A tale of two disenchantments

Twenty five years ago, I argued in my doctoral thesis that fiscal policy could be used to map changes in state objectives. In essence that is what I am doing in this column. I contend that the Indian State, at both the central and state levels, is transitioning from being a development State to a compensatory State. Both at the political and the executive level, the clamour is to find the means, technologies and modalities to put money directly into the pockets of citizens to compensate them for the fact that economic growth has not done so, and that the State has also failed in its mission to deliver public and merit goods to those who cannot afford to procure these from the market.

The overarching objectives of Indian economic policy since Independence can broadly be seen as: Self-reliance and economic modernisation (1950-1971); poverty reduction (1970-1991); stable economic growth and balance of payments security (1991-2003); and then growth with delivery of public goods like health and education. These changes in objectives, while significant, could broadly be seen as changes in emphasis and focus of what has, until now, been a development State.

RATHIN ROY

Over the past two years, there has been a discernible shift in the declared objectives of fiscal policy that is bipartisan in nature, reflected in the changing public expenditure composition of many states and now in the flagship economic offerings of both national parties. The value proposition is to use public resources to put cash directly into individual bank accounts through tax reductions and cash transfers.

In my view, this shift has arisen because of two important disenchantments with previous objectives. First, corruption, poor targeting and the low productivity of public expenditures that deliver merit goods. Attempts to use technology to fix this have met with limited success. Public finance is now to be used to compensate for this failure, not to address it.

Second, growth in India has been unequalising because the top 10 per cent have benefitted disproportionally more from it than the bottom 90. In addition, growth has been unequalising across regions and ethnicities. In these circumstances, arguments for direct transfers are in vogue to compensate for this failure, not to address it.

The elision of these two disenchantments has given rise to a variety of schemes that involve some targeting (farmer, rural population, very poor), but their common objective is to transfer money from the public exchequer to the intended beneficiary.

The focus of fiscal policy in contemporary India has thus shifted due to these two disenchantments. The productivity of public spending is low and exacerbated by corruption and poor targeting; attempts to use technology to address these problems have been largely unsuccessful. In parallel, the growth process has been highly unequalising, not just in terms of who benefits from growth, but also in terms of who participates in it. Hence, general government (Central and state governments) is progressively recusing from its commitments to deliver inclusive growth through productive inclusion, and to use public resources at scale to provide merit and public goods and services. Instead of financing development objectives, fiscal policy is now increasingly used to compensate those who were promised development.

There is an important fiscal corollary, independent of one's political or ideological view on the desirability or inevitability of this transition from a development to a compensatory State: Fiscal policy creates a commitment legacy. In India, the historic objectives of public finance have created legacy expenditures and public assets; we have public sector institutions (and development "schemes") that were created (steel plants, construction firms, universities) or acquired (banks, oil companies) to serve the development objectives of bygone eras, but the State continues to hold on to these and to spend money on them even as the objectives have changed.

In India, when the objectives of fiscal policy change, no structural adjustment happens to adapt public spending to the new objectives by reducing expenditure on things that are no longer a fiscal priority. In large measure, this is due to the absence of a strategic framework within which fiscal policy is designed and implemented. A medium-term fiscal framework as the cornerstone of budget formulation and execution would allow governments at both levels to make these fiscal transitions, thereby securing fiscal space for spending objectives without compromising fiscal consolidation.

Of course, constantly expanding the size of the State (by increasing the general government expenditure/GDP ratio) would also make this possible. This did happen in the past. General government spending expanded from 15 per cent to 25 per cent of GDP between 1971 and 1991. But the national institutional framework for fiscal consolidation has successfully restrained this tendency. This ratio has hovered around 25 per cent since 1991. Hence, it is the fiscal space that is now squeezed, which serves no government well as too little is spent on too many things. We have neither good hospitals nor adequate fighter aircraft; neither good extension services nor adequate public transport.

If, as appears from recent pronouncements, there is a political and executive consensus that the primary objective of general government is to undertake compensatory redistribution, then we would be well advised to think about what to spend less on to secure this objective so that the legacies of past spending do not compromise the effectiveness of this new focus.

The writer is director, National Institute of Public Finance and Policy. Views are personal