The Liberal Budget 2006-07
- Right Choices, Tough Decisions

FORUM
of Free Enterprise

"Free Enterprise was born with man and shall survive as long as man survives".

-A.D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

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The thrust of LB3 is based on its commitment to the reforms process. It strongly contends that neither the Left parties nor anybody can stop the enterprising India from going ahead, so much so that our entrepreneurs are everywhere; our educated young men and women are in demand across a wide spectrum of business and industry within the country and abroad. All that is needed is to move forward with tough decisions on the Unfinished Agenda of economic reforms.

The objective of the Third LIberal Budget (LB3) is to make India prosperous. If the reforms process translates itself into a better life for our people particularly those in rural India where 70% of India live; if our farmers are no longer compelled to contemplate suicide as a way out of their indebtedness; if we no longer have starvation deaths; if India enjoys medical care of world standards; if our education is not only universal but of high class quality; if we have world-class infrastructure, then we can say with some degree of legitimacy that we are indeed on the road to become a global economic power.

Assessment Of Economic Reforms

By the time the Union Budget 2006-07 is discussed, publicly debated and passed by the Parliament, the Indian economy would be moving into the fifteenth year of Economic Policy Reforms

(EPR), which began in June 1991. This decade and half of EPR provides us an excellent vantage point for evaluating its impact on the Indian economy and also factor in the experiences of this period into the policy formulations of LB3.

The political and economic background of the EPR, its rationale, and the role of multilateral agencies therein have been extensively debated, both within the polity and outside. More significantly, the electoral processes at constitutionally mandated intervals have in essence captured the mood and response of the nation vis-à-vis these reforms. The intensive and extensive debates on the EPR over the last fifteen years have been possible because of the pluralistic nature of Indian society, and this aspect is, indeed, the triumph of our democracy. In continuation of the national debate on the EPR, the LB3 takes a lead in providing an alternative approach to budgeting in India.

The Principal Message of the Reforms

—From the Liberal economic perspective, the experience of the nation with the EPR till date can be captured in three strands - the 'LPG' Doctrine - Liberalization – Privatisation–Globalization. This has resulted in greater market-orientation of economic decision-making, as opposed to the erstwhile gamut of government controls, interventions, regulations and restrictions of various kinds.

As a corollary to the above, greater reliance has to be placed on the private sector, to carry on the economic activities but with the state playing the important role of a regulator as well as being responsible for the overall improvement of the investment climate. While the idea that the private sector should have a greater role in the national economy is well understood and appreciated, there are several contentious issues with respect to disinvestment and privatisation programmes of the public sector enterprises.

Consequent to the introduction of the EPR, there have been significant changes of policies and procedures in the industrial, financial, taxation, infrastructure, and investment spheres, to mention only the main areas. The policy changes in these areas have brought about radical changes in the performance of the Indian economy. Apart from the opening up the economy to competition, the EPR has altered the psyche of the nation. The net effect: the new India dreams of becoming a global economic super power, an unthinkable idea even a decade back.

LB3 evaluates the EPR in the framework of 'Domestic Sector' and 'External Sector', indicating its **achievements** and **failures.**

I. The Domestic Sector

Turning to the domestic Sector of the economy, the results of EPR have been a 'mixed bag'. The positive aspects are:

- First, a relatively higher real GDP growth, despite significant fluctuations in agricultural growth rates. More importantly, with the services sector and, of late, the manufacturing sector having become the drivers of the economy, the growth of the Indian economy has become "drought-proofed". However, this pattern of economic performance, bypassing the farm sector, is leading to iniquitous growth, which is not acceptable in the Indian context.

- Second, the corporate sector is displaying high growth and dynamism. Indian Corporates seem to have come of age in the matter of adherence to international accounting, ethical and governance standards. This makes them an attractive destination for global investments, as witnessed by the significant flows of foreign investors into the Indian stock markets in the recent years.
- Third, coming of age of India's services sectors, especially Financial Services; IT; and Healthcare. With other services like Retail, Tourism, Accounting, Legal and Telecommunications set to boom in the next few years, India is most likely to emerge as a favourite services destination for investments.
- Fourth, stabilization of inflation at a lower level indicates the economy is reasonably insulated from major macroeconomic fluctuations, both in India and abroad. Evidently, the impact of oil-price rise, has also been felt much less now, compared to earlier years, because of the resilience acquired in the last 15 years.

- Fifth, maturing of the Indian manufacturing sector is being reflected in growing global competitiveness and manufacturing standards in key segments of industries.
- Lastly, the ratio of direct taxes to GDP is rising, as also the contribution of direct taxes in total tax-collections.

However, some major stark failures are in addressing the vexatious issues of unemployment, regional imbalances, and infrastructural constraints. The following are the main areas of concerns:

- First, the extremely weak position of Central Government finances, coupled with still weaker State government finances. More importantly, most states are yet to usher in key reforms at their respective state level.
- Second, growing regional imbalances – the prosperous South-West vis-à-vis the poor North-Central-East. This economic divide is having a telling impact on economic growth and is significantly slowing down the progress of the county.
- Third, the employment situation is threatening to become a socio-economic time-bomb. Reforms, critics argue, have resulted in "jobless growth".
- Fourth, energy and infrastructural constraints are hampering rapid and widespread growth. The reforms are yet to focus on energy security and

we need to bring about national alternatives to our over-dependence on hydrocarbons. The extraordinary price hikes of crude oil in the past two years is bound to have a telling impact on the Indian economy, sooner rather than later.

- Fifth, inadequate social sector expenditures on Health, Education, Housing.
- Sixth, the public sector, is still in an obstructive mode with consensus on disinvestment continuing to elude the polity.
- Lastly, administrative reforms are still not within the reforms radar of both the Central and state governments. We seem to carry the new economic thoughts with an age-old administrative system and mindset.

II. The External-Sector

The EPR of 1991 were primarily a response to the then-prevailing acute Balance of Payments (BoP) crisis. From that precarious situation, the Indian economy has come a very long way and can today legitimately boast of a healthy, sustainable and vibrant external sector. The principal achievements of the external sector are:

- First, the forex reserves of the country are well in excess of $ 140 billion – currently covering 14-15 months of the country's imports.
- Second, the trade to GDP ratio (that is the total of imports and exports as a percentage of GDP – indicating the extent of India's global intercourse) stands at a healthy 30% - much

above the paltry 10% at the commencement of the EPR.

- Third, exports have recorded a healthy 20% growth for over three years and 'Brand India' and 'Made in India' are slowly but surely emerging as forces to reckon with in the international arena.
- Fourth, there is a secular decline in the external debt ratios with India's debt servicing becoming quite comfortable.
- Lastly, there is an increasing inflow of capital through the route of FIIs and FDIs.

However, major shortcomings of our external sector are in terms of dominance of traditional exports with the thrust on raw materials rather than on competitive, high value added products making their visible presence in the world-markets. Likewise, actual inflows of FDI are much less than potential and much less than competing nations. Nevertheless, the Indian economy today, is far more globally integrated than it ever was, and the remarkable turnaround of the external sector within the span of a decade, is hailed to be a major success of the economic reforms process.

III. The Unfinished Agenda...

Thus, it can be said with reasonable justification that the crisis-ridden Indian economy (as of 1990-91) has been transformed, into an economy, which is recognized globally as a major emerging economic powerhouse. Indeed, it is our own lack of single-minded pursuit or resolve to push forward the EPR with vigour and boldness, which has so far prevented us from realising our "true potential". There are a host of sectors/areas crying out for comprehensive reforms: Illustratively,

- Administrative Reforms, including the crucial areas of improving the interface of the state with the citizen;
- Agricultural reforms;
- Legal reforms;
- Labour reforms with particular reference to labour legislation;
- Investment-climate reforms;
- Financial sector reforms;
- Increasing the FDI ceiling in all the remaining crucial sectors;
- Urban economic reforms;
- Reforms in key infrastructure areas – Power, Transport; Ports, Airports, Water and Roads;
- Fiscal reforms – PSUs, Subsidies, and Tax-administration.

The Current Impasse

It is evident that the 'Left' Parties (comprising CPM, CPI, and other smaller parties) are causing a strong resistance to any significant policy-reform. It is ironic that while countries swearing by the communist ideology have prospered in recent years by abandoning the basic economic principles of their ideology, the Indian communist parties are stalling the on-going EPR, and thereby greatly hampering India's progress towards economic prosperity.

Thus, the Common Minimum Programme (CMP) of the UPA government, (signed both by the Congress and the Left) has laid down the 'principles', which will govern the actions of the Central Government on disinvestments, foreign investments, labour reforms, etc. Illustratively, on foreign investment, the CMP States, "FDI will continue to be encouraged and actively sought particularly in areas of infrastructure, high technology and exports and where local assets and employment are created on a significant scale. The country needs and can easily absorb at least two to three times the present level of FDI inflows..." On this basis, FDI whether in Telecom, Retail or Insurance easily qualify for liberalization of policy.

Yet, the resistance of the Left ranges from preventing the raising of FDI-ceiling in specific sectors to banning the FDI in other sectors, altogether! It is squarely the UPA Government's responsibility to strive for effective consensus and forge ahead relentlessly on the path of reforms, while recognizing the concerns of the Left parties for strengthening the social sector.

Retrospect on the Central Budget 2005-06

In early 2005, there were high hopes and expectations about the prospects of an acceleration of economic reforms in the budgetary strategy.

However, the Finance Minister had to contend with factors like the CMP; the sharp hike in international crude oil prices; a setback to agricultural performance during 2004-05; the Tsunami tragedy; the growing economic distress of farmers leading to suicides and malnutrition deaths in some parts of the country; and further widening the rural-urban divide.

Despite these difficulties, the Indian economy could achieve impressive real GDP growth of 6.9% during 2004-05 thanks to a strong industrial recovery, inspiring corporate performance, sustained high growth in the services sector and healthy export growth. The economy was in a resilient mode.

Even more striking features of the economy in the medium-term perspective were the over-all improvement in productivity, the emergence of manufacturing competitiveness and a welcome turnaround in the investment outlook. Also, there has been increasing global recognition of India's potential for high economic growth. All these positive features did not, however, make an adequate positive impact on the fiscal health of the Central Government.

Thus, fiscal constraints continued to be reflected in the impairment of fiscal discipline despite explicit norms of the FRBM legislation. Besides, the Central Budget of 2005-06 had to reckon with the impact of the recommendations of the 12th Finance Commission, which placed an additional burden of Rs.26,000 crores on the Central Government in

2005-06 - equivalent of 0.75% of GDP. More importantly, the long-term fiscal strategy continued to suffer from lack of buoyancy of tax revenues; tinkering with tax reforms and administration; persistent huge gaps between revenue expenditure and revenue receipts; and capital receipts largely being diverted to meet the gaps in revenue expenditure.

Thus, the Central Budget 2005-06 began with major challenges of:

- Sustaining the high growth momentum (7-8% real GDP growth)
- Containing inflation to median single digit level
- Bringing about rural and agriculture resurgence
- Speeding up the expansion of industry (at least 10% annual growth)
- Fiscal consolidation and phasing out of the revenue deficit
- Sustained nurturing of the investment climate to strengthen the growth process.

Support of Substantive Reforms

The Budget sought to address these challenges by articulating the following key objectives:

- Assault on poverty and unemployment
- *Bharat Nirman* – rural connectivity and resurgence
- Agriculture diversification roadmap

- Infrastructure development
- Manufacturing Competitiveness Programme
- Investment initiatives
- Financial sector deepening and strengthening
- Fiscal consolidation through tax reforms and a "calibrated" implementation of FRBM.

While liberal position supported these objectives the size of revenue deficit, as huge as Rs.95,312 crores or 2.7% of estimated GDP at current market prices in 2005-06, was a matter of great concern. In the total expenditure (Revenue plus Capital) of Rs.514,344 crores, revenue receipts were estimated to contribute about Rs.351,200 crores or about 68.2%. Thus, out of every Rs.100 of Central Government's expenditure, almost Rs.30 represents deficit financing, which meant massive borrowings. Even more worrisome is the fact that revenue receipts could support only 78.7% of revenue expenditure. In effect, out of every Rs.100 of day-to-day spending, as much as Rs.22 were to come from borrowings.

Surely, this is a continuation of the deplorable practice over the past many years of an inefficient, unsustainable management of the budget. All the current budgetary indicators suggest that there would be the usual spill-over in the realization of key targets. Not surprisingly, the Finance Minister has admitted his inability to manage the original target of the FRBM Act to phase out revenue deficit by 2007-08.

The Budget contained several welcome features. For example: (a) increased allocations in the Central Plan Outlay for rural development (Rs.24,480 crores in 2005-06 up by 34.4% over 2004-05); (b) Bharat Nirman - the Rural Infrastructure Development Fund (Rs.8,000 crores corpus) encompassing six important programmes covering assured irrigation, road connectivity, drinking water, 60 lakh houses for the poor, electrification of 1.25 lakh villages and 2.3 crore households and telephone connection to over 66,000 villages; and (c) total outlay of Rs.93,200 crores or a hike of 43% in various physical infrastructure projects.

Also, there were several bold initiatives such as to incentivise the States to progress with the introduction of Value Added Tax (VAT) as well as the innovative approach of Special Purpose Vehicle and "Viability Gap Funding" mechanism. The underlying strategy of the Budget was also to achieve growth with stability and equity by leveraging investments in infrastructure through public-private partnership initiatives; enlarging the entitlement for low income groups through social security measures; confidence building of industry through reduction and rationalization of the tax regime, some sector-specific thrusts, reduction in transaction costs and improving productivity through financial sector reforms.

What was missing in the Central Budget was the strategy of implementation of many existing and new initiatives. The compulsions of coalition politics is taking its toll on the pace of economic reforms and distorting its implementation. There are roadblocks in agricultural reforms, labour reforms, privatization/disinvestment of PSUs and relaxation of FDI caps. While the effort to introduce "Outlay-Outcome Budget" was a welcome step, there still remained concerns regarding persistent leakages in social sector expenditures. Besides, the Central Budget has foisted several minor and major irritants (e.g. Fringe Benefits Tax, Banking Cash Transaction Tax, and a proposal to move from EEE to EET system for tax incentives on savings).

In substance, the Budget was good in some respects, but was retrograde when it departed from the path of economic liberalization. Surely, it failed in becoming a "watershed budget" in the true spirit of The Liberal Budget!

While assessing the Central Budget 2005-06, the LB3 has also comprehensively reviewed the expenditure side of Central Government finances. Our analysis has shown the extremely parlous state of the public finances, indicating the rigidities and inefficiencies in government expenditures. The major findings are:

- The percentage of revenue expenditure to total expenditure (excluding State Plans) is at an alarming level and needs to be curtailed if India's public finances are to be restored to health.
- The problems with revenue expenditures also

manifest themselves in the burgeoning and debilitating revenue deficits. These deficits have to be hammered down to zero; in fact, fiscal prudence demands that there should be revenue *surpluses*.

- The flip side of revenue deficits is the problem being experienced on the capital side of the budget. The residual share of capital expenditure is now languishing at less than 10% of total expenditure. In fact, revenue deficits have been funded for almost the last two decades by generating surpluses on the capital account. The "grocery bill" is being paid for by borrowing ever more.

- The most significant drag on the finances of the government is interest payments and subsidies. The former is the direct outcome of past "sins" of profligacy and the latter is the outcome of political economy considerations. Interest payments will fall only if budgets from now on start to generate primary surpluses. Subsidies will not be reduced so long as the government is hostage to powerful interest groups clamouring for undeserved subsidies. It should be clarified that the Liberal position does recognise the need to promote genuine, subsidised welfare enhancing activities, such as basic education and basic health. What is being opposed is the dispensing of subsidies to those who do not deserve these.

- The recommendation of the LB3 is two-fold: One, an increase in the efficiency of government expenditures directed towards the social sector so that the country "gets more bang for its bucks". Two, there should be aggressive privatisation so that the revenues so generated could be deployed for welfare improvements.

Obviously, we have reached a point where there are no easy options left. The UPA government will have to distance itself from the so-called "messiahs" of the poor and honestly commit itself to work for the welfare of those who need it the most.

Liberal Budget 2006-07 – the Strategic Framework

Against this backdrop, it is imperative to set out the strategic and operational framework of the Liberal Budget 2006-07. LB3 reiterates its aim of strategizing India as a global economic power over the period of next ten years, while at the same time coping with the challenges of achieving an equitable society.

Already, there is a growing recognition from the world over that India is a fast growing free market economy with dynamic entrepreneurship, professionalism, scientific and engineering ethos, growing skilled work culture, an emerging competitive manufacturing sector and slowly, but surely, a modernizing farming community. The record of India's economic policy has been remarkably consistent, albeit struggling and slow, in the context of managing the conflicts and contradictions of coalition governance. There is confidence about the stability of the financial system and in the independence of our judicial and regulatory institutions.

Further, the experience of economic reforms abundantly proves that by unleashing initiatives, efforts and enterprise of the private sector there could be radical improvisation of the growth momentum as well as its qualitative dimensions. It must be stressed that the private sector that is implicit, and envisaged in our liberal framework, is not just of corporate enterprises, but also encompasses a whole host of individuals, households and firms, whether in the industrial, farming or services sectors.

The Liberal Budget believes in harnessing and synergizing this vast potential, by strengthening the liberal economic environment, to achieve:

- Long-term annual rate of growth of 8 percent in real GDP;
- Reduction in India's poverty ratio to less than 15% by 2015-16 (against the present ratio of 26%); and
- Sustained absorption of the incremental addition to the labour force through the creation of at least 8 million new jobs every year. In fact, this is the most crucial aspect of the entire reforms process at this point in time in the Indian context.

We are firmly convinced these are achievable targets and over the next decade, there will be substantial change in the socio-economic profile of the country, reflecting positively on quality of life indicators. Consequently, India will also gain recognition in her international comparison of the Human Development Index, along with her achievements on the current dimensions of a knowledge-based economy, and emerging manufacturing and farming competitiveness.

A Seven-Point Strategic Framework

The key basic tenets of LB3 will continue to be (i) effective fiscal governance; (ii) fiscal consolidation and stabilization; (iii) promotion of efficiency and productivity; (iv) acceleration of growth; and (v) promotion of an equitable society. Keeping in view these basic tenets of fiscal policy, as well as the **goals of high growth, poverty reduction and employment generation,** LB3 sets out, among other things, a Seven Point Strategy for Economic Progress:

- First: setting up an Economic Reforms Implementation Authority (ERIA) for facilitating cohesive, participative and speedy implementation of critical economic reforms in a time-bound manner;
- Second: accelerating investments in infrastructure, core manufacturing and agriculture sectors;
- Third: widening considerably public-private partnership in key sectors through the mechanism of Special Purpose Vehicles (SPVs);

- Fourth: further rationalization of the tax structure, with a focussed thrust on a radical reform of indirect taxation;
- Fifth: significant streamlining and simplification of the tax administration;
- Sixth: substantive shift in expenditure management with a view to freezing the growth of revenue expenditure and releasing more resources for employment generating social sector spending; and
- Seventh: aggressive disinvestment and privatization of public sector undertakings (PSUs)

Economic Reforms Implementation Authority
LB3 is greatly concerned with the halting pace of economic reforms in several major areas, already highlighted earlier. Equally distressing is the lack of coordination and cohesion among some of the key Ministries - for example, the Finance Minister vs. Commerce Minister on some key foreign trade policy issues (Duty Exemption Pass Book (DEPB) scheme, or tax incentives for operationalising Special Economic Zones, etc); the Finance Minister vs. Petroleum Minister (on excise and customs duties applicable to petroleum products and their pricing structure). Likewise, there is lack of co-ordination between the Centre and the States on a number of issues, especially on infrastructure development, labour and land policies, judicial and administrative reforms. Besides, there is growing apprehension of increasing confrontation between

the Legislature and the Executive on the one side and the Judiciary on the other, on matters of interpretation in some crucial policy areas.

Therefore, the LB3 recommends the setting up of ERIA as a statutory body, which will have to be headed by the Prime Minister and operationally managed by a Minister with Cabinet rank with powers similar to those available to a Managing Director in a corporate enterprise. Its structure, composition and design can obviously be left to the Prime Minister. It must, however, have sufficient teeth and capable of (a) taking speedy decisions on economic policies; (b) setting out framework of Action Plans for implementation by the authorities concerned, both in the Central and State Governments; (c) making the Action Plan mandatory and subject to continuous review;(d) regularly generating Action Taken Reports from the respective Central Ministries and State governments; and (e) in performing all these tasks be free to draw upon the expertise of the corporate world and NGOs. Thus, the implementation of economic reforms will be the main task of the ERIA.

Acceleration of Investment

LB3 is driven by the conviction that India's growth momentum, as well as its efforts towards securing balanced development, are bogged down by a lack of investment buoyancy for over a decade. Fortunately, there are now signs of improvement in the investment climate. Also, at the macro level, official data suggests that the ratio of savings to

GDP has risen sharply from 23.5% in 2001-02 to 28.1% in 2003-04. Granting the validity of this data, it is the most opportune time to leverage the trend of rising savings to generate the momentum of accelerated investment, especially in infrastructure, core manufacturing and agriculture sectors.

It must be pointed out that in the last ten budgets every single Finance Minister has stressed the key role of infrastructure development in accelerating the overall growth of the economy. Recall the observations of the various Finance Ministers:

- "The state of our infrastructure - particularly power and roads - is very poor. We cannot sustain a 7 percent growth unless we can revitalize these infrastructures. Huge funds are also required for telecom, railways and ports." Mr. P. Chidambaram, Budget Speech, 1996-97

- "The next 10 years will be India's decade of development. To achieve this objective our strategy must encompass the following elements ... ... a sustained assault on infrastructure bottlenecks in power, roads, ports, telecom, railways and airways." Mr. Y. Sinha, Budget Speech, 2000-01

- "But neither in agriculture, nor in industry, shall we be able to attain our objective, if infrastructure, both physical and social, is not rapidly and efficiently developed." Mr. Jaswant Singh, Budget Speech, 2003-04

- "The importance of infrastructure for rapid economic development cannot be overstated. The most glaring deficit in India is the infrastructure deficit." Mr. P. Chidambaram, Budget Speech, 2005-06

ERIA must facilitate the process of acceleration of investment in the infrastructure areas as well as in core manufacturing and agriculture activities.

Mechanism of SPVs

Given the slow progress of investments in the economy in the last decade, LB3 envisages promotion of public private partnership, especially in infrastructure projects. For this purpose, there have already been various models that have become operational in India. What is now necessary is to push them more vigorously. The Finance Minister Mr. P. Chidambaram had announced in the last budget the conceptual framework of Viability Gap Funding (VGF), a detailed formulation of which was announced in July 2005. While welcoming this scheme, LB3 envisages its strengthening through the following measures:

- First, promoting the public-private partnership across the country with the active participation of the states. For this purpose, the Central Government will have to sell the scheme to all the states, and call upon them to create their own structure of funding with their own budgetary resources. Central funding can then be used in catalyzing more investments at the decentralized levels of infrastructure development. To induce the States, there can be a system of shared contributions - 15% coming from the Centre and 10% from the States. VGF could cover 25% of the financial outlay of identified and approved projects.

- Second, VGF should not be restricted to domestic private or public sector investors, but should be made available also to FDI sponsored infrastructure projects.
- Third, the coverage of the scheme should include some core high investment in agriculture and major manufacturing projects, provided the objective project evaluation reveals the gap in their economic or financial viability.
- Finally, the success of the scheme will be judged in terms of how actual disbursements exceed budgetary provisions, and the quality of investments catalysed by the VGF mechanism. With a sound system of evaluation and monitoring of such projects, there is unlikely to be any leakages or misuse of resources.

Reform of Direct and Indirect Tax Structure

LB3 recognize the fact that India's current structure of direct taxes (namely, both personal income and corporate tax rates) is realistic, reasonable and comparable with prevailing international benchmarks. What is, however, necessary is to remove some of the anomalies, correct distortions and build confidence in the long-term stability of the tax policy by preventing retrospective amendments that hurt the interests of tax payers.

LB3 hastens to add, that the Fringe Benefit Tax brought in the last Budget is a retrograde piece of legislation and strongly suggests that this be dropped forthwith.

LB3 sets out a series of suggestions to make tax administration efficient and tax-payer friendly. Besides, it envisages two major policy initiatives for taxing the agricultural income and charging a minimum tax of Rs.1000 from all those who are required to file income tax returns. [The details of the proposals can be obtained from the full document].

In the area of indirect taxes, the LB3 proposes definitive and radical reforms with a view to

(i) rationalizing the incidence of indirect taxes on manufacturing costs;

(ii) enhancing the competitiveness of the manufacturing sector;

(iii) reducing the transaction costs of industry and trade; and

(iv) improving the affordability of manufactured goods to the consumers.

Keeping these objectives in view, the LB3 sets out the following specific proposals:

- First, we must move to a single flat rate of customs tariff at 10 percent on all products with only a few exceptions. There will be two separate negative lists – one with zero duty rate applicable to special items like life saving drugs or medical equipment, capital goods imported by the units in the Special Economic Zones, etc; and the second comprising of high duty rates ranging from 50% to 150% applicable to sensitive goods typically agricultural products, wherein non-tariff barriers are now converted into tariff rates.

- Second, the LB3 is convinced that substantive and enduring contribution to the competitiveness of the Indian economy in general, and manufacturing in particular, can only be accomplished, if the combined incidence of all indirect taxes, both of the Centre (CENVAT) and the States (VAT, and other related taxes, including the local level levies like entry tax and octroi), are aligned with global benchmarks. Various studies have shown that a significant part of the difference between the domestic and international cost structure of most industries is accounted for by high and distorting indirect tax rates. LB3 strongly recommends that the Government should move to a GST regime as proposed by the Kelkar Committee Report.

- Third, LB3 is also convinced that with the implementation of its strategy and consequent acceleration of long-term economic growth to about 8% per annum, there will not only be a restoration of tax buoyancy, but even a substantial increase in tax revenues to GDP ratio of at least 3 to 4 percentage points to, say, around 13 to 14 percent in the coming years from the present levels of approximately 10% at the Central Government level.

Vigorous Disinvestments and Privatisation

LB3 is greatly concerned with the Government's ambivalent and hesitant policy of disinvestments and privatization of Public Sector Enterprises (PSEs). Even a modest objective of raising resources has been virtually suspended by the present Government. Witness: in 2003-04, the Central Government mobilized highest ever revenues of Rs.16,953 crores from PSEs' disinvestments, equivalent of as much as the total of such collections in the previous five years. In 2004-05, revenues from PSEs' disinvestments were reduced to a mere Rs.4,091 crores.

In fact, the Liberal Budget 2004-05 had suggested the strategy of generating at least Rs.35,000 crores and moving up progressively in the subsequent years. Alongside, it also envisaged a system of "ring-fencing" these resources and deploying them for improving the quality of life for the common man in areas , like elementary education, basic health and civic amenities thus reducing the need for raising additional resources for this purpose.

LB3 stresses that even with such modest targets for the forthcoming year, there would be significant gains in the budgetary outlook, provided there are pari passu efforts to "ring-fence" at least one third of such revenues largely for investments in critical infrastructure projects. This would help in stimulating economic growth, thereby facilitating the process of expanding the tax base.

Simultaneously, LB3 is opposed to the UPA Government's strategy of providing continuing budgetary support for restructuring financially weak and loss-making PSEs, such as Hindustan Antibiotics, Indian Telephone Industries, as these will not only be counter-productive, but drain valuable budgetary resources. The real solution in respect of such enterprises lies in full-scale divestment or privatisation as soon as possible.

Key Budgetary Arithmetic:
LB3 has set out its budget estimates for 2006-07, based on the conventional pattern of the Central Budget documents. Given the need for like to like comparison, it is inevitable that we do not disturb the existing structure and composition of the budgetary figures. However, LB3 recommends a comprehensive reform of the budgetary structure, based on the modern accounting practices.

Similarly, LB3 is making a consistent case for doing away with the existing classification of expenditure as Plan Expenditure and Non-Plan Expenditure. This does not serve any useful purpose, and often gives a distorted picture of the budgetary transactions. The most appropriate approach is to have well-defined economic and functional classifications of all Budget transactions, especially government expenditure. From this point of view, it will be necessary to undertake a comprehensive activity-wise classification of the expenditure pattern under a broad-based framework of Developmental and Non-Developmental

Expenditure. For doing so, the Government must appoint a Statutory Expert Committee to review the existing budgetary data and recommend reforms therein, including the prevailing classification of Revenue and Capital Budgets.

Having said this, LB3 highlights the following key features of its estimates for the year 2006-07 (Please see Table II for Key Budgetary Data):

- First, LB3 envisages total expenditure (Revenue + Capital) of Rs.555,000 crores, representing an increase of 8% over the budget estimates of 2005-06. The comparable increase in the previous Budget was a meagre 1.7%. It must, however, be stressed that in the last two or three years the budgetary data has become virtually non-comparable thanks primarily to the substantive impact of the Debt Swap Scheme.
- Second, this total expenditure will be funded through revenue receipts of Rs.410,200 crores (or 73.8% of the total) and capital receipts of Rs.145,300 crores (or 26.2% of the total). LB3 aims at reducing progressively the dependence on the funding of total expenditure from capital receipts.
- Third, the revenue deficit is projected to fall from 2.7% of GDP at current market prices in 2005-06 to 1.5% in 2006-07. Likewise, the ratio of fiscal deficit is projected to decline from 4.3% to 3.3% during this period. LB3 recommends more aggressive phasing out of the revenue deficits.

- Fourth, in terms of resource efforts, the emphasis of LB3 is on raising the gross tax to GDP ratio from 10.6% in 2005-06 to 11.2% in 2006-07. There are limitations on raising the non-tax revenues given the fact that a large number of Central Public Sector Enterprises are loss-making. This increase in the tax ratio is evidently going to be accomplished through better tax administration and the overall buoyancy in tax revenues.

- Fifth, it has been the mission of the LB3 to bring about a sharp cutback in non-Plan Expenditure and raise correspondingly the allocations for Developmental Expenditure. Accordingly, the ratio of Development Expenditure to Total Expenditure will increase from 49.5% in 2005-06 to 52.5% in 2006-07. In particular, the spending on Defence, Interest Payments and Subsidies – the three predominant items of Non-Development Expenditure – will together drop from 7.7% of GDP to 6.6% of GDP. This is the most challenging task in expenditure management.

- Lastly, LB3 believes in a holistic management of the fiscal system, and is strongly of the view that budgetary arithmetic is not an end in itself. What is most important is that the objective criteria of the Liberal position must be reflected not only in the budget figures, but also in the over-all stance and substance of the fiscal policy.

Concluding Observations

The Liberal Budget 2006-07 seeks to send a message that the Indian economy can be steered towards a sustained high growth path of 8% real GDP that will make a decisive impact not only on the health of the fiscal system of the country through radical improvement of investment climate, but also towards achieving our goal of an equitable society by accelerating poverty alleviation and employment creation.

Table I : Post-Reform Domestic Sector Profile (Select Indicators)

Sr. No.	Item	Unit	1990-91/ 1991-92	2005-06 (E)
1.	GDP	(% Change)	1.3	7.5
2.	Industrial Growth	(% Change)	0.6	8.5
3.	Inflation	(% Change)	13.0	5.0
4.	Fiscal Deficit	(% of GDP)	5.6	4.5
5.	Employment in Organised	(Million)	26.7	27.2
6.	Exports	($ Bln.)	18.5	80
7.	Current A/c Balance	(% of GDP)	(-) 3.4	(-)2.0
8.	Forex Reserves	($ Bln.)	0.900	135
9.	External Debt/GDP	(%)	29	16
10.	FDI Inflow	($ Mln.)	100	5,500

Table II : Liberal Budget at a Glance

	(Rs. Crores)	2001-02 (Actuals)	2002-03 (Actuals)	2003-04 (Actuals)	2004-05 (Revised Estimates)	2005-06 (Budget (Estimates)	2006-07 (LBE)
1.	**Revenue Receipts (2 + 3)**	**201,306**	**230,834**	**263,878**	**300,904**	**351,200**	**410,200**
	(2) Tax Revenue (Net to Centre)	133,532	159,425	186,982	225,804	273,466	324,100
	(3) Non-Tax Revenue	67,774	72,323	76,896	75,100	77,734	86,100
4.	**Capital Receipts (5 + 6)**	**162,500**	**180,531**	**207,490**	**204,887**	**163,144**	**145,300**
	(5) Loan Recoveries & Other Receipts	20,049	37,342	84,218	65,656	12,000	16,500
	(6) Borrowings and Other Liabilities	142,51	145,072	123,272	139,231	151,144	128,800
7.	**Total Receipts (1 + 4)**	**363,806**	**411,365**	**471,368**	**505,791**	**514,344**	**555,500**
8.	**Total Expenditure (9 + 10)**	**362,310**	**413,248**	**471,368**	**505,791**	**514,344**	**555,500**
	(9) Revenue Expenditure	301,468	338,713	362,140	386,069	446,512	468,800
	(10) Capital Expenditure	60,842	74,535	109,228	119,722	67,832	86,700
11.	**Revenue Deficit (9 – 1)**	**100,162**	**107,880**	**98,262**	**85,165**	**95,312**	**58,600**
12.	**Fiscal Deficit [8 – (1 + 5)]**	**142,451**	**145,072**	**123,272**	**139,231**	**151,144**	**128,800**
13.	**Primary Deficit @**	**33,495**	**27,268**	**(–)816**	**13,326**	**17,199**	**(–)3,800**
	Deficit Ratios (%) :						
	a) Revenue Deficit to GDP	4.3	4.4	3.6	2.7	2.7	1.5
	b) Fiscal Deficit to GDP	6.1	5.9	4.5	4.5	4.3	3.3
	c) Primary Deficit to GDP	1.5	1.1	0.0	0.4	0.5	(–)0.1
14.	**Derived GDP at Current Market Prices**	**2,329,300**	**2,458,850**	**2,739,388**	**3,094,022**	**3,514,977**	**3,936,700**

The Indian Liberal Group and Project for Economic Education released their Third Liberal Budget for the budget year 2006-07. Unlike the First and Second Liberal Budgets, which were released on the eve of the Union Budgets in 2004 and 2005, the Third Liberal Budget (LB3) has bee prepared three months ahead of the 2006-07 Union Budget in the hope that this exercise would help the Finance Minister to reflect closely on the strategic framework and right policy choices, while formulating the Union Budget for 2006-07).

The text of this booklet is a summarized version of ***"The Liberal Budget 2006-07"*** *- published by the Project for Economic Education and the Indian Liberal Group and authored by a Drafting Group comprising: Mr. S.S. Bhandare (Chairman), formerly Economic Advisor, Tata Services Ltd.; Dr Ajit Karnik, Director and Professor, Department of Economics, University of Mumbai; Mr. Narayan K. Varma, Chartered Accountant; Mr. Kishor Karia, Chartered Accountant; Dr. C.S. Deshpande, Executive Director, Maharashtra Economic Development Council; Mr. Jayraj Sheth, Chartered Accountant; and Mr. Sharad Bailur, Communications and Press Relations, Mumbai. A full version of the publication may be secured from:* ***Project for Economic Education,*** *Army Navy Building, 3rd Floor, 148, Mahatma Gandhi Road, Mumbai 400 001. E-mail: ilg@vsnl.net*

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

-Eugene Black

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