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MODI GOVERNMENT 3.0: WELFARE SCHEMES IMPACTING INDIA'S FISCAL DEFICIT?

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Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, particularly macroeconomic conditions. These include aggregate demand for goods and services, employment, inflation, and economic growth. Three instruments of the fiscal policy are government spending, tax and transfer payments to influence aggregate demand. There are four major fiscal functions of government-allocation, distribution, economic growth and stabilization.

Fiscal policy is largely based on the pioneering work of the British economist Lord John Maynard Keynes (1883-1946). Lord Keynes cogently argued that governments could stabilize the business cycle and regulate economic output rather than letting the free and unbridled pay of the markets. Pump priming, which is related to the concepts of deficit spending and expansionary policy, refers to the steps taken to stimulate spending in an economy during or after a recession. Generally, it involves pumping government funds into a depressed economy to encourage growth. These financial injections can increase purchasing power and spur demand for goods and services.

Evolving Indian Landscape - Fiscal Policy

Fiscal policy is a basic element of the policy framework pursued since the inexorable process of economic reforms in India in 1991 to achieve the objectives of economic growth, price stability and equity. The attainment of these objectives required greater resource mobilisation through taxes and other measures and curb the growth of unproductive and non-plan expenditure. Broadly since 2001-02, the Central Government has followed prudent fiscal policy comprising:

(i) Balanced tax structure of direct and indirect taxation based on moderate tax rates with minimum exemptions covering a wider class of tax payers and

(ii) An expenditure policy to restrain unbridled growth of non-developmental expenditure and provide for contextually significant social and infrastructure needs of a developing economy.

Given the magnitude and enormity of the Covid-19 pandemic, active interventions and policy support from both monetary and fiscal authorities across the world were put in place with a sense of urgency. In India, the authorities undertook multidimensional efforts to mitigate the impact of the crisis and preserve financial stability. The Reserve Bank of India deployed a slew of instruments – conventional and unconventional – to provide liquidity, promote growth and ensure financial stability. These measures were aimed at sizably expanding liquidity in the system to ensure that financial markets and institutions can function normally despite the debilitating impact of the Covid-related dislocations on income, output and employment.

India's fiscal policy response to the pandemic was characterised by a sequential and calibrated approach because of the huge hit to lives and the livelihoods and the all-pervasive environment of gloom and doom. Fiscal spending in India initially focused on providing support in cash and in kind to vulnerable households. With the Covid-19 pandemic receding into history and steady growth on, there has to be an accent on fostering investment.

Fiscal Deficits and Fiscal Consolidation

Persistently large fiscal and revenue deficits imperil the macro-economy. Such deficits raise the interest burden crowding out expenditures on productive sectors, increase the borrowing cost and financially crowd out private investments leading to an inflationary spiral, weaken the balance of payments, make financial sector reform more protracted, severely damage the ability of future generations to meet their needs and downgrading by rating agencies raise the cost of foreign borrowing by the private sector.

The debilitating impact of large deficits and growing debt was eloquently brought out by Martin Feldstein in *L. K. Jha Memorial Lecture* (2004) on "Budget Deficits and National Debt":

"*Fiscal deficits are like obesity. You can see your weight rising on the scale and notice that your clothing size is increasing, but there is no sense of urgency in dealing with the problem… Like obesity, government deficits are the result of too much self-indulgent living as the government spends more than it collects in taxes. And, also like obesity, the more severe the problem, the harder it is to correct: the overweight man has a harder time doing the exercise that could reduce his weight and the economy with a large deficit and debt is trapped by increasing interest payments that cause the deficit and debt to rise more quickly*".

In other words, larger Government debt deficits, high debt levels and higher interest rates result in a vicious circle of rising interest expenditure adversely impacting more productive programmes like infrastructure investment or social expenditure. Deteriorating debt dynamics also raises borrowing costs for the private sector, deleteriously impacting business activity, financial markets and, even the broader macro-economic prospects.

Over the last ten years, the Modi Government has been successfully straddling knife-edge equilibrium between the requirements of economic growth and the need to promote welfare of the disadvantaged sections. But the NDA Government has always been conscious of the concerns (the two Covid 19 years were once in a century event and this aberration necessitated countercyclical fiscal measure and a more active fiscal policy for macroeconomic stabilization) of containing the fiscal deficit within manageable proportions. There is no reason to believe that despite the compulsions of the coalition government, things will be markedly different in Modi government's third avatar. The record RBI dividend of ₹ 2.11 lakh crore will provide tailwinds and help to shrink the fiscal deficit by 0.40 % of GDP. There are also issues of borrowings estimated at ₹14.13 lakh crore and rising public expenditure.

Fiscal consolidation is required to check inflation and releasing resources for economic growth and employment generation, together with improving the quality of public expenditure. Over the years, direct tax rates have been reduced and the base of direct taxes broadened by withdrawing certain exemptions. This move has discernibly improved tax compliance and also led to higher direct tax kitty. Some exemptions, however, still persist for financial savings and exports.

The Fiscal Responsibility and Budget Management Act (FRBM), 2003 was enacted to provide a legislative framework for reduction of deficit and thereby debt, of the Central Government to a sustainable level over a medium term to ensure inter-generational equity in fiscal management and long term macro-economic stability. *The Fiscal Responsibility and Budget Management Act, 2003* and *the Fiscal Responsibility and Budget Management Rules, 2004* made under Section 8 of the Act came into force

with effect from 5th July 2004. The FRBM framework mandates Central Government to limit the Fiscal Deficit upto 3 % of GDP by 31st March, 2021. The Central Government shall also endeavour to limit the General Government Debt to 60 % of GDP and the Central Government Debt to 40 % of GDP by 31st March, 2025.

Surging Need of States for Greater Funding Without Expanding Fiscal Deficit

In the emerging macro-economic environment influenced *inter-alia* by the compulsions of coalition politics, it has often been asked whether the government can balance these burgeoning welfare expenditures with existing revenue streams without significantly increasing the fiscal deficit. Given the pressure on State finances and the competing claims by multiple State Governments, the Union Government will do a tight-rope walking by incentivising States to promote internal resource generation.

Adjustments in Revenue and Expenditure Management

If welfare spending has to rise without breaching the fiscal target, there has to be some adjustments in revenue and expenditure management because of the compelling debt-deficit and financing dynamics through the mechanisms of the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing.

There cannot be an across the board increase in welfare programmes because of the pressure on the fisc and the need for scarce investible resources for Schemes and programmes. A protracted debt overhang will have profound consequences, e.g., the Agriculture and Rural Debt Relief Scheme (ARDRS), 1990 and ₹60,000 crore farm loan waiver schemes of 2008 are unsustainable, apart from the "*moral hazard*" of incentivising loan defaulters, vitiating the recovery ecosystem and choking the flow of credit. Such consequences include constraining fiscal space, restricting government spending on more productive activities and programmes, exacerbating fiscal slippage and denting growth.

The welfare programmes have to be focused and carefully targeted with clear identification of beneficiaries and well-defined programme objectives to slash, if not eliminate, leakages in the overarching context of the pressure on fiscal sustainability. Fiscally irresponsible measures like the Congress promise of ₹ 8,500 per month to every poor Indian family under the Mahalakshi scheme, ideally to the bank account of the oldest woman of the household make the Budget calculus clearly unsustainable.

Sustainability of welfare schemes over the long haul in view of the macro-economic constraint and high fiscal deficit and public debt

All welfare schemes *per se* are not bad and some well-conceived schemes, e.g., mid-day meals in Tamil Nadu and some other States and bicycles for girl students in Bihar had a salutary impact on broad-based economic development. Hence there is a

compelling need to separate the wheat from the chaff without resorting to a broad generalisation and a one-size fits all approach.

Global economic conditions, such as inflation and interest rates, affect India's ability to manage its fiscal deficit, particularly revenue deficit while funding welfare programs to a limited extent because India unlike China is largely a domestically driven economy and despite heightened geopolitical tensions, India is well on course to achieve its avowed objectives. But of course, the standard disclaimer applies and the *ceteris paribus* assumption cannot be wished away. Ensuring effective and fiscally responsible welfare schemes is a delicate task and requires a sharper focus on prudent fiscal policy for central and state governments, slashing time and cost overruns, targeted welfare programmes and the government's ability to service its debts.

Strategic Options and Choices - Trade-offs and Policy Dilemmas

Going ahead, maintaining the fiscal glide path by generating adequate resources for the fisc without curbing welfare programmes constitute an important policy dilemma. All revenue streams, viz., direct and indirect taxes, disinvestment, dividends from the PSUs and the RBI and public borrowings have to be explored and examined to arrive at a judicious mix of the strategy of revenue generation to meet multiple conflicting requirements, broad-based development, restricting fiscal deficits and containing the ratio of debt to GDP. Towards this end, budget management reforms and an independent institution to monitor the implementation of rule-based fiscal policy (i.e., the Fiscal Council) as recommended by the Finance Commissions could be helpful.

There is a distinct possibility that while maintaining the fiscal deficit at 5.1 % of GDP, spending, for capital expenditure- roads, railways, and defence projects- could rise since such areas have significant multiplier macroeconomic effects. There was some scepticism at the time of presentation of the vote on account in February 2024 whether the proposed 5.1 % fiscal deficit target for FY 25 was realistic. In view of the record surplus transfer of ₹2.11 lakh crore for FY24 and the buoyancy in the tax revenues- both direct and indirect, there are no such fears now and the Government is well on course to achieve the budgeted fiscal deficit target. As a measure of fiscal prudence and rectitude, the FM may even narrow the deficit beyond the target and the new fiscal deficit target could be 4.9 %, particularly since the government targets a fiscal deficit of 4.5 % of the GDP by FY26, with potential positive implications for credit ratings.

Suspended Release of Monthly GST Data

Given the magnitude of the systemic change, the rolling out of GST collection underwent a difficult phase of teething troubles, squeeze on GST because of the devastating hit to lives and livelihoods during the Covid 19 pandemic and the leakages in the system. Since then the system of the GST has stabilised, macroeconomic growth gained traction and the compliance significantly improved.

The Government decision to dispense with the official press release and the granular State-wise details and instead place only the gross figures in the public domain for the June 2024 GST collection has been criticised because the government has been releasing these figures regularly since the initiation of the GST in July 2017 (the few Covid 19 scarred months were an aberration).

GST collections for June 2024 rose by 7.7 % over June 2023 to reach ₹1.73 lakh crore. This has sometimes been viewed as high taxation. A comprehensive assessment and perspective, however, requires that the GST collections should be seen as a microcosm of the growing Indian economy. It has also to be realised that GST, unlike income tax, is paid by everyone since it is a consumption tax. These taxes are also shared with the States. Hence any hasty judgment of the Government decision would be premature and unrealistic.