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Fiscal policy

India needs a consolidated approach

Looking at the finances of the central government alone gives an erroneous picture

The latest IMF advice to India is to continue with fiscal consolidation. By that, the IMF means further reduction in the fiscal deficit along the prescribed path under the FRBM Act. But with the passage of the GST bill and more money going to the states after the 14th Finance Commission, what India needs is a more consolidated approach to its fiscal policy, not just a smaller fiscal deficit. The GST will eventually give India a 2-3% of GDP extra revenue—but this will take time to materialise and will also have to be shared between the Centre and the states.

Given the politician's penchant for fiscal profligacy, the FRBM Act was seen as a way of constraining excessive public spending, reducing fiscal deficit and eliminating revenue deficit. It has had a mixed history and the government has constituted a new panel to review the Act and suggest improvements.

The government rigorously followed the Act between FY04 and FY08, when the fiscal deficit was brought down sharply and the revenue deficit declined below 2% of GDP. But then, in the run-up to the 2009 general elections, and, subsequently, in response to the global economic crisis, the FRBM was significantly breached and the fiscal deficit exceeded 6% of GDP and high fiscal deficits persisted, unnecessarily for another two years. The FRBM was suspended and revived only in FY12.

The NDA government wisely persisted with the Act, but deviated from the target in FY15 to delay fiscal adjustment to increase public investment by 0.4 % of GDP. The fiscal deficit in FY16 was upped from 3.5% of GDP to 3.9% of GDP. But, even with the increase, public investment of the central government, at under 2% of GDP, remains too low—even when investment by public enterprises and state and local governments are included, public investment adds up to around 8-9 % of GDP.

This is higher than the low level of public investment of 7-8% of GDP from 1995-2005 but still is quite low. India's public investment was around 12 % of GDP in India in the 1980s and peaked at 14% of GDP in 1986-87. Moreover, more than half of India's public investment is re-investment by PSUs, not service-providing public investment. By way of comparison China invests more than 15% of GDP in public investment, as did Korea and Japan during their high growth phases.

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There are three key problems with the Act which need to be reviewed. First, the Act focuses only on the Union budget whereas India must focus on the consolidated public sector borrowing requirement (PSBR) of the Centre, the states and the public sector undertakings (PSUs). The PSBR is much higher than the fiscal deficit and lately the two have moved in different directions—the fiscal deficit has been falling, but the PSBR has been rising.

Second, the revenue deficit of the central government has been high and the FRBM Act targets its elimination, but the consolidated public sector has been in revenue-surplus for much of the last 25 years, except for a brief period, 1998-2003; indeed, it remained in surplus even through and after the global economic crisis. In effect, the central government has been borrowing to finance consumption expenditure but the public sector as a whole has been investing more than its overall borrowing. So, looking at the finances of the central government alone gives an erroneous picture.

But what India needs is more investment by the central and state governments on transport, energy, irrigation and social infrastructure for urban and rural areas, not just more re-investment by PSUs. So, a consolidated picture would suggest that the Centre collect more dividends from PSUs and allocate these to its strategic investment fund for infrastructure spending.

Our latest research suggests that more public investment increases GDP growth in two ways—directly, by helping reduce business costs, and indirectly, by crowding-in private investment, which then leads to higher GDP growth. Our results show that if India had kept public investment higher by 5% of GDP, it would have increased the steady-state growth rate by around 1% point. Over a 30-year period, this would have increased the GDP by over 33%.

This positive effect holds even when higher public investment spending is financed not by internal resources but by borrowing from the banking sector, which, in turn, lowers credit available to the private sector. In this case, the net increase in GDP is lower but still positive by 20% over the actual performance.

Third, the fiscal policy needs to contra-cyclical; so, the FRBM must build in automatic rules to guide the scale and scope of such cyclicality. The current Act has no such cyclical flexibility. This meant that when the global crisis hit, the government had no choice but to breach the FRBM rules. The fiscal deficit exceeded 6% of GDP and the PSBR was over 8% of GDP.

This, by itself, may have been fine, but then, the fiscal deficit persisted at very high levels for several years after that as there were no rules for cyclical flexibility. In addition, if the fiscal stimuli in response to the global crisis had been targeted on public investment instead of higher subsidies, its growth effects would have been much more sustained and the revenue deficit would have been much smaller.

Given the size and complexity of India's economy, and the key role that the states and PSUs play in the fiscal mathematics, the FRBM panel must not just focus on a numerical target for the central budget for fiscal and revenue deficits.

In the spirit of cooperative federalism, following the excellent work of the Finance Commission and the GST, it must take a look at broader public sector finances and suggest ways in which a more sophisticated approach to the consolidated public finances is pursued to maximise returns on public spending and sustain growth while maintaining macro-economic stability.

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