Are fiscal risks increasing?

After the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003 and the related FRBM Rules in 2004, the target fiscal deficit to GDP ratio of 3% for the Union government was achieved only once, in 2007-08, when it was 2.5%. That achievement has yet to be emulated again. The FRBM Act was amended twice, in 2012 and 2015. The revisions in 2015 shifted the date for achieving the 3% target to 2017-18. By this year, the amended revenue deficit target was put at 2% of GDP.

Budget 2018-19 has proposed amending the FRBM Act again, which will shift the target of 3% fiscal deficit-GDP ratio to end-March 2021. No target has been set for revenue deficit. The new statutory anchors relate to the general and Central government debt-GDP ratios that are to be reduced to 60% and 40% of GDP, respectively, by 2024-25, based on the recommendations of the report by the FRBM Review Committee. However, only a diluted version of the recommendations has been accepted.

Missing the fiscal responsibility targets year after year and changing the statutory framework time and again bring the credibility of the government's commitment to fiscal discipline in the spotlight. As per the requirement of the FRBM Act of 2003, and amended in 2015, a medium-term fiscal policy statement has been presented by successive governments in each Budget, setting three-year rolling targets for fiscal, revenue, and effective revenue deficits and outstanding debt of the Central government. A review of these shows that the targets for all the four variables have almost always been missed, often by big margins. Thus, with reference to the new anchor of the Centre's debt-GDP ratio, the target set in the 2015-16 Budget was 42.8% for 2017-18. In the 2016-17 Budget, it was reset to 46.8%. The revised estimates for 2017-18 show the ratio at 49.1%. Thus, the deviation of the targets from the revised estimate (RE) was 6.3 percentage points of GDP when it was first set; even after being reset the next year, it was 2.3 percentage points. There was only one exception when the fiscal deficit target of 3.5% for 2016-17 (which was set in 2015-16) equalled the corresponding realisation. However in the 2017-18 RE, it has remained stuck at the 3.5% level.

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The average rate or margin by which different governments have reduced the fiscal and revenue deficits relative to GDP has been quite low. The average margin of reduction over two periods, namely 2009-10 to 2013-14 and 2014-15 to 2018-19, for fiscal deficit relative to GDP was 0.3 percentage points per year in the first period and 0.2 percentage points per year for the second period. The same margins applied for revenue deficit reduction. For the Centre's debt-GDP ratio, the average reduction margin was 1.1 percentage points and 0.5 percentage points per year for the two periods, respectively. The current Budget has retained the fiscal deficit at 3.5% of GDP, missing the budgeted target of 3.2% which was itself a deviation from the stipulated target of 3% for 2017-18 in the amended FRBM Act. A slippage margin of 50 basis points implies a delay in reaching the target by two and a half years given the average margin of reduction of 0.2 percentage points per year. In the absence of improvement in the fiscal deficit level in 2017-18, the debt-GDP ratio has increased to 49.1% in 2017-18 from 48.7% in 2016-17 rather than falling, which was the trend until recently.

In the proposed amendment to the FRBM Act, key recommendations of the review committee were not accepted. It had wanted the target at which the fiscal deficit to GDP ratio was to be stabilised set at 2.5%. The committee had derived the 2.5% target by reference to the annual estimate of available investible resources at 10% of GDP consisting of surplus savings of the household sector and sustainable net capital inflows. It assessed that half of it, that is 5%, could be pre-emptively shared equally by the Central and State governments, keeping their fiscal deficits at 2.5% of GDP each, leaving the balance of 5% for public sector and corporate borrowing. The

government apparently did not accept this framework and continued with the 3% target. If this was to be the case, we might as well have continued with the present FRBM Act. In fact, it can be shown that were the government to abide by the 3% mandate beyond 2020-21, the debt to GDP ratio would come down to 40% by 2024-25 with a nominal growth assumption of 11.5%. Thus, specifying the fiscal deficit target of 3% would have been enough to achieve the debt target.

Second, the committee had not given up on the desirability of achieving revenue account balance. It had specified a revenue deficit glide path, reaching 0.8% by 2022-23. This too was not accepted. The target of revenue account balance is well recognised in the so-called 'golden rule' wherein a country may borrow as long as the entire borrowing is spent on capital spending. This can only be achieved by keeping the revenue deficit to zero. In the Indian context, the revenue deficit with some adjustments reflects government dis-savings. Unless government dis-savings are eliminated, it will be difficult to reverse the trend of a falling savings rate.

Third, the Central government did not accept another recommendation of setting up a fiscal council, which could independently examine the economic case and justification for deviating from the specified targets. Unconstrained fiscal flexibility, both in approach and statutory provisions, adds to a climate of avoidable fiscal risks.

Fourth, in the committee's recommendations, the debt-GDP levels of 60% and 40% of GDP for the general and Central governments, respectively, were to be achieved by 2022-23. These target dates have been shifted to 2024-25.

Fiscal risks may also be higher with the reliance on extra-budgetary resources for financing a number of ambitious government spending programmes. In the Budget for 2018-19, the total outlays for three focus areas, namely, agriculture and rural livelihoods, infrastructure and education, and health and social sectors, amount to 11.6% of GDP as per Annexures 1, 2 and 3 of the Finance Minister's speech. These are to be funded using budgetary and extra-budgetary resources. Budgetary resources constitute only 16.4% of the total outlay. The balance, 83.6%, is to be raised as an extra-budgetary resource by the public sector enterprises concerned, special purpose vehicles and other similar institutions. Thus, the extra budgetary resources are meant to contribute almost 9.7% of GDP to finance the stipulated outlays as detailed in the annexures to the Minister's speech. A substantial part of this may only be based on borrowing as the relevant bodies may have limited surpluses. Any dependence on borrowing for these extra-budgetary resources along with the borrowing requirements of the State governments while the saving rate is falling can put considerable pressure on interest rates.

The projected fiscal deficit of 3.3% of GDP for 2018-19 is itself contingent upon revenues rising to the budgeted levels and expenditures being contained at levels indicated in the Budget. There are concerns and doubts on both counts. Another year of slippage can be damaging. We also need to note that interest payments to revenue receipts of the Centre stand at 35.3%. This restricts the space for other development expenditures. Some people ask whether it is at all necessary to have such rules as mandated fiscal deficits or inflation targets. Rules versus discretion is an old issue that has been debated extensively. If the rules are too rigid, they are likely to break down. But a complete abandonment of rules can lead to instability. In fact, the fiscal deficit rule in India has been honoured more in breach than in observance. More than ever, the fiscal deficit needs continued vigilance. We need to stay the course.

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