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Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

India Budget 2017: Fighting High Public Debt

The latest Indian Budget draws attention to the persistence of structural imbalance between revenue and expenditure that forces the Government to resort to borrowings. The imbalance must be corrected for achieving a sustainable public debt. This paper discusses the structural imbalance, the vicious cycle of public debt, challenges in achieving a sustainable debt path and the prospects for reducing public debt.

Amitendu Palit[1]

The Indian Budget presented on 1 February, 2017, highlights the challenge of managing India's public finances that would become more complex over time. The challenge is in mobilizing adequate resources for maintaining expenditure while ensuring that public debt doesn't become unsustainable.

Revenue-Expenditure Imbalance

India runs deficit budgets with the revenues mobilized being insufficient for managing the expenditures of the central government. These expenditures are categorized in revenue and capital expenditures. The former includes expenditure for running day-to-

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[1] Dr Amitendu Palit is Senior Research Fellow and Research Lead (Trade and Economic Policy) at the Institute of South Asian Studies (ISAS) in the National University of Singapore (NUS). He can be reached at isasap@nus.edu.sg. The author bears responsibility for the facts cited and opinions expressed in this paper.

day functions of central government ministries and departments along with expenditures that are essential such as interest payments on government borrowings, defence and subsidies. While revenue expenditure does not create any new assets, capital expenditure is devoted to creating or acquiring new assets such as acquiring land, building roads and providing various public goods through new infrastructure. Insufficient revenues for meeting the revenue and capital expenditures force the government to borrow. In the latest Budget, 19 per cent of total funds are to be mobilized from borrowing, whereas in the previous Budget the corresponding proportion was 21 per cent.[2]

For several years, particularly since the introduction of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003 and the FRBM rules from 2004, central governments in India have tried to increase revenues and reduce expenditure for bringing down government borrowings and public debt. But it hasn't been easy to do so. Raising more revenues from taxes has been particularly challenging. High income tax rates tend to encourage tax evasion. The effort of successive governments, therefore, has been to broaden the tax base by bringing more people into the tax net while keeping rates low. Broadening the tax base too hasn't been easy given the political difficulties involved in taxing income from agriculture and the informal character of the Indian economy that prevents many income-generating activities from being tracked and tapped by the tax administration network.

The current government has focused hard on 'formalizing' the economy for unearthing untaxed income and wealth that can boost revenues. The demonetization of the Indian currency on 8 November, 2016, was a major step in this regard. The Budget maintains the emphasis on increasing tax revenues by broadening the tax base and ensuring greater tax compliance by removing exemptions and reducing tax rates.

Enhancing tax collections is a gradual process. According to the revised estimates of the current Budget, India's gross tax-GDP ratio for 2016-17 is 11.3 per cent, which reflects a welcome departure from the stagnancy in the ratio at around 10 per cent for

[2] 'Budget at a glance', page 2; http://indiabudget.nic.in/ub2017-18/bag/bag1.pdf Accessed on February 10, 2017.

several years.[3] Nonetheless, it will be a long time before India is able to raise its tax-GDP ratio close to that of the OECD countries.[4]

The other major challenge in improving fiscal discipline has been controlling government expenditure. There are some areas where the government's ability to cut expenditure is severely limited. These include 'committed' revenue expenditure on defence and various subsidies. India's security concerns, particularly those emanating from difficult relations with immediate neighbours, constrain possibilities of sizeable reductions in defence expenditure. Among subsidies, considerable success has been achieved over the last few years in reducing subsidies on petroleum products such as petrol, aviation turbine fuel (ATF), diesel and cooking gas. But much less success has been achieved in rationalizing food and fertilizer subsidies. This is largely due to the seasonal vulnerability of food producers to cropping cycles and the need to support farmers in distress by government procurement of food grain. As a result, expenditure on defence and subsidies continues to be significant. Between the previous Budget and the current one, the combined expenditure on defence and subsidies has reduced only marginally from 20 per cent to 19 per cent of total expenditure.[5]

Public Debt: The Vicious Cycle

The inability to compress expenditure and the recourse to borrowing creates a vicious cycle where payment of interest on borrowing keeps adding to expenditure. This is evident from interest payments on previous borrowings comprising a significant part of total expenditure. For the current Budget, interest payments account for 18 per cent of total expenditure, which is a marginal reduction from 19 per cent in the previous Budget.[6] Reduction of interest payments is not possible unless borrowings reduce, and

3 'Fiscal Policy Strategy Statement', Page 17, Para 6. http://indiabudget.nic.in/ub2017-18/frbm/frbm3.pdf Accessed on February 10, 2017

4 'India needs to push up tax-GDP ratio; spend on health, education: Economic Survey', The Times of India, February 26, 2016. http://timesofindia.indiatimes.com/budget-2016/economic-survey/India-needs-to-push-up-tax-GDP-ratio-spend-on-health-education-Economic-Survey/articleshow/51153561.cms Accessed on February 10, 2017.

5 As in 2 earlier. Page 3.

6 Ibid.

borrowings cannot come down unless a substantial part of government expenditure is reduced or there is a substantial increase in revenues.

The complexity of the problem is clear from the compulsions of the government in maintaining 'committed' expenditures on defence and subsidies. On top of these expenditures, a large part of the revenues of the Central Government are passed on to states. The 14th Finance Commission had recommended increasing the share of states in tax revenue collected by the Centre to 42 per cent from 32 per cent. The higher share is visible in the expenditure profile of the Budgets for the last couple of years. As a proportion of total expenditure, resources transferred to states are at 24 per cent in the current Budget, compared with 22 per cent in the previous Budget.[7] Altogether, the expenditure on defence, subsidies, interest payments and transfer to states – areas where the possibilities of reducing expenditure are remote – amount to 61 per cent of total expenditure.

The difficulty of reducing these expenditures, along with the need to devote more funds to the creation of new assets and public goods through larger investments in infrastructure, has made the Government focus more on raising revenues by increasing the tax-GDP ratio, as opposed to curbing expenditure, as the main strategy for maintaining fiscal discipline.[8] Efforts to identify black money and ensuring tax compliance are essential elements of the strategy. Notwithstanding these efforts, India's public finance continues to suffer from a serious structural imbalance between revenue and expenditure.

It is in the context of the structural imbalance in India's public finance, the challenge of curbing public debt and deploying more resources for providing public goods, that the latest directions on debt management and fiscal sustainability from the Fiscal Responsibility and Budget Management (FRBM) review committee assume great significance. The Finance Minister in his Budget speech mentioned the directions.

"The FRBM Review Committee has given its report recently. The Committee has done an elaborate exercise and has recommended that *a sustainable debt path must be the principal macro-economic anchor of our fiscal policy* (emphasis added). The

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7 Ibid.
8 As in 3 earlier. Page 18, Para 13.

Committee has favoured Debt to GDP of 60% for the General Government by 2023, consisting of 40% for Central Government and 20% for State Governments".[9]

Challenges of Achieving a Sustainable Debt Path

The emphasis on a sustainable debt path has far-reaching implications for management of public finances in India.[10]

From the perspective of the Central Government, it indicates the importance of controlling borrowing and public debt. The Budget affirms the seriousness of the Government in bringing down public debt. As a proportion of GDP, the receipts from borrowing are estimated at 2.1 per cent in the current Budget compared with 2.9 per cent in the previous year. The debt-GDP ratio of the Central Government has been fluctuating in the last few years. After reaching a peak of 53.5 per cent in 2010-11, the ratio reduced to 46.8 per cent in 2014-15. The last two years – 2015-16 and 2016-17 – have produced debt-GDP ratios of 36.6 per cent and 39.5 per cent respectively. The current Budget estimates the ratio at an even lower 38.1 per cent.[11] While this ratio is within the threshold proposed by the FRBM Review Committee, it will be a challenge for future Budgets to contain the debt-GDP ratio within the Committee's threshold of 40 per cent.

The difficulty in controlling borrowings and keeping debt-GDP ratio in check is obvious. A large part of the expenditure in the Budget, as explained earlier, is of a 'committed' nature. Finance Ministers hardly have the flexibility in cutting these expenditures. Given these limitations, reduction in overall budgetary expenditure necessitates reduction in resources allocated to various development schemes. This is an eventuality that all Finance Ministers and Governments wish to avoid as it inhibits the ability of the Government to spend more on generating public goods. But stagnation in revenues and persistence of 'committed' expenditure coupled with the compulsion

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[9] 'Budget Speech 2017-18'; Page 26, Para 135; http://indiabudget.nic.in/ub2017-18/bs/bs.pdf Accessed on February 10, 2017.

[10] Experts at a Panel Discussion on the impact of the India Budget, organized by the ISAS at Singapore on February 7, 2017, discussed the issue at length.

[11] 'Debt and Deficit Statistics', Pages 4-5. http://indiabudget.nic.in/ub2017-18/bag/bag2.pdf Accessed on February 10, 2017.

of maintaining development expenditure leaves little option other than resorting to more borrowing.

The Outlook

The objective of maintaining a sustainable debt path must be met from both higher revenues and lower expenditure. As explained earlier, the Government's current emphasis in this respect is more on expanding revenues, particularly through income taxes, for augmenting the tax-GDP ratio. The emphasis needs to be maintained. But at the same time, it is also important to figure out ways for controlling expenditure. Lesser borrowings and lower debt-GDP ratios will reduce the burden of interest payments and reflect in lower revenue expenditure in the Budget. But this would be an excruciatingly slow process and would make substantive differences in expenditure outcomes only over a period of time. Therefore, it is also important to explore options for reducing expenditure elsewhere.

Areas of expenditure rationalization include food subsidies. Food subsidies continue to remain large and need to be carefully reviewed. Cheaper food imports can reduce budgetary outlays on subsidies to a large extent provided the government is prepared to handle the political implications of such decisions. Similarly, demand for government procurement of food grain at prices higher than market prices is often a result of political pressure exerted by powerful farming lobbies. It is essential to avoid these pressures in the interest of curbing public debt.

Finally, fiscal management and debt sustainability is not only the responsibility of the Central government. State governments in India have an equally important role to play in achieving a sustainable debt path. The 14th Finance Commission's recommendation has increased revenues for states by entitling them to a larger share of the taxes collected by the Centre. It is important for states to further improve revenues through innovative means. It is equally essential for them to control expenditure and reduce reliance on borrowings.

The FRBM review Committee has mandated the debt-GDP ratio of states to be limited to 20 per cent. India's combined (centre and states) debt-GDP ratio is around 67 per cent.[12] With the Central government's debt-GDP ratio to be kept within 40 per cent (the Centre has already brought down the ratio below 40 per cent in the current Budget), the debt-GDP ratio of states needs to come down from its current 27 per cent to 20 per cent. This requires a lot of work on the part of the states. Indeed, a sustainable debt path cannot be achieved without complementing debt reduction both by the Centre and States.

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[12] 'The one economic indicator from India that worries everyone from urjit Patel to ratings agencies', Quartz India, January 19, 2017; https://qz.com/887755/government-debt-the-one-economic-indicator-from-india-that-worries-everyone-from-rbi-governor-urjit-patel-to-ratings-agencies-sps-and-moodys/ Accessed on February 10, 2017.