Avoid the adventurous path

The sharp deceleration in the growth of the economy as revealed by the first quarter estimate of GDP released a month ago has been widely commented upon. The policy prescriptions needed to reverse the trend depend on our understanding of the factors responsible for the slowdown. Among other things, one factor that stands out is the steady and sharp decline in the investment rate. The Gross Fixed Capital Formation (GFCF) rate has touched the level of 27.5% in the first quarter of 2017-18. A year ago, it was 29.2%, and a decade ago, it was 10 percentage points higher. In recent years, public investment has shown a small rise. The decline in the investment rate has been largely due to a decline in the private investment rate, both corporate and household.

Given this situation, policy initiatives must be directed towards raising private investment. However, some have argued for a strong fiscal stimulus through an increase in public investment by relaxing the fiscal deficit. It is also suggested that what is relevant is revenue deficit and that there is no rationale for having a fiscal deficit target. There are two problems with this argument. First, the focus on fiscal deficit is mainly to ensure that the private sector has sufficient borrowing space. This is clearly set out in the Report of the Twelfth Finance Commission (TFC) chaired by the first author and which was reiterated by the recent Report of the Fiscal Responsibility and Budget Management (FRBM) Review Committee chaired by N.K. Singh, former Revenue and Expenditure Secretary and former Member of Parliament. The argument in the TFC was that when the transferable saving of the household sector relative to GDP is 10% and an acceptable level of current account deficit 1.5%, containing the aggregate deficit of the Centre and States at 6% and providing 1.5% to the public sector enterprises would leave 4% borrowing space to the private sector.

Similarly, the target of debt-GDP ratio at 60% in 2023 from the present level of 70% (with the Centre and States required to contain their ratios at 40% and 20%, respectively) is supposed to be achieved by limiting the fiscal deficit at 3% of GDP in the first three years and 2.5% in the next two by both the Centre and States.

Second, over 60% of the estimated fiscal deficit at the Centre in 2017-18 (1.9% out of 3.2%) is revenue deficit. At the State level, when the impact of loan waivers, additional interest payments on account of Ujwal DISCOM Assurance Yojana (UDAY) and possible impact of pay revision is considered, the revenue deficit may increase by 1% of GDP. Thus, the problem of proliferation in revenue deficit continues. The golden rule which the U.K. wanted to follow set no limit on fiscal deficit. But borrowing was limited to only financing capital expenditures. The implication is revenue deficit will be nil. We are far from this.

Indian economic history is replete with instances of adverse effects of fiscal expansion on inflation as well as the balance of payments. The huge fiscal expansion in the late 1980s, with the fiscal deficit at more than 10% of GDP leading to the macroeconomic and balance of payments crisis requiring the adoption of structural adjustment programme in 1991, has been very well documented. The recent episode of fiscal expansion after 2008-09 and 2009-10 is fresh in memory. After substantial improvement in the fiscal situation during the period 2004-05 to 2007-08, the implementation of the Pay Commission recommendation, expansion of rural employment guarantee for the whole country and the introduction of the loan waiver led to derailing the process of adjustment in 2008-09, and the fiscal deficit of the Centre increased from 2.5% in 2007-08 to 6.1% in 2008-09. It further ballooned to 6.6% in 2009-10 and the consolidated deficit was 9.4%. This was one of the important reasons for the inflation rate increasing to 10.2% in March 2010, and the average increase in wholesale price index in 2010-11 was 11.1%.

The Annual Report of the Reserve Bank of India (RBI) gives the latest estimate of the financial saving of the household sector for 2016-17 at just about 8.1% of GDP. And if the foreign savings of 2% is added, the transferable savings is just a little over 10%. The aggregate fiscal deficit at the Central and State levels budgeted for 2017-18 is about 6% of GDP, but this is likely to go up after the impact of loan waivers and increase in house rent allowance at the Centre and possible revision of pay scales in the States are taken account of. The annual report also estimates the impact of loan waivers alone at 0.5% of GDP. Taking 6.5% of GDP as the aggregate fiscal deficit and leaving aside 2% for public enterprises, the private corporate sector is left with a borrowing space of just about 1.5% of GDP. At a time when the need is to stimulate private investment, to restrict the space available for it may be counterproductive. In such an environment, there is hardly any scope for reducing the interest rates by the RBI, and even if it did, financial institutions would be unwilling to lend at lower rates. The liquidity crunch may eventually result in monetising the deficits, if not directly but indirectly.

As it is, adhering to the fiscal deficit targets set out in the Budgets is going to be challenging. There will be a sharp reduction in the dividends from banking and financial institutions. The RBI has announced that against the expected 58,000 crore, the actual dividend will be 36,905 crore, and given the difficulties in the public sector banks, there will be shortfalls in the dividends from them as well. There will be a shortfall in disinvestment and tax revenue collection, if current trends persist.

The problem of adhering to the fiscal deficit target is not confined to the Centre alone. At the State level, the combined fiscal deficit for 26 States is budgeted at 2.2% of GDP excluding the deficit arising from taking over the power distribution companies (discoms) loans. However, as mentioned earlier, the expenditure on account of loan waivers is estimated at about 0.5% of GDP. Furthermore, following pay revision at the Centre, some of the States may revise their pay scales which could add to the fiscal pressure. There could be a slippage of about 1% GDP in fiscal deficits.

The solution to the current slowdown in growth lies in reviving private investment, recapitalising banks to enable them to lend more, and speedy completion of stalled projects. Fiscal policy can at best play a role in creating the appropriate climate. Fiscal prudence is one of the elements in sustaining growth over an extended period. The fiscal deficit rules that we have evolved are consistent with the level of savings and the demands of the various sectors on those savings. Our adherence to the fiscal rules has been weak. They have been more honoured in breach than in observance. We are passing through a difficult situation. Even to maintain government expenditures at the budgeted levels, there will be a slippage in the fiscal deficit budgeted because of the likely fall in revenues. The slippage in fiscal deficit by a few decimal points may not matter but any aggressive attempt to widen the fiscal deficit will land us in problems. Our history is witness to it. We should avoid being adventurous.

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