Review of fiscal deficit in India

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Abstract

This paper examines the review of India's fiscal policy with a focus on historical trends, fiscal discipline frameworks, fiscal response to the global financial crisis and subsequent return to a fiscal consolidation path. The initial years of India's planned development strategy were characterized by a conservative fiscal policy whereby deficits were kept under control. The tax system wasgeared to transfer resources from the private sector to fund the large public sector driven industrialization process and also cover social welfare schemes. However, growth was anemic and the system was prone to inefficiencies. In the 1980s some attempts were made to reform particular sectors. But the public debt increased, as did the fiscal deficit. India's balance of payments crisis of 1991led to economic liberalization. The reform of the tax system commenced. The fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legalizations were instituted. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and inflation prevailed. During the global financial crisis fiscal policy responded with counter-cyclical measures including tax cuts and increases in expenditures. The post-crisis recovery of the Indian economy is witnessing a correction of the fiscal policy path towards a regime of prudence. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

KEYWORDS- fiscal policy, fiscal deficit, primary deficit, Revenue deficit

Introduction

The relationship between budget deficit/fiscal deficit, money growth, government expenditure and inflation has acquired a prominent place in literature on monetary economics. From a theoretical perspective, both the monetarist hypotheses, based originally on the quantitative theory of money, and the fiscal theory of the price level, known as the quantitative theory of government financing of debt, represent the two traditional approaches to understanding what links these macroeconomic variables.

High levels of fiscal deficit relative to GDP tend not only to cause sharp increases in the debt-GD Pratio, but also adversely affect savings and investment, and consequently growth. The usability of fiscal policy as a tool of countercyclical intervention is also compromised when fiscal deficit is high and structural in nature. This paper examines the long term profile of fiscal deficits in India, its impact on growth that arises from its impact on savings and investment, which may occur directly or through its effects on interest rates and inflation. It also looks at relevant considerations for determining levels of debt and deficit relative to GDPat which these should be stability in India, given the current configuration of key determinants like the revenue to GDP ratio and public and private saving rates consistent with the objective of achieving higher growth.

Definition of 'Fiscal Deficit'

When a government's total expenditures exceed the revenue that it generates (excluding money from borrowings). Deficit differs from debt, which is an accumulation of yearly deficits.

A fiscal deficit is regarded by some as a positive economic event. For example, economist John Maynard Keynes believed that deficits help countries climb out of economic recession. On the other hand, fiscal conservatives feel that governments should avoid deficits in favor of a balanced budget policy.

Revenue Deficit:-

Revenue deficit refers to the excess of revenue expenditure of the government over its revenue receipts.

Revenue deficit = Total revenue expenditure – Total revenue receipts.

Importance: - Since it is largely related with the recurring expenditure. Therefore, high revenue deficit gives a warning to the government either to cut expenditure or to increase revenue receipts. It also implies requirement burden in future.

Fiscal Deficit:-

Fiscal deficit is defined as excess of total expenditure over total receipts excluding borrowings.

Fiscal Deficit = Total budget expenditure - Total budget receipts net of borrowings.

Importance: - Fiscal deficit is a measure of total borrowings required by the government. Greater fiscal deficit implies, greater borrowings by the government. This creates a large burden of interest payments in the future that leads to increase in revenue expenditure, causing an increase in revenue deficit. Thus a vicious circle sets in. In the present, a large fiscal deficit may also lead to inflationary pressures.

Primary Deficit:-

Primary deficit is defined as fiscal deficit minus interest payment. It is equal to fiscal deficit reduced by interest payment.

Primary deficit = Fiscal deficit – interest payment.

Importance: - Primary deficit signifies borrowing requirements of the government. A low or zero primary deficit means that while government's interest requirement on earlier loans have compelled the government to borrow but it is aware of the need to tighten its belt.

Fiscal deficit in India 2013-14

The fiscal deficit in India for 2013-14 fiscal may finally turn out to be 4.5 per cent of GDP, a shade lower than what was estimated by Finance Minister P. Chidambaram.

The revenue deficit too would be lower at 3.2 per cent of GDP for 2013-14, as per the revised estimates to be tabled in Parliament at the time of presentation of final Budget for 2014-15 in July.

The fiscal deficit figure have come in lower from 4.6 per cent or in actual terms Rs 5.24 lakh crore. The revenue deficit as was given in revised estimates in the interim Budget was 3.3 per cent or Rs 3.70 lakh crore.

According to official sources, the final data shows that the development expenditure of the government has been higher by Rs 16,000 crore in 2013-14.

The fiscal deficit, which is the gap between expenditure and revenue, was 4.9 per cent of GDP in 2012-13.

Chidambaram had earlier drawn up a red line for fiscal deficit and planned to contain it at 4.8 per cent of the GDP in 2013-14.

As per current indications, the fiscal deficit has come down mainly on account of expenditure compression and higher realization from the 2G spectrum auction.

As per the fiscal consolidation roadmap, the deficit is to be reduced further to 4.2 per cent in 2014-15 and 3.6 per cent in 2015-16.

The interim Budget for 2014 has projected the fiscal deficit for 2014-15 fiscal at 4.1 per cent of GDP or Rs 5.29 lakh crore.

India's Rising fiscal deficit

India's second United Progressive Alliance Government, known as UPA-2, presented its first budget on July 6. The budget emphasized three areas for action: a) return to 8% to 9% economic growth per annum at the earliest possible time; b) more inclusive growth and c) an improved public service delivery system.

All three areas are, indeed, crucial to India's sustained economic development. First, after impressive average growth of close to India's potential growth of 9% per annum between 2003/04 and 2007/08, overall growth slowed down to less than 7% in 2008/09. It is projected to be at that level in 2009/10 as well.

Second, even during the period of rapid growth, the robust part of the growth has been largely confined to services and the industrial sectors. While contributing substantially to growth, they have not contributed the equivalent to employment. On the other hand, agriculture, which accounts for 60% of the labor force and close to 90% of the nation's poor, continues to grow randomly, depending on the weather.

Finally, India's development experience reveals that policy makers have not been particularly tardy in either allocating funds or coming out with programs (some of the programs are unexceptionable in scope and size) for social justice-oriented initiatives. But the poor outcomes, invariably, can be traced to poor delivery.

Predictably, the budget stepped up capital (investment) expenditure substantially. Also, there is a renewed thrust on infrastructure development through Public Private Partnerships. As expected, a higher allocation has been made for agriculture and various social programs. Some enabling steps have also been initiated through the rationalization of tax structure and policy.

Finally, there are hints at further reforms, including ensuring better delivery of services.

A heavy reliance is placed on enhanced government expenditure to put the economy back on course. The fiscal deficit, as percentage of GDP, is projected at 6.8% in 2009/10 compared to 6% in 2008/09 (against a target of 2.5%) and 2.7% in 2007/08.

These are the deficits of the central government. If the deficits of the state governments and other off-budget liabilities of the central government are added, the overall fiscal deficit comes to almost 11% of GDP.

A good part of the borrowing (70%) announced in the budget will be to meet the gap in the day-to-day expenditure of the government (referred to as revenue deficit in the Indian budget), which comprises interest payments, defense, salaries and pensions, subsidies and social programs. The balance is on account of the gap in investment expenditure.

The size as well as the quality of the fiscal deficit is, thus, unprecedented. The Fiscal Responsibility and Budget Management Act (FRBM), passed in the Indian Parliament with a lot of fanfare in 2004, which stipulated a fiscal deficit of 3% of GDP and zero revenue deficit by 2008/09, has been given a go by, even if temporarily.

Obviously there are concerns about what this fiscal deficit might do to the private sector business environment in India. If the deficit were financed through market borrowings that could crowd out private sector investment; if financed through money creation that could fuel inflation and, if financed through external borrowing that could upset the external sector balance.

Further, it is argued that, in an era when high fiscal deficits are a global phenomenon (the U.S. and U.K. fiscal deficits are in double digits and in the Euro zone it's between 6% and 8% of GDP), there is a difference. In developed countries, a fiscal deficit is cyclical in nature; in India it is also structural because of various subsidies. If the deficit is of the former type, it is likely to get corrected as the economy revives; if it is of the latter type, the fiscal deficit can remain high even after economic revival.

While the above concerns may well bear out, there is also a need for rethinking the role of fiscal policy in a country like India and, perhaps, other emerging economies.

In the first place, when the constraints to growth and employment generation are more from the supply side (arising out of structural rigidities) than the demand side, private sector investment may not be very responsive to policy variables. An active role by the government may be needed to bring in private sector investment.

Second, fiscal policy cannot be looked at independently of monetary policy; in a regime of low inflation, monetary policy can be accommodative, thereby minimizing the adverse effect of a fiscal deficit on interest rates in the economy.

Third, even if it comes to the crunch, there is enough of a cushion available by way of public sector disinvestment opportunities.

Finally, the difference between revenue deficit (considered to be the unproductive part of the government's borrowing) and deficit on the capital account (usually for creation of durable assets and, thus, productive) is outdated. Is government borrowing for human capital development through spending on primary education, primary health, R&D etc. -- so very important for inclusive growth, but currently a part of the revenue deficit -- unproductive?

A correct way would be to exclude such expenditure from revenue expenditure and consider those as part of capital expenditure, which will bring a return by way of intergenerational equity and tax smoothing.

Of course, the final test will be the trend in the debt to GDP ratio but research done by my student at IIMB (Sanjeev Kumar: A study on the design of Fiscal Responsibility and Budget Management Act, PGPPM dissertation, IIMB, 2008), and other scattered evidence from India, suggest that the arguments put forth above are not all jejune.

Then where is the catch? The catch is not in outlays but in outcomes. And to convert outlays into outcomes requires strong political will. It took the Government of India, for example, more than 55 years after independence to promulgate the Right to Information Act (RTI). This has made a tremendous difference to the functioning of the government.

Now, headed by NandanNilekani, a much respected business leader of the country, UPA-2 has started a major initiative to set up the Unique Identification Authority of India (UIAI) with a mandate to create an online database with identity and biometric details of Indian residents. The project, which is likely to be completed by 2010/11, will enable enrolment and verification of services across country.

The present government, after many years of fragile coalition governments in India, has come to enjoy political stability. This is, thus, the right time to forge ahead with initiatives that will help in increasingly narrowing the gap between outlays and outcomes.

In summary, economies like India, where structural rigidities, to varying degrees, act as barriers to entry for the private sector, fiscal policy has to play an expansionary role. The choice in such cases is not between public sector investment and private sector investment but between public sector investment and no investment. A higher fiscal deficit, then, need not result in unsustainable debt dynamics. The problem arises if outcomes are not commensurate with investments. And, that is what one needs to carefully monitor in the maiden budget of the UPA-2 government.

CONCLUSIONS

An important implication of this study is that while financing of deficit through the banking system from printing of new money and creating interest-bearing bonds decreases fiscal deficit, increasing government expenditure is the main cause of mounting fiscal deficit. This may be due to deficient and inefficient social programs as Tanzi (2000) reveals that in Latin American countries disequilibrium between public budget and budget deficit results from governments' wrong policies such as using borrowing in order to finance the deficit as found by Egeli (2000). It may be construed here that government's consumption expenditure is much more propelling force for fiscal deficit growth as compared to its investment-inducing expenditure programmes. Hence, an efficient priority sation of public spending is needed for fiscal consolidation. Increased accountability and transparency may control government expenditure and thereby fiscal deficit. Reduction in fiscal deficit may contain 'crowding out' and thus boost investment which concomitant with increase in productivity and production may help control inflation. Thus, in order to analyze this issue in depth one can go for empirical analysis in this direction for India. Besides, the present study can be extended by analyzing the impact of different components of government expenditure on fiscal deficit. This may give more insights about the problem.

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