Reserve Bank of India Occasional Papers
Vol. 28, No. 1, Summer 2007

A Sustainable Fiscal Policy For India - An International Perspective Edited by Peter S. Heller and M. Govinda Rao, Oxford University Press, New Delhi, 2006 pages 454

The fiscal policy assumes centre stage in policy deliberations as the continuous fiscal imbalances and rising levels of public debt pose risks to the prospects for macroeconomic stability, and accelerating and sustaining growth. Appropriate and timely fiscal policy measures can promote growth by setting efficient and effective use of scarce resources and by creating the right incentive signals. The well designed fiscal strategy would help to move an economy like India towards a higher growth path without high inflation or inter-generational transfers of the burden of public debt. India's democratic system and federal structure present challenges to fiscal policy that are also common across all federal democracies and are well recognised in theoretical terms. The fiscal experts in India and outside contributed from time to time in revealing the strengths and weaknesses of the India's fiscal policy and suggested future course of action. Set against the above backdrop, the book under review, which is a selection of 10 papers presented in a conference jointly organised by the International Monetary Fund and the National Institute of Public Finance and Policy highlights various aspects of India's fiscal policy, its sustainability and its impact on the other sectors of the economy and draws lessons and priorities taking into account the international experiences.

The book examines how India's fiscal situation evolved over the years, the role played by reforms, Central-State fiscal relations, risks of high public debt and the critical areas for reforms. It explores ways of meeting challenges including reduction of public debt and adoption of sound fiscal policies which assumes critical role in realising the economic ambitions. Interestingly, India's economy has grown rapidly since the beginning of the 1990s despite a large and growing fiscal imbalances and debt levels and it would be of great interest to examine whether India has found a way to reconcile sustained expansionary fiscal policies with relative macroeconomic stability. The analysis indicates that the India's fiscal policy requires immediate attention in order to have sound and sustainable fiscal situation in the long run as high growth and low interest rate may not be able to take care of the problem of long term debt sustainability nor risks of a crisis in the short and medium term. The focus on the budget deficit alone may be misleading as the problem of off-budget and contingent liabilities is serious and needs to be addressed. Keeping in view the growth implications in long run, there is a need to examine public consumption, investment, taxation and deficits in a framework that recognises that these are all endogenously determined, along with the growth rate.

As the fiscal imbalances continue to exist and debt level is rising, the reforms mainly aimed to enhance government revenues are critical. While there is ample room for improving the structure of indirect taxes, in particular, improved tax administration and enforcement remains one of the most critical areas for reform. Tax reform is an essential step towards increasing government revenue, as well as reducing microeconomic distortions. On the expenditure side, the quality of expenditure at both Centre and State level has deteriorated, and the same needs to be addressed on priority basis. Institutional reforms such as improvements in the intergovernmental transfer system, borrowing mechanisms for State governments, and budgeting practices and norms are all technically possible and may well be politically feasible.

The opening chapter, 'Fiscal Developments and Outlook in India', by Indira Rajaraman focuses on the factors underlying the continued weak fiscal position during the previous one and half decades as well as the prospects of recent fiscal reforms. The author identifies that the impact of trade liberalisation measures and their associated loss of tariff revenue remained the major factor underlying the weakened fiscal position since the early 1990s. Unlike other countries which undertook tariff rate reductions, India did not compensate the loss of revenue by a commensurate increase in domestic taxes. The author is of the view that buoyant growth in India is essential for fiscal reforms to be possible and this requires that the kinds of physical and social infrastructure should go up in both quality and quantity. The author finds two strands to the fiscal imbalance path in India. First, high interest rates on public debt which started rising sharply in the 1980s and details the political economy pressure that fuelled this rise. Second, non-interest fiscal indicators which worsened sharply in 1998 with the real wage hike introduced that year for government employees and pensioners raising the consolidated salary bill substantially. An econometric exercise investigates whether this event was endogenous to the political economy. The regression equations show an election year response, which has become more marked in the last 30 years. The author recognises the importance of two major reforms, *i.e.*, the reforms of the interest rates guaranteed under the NSSF and passage of the Fiscal Responsibility Legislation.

The issues relating to the scope, nature and conduct of fiscal policy, particularly in the context of maintaining macroeconomic stability and enhancing growth, assume importance. The paper, 'India: Macroeconomic Implications of the Fiscal Imbalances', by Kalpana Kochhar examines both the evolutions of fiscal imbalances and key developments in major macroeconomic variables in order to assess the macroeconomic impact of the growing fiscal imbalances. Keeping in view the persistent fiscal imbalance and indebtedness, arguably, the fiscal situation is the single biggest threat to macroeconomic stability. The rising fiscal imbalances and debt reflects a weakening in revenue mobilisation, persistent deficit at Centre and State level and narrowing of the gap between real interest rate and growth rate. The author interestingly finds that on account of high fiscal imbalance there were hidden costs on the economy in terms of the foregone potential for even higher economic growth than that has recently been experienced. The large and increasing fiscal deficit led to a crowding out of productive public expenditure and constrained the scope for further structural reforms and liberalisation and rooms for macroeconomic policy manoeuvre – adversely impacting the growth prospects. In order to avoid the crisis, the author feels that there is strong need of revenue mobilisation efforts and reorientation of expenditure away from subsidies and towards physical and social infrastructure projects. India's medium term economic prospects, among others depend critically on progress with the closely intertwined tasks of fiscal consolidation and structural reforms. The rising level of fiscal imbalances and resultant high level of debt may create a vicious circle inducing a fall in the ratio of private to total credit, rising inflation and falling economic growth. In this regard, William Easterly in his paper, 'The Widening Gyre: The Dynamics of Rising Public Debt and Falling Growth', examines that fiscal policy variables affect growth and finds suggestive evidence, in line with the previous literature, that fiscal policy variables – or variables affected by the fiscal policy such as budget deficit, inflation and the share of private in total credit do affect growth.

Sustainability of public debt has emerged as an important issue in public policy discussions and academic debates among policy makers, economists, credit rating agencies and multi-lateral institutions. It has been widely recognised that unsustainable debt often tends to impact on Governments' ability to undertake developmental activities and also may crowd out the private investment. Richard Hemming and Nouriel Roubini in their paper, 'A Balance Sheet Crisis in India?', use a balance sheet approach to assess India's vulnerability to a crisis as a result of its high fiscal imbalances. The authors explore the question of the financeability of a country debt position, the vulnerabilities associated with the way in which India's public debt is financed and the experience from other emerging market economies which face high debt ratios in recent years. The authors find that India's debt is clearly financeable over the short term, reflecting such important strengths as modest rollover/liquidity risk, lack of currency mismatches and limited liability dollarisation, small current account imbalances and low external debt, financial repression and capital controls. In principle, these are insulating factors to the large deficit and high share of debt to GDP. The paper concludes that a failure to tackle fiscal consolidation in the near term will only increase India's vulnerability in the future.

Peter S. Heller in his paper, 'India: Today's Fiscal Policy Imperatives Seen in the Context of Long-Term Challenges and Risks', provides an alternative perspective on why India needs to move soon to address the fiscal imbalances. A continuation of current fiscal policies, the level of fiscal deficits and character of government expenditure, would put India on an unsustainable course in terms of the constraints that it would impose, in the future, on the role that public sector would be able to play in effectively addressing these longer term challenges. The author emphasises on undertaking the appropriate reforms in order to placing fiscal house in order today so that India have sufficient fiscal leeway in the future to address the long term fiscal challenges including those of demographic developments in the population at large, the demographics of civil service and military pensions, the imperatives of social insurance reforms and urbanization patterns and the effects of the globalization. The paper states that India now has a fiscal policy framework that neither offers that futures fiscal leeway, nor provides an appropriate expenditure programme that is responsive to the obvious and immediate needs of the economy of the coming decades. Current fiscal policy is recognised by most analyses as unsustainable. An important policy message may be drawn from the paper is that India should be cautious about how it formulates new policy commitments so as to avoid excessive preemption of future budgetary resources and thereby avoiding the mistakes of industrial economies.

In order to enhance the revenue performance, the strategies focusing on rationalisation of tax rates, better tax compliance, improved efficiency in tax administration and review of tax exemptions/incentives would be helpful. Over the last decade, income tax rate at the Central Government level has undoubtedly been made internationally comparable, central excise duties have been converted to a truncated VAT (CENVAT) up to the manufacturing stage and custom tariffs on imports have been sequentially scaled back to approach comparable international level. The various exemptions, however, have affected the quality of tax administration and revenue performance. For a couple of decades, services sector has grown rapidly and now represent more than half of the GDP. In view of its increasing role in GDP, the taxation of service sector assumes importance. It is imperative to introduce comprehensive taxation of services at the Central level and the selected services should also be seriously considered for appropriate assignment for taxation to the States and local bodies. On taxation of services, India can draw important lessons from Brazil, which was one of the first countries to introduce a comprehensive Value added tax (VAT) on both goods and services in the mid-1960s. Parthasarathi Shome in his paper 'India: Resource Mobilization through Taxation' finds that though there have been significant changes in the tax structures in the 1990s, however, the insufficiency in streamlining the wide prevalent incentives and exemptions has adversely affected the full potential of revenue productivity in both individual and corporate income tax. It was recognised that competitive sales tax reductions by States aimed at attracting investments had led to revenue losses without commensurate gains. The author emphasises on the reforms on both tax policies and revenue administrations.

In their paper, 'Subsidies and Salaries: Issues in the Restructuring of Government Expenditure in India', Stephen Howes and Rinku Murgai find that while there are ways to reduce subsidies through a combination of efficiency improvements and tough decisions, however, attempts so far to reduce subsidies have met with little success. The paper examines the agricultural power subsidy as a case study and situates India's growing subsidy bill within the context of a trend towards agricultural protectionism. There is no assured path forward and sustained reduction in the expenses towards subsidy will require institutional experimentation. The authors suggest that there is potential of decline of salary bill of Government sector (Centre and State Governments) by 2 per cent of GDP over the next decades – *via* both wage and hiring restraint without sacrificing expenditure quality. There is also a need to address the growing pension's outlays. The usual emphasis on expenditure restructuring through subsidy reduction is complemented in the paper by an equal emphasis on salary bill reduction. The authors are of the view that a reduction in the salary bill is not likely to come about by active downsizing but by a combination of hiring and wage restraint. With regard to the power sector, the authors stress the importance of privatization as perhaps the only way to bring commercial discipline into the rural segment of the power sector, however, at the same time acknowledge the associated risks and difficulties.

Ricardo Hausmann and Catriona Purfield in their paper, 'The Challenges of Fiscal Adjustment in a Democracy: The Case of India', provide thought provoking views and find that India's tendency to run large deficit and accumulate debt has deep institutional roots embedded in its highly decentralized democratic system. The paper mainly studies three aspects of fiscal consolidation. First, it accounts for the lack of symptoms of an impending crisis by pointing to some aspects. However, the lack of symptoms is double-edged sword: it makes crisis less likely for any level of debt, but society is less responsive to fiscal imbalances, thus making the eventual problems much larger. Second, it analyses possible implications of the fiscal responsibility legislation on India's imbalances. Third, it studies India's federal system and the role of States in the fiscal adjustment effort. The authors find that India's ability to tolerate high deficit and debt without encountering the types of crises experienced by many other emerging economies is a mixed blessing. It reflects the comparatively large and closed nature of its economy as well as its deep domestic capital market and large, *albeit* captive, pool of domestic savings. The last has allowed the Government to finance deficits with long term fixed rate debt instruments. The authors recognise the recent institutional reforms based on legal backing. The authors suggest a State level fiscal consolidation plan including those of imposition of borrowing ceiling on States to constrain their deficits and reforms to the system of intergovernmental transfers to give a more stable and reliable source of revenue.

In a federal set up, stable and reliable sources of flow of funds helps in formulating the future strategies at sub national levels governments. For sound fiscal management, however, the efforts should be undertaken by both the Central and State Governments.

The federal budgetary systems bring especially difficult challenges. For example, the Argentina made significant economic progress on a wide range of issues in the 1990s. However, the complicated financial relations between the federal Government and provinces crucially undermined attempts at fiscal control as the provinces had little incentives to control their spending. Eduardo Refineppi Guardia and Daniel Sonder in their paper, ‘Fiscal Adjustment and Federalism in Brazil’, draws the lessons from the another large federal Brazil. The authors emphasise that during the time of fiscal adjustment the fiscal-federal system needs to be respected as an integral element of policy design, though the system itself may need to be adapted if situation requires to maintain macroeconomic stability and to achieve the objectives of fiscal adjustment. The authors emphasise on major elements of a fiscal-federal system and the ways in which these were adapted in the context of Brazil’ fiscal adjustment experience during the late 1990s. Among others, these include assignment of revenue and expenditure responsibilities between the Centre and the States and the rules determining the control of sub-national debt. The paper assumes importance in the sense that it sets priority for Indian policy makers to reconsider the scope for adapting their own system.

In the concluding chapter, ‘Fiscal Policy in India: Lessons and Priorities’, Nirvikar Singh and T.N. Srinivasan assesses India’s current fiscal situation, its likely future evolution and impacts on the economy. The authors examine possible reforms of macroeconomic policy and broader institutional reforms that will bear on the macroeconomic situation. The authors also take into account the factors such as political feasibility of possible reforms. They also examine both medium and longer run scenarios, fiscal sustainability and adjustment going beyond conventional government budget deficits, to include off-budget liabilities, both actual and contingent. The chapter concludes that some short run fiscal adjustments are clearly necessary to avoid any possibility of a crisis, but at the same time more fundamental adjustments- in the tax system, the structure of the expenditure and the financial sector must be on the agenda for reforms.

The book, a major contribution to the fiscal literature, is thought provoking, timely and pertinent to India's fiscal affairs. The various aspects of India's fiscal policy, related issues, implications on growth, feasibility of implementations of reforms in the existing democratic and federal set up are well recognised and addressed. It provides adequate insights and suggests a road map, taking into fiscal policy and its linkages with other macroeconomic policies, for a sound and sustainable fiscal policy for India. The reforms in tax administration, expansion of tax base through more services in tax net, introduction of transparency in fiscal matters and channelisation of expenditure along productive lines among others reforms are suggested to be initiated on priority basis. Several fiscal policy measures have already been initiated in India during 1990s covering most of these areas. Furthermore, the book provides very useful insights on the optimal level of fiscal decentralisation for India. The discussion on linkages of fiscal policy with other sectors and its implications including on growth is very relevant and will provide valuable inputs to the policy makers in India to further facilitate the fiscal reforms process with a view to strengthening fiscal situation.

Growth implications of the fiscal policy could have been addressed more adequately taking into account the more disaggregated information and also simultaneously the impact of taxation, expenditure and budget deficits components on the growth. The analysis on India's fiscal situation with an international perspective and its linkages with other sectors provides adequate insights to policy makers and provokes researchers to take further work in this area. In this regard, a phase-wise analysis of various aspects of fiscal policy could have been more useful to understand the strengths and weaknesses of policies in different phases. The issues like rigidities in bringing expenditure to a lower level or in channelising it towards productive lines apart from sustainability of public debt, which continue to pose problems for the on-going process of fiscal consolidation could have been addressed adequately. Keeping in view the problems as highlighted in number of papers, there needs to be some short run fiscal adjustment to avoid any probability of a crisis. In this context, the future course of action meant for short run and long run could have been provided adequately keeping in view India's democratic and federal set up. Nevertheless, the book remains an important contribution to the India's fiscal literature. It may be concluded that the book provides very useful insights for policy makers to undertake appropriate and timely policy measures in order to strengthen fiscal position and avoid any crisis in the short and medium term and for sustainable fiscal situation in the long run.

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