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TRADE-OFF BETWEEN GOVT DEFICIT AND EXPENDITURE ON SOCIAL INFRASTRUCTURE

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Debate: Fiscal Deficit – Good, Bad or Neutral

There is no agreement among economists either on analytical grounds or on the basis of empirical results whether financing government expenditure by incurring a fiscal deficit is good, bad, or neutral in terms of its real effects, particularly on investment and growth.

Theories

<u>The Neo-Classical View</u>

This view says that fiscal deficits increase aggregate consumption in the economy which leads to a reduction in national savings, resulting in higher real interest rates (in a closed economy). This, in turn, depresses investment and overall economic activity. In an open economy, higher fiscal deficits are reflected in higher capital flows and a real appreciation leading to lower net exports and again, a reduction in overall activity. In either case, a fiscal deficit crowds out investment/net exports and hence, brings about reduction in overall activity. The decline in current investment and build-up of external debt has adverse implications for future output.

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The Keynesian Paradigm

An implicit assumption in the neoclassical approach is that the economy is operating at full employment. In conditions of less than full employment, the Keynesian approach argues that fiscal deficits would not lead to any crowding out. Given sticky wages/prices, shifts in aggregate demand induced by changes in government spending and taxes affect the utilisation of the economy's factors of production, increasing domestic output. An expansionary fiscal policy according to the Keynesian approach is, therefore, conducive to growth.

Ricardian Equivalence

In contrast to the neoclassical and the Keynesian approaches, the Ricardian approach argues that fiscal deficits would be neutral as immortal economic agents internalise variations in government expenditures. These rational agents adjust their consumption/saving one-to-one in relation to movements in fiscal deficits thereby fully offsetting fiscal policy. With overall savings remaining unchanged, fiscal deficits do not have any impact on economic activity in the Ricardian approach.

The Endogenous Growth Theorists

The endogenous growth theory suggests that economic growth is an endogenous outcome of the system. Since growth is endogenous, public policy can influence its magnitude and the role of government in economic development acquires significance. Public capital or public investment in areas such as infrastructure, human capital, and science and technology exerts a positive influence on output. Similarly, government activities in protection of property rights and the taxation of economic activity influence growth in an endogenous manner. Thus, unlike the neoclassical growth theory, the endogenous view of growth stresses that fiscal policy can affect long-run growth performance.

The ‘Tax and Spend’ Hypothesis

In this view, raising taxes with a view to cutting down deficits would not work because it would only encourage the politicians to spend more. The result would be that, while the deficit would remain the same, in the long run, the size of the private sector would be cut down. In this view, a tax cut, which puts pressure for contraction of government spending leaving deficits and national savings unchanged, and which leads to an increase in private consumption, should be considered more desirable. The main problem is that when government expenditure does not fall, it has to run a deficit, which raises interest payments and causes total government expenditure including interest payments to rise as a share of gross domestic product (GDP).

Empirical View

Empirical studies on the influence of fiscal policy on growth found a negative impact of government spending on output growth rates, lending support to the notion that smaller government sectors are associated with faster growth rates. On the other hand, empirical exercises on the effects of government spending which distinguish between government consumption and government capital accumulation suggest that government capital stock has a positive impact on productivity growth and that government spending had a positive and highly significant impact on output growth rates.

An increase in current expenditure has positive and statistically significant growth effects while a negative relationship is detected between the capital component of public expenditure and per capita growth. The productive expenditures, when used in excess, turn unproductive and that several components of current expenditure, such as operations and maintenance, may have higher rates of return than capital expenditure.

The focus on capital expenditures by developing country governments has the implication that they may have been misallocating public expenditures in favour of capital expenditures at the expense of current expenditure, losing out in terms of growth in that process.

While a negative and significant correlation between the budget deficits and growth has been found, the correlation has not been found to be robust. Another aspect generally examined in the context of budget deficits is the long-run inflationary potential of expansionary fiscal policy. Inflation emanating from monetisation of fiscal deficits may lead to greater uncertainty about future inflation and hence have an adverse effect on growth.

Crowding-In/Out

Some of the important issues that have been noted in the literature are:

i) whether fiscal deficits have crowded out private investment by putting pressure on interest rates, thereby adversely affecting growth;
ii) whether continued high levels of fiscal deficits, resulting in growing interest payments, have crowded out government capital expenditure; and
iii) whether public investment financed by fiscal deficits has the potential of crowding-in private investment, thereby positively affecting growth.

High fiscal deficits, by raising real interest rates, crowd out private investment, especially in the context of the government borrowing being predominantly used to finance revenue deficits. A number of studies that have estimated private sector behaviour in India suggest that crowding-out/in effect of public investment is sector-specific. Public investment exerts a short-run crowding-out but establishes long-run complementarity with private investment. In the case of total private investment, the positive effect (complementarity) almost cancels out the negative effect (crowding-out), whereas in the case of private corporate investment, the positive effect seems to dominate the negative effect.

Other studies indicate that while there is some complementarity in certain sectors, the evidence on the overall impact of public investment on private investment is not definitive. The Reserve bank of India has noted that raising public sector investment to boost aggregate demand in the economy crowds out both private consumption and investment with no long-lasting impact on output. On the other hand, infrastructure investment by the public sector crowds in private investment while public investment in manufacturing crowds-out private investment.

Fiscal Responsibility and Budget Management Act

A major policy initiative that has implication for the availability of resources for financing the Plan is the Fiscal Responsibility and Budget Management (FRBM) Act enacted on 26 August 2003. The Act originally provided for reducing the gross fiscal deficit to 3 per cent of GDP and completely eliminating the revenue deficit at the Central level by end March 2008, but the target year has had to be moved further out to 2008-09 in the 2004-05 finance bill. The need to achieve FRBM targets in the medium term perspective could affect public sector resource raising for the Plan. A trade-off between development and adjustment could become an issue if this does not materialise. There are some areas in which policy and procedural changes could increase resources and improve growth prospects. The balance from current revenues could be improved through a strategy focused both on revenue raising as well as on curtailing unprofitable expenditure and reducing leakages.

Rationalising Direct and Indirect Tax Measures

There is scope for rationalising direct and indirect tax measures and user charges based on the twin principles of equity and economic neutrality and focusing on improving compliance and tax administration. Tax tools and governance can be better managed to promote entrepreneurship and superior economic performance so that the resultant improvement in growth is reflected in increased budgetary inflows.

On the direct tax front, there is substantial scope for taxpayer-friendly automatised and computerised administration that can reduce collection costs, improve compliance and curtail rent-seeking and harassment. Tax-revenues can be raised through broadening the tax base, taxing untapped/under-tapped sources, rationalizing tax rates, introducing uniform value-added tax, taxing agricultural income and raising efficiency in tax collections. The major thrust area on the tax side must, however, be on indirect taxation.

The most critical reform required is in the area of domestic consumption taxation. The coordinated countrywide goods and service tax indicated by the Task Force on the FRBM appears as of now to be only a distant goal. The full reform of the indirect tax structure that is necessary to maintain revenue growth while coping with pressures of globalisation is still only at a preliminary stage.

A thorough revamp of the indirect tax structure through rationalisation of the tax base, constitutional and statutory reform and better administration can release the potential of local industry and business and contribute significantly to higher competitiveness and growth. The goal should be movement to a comprehensive consumption tax regime at the level of both the states and the centre.

Restructuring the Expenditure

The crucial issue is to bring about improvement in the central and state finances with a view to restructuring the expenditure in favour of developmental expenditure in order to enable a higher growth. Fiscal adjustments based predominantly on expenditure reduction, particularly when government expenditure in India are already substantially lower than that in the Organisation for Economic Co-operation and Development countries, may involve welfare losses and could also have adverse implications for the growth process.

As against this, the fiscal strategy based on revenue maximisation would provide the necessary flexibility to alter the pattern of expenditure so as to ensure productive utilisation of resources.

Expenditure Prioritisation Required

In the current economic scenario, higher fiscal deficits should be used for accommodating higher expenditure on infrastructure and social sectors. While an increase in expenditures in some of these areas may be desirable and even necessary, they ought to be undertaken in such a way that there is no increase in primary deficit and debt-GDP ratio. Expenditure prioritisation is thus requisite under such a situation.

Mid Year Economic Review

In conformity with the National Common Minimum Programme (NCMP) objectives, outlays on social services and rural development have gone up from Rs51,497 crore in 2003-04 to Rs57,724 crore in 2004-05 (RE) and further to Rs66,691 crore in 2005-06 (BE). Against the budget outlay of Rs7,156 crore for the Sarva Shiksha Abhiyan (SSA) programme, by November 2005, 79 per cent amounting to Rs5,662 crore has been released. The contribution of state governments/Union Territories up to September 2005 for their share of the scheme was Rs1,018 crore.

The utilisation of funds under SSA by the state governments/Union Territories was Rs3,361 crore by September 2005, which is 55 per cent of the funds available with the state governments/Union Territories. While the fund requirements for these ambitious programmes are large, the government proposes to achieve economy in expenditure through convergence of the various ongoing social and rural infrastructure and employment-related programmes.

The National Rural Health Mission (NRHM) envisages strengthening and upgrading of the public rural health infrastructure and services aimed at delivering quality health care in the rural areas of the country. The NRHM, with an initial outlay of Rs6,731.2 crore in 2005-06, proposes to cover all the states in the country with special focus on the 18 states that have weak health infrastructures and demographic indicators.

Central Government Finances: Overview of Fiscal Trends (April –September 2005)

The key fiscal indicators during the first half of the year, that, is April-September 2005, reflect the ongoing process of fiscal consolidation even as they indicate the challenges likely to be faced in the endeavour to achieve the targets laid down under FRBM Act 2003 and rules made thereunder. With adjustments for the impact of debt swap scheme in 2004-05, all the three deficit indicators showed improvement in the first half of the current year vis-à-vis corresponding period of the previous year.

Plan Expenditure

In the overall increase of Rs12,750 crore in the Central Plan expenditure between April-September 2005 over the corresponding period of the previous year, two of the departments which have registered the highest growth were Road Transport and Highways, and Elementary Education and Literacy.

Assessment vis-à-vis FRBM

All the three fiscal indicators in *nominal* terms in the April-September 2005 Central Plan expenditure were inferior to those in the corresponding period of the previous year. Fiscal and revenue deficits were higher by Rs30,608 crore and Rs5,146 crore respectively and the primary deficit turned from a surplus of Rs2,164 crore to a deficit of Rs29,903 crore. The key parameters of non-debt receipts, fiscal deficit and revenue deficit, were also short of targets prescribed under Rule 7 of the FRBM Rules, 2004. Under the Rules, the government is required to take appropriate corrective measures in case the outcome of the second quarterly review shows that:

i) total non-debt receipts are less than 40 per cent of BE; or

ii) the fiscal deficit is higher than 45 per cent of the BE; or

iii) the revenue deficit is higher than 45 per cent of the BE prescribed under Rule 7 of FRBM Rules, 2004.

INFORMATION/DATA

Indirect tax revenue collection data released by the Finance Ministry on 13 January 2006

Though service tax revenues of the Union government has surged by 65.41 per cent to Rs13,782 crore in the first nine months of the current fiscal as against Rs8,332 crore collected between April and December 2004, the growth in revenue collections on the excise front is, however, lower than the budgeted level for 2005-06.

The Centre's Customs collections grew by 15.78 per cent between April and December 2005 to Rs47,715 crore as against a level of Rs41,212 crore between April and December 2004. As regards overall indirect taxes, the revenue collections increased by 15.73 per cent between April and December 2005 to Rs1,36,517 crore (Rs1,17,965 crore).

Mid Year Economic Review

Accounts at a glance						
Rupees Crore						
		ACTUALS		**Percentage to BE**		
	Budget Estimates 2005-06	**Up to 09/2005**	**COPPY**	**Up to 09/2005**	**COPPY**	**5 Years Moving Average**
1. Revenue Receipts	3,51,200	1,22,845	1,06,507	35.00%	34.40%	36.80%
2. Tax Revenue (Net)	2,73,466	96,249	77,860	35.20%	33.30%	34.20%
3. Non-Tax Revenue	77,734	26,596	28,647	34.20%	38.00%	43.20%
4. Capital Receipts (5+6+7)	1,63,144	88,138	89,066	54.00%	52.90%	48.60%
Non Debt Capital Receipts	12,000	4,295	35,831	35.80%	115.20%	68.90%
5. Recovery of Loans	12,000	4,284	35,639	35.70%	131.50%	100.70%
6. Other Receipts	0	11	192		4.80%	8.10%
7. Borrowings and other liabilities	1,51,144	83,843	53,235	55.50%	38.70%	44.20%
8. Total Receipts (1+4)	5,14,344	2,10,983	1,95,573	41.00%	40.90%	41.40%
9. Non-Plan Expenditure	3,70,847	1,51,577	1,42,299	40.90%	42.80%	42.70%
10. On Revenue Account	3,30,530	1,41,819	1,31,716	42.90%	44.90%	42.00%
11. of which Interest Payments	1,33,945	53,940	55,399	40.30%	42.80%	40.60%
12. On Capital Account	40,317	9,758	10,583	24.20%	27.40%	50.50%
13. Plan Expenditure	1,43,497	59,406	53,274	41.40%	36.60%	38.20%
14. On Revenue Account	1,15,982	46,123	34,742	39.80%	37.80%	38.30%
15. On Capital Account	27,515	13,283	18,532	48.30%	34.50%	38.00%
16. Total Expenditure (9+13)	5,14,344	2,10,983	1,95,573	41.00%	40.90%	41.40%
17. Revenue Expenditure (10+14)	4,46,512	1,87,942	1,66,458	42.10%	43.20%	41.20%
18. Capital Expenditure (12+15)	67,832	23,041	29,115	34.00%	31.50%	43.00%
19. Revenue Deficit(17-1)	95,312	65,097	59,951	68.30%	78.70%	55.20%
20. Fiscal Deficit {16 – (1+5+6)}	1,51,144	83,843	53,235	55.50%	38.70%	44.30%
21. Primary Deficit (20 – 11)	17,199	29,903	(-)2,164	173.90%	(-)27.4%	100.40%
Notes: 1. The figures of Railways have been netted as in Budget.						
2. COPPY - Corresponding Period of Previous Year						
3. Borrowings and other liabilities (Item 7) do not include net borrowing under Market Stabilization Scheme (Rs3116.41 crore), which is not to be used for bridging the shortfall in receipts.						

Source: Mid Year Economic Review 2005

Tax Revenues						
Rupees Crore	**2005-06**			**2004-05**		
				Percentage to BE		
	BE	**ACTUALS Up to 09/2005**	**%**	**BE**	**ACTUALS Up to 09/2005**	**%**
1 Corporation Tax	110573	33925.71	31%	88436	20337.25	23%
2 Taxes on Income	66239	21083.47	32%	50929	25175.11	49%
3 Wealth Tax	265	98.56	37%	145	20.6	14%
4 Customs	53182	31276.33	59%	54250	25204.79	46%
5 Union Excise Duties	121533	40415.92	33%	109199	36622.39	34%
6 Service Tax	17500	8159.01	47%	14150	4899.05	35%
7 Other taxes	732.52	2583.02	353%	624.02	583.85	94%
GROSS TAX REVENUE	370024.5	137542	37%	317733	112843	36%
NET TAX REVENUE	273465.5	96248.61	35%	233906	77860.25	33%
Note: Actuals for 2004-05 in respect of Corporation Tax and Taxes on Income need to be readjusted due to misclassification in challans noticed in the early stages of introduction of OLTAS. The readjusted figures would be Corporation Tax: Rs26,457.08 crore and Taxes on Income: Rs19,055.28 crore.						

Source: Mid Year Economic Review 2005

Budget – 2005-06

The overall expenditure (Plan and Non-Plan) on health and education has gone up by more than 22 per cent and 36 per cent respectively in 2005-06 BE. While plan allocations have increased sharply (by 38 per cent), non-plan expenditure has gone up by only 3 per cent on health and education. As per the NCMP, the spending on education and health is to be raised to at least $6^2/_3$ per cent of GDP respectively.

Though the overall expenditure on health and education has increased, it is still less than what was promised in the NCMP. Though this is broadly in conformity with the NCMP, it will have an impact on the government’s capacity to abide by the FRBM Act in 2005-06.

The NCMP aimed at increasing expenditure on agriculture and rural development, infrastructure, social sectors and employment generation. To fund the plan outlays there has been higher reliance on Internal and Extra Budgetary Resources (IEBR) than budgetary support. At the aggregate level the IEBR for the above-mentioned areas has been increased by 62 per cent as compared to a 33 per cent rise in the budgetary allocation to plan outlays. The plan expenditure for social services has been raised by 35 per cent. As per NCMP the public investment in agriculture, rural infrastructure and irrigation will be increased. Increased plan expenditure in agriculture and allied activities, rural development and irrigation and flood control reflects the government's intension to fulfil promises made in the NCMP.

The plan expenditure on social services has risen by a faster rate than economic services. Plan expenditure for education and health have been budgeted to increase by 47 per cent and 25 per cent, respectively. The central plan outlay for infrastructure has been budgeted to increase by 52 per cent. Within infrastructure, the sharpest rise of about 200 per cent has been witnessed in road transport and shipping.

Plan Expenditure by Key Heads of Development

	Rs Crore			**Growth**	
	2003-04	**2004-05 RE**	**2005-06BE**	**2004-05 RE**	**2005-06BE**
Social Services	28021	35404	47665	26.35	34.63
Education Art & Culture	7839	10106	14820	28.92	46.65
Health & Family Welfare	5564	6944	8711	24.80	25.45
Water Supply, Sanitation, Housing and Urban Development	6802	7930	9029	16.58	13.86
Welfare of SC/ST and other backward classes	1128	1250	1490	10.82	19.20
Labour and Labour Welfare	118	157	208	33.05	32.48
Social Welfare and Nutrition	2173	2423	3819	11.50	57.61

Source: Budget Documents – 2005-06

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