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Grasping the Nettle: Fiscal Consolidation is the key to Economic Growth

Budgetary Priorities for the Union Government

Mukul Asher, V Anantha Nageswaran & Narayan Ramachandran

INTRODUCTION

The budget is the first and the most important policy announcement that the new NDA government will be making. It has come to office riding the wave of aspiration and impatience of a youthful population. The personal credibility of the Prime Minister is high. This is an ideal setting for the government to place long-term interests of the nation ahead of short-term costs, even if they mean hurting special interest groups. The government has nothing to fear. Status-quoist incremental tinkering at the margin will leave both its supporters and the nation at large disillusioned and discouraged.

In a recent newspaper essay, Shinzo Abe, Japan's prime minister noted that economic growth was important for Japan to achieve fiscal consolidation. In India's case, with government dominance of the banking sector, government claim on national savings through the banking system and the consequent financial repression, fiscal consolidation is the key to achieving sustainable economic growth.

This Discussion Document provides directions for the 2014 and future budgets focussing on the budget-making processes, subsidies, fiscal dominance of monetary policy, inflation expectations, bank ownership and fiscal consolidation.

Mukul Asher, V Anantha Nageswaran and Narayan Ramachandran are respectively, Councillor, Trustee and Advisor at The Takshashila Institution, an independent think tank contributing towards building the intellectual foundations of an India that has global interests.

BACKGROUND

For families, a budget is a statement of income and expenditure. Even though many do not draw up a budget, when they do it, it is just about tallying up income and expenditure items. There are not too many sources of the former and there are too many claims on the latter side. Hence, for families, it is mostly about prioritisation, postponement and discipline.

Most of these considerations apply to institutions, corporations and to sovereigns. The first two, in most cases, have the ability to borrow more than individuals have. A sovereign states has the ability to levy taxes and hence, has more leeway on expenditure than households, corporations or institutions have.

All this might sound elementary but with a new government in office in India —and upon which there are high expectations—, it is important that the government gets these basics right. For the most part, since Independence, governments in India have adopted a feudalistic approach towards its subjects. They have not treated the public with respect for their intelligence and responsibilities. They have taxed a few and showered many—not just the poor—with benefits. The result is a government debt ratio—one that includes debts owed by state governments—that is nearly 60% of GDP.

Given this penchant for grandstanding and its adverse consequences for the government's finances and for the economy, some would like the budget to focus on its income and spending priorities rather than be used as a platform for making grand announcements. That will keep things in focus. However, a government's spending priorities reflect its policy priorities, and hence, the budget receives more critical scrutiny than most other government policies.

In particular, the budget expected to be presented on July 10th, 2014 by the new Finance Minister has generated enormous anticipation for several reasons. This is a government that has come with an absolute majority gained by a single political party in a long time. The budget is being presented in the backdrop of persistently high inflation and with a serious monsoon failure in prospect. That the Prime Minister has rescheduled his visit to Japan to enable full attention to be focused on the Parliament's Budget Session suggests the importance being given to it.

Moreover, this budget presentation follows ten years of the United Progressive Alliance government whose budget record is far from satisfactory. In the first four years, the UPA government appeared to follow prudent budgetary policies simply and only because India's high economic growth rate yielded ample tax revenues for the government, obscuring its irresponsible taxation and spending proposals. When economic growth dried up, the unsustainability of its budget numbers showed up rather starkly. In its last year in office, the government attempted belatedly to rein in the budget deficit. Seemingly, it has succeeded. The budget deficit ratio (to GDP) has come down to around 4.5%. However, the reduction in deficit ratio has come about both due to the deployment of dubious accounting methods, due to postponement of spending to the next financial year and due to certain decisions that have potential to cause considerable long-term damage.

These decisions include, but not limited to, forcing public sector enterprises to declare dividends and to bearing the government's subsidy burden. **Hence, bringing the deficit under control in a credible manner is an unfinished priority.** Otherwise, India's credit rating will be downgraded, undermining the government's ambition to upgrade India's infrastructure to world-class status, as financing costs will rise significantly after a downgrade and inward investments will become available only on costly terms.

We are aware of two limitations of our exercise. First, this briefing note comes too close to the presentation of the budget for the suggestions made here to be considered for the budget. Second, several experts and lobby groups have already made their suggestions for what the government should do in the areas of fiscal consolidation, revenue augmentation and expenditure control. We see little point in echoing them. Nonetheless, where necessary, we reinforce suggestions that might have been made by others elsewhere and by us too, in the past.

Keeping these in mind, we begin this Discussion Document with specific proposals that focus on the process of India's budget-making, in Section 1. The advantage of this approach is that the suggestions made here will remain relevant even for future budgets. Further, process improvement has multiple benefits. For example, if the Union government improves the budgetary process, it will inspire many State governments to fall in line. The rest of the document is structured as follows:

Section 2 deals with subsidies with particular focus on energy, agriculture and corporate subsidies. Section 3 examines the recent fiscal dominance of monetary policy and its effect on inflation expectations. The related issues of bank ownership and recapitalisation and inflation expectations are considered in Section 4. Section 5 urges fiscal consolidation and before some concluding remarks that wrap up this discussion document.

SECTION 1: THE BUDGET-MAKING PROCESS

First, the Ministry of Finance should constitute a Fiscal Risk Assessment Office with a medium-term focus. Its report should be published and debated annually. It should have professional staff, similar to the Congressional Budget Office in the United States, or similar organisations in the United Kingdom, Canada, and Australia. A longer term fiscal analysis is essential.

Second, the government should prioritise the passing of the Public Procurement Bill 2012. India's total government expenditure on goods and services, and on assets, is around 15% of GDP (out of total combined expenditure of all levels of government of around 28% of GDP). A 5-10% saving on procurement could provide savings equivalent to 0.75% to 1.5% of GDP every year for the country. The Union government should give priority to its own Public Procurement Bill, and require states and others to do so when the financing comes from the Union government. It should also provide expertise for states to pass their own Procurement Bills.

Third, the government should announce a short and precise time-table to switch in accounting methods from cash to accrual (suitably modified to suit government sector). Such a shift could first be required for public enterprises, including departmental commercial enterprises, such as Railways and India Post; statutory boards such as Employees' Provident Fund Organisation and Employees State Insurance Corporation; and central universities and other such organisations.

The current cash accounting does not reveal the full cost of an activity. For instance, the costs of adding a full time employee to Indian Railways are not fully recognised as pensions and other future liabilities are not taken into account. Further and perhaps more importantly, the cash accounting method does not permit balance sheet to be constructed, constraining more productive use of assets. (For more details see "Reforming public enterprises" by Mukul Asher in the June 2014 issue of *Pragati - The Indian National Interest Review*)

Fourth, multi-year budgeting for capital expenditure is another initiative which could be signalled but gradually introduced. The debate on restructuring the Planning Commission has advanced an idea that it should become a professional body whose functions include an independent evaluation of the proposals for new programmes, as well as of existing schemes. Currently its staff lacks requisite skill sets to do such a task.

Fifth, the government should budget for results and outcomes and not for spending. Specific programs in specific ministries (road building, power generation, Food Corporation of India's mandate) could be a starting point. Selected Ministries could also be asked to prepare substantive performance reports for the parliament and for public debate. This may happen over time but it will be good and important to signal intentions in this budget.

Sixth, the government should consolidate Central schemes according to the objectives to be achieved, with specification of indicators to be monitored, and the time-frame. In general, supply side issues and logistical supply chain aspects need to be given greater prominence.

A number of Central schemes could be modified or merged. For example, The Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) and Indira Awas Yojana are reportedly being used in a joint manner to encourage rural housing construction. This is a positive step. There is however a strong case for more explicitly linking MGNREGA with skills development particularly in industries such as textiles, agro-processing, food processing and manufacturing where there is potential to learn skills on the job, expand exports, and reduce logistics-supply chain costs in agriculture.

There are two national health schemes under the Ministry of Labour. These are Employees State Insurance Corporation (ESIC) and Rashtriya Swasthya Beema Yojana (RSBY). This has resulted in lack of policy coordination and coherence in the health sector. The government must urgently consider restructuring them to better align with India's health policies, and place them under the Ministry of Health.

Seventh, the role of the Finance Commission needs to be re-examined to better rationalise India's public finances at all levels, including urban and local bodies.

Finally, the assumptions that go behind the budget numbers: nominal and real GDP growth, the deflator, the elasticities of tax revenues (direct and indirect) have to be stated explicitly. For comparison, historical ranges can also be given. Since this transparency will enable commentators to judge the realism of the budget numbers more easily, there will be a greater sense of accountability in preparing these estimates. Most countries aiming to achieve fiscal credibility have used conservative estimates and have done better with final outcomes. India, on the other hand, has over-promised and under-delivered, or delivered with sleight of hand on budget deficit projections.

SECTION 2: SUBSIDIES

First, the decision reportedly taken directly by the Prime Minister to not merge Aadhaar with the National Population Register, and to restore the direct benefits transfer for cooking gas and other subsidies is encouraging. Second, the previous government had done a commendable job in one aspect—it had quietly brought the subsidy on diesel to insignificant levels by allowing a steady monthly increase in the price of diesel. This government should follow that path for the other subsidised petroleum products such as cooking gas and kerosene.

Elimination of subsidies on energy products and setting them free is an important priority since India is not rich in hydrocarbons. The price should reflect its scarcity for Indians. The government has the right to protect the poor from the vagaries of market prices for energy products. However, that can be done without tampering with the price mechanism. Cash transfers in lieu of subsidised cooking gas, diesel and kerosene may even enable some families to economise on the use of these items and spend the money on more useful items like family health and education.

Specifically on agricultural subsidies, there are many things that the government can do to boost agricultural productivity and employment without wasting scarce government resources.

To start with, several Ministries that deal with agriculture and allied subjects can be merged into one. Second, the government might think that it is taboo to tax agricultural income, but the abuse of non-taxation of agricultural income should be plugged. The weighted average increase in Minimum Support Prices (MSP) for food-grains announced by the NDA government is only around 2%. That is commendable. At the same time, more needs to be done to wean farmers away—especially in states like Punjab and Chhattisgarh—from the production of water-guzzling crops. For example, the current policy on fertiliser subsidies neither provides relief to farmers nor does it help boost soil fertility and productivity.

On the distribution side, we will confine ourselves with the recommendation that the government should consider rechristening Aadhar and use it to reduce inefficiencies and friction costs in the Public Distribution System.

As an aside, there is a case for including in the government a number of credible experts with current knowledge and experience in the field. For instance, the government should consider bringing in Ashok Gulati, former Chairman of the Commission for Agricultural Costs and Prices (CACP). His work on various aspects of Indian agricultural sector, while at CACP, enabled informed debate on various issues such as the Food Security Bill, water usage and management in Indian agriculture, on agricultural exports, on the role of the Food Corporation of India and so on.

Some sections of the public discourse are comfortable criticising government subsidies for farmers and for the poor. The criticisms are legitimate and relevant since they are targeted not at the objectives behind subsidies but at the outcomes they achieve.

Nonetheless, there is a lingering sentiment that urban commentators give a relatively freer pass to corporate tax subsidies. More sunlight on them is needed. In 1997, the then United Front government brought out a white paper on non-merit subsidies. It is time for another white paper on all subsidies, including tax breaks given to specific industries, and even to specific firms in some cases.

Indian capitalists have gotten away more easily than the poor at the hands of the so-called objective and unbiased commentators. As a result, India has neither a command economy nor a market economy but a selective pro-business economy which serves the interests of few at the expense of many.

SECTION 3: FISCAL DOMINATION OF MONETARY POLICY & INFLATION EXPECTATIONS

One of the most damaging consequences of the previous government's irresponsible attitude towards public resources is the impact it had on the Indian banking system and on inflation expectations. What it sought to give on the one hand through rights, it took away with the other hand through the relentless rise in cost of living, caused by its reckless borrowing. The Reserve Bank of India's report on Currency and Finance, 2009-12 states:

"The size of the government's net market borrowing programme (dated securities) increased nearly 9.7 times in eight years to INR4.9 trillion in 2012-13. In addition, the government resorted to an additional funding of INE1.16 trillion through 364-day treasury bills)"

Not content with garnering private savings through its market borrowings, the UPA government burdened the RBI with its borrowings. Due to the sheer size of the government market borrowing, much of it ended up in the balance-sheet of the central bank. They simply could not be placed in the market at the coupon rates paid by the Government of India, without seriously impairing the availability and flow of credit to the private sector. So, the UPA government imposed its own version of 'quantitative easing' on the RBI since

2008. The table below shows that RBI held just under 5% of all the government securities in 2008. It had more than trebled to 17.0% in 2013.

Table 2.7	Ownership Pattern of Government of India dated securities					
(Per cent)						
Category	2008	2009	2010	2011	2012	2013
			(end-March)			
Commercial Banks	42.5	38.9	38.0	38.4	36.3	34.5
Bank-Primary Dealers	8.4	8.1	9.2	8.6	9.8	9.4
Non-Bank PDS	0.3	0.3	0.1	0.1	0.1	0.1
Insurance Companies	24.8	23.2	22.2	22.2	21.1	18.6
Mutual Funds	0.8	0.8	0.4	0.2	0.2	0.7
Co-operative Banks	3.2	2.9	3.4	3.4	3.0	2.8
Financial Institutions	0.4	0.4	0.4	0.4	0.4	0.8
Corporates	3.5	4.7	3.0	1.9	1.4	1.1
FIIs	0.5	0.2	0.6	1.0	0.9	1.6
Provident Funds	6.4	6.6	6.8	7.1	7.5	7.4
RBI	4.8	9.7	11.8	12.8	14.4	17.0
Others	4.4	4.2	4.2	3.9	5.1	6.1
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Table 2.7, page 12, Status Paper on Government Debt, Ministry of Finance, Government of India, July 2013.

The RBI ended up holding government debt to ensure that the borrowing cost for the government did not rise. Had there been a genuine free market for the debt of the Government of India, its borrowing cost would have exploded. Had it exploded, the interest payment/budget receipt ratio would not have come down but gone up substantially. Instead, RBI balance-sheet exploded with government debt. This is what is known as fiscal dominance of monetary policy.

Consequently, inflation in India skyrocketed. The Consumer Price Index for Industrial Workers went up cumulatively by 63% from end-2008 until end-2013 (based on the index levels of 147.0 in December 2007 and 239.0 in December 2013).

The foregoing analysis makes it abundantly clear that the onus of reducing India's inflation expectations and breaking the spiral of rising inflation, rising wages and falling productivity rests solely on the shoulders of the government. Prudent, measured and responsible spending and government borrowing programme will not only release more resources for the private sector to borrow and invest, but also bring down inflation expectations. This is both urgent and important given the spectre of a serious drought facing the nation.

Put differently, the government must target reduced market borrowing and should announce a programme to bring down central bank holding of government securities. If it means facing the discipline of the market and higher borrowing costs, that is the short-term cost to be paid for the long-term financial and fiscal health of the nation. This government should be prepared to make that trade-off and credible signals towards that end must be included in the budget.

SECTION 4: PUBLIC SECTOR BANKING & FINANCIAL REPRESSION

Nearly fifty years after the first wave of nationalisation of private sector banks, it has to be said that the goal of financial inclusion remains largely elusive and public sector banks have only ended up entrenching cronyism in India. Most non-performing loans of public sector banks stem from loans to politically connected businessmen. Their businesses have failed leaving banks with a big hole and employees with uncertain future. The businessmen continue to prosper and remain pampered.

The previous government brought back the pernicious culture of loan waivers with its announcement of a farm loan waiver before the 2009 general election. The current RBI governor, then in his capacity as the Chairman of the Committee on Financial Sector Reforms had said that, "after fifteen years of getting away from the problem, the Government had vitiated it again". Just as it was the Congress government in Andhra Pradesh that announced free electricity to farmers in the 1970s to counter the popularity of N T Rama Rao, setting in motion a practice that remains hard to eradicate to date, it brought back loan waivers. The practice has been eagerly picked up by an ally of the NDA government in Andhra now. The damage is not just to the balance sheets of the government or the banks but, more importantly, to the culture of accountability and ethics in the nation.

In addition to these pressures on their commercial lending decisions leading to the problem of non-performing loans, the government has also imposed a rather high statutory liquidity ratio on banks, effectively forcing them to lend to the government. Lending to the government for creation of assets is one thing but lending for its non-productive expenditure is another thing. Had it been the case of the former, India's potential growth rate will not be languishing at 6% - 7% range.

A harsh but largely accurate commentary on Indian public sector banking has been that it has served the politicians' vote-bank politics and furthered the business interests of their cronies more than it has served the goal of financial inclusion.

Therefore, for a government wanting to establish a Congress culture-free India, it is time to free the banking sector from government domination, interference and claim on banking resources. Before that, it should address the problem of non-performing loans (NPA) in public sector banks by making it easier to sell collateralised assets. Setting up a bad bank to deal with NPA is one possibility. Then, public sector banks need to be recapitalised. The government should turn to private sources for recapitalisation, thus loosening its hold on the banking system.

Of course, one danger of private sector banking is that India follows the West in over-financialising the economy. When considerations of financial sector and its interests trump considerations of systemic stability and economic welfare, then the economy is said to be financialised. There is no imminent risk of that happening in India especially after the RBI governor has come out clearly against some of the most pernicious recommendations of the Financial Sector Legislative Reforms Commission. That said, the Finance Minister should avoid announcing proposals that would give financialisation a boost. All that he needs to do is to enable the old-fashioned credit mechanism to function efficiently and effectively.

For that to happen, the Budget must take financial consolidation very seriously. That is the subject of the next and final section of this discussion document.

SECTION 5: FISCAL CONSOLIDATION & REVENUE GENERATION

If the July 2014 Budget is to give positive signals on growth, governance and public financial management, then it must demonstrate a credible fiscal consolidation roadmap, which enhances policy credibility and trust. The government should declare goal of eliminating the primary and revenue deficits one year before the end of its first term.

Fiscal consolidation should include additional revenue generation measures, both conventional (tax and non-tax, including cost-recovery policies of government commercial enterprises such as Railways) and unconventional revenue sources such as using land, air-space and other assets more productively, more equitable natural resource rent-sharing with other stakeholders, including state governments, better treasury management and revenues from emission trading.

Further, credible steps to institute and better manage the regulatory structure for the pricing and availability of key inputs such as coal and electricity would need to form part of the road map.

CONCLUSION

The budget is the first and the most important policy announcement that the new NDA government will be making. It has come to office riding the wave of aspiration and impatience of a youthful population. The personal credibility of the Prime Minister is high. This is an ideal setting for the government to place long-term interests of the nation ahead of short-term costs, even if they mean hurting special interest groups. The government has nothing to fear. Status-quoist incremental tinkering at the margin will leave both its supporters and the nation at large disillusioned and discouraged.

In a recent newspaper essay, Shinzo Abe, Japan's prime minister noted that economic growth was important for Japan to achieve fiscal consolidation. In India's case, with government dominance of the banking sector, government claim on national savings through the banking system and the consequent financial repression, fiscal consolidation is the key to achieving sustainable economic growth.

We hope that the new government will grasp the nettle in the budget.