**Report of the 14th Finance Commission**

**Ch 03: Review of Union Finances**

The period 2004-05 to 2007-08 was a phase of impressive fiscal consolidation by the Union Government. High growth of the economy, tax reforms leading to increases in revenue combined with fiscal prudence led to considerable improvement in the finances of the Union Government until 2007-08, with the revenue and fiscal deficits declining in line with targets set in the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. However, the period from 2008-09 is characterised by an expansionary fiscal policy and consequent deterioration in the fiscal health of the Union Government. Since 2009-10, the revenue and fiscal deficits of the Union as a ratio of gross domestic product (GDP) increased to levels higher than targets in the fiscal adjustment path set by the 13th Finance Commission. While the tax-GDP ratio of the Union declined from the high level reached in 2007-08, the revenue expenditure to GDP ratio continued to increase from 2008-09 even as the pressure to contain deficits resulted in a decline in capital expenditure as a proportion to GDP. Thus, after the global crisis in 2008-09, even as the growth rate remained high up to 2011-12, fiscal parameters deteriorated. Since 2012-13, there has been a significant deceleration in economic growth as well.

The FRBM Act had laid down the target of bringing the fiscal deficit down to 3 per cent of GDP and eliminating revenue deficit by 2008-09. However, in 2008-09 the Union Government undertook several fiscal expansionary measures such as revision of pay scales based on the recommendations of the Sixth Pay Commission, waiver of farm loans and the expansion of the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) to all districts from the 200 districts it was originally slated to cover. In addition, oil prices escalated sharply, leading to a rise in subsidy. Because of all this as well as the global crisis, the fiscal deficit of Union Government increased to 6 per cent in 2008-09 and 6.5 per cent in 2009-10. Another consequence was that the total expenditure as a ratio of GDP increased by 1.5 percentage points from 14.3 per cent in 2007-08 to 15.8 per cent in 2009-10. At the same time, the gross tax revenues declined by more than 2 percentage points from a peak of 11.9 per cent of GDP in 2007-08 to 9.6 per cent in 2009-10.Though the fiscal deficit declined in 2010-11 to 4.8 per cent of GDP, this was mainly on account of additional revenue from the proceeds of the auction of telecom spectrum. Most of the expansionary measures were irreversible. Further, rising expenditure on major subsidies and stagnant tax-GDP ratios limited the return to the fiscal correction path.

The growth rate of the economy, which was initially maintained after the global crisis through the expansionary measures, registered a rapid decline after 2011-12. In the two consecutive years of 2012-13 and 2013-14, the growth rates were 4.5 per cent and 4.7 per cent, respectively. In this situation, the Union government severely compressed expenditures to achieve the budgeted levels of fiscal deficit. **The fiscal deficit** was contained at 4.8 per cent in 2012-13 and 4.6 per cent in 2013-14 largely by compressing Plan expenditure. In 2014-15 (budget estimates), the Union Government proposes to bring down the fiscal deficit to 4.1 per cent of GDP.

The Union Government introduced the concept of **effective revenue deficit** through an amendment to the FRBM Act in 2012. Effective revenue deficit makes a distinction between the grants given to the States and implementing agencies for the creation of capital assets and grants for meeting revenue expenditures. We have noted that the concept of effective revenue deficit is not recognized in the standard government accounting process. The amended FRBM Act has revised the target of revenue deficit – it is now to be brought below 2 per cent of GDP by 31 March 2015 against the original goal of eliminating it entirely. However, it appears that even this revised target may not be met. The projected budget estimates for 2014-15 has a revenue deficit of 2.9 per cent, indicating a clear revenue imbalance in Union finances.

The **primary deficit** of the Union Government improved substantially between 2001-02 and 2007-08, moving from a deficit of 1.5 per cent of GDP in 2001-02 to a primary surplus of 0.9 per cent of GDP in 2007-08. However, like other deficit indicators, primary deficit of the Union Government increased to 2.6 per cent of GDP in 2008-09 and 3.2 per cent of GDP in 2009-10. It was kept under 2 per cent of GDP in the last two financial years and is projected at 0.8 per cent of GDP in 2014-15 (BE).

The ratio of revenue deficit to fiscal deficit broadly measures the extent of borrowings used for revenue expenditure. This ratio almost doubled within a span of two years to over 81 per cent in 2009-10 and has since remained consistently above 70 per cent (except for 2010-11), thereby reflecting the levels of persistent structural imbalance in Union Government expenditures.

Between 2007-08 and 2012-13, the revenue receipts of the Union Government declined by about 2.2 percentage points to GDP, while net tax revenue fell by almost 1.5 percentage points. The non-debt capital receipts fluctuated due to slippages in achieving the projected disinvestment targets. On the expenditure side, the total expenditure as a ratio of GDP has shown a consistent decline since 2008-09. However, the decline was sharper in the case of capital expenditures. Consequently, the ratio of revenue deficit to fiscal deficit has shown a steady increase.