G R O U P   O F   T W E N T Y

INDIA
SUSTAINABILITY REPORT [1]

Prepared by Staff of the

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

[1] *Report 7 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a *set* of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—indentified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified India as experiencing "moderate" or "large" fiscal and private saving imbalances. Fiscal imbalances have remained large even as trend growth has accelerated, posing medium-term risks. Yet they continue to be financed at relatively low cost, owing to the conjunction of high private saving and restrictions that channel this saving into government bonds. Fiscal adjustment and an unwinding of financial restrictions are consequently needed to reduce imbalances and sustain growth.

Fiscal imbalances reflect a weak revenue system, large spending pressures, owing in part to political economy considerations, and financial market restrictions that permit fiscal excesses to persist with little market stress.

- Rising expenditures reflect a high incidence of poverty that creates persistent pressure to increase social spending, which is difficult to resist in an era of rapid growth; coalition governments at the national level; and complex federal-state fiscal arrangements. At the same time, the resources to fund such spending are limited by a narrow tax base, low compliance, and weak collection efforts.

- There is little market pressure for adjustment, because high private saving, external capital controls, and statutory investment requirements in government securities have ensured a stable and relatively low-cost funding base.

Private saving imbalances reflect structural factors, especially rapid trend income growth.

- As growth has quickened, a growing proportion of households has vaulted above subsistence consumption levels, while a rising share of working age population has prompted life-cycle saving (e.g., for retirement) and a poorly developed health insurance system has encouraged saving for precautionary purposes.

Fiscal imbalances pose medium-term risks to stability and growth.

- A perpetuation of fiscal imbalances limits the space for deploying counter-cyclical fiscal policy or addressing contingent needs and, as evident from recent market reactions to sovereigns with unsustainable fiscal imbalances, raises the risk of higher risk premiums.

- Subjecting financial institutions to high levels of mandatory government financing crowds out lending to the private sector and distorts interest rates, making it difficult to develop the private bond market and thereby finance much needed infrastructure investment.

Consequently, to anchor strong, sustainable and balanced growth, India needs to fiscally consolidate and alleviate financial sector restrictions.

- Revenues should be raised by implementing the long-awaited goods and service tax and reforming the personal income tax code. Expenditures could be limited by scaling back fuel and other subsidies, and improving spending efficiency.

- Financial sector restrictions, including capital controls, should be wound back gradually, and insurance markets developed.

INTERNATIONAL MONETARY FUND

INDIA

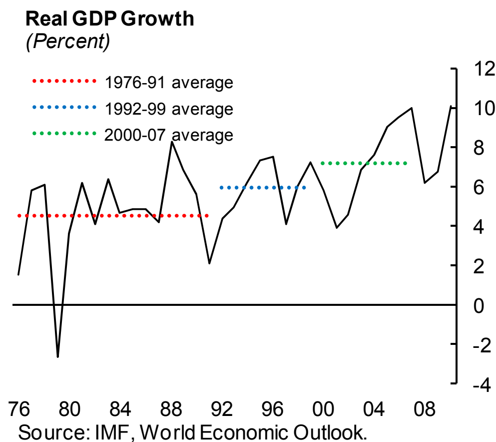
SUSTAINABILITY REPORT 2011[1]

India's fiscal imbalances have remained large despite a sustained period of high economic growth. Large budget deficits and high public debt can be traced to a political economy that exerts strong pressure on spending, a weak revenue system, and financial restrictions that permit weak fiscal balances to persist with little market stress. At the same time, high growth and favorable demographics have caused private saving to surge. The perpetuation of fiscal imbalances poses risks for macroeconomic stability, as evident from recent developments in major advanced economies, and may serve as an impediment to India's fundamental objective of sustaining high growth. Highly favorable growth-interest differentials, which have periodically helped restrain a rise in the gross debt ratio, are unlikely to persist indefinitely. So, fiscal adjustment is needed to reduce imbalances and sustain growth, through a combination of revenue reforms, a change in the size and composition of expenditures, and alleviating financial distortions.

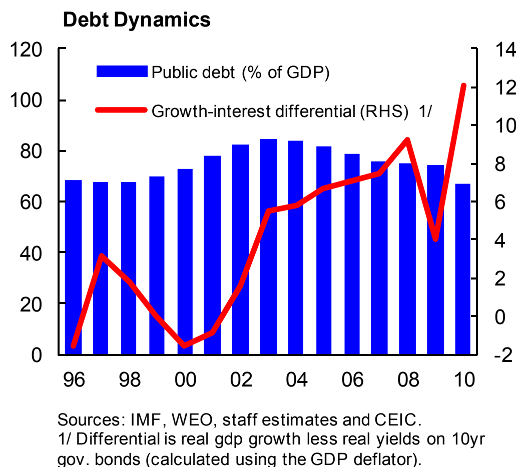
I. BACKGROUND

1. **Widespread economic reforms following an external crisis in 1991 ushered in an era of impressive growth in India.** Widening fiscal and external deficits came to the fore in 1991 when a rapid deterioration in public finances, coupled with an oil price shock and heightened political uncertainty, resulted in a classic balance of payments crisis. The post-crisis adjustment, which included a wide spectrum of fiscal, financial sector and capital account reforms aimed at reducing government control, decreasing the pervasiveness of the "license raj" and providing a larger role for market forces, raised the potential for higher growth. Real output growth, which had averaged an annual rate of 4½ percent in 1976–1991, rose to an annual average of 6 percent in 1992–99. Growth then edged higher, to an average 7.2 percent between 2000 and the run up to the global financial crisis. The crisis only modestly slowed this momentum, as output continued to grow in excess of 6 percent each year in 2008–2010.

[1] Prepared by Mitali Das under the guidance of Josh Felman, with input from Michal Andrle and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.



2. **Despite highly favorable growth-interest differentials, fiscal imbalances have remained large**. General government deficits averaged 7.7 percent of GDP



between 1992 and 2007. Primary deficits were lower, averaging 2.4 percent, but large enough to result in a steady increase in the gross public debt ratio over 1995–2003, which rose over 14 percentage points, peaking at 84.3 percent in 2003. A sustained consolidation effort, including the adoption of fiscal rules in 2003, put fiscal positions on the mend in the years preceding the crisis. But fiscal imbalances deteriorated again with the onset of the crisis.

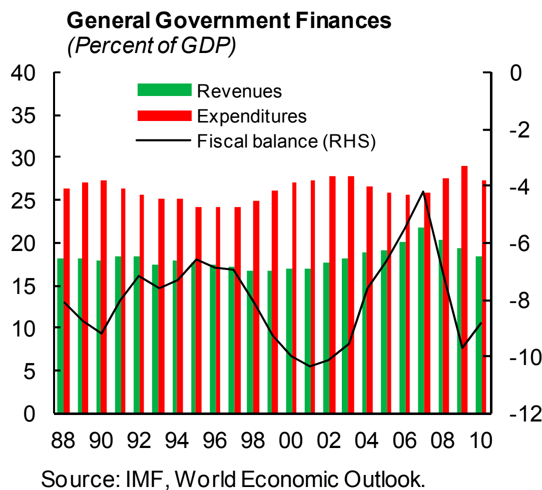
- *After a modest improvement for a few years following the 1991 crisis, fiscal positions worsened through the early 2000s*. The revenue share of GDP stayed broadly flat over the 1990s, while the expenditure share was on a mild upward trend. Thereafter, despite significant improvement in revenue collections, which rose some 2.1 percentage points of GDP in 1998–2004, expenditures rose nearly in parallel. This occurred in part due to rising interest payments and in part due to unrelenting increases in subsidies, wages, pension payments and defense spending.

- *A strong effort at fiscal tightening then helped lower deficits and the debt ratio*. The government passed the Fiscal Responsibility and Budget Management Act (FRBMA) in 2003. Following this, public debt receded nearly 10 percentage points between 2004 and 2008, to 74.7 percent of GDP in 2008, assisted by a brief surplus in the primary balance and sizable growth-interest differentials.

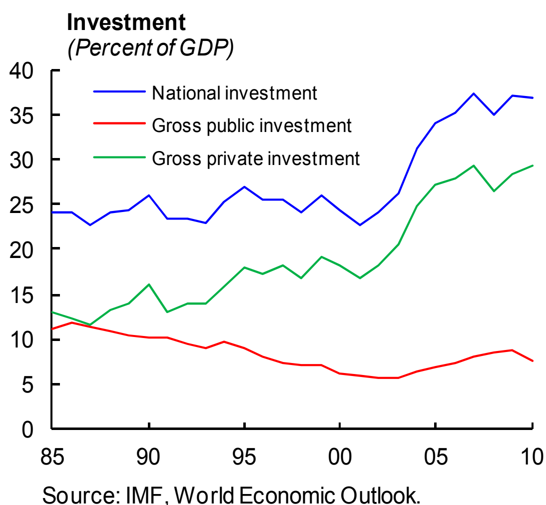
- *Progress with deficit reduction reversed following the global financial crisis*. A combination of spending measures introduced prior to the crisis, a soaring subsidy bill, a large fiscal stimulus and a cyclical downturn in revenues widened the overall deficit from 4.2 percent of GDP in 2007 to over 9 percent in 2009. However, a spike in the growth-interest differential, reflecting the swift recovery and low real interest rates, helped keep the growth of public debt in check,

which fell to 67.3 percent in 2010, remaining, however, highest among the G-20 emerging economies.

3. **Large public dissaving and high investment needs have kept the external position in modest deficit despite a secular increase in private saving.** In particular, national saving and national investment have evolved on parallel trajectories, each only modestly rising

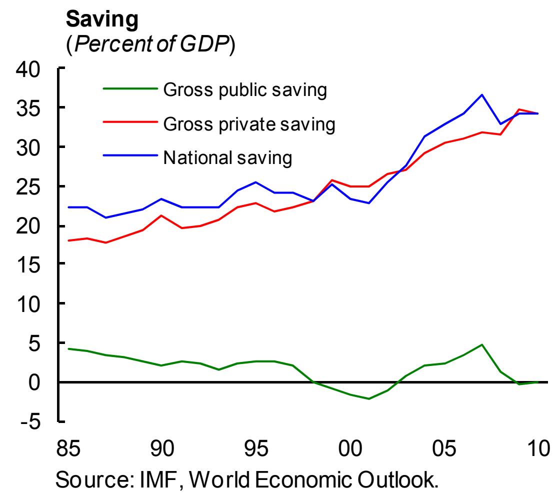


Source: IMF, World Economic Outlook.



Source: IMF, World Economic Outlook.

between 1985 and the late 1990's, before escalating sharply through 2009. Trends in national saving and investment have been driven overwhelmingly by private sector behavior.



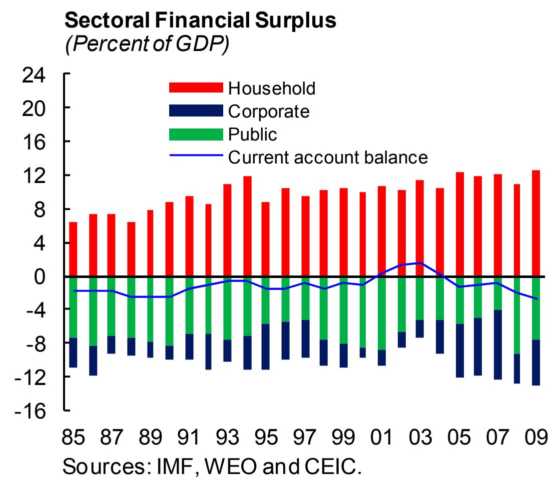
Source: IMF, World Economic Outlook.

- *Private sector investment boomed following the economic reforms of the 1990s*, while public sector investment went through a steep decline (over 4 percentage points of GDP in 1991–01), particularly in much-needed infrastructure investment, spurred by the government's early efforts in deficit reduction. Public sector capital expenditures rose modestly in 2001–09, but have played a negligible role in the dramatic rise in national investment. Although private gross investment is relatively high,[2] private sector participation in the critical area of infrastructure development has been disappointing in the past, owing to a combination of limited financial sector

[2] India's private investment rate is the highest among emerging G-20 economies (and other economies at a similar level of per capita income). Among emerging G-20 economies, India's national investment rate is second to China's.

deepening, capital controls and governance problems.[3]

- *The surge in private saving has been led by the household sector*. An era of high income growth combined with the life-cycle implications of a rising working-age population has resulted in a rapid increase in household saving rates, which rose 10 percentage points as a share of GDP, to 24 percent, between 1991 and 2009. Corporate gross savings rose as well, about 5 percentage points in this period, reflecting improved profitability since the 1990s financial reforms. Corporate *excess* saving (gross corporate saving less corporate investment), though, remained negative, as private investment boomed. At 34 percent of GDP in 2010, India's private saving rate was second to China among G-20 economies.



4. **Risks of a perpetuation of imbalances over the medium-term are high**. With growth projected to remain robust and the government's announced commitment toward fiscal consolidation, staff's baseline projection is for the public debt ratio to fall 5 percentage points between 2010 and 2015, to 62 percent, in line with authorities' targets. However, risks to this forecast are high, stemming from pressures for social spending and infrastructure investment, inertia in withdrawing fiscal stimulus and continued delays in planned tax reforms. Staff projects that high growth and favorable demographics will push private saving rates higher in the medium-term, to 37 percent of GDP, by 2015.

5. **The remaining sections of the report will explore the root causes of imbalances, discuss their implications from the domestic and multilateral perspective and outline policy recommendations to address them**.

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[3] However, during the first half of the 11th Five-Year Plan (2007–12), private sector participation in infrastructure investment has exceeded Plan projections.

II. Root Causes of Key Imbalances

G-20 indicative guidelines identified India as experiencing "moderate" or "large" fiscal and private saving imbalances. Root causes of fiscal imbalances can be traced to political economy factors that exert strong pressure on spending and resistance to raising taxes, a weak revenue system, and government regulations that permit fiscal excesses to be financed with little market stress. Rapid growth and favorable demographics underlie private saving imbalances, while missing insurance markets also play a role.

A. Fiscal Imbalances

6. **The rising share of expenditure in GDP through the late 1990s and early 2000s, then again in the years before the global financial crisis, without a commensurate increase in the revenue share of GDP reflects the failure of the government to take advantage of a sustained boom to build fiscal space**. On the expenditure side, major factors include large outlays on subsidies, including because of a high incidence of poverty, a succession of coalition governments and federal-state fiscal arrangements. The key factor on the revenue side is a complex and outdated tax code. High private saving, capital controls, and statutory purchase of government securities by financial institutions combine to provide stable and relatively low-cost financing for public debt.

What lies behind rising expenditures?

7. **The benefits of greater economic prosperity have accrued unevenly, resulting in persistent pressure to increase government social spending**. India's social indicators compare unfavorably regionally as well as with other G-20 emerging economies. In particular, while poverty rates have declined over the last two decades, the World Bank estimates that 42 percent of the population (410 million individuals) remained impoverished as of 2005.[4] As a consequence, political pressure for increasing social spending and subsidizing commodities (notably, fuel and food) is persistent. Subsidy spending accounted for 2.1 percent of GDP in 2009, almost as much as expenditures on all of health and rural development. Meanwhile, the expansion of safety nets in recent years has resulted in

India's Social Indicators: G-20 Emerging Economies Perspective

	Poverty 1/	Malnutrition 2/	Employment 3/
Argentina	0.87	2.3	56.5
Brazil	3.8	2.2	63.9
China	15.92	4.5	71.0
India	**41.64**	**43.5**	**55.6**
Indonesia	19.73	3.4	61.8
Mexico	3.44	5.3	57.1
Russia	0	n.a.	56.7
Saudi Arabia	n.a.	5.3	47.2
Africa	17.35	n.a.	41.1
Turkey	2.72	n.a.	42.3

Source: World Bank.
1/ Percent of population earning less than $1.25 a day at PPP.
2/ Percent of children malnourished, weight for age (under 5 years).
3/ Percent of population aged 15+.

[4] Using a World Bank indicator of poverty: headcount of persons (percent of population) earning less than $1.25 a day at PPP.

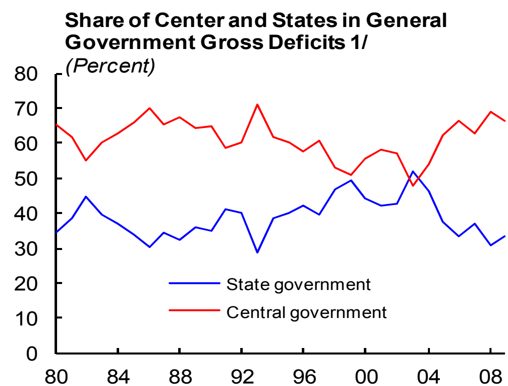
steady ascension of non-subsidy social expenditures as well, which accounted for 3.1 percent of GDP in 2009.

- *Rising expenditures are partly a result of an era of coalition governments*. Since the mid-1990s, as regional parties with diverse regional interests have strengthened, the central government has had to depend on coalitions of as many as sixteen distinct political parties to stay in power. Catering to a wide range of ideologies and constituencies has necessitated fiscal forbearance and made it politically more difficult to withdraw or reform populist schemes such as subsidized commodities and cheap electric power, which have often been poorly targeted.

- *Widening the scope of social assistance is an important step in improving human welfare*, but efficiency of implementation has been low, resulting in large leakages and denial of benefits to eligible persons.[5] This has reflected the absence of a system of unique identification or national registers (that is only now being gradually implemented), and poor enforcement.

8. **The federal-state tax and spending structure has made it difficult to enforce fiscal discipline**. Under India's fiscal federalism, about two-thirds of tax revenue is collected by the central government while states are tasked with carrying out a similar proportion of general government expenditures—using tax-sharing and transfers from the central government—to implement government policies.[6] With implicit central government guarantees on state government debt, the system offers a high degree of autonomy to states and, in the past, few incentives to maintain fiscal restraint (since the mid-2000s, a majority of states have adopted their own fiscal responsibility rules).

- *During the 1990s, deteriorating general government balances reflected rising fiscal excesses at the state level*. In particular, the trend decline in central tax collection over the 1990s led to a reduction in transfers to states. However, states not only failed to raise



[5] Comptroller and Auditor General of India (2008).

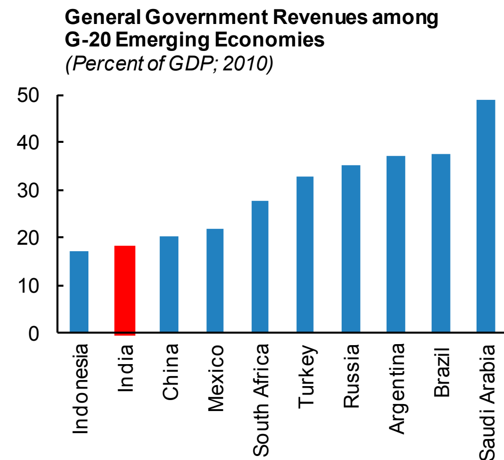
[6] The share of states in central government revenues changes over time. It is set by the Finance Commission, a constitutional body, which meets every five years with the primary purpose of determining the sharing of centrally collected tax proceeds between the central and state governments, and the distribution of grants-in-aid of revenue across states.

their own revenues, but retained a high level of spending.[7] Consequently, their contribution to the general government deficit rose from 35 percent in 1992 to nearly 50 percent in 1999.

- *Differences in tax collection responsibilities partially explain the varying evolutions of their fiscal deficits.* The central government is assigned tax collection from customs and excise duties, from which it draws its largest share of revenues, while states collect taxes on commodities and services, which constitutes the preponderance of state revenues. This system has meant that both the economic cycle and structural changes (e.g., in demand for commodities) have played a role in determining the evolution of central versus state government deficits.

Revenue mobilization is low

9. **A narrow tax base, poor compliance and weak collection efforts have eroded tax revenues**. A comparison of general government revenues across emerging G-20 economies indicates that India (with a 2010 revenue share of GDP equal to 18.5 percent) is at the bottom end in revenue collection.[8] In part, this reflects the low buoyancy of the tax system, which is narrowly based on indirect taxes and manufacturing activity, with agriculture and the rapidly growing service sector largely outside the tax net. It also reflects weak enforcement, extensive loopholes, and political resistance to raising taxes in a still-poor economy.



Source: IMF, World Economic Outlook.

10. **Incomplete tax reforms after the external payments crisis contributed to declining revenues over the course of the 1990s**. Revenue collection dropped by 1.6 percentage points of GDP in 1992–99, even as household and corporate incomes surged. In part, this reflected the impact of trade and financial liberalization reforms, which narrowed the tax base by cutting trade tax rates and customs duties, but without (planned but not implemented) compensating hikes in direct taxes and measures to reduce exemptions and loopholes.

11. **Income tax revenues have been stagnant due to constant adaptation of exemption levels and income brackets**. Despite a highly progressive income tax code, and private nominal incomes that

[7] Both central and state budget deficits rose in part due the large wage increases recommended by the Fifth Pay Commission.

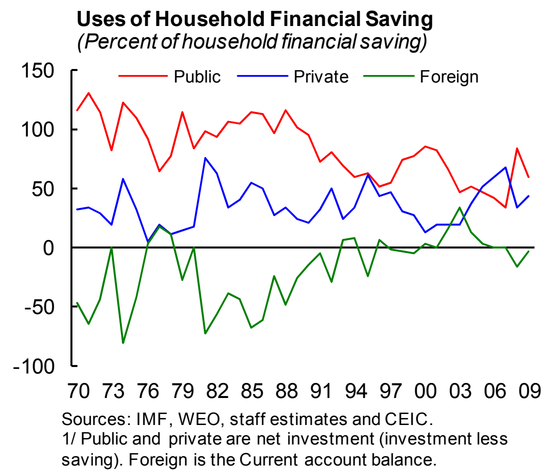
[8] India's revenue share of GDP fell in the lower third of the distribution each year of 2007–10, among economies whose nominal US dollar GDP per capita was between \$648 and \$1488 in those years.

escalated seven-fold in 1991–2008, the share of personal income tax revenues in GDP has remained very low in this time period, exceeding no more than 3.6 percent of GDP.[9] While any explanation must include low compliance, political economy has played a significant role. In particular, the tax schedule has been changed repeatedly in this time period, with continuous increases in exemption thresholds and income brackets.[10] Notably, the rise in thresholds in this period has been almost as large as the rise in nominal income growth itself. As a result, the population subject to income tax has risen modestly, from about 1 percent in 1991 to 3 percent in 2008. [11] This is a reflection of strong political resistance to taxation given the still-high incidence of poverty, and the ineffectiveness of tax policy given the very large share of informal workers.

Financial controls and fiscal imbalances

12. **High private saving, capital controls and statutory requirements for investing in government securities have permitted fiscal deficits to be financed without discernible market stress**. Major financial sector reforms since the 1990s notwithstanding, the government's statutory liquidity ratio (SLR) currently requires banks to hold one-fourth of their deposits in the form of government or other approved securities,[12] while insurance and provident funds are also subject to similar investment regulations. In combination with capital controls and an increasingly large pool of household saving, this system has provided a stable and relatively low-cost source of funds for financing government debt. Indeed, in 2001–07, on average, 50 percent of household saving was used to finance fiscal deficits. Moreover, regulatory requirements that direct private sector resources toward the purchase of government securities have hindered development of the corporate debt market.

Uses of Household Financial Saving
(Percent of household financial saving)



Sources: IMF, WEO, staff estimates and CEIC.
1/ Public and private are net investment (investment less saving). Foreign is the Current account balance.

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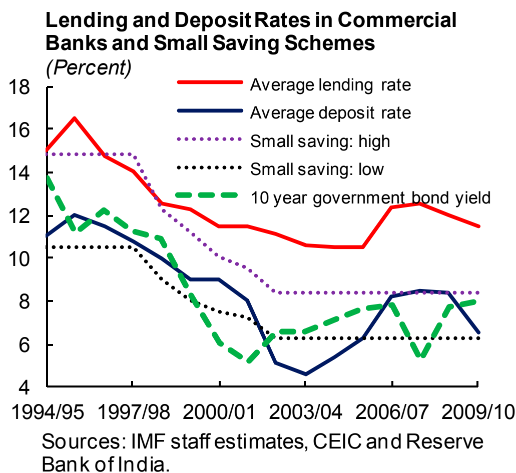
[9] Staff estimates using data from WEO and CEIC, calculated as the ratio of direct taxes paid by households and miscellaneous receipts of government to GDP.

[10] Piketty and Qian (2009).

[11] Piketty and Qian (2009).

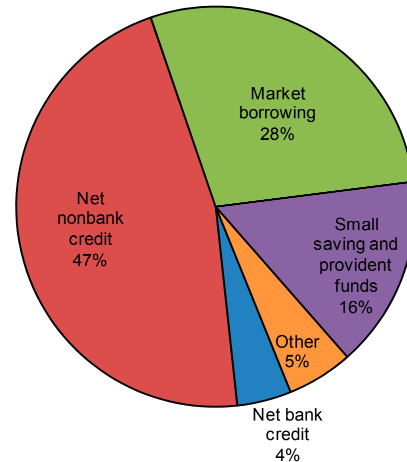
[12] As part of the reforms in the financial sector in the 1990s, the SLR was progressively reduced from 38.5 percent in 1991 percent to 25 percent in 1995. In December 2010 it was lowered to 24 percent.

13. **High administered interest rates on small saving schemes have reinforced the effects of statutory requirements on banks**. Small saving schemes are government-operated deposits, in post offices and provident funds, which are used exclusively to finance government debt. These schemes drew about 21 percent of aggregate bank deposits in 2000–08 and provided an average 16 percent of funding for government debt in this period.[13] The need to ensure adequate resources to finance the government's large borrowing has kept (administratively set) interest rates on these schemes high.[14]



Sources: IMF staff estimates, CEIC and Reserve Bank of India.

14. **High interest rates on small saving schemes have distorted lending and borrowing behavior in the banking sector**. In effect, they force banks to keep their deposit rates high and thus, lending rates high as well. For borrowers, this has served to dampen credit demand, particularly for SMEs, who have few financing options beyond bank credit.



Source: CEIC.

15. **SLRs and high administered rates on small savings, in conjunction with inadequate improvement in the financial sector's risk assessment framework, have resulted in perpetuating distortive financial restrictions**. In particular, while economic reforms in the 1990s raised competition, they also raised the risks of lending, without an accompanying increase in banks' capacity to evaluate or handle these risks.[15] As a result, in periods of high administered (and consequently, high bank lending and deposit) rates, investment in government securities has provided a relatively attractive and less risky

[13] Public sector debt to foreign creditors peaked at 37 percent of GDP during the external payments crisis, declined thereafter and is virtually absent at the current time. The only external debt the public sector has currently is to multilateral institutions.

[14] In the pie chart above, market borrowing refers to bank bond purchase under the SLR.

[15] See Banerjee and Duflo (2002); and Singh and Srinivasan (2005).

alternative than providing credit to the private sector, given the lack of opportunities for investing in corporate bonds and external capital controls that limit investment abroad.[16] As a consequence, while the 1990s reforms reduced the SLR from nearly 40 percent to 25 percent, banks' investment in government securities has since systematically surpassed these requirements, notably in long-maturity government bonds.[17] This confluence of distortions created by the SLR and high administered rates, along with very gradual improvement in banks' regulatory framework, has contributed to sustained periods of "lazy banking", reducing banks' role in financial intermediation. In addition, it has raised interest rate risk due to a significant maturity mismatch in banks' balance sheets.

Commercial Banks' Holding of Securities
(Percent of deposits)

	Government Securities	Other Securities
1996-99	32.6	5.6
2000-05	39.1	2.1
2006-07	32.1	0.6
2008-10	30.9	0.2

Source: CEIC.

B. Private Saving Imbalances

16. **The surge in household saving reflects the dramatic rise in disposable incomes and a rise in the working-age ratio**. Household saving rates in India have been on the rise for over four decades, increasing steadily from 9 percent of GDP in 1970 to nearly 24 percent in 2009.[18]

- *High growth has boosted household incomes beyond subsistence consumption levels*. Indeed, personal disposable income nearly tripled in real terms in 1991–2008, resulting in higher household saving ratios, as many households surpassed their subsistence levels of consumption. As a result, the real private consumption share of real GDP has been in steady decline, falling from 69 percent in 1991 to 59 percent in 2010. Even so, real private

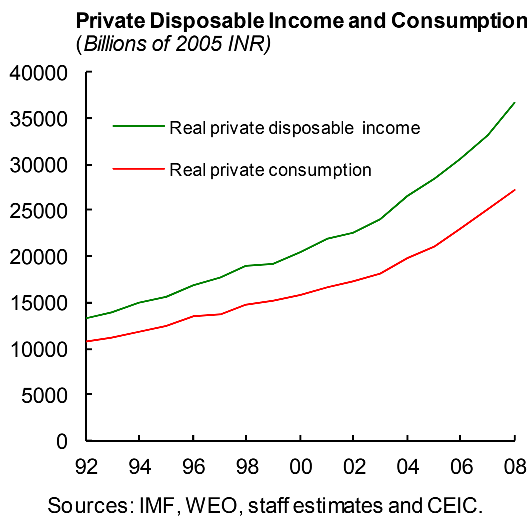
[16] Investment in government securities also has the added advantage of having low risk rating in meeting capital adequacy requirements.

[17] In part, some excess holding of government securities could be due to banks' liquidity needs given that the SLR cannot be used to obtain liquidity from the Reserve Bank of India. More recently, holdings above the SLRs could be due to an upward shift in the yield curve, which may have discouraged banks from unwinding such holdings as that would have resulted in losses being crystallized. However, these are unlikely to be a complete explanation given that banks have held as much as 40 percent of deposits in government securities, including in periods (e.g., 2003) when bond yields remained largely flat.

[18] Staff's analysis suggests that demographic, socio-economic and macroeconomic variables partially explain India's high private saving rate (IMF, 2010). These empirical estimates do not explicitly take into account whether the lack of insurance affects private saving.

consumption grew at a robust annual rate of 6 percent during this period.

- *A significant rise in the working-age dependency ratio has contributed to high saving rates*. India is in the midst of a demographic transition that has lifted the share of the working-age population from 58 percent to 64 percent over the last two decades. The observed rise in household savings thus conforms to the predictions of the life-cycle hypothesis.



Sources: IMF, WEO, staff estimates and CEIC.

- *Inadequacy of insurance vehicles and limited access to credit have played a role in the accumulation of household savings*. Households and SMEs face barriers in obtaining credit, which has contributed to the high rate of saving. Moreover, a poorly developed and state-dominated system of life insurance, a nascent private health insurance industry, combined with little scope for provident savings for informal workers, forces households to save. However, as these factors have been in place for decades, they are not an explanation for the sudden escalation in household saving rates.

- *Corporate savings have also played a role in the growth of private saving rates*. Corporate saving rates languished between 1½–2½ percent of GDP in 1970–1990, and then rose modestly in the 1990s. It was only in the early 2000s that corporate savings rose much more sharply, from 4.5 percent in 2003 to a peak of 9.5 percent prior to the global financial crisis. This occurred primarily due to significant restructuring of corporate balance sheets in the early 2000s.

III. ARE INDIA'S IMBALANCES A PROBLEM?

Large fiscal imbalances pose risks to macroeconomic stability and domestic growth objectives, perpetuate financial restrictions that create distortions and restrain development of the financial sector. The primary effects of fiscal imbalances fall on India, although a collapse in India's growth would slow the global economy, and a sudden stop in capital inflows could create financial disruptions for other economies

A. Financial Sector and Growth Implications

17. **Perpetuation of financial sector investment restrictions will pose a significant constraint on realizing India's development potential**. Subjecting domestic financial institutions (banks, insurance and provident funds) to punitive regulatory requirements, and distorting credit markets by setting deposit rates that do not necessarily reflect market conditions, distorts the allocation of private saving, crowds out private investment and potentially lowers growth.[19]

- *Financial restriction on asset purchases will limit financial deepening and restrain much-needed infrastructure investment.* Mandated purchase of government securities has curtailed the availability of domestic credit for the private sector and restrained development of a corporate bond market. Although caps on foreign purchases of domestic bonds have increased substantially in recent years, foreign participation has seen limited uptake, reflecting minimum maturity requirements, unfavorable tax treatment, as well as lock-in periods.

- *Firms have been forced to borrow from commercial banks at adjustable rates,* or long-term in foreign currency, to fund investment projects, which has raised exposure to currency and interest rate risk. Given segmentation in credit markets, credit constraints have been particularly acute for SMEs. Aside from the usual crowding out of private investment due to large public dissaving, policy-induced distortions in lending and borrowing rates have also served to reduce credit for the private sector.

- *With large infrastructure needs, and limited fiscal space, India's 11th Plan has called for higher private sector involvement in much-needed infrastructure investment*. The long-term nature of these projects has, however, laid bare the impediments in meeting these goals. A particular concern for the bank-dominated financial system is the risk of large maturity mismatches, while capital controls have limited foreign financing. Coupled with deep structural rigidities, including governance problems and implementation risks, envisaged

[19] The positive effects on growth from unwinding investment restrictions could potentially involve some trade-offs. In particular, it could affect fiscal dynamics by raising the growth-adjusted effective interest rate paid on government debt.

participation of the private sector in this critical sphere of development could again fall short of targets.

- *Capital account restrictions*: Capital controls, instituted with a view toward minimizing exchange rate risk and preserving macroeconomic stability, have hindered firms' access to foreign saving at competitive prices. If capital account restrictions were gradually eased, there could be further efficiency gains in financial intermediation and greater availability of credit for domestic entities.[20]

B. Implications for Macroeconomic Stability

18. **Fiscal consolidation will help maintain macroeconomic stability, create policy space for contingent needs and limit vulnerability to external shocks.** As evident from recent developments in major advanced economies, market sentiment toward sovereigns with large fiscal imbalances can shift abruptly, resulting in higher risk premiums and adverse debt dynamics.

- *Narrowing of the growth-interest differential*. Public debt has grown even as growth-interest differentials have been large and positive. In part, this is because a number of factors have kept the cost of government borrowing low, including the captive base for government securities and capital controls. But the large differential is unlikely to persist, especially if integration with global financial markets continues to increase and SLR requirements on domestic financial institutions ease. Independently, a protracted growth shock could set public debt on a potentially unstable path.

- *Reconstituting fiscal space*: A perpetuation of fiscal imbalances limits the space for counter-cyclical policies when needed, and raises the risk of a higher risk premium on debt over the medium term. Interest payments currently absorb 25 percent of total revenues, and could become explosive if yields were to rise.

- *External balance*: Higher public and private sector investment, notably in infrastructure projects, and lower private saving (to the extent that household saving reflects the lack of social insurance) are both desirable. To minimize pressure on the current account, these shifts in national investment and private saving must be offset by smaller government budget deficits.

[20] Since the 1990s, capital controls have been gradually liberalized, and remaining restrictions are focused on areas such as foreign purchases of Indian bonds and resident outflows. The full removal of capital controls must, however, be mindful of the risks involved, including a possible increase in domestic interest rates (if Indian financial intermediaries decide to move assets abroad), as well as higher volatility of interest rates which could be damaging for growth. Furthermore, as capital controls strengthened India's resilience to potentially destabilizing outflows during the recent crisis, authorities must retain sufficient flexibility to put them in place if circumstances dictate doing so.

IV. ADDRESSING IMBALANCES

To address imbalances and sustain high growth, India must embark on fiscal consolidation, while increasing public investment in much-needed infrastructure projects. The plan to bring the general government deficit down to 5.5 percent by 2015, anchored by a broad-based consumption tax, is an appropriate objective; the key will be implementation. Relaxing investment restrictions on financial institutions would create a favorable environment for increasing private sector participation in infrastructure development. To the extent that high private saving reflects the lack of social insurance, safety nets could be strengthened.

A. Tax Reforms

19. **Given the projected and necessary increase in public infrastructure investment, and pressing social needs, tax reforms are critical for fiscal adjustment**. Over-performance of public finances during the current expansion will help reconstitute fiscal space. Although revenue growth has been relatively strong in the recovery, there is further scope to widen the tax base, streamline collection and improve compliance. A key challenge of current tax proposals is in surmounting the political economy of shifting tax collections from the centre to the state, given the increasing relative power of the states.

- *A nationwide Goods and Services Tax (GST) will simplify the tax system, widen the tax base and increase revenues in the long run*. The government has recommended implementing a GST as a value-added tax.[21] This tax would replace India's web of state- and national-level excise, sales and value-added taxes with a unified consumption-tax framework, and draw in the entire consumption base by taxing imports while excluding exports. Although this reform has been designed to be revenue neutral, the replacement of India's current system with the more streamlined GST is likely to raise compliance and hence revenues.

- *Reform of the personal and corporate income tax code is long overdue*. The scope of the government's proposal for a new Direct Tax Code (DTC), which has provisions to limit deductions and widen the tax base, could be expanded. Although the DTC is planned as revenue-neutral, implementation of the DTC in combination with the GST will likely be growth-enhancing due to reduced distortions.

[21] The proposal is that the central government will tax goods at 10 percent, services at 8 percent and (continued) essentials at 6 percent, with the recommendation that states add identical rates. That is, the total rate on goods will be 20 percent.

- *Raising tax compliance and improving enforcement could significantly raise tax revenues.* That less than 5 percent of the population pays income tax even as the ranks of the middle class have swelled is indicative of room to raise income tax revenues by increasing compliance. Accelerating the development of a National Population Register, thus far discussed in context of better targeting subsidies to the poor (see below), could vastly improve tax collections.

- *Finally, more ambitious revenue-raising reforms should also be considered.* For example, collections from the top income brackets (where the rate is currently 30.9 percent) could be raised, possibly by reversing the recent reduction of the highest income tax bracket. Given the scope for tax arbitrage if personal income tax rates are raised and corporate tax rates are reduced, any reform of the tax code must take into account the full impact of a tax revision on raising revenue.

B. Spending Reforms

20. **Greater spending efficiency of government programs is key to square the stated consolidation objectives with high social and infrastructure needs**. Policy priorities are to shift government funds from non-essential expenditure toward infrastructure development, better allocate funds for subsidies, improve targeting, and increase the use of performance-based incentives to improve spending efficiency. Other reforms, such as land reforms and reducing red tape, while improving governance and policy predictability, are also critical for infrastructure development.

21. **There is significant potential for subsidy reforms to reduce costs and improve social outcomes**. Major subsidies, notably on fuel products, impose a high cost on the government budget, are poorly targeted (and mostly regressive) and present opportunities for arbitrage. Recent subsidy reforms, including liberalization of petrol prices, are a step in the right direction. Additional reforms include replacement of some subsidies with targeted support (e.g. cash vouchers), and accelerating development of the National Population Register and Unique Identification number (UID) to help target subsidies more effectively.

22. **The planned expansion of social spending must be undertaken with a view toward increased efficiency of implementation**. Given the country's pressing social needs, plans to expand education and employment programs are necessary to achieve inclusive growth. Furthermore, steps could be taken to ensure that the food security bill currently being discussed, which proposes to provide subsidized rice or wheat to eligible households, is affordable and well-targeted. To reconcile expansion of social programs with planned fiscal consolidation, it is critical to improve spending efficiency (e.g. by making greater use of performance-based incentives) since, without such gains, targets in the

FRBMA could only be met by tightly constraining public investment, which would undermine growth.

C. Strengthening Fiscal Accountability

23. **The commitment to fiscal consolidation made in the 2011/12 budget as well as the Government Debt Report (GDR) has improved transparency and strengthened India's medium-term budget framework**. Authorities could also provide details quantifying how they envisage fitting rising capital and social expenditures into a budget envelope that declines as a share of GDP. To minimize the risk of reversals in consolidation, amending the FRBMA as the TFC recommended, including by tightening escape clauses and introducing a fiscal oversight committee, will be crucial.

D. Financial Sector Reforms

24. **Ensuring more efficient intermediation of domestic savings will require a concerted effort toward financial sector reforms**. Gradually reducing the SLR will not only free up funds for private borrowing but will also allow government bond interest rates to become truly market determined. Then, government rates can become true benchmarks, paving the way for the development of the corporate bond market. At the same time, steps should be taken to boost bond market liquidity and develop securitization and hedging instruments both to ensure sufficient long-term rupee debt resources for domestic investment needs, and to help banks manage their liquidity and concentration risks.[22] Meanwhile, continued reduction of the SLR and opening of the financial sector would provide government the incentive to adjust by narrowing its base of captive finance.

E. Strengthening Social Safety Nets

25. **Development of a health insurance industry will aid in reducing households' precautionary saving**. Studies indicate that Indian households' financial burden from health spending is significant.[23] Over 70 percent of all health spending is out-of-pocket, [24] and the 2004 National Sample Survey revealed that about 6 percent of families became impoverished due to health expenses. A slowly growing private health care industry is largely unregulated and costly for most, and only 20 percent of the population has any form of health insurance. Steps must be taken to expand hospitalization insurance, including by government-NGO partnership, to improve access to healthcare, minimize out of pocket expenses and reduce the precautionary basis for household saving.

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[22] Steps taken to reduce statutory requirements on purchase of government securities must be mindful that banks continue to abide by international best practice (i.e. Basel liquidity standards).

[23] Balarajan, Selvaraj and Subramaniam (2011).

[24] USAID (2008).

F. Toward an Upside Scenario

26. **Strengthened policy actions should consider fiscal consolidation along with removing distortive financial restrictions**. Fiscal adjustment—improving the government's budget deficit by 2.3 percent of GDP (relative to the WEO baseline) after five years—would be in accordance with the Thirteenth Finance Commission's medium-term plans. Fiscal adjustment scenarios would rely primarily on revenue-raising measures. Reduced SLR requirements on banks would free resources for the private sector, reducing their real cost of capital and thereby boosting investment. For the government, liberalizing financial controls would entail higher interest rates (larger debt service) which would be offset by higher VAT and labor income tax revenues. Specific reforms would include

- *An increase in the GST*. To minimize tax distortions, higher tax revenues via an increase in consumption tax/GST, which is very low in international comparative perspective.

- *An increase in labor income taxes*. Raising the GST may not suffice to reduce the budget deficit to target levels, in which case remaining revenues would come from increase in labor income taxes.

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