Missing the wood for the trees

Several commentators and economists have expressed concerns about the arithmetic underlying the government's fiscal deficit calculations, spurred by a recent report by the Comptroller and Auditor General (CAG).

The report points out that (1) government has not reimbursed the Food Corporation of India and fertiliser companies fully for food and fertiliser subsidies (while paying interest on loans to finance these dues). (2) NABARD funds an irrigation programme that is a central government scheme that was previously funded through the budget.

The report says that these expenditures in 2016-17 "were through off-budget financing route with fiscal implication of understating government's expenditure in the year as they were deferred" (sic)

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The information provided is accurate but the conclusion misplaced. The fiscal deficit of the central government is simply the difference between its revenues and expenditure. If an agency of government incurs expenditures that were previously incurred within the budget then that's an executive choice. It is not an understatement of the fiscal deficit, just as if a private conglomerate finances an expenditure through one of its own companies instead of through the income of the holding company, this would not be seen to be "understating the expenditure of the holding company".

This may (or may not) have implications for the overall health of the conglomerate, but there is no violation or concealment involved. If government uses taxes to write-off Air India's losses, then it would be ridiculous to say that Air India is understating its losses. The CAG report incorrectly uses the phrase "understating government's expenditure," leading to uninformed confusion.

The report also charges government with deferring current year liabilities to the next year. While this is true, it is not illegal. No conclusion about deficits in future years can be drawn. Government may in future years continue to defer liabilities or pay them off by raising taxes and/or reducing expenditures, thereby sticking to its fiscal deficit commitment. No ex ante judgment can be drawn on this score. An auditor's dislike of unpaid bills and rollovers does not implicate the rectitude of government's fiscal reporting.

Some commentators say that such borrowings add to the public sector borrowing requirement (PSBR). This is not true. The PSBR is the sum of borrowings by government and all public sector entities. The location of the borrowing does not impact the PSBR. If someone thinks government borrowing equals the PSBR then this is an analytical error and not a consequence of fiscal jugglery.

This misplaced excitement at having uncovered some non-existent fiscal jugglery is a consequence of lazy analytical thinking which governments cheerfully exploit. The things the CAG report interdicts have been bipartisan practice. Governments of all hues have escaped scrutiny of the overall debt of the public sector because there is no pressure to install the analytical equipment that would support such scrutiny. Ideally, there should be a PSBR calculation undertaken and placed in the public domain. NIPFP has tried to do this and while we have come up with credible estimates, there is a formidable analytical challenge in India. A large chunk of the financial system and corporate sector is publicly owned. So should lending by public sector bank to a public sector corporation count as an increase in the PSBR? And what of acquisitions of public entities by other public entities? There are answers to these questions, but these are open to challenge as there can be ambiguity in interpretation. Within these limitations, it is reasonable to conclude that the non-government public sector borrows around 1.2 per cent of GDP; this is a fairly constant number in recent times. An important driver of the case of fiscal consolidation made in both the FRBM reports is that this means that the combined borrowing of central and state governments and public sector entities is more than 8 per cent of GDP. With financial savings around 11 per cent, this makes capital scarce and expensive for the private corporate sector. This practical fact is ignored by both proponents and opponents of fiscal responsibility. They prefer the easy and lazy route of casual questioning of government motivations, missing the wood for the trees.

They also ignore the hard and unglamorous task that is key to fiscal reform in India. A medium term fiscal framework with intertemporal fiscal projections would clearly reveal the medium term implications of both single and multi-year government fiscal decisions and facilitate calculation of a credible PSBR. In such a framework, the multi-year implications of a specific fiscal action would be apparent and government would be accountable for these.

I have ploughed a lonely furrow pleading with analysts to support the case for government to shift to such a framework, the basis for fiscal strategy and management in most modern economies. Analysts pay lip service to the idea but continue to focus on annual budgets (and, even more silly, on intra-year budget numbers). It is time to get serious about this major structural weakness and collectively persuade government to upgrade its annual budgeting process to a 3-5 year operational fiscal framework. Only this will improve the quality of fiscal execution and transparency.

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