Why the fuss about fiscal deficit?

To any layman watching India’s annual Budget jamboree, the entire exercise must seem very puzzling. After the Finance Minister has read out a long list of giveaways to farmers, small businesses, low-income earners and senior citizens in his speech, none of the beneficiaries seems entirely happy with their gifts.

Commentators, after cursory compliments, quickly turn their attention to the deficit numbers. It is also quite difficult to comprehend why all hell must break loose, if the fiscal deficit turns out to be 3.5% for the year, instead of 3.2%.

All this fuss would be quite easily explained if only one were aware of the precarious state of government finances.

Think of India’s central government as one sprawling household with the Ministries, State governments and citizens making up its family members. If you took stock of this family’s finances, you’d at once conclude that this is one profligate household.

Expenses overshoot

In FY18, the Centre’s total income (as per the revised estimates) from taxes, non-tax revenues and capital items is estimated at Rs. 16.23 lakh crore.

But it expects to incur a total expenditure of Rs. 22.17 lakh crore. Expenditure will thus overshoot income by about 36.5%, leaving a shortfall of Rs. 5.94 lakh crore.

This Rs. 5.94 lakh crore shortfall is euphemistically termed as the fiscal deficit. When it is expressed as a percentage of India’s nominal GDP (Rs. 167 lakh crore as per latest CSO estimates), it appears modest at 3.5%. But this tells you why even a minor slippage in the fiscal deficit is so keenly watched. A 30-basis point overshoot in the deficit means a Rs. 50,000 crore hole in the Budget.

The fiscal deficit in fact paints a more complimentary picture of government finances than necessary, because it counts both one-off receipts (from asset sales, recovery of loans etc) and recurring items (taxes) as part of the government’s ‘income’.

This mixing of capital and revenue items would be frowned upon in commercial accounting. Therefore, if one excludes capital items and takes stock of revenue items alone, the Centre is still spending more than it earns, with a revenue deficit of Rs. 4.39 lakh crore in FY18 (revised estimates).

But the fiscal or revenue deficits for FY18 are by no means standout numbers. India’s fiscal deficit in the past ten years (based on actuals) has hovered between 3.5% and 6.4% of nominal GDP.

Borrowings mount

Like your typical householder, when the Centre ends up spending more than it earns, it takes recourse to market borrowings to bridge the gap. The borrowing target for the year is closely watched by the bond market because the larger the government’s loan-taking, the less room for other borrowers — companies, small businesses, individuals — to raise funds from India’s relatively shallow bond market.

Many years of such profligacy had led to the Indian government sitting on a significant stockpile of debt. By end-March 2018, the outstanding loans of the Central government are estimated to hit Rs. 82.32 lakh crore. That's up from Rs. 57 lakh crore five years ago and amounts to 49.3% of the nominal GDP. The saving grace is that the bulk of those loans are from domestic sources, with just Rs. 2.4 lakh crore owed to foreign lenders.

Unproductive spends

If the government's expenditure routinely overshoots its receipts and budgeted estimates, why is there so much angst about the under-allocation to welfare schemes?

The answer lies in the extremely limited elbow room that the Centre enjoys in deciding on its Budget allocations.

While allocations to pet schemes may take up a lot of time in the Budget speech, the reality is that the bulk of the expenditure each year is absorbed by just three recurring items — interest payments, pensions and subsidies. In the FY18 revised estimates, for instance, interest payments (by far the largest item of expense) were expected to absorb Rs. 5.3 lakh crore, pensions Rs. 1.5 lakh crore and subsidies Rs. 2.3 lakh crore.

In short, servicing interest payouts alone will take up 32% of the Centre's earnings this year, while pensions and subsidies absorb another 23%.

With 23% allocated to State grants and 16% to defence expenditure, these repetitive expenses will effectively mop up 95% of the total Budget receipts.

This makes it evident why there's so little room in the annual Budget for allocations to new ideas or schemes.

The other long-lamented problem with the expenditure pattern is that the bulk of the Budget spending goes into consumption or maintenance expenses, with very little spent on creating new assets.

In FY18, just 12% of the budget was defrayed in capital spending.

It is important to emphasise here that while we have cited FY18 numbers in the above analysis, all of the above problems have been long-standing ones for the fisc.

This is indeed why there's a Fiscal Responsibility and Budget Management (FRBM) Act which enjoins the government to steadily tighten its fiscal and revenue deficits over the years, while reining in its debt-GDP ratio.

What the analysis tells us is that, for India's government to be really able to launch bold new schemes or make a difference to citizens' welfare, it needs to clean up its finances first — pare down debt, save on interest payouts, reduce pensions and subsidies and raise asset creation.

It must also ensure that its receipts grow at a far faster pace than expenses in future, so that the debt can be paid down.

Therefore, the success or failure of the annual Budget exercise really has to be measured on the progress in these parameters over the years.

Progress since FY14

So what has been the progress on fiscal consolidation post-FY14, when the current NDA regime was voted into power? On this score, there’s good news to impart.

For starters, in the four fiscal years between FY14 (the last Budget by the UPA government) and FY18, the Centre’s receipts have grown at a faster pace than its expenditure. Using revised estimates for both years, the Centre’s total receipts (excluding borrowings) have shot up by 50% between FY14 and FY18. Total expenditure in the same period registered a slower 39% increase. Even better, spending on interest, pensions and subsidies rose by a much lower 30%, thus freeing up room for other expenditure.

Two, the brisk pace of growth in receipts vis-a-vis expenses helped the Centre avoid a big bloat in the fiscal deficit over these four years. With the number edging up from Rs. 5.2 lakh crore in FY14 (RE) to Rs. 5.9 lakh crore by FY18 (RE), fiscal deficit as a percentage of GDP has declined from 4.5% to 3.5%. In fact, it would be even lower but for the spike in FY18.

Three, the reined-in deficit has meant lower recourse to borrowings in order to bankroll spending. In FY14, as much as 32% of annual Budget spending came from borrowings, but by FY18 it was down to 27%.

But all this frugality has made only a mild dent in the Centre’s stockpile of debt, which has dipped only from 50.4% to 49.3% of GDP over four years.

Now, pessimists will point out that even the progress achieved so far is glacial and that there’s a long way to go before India’s government finances are in the pink of health.

This is why it is so critical for this government to stick to its path of fiscal consolidation in the last year of its five-year term and not give in to populist temptations.

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