (Table 4.1). The combined revenue expenditure is estimated to increase from 26.3% in 2008–2009 to 27.1% in 2009–2010. Owing to policy interventions for inflation management and subsequently for providing a stimulus to growth, the 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 has received a setback. The combined tax revenue of both the central and state governments is expected to come down by 0.6% in 2009–2010 due to a further reduction in indirect taxes.

4.3 Fiscal Stimulus Packages

In their response to the global crisis, governments of different countries have put through an unprecedented, globally coordinated fiscal stimulus package. Consequently, in India also, three fiscal stimulus packages have been unveiled since December 2008 to help the economic recovery. These have been largely in the form of a reduction in taxes and duties and, to some extent, incentives to the export sector. As we discussed above, the government had already allowed the fiscal deficit to expand beyond the originally targeted levels both in 2008–2009 and in early 2009–2010. Thus, luckily for India, its electoral cycle pushed up public expenditure and coincided with the global recession, helping India overcome the negative impact of the crisis.

liabilities of about Rs 1,600 billion (27.6% of the GDP), the combined outstanding liabilities accounts for 76.6% of the GDP (i.e. about Rs 4,400 billion in 2009–2010 [BE]).

The first fiscal stimulus package was introduced on 7 December 2008, the second on 2 January 2009, and the third one on 24 February 2009. These included an across-the-board central excise duty reduction by 4%, additional plan spending of Rs 200 billion, additional borrowing by state governments of Rs 300 billion for planned expenditure, assistance to certain export industries in the form of interest subsidy on export finance, refund of excise duties and central sales tax, other export incentives, and a 2% reduction in central excise duties and service tax, i.e., combined reduction of 6% in central excise duties. The total fiscal burden for these packages amounted to 1.8% of GDP in 2008–2009. Along with the expansion undertaken in the two budgets, the total fiscal stimulus over the last two years can be estimated at 3% of the GDP.

4.4 Projections

The authors made projections of the shares of the combined fiscal deficit and public debt (combined outstanding liabilities) to GDP for six to seven years down the line. The projections are given in Table 4.2. We projected both fiscal deficit and public debt as a share of GDP based on the past trends. The estimation³³ is carried out from 1980–1981 to 2007–2008. The optimal number of lags in the estimation was selected by using the Akaike Information Criteria (AIC)³⁴.

The projections show that the fiscal deficit as a percentage of GDP will increase from 8.9% in 2008–2009 to 10% in 2009–2010 and probably remain at the same level for 2010–2011. While these projections indicate that there will be a subsequent reduction in the deficit, the decline is insignificant until 2015–2016. If, however, the stimulus is withdrawn and GDP grows faster than the underlying rate that has been assumed, then fiscal deficit may return to the path prescribed by FRBM targets in the near future. The share of public debt in GDP will increase at a marginal pace. What these figures indicate is that the fiscal situation might deteriorate further if appropriate measures are not taken to control the deficit and public debt.

Table 4.2: Projections (As a % of GDP)

| Year | Gross Fiscal Deficit | Public Debt |
|-----------|----------------------|-------------|
| 2008–2009 | 8.9 | 74.7 |
| 2009–2010 | 10.0 | 75.4 |
| 2010–2011 | 10.0 | 75.7 |
| 2011–2012 | 9.9 | 75.9 |
| 2012–2013 | 9.9 | 76.1 |
| 2013–2014 | 9.8 | 76.3 |
| 2014–2015 | 9.8 | 76.4 |
| 2015–2016 | 9.7 | 76.6 |

4.4.1 Debt to GDP Ratio

The basic rule in debt dynamics is that the debt ratio will rise if there is a primary deficit and if the interest rate of debt exceeds the growth rate of GDP. Therefore, to reduce the ratio of debt to GDP, there must either be a primary surplus or the economy should grow faster than the rate of interest, or both. If one condition holds, it must be large enough to outweigh the

³³ GDP has been estimated by using ICRIER's revised estimates (6.8%).

³⁴ $GFD_t = \alpha + \beta * GFD_{t-1} + \mu_t$ and $D_t = \gamma + \delta * D_{t-1} + \mu_t$ where GFD and D stand for fiscal deficit and public debt.

adverse effect of the other³⁵. We have estimated³⁶ various scenarios of India's debt to GDP ratios from 2009–2010 to 2015–2016 on three alternative assumptions of nominal GDP growth rate (12%, 13%, and 14%), interest rate on debt (7%, 8%, and 9%) and primary deficit as percent of GDP (3%, 4%, and 5%). These are shown in Tables 4.3–4.5. Here g = nominal growth rate, i = nominal interest rate, p = primary deficit.

Table 4.3: Debt Ratios with GDP Growth at 12% and Alternative Interest Rates and Primary Deficits

| Year/D _t (%) | g = 12%, i = 7%, | | | g = 12%, i = 8%, | | | g = 12%, i = 9%, | | |
|----------------------------|------------------|--------|--------|------------------|--------|--------|------------------|--------|--------|
| | p = 3% | p = 4% | p = 5% | p = 3% | p = 4% | p = 5% | p = 3% | p = 4% | p = 5% |
| 2008–2009 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 |
| 2009–2010 | 74.4 | 75.4 | 76.4 | 75.0 | 76.0 | 77.0 | 75.7 | 76.7 | 77.7 |
| 2010–2011 | 74.0 | 76.0 | 78.0 | 75.4 | 77.3 | 79.3 | 76.7 | 78.6 | 80.6 |
| 2011–2012 | 73.7 | 76.6 | 79.5 | 75.7 | 78.6 | 81.4 | 77.6 | 80.5 | 83.5 |
| 2012–2013 | 73.4 | 77.2 | 80.9 | 76.0 | 79.7 | 83.5 | 78.5 | 82.4 | 86.2 |
| 2013–2014 | 73.2 | 77.7 | 82.3 | 76.2 | 80.9 | 85.6 | 79.4 | 84.2 | 88.9 |
| 2014–2015 | 72.9 | 78.3 | 83.6 | 76.5 | 82.0 | 87.5 | 80.3 | 85.9 | 91.5 |
| 2015–2016 | 72.6 | 78.8 | 84.9 | 76.8 | 83.1 | 89.4 | 81.2 | 87.6 | 94.1 |

Table 4.4: Debt Ratios with GDP Growth at 13% and Alternative Interest Rates and Primary Deficits

| Year/d _t (%) | g = 13%, i = 7%, | | | g = 13%, i = 8%, | | | g = 13%, i = 9%, | | |
|-------------------------|------------------|--------|--------|------------------|--------|--------|------------------|--------|--------|
| | p = 3% | p = 4% | p = 5% | p = 3% | p = 4% | p = 5% | p = 3% | p = 4% | p = 5% |
| 2008–2009 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 |
| 2009–2010 | 73.7 | 74.7 | 75.7 | 74.4 | 75.4 | 76.4 | 75.1 | 76.1 | 77.1 |
| 2010–2011 | 72.8 | 74.8 | 76.7 | 74.1 | 76.1 | 78.0 | 75.4 | 77.4 | 79.3 |
| 2011–2012 | 72.0 | 74.8 | 77.6 | 73.8 | 76.7 | 79.6 | 75.7 | 78.6 | 81.5 |
| 2012–2013 | 71.1 | 74.8 | 78.5 | 73.6 | 77.3 | 81.0 | 76.0 | 79.8 | 83.6 |
| 2013–2014 | 70.4 | 74.9 | 79.3 | 73.3 | 77.9 | 82.5 | 76.4 | 81.0 | 85.7 |
| 2014–2015 | 69.6 | 74.9 | 80.1 | 73.1 | 78.4 | 83.8 | 76.7 | 82.1 | 87.6 |
| 2015–2016 | 68.9 | 74.9 | 80.9 | 72.8 | 79.0 | 85.1 | 76.9 | 83.2 | 89.5 |

³⁵ See Mason (1985), Hamilton and Flavin (1986), Spaventa (1987), Bispham (1987), Blanchard (1990), Feldstein (2004), Rangarajan and Srivastava (2005).

³⁶ The estimation is done by using the basic equation for debt ratio $dt = pt + dt-1(i-gt) / (1+gt) + dt-1$ where dt = debt-GDP ratio in time t , pt = primary deficit-GDP ratio, $dt-1$ = debt-GDP ratio in time $t-1$, i = interest rate on debt, gt = GDP growth rate in nominal terms in time t .

**Table 4.5: Debt Ratios with GDP Growth at 14% and Alternative Interest Rates
and Primary Deficits**

| Year/d _t (%) | g = 14%, i = 7%, | | | g = 14%, i = 8%, | | | g = 14%, i = 9%, | | |
|-------------------------|------------------|--------|--------|------------------|--------|--------|------------------|--------|--------|
| | p = 3% | p = 4% | p = 5% | p = 3% | p = 4% | p = 5% | p = 3% | p = 4% | p = 5% |
| 2008–2009 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 | 74.7 |
| 2009–2010 | 73.1 | 74.1 | 75.1 | 73.8 | 74.8 | 75.8 | 74.4 | 75.4 | 76.4 |
| 2010–2011 | 71.6 | 73.6 | 75.5 | 72.9 | 74.8 | 76.8 | 74.2 | 76.1 | 78.1 |
| 2011–2012 | 70.2 | 73.0 | 75.9 | 72.0 | 74.9 | 77.7 | 73.9 | 76.8 | 79.6 |
| 2012–2013 | 68.9 | 72.6 | 76.2 | 71.3 | 75.0 | 78.6 | 73.7 | 77.4 | 81.2 |
| 2013–2014 | 67.7 | 72.1 | 76.5 | 70.5 | 75.0 | 79.5 | 73.4 | 78.0 | 82.6 |
| 2014–2015 | 66.5 | 71.7 | 76.8 | 69.8 | 75.1 | 80.3 | 73.2 | 78.6 | 84.0 |
| 2015–2016 | 65.4 | 71.3 | 77.1 | 69.1 | 75.1 | 81.1 | 73.0 | 79.1 | 85.3 |

From the above alternative scenarios, the best-case scenario is when GDP is growing at 14%, primary deficit is 3% of GDP and interest rate on debt is 7%. In this case, the debt ratio will decline to 65.4% in 2015–2016 from 74.7% in 2008–2009. The worst-case scenario is when GDP is growing at 12%, primary deficit is 5% of GDP, and the interest rate on debt is 9%. In that case, the debt ratio will rise to 94.1% by 2015–2016. For the current year, with a nominal growth rate below 12.0%, a primary deficit of 4.5% and an interest rate of about 7.5%, the emerging debt position is not a sustainable one. The policy implication is that India should strive to reduce primary deficit or achieve a primary surplus, raise the growth rate, and reduce the interest rate. The growth is in nominal terms and there is surely the option of inflating a pathway out of debt. However, this is not feasible given political sensitivity regarding inflation.

5. TOWARDS A FEASIBLE FISCAL EXIT STRATEGY— RESTORING FRBM TARGETS

At present, the focus around the world, as also in India, has shifted from managing the crisis to managing the recovery. The key challenge relates to the feasible fiscal exit strategy that needs to be designed and implemented. As a response to the current global crisis, the Indian government has adopted significant discretionary fiscal stimulus packages to promote investment and sustain aggregate demand. It is time now to move away from the stimulus packages and concentrate on long-term policy scenarios to control the fiscal situation as well as improve GDP growth. The magnitude of fiscal adjustment needed in the next couple of decades is almost unprecedented, especially for countries like India with relative high debt.³⁷ However, the situation is manageable because of the high potential growth rates that may see nominal GDP growth of over 13–14% in coming years.

There is not much room for further fiscal policy action in terms of stimuli as the consolidated fiscal deficit of the central and state governments in 2008–2009 is already 9% of GDP. This may even rise further as budget estimates for 2009–2010 suggest the budget deficit is likely to be about 10% of GDP. It could be nearer to 12% if all the off-budget items are taken into account. This implies a significant increase in government borrowing, which has risen from

³⁷ A study by the IMF's Fiscal Affairs Department suggests that the countries those expected to have debt in excess of 60% of GDP by 2014 would have to maintain an average primary surplus (revenue less expenditure before interest payments) of 0.5–4.0% beginning in 2014 to reduce the debt to 60.0% of GDP by 2030 (Horton, Kumar, and Mauro 2009).

Rs 1,269.12 billion (US\$25.3 billion³⁸) in 2007–2008 to Rs 3,265.15 billion (US\$65.3 billion) in 2008–2009 and is likely to be Rs 4,009.96 billion (US\$80.1 billion) in 2009–2010. This also implies a further rise in the debt to GDP ratio, which is expected to go up to 77%.

The key challenge involves balancing between public interventions and maintaining market confidence in the sustainability of public finances. This will involve focusing policy attention on removing some of the structural bottlenecks on raising the potential GDP growth rate. Essentially, this will imply efforts to improve the investment climate for both domestic and foreign investors, remove entry barriers to corporate investment in education and vocational training, improve the delivery of public goods and services, and expand physical infrastructure capacities, including a major effort to improve connectivity in the rural regions. Infrastructure is a key binding constraint on India's growth and the government should take up long-term projects to improve infrastructure facilities. The government also needs to step-up investment in human capital development through increased spending in areas such as primary education, primary health, and research and development. Investment in human capital will help achieve inclusive growth, and furthermore such expenditures should be considered as part of capital expenditure rather than as revenue expenditure (which is how they are categorized now) since they yield a return in the long-term by way of inter-generational equity and economic growth. These measures will constitute the package of second-generation structural reforms and will enable the Indian economy to climb out of the downward cyclical phase and then extend the upward phase for a longer period than was achieved in the last cycle.

On the revenue side, one way to exit is to increase or restore excise duties, which were reduced during the economic slowdown, to previous levels.³⁹ The consequent revenue gains can be used to generate employment in public infrastructure projects. However, given the uncertainty about the robustness of the recovery, completely reversing the tax cuts would affect the growth prospects. Partial reversing may help strengthen the revenues of the government without disrupting the growth prospects. Another possible option is to broaden the tax base. This will require changes to the tax structure, which is likely to become more important than before.

An important step in this direction is the expected introduction of the GST in October 2010. GST is going to replace CENVAT, state VAT, and service tax. The salient features of GST are the following:

A dual GST model with two separate components. Namely, the central GST (CGST) and state GST (SGST) will be introduced.

Both the central governments and states have to levy GST concurrently on all goods and services other than a small list of exemptions.

Cross-utilization of input tax credit between CGST and SGST will not be allowed except in case of inter-state transactions (IGST).

GST will have a two-rate structure: a standard rate for most goods and a lower rate for necessities.

A combined rate of 12% (8% for states and 4% for the central government) is seen to be revenue neutral⁴⁰.

³⁸ All dollar figures are in US dollars.

³⁹ Since the growth in industrial production and exports is picking up and rise in the inflation rate is now seen as alarming, the government may find itself under pressure to contain the fiscal deficit and hence, to reverse the tax cuts. Also, politically this is an opportune moment to reverse tax. With no major elections due in 2010, the government has little to fear by way of an adverse political fallout if tax cuts are reversed.

⁴⁰ Task Force of Thirteenth Finance Commission (2010–2015).

The proposed GST will be a comprehensive indirect tax levy on the manufacture, sale, and consumption of goods as well as services at a national level. It will allow a single price for each product across the country. The GST is likely to reduce indirect taxes paid on most of the goods and services as it would avoid the cascading effect. Product prices, therefore, can be expected to fall and ensure growth in demand. In addition, the integration of goods and services taxes will improve tax collections and thereby help increase economic growth. It will also end the long-standing differential treatment of the manufacturing and services sectors. Apart from eliminating cascading effects, double taxation, and other issues, the introduction of GST will facilitate credit on uniform terms across the entire supply chain and across all states. The consensus GST rates may emerge to be 14%. Even this will sharply bring down the incidence of indirect taxes in the economy and release new growth impulses.

Another tax reform that is likely to become effective in near future is the Direct Tax Code (DTC)⁴¹, which is designed to greatly simplify the dual tax structure. DTC will achieve this by eliminating distortions in the tax structure, expanding the tax base, and improving tax compliance by introducing moderate levels of taxation. Initial analysis shows that most of these objectives are achievable.

6. CONCLUSION

The Indian economy was on a cyclical slowdown after a five-year record boom and there are reasonable expectations that the economy will go for another strong growth phase after this brief slowdown. The impact of the current global crisis on India has been significant in terms of fiscal imbalances and the lower GDP growth rate, though India did not have direct exposure to sub-prime assets. It also dealt a severe blow to investment sentiments and consumer confidence in the economy. The policy response so far has been prompt in the form of monetary easing and fiscal expansion. However, this has sharply reversed the steady fiscal improvement over the past five years and weakened public finances considerably. This phase of fiscal expansion has to be wound down to ensure that macroeconomic stability is not threatened and the economy does not suffer from entrenched inflationary expectations and high capital costs, both of which will adversely impact the potential growth rate. Thus, an exit strategy will have to be carefully designed.

The objective of economic policy must be to maximize gains from global integration while ensuring a reduction in poverty and inequity. Therefore, a better way of responding to the crisis is to start the "second round of reforms" that are now overdue. The focus must now shift to promoting private investment, which can alone sustain rapid growth. It is hoped that the Thirteenth Finance Commission and the forthcoming budget will lay down a road map for bringing the fiscal balance back on the track laid down by the FRBM Act.

⁴¹ The major proposals contained in the DTC are cutting corporate profit tax from 34% (including surcharge and tax) to 25% (all inclusive) and changing the basis of the minimum alternate tax (MAT). Instead of 15% of book profits, it will be 2% of gross assets for non-banking companies and 0.25% of gross assets for banking companies.

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APPENDIX 1

Table A1: Receipts and Disbursement of Central Government (As a % of GDP)

| | 1980–1989 | 1990–1999 | 2000–2001 | 2001–2002 | 2002–2003 | 2003–2004 | 2004–2005 | 2005–2006 | 2006–2007 | 2007–2008 | 2008–2009 RE | 2009–2010 BE |
|------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|--------------|--------------|
| Total Expenditure | 17.6 | 16.0 | 15.5 | 15.9 | 16.8 | 17.1 | 15.8 | 14.1 | 14.1 | 15.1 | 16.9 | 17.4 |
| Revenue Expenditure | 11.4 | 12.2 | 13.2 | 13.2 | 13.8 | 13.1 | 12.2 | 12.2 | 12.5 | 12.6 | 15.1 | 15.3 |
| Interest Payments | 2.6 | 4.2 | 4.7 | 4.7 | 4.8 | 4.5 | 4.0 | 3.7 | 3.6 | 3.6 | 3.6 | 3.8 |
| Subsidies | 1.6 | 1.4 | 1.3 | 1.4 | 1.8 | 1.6 | 1.5 | 1.3 | 1.4 | 1.5 | 2.4 | 1.9 |
| Capital Expenditure | 6.2 | 3.7 | 2.3 | 2.7 | 3.0 | 4.0 | 3.6 | 1.9 | 1.7 | 2.5 | 1.8 | 2.1 |
| Capital Outlay | 3.7 | 2.3 | 1.1 | 1.5 | 1.3 | 1.0 | 0.9 | 0.3 | 0.2 | 0.2 | 0.3 | 0.2 |
| Loans and Advances | 2.5 | 1.4 | 1.2 | 1.2 | 1.2 | 1.2 | 1.7 | 1.5 | 1.5 | 2.3 | 1.6 | 1.9 |
| Total Receipts | 18.7 | 17.8 | 18.0 | 18.3 | 19.0 | 19.7 | 18.7 | 17.4 | 17.1 | 18.3 | 20.0 | 20.2 |
| Revenue Receipts | 12.3 | 11.8 | 11.6 | 11.2 | 11.7 | 12.0 | 12.3 | 12.4 | 13.5 | 14.7 | 13.6 | 13.3 |
| Tax Revenues | 9.9 | 9.3 | 9.0 | 8.2 | 8.8 | 9.2 | 9.7 | 10.2 | 11.5 | 12.6 | 11.8 | 10.9 |
| Direct Taxes | 2.0 | 2.6 | 3.2 | 3.0 | 3.4 | 3.8 | 4.2 | 4.6 | 5.6 | 6.6 | 6.5 | 6.3 |
| Personal Income Tax | - | 1.2 | 1.5 | 1.4 | 1.5 | 1.5 | 1.6 | 1.6 | 1.8 | 2.2 | 2.0 | 1.8 |
| Corporate Tax | - | 1.3 | 1.7 | 1.6 | 1.9 | 2.3 | 2.6 | 2.8 | 3.5 | 4.1 | 4.2 | 4.4 |
| Indirect Taxes | 7.9 | 6.7 | 5.7 | 5.2 | 5.4 | 5.4 | 5.5 | 5.6 | 5.9 | 5.9 | 5.3 | 4.6 |
| Excise Duties | - | 3.6 | 3.3 | 3.2 | 3.3 | 3.3 | 3.2 | 3.1 | 2.8 | 2.6 | 2.0 | 1.7 |
| Custom Duties | - | 2.9 | 2.3 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 | 2.1 | 2.2 | 2.0 | 1.8 |
| Service Tax | - | - | - | - | 0.3 | 0.3 | 0.5 | 0.6 | 0.9 | 1.1 | 1.2 | 1.1 |
| Non-Tax Revenues | 2.4 | 2.5 | 2.7 | 3.0 | 2.9 | 2.8 | 2.6 | 2.1 | 2.0 | 2.2 | 1.8 | 2.4 |
| Capital Receipts | 6.4 | 6.0 | 6.4 | 7.1 | 7.3 | 7.7 | 6.4 | 5.0 | 3.6 | 3.6 | 6.4 | 6.9 |
| Disinvestment Receipts | | 0.2 | 0.1 | 0.2 | 0.1 | 0.6 | 0.1 | 0.0 | 0.0 | 0.8 | 0.2 | 0.0 |
| Revenue deficit | 1.7 | 3.0 | 4.1 | 4.4 | 4.4 | 3.6 | 2.5 | 2.6 | 1.9 | 1.1 | 4.5 | 4.8 |
| Gross Fiscal Deficit | 6.7 | 5.9 | 5.7 | 6.2 | 5.9 | 4.5 | 4.0 | 4.1 | 3.5 | 2.7 | 6.1 | 6.8 |
| Gross Primary Deficit | 4.1 | 1.6 | 0.9 | 1.5 | 1.1 | 0.0 | 0.0 | 0.4 | -0.2 | -0.9 | 2.5 | 3.0 |

Source: RBI, various issues.

APPENDIX 2

Table A2: Receipts and Disbursement of State Governments (As a % of GDP)

| | 1980– 1989 | 1990– 1999 | 2000– 2001 | 2001– 2002 | 2002– 2003 | 2003– 2004 | 2004– 2005 | 2005– 2006 | 2006– 2007 | 2007– 2008 | 2008– 2009 RE | 2009-10 BE |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|------------------|---------------|
| Total Expenditure | 15.7 | 15.4 | 16.2 | 16.2 | 16.7 | 18.7 | 17.6 | 15.7 | 15.9 | 15.5 | 17.3 | 17.7 |
| Revenue Expenditure | 11.4 | 12.5 | 13.7 | 13.6 | 13.5 | 13.5 | 12.8 | 12.2 | 12.2 | 12.0 | 13.4 | 14.0 |
| Interest Payments | 1.1 | 1.9 | 2.4 | 2.7 | 2.8 | 2.9 | 2.7 | 2.3 | 2.3 | 2.1 | 2.0 | 2.0 |
| Capital Expenditure | 4.3 | 2.9 | 2.5 | 2.6 | 3.2 | 5.1 | 4.8 | 3.4 | 3.7 | 3.5 | 3.9 | 3.6 |
| Capital Outlay | 1.9 | 1.4 | 1.4 | 1.4 | 1.5 | 1.9 | 1.9 | 2.2 | 2.4 | 2.4 | 2.8 | 2.6 |
| Loans and Advances | 1.3 | 0.8 | 0.4 | 0.4 | 0.4 | 0.8 | 0.5 | 0.4 | 0.3 | 0.4 | 0.3 | - |
| Total Receipts | 15.5 | 15.4 | 16.3 | 16.0 | 16.9 | 18.7 | 17.9 | 16.6 | 16.3 | 15.8 | 17.0 | 17.1 |
| Revenue Receipts | 11.5 | 11.3 | 11.1 | 10.9 | 11.1 | 11.2 | 11.5 | 12.0 | 12.8 | 12.9 | 13.6 | 13.4 |
| Tax Revenues (Including Share in Central Pool) | 7.6 | 7.7 | 7.8 | 7.7 | 7.9 | 8.0 | 8.3 | 8.5 | 9.0 | 9.3 | 9.6 | - |
| Non-Tax Revenues | 3.9 | 3.6 | 3.2 | 3.2 | 3.3 | 3.2 | 3.3 | 3.5 | 3.8 | 4.0 | 3.9 | - |
| Capital receipts | 4.0 | 4.1 | 5.2 | 5.1 | 5.7 | 7.5 | 6.4 | 4.6 | 3.5 | 2.9 | 3.4 | 3.7 |
| Revenue deficit | -0.1 | 1.2 | 2.6 | 2.7 | 2.3 | 2.3 | 1.2 | 0.2 | -0.6 | -0.9 | -0.1 | 0.6 |
| Gross Fiscal Deficit | 2.8 | 3.1 | 4.2 | 4.1 | 4.1 | 4.4 | 3.4 | 2.5 | 1.9 | 1.4 | 2.7 | 3.4 |
| Gross Primary Deficit | 1.7 | 1.2 | 1.8 | 1.4 | 1.3 | 1.5 | 0.7 | 0.2 | -0.4 | -0.6 | 0.7 | 1.4 |

Source: RBI, various issues.

APPENDIX 3

Table A3: Chronology of Fiscal Reforms in India List of Fiscal Reforms

| Effective Year | Reform | Objective | Changes |
|-----------------------|--|--|--|
| 1954–1955 | The Taxation Enquiry Commission | Raising tax revenue through higher taxes and greater progressivity of direct taxes. | 82.5% slab over Rs 2.5 lakh with the surcharge of 10%. |
| 28 February 1970–1971 | Budget Report presented by Ms. Indira Gandhi | Increasing income tax and wealth tax to achieve greater equality of income and wealth. | 93.5% slab over Rs 2 lakh with the surcharge of 10%. |
| 28 May 1971–1972 | Budget Report presented Mr. Y.B. Chavan | Raising surcharge and capital gain tax. | Increase in surcharge to 15% leading to increase in top marginal income tax rate to 97.75% |
| 1971–1972 | The Wanchoo Direct Taxes Enquiry Committee (WDTEC) | Revision of income tax rates. | Suggestions: Reduction of the effective top marginal rate to 70%. |
| 28 February 1974–1975 | Budget Report presented by Mr. Y.B. Chavan | Decreasing income tax rates following WDTEC report recommendations and increasing the wealth tax rate. | Decrease in surcharge to 10% and top marginal income tax rate to 70%. |
| 15 March 1976–1977 | Budget Report presented by Mr. C. Subramaniam | Reducing income tax rates further and decreasing wealth tax rate. | Decrease in top marginal income tax rate to 66% (60% plus 10% surcharge). |

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| 1978–1979 | L K Jha Committee on Indirect Taxes | Reviewing the structure of indirect taxes, examining the role of indirect taxation in promoting growth and examining the feasibility of adopting Value Added Tax (VAT) and other measures. | Recommendations: i) Rationalization of the duty structure on final products and raw materials. ii) Taking major steps within a time-bound program of action to avoid cascading. iii) Moving over to VAT at the manufacturers stage. iv) Sales taxation by a state should be essentially imposed on its residents without impinging on cost of production and without significantly affecting the residents of other states. v) Principle of a unified market within the country should be preserved. vi) There should be uniformity in procedures and broad structure of taxation in different states. |
| 28 February 1979–1980 | Budget Report presented by Mr. Charan Singh | Increasing income tax surcharge and wealth tax again. | i) Increase in effective top marginal income tax rate to 72%. ii) Increase in top wealth tax rate to 5% for net wealth over Rs 15 lakh. |
| 18 June 1980–1981 | Budget Report presented by Mr. R. Venkataramanan | Reverting to the top effective income tax rate and giving relief on wealth tax. | Decrease in top marginal income tax rate to 66% (60% plus 10% surcharge.) |
| 28 February 1983–1984 | Budget Report presented by Mr. Pranab Mukherjee | | Increase in surcharge to 12.5%. |
| 29 February 1984–1985 | Budget Report presented by Mr. Pranab Mukherjee | | Decrease in top effective rate to 62% by cutting the top marginal rate to 55%. |
| 16 March 1985–1986 | Budget Report presented by Mr. V.P.Singh | Comprehensive direct tax reforms following the Economic Administration Reforms Commission recommendations (1983–1984). | i) Decrease in top marginal income tax rate to 50% and wealth tax to 2%.. ii) Estate duty was abolished. iii) Reduced number of income tax slabs to four from eight. iv) Decrease in company tax to 50%. v) Unifying the tax rate to 55% for closely held companies. |

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| December 1985–1986 | Mr. V.P.Singh placed Long-Term Fiscal policy in the Parliament | | Recommendations: i) Bringing out a medium term fiscal policy as a public document. ii) Embedding tax policy intentions within an explicit macro fiscal framework. iii) Sweeping reforms of central excise and customs duties. iv) Phased introduction of VAT in excise taxation and conferred the name Modified VAT (MODVAT). |
| 28 February 1986–1987 | Budget Report presented by Mr. V.P.Singh | | Implementation of MODVAT - It enabled manufacturers to deduct the excise paid on domestically produced inputs and countervailing duties paid on imported inputs from their excise duty on output. By 1990 MODVAT covered all sub-sectors of manufacturing except petroleum products, textiles, and tobacco. |
| 4 th Quarter Fiscal Year 1991-1992 (Interim report presented in December 1991, followed by a two part final report in August 1992 and January 1993) | Chelliah committee | Simplification and rationalization of direct tax structure. | i) Introduction of three-tier personal income tax structure with an entry rate of 20% and a top rate of 40% (The maximum marginal rate of personal income tax has been reduced to 40% from 56% in June 1991). ii) The rates of corporate income tax for both publicly listed companies and closely held companies have been unified and reduced to 46% from 51.75% 57.5% respectively. iii) Abolition of wealth tax. iv) Reduction of the extraordinarily high import duties to a range of 15% to 30% for manufacturers, reduction of multiple tax rates to three in the range of 10% to 20% and extension of MODVAT credit to all inputs including machinery. |
| 28 February 1992–1993; 27 February 1993–1994; 28 February 1994–1995; 15 March 1995–1996 | Budget Report presented by Mr. Manmohan Singh | Decreasing import duties. | Reduction in import duties to: <ul style="list-style-type: none"> • 110% in 1992–1993. • 85% in 1993–1994. • 65% in 1994–1995. • 50% in 1995–1996. |

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| 1 July 1994 | Chelliah committee | Widening the tax base by including the service tax and extending its coverage gradually. | Services brought under the tax net in 1994–1995 are Telephone, Stockbroker and General Insurance at the tax rate of 5% . |
| February 1991–1992 to 1996–1997 | | | i) New taxes such as Securities Transaction Tax (STT), and Dividend Distribution Tax (DDT) partly reversed the move towards a simpler system. ii) India entered into Double Taxation Avoidance Agreement (DTAA) with 65 countries including countries like US, United Kingdom, Japan, France, and Germany. These agreements provide relief from double taxation in respect of incomes by providing exemption and also by providing credits for taxes paid in one of the countries. |
| 22 July 1996–1997 | Finance Act | | Advertising agencies, courier agencies and radio pager services were added to Service Tax Net. |
| 1997–1998 | | | Minimum Alternative Tax (MAT) was introduced in 1997–1998 |
| 28 February 1997–1998 | Budget Report presented by Mr. P. Chidambaram | | i) Reduction in excise duty rates. ii) Reduction in custom duties to 40%. iii) Reduction in triple rate structure of personal income tax to 10–20–30%. iv) Decrease in company tax rate to 35%. v) Abolition of dividend taxation in the recipients' hands and replacing it with a 10% tax at company stage. |
| 28 February 1997–1998 and 1 June 1998–1999 | Annual Budgets | | Eight more services were added to Service Tax Net |
| 27 February 1999–2000 | Budget Report presented by Mr. Yashwant Sinha | | i) Excise duties ranging from 5% to 40% were clubbed into three rates; 8%, 16% and 24%. ii) Two non-MODVAT, additional special excise rates (6% and 16%) were levied on luxury consumer goods. |
| 29 February 2000–2001 | Budget Report presented by Mr. Yashwant Sinha | | Converted the three excise duties into a single CENVAT rate of 16% buttressed by a few selective excises on luxury consumer goods. |

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| 2001–2002 | “Govinda Rao” Expert group on Taxation of Services | | Recommendations: Introduction of credit for taxes paid on inputs in services activities. |
| December 2002–2003 | The Kelkar Committee -(Kelkar reports of Task Forces on Direct and Indirect taxes (2002a and 2002b) | Taxation reforms to be introduced for the smooth and proper administration of the tax law, and also improve the tax collections. | Recommendations: The task force had given its recommendations on the aspects relating to direct and indirect taxes such as: i) Doubling the exemption limit for personal income tax. ii) Abolishing taxes on equity capital gains and dividends received by individuals. iii) Moving to dual rate structure in excise and custom duties. (These recommendations were severely criticized by economists like Bagchi, Chelliah, Acharya, Mukhopadhy et al.) iv) Abolition of minimum alternate tax is one of the major suggestions made by the task force. This was implemented in 2003–2004. |
| 8 July 2004–2005 | Budget Report presented by Mr. P. Chidambaram | | i) Abolition of taxation on long-term capital gains on all securities transactions. ii) Reduction in the rate on short-term capital gains to a flat 10%. iii) Introduction of New Securities Transaction Tax (New STT), Fringe Benefit Tax (FBT), commodities transaction tax (CTT). |
| June 2004–2005 | | | Tax Information Network (TIN) and Online Tax Accounting System (OLTAS) were operationalized. |

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| July 2004 | Fiscal Responsibility and Budget Management (FRBM) Act that had been approved by the Parliament under the NDA government was notified by the successor UPA government. | | Targets: i) Bringing down the revenue deficit by 0.5% of GDP each year until it becomes zero. ii) Reducing fiscal deficit by 0.3% each year to a total of 3% of GDP by 2008–2009. iii) Total liabilities of the Union Government should not rise by more than 9% a year. iv) Union Government shall not give guarantee to loans raised by Public Sector Units (PSUs) and State Governments beyond 0.5% of GDP in the aggregate. |
| 2000–2001 to 28 February 2005–2006 | | | Reduction in customs duties from 35% to 15%. |
| 2005–2006 | Introduction of Value Added Tax (VAT) | VAT is designed to make accounting more transparent, cut trade barriers and boost tax revenues. | Rates: i) 0.0% on necessities and some primary products i) 1.0% on bullion and precious stones. ii) 4.0% on industrial inputs and capital goods and items of mass consumption. iii) 12.5% on all other items. |
| 2003–2004 to February 2009–2010 | Changes in Service Tax | | Rates levied: <ul style="list-style-type: none"> • 2003–2004: 8.0%. • 2004–2005: 10.0% and 2.0% Education Tax was introduced. • 2006–2007: 12.0%. • February 2009–2010: 10.0%. • Current: 10.2% along with 2.0% Education Tax. <p>About 80 services covered under Service Tax Net to date.</p> |

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| 29 February 2008–2009 | Budget Report presented by Mr. P. Chidambaram | | <p>i) Changes in income tax slab; slab threshold of exemption for all Income Tax assesses raised from from Rs 1.10 lakh to Rs 1.50 lakh without any change in surcharge. Every income tax payer gets relief of minimum of Rs 4,000.</p> <p>New tax slabs are: 10% for Rs 150,000 to 300,000, 20% for 300,000 to 500,000 and 30% above 500,000</p> <p>ii) 2% reduction in central excise duties and service tax.</p> <p>ii) A commodities transaction tax (CTT) was introduced on the same lines as STT on options and futures traded in commodity exchanges.</p> <p>iii) Plan expenditure fixed at Rs 2,43,000 crore which is 32.4% in total expenditure and non-plan expenditure at 5,74,000 crore.</p> |
| | | First fiscal stimulus package was announced on 7 December 2008 to fight against global crisis. | <p>i) Across-the-board central excise duty reduction by 4%.</p> <p>ii) Rs 20,000 crore increase in plan expenditure.</p> |
| 6 July 2009–2010 | Budget Report presented by Mr. Pranab Mukherjee | | <p>i) 34% increase in plan expenditure and 37% increase in non-plan expenditure (due to factors such as Sixth Pay Commission and subsidies). Total expenditure increased by 36% over 2008–2009 budget.</p> <p>ii) Exemption limit in personal income tax raised by Rs 10,000 from Rs 1.50 lakh to Rs 1.60 lakh.</p> <p>iii) Minimum Alternate Tax (MAT) to be increased to 15% of book profits from 10%.</p> <p>iv) Abolition of FBT, CTT.</p> <p>ii) Fiscal deficit and revenue deficit of the Central government are projected as 6.8% and 4.8% of GDP respectively.</p> |

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| | | Second and third fiscal Stimulus packages on 2 January 2009 and 24 February 2009. | <ul style="list-style-type: none"> i) Service tax cut from 12% to 10%. ii) 2 percentage-point reduction in both central excise duties and service tax. iii) Additional borrowing by state governments of Rs 300,000 crore for planned expenditure. iv) Assistance to certain export industries in the form of interest subsidy on export finance. v) Refund of excise duties and central sales tax and other export incentives. vi) Along with the expansion undertaken in the two budgets, the total fiscal stimulus in the last two years can be estimated as 3% of the GDP. |
| October 2010–2011 | Introduction of the Goods and Services Tax (GST) | | <p>Salient features:</p> <ul style="list-style-type: none"> i) A dual GST model with two separate components namely, Central GST (CGST) and State GST (SGST) will be introduced. ii) Both the center and states have to levy GST concurrently on all goods and services other than a small list of exemptions. iii) Cross-utilization of input tax credit between CGST and SGST will not be allowed except in case of inter-state transactions (IGST). iv) GST to have a two-rate structure: a standard rate for most of the goods and a lower rate for necessities. |
| April 2011–2012 | Possible introduction of the Direct Tax Code (DTC) | | <p>Major proposals:</p> <ul style="list-style-type: none"> i) To cut corporate profit tax from 34% (including surcharge and tax) to 25% (all inclusive). ii) To change the basis of Minimum Alternate Tax (MAT). Instead of 15% of book profits, it will be 2% of gross assets from non-banking companies and 0.25% of gross assets for banking companies. |