

I. ECONOMIC ENVIRONMENT

(1) OVERVIEW

1. Since the liberalization process began in 1991, India's real GDP has grown at an average annual rate of approximately 6%; it is expected to rise to over 9% in fiscal year 2006/07 (April-March).¹ Growth has been led by services and manufacturing, the two largest sectors, with agriculture growing much more slowly. This impressive economic performance is largely the result of unilateral economic reforms, including liberalization of India's trade and FDI regimes, which began in the early 1990s and have continued during the period under review (2002-07). For example, the average applied MFN tariff has been cut from 32.3% to 15.8%, facilitated by internal tax reform aimed at raising India's relatively low tax/GDP ratio, which is insufficient to finance its developmental needs, including infrastructure. India has not relied solely on unilateral reforms, however; it has become increasingly involved in bilateral and regional trade agreements (RTAs).

2. In the longer term, the Government is aiming for growth of between 8% and 10% per annum; exports are now considered a main engine of growth alongside domestic consumption and investment.² These higher growth rates will require more appropriate macroeconomic policies, especially fiscal policy. They will also require the continuation of ongoing structural reforms aimed, *inter alia*, at further reducing reliance on tariffs as a source of tax revenue, broadening the tax base and cutting tax rates, addressing the lack of infrastructure (notably power, transportation, and telecommunications), the intrusiveness of industrial policy, capital and labour market rigidities, unnecessarily burdensome regulation and red tape together with other impediments to competition; all of these raise the costs of doing business in India, thereby constituting impediments to improved productivity and thus hampering exports and deterring inward FDI.³ Private domestic and foreign investment is being encouraged through private-public partnerships, especially in the development of infrastructure, and relaxation of FDI restrictions.

3. The benefits to the Indian economy of reforms initiated in 1991 have been considerable. High growth has translated into rising per capita incomes. It has also improved social and poverty indicators with infant mortality declining from 68 per 1,000 in the mid 1990s to 58 per 1,000 in 2005, and the percentage of the population living below the national poverty line declining from 36% in 1993/94 to approximately 28% in 2004/05.⁴ Literacy levels, sanitation conditions, and access to clean water have also improved.⁵

¹ According to the 2006/07 Economic Survey GDP growth during 2005/06 and 2006/07 was 9% and 9.2%, respectively.

² In his address to the National Development Council on 9 December 2006, the Prime Minister mentioned that the targeted average annual growth during the 11th Five Year Plan was 9%.

³ Investment Commission (2006).

⁴ The poverty level in India is defined on the basis of calorie intake, which is 2,100 kilocalories in urban areas and 2,400 kilocalories in rural areas. The figures for 1995 are from World Bank (2006). The figures for 2004/05, which are provisional, are provided by the Planning Commission.

⁵ In 2004, 33% of people had access to improved water sources and 5% to better sanitation facilities, an improvement from 14% and 4% in 1990. Furthermore, adult literacy levels over the same period increased from 49% to 61% (World Bank, 2006).

(2) RECENT ECONOMIC DEVELOPMENTS

(i) Economic performance

4. India's economic performance since its previous Review has remained impressive. Annual real GDP growth averaged over 7% between 2001/02 and 2006/07. Growth has been particularly strong since 2003/04, averaging over 8.5%; despite the recent increase in international petroleum prices, GDP growth for 2006/07 is in excess of 9% (Table I.1). Growth has been fuelled by the services sector, which grew by an average of 9.8% over the past four years, led by the trade, hotel, transport, and communications subsectors. The manufacturing sector has also exhibited robust growth over the past fiscal year. By contrast, growth in the agriculture sector remains sluggish owing to, *inter alia*, structural inefficiencies, such as ceilings on land holdings, and the vagaries of the weather.

Table I.1
Selected macroeconomic indicators, 2000-07

Selected macroeconomic indicators, 2000-07							
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07 ^a
National accounts							
	<i>(Percentage change)</i>						
Real GDP (at 1999/00 factor cost)	4.4	5.8	3.8	8.5	7.5	9.0	9.2
Consumption	1.8	5.4	1.2	7.0	6.9	..	..
Private consumption	2.1	6.2	1.6	7.8	6.5	..	..
Government consumption	0.3	1.7	-0.6	2.4	9.2	..	..
Gross fixed capital formation	0.0	5.0	9.9	11.3	9.5	..	..
Exports of goods and non-factor services	15.9	0.2	20.5	25.0	37.9	29.7	..
Imports of goods and non-factor services	8.1	-3.3	16.4	18.6	51.7	32.6	..
Unemployment rate (%)	7.3	..	..	..	8.3	..	..
Prices and interest rates							
	<i>(Per cent)</i>						
Inflation (%age change)							
WPI	7.2	3.6	3.4	5.4	6.4	4.4	..
CPI - industrial workers	3.7	4.3	4.0	3.9	3.8	4.4	..
Deposit rate ^b	8.5-9.0	7.5-8.5	4.25-6.0	4.0-5.25	5.25-5.5	6-6.5	..
Nominal prime lending rate (period average) ^c	11.50	11.50	10.75	10.25	10.25	10.25	..
Money credit (end period)							
	<i>(Percentage change)</i>						
Broad money supply (M3) ^d	16.8	14.1	14.7	16.7	12.3	21.2	..
Credit to private sector	15.8	11.8	18.3	13.0	26.0	32.1	..
Exchange rate							
Rupee/US\$ (financial year - annual average)	45.68	47.69	48.40	45.95	44.93	44.27	..
Real effective exchange rate ^e (%age change)	5.3	-0.1	-4.9	1.5	2.5	5.2	..
Nominal effective exchange rate ^e (%age change)	0.3	-1.8	-6.3	-1.9	-0.7	3.1	..
	<i>(Per cent of GDP, unless otherwise indicated)</i>						
Central government balance							
Current balance	-4.1	-4.4	-4.4	-3.6	-2.5	-2.6	-2.0
Current revenue	9.2	8.8	9.4	9.5	9.8	9.7	10.3
Tax revenue	6.5	5.9	6.4	6.8	7.2	7.6	8.4
Current expenditure	13.2	13.2	13.8	13.1	12.3	12.3	12.4
Capital receipts	6.3	7.1	7.4	7.5	6.1	4.4	3.9
Capital expenditure	2.3	2.7	3.0	3.9	3.6	1.9	1.8
Gross fiscal balance ^f	-5.7	-6.2	-5.9	-4.5	-4.0	-4.1	-3.7
Central government total debt	..	59.9	63.4	62.8	63.8	61.5	62.6
Domestic debt	52.8	56.8	61.0	61.1	61.8	59.6	60.6

Table I.1 (cont'd)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07 ^a
Saving and investment							
Gross domestic savings	23.4	23.5	26.4	29.7	31.1	32.4	..
Public sector	-1.9	-2.0	-0.6	1.2	2.4	2.0	..
Gross domestic investment	24.0	22.9	25.2	28.0	31.5	33.8	..
Public sector	6.9	6.9	6.1	6.3	7.1	7.4	..
External sector							
Current account balance	-0.6	0.7	1.2	2.3	-0.4	-1.1	..
Net merchandise trade	-2.7	-2.4	-2.1	-2.3	-4.9	-6.4	..
Merchandise exports	9.9	9.4	10.6	11.0	12.2	13.1	..
Merchandise imports	12.6	11.8	12.7	13.3	17.1	19.5	..
Services balance	0.4	0.7	0.7	1.7	2.2	3.0	..
Capital account	1.9	1.8	2.1	2.8	4.0	2.9	..
Direct investment	0.7	1.0	0.6	0.4	0.5	0.6	..
Balance-of-payments	1.3	2.5	3.3	5.2	3.7	1.8	..
Terms of trade (1978/79=100)	128.1	125.4	113.6	123.4	124.0	90.0	..
Merchandise exports (%age change)	27.7	2.6	21.9	16.9	25.6	22.0	..
Merchandise imports (%age change)	10.2	1.4	16.2	17.8	45.3	30.3	..
Service exports (%age change)	9.4	9.6	22.9	22.7	57.3	40.5	..
Service imports (%age change)	32.1	-1.2	25.7	-7.2	62.6	33.4	..
Foreign exchange reserves ^g (US\$ billion, end-period)	39.6	51.0	71.9	107.4	135.6	145.1	..
in months of imports	8.2	10.9	13.4	16.1	13.7	11.1	..
Total external debt (US\$ billion; as at end-March)	101.3	98.8	104.9	111.6	123.2	126.4	..
Debt service ratio ^h	16.2	13.6	16.0	15.9	6.1	10.2	..

.. Not available.

a Provisional.

b Refers to the deposit rates of five major public sector banks of maturity of one to three years, as at end-March.

c Relates to States' bank prime lending rate, which is the benchmark interest rate for the various categories and classes of advances granted by the bank.

d Including currency with the public, other deposits with the RBI, demand deposits and time deposits.

e Six-currency trade based weight (including the EURO, Japan, United States, United Kingdom, Hong Kong and China).

f Revenue receipts plus capital receipts (not including borrowing and other liabilities) minus total expenditure.

g Excluding gold, SDRs (Special Drawing Rights) and Reserve Tranche Position in IMF.

h Including debt-servicing on non-civilian credits

Source: Reserve Bank of India; Ministry of Finance (2007), *Economic Survey 2006/07 and Union Budget 2007/08*; and data provided by the authorities.

5. Services continue to be the largest contributor to GDP; the sector's share increased from 50% in 2000/01 to over 54% in 2005/06, while the share of manufacturing has remained relatively stable at between 15% and 16% of GDP. By contrast, the share of agriculture declined from around 24% to 18.3% of GDP during the period (Table I.2).

6. Growing domestic demand together with increasing commodity and oil prices have resulted in inflation, as measured by the Wholesale Price Index (WPI), rising during the period under review. However, the Government has contained it within its stipulated 5.5% target, primarily because higher oil prices have not been completely passed through to consumers.⁶ The IMF estimates that petroleum prices are undervalued by 40%; the bulk of the shortfall is provided as subsidies, which are borne by

⁶ RBI (2006). During the period under review, the WPI breached the targeted inflation in 2004/05, when it was 6.4%; it came down to 4.4% in 2005/06 and has averaged 4.9% annually during the period under review. However, on 27 January 2007, WPI was recorded at 6.6%, again breaching the official target.

public sector oil marketing companies (OMC's).⁷ While international prices have risen, domestic prices have not following suit, and the subsidy has increased steadily, from an estimated 0.5% of GDP in 2003/04 to over 1% of GDP in 2005/06.⁸ Inflation is also somewhat suppressed because basic food prices and electric power rates are subsidized by the Government.

Table I.2
Basic economic and social indicators, 2000-06

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Real GDP at factor cost (Rs billion, 1999/00 prices)	18,647.7	19,729.1	20,477.3	22,225.9	23,896.6	26,045.3
Real GDP at market prices (Rs billion, 1999/00 prices)	20,308.7	21,366.3	22,162.6	24,022.5	26,022.3	28,424.8
Current GDP at factor cost (Rs billion)	19,254.2	21,001.9	22,653.0	25,494.2	28,559.3	32,509.3
Current GDP at market price (Rs billion)	21,023.8	22,810.6	24,580.8	27,654.9	31,266.0	35,671.8
Current GDP at factor cost (US\$ billion)	421.5	440.4	468.1	554.8	635.6	734.3
Current GDP at market price (US\$ billion)	460.2	478.3	507.9	601.8	695.9	805.7
GDP per capita at current market price (Rs)	20,631.7	21,975.5	23,299.4	25,773.4	28,684.4	32,223.8
GDP per capita at current market price (US\$)	451.6	460.8	481.4	560.9	638.4	727.8
<i>Annual percentage change</i>						
GDP by economic activity at constant 1999/00 prices						
Agriculture, forestry, and fishing	-0.2	6.3	-7.2	10.0	0.0	6.0
Mining and quarrying	2.4	1.8	8.8	3.1	7.5	3.6
Manufacturing	7.7	2.5	6.8	6.6	8.7	9.1
Electricity, gas, and water	2.1	1.7	4.7	4.8	7.5	5.3
Construction	6.2	4.0	7.9	12.0	14.1	14.2
Services	5.7	7.2	7.4	8.5	9.6	9.8
Trade, hotels, transport and communication	7.3	9.1	9.2	12.1	10.9	10.4
Financing, insurance, real estate, and business services	4.1	7.3	8.0	5.6	8.7	10.9
Community, social, and personal services	4.8	4.1	3.9	5.4	7.9	7.7
<i>Per cent</i>						
Share of main sectors in current GDP						
Agriculture, forestry, and fishing	23.4	23.2	20.9	20.9	18.8	18.3
Mining and quarrying	2.4	2.3	2.8	2.5	3.0	2.8
Manufacturing	15.6	15.0	15.3	15.2	15.9	16.0
Electricity, gas, and water	2.4	2.3	2.4	2.2	2.1	2.0
Construction	5.8	5.8	6.0	6.2	6.5	6.8
Services	50.5	51.5	52.7	52.9	53.7	54.1
Trade, hotels, transport, and communication	22.3	22.8	23.3	23.9	25.0	25.4
Financing, insurance, real estate, and business services	13.2	14.0	14.7	14.7	14.5	14.3
Community, social, and personal services	15.0	14.8	14.8	14.3	14.3	14.4
Share of sector in total employment^a						
Agriculture, hunting, and fishery	5.1	5.2	4.9	5.2	..	..
Mining and quarrying	3.6	3.4	3.4	3.4	..	..
Manufacturing	23.7	23.2	22.9	22.2	..	..
Electricity, gas, and water	3.5	3.6	3.5	3.6	..	..
Construction	4.1	4.1	4.0	3.7	..	..

Table I.2 (cont'd)

⁷ To stem the losses incurred by these OMCs, petroleum prices were increased in June 2006; the pass through of higher prices to consumers was restricted to 12.5% with the rest of the burden being shared between the Government and the OMCs. However, as international oil prices have come down since then, domestic petroleum prices have also been reduced, most recently in February 2007.

⁸ IMF (2006), and Ministry of Petroleum and Natural Gas (2006).

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Services	60.0	60.6	61.3	62.0	..	..
Wholesale and retail trade	1.8	1.8	1.8	2.0	..	..
Transport, storage, and communication	11.3	11.2	11.3	11.2	..	..
Financing, insurance, real estate, etc.	5.9	5.9	6.0	6.7	..	..
Public administration and defence and other services	41.1	41.6	42.2	42.1	..	..
<i>Memorandum^b</i>						
Birth rate (per 1,000)	26.1	25.4	25.0	24.8	..	23.8
Life expectancy at birth	63.3	63.3	63.7	63.3	..	..
Infant mortality rate (per 1,000 live births)	69.0	67.0	67.0	63.0	..	58.0
Adult illiteracy rate	42.8	42.0	38.7	39.0	..	..

.. Not available.

a Organized sector employment only.

b Based on calendar year: 2000/01 should read 2000.

Source: Ministry of Finance (2006), *Economic Survey 2005/06*; Reserve Bank of India; Human Development Indicators.

7. Strong domestic demand and rising oil prices have also resulted in a widening trade deficit, pushing the current account into deficit in 2004/05 (currently 1.1% of GDP) (Table AI.1). The current account deficit reflects the extent by which gross domestic investment exceeds gross domestic saving. During the period under review, public investment was consistently greater than public sector savings; however, private sector savings were able to finance government investment as private investment was weak resulting in a current account surplus (during 2001/02-2003/04).

8. Despite the falling fiscal deficit, the current account deficit increased during 2004/05 and 2005/06 on account of a pick-up in private investment, which was in part funded through the utilization of reserves.⁹ However, foreign exchange reserves, continued to show robust growth, increasing from US\$55 billion in 2002 to US\$185 billion in February 2007. The latter figure is equivalent to over 60 weeks of imports and over 17 times short-term public and private debt.¹⁰

9. With unemployment rising (official figures show a rise from 7.3% in 2000/01 to 8.3% in 2004/05) and labour productivity in agriculture, the largest employer, only one-sixth of the level in the rest of the economy (Box I.1 and Table I.3), India faces a dilemma. An estimated 10 million persons are expected to join the labour market each year, and as the main driver of recent economic growth is services, which is relatively less labour intensive and possibly more skill intensive than other sectors, there is a need both to raise skill levels (through education and training) and to facilitate employment opportunities for the less-skilled in labour-intensive activities.¹¹ The approach paper to the 11th Five Year Plan also suggests that appropriate policies must be pursued to ensure that growth is broad based, especially addressing the problems of rural areas as envisaged in the Common Minimum Programme of the current Government. This is especially urgent, given recent estimates of rising income inequality.¹²

⁹ This is reflected in the decline in the growth rate of reserves.

¹⁰ The import cover is based on 2005/06 balance-of-payments data from the RBI while the short-term debt coverage is based on September 2006 numbers in Ministry of Finance (2007).

¹¹ It was suggested in a speech by the Deputy Chairman of the Planning Commission that the reduction in public sector employment has not been offset to the extent expected by increased job opportunities in the private sector. Viewed at: <http://www.planningcommission.nic.in/aboutus/speech/spemsa/msa048.pdf>

¹² The Gini coefficient index measures income inequality, where an index of zero represents perfect equality, and 1 perfect inequality. According to Planning Commission estimates based on per capita consumption, the Gini coefficient rose from 0.26 in 1999/00 to 0.3 in 2004/05 for the rural population and from 0.34 to 0.37 for the urban population.

Box I.1: Total factor productivity in India

Total factor productivity (TFP) reflects the efficiency with which factors of production are used, and is thus a key determinant of an economy's performance, especially its international competitiveness. TFP should be distinguished from labour productivity (that is, the amount of output per employee), which is reflected in wage rates and thus living standards. Among the main sources of improvement in labour productivity are growth in investment, which increases the amount of capital that employees have to work with, and growth in TFP. In the absence of accompanying improvement in TFP, however, higher labour productivity can only be achieved at the expense of lower capital productivity. One of the most important sources of TFP growth in the long run is technological progress.

Average annual output growth in India increased from 4.5% during the period preceding the reforms of 1991 to 6.5% during 1993-04. Of this 2 percentage point increase, 1.2 points were attributable to improved TFP, which more than doubled from an average annual of 1.1% during 1978-93 to 2.3% during the period 1993-04. The rest of the rise was largely due to increased investment. Improved TFP contributed to roughly half of the increase in labour productivity, which almost doubled between the two periods; the rest of the increase was due mainly to higher investment. Improved TFP was also largely responsible for the substantial increase in the rate of growth of capital productivity.

Growth in both output and TFP has been much faster in the services sector than in industry (where performance has seemingly been hampered by, *inter alia*, rigid labour laws and inadequate infrastructure). By contrast, growth in output and TFP in agriculture has slowed (possibly owing to weather and other natural factors). It follows that the shifting of resources, especially labour, from agriculture, where two thirds of the labour force is currently employed, to the more productive services and industry sectors would contribute to faster overall growth in output and TFP in the economy as a whole.

Source: WTO Secretariat based on Bosworth B. and Collins S. (2007), "Accounting for Growth: Comparing China and India", *Economics of Developing Countries Papers*, January.

Table I.3
Total factor productivity in India, 1978-04
(Annual change, %)

	Overall		Agriculture		Industry		Services	
	1978-93	1993-04	1978-93	1993-04	1978-93	1993-04	1978-93	1993-04
Output	4.5	6.5	2.7	2.2	5.4	6.7	5.9	9.1
Employment	2.1	1.9	1.4	0.7	3.3	3.6	3.8	3.7
Capital	1.0	1.8	0.2	0.7	1.4	1.7	0.3	1.1
Land	-0.1	0.0	-0.1	-0.1	n.a.	n.a.	n.a.	n.a.
Education	0.3	0.4	0.2	0.3	0.4	0.3	0.4	0.4
TFP	1.1	2.3	1.0	0.5	0.3	1.1	1.4	3.9
Labour productivity	2.4	4.6	1.3	1.5	2.1	3.1	2.1	5.4
Capital productivity	1.8	2.4	1.7	0.5	1.4	2.2	3.5	5.5

n.a. Not applicable.

Source: Bosworth B. and Collins S. (2007), "Accounting for Growth: Comparing China and India", *Economics of Developing Countries Papers*, January.

(ii) Macroeconomic policies**(a) Monetary policy**

10. Monetary policy is the responsibility of the Reserve Bank of India (RBI).¹³ Although there is no explicit mandate for price stability, the objectives of monetary policy in India are to maintain price stability and ensure adequate flow of credit to the productive sectors of the economy. The Reserve Bank is committed to ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations. Of late, considerations of financial stability have assumed greater importance in view of the increasing openness of the Indian economy and financial sector reforms.

11. There has been a shift in emphasis from targeting reserves via the cash reserve ratio (CRR) to targeting interest rates through open market means. The principal instrument used by the Central Bank is the liquidity adjustment facility (LAF), which enables the RBI to adjust short-term liquidity through repo and reverse repo auctions.¹⁴ To dampen the expansionary impact of net foreign assets (NFA) growth, the RBI sterilized foreign inflows through the market stabilization scheme (MSS). Under the MSS, the RBI auctions securities on behalf of the Government and keeps the equivalent cash balance in a special account.¹⁵

12. Following a period of supportive monetary policy with an emphasis on maintaining easy liquidity conditions in 2002/03 to foster growth, inflationary pressure has risen, driven by rising international commodity prices and increased demand, prompting the RBI to raise interest rates.¹⁶ The RBI has periodically raised the reserve requirement and the reverse repo rate (5.75% and 6%, respectively, in February 2007), resulting in the overnight call money rate rising to 17% in December 2006 a nine-year high.¹⁷ According to the authorities, the nominal prime lending rate is currently at 11.0%-11.5%, which translates into a relatively high real (adjusted for WPI) interest rate ranging from 6% to 7%.

13. In July 2006, the Governor of the RBI noted a continued need to maintain tight monetary policy conditions given continued strong demand and surplus liquidity.¹⁸ The RBI signalled the same by raising the repo rate by 25 basis points in November 2006 and January 2007; this is seen as a move to encourage banks to increase their deposit rates, which should result in higher savings and a slow down in domestic credit demand.¹⁹ In addition, domestic credit growth has raised concerns about asset quality and the requisite provisioning; in this regard, the RBI has raised risk weights on comparatively high risk areas, such as real estate and equities/financial instruments.²⁰ Moreover,

¹³ The RBI was set up on 1 April 1935 under the Reserve Bank of India Act, 1934.

¹⁴ The LAF was introduced in June 2000. The repo rate is the rate at which the RBI lends money to banks, while the reverse repo rate is the return earned by banks on funds deposited with the RBI.

¹⁵ MSS was initiated in March 2004, and the ceiling on the MSS account is currently Rs 800 billion.

¹⁶ Interest rate increases started in mid 2004.

¹⁷ The Government plans raise the CRR by a further 25 basis points in March 2007.

¹⁸ The easing of liquidity conditions after some tightening in December 2005-March 2006 is attributed mainly to a reduction in Central Government surplus cash balances with the RBI and the RBI's purchases of foreign exchange (RBI, 2006c).

¹⁹ Money supply growth is 21%, and growth in bank credit is in excess of 30% against respective targets of 15.5% and 20%.

²⁰ IMF online information. Viewed at: <http://www.imf.org/external/country/ind/rr/econnews/2007/013007.pdf>.

higher prices of primary food products and industrial raw materials have been putting pressure on inflation, maintaining the need for tighter monetary policy in the coming period.²¹

(b) Exchange rate policy

14. The rupee has been subject to a managed float since 1993, with the exchange rate determined in the interbank market. The exchange rate policy in recent years has been guided by the broad principles of monitoring and flexible management of exchange rates, without a fixed or pre-announced target or band, coupled with the ability to intervene when necessary. The currency of intervention is usually the U.S. dollar. Between 2001/02 and 2003/04, India had a current and capital account surplus, which created pressure on the exchange rate to appreciate. With the current account recording a deficit in 2004/05 and 2005/06, the exchange rate has depreciated.

15. The nominal effective exchange rate (NEER) depreciated between 2001/02 and 2004/05 as the both the U.S. dollar and the rupee depreciated against other currencies in India's NEER basket, before appreciating in 2006.²² On the other hand, the real effective exchange rate (REER), which is inflation adjusted, has been appreciating since 2003/04 as inflation in India has been faster than in those countries whose currencies comprise India's REER basket.²³

(c) Fiscal policy

16. Despite moderate tax rates, the pervasiveness of incentives is such that the Central Government's tax revenues net of states' shares are only 8.4% of GDP (Table I.4); this would appear to be insufficient to finance India's developmental needs, including physical infrastructure, education, health, and social programmes. (State governments collect additional tax revenues equivalent to another 8.8% of GDP.²⁴) Spending by Central and several state governments is constrained by legislation requiring them to cut their fiscal deficits, which together amount to over 6% of GDP. The consequent borrowing has resulted in public debt equivalent to 76% of GDP, which has contributed to high real interest rates to the detriment of private investment. Fiscal constraints have prompted, *inter alia*, measures to improve fiscal transparency in public finances, efforts to achieve greater value for money in public expenditure programmes, including government procurement, and have contributed to major tax reform over the past few years, which should broaden the internal tax base and allow cuts in tariff, if not tax, rates.

17. For much of the period under review, fiscal policy has been conducted within the framework of the Fiscal Responsibility and Budget Management Act (FRBMA), passed in 2003. The Act calls for the Central Government to take appropriate measures to reduce the fiscal and revenue deficits so as to eliminate the revenue deficit by 31 March 2009.²⁵ It also required the Central Government to specify the annual targets for these reductions up to 31 March 2009 as well as measures to make the process more transparent (Box I.2).²⁶ The Government established a Task Force on Implementation

²¹ RBI (2006e).

²² The NEER and REER baskets comprise the U.S. dollar, euro, yen, pound sterling, HK\$, and the renminbi.

²³ Initially the rupee appreciated against the U.S. dollar, however this did not offset its depreciation against other currencies in its NEER basket resulting in the NEER depreciating.

²⁴ Ministry of Finance (2007), Budget estimates.

²⁵ The FRBM Bill originally envisaged elimination of the deficit by 31 March 2006. The Act passed by Parliament changed this to 31 March 2008, and it was further changed to 31 March 2009 through an amendment to the Act in 2004.

²⁶ In order to prevent the further build-up of government liabilities, the Act prohibits the Central Government from borrowing from the RBI except to meet temporary cash deficits during the financial year.

of the FRBM Act, which recommended, *inter alia*, measures to increase government revenue, such as through a widening of the tax base and better tax compliance in order to meet the Act's fiscal targets. The Central Government's fiscal and revenue deficits have declined since the FRBMA was passed (Table I.1).²⁷ The fiscal deficit fell to 4.0% of GDP in 2004/05, but then rose to 4.1% the following year owing to a "pause" in fiscal adjustment to meet the increased expenditures recommended by the Twelfth Finance Commission (Box I.2), and then fell to 3.7% of GDP in 2006/07. The Government expects further reductions in the fiscal and revenue deficits to be achieved through better tax compliance and improved efficiency of the tax administration. On the expenditure front, the Government plans to improve management as well as limit the growth in non-development expenditure.

Box I.2: Fiscal Responsibility and Budget Management reforms

The Fiscal Responsibility and Budget Management Act, 2003, requires the Central Government to gradually reduce the fiscal deficit and eliminate its revenue deficit by 31 March 2009. The Government must fix annual targets and outline the path it intends to take to meet these targets. The revenue and fiscal deficits must be reduced by at least 0.5% and 0.3% respectively, annually, and the Central Government's fiscal deficit reduced to below 3% by 31 March 2009.

The Act also made changes to enhance transparency in the implementation of these reforms and in the Government's medium-term fiscal policy. Three statements must be submitted to Parliament every year: the Macroeconomic Framework Statement, a Fiscal Policy Strategy Statement, and a Medium Term Fiscal Policy Statement. The Macroeconomic Framework Statement defines the background against which fiscal policy is formulated including details about economic growth, and fiscal and external balances; the second report specifies policy measures on taxation, expenditure, subsidies, administered prices, and borrowings; and the third presents three-year rolling targets for fiscal indicators, including underlying assumptions.

The Act also requires the Minister of Finance to review every quarter the trends in receipts and expenditures in relation to the Budget and place these before Parliament. The Minister must explain any shortfall in revenue or excess of expenditure over the levels set in the Fiscal Policy Strategy Statement during any period in the financial year and any remedial action to be taken.

State finances have traditionally been problematic. Aggregate debt remains over 300% of state revenues (33% of GDP), with some states registering debt ratios of up to 100%. The Twelfth Finance Commission, which submitted its report in 2004 (a Finance Commission must be appointed once every five years to determine revenue sharing between the Centre and states), recommended a transfer of resources from the Centre to the states, and set out a path to be followed by the states on fiscal responsibility and reduction of the combined debt-GDP ratio by 2009/10. The Central Government has accepted the recommendations, which involve a total transfer from the Centre to the states of Rs 7,557.5 billion.

Source: Fiscal Responsibility and Budget Management Act, 2003.

18. Given the limited scope for reducing expenditure, especially in the face of rising infrastructure and social expenditures, the authorities have focused on increasing revenue, especially through tax reform, notably a broadening of the tax base.²⁸ As a result, during the period under review, tax revenues grew at an annual rate of approximately 20%, primarily on the back of direct taxes (especially corporate taxes) owing to implementation of the Task Force recommendations. As a

²⁷ A revenue deficit arises when current expenditures are in excess of current revenues. However, when capital/investment receipts and payments are included, the resulting deficit (or surplus) is known as the fiscal deficit (surplus).

²⁸ For example, the Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act noted that India's tax-to-GDP ratio was one of the lowest among 51 comparable economies (GDP above US\$100 billion on a PPP basis), and was therefore a central feature of India's fiscal problem (Ministry of Finance, 2003).

result, direct taxes now account for a higher percentage of total tax revenue and GDP than indirect taxes. The share of indirect taxes has also fallen on account of lower import tariffs (although higher import volumes may have partly offset this). In addition, the share of excise taxes has also come down significantly, although they still account for over 25% of tax revenues (Table I.4).

Table I.4
Central Government's tax revenue, 2000-07
(Rupees billion and per cent)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07 ^a
Total tax revenue^b (Rs billion)	1,886.0	1,870.6	2,162.7	2,543.5	3,049.6	3,661.5	4,678.5
(per cent of GDP)	(9.0)	(8.2)	(8.8)	(9.2)	(9.8)	(10.3)	(11.4)
Net of states' share (Rs billion)	1,366.6	1,335.3	1,585.4	1,869.8	2,247.1	2,702.6	3,459.7
(per cent of GDP)	(6.5)	(5.9)	(6.4)	(6.8)	(7.2)	(7.6)	(8.4)
<i>(Per cent of total tax revenue)</i>							
Direct taxes	36.2	37.0	38.4	41.3	43.3	43.8	47.6
Corporation tax	18.9	19.6	21.3	25.0	27.1	27.7	31.3
Personal income tax	16.8	17.1	17.0	16.3	16.2	16.5	17.6
Wealth tax	0.1	0.1	0.1	0.1	0.0	0.1	0.1
Indirect tax	62.9	62.1	60.7	57.9	56.1	54.5	52.1
Customs	25.2	21.5	20.7	19.1	18.9	17.8	17.5
Union excise duties	36.3	38.8	38.1	35.7	32.5	30.4	25.1
Service tax	1.4	1.8	1.9	3.1	4.7	6.3	8.2

a Provisional.

b Includes direct and indirect taxes as well as taxes of Union Territories and "other" taxes.

Source: Ministry of Finance (2006) and (2007), *Economic Survey 2005/06*, and *2006/07* and *Union Budget 2007/08*.

19. The Government has managed to keep expenditure growth mostly within budget targets. Consequently, total (current and capital) expenditure as a percentage of GDP fell from over 16% in 2002/03 to 14.2% in 2005/06 and is estimated to remain the same in 2006/07. The Government was able to reduce the proportion of debt servicing as a percentage of GDP by retiring some of its more expensive debt and as a consequence of lower interest rates. However, non-plan expenditure remains significant due to defence, wages and pension payments.²⁹ With regard to plan expenditure, the Government consolidated its spending on the eight flagship schemes (allocations budgeted to rise by 43% in 2006/07).³⁰ Despite the above, the Government needed to resort to quasi-fiscal measures to meet the revenue deficit target, most notably the oil bonds that financed a portion of the oil subsidy, as well as including privatization/disinvestment receipts as current revenue. Additionally, the Government has discontinued loan assistance to state governments to finance their annual plans as recommended by Twelfth Finance Commission; these loans are now to be raised directly by the states. As a result, capital expenditure as a percentage of GDP has declined from 3.0% in 2002/03 to 1.8% in 2006/07 (Table I.1).

20. The central and state governments guarantee loans to meet some of their capital expenditures as well as to ensure food security. Contingent liabilities of the Government and the states came down

²⁹ Plan expenditure is incurred on account of the government projects/schemes under the five-year plans; non-plan expenditure includes other budgetary spending, such as defence, subsidies salaries, pensions, and debt servicing

³⁰ The eight flagship programmes are: Sarva Siksha Abhiyan, Mid Day Meal Scheme, Rajiv Gandhi Drinking Water Mission, Total Sanitation Campaign, National Rural Health Mission, Integrated Child Development Services, National Rural Employment Guarantee Scheme, and Jawaharlal Nehru National Urban Renewal Mission.

from 11.5% in 2002 to 9.9% in 2005 due to: a reduction in the states issuing guarantees, and an annual cap of 0.5% of GDP on central government guarantees (stipulated in the FRBM).

(iii) Structural reform

(a) Tariff and tax reform

21. During the period under review, tariffs and other indirect taxes as well as direct taxes have undergone significant reform. The overall average applied MFN tariff fell from over 32% in 2001/02 to almost 16% in 2006/07. Nonetheless, India's import tariffs are still rather high and thus a major impediment to its exports, although tariff exemptions and drawbacks have been granted for certain goods and uses with a view to, *inter alia*, mitigating the adverse impact of tariffs on exports.

22. With regard to indirect taxation, a value-added tax was implemented by 30 states at the end of December 2006. The VAT covers most goods (except essential products). Furthermore, a larger number of services are also now subject to a tax rate of 12%. It is envisaged that the VAT, services tax and central excise duty (CENVAT) will be merged into a more general goods and services tax (GST). In addition, the Government intends to reduce and eventually eliminate the large number of exemptions that erode the tax base, but has hitherto been hesitant to implement these reforms.

23. The income tax regime has been made more neutral by reducing/removing some tax incentives. Other measures include an increase in thresholds in conjunction with a decrease in rates, a consolidation of savings-related exemptions and better enforcement, all of which have helped to increase direct tax collected. Despite these reforms, a large number of exemptions and tax holidays granted to investors have been maintained and even expanded with the establishment of the SEZs, and these have the potential to erode the tax base.³¹ However, these tax incentives have been somewhat offset by the minimum alternate tax (MAT), which was raised from 7.5% to 10% in 2006 in an attempt to increase the number of taxpayers. At the same time, the MAT further complicates the tax system, thereby raising administration and compliance costs.

(b) Infrastructure

24. At the time of the previous Review, it was noted that one of the major bottlenecks to faster economic growth and productivity was a lack of infrastructure. This has been recognized by the authorities and several steps have been taken to address the problem, including improved transportation (roads, port facilities, and shipping), and continued reform to increase efficiency in power and telecommunications. Recognizing the inadequacy of public funding for infrastructure, the Government has also encouraged private-public partnerships to try and increase investment, including FDI, in infrastructure-related sectors. At the same, it has relaxed limits on FDI in these sectors. Measures concerning power include the promulgation of the Electricity Act 2003, which allows private ownership in generation, distribution, and trading of electricity, as well as metering of all electricity sold. However, technical and commercial losses remain high and electricity shortages widespread. With regard to telecommunications, barriers to entry have been eased: entry and licence fees have declined, "roll-out" obligations abolished, and the limit on foreign investment increased. As a result, there has been a significant increase in telecommunication penetration, especially mobile telephony.

³¹ Tax holidays are incorporated in the SEZ Act 2005. The direct cost of holidays (in terms of revenue forgone) for regions, exports, and the construction sector alone has been estimated at some 0.5% of GDP (IMF, 2005a).

25. Improvements in the transport sector have been, *inter alia*, in the form of additional trains for freight, construction of a dedicated freight corridor, and encouraging private sector companies to operate their own freight trains. Roads remain a high priority: the Government is encouraging public private partnerships and emphasising road development through the National Highway Development Programme (NHDP) (Chapter IV).

(c) Industrial policy

26. During the review period, India's industrial policy, which includes reservations for the public and small-scale sectors and industrial licensing requirements has, by and large, become less restrictive. Currently, three industries are now confined to the public sector and industrial licensing is required for five industries (six in 2002). Products reserved for manufacture by the small-scale sector have also declined from 799 to 326. Subsidies, together with the lack of reform of the public sector, which includes a number of loss-making state-owned enterprises (SOEs) remain a major drain on public finances. In addition, there are implicit subsidies especially through subsidization of key services, such as electricity and water. Certain SOEs identified for closure on the basis of being economically non-viable continue to operate, and the privatization programme has been put on hold.

(d) Financial sector and capital market reforms

27. Financial services reforms have focused on the banking sector and are aimed at providing public banks (which still dominate the sector) with greater autonomy, so as to improve their efficiency. Furthermore, foreign banks (as of 2005) have been allowed to set up wholly owned subsidiaries in India as well as offshore banking units in SEZs. Amendments to the Banking Act, which are under consideration, would raise the current limit on FDI in domestic banks (set at 49%) to 74% before the scheduled date of 2009, and lift the 10% limit on voting rights. As a result of reforms undertaken, non-performing loans continue to decline, and the aggregate capital adequacy ratio has risen during the period under review. To mitigate risks, the authorities are currently planning to start implementation of Basel II in 2007 (Chapter IV). Cooperative banks, however, which are not subject to direct supervision by the Reserve Bank, remain poor performers with non-performing assets among certain rural cooperative banks reaching 35% of total loans.³² On the other hand, restrictive legislation, such as priority sector lending, continues to adversely affect the performance of banks, leads to problems in recovering assets, and perpetuates weak accounting practices of firms in the priority sector (such as SMEs).

28. Efforts to create a well functioning capital market are being pursued by the Securities and Exchange Board of India (SEBI), the securities market regulator. The securities exchanges have been corporatized and are in the process of being demutualized. Furthermore, all listed companies are required to adopt corporate governance requirements specified in the listing agreement by January 2006.

(e) Labour market reform

29. Among the major problems facing India today are unemployment and underemployment together with job creation. It is estimated that around 100 million new job seekers will enter the labour market over the next decade.³³ With the labour market appearing to be relatively less flexible than in other countries in the region, it is not clear whether the required jobs can be created without

³² According to the authorities, the ratio of non-performing loans to outstanding loans for the rural cooperative banks as a whole stood at 24.4% as of March 2005.

³³ IMF (2005b).

reform of India's labour laws. Some piecemeal changes have been made, such as some states allowing greater flexibility in labour policies in the SEZs, but more general reform is needed.

30. Part of the problem in implementing a more flexible labour market policy is the lack of a social safety net. The National Common Minimum Programme (NCMP) acknowledges that some changes in labour laws may be required, provided they fully protect the interests of workers and families and take place after consultation with trade unions.

31. The Government has taken certain initiatives, such as upgrading technical institutes so that they can produce a multi-skilled workforce, and training so that existing skills can be adapted to changes in technology. A skills development initiative through public-private partnerships is to be started; it is envisaged that this would provide training to a million workers in the first five years and a million workers annually thereafter.

(f) Competition policy reform

32. In order to promote competition, the Competition Act was enacted in 2002. The Competition Commission, formed under the Act, was to work as India's anti-trust body. However, implementation of the Act has been delayed due to legal challenges to certain provisions. The Act will replace the Monopolies and Restrictive Trade Practices Act.

(3) DEVELOPMENTS IN TRADE

(i) Composition of trade in goods and services

(a) Goods

33. Merchandise trade as a percentage of GDP increased from roughly 21% in 2001/02 to approximately 33% in 2005/06, reflecting the greater openness of India's goods markets. Imports have grown at a faster pace than exports, leading to a widening trade deficit. The strong growth of the manufacturing and services sectors is reflected in the import bill; shares of telecommunications equipment, office machines, and aircraft have risen appreciably. Despite the rise in international oil prices, the share of fuel imports declined marginally; nonetheless, they remain a major import item accounting for 33.7% of total imports (Table AI.2).

34. Whereas the share of manufactures in exports has declined, that of petroleum and iron ore doubled in response to higher international commodity prices as well as increased domestic refining capacity (Table AI.3). Among manufactures, driven by higher commodity prices, the share of iron and steel products has risen.³⁴ The share of automobile exports has also risen as India strives to become a regional hub for the manufacture and export of small cars and motorcycles. On the other hand, the share of textiles and clothing (T&C) exports has fallen (Chart I.1).³⁵

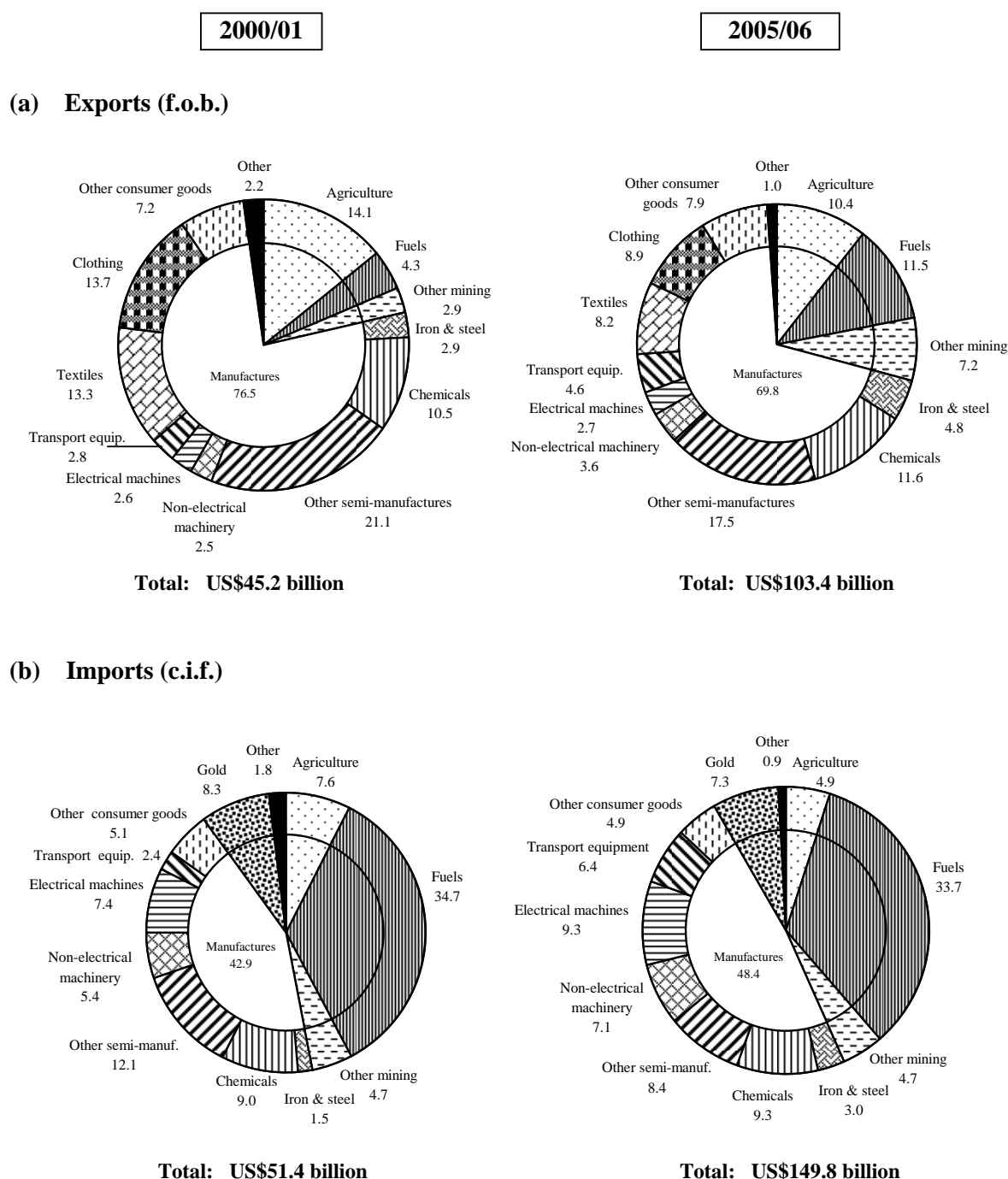
³⁴ Share of iron and steel exports as a percentage of total exports fell in 2005/06 as total exports grew at a faster rate than iron and steel exports.

³⁵ Interestingly, India's merchandise exports have grown at an average annual rate of over 23% since 2002/03, compared with world merchandise export growth of approximately 14% between 2002 and 2005, and its share of world T&C exports has risen.

Chart I.1

Product composition of merchandise trade, 2000/01 and 2005/06

Per cent



Source : UNSD, Comtrade database (SITC Rev.3).

(b) Services

35. The services trade surplus as a percentage of GDP increased from 0.7% in 2001/02 to 2.8% in 2005/06 as software and IT exports surged.³⁶ Transportation, travel and other services (telecommunications, financial, construction, legal, and accounting) also grew considerably. However, these were matched by corresponding imports. Hence, software-related services were largely responsible for the services surplus.

(ii) Direction of trade

36. Major export destinations are the EC-25 (22.5% of total exports), the United States (16.9%), the United Arab Emirates (8.3%), and China (6.6%) (Table AI.4). In recent years, there has been a shift away from Europe and the United States, while the share of the U.A.E. and Asia has increased. The same trend is witnessed with regard to the origin of imports; although the EC-25 (17.2%) and the United States (6.3%) are major exporters to India, the share of Asia (27.4%) and the Middle East (6.7%) have been increasing (Chart I.2 and Table AI.5). The diversification reflects the changing composition of India's trade.

(4) DEVELOPMENTS IN FOREIGN INVESTMENT

37. The liberalization process that started in the early 1990s has continued during the period under review; the Government initiated reforms and raised the limit on foreign direct investment (FDI) in certain sectors, resulting in continued growth in annual FDI flows. Annual FDI inflows grew from US\$3.13 billion in 2002/03, to US\$5.6 billion in 2005/06.³⁷

38. Inward FDI has been particularly robust in the electronics and electrical equipment sector, mainly due to information technology enabled services (ITES) and business process outsourcing (BPO) growth (Table AI.6). This is manifested in services sector growth, as is telecommunications sector growth, which has also been a large recipient of FDI. The increased investment in the telecommunications sector could also be attributed to an increase in the FDI limit from 49% to 74% in 2005. The financial services and automobile sectors have also been liberalized, thereby attracting increased FDI flows.

39. Mauritius remains the largest source of FDI, accounting for approximately 46% of inward FDI flows (Table AI.7). This may be the result of the tax treaty between Mauritius and India, which may induce investors to route their investment through Mauritius to take advantage of the preferential provisions.³⁸ Other major sources are the United States, the United Kingdom, and the Netherlands.

40. The sharp rise in inward portfolio investment, from approximately US\$944 million in 2002/03 to approximately US\$12.5 billion in 2005/06 (more than double inward FDI), is due to both global and domestic factors.³⁹ Emerging markets as a whole have benefited from low long-term interest rates in the advanced economies. In addition, robust corporate performance in India and the resulting strong GDP growth, coupled with increased foreign institutional investor (FII) limits may have fuelled portfolio investment.

³⁶ RBI balance-of-payments data.

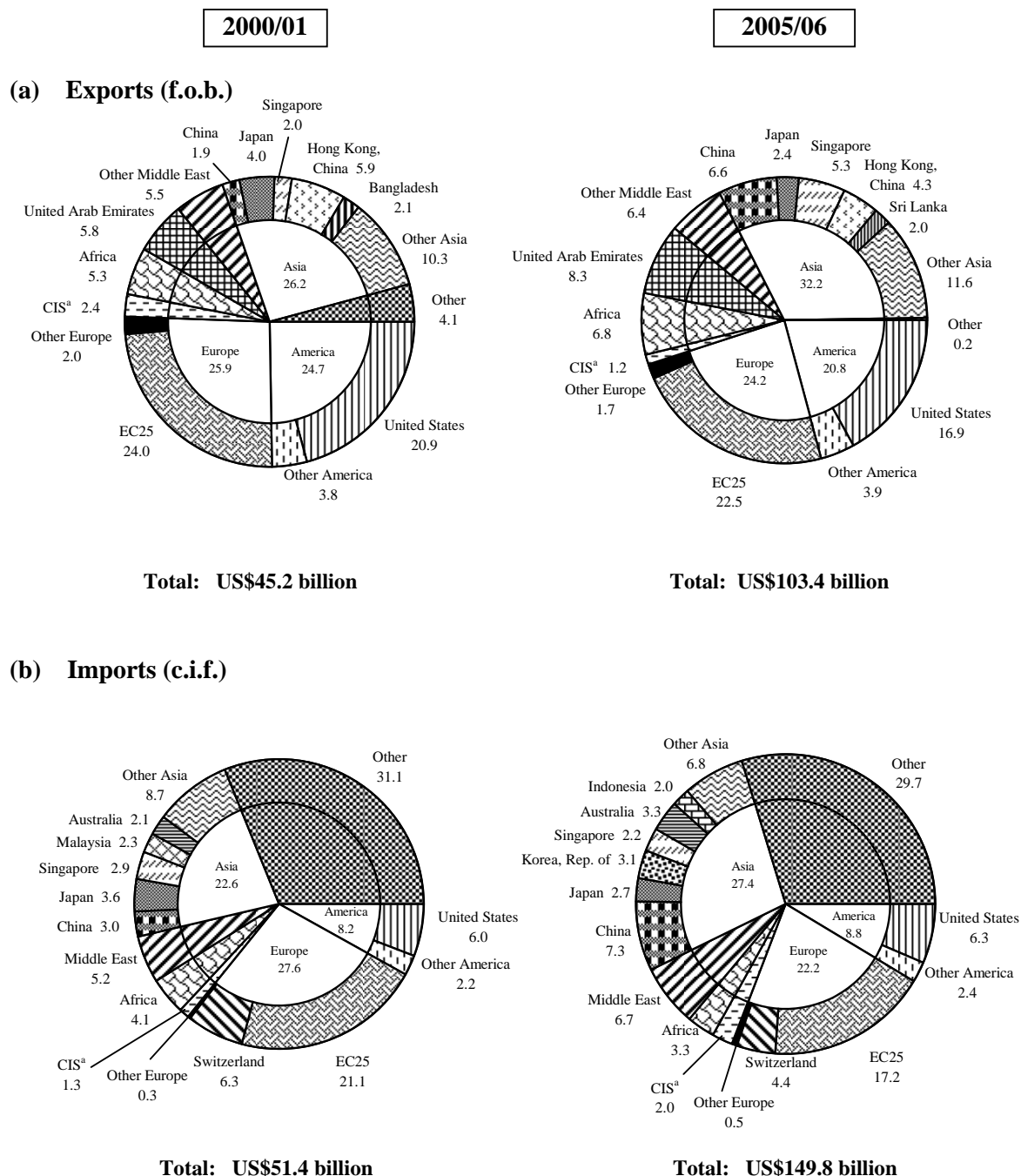
³⁷ There is a discrepancy in FDI numbers in certain cases. The RBI calculates FDI inclusive of reinvested earnings. However, the numbers used here, which were provided by the Department of Industrial Policy and Promotion, look only at investment made through the automatic or approval route.

³⁸ The main benefit is that investments are exempt from capital gains tax.

³⁹ Balance of payments numbers from RBI.

Chart I.2
Direction of merchandise trade, 2000/01 and 2005/06

Per cent



a Countries included in Commonwealth of Independent States (CIS) are listed in Tables AI.3 and AI.4.

Source : UNSD, Comtrade database (SITC Rev.3).

(5) OUTLOOK

41. Reforms in India have been significant and broad-based allowing it to realize the highest growth rates in its recent history. However, rising inflation will need to be tackled if present growth rates are to be sustained. As India strives to achieve even higher sustainable levels of growth, and to halve poverty by 2010, the reform process will need to be continued and deepened.⁴⁰

42. Considerable progress has been made in reining in the fiscal deficit and increasing tax revenue through tax reform; conversion of the recently implemented VAT into a GST, inclusive of services, would ensure a more broad-based tax system that would yield government revenues commensurate with India's public expenditure needs. At the same time, measures are necessary to ensure that central and state governments obtain the best value for money in their spending.

43. While most structural reforms have tended to be concentrated in manufacturing and some services (financial services, telecommunications, and some transport services), remaining bottlenecks in infrastructure (especially electricity and transport) as well as in agriculture need to be addressed. Reform in electricity, in particular, will go some way to addressing productivity constraints in manufacturing and services. In agriculture, although steps are being taken to reduce barriers to the marketing of agricultural products, subsidies continue to crowd out public investment in infrastructure and research, and the sector remains relatively unproductive. There is also substantial underemployment in agriculture, and efforts need to be stepped up to develop related industries, such as food processing, that could absorb excess agricultural labour.

44. Greater private and public investment in both physical and human capital (as well as in new technology, the main source of growth in the long-run) is essential if higher sustained growth is to be achieved. According to the Planning Commission, the main source of additional physical investment would be gross domestic investment, which would have to rise from around 30% of GDP currently to 35% and would need to come from both the private and public sectors. Private sector investment would need to be facilitated through a reduction of policy-related constraints and excessive transaction costs, which would support measures to improve the climate for investors (including the recently enacted competition law and measures to enhance corporate governance). Efforts could also be made to mobilize resources through increased inflows of FDI, which, despite significant reforms to the FDI regime, have remained at around 1% of GDP, suggesting that other barriers, including infrastructure and administrative constraints, continue to dissuade foreign investors. Increased public investment would also be desirable in critical areas such as agriculture, infrastructure, and other essential public services, notably education and health, to ensure that India's recent high rates of economic growth become more inclusive, a major goal of government policy. Public investment in education/training and health, *inter alia*, would contribute to growth by helping to improve human capital.

45. Continuing structural reforms together with greater investment in physical and human capital would help to generate productive employment opportunities for new entrants to the labour force, thereby enabling India to reap the "demographic dividend" associated with one third of its 1.1 billion population now being under the age of 18.

⁴⁰ India's Prime Minister recently stated that "there are no binding external constraints on India's economic growth. Most constraints ... are inherently internal" (The Prime Minister's Office online information. Viewed at: <http://pmindia.nic.in/speeches.htm> [29 November 2006]).