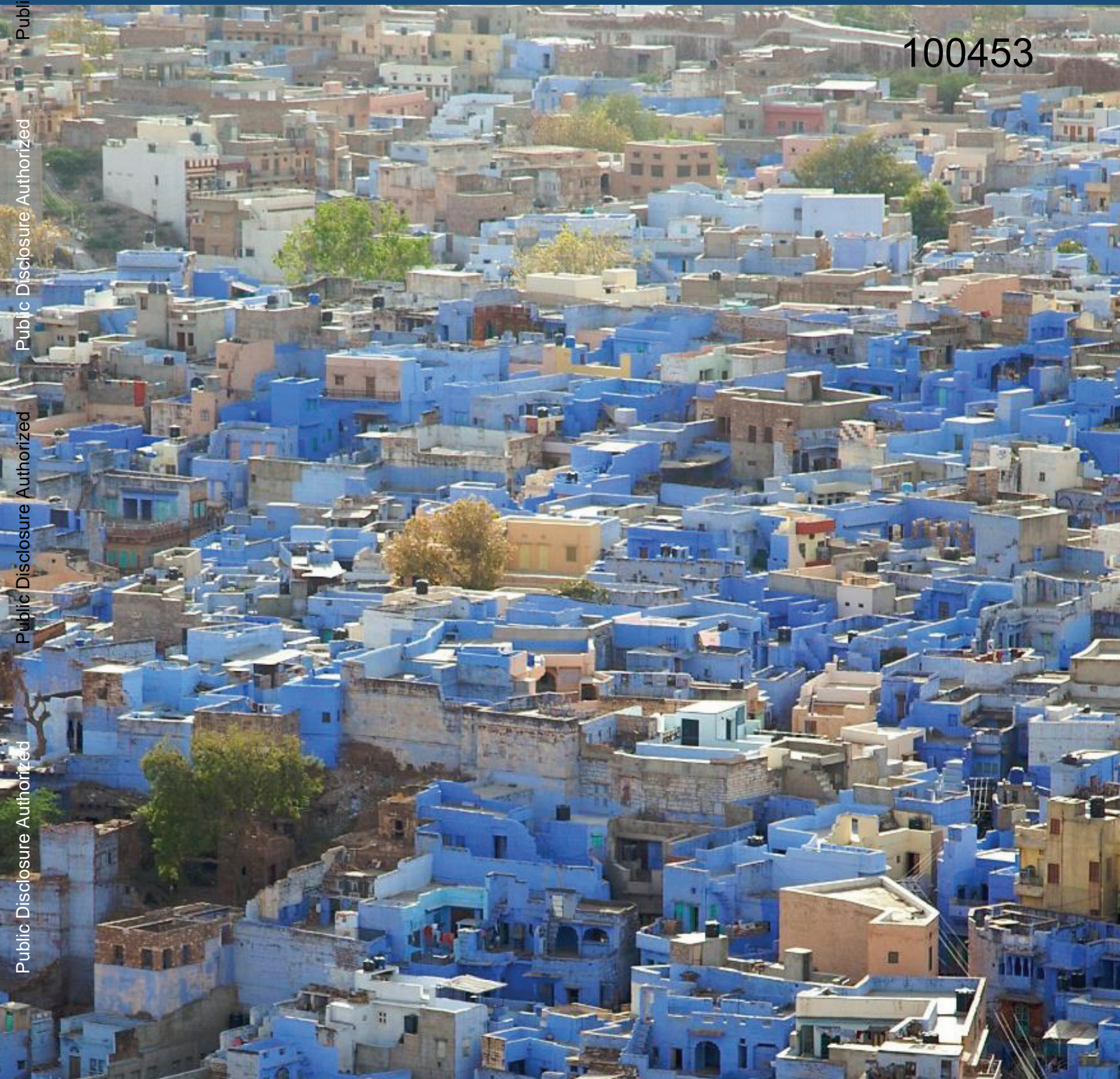


India Development Update

October 2015

Fiscal Policy for Equitable Growth

100453



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INDIA DEVELOPMENT UPDATE

Fiscal Policy for Equitable Growth

October 2015

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Photo credits: Curt Carnemark (Jodhpur) Ray Witlin (man in tractor) and Simone D. McCourtie (fuel tanker in Mumbai)

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The report is based on information current as of October 16, 2015.

Abbreviations

Abbreviation	Definition
AED	Additional Excise Duties
AMRUT	Atal Mission for Rejuvenation and Urban Transformation
AP	Andhra Pradesh
AS	Assam
ASCI	Administrative Staff College of India
ASEAN	Association of Southeast Asian Nations
BE	Budget Estimates
BIS	Bank for International Settlements
BOT	Build-Operate-Transfer
BP	Budget Projections
CapEx	Capital Expenditures
CEMBI	Corporate Emerging Markets Bond Index
CenVAT	Central Value-Added Tax
CG	Chhattisgarh
CGST	Central Goods and Services Tax
CPI	Consumer Price Index
CPR	Centre for Policy Research
CRAR	Capital to Risk-Weighted Assets Ratio
CSO	Central Statistics Office
CSS	Centrally Sponsored Schemes
CST	Central Sales Tax
CY	Crop Year
DBT	Direct Benefits Transfer
DBTL	Direct Benefits Transfer for LPG
DECPG	Development Economics Research Prospects Group
DIA	Direct Investment Abroad
EU	European Union
FC	Finance Commission
FDI	Foreign Direct Investment
FDP	First Discussion Paper
FII	Foreign Institutional Investor
FRBM	Fiscal Responsibility and Budget Management
FY	Fiscal Year
GCC	Gulf Cooperation Countries
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GNFS	Goods and Non-Factor Services
GoI	Government of India
GST	Goods and Services Tax
GVA	Gross Value Added
GVAR	Global Vector Autoregression
HR	Haryana
HST	Harmonized Sales Tax
IAY	Indira Awaas Yojana
ICDS	Integrated Child Development Service
IGST	Integrated Goods and Services Tax
IIF	Institute for International Finance
IMF	International Monetary Fund
INR	Indian Rupee
IT	Information Technology
KA	Kerala
LB	Local Bodies
LIS	Low income states
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LRP	Lei de Responsabilidade Fiscal (Fiscal Responsibility Law)

Abbreviation	Definition
M&E	Monitoring and Evaluation
MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act
ModVAT	Modified Value-Added Tax
MoF	Ministry of Finance
MP	Market Prices
MRP	Maximum Retail Price
MSP	Minimum Support Prices
NCAER	National Council for Applied Economic Research
NEER	Nominal Effective Exchange Rate
NHAI	National Highway Authority of India
NIPFP	National Institute of Public Finance and Policy
NIT	Net Indirect Taxes
NPA	Non-Performing Assets
NRI	Non-resident Indian
OECD	Organization for Economic Cooperation and Development
PBs	Payment banks
PDS	Public Distribution System
PMG	Pradhan Mantri Gram
PMGSY	Pradhan Mantri Gram Sadak Yojna
PMJDY	Pradhan Mantri Jan Dhan Yojana
PMKSY	Pradhan Mantri Krishi Sinchai Yojna
PPAC	Petroleum Planning & Analysis Cell
PPP	Public-Private Partnerships
PSBs	Public Sector Banks
PV	Photovoltaic
q/q	Quarter-on-quarter
QST	Quebec Sales Tax
RBI	Reserve Bank of India
RE	Revised Estimates
REER	Real Effective Exchange Rate
RHS	Right-hand Side
RKVY	Rashtriya Krishi Vikas Yojana
RON	Research Octane Number
RST	Retail Sales Tax
saar	Seasonally-adjusted annualized rate
SBI	State Bank of India
SCBs	Scheduled Commercial Banks
SED	Special Excise Duty
SFB	Small Finance Bank
SFC	State Finance Commission
SGST	State Goods & Services Tax
SSA	Sarva Shiksha Abhiyaan
T-bills	Treasury bills
TiVA	Trade in Value-Added
UAE	United Arab Emirates
UK	United Kingdom
US	United States
USD	US dollar
UT	Union Territories
VAT	Value Added Tax
WB	World Bank
WDI	World Development Indicators
WEO	World Economic Outlook
WPI	Wholesale Price Index
y/y	Year-on-year

Table of Contents

Acknowledgements	i
Abbreviations	ii
Table of Contents	ii
Executive Summary	1
The Indian Economy in Pictures	3
Fiscal Policy for Equitable Growth in Pictures	4
1. Recent Economic Developments and Outlook	5
Despite significant uncertainty and weak exports, the economy appears to be picking up	5
Industrial growth picked up, driven by construction	6
Domestic demand was the main contributor to growth	8
Government-driven investment growth in early FY15-16	8
Limited gains in rural wages pose headwinds to growth in household consumption	9
Exports disappoint, but low commodity prices keep the current account contained	9
Broad-based weakness of exports, led by commodities	9
Lower commodity prices limited the current account deficit	10
Subdued inflation on account of lower food prices	12
Domestic and external financial conditions bear watching	13
Monetary policy was eased on lower inflation, weak global growth	13
Deteriorating asset quality weighs on credit growth	14
Financial account surplus boosts reserves and the currency, but volatility on the rise	17
A favorable outlook with large uncertainties	18
Underpinned by domestic drivers, the robust pace of economic growth is expected to accelerate	18
Sustained momentum predicated on continued revival of investments	20
Strong domestic demand and subdued exports likely to lead to wider current account deficit	22
Domestic and external risks to the outlook are elevated	22
2. Notes on Fiscal Policy for Equitable Growth	29
A. Fiscal policy developments and outlook	29
Fiscal consolidation proceeds with a focus on quality expenditures	29
Continued fiscal consolidation and higher untied transfers to states beyond FY15-16	33
Significant fiscal risks from contingent liabilities in the infrastructure sector	35
B. Reforming India's Fuel Subsidies: Achievements and Opportunities	37
Significant progress reforming gasoline and diesel pricing with large fiscal gains	37
Efforts underway to rationalize subsidies LPG and Kerosene as well	40
C. Introducing the GST in India: Current Status and Challenges	44
GST is part of an extended process of reforming India's indirect taxes	44
The current system of indirect taxes contains many overlapping layers	46
The design of the GST has had to balance achieving efficiency and political consensus	46
International experience suggest an efficient GST is feasible in India	51
D. Moving Spending and Delivery to States: The 14 th Finance Commission	53
(Some) additional resources and (much) greater responsibilities moved from the Centre to States	53
Deep reforms present challenges and opportunities	56
Lessons from country cases	62
Annex: Key Statistical Tables	65
References	67

BOXES

Box 1: Deflators and diverging trends in India's national accounts statistics	25
Box 2: Muted impact of a slowing China on India?	27
Box 3: India's many levels of government	53

FIGURES

Figure 1. GDP growth slowed down in the first quarter of FY15-16... ..	5
Figure 2. ... but GVA growth accelerated in the same period.....	5
Figure 3. Industrial production continued to expand, albeit at a modest pace.....	6
Figure 4. Vehicle sales suggest improving momentum in domestic demand.....	6
Figure 5. Services remain the main contributors to growth.....	7
Figure 6. Construction activity surged.....	7
Figure 7. Strong private consumption and higher investments helped offset a growing drag from exports.....	8
Figure 8. The increase in Plan-spending was largely on account of investment-driven expenditures	8
Figure 9. Agricultural wages show signs of improvement in June.....	9
Figure 10. Wages in construction have been subdued compared to other non-agricultural occupations	9
Figure 11. Petroleum drives the decline in exports	10
Figure 12. The current account narrowed due to a lower merchandise trade deficit... ..	11
Figure 13. ...driven by import contraction as exports were sluggish.....	11
Figure 14. Lower imports were largely on account of lower crude oil prices... ..	11
Figure 15. ... as reflected in an improvement in India's terms-of-trade.....	11
Figure 16. Consumer inflation has been moderating... ..	12
Figure 17. ... largely due to falling food and housing prices	12
Figure 18. Since 2014, there has been limited increase in mandated MSP	13
Figure 19. Global food prices have been declining	13
Figure 20. The policy repo rate has been easing since January 2015, along with inflation	14
Figure 21. Lending rates declined less than both the policy and deposit rates	14
Figure 22. Non-performing assets have reached 5 percent, driven by higher NPAs in public sector banks.....	14
Figure 23. NPAs are concentrated in infrastructure sectors, especially power.....	14
Figure 24. Credit growth has been declining since 2014 due to weaker credit by public sector banks.....	16
Figure 25. Adjusted for inflation, credit growth has slowed less markedly and may have turned around	16
Figure 26. Lower credit growth has been driven by industry... ..	16
Figure 27. ...especially infrastructure.....	16
Figure 28. Since late 2014, the USD and nominal effective exchange rates have decoupled.....	17
Figure 29. The financial account remained in surplus despite lower portfolio flows in Q1 FY15-16.....	17
Figure 30. GDP growth is expected to accelerate modestly	19
Figure 31. Consensus forecasts have come down	19
Figure 32. Corporate bond spreads widened less than in other large emerging economies.....	19
Figure 33. ...while portfolio allocations increased.....	19
Figure 34. The output gap is expected to close in FY16-17.....	20
Figure 35. The monsoon has been deficient for the second consecutive year... ..	21
Figure 36. ... but the sown area has increased in FY15-16.....	21
Figure 37. A modest widening of the current account deficit... ..	22
Figure 38. ... as import growth is expected to exceed export growth in the coming years.....	22
Figure 39. Estimates of economic growth diverged in the previous two quarters... ..	25
Figure 40. ...reflecting different growth momentums.....	25
Figure 41. High growth in nominal net indirect taxes was not reflected in real terms.....	25
Figure 42. ...implying a jump in the NIT deflator	25
Figure 43. In recent quarters, deflators used for production estimates are not in tune with CPI	26
Figure 44. Deflators used for expenditure components present similar anomalies	26
Figure 45. India's currency depreciated less than its peers in the recent market volatility.....	27
Figure 46. India's fundamentals have improved significantly since 2013	27
Figure 47. Value-added in India for final demand in China comprises only 1.3 percent of India's GDP	28
Figure 48. India's debt markets have relatively limited foreign participation.....	28

Figure 49. The fiscal deficit of the Centre has been declining primarily due to expenditure rationalization	29
Figure 50. Expenditures and revenues in the current fiscal year are higher relative to the previous fiscal year	29
Figure 51. Collection of Indirect taxes has been more robust than direct taxes in the current fiscal	30
Figure 52. Central excise duty collection has picked up significantly	30
Figure 53. Income tax collection has been particularly weak in current fiscal year to date	31
Figure 54. Income tax collection has been lower even in nominal terms in current fiscal year to date.....	31
Figure 55. Plan expenditures rebalanced from current to capital.....	32
Figure 56. Plan expenditures for infrastructure development have increased	32
Figure 57. The total subsidy bill has fallen with the decline in petroleum and fertilizer subsidy burdens	32
Figure 58. Non-plan expenditures of the MoF has increased due to enhanced devolution	32
Figure 59. The fiscal deficit is expected to decline but remains elevated.....	33
Figure 60. The government debt is expected to remain on a declining trend.....	33
Figure 61. India collects a higher share of indirect taxes than OECD economies	34
Figure 62. ... but has a much lower level of direct tax collection.....	34
Figure 63. The exposure of SCBs to the power and roads sectors is large and correlated	35
Figure 64. Diesel prices declined only modestly in USD terms since January 2013 as taxes were introduced.....	37
Figure 65. India is well above the global median in terms of the price of gasoline.....	38
Figure 66. While India's diesel prices remain below the global median, they are in line with those in the United States .	38
Figure 67. Subsidy rationalization led to significant fiscal gains	39
Figure 68. Petrol subsidies are poorly targeted.....	39
Figure 69: Even non-subsidized LPG prices remain among the lowest in the world	41
Figure 70. LPG subsidies also accrue primarily to higher income groups.....	41
Figure 71. Kerosene prices in India are the third lowest in the world	42
Figure 72. The cost of LPG subsidies remains substantial, though it has declined	42
Figure 73. Tax devolution to the states increased.	54
Figure 74. ... but tied grants declined simultaneously.	54
Figure 75. ...leading to a more modest net increase in total transfers to states	55
Figure 76. The share of untied transfers jumped to nearly ¾ of total transfers	55
Figure 77. Nearly 60 percent of public expenditure in India will take place at the state level as of FY15-16	55
Figure 78. Grants to Local Bodies have increased sharply under the 14 th FC.....	58
Figure 79. In the past, Rural Local Bodies have largely depended on transfers	60

TABLES

Table 1: Key Reforms Implemented and To-Be Implemented.....	23
Table 2: Key Economic Indicators and Projections.....	24
Table 3: Fiscal consolidation is expected to be led by the Centre.....	34
Table 4: LPG prices in New Delhi in April 2015	40
Table 5: More than 160 countries around the world have a GST/VAT	44
Table 6: Classification of goods and tax rates in state VAT schedules in six states	50
Table 7: Somewhat higher total transfers, but a jump in tax devolution	54
Table 8. Many central schemes have been cut, but some have been retained.....	56
Table 9. The reduction in the schemes is also reflected in a reduction of plan grants	56
Table 10. Financial Requirement as Per Norms and the Service Gap in Core Services by Rural Local Bodies	59
Table 11. Key International practice in fiscal devolution challenges.....	62

Executive Summary

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Lifted by lower oil prices and prospects for implementation of critical structural reforms, India has become the world's fastest growing large economy. Growth is expected to accelerate further, albeit modestly, driven by a pick-up in investments. Although India's economic expansion is robust, uncertainty about its momentum is high and downside risks ample. The slowdown in China presages a continuation of the protracted low growth in global demand, which exacerbates supply-side constraints to faster growth of India's exports. Domestically, banks and companies in infrastructure sectors are stressed, and the reform momentum, while still strong, has faced headwinds, notably with the delay in passing the GST legislation.

India's economy expanded by 7.3 percent in FY14-15 and 7.0 percent in Q1 FY15-16 (y/y). Industrial growth picked up and the services continued to expand despite a slowdown in government services that reflected fiscal consolidation efforts. Exports languished, but domestic drivers picked up. Investment gained momentum, while private consumption growth remained firm as declining inflation boosted households' purchasing power.

India's growth performance was helped in no small part by the drastic decline in crude oil prices since June 2014. Lower oil prices underpinned a decline in inflation, which raised real incomes and created room for relaxing monetary policy. It also allowed the government to reform fuel pricing and remain on the path of deficit reduction without drastic expenditure cuts. Finally, low oil prices also led to a favorable terms-of-trade shock and a 3.4 percentage-point-of-GDP narrowing of the current account deficit between FY12-13 and FY14-15. The accompanying accumulation of reserves helped make India less vulnerable to external volatility.

GDP growth is expected to accelerate gradually to 7.5 percent in FY15-16 and to 7.8 and 7.9 percent in the subsequent two fiscal years as investments rebound. Robust consumption will support growth, but investment is expected to be the main driver averaging 8.8 percent y/y growth during FY16-18. A pick-up in investment is crucial to improve potential output and lay the foundation for sustainable growth. In the near-term, private investments are expected to be crowded in by public investments, which along with equity

injections in banks and PPPs provide temporary relief. Reforms to the current PPP model and the power sector will be required to provide a long-term solution to the burden of non-performing assets, and support growth of private investments in the medium term.

While growth will very likely remain above 7 percent in the next fiscal year, there is significant uncertainty about the momentum of the economy. Estimates of domestic output from the national accounts on the consumption and production sides have diverged in late FY14-15 and early FY15-16 due to unusual movements in deflators. High-frequency indicators have been mixed, with credit growth and wages of rural workers displaying varying degrees of weakness, while vehicle sales, industrial production and public investments point to an accelerating economy.

In the near-term, India is relatively well-positioned to weather the global volatility. India has low trade exposure to China, while Indian financial markets (local bond markets in particular) are fairly closed. India's considerable foreign exchange reserves (9 months of retained imports) provide additional buffer.

In the medium-term, however, the Indian economy is not immune to a slowdown in global demand and heightened volatility. India requires some measure of foreign capital inflows to finance both fiscal and current account deficits and ultimately the investments needed to spur growth. China's slowdown and its reverberation in the global economy has led to further deterioration of the already weak export outlook. Although India may be able to achieve fast GDP growth without export growth for a short period (as suggested by the low year-to-year correlation between exports and GDP growth), sustaining high rates of GDP growth over a longer period will require a recovery of export growth.

The overall favorable outlook is predicated on the implementation of key domestic reforms, in particular (i) boosting the balance sheets of the banking sector through a sustainable solution to the debt overhang of primarily power and road infrastructure firms, including rebooting the PPP model; (ii) continuing to improve the ease of doing business and enacting the crucial Goods and Services Tax (GST) that will make India truly a single market; and (iii) enhancing capacity of state and local governments to deliver public services as more resources are devolved from the centre.

FISCAL POLICY FOR EQUITABLE GROWTH

India's public expenditures have been rebalanced to the states. This follows from the implementation of the recommendations of the 14th Finance Commission to increase devolution to the states of resources that are not tied to any specific expenditure area. This has led to a net increase in resources to the states, and a larger increase in the share of those resources that are untied. A lower subsidy bill and higher excise and service taxes have allowed the central government to continue reducing its fiscal deficit even as it transfers more resources to the states. The challenge going forward is to ensure that the states can deliver on their mandates given often-limited capacity in the area of expenditure management, and that the centre can mobilize additional revenues to fulfil its own mandates in a continent-sized country.

The 14th Finance Commission recommended increasing states' share in the central divisible pool of tax revenues (which are untied resources) from 32 to 42 percent. Meanwhile, tied resources mostly from Centrally Sponsored Schemes have been reduced. The net impact has been an increase in overall resource transfers to the states in FY15-16 of 0.5 percent of GDP, but a much larger increase in untied resources of 1.1 percent of GDP, or from 60 to 74 percent of total transfers. As a result, Indian states are now responsible for 57 percent of all public expenditure in India compared to 46 percent as recently as FY10-11.

The increase in net transfers to the states is to be accomplished in tandem with higher capital expenditures and continued (albeit slower) fiscal consolidation by the central government. Capital expenditures are budgeted to increase by 0.2 percentage points of GDP in FY15-16. Meanwhile, the fiscal deficit of the centre has declined from 4.4 percent of GDP in FY13-14 to 4.0 percent in FY14-15 and is expected to decline further in FY15-16 to 3.9 percent of GDP. The general government deficit is also expected to consolidate to 5.7 percent of GDP by FY17-18. States are on average expected to meet their FRBM-mandated deficit targets, but some may require additional borrowing space to accommodate a restructuring of liabilities in the power sector.

Continued consolidation along with higher devolution and infrastructure investments have been made possible by shifting expenditures away from costly, untargeted, and environmentally-damaging fuel subsidies and effectively implementing a carbon tax by increasing excise taxes on hydrocarbons. The

petroleum subsidy burden came down from 1.4 percent of GDP in FY12-13 to 0.2 percent in FY15-16, while excise duties for petrol and diesel increased by an average of 130 percent in Q4 FY14-15 (y/y). This implicit carbon tax has led to a net reduction of 11 million tons of CO₂ in less than a year. Additionally, reduction in the regressive fuel subsidy regime that accrues seven times more to the wealthiest households has enhanced the equity of fiscal expenditures. Ongoing reforms to rationalize LPG and Kerosene subsidies will further add to the accrued gains.

As a result of the shift of spending power from the centre, development outcomes are increasingly tied to the priorities and capacities of the states but also to local governments, which have also received increased untied resources following the recommendations of the 14th Finance Commission. Therefore, a key challenge going forward will be to improve capacity and governance mechanisms both at the state and local government levels to ensure that public service delivery is enhanced by greater devolution.

The second key challenge pertains to the resources of the central government, which retains considerable responsibilities and is expected to continue to consolidate towards a deficit of 3 percent of GDP by FY17-18. Reducing deficits beyond FY15-16 will be challenging as oil prices are unlikely to fall further, contingent liabilities from the infrastructure sector may call on public resources, and the fiscal implications of the 7th Pay Commission are likely to be implemented starting next fiscal year. Meeting this challenge will require further improvement in the quality of expenditures, but mainly mobilizing additional tax revenues.

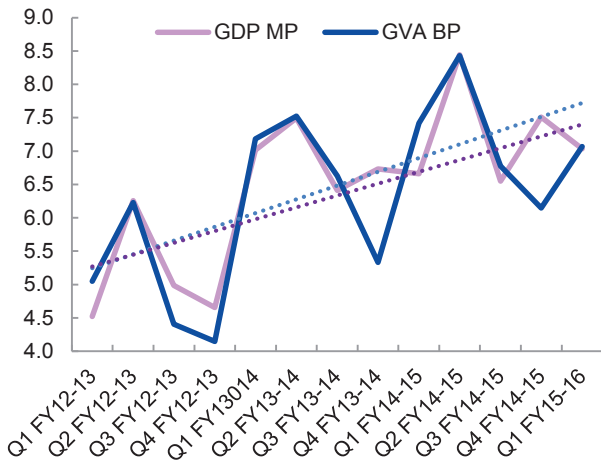
Boosting revenues will ultimately require collecting more direct taxes. Tax revenues in the economy accrue largely from indirect taxes amounting to 11.4 percent of GDP in FY13-14 compared to 5.7 percent of GDP from direct taxes. Indirect tax collections are higher than the 10.9 percent collected in OECD economies while direct tax collections are low compared to the OECD average of 11.4 percent of GDP.

The introduction of GST remains a crucial reform to remove the duplication associated with the current multi-layered system that suffers from challenges in identification, tax cascading, administration and compliance. The GST will enhance transparency and be a significant step towards creating a unified market. International experience suggests that an effective GST regime can be effectively implemented in federal countries with strong sub-national governments.

The Indian Economy in Pictures

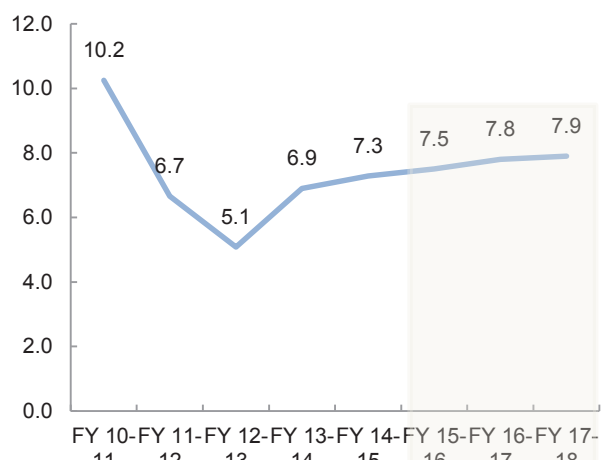
Recent momentum is unclear, but growth clearly picked up...

Change from the previous year, percent



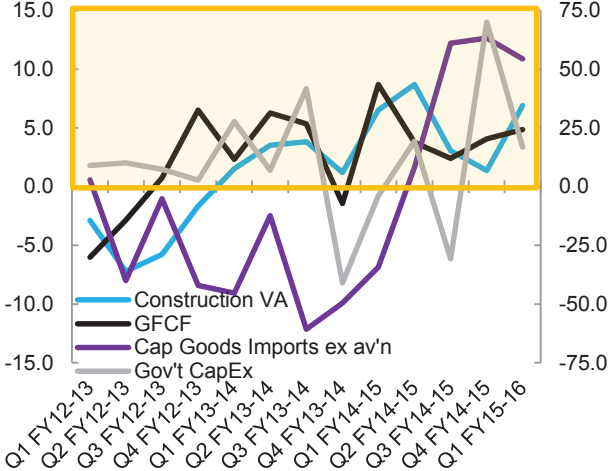
... and is expected to accelerate modestly in coming years...

Change from the previous year, percent



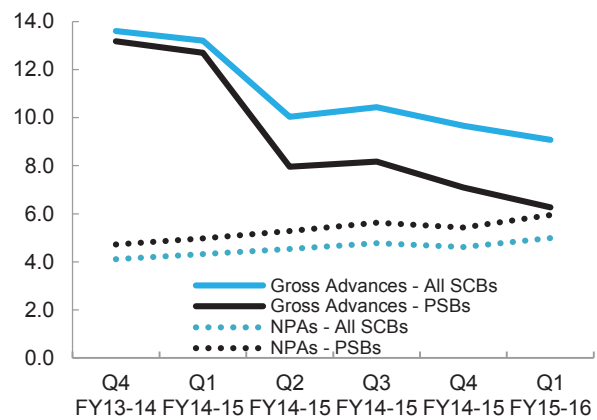
...driven by higher investments, initially from the government

Change from the previous year, percent (Gov't CapEx RHS)



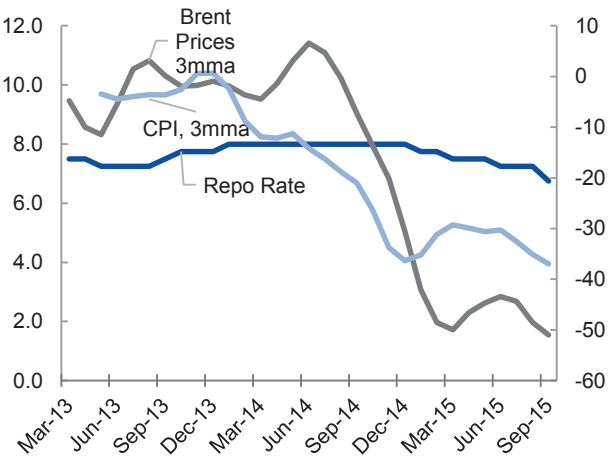
A sustainable resolution to NPAs is needed to boost credit

Growth y/y, percent (Advances) and Share of gross advances, percent (NPAs)



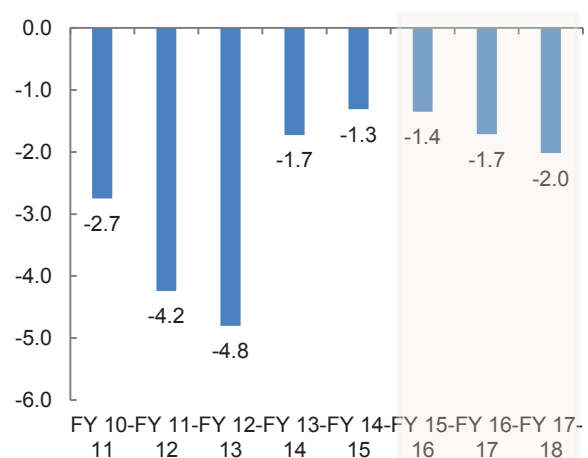
Low oil prices have helped contain inflation and created space for policy rate cuts...

Percent per annum (Repo Rate), Percent change y/y (Brent, CPI)



... and also lowered the import bill and led to a narrowing of the current account deficit

Current account balance, percent of GDP

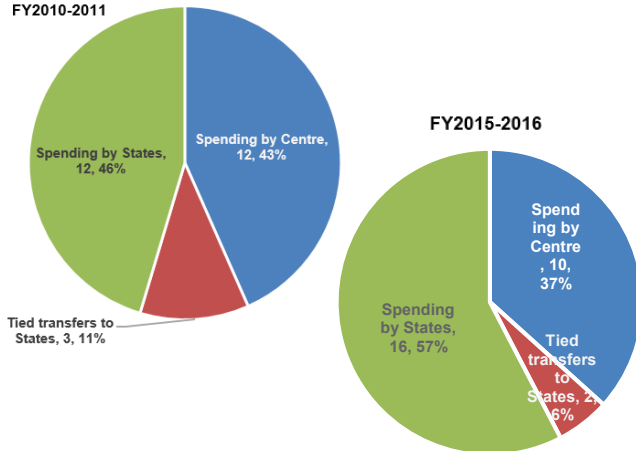


Fiscal Policy for Equitable Growth in Pictures

Most public expenditure in India is at the state level...

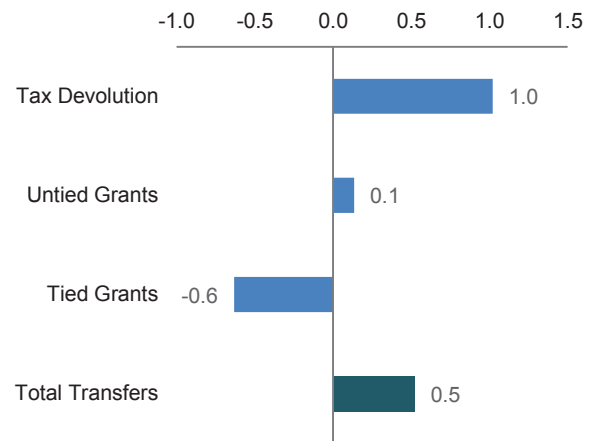
Public expenditures, share of GDP and of total expenditures (%)

FY2010-2011



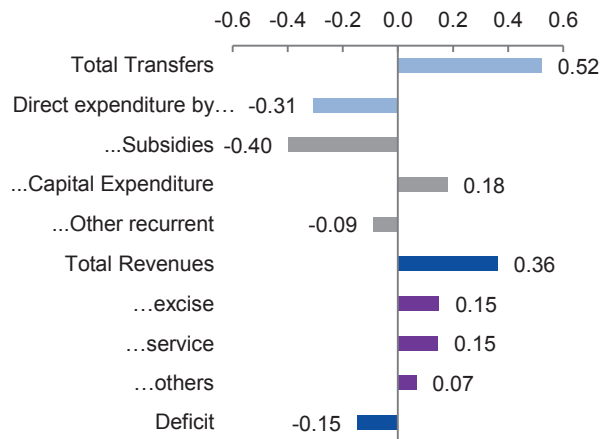
... following greater devolution of untied resources

Change between FY15-16 (BE) and FY14-15 (RE), percent of GDP



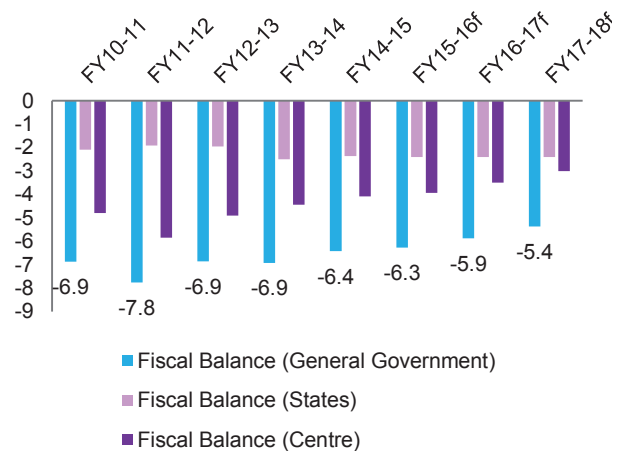
Lower subsidies and higher indirect taxes...

Change between FY15-16 (BE) and FY14-15 (RE), % of GDP



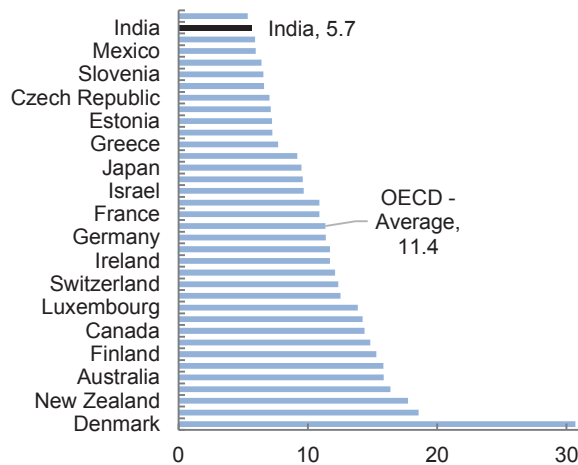
...ensure consolidation and devolution can coexist in FY16

Balances, percent of GDP



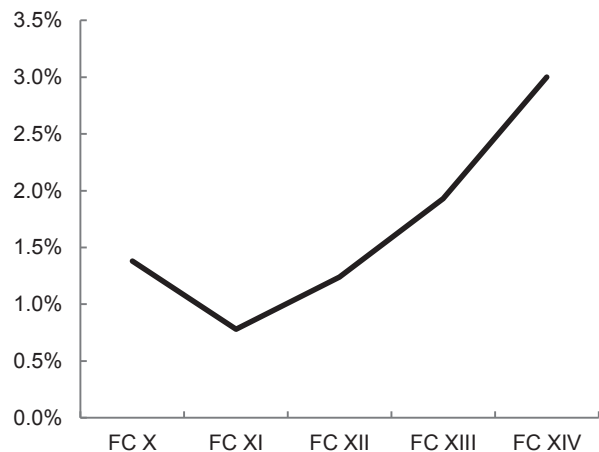
Going forward, consolidation will require more revenues, especially direct tax

Direct taxes as a share of GDP, percent



Local bodies received additional resources and will also have to deliver more

Total grants to local bodies (urban and rural), percent of divisible pool



1. Recent Economic Developments and Outlook



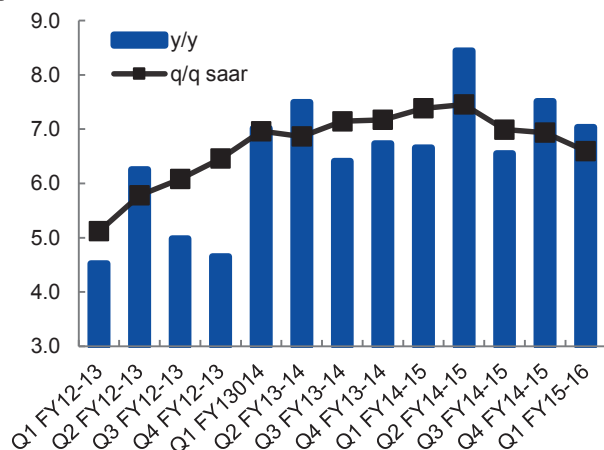
Despite significant uncertainty and weak exports, the economy appears to be picking up

Lifted by domestic demand, India has become the world's fastest growing large economy

India's economy expanded by 7.3 percent in FY14-15 and 7.0 percent in Q1 FY15-16 (year-on-year; y/y). Industrial growth picked up, while services remained robust despite a slowdown in government services that reflected the government's fiscal consolidation efforts. Exports languished, but domestic drivers picked up. Investment gained momentum, while private consumption growth remained firm as declining inflation boosted households' purchasing power.

Figure 1. GDP growth slowed down in the first quarter of FY15-16...

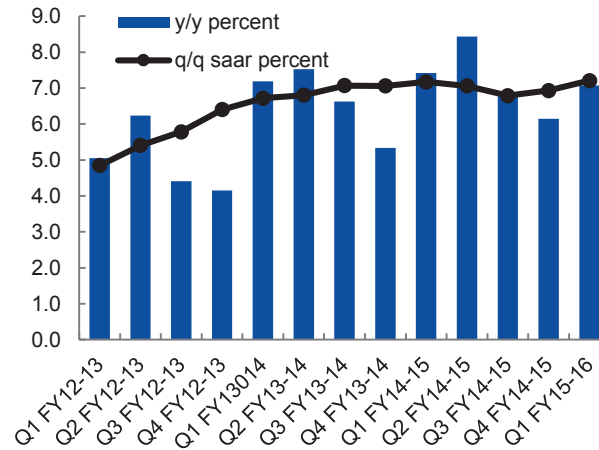
GDP adjusted for inflation and seasonal fluctuations, change from the previous quarter, annualized (line), and from the previous year (bars); percent



Source: CEIC, CSO and World Bank staff calculations

Figure 2. ... but GVA growth accelerated in the same period

GVA adjusted for inflation and seasonal fluctuations, change from the previous quarter, annualized (line), and from the previous year (bars); percent



Source: CEIC, CSO and World Bank staff calculations

Although India's economic expansion is robust, there is significant uncertainty about its momentum

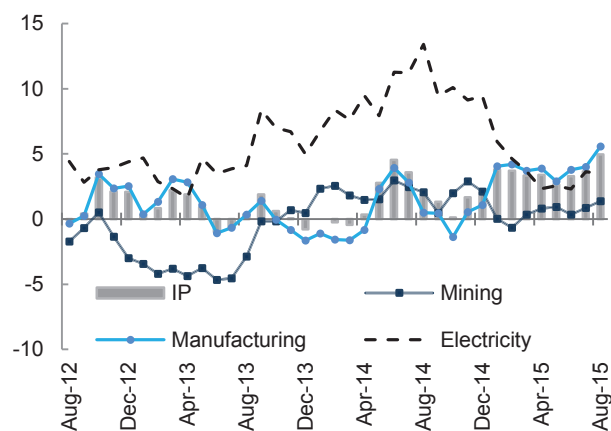
Production and expenditure-side estimates of economic activity have diverged in early FY15-16. Economic growth from the demand side, as measured by Gross Domestic Product (GDP), accelerated during FY14-15 from 6.9 percent in the previous year, but lost steam in FY15-16, moderating to 6.6 percent (quarter-on-quarter seasonally-adjusted annualized rates; q/q saar) in Q1 (Q4 FY14-15: 6.9 percent; Figure 1)¹². Economic output measured from the production side as Gross Value Added (GVA) expanded by 7.2 percent in FY14-15 (FY13-14: +6.6 percent), and continued this acceleration in Q1 FY15-16 with a sequential increase to 7.2 percent q/q saar in Q1 FY15-16 (Q4 FY14-15: +6.9 percent; Figure 2). One possible explanation for this divergence is an anomaly in the deflator for net indirect taxes, which jumped in Q1 FY15-16 and led to lower growth of GDP compared to GVA (see Box 1 for further details).

High-frequency indicators are mixed, but on balance suggest a modest acceleration in the already-robust economic activity

On the one hand, export growth, including of services, has continued to disappoint, even after price effects are taken into account. Industrial production (as measured by the Index of Industrial Production) has expanded at a sustained but moderate pace, supported by growing manufacturing output for domestic demand (Figure 3). Purchasing Managers' indices also point to a modest expansion in FY15-16, but the pace has been declining. Some indicators have been more buoyant: sales of passenger and commercial vehicles (Figure 4) tourist arrivals, and equity FDI have expanded solidly into FY15-16. Overall, the picture that emerges appears closer to the one painted by the GVA series: a growing economy that remains on a very gradual acceleration path, driven by domestic demand.

Figure 3. Industrial production continued to expand, albeit at a modest pace

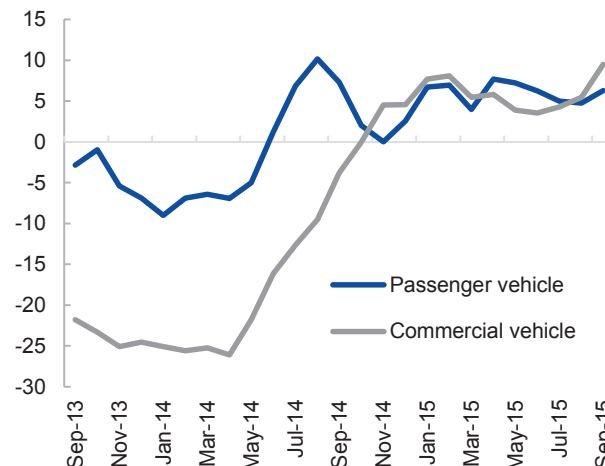
Index of Industrial Production, 3-month moving average, y/y growth, percent



Source: CEIC, CSO and World Bank staff calculations

Figure 4. Vehicle sales suggest improving momentum in domestic demand

Sales growth, 3-month moving average, y/y growth, percent



Source: CEIC, CSO and World Bank staff calculations

Industrial growth picked up, driven by construction

Construction picked up on higher infrastructure investments

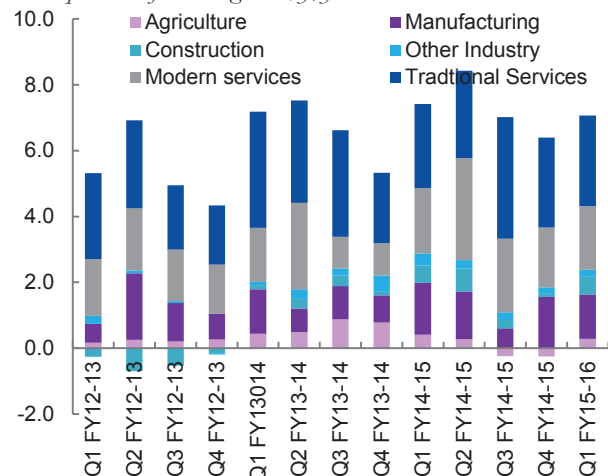
Likely lifted by higher public infrastructure investment, the construction sector expanded by 4.8 percent in FY14-15 and increased its contribution to GVA growth into FY15-16 (Q1 FY15-16: +0.6pp; Q4 FY14-15: +0.1pp; Figure 5), reflecting a growing momentum of 9.4 percent q/q saar in Q1 FY15-16 (Q4 FY14-15: +6.6 percent; Figure 6).

¹ GDP refers to GDP at market prices; GVA refers to GVA at basic prices, unless specified otherwise. FY14-15 refers to fiscal year ending 31st March 2015.

²All series in this report are seasonally adjusted by CEIC using TRAMO-SEATS.

Figure 5. Services remain the main contributors to growth

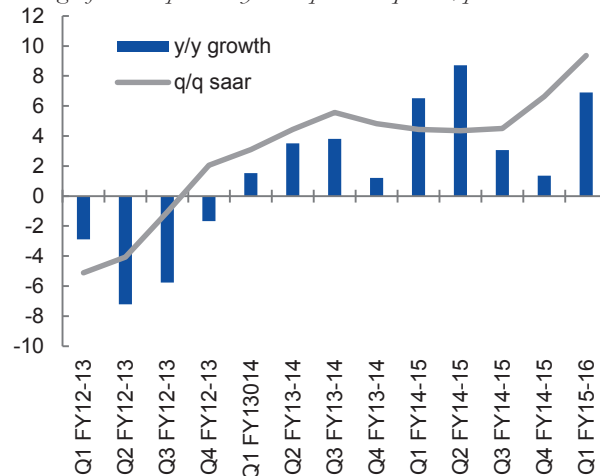
Decomposition of GVA growth, y/y



Source: CEIC, CSO, and World Bank staff calculations

Figure 6. Construction activity surged

Changes from the previous year or previous quarter, percent



Source: CEIC, CSO and World Bank staff calculations

Non-government services continued to expand robustly and remained the primary driver of growth

Overall, services growth accelerated to 10.2 percent in FY14-15 (FY13-14: +9.1 percent), but lost some momentum in 2016 (Q4 FY14-15: +9.1 percent; Q1 FY15-16: +8.9 percent q/q saar). Traditional services (trade, travel, communication and transport) grew by 10.7 percent in FY14-15 and accounted for nearly one-third of overall growth in value-added during the year (Figure 5), with growth still buoyant in early FY15-16 (Q1 FY15-16: +13.9 percent q/q saar) due to higher tourist arrivals and air travel frequencies. Modern services (financial, real estate and professional services) were key contributors to the economy’s momentum in FY14-15 (+11.5 percent vs. +7.9 percent in FY13-14), but decelerated in early FY15-16 (Q1 FY15-16: +9.2 percent q/q saar). The overall deceleration in services in late FY14-15 and early FY15-16 is primarily due to government services (public administration, defense and others), which grew by just 1.4 percent in the six months between January and June 2015 from the same period in the previous year.³

Manufacturing output continued to expand in early FY15-16 but at a slower pace

In FY14-15 manufacturing grew by 7.1 percent (FY13-14: +5.3 percent) due to higher production of capital goods. Growth in manufacturing output was sustained on account of base metals, electronics and machinery, reflecting the increase in investments and related demand for capital goods. Some of that momentum waned in Q1 FY15-16, when manufacturing activity decelerated to 5.8 q/q saar (+7.2 percent y/y) from 12.4 percent (+8.4 percent y/y) in Q4 FY14-15.

Agricultural production was affected by poor rainfall in FY14-15 but a favorable Rabi crop led to growth in early FY15-16

Growth in agricultural output (nearly one-fifth of total output) slowed to 0.2 percent in FY14-15 from 3.7 percent in the previous year, suffering from sub-normal monsoons (south-west monsoons were 12 percent below the long-term average) which hampered crop production as 53 percent of gross cropped area is rain-fed. Food-grain production declined by 5 percent from a record produce of 265 mt in FY13-14. However, the winter crop (Rabi, which accounts for slightly over half of production) performed better and there was a sequential increase of 8.6 percent q/q saar in Q1 FY15-16 even as the y/y increase was subdued in absolute terms (Q1 FY15-16: +1.9 percent; Q4 FY14-15: -1.4 percent).

³ The government services series is not amenable to seasonal adjustment given a lack of a clear seasonal pattern in the data.

Domestic demand was the main contributor to growth

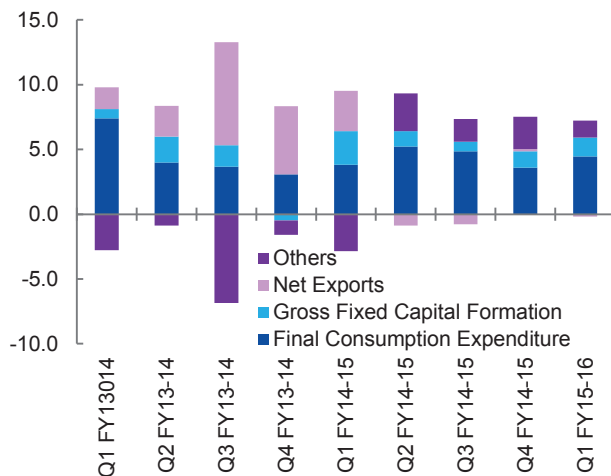
Government-driven investment growth in early FY15-16

Likely driven by public infrastructure investments, gross fixed capital formation picked up in early FY15-16

Investment growth increased to 4.6 percent in FY14-15 (FY13-14: +3.0 percent), accounting for one-fifth of overall growth (FY12-13 and FY13-14 average: 12.0 percent). This momentum was carried into the first quarter of FY15-16 with investments expanding 19.5 percent from the previous quarter (Q4 FY14-15: +1.7 percent q/q saar), and increasing its contribution to y/y growth from 1.2pp to 1.5pp (Figure 7). While investment in machinery is likely to have expanded, given the higher production and imports of capital goods in FY14-15, the buoyant performance of the construction sector suggests the main driver in FY15-16 was investment in structures. This in turn was driven by public investment: during the first five months of FY15-16, central government capital expenditure excluding loans increased by 20 percent y/y, largely on account of higher spending by the roads, transport and highways ministry, followed by rural development (Figure 8).

Figure 7. Strong private consumption and higher investments helped offset a growing drag from exports

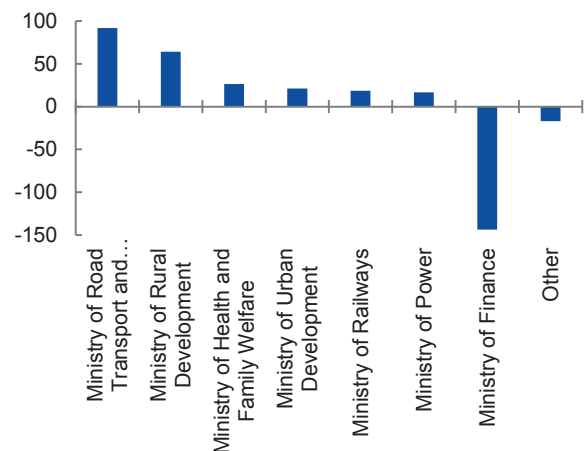
Contribution to GDP, y/y



Source: CEIC and World Bank staff calculations

Figure 8. The increase in Plan-spending was largely on account of investment-driven expenditures

Contribution of ministries to % y/y increase in Plan spending (Apr-Aug 2015)



Source: CEIC and World Bank staff calculations

Final consumption also increased its contribution to growth in early FY15-16 as government consumption turned positive

Final consumption expenditure grew by 6.3 percent y/y in Q1 FY15-16 and has been a fairly stable growth driver (FY14-15: 6.4 percent; FY13-14: 6.5 percent). Government consumption decelerated towards the end of the fiscal year on fiscal consolidation by the central government (public consumption subtracted 0.8pp from y/y growth in Q4 FY14-15) but picked up in the first quarter of FY15-16 (+10.2 percent q/q saar, though year-on-year growth was only 1.2 percent). Private consumption expenditure expanded by 7.4 percent y/y in Q1 FY15-16 (FY14-15: 6.3 percent) on declining inflation and was the largest contributor (50 percent) to overall demand growth. Despite the high y/y growth, momentum softened to 5.4 percent q/q saar following strong growth in the last quarter of the previous fiscal year (Q4 FY14-15: +10.3 percent).

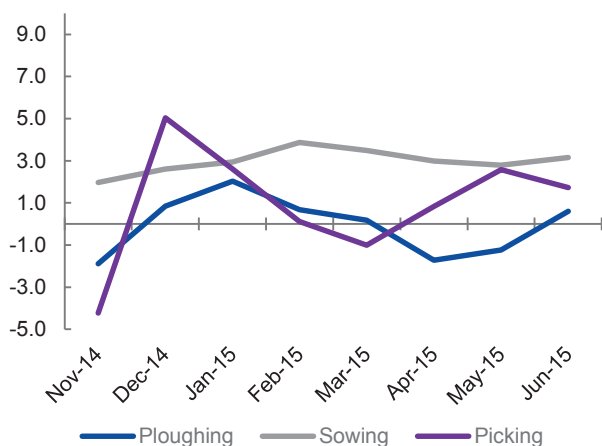
Limited gains in rural wages pose headwinds to household consumption

Wage growth in rural areas has generally kept up with inflation, but additional gains have been limited

Inflation faced by rural laborers has moderated since the end of 2014, hitting an all-time low of 3.2 percent y/y in August 2015. The rate of growth in rural wages of men has been higher than rural inflation for a number of occupations, resulting in average gains of -0.3 to 3.4 percent above inflation as of June 2015⁴. Wage gains for workers in agricultural occupations, which employ more than half of all rural males⁵, have ranged between -1.7 and 3.9 percent in 2015 (Figure 9). Construction, which accounts for about one-tenth of all rural male workers and is second only to agriculture in rural employment, witnessed negative wage growth since November 2014 (Figure 10). Nevertheless, real wages of construction workers appeared to pick up slightly in June, while wage growth of agricultural workers was positive across occupations. Limited real wage growth among rural males represents an important headwind to growth and income growth of the bottom 40 percent of India's population.

Figure 9. Agricultural wages show signs of improvement in June

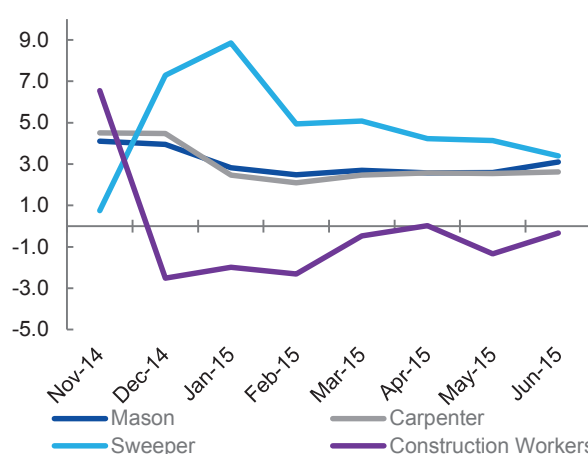
Rural wages adjusted for inflation (rural laborers): agricultural male workers, y/y changes, percent



Source: Labour Bureau and World Bank staff calculations

Figure 10. Wages in construction have been subdued compared to other non-agricultural occupations

Rural wages adjusted for inflation (rural laborers): non-agricultural male workers, y/y changes, percent



Source: Labour Bureau and World Bank staff calculations

Exports disappoint, but low commodity prices keep the current account contained

Broad-based weakness of exports, led by commodities

The contribution of net trade to real GDP growth turned negative on further deterioration of exports

Exports of goods and services (in constant prices) contracted by 0.8 percent in FY14-15, while imports of goods and services declined by 2.1 percent. Net trade, therefore, made a small positive contribution to growth (+0.4pp) in FY14-15. While the momentum on contracting imports moderated in Q1 FY15-16, the export slump worsened on account of increased global weakness, leading to a negative contribution to growth of 0.2 percent in the quarter.

Exports plummeted mainly due to lower oil prices

Merchandise exports (in nominal USD) declined by 0.6 percent in FY14-15 and a further 16.8 percent in Q1 FY15-16, largely on account of lower exports of petroleum products (18.3 percent of total merchandise exports), which contracted by 10.2 percent in FY14-15 and 51 percent y/y in Q1 FY15-16 (Figure 11). This was primarily due to lower global crude oil prices (down 31

⁴ Estimation for methodology for wages was revised in November 2013. Harmonized rural wage data for men are available from Nov 2013- June 2015, from the labour bureau.

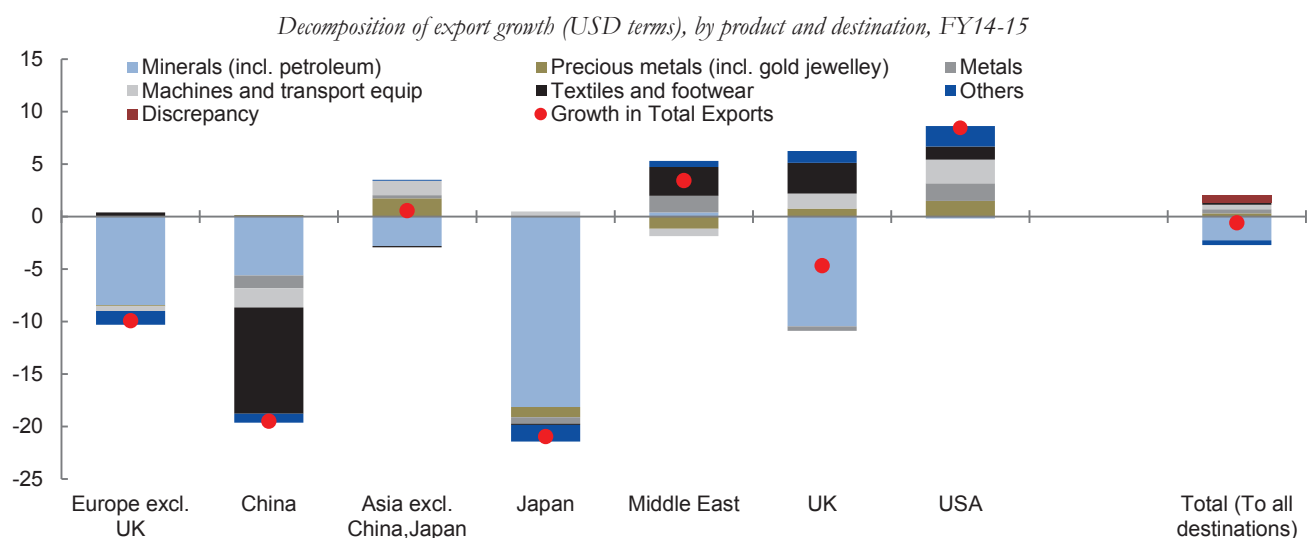
⁵ According to the 68th round of NSS in 2011-12.

percent between Q4 and Q3 FY14-15), which more than offset modest volume growth (+2.7 percent) in FY14-15. In Q1 FY15-16 the decline in prices was coupled with dwindling volumes, which plummeted by 26 percent y/y.

Other merchandise exports also slowed due weak global demand and domestic supply constraints

Non-oil exports (80 percent of total merchandise exports) grew by 0.6 percent in FY14-15 in USD terms, but lost momentum in Q1 FY15-16, declining by 6.6 percent y/y. The growth in FY14-15 was driven largely by demand for capital goods from a recovering US economy, the UK and emerging markets, and was sustained despite a decline in shipments to China (FY14-15: -19.5 percent, largely on account of lower textile and footwear exports), and reduced exports of agricultural commodities (Figure 11). In Q1 FY15-16, exports to almost all of the top fifteen export destinations registered a negative growth – in particular, exports to Saudi Arabia, Japan and China declined.

Figure 11. Petroleum drives the decline in exports



Source: CEIC and World Bank staff calculations

Notes: Europe excl. UK: Belgium, France, Germany, Italy, Netherlands, Russia and Switzerland; Asia excl. China, Japan: Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand and Vietnam; Middle East: UAE and Saudi Arabia

Lower commodity prices limited the current account deficit

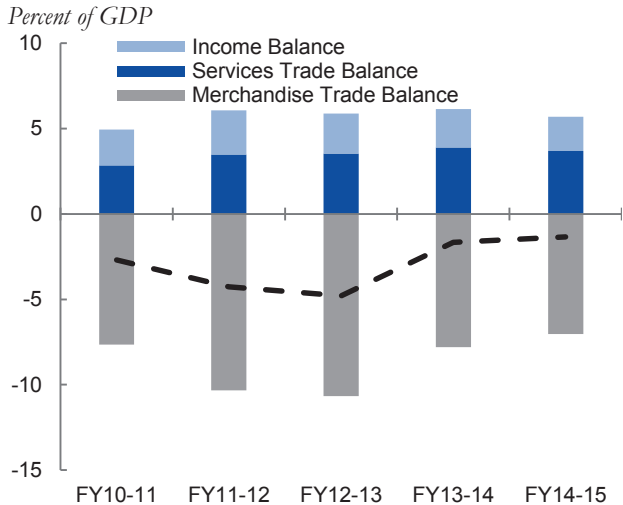
The current account deficit declined to 1.2 percent of GDP in Q1 FY15-16 on account of the oil-induced narrowing of the merchandise trade balance

Despite the growing importance of services, the current account remains closely tied to movements in the merchandise trade balance (Figure 12), which in turn has been driven by imports (Figure 13). Petroleum imports (26 percent of merchandise imports) shrank by 18.9 percent FY14-15, while gold imports were broadly stable despite Government measures to contain them.⁶ Non-oil, non-gold imports on the other hand rose by 7.0 percent in FY14-15 and continued to grow by 6.8 percent in Q1 FY15-16, reflecting strength in domestic demand (Figure 14). With a pickup in investments and industrial activity, imports of capital goods increased by 4.3 percent in FY14-15 (Q1 FY15-16: +6.6 percent). In addition, demand for agricultural commodities rose by 19.6 percent in FY14-15 on account of the decline in food grain production. Overall, the effect of lower oil prices dominated and imports shrank by 1.1 percent in FY14-15, and further by 12.1 percent y/y in Q1 FY15-16, resulting in a narrowing of the trade deficit to 6.7 percent of GDP in Q1 FY15-16 (FY13-14: 7.8 percent FY14-15: 7.0

⁶ Following the “taper tantrum” of early 2013, the government imposed the 80:20 norm as a method to curb gold imports and consequently the current account deficit, causing an almost 50 percent y/y drop in gold imports between April and June 2014. The restrictions were removed in November 2014 which caused gold import volumes to grow by 26.8 percent and gold import value to grow by 20 percent in FY15. Momentum in value terms continued in Q1FY16 as gold imports grew by 6.7 percent y/y.

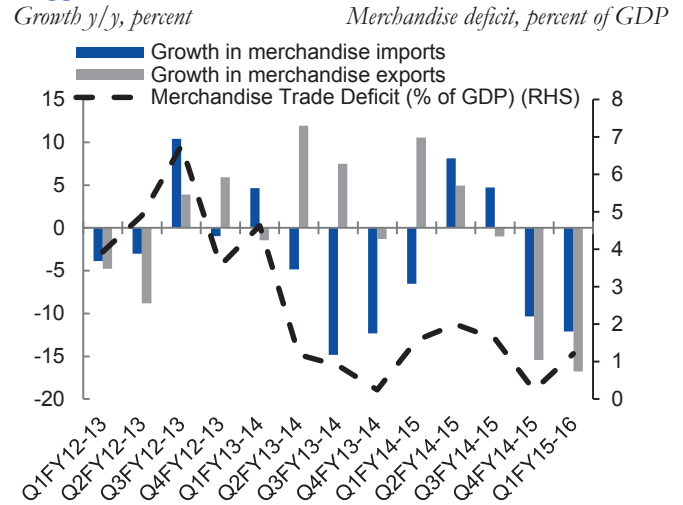
percent of GDP). Along with continued remittances into the country, the narrower trade deficit limited the current account deficit to 1.3 percent of GDP in FY14-15 (FY13-14: 1.7 percent). The gap reached 0.2 percent of GDP in Q4 FY14-15 before increasing to 1.2 percent of GDP in Q1 FY15-16 as oil prices recovered somewhat while exports continued to decline.

Figure 12. The current account narrowed due to a lower merchandise trade deficit...



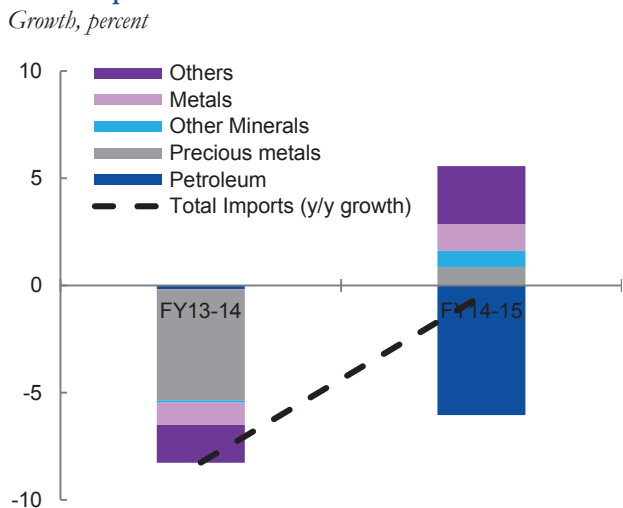
Source: CEIC and World Bank staff calculations

Figure 13. ...driven by import contraction as exports were sluggish



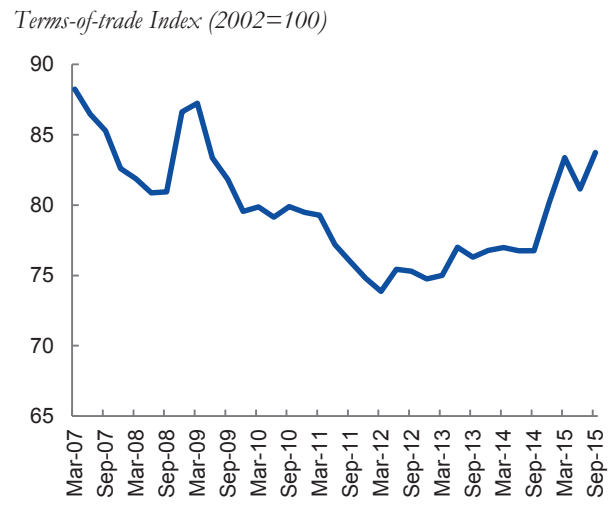
Source: CEIC and World Bank staff calculations

Figure 14. Lower imports were largely on account of lower crude oil prices...



Source: CEIC and World Bank staff calculations

Figure 15. ... as reflected in an improvement in India's terms-of-trade



Source: IMF WEO

Lower crude prices have led to some improvement in India's terms-of-trade

With an oil trade gap in excess of USD 100 billion (8.8 percent of GDP) in FY13-14, the decline of the price of crude oil in the past 16 months represented a positive terms-of-trade shock for India (Figure 15). The magnitude of the improvements were only limited by the significant weight of petroleum products in India's export basket (20 percent), as well as weak prices of India's non-petroleum exports (an additional 30 percent of the export basket is comprised of agricultural products, ores & minerals, and jewelry).

The services balance narrowed as export growth cooled

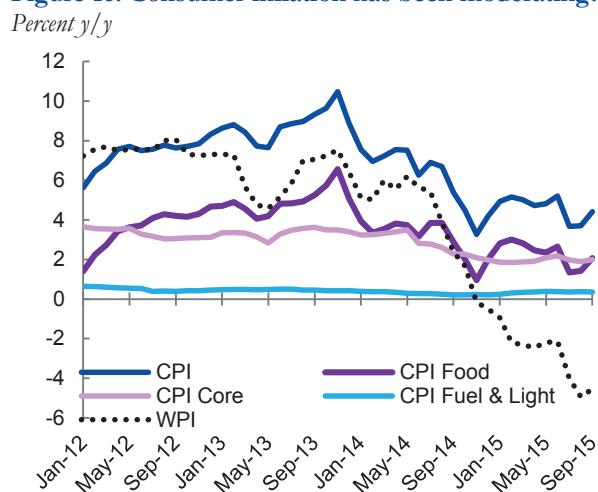
India's vibrant services export sector was hit by the global slowdown and saw export growth decelerate to 2.6 percent y/y in FY14-15 (FY13-14: 4.0 percent), largely due to slower growth of modern services (telecom, computer and information services; FY14-15: 4.6 percent; FY13-14: 6.2 percent), which were affected by renewed turmoil in Europe. Service exports ended FY14-15 contracting by 2.0 percent y/y in Q4, before recovering and expanding by 1.3 percent y/y in Q1 FY15-16. Import bills from transport and travel grew by 29.6 percent y/y (FY13-14: 9.6 percent), leading to higher service imports and a narrowing of the services surplus from 3.9 percent of GDP in FY13-14 to 3.7 percent of GDP in FY14-15 and further to 3.4 percent in Q1 FY15-16.

Subdued inflation on account of lower food prices

CPI has stabilized after declining through most of 2014 while WPI continued to move further into negative territory

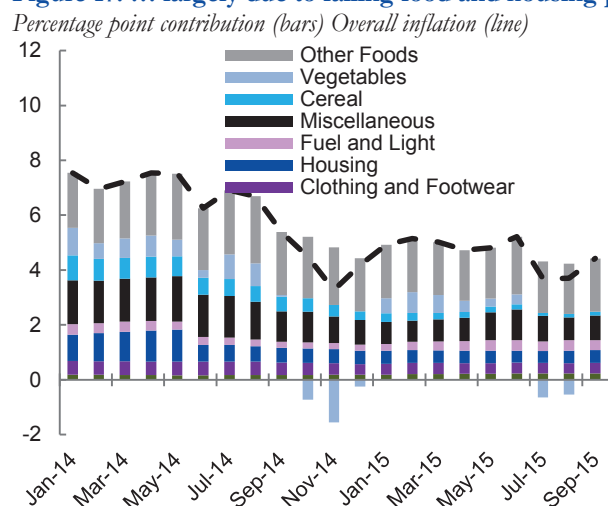
Both CPI and WPI inflation have declined since November 2013 (Figure 16). CPI inflation dropped from a peak of 10.5 percent to 3.4 percent between November 2013 and November 2014. Since then the CPI growth has stabilized at an average of 4.5 percent until September 2015. The WPI started its decline in the same month as the CPI, in November 2013, but has continued to fall until September 2015. A decomposition (World Bank 2015b) of the inflation indices indicates that fuel prices make only a minor (direct) contribution to the decline in CPI inflation but a large one to WPI inflation, accounting for most of the deflation observed in the WPI. The different role played by fuel inflation depending on whether the CPI or the WPI is considered, suggests that there was a substantial pass-through of cheaper oil to producers, but not to consumers.

Figure 16. Consumer inflation has been moderating...



Source: CEIC and World Bank staff calculations

Figure 17. ... largely due to falling food and housing prices

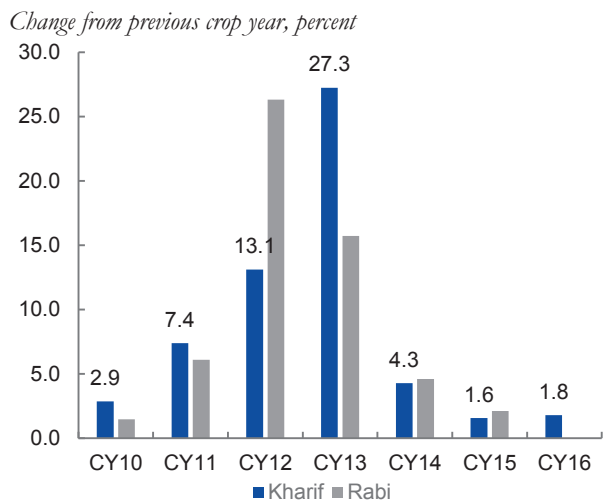


Source: CEIC and World Bank staff calculations

The decline in CPI inflation was broad-based but mainly due to moderating food prices, cereals in particular

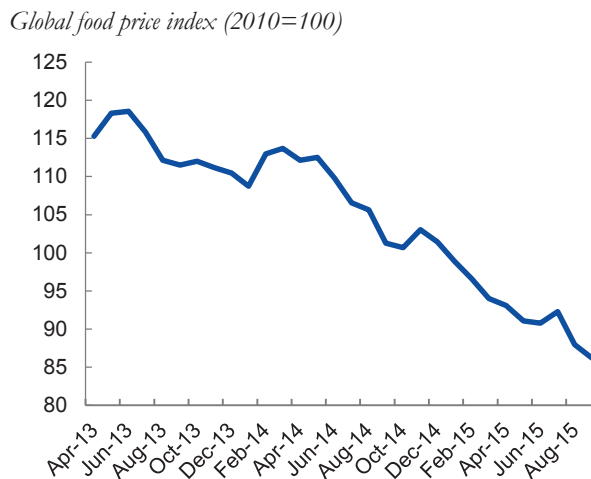
The decline in consumer inflation, while broad-based across its components and accompanied by a decline in 'core' inflation (Figure 16), was primarily driven by consistent moderation in price growth of food products, transport and communication, and housing (Figure 17). Among food products, increases in the prices of cereals, which comprise the largest share (21 percent) of the food basket, eased consistently. The contribution of cereals to overall consumer inflation dropped from an average of 17.5 percentage point (pp) in Q1 FY13-14 to 4.1pp in Q1 FY15-16 and further to 2.9pp in August 2015. The modest increase in Minimum Support Prices (MSP) from FY213-14 onwards and the decline in global food prices were largely responsible for this decline (Figure 18 and Figure 19). Among non-food categories, the contribution of housing to overall inflation declined from close to 1.0pp to 0.6pp in April-May 2014, and has moderated further since. Inflation in transport and communication prices also moderated consistently, reaching negative growth in January, 2015.

Figure 18. Since 2014, there has been limited increase in mandated MSP



Source: Department of Agriculture and Cooperation
 Note: CY: Crop Year from July-June (CY10 is July 2009-June 2010)

Figure 19. Global food prices have been declining



Source: World Bank DECPG

Domestic and external financial conditions bear watching

Monetary policy was eased on lower inflation, weak global growth

Following an extended period of constant rates and declining inflation, the central bank reduced the policy interest rate in 2015

The Reserve Bank of India (RBI) increased the policy rate in 2013 and held it firm at 8 percent from January 2014 until January 2015 (Figure 20). During this period, inflation averaged 6.7 percent, below the target of 8.0 percent recommended by the Expert Committee to Revise and Strengthen the Monetary Policy Framework. As inflation declined to 5.2 percent in January 2015 and real interest rates became decidedly positive, the policy rate was gradually cut. Rates were reduced in January, March and June, 2015 – each time by 25 basis points - to 7.25 percent, and in the latest policy review on September 29, 2015, the RBI surprised markets by cutting the policy repo rate by 50 basis points to 6.75 percent. RBI cited two reasons for its decision: weaker global growth that will in-turn reduce demand growth, and growth in food prices that is likely to remain muted due to restrained increases in MSP.

Following 125 bps of rate cuts in nine months, the RBI wants to ensure lower interest rates are transmitted to the real economy

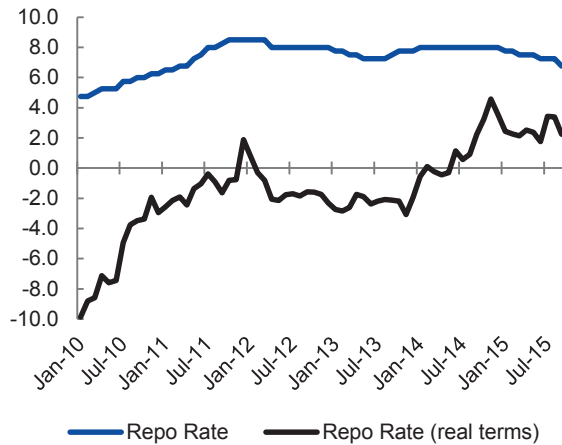
Despite the cumulative 75 basis points (bps) reduction in the policy rate between January and June, the median base lending rates of banks have fallen by only 30 bps while deposit rates have declined by 55 bps (Figure 21). RBI wants to enhance transmission by reducing the statutory liquidity ratio so that banks increase their holdings of non-government assets and encouraging a culture of establishing external benchmarks for interest rate setting (Report of The Expert Committee to Revise and Strengthen the Monetary Policy Framework, 2014). Moreover, news reports suggest that the government may link the interest rate on small saving schemes to bank deposit rates of similar maturities or to a market-linked benchmark; relatively high rates offered on government small savings schemes compete with banks' fixed deposits, making it tougher to lower deposit rates and hampering transmission. Finally, boosting banks' asset quality will also be critical, as banks may be inclined to increase interest spreads to help repair their balance sheets.

RBI has cemented its credibility as an inflation targeting bank

The caution in commencing the rate reduction cycle and institutional reforms have cemented RBI's reputation. Bringing real interest rates to positive territory after several years helped anchor inflation expectations and signaled the central bank's commitment towards inflation targeting. RBI's credibility has been further bolstered by formally signing the Monetary Policy Framework with the Government earlier in February, which has formally established the Flexible Inflation Targeting framework.

Figure 20. The policy repo rate has been easing since January 2015, along with inflation

Rates, percent per annum

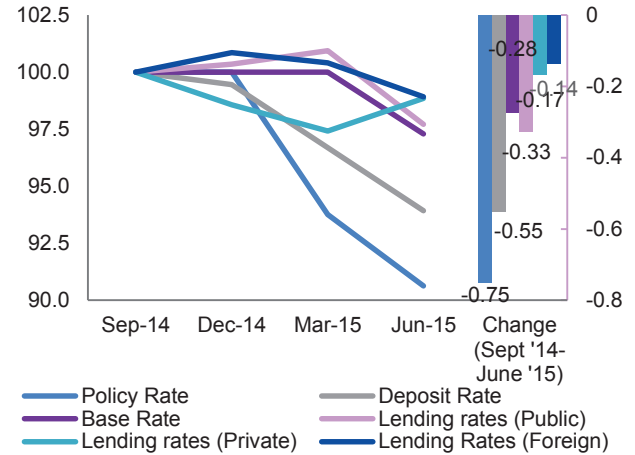


Source: CEIC and World Bank staff calculations

Note: The real policy rate subtracts contemporaneous inflation from the nominal policy rate.

Figure 21. Lending rates declined less than both the policy and deposit rates

Interest rate index, September 2014=100 Change, percentage points



Source: CEIC, RBI and World Bank staff calculations

Note: "Lending rates" are the simple average of the upper points in the median ranges of interest rates for term loans, demand loans and cash credit, at which at least 60 percent of business has been contracted.

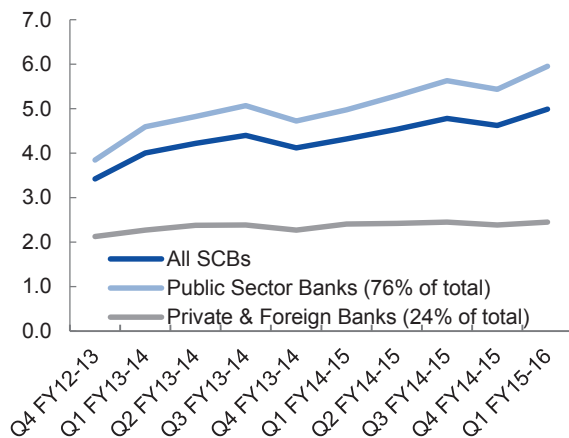
Deteriorating asset quality weighs on credit growth

Poor – and deteriorating – asset-quality of Public Sector Banks is the biggest challenge facing the financial sector and a drag on credit growth

Stressed assets of Public Sector Banks (state-owned banks; PSBs) are at 13.5 percent of total loans as of March 2015 compared to 4.6 percent for private banks, while non-performing assets are at 6.0 percent of total loans as of June 2015 compared to 2.5 percent for private banks (Figure 22). If macroeconomic conditions deteriorate, under a severe stress scenario more than half the stressed assets are expected to turn into non-performing assets (NPAs). Under such a scenario, the system level capital to risk weighted assets ratio (CRAR) of Scheduled Commercial Banks (SCBs) could decline to 11.5 percent by March 2016 from 12.9 percent as of March 2015 (RBI Financial Stability Report, 2015). The negative impact of NPAs on the profitability of PSBs is also expected to be felt in coming years. Return on Assets for PSBs remain below 1 percent and the gap with private banks is widening.

Figure 22. Non-performing assets have reached 5 percent, driven by higher NPAs in public sector banks

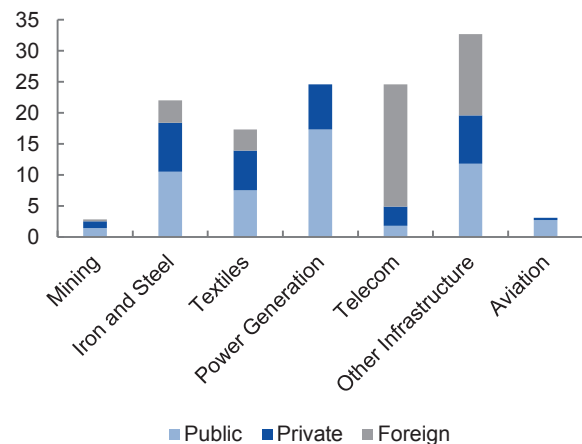
Non-performing assets as a share of gross advances, percent



Source: RBI and World Bank staff calculations

Figure 23. NPAs are concentrated in infrastructure sectors, especially power

Share of stressed assets as of December 2014, percent



Source: RBI and World Bank staff calculations

To add to the “stock” problem of high NPAs, there is a continuing “flow” of new NPAs being added due to previously restructured loans turning non-performing, particularly in the infrastructure sector

Regulatory forbearance is no longer forthcoming from the central bank. Instead, an active strategy of write-downs and sell-offs on non-performing loans is being implemented. However, asset-quality pressures remain, especially in power and roads (Figure 23), which constituted 49 percent and 16 percent respectively of total outstanding bank credit to the infrastructure sector in FY13-14. Gross NPAs and restructured standard advances as a percentage of total advances to the infrastructure sector have increased from 5.1 percent of gross advances as of March 2010 to 22.8 percent of gross advances as of March 2015. The most stressed sector appears to be power, with generation accounting for nearly 17 percent of stressed assets in SCBs. Within the power sector, distribution companies are most under stress and at risk of adding to NPAs. The RBI’s Financial Stability Report (p. 24) noted that “Considering the inadequate fiscal space, it is quite likely that the state governments might not be in a position to repay the overdue principal/installments [of restructured power distribution company loans] in time and banks may be forced to continue classifying these loans as [overdue between 61-90 days] (...). Probability of slippage of this exposure into NPAs is very high considering the implementation of new regulatory norms on restructuring of loans and advances effective April 1, 2015.”

The RBI and central government are taking steps to address the NPA problem but additional capital injections may be needed

The government and RBI have announced capital injections and governance reforms, but additional measures may be required. Eight PSBs including SBI, Punjab National Bank, Bank of India, Canara Bank, Dena Bank, Corporation Bank and Andhra Bank received a capital infusion from the government of about USD 2.1 billion in September as part of the government’s program to infuse a total USD 10.6 billion equity into PSBs over four years to 2018-19 to shore up their capital base. This amount may have to be increased further: rating agency Moody’s has estimated that public sector banks need between USD 26 and USD 37 billion in new capital by 2019 to comply with RBI’s Basel III targets assuming their assets remain sound and GDP growth is moderate.⁷

A reform strategy to enhance governance, particularly around hiring policies of banks’ senior management, is also being implemented

As part of the Indradhanush (rainbow) initiative, enablers have been put in place through regulatory and policy changes, including incentives for early resolution, sales to Asset Reconstruction Companies, and addressing asset-liability management constraints for long tenure projects through the 5/25 refinancing facility. Further, the basis for performance management of senior management in PSBs will now be a Key Performance Indicator framework with emphasis on the efficiency of capital use, NPA management and financial inclusion. The Government also intends to set up an autonomous Bank Board Bureau to search and select heads of PSBs and help them in developing differentiated strategies and capital raising plans through innovative financial methods and instruments. This would be an interim step towards establishing a holding and investment company for these banks.

Dragged by slow loan growth in PSBs, especially to infrastructure, overall credit growth has been declining

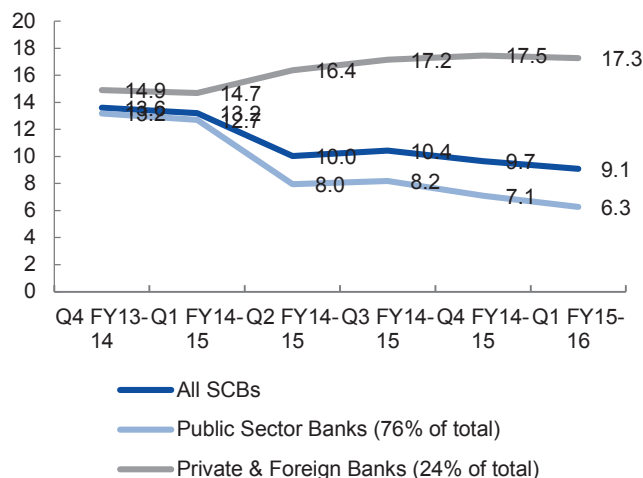
Growth in gross advances of SCBs declined to 9.1 percent from 10.0 percent on a y/y basis between September 2014 and June 2015 (Figure 24). RBI points to high NPAs in PSBs, risk aversion and moderate inflation as key factors influencing credit off-take. Credit growth in PSBs declined to 6.3 percent in June 2015, from 8.0 percent in September 2014, while credit growth in private and foreign banks improved to 17.3 percent from 16.4 percent in the same period. Declining inflation may have reduced demand for working capital credit, as evidenced by stable real credit growth, which recently showed incipient signs of a pick-up (Figure 25). Sector-wise, the industry and services sectors drove the slowdown (Figure 26). With lower NPAs compared to the business sector, banks were comfortable in lending for retail credit and personal loans, which saw slightly higher growth in FY14-15. In the industrial sector, credit growth slowed down across sub-sectors, but particularly for infrastructure-related sectors where companies are dealing with stressed balance sheets. The leveraged power sector was the largest contributor to the slowdown in credit to industry, reducing its contribution from 5.6 percentage points in May 2013 to 2.2 percentage points in August 2015 (Figure 27). In line with global trends, energy-

⁷ Moody’s Investor Service. “Indian Banks Could Need USD 26-37 Billion in External Capital for Basel III Compliance.” Research report issued September 19, 2015.

related sectors (petroleum, coal products and nuclear fuels), as well as chemicals and chemical products posted outright contractions in credit growth, subtracting 1.5 pp from credit growth in August 2015 compared to May 2013.

Figure 24. Credit growth has been declining since 2014 due to weaker credit by public sector banks

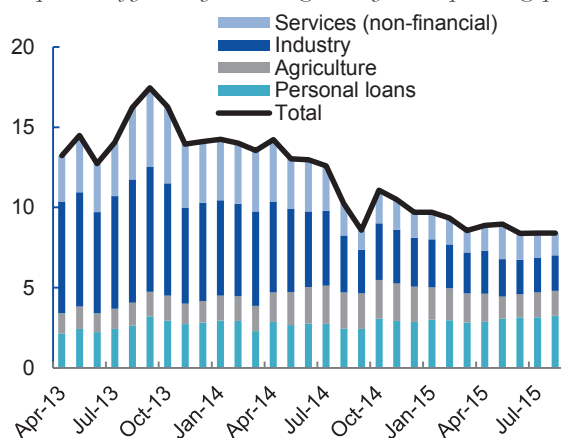
Change in total advances from the previous year, percent



Source: RBI and World Bank staff calculations

Figure 26. Lower credit growth has been driven by industry...

Decomposition of year-on-year credit growth by sector, percentage points



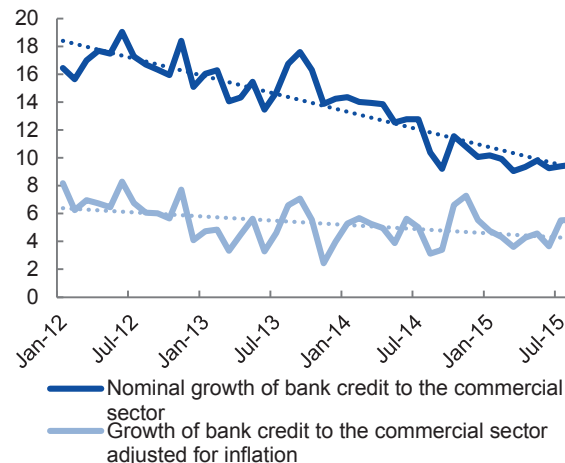
Source: RBI and World Bank staff calculations

Household credit growth may pick up further as financial inclusion expands

According to World Bank's Global Findex data (2014), 53.1 percent of adults above the age of 15 in India owned formal bank accounts but only 6.4 percent borrowed from institutional and formal sources. The government accelerated ongoing financial inclusion efforts with the launch of the Pradhan Mantri Jan Dhan Yojana (PMJDY) scheme in August 2014. As of October 10, 2015, 187 million basic banking accounts were opened under PMJDY, with a cumulative balance of approximately USD 3.8billion⁸. Beneficiaries from the PMJDY scheme are expected to receive RuPay debit cards and inbuilt accident insurance cover of INR 100,000. While deposit growth can critically impact growth in credit, benefits through the PMJDY scheme including higher penetration for direct-benefit transfer are yet to translate into credit offtake.

Figure 25. Adjusted for inflation, credit growth has slowed less markedly and may have turned around

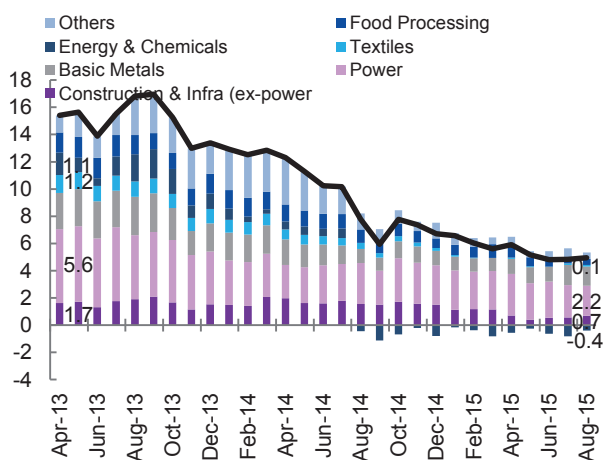
Change from the previous year, percent



Source: RBI and World Bank staff calculations

Figure 27. ...especially infrastructure

Decomposition of industry credit growth by sub-sector, percentage points



Source: RBI and World Bank staff calculations

⁸ Using RBI monthly reference exchange rate of INR 65.74 against the USD for September, 2015.

Transforming access into usage remains a challenge with high rates of dormancy and significant transactions costs for banks.

Payment banks and small finance banks may also spur further financial inclusion and growth in credit to consumers and small businesses

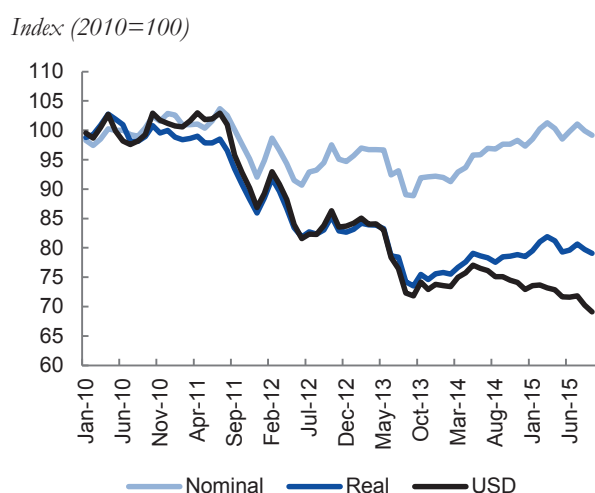
In August 2015, RBI granted in-principle approval for Payments Banks (PBs) to 11 entities including leading telecom companies. PBs intend to leverage technology to deliver simple banking and financial services to under-served populations. A technology-driven banking model is expected to enable higher reach and lower transaction costs, as viability and performance would depend on scale and cost of operations. Further, as PBs interest spreads are likely to be range-bound within 3-4 percent (to minimize risks, PBs have limited flexibility on both deposit and asset sides), their earnings can be boosted by channeling simple financial products like insurance to the target population subject to appropriate oversight mechanisms. RBI also granted in principle approval to 10 Small Finance Bank (SFB) applicants in September 2015, a large number of which are micro finance institutions. SFBs are intended to be private, well-governed deposit-taking institutions with strong local presence. They offset their higher risk from being geographically focused through higher capital requirements, a strict prohibition on related party transactions, and lower allowable concentration norms.

Financial account surplus boosts reserves and the currency, but volatility on the rise

Despite depreciating against the US dollar, the Rupee has remained stable against a basket of currencies

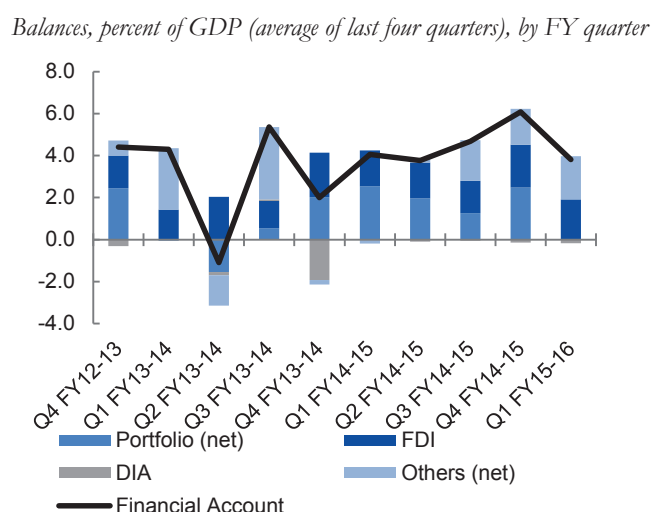
The Indian Rupee fell to a nearly-two-year low on August 21, closing at 66.0 INR per USD. This represented a 3.9 and 8.8 percent depreciation over the previous month and year, respectively. However, the Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) indices, which reflect the exchange rate against a basket of currencies, have been more stable. In particular, declining inflation has led to stability of the REER even as nominal exchange rates continued to depreciate. Meanwhile, the path of the NEER decoupled from the USD exchange rate in late 2014 and appreciated until recently (Figure 28), reflecting India’s relatively strong position compared to other emerging markets. Following the devaluation of the Yuan in August, the NEER and REER indices depreciated only modestly and remain above the “taper tantrum” levels of mid-2013.

Figure 28. Since late 2014, the USD and nominal effective exchange rates have decoupled



Source: RBI, IMF, World Bank staff calculations

Figure 29. The financial account remained in surplus despite lower portfolio flows in Q1 FY15-16



Source: RBI and World Bank staff estimates

Despite lower portfolio flows in early FY15-16, the financial account remained in surplus

Driven by higher portfolio and other inflows in FY14-15, net capital inflows increased considerably to 4.6 percent of GDP (FY13-14: 2.4 percent of GDP) and reached 6.1 percent of GDP in Q4 FY14-15, before moderating to 3.8 percent of GDP in Q1 FY15-16 as incipient global volatility curbed portfolio inflows (Figure 29). As a result of a widening financial account surplus and narrowing current account deficit, reserves started rising since November 2014 and

reached a record high of USD 356 billion in June 2015, sufficient to finance 9 months of retained imports and 4.2 times short-term external debt, supporting the relative outperformance of the rupee vis-à-vis other currencies.

FDI remained steady while portfolio flows receded in early FY15-16 after a strong showing the previous year

The key driver of the financial account in FY14-15 was a surge in portfolio (foreign institutional) investments (FIIs), which grew to 3.6 percent of GDP from 1.4 percent in FY13-14. FDI inflows were steady, primarily for the infrastructure, mining (including oil & gas) telecom, and other services, sectors. Non-resident Indian (NRI) deposits fell to 0.7 percent of GDP in FY14-15 from 2.1 percent of GDP in FY13-14, perhaps on account of declining domestic interest rates and a shift to other assets. Foreign investment inflows in Q1 FY15-16 fell to 1.5 percent of GDP despite growth of FDI to 1.9 percent of GDP, as FIIs contracted sharply by 2.5pp of GDP from Q4 FY14-15 and turned negative in July as global volatility escalated.

External liabilities increased on higher deposits by NRIs despite currency valuation losses

During FY14-15, total external obligations rose by 6.6 percent to USD 475.8 billion or 23.8 percent of GDP. The increase was primarily due to a 21.7 percent y/y increase in commercial borrowings and a 10.9 percent y/y increase in NRI deposits. The share of commercial borrowings in external liabilities has risen from 36.6 percent in FY13-14 to 38.2 percent in FY14-15 due to the rise in commercial bank loans and securitized loans. The increase in magnitude of external debt was partly offset by the decline in short-term debt and valuation losses as a result of the appreciation of the US dollar against the rupee. The decline of 7.6 percent in short-term debt (down to USD 84.7 billion) was primarily driven by the decline of FII investments in government T-bills. Sovereign foreign currency debt rose to USD 89.7 billion in FY14-15 from USD 83.7 billion in FY13-14. The share of multilateral and bilateral credit has fallen from 74.3 percent of overall sovereign external debt in FY13-14 to 65.2 in FY14-15 as a result of broad based decline in multilateral and bilateral credit, in particular bilateral credit from Japan.

A favorable outlook with large uncertainties

Underpinned by domestic drivers, the robust pace of economic growth is expected to accelerate

Lifted by lower oil prices and prospects for implementation of structural reforms, activity is poised to accelerate gradually

Three key developments underlie the growth outlook: (i) India's ambitious program of structural reforms and infrastructure investments is proceeding, albeit at a slower pace than envisaged; (ii) global fuel and food prices remain benign, offsetting the impact of a deficient monsoon and creating room for additional household and government spending; and (iii) global volatility has increased due to the slowdown in China and the prospect of imminent interest rate normalization by the US Federal Reserve.

On balance, the pace of economic growth is still expected to accelerate, but slightly more gradually than earlier projections

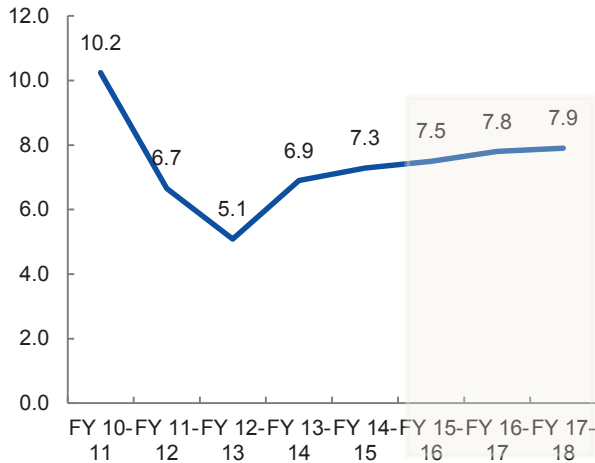
Real GDP growth is projected to pick up to 7.5 percent in FY15-16, accelerating to 7.8 and 7.9 percent in FY16-17, FY17-18 (Figure 30 and Table 2).⁹ In FY15-16, renewed decline in oil prices will create fiscal space for government-driven infrastructure investments, and along with the current momentum in reforms and cyclical recovery offset the impact of weaker exports and continued drag from leveraged balance sheets. RBI estimates suggest that a 10 percent decline in oil prices could improve growth between 0.1 and 0.3pp as more than 5 percent of costs in non-oil producing firms are in the form of fuel.¹⁰ Moreover, the (partly) oil-induced moderation in food and overall prices supports lower interest rates, as well as higher spending by households and the Government. This is a short-term effect, however, and deceleration in the reform momentum (notably the delay of the crucial GST roll-out) has slightly reduced growth prospects in FY16-17 and FY17-18. The World Bank's forecasts, which were at the low-end of consensus

⁹ All forecasts are made using the revised (base year: 2011-12) national accounts series. The officially released series only goes back till 2011/12. In order to statistically estimate relationships between different variables, we've roughly constructed a longer back-casted series up to 1960 using growth rates.

¹⁰ RBI Annual Report, 2015

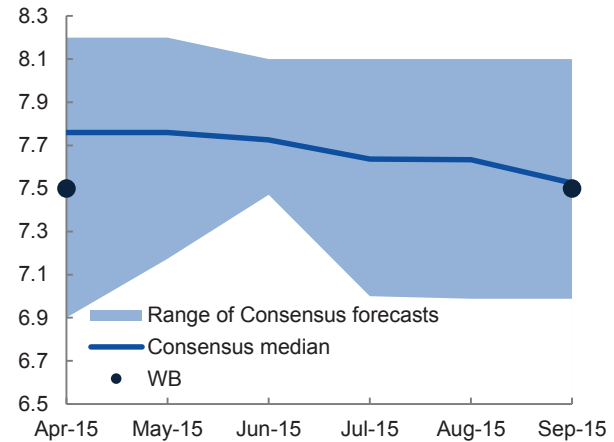
in the previous *India Development Update*, have converged to the median as observers have grown more cautious (Figure 31). Risks to the outlook remain elevated, the most immediate of which relates to the need to strengthen corporate and financial sector balance sheets and to maintain the reform momentum in order to sustain higher levels of investment.

Figure 30. GDP growth is expected to accelerate modestly
Change from the previous year, percent



Source: World Bank staff estimates

Figure 31. Consensus forecasts have come down
Evolution of consensus forecasts for India's FY16 real GDP (at market prices) growth, percent

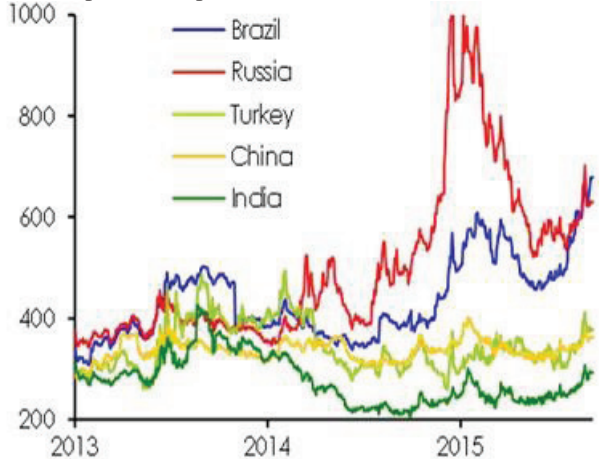


Source: Consensus economics and World Bank staff estimates

The Indian economy appears relatively well-positioned to weather the global volatility and slowdown in China – at least in the near term

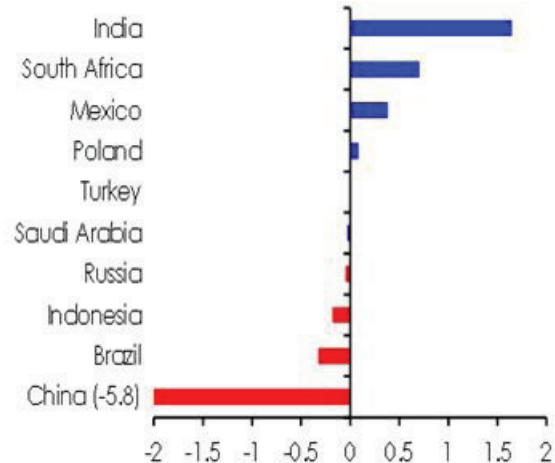
India has a relatively low trade exposure to China (only about 7 percent value added that India exports, is consumed in China), while Indian financial markets (local bond markets in particular) are relatively closed. India has accumulated considerable foreign exchange reserves (9 months of retained imports); and the current account deficit has narrowed significantly since the ‘taper tantrum’ episode of 2013, reducing vulnerabilities. Reflecting improved perceptions of financial stability, Indian corporate bond spreads have been narrower, and equity allocations increased (Figure 32 and Figure 33). Nevertheless, India is not immune to global conditions; the slowdown in China and its reverberation in the global economy has led to further deterioration of the already weak export outlook. Meanwhile, India requires some measure of foreign capital inflows to finance both fiscal and current account deficits, as well as investments to spur growth. See Box 2 for a more detailed discussion.

Figure 32. Corporate bond spreads widened less than in other large emerging economies...
CEMBI spread, basis points



Source: IIF, Bloomberg

Figure 33. ...while portfolio allocations increased
Percentage point change in portfolio weight between end-May and September



Source: IIF, EPFR

Weak global growth compounds domestic supply constraints and limits the contribution of exports to GDP growth

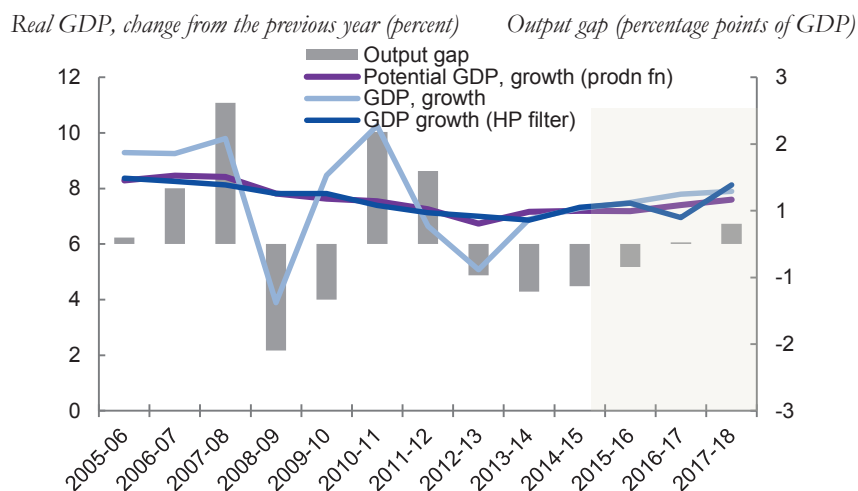
Indian exports have not been able to keep pace with the growth in world exports in the past and the share of Indian exports in world exports has stagnated. The combination of softening global demand and domestic supply constraints have led to declining exports in the first six months of FY15-16, although September data showed some signs of revival in manufacturing exports. With the low base limiting the potential contraction, merchandise export growth is expected to remain subdued, and is only likely to pick up meaningfully once investments and productivity-enhancing reforms to labor, land, and capital markets are realized. Exports of services remain a bright spot and are expected to return to double-digit growth in the medium-term, leading to an overall modest expansion in exports.

Sustained momentum predicated on continued revival of investments

A revival of the investment cycle is expected to drive growth, lifting near- and medium-term (potential) output

Improvements in the business environment, higher public investments and lower interest rates are expected to accelerate the growth of gross fixed capital formation (GFCF) to an average of 8.8 percent during FY15-16-FY18. While data constraints related to the new GDP series make precise estimates difficult to calculate, higher GFCF is expected to drive potential growth to 7.6-8.0 percent in the medium term, from about 7.2 percent in FY14-15 (Figure 34)¹¹. The economy currently has a small negative output gap – which is likely to close by FY16-17, if not earlier. Absent a faster catch-up of productivity growth or further acceleration in private investments, the output gap may turn positive, highlighting the importance of investments to expand capacity and sustain the growth momentum while avoiding imbalances.

Figure 34. The output gap is expected to close in FY16-17



Source: CEIC and World Bank Staff calculations and projections

Public investments are kick-starting the investment cycle, but increased participation of the private sector will be

In the near term, the acceleration in capital formation seen in the data is likely driven by public investments. However, private investment growth needs to pick up to ensure growth is sustainable. On the one hand, the acceleration in public investments is expected to have a ‘crowding-in’ effect on private investment growth, at least in the short-run, as Government disbursements and new contracts temporarily alleviate financial constraints in cash-strapped infrastructure companies. Private investments are also expected to benefit from several measures to mobilize funds and incentivize infrastructure projects, including encouraging PPP

¹¹ Potential GDP estimates are based on a standard production function with labor and capital shares held at 2/3 and 1/3, respectively. Capital stock estimates are based on the (2004-05) national accounts series and have been converted to the new series using the relationship between the flow of capital formation in the new and old series. Labor force estimates are UN population projections.

required going forward

projects through a plug and play model which allows private developers to hit the ground running and circumvent the initial bureaucratic bottlenecks; setting up of an infrastructure investment fund and the introduction of tax-free bonds to reallocate resources to this fund; reforming the business environment; easing the norms for foreign investors by instituting a composite cap for portfolio and direct investors; and redefining non-repatriable investments by NRI/OCI/POIs as domestic investments and alleviating any ceilings from the same.

Consumption is expected to remain robust and make the largest contribution to growth

Private consumption expenditure faces tailwinds from lower inflation, modest but positive real growth in rural wages, and the prospect of an early fillip from the civil service pay revisions in FY16-17. Accordingly, consumption is projected to sustain its momentum growing at 8 percent growth by FY17-18. In the near term, a September 2015 RBI survey of household consumer confidence reveals a two-fold increase in the number of households likely to increase consumption in the coming year, as compared to last year.

While services will remain the main driver of growth, industrial activities are expected to gain prominence in conjunction with investment growth

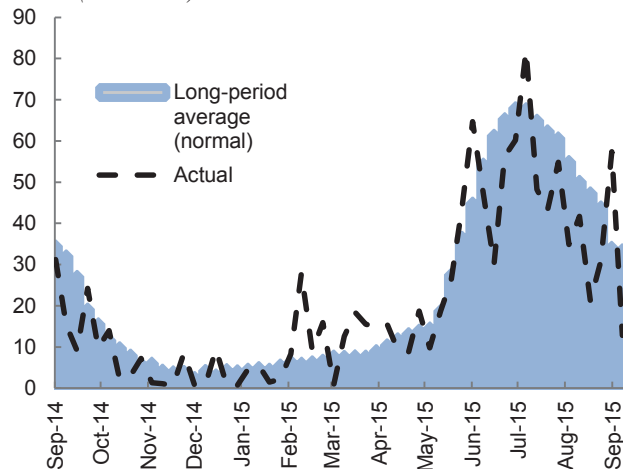
Services are expected to grow at an average of 10.3 percent during FY15-16 - FY17-18, down from a 5-year high (10.9 percent) registered in FY14-15 – supported by continued expansion in tourism, improvements in modern services as India continues to absorb new technologies and modest growth in exports to OECD economies. Industrial growth is expected to be initially driven by increased construction activity, followed up with gradual improvements in manufacturing, resulting in an overall acceleration from 5.8 percent in FY15-16 to 6.3 percent in FY17-18. Manufacturing will likely benefit from reforms on the ease of doing business including the relaxation of deposit and managerial remuneration limits for private companies; amendments to the Companies Act 2013; integrated single window clearances for centre and state regulations; and the Modified Special Incentive Package Scheme (which promotes large scale manufacturing in Electronics System Design and Manufacturing sector and provides subsidies for incurring capital expenditures, incentives for timely completion of projects and creation of employment).

Agricultural output growth will remain modest due to poor rainfall in FY15-16

Agriculture is expected to grow by 2.0 percent in FY15-16, up from a sub-normal outturn in FY14-15 but below its long term average. The acceleration, while subdued due to a second year of deficient monsoons (14 percent below normal; Figure 35), is expected on the back of an all-time high total sown area of Kharif crop at 10.1 billion ha, 2.0 percent higher than last year (Figure 36). Assuming normal rainfall in FY16-17 and FY17-18, agricultural growth is expected to converge to its longer-term average of nearly 2.8 percent.

Figure 35. The monsoon has been deficient for the second consecutive year...

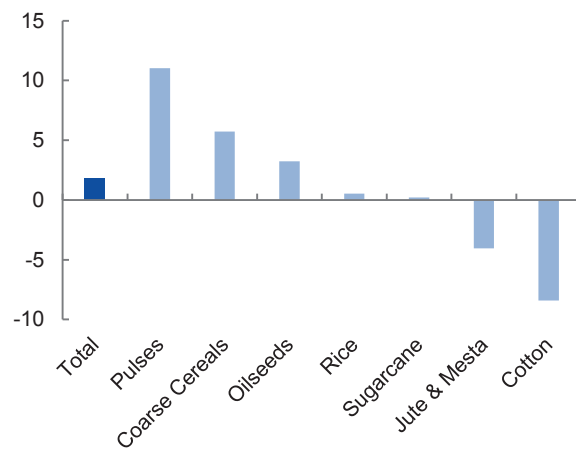
All India rainfall, mm, actual (line) and long-period average for the same months (shaded area)



Source: India Meteorological Department

Figure 36. ... but the sown area has increased in FY15-16

Change from the previous year, percent



Source: Ministry of Agriculture

Barring supply-side shocks, price increases are likely to remain contained

Renewed weakness in crude prices (which directly account for 7 percent in the CPI and have spillover effects on food inflation) are likely to keep inflation contained in FY15-16. Global food prices are also expected to rise only modestly in the coming years, limiting pressures for higher increases in minimum support prices. The negative (but closing) output gap also contributes to abating inflationary pressures in the near term, but improved production capacity is required to prevent overheating in the medium-term. Upside risks on food prices (46 percent of CPI) may arise in the event of continued poor monsoons, unanticipated large increases in the MSP of food grains or shocks to global commodity prices.

Although inflation is expected to remain moderate, the recent 50 bps cut has raised the bar on future rate cuts

The central bank has adopted a flexible inflation targeting monetary policy framework with a long-term target of 4 percent (+/- 2 percent). This development, in addition to the reformation in the monetary policy committee is likely to boost credibility of medium-term inflation targets of ~5 percent. In the baseline scenario, inflation is likely to decelerate to below 5 percent by FY17-18, creating the possibility of additional rate cuts if food and energy prices remain benign and capacity expansion keeps up with growth. In the near term, RBI has stated that it will focus on the transmission of the 125 bps cuts delivered in the first nine months of 2015.

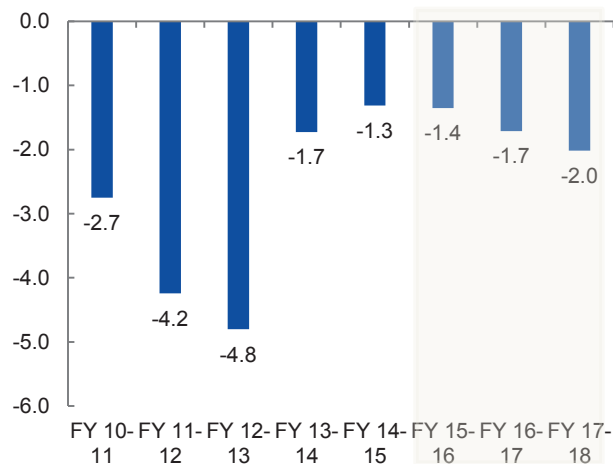
Strong domestic demand and subdued exports likely to lead to wider current account deficit

The current account deficit is expected to widen gradually as domestic demand accelerates while exports struggle

The current account deficit is expected to widen from 1.3 percent of GDP in FY14-15 to 2.0 percent in FY17-18 (Figure 37) as import growth overshoots export performance. Import growth is expected to accelerate in the later years in consonance with increased private consumption and to meet the investment requirements of the economy (Figure 38). Expanding domestic capacity and unlocking constraints to faster export growth will be important to ensure the medium-term stability of the current account.

Figure 37. A modest widening of the current account deficit...

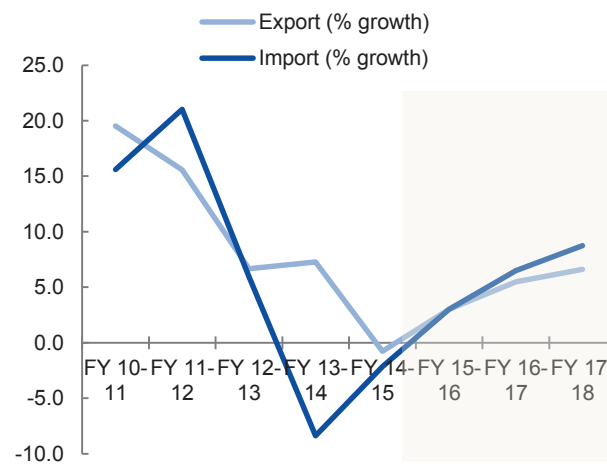
Current account balance, percent of GDP



Source: CEIC and World Bank staff calculations and projections

Figure 38. ... as import growth is expected to exceed export growth in the coming years

Change from the previous year, percent



Source: CEIC and World Bank staff calculations and projections

Domestic and external risks to the outlook are elevated

The external environment is one of weak growth and heightened volatility

Major risks stem from further weakness in India's key sources of trade, investment and remittance flows; increased volatility in financial flows; and higher global food prices. Renewed weakness in OECD economies and further weakening in China could further dampen external flows from trade and spill over to investment (see also Box 2). Although remittances have usually held up well during past shocks (see Gupta and Singh, 2010) the continued weakness in

oil prices may eventually impact remittances from GCC countries.¹² In the event that a tightening of the US monetary policy disrupts capital flows to emerging markets, as was the case during the ‘taper tantrum’ of mid-2013, financing conditions in India could be affected, delaying investments. Given the major role of low oil prices in India’s current economic performance, a renewed increase in the prices of crude oil would pose downside risks to the external and fiscal accounts, as well as growth and inflation. Finally, extreme weather is predicted to continue globally, with a severe El Nino forecast for the remainder of 2015 and posing upside risks for food prices.

The most significant risks to the outlook stem from the banking sector and financing requirements of infrastructure companies, as well as the pace of implementation of structural reforms

Unblocking the pipeline of infrastructure projects, ensuring sustainable means of financing and boosting private investment by keeping up the reform momentum are necessary to realize the meaningful and sustainable increase in investments embodied in the baseline scenario. Accordingly, the most immediate risk to growth is the related strain in corporate and financial sector balance sheets. Public Sector Banks, which account for ¾ of domestic credit, are undercapitalized, and NPLs are elevated, thus restricting financing for private investment. As RBI Deputy Governor Harun Khan remarked in a speech in August 2015, “bank financing of infrastructure is likely to be constrained going forward due to the growing trend in stressed assets from this sector in their balance sheets.” While the Governments’ actions to improve the health of the financial sector, including providing resources for bank recapitalization, are helpful, additional measures to address the debt overhang and capital for public sector banks will be likely required to address the overall profitability and soundness of these institutions. In the longer-term, the sustained implementation of the Government’s ambitious reform program is key. While progress is visible in many areas, including in improving the ease of doing business, some key reforms, most notably the GST, have been delayed (Table 1).

Table 1: Key Reforms Implemented and To-Be Implemented

Key Reforms implemented since March 2014	Key Reforms Postponed
<ul style="list-style-type: none"> • Adoption of monetary targeting and establishment of a Monetary Policy Committee • Deregulation of diesel prices • Allowing labor reforms in some states via Presidential assent • Increased FDI caps in insurance, defense, railways, etc. • Amendments to the Companies Act • Financial Inclusion - setting up infrastructure for direct transfer of subsidies • Gold monetization scheme • Facilitating infrastructure projects and financing - PMG, Plug-play projects, National Infrastructure Investment Fund 	<ul style="list-style-type: none"> • GST • Amendments to Land Acquisition • Amendments to labor regulations • Agricultural market reforms • Revised PPP model

¹² Gupta and Singh (2010) indicate that perhaps just like other financial flows, remittances in recent years are driven partly by an investment motive, and affected by the prospects of relative earnings in the native and host countries.

Table 2: Key Economic Indicators and Projections

							Baseline		
		2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
GDP, market prices	y/y percent	10.2	6.7	5.1	6.9	7.3	7.5	7.8	7.9
Private Consumption	y/y percent	8.7	9.3	5.5	6.2	6.3	7.0	8.0	8.0
Government Consumption	y/y percent	5.8	6.9	1.7	8.2	6.6	6.5	6.3	6.2
Gross Fixed Investment	y/y percent	11.0	12.3	-0.3	3.0	4.6	7.9	9.1	9.5
Exports, GNFS	y/y percent	19.5	15.6	6.7	7.3	-0.8	3.0	5.5	6.6
Imports, GNFS	y/y percent	15.6	21.0	6.0	-8.4	-2.1	3.0	6.5	8.8
GDP, factor cost	y/y percent	8.9	6.8	4.9	6.6	7.5	7.6	7.8	7.9
Agriculture	y/y percent	8.7	8.4	1.7	3.8	1.1	2.0	2.8	2.8
Industry	y/y percent	7.7	7.3	2.3	4.4	5.6	5.8	6.0	6.3
Services	y/y percent	9.8	5.9	8.0	9.1	10.9	10.4	10.3	10.3
Current account balance	percent of GDP	-2.7	-4.2	-4.8	-1.7	-1.3	-1.4	-1.7	-2.0
Total Revenues	percent of GDP	20.6	18.9	19.6	19.7	19.8	19.8	20.3	20.7
Total Expenditures	percent of GDP	27.6	26.7	26.5	26.7	26.2	26.1	26.2	26.1
Fiscal Balance	percent of GDP	-7.0	-7.8	-6.9	-6.9	-6.4	-6.3	-5.9	-5.4
General government debt	percent of GDP	0.0	68.3	67.7	64.5	63.4	62.4	61.0	59.7

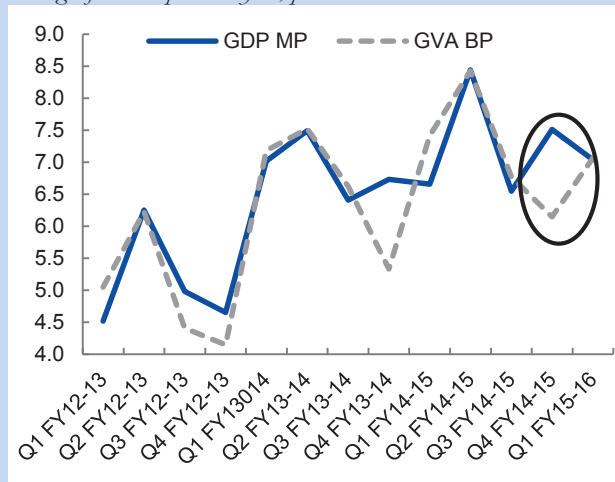
Box 1: Deflators and diverging trends in India's national accounts statistics

Gross Domestic Product at Market Prices (GDP MP) is an estimate of total expenditures by the domestic economy – including amounts spent on indirect taxes net of subsidies; while Gross Value Added at Basic Prices (GVA BP) estimates net output produced domestically measured according to the costs of production. The difference between GDP MP and GVA BP is equal to net indirect product taxes, i.e. taxes net of subsidies paid by the end consumer but not incurred at the time of production. Any other measurement errors are recorded as statistical discrepancies in national accounts.

Growth patterns based on value added (GVA BP) have diverged from expenditure estimates (GDP MP) for two consecutive quarters, creating significant uncertainty about the momentum in India's economic activity (Figure 39 and Figure 40). While production estimates (GVA BP) suggest an acceleration in Q1 FY15-16 from 6.1 to 7.1 percent y/y (or 6.9 to 7.2 percent q/q saar), expenditure estimates (GDP MP) suggest the contrary, with growth cooling from 7.5 percent to 7.1 percent y/y (7.2 to 6.6 percent q/q saar). Meanwhile, nominal GDP MP accelerated at a faster pace than GVA BP (7.7 percent y/y in Q4 FY14-15 to 8.8 percent in Q1 FY15-16, compared to GVA BP growth of 6.0 percent y/y to 7.1 percent in the same period). What explains this divergence?

Figure 39. Estimates of economic growth diverged in the previous two quarters...

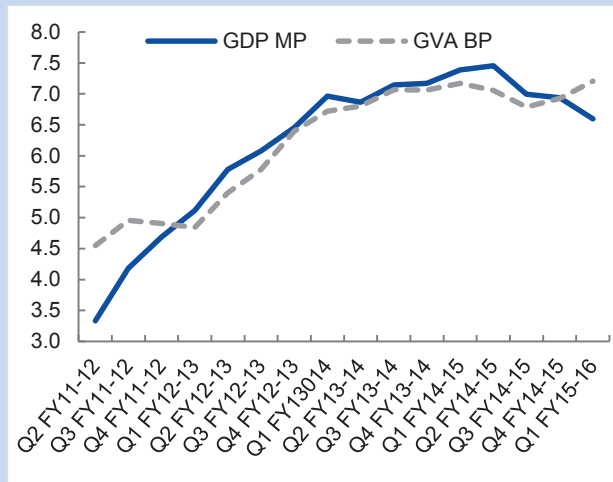
Changes from the previous year, percent



Source: CEIC, CSO, and World Bank staff calculations

Figure 40. ...reflecting different growth momentums

Changes from the previous quarter, percent saar

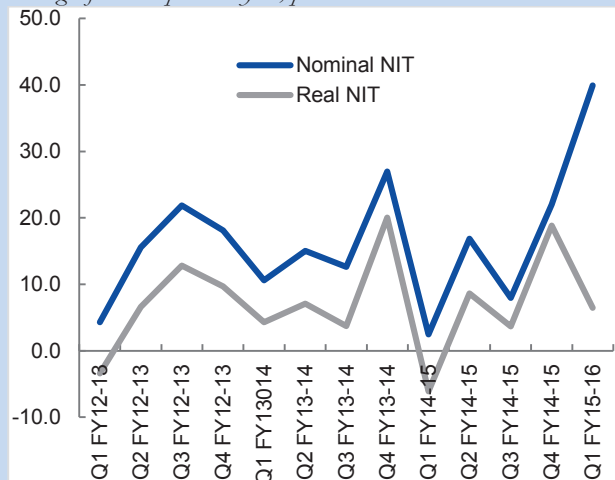


Source: CEIC, CSO and World Bank staff calculations

The differences in nominal and real GDP MP suggest the unexplained jump in the GDP MP deflator is likely to be driving the overall disconnect in national accounts. Specifically, growth in nominal net indirect taxes (NIT) increased to 37 percent y/y in Q1 FY15-16 from 22 percent in the previous quarter – which coincided with an increase in excise and service tax rates. However, this was coupled with a sharper acceleration in implied inflation in NIT; with the deflator growing by 25 percent y/y in Q1 FY15-16 from 3 percent in the previous quarter – resulting in a much smaller increase in real NIT and consequently in GDP MP (Figure 41 and Figure 42).

Figure 41. High growth in nominal net indirect taxes was not reflected in real terms...

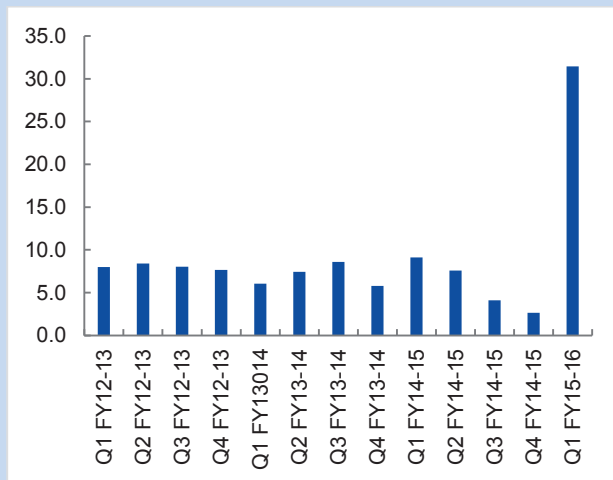
Changes from the previous year, percent



Source: CEIC, CSO, and World Bank staff calculations

Figure 42. ...implying a jump in the NIT deflator

NIT deflator, changes from the previous year, percent

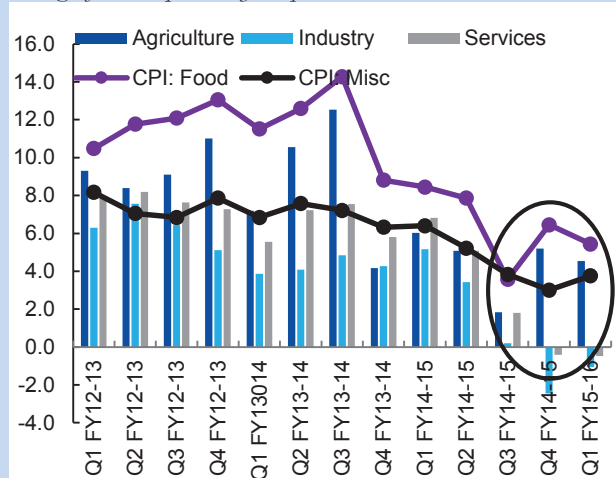


Source: CEIC, CSO and World Bank staff calculations

Deflators for other components of national accounts have also been volatile. Deflators in the new national account statistics are based on the aggregated all-India Consumer Price Index (CPI). On the production components, agricultural deflators have moved closely with Food CPI and services deflators with Miscellaneous CPI (which includes household goods and services, health, transport and communication, recreation, education and personal care and effects; Figure 43). However, over the last three quarters, the services deflator has diverged from CPI miscellaneous. Simultaneously, deflators on the expenditure front also decelerated far more rapidly than CPI (Figure 44). As additional data becomes available, as well as methodological improvements are applied to current data, estimates of the deflators are expected to become more precise and less volatile, providing a more consistent view of the direction of economic activity.

Figure 43. In recent quarters, deflators used for production estimates are not in tune with CPI

Changes from the previous year, percent

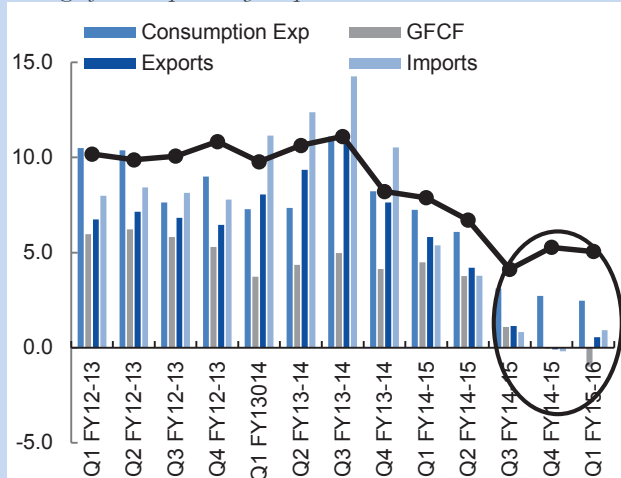


Source: CEIC, CSO, and World Bank staff calculations

Source: Authors, CSO.

Figure 44. Deflators used for expenditure components present similar anomalies

Changes from the previous year, percent



Source: CEIC, CSO and World Bank staff calculations

Box 2: Muted impact of a slowing China on India?

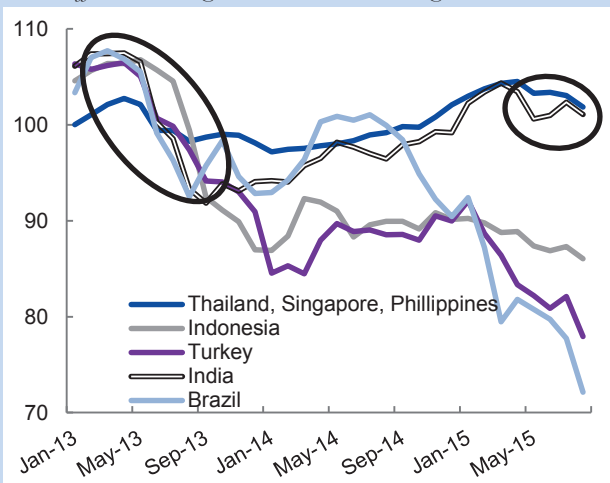
The slowdown of China's economy and further strengthening of the US dollar, with the trigger point of the devaluation of the Chinese Yuan in mid-August, led to renewed volatility in global financial markets. India was not immune to global developments, but the immediate impact was more muted compared to other countries and the 'taper tantrum' episode in mid-2013. While the near-term resilience is encouraging, in the longer-term the slowdown in the Chinese and global economies are significant risks to India's economic expansion.

The devaluation of the Chinese Yuan in August coincided with a depreciation of the rupee and a correction in Indian equity markets. The rupee depreciated by 6.0 percent between March and August 2015 and stocks lost 11 percent in just over a month as foreign investors withdrew nearly USD 2.6 billion. Currency depreciation was nonetheless benign compared to the 18 percent decline between May and August 2013, and to the performance of other emerging market currencies (Figure 45). Equity flows have also been resilient compared to other Asian economies (India remains the largest cumulative recipient of equity portfolio flows in Asia since 2012); despite the decline, as of early October India's stock market is the third best-performing in Asia in 2015 after Japan and Korea.

India's heightened resilience to the recent volatility is associated with improved fundamentals (Figure 46). Economic growth strengthened to 7.3 percent in FY14-15 from the 5.1 percent recorded in FY12-13 and the current account deficit narrowed to 1.3 percent of GDP – 3.5 percentage points lower than it was in FY12-13. Moreover, higher foreign investment inflows, a significant accumulation of reserves (9 months of imports as end of Q1 FY15-16, vs. 6 months as end of Q1 FY13-14), declining inflation, and some fiscal consolidation also contributed to stronger fundamentals. Along with prospects of structural reforms, strong fundamentals bolster investor confidence and account for the relatively favorable performance of India's financial markets.

Figure 45. India's currency depreciated less than its peers in the recent market volatility

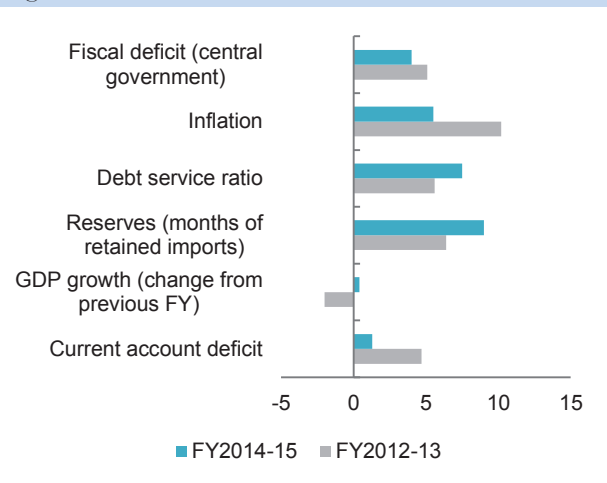
Nominal effective exchange rate index, 2013 average = 100



Source: BIS, and World Bank staff calculations

Figure 46. India's fundamentals have improved significantly since 2013

Changes between FY12-13 and FY14-15



Source: CEIC and World Bank staff calculations

In the medium-term, a deceleration in China and its second-round effects of a protracted global trade slowdown may be less benign. India is a net importer of goods from China in value terms and its direct trade linkages with China are limited compared to other advanced and emerging economies. Exports to China accounted for only 3.8 percent of India's total exports in FY14-15, less than that of Brazil, Indonesia and the European Union to China. The share of value-added in India for final demand in China is also relatively low but not negligible (1.3 percent of GDP in 2011; Figure 47).

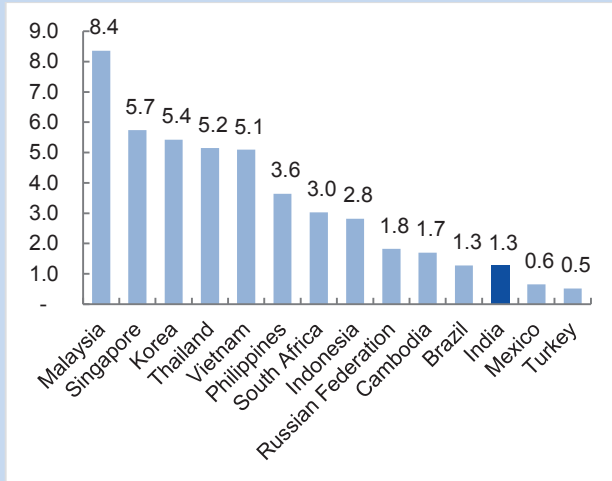
However, the slowdown in China has implications for global demand. Between 1991 and 2014, real export growth in India has averaged nearly 13 percent and supported India's impressive economic expansion during this time. While India may be able to achieve fast GDP growth without export growth for a short period (as suggested by the low year-to-year correlation between export and GDP growth), in the long-term sustaining high rates of GDP growth will require export growth as well, to drive productivity.

Consistent with this view, Inoue, Kaya and Ohshige find using a Global Vector-Autoregressive (GVAR) model that the long-term impact of a one percentage point decline in GDP growth in China translates into a decline in India's GDP growth of 0.18 percent. Although this is less than what the authors find for Thailand (0.95 percent), Singapore and Malaysia (0.50 percent) and Indonesia (1.2 percent), the negative effect is nonetheless significant and persistent.

India is also not completely isolated from global financial volatility. India's financial markets are relatively closed – for example less than 5 percent of government bonds are held by foreigners (Figure 48) – but India still has significant external financing needs. The fiscal deficit remains elevated, with large contingent liabilities from the infrastructure and banking sectors. Moreover, the current account deficit received respite from benign oil prices this year, but the weakness in exports suggests that pressures on the current account could again mount once commodity prices start rising again, especially if India maintains robust growth.

Figure 47. Value-added in India for final demand in China comprises only 1.3 percent of India's GDP

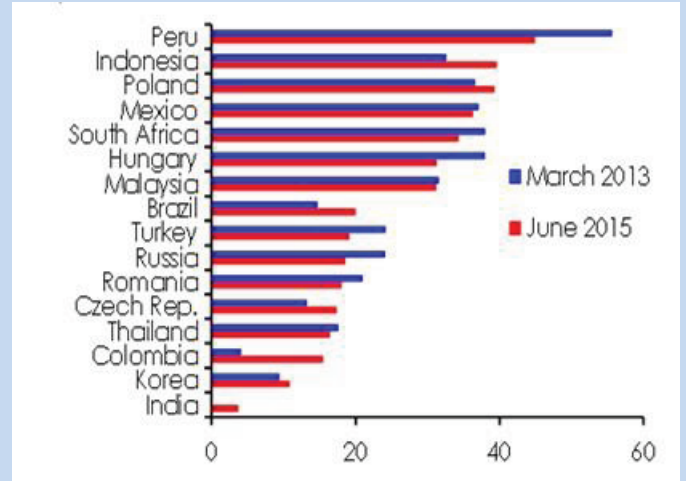
Share of GDP absorbed by final demand in China, percent



Source: OECD TiVA Database, and World Bank staff calculations

Figure 48. India's debt markets have relatively limited foreign participation

Foreign investors' share in local currency sovereign bond markets, percent



Source: IIF

Overall, there is ample reason for confidence in India's near-term prospects, but this needs to be used as an opportunity to advance structural reforms that would support the virtuous circle of investor confidence, growth and stability. That global demand is likely to be weak in the coming year, further increases the urgency of working on resolving existing supply constraints.

Source: Authors.

2. Notes on Fiscal Policy for Equitable Growth



A. Fiscal policy developments and outlook

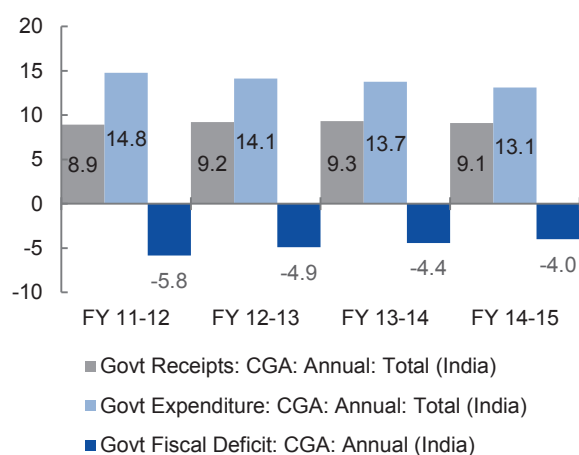
Fiscal consolidation proceeds with a focus on quality expenditures

Fiscal consolidation has relied on expenditure rationalization as revenues have been stable

The Government has been on a path of fiscal consolidation since FY11-12. The fiscal deficit of the Centre has declined consistently from 5.8 percent of GDP in FY11-12 to 4.0 percent of GDP in FY14-15. This was achieved primarily by rationalizing expenditure, which declined between FY12-13 to FY14-15 by more than 0.5 percent of GDP per year, whereas the average increase in revenue over the same period was less than 0.1 percent of GDP (Figure 49). In FY14-15, revenues in fact declined to 9.1 percent of GDP compared to 9.3 in the previous FY.

Figure 49. The fiscal deficit of the Centre has been declining primarily due to expenditure rationalization

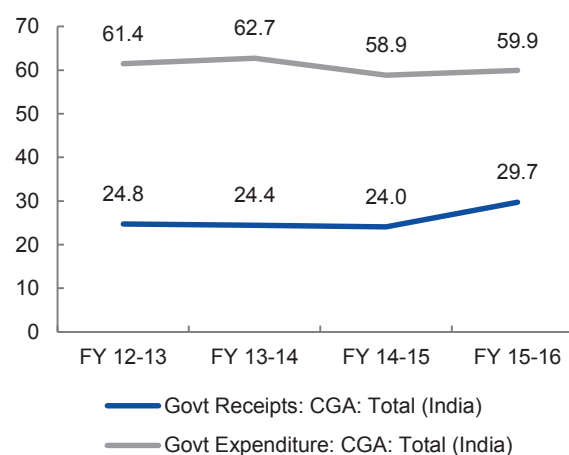
Receipts, expenditure and balances of the Centre, percent of GDP



Source: CEIC and World Bank staff calculations

Figure 50. Expenditures and revenues in the current fiscal year are higher relative to the previous fiscal year

Percent of budgeted amount (April-August)



Source: CEIC and World Bank staff calculations

Capital spending and revenue collection have been relatively front-loaded in FY15-16

In the first five months of FY15-16 revenue collection has exceeded the outturn in the corresponding period in the last FY both as a percent of GDP and as a share of the full-year target (Figure 50). Expenditures are lower as a share of GDP given the budgeted reductions, but are also higher than the average outturn in the same period over FY12-13 and FY14-15, driven by faster disbursements of capital expenditures, which are up about 19 percent compared to the previous year.

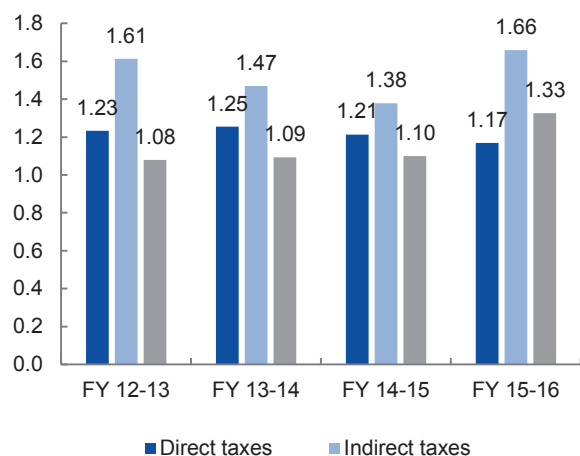
Revenues up on higher indirect tax rates

Revenues from consumption taxes have picked up, while direct tax revenue languishes

During April-August, 2015 the share of collections of direct taxes to overall tax collection has declined, while that of indirect taxes has picked up, compared to the previous year. Total receipts as a percent of GDP are rebounding from the previous FY but remained low compared to previous years. The rebound is largely due to a surge in indirect tax collection (Figure 51). The improvement in the collection of indirect taxes was broad-based, but was mostly due to a sharp rise in central excise duties from 0.36 percent of GDP in the first five months of FY14-15 to 0.57 percent of GDP in the corresponding period in the current FY (Figure 52). The proactive increase in excise duty on fuels, four times in quick succession between November 2014 and January 2015, along with an upward revision of the excise duty on polythene bags for non-industrial use (from 12 to 15 percent) resulted in the enhanced excise collections. Similarly, service taxes improved partially on account of an increase in service tax rate from 12.36 percent to 14.00 percent.

Figure 51. Collection of Indirect taxes has been more robust than direct taxes in the current fiscal

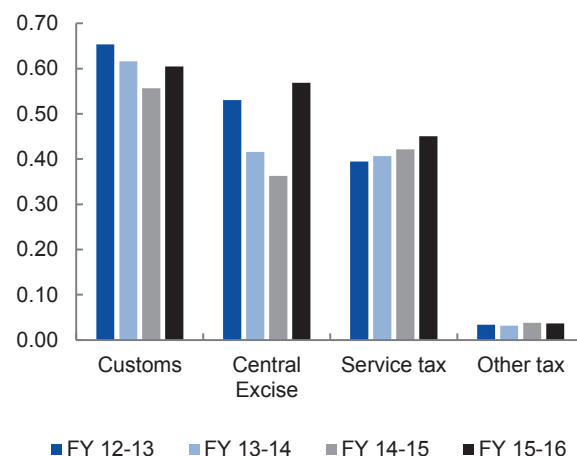
Tax collection in the first 5 months of the FY, percent of GDP



Source: CEIC and World Bank staff calculations

Figure 52. Central excise duty collection has picked up significantly

Collection of indirect taxes in first 5 months of the FY, percent of GDP



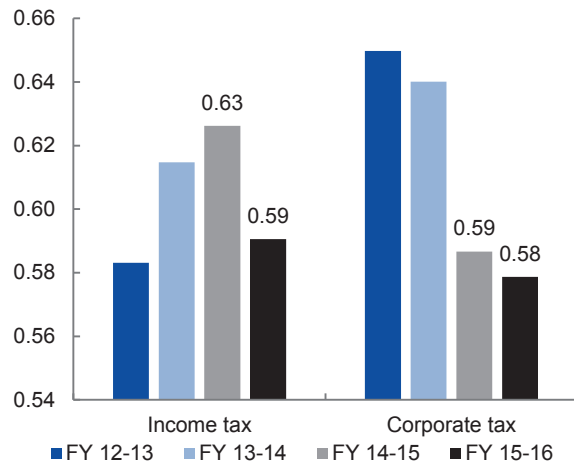
Source: CEIC and World Bank staff calculations

The collection of direct taxes declined on lower personal income tax receipts as returns (and refunds) were frontloaded

Overall, collection of direct taxes as a share of GDP declined to 1.17 percent from over 1.21 percent of GDP in previous FYs. Personal income tax collection was depressed compared to outturns in the corresponding period in the previous FY, at 0.59 percent of GDP with collections slowing down compared to the previous three fiscal years (Figure 53 and Figure 54). However, it is expected that overall personal income tax revenues will even out because the increased use of the e-filing system has led to reduced processing times for returns, thereby also leading to bunching up of returns (and refunds) in the earlier months of the fiscal year. Tax authorities reported a record 20.6 million tax returns on its e-filing portal – an increase of 26.1 percent from the previous FY. Corporate tax collections as a share of GDP remained stable at 0.58 percent (compared to 0.59 in FY14-15) despite lower corporate profitability, especially among large companies with substantial amounts of debt on their books.

Figure 53. Income tax collection has been particularly weak in current fiscal year to date

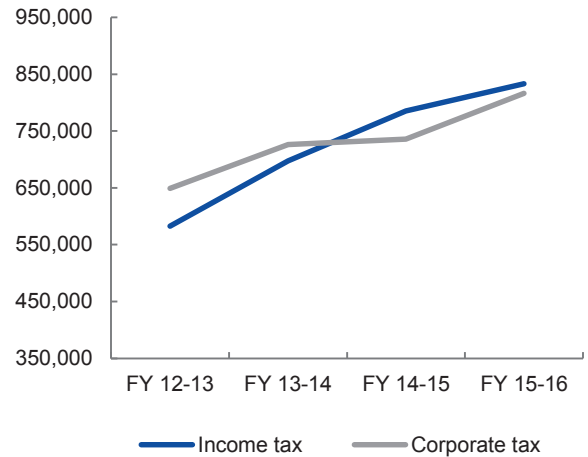
Collection of direct taxes in first 5 months of the FY, percent of GDP



Source: CEIC and World Bank staff calculations

Figure 54. Income tax collection has been lower even in nominal terms in current fiscal year to date

Collection of direct taxes in the first 5 months of the FY, Rupees (Million)



Source: CEIC and World Bank staff calculations

Non-tax and non-revenue receipts were up on higher collections from telecom spectrum auctions

In a break from past trends, non-tax and non-revenue receipts in April - August FY15-16 came in at 0.39 percent of GDP, exceeding the average 0.25 percent of GDP outturn for the corresponding period in the previous three fiscal years. The pick-up was almost entirely due to windfall increase in non-tax receipts from economic services in April 2015 that resulted from successful rounds of telecom spectrum auctions. Disinvestments in the current FY year to date too have been higher at 0.02 percent of GDP relative to the corresponding period in the previous three fiscal years. However, only INR 128,025 million has been realized against a disinvestment target of INR 695,000 million (18.4percent).

Capital expenditures and transfers to states pick up while subsidies decline

The FY15-16 Budget focused on the broad objectives of enhancing growth and strengthening cooperative fiscal federalism

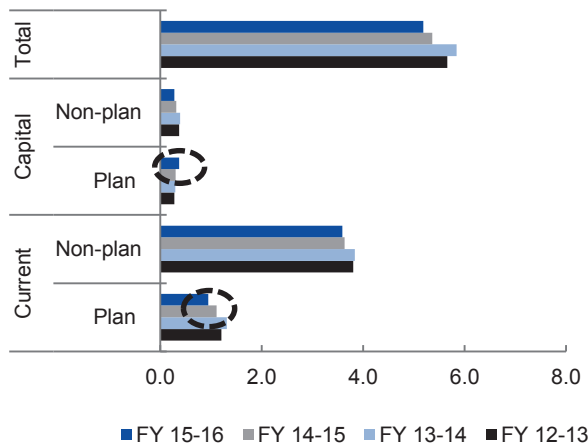
Towards the objective of enhancing growth, the Union Budget anticipated an increase in infrastructure investments, partly financed by a delayed path for fiscal consolidation (targeting a fiscal deficit of 3.9 percent of GDP in FY15-16 as opposed to the 3.7 percent FRBM target), and partly by reorienting expenditure away from subsidies. Towards the second objective, the government accepted the recommendations of the 14th Finance Commission to boost the share of states in the divisible pool of central revenues, significantly increasing untied transfers

In the first five months of FY15-16 capital expenditures have indeed increased

Capital spending increased relative to recurrent expenditures as plan expenditures were rebalanced towards infrastructure-intensive sectors¹³. The FY15-16 budget anticipates an increase in capital expenditures by the central government of 0.2 percent of GDP (vs. FY14-15), and indeed in the first five months of FY15-16 capital expenditures have edged higher, driven by a 0.1 percent of GDP increase in plan capital expenditure (Figure 55). Reflecting this increase, the share of the Ministry of Transport and Highways and Ministry of Rural Development in total plan expenditures has increased sharply year-to-date (Figure 56). This was offset by an equal compression in plan current expenditures. Most of the decline comes from lower tied transfers to states (included in plan expenditures). However, there were also declines in plan expenditures on health and education, which are largely current in nature.

¹³ The distinction between plan and non-plan spending was instituted with the establishment of the Planning Commission. Plan spending refers to that which is laid out in Five-year plans and is usually related to longer-term goals of development. The distinction is likely to be discontinued at the end of the ongoing 12th five year plan.

Figure 55. Plan expenditures rebalanced from current to capital
Percent of GDP (fiscal year-to-date)

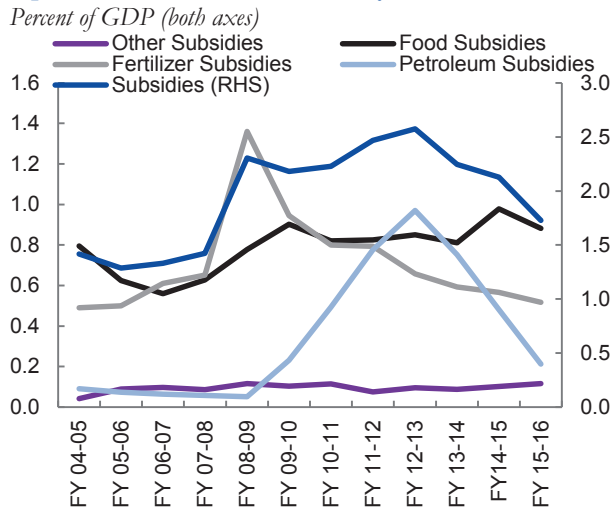


Source: CEIC and World Bank staff calculations

The subsidy bill is expected to decline to levels prevailing prior to FY08-09

Aided by rationalization efforts and depressed global crude prices, subsidies are budgeted at 1.7 percent of GDP in FY15-16 (Figure 57). The decline in subsidy expenditures since FY13-14 is predominantly due to a decrease in petroleum subsidies, though fertilizer subsidies have also declined marginally. The drop in petroleum subsidies is evident in the lower share of non-plan spending by the Ministry of Petroleum and Natural Gas (Figure 58). The Government's efforts to improve the management of energy subsidies are discussed in Special Note B.

Figure 57. The total subsidy bill has fallen with the decline in petroleum and fertilizer subsidy burdens



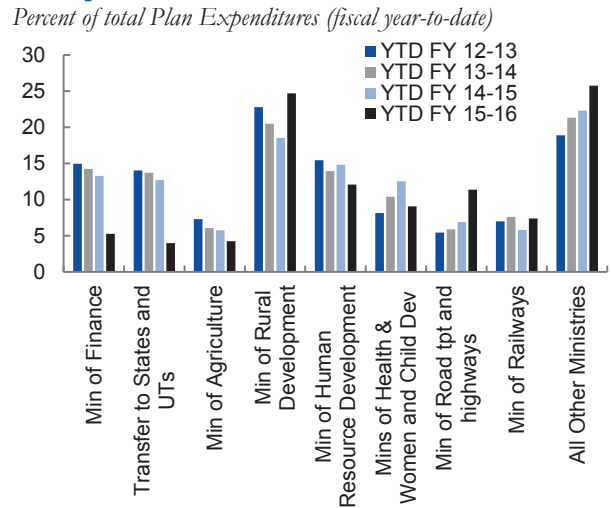
Source: CEIC and World Bank staff calculations

Note: Petroleum subsidies shown as reported in budget documents and include rolled-over amounts from FY12-13 in the following two fiscal years

The full picture on fiscal devolution is still unclear as untied transfers have been enhanced but tied transfers have declined

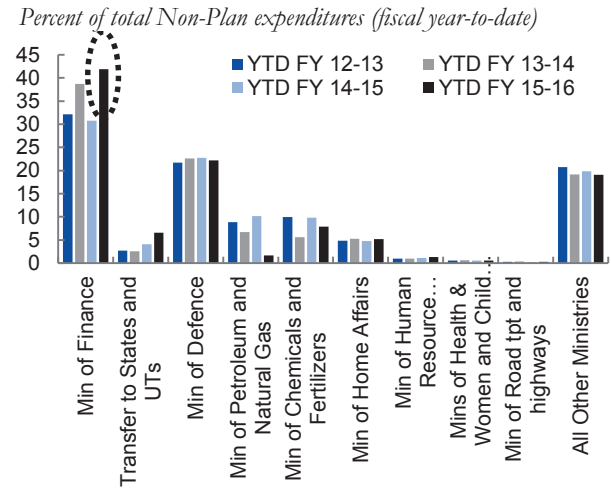
On the objective of enhancing co-operative fiscal federalism, progress has been less evident at the current time. The share of gross tax revenues allocated to the states has indeed increased, from an average of 0.87 percent of GDP in the first five months of past three fiscal years to 1.06 percent of GDP this FY. Untied grants have also gone up, as reflected in the share of non-plan spending by the Ministry of Finance, which has increased in the current fiscal year to date to almost 42 percent of total non-plan spending (Figure 58). On the other hand, the disbursement of tied transfers through Centrally-Sponsored Schemes (CSS) has been sluggish (as reflected in lower plan current expenditures in Figure 56) due to a lack of clarity on the

Figure 56. Plan expenditures for infrastructure development have increased



Source: CEIC and World Bank staff calculation

Figure 58. Non-plan expenditures of the MoF has increased due to enhanced devolution



Source: CEIC and World Bank staff calculations

Centre– State resource sharing pattern for each of the CSSs. A committee has been constituted in the NITI Aayog to provide clarity on this point.¹⁴

Continued fiscal consolidation and higher untied transfers to states beyond FY15-16

The path to fiscal consolidation beyond FY15-16 will prove more challenging without the benefit of lower oil prices

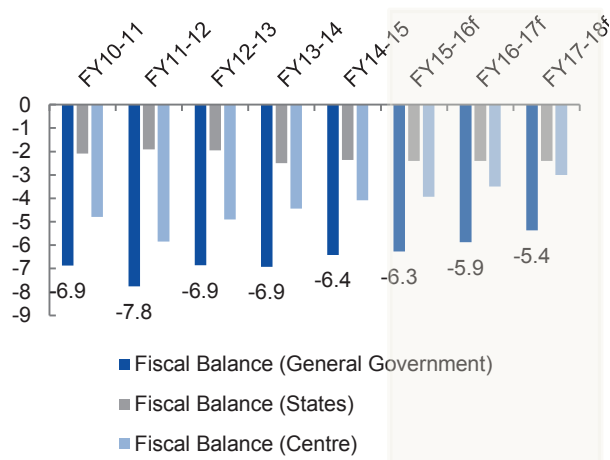
While the Government adopted a more gradual path of fiscal consolidation, the deficit remains relatively high and the Government has committed to continuing to reduce it going forward, targeting a fiscal deficit of 3.9 percent of GDP in FY15-16, followed by 3.5 and 3.0 percent of GDP in the subsequent two fiscal years (Table 3). In FY14-15 and FY15-16, low oil prices reduced the subsidy bill and created policy room for fuel price rationalization. However, fiscal headwinds are likely to increase in FY16-17. Oil prices are unlikely to decline further, with the World Bank among other observers projecting a modest increase. Corporate tax rates will be reduced over four years beginning FY16-17, from the existing 30 percent to 25 percent, posing downward pressure on direct taxes if not accompanied by a broadening of the base. Moreover, the budget will need to accommodate the implementation of recommendations from the 7th Pay Commission, which is expected to submit its report in January, 2016.

The General Government also targets lower deficits

Under the assumptions of the Government’s medium term fiscal management framework, the general government fiscal deficit is expected to decline to 5.7 percent by FY17-18 from 6.4 percent in FY15-16, primarily on account of modest improvements in revenue buoyancy driven by tax reforms (such as replacing the high-effort low-yield wealth tax for high income individuals with a 2 percent cess, other measures to improve collections and the increase in fuel excise and service tax; Figure 59). Although some states may require additional borrowing space to accommodate a restructuring of liabilities in the power sector, states are expected to, on average, adhere to the deficit limits established in the Fiscal Responsibility and Budget Management (FRBM) Act, despite the withdrawal of fiscal responsibility grants as recommended by the 14th Finance Commission. Fiscal consolidation and robust economic growth is likely to lead to continued decline in the General Government debt (Figure 60).

Figure 59. The fiscal deficit is expected to decline but remains elevated

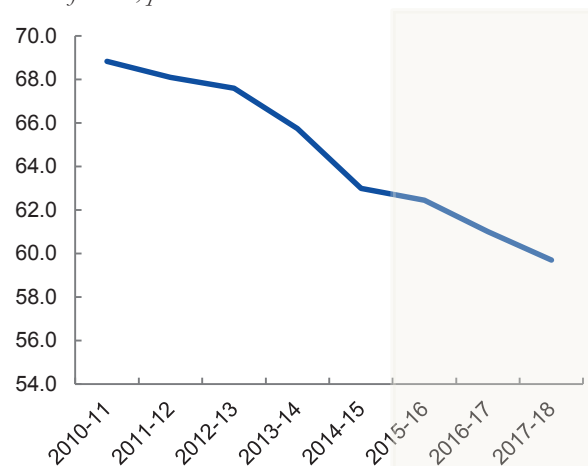
Balances, percent of GDP



Source: CEIC and World Bank staff calculations and projections

Figure 60. The government debt is expected to remain on a declining trend

Share of GDP, percent



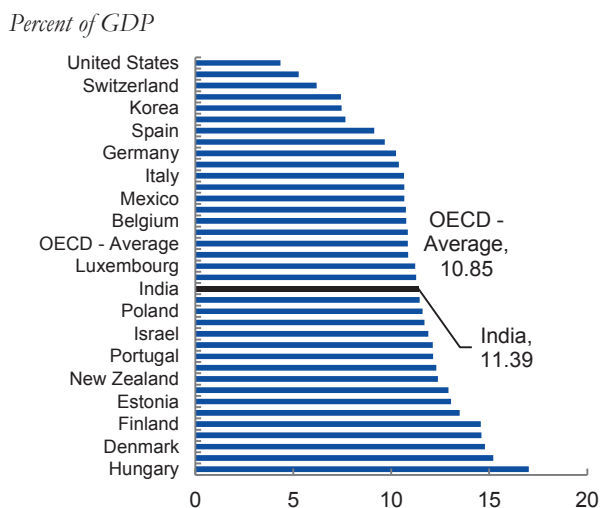
Source: CEIC and World Bank staff calculations and projections

¹⁴ The National Institution for Transforming India (NITI) Aayog (Policy Commission) is a government think-tank established to succeed the Planning Commission.

Boosting the revenue-to-GDP ratio in the long term will require higher collections of direct taxes

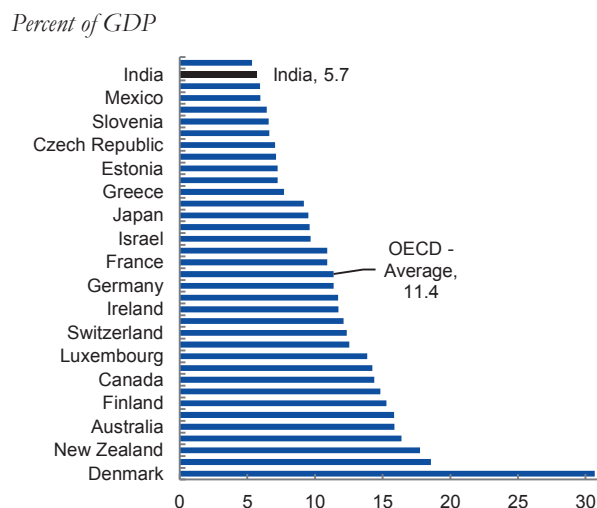
Compared to advanced emerging and developed economies, India collects relatively high levels of indirect taxes but low levels of direct taxes (Figure 61 and Figure 62). This suggests that improvements in direct tax collection are likely to provide the largest gains in raising the tax-to-GDP ratio. Reforms of indirect taxes – namely the key GST implementation – should focus on enhancing efficiency. Special Note C discusses the current status and challenges of GST implementation.

Figure 61. India collects a higher share of indirect taxes than OECD economies...



Source: OECD, MoF and World Bank staff calculations

Figure 62. ... but has a much lower level of direct tax collection



Source: OECD, MoF and World Bank staff calculations

The full impact of greater devolution of untied resources to states will be seen over the next five years

Following the recommendations of the 14th Finance Commission, subnational (state) governments have been awarded with somewhat larger fiscal resources but much greater autonomy to spend these resources. Note D discusses the implications of the 14th Finance Commission in greater detail.

Table 3: Fiscal consolidation is expected to be led by the Centre

Percent of GDP	2011	2012	2013	2014	2015	2016f	2017f	2018f
Tax Revenue (gross receipts)	10.1	10.0	10.3	10.0	9.9	10.2	...	...
... minus devolution to states	2.8	2.9	2.9	2.8	2.7	3.7	...	...
Non-Tax Revenue	3.3	1.8	1.8	2.1	2.1	2.1	...	...
Current Expenditure	13.4	13.0	12.4	12.1	11.9	10.9	...	...
... of which grants to states	3.6	3.3	2.9	2.8	2.8	2.3	...	...
... of which subsidies	2.2	2.5	2.6	2.2	2.1	1.7	...	...
... of which interest	3.0	3.1	3.1	3.3	3.3	3.2	...	...
Capital Expenditure	2.0	1.8	1.7	1.7	1.5	1.7	...	...
Total Expenditure of the Centre	15.4	14.8	14.1	13.7	13.4	12.6	...	...
States' Own Revenues	7.1	7.4	7.7	7.8	7.9	7.9	...	...
State Expenditure	15.7	15.7	15.6	15.9	15.8	16.4	...	...
... of which interest	1.6	1.5	1.5	1.5	1.5	...	...	...
Fiscal Balance (General Government)	-6.9	-7.8	-6.9	-6.9	-6.4	-6.3	-5.9	-5.4
Fiscal Balance (States)	-2.1	-1.9	-2.0	-2.5	-2.4	-2.4	-2.4	-2.4
Fiscal Balance (Centre)	-4.8	-5.8	-4.9	-4.4	-4.1	-3.9	-3.5	-3.0
Primary Balance (Centre)	-1.8	-2.7	-1.8	-1.1	-0.8	-0.7	...	...

Source: Ministry of Finance, RBI and World Bank Staff Calculations

Notes: Balances are the government's definition and include receipts from asset sales. Total expenditure includes transfers to the states.

Significant fiscal risks from contingent liabilities in the infrastructure sector

Focusing on a resolution to the debt overhang in the infrastructure sector will be key to fiscal sustainability

While the Government's finances can ultimately backstop the financial sector and ensure its soundness, the debt overhang of the infrastructure sector and related non-performing assets in the banking system represent a key source of fiscal risk. In its latest Article IV Staff Report, the IMF notes that "realization of contingent liabilities coming from future bank capital injections and liabilities of the electricity distribution companies may also push the debt trajectory up to about 70 percent."

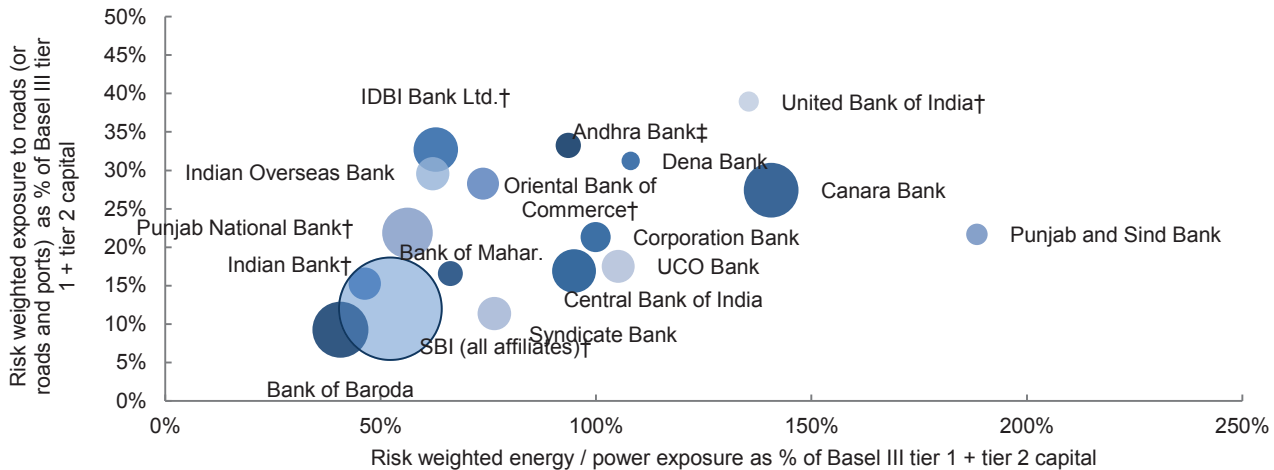
Within the infrastructure sectors, power and roads pose the greater risks

In the power sector, contingent liabilities in state-owned electricity distribution companies in some states pose risks either directly, should the Government (centre and/or states) take on such liabilities, or indirectly, if they remain on public banks' balance sheets. Although overshadowed in terms of volume of advances by the power sector by approximately 3.4 times, the roads sector is also an important source of fiscal risk as a higher share of assets are non-performing. Currently, roads account for the second largest share (after steel) of impaired assets of banks. At SBI, for example, India's largest lender, NPAs in the roads and ports sector stand at 8.4 percent of advances in the sector, above SBI's average of 5.0 percent and the power sector at 2.2 percent.

Exposure to the power and roads sectors are correlated, and addressing asset quality in both sectors is needed to mitigate risks

Banks that have proportionately more exposure are more vulnerable to very small changes in the value of these assets. This is because all losses accrue to equity and other forms of tier I and tier II capital first. Leverage means that a relatively small decrease in asset value can therefore have a relatively large impact on equity and other forms of tier I and tier II capital. Figure 63 shows exposure to highways and energy as a proportion of each bank's tier I and tier II capital. Large exposure to particular sectors (e.g. highways and energy) are therefore risky as asset values within these sectors may be correlated.

Figure 63. The exposure of SCBs to the power and roads sectors is large and correlated



Sources: June 2015 Basel III filings for selected banks or analyst presentations where Basel III filings lack broken out data

Notes: All banks shown have more than 50 percent GoI shareholding

Some fiscal risks have materialized, opening an opportunity for long-term solutions

The Cabinet approved in June and September one-time infusions of funds into stalled highway projects (under BOT toll and annuity modes, respectively) that are stuck due to lack of equity capital or the reluctance of banks to disburse any further funds. All stalled highway projects that were at least 50 percent completed as of 1 November 2014 will be eligible for this funding, subject to a case-by-case evaluation. The financial assistance would be provided by the NHAI in the form of a loan at a concessional rate of bank rate+2 percent. It is critical to complement these efforts by addressing underlying stress in projects themselves. For projects under

development, these issues include delays in the meeting of public sector obligations (e.g. land acquisition, utilities shifting, etc.) as well as sponsor-caused delays. For many projects that have entered operations, insolvency and illiquidity on account of ambitious estimates (e.g. of demand, macroeconomic variables, etc.) are the primary causes of stress.

Similarly in the power sector, accumulated losses of distribution companies grew to USD 42 billion at the end of the fiscal year ending in March 2011 leading in 2012, to the approval of a scheme for Financial Restructuring of State Distribution Companies to restructure debts with support from state and central governments. Under the scheme, banks had restructured Rs 530 billion (USD 8.5 billion) of seven distribution companies' exposure. However, the RBI in its June 2015 report stated that the scheme had not been able to improve the financial health of distribution companies on account of their inability to eliminate the gap between the cost of supply and realized revenue, reduce losses, and make regular tariff adjustments. The Reserve Bank thus warned that the debt-servicing ability of power companies might remain weak in the near term (RBI 2015). In both cases, addressing the cause of the build-up of contingent liabilities will be critical to ensuring the ability of the government to remain on a consolidation path.

B. Reforming India's Fuel Subsidies: Achievements and Opportunities¹⁵

India's fuel pricing reforms represent a triple win: for the budget, for equity and for the environment

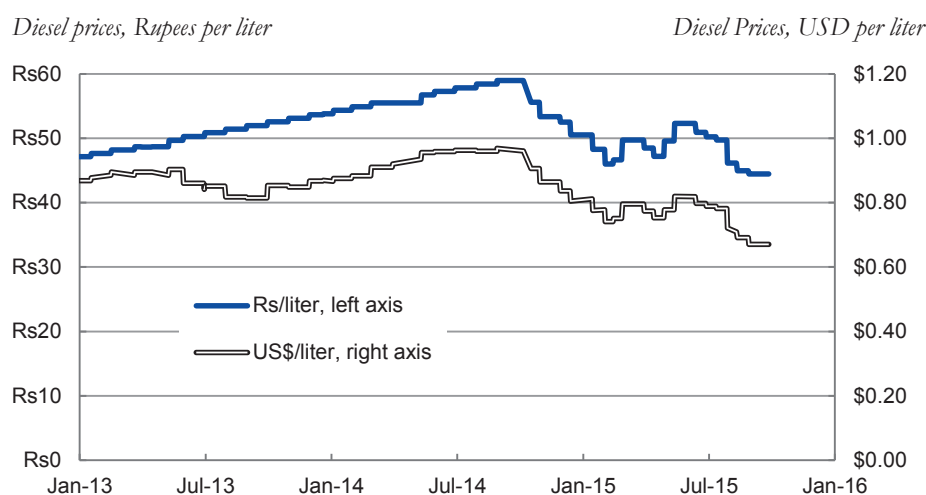
Over the past five years India has made important progress in reforming fuel pricing, accruing significant fiscal, distributional and environmental gains. On the fiscal side, savings from fuel subsidy rationalization have allowed the Government to transfer more resources to states, increase infrastructure spending, and remain on a fiscal consolidation path. Further gains are possible, especially by improved targeting of subsidies in LPG and kerosene. This note reviews India's reform efforts and points to possible areas where reforms can be extended.

Significant progress reforming gasoline and diesel pricing with large fiscal gains

India started rationalizing its fuel prices even before the recent fall in global prices

The Government deregulated gasoline prices in June 2010 and in January 2013 began raising diesel prices by INR 0.5 (USD 0.01) per liter every month (Figure 64) in order to reduce price subsidies. However, because of exchange rate fluctuations, this price increase was not always sufficient to keep up with world prices.

Figure 64. Diesel prices declined only modestly in USD terms since January 2013 as taxes were introduced



Source: <http://www.iocl.com/Products/HighSpeedDiesel.aspx>.

When oil prices declined, India took advantage to extend reforms by deregulating diesel prices entirely and raising taxes on fuel

The fall in global oil prices in the last few months of 2014 enabled the government to deregulate diesel prices in October while lowering them on the domestic market. At the same time, the government raised excise duties on gasoline and diesel in succession in October, November, and December 2014, and again in January 2015, for a cumulative 7.75 and INR 6.50 for petrol and diesel, respectively. The weighted average increase in excise duties for these two fuels was 130 percent in Q4 FY14-15, compared to the same period the year before.¹⁶

As a result of reforms, retail prices

Retail fuel prices in March 2015 are shown in Figure 65 and Figure 66 for a number of countries.¹⁷ The retail prices span a wide range, varying from a mere USD 0.01 a liter to USD

¹⁵ This Note draws from the upcoming World Bank publication "Fossil fuel subsidy and pricing policies: Recent developing country experience" led by Masami Kojima.

¹⁶ The excise duty on gasoline with 92 RON was increased from INR 9.48 (USD 0.16) per liter in September 2014 to INR 17.46 (USD 0.28)/liter in January 2015, and that on diesel from INR 3.56 (USD 0.06) per liter to INR 10.26 (USD 0.16) per liter during the same period.

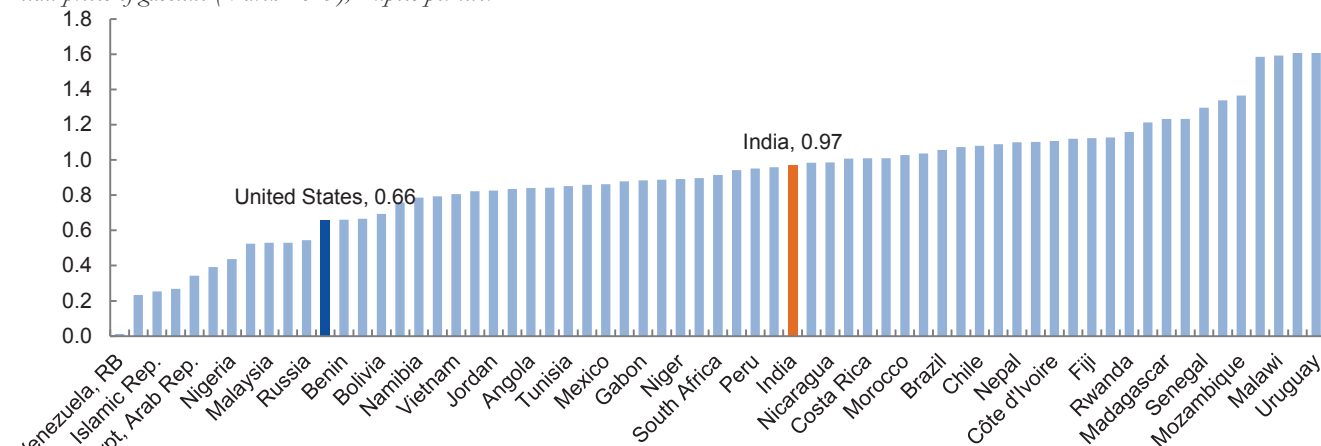
¹⁷ Where prices are controlled for one grade of a fuel, they are shown to illustrate the degree of government support.

of gasoline and diesel in India are now close to the median globally

1.60 a liter for gasoline and diesel. For gasoline and diesel, the national average price in the United States is highlighted because of the country's low costs of supply (large economies of scale and high operational efficiency due to competition) and low taxes (excise tax has been frozen since 1993 in nominal terms). India's retail prices are slightly above the global median in the case of gasoline, but below the median in the case of diesel.

Figure 65. India is well above the global median in terms of the price of gasoline

Retail prices of gasoline (March 2015), Rupees per liter

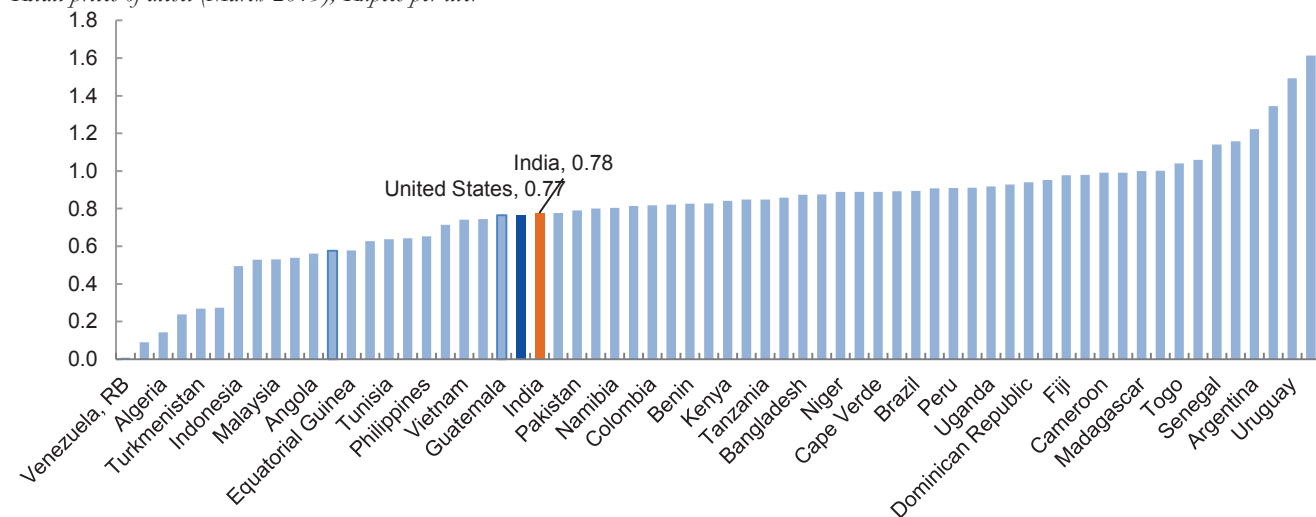


Source: Government websites, local news articles

Note: The RON is 90–93 for regular gasoline but some countries have only higher octane grades, typically 95 (Algeria, Malaysia, Tunisia).

Figure 66. While India's diesel prices remain below the global median, they are in line with those in the United States

Retail prices of diesel (March 2015), Rupees per liter



Source: Government websites, local news articles

Reforms achieved significant fiscal savings, which were allocated to higher-priority infrastructure and devolution spending

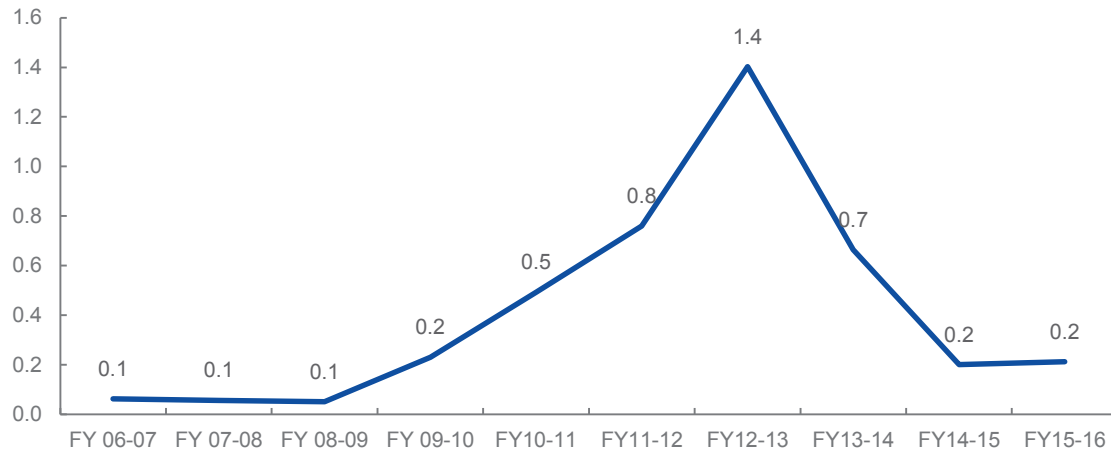
Subsidies to petroleum products (diesel, gasoline, LPG and kerosene) surged in FY12-13 to INR 1,418 billion (1.4 percent of GDP; Figure 67). To accommodate this amount, INR 450 billion had to be rolled over from FY12-13 to FY13-14, reducing the fiscal impact on a cash basis but still creating a liability of the government that had to be recognized in the following two years.¹⁸ After absorbing INR100 billion in FY13-14, the balance INR 350 billion was further rolled over to FY14-15. Taking into account the rolled-over amounts, the petroleum subsidy burden in FY14-15 has been reduced sharply to 0.2 percent of GDP from 0.7 percent in FY13-14. For

¹⁸ This practice of rolling over has no precedence prior to FY12-13 and has not been carried out in FY15-16 budget.

comparison, according to the Economic Survey 2014-15, the expenditure by the Government (Central and State combined) on health as percentage of GDP is 1.2 percent (budget estimates). With the deregulated prices of petrol and diesel, and the low crude prices prevailing, the subsidy bill is expected to remain at 0.2 percent of GDP in FY15-16 (budget estimates).

Figure 67. Subsidy rationalization led to significant fiscal gains

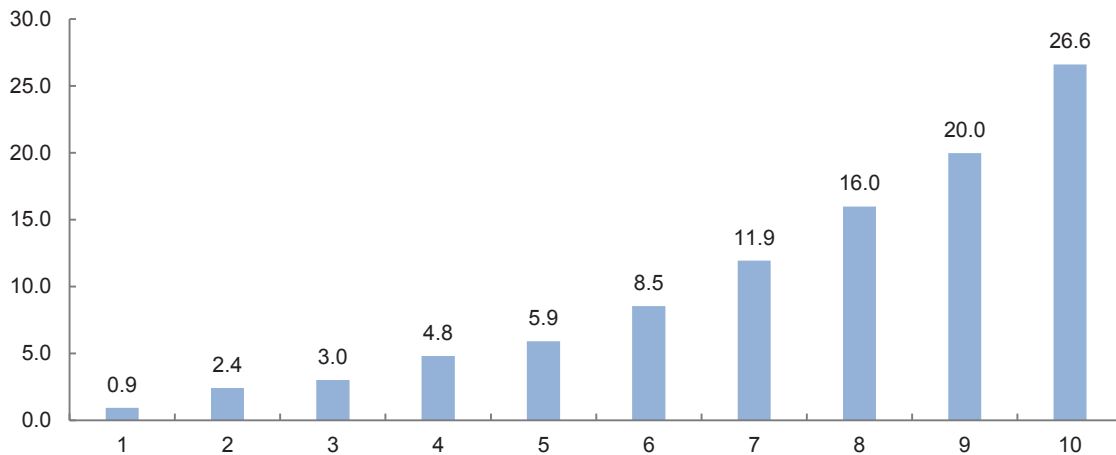
Petroleum subsidies, percent of GDP



Source: Ministry of Finance, World Bank Staff calculations

Figure 68. Petrol subsidies are poorly targeted

Share of subsidies accruing to each decile of the income distribution, percent



Source: Abdallah et al. (2015) and World Bank Staff calculations and projections

Petrol subsidies are poorly targeted, hence their removal was also a win for equity

Abdallah et al. (2015) show that the wealthiest ten percent of Indian households received 27 times more in benefits from petrol subsidies than the poorest ten percent. Nearly half of the benefits from petrol subsidies accrue to the top 20 percent of households and only 11.1 percent to the bottom 40 percent (Figure 68). The case of diesel is more complex, considering that its impact on household consumption is primarily indirect as an input to supply of other consumption items, especially food. Anand (2014) finds that second round effects from indirect use of fossil fuel in farming would have significant impacts on food inflation. While the current reform efforts in diesel have taken place in an environment of declining prices, maintaining diesel prices market-driven in an environment of rising prices will require well-targeted compensation mechanisms.

Pricing reforms are positive for the environment as India effectively implemented a carbon tax

The tax on petrol and diesel is expected to have already led to emissions reductions. The Economic Survey 2014-15 estimates that the increase in petrol and diesel prices led to a net reduction of 11 million tons of CO2 emissions in less than a year, compared to the baseline, or 0.6 percent of India's annual emissions. The government also increased the clean energy cess on coal from INR 50 (USD 0.83) per ton to INR 100 (USD 1.66) per ton starting in July 2014, and the budget for the fiscal year beginning in April 2015 doubled the cess again to INR 200 (USD 3.20) per ton. While, according to the Economic Survey, the taxes on coal are unlikely to be sufficient to compensate for externalities of burning it or achieving meaningful emissions reductions, it has established a policy instrument that can be adjusted in the future.

Efforts underway to rationalize subsidies LPG and Kerosene as well

India is in the process of transforming LPG subsidies from price subsidies to cash transfers

Reforms commenced in September 2012, when the central government initially limited the number of LPG refills at heavily subsidized prices sold in 14.2 kg cylinders to six a year. However, the government ultimately decided to increase the limit, raising it from six to nine in January 2013 and from nine to twelve in January 2014. All consumers were to pay market prices after February 14, 2015. However, those who sign up for the "Direct Benefits Transfer for LPG" (DBTL) scheme have price subsidies deposited in their bank accounts as a cash transfer. The government stopped selling subsidized LPG altogether, and the only way to receive subsidies is to become "cash-transfer compliant" by officially enrolling in the DBTL. As of August 2015, 140 million customers had enrolled, having received 238 billion rupees (USD 3.7 billion) (<http://petroleum.nic.in/dbt/index.php>). The Supreme Court has reaffirmed that the use of Aadhaar¹⁹ identities was allowed for DBTL, even as it could not be mandatory for other schemes.

One of the concerns with subsidized LPG was the extent of 'leakages' to industrial uses

"Leakages" of LNG to industrial use appear to have declined following the implementation of DBTL. The Ministry of Petroleum and Natural Gas (2015) attributed the strong growth of bottled LPG for commercial use (35 percent) and automotive LPG (9.5 percent) between April and June 2015 to curbing of diversion of subsidized LPG following the full implementation of the DBTL (PPAC 2015).

LPG prices remain low by international standards

Prices remain low even after reforms, and non-subsidized 14.2 kg cylinders of LPG appears to be cross-subsidized. There are large economies of scale in transporting, storing, and bottling LPG, and as a result, the unit price should decrease with increasing cylinder size. However, as Table 4 shows, LPG sold in 19-kg cylinders has consistently been more expensive per kg than that sold in 14.2-kg cylinders, a pattern that would not be expected if prices were purely market-determined. As Figure 69 shows, both subsidized and non-subsidized prices of LPG in India are among the lowest in the world

Table 4: LPG prices in New Delhi in April 2015

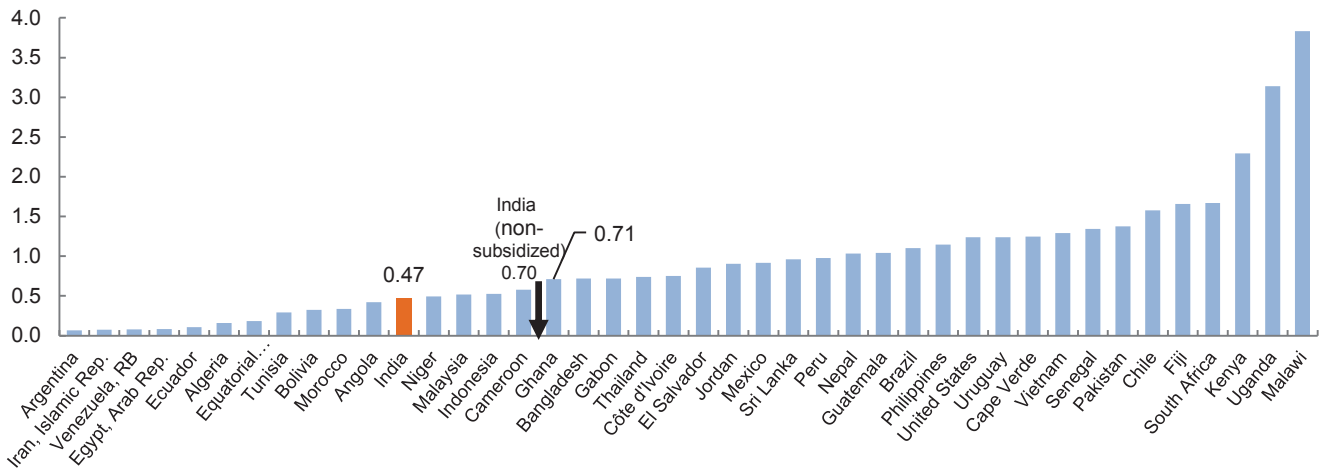
Cylinder size	14.2 kg (subsidized)	14.2 kg (non-subsidized)	19 kg
INR/kg	29.37	43.73	60.11
USD/kg	\$0.47	\$0.70	\$0.97

Source: World Bank staff calculations based on data at <http://www.iocl.com/Products/Indanegas.aspx>.

¹⁹ The government has been issuing a 12-digit individual identification number called Aadhaar to every resident. Aadhaar is based on demographic and biometric information and serves as proof of identity and address.

Figure 69: Even non-subsidized LPG prices remain among the lowest in the world

Retail prices of LPG (March 2015), Rupees per kg



Sources: Government websites and announcements, local news articles

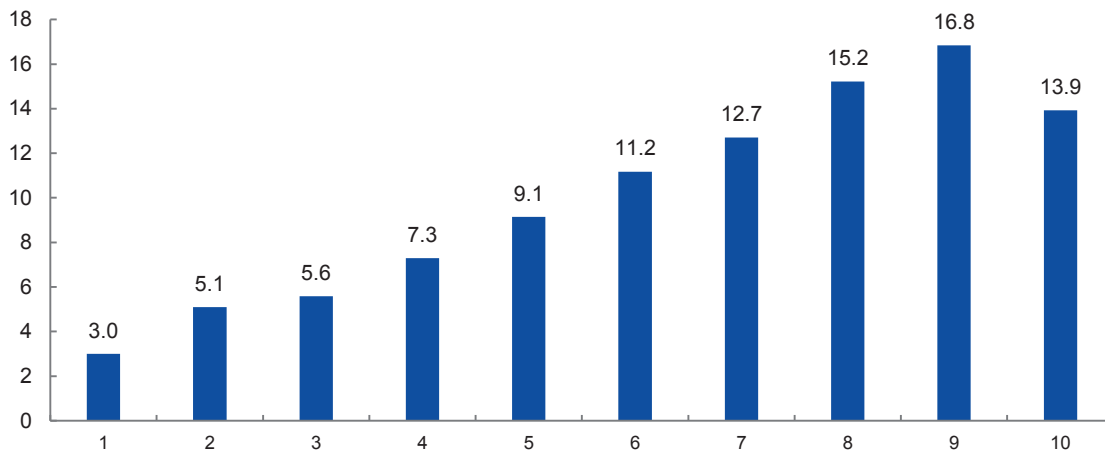
Note: The price of LPG shown for India is the net price after consumers who have signed up for the subsidy receive the subsidy deposits in their bank accounts.

LPG subsidies are also poorly targeted, though to a lesser degree than petrol

Data presented in Anand et al. (2015) suggest that the poorest 40 percent of households receive 21 percent of the benefits from LPG subsidies compared to 31 percent for the richest 20 percent of households (Figure 70). Currently every LPG consumer is eligible for the DBT LPG subsidy. The government has called on the better-off consumers to voluntarily give up the right to receive subsidies but as of August 2015 only 2.3 million consumers (2 percent of those who registered) had voluntarily given up the subsidy.

Figure 70. LPG subsidies also accrue primarily to higher income groups

Share of subsidies accruing to each decile of the income distribution, percent



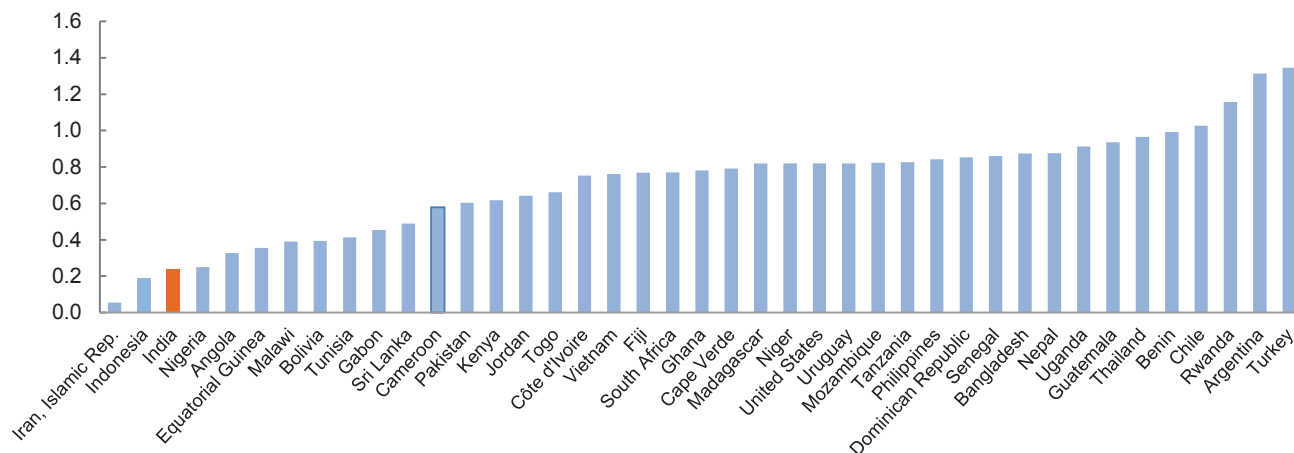
Source: Abdallah et al. (2015) and World Bank Staff calculations and projections

The government is considering how a similar direct benefit scheme could be applied to kerosene

Kerosene remains heavily subsidized (Figure 71) Although representing a relatively small fiscal cost (Figure 72) and better targeted than subsidies for motor fuel, still leakages were substantial, with only 46 percent of kerosene subsidies estimated to reach the poor (Economic Survey 2014-15). Accordingly, the Government has expressed interest in eventually moving towards a similar approach (direct benefit transfer) as for LPG.

Figure 71. Kerosene prices in India are the third lowest in the world

Kerosene prices, USD per liter



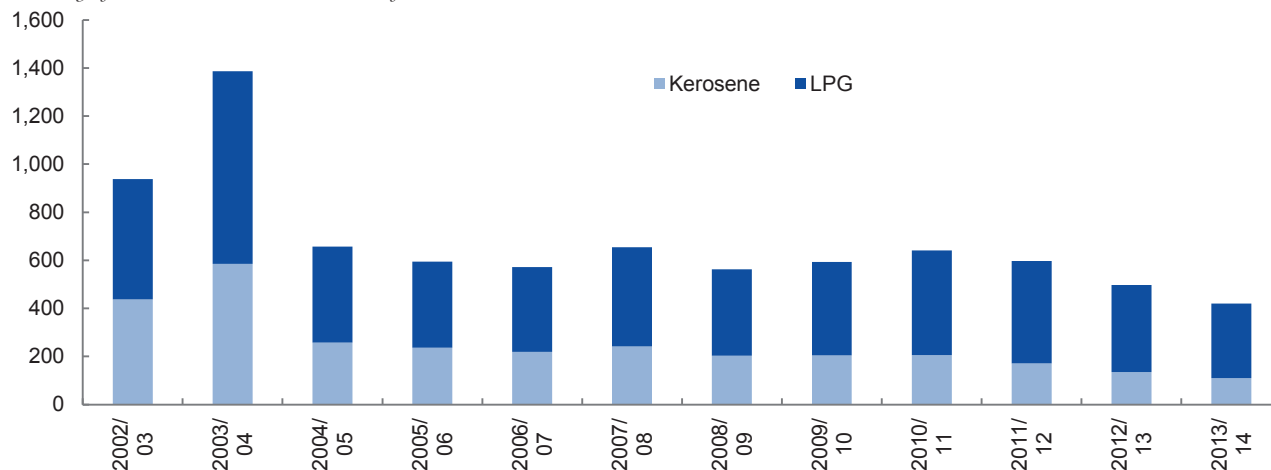
Sources: Government websites and announcements, local news articles

The cost of LPG and kerosene subsidies has been declining but remains significant

The history of fiscal outlays for LPG and Kerosene are provided in Figure 72. In addition, three upstream oil and gas companies have been partially bearing the burden of fuel price subsidies since 2003. Uncertainty about the future subsidy-burden-sharing mechanism was one factor contributing to the deferment of the 5-percent stake sale of the state-owned Oil and Natural Gas Corporation, originally part of the 2014–15 divestment road map. In August 2015, the Minister of Petroleum and Natural Gas estimated that the upstream companies would need to cover INR 50–60 billion (USD 0.8–0.9 billion) of kerosene subsidies in the fiscal year ending in March 2016, and added that the government would bear the entire burden of the LPG subsidy through the DBTL (Press Trust of India 2015).

Figure 72. The cost of LPG subsidies remains substantial, though it has declined

Fiscal outlays for kerosene and LPG subsidies for household use, USD million



Source: http://ppac.org.in/content/150_1_Subsidy.aspx

Overall, India has realized important achievements in fuel subsidy reforms, but there are further opportunities

India is to be commended for eliminating subsidies on gasoline and diesel, and working to better target and close leakages in subsidies for LPG and kerosene. To secure the long-term sustainability of reforms, India needs to be prepared when prices rise, in order to eliminate the

high past correlation between oil prices and budget deficits.²⁰ In this context, it may consider (1) ensuring that prices are changed regularly and frequently to introduce discipline, signal the government's commitment, and limit the quantum of individual increases; and (2) continue working on a comprehensive cash transfer/direct benefit transfer system that can be used in lieu of fuel subsidies to respond to any future food price rises that may arise from fuel price increases. The agenda for fuel pricing reforms may further include (1) increases in the gasoline and diesel excises, if global crude oil prices decline further; (2) further tightening of targeting of LPG subsidies and a review of pricing of non-subsidized cylinders; (3) increase the carbon tax on coal as suggested in the 2014-15 Economic Survey; and (4) move towards DBT for kerosene subsidies.

²⁰ The World Bank's South Asia Focus (April 2015) notes that based on India's experience over the last decade, oil price shocks affect the economy mainly through the current account balance and fiscal accounts. Using the predictions (or impulse responses) from a Structural Vector Auto Regression (SVAR) estimated with Indian data for the years 1995-2014, the authors find a significant positive relationship between crude oil prices and the fiscal deficit.

C. Introducing the GST in India: Current Status and Challenges

The proposed Goods and Services Tax (GST) in India is a tax on the value added by a firm to a product or service that it purchases from other upstream entities

Also known as a Value-Added Tax (VAT), it is collected through a staged process on the value added at each stage of production and distribution. First implemented by France in 1954, VAT has proliferated rapidly throughout the world partly because of its adoption by the EU and its promotion by the IMF in developing and transition economies (Ebrill et al, 2001). To date, more than 160 countries including all OECD countries (with the exception of the United States) and many developing countries have some form of a VAT scheme (Table 5). The median VAT/GST rate in OECD countries is 20 percent while the un-weighted average is approximately 19.2 percent²¹. In India, the proposed Goods and Services Tax is a VAT that will be levied at all levels of the value chain on both goods and services. Since it allows for input tax credits at each step of the value chain it promotes transparency, discourages evasion and prevents cascading. The design of an efficient GST regime hinges on harmonized rates of tax, minimal exemptions for goods and services and simplified administration.

Table 5: More than 160 countries around the world have a GST/VAT

Region	Number of countries with a VAT	Highest tax rate	Lowest tax rate
Europe	51	Hungary (27%)	Jersey, Channel Islands (5%)
North & Central America, Caribbean	19	Dominican Republic (18%)	Canada (5%)
Middle East and Africa	46	Madagascar/Morocco (20%)	Nigeria (5%)
Latin America	12	Uruguay (22%)	Paraguay (10%)
Oceania	8	New Zealand, Fiji, Samoa and Tonga (15%)	Niue (5%)
Asia (excl. ASEAN)	20	Uzbekistan, Tajikistan and Turkmenistan (20%)	Taiwan (5%)
ASEAN	8	Philippines (12%)	Malaysia (6%)

Source: Customs Malaysia website, PwC (2014), Crowe-Horwath (2014) and OECD (2014)

Note: Information is current as of 1 January, 2014. Rates refer to standard national VAT rates only.

The GST will revamp the current indirect tax structure and turn India into a single market

Currently, a single unified market does not exist within India due to inter-state tax and non-tax barriers to trade. Tax barriers include the Central Sales Tax on goods, entry taxes, and the restriction of input tax credit on inter-states sales. Non-tax barriers include the transaction costs of dealing with a different tax regime in each state, often comprising of multiple indirect taxes. The GST would make India a unified market by replacing the large number of state taxes currently in place with a single tax. In particular, the GST will replace the Service Tax and Central Value Added Tax (CenVAT) levied by the Centre, and the States' Value Added Tax (States-VAT) levied by the States. Moreover, it would allow input credits for all inter-state sales, and ultimately eliminate inter-state taxes according to the destination principle of taxation. By correcting the many distortions of the current system and creating a single market nationally, the GST is expected to provide a boost to the economy and increase growth, according to one estimate by 0.9-1.7 percent (NCAER, 2009).

GST is part of an extended process of reforming India's indirect taxes

The implementation of the GST is contingent on multiple legislations being passed at the

First, the Constitution 122nd (Amendment) Bill will provide the overarching framework to constitutionally enable the States to levy service taxes and the Centre to impose tax on all stages of the value chain (currently only the Centre can impose service tax and the Centre cannot impose taxes beyond the factory gate). This Bill needs to be approved by both houses of Parliament with a two-thirds majority, and by at least half the state legislatures by a simple

²¹ OECD consumption tax trends, data as on January 1, 2015.

Central and State levels

majority. Following the passage of this enabling legislation, GST legislation by the Centre, spelling out the design of the Central GST will be required. Concurrently, states will have to pass their own State GST legislations in their respective legislatures. Once the legal framework is in place, there are logistical and informational hurdles that need to be overcome prior to implementation, although these can be initiated concurrently with the legislative process.

The introduction of the GST has been in the works for several years

The intention to introduce the GST by April 1, 2010 was first formally proposed in FY06-07 by the then Finance Minister while presenting the Union Budget. Following delays, The Constitution 115th (Amendment) Bill, which would enable the roll out of the GST, was introduced in the Parliament in 2011. The bill was referred to a Parliamentary Standing Committee that submitted its report in August 2013, however the bill lapsed with the dissolution of the 15th Lok Sabha in May 2014. The next bill on GST, The Constitution 122nd (Amendment) Bill, 2014 (GST) was introduced in December, 2014 and was passed by the Lok Sabha (the lower house of Parliament) on May 5, 2015. The bill is pending approval in the Rajya Sabha (the upper house). The upper house, referred the bill to a Select Committee for examination, to inform discussions in the Rajya Sabha, during the Monsoon Session (in August 2015). However, a less productive monsoon session precluded any discussions. The constitution amendment bill will now be discussed in the upcoming Winter Session of the Parliament.

Significant reforms to indirect taxes have already occurred with the introduction of VAT on goods and a central service tax

India's indirect taxation system has gradually evolved from a system of input taxes and sales taxes which had a strong cascading effect to a destination based Value Added Tax (VAT). At the central level, initially India levied a Union Excise Duty that yielded 30 percent of tax revenue²². The large share of indirect tax was predicated on the fact that revenues from direct taxes were constrained by low levels of income, widespread poverty and administration capacity issues, resulting in a low tax base. A Modified VAT (ModVAT) was introduced in 1986, to replace union excise duties on selected goods. Gradually the scope of its application was widened to cover most goods and from 2000-01, it was rechristened as Central VAT (CenVAT). The CenVAT rate is 16 percent. In addition to CenVAT there are other taxes – a Special Excise Duty (SED), Additional Excise Duties (AED)²³ and cesses²⁴ on selected goods. SED is levied on a few items at 8 percent on top of CenVAT, effectively raising the taxes on such goods to 24 percent. On services, a Service Tax was introduced in 1994 by the Finance Act, 1994. The base of the Service Tax over a period of time expanded to include 115 service categories, before finally transitioning onto a system of 'negative list' of services in 2012. The Constitution (88th Amendment) Act, 2003, subsequently added the service tax to the Union List²⁵. The Centre levies a Central Sales Tax (CST) on inter-state sale of goods that has progressively been reduced to 2 percent²⁶. CST is collected and retained by the exporting State.

States have also gradually adopted a VAT on goods with the Centre supporting the

State taxes comprised of sales tax²⁷, state excise duties, motor vehicle tax, passenger and goods movement tax, entertainment tax, electricity duty and Octroi. The states suffered from a plethora of sales tax rates, within each state based on commodity classification, and across states. This led to 'rate-wars', often counter-productive from a revenue generation perspective. The transition to a VAT system began with inter-state coordination within a Standing Committee of

²² An excise duty is a tax on production.

²³ AED is levied by the Centre on certain goods (listed in the AEDLIST). The state levies sales tax on these, but at a reduced rate, not exceeding 4 percent.

²⁴ Specific purpose levies on all goods (unless specifically excluded) over the applicable CenVAT and AED

²⁵ Schedule VII of the Constitution contains three lists of subjects– the Union List, the State List and the Concurrent List – over which the Centre, the States, and both the Centre and the states concurrently, have jurisdictions.

²⁶ Reduced from 4 percent to 3 percent in 2007 and further to 2 percent in 2008

²⁷ Imposed at the first point of sale – manufacturer to the wholesaler – rather than at the final point of sale, due to inherent monitoring and collection challenges associated with the latter point of sale

transition by compensating them for revenue loss during the transition period

State Finance Ministers, later rechristened as the Empowered Committee of State Finance Ministers, to harmonize a floor of sales tax rates for commodity groups, across states. Since 2003, states started replacing their sales tax with a State-VAT²⁸. VAT rates have since been harmonized with deviations from the agreed VAT rates limited to less than 3 percent of the total list of commodities. The Centre compensated the states against revenue losses for three years, during the transitional years of the VAT implementation – 100 percent in FY05-06, 75 percent in FY06-07 and 50 percent in FY07-08.

The current system of indirect taxes contains many overlapping layers

The state VATs represent a marked improvement over the previous system but remain multi layered and therefore inefficient

The State-VATs usually follow a three-rate structure with agreed upon floor rates: zero percent on natural and unprocessed items, items constitutionally exempt from taxation (newspapers etc.) and items with social externalities (educational goods etc.); 4 percent for the majority of goods; and 12.5 percent on certain goods. There are exceptions to the three-rate structure for some product classes²⁹. In addition, small dealers are exempt from VAT if their turnover is below mandated thresholds that differ across states. Finally, VAT does not cover all goods. Petroleum and petroleum products still invite a sales tax and alcohol for human consumption invites excise duties.

In addition to complexity, shortcomings of the current indirect tax regime include identification challenges, cascading, administration and compliance

Identification challenges stem from blurring of the distinction between what constitutes a service and a good in modern products, and necessitate a comprehensive tax rather than separate taxes for goods and services. At the Central level, CenVAT suffers from definitional issues relating to manufacturing and value addition. Similarly, unlike in the case of goods, no standard nomenclature³⁰ exists for services. Though definitional issues have been resolved by the transition to a negative list for services and judicial rulings, the latter have also served to complicate the tax regime. Non-inclusion of several central taxes within the CenVAT framework, such as additional customs duty, surcharges etc. further complicates the tax structure. At the State level, several indirect taxes, such as sales tax on certain goods, luxury tax and entertainment tax are beyond the purview of the State-VAT and lead to cascading besides complicating the tax regime. Cascading of tax burden also occurs with partial coverage of Central and State taxes. For example, oil and gas production and mining, agriculture, wholesale and retail trade, real estate construction, and many services are outside the ambit of CenVAT and service tax. Thus, taxes paid on their inputs are not admissible for input credits. Exempt categories in State-VAT – the services sector, real estate, agriculture, oil and gas production and mining – suffer similar cascading. Inter-state CST also cascades – as it is not compensated for – and promotes market fragmentation by increasing the prices of imported goods in the importing state relative to the exporting state in addition to delaying movement and complicating compliance³¹.

The design of the GST has had to balance achieving efficiency and political consensus

The GST design proposed by the Empowered Committee of State Finance Ministers

The design of the GST is still evolving, but broadly, the structure recommended in the First Discussion Paper (FDP) of the Empowered Committee of State Finance Ministers in 2009 has been the basis for deliberations between the Centre and the States. It recommended the following design:

²⁸ VAT was adopted by 18 states from April 1, 2005.

²⁹ Gold and precious stones taxed at 1 percent; liquor at 20 percent

³⁰ A Harmonized System of Nomenclature (HSN) codes exist for goods

³¹ To record imports, most states issue delivery notes by the tax department of the importing state to the importer who in turn sends it to the exporter. This import permit is carried in the vehicle and verified at the cross border check point at the time of entry.

in their first discussion paper has remained largely unchanged

- i. A dual tax structure, imposed by both the centre (Central GST) and the states (State GST), would be applied on an identical tax base with input tax credits for one inadmissible against the other. This is identical to the VAT on goods (not services) that currently exists at the Centre and the States.
- ii. GST would subsume indirect taxes levied on the transaction chain involving import, manufacture/production of goods or provision of services until their final consumption. All other taxes not related specifically to the supply of goods and services would not be subsumed. Accordingly the following central and state taxes would be included:

Central taxes and levies	State taxes and levies
1. Central Excise Duty incl. Additional Excise Duties.	1. State – VAT/Sales tax
2. Excise duties levied under Medicinal and Toiletries Preparation Act	2. Entertainment tax (except those levied by local bodies)
3. Service Tax	3. Luxury tax, Taxes on lottery, betting and gambling
4. Additional Customs Duty (Countervailing Duties)	4. State cesses and surcharges
5. Special Additional Duty of Customs	5. Entry tax, not in lieu of Octroi
6. Surcharges and Cesses	

- iii. An Integrated GST (IGST) would apply on inter-state supply (including stock transfer) of goods and services. External imports would also attract the IGST in addition to customs duties. The IGST would be levied by the Centre, collected by the exporting state, transferred to the Centre, which in turn would remit it to the importing state. The importing dealer would be allowed to claim input credits. This is in consonance with the destination principle and avoids cascading.
- iv. The GST would be applicable on most goods and services. Exempt goods and services to be limited and restricted to public services provided by all the three tiers of government, service transactions between employer and employee, unprocessed food articles distributed by the Public Distribution System, and education and health services. Exemption thresholds would apply. Taxes on products containing alcohol (excise duties) and petroleum products (sales tax) would be outside the purview of the GST.
- v. Sin goods would attract central excise duties in addition to the GST. These excise duties would not qualify as input credits into the GST.
- vi. Uniform threshold exemptions would be available for small service providers and manufactures across the CGST and SGST.
- vii. There would be a two-rate structure for goods: a lower rate for necessity items and a standard rate for other goods. There would also be a special rate for precious metals (ostensibly to prevent smuggling) and a list of exempt goods.

The Task Force on Goods and Services Tax recommended improvements over the design put forward by the Empowered Committee of State Finance Ministers

The report of the Task Force on Goods and Services Tax, part of the 13th Finance Commission, recommended improvements over the design put forward by the Empowered Committee of State Finance Ministers. It trimmed the list of goods and services that were kept outside the purview of the GST – notably petroleum and petroleum products, alcohol, real estate transactions, and transportation of goods and passengers. Petroleum and related products are essential inputs for many products thus exempting them from the GST regime implies that cascading of taxes will continue for products that use them as intermediate inputs. Petroleum products that are used for final consumption and lead to emissions would be subject to both GST and excise duties without any provisions for input credit. Alcohol and tobacco were to be treated similarly: GST with additional excise duties with no input credits, invoking the same principle. The power sector that is currently subject to a state levy, would be treated like a good under the GST regime and the levy would be subsumed under the GST. Taxation of vehicles and transportation of goods and passengers were also recommended to be included in the GST tax regime as standard goods and services. The usage to be taxed additionally via the channel of emissions fuel taxation. It was also recommended that the real estate sector also be included in

the GST base. The justifications included the large size of the sector in the economy; the large proportion of an individual's consumption expenditure; and the sector's notoriety for tax evasion, criminal activities and as a repository of unaccounted wealth³².

Achieving political consensus has required a number of concessions that reduce the efficiency of the GST

The 122nd Constitution (Amendment) Bill, 2014 retains many of the inefficiencies of the current VAT regime. Petroleum and petroleum products (high speed diesel, motor spirit, natural gas and aviation fuel) will not be initially included in the purview of the GST, although the GST Council will be empowered to decide the date when the GST will apply on these products. Alcohol, electricity and real estate have been excluded entirely. While it is understandable that states would be reluctant to part with the discretion to tax these products (petroleum and alcohol account for between 40 and 45 percent of VAT/Sales Tax revenues for the states), there are few technical arguments for excluding them from the GST. This is especially true of petroleum, which is an important input to production: its exclusion means that a producer paying taxes on the fuel of her delivery lorry will be unable to claim credits and is therefore taxed twice. In the case of alcohol, including it in GST would help address concerns about state excise rate arbitrage³³. Bringing real estate under the GST umbrella may complement the Government's efforts (most recently through an amendment of the Income-tax Act to require non-cash payments of property transactions) to curb undeclared 'black money' in the sector.

The states have raised a number of concerns, which have been largely addressed

One of the earlier concerns raised by states was that the GST infringed upon the fiscal autonomy provided by the Constitution. However, an expansion in the State's tax jurisdiction to include the service sector has over time placated this concern. Another concern regarding the transparency and fairness of the dispute resolution mechanism if administered by the Ministry of Finance was addressed early by the suggestion of forming a GST Council³⁴ as the apex regulatory body

An argument has been put forward that the GST will penalize producer states in favor of the consumer states

To address this concern, the 122nd Constitution (Amendment) Bill allows for an additional tax of 1 percent, above IGST, to be imposed by the Centre on inter-state trade of goods and services for a period of two years or longer if mandated by the GST council. The additional proceeds will be collected by the Centre and assigned to the supplier state. However, such a levy is undesirable on many counts. First and foremost, it goes against the destination principle of a consumption tax. Second, since the tax cascades, it leads to market fragmentation by providing a price advantage to goods and services produced and consumed within the state boundary over those produced and imported from another state or those that are imported from countries with which India has a free trade agreement, such as Sri Lanka and Thailand. Finally, since the Centre has agreed to compensate the states fully against revenue loss for the preliminary 5 years, arguments for introducing a two year clause to achieve an identical end appear poorly founded.

Requests that the Centre should specify a ceiling rate at the current stage are premature

Until the design of the GST is finalized by the GST Council – the tax base, the exclusion list, the rate structure based on goods and services that will invite tax rates other than the usual rate - a precise assessment on the revenue neutral rate cannot be made. Nevertheless, several studies and reports have recommended the revenue neutral GST rate: the Task Force on Goods and Services Tax for the 13th Finance Commission recommended 5 percent for the Centre and 7 percent for the States in December 2009; the September 2012 report of the committee on Roadmap for Fiscal Consolidation suggested a rate of 6 percent for State and 8 percent for Central GST; an estimate by NIPFP in January 2013 suggested GST rates above the existing VAT (on goods) rate of 12.5 percent in case of a three rate tax structure and approximately

³² Currently real estate sector is subject to sales tax on works contracts, State VAT on construction inputs, stamp duty and registration fee.

³³ For example, the CAG noted in a 2011 audit report of revenues in Maharashtra that "As [Sindhudurg] is adjacent to Goa where the price of alcoholic beverages is half that of Maharashtra, illegal movement of liquor across the border into Sindhudurg district could not be ruled out as the traders enjoy a huge arbitrage advantage."

³⁴ The 122nd Constitution (Amendment) Bill creates a GST Council as the apex GST regulatory body with representatives from the Centre and the States with 1/3 and 2/3 voting shares respectively

equal to 12.5 percent for a two rate tax structure, at the state level; and a sub-committee comprising of central and state government officials suggested a revenue neutral rate of 26.68 percent (12.77 percent for Central GST and 13.91 percent for state GST) in November, 2014. While it may be possible to arrive at a revenue neutral rate at the aggregate level, ascertaining the rate for each state (which in the current structure do not levy services tax) is difficult and likely to vary considerably between states.

A (largely) harmonized tax base is a key feature of the design of the GST, with a wider base allowing for a lower revenue-neutral rate

A cursory glance across the current VAT regimes across states reveals significant context specific customization in classification of goods (though following similar overall principles) and tax rates (Table 6). As such, a careful administrative exercise will have to be undertaken to ensure that the base is largely harmonized across states, so that the GST fully achieves its main objective of facilitating commerce while ensuring revenue neutrality at the aggregate level. A wider base, with standard rates applying to the highest possible share of goods and services, will allow for a lower revenue-neutral rate concurrently simplifying compliance. The existing State VAT schedules have significant differences in how they classify goods to accommodate consumption peculiarities, besides differences in tax rates.

In the medium-term, it may be possible to collect the same level of revenues with lower tax rates once compliance improves and the base widens further

The tax base can widen through future policy changes such as the reduction in the threshold limit for registration, pruning of the negative list in the case of services, and reducing the number of excluded, exempt or zero-rated items. There are several taxes, which both the Central Government and the State Government levy on production, manufacture and distributive trade, where no set-off is available in the form of input tax credit. As more firms are incentivized to join the system to claim input tax credits and a transparent and complete chain of set-offs, compliance may increase. Such improvements, allied with higher efforts in boosting direct taxes, may eventually allow for lower GST tax rates to raise the same levels of revenues.

The key to the passage of an efficient GST in India is to identify mechanisms to compensate short term revenue losses without compromising the efficiency of the overall system

Enshrining short term concerns in a constitutional amendment will make the process to reform a sub-optimal GST regime at a future date arduous, requiring subsequent constitutional amendments. The 122nd Constitutional (Amendment) Bill, 2014 could be more forward looking by including the products in question in the taxation list. However, their inclusion has either been deferred (petroleum) to a date to be decided by the GST Council or not included at all (real estate, alcohol, goods and passenger transport). Including these goods and services, would have been more true to the principle of the GST. While a politically palatable and pragmatic way forward is desirable at the initial stages of reform, the constitutional legislation must provide flexibility to accommodate a subsequent correction in the GST legislation without going through lengthy legislative processes. Instead, such compromises should be introduced in the Central (Model) GST legislation and the state GST legislations.

Table 6: Classification examples of goods and tax rates in state VAT schedules in six states

State	Exempted	Lowest Rated	Low Rated	Standard Rated	High rated
AP		1%	5%	14.5%	20% - 190%
	. Raw wool . Fertilizers sold directly by Primary Agricultural Cooperatives Societies . Country liquor . Sugarcane, sugar and khandsari . Transfer of rights to use feature films	. Precious bullion . Jewellery from precious metals . Precious and semi-precious stones	. Flour from regular grains . Goods of intangible or incorporeal nature incl. goodwill . Most ores	All goods not included in other schedules	. Aviation turbine fuel . Alcohol for human consumption excluding country liquor . Tobacco and tobacco products . Petrol (31% + Rs. 4/l) . Diesel (22.25 + Rs. 4/l)
AS		1%	5%	14.5%	5 - 30%
	. Rice and its processed varieties and wheat . Edible oils produced by STATEFED . Anti-malaria drugs . Cancer drugs . Milled grains . School bags below MRP of 250 & sarees below MRP of 500	. Precious bullion . Jewellery from precious metals . Precious and semi-precious stones . Locally made gold and silver jewellery (0.5%)	. Seeds other than grass, vegetables and flowers . Khandsari . Sweetmeats . Lease transactions . Footwear with MRP below 500	. All goods not mentioned in any other schedule . Work contracts . Natural Gas	. Diesel (16.5%) . Petrol (27.5%) . Aviation Turbine fuels (22%) . Alcohol for human consumption including country liquor . Alcohol not for consumption . Molasses . Tobacco and its products, narcotics . Lottery tickets
CG		1%	5%	14%	4 - 25%
	. Notified power operated agriculture equipments . All grains and pulses except paddy . LPG for domestic use . Tin boxes and tin trunks . Rubber and plastic footwear below MRP of 150 . Seeds excluding oilseeds . All varieties of cloth	. Precious bullion . Jewellery from precious metals . Precious and semi-precious stones . All varieties of cloth except Khadi . Sugar and khandsari	. Milled grains . Petrol and diesel additives . Ores . Industrial inputs . Communication equipments . Lottery tickets	. All goods not mentioned in any other schedule	. Vehicle and Aircraft fuels (25%) . Tendu leaves . Natural gas . Foreign and Indian made foreign liquor for human consumption (7%) . PDS Kerosene (4%)
HR		1%	5%		4 - 25%
	. Fertilizers, all types . Notified power operated agriculture and irrigation equipments . Coarse grains and pulses . Sugar and Khandsari . PDS Kerosene . Tobacco for hooka use . LPG for domestic use . Sweetmeats made using traditional tools	. Precious bullion . Jewellery from precious metals . Precious and semi-precious stones . All varieties of cloth except Khadi	. Milled grains . Most ores . Industrial inputs . IT products . Communication equipments		. Aviation Turbine Fuel (20%) . Diesel (16.4%) . Petrol (25%) . Imported liquor . Liquor sold in bars (15%) . Paddy (4%) . Cell phones (8%)
KA		1%	5.5%	14.5%	20%
	. Sugar and Khandsari . Paddy, rice, wheat, pulses & seeds excluding oilseeds . Aviation Turbine Fuel . Liquor for human consumption including country liquor . Petrol & Diesel . Solar PV panels and inverters . Lottery tickets . Silkworm eggs, pupae, cocoons and raw silk including yarn produced within India	1. Precious bullion	. Milled grains . Notified capital goods . Fertilizers . Edible oils . Manufactured sand	. Works contracts	. Narcotics . Molasses . Alcohol not for human consumption
WB		1%	5%	14.5%	35%
	. Bed linen . Bio fertilizers . conch shells and conch shell products . Dried flower and plants . Empty domestic LPG cylinder and domestic LPG . Fuel from solid waste . PDS Kerosene . Handmade indegenous soap	. Precious bullion . Jewellery from precious metals . Rhodium . Tea auctioned by Tea Auction Centre in West Bengal	. Biscuits not manufactured in a factory . Notified capital goods . Khandsari	. All goods not mentioned in any other schedule	. Tobacco and tobacco products

Source: State VAT schedules updated until September, 30, 2015

International experience suggest an efficient GST is feasible in India

Federal countries have adopted different systems of VATs in accordance with their fiscal and political imperatives

Many forms of GST exist in federal countries. Broadly these can be classified into three kinds of systems.

- First, completely independent VATs at the centre and states. Countries including Brazil, Russia and Argentina have such systems, as does India. Though such a system would be aligned with the spirit of fiscal autonomy in a federal structure, given the complexity and evolving nature of modern products and services, overlaps and omissions in the tax base are likely to arise. Besides, constant definitional clarifications on the base complicate the system with an eventual deleterious impact on administration and compliance. Finally, such systems create challenges in managing inter-state transactions. Brazil for example adopts a part origin-part destination principle with respect to inter-state transactions. There are two interstate rates (which depend on the economic development of the destination state), which are set by the central government. The importing state then collects the difference between the interstate rate (applied on the origin principle) and its local VAT rate.
- Second, a VAT levied and administered at the central level with a sub-national revenue sharing mechanism based on estimated consumption or on a formula. Such a system is also known as a 'joint VAT'. It has the advantage of significant reduction in the cost of compliance and administration. A number of OECD countries including Germany, Austria, Australia, Belgium and Switzerland have adopted such a regime. Germany, which has strong local governments, has a single national VAT, a proportion of which is distributed among the sub-national governments on the basis of a formula. Similarly, Austria devolves 18.557 percent of the VAT revenues to the second tier and 12.373 percent to the third tier of government. In Australia, all the proceeds of the central GST are divided among the states. Effectively, a 'joint VAT' functions as an alternative form of inter-governmental transfer, but suffers from the shortcoming of absolving the local government of its revenue raising responsibilities and effectively reducing the fiscal discretion available to states by limiting their taxation options.
- Third, a 'dual VAT' – destination-based VATs applied at the central and state levels. This is largely the model of GST under development in India and currently followed in the province of Quebec in Canada (the Quebec Sales Tax or QST). The QST is a destination-based VAT applied to the GST-inclusive price of most goods and services consumed in Quebec. Goods and services that are produced and consumed in Quebec or imported in the province are subject to tax. Transactions conducted in the province are also subject, usually at the same time, to the GST at the 5 percent rate. Taxes on interprovincial sales from one business to another are handled through zero-rating (effectively a deferred payment system). Smart and Byrd (2012) argue that "The [QST] and the federal [GST] constitute an operational "dual VAT" system with essentially none of the problems usually associated with such systems."

Canada's experience demonstrates that a central VAT can work well in a country in which subnational units have their own VATs

The Canadian case is unique since it allows maximum flexibility to the states within the federal structure. Canada levies a Federal GST at the central level on a tax base that is identical and harmonized with the provinces. However, each province retains its independence to tax in the manner it deems appropriate. The example of Quebec has been discussed above. In the province of Alberta, the Federal GST is the only tax; in the provinces of British Columbia, Manitoba, Ontario and Saskatchewan, a Retail Sales Tax (RST) is applied on the harmonized base after excluding the value of the Federal GST; Prince Edward Island levies a RST on the tax base including the value of the Federal GST; in Nova-Scotia, Newfoundland and New Brunswick a

single VAT rate known as the Harmonized Sales Tax (HST) is applied³⁵. Smart and Byrd (2012) argue that the “Canadian experience also demonstrates that a federal VAT can work perfectly well in a country in which some subnational units have their own VATs, some have their own retail sales taxes (RSTs), and some have no sales tax at all.”

³⁵ The tax base and rate are harmonized between the centre and provinces, and the tax is levied and administered by the central government

D. Moving Spending and Delivery to States: The 14th Finance Commission³⁶

Additional resources and (much) greater responsibilities moved from the Centre to States

The 14th Finance Commission (FC) has recommended a significant increase in the discretionary spending powers of subnational governments

It moved spending power from the centre not only to the states but also at local tiers (see Box 3). It also addressed horizontal (between states) equalization and amended the distribution of these resources amongst states – with an intended increase in progressivity. Specifically, it has recommended:

- **Accelerate devolution of untied resources to state governments.** The states’ share in the central divisible pool of tax revenues (which represent untied resources) is to increase from 32 percent to 42 percent. This large increase is a departure from the previous commissions, which followed a much more gradual approach and recommended an increase of 1.5 and 1 percent by the 13th and 12th FC, respectively.
- **Reduce conditionality and increase transfers to local government bodies.** Grants to states for local governments will be based on 2011 population and area and will be divided into two parts: (i) basic/unconditional and (ii) performance/conditional grants, on a 90:10 and 80:20 bases for rural and urban local governments respectively. The increase for Urban Local Bodies over the 13th FC is four-fold while for the Rural Local Bodies it is more than three times of the 13th FC award. The 14th FC has fixed the total grant to local bodies at INR 2874.4 billion (USD 46 billion), including INR 871.4 billion (USD 14 billion) for Urban Local Bodies and INR 2.3 trillion (USD 32 billion) for Rural Local Bodies.
- **Horizontal equalization through redistribution of devolved revenues.** A change in the formula for distribution of devolved resources was recommended by the 14th FC to compensate states with higher rates of in-migration and other demographic changes, forest cover, and poor fiscal capacity (ability to raise its own revenues). Simultaneously, the fiscal discipline parameter was dropped to make transfers more unconditional.

Box 3: India’s many levels of government

India has three tiers of Government:

- Central (also referred to as the “Centre” or the “Union”)
- States and Union Territories
- Local Bodies (LB):

Rural (three tiers)	Urban (single tier)
○ District	○ Municipality
○ Block	
○ Gram Panchayat (village level)	

Tax devolution and untied grants have jumped, but tied transfers have been rationalized, such that the net effect on transfers is a modest increase of 0.5pp of GDP

The Government largely accepted the recommendations of the 14th Finance Commission and implemented them in the FY15-16 budget. After remaining stable around 2.8 percent of GDP during the period of the 13th Finance Commission, tax devolution was budgeted at 3.7 percent of GDP in FY15-16 compared to 2.7 percent of GDP in FY14-15 (Table 7, Figure 73 and Figure 74). Untied grants also increased, from 0.6 to 0.7 percent of GDP, such that tax devolution and untied grants increased by 1.2pp of GDP. On the other hand, transfers to states and union territories earmarked for specific purposes (“tied transfers”) will decline between FY14-15 and FY15-16 from 2.2 to 1.6 percent of GDP. When the budgeted cuts from largely tied grants from the centre are netted out from the increased devolution of tax revenues, the increase is a more modest 0.5 percent of GDP (Figure 75).

³⁶ This Note draws from “Implications of India’s 14th Finance Commission” prepared by Farah Zahir, Lili Liu, Uri Raich, Ana Bellver, Saw Young Min, Manvinder Mamak, Smriti Seth, Frederico Gil Sander, S. Krishnamurthy and William Dillinger.

Table 7: Somewhat higher total transfers, but a jump in tax devolution

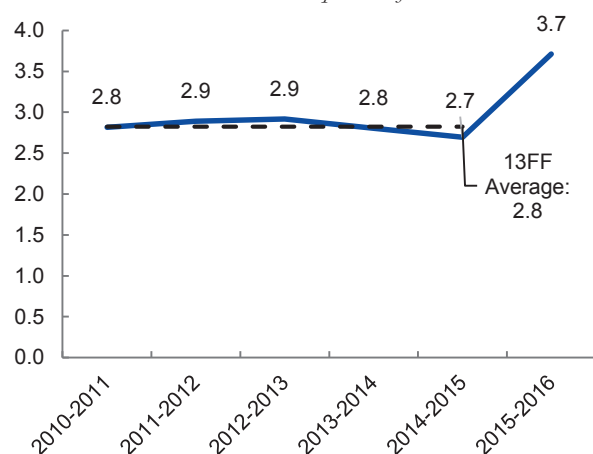
Percent of GDP	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015	13FC average	2015-2016
Tax Devolution	2.8	2.9	2.9	2.8	2.7	2.8	3.7
Untied Grants	0.6	0.6	0.5	0.5	0.6	0.5	0.7
Tied Grants	3.0	2.9	2.5	2.3	2.2	2.6	1.6
Total Transfers	6.5	6.3	5.9	5.6	5.5	6.0	6.0
... of which untied	3.4	3.4	3.4	3.3	3.3	3.4	4.4
Direct expenditure by center	11.7	11.3	11.1	10.9	10.6	11.1	10.3
...Subsidies	2.2	2.5	2.6	2.2	2.1	2.3	1.7
...Interest	3.0	3.1	3.1	3.3	3.3	3.2	3.2
...Capital Expenditure	1.9	1.6	1.6	1.6	1.5	1.6	1.6
...Other recurrent	4.6	4.1	3.8	3.8	3.7	4.0	3.7

Source: Ministry of Finance and World Bank Staff Calculations

Notes: Untied grants include non-plan grants from the Ministry of Finance (MoF), largely for state budget support. Tied grants include non-plan grants earmarked to ministries other than MoF, grants for state & UT plans, assistance for centrally-sponsored schemes, and direct disbursements to implementing agencies. Capital expenditure excludes those finance through plan capital expenditures net of loan recoveries earmarked to the states, which are included under transfers.

Figure 73. Tax devolution to the states increased...

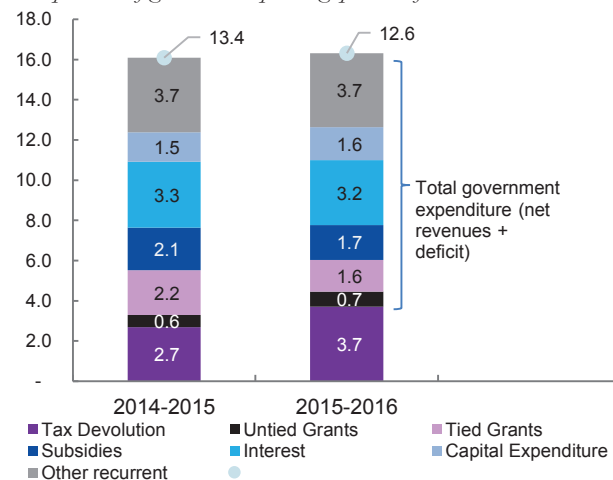
Tax devolution to states and UTs, percent of GDP



Source: Ministry of Finance

Figure 74. ... but tied grants declined simultaneously...

Composition of government spending, percent of GDP

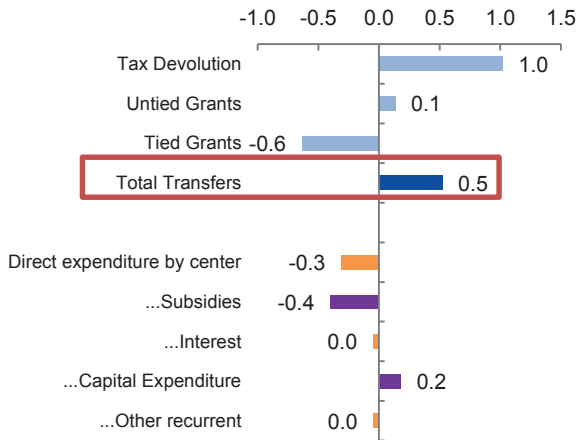


While the increase in overall resources to states has been modest, a larger share of the resources is untied

The share of untied transfers to states and union territories, comprising of tax devolution and non-plan grants for budget support and compensation for the phase-out of the CST, has increased from an average of 56.8 percent during the period of the 13th Finance Commission to 73.7 percent in FY15-16 (Figure 76). Hence, the share of untied transfers has decidedly increased.

Figure 75. ...leading to a more modest net increase in total transfers to states

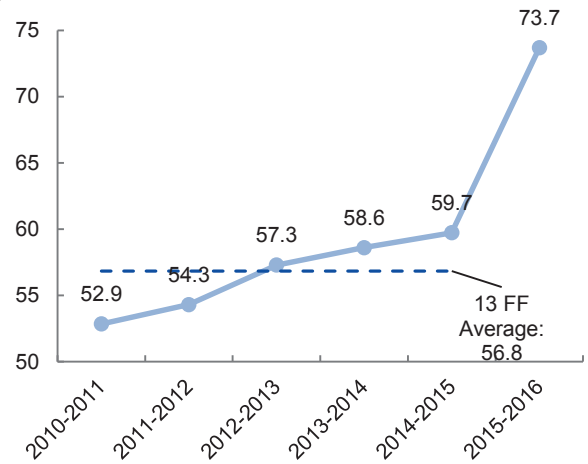
Change between FY15-16 (budget) and FY14-15, percentage points of GDP



Source: Ministry of Finance

Figure 76. The share of untied transfers jumped to nearly 3/4 of total transfers

Share of untied transfers to states and UTs as a share of total transfers, percent

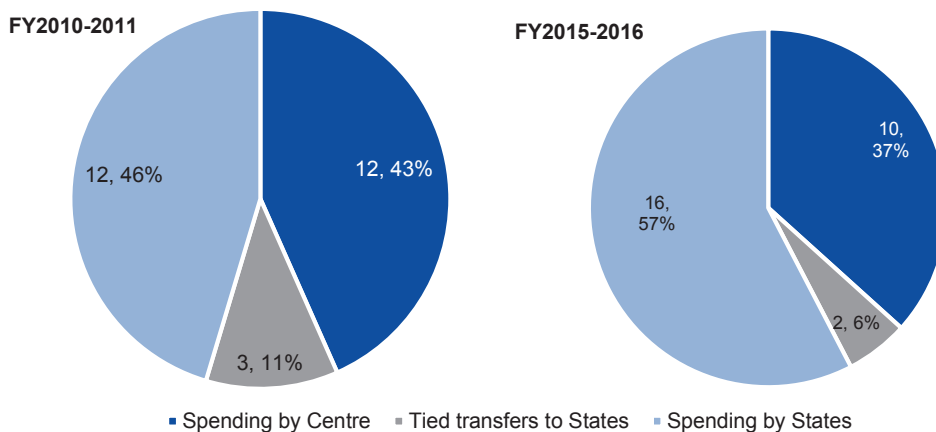


As a result of these reforms, development outcomes are increasingly tied to states' and local governments' priorities and capacities

As of FY15-16, expenditure at the state level is expected to overtake that of the Centre (Figure). While the increased devolution of unconditional resources is a positive development, efficient utilization of these resources likely varies across states. The simultaneous scaling down of centrally sponsored social sector schemes presents some downside risks for development outcomes, unless compensated for by the states. Low income states, which have historically shown lower responsiveness of poverty to growth and lower administrative capacity to implement social protection programs, are likely to increasingly bear the burden of poverty reduction. This note discusses opportunities and challenges of greater devolution of untied resources, and provides examples of how other countries have met the challenges.

Figure 77. Nearly 60 percent of public expenditure in India will take place at the state level as of FY15-16

Share of expenditure in total general government expenditure (%) and percent of GDP



Source: Ministry of Finance (Indian Public Finance Statistics 2015 and Budget documents)

Deep reforms present challenges and opportunities

States need to step in as the Centre rationalizes a number of schemes

As part of the reallocation of expenditures, centrally-sponsored schemes (CSS) are being rationalized

In parallel with the recommendation to increase untied transfers, the 14th FC proposed a structural change to progressively reduce the funding of CSSs or specific purpose grants. As illustrated in Table 8, these CSS have been classified in the FY15-16 budget as (i) schemes to be fully financed by the centre; (ii) schemes with an altered sharing pattern between the centre and states; and (iii) schemes that are completely delinked from central support. The reductions in schemes classified as (ii) and (iii) is also reflected in lower plan grants (Table 9).

Table 8. Many central schemes have been cut, but some have been retained

Changes in the Financing Pattern of Central Schemes (INR. Billion)

	2014-15 RE	2015-16 BE	Change over the previous year
A. Schemes Fully Supported	1058	1186	12.1%
MGNREGA	325	337	3.8%
Prarambhik Shiksha Kosh	222	276	23.9%
Addl Asst Externally Aided	119	125	5.0%
Pradhan Mantri Gram Sadak Yojna (PMGSY)	65	55	-15.3%
National Social Asst. Program	72	91	25.4%
Others	255	303	18.7%
B. Schemes with Changed Pattern	1003	798	-20.5%
Rashtriya Krishi Vikas Yojana (RKVY)	84	45	-46.7%
Irrigation benefit (Pradhan Mantri Krishi Sinchai Yojna (PMKSY))	0	18	
Swachh Bharat Abhiyan	119	60	-49.7%
National Health Mission	176	183	3.8%
Mid Day Meal and Sarva Shiksha Abhiyaan (SSA)	131	35	-73.0%
Housing-Rural Indira Awaas Yojana (IAY)	110	100	-9.0%
Sardar Patel Urban Housing	0	40	
Urban Rejuvenation	24	60	146.8%
Integrated Child Development Service (ICDS)	165	82	-50.1%
Others	193	174	-9.8%
C. Schemes Delinked	66	0	
Total (A+B+C)	2127	1984	-6.8%
Total (B+C)	1069	798	-25.4%
Memo:			
13th FC grants	150	0	

Source: Expenditure Budget Vol.1, 2015-2016, Annex-8, p.204-206

Table 9. The reduction in the schemes is also reflected in a reduction of plan grants

Rupees billion

	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015	13FC average	2015-2016
Tax Devolution	2,193	2,554	2,915	3,182	3,378	2,845	5,240
Non-plan loans & grants	499	516	514	606	803	588	1,086
... of which untied	468	489	457	559	754	545	1,038
Plan grants, loans and off-budget direct transfers	2,342	2,532	2,456	2,595	2,737	2,533	2,194
...State and UT Plans (current)	818	925	969	1,005	2,648	1,273	1,904
...Centrally Sponsored Schemes	306	400	413	441	46	321	239
...Direct release to implementing agency	1,187	1,092	1,050	1,127	-	891	-
...State and UT Plans (capital net of loan recovery)	31	116	25	22	43	47	52
Total Transfers	5,034	5,602	5,886	6,384	6,919	5,965	8,520

Source: Ministry of Finance and World Bank Calculations

There is uncertainty about the states readiness to fund centrally sponsored schemes whose

There is an ongoing debate in India about the likely impact of these changes on schemes such as Sarva Shiksha Abhiyaan, Mid-day meal, Integrated Child Development Service, and Housing-Rural Indira Awaas Yojana, which may suffer substantial cuts from the centre and would require the states to step in with higher funding. The changes recommended by the 14th FC have raised concerns about the reduced spending from the centre on social sector programs and the ability

financing pattern has changed and willingness of the states to finance key social sector programs under these schemes and to continue with the current program design under schemes with changed funding pattern.

The restructuring of CSS provides a message that states are fully responsible for sectors under their constitutional mandate The central government will have fiscal responsibility for financing and implementing plan CSS that are national priority or constitutional obligation. Specifically, while CSS fully financed by the central government are projected to grow by 12 percent between FY14-15 and FY15-16, CSS with shared financing (central and state governments) would decline by 21 percent for the same period. In overall terms, the centre would be saving INR 271 billion (0.2 percent of GDP) in FY15-16 by restructuring CSS.

States have the opportunity to re-cast the design and implementation of the schemes to better reflect local preferences On the other hand, the 14th FC has opened up the space for re-casting the schemes, their design and implementation into local context that better reflect local preferences. The reduction and rationalization of centrally sponsored schemes as well as the restructuring of the central plan spending provide an opportunity for the States to rethink the role of local governments. The increased fiscal space of states will allow greater devolution to local governments through State Finance Commissions.

Enhancing governance at local levels will become increasingly important

Local bodies also saw a significant increase in untied resources from the 14th FC recommendations During the 14th FC period, the total amount of grants to local bodies –urban and rural– is equivalent to 3 percent of the divisible pool. In the earlier commissions (10th, 11th and 12th FCs) the total grants to local bodies were between 0.78 and 1.38 percent of the divisible pool (Figure 78). The amount of these grants was determined on per-capita basis or on the basis of formula³⁷ and then converted as a percentage of the divisible pool. With the 13th FC, the division pool was used for the first time to estimate grants for local bodies³⁸.

States are key partners in ensuring local bodies are empowered to deliver better services The political willingness of states will be critical to ensure that the 14th FC recommendations deepen the decentralization process and empower the lower tiers of government in a meaningful way. Ultimately, the 14th FC recommendations with respect to local bodies are going to be implemented by the states and in the absence of a robust monitoring framework, there is a risk that they could be watered down. Currently, political willingness and the degree of decentralization varies across states and in some of the low income states (LIS), local bodies have not been effectively empowered.

States need to strengthen their own Finance Commissions to help local governments State Finance Commissions (SFCs) are the constitutional counterparts of the Finance Commission at the state level. They are charged with recommending the state's approach towards the determination of the requirements of local body finances within their respective States. Unfortunately, many states do not constitute SFCs on a regular basis. In other cases, SFC recommendations have not been accepted. 14th FC recommendations include timely constitution of SFCs, proper administrative support and adequate resources for smooth functioning, and timely placement of SFC reports before State legislatures with action taken notes.

There is also a need to strengthen financial management and The lack of reliable financial data on panchayats and municipalities is a cause for concern, and successive Finance Commissions have highlighted the need for robust accounting systems at the local level. The 14th FC proposes entry points to strengthen local accountability and financial management such as audited accounts triggers for performance grants, technical guidance and support from Comptroller & Auditor General, and encouragement to states to provide technical

³⁷ The formula includes population, revenue effort, area etc.

³⁸ 2.28 percent of the division pool.

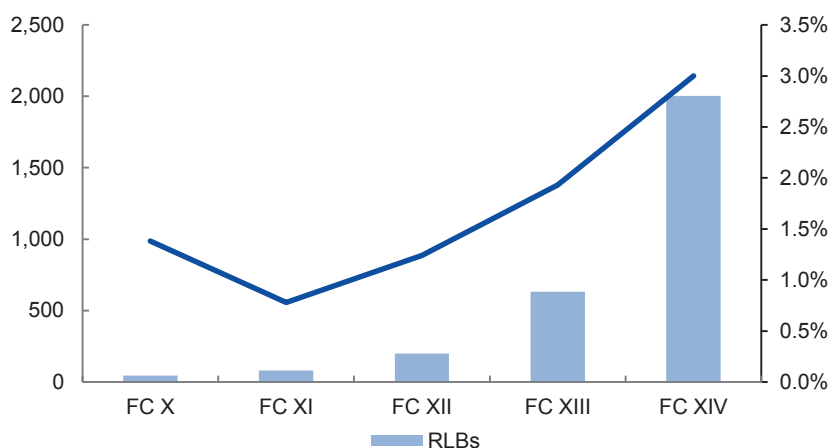
accounting of local bodies

support to local bodies. In parallel, an assessment of the capacity of the audit and oversight arrangements at the state level would help develop a time based action plan for capacity building.

Providing funds for capital expenditures to local governments on a massive scale assumes capacity is present

Without adequate human resources at the Gram Panchayat level, providing funds for capital expenditures to local governments on a massive scale is likely to be counterproductive. As highlighted consistently by the Central Finance Commission and State Finance Commission reports, a major bottleneck for Gram Panchayats is the authority to recruit technical and administrative staff. While some states have created a Municipal Cadre for urban bodies, no such efforts have been made for the Rural Local Bodies. The absence of a cadre is not only a disincentive in financial terms but is also a limiting factor for attracting talent at the local level.

Figure 78. Grants to Local Bodies have increased sharply under the 14th FC
INR billion Percent of divisible pool



Source: CPR Report, 2014.

Rural Local Bodies

Grants to Rural Local Bodies will increase by 30-40 percent

During the 14th FC period, a grant of INR 2.0 trillion (US\$32 billion) has been provided for Rural Local Bodies (Figure 78). The entire grant allocation is planned to be executed by Gram Panchayats for core services they are legally mandated to deliver.³⁹ With an average annual increase in grants of 30-40 percent during the period 2015-2020, this is a significant attempt to improve the record of service delivery at the local level. The allocation mechanism provides on average a higher proportion of funds to states with large population in rural local governments, meanwhile, states with smaller panchayats would receive substantial allocations during the last year of the period.

Grants to local bodies include two components: basic grant and performance grant

For Gram Panchayats, 90 percent of the grant will be a basic grant and 10 percent will be a performance grant. The basic grants will be distributed among Gram Panchayats using the formula prescribed by the respective State Finance Commissions (SFCs). In case the SFC formula is not available, the share of each Gram Panchayat would be distributed using the 2011 population (90 percent of the weight) and area (10 percent of the weight). This formula has been simplified and the population weight has been significantly increased compared to previous FCs.

The share of the performance grant has been reduced, and its terms and

The 14th FC has reduced the share of the performance grant, from 34 percent in the 13th FC to 10 percent, and simplified its terms and conditions. Reduced from nine to three, the conditions for performance grant include: (i) availability of reliable financial data through audited accounts, (ii) publication of service level benchmarks, and (iii) improvements of own revenue. This

³⁹ These mandatory services include water supply, sanitation and hygiene, community assets, roads and streetlights.

conditions simplified

financial and performance data requirements aim at improving available data on Rural Local Bodies, enhancing their accountability, and initiating evidence based policy making at local level. The 14th FC delegated to states the determination of the detailed disbursement procedure to Rural Local Bodies.

Financial requirements of local bodies are estimated to be significant

A report from Centre for Policy Research (CPR) estimated that the financial requirements for delivering core services by Rural Local Bodies is INR 2,375.6 billion (USD 38 billion; 1.7 percent of GDP) over the next five years (Table 10).⁴⁰ CPR's estimation includes the cost of capital investment and operations/maintenance to provide mandated core services as per the norms over the five year period. The financing requirement was determined calculating the difference between projections based on past trends and the cost of services per norms. This is probably the first attempt to determine the service delivery financial requirements at the rural local level in India. It is important to stress that given the usual quality of states data and the results of the data compilation by 14th FC⁴¹, this estimate is indicative and provides a preliminary baseline.

Table 10. Financial Requirement as Per Norms and the Service Gap in Core Services by Rural Local Bodies

Core Services	Total Financial Requirements		Financial Gap	
	INR. billion	USD billion	INR. billion	USD. billion
Water Supply	781.5	12.4	331.8	5.3
Sanitation and Hygiene	1218.8	19.3	976.7	15.5
Community Assets	46.4	0.7	12.43	0.2
Roads	149.9	2.4	149.9	2.4
Streetlights	179.0	2.8	5.95	0.1
Total	2375.6	37.7	1476.7	23.4

Source: Rural Local Bodies Core Functions and Finances, Report for 14th FC by CPR

The 14th FC grant aims to narrow the financial gap.

The 14th FC grant aims to address the financial gap and provide financial stability to Rural Local Bodies through assured transfers for planning and delivering of local services smoothly and effectively. The 14th FC recommendations are vague in terms of the specific expenditures to be covered, but the grant to Rural Local Bodies is expected to provide funding not only for the provision of core services but also for the necessary administrative infrastructure and capacity building support. The SFCs will play an important role in defining further the guidelines for the use of these grants.

Rural Local Bodies will still need to raise more own-revenues to close the financing gap

Based on the Rural Local Bodies current spending, the CPR report estimates a financial gap of INR 1.48 trillion (USD 23 billion; 1 percent of GDP) to deliver core services. One way to address the financial gap is through own sources of revenue, but this is an overwhelming challenge for the Rural Local Bodies with limited capacity to collect taxes⁴². Currently, incomes from Rural Local Bodies from own revenues are not significant enough to make a considerable difference to their overall financial position and not much action has been taken so far by the States to ensure that local taxes and user charges are collected by local governments. In the past the Rural Local Bodies have largely depended on the Centre and state transfers to meet their requirements, as illustrated in Figure 79.

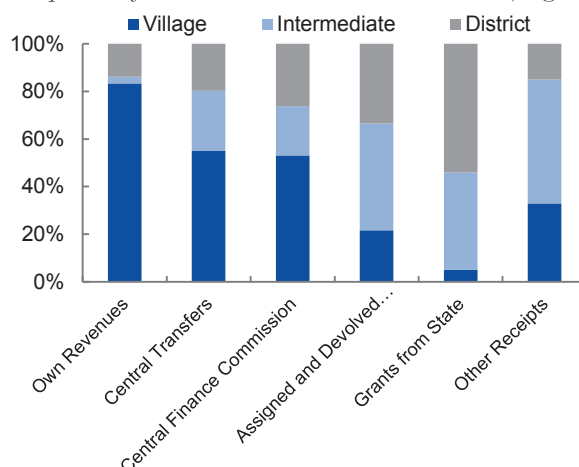
⁴⁰Rural Local Body: Core Functions and Finances, A study for 14th FC, Centre for Policy Research, New Delhi, 2014.

⁴¹In most states, the quality of financial and fiscal data is poor and not even computerized. 14th FC sent formats to all states to fill the data as per the formats and then tabulated and cleaned the datasets to make them comparable. The report elaborates in detail the data anomalies and inconsistencies in information provided.

⁴² Rural Local Bodies (in particular, the Gram Panchayats) have the authority to collect taxes, including property tax, building and water tax, fees, fines and rents.

Figure 79. In the past, Rural Local Bodies have largely depended on transfers

Composition of revenues tier-wise in Rural Local Bodies (Avg. 2009-13), percent



Source: Rural Local Body core functions and finances, Centre for Policy Research, 2014.

Yet there is a risk that larger resource flows create a disincentive to collect own revenue

In fiscal devolution processes, large resource flows from the centre usually represent a disincentive to collect own revenue at local level. The 14th FC has incentivized better revenue collection by making it a condition for accessing performance grants, but at the same time performance grants have been significantly reduced. Previous FCs have also suggested ways to increase revenue and improve collections in the Gram Panchayats with limited success.

Large resource transfers may also generate unrealistic expectations about the service delivery improvements

The expected large resources to be transferred may generate unrealistic expectations about the service delivery improvements that could be achieved over the five year term and its sustainability. Even though preliminary, CPR estimates on core service delivery financing gaps might be underestimating the financing requirements of Rural Local Bodies given that they do not take into account the operation and maintenance cost of current assets, and the staff cost. 14th FC recommendations only apply to the five year period (2015-2020) without offering any revenue sharing arrangements that contemplate tax and non-tax measures for bridging the funding gap in a sustainable way.

Concerns have been raised about the capacity of Rural Local Bodies to administer larger transfers

Oomen (2015) expressed reservations about this massive provision of grants to be transferred to Rural Local Bodies in the next five years without addressing capacity and institutional constraints at the local level⁴³. While there is indeed an absorption capacity risk, the 14th FC focus on service delivery at local level is timely, and the proposed transfer of financial resources at panchayat level for their mandatory services is justified due to the low record of service delivery at local level in India and significant needs at local levels. Ensuring that Rural Local Bodies have the capacity to manage those funds and increase the level and quality of core services would require more than transferring financial resources.

Strengthening public management and accountability systems at the local level will be critical

Ensuring that Rural Local Bodies have the capacity to manage the 14th FC large transfers and increase the level and quality of core services would require strengthening public management and accountability systems at the local level. There is a need for strengthening State and Panchayat capacities over a wide range of areas, including planning, public investment management, accounting and auditing, public procurement, human resources management, and environmental screening. Using FC funds effectively would also require Panchayats to become an integral part of the planning, financial management and project management systems of the upper tiers of government. In fact, more significant projects across Gram Panchayats needed to

⁴³Indian states have not followed a scientific, structured and systematic approach to the devolution of 3F's (Funds, Functions and Functionaries) to Rural Local Bodies given that the "Panchayat Raj" is a state subject.

significantly improve service delivery –like water supply schemes– cannot be developed without proper planning.

Urban local bodies

The 14th FC also recommends a massive increase in the grants for Urban Local Bodies

The 14th FC also recommends a fourfold increase in the grants for Urban Local Bodies, for a total of INR 871.4 billion. From 2007/08 to 2012/13, grant transfers to municipalities more than doubled from INR 218.5 to INR 467.3 billion. For the 2015-20 period, transfers to municipalities will continue to grow with a total of INR 871.4 billion split between INR 697.2 billion for basic grants and INR 174.3 billion for performance grant. This represents a yearly per capita allocation of 488 rupee or USD 7.7. In addition to the 14th FC grants, the central government has come with a recent urban scheme called Atal Mission for Rejuvenation and Urban Transformation (AMRUT) which will provide 50,000 crore for 500 cities in 5 years.

The demand for better urban infrastructure and public services is large and growing

The level of urbanization in India is unprecedented. According to High Powered Expert Committee (HPEC), in 2010, 50 percent of the GDP was generated in cities with an urban population of 357 million in 2011, which is expected to reach 598 million by 2031. The HPEC also estimates that investments in urban infrastructure over the next 20 years are in the order of 50.9 lakh crore or USD 822 billion. This amounts to an investment need of USD 40 billion per year or USD 112 per urban resident per year. For the core services only⁴⁴, annual investment needs are about USD 12.3 billion or USD 34 per person⁴⁵.

The increase in FC grants remains marginal compared to the financing needs of Indian cities

The fourfold increase in the quantum of the FC grants remains marginal compared to the financing needs for the Urban Local Bodies. The FC grants will bring additional resources of USD 13.7 billion to urban areas over the life of the 14th FC. On the basis of 2012/13 expenditures, the FC grants alone will only cover 25 percent of the Urban Local Bodies current expenditures or 43 percent of their capital needs. Given the limitations of the other sources of local revenue, a large proportion of the grants will probably cover statutory obligations, leaving little, if any, resources for capital investments.

Despite these huge needs, municipal revenues in India account for 1 percent of GDP

In contrast, in other important emerging federal countries municipal revenues are above 5 percent of GDP. In India municipal revenues account for about 0.76 percent of GDP⁴⁶, with 0.5 percent from own source revenue and 0.47 from total grant transfers. The proportion of grants to Urban Local Bodies is significantly lower than other countries with low levels of own source revenue such as Indonesia, South Africa, Mexico and Brazil, which are all above 5 percent of GDP. More generally, total local revenues in India are very low by international standards. Local revenue as a proportion to GDP India is at the level of half of African countries and below all but one European and Latin-American and Caribbean countries (Malta and Jamaica).

Improvements in service delivery may lead to increases in own source revenue generation

This will be the case if service delivery is appropriately calibrated with timely rate revisions and updates of property records. This would however require to undertake structural reforms to give more fiscal autonomy to local bodies. Existing preliminary simulations are not optimistic about the potential of increase of municipal own-source revenues under current conditions.⁴⁷

⁴⁴ Water supply, safe sanitation and elimination of open defecation, sewerage and storm water drainage.

⁴⁵ ASCI, 2014.

⁴⁶ Prasad and Chary (2014).

⁴⁷ Blane (2013) - If all municipalities were to generate own-source revenues at expected levels then total such revenues would only increase from 0.62 to 0.64 percent of GDP. Doubling the expectation on the levels of collection, which is quite an ambitious assumption, leads to aggregate own-source revenues of less than one percent of GDP.

Lessons from country cases

Many countries face similar challenges related to managing fiscal risks, ensuring efficient use of devolved resources, and building implementation capacity

While approaches to fiscal decentralization vary across countries, they face similar challenges related to managing fiscal risks, ensuring efficient use of devolved resources, and building implementation capacity. Developing and advanced countries have over time adopted a range of strategies to address these challenges including preventive measures of strengthen administrative capacity and the imposition of budget constraints. Table 11 summarizes these strategies, which are discussed further below.

Table 11. Key International practice in fiscal devolution challenges

Issue	Country	Measures
Risk of fiscal sustainability and inefficient use of resources	Brazil	Align national and local priorities through earmarking funds for key sectors
	Colombia	Performance management and M&E systems
	Indonesia	Hard constraints on budget
	Russia	Tight constraints on deficit limit and debt service
	Argentina	Institutional strengthening, stricter limits on spending and debt levels, and monitoring of fiscal accounts
Lack of institutional capacity and accountability	Indonesia	Deploy central officers to train local officers and build rules and processes
	Colombia	Create associations and share professional staff
	Spain	Asymmetric devolution
	OECD countries	Multilevel governance coordination across levels of government
	Kenya	Citizen participation and social accountability
	Uganda	Local government to train in and monitor budgets

Managing fiscal risks

Several countries adopted hard budget constraints on subnational entities to enforce fiscal and debt sustainability and curtail wasteful expenditures

- **Indonesia** imposed limits on the sources for deficit financing for local governments and set intergovernmental transfers at a level sufficient to cover only administrative costs.⁴⁸
- **Russia** adopted a Budget Code which imposed hard ceilings for deficits, debt stocks, and debt service for subnational governments. This code especially tightened the budget deficit limits of the highly subsidized entities.⁴⁹
- Following the debt crisis in early 2000s, **Argentina** introduced a new fiscal responsibility framework that placed stricter limits on spending and debt levels, and monitoring of fiscal accounts. In extreme cases of lack of governance and public order, the federal government could resort to “federal intervention” substituting the provincial powers.⁵⁰
- **Brazil** enacted a Fiscal Responsibility Law (LRF) that strengthened fiscal institutions and established a deficit ceiling of 120 percent of current revenue at the national and state levels. If this ceiling is breached, the debt has to be brought back within the ceiling over the following 12 months, and no form of borrowing is permitted until that happens. There is also a “golden rule” provision, stating that net borrowing cannot exceed the volume of capital spending. Loans between the national, state, and municipal governments are outlawed.

⁴⁸ Bahl and Martinez-Vazquez. 2006. Sequencing Fiscal Decentralization. Policy Research Working Papers. World Bank.

⁴⁹ Canuto, Otaviano, and Lili Liu, Eds. 2013. Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets. Washington, DC: World Bank

⁵⁰ Colombia Decentralization: Options and Incentives for Efficiency, Report No. 39823-CO, World Bank 2009.

Ensuring efficient use of resources

To ensure the efficient use of resources, countries have improved monitoring and evaluation systems, enhance citizen engagement in the budget process, earmarked spending, increased transparency and enhanced coordination mechanisms

- **Colombia** adopted monitoring and evaluation systems and performance management strategies to communicate expectations and monitor improvements in service delivery. With subnational governments falling short of meeting national targets on key services, Colombia passed a law in 2007 (Acto Legislativo No. 04) authorizing the Executive to monitor, track and control the coverage and quality of key services managed by subnational governments. The central government was authorized to enforce preventive measures or take corrective action if transfers are not used according to pre-agreed requirements, or when the services financed by these transfers do not reach the expected beneficiaries. The Colombian government provides technical assistance and helps in developing performance plans (preventive measures); or could also suspend resource transfer and temporarily assume management of service delivery (corrective action).
- **Kenya's** 2010 Constitution laid the ground for a large-scale decentralization and the emphasis has been put on citizen engagement in the planning, budgeting and monitoring process of the budget cycle. It seeks to ensure that budget documents are publicly available, and that citizen's priorities are reflected in the annual plans and budget.⁵¹
- **Brazil** adopted a quasi-conditional devolution approach by earmarking some of the transfers for key development purposes⁵². Brazilian legislation requires subnational governments to spend a minimum of 25 percent of recurrent revenues on education and 12 percent on health. The fiscal responsibility law sets ceilings on personnel spending—inclusive of pensions and payments to subcontractors—at 50 percent of federal government spending and 60 percent of state and local government spending. If these limits are breached in any given four-month period, the lapse must be corrected within the following eight months. There are strict penalties, including prison terms, for public officials who violate the provisions of the LRF or engage in other prohibited fiscal actions, as legislated in the Fiscal Crimes Law. The law further requires the presentation of fiscal administration reports at four-month intervals, with a detailed account of budget execution and compliance with the LRF provisions.⁵³
- **OECD countries** have created or enhanced existing coordination mechanisms in an effort to ensure coherence across the different levels of government in policy implementation. Coordination across levels of government is being revisited particularly in OECD countries as decentralization becomes more complex with unclear or overlapping roles and responsibilities and gaps in information and policy implementation. For example, it was found that countries with a well-developed coordination arrangement better managed public investment challenges during the 2008 economic crisis. **Sweden** created the “regional coordinators” who liaised with the different levels of government on resource mobilization and strategies. **Australia** used its existing Council of Australian Governments which comprised of the prime minister, state officials and other key staff and provided a platform for decision making and prioritization of public investments and the stimulus packages.⁵⁴

⁵¹ World Bank. 2012. Devolution without Disruption: Pathways to a Successful New Kenya.

⁵² Brazil Issues in Fiscal Federalism. Report No 225-23-BR. World Bank report. 2002.

⁵³ Drawn from IADB, 2007.

⁵⁴ Charbit, C. (2011), “Governance of Public Policies in Decentralised Contexts: The Multi-level Approach”, OECD Regional Development Working Papers, 2011/04, OECD Publishing.

Building capacity for delivery

Concrete measures were taken by several countries to strengthen the capacity of subnational administrations

- **Indonesia** provided assistance to local governments to build capacities in financial management, human resource management and rule compliance.⁵⁵ The central government sent a cadre of central or state officers to guide and train local governments in planning, executing and monitoring of programs. It also helped build processes and systems to comply with rules and regulations⁵⁶. With the new 2014 Village Law, which strengthens the responsibilities of villages, increases fiscal transfers to the villages, and establishes a framework for community development, the central government will be deploying village facilitators and providing technical assistance.⁵⁷
- In **Colombia**, municipalities tasked to improve human resource capacity through innovative way of sharing and rotating professionals within their associations. For example, a small municipality, the Department of Cundinamarca splits the salary of a lawyer and shares his time with other members of its municipal association⁵⁸.
- **Uganda** has seen a substantial improvement in local government's public financial management capacity through greater engagement of local government in the national budgeting process. Local governments participate in national budget conferences and have received training on public financial management such as planning, budgeting and accounting, as well as the elaboration of medium term fiscal paths.
- **Argentina** introduced mechanisms for institutional strengthening in provinces by modernizing the tax collection budgeting systems.
- **Spain** adopted an asymmetric approach to decentralization by differentiating the pace and scope of autonomy of local governments based on their implementation capacity. As local governments did not have the same level of administrative and economic capacity to implement public services, the government differentiated the expenditure and revenue responsibilities.⁵⁹ Through asymmetric decentralization, local governments with higher levels of capacity can be left to fulfill their responsibilities with minimal capacity support from the central government, whereas those with weaker capacity may be allowed to move progressively with targeted greater technical assistance and training.

⁵⁵ The Indonesian government increase the amount of fiscal transfer to subnational governments from 2.7 percent of GDP in 2000 to 7.2 percent of GDP with the expectation that service delivery would improve. 90 percent of subnational expenditures are comprised of fiscal transfers.

⁵⁶ Decentralization that delivers: Improving Decentralization and Local Service Delivery in Indonesia. Program Concept Note Draft. 2015. World Bank.

⁵⁷ Indonesia Country Summary Brief. World Bank. http://siteresources.worldbank.org/EXTCDD/Resources/430160-1435154813801/Indonesia_Country_Brief.pdf

⁵⁸ Fiszbein, Ariel. 1997. The Emergence of Local Capacity: Lessons From Colombia. World Development, Vol. 25, No. 7, pp. 1029-1043

⁵⁹ World Bank. 2009. Colombia - Decentralization: Options and Incentives for Efficiency - Main Report.

Annex: Key Statistical Tables

Annex Table 1: Central Government Finances

(Percent of GDP)	2011-12	2012-13	2013-14	2014-15	2015-16 (BE)	2014-15 (Apr-Aug)	2015-16 (Apr-Aug)
Total Revenue	8.9	9.2	9.3	9.1	8.7	3.3	3.9
Net Tax Revenue	10.1	10.4	10.0	9.9	6.6	2.6	2.8
Gross Tax Revenue	13.0	13.3	12.8	12.6	10.3	3.7	4.2
Corporate Tax	3.7	3.6	3.5	3.4	3.3	0.6	0.6
Taxes on Income	1.9	2.0	2.1	2.1	2.3	0.6	0.6
Excise Tax	1.6	1.8	1.5	1.5	1.6	0.4	0.6
Service Tax	1.1	1.3	1.4	1.3	1.5	0.4	0.5
Customs Duties	1.7	1.7	1.5	1.5	1.5	0.6	0.6
Less: States' share	2.9	2.9	2.8	2.7	3.7	1.1	1.3
Non Tax Revenue 1/	1.4	1.4	1.8	1.6	1.6	0.7	0.4
Non-Debt Capital Receipts	0.4	0.4	0.4	0.3	1.7	0.03	0.05
Total Expenditure	14.8	14.1	13.7	13.1	12.6	5.4	5.2
Total expenditure and net lending	14.6	14.0	13.6	13.0	12.5	5.3	5.2
Current Expenditure	13.0	12.4	12.1	11.6	10.9	4.7	4.5
Interest Payments	3.1	3.1	3.3	3.2	3.2	1.2	1.2
Subsidies	2.5	2.6	2.2	2.1	1.7	..	..
<i>o/w Petroleum</i>	0.8	1.0	0.8	0.5	0.2	..	..
Capital Expenditure and net lending	1.6	1.5	1.5	1.4	1.6	0.6	0.6
Recovery of loans	0.2	0.2	0.1	0.1	0.1	0.03	0.03
Capital Spending	1.8	1.7	1.7	1.5	1.7	0.6	0.7
Gross Fiscal Deficit (Gol defn)	5.9	4.9	4.5	4.0	3.9	3.2	2.6
<i>Memo items</i>							
Disinvestment 1/	0.2	0.3	0.2	0.2	0.5	0.00	0.09
Gross Fiscal Deficit (WB defn)	6.0	5.2	4.7	4.2	4.4	3.2	2.7
Primary Deficit (Gol defn)	2.8	1.8	1.2	0.8	0.7	1.9	1.5
Primary Deficit (WB defn)	3.0	2.0	1.4	1.0	1.2	1.9	1.5

Source: Ministry of Finance

1/ Includes revenues from spectrum auctions

Annex Table 2: Development Indicators

Development Outcomes							
Indicator	2000	2005	2010	2011	2012	2013	2014
Demographics							
Population (millions)	1053.5	1144.3	1231.0	1247.4	1263.6	1279.5	1295.3
Poverty and Income Distribution							
Poverty \$1.9/day PPP, headcount ratio percent	..	..	..	21.3	..	..	..
Poverty \$3.10/day PPP, headcount ratio percent	..	..	..	21.9	..	..	..
National Poverty Estimates, headcount ratio percent	..	..	..	58.0	..	..	..
Gini Coefficient	..	..	..	..	..	..	..
Labour							
Labor force participation rate, total	58.6	60.4	54.8	..	53.4	..	..
Labor force participation rate, male	82.3	82.9	79.7	..	78.8	..	..
Labor force participation rate, female	34.1	37.3	29.0	..	27.2	..	..
Unemployment, total	4.3	4.4	3.5	..	3.6	..	..
Health							
Infant Mortality Rate (per '000 live births)	68.0	58.0	47.0	44.0	42.0	40.0	
Education							
Lower Secondary gross enrolment rate (%)		52.2	65.2	66.6	..	..
Senior Secondary gross enrolment rate (%)		28.5	39.4	45.9	..	..
Tertiary gross enrolment rate (%)		..	19.4	20.8	21.5	..	

Sources: WDI Databank, CEIC Database and World Bank Staff Estimates.

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