Will the Budget suspend the FRBM's fiscal deficit goals?

PARLEY

Any fiscal review needs to ideally redirect spending priorities to capital from consumption

With revenue receipts lagging behind budget estimates and economic growth slowing sharply, there is a real risk of the Centre missing its fiscal deficit target this year. In a discussion moderated by **Suresh Seshadri,** *N.R. Bhanumurthy and Ajit Ranade look at how the Union Budget may approach the fiscal balancing act in the face of a need for a stimulus and the government's stated commitment to adhere to the Fiscal Responsibility and Budget Management Act (FRBM). Edited excerpts:*

How realistic does the FRBM's goal of reducing the fiscal deficit to 3% of GDP by March 2021 appear now?

N.R. Bhanumurthy: First of all, I would like to say that the FRBM amendments that were part of the Finance Bill 2018 are very different from the original FRBM Act of 2003. The original FRBM Act had said that you have to bring down the fiscal deficit to 3% and the revenue deficit to 0%. The 2018 Finance Bill actually did away with the revenue deficit target. So, there is no revenue deficit target any more. Rather, we have the target of bringing down the fiscal deficit to 3% and at the same time, we expect that that will bring down the public debt to 40% at the Central level.

In my view this is a very flawed kind of FRBM roadmap that the Central government has adopted. To that extent I am not really concerned about bringing down the fiscal deficit to 3% because if you look at the last two years, the fiscal deficit has been brought down to 3.3% and the revenue deficit is actually increasing; that itself violates the original FRBM Act.

In principle, the FRBM is basically an expenditure switching mechanism, where you try to switch the expenditure from consumption to capital. That would lead to higher GDP growth and then lead to reduction in the public debt-to-GDP ratio. What we are seeing is not expenditure switching from consumption to capital, but we are actually seeing a switch from capital to consumption. And that would be growth retarding, in my view.

What is likely to be the impact from a markets, ratings and investment perspective if the Budget does end up signalling at least a temporary suspension of the fiscal deficit goals?

Ajit Ranade: Since the last quarter of calendar 2018 and the subsequent three quarters, we have seen declining GDP growth to the extent that nominal GDP growth [estimated at 7.5% for the full fiscal year] will be the lowest in the last 42 years. This is an alarming number. Even real GDP growth is very low, below 5%. So, clearly this is evidence of lack of demand – whether it is for consumption, investment or exports – and it requires a growth impetus. In the short run, the biggest impetus comes from fiscal stimulus. Now the thing about the fiscal responsibility act, the fiscal discipline Act, is that it tends to be what is called 'pro-cyclical'. If you are going to focus on just a number, discrete 3% of GDP, so when the GDP itself is small now, the growth is slower, the 3% is going to be more. And when the GDP is rising fast the 3% is not so bad. You want a higher deficit spending to boost growth if you believe that the government spending is going to help. So, for fiscal policy to be effective, it has to be countercyclical. But the way the fiscal responsibility act has been framed, if you are only focussing on a number from year to year, it ends up being pro-cyclical. So, actually the spirit of the fiscal responsibility act should have been over a business cycle. So over a multi-year horizon it should be declining. That is the sign of fiscal discipline. But there should be room for governments to spend extra when needed. That is an important point to note. Also, there is nothing in theory which says 3% is ideal and 2.8% is not and 3.5% is not ideal, there is no basis for saying it.

I believe that in the Indian context, because of our young demography, our dependency ratio is low. This means there are more taxpayers than retired people. And this is going to remain like this for the next couple of decades, which means that if we have higher deficit spending today to induce growth – what Professor Bhanumurthy said about capital spending – tomorrow's generation will have to pay it back in the form of taxes. But per capita tax burden on future generations is going to be relatively low or modest because we have the young demography advantage. So I think the bottom line is that there is an expectation that the Budget will do something about providing a fiscal stimulus but there will also be a challenge of remaining within the legislative remit. Also, the legislation itself gives the government some leeway of overshooting by 0.5% in times of rapid fall in GDP growth rate, which is what we are seeing.

R.V. MOORTHY

> **Revisit the FRBM Act, revert to the original FRBM, try to focus more on the revenue deficit and at the same time try to increase capital expenditure.**
>
> N.R. BHANUMURTHY

Is there a downside to all this?

AR: The downside is that first of all we need to worry about sustainability... when you go into deficit spending, whether the debt that you take on additionally is sustainable. The young demography and medium-term growth prospects make it reasonably sustainable. And you also need to worry about whether international ratings agencies would react negatively to an extraordinary fiscal stimulus. That's the balancing you would need to do. On that count I believe India's ratings have improved, at least the outlook, and I don't think it's going to become negative simply because of a higher fiscal deficit this year. In any case you know the world today is awash with so much funds and negative interest rates in most of the developed world, so I don't think the adverse impact of a rating action, which I think is very unlikely, and higher interest rates for India, including corporates, is a big risk.

Is it time to trigger the FRBM's 'escape clause'? And if so, what is the roadmap when the escape clause gets triggered?

NRB: I think in terms of the escape clause, my guess is that we are actually 'escaping' every year. The way we are amending the FRBM Act regularly shows that we seem to have the escape clause within the mandate. The initial FRBM said you need to achieve 3% by 2018; now we are in 2020. That itself shows that the Act has some kind of flexibility. Now we don't know what the 15th Finance Commission is going to recommend; they're also supposed to come out with their own FRBM roadmap. I think when the Action Taken Report is placed in Parliament, we will know what the 15th Finance Commission is recommending. But in terms of this analytical issue, the 3% fiscal deficit target, what we are looking at is a general government fiscal deficit of 5.6-6% and that actually came from some of the studies done by Dr. Rangarajan as part of the 12th Finance Commission. And later for the 13th and 14th Finance Commission, we have done some work, where it is clearly evident that if you can bring down the revenue deficit to zero, that means if you are not borrowing for consumption purposes, that itself will bring down the general fiscal deficit to close to 6%. That is how this whole 3 plus 3 has been worked out.

Would a targeted TARP-like programme, which tries to give fiscal support to just the financial services sector, because it is such a key sector in terms of its multiplier impact, work?

AR: I absolutely feel that is so. It is true in general that capital spending is seen as more productive and better quality spending than consumer spending. But this year is so unusual that we also need to give a consumption stimulus, including in the form of PM-Kisan, enhanced spending for the MGNREGA, and so on. Growth today is constrained due to a collapse in credit. Bank credit growth has fallen steeply and ironically there is so much excess liquidity... in fact, on a daily basis the Reserve Bank of India finds that there is more than 3 lakh crore of excess liquidity. The reasons for the credit collapse is because of the NPA [non-performing assets] situation. NPAs are actually incrementally rising. Plus the lingering effects of the NBFC [Non-Banking Financial Company] crisis and the still relatively high real interest rates. So, I believe it is going to help if some kind of a credit enhancer, or anything that can release the credit flow which is required for growth, is done. There is some discussion about gathering all the NPAs... the toxic ones and into a bad bank. I am not sure a bad bank is appropriate but something like that needs to be done.

We need to give high priority for recapitalisation wherever nece sary, identifying or isolating bad a sets and let credit grow. For GDP t grow at 7-8%, we need credit to gro at 15-20% and that includes bar credit, NBFCs, ECBs [external con mercial borrowings], everything.

Where would you suggest the whole thrust of the Budget's emphasis on the FRBM and the fiscal deficit should be?

NRB: Revisit the FRBM Act, reve to the original FRBM, try to focu more on the revenue deficit and the same time try to increase capit expenditure. That alone will brir you more growth and fiscal disc pline. I've been arguing that whe you're going to revise the FRBM Ac please come out with some kind range target. Not just point targe of 3% you know you're going to vi late.

AR: I agree with Professor Bhan murthy that we should not ignor the quality of spending and cost sa ings or cost efficiency wherever po sible before we embark on fiscal st mulus in terms of increase spending. Secondly, remember fi cal deficit is equal to expenditu minus revenue. It's got two aspect expenditure and revenue. So let not forget the revenue sources f spending as well. For example, would not let go of the capital gai tax. And the fact that the stock ma kets are at an all-time high I thir negates the argument that LTC [long-term capital gains] would b detrimental to the stock market. S don't let go of revenue sources yc have.

The government has to acknov ledge that this is a year when aggr gate demand has really fallen ar while we wait for consumption, i vestment spending from the priva sector to come up, to revive, it fal on the government to stimulat And I would say not just capit spending but you might have to loc at providing a consumption stim lus especially to the lower income Also, look at avenues to revive fina cial savings. This is a year wher they have very little choice but t provide fiscal impetus and th means we will have to exceed tl target and perhaps take refuge i some of the escape clauses. And a so wait for the growth revival ne year.

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