

## Public Finance

---

Fiscal policy is a critical component of the policy framework for achieving sustained annual growth of 8-10 per cent with macroeconomic stability. High deficits, unproductive expenditure and tax distortions have constrained the economy from realising its full growth potential. The resources for building physical and social infrastructure, so essential for promoting growth, have to be generated within the framework of the Fiscal Responsibility and Budget Management Act (FRBMA), 2003. The emphasis of fiscal policy under FRBMA has been on revenue-led fiscal consolidation, focus on better expenditure outcomes and rationalization of the tax regime to remove distortions and improve competitiveness of domestic goods and services in a globalised economic environment.

2.2 Some of the important fiscal measures implemented included: reducing the peak rates of customs duties; rectifying anomalies like inverted duty structure; rationalising excise duties with a movement towards a median CENVAT rate; revisiting the tax exemptions; relying on voluntary tax compliance through taxpayer facilitation; introduction of State-level VAT for achieving a non-cascading, self-enforcing, and harmonized commodity taxation regime; increasing productivity of expenditure through an outcome budget framework, which seeks to translate outlays into better outcomes through monitorable performance indicators; and innovative financing mechanism like creation of a Special Purpose Vehicle (SPV) for infrastructure projects. While the Centre continued to pursue

the path of fiscal consolidation as ordained in the FRBM Rules, these efforts of the Central Government were complemented by the States, which initiated the process of fiscal consolidation in line with the Twelfth Finance Commission's (TFC) recommendations.

2.3 The FRBMA continued to provide a strong institutional mechanism for making sustained progress at fiscal consolidation. Past efforts at fiscal consolidation in the pre-FRBM era, after an initial burst of progress, faltered in the face of strong sectoral short-term needs-driven demand on resources. For instance, while the fiscal deficit of the Central Government, as a proportion of GDP, declined from 6.6 per cent in 1990-91 to 4.1 per cent in 1996-97, this progress could not be sustained and the fiscal deficit again rose to 6.2 per cent in 2001-02 (Table 2.1). Together with the rapid decline in the quality of deficit, indicated by the proportion of revenue deficit to fiscal deficit, the deterioration in the fiscal situation became a cause for serious concern.

2.4 With the FRBMA in place since 2003-04, not only did the fiscal deficit as a proportion of GDP decline to 4.1 per cent of GDP in 2004-05 (Prov)<sup>1</sup>, but this was also accompanied by a commensurate decline in the revenue deficit from 4.4 per cent in 2002-03 to 2.5 per cent in 2004-05 (Prov), leading to a marked improvement in the quality of deficit. The fiscal deficit, as a proportion of GDP, in 2004-05 was lower than the budget estimate (BE) of 4.4 per cent. The revenue and fiscal deficit in BE 2005-06, as proportions of GDP, are 2.7 per cent and 4.3 per cent, respectively.

---

<sup>1</sup> Provisional (unaudited) figures of fiscal aggregates of Union Government accounts have been used in place of revised estimates for 2004-05, wherever possible, in this chapter.

| <b>Table 2.1 : Trends in deficits of Central Government</b>   |                        |                        |                       |  |
|---|------------------------|------------------------|-----------------------|--|
| <b>Year</b>   | <b>Revenue deficit</b> | <b>Primary deficit</b> | <b>Fiscal deficit</b> | <b>Revenue deficit as per cent of fiscal deficit</b> |
| <b>(As per cent of GDP)</b>   |                        |                        |                       |  |
| 1990-91   | 3.3                    | 2.8                    | 6.6                   | 49.4   |
| 1991-92   | 2.5                    | 0.7                    | 4.7                   | 52.7   |
| 1992-93   | 2.5                    | 0.6                    | 4.8                   | 51.7   |
| 1993-94   | 3.8                    | 2.2                    | 6.4                   | 59.2   |
| 1994-95   | 3.1                    | 0.4                    | 4.7                   | 64.6   |
| 1995-96   | 2.5                    | 0.0                    | 4.2                   | 59.2   |
| 1996-97   | 2.4                    | -0.2                   | 4.1                   | 58.2   |
| 1997-98   | 3.1                    | 0.5                    | 4.8                   | 63.5   |
| 1998-99   | 3.8                    | 0.7                    | 5.1                   | 74.8   |
| 1999-2000   | 3.5                    | 0.7                    | 5.3                   | 64.6   |
| 2000-01   | 4.0                    | 0.9                    | 5.6                   | 71.7   |
| 2001-02   | 4.4                    | 1.5                    | 6.2                   | 71.1   |
| 2002-03   | 4.4                    | 1.1                    | 5.9                   | 74.4   |
| 2003-04   | 3.6                    | 0.0                    | 4.5                   | 79.7   |
| 2004-05(Prov.)*   | 2.5                    | 0.0                    | 4.1                   | 62.2   |
| 2005-06(BE)   | 2.7                    | 0.5                    | 4.3                   | 63.1   |
| * Provisional and unaudited as reported by Controller General of Accounts, Department of Expenditure, Ministry of Finance.  |                        |                        |                       |  |
| Note: 1. The ratios to GDP for 2005-06 (BE) are based on CSO's Advance Estimates. GDP at current market prices prior to 1999-2000 based on 1993-94 series and from 1999-2000 based on new 1999-2000 series. |                        |                        |                       |  |
| 2. Fiscal deficit excludes transfer of states' share in small savings collections.  |                        |                        |                       |  |
| Source : Budget documents.  |                        |                        |                       |  |

2.5 The apparent deterioration in BE 2005-06 does not imply a setback and needs to be seen in the context of the fact that these BEs

finalised in February 2005 were on the basis of revised estimates (RE 2004-05) of revenue and fiscal deficits as proportions of GDP available at that point in time, which were 2.7 per cent and 4.5 per cent, respectively. The Budget for 2005-06 had explicitly paused the process of fiscal adjustment in revenue deficit, while continuing with the reduction in fiscal deficit. As detailed in the Finance Minister's Statement under Section 7 of the FRBMA, which was laid on the table of the Parliament along with the Budget for 2005-06, this 'pause' was on account of the higher demands on resources, particularly arising out of the award of TFC. The pause was temporary and Budget 2005-06 expressed optimism about resumption of the adjustment process from 2006-07.

2.6 The fiscal situation of the States followed a pattern similar to that of the Centre. As a proportion of GDP, the fiscal deficit of the States, after declining from 3.3 per cent in 1990-91 to 2.7 per cent in 1996-97, rose to reach 4.7 per cent in 1999-2000. This was accompanied by a rapid three-fold rise in the revenue deficit to GDP ratio from 0.9 per cent in 1990-91 to 2.7 per cent in 1999-2000, indicating a deteriorating quality of the deficit. The persistent and large imbalances in State finances necessitated a strong incentive-based restructuring scheme. The terms of reference for TFC included the mandate for restructuring public finances, and the TFC has proposed a scheme of fiscal transfers to serve the objectives of equity and efficiency by embedding it in a framework of fiscal consolidation.