What’s a Right Fiscal Deficit?

BUDGET 2019 Supplementing RBI stimulus measures from the fiscal side needs to be examined

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GDP growth fell to 6.8% in 2018-19, as per provisional Central Statistics Office (CSO) estimates. RBI, in its June 6 monetary policy review, has estimated GDP growth at 7% for 2019-20, lowering its earlier estimate of 7.2%. The growth in Q4 2018-19 was as low as 5.8%. There are broad-based indicators of a demand slowdown reflected in the index of industrial production (IIP) and purchasing managers’ index (PMI) data.

With a view to stimulating growth, there have been three consecutive cuts in the repo rate of 25 basis points each during this calendar year. But transmission of these cuts has been fractional. The possibility of supplementing these stimulus measures from the fiscal side need to be examined.

The recently released Controller General of Accounts (CGA) data for 2018-19 indicates that GoI has adhered to the fiscal target of 3.4% of GDP in line with the revised estimates. This was despite the fact that compared to the revised estimates, direct taxes fell short by □74,774 crore and indirect taxes by □93,198 crore.

Together, the shortfall in GoI’s net tax revenues amounted to 0.9% of GDP. Maintaining the fiscal deficit at 3.4% in 2018-19 required cutting GoI’s expenditures, or shifting these to public sector entities such as the Food Corporation of India (FCI), which undertook a substantial food subsidy burden away from the Budget.

While the need for stimulating growth is paramount, there is a limit to which fiscal deficit may be stretched. We have missed the Fiscal Responsibility and Budget Management Act (FRBMA) fiscal deficit target of 3% after 2007-08, when it was 2.6%. After that, in the next two years, it shot up to 6.1% and 6.6% respectively. The consequences were severe and lasted for more than five years.

The fiscal deficit target of 3% was determined keeping in mind relative levels of supply of investible resources and demand for these. The supply of resources consists of household sector’s net financial savings and net foreign capital inflows. The claims on these arise from the central and state governments, and the public and private corporate sectors. In fact, the broad fiscal deficit target for Centre and states together was 6%, as detailed in the report of the 12th Finance Commission.

Not Saving Enough

In the early 2000s, the household sector’s net financial savings were10-12 %. To this, if we add, about 2% of GDP as net foreign capital inflows, 12-14% became the investible surplus. If out of this, 6% was pre-empted by GoI’s borrowing, a margin of 6-8% was still available for the private corporate sector and the non-government public sector.

Since then, the household sector’s net financial savings have fallen to about 7%. Adding 2-2.5% as current account deficit (CAD) that becomes available as net capital inflows, total available investible surplus has shrunk to about 9.5%. If the Centre and states together pre-empt more than 6% of GDP for their borrowing, about 3.5% is left for the public sector and private corporate sector. At the moment, corporate demand for investment is weak. The moment this demand gathers momentum, interest rates will come under pressure.

Accumulated fiscal deficits translate into debt and interest payments. In 2018-19, GoI's interest payments amounted to 37.3% of revenue receipts. With a large part of revenue receipts preempted by interest payments, capital expenditures accounted for only 1.6% of GDP — less than half of the fiscal deficit of 3.4%. GoI's debt-GDP ratio is currently close to 47%, well above the amended FRBMA target of 40%.

The longer we delay limiting fiscal deficit to the prescribed target, the longer it will take to bring the debt-GDP ratio to the prescribed limit. The longer also will be the period when interest payments claim an unduly large portion of revenue receipts.

February's interim Budget had estimated a fiscal deficit of 3.4% for 2019-20. Next month's Budget will have to contend with pressures of underperformance of revenues in the base year, 2018-19, while also providing for the additional expenditures in line with the election promises made by the government.

Relative to the revised estimates for 2018-19, both direct and indirect taxes have underperformed, the shortfall in GoI's net tax revenues being 0.9% of GDP. The direct and indirect tax buoyancies for 2018-19 are estimated at only 1.1and 0.4 respectively, giving an overall buoyancy of 0.5. If the interim Budget estimates for tax revenues for 2019-20 are to be met, the required buoyancy is 2.8, a tall order. Realistic budgeting would require a lowering of tax revenues from the levels in the interim Budget.

On the expenditure side, however, the annual counterpart of the election manifesto and related commitments will have a bearing. The PM-Kisan Samman Nidhi (PM-KISAN), with the recent expansion of its scope is expected to cost □87,218 crore in 2019-20. GoI has been funding a good part of its expenditures through off-budget borrowing. The extra-budgetary resources constitute liability not shown in fiscal deficit but are reflected in government liabilities. That is why there is a growing gap between increment in liabilities and fiscal deficit.

Difficult Gap to Bridge

The prospects of revenues rising above the levels indicated in the interim Budget are bleak. Finance minister NirmalaSitharaman has a difficult task before her to contain fiscal deficit. There is no scope for including any large expenditure programmes beyond what the interim Budget had already included and the programmes announced after the election. Perhaps there could be some leeway, if the Jalan Committee recommends additional transfers from RBI.

All in all, the FM should try to keep the fiscal deficit close to 3.4% of GDP.

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