Govt's shrinking fiscal space

FLUCTUATING NUMBERS	2014-15	2015-16	2016-17	2017-18	2018-19 R	2019-20 B
Total expenditure (% GDP)	13.34	13.01	12.95	12.77	13.04	13.25
Fiscal deficit (% GDP)	4.10	3.90	3.50	3.50	3.40	3.40
Revenue deficit (% GDP)	2.90	2.50	2.10	2.60	2.20	2.20
Revenue/fiscal deficit	0.71	0.64	0.60	0.74	0.65	0.65
Committed expenditure*/total expenditure		0.62	0.65	0.68	0.68	0.66
State's share of GTR	27.14	34.77	35.43	35.07	33.87	33.09
Revenue receipts/GDP	8.83	8.68	9.01	8.56	9.18	9.41
Disinvestment/total revenue receipts	3.43	3.53	3.47	6.97	4.63	4.55
Tax-GDP ratio	7.25	6.86	7.22	7.41	7.88	8.12

* Expenditure on Establishment, GST Cess, Statutory and Finance Commission Transfers

Election year should be a time when we seriously reflect on the medium-term structure of fiscal policy. But election year also involves an interim Budget which, by definition, should not take up much analytical space. But unfortunately, it does, distracting attention from medium-term fiscal issues.

There are four important medium-term trends in central government finances that are of economic interest.

The central government is shrinking: Central government expenditure has been falling continuously as per cent of GDP. Fiscal consolidation is largely due to this shrinking — 76 per cent of the fall in fiscal deficit since 2014-15 is directly because of expenditure compression. Since fiscal consolidation has been secured through expenditure compression, the Centre is fiscally constrained.

Two-thirds of borrowing is for recurrent (revenue) expenditure: This administration has done well to keep the revenue deficit under control. However, the hard fact is that even as total expenditure is shrinking, the central government continues to use two-thirds of its borrowings for recurrent purposes. This means the central government is an insignificant player when it comes to direct financing of capital expenditure.

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Over half of central government expenditure is committed expenditure: As the table shows, committed expenditure, most of which is revenue expenditure, accounts for 60 to 65 per cent of total government spending.

The tax-to-GDP ratio continues to be low even as non-tax revenues and disinvestment receipts are volatile. This structural weakness causes poor revenue predictability and adds to structural weakness of the fisc.

Thus, the structural condition of central government finances is weak: public expenditure is shrinking, 65 per cent of borrowing is for recurrent expenditure, two-thirds of expenditure is non-discretionary in nature, and there is stagnation and volatility in revenue receipts. Government policy autonomy and transformational potential is thus structurally constrained. This depressing truth is obscured by analysts and, unfortunately, even economists and government officials, by turning the entire discussion about fiscal policy into an event management exercise centred on annual Budgets.

But frivolity will not resolve this serious structural challenge, which has at least two important political economy considerations.

The lack of an operational medium-term fiscal framework means that there is no capacity to understand, let alone address, these structural challenges. Therefore, fiscal decisions are piecemeal in nature, resulting in great volatility in the composition of revenue as well as expenditure. There is poor predictability of tax receipts; thus, this year there was a huge shortfall in GST collections and an overshoot on direct taxes. Disinvestment and non-tax revenues are volatile and ad-hoc from one year to the next. Allocations to major schemes fluctuate wildly year to year as a glance at allocations to major flagship schemes over the past five years will show.

Inevitably, such serious structural pressure on central government fiscal space causes actions by the Centre to reduce the fiscal space of states. Two examples: The Fourteenth Finance Commission mandated that the State's share in the divisible pool of taxes (GTR) should be 42 per cent of gross tax revenue. As the table shows, this has never been achieved, and the share has hovered around a third of GTR since 2015-16. Second, in 2016-17, central sector schemes and centrally sponsored schemes both accounted for 9 per cent of total central expenditure. In the 2019-20 Budget estimates, the share of central sector schemes has risen to 12 per cent, while the share of centrally sponsored schemes is the same (9 per cent). Thus, the federal compact is being broken on two fronts. States are getting less as their share of tax revenue, and less in terms of the share of centrally sponsored schemes.

Indian politics exacerbates this tendency to squeeze the states. National parties can aspire to control central, but not state finances, due to robust presence of regional parties in a majority of states. But central government is fiscally weak; unless structural constraints are addressed, the Centre can, at best, make infra-marginal changes to its fiscal policy. But national parties make grand promises and then, when in power, scramble to find even meagre additional resources. This causes both volatility in structural spending and fiscal competition with the states.

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