Rationality in Fiscal policy

What is the issue?

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India has to set up proper institutional apparatus to bring rationality in the budgetary process and fiscal policy.

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What are the challenges to the fiscal policy?

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- The budgetary process and fiscal policy in India face two big problems.
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- The first is the mismeasurement of GDP and potentially its over-estimation.
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- This has important consequences for tax targets and the bond issuance programme.
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- The second is the emergence of population-scale entitlement programmes.
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- These have induced adverse effects upon the political economy worldwide.
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- Thus, India will need to build the countervailing forces to check and balance the political imperative.
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What are the implications of an unreliable GDP estimates?

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- GDP data has direct consequences for budget-making, since tax targets in each budget process are made upon the GDP projections.
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- Thus, errors in GDP estimation induce errors in the tax targets.
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- The tax revenue for 2018-19 was 7.9% of GDP, and the tax target for 2019-20 has been set to 8.1% of GDP.
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- However, there are important errors in GDP estimation.
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- Some independent data sources such as corporate sales, corporate profits, private investment suggest that the official GDP data is over-estimated.
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- As an example, from 2014-15 to 2017-18 (three years), nominal GDP went up by 37% but the nominal net sales of nearly 5,019 non-oil, non-finance companies went up by 22%.
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- Also if GDP is over-estimated, the government will set high tax targets.
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- This will force the tax inspectors to comply with the stipulated targets, which will become a source of stress for the economy.
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- The bond issuance programme are also affected by mismeasurement of GDP.
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- If GDP is over-estimated, the magnitude of bond sales is too large, compared with what the economy can absorb.
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What are the concerns with fiscal spending?

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- Therecent concern in public finance is the rise of population-scale entitlement programmes.
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- Net present value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows over a period of time.
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- A positive net present value indicates that the projected earnings generated by a project or investment exceeds the anticipated costs.
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- For many of the schemes in India, the NPV was not computed or analysed before it was getting approved.
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- These entitlement programmes are getting more and more based on a projected expenditure for next year and not on long-term projections.

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- Thus, the government should make sure that these programmes be approved only after comparing the short-term political gains versus the NPV over a long-term.
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What should be done?

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- The government can keep the debt on track even when GDP is mismeasured.
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- Primary deficit refers to difference between fiscal deficit of the current year and interest payments on the previous borrowings. [Primary Deficit = Fiscal Deficit – Interest Payments]
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- It indicates, how much of the government borrowings are going to meet expenses other than the interest payments.
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- If the government run a primary surplus, it is paying down debtand lowering its debt-GDP ratio, without even knowing the correct GDP estimates.
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- Thus, it would be prudent for fiscal policy makers in our data-poor environment to use such a rule.
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- This would protect us from the possibility of faulty fiscal policy calculations flowing from faulty GDP estimates.
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- Also, it is essential to build the institutional apparatus through which debt-management decisions could be made.
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- These include -
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1. A reliable GDP measurement
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2. Strengthening of bond market
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3. Setting up a full-fledged independent public debt management agencyto manage government borrowing programme
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4. Establishing the Fiscal Councilto advise and assess government's spending and fiscal policy
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Source: Business Standard

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