Union Budget 2014-15

Creative Budgeting or Actual Deficit Reduction?

The case of FRBM Act

The FRBM Act was reflective of the shared commitment across political parties towards fiscal conservatism. A decade later, the picture, as reflected in the Union Budget, is yet to change for the better. And given the interests that the current Government represents, a real departure from the past may safely be ruled out.

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The Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act 2003)[1] was a creation of the NDA government and its notification was one of the first actions that the UPA I government took. Ten years ago this was reflective of the shared commitment of the two political formations to fiscal conservatism – that is, the maintenance of a low fiscal deficit along with a low tax rate policy by imposing restraints on the level of public expenditures. That the picture has not changed over the last decade is reflected by the fact that the main Union Budget for 2014-15 is almost a carbon copy of the interim budget presented in February this year by the previous government. Barring minor changes the rates of different taxes, the estimates of revenue receipts, the total budgeted level of expenditure and its allocation under different heads and the level of the fiscal deficit are as they were in the interim budget.

To put Budget 2014-15 into perspective, it is important to remember that it falls within the third phase of the post-FRBM history of budget making. The end of the first phase coincided with eruption of the global financial crisis in 2008. In this period the fiscal deficit was brought down in a situation of high GDP growth – mainly because the tax-GDP ratio increased as a result of not increases in rates but rapid increases in the incomes of the rich and of corporate profits. Some moderate levels of growth in public expenditure were still possible

[1] Editor's note: The objective of the Act was to ensure inter-generational equity in fiscal management, long run macroeconomic stability, better coordination between the government's fiscal and monetary policy and transparency in operations in public finance. The Government notified FRBM rules in July 2004 to specify the annual reduction targets for fiscal indicators.

under these circumstances; this could compensate for some of the effects of the very sharp increases in inequality that happened during that period.

Then followed the second phase of the post-crisis 'fiscal stimulus' package. This involved a combination of some limited stepping up of expenditure and major tax concessions which resulted in an increase in the fiscal deficit. From 2011-12 began the third phase in which began a concerted effort to bring the fiscal deficit down again by retreating from the stimulus. However, by that time the economy had also come into the grips of an economic slowdown. This not only hit revenues but also aborted the 'retreat' from the tax side of the stimulus package - the tax-GDP ratio instead of improving has, therefore, got stuck at a level far below that in 2007-08. Consequently the entire burden of reducing the fiscal deficit reamained on expenditures. The budget of 2014-15 follows in the same vein.

Fiscal conservatism by strapping the hands of the government limits its capacity to intervene and change a growth trajectory and the fundamental distribution of the benefits it gives rise to or to redistribute them. Compressing public expenditure in conditions of an economic slowdown has an added dimension – instead of stimulating economic activity it reinforces the slowdown. This in turn leads to a slow growth of revenues with given tax rates and a further squeeze on public expenditure to keep the deficit in check. In other words a vicious circle where slow economic growth, poor revenue generation and low levels of public expenditure act to strengthen each other. This is precisely what has been happening in the last three years as even relatively modest tax revenue targets have not been realized and expenditures have been eventually even lower than the relatively low budgeted levels.

The Union Budget 2014-15 continues in the same vein – despite the fact that the effects of deficient rainfall and a spike in oil prices are distinct possibilities. The budget has put the total expenditure for the coming year at a very modest level which will keep the Central Government expenditure to GDP ratio at under 14 per cent, below the level in 2007-08. Despite no additional measures to raise tax revenues (some further concessions in fact), they are expected to increase by a degree which is much too optimistic in current economic circumstances. The story of the actual expenditure level turning out to be even lower than budgeted to ensure that the deficit target is met may thus be repeated this year.

When expenditures are compressed not all heads are affected equally and often some of the most needed expenditures have to bear the brunt. That is precisely what has happened in India too in the current phase of fiscal consolidation as agriculture and rural development, subsidies, the social sector and capital expenditure have been the main targets of expenditure control.

The Union Budget 2014-15 is no exception. Since many of these heads have faced the axe in successive years, the scope for doing so further has progressively shrunk as this would run the risk of a severe political backlash. Since expenditure compression has touched such limits, even a government wanting to give more tax concessions would find it difficult to find the room for these given the commitment to checking the fiscal deficit.

It is this situation which explains why the Modi government's first budget disappointed those expecting a 'change' from the UPA policy in the form of big expenditure cuts and major tax concessions. The government perhaps felt it was not yet politically prepared to administer such a bitter pill on the populace. But one can be assured that the effort to create the conditions for it will be there swiftly. This is because the alternative way out of the present economic crisis, which would be a real departure from the past to a policy of expanding public expenditures and generating the taxes to finance them, is ruled out by the nature of the interests the Government represents.