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Earnest about fiscal responsibility

Staying the course and delivering on the FRBM targets is critical to sustaining the current growth momentum

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THERE is, by definition, a tension between fiscal restraint and finding resources for all the expenditure needs of the government. Where this line is drawn and how this tension is managed is the stuff of much economic analysis as well as ideological debate. The Fiscal Responsibility and Budget Management (FRBM) Act mandates the Centre to reduce fiscal deficit to 3% of GDP and to completely eliminate revenue deficit by 2008-09. Similarly, acting in response to the debt relief package recommended by the Twelfth Finance Commission (TFC) in return for fiscal correction, 24 of the 29 states too have enacted fiscal responsibility Acts accepting similar obligations — fiscal deficit of 3% of Gross State Domestic Product (GSDP) and zero revenue deficit by 2008-09. The case for fiscal responsibility, both at the Centre and in the states, was made on the argument that fiscal consolidation is an essential condition for accelerating growth.

Some economists and critics have called into question the advisability of fiscal restraint when the public sector investment needs are so large and pressing. They have contended that in the Indian context, it is not fiscal contraction, but fiscal expansion that is growth enhancing. The Approach Paper to the Eleventh Plan too has made out a case for relaxing the FRBM targets in order to find sufficient resources for the 'gross budgetary support' (GBS) that the Plan demands.

> **Fiscal deficits are not bad per se. They may be necessary, even desirable in some situations. The issue is not whether or not there should be a fiscal deficit, but its appropriate level.**

This article will argue that staying the course and delivering on the FRBM targets is critical to sustaining the current growth momentum. The bedrock of sustainable growth is macroeconomic stability. Maintaining macroeconomic stability, as characterised by low inflation, stable interest rates and comfortable balance of payments, is critically dependent on redressing fiscal imbalances.

Three important qualifications on the way forward to fiscal responsibility are in order. First, there needs to be fiscal correction not just at the Centre but also in the states. Second, for sustaining and accelerating growth, achieving the FRBM targets is necessary, but not sufficient. We need to pay attention not only to achieving the targets in quantitative terms but also to the quality of adjustment. In particular, this will mean improving both the allocative and technical efficiencies of public expenditures. Third, a stand-alone deficit target is incomplete unless the level of revenue or expenditure is specified too. Given that fiscal deficit is the gap between the government's revenue and its expenditure, a given level of deficit can be achieved at different levels revenue and expenditure. It is important that these levels are maintained sufficiently high even as we target a specified fiscal deficit.

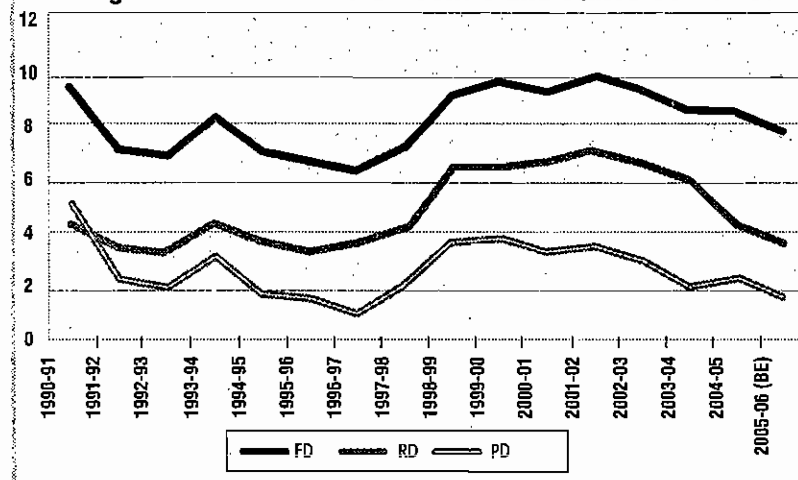
To put the fiscal responsibility debate in perspective, it is important to take stock of the trends in fiscal and revenue deficits in the post-reform period. Public finances, both at the Centre and in the states, had deteriorated progressively since the mid-90s. The combined fiscal deficit of the Centre and the states which was 9.3% of GDP in the crisis year of 1990-91 dropped to 6.3% in 1996-97 (Fig-1 and Table-1) before creeping back up to 9% in 1998-99 largely on account of the impact of the Fifth Pay Commission award. The fiscal deficit had remained at over 9% until 2002-03 and has since been on a downward shift declining to 7.5% in 2005-06 (RE). Similarly, the combined revenue deficit of the Centre and the states which was 4.2% in the crisis year of 1990-91 and had declined to 3.2% by 1992-93, grew to an alarming level of 6.9% by 2001-02. Like fiscal deficit, revenue deficit too has shown a welcome downward shift since 2002-03 declining to 3.1% for 2005-06 (RE).

Table1: Fiscal Indicators - Centre and States Combined

Year	Fiscal Deficit (FD)	Revenue Deficit (RD)	Primary Deficit (PD)	RD/FD	Debt	Interest Payments
	% of GDP			%	% of GDP	
	Combined for Centre and states					
1990-91	9.4	4.2	5.0	44.6	64.9	4.4
1995-96	6.5	3.2	1.6	48.8	61.3	5.0
2004-05	7.5	3.7	1.4	48.9	82.5	6.2
2005-06 (RE)	7.5	3.1	1.6	41.5	79.5	5.8
2006-07 (BE)	6.5	2.2	0.8	33.6	78.6	5.7

Source: Reserve Bank of India, Handbook of Statistics on Indian Economy 2005/06

Fig 1: Deficit Indicators - Centre and States Combined



The net picture that emerges is of a short-lived improvement in the deficit indicators in the immediate post-reform period followed by a steep deterioration from around the mid-90s until 2002-03 and gradual improvement since then. The impact of year-on-year deficits shows up in the stock of debt and interest payment indicators (Table 1). The debt-GDP ratio of the Centre and states combined had increased from 64.9% in 1990-91 to 79.5% in 2005-06. Correspondingly, the ratio of interest payments to GDP had increased from 4.4% to 5.8% reflecting both higher debt stock as well as higher average interest rate.

What is even more worrisome in our situation is that we have not just fiscal deficits, but we have fiscal deficits together with revenue deficits. What this means is that governments, both at the Centre and in the states, are using up a significant proportion of the borrowed funds not for capital investment that will yield future incomes but for current consumption like payment of salaries, pensions and subsidies. A measure of this profligacy is the share of revenue deficit in fiscal deficit which increased from 45% in 1990-91 to over 71% in 2001-02 — an increase of 25 percentage points. This ratio has since come down to 41.5% by 2005-06 but even this is just too high. If the FRBM target on revenue deficit is achieved, this ratio should come down to zero by 2008-09.

Another cause for concern is that our fiscal deficits are actually higher than acknowledged. They are understated because some of the liabilities of the government are not treated as debt in the budget numbers. Notably, the oil bonds which have become a regular feature are not accounted for above the line. This year alone the oil bonds are of the order of Rs 28,000 crore, and if acknowledged, will add to the fiscal deficit by a not insignificant 0.7 percentage points of GDP. Regardless of accounting practices, it is important to keep this in mind for its macroeconomic implications.

It must be acknowledged up front that fiscal deficits are not bad *per se*. In fact, they may be necessary, even desirable in some situations. The issue, therefore, is not whether or not there should be a fiscal deficit, but its appropriate level. The answer depends on a number of variables, particularly the level of savings and the ratio of revenues to GDP. It is also a function of the existing stock of debt and debt servicing burden, the rate of interest, the external payments situation, the degree of capital controls, and importantly the use to which the borrowed resources are put. The advisable fiscal deficit level, therefore, is very contextual and varies from country to country.

In general, continued high fiscal deficits are a concern for several reasons. First, they disempower the government's fiscal stance by preempting a larger share of public resources for debt servicing thereby leaving that much less for desirable expenditures such as physical infrastructure (e.g., roads, power) and social infrastructure (education, health). This leads to a declining ratio of capital expenditure to total expenditure as seen over the period 1990-91 to 2002-03 (Fig-2).

Second, if we incur fiscal deficits together with revenue deficits, it means we are using up borrowed resources for current consumption which may raise growth in the short term, but of the spurious variety. For sustainable growth, we need to balance our books on the revenue account and use borrowed funds only for investment.

Third, to the extent the government preempts the available investible resources, it crowds out the private sector. A balance needs to be struck in apportioning the investible resources between the government and the private sector.

Fourth, continued fiscal deficits impact on interest and inflation rates depending on how the deficits are financed. If the government borrows in the domestic market, it puts pressure on the interest rate. If the government finances the deficit by creating high power money, it fuels inflation. In our case, since deficits are financed by open market borrowing, albeit through a preferential SLR window, the risk is largely of government borrowing leading to higher interest rates.

Finally, fiscal deficits are also bad for another little realised, but powerful reason. Fiscal deficits, especially in the face of revenue deficits, exacerbate inter-temporal equity concerns as they give the pleasure of spending to the current generation while passing on the pain of debt servicing to the later generation.

While the mainstream view on fiscal adjustment accords with textbook economics, the contrarian view that an expansionary fiscal policy is the key to economic development has some distinguished academic credentials as well. Much of this debate between fiscal restraint and fiscal expansion has played out in the Indian context in recent months. It is important to visit this debate in order to make an informed appreciation of the quantum and quality of fiscal responsibility required of our economy.

The argument for fiscal expansion runs on two strands — an analytical one and an empirical one. The analytical argument is that the government should relax the FRBM targets, borrow aggressively and invest in physical and social infrastructure. This will accelerate growth and raise the tax buoyancy, and the higher revenues so generated will be more than sufficient to meet the additional debt service obligations. In other words, through a 'borrow and invest' fiscal stance, the economy can get on to a virtuous circle of higher growth and higher revenues, and in a manner of speaking the government can borrow its way out of a debt crisis!

The empirical argument for fiscal expansion draws from recent Indian experience. The conventional wisdom that fiscal deficits put pressure on interest and exchange rates and fuel inflation is not borne out by the Indian experience of the recent period. On the contrary, during the period 1996-97 to 2001-02 when fiscal deficits were on the rise, inflation had remained subdued and interest rates were restrained. What this shows is that India was not affected by the maladies associated with high fiscal deficits because our economic dynamics are different from those underlying the mainstream theory. Fiscal deficits hurt growth only when the imbalances are way off track. In India we are still very much within the limits of safety. Too drastic an adjustment in pursuit of some predetermined target for fiscal deficit (set by FRBM) will threaten the growth momentum. What we need is not fiscal contraction, but fiscal expansion.

This argument is quite persuasive, but is contestable from both analytical and empirical perspectives. *(To be continued)*

*(Co-authored by **Duvvuri Subbarao**. The authors are chairman and secretary respectively of the PM's Economic Advisory Council)*