FISCAL POLICY STRATEGY STATEMENT

A. FISCAL POLICY OVERVIEW

The growth trends for the last four years indicate a continuous upswing in the economy. Increasing productivity, growth of service sector and buoyancy in tax receipts associated with the growth and to some extent, improvement in tax compliance and enforcement as a result of a more rational, liberal and efficient tax system, have contributed toward achieving quantitative goals set under the FRBM Act. Reduction of fiscal deficit has been achieved from 4.5 per cent of GDP in 2003-04 to 3.1 per cent of GDP in RE 2007-08. During the same period, revenue deficit has declined from 3.6 per cent of GDP to 1.4 per cent. The advance estimate for growth of GDP at factor cost at constant (1999-2000) prices in 2007-08 is pegged at 8.7 per cent which is the average growth of the last four years, albeit lower by 0.9 percentage points as compared to 2006-07 (Quick Estimates 9.6 per cent). The slowdown is triggered by lower than expected growth in manufacturing sector, although services sector continued to record double digit growth in first half of 2007-08. Improvement in deficit indicators has been achieved through growth in tax receipts, which exceeded growth of revenue expenditure, notwithstanding increase in non-plan revenue expenditure fuelled largely by a high subsidy bill and interest payments. The process of fiscal consolidation would continue to be sustained through improvement in tax-GDP ratio, moderate growth in non tax revenue, reprioritization and improving the quality of expenditure including promotion of capital expenditure to boost infrastructure development while ensuring adequate resources for social sectors like health and education.

B. FISCAL POLICY FOR THE ENSUING FINANCIAL YEAR

2. Budget 2008-09 is being presented against the backdrop of the fiscal consolidation achieved during the X Plan period, which has provided a good foundation for making available the resources required to implement the objective of faster and more inclusive growth of XI Plan. Government's commitment to ensure faster and more inclusive growth as also the need to address the supply constraints on growth are intertwined in the fiscal policy objectives for the year. The achievement on the inflation front has been significant but downside risks arising *inter alia,* from rising energy prices, foodgrains and commodity prices and continuing capital flows, which have inflationary potential, are challenges that will need to be addressed through a mix of fiscal, administrative and monetary policy measures. Uncertainty associated with significant changes in global macroeconomic and financial environment also continue to be key concerns in fiscal policy management.

3. Despite pressure from committed and non-discretionary expenditures on items like interest payments, defence, pensions, salaries, subsidies, etc. the fiscal policy for 2008-09 remains committed to the overarching objectives of achieving faster and more inclusive growth by increasing allocation for social sectors, including rural employment, education and health, while at the same time ensuring adequate resources for improving infrastructure to boost employment, investment and consumption levels.

4. With direct taxes as a percentage of total tax receipts exceeding the 50 per cent mark and the service tax emerging as a promising source of revenue, the composition of receipts is changing. Buyoyancy in tax revenues witnessed over the last three years is expected to continue through 2007-08. State Governments will also benefit through higher devolution which register a growth of 17.7 per cent in BE 2008-09 over RE 2007-08. The adoption of VAT by States/Union Territories was a path breaking development in the area of tax reforms. The initial trend in revenue collection in the VAT implementing States has been quite impressive with the growth in the first 7 months in States put together, exceeding the compounded annual rate of growth achieved over the last five years in these States.

Government's strategy to pursue fiscal consolidation

***Tax Policy* :**

5. In recent years, tax policy has been governed by the overarching objective of increasing the tax-GDP ratio for achieving fiscal consolidation. This is sought to be achieved both through appropriate policy interventions and a steadfast improvement in the quality and effectiveness of tax administration. On the policy side, a strategy of moderate and few rates, removal of exemptions and broadening of the tax base has

yielded good results. As for tax administration, the extensive adoption of Information Technology solutions has enabled a less intrusive tax system that fosters voluntary compliance. In a broad sense, the relatively high buoyancy exhibited by direct taxes indicates that the tax system is maturing. On the indirect tax side, the objective is to integrate the taxes on goods (Central Excise) and services and finally move to a comprehensive Goods and Services Tax (GST). It is also the aim to improve the revenue yield from service tax in keeping with the contribution of the service sector to GDP.

Indirect Taxes

Customs duty :

- In the wake of the sharp appreciation of the rupee against the US dollar, the peak rate of customs duty on non-agricultural goods has been maintained at 10 per cent .
- Continuing the pace of reforms, the rate of customs duty on ‘Project Imports’ has been reduced from 7.5 per cent to 5 per cent. This will serve as an incentive for setting up of large projects, and also encourage capacity expansion and modernization of existing industries.
- For promotion of exports, customs duty reduction has been effected on specified machinery and raw materials for producing sports goods, and also on cubic zirconia (rough and polished) and rough corals used in the gems and jewellery sector.
- To improve the availability of base metals in the country, import duty on ‘melting scrap of iron or steel’ and ‘aluminium scrap’ – raw materials for the ferrous and non-ferrous sector, has been exempted.
- To help conserve the country’s natural resource of chromium ores, and increased domestic availability of this scarce raw material, export duty on chromium ores and concentrates has been increased.
- For the Electronics and Information technology hardware sector, problem of inversion arising on account of various FTAs and PTAs has been sought to be addressed by providing customs duty exemptions on specified raw materials on end use basis.
- As a part of continued review of existing exemptions, customs duty on ‘naphtha imported for manufacture of specified polymers’ has been withdrawn.

Excise duty :

- The general Cenvat rate has been reduced from 16 per cent to 14 per cent i.e. a reduction of 12.5 per cent in Central excise duty. This is likely to boost growth of the domestic manufacturing sector, which has suffered a slowdown.
- Several sector specific interventions have also been made to provide a fillip to growth through lower excise duties. The important sectors are: automobiles, paper, drugs and pharmaceuticals, and food processing.
- To provide clean drinking water, excise duty on water filtering and purifying devices has been reduced.
- For replenishment of the National Calamity Contingency Fund, one per cent National Calamity Contingent duty has been imposed on mobile phones.
- Specific rates of duty on cement clinker and non-filter cigarettes have been rationalized.

Service Tax :

- Widening of service tax base, simplification of law and procedure, improved tax administration and increase in tax compliance continue to show higher buoyancy in service tax revenue collection during 2007- 08 also. Service tax revenue during the period April – December 2007, has grown by about 37 per cent as compared to the corresponding period of the previous year.
- In order to facilitate small service providers and to ensure optimum utilization of the administrative resources, threshold limit of annual turnover to small service providers for full service tax exemption has been increased from Rs. 8 lakh to Rs.10 lakh w.e.f. 1.4.2008. This exemption would benefit about 65,000 small service providers.

- In line with the Government's declared policy of broadening the tax base, the scope and coverage of services leviable to service tax is being further widened by adding more services and expanding the scope of some of the existing services.

Direct Taxes

6. Over the last four years, widespread reforms have been ushered into the direct tax arena. The touchstone of such reforms have been the following:—

- Distortions within the tax structure have been minimised by expanding the tax base and maintaining moderate tax rates.
- Tax administration has been geared up to provide taxpayer services and also enhance deterrence levels. Both these objectives reinforce each other and have promoted voluntary compliance.
- Business Processes have been re-engineered in the Income-Tax Department through extensive use of information technology, viz., e-filing of returns; issue of refunds through ECS and refund banks; selection of returns for scrutiny through computers; etc. These measures have modernized the Department and enhanced its functional efficiency.

7. The Union Budgets of 2006-07 and 2007-08 managed to consolidate the landmark achievements of the 2005-06 Budget in the field of direct tax reforms. In the Union Budget of 2007-08, some major tax concessions provided in the Income-tax statute were either eliminated or curtailed to broaden the tax base. For example, the MAT base was expanded by bringing the profits of STPI units and Export Oriented Units within its ambit; the rate of Dividend Distribution Tax (DDT) for domestic companies on distribution of profits to share holders was increased; new rates of Dividend Distribution Tax were specified for Money Market Mutual Funds (MMMF) and Liquid Funds (LF) on distribution of income to unit holders; and the non-chargeability of capital gain tax on sale of a long-term capital asset, by investing the same in certain bonds, was restricted to a maximum amount of Rs. 50 lakhs in a year.

8. The policy proposals in the Union Budget 2008-09 are intended to further consolidate the achievements made in the last four years. Some of the major proposals are:—

(i) Rationalisation of the Personal Income Tax [PIT] rate structure for individuals, HUFs, etc. by enhancing the threshold limit and revising the income slabs.

(ii) Introducing a transaction based tax (Commodities Transactions Tax [CTT]), on the lines of STT, in respect of commodities traded on recognized commodity exchanges.

(iii) Allowing STT paid as a deduction from income, in case of assessees deriving business income from sale of securities, as against the existing provisions of allowing a rebate from taxes.

(iv) Restricting the scope of the term "charitable purpose" by amending its definition and, thereby, bringing many "non-charitable" activities into the tax net.

(v) Enhancing the existing tax rate of 10 per cent to 15 per cent in respect of short term capital gains arising from the transfer of short term capital asset, being an equity share in a company or a unit of an equity oriented fund and where such transactions are chargeable to securities transaction tax (STT).

(vi) Exempting interest income on Bonds issued by companies listed on recognised stock exchanges, from the purview of TDS provisions so as to facilitate development and deepening of the Bond market.

(vii) Introduction of a scheme for Centralised Processing of Returns to provide better taxpayer services, in sync with the best international practices, by harnessing India's inherent advantage in the sphere of information technology.

(viii) Streamlining of certain procedural matters to offer improved taxpayer services.

9. The modernization of tax administration for providing quality taxpayer services has been a constant endeavour of the Government. In this regard, the compulsory electronic filing of returns for companies [introduced last year] was extended in the current year to firms liable to audit under the provisions of the Income-tax Act. While the response has been very positive from this segment of assessees, what is most

encouraging is that about 7 lakh taxpayers have voluntarily e-filed their returns till 31.01.2008. It would not be out of place to mention here that the Income-tax Department's initiatives in this regard have been appreciated and recognized and it has been conferred with the "**National E-governance Silver Award for Outstanding Performance in Citizen-centric Services**". Further, the introduction of annexure-less returns for all categories of taxpayers [other than non-profit organizations] is a noteworthy taxpayer service.

10. A key feature of all efficient tax administrations is an effective taxpayers' information system. Over the past few years, the Income-tax Department has gradually migrated to non-intrusive methods of collecting and collating information about financial transactions of taxpayers. While the Annual Information Return (AIR) system is already in place and has strengthened the Department's database, the electronic filing of returns by different categories of assessees – as mentioned above – has added an entirely new dimension to the Department's information bank. As more information about taxpayers becomes available, the Department would be able to hand out better taxpayers services while simultaneously targeting tax evaders.

Contingent and other Liabilities

11. FRBM Rules envisage a cap of 0.5 per cent of GDP on the quantum of guarantees that the Central Government can assume annually. The present policy on government guarantees limits these guarantees only to non-private sector entities. Within the ceiling prescribed under the Rules, Central Government extends guarantees to loans from multilateral agencies, loans raised by Public Sector Entities, e.g. FCI for cash credit limits, India Infrastructure Finance Company borrowings, etc. The stock of contingent liabilities in the form of guarantees given by the Government has slightly reduced from Rs.1,10,626 crore at the end of 2005-06 to Rs.1,09,826 crore at the end of 2006-07. The number of guarantees during the same period has also gone down from 492 to 466. There was no net accretion to the outstanding guarantees during the year 2006-07. In BE 2008-09, drawdown from the Government's cash surplus is also envisaged as a source of financing the fiscal deficit. As regards borrowings, the emphasis is on: (i) greater reliance on domestic borrowings over external debt, (ii) preference for market borrowings over higher cost instruments carrying administered interest rates, (iii) elongation of maturity profile of its debt portfolio and consolidation of the same and (iv) development of a deeper and wider market for government securities to improve secondary market tradability. As part of policy to elongate maturity profile, Central Government has been issuing securities with maximum 30-year maturity for quite some time. With a view to passively consolidating its securities portfolio, re-issues are favoured rather than the fresh issues. Government does not envisage any difficulty in raising the necessary resources to finance the estimated market borrowings during FY 2008-09.

12. The window of Market Stabilization Scheme to assist Reserve Bank of India in its monetary policy objectives will continue to be resorted to during 2008-09 in terms of the Memorandum of Understanding between the Central Government and RBI. The MSS ceilings for 2008-09 has been retained at Rs. 2,50,000 crore. The interest cost of operating MSS is estimated to be Rs. 13,958 crore in BE 2008-09.

13. The role of Central Government as a financial intermediary for State Governments/UTs, CPSUs, etc. has been declining over a period of time. The decline is consistent with the development of financial market in the country and spirit of economic reforms that envisages greater market scrutiny and discipline on the one hand, and desirability of affording the freedom to States to choose as to how and from whom to borrow on the other. Enhanced devolution through the State's Shares of taxes has also contributed to the improved fiscal position of the States.

Initiatives in Public Expenditure Administration

14. Improving quality of expenditure is key to sustain fiscal reforms. Under the FRBMA obligations containing revenue expenditure and encouraging capital expenditure for productive assets are critical to ensure fiscal correction. Approach to allocation is based on the plan and non-plan criterion. Plan expenditure is seen as proxy to development expenditure. Therefore, containing non-plan expenditure to free additional resources for meeting the objectives of priority schemes is central to various expenditure management measures introduced from time to time. Further, the need for efficient tracking of expenditure, improving the quality of expenditure and enhancing the efficiency and accountability of the delivery mechanism have been recognized as critical for better tracking of the funds and to obtain value for money.

- There is a shift in the focus from outlays to outcomes. Such a shift is expected to ensure that the budgetary provisions are spent to achieve actual intended outcomes. Government presented an Outcome Budget in respect of its Plan Expenditure in August 2005 for the first time as a step to identify, monitor and assess actual outcomes. Outcome Budgets for 2008-09 are being shortly presented by various individual Ministries/Departments.

- There is emphasis on utilizing money on time. Since, mere release of funds to implementing entities does not ensure actual expenditure; emphasis is placed on timely utilization of the released funds. Release of funds in fourth quarter, particularly in the month of March is aligned with spending capacity during the remaining part of the year. Thus, excess funds/ unutilized funds in the hands of releasing entities are discouraged. Strict enforcement and discipline in this regard will continue.
- A revised and updated "General Financial Rules" has been implemented. The thrust of revised Rules is on simplification of rules and greater delegation of authority to administrative Ministries in managing their financial affairs. This measure is intended to speed up decisions while also ensuring accountability.
- In a significant move towards sound cash management system, and to reduce rush of expenditure during the last quarter, a quarterly exchequer control based expenditure management system is being implemented in respect of twenty three Demands for Grants, viz. (i) Department of Agriculture and Cooperation (ii) Department of Agricultural Research and Education (iii) Department of Fertilizers (iv) Department of Commerce (v) Department of Telecommunications (vi) Department of Food and Public Distribution (vii) Department of External Affairs (viii) Department of Economic Affairs (ix) Indian Audit and Accounts Department (x) Department of Revenue (xi) Direct Taxes (xii) Department of Health and Family Welfare (xiii) Department of School Education and Literacy (xiv) Department of Higher Education (xv) Ministry of Panchayati Raj (xvi) Ministry of Petroleum and Natural Gas (xvii) Ministry of Power (xviii) Department of Rural Development (xix) Indirect Taxes (xx) Department of Road Transport and Highways (xxi) Ministry of Textiles (xxii) Department of Urban Development (xxiii) Department of Women & Child Development.
- In a bid to improve transparency and accountability, Ministries are being encouraged 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. The consolidated monthly position of receipts and payments is put in public domain every month.
- In order to ensure better expenditure discipline, the Accounting Department is expanding E-lekha programme to provide online tracking of status on Government receipt and expenditure through various Central Government Ministries/Departments, is being expanded to capture the online releases status on the various Central/State Schemes. The initiative has already been piloted through tracking of releases status on 27 flagship schemes, and is expected to cover all the Central schemes in a short period. In 2008-09 the Controller General of Accounts through a Plan Scheme of the Planning Commission is set to undertake a programme for online tracking and reporting on the expenditure under the various schemes of Govt. of India, through a robust online reporting mechanism captured from the district/block levels. This initiative is expected to bridge the gaps that exist on reporting on outcome against outlays.
- Ministries are advised to pay greater emphasis on explicit recognition of revenue constraints and should make only a realistic projection of budgetary provisions required for various projects/schemes. Emphasis is placed for schemes proposed by Ministries and Departments to be financially viable, and carry internal rate of return of not less than the rate prescribed. And where such quantification is not possible, the overall socio- economic cost-benefit analysis of schemes to be indicated explicitly.
- Review and rationalization of user charges will continue 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

15. The past four years have been marked by an impressive revenue led fiscal consolidation. The performance in RE 2007-08 shows an improvement over BE 2007-08 achieved by revenue receipts exceeding the budgeted amount and non-plan expenditure getting moderated. Budget 2008-09 marks the path of fiscal correction with emphasis on quality in expenditure in accordance with the FRBM goals. Continuation of the policy measures already implemented in the domain of tax policies, expenditure management, etc. and fresh initiatives being launched in these areas form the basis of projections included in the FRBM Statements.