

Road map for fiscal consolidation

The interim Budget or 'vote on account' for 2024-25 was presented on February 1, 2024. In keeping with the best traditions, Finance Minister Nirmala Sitharaman announced that she was not proposing to make any changes in the tax rates either for direct taxes or indirect taxes. Nevertheless, a few things stand out in the Budget. First, there is a continued emphasis on increasing capital expenditures of the Union government and second, there is a continued emphasis on fiscal correction and consolidation.

Not overstretched

In some sense, the Budget is not overstretched. The buoyancy of tax revenue comes to 1.33, if the base is taken as Budget Estimates of the present year and using nominal GDP growth for 2023-24 as per the National Statistics Organisation's (NSO) first advance estimates. The buoyancy comes down to 1.09 if the base is taken as Revised Estimates. The nominal GDP growth for 2024-25 is conservatively estimated at 10.5%. This means an implicit price deflator-based inflation of 3.3% if we assume a 7% real growth. Thus, the revenue projections provide a buffer that can be used to increase expenditures or reduce deficit later. That will be known only when the regular Budget is presented later.

One important feature of the Budgets presented in recent years is an increase in capital expenditures of the Central government. In the context of COVID-19 and other global developments, perhaps it was felt that the investment climate could be improved only by the government raising its own investment. It could act as a catalyst for private investment. The interim Budget has maintained this trend and has provided for an increase of 11.1% in capital expenditures when a comparison is made with the 2023-24 Budget Estimates.

The growth rate of capital expenditure is higher at 16.9%



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when compared with the Revised Estimates of 2023-24. It is implied that capital expenditure growth is lower than what was budgeted in 2023-24.

In fact, as per the Revised Estimates, the growth in capital expenditure is 28.4% instead of the budgeted growth of 37.4%. This lower capital expenditure growth is associated with a real GDP growth of 7.3% in 2023-24. Thus, it may be possible for a 17% capital expenditure growth in 2024-25 to enable a real GDP growth of 7% provided private sector investment picks up and the momentum of capital expenditure growth of State governments is maintained as in the current year. This would be feasible as the government has extended the interest-free loan facility for the State governments. The lower fiscal deficit might also facilitate a lowering of interest rates later during the year. It is important to remember that the capital expenditures of the government are not identical with gross fixed capital formation. However, it contributes to increasing capital formation. It is worth noting that the capital expenditures of the Central government in 2024-25 as a proportion of GDP are budgeted to increase marginally from 3.2% in 2023-24 to 3.4% in 2024-25. In developing economies, growth is driven by investment. For the continued growth of the economy at 7%, we need an investment rate of 35%. This is on the assumption of an Incremental Capital Output Ratio (ICOR) of 5.

As per NSO's first advance estimates for 2023-24, the gross fixed capital formation to GDP ratio at constant prices is 34.9%. If in 2024-25, government capital formation falls, correspondingly private sector investment may have to increase.

Fiscal deficit target

The fiscal deficit for 2024-25 is expected to go down to 5.1%, a decline of 0.7 percentage points from the previous year. This is in accord with what the Finance

Minister had earlier stated. While this bold step in a Budget before the election is welcome, we need to have a good road map to achieve what our target is.

This has to be 3% of GDP for the Central government and not 4.5% of GDP. Together with State governments, the target fiscal deficit can be 6% of GDP. We need to understand the logic behind this number. It is linked to household savings in financial assets and a net inflow of resources from abroad. The household sector is the only surplus sector in the economy. The surplus of this sector needs to feed the public sector as well as the private corporate sector. If the household savings in financial assets were increasing, it may be possible to make some adjustments to the desired level of fiscal deficit.

However, recent numbers show household savings in financial assets going down. The committee that was appointed to look at the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 wanted that the debt-GDP ratio of the Centre and States taken together should not exceed 60%. For the Centre, the target level was indicated at 40%. There is no clear logic for this number if the Centre's target fiscal deficit is kept at 3% of GDP.

The corresponding level of Centre's debt would be 30% of GDP with an underlying nominal growth of 11.1%. Simulations indicate that given the current consolidation path, if a 3% fiscal deficit is reached by 2028-29 and maintained at this level thereafter while sustaining a nominal GDP growth of 11.1%, a 40% debt-GDP ratio for the Centre would be reached by 2034-35. Any fiscal deficit of the Centre and States taken together substantially above 6% of GDP can only lead to inflation. We need to set a target fiscal deficit relative to GDP and the time horizon over which this target is achieved. The goal must be to get to a fiscal deficit of 3% of GDP each for the Centre and the States.