Balancing act on fiscal deficit

PUBLIC INTEREST

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I normally comment on Budget numbers when they are published. However, this year many commentators assert that the fiscal deficit target (3.2 per cent of gross domestic product, or GDP) will be missed and laud this as a good thing. This attitude is a legacy of the past, when private players expected to make profits without taking risks in a difficult economic environment, and sought to transfer this risk to government finances. This attitude cannot serve the government of a G20 country, however attractive the economic bailout may seem to private players. Historic pandering to these voices has meant that government fiscal pronouncements have low credibility. This government's commitment to meeting fiscal deficit targets has been a notable exception.

We have now numbers for government revenues and expenditures from April to November, 2017. I compare these with the numbers for April to November 2016. As of December 1, 2017, the fiscal deficit was 3.63 per cent of GDP, 0.6 per cent higher than in the previous year. Was this because of the goods and services tax (GST)? I found that this was not so. Indirect tax revenues declined by 0.02 per cent of GDP. Direct tax revenues are 4.15 per cent, marginally higher than the 4.12 per cent of GDP that was collected during April to November 2016-17. Thus, even if the GST correction has been low, this has been compensated for by other tax collections. If this continues, then the GST cannot be an excuse for fiscal slippage.

The problem is with non-tax revenues which are 0.53 per cent of GDP lower than in the same period of 2016. Contrary to the grandiose claims made last year by many commentators, (and, of the record, by some in the government), there has been no direct fiscal gain from demonetisation through an increase in the Reserve Bank of India (RBI) surpluses. Rather, the RBI dividend to the government has fallen (by 0.25 per cent of GDP). The RBI attributes this to demonetisation though it is difficult to see why this fiscal cost should be transferred to government books given its one off nature, and the fact that the RBI was in concurrence with the decision to demonetise. Surely, the RBI's huge reserve exists precisely to absorb such shocks.

Revenue expenditure is marginally higher by 0.1 per cent of GDP and capital expenditure by 0.15 per cent of GDP. In my view, this reflects better distribution of expenditure across the fiscal year. Given this, it should be possible to reduce this gap in the last quarter such that expenditure out-turns are as budgeted. There is very little "counter cyclical" return from accelerating public expenditure in the final quarter. There are also areas like railway and defence where a hard forensic look at unspent balances and shortfalls could yield results. This is also true of committed expenditure on centrally sponsored schemes; there are considerable unspent balances which have been released from treasury but not spent. The new public financial management system can be used to ensure that these balances are utilised before fresh releases are made.

Expenditure control apart, we are left with a revenue gap caused by a fall in non-tax revenue. This could be closed by the RBI taking a fresh look at its dividend policy in light of the exceptional circumstance of demonetisation, and a modest increase in public sector dividends. Both difficult to do, but feasible.

So in my personal view, adhering to the fiscal deficit target is a difficult task this year. But it is possible, if collective efforts are made by all stakeholders. Any pleading that the deficit is the result of structural reforms will not wash; this will only mean that the government poorly planned and executed its reforms and its fiscal management, given that the reforms were well on their way when the commitment to a 3.2 per cent fiscal deficit was announced.

This is of the highest importance, given that the commitment to fiscal responsibility, broken so often by so many governments past, is a hallmark of the current administration. We will see on February 1 whether courage and commitment prevail over the weak excuses that typically follow the myriad occasions when the government breaks a public commitment. In the case of the fiscal deficit, this will be particularly unfortunate, given the admirable efforts made by this administration to stick to fiscal consolidation since 2014.

There is also a structural concern that this years' pre-Budget drama reveals. The growth and buoyancy of direct tax revenue in the 2014-2017 period is lower than in any sub-period this millennium. Tax revenues have been kept buoyant by good indirect tax collections. Since 2008, the buoyancy of direct taxes has been less than 0.9. This has added to the fragility of fiscal policy. If direct tax revenue growth in the period of recovery from crisis had been anywhere close to that experienced in the 1998-2008 period, weathering a revenue shock of 0.25-0.5 per cent of GDP would have been accomplished with much less fallout. The government's ability to protect expenditure priorities would also have been buffered. It is essential that direct tax reforms be designed and implemented much faster and more efficiently than has been the case to date, to reduce this fiscal fragility. A 1-2 per cent increase in the tax GDP ratio would give the government much less reason to scramble to keep its commitments. And to resort to lame excuses, when its best laid plans go wrong because of poor administrative execution, as they have done, and continue to do, in a quite remarkably bipartisan way.

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