Budget 2014-15: Containing Fiscal Deficit

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India at a Glance

India is the 10th largest economy on the planet and one of the fastest growing economies. However, it has a public debt-to-GDP ratio of 49.6%. The interest burden is quite high and can be seen every year in the budget. But overall, India is currently in a better position than most countries in the world. It has a new government which is supported by an overwhelming majority of people nation-wide. Following are some economic indicators which tell us the current economic condition of India:

- Inflation at 8.28% (as per CPI)
- Rising unemployment
- Downtrend in savings as a % of GDP due to negative real returns on savings
- Inelastic demand for imports (oil and gold)
- Rising factor costs due to inflation
- Expected growth at around 5-5.9%
- 10 year Govt. bond yield 8.71%
- High interest rates and therefore, high costs of capital

Demographically, India is a very young country with majority of the population below 35 and low dependency ratio. However, the disparity in income and wealth of the people is quite acute. About half the work force is employed in the agricultural sector and yet it contributes less than 20% to the total GDP. It is also one of the least productive sectors of the economy. Trend suggests that, more the labour productivity in a sector, lower the proportion of the workforce employed in the sector. This makes one thing clear. India is operating way below its potential GDP, technically called the contractionary output gap. There is a lot of spare capacity in the economy and this will be utilised when the producers of goods and services see an increasing demand in the domestic and/or foreign markets.

Challenges for the Government

In a market there are suppliers/producers and customers/consumers. The producers are facing a slowdown while on the other hand RBI is trying to battle inflation caused by output gap. These two contradicting situations don't make sense unless there is a third factor in play. There is a lack of infrastructural facilities in the economy. Also the factor costs fell slower than the market prices squeezing the value added through either lower margins or lost demand due to price rise. The factor costs are downward sticky, which means that market price of a commodity may change up/down within seconds or weeks but it takes time for factor prices like wages and costs of capital to change. The real challenge for the government lies here. It has to give some assurance to the producers in the country for at least a steady demand without squeezed margins while it tackles inflation on the other side of the field. Traditionally, the economies suffered either from inflation or unemployment but in case of India it is both. If the government focuses on one, the other may become a bigger problem. Let's add a third dimension, savings. The savings has been declining due to unemployment and inflation both. The real return on savings has been negative for the past few years and people have started saving out of the financial system. This has left a savings-investment gap which can be filled only by bringing in capital from abroad or printing money. Since printing money causes inflation, and current account in a deficit,

the Government relies on FDI and public debt. FDI has also not been stable and has been discouraged by the practices of UPA government in the past few years. Therefore, the government is piling on public debt and increasing its interest burden which will again affect the fiscal deficit. Another problem faced by the economy as a whole is availability of skilled labour. There is plenty of supply of labour but skilled people are quite few and therefore, there is unemployment even though there is a positive outlook on the economy right now. In the past, the UPA has financed the deficits through printing money. However, this has been a cause for inflation all these years. The challenge for the current government is to contain fiscal deficit, inflation, unemployment altogether while boosting savings in the financial system.

Expectations

The new government came into power by promising development and good governance. Therefore, we can expect it to spend money on building processes, promoting transparency and reducing human interference as much as possible. It is also expected to spend on education and training of the workforce so as to enable them to be employed a sooner. Historically, fiscal deficits may have been around 5% on an average. However, the current situation is such that inflation cannot be allowed to rise further. Interest rates are high already and pulling them higher will do more damage than good. If government does keep a fiscal deficit to those levels, it will either end up printing or borrowing money. In either case, it will cause an upward pressure on interest rates and RBI to tackle inflation. Therefore, the fiscal deficit can be expected to be kept lower, around 3-4.5%. Taxes as the only source of revenue may not be reliable. The income tax is steady while the corporate tax is declining. Lower GDP growth and concessions in excise and custom duties have stopped the indirect taxes to rise. Divestments and disinvestments will prove to be major revenue sources as the new government supports privatization as well as public private partnerships. Any immediate resolution on goods and services tax and direct tax code is not expected. However, we can at least expect guidelines for future course about the same as implementation of GST and DTC will help reduce the fiscal deficit itself. Structural reforms on tax revenues and collection can be expected because currently, only 3-4% of the Indian population pays taxes. In fact, India has one of the lowest tax-to-GDP ratios in the continent. Following are the few industries/sectors in which reforms are expected:

- Infrastructure
- Capital goods
- Oil & gas
- Defence
- Banking, financial services and insurance

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