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Some medium-term fiscal arithmetic

A medium-term macro-fiscal exercise will make clear the analytical choices and trade-offs that the government faces

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There is little doubt that the central government is constrained for fiscal space and it is, therefore, important to think about solutions going forward. I offer a medium-term macro-fiscal exercise that makes clear the analytical choices and trade-offs that government faces. I hope that this will demonstrate the value of a medium-term approach to budgeting, and the pressing need to shift to an operational medium-term fiscal framework (MTFF), which is how budgeting is now done in most major economies.

The baseline scenario

The baseline is built on the premise that all fiscal numbers, as well as GDP growth, over the next three years will be exactly the same as the average of the preceding three years. The medium-term baseline scenario is the foundational building block of a MTFF.

If the baseline continues into the future, then net tax and non-tax revenues to the centre will be 9 per cent of GDP. Add to this a further 0.55 per cent from non-debt capital receipts. Thus total revenue receipts average 9.55 per cent.

Baseline committed expenditures (GST compensation, establishment expenditure, interest payments and finance commission and other statutory grants) account for 6.87 per cent of GDP. Subtracting this from total receipts, we are left with a surplus of about 2.7 per cent of GDP.

If the 3 per cent target fiscal deficit/GDP is to be achieved, this allows 5.7 per cent of GDP for all other expenditures. Expenditure on "core of the core" and on central sector schemes amount to 4.5 per cent of GDP. That leaves just 1.2 per cent of GDP for all other expenditures, including important centrally sponsored schemes such as the national health and education missions, mid-day meals, Integrated Child Development Services, smart cities etc.

In these circumstances, it is understandable that the central government is constrained on account of inadequate fiscal space. As a result, underfunding of schemes is ubiquitous, expenditure liabilities are transferred to public sector entities, and it is difficult to enhance investments in important areas where the central government has sole responsibility like defence, internal security and railways.

The centre's constrained fiscal space in this baseline scenario could relax if (a) the Fifteenth Finance Commission recommends a historically unprecedented increase in the centre's share of the divisible pool, (b) the centre drastically cuts its outlays on schemes. The first is not within the control of the central government. The second involves drastic austerity measures which would have a negative impact on growth and development. The low hanging fruit have already been harvested, and even with drastic cuts in subsidies and winding up loss making public enterprises, it is not going to be the case that the fiscal target is met without expenditure austerity in areas that impact national interest. It is also not prudent to treat disinvestment receipts as a source of medium-term financing.

The baseline scenario therefore reveals that if business as usual continues, then it is impractical to imagine that the fiscal deficit could be reduced to 3 per cent of GDP, without forcing government to undertake unacceptable austerity measures, disinvest only to fill a fiscal gap, or resort to off-budget fiscal procedures which only postpone the problem, not resolve it.

Moving forward from the baseline

In a medium-term fiscal framework, it is possible to budget scenarios that are better (or worse) than the baseline. I consider three scenarios:

1. Nominal GDP growth increases to 13 per cent. The revenue-GDP ratio remains constant at 9.5 per cent. But committed expenditure only increases at the old GDP growth rate— that is, 11.5 per cent. Thus, it falls from 6.87 to 6.1 per cent of GDP. This gives 0.77 extra fiscal space which can be used, without any improvement in revenue performance, to significantly enhance expenditure outlays.

2. The revenue-GDP ratio (assuming no change in the vertical devolution by the Fifteenth Finance Commission) increases, but the GDP growth rate is the same. Presently, transfers to states account for 31 per cent of total revenue receipts. Therefore, if the revenue-GDP ratio increases by 0.5 per cent, the centre's revenues will increase by 0.35. This is not sufficient to achieve the 3 per cent fiscal deficit target. But, in the medium term, it is unrealistic to expect sustainable increases in the ratio beyond 0.5 per cent, without significantly increasing the tax burden.

3. The revenue-GDP ratio and the GDP growth rate both increase. The government will then of course have sufficient fiscal space to achieve its fiscal consolidation and development objectives.

In the baseline scenario, it is difficult to achieve the fiscal consolidation target and maintain spending on policy priorities without resorting to imprudent or impractical measures. The baseline implies either a smaller (as share of GDP) central government or quantum increases in the productivity of public spending. Increasing the nominal growth rate (including through aligning fiscal and monetary policy objectives) secures significant fiscal space. Increases in the revenue-GDP ratio secure limited fiscal space unless the tax burden and/or disinvestment receipts increase significantly. If a separate exercise pinpoints the medium-term requirements for financing the centre's core and sole responsibilities (internal security, defence, and railways), then there is further clarity on the space for other development activities.

This is the kernel of a medium-term fiscal exercise that would necessarily be more complex if operationalised as a MTFF. I would hope that the benefits of doing so to secure better fiscal policy coherence are apparent.

The writer is director, National Institute of Public Finance and Policy. Views are personal