Mihir Rakshit
Director, Monetary Research Project
Investment Information and Credit Rating Agency

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Comments on "Fiscal Developments and Outlook in India" by Indira Rajaraman and "Macroeconomic Implications of the Fiscal Imbalances" by Kalpana Kochhar

There are some differences in approach and emphasis of the two papers. Rajaraman's covers a longer period, goes into greater detail and draws attention to the political economy of election-eve jump of fiscal deficits. The paper's assessments (e.g., those of fiscal responsibility legislations and accounting changes relating to small savings) are also more pinpointed than Kochhar's. However, the similarities in overall approach and conclusions of the two papers are more manifest than their differences. Both focus on (a) mounting internal debt burden; (b) slippage in tax effort (or what Rajaraman calls uncompensated loss of trade tax revenues) in the post-Reforms era; (c) deteriorating quality of government expenditure; and (d) administered interest rates acting as a floor to deposit and other rates. Hence the two authors emphasise the need for raising the tax-GDP ratio in a non-distortionary manner; rule-based correction of fiscal imbalances so as to obviate political pressure; and reduction in (and gradual elimination of) States' reliance on high-cost small savings.

Quite a few observations and conclusions of the two papers are unexceptionable; but some of their arguments seem unsatisfactory and these together with the absence of a sound macrotheoretic approach make their analysis relatively weak. What we propose to do is to comment on some specific but important commissions and omissions of the papers; and suggest an approach for examining fiscal issues in the Indian context.

Interest rate and internal debt trap

For analysing fiscal developments and locating the sources of budgetary imbalance Rajaraman and Kochhar trace the temporal behaviour of effective interest rate, defined as actual interest payments in a year divided by public debt outstanding at the end of the year. Noting that the *real* effective interest rates rose sharply over 1997-02, Kochhar goes on to argue that "India is now dangerously close to an internal debt trap." There are several problems with this line of reasoning. First, for assessing the sustainability of debt financing what is relevant is not the average interest rate on public debt, but the rate at which the government can borrow *now* and in the foreseeable future. The two rates can be quite different since the interest rates at which past loans were taken are decisive in determining the average rate, but of no relevance for the marginal rate. The reason why the real effective rates have risen despite significant softening of interest rates on government securities is that, given the fixity of nominal interest payments on past loans, a fall in inflation rate has raised their real magnitude, even when the *real* interest rates on new loans have registered a decline. Had Kochhar considered marginal and not average interest rates, her conclusions would have been different. The more important point that has been missed is that the growth-interest differentials in some years or over a specified period provides, as we shall presently discuss, little clue to budgetary viability or policies required for fiscal correction.

Monetised debt and deficit

Both Rajaraman and Kochhar include monetised debt and net RBI credit to government in aggregate public debt and fiscal deficit respectively. This prevents them from analysing the fiscal implications of monetary developments during the post-1991 decade and from examining the links between fiscal, monetary and exchange rate policies. The quantitative significance of these developments is underlined by the fact that while there has been a 2 percentage point fall in the tax-GDP ratio, the fall in the ratio of monetised deficit to GDP amounts to nearly 3 percentage points. Nor do the two papers go into the substantial quasi-fiscal cost of foreign exchange reserves and their accretion, remembering that substitution of foreign government bonds for GOI securities entails a considerable revenue loss to the Reserve Bank and hence to the government.

In connection with alternative policy options Kochhar considers the case for monetised deficit in the presence of output gap, but dismisses it out of hand since the policy is based on some notion of an "optimal" rate of inflation, whose underlying relations have "undergone major structural changes during the past decade". Unfortunately Kochhar does not distinguish the role of monetised deficit under two situations, the first with and the second without an output gap. The notion of an optimum inflation arises only in the second, but not in the first case. In the presence of underutilised capacity monetised financing of government expenditure constitutes a free lunch to the economy in as much as it raises current income and employment sans inflation *and* the cost associated with future debt servicing. Indeed, even under full employment, there is scope for *zero-inflation* monetised deficit in a growing economy, remembering that in such an economy demand for real balances tends to rise over time. It is also worth noting that, contrary to Kochhar's perception, (a) the notion of "optimal" inflation, as that of the text-book concept of seignorage maximising inflation, subsumes expectational effects through adjustments in the nominal rates of interest entering the demand function for real balances; and (b) structural changes, e.g., growing commercialisation and specialisaiton, have in fact raised the scope for seignorage, both zero-inflation and "optimum".

Private investment and public debt

Relatively low interest rate due to slack in private investment demand since the mid 90s is considered by the two authors as an important reason why the country has not faced a serious crisis despite large fiscal deficits and mounting public debt. In the context of recent pick-up in private capital accumulation and expected hardening of interest rates, both, especially Kochhar, voice serious concern regarding the government's debt burden and fiscal woes in the near future. This has led Kochhar to pose an interesting dilemma: while an increase in private investment may be good for the economy, its impact on public finances is unambiguously negative. Fairly straightforward macroeconomic considerations suggest however that there is in fact no such dilemma.

To see why, consider once again the full-employment situation and an economy with excess capacity. In the later case, when private investment picks up, expansion in income (directly and through the multiplier process) raises both tax and non-tax revenue. Remembering that the major part of government expenditure (consisting of interest payments and employees' compensations) is fixed in the short run or not responsive to current GDP changes, the result will be a decline in revenue and fiscal deficits not only as ratios of GDP but in absolute terms as well. This relation between private investment, GDP growth and government revenue provides an important clue to improvement of budgetary balances in the initial phase of the post-reforms period and their deterioration from 1997. It is also noteworthy that the recent pick-up in private investment and GDP growth has been associated with lower revenue and fiscal deficits than their (2003-04) budget estimates.

What about the possible hardening of interest rates to which Kochhar and Rajaraman draw pointed attention? The important point to note in this connection is that so long as the economy operates with an output gap, accommodating (or expansionary) monetary policy can help faster rise in capacity utilisation and keep down interest rates without creating *sustained* inflationary pressure. Only when excess capacity has been eliminated would the real interest rate rise in response to (further) increases in investment demand. However, even in this case debt financing of government expenditure does not become more problematic at higher levels of private investment demand: in the long run a higher investment-GDP ratio, *a la* neo-classical growth models, causes a lower real rate of interest.

Fiscal deficit and private saving

Kochhar reiterates the popular view that "India's fiscal imbalances have been financed by tapping into the relatively large pool of private sector saving…, often made "captive" to the government through the use of statutory liquidity ratio and tax-preferred small savings schemes…, leaving very few resources for the private corporate sector". Though widely held, the view unfortunately reflects an inadequate appreciation of the chain of causation under conditions of demand deficiency (apart from the fact that the SLR requirement has been inoperative over the last 9 years). In such a situation an increase in government expenditure with no changes in tax *rates* raises GDP, private disposable income and hence private saving. With weak private investment demand the additional private saving then finds its way in government borrowings under various programmes. In other words, in a demand deficient economy not only are government expenditure and private investment non-competitive, but the former also plays an important part in generating private saving. Government expenditure may in fact help raising private investment demand through an increase in capacity utilisation and profits.

Taxes and Budget Deficits

Neglect of the causal link considered above also mars Rajaraman's results relating to the impact of uncompensated customs revenue. Thus the exercise in Table 2 on "what the overall fiscal, primary fiscal and primary revenue deficits would have been had the fall been fully compensated" is not very illuminating. The reason is two-fold. First, given the fact that the major part of the reference period was characterised by output gap, any attempt to fully compensate the loss of trade tax would per se have aggravated the demand deficiency problem and caused a GDP loss. Second and related to the first, the tax-GDP ratio (like practically all other ratios examined in the two papers) is endogenous and depends on interaction of several factors, given the *structure* of tax rates. Hence the need for a well-designed macro-economic framework as a guide to examining fiscal deficit and related issues.

Some Dos and Don'ts of Fiscal Analysis and Policy Prescription

Our observations highlight the need for distinguishing among (a) policy parameters the government can directly control; (b) exogenous factors including random ones and international economic environment[1]; and (c) endogenous variables. Intermediate targets like revenue, fiscal and primary deficits, both in nominal terms and as ratios of GDP, are the outcomes of the entire economic process which the government can try to influence through tax rates, (nominal) expenditure and other instruments it can directly wield. In examining the evolution of the fiscal scenario and drawing policy conclusions it is thus necessary to focus on these instruments and assess their suitability in the context of operation of other factors in the economic system. Perhaps the most important point to note in this connection is that policies which are appropriate under full employment may be counter-productive when the economy operates with excess capacity. Thus when there is an output gap *and* government infrastructural and social sector expenditure crowd in private capital accumulation, an increase in such expenditure with no changes in tax rates and other items of government expenses strengthens revenue and fiscal balances in both the short and medium run, especially when the shortfall in revenue if any is met through monetised deficit. It is only when there is no slack in the economy and full-employment tax collections and seignorage are inadequate, does it become necessary to raise revenue in order to finance an increase in government expenditure. This perspective provides a quite different interpretation of India's fiscal woes. The main policy failures since the mid 90s would then seem to consist in slowdown in public infrastructural (including agricultural) investments, bottlenecks impending the supply of working capital to small and medium enterprises, continuance with quasi-fiscal barriers to free mobility of goods and services, and large scale substitution of forex reserves for GOI securities in Reserve Bank's portfolio (making net RBI credit to government negative in recent years).

[1] Remembering that India's part in global trade and finance is as yet insignificant

The above diagnosis suggests that stepping up infrastructural and social sector expenditure and relying on monetised financing in the presence of output gap not only promote basic social and economic objectives, but contribute toward fiscal viability as well. Of more fundamental importance is to chalk out a fiscal restructuring programme from a longer term perspective. On the expenditure side the restructuring relates primarily to (composition and) scale of public consumption and investment as *ratios of full employment output*. The complementary part of the programme concerns tax structure and the extent of reliance on seignorage and public borrowing. By its very nature the programme involves balancing of pros and cons since there is no free lunch in a full employment regime: larger provisioning of public goods or government investment implies some cutback in private consumption or investment; an increase in tax rates and inflation-raising seignorage tend to create distortion and reduce the availability of final goods and services; and larger borrowing from the public results in lower levels of private investment or consumption.

Despite the complexity of issues, it is possible to suggest the nature of fiscal correction called for in the Indian context. Given the abysmal state of education, health and infrastructural services, the need for raising public expenditure in these areas as proportions of full employment GDP can hardly be overemphasised. So far as taxes are concerned, while elimination of output gap will go a long way in raising the revenue-GDP ratio, it is necessary to do away with tax and other concessions extended to exports, and other sectors of the economy. However, in view of distortionary effects of practically all taxes, reliance on both seignorage and borrowing from the public appears optimal in the intermediate run, especially when they are used for financing growth promoting public expenditure. To the extent distortionary effects of inflation accompanying (full-employment) seignorage are less than that of tax increases, the former is to be preferred, remembering that neither involves future debt-service burden. Again, crowding out of debt-financed public investment being partial, it tends to raise the aggregate investment and saving ratio of the economy.

So far as sustainability of a fiscal programme is concerned, what is relevant is its impact on long-term growth and real rates of interest. Considerations of government debt-dynamics in a fully employed economy suggest that while taxes impinging on consumption rather than saving tend to raise capital intensity and lower interest rates under steady state equilibrium, the most important growth promoting measures are investment in human resource development including the knowledge-base of the economy and provision of physical-cum-financial infrastructural facilities. Finally for phasing of fiscal restructuring. At the country's current stage of development structural bottlenecks are acute, but costs of raising the tax-GDP ratio are not inconsequential either. Thus though elimination of a plethora of tax concessions can have a positive impact on efficiency as well as the tax-GDP ratio, in the short and intermediate run reliance on monetised deficit and borrowing appears optimal to meet the urgent need of government expenditure in priority areas. In course of time the urgency of allocation of government expenditure in these areas should decline, tax-GDP ratio can be raised and reliance on monetised deficit be reduced. It is these considerations and perspectives which are crucial in deciding on budgetary programmes and appropriate fiscal responsibility ligislations.