Chapter 9

Assessment of the Impact of Stimulus, Fiscal Transparency and Fiscal Risk: Evidences from India

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CHAPTER 9

Assessment of the Impact of Stimulus, Fiscal Transparency and Fiscal Risk: Evidences from India

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1. Introduction

The Indian economy has undergone a remarkable transformation over the past two decades. After a long spell of growth at an average annual rate close to 9 per cent (2003-08), GDP growth slowed down to 6.7 per cent in 2008-09 in the wake of the global crisis. The growth rate picked up to 7.4 per cent in 2009-10. Undoubtedly, both fiscal and monetary stimuli contributed significantly to prevent a sharper decline in 2008-09 and promoted recovery in 2009-10. Fortuitously, large fiscal stimulus was provided ahead of the Lehman crisis in April 2008 when the budget for 2008-09 included significant allocations for social sector and transfer payments in preparation for the forthcoming elections. Some more fiscal stimulus was provided also after the crisis broke out and together with the earlier increase contributed to generating huge fiscal deficits for India, which may have adverse effects on growth due to the concerns over fiscal sustainability and macroeconomic stability.

Given India's long history of running huge fiscal deficits, the sharp increase in fiscal deficit in the last two years is a major concern for both academicians and policy makers in India (Govinda Rao 2009, Rangarajan 2009). The level of combined (central

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plus state governments) fiscal deficit in 2009-10 at 10.1 per cent of GDP exceeded the previous record of 9.9 per cent of GDP in 2001-02 and was considered unsustainable. This follows a sharp rise in the fiscal deficit from 4.2 per cent of GDP in 2007-08 to 8.5 per cent in 2008-09. In consequence, the debt to GDP ratio rose to 72.4 per cent for the year 2009-10, up from 71.6 per cent in 2008-09. This rise seems to have reversed all the fiscal gains made since 2003-04. The fiscal situation was reversed sharply as the government undertook a number of measures to stimulate the economy in the run up to the elections and subsequently in the wake of the global crisis. According to budget estimates for the year 2010-11, the ratio of fiscal deficit to GDP (for both the centre and states but excluding off-budget bonds) is expected to be 8.5 per cent. It will be about 10 percent with the off-budget bonds (mainly oil bonds). Thus, 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, 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. Section 2 provides an overview and 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 decades (1980-81 to 2010-11), discusses the major fiscal reforms that have been undertaken in recent years and examines the structural/cyclical behaviour 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 – The Oretical Perspective

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, following Keynes, is that high fiscal deficits are not unusual to developing economies as governments use fiscal deficits to keep aggregate domestic demand at high levels in an effort to generate growth and employment. High fiscal deficits accelerate capital accumulation and growth (Krishnamurty 1984, Krishnamurty 2001, 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 (which consists of highways, airports, mass transit, etc.) 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 leading to overall economic growth. This is generally referred to as the positive ‘crowding in’ impact of fiscal deficit.

Classical/neo classical theory, on the other hand, postulates that high fiscal deficit created through higher public investment may displace private investment, or more generally private expenditure-the so called crowding out effect. Public investment-driven fiscal deficit crowds 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 utilisation in the economy. Public expenditure in general increases aggregate consumption in the economy, which leads to a reduction in aggregate savings, resulting 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. Two implicit assumptions in the above approach are that the economy is already at near full capacity level and the efficiency of private expenditure is higher than of public expenditure.

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

The Reserve Bank of India has done significant research on the role of fiscal policy in reviving the Indian economy (RBI 2001). RBI's research shows that an attempt to raise public consumption to revive aggregate demand crowds 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 seen to be 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. While differing in their views about crowding out, 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. This argues 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 with overall savings remaining unchanged. The empirical support in favour 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 a-priori policy conclusion can be advanced.

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 stance 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, Rajiv 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 emphasising only on primary balances (Nirvikar singh, Srinivasan 2004).

3. Trends and Patterns in Fiscal Variables in India

As in other developing economies fiscal policy plays an important role for macroeconomic stabilization In India. The large share of public (government) investment, production, and consumption in the economy confers on fiscal tools a considerable direct influence on the economy. Fiscal imbalances have remained a cause for concern in India in recent years. Despite impressive increases in the revenue buoyancy from direct taxes, there is a real fear that fiscal imbalances will accentuate, causing interest rates to harden and crowd out private investment. A higher fiscal deficit essentially means government taking more loans from banks pre-empting other borrowers and driving up the interest rates at the cost of industry and individual borrowers. With a deficit of over 10 per cent and the household sector's financial savings at just about 11 per cent 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.

At this juncture, a detailed analysis of trends and patterns over the last three decades (1980-2011) that cover both the pre and post reform period would help 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 per cent from the average 'Hindu' growth rate[3] of 3.5 per cent in earlier decades. Unfortunately, this spurt was achieved by unsustainable fiscal expansion financed by domestic credit and external borrowing. Growth accelerated to 5.8 per cent during the 1980s, but in the second half of the decade, fiscal and current account deficits

[3] 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, which stagnated around 3.5 per cent from the 1950s to the 1980s is called the 'Hindu' growth rate.

widened significantly causing serious macroeconomic imbalances, culminating in the balance of payment (BOP) crisis of 1991. These triggered the series of economic reforms introduced since 1991, which also aimed to bring about macroeconomic stabilisation and implement structural measures[4] to push up growth.

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

3.1. Deficit Indicators

The 1980s saw a sharp rise in the combined fiscal deficit of centre and states to eight per cent on the average. (see Table 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[5] became 56 per cent of GDP on the average, with interest payments at 14.6 per cent of revenue expenditure (3 per cent of GDP on the average) accounting for a large proportion of government revenue expenditure and posing a debt trap in the 1980s. During the first half of the 1980s, these revenue expenditures averaged 18.5 per cent of GDP. In the second half, they rose to an average of 22.4 per cent with the bulk of the expansion coming under the heads of defence, 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 these 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 per cent and 9.4 per cent of GDP respectively, leading to the BOP crisis of 1991 (Arvind Panagariya 2004, Balakrishnan, P. 2004, Nirvikar Singh and T.N.Srinivasan 2004). Containing this deficit was one of the key structural adjustments undertaken by the Indian government at the time, largely

[4] Structural measures initially emphasised accelerating the process of industrial and import delicensing simultaneously with a switch to a flexible exchange rate regime, and then shifted to further trade liberalisation, financial sector reforms and tax reforms.

[5] Outstanding Liabilities.

as part of an IMF structural program that was adopted when India borrowed $ 4 billion from the Fund to thwart the external payments crisis. Economic reforms helped reduce the fiscal deficit and the combined deficit of the central and state governments came down to 6.3 per cent of GDP in 1996-97. A sharp rise in government salaries and pensions in the next year put a brake on the process of fiscal improvement until 2003-04 when the government introduced the Fiscal Responsibility and Budget Management Act[6] (FRBM) to try and statutorily control the fiscal deficit.

The FRBM Act enabled India, which had a long periods of high fiscal deficits, to make break from this structural trend in 2003-04. The Act required the Government of India (GOI) to bring down its revenue deficit by 0.5 per cent of GDP each year until it touched zero and its fiscal deficit by 0.3 per cent each year to a level of three per cent of GDP. The targets were to be achieved by 2008-09. These limits were to be applicable for state government as well. Further, it set an annual limit of nine per cent in the union government's total liabilities while simultaneously capping union government guarantees for public sector units and state government loans at 0.5 per cent of GDP. FRBM targets were achieved in 2007-08, a year ahead of schedule, except for the centre's revenue deficit target. The combined fiscal deficit came down to 4.2 per cent of GDP in 2007-08 (well below the prescribed 6 per cent) and the primary deficit (fiscal deficit net of interest payments) turned into a surplus of 1.3 per cent in the same year. It seemed that India had put its structural fiscal deficit behind it specially as the positive impact of implementing the FRBM Act provisions were amply evident in higher growth rates during the 2003-2009 period that saw also a change in the government.[7]

[6] The FRBM Act was enacted by Parliament in 2003; later, Mr. Chidambaram, the finance minister in the UPA government, notified the act on July 2, 2004.

[7] However, there is a lot of disagreement among policy makers about targeting zero revenue deficit in India. The argument is the following. It sounds quite unrealistic to target a zero revenue deficit and a three per cent 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 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. It means the government would be saving and contributing to capital formation (Raja. J. Chellaih, 2000). Public finance experts like Dr. Chelliah have also questioned the wisdom of setting a three per cent fiscal deficit target. He says, "....three per cent 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".

Fig. 1 provides a synoptic view of fiscal trends from 1990-91, the year in which India faced its economic crisis. There was a steady improvement in central and state finances since 2001-02, when the fiscal and revenue deficits of the combined central and state governments had peaked at 9.9 per cent and 7.0 per cent of GDP respectively.

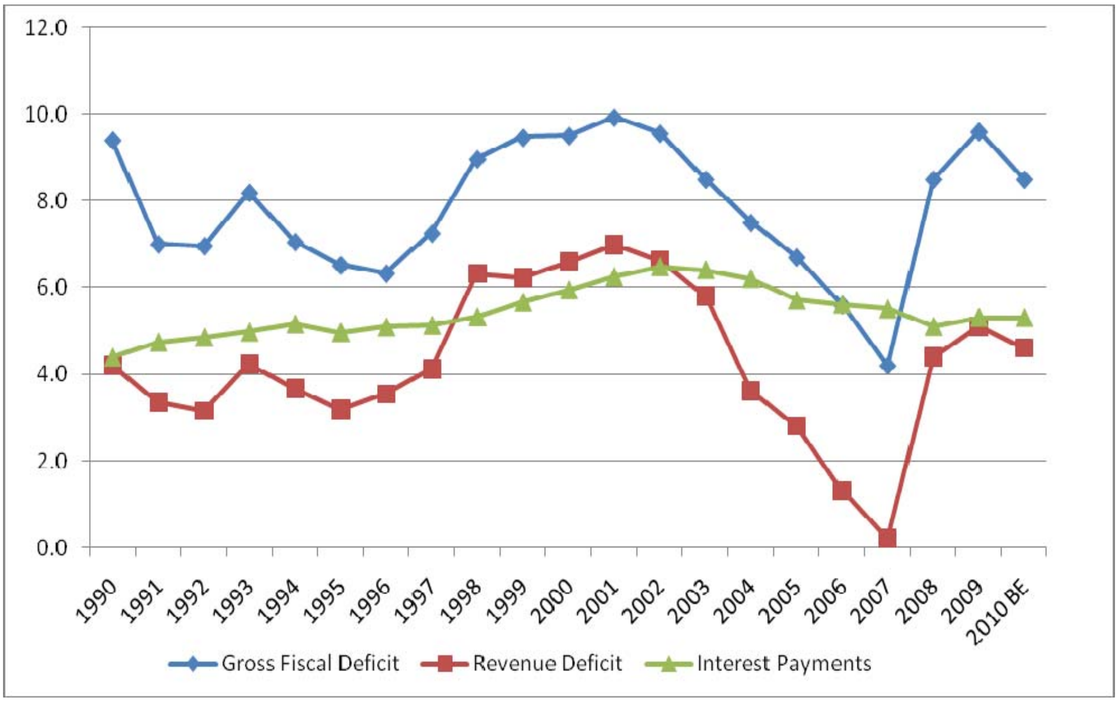
Table 1. Finances of the centre and states: selected indicators (As per cent of GDP)

	Centre			**States**			**Combined**		
Year	**GFD**	**GPD**	**RD**	**GFD**	**GPD**	**RD**	**GFD**	**GPD**	**RD**
1980-89	6.7	4.1	1.7	2.8	1.7	-0.1	7.9	4.9	1.6
1990-99	5.9	1.6	3.0	3.1	1.2	1.2	7.7	2.7	4.2
2000-01	5.7	0.9	4.1	4.2	1.8	2.6	9.5	3.6	6.6
2001-02	6.2	1.5	4.4	4.1	1.4	2.6	9.9	3.7	7.0
2002-03	5.9	1.1	4.4	4.1	1.2	2.3	9.6	3.1	6.6
2003-04	4.5	-0.03	3.6	4.4	1.5	2.3	8.5	2.1	5.8
2004-05	4.0	-0.04	2.5	3.4	0.7	1.2	7.5	1.3	3.6
2005-06	4.1	0.4	2.6	2.5	0.2	0.2	6.7	1.0	2.8
2006-07	3.5	-0.2	1.9	1.9	-0.4	-0.6	5.6	-0.01	1.3
2007-08	2.7	-0.9	1.1	1.5	-0.6	-0.9	4.2	-1.3	0.2
2008-09	6.0	2.6	4.5	2.6	0.7	-0.2	8.5	3.4	4.4
2009-10 RE	6.6	3.1	5.3	3.2	1.3	0.5	9.6	4.3	5.1
2010-11 BE	5.5	1.9	4.0	3.0	1.2	0.6	8.5	3.2	4.6

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

Source: Reserve Bank of India (RBI)

Figure 1. Fiscal Indicators of the Combined Centre and States (As a per cent of GDP)



Source: Reserve Bank of India (RBI)

3.2. Debt Sustainability

The trends in fiscal deficit were mirrored in the rising public debt levels. The combined debt of the centre and states, which averaged 56 per cent of GDP in the 1980s, rose to an average of slightly over 63 per cent in the 1990s and climbed further to touch a peak of 81.4 per cent in 2003-04 (see Table 2 and Fig. 2). A notable feature was the drastic reduction in the share of the external liabilities to GDP from 6.7 per cent (on the average) in 1980s to 1.7 per cent in 2003-04[8]. After the introduction of the FRBM Act, public debt showed a steady decline until 2008-09 when it stood at 74.7 per cent. The concern now is that the high fiscal deficits of the past two years may see a long-term reversal of this trend. Revised estimates for 2009-10 indicate a rise in the

[8] Reinhart *et al.*, (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 (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 per cent of GDP.

public debt to about 70 per cent. It could be higher for the year 2010-11 if the GDP growth slows down.

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. 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/GDP ratio. We hope the next set of FRBM targets include policies towards reducing public debt. Moreover, it may be essential to make the FRBM caps statutory and unbreachable so as not to shield fiscal management from the vagaries of the political cycles. A way forward would be to make it mandatory to secure a three quarters majority of the lower house of the Parliament to breach FRBM limits in response to any severe external or internal shock that threatens to derail economic growth and requires extraordinary fiscal measures.

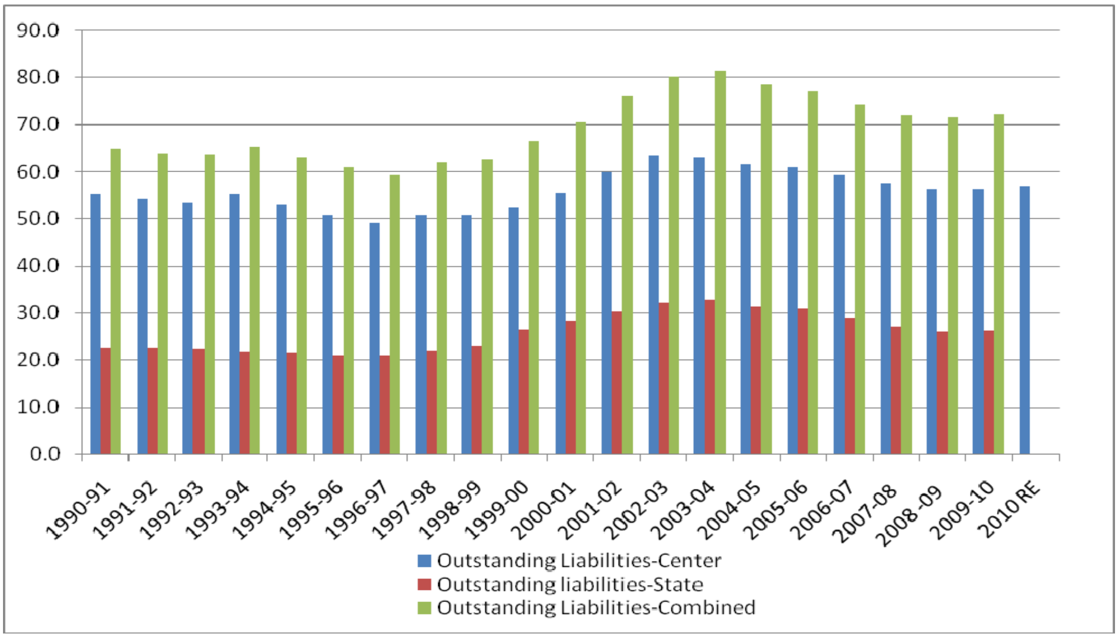
There is little consensus on what the ideal debt-GDP ratio for an economy should be. Internationally, the Maastricht Treaty has set the tolerable debt level at around 60 per cent of GDP for the European Union countries. The Thirteenth Finance Commission had recommended a little higher target of 68 per cent of GDP by 2014-15 for India. If one goes by the budget estimates for 2010-11 of the central government, the government is quite clearly not going to be able to meet the Finance Commission's target.

Table 2. Debt Components of the Centre and States (As per cent of GDP)

Year	Internal Debt-Centre	Internal liabilities-Centre	External Debt/Liabilities-Centre	Outstanding Liabilities[9]-Centre	Outstanding Liabilities-State	Combined Outstanding Liabilities
1980-89	24.7	41.2	6.7	47.9	20.7	56.0
1990-99	27.4	48.0	4.5	52.5	22.4	63.2
2000-01	38.2	52.4	3.1	55.6	28.3	70.6
2001-02	40.0	56.8	3.1	59.9	30.3	76.0
2002-03	41.5	61.0	2.4	63.4	32.0	80.2
2003-04	41.4	61.4	1.7	63.0	32.8	81.4
2004-05	40.5	61.4	1.9	61.6	31.3	78.6
2005-06	38.7	60.4	2.6	61.0	31.0	77.2
2006-07	37.4	59.0	2.5	59.3	29.0	74.3
2007-08	38.3	57.7	2.4	57.4	26.9	72.0
2008-09	37.8	56.6	2.3	56.3	26.2	71.6
2009-10 BE	40.2	57.2	2.3	59.9	27.6	76.5
2009-10 RE	-	-	-	56.3	26.3	72.4
2010-11 BE	-	-	-	56.9	-	-

Source: Reserve Bank of India (RBI)

Figure 2. Debt of the Centre and the States (As per cent of GDP)



Source: Reserve Bank of India (RBI

[9] Outstanding liabilities (public debt) comprise of the internal (market borrowings, RBI treasury bills, small savings and deposits, provident fund, reserve fund) and external liabilities.

3.3. Receipts and Disbursement of the Government

3.3.1 Central and State Governments' Expenditure

At the central level, average government expenditure[10] stood at 17.6 per cent of GDP in the 1980s (see Appendix-I). The share fell by 1.6 percentage points immediately after the reforms, mainly because of the macroeconomic stabilisation programme that followed the balance of payments crisis in 1991. However, a sharp rise in salaries and pensions following the acceptance of the Fifth Pay Commission report[11] in 1996-97 pushed the expenditure level back to the 16-17 per cent level in the following year – a level at which it stayed until the FRBM Act in 2004-05. After the FRBM was passed, central government's total expenditure fell from approximately 16 per cent to 14 per cent 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 always been a matter of concern, remains so with revenue expenditure accounting for about 80 per cent of total expenditures.[12]

Public capital expenditure as a percentage of GDP declined from an average of 6.2 per cent in the 1980s to 3.6 in 2004-05 and further to 1.6 per cent in 2008-09. By contrast, revenue expenditure, which was 11.4 per cent of GDP during the 1980s, rose to 12.2 per cent in 2004-05 and to 14.2 per cent in 2008-09. As in the mid-1990s, the reason for the sharp rise in revenue expenditure in 2008-09 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 per cent of revenue expenditure, stood at about 4 per cent of GDP until 2004-05. However, these came down to 3.6 per cent in 2005-06 and continued at the same level until 2008-09. This, however, was less the result of a reduction in borrowings; much of

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[10] 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.

[11] 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.

[12] Remaining 20 per cent is the capital expenditure.

the credit for this achievement goes to a softening of interest rates. These are likely to rise in the coming years as the RBI tries to rein in inflation.

The other major item of revenue expenditure has been subsidies (See table-3.3). 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)[13]. Explicit government budgetary subsidies like those on food, fertilisers and petroleum products are only a small portion of the total subsidy.

Food subsidy as a percentage of GDP rose from 0.4 in 1990-91 to 0.9 in 2003-04. This has decreased since 2003-04 and reached 0.6 per cent in 2006-07. However it started rising again from 2007-08 (see Table 3.3)[14], 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. R, Manoj Panda 2006). The government has recently taken some measures to make the food subsidy better targeted to actual beneficiaries by revamping the public distribution system and introducing differential prices for the poor and non-poor groups. Nonetheless, food subsidy has increased further and reached 0.9 per cent of GDP in 2009-10. Fertiliser subsidies have gradually increased to 0.7 per cent of GDP in 2007-08 and further shot up to 1.4 per cent of GDP in 2008-09, the highest ever. On the other hand, petroleum subsidies have remained constant at 0.1 per cent of GDP until 2009-10.

[13] 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 per cent of GDP during the period (e.g., Mundel and Rao, 1992 and NIPFP, 1997).

[14] The figures given in the 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. Subsidies (As a per cent of GDP)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11 BE
Subsidies	1.6	1.4	1.3	1.4	1.5	2.3	2.1	1.9
i) Food	0.9	0.8	0.6	0.6	0.7	0.8	0.9	-
ii) Fertiliser	0.4	0.5	0.5	0.6	0.7	1.4	0.8	-
iii) Petroleum	0.2	0.1	0.1	0.1	0.1	0.1	0.2	-

Source: Reserve Bank of India (RBI)

More importantly, the growing practice of issuing special bonds to oil and fertiliser 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 risks for the government.[15] Oil subsides, 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 1.8 per cent of the GDP (Rs.970.19 billion) in 2008-09 from 0.98 per cent (Rs.403.61 billion) in 2006-07. However, the government has decided to include these bonds into the budget from 2010-11, which is a good sign.

Expenditures at the state level exhibit a trend similar to that at the central level. From an average of roughly 15.5 per cent of GDP in the 1980s and 1990s, the total expenditure of states rose to nearly 18 per cent in 2004-05 (see Appendix-II). While expenditures fell steadily for the next three years to 15.5 per cent in 2007-08 on account of the 12th Finance Commission measures, they rose again to 17.3 per cent in 2008-09. Revised estimates indicate that the level for 2009-10 will climb back to the level in 2004-05.

The rise in States' expenditure too has been because of a rise in revenue expenditure. Between 2004 and 05, there was some reduction in revenue expenditure but the trend was reversed in 2008-09 and it is expected to touch a high of 14 per cent in 2009-10. 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

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

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 2002-04 but it slipped again thereafter. However, it has again increased from 3.5 per cent in 2007-08 to 3.9 per cent in 2008-09.

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 rationalisation of the tax structure. Total tax revenue as a proportion of GDP declined from 10.3 per cent in 1990-91 to the lowest level of 8.2 per cent in 1998-99. It was only in 2005-06 that tax revenue touched the level it was at in 1990-91 (see Appendix-I). Tax receipts rose to 12.6 per cent in 2007-08 but again declined to 9.7 per cent in 2008-09.

The tax reforms[16] initiated since 1991 were part of the structural reform process after the 1991 economic crisis. The Tax Reforms Committee (TRC), headed by Professor Raja K Chelliah, 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 rationalisation of the direct tax structure (Chelliah committee report 1992); the other was to introduce a service tax to widen the tax base (Chelliah committee, 1994).

The Chelliah committee (1992: 4) had, in its interim report, recommended that as a first step towards the rationalisation 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 per cent from 56 per cent in June 1991. Further, rates of corporate income tax, which were 51.75 per cent for a publicly listed company and 57.5

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[16] List of fiscal reforms mainly on taxation is given in Appendix-III

per cent for a closely held company, were unified and reduced to 46 per cent in 1992. These rates were inclusive of a 15 per cent surcharge.

The 1992 reforms radically altered the composition of tax revenue at the central level[17]. Direct taxes as a percentage of GDP rose from 2 per cent in the 1980s to 6.5 per cent in 2008-09. 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 per cent to 5.3 per cent over the same period. The share of non-tax revenue[18] in GDP at the central level fluctuated between two and three per cent during 1980-2009 with the highest three per cent recorded in 2001-02 and lowest 1.7 per cent observed in 2008-09.

The government also introduced a service tax in 1994 in line with the recommendations of the Chelliah Committee[19]. 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 per cent by 1993-94. Starting with three services, viz., 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 so far. A few important services brought under the service tax net are banking and other financial services, management consultants, credit rating agencies, market research agencies etc. Some important services that are still out of the tax net are legal consultancy services, transport of goods by waterways, cosmetic or plastic surgery etc. The rate imposed originally was a moderate 5 per cent of turnover. This was, however, progressively increased to 12 per cent and an additional education cess of 2 per cent on service tax was imposed in 2006-07. The 2008 crisis, however, forced a rollback in the service tax rate to 10 per cent in February 2009. Collections from service tax have shown a steady rise from 1994-95 (0.2 per cent of GDP) to 2008-09 (1.1 per cent of GDP). However, in 2008-09, they accounted for only 10.4 per cent of the total tax receipts of the centre

[17] Direct taxes contribute a negligible amount to state revenues.
[18] Non-tax revenue includes interest receipts, income from property etc.
[19]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 2003-04).

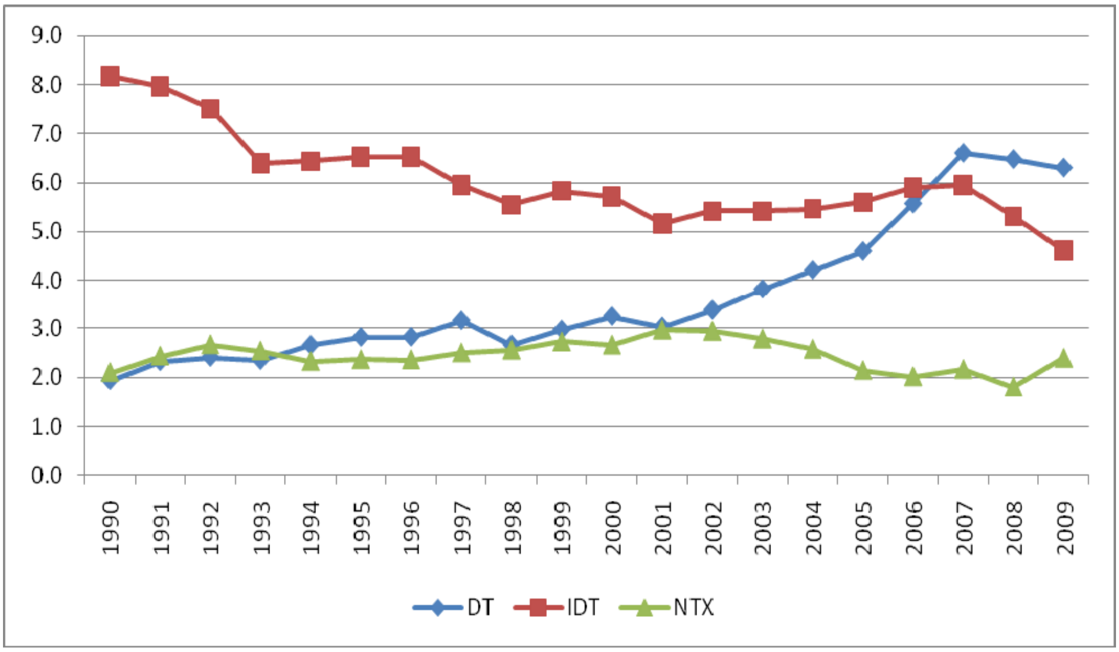
while the share of services in total GDP has gone up to 57 per cent. This anomaly of the services sector contributing only 10% of the total tax revenues while accounting for more than half of economic activities needs to be rectified.

Major changes on the indirect tax side included a sharp reduction in import duties from extremely high levels to a range of 15 to 30 per cent for manufacturers, reduction of multiple excise tax rates to three in the range of 10 to 20 per cent and extension of the then existing MODVAT[20] 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 per cent. Subsequently, state-level value added tax (VAT) replaced CENVAT in 2005-06. While only 20 states agreed to shift to the VAT regime when it was first brought in, the numbers have gone up to 28 by the end of 2010. Four slabs of VAT have been uniformly applied across all states that adopted it – zero per cent on necessities and primary goods, one per cent on bullion and precious stones, four per cent on industrial inputs and capital goods and items of mass consumption and 12.5 per cent 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. As proposed, 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 supposed to be launched in April 2010, but has been delayed by a year already and could see further postponement due to political reasons. This will be unfortunate. When introduced, GST will mark a major step in unifying the tax regime across the country and do away with tax arbitrage that currently distorts investment decisions. It will also contribute significantly to the creation of an integrated domestic market in India and facilitate inter-state movement of goods and services thereby encouraging firms to put up larger integrated capacities to take advantage of economies of scale offered by a large unified and growing domestic market. Its beneficial effects on reducing transactions costs and generating scale economies could be expected to be substantial.

[20] Under the MODVAT (modified Excise Rule, a manufacturer can obtain credit for excise tax paid on capital goods and on inputs used in the manufacture of final products.

Figure 3. Direct and Indirect Taxes and non-Tax Revenues of the Centre (As a percent of GDP)



DT: Direct Taxes, IDT: Indirect Taxes, NTX: Non-Tax Revenues
Source: Reserve Bank of India (RBI)

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 fiscal transfer mechanism in India. First, the Indian Constitution provides for mandatory transfer of revenue from central taxes on the basis of the recommendation of the constitutionally mandated Finance Commission that the central government is required to set up every five years. Each Finance Commission recommends a criterion to transfer funds from the Center to the states from the pool of centrally collected tax revenues which the Centre collects on behalf of the state governments. These transfers, mandated by the Finance Commission (and currently the recommendations of the 13th Finance Commission are being implemented) are the largest source of revenues for state governments. Second, there are budgetary transfers made through the Planning Commission to implement plan projects[21]. Third, there are optional transfers through

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

various union ministries and agencies for funding Central Government sponsored schemes.[22]

A look at the revenue receipts of states shows that there has been a steady improvement in the tax ratio over the years. The revenue from state's tax receipts (including their share in the central pool) as a ratio of GDP was virtually stagnant throughout the 1980s and 1990s at around 7.7 per cent (see Appendix-II). There was some decline from 1994-95 and the low point of 7.2 per cent was reached in 1998-99, the year in which the states had to revise their pay scales in line with the Fifth Pay Commission, and the combined effect of lower revenues and higher mandatory expenditures exacerbated their fiscal problems. The fiscal stress for state governments is revealed by the rise in their revenue deficit from 0.9 per cent of GDP in 1990-91 to 2.6 per cent in 2000-01. 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 per cent of revenue receipts in most states. However, the tax ratio of the states combined has steadily improved from 7.8 per cent in 2000-01 and reached 9.6 per cent in 2008-09.

A major development at the state level is the adoption of value added tax (VAT) from 2005-06. The VAT would help to remove the cascading tax burden. Tax revenue[23] is expected to rise as compliance improves under VAT. The state VAT has evidently helped tax revenues to increase from 8.6 per cent in 2005-06 to 9.6 per cent in 2008-09.

3.3.3. Combined Receipts and Disbursement

Taking the budgetary position of the centre and states together, one finds that the combined expenditure as a percentage of GDP rose from 26.8 per cent in the 1990s to 27.4 per cent in 2007-08 (see Table 3.4). The subsequent two years show a sharp rise in expenditures, with the revised estimates for 2009-10 showing expenditure at about 30 per cent of GDP. As discussed above, this has been a consequence of a sharp increase in public expenditure in the run up to the general elections of 2009-10.

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[22] There are several issues related to transparency of central government transfers and accounting problems. The discussion about these problems is beyond the scope of this paper.
[23] The states receive about 30 per cent of total tax collection from the centre from the shareable common pool according to the norms prescribed by the Finance Commission.

Total receipts have also shown a similar increase from around 26 per cent to roughly 31 per cent from the 1990's to 2008-09 (see Table 3.4). Over 60 per cent of receipts are accounted for by revenue receipts (both tax and non-tax). The rest has come from capital receipts in which disinvestment is a major component. The share of the central government's capital receipts[24] in GDP was just above six per cent until 2000-01 and thereafter increased until 2003-04. Since then, it declined reaching 3.6 per cent in 2007-08. As the table 3.4 indicates, the contribution from disinvestment has been about 1 to 2 per cent of capital receipts in the post-reform period. Disinvestment was the highest in 2003-04, amounting to Rs.169.53 billion (0.6 per cent of GDP). However, it did not pick up momentum till 2007-08 where the disinvestment receipts were Rs.457.50 billion (about one per cent of GDP)[25].

[24] Capital receipts consists of debt and non-debt capital receipts of the central government. Disinvestment receipts are considered to be the important non-debt capital receipts from 1991-92.
[25] 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 4. Combined Receipts and Disbursement of Centre and States (As a per cent of GDP)

	1980-89	1990-99	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11 BE
I) Total Expenditure	28.8	26.8	28.3	28.6	28.7	28.9	27.6	26.8	26.9	27.4	28.4	30.4	29.6
A) Revenue Expenditure	20.7	22.3	24.6	24.5	25.1	24.6	23.2	22.5	22.6	22.4	24.2	25.9	25.0
i)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	-
B) Capital Expenditure	8.1	4.5	3.7	4.1	3.6	4.3	4.4	4.3	4.3	5.0	4.3	4.5	4.6
i) Capital Outlay	-	-	-	2.6	2.7	3.1	3.6	3.7	3.8	4.7	4.4	4.5	-
ii)Loans and Advances	-	-	-	1.2	0.9	1.2	0.8	0.6	0.5	0.4	0.4	0.3	-
II) 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	-
A) Revenue Receipts	18.9	18.1	18.0	17.5	18.5	18.8	19.5	19.7	21.2	22.2	19.8	19.7	20.5
i) Tax Revenues	15.0	14.6	14.5	13.8	14.6	15.1	15.7	16.3	17.5	18.5	16.6	15.9	16.7
(a)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	-
(b) 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	-
ii) Non-Tax Revenues	3.9	3.5	3.5	3.8	3.9	3.7	3.9	3.3	3.7	3.7	3.2	3.8	3.8
B) 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	-
i) Debt Capital Receipts	-	-	-	10.2	9.7	8.6	8.0	8.2	6.0	4.5	8.6	9.6	-
ii) Non-Debt Capital Receipts	-	-	-	0.80	0.65	1.57	0.62	0.37	0.04	1.07	0.40	0.17	-
(a) Disinvestment Proceeds	-	0.2	0.1	0.2	0.1	0.6	0.1	0.0	0.0	0.96	0.2	0.0	-
III) Revenue deficit	1.8	4.2	6.6	7.0	6.6	5.8	3.6	2.8	1.3	0.2	4.4	6.2	4.6
IV) Gross Fiscal Deficit	8.0	7.7	9.5	9.9	9.6	8.5	7.5	6.7	5.6	4.2	8.5	10.1	8.5
V) Gross Primary Deficit	4.9	2.7	3.6	3.7	3.1	2.1	1.3	1.0	0.0	-1.3	3.4	4.9	3.2

Source: Reserve Bank of India (RBI)

3.4. Public Sector Savings and Investment [26]

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 output[27] averaged just above 3.5 per cent in the 1980s (see Table 3.5). This had reduced to an average of 1.5 per cent in the 1990s. Public sector savings deteriorated further in the period after reforms were initiated, turning negative (-1.8 per cent) in 2000-01. Though there was some improvement in 2002-03, public sector savings turned positive again only in 2003-04, a trend that was maintained until 2008-09. They peaked in 2007-08 reaching 4.5 per cent of GDP. There was a sharp deterioration in 2008-09 when public sector savings turned negative at -1.8 per cent. Budget estimates for 2009-10 indicate a further deterioration.

The period (1980-2009) 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 both agriculture and infrastructure are mainly dealt with by state governments, declining public sector investment reflects in part the deterioration in the fiscal position of state governments. What is of concern is 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 critically needed investments in expanding infrastructure capacities and improving social sector services deliveries 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.

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[26] Public sector includes administrative departments, department enterprises, non-departmental enterprises and quasi government bodies. The data is available for quasi govt. bodies from 1993-94 only.

[27] The percentage share of public sector output in the total GDP was fluctuating between 20-30 per cent in 1980's and 1990's. It has been stagnant just above 20 per cent from 2005-06.

Table 5. Public sector savings and investment[28] (As per cent of GDP)

Year	**Public Investment**	**Public Savings**
1980-89	10.6	3.7
1990-99	8.5	1.5
2000-01	6.9	-1.8
2001-02	6.9	-2.0
2002-03	6.1	-0.6
2003-04	6.3	1.1
2004-05	6.9	2.2
2005-06	7.6	2.4
2006-07	8.0	3.3
2007-08	9.1	4.5
2008-09 RE	6.9	-1.8
2009-10 BE	6.9	-2.0

Source: Central Statistical Organisation (CSO)

3.5. Structural/Cyclical Behaviour of Major Fiscal Variables

We now turn to an empirical analysis of the impact of fiscal deficits on growth.

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 below, the annual data of the combined gross fiscal deficit (GFD) of both the centre and states is plotted against GDP at market prices from 1980-81 to 2009-10 (BE). There seems to be considerable long-run co-movement between these two series till 2002-03. This indicates that the relationship is structural rather than cyclical though for a short period, 2006-07 and 2007-08, fiscal deficit decreased as the output increased. This negative relationship could be attributed to the implementation and realisation of FRBM targets. There is a sudden jump in fiscal deficit in 2008-09 and 2009-10 (BE) though output has grown at a slower pace[29], making the association between GFD and GDP horizontal in 2008-09 and 2009-10.

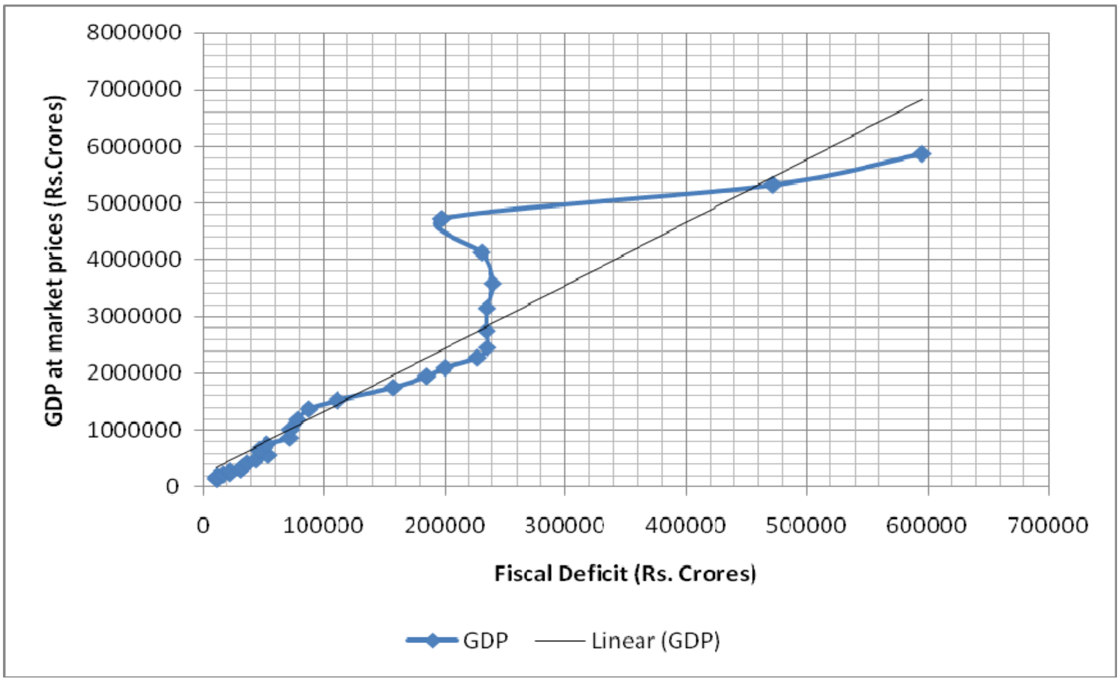
[28] The difference between public investment and public savings does not equal to fiscal deficit as the definition of public sector also includes non-departmental enterprises. Savings and investment of administrative departments and departmental enterprises are more directly related to fiscal deficit,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

[29] 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 etc.

Nonetheless, there is an upward linear trend exhibited throughout the study period implying a positive relation between fiscal deficit and output growth.

Interestingly, we find different results altogether when we plotted growth rates of fiscal deficit and GDP against each other. The trend shows a downward moment (see Fig 3.5). Similar trend was observed when gross fiscal deficit as a share of GDP is plotted. Fig. 3.6 shows the gross fiscal deficit as a share of GDP. The relative growth of GFD to GDP exhibits cyclical behaviour through the study period. The cycle does not seem to coincide with the electoral cycle but the peaks coincide exactly with the pay commission recommendations[30] and the troughs coincide with fiscal reforms[31].

Figure 4. Scatter Plot of Combined Gross Fiscal Deficit and GDP

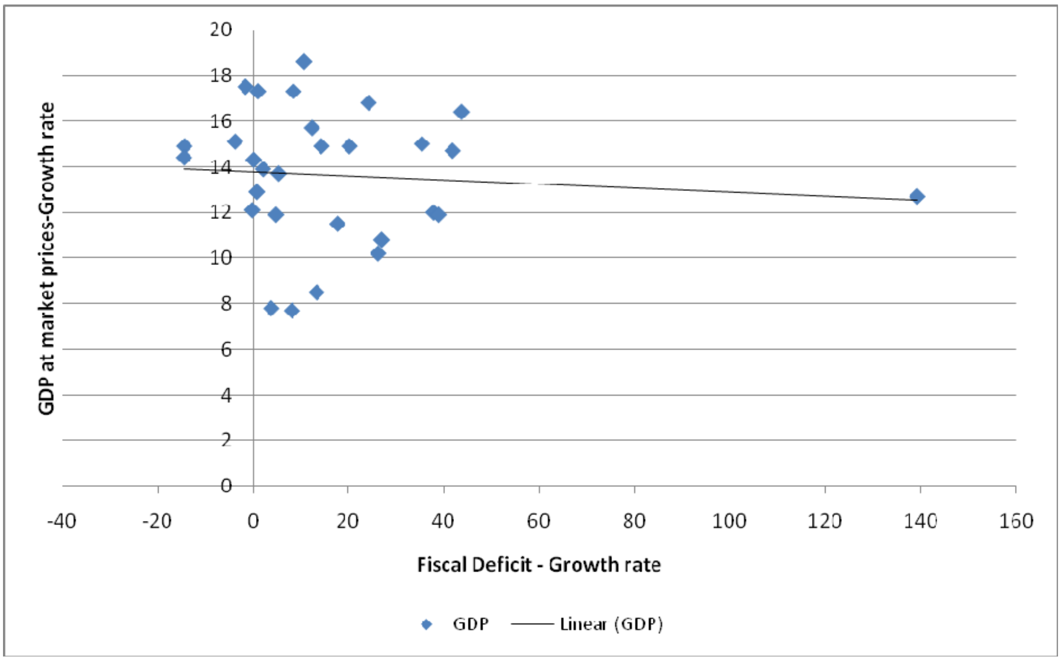


Source: Reserve Bank of India (RBI)

[30] 4th Pay Commission in 1986-87, 5th Pay Commission in 1997-98 and, 6th Pay Commission in 2008-09.

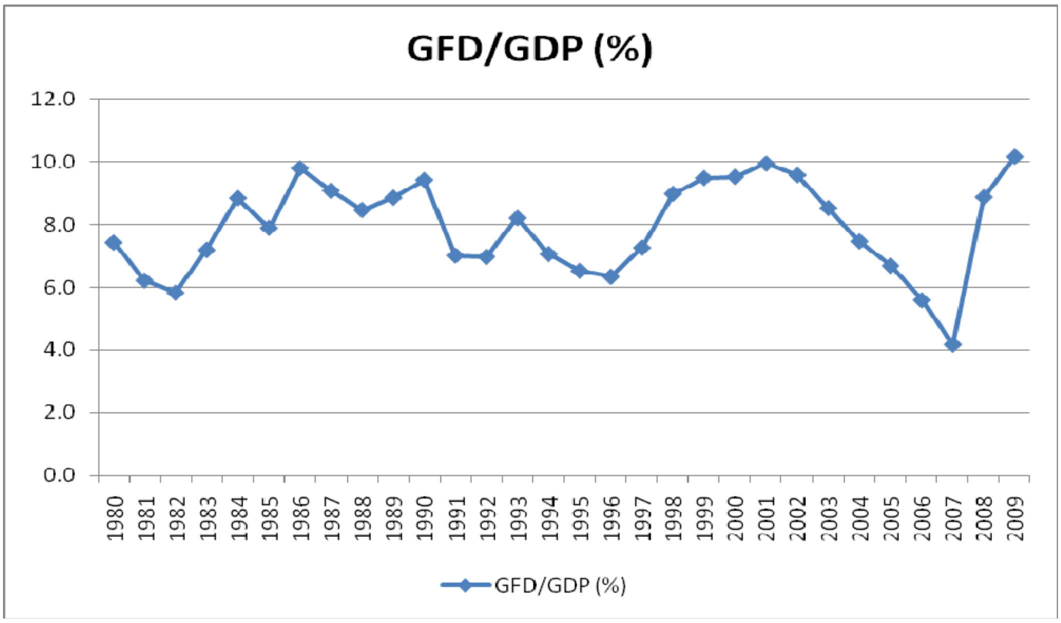
[31] Economic reforms in 1991-92, tax reforms in 1992-93 and FRBM Act in 2004-05.

Figure 5. Scatter Plot of Combined Gross Fiscal Deficit and GDP



Source: Reserve Bank of India (RBI)

Figure 6. Combined Gross Fiscal Deficit as a Share of GDP (percentage)



Source: Reserve Bank of India (RBI)

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. Gr GDP = 8.63 + 0.07 Gr GCF - 0.41 GFD/GDPM[32]

$$\begin{array}{lll} (3.8) & (1.8) & (-1.5) \end{array}$$

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

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. Log GDP = 1.28 + 0.64 Log GCF + 0.19 Log GFDR + 0.39 AR (1)

$$\begin{array}{llll} (2.6) & (15.9) & (3.4) & (2.0) \end{array}$$

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

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.[33]

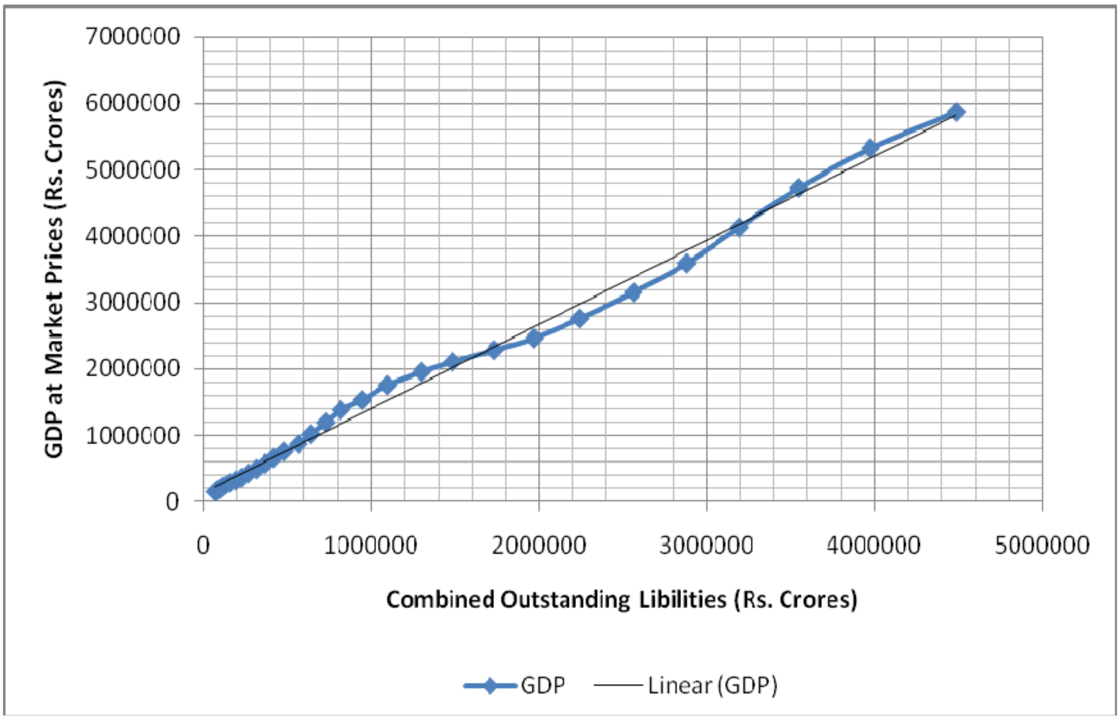
[32] GDP = Gross domestic product at constant factor prices, GDPM = Gross domestic product at current market prices, GCF = Real gross capital formation, GFD = Gross fiscal deficit, GFDR= Gross fiscal deficit in constant prices, Gr indicates growth rate.

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

3.5.2. Relationship Between Public Debt and Growth

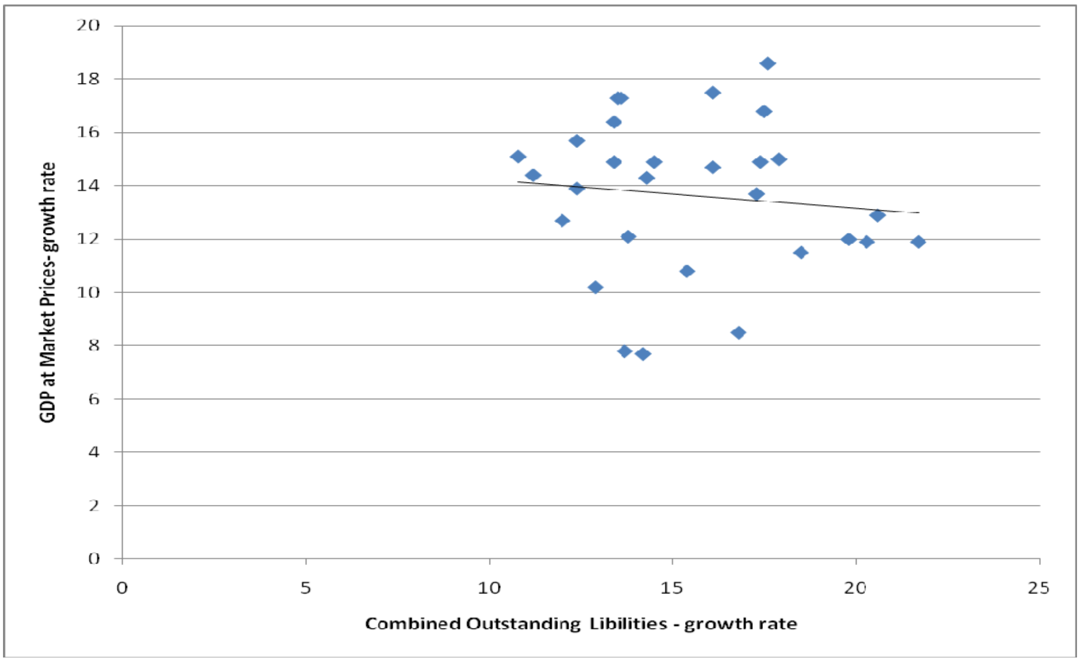
Annual data on the combined outstanding liabilities and GDP at current market prices from 1980-81 to 2009-10 (BE) is plotted in Figure 3.7. The scatter graph below depicts trends that are similar to that in the case of the fiscal deficit throughout the study period, confirming the structural behaviour 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 2007-08 to 2009-10, implying rising public debt has had a negative impact in recent years. The results are opposite when we plot growth rates (see Fig 3.8). The scatter plot shows a downward trend.

Figure 7. Scatter Plot of Combined Outstanding Liabilities and GDP



Source: Reserve Bank of India (RBI)

Figure 8. Scatter Plot of Combined Outstanding Liabilities and GDP



4. Global Crisis and India Fiscal Deficit

The deviations seen in the structural relationship between the GDP and GFD in 2008-09 and 2009-10 can be attributed to the impact of the global economic crisis.

4.1. Global Financial Crisis

The sub-prime crisis that emanated from the US has led to liquidity crunch 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, viz., the financial sector, exports, and exchange rates (Rajiv Kumar, 2009). However, four factors helped India to cope with the crisis and soften its impact. They are: (1) the robust, well-capitalised and wellregulated financial sector; (2) gradual and cautious opening up of the capital account; (3) the large stock of foreign reserves and (4) greater dependence on domestic consumption as a driver of GDP growth. Consumption accounted for more than 70 per cent of India's GDP and GDP growth was 7.3 per cent during 2000-2007. India's GDP growth declined to 5.8 per cent (year-on-year) in the second half of 2008-09 from 7.8 per cent in the first half. The growth improved to 7.4 per cent in 2009-10. Undoubtedly, the massive fiscal and monetary stimulus measures helped to prevent a sharper downturn in 2008-09 and promote recovery in 2009-10. The global economic recovery from second quarter of 2009 also helped.

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 impact of current crisis, Indian fiscal response and recovery in detail.

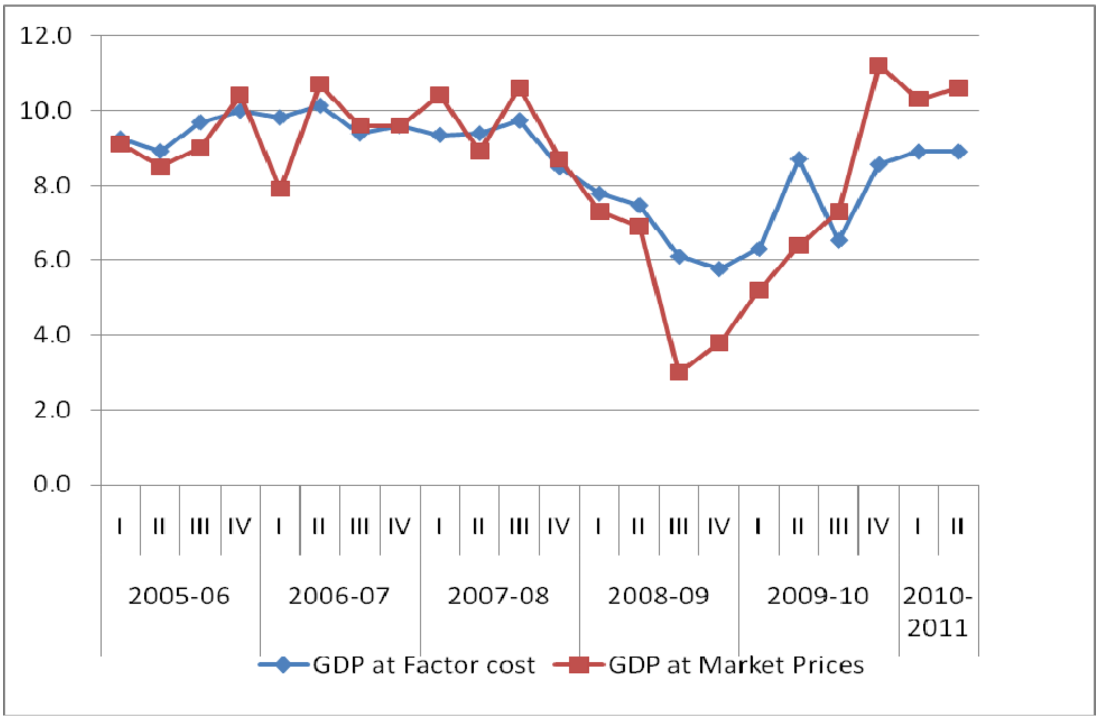
4.2. Impact on the Indian Economy and Recovery

Indian economy was affected negatively by the global phenomenon in two phases. In the first phase that could be said to have started in January 2008, with the withdrawal of foreign portfolio equity flows in the wake of the demise of Kleinwort, which saw portfolio flows reversing to advanced economies both to strengthen parent company's balance sheets and also find a safety in developed economy investments. At the same time the economy was hit by sharply rising global commodity specially fuel and food prices that forced domestic prices upwards with the inflation rising in a sustained manner and peaking at above 12 % in July 2008. This period therefore witnessed the RBI raising interest rates successively right until August 2008 and tightening liquidity in the market. As a result of massive withdrawal of FII investments from India, the consequent crash of the equity market and a massive slowdown in external commercial borrowing by India's companies the rupee fell by about 20 per cent from May to November 2008. The Reserve Bank of India intervened heavily to support the rupee by selling dollars, which eventually lead to some depletion of the stock of reserves. By mid-September 2008, India's money markets were already showing signs of severe strain and overnight rates had started to rise unmistakably. An unintended fortunate outcome of this phase was that the RBI having significantly tightened the monetary policy had sufficient space to respond to the second phase of the crisis which began with the collapse of Lehman brothers on 23rd September 2008.

The Lehman crisis did not affect the financial or the banking sector due to the minimal exposure of Indian commercial banks to sub-prime securities and the massive infusion of liquidity undertaken by the RBI starting in October 2008 along with a sharp reduction in repo and reverse-repo rates which fell from 9% and 6% in August to 7.5% and 5% in November 2008 respectively. However, this happened only after overnight money market rates had spiked to 22% in mid October sending a scare in the Indian banking sector. The real impact of the Lehman crisis was in the second round effects on the real economy. From September 2008, the trade sector collapsed. In the second half of 2008-09, merchandise exports declined by 18 per cent against a growth of 35 per cent. In the next stage, the crisis spread to the domestic credit market. The real economy deteriorated from September 2008, shown first by the sharp fall in export growth to 10 per cent in that month from about 35 per cent during April-August 2008, and negative growth thereafter; virtually negligible or negative growth in industrial output from October 2008; and negative growth in central tax revenue collection, also from October 2008.

Following the global crisis India's growth rate of GDP at factor cost (year-on-year) declined from 7.7 per cent in the first half of 2008-09 to 6.0 per cent in the second half of 2008-09. The trend continued to the first quarter of 2009-10, but growth rate picked up to an average 8.1 per cent in the next three quarters of 2009-10. The GDP growth rate has been steady at 8.9 per cent in the first half of 2010-11. Both the downturn and the recovery have been steeper if we consider GDP at market prices (Fig. 9). The slight divergence between GDP at factor cost and market prices is because of the shortfall in indirect taxes and rise in subsidies during the crisis period.

Figure 9. Quarterly Growth Rate of Real GDP (YoY)

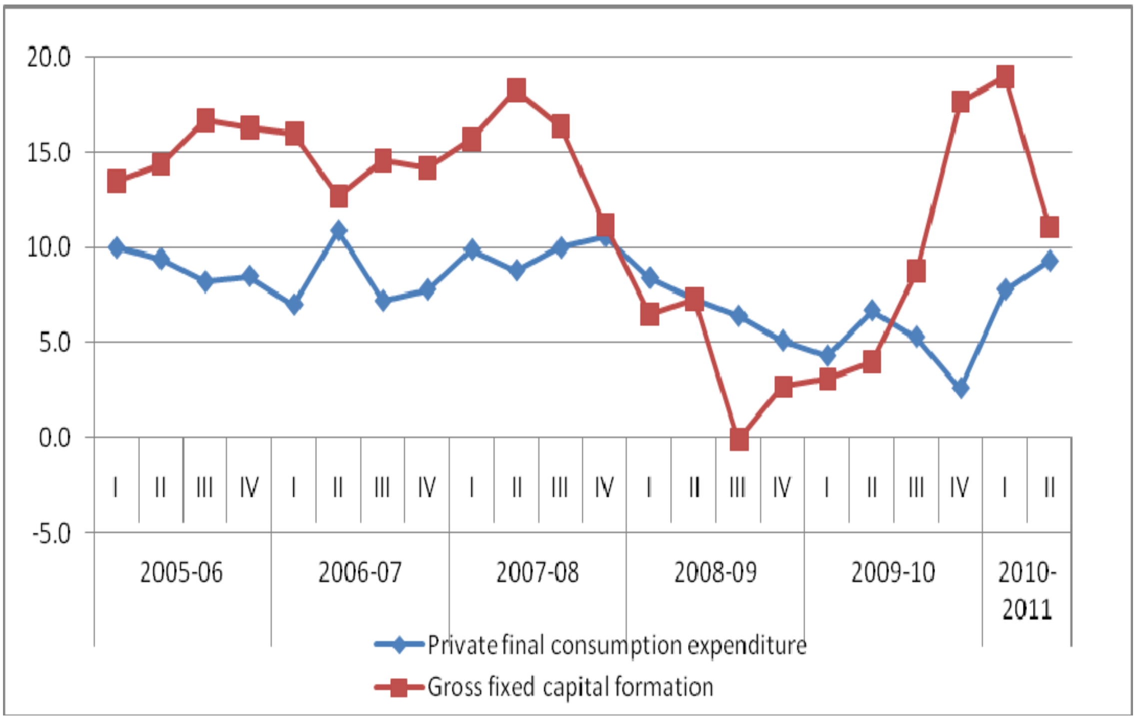


Source: Central Statistical Organisation (CSO)

4.2.1. Demand Side Factors

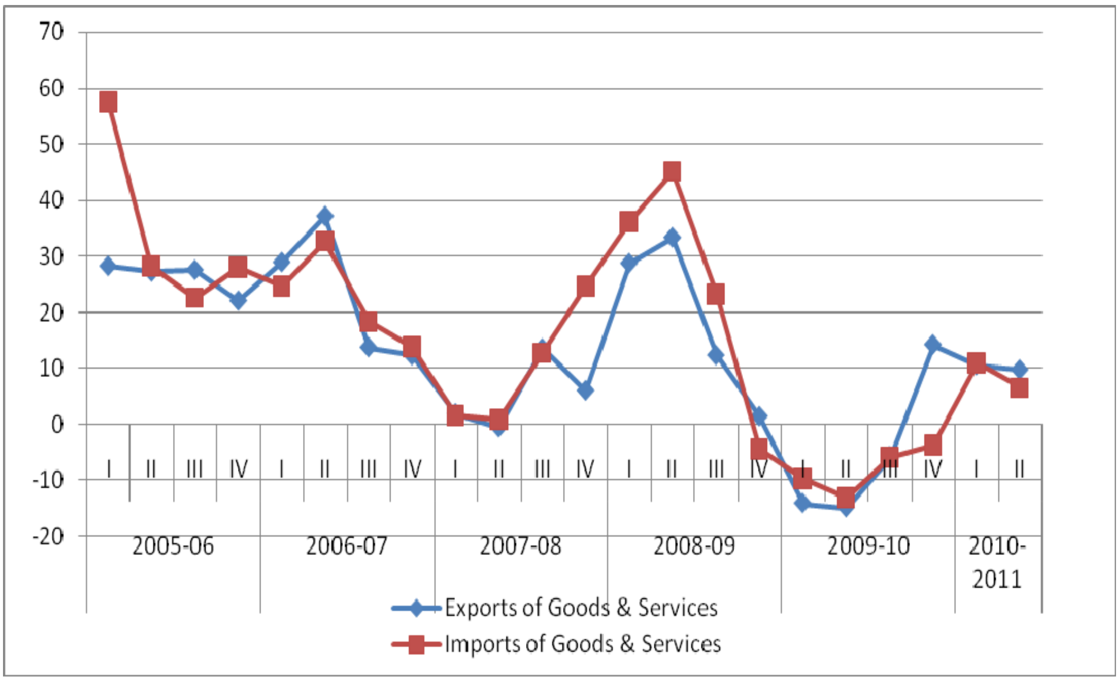
The slowdown in growth during the crisis is attributed to a steep decline in investment and private consumption growth. Fixed investment growth declined from about 15 per cent in the pre-crisis period to near zero levels during the second half of 2008-09 (Fig.10). Private consumption growth dropped to below 5 per cent from about 10 per cent in the pre-crisis period. However, the rise in government consumption compensated for the fall in private consumption and investment, and contributed to the quick recovery. External demand also contracted with a steeper decline in exports than imports during the crisis period (Fig.11). The strong recovery in GDP growth is driven by the steep recovery in investment and exports. Fixed investment grew by about 9 per cent and 18 per cent respectively in Q3 and Q4 2009-10. Exports of goods and services rose by 14 per cent against a decline in imports of goods and services in Q4 2009-10. The trend continues in the first quarter of 2010-11. This rise in exports followed the industrial recovery. However both exports and imports seem to have decreased in Q2 2010-11. All the demand side variables as shares of GDP are given in Table 4.1.

Figure 10. Quarterly Growth Rates (YoY)



Source: Central Statistical Organisation (CSO)

Figure 11. Quarterly Growth Rates (YoY)



Source: Central Statistical Organisation (CSO)

Table 6. Expenditure Side of GDP (As a Per cent of GDP)

			2008-09				2009-10 RE				2010-11BE	
Relative Shares	2008-09	2009 -10 RE	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Total Consumption Expenditure	70.9	69.4	71.8	69.4	75.2	67.5	73.0	72.6	73.4	62.3	71.6	71.8
i) Private	59.5	57.6	61.3	60.1	61.5	55.4	61.6	61.3	60.4	51.1	60.3	60.6
ii) Government	11.5	11.8	10.5	9.2	13.7	12.2	11.4	11.3	13.1	11.2	11.3	11.2
Gross Fixed Capital Formation	32.9	32.8	33	34.8	31.5	32.7	32.4	34.3	31.9	34.6	35	34.4
Change in Stocks	1.3	1.3	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.4
Net Exports	-6.1	-5.1	-5.2	-8.8	-7.3	-3.5	-6.5	-8.7	-6.7	0.4	-5.8	-6.8

Source: Central Statistical Organisation (CSO)

4.2.2. Trends in Fiscal Indicators from 2007-08 to 2010-11

As discussed in the seciont-2, India's fiscal situation improved significantly after the adoption of FRBM targets by successive governments since 2003-04 until the global crisis hit the Indian economy in early 2008-09. The high rate of GDP growth, which averaged 8.7 per cent between 2003-04 and 2008-09, also contributed to revenue buoyancy and helped bring down both revenue and fiscal deficits.

The combined fiscal deficit in 2007-08 was just about 4 per cent and revenue deficit was very close to zero along with a primary surplus. However, the situation changed drastically in 2008-09. The central budget, 2008-09, announced in February 2008, seemed to continue the progress towards FRBM targets by showing a low fiscal deficit of 2.5 per cent of GDP. However, the 2008-09 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, fertiliser and petroleum. These together pushed up the fiscal deficit to sharply higher levels. There were also off-budget items like the issue of oil and fertiliser bonds, which should be added to give a true picture of fiscal deficit in 2008-09. The fiscal deficit shot up to 8.5 per cent of

GDP (10.3 per cent including off-budget bonds) against five per cent in 2007-08 and the primary surplus turned into a deficit of 3.4 per cent of GDP (see Table 7). The combined public debt, however, declined marginally to 71.6 per cent of GDP because of a nominal growth in GDP of 12.7 per cent. The revenue deficit increased substantially to 4.4 per cent in 2008-09.

The huge increase in public expenditure in 2008-09 of 28.4 per cent that followed a 27.4 per cent in 2007-08 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 crisis.

Budget estimates for 2009-10 indicate a further worsening with the fiscal and primary deficits rising in the current year. According to the revised estimates of 2009-10, fiscal and primary deficits were increased to 10.1 per cent and 4.9 per cent of GDP respectively. This has raised the issue of India's fiscal stability and debt sustainability afresh. However the debt[34] ratio has slightly improved to 72.4 per cent of the GDP due to the high nominal rate of growth of the GDP.

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 2008-09 and 2009-10 from the fiscal consolidation path mandated under the FRBM Act. The revenue deficit and fiscal deficit in 2009-2010 are, as a result, higher than the targets set under the FRBM Act and Rules. The combined government expenditure was 28.4 per cent of GDP in 2008-09 and it is increased significantly to 30.4 per cent in 2009-10 (Table 6). The combined revenue expenditure has increased from 24.2 per cent in 2008-09 to 25.9 per cent in 2009-10. Owing to policy interventions for inflation management

[34] The total outstanding liabilities of the centre as per 2009-10 (BE) is about Rs.3400 billion (59.6 per cent of the GDP) of which internal debt accounts for 67 per cent. Adding the state governments' outstanding liabilities of about Rs.1600 billion (27.6 per cent of the GDP), the combined outstanding liabilities accounts for 76.6 per cent of the GDP, i.e., about Rs.4400 billion in 2009-10 (BE).

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 centre and states has come down by 0.5 percentage points in 2009-10 due to a further reduction in indirect taxes.

The fiscal situation is expected to improve in 2010-11. The government seems committed to return to the higher growth trajectory of 9% a more inclusive growth. The grounds laid down by the 13th finance commission for fiscal consolidation have been improved upon by the fiscal deficit targets announced in the budget. The budget has moved one step towards a selective roll-back of fiscal stimulus in favour of exports and agriculture, which is likely to be positive for the broad economic recovery. The target for fiscal deficit has been set at 5.5% in 2010-11. On the expenditure front, thrust on rural development and infrastructure is in line with expectations. The partial roll back of indirect taxes is expected to further improve revenues.

Table 7. Receipts and Disbursement of Centre and States (As a Per cent of GDP)

	Combined				Centre				States			
	2007-08	2008-09	2009-10 RE	2010-11 BE	2007-08	2008-09	2009-10 RE	2010-11 BE	2007-08	2008-09	2009-10 RE	2010-11 BE
I) Total Expenditure	27.4	28.4	30.4	29.6	15.1	15.9	16.4	16.0	15.5	17.3	-	-
A) Revenue Expenditure	22.4	24.2	25.9	25.0	12.6	14.2	14.5	13.8	12.0	13.4	-	-
B) Capital Expenditure	5.0	4.3	4.5	4.6	2.5	1.6	1.8	2.2	3.5	3.9	-	-
II) Total Receipts	27.8	30.9	31.4	-	18.3	20.0	-	-	15.8	17.0	-	-
A) Revenue Receipts	22.2	19.8	19.7	20.5	14.7	9.7	9.3	9.8	12.9	13.6	-	-
i)Tax Revenues	18.5	16.6	15.9	16.7	12.6	8.0	7.5	7.7	9.3	9.6	-	-
ii)Non-Tax Revenues	3.7	3.2	3.8	3.8	2.2	1.7	1.8	2.1	4.0	3.9	-	-
B) Capital Receipts	5.6	9.0	9.8	-	3.6	6.4	-	-	2.9	3.4	-	-

	Combined				Centre				States			
	2007-08	2008-09	2009-10 RE	2010-11 BE	2007-08	2008-09	2009-10 RE	2010-11 BE	2007-08	2008-09	2009-10 RE	2010-11 BE
III) Revenue Deficit	0.2	4.4	6.2	4.6	1.1	4.5	5.3	4.0	-0.9	-0.1	1.0	0.6
IV) Gross Fiscal Deficit	4.2	8.5	10.1	8.5	2.7	6.0	6.6	5.5	1.4	2.7	3.6	3.0
V) Gross Primary Deficit	-1.3	3.4	4.9	3.2	-0.9	2.6	3.1	1.9	-0.6	0.7	1.7	1.2

Source: Reserve Bank of India (RBI)

4.3. Fiscal Stimulus Packages

In their response to the global crisis, governments of different countries have resorted to an unprecedented, globally co-ordinated fiscal stimulus package. Consequently, in India also, three fiscal stimulus packages were unveiled since December 2008 to help 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 2008-09 and in early 2009-10. Thus, luckily for India, its electoral cycle that pushed up public expenditure, coincided with the global recession and helped India overcome its negative impact.

The first fiscal stimulus package was introduced on December 7, 2008, the second on January 2, 2009 and the third one on February 24, 2009. These included an across-the-board central excise duty reduction by 4 percentage points, 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/central sales tax, other export incentives and a 2 percentage point reduction in central excise duties and service tax, i.e., combined reduction of 6 percentage points in central excise duties. The total fiscal burden for these packages amounted to 1.8 per cent of GDP in 2008-09. Along with the expansion undertaken in the two budgets, the total fiscal stimulus over the last two years can be estimated at 3 per cent of the GDP. (Soumya please check this as the fiscal expansion in the previous two budgets would most likely be more than 1.2% of the GDP as implied here).

5. Towards a Feasible Fiscal Exit Strategy – Restoring FRBM Targets

Stimulus packages announced in India were discretionary in nature. Temporary changes, to tax and expenditure rules, triggered for crossing short-term macroeconomic thresholds may not help achieving fiscal sustainability in the long run. Further the discretionary stabilizers may suffer from mobilization of political support and lags in implementation. This kind of discretionary fiscal policy is not automatically reversed when the economy improves. The India's fiscal balances require immediate attention in order to have sound and sustainable fiscal and macroeconomic situation. A policy stance that relies exclusively on high growth and the continuation of a low interest rate regime may be inadequate to ensure long term debt sustainability. Therefore, as discussed above, the government needs to concentrate on automatic stabilizers pertaining to permanent expenditure and tax rules to attain fiscal sustainability and macroeconomic stability.

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 exit 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.[35] However, the situation is manageable because of

[35] A study by the IMF's Fiscal Affairs Department suggests that the countries those expected to have debt in excess of 60 per cent of GDP by 2014 would have to maintain an average primary surplus (revenue less expenditure before interest payments) of 4 and 0.5 percent beginning in 2014 to reduce the debt to 60 per cent of GDP by 2030 (Horton, Kumar, and Mauro, 2009).

the high potential growth rates that may see nominal GDP growth of over 13-14 per cent 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 2008-09 is already 8.5 per cent of GDP. This may even rise further as revised estimates for 2009-10 suggest the budget deficit is likely to be about 10 per cent of GDP. It could be nearer to 12 per cent if all the off-budget items are taken into account. This implies a significant increase in government borrowing, which has risen from Rs.1269.12 billion ($25.3 billion[36]) in 2007–2008 to Rs.3265.15 billion ($65.3 billion) in 2008–2009 and is likely to be Rs.4009.96 billion ($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 75 per cent.

We attempt to calculate best growth rate, primary deficit and interest rate that stabilises public debt for six to seven years down the line. 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 adverse effect of the other[37]. We have estimated[38] various scenarios for India's debt-GDP ratios from 2009-10 to 2015-16 on three alternative assumptions of nominal GDP growth rate (12 per cent, 13 per cent and 14 per cent), interest rate on debt (7 per cent, 8 per cent and 9 per cent) and primary deficit as per cent of GDP (3 per cent, 4 per cent and 5 per cent). These are shown in Tables 5.1-5.3. Here g = nominal growth rate, i = nominal interest rate, p = primary deficit.

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[36] All $ figures are in US dollars.

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

[38] The estimation is done by using the basic equation for debt ratio $d_t = p_t + d_{t-1}(i-g_t) / (1+g_t) + d_{t-1}$ where d_t = debt-GDP ratio in time t, p_t = primary deficit-GDP ratio, d_{t-1} = debt-GDP ratio in time t-1, i = interest rate on debt, gt = GDP growth rate in nominal terms in time t.

Table 8. 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%
2009-10	72.4	72.4	72.4	72.4	72.4	72.4	72.4	72.4	72.4
2010-11	72.2	73.2	74.2	72.8	73.8	74.8	73.5	74.5	75.5
2011-12	71.9	73.9	75.9	73.2	75.2	77.1	74.5	76.5	78.4
2012-13	71.7	74.6	77.5	73.6	76.5	79.4	75.5	78.4	81.3
2013-14	71.5	75.3	79.0	74.0	77.8	81.6	76.5	80.3	84.2
2014-15	71.3	75.9	80.5	74.3	79.0	83.6	77.4	82.2	86.9
2015-16	71.2	76.5	81.9	74.7	80.2	85.7	78.4	84.0	89.6

Table 9. 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%
2009-10	72.4	72.4	72.4	72.4	72.4	72.4	72.4	72.4	72.4
2010-11	71.6	72.6	73.6	72.2	73.2	74.2	72.8	73.8	74.8
2011-12	70.8	72.7	74.7	72.0	74.0	75.9	73.3	75.2	77.2
2012-13	70.0	72.8	75.7	71.8	74.7	77.6	73.7	76.6	79.5
2013-14	69.3	73.0	76.7	71.6	75.4	79.1	74.1	77.9	81.6
2014-15	68.6	73.1	77.6	71.5	76.0	80.6	74.4	79.1	83.8
2015-16	68.0	73.2	78.5	71.3	76.7	82.1	74.8	80.3	85.8

Table 10. 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%
2009-10	72.4	72.4	72.4	72.4	72.4	72.4	72.4	72.4	72.4
2010-11	71.0	72.0	73.0	71.6	72.6	73.6	72.2	73.2	74.2
2011-12	69.6	71.5	73.5	70.8	72.8	74.7	72.1	74.0	76.0
2012-13	68.3	71.1	74.0	70.1	72.9	75.8	71.9	74.8	77.6
2013-14	67.1	70.8	74.4	69.4	73.1	76.8	71.7	75.5	79.2
2014-15	66.0	70.4	74.9	68.8	73.3	77.8	71.6	76.2	80.8
2015-16	65.0	70.1	75.3	68.1	73.4	78.7	71.5	76.8	82.2

From the above alternative scenarios, the best case scenario is when GDP is growing at 14 per cent, primary deficit is 3 per cent of GDP and interest rate on debt is 7 per cent. In this case, the debt ratio will decline to 65 per cent in 2015-16 from 72.4 per cent in 2009-10. The worst case scenario is when GDP is growing at 12 per cent, primary deficit is 5 per cent of GDP and interest rate on debt is 9 per cent. In that case, the debt ratio will rise to 89.6 per cent by 2015-16.

For the current year, with a nominal growth rate below 12 per cent, a primary deficit of 3.2 per cent and an interest rate of about 7.5 per cent, the emerging debt position is not a sustainable one. The policy implication is that we 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 our way out of debt. However, this is not feasible given political sensitivity regarding inflation. If, however, the stimulus is withdrawn and GDP grows faster than the underlying rate that has been assumed, then primary deficit may return to the path prescribed by FRBM targets in the near future. The share of public debt in GDP will decrease at a significant pace. What these figures indicate is that the fiscal situation might deteriorate further if appropriate measures are not taken to control the public debt.

5.1. Long-term Policy Measures

The key challenge involves balancing between public interventions and maintaining market confidence in the sustainability of public finances. This will require 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. One of the weaknesses of the FRBM Act was that it did not have any provisions for protecting a decline in public investment. Consequently, in order to reach FRBM targets, productive expenditure was cut so that current expenditures could be continued at high levels. The former would have improved human, social, and physical capital, and therefore the economy's supply response capabilities. Now the government needs to step up investment in human capital development through increased spending on primary, vocational and higher education and, primary health that will also help achieve inclusive growth. Further, such expenditures on improving human capital should be considered as part of capital expenditure rather than as revenue expenditure (which is how they are categorised now) since they yield a return in the long-term by way of inter-generational equity and economic growth. These measures will constitute one of the major components of 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. The other important component of second generation reforms required to generate sustained rapid and inclusive growth is improvement in governance with a focus on minimising rent seeking and improving the delivery of public services.

Fiscal policies should be formulated within medium-term fiscal frameworks (and supportive institutional arrangements) that envisage a gradual fiscal correction once economic conditions improve. Reforms in the these areas will play a key role by directly improving prospects for the primary balance, thereby helping to contain the debt-to-GDP ratio and bolstering confidence in fiscal sustainability. But at the same time more fundamental adjustments in the tax system, the structure and efficiency of public expenditure and the financial sector must be on the agenda for reforms. The FRBM legislation brought down only reported deficits. But the global shock exposed the inadequate attention paid to incentives and escape clauses in formulating the Act. Targets were mechanically achieved, compressing essential expenditure on infrastructure, health and education, while maintaining subsidies and loan waivers. A new path of fiscal consolidation proposed by the 13th Finance Commission draws heavily on and seeks to maintain India’s growth prospects. There is only a gentle attempt to prevent reduction in capital expenditure. Stricter constraints on the revenue deficit, protecting capital expenditures and more concentration on the medium term fiscal plan are needed.

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 could affect the growth prospects and cause concern on public debt sustainability. Partial reversing may help strengthening 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 Goods and Services Tax (GST) in October 2010. GST is going to replace CENVAT, state VAT and service tax. 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 etc., 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 per cent. 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 be become effective in near future is the Direct Tax Code (DTC)[40], which is designed to greatly simplify the direct tax structure. DTC

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

will achieve this by eliminating distortions in the tax structure, minimizing exemptions, expanding the tax base, and improving tax compliance by introducing moderate levels of taxation. Initial analysis shows that most of these objectives are achievable.

5.2. 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 post Lehman global crisis on India were evident only in the second round which saw a sharp decline in exports, a temporary lowering of GDP growth rates and a significant worsening of fiscal balances. India did not suffer the direct negative impacts of the crisis as its banking sector was not exposed to sub-prime assets. 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 maximise 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 the recommendations of the 13th Finance Commission will be implemented to restore fiscal health 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. At the same time immediate and concerted attention has to be given to implement governance reforms and measures for more sustained improvements in human resource development for the economy to remain on the trajectory of rapid and inclusive growth.

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APPENDIX-I

Receipts and Disbursement of Central Government (As a Per cent of GDP)

	1980-89	1990-99	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10 BE	2009-10 RE	2010-11 BE
I) Total Expenditure	17.6	16.0	15.5	15.9	16.8	17.1	15.8	14.1	14.1	15.1	15.9	17.4	16.4	16.0
A) Revenue Expenditure	11.4	12.2	13.2	13.2	13.8	13.1	12.2	12.2	12.5	12.6	14.2	15.3	14.5	13.8
i)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	-	
ii) 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	-	
B) Capital Expenditure	6.2	3.7	2.3	2.7	3.0	4.0	3.6	1.9	1.7	2.5	1.6	2.1	1.8	2.2
i) 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	-	
ii)Loans & 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	-	
II) 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	-	
A) Revenue Receipts	12.3	11.8	11.6	11.2	11.7	12.0	12.3	12.4	13.5	14.7	9.7	13.3	9.3	9.8
i) Tax Revenues	9.9	9.3	9.0	8.2	8.8	9.2	9.7	10.2	11.5	12.6	8.0	10.9	7.5	7.7
(a)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	-	
(b) 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	-	
ii))Non-Tax Revenues	2.4	2.5	2.7	3.0	2.9	2.8	2.6	2.1	2.0	2.2	1.7	2.4	1.8	2.1
B) 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	-	
i) Disinvestment Receipts		0.2	0.1	0.2	0.1	0.6	0.1	0.0	0.0	0.8	0.2	0.0	-	
III) 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	5.3	4.0
IV) Gross Fiscal Deficit	6.7	5.9	5.7	6.2	5.9	4.5	4.0	4.1	3.5	2.7	6.0	6.8	6.6	5.5
V) Gross Primary Deficit	4.1	1.6	0.9	1.5	1.1	0.0	0.0	0.4	-0.2	-0.9	2.6	3.0	3.1	1.9

Source: Reserve Bank of India (RBI)

APPENDIX-II

Receipts and Disbursement of State Governments (As a Per cent of GDP)

	1980-89	1990-99	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10 BE	2009-10 RE	2010-11 BE
I) 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	-	-
A) 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	-	-
i)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	-	-
B) 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	-	-
i) 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	-	-
ii)Loans & Advances	1.3	0.8	0.4	0.4	0.4	0.8	0.5	0.4	0.3	0.4	0.3	-	-	-
II) 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	-	-
A) 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	-	-
i) 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	-	-	-
ii))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	-	-	-
B) 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	-	-
III) Revenue deficit	-0.1	1.2	2.6	2.7	2.3	2.3	1.2	0.2	-0.6	-0.9	-0.2	0.6	1.0	0.6
IV) Gross Fiscal Deficit	2.8	3.1	4.2	4.1	4.1	4.4	3.4	2.5	1.9	1.4	2.6	3.4	3.6	3.0
V) Gross Primary Deficit	1.7	1.2	1.8	1.4	1.3	1.5	0.7	0.2	-0.4	-0.6	0.6	1.4	1.7	1.2

Source: Reserve Bank of India (RBI)

APPENDIX-III

Chronology of Fiscal Reforms in India

List of Fiscal Reforms

Effective Year	Reform	Objective	Changes
1954-55	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%.
1970-71, February 28th	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%.
1971-72, May 28th	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%
1971-72	The Wanchoo Direct Taxes Enquiry Committee (WDTEC)	Revision of income tax rates	Suggestions: Reduction of the effective top marginal rate to 70%
1974-75, February 28th	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%
1976-77, March 15th	Budget Report presented by Mr. C. Subramanium	Reducing income tax rates further and decreasing wealth tax rate	Decrease in top marginal income tax rate to 66% (60% plus 10% surcharge)
1978-79	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) etc.	Recommendations: i) Rationalisation of the duty structure on final products and raw materials ii) Taking major steps within a time-bound programme 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 etc.

1979-80, February 28th	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
1980-81, June 18th	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)
1983-84, February 28th	Budget Report presented by Mr. Pranab Mukheree		Increase in surcharge to 12.5%
1984-85, February 29th	Budget Report presented by Mr. Pranab Mukheree		Decrease in top effective rate to 62% by cutting the top marginal rate to 55%
1985-86, March 16th	Budget Report presented by Mr. V.P.Singh	Comprehensive direct tax reforms following the Economic Administration Reforms Commission recommendations (1983-84)	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
1985-86, December	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)
1986-87, February 28th	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
1992, 4th quarter (Interim report presented in Dec 91, followed by a two part final report	Chelliah committee	Simplification and rationalisation 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 per cent 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 per cent from 51.75 per cent 57.5 per cent

in August 1992 and January 1993)			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 etc.
1992-93, February 28th; 1993-94, February 27th; 1994-95, February 28th; 1995-96, March 15th	Budget Report presented by Mr. Manmohan Singh	Decreasing import duties	Reduction in import duties to: 110% in 1992-93 85% in 1993-94 65% in 1994-95 50% in 1995-96
1994, July 1st	Chelliah committee	Widening the tax base by including the service tax and extending its coverage gradually.	Services brought under the tax net in 1994-95 are Telephone, Stockbroker and General Insurance at the tax rate of 5%
1991-92 to 1996-97, February			i) New taxes such as Securities Transaction Tax (STT), and Dividend Distribution Tax (DDT) have partly reversed the move towards a simpler system ii) India has entered into Double Taxation Avoidance Agreement (DTAA) with 65 countries including countries like U.S.A., U.K., Japan, France, Germany, etc. 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
1996-97, July 22nd	Finance Act		Advertising agencies, Courier agencies and Radio pager services were added to Service Tax Net
1997-98			Minimum Alternative Tax (MAT) was introduced in 1997-98
1997-98, February 28th	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

1997-98, February 28th and 1998-99, June 1st	Annual Budgets		Eight more services were added to Service Tax Net
1999-2000, February 27th	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
2000-01, February 29th	Budget Report presented by Mr. Yashwant Sinha		Converting the three excise duties into a single CENVAT rate of 16% buttressed by a few selective excises on luxury consumer goods
2001-02	'Govinda Rao' Expert group on Taxation of Services		Recommendations: Introduction of credit for taxes paid on inputs in services activities
2002-03, December	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 criticised by economists like Bagchi, Chelliah, Acharya, Mukhopadhya et al.) iv) Abolition of minimum alternate tax is one of the major suggestions made by the task force. This was implemented in 2003-04
2004-05, July 8th	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)
2004-05, June			Tax Information Network (TIN) and Online Tax Accounting System (OLTAS) were operationalised
July 2004	Fiscal Responsibility and Budget Management (FRBM) Act that had been approved		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

	by the Parliament under the NDA government was notified by the successor UPA government		should not rise by more than 9% a year iv) Union Government shall not give guarantee to loans raised by PSUs and State Governments beyond 0.5% of GDP in the aggregate
2000-01 to 2005-06, February 28th			Reduction in customs duties from 35% to 15%
2005-06	Introduction of Value Added Tax (VAT)	VAT is designed to make accounting more transparent, cut trade barriers and boost tax revenues.	Rates: i) 0% on necessities and some primary products i) 1% on bullion and precious stones ii) 4% on industrial inputs and capital goods and items of mass consumption iii) 12.5% on all other items
2003-04 to 2009-10, February	Changes in Service Tax		**Rates levied:** 2003-04: 8% 2004-05: 10% and 2% Education Cess was introduced. 2006-07: 12% 2009-10, February : 10% Current: 10.2% along with 2% Education Cess About 80 services covered under Service Tax Net till date
2008-09, February 29th	Budget Report presented by Mr. P. Chidambaram		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 assessee to get relief of minimum of Rs 4,000. New tax slabs are: 10 per cent for Rs. 150,000 to 300,000, 20 per cent for 300,000 to 500,000 and 30 per cent above 500,000 ii) 2 percentage point reduction in central excise duties and service tax ii) A commodities transaction tax (CTT) was introduced on the same lines as STT on options and futures traded in commodity exchanges. 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
		First fiscal stimulus package was announced on 7th December 2008 to fight against global crisis	i) Across-the-board central excise duty reduction by 4 percentage points ii) Rs. 20,000 crore increase in plan expenditure

2009-10, July 6th	Budget Report presented by Mr. Pranab Mukheree		i) 34% increase in plan expenditure and 37% increase in non-plan expenditure (due to 6th pay commission, subsidies etc.) – Total expenditure increased by 36% over 2008-09 budget ii) Exemption limit in personal income tax raised by Rs.10,000 from Rs.1.50 lakh to Rs.1.60 lakh iii) Minimum Alternate Tax (MAT) to be increased to 15% of book profits from 10%. iv) Abolition of FBT, CTT. ii) Fiscal deficit and revenue deficit of the Central government are projected as 6.8% and 4.8% of GDP respectively
		Second and third fiscal Stimulus packages on 2nd January 2009 and 24th February 2009	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/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
2010-11, October	Introduction of the Goods and Services Tax (GST)		Salient features: i) A dual GST model with two separate components namely, Central GST (CGST) and State GST (SGST) will be introduced ii) Both the centre and states have to levy GST concurrently on all goods and services other than a small list of exemptions iii) Cross-utilisation 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
2011-12, April	Possible introduction of the Direct Tax Code (DTC)		**Major proposals:** i) To cut corporate profit tax from 34% (including surcharge and cess) 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