

Suman Bery: Debt and exit

Can a debt cap limit fiscal indiscipline?

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In his Budget speech on February 26, the finance minister articulated the three important challenges confronting him in preparing this year's Budget.

These were to restore growth (to 9 per cent, ideally higher); to use this growth to make development more inclusive, particularly by strengthening rural infrastructure; and to address bottlenecks in public delivery mechanisms

and institutions.

Somewhat surprisingly, the minister started the part of his speech dealing with "consolidating growth" with a call for fiscal consolidation.

"In shaping the fiscal policy for 2010-11, I have acted on the recommendations of the Thirteenth Finance Commission (which) has recommended a capping of the combined debt of the Centre and the states at 68 per cent of the GDP to be achieved by 2014-15. As a part of the fiscal consolidation process, it would be for the first time that the government would target an explicit reduction in its domestic public debt-GDP ratio," the finance minister had said.

As was pointed out by T N Ninan the day following the Budget, this is a vow of temperance after an almighty binge: the targeted fiscal deficit of the Centre for 2012-13 of 4.1 per cent (presented in the Medium-Term Fiscal Programme, or MTFP), if achieved, would be at the same level as in 2005-06. Even on the best case, it will take seven years to undo the extravagance of the last two.

The MTFP openly acknowledges that the pace of adjustment in the revenue deficit is unlikely to be as aggressive as proposed by the Thirteenth Finance Commission (TFC). This is both because revenue buoyancy in the future, even with fast growth, is presumed to be lower than in the recent past, and because the government has taken on revenue expenditure commitments that are not particularly flexible. Thus the squeeze will remain on capital expenditure.

As the Prime Minister's Economic Advisory Council noted in its mid-February "Review", the fiscal deterioration at the Centre has been less on account of automatic stabilisers on the revenue side than due to discretionary increases in revenue expenditure. Changes in the revenue deficit are also a good proxy for changes in the saving (or dis-saving) of the public sector. An important part of the improved saving performance of the Indian economy in the last boom was fiscal consolidation on the revenue account. This has also been sharply reversed, primarily at the Centre.

The conclusion is inescapable, even if not particularly novel or surprising. The Central government has been through a massive growth in revenue expenditure prior to and following the general election. This expenditure has used up much of the fiscal space created under the Fiscal Responsibility and Budget Management Act of 2003. Such expenditure was superimposed upon a revenue boom generated by buoyant growth, itself partly the product of benign conditions in global capital markets.

Both these phenomena are well established in the economic literature. The expenditure surge forms part of the literature on what has come to be called the "political business cycle". Equally, there is a rich tradition, particularly for Latin America, which documents the fiscal consequences of capital surges. Low global interest rates transmit themselves to the local economy via the capital account. The surge in growth and asset values boosts tax revenue and induces expenditure which is difficult to unwind when capital starts to withdraw.

Since both the political and economic cycle will persist, and India's global integration will likely deepen, the TFC's views on fiscal consolidation need to be examined to see what safeguards they provide to manage these pressures

and temptations. Given the convention that the finance ministry typically accepts the important recommendations of the Finance Commission, I would not be surprised if the architecture proposed by the TFC had been discussed with the ministry in advance, although I have no idea if this is, in fact, the case.

The basis for the TFC's proposal is set out in Chapter 9 of its report, entitled "Revised Roadmap for Fiscal Consolidation". Two key propositions are asserted in that chapter. The first is that "to create an environment favourable to private investment in the economy", it is necessary that the ratio of consolidated (i.e., Centre plus states) liabilities to GDP be reduced below that targeted by the Twelfth Finance Commission (75 per cent of GDP in the last year of the award). The second is that "a target-based framework" needs to be maintained for the award period of the present Commission.

These two principles then lead to the Commission's recommendations that the consolidated debt to GDP ratio be targeted at 68 per cent of GDP by 2014-15, the figure picked up by the finance minister in his speech, with separate targets for the Centre and the states. In the case of the Centre, the starting point is an estimated adjusted debt stock of 54 per cent of GDP on March 31, 2010, to be reduced to 45 per cent of GDP by March 2015. A similar exercise is conducted for the states.

Based on these targets, and a belief that the revenue deficit should normally be zero, the Commission specifies a trajectory for both the revenue deficit and the overall fiscal deficit, as shares of GDP. As already noted, if the overall fiscal deficit target is to be taken seriously, one implication of these calculations is that any slippage on the revenue deficit will result in compression of capital expenditure. On the optimistic revenue deficit scenario presented, the Centre's capital expenditure is projected to rise to 4.5 per cent by the end of the award period.

It is an act of courage and boldness on the finance minister's part to portray fiscal consolidation as supportive, even essential to sustained growth, in what is sometimes referred to as an expansionary fiscal contraction. The finance minister has given himself six months to develop the rules to implement the proposals of the TFC. Their design will be critical to ensure that the right balance is struck between credibility and flexibility, and the TFC has some important suggestions on how this might be achieved, to avoid the licence that caused so much damage this time round.

The Centre has got away lightly for its profligacy this time round. We may not always be that lucky.

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