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Fiscal Policy in the Wake of Demonetization

Supplement

UNION BUDGET 2018-19

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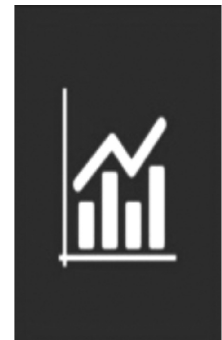

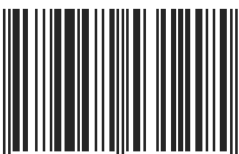
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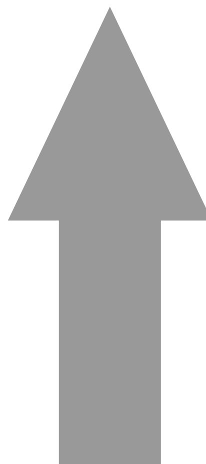
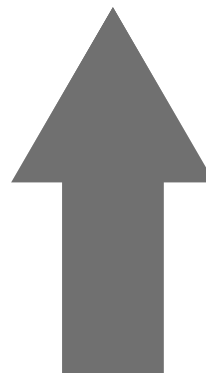
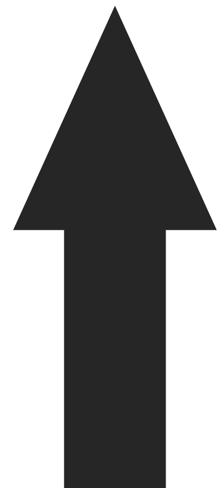

Fiscal Policy in the Wake of Demonetization

An Assessment of The Union Budget 2018-19

1. RECENT DEVELOPMENTS AND ECONOMIC OUTLOOK

On February 1, 2018, the Minister of Finance presented the Union Budget for the last full fiscal year of the National Democratic Alliance (NDA) government. Being the final full-year budget of the government, the delivery of the Budget was marked with a degree of anticipation. For the third year in a row, the Finance Minister's Budget Speech began with an accolade to India's economic performance, with the earlier language of "India stands out as a bright spot in the world economic landscape" only very subtly muted with "India stands out among the fastest growing economies of the world". It is true that India continues to enjoy one of highest growth rates globally. The economy also appears to be ticking along reasonably well in terms of the three standard indicators of macroeconomic stability relating to inflation, fiscal and current account deficit, and foreign exchange reserves (see Table 1). Inflation during FY2017-18 has been moderate at under 4%, fiscal deficit during FY2017-18 remained contained at 3.5% of GDP, and while the current account deficit widened to US$ 22 billion in the first half or FY2017-18, India's foreign exchange reserves were at a high of US$ 414 billion in January 2018, offering a comfortable cover both for imports and volatility in foreign capital flows.

Table 1: Recent Economic Performance

	Item	*Percentage change (April-December)*		
		2015-16	*2016-17*	*2017-18*
1	GDP at market prices (thousand crore) (#)			
	a. at current prices	8.7	11.0	9.5
	b. at 2011-12 prices	7.6	7.1	6.5
2	Index of Industrial Production (2004-05=100) *	3.8	5.5	3.2
3	Wholesale Price Index (2004-05=100)	–3.0	0.7	2.9
4	Consumer Price Index- Combined (2012=100)	4.8	4.8	3.3
5	Money Supply (M3) (thousand crore) (at end December)	7.2	3.7	3.8
6	Imports at current prices ** (in US $ million)	–15.4	–6.6	21.8
7	Exports at current prices ** (in US $ million)	–17.8	1.1	12.1
8	Trade Deficit (US$ million) **	–10.4	–21.6	46.4
9	Foreign Exchange Reserves (up to end January)	9.3	2.4	14.1
10	Current Account Balance (US$ billion) ##	–14.4	–3.7	–22.2

*# GDP figures and growth relate to full year (April-March). The figure for 2016-17 is provisional, and that for 2017-18 is the first estimate. * April-November. ** On Customs basis (April-December).*

Refers to levels *in April-September, 2015, 2016 and 2017.*

Source: Macro-Economic Framework Statement, Union Budget 2018-19, Ministry of Finance (MOF, 2108a).

However, alongside these points of strength, the current economic environment has also been marked by vulnerabilities and challenges on several fronts that are important in considering the fiscal policy environment for this year's budget. The following offers a brief review of the recent economic developments relevant to this mixed scenario.

(i) *Deceleration of economic growth and "decoupling"*. The Central Statistics Office's (CSO) recently-released "Press Note on Second

Advance Estimates of National Income 2017-18" (CSO, 2018) confirmed that the Indian economy slowed down during 2017-18, continuing further the deceleration of the previous year. CSO's Advance Estimate of real GDP growth for 2017-18 is 6.6%. This is down from 7.1% growth in 2016-17, which itself was down from 8.2% in 2015-16. Real Gross Value Added (GVA) growth–which is sometime considered a better measure of growth–shows a similar deceleration from 8.1% in 2015-16, to 7.1% in 2016-17, to 6.4% in 2017-18 (Table 2). In terms of quarterly (year-on-year) growth rates, GVA (and GDP) growth peaked in Q4 of 2015-16 (the quarter of January-March 2016) at 8.8%. Since then, the economy went through five successive quarters of declining growth, falling all the way down to 5.6% in 2017-18 Q1. There are signs of recovery in Q2 and Q3 of 2017-18 (i.e. since July 2017), but the interruption of the growth momentum of the economy during 2016-17 and 2017-18 has clearly been an important framing issue for this year's Budget.

Table 2: Recent growth Performance

		GDP at constant 2011-12 prices	*GVA at constant 2011-12 prices*
2015-16	Full year	8.2	8.1
2016-17 (RE)	Full year	7.1	7.1
2017-18 (2nd AE)	Full year	6.6	6.4
2016-17 (year on year)	Q1	8.1	8.3
	Q2	7.6	7.2
	Q3	6.8	6.9
	Q4	6.1	6.0
2017-18 (year on year)	Q1	5.7	5.6
	Q2	6.5	6.2
	Q3	7.2	6.7

GDP is measured at market prices while GVA is measured at basic (producers') prices excluding taxes and subsidies. Full-year refers to the fiscal year from April to March. Q1-Q4 refer to the four quarters of the full year. The figures for 2016-17 are Revised Estimates, and those for 2017-18 are Second Advance Estimates.

Source: CSO (2018).

The recent period also witnessed what the Economic Survey 2017-18 dubbed as temporary "decoupling" of India's growth from global growth – with the Indian economy decelerating while the rest of the world has been accelerating. There are several factors contributing to this decoupling as noted in the Economic Survey, that have to do with India pursuing a relatively tighter monetary policy, the economic shock induced by demonetization and the introduction of GST, the burgeoning effects of non-performing assets of the banking sector, and the sharp upturn in global oil prices. Some of these are discussed further later.

(ii) *Led by manufacturing, several major sectors of the economy contributed to the economic slowdown*. The sectoral decomposition of growth sheds light on which sectors have contributed to the growth slowdown. As noted above, GVA growth slowed down by 1.8 percentage points between 2015-16 and 2017-18. The last column of Table 3 shows a breakdown of this 1.8 percentage point deceleration by economic sectors. It is obvious from the Table that the sector most responsible for the slowdown has been manufacturing, contributing 1.3 of the 1.8 percentage point decline. Note that manufacturing growth rate fell sharply from nearly 13% in 2015-16 to 5% in 2017-18. Financial, real estate and professional services has been the second largest contributor to the economic slowdown. Mining and quarrying sector, and the Trade, hotels, transport, communication & broadcasting sector also contributed to the slowdown. It is notable that these four major sectors account for more than 60% of the total GVA. Thus, it is fair to say that most of the economy slowed down during this period.

(iii) *Favorable monsoons helped shore up agricultural and overall growth, but vulnerabilities remain*. The economic slowdown would have been

TABLE 3: Growth by sectors and their contribution to overall growth

Sector	Growth over previous year (%)			Contribution to growth (% points)			Contribution to deceleration between 2015-16 and 2017-18
	(A) 2015-16	(B) 2016-17	(C) 2017-18	(D) 2015-16	(E) 2016-17	(F) 2017-18	(F) – (D)
1. Agriculture, forestry & fishing	0.6	6.3	3.0	0.1	1.0	0.5	0.4
2. Mining & quarrying	13.8	13.0	3.0	0.4	0.4	0.1	–0.3
3. Manufacturing	12.8	7.9	5.1	2.2	1.4	0.9	–1.3
4. Electricity, gas, water supply & other utility services	4.7	9.2	7.3	0.1	0.2	0.2	0.1
5. Construction	3.7	1.3	4.3	0.3	0.1	0.3	0.0
6. Trade, hotels, transport, communication & services related to broadcasting	10.3	7.2	8.3	1.9	1.4	1.6	–0.3
7. Financial, real estate & professional services	10.9	6.0	7.2	2.3	1.3	1.6	–0.8
8. Public Administration, defence and other services	6.1	10.7	10.1	0.8	1.3	1.3	0.5
GVA at Basic Price	8.1	7.1	6.4	8.1	7.1	6.4	–1.8

Growth rates are at constant 2011-12 prices. The figures for 2015-16 are 2nd Revised Estimates, for 2016-7 are 1st Revised Estimates and for 2017-18 are 1st Advance Estimates.

Source: Calculated from CSO (2018).

larger but for the better agricultural performance on account of two successive good monsoons. As seen in Table 3, the agricultural sector in fact contributed to an *increase* in the overall growth rate between 2015-16 and 2017-18. However, the growth in agriculture in the last two years needs to be put in perspective. Coming on top of two successive drought years, the growth is less impressive than it may appear. Indeed, the average agricultural growth rate over the last four years is only about 2.4%, even lower than the long-run average agricultural growth of 2.8% since 1960. At this growth rate, it would take 29 years for real value-added in the sector as a whole to double – a far cry from the promise of doubling farmers' income in five years held out by the NDA government. The sector is yet to shake off its monsoon-dependency and the endemic problems of price and income volatility. With the sector still accounting for 64% of usual status workers in rural areas[1], these problems have been an important source of rural unrest that has also spilled over into a growing number of farmer protests.[2]

(iv) *Higher public consumption helped too*. Table 3 also shows that another factor that helped moderate the economic deceleration was the growth in public administration, defense and other services.

[1] This estimate is for 2011-12 based on NSSO (2013).

[2] By the National Crime Records Bureau data, the number of farmer protest rose from 628 in 2014, to 2683 in 2015, to 4837 in 2016 (Himanshu, 2018).

This reflects in large measure the pay hikes following the Seventh Pay Commission (for public sector wages) and the revised One Rank One Pension (OROP) scheme for the defense forces. When looked at from the perspective of an expenditure breakdown of the GDP, government final consumption expenditure, growing at 12% in constant prices during 2016-17 and estimated to grow at 11% during 2017-18, helped offset the slower growth in private final consumption expenditure of about 7% in 2015-16 and 2016-17 and 6% in 2017-18. Private consumption is still by far the largest component of GDP on the expenditure side with a steady share of around 56% since 2011-12 up to 2017-18, and it thus continues to be the main source of demand for national output. However, the recent increases in public spending, together with better rainfall-induced boost in agricultural incomes, have been important in propping up private consumption spending too.

(v) *Favorable monsoons also helped keep inflation in check, though food and petroleum price rise remain risk factors*. After reaching a peak of about 6% in July 2016 (on year-on-year basis), headline CPI inflation had declined steadily to under 2% in June 2017. Since then, headline inflation climbed steadily to over 5% in December 2017-January 2018, then moderating to 4.3% in March 2018. As seen in Figure 1, these changes have been driven primarily by food prices. Core CPI inflation (exclusive of food, fuel and light) has however remained sticky at around 5%, which may be more indicative of price trends beyond the short-term. It is notable that the rise in inflation – both food and general – during June-December 2018 occurred despite a favorable monsoon. The recent Monetary Policy Report (April, 2018) attributes this to an unseasonal spike in prices of vegetables and the implementation of the 7Th Pay Commission's Housing Rent Allowance (HRA) award which directly feeds into the CPI. While inflation has remained within the RBI inflation targeting range of 4 ± 2 percent, the rising global crude oil prices since July 2017 (with a delayed pass-through to domestic prices), the proposed revisions to the Minimum Support Prices, and potential fiscal slippage at the central and state level pose significant risks for monetary policy.

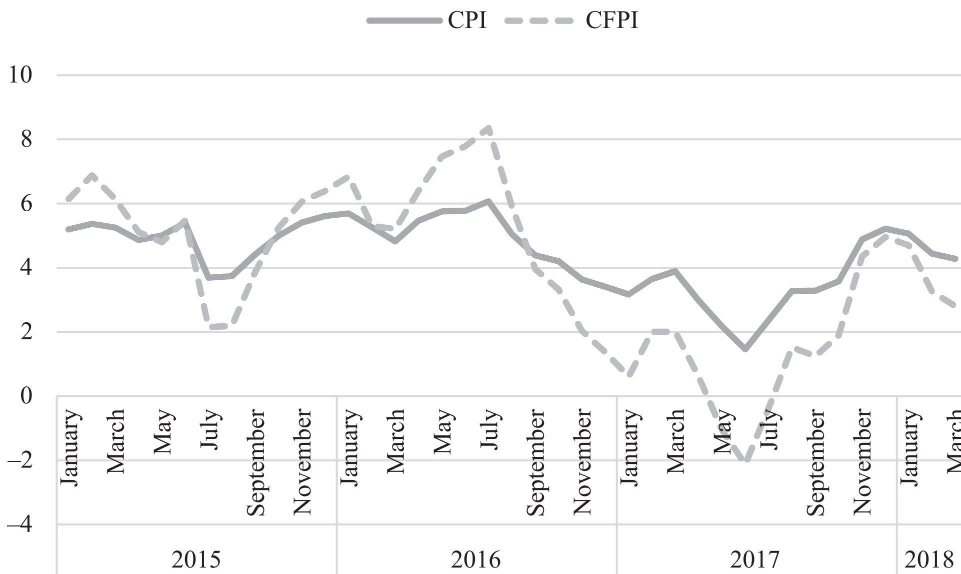

Figure 1: Annual general and food price inflation, year-on-year basis

Note: The Figure plots percentage change in the Consumer Price Index (CPI) and the Consumer Food Price Index (CFPI) between the current month and the same month for the preceding year.

Source: Based on data from the Ministry of Statistics and Programme Implementation, Government of India.

(vi) *Weakness in investment activity despite some recent recovery*. A continuing area of concern has been in relation to investment activity that has only recently shown some signs of recovery after a period of prolonged weakness. There was a continued decline in the overall investment ratio (the ratio of gross fixed capital formation (GFCF) to GDP) from 34.3% in 2011-12 to 31.1% in 2016-17. There are some green shoots of recovery in the first three quarters of 2017-18 (see Figure 2 for quarterly trend for the whole period) and CSO's Second Advance Estimates for 2017-18 put investment ratio at 31.4%.

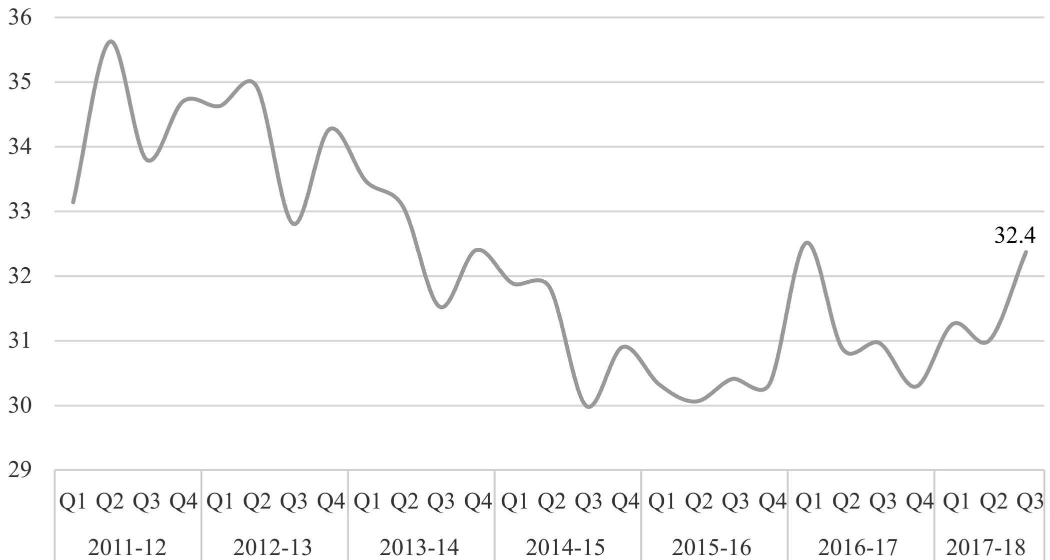

Figure 2: Gross Fixed Capital Formation Ratio (as % of GDP) by Quarter, year-on-year basis

Source: Based on CSO (2018) and CSO data for earlier years.

But trends in several indicators paint a picture of persisting weakness in investment. For instance, according to the RBI's Order Books, Inventories and Capacity Utilisation Survey, industrial capacity utilization declined successively during the first three quarters of 2016-17 to 71%, improving only marginally during Q2 and Q3 of 2017-18 to 72 and 74% respectively. Gross bank credit outstanding to industry (by all Scheduled Commercial Banks) was stagnant during April 2015-April 2016 (0.1% growth), and it declined by 1.9% during March 2016-March 2017, and increased minimally by 0.7% during March 2017-March 2018 (various *RBI Bulletins*). For this 3-year period as a whole, bank credit to industry has witnessed a decline. Non-performing assets of Scheduled Commercial Banks (SCBs) have been on a continuing rising trajectory for several years, rising from a low of about 2% of total advances in 2009-10 to about 8% in 2015-16; most recently, the gross non-performing advances (GNPA) ratio of SCBs climbed further from 9.2% in September 2016 to 10.2% in September 2017. Large borrowers with total exposure of ₹ 50 million or more account for 56% of gross advances and 83% of GNPAs of SCBs in September 2017 (RBI Financial Stability Report, 2018).[3] Thus, both the corporate and the banking sector are under continued stress and this is reflected in sluggish private investment – what the Economic Surveys of 2016-17 and 2017-18 have referred to as "the festering twin balance sheet problem".

[3] The top 100 large borrowers (interms of outstanding funded amounts) alone accounted for 16% of credit and 25% of GNPAs of SCBs (RBI, 2017).

(vii) *Signs of export recovery amidst looming uncertainties in external environment*. On the external front, there was a sizeable reduction in the trade and current account deficit in 2016-17 as a result of positive growth in exports, halting the sharp decline of the preceding year and a slower growth in imports. During the first half of 2017-18, export growth has continued but it has been outpaced by import growth, leading to a widening of both the trade and current account deficits (Table 4). The worsening of the current account balance was mitigated by a faster growth of service exports and inflow of private transfers (remittances). And foreign exchange reserves have continued to grow (to US$ 409 billion in January 2018) offering a comfortable margin for reserve adequacy (see Table 1). However, there has also been a significant shift in the global economic environment following the United Kingdom's exit from the European Union, and with the recently announced hike in tariffs by the US there is a heightened risk of reciprocal protectionist policies by other countries too. The US has also already withdrawn from the Trans Pacific Partnership (TPP) agreement, and the recent rise in the US dollar is likely to add to the existing protectionist pressures. This shrinkage of the "political carrying capacity for globalization" presents new risks for India's future export growth, and could limit the contribution of external demand to future economic growth.

Table 4: Trade and current account balance (US $ billion)

					2016-17	2017-18
	2012-13	*2014-15*	*2015-16*	*2016-17*	*H1*	*H1(P)*
1 Exports	306.6	316.5	266.4	280.1	134.0	149.2
2 Imports	502.2	461.5	396.4	392.6	183.5	224.0
3 Trade Balance (1-2)	–195.7	–144.9	–130.1	–112.4	–49.4	–74.8
4 Invisibles (net)	107.5	118.1	107.9	97.1	45.6	52.5
A. Services	64.9	76.5	69.7	67.5	32.0	36.7
B. Income	–21.5	–24.1	–24.4	–26.3	–14.4	–14.3
C. Transfers	64.0	65.7	62.6	56.0	27.9	30.1
5 Goods and Services Balance	–130.7	–68.4	–60.4	–45.0	–17.4	–38.1
6 Current Account Balance (3+4)	–88.2	–26.9	–22.2	–15.3	–3.9	–22.2

Source: Economic Survey 2017-18, Vol. 2.

(viii) *Demonetization and its aftermath*. On November 8, 2016, the Prime Minister announced the immediate demonetization of currency notes of ₹ 1000 and ₹ 500 denominations, thereby rendering in one stroke 86.9% of all currency in circulation as invalid. The old notes could be exchanged for new notes (of denominations ₹ 500 and ₹ 2000) in small amounts or could be deposited in banks up to December 30, 2016 though subject to withdrawal restrictions. The economic impacts of a monetary policy shock of this magnitude are still being debated. But for a largely cash-based economy[4], there is little doubt that it slowed the growth momentum of the economy. By how much remains a point of controversy; estimates have ranged from 0.25-0.50 percentage point (pp) (*Economic Survey 2016-17*, MOF 2017b), 0.33 pp (Reserve Bank of India) to 1 pp (IMF). The aggregate economic impact also masks diversity across sectors and income groups. The impact on the very heavily cash-dependent informal sector, which accounts for about 42% of GVA and 82% of all employment, is likely to have been far more severe; emerging evidence from several micro studies appears to confirm this.[5] While both the Ministry of Finance and the RBI have discounted persistent effects and it is difficult to evaluate the

[4] According to estimates in the Report of the Committee on Digital Payments (MOF, 2016c), 78% of all consumer payments are in cash. Other estimates, such as those by Price Waterhouse Coopers reported in the *Economic Survey 2016-17*, indicate that cash accounts for 98% of volume and 68% of the value of all consumer transactions (MOF, 2017b).

[5] See for instance, Chaddha et al (2017), Krishnan and Seigel (2017), Mohan (2017) as well as several other studies referred to in Bhattacharya et al (2017) for Ranchi, Amritsar, Jaipur and Delhi.

counterfactual of what would have happened without demonetization, it is evident from the CSO's GDP and GVA estimates (presented in Table 2) that the economy's growth momentum stalled during 2016-17 and 2017-18. Some residual lagged effects may linger on, but the remonetization process is now complete. Currency in circulation reached the pre-demonetization level during the week ending March 9, 2018 (Monetary Policy Report, April 2018), and there are signs that the economy is beginning to emerge from the aftermath of this shock.

(ix) *GST.* The other major policy intervention in this fiscal year related to the introduction of the Goods and Services Tax (GST) which came into effect on July 1, 2017. It had long been in the making – no less than 13 years since it was proposed by the Kelkar Task Force on Implementation of the Fiscal Responsibility and Budget Management (FRBM) Act in July, 2004. The GST is a tax based on the Value-Added Taxation (VAT) principle levied on a comprehensive tax base with nationwide coverage of goods and services. The GST represents a major overhaul of the country's indirect taxation system, subsuming a wide variety of indirect taxes previously levied by the central and state governments. Less than a year into implementation, the GST is still in a transitional state. But expectations from the GST have been high, and while it is early to assess its performance in terms of the four main goals of establishing a unified market, expansion of the tax base, better tax compliance and higher revenues, there are several concerns of both design and implementation with respect to each of these goals. Some of the key issues include: (i) the multiplicity of tax rates (with the GST Council having gone for a 5 tax-slab structure) and outright exemptions thus departing from the "One Tax" vision and with implications for creating economic distortions, increasing complexity of the tax system, administrative costs, and tax litigation; (ii) relatively high compliance costs (especially for smaller firms), with a regular GST registrant required to file 37 returns in a year and a registrant under the composition scheme required to file quarterly returns; (iii) these costs being accentuated further by a continuing flurry of changes to GST design; (iv) slow clearance of tax refunds with an accumulation of unpaid tax refunds threatening a serious liquidity crunch for exporters and small operators. As discussed later, the evidence on expansion of the tax base and higher revenues available thus far remains inconclusive.

(x) *Enduring under-provision of public services*. Beyond these recent developments, there are also longstanding development and fiscal policy concerns, in particular, those related to the serious under-provision of public services in India, especially in education, health and infrastructure. Despite some growth in absolute terms, India's public spending in these areas is one of the lowest amongst the BRICS and emerging markets. Addressing this under-provision is not only vital for long-term growth, but also important in relation to the redistributive role of budgetary policy in addressing economic and social inequalities.

Thus, the environment for the Union Budget for 2018-19 presented a number of important issues with implications for not only the desired level of fiscal consolidation, but also for how a particular level of fiscal consolidation ought be achieved through tax and expenditure proposals that try to address current as well as longstanding challenges. Before turning to an assessment of the Union Budget for 2018-19, we first look at its key features.

2. UNION BUDGET 2018-19 AT A GLANCE

The Union Budget typically presents three sets of numbers on receipts and expenditures of the central government: the budget estimates (BE) of for current financial year, and the budget estimates (BE) and revised estimates (RE) for the just-finished financial year. The difference between revised and budget estimates for a financial year (FY) is a measure of the budget execution performance for that FY. It is also customary to present "actual" receipts and expenditures from two financial years ago as audited by the Comptroller and Auditor General of India. The 2018-19 Budget thus presents the actual budget figures for FY2016-17, the budget and revised estimates for FY2017-18 and budget estimates for FY2018-19 (see Table 5).

2.1 Overall size of the Budget and its financing

As seen in Tables 5 and 6, the Union Budget 2018-19 has a total spending envelop of ₹ 2442 thousand crores for FY2018-19, equivalent to 13% of

Table 5: Union Budget 2018-19 at a Glance *(In thousand crore of Rupees)*

		2016-17 Actuals	*2017-18 Budget Estimates*	*2017-18 Revised Estimates*	*2018-19 Budget Estimates*
1.	**Revenue Receipts**	**1374.2**	**1515.8**	**1505.4**	**1725.7**
	2. Tax Revenue (Net to Centre)	1101.4	1227.0	1269.5	1480.6
	3. Non-Tax Revenue	272.8	288.8	236.0	245.1
4.	**Capital Receipts**[1]	**601.0**	**631.0**	**712.3**	**716.5**
	5. Recovery of Loans	17.6	11.9	17.5	12.2
	6. Other Receipts	47.7	72.5	100.0	80.0
	7. Borrowings and Other Liabilities[2]	535.6	546.5	594.8	624.3
8.	**Total Receipts (1 + 4)**	**1975.2**	**2146.7**	**2217.8**	**2442.2**
9.	**Total Expenditure (10 + 13)**	**1975.2**	**2146.7**	**2217.8**	**2442.2**
10.	On Revenue Account of which:	1690.6	1836.9	1944.3	2141.8
	11. Interest Payments	480.7	523.1	530.8	575.8
	12. Grants in Aid for creation of capital assets	165.7	195.4	189.2	195.3
13.	On Capital Account	284.6	309.8	273.4	300.4
14.	**Revenue Deficit (10 – 1)**	**316.4**	**321.2**	**438.9**	**416.0**
15.	**Effective Revenue Deficit (14 – 12)**	**150.6**	**125.8**	**249.6**	**220.7**
16.	**Fiscal Deficit [9 – (1 + 5 + 6)]**	**535.6**	**546.5**	**594.8**	**624.3**
17.	**Primary Deficit (16-11)**	**54.9**	**23.5**	**64.0**	**48.5**
	Gross Domestic Product	**15253.7**	**16847.5**	**16784.7**	**18722.3**

Notes: 1 Excluding receipts under Market Stabilisation Scheme
2 Includes drawdown of Cash Balance
(i) GDP for BE 2018-2019 has been projected at ₹ 18722.3 thousand crore assuming 11.5% growth over the estimated GDP of ₹ 16784.7 thousand crore for 2017-18 (RE).
(ii) Individual items in this document may not sum up to the totals due to rounding off.
Source: Union Budget 2018-19, Ministry of Finance (MOF, 2018a).

the GDP. Of this, the capital expenditure component (including grants for capital expenditure) which represents public investment is 20%, while the rest (80%) is expenditure on the revenue account.

About 71% of the total expenditure for 2018-19, or about ₹ 1726 thousand crores, is planned to be financed through revenue receipts (tax and non-tax revenues). A small fraction (3.8% of total expenditure) representing ₹ 92 thousand crores is financed out of non-debt capital receipts (disinvestments and recoveries of loans). The rest, 25.6% of total expenditure or ₹ 624 thousand crores, represents

Table 6: Union Budget 2017-18 at a Glance *(as % of GDP)*

		2016-17 Actuals	*2017-18 Budget Estimates*	*2017-18 Revised Estimates*	*2018-19 Budget Estimates*
1.	**Revenue Receipts**	**9.0**	**9.0**	**9.0**	**9.2**
	2. *Tax Revenue (Net to Centre)*	7.2	7.3	7.6	7.9
	3. *Non-Tax Revenue*	1.8	1.7	1.4	1.3
4.	**Capital Receipts**[1]	**3.9**	**3.7**	**4.2**	**3.8**
	5. *Recovery of Loans*	0.1	0.1	0.1	0.1
	6. *Other Receipts*	0.3	0.4	0.6	0.4
	Total Non-Debt Receipts (1 + 5 + 6)	**9.4**	**9.5**	**9.7**	**9.7**
	7. *Borrowings and Other Liabilities*[2]	3.5	3.2	3.5	3.3
8.	**Total Receipts (1 + 4)**	**12.9**	**12.7**	**13.2**	**13.0**
9.	**Total Expenditure (10 + 13)**	**12.9**	**12.7**	**13.2**	**13.0**
10.	On Revenue Account of which:	11.1	10.9	11.6	11.4
	11. *Interest Payments*	3.2	3.1	3.2	3.1
	12. *Grants in Aid for creation of capital assets*	1.1	1.2	1.1	1.0
13.	On Capital Account	1.9	1.8	1.6	1.6
14.	**Revenue Deficit (10 – 1)**	**2.1**	**1.9**	**2.6**	**2.2**
15.	**Effective Revenue Deficit (14 – 12)**	**1.0**	**0.7**	**1.5**	**1.2**
16.	**Fiscal Deficit [9 – (1 + 5 + 6)]**	**3.5**	**3.2**	**3.5**	**3.3**
17.	**Primary Deficit (16 – 11)**	**0.4**	**0.1**	**0.4**	**0.3**
	Gross Domestic Product	**100.0**	**100.0**	**100.0**	**100.0**

Notes and Source: Same as Table 5.

the fiscal deficit, which will be financed through government borrowings including drawdown of cash balances.

Relative to the GDP, total tax and non-tax revenues for 2018-19 represent 9.2% of GDP. With expenditures at 13% of GDP, this leaves a gap between total expenditures and total tax and non-tax revenues of about 3.8% of GDP. A small part of this, 0.5% of GDP, is filled by the aforementioned non-debt capital receipts, leading to a fiscal deficit of 3.3% of GDP which is left to be financed by government borrowings primarily through sale of government securities.

Relative to the last two budget cycles, there is not much change in the expenditure-to-GDP ratio: it was 12.9% in FY2016-17 (Actual), 13.2% in FY2017-18 (RE) and there is a small decline to 13.0% for FY2018-19 (BE). Thus, relative to the projected GDP for 2018-19, there is certainly no expansion in the government's overall spending envelop. On

the revenue side, there is also only a small change in the total tax and non-tax revenue ratio, which increased by 0.2 percentage points (pp) from 9.0% to 9.2% of GDP. This is offset by a 0.2 pp decline in non-debt capital receipts from 0.7% of GDP in FY2017-18 (RE) to 0.5% for FY2018-19 (BE). As a result, the total of non-debt receipts has remained unchanged at 9.7% of GDP for FY2017-18 (RE) and FY2018-19 (BE). Thus, in aggregate terms, the Budget for 2018-19 has more-or-less towed the line of the previous two budgets despite an altered economic context as discussed above.

The above is however subject to one caveat. Both the receipts and expenditure sides of the budget include an allowance for the GST Compensation Cess, to the tune of ₹ 61.3 thousand crores for FY2017-18 (RE) and ₹ 90 thousand crores for FY2018-19 (BE). This Cess is levied over and above the standard GST rate on certain specified luxury and demerit goods to compensate the states for any revenue loss on account of the implementation of GST. The Cess is transferred to a non-lapsable public account as per the GST (Compensation to States) Act 2017. While this Cess is budget-neutral (and therefore does not have a bearing on the fiscal deficit), it inflates both the receipts and expenditures in the Union Budget. Excluding the Cess, the size of the Union Budget is smaller, with expenditure/GDP ratios of 12.8% for FY2017-18 (RE) to 12.6% for FY2018-19 (BE).[6]

2.2 Composition of Expenditures and Receipts and the Financing of Fiscal Deficit

Expenditure Profile

How total expenditures in FY2018-19 and the previous two budget cycles have been allocated over the major budget heads is shown in Table 7.

Focusing on the Budget Estimates for 2018-19, Table 7 highlights a number of features of central government's spending profile.

(i) Two big claims on the Budget are interest payment and debt servicing, accounting for about 24% of the total expenditure, and defence, accounting for another 17%. Thus, these two items alone account for two-fifths of all central government expenditure. This is not a new, but a longstanding feature of central government budgets.

(ii) Another 4-5% of the budget goes into Home and External Affairs, while transfers to states and union territories (other than transfers under Centrally Sponsored and Central Sector Schemes or through the devolution of states' share in taxes) account for another 6-7%. The share of transfers to states and union territories rises to about 10% if the allocation for GST Compensation Cess is included (this is included under Tax Administration in Table 7).

(iii) Thus, only a little under half the central government budget is available for all other spending on economic and social development and on the provision of other public goods and services. This basic feature of the expenditure allocation of the union budget has persisted for a long time, but is useful to bear in mind when considering how much of the budget directly addresses the developmental needs of the country.

(iv) Amongst economic sectors, agriculture, allied activities and fertilizers (the latter entirely for the fertilizer subsidy) comprise 5.5% of total expenditure. Rural Development accounts for 5.7% Industry, commerce, finance and urban development account for 3.6%. Transport, energy, IT and telecom account for 8.1%. Amongst social sectors, education, health, water and sanitation together account for 6.6% of total expenditure.

(v) Of the remaining about 20% of the expenditure budget, about 11% is allocated to subsidies: about 7% for food (through the Public Distribution System), 3% for fertilizers, and 1% for petroleum (LPG and kerosene).

(vi) The rest – about 11% of total expenditure – is thinly spread over a large number of budget heads including pensions (other than those for defence personnel), housing, women and child development, youth affairs and sports, labour, employment and skill development, social justice and empowerment, tribal and minority affairs, Panchayati Raj, development of North Eastern

[6] The corresponding non-debt receipts/GDP ratios are 9.3% and 9.2% respectively (relative to the 9.7% ratio for both FYs inclusive of the Cess).

Table 7: Expenditure Budget 2017-18: Summary Profile

	2016–17 Actuals	*2017-18 Revised Estimate*	*2018-19 Budget Estimate*	*2016-17 Actuals*	*2017-18 Revised Estimate*	*2018-19 Budget Estimate*
	(₹ thousand crores)			*(% of total expenditure)*		
Interest and debt servicing	480.7	530.8	575.8	24.3	23.9	23.6
Defence	351.5	374.0	404.4	17.8	16.9	16.6
Home Affairs	78.4	88.1	93.5	4.0	4.0	3.8
External Affairs	12.8	13.7	15.0	0.6	0.6	0.6
Subsidy	204.0	229.7	264.3	10.3	10.4	10.8
Food	*110.2*	*140.3*	*169.3*	*5.6*	*6.3*	*6.9*
Fertilizer	*66.3*	*65.0*	*70.1*	*3.4*	*2.9*	*2.9*
Petroleum	*27.5*	*24.5*	*24.9*	*1.4*	*1.1*	*1.0*
Rural Development	113.9	135.6	138.1	5.8	6.1	5.7
Agriculture and Allied Activities	50.2	56.6	63.8	2.5	2.6	2.6
Urban Development	36.9	40.8	41.8	1.9	1.8	1.7
Commerce and Industry	21.4	26.3	28.0	1.1	1.2	1.1
Finance	41.5	29.4	20.3	2.1	1.3	0.8
Transport	102.2	107.1	134.6	5.2	4.8	5.5
Energy	31.0	41.7	41.1	1.6	1.9	1.7
IT and Telecom	18.0	17.8	22.4	0.9	0.8	0.9
Education	72.0	81.9	85.0	3.6	3.7	3.5
Health	39.0	53.2	54.7	2.0	2.4	2.2
Drinking water and sanitation*	16.5	24.0	22.4	0.8	1.1	0.9
Civil Pensions	43.6	52.4	59.6	2.2	2.4	2.4
Social Welfare	31.8	38.6	44.2	1.6	1.7	1.8
Scientific Departments	19.5	22.4	24.9	1.0	1.0	1.0
Planning and Statistics	4.5	5.1	5.2	0.2	0.2	0.2
Others	35.2	33.6	37.7	1.8	1.5	1.5
Development of the North East	2.5	2.7	3.0	0.1	0.1	0.1
Transfer to States	132.7	120.3	142.9	6.7	5.4	5.8
Union Territories	13.3	14.2	14.1	0.7	0.6	0.6
Tax Administration **	22.1	77.7	105.5	1.1	3.5	4.3
Total	**1975.2**	**2217.8**	**2442.2**	**100.0**	**100.0**	**100.0**

* This does not include the amounts of ₹ 2.1, 2.3 and 2.5 thousand crores in 2016-17 (Actual), 2017-18 (RE) and 2018-19 (BE) respectively for *Swacch* Bharat Mission (Urban) which is included under “Others”.

** This includes GST Compensation Cess of ₹ 61.3 crores in 2017-18 (RE) and ₹ 90.0 thousand crores in 2018-19 (BE) to compensate the states for any revenue losses on account of GST implementation.

Source: Union Budget 2018-19, Ministry of Finance (MOF, 2018a).

Region and tax administration. Environment, forests and climate change including renewable energy only account for 0.5% of the total budget, while science and technology accounts for 1%. This broad pattern of expenditure has remained largely unchanged since FY2016-17.

Receipts Profile

The composition of the receipts side of the Union Budget is shown in Table 8.

Table 8: Receipt Profile of the Budget, 2018-19

	2016-17 Actual	*2017-18 Revised Estimate*	*2018-19 Budget Estimate*		*2016-17 Actual*	*2017-18 Revised Estimate*	*2018-19 Budget Estimate*
1. Gross Tax Revenue	**1715.8**	**1946.1**	**2271.2**		**83.5**	**84.6**	**87.1**
(a) Corporation Tax	484.9	563.7	621.0		23.6	24.5	23.8
(b) Taxes on Income	364.6	441.3	529.0		17.8	19.2	20.3
(c) Wealth Tax	0.2				0.0		
(d) Customs	225.4	135.2	112.5		11.0	5.9	4.3
(e) Union Excise Duties	382.1	277.0	259.6		18.6	12.0	10.0
(f) Service Tax	254.5	79.5			12.4	3.5	
(g) GST		444.6	743.9			19.3	28.5
– CGST		221.4	603.9			9.6	23.2
– IGST		161.9	50.0			7.0	1.9
– GST Compensation Cess		61.3	90.0			2.7	3.5
(h) Taxes on Union Territories	4.1	4.7	5.2		0.2	0.2	0.2
Less: NCCD transfer to NCCF/ NDRF	6.5	3.7	2.5		0.3	0.2	0.1
Less: State's share	**608.0**	**673.0**	**788.1**		**29.6**	**29.3**	**30.2**
1a. Centre's Net Tax Revenue	**1101.4**	**1269.5**	**1480.6**		**53.6**	**55.2**	**56.8**
2. Non-Tax Revenue	**272.8**	**236.0**	**245.1**		**13.3**	**10.3**	**9.4**
Interest receipts	16.2	13.6	15.2		0.8	0.6	0.6
Dividend and Profits	123.0	106.4	107.3		6.0	4.6	4.1
External Grants	1.3	3.7	2.7		0.1	0.2	0.1
Other Non-Tax Revenue	130.5	110.4	117.9		6.4	4.8	4.5
Receipts of Union Territories	1.8	1.9	2.1		0.1	0.1	0.1
Total Revenue Receipts (1a + 2)	**1374.2**	**1505.4**	**1725.7**		**66.9**	**65.5**	**66.2**
3. Capital Receipts (A + B)	609.9	751.7	673.4		29.7	32.7	25.8
A. Non-debt Receipts	**65.4**	**117.5**	**92.2**		**3.2**	**5.1**	**3.5**
(i) Recoveries of loans & advances@	17.6	17.5	12.2		0.9	0.8	0.5
(ii) Disinvestment Receipts	47.7	100.0	80.0		2.3	4.3	3.1
B. Debt Receipts*	**544.5**	**634.2**	**581.2**		**26.5**	**27.6**	**22.3**
Total (Gross) Non-Debt Receipts (1 + 2 + A)	**2054.0**	**2299.6**	**2608.5**		**100.0**	**100.0**	**100.0**
4. Draw-down of cash balance	**– 8.9**	**– 39.4**	**43.1**		**– 0.4**	**– 1.7**	**1.7**
Total Receipts (1a + 2 + 3)	**1984.1**	**2257.1**	**2399.1**		**96.6**	**98.2**	**92.0**

* The receipts are net of payment.
@ Excludes recoveries of short-term loans and advances.
Source: Union Budget 2018-19, Ministry of Finance (MOF, 2018a).

The overall resources raised to finance expenditures of the central government come from three broad sources: (i) gross tax revenues, (ii) non-tax revenue receipts, and (iii) non-debt capital receipts. A fraction of the gross tax revenues are passed on to the states as their share in pooled taxes. On the other hand, debt receipts and the draw-down of the cash balances of the government go towards financing the fiscal deficit. Thus, to focus on the overall resource mobilization effort of the central government, it is meaningful to look at composition of different receipts in terms of their shares in the total gross revenue receipts and non-debt capital receipts (hereafter, simply referred to as total non-debt receipts). This is shown in the last three columns of Table 8 for the three budget cycles. Several features of the pattern of revenue mobilization for the 2018-19 Budget are notable.

(i) To begin with the three main sources of receipts, note that 87% of total non-debt receipts for 2018-19 (BE) are planned to be mobilized through (gross) tax revenues. Non-tax revenues are expected to contribute 9.4% and non-debt capital receipts 3.5%.
(ii) The gross tax revenue is split roughly half and half between direct taxes (corporation and income tax) and indirect taxes (Customs, Union Excise and GST).
(iii) Of the 51% share of direct taxes in gross tax revenue, the share of corporate taxes is 27% and that of income taxes is 23%.
(iv) The 49% share of indirect taxes in gross tax revenue is made up of a 33% share of GST, an 11% share of Union excise duties and a 5% share of Customs duties. Thus, after the introduction of the GST since July 1, 2017, it has emerged as the largest contributor to tax revenues raised by the central government. However, it is notable that union excise and customs duties are still important for the central government, contributing about one-sixth of the gross tax revenue.
(v) The two main sources of non-tax revenue (each contributing about 4% of total non-debt receipts) are dividends and profits of public enterprises and other non-tax revenue which is mostly revenue from spectrum charges.
(vi) The most important source of non-debt capital receipts is the proceeds from disinvestment or privatization of public enterprises, accounting for 3% of total non-debt receipts)

This broad pattern of resource mobilization has not altered radically since 2016-17. Nonetheless, there are some notable changes.

(i) The most significant change relates to the introduction of GST which has displaced other indirect taxes either fully or partially. The service tax is displaced fully, while customs and excise duties have been partially displaced. Thus, the shares of customs and excise in total non-debt receipts have declined from 11 and 19 percent in FY2016-17 to 4 and 10 percent in FY2018-19 (BE), while GST's is expected to contribute 28.5% of all non-debt receipts in FY2018-19, significantly higher than the 19.3% contribution even in FY2017-18 (RE).
(ii) Among direct taxes, while the contribution of corporate taxes has remained stable at 24% of total non-debt receipts, the contribution of direct taxes has increased gradually from 18% in FY2016-17, to 19% in FY2017-18 (RE) and is projected to rise further to 20% in FY2018-19.
(iii) There is a notable decline in the contribution of non-tax revenue to total non-debt receipts in FY2018-19 relative to FY2016-17, mostly due to a decline in dividends and profits and other non-tax revenues (primarily due to lower revenue from spectrum charges).
(iv) Non-debt capital receipts have been volatile over the budget cycles, increasing by about 80% in FY2017-18 (RE) relative to the previous year on the strength of high proceeds from disinvestment. But disinvestment proceeds are expected to moderate in FY2018-19, with their contribution to total non-debt receipts declining from 4.3% in FY2017-18 (RE) to 3.1% in FY2018-19 (BE).

Financing of the Fiscal Deficit

Table 9 shows the sources of financing of the fiscal deficit. Traditionally, market borrowings through sale of dated securities and Treasury Bills issued by the Government of India have been the main channel for financing the fiscal deficit. For the 2018-19 Budget, about two-thirds of the fiscal deficit is planned to be financed through market borrowings. This proportion is about the same as in FY2016-17. However, in 2017-18 (RE), there was a spike in the

Table 9: Sources of Financing of Fiscal Deficit: 2018-19

	2016-17 Actual	*2017-18 Revised Estimates*	*2018-19 Budget Estimates*	*2016-17 Actual*	*2017-18 Revised Estimates*	*2018-19 Budget Estimates*
	(₹ Thousand crores)			*(% of Fiscal Deficit)*		
Fiscal Deficit	**535.6**	**594.8**	**624.3**	**100.0**	**100.0**	**100.0**
Sources of finance:						
Debt Receipts (Net)	**544.5**	**634.2**	**581.2**	**101.7**	**106.6**	**93.1**
1. Market borrowings (G-Securities and T-Bills)	355.2	479.9	407.1	66.3	80.7	65.2
(*a*) *G-securities and 364-day T-bills*	*338.1*	*409.9*	*399.1*	*63.1*	*68.9*	*63.9*
(*a*) *Other T-bills*	*17.1*	*70.0*	*8.0*	*3.2*	*11.8*	*1.3*
2. Securities against Small Savings	67.4	102.6	75.0	12.6	17.3	12.0
3. State Provident Funds	17.7	15.0	17.0	3.3	2.5	2.7
4. Other Receipts (Reserve Fund, Deposit and Advances, NSSF)	86.1	34.3	84.7	16.1	5.8	13.6
5. External Debt	18.0	2.4	–2.6	3.4	0.4	–0.4
Draw-Down of Cash Balance	**–8.9**	**–39.4**	**43.1**	**–1.7**	**–6.6**	**6.9**

Source: Union Budget 2018-19, Ministry of Finance (MOF, 2018a).

share of market borrowings to 81% of the fiscal deficit. The fall in the share of market borrowings planned in the current Budget for 2018-19 to 65% reflects the combined effects of (i) a greater reliance on the drawing down of cash balances (cash balances were in fact built up during 2017-18), (ii) a lesser reliance on short-term Treasury Bills, and (iii) a greater resort to the National Small Savings Fund (NSSF) and other smaller saving. This change in the pattern of financing has some implications. First, drawing down of cash balances in FY2018-19 may be fine in light of the accretion to cash balances in the previous fiscal year, but it is clearly not a sustainable source of finance. Second, the yield on short-term T-bills is lower than on longer-term government securities by a 100 basis points or more. So, lesser use of this source will increase the government's cost of borrowing. Third, greater recourse to the NSSF and other small savings may also increase interest costs for the government. Thus, changes in the pattern of financing have implications for the already high expenditure on interest payments (as noted earlier in Table 7).

3. AN ASSESSMENT OF THE BUDGET

The budget as the main instrument of fiscal policy can be assessed from several different perspectives informed by both immediate and longer-term considerations. In assessing the current Union Budget for 2018-19, the immediate economic context as discussed above is clearly important. But it is also important to bear in mind the broader objectives of fiscal policy, which are not limited to promoting macroeconomic stability and economic growth, but also include a development and redistributive role for fiscal policy. An additional context for this year's budget is that it is the last full-year budget of the NDA government, and hence it is also useful to view it in conjunction with the experience of the previous three full budget cycles of this government's term in office. The following discussion is informed by a mix of these diverse perspectives.

(i) ***Slippage in fiscal consolidation and sliding targets***. The realized fiscal deficit in 2017-18

was 3.5% of GDP as against the target of 3.2% in the Medium Term Fiscal Policy (MTFP) Statement of 2017. Fiscal performance thus deviated from the proposed glide path of fiscal consolidation, and with the deficits exceeding the targets, the glide path itself has been revised over successive MTFPs (see Figure 3). For instance, MTFP for 2015 envisioned reaching a 3% fiscal deficit by 2017-18, but the most recent MTFP has deferred this to 2020-21. This has certainly put added stress on monetary policy.

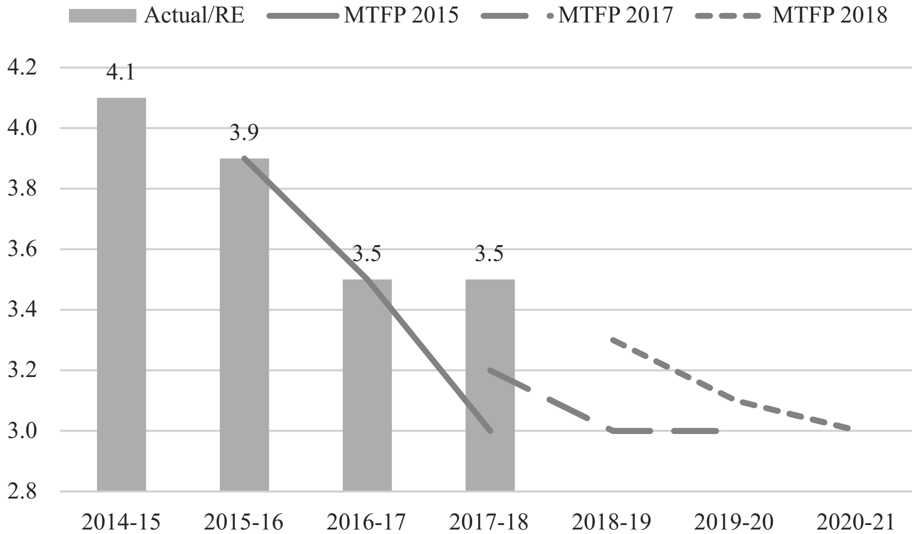

Figure 3: Slipping targets of fiscal consolidation (fiscal deficit as % of GDP)

Source: Union Budget (various years), Ministry of Finance.

However, the sliding targets and slippage in fiscal consolidation needs to be put in perspective. First, the slippage is not large. Second, a declining trend in fiscal deficit has nonetheless been maintained. Indeed, one can argue that *given the level of resource mobilization effort*, this measure of fiscal slippage was unavoidable in light of the prevailing economic conditions:

(a) There has been a slippage in the growth momentum of the economy since 2016-17, as already noted above (Table 2). Relative to 2015-16, the growth of both real GDP and GVA in 2017-18 is lower by 1.6 and 1.7 percentage points to 6.6% and 6.4% respectively.

(b) The economy is still recovering from the shock of the demonetization experiment. Estimates of the economic impact vary, ranging between 0.25 to 1 percentage point of GDP, and the decline in (year-on-year) growth rates for four successive quarters from FY2016-17 Q2 to FY2017-18 Q1 (Table 2) is suggestive of prolonged impact despite re-monetization.

(c) The impact of demonetization on the informal sector is likely to have been significantly more severe than suggested by the average economy-wide impact for both a structural and a statistical reason. The structural reason is that informal sector being far more heavily cash-based than the formal economy bore the brunt of supply-side shock of the liquidity squeeze. The statistical reason is that CSO's procedures for the estimation of the output of the informal sector rely on formal sector indicators. For instance, as noted by the *Economic Survey 2016-17*, "informal manufacturing is proxied by the Index of Industrial Production, which mostly [covers] large establishments." (pp. 73-74). The economic slowdown may have been larger than that suggested by official GDP/ GVA estimates.

(d) The GST rollout in July 2017, though a step in the right direction from the perspective of the reform of the indirect tax system, has been another major economic shock that has caused at least a short-term disruption of supply chains,

especially for small operators for whom the new system imposed significant compliance costs. This together with the fact GST collections during FY2017-18 will be limited to an 11-month period may also lead to revenue shortfalls.

(e) In important ways, the budgets for FY2017-18 and FY2018-18 have been rescued by the good monsoons leading to bumper crops, but for which the economic slowdown would have been sharper. However, as already noted above in Table 3, most of the non-agricultural economy experienced significant deceleration, led by the marked slowdown in manufacturing. Also as noted before, investment activity has been sluggish with a continued decline in the ratio of gross fixed capital formation (GFCF) to GDP.

(f) There are also uncertainties on the external front. Exports began to recover in FY2016-17, reversing the negative growth of the previous year, but whether this incipient recovery can be consolidated to offer significant demand support to overall growth remains uncertain on account of both global economic volatility as well as risks of greater protectionism.

Thus, in light of all these factors, a slower glide path to fiscal consolidation does not seem unwarranted.

However, having acknowledged that, there is no room for complacency on the fiscal consolidation front. Nor is the size of the fiscal deficit the only metric of fiscal performance. Both in terms of containing exposure to further fiscal slippage and in terms of broader development goals, there remain many areas of concern where the current budget, and fiscal policy more generally over the last the last four budget cycles, has failed to deliver adequately. We turn to a discussion of some of these issues.

(ii) ***Fiscal consolidation through (hidden) expenditure compression***. While fiscal deficit has been gradually declining from 3.9% of GDP in FY2015-16, to 3.5% in both FY2016-17 and FY2017-18, and is projected to decline further to 3.2% in FY2018-19, the main avenue for fiscal consolidation has been through expenditure compression, and some of this expenditure compression has been hidden. This is evident from the figures shown in Table 10.

Table 10: Resource mobilization and spending in the Union Budget ***(% of GDP)***

		2015-16 Actuals	*2016-17 Actual*	*2017-18 Revised Estimates*	*2018-19 Budget Estimates*
1.	Gross Tax Revenue	10.6	11.2	11.6	12.1
2.	Non-tax revenue	1.8	1.8	1.4	1.3
3.	Non-Debt capital receipts	0.5	0.4	0.7	0.5
4.	**Gross Non-Debt Receipts (1 + 2 + 3)**	**12.9**	**13.5**	**13.7**	**13.9**
5.	Less States' share of taxes (including NCCD transfer)	3.7	4.0	4.0	4.2
6.	**Net Non-Debt Receipts (4 – 5)**	**9.2**	**9.4**	**9.7**	**9.7**
7.	**Total expenditure**	**13.1**	**12.9**	**13.2**	**13.0**
8.	Fiscal deficit (7 – 6)	3.9	3.5	3.5	3.3
9.	**Net Non-Debt Receipts (ex. GST Comp. Cess)**	**9.2**	**9.4**	**9.3**	**9.2**
10.	**Total Expenditure (ex. GST Comp. Cess)**	**13.1**	**12.9**	**12.8**	**12.6**
	Fiscal deficit (10 – 9)	3.9	3.5	3.5	3.3

Source: Union Budget 2017-18 and 2018-19, Ministry of Finance (MOF, 2017a, 2018a).

If we look at the Gross and Net Non-Debt Receipts as reported in budget documents (rows 4 and 6 in Table 10), there seems to be a steady growth, from 12.9% and 9.2% of the GDP respectively in FY2015-16 to 13.9% and 9.7% in FY2018-19 (BE). At the same time, Total Expenditure as reported in budget documents (row 7 in Table 10) seems to have remained stable around 13% of GDP comparing FY2015-16 with FY2018-19 (BE), although there is a small decline compared to FY2017-18 (RE). However, the receipts for FY2017-18 (RE) and FY2018-19 (BE) include ₹ 61.3 thousand crores

and ₹ 90 thousand crores respectively for the GST Compensation Cess which are earmarked for a non-lapsable fund for compensating states for any revenue shortfall due to GST, and hence are not available to the central government. The same amounts are also included on the expenditure side. While this is budget neutral (has no bearing on the fiscal deficit), this artificially inflates both sides of the budget. The net non-debt receipts and total expenditure excluding the GST Compensation Cess are shown in rows 9 and 10 of Table 10. It is evident from these numbers that the "true" non-debt receipts have remained practically unchanged between FY2015-16 and FY2018-19 (BE) at 9.2% of GDP, and the total expenditure ratio has declined steadily from 13.1% in FY2015-16, to 12.6% in FY2018-19. Thus, the entire fiscal consolidation achieved or planned since FY2015-16 has been effected on the strength of expenditure compression. However, in an environment of slower growth momentum as described above, the merits of pursuing a path to fiscal consolidation through expenditure compression in this and the preceding budget remain highly questionable.

At the same time, there are risks of further fiscal slippage.

(iii) ***Windfall gains from falling oil prices have evaporated***. One major risk is on account of global oil prices – what the Economic Survey 2017-18 has called "India's historic macroeconomic vulnerability". Over the last three budgets of FY2015-16 through FY2017-18, the government was enormously helped in the task of fiscal consolidation by the large windfall gain due to the dramatic decline in international price of crude oil since mid-2014 (see Figure 4).

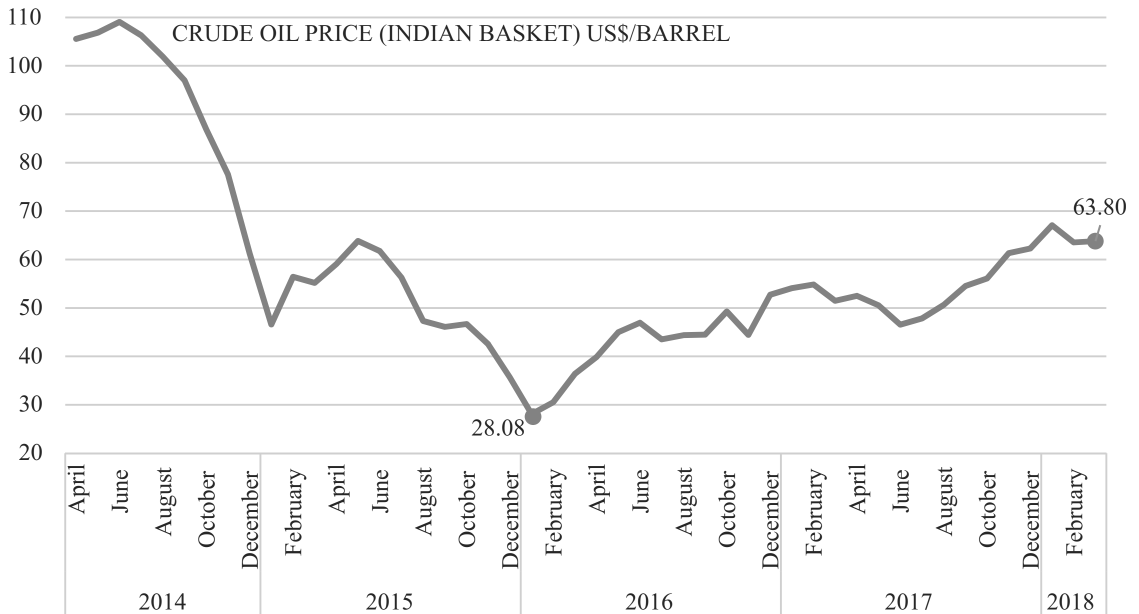

Figure 4: The fall and rise of crude oil prices since 2014

Source: Based on data from the Petroleum Planning and Analysis Cell (PPAC).

The fall in global oil prices helped in two ways. On the revenue side, it allowed the government to increase excise on motor spirits and diesel, and on the expenditure side, it allowed a reduction in petroleum subsidies. Singh and Mate (2018) term this as the "terms of trade benefit" to the fiscal bottom line. Table 11 shows their estimates of this benefit, estimated as the excess excise on petrol and diesel in these years above their long-term trend plus the saving in petroleum subsidies based on their elasticity to the oil price gap.

The terms of trade benefit arose as the lower oil prices were not fully passed on to consumers. As Table 11 shows, without this benefit, the fiscal

deficit would have been higher at upwards of 4% of GDP in the last three fiscal years. However, as also seen in Figure 4, crude oil prices for the Indian basket bottomed out in December 2015 and have been rising rapidly since, more than doubling by March 2018. Thus, the terms of trade benefit is likely to turn negative in FY2018-19 and this seems to have been at best only partially factored into the projected fiscal balance for FY2018-19.

Table 11: Fiscal deficit with and without the terms of trade benefit of petroleum prices

	2015-16	*2016-17*	*2017-18 (RE)*	*2018-19 (BE)*
Actual/planned fiscal deficit	3.93	3.51	3.54	3.33
Terms of trade benefit	0.32	0.62	0.48	negative
Fiscal deficit without terms of trade benefit	4.25	4.13	4.02	

Source: Singh and Mate (2018).

(iv) ***Spike in bond yields and the rising cost of borrowing.*** Another risk factor for the fiscal balance is the recent sharp rise in bond yields. Figure 5 shows that the yield on 10-year Government Securities after a 3-year decline to a low of about 6.2% in December 2016 has been climbing up, and especially sharply so since August 2017 reaching a high of 7.7% in May 2018.

Figure 5: The fall and rise of 10-year G-Sec yields since 2014

Source: https://tradingeconomics.com/, based on Ministry of Finance/RBI data.

This spike in yields on government securities of nearly 150 basis points since August 2017 has major implications for the government's cost of borrowing. As noted above, interest payments on government debt already swallow about a quarter of total government expenditure (see Table 7). The rise in yields could substantially increase the government's interest obligations putting a further strain on the budget. It is notable in this context that interest payment as a proportion of government expenditure in India is amongst the highest in the world. This is not because India has an exceptionally high public debt. The debt-to-GDP ratio in India is much in the middle range internationally. The large share of interest payments is mainly due to India's high interest rates, much higher than rates globally. This may be thought of as an issue for monetary policy, but it does have major fiscal implications. It is also not a new issue, but a longstanding structural problem which requires a coordinated response from both the fiscal and monetary fronts. But the potential gains from tackling this issue in terms of releasing fiscal space for financing all kinds of socially-useful public spending can be enormous.

(v) ***Elements of over-optimism on the revenue front.*** There is also the concern that tax revenue projections in the Budget for 2018-19 may have been over-optimistic on three counts. First, the Budget assumes a higher responsiveness of tax revenues to growth in national income than has been possible to achieve in recent years. As seen in Table 12, the buoyancy for gross tax revenue implicit in 2018-19 Budget estimates is 14% higher than the average for the past six years from 2012-13 to 2017-18. Income taxes are assumed to be 10% more responsive to growth and indirect taxes are assumed to be 16% more responsive. There is certainly an expectation that the introduction of GST will boost government revenues from indirect taxation. However, with multiple GST rates, product and threshold exemptions and compliance challenges, it remains to be seen how much of an expansion of the tax base or tax revenues will be delivered by the GST. The expected gains in tax buoyancy for personal income taxes may also be hard to realize. Second, tax revenue growth could also be compromised if the real GDP growth in FY2018-19 falls short of the assumed growth of 7.2% in the Medium Term Fiscal Policy Statement. Third, there is also an issue with the accounting of IGST (for inter-state sale of goods and services), as some of credit against IGST appropriated in FY2017-18 will be claimed in FY2018-19, and will thus cause a corresponding reduction in net GST collections for that year (Rao, 2018).

Table 12: Actual and budgeted tax buoyancy

	Average for 2012-13 to 2017-18 (1)	*2018-19 (BE) (2)*	*2018-19 (BE) as a ratio of 2012-18 average (2)/(1)*
Gross tax revenue	1.24	1.42	1.14
Corporation tax	0.87	0.86	0.99
Income tax	1.58	1.74	1.10
Indirect taxes	1.39	1.61	1.16

Note: Tax buoyancy is defined as the ratio of proportionate increase in tax revenue to proportionate increase in current price GDP, and measures the responsiveness of tax revenue from a particular source to economic growth.

Source: Calculated from tax receipts data from Union Budget 2018-19, Ministry of Finance, and current price GDP data from CSO, Ministry of Statistics and Program Implementation.

(vi) ***Dubious promise of doubling farmers' income in 5 years***. In the Budget Speech in March 2015, the Finance Minister spoke of the "nine distinct pillars" of the budget proposals for FY2015-16, the first of which was described as "Agriculture and Farmers' Welfare: with focus on doubling farmers' income in five years". The Finance Minister's Budget Speech in February 2017 for FY 2017-18 reiterated this promise. Favorable monsoons have indeed helped raise agricultural incomes during 2016-17 and 2017-18, but budgetary allocations for the agricultural sector do not accord well with this commitment to farmers, and only show modest growth even in nominal terms.[7] The total allocation to agriculture and allied activities including fertilizer subsidy and interest subvention for short-term credit to farmers was about ₹ 108 thousand crores in FY2015-16. It increased to ₹ 116 thousand crores in FY2016-17 (RE), to ₹ 122 thousand crores in FY2017-18 (RE), and the allocation for FY2018-19 (BE) is at ₹ 134 thousand crores – thus, a net increase of ₹ 26,000 crores (or 24%) in nominal terms over four budget cycles. The share of agriculture in total spending at 5.5% in FY2018-19 (BE) is in fact lower than the its 6.1% share in FY2015-16.

Of this total allocation to the agricultural sector, the fertilizer subsidy component (around ₹ 70 thousand crores) alone accounts for about 52%.

[7] By one recent estimate, real income per cultivator has grown at the rate of 3.4% per annum between 1993-94 and 2015-16. At this rate, it would take nearly 21 years for the cultivator income to double (Chand, 2017).

But, there are significant concerns as to how much of the benefits of the subsidy accrue to the farmers, especially small farmers. The fertilizer subsidy is given to fertilizer companies and importers. In the case of Urea, which accounts for 70% of total fertilizer subsidy, the subsidy is offered on a cost-plus basis with a regulated maximum retail price (MRP). Analysis undertaken in the *Economic Survey 2015-16* highlighted serious leakages through a thriving black market (with 51% of farmers buying Urea above MRP with an average mark-up of 60%) and support to inefficient producers (with an estimated cost equivalent to about a quarter of Urea subsidies). This is in addition to the subsidies distorting the optimal use of fertilizers.

The Budget for FY2018-19 also declared that the minimum support price (MSP) for "the majority of rabi crops" and "all unannounced crops of kharif" will be at least at one and half times of their production cost, following the recommendation of the National Commission on Farmers (2006) headed by Prof MS Swaminathan. The budgetary allocations for this measure however indicated that MSPs were intended to be 50% higher than a narrower concept of production costs (the so-called A2+FL cost) than the full costs (the C2 cost) as implied in the Swaminathan Commission's recommendations.[8] The MSP for wheat has already been well above 50% mark-up on the A2+FL costs since more than a decade, and the MSP for paddy has been close to, and in some years higher than, 50% mark-up on A2+FL costs (Himanshu, 2018). Thus, without a clear commitment to a 50% mark-up over the full C2 costs, the Budget's MSP measure offers little additional support to farmers.

(vii) ***Continued underspending on health and education***. While under-provision of health care and education has been an endemic issue for development policy in India, the Union Budget for FY2018-19, much like the preceding several budgets, has failed to break any new ground in this respect. The combined allocation for education, health, including drinking water and sanitation represents less than 7% of the total budgeted expenditure for FY2018-19, and this proportion has not changed much over the years (see Table 7). As a proportion of GDP, Union government spending on education and health in FY2018-19 (BE) is 0.9 percent, even lower than the 1 percent mark it reached in 2012-14 (see Table 13).

As against this, defence spending alone accounts for about 17% of the Union Budget, more than the allocation to education, health, drinking water and sanitation, agriculture and rural development combined (Table 7). Defence spending of course has somewhat of a status of holy cow in India, but clearly all spending has an opportunity cost and a reexamination of the spending priorities to make room for better resourcing of education and health ought not be beyond the scope of policy and public discussion.

Table 13: Spending on Education and Health *(Percentage of GDP)*

	2012-13	*2013-14*	*2014-15*	*2015-16*	*2016-17*	*2017-18 (RE)*	*2018-19 (BE)*
Total Expenditure by Union and State Governments							
Education	3.1	3.1	2.8	2.4	2.6	2.7	—
Health	1.3	1.2	1.2	1.1	1.5	1.4	—
Total-Education and Health	4.4	4.3	4.0	3.5	4.1	4.1	—
Union Government Expenditure							
Education	0.66	0.63	0.55	0.49	0.48	0.49	0.45
Health	0.40	0.37	0.35	0.39	0.37	0.46	0.41
Total-Education and Health	1.07	1.00	0.90	0.88	0.85	0.95	0.87

Note: Health includes Drinking Water & Sanitation.
Source: Economic Survey 2017-18, Volume II, Ministry of Finance (MOF, 2018b); Union Budget (various years), Ministry of Finance; CGBA (2018).

[8] Over and above the production costs included in A2+FL cost, the C2 cost also includes interest on the value of owned capital assets, the rental value of owned land (net of land revenue) and rent paid on leased-in land.

Of course, within the federal system, the States in India have a major responsibility in education and health sectors. However, even the combined Centre and States spending on education and health as a proportion of GDP has been stagnating at about 4% for a long time (Table 13), and is very low by international standards (the world average for 2014 is about 11% of GDP, about 5% for education and 6% for health).[9] As for the Union Government spending on these two sectors as a proportion of GDP, it is less than 1% and has been gradually declining over the years (see Table 11). While improving education and health standards in the country is not just a matter of increasing public spending, these social sectors are clearly highly under-resourced.

The Budget for 2018-19 also announced "a flagship National Health Protection Scheme to cover over 10 crore poor and vulnerable families (approximately 50 crore beneficiaries) providing coverage upto 5 lakh rupees per family per year for secondary and tertiary care hospitalization. This will be the world's largest government funded health care programme." (Budget Speech of the Finance Minister, Union Budget 2018-19, Ministry of Finance). However, with an allocation of only ₹ 2 thousand crores to the National Health Insurance Scheme (RSBY) for FY 2018-19 and no clear financing plan for the announced scheme, this seems largely an unfunded mandate.

(viii) ***Fluctuating spending on safety nets***. Four of the major safety net programs in the country relate to (a) the provision of subsidized food through the Public Distribution System (PDS), (b) provision of low-wage employment to unskilled labor in rural areas under the Mahatama Gandhi National Rural Employment Guarantee Act (MNREGA), (c) supplementary nutrition, healthcare and education for pre-school children and their mothers under the Integrated Child Development Services (ICDS) program, and (d) the Mid-day Meal Program for primary (class I to V) and upper-primary (class VI to VIII) school-going children. The importance of these programs in improving the wellbeing of the poor has been documented in a number of studies (see for instance, discussion in Dreze and Sen, 2013, and Dreze, 2017). The combined spending on these programs represents about 11% of the budget for 2018-19, which is about the same as in FY2015- 16 (Table 14). There was a drop in spending during FY2016-17, but budgetary resources for these programs have grown in FY2017-18 and FY2018-19. This is a positive development.

Table 14: Spending on major safety net programs

	Amount in ₹ Thousand crores					*% age change*		
	2015-16	*2016-17*	*2017-18 (RE)*	*2018-19 (BE)*		*2016-17 over 2015-16*	*2017-18 RE over 2016-17*	*2018-19 BE over 2017-18 RE*
Food and Public Distribution	139.4	110.2	140.3	169.3		–21.0	27.3	20.7
MNREGA	37.3	48.2	48.0	55.0		29.1	-0.4	14.6
ICDS	16.8	15.9	20.0	23.1		–5.6	25.6	15.7
Mid-day Meal (MDM)	9.1	9.5	10.0	10.5		3.6	5.5	5.0
Total	**202.7**	**183.8**	**218.2**	**257.9**		**–9.4**	**18.8**	**18.2**

Source: Union Budget 2017-18 and 2018-19, Ministry of Finance (MOF, 2017a, 2018a).

However, spending on these programs has been fluctuating, and not all fluctuations are demand driven. For instance, PDS spending sharply declined in 2016-17 followed by recovery and growth later. Spending on ICDS too fell in 2016-17, but has rebounded in the following years. For MNREGA, the overrun of actual spending during FY2016-17 (a 29% increase over 2015-16) reflects in part the spike in MNREGA employment in the months following the demonetization of November 8, 2016, and is indicative of the willingness of the government to contain the negative fallout on people's livelihood, especially those in the informal sector. There was virtually no change in the expenditure on MNREGA

[9] World Bank (2017). *World Development Indicators*, World Bank (http://data.worldbank.org).

in FY2017-18 even as the economy decelerated. The allocation for FY2018-19 is higher by about 15%, but this needs to be viewed against the evidence of significant unmet demand for MNREGA work, even in "normal" times. In relation to the latter, Dutta et al. (2012) for instance estimated for 2009-10 that 44% of households who wanted MNREGA work did not get it.

(ix) ***Low-tax low-spend fiscal equilibrium with low share of direct taxes***. Finally, we turn to a longstanding issue with fiscal policy in India – that it seems to be stuck in a low-tax low spend equilibrium. Notwithstanding all the concerns with fiscal consolidation and slippage, it is worth noting the simple point that the same level of fiscal deficit can be achieved with higher (or lower) levels of both receipts and expenditures. The Nobel Laureate, Joseph Stiglitz, writing in the context of "deficit fetishism" in the US observed that "If the government simultaneously increases taxes and increases expenditures – so that the current deficit remains unchanged – the economy can be stimulated" (Stiglitz, 2012).

The argument also applies to fiscal policy in India. It seems that the Union Budget for 2018-19 and several previous Budgets have taken a gross tax revenue of about 11-12% of GDP and a fiscal deficit of around 3-3.5% of GDP as given parameters, which (together with states' tax share of around 4% of GDP and non-tax and non-debt capital receipts of around 2% of GDP) pretty much fixes an expenditure-to-GDP ratio of around 12.5-13% as the spending envelope (Table 15). There however remains the larger question of whether Indian budgets tend to both under-tax and under-spend[10]. It is arguable that a central government expenditure ratio of 13% of GDP, or even a consolidated central and state government expenditure ratio of about 26%, is low for a democratic country at India's current stage of development[11].

Table 15: Spending on major safety net programs

(% of GDP)

	2011-12	*2012-13*	*2013-14*	*2014-15*	*2015-16*	*2016-17*	*2017-18 (RE)*	*2018-19 (BE)*
Central Government								
Total expenditure (incl. GST Comp. Cess)	14.9	14.2	13.9	13.4	13.1	12.9	13.2	13.0
Gross tax revenue (incl. GST Comp. Cess)	10.2	10.4	10.1	10.0	10.6	11.2	11.6	12.1
GTR Net of States' share	7.2	7.5	7.3	7.3	6.9	7.2	7.6	7.9
Other non-debt receipts	1.8	1.8	2.1	2	2.3	2.2	2.1	1.8
Gross fiscal deficit	5.9	4.9	4.5	4.1	3.9	3.5	3.5	3.3
Share of direct taxes in gross tax revenue	**55**	**54**	**55**	**55**	**51**	**50**	**52**	**51**
Central and State Governments								
Total expenditure	27.7	27.1	26.7	26.4	24.7	26.9	26.1	
Tax revenue	16.5	17.0	16.4	16.2	15.2	15.9	16.1	
Other non-debt receipts	3.4	3.2	3.6	3.4	3.2	4.7	4.6	
Gross fiscal deficit	7.8	6.9	6.7	6.7	6.4	6.4	5.5	
Share of direct taxes in tax revenue	**33**	**32**	**34**	**33**	**33**	**33**		

Source: Economic Survey 2017-18 and Union Budget 2018-19, Ministry of Finance (MOF, 2018b, 2018a).

[10] In the Indian context, see Shetty (2016), for instance, for making such an argument.

[11] Cross-country analysis presented in the *Economic Surveys* of 2015-16 and 2017-18 lends credence to such a view (MOF, 2016b, 2018b).

But supporting a higher level of public spending will require greater effort on revenue mobilization, especially with respect to direct taxes which have been stagnating at less than 6% of GDP for nearly a decade, resulting in a continued heavy reliance on indirect taxes. The share of direct taxes in the gross tax revenues of the Union government has in fact been declining; it was 55% in 2011-12 and is projected at 51% for 2018-19 (BE). The issue is not limited to the central government. The share of direct taxes in total tax revenues of the central and state governments is much lower – only about a third since 2011-12, and even lower in previous decades (Table 15).

One of the factors responsible for the poor performance on direct taxes is the low tax base of personal and corporate income taxes. According to the figures released by the Income Tax Department, the total number of effective individual assessees[12] (those who filed income tax returns plus cases of tax deduction at source) was 49.57 million during 2014-15. The Department also reported that 17.90 million of the individual tax returns had a zero taxable income. Thus, the number of taxpayers was about 31.67 million (including cases of at-source tax deductions). As against this, according to the NSS 68th Round Survey (2011-12) on Employment and Unemployment, India had 472.9 million usual (principal and secondary) status workers, which projected to 2014-15 comes to 494.5 million. In other words, only 6.4% of workers in India were taxpayers (see Table 16). Similarly, for corporate income taxation, only 1.75 million companies and firms were effective assessees, of which more than one-third had zero taxable income, thus leaving only 1.15 million taxpaying entities for the country as a whole. Moreover, the effective tax rate amongst the companies assessed was 28.24%, well below the statutory rate of 34.47%,[13] reflecting a number of exemptions in the tax code and various forms of tax avoidance. And there are no taxes on wealth, property or inheritance.

TABLE 16: Personal and Corporate Income Tax Assessess, 2014-15

(in million)

	Total assessees	*Assessees with zero taxable income*	*Taxpayers*
Personal income taxes			
Individual effective assessees	48.664	17.415	31.248
Hindu Undivided Families	0.907	0.489	0.419
Total	**49.571**	**17.904**	**31.667**
Uuual (ps+ss) status workers			494.5
Personal income taxpayers as % of workers			6.4
Corporate taxes			
Companies	0.714	0.367	0.348
Firms	1.031	0.230	0.802
Total	**1.746**	**0.596**	**1.149**

Note: * Effective assessees include those filing tax returns plus those with income tax deductions at source. ps: primary status; ss: secondary status.

Source: Income Tax Department (2017): Income Tax Data - Time Series Data: Financial Year 2000-01 to 2014-15; Income Tax Department (2017): Income Tax Return Statistics: Assessment Year 2014-15; Ministry of Statistics and Programme Implementation (2013): Key Indicators of Employment and Unemployment in India, 2011-12, NSS 68th Round (July 2011-June 2012), National Sample Survey Office (NSSO, 2013).

[12] Including Hindu Undivided Families who are treated as a 'persons' under the Income Tax Act, 1961.

[13] Average statutory tax rate is calculated as a weighted average of the tax rate of 33.06% in the case of companies having total income up to ₹ 10 crore and 34.6% in the case of companies having total income exceeding ₹ 10 crore (*Union Budget 2017-18*, Ministry of Finance, MOF, 2017a).

Recent analysis presented in the *Economic Survey 2017-18* also indicates a very weak effort at collection of direct taxes at state and lower levels of government, and this does not appear to be a matter of just an inadequate devolution of taxation powers (MOF, 2018b). The evidence also points to a gross under-utilization of the taxation powers available to the lower tiers of government for the collection of direct taxes, especially taxes on property. Thus, the overall low tax effort, especially in relation to direct taxes, afflicts all tiers of government, and remains a serious and binding constraint on fiscal policy in India.

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THE GOODS & SERVICES TAX (GST)

The Goods and Services Tax (GST) came into effect in India on July 1, 2017. It had long been in the making – no less than 13 years since it was proposed by the Kelkar Task Force on Implementation of the Fiscal Responsibility and Budget Management (FRBM) Act in July, 2004: "The major proposal of the Task Force is that the VAT [Value-Added Tax] principle should be comprehensively used to tax the consumption of almost all goods and services in the economy." (GOI, 2004).

The Task Force proposed this as a 'grand bargain' within the Indian federal structure, whereby "both central and state government would exercise concurrent but independent jurisdiction over common or almost common tax bases extending over all goods and services, and in both cases, going up to the final consumer." The grand bargain however took well over a decade to hammer out before the GST Bill, passed by both houses of the Parliament, received the President's assent on September 8, 2016, and was enacted as the Constitution (101st Amendment) Act, 2016.

India has been a bit of a latecomer to the introduction of GST or VAT, which is now by far the most common form of indirect taxation around the world. In 2016, 166 countries were operating a VAT or GST (OECD, 2016). While the United States is the most notable exception, it would be fair to say that GST/VAT is the global norm for indirect taxation and an increasingly important source of government revenue for growing number of countries.[1]

KEY FEATURES AND PROVISIONS OF INDIA'S GST

As the institutional mechanism for the grand Centre-States bargain, the Constitution (101st Amendment) Act, 2016 provided for the constitution of the Goods and Services Tax Council (GSTC) comprising the Union Finance Minister, the Minister of State (Revenue) and the Finance Ministers of each State, empowering the Council to make recommendations on the GST rates, exemptions, thresholds, taxes to be subsumed and other features of the GST. The Council came into effect from September 12, 2016 and by the end of 2017 had held 24 meetings to decide on specific elements of the GST system and its implementation. While the administration of GST is still evolving, key features of the current system include the following:

A Value-added Tax: The GST is essentially a Value-Added Tax (VAT) – a broad-based tax on consumption levied on the value-added principle. A central feature of GST is that while it is a tax on final consumption, it is collected through a staged process with tax levied on the value added at each stage of production and distribution in the supply chain. At each point of the supply chain, businesses collect the applicable GST on the value of their output from their customers while they are entitled to an Input Tax Credit (ITC) with respect to the GST paid on any goods or services they have purchased as inputs, and they remit the difference to (or receive a refund from) the tax authority. Thus, a business's tax liability is limited to the tax on the value added by that business. In this respect, the GST is different from an excise or sales tax imposed as a single-stage levy on the manufacture or sale of a product.

■ **A Comprehensive Nationwide Tax Base:** Taxes based on the VAT principle have existed in India prior to the introduction of GST (e.g. the CENVAT and States VAT), but they have been rather piecemeal and limited in scope. By contrast, a comprehensive tax base with nationwide coverage of goods and services is a key distinguishing feature of the GST. Thus, as per the current provisions,

(*a*) GST applies to all goods and services except Alcohol for human consumption.

(*b*) GST on five specified petroleum products (crude, petrol, diesel, aviation turbine fuel & natural gas) would be applicable from a date to be recommended by the GST Council.

(*c*) The list of exempted goods and services would be kept to a minimum and it would be harmonized between the Centre and the States as well as across States as far as possible.

(*d*) Tobacco and tobacco products are not only subject to GST, but also an additional Central Excise duty.

■ **"Dual" GST:** In keeping with the Constitutional imperative of fiscal federalism and as part of the 'grand bargain', GST will be simultaneously levied by both the Centre and the States on a common tax base. The GST on *intra*-State supply of goods and services levied by the Centre is called the Central GST (CGST) and that levied by the States (including Union Territories with legislature) is called the States GST (SGST). Union territories without legislature levy the Union Territory GST

[1] There were only about 50 countries with a VAT/GST in 1990, the number having more than tripled since (OECD, 2016).

(UTGST). For *inter*-State supply (including stock transfers) of goods or services, an Integrated GST (IGST) will be levied and collected by the Centre. CGST, SGST /UTGST & IGST are levied at rates mutually agreed upon by the Centre and the States under the aegis of the GSTC.

Input Tax Credit of CGST paid on inputs can be used only for paying CGST and the credit of SGST/UTGST paid on inputs can be used only for paying SGST/UTGST. The two streams of input tax credit (ITC) cannot be cross-utilized, except in the circumstance of inter-State supplies for payment of IGST in the following manner:

(*a*) ITC of CGST allowed for payment of CGST & IGST in that order;

(*b*) ITC of SGST allowed for payment of SGST & IGST in that order;

(*c*) ITC of UTGST allowed for payment of UTGST & IGST in that order;

(*d*) ITC of IGST allowed for payment of IGST, CGST & SGST/UTGST in that order.

■ **Destination-based Tax:** Consistent with international practice, GST is designed as a destination-based tax. Under the destination principle, the tax is fully levied on final consumption occurring within the taxing jurisdiction. In the context of international trade, under the destination principle, no tax will be payable on exports of goods or services; however, input tax credit will be available as refund to exporters. Imports of goods or services would be treated as inter-State supplies and would be subject to IGST (in addition to any applicable customs duties).

■ **Subsumption of Existing Central and State Taxes:** GST would replace the following taxes currently levied and collected by the Centre: (*i*) Central Excise Duty; (*ii*) Duties of Excise (Medicinal and Toilet Preparations); (*iii*) Additional Duties of Excise (Goods of Special Importance); (*iv*) Additional Duties of Excise (Textiles and Textile Products); (*v*) Additional Duties of Customs (CVD); (*vi*) Special Additional Duty of Customs (SAD); (*vii*) Service Tax; (*viii*) Central Cesses and Surcharges insofar as they relate to supply of goods or services.

■ **GST will also Subsume the Following State Taxes:** (*i*) State VAT; (*ii*) Central Sales Tax; (*iii*) Luxury Tax; (*iv*) Entry Tax (all forms); (*v*) Entertainment and Amusement Tax (except when levied by the local bodies); (*vi*) Taxes on advertisements; (*vii*) Purchase Tax; (*viii*) Taxes on lotteries, betting and gambling; (*ix*) State Surcharges and Cesses so far as they relate to supply of goods and services.

■ **Threshold for GST Exemption:** A common threshold exemption would apply to both CGST and SGST. Taxpayers with an annual turnover of up to ₹20 lakh (₹10 lakh for special category States, except Jammu & Kashmir, as specified in article 279A of the Constitution) would be exempt from GST. The threshold is introduced to reduce the administrative burden for both small operators as well as tax authorities.

■ **Composition and Regular GST:** Small taxpayers with an annual turnover of up to ₹1.5 crore (₹75 lakh for special category States, (except Jammu & Kashmir and Uttarakhand, as specified in article 279A of the Constitution) will have the freedom to opt for the Composition Scheme to pay GST at a flat rate (at 1-5% of the value of turnover) without input tax credits. A taxpayer opting for composition levy shall not collect any tax from his/her customers. Compensation Scheme is not available for inter-state supplies or for supply of services.

■ **GST Rate Structure:** There is a 5–rate structure for GST, with goods and services categorized into tax slabs of 0%, 5%, 12%, 18% and 28%. In addition, the rate for precious metals is fixed at 3%, while unworked diamonds and precious stones attract a rate of 0.25%. A cess over the peak rate of 28% is applicable on certain specified luxury and demerit goods (e.g. tobacco and tobacco products, pan masala, aerated waters, motor vehicles) for a period of five years to compensate States for any revenue loss on account of implementation of GST.

■ **Compliance:** Taxes payable are self-assessed by registered persons. The system of self-assessment is supplemented with audits of registered persons to verify compliance with the provisions of Act. Arrears of tax can be recovered using various modes including detaining and sale of goods, movable and immovable property of tax defaulters. Various provisions have been made to facilitate transition of existing taxpayers to the GST regime.

TOWARDS AN ASSESSMENT

The GST came into effect only on July 1, 2017, and its implementation is very much in a transitional state. So, it is too early to assess its performance. However, there were a number of issues with the prevailing system of indirect taxation prior to GST. In summary, the existing taxation regime was based on a strict demarcation of fiscal powers between the Centre and the States. The Centre had the power to levy taxes on the manufacture of goods (except for alcoholic liquor, opium and narcotics), while States had the power to levy taxes at the point of sale. In case of inter-State sales, the Centre had power to levy a tax (the Central Sales Tax) but the tax was collected

and retained entirely by the originating States. Only the Centre had the power to levy taxes on services, and service taxes on a limited scale began in 1994. The Centre too had exclusive powers for taxation of imports and exports, which took the form of Basic and Additional Customs duties, the latter levied in part to counterbalance existing (central and state) taxes on domestic production. Over time, taxes on goods and services by the Centre gradually though partially shifted towards a VAT - type system. Many States also introduced States VAT. But the State tax systems also evolved with a plethora of other taxes at varying rates reflecting the ever-shifting political economy of different state governments and their contested relationship with the central government over the sharing of tax revenues.

The existing indirect tax regime prior to the introduction of GST thus had a number of problems. Indeed, these have been known for quite some time, as also noted in the Kelkar Task Force Report of 2004. The following quote from that Report offers a good summary of the main issues:

> "The tax base is fragmented between the Centre and States. Services which make up half of GDP are not taxed appropriately. In many situations, the existing tax structure has cascading effects, where moving to a full VAT system has not yet taken place. These difficulties have led to substantial distortions, where the tax revenues from a few sectors are disproportionate, and the choice of production technologies and inputs in the country has become distorted. The existing flaws in tax policy have induced a malfunctioning tax administration. These problems have manifested themselves in terms of a poor buoyancy of excise collections, which has led to a low Tax/GDP ratio. More importantly, this has been a factor leading to slow growth of the manufacturing sector, and employment, in the country." (GOI, 2004).

In light of these problems with the prevailing indirect taxation regime, the introduction of GST is a step in the right direction. However, the expectations from GST have been high. The Finance Minister and the Prime Minister have been very upbeat about the GST, which was launched at a special midnight session of the Parliament on June 30, 2017, with the Finance Minister declaring that "At midnight, India will awake to limitless possibilities" (*Financial Express* Online, June 30, 2017). Similarly, the Central Board of Excise & Customs (CBEC), Ministry of Finance–a key implementing agency for GST–lists a large number of benefits expected from GST (see Box 1).

The list in Box 1 is indeed a large wish-list with some fairly unrealistic items, for instance, those relating to lower general level of prices, which seems as naïve as the fears of inflation due to GST. One can and should expect changes in relative prices of goods and services as a result of the GST. Prices of individual items may increase or decrease depending upon the effective tax rates they attract under the new regime relative to the subsumed taxes. But even if tax changes are fully passed on to the final consumers, this will induce one-off changes in the level of individual prices. There is no presumption that GST should have a persistent effect on inflation or the *rate of change* in the general price level.

More broadly, even as it is too early to judge the performance of GST relative to the system it has replaced, there are a few aspects with respect to which it is possible to offer some evaluative comments:

■ ***One Tax, One Market and efficiency of the tax system*:** Insofar as it has subsumed a range of existing Central and State indirect taxes and set up a common national tax base and framework for the taxation of goods and services by both levels of government, the GST has certainly moved the economy in the direction of establishing a more integrated national market. However, the "One Tax" part of the vision has remained elusive with the GST Council opting for a 5–rate structure for GST, not to mention the threshold exemption and the composition scheme (described above). The multiplicity of GST rates has come in for some criticism from several economists. Most countries operating a GST/VAT systems around the world follow the practice of using one standard rate and one or two reduced rates including the zero rate for tax-exempt items. For India too, the Task Force on Good & Services Tax (Thirteenth Finance Commission) did recommend a standard rate of 12%. (Finance Commission India, 2009). However, the GST Council has instead gone for a 5 tax-slab structure where it is difficult to define the notions of the standard GST rate and reduced rates.

Differential rates across the tax base have been driven by several considerations. First, there have been distributional or merit goods considerations, e.g. 28% tax on many luxury or "sin" goods and zero rate on basic food items. This is done with a view to impart a degree of progressivity into the indirect tax system or to encourage (or discourage) consumption of merit (demerit) goods or goods with positive (negative) externalities. However, multiple tax rates come at a price (as discussed below). Nor are such social considerations the only reason for multiple rates. Another important factor has been to protect revenues for both

Box 1: Expected Benefits of GST listed by CBEC, Ministry of Finance

Make in India:

(*i*) Will help to create a unified common national market for India, giving a boost to Foreign investment and "Make in India" campaign;

(*ii*) Will prevent cascading of taxes as Input Tax Credit will be available across goods and services at every stage of supply;

(*iii*) Harmonization of laws, procedures and rates of tax;

(*iv*) It will boost export and manufacturing activity, generate more employment and thus increase GDP with gainful employment leading to substantive economic growth;

(*v*) Ultimately it will help in poverty eradication by generating more employment and more financial resources;

(*vi*) More efficient neutralization of taxes especially for exports thereby making our products more competitive in the international market and give boost to Indian Exports;

(*vii*) Improve the overall investment climate in the country which will naturally benefit the development in the states;

(*viii*) Uniform SGST and IGST rates will reduce the incentive for evasion by eliminating rate arbitrage between neighboring States and that between intra and inter-State sales;

(*ix*) Average tax burden on companies is likely to come down which is expected to reduce prices and lower prices mean more consumption, which in turn means more production thereby helping in the growth of the industries. This will create India as a "Manufacturing hub".

Ease of Doing Business:

(*x*) Simpler tax regime with fewer exemptions;

(*xi*) Reduction in multiplicity of taxes that are at present governing our indirect tax system leading to simplification and uniformity;

(*xii*) Reduction in compliance costs - No multiple record keeping for a variety of taxes- so lesser investment of resources and manpower in maintaining records;

(*xiii*) Simplified and automated procedures for various processes such as registration, returns, refunds, tax payments, etc.;

(*xiv*) All interaction to be through the common GSTN portal – so less public interface between the taxpayer and the tax administration;

(*xv*) Will improve environment of compliance as all returns to be filed online, input credits to be verified online, encouraging more paper trail of transactions;

(*xvi*) Common procedures for registration of taxpayers, refund of taxes, uniform formats of tax return, common tax base, common system of classification of goods and services will lend greater certainty to taxation system;

(*xvii*) Timelines to be provided for important activities like obtaining registration, refunds, etc.;

Benefit to Consumers:

(*xviii*) Final price of goods is expected to be lower due to seamless flow of input tax credit between the manufacturer, retailer and supplier of services;

(*xix*) It is expected that a relatively large segment of small retailers will be either exempted from tax or will suffer very low tax rates under a compounding scheme- purchases from such entities will cost less for the consumers;

(*xx*) Average tax burden on companies is likely to come down which is expected to reduce prices and lower prices mean more consumption.

Source: Central Board of Excise and Customs, Department of Revenue, Ministry of Finance (GOI, 2018a).

the Central and State governments. Thus, for instance, the vast majority of items are in the 18–28% brackets. Similarly, the reason why petroleum and alcohol products have stayed outside the ambit of GST is because they are important sources of revenue for the Central and State government respectively. Finally, why certain items end up in a particular tax slab rather than another reflects a lot of political jostling within the GST Council reflecting often divergent political interests across States and between the Centre and the States.

However, a multiplicity of rates can create economic distortions, increase complexity of the tax

system, raise administrative and compliance costs, and induce tax cascading effects.[2] Multiple rates may induce further tax litigation by businesses around the applicable tax slabs for the particular products and services they supply or receive as inputs. It is also arguable that multiple rates may not be the best means of achieving distributional objectives which may be better served by measures directly benefitting the poorer sections of the population.

■ ***Expansion of the tax base*:** An "ideal" GST has comprehensive coverage of almost all goods and services with a minimal list of exemptions. The GST provisions so far allow for (*a*) a significant list of exempt (zero-rated) items, and (*b*) a threshold exemption for businesses with an annual turnover of up to ₹20 lakhs. By some estimates, the exempt items account for 30–40% of the CPI basket, and nearly three-quarters of all non-farm enterprises are outside the GST net (GOI, 2018b).

Recently, the CBEC and the Economic Survey presented some data based on GST registrations and returns since its inception in July 2017 indicating a substantial increase in the number of indirect taxpayers. As shown in Table 1, as of January 1, 2008, there were 9.9 million GST registrants, of which 6.4 million were old taxpayers migrating from the erstwhile Central (Excise and Service Tax) and States (VAT) tax systems, while there were 3.5 million new GST registrants, leading the Economic Survey 2017–18 to conclude that "the GST has increased the number of unique indirect taxpayers by more than 50 percent" (GOI, 2018*b*). However, it would be incorrect to construe this as evidence for an expansion of the tax base which ought to be measured not by the number of GST registrants or taxpayers but by the total value added that is subject to taxation.

Table 1: Number of GST registrants as of Jan 1, 2018 (million)

Total	**9.9**	
New	3.5	
Old (Migrated)	6.4	
Excise (Centre)		0.01
Services (Centre)		0.6
VAT (States)		5.8
Composition	1.7	
Regular	8.2	

Source: GOI (2018b). Economic Survey 2017–18, Ministry of Finance.

Other data also presented in the Economic Survey 2017–18 show a highly skewed distribution of turnover and tax liability across firms (Table 2). Thus, 32% of GST returns are filed by firms below the exemption threshold (₹20 lakhs) and another 36% by firms with turnover below ₹1 crore (eligible for the composition scheme). Taken together, these firms represent 68% of total returns filed. However, they account for only 3.8% of total turnover and 5.3% of total tax liability. Since such smaller firms are likely to be over-represented amongst new GST registrants, the 50% increase in the number of tax registrants may not amount to much by way of an expansion of the GST tax base or tax liability.[3] Thus, it remains to be seen how much of an expansion of the real tax base will result from the GST regime.

Table 2: Distribution of GST returns, turnover and tax liability by firm size (July-Dec 2017)

Firm size (annual turnover)	*% share in*		
	Filed returns	*Turnover*	*Tax Liability*
Below threshold (<₹20 lakhs)	32.2	0.4	0.9
Composition group (₹20–100 lakhs)	36.0	2.4	4.4
Small and micro enterprises (₹1–5 crores)	22.0	6.8	10.5
Medium enterprises (₹5–100 crores)	9.2	24.1	29.8
Large firms (> ₹100 crores)	0.6	66.2	54.4
Total	**100**	**100**	**100**

Source: GOI (2018b). Economic Survey 2017–18, Ministry of Finance.

■ ***Better tax compliance*:** It is expected that the GST regime will promote better tax compliance through a presumed reduction in compliance costs due to a simpler unified GST system replacing a number of central and

[2] Cascading effect refers to a situation where the tax on the selling price of an item already includes taxes on earlier stages of production or distribution in the supply chain, thus effectively imposing a tax on taxes incurred earlier

[3] The Economic Survey 2017–18 also reports direct estimates of the GST tax base of ₹65–70 lakh crores for 2017–18, but it is difficult to compare this with tax base of the earlier indirect tax system.

state taxes and better incentives for compliance. The Prime Minister described the GST as a "good and simple tax". However, the system is not as simple as it may appear to be. A regular GST taxpayer is required to file 37 returns over the year (three per month for outward, inward supplies and consolidated return, plus an annual return), while a composition GST taxpayer is required to file returns on a quarterly basis. Invoice information needs to be uploaded to the system, and there are penalties for late submission of returns. The presumption is for an electronic filing of returns, though manual paper filing has also been allowed. Compliance burden can thus be heavy, especially for smaller firms, and it is accentuated further by a continuing flurry of changes to GST design. The multiplicity of tax rates, exemptions and parallel options of composition and regular GST can also be impediments to compliance as they increase the complexity of the system and open the door for tax litigation as well as evasion.

It is well-known that large scale under-reporting of sales was rampant under the earlier tax regime. The provision for availing input tax credit under the GST is intended to be an antidote to this practice. This may be helpful in case of B2B (business-to-business) supplies, but it is unclear how far it will incentivize better reporting of B2C (business-to-consumer) supplies. Thus, while it is early days, it remains to be seen how successful the new GST regime will be improving overall tax compliance.

■ ***Higher tax revenues*****:** An overall expectation from the introduction of GST is that it will yield higher government revenues from indirect taxation. Indeed, even the Kelkar Report of 2004 saw it as an instrument for revenue-led fiscal consolidation that will help raise the tax/GDP ratio. Revenue implications of GST are ultimately a function of three factors: (*i*) the size of the tax base, (*ii*) the GST rate structure, and (*iii*) degree of tax compliance. In relation to the tax base and compliance, as discussed above, it is yet unclear how much of an improved performance will result from the GST regime. As for the rate structure, the Economic Survey 2017-18 reported that the average weighted tax collection rate over the first few months of the implementation of GST was 15.6%, which was very similar to the revenue-neutral rate of 15-16 percent estimated in the Report on Revenue Neutral Rate and the Structure of Rates for the Goods and Services Tax submitted to the Government of India in December 2015. Whether we will go past the revenue neutral rate of collection is thus also something that remains to be seen.

In sum, therefore, given the inefficiencies and problems associated with the prevailing system of indirect taxation, most observers agree that the move to GST is a step in the right direction. That said, the inflated expectations from GST are not only premature but may also be unrealistic, as the GST is unlikely to be the magic bullet to the country's economic woes that the hype around this move has made it out to be.

While it is still early days, there remain many challenges for effective implementation and several glitches to be fixed. For instance, a recent report documented how an accumulation of unpaid tax refunds has caused a serious liquidity crunch for exporters, threatening the survival of many in the tea and textile sectors (*Financial Times*, January 15, 2018). High compliance costs associated with the system of filing returns remain an important concern especially for small operators. And frequent revisions to the rules and provisions–for instance, those relating to the reclassification of items across tax slabs, threshold exemption limits and the filing of returns–by the GST Council and the Ministry of Finance have not helped. Despite a very long lead time, the eventual launch of the GST seems to have come with inadequate preparation which is difficult to simply pass off as 'teething' problems.

There are also significant challenges for the institutional mechanism of the GST Council as the grand Centre-States bargain. The Council is likely to emerge as a significant battle ground for fiscal federalism in India. While at one level, the many changes of policy details by the Council could be seen as just an expression of democratic practice in a federal system, the institution may also be hostage to all sorts of political lobbying by vested interests. How well it can ward off these dangers also remains to be seen.

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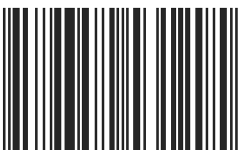

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