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India's Roadmap to Nowhere

By Kunal Kumar Kundu

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There's no way the government can reduce its expenditure before the polls in early 2014, writes Kunal Kumar Kundu.

India's latest fiscal deficit numbers, released Wednesday, showed that the government's focus on austerity measures is having some impact.

The cumulative deficit for the first six months of the year beginning April 1 was lower than the cumulative deficit over the first five months.

The good news, however, ends there.

The deficit during the first half of fiscal year 2012-13, through September, was still 65.6% of the budget, just slightly lower than the 68% deficit recorded for the same period in 2011-12, the year India's fiscal deficit shot up to 5.8% of gross domestic product. More importantly, the revenue deficit – revenue receipts less revenue expenditure – accounts for close to 80% of the total fiscal deficit.

This means the government spends nearly four fifths of its borrowing on housekeeping expenses, such as salaries, interest and subsidies, leaving only about one fifth for capital projects, which are desperately needed and could potentially generate revenue.

Clearly, putting the government's finances in order ought to be the first and most important priority of the finance minister. With this avowed objective, P. Chidambaram unveiled his roadmap for fiscal consolidation on Oct. 29.

The government said it hopes to contain the fiscal deficit of the central government during 2012-13 to 5.3% of GDP compared with the estimated 5.1% in the budget. Next year, the deficit is expected to be reduced by 0.5 percentage point and by 0.6 percentage point every subsequent year till it touches 3% of GDP by 2016-17.

Timing it perfectly — just a day before the Reserve Bank of India was to unveil its monetary policy – the release seemed to be a desperate effort to nudge the RBI into action. The RBI in the past has called for the government to contain the deficit before it can aggressively reduce interest rates. This seemed to be a bid to show that the government is on the case, so the central bank can act.

Not surprisingly, the RBI didn't act. It clearly prefers to await the evidence than pay heed to over-optimistic statements.

Mr. Chidambaram's move also could be construed as another round of signaling to global credit rating agencies that India is serious about addressing their concerns as they consider downgrading the country's sovereign rating to junk status.

But, in fact, all the announcement did was to give us a sense of déjà vu: This was not the first time that Mr. Chidambaram as finance minister had officially made such an attempt.

In a previous stint in the job, in 2004, he took the grand stand of announcing the Fiscal Responsibility and Budget Management Act, which sought to reduce the revenue deficit to zero and the fiscal deficit to 3% of GDP within five years. But the government soon realized that it had gone too far and had to engage in some creative accounting to make the numbers add up. So it pushed certain expenditures off its balance sheet.

The result? The issuance of oil bonds, fertilizer bonds, and suchlike instead of granting direct subsidies. The obvious reason to issue bonds instead of paying in cash is that there is no immediate cash outflow for the government. The not-so-obvious reason is that the bonds are kept off the government's financial statements.

In other words, they are not reflected in the fiscal deficit. So the government was able to show a combined deficit (of the central and state governments) of 4.09% by 2007-08. In reality, without its accounting juggling act, the deficit would have been much higher.

The International Monetary Fund, which includes all such items that otherwise are excluded, said India's general government deficit in calendar year 2008 was 8.7% of GDP and it rose to 10% of GDP by 2009.

By 2009-10, the government stopped issuing oil bonds and direct cash subsidies were made to the oil marketing companies. Partially subsidizing oil companies' under-recoveries (selling oil at prices lower than the cost of production) while forcing them to share the burden was, essentially, another way of under-reporting the actual deficit.

Moreover, the finance minister oversaw India's rather disturbing trip downhill toward fiscal profligacy when he used the global financial meltdown as a reason to disown his own promise of sticking to FRBM Act. At the same time, the government's financial commitments increased dramatically.

The Sixth Pay Commission, which increased salaries for public-sector employees, permanently damaged India's finances as expenditure continued to climb without adequate sources of matching revenue.

Then there was the increasing financial burden of the National Rural Employment Guarantee Scheme, which enabled the Congress party-led United Progressive Alliance government to retain power in the 2009 elections. With increased focus on social sector spending, all semblance of fiscal consolidation went out of the window.

Now the finance minister has unveiled his new plan, which is steeped more in hope than reality. Not surprisingly, Mr. Chidambaram focused a lot on one-time revenue generation such as disinvestment of stakes in government companies and the auction of second-generation telephone spectrum (after the allotment fiasco before.) With seven months of this financial year already over, it is highly doubtful that the government will succeed in meeting its financial goals in these areas.

Even if it does, what about next year? Assuming that all the one-time revenue gains occur this year, the government expects the deficit to be to be 5.3% of GDP.

How can it expect to reduce that to 4.8% next year when such one-off revenue streams might not materialize?

The fine print isn't available as of now. No doubt the devil will be in the details. An important question here is the assumed GDP growth rates. If they are the same as in the Planning Commission's five-year plan, this roadmap goes nowhere but a dead end.

The finance minister said the government will accept the recommendations of the Kelkar committee that studied public finances. Readers would do well to remember that this same government rejected the committee's recommendations about a month back by stating that, given its social considerations, it cannot adhere to the committee's proposed timeline of subsidy reduction.

Can it now promise that it can? Highly unlikely, given that the nation is expected to return to the polls in early 2014 and there's no way the government can reduce its expenditure before that.

On the contrary, the new Food Security Bill is a legislative certainty. The government believes it will do for its electoral fortunes this time what it credits the rural employment program for doing last time. That will be a costly new measure for the government to fund.

With expenditure slated to go up, revenue increases uncertain and hardly any source of additional one-time revenue available, the fiscal consolidation path will need to be re-laid, unless it is abandoned altogether — like many such previous efforts.

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