Macroeconomic Performance and Projections

1.1 The Tenth Five-Year Plan (2002-07) set an ambitious target for growth of gross domestic product (GDP) of 8 per cent per annum, along with a key sub-target of 4 per cent growth in agriculture, set against the backdrop of a disappointing performance of only about 5.35 per cent GDP growth and 2 per cent growth in agriculture that was achieved during the Ninth Plan (1997-2002). The Tenth Plan strategy was explicitly based on the recognition that the economy was in the middle of a cyclical slowdown and that public investment in infrastructure would have to be the key to accelerate the recovery process. The existence of large unutilised capacities in manufacturing presented an opportunity to accelerate growth in those sectors without corresponding increases in investment. Agriculture was seen as the key sector of the economy for two important reasons: to generate adequate employment opportunities and thereby reduce poverty; and to provide the necessary level of domestic demand support for sustaining the high level of growth in the longer term.

1.2 The experience of the first three years of the Plan suggests that both the overall growth target as well as the agriculture sub-target will not be achieved, and these targets for the Plan period as a whole have to be scaled down significantly even as efforts are made to improve performance in the last two years of the Plan. In such a situation, the employment and poverty reduction objectives are also likely to slip and there is, therefore, a strong case for measures that can mitigate the consequences of non-attainment of the targets.

GROWTH PERFORMANCE

1.3 The Tenth Plan had targeted an average annual growth rate of GDP of 8.1 per cent for the Tenth Plan period to be achieved by a steady acceleration in the course of the Plan period from around 6.7 per cent in 2002-03 to 9.3 per cent in the terminal year 2006-07. This was expected to lay the basis for a growth rate of above 9 per cent during the Eleventh Plan period.

1.4 The expected growth rate in the first three years was about 7.4 per cent on average, and the actual performance has been 4.1 per cent in 2002-03, 8.6 per cent in 2003-04 and is estimated to be around 6.9 per cent in 2004-05, averaging 6.5 per cent for the three years. The shortfall in the first three years is, therefore, about 1 per cent per year. More disturbing is the fact is that the acceleration needed to achieve the 8.1 per cent target is too great to be achieved. Achievement of the Plan target is only possible if GDP growth in the last two years averages nearly 11 per cent per year, which is clearly infeasible on present trends.

1.5 A reassessment of the likely growth that can be achieved during the Tenth Plan has been made on the basis of the actual growth experienced in the past three years, and the behavioural relations underlying the Indian growth process. The macroeconomic parameters consistent with the revised growth scenario have been worked out on this basis. These estimates are shown in Table 1.1 below. In working out these estimates, it has been assumed that the target growth rate during the post-Plan period, i.e. the Eleventh Plan, will be 8 per cent, which is ambitious but not infeasible provided that the projected trends are realised.

1.6 As may be seen from the Table, although the growth rate of GDP in each of the last two years of the Plan (2005-007) can potentially be above 7.5 per cent, the over-all GDP growth rate for the Plan as a whole is unlikely to exceed 7 per cent. It may further be seen that the cause of the relatively slower growth is not the availability of investible resources, since the domestic savings rate has exceeded the Plan targets in the first two years of the Plan. The current account balance (CAB), which is a measure of the inflow of foreign savings, has also been positive rather than the targeted negative, indicating that the country has not been able to absorb the foreign capital inflows and has actually exported capital during the first two years of the Plan, and may do so again in 2004-05. This is reflected in the fact that although the country has experienced large inflows of external financial capital, this has only led to a burgeoning of the foreign exchange reserves of the nation without contributing to additional physical investment. It is projected that the current account balance may turn into a deficit from 2004-05 onwards, but the magnitudes are not likely to be large enough to fully absorb the external capital flows.

1.7 The inability to absorb the external capital inflows is actually understated in the figures given in Table 1.1. While working out the macroeconomic projections for the Tenth Plan period, it had been assumed that the price of the Indian basket of crude oil would be at US$ 28 per barrel, which was higher than the prevailing rate of US$ 24 in 2001-02. Oil prices have moved up steadily since then, and especially from 2003 onwards, and had touched US$ 54 at one stage. As a consequence, the value of imports has been higher only on account of the higher oil prices. If corrections are made for this factor, the current account surplus in the first two years of the Plan would be even larger than has been shown, and would almost certainly be positive in 2004-05 as well. While making projections for the last two years of the Plan, it has been assumed that oil prices will stabilize at around US$ 40 per barrel. This does, however, represent a downside risk for the economy, and if oil prices stay above the assumed level, there may have to be some moderation in the growth projections. Unlike earlier episodes, however, the threat is not really to the balance of payments, but to inflation, on the one hand, and to aggregate demand for non-oil goods and services, on the other. The appropriate macroeconomic policy responses will, therefore, have to be different from the past.

1.8 The uncertainties prevailing the international economic environment and the expectations of slower growth of the world economy in the immediate future could also pose problems. There are two major areas of concern. First, a rise in international interest rates is likely to lead to slow down or even reversal of capital flows and to corresponding upward pressure on domestic interest rates. This may not be a matter of immediate concern, since the cushion provided by our foreign exchange reserves can mitigate such pressures for atleast some time. More importantly, the growth rate of Indian exports may be adversely affected, leading to reduction in the aggregate demand in the economy. The growth rate of the economy for the next two years is based on a projected export growth rate of 16.2 per cent - which is more than double the estimates for the growth rate of world trade in 2005-06. This itself is not unreasonable since India's share in world trade is still very small, and high rates of export growth can be sustained without inviting repercussions. In fact, during the last three years (2002-2005), the growth rate of Indian exports has been significantly higher than the growth rate of world trade. Nevertheless, it is necessary to recognise that this could be a problem area. It has been estimated that every one percentage point reduction from the targeted growth rate of exports could potentially pare the GDP growth rate by nearly 0.2 percentage points, unless compensated by higher than projected growth of agriculture. Thus a 5 percentage point lower export growth rate – i.e. 11 per cent - would reduce the GDP growth rate by one full percentage point. In such a situation, agriculture would have to grow a full percentage point more than the target – i.e. at 4.5 per cent - compensate, which may not be feasible. This underscores the importance of taking innovative steps to improve the policy and procedural environment for exports.

1.9 The rate of savings as reported by the CSO shows a very sharp increase in the first two years of the Plan taking the savings rate to a level much higher than projected in the Tenth Plan. Correspondingly, the rate of investment also exceeded the plan target in the first two years of the Tenth Five Year Plan, though by a lesser amount. This higher than expected rate of savings is a welcome sign, though it is important to be cautious for future projections based on these high estimates of savings and investment in view of high level of errors and omissions in the CSO's quick estimates. Therefore for 2004-05, 05-06 and 06-07 we have adopted more conservative savings and investment rates. If they turn out to be higher, we could have higher growth rates.

1.10 It is important to note that there is a welcome reversal of the slow growth pattern observed during the Ninth Plan period. With appropriate policy changes in critical areas, the

Table 1.1
Macroeconomic indicators for the Plan

(percentage of GDP)

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	Tenth Plan	Post Plan
1. GDP Growth Rate								
(a) Tenth Plan		6.8	7.4	8.2	8.8	9.3	8.1	9.3
(b) Actual/MTA*	*5.2*	*4.1*	*8.6*	*6.9*	7.6	7.8	7.0	8.0
2. Investment Rate								
(a) Tenth Plan		24.5	25.9	27.7	30.1	32.3	28.4	32.3
(b) Actual/MTA*	*23.1*	*24.8*	*26.3*	26.0	27.1	28.6	26.6	29.4
3. Public Investment Rate								
(a) Tenth Plan		7.5	7.5	7.8	9.0	9.9	8.4	9.9
(b) Actual/MTA*	*5.8*	*5.9*	*6.4*	6.9	7.6	8.6	7.1	9.1
4. Domestic Savings Rate								
(a) Tenth Plan		23.8	25.2	26.6	28.1	29.4	26.8	29.4
(b) Actual/MTA*	*23.5*	*26.1*	*28.1*	25.9	26.6	27.7	26.9	27.9
5. Public Savings Rate								
(a) Tenth Plan		-1.5	-0.6	0.3	1.2	2.1	0.4	2.1
(b) Actual/MTA*	*-2.7*	*-1.1*	*-0.3*	-0.1	0.0	0.6	-0.1	0.8
6. Current Account Balance (CAB)								
(a) Tenth Plan		-0.7	-0.7	-1.1	-2.0	-2.9	-1.6	-2.9
(b) Actual/MTA*	*0.4*	*1.3*	*1.8*	-0.1	-0.4	-1.0	0.3	-1.5

NOTES:

* : Numbers in italics are actuals and others are projected for Mid-Term Appraisal (MTA).
1. GDP refers to GDP at Market Prices, and all ratios are expressed with respect to GDPmp
2. CAB: Negative value implies Savings < Investment and vice versa.
3. The Plan does not have annual targets, and the figures shown against the Tenth Plan are obtained through intrapolation.
4. The growth rate for 2001-05 and savings and investment ratios for 2001-04, are based on National Account estimates, whereas those for other years are projected from the Plan model.

investment momentum will have to be maintained in the near future as the economy moves up the expansionary phase of the business cycle. The projected growth rate of investment in the last three years of the Plan (2004-07) has, therefore, been placed at 10.5 per cent per annum, with private investment growing at 7.6 per cent. It needs to be noted that public investment has been targeted to grow significantly faster than private during this period. This is based on three important considerations. First, the experience of the Ninth Plan suggests that the Indian economy is now much more vulnerable to business cycle behaviour, and sustained growth requires the stability provided by public investment. Second, infrastructural infirmities need to be addressed as early as possible in order to prevent them from becoming constraints on private investment and growth. Third, since most public investment is in infrastructure, almost all of which have fairly long gestation lags, the pipe-line investments necessary for creating adequate infrastructure for attaining the 8 per cent plus growth target in the Eleventh Plan have to be initiated at this stage itself.

1.11 It can be further observed from Table 1.1 that despite the high investment growth expected in the coming years, the Indian economy is unlikely to either overheat or face balance of payments problems. The domestic savings rate is projected to increase steadily, mainly on account of increases in public and private corporate savings. As a consequence, the current account will, no doubt, turn into deficit, but it should be significantly lower than the expected flow of external financial resources, which could be as high as 3.5 per cent of GDP over this period. In fact, total foreign investment alone is projected to reach $ 13.1 billion by 2006-07, which is 1.5 per cent of GDP.

1.12 Sectorally, the targets that had been set for the Tenth Plan have been missed in all the sectors during the first two years, and are likely to continue to fall short in the future as well. The sectoral growth targets for the Plan along with the actual and projected performance are presented in Table 1.2. The most worrying feature of the recent growth experience has been the performance of agriculture. The Tenth Plan had targeted growth of agricultural GDP of 4 per cent per year, aiming to reverse the deceleration in the second half of the 1990s – from 3.2 per cent in the period 1980-1996 to 2.6 per cent in the period 1996-2002. This is nowhere near being achieved. The average agricultural GDP growth in the first two years of the Plan has been only 1.35 per cent as against the targeted 3.6 per cent, and it is unlikely to be very much above 1 per cent in the 2004-05 . Therefore, in the first three years of the Plan, average agricultural growth would be about 1.3 per cent at best, which would be more than 2.5 percentage points below the target. The failure in this area is a major factor underlying rural distress which has been visible in recent years, and also the slower growth of the economy as a whole. It may be recalled that the Tenth Plan had laid considerable stress on the role of agricultural incomes in providing demand support to the non-agricultural sectors. This continues to be true despite the fact that exports have performed better than expected, with almost 18 per cent average annual growth in dollar terms during the first three years of the Plan, and thereby reduced, to some extent, the short-fall in aggregate demand emanating from the agricultural slow-down. In the longer term, however, this pattern of growth is unsustainable, even though exports are projected to grow by 16.2 per cent during the remaining years of the Plan.

1.13 Industrial growth in the first two years was 6.6 per cent, which is also short of expectations (average 7.6 per cent), though not quite as much as in agriculture. Although industrial growth has picked up strongly in 2004-05, we are still far from the rates needed to achieve Plan targets. Our projections indicate that industrial growth can accelerate substantially in the coming years, but it would require concerted efforts on both policy and infrastructure fronts. This should be of the highest importance, since failure to achieve high rates of industrial growth will limit the ability of the economy to generate high quality jobs, particularly for the educated youth. In addition, the strong backward and forward linkage effects of the industrial sector make the

Table 1.2
Sectoral Growth Rates

(at factor cost and at 2001-02 prices)

	2002-03	2003-04	2004-05	2005-06	2006-07	Tenth Plan	Post Plan
Agriculture & Allied							
(a) Tenth Plan	3.5	3.7	4.0	4.2	4.4	4.0	4.4
(b) Actual/MTA	-6.8	9.5	1.1	4.0	3.2	2.2	3.4
Industry							
(a) Tenth Plan	7.2	8.0	8.8	9.7	10.6	8.9	10.6
(b) Actual/MTA	6.6	6.6	7.6	8.2	8.9	7.6	9.1
Services							
(a) Tenth Plan	8.0	8.5	9.5	10.0	10.3	9.3	10.3
(b) Actual/MTA	7.3	8.4	8.3	8.5	8.8	8.3	9.0
GDP at Factor Cost							
(a) Tenth Plan	6.7	7.2	8.0	8.6	9.1	7.9	9.1
(b) Actual/MTA	3.7	8.2	6.5	7.5	7.7	6.7	7.8

NOTES:
1. The Plan does not have annual targets, and the figures shown against the Tenth Plan are obtained through intrapolation.
2. The figures for the first three years (2002-05) are based on National Account estimates, whereas those for the last two years are projected from the Plan model.

growth of other sectors highly sensitive to its performance.

1.14 The services sector has averaged 7.85 per cent growth in the first two years of the Plan, which is quite creditable even though below the targeted 8.3 per cent for the period. In particular, the telecommunication sector has grown much faster than expected. This strong performance of the services sector is expected to continue for the remainder of the Plan, although it may not actually touch the targets that had been set originally, mainly because the commodity-producing sectors (agriculture and industry) are growing slower than expected and are not likely to provide the level of demand support that had been anticipated.

1.15 One of the brightest spots in India's economic performance in recent years has been the emergence of knowledge-based industries as the front-runners in the global marketplace. The early successes of the software sector are being replicated in a number of other activities such as business process outsourcing (BPO), bio-technology, pharmaceuticals, industrial design, tertiary health-care, etc. There is vast potential in these activities, but it is clear that a number of other developing countries have also identified them as areas of focus for the future. In order to prevent an erosion of India's present pre-eminence from these emerging threats, the factors behind the country's success will have to be identified and it has to be ensured that we strengthen and creatively build upon them. The entrepreneurial dynamism and competitiveness of these sectors suggest lessons about the policy and operating environment that promotes dynamism, and these lessons can be fruitfully applied to other segments of Indian industry.

1.16 The revision of the aggregate as well as sectoral growth targets for the economy as a whole will necessitate changes in the state-wise growth targets that have been specified in the Plan document. Unfortunately, the data on Gross State Domestic Product (GSDP) are not available after 2002-03, thereby precluding any meaningful assessment of state-wise performance *vis-à-vis* the targets.

SECTORAL PROGRESS AND PROSPECTS

1.17 A key assumption in the Tenth Plan was that the high growth rate of 8 per cent could be achieved with only a relatively modest investment rate of around 28 per cent, instead of 32 per cent or so suggested by traditional incremental capital-output ratio (ICOR) relationships. This was felt to be justified because of the existence of two types of unutilised capacities:

- Those which have arisen out of the demand constraint
- Those which are more structural in nature and arise out of policy rigidities in transfer and utilisation of capital assets.

It was visualised that much of the growth during the first two years of the Plan would come from the former. In later years, policy reforms (including legal changes) were expected to facilitate more effective use of structurally hampered capacities.

1.18 In taking stock of the progress made in utilising productive capacities and the success achieved on the investment front, the sectoral status of capacity utilisation has been recomputed using the latest investment and production data. The methodology used for computing the assessed capacity (or, alternatively, the potential output) is briefly described in Box 1.2. The extent of excess capacity is defined as the percentage deviation of the actual output of the sector from its assessed capacity. These are presented in Table 1.3. These results should be used with caution, since they are very sensitive to the ICOR estimates, but they throw interesting light on some features of the Indian economy, and offer pointers towards future action.

1.19 Although the notion of capacity is very difficult to apply to agriculture & allied activities due to the complexity of factors intermediating the relationship between investment and output, the existence of such high 'excess capacities' in recent years as indicated in Table 1.3 demands careful reflection, especially in view of the tendency to ascribe poor agricultural performance entirely to the lack of adequate investment. Historically, the agricultural sector has never displayed excess capacity except in years of poor rainfall, and even then the magnitudes have been small (never more than 5.5 per cent). This pattern changes dramatically from 1997-98, and the series displays a secular increase in excess capacity, rising to above 18 per cent in the drought year of 2002-03. Even the bumper year of 2003-04 has not led to

BOX 1.1
Estimating capacities

The assessed capacity of each sector for the Tenth Plan as well as for the mid-term appraisal (MTA) has been computed on an annual basis using the sectoral investment data generated by CSO and the incremental capital-output ratios (ICORs) estimated by the Planning Commission. The key elements of the methodology are:

- ICORs used for this purpose take into account the gestation lags in each sector using a procedure described in the Tenth Plan document.
- The year in which the actual output exceeded the assessed capacity by the highest amount was taken to be the base year with zero excess capacity and the series recalibrated around it. Thus the base year varies from sector to sector.

This methodology is, therefore, based on actual investments made in each sector and not on any trend analysis, which is the common way of estimating potential output. It is, however, driven purely by investment and does not take into account other influences which may affect output behaviour, such as weather conditions, technological change or X-efficiency factors. To this extent, it tends to underestimate actual capacity.

Table 1.3
Sector-wise Excess Capacity in the Economy
(percentage of assessed capacity)

SECTORS	2001-02	2002-03	2003-04	2004-05
Agriculture & Allied	8.8	18.4	14.7	17.6
Mining & Quarrying	7.3	2.1	0.0	0.1
Manufacturing-Registered	18.6	16.5	15.8	12.7
Manufacturing-Unregistered	3.7	2.1	0.8	0.0
Electricity	6.3	9.2	10.7	9.6
Construction	3.2	2.9	0.2	0.0
Trade	7.0	5.2	0.0	0.0
Hotels	0.0	0.7	0.0	0.0
Railways	0.0	0.0	0.0	0.0
Other Transport	2.8	1.9	0.0	0.0
Storage	11.3	26.1	26.6	30.1
Communications	0.0	0.0	0.0	0.0
Banking & Finance	7.8	4.7	2.5	0.5
Real Estate	3.2	3.9	4.3	3.8
Public Administration, etc	5.8	8.7	9.8	11.8
Other Services	3.3	12.4	14.1	14.7
All Sectors	**7.4**	**9.9**	**7.9**	**8.1**

NOTE: The capacity calculations are based on the sectoral investment figures of the CSO which are obtained from the Commodity Flow Approach (CFA). These numbers are, therefore, not comparable with the aggregate investment figures given in Table 1.1, which are based on Flow of Funds Approach (FFA).

any perceptible divergence from the trend. This suggests that the agricultural sector has lost about 2 percentage points of annual growth on the average for a period of more than seven years continuously. Clearly, there are factors at work which are retarding the ability of this sector to obtain full advantage from even the limited investments that are being made. Therefore, focus needs to shift away from an 'investments only' approach — although acceleration in agricultural investment no doubt remains essential — to addressing the range of *malaise* affecting this sector.

1.20 On the supply side, irrigation and effective water resources management are the most critical issues for agricultural development, and it is possible that much of the problem may lie here. The following issues need consideration:

- The Accelerated Irrigation Benefit Programme (AIBP), which was designed to bring on-going irrigation projects to quick completion, does not appear to have had sufficient tangible benefit. The area under irrigation is still expanding very slowly despite additional allocation of funds. The Comptroller & Auditor General (CAG) has criticised the functioning of the scheme on a number of grounds.
- The continuing neglect of existing irrigation assets in terms of repairs and maintenance may have led to a situation where the loss of irrigation

potential is larger than the new potential created.

- Existing irrigated areas are displaying serious water-stress, as ground water sources seem to be depleting and reservoirs are not being adequately recharged. Consequently, the agricultural output from irrigated areas also seems to be more vulnerable to weather shocks than earlier.
- There is no effort at either restoring the natural recharge systems of primary water sources or creating artificial recharge mechanisms.
- Watershed development has been given high priority in name for several years, but it does not appear to be making much headway except in isolated cases. A possible reason could be that there is insufficient technical expertise available for this purpose. In addition, there are too many agencies of the Centre and state governments implementing watershed schemes. This opens the possibility of large-scale misuse. Lack of community participation is now regarded as the principal reason why earlier efforts failed. However, the ability to achieve effective community participation varies enormously across states.
- Traditional water harvesting structures have become virtually defunct. Their restoration involves not only the physical and financial aspects of the task, but a clear demarcation of water rights and entitlements. Indeed, assignment of water entitlements may lie at the heart of successfully implementing decentralised irrigation systems.
- The existing institutional structures and manpower deployment in state Irrigation Departments were designed essentially for major and medium irrigation projects. There is further potential for these, but much more attention must now be paid to watershed development and micro-irrigation. The departments may need to be completely reconstituted to provide necessary technical expertise for such purposes.

1.21 Bringing wastelands and degraded lands into productive use was an important component of the Tenth Plan agricultural strategy. To this end, two major initiatives have been launched – the National Mission on Bamboo Technology and Trade Development and the National Mission on Bio-Diesel. Although there has been some progress in this direction, it appears that the issue of land rights is yet to be resolved for the most part, and this is proving to be the major constraint. For both forest and government lands, it is difficult to involve local communities unless land ownership is given to them.

1.22 Revival of agricultural dynamism will also call for corrective steps to deal with the near collapse of the extension systems in most states and the decline in agricultural research universities. Research efforts will need to be more strategic in nature and should harness the expertise available in the private sector as well.

1.23 The supply side apart, the demand side also needs to be addressed. Recent evidence suggests that the traditional assumption of more than adequate demand for all kinds of agricultural products may no longer be valid. Agricultural diversification has to be a major element in the strategy for accelerating agricultural growth and this calls for action on several fronts. Ideally, there should be a shift of land from cereals to non-cereals (increasing both farm incomes and employment) combined with an increase in productivity in cereals to ensure that per capita availability of cereals does not decline. Diversification is unlikely to be a feasible strategy all over the country but it could hold great promise in some areas. The shift from cereals to horticultural crops requires a supportive policy framework in other respects, notably a much greater focus on: marketing arrangements, including encouragement of private sector involvement in marketing, encouragement of downstream food processing and research linked to market requirements for diversifying into horticulture.

1.24 Non-farming rural activities, which are synergistically related to agriculture, have seen a secular decline in recent years. To some extent this may be related to the slow down in agriculture, but there does not appear to be any strategic approach to this issue in terms of policies and programmes. Little has been done in this matter, other than the initiatives taken on self-help groups (SHGs). Much greater focus is clearly necessary on agro-processing and a range of other rural services, which require infrastructural support beyond what is traditionally considered necessary for rural areas.

1.25 The other major problem is the lack of credit availability and the inability of the farmers to repay debt. This is due, in part, to the pervasive sickness of the co-operative credit system and also the unwillingness or inability of the banks to extend direct credit.

1.26 As far as the policy framework is concerned, it is necessary to consider changes for promoting market institutions needed for diversified agriculture. The Essential Commodities Act (ECA) is a major impediment to the development of modern markets and there is a strong case for replacing it with suitable provisions which could deal with emergency situations without hampering normal market activity. The Agricultural Produce Marketing Committee (APMC) Acts in the states also restrict the growth of agricultural marketing and are not conducive to development of horticulture, and should be replaced by a new model legislation which would allow co-operatives and private parties to set up modern markets. A number of items have been taken off the ECA, but the relatively rigid rules framed under the Act by various states continue for the most part. The NCMP states that the Act will not be diluted, but it is necessary to examine this issue in depth so that changes which are necessary in the interest of accelerating growth of farm incomes can be made. A model APMC Act has been drafted and circulated to the states, but there is little movement towards its adoption. There has also been little progress in rationalising the multiple food safety laws, which hamper the development of a modern food processing industry.

1.27 In so far as mining & quarrying is concerned, whatever little excess capacity existed at the beginning of the Plan period has clearly been exhausted. This is cause for concern, since there has been inadequate investment in this sector in recent years, other than in petroleum and natural gas. To make matters worse, this sector typically has long gestation lags, usually more than seven years for major projects, which demands adequate advance planning. Unfortunately, the policy framework for this sector is still not conducive for substantial private participation, and a number of public sector undertakings (PSUs) have not invested even the internal resources available to them. Therefore, little dynamism can be expected in the short to medium run. On the other hand, immediate shortages can be overcome through higher imports, even though the international markets for most such products are fairly tight at the moment. In the longer run, however, this sector may prove to be a binding constraint unless measures are taken immediately.

1.28 The registered manufacturing sector, with nearly 19 per cent excess capacity in 2001-02, was viewed as being the source of much of the growth during the initial years of the Plan, with output increasing rapidly as the demand constraint was eased through higher public investment. In the later years of the Plan, as excess capacities were used up, fresh investment demand from this sector was expected to be the principal driver of growth in the economy. Table 1.3 suggests that capacity utilisation in this sector has no doubt improved, but not to the extent that had been expected. This would mean that, on the one hand, there is ample scope remaining for high growth of this sector in the coming years; but, on the other hand, new investment in this sector may not be as high as could be hoped.

1.29 The unregistered manufacturing or the small and medium enterprises (SME) sector has been a dynamic segment of Indian industry and has proved its competitive ability in recent years. It never displayed the kind of excess capacities seen in the registered sector even during the trough of the industrial slowdown. Indeed, much of the investment activity in manufacturing during the low investment years between 2000 and 2003 took place in this sector. This was partly the outcome of the resources released by slack investment activity in the corporate sector. There is, however, reason to believe that the growth of this sector has been and is likely to be hampered by the lack of a sufficiently dynamic financial sector. In fact, as corporate investment demand rises in the coming years, it may 'crowd out' the SME investment unless appropriate policy interventions are made.

1.30 The capacity utilisation in the electricity sector presents a conundrum, which needs to be resolved. It can be nobody's case that the power sector is either demand constrained or has received more than necessary investment in recent years – indeed, quite to the contrary. Also, the plant load factor has increased over this period, which should have led to a decline in the excess capacity. The causes of the estimated 'excess capacity' must therefore lie elsewhere. In this sense it is similar to the discussion on agriculture. The emergence of this excess capacity begins in 2001-02, and increases quite rapidly thereafter. It may be the case that this is the outcome of the greater emphasis that is being placed on transmission and distribution in recent years, which improves the quality and efficiency of the power sector without materially contributing to its output or value-added. This is, of course, eminently desirable. It could also be the case that there has been a recent spurt in the investment activity in this sector, and the capacities have yet to come into production due to longer gestation lags than has been assumed.

1.31 The other infrastructure sectors – construction, railways, other transport, and communications – expectedly have little or no excess capacity, which may cause problems in the coming years. Infrastructure was recognised to be a critical constraint needing large investments in the Tenth Plan, and it was expected that policies would be evolved which would allow a large contribution of private investment to support expanded public investment in these areas. It is becoming increasingly clear that with the exception of a few sub-sectors, such as telecommunications, ports and airports, private participation will require not only policy support but some financial support as well. Developing credible public-private partnership (PPP) models and backing these with adequate public resources, in terms of both long-term debt and viability-gap support, will be the key to ensuring that infrastructure does not become the binding constraint to sustained high growth rates in the country.

1.32 The most surprising feature of Table 1.3 is the large excess capacities that have appeared in the services sectors excluding trade, banking & finance, and hotels & restaurants. It is difficult to comment on this since the services sectors comprise of a large number of disparate sub-sectors, each with its own particular characteristic. On the whole, it appears that the under-capitalisation, which has traditionally characterised services in India, is beginning to change, and the country is starting to witness the emergence of more organised service activities. This has both pros and cons, and care will have to be taken to ensure that the unorganised service sectors, which provide livelihoods to a large number of the poor, are not adversely affected. In the case of public services, however, since the value-added is measured as the real wage bill, it may well be the case that facilities are being created without adequate provisioning of staff due to the desire to contain revenue expenditures. This may not augur well for the effectiveness of these investments.

SOCIAL DEVELOPMENT

1.33 A basic shift in priorities signalled by the NCMP was the need to give greater importance to social sector expenditures as part of the effort to promote development with social justice, in particular for the scheduled castes and scheduled tribes. The Tenth Plan specifies monitorable targets for certain indicators of social development in health, education and gender equality. These targets are not identical to the Millennium Development Goals (MDGs) but it is believed that if these targets are met, then the other MDGs are also likely to be achieved. It is a matter of deep concern that at the current pace of progress, it appears unlikely that many of these targets will be met.

1.34 The targets regarding education required that 100 per cent enrolment in primary schools be achieved by 2003 and 100 per cent retention be achieved immediately thereafter. The slow pace of roll-out of the Sarva Shiksha Abhiyan (SSA) has led to a situation that the 100 per cent enrolment target is unlikely to be achieved even by 2005. There are a number of issues that need to be addressed in this context:

- The fiscal implications of SSA, especially for state finances, does not seem to have been factored in adequately in the TFC award. Unless the Planning Commission provides adequate support, the programme is likely to run into financial constraints rapidly.
- Since elementary education has been declared a Fundamental Right, there is always the possibility of the courts intervening, which could prove disruptive. In order to forestall such a possibility, it is necessary to clearly lay down the roll-out plan and to adhere to it strictly. This will require close coordination between the Centre and the states.
- An important instrument for improving retention in schools is the Mid-day Meal scheme. This scheme has worked well in some states but its operation has not been satisfactory in a number of others. At the moment, however, the Mid-Day Meal is operating under Supreme Court direction as a component of the right to food, and the Centre has been charged with providing adequate financial support, but the financial aspect may not in fact be the most important consideration in achieving the desired objective.
- The Tenth Plan had pointed out that if the SSA succeeded, it would place heavy demands on the secondary school system, which may become difficult to meet unless steps are initiated right away. This concern remains valid even though the progress of SSA has been slower than planned.

1.35 Inadequate progress on the health and family welfare front is a matter of grave concern. Unless prompt and decisive steps are taken, the Plan targets on infant mortality rate (IMR) and maternal mortality rate (MMR) will not be met, and the MDG targets too will almost certainly be missed. Unlike the case of primary education, where a well-designed intervention in the form of SSA exists, there is no real blue-print for the development of the primary health sector. There is need to initiate a fresh approach in this area that can be initiated within the Tenth Plan period even if it can be fully operationalised only in the Eleventh Plan period. It may also be necessary to identify more limited interventions within the existing health framework e.g. focusing on the empowered action group (EAG) states identified for family welfare purposes. In particular, the health needs of the rural areas of the country have to be addressed in a mission-mode if the MDG targets are to be achieved.

1.36 Concerns about gender equity are reflected in the monitorable targets of the Plan, but little appears to have been done about empowering women so that these intentions are backed by gender-sensitive institutional structures. More generally, inadequate attention has been paid to finding ways of mainstreaming gender concerns in our policies and programmes. This is an issue which needs careful consideration while designing intervention strategies.

1.37 Social justice and empowerment of backward classes by and large continues to be followed as a set of special programmes rather than as an integrated strategy. The needs of the tribal population in particular have to receive focus, since the available evidence indicates that the gap between the scheduled tribes and the rest of the population in almost all social indicators is widening despite some improvement in absolute terms.

1.38 Over the years, a number of programmes have come into existence for providing food and nutritional support, especially for the poor. At present, from the Centre, the schemes which provide food support are the Targeted Public Distribution System (TPDS), Antyodaya Anna Yojana, Mid-day Meal Scheme, Integrated Child Development Services (ICDS) and Food for Work scheme. In addition, some states have their own schemes for similar purposes. These schemes have increased in recent years as a result of a perceived worsening of the nutritional problem. However, there has been no stock-taking of the overlap between these various schemes in terms of the target groups. There is need to rationalise the overall food and nutritional interventions being made by government. The issue of adequacy of nutrition needs to incorporate the fact that certain vulnerable groups, particularly children, lactating mothers and adolescent girls, require interventions that go beyond the calorie-protein norms currently sought to be met through foodgrains alone.

INVESTMENT STRATEGY AND NEEDS

1.39 The investment strategy of the Tenth Plan reflected the fact that in the base year of the Tenth Plan (2001-02), the economy was in the middle of a cyclical slow-down, with the investment rate at 23.1 per cent of GDP as against the peak of 26.2 per cent achieved in 1995-96. Capacity utilisation was low in a number of sectors, especially in manufacturing. Agricultural output, and thereby rural incomes, had shown relatively low growth and high volatility through the Ninth Plan period (1997-98 – 2001-02). International markets had gone into a recessionary phase.

1.40 It was felt that private investment demand was unlikely to revive until the capacity utilisation in industry increased to significantly higher levels. Revival of rural consumption demand was expected to contribute to investment expansion, but this would only happen over time if agricultural growth targets were met. Exports were unlikely to provide adequate demand support due to depressed international market conditions. Moving into a high growth trajectory from this base level situation, therefore, required a sustained demand impetus from public expenditures, especially public investment, even if it required some relaxation of fiscal discipline. There was little danger of "crowding out", since private investment demand was well short of the resources available, especially if one included the potential availability of external resources which went into a build up of reserves.

1.41 The strategy adopted, therefore, was to accelerate the recovery process through an early stimulus to public investment, which, in turn, was expected to lead to a revival of private investment to take the momentum forward in the later years. Since private investment would really start to pick up only some time during 2003-04, the level of investible resources available to the private sector would not be a major concern until then, but it would become so in the last two years of the Plan. It was, therefore, envisaged that the process of fiscal correction should focus on the revenue deficit and not the fiscal deficit, which could remain as high as 4.3 per cent of GDP for the Centre and 2.2 per cent for the states even in the terminal year of the Plan. The consolidated revenue deficits, however, was envisaged to go down to around 2.4 per cent of GDP by the terminal year 2006-07 in order to provide the requisite amount of public savings for financing sustained high levels of public investment.

1.42 In the event, growth has been slow in the first three years of the Plan,and despite the high rate of investment, capacity utilisation in industry appears to have increased, although not to the extent that had been anticipated in the Plan. Some excess capacity remains for tapping in the immediate future, but increasingly future growth prospects will now depend on sustained growth of private investment and also public investment in critical infrastructure. However, as indicated in Table 1.3, there is enough excess capacity available to

Table 1.4
Investment trends and projections

	97-98	98-99	99-00	00-01	01-02	02-03	03-04	04-05	05-06	06-07
Public	7.2	7.0	7.4	6.6	6.4	5.9	6.4	6.9	7.6	8.6
Corporate	8.7	6.8	6.9	5.4	4.8	4.7	5.2	6.0	6.9	8.0
Household	8.7	8.9	11.0	11.9	11.9	14.2	14.7	13.1	12.6	12.0
TOTAL	24.6	22.6	25.3	23.8	23.1	24.8	26.4	26.0	27.1	28.6

ensure that the growth process in the rest of the Tenth Plan period will not be hampered by a lack of capacity or that the economy will overheat. The principal areas of concern are in the infrastructure sectors, which have exhausted what little surplus capacity existed at the beginning of the Plan period. The existence of excess capacities in demand-constrained sectors also implies that the need for investment buoyancy to provide adequate demand impetus continues to be relevant.

1.43 The behaviour of investments by type of institutions in the recent past is given in Table 1.4, and brings out quite clearly the investment dynamics in the Indian economy. As can be seen, the Ninth Plan period (1997-98 to 2001-02) was characterised by a more or less steady decline in the public investment rate, and a precipitous reduction in the corporate investment rate. The only reason that the economy did not go into recession was the dynamism shown by the household sector, which partially filled the space vacated by the organised sectors.

1.44 The declining trend in the public investment rate continued in the first year of the Tenth Plan (2002-03), and has reversed only thereafter. Interestingly, in the first two years of the Plan, public savings increased by 2.4 per cent of GDP, but public investment by only 0.2 per cent. One part of this problem, other than the declining trend in Plan allocations as a percentage of GDP, is the inability or unwillingness of public sector undertakings (PSUs) to fully utilise their internal resources. During the first three years of the Tenth Plan, for instance, PSU savings averaged nearly 4 per cent of GDP, while their investment was around 3 per cent. The problem is actually even worse, since several Central PSUs, especially in the energy and telecommunication sectors, have invested significantly more than their internal accruals. Thus, there is considerable scope for increasing the public investment rate simply by removing the controls and constraints on PSU decision-making.

1.45 Data on private corporate investment are not available beyond 2003-04, but there is evidence that the economy is well into the recovery phase of the business cycle and private investment has picked up. However, this still appears tentative, and more should be expected in 2005-06. Despite this optimistic outlook, there is still a substantial unfinished agenda that needs to be addressed before the manufacturing sector can embark upon a sustained high growth path. A few of the critical elements are:

- Inadequate progress has been made in releasing capacities which are locked up due to structural factors. The Securitisation Act for the banking sector has been the only major step forward so far. Other Tenth Plan proposals were: repeal of the Sick Industrial Companies Act, (SICA) and the winding up the Board for Industrial and Financial Reconstruction (BIFR); passage of bankruptcy and foreclosure laws; reform of the Industrial Disputes Act; release of excess lands held by PSUs and privatisation of sick PSUs. There has been little progress on these.
- There is an unfinished agenda as far as creating an investor-friendly climate is concerned. The Plan had identified a number of critical policy and

procedural constraints, particularly in the domain of states, that may be holding back private investment, including foreign direct investment (FDI). These need to be addressed early.

- The Plan had also indicated that FDI is an important instrument for expanding private investment in the economy. FDI flows have continued, but the perception remains that there are bottlenecks holding up FDI, which could be much larger if these are addressed.

1.46 The projections made for private corporate investment in Table 1.4 are driven mainly by cyclical factors, with capacity utilisation steadily improving in manufacturing and public investments addressing infrastructural needs. They do not, however, entirely take into account the effects of further policy reforms, which may lead to even higher corporate investment rates.

1.47 The revival in organised sector investment demand, both public and private, in the coming years, however, is likely to lead to a decrease in the household sector investment rate, since it has only residual access to investible funds, unless the recent upsurge in domestic savings rate is maintained in the future. While this may not affect the growth performance of the economy, it could have adverse implications for the pace of employment creation.

1.48 Revision of the growth targets for the remainder of the Tenth Plan period as well as for the Eleventh Plan necessitates a revision of the investment programme presented in the Tenth Plan document. A reassessment of the sectoral investment requirements, and also the corresponding public investment, has been made reflecting the likely behaviour of the economy in the next two years, and is shown in Table 1.5. As may be seen, there is an almost 12.5 per cent reduction in the total investment necessary for attaining the growth

Table 1.5
Sectoral investment requirements

(Rs. '000 crore at 2001-02 prices)

Sector	Tenth Plan		Mid Term Appraisal	
	Total	Public	Total	Public
Agriculture & Allied	219.6	132.2	175.7	95.7
Mining & Quarrying	89.4	106.4	98.2	105.8
Manufacturing	1476.9	97.2	1196.6	71.3
Electricity, Gas & Water Supply	412.5	251.6	316.1	174.5
Construction	61.0	71.0	53.5	56.4
Trade, Hotels etc:	136.6	16.0	115.1	12.2
Rail Transport	81.9	60.6	77.8	52.1
Other Transport	237.6	80.7	230.0	70.7
Communications	296.4	91.0	431.4	119.9
Financial Services	151.2	26.5	129.4	20.5
Public Administration & etc	273.1	156.3	213.1	110.4
Other Services	645.3	119.8	545.3	91.6
Total	**4081.5**	**1209.3**	**3582.2**	**981.1**

NOTE: The reasons why public investment is larger than the total requirement in mining & quarrying and construction are explained in detail in the Tenth Plan document.

rate now projected for the Plan. However, public investment requirements have been reduced by nearly 19 per cent. The main reason for this is that public investment has fallen seriously short of the targets in the first two years of the Plan, especially in agriculture, manufacturing, electricity, and public administration, community, social & personal services, and it appears unlikely that these backlogs can be made up in the remaining three years. As far as manufacturing and electricity are concerned, the main problem has been the inability of the concerned public sector units to generate the requisite amount of internal resources, while in the other two, it has been the lack of sufficient budgetary resources. On the other hand, investment in two infrastructure sectors, namely mining & quarrying (which includes the hydrocarbon sector) and communications, have been and are expected to be nearly as high or even higher than originally targeted, mainly due to higher than expected internal resource generation by the concerned Central public sector undertakings (CPSUs). However, within mining & quarrying, the non-hydrocarbon sub-sectors have invested well below the target.

1.49 The above estimates of investment requirements should be treated with some caution, since they represent a minimalist position determined by a business-as-usual projection for the short- to medium-run. Consequently, historical under-investment behaviour is embedded in these estimates. In particular, investment in infrastructure, including social infrastructure, has to be driven by longer term considerations and, therefore, should not be reduced below a point. A similar situation also exists for agriculture, which would probably require significantly higher investment, both total and public, than indicated in the Table if the sector is to be placed on a higher growth trajectory on a sustainable basis. The principal reason why such minimal requirements are being projected at this time is that the fiscal position of governments, both at the Centre and in the states, are projected to be such that even these levels of public investment may be difficult to attain given the constraints imposed upon them.

FISCAL RESOURCES FOR THE PLAN

1.50 Table 1.6 presents Plan outlays for the Centre and the states separately for the first three years. It is clear that Plan allocations have been considerably below expectations. The revised requirements consistent with the macroeconomic balances and sectoral investment needs discussed above are also presented in the same table. With the allocations made for 2004-05, the Central sector Plan (including PSU plan) for the first three years will be about 44.2 per cent of the total Plan against a normal expectation of 54 per cent. The Central PSUs, in particular, appear to have performed exceptionally poorly in terms of their internal resource generation, which, in turn, has affected their investment, despite more than adequate support from the Central government. The performance of the states may have been marginally better than that of the Centre, but it has been at the cost of much higher levels of borrowings than had been planned. In this situation, meeting the public investment requirements indicated in the previous section may not be easy. It is, therefore, necessary to examine the likely fiscal positions of the Centre and the state governments in some detail.

1.51 The fiscal position of the Central government is presented in Table 1.7 (the detailed budgetary projections are given at Annexure 1.1). It may be noted that the gross budgetary support (GBS) to the Plan consistent with the revised public investment requirements and after removing Plan loans to States averages more than 1 percentage points of GDP below the original during 2005-06 and 2006-07. Despite this, the fiscal position is not likely to improve very much beyond the original projections.

1.52 In working out these budgetary estimates, it has been assumed that the interest rates will remain benign and control over Central government employment will continue, so that both interest payments and pay & allowances as percentages of GDP will decline significantly from the base year (2001-02). However, non-Plan grants to states arising from the award of the Twelfth Finance Commission (TFC) will virtually double over the period.

Table 1.6
Structure of Public Sector Outlays and Resources

(Rs. crore at 2001-02 prices)

	Tenth Plan 2002-07	MTA 2002-07	Realisation 2002-05	Realisation as % of Tenth Plan	Realisation as % of MTA
Centre:					
Central Plan Outlay of which	706000	644003	342164	48.5	53.1
(a) Support to State Plans	300265	247395	138721	46.2	56.1
(b) Support to CPSEs	76250	69554	44519	58.4	64.0
(c) Support to Ministries	329485	327054	158924	48.2	48.6
(i) Investment	181217	163527	72251	39.9	44.2
(ii) Current Outlay	148268	163527	86673	58.5	53.0
Financed by:					
(a) Borrowings	678574	679240	376995	55.6	55.5
(b) Other Resources	27426	-35237	-34831	-127.0	98.8
States:					
State Plan Outlay of which	588325	539300	289920	49.3	53.8
(i) Investment	357096	307401	148698	41.6	48.4
(ii) Current Outlay	231229	231899	141222	61.1	60.9
Financed by:					
(a) Central Support	300265	247395	138721	46.2	56.1
(b) Borrowings	300951	336596	227491	75.6	67.6
(c) Other Resources	-12891	-44691	-76292	591.8	170.7
PSEs:					
Outlay/Investment	674490	510185	234888	34.8	46.0
Financed by:					
(a) Central Support	76250	69554	44519	58.4	64.0
(b) Savings (IR)	401240	269025	105128	26.2	39.1
(c) Borrowings (EBR)	197000	171606	85241	43.3	49.7
Total Budgetary Resources	994060	935908	493363	49.6	52.7
Total Investment (Centre +State + PSEs)	1212802	981113	455837	37.6	46.5
Total Public Sector Outlay	1592300	1376539	683732	42.9	49.7

NOTES:
(1) All Union Territories (UTs) are clubbed with the states.
(2) A part of the investment outlay of the states will be towards budgetary support to state PSEs for investment purposes. Since this quantum is not yet known, it is being carried in the state budgets.
(3) The 'borrowings' of PSEs include all market related funds including new equity issues, if any.
(4) 'Other resources' of the Centre and the states include balance on current revenues (BCR), miscellaneous capital receipts (MCR) and external grants, less non-Plan capital expenditures.
(5) PSEs includes both Central PSEs and State PSEs in the Tenth Plan and MTA targets. However, the corresponding realised figures are only for Central PSEs since the requisite data is not available for state PSEs.
(6) Central support to State Plan includes loan component of Central Plan assistance. However, as per the Twelfth Finance Commission recommendations, from 2005-06 onwards, loan assistance from Centre to states may stop and the states may raise loans directly from the market.

Table 1.7
Central government finances

(Percentage of GDPmp)

	2002-03	2003-04	2004-05	2005-06	2006-07
1. Gross Budgetary Support					
(a) Tenth Plan	4.4	4.7	4.9	5.1	5.4
(b) Actual/MTA	4.5	4.4	4.4	4.1	4.1
2. Total Expenditure					
(a) Tenth Plan	16.0	15.9	15.7	15.5	15.3
(b) Actual/MTA	16.8	17.1	16.3	14.6	14.2
3. Total Non-Debt Receipts					
(a) Tenth Plan	10.7	10.9	10.9	10.9	11.0
(b) Actual/MTA	10.9	12.6	11.8	10.3	10.3
4. Gross Fiscal Deficit					
(a) Tenth Plan	5.3	5.0	4.8	4.5	4.3
(b) Actual/MTA	5.9	4.5	4.5	4.3	3.8
5. Revenue Deficit					
(a) Tenth Plan	3.7	3.5	3.1	2.6	2.2
(b) Actual/MTA	4.4	3.6	2.7	2.7	2.2

Despite this, total non-Plan expenditures as a percentage of GDP is expected to reduce by nearly 1.5 percentage points over the Plan period, which is more or less in line with the decline projected in the Tenth Plan. This, taken with the lower GBS projections, imply that total Central government expenditures, both in absolute terms and as a percentage of GDP, will be somewhat lower than the original Tenth Plan projections.

1.53 On the tax revenue front, the projections made in the Union Budget 2005-06, suggest that the Tenth Plan targets of the gross tax/GDP ratio will be met, because of the introduction of new taxes and cesses, increased coverage of the services sectors and better compliance through tax reform and simplification. The possible introduction of a national VAT or of a unified goods and services tax (GST) has not been factored into the estimates. The higher tax devolution to states arising from the TFC award has been included, but it makes little difference. Despite this positive outlook on taxes, it appears very likely that the total non-debt receipts of the Centre will fall significantly short of the Tenth Plan projections. The primary reasons for this are the expected short-fall in disinvestments receipts, the lower interest receipts from states on account of the debt swap which has taken place in recent years and the reduction in the interest rate on outstanding debt recommended by the TFC, and the lower recovery of loans from states due to consolidation and rescheduling of the debt stock.

1.54 As a consequence, the gross fiscal deficit (GFD) of the Centre (without adjusting for the change on account of states borrowing directly) is likely to rise above the current level of about 4.5 per cent of GDP, rather than declining slowly as had been projected earlier. The revenue deficit position, however, is expected to be somewhat better, but not very much so. However, neither of these magnitudes is a cause for alarm, and is perfectly compatible with fiscal sustainability, provided growth accelerates in future and tax reforms lead to further improvements in the tax ratio. It may be noted that the total government borrowing by both Centre and States is unlikely to change and therefore it would not have an impact on the interest rate.

1.55 However, the importance of sustained and substantial improvement in the tax/GDP ratio cannot be overemphasised. The Fiscal Responsibility and Budget Management (FRBM) Act, and particularly the statutory Rules notified under it, introduces targets for the fiscal and revenue deficits, which have implications for the size of GBS to the Plan in the years ahead, unless tax revenues achieve the targets laid down in the Medium Term Fiscal Policy Statement (MTFPS) tabled with the Union Budget 2005-06. The main fiscal indicators presented in the MTFPS, and extended by one year to fully cover the critical period by which the FRBM Act targets are to be met, are given in Table 1.8. As can be seen, achievement of the MTFPS milestones and the FRBM targets rest crucially upon the projected tax receipts. Over the four-year period, 2004-05 to 2008-09, taxes would have to grow at over 22 per cent annually, implying a buoyancy of around 1.7, which is significantly higher than the buoyancy of 1.2 achieved during the first three years of the Tenth Plan. The requirements are particularly stringent in the first two years of the Eleventh Plan (2007-09), when the buoyancy will have to be upward of 1.9. This is a cause for concern since, as can be seen from Table 1.1, public investment will have to rise to 31 per cent of total investment in the country in the post-Plan period, as compared to a likely 27.5 per cent during the Tenth Plan, if a 8 per cent growth target has to be achieved during the Eleventh Plan. Longer run considerations, therefore, require that suitable strategies be evolved to ensure that public expenditures in infrastructure and critical social sectors are protected in the event of the tax targets not being met. In doing so, it may be necessary to draw a balance between excessive monetary expansion, on the one hand, and deflationary impulses, on the other.

1.56 The fiscal deficit does not appear to be a binding constraint at this stage, since the decision to move state borrowings off the Central Budget, which was recommended by the TFC and has been accepted, leads to the Centre's fiscal deficit ratio being reduced by about 0.8 percentage points. However, much will depend upon the ability of states to exercise their option to shift loans directly to market borrowings. This, in turn, will be determined by the conditions likely to prevail in the financial markets and the terms the Centre will offer to state borrowings. With the expected increase in private investment demand, and the consequent hardening of market terms, it appears quite likely that states may require Central borrowing support unless at least a minimum shift is made mandatory and/or the terms of Central lending made relatively unattractive. In such a situation, the fiscal deficit targets of the FRBM may indeed turn out to be a more binding constraint than the revenue deficit insofar as the size of the Plan is concerned.

1.57 It should be noted, however, that the projections in Table 1.5 could prove to be over-optimistic if the commitments made in the National Common Minimum Programme

Table 1.8
Achieving FRBM Act targets

(% of GDP)

	2003-04*	2004-05	2005-06	2006-07	2007-08	2008-09**
Revenue Deficit	3.6	2.7	2.7	2.0	1.1	0.0
Fiscal Deficit	4.5	4.5	4.3	3.8	3.1	3.0
Gross Tax Revenue	9.2	9.8	10.6	11.1	12.6	13.2 - 13.7

* Actuals
** Projected for achieving FRBM Act targets

(NCMP) lead to rapid increases in expenditure because of the compulsions of spending in critical areas such as health, education, irrigation, watershed management, railway modernisation and employment programmes. While some of these priorities can be subsumed under the public investment requirements reflected in the projected GBS, others will involve higher revenue expenditures which would require a further expansion in the GBS, and, thereby, worsening of both the fiscal and revenue deficits. The exact position in this regard is difficult to ascertain at this stage, since much will depend upon the extent to which it is possible to converge and gain synergies between various existing schemes and the new ones.

1.58 It is clear that the resource position of the Centre in the remainder of the Tenth Plan period will be more difficult than was envisaged at the time the Plan was formulated. Nevertheless, the problems are by no means insuperable, and the overall position does not in itself contradict macroeconomic stability, though it may prove difficult to meet the requirement of the FRBM Act, especially on the revenue deficit. As far as macroeconomic balance is concerned, it appears that there is sufficient slack in the savings-investment balances of the economy (including external inflows) to be able to absorb higher fiscal deficits without any perceptible "crowding out". However, care would need to be taken to ensure that the widening of the fiscal deficit does not lead to a spiralling interest burden on the exchequer, which would have sustainability implications, or to an increase in inflationary pressures. Fortunately, the accumulated stock of foreign exchange reserves of the country provides a measure of assurance that even if the fiscal deficit is exceeded, it will be possible to neutralise the effect of any excess demand by encouraging a larger inflow of imports. The decision to form a Special Purpose Vehicle (SPV) to fund viable infrastructure projects is an instrument which relies on this comfort.

1.59 The principal source of the contradiction between the intent of the FRBM and its impact in practice is the budgetary classification that is followed in India, especially with regard to Central support to the states' development activities, whether through Additional Central Assistance (ACA) or Centrally sponsored schemes (CSS). Since both these forms of support are by way of grants, they are routinely classified as 'revenue expenditures' regardless of the purpose for which they are applied. Therefore, it seems to be more rational to change the classification system, somewhat along the lines used for Central sector schemes, rather than go through the tortuous devices that are sought to be adopted for meeting the FRBM targets. The difference between the budgetary classification and the economic classification used in the National Accounts suggests that the revenue deficit overstates government dissavings by about 1 percentage point of GDP, even after accounting for depreciation of departmental enterprises, which gives a clear indication of the extent to which capital expenditures are being misclassified as current expenditures. Nevertheless, the conclusion is inescapable that between the TFC award and the FRBM, the Central budget will have to walk a tightrope in the coming years.

1.60 The position of the states, however, is likely to be even more difficult than of the Centre despite the substantial relief that has been granted by the TFC. States have passed through difficult times since they have not received as much resources as were envisaged through devolution because: the economy has grown more slowly than projected; the Centre's ratio of tax revenue to GDP has not increased as was projected in the Plan; the states' performance has also been below targets, but it has been better than the Centre's; the losses of the SEBs continue to impose a very heavy burden; and the Pay Commission effect on the states, though it is beginning to wear off, has left most of the states with a very heavy debt overhang. As a consequence, if the states are to fully meet their public investment responsibilities, their fiscal condition could be in serious jeopardy, unless Central transfers by way of devolution and Plan support meet the provisions made in the projections of the Central budget.

1.61 The likely fiscal position of the states taken collectively for the Tenth Plan period is presented in Table 1.9 (details are given in Annexure-1.2). As may be seen, although the Plan expenditure of states as a percentage of GDP has been significantly lower than the Plan targets, their non-Plan expenditure has continued to balloon despite the relief arising from the debt swap. Fortunately, much of the increase in the non-Plan expenditure in 2002-03 and 2003-04 is the consequence of early repayment of Central loans, which is a capital account transaction and should, therefore, be omitted while computing the fiscal deficit. On the other hand, their tax revenues have failed to achieve the projected buoyancies. The net effect is that both the adjusted fiscal and the revenue deficits have in fact contracted in the manner that had been expected, which goes to the credit of the state governments. The projections for the future, however, do not hold out too much hope for any substantive fiscal correction on current trends, despite the sizeable difference made by the TFC award in 2005-06.

1.62 Although the position of the states as a collective in this regard is not very different from that of the Centre, their ability to sustain these levels of deficit is much less. Moreover, there are substantial differences between states in terms of their fiscal position, and there are a number of states which are chronically debt stressed. The position of the various states in this regard is discussed in detail in Chapter 15.

1.63 The TFC award, the salient features of which are given in Box 1.2, will be implemented from 2005-06, and is expected to ameliorate the fiscal condition of these states to some extent. However, it is unlikely to be enough unless other conditions are met, some of which are not within the control of the states. It is, therefore, imperative that the assumptions underlying the figures in Table 1.7 are realised. In particular, the above projections are critically dependent upon the Centre achieving its tax collection targets, which, as has already been mentioned, may be open to doubt. The assessment made by the Planning Commission in this regard suggests that both the fiscal and revenue deficit of the states may be 0.2 percentage points of GDP higher than shown in Table 1.9. Although the TFC has reduced the extent of dependence of

Table 1.9
State government finances

(Percentage of GDPmp)

	2002-03	2003-04	2004-05	2005-06	2006-07
1. States Plan Expenditures					
(a) Tenth Plan	4.0	4.0	4.1	4.2	4.2
(b) Actual./MTA	3.6	3.7	4.0	4.0	4.1
2. Total Expenditure					
(a) Tenth Plan	17.2	17.0	16.7	16.3	15.8
(b) Actual/MTA	17.1	18.3	17.6	16.5	16.4
3. Total Non-Debt Receipts					
(a) Tenth Plan	12.2	12.4	12.5	12.6	12.9
(b) Actual/MTA	11.5	12.0	12.2	12.8	12.9
4. Gross Fiscal Deficit					
(a) Tenth Plan	4.3	3.9	3.5	2.9	2.2
(b) Actual/MTA	4.1	3.8	3.5	2.7	2.6
5. Revenue Deficit					
(a) Tenth Plan	2.5	2.1	1.6	1.0	0.2
(b) ActualMTA	2.2	1.9	1.6	0.9	0.8

BOX 1.2
Main recommendations of Twelfth Finance Commission

- Share of the states in the net proceeds of shareable Central taxes shall be 30.5 per cent.
- Statutory grants include grant for panchayati raj institutions and urban local bodies; grant for calamity relief; non-Plan revenue deficit grant; grants to specific states for education and health sector; maintenance grant for roads and bridges; grants for maintenance of public buildings and forests; heritage conservation grant and grant for states specific needs.
- Central loan to the states contracted till 31 March 2004 may be consolidated and rescheduled for repayment in 20 equal annual installments with an interest rate of 7.5 per cent per annum subject to the state enacting the fiscal responsibility legislation.
- A debt write off scheme linked to the reduction of revenue deficit of states may be introduced in which the quantum of write off would be linked to the absolute amount by which the revenue deficit is reduced in each successive year during the award period.

states on Central devolution by recommending higher level of grants and debt restructuring, devolutions nevertheless constitute a sizeable fraction of state resources, especially for the fiscally weaker states. The expected additional impact of the TFC recommendations on state finances is given in Table 1.10. As can be seen, on past trends, there was likely to have been a net transfer of resources from the states to the Centre on the non-Plan account, which has been reversed by the TFC award.

1.64 Second, it has been assumed that the states will be able to raise market loans at around 150 basis points above the Centre's borrowing rate. Although this has been true in the recent past, the indications are that it may not obtain in the future, especially if the Centre reduces its role in intermediating between the financial markets and the states. In any case, there is no doubt that the average maturity profile of state debt will shorten over time despite the immediate relief that has been provided by the TFC through consolidation and rescheduling of outstanding Central loans to states. Debt stressed states will be hit particularly hard, since their ability to roll over past debts will be impaired. In addition, the TFC has recommended that the debt and interest relief would be provided only to those states which enact FRBM Acts targeting zero revenue deficit by 2008-09. Although this measure is eminently desirable in the long-run, it can have serious repercussions on State Plan expenditures given the normal time taken for legislative action in the country and because of

Table 1.10
Impact of Twelfth Finance Commission on state finances

(% of GDP)

	Without TFC		With TFC		Gain to States	
	2005-06	2006-07	2005-06	2006-07	2005-06	2006-07
Interest payment	2.62	2.50	2.42	2.30	0.20	0.20
Share in Central taxes	2.70	2.77	2.75	2.92	0.05	0.15
Non-Plan grant	0.61	0.62	1.00	0.80	0.39	0.18
Debt repayment	1.01	1.00	0.85	0.83	0.16	0.17
Total	-0.32	-0.11	0.48	0.59	0.80	0.70

NOTE: Interest and debt repayment are treated as negative items in state budgets while tax share and non-Plan grants as positive.

short-run rigidities in non-Plan expenditures. The problem is likely to become even more acute in the future since the NCMP commitments will require states to increase Plan expenditures beyond what has been indicated in Table 1.9, especially in terms of current expenditures.

1.65 Third, Plan grants from the Centre, which constitute about 12 per cent of the non-debt receipts of states and are not statutory in nature, have been assumed to remain fixed as a proportion of the total GBS. However, if these are reduced due to pressures on the revenue deficit of the Centre, it will erode the states' ability to comply with their own FRBM targets.

1.66 Finally, as greater functions and resources are devolved to the panchayati raj institutions (PRIs) as mandated by the 73rd and 74th Constitutional Amendments, the states will face exactly the same disjunction between budgetary and economic classification of their expenditures as the Centre faces today *vis-à-vis* the states. More importantly, it is quite likely that the Centre may pass on a portion of its support to states directly to the PRIs, which would further erode the revenue flow to the state budgets.

1.67 Therefore, it should be clear that states face uncertainties and limitations that are considerably more onerous than those faced by the Centre. Unless some method is devised to correct this situation expeditiously, some of the states may rapidly sink into acute fiscal distress and will have to cut back on their Plan expenditures. This will have serious repercussions on public investments in the country and will inevitably affect both the growth rate and the pace of progress in our social indicators. Consequently, the fiscal position of government as a whole, including both the Centre and the states, will remain vulnerable unless appropriate steps are taken at both levels of government. The options available to the Centre have already been discussed, but for the states there appears to be little choice except to increase revenues either through higher tax collections or enhanced user charges, especially in power.

1.68 In recognition of their fiscal problems, most states have entered into a process of fiscal correction. The most important of these is the implementation of the state Value-added Tax (VAT), which has come into effect from 2005-06. However, operation of the VAT will take some time to stabilise and, in the interim, will introduce yet another element of uncertainty to state finances, despite the Centre's commitment to make good any losses on this account in a phased manner. In the meantime, every effort will need to be made to ensure that the legitimate borrowing needs of the states can be met without disruption and at reasonable terms in a situation where uncertainties are increasing. The TFC recommendation that the Centre should gradually withdraw from its role as financial intermediator is an eminently desirable one, but the states can be left to cope with market realities only after their 'balance sheets' have been cleaned up to a significant extent.

1.69 In this regard, the TFC has also recommended a debt write-off mechanism whereby states which reduce their revenue deficits according to a pre-specified calendar will be entitled to have their annual debt repayment liability to the Centre written off in proportion to their revenue deficit reduction. At the limit, a state which reduces its revenue deficit to zero by 2009-10 would get 25 per cent of its outstanding debt to the Centre written off through this mechanism. This is certainly a step in the right direction, but it may not be enough. In the first instance, the projections made suggest that if the Plan expenditures are to be met, the revenue deficit of states will reduce only very slowly after 2005-06. Indeed, if the state component of the NCMP commitments are to be fully funded, even this may not happen. Second, as has already been mentioned, there are too many sources of revenues of state governments that are beyond their control. This implies that it would be very difficult for states to comply with a pre-specified time-line on revenue deficit reduction unless appropriate adjustments are made for the Centre's failures. It is, therefore, felt that a more case-sensitive proposal for debt write-off be evolved on the basis of the TFC recommendation so that the transition to a fully market-based borrowing for states can be effected expeditiously.

Annexure 1.1

Central Government Finances- MTA of the Tenth Five Year Plan

(in Rs. Crore)

	2002-03	2003-04	2004-05	2005-06	2006-07
I Gross Budgetary Support					
a. Tenth Plan (as % of GDP)	113500 4.4%	134985 4.7%	159993 4.9%	189892 5.1%	231073 5.4%
b. Actual/MTA (as % of GDP)	111455 4.5%	122280 4.4%	137387 4.4%	143496 4.1%	162571 4.1%
II Total Non Plan Expenditure					
a. Tenth Plan (as % of GDP)	296809 11.6%	324966 11.3%	355243 10.8%	388577 10.4%	425085 9.9%
b. Actual/MTA (as % of GDP)	302710 12.3%	349089 12.6%	368405 11.9%	370849 10.6%	400088 10.1%
III Total Expenditure					
a. Tenth Plan (as % of GDP)	410309 16.0%	459951 15.9%	515236 15.7%	578469 15.5%	656158 15.3%
b. Actual/MTA (as % of GDP)	414165 16.8%	471369 17.1%	505792 16.3%	514345 14.6%	562659 14.2%
IV Gross Tax Revenue					
a. Tenth Plan (as % of GDP)	235800 9.2%	272145 9.4%	317735 9.7%	373133 10.0%	440736 10.3%
b. Actual/MTA (as % of GDP)	216266 8.8%	254348 9.2%	306021 9.8%	370025 10.5%	430755 10.8%
V Non Debt Receipts					
a. Tenth Plan (as % of GDP)	274785 10.7%	315042 10.9%	357250 10.9%	408799 10.9%	470551 11.0%
b. Actual/MTA (as % of GDP)	269092 10.9%	348096 12.6%	366561 11.8%	363200 10.3%	410224 10.3%
VI Gross Fiscal Deficit					
a. Tenth Plan (as % of GDP)	135524 5.3%	144909 5.0%	157985 4.8%	169670 4.5%	185606 4.3%
b. Actual/MTA (as % of GDP)	145072 5.9%	123272 4.5%	139231 4.5%	151145 4.3%	152436 3.8%
VII Revenue Deficit					
a. Tenth Plan (as % of GDP)	95687 3.7%	100588 3.5%	100795 3.1%	98539 2.6%	95891 2.2%
b. Actual/MTA (as % of GDP)	107880 4.4%	98262 3.6%	85165 2.7%	95312 2.7%	88086 2.2%

Annexure 1.2

State Government Finances- MTA of the Tenth Five Year Plan

(in Rs. Crore)

	2002-03	2003-04	2004-05	2005-06	2006-07
I States Plan Expenditure					
a. Tenth Plan (as % of GDP)	101308 4.0%	116504 4.0%	135145 4.1%	156768 4.2%	181851 4.2%
b. Actual/MTA (as % of GDP)	88603 3.6%	101784 3.7%	124675 4.0%	142129 4.0%	162027 4.1%
II Total Non Plan Expenditure					
a. Tenth Plan (as % of GDP)	338468 13.2%	374809 13.0%	413349 12.6%	454032 12.1%	497074 11.6%
b. Actual/MTA (as % of GDP)	331860 13.5%	402496 14.6%	423655 13.6%	437883 12.5%	489357 12.3%
III Total Expenditure					
a. Tenth Plan (as % of GDP)	439776 17.2%	491313 17.0%	548494 16.7%	610800 16.3%	678925 15.8%
b. Actual/MTA (as % of GDP)	420463 17.1%	504280 18.3%	548329 17.6%	580012 16.5%	651384 16.4%
IV Tax Revenue					
a. Tenth Plan (as % of GDP)	216645 8.5%	252248 8.7%	294060 9.0%	344686 9.2%	406237 9.5%
Of which share from Centre (as % of GDP)	62835 2.5%	75256 2.6%	88161 2.7%	103863 2.8%	123048 2.9%
b. Actual/MTA (as % of GDP)	198798 8.1%	227128 8.2%	262442 8.4%	308666 8.8%	360369 9.1%
Of which share from Centre (as % of GDP)	56655 2.3%	65296 2.4%	77887 2.5%	96558 2.7%	116136 2.9%
V Non-tax Revenue					
a. Tenth Plan (as % of GDP)	85985 3.4%	95366 3.3%	106431 3.2%	119508 3.2%	136899 3.2%
Of which plan grant from Centre (as % of GDP)	35469 1.4%	42183 1.5%	49998 1.5%	59341 1.6%	72210 1.7%
b. Actual/MTA (as % of GDP)	81541 3.3%	101822 3.7%	110790 3.6%	138394 3.9%	146646 3.7%
Of which plan grant from Centre (as % of GDP)	30440 1.2%	39132 1.4%	43595 1.4%	50362 1.4%	56939 1.4%
VI Non Debt Receipts					
a. Tenth Plan (as % of GDP)	311643 12.2%	356627 12.4%	409504 12.5%	473207 12.6%	552148 12.9%
b. Actual/MTA (as % of GDP)	284243 11.5%	332218 12.0%	380207 12.2%	451073 12.8%	511028 12.9%

(in Rs. Crore)

	2002-03	2003-04	2004-05	2005-06	2006-07
VII Gross Fiscal Deficit					
a. Tenth Plan (as % of GDP)	109727 4.3%	113150 3.9%	113794 3.5%	108112 2.9%	92284 2.2%
Of which plan loan from Centre (gross) (as % of GDP)	24119 0.9%	28684 1.0%	33999 1.0%	40352 1.1%	49103 1.1%
b. Actual/MTA (as % of GDP)	102126 4.1%	104732 3.8%	109926 3.5%	93633 2.7%	101361 2.6%
Of which plan loan component from Centre (gross) (as % of GDP)	22021 0.9%	23534 0.9%	25002 0.8%	0 0.0%	0 0.0%
VIII Revenue Deficit					
a. Tenth Plan (as % of GDP)	63467 2.5%	60122 2.1%	51417 1.6%	36602 1.0%	10553 0.2%
b. Actual/MTA (as % of GDP)	55113 2.2%	53643 1.9%	50838 1.6%	33136 0.9%	33304 0.8%