Fiscal Prospects and Reforms in India

Richard Herd,

Sam Hill,

Vincent Koen

OECD

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By Richard Herd, Sam Hill and Vincent Koen

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ABSTRACT/RESUMÉ

Fiscal Prospects and Reforms in India

Substantial fiscal consolidation was achieved under the aegis of the 2003 Fiscal Responsibility and Budget Management Act. While deficits widened anew in 2008 and 2009, against the backdrop of the global financial and economic crisis, efforts to reduce them have resumed since. To ensure continued progress, as well as stronger government finances in the longer term, the medium-term fiscal framework needs to be improved, notably by embedding the annual budget in a detailed three-year rolling programme. Expenditure needs to be controlled better, in particular as regards subsidies, which the central government has indeed been trying to rein in, though with difficulty in the face of rising world oil prices. Expenditure also needs to become more effective, in particular in the areas of health care, education and social assistance. On the revenue side, tax reforms have been tabled, both for direct taxes and for the complex and inefficient system of indirect taxes. Corporate income tax rates are being cut, though the headline rate remains high. Lower taxation for large special economic zones deserves to be maintained for some time. For the personal income tax, which only a fairly small proportion of the population pays, thresholds are set to be raised considerably. A goods and services tax is to be introduced, which should help reduce the segmentation of the national market for goods and services. Customs duties have been reduced on average but remain high for some categories of imports, implying scope for further reduction over time.

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Keywords: debt, expenditure, fiscal institutions, fiscal policy, government budgets, India, poverty, saving, subsidies, tariffs, taxation, transfers.

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Perspectives et réformes budgétaires en Inde

La loi de 2003 sur la responsabilité et la gestion budgétaires a permis d'avancer sur la voie de l'assainissement des finances publiques. Certes, le déficit s'est de nouveau aggravé en 2008-2009, du fait de la crise financière et économique mondiale, mais de nouvelles mesures ont été prises ensuite pour le réduire. Afin d'assurer la poursuite des progrès en ce domaine et de consolider la situation à plus longue échéance, il faut améliorer le cadre budgétaire à moyen terme, notamment en intégrant la loi de finances annuelle à un programme glissant, détaillé, étalé sur trois exercices. Il faut aussi mieux maîtriser les dépenses, en particulier les subventions, que l'administration centrale a d'ailleurs tenté de freiner, quoique non sans difficultés face à la montée des cours mondiaux du pétrole. Enfin, il est nécessaire de renforcer l'efficience des dépenses, surtout dans les domaines de la santé, de l'éducation et de l'aide sociale. En matière de recettes, des réformes ont été présentées ; elles portent à la fois sur la fiscalité directe et sur le système, complexe et inefficient, des impôts indirects. Les autorités sont en train d'alléger l'impôt sur les sociétés, bien que son taux nominal demeure élevé. Il convient de conserver pendant un certain temps les allégements en faveur des grandes zones économiques spéciales. S'agissant de l'impôt sur le revenu des personnes physiques, qui n'est acquitté que par une faible proportion de la population, les seuils d'imposition devraient être sensiblement relevés. Une taxe sur les biens et les services doit être mise en place, ce qui devrait réduire la segmentation du marché national. Les droits de douane ont été abaissés en moyenne, mais restent élevés pour certaines catégories d'importations, ce qui laisse des marges de réduction à l'avenir.

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Mots-clés : budgets des gouvernements, dépenses, dette, épargne, Inde, institutions budgétaires, pauvreté, politique budgétaire, subventions, tarifs, taxation, transferts.

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FISCAL PROSPECTS AND REFORMS IN INDIA

Richard Herd, Sam Hill and Vincent Koen[1]

The past decade in India has seen a major change in the emphasis given to the medium-term control of public finances. However, progress has not been uniform and recently there has been some deviation from medium-term targets as the world business cycle impacted India but also because of pressures to achieve some key governmental objectives. This paper discusses how the government's medium-term deficit and debt reduction objectives could be better integrated with the annual budget process, and the choice of an appropriate deficit target. The composition of government spending is also addressed, as across-the-board subsidies form a sizeable share of government outlays. Finally, the paper looks at two areas of taxation where the government has proposed major reforms, namely direct taxation of individuals and companies, and indirect taxation of domestic goods and services.

Fiscal consolidation: a partial success

Legislation helped bring about consolidation

In response to high and rising public debt, the Fiscal Responsibility and Budget Management Act (FRBMA) was enacted in 2003. The Act specifies a mechanism for setting targets for various concepts of the budget deficit and requires the government to submit a series of documents to parliament spelling out its fiscal strategy, as well as a quarterly report reviewing progress in meeting the annual target. The Act specifies that targets should be set for two key concepts in the budgetary process of the central government: the so-called revenue account and the gross fiscal deficit (Box 1). The only specific target in the Act was that the revenue deficit should be eliminated by March 2008 and that an adequate revenue surplus should be built up thereafter. The Act itself did not specify the time path for deficit reduction, which was to be set out in regulations issued by the government. Once the rules were issued, though, the government was allowed to over-run the previously specified targets on exceptional grounds that it must specify. In July 2004, the Act was amended so that the targets were to run from April 2004 to March 2009 (*i.e.* the fiscal years 2004 to 2008; hereafter data for a given year refers to the fiscal year starting in April). At the same time, the government issued the regulation specifying the annual path for the reduction of the deficit. The revenue account of the government was to be balanced by March 2009 through an annual deficit reduction of a minimum of ½ per cent of GDP and the gross fiscal deficit was to be reduced to 3% of GDP by March 2008. The incremental central government guarantees were capped and a ceiling was put on annual debt accumulation. In the first budget following the issuance of the regulations called for by the amended act, the government postponed deficit reduction by one year. It did so again in 2008.

Significant progress was achieved during the first four years of the FRBMA: the revenue deficit was reduced by 0.6% of GDP per year on average to 1.1% of GDP by 2007. As capital outlays and government financing increased somewhat faster than GDP, the headline fiscal deficit came down a bit less but it nonetheless dropped to 2.6% of GDP – close to the original target of the Act.

Box 1. Measuring the fiscal deficit in India

The central and sub-national governments in India use two budget deficit measures: the revenue balance and the gross fiscal balance (Table 1). The first one attempts to measure the difference between current revenue and expenditure. The second one contains all capital transfers to state governments and public-sector entities used to finance the acquisition of physical assets. It also contains net government acquisitions of financial assets. However, the accounting rules have changed several times. In some years, asset sales were counted as income, in other years they were not. In the past, financial transactions generally added to the deficit as the central government has lent money to the states. In recent years, however, lending to the states has barely exceeded repayments, while the government has been selling shares in public-sector companies. Sale of financial assets helped reduce the gross fiscal deficit in 2010.

There are two further complications in using the fiscal data: *first*, the centre and states use different accounting conventions for the repayment of loans between the centre and the states, so that the fiscal deficits of the centre and the states cannot be added to obtain the general government deficit; second the central government has funded subsidies off-budget, notably in the energy sector (Conway and Herd, 2011).

The government's financial asset transactions do not have a direct impact on private consumption or capital formation. This impact is best measured by the balance of non-financial transactions (known as net lending) which reflects the extent to which the government is adding or subtracting demand to the economy. This indicator provides an internationally comparable measure of the government budget deficit. It is not available, however, from the government at the time of the budget, but only close to one year later, when the budget year is almost completed. Similar data for the states are not available until the publication of the national accounts two years after the fiscal year. These delays make the use of this indicator problematic for India. Moreover, no reconciliation table is available to show exactly how to go from the gross fiscal deficit to net lending.

Table 1. Various measures of government fiscal balances

	2007	2008	2009	2010	2011 Budget estimates
	Year starting April 1st				
	% of market-price GDP				
Central government fiscal balances					
Revenue balance	-1.1	-4.5	-5.2	-3.1	-3.4
Fiscal balance (ex financial transactions)	-3.2	-5.9	-6.6	-4.7	-4.9
Financial transactions	0.7	-0.1	0.3	-0.1	0.3
Gross fiscal balance	-2.6	-6.0	-6.4	-4.8	-4.6
Fiscal balance corrected for subsidy bonds	-3.4	-6.5	-7.9	-4.9	-4.6
State governments fiscal balance					
Revenue balance	0.9	0.2	-0.7	-0.3	0.0
Fiscal balance (ex financial transactions)	-1.5	-2.6	-3.1	-2.6	-2.4
Financial transactions	-0.1	-0.1	-0.1	-0.1	-0.1
Gross fiscal balance	-1.5	-2.4	-3.3	-2.5	-2.3
Central and states fiscal balance					
Gross fiscal balance	-4.1	-8.5	-9.5	-6.9	-6.8
Off-budget transactions	-0.8	-0.5	-1.5	-0.1	0.0
Corrected fiscal balance	-4.9	-9.0	-11.1	-7.0	-6.7

1.   From 2008 onwards State government data refer to 28 states only. For 2010, State data are budget estimates, while 2011 data are OECD projections.

Source: Controller General of Accounts, RBI Bulletin, RBI Handbook of Economic Statistics, Ministry of Finance (2010b), Ministry of Finance (2011), Budget documents.

However, this was only achieved by reviving the practice of paying subsidies to companies in the form of special bonds. Under government accounting rules, as payments were not made in cash, the value of these bonds would not count towards government expenditure and so would not raise the budget deficit. The companies that received these bonds were free to sell them on the open market. Their issuance did,

however, raise the stock of outstanding government bonds. In 2007, such bonds with a face value of 0.8% of GDP were issued, implying an actual central government gross fiscal deficit of 3.4% of GDP.

In the years following the introduction of the FRBMA most state governments introduced fiscal responsibility laws that limited their deficits to 3% of gross state product (GSP). By 2007, the average gross fiscal deficit across states had been reduced to 1.7% of GSP, down from 2.9% in 2002, although this also reflected a marked increase in transfers from the central government.[2] As a result, the overall deficit of both levels of government fell to under 5% of GDP by 2007, even after the adjustment for the issuance of bonds. This was within the combined target for the deficit of the central and state governments.

The reduction in the deficit between 2002 and 2007 was mainly achieved thanks to the expansion of the corporate sector, which boosted corporate tax receipts, and to the new tax on services (see below), which also increased the tax base. In addition, personal income tax receipts spiked towards the end of the period due to the strength of the economy while government consumption declined, reflecting temporary public sector wage restraint.

Deficits soared with the crisis and the electoral cycle

The period of fiscal restraint ended in 2008. For domestic reasons and as world growth pushed up energy and commodity prices, the government raised public expenditure markedly (Table 2). The increase in spending was concentrated in four areas. *First*, the government was firmly committed to implementing a number of flagship programmes in the last year of its mandate, notably the National Rural Employment Guarantee (Box 2). *Second*, a significant programme of debt relief for small farmers was introduced. *Third*, in early 2008, the oil price surged and the government decided to restrict their pass-through into domestic prices by raising subsidies (Conway and Herd, 2011). *Fourth*, the Pay Commission, which reviews civil service pay once every ten years, recommended close to 40% pay rises with large amounts of back pay. These factors raised government outlays by 2¼ per cent of GDP in 2008 and a further ½ per cent in 2009.

Table 2. A breakdown of the factors raising the central government deficit

	2008	2009	2010
	Change in spending/taxation since 2007 % of GDP		
Underlying spending increases			
Rural employment	0.4	0.4	0.4
Debt relief	0.4	0.4	0.3
Government consumption	0.4	1.0	0.2
Subsidies	0.9	0.5	0.1
Transfers to nationalised banks	0.0	0.2	0.1
Interest	0.1	0.3	0.0
Total	2.2	2.8	1.1
Crisis-related tax reductions			
Excise taxes and countervailing duties	0.7	1.2	1.0
Service tax	0.0	0.2	0.2
Automatic stabilisers	0.1	0.1	0.2
Total	0.9	1.5	1.4
Receipts from wireless spectrum	0.0	0.0	1.2
Total identified increase in deficit	3.1	4.3	1.3
Actual change in gross fiscal deficit	3.5	3.9	1.8

Source: Budget documents and OECD analysis.

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2.   See the previous OECD (2007) for a detailed discussion of fiscal federalism arrangements.

When the world economy slowed markedly in late 2008, the government responded with a range of measures. The most costly of these was a two-stage cut in indirect taxes. First, in December, the indirect tax rate on manufacturing output was reduced from 16% to 12%. Then, in the 2009 Budget, it was cut by a further two percentage points and the service tax was also cut by two percentage points, bringing both to 10%. On a full-year basis, these two cuts lowered the tax take by around 1½ per cent of GDP, even as the automatic stabilisers worked in the same direction. A large number of other steps were taken, mostly involving increases in lending by development banks and in interest rate subsidies for selected industries. In 2009, the combined impact of the crisis-related measures and the pre-crisis spending increases was to push up the central government deficit to almost 8% of GDP, after re-integrating off-budget expenditure on subsidies.

Box 2. The National Rural Employment Guarantee Scheme

The National Rural Employment Guarantee Scheme (NREGS) aims to provide a welfare safety net for rural inhabitants and to promote local development by funding small-scale farm and infrastructure projects. It was rolled out in a few states in 2006 and subsequently expanded nationally. The scheme provides 100 days or more of employment at a wage determined by the central government to any member of a rural household who wishes to participate. This enables people to move in and out of the scheme as their circumstances change, thereby offering some protection against idiosyncratic shocks. Workers are issued a job card and request work with *Gram Panchayats* (local governments), which are responsible for devising and overseeing projects. Employment is to be allocated within 15 days of a request. Work is focused on unskilled manual tasks. Most of the associated projects focus on local infrastructure such as improving roads and irrigation, preventing flooding and addressing soil erosion.

Government funding, predominantly from the Centre, covers wage and material costs. In line with the focus on assisting the poor, wage costs are required to account for at least 60% of total project outlays. Total outlays in 2009-10 amounted to around 0.6% of GDP, of which over two thirds for wages. According to government sources, in 2009-10 over 52 million households participated in the scheme, up from around 45 million in the previous year. The total number of person work days exceeded 2.8 billion, with women accounting for just under half of this total and participation amongst officially designated disadvantaged minority groups also high. An independent evaluation of the NREGS indicates that some official figures may have suffered from over-reporting (NCAER, 2009). Notably, in some districts the number of households issued with job cards was found to exceed the number of households. However, the strong participation of women and minority groups was verified, and the average wage paid to participants was close to the statutory rate.

A potential strength of workfare schemes such as the NREGS is that the requirement to work at a low wage may encourage the self-selection of the neediest and discourage those who have a higher reservation wage. Also, to the extent that projects focus on public works that provide better infrastructure, they can generate wider gains through second-round employment effects and higher earnings. How well the scheme is targeted depends heavily on the wage offered relative to the alternatives. If the wage is too high the non-poor may be drawn away from the labour market. Experience with a state-based workfare scheme operating in Maharashtra since the 1970s confirms a strong tendency for people to opt into the scheme when the wage offered is high relative to the market alternative (Scandizzo *et al.*, 2009). The wage offered under the NREGS is based on the statutory minimum wage, which varies across states. In 2009 the average national wage paid under the scheme exceeded the average market wage for many types of agricultural and non-agricultural unskilled jobs (Figure 1). Generalised wage increases resulting from this premium could lead some workers to be priced out of the market, lowering output and ultimately reducing employment opportunities. In 2011, the government announced that it would index the wage paid under the scheme to the CPI for agricultural workers. Nationally, this implies an increase in the NREGS wage by around 22%, raising it above the statutory minimum wage offered in a number of states. Recent empirical evidence on the characteristics of NREGS participants indicates mixed success in targeting the neediest (Jha *et al.*, 2009 and Jha *et al.*, 2010a). Participation has been higher amongst illiterates but also those with larger agricultural land holdings. There are also indications that higher NREGS wages relative to the local market wage encourage participation, suggesting that those who could access alternative employment are being drawn into the scheme.

Figure 1. Market and NREGS wage rates[1]
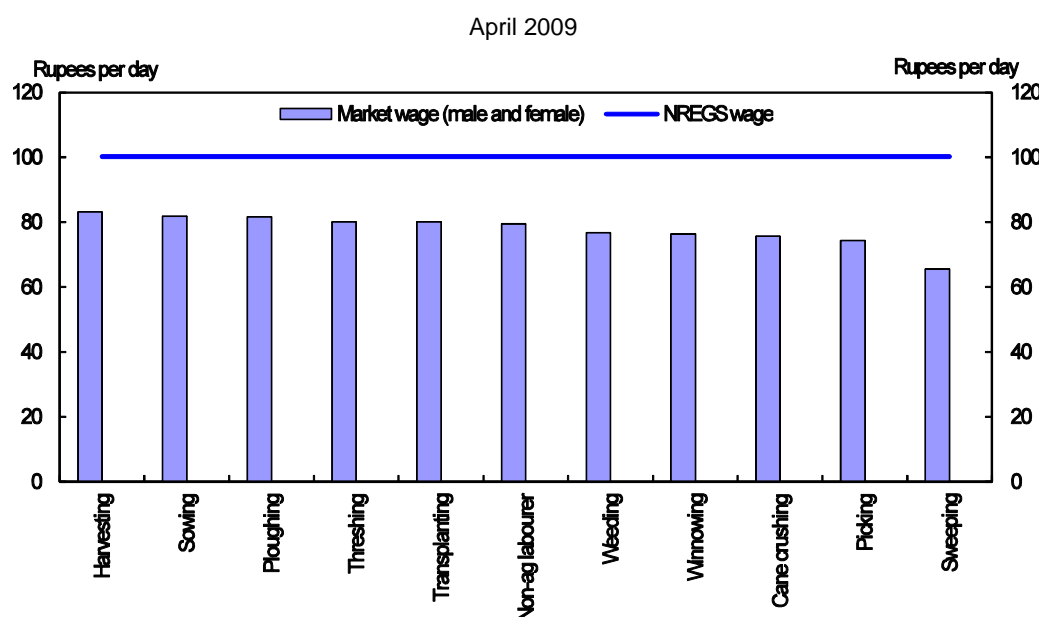
April 2009

1. The NREGS wage is calculated as the weighted national average of wages offered in different states on 1 April 2009. The market wage is the simple average of the reported average wage of men and women in April 2009.

Source: Ministry of Labour and Employment (2010), Ministry of Rural Development and OECD calculations.

One downside to workfare schemes such as the NREGS is that by occupying the time of workers they may give rise to significant opportunity costs, potentially resulting in relatively low net transfers compared with schemes that provide cash or in-kind transfers. In a study using household data in Andhra Pradesh, Maharashtra and Rajasthan, Jha *et al.* (2010b) estimate that the net transfer to households from the NREGS varies widely, reflecting different opportunity costs to participants. On average, in these three states the net transfer was relatively low, between 6 and 16% of household income.

Given the size of outlays associated with the NREGS, it is important that the government take steps to ensure its cost effectiveness as a mechanism for helping the neediest. The prospect of further wage increases raises risk that the scheme will attract workers with viable alternatives. The government may therefore need to consider introducing eligibility criteria, such as limiting access to those with below the poverty line status. Ultimately, the success of the scheme also depends heavily on the social value of the public works being funded, highlighting the importance of ongoing audits required by the government.

Source: Jha *et al.* (2009), Jha *et al.* (2010a), Jha *et al.* (2010b), Ministry of Labour and Employment (2010), Ministry of Rural Development, NCAER (2009) and Scandizzo *et al.* (2009).

Public spending also picked up at state level in 2009 and 2010. However, given that states have less access to capital markets than the Centre, the rise in spending was more modest and the aggregate state gross fiscal deficit rose by only 1½ per cent of GDP to just over 3% of GDP, broadly staying within the limits imposed by their fiscal responsibility laws. With state government deficits also rising, the combined central and state government deficit reached 11% of GDP in 2009, reversing all of the deficit reduction seen under the aegis of the FRBMA.

A new start in deficit reduction

In the 2010 Budget, the government announced its intention to resume fiscal consolidation and to reduce the central government gross fiscal deficit by over 2½ per cent of GDP by 2014. It also announced

its intention to end the use of off-budget financing to pay for subsidies, so that the projected fall in the underlying fiscal deficit was even greater, at 4% of GDP, unwinding most of the increase seen in 2008 and 2009. For 2010 the government planned to reduce expenditure by 1¾ per cent of GDP, based on the absence of payment of salary arrears to civil servants and a stringent policy with regard to subsidies. Tax revenue was expected to remain broadly stable relative to GDP but supplemented by a one-off sale of wireless spectrum. Together, these factors were expected to reduce the gross fiscal deficit (corrected for off-budget transactions) by 3% of GDP.

In the event, the government exceeded its initial consolidation target for 2010, with the deficit falling to 4.8% of GDP, down from 6.4% in the previous year. This was largely due to nominal GDP growth outcomes exceeding budget estimates as well as higher-than-expected proceeds from the telecommunications auction. The reduction in the deficit would have been larger if it were not for an 8% overshooting in current spending, which in part reflected unplanned outlays that were made following the successful completion of the telecommunications auction.

For 2011, the government is planning a further reduction in the deficit to 4.6% of GDP. It has also set rolling targets of 4.1% and 3.5% of GDP in 2012 and 2013 respectively. In the near term, the government expects tax revenue to rise a little faster than GDP. The central excise duty rate was kept at 10%, thereby not fully rolling back the reduction made in response to the slowdown. However, with a view to mooted reforms of the indirect tax system (see below), the number of items exempted from this tax was reduced. Current spending growth is expected to slow markedly, to just 4%, *i.e.* below foreseeable inflation, following a rise of over 15% in 2010. Whether the targeted deficit reduction can be achieved, therefore, depends heavily on the government's ability to adhere to its spending plans. One specific risk concerns a possible blow-out in spending on food and oil subsidies, which the government is considering expanding markedly. Another concerns spending on the NREGS: despite its announcement that it would index wages offered under the scheme to inflation, the budget allocation has not increased from 2010.

The evolution of debt

While deficits widened sharply from 2007 onwards, the central and the combined state debt-to-GDP ratios rose far less than in most OECD countries (Figure 2 and Box 3). Although the addition of new debt generated by the deficits has been large, the stock of debt has not risen as fast as nominal GDP. As a result, the overall debt ratio of the central government did not increase during this period of very large fiscal deficits. A similar, but somewhat less powerful process (given the lower initial level of debt) has occurred at the state level. Overall, most of the run-up in central government debt in the years prior to the introduction of the FRBMA has been reversed. The process has not advanced as much for states, however, where the increase in debt from 1999 onwards appears to have been linked to the new automatic source of finance, the National Small Savings Fund, which was offered to them in 1999 (Box 3).

Figure 2. Evolution of government debt
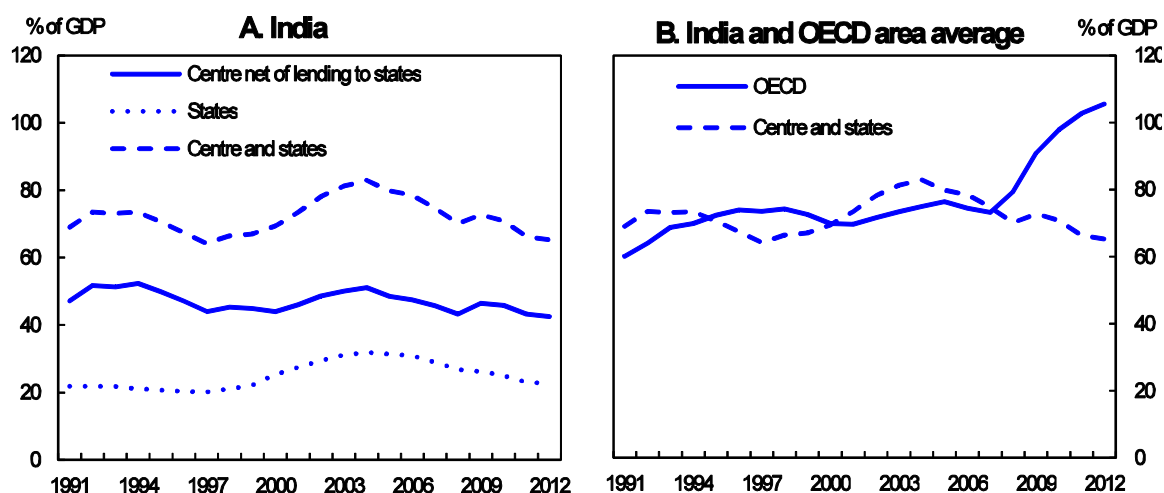
Source: Same as Box 1.

Box 3. Accounting for government debt

The central government borrows money through two routes. The first is through the Consolidated Fund: the total borrowing through this route is known as the public debt in India (line 1). However, the government also has the right to issue liabilities through the Public Account (line 2). Such liabilities are backed by the full faith of the government and only differ from the debt issued through the Consolidated Fund in that they can be issued without the authority of the parliament. The total liabilities of the government are the sum of the two sets of debt (line 3).

The Public Account has historically existed as a form of financial intermediary. It sells liabilities to various government financial intermediaries such as the National Small Savings Fund (NSSF), similar to a Postal Savings Bank, and State Provident Funds that are obliged to invest in government securities. Since 1999, however, Small Savings deposits have been lent to the state government where the deposits were made. From 1999 to 2007, the states were obliged to take 100% of the deposits. Since 2007 they are obliged to borrow only 80% of net new deposits, but can borrow up to 100% of the flow. Only the profit or loss of the NSSF enters the Consolidated Fund and so the borrowing of the NSSF that is re-lent to the state governments should not be counted as part of central government debt (line 4).

From 2004 onwards, in agreement with the Reserve Bank of India (RBI), the government has issued bonds, the proceeds of which were deposited with the RBI in order to sterilise foreign exchange interventions. This debt has an offset in assets held at the RBI and so can also be deducted from the gross liabilities of the central government (line 5).

On the other hand, the data for public debt (line 1) includes the external debt at its historic local currency value, rather than at its current local currency value. An adjustment thus needs to be made to the public debt for the rupee's depreciation since the debt was contracted (line 6). Once the above adjustments are made, the revised total represents the total liabilities of the central government as reported in the annual Budget.

The change in these liabilities (abstracting from the exchange rate valuation effects) should equal the gross fiscal deficit which could also be called the government's borrowing requirement. However, during the period of the FRBMA the ability of the Public Account to issue liabilities without parliamentary approval was used to pay subsidies to petroleum, fertiliser and food companies, following the approach taken in the 1990s to recapitalise public sector banks. Thus the gross fiscal deficit needs to be adjusted to take into account the issuance of these liabilities (the stock of which amounted to 5.8% of GDP in 2009).

The total debt of the central and state government cannot be calculated by adding the debt of the states to the debt of the central government, as states have borrowed from the central government. The extent of this borrowing has to be deducted from the central government debt prior to the addition of the states' debt in order to avoid double-counting of outstanding debt,

A fair picture of the government balance sheet also requires an accurate measurement of government financial assets, apart from loans to state governments. In some cases, these assets represent majority holdings in public-sector

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enterprises that are quoted, in other cases the assets are not quoted. The government balance sheet shows these assets as having a value of just under 4½ per cent of GDP (excluding the investment in railways). The yield on these assets appears to be around 11%. Consequently, given that over half of these investments are equities their market valuation would likely be far superior to the historic cost valuation given in the government's balance sheet.

Table 3. Central and State government debt

	2008	2009	2010	2011 (estimate)	2012 (budget)
	March 31st each year				
	% of market-price GDP				
Public debt (1)	38.5	38.5	37.9	36.3	36.5
Public Account liabilities (2)	18.4	18.0	15.8	13.6	11.9
Total central government liabilities (3)	56.9	56.6	53.7	49.9	48.5
Adjustments to total central government liabilities					
National Small Savings Fund lending to states (4)	-9.6	-8.4	-7.4	-6.1	-5.4
Borrowing under the Market Stabilisation Scheme (5)	-3.4	-1.6	0.0	0.0	-0.2
Adjustment of external debt to market exchange rates (6)	2.0	2.5	1.8	1.6	1.2
Central government liabilities used for financing the deficit	46.2	49.1	48.1	45.3	44.2
Loans and advances to states	2.9	2.6	2.3	1.9	1.7
Central government liabilities net of lending to states	42.9	46.5	45.8	43.3	42.5
State government debt	26.8	26.2	25.0	23.0	22.7
Consolidated central and state debt	79.1	72.7	70.8	66.3	65.2

Source: Ministry of Finance (2010a, 2010b), Reserve Bank of India (2010) and Budget documents.

The finances of the government would be considerably clearer if the NSSF were made into a public corporation and its asset portfolio managed by an agency such as the National Debt Management Agency. The current interest subsidies given to the NSSF should be ended. Similarly the pension contributions paid to the new civil servant pension fund should be held by an entity outside the government accounts. Finally, government assets should be valued at depreciated replacement cost for physical assets and market value for financial assets.

The practice of issuing securities through the Public Account Fund in lieu of subsidies should be ended and the debt transferred to the Consolidated Fund.

Spending and deficits in the medium term: can expenditure be made more effective?

The needs for public expenditure in India are vast and so any policy of holding back expenditure has to be implemented very carefully. Government outlays in some key areas are relatively low. In particular, health care outlays are extremely low, even if a start has been made on improving facilities in rural areas. Education outlays are much higher, but their effectiveness could be improved substantially (Hill and Chalaux, 2011). In both areas, there are pressures for increased expenditure.

In recent years government spending on health care in India has risen strongly, though it remains low by international standards, at around 1.1% of GDP in 2009. Under the Indian Constitution the provision of health care is the responsibility of state governments but funding is also provided by the Centre. Although state governments continue to account for the majority of funding, which covers recurrent expenditures including salaries, the Centre has contributed more to the recent increase and now accounts for over a third of total spending, much of it focused on special centrally-sponsored schemes. The central and local governments are aiming to significantly increase health care spending in the coming years, to 2-3% of GDP. However, given the fiscal pressures faced by some poorer states in particular, meeting this target will pose a considerable challenge and it is likely that much of the anticipated extra spending will have to come

from the Centre. One of the main mechanisms to raise spending is the National Rural Health Mission (NRHM) launched in 2005. This initiative has several goals including the expansion of health care infrastructure, with a focus on the poorer states.

Capacity constraints are evident in many parts of the health care sector, limiting the ability of governments to expand access rapidly. Manpower shortages are particularly acute. In 2008 the number of specialist doctors working in primary health centres was only one-third of the authorised level, due to recruitment problems.[3] Severe shortages also exist for less specialised health professionals, notably male health workers at secondary centres. A shortage of managerial and policy expertise within the bureaucracy is also a problem in some states. These constraints have led to considerable under-spending on some important programmes in recent years. For example, only 28% of approved outlays for the National Cancer Control Programme, which aims at early diagnosis and treatment, was spent in 2008. A similar level of under-spending held back expansion of facilities to treat mental health illnesses under the National Mental Health Programme. Under-spending appears to be particularly acute in the case of state governments, where spending on the NRHM was only 65% of budgeted allocations in 2008. Given the outlook for increased spending it is important that governments focus on addressing supply bottlenecks, including by expanding both the number of students and medical lecturers in teaching hospitals and tertiary education institutions.

Other public outlays are concentrated in a few areas (Figure 3): other classic public services (administration, justice, police and defence) represent 26% of total outlays, while interest payments account for 13% of total outlays. Finally, transfers to selected business sectors and subsidies represent 24%, notably in the area of food (Box 4).

Figure 3. Government spending on selected functional areas

In 2008
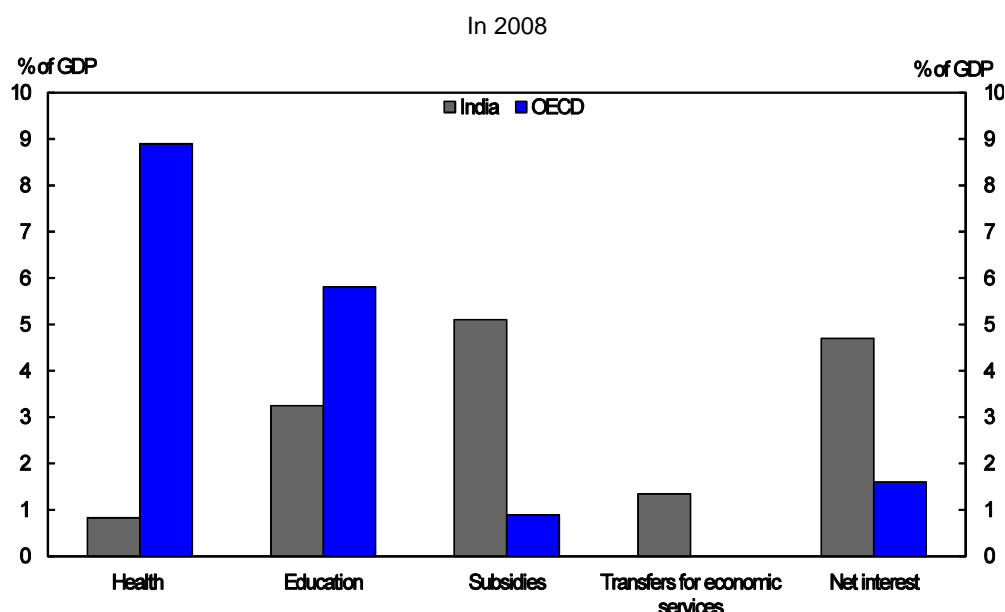
Source: Central Statistical Office: National Accounts Statistics.

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3.   Currently public health care in rural areas is provided on a three-tier basis with shortages in the number of facilities at all levels. At the local village level are secondary centres, normally staffed by two general health care workers. Primary health centres feature a small number of beds and offer basic inpatient treatment while community health centres and rural hospitals are larger and offer a wider array of specialist services.

Box 4. The Public Distribution System

Since independence, the wartime food subsidy and ration programmes have become a cornerstone of the Indian welfare system. Although rapid economic growth has enabled steady progress in reducing poverty, malnutrition is widespread and ensuring food access for the poor remains a priority for Indian governments (Herd *et al.*, 2011). Total expenditures on food subsidies are significant, amounting to $12.4 billion or around 1% of GDP in 2009. The largest food subsidy programme is the Targeted Public Distribution System (TPDS or PDS in short), which provides households access to subsidised food staples as well as a small number of other items including kerosene (Conway and Herd, 2011). In addition to being a food subsidy programme, the PDS serves as a minimum support price mechanism for farmers. Governments also provide subsidised food through other special programmes, including the Midday Meals Scheme, which aims to provide a hot meal for all children attending government-funded elementary schools (Hill and Chalaux, 2011). Subsidised food is also provided through various programmes in public hostels, which target vulnerable groups including the elderly and pregnant women and young mothers.

Under the PDS, the central government has responsibility for procurement and delivery of food to state government facilities. State governments indentify those eligible for subsidised food using national guidelines and distribute to households through a network of privately-owned fair price shops (FPS). Since the late 1990s, the PDS has worked on a targeted basis whereby ration cards are issued to three types of households: above the poverty line (APL), below the poverty line (BPL) and the poorest of the poor, which have access to a special programme, *Antyodaya Anna Yojana* (AAY). Prices for AAY card holders are fixed and incorporate the largest subsidy. The subsidy for APL and BPL households is supposed to be a fixed percentage of procurement costs, with the subsidy larger for BPL households. However, the prices offered to these groups have not been revised since 2002.

The PDS suffers from extensive leakages, including widespread diversion to the black market through the manipulation of stock and sales records (Planning Commission, 2008). Poor targeting is also a major problem, with some poor households missing out on entitlements and some non-poor being assigned BPL status. Jha and Ramaswami (2010) find that in rural areas around 60% of the poor are incorrectly assessed as APL or have no ration card whatsoever. A portion of those with BPL status fail to make use of the PDS, possibly on account of discrimination or lack of awareness. Recent household survey data confirm targeting problems. Although the poor were the most frequent consumers of PDS cereals, less than half of households in the poorest decile reported PDS purchases in the previous month (Figure 4). Further, a significant proportion of relatively affluent households availed themselves of PDS food. Moreover, the average price paid by households of varying affluence shows little variation. After accounting for targeting errors, illegal diversions and excess costs associated with inefficiencies in procurement and delivery, Jha and Ramaswami (2010) estimate that only 10% of total outlays under the PDS are directly transferred to the poor. Part of the excess cost borne by the government may reflect above-market prices paid to farmers. However, as food is sourced mainly from relatively affluent states and farmers with sufficient land to sell surplus crops, the poorest farmers are likely to benefit less from generous procurement prices.

Figure 4. Food purchases through the Public Distribution System

By total monthly per-capita household expenditure deciles, 2007
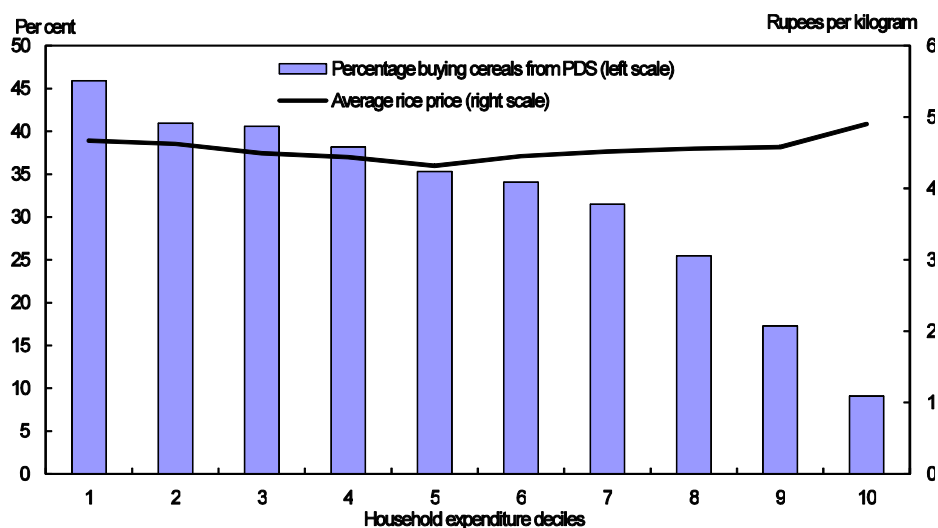
Source: NSSO, National Sample Survey 64th round.

Source: Jha and Ramaswami (2010) and Planning Commission (2008).

There are also a number of hidden subsidies. For example, almost one-fifth of the electricity produced is supplied to irrigation pumps at zero cost. While the Electricity Act provided that such subsidies should be brought onto state budgets, none have done so, preferring to keep the cost of electricity to other users high so as to cross-subsidise irrigation (Conway and Herd, 2011).

Irrigation is indeed another area where subsidies are rampant. Governments make good the operating losses of the irrigation authorities as user charges only cover one-sixth of operating costs. Subsidies could be reduced in this area by lowering costs that are overly high due to bloated staff numbers. But in addition, capital has been supplied to the authorities completely free of charge, through the state government budgets. The capital stock of irrigation systems amounted to 5% of GDP in 2007 (Finance Commission, 2009) and may have reached 8% of GDP in 2010. Such free provision of capital represents a subsidy as much as the subsidy to cover operating losses. If a modest rate of return of 6% is assumed, then the subsidy due to the provision of free capital amounts to around 0.5% of GDP. While it might be thought that such subsidies would benefit poor farmers, only 13% of rural households use irrigation systems.

Overall, most expenditure on subsidies does not benefit the poor:

- Half of irrigation subsidies were found to accrue to medium and large farmers in two major states (Sur and Umali-Deininger, 2004).

- Two-thirds of the subsidy for fertilisers accrues to medium and large-scale farms (Singh, 2004).

- Only a small proportion of food subsidies directly accrue to households below the official poverty line (Box 4).

- Electricity and bottled gas subsidies are also found to be regressive (Conway and Herd, 2011).

- Up to half of subsidised kerosene is resold at higher prices in parallel marketing networks.

The total cost of subsidies is difficult to estimate, as opportunity costs represent a major, but hidden, part of the total subsidy. One method it is to start from the subsidy estimates from the national accounts and to combine them with the estimates of fossil fuel subsidies in Conway and Herd (2011), making due allowance for double-counting. The definition of subsidies used here starts from the meaning in the national accounts, as approved by the United Nations, where a subsidy is an unrequited payment made to an enterprise producing marketable output. By definition, such subsidies cannot be received by consumers. Payments to consumers are classed as social transfers. The provision of a non-marketable service, such as education or health services directly provided by the government, is not classified as subsidies, in contrast to one Indian government report (Ministry of Finance, 2004). However, a payment to a public sector enterprise that sells its output at below its average cost is counted as a subsidy. In addition, as noted above there are also many implicit subsidies that arise from public-sector enterprises making less than the normal cost of their capital. The electricity, water and irrigation sectors are some of the most egregious examples. In the electricity sector the losses of state-level companies were expected to be significant in 2010 and, on past experience, only one-quarter of the losses will be directly shown in the budgets of the states. In the irrigation sector, the implicit losses from the failure to earn a market rate of return are significant.

The extent to which goods and services are subsidised in India is extremely high. Direct budgetary subsidies amounted to 5¾ per cent of GDP in 2008 (Table 4). In addition, various forms of regulations generated subsidies that amounted to 3½ per cent of GDP. Overall, the total level of subsidisation amounted to just over 9% of GDP in 2008.

Table 4. Estimates of different categories of economic subsidies

2008, % of GDP

Budgetary subsidies	
Central and state government non-energy sector[1]	4.3
Central government on-budget oil sector	0.1
Central government issues of oil bonds in place of cash subsidies	1.3
Total	5.7
Regulatory subsidies	
Oil products: burden on companies of regulated prices held below world prices	1.3
Coal and natural gas: regulated prices held below world prices	0.7
Electricity: subsidies due to not covering the cost of capital	0.9
Irrigation: subsidies due to not covering the cost of capital	0.5
Total	**3.4**
Total of above	**9.1**

1. Excludes subsidies to general public services, health, education and welfare.

Source: National Accounts Statistics (2010); International Energy Agency (2010); Finance Commission (2009).

Given that the rate of poverty reduction in India has not been as fast as might have been possible given sustained strong growth (Herd *et al*., 2011), and the evident fiscal wastage, there is a pressing need for further reform of subsidies. One approach is to improve targeting, which poses a major challenge. In

practice, it is impossible to determine whether a given household is below the poverty line. At an income level of $1.25 per day, accurate income data for individual households is not available. One method may be to target the subsidies on individuals that have characteristics that make them highly likely to be living in poverty and give them the so-called below the poverty line (BPL) card (Box 5). Given the significance of the BPL card, the BPL census should be taken every five years. The introduction of new identification technologies would also help reduce the proliferation of fake BPL cards. For the poor who currently lack an appropriate BPL card, public awareness campaigns could be a cost-effective way to increase awareness of their entitlements.[4]

The delivery mechanism for subsidies also needs to be improved. Even if it is politically difficult to reduce the income received by genuine final users of subsidised products, it should be possible to ensure that subsidised products reach the intended consumers. Probably one third of total costs could be saved by ensuring that corrupt practices in the distribution system are ended. Greater use of alternative forms of assistance also needs to be considered. International experience suggests conditional cash transfer (CCT) schemes can be a cost-effective instrument for assisting the poor and reducing poverty but these are little used in India (Grosh *et al.*, 2008; Fiszbein and Schady, 2009; Neri, 2010). While providing the usual benefits associated with welfare programmes that involve cash payments, including redistributing wealth and supplementing the incomes of the poor, CCT schemes aim to reduce longer-term poverty by addressing under-investment in health and education. Typically, CCT scheme conditions for payment focus on school enrolment and attendance for school-aged children, as well as regular health checks for younger children and pregnant women.

Large-scale CCT schemes now operate in most Latin American countries, as well as an increasing number of countries in Asia and Africa. As participation is normally restricted to the poor, outlays are minimised. Two of the largest and most mature schemes which target poor households but have a broad coverage are the *Bolsa Familia* in Brazil and the *Oportunidades* in Mexico. Under each scheme around 20% of all households participate, representing nearly 13 million households in the case of the *Bolsa Familia* (Castro and Modesto, 2010; OECD, 2010). Nevertheless, outlays are relatively small at around ½ per cent of GDP, considerably lower than spending on poorly targeted and environmentally damaging energy subsides in India.

Box 5. Targeting subsidies

At present, the government assesses whether or not a person belongs to a below the poverty line (BPL) household on the basis of a specific census. The household then keeps this status until the next census. In the second half of the last century, eligibility was based on income or consumption. The methodology was changed with the 2002 census. The definition changed to being a weighted average of 13 indicators. Not all of these were true indicators of poverty and some could even give misleading results. Apart from the design of the indicators, there were also major implementation problems. Families knew that the census would result in access to targeted benefits and so adjusted their answers accordingly. In particular, multi-generation households split themselves into nuclear households and under-reporting of the ownership of consumer durables was prevalent (Usami *et al.*, 2010). Moreover, different cut-off points were used in different states and even in different villages in the same state (Alkir and Seth, 2009). In practice the determination of whether a person is above or below the poverty line, though supposedly based on a census, is a highly political exercise (Hirway, 2003).

As noted, the 2002 BPL definition was based on a multidimensional concept of poverty. If this definition of poverty is compared to a standard consumption-based definition of the poverty line, then it gives a very different picture of poverty. In fact, when judged by the official definition of the poverty line used by the Planning Commission, the definition of the poverty line used for the attribution of a card since 2002 shows that only 39% of those below the Planning Commission definition of the poverty line have a BPL card (Saxena Committee, 2009). These mis-

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4.   For the other cards (AAY and APL), the criteria for attribution are quite clear. The major problem is ensuring that people do not have multiple cards.

classifications can occur for a number of reasons: *first* expenditure may not reflect the more general concept of poverty; *secondly* there is usually a high degree of movement from year to year as to whether a person is in poverty; *finally* the card may have been obtained corruptly. These types of errors are quite common in other emerging economies (Morestin *et al.*, 2009). The question arises though as to whether the instrument of government transfers is adapted to offsetting many of these multidimensional forms of poverty (for example being exposed to air pollution) or whether other government policies should be used to counter non-income forms of deprivation.

In order to address some of these problems proposals have been floated to use the results of the 2011 BPL survey in a different way to previous censuses. In particular, one government report recommends a number of automatic exclusion and inclusion criteria. The remaining households would be scored according to a number of transparent verifiable criteria with a procedure for appeals and public dissemination of the holders of BPL cards and their scores (Saxena Committee, 2009). The status of individuals would remain unchanged, in principle for ten years. States would have the right to modify lists in between censuses to take account of deaths and migration.

An important reform ushered in with the 2011 Budget was a decision to replace subsidised fertilisers, kerosene and natural gas with cash transfers for poor households (Conway and Herd, 2011). Reform to the delivery mechanism should be broadened to include other subsidised items, including food. This could be done by way of cash transfers or food coupons which could be distributed through post offices and redeemed either through the existing network of fair price shops (FPS) or, in cities and larger towns, commercial shops (Basu, 2011). Food would be provided to FPS at commercial rates so there would be no incentives for storeowners to divert supplies to the black market. By providing eligible households an alternative point of access this system would also introduce competition between FPS and commercial operators, thereby reducing the ability of FPS owners to deny access to entitlements. Over time the need for FPS may diminish though in remote localities where commercial outlets are limited, a continued presence may be required. The system for ensuring emergency food supplies would be maintained. Such a system would involve much less cost to the government, while meeting concerns over poverty, than proposals, being considered by the government, to move in the opposite direction by extending the provision of subsidised grains to the population. This proposal would take the form of a legal requirement for the government to provide 7kg of grains per person each month to 90% of the rural population and 50% of the urban population through the PDS. Such levels of provision would represent about three-quarters of household consumption of grains by the poorer groups in rural areas. The proposal also calls for households to be charged less than current prices charged by the PDS. According to estimates from the government, the implementation of such a scheme would require a two-thirds increase in government outlays on food subsidies (½ per cent of GDP) (Economic Advisory Council to the Prime Minister, 2010). Ensuring an adequate food supply for people having incomes no more than 10% above the poverty line should be an important government objective. The key is to use modern technology to ensure efficient delivery by turning the subsidy into a social transfer.

Spending in other areas also needs to be made more cost-effective, including in the key area of health care, where the government has earmarked large increases in outlays. Spending should continue to focus on the most cost-effective ways to ensure widespread improvements in health status. As the poor typically make less use of inpatient care, spending in this area can be biased in favour of the non-poor (Mukherjee and Levesque, 2010). Good progress has been made in improving access to safe drinking water (Planning Commission, 2010). However, progress in increasing child immunisation coverage has been slower, with large swathes of the population continuing to be unprotected against preventable diseases. The latest national household survey indicates that only 54% of children in the country were fully immunised in 2005, a rise from the 46% covered in 1998. Progress has been highly uneven and some large poor states such as Uttar Pradesh lag well behind the national average. Recent empirical evidence indicates that improving the reliability of access to immunisation services in highly impoverished areas can improve coverage somewhat (Banerjee *et al.*, 2010). However, larger gains may require a combination of better access and cash or in-kind incentives.

In addition to better prioritising spending, efforts to address bottlenecks in the supply of health services and improve efficiency must be accorded a high priority. Comparisons of health care systems around the world show that the correlation between inputs and outputs is low (Joumard *et al.*, 2010) and there are indications of high levels of waste in the Indian public system. As with the public education system there are signs of a lack of accountability in the public health care system, including high staff absenteeism. Empirical evidence suggests that improving incentives and accountability mechanisms for medical professionals can deliver significant progress (Banerjee *et al.*, 2008). Governments should therefore consider reforming employment arrangements, including the introduction of more systematic performance assessment and reward mechanisms, to lift productivity in the sector.

A new framework for fiscal policy

The current policy debate

With the expiry of the FRMBA, there is now a need for a new framework for fiscal policy. The central government has announced that it intends to reduce its gross fiscal deficit to 4.1% of GDP by 2012 and 3.5% the year after. The Finance Commission (2009), which reports on fiscal relations between the central and the state governments, has recommended that the central government should go further and reduce its fiscal deficit to 3% of GDP by 2014. The Commission also recommended a 2.4% deficit for the states, bringing a combined deficit of both levels of government to 5.4% – down from its 2010 level of 7.2% of GDP.

This would markedly reduce the ratio of consolidated state and central debt to GDP, which would fall to 60% by 2015, a drop of 11 percentage points in five years. Given current interest rates on long-term debt and growth in nominal GDP, such a target could be met with only a modest reduction, of about one-third of a percentage point of GDP per year, in the primary balance (*i.e.* excluding net interest payments). Such an improvement could be achieved through the natural buoyancy of the tax revenues, as more people are subject to income tax, and as more people move out of a subsistence existence and start paying indirect taxes.

What fiscal rule to adopt?

The natural question that arises from such targets is how such a level of deficit can be justified. The Finance Commission argued meeting these targets would ensure there were sufficient funds to meet likely business sector investment demand and only involve borrowing of 1½ per cent of GDP from abroad. In practice, the future growth of investment is difficult to predict, but to achieve durable double-digit growth a significantly higher investment rate will be needed. Given the current size of the capital stock an increase of 4 percentage points might be necessary. Such a jump would require a substantial drop in the public sector deficit, to avoid an unsustainable increase in the current account deficit. Strikingly, none of four East Asian economies that enjoyed periods of very rapid growth did so with large government deficits (Figure 5).

Figure 5. Gross national saving and government net lending: India and other high-growth economies
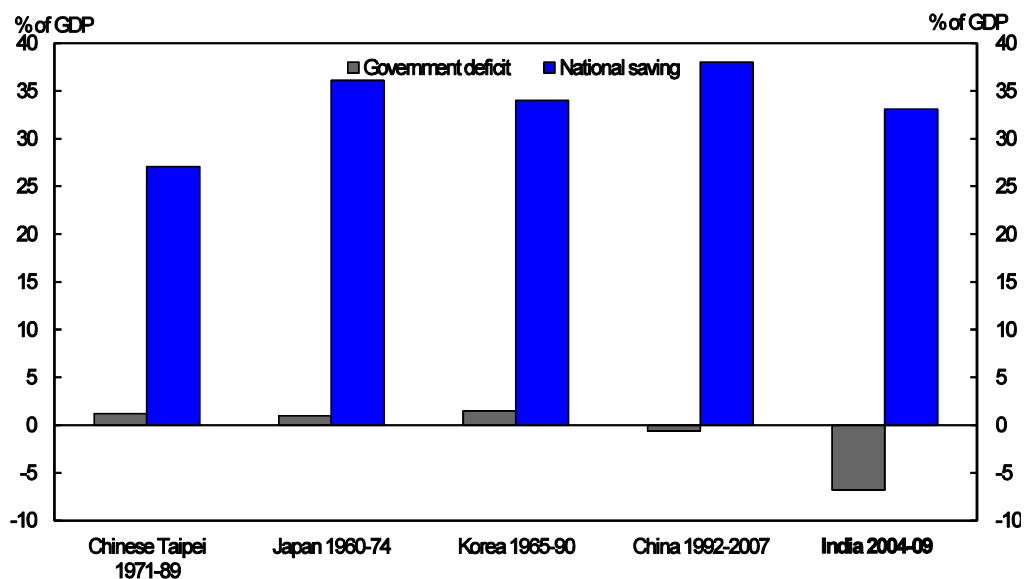
Source: OECD Analytical Data Base, national statistical offices.

One rule that has been suggested for regulating government borrowing is that the deficit should be no larger than net government investment in fixed assets. In principle, such a "golden rule" allows for faster growth and greater intergenerational welfare than a balanced budget rule and is also superior to a fixed deficit rule. The golden rule stops governments borrowing to finance consumption and so eventually ensures that government debt does not exceed its assets. It has been found to reduce the anti-investment bias of most government financing rules (Blanchard and Giavazzi, 2008).

While the FRMBA for the central government prescribed a zero revenue balance, this was not equivalent to a golden rule. Indeed, this balance is not equal to government saving (Finance Commission, 2009). The difference averaged 1.5% of GDP in 2007 and 2008 (Ministry of Finance, 2010c). Moreover, the difference between the revenue balance and the fiscal balance does not measure net investment in physical assets but gross investment in both physical and financial assets. The government accounts do not allow for depreciation. Hence, if all gross physical investment is financed by borrowing, government debt will eventually vastly exceed its stock of physical assets. Finally, the government accounts include financial investment in the gross deficit. This would be justified if the investments were profitable, but many government investments have been in loss-making companies (Conway and Herd, 2011). Thus, the Finance Commission stated that it could not recommend a golden rule for public finances until government accounts had been corrected and put on an acceptable basis.

The national accounts, however, provide an estimate of the combined physical investment of general government in fixed assets (net of capital consumption), which amounted to 3.7% of GDP in 2008. The government also makes financial investments. Strict adherence to such a golden rule would require that the government recognises the falls in the value of investments in its income account, as with depreciation of physical assets. Some of these falls in values might be large, notably when loans are made to loss-making firms. In practice, the central government has only made small net financial investments: over the past five years they have averaged 0.1% of GDP. Thus, even with allowance for financial investments, over recent years, a golden rule would have called for the gross fiscal deficit to decline to 3.8% of GDP. In contrast, the combined target for the state and central governments under the FRMBA and associated state laws was

6%. Thus, despite appearances, FRMBA rules were not equivalent to a golden rule based on investment in net physical assets.

Adoption of a genuine golden rule would lead to a bigger reduction in the deficit than either the government or the Finance Commission have suggested. With GDP growth of 8½ per cent, inflation of 5% and interest rates at 8%, it would require a deficit reduction of just over ½ per cent of GDP per year to reach the target by 2016. Making this rule operational would require an overhaul of government accounting principles, notably to recognise depreciation of its assets in the accounts. Such a strategy would generate substantial savings on interest payments and make room down the road for greater public spending in underfunded areas such as health.

Adoption of a genuine golden rule would lead to a bigger reduction in the deficit than either the government or the Finance Commission have suggested, especially for the central government. State governments are expected to have deficits equal to around 2% of GDP in 2011, well below the target of their Fiscal Responsibility Acts and even below the limit of a golden rule at the state level. The major effort of compliance would thus fall on the central government, whose current deficit is much larger than its net physical investment. If both levels of governments were to comply with the proposed rule by 2016, general government gross debt would fall considerably. For example, assuming a medium-term growth scenario as described in Herd *et al.* (2011), together with an average interest rate on debt of 8% and inflation of 5%, debt would drop from 66% of GDP in 2011 to 40% of GDP in 2016 and 30% five years later. As a result, government spending (excluding interest payments) could rise by 3% of GDP while maintaining a deficit of 3.8% of GDP. The policy would allow, for example, a tripling of government expenditure on health over a decade with no increase in taxation. Making this rule operational would require an overhaul of government accounting principles, notably to recognise depreciation of its assets in the accounts. Such a strategy would generate substantial savings on interest payments and make room down the road for greater public spending in underfunded areas.

Enhancing institutional arrangements

The major problem with basing fiscal policy on a set of rules is that governments often have little incentive to comply with them once they have been enacted, as witnessed in recent years both in India and in many OECD countries. One remedy might be for the Centre and states to agree that penalties have to be paid by the governments that break the rules. However, as illustrated by the recent European experience, this may not work. One suggestion is that a third institution, such as the judiciary, may need to step in (Buiter and Patel, 2010). This, however, might be difficult to reconcile with parliamentary control of the budget.

There is one institution that has sufficient prestige to try safeguard the implementation of fiscal rules. The Finance Commission already undertakes a similar task as well as deciding the distribution of tax revenue between the states and the Centre. This institution currently only reports once every five years and has no permanent staff. The Finance Commission could become more of a supervisory body, making annual reports and having permanent staff.

Ensuring that the government adheres to a medium-term target may also require changes in the way the budget is formulated. The FRMBA mandated a medium-term plan for the budget. However, this stands apart from the budget itself. At present, the medium-term analysis for the budget consists essentially of a set of targets for the deficit. The whole budgetary process needs to be placed in a rolling three-year framework so that the consequences of new policies can be better seen and greater stability can be given to programmes. At the same time, the annual expenditure budget needs to be seen more as a constraint: over the five years to 2010 the expenditure budget has been overrun by 5% on average, even though planned expenditure growth was 12% (relative to the expected outcome for the previous year).

Moving the emphasis towards reducing the claims that the government makes on the rest of the economy may also require recasting the form in which some budgetary documents are produced. At present, the focus is on the gross fiscal deficit. This aggregate is relevant for controlling gross debt but less so for measuring the impact of the budget on the economy (Box 1). The presentation could be improved by producing timely estimates based on an economic and functional breakdown of revenue and expenditure, where the government's role as a financial intermediary is separated from its direct impact on spending. At present, government expenditure is split between expenditure that is within the five year plan for development purposes and other expenditure. Such a split is becoming anachronistic as non-plan expenditure, such as education and health, has developmental consequences. Moreover, the running costs of development expenditure are not taken into account.

Tax reform

Reforming direct taxes

As in many other countries, the direct tax system has become ever more complicated over the years as an increasing number of special exemptions lowered the overall tax take, contributing to keeping tax rates higher than they otherwise would be. After a period of consultation, a new draft Tax Bill was introduced in the summer of 2010. This new law will considerably simplify legislation, though the number of changes to the system is relatively limited. It is expected to come into force in 2012 and the associated reduction in income taxes on individuals and corporations is estimated at around 0.7% of GDP.

Overall, only a small proportion of the population pays income tax. All agricultural income is, effectively, exonerated from income tax. Agricultural income can only be taxed by state governments, who in practice choose not to. Thus, although only 6.7% of the total working and retired population pay income tax, the proportion rises to just under 14% when the agricultural population is excluded. A draft Tax Bill has been introduced to parliament by the government and is scheduled to become law by March 2012. When passed, the proposed law will result in a considerable increase in the income tax thresholds. The highest income tax rate of 30% will not start to be paid until an income level (after deductions) of 8.3 times the average wage, up from 4.2 at the moment. Concerning deductions from gross income, the basic savings deduction is now restricted to retirement saving plans. Many forms of saving will no longer be deducted from income (including principal payments on mortgages), but the overall deduction remains unchanged. A new deduction will be created which has to be shared between various forms of outlays. The short-term capital gains tax will be reduced to between zero and 7.5%, more than halving tax liabilities. Capital gains from securities held for over one year will remain exempt from tax. Income and lump sum payments from the National Pension Scheme (NPS) will become exempt from tax.

The changes in individual taxation reorient the tax system further, and perhaps unduly, toward favouring long-term saving. In order to move the income tax towards a consumption tax base, withdrawals from tax-deductible savings should be taxed when they are withdrawn, totally or partially, from the scheme, while interest income during the accumulation should not be taxed. Most savings schemes in India (pensions, provident fund and insurance) are not taxed in this way. At all three stages, savings can be exempt from taxation in many schemes. The proposed Direct Tax Code moves further in this direction by allowing withdrawals from the NPS to be tax-free. At the same time it moves partially in the opposite direction by subjecting certain investment vehicles (such as life insurance) to a 5% tax on income. Such a move may be justified as a second-best solution to over-generous treatment of withdrawals, given the difficulty of removing such concessions. In the future, it would be better to move towards taxing withdrawals.

Individuals will continue to be subject to a wealth tax but the threshold has been trebled. For individuals, the principal asset covered is undeveloped residential land and unoccupied housing. By

contrast, investment in bonds, equities, insurance, the principal residence and all rented property will not be included in the tax. The threshold has been increased threefold.

For companies, the major change is the proposed reduction of corporate tax rates, from 34 to 30%. To some extent this will be offset by the abolition of all geographically-based tax allowances and holidays. For SEZs established from 2014 onwards tax holidays will be replaced by complete first-year depreciation. Industry in India tends to be capital-intensive rather than labour-intensive, due, in part, to strict labour regulations (OECD, 2007). So while more investment is needed, the tax code should not further bias production technology further towards capital-intensive projects. Low tax rates or tax holidays also boost investment, but are neutral between labour and capital-intensive projects. For the same net present value of tax benefits, one that is contingent on investment will result in companies choosing capital-intensive means of production rather than a labour-intensive technology. Moreover, the tax holiday basis has been extremely successful in promoting SEZs (OECD, 2011). In the future, investment in these areas is likely to be more capital-intensive.

The new Direct Tax Code also stipulates that companies must pay a minimum amount of corporate tax, which is set at 20% of the book profits of a company if this amount is higher than the corporate tax liability of the corporation due to large special tax deductions. However, this minimum tax payment is more in the nature of a partial loan to the government, as the difference between the minimum tax paid and the standard tax payable can be carried forward as a tax allowance for 15 years, thereby offsetting future corporate tax liabilities. For the first time, this provision will also apply to companies in SEZs. In order to mitigate its impact, companies will be able to consolidate their results inside and outside SEZs, implying that many companies with established tax-paying operations outside SEZs will not have to pay the minimum tax on their SEZ profits. Start-ups with no other operations outside India will not enjoy this benefit.

When the new Direct Tax Code becomes law, the current discriminatory tax regime for foreign companies will end. The corporate tax rate for foreign-owned companies will fall from 40% to 30%, in line with the rate for domestic companies. In addition, in October 2009, the regime for determining transfer prices became substantially more certain. A Disputes Resolution Panel (DRP) was introduced to speed up settlements of disagreements over transfer prices (Deloitte Touche Tohmatsu, 2009). This institution draws on the experience of the successful Authority for Advance Rulings (AAR), which reduces the scope for prolonged litigation inherent in the four-tier structure of the current appellate structure for tax rulings. By appealing to the AAR, a taxpayer can obtain a binding decision in six months, even for proposed transactions. For transfer prices, a foreign company can register an appeal with the DRP against any ruling of the tax authorities. This appeal suspends the application of any ruling of the tax authorities. The panel has nine months to give its verdict on the case. Only the taxpayer can appeal. Both the ending of the discriminatory tax regime and this new tribunal give foreign companies a markedly better environment for operating in India.

Introducing a goods and services tax

India's indirect tax system is complex and inefficient. Its design has its roots in the way that the Constitution specifies the respective taxing rights of the Centre and the states. The Centre has the right to tax goods (up to when they leave the manufacturing process), imports and, since 1999, services, but not to tax goods at the wholesale or retail level. Such forms of taxation are reserved to the states, along with a number of specific taxes on certain activities, but states cannot tax services. Finally, the Centre can levy taxes on inter-state sales, but the taxes are collected and retained by the originating state. The original design of these taxes did not allow for the claiming of credits for taxes paid on inputs. As a result there was severe cascading of taxation.

Over time the extent of cascading has been reduced. At the central level, the taxes on goods became a value-added tax, albeit with a boundary restricted to the manufacturing sector. At state level, a sales tax on goods was replaced by a VAT on goods but not on services. Moreover, once goods leave the factory, the central VAT on manufacturing becomes an excise tax and so is not subject to rebate at the state level. Finally, the tax on inter-state trade has been reduced, with the Centre compensating the exporting states for their loss of revenue. Hence, the system remains complex, with many disputes as to what constitutes a service. It still generates considerable cascading, which distorts resource allocation since effective tax rates on different products can vary considerably depending on the extent of cascading.

Given these drawbacks, reform was needed and is now on the way. The previous *OECD Economic Survey of India* recommended a dual VAT structure where both the states and the central government could levy taxation and also that the tax should be destination-based. It recognised that this would imply zero-rating of goods crossing state borders and was concerned to avoid problems of VAT fraud that have occurred with similar systems in the European Union.

The central and state governments have agreed to a dual system of value-added tax. Any transaction in goods or services (including imports) will be subject to a central goods and services tax (CGST) and a state goods and services tax (SGST). Taxation on inputs can be credited against taxation on outputs, but only within each stream of taxation. To ensure traceability of sales between states, there will be a tax on interstate trade so that when the purchaser is out-of-state, the seller will pay an interstate goods and services tax to the central government (IGST). This tax can then be credited against both CGST and SGST in the importing state. This is a key anti-fraud element as there will be no payment of a rebate when a product crosses a state border. One problem with such a design was deciding where services sold across state borders are produced and consumed. However, most such sales are made from business to business and so definitional problems do not have any incidence on the final receipts of tax, which are based on where final consumption takes place (Poddar and Ahmad, 2009). State governments are expected to settle this issue in 2011.

The widest base for the value-added taxation would be the sum of private consumption, government consumption of goods and services and investment goods, essentially housing sold to individuals. In addition, the tax base would normally include the difference between the sales of exempt small traders going to final consumption and intermediate consumption. This base can be calculated using national accounts (Modi, national accounts line in Table 5); or by using the 2003-04 input-output table and assumed unchanged subsidy rates and petroleum taxation Chadha (2009); or by corporate tax returns (Modi tax returns line) or private consumption excluding indirect taxation (Poddar and Ahmad line).

Table 5. Various estimates of the tax base and of revenue-neutral tax rates

	Tax base	Standard tax rate (%)	
	% of GDP at factor cost	Unified rate	Half rate for food, health and education
Modi (national accounts)	93.3	8.6	9.3
Chadha	88.0	9.5	n.a.
Modi (tax returns)	61.2	13.1	14.8
Poddar and Ahmad	51.3	15.6	18.2

Source: Modi (2009), Poddar and Ahmad (2009), Chadha (2009).

There is a considerable difference between these estimates. The lowest one (Modi on national accounts data) has a high tax base and a low tax rate. As the tax base declines relative to GDP the required revenue-neutral GST increases. The highest estimate (nearly 16%) is made by Poddar and Ahmad but they exclude residential construction and government purchases of goods and services from the tax base. The

government has stated that a 16% tax rate is likely, suggesting that residential construction will not be taxed (Mukerjee, 2010). However, no decision has been made by the Centre and states, nor has it been decided whether the land value of a new house should be included in taxation. At a minimum, new residential construction, excluding the land value, should be taxed. In practice, it may be difficult to assess land value and so a tax on the entire sale value would seem better.

The GST would replace a large number of central and state government taxes. There is a broad consensus that petroleum products and alcohol for human consumption will be excluded from the GST while tobacco, and its products, will be included. The final tax rate depends on whether there are additional exemptions or decisions to tax certain goods and services at lower rates. For example, if food, health and education are taxed at half the standard rate then the latter could rise by at least two percentage points. A detailed audit of the different bases for the GST is required in order to avoid undue tax buoyancy when the GST is introduced due to under-estimation of the base and should be feasible given that the start of the GST has been delayed. This should not involve delay in implementing the GST since a constitutional amendment, currently before parliament, still has to be passed in order to validate the change in tax powers for the central and state governments.

There have been some examples in recent years of jurisdictions that have introduced a GST with a wide tax base and low rates. For example, in New Zealand the tax base amounts to 94% of total consumption and the tax rate has been kept to 15%, while in Singapore the rate is 7%, also with few exemptions. Government policy there is to give direct benefits to the poor rather than tax certain products at lower rates. However, in Europe there tends to be a high standard rate accompanied by multiple tax rates and many exemptions. As a result, the average VAT rate on consumption is often only half the standard rate (de Mello, 2008). This leads to distortions in the choice of goods.

The Indian debate on public finance has been dominated by distributional concerns for more than a generation, resulting in excessive differentiation of tax rates (Ahmad and Stern, 1984). Some progress has been made in reducing such differentiation but there is likely to be considerable pressure for lower tax rates on food and perhaps even other items such as kerosene. However, as discussed above, there are other instruments available to offset distributional effects and a tax subsidy is a blunt weapon for aiding the poor. Moreover, once differentiation of VAT rates is accepted, the standard rate has to rise to maintain revenue neutrality and this increases political pressure for even more exemptions and special treatments.

In the case of India, state governments have already agreed that there should be a dual rate structure, though no decision has been made on the rates, the base or the exemption threshold for dealers. Variation in state-level GST rates should be permitted. Cross-border shopping was a problem for high-value products under the sales tax system, as states selectively reduced the sales tax rate. With the unification of the tax base across states, the attraction of cross-border shopping will be limited as differences in tax rates are unlikely to be large. For example in 2008, states that raised between 4% and 6% of GSP accounted for 80% of total state indirect taxes. Only two major states were outliers, namely Karnataka (7.0%) and West Bengal (2.6%), and only a few remote states or territories raised less than 3% of GSP in indirect taxation.

Reforming customs duties

The third area in need of reform is external tariffs. The government embarked on a substantial programme of unilateral tariff reduction that has reduced the weighted average of actual tariff rates to below 9% for manufactured goods (Table 6). This average is slightly below the standard tariff rate of 10% due to fluctuations in the tariff rate across products. The extent of the fluctuations is quite small, with a standard deviation of 2.4%. However, the government chose not to reduce the bound tariff rates which remain, on average, between 35% and 40% for manufactured products. This introduces uncertainty for manufacturers as tariffs can easily be raised without contravening WTO obligations. There is evidence

though that substantial exemptions are granted for certain products imported by favoured industries. For example, the total effective rate of customs and countervailing duties (the latter being a form of VAT on imported products) was only 8% in 2009. Given that the countervailing duty, alone, was 10%, and the weighted average of tariffs on manufactured goods was 8.8%, legislated industry-specific exceptions appear to be extremely prevalent.

Table 6. Tariff rates in India and selected other countries

2009

	India	China	Indonesia	South Africa	Brazil	Russia	United States
Food and live animals							
Simple average							
Actual	34.6	13.4	4.3	7.8	10.1	8.1	2.2
Bound	108.1	15.6	45.9	40.3	36.2	-	4.1
Most favoured nation	32.4	15.6	5.2	9.2	11.0	9.4	4.1
Weighted average							
Actual	33.9	9.7	4.0	5.4	3.3	5.9	1.3
Bound	96.2	13.1	63.0	47.0	40.0	-	4.0
Most favoured nation	39.2	12.7	5.2	6.6	10.4	8.1	4.0
Standard deviation of rates							
Actual	37.3	10.6	23.4	10.4	7.4	5.6	7.3
Bound	38.1	10.4	20.0	39.4	10.2	-	9.7
Most favoured nation	23.5	11.1	11.2	12.2	5.3	4.3	9.8
Manufactured goods							
Simple average							
Actual	8.8	8.1	5.7	7.9	14.5	10.5	3.2
Bound	35.1	9.0	34.2	17.2	33.7	-	4.2
Most favoured nation	8.9	8.8	7.7	9.9	16.1	10.8	4.2
Weighted average							
Actual	8.8	4.5	4.1	5.3	11.1	7.9	1.6
Bound	39.0	5.7	35.9	14.5	31.7	-	2.3
Most favoured nation	8.9	5.1	7.6	6.8	12.9	9.8	2.3
Standard deviation of rates							
Actual	2.4	4.8	5.0	8.7	8.0	6.2	4.7
Bound	7.6	4.5	7.3	8.1	5.4	-	4.7
Most favoured nation	2.2	4.6	4.6	9.6	7.8	5.6	5.0
Total trade							
Simple average							
Actual	10.2	8.2	5.2	7.6	13.4	8.1	2.9
Bound	50.2	10.0	37.5	19.4	31.4	-	3.7
Most favoured nation	12.4	9.7	6.8	7.8	13.7	8.7	3.8
Weighted average							
Actual	7.9	4.2	3.1	3.9	7.6	5.9	1.8
Bound	33.1	5.2	36.9	19.7	30.5	-	2.8
Most favoured nation	8.1	4.6	5.3	4.9	10.1	6.7	3.0
Standard deviation of rates							
Actual	14.8	6.5	11.8	10.5	8.2	6.6	10.0
Bound	39.2	7.1	12.3	25.4	8.4	-	11.5
Most favoured nation	15.9	7.4	12.7	11.0	8.4	6.1	11.6

Note: The bound rate is not applicable in the case of the Russian Federation, which is not a member of the World Trade Organisation.

Source: WTO Tariff Database.

The government had announced a target of reaching a standard tariff rate of 5% by 2010. Such a tariff would have put India on a par with ASEAN countries. With the economic crisis the government decided not to continue with the process. A number of manufactured products have a tariff of over 10%, most notably cars, where it stands at 57.5%, and a number of textile products. There is no evidence of tariff escalation between unprocessed, intermediate and finished products in the non-agricultural sector. The level of tariffs is much higher for agricultural products: alcoholic drinks face tariffs of between 100% and 150% and for grains they vary between nil and 80%. The goal of a unified tariff of 5% on the bulk of manufactured goods is now within reach, including those products which currently have mixed fixed and *ad valorem* rates. The emphasis of government policy has changed from unilateral reduction to negotiating Free Trade Agreements (FTA), with agreements being negotiated with Australia, New Zealand and the European Union, while feasibility studies have started with Chinese Taipei, following the agreements with Malaysia, Thailand, Indonesia and Japan. Agreements with Brunei, Cambodia, Laos and the Philippines are likely to follow, fully implementing the ASEAN FTA.

Conclusion

Sound fiscal policy is essential for promoting sustained high growth in India, as well as facilitating the government's redistributive objectives. The fiscal framework needs to be strengthened, particularly given that the targets set out under the original FRBMA have now expired. New legislation needs to be introduced to programme a marked reduction in the combined central and state deficit so as to move towards meeting the golden rule for public finances. Currently, such a target would imply a combined deficit of around 3% of GDP, excluding all financial transactions.

The government's proposal to cut the corporate income tax rate to 30%, coupled with ending a number of allowances, is welcome as it goes in the direction of widening the tax base and lowering marginal rates. The government should also consider removing accelerated depreciation and putting depreciation onto an economic basis, which would move taxation closer to being on a book profit basis and allow for a deeper cut in the tax rate. Regarding SEZs, the current proposal is to replace tax holidays by allowing full first-year depreciation for investment in new SEZs. This proposal will tend to bias projects towards capital-intensive projects in lieu of a system that is neutral between projects of different capital intensities. Given that India has a surplus of labour, this is a move in the wrong direction. The government's worthy proposal to move the income tax towards a form of consumption tax with deferred taxation of saving proved unpopular, given that it would have raised taxes on many pension schemes.

The planned introduction of the GST will be a major gain for the country as it will permit a unified market for the first time, while maintaining the fiscal autonomy of states. It will also permit a major simplification of the various exemptions that bedevil indirect taxes and should set the scene for a similar unification of the tariff structure.

In sum, fiscal consolidation ought to continue, the fiscal framework needs to be enhanced, and further progress is needed with respect to expenditure and tax reforms (Box 6).

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Box 6. Summary of recommendations on fiscal policy

Fiscal framework

- Revise government accounting principles to recognise depreciation. Use the concept of government acquisition of financial assets (net lending) as the key measure for the fiscal deficit.

- Aim to reduce the fiscal deficit so that it is no larger than government net fixed capital formation.

- Introduce three-year detailed rolling budgets that fit with the medium-term deficit strategy.

- Introduce new legislation to create a permanent Finance Commission to oversee implementation of fiscal rules.

- Ensure that expenditure within a given year keeps to budget plans, in order to make the budget a better instrument of control.

Spending

- Improve the efficiency of the Public Distribution System by introducing food tokens which could be redeemed at fair price or commercial shops, or instead by providing cash transfers.

- Introduce eligibility criteria for the National Rural Employment Guarantee Scheme so as to restrict access to the poorest. Ensure that future adjustments to the wage offered under the Scheme are not excessive relative to the market wage.

- Address bottlenecks that are impeding the expansion of health care. Prioritise higher health spending towards programmes and areas that will yield the widest, cost-effective benefits, including improved immunisation coverage.

Tax reform

- Withdraw the accelerated depreciation allowances and lower corporate tax rates.

- Ensure that tax incentives in new SEZs are neutral between labour and capital-intensive projects which produce the same pre-tax return.

- Move income taxation more to a consumption tax base by reconsidering the decision not to tax withdrawals from tax-exempt savings and pension schemes.

- Reconsider the complete exemption on taxation granted to retirement pensions which goes beyond a consumption tax treatment of that category of saving.

- Reconcile the different estimates for the GST base in order to estimate a correct revenue-neutral rate.

- Complete the move to a 5% import tariff for all manufactured products, including textiles, cars, tobacco and alcohol.

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