New Fiscal Rule – Implications and Concerns

Mains: *GS III – Economy*

Why in News?

Recently, the annual financial statement was placed by the union finance minister and it has various implications and concerns.

What is fiscal policy?

- **Fiscal policy** – It refers to the use of government spending and taxation to influence a nation's economic conditions, including aggregate demand, employment, inflation, and growth rates.
- **Administration** – It is managed by the government (often the finance ministry).
- It aims to stabilize the economy over business cycles—typically increasing spending or cutting taxes during downturns (expansionary) and reversing these during booms (contractionary).
- **Tools** – The primary tools are government spending (infrastructure, social programs) and taxation (personal/corporate income tax, indirect taxes).
- **Objectives** – To promote economic growth, maintain price stability (control inflation), reduce unemployment, and achieve an equitable distribution of income.
- **Types**
    - **Expansionary Fiscal Policy** – Involves higher government spending or lower taxes to boost demand and stimulate growth, usually during recessions.
    - **Contractionary Fiscal Policy** – Involves reducing spending or increasing taxes to lower demand and cool down an overheating economy.
- **Importance and Context** – Fiscal policy is a crucial tool for long-term economic development, infrastructure building, and responding to economic crises.
- It is often used in conjunction with monetary policy (managed by central banks) to manage the overall economy.
- The concept is rooted in Keynesian economics, which suggests active government intervention can counteract recessionary or inflationary pressures.

What are the directions of fiscal policy in India?

- **Role of fiscal rules** – The direction of fiscal policy is influenced by the nature of fiscal policy rules.
- The present fiscal policy rule of the Union government is informed by what can be termed as sound finance rules, where the government typically aims to meet a given borrowing target.

- **Recent Modification** – While India has been largely following sound finance rules since the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, there have been two modifications since the last year.
    - **First,** in contrast to the FRBM Act, where the fiscal deficit-GDP ratio acted as the primary policy target, it is the debt-GDP ratio which appears as the primary policy target in the new policy rule.
    - **Second**, the targeted level of debt-GDP ratio in the new rule stands at around 50%, which the government proposes to meet by 2031.
    - The new rule allows the government to sustain higher debt-GDP ratio as compared to the level suggested in the FRBM Act (40%).
- **Implications** – The two implications of the present variant of sound finance rule for this year's Budget:
    - **First**, since the present level of debt-GDP ratio stands above the targeted level, the government has aimed to reduce its debt-ratio by reducing the primary deficits and fiscal deficits from 0.8% and 4.4% in FY 2026 to 0.7% and 4.3% respectively in FY 2027.
    - The fiscal consolidation strategy is similar to one pursued since FY 2022.
    - **Second,** the new target of debt-GDP ratio has provided greater fiscal space to the government as compared to the FRBM Act.
    - While both the primary and the fiscal deficits have been reduced for FY27, the magnitude by which they have been reduced is less severe compared to the period since FY22.

What does the annual financial statement Indicates?

- **Reduction of expenditures** – Any reduction in primary deficits and fiscal deficits requires the government to reduce its expenditures as compared to the non-debt receipts.
    - The Budget Estimate (BE) of FY27 indicates a fall in the government's share of non-debt receipts in GDP to 9.3% as compared to 9.5% in FY26.
- This is largely on account of the fall in the share of indirect taxes and GST, both of which indicate a decline by 0.3% points in FY27 as compared to FY26.
- Amid lower non-debt receipts, the reduction in deficits in FY27 is brought about by a more than proportionate fall in the share of total expenditure in GDP.
- As compared to 13.9% in FY26, the BE of expenditure-GDP ratio indicates a decline in FY27 to 13.6%.
- **Capital expenditure-GDP ratio** – It remains roughly at the same level (3.1%), the reduction in expenditure ratio is brought about by the reduction in revenue expenditure.
- This trend is similar to the previous years, where the government has aimed to change the composition of expenditures in favour of capital expenditure on account of its high multiplier value.
- The burden of adjustment of this reduction in total expenditures has fallen on development expenditures.
- The latter is the sum of government expenditures on the social sector and economic services.
- **Reduction in Budget estimate (BE)** – The Annual Financial Statement indicates a

reduction in the BE of the share of development expenditures in GDP to 5.7% in FY27 as compared to 6.1% in FY26.

- **Reduction in development expenditure** – The reduction in the share of development expenditures is largely on account of a similar fall in the expenditures on, rural development and agriculture and allied activities the share of which indicates a decline to 1.2% in FY27 as compared to 1.5% in FY 26.
- The fall in rural development expenditures was on account of sharp fall in the expenditures in the revenue account of rural employment.

What are the major concerns?

- **Stimulus for Investments** – The first concern relates to stimulus for investments in an uncertain global economy.
- The investment-capital ratio of the corporate sector in the recent period has remained low in the midst of low global demand and exports.
- The present fiscal strategy hardly provides any stimulating role to corporate investments.
- **Concern of distribution** – The second concern involves the distribution question in India's growth process.
- The burden of adjustment of the fiscal consolidation strategy of the government has been largely borne by the development and agricultural expenditures in the recent period.
- This is in contrast to the corporate tax-GDP ratio, the level of which remains largely the same as the pre-covid level.
- While meeting its debt targets, the present fiscal strategy has largely bypassed these two challenges.

Reference

The Hindu| Fiscal Policy and Recent Changes