

Public Finance

Fiscal policy is the building block for an enabling macro-environment, which not only provides stability and predictability to the policy regime, but through its tax transfer mechanism, also ensures that national resources are allocated in terms of its defined priorities. Unproductive expenditure, tax distortions and high deficits are considered to have constrained the economy from realising its full growth potential. The medium-term fiscal policy stance of Government, therefore, has been to reduce deficits; prioritise expenditure and ensure that these results in intended outcomes; and augment resources by widening the tax base and improving the compliance while maintaining moderate rates. At the beginning of the fiscal reforms in 1991, the fiscal imbalance was identified as the root cause of the twin problems of inflation and the difficult balance of payments position. The fiscal consolidation, which followed in response, in the absence of a defined mandate, however, failed to sustain itself. For medium-term management of the fiscal deficit, and to provide the support of a strong institutional mechanism, the Fiscal Reforms and Budget Management Act (FRBMA) was enacted on August 26, 2003 and the Act and the rules were notified to come into effect from July 5, 2004. FRBMA is an important institutional expression to ensure fiscal prudence and support for macroeconomic balance. With the enactment of the FRBMA, the traditional annual budgeting moved to a more meaningful medium-term fiscal planning framework. According to the Rules, revenue deficit is to be reduced by an amount equivalent to half per cent or more of the

estimated GDP at the end of each financial year and eliminated by March 31, 2009. Fiscal deficit is to be reduced by an amount equivalent to 0.3 per cent or more of the estimated GDP at the end of each financial year and reduced to no more than three per cent of the estimated GDP by the financial year ending on March 31, 2009.

2.2 The process of fiscal consolidation under FRBMA has been continuous and essentially an incremental one. Some of the important fiscal measures that are being implemented include: 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 Special Purpose Vehicle (SPV) for infrastructure projects. States have also joined the process of fiscal consolidation in line with the Twelfth Finance Commission's (TFC) recommendations and are complementing the efforts of the Central Government.

2.3 Progress in fiscal consolidation has also been satisfactory in the post-FRBM period. The fiscal deficit of the Centre as a proportion of GDP has come down from 6.2

per cent in 2001-02 to 3.8* per cent in 2006-07 (Budget Estimate (BE)). While past efforts at fiscal consolidation in the pre-FRBM era, after an initial burst of progress, had faltered because the sectoral demands on resources could not be resisted, the mandated FRBMA mechanism has proved more effective. 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, but this progress could not be sustained (Table 2.1). Further, increase in the ratio of fiscal deficit to GDP during this period was also associated with an increase in the proportion of revenue deficit, which increased from 49.4 of fiscal deficit in 1990-91 to 79.7 per cent in 2003-04. As against more than half of the incremental borrowings being applied to asset creation in 1990-91, the ratio declined to 20.3 per cent in 2003-04. Since FRBMA mandated a reduction in revenue deficit as well, gradual reduction in revenue deficit together with the reduction in fiscal deficit resulted in a decline in the proportion of revenue deficit to fiscal deficit by 22.7 percentage points in three years. The proportion of borrowed funds applied to assets creation, correspondingly, increased to 43 per cent in 2006-07 (BE).

2.4 In 2005-06, though the budget targets were met, there was deterioration in ratios of fiscal and revenue deficits to GDP compared to 2004-05. This apparent deterioration should not, however, be seen as a setback as the Budget for 2005-06 had explicitly paused the process of fiscal adjustment on account of the higher devolution of resources, arising out of the award of TFC. The pause was temporary as the process was resumed thereafter. In 2006-07, proposed reduction in revenue and fiscal deficit as proportions of GDP by 0.6 percentage points and 0.5 percentage points, respectively was higher than the levels prescribed under FRBM Rules.

2.5 The fiscal situation of the States also showed considerable improvement, which in

Table 2.1 : Trends in deficits of Central Government				
Year	Revenue deficit	Primary deficit	Fiscal deficit	Revenue deficit as per cent of fiscal deficit
(As per cent of GDP)				
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	5.4	64.6
2000-01	4.1	0.9	5.7	71.7
2001-02	4.4	1.5	6.2	71.1
2002-03	4.4	1.1	5.9	74.4
Enactment of FRBMA				
2003-04	3.6	0.0	4.5	79.7
2004-05	2.5	-0.1	4.0	62.6
2005-06#	2.7	0.4	4.1	64.7
2006-07(BE)	2.1	0.2	3.8 \$	57.0
# Provisional and unaudited as reported by Controller General of Accounts, Department of Expenditure, Ministry of Finance.				
\$ Refer footnote on page 2.				
Note: 1. The ratios to GDP for 2006-07 (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.				

fact was even better relative to the performance of the Central Government. As a proportion of GDP, the fiscal deficit of the States, declined by 1.9 percentage points, post FRBMA, from 4.5 per cent in 2003-04 to 2.6 per cent in 2006-07 (BE). In so far as the reduction in revenue deficit is concerned, on an aggregate basis, this is budgeted to get eliminated in 2006-07 (BE), two years ahead of the target. A strong incentive-based restructuring scheme of fiscal transfers to serve the objectives of equity and efficiency by embedding it in a framework of fiscal consolidation proposed by TFC appears to have succeeded.

* Advance estimates (AE) of GDP for 2006-07 released by CSO on February 7, 2007 placed 2006-07 GDP at market prices at Rs 4,100,636 crore. Fiscal deficit, as projected in Budget 2006-07, as proportion of GDP based on AE works out to 3.6 per cent.