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GOVERNING INDIA THROUGH FISCAL MATH

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

While it is important for a government to pursue a sound economic policy, including management of the public finances, it is yet another matter to make a fetish of any one aspect of it. The latter appears to govern this government's approach to policy when the fiscal deficit is given pride of place in its self-assessment. Not only is this unlikely to yield results on its own, it is not even necessarily prudent.

Soon after the Budget for 2019-20 was presented, one of the Finance Minister's predecessors remarked that "fiscal prudence rewards economies". This was perhaps issued both as praise for the Budget itself and as a justification of the approach taken during his own tenure. Though a concern for the size of the fiscal deficit would have been inevitable since the enactment of the Fiscal Responsibility and Budget Management Bill in 2003, and has therefore been on the radar of political parties of all persuasions at the Centre, it has been raised to special significance since 2014. It figured in the most recent Economic Survey, and its anticipated magnitude for 2019-20 was the final statement in the Budget speech that had followed. The Finance Minister had commenced the speech saying how the government was committed to fiscal discipline.

In the context, "fiscal discipline" is understood as taking the economy towards the 3% of the gross domestic product. The basis for this figure can be queried but that is beside the point. Actually, the point is two fold: whether the fiscal deficit should be the sole index of fiscal management and what a reduction in the deficit would achieve. To suggest that fiscal prudence rewards economies is to suggest both that the fiscal deficit is the right indicator of fiscal soundness and that reducing it is bountiful.

While a sound fiscal policy is highly desirable, the magnitude of the fiscal deficit is not always and everywhere — think here of the state of the economy — a good measure of soundness. First, the fiscal deficit reflects the overall imbalance in the Budget. Embedded in the accounts of the government is the revenue account which is a statement of current receipts and expenditure. A fiscal deficit may or may not contain within it a deficit on the revenue account, termed the "revenue deficit". The possible embeddedness of a revenue deficit within a fiscal deficit muddies the waters somewhat. For movements in the overall, or fiscal, deficit by itself tell us nothing about what is happening to the revenue deficit. Why should we worry, one might ask. We worry because it is the balance on the revenue deficit that indicates whether the government is saving out of its income or spending more than it receives as current revenue. A revenue deficit implies that the government is dissaving.

A fiscal deficit co-terminus with a revenue deficit is to be frowned upon as it implies that at least some part of the borrowing is to finance current consumption, something a government ought prudently to avoid, at least for long. Therefore, unless the revenue deficit is kept explicitly in the picture, we cannot deduce the soundness of economic management from a mere reduction in the fiscal deficit. In fact, in the Budget for 2019-20, while the fiscal deficit projected is marginally lower than earlier, the revenue deficit is projected to rise. Even though the magnitude of the changes is minuscule, their direction calls into question the Finance Minister's claim that the government is committed to fiscal discipline. It is yet another instance when the fiscal deficit can end up being no more than window dressing. While a pathological adherence to a revenue account balance is itself avoidable, a steady revenue deficit as the fiscal deficit shrinks makes a mockery of fiscal consolidation. Worse still it is open to the interpretation that the exercise is ideological in that it aims only to shrink the size of government, fiscal prudence be damned.

A detour through history would help bring some perspective here. A revenue deficit of the Central government is relatively recent, having been virtually non-existent till the 1980s. After that a rampant populism has taken over all political parties, reflected in revenue deficits accounting for over two thirds of the fiscal deficit such as the case today. Revenue deficits have become structural in India by now. This has three implications: that the public debt is only bound to rise; we are permanently borrowing to consume, and leaving it to future generations to inherit the debt. While the populism referred to is not the monopoly of any one political party, it is particularly stark in the case of the present one which relentlessly flags its virtue in lowering the fiscal deficit.

We can see the hollowness of the claim that fiscal consolidation or the shrinking of the fiscal deficit is always and everywhere prudent, for the issue is what is happening to the revenue deficit. Now onto the former Finance Minister's claim that "it rewards" economies. This government has lowered the fiscal deficit alright, though not as much as the United Progressive Alliance government, but the rewards are yet to be seen. Export growth has slowed and the unemployment rate has risen. Even private investment has not soared, an outcome predicted following the claim that government borrowing "crowds out" private investment.

Of late an entirely new dimension has been added to fiscal management, but here again the appropriateness of conducting economic policy by reference to the magnitude of the fiscal deficit remains the issue. In the last Budget the government has signalled its intention to borrow in foreign currency from the international market. This is an innovation alright as the Government of India has so far never borrowed in the international markets, leaving it to public sector organisations and the private corporate sector to do so.

In the Budget speech of the 17th Lok Sabha, the Finance Minister justified the move in terms of the very low share of foreign debt to GDP. The proposal has received criticism, some of it focussing on the consequences of exchange rate volatility. Benefits have been flagged too, such as that Indian sovereign bonds will attract a lower risk premium because the price of the foreign-currency-denominated sovereign bond will now be discoverable. This though ignores the biggest lesson from the global financial crisis of 2007, that the market cannot be relied upon to price risk correctly. And, both arguments overlook the foreign exchange constraint.

Dollar-denominated debt has to be repaid in dollars. Right now our reserves are fairly high but this could change. Oil prices could go back to where they were, the trade war initiated by U.S. President Donald Trump holds little prospect for faster export growth, and portfolio investment may flow out. While these are only possibilities, they point to the need to ultimately base your borrowing plan on expected dollar earnings. The opportunity offered by low global interest rates right now is not matched by the likelihood of robust export growth.

In the final analysis though, it is not the risk of exchange rate depreciation or stagnant exports or even capital flight that is the issue; it is the rationale for borrowing. With revenue deficits the overwhelming part of the fiscal deficit, we would be borrowing to finance consumption. Dollar denominated sovereign debt is just a matter of shifting this borrowing overseas. That is the real issue.

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