India’s Fiscal Situation: Is a Crisis Ahead?

by

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Abstract

Although, on the surface, the achievements of the Indian economy during the past two decades paint a comforting macroeconomic picture, the accompanying rapid expansion in fiscal deficits is unsustainable. The current fiscal problems existing in the states can be attributed to the increasing subsidies on publicly supplied goods and services, inter-state competition in attracting investment through tax incentives, and overstaffing of administrations and public enterprises. The federal structure of India’s fiscal system also implies difficulties in improving the states’ finances. After discussing ways to reform taxes and expenditure, this paper identifies high explicit and implicit subsidies as a major cause of the fiscal problems at the central and state level. Reducing these subsidies requires far-reaching changes in the domestic political economy. The paper also analyzes the fiscal impact of disinvestment. To achieve the goals of development, fiscal sustainability is indispensable. Although there are some positive signs, a political consensus on and commitment to fiscal reform are yet to emerge.

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1. Introduction

India has been among the fastest growing economies of the world in the last two decades. According to the World Bank (1999, Table 11), during the 1980's, prior to the severe balance of payments and macroeconomic crisis of 1991, India's GDP growth rate accelerated to an average of 5.8 percent per year, a rate that was exceeded by only 9 out of 123 countries. GDP growth resumed after 1991-92, the year of stabilization, and has averaged at 6.1 percent per year in the 1990's. Again, this growth rate was exceeded in relatively few, viz. 19 out of 137, countries. The economy weathered the Asian crisis admirably with the monetary authorities having handled the situation very well. The macroeconomic picture is comforting, with growth expected to be around 6% in 1999-2000 and likely to accelerate in 2000-2001. Inflation has moderated, current account deficit is around 1% of GDP, private capital inflows have recovered since the Asian crisis, and industrial growth has accelerated. Short term external debt, which accounted for a little over 10% of total debt in 1990-91, and was four times the stock of external reserves, was only around 4.4% of total debt and, what is even more remarkable, less than a sixth of the stock of external reserves in 1998-99 (World Bank 2000, Table A3.1a). Debt service as a proportion of current account receipts has dropped from over a third to less than a fifth during the same period. The major disquieting element in this otherwise bright macroeconomic picture is the fiscal imbalance.

Until the early eighties India's macroeconomic policies were conservative. Current revenues of the central government exceeded current expenditures so that there was a surplus available to finance in part the deficit on capital account, a deficit that is normal for a developing country. In the early eighties, fiscal prudence was abandoned--with the consequence that current revenue surpluses turned into deficits. This meant that the government had to borrow at home and abroad, not only to finance its investment, as would normally be the case in a developing country, but also its current consumption.

Fiscal deficits, as published in government budget documents, have tended in the past to understate the real imbalances. The reason was that the rates of interest, at which the

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1 Among countries that grew faster than India, many were in East and South East Asia. Thus, India's growth performance relative to its neighbours in Asia is not that impressive. It is also the case that the growth rate has to be still higher if poverty is to be eradicated within a not-too-distant time horizon

2 The overall fiscal deficit of the central and state governments is an indicator of borrowing by the government. It is not necessarily a good indicator of a broader measure of fiscal balance based on the difference between what
government appropriated a large share of the loanable resources of the banking system through statutory liquidity ratio (38.5% maximum) and cash reserve ratio (15% maximum), were administratively set below what would have been market clearing levels. Also, at least in the early years, external borrowing was largely on concessional terms from multilateral lending institutions and from bilateral government to government external aid transactions. As the eighties wore on, the government also resorted to borrowing from abroad on commercial terms both from the capital market and non-resident Indians.

In 1980-81, out of $18.3 billion of public and publicly guaranteed external debt, $2 billion was owed to private creditors (World Bank 1990, Table 4.1). On the eve of the macroeconomic crisis in 1990-91, external debt had nearly quadrupled to $71.1 billion, of which $23 billion was owed to private creditors (World Bank 2000, Table 3.1a). Debt to external private creditors grew eleven-fold in ten years. What was left of the gross fiscal deficit --after domestic and external borrowings, small savings and provident funds --was monetized through the ad hoc sale of treasury bills to the Reserve Bank. For example, in 1988-89 and 1989-90, before the crisis year of 1991, the gross fiscal deficits of the centre and states together were rupees 356.7 and 452.0 billion respectively, and nearly rupees 62.4 billion and 109.1 billion respectively of the deficits, were financed by treasury bills (World Bank 2000, Table A4.4). Domestic debt held outside of the banking system grew six fold, from Rs. 290 billion to Rs. 1752 billion in the decade 1980-81 to 1990-91. Debt held by the banking system grew roughly at the same rate from Rs. 257 billion to Rs. 1419 billion during the same period (World Bank 2000, Table A4.14).

Clearly the reckless fiscal expansionism of the eighties was unsustainable. But accompanied by some liberalization in the form of delicensing of a few industries and flexible use of capacity in others through permitted changes in product-mix within the licensed capacity under so-called "broad banding" and relaxation of some import restrictions, it did generate growth. Indeed there was a mini-industrial boom during 1985-88. The average annual rate of

resources the government is able to generate through means that cause the least distortion (i.e. welfare loss to the rest of the economy) and what are needed to sustain its appropriately defined role in the economy. For example, Sahota (2000) argues that by not taking into account tax expenditures (i.e. revenue loss from tax waivers and concessions) and transfers that cannot be deemed socially desirable, conventionally measured fiscal deficits understate the fiscal imbalance. Rao and Nath (2000) point out that reducing fiscal deficits by reducing socially desirable capital expenditure would weaken broader fiscal balance.
growth of real GDP in the sixth and seventh plans, which covered the eighties, was 5.5% and 5.8% respectively, much higher than the Hindu rate of growth of 3.5% of the earlier three decades.

The eighties also covered the period of a steep reduction in the proportion of poor in India's population--from 48.36% in 1977-78 to 34.07% in 1989-90 (World Bank 2000, Annex Table 1.1). Needless to say, reduction in poverty achieved during a period of unsustainable debt-led growth could not have lasted. When the macroeconomic crisis hit in 1990-91, the gross fiscal deficit of the central and state governments had grown to 9% of GDP at market prices. If one includes the losses of the non-financial public sector enterprises and the oil pool balance, the consolidated public sector deficit stood at around 10.9% of GDP in 1990-91. Nearly two-fifths of this deficit, or 4.3% of GDP, was for interest payments on domestic and external debt (World Bank 2000, Annex Table 8.6). An analysis by Willem Buiter and Urjit Patel (1992) showed that unless corrective steps were taken, India faced fiscal insolvency.3

It is no surprise therefore that one of the major objectives of the then Finance Minister Dr. Manmohan Singh's reforms of 1991 was to reduce the central government's fiscal deficit from 7.7% of GDP in 1990-91 to around 4% or lower in three years or so. In fact, he did achieve a significant reduction to 5.9% in 1991-92, his very first full year as Finance Minister, and further to 5.5% in 1992-93. But then it ballooned to 6.9% in 1993-94. The deficit was estimated at 6.5% in 1998-99 (World Bank 2000, Figure 1 and Annex Table 8.6)4.

A recent new definition of the centre’s fiscal deficit was introduced on April 1, 1999,

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3 Conventional solvency criterion requires that the outstanding debt at any time does not exceed the expected present value of future primary surpluses, using a discount rate that is the difference between the rate of interest on public debate and the growth rate of real GGGDP. Although in a growing economy debt-GDP ratio could grow indefinitely without violating the conventional solvency criterion, this would require that the ratio of primary surplus to GDP to grow as well. Kletzer notes that if the primary surplus is based on distortionary taxation, this may not be feasible.

4 The figures of fiscal deficit as a percentage of GDP in the publications of Government of India, International Monetary Fund and the World Bank differ for at least three reasons: (i) whether or not the government’s new definition of the deficit is adopted (this affects only the central government’s deficit and not the total deficit of centre and states together), (ii) whether the GDP for years prior to 1993-94 are changed to account for the difference between GDP (old series) with 1980-81 as base and the new series with 1993-94 as base (iii) whether proceeds from disinvestment are included in current receipts and (iv) whether or not the entire profits of the Reserve Bank of India are transferred to the central budget. Rao and Nath (2000, Table 1) provide a comparable series of fiscal deficits for the central government and find that their adjusted fiscal deficit was 6.8% of GDP in 1990-91 and 5.71% in 1998-99. Although for these reasons the levels of the fiscal deficit as published by various sources naturally differ, their time trends appear to be very similar.
which excluded the state’s share of small savings from the centre’s expenditure. Under the new definition, there was a peak fiscal deficit of 6.4% in 1993-94 and a deficit of 5% in 1998-99 (Government of India 2000, Table 2.1). With the unexpected conflict in Kargil and the associated increase in spending, the hope of reducing the budget figure to 4.1% for 1999-2000 receded.

The realized figure is likely to be 5.6% according to the budget data for 2000-01. The budgeted figure for 2000-01 is 5.1% of GDP. Neither the government’s annual Economic Survey, nor the budget document, provides their estimates of the deficit of non-financial public sector. If we adjust the World Bank’s estimate (old definition) for the budgeted deficit for 1999-2000 by the slippage by 1.6% in the centre’s fiscal deficit, the overall deficit for the non-financial public sector in 1999-2000 is likely to have been 10.8% of GDP or about the same as in 1990-91 just prior to the crisis and reforms! Among countries with over 20 million in population, Indian central government’s average fiscal deficit during the decade 1987-1997 was exceeded by the deficit of only three countries, Nigeria, Pakistan and Brazil (World Bank, 2000, Figure 8.3). There is no doubt that most economists would deem India’s fiscal deficit unsustainable. In fact, the Reserve Bank of India has warned, “while the high level of government sector deficit is attributable to some unavoidable expenditure commitments as well as unanticipated shocks, any further erosion of the fiscal position could turn out to be unsustainable.” (Reserve Bank of India, 2000, P. Part 7)

Studies of the experience of a cross section of countries suggest that large public sector deficits reduce growth by crowding out productive private investment. Monetization of deficit could be inflationary. Inflation tax is not obviously legislated and it is also the most regressive in that it hurts the poor most, since they have no way of hedging against inflation. On the other

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5 Reserve Bank of India (2000) reports a figure of 9.9% of GDP for the gross fiscal deficits of central and state Governments.

6 Acharya notes that, despite occasional slippage, the fiscal situation was in fact improving until 1996-97. It has been steadily deteriorating since then. He attributes the deterioration primarily to the increase in central and state government expenditures on wages and salaries following the implementation of the recommendations of the Fifth Pay Commission. Although these increases undoubtedly contributed to the worsening situation, Acharya is wrong in viewing them as unanticipated and exogenous shocks. Even if the size of the recommended increase could not have been fully anticipated, there was no doubt that some increase would be recommended. In fact the actual increase granted by the government was even more generous than that recommended by the Commission. A government concerned about the likely impact of a pay increase on the fiscal deficit would have planned for reductions in other expenditures in order to absorb any anticipated pay increase and in any case, would not have been more generous than the Commission itself.
hand, attempts to reduce monetization of deficit through domestic borrowing will raise interest rates and increase the cost of investment. Some studies (e.g. World Bank 2000, p. 114) suggest that in India, during the eleven-year period since 1986-87, an increase in the central government’s fiscal deficit (inclusive of oil pool deficit) by one percent of GDP was associated with a reduction in private corporate investment by one percent of GDP. Although correlation is by no means causation, and other factors also could have induced a reduction in corporate investment, one cannot rule out the possibility that fiscal deficits crowded out private investment.

There are activities which are socially important and for which there are no viable private sector substitutes for the government’s involvement. A strong case can be made for increasing expenditures on such activities by redirecting public expenditures away from other activities that are better left to the private sector, even in the absence of a fiscal deficit. When deficits are financed by increasing public debt, a potential debt-trap can arise if the nominal interest rate on debt exceeds the rate of growth of nominal GDP, as debt service payments would outstrip output growth. The Reserve Bank has been drawing attention to this possibility, most recently in its annual report for 1999-2000, wherein it said "… the debt growth has generally exceeded the nominal GDP growth since 1997-98 with an exception to 1998-99. As high levels of public debt have deleterious effects on macroeconomic stability, the need for reducing the fiscal deficit and debt to sustainable levels is widely felt.” (Reserve Bank of India, 2000, Part Four). In a recent econometric analysis of this issue, Olekalns and Cashin (2000) come to the sobering conclusion that current fiscal policies are unlikely to be sustainable in the long run. Of course, the average interest rate on government debt has been below the rate of growth of nominal GDP, so that new borrowing undertaken to service existing debt has not raised the debt/GDP ratio, this favourable interest rate-GDP growth differential is unlikely to last forever.

Since the large fiscal deficit of the last decade has apparently neither raised inflationary pressures nor increased current account deficits, some argue that the fiscal deficit has not

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7 Sahota, in a private communication suggests that to the extent reduction in deficits releases resources for investment in infrastructure, private investment may go up even further, i.e. the elasticity of private investment with respect to fiscal deficit would rise above one.
adversely affected growth and the reform process. In their view, the concern about fiscal deficit has been excessive and has prevented an expansion, as in the 1980's, that would have triggered faster growth and poverty reduction. For example, Chandrasekhar (2000) argues, first of all, the deficit is not now being monetized as it was in the past and, second, even if it had been, it would be “Inflationary only if the system is at full employment or is characterised by supply bottlenecks in certain sectors. The fact of the matter is, not only is the industrial sector burdened with excess capacity at present, but the government is burdened with excess foodstocks and foreign exchange reserves...Since inflation is already at an all time low, this provides a strong basis for an expansionary fiscal stance, financed if necessary with borrowing from the central bank. To summarise, in the current context a monetized deficit is not only non-inflationary, but virtuous from the point of view of growth” (p. 1141)

In his view, reforms that resulted in government borrowing at market rates and providing tax concessions for private saving and investment explain the failure of the government to rein in fiscal deficits. He concludes, “In sum, the evidence suggests that the fiscal effects of economic reform have put the government in a state of paralysis with respect to triggering growth and reducing poverty, even though current circumstances offer an opportunity for major advances in these areas” (p. 1142).

This line of reasoning implies that (i) financial repression is beneficial, (ii) the reason that there is excess capacity is lack of domestic demand, (iii) expansionary fiscal policy would result in its utilization and generate growth, and (iv) the most productive use of stocks of food grains and foreign exchange reserves is to support such fiscal expansion. Each of these implications is questionable. Even Joseph Stiglitz, who is sympathetic to mild financial repression, has not suggested that enabling government to borrow, regardless of the use to which the borrowed funds are put, at administered low interest rates are appropriate. Second, viewing

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8 Acharya is intrigued by the fact that GDP grew at 6% to 7% per year in the nineties despite large fiscal deficits. There is nothing surprising or intriguing about this. Clearly to the extent that there is unutilized capacity, fiscal expansion can generate growth as it did in the 1980s without a step-up in investment and without major reforms. Equally, efficiency gains from reforms could also generate growth without a substantial increase in the investment rate, as I believe was the case in the 1990s. But in both instances, the spurt in growth is most unlikely to be sustainable--sooner or later the excess capacity would disappear, further costless efficiency gains would be exhausted, and investment rates would have to be increased for sustaining growth. Then fiscal deficits would begin to bind as they will crowd out investment.

9 Kletzer suggests that financial repression is in part a consequence of the Indian government’s reliance on a closed domestic capital market for financing public expenditures. He notes that the large spread between lending and
domestic demand as a constraint on capacity utilization reflects a closed economy mindset of the past. Thirdly, there are options, other than supporting fiscal expansion, for the use of stocks of food grains (e.g. exporting them) and of foreign exchange reserves (e.g. reducing the stock of external debt). Without examining what the appropriate level of food or foreign exchange stocks would be to reduce volatility in food prices and contain any sudden outflow of short-term capital, the assertion that such stocks could have been used to support fiscal expansion has no analytical basis.

The most critical issue facing the governments at all levels is the unsustainability of the fiscal situation. In what follows, I will explore some of its contributory causes and possible approaches to restoring sustainability. These include state finances (Section 2), tax and expenditure reform (Section 3), reduction of subsidies (Section 4) and disinvestment (Section 5). Section 6 concludes.

1. State Finances

The fiscal deficit of states fell from 3.2% of GDP in 1990-91 just before reforms to a low of 2.3% of GDP in 1993-94 and has since risen to over 4.3% of GDP in 1998-99 (World Bank 2000, Table 3.5 and Annex Table 3.1, Business India, April 3-16, 2000). The revised estimates for 1999-2000 show a deficit of 4.8% of GDP (Reserve Bank of India, 2000, Part Four). There is little doubt that the fiscal deficits of several states have become unsustainable. The average fiscal deficit during 1991-97 as a percent of state domestic product (SDP) among 14 major states varied from 2.5% in the high-income state of Maharashtra to 5.9% in the poor state of Orissa. Correspondingly, average outstanding debt varied from 13.4% of SDP in Maharashtra to 41.2% in Orissa. In fact, in all the four low income states of Bihar, Orissa, Rajasthan and Uttar Pradesh (U.P.) average fiscal deficit and outstanding debt during 1991-97 exceeded 4.1% and 29.2% of GDP respectively. The emerging fiscal crisis in the states has

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caught media attention—the magazine India Today in its February 14, 2000 issue headlined the crisis on its cover page with these ominous words: “States Going Broke: Bankruptcy Stalking States, Threatening a Collapse of Public Services.”

Although sensationalism is to be expected from the news media, the seriousness of the situation has even dawned on policy makers, leading to eleven states signing in 1999-2000 Memoranda of Understanding (MOUs) with the central government promising fiscal reforms in return for bail-outs from the centre in the form of ways and means advances from tax transfers and grants due to them. These are the domestic counterparts of loans from multilateral agencies conditioned on structural reforms, i.e. policy based lending. Although one year is too short a time to evaluate the MOUs, the experience is not very encouraging–transfer payments had to be withheld for non-compliance on occasion and part of the advances had to be converted into three-year loans. The states have been allowed to increase their market borrowing as well. It is unlikely that there will be any further advances under the MOU process in 2000-01.

The current precarious fiscal situation of states is the result of increasing implicit and explicit subsidies on goods and services supplied by the government (electricity, irrigation water, transport, education, health) with virtually no attempt to raise revenues to finance them. States also competed with each other in offering tax and other fiscally costly incentives in an attempt to attract investment. Overstaffing of administration and public enterprises was the norm in all states. Reserve Bank of India (2000, Part Seven) rightly emphasizes that State public enterprises, like the State Electricity Boards and State Road Transport Corporations, have been reporting losses and have been absorbing scarce funds through budgetary support..[and thus contributed to] the growth in the implicit or contingent liabilities [of State Governments].11 Salary increases awarded to staff of all state and state supported institutions, following similar awards by the central government to its employees, have increased the already high share of employee compensation in state revenues. For example, in the high-income state of Maharashtra wage bill accounted for over 70% of tax revenue (India Today, February 14, 2000). Business

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11 Acharya is right in emphasizing the seriousness of the situation. He points out that politicians believe that the role of the state is to provide jobs, and not services. As a consequence, the state governments spend on little else other than wages and salaries and, as such, the already inadequate provision of public goods and services such as education, health and roads is further eroded. What is more, the labour market is severely distorted by non-market determined high wages in the public sector. Such high wages make growth less employment intensive than it would have been otherwise.
India (April 3-16) reports that in states, such as UP, salaries make up almost 89 percent of the total non-plan expenditure. In Madhya Pradesh, nearly 75 percent of the increase hike in non-plan current expenditures between 1999 and 2000 is meant for dearness allowances of the state bureaucracy. Debt service is another major expenditure-interest payments alone, at 2% of GDP, amounted to 35% of states’ own tax revenue and 15% of states’ revenue receipts from all sources.

The constitution has assigned exclusive responsibility to the states for most matters concerned with the life and welfare of the population including public health, infrastructure, agriculture, and land and water management. Yet with a large part of the states’ fiscal resources increasingly being spent on non-developmental activities, expenditure (revenue and capital) on developmental activities has remained static with significant year-to-year fluctuations. What is worse, developmental capital expenditure has been declining and there is no evidence of any improvement in the efficiency of capital use, which, had it occurred, could have offset at least in part any decline in investment. One cannot underestimate the deleterious consequences of the parlous state of the fiscal health of states both for poverty alleviation and for reaping the benefits of economic reforms already instituted, let alone implementing further reforms.

The constitution empowers states to tax land, agricultural income and sales, and imposes excise taxes on alcohol while the centre is empowered to collect taxes on personal and corporation income, wealth and foreign trade, as well as excise taxes. It also requires the centre to share the revenue from certain taxes in proportions recommended by the Finance Commission, which the President is constitutionally required to appoint every five years. In addition to the transfers recommended by the Finance Commission, the Planning Commission, a non-statutory body established by a resolution of Parliament, makes transfers for financing approved outlays of the states on their annual development plans. Although some legal scholars have questioned the constitutionality of transfers made by the Planning Commission, I am not aware of any Supreme Court decision on the issue. The sum of the states’ share in central taxes and grants from the centre have accounted for around 40% of the total revenue receipts of the

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12 There are several excellent studies on state finances and fiscal federalism of the Indian Constitution (see in particular Rao and Singh (1999a, b, c, d), Bajpai and Sachs (1999)). The report of the World Bank (2000) also discusses the issues in some detail.
states during 1990-91 to 1997-98 (World Bank 2000, Annex Table 8.8).

The centre has the responsibility to provide crucial public goods such as defense and a common currency. Also given the diversity in per capita incomes and other indicators of development of the states, the centre has a redistributive role in making transfers to the poorer states. The states have been assigned large responsibilities in crucial sectors such as education, health, irrigation and other investment in agricultural development. Naturally, they cannot discharge these responsibilities adequately if they cannot generate the required resources. The transfers from the centre to states are meant in part to bridge the gap between resources required for by states for meeting their assigned responsibilities and the resources they can raise themselves.

In practice the tax-transfer system has had some disincentive and efficiency reducing effects. The centre's efforts in collecting taxes, such as the income tax, the revenues from which have to be shared with the states, are likely to have been less vigorous as compared to taxes such as customs, which accrue entirely to the centre. However, the recently enacted amendment to the Constitution requires that 29% of the net proceeds of ALL taxes be transferred to the states. This removes the incentive for the centre to raise and vigorously collect those taxes all the proceeds of which accrue to the centre. By the same token, if the transfers received from the centre form a large part of its expenditure, and these transfers have no relationship to its own efforts to raise resources, clearly a state is unlikely to be diligent in raising resources.

The approach of the first (1951-56) to eighth (1985-90) Finance Commissions was to fill the gap between the states' revenues and expenditures and completely ignored this incentive effect. The eleventh Finance Commission for 2000-2005, appointed in July 1998, has been given broad terms of reference to review the state of finances of the union and the states and to suggest ways and means to restore budgetary balance and macroeconomic stability. These terms were augmented in April 2000 asking the commission to draw a monitorable fiscal reforms programme and recommend ways to link grants to states to their progress in implementing the programme. Several states have apparently objected to this linkage, with one state chief minister comparing any link between devolution and fiscal performance with IMF conditionalities! The commission submitted its report in June 2000 on its initial term of reference and a report on its augmented terms of reference is expected at the end of August 2000. The report of June 2000
goes part of the way in adopting a normative approach, but until its final report is received, it is hard to judge how firm and enforceable its recommendations for linking performance on implementing fiscal reform with transfers would be.

The states have the right to impose sales taxes, a right that extends to sales to buyers in other states. Obviously an interstate sales tax is a tax on the exports of one state to another. Such taxes prevent India from being a common market and consumers from reaping the static and dynamic efficiency gains of a large market. Unless a state has a national monopoly over a commodity that is competitively produced within its border, a case that is extremely unlikely to arise, it hurts itself by taxing its exports to other states. Even when a state has monopoly power, its exercise will be at the expense of consumers in other states, restricting commerce and inviting retaliation by other states. In the end consumers in all states are likely to lose. Fortunately the states have come to a unanimous decision to impose a uniform sales tax throughout the country from January 1, 2000. This is a step in the right direction.

Recent reforms induced states to compete with each other to attract private investment by offering tax concessions. Such competition might end up transferring resources from taxpayers to investors without affecting their location decision. Fortunately the states have decided not to compete with tax concessions.

The states are constitutionally barred from borrowing in international financial markets and need the centre’s consent for any borrowing in the domestic market if they are indebted to the centre. Since all states are indebted to the centre, this constraint is binding on all of them. The states share in the central government’s borrowing from captive sources of finance such as banks, insurance companies and non-government pension and provident funds, which are required to be invested in designated government securities. Of course the states cannot directly monetize any part of their deficits. It would seem that these restrictions impose a hard budget constraint on states. And if, as is often argued, “hard” budget constraints on individual states in

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13 Kletzer argues that linking policy reforms of states and central transfers to them runs the risk of time inconsistency. Since the transfers in large part finance mandated social expenditures by states, the Center’s commitment to withhold transfers in case a state fails to institute policy changes in return for transfers may not be credible. Moreover, the lack of credibility of the threat not to bail out states, if they run excessive deficits, will lead the states to run more and more deficits which become contingent liabilities of the central government in a time-consistent equilibrium. However, it is possible, if the Centre’s commitment is the result of an agreement between all the states and the Centre, the credibility problem could be mitigated since other states will have an incentive to side with the Centre if any individual state deviates.
the U.S. are the reason why government expenditure is restrained there, and if looser budget constraints on Canadian provinces explain poorer fiscal discipline in Canada, then in India one should see greater fiscal discipline in the states. But this is obviously not the case.

In fact, the states have succeeded in getting around ostensibly hard budget constraints by diverting resources meant for investments to current expenditure, and through indirect borrowing by running up arrears with central public sector enterprise (PSEs). For example, state-owned electricity boards (SEBs) have been tardy in paying their dues to Coal India and National Thermal Power Corporation (NTP) owned by the Centre. This in turn has led the centre and central PSE's to impose restrictions--Coal India has instituted a cash and carry policy and central government has chosen to retain up to 15% of the transfers due to the states to clear the SEB's arrears with NTP. Prior to 1994-95, each state PSE was set separate borrowing limits for each year. With the removal of these limits, state guarantees given to borrowing by state PSEs have become an easy way for states to circumvent the ceiling on borrowing imposed by the central government. The volume of state guaranteed loans to state PSEs have been increasing at 12% a year recently (World Bank 2000, Box 3.1, and p. 33).

The perverse incentives created by the Planning Commission in financing the capital and operating costs of new (centrally sponsored) state projects in each five year plan for the duration of that plan should be noted. States are thus encouraged to attract such projects, but once the centre ceases to pay for the operating costs, their incentives to run the projects wane. Also, since all states pay the same rate of interest on loans from the central government, they feel no market pressure to maintain credit worthiness.

Under the present system, the states have established a large infrastructure and spent on social services including many populist programmes without adequate financing through taxes or recovery of costs from users of state provided goods and services. In the context of electoral politics as practiced in India populism is attractive to politicians of all shades.

Supply of electricity free of charge or at a heavily subsidized price to farmers is one among many populist policies. The gross subsidy on account of sale of electricity in 1999-2000 was estimated at Rs. 338 billion of which three fourths was from sales to the agricultural sector. The rate of return on invested capital in state electricity enterprises was -31%! If the state electricity boards were to increase prices just enough to raise revenues to the equivalent of a 3%
rate of return on capital that Section 59 of the Electricity Supply Act of 1949 enjoined them to do, 70% of the gross subsidy would not be needed. If they were to increase just Rs. 0.50 per kilowatt hour to agricultural users, as the chief ministers of states had once agreed to do, gross subsidy will go down by 10% (Government of India, 2000, Table 9.4).

Other state pricing policies are also damaging. Charging reasonable tuition fees at state-supported institutions of higher learning would also help. Many states have not revised water rates for irrigation in over three decades. The current charges do not even cover the costs of operation and maintenance. These problems of inadequate cost recovery are massive by any reckoning. As noted earlier, state payrolls have expanded to the point that a substantial part of their revenues are spent on wages and salaries alone. The states had little choice but to follow the centre’s implementation of the recommendations of the Fifth Pay Commission. This has accentuated their already high wage and salary expenditures.

The economic reforms of 1991 have radically altered the options open to states--they can now compete for private investment in infrastructure sectors that were earlier financed entirely by the government. But states will be unable to attract private capital without good quality infrastructure, particularly power and roads, an educated labour force and efficient, business-friendly bureaucracy. Improvement in the quality and an increase in the quantity of infrastructures services depend on reforms of the operation, pricing and regulation of the PSEs as well as on additional investment that would require substantial resources. Both for sending the appropriate signals to users and for raising resources for investment, states will have to address pricing issues with respect to electricity, irrigation, water, education and other goods and services provided by the government.

There is a lot to be said for the view that the centre's roles should be confined to national defense, external relations, the maintenance of national networks of communications and transport and a common currency and ensuring that there is a single, i.e. national common market. To these I would also add a relatively circumscribed role of redistribution across states. All other activities could be left to the states. Such a set-up would approximate the market preserving federalism (mpf) of Weingast (1995). Under mpf, the central government would ensure that goods and factors are mobile across states, there is limited revenue sharing among levels of government, and access to capital markets is limited for all levels of government.
Under these assumptions, the ability of any level of government to tax and spend unwisely would be severely limited since factors will flee that state, were any state to do so. However, adhering to other requirements of mpf in the absence of mobility of factors across states might either accentuate the existing inter-state disparities in income and poverty as well as lower public expenditures on rural development and poverty alleviation. Alternatively, it might encourage states to compete for providing an environment that is most conducive to economic and social development. I am optimistic that it would be the latter, and as such, interstate competition in tax rates and provision and pricing of infrastructures services will in fact be a race-to-the top rather than a race-to-the-bottom.

My optimism is based on the following, admittedly scanty evidence. First, there is now much greater mobility of factors, even of labour, and it is increasing. Second, thanks to the spread of communications, awareness among the general public of the failure of some states and success of other states in the performance of their social sectors is also increasing. As such, politicians in failing states would have much explaining to do. In any case, any move in this direction would require a major overhaul of the constitution. The recently appointed Constitutional Review Committee should look carefully into whether the provisions adopted five decades ago relating to the roles, powers and resources assigned to the centre and states need revision in the contemporary context. The committee ought to consider whether the Planning Commission should be abolished and replaced by two institutions analogous to International Bank For Reconstruction and Development (World Bank) and International Development Association (IDA). The former will provide “hard” loans to relatively richer states after a thorough appraisal of the projects to be financed by loans, and the latter “soft” loans to relatively poorer, based on criteria similar to those used by the two Washington institutions. Let me hasten to add that such a change, while it would help in improving the efficiency in the use of scarce resources at the disposal of governments at all levels, is not necessarily the most efficient. After all, it shares the fundamental fault of IDA, viz., it would alleviate the resource scarcity of poorer states through the provision of subsidized loans. As is well known, resource transfers that are “tied”, in this case, to investing in projects financed by

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14 Kletzer who expresses some skepticism about my optimism, may not find these arguments persuasive. He might point to the reported statement of the inimitable Laloo Prasad Yadav, the former Chief Minister of the abysmally poor and poorly governed state of Bihar: "Development does not buy votes: empowerment does!"
subsidized loans, are less efficient than untied transfers.

3. **Tax and Expenditure Reform**

In the decade of the 1990's gross (i.e. gross of states' share) tax revenues of the central government have declined from about 10.1% of GDP in 1991-92 to 8.7% in the budget estimates of 1999-00 (World Bank, 2000, Annex Table 8.5). However, the ratio of direct taxes to GDP has increased. As noted earlier, the situation of the states is not much better–revenues from their own taxes have stagnated at about 7.8% of GDP (ibid. Annex Table 8.8). Substantial reductions in tariff rates and some reduction and rationalization of excise rates explain much of the reduction in the sum of revenues from customs duties and excise taxes from 7.5% of GDP in 1991-92 to 5.7% of GDP in 1999-00. It is also the case that there were reductions in personal income tax rates. However, there is some evidence that buoyancy of gross tax revenue has gone down since the mid nineties (World Bank 2000, Annex Table 4.12). The revenue losses from tax concessions and exemptions are also significant (World Bank 2000, Annex Table 4.11). With fiscal deficits continuing to be large, the need for raising tax revenue as a proportion of GDP is evident.

The task of reforming the complex set of taxes, direct and indirect, at the centre and states is a challenging and daunting task. The contours of needed reforms are well known and have been discussed in the several studies, in particular by the Chelliah Committee (Ministry of Finance 1992). Some measures were announced in the central budget for 1998-99 to expand the tax base by identifying potential taxpayers through several presumptive criteria. At the same time, the budget raised income tax exemption limits that are already high relative to per capita income. While there may be good administrative reasons for this step, nonetheless it has the undesirable consequence of reducing the tax base. The 1999-2000 budget reduced the multiplicity of tax rates, particularly tariffs, rationalized the rate structure, and reduced the number of excise duty rates from 11 to 3 so that the system is much closer to that of value added Tax (VAT) at a single rate. 15 That budget also phased out the tax exemption of export income. The policy statement of March 2000 on exports and imports replaced half of India’s remaining

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15 Acharya comments that although in his two budget Finance Minister Yashwant Sinha has moved the excise tax structure closer to a single-rate central value added tax (CENVAT) problems remain because of continued
quantitative restrictions (QRs) on imports by tariffs with the remaining QRs to be eliminated by April 2001. The budget for 2000-01 cut subsidies on food and fertilizers. However the increased revenues from changes in taxes and subsidies are offset by a significant increase in defense expenditure. Besides the implementation of the recommendation of Eleventh Finance Commission will involve increases in States’ share of central tax collections and central grants to States.

The three important sectors that are yet to be fully integrated into the tax base are: agriculture, small-scale industry and services. Land tax as a source of revenue has virtually disappeared and agricultural incomes remain largely outside the tax net. Also replacing the existing set of indirect taxes through a system of value added taxes (VATs) have not made rapid progress. Issues such as whether, by amending the constitution if necessary, the centre should levy the VAT and share the revenues with the states, or whether the VAT should be completely in state hands with each state choosing its own rates, coverage and exemptions, are yet to be discussed extensively, let alone resolved. However the states have agreed to implement a VAT from April 1, 2001 with the central government pledging to compensate states for any revenue losses during initial years of implementation.

Almost half of the central government’s expenditures are accounted for by interest payments on public debt, defense outlays and transfers to state governments. A significant part of the fiscal correction in the early nineties was through reductions in development spending, particularly capital spending, which could jeopardize growth. Unfortunately the government chose not to accept the Fifth Pay Commission’s recommendation to reduce government employment by 30% over 10 years, while being even more generous than the Commission’s recommendations in increasing wages and salaries of its employees. Since what the central government pays its employees inevitably extends to institutions financed by the central government, central public sector enterprises, as well as to corresponding categories in the states, the central government’s decisions on the Pay Commission recommendations have been costly. Tax expenditures (i.e. tax exemptions and concessions) are ubiquitous at the central and state levels. The revenue loss from these exemptions and concessions is not negligible. Yet to the best of my knowledge there has been no serious analysis of the social rationale for such tax exemptions for small-scale industry and many products. Besides, CENVAT is confined to the manufacturing end
expenditures. The cost of explicit and implicit subsidies is taken up in the next section.

The decision to establish an Expenditure Reforms Commission, the introduction of zero-based budgeting, and the possibility that a Fiscal Responsibility Act will be passed by Parliament are hopeful signs. It is clear that greater and faster progress towards needed fiscal correction can be made if possibilities on both revenue and expenditure sides of the budget are explored. These naturally include, besides raising the tax/GDP ratio, a substantial reduction in implicit and explicit subsidies as well as more aggressive privatization.

4. Reduction of Subsidies

Explicit subsidies of the central government accounted for around 1.1% to 2.1% of GDP during the nineties (World Bank 2000, Annex Table 8.5). Major subsidies of the central government are budgeted to absorb 22% of non-interest-non-plan revenue expenditure and 12% of net revenue receipts of the central government (Government of India 2000, paragraph 2.17). State governments also subsidize and both levels of government offer implicit subsidies (e.g. tax concessions, pricing of public enterprise output such as electricity, irrigation water at below cost, concessions on interest rates). It is not easy to define precisely whether or not some good or service is being subsidized, measure accurately the extent of such a subsidy once defined and analyze its ultimate incidence. The National Institute of Public Finance and Policy (NIPFP) estimated (Government of India 1999) that the explicit and implicit subsidies were as high as 14.4 percent of GDP in 1994-95 of which three-fourths were on non-merit goods (defined as goods that neither generate significant positive externalities nor were of importance of poverty alleviation) \(^{16}\). The extent of subsidies in 1994-95 was indeed staggering and further, there is no reason to believe that the situation has changed much since.

The two politically sensitive subsidies relate to food and fertilisers. Until recently, when a distinction was made between those below the poverty line who were to pay only 50% of the cost to the government of food supplied through the public distribution system (PDS), food subsidies were not targeted at the poor. In his budget for 2000-01 the Finance Minister has

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\(^{16}\) Gian Shaota (2000), in an as yet unpublished paper, has strongly criticised the methodology of the NIFP study for its conceptual weakness, its omission of tax expenditures, implicit interest subsidies on concessional loans, subsidy in the development plan outlays and extra budget subsidies, and finally, its underestimation of cost recoveries in publicly provided services.
withdrawn subsidized sugar allocation for those above the poverty line and raised the sale price of rice and wheat supplied through the PDS and linked it to their open market price. The opposition parties on the ground have condemned these proposals and the one to raise subsidized fertilizer prices that they adversely affect the poor.

However the available evidence does not support the belief that the poor are benefiting from the PDS. The study of Radhakrishna and Subbarao (1997) is very revealing. They find that in 1986-87, the PDS and other consumer subsidy programmes accounted for less than 2.7% of the per capita expenditure of the poor in rural areas and 3.2% in the urban areas. The impact on poverty and nutritional status of the population was minimal. The PDS had at most brought down the poverty ratio to 38% from 40% that year, a small reduction indeed. What is even more disturbing, the PDS had a negligible impact in the rural areas where more than three-fourths of the poor live. The cost of the transfer through PDS and other subsidies was very high. The World Bank (1998, Table 4.2, p. 39) reports that the participation of the poorest quintile in the population in PDS as compared to the average is lower at 92% and the next two quintiles participate at a slightly higher rate than the average. Even the marginal odds of participation, that is the gain for each quintile following a rupee increase in aggregate spending on PDS, is only 1.06 for the poorest quintile as compared to the richest quintile's 0.81 (ibid. Table 4.3, p. 41). Thus PDS subsidies are not particularly pro-poor in their incidence. The central government alone spent more than 4.25 rupees to transfer one rupee to the poor. Combining central and state government expenditures, in Andhra Pradesh it took 6.35 rupees to transfer one rupee to the poor.

It is generally recognized that a significant part of what is included under the heading “food subsidies” in the budget reflects the inefficiency of the public sector enterprise, Food Corporation of India (FCI). In other words, the cost of procuring, transporting, storing and delivering the amounts supplied by the PDS of various commodities is believed to be much higher than what an efficient enterprise would have incurred. Balakrishnan and Ramaswami (2000) state that the definition of subsidy in government accounting implies that the higher the stocks held by the PDS, the higher is the recorded subsidy due to carrying costs. Clearly, if

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17 In an attempt to reduce the mounting stocks, the government recently announced a reduction in the price of wheat issued to distribution outlets. Such a reduction, if it increases the amount of wheat distributed, would also increase the distribution subsidies, while having only a limited effect on reducing the costs of carrying stocks.
the FCI is inefficient as it is believed to be, “using the ‘economic cost’ of FCI as the benchmark in fixing the PDS [issue] price would be to institutionalize the poor quality of the system as a whole” (ibid. p. 1138, Gulati (2000), p. 1145). These authors and others have proposed replacing the existing PDS with a system of food stamps.

Fertiliser subsidies also reflect in part the relatively high cost of domestic fertiliser production, which in turn is a legacy of the autarkic industrial policy of the pre-reform era. Indeed, the relatively high cost of domestic production arises from the fact that the industry consists of plants of various vintages, less than efficient sizes, and different technologies using a plethora of feedstocks. Some plants are owned by the government and others by cooperatives and the private sector. The Fertiliser Pricing Committee (Department of Fertilisers 1998) has pointed out that the retention pricing scheme (RPS), which in effect is based on ensuring that even the most costly plant breaks even, is a sure prescription for inefficiency and recommended a flat rate subsidy. A respected elder statesman and former Finance and Food and Agriculture Minister, C. Subramaniam (The Hindu, March 1, 2000), has recently argued that inefficiency is being subsidized. The current Finance Minister himself drew attention to this in his budget speech to the parliament on February 29, 2000. Gulati (2000) points out that part of the high cost of domestic fertiliser production is due to the higher cost of feedstock, such as natural gas in India, compared to the price of gas in West Asia. He goes on:

“And on top of that there are certain plants, some of them new ones, which have taken full advantage of the RPS and gold-plated themselves, while some others have understated their capacity. All this is pretty well known in fertiliser industry circles. The problem with this RPS is that it encourages gold plating and does not provide extra incentive to those plants that are on the lower part of the cost curve (economically more efficient) to expand. There is always a tendency to put up another new plant rather than expand the more efficient ones. Lately this has been realised and some expansions have taken place. The industry has to face this reality of open imports very soon. Earlier they prepare themselves, the better it is for them.” (Pp. 1145-1146)

Although India as a large importer would face a rising supply price of imports, Gulati is surely right in suggesting that:
“Thus, it is better to dismantle RPS, align domestic price of urea with long-term import parity price to ensure healthy growth of domestic industry. This would be a better system than the existing one, and it can cut down the fertiliser subsidy by a much greater amount than has been achieved by the finance minister in this budget.” (p. 1146)

The issue of explicit and implicit subsidies is not simply one of raising or lowering this price or that price at the margin, but a much deeper one of domestic political economy. Whatever be the true ultimate incidence of any of the subsidies and the factors that brought them about, vested interests have formed in ensuring that they are not touched. The pressure on the Finance Minister both from some of the constituents of his own coalition, the National Democratic Alliance, and from the opposition to roll back the modest reductions in subsidies he has proposed in the budget for 2000-01, has been unrelenting. The leader of the opposition, Mrs. Sonia Gandhi, has led a “protest march” of members of parliament from her party to the Prime Minister’s house (The Hindu, May 17, 2000). Fortunately, there is some faint hope that wiser counsels may prevail. Dr. Manmohan Singh, the architect of reforms, and a senior leader of Mrs. Gandhi’s party, has himself argued for the abolition of at least “non-merit” subsidies. Although a spokesman of his party took pains to say, not very convincingly, that Singh’s views do not contradict the party president’s, he did not enthusiastically endorse them either. However, the Prime Minister has embraced Dr. Singh’s views and suggested that they could become the basis of a consensus (The Hindu, May 18, 2000).  

5. Disinvestment

From the fiscal perspective, disinvestment, i.e. the sale to private investors of the government’s equity in public sector enterprises (PSE), is relevant for at least two reasons. First, with disinvestment, only a part of the surpluses and deficits of PSEs will enter the overall deficit of the non-financial public sector. Second, the proceeds from the sale of government equity could be used to reduce the fiscal deficit. Of course, there is the indirect effect on government revenues of the improvement, if any, in the efficiency of resource allocation in the

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18 As this paper was being presented on May 31, 2000, the Minister of Telecommunications announced that all employees of the Department of Telecommunications (DOT) would be provided free telephone connections. There was absolutely no rationale for this other than a desire to pander to employees who were threatening to go on strike.
economy and more rapid growth that might be brought about by the shift of ownership to private hands. Until now, the government has chosen to retain more than 50% of the equity in most PSEs put up for disinvestment. Such disinvestment, as contrasted with outright sale of a PSE through full privatization, does not transfer of control and operation of the PSE to private hands, and no significant efficiency gain or more rapid growth could be expected from disinvestment. The government’s recent commitment to reduce its equity in non-strategic PSEs to 26% or less and in public sector banks to 33%, is a step in the right direction. Also, the statement of the then Minister for Information and Broadcasting, that “in the last four months we have changed the emphasis from the selective sale of minority shares of successful PSEs to the strategic sale of a significant holding to a strategic partner” (India Today, May 15, 2000, p. 4) is also encouraging. I will not touch on the broader issues of disinvestment and privatization, such as modalities of sale of equity, the need for ensuring that a PSE, once privatized, will face adequate competition and for setting up an appropriate regulatory framework in sectors where only a few enterprises can be expected to operate. I will focus only on the fiscal impact of disinvestment.

A Disinvestment Commission was set up in 1996 to advise the government on the extent, mode or timing of disinvestment. At the beginning of 1998, the commission was divested of its powers to monitor and supervise the disinvestment process. The term of the commission expired in 1999 and was not renewed. Instead a new Department for Disinvestment has been created. During its existence, the commission issued 11 reports containing recommendations on 58 of the 64 PSEs referred to it. The recommendations in only 13 cases were or are being implemented. The “Disinvestment Fund”, set up in 1996 on the advice of the commission to use the sale of proceeds for restructuring PSEs and to finance voluntary retirements of excess staff is not yet operational.

Proceeds of disinvestment, after reaching a peak of Rs. 50.18 billion in 1994-95, fell to a paltry Rs. 3.62 billion in 1995-96. It recovered subsequently to Rs. 4.55 billion in 1996-97, and Rs. 9.0 billion in 1997-98. In 1998-99 it reached another peak of Rs. 53.71 billion as against a target of Rs. 50 billion. However, this peak is somewhat illusory: the purchases by some PSEs of the equity divested in other PSEs, rather than sale of equity to private investors, was largely against corporatization of service providing units of DOT. It is a pity that the Prime Minister and the government
responsible for it. The budgeted figure for 1999-2000 was Rs. 100 billion (World Bank 2000, Annex 8.3); but only Rs. 26 billion is expected to be realized (Budget Speech of the Finance Minister, para 62). A target of Rs. 100 billion is again set for 2000-01.

It is often suggested that since the sale of public equity in a PSE is in fact a sale of government’s assets, the proceeds from such a sale should be used to reduce the government’s liabilities by the same amount through reduction of public debt. As such, it is further argued, such proceeds should not be used to reduce current fiscal deficits. This argument may have some merit as a way of putting pressure on the government to undertake the politically more difficult tasks of raising revenues or cutting expenditures in order to reduce the fiscal deficit. But logically, if the government efficiently uses its resources, it should not make any difference whether a rupee of proceeds is used to reduce the stock of debt or the deficit since in either case the relevant cost is the same, viz. the marginal cost of new debt issue.

Moving from sale of equity to the surpluses and deficits of PSEs, according to the Economic Survey (Government of India 2000, Table 7.8), the ratio of pre-tax profit to capital employed of central public sector undertakings rose from an average of 3.5% during 1990-93 to 8.0% during 1995-98. This aggregate profitability measure is misleading since the enterprises whose profits are aggregated included state oil and petroleum monopolies. Besides, at least for those enterprises that are competing with private enterprises, their post-tax return has to be compared with similar returns for their private counterparts. Be that as it may, if we measure PSE performance by the deficit in their plan expenditure (mainly on investment) relative to their net internal resources, the deficit of central government PSEs (CPSE) as a ratio of GDP has halved from 3.0% in 1990-91 to a budget estimate of 1.5% in 1999-2000 (World Bank 2000, Table 8.6). The factors contributing to the decline are the fall in PSE investment from 4.8% of GDP in 1990-91 to 3.4% in 1999-2000 and the growing importance of petroleum and telecom enterprises which now account for nearly half the investment and generate more than two-thirds of the net internal resources of CPS’s. Put another way, government support (through loans and financing of losses) to CPSE has declined sharply as a proportion of GDP. This is welcome.

The government’s economic survey for 1999-2000 does not provide any information on the so-called “sick enterprises” (public and private). The economic survey of 1998-1999 chose to approve this bonanza.
reported that between its inception in May 1987 and the end of November 1998, India’s Bureau for Industrial and Financial Restructuring (BIFR) received 3441 references of which 2404 were registered and 452 were dismissed as non-maintainable under the Sick Industries Company Act of 1985. It recommended winding up 606 and rehabilitating another 637 and declared 214 as no longer sick. Out of the 225 PSEs that were referred, it registered 157, recommended winding up 29 and rehabilitating 50, and declared 6 to be no longer sick (Government of India, 1999, p. 111).

Unfortunately most of the recommendations are yet to be implemented. With failing enterprises having to obtain rarely granted government permission to close down, and in the absence of well crafted bankruptcy legislation and reform of labour laws that would make it easier to reduce employment, restructuring the viable and closing the non-viable among failing enterprises, is difficult to bring about. As sick PSEs continue to operate they are a fiscal drain. The Industrial Relations Bill that would have amended India’s restrictive labour laws is yet to be approved by Parliament. The politicians and the judiciary do not seem to appreciate that laws protect only the labour aristocracy employed in the organized manufacturing and the public sector at the expense of the vast majority of workers in other sectors. Recently two Supreme Court judges even castigated Steel Authority of India, a PSE for not giving employment to the family members of employees who died while in service on compassionate grounds, even after the families had received gratuity and pension benefits!

6. Conclusions

The clearest statement on the seriousness of the fiscal situation and the need for fiscal correction can be found in the *Economic Survey, 1999-2000* (Government of India, 2000, p. 1.85):

“More effective management of public finances continues to be the central challenge facing all levels of government in India. In some ways the challenge has become more daunting in recent years pursuant to the sharp increase in government wage bills resulting from the Fifth Pay Commission...The adverse effects of large fiscal and revenue deficits on virtually every important dimension of macro-economic performance are well known. They range from low savings and investment, high real interest rates and reduced growth, to adverse pressure on inflation, financial markets and the external sector. Furthermore, the continuous series of large deficits lead to inexorably mounting interest payments, leaving a declining share of government
expenditure available for essential functions such as defence, law and order, social services and public investment in infrastructure. The recently published estimate of a significant decline in domestic savings and investment in 1998-99 is primarily traceable to burgeoning revenue deficits of Central and State Governments. Similarly, the high level of real interest rates prevailing in recent times is largely due to high fiscal deficits...Quite clearly, the prospects for accelerating economic growth depend crucially on the success in managing the fiscal challenge confronting the economy.”

The same document is explicit on the need for

“hard decisions and many fronts…They include: a redefinition and narrowing of government responsibilities to those functions that only government can discharge effectively, with a view to downsizing government; systematic efforts to reduce subsidies by targeting them to the poorest segments of society; a vigorous drive to divest commercial undertakings such as power utilities and transport undertakings; a concerted programme to deploy user charges for economic services rendered by government; systematic induction of information technology tools and modern management practices to enhance efficiency of government; resource generation through transparent sale of under-utilised public properties such as land; and, above all, a determined political commitment to truly effective expenditure management.” (p. 1.86)

Although there are some who deny that fiscal deficits are serious enough to matter, fortunately they are a minority and, in any case, I have argued that they have not made a plausible, let alone convincing, case. The majority view, which I share, is eloquently expressed by the Economic Survey. Indeed, it is not an exaggeration to call the situation as a crisis that needs to be attended to immediately. Otherwise, the overarching objective of Indian development that was articulated before independence, viz. the eradication of mass poverty through rapid and well distributed growth, is unlikely to be realized in the foreseeable future. When the economy seems to be at last on the verge of achieving sustained and rapid growth, jeopardizing it is unconscionable.

The catalogue of “hard decisions” (Economic Survey, 1999-2000, p186) required is unexceptionable. Whether some or all of these decisions will be taken depends on “determined political commitment,” not only for an “effective expenditure management”, but also for radically reshaping the economic, political and social institutions. Such reshaping is essential if
the Indian economy is to be well integrated, as it must, with the global economy that has changed and is changing rapidly. Unfortunately there are not many visible signs that the required political consensus and commitment are emerging. On the contrary, there are several discouraging signs as against few encouraging ones.

   Let me start with the most encouraging sign. 19 In a forthright speech to the Inter-State Council on 20 May 2000, the Prime Minister pointed out that an unsustainable fiscal deficit has serious negative effects on the economy. It pre-empts resources which would otherwise be available for investment by the non-government sector. This is reflected in the high cost and limited availability of credit; high fiscal deficit also leads to rising debt burdens and a continuous growth in interest payments. This, in turn, squeezes outlays for essential social and economic infrastructure. What is of even greater concern is that these high deficits are not being used to finance investment. They are being increasingly used to finance rising levels of non-Plan expenditure. He continued that “if we do not reverse the trend, we will not be able to achieve the desired GDP growth. We will neither generate employment opportunities nor achieve a reduction in poverty,” and listed several critical tasks: the reform of the power sector has become critical; user charges on utilities and services have to be rationalised; a more rational policy needs to be evolved in respect of State PSEs; State Governments have seen a much faster growth in Government employment than the Centre, although this policy is unsustainable. The Prime Minister rightly emphasized that the Inter-State Council, in which the Chief Minister of all the states are members, is an inter-governmental forum that could be used for evaluating policy, ensure its implementation and more generally for strengthening India’s plural democracy, polity and society. Although he did not say so himself, the Council could be used to evolve a consensus on right sizing of Government.

   Turning to the many discouraging signs, some private sector entrepreneurs seem to be nostalgic for the good old days when they did not face serious external competition: the Prime Minister’s Advisory Committees on Industry and Trade, headed by leaders of the private sector industry, have apparently recommended further restrictions on foreign investment and the re-imposition of quantitative restrictions and tariffs on textile imports. To be fair, other

   19 Acharya adds a few others: the shocks to expenditures from the implementation of the Fifth Pay Commission’s recommendations and increase in defence needs following Pakistani incursion in Kargil are already mostly
entrepreneurs have been forward-looking and are putting pressures on the government to accelerate reforms. However, the preference for insulating the Indian economy from external competition is not confined to a few entrepreneurs. It appears to be shared by supporters of the dominant Bharatiya Janata Party (BJP) in the ruling coalition at the centre, such as the Swadeshi Jagaran Manch and the supreme leader of the Rashtriya Swayam Sevak Sangh. A member of the coalition, the Telugu Desam Party has cautioned the government against “hasty” privatization of some PSE’s raising the spectre of unemployment. The trade union arm of BJP has opposed the amendment to the Industrial Disputes Act that would have raised to 1000 the lower limit of employment in an enterprise that needs to obtain government permission for any retrenchment.

The opposition Congress Party, which initiated the process of reforms, has recently appointed a committee to “re-examine” reforms for their bias against the poor. The Indian communist parties continue to be Stalinist and against most reforms, particularly of the public sector. Organized labour is against privatization, regardless of whether the enterprise to be privatized serves any social purpose: for example, workers of a public sector bakery have recent moved the courts to block its sales to a private enterprise. One hundred and twenty members of Parliament cutting across party lines have asked for a discussion in Parliament of each and every PSE to be sold to private parties. What is worse, the powers of the recently created regulatory agencies in telecommunications and electricity sectors are being challenged by government departments and enterprises in those sectors. Of course, one could view all these signs optimistically as manifestations of a vibrant democratic polity. Unfortunately, the views expressed and positions taken, seem to be those of some powerful and organized special interest groups and against the interests of the public at large, particularly the poor among them. I sincerely hope my pessimism is exaggerated, if not unwarranted

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20 Acharya is less pessimistic than I am in viewing the fiscal situation as heading towards a crisis, though he concedes that the fiscal pressure could reduce potential growth and this drag could worsen if corrective action is not taken soon. He sees signs of the drag in declining investment, high real interest rate and rekindling of inflation. He deems it unlikely that a simultaneous fiscal and balance of payment (BOP) crises as happened in 1991 will happen again, primarily because the reforms of the external sector have made a BOP crisis less likely. As I argue in the paper, the fact that fiscal deficits have not thus far resulted in deleterious consequences does not imply that they are sustainable.
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