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THINK OVER

Is the 3% fiscal deficit target a number pulled out of thin air? Although the FRBM law does not say it explicitly, the number was determined through some simulations of debt dynamics

In defence of fiscal adjustment

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This is the second and concluding part of a series, the first part of which appeared in Viewpoint page on Feb 19.

WHAT we need is not fiscal contraction but fiscal expansion. Although the argument for an expansionary fiscal stance is quite persuasive, it is also contestable from both analytical and empirical perspectives.

From an analytical perspective, the fiscal expansion argument works only in a very limited case — there is no revenue deficit and the investments made out of the borrowing generate returns sufficient to service the debt. Neither of these conditions is met is the Indian case. Even if we achieve zero revenue deficit and use borrowings only for investment expenditure a la the golden rule, we still need to restrain fiscal deficits because the budgetary returns on investment are typically lower than the cost of borrowing. We will need to dip into the revenue pool to service the debt. After all, today's fiscal deficits incurred to support capital expenditures can all too easily become tomorrow's revenue deficits. We need to operate the golden rule together with a ceiling on fiscal deficit. It is worth noting that even the UK's golden rule is subject to a debt ceiling.

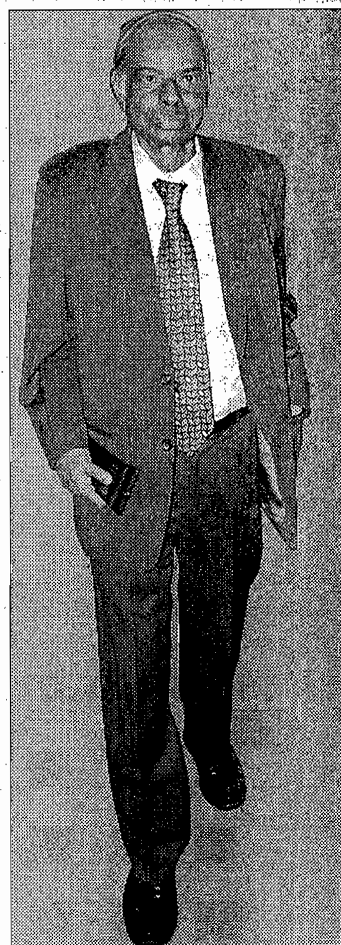
From an empirical perspective, it is true that our high fiscal deficits have not, over an extended period, had an adverse economic impact by way of higher inflation or interest rates. Admittedly, this is contrary to received wisdom. But this apparent paradox is the result of a fortuitous combination of circumstances. The economic reforms launched in 1991 — notably, the abolition of industrial licencing, dereservation of industries and trade liberalisation — had unleashed competitive forces resulting in higher investment as well as higher efficiency in production, leading to an increase in production capacity which ran ahead of demand. This excess capacity led to a slackening of corporate investment demand, which declined from 9.6% of GDP in 1995-96 to 5.6% in 2001-02. The slackening of corporate investment demand coincided with the period when fiscal deficits, after the compression of the immediate post-reform period, started to expand once again. It was because of this sluggish private investment demand that we escaped higher interest rates despite higher fiscal deficits. These domestic dynamics were aided by some exogenous factors as well such as the softening of global interest rates which helped restrain domestic interest rates.

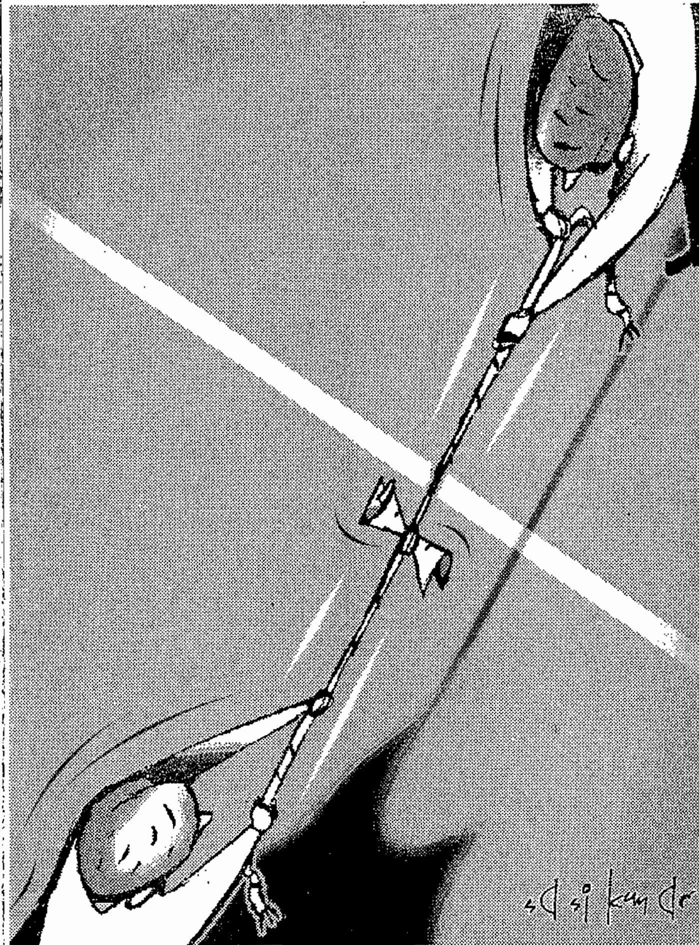
Some of these one-off circumstances are beginning to reverse. Globally, the era of cheap money has come to an end. For the first time in 15 years, the three big central banks — the US Federal Reserve, the European Central Bank and the Bank of Japan — have all tightened monetary policy. More importantly, the slack in the economy has been fully absorbed and the 'output gap' has been fully bridged. In fact, the concern today is the precise opposite — that the economy is performing at its full capacity and demand is running ahead of potential output. Interest rates are inching back up and year-on-year inflation had crossed 6.5% in January 2007. Two inferences follow from this. First, the temporary reprieve that the economy had in the later half of the 90s cannot be taken for granted; fiscal deficits do take their toll. Second, we are heading into a situation of increasing competition for the limited pool of invetstable resources and this will intensify the crowding out impact of fiscal deficits and compromise the growth momentum.

A variant of the fiscal expansion argument, drawing from the Keynesian worldview, is that the government needs to borrow and spend in order to stimulate aggregate demand thereby spurring employment and growth through the multiplier effect. But it is important to remember that the Keynesian logic works only if the economy is demand-constrained and is operating below full employment as, for example, the US economy during the Great Depression of the 1930s.

The Keynesian effect does not materialise if the economy is not demand constrained. This is evidenced by our own experience over the last decade. The burgeoning fiscal deficits during 1998-99 to 2002-03 were accompanied by economic slowdown. This was because our debt was large relative to GDP and the borrowings went not to finance productive expenditure but to service the debt. On the contrary, the fiscal correction starting 2002-03 saw a healthy rebound in growth. This cannot simply be a coincidence. It is important to remember that even Keynes recommended his approach only for 'pump priming', but not to keep the pump running on a long-term basis.

Even those who admit to fiscal responsibility at the big picture level question some of the details. The following paragraphs address the more contentious issues in this debate.





INTERNAL AFFAIR

Combined fiscal deficit of Centre & states at 6% of GDP is consistent with ratio of savings of household financial assets relative to GDP & prudent levels of current account deficit

IS THERE SANCTITY TO 3% FISCAL DEFICIT TARGET?

Among the most contentious issues is the sanctity of a 3% target of fiscal deficit each for the Centre and the states. Is there a rationale for this or is it just a number pulled out of thin air?

First of all, it must be acknowledged that determining an appropriate level of fiscal deficit is a complex problem. There is an enormous amount of public finance literature on fiscal deficits but virtually no paper that gives a template for determining the appropriate fiscal deficit. It is this backdrop which has triggered the criticism that the 3% target has no justification and that it has simply been copied from the Mastricht Treaty which mandates the members of the EU to maintain a 3% fiscal deficit over an economic cycle.

Even though the FRBM Act has not been explicit about it, the targets for both fiscal and revenue deficits are based on the recommendations of a finance ministry committee which determined these numbers on the basis of some simulations of the debt dynamics. The simulations themselves though are not in the public domain.

Quite independently, the Twelfth Finance Commission provided a detailed rationale for the fiscal deficit target of 6% for the Centre and states combined. The commission argued as follows. The Mastricht Treaty allows its members a 3% fiscal deficit. Undoubtedly, the higher savings rate in India will allow a higher level of fiscal deficit relative of GDP to be maintained. Time series data on savings show that the household sector in India has excess savings over its investments of the order of 10-11% of GDP. Add to this foreign savings by way of current account deficit of the order of 1.5-2% of GDP yielding savings of the order of 13% of GDP available to be appropriated by the other two sectors of the economy — public sector and the corporate sector — for investment. Up to 5% of this will go to the corporate sector and 8% to the combined public sector. Of the latter about 2% will go to the non-departmental undertakings leaving 6% for the government to be apportioned equally between the Centre and the states. Thus, a combined fiscal deficit of 6% of GDP is consistent with the existing ratio of savings of the household sector in financial assets relative to GDP and prudent levels of current account deficit and the demand on these by the private corporate sector and non-departmental public enterprises.

Apart from the savings dimension, the target for fiscal deficit also needs to be informed by the debt dynamics such as the ratios of debt to GDP and interest payments to revenue. The debt dynamics are such that unrestrained fiscal deficits will put us on a vicious cycle of higher debt relative to GDP and a larger portion of the revenues being preempted for interest payments. It is important to restrain fiscal deficit in order to first bring down and then stabilise the debt-GDP and interest payments to revenues at reasonable levels.

SHOULD REVENUE DEFICIT BE A TARGET?

It is argued that internationally fiscal rules do not target revenue deficits; they focus instead on the fiscal deficit and on the primary deficit (i.e., fiscal deficit excluding interest payments) as the relevant control variables. The case for focusing on the primary deficit is simply that interest costs on accumulated debt are outside the scope of government control and while they may vary with interest rate changes, this variation does not reflect the quality of fiscal control.

This is debatable. First, it is not correct to say that the revenue deficit target is not internationally recognised. The UK, for example, has the 'golden rule' which mandates the government to restrict borrowing to the extent of capital expenditure. Accordingly, under the golden rule, capital expenditure equals borrowing plus any plough back from surplus on the revenue account. The golden rule is, therefore, similar to our zero revenue deficit target. Several other countries too have mandated discipline on maintaining a balance on the current account of the budget. If we do not hear much of a debate on revenue deficits, it is not because restraining them is considered unimportant for macro management but because not many countries have revenue deficits as we know them. It may be recalled that even in India, revenue deficits were a phenomenon that started life only in the early 80s.

Second, in a conceptual sense, of the three variables, fiscal deficit, primary deficit and revenue deficit, it does not matter which two variables we target. As long as we target any two variables, the third variable is determined too. Illustratively, it is possible to calibrate a primary deficit target corresponding to a zero revenue deficit and shift targeting from revenue deficit to primary deficit. In that sense what matters is the quantum of adjustment we want to make and not which two variables we target.

FIXATION

EU & the UK have cyclically adjusted fiscal deficit targets, which suit economies which have achieved sustainable debt-GDP ratios. India would be better off with a fixed target

CYCLICALLY ADJUSTED FISCAL DEFICIT TARGET

Reflecting the efficacy of a counter-cyclical fiscal policy, both the EU and the UK have cyclically adjusted fiscal deficit targets. This means that during an upturn the economy builds up credit by running a surplus and encashes the credit by incurring a deficit during a downturn so that over the economic cycle the target deficit is maintained. It is argued that India too must adopt a similar cyclically adjusted fiscal management.

However, we would be better off with a fixed target. A cyclically adjusted policy works only when the debt-GDP ratio is at a sustainable level. Debt sustainability and fiscal deficit are interlinked and should not be viewed on a stand-alone basis. A fiscal deficit of 8% when the debt-GDP ratio is 100% has sustainability implications quite different from an 8% deficit when the debt-GDP ratio is 50%. In our case the debt-GDP ratio is above the sustainability level. We need to first bring it down and then stabilise it at that low level. It cannot be achieved unless we maintain a low fiscal deficit over a period. A cyclically adjusted policy can be an option after the adjustment phase is complete. Cyclical adjustment, of course, presupposes that the economy is subject to economic cycles.

After years of discussion, the Centre and states have enacted fiscal responsibility legislations. It is important to remain committed to the FRBM targets. These targets need not necessarily come in the way meeting necessary and desirable expenditures. Recent experience shows that strong growth will make it possible to meet deficit targets and still leave enough resources for meeting the expenditure needs. Remaining committed to fiscal responsibility will strengthen the growth momentum.

(Author is chairman, PM's Economic Advisory Council. Dr Duvvuri Subbarao, secretary to the council, co-authored the article)

ZERO-SUM GAME

The UK has a 'golden rule' restricting govt borrowing which is akin to India's zero revenue deficit target. Targeting any two of the three deficits will automatically fix the third