FISCAL DEFICIT

# Who Will Belt the Cat?

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At a time when the economy is operating below its potential, there is always a growing pressure on public spending. In fact, when private investment is weak, the standard prescription is to raise public spending, and more particularly public investment.

It is all the more so in a country like ours where the public sector still plays an important role in critical sectors like coal, power, roads and railways. But a critical question is whether under these circumstances there should be a deviation from the road map for fiscal consolidation. The fiscal road map as indicated by the 2015 Union Budget was a target fiscal deficit of 3.5% for 2016-17 and 3% for 2017-18.

It is important to have a proper perspective on fiscal deficit. Persistent high fiscal deficits lead to a rise in the debt-GDP ratio, and interest payments pre-empt an increasing share of revenues, leaving less for productive expenditures. Let us look at the numbers.

As a percentage of the net tax revenue to the Centre, interest payments jumped from 38.9% in 2007-08 to 43.4% in 2008-09 and further to 46.7% in 2009-10. In Budget 2015-16, interest payments were projected to touch 49.6%. Part of the increase is due to the reduction in the revenue base consequent on the acceptance of the recommendations of the 14th Finance Commission.

It was after much debate and discussion that the Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2003. Under the Act, the mandated target was fixed at 3% of GDP for the central government. After the recommendations of the 12th Finance Commission, the state governments also came around to fix a target for fiscal deficit.

Thus, for all the states taken together, the target is another 3% of GDP. Which means that the overall fiscal deficit for the Centre and states taken together is at 6%. This is way above what the Maastricht Treaty had fixed for European countries. But this is justified here because of the much higher savings rate in India.

Both private business and government are deficit sectors. They drew on the surplus of the household sector. Household sectors' savings in financial assets are the transferable savings. The fiscal deficit of 6% is consistent with household savings in financial assets, which used to be 11% of GDP. In fact, this ratio has been falling and for 2013-14, it is estimated at 7.3%.

So, it must be understood that at a given point in time, the government's increased borrowings can reduce the resources available for other sectors. This will also have the effect of pushing up interest rates.

One standard argument asking for a relaxation of the fiscal deficit target rule is that such a relaxation is needed to allow for increased expenditure on social sectors and for investment. The art of budget-making lies in balancing expenditures and revenues with some constraint on borrowing for reasons listed earlier.

Not a running dog of capitalism

If there is no constraint on borrowing, budget-making will not be the arduous exercise it has become. There is, however, one additional issue in the coming fiscal. Any slippage from the fiscal path will not be because of an increase in capital expenditures or social sector spending. It will be because of the self-imposed burden of increasing the emoluments of government employees by ₹1 lakh crore.

This is a huge increase for which the rationale is not clear. It is nearly 2-3 times the total amount spent on the Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) scheme. Calculations show that the increased burden will be 0.65% of GDP. After allowing for the increase in tax revenue arising out of the enhanced emoluments, the net impact of the burden is estimated at 0.4% of GDP. This will be the slippage.

Some serious thinking is needed to modify the recommendations of the Pay Commission to spread the burden more evenly. In our efforts to contain fiscal deficit, subsidies and tax exemptions also need a relook.

There is some debate whether we should focus on fiscal deficit or revenue deficit or primary deficit. So far, we have been monitoring fiscal and revenue deficits. More recently, we have even introduced a new concept of effective revenue deficit.

While the concept is acceptable, there are problems in measurement. Even on primary account, the Centre had a deficit every year since 2008-09. Our record on fiscal prudence has been disappointing. It is a case of where the fiscal rule is more honoured in breach than in observance.

For sustained high growth, stability is critical. Macro-economic stability has three dimensions: price stability, fiscal consolidation and low current account deficit. We should not throw away lightly concerns on fiscal deficit.

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