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INDIA
FISCAL REFORMS AND THE BATTLE AGAINST POVERTY

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DEVELOPMENTS in the public sector continue to have a major impact on the prospects for economic growth and poverty reduction. That is why the recent deterioration in the fiscal position at the center and in the states is cause for concern. The center and states now spend almost all their revenues on interest payments, subsidies, civil service salaries and pensions, administration, and defense. This paper looks at the policy agenda to raise growth and achieve the goals of the Tenth Plan. These reforms can be grouped into two broad areas. The first is improving the management of public resources, by reducing budgets deficits, reallocating spending to expenditures that are more productive and enhancing the quality of service delivery. The second is improving the investment climate and raising productivity in industry, services and agriculture and rural areas. This paper reviews the debate over fiscal sustainability, proposing reforms in fiscal policy and public resource management to steadily reduce the primary deficits at the center and state levels-and to improve the composition of public expenditure.

Introduction

India's balance-of-payments crisis in 1991 followed acceleration in economic growth to 5.6% a year in the 1980s from a trend of 3.5% over the previous three decades. Large fiscal deficits fed into current account deficits and depleted foreign exchange reserves, pushing India to the brink of default in 1991. The general government fiscal deficit center and states consolidated) averaged 9% of GDP before the crisis (Figure 1). It then fell sharply during the high growth and fiscal restraint of the Eighth Plan period, but resumed growing equally sharply after 1997/98, returning to the 9-10% of GDP range in the Ninth Plan period.

The general government debt-to-GDP ratio rose from about 58% in 1985/86 to 85% of GDP in 2002/03, at which time public sector debt (general government plus central public enterprises) stood at 95% (Figure 1). Contingent liabilities from guarantees in support of loss-making public enterprises, largely in power and irrigation, amounted to 12% of GDP.

In addition to the big rise in the debt burden, the deteriorating quality of the fiscal stance in the 1990s has been another serious concern. Revenues fell considerably during the Ninth Plan period relative to the second half of the 1980s (Table 1). While 2002/03 shows a large revenue increase, it is based on the budget estimate for states, which tends to be optimistic. Compared with the average for the second half of the 1980s, capital expenditure fell by more than three percentage points of GDP during the Ninth Plan, while the sum of interest, administration, and pensions rose by three percentage points of GDP- and a massive 22 percentage points of revenue. Revenue deficits more than doubled, with spending on

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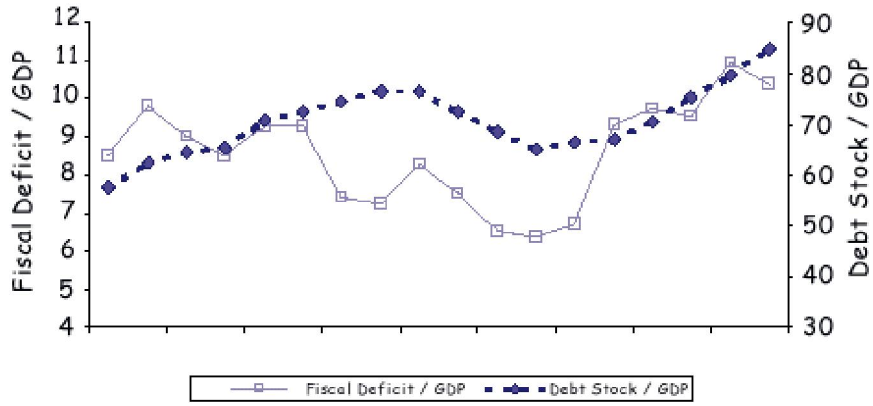
Figure 1. General Government Deficit and Debt Stock, 1985/86-2002/03 (% of GDP)



Source: *India, Ministry of Finance, budget documents (center); RBI; IMF; World Bank staff estimates.*

Table 1. General Government Fiscal Trends, 1985/86-2002/03 (% of GDP)

	1985/86-1989/90	1992/93-1996/97[a]	1997/98-2001/02[b]	2002/03[c]
Revenues	19.4	17.9	17.0	18.4
Current expenditure [d]	22.1	21.5	23.1	25.3
Social services	5.4	5.0	5.6	5.7
Economic services	6.5	5.8	5.5	6.5
General services	9.5	10.3	11.7	12.8
Capital expenditure[c]	6.4	3.6	3.2	3.5
Gross fiscal deficit	9.0	7.2	9.3	10.4
Memo				
Primary deficit	5.3	2.1	3.5	3.8
Revenue deficit	2.6	3.6	6.1	6.9
Interest	3.8	5.1	5.8	6.5
(Irrigation+power+transport)/GDP	4.7	3.5	3.5	3.8
(Interest+admin.+pensions)/GDP	6.3	8.1	9.2	10.1
(Interest+admin.+pensions)/revenue	32.6	45.1	54.3	54.8

a. Eighth Plan; b. Ninth Plan; c. Revised estimates for the center and budget estimates for the states; d. Refers to revenue expenditure in the budget; e. Refers to capital outlay and net loans and advances from the center to the states.

Source: *India, Ministry of Finance, budget documents (center); Central Statistical Organization; RBI 2001b; World Bank staff estimates.*

interest, administration, and pensions crowding out that on social and physical infrastructure. The fiscal improvement secured in the Eighth Plan period involved a large compression of capital spending.[1]

At the center, revenues declined substantially during the Ninth Plan period relative to the pre-crisis benchmark, while interest payments, subsidies[2], civil service salaries[3] and pensions, administration, and defense literally consumed 100% of revenues (Table 2). The primary deficit fell by half, while the revenue deficit increased substantially-as rising interest payments displaced capital spending. The fiscal deficit has been reduced, but the fiscal stance has worsened. According to the revised estimates for 2002-03, there has been an encouraging increase in revenues (*RBI, 2002a*), but interest payments, the primary deficit, the revenue deficit, and the gross fiscal deficit have all increased.

Table 2. Trends in Central Government Finances, 1985/86-2003/04 (% of GDP)

	1985/86-1989/90	1992/93-1996/97[a]	1997/98-2001/02[b]	2002/03[c]	2003/04[d]
Revenues	10.4	9.2	8.9	9.7	9.3
Tax revenue (net)	7.8	6.8	6.2	6.7	6.8
Nontax revenue	2.5	2.5	2.7	3.0	2.6
Current expenditure	12.9	12.1	12.7	13.9	13.4
Interest payments	3.2	4.3	4.6	4.7	4.5
Subsidies	1.8	1.2	1.3	1.8	1.8
Salaries	0.0	1.1	1.0	1.3	1.2
Pensions	0.4	0.4	0.7	0.6	0.6
Defense	2.5	1.6	1.7	1.7	1.6
Capital expenditure	4.3	2.2	1.8	1.8	2.0
Capital outlay	2.6	1.4	1.1	1.2	1.5
Net lending[c]	1.7	0.8	0.7	0.6	0.4
Gross fiscal deficit[f]	6.9	5.1	5.6	6.1	6.1
Memo					
Primary deficit	3.7	0.8	1.0	1.3	1.6
Revenue deficit	2.5	2.8	3.8	4.3	4.1

a. Eighth Plan; b. Ninth Plan; c. Revised estimates; d. Budget estimates; e. Excludes state's share of net small savings loans; f. Divestment receipts are treated as a financing item and not as revenues in computing the deficit.

Source: *India, Ministry of Finance, budget documents (center); World Bank staff estimates.*

1 *It was hoped the private sector would step into the breach and invest in infrastructure, but this has not happened on the* desired scale except for telecommunications. As noted in RBI (2003a), a bigger private role in infrastructure would require institutional reform and "economically efficient user charges to ensure the reasonable return on investment."

2 *Explicit budgetary subsidies.*

3 *Excluding railways and posts and telecommunications.*

Trends in revenues and expenditure at the consolidated state level mirror those at the center, except that the gross fiscal deficit rose significantly after falling during the Eighth Plan period (Table 3). Revenue deficits have grown alarmingly, while capital expenditures were cut-in part to accommodate growing interest payments. The share in central taxes plus grants almost fully explains the decline in revenues in the Ninth Plan period relative to the second half of the 1980s. Once again, the signs of a deteriorating fiscal stance are unmistakable. Interest spending has risen, capital expenditure has declined, and developmental spending stagnated, even though the states have primary responsibility under the Constitution for poverty reduction and the people's welfare.

Table 3. Trends in State Government Finances, 1985/86-2002/03 (% of GDP)

	1985/86-1989/90	1992/93-1996/97[a]	1997/98-2001/02[b]	2002/03[c]
Revenues	12.2	11.8	11.0	12.0
Share in central taxes	2.7	2.6	2.4	2.5
Grants from the center	2.2	2.1	1.7	2.2
Current expenditure	12.3	12.6	13.3	14.5
Education	2.6	2.5	2.7	2.7
Health and family welfare	0.8	0.7	0.7	0.7
Agriculture and allied services	1.1	0.9	0.8	0.7
Rural development	0.8	0.7	0.5	0.5
Interest payments	1.4	1.9	2.4	3.0
Administrative services	1.2	1.2	1.2	1.2
Pensions	0.4	0.7	1.0	0.9
Other	3.9	4.0	4.0	4.6
Capital expenditure	2.7	1.9	1.9	2.2
Capital outlay	1.9	1.5	1.5	1.8
Loans and advances (net)	0.9	0.4	0.4	0.4
Gross fiscal deficit	2.8	2.6	4.2	4.7
Financed by:				
Internal debt (net)	0.5	0.5	0.7	0.6
Loans from center (net)	1.8	1.2	0.9	0.5
Provident and insurance funds (net)	0.4	0.5	0.6	0.5
Memo				
Primary deficit	1.4	0.7	1.8	1.6
Revenue deficit	0.1	0.7	2.3	2.5

a. Eighth Plan; b. Ninth Plan; c. Revised estimates.

***Source:** RBI bulletins; World Bank staff estimates.*

A mechanical comparison of the numbers for the general government, center, and states[4] shows that most of the increase in the general government's revenue deficit between the second half of the 1980s and the Ninth Plan period is traceable to a big deterioration in state finances. But the underlying causes are a complex mix of fiscal developments at the center and states. The Fifth Pay commission has had a big impact for states, which were following the example of the center (*Acharya, 2001, 2002a*). The states have also suffered from rising interest rates over the 1990s in part because of the high, administratively determined interest rates on "small savings" loans (*Rao, 2000*).

Government Debt Dynamics and External Vulnerability

Despite the growing debt burden and rising revenue deficits, some are of the view that the large fiscal deficit is not a serious problem because the Reserve Bank of India's foreign exchange reserves are at record levels, as are food stocks. They assert that the high fiscal deficit has countered the slowdown in the private sector and that India will eventually grow out of its debt problem. Developments over the past 18 months appear superficially to support this. Inflation and interest rates have reached their lowest levels ever. Foreign exchange reserves have continued their remarkable growth. And according to banks, the demand for credit from industry remains low, while there is considerable excess capacity in manufacturing.

Arguing in favor of a fiscal consolidation is the worsening trend in debt dynamics. It is one thing to run a 10% deficit when general government debt is less than 60% of GDP, as it was in 1985/86. But it is quite another when that debt is more than 25 percentage points of GDP higher, as it is today, with guarantees amounting to another 12% of GDP. Moreover, the increase in the general government debt-to-GDP ratio has accelerated from less than 2 percentage points of GDP per year over the first three years of the Ninth Plan period (1997-98 to 1999-00) to more than 4.5 percentage points over the last three years (2000-01 to 2002-03), despite the low interest rates. (*RBI, 2001b, 2002b*)

Interest rates on government debt have fallen sharply at the margin. But they will have to persist for several years to improve the debt dynamics, driven by the weighted average yield of all outstanding debt minus the growth rate.

The second issue needing a judgment is how long interest rates will stay low and whether this will be enough to stimulate growth without a fiscal adjustment and faster structural reforms. Capital flows into India have been driven by one-off events since September 11, 2001, including fears of increased scrutiny of accounts held overseas as part of anti-money laundering drives or by the instability in Iraq-it would be risky to slow fiscal reform on a gamble that such flows will continue indefinitely[5].

But the increase in IT-related exports and remittances from abroad, which have contributed to unprecedented back-to-back current account surpluses over the past two fiscal years, might well continue-though the bulk of the increase in the Reserve Bank of India's reserves is still explained by the capital account. As analyzed here, they strengthen the case for a fiscal adjustment.

Government Debt Dynamics

Data on net public debt-defined as general government debt minus net domestic assets and net foreign assets of the Reserve Bank of India plus its non-monetary liabilities-capture compactly the joint position of public debt dynamics and international liquidity (table 4). Except for the primary fiscal deficit and current account balance, there was an across-the-board deterioration during the Ninth Plan relative to

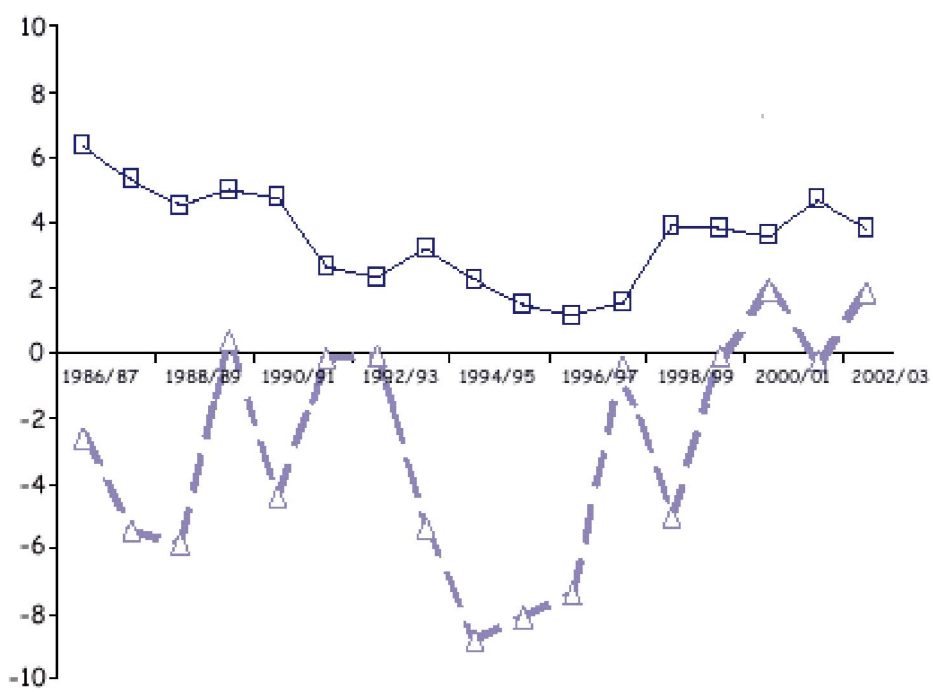
4 *Note that the general government gross fiscal and primary deficits differ from the sum of the respective deficits at the* center and states, because of the netting out of interest paid by the states to the center and net lending from the center to the states, which is a component of capital expenditure.

5 Interestingly, a coincident reserve buildup has been observed in all the South Asian countries.

the second half of the 1980s and an even more striking deterioration relative to the Eighth Plan. General government debt fell from 71% of GDP at the end of 1989-90 to 65% at the end of the Eighth Plan period (*Kapur, 1998*). But it then rose an alarming 15 percentage points by the end of the Ninth Plan, and another five percentage points the following year, notwithstanding record low interest rates.

Interest payments consumed less than 20% of total revenues in the pre-crisis period, compared with over 30% during the Ninth Plan period. Revenue deficits doubled from less than 3% in the second half of the 1980s to 6% during the Ninth Plan period and beyond, capturing deterioration in the fiscal stance, with spending on social and physical (*RBI, 2002*) infrastructure crowded out by rising interest and other current payments (see Table 1). Primary deficits fell from pre-crisis levels during the Eighth Plan period but have grown steadily since (Figure 2). The implied gap between the real interest rate on the stock of government debt and the growth rates charted a clear upward trend after 1994/95 and has been either close to zero or positive since 1999-00, a trend maintained despite record low interest rates over the last 18 months. The average implied difference between real interest rates and growth rates rose from -6.0 percentage points during the Eighth Plan period to -0.74 percentage points during the Ninth Plan period, while the primary deficit rose from an average of 2.1% to 3.5% of GDP.

Figure 2. Primary Deficits and the Implied Difference between the Real Rate of Interest and Growth, 1986/87-2002/03 (%)



Source: *World Bank staff calculations based on India, Ministry of Finance budget documents (center and states); RBI bulletins.*

Government debt dynamics have accelerated on both counts. Given the large volume of guarantees in support of loss-making public enterprises (especially in the power and irrigation sectors), government debt is on a considerably faster upward trajectory than hitherto observed.

Foreign exchange reserves built up steadily after the 1991 crisis-with a dramatic increase of $ 22 billion over the past fiscal year, about 40% of it after November 2002. An unknown part of this might have been driven by capital inflows related to fears of the Iraq war, so this pace might not be maintained (*RBI, 2003b; Kapur and Patel, 2003*). Furthermore, the reserve accumulation of the past few years has been facilitated by private sector sluggishness, which has prevented fiscal deficits around 10% of GDP from feeding into sizable current account deficits (*Ahluwalia, 2002a; Acharya, 2001; IMF, 2002*). The current account deficit averaged 2.2% of GDP in the five pre-crisis years, but less than 1% during the Ninth Plan period, even though fiscal deficits were similar (Table 4). This suggests a crowding out, as well as a relative tightening of monetary policy, discussed later in this chapter.

Table 4. Key Macroeconomic Aggregates, 1985/86-2003/04

Aggregate	1985/86-1989/90 Pre-crisis period	1990/91 Crisis	1992/93-1996/97 Eighth Plan	1997/98-2001/02 Ninth Plan	2002/03[a]	2003/04[b]
Gross fiscal deficit[c]	9.0	9.3	7.2	9.3	10.4	9.8
Revenue deficit[c]	2.6	4.0	3.6	6.1	6.9	6.2
Primary deficit[c]	5.3	4.8	2.1	3.5	3.8	4.1
Debt outstanding[d]	70.6	72.5	65.1	79.8	85.0	n.a.
Net public debt,[e]	60.1	63.8	53.8	70.2	76.3	n.a.
Memo						
Interest/revenue (%)	19.4	24.6	28.5	34.0	35.3	n.a.
Forex reserves (billions of U.S. dollars)[d]	4.0	5.8	26.4	54.0	75.4	n.a.
Current account balance/GDP (%)	-2.2	-3.1	-1.2	-0.7	1.0	n.a.
Real GDP growth (%)	5.9	5.6	7.1	5.5	4.4	n.a.

a. Reliable data not available; a. Revised estimates; b. Budget estimates; c. For the general government. The figures for 2002/03 are revised estimates for central government and budget estimates for state governments. For 2003/04, the figures are budget estimates for center and World Bank staff estimates for states; d. For end of last fiscal year in period. External debt is at current exchange rates; e. General government debt, minus net domestic assets and net foreign assets of RBI plus its non-monetary liabilities.

Source: *India, Ministry of Finance, budget documents (center); RBI 2001b; World Bank staff estimates.*

External Vulnerability

Reserves, $ 75 billion at the end of 2002/-03, and now more than $ 80 billion, imply a healthy cushion against external vulnerability, using standard measures. An additional factor boosting liquidity has been the shift toward long-term rupee debt in government financing after the 1991 crisis. The average maturity of dated securities issued more than doubled from 6.6 years in 1997-98 to 14.3 in 2001-02 (*RBI, 2002a*).

Moreover, about 90% of central and state government securities are held by nationalized banks, State Bank of India, the Reserve Bank of India, and the Life Insurance Company, with the rest held by Unit Trust of India, National Bank for Agriculture and Rural Development, employee provident funds, and private banks (*RBI, 2001b*).

Since the 1991 balance-of-payments crisis, interest rates have been liberalized, India has become more integrated into the world goods and capital markets, and fiscal fundamentals have deteriorated, even relative to the late 1980s. India's public debt dynamics have worsened, with state government finances in crisis, significant nonperforming assets in the financial system, and a large volume of guarantees.

But reserves are high, bolstered by limited capital account convertibility, a flexible exchange rate, long-term capital inflows, and a pliant financial system that willingly holds long-term, rupee-denominated government paper. In short, India is not vulnerable to the type of collapse suffered by Russia. But without a fiscal adjustment, it is open to substandard growth.

Costs of the Fiscal Stance

The growth target for the Tenth Plan is 8% a year, part of a strategy to double per capita GDP by the end of the Eleventh Plan. Chapter 2 of the plan notes that the investment rate will need to rise by four percentage points to a little over to 28%, with domestic savings contributing an additional 3.5 percentage points and the rise in the current account deficit 0.5 percentage points. The incremental capital-output ratio is expected to fall from 4.5 to 3.6, investments to grow by 14% a year compared with the long-run growth rate of 6.5%, and consumption by 6.9% a year. (*RBI, 2001b*)

The chapter notes that private household savings rose over the Eighth and Ninth plans in response to the cut in tax rates and consequent rise in disposable income. This could slow in the Tenth Plan period because of the need to raise the tax-to-GDP ratio, highlighting the need to increase public savings from -1.7% in the base year of the Tenth Plan (2001-02) to +2.1% in its last year (2006-07). Unless this happens, the plan is quite explicit that the growth target is unlikely to be reached. It also cautions that the current account deficit should not be used to slacken the public savings target-and that a safe upper limit is 3% of GDP. (*RBI, 2002b*)

The plan then compares the fiscal deficits projected under the preceding savings- investment scenario (the "desirable deficit" from a growth perspective) with the fiscal deficit that would achieve sustainability, defined as a stable government debt-to-GDP ratio (Table 5).

Table 5. Sustainable and Desirable Deficits in the Tenth Plan Context

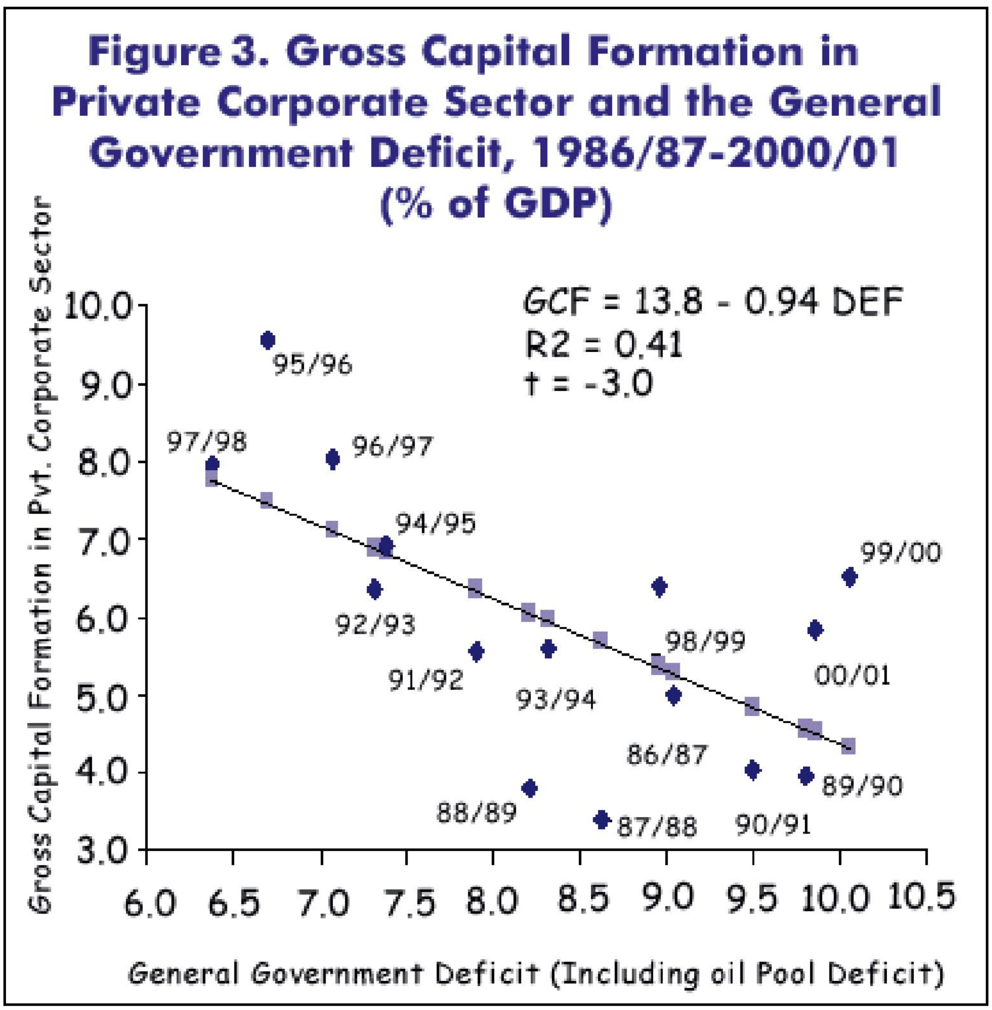
	Sustainable deficit[a]			
	Growth target 6.5 (1)	Growth target 8.0 (2)	Desirable deficit[b] (3)	Base year (4)
Combined	7.4	8.6	6.8	9.3
Center	4.4	5.2	3.6	4.9
States	3.0	3.4	3.2	4.5

Source: *India, Planning Commission 2003.*

Comparing columns (2) and (4) shows the sizable fiscal correction for the states to achieve sustainability, even if growth is 8%. Comparing columns (3) and (4) shows that an even bigger fiscal correction is needed to generate the needed public savings for investment and growth. (*RBI, 2003a*)

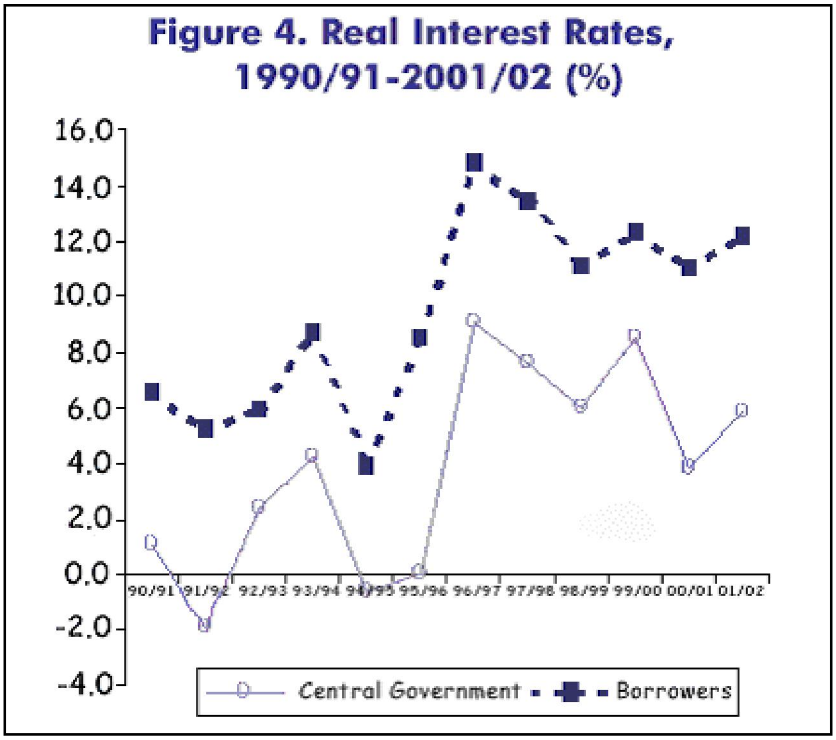
Therefore, achieving sustainable debt is "easier" than generating the public savings consistent with 8% growth. In other words, growth could continue to be substandard even if a crisis does not erupt-and avoiding crisis is not enough.

India has a relatively closed capital account and substantial government ownership of financial institutions. The incentives would favor government-financing needs, with a residual claim for the private sector. And the higher the deficit, the higher the real interest rate-and therefore the fewer the private sector investment projects likely to be profitable, increasing the severity of crowding out. Not surprisingly, there is a well-documented negative association between fiscal deficits and private investment (Figure 3).[6]



Source: *National Accounts Statistics, India, Ministry of Finance, World Bank staff estimates.*

6 See World Bank 2000a and Reynolds 2001.



Source: *Mohan, 2003.*

Insurance companies must hold at least 50% of their assets in government debt and provident funds, at least 50% in central government debt and 25% in state government debt. Annual inflows into small (postal) savings, which compete with banks for deposits, are invested wholly in government debt. These flows have grown from an average of 7.9% of GDP in the Eighth Plan to nearly 10% currently, consuming nearly the whole increase in net household financial saving. The administratively determined interest rates for these instruments were set artificially high, at 10.5-13% until 2000 and are still at 7.5-9%, with tax concessions. (*Kelkar, 2002*) This worsens the public debt dynamics while raising the cost of funds for banks and hence lending rates to the private sector. Moreover, banks are under pressure to reduce their nonperforming assets, which attracts them even more to government debt.

And non-bank financial corporations, which held little government debt and funded riskier firms, represented an average of 7.7% of GDP in the Eighth Plan but only 1.1% in the Ninth. Their decline probably contributed to the rapid growth in bank deposits after 1996. So, dominant government ownership of the financial sector, the investment rules for insurance companies and provident funds, and the interest rates on small savings all create a natural proclivity toward lending to government. This is reinforced by the incentive structure in banks: managers complain of being subject to criminal investigation if a loan to a private enterprise goes sour.

A last point is that the substantial shift in the composition of government spending away from capital expenditure directly inhibits private investment. An empirical investigation concludes that a rise in government consumption crowds out private consumption, a rise in public investment in manufacturing crowds out private investment, and public investment in infrastructure has strong positive complementarities with private investment (*RBI, 2002c*).

So, the rise of revenue deficits, accompanied by an offsetting decline in government social and infrastructure spending, has also contributed to crowding out the private sector.

Fiscal Reform Priorities

In addition to the Tenth Plan document, concerns about the fiscal situation have been expressed in key government reports and pronouncements. During the 2003-04 Union Budget discussions, the Finance Minister informed the Rajya Sabha on March 14, 2003 that "Of our revenue, 50% is swallowed by payment of just interest on (government) debt. Another 20% goes on subsidies and 25% on defense. What am I left with?"

In view of the preceding analysis, fiscal reforms are needed to ensure a phased reduction in the primary and revenue deficits of the center and state governments, and to reallocate expenditure toward more productive uses. The discussion turns to proposals for policy reforms in four key areas:

- Tax reform.
- Subsidy reduction.
- Financial policy.
- Fiscal management.

Tax Reform

The gross tax revenue of the central government fell from 10.3% of GDP in 1991/92 to 8.6% in 2001-02 (*India, Planning Commission, 2003*). The goal is to raise taxes back to 10.3% of GDP by the end of the Tenth Plan. Plan projections assume a big increase in tax buoyancy-from 0.8 in the Ninth Plan to 1.26 in the Tenth. Most of this increased buoyancy is expected to come from indirect taxes, particularly customs duties. Achieving this goal rests on several key assumptions: complete withdrawal of import tariff exemptions (except on strategic imports), a strong resumption of growth in manufacturing, the sector with the highest tax buoyancy, and extending the tax net to include the booming services sector.

The states' own tax collection is projected to be raised from 5.9% of GDP in the base year to 6.6% by the end of the Tenth Plan. This increase rests crucially on the implementation of a unified VAT covering all goods and services.

The decline in the tax-to-GDP ratio in the 1990s is due partly to the "costs of reform," reflecting the reduction in customs and excise duties to increase competition and enhance efficiency. But it also reflects the costs of incomplete reform.

The shift toward direct taxes has failed to compensate fully for the reduction in indirect taxes implemented as part of the reforms during the 1990s. As the Kelkar Committee reports emphasize, the lowering of tax rates needs to be complemented by eliminating exemptions, bringing services and agriculture into the tax net, and improving technology-based tax administration (*Kelkar, 2002*). These reforms deserve the highest priority in view of the decline in the tax-to-GDP ratio in the 1990s and the direct positive effect this will have on reducing primary and revenue deficits. In this respect, while tax administration has been given due prominence in the Union Budget for 2003/04, there has been a tendency to increase exemptions and special rates, even for excise taxes, despite the rationalization of main rates. And there has been no move to tax agricultural income, which will perpetuate incentives to disguise nonagricultural income as agricultural income.

Subsidy Reduction

Subsidies: The central food subsidy amounted to Rs. 242 billion with fertilizer subsidies adding another Rs. 110 billion, a total of 1.4% of GDP in 2002-03 (Table 6). Food grain and input subsidies have distorted farmer cropping and investment decisions, contributing to natural resource degradation (soil nutrient imbalances, water logging, and salinity). At the same time, public

Table 6. Government Subsidies, 1997/98-2003/04

Item	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03[a]	2003/04[b]
Billions of rupees at current prices							
Food (including sugar)	79.2	92.1	94.8	121.0	175.1	242.0	278.0
Fertilizer	99.2	116.0	132.4	138.0	126.0	110.1	127.2
Petroleum	n.a.	n.a.	n.a.	n.a.	n.a.	62.7	81.2
Interest subsidies	0.8	14.3	13.7	1.1	2.1	7.7	1.8
Others	6.2	13.6	3.9	8.3	8.9	23.8	10.9
Total subsidies	185.4	235.9	244.9	268.4	312.1	446.2	499.1
Percent of GDP							
Food (including sugar)	0.5	0.5	0.5	0.6	0.8	1.0	1.0
Fertilizer	0.7	0.7	0.7	0.7	0.5	0.4	0.5
Total subsidies	1.2	1.4	1.3	1.3	1.4	1.8	1.8
Memo (%)							
Food (including sugar)/gross fiscal deficit	10.7	9.5	8.9	10.0	12.1	16.3	16.7
Food /revenue	5.9	6.2	5.2	6.3	8.7	10.2	10.9
SEB losses/GDP	0.9	1.2	1.4	1.2	1.4	n.a.	n.a.

a. Reliable data not available; a. Revised estimates; b. Budget estimates.

Source: *India, Ministry of Finance, budget documents (center); India, Planning Commission 2002a.*

investments in agriculture have declined over the last decade, in large part due to the pressing need to meet subsidy requirements in the food grain, fertilizer, irrigation, and power sectors. The main reform goal therefore would not be to achieve fiscal savings.

It would be to achieve faster growth in agriculture by shifting central expenditures from food (subject to the maintenance of a minimum social safety net) and fertilizer subsidies toward productivity-enhancing investments, including irrigation, rural infrastructure, and research and extension. The petroleum subsidy, about 0.4% of GDP, is to be phased out over the medium term.

Power Reform: This is a key reform both for fiscal sustainability and for spurring growth through more efficient provision of power services to industrial and commercial users and more reliable provision to the rural areas. Estimated State Electricity Board (SEB) losses in 2001-02 were Rs. 332 billion, about three times those in 1996-97.[7] To put this in perspective, the gross fiscal deficit of the states was 4.4% of GDP in 2001-02, or about Rs. 1,183 billion. Subtracting from this the actual subsidy paid by the states to SEBs of Rs. 83 billion gives a fiscal deficit net of the subsidy of Rs. 1,100 billion. This means that if the total losses of SEBs were consolidated with the fiscal deficits of the states, these would rise on average by 30%. Given the low actual subsidy received, SEBs have been defaulting on their payments to central government agencies (suppliers and lenders) to finance a part of these losses.

7 *India, Planning Commission (2002a). The actual financial loss is even greater because of collection problems.*

SEB operations also entail significant transmission and distribution losses (technical and commercial losses as well as theft), in some states as high as 40-50%. Owing to poor collections, outstanding receivables of various state utilities grew from Rs. 145 billion in 1996-97 to Rs. 248 billion in 1999-2000. Tariffs covered only 68% of the cost of supply in 2001-02. There is also high dispersion in tariffs, with commercial and industrial users cross-subsidizing agricultural and domestic consumers and being charged rates far in excess of the cost of supply. Given the poor quality of supply, many manufacturing companies install their own generators. Moreover, recent studies show that subsidies are regressive. The poor benefit little from subsidized electricity, both in urban and rural areas, providing little justification for continued subsidies to consumers (*World Bank, 2001b, 2002j*).

The financial and social case for reform is clear, as are the essential elements. Average tariffs need to be raised to reflect cost of supply. Universal metering of consumption is required, especially for agricultural and domestic consumers. Payments discipline needs to be enforced. And a targeted subsidy scheme needs to be introduced for poor households and farmers so that the cross-subsidy burden on industrial and commercial users can be eliminated. It is also accepted that there will be greater incentive to sustain reform with the privatization of the distribution business. But political will has often been found wanting, especially for raising tariffs for farmers, or for implementing better governance.

The fundamental problems affecting the sector stem from the apparent unwillingness of the state and central governments to allow the sector to function along commercial and economic lines. The Government of India has recently initiated a few potentially decisive steps to give stronger incentives to states for reforming their power sectors. For these to work, privatization of distribution, stronger action on tariffs, better governance, and financial restructuring are needed. Parliament has passed a new Electricity Act, and the Ministry of Finance has instituted the Accelerated Power Development and Reform Program (APDRP) in support of power reforms.

The Ahluwalia Committee had recommended that the past-due arrears of SEBs to central government agencies – Rs. 415 billion at the end of February 2001 be compensated by bonds issued by the respective state governments, guaranteed by the Government of India and carrying a tax-free interest rate of 8.5% a year. For this, a tripartite agreement involving the Reserve Bank of India, state governments, and the Ministry of Power was signed in March 2003. Under the agreement, state governments have also agreed that in case of SEB default on payments of bills to central agencies, the Reserve Bank of India would deduct at source a corresponding amount due to the states.

While initial signs are encouraging, the effectiveness of this agreement in imposing a hard budget constraint on states, and thereby providing a stronger incentive for reform, will depend on its continued enforcement by the Government of India. The APDRP could be another effective step. But if the scheme is to provide incentives to states for reform, it needs to clearly link assistance strictly to tangible and irreversible measures for reversing SEB losses and improving governance. Without such a link, the APDRP may weaken the resolve to reform.

Financial Policy

Since 1992-93 varying but relatively small sums have been spent to assist nationalized banks, regional rural banks, Unit Trust of India, Industrial Development Bank of India, and Industrial Financial Corporation of India-with another 0.8% of 2002-03 GDP identified to help the latter three. The banks' reported gross nonperforming loans were 10.4% of all loans in March 2002. Net of provisions the figure was 5.5%. And net nonperforming loans as a percent of assets were 2.3% or about 1.5% of GDP.

There are two key reform issues. The first is enhancing the role of the financial system in efficient resource allocation. The second is minimizing risks. The first is closely related to the fiscal stance. As long as deficits are high, a high proportion of bank assets will be invested in government debt. As of March 2002, about 28% of bank assets were invested in government debt and another 5.6% was with the Reserve Bank of India.

Measures are also needed to contain risk and manage nonperforming assets. In this connection, the new Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (2002), which allows banks to take over collateral more easily, could push debtors to pay up.

Similarly, establishment of credit information bureaus should help in sharing information on credit risk, which would lower transaction costs while helping to control nonperforming loans. It would particularly help small and medium-scale enterprises, which suffer from very high real lending rates owing to the perception of high risk.*(Mohan, 2003)*

Guarantees: It is estimated that of the market borrowings by state entities guaranteed between 1995 and 2002, Rs. 440 billion will be called over the next five years (*CRISIL, 2002*). This may not seem much, but the estimate excludes guaranteed loans from the National Bank for Agriculture and Rural Development, the Housing and Urban Development Corporation, the Life Insurance Corporation, the National Cooperative Development Council, the Rural Electrification Corporation, public sector banks, and regional rural banks.

Moreover, the guarantors-the state governments-are already heavily indebted. Not surprisingly, the spread on state guaranteed bonds relative to central government securities widened from 2-2.5% in 2000 to more than 4% in 2002.

Another problem is that even when state-guaranteed bonds are not being serviced, creditors do not treat them as nonperforming assets unless the guarantee is invoked and payment is not received for two quarters. There is reluctance to invoke guarantees, so defaults remain hidden, adding to the uncertainty and instability. Given the extensive list of creditors, a default would hurt the integrity and credibility of public institutions. Containing the problem requires a need for a clear and transparent framework for guarantees.

Fiscal Management

There is growing recognition that fiscal institutions need to be strengthened. This will require changes at the center, in the states, and in center-state fiscal relations. The central government needs to lead by example, getting its own house in order and providing the right incentives for fiscal adjustment at the state level. And it needs to give states enough flexibility to use their limited resources efficiently.

Legislating for Fiscal Prudence: The Fiscal Responsibility and Budget Management Bill, passed by the Lok Sabha in early 2003, mandates the elimination of the center's revenue deficit by March 2008. The bill pertains only to the central government, but three states-Karnataka, Punjab, and Tamil Nadu-have so far passed similar acts to limit their own deficits. And others are following suit. The proof of the usefulness of these pieces of legislation will be progress toward their fiscal goals.

A useful feature of the acts is the requirement that the central and concerned state governments annually publish multiyear fiscal strategies-developing time-bound road maps for restoring fiscal sustainability and publicly monitoring progress. If carefully implemented, this could enhance the credibility of India's fiscal policy.

State Borrowing: While states ultimately have to be responsible for their own fiscal adjustment, reforming the borrowing regime they operate in will also help induce fiscal reform. Global borrowing caps should be introduced and enforced by the Government of India, using powers under Article 293 of the Constitution. In return for much tighter control by the Government of India over the annual quantum of borrowing, states could be given much greater freedom over how they arrange that borrowing.

States should be allowed to borrow responsibly from the markets within their global cap. And borrowing from captive sources-small savings, negotiated loans, and Government of India loans-should be phased out.

Measures to Simplify Expenditure Management: India's five-year plans help provide a strategic framework for development efforts, but the division of budgetary resources into "plan" and "non-plan" is counterproductive. It adds complexity to the budgeting-and perpetuates a perception that plan spending is always better than non-plan and should always be increased. Unfortunately, substantial government assistance is provided for state plan spending, making elimination of the plan-non-plan distinction at the state level a complex and unpopular proposition. But the Government of India could take the lead by abolishing the distinction at the central level. It could also propose to states that its financial support to them be de-linked from their annual plans.

Funding currently provided as plan support would be provided on the basis of an agreed and explicit set of criteria-which initially could be based on those currently in place-but could be termed "development support" rather than "plan support." Any such move would require consensus among states to succeed. The government could help build this support by announcing that the move would enable funding for non-plan areas, such as maintenance.

Government Debt Projections: Why Fiscal Adjustments?

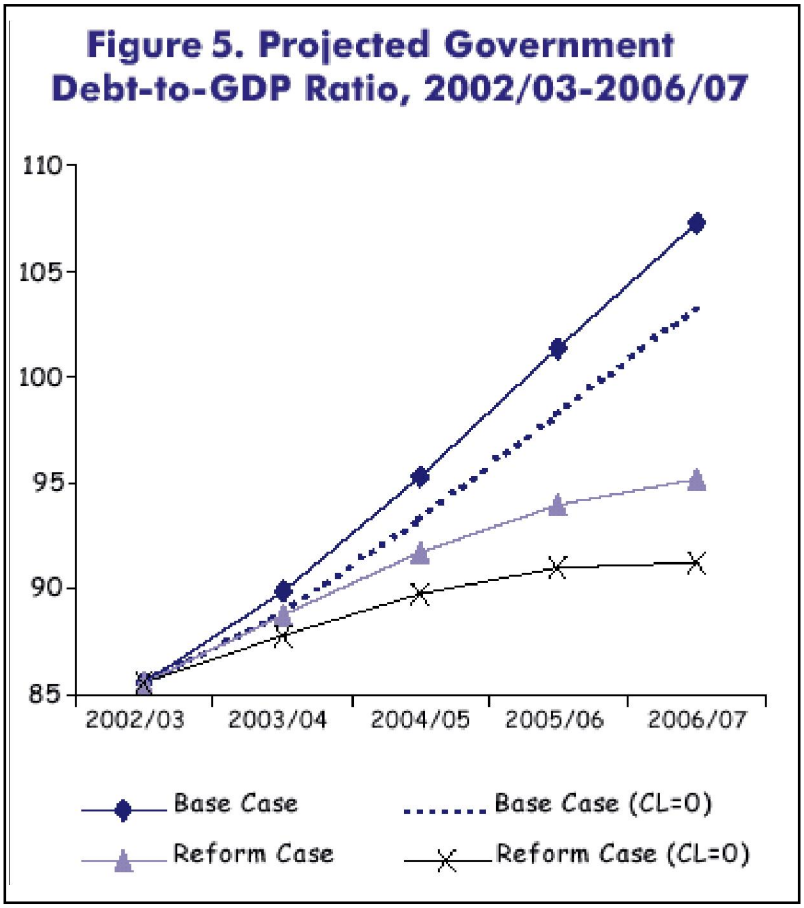
The case for fiscal adjustment is illustrated by general government debt projections to the end of the Tenth Plan period, 2006-07, under a base case scenario of "no reform" versus a "reform" scenario. In both scenarios, the debt trajectory is driven mainly by the primary (non-interest) fiscal deficit-because based on actual developments in recent years, interest rates are unlikely to be substantially below growth rates without an undesirable reversion to financial repression.

If the goal is to stabilize or reduce the debt-to-GDP ratio, generating primary fiscal surpluses is a must. So the focus of reform will have to be on cutting the primary deficit and raising growth. Moreover, it is envisaged that the cut in the primary deficit will be achieved without reducing capital expenditure. Cuts in the primary deficit will thus automatically mean cuts in the revenue deficit, improving the quality of public spending. But the net impact on the revenue deficit will also depend on the path of interest payments[8]. For fiscal measures, revenue mobilization needs to be given top priority, because revenues are low and debt is high while spending is roughly in line with other countries (*IMF, 2002*).

The major policy levers flowing out of the preceding analysis are raising tax revenues, reducing SEB losses, and eliminating the petroleum subsidy, supplemented with structural reforms to spur growth. The base case assumes that fiscal and structural reforms will proceed slowly or not at all.

In the base case, the general government debt-to-GDP ratio reaches 107% by the end of the Tenth Plan period (Figure 5). In the reform scenario, it reaches 95%. These results are being driven by the general government primary deficit, SEB losses, and the calling of guarantees-underlining the need for implementing fiscal and structural reforms.

8 The Government of India has initiated debt swaps and prepayment of external debt in order to reduce interest payments. However, these measures are unlikely to be a substitute for a fundamental fiscal adjustment.



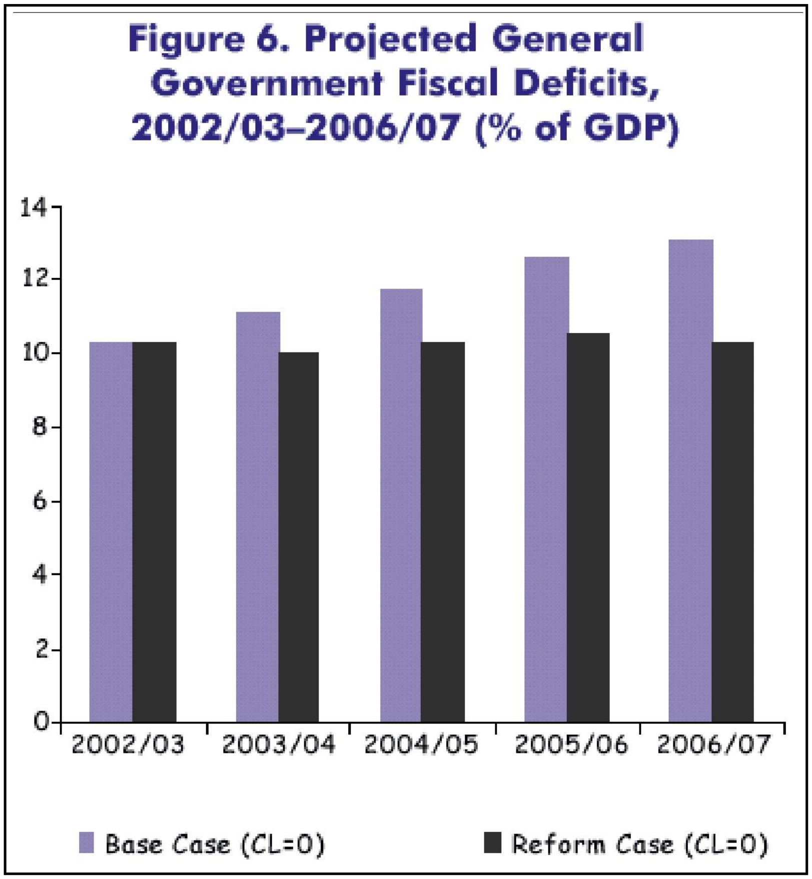
Source: *World Bank staff estimates.*

The broken lines are debt-to-GDP excluding contingent liabilities, which would lower the debt-to-GDP ratio to 103% by 2006-07 in the base case and 91% in the reform scenario. In the base case, general government fiscal deficits rise steadily to 13% of GDP, as one would expect with primary deficits at 3.5% of GDP, debt exceeding 100% of GDP, and nominal interest rates of some 10% (Figure 6). With reforms, deficits remain in the 10% of GDP range because the impact of rising interest rates as growth picks up; deficits will decline slowly as debt levels are brought under control.[9]

The only sure way to bring about a faster decline is to achieve primary fiscal surpluses. The “true” picture especially under the base case is likely to be worse than depicted unless power sector losses are aggressively eliminated.

What is the potential for a more efficient composition of public spending under reform? There is not much difference in interest payments between the two scenarios-because of the high level of initial debt, the absence of primary fiscal surpluses even in the reform scenario, and similar levels of nominal interest rates. But the reform scenario permits significantly higher “other spending” (defined as total spending minus subsidies and interest) by the end of the Tenth Plan period (Table 7).

9 The deficit projections here, which are repeated in table 7, are substantially higher than those reported in table 5 based on the macroeconomic framework for the Tenth Plan. The reason is that table 5 is formulated on the basis on either achieving debt sustainability (at a minimum) or the growth target of 8% a year (much more difficult); in this sense, it *embodies an ideal outcome.*



Source: *World Bank staff estimates.*

Table 7. Fiscal Projections, Base Case and Reform Case, 2003/04-2006/07 (% of GDP)

Item	2003/04	2004/05	2005/06	2006/07	2003/04	2004/05	2005/06	2006/07
	Base case				Reform case			
Primary deficit	3.5	3.5	3.5	3.5	2.8	2.1	1.4	0.7
Interest payments	7.6	8.3	9.1	9.6	7.2	8.1	9.1	9.6
Fiscal deficit	11.1	11.8	12.6	13.1	10.0	10.2	10.5	10.3
Revenues	17.5	17.5	17.5	17.5	18.1	18.7	19.3	19.9
Total spending	28.6	29.3	30.1	30.6	28.1	28.9	29.8	30.2
Subsidies	1.8	1.8	1.8	1.8	1.5	1.2	0.9	0.5
Other spending	19.2	19.2	19.2	19.2	19.4	19.6	19.8	20.1
Interest/revenue (%)	43.3	47.2	51.9	54.7	39.8	43.6	47.1	48.2

Source: *World Bank staff estimates.*

The increase in revenues (2.4 percentage points of GDP), the elimination of petroleum subsidy (0.4 percentage points), and the reduction in food and fertilizer subsidies (0.9 percentage points) will reduce the general government revenue deficit by close to 4 percentage points of GDP. But interest payments are projected to rise by about 3 percentage points-from 6.5% of GDP in the first year of the Tenth Plan to about 9.5% of GDP by the terminal year, 2006-07. So the net reduction in the revenue deficit will only be about 1 percentage point of GDP. But the quality of spending will have vastly improved.

Three points emerge. First, it is not going to be easy to eliminate revenue deficits by 2007-08. Further, the focus must be on raising revenues, cutting subsidies, and controlling salaries-that is, on the non interest component of the revenue deficit, because there is little or no control over interest payments. Second, even under a reform scenario, the government debt burden will continue to be heavy in the medium term. And third, without reform, the debt burden and ratio of interest payments to revenues will increase quickly, fueling inflationary expectations and eventually higher inflation. Private investment will be dampened if the private sector feels it is going to be taxed to service the debt, leading to anemic growth.

Even in a reform scenario, the general government fiscal deficit is likely to remain in the 10% range over the next few years. But with primary deficits more or less eliminated by the end of the Tenth Plan period, the deficit should later decline as debt levels and interest payments are brought under control.

The focus needs to be on tax reform and eliminating SEB losses. The reallocation of food and fertilizer subsidies-amounting to about 1% of GDP towards rural infrastructure and agricultural R&E, while maintaining 0.5% of GDP as a minimum food social safety net-will raise development spending without a negative fiscal effect.

Conclusion

Summary of Priority Reforms

- Progressively reduce the primary deficit at the center and in states by completing tax reforms (eliminating exemptions, bringing services into the tax net, and implementing a uniform state value-added tax), reducing power sector losses, and phasing out petroleum subsidies.
- Reduce financial sector risks by implementing the new securitization law, linking returns on provident funds and small savings to market benchmarks, and establishing a clear framework for managing state government guarantees.
- Improve fiscal management by imposing greater fiscal discipline on state borrowing and transfers, breaking down artificial distinctions between plan and nonplan expenditures, and consolidating centrally sponsored schemes.
- Improve the composition of public expenditures, by reducing the share spent on wages, pensions, interest payments, and agricultural subsidies, and increasing investment and operations and maintenance for priority social, infrastructure and agriculture programs.

India's large fiscal imbalances pose a serious threat to sustained growth and development over the medium term. In the short run, the risk of a speculative attack is reduced by a compliant financial system, a large pool of household savers, the limited convertibility of the current account, and a flexible exchange rate. So, in the absence of a rapid increase in interest rates and weakening growth performance, India is not vulnerable in the short term to the type of collapse suffered by Russia. But over the medium term, there are consequences to leaving the current fiscal situation unchecked.

Current policies have helped reduce external vulnerabilities, but they have also kept economic growth below potential-with growing interest payments crowding out public investment and high real interest rates constraining private investment. Slower growth, in turn, speeds up the deterioration in debt dynamics. Even though interest rates have declined over the past 18 months, public debt dynamics have continued to worsen. With interest rates can be expected to increase from the current historical lows, the growth-interest rate ratio that has prevented the current fiscal vulnerabilities from translating into a full-blown macroeconomic crisis could deteriorate.

The persistence of current fiscal trends will, at best, further limit growth and job creation. If this negative cycle continues, a full-fledged fiscal crisis cannot be ruled out over the medium term. It is easy politically to downplay this risk, hoping that higher growth and lower interest rates will eventually solve the fiscal problem. But it would be unwise to sit back and wait for such a virtuous circle to emerge. Instead, the central and state governments will have to be active in reducing the fiscal deficit, shifting expenditures to more productive areas, and removing structural impediments to higher private investment and productivity. The sooner the roadmap for these reforms is put in place, and concrete actions taken to show commitment to follow through, the more manageable will be the adjustment path, and the quicker the payoff in higher growth and reduced poverty.

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