Ashok K.Lahiri

Comments on

The Challenge of Fiscal Adjustment in a Democracy: The case of India

by

Ricardo Hausmann and Catriona Purfield

NIPFP-IMF Conference on Fiscal Policy in India

January 16-17, 2004, New Delhi

("Longchamp Hall", Taj Mahal Hotel, Mansingh Road, New Delhi)

This is a very important paper which brings together the multifarious dimensions of the fiscal adjustment problem that India is currently trying to grapple with. I can not but quote two quotable quotes from the paper, which I intend to use extensively in the future.

First, "Public debts have a lot in common with unwanted pregnancies. They are usually the *undesired* and *delayed* consequences of action undertaken *with other intents by more than one person.*" This metaphor drives home the common pool problem in public finance like nothing else does. But, to extend the simile further, the question is how often does the problem of unwanted pregnancy recur for the same individual? Rarely. To come back to the Indian context, the unwanted debt explosion problem took place in the 1980s. The debt-to-GDP ratios of the Central and State Governments in India increased sharply during the 1980s. For example, the Centre's debt, as a proportion of GDP, after declining by 1.9 percentage points during 1970-1 to 1980-1, rose by almost 18 percentage points during 1980-1 to 1990-1. During the 1990s, it actually declined from 61.4 per cent in 1990-1 to 59.6 per cent in 1999-2000. Even the consolidated Central and State Government debt, after increasing from 47.9 per cent of GDP in 1980-1 to 66.6 per cent of GDP in 1989-90, increased only marginally from 67.8 per cent in 1990-1 to 70.1 per cent in 1999-2000. I am not claiming that the debt problem has been solved, but only that there are no signs of recurrence of the problem of debt explosion observed in the 1980s.

Second, commenting about debt, the authors observe, "Just as with cancer, it may not be good in the long run to be symptom-free: it prevents the patient from taking early action." The question is: are there reasons to believe that we have been either symptom-free or that there is no early action. The answer is surely not a resounding yes. There are many in India, I would say, a majority of the people, who believe that the balance of payments crisis in 1990-1 was compounded, if not caused, by the mounting fiscal deficits and rising debt of the 1980s. Furthermore, growth, and capital account convertibility are impeded by the fiscal problem. Last, and not the least, the patient has already taken early action in the form of the Central Fiscal Responsibility and Budget Management Act, 2003. Even the States have seized the initiative; the State of Karnataka enacted the Fiscal Responsibility Act even before the Centre. Punjab has also got its own Fiscal Responsibility Act. The Governments of Maharashtra and Kerala have introduced the Fiscal Responsibility and Budget Management Bill in their respective legislatures.

All this is not to deny that there is an urgent need to go behind the debt and deficit problem in the country, investigate the underlying causes, and address the relevant issues, including the institutional ones. This is where we should be grateful to Profs. Hausmann and Purfield for their insightful analysis.

First, the debt-revenue ratio is large. A comparison of debt-GDP ratio with other countries reveals that while the ratio may be large for India, it is not of threatening proportions. But, as the authors point out, what is worrisome is the debt-revenue ratio at over 400 per cent. This is a problem of insufficient revenues, which also manifests itself in high deficits in spite of the expenditure-GDP ratio being of modest proportions. The message is clear: revenues have to be enhanced.

Second, the saving grace has been the stability of our revenues and GDP growth. This has contained our risk rating. This is a strength that is likely to persist. Last year was the year of testing by fire. Growth declined, but only to 4 per cent in spite of a severe drought. As we transit to higher growth, we have to contain the volatility of growth and revenues.

Third, the differential between the rate of interest and growth rate is important in determining the debt-stabilizing primary deficit/surplus. In 1999-2000, if you look at the Centre, the average cost of borrowing was 10.3 per cent while the nominal growth rate of GDP was also 10.3 per cent. In 2000-01, the average cost of borrowing was higher than the growth rate of GDP. In 2001-02, the average cost of borrowing was slightly lower than the growth rate. In the drought-affected year of 2002-03, the average cost of borrowing was about 2.3 percentage points higher than the growth rate. The authors have compared the average cost of borrowing for the Centre and States together with the growth rate of GDP, and the average cost of borrowing for the States is about 300 basis points higher than that of the Centre. Nevertheless, there is a reasonable expectation that with interest rates moving south and growth rates moving north, we may be blessed again by the benign growth-interest combination with interest rate lower than the growth rate. Furthermore, under the Debt Swap Scheme, the Centre has already started to retire the high cost debt of State Governments with the help of National Small Savings Fund, which the authors discuss in great detail.

Fourth, the authors express some skepticism about the fiscal behaviour of State Governments. I was a bit surprised to note that contrary to what we believe to be a strict regulation of borrowing by State Governments, the Rodden index describes the regime as quite liberal by international standards. In this context, if I may point out, the States were quite responsible in fiscal matters and profligacy was started by the Centre. States followed the example with a lag. Until 1986-87, the States had primary and revenue surpluses. Even until 1995-96, the States' revenue deficit was less than 1 per cent of GDP. It is eminently likely that once the Central Government starts practicing the fiscal rectitude that it preaches, the States will follow suit. The States' record in terms of enacting Fiscal Responsibility Acts provides supporting evidence in this direction.

Fifth, the authors point out the problems stemming from the system of dual control of grant allocations across two agencies, namely Finance and Planning Commissions. I shall leave this important aspect to the other discussant Prof. Bagchi, a noted expert in this matter.

Finally, the authors raise the question whether the system of name or shame in the Fiscal Responsibility and Budget Management Act will work or not. Will there be problems of creative accounting and bias in budget making? In the Report accompanying the Fiscal Responsibility and Budget Management Bill, there was a mention of an expert body, which the authors call the score keeper. But, that was not considered necessary in our system, where we already have Parliamentary Standing Committees and other parliamentary checks and balances. In terms of marksmanship or the absence of bias in budget-making, the Finance Minister has already promised pleasant surprises in the coming budget.[1] It is true that in the past, with the benefit of hindsight, the estimates may not have looked very good, but there are signs of improvement. Will the punishment come from the political market or capital market? Even the rules regarding the Fiscal Responsibility and Budget Management Act have not been framed as yet. I believe it is a bit premature to conclude that with a very active Indian Parliament, and a system of quarterly reports and a system of explanations regarding assumptions and outcome, the system of name and shame will not work with the honourable Indian politicians.

Let me conclude by thanking the authors for a very important contribution to the debate on how to go forward on fiscal consolidation.

[1] In the event, for 2002-03, the revised estimate of fiscal deficit was lower than the budget estimate.