Printed from
THE TIMES OF INDIA

Finessing the deficit

Aug 26, 2010, 12.00 AM IST

With the monsoon session of Parliament drawing to a close, attention in North Block will soon shift to preliminary exercises for next year's budget. The challenge facing the finance minister is to craft a budget that will proceed with fiscal consolidation without compromising growth. Is that a feasible option?
One of the two key fiscal relationships that determine the answer to this question is the fiscal multiplier. Any expenditure by one party is also a receipt or income for another party that will in turn spend the whole or a part of this income, which will then become the income of a third party and so on. The sum total of income generated by this chain of expenditure and receipts is larger than the original amount of expenditure. The amount of income generated relative to the original expenditure, the ratio of the two, can be estimated and this is what economists call the multiplier.

Different forms of original expenditure generate different expenditure-receipt chains and, therefore, carry different multiplier values in terms of total income generated. For instance, income generated by a given volume of investment expenditure will be different from income generated by the same volume of public expenditure. Hence, the investment multiplier will be different from the fiscal multiplier.

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Further, different forms of public spending will also trigger different expenditure-receipt chains, with different values of their respective fiscal multipliers. In India, public investment catalyses additional private investment, thereby generating additional income both directly and indirectly. Hence the fiscal multiplier for capital expenditure by the government turns out to be much stronger than the fiscal multiplier for current or revenue expenditure.

The other key relationship is revenue buoyancy, the percentage increase in revenue that would arise from a given percentage increase in income. This measure can change from year to year because of new tax proposals, change in tax rates, etc. In India, this ratio is around 1.3, implying that a 1 per cent increase in GDP would lead to an additional revenue flow of 1.3 per cent. Of course, this is an average and different taxes will have their own rates of buoyancy.

The fiscal multipliers and revenue buoyancies taken together tell us that revenue is not independent of public spending. The latter not only leads to higher income but also higher revenue, and that should be factored into revenue projections. On average, Rs 100 of extra spending will automatically generate additional revenue of about Rs 60 via the fiscal multiplier and revenue buoyancy, requiring an additional revenue effort to cover the balance Rs 40 that will otherwise add to the deficit. Again, this is an average. Additional revenue flow will be less in case of current expenditure by the government and more in case of capital expenditure because the latter has a higher fiscal multiplier.

It follows from the foregoing discussion that a given volume of capital spending by the government is much more effective than the same volume of current expenditure for generating additional income as well as for generating additional revenue. The preceding observations also enable us to confirm that it is possible to achieve fiscal consolidation without compromising growth. The required strategy is to progressively reduce the fiscal deficit and, at the same time, shift public expenditure away from current expenditure in favour of capital expenditure.

In setting the target for fiscal consolidation, the 13th Finance Commission proposed that the public debt to GDP ratio should be brought down to less than 68 per cent by 2014-15, a target which the finance ministry has adopted in the current budget. Recent analysis at the National Institute of Public Finance and Policy suggests that this target can be achieved by bringing down the combined fiscal deficit of the central government and all the state governments to about 3 per cent each, i.e. a total deficit of 6 per cent. If at the same time the pattern of public expenditure is gradually shifted in favour of capital expenditure, eliminating the revenue account deficit altogether by 2014-15, this would yield an average medium-term growth path of around 9 per cent.

But can the revenue deficits be eliminated by 2014-15? A part of the revenue expenditure of the central government consists of transfers to the states for items of capital expenditure, and this accounting procedure needs rationalisation. A committee

chaired by C Rangarajan is looking into this. That apart, it is not easy to compress revenue expenditure because a large part of it is committed such as interest payments on public debt and the wages and salaries of government employees, including large numbers of teachers, health workers, postal workers, security forces, armed forces, etc.

However, there is room for compression of the large number of subsidies, especially some major subsidies. The subsidy on food cannot be reduced because that would run counter to the inclusive agenda of the government, though much can be done to clean up the PDS and eliminate leakages. Other major subsidies such as on fertilisers and oil and petroleum products are a different story. The main beneficiaries here are not poor households, and the government has already started rolling back these subsidies. The focus of expenditure compression needs to be sustained in this direction.

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