South Asia

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Empty promises darken outlook for India's fiscal deficit

By Kunal Kumar Kundu

BANGALORE - India's current account deficit is arguably on the mend now. The same cannot be said about the country's fiscal deficit. The government, though, seems to believe otherwise as it reiterated its borrowing plan for the current financial year, which ends in March 2014.

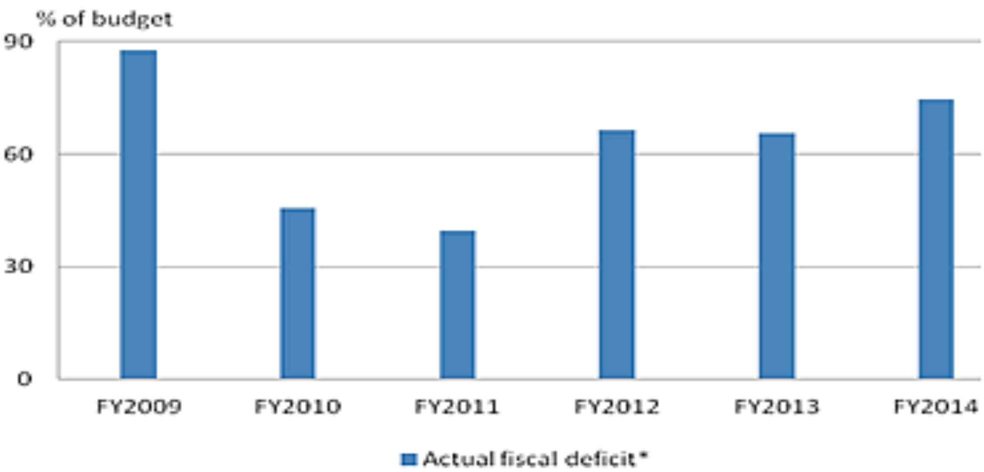
The government said it will stick to its overall borrowing target for the fiscal year of 5.79 trillion rupees (US$93 billion) as it announced plans to borrow 2.35 trillion rupees during the second half. What this means is that the government believes that it will be able to stick to its overall fiscal deficit target for year.

This is unlikely to materialize given that India is facing pressure on two fronts - slowing revenue as a result of weak economic growth and an increasing burden on expenditure as social sector spending rises, given that India will be entering the home stretch for the forthcoming general election to be held during spring of 2014.

When India presented the financial budget for the 12 months to March 2014, nominal gross domestic product (GDP) growth was assumed at 13.4%. Given expectation of inflation at around 6.7%, this meant that the expected real GDP growth rate was 6.7%.

Following a sharp slowdown thereafter (first quarter growth rate came in at a mere 4.4%, a 17-quarter low, the latest estimate by the Prime Minister's Economic Advisory Council (PMEAC) pegs the real GDP growth expectation for the year at 5.3%. Even this is unlikely to materialize as growth for the year will likely come in at 4.8%. Yet, the government expects the deficit for the year to remain unchanged.

However, subsequent released data show that there's trouble on the horizon. According to the data from the Controller General of Accounts, India's fiscal deficit during the first five months of the current year was as high as 74.6% of the target, compared to 65.7% last year and the highest in five years.

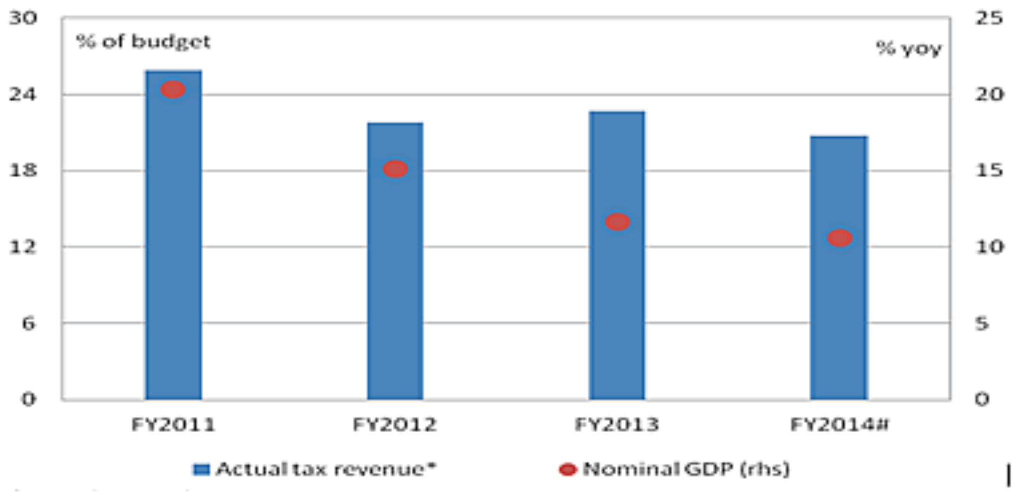


** - For the period Apr-Aug. Source: Controller General of Accounts*

Interestingly, expenditure (as a percentage of budget) during this period was a mere 2 percentage points higher compared to what it was in the previous year, while the fiscal deficit (as a percentage of budget) was higher by nearly 9 percentage points. Clearly the government cannot claim front-loading of expenditure to justify the overshooting of the deficit.

The sharp rise in the deficit can be attributed to slowdown in tax revenue collection. India's advanced tax collection data for the first half of the current year shows an increase in collection of a mere 9% from the same period in the previous year. This compares poorly with the government's budget expectation of a 21.16% increase in tax revenue for the year.

During the previous year (2012-13), while the government budgeted for a 24.5% collection increase, actual tax revenue rose by only 16% as real GDP growth slipped to a mere 5%, a decadal low. Even for the current year, tax revenue will come in on the the downside.

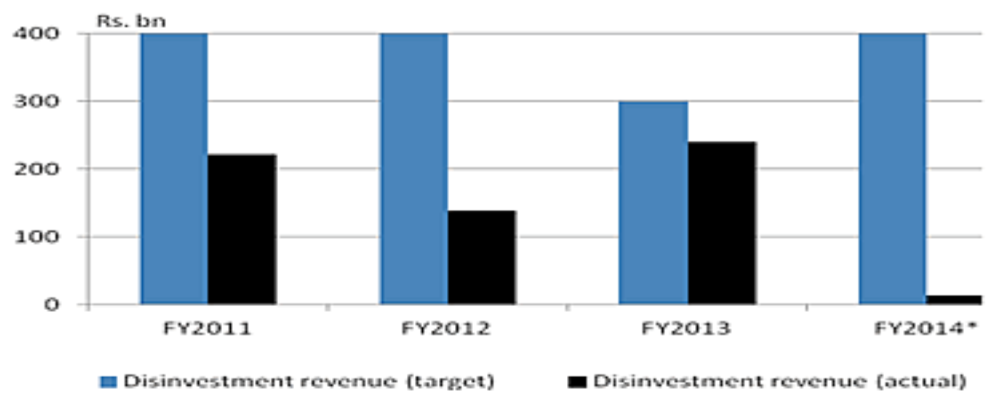


** - For the period Apr-Aug. # - Expected Source: CGA, Reserve Bank of India*

One can also expect a similar under-performance on the non-tax revenue front.

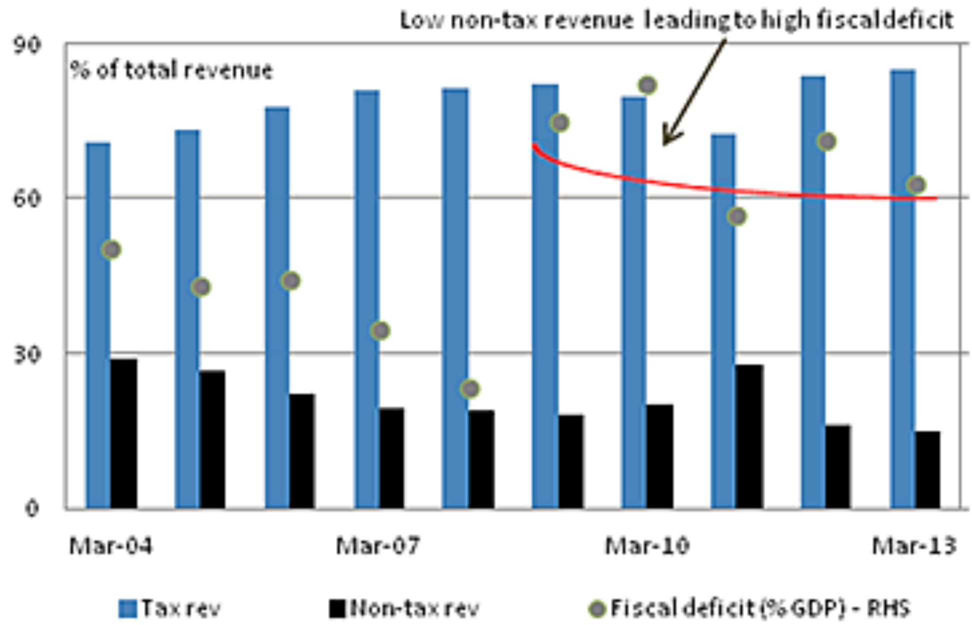
During 2012-13, non-tax revenue (an important component of which is revenue earned by the government by selling stakes in public sector enterprises) grew by a mere 6.6%, against the budget estimate of a 35.3% increase. In fact, as against the budget expectation of disinvestment revenue of 300 billion rupees, the government ended up with a final collection of 240 billion rupees, and that by forcing state-owned enterprises such as State Bank of India and Life Insurance Corporation of India to bail it out when there was hardly any taker for its share offerings.

For the current year, the government expects non-tax revenue to increase by as much 32.8%, of which the disinvestment revenue is expected to be to the tune 400 billion rupees. However, over the first six months, the government could garner a mere 13.25 billion rupees on this account.



** - For the period Apr-Sep. Source: Ministry of Disinvestment*

The problem is, the government is increasingly reliant on multiple sources of non-recurrent non-tax revenue - such as selling government's stake in state-owned enterprises and auctioning off natural resources like coal blocks, and telecom airwaves) to meet the recurrent expenditures of their various programs. Hence, whenever non-tax revenue fails to keep pace, the deficit bloats further.



Source: CGA, author's calculation.

Meanwhile, expenditure is unlikely to remain contained. For a country that is hugely dependent on imported energy, India is clearly in an unenviable position.

During 2012-13, India's net import of oil was as much as US$109.03 billion, more than half of the country's $191.9 billion trade deficit and accounting for about 80% of the country's oil needs. According to BP Statistical Review of World Energy, Indian energy use rose 5.1% during the year to March 2013 (equivalent to 563.5 million tons of oil), despite economic growth falling to 5%.

Given the highly inelastic nature of India's oil imports, a weakening rupee will add to the burden of import costs. During 2012-13, the rupee averaged about 54.47 to the US dollar. So far this fiscal year it has averaged 59.85 (April 2013 to September 2013) - a depreciation of nearly 10% - and it is expected to weaken even further.

Moreover, when India's oil subsidy budget was arrived at, the assumed price of a basket of imported crude was pegged at $104 per barrel. However, it recently peaked at $114 per barrel and is currently at around $106.7 per barrel.

This will increase India's oil subsidy burden drastically. According to the government's Petroleum Planning and Analysis Cell, total under-recovery (selling certain petroleum products at government-controlled rates) by India's oil marketing companies during April to June 2013 was 255.8 billion rupees, of which diesel accounts for a shortfall of 105.5 billion rupees.

At current rates, the total under-recovery for the full year is likely to be between 1.450 trillion and 1.5 trillion rupees unless the government raises the price of diesel substantially.

For the fairly long time now, the government has been assuring the market that it would raise the domestic retail price of diesel by as much as 5 rupees per liter to reduce the extent of under-recovery. However, the expectations have been belied, as the government finally decided not to go ahead with the rate increase, being forced to give in to political compulsions with a view to the general election due early in 2014.

Apart from this, the government is now planning to recapitalize the state-owned banks by infusing a much higher level of capital (given rising levels of bad loans) than was envisaged in the budget.

How all of these expenses will be funded - that too, when there is immense revenue pressure - remains a question. Finance Minister P Chidambaram maintains that he will stick to his deficit target by ensuring a 200 billion rupee cut in non-plan expenditure. This however, is as good as ruled out given the looming election.

Therefore, the only way the target can be met is by forcing the oil companies to bear the subsidy burden virtually in its entirety and/or drastically cutting down on planned capital expenditure. Either way, the economy will have to bear the severe consequences of a contraction in expenditure unless the government gets serious about managing its finances by reducing wasteful expenditure.

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