Chapter 4

Macro perspective on fiscal consolidation

Chapter 3 has argued that in the 'baseline scenario', there is a need of a substantial fiscal correction in order to achieve compliance with the FRBM Act. This chapter brings macroeconomic perspectives to bear on the questions and major policy choices concerning the trajectory to the FRBM targets.

4.1 Policy alternatives

The broad goal of macroeconomic policy is to find the most effective trajectory through which the FRBM goals can be achieved. There are two main questions about the implementation of the fiscal correction which is required by the FRBM: (a) The question of an early or a late adjustment, and (b) The question of how adjustment should be shared between taxation and expenditure. In this chapter, we seek to bring economic principles to bear on these two key choices.

4.1.1 Early versus delayed adjustment

Figure 4.1 shows alternative paths for the revenue deficit. One thing is clear, that the revenue deficit has to go to zero at the end of 2008-09. There is room for flexibility when it comes to the intermediate years.

However, there are alternative trajectories which can achieve this. It is possible to have a 'front-loaded adjustment', which emphasises finishing the bulk of the required fiscal correction in the early one or two years. Alternatively, there can be a 'back-loaded adjustment', which emphasises achieving the bulk of the required fiscal correction in the late years.

In addition, there is an important distinction between front-loaded *policy reforms* and front-loaded *fiscal adjustment*. It is possible to conceive of policy decisions taken early in the adjustment period, which generate a sustained impact over the following years.

4.1.2 Cutting expenditure versus raising tax revenues

The second key question about the fiscal correction concerns the relative role of revenue expenditure and revenue receipts. Going by the requirement of the FRBM, by 2008-09, the revenue deficit has to be eliminated. However, in terms of adjustment, many alternative paths can be envisaged. For example:

1. The existing ratio of revenue receipts to GDP could stay unchanged, and expenditure could adjust downwards, so as to be equal to revenue

Figure 4.1 Alternative paths to elimination of the revenue deficit

receipts as per cent of GDP by 2008-09.

2. Alternatively, the adjustment of 3.6 percentage points could be shared in half between the two.

3. Alternatively, revenue expenditure could stay fixed as per cent of GDP, and the tax GDP ratio could rise by 3.6 percentage points by 2008-09.

4. Alternatively, we could actually have a rise in revenue expenditure as per cent of GDP. For example, revenue expenditure could rise from the present level of 13.17% of GDP to a level of 14.17% of GDP. This would require a rise of 4.6% of GDP on the part of revenue receipts.

4.2 Business-cycle considerations

Reducing expenditure or raising taxes, in the quest for the FRBM targets, can be contractionary. At the same time, one of the goals of fiscal policy is to be countercyclical. There is a need to reconcile these two objectives. This requires a closer appraisal of questions about the business cycle, and the impact of taxation or expenditure proposals in terms of the business cycle.

4.2.1 Closed economy multipliers

In the standard Keyenesian framework of a closed economy, raising government expenditure G or cutting tax revenues T have a 'multiplier effect', with the following multipliers:

$$\frac{\Delta Y}{\Delta G} = \frac{1}{1 - \text{MPC}}$$
$$\frac{\Delta Y}{\Delta T} = \frac{-\text{MPC}}{1 - \text{MPC}}$$

Here, ΔY is the change in GDP associated with a change of ΔG in government expenditure or ΔT in taxes. The size of both multipliers is related to the marginal propensity to consume (MPC). These 'multiplier effects' are most useful as a guide for understanding situations where there is excess capacity in the country, and recessionary conditions prevail.

Since the savings rate in India is high, when compared with most OECD countries, we expect that the multipliers in India would be correspondingly smaller.

We see that the expenditure multiplier is larger; that the contractionary effect of cutting expenditure is larger than the contractionary effect of raising taxes. This is an argument in favour of placing a larger share of the required fiscal adjustment upon the growth of revenue receipts.

We may note that FRBM targets could also be met while increasing expenditure, where it would be required that the Tax/GDP ratio rise by more than 3.6%. In this scenario, *raising* expenditure would have an expansionary effect, which would partly counteract the contractionary effects of raising the Tax/GDP ratio.

4.2.2 Attenuation of fiscal multipliers in an open economy

It is important to emphasise that the above relationships are for a closed economy. In an open economy, characterised by a combination of trade flows, capital flows, and a flexible exchange rate, these multipliers are considerably weakened.

When there is a domestic fiscal contraction in an open economy, the weakness in domestic demand is counteracted by a depreciation of the currency, which improves net exports and aggregate demand. Given the increasing openness of the Indian economy, the fiscal multipliers may be smaller, and fiscal consolidation may have a lesser impact on aggregate demand.

4.2.3 Where are we in the business cycle?

The timing of fiscal consolidation has to be closely interwoven with the domestic and international business cycle. For example, if India had embarked on a strong fiscal correction in 2001-02, the welfare consequences would have been highly negative.

As of early 2004-05, we appear to be standing at a relatively high point in the domestic and international business cycle. Business confidence is high. Investment demand has grown well, with imports of capital goods having grown by 31% in the period from April 2003 to February 2004, compared with the previous year. There is heightened interest in India as a destination for FDI, and in integrating India into global production chains for manufacturing and services.

In 2002 and early 2003, there were global fears of slow economic growth and deflation. However, the international business cycle has turned around, with a distinct pickup in growth in the US and Japan. Commodity prices are sharply on the upswing in 2004.

This environment constitutes an argument in favour of front-loading. As John F. Kennedy argued, *the time to fix the roof is when the sun is shining*. At this moment, the welfare costs of the fiscal adjustment will be the most muted. Furthermore, if India is able to obtain substantial progress in the fiscal adjustment in 2004-05 and 2005-06, then this will 'recharge the guns' of fiscal policy for possible use in countercyclical fiscal policy, which may be required if the domestic and the world business cycle turns around in the future.

The US is an important case study in this regard (Figure 4.2). The US achieved a dramatic fiscal consolidation in the years after 1992, at a time when the US economy was growing strongly. This created the fiscal space for countercyclical fiscal policy, in the form of the enormous tax cuts which were implemented in recent years in order to counteract the downswing of the business cycle. If the fiscal consolidation had not taken place in the US over 1992-2000, then it would not have been possible to use fiscal policy as a tool for tackling the recession of the following years.

4.2.4 Investment-led growth

In the mid 1990s, India experienced a boom in investment until 1995. After this, investment demand has been weak, except for the spurt in investment which was also observed in 1999-2000.

This has been a period of consolidation, where firms were improving efficiency, and optimally utilising existing capacity. Largely speaking, after 1995, growth in consumption played a prominent role in obtaining GDP growth.

This period of better utilising existing capacity now seems to be behind us, and the next wave of GDP growth in India is likely to be based on investment. Some evidence of an upsurge in investment is visible in the early months of 2004 for which data is available.

From the viewpoint of macro policy, our goal should be to best harness this cyclical revival of investment, to prolong the period of positive expectations and high investment rates, and to maximise the impact that these investments have upon GDP growth.

The fiscal reforms process needs to foster this process of investment-led growth, by establishing a non-distortionary and effective tax system to raise revenues, and by pursuing expenditure policies which yield an adequate quantity and quality of public goods.

4.3 Other considerations

4.3.1 Lags in policy

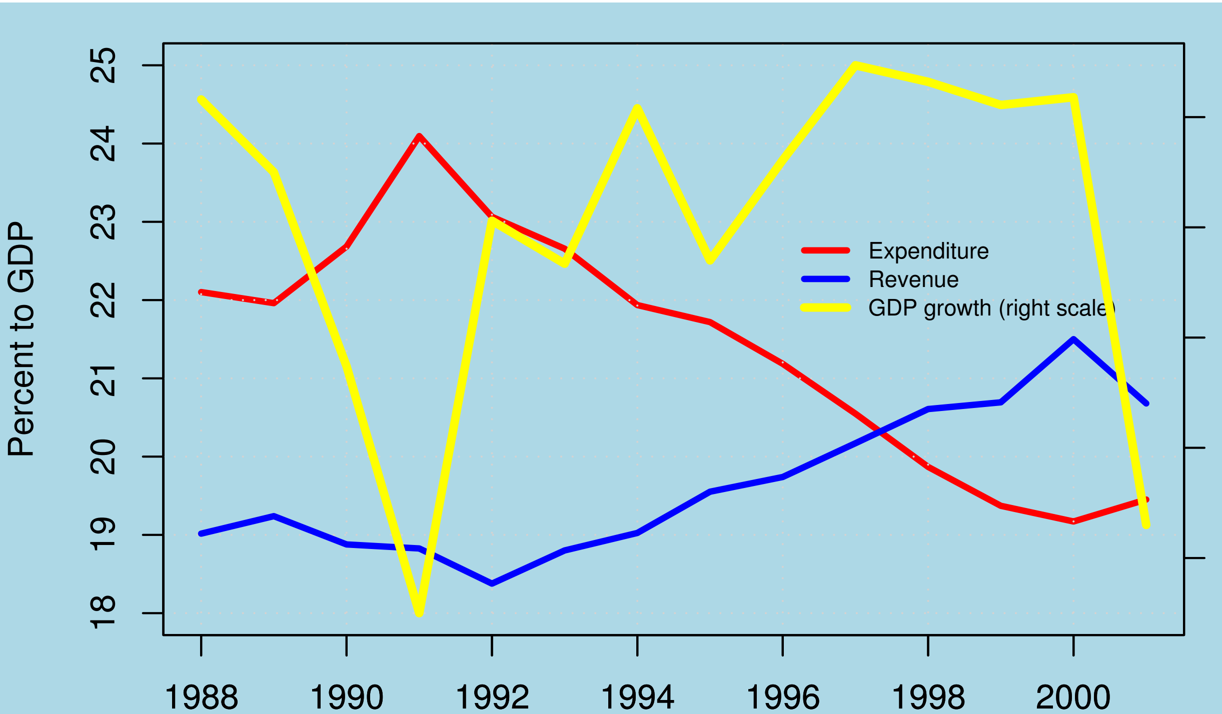
Fiscal consolidation is about reforms in revenues and reforms in expenditure. There is an innate time delay between decisions and their full impact upon the revenue deficit.

We may outline the sequence of events that might unfold. First, a new policy would be *adopted*. After this, there would be a time delay required for *implementation* in terms of processes and IT systems. There would then be a time delay for these systems to *stabilise*.

Finally, there are time delays before the full impact of new policies is seen in terms of *behavioural impact*. A central plank of tax reforms consists of finding strategies which give firms and households *incentives* to behave in a different way, and in a way that is compatible with a reduction in the revenue deficit. This would require some time to fall into place, as firms and households gradually shift away from traditional decision processes, which are rooted in a distortionary

Figure 4.2 Fiscal adjustment in the US in the 1990s

There are numerous international precedents of comparable adjustments taking place in a short time. One prominent example of a substantial fiscal adjustment was that of the United States in the 1990s, which is shown in the chart. A striking fact about this period was the acceleration of GDP growth that took place along with this fiscal consolidation. This phenomenon of 'expansionary fiscal consolidation' has also been experienced by many other countries which have embarked on fiscal consolidation.



fiscal system, and shift into new ways of thinking.

Through these channels, there will innately be some lag between policy *decisions* and their full impact on the revenue deficit. This constitutes an argument in favour of front-loading of *decisions*. At the same time, this suggests that while decisions should be front-loaded, their full impact should only be expected with a lag. The full impact of a decision on reforms in 2004-05 will only be seen in 2005-06, 2006-07 and beyond.

4.3.2 Flexibility on capital expenditure

It is important to emphasise that the focus of the FRBM is on ensuring that *revenue* receipts exceed *revenue* expenditure. FRBM does leave government with flexibility in engaging in capital expenditure.[1]

[1]Increased capital expenditures do impinge upon the calculations required by the FRBM, if they are financed by bond issuance. For example, if capital expenditure takes place in 2004-05 using bond issuance, then the interest payments on these bonds would serve to increase revenue expenditures from 2004-05 onwards, and would require a consequential increase in revenue receipts in order to ensure that the revenue deficit is eliminated by 2008-09.

Hence, if there are strong fears of the contractionary effects of increasing tax revenues, or cutting expenditures, then increasing capital expenditures remains available as a policy tool.

From a debt dynamics perspective, capital expenditures can be safely undertaken when future user charges and the incremental tax revenues from the increased future GDP (caused by the new capital goods) are large enough. In technical terms, government can confidently build a railway line costing Rs.1000 crore, financed by issuing a bond worth Rs.1000 crore, when the NPV of the increased tax revenues on the increased GDP in the future, coupled with the NPV of future user charges, exceeds Rs.1000 crore.

If this condition is not met, then capital expenditures which are financed by issuing bonds serve to raise the Debt/GDP ratio and are not fiscally sustainable. This difficulty poses significant constraints upon the ability of government to easily ramp up countercyclical capital expenses in a way that does not adversely affect debt dynamics.

This approach emphasises the need to acute care in the *institutional design* of the processes through which debt-financed capital expenditures are undertaken. This aspect also links up to the issue of lags in policy discussed in Section 4.3.1, since creating new institutional mechanisms to achieve high quality capital expenditure (in the sense sketched above) is difficult and time-consuming.

Table 4.1 summarises the experience with one successful experience of capital expenditure by the Centre: that of NHAI. The Union Budget for 1998-99 had provided for the fuel cess, and 1998-99 can be viewed as the first year of the highway-building effort. As the table shows, it was only in year 4 that the capital expenditure reached a level of roughly 0.2% of GDP, and in year 6 that it reached 0.33% of GDP.

Table 4.1 Buildup of capital expenditure of NHAI

		Capital expenditure	
	Year	(Rs. crore)	(Percent to GDP)
2	1999-00	746	0.04
3	2000-01	1,261	0.06
4	2001-02	3,997	0.18
5	2002-03	6,584	0.21
6	2003-04	9,525	0.33

This suggests that if there is an intent of engaging in countercyclical capital expenditures in the period 2007-2009, institutional mechanisms through which these will take place need to be created well ahead of time.

4.3.3 Expansionary effects of tax reforms

The above discussion has focused on the contractionary effects of the fiscal consolidation, and how this can be directly counteracted.

At the same time, there are many important channels through which fiscal consolidation is expansionary. In many countries, there have been experiences of ‘expansionary fiscal consolidation’, which underline the importance of these channels of influence.

In India’s case, the most important positive impact is rooted in tax reforms themselves. Tax rationalisation, removal of exemptions, and modernisation of tax administration will innately reduce deadweight costs, reduce the extent to which resource allocation is distorted in the quest for tax evasion, and thus raise productivity. These improvements can be viewed as positive productivity gains which will be caused by tax reforms. They will fuel GDP growth in the years that follow the tax reforms.

The second channel lies through interest rates and the bond market. To the extent that the fiscal deficit goes down, Government would make a smaller claim on resources through bond issuance. This would reduce the crowding out of the private sector, make greater resources available to the private sector, foster reduced interest rates and a lower cost of capital for equity and debt, and foster economic growth.

Tax reforms would give greater support to entrepreneurship, support relatively labour-intensive small and medium enterprises, and reduce the cost of capital for risk capital. Through these channels, resource allocation would be improved.

Credit rating agencies have focused on India's fiscal problems as the defining issue which has led to near-junk ratings for Indian debt.[2] When India is visibly seen as making progress on the fiscal question, India's credit rating would improve. This would reduce the cost of capital faced by firms when borrowing abroad, and thus further spur investment.

Domestic capital markets and business confidence would improve, when it is seen that Government is serious about establishing prudent ground rules.

Thus, there is a strong link between fiscal consolidation and an expansion of investment and thus employment in the economy. Conversely a failure to make progress on fiscal consolidation would lead to a continued preemption of investible resources, and lower job creation.

4.3.4 Positive impact on state finances

In the last decade, the finances of state governments have been facing extreme stress. This has manifested itself in poor production of local public goods, most of which are controlled at the state level. Weaknesses in health, education, water and sewage, local roads, etc. are all important problems which hold back GDP growth. There is an urgent need to improve expenditures on health and education.

At present, many state governments have signed *Memoranda of Understanding* which require elimination of the revenue deficit by 2005-06. The accomplishment of this target is a central issue that is shaping policies at the state level.

This constitutes a strong argument in favour of front loading. If the centre is able to improve the Tax/GDP ratio in 2004-05 and 2005-06, then roughly 30% of these increased proceeds will go to the state governments, where they will substantially alleviate the state fiscal crisis, help achieve the targets agreed to under *Memoranda of Understanding*, lead to improved production of local public goods and thus strengthen the development process at the grass-root level.

This constitutes one of the most important channels through which expenditures on health and education, which are state subjects, can be sharply increased in the near future.

[2]Using ratings by S&P, the median values for the central interest / revenues ratio for various rating categories were as follows: BBB (8.68%), BB (19.21%), B (16.68%). The median values for the central government Debt/GDP ratio for various rating categories were as follows: BBB (29.98%), BB (55.95%), B (70.8%). By S&P scales, investment grade runs from AAA till BBB-. Below that, starting from BB+, is speculative grade.

4.3.5 Need for pre-announced trajectory

Government is presently engaged in medium term fiscal planning, leading to a removal of the revenue deficit by 2008-09. These plans necessarily involve many actors, will be phased in over a period of years, and will have a considerable impact upon the optimising decisions of individuals and firms.

These decisions of economic actors will be best undertaken under conditions of fuller information, and sound expectations about the future. The changes in policy will undoubtedly affect the economy, but they will have the smallest effect if economic agents have sound expectations about the future, and are able to well anticipate the changes that are underway.

This suggests a need for good quality disclosure by government about the path to 2008-09, to ensure that there is full transparency about the path, and to minimise the shocks to the economy that come about from policy announcements.

4.4 Proposals

To summarise, there are a number of arguments favouring fiscal consolidation through higher tax revenues rather than reduction in expenditure:

- Raising tax revenues helps state finances through the devolution of resources, and thus fuels GDP growth through better resource flows into local public goods. In contrast, cutting central expenditure does not address the problem of local public goods.
- The expenditure multiplier is larger than the tax multiplier, hence the business cycle implications of cutting expenditures are more onerous than the business cycle implications of raising tax revenues.
- Tax reforms, which move towards a *simple* tax system, yield positive productivity gains: they eliminate deadweight costs and reduce distortions in resource allocation. Through this, they serve to boost GDP growth and employment growth.

There are several reasons that indicate the desirability of front-loaded fiscal consolidation compared with back-loaded fiscal consolidation:

- Swift and decisive actions would greatly strengthen the credibility of the country's economic policy making.
- The domestic economy and the world economy are faring well in terms of business cycle issues. Fears of deflation have receded, and there appears to be little slack capacity. Hence, a front-loaded fiscal consolidation may not adversely affect demand.
- An early fiscal consolidation will 'reload the guns' for countercyclical fiscal policy two moves ahead.
- An early fiscal consolidation will quickly free up resources for investment by the private sector. It will quickly improve India's credit rating, improve investment flows, and accelerate GDP growth.
- An early improvement in the central Tax/GDP ratio will swiftly ease the difficulties of state finances, and thus have a positive impact on the development process at the state level.
- Owing to lags in policy, decisions taken in 2005 will fully yield fruits in terms of higher GDP growth and sound fiscal outcomes by 2006 and 2007. It is hence important to take *decisions* early about reforms in tax and expenditure policies, so as to benefit from the full impact of these decisions by 2008-09. The ideal sequencing is thus one where a comprehensive exercise in reforming tax policy is put in force early. The full impact of this upon fiscal *outcomes* would come over a two to three year period, reflecting the time taken to build sound

tax administration, for behavioural changes to take place among firms and households who would then shift out of their existing distorted states, and for higher GDP growth rates to materialise.

- FRBM also places obligations on the Debt/GDP ratio. A slow fiscal consolidation will give a greater accumulation of debt.

In the light of this analysis, the four fundamental principles for an Indian strategy in achieving fiscal consolidation may be articulated as follows:

I. Fiscal consolidation should be revenue-led.

II. Fiscal consolidation should be front-loaded.

III. Capital expenditure should be enhanced, while simultaneously engaging in institutional reform to ensure an adequate translation of capital expenditure into an increased flow of GDP.

IV. The reforms efforts on revenue expenditure should be further intensified.