THE LIBERAL BUDGET

2007-2008

TAKING REFORMS TO THE POOR

The Liberal Position

Liberalism is built around the centrality of the human being; what is good for him - or her acceptable. What is not, is not.

The Liberal position on the economy is very clear. The business of the State is not business government. In a liberal State, the individual is supreme and the State must work to further his or potential. Therefore, the State will focus its activities on maintaining law and order, defence physical and social infrastructure, health, education and a social safety net.

India's great Liberal Gopal Krishna Gokhale spelt out the Liberal dream when he said: "*I recognise no limits to my aspiration for my motherland. I want our people to be in their country what other people are in theirs. I want our men and women, without distinction of caste or creed, to have opportunities to grow to the full height of their stature, unhampered by cramping and unnatural restrictions. I want India to take her place among the great nations of the world.*"

Another outstanding Indian Liberal D.V.Gundappa, even while spelling out the global nature liberal values cautioned: "*It has been India's habit all through history to turn to every corner of the globe for the light of truth and blessedness of wisdom. But she must be selective in taking things from others.*"

The role of the Indian State, which has jettisoned State Capitalism of the communist variety and embraced Market Economics, is on the one hand, to create an enabling environment for growth by unshackling the remaining vestiges of control, eliminating regulations that stifle development and do away with 'the inspector raj', and on the other, to build the confidence of the nation in the rule of law and in the legislative and legal systems.

The main focus of a liberal budget, will be on issues concerning human development or human capital formation - health, education and a social safety net for those who are not capable of looking after themselves.

We have kept these in mind when preparing this Liberal Budget.

TAKING REFORMS TO THE POOR

THE LIBERAL BUDGET 2007-08

FREEDOM WITH RESPONSIBILITY

INDIAN LIBERAL GROUP

PROJECT FOR ECONOMIC EDUCATION

THE DRAFTING GROUP

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for greatly facilitating the work of the Drafting Group with their inputs on a number of crucial issues.

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Preface

Liberalisation comes naturally to Liberals. Not so to the socialists, not even the communists. In the case of the latter both the late unlamented Soviet Union and Communist Chinese are unabashed practitioners of free market economics (fooling their mentor by calling it "Market Socialism" even if China continues to be a one-party dictatorship and Putin's Russia is fast moving in that direction. The advantage of a dictatorship is that decisions are quick even if arbitrary. Also, it is easier to shift gears forward or reverse. The Chinese dictatorship, miscalled the "People's Republic" is today moving headlong and forward in top gear. Tomorrow they could well choose to go into reverse gear.

Why this exercise in polemics at the very beginning of this preface? Because, a large number of otherwise intelligent people within the country and overseas belittle India's performance vis a vis China . They do not seem to realise (or not bothered over much with the fact) that India is a real democracy and has been able to achieve an 8.5% growth despite the many hurdles the government has had to reckon with from friends and foes alike. The present establishment certainly deserves to be complimented, even if the quality of governance leaves much to be desired. We, in the Liberal movement, feel it is important to pay this compliment to the present (and the previous) coalitions that have been in power.

This is the preface to the 4th Liberal Budget. It may be useful, at this point to recall our rationale for the liberal budgets. In May 2004, in our preface to the first Liberal Budget, we wrote: "In the evolving liberalisation of the economy there is need to promote better fiscal governance through transparency and accountability, fiscal consolidation, productivity, growth and equity. The Project for Economic Education is convinced that a liberal economy needs a different kind of budget – a budget that is de-mystified and made simpler, highly transparent, and above all, brought in tune with reality. The reality is that since 1991, the country has been heading in the direction of a liberalised economy. A liberalising economy needs a truly Liberal Budget".

During the discussions on this the 4th Liberal Budget it became clear that in the matter of numbers we were witnessing a growing convergence of the Liberal and Union Budgets. For instance a comparison of the Liberal Budget and the Government budget for the same year, shows considerable convergence in the receipts and expenditure estimates. On the other hand the divergence is obvious when measured in terms of policies, programmes and in the larger issue of governance. In such a comparison, the government budget trails well behind the expectations set out in the Liberal Budget.

Also, in recent months, there have been a number of contrary signals emanating from the present establishment and its allies that could well put the economic reform process itself in jeopardy. For instance, earlier this year there were media reports that the Petroleum Ministry was trying desperately to get the Petroleum Sector Regulator appointed as a Director on the ONGC Board. Then there was the draft Bill circulated for comments by the Information and Broadcasting Ministry a bill that seeks to impose censorship on the Media. Though the Foreign Exchange position is more than comfortable, and import of paper is on OGL, newspapers have still to approach the Registrar of Newspapers of India every year for fresh import clearance. There were reports that when the Reserve Bank of India recently increased the Repo rates, the Finance Ministry, used its clout on the Boards of the Public Sector Banks to negate the impact. There are reports that the government intends to backtrack on the BALCO sale agreement. There are also reports of a likely major rollback of the Right to Information Act. The Union Ministry of Agriculture has reportedly imposed, all of a sudden, restrictions on the export of certain agricultural commodities, notwithstanding the fact that considerable time and effort are required to establish stable export markets. The Planning Commission has, in its Eleventh FiveYear Plan draft approach paper made out a case for full funding of its ambitious Plan, even if it requires fiscal prudence to be abandoned. In a pluralistic democratic polity like ours, it is inevitable that some decisions are likely to go against the grain of economic reforms. But so many straws in the wind, all in the space of a few months, makes one wonder whether a kind of reform fatigue is setting in and the parties in power have begun thinking that the earlier control regime would be a better option!

Moreover whenever there is a natural calamity or when farmers are committing suicide in their hundreds, the immediate reaction of the government is to announce liberal financial compensation packages to the families of the victims. There is nothing wrong in this except that such largesse is not followed by action to treat the basic malaise. Again we have that uncomfortable feeling – is the government reverting to the earlier pattern of support/ subsidies/reservation as the solution for all problems, an approach that has led to the subsidy bill reaching a staggering 15% of the GDP?

One reason for this perhaps could well be the considerable erosion in the strength of both the Congress, and the BJP, and the emergence of the Left and a number of regional / state level parties as major players at the Centre. Regional and state level vote bank politics have tended to take precedence almost to a point of exclusion of national and international concerns.

Another is the fact that the 8% GDP growth rate over the last three-year period may have given rise to a sense of complacency. That such complacency is not justified was clearly demonstrated, by two recent international events. First at the annual IMF-World Bank meeting at Singapore, when India demanded an increase in its vote share on the basis of good GDP growth rates in recent years. Ironically we ended up with a *reduced* vote share, when those of South Korea, Mexico, Turkey and China were increased. This clearly indicated that in the international arena of finance and trade, India is still considered to be of little consequence.

The other instance was the former US Deputy Secretary Mr. Strobe Talbot's statement recently during an interview to an Indian TV channel that US support for the US-India nuclear deal was contingent on India toeing the US line on Iran! In other words India is still not considered strong enough to pursue an independent foreign policy of its own. It is clear that if India wishes to be recognized as an important player in the international arena, economic reforms need to be pursued more vigorously.

At the same time we wish to reiterate what we said when presenting the last Liberal Budget (2006-2007) that the long term Liberal perspective may be to see India's emergence as a global power. Which Indian would not want it so! But as Liberals our immediate concerns are entirely internal. If the reforms process translates itself into a better life for our people particularly those in rural India where 70% of India live; if farmers are no longer compelled to commit suicide as a way out of their indebtedness; if we no longer have starvation deaths; if India enjoys medical care comparable with the best that the world has to offer; if our education is not only universal but of high class quality; and if we can boast of a world-class infrastructure, then we can say with some degree of legitimacy that we are indeed on the road to becoming a world power. Meanwhile as the slogan on the cover of this Liberal Budget reveals, our expectation is more modest, though as difficult: "Taking Reforms to the Poor"

In the making of the Fourth Liberal Budget 2007-2008, we have had the support of people of eminence in their fields endeavour. We are particularly grateful to Professor Suresh Tendulkar of the Delhi School of Economics, Professor Lalit Deshpande and Dr. Sudha Deshpande, formerly of the University of Bombay, Dr. A Vasudevan, formerly Executive Director in the Reserve Bank of India. Their keynote addresses at the symposiums on Post-Reform Trends in Poverty and Inequality, Employment and Labour Policy and a commentary on the Draft Approach Paper to the 11th Plan, respectively, laid the groundwork for the 4th Liberal Budget. A special thanks to Mr. P. Geethakrishnan, former chairman of the Expenditure Commission of the Government of India for his guidance in ensuring that we got our facts and priorities right and Dr. Dinesh Chandra, former Secretary, Banking, Government of India, for his valuable insights on issues relating to agriculture and the bureaucracy.

A special thanks to the Drafting Group led by Mr. Sunil Bhandare. We are grateful to them for finding the time, despite their busy schedules to produce this document. It is their expertise in their respective areas of specialisation that has lent quality and credibility to this document.

We are grateful to the Friedrich Naumann Foundation and the Press Institute of India for their encouragement and assistance in the task of producing LB4.

S. V. Raju
Director, Project for Economic Education
National Coordinator, Indian Liberal Group

Mumbai,
October 31, 2006.

Chapter 1

Fiscal Issues: Challenges and Policy Response

Introduction

LB4 is a sequel to the three previous Liberal Budgets (LBs) presented by the Indian Liberal Group. LBs are not frozen in time; and hence, the proposed changes in fiscal and budgetary policies seek to truly reflect the dynamics of economic and fiscal environment. While doing so, there is unrelenting emphasis on fine-tuning and fostering consistently liberal economic policies, principles and systems in the Indian economy.

Unfortunately, it is very disconcerting to witness that economic reforms continue to be heavily distracted and diluted by the constraints of coalition politics, and in particular, by the demands on the government from its Left Front allies. In the process, the Left Front has impeded privatization and disinvestments; stalled labour reforms; attempted to limit the role of foreign direct investment (FDI); and pushed through fiscally unsustainable social welfare programmes. Specifically, for example, the last Central Budget (2006-07) may not have done anything to impede India's current rapid economic growth, but nevertheless lacked any significant structural liberalisation measures and initiatives.

Admittedly, despite the constraints on the ruling coalition Government, some bold policy measures are invariably proclaimed to be under active consideration of the Government, and some creeping reforms across some sectors and industries have been moving along. But neither is this process in conformity with the underlying requirements of the pace of economic reforms nor with the basic tenets of liberal economic position.

Yet, The Economy Broadly is in Good Shape!

On the side of economic performance, India is now well poised to achieve yet another year of impressive real GDP growth of 7.5 to 8 per cent in 2006-07. By virtue of this, India, undoubtedly, has emerged as the second major fastest growth economy globally after China, based on the average GDP growth rate of the last four years (including the projected growth of the current fiscal year). Alongside the services sector, the Indian manufacturing sector is experiencing growth resurgence over the last three years. Exports are also on a sustained high growth path, albeit there is a progressive widening of the trade gap thanks to rapid increase in imports. Yet, the foreign exchange reserves are rising continuously, supported by India's success in expanding invisible receipts, especially the exports of computer software services. At the same time, capital inflows have gained new momentum, not only due to FIIs' inflows, but on account of increased foreign direct investment.

India Inc. is gradually gaining global recognition reflecting the competence and credibility of the corporate sector. In turn, the Indian corporate sector has displayed remarkable resilience and is exuding unprecedented confidence in its capacity to ride the new wave of investment driven growth as well as opportunities unleashed by the process of globalization. Outbound direct investments, including mergers and acquisitions in the global

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markets by Indian corporates, are as inspiring as FDI inflows into India.

Several Areas of Serious Concern

But there are several issues of serious concerns such as (i) prolonged stagnant growth of the agriculture sector; (ii) growing regional imbalances; (iii) declining effectiveness of social sector expenditure; (iv) inadequate infrastructure development, especially power, irrigation, rural connectivity; and so on. Further, India's current growth momentum is driven predominantly by domestic consumption, especially of the middle-class; it is driven by the resurgence of the Indian corporate sector; it is driven by the selective thrust in infrastructure development (roads, telecom and ports); it is driven by some remarkable achievements in select areas of the services sector (finance and banking; construction; civil aviation; hotels and tourism, for instance); and it is driven by certain states and regions.

" In substance, India's post-reforms development experience lacks in its "inclusive" dimensions, as is so often reflected upon by the Prime Minister, and more elaborately and eloquently articulated by the planners in the 11th Plan Approach Paper.

Likewise, on the external front, there are several major challenges confronting the Indian economy. The most critical issue is about the on-going behaviour of crude oil and petroleum product prices. "

In substance, India's post-reforms development experience lacks in its "inclusive" dimensions, as is so often reflected upon by the Prime Minister, and more elaborately and eloquently articulated by the planners in the 11th Plan Approach Paper.

Likewise, on the external front, there are several major challenges confronting the Indian economy. The most critical issue is about the on-going behaviour of crude oil and petroleum product prices. Despite the recent sharp fall in international crude oil prices from their unprecedented range of $75 to $78 per barrel some weeks ago to $60-65 per barrel at present, most expert forecasts tend to suggest that its average level will remain more or less unchanged at the current level once the winter sets in and demand starts picking up. Surely, there are a number of significant risks to this forecast, which could lead to higher domestic prices of petroleum products, if the full pass-through mechanism is made operational. On the other hand, it would also impose a substantial burden of subsidies on the budget, given the overriding proclivity of the coalition Government to protect the interests of the vulnerable sections of society.

On the demand side, global demand for oil could rise faster than what is currently forecasted, especially in China, India and other emerging markets. On the supply side, there could be a possibility of major disruptions in Iran or Saudi Arabia due to geo-political tensions. As a major importer of oil, India's economy could suffer if oil prices were to turn out higher than the earlier forecast in the range of $60 to $65 per barrel. Even at this level, there are challenges of absorbing the consequential high cost of energy inputs and transportation.

So also, the Indian economy will have to constantly evaluate the implications of prolonged imbalances in the major players of the global economy – the massive current account deficit in the USA and equally hefty current account surpluses of exporting countries, namely China, Germany and Japan. It has been estimated that in 2006, the US current account deficit will be of the order of $900 bn or 6.5% of its GDP, while China's current account surplus will continue to push towards 10% of its GDP i.e. roughly $150 bn. Even in the context of the budgetary implications, the repercussions of such global imbalances on movement of interest rates, capital flows, trade and exchange rates call for constant evaluation.

Issues and Strategic Framework of LB4

In substance, the strategic framework of LB4 is going to be designed and determined by the current state of the Indian economy and the underlying risks therein. While reflecting upon the current fiscal challenges, it is also necessary to recall the principal message of the previous LBs.

It has been the endeavour of the Indian Liberal Group to offer an alternative based on the basic premise of liberal economic thinking that the business of government is governance and not business. Unfortunately, however, governance is the weakest link in our democratic system and institutions. Indeed, the government – instead of strengthening governance – is engaged in unrelated and non-core activities of owning and managing public sector enterprises, many of which have been perennially loss-making. What the LBs have argued for is effective government and not overstretched non-functional government.

Further, the ILG through its previous three LBs has repeatedly stressed that its basic liberal beliefs are:

- Man is the measure of all things and on this there can be no compromise;
- The individual is supreme and the state must work to further his or her potential;
- The Market is the most efficient allocator of resources and provider of goods and services;
- A Liberalising economy needs a truly Liberal Budget; and
- The LB is for a truly distinctive liberal fiscal stance, and is not for incremental change

The key basic tenets of the three LBs have been:

- Effective fiscal governance
- Fiscal consolidation and stabilization
- Efficiency and productivity
- Acceleration of growth
- Promotion of equity

It is also worth recalling that the ILG's LB initiatives began in the midst of two major developments:

- First, the new coalition government – the United Progressive Alliance – came to power with its own economic agenda dominated by the National Common Minimum Programme; and
- Second, the Indian economy started experiencing a growth resurgence – real GDP rising by 8% in 2003-04. That India has sustained this level of growth since then is itself a matter of great satisfaction for the ILG.

Further, there are many other facets of healthy quantitative and qualitative transformation of the Indian economy over the last three years, which have been broadly overviewed earlier. More importantly, there is a growing confidence, both here and abroad, about India emerging as a major economic power in the world over the next two decades.

But the continuing worry is about the strained fiscal situation, and the consequential fiscal constraints – their implications on the sustainability of high growth in an equitable society. All these developments make it imperative to quickly reflect upon the areas of convergence and divergence of the last three Central Budgets with the earlier LBs.

Overview of Earlier Liberal Budgets

All the three previous LBs highlighted the fact that the basic core of its liberal economic philosophy is to strive towards building an equitable society. However, it needs to be re-emphasized that this liberal position is not to be confused with an egalitarian society. Instead, the liberal strategy is to create a just and fair society – a society where the state provides equal opportunities for growth to all individuals, households, professionals, firms and corporates. The major thrust of the LBs has also been on the state's increased social sector commitments to deal with the massive problems of poverty, unemployment, primary education, and healthcare services.

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Better Fiscal Discipline

The strategic framework of the LBs, among other things, stressed the urgency of virtually phasing out the revenue deficit by 2006 i.e. in the current year itself in contrast to the subsequent FRBM Act promising to achieve this target by 2008-09. It has been pointed out that the positive impact of fiscal consolidation will manifest in:

- Raising the investment ratio from 24-25% of GDP to 28-30%;
- improving competitiveness and productivity of the economy (ICOR).

By virtue of these key macro parameters, it would be possible to strive for a long-term sustainable real GDP growth of 7.5-8% per annum. LBs' scope and canvas was not restricted to fiscal policy alone, but covered an overall economic policy regime (off-budget policy initiatives) to create a genuinely liberal environment fostering private initiatives, enterprise and investment.

Tax Reforms

The main thrust of the previous LBs has been on further rationalisation and reform of tax policies and administration through such measures as:

- Stability of tax policy;
- Simplification and rationalization of tax structure and moving towards globally competitive tax rates;
- Simplification of tax administration through computerisation of all tax operations, including customs clearances; and without any draconian powers to tax authorities – like search and seizure;
- Agricultural Income Tax;
- Restoration of tax buoyancy through high growth of the economy rather than imposition of additional tax incidence; and
- Raising the tax ratio by 3 to 4 percentage points to about 18% of GDP

Expenditure Reforms and Management

LBs articulated the importance of expenditure policy as a powerful tool of fiscal policy. For this purpose, it recommended:

"LBs recognized the severity of fiscal constraints in improving fiscal management as well as in giving impetus to development strategy with a thrust on the inclusiveness of economic progress. On considerations of liberal economic stance, LBs, as pointed out earlier, were deeply concerned with the proposition that the State must withdraw completely from commercial, financial and industrial activities, except on grounds of national security and meeting the demands of the social sector."

- Restricting expenditure growth to the anticipated growth in GDP – in effect, keeping expenditure to GDP ratio virtually constant at the present level.
- Changing the composition of expenditure decisively in favour of development expenditure by reducing non-development expenditure.
- Increased allocations for the social sector commitments - raising the ratio of spending to GDP in this area from the present 8% of GDP by at least 4 to 5 percentage points. Specifically, it has suggested allocation of 6% of GDP for education, and 2.5% of GDP for public health.
- Specific targets with human development focus; illustratively, to reduce poverty ratio by 5% points by 2007 and by 15% points by 2012; to ensure schooling for all children and complete 5-years schooling by 2009; to increase literacy rate to 75% by 2007; to bring down infant mortality rate to 45 per 1000 live births by 2007 and 28 by 2012.
- Focussed attention on the physical infrastructure with a more vigorous pursuit of public-private partnership (PPP) model of development.

Further, LBs placed greater stress on the quality of expenditure through better governance and for this purpose it felt it was imperative to formulate and execute –

- Ministry/Department-wise mission, aspirations and targets
- Performance cells in each Ministry/Department (for Performance Audit)
- Effective performance monitoring system
- Transparency in targets and their achievement parameters
- Restructuring of the government by rationalizing and rightsizing employees strength

More Vigorous Disinvestments/Privatisation Policy

LBs recognized the severity of fiscal constraints in improving fiscal management as well as in giving impetus to development strategy with a thrust on the inclusiveness of economic progress. On considerations of liberal economic stance, LBs, as pointed out earlier, were deeply concerned with the proposition that the State must withdraw completely from commercial, financial and industrial activities, except on grounds of national security and meeting the demands of the social sector.

It is the business of the private sector to be in business, and at the same time, it is the business of the Government to govern and create an environment for private initiative, enterprise and investment to flourish. Accordingly, LBs articulated comprehensively the imperatives of vigorous disinvestment and privatization policy, aiming at

- progressive expansion of revenues from such efforts to about Rs.35,000 crores immediately; and to Rs.50,000 crores in the following three to four years,
- promoting the principle of "ring-fencing" and "earmarking",
- insisting on the criterion of privatisation not governed by considerations of loss-making or profit-making PSUs; it should be based on whether the State should be in that field of activity at all.

Evaluating Central Budgets with the LBs over the Last Three Years

The ILG has sought to position its LBs as templates (or benchmarks) to evaluate annual budgets of the Central Government on a regular basis. The main objective is to create public awareness and education on matters concerning liberal economic thinking and dispassionately bring out areas of serious flaws and deviations in the process of economic reforms and free market economy. Equally importantly, it has been the LBs' endeavour to make a positive impact on economic decision-making. Hence, it is imperative to compare the LBs' policy formulations with the previous three Central Budgets (2004-05; 2005-06 and 2006-07).

Areas of Convergence

While doing so, LB2 as well as LB3 have acknowledged and appreciated several important policy initiatives of the Government of India such as:

- Increased allocations for rural development - Bharat Nirman, RIDF financing of six important programmes;
- Implementation of VAT through incentivising the States;
- Viability Gap Funding and Special Purpose Vehicles mechanism for infrastructure development;
- Further reduction and rationalisation of the tax structure; and
- Some social security measures.

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Likewise, while being critical of the overtly political contents and stance of the NCMP, which has exercised its overarching influence in the shaping of the Central Budgets presented in 2004-05 and 2005-06, the LBs have also welcomed some of its features like NREG (guaranteed employment of at least 100 days); food for work programme; target of expenditure on health and education; targeting subsidies to the poor; FDI policy liberalisation in areas of infrastructure, high technology and exports; and important role for the private sector in infrastructure areas. Specifically, LBs have found significant convergence in the following areas:

- FRBM becoming operational;
- Implementation of some major recommendations of the Kelkar Task Force on tax reforms, including VAT in the states;
- Reducing customs tariffs, expanding the coverage of service tax;
- Gradual increasing of the tax to GDP ratio, especially of direct taxes;
- Raising the FDI cap in telecom;
- Social sector initiatives – Food for Work, Midday Meal Scheme, PURA, safe drinking water, Accelerated Irrigation Benefit Programme; and
- SEZ Policy

Areas of Divergence

LBs have been unequivocal in bringing out many areas of divergence between liberal economic and fiscal policy prescriptions and actual policy measures and provisions of the Central Budgets. Illustratively,

- Postponement of FRBM targets – especially of revenue deficit. *LBs consider fiscal discipline envisaged in FRBM legislation as sacrosanct and there can be no compromise on this score* except in the event of fiscal emergency or unprecedented counter cyclical considerations;
- Lack of major initiatives on expenditure policy and management, including reform and control of subsidies – *LBs' highest priority is on administrative and expenditure reforms, including reduction in Government's employment*
- Lack of efforts to raise non-tax revenues to GDP ratio – especially the performance of PSUs and Departmental Undertakings, the system of user charges for public utilities and services

" In understanding the need for restructuring public finances, considering the combined accounts of the center and states, we take note of five key fiscal trends that cause serious concern. These are: decline in the tax-GDP ratio, large pre-emptive claims of interest payments relative to revenue receipts, high revenue-deficit to GDP ratio, large unsustainable fiscal deficit to GDP ratio, and falling levels of capital expenditure relative to GDP. "

- Provision of budgetary support to loss-making PSUs and efforts to restructure them through creation of Board for Reconstruction of PSEs – *the LBs' consistent stance has been for aggressive disinvestment and privatization*
- Promise-Performance Gap in the allocations for social sector initiatives – *the LBs' has laid great stress on the quality of expenditure and its effectiveness in the delivery of benefits to the deserving*
- Changes in tax structure and tax laws – several new taxes complicating tax structure (e.g. STT, CWT, new cesses) and amendments to tax laws, the continuing practices of retrospective changes.

Fiscal Challenges Before India

It is against the backdrop of the foregoing discussion that LB4 reflects on fiscal challenges before the country. It strongly contends that these have remained virtually unchanged over the period of reforms despite the fact that reductions in revenue and fiscal deficits ratios are now slightly better managed than in earlier years. The impact of the FRBM legislation is becoming visible only gradually.

At this stage, the ILG believes that instead of re-inventing the wheel, it may be desirable to quote from the various recent official documents on the true dimensions of fiscal challenges and concerns. Thus, in its Report presented to the Government of India in November 2004, the Twelfth Finance Commission observes (page 22): *"In understanding the need for restructuring public finances, considering the combined accounts of the center and states, we take note of five key fiscal trends that cause serious concern. These are: decline in the tax-GDP ratio, large pre-emptive claims of interest payments relative to revenue receipts, high revenue-deficit to GDP ratio, large unsustainable fiscal deficit to GDP ratio, and falling levels of capital expenditure relative to GDP."*

Admittedly, while some modest gains have been scored in some of the above parameters of fiscal health in recent years, the sustainability of fiscal consolidation continues to be the most daunting task for the Centre and the states. Thus, while analysing the Indian experience in the recent years, the latest Annual Report of the Reserve Bank of India for 2005-06, released in August 2006 observes (page 59) *"the correlation between change in GFD-GDP ratio and real GDP growth of the period 1999-2000 to 2005-06 at (-)0.42 was substantially stronger than that of (-)0.02 for the period 1971-1989-90. The experience of the recent years suggests that prudent fiscal policy and high economic growth comprise a virtuous circle."*

This Annual Report also seeks to suggest that *"fiscal consolidation plays a key role in determining an economy's growth path"*. Further, it states that *"high growth contributes to fiscal consolidation through improved tax collections and lower requirement for undertaking social sector expenditures such as unemployment benefits and social security. Similarly, reduction in fiscal deficit, particularly when the public debt is high and unsustainable, can accelerate economic growth through lower interest rates and increase in investment."*

Further, the Report cautions that *"notwithstanding the fiscal consolidation in recent years, the combined fiscal deficit continues to be high by global standards. The persistence of large deficits over the past decades has resulted in* *high level of public debt, currently around 80 per cent of GDP. Furthermore revenue deficits continue to remain high."* It, therefore, suggests that *"determined measures for fiscal consolidation would be necessary to achieve the declared FRBM targets so that the current growth momentum of the Indian economy can be maintained."*

Equally importantly, The Report of the Committee on Fuller Capital Account Convertibility submitted to the RBI on July 31, 2006 makes several significant observations on the challenges of fiscal consolidation, which is one of the major concomitants of further initiatives towards liberalization of the Indian rupee on capital account. It points out: *"It is clear that fiscal consolidation has fallen short of the expectations of the 1997 Committee"* and goes on to comment that *"the shortfall in the extent of fiscal consolidation envisaged by the 1997 Committee for 1999-2000 has not been attained even by 2005-06."*

While recommending the sequencing framework for fuller capital account convertibility, the Report not only suggests the strict implementation of the FRBM legislation in terms of fiscal and revenue deficit targets, but advances the case for graduating towards a comprehensive measure of fiscal deficit manifesting in the *"Public Sector Borrowing Requirement (PSBR), as a more accurate assessment of the fisc's resource dependence on the economy."* Further, endorsing the views of the Twelfth Finance Commission it suggests that *"By 2010-11, the Center should endeavour to build a revenue surplus of 1.0% of GDP which would amount to an estimated Rs. 62,97 crore in 2010-11 (assuming a nominal GDP growth of 12 per cent). .... A substantial part of the revenue surplus of the Center should be earmarked for meeting the repayment liability under the Center's market borrowing programme, thereby reducing the gross borrowing requirement." LB4 fully endorses these recommendations of the Committee.*

Unfortunately, new pressures on the fiscal situation are in the pipeline: Witness,

- the Approach Paper to the 11th Plan has evidently articulated the case for soft-peddling of FRBM targets
- the appointment of the 6th Pay Commission
- failure to manage even the "manageable subsidies" (e.g. issues of domestic POL pricing)
- the rising burden of social sector commitments under the NCMP framework
- virtual retreat of disinvestment and privatisation initiatives of PSEs
- implications of deterioration of fiscal situation of the States.

The Contextual Framework for LB4 (2007-08)

No budget can realistically be prepared without reference to the current context of economic performance of the country. Therefore, LB4 needs to reflect on the fiscal issues against the backdrop of the current strengths and weaknesses of the economy. Since this area has been debated and discussed so much we can only briefly touch upon the salient aspects of the current and emerging economic situation.

> *"The Report of the Committee on Fuller Capital Account Convertibility submitted to the RBI on July 31, 2006 makes several significant observations on the challenges of fiscal consolidation, which is one of the major concomitants of further initiatives towards liberalization of the Indian rupee on capital account."*

Strengths of the Economy

- ✔ High growth with relatively low inflation,
- ✔ Resurgence of manufacturing,
- ✔ Consistent high performance of the services sector,
- ✔ Growing competitiveness and dynamism of the corporate sector,
- ✔ Increasing globalisation and confidence about the importance of the external sector,
- ✔ Growing confidence of foreign investors,
- ✔ Demographic dividends and emergence of the Indian middle-class,
- ✔ Recognition of the role of the knowledge economy,
- ✔ Rising direct taxes to GDP ratio.

Weaknesses of the Economy

- ✗ Compulsions of coalition politics,

- Fiscal situation and constraints,
- Limitations of the current growth dynamics in making it "inclusive",
- "Drag effect" of stagnant agriculture growth – want of reforms or new green revolution,
- High levels of poverty and unemployment/ underemployment,
- Infrastructural inadequacies,
- External vulnerabilities,
- Governance issues – fiscal, administrative, etc,
- Slow progress of second generation reforms.

The Thrust of LB4:

LB4 believes that this is the time to focus on the Unfinished Agenda of reforms and prioritise a few specific issues based on the 11th Plan Approach Paper; illustratively, (a) agriculture reforms; (b) investment climate reforms; and (c) governance and administrative reforms.

It is against the backdrop of evaluation of the Central Budgets of the previous three years, the Approach Paper for the 11th Plan, the current strengths and weaknesses of the Indian economy and the on-going fiscal challenges that the Liberal Budget for 2007-08 has been cast. It seeks to deal with the specifics of:

Tax Reforms

- Stability of the tax structure – There should be no new innovations, but efforts should be concentrated upon consolidation and rationalisation of the existing framework,
- Radical Reforms in the area of indirect tax structure – broadly in line with the recommendations of the Kelkar committee,

" LB4 believes that this is the time to focus on the Unfinished Agenda of reforms and prioritise a few specific issues based on the 11th Plan Approach Paper; illustratively, (a) agriculture reforms; (b) investment climate reforms; and (c) governance and administrative reforms. "

- Significant streamlining and simplification of the tax structure,
- Withdrawal of FBT, CWT, and multiplicity of cesses
- Merging some of the cessess in the existing tax framework by compounding and simplifying the respective main tax rates,
- Allowing the Central Government to "ring-fence" 10% of gross tax collections for NCMP social sector commitments, and
- Agricultural Income Tax as an integral part of the Income Tax Act.

Expenditure Reforms and Management

- Stricter control on administrative expenditure – the expenditure control assumes further significance in the light of the impending Sixth Pay Commission,
- Reforms in the area of Subsidies – Gradual reduction in the outgo on subsidies through better targeting,
- Substantive shift in expenditure composition- freezing the growth of revenue expenditure and more resources for social sector spending,
- Emphasis of delivery of public services on matters concerned with social sector spending.

Disinvestments and Privatisation of PSEs:

- As mentioned earlier, the government needs to pursue a far more ambitious programme of disinvestments,
- The proceeds to be used for social sector investment and retiring of past debt.

PPP and Mechanism of SPVs

The emphasis of the LB4 is on promotion of investment in key infrastructure areas, for which it suggests aggressive pursuit of public private partnership (PPP) mechanism, viability gap funding and Special Purpose Vehicles (SPVs).

ILG is happy to observe that the 11th Plan Approach Paper is "aiming at doubling the real income of the average Indian in less than ten years time and also committing ourselves to reducing poverty to less than 10% in the same period. This calls for a targeted growth rate of GDP of around 8.5% in the 11th Plan combined with policies to ensure that growth is broader based than in the past."

It further states that "a central part of the vision of the 11th Plan must be to extend access to essential public services such as health, education, clean drinking water, sanitation, etc. which are currently denied to large parts of our population especially in rural areas. The provision of good quality education is the most important equalizer in society and it is time we launched a major effort in this area." Further, it emphasizes that "resources are only one part of the problem. It is equally important to ensure that the existing system can deliver quality services." We endorse this objective. At the same time LB believes that real GDP growth rate cannot be an end in itself; it should be the outcome of right policies and right choices.

The Approach Paper states that "to grow at an average rate of 8.5% over the 11th Plan period will require a substantial increase in domestic investment from around 29% which is needed for continuing with 7% growth, to about 34%. Apart from improving the investment climate for the increasing private investment, it sets out the strategy for bringing about "a substantial improvement in government savings. This will present a major fiscal challenge for the Center and the States."

While outlining the public sector responsibilities in the development strategy of the 11th Plan, the Approach Paper states that it "would require an increase in the Budgetary Resources for the Plan from an average of

"The Approach Paper states that "to grow at an average rate of 8.5% over the 11th Plan period will require a substantial increase in domestic investment from around 29% which is needed for continuing with 7% growth, to about 34%."

7.15% of GDP (center and states combined) in the Tenth Plan to an average of around 9.5% in the 11th Plan period. For assessing the feasibility of achieving this order of increase in the budgetary support, it suggests a combination of the following:

- An increase in tax revenues as a percentage of GDP;
- A fall in non-Plan expenditure (including explicit and hidden subsidies) as a percentage of GDP; and
- An increase in fiscal deficit.

It recognizes the fact that the scope for increasing the fiscal deficit as a means of financing Plan expenditure is constrained by the Fiscal Responsibility and Budget

Challenge of the Sixth Pay Commission

The Pay Commissions are the device by which a neutral authority investigates the aspirations of government employees and submits its recommendations that are, by and large, binding on both, government and its employees. Usually, such Commissions are set up after intervals of 10 to 15 years. Thus, the Sixth Pay Commission was inevitable and cannot be wished away by reformers.

There are about 40 lakh employees in Central Government, out of which 94% are in Class III and IV, 3% in Class II and another 3% in Class I. In State Governments, the number of employees is estimated at around 75 lakhs, and group wise breakup is similar, due to similar work culture. This explains the impression that government employees are salary oriented and not service oriented. The arguments about the current climate of fiscal deficits and a mounting public debt are irrelevant in this scenario and will get brushed aside. The estimated liability of implementing the Fifth Pay Commission recommendations in Central Government was Rs.15,000 crores, and similar liability in State governments was even higher. It appears that the implementation of the Sixth Pay Commission will mean an additional liability of about Rs.30,000 crores, because the base of pay scales are already high, unlike the structure 15 years ago. Similarly, the increase in State expenditure will also go up substantially.

Then, should we feel helpless? Is nothing possible? The policies of freeze on recruitment across the board, ban on creation of new posts, VRS have turned out be virtual non-starters. There is about one lakh recruitment each year due to retirements, deaths, resignations and launching or expansion of schemes. A freeze can never be feasible. The appropriate course is downsizing of government through privatisation and its withdrawal from manufacturing of goods or the provision of commercial services.

Railways is the biggest employer, accounting for 40% of the strength. Activities like manufacturing of engines, coaches and wagons can be privatised. In Defence, the production of many defence goods – from small arms to war machines – is with government. It can be privatised, as is the practice in most major countries having large defence requirements, by keeping quality control and secretive instalments within. In such a scenario, there will be a surplus of employees for redeployment and they can be adjusted against new recruitment. In Ministry of Personnel, there exists a scheme for redeployment of surplus employees. The limited scope of the Scheme can be enlarged through proper legislation.

An independent Commission can be constituted under that law, keeping in view the rank and pay scale, and the educational or other professional requirements of the posts. With restrictions on new recruitment combined with redeployment due to privatisation and giving up of certain activities by government, about one lakh strength in government can be reduced every year. Over a course of a decade, the numbers will be manageable with a better pay and pension in spite of their escalation.

FRBM Dilution – An Inappropriate Proposal

The LB4 Does Not Support the Planning Commission's View on Dilution of Fiscal Discipline Envisaged in FRBM Act

LB4 emphatically stresses that the 11th Plan Approach Paper's fiscal stance does not make an appropriate strategy for India's development process:

- First, the combined fiscal deficit of the Centre and states is already very high. There is a substantial share of revenue deficit in it. The current high fiscal deficit has not been deployed in financing capital expenditure (or capital formation) in the economy. Consequently, there are no income streams, which would accrue to the economy, to ensure servicing of the debt created through increased fiscal stimulus. This situation is unlikely to change, given the ongoing pressures on the side of revenue expenditure, and in turn, on revenue deficit.

  Hence, valuable domestic savings, which would otherwise be available to the private sector for financing their investment projects, would be eroded. The phenomenon of "crowding out", which was conspicuous by it absence in the last two or three years, would become more assertive in the coming years.

- Second, interest rates have already started edging up. Further fiscal stimulus would imply increased pressures through more and more public borrowings, given the fact that straight forward deficit financing (through RBI issues of *ad hoc* Treasury Bills) is now forbidden under the new monetary-fiscal dispensation. Therefore, "interest risk" perceptions would be further adversely affected.

- Third, inflation has been benign for some time now. Quite apart from better macro management of the economy, there are some healthy factors of our micro economy – productivity, efficiency and/or reductions in transaction costs. These are probably immediate "one time" gains of the radical transformation of the manufacturing and services sectors in the post-reforms period.

- Fourth, at the same time, we need to recognize the "repressed" component of inflation thanks mainly to large subsidies (explicit and implicit) in the pricing of several products and user charges of some public services (e.g. petroleum products like kerosene and LPG, electricity, water, railway passenger fares, etc.). Even if such subsidies were to be phased out gradually over the next few years, there is an element of in-built "cost-push" of at least extra one to one and half percentage point, which is currently being concealed. In substance, the "potential core inflation" in the Indian economy would be well above 5 percent for the next few years.

- Fifth, given the divergence in the "perceived" domestic inflation potential and the likely inflation in India's competing countries, there would be visible disturbance in the management of the exchange rate parity. In turn, the "exchange rate" risks are very much ingrained in the proposed relaxation of fiscal deficit/ revenue deficit targets under FRBM Act. The fact that the global view of India's growth story is extremely positive (bordering on overt optimism) augurs well for sustained and rising net capital inflows. But this perception can be very fickle, once there sets in persistent disturbances in the current relatively stable and healthy inflation-interest rate-exchange rate nexus.

- Sixth, on the side of the real economy, it is evident that capacity utilization in almost all sectors and sub-sectors, be it in infrastructure areas like power, ports, airports or manufacturing industries like cement, steel, aluminium, chemicals, capital goods, etc. have already peaked rapidly. There is no evidence of any "excess" capacities in any major industries, which phenomenon was so widespread just a couple of years ago. Even foodgrains godowns do not proclaim any "excess" stocks anymore. Indeed, after a lapse of many years India has started importing wheat to ease the supply situation.

  Thus, fiscal relaxation at this stage would generate instant "demand-pull", especially the social sector spending on health and education. But the supply elasticity will be found wanting, given also the fact that some part of additional fiscal stimulus will be directed towards "long-gestation" physical infrastructure.

- Seventh, there is a very thin line between "fiscal relaxation" and "fiscal profligacy". The Approach Paper seems to give an impression that the FRBM Act is likely to impose severe constraints on the financing of the social sector expenditure and infrastructure initiatives under the framework of 'viability gap funding" and the PPP public-private partnership) model. India is already in the league of only a few countries with a persistent very high level of fiscal deficit, and most of them are also high in their corruption perception index. In the absence of effective and strong governance mechanism, the probability of misuse of "excess" command over fiscal resources in the hands of Government is extremely high. We need to strategize the operational framework of "outlay-outcome" budget before venturing into any relaxation of fiscal discipline for supporting increased expenditure on either physical infrastructure or on social sectors.

- Finally, the current estimation of fiscal deficit of the Center and states does not reckon with the hidden liabilities of the government in terms of provisions for contingencies, guarantees and counter guarantees, liabilities on account of the "sick" departmental and public sector enterprises, etc. According to one estimate (*Economic Times*, 20/02/2006) government-guaranteed debt outside of the general government framework amounts to 10 to 11% of GDP. Further, the World Bank estimated losses from subsidized supply of power and irrigation to households and farmers at 1% of GDP. Such off-budget activities are not very transparent. There is, therefore, need to make a fuller evaluation and auditing of the Governments apparent total liabilities, as shown in the budget documents. It is imperative to generate the "true" picture of the fiscal health of the country before making a case for further fiscal stimulus and the consequent dilution of the Fiscal Responsibility Budget Management Act.

Management (FRBM) Act which requires the central government to reduce the fiscal deficit to 3% of GDP by 2009 and also requires the revenue deficit to be wiped out by this year. Similar Acts have been passed by most of the states. This forces the combined fiscal deficit of the Center and the States to be limited to 6 percent of GDP from 2008-09 onwards.

Thus, the Approach Paper recognizes that for the increase in plan size we will have to depend on some combination of an increase in tax revenues as a percentage of GDP and a reduction in non-plan expenditure.

After some detailed exercise on resources for the 11th Plan at 8.5% growth rate target, the Approach Paper deals with the problems of "the time phasing problem"

> "... the FRBM requirement calls for a reduction in the fiscal deficit of the Center and the States combined by about 1% of GDP in the first two years of the 11th Plan. This means the increase in resource availability will be relatively modest in the first two years, followed by fairly sharp increase thereafter. This has the consequence that some of the plan expenditures needed for making growth more inclusive may have to be postponed. This time phasing may also present problems for infrastructure development, where there are some time lags, and delays could jeopardize growth with corresponding effect on revenues. In addition, during these two years there would be very little, if any, scope to undertake counter-cyclical fiscal measures."

However, LB4 believes that the dilution of FRBM is unwarranted and is not appropriate for India's development process (please see box: 'FRBM Dilution – An Inappropriate Proposal').

We believe that, in the current context, the ideal proposition would be to continue on the path of fiscal consolidation, tax reforms and developmental-bias in expenditure – a similar agenda that LBs have been proposing in the past.❖

Chapter 2

Taking On the Challenge of Poverty

In recent years, there has been a pronounced improvement in perceptions about India's growth potential. A growth rate of 7.5-8% is no longer considered to be a surprise. Alongside, however, there are concerns that large segments of our population are yet to benefit significantly from the growth upsurge and that some segments could even have been marginalized.

These concerns find their echo in oft-repeated catchphrases such as '*aam admi*' and 'human face of reforms' that have gained currency in political debates as also in the title of the draft approach paper of the Eleventh Five Year Plan that reads 'Towards Faster and More Inclusive Growth'. The Liberal Budget welcomes this well-deserved recognition of the issues of poverty and inequality in our economic policy discussions. In fact, the very first Liberal Budget had chosen 'Towards Equitable Society' as its theme in 2003. However, we believe that the focus on inclusive growth should lead us to well thought out, sustainable and effective strategies to address the problems of poverty and inequality rather than any unsustainable and populist government interventions.

> *“Prevalence of poverty among a large section of the population is a scar on India's development performance that has refused to fade quickly.”*

Trends in Poverty

Prevalence of poverty among a large section of the population is a scar on India's development performance that has refused to fade quickly. The most recent official estimates place the proportion of population below the poverty line at 28%, implying that over 30 crore people are not able to buy the basic calorific requirements for their subsistence.

In fact, the current definition of poverty line can itself be considered to be quite restrictive. It is defined on the basis of whether a person can afford to consume 2,400 calories of food in rural India or 2,100 calories of food in urban India per day. This definition ignores the other bare minimum necessities for a decent living, such as access to clothing, shelter, sanitation and education. If one were to consider a more realistically defined poverty line, the number of poor in India could be far in excess of 30 crores. We believe that as a nation with higher growth aspirations, India needs to gradually move to a more realistic definition of poverty line in the coming years, which would also imply gradually expanding the breadth of the poverty alleviation programmes.

Even with the current definition, the problem of poverty is far too grim and sticky. Trends during the last decade show that the poverty ratio has declined, but not fast enough as the following indicates:

Trends in Poverty and Growth

(a) Poverty Ratio (% of population)

	Total	Rural	Urban
1983	44.5	45.7	40.8
1993-94	36.0	37.3	32.4
2004-05	28.0	n.a.	n.a.

(b) GDP Growth (% per annum)

	Overall GDP	Agriculture
1983-84 to 1993-94	5.2	2.9
1993-94 to 2004-05	6.3	2.4

It may be noted that trends in poverty are captured through surveys of National Sample Survey Organisation (NSSO) based on consumption expenditure. These sample surveys that are conducted roughly every five years provide relatively reliable estimates of poverty ratio. Recent preliminary results available from the survey for 2004-05 are comparable to the results of the 1993-94 survey but not to the 1999-00 survey that used a different methodology. This aspect limits our ability to discern the dynamics of poverty trends very conclusively.

Notwithstanding these technical limitations, NSSO surveys show that the proportion of population below the poverty line has declined in the post-reforms period – from 36% in 1993-94 to 28% in 2004-05. But the pace of decline is certainly not spectacular. In fact, the data suggests three worrisome aspects of the problem of poverty.

First, the goal of eradication of poverty appears quite distant on the basis of current trends. In the last eleven years, the poverty ratio declined at the rate of just about 0.75 percentage points per year. At this rate, it will take over 35 years to eradicate poverty. This kind of a stretched time frame is certainly not acceptable.

The second aspect, which is linked to the first one, is the fact that the absolute number of poor is still large and quite sticky. The number of people below the poverty line was over 32 crores in 1993-94, which has come down to around 30 crores in 2004-05. Going by the current rates of population growth and reduction in poverty ratio, India could still have more than 22 crore people below the poverty line in 2020.

The third worrisome aspect is the reduced effectiveness of growth in tackling poverty. If one compares the pre-reforms (1983 to 1993-94) and post-reforms (1993-94 to 2004-05) periods, the growth rate has clearly accelerated in the latter period, but the rate of poverty reduction has slowed a bit.

This paradox needs to be investigated further when more details on the 2004-05 survey become available. But *prima facie*, three likely explanations can be pondered upon.

- First is the relatively lower growth in the agricultural sector during the latter period. Agricultural growth rate slipped to 2.4% p.a. in the latter period from an already not-too-impressive rate of 2.9% p.a. in the former period. Agricultural stagnation not only affects the process of poverty reduction in rural areas, but also affects urban poverty because of higher migration and higher food prices.
- The second possible explanation relates to the lags in the transmission of gains of growth. Various other economic indicators show that larger gains of the reforms process have become visible only in the last couple of years. The earlier spurt in growth was driven most noticeably by certain sectors (such as financial services or IT) that probably do not make a direct dent on mass poverty. The sectoral distribution of growth appears to have become more broad-based in the recent period. With such broad basing of growth and possible second-round effects of the growth in IT or financial services, it is likely that poverty could reduce more quickly in the current growth phase. This possibility can, however, be confirmed only a few years down the line when data from the next survey become available.
- The third, empirical and anecdotal evidence suggests that the force of government intervention in alleviating poverty could have blunted during the last decade – in terms of the composition of government expenditure on social sector programmes as also the quality of governance in implementing the programmes. According to calculations based on the data in the Reserve Bank of India Handbook of Statistics, the per capita developmental expenditure of the Centre and States has increased by 51% in inflation-adjusted terms from around Rs.1,450 in 1993-94 to Rs.4,082 in 2004-05. But it appears that the process of asset building through capital expenditure has slowed down, especially in the early years of reforms. Also, there are reports of significant leakages and poor administration of government programmes, affecting their effectiveness. Problems such as absenteeism of teachers and health workers, disbursal of funds to fictitious beneficiaries and discrimination in delivery of public services, have been reported widely.

“The second aspect, which is linked to the first one, is the fact that the absolute number of poor is still large and quite sticky. The number of people below the poverty line was over 32 crores in 1993-94, which has come down to around 30 crores in 2004-05. Going by the current rates of population growth and reduction in poverty ratio, India could still have more than 22 crore people below the poverty line in 2020.”

Challenge of Inequality

Unlike poverty, inequality is a relative concept. In advanced societies too, one could have groups with unequal levels of prosperity. In a developing society like India, however, inequality is typically associated with poverty, where bottom ladders of the society experience absolute deprivation.

While some degree of inequality is bound to exist in any society, large and evident inequality can lead to social tensions, eruptions of which can be substantially damaging to growth and stability. It is widely perceived that India's recent growth experience has also witnessed widening of gaps across different strata of the society, viz. rural vs. urban, developed regions vs. backward regions; and, of course, rich vs. poor. With malls, multiplexes and various gizmos screaming out as very visible symbols of the rising prosperity of the upwardly mobile sections of the population, the perception of rising inequality has got further embossed in recent years.

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This perception is somewhat supported by data, especially in the case of regional disparities. There is a widening gap in per capita income across States; sometimes the differences are larger than what one witnesses across countries at different stages of development. While some States are trying to position themselves as emerging giants of Asia, a few States in the heartland are still struggling to come out of the BIMARU tag.

Data on the urban-rural divide shows rising inequality, but not at the rate that one would have expected going simply by popular perceptions. The ratio of urban to rural per capita consumption expenditure has gone up to some extent in the NSSO surveys. Regarding the income inequality i.e. the rich-poor divide, while anecdotal evidence seems to suggest some widening of inequality, the results of the NSSO surveys do not indicate any significant adverse movement (see table 'Estimates of Lorenz Ratio'). The Lorenz ratio, which measures the distribution of consumption expenditure across various groups has been fairly stable in recent years.

Estimates of Lorenz Ratio*

	Rural	Urban
1973-74	0.28	0.30
1983-84	0.30	0.33
1993-94	0.28	0.34
1999-00	0.26	0.34
2004	0.27	0.35

* Higher the ratio, greater the inequality in distribution of consumption expenditure

Figures based on NSSO surveys; all rounds are not strictly comparable.

Sources: Planning Commission, National Institute of Rural Development

One must, however, recognize that inequality measured simply in terms of incomes or expenditures can sometimes mask the extent of inequality. There are gaps in availability of essential services, such as health and education across regions or between rural and urban areas. When one recognizes these gaps, the extent of inequality is likely to be larger than what the indicators based on NSSO surveys would suggest.

Liberal Budget Approach to Issues of Poverty and Inequality

The previous sections make it amply clear that poverty and inequality are certainly amongst the most serious issues that India is confronting at this stage in its developmental process. Therefore, one needs to tackle these issues on a war footing. From that perspective, this Liberal Budget suggests the following approach to addressing these issues:

- While poverty and inequality are both important problems, alleviation of poverty should assume centre-stage of the policy emphasis. If deprivation levels are brought down sizeably, the severity of the issue of inequality would be contained to some extent by itself. Of course, one must keep on addressing the issues of inequality by helping the laggard sections/ States catch up with the others and by promoting more equitable distribution of opportunities. But to the extent that prioritizing efforts and funds is involved, the prime focus should be on reducing poverty at the earliest. The rate of reduction in poverty ratio, which has been around 0.7-0.8 percentage points per annum in the last two decades, needs to be at least trebled so as to substantially remove the scar of poverty from India by 2015 - if not earlier.

- Empirical cross-country studies have established the strong linkage between growth and poverty reduction. Though recent Indian experience did not witness an accelerated reduction in poverty despite accelerated growth (some plausible explanations for which were mentioned earlier), the importance of sustained and robust growth in attacking poverty cannot be ignored. In fact, high growth can be viewed as an essential pre-condition for a substantial dent in poverty. Also, it is well known that high inflation – especially of food items – hurts the poor the most and it becomes difficult to bring down poverty in times of high inflation. Thus, from a macroeconomic perspective, a combination of high growth and low structural inflation can be considered to be the most conducive for tackling the issue of poverty.
- Government policies need to pursue vigorous growth and stable inflation, which calls for speedier implementation of the second-generation reforms, such as further lowering of tariff barriers, flexibility in labour laws, more conducive investment climate, thrust on infrastructure, move towards unified goods and services tax, removal of barriers on internal trade, among others.
- The necessity for a stable and conducive macroeconomic environment also implies a certain code for government interventions (through social sector programmes). Government cannot shy away from the responsibility of providing a certain degree of safety net, especially when a lot of structural churning is taking place in the economy. It must commit larger resources to developmental purposes in general, and for sectors like health, education, basic amenities and employment in particular. But while committing to such interventions, it must ensure that the interventions are effective and are fiscally sustainable. The temptation to announce quick-fix grandiose schemes that could burden the fiscal health in future should be avoided since weak fiscal health would be one of the largest threats to the macroeconomic environment, and ultimately to the long-term goal of poverty reduction.
- In terms of India's macroeconomic performance, one major indicator that needs to improve on an urgent basis from the poverty reduction perspective is – agricultural growth. The stagnation in this sector has been reflected in the much-publicised farmers suicides and rising rural distress levels. In order to correct this situation, one needs to focus on improving availability of farm credit, better administration of agricultural extension services and encouragement to new institutional structures, such as corporate farming and contract farming. One model that can be seriously looked upon to jump-start agricultural growth is that of Special Agricultural Regions (see box on page 20: Agriculture Vision 2020).
- Besides promoting agricultural regions, it is also necessary to unshackle the agriculture sector by focusing on agricultural reforms at the earliest. In the current scenario, Market Committee Laws have the effect of taxing the farmers and putting restrictions on movements of farm produce. Such laws should be made optional for the farmers and marketing bodies should be encouraged to raise their independent resources. There should be complete freedom to farmers to sell their produce directly to potential purchasers. This will ensure better price and access to new markets. Also, all restrictive orders inhibiting storage, selling and movement of farmers' produce should be removed. Another issue is that of Land Ceiling laws, which in many States apply to operational holdings, i.e. the combination of owned land, leased land, mortgaged land, and so on. This is hampering economies of scale in the agricultural sector. Therefore, Land Ceiling laws should be confined only to ownership land so that wherever possible, farmers would be free to reap scale economies by leasing of land. (See box on page 22)

How to Increase the Effectiveness of Interventions?

It appears that there has been a deterioration of governance in general in the last few years, which has

“ In terms of India's macroeconomic performance, one major indicator that needs to improve on an urgent basis from the poverty reduction perspective is – agricultural growth. The stagnation in this sector has been reflected in the much-publicised farmers suicides and rising rural distress levels. ”

Agriculture Vision 2020

The Indian economy is now on the threshold of a sustained long-term high growth performance. But a major area of concern is the consistent stagnant agriculture growth for the past many years. It is imperative, therefore, to formulate Agriculture Vision 2020, which can hold a promise of becoming an intrinsic part of the long-term strategy of inclusive growth.

Agriculture Vision 2020 promises to stabilize the growth momentum of the economy; mitigate to a large extent the concerns of employment generating growth; and alleviate poverty and social tensions through the process of sharing more equitably the gains of economic development. We set out the basic framework of this strategy as follows:

Objectives of Agriculture Vision 2020:

- First, to strive for a sustainable annual real growth of at least 4% per annum in the agriculture sector, as envisaged in the 11th Plan Approach Paper.
- Second, to enhance the value creating agro-processing (or food-processing) activities to score an average annual growth rate of 8 to 10%.
- Third, to improve the global competitiveness of agriculture and related activities so that India annually exports at least 15% of the value of their output. At present, the Agriculture Sector accounts for roughly $200 bn of value of output, but our exports are not commensurate primarily because of inadequate competitiveness and absence of relevant infrastructure support.
- Fourth, to create robust employment opportunities in the off-farm activities in and around rural areas through modernization and commercialization of agricultural operations.
- Fifth, to build confidence in the growing potential of agriculture and the rural economy so as to face the on-going WTO negotiations boldly and positively.

Special Agricultural Regions

In order to realize the vision for agriculture, we propose the development of Special Agriculture Regions (SARs) on the pattern of the Special Economic Zones (SEZs). SARs must have similar substance and stance as SEZs, especially the framework of a single window clearance and enabling environment. SARs could be developed in the following framework -

- First, the responsibility for promoting SARs must almost entirely be of the respective State Governments. For this purpose, a large agricultural area has to be mapped out for comprehensive agro-climatic evaluation, and for determining the appropriate agriculture related activities.
- Second, the Central Government to allocate a special grant of Rs.100 crores for each State for undertaking such comprehensive agro-climatic and techno-economic feasibility reports of at least three or four alternative prospects of SARs in their respective geographical areas.
- Third, once SARs are finalized with the ultimate clearance of the Planning Commission jointly with the Agriculture Ministry of the Central Government, the Central Government can consider appropriate funding mechanism under the Special Purpose Vehicle (SPV) model. Further, the facility of Viability Gap Funding can also be extended to SARs with the necessary modifications, keeping in view the nature of agri-businesses. However, the implementation responsibility must rest with the States.
- Fourth, SARs can be driven by PPP model, which is increasingly becoming popular in many complex and capital-intensive infrastructure projects. Here, what will be more distinguishing is the tripartite strategic alliance, namely, among the Governments (Central and States); the farmers; and the Private Sector. The Private Sector's vital role will be to provide orgnisational, managerial, financial, marketing and technological support. Already, there are some successful corporate experiments in the agro and food-processing manufacturing activities. This model for SARs will be known as PFPP model representing Public-Farmers-Private Partnership.
- Lastly, PFPP initiative can trigger off the implementation of PURA (Providing Urban Amenities in Rural Areas), the strategic framework of which has been so well articulated by the President of India and also formed a part of the previous Central Budget.

To sum up, Agriculture Vision 2020 offers a strategic framework for realizing the objective of rural resurgence through the route of PFPP and engaging the stakeholders concerned to promote inclusive high economic growth for the Indian economy. In doing so, India can substantially resolve the problems of rural poverty and unemployment. At the same time, India will participate in the modernization and globalization of its economy by making those engaged in the agriculture and rural sector, partners in the whole process.

also hampered the effectiveness of government's social sector programmes. While new programmes are announced periodically, their effectiveness on the ground remains under cloud. Substantial leakages on account of corruption, inefficiencies and indifference of implementing agencies imply that only a small portion of the intended benefits reach the poor households.

These problems have been recognized in the recent policy debates and the government seems to be taking some steps to improve the effectiveness of its expenditure. The Right to Information Act was one major step, which *inter alia*, would also help improve transparency in the implementation of government programmes. Government has also recently started documenting the outcomes budget, which is a welcome step. Lastly, there have been efforts to improve the targeting of subsidies and other doles so that such expenses are channeled more effectively.

The Liberal Budget believes that such efforts need to be continued even more vigorously in the coming years so as to drastically improve the effectiveness of government programmes in dealing with poverty. In this connection, the following proposals can be explored –

- Public Servants need to be made more accountable for the discharge of their duties. For this purpose, a dual system of performance measurement can be explored. First, for key functions that have critical developmental implications, systems to track outcomes need to be put in place. For example, information on social indicators captured through various surveys could be used to map the performance of particular schemes at local levels. In most cases, measurement of outcomes should be possible within the existing systems. Second, a formal feedback should be taken from elected representatives of local bodies regarding the quality of delivery of public services in their areas. The performance of public officials should be measured on the basis of both feedback mechanisms, which will reduce the chances of manipulation of either mechanism. Public servants should, then, be rewarded or punished on the basis of their performance. Such feedback mechanisms should be an integral part of administrative reforms.

- At present, the Below Poverty Line (BPL) families are identified for targeting under the public distribution system. In several States, such BPL families have been identified and provided separate ration cards. One can explore the possibility of according a unique beneficiary number (UBN) to each BPL family. Thereafter, under all government schemes, it should be mandatory to record the data on UBN of each beneficiary. Such a system will serve two purposes. First, it will make it easier to monitor the performance of schemes. Secondly, it would leave a trail of the funds disbursed, which can be verified in case of any doubts. Such a trail would substantially close the possibility of disbursal of funds to fictitious beneficiaries. In fact, periodical verification can be conducted on samples of the UBNs to ensure that benefits have indeed reached these families. Gradually, all schemes of government support, including food subsidy and employment programmes can migrate to the UBN system.

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- The government has been making some efforts in recent years to target its subsidies. However, very often the process of providing a subsidized item (such as food or fertilizer or education) itself becomes a large operational activity for the government with scope for large inefficiencies. Thus, a large part of the subsidy expenditure actually gets diverted to fund the inefficiencies in the system. For example, a large part of the food subsidy goes to maintain the operations of the Food Corporation of India or a large part of the education budget goes towards salaries of teachers regardless of their actual performance. It has been often suggested in the literature on this subject that the best way to avoid such diversion is to provide subsidies directly to the consumer in monetary terms and then, allow the consumers to source their needs from the market. Suggestions such as food coupons have come up in this regard. One needs to start experimenting with this concept, wherever feasible, in an aggressive manner. This would gradually free the resources locked in inefficient operations for providing subsidized items and enable the government to intensify its intervention where it is required the most.

- In order to improve the effectiveness of government programmes, what one needs the most are innovations – both radical and incremental – in institutional mechanisms. In fact, various NGOs and several government wings are possibly already engaged in such innovative experiments in different pockets of the country. It would be worthwhile to set up an 'Innovations for Development Institute' to study various developmental experiments, draw appropriate lessons and then suggest ways of replicating successful models. Such an institute can catalyse the process of learning from successful development experiments.

To conclude, the Liberal Budget believes in a three-fold strategy to take upon the challenges of poverty and inequality: First, to pursue sound macroeconomic policies that aim at accelerated growth with modest structural inflation, with a special emphasis on raising the growth performance of agriculture. Second, to commit larger resources to the social sectors within what the overall fiscal discipline permits. And finally – and most importantly, to promote institutional innovations that would dramatically improve the effectiveness of government's social sector interventions.

We believe that with the Indian economy being likely to move along a high growth trajectory over the next decade or more, this is the most opportune time to aim for a decisive assault on poverty.❖

Agricultural Reforms

1. There must be a clear and unambiguous policy towards free market in Agriculture and Foodgrains. The free market exists for traders but not for producer-farmers. There should be unfettered freedom for farmers to sell their produce directly to potential purchasers. This will ensure better price and access to new markets. Market Committee laws are in the nature of taxing farmers in raising their own resources and putting restrictions on movements. Such laws should be optional for the farmers and the marketing bodies should raise their independent resources. In the process, the MSP (Minimum Support Price) mechanism must be abolished. All restrictive orders inhibiting storage, selling and movement on farmers produce should be removed.

2. Small and marginal farms are not viable. They can only be supplementary to the income of their owners, who have some other occupational income. Therefore, any policy of allotting one or two acres of land to the poor only perpetuates their problem and such populist measures need to be avoided.

   The phenomenon of "Reverse Tenancy" is on the rise. Small farmers lease out their land to big farmers, who operate additional holding on the economies of scale. Such tenancies are not recorded in papers to avoid any confrontation with land laws or for the fear of addition or deletion of rights of the parties in the leased land. The land ceiling laws in several States combine ownership land with leased land, mortgaged land etc., and then put a ceiling on the operational holding. Ownership comes by providence or fortune Curtailment on that by a ceiling limit is rational. But the cultivation of leased land is the enterprise of the operator, and it is illogical to apply ceilings criteria on that. In trade and industry, there is no limit on expansion of enterprise. It is, therefore, recommended as a policy that the land ceiling laws should apply only to ownership land.

3. On the subject of agriculture credit, the statements by the Finance Minister or the Governor of the Reserve Bank of India are always misleading either by design or ignorance. Their statements speak of outstandings, and the linear progress is mentioned by noticing the increase in outstandings. The outstanding are stocks and disbursements are flows. Agriculture production and disbursements in the year are related. The information can be conveyed on the basis of well-judged estimates like any other projections and should not be concealed.

Chapter 3

Post-Reforms Labour and Employment Issues

Being a populous country, India has had to face the perennial problem of labour and employment. Providing employment to the millions of job seekers has been a major challenge for our planners since the beginning of India's planning process. Till the economy remained closed (mid-80s and more particularly the beginning of the 90s) under the socialistic pattern model, employment generation and labour protection was an overriding goal. Particularly, the organized sector was legally obliged to protect employment in return for protection from competition. The interventionist regime created a complex web of labour laws and extensive executive machinery. This resulted in a well-laid framework seeking to provide security of tenure of employment in the organized sector while largely ignoring similar efforts in the unorganized and small-scale sectors.

The economic scene started changing in the 'nineties. The New Economic Policy (NEP) introduced stabilization and structural adjustment programmes. Stabilization measures basically aimed at controlling fiscal balance, balance of payment deficit and maintaining lower inflation while structural programmes focused on measures for integrating the domestic economy with the global economy, productivity enhancement, and higher movement of capital. This exposed the economy to both domestic and global competition. During the post-reforms period labour-saving modern technology was adopted by industry in order to attain higher goals in terms of quality and quantity, while de-reservation led to increasing the scale of the economy. These measures in turn resulted in higher output but lower employment generation particularly in the organized sector. As a result, the higher growth achieved during the post-reforms period without a corresponding rise in employment was termed as 'jobless-growth'. Even as the protection given to organized sector was taken away under the new policy framework, labour law rigidities remained unchanged. This started the conflict between employers and employees.

As the employment generation potential of the organized sector started waning, labour started moving into the unorganized sector. This in turn led to an increase in the number of those engaged in low quality employment (lack of decent jobs) and other related issues. *The growing unorganized sector also became a source of income inequalities in the country.*

After a decade and half of reforms, India is at the crossroads. It is high time to complete the unfinished agenda of reforms by adopting a second dose of hard-core reforms including the labour reforms. At the same time, demographic changes resulting in a growing proportion of economically active younger population, throws a major challenge as well as an opportunity for the economy. The trade off between capital intensive (higher productivity) and labour intensive (employment generating) techniques adds to the complexities. Simultaneously, the problems of child labour, and gender bias in the labour market continue to bother.

In the post-reform period, India has embarked on a high growth path leaving behind a Hindu growth rate of 3.5%. Today the economy is capable of posting a sustained growth of 8%. Most importantly, our policy makers have

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realized the significance of 'inclusive growth'. The draft Approach Paper to the 11th Five Year Plan mentions that "...the 11th plan provides an opportunity to restructure policies to achieve new vision of growth that will be much more broad-based and inclusive..."

Labour and employment issues in our economy cannot be seen in isolation. On the contrary they are closely connected to the issues of income and poverty levels and overall developmental policies – the topics dealt separately in this edition of the Liberal Budget.

With this background, we attempt to briefly analyse the issues relating to labour and employment particularly during the post-reforms period and also try to find out solutions in broad terms. The chapter is broadly divided into three parts. The first part deals with the structural changes in the labour and employment scene in India. The second part discusses the imperatives inherent in the problem while the last part deals with the challenges posed by these problems.

I – Structural Changes in Labour and Employment

The Post-Reforms period has witnessed structural changes in the labour and employment scene *vis-à-vis* the pre-reforms period. In the following paragraphs changes in the labour scene are analysed followed by an examination of the changes in employment.

Changes in the Labour Scenario

These transformations can be analysed under three broad categories viz. demographic, social and economic changes explained below.

" Labour and employment issues in our economy cannot be seen in isolation. On the contrary they are closely connected to the issues of income and poverty levels and overall developmental policies – the topics dealt separately in this edition of the Liberal Budget. "

Demographic Changes

During this period, the most radical demographic change has been the slowdown in population growth in rural and urban areas of both males and females. This in turn led to a slow down in the annual growth of labour force (total labour supply i.e. employed plus unemployed) as well as work force (the labour force that is employed i.e. labour force minus unemployed). Despite declining incremental labour force there has been a rise in the growth of unemployment. Interestingly, there has been some slow down in the rate of unemployment of females particularly in urban areas.

Table 1: Labour Scenario: Growth Rates (CARG %)

	Pre-Reforms (1983-94)	Post-Reforms (1994-2004)
Labour Force		
Males	2.2	1.7
Females	1.7	1.6
Rural		
Males	1.9	1.4
Females	1.4	1.2
Urban		
Males	3.1	2.7
Females	4.0	2.2
Work Force		
Males	2.2	1.7
Females	1.7	1.5
Rural		
Males	1.9	1.3
Females	1.4	1.2
Urban		
Males	3.2	2.7
Females	3.8	2.2
Unemployment		
Males	1.3	3.1
Females	4.6	3.7
Rural		
Males	1.9	3.7
Females	2.7	5.3
Urban		
Males	0.7	2.5
Females	6.3	2.3

Note: Including Principal Status and Subsidiary Status
Source: NSSO surveys.

Social Changes

During the post-reforms period, there have been certain welcome changes in India's labour structure from the social point of view. Illustratively, the component of child labour in the total work force has been declining. Between 1993-94 and 2004 the share of child labour (between the age group of 5-14) has declined from 3.3% of the total work force to1.7% in the case of male and from 5.1% to 2.6% for females. This, in a way, is also reflected in increasing school enrolments. Between 1991 and 2002-03 enrolment in primary education increased from 80.5% to 95%. In the case of secondary education, the proportion has risen from 42% to 61% in this period. Still, child labour continues to be major menace and its eradication poses a social challenge. As liberals we support all measures – legal and financial - that will help uproot this problem.

Another area of progress has been the improving educational levels of workers. For example, the share of graduate rural males has increased from 2.6% of the total work force in 1993-94 to 5.6% in 2004. In the case of females the proportion has risen from 0.4% to 1.3%. Their urban male counterparts show an increase from 14.3% to 17.3%. For females the proportion has risen from 10.6 to 17.1%.

Rising educational levels of workers have been facilitating improving productivity levels of labour. Gross real value added per worker has increased from Rs.19, 737 in 1993-94 to Rs.27, 722 in 1999-2000 – 5.82% growth per annum.

Economic Changes

The rising rate of growth of real wages provides some solace for the working class particularly, in the rural sector. For instance, in the case of casual labour in all activities, real wages increased at an annual rate of 2.51% during 1983 to 1993-94 for males and 3.15% for females. In post-reforms period the growth rate was 3.59% for males and 3.19% for females. The analysis of activity-wise real wage growth rate shows that the rise in wages has been higher for females vis-à-vis males (Table-II).

Table II: Average Real Daily Casual Wage Growth Rate (% p.a.)

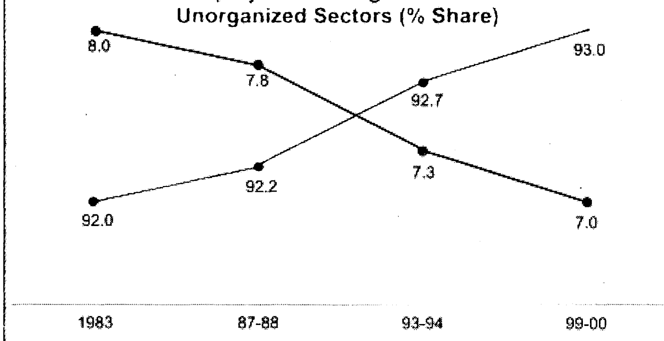
Activity	Males		Females	
	'83-'94	'93-'00	'83-'94	'93-'00
Manual work in Agriculture	2.74	2.77	3.09	2.93
Non-Manual work in Agriculture	4.51	3.47	2.69	3.18
Non-Manual work in Non-Agriculture	2.82	3.07	4.12	4.57
Public Works	2.29	3.83	4.10	5.04

Source: NSSO Surveys

Another structural change in the Indian labour market has been the shift of labour from the organized sector to the unorganized sector. Total employment in the organized sector has increased marginally from 24 mn in 1983 to 27.8 mn in 1999-2000. During this period total employment in the unorganized sector increased from 275.6 mn. to 371.2 mn. Compound annual growth of employment in the organized sector declined from 1.26% during pre-reforms period (1983 to 1993-94) to 0.24% in the post-reforms period (1993-94 to 1999-2000). In the case of the unorganized sector however, the decline was slower from 2.24% to 1.04% during the same period.

As a consequence of labour shifting to the unorganized sector, its share in total employment has increased over a period of time. Conversely, the share of the organized sector has decreased (Chart I).

Chart I
Employment in Organized and Unorganized Sectors (% Share)



"Between 1991 and 2002-03 enrolment in primary education increased from 80.5% to 95%. In the case of secondary education, the proportion has risen from 42% to 61% in this period. Still, child labour continues to be major menace and its eradication poses a social challenge."

Interestingly, the share of the unorganized sector in farm employment has declined from 74.4% in 1983 to 64.5% in 1999-2000. On the other hand, its share in non-farm employment particularly, in the areas of manufacturing, construction, trade, restaurant, transport and services, increased considerably during the this period.

Another development in the labour market has been the rising regular salaried class among females in the rural as well as urban areas. However, in the case of males, self-employment has been on the rise in urban areas (the regular salaried employed has declined while casual employment has remained almost steady) while casual employment has been rising in rural areas (self employed regular salaried class have declined)

" Between 1980 and 1990 (the period of the second and third Economic Census) growth rate in total employment declined. The fall in employment was seen in both rural and urban areas. Decline in urban employment has been relatively sharper as compared to rural employment. This could be due to an increase in non-farm jobs in rural areas. However, during the same period, the overall economic growth was higher. "

A major implication of this shift of labour from the organized sector to the unorganized sector has been the deteriorating quality of employment. Job security and other labour welfare benefits available under the organized sector are more or less absent in the unorganized sector. This would adversely affect productivity, social security, and the standard of living of labour.

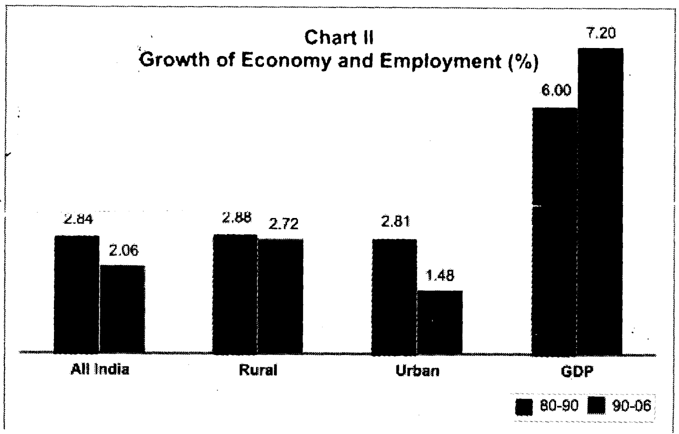
There has been a major decline in labour unrest in the recent past. The numbers of strikes and lockouts have decreased from 771 in 2000 to 404 in 2004. As a result, man-days lost have also reduced from 28.8 mn to 13.5 mn in this period. The growing unorganized sector could be one of the factors responsible for declining labour unrest in the country.

Changes in the Employment Scene

During the post-reforms period changes in the employment scene have occurred in the form of growth rates, sectoral changes in employment and inter-state disparity in employment.

Growth of Employment and Unemployment

Between 1980 and 1990 (the period of the second and third Economic Census) growth rate in total employment declined. The fall in employment was seen in both rural and urban areas. Decline in urban employment has been relatively sharper as compared to rural employment. This could be due to an increase in non-farm jobs in rural areas. However, during the same period, the overall economic growth was higher. This implied that the higher growth was achieved without corresponding increase in employment – a jobless growth.



Conversely, the unemployment rate has been growing faster during the post-reforms period. Interestingly, during post-reforms period male unemployment has grown faster than female unemployment. For instance, between 1993-94 to 2004 male unemployment increased at a compound annual average rate of 3.1% as compared to 1.3% in 1983 to 1993-94. These growth numbers for females are 3.7% and 4.6% respectively. Open unemployment is more acute in urban areas as compared to rural areas. Along with unemployment, the problems of under-employment (both visible and invisible) also add to the problem. Rural visible under-employment shows greater increase among females than males. Invisible underemployment (reflected by the amount of workers seeking additional work) has declined more among males than females.

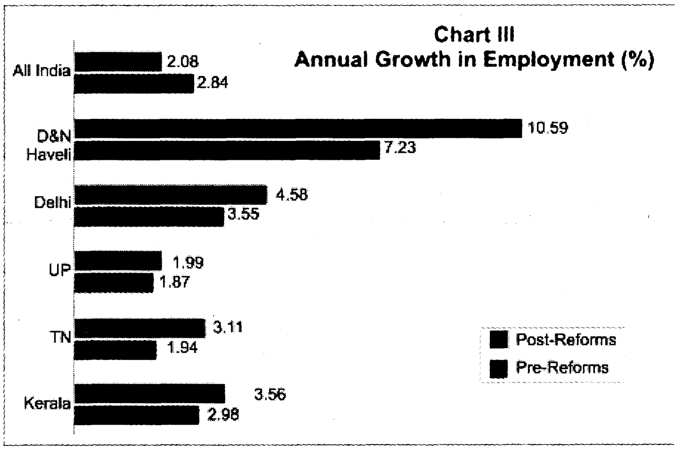
Sectoral Analysis

Sector-wise annual growth in employment (labour absorption) during pre and post reforms shows a slow-down in employment growth in agriculture, electricity, gas and water supply both at rural and urban areas. On the other hand, sectors like manufacturing and construction reported an increase in labour absorption during the post-reforms period vis-à-vis the pre-reform period. Trade and transportation showed an increase in labour absorption in rural areas and a fall in urban areas.

Inter-state Disparity in Employment Generation

Although, at the all-India level there has been a fall in the growth of employment during the post-reforms period, some states have reported an increase in employment growth. These include, Kerala, Tamil Nadu, U.P., Delhi and Dadra/ Nagar Haveli (Chart III).

Barring U.P., other states are relatively developed in the areas of industry and services. That may be the factor responsible for higher employment growth.



II – Imperatives

Considering, the incremental labour force being added to the existing backlog of unemployed population, it is necessary to generate at least 10 million new jobs every year. Moreover the ongoing demographic change in India where economically active population (between the age-group of 15-59) is rising at a higher rate adds urgency to the task of job creation.

The first imperative is to focus on labour-intensive manufacturing industries such as textiles, toys, food processing, transport services and leather. This bears greater significance in the face of deteriorating employment elasticity in India. Barring the transport storage, finance and insurance sectors employment elasticity has fallen across the sectors between the periods 1983-94 and 1993-2000 (Chart IV).

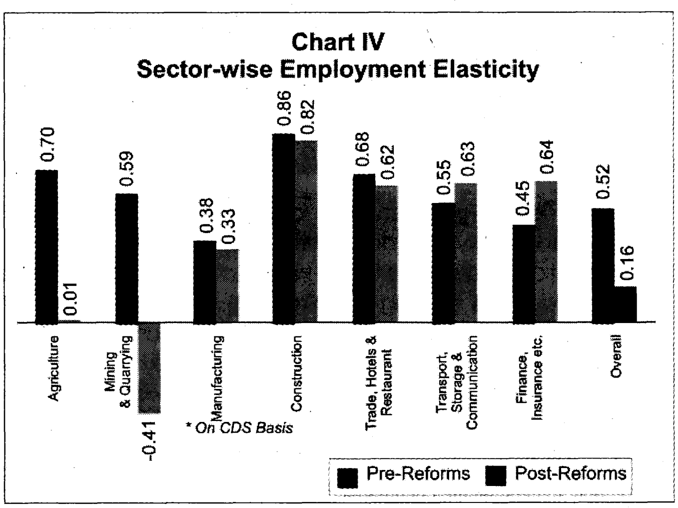
In this connection according to the Approach Paper to 11th Five Year "to increase the employment intensity of economic growth, the 11th Plan must pay special attention to labour intensive manufacturing sectors such as food processing industry, textiles, small and medium enterprises, tourism and construction."

While emphasizing the employment aspect of industry, one should not lose sight of the technological aspect of the industry, the factor which determines the competitiveness of industry.

The second imperative is Training and Development (T&D). In order to sustain the rapidly changing technological situation, constant T&D is essential. This helps in enhancing labour productivity and helps labour in getting absorbed quickly in the event of lay offs.

The third imperative is providing a safety net to take care of laid-off labour during the transition period by devising appropriate devices acceptable to all the stakeholders.

The fourth imperative is reviewing the age-old labour laws to make them more relevant to the current situation which is open and global in nature. Policy makers have expressed umpteen number of times the need to review and reform



Employability of Labour: A Critical Prerequisite for Achieving Inclusive Growth

A GDP growth rate of 8.5 to 9 per cent over the next 5 years is critical to improving real per capita incomes and employment generation. If sustained it will raise India's rank in GDP from around 11th today to 4th from the top by 2020.

About 50 million will be added to India's current labour force of 460 million in 2005 by 2011 i.e.10 mn a year. We will need to create new jobs for these 50 million and for the current backlog of 39 million unemployed. The challenge is to create 89 million jobs by 2011 or 18 million jobs a year to eliminate unemployment.

The challenge is magnified by the fact that 60% of the workforce is in agriculture and 66 % in the rural areas. Illiteracy rate is 39%. The quality of education infrastructure is poor and only 3% of the rural and 4% of the urban workforce has any kind of vocational training as per the 60th round of NSSO (National Sample Survey Organisation). While in other countries enrolment in VTIs (Vocational Training Institutes) is 3 times that in higher education in India it is the reverse. It needs to be remembered that only 15.5% enter tertiary level education in India.

International experience confirms that the largest number of new jobs are generated in small and medium enterprises (SMEs). Employment has nearly tripled in India's small and medium sector over the past 20 years. A repetition of this performance would generate an additional 10– to15 mn jobs a year. High employment potential sectors, include commercial agriculture, agro-industry and agri-business; retail and wholesale trade; tourism, housing and construction; IT and IT-enabled services; transport and communications; education, health and financial services.

Better agro-services and linkages to down-stream agro-industries will serve to reduce waste and spoilage of perishable commodities, while broadening the range of marketable products in horticulture agro-forestry . animal husbandry and non-farm agro services. The country will also require millions of additional teachers and para medical persons to meet the surging demand for education and health services.

But the needs of globalization and competition will require quality and productivity standards hitherto unknown. Technology competition and market forces will compel emphasis on quality and production efficiencies. World class sills will be a major criterion for employment and a peculiar scenario will most likely occur where in spite of a hugely growing workforce there will, in fact, be an acute shortage of *employable* workforce. Training and retraining workers to raise skill levels will be required on a fast track basis.

Literacy will have to be addressed on a mass scale as a minimum requirement. Currently the country has about 300 million illiterate adults and 60 miilion illiterate children The Government's goal of 75 per cent literacy within the next five years may prove grossly inadequate A 100 per cent literate India is of paramount importance for literacy is an indispensable minimum condition for any kind of skills training. Ten years of school education will also need to be considered an essential prerequisite in order to make the work force capable of availing the new opportunities and potential. This also means that the dropout rate of 25% at the primary level must be first addressed.

In addition to school participation the quality and relevance of school curriculum rates equal emphasis and needs to be addressed with equal force. Every form of education, formal and non-formal, will need to be tapped to take education and training to the masses as the fastest way to overcome inadequacies of education infrastructure and shortages of teachers/ trainers. In the case of vocational training the task is Herculean. India has vocational training in 40 streams as compared to 4000 in China. We need to identify more trades, draft curricula, syllabus course material and training modules and define skill standards and undertake a rapid training of trainers program to address this gap. A comprehensive strategy is needed to enhance the nation's employable skills, and vocational training institutes and facilities expanded to widen the range of vocational skills that can be taught.

A similar effort is required at the farm level to upgrade the skills of Indian farmers, and agricultural labour who represent 56 per cent of the total workforce. The 300 Krishi Vignan Kendras needs to be expanded and and network of farm schools for training farm hands will be equally necessary to train them in farm and non farm skills.

The current expenditure on education of 2.9% of GDP will need to be extended to at least 4.5-5% of the GDP for expanding its education infrastructure. Even if 1% is allocated for vocational training this would facilitate introducing a 1000 new trades and train about 10 million workers a year.

India needs to introduce a multi-dimensional rural sector complementing the predominantly agrarian economy with a whole range of new industries and services which transform rural lifestyles and expand the range of employment options. An increase in rural incomes will open new avenues for retail trade, transport, logistics, health and education, insurance, and financial services integrating the rural economy into the mainstream and closing the divide between.

labour laws in order to enhance their effectiveness by providing labour flexibility. Labour flexibility does not necessarily mean only and hire and fire of labour. It includes a wide spectrum of laws, rules and regulations which will help in enhancing the welfare of labour while increasing their productivity and raising the competitiveness of the industry. In India labour is also governed by state laws, which differ from state to state. States should formulate conducive labour laws for the overall development of industry while taking care of labour.

Lessons from China

Regarding labour law reforms a lesson or two can be learnt from China – hard-core communist country. China having a long history of providing job security has radically reformed its labour laws and created new labour market where labour is made highly mobile. These reforms facilitated higher industrial growth and wage growth, simultaneously creating additional jobs by emphasizing infrastructure development and labour intensive manufacturing industry which have helped in the redeployment of laid-off labour.

III – Challenges

The way ahead in the effective capitalization of Indian labour and generating adequate employment opportunities is quite difficult. There are social, political,-economic factors posing challenges.

- **Attaining sustained high growth:**

  Liberals believes that a sustained high growth is the only panacea for overcoming the problem of labour and employment. However, agriculture is still exposed to the vagaries of nature and it accounts for 1/4th of our GDP providing livelihood for nearly 2/3rd of the population. Therefore, achieving a higher growth of 9-10% on a sustained basis becomes a challenging task.

- **Arriving at a Consensus:**

  Even though, at the individual level everyone agrees with need for amending labour laws, attaining consensus among various parties is really a daunting task. The coalition government is hindering the pace of labour reforms. We strongly advocates the de-politization of labour issues.

- **Achieving Co-ordination:**

  Being astate subject, labour laws differ from state to state. For the free mobility of labour broadly uniform labour laws are essential. However, coordinating among the states and formulating a broadly uniform labour law is yet another challenging task.

- **Managing Competition and Employment:**

  As noted earlier sustaining higher productivity in the context of the global competition is crucial. Higher productivity is obtained by adopting high technology, which in turn is labour saving. This does not help in achieving our objective of generating higher employment. On the other hand, merely emphasizing labour intensive technology could affect our productivity and ultimately our competitiveness. Therefore, achieving a golden mean between labour-intensive and capital-intensive technology poses another challenge.

IV – Recommendations

Considering the dire need to generate more than ten million jobs annually while keeping in mind the challenges and limitations discussed the Liberal Budget 2008-09 recommends following.

1. The formulation and execution of policies to achieve 8-9% job-oriented growth on a sustained basis to take care of both the organized as well as unorganised sectors. We believe that only higher growth will provide greater and better quality employment opportunities.

2. The appointment of an expert committee to look into the re-orientation of existing labour laws in a time bound manner. There is need for an all party debate on this committee's findings leading to consensual decision.

3. Steps to bring about broad uniformity in labour laws across the states.

4. Effective implementation of laws relating to Child Labour (minimization) and female workers

5. Simplifying labour rationalization and exit laws

6. Emphasis on labour intensive manufacturing activities

7. Measures to enhance investments in agriculture with a focus on dry-land and contract farming

8. Stress on improvement of education and training and development of infrastructure particularly vocational institutes including ITI s.

9. Devising a safety net for laid-off labour – some form of social security.. Strengthening and effective implementation of the National Renewal Fund. Formulating unemployment insurance schemes.

10. Time-bound implementation of labour-intensive infrastructure projects under Public-Private Partnership (PPP).

11. Building strong national, state and local level database on labour and employment and its regular dissemination.

12. Effective negotiations at WTO under GATS to achieve smoother cross border movement of Indian labour. ❖

Chapter 4

Towards Faster and Inclusive Growth

– A Critique of the 11th Plan Approach Paper

An appraisal of the Central Government's 'Approach Paper to the 11th Plan' (AP), is necessary in the current context, mainly for evaluating the Government's mid-term policy from a Liberal perspective. After about 15 years of 'Reforms', the issues of 'growth with equity' and /or 'growth with employment' have come to the Centre-stage. It is necessary to take serious note of the (as yet) 'official' position of the Government on the subject of – 'Sustaining Rapid Growth with Equity'.

'Towards faster and more inclusive growth' is a very appropriate title in the sense that this is the single most important challenge to the Indian economy today. As liberals, we are equally concerned with equity. The Drafting Group (DG) is of the view that especially in the current context, *while the need for rapid growth is undisputed, serious socio-economic distortions may emerge in the near future, if 'this' growth is not made sufficiently broad-based.*

A major concern of India's development phase today, is the challenge of widespread or shared growth: *How to ensure that rapid growth will ensure wider distribution of prosperity and will rapidly reduce chronic poverty. If (as we have seen in a previous chapter), even an unprecedented 6.5% annual GDP growth is not going to bring about even 1 percentage point of annual reduction in poverty, then there are very serious issues, which need to be addressed by the policy-makers*

The World Bank development policy review (DPR), *which almost coincides with the publication of the* AP, deals with the same theme. It lays stress on – "growth accelerators" which are - infrastructure, institutional issues, investment climate, and also *"equalizing accelerators"* – i.e. service delivery mechanism, agricultural reforms etc. – which will make the growth more equitable.

As Liberals, it is important to assess whether the AP envisages more role for the government or whether the AP is moving towards a lesser role for the state.

As regards *Growth,* the AP lays overwhelming emphasis on the role of private investment, with about two-third to 70% share envisaged for private investment. (Refer Tables I and II). While some critics have felt that it is undesirable and ambitious, we feel that such dependence on private investment is certainly desirable.

The more crucial question here really is whether the government is creating an environment for the flourishing of such high magnitude of private investment. If, reliance on private investment is likely to continue, and if we as Liberals think that it is a desirable strategy and that public investment or public sector investment in particular takes a back seat, then the government must create a conducive environment or policy framework.

Occasionally, *consensus on major economic policy-matters* is conspicuously absent. Illustratively, on SEZs – there are so many confusing signals. The inter-ministerial differences of views on petroleum-pricing, between minister and the Planning Commission (on FRBM), or between the minister and the RBI, on interest rates – all tantamount

"The more crucial question here really is whether the government is creating an environment for the flourishing of such high magnitude of private investment. If, reliance on private investment is likely to continue, and if we as Liberals think that it is a desirable strategy and that public investment or public sector investment in particular takes a back seat, then the government must create a conducive environment or policy framework."

to uncertainty which becomes increasingly costly for entrepreneurs.

The *nature of coalition politics* itself and, in particular, the excessive dependence on the CPM and on the other Left-wing partners is proving to be a major stumbling block. This is because the decision-making gets inordinately delayed, on all substantive issues, ranging from Disinvestment-to-Pension Reforms – to FDI. Consequently, disinvestment has been virtually put on the backburner and there have been many such instances on policy matters.

On *Equity,* the AP has mentioned various kinds of inequalities – *the rich-poor divide, the rural-urban divide, the regional divide, the gender* divide. Undoubtedly, some glaring or stark inequalities exist in the economy today, which have contributed to social incohesiveness.

> *" In order to facilitate and ensure equitable development within the regions and states of India, it is again the responsibility of the government to see that the finances of the state governments, especially those lagging states, are far more prudently managed and Governance failures redressed, so that private investment even in these states can come and flourish. The quality of political leadership in these states also matters greatly. "*

As regards *regional inequalities,* the inter-state economic disparities are growing between the States in South-West India on the one hand and the remaining States from East, Central and Northern Zones. However, it is not the reform process *per se* which has accentuated these inequalities. There were wide inter-state inequalities even before the reforms. However, it needs to be recognized that some of these advanced states have surged ahead in the recent period, because they are following at least some reforms in investment climate, institutions etc. Actually, *the interstate inequalities have been accentuated not by market forces but precisely by the failure of the government.*

The failures of the governments in these backward States are well known. Fiscal profligacy is of course the most common. Although the fiscal profligacy aspect is applicable equally to the advanced states, one must also consider that while they have been fiscally imprudent, yet they have witnessed high industrial growth and investment notwithstanding their fiscal imbalance. That is not luxury enjoyed only by the backward states – that they are not only fiscally mismanaged but the real investment growth or real growth of industry, agriculture, enterprise is far less there than the advanced states.

In order to facilitate and ensure equitable development within the regions and states of India, it is again *the responsibility of the government to see that the finances of the state governments, especially those lagging states, are far more prudently managed and Governance failures redressed,* so that private investment even in these states can come and flourish. The quality of political leadership in these states also matters greatly.

Although regional inequalities have been accentuated in the post-reform period, the blame is not on globalization or liberalization reforms, but it is on the failure of the

MACRO-ECONOMIC INDICATORS

	Ninth Plan (1997-98 to 2001-02)	**Tenth Plan** (2002-03 to 2006-07)
GDP growth (%) of which	5.5	7.0
· Agriculture	2.0	1.8
· Industry	4.6	8.0
· Services	8.1	8.9
Gross Domestic Savings (% of GDP, at market prices)	23.1	28.2
Gross Domestic Investment (% of GDP, at market prices)	23.8	27.5
Current Account Balance (% of GDP, at market prices)	-0.7	0.7
Combined Fiscal Deficit of Centre and States (% of GDP at market prices)	8.8	8.4
Foreign Exchange Reserves (US $ billion)	54.2	151.6
Rate of Inflation (based on WPI)	4.9	4.8

government.. Effective state-action in delivery of essential services and rising Government expenditure on social sectors, is generally supported by even the protagonists of liberalization or by "reformers". The recent spurt of investment plans in Orissa, Jharkhand amply demonstrate that if the State Governments are willing to put their acts together, private and even foreign investment will flow into these regions. (Mittal's proposed investment in Orissa is a case in point).

STRUCTURE OF GROWTH IN DIFFERENT SCENARIOS

GDP	**7.0**	**8.0**	**9.0**
Agriculture	3.2	3.7	4.1
Industry	8.2	9.4	10.5
Services	7.7	8.8	9.9
Imports*	10.9	11.7	12.5
Exports*	14.2	15.4	16.4

[illegible] YEAR PLAN

1.	Growth rate of GDP (%) of which;	8.5
1a.	Agriculture	3.9
1b.	Industry	9.9
1c.	Services	9.4
2.	Investment rate (% of GDP) of which	33.6
2a.	Public	10.4
2b.	Private	23.2
3.	Domestic Savings rate (% of GDP) of which:	31.0
3a.	Household	20.7
3b.	Corporate	5.8
3c.	PSEs	3.0
4.	Current account balance (% of GDP)	-2.6
4a.	Growth rate of Imports (%)	12.1
4b.	Growth rate of Exports (%)	16.0
5.	Government revenue balance (% of GDP)	-0.5
6.	Government fiscal balance (% of GDP)	-6.1

Concluding Remarks

While the chosen theme of the approach paper is appropriate in the current macro economic context, it does not come out with any solution to tackle this major problem except for some piecemeal solutions for creating employment in agriculture or off-farm employment, or creating employment by labour intensive manufacturing etc. The success of the Plan will rest crucially on Governments abdicating their economic role in favour of market and private sectors, while ensuring equity, through better governance, appropriate fiscal management and through the creation of an investment-friendly environment.

World Bank on Inclusive Growth

The government of India's justifiable concern with the inclusiveness of economic growth can be addressed by focusing on expanding the regional scope of economic growth, expanding access to assets and thriving markets and expanding equity in the opportunities for the next generation of Indian citizens no matter who they are or where they live. While reforms that are growth accelerators are important, even more pressing is the need for equalizing accelerators – actions that promote more rapid growth in those areas, sectors and groups where it is needed the most...

Government policy is looking beyond just maintaining rapid growth to making growth more inclusive by addressing imbalances in the pattern of growth: too few jobs, too little growth in agriculture, lagging states and regions, and groups and people left out of progress. The foundation of these efforts is empowerment, which is key to expanding the equity of opportunity. But while social protection remains one element of inclusive growth, and empowerment approach does not seek to protect people from the market but rather it sees policy and public sector activity as facilitating success in the market. This makes empowerment foundational both for greater accountability and service delivery as well as for expanding the benefits of economic growth...

Source: World Bank Development Policy Review, *INDIA – " INCLUSIVE GROWTH AND SERVICE DELIVERY – BUILDING ON INDIA'S SUCCESS", 2006.*

Chapter 5

Reforms in Tax Policy and Tax Administration

PART I – DIRECT TAXES

Steps to remove leakages in government expenditure and control of wasteful expenditure are necessary to manage the ever-growing government spending in essential areas. At the same time steps to increase revenue i.e. the Tax-GDP ratio are also necessary. The main source of income for the government being tax revenues, sincere efforts are needed to meet the demands of high levels of growth through diligent tax administration and creation of atmosphere of trust resulting in to higher voluntary compliance at low cost. The Liberal Budget is based on the belief that tax revenues can be enhanced without making any changes in the current tax structure or rates of taxes. How this can be done is the subject matter of this chapter on tax policy and tax administration.

Principles and Objectives

Rationalising and simplifying direct and indirect tax laws and bringing them in line with the current needs of a liberalising and competitive global economy is an urgent though uphill task especially considering the mind set of the people involved in tax administration at different levels. Accordingly, in the areas of tax reforms, the liberal budget would *continue to* be guided by the following broad principles:

i. Any increase in tax revenue would not be by way of increase in tax rates, but by increasing the tax base to be achieved by humane, fair, efficient, transparent and accountable tax administration on the one hand and rationalisation and reasonable simplification of the tax laws on the other;

> *"Rationalising and simplifying direct and indirect tax laws and bringing them in line with the current needs of a liberalising and competitive global economy is an urgent though uphill task especially considering the mind set of the people involved in tax administration at different levels."*

ii. Tax reforms would be through the creation of an atmosphere in tax administration resulting in voluntary compliance with tax laws by taxpayers;

iii. Tax reforms would be through the creation of a simplified tax policy with rational and globally competitive tax rates;

iv. Tax reforms should also be aimed at providing a fair, speedy and efficient mechanism to resolve genuine disputes in the interpretation and administration of tax laws;

v. Tax reforms should also be aimed at providing a speedy and efficient mechanism to severely punish habitual tax evaders and corrupt officials on the one hand, and give a fair deal to those tax payers who sometimes become victims of complex tax laws which are difficult to simplify beyond a point considering their basic nature. Likewise, such mechanism should also provide an opportunity for forthright officials to get a fair deal in the event of their becoming victims of the present system of tax administration;

vi. Tax policy should aim at offering a lighter burden on earned income as compared to unearned income, by making proper and appropriate adjustments in the tax structure and tax rates; and

vii. Tax reforms should also be aimed at achieving a minimum number of tax rates even for individuals/ HUFs by adopting not more than two rates of taxes, with appropriate adjustments in the level at which the second rate of tax should apply.

viii. *Tax reforms should ensure minimum cost of compliance to the taxpayers.*

Tax Laws & Tax Administration and Broad Framework

To achieve the objectives of tax reforms, certain basic parameters for making/amending tax laws and their administration should be fixed and should be adhered to strictly as has been the case with the Directive Principles of State Policy in the Constitution. The broad outline of such parameters is as follows:

i. It has been the experience in the past that tax laws are amended with a view to punish a small percentage of defaulters. Unfortunately in the process, the tax laws turn out to be very harsh and complex for the large tax paying community. This is also the main cause for complexities in the present tax laws. Therefore, tax laws should be amended bearing in mind the convenience of the large number of taxpayers (and not with a view to punish a few defaulters). This will have the added advantage of creating an atmosphere of trust on the one hand, and substantial reduction in corrupt practices on the other.

ii. One of the basic tenets of a good tax policy is stability in tax rates for a period of at least five years. Therefore, frequent changes in tax rates should be avoided. Unfortunately, in the recent past, experience shows that while keeping the schedule of tax rates unchanged or while marginally reducing them, various 'clever' methods are adopted to indirectly increase tax rates. A classic example is the increase in surcharge for most of the assessees, introduction of Education Cess, introduction of Health Cess in a limited sector. Apart from this, the introduction of the Fringe Benefit Tax (FBT), has resulted in a substantial increase in the effective rates of tax in most cases.

iii. Another basic tenet of a good tax policy is stability in tax laws. For this, there is need to formulate a long term tax policy for a period of at least five years. Once such a policy is formulated after public debate, it should not be tampered with except under extraordinary circumstances. This will avoid the need for frequent amendments in the tax laws, which have made present tax laws not only complex but also difficult to implement in a fair manner. Towards this end, the annual exercise of amendments in the tax laws through the Union Budget should be given up. The annual budget and amendments to the tax laws should be de-linked. Amendments to tax laws should be made only by a separate Tax Laws (Amendment) Act. This should be enacted only after detailed public debate and after due consideration by a Select Committee of Parliament having members who are conversant with the complexities in tax laws and the realities of their administration. In the same manner, even tax rates should be de-linked from the Union Budget and incorporated in the tax laws. In an emergency, of course, the law can always be amended through ordinance. To begin with, this policy can be adopted for direct tax laws and then be subsequently extended to laws relating to indirect taxes.

> “*The annual exercise of amendments in the tax laws through the Union Budget should be given up. The annual budget and amendments to the tax laws should be de-linked.*
>
> *Amendments to tax laws should be made only by a separate Tax Laws (Amendment) Act.*”

iv. For the purpose of raising tax revenues, it is necessary to widen the tax base rather than increase the tax burden of existing taxpayers. This is the only way to achieve real growth in tax revenue. The main hurdle in increasing the tax base is the perception of the people at large about tax administration. Unless this changes, it is unlikely that the tax base will increase in real terms. This can be achieved only by gaining the confidence of the citizens in the tax administration. For this, some permanent statutory provisions should be made whereby the small assessees can be asked to pay a fixed amount of tax in absolute terms upto a certain level of income with the assurance that their declaration of income will be accepted at face value without further enquiries except in cases where the Revenue Department has concrete evidence in its possession about the incorrectness of the declaration made by an assessee. For this, a simple scheme can be worked out in the Act itself to provide safeguards against the abuse of such a scheme.

v. As stated earlier, it is the fear of harassment at the hands of the tax administration, which has kept a number of small potential tax-payers outside the tax net. Another way to persuade this large number of potential taxpayers is to assure them that by filing returns of income they will have some advantage. *In this context, some sort of reliable and convincing assurance for protection against the harassment at the field level is essential. For achieving this, some workable solution of monitoring at the field level administration has to be provided. A group of impeccable social activists be attached to each IT establishment who can be looked upon as protection assurance.*

vi. It has been the experience that the present scheme of assessment of income by the Tax Department at various levels has also raised a number of practical issues with regard to harassment of the tax payers and an increasing resort to unethical practices. One way to combat this and also to create a proper atmosphere, is to encourage people to file their returns of income by eliminating many of the discretionary powers vested in Assessing Officers while assessing income. This can be done by providing a scheme of presumptive income for all medium level assessees on the lines of the present provisions of Sec.44AF, while simultaneously increasing the basic limits of Tax Audits to Rs.100 lakhs from the present Rs.40 Lakhs for Business and Rs.25 lakhs from the present Rs.10 lakhs for professionals. The earlier limits were fixed almost two decades ago and need revision.

> *"All amendments to the tax laws should be made prospective and wherever possible, no retroactive effect should be given to such amendments on transactions entered into prior to the date of making such amendments. Unfortunately, in the recent past, it has become routine to make retrospective amendments."*

vii. In the recent past, it has been the experience of the tax paying community that tax laws are amended with retrospective effect, in most cases to nullify the effects of judicial pronouncements. This has a dual effect, firstly, it creates an atmosphere of disrespect for the judiciary, which is not a good sign in the long term in any civilised, democratic country and secondly, it affects all financial projections of the assessees and in many cases, it has a severe impact on the business community. This, indirectly, contributes to the creation of disrespect for the tax laws and affects the basic spirit of the citizens to fight for their rights. In fact this is one of the main causes for large-scale corrupt practices so prevalent in the tax administration.

Therefore, bearing in mind the long-term interests of the country and its object of increasing tax revenue by voluntary compliance, as a policy, no retrospective amendment should be made in the tax laws, which will have an adverse effect on the taxpayers. *All amendments to the tax laws should be made prospective and wherever possible, no retroactive effect should be given to such amendments on transactions entered into prior to the date of making such amendments. Unfortunately, in the recent past, it has become routine to make retrospective amendments. Classic example of this attitude is found in some of the provisions of Taxation Laws (Amendment) Act, 2006.*

Cost of Compliance should be the bare minimum

The most important basic tenet of a good Tax Law and fair Tax Administration is to keep the cost of compliance of various requirements of the Tax Laws as low as possible. The attempt should be to reduce the cost of such compliance year after year and finally bring it down to the bare minimum. Unfortunately, in this respect, the Government has been working exactly in the opposite direction, especially in the recent past. This is evident from the fact of rapid and arbitary expansion of the area of deduction of Tax Deducted at Source (TDS) in a routine manner without any provision for genuinely required exceptions; introduction of separate Return, Assessment and Other Procedure to be complied with in respect of the newly introduced Fringe Benefit Tax; introduction of the requirement of furnishing quarterly returns of TDS, etc. in addition to many other existing requirements of a procedural nature. All these requirements have substantially added to the cost of compliance of the Taxpayer. The time has come that some mechanism should be introduced to collect the data with regard to the cost of compliance annually incurred by the Taxpayers for which so far nobody has bothered in the Government. In fact, the cost of compliance incurred by the Taxpayers is indirectly nothing but a cost of Tax Administration borne by the Taxpayers and therefore, it should also be included in the amount of cost of running Tax Administration for various purposes.

Administrative Reforms is the Key

The Liberal Budget is guided by the basic principle that if a harsh tax law is administered in a fair and humane manner it does not have any impact on the large tax paying community but the reverse is not true. This does not mean that the tax laws should be made harsh but an acknowledgement of the fact that the manner of administration of tax laws is more important than the tax laws themselves from the point of view of achieving the objectives of tax revenue. Accordingly, genuine reforms in tax administration are paramount to provide humane, fair, efficient, transparent tax administration with accountability. *There is urgent need to carry out major* reforms in this area. For this, a number of genuine steps need to be taken such as:

(i) Some statutory monitoring mechanism with requisite powers independent of tax administration should be provided in the tax laws. Such mechanism should provide a forum to the tax paying community to approach them for redressal of unfair and discriminatory treatment. Such a forum should also have the power of taking *suo moto* action against tax officials at all levels of tax administration. Such forum should ultimately provide for speedy disposal of cases against erring officials and justice to honest officials who have, unfortunately, become victims of the present system. To begin with, such a forum can be created in each State (to be headed by the Chief Justice of the High Court in the State) and responsible to Parliament through the Finance Ministry (and not the CBDT). Such a forum should have representatives from the tax profession and respectable citizens as its members in addition to retired judges of High Court and/or Supreme Court. This forum should not become a place for extension of service, after the age of retirement, for tax officials as is the case with the Settlement Commission. *In this context, considering the present atmosphere in the tax administration, the concept of OMBUDSMAN is not worth considering. Only a High Powered Forum of the type suggested herein may have real and the desired impact.*

(ii) All instructions issued by the CBDT that affect the rights and duties of the taxpayers should be made public.

(iii) Now that the Right to Information Act has become operative, appropriate steps should be taken to see that the tax administration strictly complies with the provisions of the Act and gives appropriate publicity to the manner of its implementation.

(iv) We understand that in the last year, the Prime Minister had taken the initiative to adopt the policy of performance-based promotion. *Unfortunately, nothing concerete seems to have happened in this regard. Immediate steps for implementation of this policy need to be taken.* For this, the method of evaluation of performance should be transparent and should be made known to citizens. At the same time, while adopting such a policy, merely higher collection of tax revenue should not be regarded as good performance unless such collection is proved to have been made in a fair and equitable manner and without being unduly harsh to the taxpayer. For this, an appropriate scheme should be worked out to check if tax officials concerned have, in their over-enthusiasm, indulged in unjustifiable and harsh actions. This can be done by assessing their performance with reference to the ultimate result in terms of approval of their actions at the first two Appellate levels. Apart from this, to be fair to the tax officials, the targets fixed for collection should not be too high or unrealistic and should also be flexible by taking ground realities into consideration.

“ We understand that in the last year, the Prime Minister had taken the initiative to adopt the policy of performance-based promotion. Unfortunately, nothing concerete seems to have happened in this regard. Immediate steps for implementation of this policy need to be taken. For this, the method of evaluation of performance should be transparent and should be made known to citizens. ”

(v) Appointment of Members of CBEC/CBDT should not be made merely on the basis of seniority *and such appointment should be for a minimum period of two years.* Members of such body should be of high integrity with proven track record with regard to fair and efficient tax administration. There should be some strict guidelines for such appointments to be monitored by an independent judicial form. This is of utmost importance because these bodies are ultimately responsible for tax administration. Last year's exposure of the Chairman, CBEC being involved in corrupt practices should be an eye opener. *Timely appointment of forthright, efficient and competent officials with good administrative compatibility can go a long way in improving tax administration and inspiring the confidence of the Taxpayers in the Tax Administration.*

(vi) *Unfortunately, the Settlement Commission has become place for extention of service for many tax officials after reaching retirement age. Even the object for which the Commission was set-up is hardly achieved in the recent past. At present, ethical professionals and honest taxpayers view the Settlement Commission as a window for amnesty for tax evaders. This Commission has, in the present atmosphere, outlived its utility and therefore should be scrapped.*

(vii) One of the basic tenets of any tax administration is to provide sufficient time to the Taxpayers to adjust their administrative affairs to comply with any new procedural requirements whenever they are introduced. Unfortunately, in the recent past, the Tax Administration is functioning exactly in the opposite direction in this regard. A classic example of this is to be found in the recent amendments made in the Statement of Particulars in Form 3CD [part of Tax Audit Report] by Notification dated 10/08/2006, which have been made applicable for the Asst. Year 2006-07. How does one comply with such extra requirements in relation to the Accounting Year which had commenced on 01/04/05 and has already ended? Similarly, the requirement of filing Return of Income electronically in case of a corporate entity, and the new Form No.1 for the same for Asst. Year 2006-2007 has also been notified on 24/07/06. Such an approach on the part of the Government reduces the confidence of the Taxpayers in the Tax Administration and makes the life of the Taxpayer very difficult to remain compliant in respect of the requirements. In principle, such new requirements should always be made known to the Taxpayers in advance, preferably before commencement of the relevant Accounting Year, to enable them to comply properly and without any undue pressure.

❝ The Settlement Commission has become place for extention of service for many tax officials after reaching retirement age. Even the object for which the Commission was set-up is hardly achieved in the recent past. At present, ethical professionals and honest taxpayers view the Settlement Commission as a window for amnesty for tax evaders. This Commission has, in the present atmosphere, outlived its utility and therefore should be scrapped ❞

Rates of Tax *vs.* Incentives

The Government has accepted the proposal that instead of the policy of having many tax incentives and high rates of tax, it is better to have fewer incentives which are absolutely essential and lower rates of tax. The Finance Act, 2005 has taken forward this policy. In this connection and to encourage compliance and reduce the cost of compliance which is quite high for taxpayers, it is suggested that:

i. To bring simplicity, no surcharge and cess like education cess be levied and the basic rate must absorb such cess.

ii. In any case, such surcharge/cess should not be made applicable on tax rates of TDS to avoid cumbersome rates like 1.0455, 5.2275.

iii. Further, no rates be enhanced retrospectively e.g. in the month of September 2004, rates of TDS etc. enhanced by education cess w.e.f. 1st April, 2004.

Real Income *vs.* Taxable Income

The Income-tax law contains many distortions in the computation of income which ideally should be one which is the real income, which any businessman would consider as income. While it may not be practical to eliminate completely all differences between taxable income and book income (real income), every effort needs to be made to match the two. Specific reforms in this direction to be carried out are:

i. Depreciation allowance under the income-tax law be harmonised with the same under the Companies Act.

ii. If any incentive-depreciation is to be granted, it should be on the condition that it be provided for in the books of account.

iii. The provisions of section 115JB, Minimum Alternate Tax (MAT) be deleted.

iv. Carry forward of losses and depreciation be merged together and be treated on par and be allowed to be set-off indefinitely.

v. Carry forward of losses under all heads of income be permitted. Currently it is not allowed for income from house-property, and income from other sources etc.

vi. Both 'set-off in any year' and 'carry forward in subsequent year and set-off', be not compartmentalised on the basis of heads of income but be treated as a single block. However, items such as speculation loss or any similar item as exception to the general rule may be differently treated.

vii. All expenses that are incurred for business purposes but are neither revenue in nature nor result in acquisition of a depreciable fixed asset should be allowed as deduction over a period of three to five years by way of amortisation.

Tax Deduction at Source

While one accepts that tax deduction at source (also tax collection at source) (which now comprises 40% of total direct tax collection) has many merits, the fact remains that the way the law is being legislated and administered, it has become a nightmare to a large number of taxpayers with uncertainty all round, with compliance cost going very high and facing disallowance of expenditure itself [u/s 40(a)(i) and 40(a)(ia)] even for some unintended mistake committed.

It is no doubt the duty of every citizen to pay his own tax properly and if such duty is not observed to face adverse consequences. However, it is unfair if he is asked to act as Government's agent for collecting tax from others and pay to the Government, without any remuneration or even a word of appreciation. On the other hand, he is expected to act under the environment of uncertainties and threats, penalties and prosecution and disallowances of expenditure. The Liberal Budget believes that this is against any good cannon of taxation policy and the provisions need to be thoroughly and completely overhauled to make them tax deductor-friendly.

Provisions of Section 40 (ia) of the Income-Tax Act

Clause (ia) inserted in section 40 w.e.f. A.Y.2005-06 was amended recently on 13.08.2006 by the Taxation Laws (Amendment) Act, 2006 with retrospective effect applicable from the financial year 2005-06. The Clause as it now stands, provides for non-deduction of expenditure under various heads [including (i) Interest (ii) Commission & brokerage (iii) Rent (iv) Fees for professional/technical services (v) Payments to contractors etc. (vi) Royalties etc.] if the tax is deductible at source on it and is not deducted or after deduction is not paid in the manner provided in this clause. This is the latest punishment for any default related to tax-deduction provisions. This is in addition to payment of TDS and interest and continuing liability for penalty & prosecution relating to provisions of TDS. Harsh effect of this may be illustrated by real life example:

There is a case of a small firm which has entered into a contract for renovation of one building. The contract was for Rs.50 lakhs, it subcontracted it for Rs.49 lakhs i.e. by keeping a margin of 2% earning gross profit of Rs. 1 lakh. Due to ignorance, it did not deduct tax on payments to sub-contractor of Rs.49 lakhs, in the year ending 31.3.2006. Tax deductible was less than Rs.60,000. It is understood that the sub-contractor has paid his own tax, thus as such no loss to the Government. The default was pointed out by the tax-auditor in the month of August 2006. The firm is told that Rs.49 lakhs will be disallowed & it will have to pay tax on Rs.50 lakhs (and not on Rs.1 lakh only) which works out to Rs.16,80,000 and further interest leviable thereon. The firm was ready to pay TDS of Rs.60,000 in August 2006 but still it can't get out of disallowance of Rs.49 lakhs in the year ended 31.3.2006, besides other consequences of default & delay for tax-deduction. Is this fair? Is this not harsh? Can Government which continuously makes mistakes and amends them retrospectively justify penalising an innocent taxpayer, treating an unintended mistake so harshly?

> *"It is no doubt the duty of every citizen to pay his own tax properly and if such duty is not observed to face adverse consequences. However, it is unfair if he is asked to act as Government's agent for collecting tax from others and pay to the Government, without any remuneration or even a word of appreciation."*

In this context, it is relevant to extract a paragraph on the provisions of section 194A from the late Shri N.A. Palkhivala's book "The Law and Practice of Income-tax":

"This section has introduced a new provision. It enjoins deduction of tax at source from interest (other than interest on securities) payable to residents. It is a striking example of how new fiscal legislation pays no regard to any considerations of public convenience or administrative efficiency and ignores the express recommendations of high-powered Commissions".

Fringe Benefit Tax

We believe the levy of Fringe Benefit Tax (FBT) is whimsical.

We also believe that taxing unearned short-term capital gains on transactions in listed equity shares at a reduced rate of 10% against the normal rate of tax (maximum 30%) applied to all income is also whimsical. The tax system is becoming more and more whimsical day by day.

There is no justification and it is against horizontal and vertical equity to have concessional rate of tax as noted above and then unnecessarily create litigation and bring uncertainties to determine whether one is to be taxed at concessional rate or at full rate.

Similarly, we believe that there is no justification to levy FBT and to justify it on the ground of horizontal & vertical equity. To levy FBT on a firm which has only one employee, a peon, for expenditure on sales-promotion & other expenses, 100% incurred on non-employees is travesty of fairness. FBT is levied without provision of any threshold limit which also brings in thousands of small & medium level enterprises into FBT net leading to hardship. FBT has high compliance cost and it is highly uncertain & not easily understandable law, it is litigation-prone, and also very confusedly administered with controversial guidance provided in the CBDT circular No. 8/2005 dated 29th August, 2005.

> *"We believe the levy of Fringe Benefit Tax (FBT) is whimsical.*
>
> *We also believe that taxing unearned short-term capital gains on transactions in listed equity shares at a reduced rate of 10% against the normal rate of tax (maximum 30%) applied to all income is also whimsical. The tax system is becoming more and more whimsical day by day."*

The provisions for taxing such assumed "benefits" are inappropriately drafted and interpreted in the circular as referred to above and highly prone to litigation. It needs to be scrapped. If the Government needs Rs.6,000 crore (expected revenue from FBT levy), the amount can be collected by increasing Corporation Tax appropriately as suggested by industry-associations and free the citizens from FBT's heavy procedural and compliance burden.

Presumptive Computation of Income (optional)

1. In order to make the operation and management of the tax-system simple both for the tax-gatherer and taxpayer and to reduce compliance cost, it is suggested that the concept of presumptive tax be extended to many items of income at the option of the tax-payer.

2. To-day such provisions for income of the residents are for (a) Computing profits and gains of business of civil construction (b) Computing profits and gains of business of plying, hiring or leasing goods carriages (c) Computing profits and gains of retail business

3. We suggest that similar provisions for computing income in cases of different professions be enacted at the earliest and then extended to (a) wholesale business (b) small scale undertakings (c) various service providers like caterers, commission agents, beauty parlours, interior decorators, fashion designers and the like.

4. Without prejudice to the above, we suggest the combination of actuals and presumptive basis be tried in some cases as an experiment. Under this system, only gross profit will have to be computed on actual basis and all overheads be allowed on presumptive basis. The advantage of this scheme would be that the tax officer will only have to verify items related to determination of gross profit such as sales, purchases, wages etc. and all the effort required to verify genuineness and allowability or otherwise of overhead expenditure will get eliminated and become litigation free. Also, unethical practices of inflating overheads to reduce income and the official's temptation for indulging into corruption will get eliminated.

Minimum tax payable by all filers of income-tax returns

It is our estimate that before deletion of provisions for mandatory furnishing of returns of income under the 'one-by-six' scheme with effect from the current year (i.e. A.Y. 2006-07) 4 crore persons were filing income tax returns. Nearly two-third of them i.e. 2.6 crores were paying no tax. In the light of these figures we suggest an interesting proposal:

1. The Government may consider reviving the scheme of "one-by-six" requiring individuals and HUFs having income below the threshold limit (currently Rs.100,000)

to mandatorily furnish the return of income if they are covered under one of the six criteria of the scheme. At present every company and partnership firm even though it has no taxable income is required to file the return of income and so also many charitable trusts and similar institutions. We believe that crores of persons having income above the threshold limit do not furnish their return of income. We suggest that the department's efforts to bring such non-filers on record needs to be strengthened. Such number is likely to increase rapidly with the growth of the economy and reintroduction of 'one-by-six' scheme with the number of homes, cars and number of persons travelling abroad multiplying.

2. We realise that such a large number of return-filers add considerably to the volume of work of the tax administration and constitute a drain on the financial resources of the tax-department. Yet we do believe that it is in the interest of revenue to have mandatory requirement of filing of such returns.

3. However, to boost revenue, and to instil a spirit of pride in the tax return filers that they are contributing some tax to the national exchequer, we suggest that all individual and HUF return-filers other than senior citizens be required to pay tax of Rs.1,000 per year assuming their income in the case of women is Rs.1,45,000 and in other cases Rs.1,10,000. Similarly all other filers i.e. companies, firms etc. also having no taxable income may be required to pay tax or call it filing fees of Rs.1000 (similar to charge being made for allotment of PAN, for furnishing of TDS returns etc.)

   This proposal, assuming the number is around 3 crores, will bring in revenue of Rs.3,000 crores and make all those who are covered proud citizens.

4. We are aware that the Finance Act, 1992 had introduced a scheme to enable certain small income earners to pay their tax without having to undergo the cumbersome task of computing their income and furnishing their returns. Under the scheme, a fixed annual tax of Rs.1,400 was payable. The scheme was dropped with effect from 1.4.1998. We are of the opinion that this was because of improper administration of the scheme rather than any demerits in the scheme itself.

5. The scheme suggested here will not only serve the purposes envisaged in the "one-by-six provisions" and garner revenue of Rs.3,000 crores and other benefits but also bring some part of unaccounted money, into the main stream as individuals who furnish returns of income under this scheme shall account for their income at Rs.1,45,000/Rs.1,10,000 as the case may be.

“To boost revenue, and to instil a spirit of pride in the tax return filers that they are contributing some tax to the national exchequer, we suggest that all individual and HUF return-filers other than senior citizens be required to pay tax of Rs.1,000 per year assuming their income in the case of women is Rs.1,45,000 and in other cases Rs.1,10,000.”

6. The revenue collected by the Government under this scheme will be additional revenue. We recommend that it be appropriated into a new fund to be called "old age security/pension fund" a long needed requirement of providing old age pension to citizens. Initially, only those individuals who have paid income-tax for 10 years, be covered, then progressively more and more individuals can get covered.

7. We also suggest that the administration for returns of income furnished under this scheme, let us call it "Tax Rs.1,000 scheme" be outsourced to some institution like post office or NSDL or the Institute of Chartered Accountants of India. That would instill confidence in the filers referred to in para V under "Tax Laws and Tax Administration and Broad Frame Work.".

Tax on Non-agricultural Income when the Person also has Agricultural Income

At present agricultural income is exempt u/s.10(1) of the Income-Tax Act, 1961. However, in the case of an assessee who has both agricultural and non-agricultural income, he should be taxed on non-agricultural income in a manner under which he pays tax slightly higher than what he would have paid on the same non-agricultural income if he had no agricultural income. Often it is believed that the agricultural income declared by such assessees is fictitious and is usually black money camouflaged. We suggest

1. that tax on non-agricultural income in cases of persons

also having agricultural income be higher than in the method at present being prescribed in the Finance Act each year.

2. that in cases where agricultural income is higher than non-agricultural income, the rate of tax for non-agricultural income for all assesses should be at a flat rate of 40%. Where agricultural income is lower than non-agricultural income, tax should be at the rate of 30% multiplied by the ratio of total of agricultural income and non-agricultural income to non-agricultural income, or at 40% whichever is lower.

Illustration: Rate of tax on non-agricultural income

	1	2
Agricultural income	Rs.2 lakhs	Rs.1 lakh
Non-agricultural income	Rs.5 lakhs	Rs.7 lakhs

1. Rate of tax 30% x 7/5 = 42% (to be restricted to 40%).
2. Rate of tax 30% x 8/7 = 34% (rounded)

Section 80 CCA of the I.T. Act

Section 80 CCA of the I.T. Act was in operation from 1.4.1988 to 31.3.1992 providing for deduction in respect of deposits under National Savings Scheme or payment to a deferred annuity plan. We suggest:

1. that the scheme similar to the above provisions be revived. It is very essential to encourage citizens to honestly pay their tax especially in cases when the earning-life is short or substantial additional income is earned in certain years. Citizens should be given the option to defer payment of tax on some portion of their income if they are prepared to block that income with such authority as may be prescribed.

2. We suggest that an individual or HUF be allowed to deposit out of the annual income

   - upto 20% of his returned income equivalent to or less than as returned in the earlier year
   - upto 60% of his incremental income over and above as returned in the earlier year.

3. Such deposits shall be for the purpose of national infrastructure projects to be managed by any nationalised bank or as may be decided by the Government. Terms of the deposit will be:

   a) Period of the deposit to be freezed / locked for a minimum 5 years with no limit for its continuity.

   b) Interest at the rate of 8% p.a. (taxable) to be credited to the deposit account for the period it is freezed/locked period or till the deposit is withdrawn

   c) Any amount withdrawn, principal and interest shall be taxable in the year of withdrawal.

4. This scheme shall be an extension of the policy of EET (exempt-exempt-tax) which the Government is planning to introduce for investments referred to under section 80C of the Income-tax Act.

5. This scheme is similar to the provisions now introduced in section 80C of the Income tax Act under which term deposit for a fixed period of not less than five years with a Scheduled Bank is also made qualified for deduction upto Rs. 100,000 in the computation of total income

6. This scheme has win-win benefits:

   a) Creation of black money will be minimised

   b) Infrastructure projects will have resources

   c) Government gets the tax as and when the deposits are encashed

   d) Scheme shall work as pension in old age or to meet additional expenditure on occasion of marriage, sickness etc.

   e) It will act like insurance,with money available to the family after the death of the earning member.

"It is very essential to encourage citizens to honestly pay their tax especially in cases when the earning-life is short or substantial additional income is earned in certain years."

PART II – INDIRECT TAXES

Rate structure

1. Significant stability has been achieved over the past few years as far as the CENVAT (Central Excise Duty) and Customs Duty rates are concerned. In line with the road map already drawn by the Government, Peak Customs duty rate for majority items can now be brought down to 10% from the existing level of 12.5% leaving aside sensitive items like agricultural and petroleum products.

2. Inter-sectoral credit between CENVAT and service tax that has been allowed since 10 September 2004 is working well. It is also an accepted fact that as soon as possible, the CENVAT rates and service tax rates should be on par. As a step in that direction, CENVAT rate of 16% should be reduced to 14%.

3. State-level VAT introduced in a majority of states from 1 April 2005 has been a great success. As recommended by the Empowered Committee of State Finance Ministers, Central Sales Tax (CST) should be phased out as soon as possible and as a step in that direction, the current rate of CST at 4% should be reduced to 2%.

Dispute Resolution Mechanism Under Service Tax

The benefit of seeking Advance Ruling is available only to joint ventures with non-residents or wholly owned subsidiaries of foreign companies. This facility should be extended to all non-residents (whether or not they have joint ventures or wholly owned subsidiaries in India) and also to residents. Further, in most cases, this facility is available only for proposed business activities. However, with expansion in the service tax net on a selective basis year after year, there is need to extend this facility to such newly introduced services as well, irrespective of the fact that the activities in such cases, are already being undertaken by the applicant.

Coverage of Service Tax

The time has come for extending the levy of service tax to all services except a specified negative list of services like medical services, social services, educational services, defence services etc. This would avoid classification disputes and also provide smooth mechanism for claiming input tax credits. Further, such a step would be a precursor to unveiling the Goods and Service Tax Act.

Administration of Service Tax Department

On the lines of CEBC's Central Excise Manual, a Manual of Service Tax should be prepared and made available to the public for a better understanding of the service tax law and its administration by the assessees.

Appendices

Explanatory Notes on Appendices I to VI

The Liberal Budget has set out its budgetary estimates for 2007-08, based on the conventional pattern of the Central Budget documents. Given the need for like to like comparison of crucial budgetary data, it is inevitable that we do not disturb the existing structure and composition of the budgetary figures.

However, the Liberal Budget recommends a comprehensive reform of the budgetary structure, based on the system of Fund Based Accounting system, outlined in the Liberal Budget 2004-05. In this context, we are happy that the Finance Ministry has begun the efforts to document Outcomes Budget. Of course, this system needs to be continuously fine-tuned with a view to make it more comprehensible and analysis-friendly.

The Liberal Budget has also been making a consistent case for doing away with the existing classification of expenditure as Plan Expenditure and Non-Plan Expenditure. This does not serve any useful purpose, and often gives a distorted picture of the budgetary transactions.

The most appropriate approach is to have well-defined economic and functional classifications of all Budget transactions, especially government expenditure. From this point of view, it will be necessary to undertake a comprehensive activity-wise classification of the expenditure pattern under a broad-based framework of Developmental and Non-Developmental Expenditure. While doing so, the Government must appoint a Statutory Expert Committee to review the existing budgetary data and recommend reforms therein, including the prevailing classification of Revenue and Capital Budgets.

Having said this, the Liberal Budget highlights the following key features of its estimates for the year 2007-08:

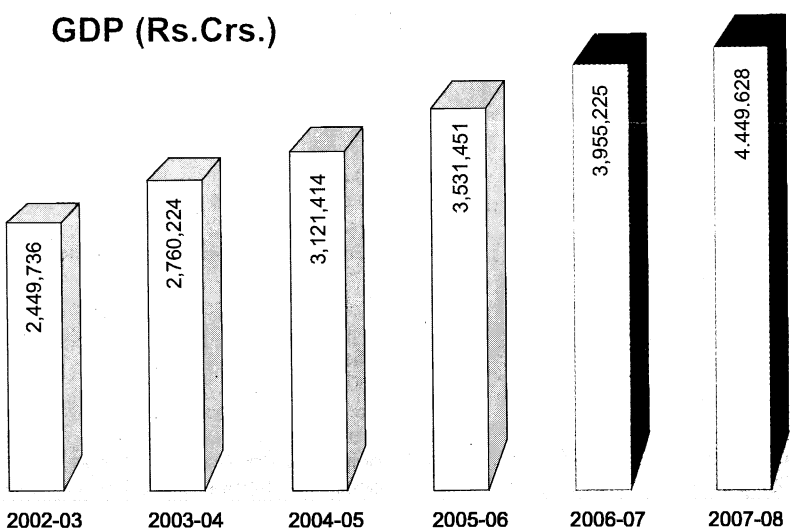
- First, the Liberal Budget 2007-08 envisages total expenditure (Revenue + Capital) of Rs 617,000 crores, representing an increase of 9.4% over the budget estimates of 2006-07. The increase in the previous Central Budget was 10.9%.
- Second, this total expenditure will be funded through revenue receipts of Rs 461,000 crores (or 74.7% of the total) and capital receipts of Rs 156,000 crores (or 25.3% of the total). It is the aim of the Liberal Budget to reduce progressively the dependence on the funding of total expenditure from capital receipts. The purpose is to reduce fiscal deficits substantially.
- Third, the revenue deficit is projected to fall drastically from 2.1% of GDP at current market prices in 2006-07 to 1% in 2007-08. Likewise, the ratio of fiscal deficit is projected to decline from 3.8% to 3.3% during this period. The Liberal Budget recommends more aggressive phasing out of the revenue deficits, which is consistent with the strategy of controlling revenue expenditure and boosting capital expenditure.
- Fourth, in terms of resource efforts, the emphasis of the Liberal Budget is on raising the gross tax to GDP ratio from 11.2% in 2006-07 to 11.6% in 2007-08. There are limitations on raising the non-tax revenues given the fact that a large number of Central Public Sector Enterprises are loss-making. The increase in tax ratio should be accomplished through better tax administration and the overall buoyancy in tax revenues.
- Fifth, it has been the mission of the Liberal Budget to bring about a sharp cutback in non-Plan Expenditure and raise correspondingly the allocations for Developmental Expenditure. Accordingly, the ratio of Development Expenditure to Total Expenditure will increase from 45.4% in 2006-07 to 50.8% in 2007-08. In particular, the spending on Interest Payments and Subsidies – the two predominant items of Non-Development Expenditure – will together drop from 4.7% of GDP to 4.4% of GDP. This is a major task in expenditure management. The spending on Defence is maintained in terms of ratio to GDP in 2007-08 in view of the rising threats of internal insurgency. However, this is more of an exception for this year.
- Lastly, the Liberal Budget believes in a holistic management of the fiscal system, and is strongly of the view that budgetary arithmetic is not an end in itself. What is most important is that the objective criteria of the Liberal Philosophy must be reflected not only in the budget figures, but also in the overall stance and substance of the fiscal policy.

Appendix I

Liberal Budget at a Glance

(Rs. Crores)

		2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Actuals)	2005-06 (Revised Estimates)	2006-07 (Budget Estimates)	2007-08 (LBE)
1.	**Revenue Receipts (2 + 3)**	**230,834**	**263,813**	**306,013**	**348,474**	**403,465**	**461,000**
	(2) Tax Revenue (Net to Centre)	158,544	186,982	224,798	274,139	327,205	385,000
	(3) Non-Tax Revenue	72,290	76,831	81,215	74,335	76,260	76,000
4.	**Capital Receipts (5 + 6)**	**180,531**	**211,333**	**191,669**	**160,231**	**160,526**	**156,000**
	(5) Loan Recoveries & Other Receipts*	35,459	88,060**	66,467**	14,056	11,840	11,000
	(6) Borrowings and Other Liabilities #	145,072	123,273	125,202	146,175	148,686	145,000
7.	**Total Receipts (1 + 4)**	**411,365**	**475,146**	**497,682**	**508,705**	**563,991**	**617,000**
8.	**Total Expenditure (9 + 10)**	**411,365**	**475,146**	**497,682**	**508,705**	**563,991**	**617,000**
	(9) Revenue Expenditure	338,713	362,074	384,351	440,295	488,192	507,000
	(10) Capital Expenditure	72,652	113,072^	113,331^	68,410	75,799	110,000
11.	**Revenue Deficit (9 - 1)**	**109,879**	**98,261**	**78,338**	**91,821**	**84,727**	**46,000**
12.	**Fiscal Deficit [8 - (1 + 5)]**	**145,072**	**123,273**	**125,202**	**146,175**	**148,686**	**145,000**
13.	**Primary Deficit @**	**27,268**	**(-) 815**	**(-) 1,732**	**16,143**	**8,863**	**(-) 6,000**
	Deficit Ratios (%) :						
	a) Revenue Deficit to GDP	4.4	3.6	2.5	2.6	2.1	1.0
	b) Fiscal Deficit to GDP	5.9	4.5	4.0	4.1	3.8	3.3
	c) Primary Deficit to GDP	1.1	(-) 0.0	(-) 0.1	0.5	0.2	(-) 0.1
14.	**Derived GDP at Current Market Prices**	**2,449,736**	**2,760,224**	**3,121,414**	**3,531,451**	**3,955,225**	**4,449,628**



LBE Liberal Budget Estimates
@ Fiscal Deficit *less* Interest Expenditure
(-) denotes generation of surplus position
* Includes Disinvestment Proceeds
** Includes Receipts from States on account of Debt Swap Scheme
# Borrowing does not include receipts in respect of Market Stabilization Scheme, which remain in the cash balances of the government and is not used for expenditure
^ Includes repayment to National Small Savings Fund out of the proceeds of Debt Swap Scheme

Notes:

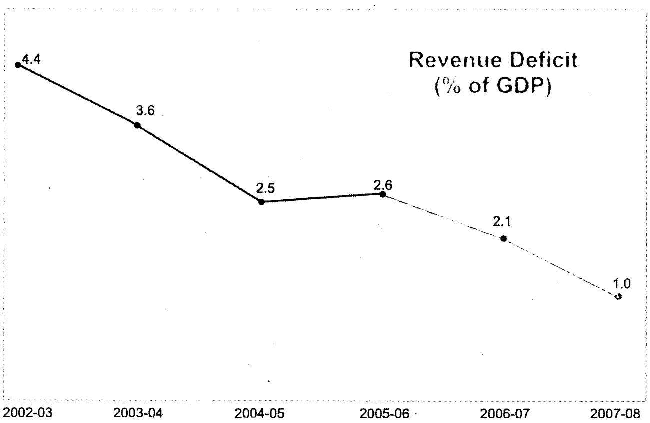
1. Figures from 2002-03 to 2006-07 are based on official budget documents
2. Figures for 2007-08 are Liberal Budget Estimates, based on various proposals set out in the text
3. GDP growth at current market prices is assumed to rise at 12% in 2006-07 as projected in the official budget document and at 12.5% in 2007-08
4. From 2005-06, the government stopped the practice of routing State government borrowings for Plan expenditure through its accounts. This has resulted in a reduction of its Capital Expenditure

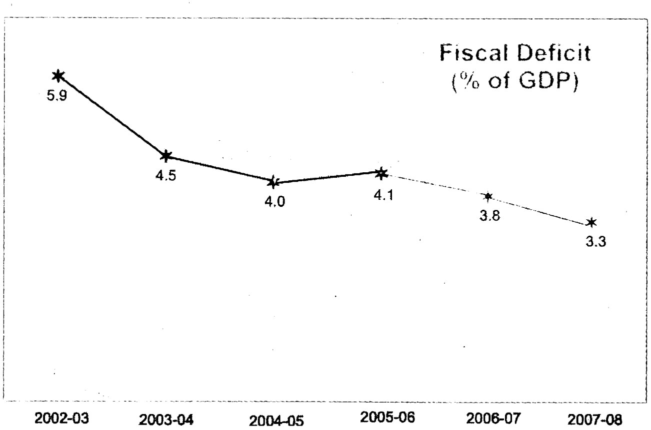
Appendix II

The Liberal Budget at a Glance

(% of GDP)

		2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Actuals)	2005-06 (Revised Estimates)	2006-07 (Budget Estimates)	2007-08 (LBE)
1.	**Revenue Receipts (2 + 3)**	**9.4**	**9.6**	**9.8**	**9.9**	**10.2**	10.4
	(2) Tax Revenue (Net to Centre)	6.5	6.8	7.2	7.8	8.3	8.7
	(3) Non-Tax Revenue	3.0	2.8	2.6	2.1	1.9	1.7
4.	**Capital Receipts (5 + 6)**	**7.4**	**7.7**	**6.1**	**4.5**	**4.1**	3.5
	(5) Loan Recoveries & Other Receipts *	1.4	3.2**	2.1**	0.4	0.3	0.2
	(6) Borrowings and Other Liabilities #	5.9	4.5	4.0	4.1	3.8	3.3
7.	**Total Receipts (1 + 4)**	**16.8**	**17.2**	**15.9**	**14.4**	**14.3**	13.9
8.	**Total Expenditure (9 + 10)**	**16.8**	**17.2**	**15.9**	**14.4**	**14.3**	13.9
	(9) Revenue Expenditure	13.8	13.1	12.3	12.5	12.3	11.4
	(10) Capital Expenditure	3.0	4.1^	3.6^	1.9	1.9	2.5
11.	**Revenue Deficit Ratio (% of GDP)**	**4.4**	**3.6**	**2.5**	**2.6**	**2.1**	1.0
12.	**Fiscal Deficit Ratio (% of GDP)**	**5.9**	**4.5**	**4.0**	**4.1**	**3.8**	3.3
13.	**Primary Deficit Ratio (% of GDP)**	1.1	(-) 0.0	(-) 0.1	0.5	0.2	(-) 0.1





- LBE Liberal Budget Estimates
- @ Fiscal Deficit *less* Interest Expenditure
- (-) denotes generation of surplus position
- * Includes Disinvestment Proceeds
- ** Includes Receipts from States on account of Debt Swap Scheme
- # Borrowing does not include receipts in respect of Market Stabilization Scheme, which remain in the cash balances of the government and is not used for expenditure
- ^ Includes repayment to National Small Savings Fund out of the proceeds of Debt Swap Scheme

Notes:

1. Figures from 2002-03 to 2006-07 are based on official budget documents
2. Figures for 2007-08 are Liberal Budget Estimates, based on various proposals set out in the text
3. GDP growth at current market prices is assumed to rise at 12% in 2006-07 as projected in the official budget document and at 12.5% in 2007-08
4. From 2005-06, the government stopped the practice of routing State government borrowings for Plan expenditure through its accounts. This has resulted in a reduction of its Capital Expenditure

Appendix III

The Liberal Budget - Revenue Receipts

(Rs. Crores)

	2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Actuals)	2005-06 (Revised Estimates)	2006-07 (Budget Estimates)	2007-08 (LBE)
Gross Tax Revenue	**216,266**	**254,348**	**304,958**	**370,141**	**442,153**	**515,000**
Union Excise duties	82,310	90,774	99,125	112,000	119,000	133,000
Customs	44,852	48,629	57,611	64,215	77,066	79,500
Corporation tax	46,172	63,562	82,680	103,573	133,010	155,000
Income tax	36,866	41,387	49,259	66,239	77,409	100,000
Service tax	4,122	7,891	14,200	23,000	34,500	46,000
Others	1,944	2,105	2,083	1,114	1,168	1,500
Less: States' Share and Transfer to National Calamity Contingency Fund	**57,722**	**67,366**	**80,160**	**96,002**	**114,948**	**130,000**
1. Net Tax Revenue	**158,544**	**186,982**	**224,798**	**274,139**	**327,205**	**385,000**
Non-Tax Revenue						
Interest receipts	37,622	38,538	32,364	21,245	19,263	18,000
Dividend and profits	21,230	21,160	22,939	25,481	27,500	27,000
Others	13,438	17,133	25,912	27,609	29,497	31,000
2. Total Non-Tax Revenue	**72,290**	**76,831**	**81,215**	**74,335**	**76,260**	**76,000**
Total Revenue Receipts (1 + 2)	**230,834**	**263,813**	**306,013**	**348,474**	**403,465**	**461,000**

LBE Liberal Budget Estimates

Notes:

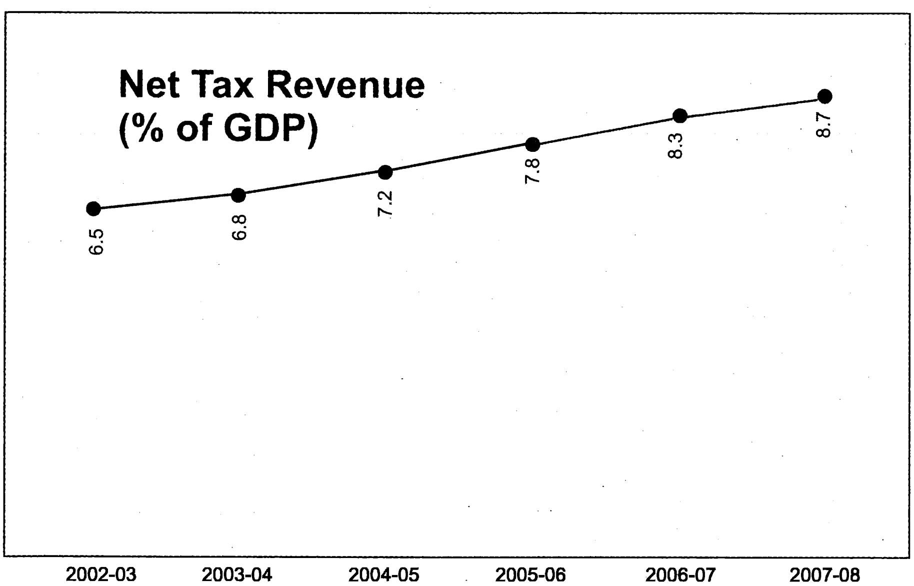
1. Figures from 2002-03 to 2006-07 are based on official budget documents
2. Figures for 2007-08 are Liberal Budget Estimates, based on various proposals set out in the text
3. GDP growth at current market prices is assumed to rise at 12% in 2006-07 as projected in the official budget document and at 12.5% in 2007-08
4. From 2005-06, the government stopped the practice of routing State government borrowings for Plan expenditure through its accounts. This has resulted in a reduction of its Capital Expenditure

Appendix IV

The Liberal Budget - Revenue Receipts

(% of GDP)

	2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Actuals)	2005-06 (Revised Estimates)	2006-07 (Budget Estimates)	2007-09 (LBE)
Gross Tax Revenue	**8.8**	9.2	9.8	**10.5**	**11.2**	11.6
Union Excise duties	3.4	3.3	3.2	3.2	3.0	3.0
Customs	1.8	1.8	1.8	1.8	1.9	1.8
Corporation tax	1.9	2.3	2.6	2.9	3.4	3.5
Income tax	1.5	1.5	1.6	1.9	2.0	2.2
Service tax	0.2	0.3	0.5	0.7	0.9	1.0
Others	0.1	0.1	0.1	0.0	0.0	0.0
Less States' Share and Transfer to National Calamity Contingency Fund	**2.4**	**2.4**	**2.6**	**2.7**	**2.9**	**2.9**
1. Net Tax Revenue	**6.5**	**6.8**	**7.2**	**7.8**	**8.3**	**8.7**
Non-Tax Revenue						
Interest receipts	1.5	1.4	1.0	0.6	0.5	0.4
Dividend and profits	0.9	0.8	0.7	0.7	0.7	0.6
Others	0.5	0.6	0.8	0.8	0.7	0.7
2. Total Non-Tax Revenue	**3.0**	**2.8**	**2.6**	**2.1**	**1.9**	**1.7**
Total Revenue Receipts (1 + 2)	**9.4**	**9.6**	**9.8**	**9.9**	**10.2**	**10.4**
GDP at current market prices (Rs. Crores)	**2,449,736**	**2,760,224**	**3,121,414**	**3,531,451**	**3,955,225**	**4,449,628**



LBE Liberal Budget Estimates

Notes:

1. Figures from 2002-03 to 2006-07 are based on official budget documents
2. Figures for 2007-08 are Liberal Budget Estimates, based on various proposals set out in the text
3. GDP growth at current market prices is assumed to rise at 12% in 2006-07 as projected in the official budget document and at 12.5% in 2007-08
4. From 2005-06, the government stopped the practice of routing State government borrowings for Plan expenditure through its accounts. This has resulted in a reduction of its Capital Expenditure

Appendix V

The Liberal Budget - Expenditure Pattern

(Rs. Crores)

		2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Actuals)	2005-06 (Revised Estimates)	2006-07 (Budget Estimates)	2007-08 (LBE)
I.	**Non-Development Expenditure** ***of which***	**242,749**	**243,298**	**262,904**	**290,264**	**316,081**	**311,000**
	1. Defence	40,709	43,203	43,862	48,625	51,542	56,000
	2. Interest Payments	117,804	124,088	126,934	130,032	139,823	151,000
	3. Subsidies	43,533	44,323	43,653	46,874	46,213	45,000
II.	**Developmental Expenditure** ***of which :***	**184,197**	**195,428**	**214,955**	**232,698**	**262,515**	**321,000**
	1. Economic Services	103,820	108,071	115,030	139,254*	156,629**	175,000
	2. Social Sector	58,606	61,178	62,614	74,275	81,605	102,000
Total Expenditure (I + II)		**426,946**	**438,726**	**477,859**	**522,962**	**578,596**	**632,000**
Ratio of Development Expenditure to Total Expenditure(%)		43.1	44.5	45.0	44.5	45.4	50.8

LBE Liberal Budget Estimates

* Revised Estimates

@ Budget Estimates

(1) Figures of Non-Development and Development Expenditure (including that for Social Sector) from 2002-03 to 2006-07 are compiled from the Reserve Bank of India's Annual Report 2005-06 (Page no. 295). Figures of Economic Services are from the RBI's Handbook of Statistics on Indian Economy, 2006

(2) Data for 2007-08 are estimates for the Liberal Budget based on certain assumptions set out in the text.

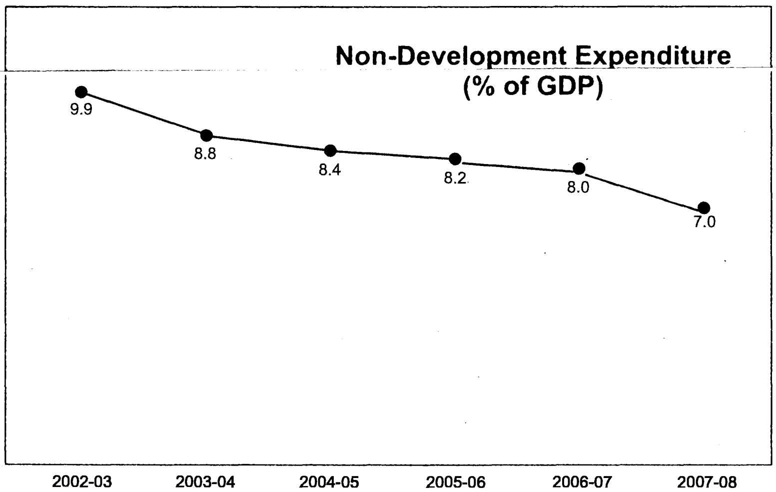
(3) Total expenditure in this table is inclusive of transaction of Commercial Departments. Hence, these figures do not tally with figures in Appendix I & II.

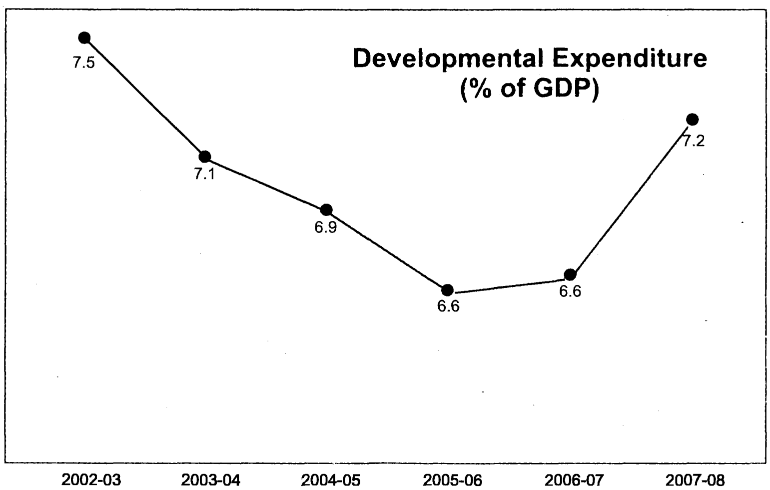
Appendix VI

The Liberal Budget - Expenditure Pattern

(% to GDP)

		2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Actuals)	2005-06 (Revised Estimates)	2006-07 (Budget Estimates)	2007-08 (LBE)
I.	**Non-Development Expenditure *of which :***	**9.9**	**8.8**	**8.4**	**8.2**	**8.0**	**7.0**
1.	Defence	1.7	1.6	1.4	1.4	1.3	1.3
2.	Interest Payments	4.8	4.5	4.1	3.7	3.5	3.4
3.	Subsidies	1.8	1.6	1.4	1.3	1.2	1.0
II.	**Developmental Expenditure *of which :***	**7.5**	**7.1**	**6.9**	**6.6**	**6.6**	**7.2**
1.	Economic Services	4.2	3.9	3.7	3.9*	4.0**	3.9
2.	Social Sector	2.4	2.2	2.0	2.1	2.1	2.3
Total Expenditure (I + II)		**17.4**	**15.9**	**15.3**	**14.8**	**14.6**	**14.2**
GDP at current market prices (Rs. Crores)		**2,449,736**	**2,760,224**	**3,121,414**	**3,531,451**	**3,955,225**	**4,449,628**





LBE Liberal Budget Estimates

* Revised Estimates

** Budget Estimates

Notes:

1. Figures from 2002-03 to 2006-07 are based on official budget documents
2. Figures for 2007-08 are Liberal Budget Estimates, based on various proposals set out in the text
3. GDP growth at current market prices is assumed to rise at 12% in 2006-07 as projected in the official budget document and at 12.5% in 2007-08
4. From 2005-06, the government stopped the practice of routing State government borrowings for Plan expenditure through its accounts. This has resulted in a reduction of its Capital Expenditure

Appendix VII

PARTICIPANTS AT THE DISCUSSIONS PREPARATORY TO THE DRAFTING OF LIBERAL BUDGET 2007-08

Three symposiums in Mumbai *

Mr. Sunil S. Bhandare
Advisor,
Economic and Government Policy,
Tata Strategic Management Group

Mr. Saugata Bhattacharya
Vice President,
Business and Economic Research,
UTI Bank

Mr. Arun Chacko
Director, Press Institute of India

Dr. Madhav Datar
Corporate Strategy and Planning
Department, IDBI

Dr. C. S. Deshpande
Executive Director,
Maharashtra Economic Development
Council

Mr. Allwyn Fernandes
Vice President,
R&P Management Communications
Pvt. Ltd.

Ms. Snehal Herwadkar
Reserve Bank of India,
Department of Economic Analysis
and Policy

Dr. Ajit Karnik
Professor of Political Economy,
Mumbai University

Mr. R. G. Katoti
Senior Economist,
Tata Services Ltd.

Ms. Neela Khandge
Economic Advisor,
Hindustan Construction Co. Ltd.

Dr. Mala Lalwani
Professor of Economics,
Mumbai University

Dr. Avadoot Nadkarni
Professor of Economics,
Mumbai University

Ms. Kiran Nanda
Economic Advisor,
Indian Merchants' Chamber

Dr. Rupa Rege Nitsure
Chief Economist,
Bank of Baroda

Mr. Sanjay Panse
Chartered Accountant

Mr. D. R. Pendse
Economic Consultant

Mr. Abhay Pethe
Professor of Urban Economics and
Regional Development,
Mumbai University

Mr. Niranjan Rajadhyaksha
Deputy Editor, *Businessworld*

Dr. Nishita Raje
Reserve Bank of India
Department of Economic Analysis
and Policy

Mr. A. B. Rastogi
Infrastructure Development Finance
Co. Ltd.

Mr. Partha Ray
Executive Assistant to Deputy Governor,
Reserve Bank of India

Dr. Siddhartha Roy
Economic Advisor –
Tata Group, Tata Services Ltd.

Mr. Jayraj Salgaokar
Writer and Publisher of *'Kalnirnay'*

Mr. Mangesh Soman
Dy. General Manager,
Aditya Birla Management
Corporation

Mr. Narayan Varma
Chartered Accountant

Mr. Mahesh Vijapurkar
Deputy Editor, *The Hindu*

* **Post-Reform Trends in Poverty and Inequality in India, June 29, 2006**
Keynote Speaker: Prof. Suresh Tendulkar, Economist and currently member of the Prime Minister's Economic Advisory Council.

* **Post-Reform Trends in Employment and Labour Policy in India, July 28, 2006**
Keynote Speakers : Prof. Lalit Deshpande, Research Consultant, retired Professor of Economics and Director of Economics, Bombay University and Prof. Sudha Deshpande, Demographer.

* **The Approach Document to the 11th Five Year Plan, August 25, 2006**
Keynote Speaker : Dr. A. Vasudevan, formerly Executive Director, Reserve Bank of India.

Note: The list is a composite one. Not every one was present at all three symposiums.

Workshop in Chennai, August 5, 2006

Mr. Sunil S. Bhandare
Economist

Mr. P. K. Doraiswamy
IAS Retd.

Mr. K. P. Geethakrishnan
IAS Retd.

Mr. T. S. Gopal
Social Activist

Dr. U. Jayalakshmi
Professor of Economics

Mr. R. G. Katoti
Economist

Ms. J. Madhuri
Equity Research Analyst

Mr. R. Natarajan
Retired Banker

Mr. Rajmohan V Pai
Company Executive

Prof. S. Radhakrishnan
Professor of Economics

Mr. N. Ramesh
Social Activist

Mr. Pavan N. Rao
Chartered Accountant

Mrs. Sushila Ravindran
Teacher in Economics

Mr. Sunil Rongala
Economist

Dr. A. Selvaraj
Professor of Economics

Dr. A. Singarayar
Professor of Economics

Mr. T. S. Sitaram
Insurance Executive

Mr. S. Sivarajasingham
Agronomist

Mr. Mangesh Soman
Economist

Mr. H. Sai Sridhar
Business Executive

Dr. G. Sundaram
IAS Retd.

Dr. A. M. Swaminathan
IAS Retd.

Mr. O. P. Tandon
Coordinator - Projects,
Press Institute of India

Mr. M. R. Venkatesh
Chartered Accountant

Dr. V. Vijayalakshmi
Professor of Economics

Mr. S. Viswanathan
Editor, *Industrial Economist*

Students from the Great Lakes Institute of Management, Chennai
Ms. Abhirami G.
Mr. Hariprasad B.
Ms. Indranil D.
Mr. Anil Kumar
Ms. N. Manjula
Mr. S. Subramanian
Mr. Kuldeep Tahim

Workshop in Devlali at the LSP Centre, September 9 & 10, 2006

Mr. S. Arunajatesan
Formerly Deputy General Manager,
State Bank of India

Dr. Shyam Ashtekar
Director, School of Health Science,
Maharashtra Open University

Mr. Sunil S. Bhandare
Economist

Dr. Dinesh Chandra
IAS Retd.

Dr. C. S. Deshpande
Economist

Mr. R. G. Katoti
Economist

Ms. Neela Khandge
Economist

Dr. Girdhar Patil
Homeopath

Mr. V. V. S. Rama Rao
Agriculturist

Prof. R. M. Mohan Rao
Professor of Agriculture

Dr. Y. Sivaji
Former Member of Rajya Sabha

Mr. Mangesh Soman
Economist

Mr. M. R. Venkatesh
Chartered Accountant

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The ILG seeks to emphasise the fact that a market economy by itself does not ensure an op society; that a free economy and a free society are two sides of the same coin; and that a fr and liberal democratic society alone will ensure a satisfying standard of life for the people.

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