Fiscal Framework

02

CHAPTER

2.1 Introduction and Summary

Santayana once warned that those who ignore history are condemned to repeat it. For that reason, it's worth examining India's recent fiscal past, to see if there are lessons for the country's future fiscal trajectory. A look back at recent history is especially warranted now because India today is in a very similar situation to that in the early 2000s, with comparable fiscal deficit (4 percent of GDP) at a broadly similar state of the macroeconomic cycle. Today, like then, inflation is close to 5 percent. Today, like then, the current account deficit is manageably low. And, today, like then, the economy is poised to attain a faster growth trajectory.

So, it is worth asking: What are the lessons from recent fiscal performance in India? How should they inform fiscal policy in this year's budget and for the medium term? This chapter attempts to answer these questions. The major conclusions are:

First, in the medium term, India must meet its medium-term fiscal deficit target of 3 percent of GDP. This will provide the fiscal space to insure against future shocks and also to move closer to the fiscal performance of its emerging market peers. It must also reverse the trajectory of recent years and move towards the golden rule of eliminating the revenue deficit and ensuring that, over the cycle, borrowing is only for capital formation.

Second, the way to achieve these targets will be expenditure control, and expenditure switching from consumption to investment. The loss of expenditure control and hence fiscal space contributed to the near-crisis of 2013. From 2016-17, as growth gathers steam and as the GST is implemented, the consequential tax buoyancy when combined with expenditure control will ensure that medium term targets can be comfortably met. This buoyancy is assured by history because over the course of the growth surge over the last decade, the overall tax-GDP ratio increased by about 2-2.5 percentage points with some but not radical increases in the tax rate and base.

Third, in the upcoming year, the pressures for accelerated fiscal consolidation have been lessened because macro-economic pressures have significantly abated with the dramatic decline in inflation and turnaround in the current account deficit. In these circumstances, especially if the economy is recovering rather than surging, pro-cyclical policy will be less than optimal.

Moreover, growth will ensure favourable debt dynamics going forward which alleviates consolidation compulsions emanating from concerns about public sector indebtedness. Further, accelerated fiscal consolidation will also be limited in the upcoming fiscal year by a number of new and exceptional factors, such as implementing the recommendations of the Fourteenth Finance Commission, clearing the compensation obligations to the states for the reduction in the central sales tax in 2007-08 and 2008-09, and the need to modestly ramp-up investment.

Finally, nevertheless, to ensure fiscal credibility and consistency with the medium-term goals, the upcoming budget should initiate the process of expenditure control to reduce both the fiscal and revenue deficits. At the same time, the quality of expenditure needs to be shifted from consumption, by reducing subsidies, towards investment. Increases in the tax-GDP ratio stemming from the taxation of petroleum products will also help achieve short and medium term fiscal goals.

2.2 Background and History Lessons

India's macroeconomic improvement has been nothing short of dramatic—inflation has been cut in half to about 5 percent today, underlying rural wage growth has declined from over 20 percent to below 5 percent, and the current account deficit has shrivelled from over 6.7 percent of GDP (in Q 3, 2012-13) to an estimated 1.0 percent in the coming fiscal year.

That said, there is hardly room for fiscal complacency. To understand why, to realize where India needs to go, it is important to understand where it has been, and to draw lessons from this experience. The similarity between India's situation today and in the early 2000s makes this exercise especially important.

Key fiscal indicators for the central government are summarized in Table 2.1. At least three phases of policy can be distinguished since the early 2000s: 2002-2007; 2008-2011; and post-2012 (Figures 2.1-2.3 describe these phases in terms of the overall flow aggregates (Figure 2.1), debt stocks (Figure 2.2), and quality of expenditure (Figure 2.3).

In the first phase, all key measures of fiscal performance improved dramatically, driven largely by rapid growth. The fiscal deficit of the central government declined by nearly 3.2 percentage points, accounted for largely by an increase in the tax-GDP ratio (3.4 percentage points) along with a decline in other non-debt receipts (1.4 percentage points) and the rest by expenditure reductions (1.2 percentage points). Growth drove the increase in tax-GDP ratio but there was some expansion in the indirect tax base and increases in rates relating to the service tax (Figure 2.1). This tax was levied on 52 services at a rate of 5 per cent, yielding ₹ 4122 crore in 2002-03 but was expanded to 98 services at the rate of 12 per cent, resulting in revenues of ₹ 51301 crore in 2007-08.

On the stock side, debt declined because of a strong improvement in the "debt-dynamic wedge", defined as the difference between the real rate of economic growth (g) on the one hand, and the real cost of borrowing (r, which is itself the difference between the interest on government securities and inflation as per the GDP deflator) and the primary deficit (pd) on the other.[1] (Figure 2.2).

This wedge increased by about 9 percentage points in this period, resulting in a decline in the debt-GDP ratio of 8 percentage points. It is important to note that growth was the primary driver of this improving wedge, directly (by increasing g) and indirectly via improving the primary balance.

Two noteworthy conclusions can be drawn from this period. First, nearly all the improvement in the fiscal indicators stemmed from rapid growth, which averaged about 8 percent in this phase. Second, and one with important lessons for the future, was the ratcheting up of overall expenditures. Until 2005-06, the expenditure to GDP ratio declined in line with rising growth but in the following two years, it increased—at a time when growth averaged 9.5 percent. In other words, real expenditures grew at a staggering 10 percent.

Rapid expenditure growth over 2005-06 to 2007-08 did not stem from any increase in the subsidy burden. Rather, it largely reflected higher growth in interest payments (13.2 percent average annual growth) and an increase in non-plan grants recommended by the Twelfth Finance Commission for state-level fiscal reforms. Unavoidable though some of these expenditures may have been, the consequence was to limit the favourable fiscal impact of rapid growth.

[1] (Roughly, if g-r-pd = 0, the debt-GDP ratio remains stable)

Table 2.1: Select Fiscal Indicators (as per cent of GDP)

	Particulars	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
1	Real GDP growth [g] (in per cent)	3.9	8	7.1	9.5	9.6	9.3	6.7	8.6	8.9	6.7	4.5	4.7^	5.9
2	CPI Inflation # (in per cent)	5	4.1	4	3.7	6.8	5.9	9.2	10.6	9.5	9.5	10.2	9.5	7.2
3	Inflation from GDP Deflator (in per cent)	3.7	3.9	5.7	4.2	6.4	5.8	8.7	6.1	9.0	8.5	7.2	6.9	
4	GDP at market price in ₹ lakh crore	25.3	28.4	32.4	36.9	42.9	49.9	56.3	64.8	78.0	90.1	101.1	113.6	128.8
		Central Government												
5	Total Revenue ## (before devolution)	12.8	14.6	13.9	12.3	13.1	14.8	12.6	11.9	13.4	11.6	12.0	12.2	12.8
6	Gross Tax Revenue	8.5	9.0	9.4	9.9	11.0	11.9	10.8	9.6	10.2	9.9	10.2	10.2	10.6
7	Total Expenditure (including tax devolution)	18.5	18.9	17.8	16.2	16.4	17.3	18.5	18.4	18.2	17.3	16.8	16.8	16.9
	Major Subsidies	1.6	1.5	1.4	1.2	1.2	1.3	2.2	2.1	2.1	2.3	2.4	2.2	1.9
	Food	1	0.9	0.8	0.6	0.6	0.6	0.8	0.9	0.8	0.8	0.8	0.8	0.9
	Fertilizer	0.4	0.4	0.5	0.5	0.6	0.7	1.4	0.9	0.8	0.8	0.6	0.6	0.6
	Petroleum	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.5	0.8	1.0	0.8	0.5
	Tax devolution to States	2.2	2.3	2.4	2.6	2.8	3.0	2.8	2.5	2.8	2.8	2.9	2.8	3.0
	Revenue Expenditure	13.4	12.8	11.9	11.9	12.0	11.9	14.1	14.1	13.4	12.7	12.3	12.3	12.2
	Capital Expenditure	2.9	3.8	3.5	1.8	1.6	2.4	1.6	1.7	2.0	1.8	1.6	1.7	1.8
	Non-Defence	2.4	3.3	2.5	0.9	0.8	1.6	0.9	1.0	1.2	1.0	1.0	1.0	1.0
8	Fiscal deficit	5.7	4.3	3.9	4	3.3	2.5	6	6.5	4.8	5.7	4.8	4.6	4.1
9	Revenue Deficit	4.3	3.5	2.4	2.5	1.9	1.1	4.5	5.2	3.2	4.4	3.6	3.3	2.9
10	Primary Deficit [pd]	1.1	0	0	0.4	-0.2	-0.9	2.6	3.2	1.8	2.7	1.8	1.3	0.8
11	Total outstanding liabilities	66.9	66	65.5	63.9	61.4	58.9	58.6	56.3	52.1	51.7	51.7	50.9	49.8
12	Average cost of borrowing [n] (in per cent)	7.5	7.3	7.2	7	7.3	7.6	7.6	7.5	7.4	7.8	7.7	8.3	--
13	Average cost of borrowing [r] (in per cent)	3.8	3.4	1.5	2.8	0.9	1.8	-1.1	1.4	-1.6	-0.7	0.5	1.4	--
14	Debt Dynamic Wedge [g-r-pd]	-1.0	4.6	5.6	6.3	8.9	8.4	5.2	4.0	8.7	4.7	2.2	2.0	--

^: Provisional **n=nominal** **r= real**

 # Back series from the Urjit Patel Committee Report, RBI. CPI Data for 2014-15 is up to November, 2014.

Total revenue consists of GTR, non-tax revenue, recovery of loans and other receipts.

Note: **1. Data for 2013-14 and 2014-15 for central government is revised estimates and budget estimates respectively.**

2. Total outstanding liabilities are derived by adding 'other liabilities' (that includes national small savings fund, state provident funds and other accounts) to the government's public debt. External liabilities of the Centre is at current exchange rate.

3. Data on GDP at current market prices and GDP growth numbers at factor cost are from CSO's National Accounts series of 2004-05.

4. The exact formula for the Debt Dynamic Wedge is: $\triangle d_{(t+1)} = p_{(t+1)} + [(r_t - g_t)/(1+g_t)]\ d_t$ **where** p_t **is the primary deficit as per cent of GDP,;** r_t **is the real rate of interest;** g_t **is the real growth rate;** d_t **is debt to GDP ratio**

Source: **Budget documents and MoSPI.**

Figure 2.1: Fiscal Flow Indicators, 2002-03 to 2014-15 (Per cent of GDP)

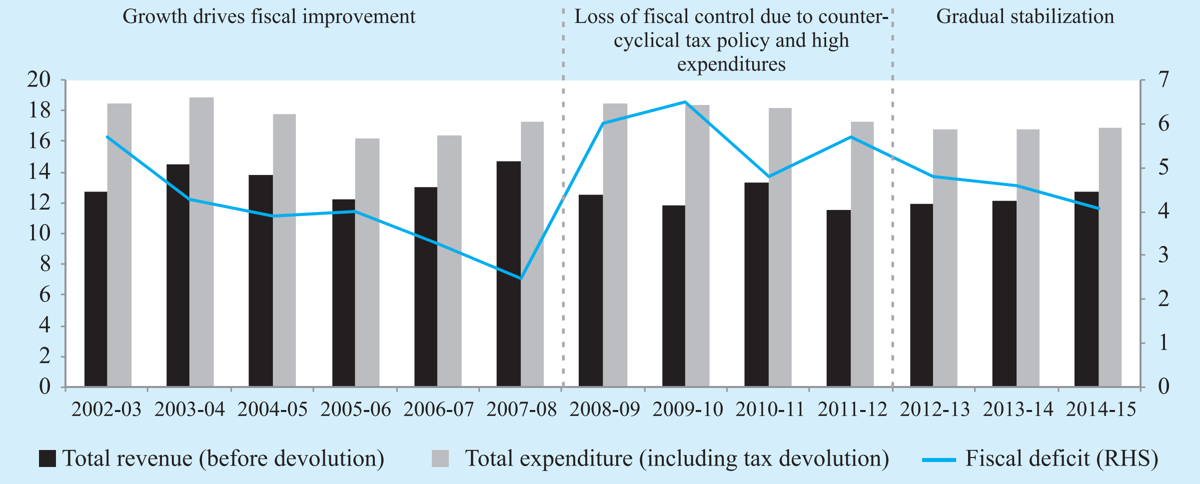
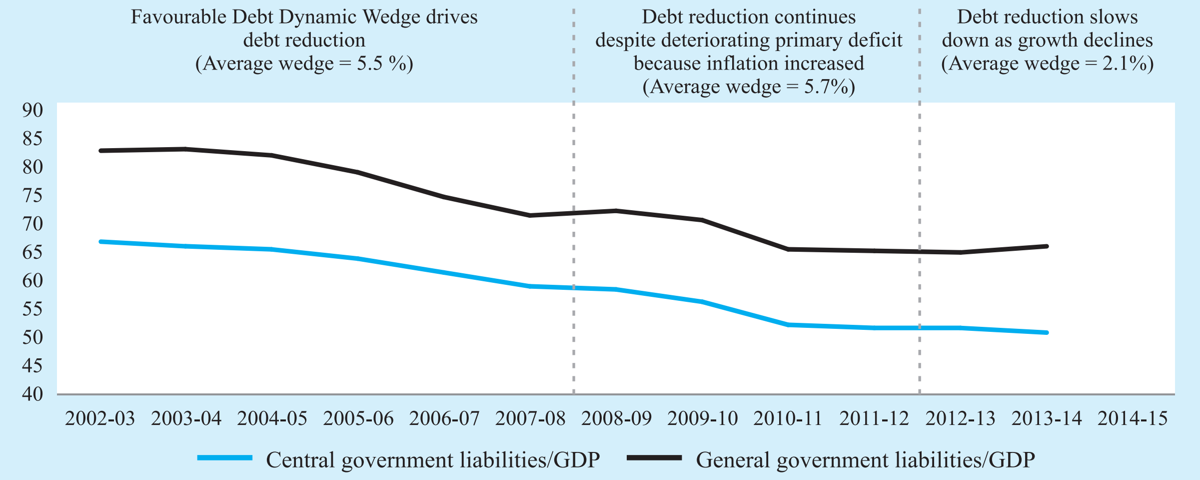
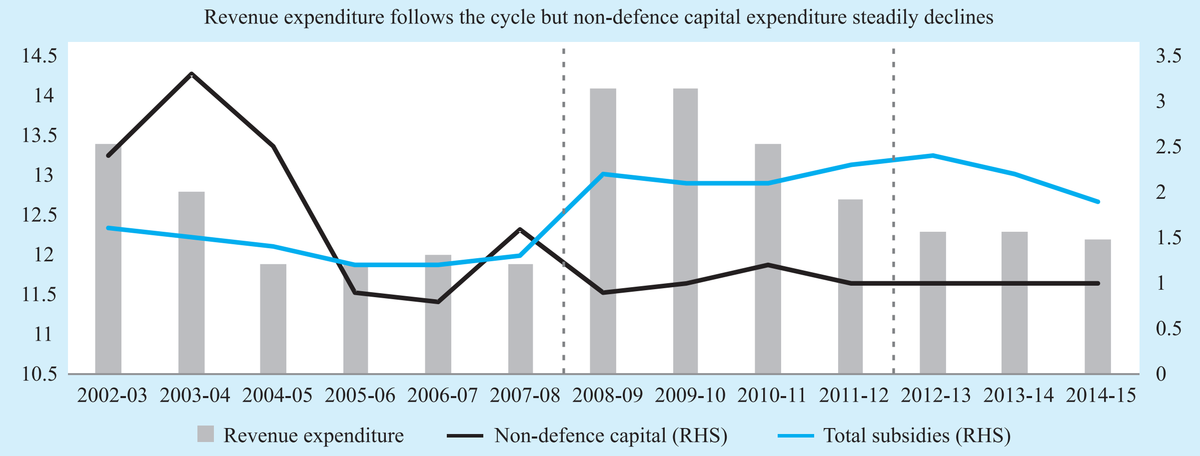


Figure 2.2: Fiscal Stock Indicators, 2002-03 to 2014-15 (Per cent of GDP)



Numbers for the year 2013-14 and 2014-15 for Central government are revised estimates and budget estimates respectively. For General government, numbers for the year 2012-13 and 2013-14 are revised estimates and budget estimates, respectively.

Figure 2.3: Expenditure Quality Indicators, 2002-03 to 2014-15 (Per cent of GDP)



***Source*: Budget documents and CSO.**

The second and difficult phase of Indian fiscal history began with the Lehman crisis in 2008-09 and lasted four years. In this period nearly all the positive trends of the previous six years were reversed. The fiscal deficit increased by about 4 percentage points, shared equally between revenue reductions (owing to large indirect tax cuts) and expenditure increases. In the initial years (2008-09 to 2011-12), current expenditures (public consumption) increased dramatically due to the rising subsidy bill (up by 1 percentage point of GDP); the increase in pay and allowances because of implementation of the Sixth Pay Commission recommendations (0.4 percent of GDP); and schemes that built in permanent entitlements such as MGNREGA (0.3 percent of GDP). Meanwhile, the quality of spending suffered as non-defence capital expenditure stagnated while current expenditures rose by about 2 percentage points on average during the period (Figure 2.3).

Despite the deterioration in the deficit, government debt continued to decline. The basic debt dynamic wedge became less favourable initially because of the increase in the primary deficit but was subsequently shored up by high growth, and rising inflation and the associated financial repression which lowered the real cost of borrowing for the government.

In the third and most recent phase, from 2012-13 to 2014-15, which was characterized by a sharp growth slowdown, the fiscal position finally began to be repaired. The fiscal stimulus provided in the post-Lehman phase was unwound, with equal contributions from revenue increases and expenditure reductions, bringing the deficit close to the level prevailing in the early 2000s, at a comparable stage of the business cycle.

Even so, developments in other key indicators have been less encouraging. During this phase, the debt-GDP ratio stopped declining on account of slowing growth and still-high deficits, which rendered the debt dynamic wedge less favourable. Moreover, non-defence public capital expenditures remained exceptionally low, significantly below the level recorded in the early 2000s. Most significantly, India experienced a near-crisis during July/August 2013, as the conjunction of the U.S. Federal Reserve's decision to taper its monetary stimulus and India's growing current account deficit, high inflation, and still-large fiscal deficits caused capital to flee the country. This episode underscored the final and most critical lesson, namely that India needs to create additional fiscal space, in order to ensure macro stability and to create buffers for economic downturns in the future.

2.3 Medium-term Strategy

To create this fiscal space, a medium-term fiscal strategy needs to be put in place, based on fundamental principles, as well as on legacy and credibility issues. In India's case, both of these considerations point in the same direction.

2.3.1 Investment and the golden rule

The case for increased public investment has been made earlier in this Survey. What are the medium term implications? The *golden rule* of fiscal policy is that governments are expected to borrow *over the cycle* only to finance investment and not to fund current expenditures. This implies that achievement of the government's fiscal consolidation should ideally take place over the business cycle and short-term targets should be set accordingly.

In the first phase of recent fiscal history, India did move toward the golden rule by narrowing revenue deficits. But the period from 2008-09 to 2012-13 saw a reversal. Looking ahead and beginning in this budget, the government should target steady declines in the revenue deficit to move closer to the golden rule. This would also assist the government to take the economy back to a durably higher growth path.

2.3.2 Legacy/credibility

Reinforcing these considerations are legacy issues. India's FRBM Act as well as the Kelkar Committee (2012) established the principle of aiming to bring the centre's fiscal deficit down to 3 percent of GDP. Adhering to this objective is essential for maintaining credibility and also to bring India closer in line with its emerging market peers. For example, the average general government deficit for India in 2013-14 is about 4.8 percentage points higher than the average for countries in India's investment grade rating[2]. States are a constant while governments come and go. In this regard, if every new government decided to change the rules of the game, volatility and uncertainty would be the rule and the overall credibility of the state and the country would suffer as a result.

Moreover, even if there were good reasons to change the rules of the game, there is a signalling problem. Fiscally responsible governments may not be able to credibly convey to the market early in their tenure that they are indeed fiscally responsible. In this situation, until they can establish a track record, governments will be required to adhere to previous commitments.

Accordingly, the medium-term fiscal strategy should be based on two pillars. First, the fiscal deficit should be reduced over the medium-term to the established target of 3 percent of GDP. Second, and mindful of the experience of the past decade, efforts to achieve this objective should be based on firm control over expenditures, most notably by eliminating leakages in subsidies and social expenditures.

Further, switching from public consumption (via the rationalisation of subsidies) to public investment will, for any given level of overall spending, mitigate long-run inflationary pressures because the latter will add to capacity and boost the aggregate supply potential of the economy. Also, asset sales to finance investment is consistent with boosting growth without adding to aggregate demand pressures in the short run.

If expenditure control is maintained, revenue increases will flow straight through to the flow and stock fiscal aggregates. This effect should be large, since accelerating growth and the introduction of the GST in 2016-17 could raise India's tax-GDP ratio from the current level of 17.5 percent to close to 20 percent for the general government. Moreover, debt dynamics will then work strongly in India's favour. Simple calculations suggest that if growth averages 9 percent over the next three years, and real interest rates remain broadly where they are, overall debt-to-GDP ratios (more precisely, the ratio of total outstanding liabilities[3] to GDP) for the central government could decline to around 40 percent in 2017-18 from the current level of 49.8 percent and would be associated with a similar decline in the general government debt. This would create the buffers to insure against future downturns.

2.4 Short-term issues

Against this medium-term background, what should be the stance of fiscal policy in the short term? A number of perspectives help shape this answer, including cyclical considerations and one-off factors.

1. Cyclical considerations

In the short-run, fiscal policy serves as a cushion, stabilizing demand and growth. A generally accepted rule is that from a demand management perspective governments should not run a pro-cyclical fiscal policy unless there are compelling factors such as macro-economic overheating. Put differently, if short run growth is below potential growth or the actual level of output is below potential output, actual fiscal deficits can increase without reflecting any weakening of fiscal discipline.

As discussed earlier, macro-economic pressures have abated significantly. And, notwithstanding the new GDP growth estimates, the Indian economy appears to be reviving rather than surging. Both these factors weaken the case for pro-cyclical policy.

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2 In the Fitch ratings, for example, India is in the BBB (investment grade) category.

3 Total outstanding liabilities are derived by adding 'other liabilities' (that includes national small savings fund, state provident funds and other accounts) to the central government's public debt.

2. One-off/new factors

The budget for 2015-16 will be confronted by a number of one-off factors. One one-off factor/ windfall that favours further consolidation stems from the windfall reduction in prices that will reduce the subsidy burden by about 0.2-0.3 percent of GDP. However, there are three countervailing factors.

- The Fourteenth Finance Commission has just submitted its recommendations on the transfer of resources to the states. It is possible that implementing them will entail the centre having to pay an additional cost.
- Negotiations on the GST had been stalled on account of a trust deficit between the centre and states which had arisen because the centre had not compensated the states for the reduction of the CST (Central Sales Tax) from 4 percent to 2 percent in the aftermath of the global financial crisis. Securing political agreement to launch the GST in 2016/17 was facilitated by the offer of the government to compensate the states for the backlog of CST compensation of up to 25,000 crores.
- As discussed in Chapter 4 of this Volume, there is a pressing need to increase public investment to revive private investment and growth.

2.5 Conclusions

Macro-economic circumstances have improved dramatically in India. Macro-economic pressures have abated and as per the latest estimates for the GDP (2014-15), the GDP growth has exceeded that in most countries including China. Provided that fiscal discipline is maintained, India's debt dynamics will consequently remain exceptionally favourable going forward.

At the same time, India's fiscal situation is close to that about ten years ago at a comparable stage of the cycle. In other words, the stimulus provided in the last few years has mostly been withdrawn. All of these factors suggest that in the short-run, the pressures for sharp further fiscal consolidation have lifted to some extent.

But there is no ground for complacency. The loss in fiscal discipline led to the near-crisis in 2013 and on pure fiscal measures, India does not rank as favourably as its investment grade peers. Even allowing for the fact that a narrow focus on fiscal measures does not capture the full range of factors that go into serious investors' risk-reward calculation when allocating portfolios across countries, India must meet its medium-term target of fiscal deficit of 3 percent of GDP. India must also reverse the trajectory of recent years and move toward the golden rule of eliminating revenue deficits and ensuring that, over the cycle, borrowing is only for capital formation.

In this light, the lessons of recent fiscal history are clear.

For India, the key to achieving medium-term fiscal targets resides in expenditure control, the failure to do so during the boom growth years between 2005-06 and 2008-09, playing a major role in the loss of macro-economic control and the near-crisis of July/August 2013.

Another cost of the failure to maintain expenditure, and hence fiscal control was the quality of spending, with public investment being the casualty and public consumption the beneficiary. This, in turn, has affected India's medium-term growth potential.

These trends need to be reversed, and the nation's public finances need to be set back on the path toward fiscal deficit of 3 percent of GDP, as planned in FRBM (Amendment) Act 2012. To do this, concrete actions will be needed in this budget to control expenditure via subsidy reductions, improve its quality in altering the mix between public consumption and investment in favour of the latter, and move India toward the golden rule of borrowing only for public investment. Broadly, the increase in fiscal space, including that gained from subsidy reductions and higher disinvestment proceeds should be devoted to public investment.

Even with these measures, progress toward the medium-term target may be limited in the upcoming fiscal year by a number of new and exceptional factors, such as implementing the recommendations of the Fourteenth Finance Commission, clearing the compensation obligations to the states for the reduction in the central sales tax, and the need to modestly ramp-up investment.

Subsequently, with current expenditures on a downward path and the quality of spending improving through a switch away from public consumption to investment, India's growth, introduction of the GST, and the associated revenue buoyancy can comfortably ensure the attainment of medium-term targets. This buoyancy is assured by history because over the course of the growth surge over the last decade, the overall tax-GDP ratio increased by about 2-2.5 percentage points even without radical tax reform.