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Background Study for the Swedish Country Strategy for India 2003–2007

Fiscal Trends in India

Foreword

Effective poverty alleviation presupposes economic growth coupled with a pro-poor macroeconomic framework. Among other things, this means creating an environment conducive to increased investment in infrastructure and social sectors, as well as improving the quality and efficiency of existing expenditure.

While most observers agree that the wide-ranging programme of structural adjustment and macro-economic stabilisation initiated in 1991 has played a crucial role in India's economic recovery, the impact of reforms on society and the standard of living of the poor has been much debated. One issue of concern has been the inclination to address fiscal imbalances by squeezing public investment rather than government consumption. As a result, Indian states are falling deeper and deeper into deficits – their spending running far ahead of their incomes. The resulting debt-burden has undermined the ability of the states to finance essential expenditure on social services and investment in infrastructure.

The Swedish International Development Cooperation Agency (Sida) is currently preparing a new Country Strategy for the development co-operation between Sweden and India. In order to provide Sida with information on the causes and consequences of the current fiscal situation in India we have asked the Administrative Staff College of India to:

- Analyse trends in fiscal performance at the central and state level, and draw conclusions for the sustainability of development expenditure,
- Review the disparities between states when it comes to addressing and overcoming fiscal constraints, and the nature of such efforts,
- Assess the importance of external financing and the potential for increased private sector participation in development, and
- Elaborate on the most important areas in need of further reform with respect to a correction of fiscal imbalances.

We are pleased to share with you their findings and recommendations.

New Delhi, November 2002

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The views and opinions presented in this report are solely those of the named authors
and do not necessarily reflect the policy of the Swedish International Development Cooperation Agency (Sida).

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Analysis of government financing and the sustainability of development expenditure in India

1. Background

Sida has been entrusted with the task of proposing a new Swedish country strategy for India, to take effect from 1 January 2003. It is envisaged that the main objective of the new strategy will be poverty reduction with specific emphasis on social sectors and the environment. Cross-cutting issues to be looked into include human rights, gender, governance, HIV/AIDS and natural disasters. It is further understood that, to achieve tangible results, future development co-operation with India should be geared towards initiatives that clearly bring out the value-added of the use of Swedish funds and expertise.

Poverty alleviation in India presupposes a continued high economic growth within a pro-poor macroeconomic framework. Among other things, this means creating an environment conducive to increased investment in infrastructure and social sectors, as well as improving the quality and efficiency of existing expenditure. The urgency of such measures have become even more pronounced in the past two-three years along with the rapidly deteriorating fiscal situation at the central as well as state level.

2. Objective of the Consultancy

The Consultant shall analyse the current fiscal situation in India, draw conclusions for the sustainability of development expenditure and discuss the nature of proposed corrective measures as well as the probability for the timely realisation of the same. This analysis will constitute an important input to the Country Analysis, to be prepared by the Development Co-operation Section (DCS) of the Embassy of Sweden in New Delhi.

3. Specific Tasks

The analysis shall specifically address:

- trends in the fiscal performance of the central government and state governments from the introduction of reforms in the early 1990s to date;
- the causes and consequences of the fiscal deterioration in recent years;
- disparities between states when it comes to addressing and overcoming fiscal constraints, and the nature of such efforts;
- the potential for increased private sector financing of development-related investments;
- the importance of external assistance financing at the state level and beyond;
- the likely scenario for the next five-year period in terms of economic growth, fiscal correction and development spending;
- the most important areas in need of further reform with respect to a correction of fiscal imbalances.

The analysis should conclude with a recommendation to the DCS on how to address the deterioration of government finances and its implication for the ownership and financial sustainability of development projects and programmes.

4. Methodology

The Consultant shall:

- collect and undertake a desk review of important material on government finances and related issues; and
- consult with expertise in the government as well as non-government sector.

The entire exercise, including report writing, shall be undertaken within a maximum of 15 working days.

5. Reporting

A draft report shall be submitted to the DCS no later than 12 April 2002, shortly after which the Consultant will be invited to present the findings at a seminar arranged by DCS. The final report shall be submitted to the DCS no later than 26 April 2002.

The report shall *not exceed 15 pages*, including an executive summary of *not less than three pages* as well as conclusions and recommendations. The Consultant should quote the source or attach excerpts from such sources whenever possible as well as a list of people interviewed.

The final version of the report shall be submitted in three copies and by e-mail to sida@vsnl.net. The report should be written in Word 6 or in a compatible format.

5. The Consultant

The assignment will be performed by an individual with in-depth knowledge of systems of government financing, development expenditure and economic reforms. Excellent (English) oral and writing skills are essential.

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1. Executive Summary

A. Fiscal Deterioration – A Road Block to Development

India made enormous strides since it achieved independence more than half a century ago. Barring the initial two-year crisis period, economic growth averaged to an unprecedented 6.1 per cent during the last decade. The per capita GDP, reflective of overall development is also improved over the last two decades. After 1996–97, however, the political instability, rising fiscal deficits and implementation of the Fifth Pay Commission recommendations resulted in a downtrend in the growth rate and reforms remained unfinished or undone.

A significant roadblock in this regard has been the rapidly deteriorating fiscal situation. The rising fiscal deficit and the decline in expenditures pose a constant risk to macroeconomic stability. Heavy debt-servicing expenditure, large subsidies, narrow tax base, and high wage bill can be cited as the major reasons for the continued fiscal imbalances.

The present study aims to analyze the current fiscal situation in India, draw conclusions for the sustainability of development expenditure and discuss the proposed corrective measures as well as the probability for timely realization of the objectives of the measures.

B. Trends in the fiscal performance of the Central and State governments

During the later part of the 90s the combined total government expenditure has risen steadily while total receipts have fallen. The gross fiscal deficit at 9.5 per cent of GDP in 1999–2000 marginally exceeded the pre-crisis level of 1990–91 predominantly due to adverse trends in States. A disconcerting feature has been the growth in the revenue deficits.

Revenue growth suffered due to lower excise and customs collections. However, corporate and personal income tax collections were only slightly below target. The Centre's problems had their reflection in the State budgets too. The drop in the growth of Central taxes affected the flow of tax devolution. Tax reform, while introducing some rationality in the tax structure apparently had a dampening effect on the Centre's revenue. The increase in non-tax revenues of the Centre has been far from adequate. The poor financial performance of public sector enterprises has been a drag on the government finances in India. Another basic malaise of our public finances is the poor cost recovery of public services.

On the expenditure side, the items with significant rise have been interest payments, military expenditure due to the border conflict with Pakistan in 1999, higher wage bill associated with the 5th Pay Commission awards, emergency assistance to States such as Orissa, Gujarat, Andhra Pradesh, rising fertilizer subsidies and the high costs of maintaining large grain stockpiles. All this resulted in significant shortfalls in capital expenditure.

With both the Centre and the States resorting to borrowing over the last two decades to finance even a part of their current expenditure, the level of indebtedness of the government has gone up significantly and stood at a little above 65 per cent of GDP in 2000–01. The Central government's deficit is mostly financed from higher domestic market borrowing although the small saving collections was also an important source of funding.

C. State government Finances

State level performance and policies deserve a closer attention. The basic structural weakness of State finances has been the difficulty in containing the current expenditure growth in the face of the inad-

equate generation of own resources and the variability in the federal resource transfers. Not only are these expenditures committed, they are also downward sticky and difficult to control. Consequently, States also resort to the soft option of cutting capital outlays.

The growing revenue deficit has led to a steady deceleration in capital and social expenditures thereby affecting the development of social and economic infrastructures in the areas of education, health, infrastructure, and social security and welfare because of acute fiscal stress.

On the revenue side, there has been steady deterioration in State level tax-GDP ratio and lack of buoyancy in the State level non-tax revenue collections. The non-tax revenue collection has not been showing sufficient growth due to factors like poor recovery from investment and heavy loss of State level undertakings like electricity boards, transport and commercial undertakings.

The downward rigidity of current expenditure combined with inelastic tax structure has put constraints to any significant debt reduction particularly at the States' level. Account should also be taken of the contingent liabilities assumed by the governments which, as a proportion of GDP stands at about 9 per cent of GDP.

The growth of the off-budget borrowing practices raise questions about the transparency of the budgets of the State governments and create doubts about their solvency even if the debt-GDP ratio shows some stability over a few years. The excessive strain on the State finances, especially on the revenue account, during the recent years has been the main cause for higher recourse to overdrafts.

D. Variations in Fiscal Performance across States

A comparative analysis of the budgetary positions of the States reveals substantial inter-state differences in the fiscal stability as reflected by the fiscal deficit and revenue deficit. There is an obvious and significant inverse relation between the fiscal stability indicators and economic development as reflected by the percapita income and fiscal deficit.

The share of own funds in financing government expenditure has been coming down in almost all the States but more so in States with high fiscal deficits.

E. States Efforts to overcome fiscal constraints

Several States have also initiated policy measures towards fiscal restructuring and fiscal consolidation. These initiatives can be broadly classified under fiscal restructuring and growth enhancing sectoral policies. The fiscal restructuring measures are intended to focus on revenue mobilization, expenditure management, PSU reforms and infrastructure development.

Several States such as Andhra Pradesh started formulating a medium-term rolling fiscal framework, which would provide realistic estimate of the margin of the resources available to finance new programmes and to prevent expenditure from exceeding available resources.

The institutional reforms proposed in the State budgets essentially aim at facilitating the fiscal consolidation process.

States are in the process of entering into agreements with the Centre to speed up fiscal reforms. The reforms package includes, downsizing the Government by abolition/freezing of posts, compressing non-Plan revenue expenditures, mobilizing additional revenues through better tax collection and rationalizing taxes and increasing user charges specially for power, water and transport.

F. Restructuring Public Finances – Scenario Analysis

It is clear from the above analysis that large fiscal deficits fuelled by revenue deficits are only visible manifestations of deep-seated imbalances in government finances calling for fundamental restructuring.

The 'base line scenario,' are analyzed in detail by the 11th Finance Commission (EFC), and later by the Tax Policy Advisory Group (TPAG) of the Planning Commission. The unacceptable features of this base scenario, are a high revenue deficit, a high fiscal deficit, and a low level of capital expenditure relative to GDP.

Under the specified restructuring programme, the fiscal profile that was expected to emerge was as follows: The combined fiscal deficit will be brought down to 6.5 per cent of GDP by 2004–05. Revenue balance will be restored in the Central budget by 2006–07 and in the States budgets by 2004–05 itself.

G. Potential for Private Sector financing of development-related investments

In this context, it is noteworthy that almost three-fourths of the gross fixed investment in the economy is in the private sector, with private corporate investment accounting for 38 per cent and private household investment about 33 per cent.

The poorer States in India particularly suffer from obvious handicaps in attracting private investment.

Improving basic infrastructure services and encouraging greater private sector participation in telecommunications, electricity, transport, and water supply can make a major contribution to growth. Notwithstanding this progress, the introduction of private capital in key infrastructure sectors has been slower than anticipated. Further, improved sectoral regulatory frameworks and independent and empowered regulatory authorities are expected to stimulate efficient private sector participation.

H. Scope for External Financing and Likely Areas

The inflow of foreign investment does not compare well with many East Asian and Latin American countries.

The key area for external assistance is the infrastructure. The massive investment requirements arising from liberalization and rapid growth call for additional sources of financing against the backdrop of fiscal stringency.

There is also increasing understanding of the social dimension in infrastructure. In poor countries in particular, the State bears a responsibility to provide the impoverished adequate access to basic services such as health, education water supply, sanitation and sewerage. Thus, although commercialization of infrastructure investment and services has increased over the last decade, the role of the public sector in investment, delivery of services and in regulation will continue to be vital. Therefore a new framework for public – private partnerships in different forms is called for.

Clearly, infrastructure investment requires significant mobilization of external capital inflows. According to the Expert Group on Infrastructure (1996), the total infrastructure investment requirement over the next five years (upto 2005–06) would be about INR 7500 billion, of which about 15 percent will need to be externally financed. As for the likely areas where the external capital can be usefully employed, roads, urban water supply, telecommunications, power, rural development, industrial parks, ports and social development are important.

I. Conclusions & Recommendations

The picture depicted above shows that the present fiscal situation in most States is unsustainable. There is an urgent need for restoring balance between revenue receipts and revenue expenditure and bring down the revenue deficit. The following suggestions need consideration.

Apart from bringing down customs tariff rates to internationally comparable levels there is need for streamlining the exemptions and reducing distortions.

There is also a need for coordination of central excises (CENVAT) with a state level VAT, with the objective of structuring a national VAT.

It is imperative to introduce comprehensive taxation of services at the earliest. It should also be seriously considered for appropriate assignment at the levels of states and local bodies.

A definitive strategy is required to reduce non-Plan expenditures particularly, the containment of wage bill through reduction in Government employment following the Expenditure Commission and Pay Commission recommendations.

The subsidy reforms should aim at reduction in size, making them of finite duration, making them transparent and better administration through proper targeting.

An increase in user charges in agriculture, irrigation, industries, power and transport is called for to substantially mitigate pressures on the fiscal deficit.

There should be a definite strategy of using proceeds of disinvestment in public enterprise to amortize public debt.

2. Fiscal Deterioration – A Road Block to Development

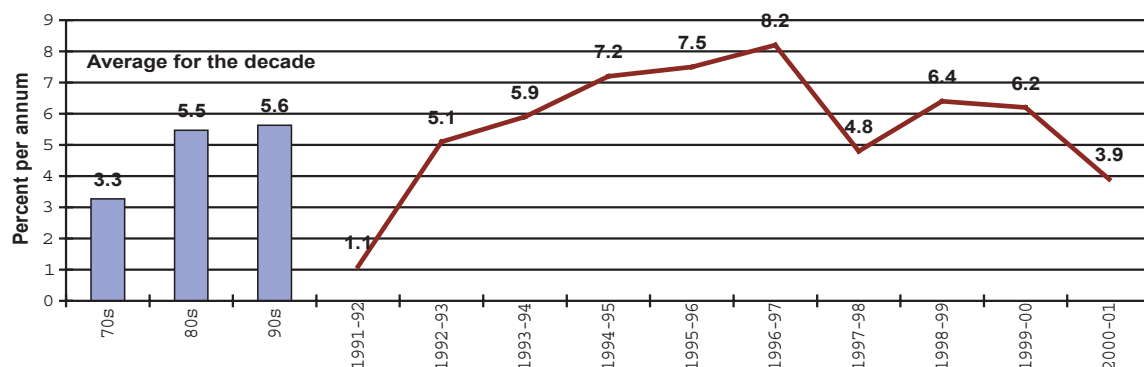
India made enormous strides since it achieved independence more than half a century ago. From a modest 3.3 percent upto 70s the GDP growth rate accelerated to over 5.5 per cent in the 80s and 90s. Although the 90s began with a collapse of the growth due to the balance of payments (BoP) crisis the stabilization and the structural reform measures of 1991–93 provided a decisive break from the traditional closed and regulated policy regime. Improvements have been made to economic and regulatory frameworks and almost all key economic areas have been opened up to foreign and domestic private investors to enhance competition and efficiency. The reforms have increased the role of market forces in the economy and unleashed the energies of the private sector to play a more extensive role in the productive sectors of the economy as well as the infrastructure sectors. With economic liberalization gaining momentum, India has attracted significant flows of foreign capital and technology, and its economy has become more integrated with the global economy. The reforms fuelled one of the swiftest economic recoveries seen anywhere in the world in recent decades. In fact, India ranks as the sixth fastest growing economy among countries with more than 10 million populations during the last two decades. Along with the growth, the per capita GDP, reflective of overall development, is also improved over the last two decades. In fact, the first half of the 90s was boom time for the Indian economy. The external sectors had become far more manageable than earlier and export growth averaged to as high as 20 per cent. Real total investment rose by nearly 40 per cent, led by a more than 50 per cent increase in industrial investment. Thus the first phase of economic reforms has been well managed and has supported the revival of economic growth.

However, after 1996–97 as a result of the frequent change of governments and consequent political instability, there has been a loss of momentum in reforms. Since 1997–98 the country is saddled with a downtrend in the growth rate averaging to mere 5.3 percent¹. Although the reforms continued throughout the decade, they never regained the depth of the early 90s. Thus, there is need to carry forward the more complex phase of structural reforms to stimulate higher sustainable economic growth. The major elements of the unfinished economic reform agenda include the fiscal consolidation, reforms in the financial sector, infrastructure, trade and industrial policy and privatization. Poverty reduction, health and nutritional improvement, and access to education remain the most pressing challenges.

A significant roadblock in this regard has been the rapidly deteriorating fiscal situation. There has been a perceptible slowdown of the pace of fiscal reforms during the later half of 90s, bringing back the fiscal stress. Weak revenue performance and lack of expenditure control at both the Central and State government levels caused the consolidated deficit of the public sector to rise sharply. Central Government finances are under pressure from both revenue shortfall and expenditure overrun, while State government finances weakened due to the persistent rise in the recurrent expenditure mainly on account of pay revisions. The fiscal deterioration has been accompanied by deteriorating expenditures in critical areas especially, the physical and social infrastructure. Heavy debt-servicing expenditure, high wage bill, large subsidies and narrow tax base, are the major reasons for the continued fiscal imbalances. Thus, doubts arise whether the favorable performance of early 90s in terms of high growth and a relatively comfortable balance of payments position can be sustained without significant policy adjustments.

¹ It would have been even worse but for the extraordinary growth of the services sector.

Figure 1 Growth rate of real GNP over the past decades

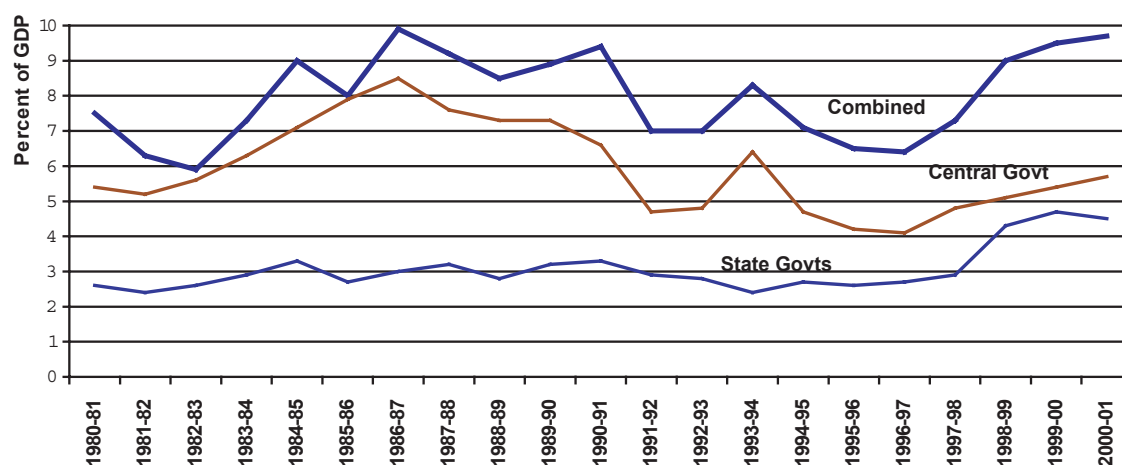


The present study aims to look into the current fiscal situation in India, and discuss corrective measures including possible private sector financing and recourse to external assistance. In particular, the study examines the extent to which the limited inflows of external assistance can be leveraged to catalyze reforms. The analysis is aimed at providing concrete recommendations as to how to address the deterioration of government finances and its implications for the fiscal sustainability of development expenditure programs. Keeping in view the terms of reference, the scope of the study is as follows. Section 2 analyzes the broad trends in the fiscal performance of the Central and State governments from the introduction of reforms in the early 90s to-date and studies the causes and consequences of the fiscal deterioration in recent years. Section 3 examines the problems faced by States and methods adopted to overcome the fiscal constraints. Section 4 looks into the forecasts of the likely scenario for the next five-year period in terms of economic growth, fiscal correction and development spending. Section 5 assesses the potential for increased private sector financing of development-related investments. Section 6 examines the importance of external assistance in financing the development at the State level and beyond. Finally, Section 7 attempts to identify the most important areas in need of further reform.

3. Trends in the fiscal performance of the Central and State governments

A major cause of the 1991 economic crisis in India was the high fiscal deficits in the late 80s. The fire-fighting measures initiated did result in controlling the fiscal deficit to some extent but the recovery was also short lived. With the slowdown of the reforms since 1996-97 the fiscal slippage continues and the fiscal deficit has been consistently rising (Figure 2).

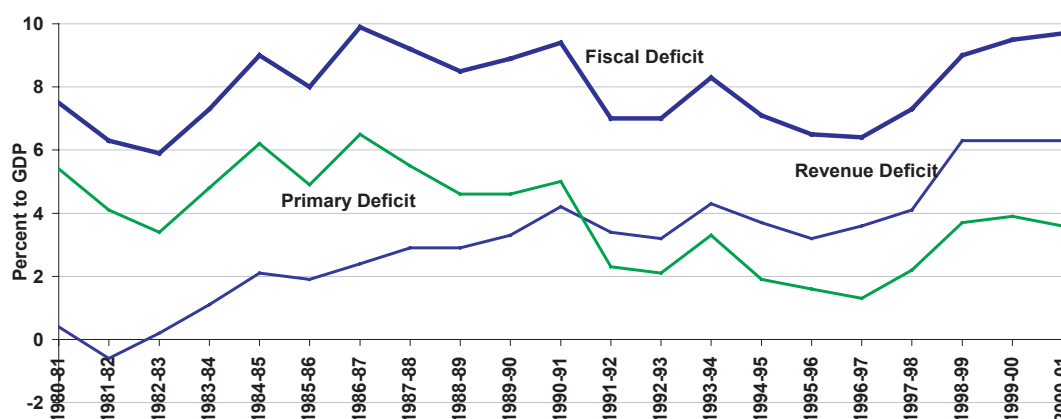
Figure 2 Trends in Combined Central and State government Fiscal Deficit in India during the last two decades



More than the size of the fiscal deficit, what is disconcerting is its composition in terms of revenue and primary deficits. Firstly, the fiscal deficit appears to be driven more by revenue deficits especially in the 90s. There was a time when revenue balances used to turn out to be surpluses, though not large. In recent years, however, the deficit on the revenue account constitutes as much as one-third of the fiscal deficit. Revenue deficits imply preemption of private savings for government consumption and tend to crowd out private investment without corresponding increase in the capital spending by the government. Secondly, the deteriorating share of primary (or non-interest) deficit shows that a significant part of the fiscal deficit is due to the burden of servicing the past debts. In 1980–81 about one-third of the fiscal deficit was due to the debt-servicing burden. By 1990–91, the share of the debt-servicing component went up to over 50 percent. And currently about two-thirds of the fiscal deficit is caused by the past debt-burden.

While trends in the consolidated deficit indicators were dominated by those of the Central government up to 1996–97, the recent deterioration is predominantly due to adverse trends in States².

Figure 3 Fiscal Deficit Trends – Central and State government Components in India during the last two decades



² The deficit of the consolidated public sector (including the deficit of public sector undertakings and Oil Pool deficit) remains one of the largest in the world. It deteriorated to as much as 11.2 percent of GDP in 1999–2000. Although it appears to have narrowed down to 10.6 percent of GDP in 2000–01, 10.4 percent in 2001–02, and further expected to go down to 10.2 percent in 2002–03. [International Monetary Fund (2001)].

In general, the rise in the combined fiscal deficit has been due to both revenue shortfalls and expenditure overruns (Table 1).

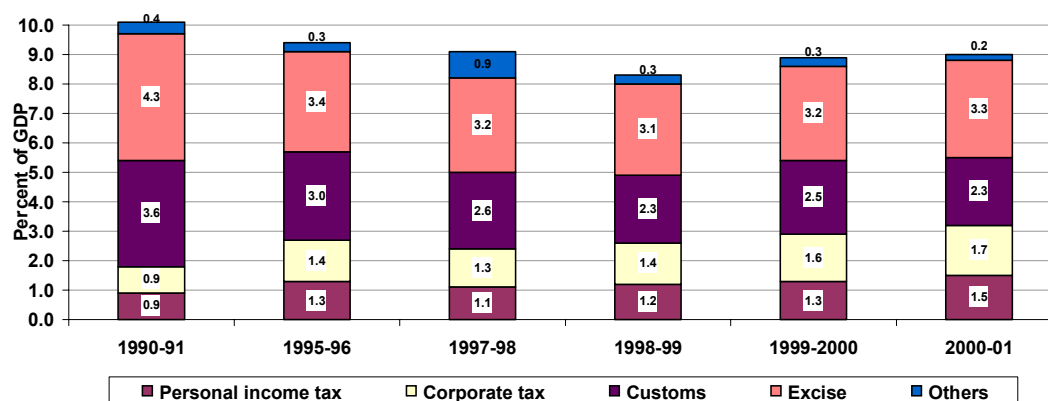
Table 1 Combined Receipts and Disbursements of the Central and State governments (Percent of GDP)

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
I. Total Disbursements (A+B+C)	25.6	25.1	25.8	26.3	27.9	28.1
A Revenue expenditure	21.5	21.6	21.9	22.7	23.8	24.1
Interest Payments	5.0	5.1	5.1	5.3	5.6	5.7
Subsidies	1.7	1.6	1.8	1.8	1.8	1.9
B Capital expenditure	2.9	2.4	2.8	2.6	3.0	3.0
C Loans	1.2	1.1	1.1	1.0	1.1	1.0
II. Total Receipts	18.9	18.6	18.4	17.1	18.0	18.9
A. Revenue Receipts	18.3	18.0	17.8	16.3	17.6	18.2
i) Tax Receipts (a+b)	14.7	14.6	14.3	13.2	14.1	14.5
a) Taxes on commodities	11.2	11.1	10.7	10.0	10.4	10.6
b) Taxes on Income and Property	3.5	3.5	3.6	3.3	3.6	3.9
ii) Non-Tax Receipts	3.6	3.4	3.5	3.1	3.5	3.7
Interest Receipts	0.9	1.1	1.0	0.9	0.9	0.8
B. Non-debt Capital Receipts (i+ii)	0.6	0.6	0.6	0.8	0.4	0.7
i) Recovery of Loans & Advances	0.5	0.6	0.5	0.4	0.3	0.5
ii) Disinvestment proceeds	0.1	0.0	0.1	0.4	0.1	0.1
III. Gross Fiscal Deficit	6.5	6.4	7.3	9.1	9.4	9.7
Financed by Instrument-wise						
i) Domestic Financing (a+b+c+d+e)	6.5	6.2	7.2	8.8	9.4	9.7
a) Market Borrowings (net)	3.3	1.9	2.6	4.5	4.2	4.2
b) Small Savings (net)	0.8	0.9	1.6	1.9	1.8	1.8
c) State Provident Funds (net)	0.6	0.6	0.6	0.9	1.2	1.0
d) Budget Deficit	0.6	1.5	-0.2	0.2	0.2	0.2
e) Others	1.2	1.3	2.5	1.3	1.9	1.9
ii) External Financing	0.0	0.2	0.1	0.1	0.1	0.0

Source: Government of India Economic Survey.

Revenues fell short of budget targets largely due to lower tax collections particularly, Central excise and customs. Excise revenues were affected by slow industrial growth, while customs revenues were affected by lower external trade and deteriorating import unit values (particularly for petroleum products). Further, corporate and personal income tax collections were below target. The drop in the growth of Central taxes affected the flow of tax devolution to the States as well.

Figure 4 Trends in Tax-GDP Ratios of Central Government



The growth of revenue in terms of tax buoyancies with respect to GDP had decelerated even before the onset of the recessionary phase of the economy (Figure 5 and Table 7). The buoyancy of gross tax revenue of the Centre has come down from about 1.15 in the 80s to 0.94 during the 90s. Tax reform, while no doubt helping to introduce some rationality in the tax structure apparently had a dampening effect on the Centre's revenue, as the impressive growth of direct taxes could not fully compensate for the drop in customs and Union excises that took place in the post-reform period. In the case of the States, the tax buoyancy has come down from 1.12 in the 80s to 1.04 in the 90s. The dip in tax buoyancy occurred as revenue from sales tax, the principal component of their own tax sources, showed a deteriorating growth trend owing to tax competition among the States to attract trade and industry.

Figure 5 Tax Revenue Buoyancies in 80s and 90s – Central, States and Combined



Non-tax revenues of the Centre as a proportion of GDP registered an increase during the 90s, but the increase has been far from adequate to neutralize the adverse impact of the fall in tax revenue growth. Non-tax revenues of the States as a proportion of GDP on the other hand registered a decline in the 90s. There was an upward trend for two years, 1994–95 and 1995–96, but it was short-lived. On the whole, non-tax revenue growth has practically stagnated at both levels of government during the 90s.

Between the two principal sources of non-tax revenue, the poor financial performance of public sector enterprises has been a drag on the government finances in India. Approximately, INR 3,500 billion of investment – (INR 2,300 billion in Central sector and INR 1,170 billion in State sector) – is locked up in public sector enterprises in the form of equity or loans. On this investment, the rates of return of most of the PSUs do not cover even a fraction of their cost of funds. The recovery from State level undertakings like electricity boards, transport and commercial undertakings has been especially low. The performance of Central Public Sector Undertakings (CPSUs) is slightly better than those of States as 127 out of 237 CPSUs made profits, mostly in petroleum, telecommunication and financial sectors. Studies show that the average rate of return on capital invested in State Electricity Boards (SEBs) that account for the bulk of the States' investments in PSUs has been persistently negative. Far from yielding the stipulated 3 per cent rate of return the rate has been a negative with a steady deterioration during the 90s. State road transport undertakings (SRTUs), the other major enterprise of the States, also has been a drag on their budgets, reflecting organizational inefficiencies and uncompensated burden of social obligations on the other. In several States the SRTUs are in extremely bad shape, with the bulk of their fleet of buses off the road and employees going without pay for years. It is evident that the low returns and draft on budgetary resources by the PSUs have been one of the structural factors underlying our weak public finances.

Another basic problem has been the poor cost recovery of public services. According to a study carried out at the National Institute of Public Finance and Policy (NIPFP), for the years 1995–96 and 1996–97, recovery rates were as low as 8.4 percent of the costs for social services provided by the Centre and 16.6

per cent for economic services implying subsidization varying from 91 to 83 percent of the costs. The enhancement of non-tax revenue requires levying appropriate user charges on social and economic services rendered by the State governments, periodical revision of tariff by electricity boards and fare structure of road transport corporations. Yet, subsidization of power continues in many States, although a few States have made significant progress in organizational restructuring. In the area of irrigation, efforts are on towards decentralization of water management especially through participative approaches and upward revision of water rates. Nonetheless, the overall situation, taking into account the position of all the States together, is that a reasonable cost recovery on a durable basis is yet to be achieved.

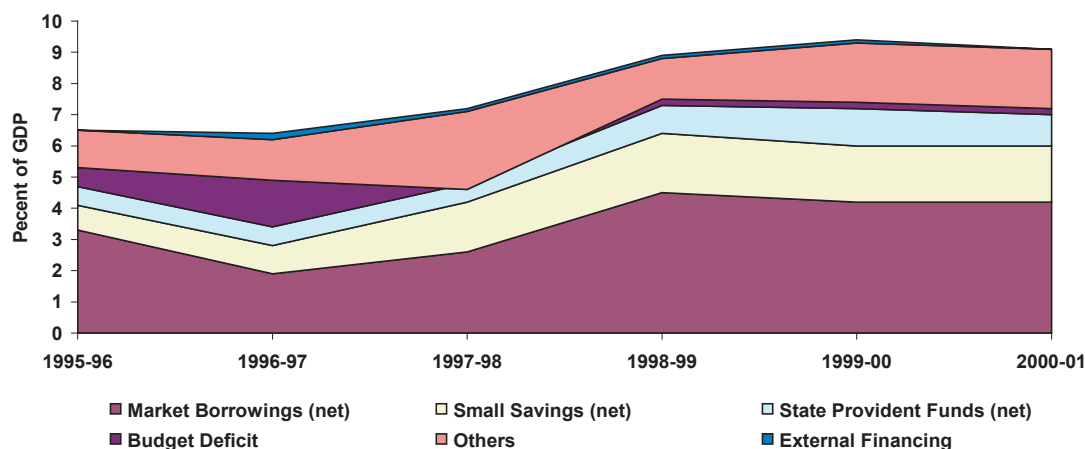
On the expenditure side, the items with significant rise have been interest payments, defence expenditure due to the border conflict with Pakistan in 1999, higher wage bill associated with the 5th Pay Commission awards, emergency assistance for calamity relief to States such as Orissa, Gujarat, Andhra Pradesh, rising fertilizer subsidies and the high costs of maintaining large grain stockpiles and a subsidized public distribution system as a measure of food security.

The salaries and pensions of government employees rose sharply from 1997–98 following the implementation of the wage adjustments recommended by the 5th Pay Commission³. Currently, salaries and pensions account for over 20 percent of the revenue receipts of the Centre as against 17 per cent prior to the revision. More than the salaries, the pensions bill has registered rapid growth in the 90s. The impact of pay revision has been even more severe in the case of the States, as the revisions were extended not only to employees of the government administration but also to those of aided institutions and local bodies. In several States, salary related expenditures absorb over two-thirds to three-fourths of their revenue receipts. Apart from aggravating the budget imbalances, the sharp rise in salaries has resulted in inadequate provision for spending on materials essential for running public services efficiently and maintaining assets in workable conditions. Salary intensity in social services went up in all States leaving too little for efficient delivery of services in vital areas like healthcare and education. Not only are these expenditures committed, they are also downward sticky and difficult to control. Consequently, States also resort to the soft option of cutting capital outlays. This has adversely affected the allocation of adequate resources for education and health sectors, which are the primary responsibility of the States.

The interest and debt-servicing expenditure increased steadily throughout the decade. Large interest payments resulting from higher borrowing and the rolling over of maturing domestic debt at higher interest rates as also the on-lending to State governments against small savings collections. Continuous accumulation of debt has entailed growing burden of debt servicing, with interest payments accounting for 52 per cent of the net revenue receipts of the Centre. In fact, the two structural factors that accentuated budget imbalances during the 90s are the rise in the interest rates on borrowings and change in the composition of government debt that started in the latter half of the 1980s. With the interest rates on government securities getting aligned more and more to the market, the weighted average interest rates on Central government securities went up from around 7 per cent in the early 80s to 12 per cent by the end 90s. Almost concomitantly the share of market loans in the total outstanding domestic debt of the government increased from 31 per cent to 35 per cent (Figure 6). The rate of interest on the other major constituent of domestic debt of the government namely the liabilities on public account (small savings and provident funds) also registered a significant increase and their share in the government debt went up from 36 per cent to 45 per cent over the same period.

³ Central Government wage revisions are determined by the awards of the Pay Commission, a constitutional body set up to make recommendations about every ten years. Recommendations of the 5th Pay Commission, which submitted its report in January 1997, included a three-fold increase in basic pay scales, downsizing of 30 percent in each government department with some restructuring of the Central government. Although the wage awards were incorporated beginning with the 1997–98 budget – resulting in an increase in Central Government wages and salaries of roughly 0.5 percent of GDP – the recommended reorganization and staffing cuts were not implemented.

Figure 6 Pattern of Financing the Fiscal Deficit in the late 90s



Direct subsidies formed 1.98 per cent of GDP and 18.6 per cent of the Centre's net revenue receipts in 1991-92. Although the level of subsidies has come down to less than 1.5 percent of GDP at present (1999-00), they still form 14.3 per cent of the Centre's revenue receipts. The amount of subsidies provided by the States through their budgets is difficult to make out as they are shown under several heads. From whatever information that is available, it is evident that the volume of budgetary subsidies remains large. Resistance encountered by the Union government in cutting down the subsidies in the last few annual budgets and the relentless growth of interest and salary related expenditure evidence the intractability of the problem of budget deficits.

In this context, account should also be taken of the contingent liabilities assumed by the governments (both by the Centre and the States) over the years. As a proportion of GDP, outstanding government guarantees stood at 9.4 per cent of GDP at the end of 1998-99. Although this marks a decline from the level that prevailed in 1992, such liabilities go into the assessment of the country's creditworthiness and sustainability of debt. The issue here is the element of risk associated with such guarantees that mainly emanates from the financial viability of the projects. From the perspective of the sustainability of the guarantee policies, proper risk assessment should be associated with the guarantee policies of the States.

With both the Centre and the States resorting to borrowing over the last two decades to finance even a part of their current expenditure, the level of indebtedness of the government has gone up significantly and stood at a little above 65 per cent of GDP in 2000-01. More important, the growth of domestic debt continues to outpace GDP growth pointing to the unsustainability of the fiscal deficits. The Central government's deficit is mostly financed from higher domestic market borrowing although the small saving collections was also an important source of funding. While total liabilities of the Central government including small saving deposits, provident funds, stood at 50 percent of GDP by the end of the year 2000-01, about 26 percent were in the form of domestic securities and loans, largely held by public sector banks and financial institutions.

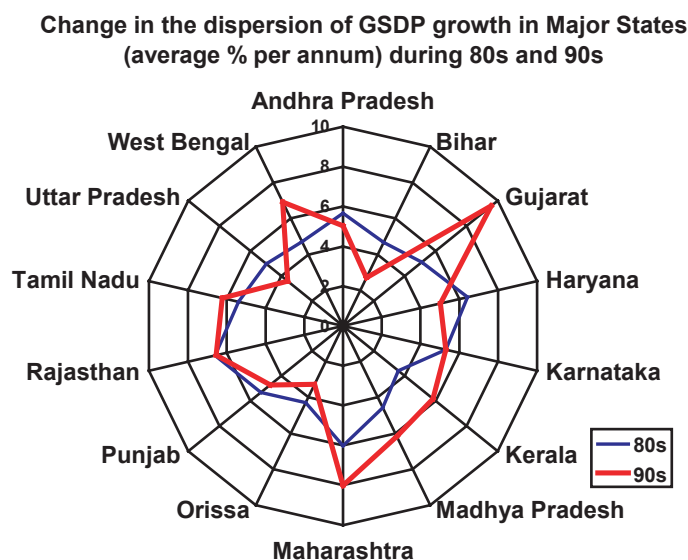
All this resulted in significant shortfalls in capital expenditure. The Central government's capital expenditure as a proportion of GDP has declined from over 6 per cent in the eighties to an average of about 4.6 per cent in the first half of the 90s and 2.6 per cent 2000-01.

It must be recognized that the imbalances in the Government finances are also reflective of institutional rigidities and structural constraints in the division of resources and expenditure responsibilities between the Centre and State governments.

4. Variations in Fiscal Performance across States

In a federal democracy like India there exists greater scope for state level initiatives particularly in attracting investment, both domestic and foreign. Therefore, State level performance and policies deserve a closer attention. The basic structural weakness of State finances has been the difficulty in containing the current expenditure growth in the face of the inadequate generation of own resources and the variability in the federal resource transfers. As in the case of the Central Government, the rising expenditures of the State governments have been mainly due to rising wages and salaries, pensions, subsidies and interest payments. Also, the downward rigidity of current expenditure combined with inelastic tax structure has constrained significant debt reduction. There is a serious adverse impact on public expenditure in the areas of education, health, infrastructure, and social security and welfare⁴ because of acute fiscal stress.

Considerable variation exists in the performance of individual States with some growing faster than the others⁵, which explains the variations in the fiscal insecurity. What is important, however, is that the degree of dispersion in growth rates across States that increased significantly in the 90s compared to the 80s. In the 80s, the growth rate of GDP varied from 3.6 per cent per year in Kerala to 6.6 per cent in Rajasthan. In the 90s the variation was much larger, from 2.7 per cent for Bihar to 9.6 per cent for Gujarat. Thus, while growth accelerated for the economy as a whole, it actually decelerated sharply in States such as Bihar, Uttar Pradesh and Orissa, all of which had relatively low rates of growth to begin with and were also the poorest states.



⁴ The distribution of tax powers and expenditure assignment among the centre and the states according to lists I, II, and III of the seventh schedule (Article 246) and other constitutional provisions for fiscal federalism are well known and are described well by Mukherji (1991) and Vithal and Sastry (1998).

⁵ Due to various statistical problems, the analysis here is confined to 14 major states, which together account for 95 per cent of the total population.

Table 2 Indicators of States' Fiscal Stability and Budgetary Flexibility – State-wise (Major States)

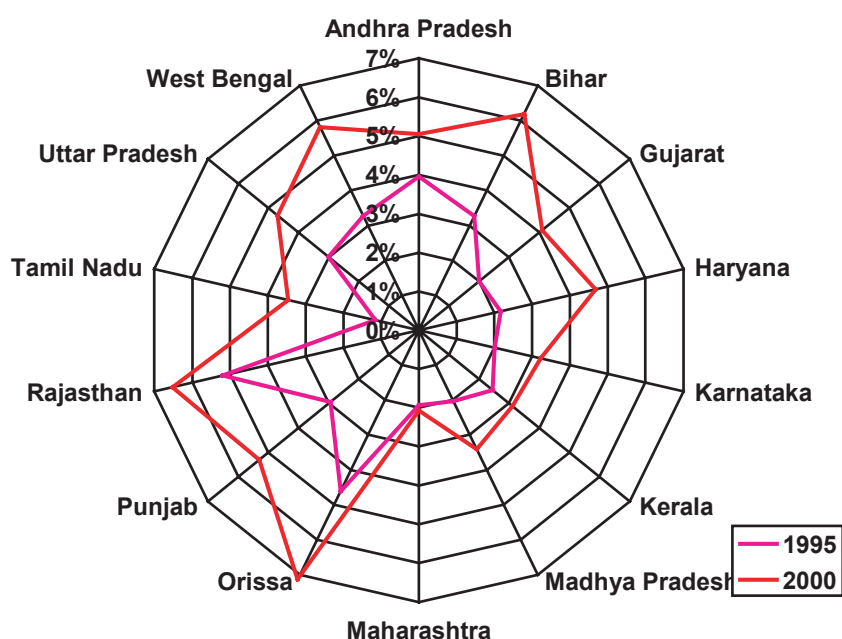
States	Fiscal Deficit /SDP (%)	Outstanding debt stock/ SDP	Interest expenditure/ Revenue	Own revenues/ Total expenditure	Average Per capita SDP (current prices INR)	
	1995–96	1999–2000				
Andhra Pradesh	4.0	5.1	23.2	16.9	45.0	8,626
Bihar	3.3	6.2	41.1	20.2	30.4	4,051
Gujarat	2.0	4.1	18.6	17.4	58.0	11,798
Haryana	2.2	4.7	23.9	15.7	62.7	12,622
Karnataka	2.0	3.2	20.4	13.6	58.4	9,219
Kerala	2.4	3.1	27.9	19.5	51.4	10,093
Madhya Pradesh	2.0	3.4	22.5	14.8	46.4	6,901
Maharashtra	1.9	2.1	17.0	15.1	60.6	13,759
Orissa	4.6	7.1	48.1	26.1	27.3	5,576
Punjab	2.9	5.3	41.4	32.6	55.7	13,703
Rajasthan	5.2	6.5	33.4	22.9	40.1	7,730
Tamil Nadu	1.1	3.5	18.3	13.8	57.3	10,708
Uttar Pradesh	3.0	4.7	31.3	27.2	33.0	6,005
West Bengal	3.3	5.8	25.8	28.9	34.0	8,540

Source: Reserve Bank of India.

A comparative analysis of the budgetary positions of the States reveals substantial inter-state differences in the fiscal stability as reflected by the fiscal deficit as shown in the adjacent figure. For example, during 1995–96 the fiscal deficit as a ratio to SDP varied between 1.1 percent in Tamil Nadu to 5.2 percent in Rajasthan. in 1999–2000 the variation was greater (from 2 percent in Maharashtra to 7 percent in Orissa).

Figure 7 Change in the ratio of fiscal deficit to GSDP in 14 major States

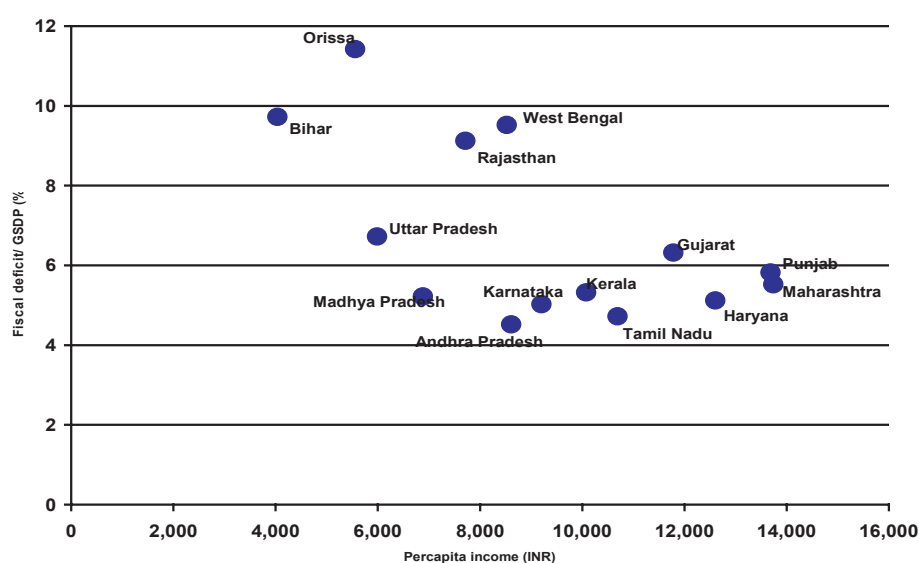
Trends in the Fiscal Deficit/GSDP ratio in 14 Major States



The deterioration in the fiscal situation of the States in the 90s, especially in the latter half, has, in fact been more acute than what would appear from the consolidated deficit figures of all States (Table 8). In 1990–91, the State level FD was less than 5 per cent, while by 1998–99, as many as 19 States had FD of more than 5 per cent. Going by 1999–00 budget estimates, the majority of the States had fiscal deficit of more than 7 per cent⁶.

There is an obvious and significant inverse relation between the fiscal stability indicators and economic development as reflected by the percapita income and fiscal deficit. This points to the fact that while there has been an overall deterioration in the finances of almost all the major states, the fiscal deterioration has been exceptionally damaging in the case of a few low income states and Bihar stands apart even among them.

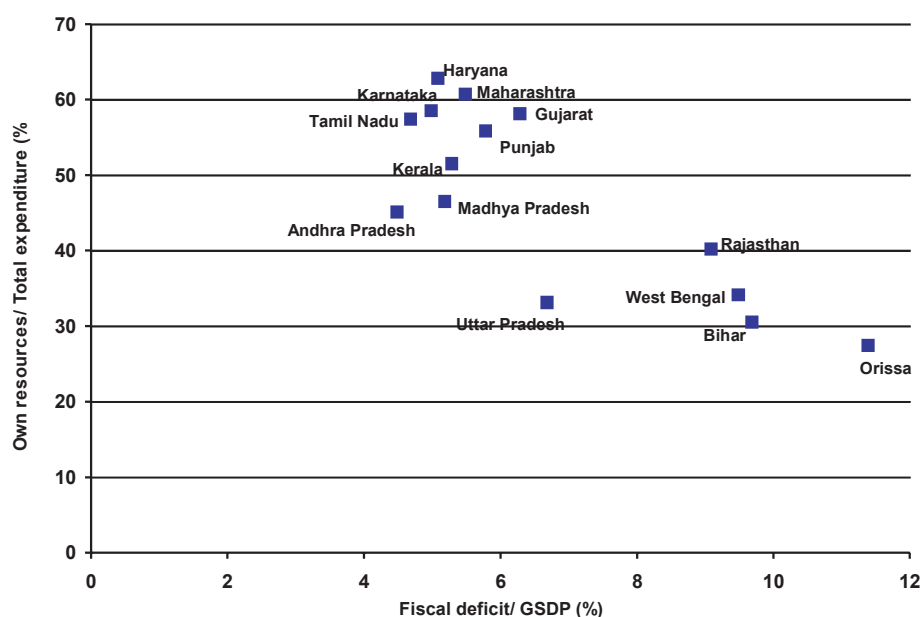
Figure 8 Percapita income and ratio of fiscal deficit to GSDP in 14 major States of India



In general, the States have been especially facing difficulty in containing the current expenditure growth in the face of the inadequate generation of own resources and the variability in the federal resource transfers. The share of own funds in financing government expenditure has been coming down in almost all the States but more so in States with high fiscal deficits.

⁶ Government of India, Report of the Eleventh Finance Commission.

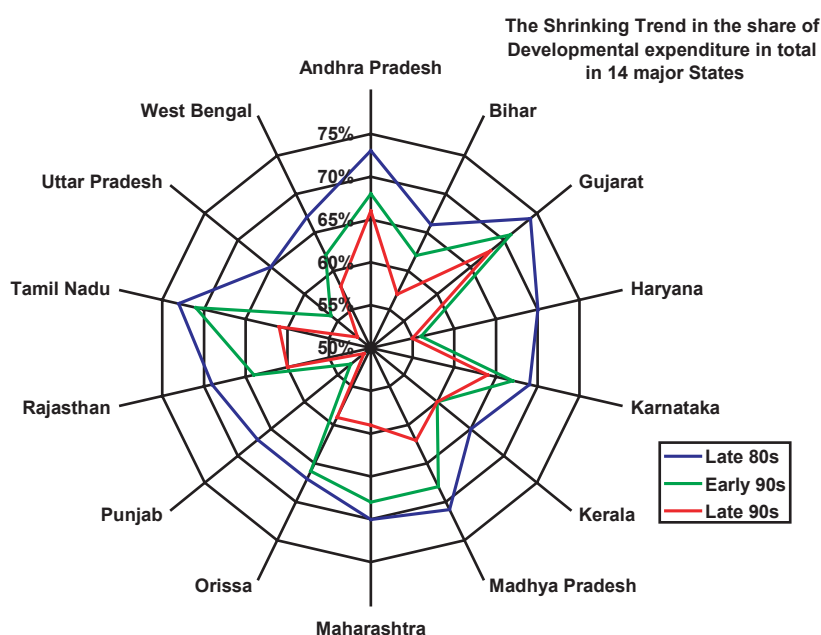
Figure 9 Ratio of own revenue to total expenditure and ratio fiscal deficit to GSDP in 14 major States in India



The growing revenue deficit has led to a steady deceleration in capital and social expenditures thereby affecting the development of social and economic infrastructures. For example, even within the revenue expenditure, the share of developmental activities (social and economic sectors) has also come down (Table 3) during the last two decades. The extent of fiscal stress in the States is also reflected in the ratio of interest payments to total revenues (tax plus non-tax revenues). The problem is particularly acute in states like Uttar Pradesh and Orissa. It is interesting to note that it is not the poor performing states alone that have problems. There are some states, such as Madhya Pradesh, Tamil Nadu, Karnataka, Haryana and Maharashtra that have large revenue deficits, but do not have large accumulation of past debts and as such they may find it easier to finance development expenditure in future. As for the poorer States, unless their finances are put in order, there is little chance of them being able to undertake the substantial infrastructure financing needed to raise their rates of growth to reasonable levels.

Table 3 Share of Developmental expenditure to Revenue Expenditure in 14 major States

	Late 80s	Early 90s	Late 90s	Notes
Andhra Pradesh	73%	68%	66%	Social sectors: Education, medical Education, Sports, Art and Culture, Medical and Public Health and Family welfare, Public Health, Family Welfare, Water Supply and Sanitation, Housing, Urban Development, Welfare of SCs, STs and Other BCs, Labour and Labour Welfare, Social Security and welfare, Food and Nutrition, Relief on account of natural calamities.
Bihar	66%	62%	57%	
Gujarat	74%	71%	68%	
Haryana	70%	56%	55%	
Karnataka	69%	67%	64%	
Kerala	65%	60%	60%	Economic sectors: Agriculture (Crop Husbandry), Soil and Water Conservation, Animal Husbandry, Dairy Development, Fisheries, Forests, Plantations, Food Storage and Warehousing, Agricultural Research and Education, Agricultural Finance Institutions, Co-operation, Rural Development, Special Areas Programmes, Irrigation and Flood Control, Energy, Industry and minerals, Village and Small Industries, Industries, Others, Transport and Communications, Science, Technology and Environment, General Economic Services.
Madhya Pradesh	71%	68%	62%	
Maharashtra	70%	68%	59%	
Orissa	67%	66%	59%	
Punjab	67%	53%	51%	
Rajasthan	69%	64%	60%	
Tamil Nadu	73%	71%	61%	
Uttar Pradesh	65%	56%	52%	
West Bengal	67%	62%	58%	



The problem of state finances exists not only for the poorer performing states but also for all states. Acceleration in growth almost certainly calls for higher levels of public investment in critical social and economic infrastructure sectors by State governments. However the financial position of most states is actually forcing a squeeze on investment. Thus the States have been resorting to larger and larger volumes of borrowing to finance capital expenditure, which is shrinking as a percentage of SDP. The process has led to a steady growth of debt, which in turn has generated a rising interest burden. Borrowing to finance development even when there is no immediate financial return is justifiable if development leads to greater growth that in turn generates the buoyancy in tax revenues needed to service the debt, unfortunately, this has not happened. Total revenues of the State governments are stagnant relative to GSDP and resort to borrowing has only led to a steadily rising interest burden.

In this context, it is useful to note that the borrowing constraint on the States in India, is not as hard as it looks. There are at least four sources of financing through 'off-budget' route that tend to relax the constraint. These are: (a) public account; (b) ways and means advance (WMA) and overdrafts from the RBI; (c) guarantees⁷; and (d) public sector enterprises (PSEs). In several States, there has been a tendency to resort to borrowing through these 'off-budget' route, through WMA and State-owned corporations. The persistent use of WMA and frequent recourse to overdrafts in recent years reflects the stress in the liquidity management stemming mainly from structural imbalances in State finances. As regards the guarantees, although not part of the States' debt, the liabilities of State corporations ultimately fall on the State government. The aggregate outstanding guarantees of major states are have been persistently growing and are currently equivalent to about 9 per cent of GDP. The growth of the off-budget borrowing practices raise questions about the transparency of the budgets of the State governments and create doubts about their solvency even if the debt-GDP ratio shows some stability over a few years. The excessive strain on the State finances, especially on the revenue account, during the recent years has been the main cause for higher recourse to overdrafts.

⁷ Article 293(1) of the Constitution of the India allows the State governments can give guarantees within such limits as fixed by the legislature of the concerned State.

5. States' Efforts to overcome fiscal constraints

In view of this, several State governments have initiated policy measures for overcoming these fiscal constraints. These initiatives can be broadly classified under fiscal restructuring and growth enhancing sectoral policies. The fiscal restructuring measures are intended to focus on revenue mobilization, expenditure management, PSU reforms and infrastructure development. On the revenue side, the tax policy is being rationalized to make it simpler, more transparent, easy for compliance and supportive of both trade and industry. Some of the State level proposals include restructuring of sales tax, land revenue, motor vehicle tax, entertainment tax, and betting tax besides introduction of profession tax. Sales tax being the most important revenue earner, the focus of many States is to how to rationalize it. Preparations are underway for the replacing it with value added tax (VAT). Under a recent Central Government initiative, uniform floor rates of sales tax in the entire country are under implementation to achieve inter-State tax harmonization. It is also agreed upon to phase out sales tax based incentive schemes for industries, reform the Central Sales Tax System and simplify the tax system as prevailing in the States. It has now been decided that all States and Union Territories would implement VAT from April 2003. Maharashtra proposes to make administrative and institutional changes and introduce a new scheme of summary assessment to dispose of all pending cases of tax assessment by April 2003. Karnataka has set up a Tax Reforms Commission for examining the tax structure and making recommendations to enhance tax receipts. Tamil Nadu has initiated steps towards the implementation of VAT.

Several States such as Andhra Pradesh started formulating a medium-term rolling fiscal framework, which would provide realistic estimate of the margin of the resources available to finance new programmes and to prevent expenditure from exceeding available resources.

On the expenditure front, proposals include identification of redundant posts and effective monitoring of schemes. Some States have initiated measures to contain the expenditure through a ban on creation or filling up of posts, purchase of vehicles, foreign tours, engagement of contingent staff, etc. Following the Fiscal Responsibility initiative of the Centre⁸, States started imposing ceiling on Government guarantees.

The institutional reforms proposed in the State budgets essentially aim at facilitating the fiscal consolidation process. The important areas of focus in this regard relate to improvements in governance and pursuit of decentralization. The financial health and management of State level PSUs has been a cause for concern in the last few years. In this context, the initiatives proposed by States include undertaking a comprehensive review of the functioning of the State PSUs and their restructuring. To address the issue, Karnataka has come out with a Policy Paper on restructuring of public sector enterprises, while Maharashtra has introduced a Bill for setting up a Board for Restructuring of the State PSUs. In order to restore financial viability of electricity boards, some States have signed Memorandum of Understanding (MoU) with the Central Government for bringing reforms in the power sector. Several States have set up State Electricity Regulatory Commissions (SERCs) in order to determine electricity tariff in a rational and remunerative manner. Some States have proposed to set up infrastructure development funds. In order to strengthen the administrative machinery, many States have proposed to computerize their records.

States are in the process of entering into agreements with the Centre to speed up fiscal reforms. The reforms package includes, downsizing the Government by abolition/freezing of posts, compressing

⁸ A Standing Committee on International Financial Standards and Codes under the co-chairmanship of Dr. Y.V. Reddy, Deputy Governor and Dr. E.A.S. Sarma, then Secretary, Economic Affairs, was set up to review developments regarding international standards and Codes that have come up in various areas and to assess the relevance of these Codes for India. The Standing Committee in turn established ten separate Advisory Groups to look into existing Codes and standards in specific areas. The Advisory Group on Fiscal Transparency is one of these groups.

non-Plan revenue expenditures, mobilizing additional revenues through better tax collection and rationalizing taxes and increasing user charges specially for power, water and transport. Some States have set specific target of reducing revenue deficit as also agreed to undertake institutional reforms aimed at cost recovery for various economic and social services being provided by the State governments. Concomitantly, the Ministry of Finance has agreed to extend financial assistance to these select States to alleviate their temporary financial difficulties.

Further, some State governments have already initiated legislation towards placing a statutory limit on guarantees and the setting up of Sinking Fund. Gujarat was the first State to have a ceiling on the level of guarantees followed by Karnataka and Rajasthan. Bihar and Nagaland are to follow soon. As regards the creation of consolidated sinking fund (CSF), five State governments – Andhra Pradesh, Arunachal Pradesh, Goa, Maharashtra and Mizoram have already instituted the same, while West Bengal has issued notification to implement the scheme, and Nagaland and Punjab are actively considering the same.

On the sectoral front, to enhance inflow of private investment into infrastructure sectors and ensure sustainable development, several States have taken measures to provide a facilitating environment. Focus is on for construction and maintenance of State highways, district roads and rural roads. Some State governments have also set up special purpose vehicles such as Infrastructure Development Boards to monitor infrastructure funds, which are to be financed through a specially collected cess. In the area of power, measures include privatization of power generation, restructuring of State Electricity Boards into separate corporations for generation, transmission and distribution, and establishment of regulatory/tariff authorities.

Initiatives pertaining to agriculture relate to the launching of wasteland development programmes, modernization of irrigation schemes as also assistance for the establishment of food processing and agro-based industries. Recognizing the role of private enterprise, initiatives have also been taken by the States for the participation of private and co-operative sector institutions for transporting and marketing vegetables. The State governments have also taken steps to enhance the irrigation potential through schemes like Integrated Watershed Development Programmes and also through assistance from the World Bank under the Water Resources Consolidation Project.

Information technology is yet another area that received major policy support in the States' budgets. Several States have proposed setting up of IT Parks and schemes to promote computer education at the school level and computerization of land records. Himachal Pradesh has decided to confer the status of industry on all IT projects in order to promote the future growth and expansion of this sector, while the IT policy of Haryana provides incentives in the shape of preferential allotment of land, uninterrupted power supply and priority in term-lending. Some States have proposed to set up software technology parks in order to provide enabling environment at the State level for private resources to flow into the IT sector. In the agricultural sector, the reform initiatives include further strengthening of horticulture, floriculture, animal husbandry, farm mechanization and wasteland development.

A number of States have focused on review of user charges for power, water, transport, etc. Both the Centre and the States have taken measures to reform the power sector, which is crucial for the fiscal reforms programme. The power sector reforms have focused on setting up of independent electricity regulatory commissions and restructuring electricity boards in order to separate the power generation, transmission and distribution functions. So far, fifteen States have set up their respective State Electricity Regulatory Commission (SERC). While the States of Orissa, Andhra Pradesh and Haryana have set up SERC under their own Acts, the other States, viz., Uttar Pradesh, Madhya Pradesh, Punjab, NCT Delhi, West Bengal, Gujarat, Rajasthan, Tamil Nadu, Maharashtra, Arunachal Pradesh, Himachal Pradesh and Karnataka, have set up SERCs under the Central Electricity Regulatory Commission Act.

6. Restructuring Public Finances – Scenario Analysis

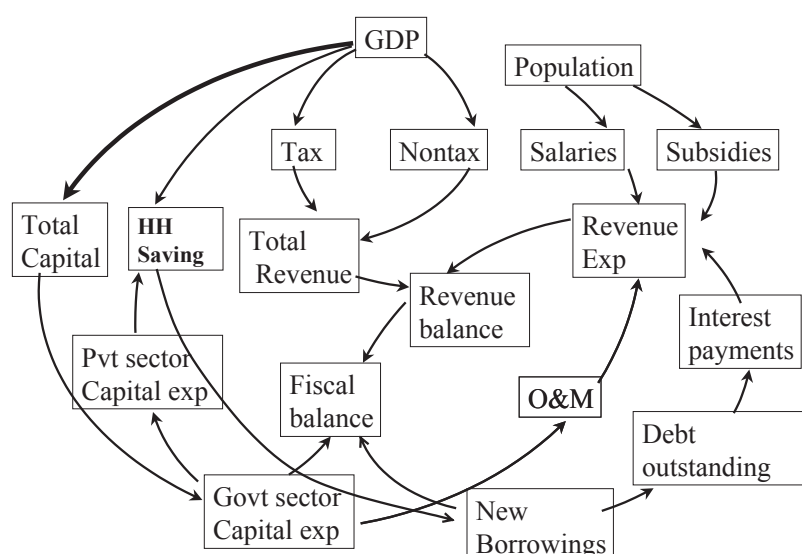
It is clear from the above analysis that large fiscal deficits fuelled by revenue deficits are only visible manifestations of deep-seated imbalances in government finances calling for fundamental restructuring. The structure of public finances in an economy is defined by the level and composition of expenditure of the government (current and capital) and the instruments relied upon to finance them, namely, the tax and the non-tax revenue sources and borrowings. Public finances impact the economy in many ways, directly and indirectly, in the long as well as the short run as shown in Figure 10. To the extent the fiscal deficit is not covered by seignorage, it steadily adds to outstanding debt, resulting in increasing interest payments. Unless met with larger revenue receipts, this gives rise to a self-perpetuating spiral of debt and deficit. In the absence of commensurate increase in domestic savings, deficits in government budgets tend to spill over to the external sector in the form of current account deficit leading eventually to adverse balance of payments. This, in turn, jeopardizes the macro-stability and the solvency of the economy. Thus a restructuring programme is called for to steer public finances away from such a spiral towards sustainable levels of debt and deficit.

The fiscal scenarios that would emerge for the Centre and the States – if the current trends prevailed – called the ‘base line scenario,’ are analyzed in detail by the 11th Finance Commission (EFC), and later by the Tax Policy Advisory Group (TPAG) of the Planning Commission.

In the base scenario, it was assumed that revenues and most components of expenditure grow by their historical drives. The 1999–00 revised estimates were taken as the base figures and the trend growth rates calculated over the period 1987–88 to 1998–99 were applied on these base figures to arrive at projections in the base scenario. However, interest payments were projected by applying the effective interest rate on outstanding debt at the end of the previous financial year. Outstanding debt was projected forward by an estimate of fiscal deficit, which is the resultant of the excess of total expenditure over non-debt revenue and capital receipts.

According to the EFC projections, if the current trends continue, by 2004–05, Centre’s gross tax revenues will rise to a level of about 9.2 per cent of GDP, while the non-tax revenues will actually fall from a level of 2.75 per cent to 2.3 per cent of GDP. Fiscal deficit of the Centre will rise from 5.6 per cent of GDP in 1999–00 to above 6 per cent by 2004–05. This level will be accompanied by a fall in capital expenditure from 2.6 per cent of GDP to 2.1 per cent, if it grows at the historical rate of around 8 per cent. As a result of the rise in fiscal deficit, outstanding debt will remain roughly at about 53 per cent of GDP. However, revenue deficit will be as high as 4.6 per cent of GDP. The unacceptable features of this base scenario, are a high revenue deficit, a high fiscal deficit, and a low level of capital expenditure relative to GDP.

Figure 10 Macro-fiscal flows



Under the specified restructuring programme, the fiscal profile that was expected to emerge was as follows: The combined fiscal deficit will be brought down to 6.5 per cent of GDP by 2004–05 (Table 4). Revenue balance will be restored in the Central budget by 2006–07 and in the States budgets by 2004–05 itself. Aggregate tax revenues of the Centre and the States measure 16.7 per cent of GDP and non-tax revenues reach a level of 3.2 per cent by 2004–05. Capital expenditure of the Centre and the States taken together will rise to 6.6 per cent of GDP by 2004–05. However, most of the projections have already deviated from the actuals for the last two years 2000–02. Thus, there is need to take into account the downside risks. Also, to attain the targets set for the various budget variables in the restructuring plan, the extent of increase in tax-GDP ratio would be 1.48 for Central taxes and 1.15 for State taxes. This in deed appears to be over-ambitious considering the present economic trends, although this was the level that prevailed in the latter half of the eighties. On the expenditure side while the thrust should be on compression, the composition of expenditure would also need to be restructured in favor of priority sectors like elementary education, primary healthcare, water supply, sanitation, roads and bridges and other infrastructure. Items that would require a tight rein are salary and pensions, interest payments and subsidies. Expenditure on salaries can be reduced only when the government's involvement in the non-essential sectors comes down permitting its downsizing. The Expenditure Reforms Commission set up by the Central Government has made some important recommendations in this regard and these recommendations need to be implemented without delay.

Table 4 Fiscal Adjustment scenarios

(Percent of GDP)

	Combined		Centre			States		
	1999–00	2004–05	1999–00	2004–05	2006–07	1999–00	2004–05	2006–07
Tax Revenues	14.09	16.73	8.80	10.28	7.89	5.29	6.44	6.90
Non-Tax Revenues	2.48	3.23	2.75	3.00	3.10	1.03	1.53	2.99
Revenue Receipts	16.57	19.96	11.54	13.28	10.99	10.38	12.96	13.87
Revenue Expenditure	23.33	20.96	13.10	11.47	10.99	13.33	12.96	13.37
Capital Expenditure	4.17	6.61	2.62	4.00	4.60	2.06	2.85	3.83
Revenue Deficit	6.77	1.00	3.81	1.00	0.00	2.96	0.00	-0.50
Fiscal Deficit	9.84	6.50	5.64	4.50	4.00	4.71	2.50	3.00

Source: Report of the 11th Finance Commission, Government of India for Projections for 2004–05.

Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, Government of India for projections for 2006–07.

7. Potential for Private Sector financing of development-related investments

Rapid development of the economy depends on adequate investment in infrastructure. In the backdrop of the economic slowdown the issue of quality rather than quantum in fiscal adjustment assumes importance. Higher Government spending with low capital expenditure content may not translate into much needed higher aggregate demand to stimulate the economy. Therefore, capital expenditure, which has been crowded out in both Central and State government budgets needs to be restored in growth augmenting infrastructure sectors. Government investment and reforms should also focus on leveraging private sector participation rather than for furthering government ownership. Given that the scope for increasing public investment for the development of infrastructure is limited by institutional factors and availability of resources, one way of overcoming the problem would be to accelerate the private financing of the development related investment.

In this context, it is noteworthy that almost three-fourths of the gross fixed investment in the economy is in the private sector, with private corporate investment accounting for 38 per cent and private household investment about 33 per cent. Public sector investment is just about 28 per cent of total and forms about 6.8 per cent of GDP. Thus, any effort to increase the total level of investment must recognize the importance of private investment, identify the constraints on increasing such investments and devise policies that will deal with these constraints. For example, agricultural growth depends upon the spread and quality of rural infrastructure particularly irrigation, land development, rural electrification and rural roads. Some of these infrastructural needs can be met by the private sector. Other sectors with substantial scope for private sector are the national highways, rail transportation, telecommunications, airports and major ports. Investment in these sectors can be crucial. To facilitate this, there is need to de-politicize economic decisions by setting up independent regulatory systems. Some progress has already been made in this direction in telecommunications, power and ports.

The poorer States in India particularly suffer from obvious handicaps in attracting private investment. Private corporate investment being highly mobile is likely to flow across to States which have skilled labour force, good physical infrastructure especially power, transport and communications. Therefore, there is need to make special efforts to attract private investment to such States. The recently launched National Highways Development Project, which is being funded by a cess on petrol and diesel, is a major government initiative that could help to overcome transport bottlenecks affecting 'hinterland' States. There is considerable scope for private investments in road segments of high traffic densities. A beginning has already been made in this direction. A similar large-scale effort is needed to modernize the railway system, with particular emphasis on its freight carrying capacity. Hinterland States would benefit the most from an efficient railway system capable of transporting freight over long distance at attractive rates. The present pricing policy of subsidizing passenger traffic by overcharging freight appears to be against the interest of hinterland States because it increases the cost of rail freight. In fact, such a policy has made it cheaper for coastal power plants in the south to import coal rather than transport it from the coalfields of Bihar. While there is resistance to private investments in railways *per se*, private ownership has been allowed in the case of rolling stock to a limited extent. Besides, there is also a need for investment in social sectors – schools and health facilities and also investments in critical economic infrastructure such as the power system including especially rural electrification, the development of irrigation and water management systems, land development, state highways and district and rural roads. There is also ample scope for private investment in several urban services including sanitation, waste reprocessing and urban water distribution.

Improving basic infrastructure services and encouraging greater private sector participation in telecommunications, electricity, transport, and water supply can make a major contribution to growth. Notwithstanding this progress, the introduction of private capital in key infrastructure sectors has been slower than anticipated. Further, improved sectoral regulatory frameworks and independent and empowered regulatory authorities are expected to stimulate efficient private sector participation.

8. Scope for External Financing and Likely Areas

The external sector of India's economy was the focal stress point of the 1991 balance of payments crisis. The key contributory factors include an overvalued exchange rate (aggravated by real appreciation of the rupee in the first half of the 80s), large trade deficits and recourse to different forms of external borrowing to finance current account deficits in the latter half of the 80s. Because of this the external sector saw the most far-reaching stabilization and structural reforms – devaluation of the exchange rate, phased reduction in the customs tariffs and quantitative restrictions on imports, encouraging foreign investment, and accumulation of foreign exchange reserves. As a result, the performance of the external sector over the last decade has been generally strong. The stabilization measures of 1991–92 gave an impetus to exports, reduced the trade deficit and the current account deficit. Many policy initiatives were taken to liberalize the investment environment in order to facilitate the inflow of FDI.

Yet, the inflow of foreign investment does not compare well with many East Asian and Latin American countries, including China and Brazil, where FDI has attained 5 per cent of GDP. Comparing the latest decade to the late 80s, three sources of foreign borrowing have clearly declined in significance – external assistance and NRI deposits. On the other hand, net external commercial borrowings (ECBs) have gained in importance reaching peak levels in 1996–97. Together, they pushed the capital account surplus to reach its peak in 1993–94 (at 3.5 per cent of GDP). Except for 1995–96, the capital account surplus has been large enough in relation to the corresponding current account deficit during the last decade. Consequently, foreign exchange reserves have increased from \$5.8 billion in March 1991 representing 2.5 months of import cover, to \$42.3 billion a decade later, amounting to more than 8 months of import cover. Also, by March 2000 the external debt service ratio had more than halved (from its peak) down to 16 per cent. The external debt to GDP ratio had fallen from 41 per cent in 1991–92 to 22 per cent in 1999–2000. During the same period, the ratio of short-term external debt to total debt declined from 10.2 percent to 4.7 percent. International comparisons with 14 other large external debtor developing countries for December 1999 also show India in a very favorable light.

The key area for external assistance is the infrastructure. The massive investment requirements arising from liberalization and rapid growth are pushing countries to look for additional sources of financing against the backdrop of fiscal stringency. The rising awareness of the importance of efficiency in investment and delivery in the context of tight fiscal conditions is leading to rethinking on the ability of government owned entities to supply infrastructure services. The increasing need for countries to compete in the global markets is putting additional pressure to provide cost-effective and efficient infrastructure services. Also, the integration of world capital market have vastly increased the possibility of raising large funds for infrastructure investment on a commercial basis.

There is also increasing understanding of the social dimension in infrastructure. In poor countries in particular, the State bears a responsibility to provide the impoverished, adequate access to basic services such as health, education water supply, sanitation and sewerage. Thus, although commercialization of

infrastructure investment and services has increased over the last decade, the role of the public sector in investment, delivery of services and in regulation will continue to be vital. Therefore a new framework for public – private partnerships in different forms is called for.

Clearly, infrastructure investment requires significant mobilization of external capital inflows. According to the Expert Group on Infrastructure (1996), the total infrastructure investment requirement over the next five years (upto 2005–06) would be about INR 7,500 billion, of which about 15 percent will need to be externally financed⁹. As for the likely areas where the external capital can be usefully employed, roads, urban water supply, telecommunications, power, rural development, industrial parks, ports and social development are important.

Urban infrastructure: The likely increase in urban productivity and population due to the new economic policies places a heavy demand on urban infrastructure and services. Approximately 20 percent of urban households do not have access to safe drinking water. Access to sanitation is poor. The drainage system covers only 66 percent of the urban population. The city roads are inadequate for traffic requirements leading to congestion. The operation and maintenance (O&M) of infrastructure leaves a lot to be desired. The total investment requirement in this sector falls in the range of INR 800–940 billion. Urban infrastructure services are provided by local level agencies. Funds have generally been in the form of loans and grants from the Central and State governments. The resources of urban local bodies (ULBs) are grossly inadequate. Investment in urban infrastructure can be greatly facilitated if there is an overall improvement in urban governance. Concessional external assistance can be leveraged to catalyze good governance through capacity building and adoption of best practices in this important sector.

Power: The power sector has been plagued by serious shortage of supply *vis-à-vis* demand. The weak financial position of the State Electricity Boards (SEB) remains a major obstacle to private sector investment in the power sector. Several states like Orissa, Andhra Pradesh, Rajasthan, Haryana and Uttar Pradesh have initiated comprehensive power sector reform programs with the World Bank assistance. Domestic and agricultural segments that receive power subsidies have shown maximum growth in consumption in the last three decades, worsening the SEB finances. Substantial shortfalls in the estimated installed capacity occurred because of problems related to resource constraints. While the recently set up regulatory authorities are expected to rationalise the electricity tariffs to a significant extent and augment resources for the sector, it is also well recognised that the key to any major improvement in the performance of the power sector lies in distribution reforms. External aid can be leveraged to enhance the capacity of the regulatory bodies and trigger distribution reforms. This will also pave the way for both domestic and foreign investments to flow into the power sector, which is vital for the economy

Roads: The main roads comprising national and State highways need strengthening and capacity augmentation. Already, in the roads sector, multi-lateral aid agencies are supporting an ambitious program of highway maintenance and construction at the national and State-level. The programme is aimed at relieving traffic congestion by widening and upgrading priority roads, enhancing road maintenance, and strengthening the management of road programs and assets. The Third National Highways Project was approved in June 2000, which covers States such as Uttar Pradesh and Bihar, which have missed out the recent economic growth partly due to poor infrastructure. External aid can play an important role in the introduction of best technical and financial practices in the construction, maintenance and management of highways. Both domestic and external investments can flow into construction and maintenance of roadways of high traffic densities.

Telecommunications: The telecom network in India has the potential to be one of the largest in the world. There is scope for external assistance in telecommunications sector to help in implementing the

infrastructural reforms suggested by the Expert Group (1996). Already, the World Bank is helping the Government of India to implement reforms by establishing an appropriate regulatory framework for opening the sector to competition from private sector operators. The Telecommunications Sector Reform Technical Assistance Project by the World Bank approved in May 2000 will help India strengthen the regulatory role of government agencies responsible for the sector. Yet, there is further scope for improvements in the management of the radio frequencies for radio stations, cellular phones, satellite communications, and long-distance telephone and data traffic.

The private sector is expected to invest over INR 1,000 billion by 2005–06 for providing telecom services in the country. With revenues expected to grow at a very slow pace, there is very little scope for any significant operating cash flow in the early stages of the project. There is need for the government to adopt liberal policy guidelines and to encourage long-term investment including foreign in this sector.

Ports: Quantitative and qualitative improvement in port infrastructure cannot be achieved with some sort of autonomy to the ports and exposing to competition by of private sector participation for cargo-handling activities. External financing can help Indian ports to upgrade their technology levels to be comparable to international standards. There is need to strengthen the regulatory authority for ports and external aid can play an important role in this by providing technical assistance.

Rural Development: With 75 percent of the population living in rural areas, improving the efficiency of agriculture is the obvious key to attaining high growth and reducing poverty. While India spends twice as much on agriculture as its East Asian neighbors, the composition of its public spending is not conducive to faster, labor-intensive rural growth and poverty reduction. Accelerating rural development and poverty reduction requires better targeting of fertilizer subsidies, investing in rural infrastructure, providing more effective rural services, especially to the poor and socially-excluded, improving management of water, forests, and other natural resources, liberalizing the rural financial system, and dissemination of agriculture technology and extension, rural infrastructure, and social safety nets. Concessional external assistance in this sector could address issues of governance, capacity building and choice of delivery systems. There is considerable scope for both domestic and external investment in post-harvest agricultural activities including storage and processing of agricultural produce, milk and milk products, edible oils etc.

Social Development: The primary role of India's development strategy is to create direct and indirect wage and self-employment opportunities for the poor and empower the poor to take full advantage of the development programmes. The proportion of concessional external aid that flows into India is far less than what is commensurate with its share in the global population below the line of poverty. It is significant that the level of concessional aid to India has been on the decline. If external aid is to have any visible impact on poverty reduction, apart from enhancing the level of concessional aid to India, there is also need to leverage the limited external aid flows towards strengthening of delivery systems, decentralization of decision making and improvement of governance, capacity building at the district and local body levels, empowerment of women and other vulnerable sections of population, rehabilitation of child labour etc.

Efforts are required for addressing child labor by developing alternative strategies for projects that may indirectly or directly involve working children. Also there is need for programs to draw women into the mainstream of economic activity by improving their welfare and status through support for family planning, nutrition, health, technical education, and vocational training.

9. Conclusions & Recommendations

The picture depicted above shows that the present fiscal situation in most States is unsustainable. There is an urgent need for restoring balance between revenue receipts and revenue expenditure and bring down the revenue deficit. This can be achieved only if considerable restraint is practiced in containing government expenditure. Most of the states have considerable scope for raising additional tax revenues. The scope for raising non-tax revenues by cutting implicit subsidies on a variety of economic and social services of a non-merit nature through appropriate user charges are substantial. More specific recommendations are as follows.

First, on Centre's tax reform while bringing down customs tariff rates to internationally comparable levels is a challenge, a greater challenge remains in terms of streamlining the exemptions. While there has been considerable progress in restructuring, the central excise rate structure as well as in reducing distortions by minimizing taxation of inputs, existing leakages from the tax base through exemptions pose a major problem. A major challenge remains in the coordination of central excises (CENVAT) with a state level VAT, with the objective of structuring a national VAT. Finally, it is imperative to introduce comprehensive taxation of services at the central level at the earliest. It should also be seriously considered for appropriate assignment at the levels of states and local bodies.

Second, on State's tax reform, some States are moving ahead with their own VAT reforms pertaining only to intra state sales. These attempts are not as yet coordinated fully and may conflict with agreements on the floor rates of their sales tax regimes. It is important to address the issue of a State level VAT that includes interstate trade. This will obviously require close coordination among states and also with the centre, which should be facilitated by guidance from the Centre.

Third, on expenditure policy, in accordance with the Pay Commission and Expenditure Commission recommendations, the Ministry of Finance should propose a definitive strategy to reduce non-Plan expenditures. Its wage bill should be reduced through reduction in Government employment following the Expenditure Commission and Pay Commission recommendations.

Fourth, as regards the subsidies, the reforms should be directed towards reduction in their size; making them of finite duration; using them for strict economic objectives; making them transparent; and administering them through final goods, with a view to maximizing their reach towards the target population at minimum cost. Recovery rates even for non-merit services are low. Most important, an increase in user charges in agriculture, irrigation, industries, power and transport would substantially mitigate pressures on the fiscal deficit.

Fifth, if public debt is to be amortized completely in the medium term, there will be no doubt severe pressure on the primary balance. One way out could be, if disinvestment in public enterprises progresses with some success, the proceeds could be utilized to amortize public debt.

Finally, the performance of individual States in terms of their fiscal deficit to GDP ratios has not changed much over the past decade, with poor performers remaining below the better performers. This indicates that the Centre's revenue sharing and redistribution across states have not necessarily encouraged States to improve their performance.

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Tables

Table 5 Aggregate Budgetary Balances of Central and State governments in India [% of GDP]

	Fiscal Deficit			Revenue Deficit			Primary Deficit		
	Combined	Centre	States	Combined	Centre	States	Combined	Centre	States
1990-91	9.4	6.6	3.3	4.2	3.3	0.9	5	2.8	1.8
1991-92	7	4.7	2.9	3.4	2.5	0.9	2.3	0.7	1.2
1992-93	7	4.8	2.8	3.2	2.5	0.7	2.1	0.6	1
1993-94	8.3	6.4	2.4	4.3	3.8	0.4	3.3	2.2	0.6
1994-95	7.1	4.7	2.7	3.7	3.1	0.6	1.9	0.4	0.8
1995-96	6.5	4.2	2.6	3.2	2.5	0.7	1.6	0	0.8
1996-97	6.4	4.1	2.7	3.6	2.4	1.2	1.3	-0.2	0.9
1997-98	7.3	4.8	2.9	4.1	3.1	1.1	2.2	0.5	0.9
1998-99	9	5.1	4.3	6.3	3.8	2.5	3.7	0.7	2.2
1999-00	9.5	5.4	4.7	6.3	3.5	2.8	3.9	0.7	2.4
2000-01	9.7	5.7	4.5	6.3	4.1	2.5	3.6	0.9	2
Averages									
1980-81/1983-84	6.8	5.6	2.6	0.3	0.9	-0.6	4.4	3.7	1.8
1984-85/1990-91	9	7.5	3.1	2.8	2.5	0.4	5.3	4.3	1.8
1991-92/1996-97	7.1	4.8	2.7	3.6	2.8	0.8	2.1	0.6	0.9
1997-98/2000-01	8.9	5.3	4.1	5.8	3.6	2.2	3.4	0.7	1.9

Source: Reserve Bank of India, Annual Reports (various issues), Handbook of Statistics on the Indian Economy, 2000 Government of India, Economic Survey (various issues), and Budget documents, and Central Statistical Organization National Accounts Statistics various issues.

Note: For 1998-99 onwards the RBI data have been adjusted for revision of GDP estimates published by CSO in January 2002. For 2000-01 the central government fiscal accounts have been used. Deficits are uniformly computed net of small savings transferred to states.

Table 6 Summary of Fiscal Position of Central Government (% of GDP)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Revenue receipts	9.7	10.1	9.9	8.8	9	9.3	9.2	8.8	8.6	9.4	9.2
Tax revenue (net)	7.6	7.7	7.2	6.2	6.7	6.9	6.8	6.3	6	6.6	6.6
Non-tax revenue	2.1	2.4	2.7	2.6	2.3	2.4	2.4	2.5	2.6	2.8	2.7
Expenditure	17.3	16.2	15.8	15.9	14.9	14.2	13.9	14.2	14.7	15.4	15.6
Revenue expenditure	12.9	12.6	12.4	12.6	12.1	11.8	11.6	11.8	12.4	12.9	13.3
Capital expenditure	4.4	3.6	3.4	3.3	2.9	2.4	2.3	2.4	2.2	2.5	2.3
Revenue balance	-3.3	-2.5	-2.5	-3.8	-3.1	-2.5	-2.4	-3.1	-3.8	-3.5	-4.1
Fiscal balance	-6.6	-4.7	-4.8	-6.4	-4.7	-4.2	-4.1	-4.8	-5.1	-5.4	-5.7

Source: Reserve Bank of India.

Table 7 Tax Buoyancies – of Centre and States

Decade	Combined tax revenue	Centre's gross tax revenue	States' own tax revenue
1950–51 to 1959–60	1.38	1.38	1.39
1960–61 to 1969–70	1.16	1.15	1.17
1970–71 to 1979–80	1.30	1.27	1.35
1980–81 to 1989–90	1.14	1.15	1.12
1990–91 to 1999–00	0.96	0.94	1.04

Source: (Basic Data), Indian Public Finance Statistics (various issues).

Table 8 Summary of Fiscal Position of State governments (% of GDP)

	1990–91	1991–92	1992–93	1993–94	1994–95	1995–96	1996–97	1997–98	1998–99	1999–00	2000–01
Revenue receipts	11.7	12.3	12.2	12.3	12.1	11.5	11.2	11.2	10	10.6	11.4
Tax revenue	7.8	8.1	8.1	8	8	7.8	7.8	8	7.3	7.5	7.9
Non-tax revenue	3.9	4.3	4.1	4.3	4.1	3.7	3.4	3.2	2.7	3.1	3.5
Expenditure	16	16.5	15.9	15.7	16	14.9	14.8	15	15.1	16.3	16.9
Revenue expenditure	12.6	13.2	12.9	12.7	12.7	12.2	12.3	12.3	12.5	13.3	13.9
Capital expenditure	3.4	3.3	3.1	2.9	3.3	2.7	2.5	2.7	2.6	3	3
Revenue balance	-0.9	-0.9	-0.7	-0.4	-0.6	-0.7	-1.1	-1.1	-2.5	-2.7	-2.5
Fiscal balance	-3.3	-2.9	-2.8	-2.4	-2.7	-2.7	-2.7	-2.9	-4.2	-4.7	-4.4

Source: Reserve Bank of India, Annual Report, various issues.

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