FISCAL POLICY STRATEGY STATEMENT

A. FISCAL POLICY OVERVIEW

1. Economic Reforms have yielded credible gains in the external and monetary sector since the early 1990s. Inflation has climbed down from a peak of 17 per cent in August, 1991 to about 5 per cent now. The economy has grown at an average of over 6 per cent p.a. In a major structural change in the economy, the share of the services sector continues to grow steadily. Tax reforms during this period have laid the foundation of a robust, expanding tax base. Out of our total external debt of nearly US $ 112 billion, only about 5 per cent is short term debt. Gradual and cautious liberalization of the capital account has sought to control short term capital inflows and keep the maturity profile, end-use etc. within prudential norms. These are very impressive achievements. Stability has been achieved in the external sector and the central bank can now conduct autonomous monetary policy. However, continued fiscal deficits are restraining the economy from realizing its full potential to grow and in providing quality infrastructure, both physical and social, that can meet the growing needs of a resurgent economy.

2. The fiscal stress, which had peaked in the aftermath of the 5th Central Pay Commission and the economic slowdown, has since eased, mainly due to improvement in tax collections and softening of interest rates. In an attempt to remove the fiscal drag on the economy, the government has been attempting to increase the tax base and improve tax collections. The current fiscal challenge is to ensure that the fiscal consolidation achieved through improved tax collection and the benign interest rate regime is not eroded by the growing expenditure requirements of defence and internal security, subsidies, support to States and parastatals, and the need for making up the expectation gaps in financing social infrastructure. The current fiscal stance is to be seen in this background.

B. FISCAL POLICY FOR THE ENSUING FINANCIAL YEAR

3. As indicated in the Macroeconomic Framework Statement, the Budget 2005-06 is being presented in the backdrop of a positive outlook for the economy, driven by a spurt in domestic and export demand. The large increase in crude oil and other commodity prices had induced inflationary pressures but these have been contained and the growth momentum has been sustained. This reflects the resilience of the economy as well as the benefits arising from global recovery and increased trade & investment links.

4. The fiscal policy emanating from the National Common Minimum Programme (NCMP) is one that will facilitate employment-oriented growth at a rate of 7 - 8 per cent a year. It also envisages provision of universal access to education and health care, and assurance of one hundred days of employment to one person in each family. Higher fiscal devolution to States is also expected while staying on the course of fiscal consolidation. The agenda for the next year is part of a bigger agenda of 'Bharat Nirman' under which the Government intends to provide rural India a new deal in six areas of irrigation, roads, water supply, housing, rural electrification and rural telecom connectivity. Government would also like to utilize the current favorable conditions to undertake the next generation tax reforms

for widening the tax base, increase disposable incomes, spur demand and sustain, accelerate and broad-base economic growth, with particular emphasis on increasing hitherto neglected investment in agriculture and the rural economy.

5. Hence, through the Budget 2005-06, the Government commits itself to pursuing fiscal policies designed to promote savings, to devise ways and means to channel these savings into productive investment, and to fund necessary social expenditures. The central theme that runs through the various schemes and programmes is creation of jobs, strengthening of social infrastructure and providing succour to the weaker sections of society. The sectors targeted for special attention are agriculture, textiles, rural employment, elementary education, rural healthcare, childcare, urban renewal in megacities and nurturing the knowledge-based economy.

Tax Policy

6. The current phase of high growth provides us an opportunity that should be used to improve the fiscal health of the country. We must increase our revenues without hurting the growth momentum. It is Government's intention to undertake major tax reforms to improve the tax to GDP ratio, expand the tax payer base, increase tax compliance and make tax administration more efficient. Government is moving to a tax system that is based on moderate rates and wider base through rationalisation of exemptions.

Indirect Taxes

Customs and Excise Duties

- In line with the Government's declared policy of moving customs duty rates closer to those in ASEAN countries, the peak rate for non-agricultural imports is being reduced from 20 per cent to 15 per cent. Steeper duty reductions have been made for raw materials and fuels, with a view to give a boost to manufacturing and onshore value addition, and for capital goods with a view to promote investment and technology upgradation. Accordingly, anomalies relating to inverted duty structure are also being addressed.
- The duty structure related to the petroleum sector is being rationalized. The customs duty on crude petroleum is sought to be reduced from 10 per cent to 5 per cent. On LPG for domestic consumption and on subsidized kerosene, the customs duty will be nil. On both products, the excise duty will also be nil. On other petroleum products, including motor spirit (MS) and diesel (HSD), the customs duty is sought to be reduced from 20 or 15 per cent to 10 per cent and the excise duties on these petroleum products are sought to be fixed as a combination of ad valorem and specific duties. The proposed changes are revenue neutral to the Department of Revenue and hence there should be no increase in the retail prices of these products as a result of the changes in the duty structure.
- Government's intention is to bring as many goods as possible to the CENVAT rate of 16 per cent. Hence, out of 5 items that presently attract 24 per cent excise duty, 3 items are being moved to the 16 per cent duty level.
- To give the textile industry the required impetus in the post-quota regime, the tax system is being further rationalized.
- Realizing the potential of small scale industry to give a boost to employment-oriented growth and exports, the ceiling for SSI exemption based on turnover is being raised from the level of Rs.3 crore per year to Rs.4 crore per year.

- So as to raise resources to finance the National Rural Health Mission, enhanced excise duty/surcharge is being imposed on cigarettes and other tobacco products including gutka, chewing tobacco, snuff and pan masala, but excluding biris.

Service Tax

- Reflecting the growing share of Services in the economy, the Service Tax net is being continued to be widened.
- As a relief to small service providers, those with gross turnover not exceeding Rs.4 lakh per year are sought to be exempted from service tax.

Direct Taxes

- The personal income tax structure regime is being rationalized and simplified. The last Budget ensured that persons with a "taxable income" of Rs.100,000 are not be required to pay any income tax. As part of a major overhaul of direct taxes, the tax brackets and tax rates are sought to be revamped and the level at which the surcharge of 10 per cent is levied is also sought to be raised. In line with international practice, given the higher exemption limits and the scaling up of tax brackets, the "standard deduction" will be abolished. Various exemptions and deductions, ostensibly intended to promote savings, are now sought to be replaced by consolidated limit of Rs.1 lakh for savings in addition to the basic exemption limits which will be deducted from the income before tax is calculated.
- The corporate tax regime is also being rationalized with lowering of tax rates and revision of present liberal depreciation norms that are at variance with truly commercial considerations for providing depreciation.
- The one-in-six criteria for filing income tax returns is to be amended to exclude mobile telephone but include "payment for electricity of more than Rs 50,000 per year".
- Fringe Benefits Tax is being introduced to tax perquisites (excluding transport and canteen services), that are presently escaping payment of tax. The tax will be paid by the employer where the benefits are usually enjoyed collectively by the employees and cannot be attributed to individual employees.
- In a bid to unearth black money without giving undeserved relief or an amnesty, two anti tax-evasion measures are being introduced. Firstly, a new tax on withdrawal of cash on a single day of over Rs.10,000 or more from banks at the rate of 0.1 per cent. Secondly, all banks to report to the Government all deposits which are exempt from TDS on interest.

Rationale for Policy changes

- Changes in Customs duty structure are broadly in line with the medium term objective of moving towards tariff levels prevailing in ASEAN countries. Inclusion of 12 additional services within the service tax net is in line with the medium term objective of removing the distortion caused by inadequate taxation of services commensurate with their rising share in GDP. Changes in Excise duty structure are designed to inter alia, serve the medium term objective of movement towards introduction of a Value Added Tax and eventual integrated taxation of goods and services.

- Since the services sector accounts for nearly 52 percent of the GDP it is necessary to cast the service tax net wide with relief to small service providers in the interest of administrative efficiency.
- The corporate income tax rate, the surcharge thereon and the rates of depreciation are inter-linked. The international best practice is to provide for depreciation at rates that would enable the investor to replace the asset before its economic life ends. In India, in addition to the depreciation rate we have allowed an initial depreciation in order to encourage new investment. Thus, a number of profit making companies continue to pay low tax, even if well within the law, by taking advantage of liberal depreciation rates and of exemptions and incentives. Moreover, the current depreciation rates lean in favour of employing capital rather than labour. The proposed tax structure gives relief of nearly 3 per cent in the tax rate, encourages new investment and ensures equity among all sections of corporate tax payers.
- Raising the effective zero-tax slab for personal income tax is designed to increase disposable income and give the taxpayers flexibility in planning their savings and investments. This is expected to further improve tax compliance. While it is true that the effective zero-tax personal income would henceforth be significantly higher than the per capita income but the divergence would not be so wide when we consider the per capita income in urban areas since personal income does not cover agricultural income and for administrative reasons it is not practicable to go in for itemized deductions towards higher cost of urban living.

Contingent and other Liabilities

7. The Government believes in creating an investor-friendly environment through deepening the process of decontrol and deregulation. With credit and infrastructure (energy, transport and communications) no longer being major hurdles for new investment as they used to be, the need for sops like Government guarantees to attract investment has substantially reduced. Hence, the Government would limit guarantees within the limits set under the FRBM Act, mainly to external loans from multilateral agencies. Government will not give guarantees to any borrower not owned and controlled by it. In general, government will discourage guarantees for normal commercial operations which need to be secured through due diligence by lenders.

8. A Special Purpose Vehicle (SPV) is to be set up to cater to the requirements of financially viable infrastructure projects facing difficulties in accessing long-term debt. For 2005-06, the limit on Government - guaranteed borrowing by the SPV will be Rs.10,000 crore.

Pricing of Administered Goods

9. At present, no further change is proposed in the policy regarding pricing of administered products. The situation regarding international crude oil prices is still volatile will remain under close watch. Adjustments will be made as and when required with equitable sharing of burden between consumers, oil companies and government.

Government Borrowings, Lending and Investments

10. The Fiscal Policy Strategy Statement for Budget 2004-05 brought out Government's intention to encourage States to approach the market directly rather than routing State

debt through the Central Budget and to consider on-lending external loans to States on the same terms and conditions on which these are received by the Central Government. Both these measures have now been accepted by the Government following the recommendations of the Twelfth Finance Commission.

11. There is no change in the policy stance regarding management of public debt—both internal and external. It continues to favour greater reliance on market borrowing for financing fiscal deficit; to promote a soft interest rate regime; promote long term savings; and to develop a deep and wide market for government securities. The practice of government lending to public sector undertakings is weakening since these undertakings are now being encouraged to borrow directly from the market on commercial terms.

12. The Government has decided to delink the disinvestment proceeds from the Budget and invest the same in a separate corpus fund, the income from which alone will be used to finance social infrastructure and provide capital to viable Public Sector Enterprises.

Government's Strategy to Pursue Fiscal Consolidation

Initiatives in tax administration

13. Major planks of the administrative dimension of tax reforms are (i) computerization of departmental business processes (ii) encouragement to voluntary tax-compliance through better taxpayers service (iii) reduction in compliance cost to the tax payers including minimization of direct interface through improved e- governance.

- The flagship programmes are the Tax Information Network (TIN) and the On-Line Tax Accounting System (OLTAS). Increased automation will help linking of information and reporting of high value transactions; simplification of returns, forms and procedures; dematerialization of tax-payment *challans*; time-bound refunds including electronic credit of refund in the taxpayer's bank account (ECS); e-filing of PAN applications; and on-line filing of returns.

- The Tax Information Network (TIN) is being expanded, which will facilitate e-filing of TDS returns; collation of deductee-wise data in tax deduction at source (TDS)/Tax Collection at Source (TCS) returns; eventual dematerialisation of TDS certificates; computerisation of Annual Information Returns (AIR) of high value transactions and integration of information relating to processing of returns of income. While computerisation of AIRs is expected to help widen and deepen tax base, the dematerialisation of TDS and TCS certificates would enable paperless filing of returns of income by the deductees on Internet. Further, cross-verification of TDS and TCS deducted by the deductors vis-à-vis credit claimed by corresponding deductees would eliminate frauds. The e-filing of TDS returns will result in reduction in cost of compliance. As part of e-governance initiatives, a pilot project for electronic payment of customs duty has been recently launched at Air Cargo, Bangalore. This will reduce physical interface between the taxpayer and the tax collector and the transaction costs of the assessee, The facility would be gradually extended to the rest of the country. Similarly, e-filing of Customs documents relating to imports and exports and e-filling of income tax, Central excise and service tax returns will reduce compliance costs for taxpayers. Other e-governance measures in pipeline include dematerialisation of excise challans, development of a CBEC data centre etc.

- The Task Forces to develop and implement multi-pronged strategy for effecting substantial recovery from arrears of taxes will continue.
- More scientific working of revenue intelligence, identification of commodities and assesses with reference to different modes operandi like suppression of production, clandestine removals, misuse of CENVAT credit and mis-declaration of assessable values for focused enforcement.
- Other measures include: expediting clearance of imported goods which have already been assessed, but not cleared; verification of compliance with end-use conditions wherever end-use based exemptions have been given, and monitoring of export obligations. Special watch for abnormal variations in unit values, production and clearance trends, a watch that the proportion of lower rated or exempt items are not over-declared, a broad correlation between receipt and utilization of principal raw materials and production to guard against misuse of CENVAT facility as also suppression of production and clearances.

Initiatives in Public Expenditure Administration

- Outlays do not necessarily mean outcomes. We need to reorient expenditure to extract better value for money. There is imperative need to improve the quality of implementation and enhance the efficiency and accountability of the delivery mechanism. During the course of the year, a mechanism is sought to be put in place to measure the development outcomes for all major programmes.
- A revised and updated "General Financial Rules" will be brought into force latest by 1st July, 2005. The thrust of the new expenditure administration will be on greater delegation of authority to administrative Ministries in managing their financial affairs. A review of norms governing re-appropriation will be carried out and specific proposals will be placed before the Public Accounts Committee by Sept., 2005 for consideration with a view to giving the Ministries/Departments greater flexibility in managing their departmental budgets with concomitant incentives and disincentives. Ministry of Finance will focus on budgetary/ exchequer control, formulation and modification of schemes, review of norms and tariff governing user charges and scales of expenses, manpower ceilings, responsiveness to internal audit and follow up on Audit Reports and clearance of high value expenditures and expenditures not conforming to prescribed norms.
- In a gradual move towards Quarterly Budgeting and better Exchequer Control, quarterly ceilings and targets will be prescribed for expenditure and revenue collection. Expenditure in excess of the ceilings as well individual cases not adhering to prescribed norms will require clearance from the Ministry of Finance.
- Systems and procedures of release for funds will be reviewed and revamped. Central Government's funds have become an interest free source of financing cash deficits. In terms of volume and the urgency of fiscal correction, a stage has been reached where the Central Government cannot afford to be indulgent as before. It is fair and reasonable to demand accountability, value for money spent and improved service delivery to the ultimate intended beneficiaries. Hence, Ministries/Departments will be asked to initiate action to obtain utilization certificates, audit certificates and expenditure statements and ensure that all are received, wherever due, latest by 30th June, 2005.

After this date, no funds can be released to any entity in default without express clearance from the Ministry of Finance. State Governments will be required to send monthly expenditure returns in respect of all Central Sector Schemes and Centrally Sponsored Schemes including those funded from cesses and also expenditure on State Plan. The Ministries of Rural Development, Human Resources Development and Health & Family Welfare, which handle bulk of social sector expenditure and disburse funds to a large number of autonomous entities will work towards streamlining their cash management. Each district level autonomous body receiving more than Rs.10 crore will be required to open a separate bank account in one of the designated banks and arrangements will be made to have the Central Budgetary transfers electronically credited to their accounts. The banks will report the cash balance position to the designated authorities in Central Government, as prescribed. The arrangement is targeted to be put in place latest by December 2005. The District Rural Development Agencies will be covered on priority. In consultation with States, Government will consider release of States' share in taxes in monthly installments based on latest data on actual tax collection.

- In a bid to improve transparency and accountability, Ministries will be expected to release a summary of their monthly receipts and expenditure to general public (through their website etc) and in particular disclose scheme-wise funds released to different States. Special drive will be taken up to clear arrears is taking appropriate action on Audit Reports.
- Despite isolated efforts to merge schemes targeting the same set of beneficiaries as also to remove schemes which have outlived their utility the portfolio of Plan Schemes of the government has increased in size and complexity over the years. Under many schemes, the budgetary outlays are so small as to be practically ineffective in achieving the intended objectives. During the course of the year, the Ministry of Finance will conduct a systemic review of all the schemes in consultation with the Planning Commission and identify such schemes which are below the 'critical mass' required to make discernible impact on ground. A review of the Centrally sponsored schemes will be carried out in line with the Government's commitment under the National Common Minimum Programme.
- Government intends to restructure the subsidies, as contemplated in the National Common Minimum Programme, so that the benefits are not usurped by those not intended to be the beneficiaries of these subsidies. The Ministry of Agriculture intends to make procurement of food grains more cost effective through decentralized procurement, especially in the non-traditional States, without impairing the present MSP-based procurement. The fertiliser subsidy bill could be severely pruned if naphtha and fuel oil, now used as feedstock, are replaced by natural gas. Recent success of the bond issue of the Food Corporation of India will lead to reduction in the interest burden on the Corporation. Administrative overhead costs and finance charges will be put under scanner to find innovative methods to cut costs without affecting the intended beneficiaries. The Government will explore all available options.

- A review of user charges will be undertaken with a view to increase non tax revenue and reduce the operational losses of Commercial Undertakings. Besides further improvements are expected as return on investment improves and temporary fiscal concessions are phased out as a result of improved performance of Public Sector Enterprises

Policy Evaluation

14. Strong macroeconomic fundamentals have prevented occurrence of a fiscal imbalance-induced macro-economic crisis. The easing of constraints on financing of government deficits does not imply an automatic fiscal expansion without looking at the quality of public expenditure and investment. To the extent the deficits finance sub-optimal expenditure, there is a cost to the economy in the most efficient use of scare resources and the opportunity cost in terms of growth foregone in such fiscal deterioration.

15. Widening the tax base by reducing exemptions, incentives and concessions, reducing multiplicity of rates, lowering tax rates, shifting the incidence of tax burden from production to consumption, moving away from the excessive reliance on manufacturing and taxing all value additions including services, enhancing the neutrality between present and future consumption, enhancing the neutrality of the tax system to forms of business organisations and sources of finance, and reengineering business process of the tax system to overcome the culture of tax avoidance and evasion; effecting business process changes in tax administration to establish an effective and efficient tax system are the guiding principles of the tax policy. It is the continuing endeavour of the Government to operationalise these principles.

16. Though it has been argued that public expenditure as a proportion of GDP is small in India by international comparison, the low tax-GDP ratio, debt build-up and high deficits are specific contexts that militate against an increase in public expenditure, despite developmental needs. Further, it has been observed that the overt focus on outlays and neglect of outcomes has led to serious shortcomings in realising the developmental objectives. In 2005-06, the inability of the Government to achieve further revenue deficit reduction is attributable to the impact of the TFC's recommendations which put a large burden on Central finances of the order of about Rs 26,000 crore, about 0.75 per cent GDP. Consolidation and rescheduling of Central loans, reduction in the interest rate and specific grants under different heads will affect both capital and revenue receipts of the Central Government. Besides, the disinvestment proceeds have now been delinked from the Budget. Needless to say, this will have an impact on Government's capacity to abide by the FRBM Act in 2005-06. The Government hopes to adjust to the new pattern of devolution and financing in 2005-06. Thereafter, revenue buoyancy and the tax reforms in pipeline will enable the Government to resume the process of fiscal correction with effect from 2006-07 and achieve the FRBM goals by 2008-09.

17. Deepening of tax reforms at Central and State level; improved e-governance in tax administration; more focused approach to tackling arrears; and administrative/legislative measures to close exit routes for tax evaders are expected to bring greater revenue buoyancy in the medium term. On non-tax fiscal side, Government is targeting to achieve efficiency gains in expenditure through revamping the system of release of funds and monitoring utilization thereof; review of schemes; cost reduction measures to achieve the same intended performance level at lesser budgetary outgo and review of user charges. These are the major planks of Government's strategy to return on course to meeting the FRBM targets.