India's Fiscal Consolidation

For Prelims: **Fiscal Deficit, GDP**, **Fiscal Consolidation**, **Fiscal Responsibility and Budget Management (FRBM) Act, 2003**, **Tax Evasion**, **Inflation**, **Currency Exchange Rate**, **Revenue Deficit**, **Medium Term Fiscal Policy Statement**, Macroeconomic Framework Statement, **Fiscal Policy Strategy Statement**, **Effective Revenue Deficit**, **NK Singh Committee**, **Fiscal Council**, **Primary deficit**, **MSMEs**, **Production Linked Incentive (PLI) Scheme**, **Reserve Bank of India (RBI)**.

For Mains: Importance of fiscal consolidation in an economy, India's performance in fiscal consolidation and related concerns.

Source: LM

Why in News?

India has significantly reduced its **fiscal deficit** from a pandemic high of **9.2% of GDP** in FY 2020-21 to an estimated **5.6% in FY 2023-24**, with a target of **4.9% for FY 2024-25.**

- Through **targeted spending** and enhanced **revenue collection,** the country has made substantial progress in **fiscal consolidation** under the **Fiscal Responsibility and Budget Management (FRBM) Act, 2003**.

What is Fiscal Consolidation?

- **About:** Fiscal consolidation refers to the **prudent management of government finances** to ensure long-term economic stability.
  - It focuses on balancing government **revenue (taxes and non-tax receipts) with expenditure**, aiming to **minimize fiscal deficits, control public debt,** and support sustainable economic growth.
- **Key Features:**
  - **Prudent Spending:** Focus on **essential, efficient, and productive areas** like infrastructure, health, and education.
  - **Revenue Optimization:** Maximize **tax collection, reduce tax evasion, and broaden the tax base.**
  - **Deficit Control:** Limit fiscal deficits to **avoid excessive borrowing.**
  - **Debt Management:** Keep **public debt sustainable** to prevent economic crises.
  - **Accountability:** Ensure transparency through **audits and compliance** with regulations.
- **Significance:**
  - **Macro-Economic Stability**: It controls **inflation** by lowering government borrowing **(low money circulation)**, stabilizes **currency exchange rates** (**reducing volatility** in exchange rates), and ensures stable economic growth.
  - **Reduced Debt Burden**: Prevents **unsustainable borrowing**, thereby reducing the burden on future generations.
  - **Investor Confidence**: Signals **sound economic management**, attracting domestic and foreign investments.

    - **Efficient Resource Utilization**: Prevents wasteful expenditure and ensures resources are directed toward development priorities.

How Does Fiscal Consolidation Impact Economic Stability and Growth?

- **Inflation Control**: Under the **FRBM Act, 2003**, the fiscal deficit was reduced from **4.5% of GDP in FY 2013-14 to 3.4% by FY 2018-19** reducing government borrowing.
    - By **curbing excessive borrowing** and government spending, fiscal consolidation helps **keep prices stable** and inflation in control.
- **Increased Capex:** During the **Covid-19 pandemic**, India focused financial relief on sectors like **MSMEs and displaced individuals**, while prioritizing **capital expenditure (capex)** which increased from **1.6% of GDP in FY 2014-15 to 3.2% in FY 2023-24.**
    - It helped **cushion the negative economic impact** on vulnerable sectors and laid the foundation for **long-term economic growth** by improving critical infrastructure
- **Revenue Mobilization:** The **digitization of the tax system** led to greater efficiency in tax collection, with tax receipts rising from **10% of GDP in FY 2014-15 to 11.8% in FY 2023-24.**
    - Increased tax revenues enhanced the government's ability to **invest in public services.**
- **Long-Term Structural Reforms:** India launched the **Production Linked Incentive (PLI) scheme** to **boost domestic manufacturing.**
    - It helped **mitigate** the effects of **global trade disruptions and geopolitical tensions**, ensuring steady growth despite global uncertainties.
- **Capacity Building**: As the fiscal deficit narrowed, India became more competitive in exports, reduced its reliance on imports, and improved its trade balance.
    - As the fiscal deficit narrowed and the economy became more stable, India's **competitiveness in exports** improved.

What is FRBM Act, 2003?

- **About:** The FRBM Act was enacted in 2003 to establish financial consolidation in the government to **reduce fiscal deficits** and promote **fiscal responsibility.**
- **Key Features:** Union and States to reduce the Fiscal Deficit to 3% of GDP (Union) and 3% of GSDP (States), and eliminate the Revenue Deficit by 2008.
    - Present the **Medium Term Fiscal Policy, Macroeconomic Framework, and Fiscal Policy Strategy Statements** with the Union Budget.
- **Escape Clause:** Under **Section 4(2)** of the FRBM Act, 2003, the government can **exceed its fiscal deficit target by up to 0.5% of GDP** in times of severe economic stress in situations such as **national security/act of war, national calamity, etc.**
- **Amendments:** It was amended in **2012** to **remove** the requirement for a **0% Revenue Deficit**, instead mandating a **0% Effective Revenue Deficit by 2015**.
    - Effective revenue deficit implies **revenue deficit minus grants to states for capital assets creation.**
    - In **2016, NK Singh Committee** was set up to suggest improvements to the Act due to the perceived rigidity of its targets.

N.K. Singh Committee Recommendations

- **Deviations**: Both Union and State governments **may exceed** the fiscal deficit target by **up to 0.5% of GDP.**
    - **Primary deficit** target of 0% shifted to **2022-23** (earlier 2020-21).
        - **Primary deficit** is the difference between the government's **fiscal deficit** and its **interest payments** on existing public debt.
- **Debt as Primary Target**: Focus on **debt reduction** rather than rigid fiscal deficit targets.
- **Fiscal Council**: Creation of an autonomous **Fiscal Council** with independent members to oversee fiscal policy.
- **Borrowings**: Restrictions on **borrowing** from RBI, allowing it only in specific cases:
    - Meeting **temporary shortfalls** in receipts.
    - RBI purchases **government securities** for deviations from targets.
    - RBI subscription to government securities in certain conditions.

What are Challenges in India's Fiscal Consolidation?

- **Compromising Welfare:** Critics argue that **focusing too much** on reducing the fiscal deficit may **limit essential spending** for economic growth and harm public welfare programs, with the **3% GDP target** being **too ambitious**.
- **Geopolitical Tensions**: Shifting trade dynamics, with **tighter regulations and tariffs**, can impact India's **external trade, fiscal health**, and increase pressure on government spending to support domestic industries and self-sufficiency. E.g., Trump's tariff threats.
- **Volatile Capital Flows**: Capital flows into India have become **volatile** due to increase in **interest rates** in developed economies. **Unexpected outflows** could lead to fiscal deficits or put pressure on currency stability.
- **Rising State Deficits**: Many states are struggling with rising fiscal deficits, which exceed the recommended 3% of GSDP. E.g., **Himachal Pradesh (4.7%), Andhra Pradesh (4.2%).**
  - Also, many states are witnessing a rise in their **debt-to-GDP ratios.**
- **Sustaining Capital Expenditure:** Sustaining 3.2% of Capex investment without further escalating the fiscal deficit is a **challenge** due to **higher borrowing costs**, low tax compliance and collections etc.

Way Forward

- **Tax Reforms and Mobilization**: Improving the **tax base,** particularly in the **informal sector** by **higher tax collection** without needing to raise tax rates, and addressing leakages will be essential to meet fiscal targets without overburdening the economy.
  - State governments need to implement **fiscal reforms tailored to their specific challenges** and reduce wasteful expenditures.
- **Investment vs. Deficit Control**: Maintaining **fiscal consolidation** is crucial, but India must balance it with the need for long-term growth, as overly strict measures could hinder essential investments.
  - E.g., The **14th Finance Commission (2013-2014)**, recommended more flexibility in fiscal management to support growth and development while ensuring long-term sustainability.
- **Monetary and Fiscal Coordination**: The **Reserve Bank of India (RBI)** and the government must coordinate effectively to **manage volatility** in the currency markets and keep **inflation** in check.

Drishti Mains Question:

Analyze the importance of fiscal consolidation in ensuring India's macroeconomic stability. What steps have been taken to reduce the fiscal deficit, and what challenges remain?

UPSC Civil Services, Previous Year Questions (PYQ)

Prelims

Q. Which one of the following is likely to be the most inflationary in its effect?

(a) Repayment of public debt

(b) Borrowing from the public to finance a budget deficit

(c) Borrowing from the banks to finance a budget deficit

(d) Creation of new money to finance a budget deficit

Ans: (d)

Q. In the context of governance, consider the following: (2010)

1. Encouraging Foreign Direct Investment inflows
2. Privatization of higher educational Institutions
3. Down-sizing of bureaucracy
4. Selling/offloading the shares of Public Sector Undertakings

Which of the above can be used as measures to control the fiscal deficit in India?

(a) 1, 2 and 3

(b) 2, 3 and 4

(c) 1, 2 and 4

(d) 3 and 4 only

Ans: (d)

Mains

Q. Distinguish between Capital Budget and Revenue Budget. Explain the components of both these Budgets. (2021)

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. (2019)