Fiscal Consolidation Ex-post the Escape Clause: A Call for "Excessive Deficit Procedure"

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Abstract

Launching an "excessive deficit procedure" in India is inevitable for growth revival. This is crucial especially when there is considerable ambiguity about why the "escape clause" was invoked in the Union Budget 2020 - whether to meet the shortfall in tax revenue emanating from the unanticipated fiscal outcomes of structural reforms or to boost the capital formation in the economy.

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I. Introduction

The World Economic Outlook (WEO) 2020 released by the International Monetary Fund (IMF) has reduced India's growth forecast to 4.8%, a reduction of 1.3% within three months. The WEO also indicated that the growth slowdown in an emerging economy like India has pushed down the global growth forecast by "0.1%" (IMF 2020). However, the Union Budget 2020 has done little to stimulate the economic growth, and Ministry of Finance is in constant denial to accept that the economic slowdown in India is a "drag" on the world economy. Beyond the point of the " synchronised slowdown" argument - that the global growth downturn is also affecting India's growth rate - the Union Budget 2020 has failed to use the "budget" as a potential fiscal tool to trigger the economy.

The only move by the Finance Minister, Nirmala Sitharaman, with regard to fiscal consolidation, was to invoke the "escape clause" of new Fiscal Responsibility and Budget Management (FRBM) Act 2018. However, there remains a genuine confusion as to whether invoking the "escape clause" to deviate from the fiscal consolidation path is in response to the shortage in tax revenue, emanating from the unanticipated outcome of structural fiscal policies undertaken, or whether it is for increasing capital (infrastructure) expenditure.

Invoking the 'Escape Clause'

Instead of a fiscal deficit – gross domestic product (GDP) threshold at 3%, the finance minister has announced that India has gone for a fiscal deficit – GDP threshold of 3.5% for the next fiscal. This is strictly within the purview of the new FRBM Act, incorporated in the Finance Bill 2018.

The Finance Minister has referred to the "escape clause" embedded in the Act, which mentioned a flexible upper bound of deficit-GDP ratio under special circumstances. As per the Section 4 (2) of the FRBM Act, there is a provision for a trigger mechanism for the deviation from the estimated fiscal deficit on account of structural reforms in the economy, with unanticipated fiscal implications. The Finance Minister re-confirmed that the deviation of 0.5% up from the threshold is consistent with Section 4(3) of FRBM Act, both for 2019-20 revised estimate (RE) at 3.8% and 2020-21 budget estimate (BE) at 3.5%.

Deficits: Levels and Financing

It is not only the "levels" of deficit that matter, but the changing financing pattern of the fiscal deficits is equally significant to analyse. The New FRBM 2018–19 mentioned that "in the proposed FRBM architecture, Government will simultaneously target debt and fiscal deficit, with fiscal deficit as an operational target and do away with the deficit targets on revenue account that is revenue deficit (RD) and consequentially, effective revenue deficit (ERD)." If invoking the "escape clause" is linked to forward looking strategies to increase capital formation, then India needs to maintain the "golden rule" of fiscal rules that RD is zero. However, in India, ex-post to the new FRBM in 2018, with no target, RD has stubbornly increased to 2.4% of GDP in 2019-20 and would be at 2.7 % in 2020–21 (Table 1).

Table 1: The "Levels" of Deficit

(in Rs. crores)

Deficit Statistics	2018-19	2019-20		2020-21
	Actuals	BE	RE	BE
Fiscal Deficit	6,49,418 (3.4)	7,03,760 (3.3)	7,66,846 (3.8)	7,96,337 (3.5)
Revenue Deficit	4,54,483 (2.4)	4,85,019 (2.3)	4,99,544 (2.4)	6,09,219 (2.7)
Effective Revenue Deficit	2,62,702 (1.4)	2,77,686 (1.3)	3,07,807 (1.5)	4,02,719 (1.8)
Primary Deficit	66,770 (0.4)	43,289 (0.2)	1,41,741 (0.7)	88,134 (0.4)

Source: Government of India, Union Budget 2020 documents
Note: Figures in the parentheses represent per cent of GDP

This "non-zero" RD is a matter of concern, especially when the escape clause is invoked. The golden rule is to prevent fiscal profligacy and to imply a hard budget constraint on government to prevent the use of borrowed resources for the purpose of recurrent spending, including wages and salaries, interest payment, pension and subsidies. However, with the simultaneous situation of invoking escape clause to raise the threshold fiscal deficit ratio to GDP and having a non-zero RD can be tricky.

The point to be noted here is that the financing pattern of deficits has undergone a major change over the recent years. In 2018-19, the financing of deficits through small savings was 19.25%, which has now become 31% (Table 2). However, the market borrowings still remain as the predominant form of financing deficits, at around 68%. The external sector borrowing is insignificant and below 1% .

Table 2: Financing Pattern of Fiscal Deficits in India

Sources of Financing Deficits	2018-19		2019-20		2019-20		2020-21	
	Actuals	% of Total	BE	% of Total	RE	% of Total	BE	% of Total
Debt Receipts (Net)								
Market Borrowings (G-sec + T-Bill +POLIF)	4,30,164	66.24	4,48,122	63.68	4,98,972	65.07	5,35,870	67.29
Securities against Small Savings	1,25,000	19.25	1,3,0000	18.47	2,40,000	31.30	2,40,000	30.14
State Provident Funds	16,059	2.47	18,000	2.56	18,000	2.35	18,000	2.26
Other Receipts (Internal Debts and Public Account)	73,997	11.39	59,532	8.46	4,941	0.64	5,08,48	6.39
External Debt	5,519	0.85	-2,952	-0.42	4,933	0.64	4,622	0.58
Draw Down of Cash Balance	-1,321	-0.20	51,059	7.26	0	0.00	-53,003	-6.66
Grand Total	6,49,418	100	7,03,761	100	7,66,846	100	7,96,337	100

Source: Government of India, Union Budget 2020 documents

Anatomy of Revenue Expenditure

Having said that, it is significant to examine India's revenue expenditure. The anatomy of revenue expenditure reveals that the centre intends to spend the highest on interest payments (23.28 %) and defence and its components (10.62%) (Table 3). There is also deviation between BE and RE figures (as reflected in the ratio of BE/RE for the year 2019-20) in the components of revenue expenditure. This deviation between BE and RE is referred to as "fiscal marksmanship" and it is perfect only if the value is 1.

Table 3: How Central Government Spends: Share of total expenditure across various components (%)

	2018-19 Actuals	2019-20 BE	2019-20 RE	2020-21 BE	Fiscal Slippage (BE/RE) 2019-20
Pension	6.92	6.26	6.82	6.93	0.95
Defence	12.56	10.96	11.72	10.62	0.97
Subsidy – of which					
i. Fertiliser	3.05	2.87	2.96	2.34	1.00
ii. Food	4.38	6.61	4.03	3.80	1.69
iii. Petroleum	1.07	1.35	1.43	1.34	0.97
Agriculture and Allied Activities	2.73	5.44	4.48	5.09	1.25
Commerce and Industry	1.20	0.97	1.06	0.89	0.95
Development of North East	0.08	0.11	0.10	0.10	1.12
Education	3.47	3.40	3.51	3.26	1.00
Energy	1.96	1.60	1.57	1.40	1.05
External Affairs	0.67	0.64	0.64	0.57	1.03
Finance	0.64	0.72	0.92	1.37	0.81
Health	2.35	2.33	2.37	2.22	1.02
Home Affairs	4.24	3.73	4.60	3.76	0.84
Interest Payments	25.17	23.70	23.16	23.28	1.06
IT and Telecom	0.64	0.78	0.59	1.95	1.36
Others	3.22	2.75	2.85	2.77	1.00
Planning and Statistics	0.23	0.21	0.22	0.20	1.00
Rural Development	5.74	5.05	5.31	4.76	0.98
Scientific Departments	1.07	0.98	1.03	0.99	0.99
Social Welfare	1.89	1.82	1.79	1.77	1.05
Tax Administration	3.00	4.21	5.09	5.03	0.85
Transfer to GST Compensation Fund	2.34	3.63	4.49	4.45	0.83
Transfer to States	5.15	5.58	5.76	6.59	1.00
Transport	6.20	5.65	5.86	5.58	1.00
Union Territories	0.61	0.54	0.56	1.74	1.00
Urban Development	1.75	1.72	1.57	1.64	1.14
Grand Total	100	100	100	100	1.03
Grand Total (in Rs crores)	2315113	2786349	2698552	3042230	

Source: **(**Basic Data), Union Budget 2020 documents, Government of India

The central government estimates to spend around 23.28% of their total expenditure on interest payments, 6.88 % , 4.40% and 3.74% on defense services (revenue expenditure), defense pensions, and capital outlay on defense services respectively, 6.59% on transfers to states and 2.01 per cent on pensions, which add up to 46.90%. Among the ministries, the departments of revenue, agriculture, food and public distribution, rural development, police, road transport and highways, railways, fertilizers, telecommunication, housing and urban affairs, petroleum and natural gas, health and education (elementary and higher) constitute 38.71% of total expenditure (Table 4). The rest of the expenditure, 14.39% is allotted to the remaining of the 80 Demand for Grants of ministries/departments. Each of these Demand for Grants constitute below 1% of the total expenditure.

Table 4: Share of Total Expenditure across Top 15 Demand for Grants Ministries/Departments for 2020-21

Name of the Ministry/Department	%
Interest Payments	23.279
Defence Services (Revenue)	6.880
Transfers to States	6.589
Department of Revenue	4.491
Department of Agriculture, Cooperation and Farmers' Welfare	4.418
Defence Pensions	4.399
Department of Food and Public Distribution	4.018
Department of Rural Development	3.949
Capital Outlay on Defence Services	3.739
Police	3.459
Ministry of Road Transport and Highways	3.018
Ministry of Railways	2.374
Department of Fertilizers	2.345
Department of Telecommunications	2.184
Department of Health and Family Welfare	2.137
Pensions	2.011
Department of School Education and Literacy	1.967
Ministry of Housing and Urban Affairs	1.645
Ministry of Petroleum and Natural Gas	1.410
Department of Higher Education	1.297

Source: Same as Table 3

Revenue-led Fiscal consolidation?

More often than not, fiscal consolidation is attained by retrenchment of public spending and not increased tax buoyancy. This has severe negative growth consequences. In the 2020 Union Budget, there is significant deviation between the BE and RE for tax revenue. The budget credibility is a serious concern when there is huge gap between the tax projections and realised receipts.

Roy (2020) highlighted that in FY20, the shortfall in net tax revenue to the centre is 0.7% of GDP and for the states it is 0.75% per cent of GDP, which reflects how the fiscal stress is now impacting the states. The shortfall in gross tax receipts was to the extent of Rs 3 trillion, half of it through corporate tax shortfall and the other half from the goods and services tax (GST) and other indirect taxes. This along with the shortfall in the disinvestment proceeds made the situation further worse. In the 2020 budget, the disinvestment proceeds are projected from Rs 65,000 crores to Rs 2.1 trillion for FY21. The risk associated with the ambitious disinvestment projections is a matter of further research.

Scope for EDP

Invoking the "escape clause" of the FRBM Act 2018 in the 2020 budget for stimulating the economy was inevitable. However, there is considerable ambiguity about why the escape clause is invoked in the this budget - whether to meet the shortfall in tax revenue emanating from the unanticipated fiscal outcomes of structural reforms or to boost the capital formation in the economy.

Ex-post to invoking this clause in the FRBM, I suggest that launching an "excessive deficit procedure" (EDP) in India is inevitable for long term economic growth revival. Initiating EDP in India would be benign when there is empirical evidence that fiscal deficits do not have adverse impacts on interest rates and there is no risk of crowding out of private corporate investment in India (RBI 2018, IMF 2016, Bahal and Tulin 2015, Chakraborty 2016, Vinod et. al 2019).

EDP is defined as the procedure to be followed while initiating a flexibility to breach the fiscal threshold from 3% of GDP for the centre and the states or to violate the public debt threshold from 60% of GDP. In the context of the European Union, the member states can adopt appropriate policy responses to correct excessive deficits (and/or debts) by implementing the EDP. The original purpose of EDP in the European Union was to soften the limits on deficits and debts set in the Maastricht Treaty of 1992, and not to punish countries for exceeding them (Leandro, 2019).

Given the economic growth plummeting in India, fiscal re-dominance through effective fiscal stance is the key to growth revival. The monetary policy tools have been ineffective in reviving growth in India in isolation. The fiscal re-dominance is crucial for growth upturn at national and subnational levels in India through flexibility in fiscal rules (FRBM) and subsequent EDP.

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