



Macro-fiscal Issues Facing India

Sanjaya Panth
Senior Resident Representative

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- The views expressed are personal and are not necessarily those of the IMF, its Executive Board, or its management.

Outline

- I. What are the key macroeconomic issues ?
 - Short-term challenges: Global crisis and the Indian economy
 - Long term challenges: Growth and poverty reduction

- II. What are the fiscal constraints ?
 - Debt and deficits have been too high.
 - Little room for countercyclical policies
 - Risk of adverse long-term debt dynamics

- III. How can India's fiscal position adjust ?
 - Appropriate targeting and institutional reforms: FRBM II
 - Revenue reforms
 - Subsidy reforms

I. Key Macroeconomic Issues

Deepest global economic downturn in a lifetime

WEO Real GDP Growth Projections

(In percent change from a year earlier)

	U.S.	Euro	Japan	China	India	World
2009 (Jan.09)	-1.6	-2.0	-2.6	6.7	5.1	0.5
2009 (Nov.08)	-0.7	-0.5	-0.2	8.5	6.3	2.2
Change	-0.9	-1.5	-2.4	-1.8	-1.2	-1.7
2010 (Jan.09)	1.6	0.2	0.6	8.0	6.5	3.0
2010 (Nov.08)	1.5	0.9	1.1	9.5	6.8	3.8
Change	0.1	-0.7	-0.5	-1.5	-0.3	-0.8

Source: IMF, World Economic Outlook.

Abrupt fall in industrial activity and trade ...

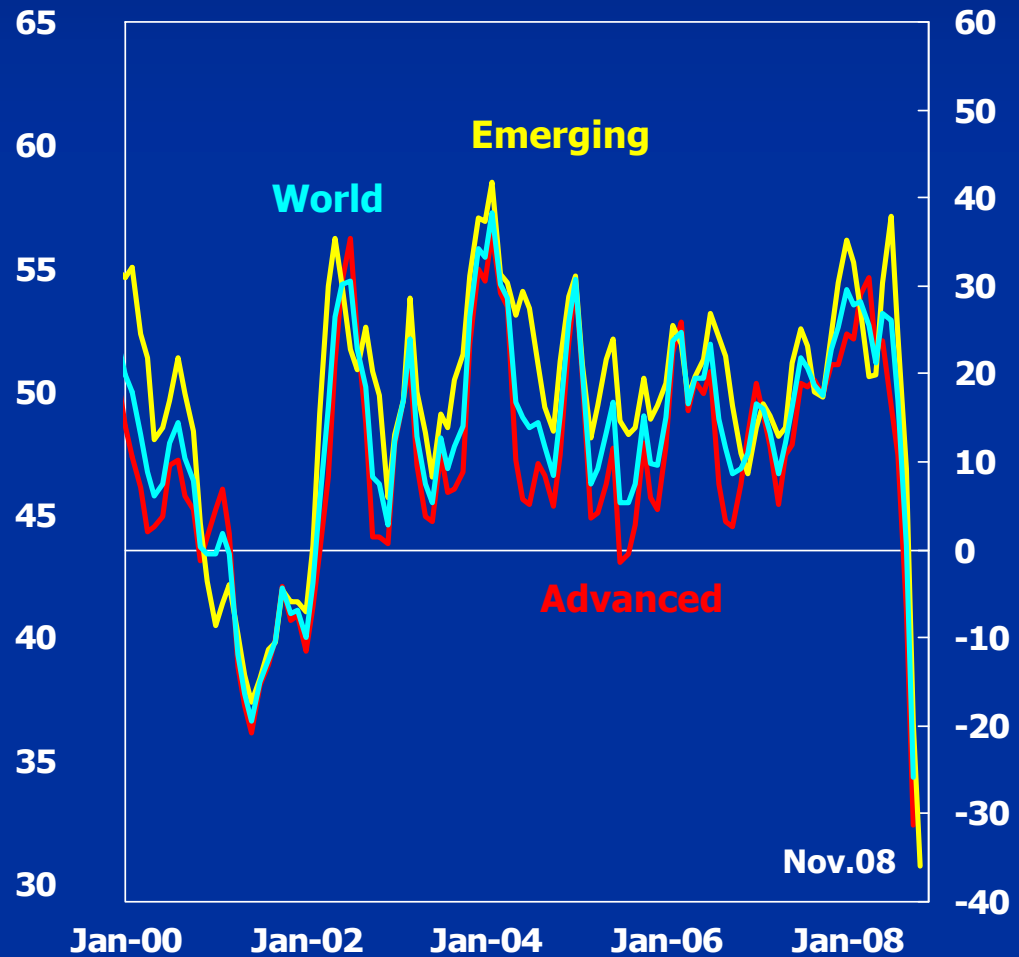
Industrial Production

(Annualized percent change of 3mma over previous 3mma)



Merchandise Exports

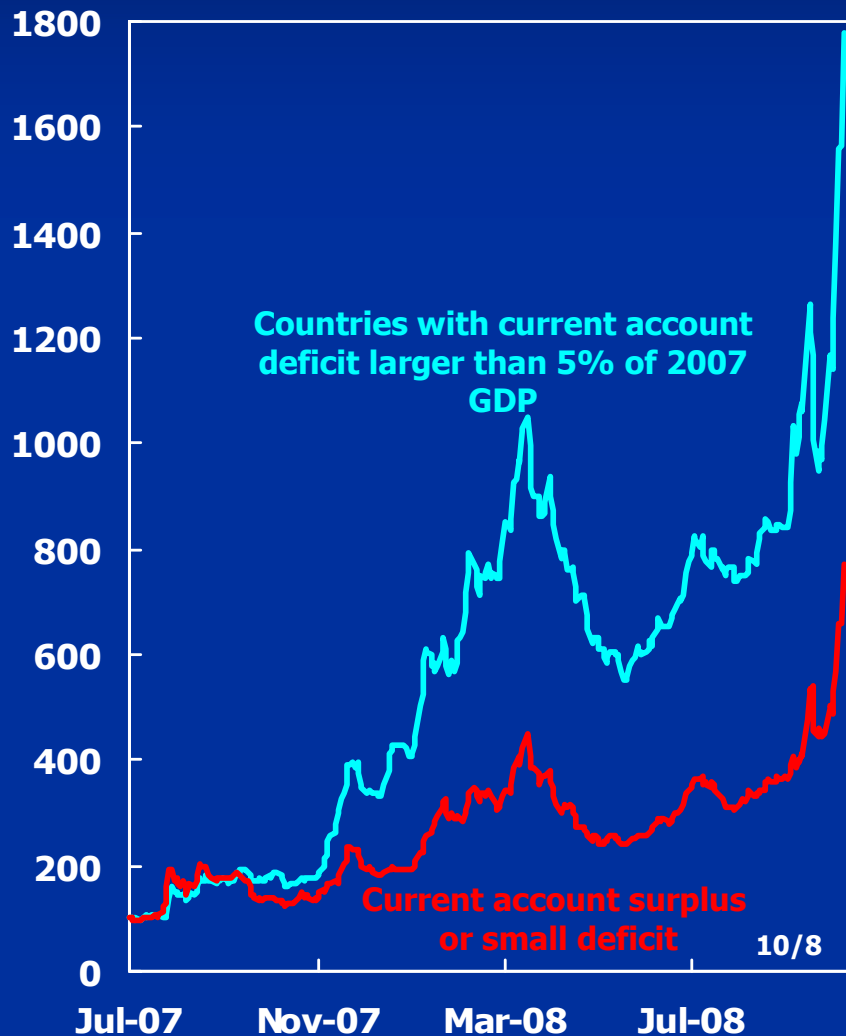
(Annualized percent change of 3mma over previous 3mma)



... and a very difficult financing environment.

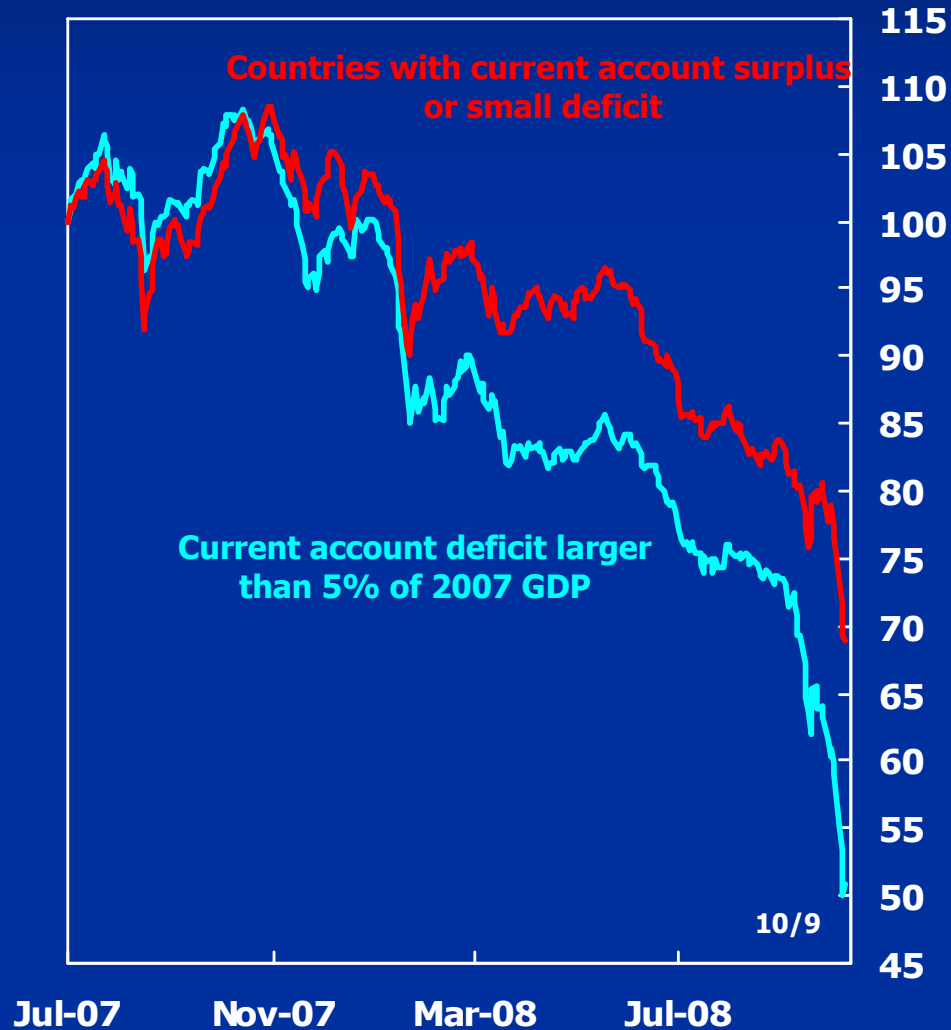
Sovereign CDS Spreads

(index: 7/1/2007=100)



Equity Prices

(index: 7/1/2007=100)

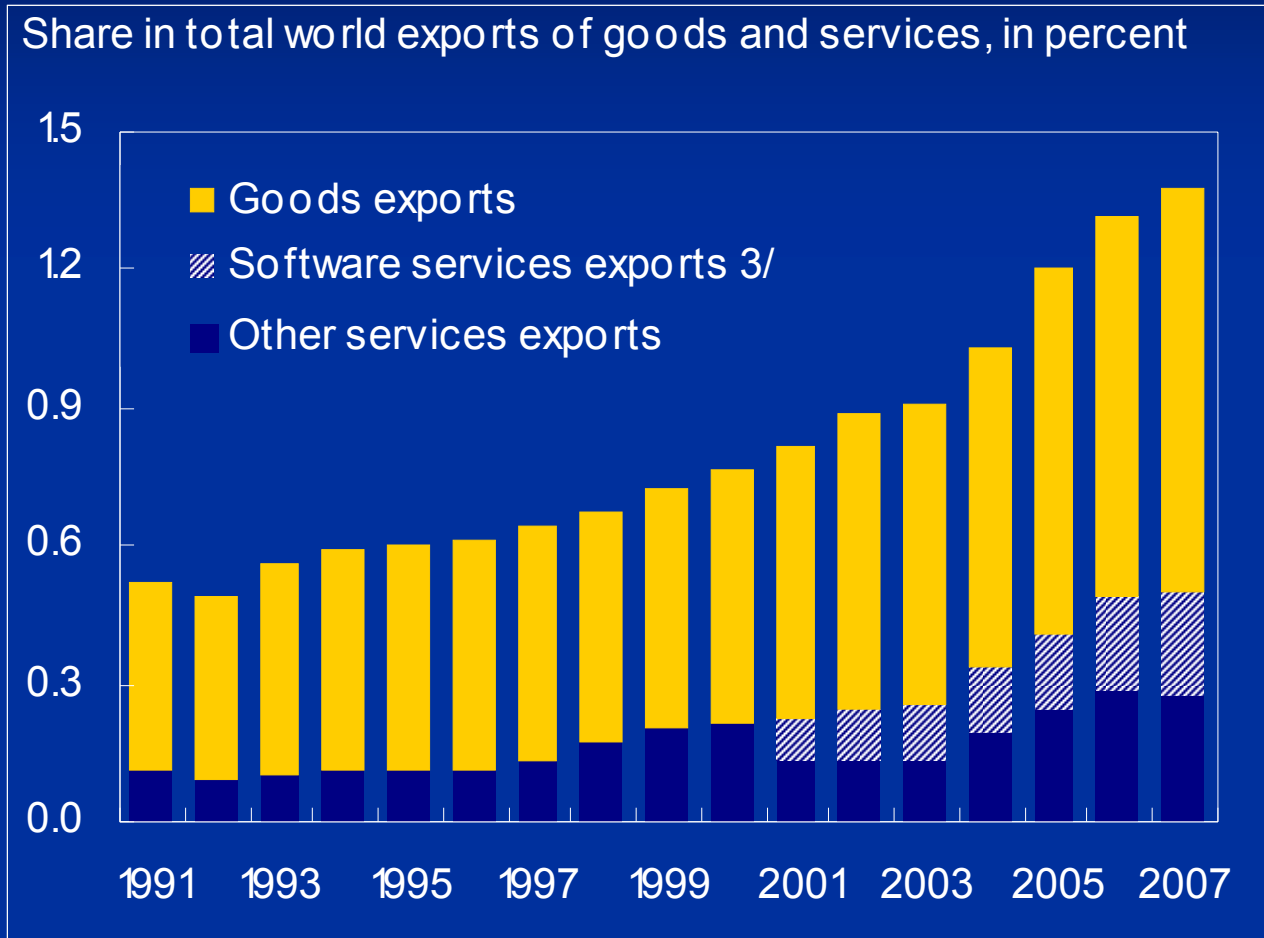


India shares many (not all) characteristics with other emerging market countries : ⁷

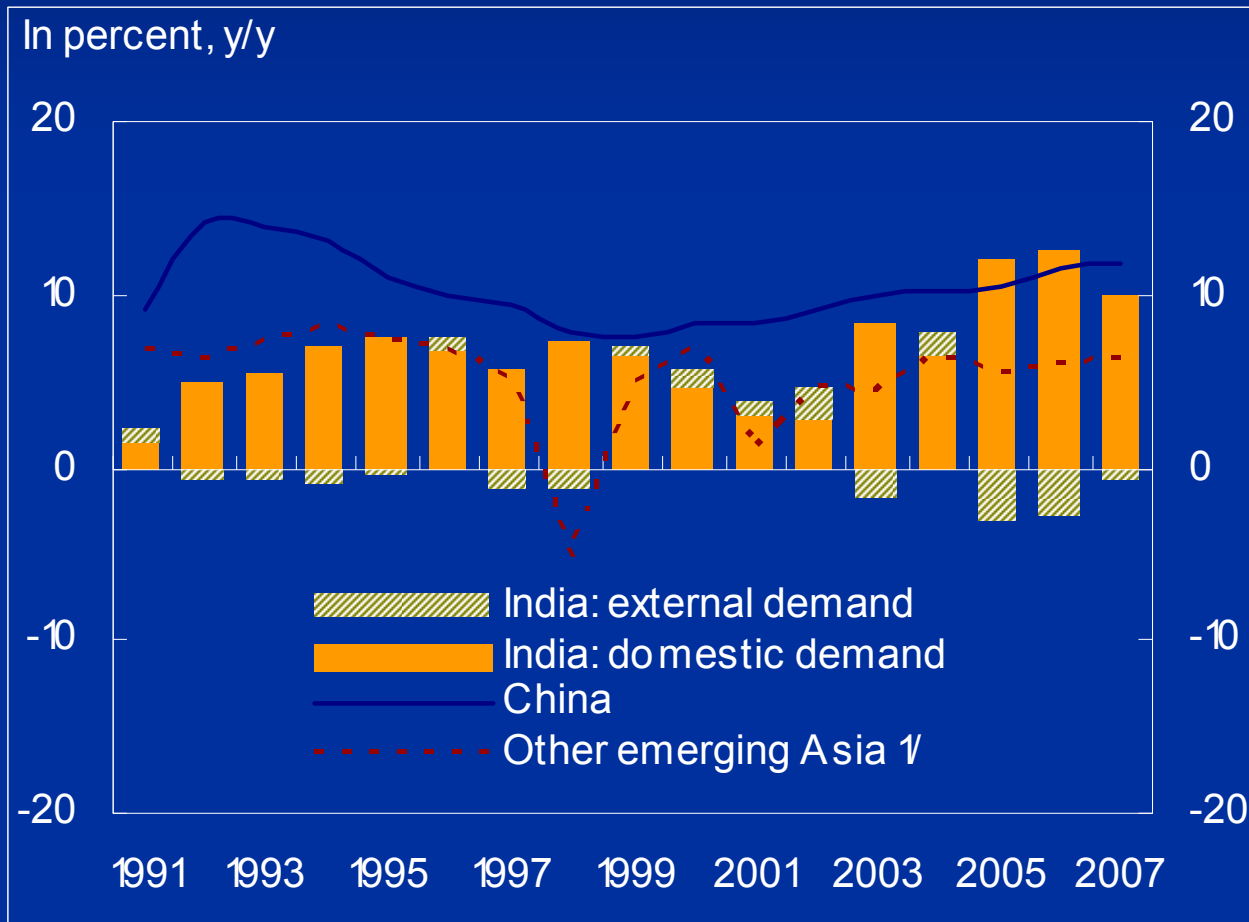
Growth shocks to emerging market countries:

- Declining External Demand and Exports – √
- Tighter Credit (External Financing) – √
- Lower Commodity Prices – × (India actually benefits).

External trade linkages have been growing...



but high domestic demand means India is still relatively shielded on the current account...



Foreign financing, however, has been significant.

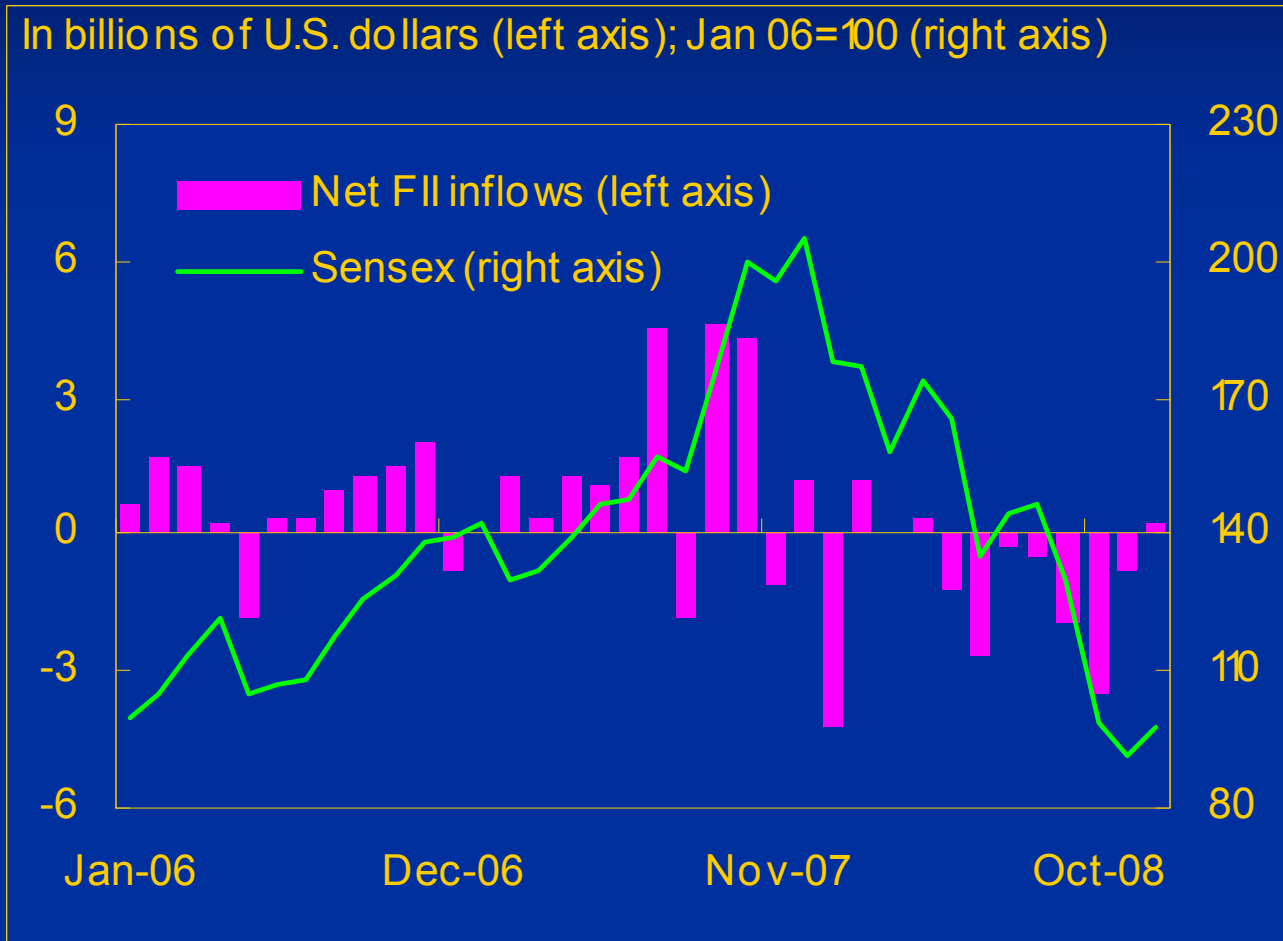
The contribution from foreign financing has risen significantly

in percent of total funds

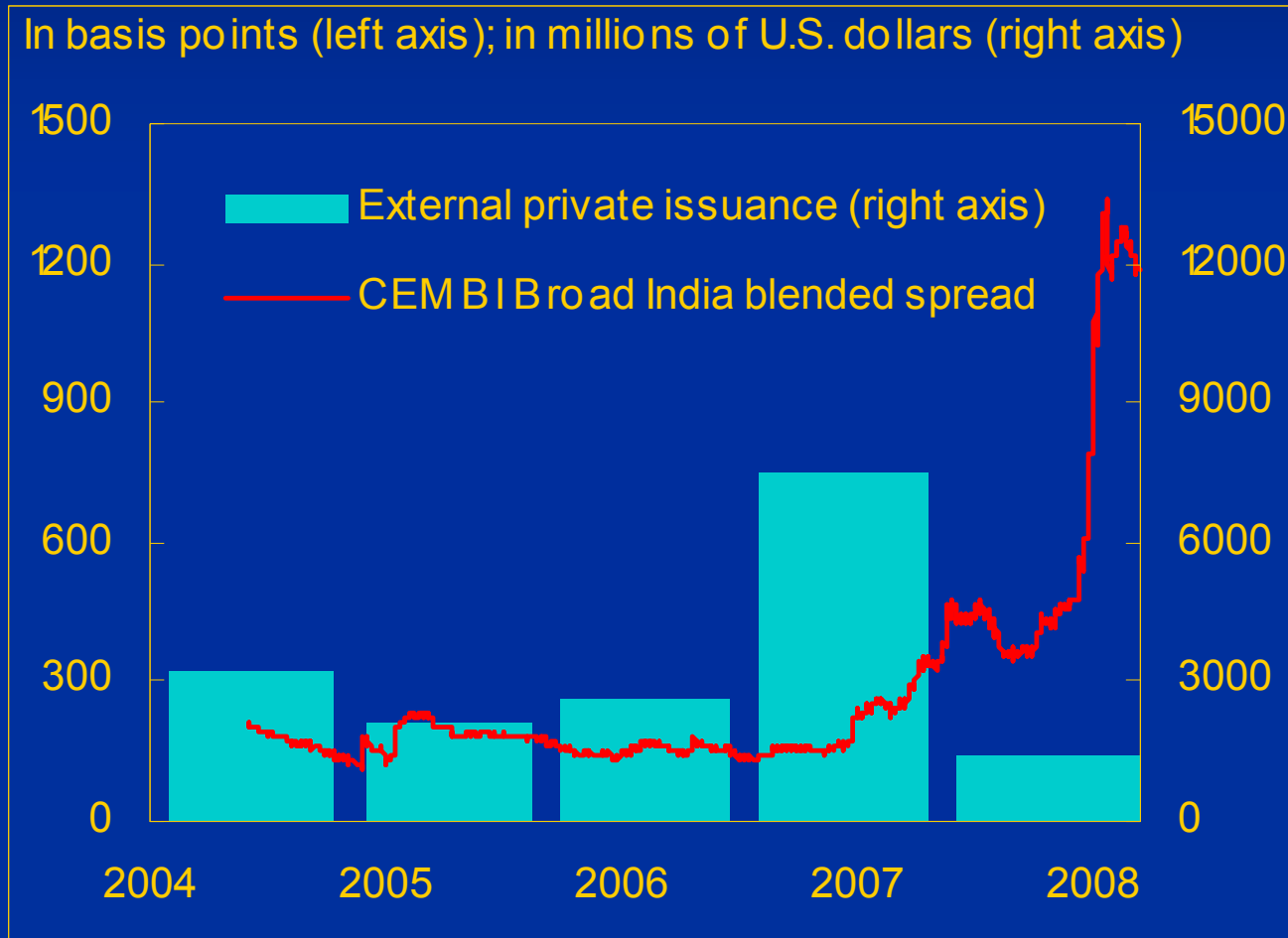
	Foreign Direct Investment	Foreign Borrowing	Equity Issuance	Bank Credit	Retained Earnings
2003-04	11.8	-7.9	13.8	10.4	71.8
2004-05	6.8	5.9	7.2	27.9	52.3
2005-06	8.3	2.4	5.8	26.9	56.6
2006-07	14.7	10.8	5	21.8	47.7
2007-08	15.4	10.5	10.2	20.6	43.3

Sources: SEBI, RBI and CSO, India

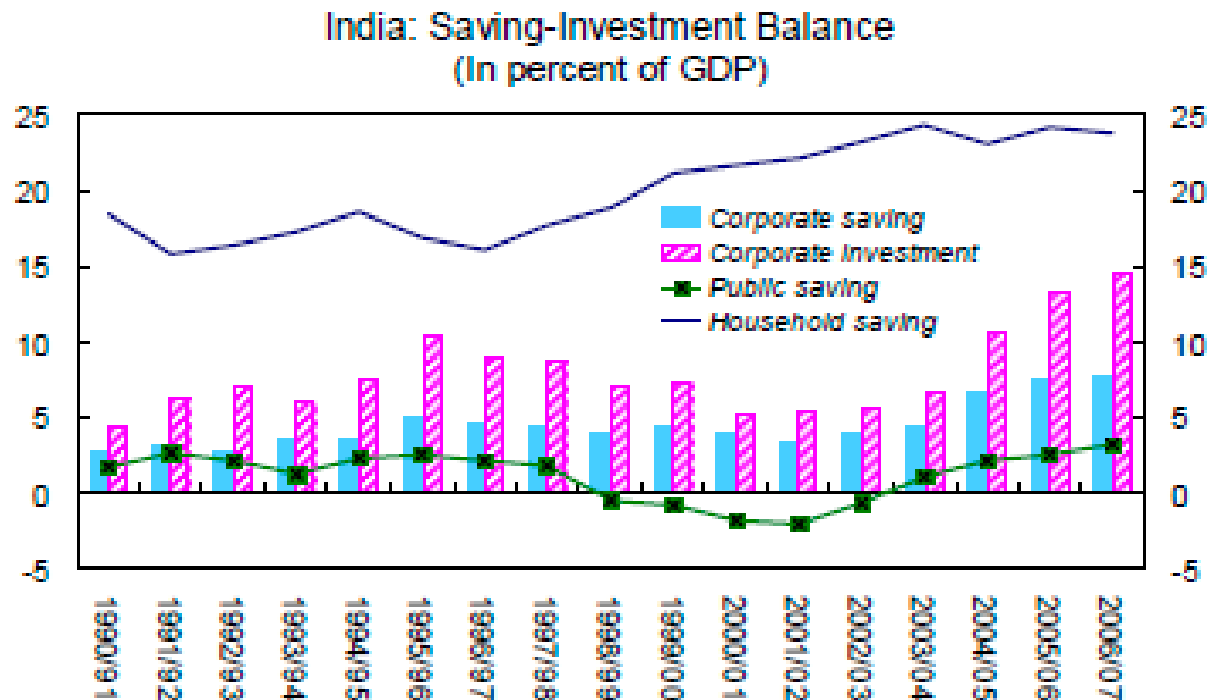
Outflows from stock markets...



... and lower & more expensive bond placements abroad mean less funds for investment.

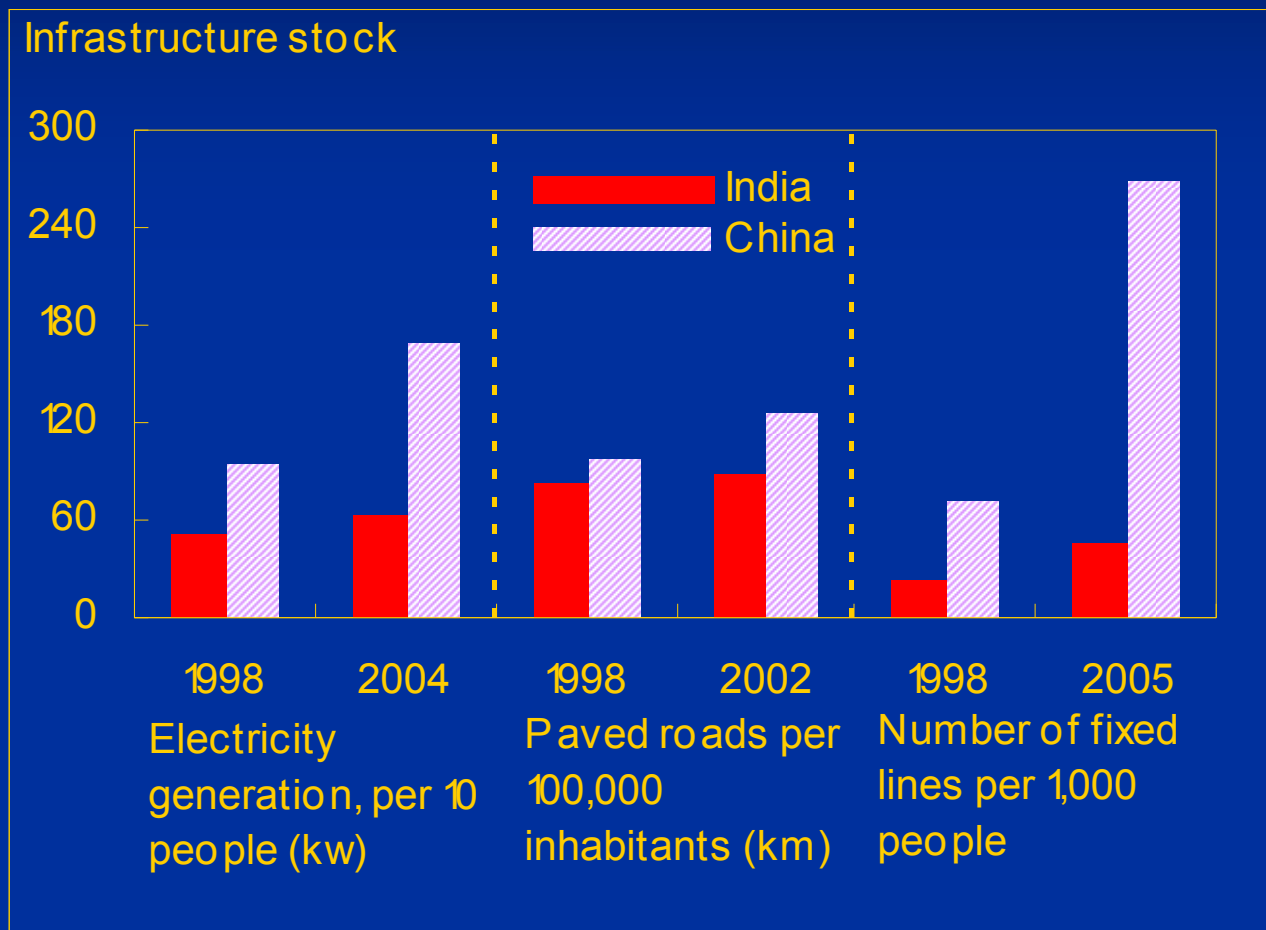


...when investment has been the engine of growth in recent years.

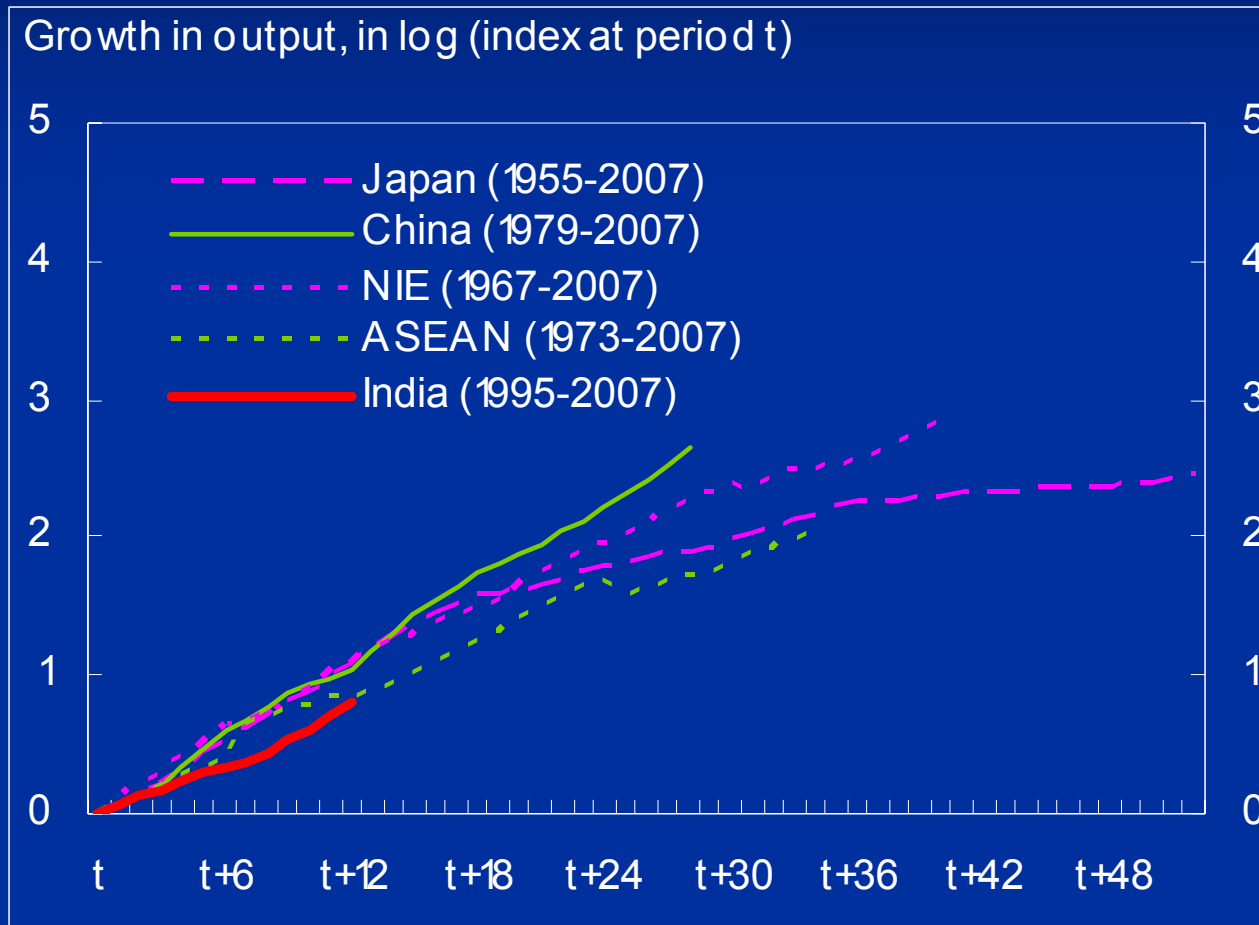


Sources: CEIC Data Company Ltd.

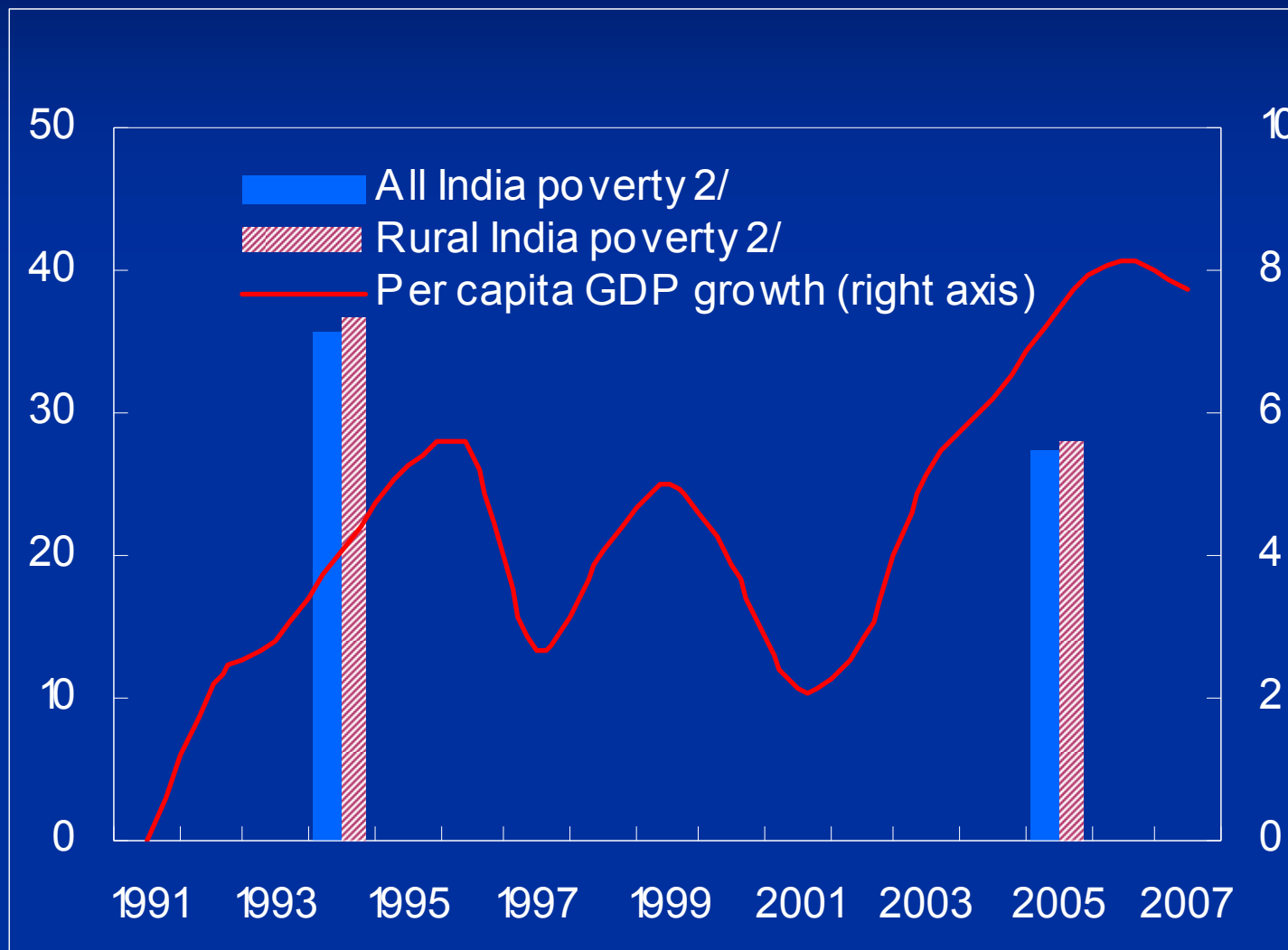
Over the long-term, investment needs are acute



...if India is to continue to grow rapidly...

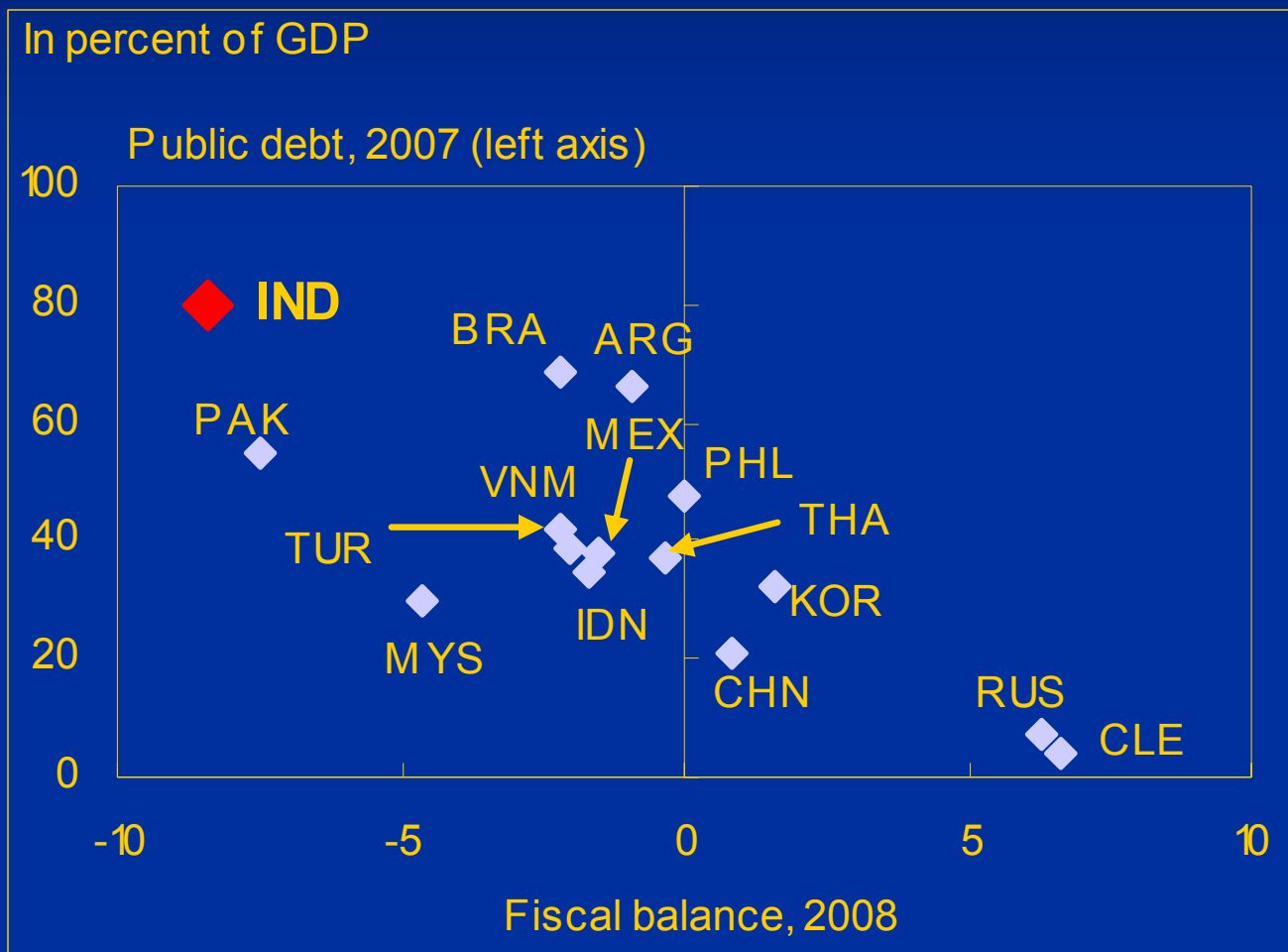


...and make further progress in meaningfully reducing poverty



II. Fiscal Constraints

India's public debt and deficit numbers are eye-popping !

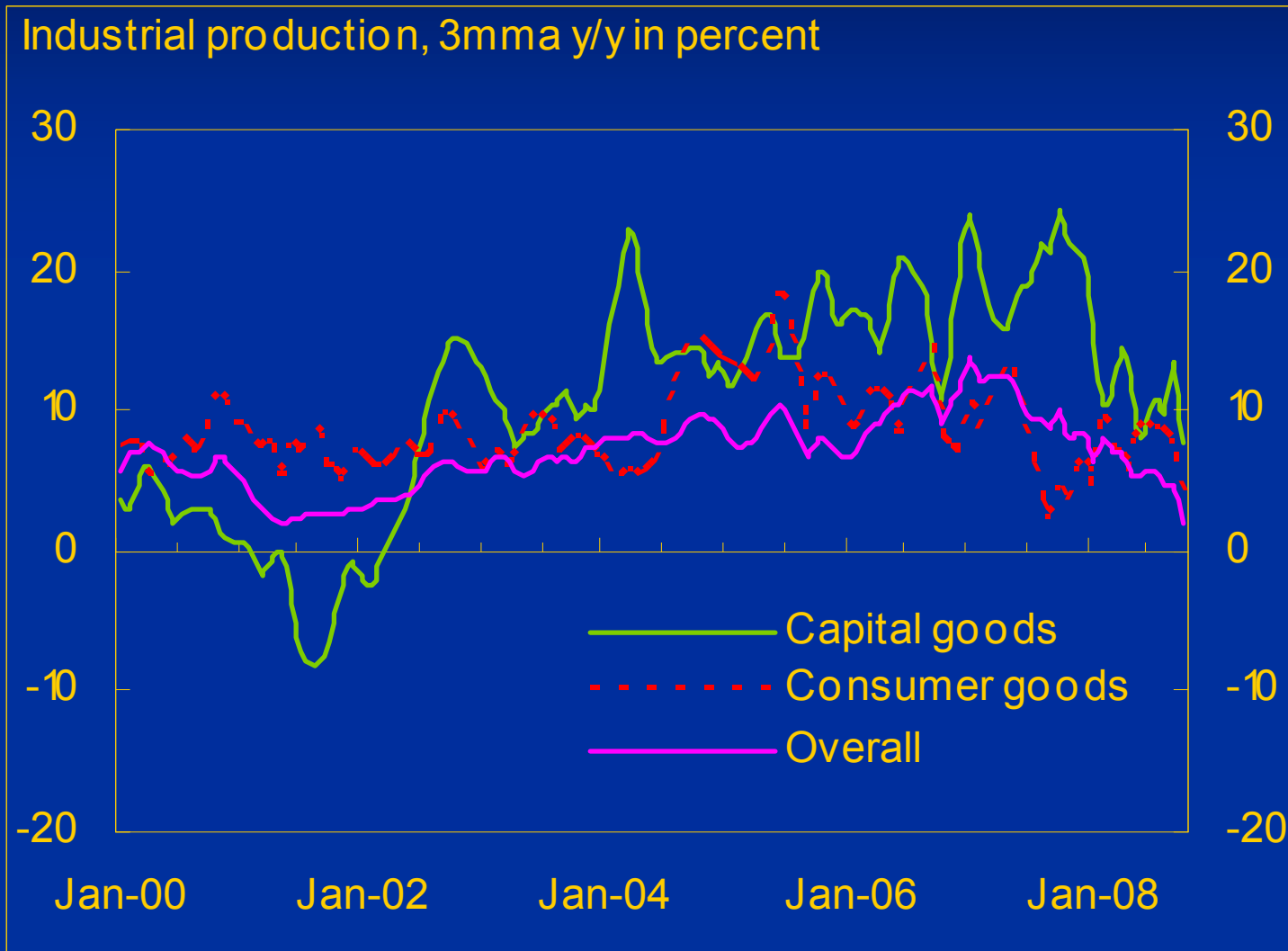


So, why has there not been more of a problem ?

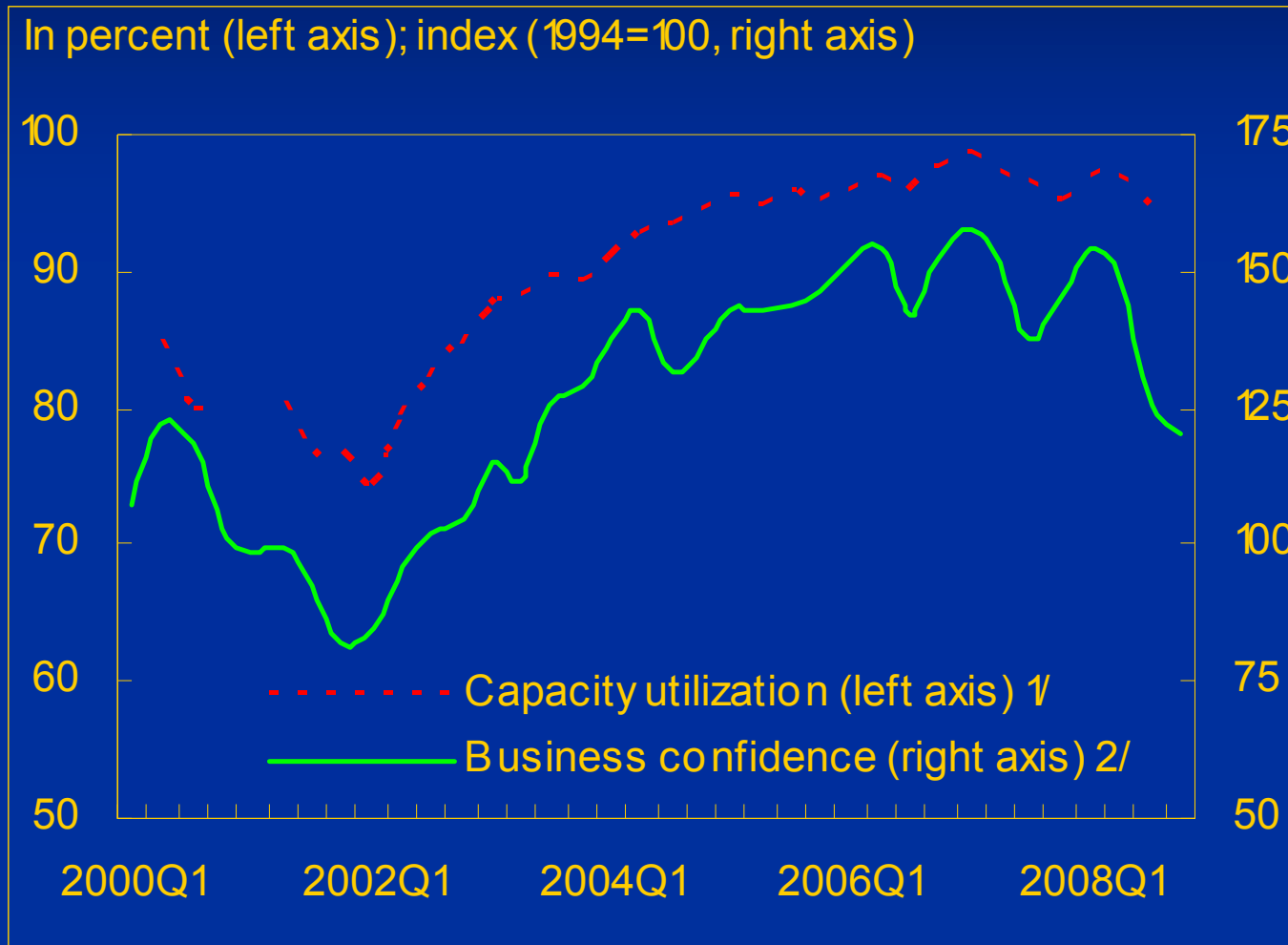
- Stable (but low) revenue base
- Limited foreign currency debt
- Deep, fixed-rate (captive !) domestic currency debt market

But domestic debt is funded by short-term bank deposits, so how long-term is it really ?

Global economic crisis is contributing to sharp downturn in India



And the short-term outlook is poor



Some fiscal stimulus ... but necessarily limited in scope because of fiscal constraints

Major Discretionary Fiscal Measures in 2008/09 will contribute to a substantial widening of the deficit

	(In percent of GDP)
Budget (and Supplementary Budgets) 2008/09	
Tax measures 1/	1.1
Spending 2/	1.8
Fiscal Stimulus Packages (Dec 2008, Jan 2009) 3/	
Tax measures	0.2
Spending	0.4
Total	3.5
Other (off-budgetary) measures 3/	1.7
Within 2008/09	0.7
Beyond 2008/09	0.9

1/ Includes post-budget, inflation-related cuts in customs duties.

2/ Reflects full amount of agricultural debt relief (Rs 600bn). The related net cash outgo in 2008/09 is Rs 150bn.

3/ For details, see Box 1.

Debt could stay high: no room at all for shocks

Public debt as percentage of GDP						
	2008 1/	2009	2010	2011	2012	2013
Key variables at their historical averages	80.6	81.2	81.4	81.5	81.7	81.8
No policy changes (constant primary balance)	80.6	80.2	80.8	80.6	80.1	79.4

1/ projection.

III. Reform Options

Reform Options

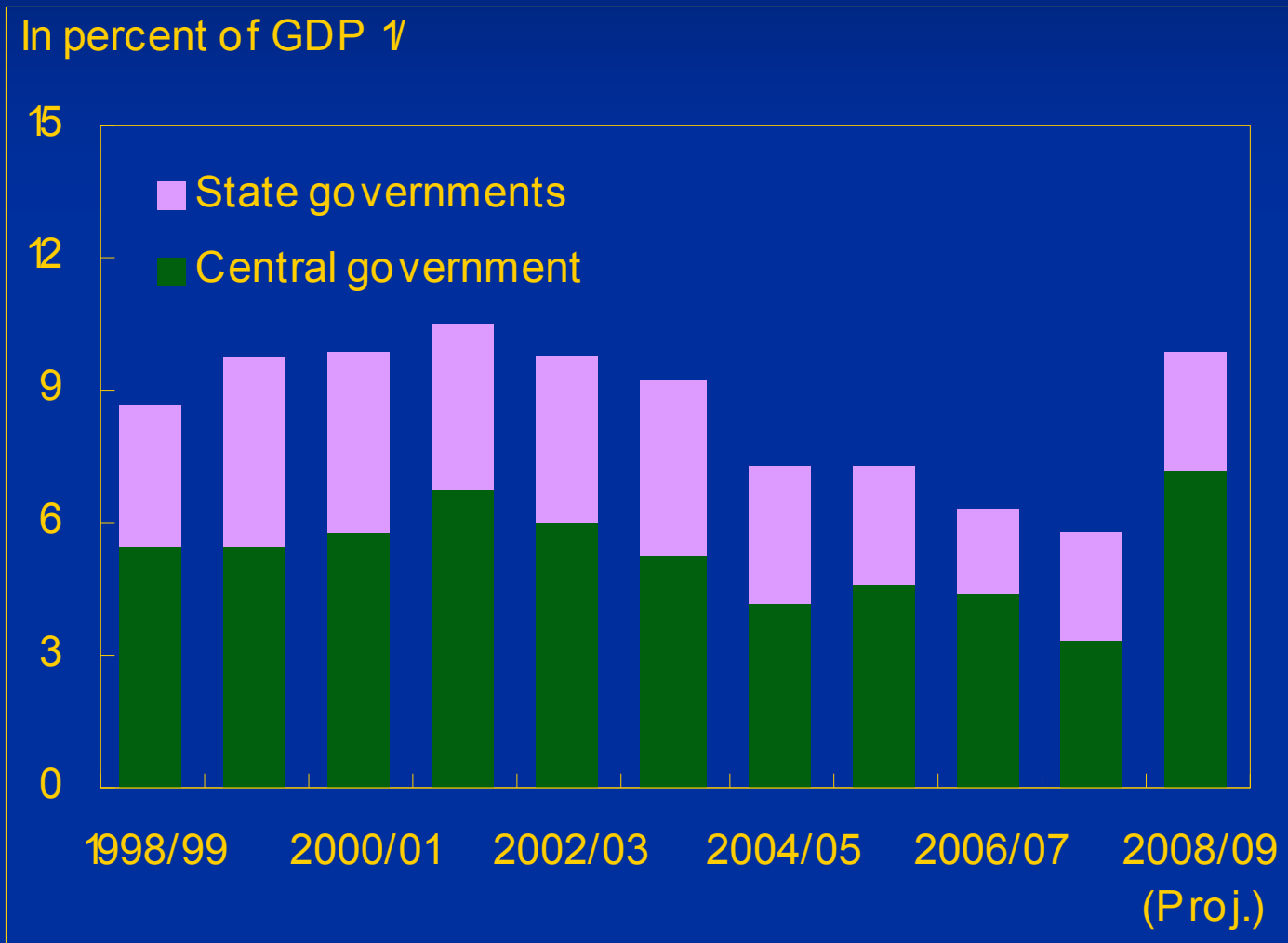
- Fiscal Responsibility Legislation (FRBM II)
- Raise More Revenue Efficiently (VAT)
- Reorient Spending (Subsidy reforms)

Fiscal Responsibility Legislation

Challenges of a federal system: India is one of the most fiscally decentralized economies:

- How to distribute tax powers ?
- How to distribute & mandate spending powers ?
- How to organize system of intergovernmental transfers?
- How to allocate power to borrow ?

Deficit and debt reduction requires efforts at both central and state levels



Institutional reforms to improve cooperation and coordination

Common Elements of Fiscal Responsibility Legislation:

- Numerical rules
- Procedural rules
- Transparency rules

FRBM I

Objective: inter-generational equity; fiscal sustainability necessary for macroeconomic stability; improve transparency.

Numerical rules: zero current balance by 2008 to be achieved by step reductions (specified) in current deficit and in fiscal deficit over a multi-year period.

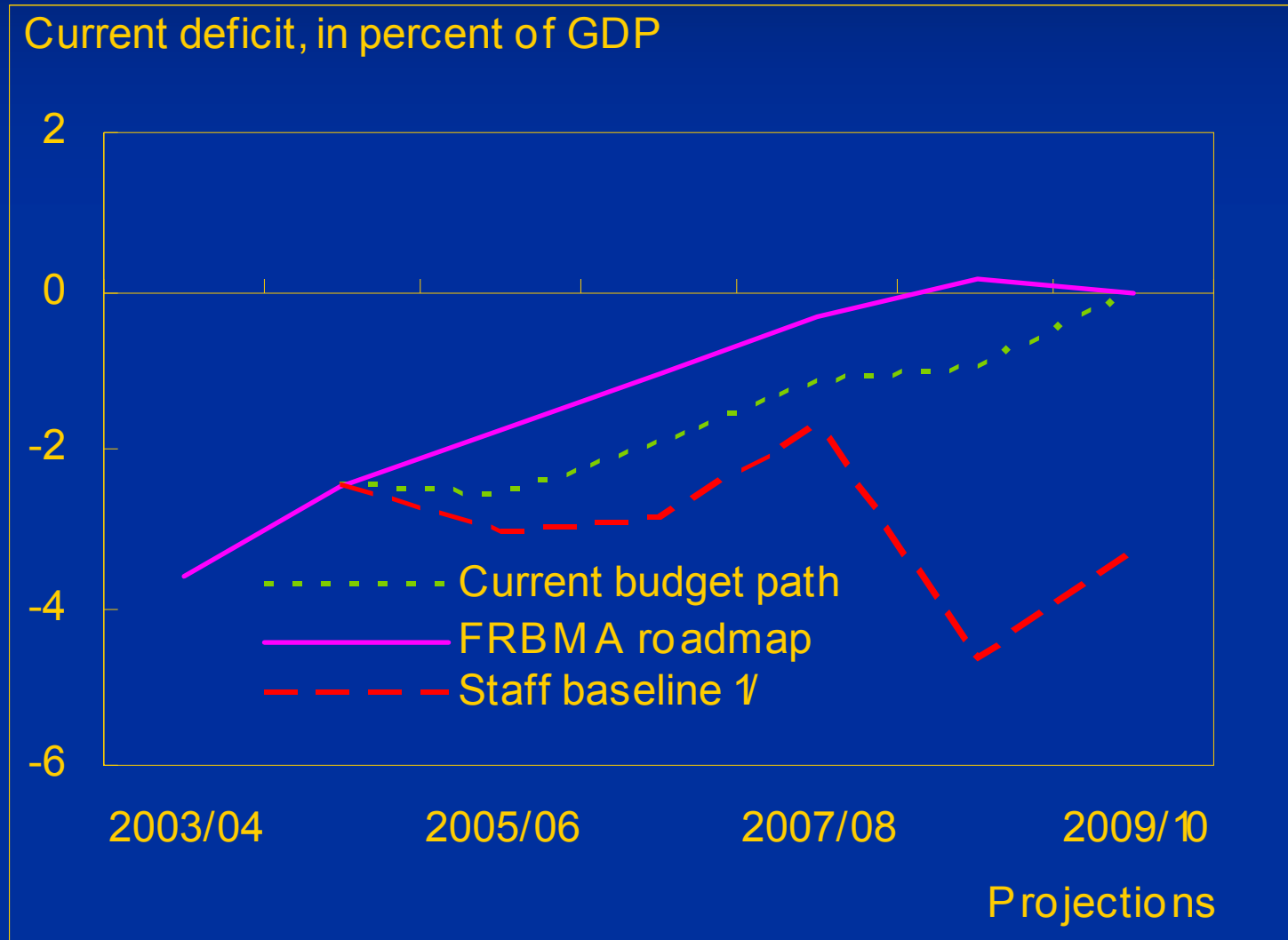
Procedures: multiyear strategy; report & publish outcomes and strategy changes on a routine basis to improve transparency

Fiscal Performance under FRBM I

- Significant fiscal adjustment up until 2007/08
 - More than 2/3 of adjustment due to revenue gains

- However, several problems have emerged:
 - Increasing use of off-budget bonds
 - Postponement of deadlines
 - Key vulnerabilities of public finances left unaddressed

And achieving (revised) target by 2010 unlikely



FRBM I also encouraged states to enact their own FRLs

Mixed Results:

- Significant fiscal adjustment at the state level
- But more than three-quarters of states' aggregate fiscal deficit decline due to an increase in states' revenue
 - the bulk of revenue gains stem from increased transfers from the Center
- And limited decline in current expenditure stemming from lower interest payments partly due to debt relief

The way forward: FRBM II ?

- Reduce opportunities for creative accounting and biased forecasts.
- Continue to increase transparency.
- Use debt and expenditure growth targets.
- Clearly specify escape clauses and strengthen enforcement.
- Give incentives to align state-level FRLs with central law.
- Combine fiscal rule reforms with other strategies to promote fiscal discipline at state level.

There is room to increase revenue

Factors affecting tax ratios I:

- Higher income (+)
 - Structure of economy (?)
 - International openness (?)
 - Age dependency (-)
 - Current spending of the government (+)
 - Higher literacy levels (+)
- India's tax intake is significantly lower than predicted by these variables (Hattari, Kochhar, Poirson, Topalova)

There is actually even more room to increase revenue

Factors affecting tax ratios II:

- Democracy (+)
 - Corruption (-)
 - Institutional Quality (+)
-
- India's tax intake is even lower than predicted when these factors are also taken into account (Hattari, Kochhar, Poirson, Topalova)

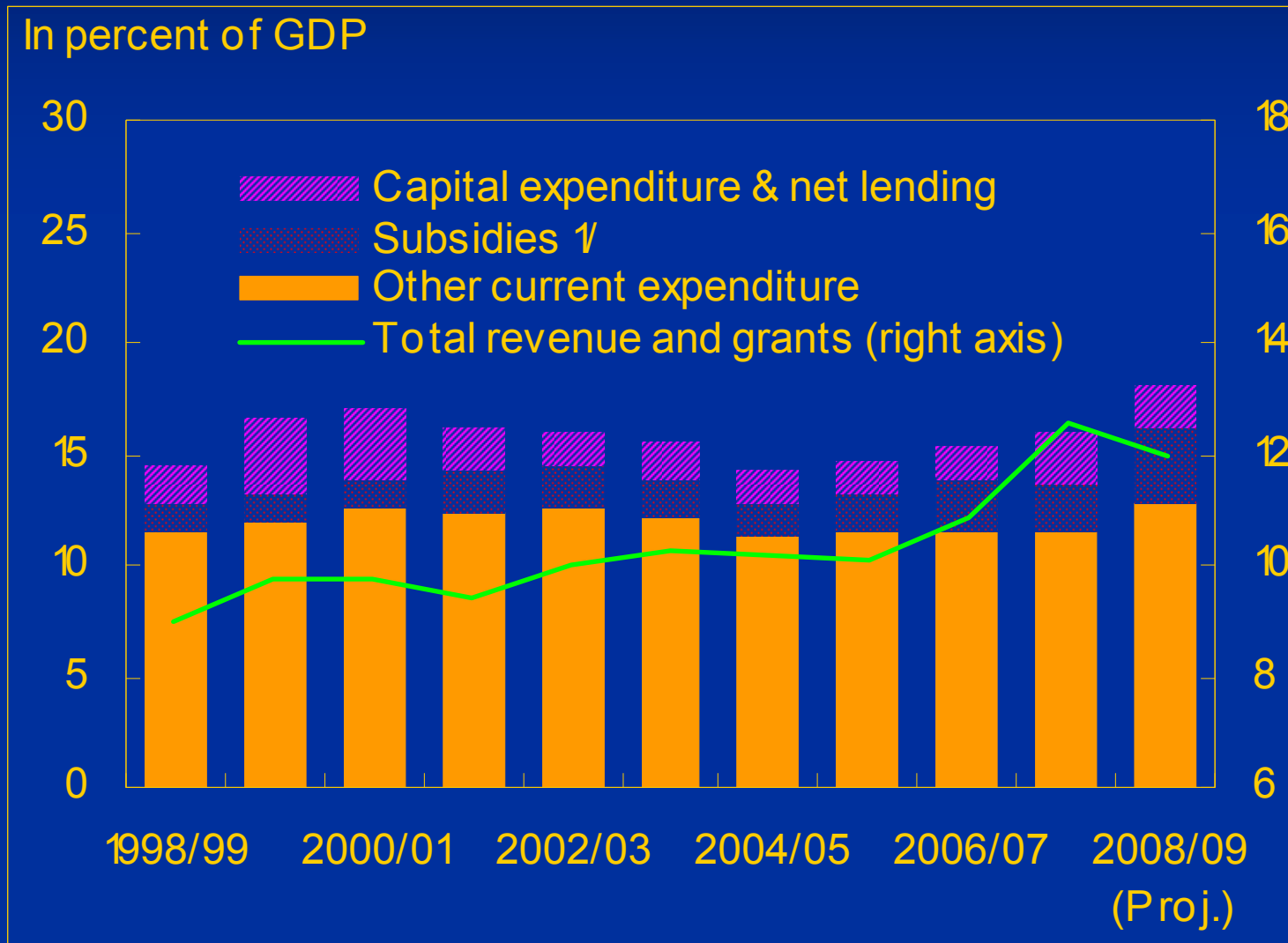
Tax reform can raise revenues without necessarily increasing overall tax burden

- There is a degree of coherence between the center, states and local governments where income and trade taxes are concerned.
- There is, however, less coherence where taxes on goods and services (G&S) are concerned.
- Myriad and complex G&S tax regimes within the country distort incentives, impose transaction costs, and increase the costs of doing business.

A road map to a national GST

- Extend state level VAT to all states and incorporate services in the base.
- Eliminate the tax on interstate trade (CST)
- Expand service tax base in the center.
- Integrate central VAT and service tax into a central GST
- Broaden the base by eliminating exemptions.
- Introduce a GST having a common base at the central and state level (but allowing different rates of tax).

Expenditure reforms: subsidies have been much larger than investment



Subsidy & Assistance Reforms

- Depoliticize and make automatic pricing rules for fuel.
- Strengthen subsidy targeting – biometric cards !
- Make directed lending less distortionary: for example, allow banks to trade in certificates to meet compliance with lending to priority sectors.



Thank you