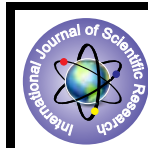


An Assessment of Fiscal Imbalance Position of the Central Government of India



Economics

KEYWORDS : Fiscal Imbalance, Fiscal, Primary, and Revenue Deficits, Public Debt,

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ABSTRACT

In the presence of sharp fiscal deterioration at central government, fiscal imbalance position assumes a critical importance in the overall macroeconomic framework in India. This paper analyses the Indian experience with fiscal imbalance position of the central government during 1970-71 to 2012-13. The main focus is on the growth and pattern of the different measures of the deficit and debt and principal causes of high fiscal imbalance position of the central government of India. Study concluded that gross primary deficit was the main culprit for the economic crisis of 1991 but in the post-reform period, revenue and fiscal deficit have become the main culprits for most of the years. On the other hand public debt as percent of GDP has increased continuously through the study period. Increase in subsidies, interest payments and defence expenditure were the principal causes for the high fiscal imbalance position of India.

1. Introduction

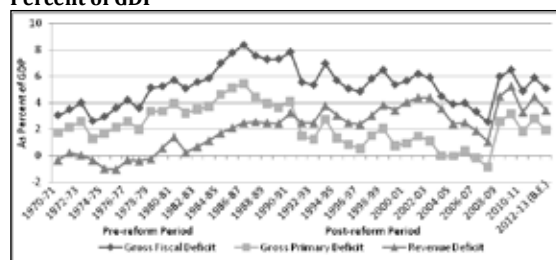
Fiscal imbalance continues to be the most frequently debated problem among academicians and policy makers in India. As against most develop countries, in India ordinary citizens, investors and corporate bodies look at the tax rates (income tax, corporate tax etc.) and on the other hand economists and academia look at the budget and fiscal deficits (Srivyal and Venkata, 2004). The fiscal imbalance situation of the central government represented by the three major deficit indicators fiscal, primary and revenue deficit. Further, there is no single "correct" or "standard" measure of deficit in India. The existence of different number of measures is explained by the fact that each measure has analytical and policy relevance. As the World Development report (1989) of the World Bank says, the choice of the correct measures depends upon the purpose of analysis. The following sections examine the growth and pattern of deficit and debt and principal causes of high fiscal imbalance position of the central government of India.

2. Growth and Pattern of Deficit of the Central Government

The fiscal imbalance situation of the central government represented by the various deficit indicators has worsened since the mid-1980s. Figure 1 reveals the overall picture regarding gross fiscal, gross primary and revenue deficit as percent of GDP of the central government. India has been facing gross fiscal and gross primary deficits since 1970-71 and revenue deficit since 1979-80. The latter half of the 1980s saw gross fiscal deficit in the range of 7-8 percent of GDP and gross primary deficit and revenue deficit in the range of 4-5 percent of GDP and 2-3 percent of GDP, respectively. As percent of GDP, gross fiscal deficit was 7.84 percent, gross primary deficit 4.06 percent and revenue deficit was 3.26 percent during 1990-91. Fiscal consolidation was hence a major focus of the reform process introduced in 1991-92. The 1990s have also seen varied performance in the deficit indicators, gross fiscal deficit declined by more than 2 percent of GDP during 1991-92.

The period 1991-92 to 1996-97 with the exception of 1993-94 has seen a decline in the fiscal deficit due to a combination of factors like an increase in revenues coupled with a reduction in expenditure and other deficit indicators as a percentage of GDP. From 1997-98, expenditure started rising once again and by the year 2001-02, all the major deficit indicators, viz. revenue deficit, fiscal deficit and primary deficit rose to the levels higher than those prevalent at the beginning of the reform process.

Figure 1: Deficit Indicators of the Central Government as Percent of GDP



Note: Negative (-) values indicates surplus.

Source: Data Compiled and Computed from Handbook of Statistics on Indian Economy, Reserve Bank of India, 2011-12.

With Fiscal Responsibility and Budget Management Act (FRBM Act), 2003 in place since 2003-04, not only the gross fiscal deficit as percent of GDP declined, but a commensurate decline in the revenue deficit was also noticed which indicated an improvement in the quality of deficit. This fiscal correction in the central government since 2003-04 has been achieved on the strength of higher revenues. However the success in containing or maintaining expenditure has been limited.

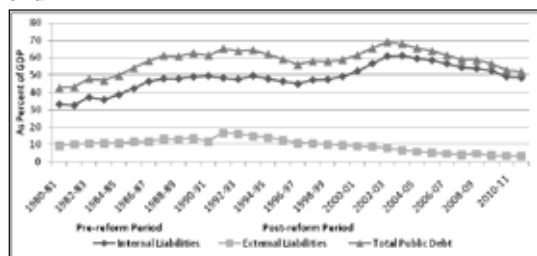
It is also clear from Figure 1 that in spite of efforts to bridge the gap between revenue and expenditure, the central government has faced fiscal deficit throughout the study period. Gross primary deficit increased till 1990-91 and declined till 2008-09, but after that it again started rising. Revenue deficit which was negative till 1978-79 showed growing trend after that. India's fiscal situation improved significantly after the adoption of FRBM targets by the successive government since 2003-04 until the global crisis hit the Indian economy in 2008-09. The measures taken by the government to counter the effects of the global meltdown on the Indian economy have resulted in a shortfall in revenues and substantial increase in government expenditure, leading to deviation from the fiscal consolidation path mandated under FRBM Act. Conclusively, all the three indicators of the central government have shown deficits during three decades of 1980s, 1990s and 2000s. After the reform process, the position improved only for a few years, but it again worsened in mid 1990s except some signs of improvement since 2001-02 after the enactment of FRBM Act.

3. Growth and Pattern of Public Debt of the Central Government

Figure 2 shows public debt of the central government as a percent of GDP. Public debt of the central government, comprising of internal liabilities and external liabilities, continuously increased during the eighties. Public debt formed about 42.60 percent of GDP in 1980-81 and increased to over 61.33 percent of GDP in 1990-91. This growth of public debt has led to a substantial increase in gross interest payments (Economic Survey, 1990-91).

The fiscal reform measures adopted in 1991 such as absorption of Government of India dated rupee securities, longer treasury bills and introduction of auctions of repurchase agreements (REPOS) of dated securities aimed at reducing the central government's fiscal deficit. These measures curtailed the rising trend in debt-GDP ratio from 65.28 percent of GDP in 1991-92 to 55.93 percent of GDP in 1996-97. This declined in debt-GDP ratio was also due to the reduction in total expenditure to GDP ratio. From 1997-98, expenditure started rising once again, and by the year 2001-02, public debt-GDP ratio rose to the level higher than those prevalent at the beginning of the reform process (Report on Currency and Finance, 2001-02).

Figure 2: Public Debt of the Central Government as Percent of GDP



Source: Data Compiled and Computed from Handbook of Statistics on Indian Economy, Reserve Bank of India, 2011-12.

During 1997-98 to 1999-2000, debt-GDP ratio was around half of GDP. By this time, the definition of the National Small Saving Fund (NSSF) changed (Srivastava, 2005). But even after the change in definition, it rose to about 52.81 percent in 2010-11. This increase in the debt-GDP ratio witnessed since 1999-2000 was mainly on account of increase in the internal liabilities of the central government (Economic Survey, 2003-04). The increasing trend in government public debt as a GDP ratio was a matter of serious concern because of the associated pre-emption of resources from the private sector (Economic Survey, 2003-04).

Looking at the internal liabilities as percent of GDP, these registered a sharp increase in the pre-reform period from one-fourth in mid-1980s to nearly half of the GDP in 1990-91. This occurred due to a combination of revenue deficits and poor returns on assets financed by capital receipts (Economic Survey, 1992-93). This development resulted in the higher interest rate, crowding out of interest-sensitive investments in the short-run and lowering of the growth rate of the economy (Singh, 2008). During the post-reform period, internal liabilities as percent of GDP declined marginally from 49.69 percent in 1990-91 for two years of 1991-92 and 1992-93 but since 1997-98 it has been continuously growing and reached around 60 percent during 2000s. It is only recently that it has declined to 47.71 percent of GDP in 2012-13 (B.E.). The reason for increase in internal liabilities was mainly due to continuously increase in internal debt.

External Debt as a ratio of GDP started increasing in the late eighties. As a Percent of GDP, it increased from 9.27 percent in 1980-81 to 13.54 percent of GDP in 1989-90 and further to 16.75 percent in 1991-92. In the post-reform period, it reduced from 16.07 percent in 1992-93 to 9.57 percent in 1999-00. This was mainly due to the devaluation of rupee. Since then, external debt declined continuously and reached to 4.68 percent in 2006-07. It again started decreasing and reached the level of 3.31 percent of GDP in 2011-12 (R.E.).

4. Principal Causes of Fiscal Imbalance of the Central Government

The main factors responsible for the high fiscal imbalance in India are increase in subsidies, payment of interest and increase in defence expenditure.

a) Increase in Subsidies

The Indian Government, since independence has been subsidiz-

ing many industries and products, from gasoline to food, loss-making state- owned enterprises. Hence the subsidies of the central government have been continuously increasing since 1970-71. There was a rapid increase in the subsidies related expenditure of the central government in the pre-reform period. The core reason behind the increase the subsidies bill of the central government was the sharp increase in the volume of food subsidies. Immediately after implementation of the reform in 1991 subsidies started declining for some years but again stated growing in the latter half of 2000s. The main reason behind the growing subsidies of the central government during latter half of the 2000s, especially in the in years 2008-08 was global financial crisis.

b) Payment of Interest

In India public debt of the central government has increased considerably over the years. This has resulted in increased interest burden on the central government. This was due to the increasing relying on borrowed funds to meet the expenditure commitments (Economic Survey, 1986-87). Continued dependence on borrowing for financing the major portion of the gap in resources has resulted in a significant increase in the interest payments (Economic Survey, 1990-91). Further, there has been a considerable increase in the growth of the interest payments during post-reform period. Due to such an increase of interest payments, the country faced a fiscal crisis during post-reform period. However, during post-reform period, especially after 2004-05 interest payments started declining.

c) Increase in Defence Expenditure

There has been an enormous increase in defence expenditure in India during the planning period. The core reasons behind the increasing number of defence expenditure in India is due to modernization of defence equipments used by army, navy and air force. Further, with the growth of the economy, the security gets an important role. Thus we can find enormous increase in defence expenditure in India as the government has limited scope to reduce defence budget due to security reasons. As percent of GDP the defence expenditure of the central government, hovered around 2 to 3 percent of GDP during pre-reform period. Defence expenditure as percent of GDP was 2.59 percent in 1970-71, which increased to 2.71 percent (by 0.12 percent points) in 1990-91. During post-reform period defence expenditure of the central government, hovered around 1 to 2 percent of GDP.

Except this principal causes, there were some other factors which are also responsible for the fiscal crisis in India. They are:

- (a) First factor is poor performance of public sector. The poor performance of public sector in India due to various reasons such as political inference, inefficiency and corruption of management, low labour efficiency, lack of professionalism, surplus staff, etc. Due to poor performance of public sector, the government gets low revenue by way of dividend from public sector units.
- (b) Tax evasion is second factor responsible for the fiscal crisis in India. Indian tax system is made up of complex procedures with numerous exemptions.
- (c) Corruption is rampant at all levels, which also leads to increase in the fiscal imbalance of the central government in India.
- (d) Weak revenue mobilization is another cause of high fiscal imbalance. The revenue receipts of the centre, consisting of tax revenue, net of state's share and non-tax revenue has increased at slower rate than that of growth in expenditure which also lead to increase in fiscal imbalance position of the central government of India.

5. Conclusion

Conclusively, Gross primary deficit was very high in the pre-reform period. This showed that gross primary deficit was the main culprit for the economic crisis of 1991 but in the post-reform period, revenue and fiscal deficit have become the main culprits for most of the years. On the other hand, public debt of the central government, as percent of GDP, has increased

continuously throughout the study period. This shows that fiscal measures adopted by the central government in 1991 could not help much to curtail the rising trend of its debt-GDP ratio. As percent of GDP, internal liabilities registered sharp increase since 1980-81 and external debt declined continuously. While analyzing the root causes of fiscal imbalance of the central government it was found that increase in subsidies, interest payments and defence expenditure were the principal causes for the high fiscal imbalance position of the Indian economy. The burden on government can only be reduced by decreasing expenditure in subsidies, interest payments and defence expenditure.

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