2

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).

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.

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 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.

Central Government finances during Tenth Five Year Plan (2002-2007)

2.6 Robust economic growth and improved performance of the manufacturing sector helped to maintain the revenue receipts, particularly the tax revenues, buoyant throughout the Tenth Five Year Plan. Average annual growth of revenue receipts of the Central Government between 2002-03 and 2006-07 (BE) was 14.9 per cent. Though the corresponding growth in non-tax revenue was a moderate 2.6 per cent, improved growth of tax revenue (net to centre) at 19.6 per cent generated overall high growth of revenue receipt. Gross tax revenue of the Central Government recorded an average annual growth of 18.8 per cent, higher than the rate of growth of GDP (at market prices), which averaged 12.5 per cent during this period. The gross tax-GDP ratio, which had stagnated at 8-10 per cent range, increased to 10.3 per cent in 2005-06 (prov.)[1] (Table 2.2) and is expected to improve further to 10.8 per cent in 2006-07(BE). Revenue expenditure during the Tenth Plan recorded a moderate average annual growth of 10.2 per cent leading to a reduction in revenue deficit in rupee terms and also relative to GDP. Growth of plan expenditure at 11.4 per cent was higher compared to the growth in non-plan expenditure of 8.6 per cent during the Tenth Plan, because of a significant increase of 23.3 per cent in 2006-07 (BE) over 2005-06 (prov.).

Central Government finances 2005-06

2.7 The Budget for 2005-06 had projected gross tax revenue of the Central Government to increase by 20.9 per cent. The assumed rate of growth for corporate income tax and personal income tax was 33.2 per cent and 30.1 per cent, respectively. As against this, the realised growth for gross tax revenue; corporate income tax; and personal income tax were 20.0 per cent; 20.3 per cent; and 22.7 per cent, respectively. In case of customs and excise duties, Budget had estimated a growth of (-) 5.5 per cent and 20.7 per cent respectively. Though the realised growth in excise duties was 12.2 per cent, lower than the budget estimates, customs collections had a positive growth of 12.9 per cent. The revenue receipts from service tax at 62.4 per cent as against 23.7 per cent envisaged in the Budget were particularly buoyant. Higher service tax and customs duty collections more or less neutralised the lower collections from direct taxes and excise duties resulting in overall growth of gross tax collection to be only marginally lower than the Budget targets. Non-tax revenue, which was projected to grow at 3.5 per cent, witnessed a decline of 9.0 per cent, mainly due to a decline in interest receipts from Rs. 32,364 crore in 2004-05 to Rs. 20,564 crore in 2005-06 (prov.). Interest receipts were short of the budget estimates by Rs. 4,936 crore. Interest receipts declined rapidly during the Tenth Plan period from Rs. 37,622 crore in 2002-03 to Rs. 20,564 crore in 2005-06 because of the impact of two factors: (i) the debt-swap scheme wherein the prepayment of high-cost loans of 13 per cent and above was enabled through lower-coupon small savings transfer and additional market borrowings, and (ii) the TFC award which resulted in dis-intermediation of Central Government from loan assistance to States for financing their plan except for loans under externally aided projects, as also the consolidation and rescheduling of outstanding loans at lower rates of interest to eligible states.

2.8 In 2005-06, total expenditure at Rs. 503,908 crore was lower relative to the budget estimates of Rs. 514,344 crore. Both revenue and capital expenditure were short of the budget estimates. As against an estimated growth of 15.7 per cent in revenue expenditure, the observed growth was 14.1 per cent. Decline in the observed growth of revenue expenditure was mainly due to lower than the budgeted expenditure for interest

[1] Provisional (unaudited) figures of fiscal aggregates of Union Government accounts have been used in place of revised estimates for 2005-06, wherever possible, in this chapter.

Table 2.2 : Receipts and expenditure of the Central Government

	1990-91	2001-02	2002-03	2003-04	2004-05#	2005-06 (B.E.)	2005-06 (Prov.)@	2006-07 (B.E.)
					(Rs crore)			
1. Revenue receipts (a+b)	**54,954**	**201,306**	**230,834**	**263,813**	**306,013**	**351,200**	**343,883**	**403,465**
(a) Tax revenue (net of States' share)	42,978	133,532	158,544	186,982	224,798	273,466	269,992	327,205
(b) Non-tax revenue	11,976	67,774	72,290	76,831	81,215	77,734	73,891	76,260
2. Revenue expenditure	**73,516**	**301,468**	**338,713**	**362,074**	**384,351**	**446,512**	**438,527**	**488,192**
of which:								
(a) Interest payments	21,498	107,460	117,804	124,088	126,934	133,945	131,757	139,823
(b) Major subsidies	9,581	30,447	40,716	43,535	42,484	46,358	44,220	44,792
(c) Defence expenditure	10,874	38,059	40,709	43,203	43,862	48,625	48,297	51,542
3. Revenue deficit (2-1)	**18,562**	**100,162**	**107,879**	**98,261**	**78,338**	**95,312**	**94,644**	**84,727**
4. Capital receipts (a+b+C)	**31,971**	**161,004**	**182,414**	**207,390**	**191,669**	**163,144**	**160,025**	**160,526**
(a) Recovery of loans*	5,712	16,403	34,191	67,165	62,043	12,000	12,097	8,000
(b) Other receipts (mainly PSU disinvestment)	0	3,646	3,151	16,953	4,424	0	1,580	3,840
(c) Borrowings and other liabilities$	26,259	140,955	145,072	123,272	125,202	151,144	146,348	148,686
5. Capital expenditure	**24,756**	**60,842**	**74,535** **	**109,129** **	**113,331** **	**67,832**	**65,381**	**75,799**
6. Total expenditure [2+5=6(a)+6(b)]	**98,272**	**362,310**	**413,248**	**471,203**	**497,682**	**514,344**	**503,908**	**563,991**
(a) Plan expenditure	28,365	101,194	111,470	122,280	132,276	143,497	140,138	172,728
(b) Non-plan expenditure	69,907	261,116	301,778	348,923	365,406	370,847	363,770	391,263
7. Fiscal deficit [6-1-4(a)-4(b)]	**37,606**	**140,955**	**145,072**	**123,272**	**125,202**	**151,144**	**146,348**	**148,686**
8. Primary deficit [7-2(a)=8(a)+8(b)]	**16,108**	**33,495**	**27,268**	**-816**	**-1,732**	**17,199**	**14,591**	**8,863**
(a) Primary deficit consumption	6,358	36,180	38,607	25,037	-298	304	1,670	-16,864
(b) Primary deficit investment	9,750	-2,685	-11,339	-25,853	-1,434	16,895	12,921	25,727
					(As per cent of GDP)			
1. Revenue receipts (a+b)	**9.7**	**8.8**	**9.4**	**9.5**	**9.8**	**9.8**	**9.6**	**9.8**
(a) Tax revenue (net of States' share)	7.6	5.9	6.4	6.8	7.2	7.7	7.6	8.0
(b) Non-tax revenue	2.1	3.0	2.9	2.8	2.6	2.2	2.1	1.9
2. Revenue expenditure	**12.9**	**13.2**	**13.8**	**13.1**	**12.3**	**12.5**	**12.3**	**11.9**
of which:								
(a) Interest payments	3.8	4.7	4.8	4.5	4.1	3.8	3.7	3.4
(b) Major subsidies	1.7	1.3	1.7	1.6	1.4	1.3	1.2	1.1
(c) Defence expenditure	1.9	1.7	1.7	1.6	1.4	1.4	1.4	1.3
3. Revenue deficit (2-1)	**3.3**	**4.4**	**4.4**	**3.6**	**2.5**	**2.7**	**2.7**	**2.1**
4. Capital receipts (a+b+C)	**5.6**	**7.1**	**7.4**	**7.5**	**6.1**	**4.6**	**4.5**	**3.9**
(a) Recovery of loans*	1.0	0.7	1.4	2.4	2.0	0.3	0.3	0.2
(b) Other receipts (mainly PSU disinvestment)	0.0	0.2	0.1	0.6	0.1	0.0	0.0	0.1
(c) Borrowings and other liabilities $	4.6	6.2	5.9	4.5	4.0	4.2	4.1	3.6
5. Capital expenditure	**4.4**	**2.7**	**3.0**	**3.9**	**3.6**	**1.9**	**1.8**	**1.8**
6. Total expenditure [2+5=6(a)+6(b)]	**17.3**	**15.9**	**16.8**	**17.0**	**15.9**	**14.4**	**14.1**	**13.8**
(a) Plan expenditure	5.0	4.4	4.5	4.4	4.2	4.0	3.9	4.2
(b) Non-plan expenditure	12.3	11.4	12.3	12.6	11.7	10.4	10.2	9.5
7. Fiscal deficit [6-1-4(a)-4(b)]	**6.6**	**6.2**	**5.9**	**4.5**	**4.0**	**4.2**	**4.1**	**3.6**
8. Primary deficit [7-2(a)=8(a)+8(b)]	**2.8**	**1.5**	**1.1**	**0.0**	**-0.1**	**0.5**	**0.4**	**0.2**
(a) Primary deficit consumption	1.1	1.6	1.6	0.9	0.0	0.0	0.0	-0.4
(b) Primary deficit investment	1.7	-0.1	-0.5	-0.9	0.0	0.5	0.4	0.6
<u>Memorandum items</u>					(Rs. crore)			
(a) Interest receipts	8,730	35,538	37,622	38,538	32,364	25,500	20,564	19,263
(b) Dividend and profit	564	7,940	10,910	12,326	15,934	13,437	18,219	18,969
(c) Non-plan revenue expenditure	60,896	239,811	267,144	283,436	296,856	330,530	326,635	344,430

@ Provisional and unaudited as reported by Controller General of Accounts, Department of Expenditure, Ministry of Finance
# Based on provisional Actuals for 2004-05.
* Includes receipts from States on account of Debt Swap Scheme for 2002-03, 2003-04, and 2004-05.
** Includes repayment to National Small Savings Fund.
$ Does not include receipts in respect of Market Stabilization Scheme, which will remain in the cash balance of the Central Government and will not be used for expenditure.

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. The figures may not add up to the total because of rounding approximations.
3. Primary deficit consumption =Revenue deficit-interest payments+interest receipts+dividend & profits
4. Primary deficit investment =Capital expenditure-interest receipts -Dividend & profits-recovery of loans-other receipts.
5. Figures are exclusive of the transfer of States' share in the small savings collections.

Source : Budget documents.

payments (Rs. 2,188 crore); major subsidies (Rs. 2,138 crore) and grants to States (Rs. 6,264 crore). Capital expenditure at Rs. 65,381 crore was less than the budgeted amount by Rs. 2,451 crore. In terms of plan and non-plan expenditure, while plan expenditure was higher than the budget estimates by Rs. 731 crore, non-plan expenditure was Rs. 3,182 crore less than budget provision. Reduction in revenue and total expenditure, together with increased resource mobilisation, resulted in both revenue and fiscal deficits declining from the budgeted levels. As proportion to GDP, while revenue deficit at 2.7 per cent remained as envisaged in the Budget, fiscal deficit at 4.1 per cent was lower than the budget estimates of 4.3 per cent.

Budgetary developments in 2006-07

2.9 Formulation of Budget 2006-07 was based on two important considerations. First, it had to be in line with the medium-term fiscal policy objectives consistent with FRBMA; and second, it had to further the NCMP objectives of sustaining high and inclusive growth with macroeconomic stability manifesting itself in moderate inflation and a sustainable current account. Budget 2006-07 further strengthened the process initiated earlier through augmentation of resources and allocating these in terms of NCMP priorities. The series of initiatives that were taken in the Budget included: hike in gross budgetary support (GBS) for the plan by 20.1 per cent from Rs.143,791 crore in 2005-06 (RE) to Rs.172,728 crore in 2006-07(BE); an increase of 54 per cent in the outlay for the six components of visionary development proposal Bharat Nirman - for building infrastructure, especially in rural areas - from Rs. 12,160 crore (including the North East component) to Rs. 18,696 crore; eight flagship programmes - Sarva Siksha Abhiyan, Mid-day Meal scheme, Rajiv Gandhi Drinking water mission, Total Sanitation Campaign, National Rural Health Mission, Integrated Child Development Programme, National Rural Employment Guarantee Scheme and Jawaharlal Nehru National Mission Urban Renewal Mission - from Rs. 34,927 crore in 2005-06 to Rs. 50,015 crore; and a focus on outcomes rather than outlays. The process of fiscal consolidation, which was paused during 2005-06, was resumed again in full earnest and Budget envisaged bringing revenue and fiscal deficits as proportion of GDP to 2.1 per cent and 3.8 per cent, respectively.

Revenue and Capital receipts

2.10 Expenditures of Government are generally sticky. A significant part of the expenditure, particularly interest payments; pay and allowances; transfers to the States and Union Territories are committed, and there is very little possibility of their compression in the short run. Resources that are required for allocating to the new programmes, therefore, could largely come through an augmentation of revenue receipts. The approach to fiscal consolidation was, therefore, largely revenue-led, though an attempt was made to balance it by emphasising outcomes of expenditure. Budget for 2006-07, continuing with this revenue-led strategy, estimated a growth of 15.8 per cent in revenue receipts over 2005-06 (RE), composed of 19.4 per cent growth in tax revenue accruing to the Central Government and 2.6 per cent growth in non-tax revenues. Capital receipts comprising the non-debt capital receipts and borrowings and other liabilities were expected to remain unchanged more or less at the 2005-06 (RE) levels. An expected decline in receipts from recoveries of loans was to be neutralised by an increase in other receipts and borrowings (Table 2.2).

2.11 Budget further strengthened the continuing shift in the compositional structure of taxes from regressive indirect taxes to direct taxes. The proportion of direct taxes to gross tax collections of the Central Government, which had increased from 19.1 per cent in 1990-91 to 43.8 per cent in 2005-06, was projected to grow to 47.6 per cent in 2006-07 (BE). The direct tax-GDP ratio, which was only from 1.9 per cent in 1990-91, was expected to improve to 5.1 per cent in 2006-07. With indirect tax-GDP ratio

website: http:/indiabudget.nic.in

stabilising at 5.3 to 5.6 per cent in the last four years, a distinct recovery in gross tax-GDP ratio was envisaged with the ratio going up to 11.2 per cent (which with the recent upward revision in GDP now works out to 10.8 per cent) in 2006-07 (BE) (Table 2.3).

Tax measures

a) Direct taxes

2.12 In order to provide medium term-stability and predictability, Budget 2006-07 kept the tax rates moderate and stable, and no change in the rates of personal income tax or corporate income tax was proposed. No new taxes were imposed. However, for equity, there were marginal revisions in certain tax rates. The rate under Minimum Alternate Tax (MAT) was increased from 7.5 per cent of book profits to 10 per cent. Long-term capital gains arising out of securities and subject to Securities Transaction Tax were also included in calculating book profits. MAT-paying companies were allowed the credit for MAT over seven years instead of the five years allowed earlier. Adjustment of MAT credit was also allowed while calculating interest liability. Major initiatives in the field of direct taxes, particularly personal income tax, had been initiated in 2005-06 itself. These included having, through a general rebate on savings in any approved instrument up to Rs.1 lakh, neutrality of taxes between forms of savings. Budget for 2005-06 had also introduced two new taxes: a fringe benefit tax targeted at those benefits enjoyed collectively by the employees and not attributable to individual employees, which

Table 2.3 : Sources of tax revenue

	1990-91 Actuals	1995-96 Actuals	2001-02 Actuals	2002-03 Actuals	2003-04 Actuals	2004-05 Actuals	2005-06@ (Prov.)	2006-07 (BE)
					(Rs. crore)			
Direct (a)	**11,024**	**33,563**	**69,197**	**83,085**	**105,090**	**132,172**	**160,119**	**210,684**
Personal Income tax	5,371	15,592	32,004	36,866	41,387	49,259	60,440	77,409
Corporation tax	5,335	16,487	36,609	46,172	63,562	82,680	99,433	133,010
Indirect(b)	**45,158**	**76,806**	**116,125**	**131,284**	**147,294**	**170,936**	**199,351**	**230,566**
Customs	20,644	35,757	40,268	44,852	48,629	57,611	65,070	77,066
Excise	24,514	40,187	72,555	82,310	90,774	99,125	111,226	119,000
Service tax	0	862	3,302	4,122	7,891	14,200	23,055	34,500
Gross tax revenue #	**57,576**	**111,224**	**187,060**	**216,266**	**254,348**	**304,958**	**365,874**	**442,153**
					Tax revenue as a percentage of gross tax revenue			
Direct (a)	**19.1**	**30.2**	**37.0**	**38.4**	**41.3**	**43.3**	**43.8**	**47.6**
Peronal Income tax	9.3	14.0	17.1	17.0	16.3	16.2	16.5	17.5
Corporation tax	9.3	14.8	19.6	21.3	25.0	27.1	27.2	30.1
Indirect(b)	**78.4**	**69.1**	**62.1**	**60.7**	**57.9**	**56.1**	**54.5**	**52.1**
Customs	35.9	32.1	21.5	20.7	19.1	18.9	17.8	17.4
Excise	42.6	36.1	38.8	38.1	35.7	32.5	30.4	26.9
Service tax	0.0	0.8	1.8	1.9	3.1	4.7	6.3	7.8
					Tax revenue as a percentage of gross domestic product*			
Direct(a)	**1.9**	**2.8**	**3.0**	**3.4**	**3.8**	**4.2**	**4.5**	**5.1**
Personal Income tax	0.9	1.3	1.4	1.5	1.5	1.6	1.7	1.9
Corporation tax	0.9	1.4	1.6	1.9	2.3	2.6	2.8	3.2
Indirect(b)	**7.9**	**6.5**	**5.1**	**5.3**	**5.3**	**5.5**	**5.6**	**5.6**
Customs	3.6	3.0	1.8	1.8	1.8	1.8	1.8	1.9
Excise	4.3	3.4	3.2	3.3	3.3	3.2	3.1	2.9
Service tax	0.0	0.1	0.1	0.2	0.3	0.5	0.6	0.8
Total#	**10.1**	**9.4**	**8.2**	**8.8**	**9.2**	**9.8**	**10.3**	**10.8**

@ Provisional and unaudited as reported by Controller General of Accounts, Department of Expenditure, Ministry of Finance.

 # includes taxes referred in (a) & (b) and taxes of Union Territories and "other" taxes. .

*** Refers to gross domestic product at current market prices.**

Note: (1) Direct taxes also includes taxes pertaining to expenditure, interest, wealth, gift and estate duty.

(2) The ratios to GDP for 2006-07 (BE) 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 1999-2000 series.

Source : Budget documents

are to be taxed in the hands of employer; and a tax on banking cash transactions (withdrawals) over a certain threshold in a single day. In Budget 2006-07, some of the concerns/anomalies in these taxes were addressed (Box 2.1).

b) Indirect taxes

2.13 As part of continuous process of bringing about a moderate, rational and simplified tax structure and to align them with ASEAN levels as per pre-announced commitments, the peak rate of customs duty on non-agricultural products was reduced from 15 per cent to 12.5 per cent in 2006-07 with a few exceptions (Box 2.2).

Box 2.1 : Budget 2006-07 - Rationalisation of Direct Taxes

- In order to tax unaccounted money being contributed to charitable and religious organizations by way of anonymous donations, such donations brought to tax at the rate of 30 per cent in the hands of certain charitable and religious organizations in certain cases. Wholly religious organizations have been kept out of the purview of this provision.
- Section 10(23G) of the Income Tax Act exempted certain income of an infrastructure capital fund/ company/co-operative bank from investments made on or after June 1, 1998, in any enterprise or undertaking engaged in infrastructure projects or other eligible business. The section omitted so as to make income from existing as well as future investments in infrastructure projects taxable.
- Exemption available to any income of a notified Investor Protection Fund restricted to any income by way of contributions received from recognized stock exchanges and the members thereof.
- Exemption provided to any specified income arising to a notified non-profit body or authority established, constituted or appointed under a treaty or agreement entered into by the Central Government with two or more countries or a convention signed by the Central Government.
- To plug revenue leakages, interest not treated as actual payment not to be allowed as deduction in the computation of income of a business concern.
- The provisions of Section 54EC of the Income-tax Act amended so as to restrict the benefit of tax exemption in respect of long-term capital gains invested in the notified bonds of National Highways Authority of India (NHAI) and Rural Electrification Corporation Limited (REC).
- In Budget 2005-06, the provisions relating to savings were recast. However, fixed deposits in banks were not included as one of the avenues of savings in terms of Section 80C. Considering the demand fixed deposits in scheduled banks for a term of not less than five years were included in Section 80C of the Income Tax Act, 2006. Further, the limit of Rs. 10,000 in respect of contribution to certain pension funds in Section 80CCC was removed, subject to the overall ceiling of Rs. 1,00,000 as prescribed under section 80CCE.
- Primary Agricultural Credit Societies (PACS) and Primary Cooperative Agricultural and Rural Development Banks (PCARDB) continue to be exempt from tax under Section 80P of the Income Tax Act, while other cooperatives were brought under tax net.
- Income Tax Act amended to provide for compulsory obtaining of the permanent account number (PAN) before entering into prescribed transactions, and also to allot PAN suo moto in certain cases.
- As a procedural simplification, annexure-less return forms introduced so that returns could be furnished electronically. New return forms made compulsory for corporate taxpayers.
- The rates of STT been increased by 25 per cent in respect of all transactions chargeable to STT.
- Rationalisation of provisions of FBT done by making the following changes:
  - Valuation of the fringe benefit arising from 'tour and travel' reduced to 5 per cent from 20 per cent;
  - Valuation of the fringe benefit arising from 'hospitality' and 'use of hotel boarding and lodging facilities', in the case of airline companies and shipping industry, reduced to 5 per cent from 20 per cent;
  - Exclusion of the expenses on free samples of medicines and of medical equipment distributed to doctors;
  - Exclusion of the expenses incurred on brand ambassador and celebrity endorsement; and
  - Contribution by an employer to an approved superannuation fund in excess of Rs. 1,00,000 per year for an employee to attract the provisions of FBT.

Commodity taxes have been important instruments for management of prices, neutralising the disadvantages to domestic industry because of domestic taxes, removing anomalies in duty structure and strengthening competitiveness of domestic industry. Extension of countervailing duties (CVD) on all imported goods; reduction in duty of metals and other intermediate products; and withdrawal of exemptions to lend simplicity to the tax laws, were some of the important measures taken in Budget 2006-07. The structural shift of the taxes in favour of direct taxes was in line with the policy of removal of price distortions.

2.14 The current year has been characterised by inflationary pressures, initially upon, primary articles and fuels, but subsequently also on manufactured products. The moderation in inflation in the fuel group, with a reduction in international oil prices, from 7-9 per cent up to September 2, 2006 to 3.7 per cent in January 2007, was more than neutralised by the acceleration in inflation in primary articles and manufactured products. Along with the administrative measures, fiscal measures to combat inflation have included duty reduction in some of the items under heavy inflationary pressures. Customs duty of wheat and pulses were reduced to zero in June 2006. Duty on edible oils, particularly the palm group of oils was reduced by 10 percentage points each in August 2006 and January 2007. Duty on portland cement and metals was also reduced in January 2007.

2.15 Performance of revenues from excise duty, which had been quite disappointing with growth of such revenues declining steadily from 13.4 per cent in 2002-03 to 10.3 per cent and 9.2 per cent in the two subsequent years, revived somewhat to 12.8 per cent in 2005-06. Among others, three factors, which have had - and continue to have - a major bearing on excise duty collection, are: area-based excise duty exemptions, small-scale industries' (SSI) excise duty exemption scheme, and the low rates on selected products. Budget 2006-07, while projecting a modest growth in excise duty revenues of 6.3 per cent, took some important steps in redressing these root causes (Boxes 2.3 and 2.4)

Tax expenditure

2.16 Tax expenditure in 2006-07 is estimated at Rs. 1,00,147 crore. Such exemptions and incentives distort resource allocation and stunt productivity. They also result in multiplicity of rates, legal complexities, classification disputes, litigation, higher cost of tax compliance and administration. Such exemptions have been justified in the past for promoting balanced regional growth; dispersal of industries; neutralization of disadvantages on account of scale of operation and location; and incentives to priority sectors including infrastructure. Furthermore, tax exemptions often create pressure groups for their perpetuation, and rent seeking can be avoided only by subjecting such exemptions to a sunset clause.

2.17 Based on a comprehensive review of the tax exemptions, 8 such exemptions in customs duties, 68 in central excise duties and 6 in service taxes were withdrawn in Budget 2006-07. Simultaneously, on the direct tax side, tax benefits available to certain cooperative banks and for income from investment in infrastructure and certain other eligible businesses were also withdrawn. Further, the Department of Revenue has posted on its website select tax exemptions/incentives currently available for eliciting the views of the stakeholders and to generate an informed debate regarding their continuance.

Service tax - a promising source of revenue

2.18 The gradual expansion of the service tax, introduced in 1994-95 to redress the asymmetric and distortionary treatment of goods and services in the tax regime, has been a buoyant source of revenue in recent years. The number of services liable for taxation was raised from 3 in 1994-95 to 6 in 1996-97, and then gradually to 99 in 2006-

Box 2.2 : Budget 2006-07 - Rationalisation of Basic Customs Duties

- The peak rate of duty on non-agricultural products reduced from 15 per cent to 12.5 per cent. Ad-valorem component of duty on textiles fabrics and garments also reduced to 12.5 per cent.
- Budget 2005-06 had introduced special additional duty of customs at 4 per cent to partly make up for the corresponding domestic levies and to start with, this duty had been imposed on ITA (Information Technology Agreement)-bound items and on specified inputs/raw materials used for manufacture of electronics/information technology items. Budget 2006-07 extended this duty to all imported goods, with a few exceptions.
- Duty reduced from 10 per cent to 7.5 per cent on primary and semi-finished forms of metals, viz., alloy steel, aluminium, copper, zinc, ashes and residues of copper and zinc, tin, base metals of Chapter 81 (such as tungsten, magnesium, cobalt, and titanium).
- Duty on ores and concentrates reduced from 5 per cent to 2 per cent.
- Duty on mineral products, except for marble, granite, asbestos and cement reduced from 15 per cent to 5 per cent.
- Duty on refractories and raw materials for refractories reduced from 10 per cent to 7.5 per cent.
- Duty reduced from 15 per cent to 10 per cent on halogens, sulphur, carbon, hydrogen, and methanol; and from 10 per cent to 5 per cent on organic chemicals. Duty on polymers of ethylene (LDPE, LLDPE, HDPE, LHDPE, LMDPE), polymers and copolymers of propylene, polymers and copolymers of styrene and polymers of vinyl chloride and ethyl vinyl acetate duty on catalyst reduced from 10 per cent to 5 per cent. Duty on styrene, ethylene dichloride and vinyl chloride monomer reduced from 5 per cent to 2 per cent. Duty on naphtha for manufacture of specified polymers reduced from 5 per cent to nil.
- Duty increased from 30 per cent to 60 per cent on honey and from 30 per cent to 80 per cent on vanaspati, bakery shortening, inter-esterified, elaidinised fats, margarine and similar boiled, oxidized, dehydrated, sulphurised, blown, polymerized or modified preparations of edible grade.
- Duty reduced from 15 per cent to 10 per cent on man made fibers, filament yearns, spun yearns, specified textile machinery and parts for manufacture of such machinery and also on textile intermediates. Duty on paraxylene has been reduced from 5 per cent to 2 per cent.
- Duty on set top boxes unified at nil basic customs duty plus 16 per cent CVD plus 4 per cent special additional duty of customs.
- Duty reduced from 10 per cent to 5 per cent on naphtha and petroleum coke. Duty on natural gas, including propane and butanes, unified at 5 per cent.
- Duty on 14 specified anti-cancer, 10 specified anti-AIDS and four other specified drugs with bulk drugs for their manufacture, and two specified diagnostic kits and one equipment, reduced to 5 per cent with nil CVD.
- Duty on vinyl acetate monomer; butyl rubber; metallurgical grade silicon; borax/boric acid; potassium chloride reduced from 15 per cent to 10 per cent.
- Duty on non-edible grade oils having free fatty acid content of 20 per cent or above, and used for manufacture of soaps, industrial fatty acids and fatty alcohols reduced from 15 per cent to 12.5 per cent, and on crude glycerine from 30 per cent to 12.5 per cent.
- Duty on cullet (broken glass); parts of pens; phenol/acetone, for manufacture of bisphenol-A; packaging machinery reduced from 15 per cent to 5 per cent. Duty on bisphenol-A and epichlorohydrin for manufacture of epoxy resins reduced from 10 per cent to 5 per cent.
- Duty reduced from 5 per cent to nil on parts of hearing aids.

Withdrawal Of Exemptions

- Duty exemptions/concessions withdrawn on following items: saddle tree; parts of outboard motors imported by specified agencies; spare parts of maintenance of textile machinery; video cassettes and video tapes; food products (excluding alcoholic preparations) imported by hotels/tourism industry in terms of licenses issued under 1997-2002 Exim Policy; plant, machinery, equipment imported for setting up of Currency Note/ Bank Note Press.
- Exemption from CVD withdrawn on specified goods for setting up of a unit with an investment of Rs.5 crore or more for manufacture of capital goods.

Box 2.3 : Budegt 2006-07 – Rationalisation of Central Excise Duties

A. Relief Measures:

I. Duty on aerated waters; petrol cars with length not exceeding four meters and engine capacity not exceeding 1200 cc; diesel cars with length not exceeding four meters and engine capacity not exceeding 1500 cc reduced from 24 per cent to 16 per cent.

II. Duty on heat-resistant latex rubber thread; LPG gas stoves of value exceeding Rs. 2,000 per unit; compact fluorescent lamps; footwear of retail sale price between Rs. 250 and Rs. 750 per pair reduced from 16 per cent to 8 per cent.

III. Paddy de-husking rice rubber rolls; nuclear-grade sodium produced by Heavy Water Board for supply to Kalapakkam Nuclear Power Plant; drawing inks; quebracho and chestnut extract; gold concentrate for refining exempted from duty.

IV. Duty on specified printing, writing and packing paper reduced from 16 per cent to 12 per cent.

B. Imposition and increase:

I. Duty of 8 per cent with CENVAT credit imposed on goggles; articles of wood, registers; accounts books, receipt books, letter pads, memorandum pads, dairies, binders, folders, file covers, etc (excluding note books and exercise books); paper labels; paper pulp moulded trays; articles of mica; goods containing at least 25 per cent by weight of fly ash/phosphor-gypsum; roofing tiles; raw, tanned or dressed fur skins; portable receivers for calling, alerting and paging; henna powder which is not mixed with any other ingredient; 100 per cent wood-free plain or pre-laminated particle or fibreboard made from sugarcane bagasse or other agro-waste; parts of walking-sticks, seat-sticks, whips, riding-crops and the like; parts of drawing and mathematical instruments; and frames and mountings for spectacles, goggles or the like having value below Rs. 500 per piece.

II. Duty of 16 per cent imposed on umbrellas, sun umbrellas and their parts; food preparation intended for free distribution subject to end-use certification (food products, in general, are exempted unconditionally from excise duty); soap manufactured under a scheme for sale of Janata soap; strips and tapes of polypropylene used in the factory of its production in the manufacture of polypropylene ropes; parts and components of motor vehicles transferred to a sister unit for manufacture of goods falling under chapter 87; goods (other than electrical stampings and laminations, bearings and winding wires) supplied for manufacture of PD pumps of handing water; specified goods meant for display in any fair or exhibition in India; parts of table ware, kitchenware and other household articles made of iron & steel, copper, aluminium; railway track machines; sulphur; mixture of graphite and clay for manufacture of pencils and pencil leads; aluminium ferrules for manufacture of pencils; tobacco used for smoking through 'hookah' or 'chilam' and 'gudaku'. Sulphur for fertilizers has been exempted from excise duty.

III. Duty raised from 8 per cent to 16 per cent on mosaic tiles; glassware; lay flat tubing ; and cigarette filter rods. The rate of compounded levy on stainless steel patti/pattas has been increased from Rs. 15000/- per machine to Rs. 30000/- per machine.

C. Miscellaneous:

I. Exemption withdrawn for the unbranded goods like wadding, gauges, protein concentrates, textured protein substances, churan for pan, custard powder, and mineral water.

II. Exemption of goods manufactured without the aid of power removed from items such as essential oils, perfumes and toilet waters, blocks, ceramic tiles, metal containers of iron, steel and aluminium.

III. Exemption available on raw materials for manufacture of rotor blades of wind operated energy generators, extended to all glass fiber items and resin binders.

IV. Generic exemption withdrawn from products of coir industry, cashew industry, tanning industry, oil mill and solvent extraction industry and rice industry.

07. Simultaneously, the rate of tax was raised from 8 per cent to 10 per cent in 2004-05, and further to 12.0 per cent in 2006-07. Revenue from service tax, as the combined outcome of expanding tax net, creeping rate, and buoyant service sector growth, increased rapidly from a paltry Rs. 407 crore in 1994-95 to Rs. 14,200 crore in 2004-05. In 2005-06 (Prov.), service tax revenue was Rs. 23,055 crore (Table 2.4). Budget 2006-07 took some significant steps in rationalising the service tax regime (Box 2.5).

Box 2.4 : Budget 2006-07 – Changes in Commodity-Specific Excise Duties

Food processing:

- Duty reduced from 16 per cent to nil on condensed milk, ice cream, pectic substances, pectinates and pectates, pectin esterase, yeast and pasta.
- Duty reduced from 16 per cent to 8 per cent on ready to eat packaged food, texturised vegetable protein (soya bari), and instant food mixes, namely, pongal mix, vadai mix, pakora mix, payasam mix, gulab jamun mix, rava dosa mix, idli mix, dosai mix, murruku mix and kesari mix.
- Processed meat, fish and poultry products exempted from duty.

Petroleum:

- The general rate of cess applicable on domestic petroleum crude oil under the Oil Industry (Development) Act, 1974 increased from Rs. 1,800 per tonne to Rs. 2,500 per tonne.

Tobacco products:

- Duty rates unified at 66 per cent for all types of Pan Masala.
- Specific rates of excise duty on cigarettes revised.

Textiles:

- Duty on all man-made (like polyester, nylon, viscose and acrylic) fibers and filament yarns reduced from 16 per cent to 8 per cent

Small-scale industries (SSI):

- SSI exemption available to power-driven pumps restricted to only pumps conforming to prescribed BIS Standards.

Information technology:

- Excise duty of 12 per cent and 8 per cent imposed on computers and packaged software on electronic media, respectively.
- Set top boxes not covered under the Information Technology Agreement subjected to 16 per cent duty.
- Storage devices, namely, DVD-drives, flash drives and combo drives, exempted from duty.
- Excise duty on MP3 and MPEG4 players reduced from 16 per cent to 8 per cent

Export-oriented units

- Duty on clearances of goods to Domestic Tariff Area (DTA) from Export Oriented Units (EOU), Software Technology Parks, Electronic Hardware Technology Parks, etc. changed from 50 per cent of aggregate customs duties to 25 per cent of the basic custom duty plus excise duty payable on like goods.

Retail sale price (RSP) based assessment:

- RSP-based assessment extended to parts, components and assemblies for automobiles, plant growth regulators, and toothbrushes.
- Abatement from RSP for levy of excise duty reduced from 45 per cent to 42.5 per cent on aerated waters and 40 per cent to 37 per cent on compact fluorescent lamp, footwear of RSP between Rs. 250 to Rs. 750 per pair, ready to eat packaged food, and instant food mixes.
- Existing rate of abatement of 50 per cent to apply to all varieties of pan masala, which are subject to RSP based assessment.

Expenditure trends

2.19 The NCMP has pledged to raise the level of public spending in education to at least 6 per cent of GDP, and on health to at least 2-3 per cent of GDP in a phased manner. Further, it attaches highest priority to the development and expansion of physical infrastructure like roads, highways, ports, power, railways, water supply, sewage treatment and sanitation through higher public investment, even as the role of the private sector is expanded. This has to be accomplished in an overarching framework of fiscal consolidation. With about 86 per cent of the revenue receipts in 2005-06 appropriated by committed expenditure like interest payments, subsidies, pay, pensions and defence, expenditure reprioritization needs to be calibrated through higher allocation of incremental revenue towards the NCMP objectives.

2.20 FRBMA stipulates that public expenditure must be reoriented for the creation of productive assets. Given the existing classification of expenditure, plan expenditure and capital expenditure are the

Table 2.4 : Service Tax–A Growing Revenue Source

Year	No of services	Number of assessees	Tax rate in per cent	Revenue (In rupees crore)	Growth in per cent
1994-95	3	3,943	5.00	407	…
1995-96	3	4,866	5.00	862	111.8
1996-97	6	13,982	5.00	1,059	22.9
1997-98	15	45,991	5.00	1,586	49.8
1998-99	26	107,479	5.00	1,957	23.4
1999-00	26	115,495	5.00	2,128	8.7
2000-01	26	122,326	5.00	2,613	22.8
2001-02	41	187,577	5.00	3,302	26.4
2002-03	52	232,048	5.00	4,122	24.8
2003-04(with effect from May 14, 2003)*	60	403,856	8.00	7,891	91.4
2004-05 (with effect from September 10, 2004)*	75	740,267	10.00	14,200	80.0
2005-06 (Prov.)	84	805,591	10.00	23,055	62.4
2006-07 (BE) (with effect from April 18, 2006)*	99	…	12.00	34,500	49.6

* **The date mentioned in parentheses after 2003-04, 2004-05 and 2006-07 is the date from which the number of services under service tax increased from the previous year.**

Source : Department of Revenue, Ministry of Finance.

closest approximation to expenditure for creation of productive assets. As a proportion of GDP, plan expenditure, after declining from 5.0 per cent in 1990-91 to 3.8 per cent in 1998-99, again started rising to reach 4.5 per cent in 2002-03 before declining to 3.9 per cent in 2005-06. Plan expenditure was budgeted to increase by 20.4 per cent over 2005-06 (BE) to 4.2 per cent of GDP in 2006-07. Non-plan expenditure, after recording a year-on-year growth of 15.6 per cent in each of the two years of 2002-03 and 2003-04, witnessed a moderation in growth in 2004-05 and 2005-06. While non-plan expenditure in fact had declined in 2005-06 (prov.), in 2006-07, an increase of 5.5 per cent in such expenditure was proposed over 2005-06(BE). As a proportion of GDP, non-plan expenditure followed a pattern similar to that of plan expenditure. It fell from 12.3 per cent of GDP in 1990-91 to reach 10.0 per cent in 1996-97. The proportion rose again to reach 11.4 per cent in 2001-02 and further to 12.6 per cent in 2003-04. The proportion, which is expected to have declined to 10.2 per cent of GDP in 2005-06 (prov.), was budgeted at 9.5 per cent of GDP in 2006-07.

2.21 The Constitution requires revenue and capital expenditures to be shown separately in the budget. Article 112 (2) states: "The estimates of expenditure embodied in the annual financial statement shall show separately - (a) the sums required to meet expenditure described by this Constitution as expenditure charged upon the Consolidated Fund of India; and (b) the sums required to meet other expenditure proposed to be made from the Consolidated fund of India, and shall distinguish expenditure on revenue account from other expenditure." The same provision is repeated under Article 202 under the State Section. The distinction between revenue and capital expenditures not only is a Constitutional requirement but also an essential ingredient for policy formulation and efficient resource allocation. FRBMA 2003 highlights the significance of keeping the revenue expenditure under control and envisages elimination of the revenue deficit by the end of 2008-09.

Box 2.5 : Budget 2006-07 – Service Tax

New Services added

- Service provided by a Registrar to an issue;
- Service provided by Share Transfer Agent;
- Automated Teller Machine operations, maintenance or management;
- Service provided by recovery agent;
- Sale of space or time for advertisement, other than in print media;
- Sponsorship services provided to anybody, corporate or firm, other than sponsorship of sports events;
- Transport of passengers, other than economy class passengers, embarking on international journey by air;
- Transport of goods in containers by rail by any person, other than Government railway;
- Business support services;
- Auctioneers' service, other than auction of property under directions or orders of a court of law or auction by the Central Government;
- Public relation service;
- Ship management service;
- Internet telephony service
- Transport of persons by cruise ship;
- Credit card, debit card, charge card or other payment card related services.

Exemption withdrawn

- In relation to general insurance where -- premium is received from re-insurance, both domestic and overseas, and business for which premium is booked outside India;
- For services, other than accounting, auditing and statutory certification services, provided by practicing chartered accountant, company secretary or cost accountant in her professional capacity;
- For taxable services provided by a Call Centre or a Medical Transcription Centre;
- For services provided in relation to Enterprise Resource Planning (ERP) software system provided by a management consultant in connection with the management of any organization;
- For catering services provided on railway train by an outdoor caterer;
- For catering services provided within the premises of an academic institution or medical establishment by an outdoor caterer.

Exemption granted

- For financial leasing services including equipment leasing and hire-purchase, on that portion of the taxable value comprising of 90 per cent of an amount representing as interest, i.e., the difference between the instalment paid towards repayment of the lease amount and the principal;
- For testing and analysis services provided in relation to water quality testing by Government-owned State and district level laboratories;
- For all taxable services provided by Reserve Bank of India.

2.22 Broadly, revenue expenditure is expenditure incurred for purposes other than creation of assets of the Central Government. In many countries, it is known as current expenditure. Revenue deficit is the difference between revenue expenditure and revenue receipts. Broadly, the revenue deficit indicates the excess of current expenditures over revenues, or dis-savings by the Government, while the fiscal deficit captures the excess of overall expenditure over revenue. Revenue deficit implies an increase in the liabilities of the Central Government without corresponding increase in its assets. The existence of revenue deficit indicates a departure from the observance of the golden rule of public finance whereby all borrowings by the Government is for financing public investment. When the focus is only on reducing the fiscal deficit, the brunt of fiscal correction is often borne by compression in capital expenditure. The change in revenue deficit on the path of fiscal adjustment indicates the quality of fiscal correction, which is as important as the level of fiscal correction itself.

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2.23 As a proportion to GDP, capital expenditure declined from 4.4 per cent in 1990-91 to 1.8 per cent in 2005-06 (prov.). It is budgeted at the same level of 1.8 per cent in 2006-07. As a proportion to GDP, revenue expenditure after increasing to 13.8 per cent in 2002-03, declined to 12.3 per cent in 2005-06 (prov.). It is budgeted to decline further to 11.9 per cent in 2006-07. In terms of economic classification, revenue expenditure is composed of pay and allowances; interest payments; grants to the States and Union Territories; subsidies and others.

Interest payments

2.24 Persistent and high deficits seriously impair the counter cyclical ability of fiscal policy, lead to unsustainable debt build-up and adversely affect the composition of expenditure through larger and larger interest outgo. As a proportion of GDP, interest payments after remaining at highs of 4.6 per cent to 4.8 per cent in the four-year period from 1999-2000 to 2002-03, started declining to reach 3.7 per cent in 2005-06(prov.). It is budgeted to decline further to 3.4 per cent of GDP in 2006-07. As a proportion of revenue receipts, the corresponding decline was from a high of 53.4 per cent in 2001-02 to 38.3 per cent in 2005-06, and further to 34.7 per cent in 2006-07(BE). These declining trends, as proportion of both GDP and revenue receipts, was partly on account of the soft interest rate regime in vogue and progressive reduction in the average cost of borrowing (Table 2.5). The average cost of internal borrowing, including those under Market Stabilisation Scheme (MSS), is budgeted at 8.0 per cent in 2006-07. Bringing down the average cost of borrowing and reducing, in general, the interest outgo are critical to fiscal consolidation, growth and macroeconomic stability.

Table 2.5 : Interest on outstanding internal liabilities of Central Government

	Outstanding internal liabilities	Interest on internal liabilities*	Average cost of borrowings (per cent per annum)
	(Rs. crore)		
1990-91	283,033	19,664	8.2
1991-92	317,714	23,892	8.4
1992-93	359,654	27,546	8.7
1993-94	430,623	33,017	9.2
1994-95	487,682	40,034	9.3
1995-96	554,984	45,631	9.4
1996-97	621,438	55,255	10.0
1997-98	722,962	61,527	9.9
1998-99	834,551	73,519	10.2
1999-00	933,000	85,741	10.3
2000-01	1,047,976	94,900	10.2
2001-02	1,196,245	103,175	9.8
2002-03	1,323,704	113,238	9.5
2003-04	1,457,583	116,869	8.8
2004-05	1,603,785	124,126	8.5
2005-06(RE)	1,708,885	126,859	7.9
2006-07(BE)	1,891,346	136,191	8.0

Note : 1. Average cost of borrowing is the percentage of interest payment in year ' t' to outstanding liabilities in year 't-1'.
2. Outstanding internal liabilities exclude NSSF loans to States, with no interest liability on the part of the Centre.

*** Excludes Rs.313.61crore and Rs. 4079.62 crore towards premium on account of domestic debt buyback scheme and prepayment of external debt for 2002-03 and 2003-04 respectively.**

Source : Budget documents.

Subsidies

2.25 Subsidies are an important fiscal policy tool for correcting market failures, particularly under-consumption of basic essentials such as food. With direct provision by the Centre, major subsidies, mainly on food, fertiliser and petroleum grew from Rs. 40,716 crore in 2002-03 to Rs. 44,220 crore in 2005-06 (prov.), and were budgeted at Rs. 44,792 crore in 2006-07. As a proportion of GDP, subsidies fell from 1.7 per cent in 2002-03 to 1.2 per cent in 2005-06 (prov.) and 1.1 per cent of GDP in 2006-07 (BE). Including the supplementary demand for grants, the expenditure on subsidies is expected to increase by Rs. 5,200 crore in 2006-07. These subsidies, however, do not include the compensation through the issue of special securities to Oil Marketing companies towards the estimated under recoveries on account of domestic LPG and PDS Kerosene and special securities issued to Food Corporation of India for settlement of outstanding dues on account of release of foodgrains under Sampoorna Gramin Rozgar Yojana and National Food for Work Programme.

Supplementary demands for grants

2.26 There were two supplementary demands for grants in 2006-07 for which Parliament gave its approval. The first batch of demands included 42 grants involving a net cash outgo aggregating to Rs. 8,668 crore. Together with the demands for additional expenditure of Rs. 39,201 crore of a technical nature without cash outgo, the gross additional expenditure authorised was Rs. 47,869 crore. The major items involving cash outgo included subsidy on imported urea and on imported decontrolled fertiliser (Rs. 1,500 crore); transfers to State and Union Territory Governments for (i) providing Normal Central Assistance (Rs. 1,000 crore), (ii) providing special Central Assistance (Rs. 500 crore) and (iii) releasing grants-in-aid to States under Additional Central Assistance for Externally Aided Projects (Rs. 3,000 crore). Some major items of expenditure of a technical nature were for transfer of assets of erstwhile Nuclear Power Board to Nuclear Power Corporation of India as investment (Rs. 967 crore) and loan (Rs. 346 crore); writing off of accumulated losses of Indian Bank (Rs. 3,830 crore) and netting of accumulated losses of United Bank of India (Rs. 278 crore) against their equity capital as on March 31, 2006; for compensation through issue of special securities to Oil Marketing Companies towards estimated under recoveries in 2006-07 on account of domestic LPG & PDS Kerosene (Rs. 14,150 crore) and for issue of special securities to Food Corporation of India(FCI) for settlement of outstanding dues on account of release of food grains under Sampoorna Gramin Rozgar Yojana (SGRY) and National Food for Work Programme (NFFWP) till April 30, 2005 (Rs. 16,200 crore).

2.27 The second batch of supplementary demands for grants for 53 items approved by Parliament authorised gross additional expenditure of Rs. 21,824 crore. Net cash outgo involved was Rs. 11,445 crore and the rest were matched by savings or enhanced receipts. The major items of expenditure with cash outgo included subsidies on (i) imported urea, (ii) indigenous decontrolled fertilisers and (iii) imported decontrolled fertilisers (Rs. 2,000 crore); subsidy on nitrogenous fertilisers (Rs. 1,700 crore); interest relief to debt-stressed farmers of Andhra Pradesh, Karnataka, Kerala and Maharashtra (Rs. 1,359 crore); for providing interest subvention on short-term credit to farmers (Rs. 1,000 crore); transfer to State and Union Territory Governments to recoup of the National Calamity Contingency Fund (Rs. 500 crore); and to provide (i) Normal Central Assistance (Rs. 2,100 crore), (ii) Special Central Assistance (Rs. 436 crore) and (iii) National Social Assistance Programme (Rs. 900 crore). The major items of expenditure of a technical nature, that is, without net cash outgo, were transfer to State and Union Territory Governments for write off of loans under Debt Waiver Scheme under the TFC award (Rs 3,857 crore); and for compensation through issue of special securities to the Oil Marketing Companies towards estimated under recoveries in 2006-07 on amount of domestic LPG & PDS Kerosene (Rs 5,000 crore).

Central Plan outlay

2.28 The Budget for 2005-06 had envisaged a Central Plan outlay of Rs. 211,253 crore, the RE for which was placed at Rs. 205,338 crore because of a shortfall under Internal and Extra Budgetary Resources (IEBR) of Central Public Sector Enterprises (CPSEs). The Budget for 2006-07 hiked the Central Plan outlay to Rs. 254,041 crore, up 20.3 per cent from 2005-06 (BE). This outlay is composed of Budget support of Rs. 131,284 crore and IEBR of CPSEs of Rs. 122,757 crore. The IEBR and Budget support in 2006-07(BE) are 21.7 per cent and 18.9 per cent higher than 2005-06(BE). The relative shares of important heads of development are: energy (27.4 per cent); social services (24.9 per cent); transport (19.1 per cent); communication (7.8 per cent); rural development (7.2 per cent); industry and minerals (5.7 per cent); agriculture and allied activities (2.9 per cent); and irrigation and flood control (0.2 per cent).

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Central assistance for States and UTs Plans in 2006-07(BE) at Rs. 41,443 crore is up 13.4 per cent from 2005-06 (RE).

Government debt

2.29 As a proportion of GDP, outstanding liabilities (including external debt at historical exchange rate) of the Central Government declined from 55.3 per cent in 1990-91 to reach 49.4 per cent in 1996-97, reflecting the lower fiscal deficit in the intervening years. This trend got reversed subsequently, and such liabilities as a proportion of GDP rose to 63.8 per cent in 2004-05. During the Tenth Five Year Plan, average annual rate of growth of outstanding liabilities at 12.6 per cent was marginally higher than the GDP growth of 12.5 per cent. Compared to 2001-02, the ratio of outstanding liabilities to GDP in 2006-07 (BE), therefore, was higher by 0.4 percentage points. However, with the nominal rate of growth of GDP accelerating to 14.1 per cent and 15.0 per cent in 2005-06 and 2006-07, respectively, a relatively lower growth in outstanding liabilities moderated the ratio in the two recent years at 61.5 per cent in 2005-06 (RE) and 60.3 per cent in 2006-07 (BE) (Table 2.6).

2.30 The Central Government debt is composed primarily of external and internal debt, which includes market loans (as also treasury bills) and relief/savings bonds and others. The share of debt in total internal liabilities rose from 54.4 per cent in 1990-91 to 66.0 per cent in 2004-05 before marginally declining to 63.5 per cent in 2006-07 (BE). Market borrowings, as a proportion of Government debt, after increasing from 22.4 per cent in 1990-91 to 40.8 per cent in 2003-04, has hovered around 38-39 per cent. The RBI, in consultation with Ministry of Finance, fixes biannual indicative issuance calendar for Government borrowings. The Budget for 2006-07 placed the net market borrowings (dated securities and 364-day Treasury Bills excluding borrowings under MSS) at Rs. 113,778 crore. The banks have been subscribing to Government securities much in excess of their statutory liquidity ratio (SLR) requirement. With the pick up in non-food credit (details in Chapter 3), such investments are placed at 31 per cent of net demand and liabilities of scheduled commercial banks on as on end March 2006.

2.31 Under the golden rule principle, borrowings are resorted to only for the purpose of assets creation. However, with the existence of a revenue deficit all through these years, a significant proportion of liabilities were contracted to meet the current expenditure commitments. Government accounting systems do not provide a comprehensive accounting of its assets, particularly the land, building etc., owned by it. But Government accounts do capture the assets created in the form of capital expenditure and outstanding loans receivable by the Central Government. These two together form the assets of Government created out of its annual fiscal operations. Though the assets, for example, machinery and buildings, are of different vintages, their sum total nonetheless provides an assessment of Government's assets. Total assets as defined above were 55.8 per cent of Government's outstanding liabilities, indicating that cumulatively so far nearly 45 per cent of the outstanding liabilities went to meet the current expenditure of Government.

Economic and functional classification

2.32 The economic and functional classification of the Central Government Budget 2006-07, which reclassifies budgetary transactions in significant economic categories on the lines of national income accounts, places total expenditure at Rs. 563,145 crore, indicating an increase of 10.8 per cent over 2005-06 (RE). Average annual growth of total expenditure during the Tenth Five Year Plan was 9.3 per cent. The total expenditure of Rs. 563,145 crore, excluding an allocable Rs. 4,785 crore, was composed of consumption expenditure of Rs.127,078 (22.6 per cent), current transfers of Rs.337,030 crore (59.8 per cent) and gross capital formation of Rs.94,252 crore (16.7 per cent) (Table 2.7). In terms of functional classification, general services accounted for 24.8 per cent of total expenditure, while social

Table 2.6 : Outstanding liabilities of the Central Government

(end-March)

	1990-91	2001-02	2002-03	2003-04	2004-05	2005-06 (RE)	2006-07 (BE)
				(Rs. crore)			
1. Internal liabilities ##	**283,033**	**1,294,862**	**1,499,589**	**1,690,554**	**1,933,544**	**2,126,995**	**2,396,846**
a) Internal debt	154,004	913,061	1,020,688	1,141,706	1,275,971	1,355,943	1,522,030
i) Market borrowings	70,520	516,517	619,105	707,965	758,995	867,368	984,645
ii) Others	83,484	396,544	401,583	433,741	516,976	488,575	537,385
b) Other Internal liabilities	129,029	381,801	478,901	548,848	657,573	771,052	874,816
2. External debt(outstanding)*	**31,525**	**71,546**	**59,612**	**46,124**	**60,878**	**68,392**	**76,716**
3. Total outstanding liabilities (1+2)	**314,558**	**1,366,408**	**1,559,201**	**1,736,678**	**1,994,422**	**2,195,387**	**2,473,562**
4. Amount due from Pakistan on account of share of pre-partition debt	300	300	300	300	300	300	300
5. Net liabilities (3-4)	**314,258**	**1,366,108**	**1,558,901**	**1,736,378**	**1,994,122**	**2,195,087**	**2,473,262**
				(As per cent of GDP)			
1. Internal liabilities	**49.8**	**56.8**	**61.0**	**61.1**	**61.8**	**59.6**	**5.85**
a) Internal debt	27.1	40.0	41.5	41.3	40.8	38.0	37.1
i) Market borrowings	12.4	22.6	25.2	25.6	24.3	24.3	24.0
ii) Others	14.7	17.4	16.3	15.7	16.5	13.7	13.1
b) Other Internal liabilities	22.7	16.7	19.5	19.8	21.0	21.6	21.3
2. External debt(outstanding)*	**5.5**	**3.1**	**2.4**	**1.7**	**1.9**	**1.9**	**1.9**
3. Total outstanding liabilities	**55.3**	**59.9**	**63.4**	**62.8**	**63.8**	**61.5**	**60.3**
Memorandum items							
(a) External debt@ (Rs.crore)	66,314	199,869	196,043	184,177	191,182	194,078	n.a.
(as per cent of GDP)	11.7	8.8	8.0	6.7	6.1	5.4	n.a.
(b) Total outstanding liabilities (adjusted) (Rs.crore)	349,347	1,494,731	1,695,632	1,874,731	2,124,726	2,321,073	n.a.
(as per cent of GDP)	61.4	65.5	69.0	67.8	68.0	65.1	n.a.
(c) Internal liabilities(Non-RBI)# (Rs.crore)	208,978	1,142,698	1,337,752	1,529,571	1,771,117	1,964,070	2,234,031
(as per cent of GDP)	36.7	50.1	54.4	55.3	56.6	55.1	54.5
(d) Outstanding liabilities (Non-RBI)# (Rs.crore)	275,292	1,342,567	1,533,795	1,713,748	1,962,299	2,158,148	n.a.
(as per cent of GDP)	48.4	58.9	62.4	62.0	62.8	60.5	n.a.
(e) Contingent liabilities of Central Government (Rs.crore)	n.a.	95,859	90,617	87,780	107,957	n.a.	n.a.
(as per cent of GDP)	n.a.	4.2	3.7	3.2	3.5	n.a.	n.a.
(f) Total assets (Rs crore)	236,740	760,592	840,768	903,558	1,083,422	1,189,340	1,381,289
(as per cent of GDP)	41.6	33.3	34.2	32.7	34.7	33.3	33.7

n.a. : not available

*** External debt figures represent borrowings by Central Government from external sources and are based upon historical rates of exchange.**

@ Converted at year end exchange rates. For 1990-91,the rates prevailing at the end of March,1991; For 2002-2003,the rates prevailing at the end of March, 2003 and so on.

 # This includes marketable dated securties held by the RBI.

Internal debt includes net borrowing of Rs 64,211crore for 2004-05, Rs 27,230 crore for 2005-06(RE) and Rs 73,230 crore for 2006-07(BE) under Market Stabilisation Scheme.

Note: 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.

Source: 1. Budget documents. 2. Controller of Aid Accounts and Audit. 3. Reserve Bank of India.

and economic services accounted for 13.2 per cent and 24.4 per cent, respectively, with the balance 37.6 per cent (being in the nature of statutory grants-in-aid to States, non-plan grants, food and other consumer subsidies, etc.) unallocable.

2.33 The share of wages and salaries within consumption expenditure at 38.6 per cent in 2006-07 (BE) was marginally less than 40.1 per cent in 2005-06(RE). The reclassification shows that share of current grants in total expenditure went up from 19.1 per cent in 2005-06 (RE) to 22.7 per cent in 2006-07 (BE), reflecting the impact of implementation of the TFC award. Dissavings of the Central Government, which grew steadily from Rs. 10,502 crore in 1990-91 to Rs. 81,734 crore in 2002-03, was reduced to Rs. 71,968 crore in 2003-04 and

Table 2.7 : Total expenditure and capital formation by the Central Government and its financing
(As per economic and functional classification of the Central Government budget)

		1990-91	2001-02	2002-03	2003-04	2004-05	2005-06 (RE)	2006-07 (BE)
					(Rs. crore)			
I.	**Total expenditure**	**97,947**	**360,616**	**398,879**	**426,132**	**463,831**	**508,287**	**563,145**
II.	**Gross capital formation out of budgetary resources of Central Government**	**28,032**	**76,888**	**76,782**	**82,561**	**92,855**	**85,551**	**94,252**
	(i) Gross capital formation by the Central Government	8,602	12,634	21,697	23,997	27,396	36,628	38,615
	(ii) Financial assistance for capital formation in the rest of the economy	19,430	64,254	55,085	58,564	65,459	48,923	55,637
III.	**Gross saving of the Central Government**	**-10,502**	**-76,306**	**-81,734**	**-71,968**	**-60,378**	**-63,491**	**-55,277**
IV.	**Gap(II-III)**	**38,534**	**153,194**	**158,516**	**154,529**	**153,233**	**149,042**	**149,529**
	Financed by							
	a. Draft on other sectors of domestic economy	34,768	145,841	168,582	165,858	135,918	138,508	138,588
	(i) Domestic capital receipts	23,421	147,337	166,699	169,800	208,259	123,021	138,588
	(ii) Budgetary deficit/draw down of cash balance	11,347	-1,496	1883	-3,942	-72,341	15,487	0
	b. Draft on foreign savings	3,766	7,353	-10,066	-11,329	17,315	10,534	10,941
					(As per cent of GDP)			
I.	**Total expenditure**	**17.2**	**15.8**	**16.2**	**15.4**	**14.8**	**14.2**	**13.7**
II.	**Gross capital formation out of budgetary resources of Central Government**	**4.9**	**3.4**	**3.1**	**3.0**	**3.0**	**2.4**	**2.3**
	(i) Gross capital formation by the Central Government	1.5	0.6	0.9	0.9	0.9	1.0	0.9
	(ii) Financial assistance for capital formation in the rest of the economy	3.4	2.8	2.2	2.1	2.1	1.4	1.4
III.	**Gross saving of the Central Government**	**-1.8**	**-3.3**	**-3.3**	**-2.6**	**-1.9**	**-1.8**	**-1.3**
IV.	**Gap(II-III)**	**6.8**	**6.7**	**6.4**	**5.6**	**4.9**	**4.2**	**3.6**
	Financed by							
	a. Draft on other sectors of domestic economy	6.1	6.4	6.9	6.0	4.3	3.9	3.4
	(i) Domestic capital receipts	4.1	6.5	6.8	6.1	6.7	3.4	3.4
	(ii) Budgetary deficit/draw down of cash balance	2.0	-0.1	0.1	-0.1	-2.3	0.4	0.0
	b. Draft on foreign savings	0.7	0.3	-0.4	-0.4	0.6	0.3	0.3
					(increase over previous year)			
II.	**Gross capital formation out of budgetary resources of Central Government**	**2.8**	**14.8**	**-0.1**	**7.5**	**12.5**	**-7.9**	**10.2**
	Memorandum items							
					(Rs crore)			
1	Consumption expenditure	22,359	77,324	85,389	87,170	105,692	121,680	127,078
2	Current transfers	45,134	201,188	228,501	248,436	259,529	295,367	337,030
					(As per cent of GDP)			
1	Consumption expenditure	**3.9**	**3.4**	**3.5**	**3.2**	**3.4**	**3.4**	**3.1**
2	Current transfers	**7.9**	**8.8**	**9.3**	**9.0**	**8.3**	**8.3**	**8.2**

Notes:
(i) Gross capital formation in this table includes loans given for capital formation on a gross basis. Consequently domestic capital receipts include loan repayments to the Central Government.
(ii) Consumption expenditure is the expenditure on wages & salaries and commodities & services for current use.
(iii) Interest payments, subsidies, pension etc. are treated as current transfers.
(iv) Gross capital formation & total expenditure are exclusive of loans to States'/UTs' against States'/UTs' share in the small savings collection.
(v) The figures of total expenditure of the Central Government as per economic and functional classification do not tally with figures given in the Budget documents. In the economic and functional classification, interest transferred to DCUs, loans written off etc, are excluded from the current account. In the capital account, expenditure financed out of Railways, Posts &Telecommunications' own funds etc, are included.
(vi) 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.

Source : Ministry of Finance, An Economic and Functional classification of the Central Government Budget-various issues.

further to Rs. 63,491 crore in 2005-06 (RE). It was budgeted to decline further to Rs. 55,277 crore in 2006-07. As a proportion to GDP, total expenditure was budgeted at 13.7 per cent, a secular decline from 17.2 per cent in 1990-91 and 16.2 per cent in 2002-03. All the three components, viz., consumption expenditure, current transfers, and gross capital formation, shared the decline. As a proportion of GDP, dissavings were placed at 1.8 per cent in 2005-06 (RE) and 1.3 per cent in 2006-07 (BE).

2.34 In economic and functional classification, non-monetary transactions are not recorded. The Government Finance Statistics (GFS) Manual 2001 of IMF updates the internationally recognized standards for the compilation of statistics required for fiscal analysis and harmonizes these with other internationally recognized macroeconomic statistical systems to the extent consistent with supporting fiscal analysis. GFS 2001 suggests that flows should be recorded on accrual basis, which means that the flows should be recorded at the time when economic value is created, transformed, exchanged, transferred or extinguished. TFC had recommended adoption of accrual accounting to allow better cost-price calculations, record capital use properly, distinguish between current and capital expenditure, and focus policy attention on financial position. A balance sheet can be more informative than just cash flows or debt. There has been some progress towards migration to accrual-based accounting (Box 2.6).

Expenditure management

2.35 Public expenditure management is an integral part of the fiscal reforms and Government has been taking a series of initiatives in this regard, like avoiding rush of expenditure through releases in a time sliced manner and simplification of procedures. Recent initiatives include: special drive to bring down outstanding 'unspent balances' and 'utilisation certificates' from States and other implementing agencies; instructions that prohibit relaxation of conditionalities attached to transfer of funds under Plan schemes; revision of General Financial Rules; speeding up the process of transmission of funds and simultaneously facilitating faster feedback on unspent balances through utilization certificates; and

Box 2.6 : Accrual Accounting in Government

Traditionally, India has followed a cash-based system for accounting and financial reporting. A cash-based system is simple, and recognizes a transaction when cash is paid or received. This system of accounting, however, is not the most informative way of presenting government accounts. It is limited in scope because it lacks an adequate framework for accounting for assets and liabilities, depicting consumption of resources and full picture of government's financial position at any point of time. Importantly, capital expenditure under the cash system is brought to account only in the year in which a purchase or disposal of an asset is made. An asset once acquired is expensed in the same year and only progressive figure of expenditure remains in the book of accounts. The present system also fails to reflect accrued liabilities. Because of these weaknesses, the existing accounting system does not capture the long-term impact of the decisions taken and promotes a bias in favour of short-term policies.

Initiatives by the Office of the Comptroller & Auditor General of India:

In July 2004, Office of the Comptroller and Auditor General of India had commissioned a study on Conceptual Framework of Government Accounting System in India under Shri D. N. Ghosh, former Chairman of the State Bank of India and presently with ICRA Advisory Services. The study emphasized that the prevailing cash-based accounting system is deficient on the dimensions of transparency and user-friendliness, and suggested the need for migration to accrual accounting.

Recommendation of the Twelfth Finance Commission (TFC) & Role of Government Accounting Standards Advisory Board (GASAB):

TFC in its Report submitted in November 2004 recommended introduction of accrual accounting in Government. Government has accepted the recommendation in principle and has asked Government Accounting Standards Advisory Board (GASAB) in the office of the Comptroller and Auditor General of India to draw up a roadmap for transition from cash to accrual accounting system and an operational framework for its implementation. Besides the Union, so far, 18 State Governments have also in principle agreed to introduce the accrual accounting system. In line with these expectations, GASAB has deliberated the matter and has also discussed the study by Shri D N Ghosh. It has suggested a roadmap for transition to accrual accounting system. The roadmap spells out the constituent activities and tasks that have to be completed for transition from a cash-based system to accrual-based accounting. Currently, it is finalizing its Report on Operational Framework, which would provide a broad design of accrual accounting system in Government, and be a reference point for financial reporting by Governments to ensure uniformity and comparability in reporting across different Ministries and also the Union and the State Governments.

e-banking scheme for transfer of funds to district level implementation agencies by three Ministries which are big in the social sector, namely, the Ministries of Human Resource Development, Rural Development and Health & Family Welfare. Simultaneously, an institutional mechanism of "outcome" budget which was placed in 2005-06 has been strengthened. Performance audit by the Comptroller & Auditor General of India of selected programmes continued to throw up important lessons for expenditure management (Box 2.7).

Collection rates

2.36 The peak rate of customs duty was brought down progressively from 150 per cent in 1991-92 to 15 per cent in the Budget for 2005-06. As the spread between peak rate and average effective rate of duty was high to begin with, the initial reductions in the former did not have significant adverse impact on revenues. However, with the spread coming down, revenue growth from customs decelerated. Since there were numerous rates and exemptions, the closest approximation to the average effective rates for customs duty for different sectors is given by the relevant collection rates. The collection rate for all commodity groups combined fell from 47 per cent in 1990-91 to 10 per cent in 2005-06 (Prov). There are large variations in the collection rates for various groups. The collection rates for the food products group fluctuated over the years, and after a decline to 19 per cent in 2003-04, climbed up to 32 per cent in 2005-06 (prov.). Apart from the changes in the composition of commodities, increase in collection rate for food products in 2005-06 compared to 2004-05 was because of special additional duties which were imposed to neutralise the disadvantes on account of domestic taxes. In chemicals group, collection rates have declined from an average of 92 per cent in 1990-91 to 20 per cent in 2005-06 (prov.). In metals also, collection rate have come down in the last few years (Table 2.8).

Fiscal outcome 2006-07 so far

2.37 As per the data on Central Government finances published by the Controller General of Accounts, for the period April-December, 2006, gross tax revenue was placed at Rs.306,527 crore and total expenditure at Rs.383,721 crore. As against an assumed growth of 19.5 per cent in gross tax receipt in 2006-07 (BE) over 2005-06 (BE), the realised growth during April-December has been 32.8 per cent. Up to December 2006, 69.3 per cent of the budgeted amount was collected. The overall growth in gross tax revenue so far vis-a-vis

Box 2.7 : Performance Audit

The Comptroller & Auditor General of India (C&AG), during audit of expenditure and revenues of the Government of India, goes beyond the accounting of such transactions and conformity with the laid down procedure, to the underlying wisdom with which the expenditures have been incurred. C&AG recently completed such performance audits on Accelerated Irrigation Benefit Programme (AIBP) and Sarva Siksha Abhiyan (SSA).

Performance review of AIBP during 2003-04 revealed that despite allocating Rs 13,823 crore (including the State's share) in 24 States during 1996-2003, could not achieve the intended objective of accelerating irrigation benefits by ensuring completion of projects over four agricultural seasons. As on March 2003, only 23 of the 172 projects covered under the programme were completed. Irrigation potential created was a mere 28.28 per cent of the target, of which only 11.06 per cent could be utilized. Poor performance was due to inadequate planning and lack of coordination; frequent modification of guidelines; inappropriate selection of projects; ineffective execution and substantial time and cost over-runs; insufficient monitoring, and lack of any meaningful mid-term evaluation for possible mid-course correction.

The performance audit of SSA (2006) revealed that even after four years of the implementation of the scheme and utilization of almost 86 per cent of the funds available with implementing agencies, the revised target to enroll all children in schools, education guarantee scheme, alternate schools, and back to school camps by 2005 was not achieved. As many as 1.36 crore children in the age group of 6-14 years (40 per cent of the total 3.40 crore children out of school) remained out of school. There were delays in the release of funds and substantial gap between planned and actual achievement.

Table 2.8 : Collection rates* for selected import groups

(in per cent)

Sl. No.	Commodity Groups	1990-91	1995-96	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 (Prov.)
1	Food Products	47	23	31	40	30	19	22	32
2	POL	34	30	16	10	11	11	10	6
3	Chemicals	92	44	38	29	28	24	22	20
4	Man-made fibres	83	36	49	31	31	46	39	34
5	Paper & newsprint	24	8	8	6	7	7	7	9
6	Natural fibres	20	12	18	8	10	13	11	12
7	Metals	95	52	48	36	36	32	26	25
8	Capital goods	60	33	36	28	23	19	16	12
9	Others	20	13	12	9	9	8	6	5
10	Non POL	51	28	23	19	17	14	12	11
11	**Total**	**47**	**29**	**21**	**16**	**15**	**14**	**11**	**10**

* Collection rate is defined as the ratio of realised import revenue (including additional customs duty/countervailing duty (CVD), and special additional duty) to the value of imports of a commodity.

S.No.1 includes cereals, pulses, tea, milk and cream, fruits, vegetables, animal fats and sugar.

S.No. 3 includes chemical elements, compounds, pharmaceuticals, dyeing and colouring materials, plastic and rubber.

S.No. 5 includes pulp and waste paper, newsprint, paperboards and manufactures and printed books.

S.No. 6 includes raw wool and silk.

S.No. 7 includes iron and steel and non-ferrous metals.

S.No. 8 includes non-electronic machinery and project imports, electrical machinery.

Source : Department of Revenue, Ministry of Finance

the growth assumed in BE for 2006-07 and 18.8 per cent recorded in the corresponding period of the previous year suggests that the current financial year may end up with collection higher than initially estimated. Non-tax revenue at Rs. 48,744 crore for the first nine months of this financial year recorded a modest growth of 1.5 per cent over the corresponding period of the previous year, and was 63.9 per cent of 2006-07 (BE) (Table 2.9).

2.38 Month-to-month movement of major fiscal parameters (Table 2.10) reveal that both revenue and expenditure have generally been well time-spaced. Revenue receipts generally become buoyant in September and December with quarterly advance tax payments falling due during these months, while both revenue and total expenditure are more evenly spread. Higher realisation from taxes in September and December get associated with a reduction in revenue and fiscal deficit in these months. Both these months in 2006 actually ended with a revenue surplus.

Financing of the Eleventh Plan

2.39 The National Development Council at its 52nd meeting on December 9, 2006 adopted the Approach Paper to the Eleventh Plan setting a "faster, more broad-based and inclusive" growth at the average annual rate of 9 per cent for the five years starting from 2007-08. This, as the Approach Paper points out, 'requires a substantial increase in the allocation of public resources for plan programmes in critical areas', including education, health, agriculture and infrastructure; an improvement in government savings from around -1.5 per cent of gross domestic product (GDP) in 2005-06 to at least +1.0 per cent to support -- without a balance of payments problem -- an increase in the total investment rate (as a proportion of GDP) from 30.1 per cent in 2005-06 to an average of 35.1 per cent on average during the Eleventh Plan; and 'call for additional (public sector) plan expenditure above current levels, of about 1 percentage point of GDP in 2007-08, rising to about 2.5 percentage points of GDP in 2011-12'. The

Table 2.9 : Central Government finances					
	Budget estimates 2006-07	April-December		Col. 4 as per cent of BE 2006-07	Percentage change over 2005-06 (Col. 4/3)
		2005-06	2006-07		
1	2	3	4	5	6
		(Rs. crore)			
1. Revenue receipts(net to Centre)	**403,465**	**216,746**	**280,915**	**69.6**	**29.6**
Gross tax revenue	442,153	**230,839**	**306,527**	69.3	32.8
Tax (net to Centre)	327,205	168,715	232,171	71.0	37.6
Non tax	76,260	48,031	48,744	63.9	1.5
2. Capital receipts	**160,526**	**115,753**	**102,806**	**64.0**	**-11.2**
of which:					
Recovery of loans	8,000	7,408	7,952	99.4	7.3
Other receipts	3,840	11	0	0.0	-100.0
Borrowings and other liabilities	148,686	108,334	94,854	63.8	-12.4
3. Total receipts (1+2)	**563,991**	**332,499**	**383,721**	**68.0**	**15.4**
4. Non-plan expenditure (a)+(b)	**391,263**	**237,904**	**272,203**	**69.6**	**14.4**
(a) Revenue account	344,430	221,552	253,791	73.7	14.6
of which:	0	0	0	0.0	0.0
Interest payments	139,823	80,972	92,634	66.3	14.4
Major subsidies	44,532	33,230	40,225	90.3	21.1
Pensions	19,542	14,621	15,050	77.0	2.9
(b) Capital account	46,833	16,352	18,412	39.3	12.6
5. Plan expenditure (i)+(ii)	**172,728**	**94,595**	**111,518**	**64.6**	**17.9**
(i) Revenue account	143,762	74,875	93,901	65.3	25.4
(ii) Capital account	28,966	19,720	17,617	60.8	-10.7
6. Total expenditure (4)+(5)=(a)+(b)	**563,991**	**332,499**	**383,721**	**68.0**	**15.4**
(a) Revenue expenditure	488,192	296,427	347,692	71.2	17.3
(b) Capital expenditure	75,799	36,072	36,029	47.5	-0.1
7. Revenue deficit	**84,727**	**79,681**	**66,777**	**78.8**	**-16.2**
8. Fiscal deficit	**148,686**	**108,334**	**94,854**	**63.8**	**-12.4**
9. Primary deficit	**8,863**	**27,362**	**2,220**	**25.0**	**91.9**

Source : Controller General of Accounts.

Approach Paper points out that "The final picture on the size of the 11th Plan will only emerge after further consultations with the States and Central Ministries, and taking account of the reports of the various working groups on Plan resources".

2.40 In view of the FRBMA passed by the Centre and most of the States, the Approach Paper notes that bringing down the combined fiscal deficit of the Centre and the States to no more than 6 per cent of GDP from 2008-09 onwards will require a reduction in the fiscal deficit by around 1 percentage point of GDP in the first two years of the Plan. It notes "Preliminary exercises suggest that the fiscal deficit reduction in the 11th Plan period to attain the FRBM target will be achieved consistent with an increase in GBS for the Plan by 2.3 percentage points of GDP for the Plan period as a whole. This would require an adjustment through lower non-plan expenditure or additional taxation by around 0.2 percentage points of GDP. However meeting the fiscal deficit targets will limit the scope for increasing Plan expenditure in the first two years unless the reduction in non-Plan expenditure can be significantly front loaded."

2.41 FRBMA, 2003 and the associated rules notified on July 5, 2004, by enjoining the Central Government to reduce the fiscal deficit by no less than 0.3 per cent of GDP every year and to bring it down to no more than 3 per cent of GDP by 2008-09, constrains the scope of enhancing GBS by resorting to more liabilities. However, it is

Table 2.10 : Trends in Cumulative Central Government Finances (April- November) for 2006-07										
										(Rs crore)
	Budget Estimates	April	April-May	April-June	April-July	April-August	April-Sept.	April-Oct.	April-Nov.	April-Dec.
1	2	3	4	5	6	7	8	9	10	11
1. Revenue Receipts	**403,465**	**9,434**	**19,330**	**52,382**	**77,336**	**106,551**	**161,406**	**196,474**	**221,190**	**280,915**
Per cent to BE		2.3	4.8	13.0	19.2	26.4	40.0	48.7	54.8	69.6
2. Capital receipts	**160,526**	**32,377**	**72,588**	**79,088**	**88,745**	**93,885**	**90,538**	**92,795**	**115,349**	**102,806**
3. Total Receipts	**563,991**	**41,811**	**91,918**	**131,470**	**166,081**	**200,436**	**251,944**	**289,269**	**336,539**	**383,721**
Per cent to BE		7.4	16.3	23.3	29.4	35.5	44.7	51.3	59.7	68.0
4. Non Plan Expenditure	**391,263**	**35,714**	**62,882**	**92,946**	**120,110**	**146,516**	**183,065**	**214,017**	**245,393**	**272,203**
Per cent to BE		9.1	16.1	23.8	30.7	37.4	46.8	54.7	62.7	69.6
5. Plan Expenditure	**172,728**	**6,097**	**29,036**	**38,524**	**45,971**	**53,920**	**68,879**	**75,252**	**91,146**	**111,518**
Per cent to BE		3.5	16.8	22.3	26.6	31.2	39.9	43.6	52.8	64.6
6. Total Expenditure	**563,991**	**41,811**	**91,918**	**131,470**	**166,081**	**200,436**	**251,944**	**289,269**	**336,539**	**383,721**
Per cent to BE		7.4	16.3	23.3	29.4	35.5	44.7	51.3	59.7	68.0
7. Revenue Expenditure	**488,192**	**40,298**	**87,950**	**123,057**	**155,546**	**185,949**	**230,683**	**263,773**	**305,673**	**347,692**
Per cent to BE		8.3	18.0	25.2	31.9	38.1	47.3	54.0	62.6	71.2
8, Revenue Deficit	**84,727**	**30,864**	**68,620**	**70,675**	**78,210**	**79,398**	**69,277**	**67,299**	**84,483**	**66,777**
Per cent to BE		36.4	81.0	83.4	92.3	93.7	81.8	79.4	99.7	78.8
9. Fiscal Deficit	**148,686**	**31,956**	**72,088**	**77,740**	**86,404**	**90,678**	**86,461**	**87,100**	**108,201**	**94,854**
Per cent to BE		21.5	48.5	52.3	58.1	61.0	58.2	58.6	72.8	63.8

Source : Contoller General of Accounts, Department of Expenditure, Ministry of Finance

necessary to take a more long-term view of the implications of FRBMA than a myopic one of how it constrains liabilities and hence GBS in the short run. Liabilities by increasing the debt, and hence the interest burden, of the Centre, increases non-plan revenue expenditure, and hence reduces GBS in the future. This is particularly true of liabilities above a certain sustainable level. It may be argued that high GBS through high liabilities beyond a prudent limit in the past, mortgaged the present GBS.

Performance of the departmental enterprises of the Central Government

Railways

2.42 Indian Railways in 2005-06 achieved a record incremental freight loading of 65.3 million tonnes (MT) as against the incremental loading of 44.7 MT achieved in 2004-05. Consequently, freight revenues reflect an additional realization of Rs. 5,509 crore, registering a growth of 17.9 per cent over 2004-05. The overall traffic revenues for 2005-06 at Rs. 54,405 crore registered a growth of 15.7 per cent over 2004-05. These revenues have come about with no increase in passenger fares and only a minor adjustment in freight classification. The gross traffic receipts of the Railways for 2005-06 was Rs. 54,491 crore, showing a growth of 15.0 per cent over Rs. 47,370 crore in 2004-05.

2.43 The total working expenses including appropriations to Depreciation Reserve and Pension Funds at Rs. 45,574 crore reflect an increase of 6.6 per cent over the previous year. Taking into account the net variation of the miscellaneous receipts and miscellaneous expenditure, Railways' net revenue in 2005-06 works out to Rs. 8,006 crore, which is Rs. 2,732 crore more than that of 2004-05. Out of the net revenue earned, Railways fully discharged the dividend liability of Rs. 3,005 crore for 2005-06. Besides, Railways also paid Rs. 663 crore towards outstanding deferred dividend liability of Rs. 1,990 crore. The overall effect

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of the all round improvement is visible in the Operating Ratio of Railways which has improved to 83.7 per cent as against 91.0 per cent in 2004-05. The net revenue as a proportion of capital-at-charge and investment from capital fund has also improved from 8.7 per cent in 2004-05 to 12.2 per cent in 2005-06.

2.44 The plan expenditure in 2005-06 amounted to Rs 18,320 crore. This included Rs 3213 crore financed by market borrowings of Indian Railway Finance Corporation (IRFC) and Rs 518 crore as the borrowings of Rail Vikas Nigam Limited (RVNL). Apart from some important projects, which are in progress under a cost-sharing basis with the State Governments and strengthening of golden quadrilateral under National Rail Vikas Yojana, Railways have drawn up a comprehensive modernization plan to modernize, upgrade and augment rail services to the nation.

Posts

2.45 In 2005-06, the gross receipts of the Department of Posts were Rs. 5,023 crore. With gross and net working expenses of Rs. 6,429 crore and Rs. 6,233 crore, there was a deficit of Rs. 1,210 crore. Gross receipts are budgeted to go up to Rs 4,999 crore. With gross and net working expenses estimated at Rs. 6,534 crore and Rs. 6,378 crore, respectively, the deficit is projected to be Rs. 1,379 crore in 2006-07 (BE).

2.46 In a bid to reduce the deficit, the Department of Posts has, over the last few years, made efforts at increased revenue generation. However the activities performed by Department of Posts have a predominantly “social welfare” nature, where profit generation is not the prime motive. With a view to cutting down the deficit, various measures such as retail post, direct post, and business post, have been initiated. The Department of Posts has also emerged as a single point of interface between the Government of India and the general masses through initiatives such as acceptance of passport forms and filing of income tax returns, and even socially relevant initiatives such as pulse polio campaign and NREGP payments.

Broadcasting

2.47 Prasar Bharati, a public service broadcaster, has taken a number of steps to increase its commercial revenue. Some of the important steps include production and sale of recorded media (CD/VCDs) by All India Radio (AIR) and Doordarshan, emphasis on hiring out technical facilities, in-house marketing and production of programmes for other departments, and establishment of a resource center for AIR. Total expenditure of Prasar Bharati in 2005-06 was Rs. 1,996 crore. Total receipts at Rs. 1,220 crore in 2005-06 were 47 per cent higher than Rs. 831 crore in 2004-05. A resource gap continues to exist and Rs 1,389.76 crore has been allocated in 2006-07 (BE) to cover the resource gap of Prasar Bharati.

Pension reforms in India

2.48 In the years to come, poverty amongst the elderly may be the dominant form of poverty in the country, given the breakdown of the joint family, increasing life expectancy, increasing migration flows of labour within the country, and the limited effectiveness of poverty-alleviation programmes – such as employment guarantee schemes – in targeting the elderly. A modern pension system will lay sound foundations of financial portfolios through which individuals will be able to obtain income support in old age. Pension funds are natural vehicles for long-term investment, including in equity. A modern, well-regulated pension sector, populated with professional pension fund managers, will also be a highly beneficial force in India’s financial system, and improve resource flows in the form of long-term debt and equity to sound projects, particularly in infrastructure. The pension sector can also be a major customer of insurance companies for the purpose of converting a stock of pension wealth at retirement date into a flow of monthly pensions in the form of ‘annuities’.

Objectives of pension reform in India

2.49 Global pension reform experience over the past 10 years has shown that "no one size fits all". However, the two main aims of pension systems everywhere remain the same, namely; (i) reducing poverty and eliminating the risk of rapidly falling living standards post-retirement, and (ii) the broader goal of protecting the elderly from economic and social crisis.

2.50 India needs a pension system which is: self-sustainable; universally accessible, especially to the uncovered unorganised sector workers on a voluntary basis; low-cost, efficient and available throughout the country; equitable and pro-labour and does not inhibit labour mobility; and well-regulated in order to protect the interests of subscribers. On August 23, 2003, Government decided to introduce a new restructured defined contribution pension system for new entrants to Central Government service, except to Armed Forces, in the first stage, replacing the existing defined benefit system. Subsequently, the New Pension System (NPS) was operationalised from January 1, 2004 through a notification dated December 22, 2003. The main features of the NPS are:

- It is based on defined contribution. New entrants to Central Government service contribute 10 per cent of their salary and dearness allowance (DA), which is matched by the Central Government (Tier-I).
- Once the NPS architecture is fully in place, employees will have the option of a voluntary (Tier-II) withdrawable account in the absence of the facility of General Provident Fund (GPF). Government will make no contribution to this account.
- Employees will normally exit the system at or after the age of 60 years. At the time of exit, it is mandatory for them to invest 40 per cent of the pension wealth to purchase an annuity to provide for lifetime pension of the employee and his dependent parents and spouse. Remaining 60 per cent of pension wealth will be paid to the employee in lump sum at the time of exit. Individuals would have the flexibility to leave the pension system prior to age 60. However, in this case, mandatory annuitisation would be 80 per cent of the pension wealth.
- The new system will have a central record keeping and accounting infrastructure and several fund managers to offer investment options with varying proportions of investment in fixed-income instruments and equity.
- The new system will also have a market mechanism (without any contingent liability) through which certain investment protection guarantees would be offered for the different schemes.

2.51 An interim regulator, the Pension Fund Regulatory and Development Authority (PFRDA) was constituted through a Government resolution dated October 10, 2003 as a precursor to a statutory regulator and became operational from January 1, 2004.

2.52 Till the architecture is fully in place, the Central Pension Accounting Office (CPAO) under the Controller General of Accounts is acting as the interim Central Record-keeping Agency (CRA). Contributions are currently being credited into the public account earning a return equal to the GPF rate. As per data available, about 137,952 employees are covered under the NPS. Approximately Rs. 200 crore, including Government contribution, has been credited into the pension account. The Pension Fund Regulatory and Development Authority Bill, 2005 was introduced in Parliament on March 21, 2005. The Bill proposes that the main mandate of PFRDA is to regulate the NPS, as amended from time to time by the Central Government. Pension schemes already covered under the Employees' Provident

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Fund & Miscellaneous Provisions Act, 1952 and other enactments would be specifically excluded from the regulatory jurisdiction of PFRDA. However, individuals covered under such mandatory programmes under other Acts can voluntarily choose to additionally participate in the NPS.

2.53 PFRDA will establish the institutional architecture of the NPS including the CRA and pension funds. It will also frame investment guidelines for pension funds. PFRDA is empowered to impose stringent penalties for any violation of the law. The regulator will also create a special fund, which will be used for educating and protecting the interests of subscribers to schemes of pension funds. The Bill was referred to the Standing Committee on Finance. The Committee presented their report in Parliament on July 26, 2005 recommending:

(i) allowing withdrawal from Tier I account also;

(ii) specifying in clear terms in the Bill that one of the pension funds would be from the public sector;

(iii) giving preference in selection to such pension fund managers that guarantee returns and spelling out the pre-requisites relating to capital structure and experience criteria for selection of pension funds and other intermediaries in the Bill;

(iv) making available to subscribers an option of 100 per cent investment in Government securities and indicating this in the Bill;

(v) implementing any decision relating to permitting FDI in the pension sector only by way of suitable amendments in the legislation; and not allowing such decisions and decisions relating to deployment of pension funds outside the country to be at variance with related provisions applicable to the insurance sector;

(vi) setting up a Pension Advisory Committee similar to the Insurance Advisory Committee of IRDA;

(vii) rephrasing clause 4 of the Bill to clearly depict the composition of the Authority; selecting members of the Authority only from amongst professionals having experience in economics or finance or law; and having a Central Government nominee as one of the part-time members;

(viii) including the differentiation between Tier-I and Tier II accounts as a part of the basic or essential features of the New Pension System in clause 20 of the Bill; and

(ix) bringing forward a comprehensive legislation in order to cater to the social security of the unorganized sector, inclusive of pension coverage of the workforce, simultaneously with the setting up of PFRDA as a statutory body.

A proposal to amend the PFRDA Bill, 2005, based on the recommendations of the Committee is under Government's consideration.

2.54 Ministry of Finance convened a conference of Chief Ministers and State Finance Ministers on January 22, 2007. Majority of the State Government participants generally welcomed the move towards a fiscally sustainable pension system for civil servants and the establishment of an old age income security system for all Indians. Following the lead of the Central Government, 17 States have notified a defined contribution pension system for their new employees. In the conferenc, States were assured that the PFRDA Bill will be amended to provide an option for investing 100 per cent of pension funds in government securities, entrusting the job of fund management initially only to public sector fund managers, etc. The investment pattern for non-government provident funds, while

conservative and restrictive, would be adopted as an interim model, pending the passage of the PFRDA Bill.

Finances of State Governments

2.55 The finances of State Governments traditionally follow a pattern similar to that of the Centre, albeit with a lag. State's own tax receipts, as a proportion of GDP, increased from 5.3 per cent in 1990-91 to 6.3 per cent in 2005-06 (RE) and are projected to marginally decline to 6.2 per cent of GDP in 2006-07 (BE). When measured as proportion of GDP, with a marginal decline in States' own tax and non-tax receipts between 2005-06 (RE) and 2006-07 (BE), total revenue receipts of the States' is expected to decline from 12.7 per cent of GDP in 2005-06 (RE) to 12.5 per cent of GDP in 2006-07(BE). But, again as a proportion of GDP, with an expected decline in revenue expenditure by 0.6 percentage points from 13.2 per cent in 2005-06 (RE) to 12.6 per cent in 2006-07 (BE), all the States together are expected to achieve the FRBMA mandated target of eliminating revenue deficit two years ahead of the scheduled 2008-09. Similarly, with a one percentage point reduction in total disbursements as a proportion to GDP, the consolidated fiscal deficit of all the States is expected to be lower than the FRMBA mandated target of 3 per cent two years ahead of schedule (Table 2.11).

Table 2.11 : Receipts and disbursements of State Governments

	1990-91	2001-02	2002-03	2003-04	2004-05	2005-06 (RE)	2006-07 (BE)
				(Rs. crore)			
I. Total receipts(A+B)	91,160	373,886	425,073	527,097	582,910	616,397	665,260
A. Revenue receipts (1+2)	66,467	255,675	280,339	316,535	372,075	454,152	513,166
1. Tax receipts	44,586	180,312	198,798	226,999	267,683	317,502	360,898
of which							
State's own tax revenue	30,344	128,097	142,143	159,921	189,132	224,780	252,573
2. Non-tax receipts	21,881	75,363	81,541	89,536	104,392	136,650	152,268
of which:							
Interest receipts	2,403	9,205	9,502	8,617	9,470	9,666	9,648
B. Capital receipts	24,693	118,211	144,734	210,562	210,835	162,245	152,094
of which:							
Recovery of loans & advances	1,501	7,766	3,905	16,414	8,568	7,456	4,813
II. Total disbursements(a+b+c)	91,088	377,311	420,461	526,023	572,354	610,751	659,530
a) Revenue	71,776	314,863	335,450	377,681	408,497	471,437	514,952
b) Capital	13,556	50,145	70,664	122,429	144,014	120,495	129,848
c) Loans and advances	5,756	12,303	14,347	25,913	19,843	18,819	14,730
III. Revenue deficit	5,309	59,188	55,111	61,145	36,423	17,284	1,786
IV. Gross fiscal deficit	18,797	95,994	102,123	123,070	109,256	113,978	105,895
				(As per cent of GDP)			
I. Total receipts(A+B)	16.0	16.4	17.3	19.1	18.6	17.3	16.2
A. Revenue receipts (1+2)	11.7	11.2	11.4	11.4	11.9	12.7	12.5
1. Tax receipts	7.8	7.9	8.1	8.2	8.6	8.9	8.8
of which							
State's own tax revenue	5.3	5.6	5.8	5.8	6.0	6.3	6.2
2. Non-tax receipts	3.8	3.3	3.3	3.2	3.3	3.8	3.7
of which:							
Interest receipts	0.4	0.4	0.4	0.3	0.3	0.3	0.2
B. Capital receipts	4.3	5.2	5.9	7.6	6.7	4.5	3.7
of which:							
Recovery of loans & advances	0.3	0.3	0.2	0.6	0.3	0.2	0.1
II. Total disbursements(a+b+c)	16.0	16.5	17.1	19.0	18.3	17.1	16.1
a) Revenue	12.6	13.8	13.6	13.7	13.1	13.2	12.6
b) Capital	2.4	2.2	2.9	4.4	4.6	3.4	3.2
c) Loans and advances	1.0	0.5	0.6	0.9	0.6	0.5	0.4
III. Revenue deficit	0.9	2.6	2.2	2.2	1.2	0.5	0.0
IV. Gross fiscal deficit	3.3	4.2	4.2	4.5	3.5	3.2	2.6

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. **Capital receipts include accounts on a net basis.**
3. **Capital disbursements are exclusive of public accounts.**

Source : Reserve Bank of India.

2.56 Most recent indicators of State finances show a distinctly improved picture. The causative factors of fiscal deterioration in the past will, however, need to be monitored in the future as well to sustain this progress and keep the balance at the desired level. The causative factors are: interest payment; pension liabilities; losses of State PSUs; lack of proper user charges; and lack of buoyancy in taxes. The successful introduction of VAT by 30 States/ UTs and the TFC incentive to enact State-level FRBM legislations appear to have deepened State-level fiscal reforms and put them on the path towards fiscal sustainability.

State level reforms

2.57 The need for fiscal adjustment have not only been recognized by States, they have also been taking a number of pro-active steps including enactment of their FRBMAs, and introduction of monthly cash flow systems aimed at improving their financial positions. Even prior to the TFC recommending enactment of FRBMA as a prerequisite for States to claim the benefits under the Debt Waiver and Relief Facility, a few States had already enacted their FRBMAs. TFC's Debt Consolidation and Waiver Facility (DCRF) has a two-stage benefit scheme as incentives to the States: first, a general scheme of debt relief applicable to all States, which provides for consolidation of Central loans (from Ministry of Finance) contracted by States till March 31, 2004 and outstanding as on March 31, 2005 for a fresh term of 20 years at an interest rate of 7.5 per cent, prospectively, from the year in which they enact FRBMAs; and second, a Debt Write-off scheme (after consolidation of Central loans-Ministry of Finance) linked to fiscal performance, subject to the following conditions:

i) Enactment of FRBMA (required, in any case for debt consolidation),

ii) Reduction of revenue deficit every year starting from 2004-05, when compared to the average of the preceding three years (i.e., 2001-02, 2002-03 & 2003-04). In the process, if revenue deficit is eliminated completely by 2008-09, the State gets full benefit of the waiver,

iii) Reduction in revenue deficit should be equal to at least the interest rate relief on account of consolidation, and

iv) Containing fiscal deficit/GSDP ratio at the 2004-05 level in all the subsequent years.

2.58 Under debt write-off scheme, repayments falling due during the period 2005-06 to 2009-10 on the consolidation of the Central loans would become eligible for write-off. The quantum of write-off will be linked to the absolute amount by which revenue deficit is reduced in each successive year, during the award period. TFC has estimated that the debt relief during its award period (2005-10) for all States would be Rs. 21,276 crore in interest payments and Rs. 11,929 crore in repayments of consolidated Central loans. If all the States eliminate revenue deficit in 2008-09, the amount of debt waiver that would be available to the States is expected to be Rs. 33,205 crore. To traverse on a credible path of eliminating revenue deficit to zero by 2008-09 and to bring down the fiscal deficit to 3 per cent of GSDP and achieve other targets of TFC, States are required to draw up their own "Fiscal Correction Paths". So far, 23 States have enacted their FRBMAs and 21 States had drawn up their fiscal correction paths. Debt consolidation has been done for 19 States namely, Andhra Pradesh, Assam, Bihar, Chhatisgarh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Orissa, Punjab, Rajasthan, Tamil Nadu, Tripura, Uttarakhand and Uttar Pradesh. Central loans in respect of these States have also been consolidated. Out of 19 States, 6 States namely, Assam, Bihar, Kerala, Maharashtra, Tripura and Uttarakhand were not found eligible for debt waiver in 2005-06. In case of 13 States, amount of debt waiver is estimated at Rs. 3,856 crore.

Value Added Tax (VAT)

2.59 Introduction of State Level VAT is the most significant tax reform measure at State level. The State level VAT implemented has replaced the existing State Sales Tax. The decision to implement State level VAT was taken in the meeting of the Empowered Committee (EC) of State Finance Ministers held on June 18, 2004, where a broad consensus was arrived at to introduce VAT from April 1, 2005. Accordingly, VAT has been introduced by 30 States/UTs so far. Tamil Nadu has implemented VAT from January 1, 2007. The union territory of Puducherry has communicated its decision to implement VAT from April 1, 2007. Uttar Pradesh has not yet taken any decision in this regard. Since Sales Tax/VAT is a State subject, the Central Government has played the role of a facilitator. A compensation formula has also been finalised in consultation with the States, for providing compensation, during 2005-06, 2006-07 and 2007-08, for any losses on account of introduction of VAT and compensation is being released according to this formula. Technical and financial support has also been provided to the States for VAT computerization, publicity and awareness and other related aspects.

2.60 The Empowered Committee, through its deliberations over the years, finalized a design of VAT to be adopted by the States, which seeks to retain the essential features of VAT, while at the same time, providing a measure of flexibility to the States, to enable them to meet their local requirements. Some salient features of the VAT design finalized by the Empowered Committee are as follows:

(a) The rates of VAT on various commodities shall be uniform for all the States/UTs. There are 2 basic rates of 4 per cent and 12.5 per cent, besides an exempt category and a special rate of 1 per cent for a few selected items. The items of basic necessities have been put in the zero rate bracket or the exempted schedule. Gold, silver and precious stones have been put in the 1 per cent schedule. There is also a category with 20 per cent floor rate of tax, but the commodities listed in this schedule are not eligible for input tax rebate/set off. This category covers items like motor spirit (petrol), diesel, aviation turbine fuel, and liquor.

(b) There is provision for eliminating the multiplicity of taxes. In fact, all the State taxes on purchase or sale of goods (excluding Entry Tax in lieu of Octroi) are required to be subsumed in VAT or made VATable.

(c) Provision has been made for allowing "Input Tax Credit (ITC)", which is the basic feature of VAT. However, since the VAT being implemented is intra-State VAT only and does not cover inter-State sale transactions, ITC will not be available on inter-State purchases.

(d) Exports will be zero-rated, with credit given for all taxes on inputs/ purchases related to such exports.

(e) There are provisions to make the system more business-friendly. For instance, there is provision for self-assessment by the dealers. Similarly, there is provision of a threshold limit for registration of dealers in terms of annual turnover of Rs. 5 lakh. Dealers with turnover lower than this threshold limit are not required to obtain registration under VAT and are exempt from payment of VAT. There is also provision for composition of tax liability up to annual turnover limit of Rs. 50 lakh.

(f) Regarding the industrial incentives, the States have been allowed to continue with the existing incentives, without breaking the VAT chain. However, no fresh sales tax/VAT based incentives are permitted.

VAT implementation–experience so far:

2.61 The experience of implementing VAT has been very encouraging. The new system has been received well by all the

stakeholders, and the transition has been quite smooth with the Empowered Committee constantly reviewing the progress of implementation. The revenue performance of VAT-implementing States/UTs has been very encouraging. During 2005-06, the tax revenue of the 25 VAT implementing States/ UTs registered year-on-year increase in VAT revenues of 13.8 per cent, higher than the average annual rate of growth in the last five years. In the first seven months of 2006-07 (April-October), the 30 VAT State/UTs have collectively registered revenue growth rate of 26.1 per cent over the corresponding period of the previous year. The Central Government had announced a compensation package under which the States are compensated for any revenue loss on account of VAT introduction at the rate of 100 per cent of revenue loss during 2005-06; 75 per cent during 2006-07, and 50 per cent during 2007-08. The initial Budget provision for the year 2005-06 was Rs. 5,000 crore, which was reduced to Rs. 2,500 crore at the RE stage. For the year 2006-07, a provision of Rs. 2,990 crore (BE) was initially made, and an additional provision of Rs. 1,000 crore has been made through First Supplementary. In all, 8 States requested for VAT compensation for a total amount of Rs 6,765.6 crore in 2005-06. In 2006-07 so far, claims for a total of Rs. 514.3 crore have been received from 5 States.

CST Reforms

2.62 It is generally agreed that the CST, being an origin-based non-rebatable tax, is inconsistent with the concept of VAT and needs to be phased out. One critical issue involved in phasing out of CST is that of compensating the States for revenue losses on account of such a phase out. During 2005-06, the total revenue collection from CST for all States was around Rs. 18,000 crore. Since phasing out of CST will entail a revenue loss, States are insisting on a mechanism to compensate them on a permanent basis. The EC has been deliberating on the issue. The matter was also discussed in the meetings of State Finance Ministers. The EC had submitted a proposal to the Department of Revenue containing their recommendations on the modalities for phasing out of CST and for compensation of revenue loss on this account. The proposal of the EC was examined and, thereafter, the views and suggestions of the Government on the same have been communicated to the EC. Further deliberations on the issue are going on in the EC.

Consolidated General Government

2.63 The macroeconomic impact of the state of public finances are best analysed through the construct of 'Consolidated General Government'. With very limited data on local finances and the grant-dependent nature of local bodies in India, the aggregation of State and Central Government finances after due process of adjustment for inter-Governmental transfers, are usually taken as the General Government finances. As a proportion of GDP, tax receipts of the General Government fell from 15.4 per cent in 1990-91 to 13.8 per cent in 2001-02. Thereafter the proportion picked up to reach 16.6 per cent in 2005-06 (RE) and is budgeted at 16.8 per cent in 2006-07. With total expenditure declining from 30.9 per cent in 2003-04 to 27.6 per cent in 2006-07 (BE), there have been reductions in the revenue and fiscal deficits as proportions to GDP (Table 2.12). This reduction was possible through the harmonized fiscal policies being followed by both Central and State Governments. Sustaining this harmony in fiscal balances is a critical requirement for reaping the growth dividend through macroeconomic linkages.

Outlook

2.64 The encouraging buoyancy of revenues, particularly tax revenues, of both the Centre and the States observed in the recent past is likely to continue with tax reforms and improved compliance. But, such tax reforms must also involve accelerated improvement in tax administration, including the putting in place of an impersonal, hassle free collection mechanism that punishes

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Table 2.12 : Combined receipts and disbursements of the Central and State Governments							
	1990-91	2001-02	2002-03	2003-04	2004-05	2005-06 (RE)	2006-07 (BE)
				(Rs. crore)			
I. Total receipts(A+B)	152,245	651,039	726,435	860,090	947,930	1,027,547	1,137,245
A. Revenue receipts (1+2)	105,757	400,162	452,969	518,546	615,643	732,848	835,469
1. Tax receipts	87,564	313,844	357,342	413,981	492,481	591,641	688,103
2. Non-tax receipts	18,193	86,318	95,627	104,565	123,162	141,207	147,366
of which							
Interest receipts	5,975	17,164	17,781	18,856	11,063	9,041	7,529
B. Capital receipts	46,488	250,877	273,466	341,544	332,287	294,699	301,776
of which:							
a) Disinvestment proceeds	-	3,646	3,151	16,953	4,424	2,356	4,840
b) Recovery of loans & advances	3,233	14,514	12,916	26,318	14,969	11,265	6,137
II. Total disbursements(a+b+c)	163,520	652,967	726,706	855,071	929,243	1,036,936	1,131,515
a) Revenue	129,628	559,511	615,960	677,953	730,403	841,952	921,982
b) Capital	22,304	67,048	88,353	145,427	172,793	169,597	190,110
c) Loans and advances	11,588	26,408	22,393	31,691	26,047	25,387	19,423
III. Revenue deficit	23,871	159,350	162,990	159,500	114,760	109,105	86,513
IV. Gross fiscal deficit	53,580	226,425	234,987	234,502	234,719	263,195	257,088
				(As per cent of GDP)			
I. Total receipts(A+B)	26.8	28.5	29.6	31.1	30.3	28.8	27.7
A. Revenue receipts (1+2)	18.6	17.5	18.4	18.8	19.7	20.5	20.4
1. Tax receipts	15.4	13.8	14.5	15.0	15.8	16.6	16.8
2. Non-tax receipts	3.2	3.8	3.9	3.8	3.9	4.0	3.6
of which							
Interest receipts	1.1	0.8	0.7	0.7	0.4	0.3	0.2
B. Capital receipts	8.2	11.0	11.1	12.4	10.6	8.3	7.4
of which:							
a) Disinvestment proceeds	0.0	0.2	0.1	0.6	0.1	0.1	0.1
b) Recovery of loans & advances	0.6	0.6	0.5	1.0	0.5	0.3	0.1
II. Total disbursements(a+b+c)	28.8	28.6	29.6	30.9	29.7	29.1	27.6
a) Revenue	22.8	24.5	25.1	24.5	23.4	23.6	22.5
b) Capital	3.9	2.9	3.6	5.3	5.5	4.8	4.6
c) Loans and advances	2.0	1.2	0.9	1.1	0.8	0.7	0.5
III.Revenue deficit	4.2	7.0	6.6	5.8	3.7	3.1	2.1
IV. Gross fiscal deficit	9.4	9.9	9.6	8.5	7.5	7.4	6.3

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. State Government for 2004-05(Acounts), 2005-06(RE) and 2006-07(BE) pertain to Budget of 29 State Governments of which four are Vote-on-Accounts. All data for these years are, therefore, provisional.

Source : Reserve Bank of India.

evaders but does not inconvenience the honest tax payer. Building up a comprehensive data base of tax payers, taxes paid, income, and transactions in the asset markets, and linking it up effectively with scrutiny and assessment process is critical in this regard.

2.65 The sustained improvement in the fiscal position of the Centre and the States in the post-FRBM era has been attained mostly through enhanced revenues. Success in containing or managing expenditure has been limited. The benign interest rate regime has also helped in the consolidation process. Expenditure management, particularly careful monitoring of outcomes of outlays and targeting of subsidies, remains an unfinished task. Considerable downside risks remain from potential pressures on the expenditure front.