PRS LEGISLATIVE RESEARCH

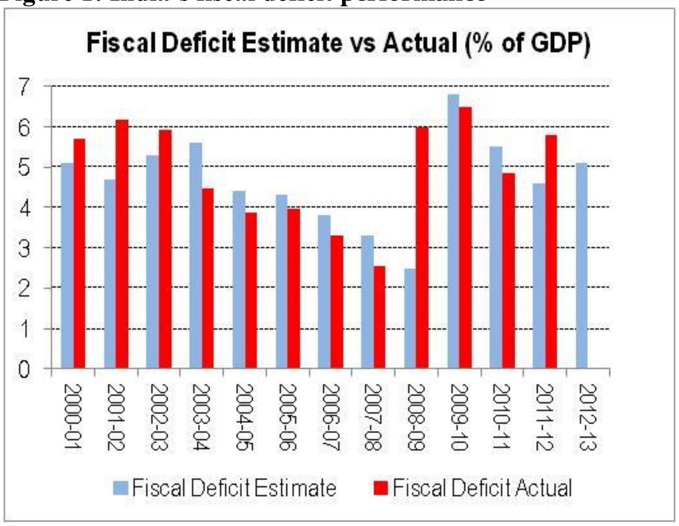
Report Summary
Roadmap for Fiscal Consolidation

- In August 2012, the Finance Minister constituted a committee under the chairmanship of Dr Vijay Kelkar to outline a roadmap for fiscal consolidation. The committee was asked to recommend mid-term corrections for the current fiscal year (2012-13) and reforms for medium term fiscal consolidation.

Need for fiscal consolidation

- According to the committee, the Indian economy stands at the edge of a 'fiscal precipice' making fiscal consolidation imperative. India's fiscal deficit, the excess of government expenditure over receipts, is forecasted to expand to 6.1% of GDP, higher than the budget estimate of 5.1%.

Figure 1: India's fiscal deficit performance



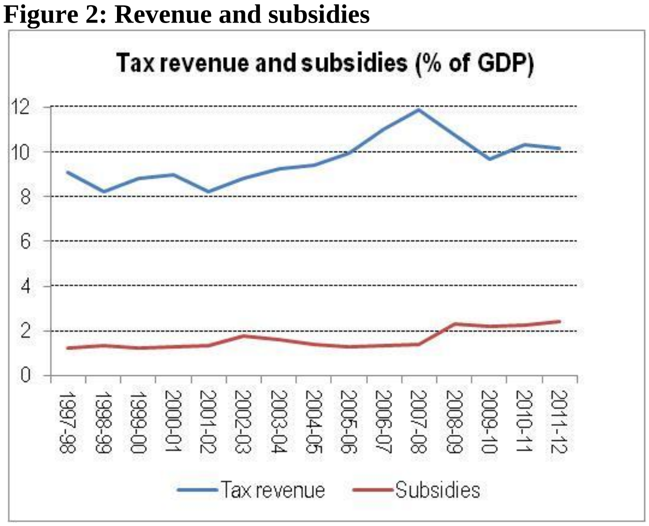
Source: Union budget documents; PRS

- A high fiscal deficit can be problematic for many reasons: inflation could increase; monetary policy expansion may be constrained; external sector imbalances could widen; and investment, growth and employment could all weaken. In addition, high fiscal deficits might reduce investor confidence in India.
- The report highlights India's fiscal consolidation from 2002-03 to 2007-08 and suggests that fiscal discipline positively affected other economic variables like inflation and investment. The committee points to India's current investment decline, weak Index of Industrial Production and widening current account deficit as signs of a deepening fiscal crisis.
- The committee is particularly concerned about the financial health of Oil Marketing Companies (OMCs). Rising under-recoveries could lead to a financial crisis for OMCs and a possible oil supply breakdown.
- Cross-country comparisons suggest India is an outlier in terms of fiscal performance.
- With a surge of young people expected to enter the economy, the committee stresses the importance of growth to increase employment. According to the committee's calculations, growth at around 7% would provide adequate employment opportunities.
- Finally, the committee believes as a responsible nuclear power, India requires a responsible fiscal policy to maintain strategic autonomy.

2012-13 fiscal situation

- In 2012-13, the committee predicts a shortfall in tax revenues of around Rs 60,000 crore as a result of reduced corporate profits, weaker industrial output and decreasing imports. The tax to GDP ratio is expected to fall from an estimated 10.6% to 10.1%.
- Subdued equity market conditions will hinder disinvestment receipts; in 2012-13, disinvestment receipts are expected to total Rs 10,000 crore (of the budgeted Rs 30,000 crore).

Figure 2: Revenue and subsidies



Source: RBI; PRS

- On the expenditure side, the report highlights subsidies as the greatest fiscal risk. In 2012-13, subsidy expenditure is expected to overshoot budget estimates by Rs 70,000 crore and rise to 2.6% of GDP.
- The fertilizer subsidy is expected to exceed the budget estimate by Rs 10,000 crore, largely due to severe under pricing of urea. The report also points out that excessive

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usage of urea could adversely impact soil quality and agricultural productivity.

- Food subsidy expenditure has increased because of a widening gap between the central issue price of wheat and rice and the economic cost of delivering foodgrains. In 2012-13, the food subsidy is expected to exceed budget estimates by Rs 10,000 crore.

Policy Interventions: Receipts

- The committee proposes tax reforms to bring the tax to GDP ratio to the high levels of 2007-08 (11.9%). Several reforms to tax administration are suggested to effectively detect and penalize non-compliance. For instance, the committee calls on the government to establish data-warehousing and data-mining infrastructure, modernize outdated investigation processes and amend tax laws to charge a market based interest rate on defaulted tax payments.
- In addition, the committee warns that the pending Direct Taxes Code Bill will result in major losses and should be reviewed.
- For indirect taxes, the committee suggests implementing the nationwide Goods and Services Tax (GST) recommended by the 13th Finance Commission. This should increase output, exports and tax revenues.
- The committee recommends reforming union excise duties and service tax to allow for integration into the GST regime. The standard tax rate of 12% should be gradually phased down to the 8% proposed for the central GST.
- Currently items on the negative list of services are exempt from tax. The list should be reviewed and pruned.
- The committee proposes a 'call option model' to accelerate the disinvestment process. This mechanism would allow the government to offer for sale multiple securities over a period of time till disinvestment targets are achieved. Investors would have the option to purchase securities at the cost of a premium.
- To encourage retail investor participation in the disinvestment process, the committee also recommends creating an 'exchange traded fund'. The fund would comprise all listed securities of Central Public Sector Enterprises and would provide investors with the benefits of diversification, low cost access and flexibility.

- Finally, the committee is urged to sell its minority holdings in largely private entities.

Policy Interventions: Expenditure

- The committee views the subsidy on diesel as a major contributor to India's fiscal deterioration. It recommends an immediate increase of Rs 4/ litere of diesel, Rs 2/litre in kerosene and Rs 50 per LPG cylinder. This would decrease the under –recovery burden by Rs 20,000 crore within 6 months.
- In the longer term, the committee wants to gradually phase out the per unit subsidy on diesel in two years and LPG subsidy by 2014-15.
- For the fertilizer subsidy, the committee calls for a revision in the price of urea. It recommends implementing the Department of Fertilizers proposal to increase the price of urea by 10% with further increases coming through the pool price of overall energy like natural gas.
- Any increase in the minimum support price for food should be matched by a proportional increase in the central issue price. In addition, the government needs to reduce administrative costs of food delivery and direct subsidies towards beneficiaries. The Food Security Bill should be phased in appropriately with relation to fiscal challenges.
- The committee also calls for reallocation of plan expenditure across schemes to create savings.
- To minimize the adverse social impact of their proposals, the committee urges the government to protect incomes of the poor households. The MGNREGA scheme should not be fiscally constrained; diesel subsidies in rainfall deficient districts should be provided; and access to seeds, fertilizer and credit should be increased.

Medium term

- The committee lays out a medium term roadmap and projects key fiscal performance indicators based on measures implemented to raise the tax-to GDP ratio, prune expenditure on subsidies and adjust planned expenditure.
- Table 1 outlines the committee's forecasts for key fiscal indicators in 2012-13, under both 'no reform' and 'reform' scenarios, along with longer term projections for 2013-14 and 2014-15.

Table 1: Committee roadmap for fiscal consolidation

	2012-13			2013-14	2014-15
(% of GDP)	Budget	No reform	Reform	Projections	
Gross tax revenue	10.6	10.1	10.3	10.6	11.1
Total receipts	**9.6**	**9.1**	**9.4**	**9.3**	**9.5**
Subsidies	1.9	2.6	2.2	1.7	1.5
Plan expenditure	5.1	5.0	4.8	4.9	4.9
Total expenditure	**14.7**	**15.2**	**14.6**	**13.9**	**13.4**
Revenue deficit	3.4	4.4	3.7	2.8	2.0
Fiscal deficit	**5.1**	**6.1**	**5.2**	**4.6**	**3.9**

Source: Kelkar Committee report

- As part of the longer term disinvestment process, the committee also proposes monetizing government's unutilized and under-utilized land resources.

- Finally the committee calls for structural supply side reforms to improve and accelerate growth. According to the committee, increasing infrastructure investment in power, roads and railways would have the largest impact.

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