Institute for Management in Government
Trivandrum

Public Finance

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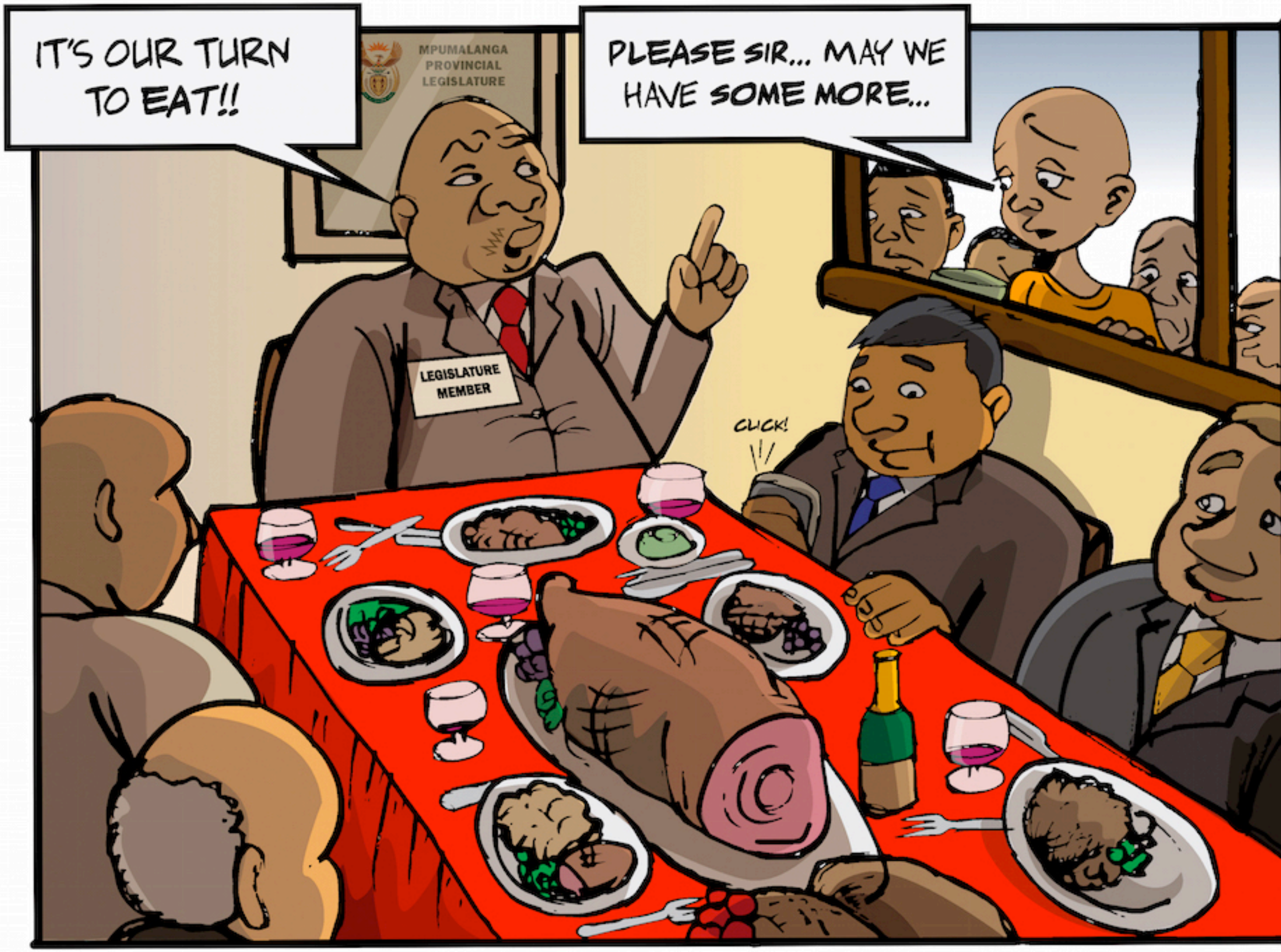
Public Finance in textbooks

- A dull subject in college: a soporific opening line – public finance is the finance of the public.
- **Wikipedia definition:** *Public finance is the study of the role of the government in the economy. It is the branch of economics which assesses the government revenue and government government expenditure of the public authorities and the adjustment of one or the other to achieve desirable effects and avoid undesirable ones.*

Public Finance in practice

- It was only several years into the service that I began to find the subject increasingly useful, and as I became more senior, increasingly fascinating.
- What is called government funds is actually money that belongs to the taxpayer/public.
- Public finance is about how this money is used. This should be of interest to everybody ……


IT'S OUR TURN TO EAT!!
MPUMALANGA PROVINCIAL LEGISLATURE
PLEASE SIR... MAY WE HAVE SOME MORE...
LEGISLATURE MEMBER
CLICK!

Overview

- **Part I**
  - **Public Finance 101**
- **Part II**
  - **Public Finance in Real Life**
    - Indian Public Finance
    - Global Public Finance

Part I

Public Finance 101

Basic Concepts

- Public finance accounting consists of the revenue and capital accounts.
- Important to remember this distinction.
- The revenue account is the ***flow*** (usually annual) of income and consumption expenditures.
- The capital account is about ***changes*** in government assets, physical and financial.
- The public debt is the accumulated ***stock*** of government borrowings.

Government Accounts

- Government accounts consists of annual government revenue and expenditure.
- The difference between the two is the fiscal deficit.
- The lagged effect of fiscal deficits is the STOCK of public debt. It is possible, but unlikely, to be debt free, or have a surplus of assets over debt.
- Stock of physical assets.
- Sovereign Guarantees: Contingent liabilities

Domestic Public Debt and External

- Domestic debt is what is repayable in borrowing in own currency
- External debt is what is to be repaid in foreign currency, usually in the five reserve currencies – dollar, euro, pound, yen, swiss francs
- External borrowing necessary to finance external deficits, although governments frequently make the error of borrowing to cover domestic deficits as well.

Default on Public Debt

- Domestic debt
  - Sovereign ***nominal*** default on domestic debt can only be wilful as they have the power to mint their own currency.
  - Most common sovereign default on domestic debt is through the ***inflation*** tax.
- Foreign debt
  - Sovereigns can and do default
  - Since markets treat default of private foreign debt as national default, governments usually put controls on external borrowing by private parties.

Government Revenue

- Tax revenue
  - Direct Taxes
  - Indirect Taxes
- Non Tax revenue
  - All other income, including ***earnings*** from assets, such as interest, user charges, natural resources.
  - A common mistake is to include ***sales*** of assets, such as disinvestment, as revenue, when it is a capital account transaction. Disinvestment impacts the fiscal deficit and not the revenue deficit
- Capital receipts: borrowings, sale of assets

Government Expenditure

- Revenue Expenditure
- Capital expenditure
  - Repayment of debt
  - Creation of physical assets.
- Plan expenditure
  - Capital expenditure
  - Revenue Expenditure

Annual Budget

- Annual financial statement of the government.
- Gives a statement of accounts of the year gone by, and makes projections for the coming year. Could have longer medium term projections, such as the Medium Term Fiscal Policy Statement of GOI and Five year Plan
- Main budget documents
  - Receipt budget, both revenue and capital
  - Expenditure Budget, both revenue and capital
  - Annual Plan Budget

Different kinds of budget

- Flow basis
  - Can understate both revenue (due not collected) and expenditure (contracted but not incurred) during the year.
  - Window dressing is possible, one needs to go behind the budget figures – off balance sheet
- Accrual basis
- Zero-based
- India follows the flow based system, which is also the most widely prevalent.

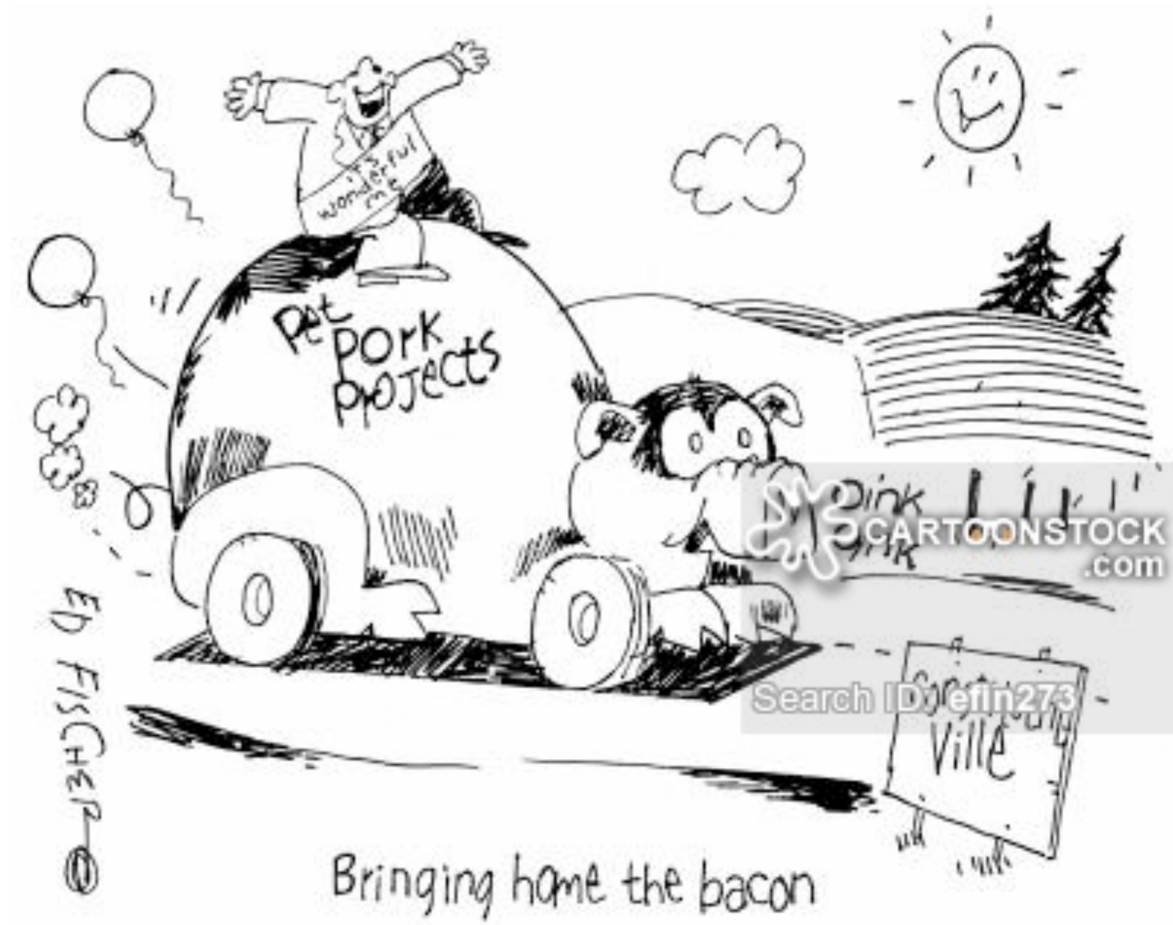
Measures of Public deficits/surplus

- Revenue deficit
- Fiscal deficit
- Primary deficit (excluding interest on debt)
  - Revenue
  - Fiscal
- Cyclical and structural deficits
  - Revenue is very sensitive to growth
  - Expenditure is sticky

Fiscal policy

- Merit and non-merit goods/subsidies
- Keynes and macroeconomic stabilization
  - Monetary policy
  - Fiscal policy
- Automatic and discretionary stabilizers: entry and exit issues; 'pork barrel' politics
- Fiscal multipliers: vary across space and time
- Ricardian equivalence: debt is deferred tax.

Pork Barrel Politics



Sustainable deficits and debt

- These ultimately depend on the real growth rate of the economy and the interest paid on the public debt.
- Sustainable levels of external debt depend on the country's ability to earn hard currency, on its balance of payments.
- The EU Maastricht Treaty set prudential ceilings of 3% and 60% of GDP respectively for the fiscal deficit and debt. These have been used by Indian Finance Commissions.
- Recent study by Reinhart and Rogoff:
  - Public debt over 90% of GDP damages growth
  - For developing country, external debt of over 60% of GDP exposes them to crises.

Domar Debt Sustainability Equation

- nomGDPgr<nomRrate or PD=0

- Debt dynamics: if trend growth goes down and/or real borrowing cost goes up, ceteris paribus, the sustainable debt threshold also goes down

Fiscal Dominance

- Large fiscal deficits put upward pressure on interest rates and prices.
- This can crowd out private investment and lower investment and growth.
- Central banks need to respond by keeping real interest rates lower than they might have otherwise done.
- Failure to do so would only magnify the problem: "unpleasant arithmetic".
- Till recently fiscal dominance mostly a developing country phenomenon.

Part II

Public Finance Practice

Overview

- Indian Public Finance
- Global Public Finance

Indian Public Finance

- Indian Constitution
- Fiscal Federalism
- Finance Commission
- Union and State Budgets
- Annual Plans
- Current fiscal parameters

Indian Constitution

- India is a Union of States.
- In fiscal matters India functions like a federation and not a unitary state.
- The Union and States have separate fiscal powers that they draw from the Constitution.
- State, Union and Concurrent lists of subjects.
- Taxation powers of Centre and States clearly defined.
- 73rd constitutional amendment bestowed Local Bodies with authority and responsibility to perform functions entrusted to them by the Act. However, the Act has not provided them with any powers directly, leaving it to state government discretion.

Fiscal Federalism mimics Monetary Union

- Constituent States do not have monetary autonomy
- So they cannot print their way out of default on debt.
- So Monetary unions have a mechanism for fiscal transfers from the Centre to the States
- So hard budget constraints need to be imposed on constituent States: Article 293 of the Indian Constitution.
- The US has s similar fiscal structure: fiscal transfers, and States cannot run budget deficits.
- The Eurozone crisis continues to fester because there is no mechanism for fiscal transfers and no hard budget constraint.

Finance Commissions

- Two fundamental imbalances
  - Vertical: revenue skewed towards centre and expenditure towards States
  - Horizontal: Fiscal capacities of States vastly different.
- The Constitution mandated five yearly Finance Commissions to address both these imbalances: 14 Commissions so far.
- The Finance Commission divides the Centre's tax revenues (the divisible pool) between the Centre and the States – vertical devolution.
- It also decides how the State's share is to be allocated between different States

XIV Finance Commission Award

- Funds transferred from divisible pool of taxes to States averaged 66.9% between 2007/08 and RE 2013/14.
- XIV FC projects 63.44% (actuals will depend on actual tax receipts) over the next five years.
- Of this tax devolution from pool was 32%. XIV FC raises this to 42%.
- Share of discretionary transfers (including those of FC) reduced from 34.9% to 21.44%
- Changes in Budget 2015-16 on account of XIV FC Award:
  - Central support to some centrally sponsored schemes reduced, and some delinked altogether.
  - Normal and Special Central Assistance for State Plans discontinued.

Union and State Budgets

- Prepared by finance departments and assed by Parliament and State legislatures before each financial year each year, with supplementaries during the year.
- Make projections of revenue likely to be available, projected expenditures, and how the deficit is to be financed.
- The accounts of the Union and the States are audited by the Comptroller and Accountant General, another constitutional body, and presented to Parliament and State legislatures
- For historic reasons India also has a separate Railway Budget

Budgeting exercise

- Revenue
  - Tax revenues estimate on the basis of past growth trends, and/or estimated economic growth and tax buoyancy.
  - Estimate of non-tax revenues
  - States make estimates of devolutions from centre, both mandatory (FC Award) and discretionary – centrally sponsored schemes.
- Department wise expenditure allocations: revenue, capital, plan.
- Financing the deficit

Central Expenditure

	2014-15	2015-16
Transfer to States	36	37
Interest payments	20	20
Central Plan	11	11
Subsidies	12	10
Defence	10	11
Other Non-plan	11	11

Expenditure Rigidities

- Over over 90 % of central non-plan expenditure, accounted for by 6 items where expenditure cannot be easily reduced: interest, defence, pension, salaries, subsidy and grants to States.
- Almost 70% of central government expenditure is non-plan.
- Plan ***Capital*** Expenditure as a percentage of total Plan expenditure is less than 10%.
- Gross capital formation out of central budgetary resources has remained around 2.5% of GDP

Infrastructure and Public Finance

- India has a huge infrastructure deficit: the biggest drag on sustaining high growth.
- Much of this investment has to come from budgetary sources
- This would mean reorienting expenditure away from subsidies :fuel and fertilizer in particular.
- Biggest challenge for Indian public finance.

Annual Plans

- Passed along with the budget.
- Resources finalized through consultations between Finance Departments and Planning Departments/ Commission/Boards.
- Outlays finalized by Planning Departments/ Commission/ Boards in consultation with line departments
- Major change from 2015-16 because of abolition of the Planning Commission and central support for State Plans.
- Central Plan now coordinated by Union Finance Ministry.

Public Finances 2014/15 (% of GDP)

- Central
  - Fiscal Deficit : 4%
  - Revenue Deficit: 2.9%
  - Primary Revenue Deficit: - *0.4%%*
  - Public Debt: 50.3%
- States
  - Fiscal Deficit: 2.9%
  - Revenue Deficit: 0.1%
  - Primary Revenue Deficit: - *1.4%*
  - Public Debt: 21.8%

Consolidated 2014/15 (% of GDP)

- Fiscal Deficit : 6.3%
- Revenue Deficit: 3%
- Primary Revenue Deficit: *-1.7%*

- Public Debt: 67% (incl. publicly held external debt)

- Total External Debt: 23.8%

Global Public Finance

- The GFC and Public Finance
- Reversal of roles?
- Reasons for increase in public debt in AEs
- Return of Fiscal Dominance in AEs?
- Fiscal Lessons for India

The Global Financial Crisis

- Fiscal crisis brewing in advanced economies because of ageing, declining trend growth and generous social protection programs.
- Crisis accelerated by the policy response to the GFC:
  – Monetary policy: conventional and non-conventional
  – Fiscal policy: to bail out the financial sector and to stimulate demand to restore growth
- Rapid worsening of fiscal parameters and steep rise in public debt in AEs

Fiscal Response: Deficits and Gross Debt

% of GDP	2007		2008		2009		2010		2011		*2012**		*2013**	
	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt
Advanced	**-2.7**		**-3.5**	**81.3**	**-9.0**	**94.9**	**-7.8**	**101.5**	**-6.6**	**105.5**	**-5.9**	**110.2**	**-4.7**	**109.3**
France	-2.8	64.2	-3.3	68.2	-7.6	79.2	-7.1	82.3	-5.2	86.0	-4.6	90.3	-3.7	92.7
Germany	0.2	65.4	-0.1	66.8	-3.1	74.5	-4.1	82.5	-0.8	80.5	0.2	82.0	-0.3	80.4
Greece	-6.8	107.3	-9.9	112.5	-15.6	129.3	-10.7	147.9	-9.4	170.6	-6.4	158.5	-4.6	179.5
Iceland	5.4	29.1	-0.5	70.4	-8.6	88.0	-6.4	90.6	-5.0	102.3	-3.0	99.1	-1.3	91.9
Ireland	0.1	25.0	-7.4	44.5	-13.9	64.9	-30.9	92.2	-13.4	106.5	-7.7	117.1	-7.5	122.0
Italy	-1.6	103.3	-2.7	106.1	-5.4	116.4	-4.3	119.3	-3.7	120.8	-3.0	127.0	-2.6	130.6
Japan	-2.1	183.0	-4.1	191.8	-10.4	210.2	-9.3	216.0	-9.9	230.3	-10.2	237.9	-9.8	245.4
Portugal	-3.2	68.3	-3.7	71.6	-10.2	83.1	-9.8	93.2	-4.4	108.0	-4.9	123.0	-5.5	122.3
Spain	1.9	36.3	-4.5	40.2	-11.2	53.9	-9.7	61.3	-9.4	69.1	-10.3	84.1	-6.6	91.8
United Kingdom	-2.9	43.7	-5.1	52.2	-11.4	68.1	-10.1	79.4	-7.9	85.4	-8.3	90.3	-7.0	93.6
United States	-2.7	66.5	-6.7	75.5	-13.3	89.1	-11.1	98.2	-10.0	102.5	-8.5	106.5	-6.5	108.1
BRICS	***0.3***	***39.3***	***-1.2***	***37.9***	***-5.6***	***40.4***	***-4.3***	***42.8***	***-2.9***	***41.6***	***-3.5***	***42.3***	***-3.3***	***41.6***
Brazil	-2.7	65.2	-1.4	63.5	-3.1	66.9	-2.7	65.2	-2.5	64.9	-2.8	68.5	-1.2	67.2
Russia	6.8	8.5	4.9	7.9	-6.3	11.0	-3.4	11.0	1.5	11.7	0.4	10.9	-0.3	10.4
India	-4.8	75.0	-8.6	73.3	-10.1	75.0	-8.7	68.5	-8.4	66.4	-8.3	66.8	-8.3	66.4
China	0.9	19.6	-0.7	17.0	-3.1	17.7	-1.5	33.5	-1.3	25.5	-2.2	22.8	-2.1	21.3
South Africa	1.4	28.3	-0.4	27.8	-5.5	31.3	-5.1	35.8	-4.0	39.6	-4.8	42.3	-4.8	42.7

Biggest Peacetime Increase in US Public Debt

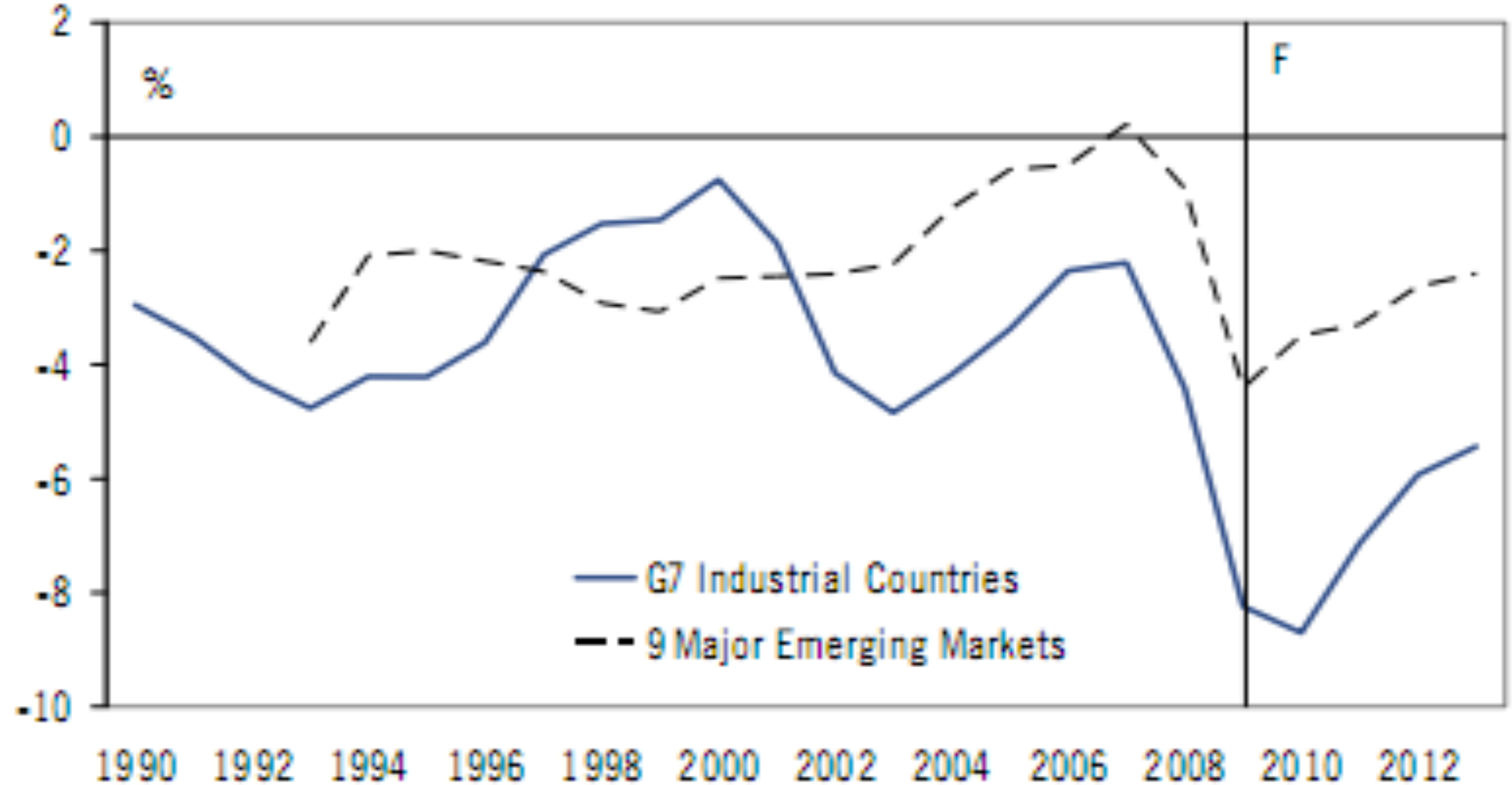
Federal Debt Held by the Public, 1790 to 2011

(Percentage of gross domestic product)

Sources: Congressional Budget Office; Office of Management and Budget.

Reversal of Roles I

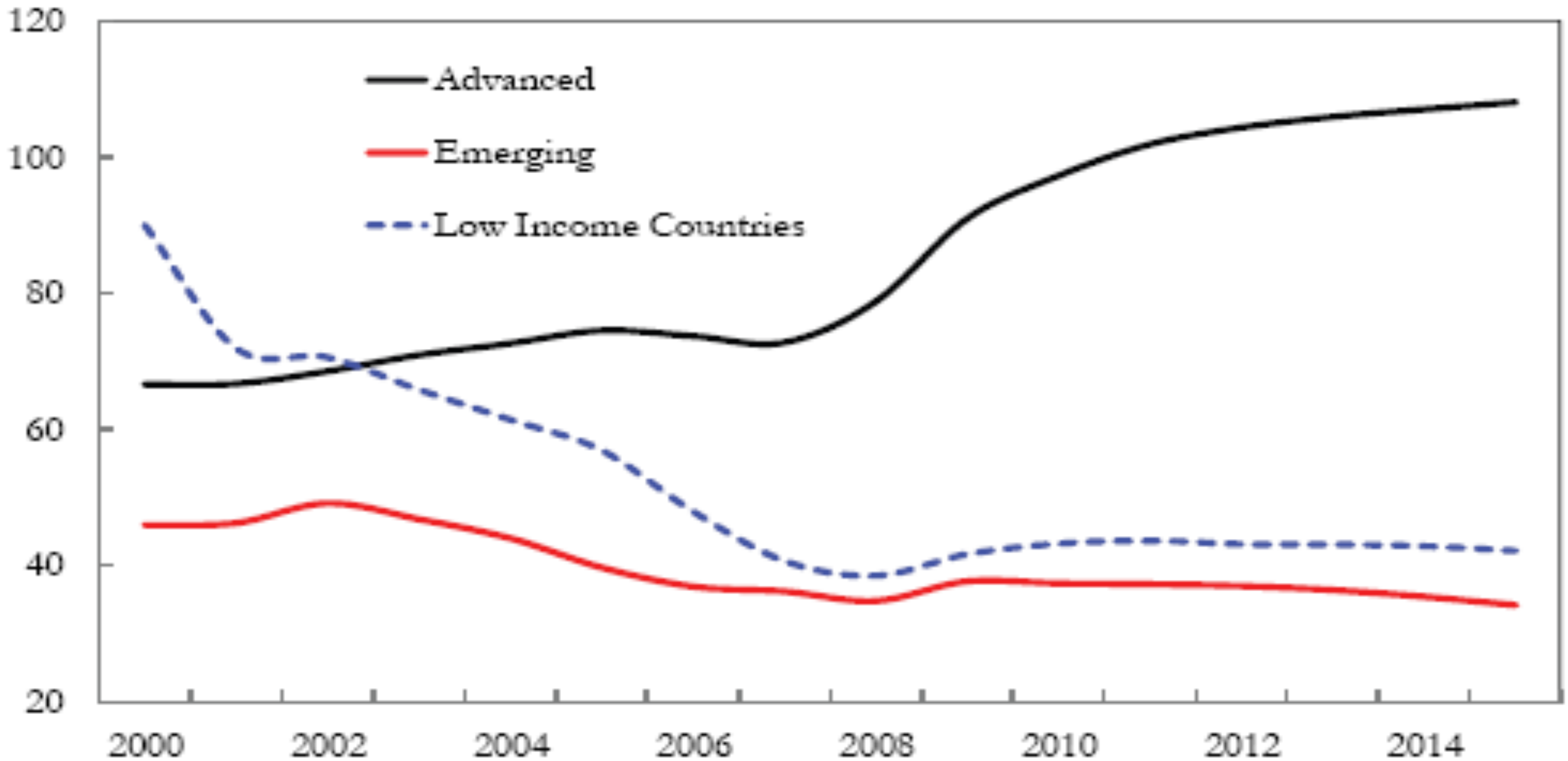
Figure 4. Global — Fiscal Deficits in Industrial Countries and Emerging Markets, (% of GDP), 1990-2013F



Reversal of Roles II

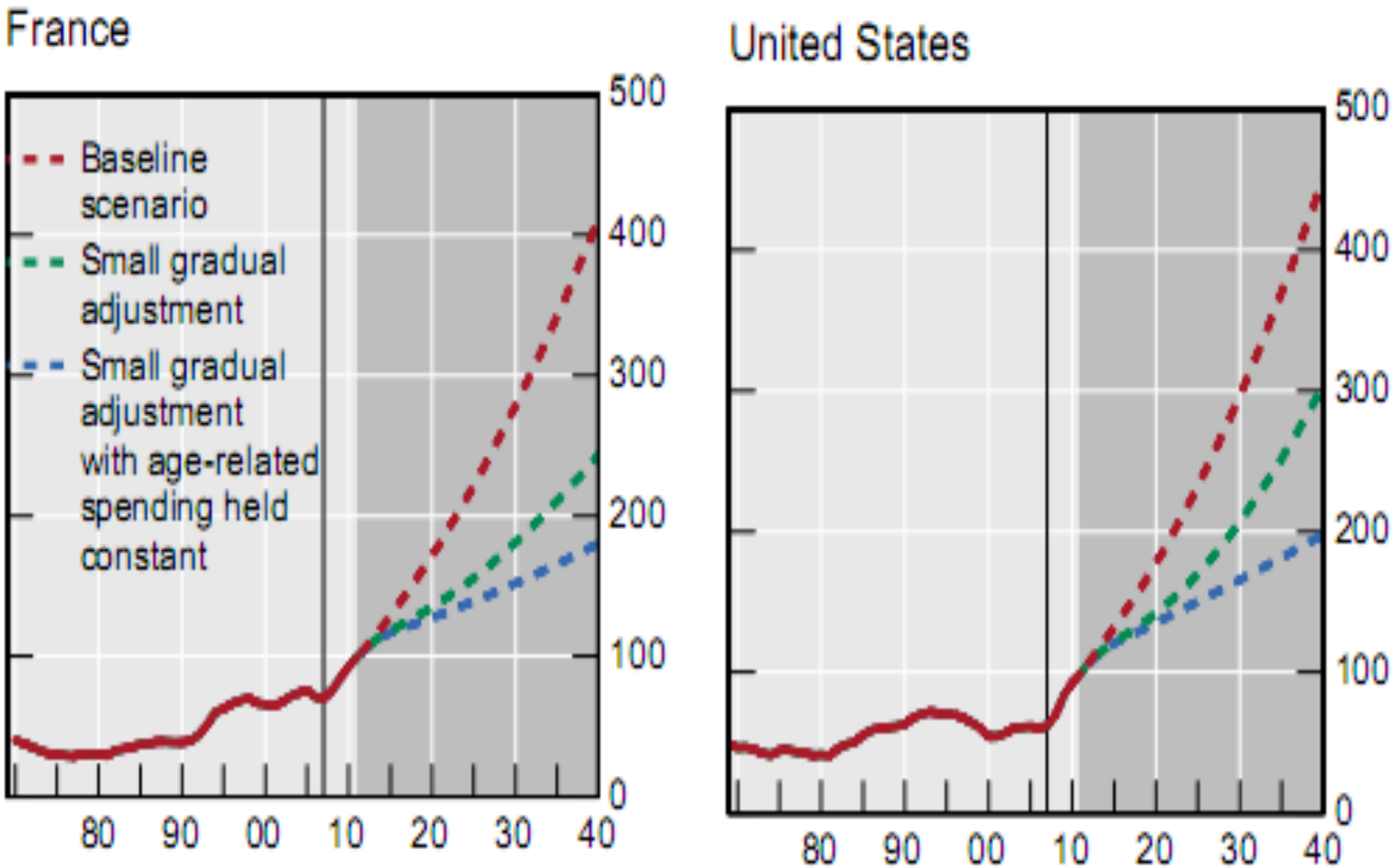
Figure 1.6. General Government Gross Debt Ratios

(Percent of GDP; 2009 PPP-GDP weighted average)



Source: IMF staff estimates based on October 2010 WEO projections.

Debt Projections



Source: **BIS**

So what has happened?

- Adverse fiscal dynamics:
  - Demographics: rising welfare expenditures and falling trend growth
    - Social compacts became unsustainable
    - No serious attempts to deal with the problem
    - Above trend growth during the 'Great Moderation' limited impact of deficits on Debt/GDP ratios
    - Rising deficits meant that there was little fiscal space to deal with cyclical downturns
- Adverse fiscal dynamics accelerated by the Global Financial Crisis that may have permanently damaged growth ('New Normal')

Fiscal Aftermath of the Global Economic Crisis

- Cyclical deficits widen and public debt typically rises after deep recessions.
- Effective macroeconomic management entails growing out of cyclical deficits and debt.
- Present crisis not just another cyclical downturn: structural impediments to fiscal health need structural reforms
- If debt levels reach explosive levels there may be little alternative but to partly inflate it away ('inflation tax')
- Sovereign debt sustainability problems compounded by market response in peripheral Euro Zone countries (PIGS): existing level of debt can become unsustainable if borrowing costs rise sharply
- Fears of debt trap and inflationary outcomes extend beyond PIGS.

What drives deficits and Debt

- IMF: sharp rise in fiscal deficits in downturns more on account of revenue declines consequent on falling growth than because of stimulus.
- Debt=lagged outcome of past fiscal deficits
- If two countries have similar deficits, but different growth rates, Debt/GDP ratios will rise faster in the country growing slower
- Contrast India and US:
  - both have seen sharp rise in fiscal deficits
  - Debt/GDP in India improved US dramatically worsened.
  - 13th FC debt/GDP targets achieved comfortably ahead of schedule, despite continuing fiscal slippages.

India – US: Deficit and Debt

Percentage of GDP								
	India						United States	
	Gross Fiscal Deficit			*Debt*			*GFD*	*Debt*
Year	Centre	State	Comb	Centre	State	Comb	Federal	
2002-03	6.0	3.9	9.7	61.1	32.0	77.6	-1.5	58.8
2003-04	4.6	4.3	8.7	61.4	32.8	79.2	-3.4	61.6
2004-05	3.9	3.1	7.3	59.6	31.3	76.2	-3.5	63.0
2005-06	4.7	2.3	7.3	58.6	31.1	73.8	-2.6	63.6
2006-07	4.3	1.8	6.3	56.7	28.9	70.0	-1.9	64.0
2007-08	3.1	1.5	4.7	54.6	26.6	67.2	-1.2	64.6
2008-09	8.1	2.4	10.5	53.9	26.1	67.5	-3.2	69.7
2009-10	6.7	2.9	9.6	52.4	25.5	66.8	-10.1	85.1
2010-11	4.8	2.1	6.9	48.5	23.5	61.5	-9.0	94.3
2011-12	5.8	2.3	8.1	47.9	22.3	61.4	-8.7	98.9
2012-13	5.2	2.4	7.6	48.3	22.2	63.9	-7.0	103.2
Source :	for India : Data Base on Indian Economy, Reserve Bank of India							
	for US : Office of Management of Budget, US ,							
		Link: http://www.whitehouse.gov/omb/budget/Historicals						

Nominal General Government Balance

General Government Balance: Per Cent of GDP									Expansion	Tightening
	2006	2007	2008	2009	2010	2011	2012	2013	08-10	11-13
ADVANCED		***-1.1***	***-3.5***	***-9***	***-7.8***	***-6.6***	***-5.9***	***-4.7***	***-6.2***	***2.7***
US	**-2**	**-2.7**	**-6.7**	**-13.3**	**-11.1**	**-10**	**-8.5**	**-6.5**	***-8.0***	**3.9**
UK	**-2.6**	**-2.7**	**-5.1**	**-11.4**	**-10.1**	**-7.9**	**-8.3**	**-7**	***-6.2***	**3.0**
Japan	**-3.7**	**-2.4**	**-4.1**	**-10.4**	**-9.3**	**-9.9**	**-10.2**	**-9.8**	***-4.9***	**-0.1**
Euro Area	**-1.3**	**-0.6**	**-2.1**	**-6.4**	**-6.2**	**-4.1**	**-3.6**	**-2.9**	***-4.0***	**2.8**
Germany	-1.6	0.2	-0.1	-3.1	-4.1	-0.8	0.2	-0.3	***-1.7***	**3.3**
France	-2.4	-2.7	-3.3	-7.6	-7.1	-5.2	-4.6	-3.7	***-3.5***	**2.9**
Italy	-3	-1.5	-2.7	-5.4	-4.3	-3.7	-3	-2.6	***-1.9***	**1.8**
Spain	2	1.9	-4.5	-11.2	-9.7	-9.4	-10.3	-6.6	***-10.4***	**1.7**
Greece	-6	-6.8	-9.9	-15.6	-10.7	-9.4	-6.4	-4.6	***-5.7***	**6.4**
Portugal	4.1	-3.2	-4.5	-10.2	-9.8	-4.4	-4.9	-5.5	***-8.6***	**5.1**
Ireland	2.9	0.1	-7.4	-13.9	-30.9	-13.4	-7.7	-7.5	***-18.9***	**12.9**
BRICS	**-0.3**	**0.48**	**-1.24**	**-5.62**	**-4.28**	**-2.94**	**-3.54**	**-3.34**	***-3.8***	**1.7**
Brazil	-3.5	-2.6	-1.4	-3.1	-2.7	-2.5	-2.8	-1.2	***0.6***	**0.7**
Russia	8.3	6.8	4.9	-6.3	-3.4	1.5	0.4	-0.3	***-9.2***	**5.4**
India	-6.4	-4.2	-8.6	-10.1	-8.7	-8.4	-8.3	-8.3	***-3.8***	**1.1**
China	-0.7	0.9	-0.7	-3.1	-1.5	-1.3	-2.2	-2.1	***-1.9***	**0.4**
South Africa	0.8	1.5	-0.4	-5.5	-5.1	-4	-4.8	-4.8	***-4.8***	**0.8**
Source	***IMF, Fiscal Monitor April 2013, etc.***									

Cyclically Adjusted General Government Balance

Cyclically Adjusted General Government Balance: Per Cent of GDP									*Stimulus*	*Tightening*
	2006	2007	2008	2009	2010	2011	2012	2013	*08-10*	*11-13*
G-7	***-2.7***	***-2.7***	***-4.1***	***-6.6***	***-7.1***	***-6.2***	***-5.4***	***-4.2***	***-3.2***	***1.8***
US	**-2.3**	**-2.8**	**-5.1**	**-8.1**	**-8.5**	**-7.7**	**-6.4**	**-4.6**	**-4.7**	**2.3**
UK	**-4.7**	**-5.2**	**-7.3**	**-9.7**	**-8.6**	**-6.5**	**-5.4**	**-4.3**	**-3.6**	**3.2**
Japan	**-3.6**	**-2.2**	**-3.5**	**-7.5**	**-7.9**	**-8.5**	**-9.3**	**-9.5**	**-3.4**	**-1.2**
Euro Area	**-2.1**	**-2.1**	**-3.1**	**-4.6**	**-4.8**	**-3.4**	**-2.4**	**-1.3**	**-2.1**	**2.4**
Germany	-2.2	-1.2	-1.3	-1.2	-3.5	-1	0.1	0	-0.3	3.2
France	-2.4	-3.1	-3.1	-5.1	-5.1	-3.9	-3.1	-1.9	-1.7	2.1
Italy	-4.7	-3.3	-3.6	-3.4	-3.4	-2.8	-1.2	-0.2	0.5	2.0
Spain	1.1	0.3	-5.6	-10.2	-8.3	-7.6	-5.1	-4.2	-8.7	2.7
Greece	-8.7	-10.9	-14.2	-19.1	-12.2	-8.2	-2.7	0.2	-5.4	8.6
Portugal	-3.8	-4	-4.3	-9.4	-9.7	-3.6	-3	-3	-3.9	6.5
Ireland	-4	-8.6	-11.9	-10.3	-8.7	-7	-6	-5.5	-4.0	2.5
BRICS	**-0.2**	**-0.52**	**-2.26**	**-4.78**	**-4.06**	**-2.88**	**-3.3**	**-3.16**	**-3.3**	**0.9**
Brazil	-3.3	-3	-2.1	-2.3	-3.3	-3	-2.7	-1.2	0.6	1.0
Russia	8.2	6.1	3.9	-3.2	-1.8	2	0.5	-0.4	-7.5	2.5
India	-6.2	-6.5	-10.4	-10.5	-9.5	-9.2	-8.8	-8.8	-3.8	0.6
China	0	1	-0.5	-2.6	-0.9	-0.2	-0.9	-0.9	-1.8	0.2
South Africa	0.3	-0.2	-2.2	-5.3	-4.8	-4	-4.6	-4.5	-4.2	0.4
Source	***IMF, Fiscal Monitor April 2013, etc.***									

US, Japan, Italy & Euro Periphery

- Large fiscal deficits and low borrowing costs
  - reserve currency advantage: Big external demand for US Treasuries
- Japan running huge government deficits, with public debt of over 200% to GDP with no impact on borrowing costs.
  - public deficits lower than private savings
- Italy: High debt but low borrowing costs:
  - balanced budget
- Peripheral European countries like developing countries:
  - borrowing costs suddenly dropped after joining Euro
  - ran up high deficits and debt
  - Market revolt

When growth & private demand revive

- High fiscal deficits would have to be reduced to prevent crowding out of private demand
- Might be difficult to reduce fiscal deficits because of sharp rise in debt servicing as interest rates rise : fiscal dominance
- QE tapering shock: Will central banks be forced to keep interest rates low (below inflation rate) for a longer period than necessary to protect sovereign balance sheets? Return of financial repression = insidious tax.
- Would need to keep inflationary expectations well anchored because of adverse fall out on growth.
- Could sovereign debt lose its risk free status? For brief periods yields on top rated Corporate paper fell below that of US Treasuries. Sovereign bonds the new sub-prime? New safe havens: gold; prime Corporate equities; Oil/commodities

Fiscal Lessons for India

- Fiscal rules should be counter cyclical: difference between structural and cyclical balance.
- Sustainability of debt is linked to trend growth: fiscal space for structural transformation (infrastructure) available at a critical stage of growth. Needs to be used wisely
- Long term sustainability of social compacts an issue.