

Economic Times Exclusive: HARVARD PUNDITS RESET THE AGENDA
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Fiscal Restraint is the Need of the Hour

Nirupam Bajpai and Jeffrey Sachs caution against the widening budget deficit and the growing burden of public sector debt

FORTUNATELY, the Reserve Bank of India has been more circumspect in its exchange rate policy, letting the rupee weaken in the face of the Asian . crisis.

There is probably more currency weakness to come, if only because India competes with Indonesia and Thailand in several product lines, and thus will face pressures on cost competitiveness now that the competitors currencies have been deeply: depreciated.

Fifth, and perhaps most urgently needed for India, is fiscal restraint. Unless substantial fiscal consolidation is achieved, in our view, continued fiscal deficits pose India's greatest risk to future destabilisation. Despite several years of fiscal consolidation effort, large and persistent fiscal deficits remain. Revised figures of major deficit indicators for the fiscal year 1997-98 bear testimony to the fact that the fiscal situation has not been brought under control.

As a matter, of fact, except for the first year of fiscal stabilisation, that is, when the fiscal deficit was reduced from 8.3 per cent of GDP in 1990-91 to 5.9 per cent in 1991-92, the performance on this front has been disappointing.

As against the original scheme of reducing the fiscal deficit to around 3 per cent by 1996-97 set out in the Ministry of Finance Discussion Paper (1993), the actual fiscal deficit for the year 1996-97 turned out to be as high as 5.2 per cent. Furthermore, the fiscal deficit in 1997-98 was even higher at,6.1 per cent. India's overall government spending, currently around 33 per cent of GDP (centre and states together) will need to be brought down substantially as a proportion of national product in order for India to achieve its reform goals of macroeconomic stability and long-term rapid growth.

There are several risks with high fiscal deficits. First, budget deficits could once again spill over into macroeconomic instability, if the government again resorts to inflationary finance. This would happen, for example, if the government meets increasingly onerous terms in financing the increasing stock of public debt on the open market, and therefore turns to the Reserve Bank. of India for increased financing.

Second, the budget deficits imperil national saving rates, thereby reducing overall aggregate investment, and jeopardising the sustainability of high growth. Third, the continuing large budget deficits, even if they do not spill over into macroeconomic instability in the short run, will require higher taxes in the long term, to cover the heavy burden of internal debt.

High tax rates will place India at a significant disadvantage relative to other fast-growing countries. We believe that deficits should be brought under control mainly by cutting government expenditures relative to GDP rather than by raising revenues relative to GDP.

Moreover, there is probably little room to reduce capital expenditure, which have already been squeezed to a mere 3.7 per cent of GDP in 1997-98. Hence, it is the current expenditure which needs to be reduced significantly. Current expenditures at the central level are predominantly made up of interest payments, grants to states, subsidies, and defence expenditure

In the latter three areas, there have been some reductions in spending relative to GDP. Grants to states have declined from 2.5 per cent of GDP in 1990-91 to 2 per cent of GDP in 1997-98; explicit central government subsidies have been reduced from 2.3 per cent of GDP to 1.4 per cent of GDP, and defence expenditure has declined from 2 per cent of GDP to 1.9 per cent of GDP. Interest payments, of course, have risen not declined, but have risen from 4 per cent of GDP in 1991 to 4.6 per cent of GDP in 1997-98. Further progress is needed in reductions in most of the main areas of current spending.

With respect to internal public debt, there is one mechanism that could substantially ameliorate the fiscal situation. Privatisation of public enterprises could raise significant funds as a percentage of GDP, which could then be used to buy down the public debt.

Not only, would the stock of debt itself be reduced, but also the interest costs of servicing the debt would surely decline as the debt stock itself was brought under control.

The cash value of these enterprises vastly exceeds the present value of profit flows that the state now collects on these assets. Public sector profits are dissipated in poor productivity, over manning, excessive public sector salaries, soft budget constraints, and generally poor public-sector management.

For this reason, sales of the enterprises to private sector buyers, if used to buy down the public debt, would yield annual saving in interest costs that most likely would far exceed the government revenues that are claimed by virtue of state ownership of assets. (This is especially true in view of the fact that many enterprises with significant positive market value are actually loss makers in current cash flow, under state management).

A substantial amount of interest savings on India's internal debt could be generated if the government were to undertake an extensive privatisation of the central public sector enterprises.

According to the Economic Survey, 1996-97, at least 25 per cent of the outstanding marketable debt (largely made up of market loans, special bearer bonds, and 91/182-day treasury bills) could be retired by selling the economic assets of the government.

However, this estimate is based on the book value of the assets, and consequently it would be much higher when converted into current value. Besides, the sale of these assets could retire more of the total liabilities depending upon the mode and timing of such sale. The central government currently has equity holdings in 240 enterprises, 27 banks, and two large insurance companies. Further

spending cuts could come from liquidation of loss-making enterprises that have no positive net market value.

There were 104 loss-making enterprises in 1992 accounting for a total loss of Rs 39.5 billion. Liquidation of these would imply a rise in domestic savings and, of course, these savings would be higher if there is salvage value in part or all of some of these enterprises. To capture these savings would require implementation of an exit policy to allow the government to close down these loss making enterprises. Reduction in central government subsidies (both explicit and implicit) is another area of expenditure control. While central government explicit subsidies have declined from a total of 2.3 per cent of GDP in 1990-91 to 1.4 per cent of GDP in 1997-1998 there still is room to reduce these further, especially those that do not benefit the poor.

The explicit subsidy bill of the central government is almost entirely made up of fertiliser and food subsidy.

Fertiliser subsidy, for instance, could be phased out over the medium term, and simultaneously during this period the government could undertake a well targeted, and time-limited programme for compensating the poor farmers for their loss of income.

The food subsidy bill also needs to be reduced with the exclusion of the non-poor from access to the public distribution system. In the case of the central government there has been notable progress with regard to tax reforms, but almost nothing in the area of expenditure reform.

At the state level, both tax and expenditure reforms have a long way to go as we discuss them below. Like the central government, the financial condition of the state governments in India has also been a cause for concern.

Over the years, the consolidated financial position of the state governments has shown a marked deterioration in some of their major deficit indicators. One of the fundamental weaknesses of state government finances in India can be attributed to the increases in non-developmental expenditure, particularly the revenue component of the non-developmental expenditure, and interest payments as a proportion of revenue receipts.

These problems have been aggravated a great deal over the past few years because of a variety of reasons. The resource constraints in state finances have been accentuated by a near stagnant tax-GDP ratio, rising share of non-developmental outlay in the total expenditure, large volumes of hidden or implicit subsidies and, increasing financial losses of state enterprises. A growing pressure on state finances has also stemmed from the rising demand for public services. Furthermore, the fiscal situation in the states is likely to come under much greater pressure with the acceptance of the report of the Fifth Pay Commission by several state governments in India. The slow growth in revenue mobilisation at the state level has posed serious difficulties for the state governments to meet their expenditures.

Be that as it may, the critical problem in state finances is not only one of high levels of expenditure, but also one of increasing distortions in the pattern of expenditure. Further progress in the area of tax and expenditure reform is as crucial for the states as it is for the Centre. State governments are

required to reduce and eventually do away with subsidies on power, transportation, and irrigation so as to reduce the burden on state budgets. Importantly enough, state governments have to find a way to reduce their expenditure on wages and salaries of their employees.

The state expenditure on administrative services is budgeted to rise by 44.3 per cent on account of the revision of pay scales of government employees following the Fifth Pay Commission awards. According to estimates of a study by the Planning Commission, should all the state governments raise the salaries of their employees in line with the Fifth Pay Commission, then the states will have to pay out an additional Rs 1,000. billion as salaries and wages over the next five years.

The Planning Commission estimates also include higher salaries for quasi government employees, including staff of public sector undertakings (PSUs) and local bodies. The state governments wage bill, even without the Fifth Pay Commission awards, is the single biggest expenditure item for almost all state governments. On an average, all state governments, spend around 60 paise of every rupee earned as revenue on wages and salaries. In particular, states like Maharashtra (with 2.2 million employees), Andhra Pradesh (1.1 million employees), West Bengal (950,000 employees), Gujarat (620,000 employees), and Kerala (520,000 employees) are likely to be the hit hard with these awards. Expenditure adjustment at the state level should take into account its implications for the critical sectors such as social services.

A significant portion of the expenditure on social services comes under the purview of the state governments, because of the federal set-up of the constitution, which places the responsibility of undertaking human resource development primarily on the state government. The social service expenditure of the state governments as a percentage to GDP showed a rising trend during the 1980s, from 4.8 per cent of GDP in 1980-81 to 5.6 per cent in 1990-91. In the first half of 1990s, however, there was a decline in the ratio owing to the resource crunch faced by a number of states. It came down to 5.3 per cent in 1992-93 and further to 5.1 percent in 1994-95 and remained thereafter in the range of 5.1 to 5.5 per cent.

A shift of policy focus towards changing the pattern of resource allocation and improving the resource base of states is critical for improving the financial situation of the state governments. On the tax, front, sales tax is the single most revenue earning source for the state governments, and its reform, is crucial so as to attain higher levels of revenue mobilisation.

While efforts to introduce state level VAT and other tax reform measures have begun, their implementation across 11 states is necessary in order to enhance the revenue productivity of the tax system and, to reduce its distortionary implications for the economy. In the final analysis, fiscal control will require an overhaul not just in budgetary patterns, but in the basic functioning of the public sector in the economy. For example, we have noted that privatisation is a key method for reducing the overhang of public debt. Similarly, the privatisation of infrastructure services is a key way to relieve the growing burden on state budgets, which are heavily weighed down by losses of SEBs and other parastatal institutions.

Greater autonomy for local and state-level governments in infrastructure reform and investment priorities will similarly allow the central government greater freedom in cutting back on transfer payments to the states (which will be in a better position to prioritise and economise on state

spending). , Until India resolves to, push even farther in market reforms, the soft budget constraint of the public sector will continue to spill over into large public deficits and a growing burden of public sector debt.