

Time for Centre & States to Pull Up Socks on Fiscal Front

JUNE 27, 2022

By TIOL Edit Team

INDIAN economy is at a tipping point of crisis whose future shape is difficult to predict. Both external and domestic risks are acting in concert.

Declining foreign portfolio investment (FPI) and foreign direct investment (FDI) are cause for deep concern. So is persisting months-long pause in external commercial borrowings (ECBs) by corporates.

These, coupled with hardened prices of imported commodities are putting pressure on foreign exchange reserves, rupee, current account deficit (CAD) and fiscal deficit.

The latest data from Reserve Bank of India (RBI) shows total foreign investment (FDI+FPI) plummeted to USD 21.8 billion in 2021-22 from USD 80.1 billion in preceding year. The Rupee touching a new low has now become a staple news.

As for domestic factors constraining growth, frequent, socio-political protests disrupt transport of goods and other economic activities. The adverse fall-out of protests is much worse if they turn violent, leading to destruction of public and private assets. Local protests, including public interest litigation, against new or expansion projects act as potholes on the Vikas Path.

The phased increase in interest rates on loans, designed to check inflation, is bound to slow down growth. According to RBI's Monetary Policy Statement, 2022-23,

"The projections indicate that inflation is likely to remain above the upper tolerance level of 6 per cent through the first three quarters of 2022-23. Considerable uncertainty surrounds the inflation trajectory due to global growth risks and geopolitical tensions"

It continues:

"The supply side measures taken by the government would help to alleviate some cost-push pressures. At the same time, however, the MPC notes that continuing shocks to food inflation could sustain pressures on headline inflation. Persisting inflationary pressures could set in motion second round effects on headline CPI (consumer price index)".

Yet another domestic hurdle in inclusive growth and fiscal stability is unsustainable debt piled up by certain states. They are facing cash constraints and staring at worsening fiscal distress, thereby affecting growth of state's economy. Most of them have also blamed the Centre for delays in transfer of funds to them.

A paper in RBI's Bulletin for June 2022 has X-rayed fiscal risks faced by the States. As put by the paper,

"Against the backdrop of the Sri Lankan crisis, this article attempts to put the spotlight on fiscal risks confronting state governments in India, with emphasis on the heavily indebted states. The slowdown in own tax revenue, a high share of committed expenditure and rising subsidy burdens have stretched state government finances already exacerbated by COVID-19. New sources of risks have emerged in the form of rising expenditure on non-merit freebies, expanding contingent liabilities, and the ballooning overdue of DISCOMs".

It concludes:

"For the five most indebted states, the debt stock is no longer sustainable, as the debt growth has outpaced their GSDP growth in the last five years" The paper adds: "Stress tests show that the fiscal conditions of the most indebted state governments are expected to deteriorate further, with their debt-GSDP ratio likely to remain above 35 per cent in 2026-27".

The Union Government would, of course, be the last entity to admit that deteriorating economic fundamentals constitute an alarm. The Finance Ministry has however, done well to share its perspective on challenges with the public.

According to Finance Ministry's latest Monthly Economic Review (MER) released on 20th June 2022,

"India faces near-term challenges in managing its fiscal deficit, sustaining economic growth, reining in inflation and containing the current account deficit while maintaining a fair value of the Indian currency".

MER says:

"Many countries around the world, including and especially developed countries, face similar challenges. India is relatively better placed to weather these challenges because of its financial sector stability and its vaccination success in enabling the economy to open up".

It adds:

"As government revenues take a hit following cuts in excise duties on diesel and petrol, an upside risk to the budgeted level of gross fiscal deficit has emerged. Rationalizing of non-capex expenditure has thus become critical for avoiding fiscal slippages".

We commend MER's call to manage near-term challenges **"carefully without sacrificing the hard-earned macroeconomic stability"**.

We believe the best way to overcome challenges is the vibrant Cooperative Federalism. We thus urge Prime Minister Narendra Modi to convene a series of conferences of Chief Ministers on economic problems including fiscal challenges.

To begin with, the agenda can be preparing a road-map for fiscal prudence for both the Centre and the States. The 15 th Finance Commission's (15 th FC's) unimplemented recommendations should constitute the core of the agenda.

In its final report submitted in October 2020, 15 th FC observed:

"In view of the uncertainty that prevails at the stage that we have done our analysis, as well as the contemporary realities and challenges, we recognise that the FRBM Act needs a major restructuring".

It thus recommended that the time-table for defining and achieving debt sustainability may be examined by a High-powered Inter-governmental Group. This Group can prepare the new FRBM (Fiscal Responsibility and Budget Management) framework and oversee its implementation.

15 th FC stated:

"It is important that the Union and State Governments amend their FRBM Acts, based on the recommendations of the Group, so as to ensure that their legislations are consistent with the fiscal sustainability framework put in place ".

Information on action taken on such non-binding recommendations of 15 th FC is hard to come by. We urge the Central Government to give requisite importance to fiscal prudence. It is the key to ensuring financial stability, low inflation and inclusive economic development.

The conference should strive for a consensus on putting a cap on freebies doled out, both by the Centre and the States. The Centre and the States should also consider pooling funds splurged on overlapping and multiple freebies. The pooled funds can be used jointly to avoid proliferation of freebies.

As for the five fiscally stressed-states of Bihar, Kerala, Punjab, Rajasthan and West Bengal, 15 th FC's advice should serve as powerful reminder for the Centre. The Commission stated

"since the overall responsibility of macro-fiscal balance rests with the Union Government, it should support the budgets of State Governments and local governments generously in the next five years".

We would urge the Government to keep open the option to exercise timely initiatives, both on the expenditure and revenue mobilisation sides. The Government should consider levy of windfall profit tax on companies that have benefitted from global commodities price boom and lockdowns. It should also consider imposing one-time national duty surcharge on income-tax paid by high net-worth individuals.

As for cutting expenditure, the easiest way is to freeze expenditure on publicity, events and foreign jaunts.

We urge the Government to issue a white paper on economic challenges, including competitive populism between the political parties vying for power at the Centre, the States and the local government bodies.

The Paper should dwell on the rise in both unsustainable population and poverty, that together neutralize benefits of economic development.