# The Importance of Being Earnest
# About Fiscal Responsibility

**- By D. C. Rangarajan and Dr. Duvvuri Subbarao**

## Fiscal Responsibility - the Debate

1. 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 Center and in the states, was made on the argument that fiscal consolidation is an essential condition for accelerating growth.

2. Some economists and critics have called into question the advisability of fiscal restraint when the public sector investment needs are so large and pressing, and 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.

3. This paper 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 characterized by low inflation, stable interest rates and comfortable balance of payments, is critically dependent on redressing fiscal imbalances.

4. 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.

**Post-Reform Trends in Deficits**

5. 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.

6. 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 9.0% in 1998/99 largely on account of the impact of the Fifth Pay Commission award. The fiscal deficit had remained at over 9.0% 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).

7. 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.

8. 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 Center 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.

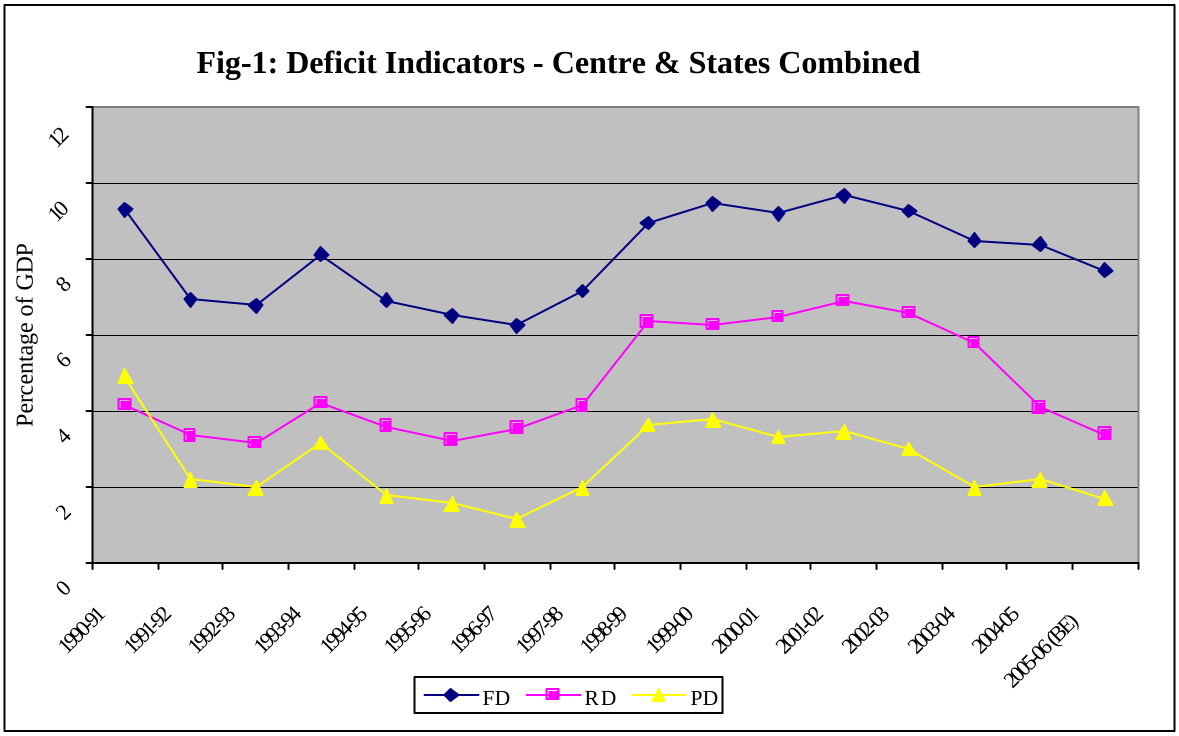
9. What is even more worrisome in our situation is that we have not just fiscal deficits, but we have fiscal deficits together with revenue deficits. What this means is that governments, both at the Center and in the states, are using up a significant proportion of the borrowed funds not for capital 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.

10. 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. 28000 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.

**Table 1: Fiscal Indicators - Centre and States Combined**

| | Fiscal Deficit (FD) | Revenue Deficit (RD) | Primary Deficit (PD) | RD/FD | Debt | Interest Payments |
|---|---|---|---|---|---|---|
| | Percent of GDP | | | Percent | Percent of GDP | |
| Year | 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




**Impact of Deficits on Economic Prospects**

11. 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.

12. In general, continued high fiscal deficits are a concern for several reasons. First, they disempower the governemnt'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 (e.g.: education, health). This leads to a declining ratio of capital expenditure to total expenditure as seen over the period1990/91 to 2002/03 (Fig-2).

13. 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.

14. 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. The crowding out argument has even greater force in an economy with capital controls.

15. 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.

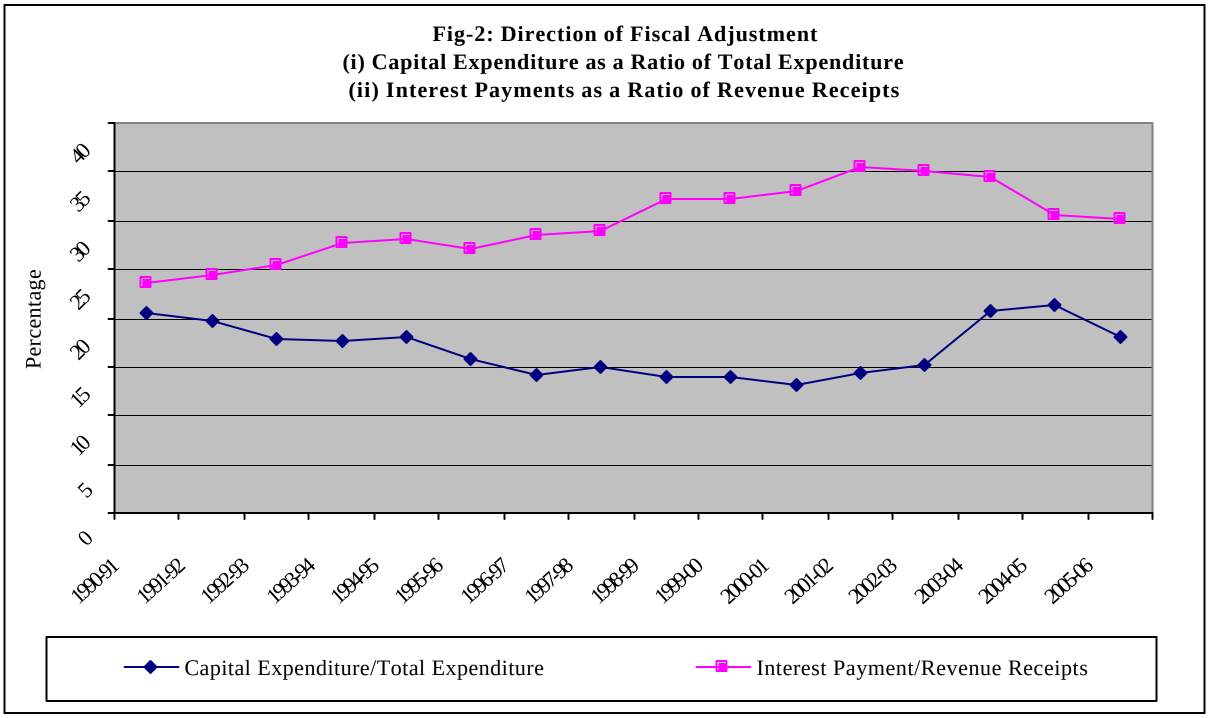
16. Finally, fiscal deficits are also bad for another little realized, but powerful reason. Fiscal deficits, especially in the face of revenue deficits, exacerbate inter-temporal equity concerns as they give the pleasure of spending to the current generation while passing on the pain of debt servicing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

**Fiscal Adjustment - the Contrarian View**

17. 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.

18. 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!

19. The empirical argument for fiscal expansion draws from recent Indian experience. It goes as follows. 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 1996/97-2001/02 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 traditionally 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 pre-determined target for fiscal deficit (set by FRBM) will threaten the growth momentum. What we need is not fiscal contraction, but fiscal expansion.




Source: Handbook of Statistics on Indian Economy, 2005/06, Reserve Bank of India, September 2006

## In Defence of Fiscal Adjustment

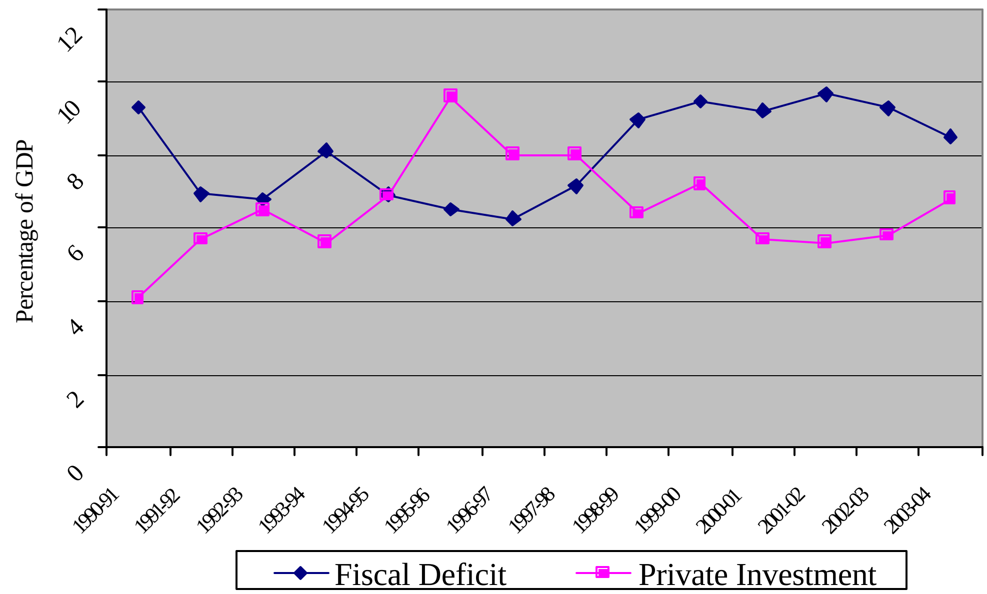
20. The above expansionary fiscal stance argument is quite persuasive, but is contestable from both analytical and empirical perspectives.

21. 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.

22. 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 liberalization – 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 (Fig-3). 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 to restrain domestic interest rates.

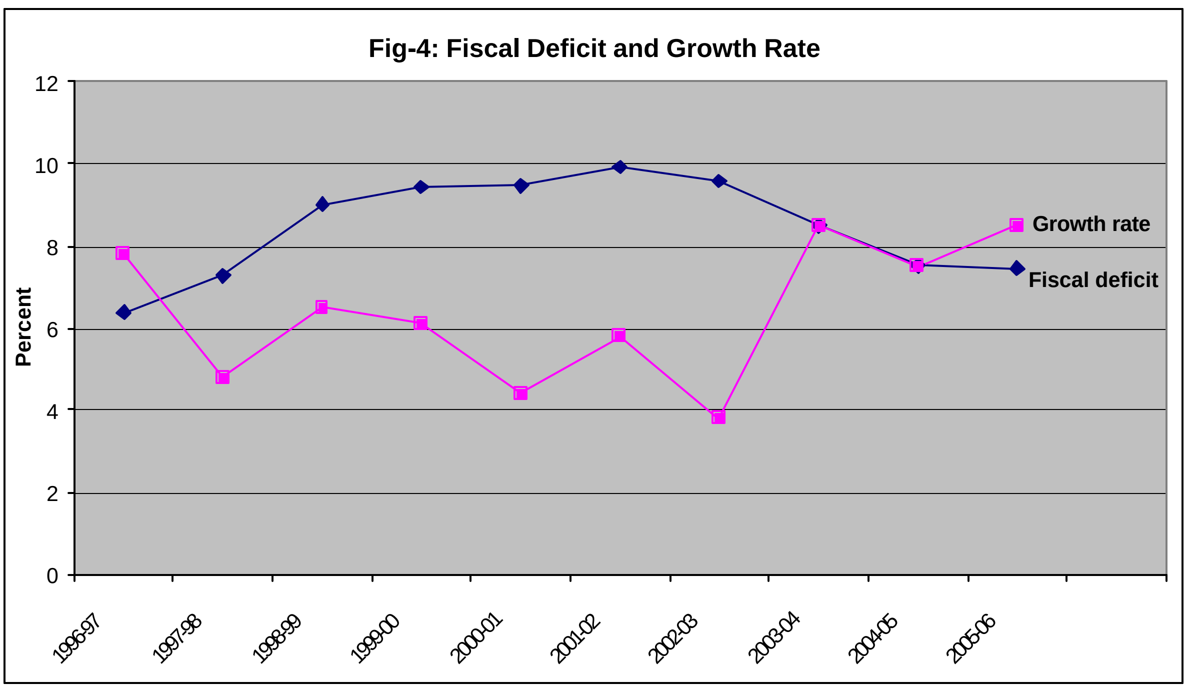
**Fig-3: Fiscal Deficit and Private Investment**




23. 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.

24. 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.

25. The Keynesian effect does not materialize if the economy is not demand constrained. This is evidenced by our own experience over the last decade. The burgeoning fiscal deficits during the period 1998/99 - 2002/03 were accompanied by economic slow down (Fig-4). 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 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.



## Targeting Deficits – Some Issues

26. 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.

*Is there sanctity to a 3% fiscal deficit target?*

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

28. 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 a maintain a 3% fiscal deficit over an economic cycle.

29. 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.

30. Quite independently, the Twelfth Finance Commission provided a detailed rationale for the fiscal deficit target of 6% for the Center 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 Center and the states. Thus, a combined fiscal deficit of 6% of GDP is consistent with the existing ratio of the 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.

31. 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 stabilize the debt-GDP and interest payments to revenues at reasonable levels.

*Should revenue deficit be a target?*

32. Another contentious issue in the debate has been the need to target revenue deficit as part of fiscal responsibility. 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.

33. This is debatable. First, it is not correct to say that the revenue deficit target is not internationally recognized. 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.

34. 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.

*Is a cyclically adjusted fiscal deficit target better than a fixed annual target?*

35. Reflecting the efficacy of a countercyclical 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.

36. Notwithstanding the appeal of this argument, we would be better off with a fixed target. A cyclically adjusted policy works only when the debt-GDP ratio is already 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 stabilize it at that low level. This cannot be achieved unless

we maintain a low fiscal deficit over a period. A cyclically adjusted policy can certainly be an option after the adjustment phase is complete. Cyclical adjustment, of course, presupposes that the economy is subject to economic cycles.

**Conclusion**

37. After several years of discussion, the Center 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. Indeed recent experience shows that strong growth will make it possible to meet the deficit targets and still leave enough resources for meeting the expenditure needs. Remaining committed to fiscal responsibility will strengthen the present growth momentum.

(The authors are Chairman and Secretary respectively of the Prime Minister's Economic Advisory Council)

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