# Restructuring of the Public Finances and Macro-economic Stability[•]

Mr. Chairman and friends,

This meeting has been convened to solicit views on one of the specific references to the Eleventh Finance Commission, viz., means by which the Union (or Centre) and the States may bring about restructuring of the public finances so as to restore the budgetary balance and maintain macro-economic stability. I will, therefore, confine myself to this theme, in the context of reform process under way. I will, first, describe what may be called the new realities relevant to current macro-economic management. Then some specifics relating to devolution mechanisms and macro-economic issues could be considered. Reserve Bank of India's (RBI's) initiatives in this context will be briefly listed. I will conclude with comments on specific issues on which some participants in this meeting have expressed strong views.

## New Realities

1. With increasing integration between the Indian and world economy, in terms of trade and financial flows and especially private external capital flows, we have to recognise the need for some sort of convergence of macro-economic stability parameters. Most critical are, fiscal deficit and within it revenue deficit and especially monetised deficit, inflation and of course interest rates. So, we should consider world trends in say, inflation and fiscal deficit, public sector savings and compare our performance in this respect to judge how competitive we stand in terms of stability and efficiency indicators. While we may afford to be out of alignment temporarily, or marginally, or with reference to one or two of the parameters, we will find it difficult to maintain macro stability if we are too far away on most of them, especially, on the inflation and fiscal deficit front. Today, fiscal and monetary options are no longer driven by domestic compulsions alone; they have to broadly conform to certain internationally acceptable norms of what constitutes the sound fundamentals of an open and competitive economy. I do not think we have much option to deviate from these standards in the medium to long-run.

2. The challenges for fiscal restructuring also stem from several domestic factors. Reforming the financial sector to augment efficiency in financial intermediation is inevitable. Further intensification of financial sector reforms means development of a well-organised and efficient debt market, which cannot be realised without strengthening fiscal consolidation and addressing legal, institutional and technology issues. Hence, limiting the fiscal deficit of Centre and States to a sustainable level is critical for further progress in financial sector reform. This will facilitate further liberalisation of regulation relating to banks' investment in government securities and promotion of a more orderly growth of debt market. Fiscal discipline is a precondition for successful financial sector

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reform. Incidentally, the concept of public sector deficit which includes government deficit including those of public-enterprises', loses, technically, its significance when many enterprises get into diversified (government and public) ownership patterns or being privatised, and when they start operating purely on commercial lines. However, there is an implicit government guarantee in respect of borrowings by any public enterprise, and thus the magnitude of public sector deficit also needs to be reckoned.

3. There is now an increasing realisation about the importance of monetary policy, and the autonomy in conduct of monetary policy as well as efficiency in monetary transmission mechanism and these require drastic reduction in the currently ruling high level of government borrowing – which again has a significant bearing on fiscal and revenue deficits.

4. Economic reform in a broader sense would also encompass realigning of relative functions of Centre and States towards achieving economic prosperity and improving the quality of life. In our context, it means greater emphasis on development of social infrastructure and physical infrastructure. Most of the social, and a significant part of physical infrastructure lies in the domain of States compared to Centre. Expenditure responsibility of States is likely to grow in social sectors; particularly education, health, sanitation and nutrition, even after reckoning with some unbundling as also scope for private provision. Economic reform is not sustainable if expenditure of State Governments is not buoyant in desired directions and this has a bearing on vertical distribution of resources.

5. On the inter-state plane, the new reality is greater role for market based resources for development of a State. So, while States need to be encouraged to compete for resources in the market, there should exist mechanisms in transfer of resources which would differentiate between ability-consistent efforts and the ability–enhancing efforts. By this I mean States which already have a reasonably developed institutional support base and strong fiscal position can garner resources from market and consequently reduce their dependence on central transfers. In States where institutional setting is underdeveloped, public policies may have to address the issue of improving their ability to access financial markets, while at the same time augmenting their resource base through transfers to help prepare them towards a greater degree of self-sufficiency. This has greater relevance now than before due to market orientation and has a bearing on equity/horizontal distribution.

6. Against the backdrop of new constitutional provisions relating to giving financial autonomy and responsibilities to local bodies and its inclusion as terms of reference for the first time for Eleventh Finance Commission, the issues of inter-state and intra-state transfers have assumed a new dimension. In this context, there is an increasing reference to Municipal bonds as a means of financing urban infrastructure, especially against the backdrop of recommendations of the Rakesh Mohan Committee. To the extent these proposals involve guarantees by State Governments, they affect State finances and provide expediency to state level reforms, and to the extent there is a demand for counting them as approved securities for SLR, it has a bearing on interest rate structure and monetary and debt management policies. Our objective is to reduce statutory

preemptions. The Central and State enterprises should, therefore, be encouraged to access market on the basis of financial strength and viability rather than through sops like tax benefits and SLR routes which distorts the interest rate structure and hampers market efficiency.

7. On fiscal deficit situation, we have to be concerned about the total liabilities of governments, rather than marketable debt alone, since this has dynamic and spiraling consequences for fiscal policy and its future sustainability, involves a signaling effect for the market, and is important from the view point of the focus of rating agencies. While market liabilities would include public debt and contingent liabilities due to guarantees, total liabilities would include, for example, provident fund, small savings etc.

8. Against the backdrop of Asian crisis, a new reality in the sphere of management of financial risk for the economy is the need to recognise and monitor off-balance sheet liabilities, whether these are due to banks or Governments. In this context, the guarantees given by the State Governments and Central Government, will have to be assessed and monitored. The focus on such guarantees has increased recently in the context of attracting private sector and foreign investment in infrastructure, especially when cost recovery systems are not fully in place. Managing these guarantees can pose difficult problems at a time when exchange rate is fluctuating and the guaranteed amount is pushing up the external liabilities, as for example, in the case of power projects. Another non-transparent way of assuming liability by the Government is to issue letters of comfort which do have the same effect as guarantees for the rating purpose and for the sustainability of government finances, though such letters of comfort may not be reported in the budget documents.

9. We have to be also aware of new realities in the Government borrowing programme. Let me draw attention to two critical issues in the government market borrowing programme. One is the increasing cost of Government borrowings, and the other, the shortening of maturities. Both affect the debt management and monetary policy objectives. While the former is related to the size of the borrowing and hence the fiscal deficit, the latter is influenced by the future policy uncertainties, particularly relating to fiscal policy, and consequently the market preference for short-term government papers to ward off long-term interest rate risk. What is therefore important is a dynamically consistent fiscal policy with emphasis on low fiscal deficit. Another source of high cost fund for the Government is borrowing through the tax-favoured instruments such as small savings and relief bonds, apart from public sector undertaking bonds, which not only affect the overall cost to Government but operate as wrong benchmarks for other markets. These schemes may need a thorough review if we have to move away from dependence on captive borrowing sources towards retailing of Government securities to a larger investor class.

10. Abolition of *ad hoc* treasury bills and introduction of the scheme of Ways and Means Advances for the Centre is a major development, impinging on both development of Government securities market and fiscal discipline, including quality of cash and debt management. Adherence to budget assumptions on borrowing programme and to the

extent possible, subject to monetary policy considerations, adherence to pre-announced extent of monetisation of government debt by RBI would be essential if credibility in the new system is to be reinforced.

11. Finally, in consonance with the Narasimham Committee–II recommendations, we have introduced risk weights for Government securities for the purpose of assessing capital requirement for the banking system and provisioning norms for unhonoured guarantees as essential measures to promote soundness of financial sector. This could imply greater caution on the part of banks in supporting Government borrowing or granting advances against guarantees. Incidentally, the share of banks in total financial intermediation, and that of public sector banks in total banking system are likely to come down in the medium term. Hence, the extent of what may be called captive investors for Government securities, could be proportionately less in both formal and informal terms. This has implications for the interest rate in funding a high level of fiscal deficit of centre and states.

12. As part of economic reform, substantial restructuring of public enterprises has been taking place both at Centre and States and this is likely to be intensified in future. Such restructuring has often meant some immediate financial costs, especially when there is large scale rescheduling of debt, and conversion of debt into equity. These measures amount to impact of not several hundreds but several thousands of crore. There is a potential for serious erosion of quality of assets. This aspect requires intensive analysis for designing a suitable approach to restructuring and it is as important as an approach to privatisation in terms of its dynamic impact on government finances.

## Macro-economic Issues

1. In the light of the new realities described, revenue and expenditure assessments by the commission should reflect the broad macro-economic concerns of reducing the revenue and fiscal deficit of the combined Government sector. This may require working towards a consensus on the desirable path of fiscal deficit of Centre and States.

2. While fixing the target levels of fiscal deficits for the combined Government sector, some redistribution of revenue deficits and perhaps even creation of revenue surplus would be needed. This poses a critical task of devising a balancing mechanism by the Eleventh Finance Commission. The major element here would be the incentive system, which needs to be built into the devolution mechanism for transfer of resources. Tenth Finance Commission provided a weight of ten per cent for tax effort in its devolution formula. This may need some review. Also, a revisit to the issue of unutilised tax potential in the States, tax capacities etc. may be worthwhile. Given the importance of cost recovery of expenditure, an analysis could be made to see if we could build some reasonable incentives for promoting fiscal performance of states.

3. A ‘totality’ view of fiscal and financial sector interaction is absolutely essential, in the context of new realities that have been described. What we have to keep in mind is the signaling effect that the Commission’s fiscal recommendations would have on the

financial markets. If there is a clear and credible indication of fiscal consolidation by the Eleventh Finance Commission, it will help smoothening the movements in long-term interest rates. Now, with the growing size of gross and net borrowings of Centre and States, persistent combined revenue deficits, and cut in capital expenditures, borrowing costs to Government remain high and sticky. The Eleventh Finance Commission's recommendations can help change the market expectations through the adoption of a more credible approach to fiscal restructuring.

4. While the Finance Commission deals basically with horizontal and vertical equity in resource sharing arrangement, incentives for tax-effort, and perhaps even cost-recovery issues, one can raise the question of incentive framework in expenditure allocations also. If education and health are critical for reform, and if the assignment of resources is based on the assumption of increased outlays to such sectors, how do we ensure that the assumption is realised? How should we devise transfer mechanisms that ensure allocation and performance in these sectors? In a way, this is stretching the point, but it is worth exploring to confront the reality.

**RBI's Initiatives**

1. RBI has been taking initiatives, in multiple capacities, viz., as monetary authority, as debt-manager of Centre and States, and as banker to Centre and States. There is an overlap, and for that matter even conflict, in discharge of these three functions. Hence, it is difficult to pigeonhole RBI's initiatives. For the present purpose, let me allude to some of the efforts we have taken to improve the quality of information, analysis, and operations relating to government finances.

2. RBI has been expressing its views in its Annual Reports on the issue of government borrowings. A specific proposal on putting a ceiling on public debt has also been suggested in a technical paper on the subject published in the RBI Bulletin (December 1997).

3. Initiatives have been taken to bring about reconciliation between interests of some well managed States and others in imparting market orientation to State borrowings, in the absence of progress on State Funding Corporation earlier advocated by the RBI. Currently, a State has an option to access market borrowings outside the tranche of all States, to the extent of 5 to 35 per cent of annual borrowing programme.

4. A scheme for consolidated Sinking Fund has been designed by the RBI as a mechanism to ensure orderly retirement of market debt, although only a few States have responded favourably.

5. In recognition of the emerging problems relating to guarantees, we have constituted a Working Group whose Report is due soon. Similarly, we had constituted an informal Committee to review Ways and Means Advance System of States. The recommendations of this committee are under study.

6. RBI is separately, studying the implications of management of public account for finances of governments.

7. RBI has been taking active interest in developing Government securities market, in terms of policy (elimination of *ad hoc* Treasury Bills), instruments (Treasury Bills of varying maturities and innovative instruments in dated securities), institutional development (Primary Dealers and Satellite Dealers), technology (screen based) and legal changes (Public Debt Act, SCR Act, Stamp Duty etc.).

8. RBI is constantly improving interactions with Governments, as for example, through recently constituted Cash and Debt Management Group with the Central Government, and two meetings with State Finance Secretaries conducted recently. The interaction is also continuing through *ad hoc* groups.

9. RBI publishes data and analysis in its weekly and monthly Bulletins, which are available at website on an adequate and regular basis. The Report on Currency and Finance and the Annual Report provide the Bank’s analysis of government finances and the policy priorities in this sector. There is an annual study of State Finances published in RBI Bulletin, which carries a wealth of information on state finances.

10. RBI has been conducting policy intensive research studies on fiscal and other macro-economic issues through its Development Research Group (DRG) wing and through the medium of its research journal, viz.; Occasional Papers, which are available for wider public dissemination. Moreover, the bank provides active research support to Government, Planning Commission and other national institutions on public finance issues. Recently, we have initiated a DRG study on the implications of fiscal deficit for macro-economic stability which should be of use to the Eleventh Finance Commission. As requested by the Commission, we will take up analysis of specific subjects in this study and make it available to the Commission in view of the Eleventh Finance Commission’s appreciation of research capabilities available in the RBI.

**Comments on Specific Issues**

A number of issues have been flagged in this meeting by the eminent economists and economic administrators and I agree with most of what has been said especially on the importance of cost-recovery for commercial services rendered by government, especially in sectors of power, water and road transport. There were strong and somewhat divergent views on the relevance of fiscal deficit, importance of public ownership, advantages of decentralisation, transparency in tax-expenditures and on the issue of insensitivity to market related interest rates. I will briefly give my views on each of these.

1. On the issue of fiscal deficit, what level of fiscal deficit is sustainable is contextual - depends entirely on the context, including in particular, the level of domestic savings, especially financial savings of households, the level of Current Account deficit, the acceptable level of inflation and, of course, the rate of economic growth. More than size, what is important is how fiscal deficit is financed and for what purposes it is used. If it is

financed by large order of monetisation, it has adverse implications for inflation with a lag. This has been an empirical fact for us. Dr. C. Rangarajan, our former Governor, has made research based observations on this phenomenon in our country. As regards use, to the extent it is used for financing revenue deficit, there would be no return directly attributable to such expenditures. Further, there is an addition to stock of liabilities without corresponding addition to stock of assets, impinging on future cash flows. On the other hand, if the deficit is used to finance capital expenditures, there is addition to both stock of assets and liabilities, but even then such a deficit will have negative impact as long as the direct financial return to Government on addition to stock of assets is less than cost of servicing of additional liabilities. If such expenditures directly compete with private investment and if productivity in public sector is demonstrably lower than that of private sector in the same activity, there would be a further negative impact. To the extent there is funding of public investment out of such a deficit with clear complementarity to private investments, it is possible that deficiency in direct return is made up by increase in indirect returns. One aspect often ignored by economists advocating large fiscal deficits to fund public investment is the expectations on the part of potential creditors, domestic or foreign, that borrowed funds are indeed used for genuinely productive purpose. It is not merely the advocacy or promise of productive use of funds but expectations of creditors about such productive use that becomes important if ‘preemption’ is reduced. The sustainable or defensible level of fiscal deficit should be viewed in the current context of mode of financing and use of funds in Centre and States. Sometimes, it is argued that increased fiscal deficit would help stimulate demand and should not be eschewed. But the issue really is whether this is a sustainable course to follow in the medium to long term. Year-to-year variations may be desirable from the view point of counter-cyclical objectives of fiscal policy but only within the objective of medium-term sustainability. The desirability or otherwise cannot, therefore, be settled in abstract terms, but only with reference to context.

2. On public ownership also, there have been strong views and it cannot be held that public ownership, by itself is inefficient or for that matter relatively more efficient, be it efficiency in technical, allocative or dynamic terms. Contextually, I would suggest, that there are three inter-related approaches. First, if on ideological and strategic grounds, an enterprise has to be a public enterprise, 100 per cent owned or 51 per cent, there can be no debate. On instrumentalist grounds, i.e., as an instrument of non-commercial objective, alternative ownership patterns and optimisation of results could be examined to achieve such non-commercial objectives, provided there is a debate on desirable changes, if any, in market structure also. Third, and in all other cases, a portfolio approach to ownership rather than ideological or instrumentalist needs to be considered. In an investment portfolio approach, it is not material whether a particular public enterprise is currently profit making or loss making or giving high or low returns. For all predominantly commercial activities, where entry of private enterprise is permitted, portfolio approach appears logical. In a portfolio approach, we can project future cash flows, both with plans for restructuring and without to obtain the Net Present Value. If the present value of anticipated proceeds from privatisation appear to exceed the net asset value, with or without restructuring, then privatisation is warranted. The portfolio approach can factor-in degrees of public ownership and control since restructuring option

includes consideration of degrees of autonomy also. Such a framework can be applied for public enterprise in both Centre and States. The real issue is a credible threat of privatisation, which in itself will help improve the efficiency of public enterprise in as much as management and workforce would be motivated to improve their performance toward change of ownership. As a result, it is inevitable that a large public enterprise sector will remain, but with greater dynamism. I agree with the view that, a large segment of public enterprise sector will continue to exist for quite some time because of sheer size of public enterprise now. It could also be as a consequence of costly restructuring to avoid privatisation resulting in continued fiscal burden. In my view, effective threat of privatisation is useful, resulting in some actual privatisation combined with increased level of efficiency in the public enterprise sector, thus reducing the fiscal burden.

3. On the issue of decentralisation, either a conceptual approach or a pragmatic approach is possible. Conceptually, the case for decentralisation in Government can be made when an optimal distribution of powers and functions between various levels is arrived at and a process of decentralisation is warranted to reach the optimum. Further, decentralisation in some aspects or powers could be combined with centralisation in regard to others while meeting optimality criterion.

In the current debate, there is an impressionistic or anecdotal evidence of need for decentralisation. Empirically, it can be established, that where Centre and States are currently performing same functions (Delhi Electricity or Road Transport), States are seen to be less inefficient both in physical and financial parameters. Quantitative analysis of efficiencies, activity-wise, at Centre/district/municipal/ panchayat could certainly be attempted. I will not be surprised if the results vary as between States, with a distinct tilt in favour of more decentralisation. However, real decentralisation is not possible unless the staff is squarely brought under the administrative control of relevant level of Government and democratic process is ensured.

4. Transparency in budget, especially quantifying, to the extent possible, and presenting tax-expenditures is certainly worthwhile. Ideally, the Eleventh Finance Commission should work on quantifying tax-expenditures in the last five years at Centre and State levels, recast their budgets on a proforma basis and consider these as inputs for assessing revenues and expenditures. There are also related issues of tax exemption of municipal bonds which has been advocated by some. It is no doubt a standard practice in many countries. In India however, municipal bonds may not sell without State guarantees, which could imply adverse credit worthiness effects for states themselves. Further, while Centre has been allowing tax exemptions to entities like PSUs for raising resources from the market, no such allowance was made for its own securities, till two years ago. Now, some relief on par with mutual funds is available. One clear way of reducing interest burden and encouraging retailing of Government securities would be to review this issue.

5. Finally, it has been argued that encouraging borrowing by Government at market related interest rates has not brought about any fiscal discipline since Governments in India are not sensitive to interest rates. Hence, it is argued that we need not pursue this cause. I am afraid I have serious problems with such an approach. At an abstract level,

one can argue that accepting over-sensitivity in these matters as a fact helps none except those who are insensitive. Again, at an abstract level, it can be argued that price has both a demand side and supply side. If the whole of borrowing programme is monetised technically, then price is immaterial, especially since seigniorage or interest paid by Government comes back, as dividend from Reserve Bank to Government of India. But what about costs of monetisation or inflation costs to the economy, which are recognisably high and distorting? Hence, if government does not pay this price, someone else pays it. Even so, ends of transparency of budget operations are not met. We have to separately reckon such other costs of monetisation. Assuming that there is a mix of monetisation and non-monetisation, not charging market related rates on monetised deficit has moral hazard implications. As regards non-monetised part, some cross subsidisation between the Government and the financial sector becomes inevitable if interest rates are not market related. It is true that for this logic to be convincing, markets need be developed, but developing markets and gradually adopting market related rates serve the longer term interests of efficiency and any effort in the meantime, to artificially depress the cost of borrowings to Government will not be desirable.