Fiscal consolidation today

Fiscal consolidation (FC) in a recession is contextually very different for emerging market economies like India from FC in times of normal growth.

By my definition (a consistent fall in gross domestic product, or GDP, growth for three years running), India has been in a recessionary situation since FY16, with the usual consequences, particularly falling tax revenue buoyancies. The situation was further complicated by the painful and slipshod implementation of the goods and services tax (GST), which was a task of complexity well beyond the capabilities of the Ministry of Finance. For the same reason, disinvestment targets were unrealistic, and consistently never met. Fiscal restraint was maintained by cutting public, especially capital, expenditure.

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Covid and its aftermath have complicated matters by raising the fiscal deficit in FY21 to 9.2 per cent, and 6.9 per cent in FY22, compared to 3.4 per cent in FY19. Only a fraction of this increase was for capital expenditure; this rose by just 1 percentage point of GDP from FY19 to FY22 whereas the fiscal deficit jumped by 3 percentage points. The revenue deficit increased from 2.4 per cent to 4.7 per cent of GDP in the same period. India continues to borrow largely to consume and the problem is only magnifying.

Tax buoyancy in FY22 was 1.4 compared to 0.8 in FY19 but, worryingly, this is projected to fall to 0.67 in FY23, indicating that the rising buoyancy was temporary and largely due to the base effect.

The fiscal crisis thus remains with us and has, in fact, been exacerbated in two important ways. First, the government has not resolved its revenue problems. It has merely become realistic about its revenue and disinvestment capabilities. However, the laudable realism of moderating expectations does not solve the problem of low revenue buoyancies, an important driver of India's silent fiscal crisis. This means that unless the government intends to lower the deficit through expenditure compression (which happened between FY16 and FY19), the need to borrow will continue to rise in the medium term. But such expenditure compression now will either delay the government's incremental capital expenditure ambitions or force it to reduce committed expenditures, which have risen across the pandemic period. However, interest payments account for the bulk of the rise, and these are not amenable to fiscal correction, particularly in a period of high inflation and rising interest rates.

Mercifully, India has been spared the problems that foreign currency sovereign debt would have posed. This was a course much recommended by the Bretton Woods institutions, when I was a member of the FRBM committee, and even adopted in the FY20 budget. Thankfully, this was not implemented due to vigorous efforts by many concerned experts.

Second, the Centre has regrettably transmitted the fiscal crisis to the states. The share of states in gross tax revenue has fallen from 36.69 per cent in FY19 to 29.8 per cent in FY22. This, on the back of low aggregate buoyancies, and compounded by volatile releases of GST shares to the states (both compensation cess and Integrated GST) have exported fiscal fragility from the Centre. There is one more worrying trend in these hard times that will impact the FC imperative. Not only is growth low, but we now have rising inflation. A widening current account deficit in the face of a rising dollar means that at least for now, the Marshall Lerner conditions do not apply.

This brings into play a further factor. The proportion of foreigners holding rupee-denominated government debt has been growing over time. In this situation, rising government debt/GDP ratios (even if largely rupee denominated) can signal fragility and incentivise exit of inward foreign capital flows, which have financed India's recurrent current account deficit. Further, exit of international players from the rupee sovereign debt market will directly impact the management of the public finances. This, while not identical, has parallels with the 1991 situation. It is not yet a crisis — reserves are comfortable, exiting the rupee sovereign debt market will be costly, but the situation demands close attention.

The situation is not irredeemable. What is urgently needed is a medium-term road map for the Indian economy which acknowledges the hard times we are in, sets out the policy initiatives that will address these challenges over the medium term, and ensures that short-term policymaking conforms to this medium-term road map. Merely positing a $5-trillion economy target or something of the sort will not do the trick. We need to know, what will a $5-trillion economy look like? Will it be export led or *atmanirbhar* or both, and how will this change structural conditions? Will it raise tax buoyancy and limit committed government spending? Modern fiscal policymaking involves nesting annual fiscal budgeting within such a macro fiscal road map and its utility, in those countries which have done so, has been amply demonstrated in Covid times.

In addition to the redevelopment of the macro and fiscal medium-term policy levers, this task will require a supporting institutional fiscal framework —such as a fiscal council and fiscal rules —that will be resisted by a turf-oriented economic bureaucracy comfortable only with short-term policymaking. Overcoming this will require considerable investment of political capital, which is yet to be forthcoming.

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