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INDIA: THE NEED FOR GOOD MACRO POLICIES

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India: The Need for Good Macro Policies

(4th Dr. Raja J. Chelliah Memorial Lecture)

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Ashok K. Lahiri

INTRODUCTION

Dr. Rangarajan, Prof. Shanmugam, Mr. Arun, faculty members and dear students of MSE, and friends,

Thank you very much for inviting me to deliver the 4th Dr. Raja J. Chelliah Memorial Lecture. I feel honoured particularly because I have had the privilege of knowing Dr. Chelliah, learning from him and working under him. He was the Chairman of NIPFP for a part of the time, when I worked there.

During our student days, we learnt fiscal policy from Dr. Chelliah's celebrated book "Fiscal Policy in Underdeveloped Countries – With Special Reference to India." He had published it in 1960. I have vivid memory of the first time I met Dr. Chelliah. I was a Ph. D. student in Delhi School of Economics. My supervisor, Prof. Nagar introduced me to him. Thinking that he will be pleased, I told him that I had read the book. With the distinctive twinkle in his eyes and great sense of humour, he said "I hope you bought a copy." I had to disappoint him by saying that I had read it on library loan. Thinking about my younger days, it is also difficult for me to forget that I am speaking at a meeting chaired by Dr. Rangarajan, who some forty years ago, as my Ph. D.examiner, was drilling me on my doctoral thesis.

For well over four decades, Dr. Chelliah was a stalwart in the country working on macroeconomic issues, particularly fiscal reforms. He was a distinguished member of the Indirect Taxation Enquiry Committee headed by L. K. Jha that was set up in July 1976. The recently introduced Goods and Services Tax and VAT before that can be traced back to the report of this committee which became available in 1978.[1] Dr. Chelliah went on to head the famous Tax Reforms Committee of 1991-92. In the words of former Chief Economic AdvisorShankar Acharya "Its three volumes were widely (and rightly) acclaimed as the most comprehensive and analytical treatment of Indian tax policy and reform issues since Independence. The TRC's recommendations guided the policy actions of all three finance ministers (and their senior officials) of the nineties."[2]He also headed the Committee on "Saving and Capital Formation in India 1950-51-1994-95."

[1] Dr. Chelliah was an Adviser to Finance Minister Manmohan Singh when three services -- non-life insurance, stock brokerage and telephones -- were brought into the tax net, laying the foundation for GST.

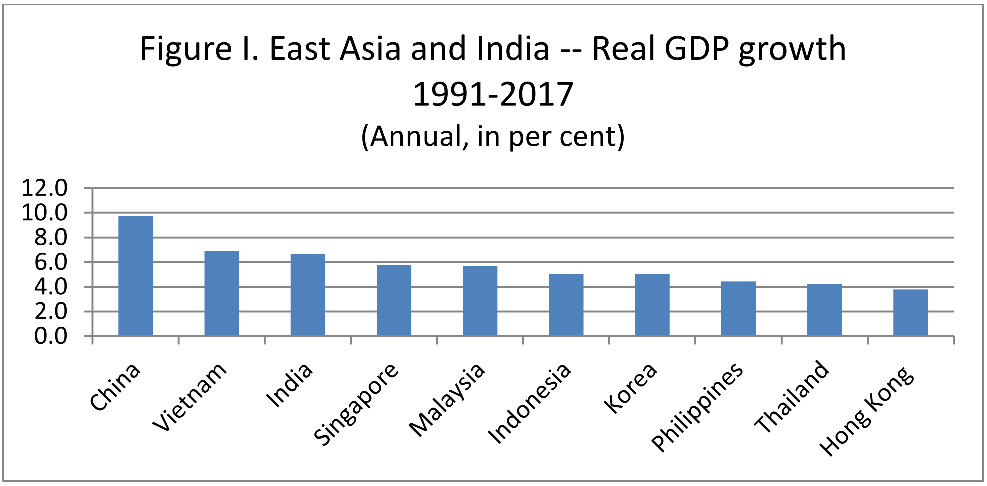
[2]Shankar Acharya: "India's tax reformers," Business Standard, **February 6, 2013.**

Dr. Chelliah did not stop at writing incisive reports and advising the government. He built up institutions to continue the pursuit of scholarship in economics. He set up the National Institute of Public Finance and Policy (NIPFP) in 1976 as a centre for research in public economics and policies, including policy advocacy and capacity building in areas related to public economics. As I told you, I had the privilege of working at the NIPFP during 1998-2002. As you all know, the indefatigable Dr. Chelliah did not stop at NIPFP. In 1995, in his early 70's, he went on to set up this Madras School of Economics or MSE as a privately funded post-graduate institution for teaching and research in economics. We all know the reputation that the MSE has acquired in the short span of two decades.

Given Dr. Chelliah's life-long focus on public economic and policy, I propose to speak on the need for good macroeconomic policies in India. I wish to do so for two additional important reasons. First, there has been a lot of welcome progress on macroeconomic policy issues in recent times, that is, the last two and a half decades. This is particularly manifest in moves to rule-based, transparent and predictable policy frameworks in fiscal and monetary policies. Second, in spite of this progress, vulnerabilities remain particularly because of a distinct proclivity for high fiscal deficit, or what is called a 'deficit bias' of a democracy. There is need to consolidate the gains on the macroeconomic front on a sustained basis. In what follows, I concentrate on the overall stance of fiscal policy and monetary policy and leave aside issues such as taxation policy or exchange rate management. So, without further ado, let me get into the issues.

HOW HAVE WE FARED?

For analysing the macroeconomic issues, first and foremost we should ask the question: How have we done? The answer depends on 'relative to which period of our own past and relative to which other country'. If we compare the country's performance since the launch of the reforms in 1991 with that in the past, the answer is gratifying. We have grown faster than in the past; poverty has gone down more rapidly though not enough; we have had no periods of sustained high inflation like after the two oil price shocks in the 1970s; and we have had no balance of payments crisis compelling us to seek exceptional balance of payments support from multilateral bodies such as the International Monetary Fund (IMF).



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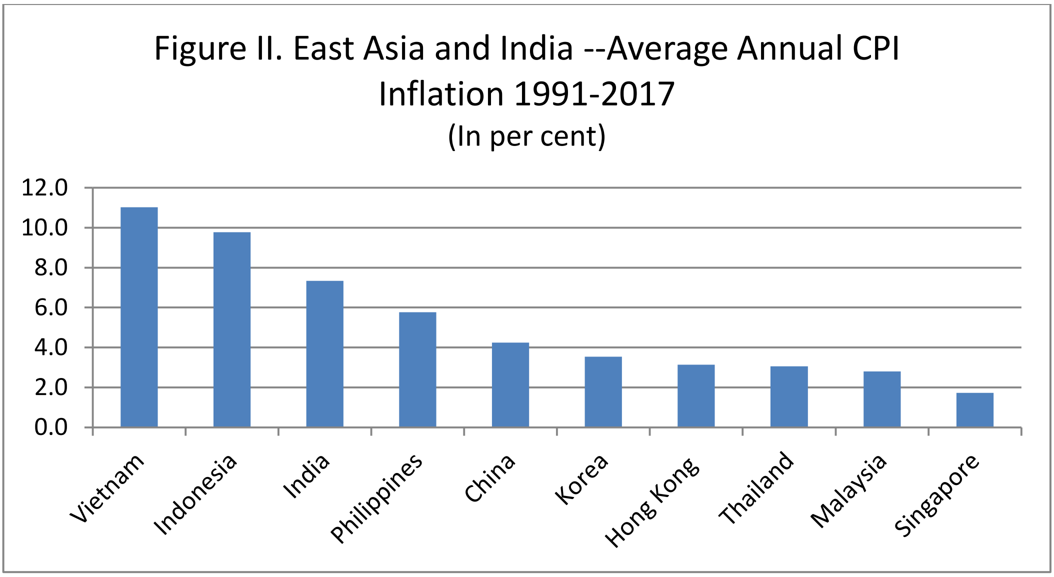
Comparing how we have done relative to our not-too-distant neighbours in the east is a more sobering experience. We take People's Republic of China, Hong Kong, Indonesia, Republic of Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam for comparison. For little more than a quarter century, China has grown at about one and a half times the speed of India.[3]Even Vietnam has grown slightly faster than India. We may have done better than the other seven in terms of growth, but not fast enough for a rapid catch up. These seven started in 1991 with per capita incomes between two and a half to forty-eight times that of India.[4]

What about macroeconomic stability? India stands out as the country with the highest rate of inflation, next only to Vietnam and Indonesia (Figure II). Our performance on the balance of payments front has been the worst (Figure III).[5] Apart from Vietnam, India is the only country among the ten under consideration which had a current account deficit.

[3]By China we mean People's Republic of China. Similarly, Korea refers to Republic of Korea.

[4] In 1991, compared to India's per capita income of $318 (=100), per capita income of China was $359 (=113), Hong Kong $15,190 (=4,775), Indonesia $848 (=266), Korea $7,523 (=2,365), Malaysia $2,845 (=894), the Philippines $807 (=254), Singapore $14,504 (=4,560), Thailand $5,902 (=1,855) and Vietnam $2,172 (=683).

[5]We consider 1997-2017, the period after the East Asian Crisis partly because current account data is not available for China prior to 1997.



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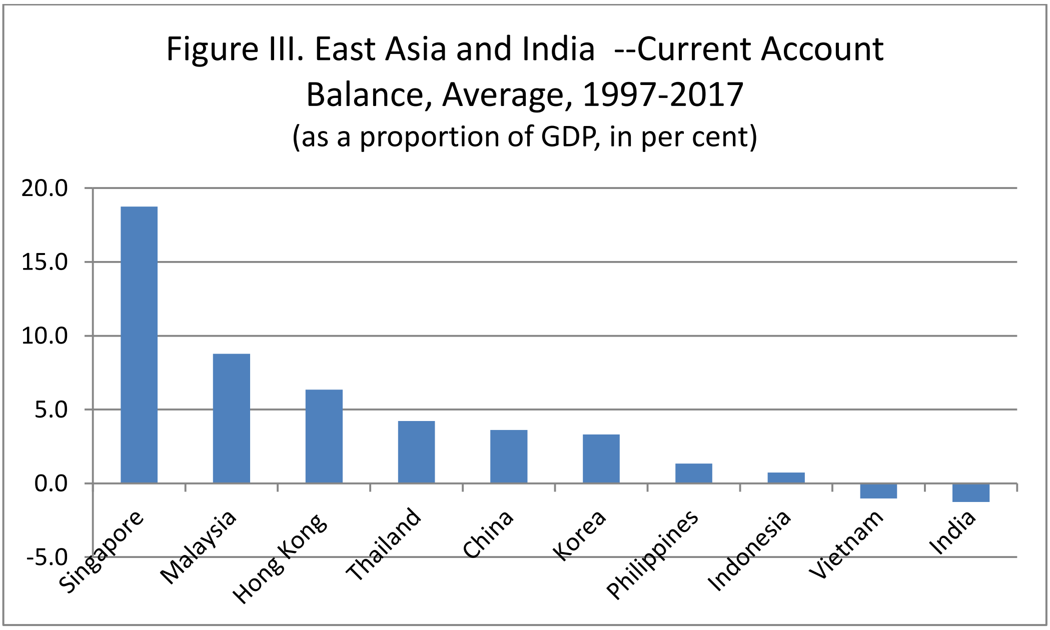

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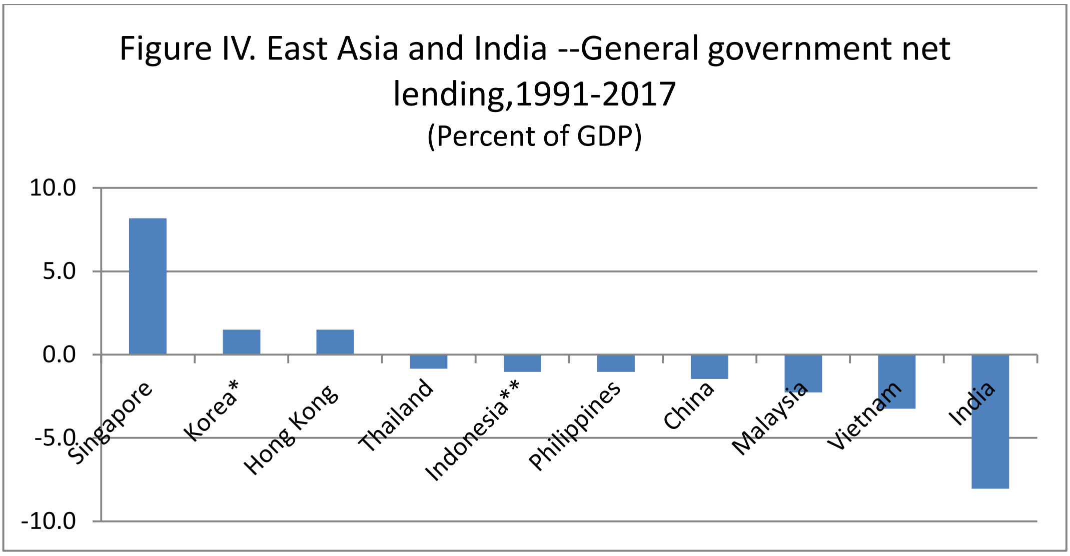
If we look at the fiscal position of the general government, that is centre, states and local governments combined, we find that India has had the largest general government net borrowing as a proportion of GDP (Figure IV).[6] It is not true that all countries in East Asia generate fiscal surpluses, but all the countries under consideration were fiscally far more conservative than India. They incurred fiscal deficits, but none, on the average, as large and as persistent as that of India. None had as large debts or as adverse primary balance as India.[7]



Note: * Korea relates to 1997-2017. ** Indonesia relates to 1993-2017
Source: IMF Data Mapper.
http://www.imf.org/external/datamapper/NGDPDPC@WEO/OEMDC/ADVEC/WEOWORLD/CHN/HKG/IND/IDN/KOR/MYS/SGP

Now, the question that we can ask is why has India not grown faster? The answer to that question surely does not lie in insufficient fiscal stimulus. If government borrowing and spending more held the key to higher growth, India should have grown faster than Vietnam and even China. It is more than likely that structural factors, such as lack of physical infrastructure, inability to transform money spent on public education and health into appropriate outcomes, slow agricultural reforms and facilitation of business,

[6]General government net lending reported by the IMF does not correspond to general government fiscal surplus reported by Indian official statistics primarily because of the differential treatment of disinvestment receipts.

[7] We disregard Singapore's high public debt (110.6 per cent of GDP in 2017 as Singapore's public debt consists largely of Singapore Government Securities (SGS) issued to assist the Central Provident Fund (CPF), which administers Singapore's defined contribution pension fund; special issues of SGS are held by the CPF, and are non-tradable; the government has not borrowed to finance deficit expenditures since the 1980s; Singapore has no external public debt

and insufficient progress in liberalising land and labour markets, inhibited growth. Over-expansionary fiscal policy resulted only in higher inflation and weaker balance of payments outcomes. Higher inflation and balance of payments problems may have actually hurt our growth and development performance. In what follows, I argue that higher inflation and weaker balance of payments performance were, and to some extent continue to be, the result of a relative neglect of fundamental macroeconomic policy issues from right after independence.

RELATIVE NEGLECT OF MACROECONOMIC POLICY ISSUES

The obfuscation of macroeconomic issues could be considered a legacy from the Second World War days under British rule.[8] Goods and services were bought in India for the British war effort in Indian rupees. The British government paid the Government of India in blocked sterling balances. The large war-time mobilisation of resources in India led to a shortage of commodities and a steep rise in money supply. Many of you would be familiar with Amartya Sen's work on famines during that time coinciding with these mobilisation efforts. Money supply with the public increased more than six times in six years from Rs. 3.2 billion in 1938 to Rs. 20.5 billion in 1945.[9] Inflation went up from an already high 19.3 per cent in 1941-42 to 24.8 per cent in 1942-43 and further to 38.3 per cent in 1943-44.

Prof. C. N. Vakil in his celebrated book "The Falling Rupee", published in 1943, drew attention to the inflation problem and also pointed out its link with money supply. But, C. E. Jones, Finance Secretary of Government of India, talked instead about 'inflation psychology' and said "the operation of two factors, namely speculation and fear of invasion, were bound to result in a general rise in prices." Furthermore, believe it or not, there was a controversy not only about whether excessive money supply had anything to do with inflation, but also about whether there was any inflation or not![10]

After independence, the country followed socialist planning. The state was engaged in actively spearheading development through a plan framework, particularly by

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[8] Andrew J. Grajdanzev: "India's Wartime Finances," Pacific Affairs, Vol. 16, No. 4, December 1943. Pp. 418-440.

[9] Dharma Kumar (ed): "The Cambridge Economic History of India," Vol. II c. 1757-2003. Orient Black Swan 2010. P. 767.

[10] "A certain member of the Legislative Assembly, Sir Zia-ud-Din, in a sitting of the Assembly on March 11, 1943, deprecated the talk of "inflation", and traced it to the "enemy-engineered plans to upset trade, dislocate currency and distribution of food, and make travel insecure." Grajdanzev (1943), p. 428.

promoting public sector enterprises and channelling private investment through industrial licensing. An active government expenditure programme to provide financial support to the plans followed as a corollary. Such expenditure, even when financed by additional money supply to cover a fiscal deficit, was expected to be beneficial for the economy by creating assets that enhanced the productive capacity of the economy.

The traditional canons of sound finance consist in current revenues covering current expenditure, and capital expenditure financed by public savings, and whenever possible, surpluses on current account used for amortising public debt. The British colonial government, except during the Second World War, had scrupulously followed the canons of sound finance, perhaps too sound for the good of the Indian economy. After independence, the commitment to soundness principle continued for a while, and defending his 'deficit' of Rs. 24.59 crore, on November 26, 1947, Shanmukham Chetty had alluded to the partition and the challenges of refugee rehabilitation and said "If these special factors are taken into account it will be seen that we have not been living beyond our means or heading towards bankruptcy."[11] But, soon, concerns about such deficit became not-so-important as Five Year Plans started to hold sway.

With so much backwardness around, there was the legitimate assumption of a large amount of latent aggregate demand. Such demand potentially could be translated into effective demand by fiscal and monetary pump priming, and Keynesian theory ruled the roost. Implicit in the analysis was the assumption that a problem of excess demand, if any at any point of time, could and should be met by augmenting supply. The possibility that, with limited supply of resources and lags in supply response, merely increasing the rate of monetary outlay on various plan projects would only inflate prices, at least in the short run, did not receive adequate attention.

At a higher level of sophistication, there was also the debate about the relative emphasis the Plans attached to various sectors or sub-sectors. To maximize the speed of expansion of the capital goods industry and hence the eventual mechanization of the consumer goods industry, the Mahalanobis Plan model focused on production of capital goods or machines for production of more machines. P. R. Bramhananda and C. N. Vakil provided a critique of this Mahalanobis strategy by highlighting its neglect of wage-goods. Shortage of wage-goods – mainly food – would have implications for workers'

[1111] Speech of R. K. Shanmukham Chetty introducing the first budget of independent India on November 26, 1947, p. 16. http://indiabudget.nic.in/bspeech/bs194748.pdf productivity as well as prices. But this critique again was also not so much in terms of fiscal policy or monetary policy as in terms of the plan's sub-sectoral emphasis.

But, it was not fashionable to talk in terms of mundane monetary or fiscal policy with the pursuit of socialist economics and attempts to put the public sector at the commanding heights. In a planned communist system, monetary policy played a purely passive role. It only did the accounting work, and through appropriate financial flows, supported the planned economic activity, including investment. Plans were supposed to be drawn up in a careful and consistent manner to match demand and supply and satisfy inter-sectoral balances. With the plan in place, theoretically, there was no scope for mismatches. Any imbalances arising only revealed 'mistakes' in drawing up the plan or implementing it. The solution lay in correcting the mistakes in plan formulation and implementation, not in monetary policy.

Public spending was at a premium in the country's quest for industrialisation through planning. Fiscal illusion of public choice theory of government expenditure held in full force. The effect of public expenditure on the taxpayer and general public through higher taxes in the future, including inflation tax, was not obvious to the people. Future taxpayers had no vote on the merits of public spending in promoting industrialisation. The political incentive to carry on with deficit-financed public expenditure resulted in a bias toward deficit finance. The supply-side theory of inflation also contributed to the deficit bias. The belief was that inflation was basically a supply-side phenomenon. It was spurred mainly by shortfalls in the availability of food grains, petroleum, and other essentials. India was a democracy in deficit, fitting in with the title of James M. Buchanan and Richard E. Wagner's famous 1977 book with the same title.[12]Public investment did not pay back and financing the large public investment necessitated pre-emption of loanable funds through financial repression embodied in administered interest rates and statutory liquidity ratios for banks.

Compared to its dismal performance under colonial rule, the economy after independence did remarkably well until the late 1950s. It was a story similar to that of the former Soviet Union, which did remarkably well in the first half of the last century. Problems surfaced after the initial encouraging response. Not many had anticipated 'Government failure' or the limited capacity of the government to administer an industrial

[12]James M. Buchanan and Richard E. Wagner: "Democracy in Deficit: The Political Legacy of Lord Keynes", Academic Press, New York, 1977.

licensing regime. The system deteriorated into the "permit-quota-license Raj," a memorable phrase coined in 1961 by one of the great sons of this state of Tamil Nadu, Chakravarti Rajagopalachari or Rajaji, also known as Kautilya of Indian politics of his times. Incidentally, the permit-quota-license raj extended even to the financial sector.[13]

During the 1960s and 1970s, to the east of India -- the so-called East Asian Tigers, namely Hong Kong, South Korea, Singapore and Taiwan – were growing rapidly and transforming the very nature of living for most of their population. These four Tigers increased their per capita income by a factor of over 6 times in thirty years between 1960 and 1990. Indian per capita income (in 2010 US dollars), on the other hand, increased only by 77 per cent from $307 in 1960 to $542 in 1990. Increasingly, it became clear that India was growing at a slow rate primarily because of the 'permit-quota-license raj'. All of you know the problems during this 'permit-quota-license' raj, and I need not elaborate on how strident critiques of the system led to some relaxation in the 1980s and finally its abandonment in 1991.

Let us get back to the relative neglect of macroeconomic policy issues. The economic problems of the country during the 1950's to the 1970's were attributed to the permit-quota-license raj, and infirmities in the design and implementation of the Five Year Plans. Faulty macroeconomic policies rarely came up for blame. This is surprising because, beyond low growth, there were the two additional problems in frequent bouts of high inflation and persistent balance of payments difficulties. Yet, the relative neglect of fiscal and monetary policy issues in public discourse continued until the early 1980s.[14] This is surprising because bad microeconomic policies may lead to sluggish growth, but not necessarily high inflation or balance of payments crises with appropriate macroeconomic policies.

[13] Until October 1958, interest rates were more or less free. In that month, ceilings were imposed on the deposit rates of banks through a voluntary agreement between Indian and foreign banks. From 1960, RBI started prescribing the lending rates of interest for banks. In September 1964, the RBI brought both the maximum and minimum rates of interest on deposit under its regulation. From 1973, the Indian Banks' Association imposed a ceiling on the call money rate. Interest rates on company debentures were regulated by the Controller of Capital Issues. Interest rates were kept low to reduce the interest burden on government debt and promote investment. The real rates of interest were often negative. With price restrictions in the credit markets, quantitative rationing prevailed.

[14] The setting up of the Sukhomoy Chakravarty Committee -- Committee to Review the Working of the Monetary System -- in 1982 has been taken as the first official and public recognition of the critical role of macroeconomic policy.

I would be remiss if I do not mention the rare debate about the role of deficit finance during the run-up to the Second Plan (1956-61).[15]The Planning Commission appointed a panel of twenty-one economists (chaired by C. D. Deshmukh) to produce a joint memorandum entitled "The Second Five Year Plan: Basic Considerations Relating to the Plan Frame".The panel produced some differing positions. B.R. Shenoy, in his note of dissent, opposed resort to deficit financing because of its inflationary impact. He was a prophet before his time.[16] He was not against deficit financing per se, but the level of deficit that was too high for maintaining price stability.[17,18,19,20] In the end, Shenoy's lone voice of dissent was drowned by the clamour for activist State borrowing and spending on projects that the planners felt the country needed. With the quest for rapid industrialisation by the state's interventionist investment, concerns about deficit and debt became of secondary importance.[21] Even the businessmen seemed to be in favour of deficit financing and of money creation for increasing the productive capacity of the nation.

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[15] See Ashok K. Lahiri and R. Kannan: "Indian Fiscal Deficits and their Sustainability in Perspective", in Edgardo Favaro and Ashok K. Lahiri (edited): "Fiscal Policy and Sustainable Growth in India," Oxford University Press, New Delhi, 2004, pp. 23-59.

[16]"Shenoy would be an active opponent of state intervention and planning: a consistent, penetrating and active proponent of what would now be called the neo-liberal position – a prophet before his time." See Byres (1998):): "The State, development planning and liberalisation in India," Oxford University Press, New Delhi, 1998. , p. 80..

[17] Shenoy had clearly stated: "I also generally agree with .scope for a certain measure of deficit financing."Shenoy, B.R. (1955): "A Note of Dissent", in "Second Five Year Plan: The Framework", Publications Division, Ministry of Information and Broadcasting, Government of India, p. 163.

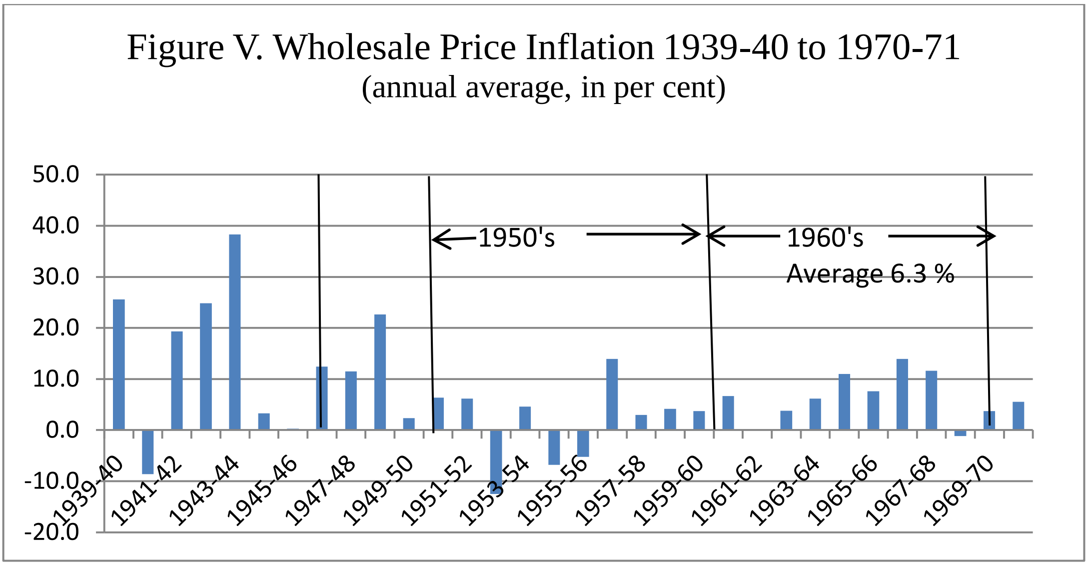
[18]A. K. Dasgupta, who had differed with Shenoy, continued the debate by joining issues with V. K. R. V. Rao in 1987 about the whole question of relevance of Keynesian economics in an underdeveloped country. See A.K.Dasgupta (1987c), p. 2126

[19]The debate, in its wider context, even raised issues about the relevance of the multiplier in an underdeveloped country. See A. K. Dasgupta (1987a): "Keynesian Economics and Underdeveloped Countries Again", Economic and Political Weekly, Vol. 22, No. 38, September 19, 1987, pp. 1601-06. A. K. Dasgupta (1987b): "Keynesian Economics and Underdeveloped Countries Again: Postscript", Economic and Political Weekly, Vol. 22, No. 37, 21 November, 1987, pp. 2019-20. A. K. Dasgupta (1987c): "Keynesian Economics and Underdeveloped Countries Again: Rejoinder", Economic and Political Weekly, Vol. 22, No. 49, 5 December, p. 2126. In an exchange with L. K. Jha, A. K. Dasgupta put it succinctly: "I have not indeed made 'the point', as Jha suggests, 'that with the shortage of capital addition to aggregate demand through budgetary deficits will not help countries like India'. I have, on the other hand always argued, …that deficit financing can be legitimately used towards capital formation (and hence growth), provided its inflationary impact could be regulated."

[20]As early as 1952, V.K.R.V.Rao had pointed out the problems posed by supply constraints in limiting the role of government expenditure in boosting GDP or national income.V.K.R.V. Rao: "Investment, Income and the Multiplier in an Underdeveloped Economy," Indian Economic Review, 1952.

[21]As Dasgupta (1987) points out "It was, let us remember, the eve of the Second Five Year Plan, and the problem before us, among other things, was whether we could go in for some deficit-financing for the mobilisation of additional resources." See A.K.Dasgupta (1987a), p. 1601.

Inflation, as measured by the wholesale price index (WPI), was in single digit or even negative during the 1950s, except for in 1956-57.[22] From 1.7 per cent in the 1950s, annual average inflation during the decade of the 1960s (1960-61 to 1969-70) went up almost four times to 6.3 per cent (Figure V).

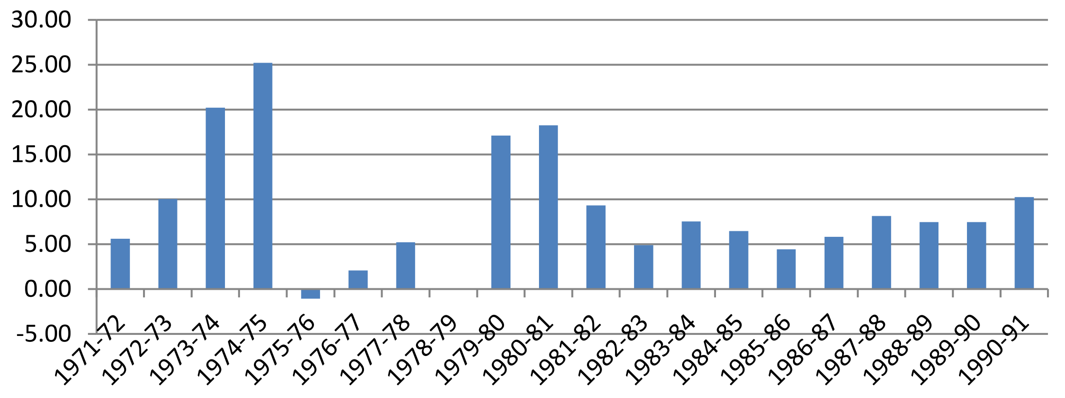


Source: C.N. Vakil: "War Against Inflation The Story Of The Falling Rupee 1943-77", The Macmillan Company of India Ltd., 1978, pp.4-5. Base 1960-61.

Inflation continued to be troublesome throughout the 1970s and 1980s (Figure VI). During 1973-75 and 1979-81, after the two oil price shocks, WPI inflation reached double digits and even pushed 25 per cent in 1974-75.

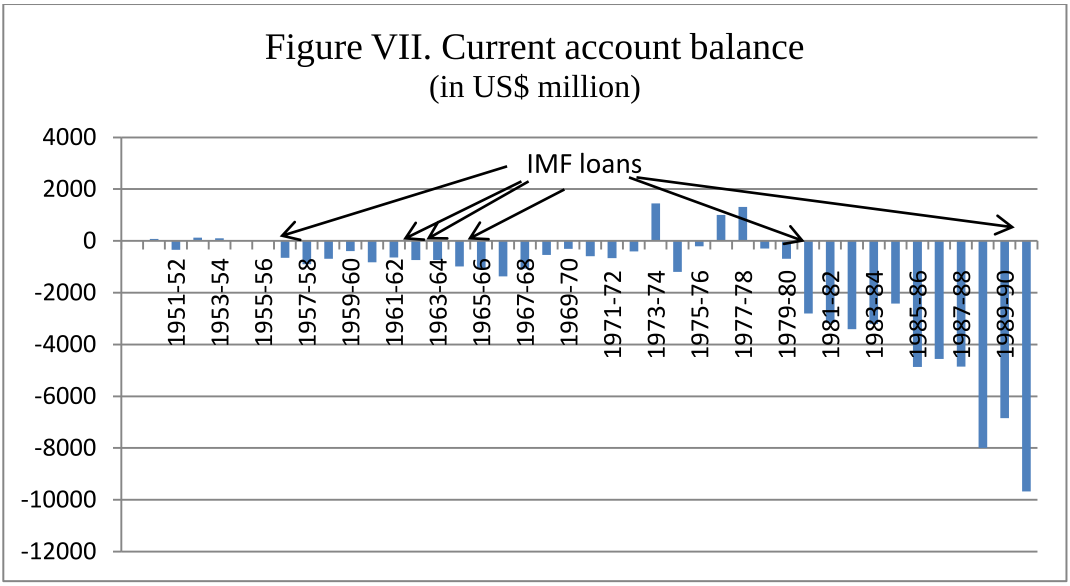
[22] In 1956-57, it reached almost 14 per cent. It started rising in the following decade. In 1964-65, it reached 11.0 per cent, and after declining to 7.6 per cent in the following year, rose back to 13.9 per cent and 11.6 per cent in 1966-67 and 1967-68. WPI rather than Consumer Price Index (CPI) is considered, because prior to 2012, no series of combined CPI exists. WPI inflation has been calculated fo 1971-72 to 1981-82 from the WPI series with base 1970-71=100, and for 1982-83 to 1990-91 from the series with base 1981-82=100.

Figure VI. Wholesale Price Inflation 1971-72 to 1990-91
(annual average, in per cent)



Source: RBI Handbook of Statistics. Table 40. Wholesale Price Index – Annual average.

The explanation of high inflation was almost always in terms of too high investment demand with the thrust on industrialization in the second five-year plan, the emphasis on heavy industry and neglect of wage goods, and droughts and crop failures. Overall stance of monetary and fiscal policy was not the centre of attention. Inflation in India in the first two decades after independence was, more often than not, explained by droughts, food shortage, or rise in international prices without invoking the possibility of 'too much money chasing too few goods' or the government borrowing too much from the RBI to make both ends meet. Explanation of inflation ran in terms of shortfall in aggregate supply, including, from the 1970s, 'infrastructural bottlenecks' as a factor inhibiting supply.



Source: RBI Handbook of Statistics. Table 143. Key Components of India's Balance of Payments – US dollars

Beyond slow growth, inflation was not the only macroeconomic problem that the country suffered. There was also the ominous and persistent foreign exchange or balance of payments problem. From 1957, balance of payments crises became an endemic feature of the Indian economy (Figures VII). After the Suez crisis in 1956, the country was in the midst of a balance of payments crunch and had to go to the IMF for a stand-by arrangement.[23] Then, rapidly, in quick succession, India had to go to the IMF in 1962, 1963, 1965, 1981, and 1991. Under the permit-quota-license raj, the main reaction of the Government to the balance of payments problem was to impose stringent trade and payments controls. Again, overall stance of monetary and fiscal policy was not the centre of attention, at least in public policy discourse.

The Indian policy approach to macroeconomics, much like in Latin America and unlike in East Asia, was in the structuralist tradition. Let me elaborate with the case of inflation. In the economic literature, the explanation of inflation runs along two distinct, sometimes intertwined, lines. The structuralist explanation delves into the political economy of a country, its ownership structure, the efficiency of investment, agriculture

[23] The country inherited a comfortable balance of payments position at independence because of the Rs. 17.4 billion 'sterling balance'. This was the payment that UK had paid in blocked sterling for the expenditure that Government of India had incurred on behalf of the British government during the Second World War. Indeed, India had balance of payments problems right after independence and approached the IMF for a loan right in 1948 because of UK's difficulties in releasing the sterling balances that it owed to India. It was no longer because of the UK's troubles to meet its own obligations.

and industry, and competition among different groups. The second, termed monetarist, explains inflation in terms of interaction between money and prices. Monetarists have been called 'structuralists in a hurry', because their explanation of inflation seldom goes beyond the proximate or mechanical determinants of money supply to elaborate the fundamental structural forces driving the process.

Take the case of an agricultural shortage. With farm output in short supply, the relative price of farm products has to go up. This relative price adjustment can take place either with all prices rising with agricultural prices rising faster than others, or with agricultural goods' prices rising somewhat while other prices decline. In the first case, there will be an increase in the general price level, while in the second, the general price level may remain unchanged. Which contingency is realised will depend on the stance of monetary policy – or whether it is accommodative or not. Structuralists would argue that with a shortage of farm products, as the price of such goods rise, there will be a natural tendency for money supply to increase to allow producers of industrial good to finance their purchases of farm goods for intermediate use and consumers to buy their needs for final consumption. According to them, money supply will have a tendency to expand and validate a general price increase. If monetarists are structuralists in a hurry, structuralists are those who resign their fate to inflation in the short to medium run.

Like for inflation, the approach to the balance of payments problem was also in the structuralist tradition, and in terms of increase in the price of importables, particularly petroleum, which the country had to import to a large extent, and decline in price or demand for traditional export goods such as jute and tea. If there was a balance of payments problem, cutting down 'excessive' imports through a more restrictive 'permit-quota-license raj' regime was the recommended medicine. There was hardly any focus, at least in public policy discourse, on underlying savings and investment in the economy or fiscal profligacy.

Those who mentioned the possibility of too much investment relative to savings or fiscal deficit being behind the balance of payments crises were dramatically side-lined. The fate of Penderel Moon after crisis of 1956-57 is a case in point. The 1956-57 crisis led to panic as well as acrimony. Penderel Moon, a former British civil servant, was serving at the Planning Commission as adviser. An Oxford scholar and Fellow of All

Souls, Moon had joined the Punjab cadre of the Indian Civil Service in 1928.[24]At the time of independence, he was in the princely State of Bahawalpur (now in Pakistan) as an administrator. After independence, at Prime Minister Nehru's invitation he joined the Planning Commission, and stayed back.

Moon, in his talk broadcast on All India Radio, argued that the steep decline in foreign exchange reserves was due to the increase in import of capital goods stemming from an excessive exuberance in the Second Five Year Plan. He suggested the need for cutting down the ambitious investment targets of the Plan. K. N. Raj was unhappy that Moon, a Planning Commission official, gave the broadcast and misled the people. Raj saw the decline in foreign exchange reserves as a consequence of excessive domestic demand for consumer goods.[25] The rate of investment was already low at only 8 per cent of GDP, and to argue for even lower investment was not the right recipe for the Plan.[26] Raj argued for stricter controls on imports of consumer goods and inessential imports.Moon was perhaps right about the infirmities of the Second Plan. But, he did not win the battle, and soon left India[27]

The 1957 balance of payments crisis also led to acrimony between Finance Minister T. T. Krishnamachari and his predecessor C. D. Deshmukh. The crisis was preceded by a liberalization of import licensing in 1955-56 and an import boom in 1956-57. Deshmukh, who was Finance Minister during 1950-57, claimed that he was "...kept in the dark by the other wings of the government, in particular the Commerce and Industry Ministry, about the liberal import policy." Finance Minister T.T. Krishnamachari, who was earlier in Commerce and Industry, responded to Deshmukh's attack by claiming that ".. the crisis was a result of the Planning Commission's sloppy resources arithmetic, about

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[24] J.L.Mehta: "Advance Study in the History of Modern India, 1707-1813", New Dawn Press Group, USA, 2005, p. xi. Moon's book "Divide and Quit", published in 1961, is considered a very valuable contribution to Indian historical studies. He was friendly with many Indians, including the freedom fighter Rajkumari Amrit Kaur. His correspondence with Amrit Kaur, when she was in prison during the Quit India movement, attracted the ire of his superiors and led him to resign from the Indian Civil Service in 1943. [24] Ramachandra Guha: "A Mask that was Pierced?" The Hindu, April 24, 2005.

[25] K. N. Raj: "Foreign Exchange Crisis and the Plan," Economic Weekly, February 23, 1957. Also, K.N.Raj: "Foreign Exchange Crisis and the Plan —Reply", Economic Weekly, April 6, 1957.

[26] Raj was talking about the net domestic capital formation.

[27] He joined the World Bank and by the 1960s settled in London.In the milieu of the mid-1950s, Moon's chances of success were slim. Ashok Mitra portrayed Moon as "....notorious for his narrow, ultra-conservative attitude towards the problems of development faced by economies emerging from under the dark shadow of prolonged colonialism." Mitra says: "On one occasion, P.C. Mahalanobis tore into him, ridiculed his persistently negative approach and cited him and his like as one major reason for India's chronic under-development." A.M. "Ideology and Friendship", The Telegraph, May 23, 2013. Mitra also narrates how Moon, during the Emergency, in a letter "…extolled Indira and her son's efforts to extricate India from the obnoxious course the country had been forced to take by adhering to the Soviet-inspired designs of Mahalanobis and his associates."

which the Finance Ministry was not consulted", and the former Finance Minister's failed to spot or correct it. The Planning Commission blamed the crisis "..on adverse changes in India's external environment caused by heavy demands for defence, larger food imports, and the impact of the Suez crisis on prices and freight rates."[28]

What seldom got mentioned was the burgeoning gap between government's saving and investment. Let us look at the relationship between the balance of payments and saving-investment balance in a country. Robinson Crusoe, marooned in his island, had to save for whatever he wanted to invest. If he wanted some equipment for catching fish, say a fish net, he had to save enough food for the days it would take him to weave the net.

If Crusoe had trade with some other island, his saving need not have been equal to his investment every year. He could have imported the necessary food on loan and made the fish net without saving for the investment project.[29]Savings need not have equaled investment for a Crusoe with international trade.

A 'closed economy', which is the term economists use for countries like Robinson Crusoe's island, does not interact with other countries and has to satisfy the equality between saving and investment. An 'open economy' – which trade with other countries – does not have to maintain this equality. Its investment can exceed its saving, with the excess matched by an excess of imports over exports. Or, it can save more than what it invests and have the excess reflected in a surplus of exports over imports. The difference between savings and investment in an open economy is reflected in its current account balance, which in turn is reflected in a change in its net claims on the rest of the world. A balance of payments problem crops up in such an economy if its investment exceeds its savings and other countries refuse a build-up in its debt to the rest of the world. That the repeated balance of payments crises in India before 1991 may have had its roots in too much public investment relative to public saving was a possibility that did not get highlighted enough until the reforms of 1991.

[28]RBI: "Dealing with Scarcity", p.627-628

[29]Similarly, In case he had some savings in the form of excess food which he did not want to use for investment purposes – say changing the thatch on his hut – he could have exported the excess food.

PUBLIC SAVINGS AND INVESTMENT, FISCAL DEFICIT AND RBI CREDIT TO GOVERNMENT

The balance of payments problem in the first four decades after independence was seldom looked at as too little saving relative to investment, particularly by the government.[30] The imbalance between exports and imports reflected the sum of the imbalances between savings and investment of the public sector and that of the private sector. By the public sector I mean general government that is the central government, state government and local bodies together with public sector undertakings. The estimates of public sector savings and investment provided by the Raja Chelliah Committee on "Saving and Capital Formation in India 1950-51-1994-95" are plotted in Figure VIII.[31]

The public sector, which was investing 2.7 per cent of GDP over and above what it was saving annually on the average during 1950-51 to 1959-60, started investing 4.4 per cent of GDP over and above what it was saving during 19601-61 to 1969-70, 4.7 per cent of GDP over and above what it was saving during 1970-71 to 1979-80, and as much as 7.4 per cent of GDP over and above what it was investing during 1980-81 to 1989-90. In 1986-87, this excess of public sector investment over savings reached a peak of over 9 per cent of GDP!

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[30] To illustrate, in terms of the basic national income identity between income and expenditure, we can write

$$Y = C + I + G + X - M, \tag{1}$$

where Y is income, C is consumption, I is investment, G is government expenditure, X is exports and M is imports. Rearranging terms, we get

$$X - M = (Y - C) - I, \tag{2}$$

or

$$X - M = S - I, \tag{3}$$

where S is saving. Decomposing savings (S) into public sector savings (S_{pub})and private savings (S_{pvt}), and investment (I) into public sector investment (I_{pub}) and private investment (I_{pvt}), we get

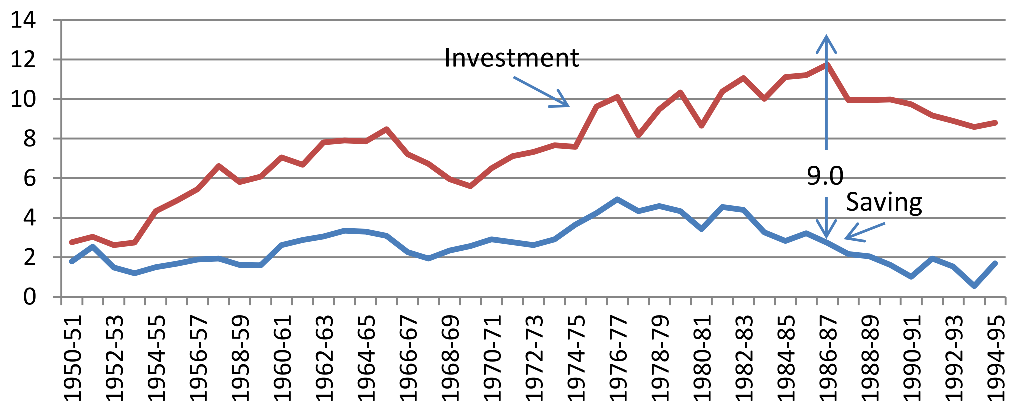
$$X - M = (S_{pub} - I_{pub}) + (S_{pvt} - I_{pvt}) \tag{4}$$

The imbalance between exports and imports reflected the sum of the imbalances between investment and savings of the public sector and the private sector.

[31] http://www.mospi.gov.in/sites/default/files/publication_reports/Chelliah_1995.pdf

Figure VIII. General Government Saving and Investment

As a proportion of GDP, in per cent



Source: Raja Chelliah Committee on "Saving and Capital Formation in India 1950-51-1994-95" http://www.mospi.gov.in/sites/default/files/publication_reports/Chelliah_1995.pdf

This excess of public investment over savings had three important implications. First, the excess of private savings over private investment was not enough to make up for the excess of public investment over public savings and resulted in balance of payments crises. This causality is captured well by Finance Minister Manmohan Singh's Budget speech for 1991-92, where he described the 1991 crisis as "deep" and said "The increasing difference between the income and expenditure of the Government has led to a widening of the gap between the income and expenditure of the economy as a whole. This is reflected in growing current account deficits in the balance of payments. The crisis of the fiscal system is a cause for serious concern."

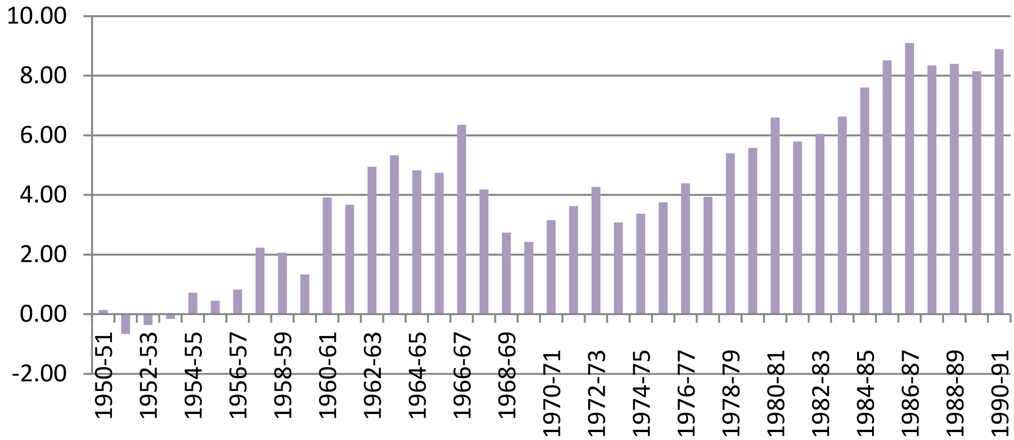
Second, public investment was not paying off. It was yielding little additional public sector income and savings in later years. This was in sharp contrast to China, where public investments, particularly in infrastructure, were paying back rich dividends in terms of higher productivity. The optimism of Prof. Mahalanobis that in 15 years' time surpluses of the public sector would render the need for extra taxation superfluous in the Indian economy was proving to be a chimera.[32] The gross fiscal deficit of the central

[32] See P.N.Dhar (2003): "The Evolution of Economic Policy in India – Selected Essays", Oxford Universiy Press, New Delhi

government, for example, which is its excess of expenditure over revenue receipts, as a proportion of GDP, climbed up from 0.1 per cent in 1950-51 to 8.9 per cent in 1990-91 (Figure IX).[33] Tax revenues and surpluses generated by public sector undertakings were not keeping up with the aggressive expenditure programme of the government.

Figure IX. Gross fiscal deficit of Central Government

as a proportion of GDP (per cent)



Source: Ministry of Finance and RBI Handbook of Statistics.Table 100. Key Deficit Indicators of the Central Government.

Third, government not only resorted to financial repression to preempt funds but also borrowed from the RBI to meet the imbalance between public saving and investment. It pushed money supply up above what was demanded. One of two consequences, or a combination of the two, followed. People tried to get rid of the extra money by spending it and prices went up, that is, there was inflation. Or/or people exchanged local currency for foreign exchange and imported goods and services or held foreign exchange instead of rupees, partly through extra-legal means, and money supply went down. That is, the balance of payments deteriorated and the RBI, India's central bank, lost foreign reserves.

[33]Central Government saving does not equal its revenue deficit figure in its Budget mainly because the Budget treats most of the defence capital outlays and grants for creation of capital assets as revenue expenditure, and the Budget disregards retained profits and depreciation of departmental commercial undertakings.

There is another important relationship between the balance of payments and RBI credit to the government. Look at also how money gets supplied to the economy. Money consists of currency with the public plus deposits with banks. The public has a preference for how much currency it holds relative to deposits. To meet cash withdrawal by depositors and partly also for regulatory requirements, the banks hold a proportion of their deposits as balances with the RBI or as cash in vault. The monetary liabilities of the RBI, which consists of currency with the public, cash in vault of banks, and balance of banks with the RBI, play a critical role in determining money supply. These monetary liabilities of the RBI are called high-powered money or reserve money. It is 'high-powered' because money supply is a multiple of this item because of the preference of the public regarding an optimal currency-deposit ratio and the banks holding a proportion of their deposits in the form of currency.[34]

[34]For the more mathematically inclined, we can look at what is called reserve or high-powered money (H) and the relationship between money supply and high-powered money, and high-powered money and RBI credit to the government ($RBIC_G$).Money (M) consists of currency with the public (C_P) and deposits with banks (D). The public has a preference about how much currency it wants to hold relative to deposits, and let this proportion be c or $C_P = c.D$. Thus,

$$M = C_P + D, \tag{5}$$

which can be rewritten as

$$M = (1 + c)D. \tag{6}$$

Banks also are required to hold a fraction, say r, of the deposits in cash as reserves of banks (R_B) with the RBI or cash with banks (C_B) in vault . Thus,

$$R_B + C_B = rD. \tag{7}$$

High-powered money (H) consists of the monetary liabilities of the RBI, and is given by

$$H = C_P + C_B + R_B, \tag{8}$$

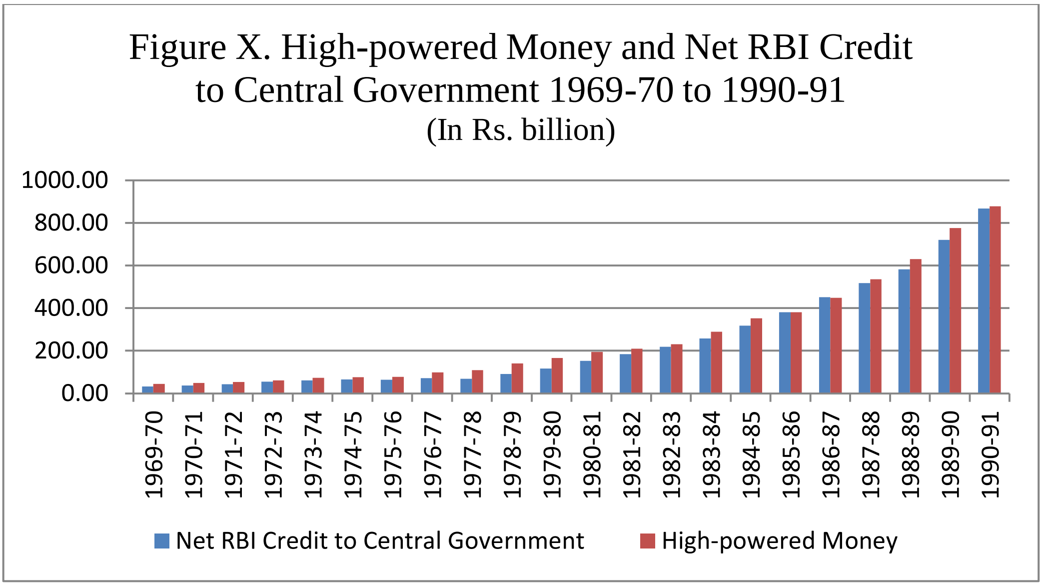
which can be rewritten as

$$\begin{aligned} H &= cD + rD \\ &= (c + r)D. \end{aligned} \tag{9}$$

Combining (6) and (9), we get

$$M = \left(\frac{1+c}{c+r}\right) H \tag{10}$$

or, money supply is a multiple of high-powered money.

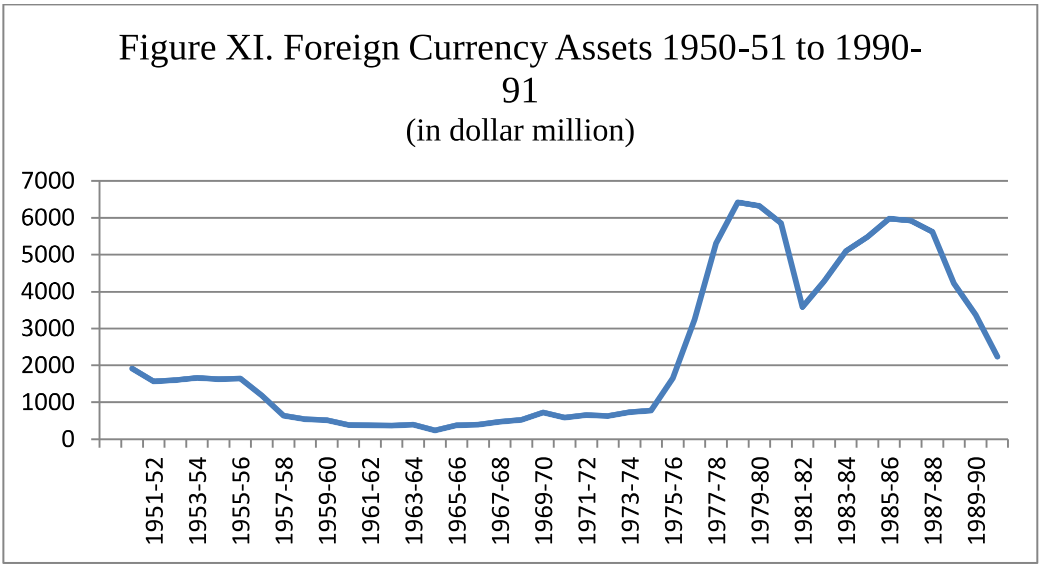


Source: RBI Handbook of Statistics. Table 45. Sources of Money Stock.

Now, think of how the RBI creates high-powered money. It does so by giving loans to the government or banks or the commercial sector, or by exchanging or buying foreign currency for rupees. If the RBI pumps too much high-powered money by giving too much loans to the government, the public will find that it has more money than what it wishes to hold. With the resulting disequilibrium, people will get rid of the excess money in their hands by spending it on goods and services, prices will increase, and with higher prices, people will become willing to hold a higher level of money supply, and/or people will surrender local currency for foreign exchange to buy foreign goods and services and money supply will come down. Too much RBI credit to government will weaken the balance of payments.

Too much money supply because of too much RBI credit to the government results in inflation and balance of payments problems. And, this is what happened during much of the post-independence period up to 1991. Data on RBI credit to the central government available from 1969-70 along with the high-powered money are plotted in Figure X.

Between 1969-70 and 1990-91, RBI credit to the central government accounted for almost 85 per cent of high-powered money. With RBI credit to the central government exhausting the room for expansion of high-powered money, foreign currency assets declined from $1.9 billion in 1950-51 to $1.7 billion in 1975-76, only to grow to $6.4 billion in 1978-79 before declining again to $2.2 billion in 1990-91 (Figure XI).



Source: RBI Handbook of Statistics. Table 157: Foreign Exchange Reserves -- Annual

As is well-known, given the vulnerabilities of the Indian economy, an external shock precipitated a severe balance of payments crisis in 1990-91.Iraq had invaded and occupied Kuwait in August 1990, and to liberate Kuwait, the United States launched Operation Desert Storm by a coalition force of 34 nations on January 17, 1991. The Gulf War, as it is popularly known, got over on February 28, 1991. But, by more than doubling of the price of oil, it had its serious impact on India, a heavy importer of oil. The high price of imported oil impacted inflation and the balance of payments. The balance of payments was also affected by the drying up of remittances from the middle-east and the need to repatriate and rehabilitate 180,000 Indian workers from the war affected zones. A crisis was brewing, and the Gulf war blew the lid. The crisis was so deep that, until the IMF loan materialised, we had to pledge part of our gold and airlift it to the Bank of England to secure foreign loans. Foreign loans had to be raised on a continuous – often on an overnight – basis to avert a default on external debt. India's robust response to the crisis and the story of reforms in 1991 are too well known to repeat in detail.[35] What I want to emphasise here again is the relative neglect of what was done on the macroeconomic front. It is a pity that the 1991 reforms have become synonymous with internal and external liberalisation only. The macroeconomic components of the reform are often forgotten.

My broad brush picture of the public discourse on policies until 1991 given so far unjustly accuses all policy makers of ignorance about the workings of the macroeconomic forces. Admittedly, some policy makers were aware of the macroeconomic malaise, and under pressure of crises, did sometimes act through macroeconomic policy instruments, for example, in 1967-68 and 1974-75. WPI rose by 13.9 per cent in 1965-66 and 11.6 per cent in 1966-67. A vigorous demand management policy was followed in 1967-68 and the rate of growth of high powered money was brought down from 7.6 per cent in the previous two years to 6 per cent in 1967-68.[36] Inflation of 11.6 per cent in 1966-67 was reversed and the economy actually experienced a deflation of 1.2 per cent. Similarly, with inflation at 10 per cent, 20.2 per cent and 25.2 per cent during 1971-72, 1972-73 and 1973-74, the government pursued a vigorous demand management policy. Rate of growth of high powered money was brought down from 22.5 per cent in 1973-74 to 6.6 per cent in 1974-75. As a result, inflation fell rapidly from 25.2 per cent in 1973-74 and turned into a deflation of 1.1 per cent in 1974-75. But such action did not result in sustained reforms on the macroeconomic policy front. This lack of continuity, according to me, reflects the relative neglect of macroeconomic policy issues among the majority who were formulating policies. Reforms of 1991 heralded a welcome change in this approach, but as I argue later, only haltingly.

A WELCOME CHANGE IN POLICY APPROACH TO MACROECONOMIC ISSUES FROM 1991

Prime Minister Narasimha Rao assumed office on June 21, 1991in the midst of a macroeconomic crisis manifested starkly in the dwindling foreign exchange reserves, an

[35] There is a debate about whether the Indian reforms start from 1991 or earlier. For example, Arvind Virmani "Propelling India from Socialist Stagnation to Global Power" (Academic Foundation, 2006) claims that the break-point comes in 1981, after Indira Gandhi abandoned socialist policies. Kaushik Basu (2008): "The Enigma of India's Arrival: A Review of Arvind Virmani's Propelling India from Socialist Stagnation to Global Power", Journal of Economic Literature, Vol 46, No. 2, 2008, pp. 396-406, disagrees with the claim partly because of the unsustainable fiscal policy stance. Some others point out the liberalization attempt by Rajiv Gandhi in 1985, but the process was short-lived and came to a halt in 1987 because of the Bofors scandal.

[36] High-powered money, or base money or reserve money is defined as currency with the public plus currency with banks plus balances maintained by commercial banks with the RBI.

unsustainable balance of payments deficit, and double-digit inflation.[37]The government of Rao and his Finance Minister Manmohan Singh was forced to respond immediately with demand compression, and followed it up with a major shift in India's development strategy, or the 'reforms', including internal and external liberalizations.

One of the first acts of the government was swiftly correcting the overvaluation of the rupee by a two-step 18 per cent devaluation on July 1 and July 3, 1991.[38]Devaluations are well-known for compressing domestic demand, particularly in the short run.[39]The reforms of 1991 contained both structural reforms and stabilization measures, but the description of what was done more often than not emphasizes 'liberalisation', the slew of measures that included the dismantling of the industrial licensing regime, reduction in import tariffs, and removal of quantitative restrictions on imports, and not so much the macroeconomic stabilization measures. What is often forgotten is that 1991 was a macroeconomic crisis and stabilization had to be the first and foremost objective.

The importance of the stabilization or macroeconomic component of 1991 reforms is best captured by what Finance Minister Manmohan Singh said in his Budget Speech on July 24, 1991: "There is no time to lose. Neither the Government nor the economy can live beyond its means year after year. The room for manoeuvre, to live on borrowed money or time, does not exist anymore. Any further postponement of macroeconomic adjustment, long overdue, would mean that the balance of payments

[37] National Council of Applied Economic Research (NCAER) (2001): "Economic and Policy Reforms in India", NCAER, New Delhi, August 2001. P. 2. Inflation (on an end-of-period basis) was in double digits – 12.1 per cent – in 1990-91. Foreign currency assets of the RBI came down to $975 million on July 12, 1991, equivalent to less than a month of import cover.

[38] The rupee was under 'managed float' and tied to a basket of currencies since September 1975. Vis-à-vis the US dollar, the exchange rate of the rupee at around Rs.21.14 per US dollar on June 30, 1991 was clearly unsustainable as manifest in the precarious balance of payments. "Economic Survey, 1991-92, Part II", Ministry of Finance. http://indiabudget.gov.in/es1991-92_B/0%20Economic%20Survey%201991-92_B%20Index.pdf P. 60 "On July 1, the RBI announced a downward revision in the rupee's external value against major foreign currencies. The spot selling rate for the Dollar was raised to Rs 23.04 from Rs 21.14 on June 30. Government officials called the exercise a "realignment" or "downward adjustment" of the Rupee, and Finance Minister Singh assured the media that nothing that was inconsistent with India's national interests had been done. Two days later, on July 3, the RBI announced a second devaluation, taking the Dollar to Rs 25.95." On this day 25 years ago, an invaluable devaluation", Indian Express, July 6, 2016. http://indianexpress.com/article/explained/on-this-day-25-years-ago-an-invaluable-devaluation/

[39] Over time, the command and control regime was ended in the monetary and foreign exchange spheres. Import controls were abolished on July 4, 1991. From March 1, 1992, came the dual exchange rate – a market-determined rate and an official rate -- under the Liberalised Exchange Rate Management System (LERMS). Under LERMS, 60 per cent of all export earnings and foreign exchange receipts were allowed to convert at the market-determined exchange rate and the balance, namely 40 per cent had to be converted at the official rate. A unified exchange rate regime was implemented on March 1, 1993. India achieved current account convertibility from August, 1994. Both foreign direct investment (FDI) and investment by foreign institutional investors (FIIs) were liberalised.

situation, now exceedingly difficult, would become unmanageable and inflation, already high, would exceed limits of tolerance."To deal with the crisis of a potential default on external payments, the new Government "moved urgently to implement a programme of macroeconomic stabilisation through fiscal correction."[40]

The gross fiscal deficit of the Central Government, as a proportion of GDP at market prices, was brought down from 8.9 per cent in 1990-91 to 6.2 per cent in 1991-92 and further to 6.0 per cent in 1992-93. Recourse to the RBI for financing the deficit was also curtailed, and RBI credit to Central Government, as a proportion of high-powered money, declined from 98.8 per cent in 1990-91 to 92.7 per cent, 87.1 per cent and 69.8 per cent in the three following years. The economy responded vigorously – the current account deficit declined from $9.7 billion in 1990-91 to $1.2 billion in 1991-92, and after going up to $3.5 billion in 1992-93, fell again to $1.2 billion in 1993-94. WPI inflation acted a bit stubbornly, after declining mildly from 13.7 per cent in 1991-92 to 10.1 per cent and 8.4 per cent in the two subsequent years, raised its head to 12.6 per cent in 1994-95. But such inflation fell to 8.0 per cent in 1995-96 and 4.6 per cent in 1996-97. Growth of GDP at factor cost at constant prices revived from 1.4 per cent in the crisis year of 1991-92 to 5.4 per cent in 1992-93 and increased steadily to 5.7 per cent, 6.4 per cent and 7.3 per cent in the three subsequent years, to reach 8.0 per cent in 1996-97.

In spite of this remarkable success of macroeconomic stabilization measures, why is there so little discussion of these measures relative to structural reforms in 1991? First, the internal and external liberalization measures simultaneously launched with stabilization fundamentally changed the way India did business. These structural measures benefitted or affected many individuals in a more direct way than the stabilization measures did. Second, these structural measures went against the canons of socialist planning and were controversial to say the least and attracted utmost attention. In fact, the ruling Congress Party's manifesto for the 1991 election had promised the rolling back of prices of items such as diesel, kerosene, salt, edible oils, and cycles and two-wheelers, to levels obtaining in July 1990 in the first hundred days of office.[41] A senior leader, in a press interview on June 20, 1991, had explained that the 'government had some fiscal maneuverability in this regard, as also administrative measures available

[40]Economic Survey 1991-92, Part I, p.11.

[41] Other items were electric bulbs, cotton sarees and dhoti of 40s count or below, stoves including smokeless chulhas, newsprint, postcards, inland letters and envelopes. Jairam Ramesh: "To the Brink and Back – India's 1991 story," Rupa, 2015. P. 29.

to it.'[42] Perhaps what he had in mind was price controls together with tax and subsidy measures. It can be argued that the Narasimha Rao government showed tremendous ingenuity in using the crisis as an opportunity to push through structural reforms that were not absolutely essential to resolve the immediate crisis itself.[43]The push by the IMF helped.

Third, given the lack of conviction that many left-leaning thought-leaders had about the benefits of fiscal prudence and of limited recourse to monetized deficit, there was perhaps an opportunistic bias in not highlighting the stabilization measures and also in the sequencing of the stabilization and structural reform measures. Thus, the Rao government carefully sequenced the announcement of these measures. For example, a day after the second devaluation on July 3, 1991, came the important structural measure of ending the system of import controls with the announcement of a new foreign trade policy.[44]Similarly, on July 24, 1991, the day the Budget was presented at 5 pm, at around 12:50 pm, the minister of state for industry placed the statement on Industrial Policy in the Lok Sabha practically abolishing industrial licensing.[45]

Fourth, it is easy to forget the fundamental role that macroeconomic stabilization measures played in facilitating the liberalization moves. For example, in the financial sector, the gradual removalof financial repression through reductions in statutory pre-emption, such as statutory liquidity ratio (SLR) and cash reserve ratio (CRR), or deregulation of interest rates was possible only because of the progress in fiscal consolidation.

I want to stress that I am not belittling the fundamental nature of the structural reform measures introduced in 1991. I believe that no discussion of macroeconomic policy around 1991 can be complete without an analysis of these structural measures. These measures improved the macroeconomic functioning of the economy in the medium to long term. All I am saying is that the massive changes that the structural reforms brought about in the way domestic production could be organised or external trade could

[42] Times of India interview by Pranab Mukherjee reported in Jairam Ramesh: "To the Brink and Back – India's 1991 story," Rupa, 2015. P. 26.

[43]National Council of Applied Economic Research (NCAER) (2001): "Economic and Policy Reforms in India", NCAER, New Delhi, August 2001. P. 3. Ashok K. Lahiri: "Macroeconomic Policy," in S. Narayan (ed): "Documenting Reforms – Case Studies from India", Observer Research Foundation in Association with Mcmillan India Ltd., 2006.

[44]"July 1991 – the month that changed India," Mint, July 1, 201

[45]The minister was P. J. Kurien. Vinay Sitapati: "Half Lion – How P. V. Narasimha Rao transformed India," Penguin India, 2016. P. 129.

be carried outunfortunately dwarfed the important role that the macroeconomic measures played in stabilizing the economy in public perception and collective memory.

PROGRESS ON THE MACROECONOMIC POLICY FRONT

To give credit where it is due, India has made some progress on the macroeconomic policy front in little more than the last two and a half decades since 1991. In what follows, by government I shall be referring to the Central Government, unless otherwise specified. I focus on the Central Government, because the Central Government plays a predominant role in macroeconomic management of the country.[46] The state governments have large debts to the Central Government, and cannot borrow without the Central Government's permission. The major achievements are; (i) introduction of the fiscal deficit' figure in the Budget document from 1991-92 budget; (ii) the discontinuation of ad hoc treasury bills from April 1, 1997; (iii) the Fiscal Responsibilty and Budget Management (FRBM) Act from July 5, 2004; (iv) Value Added Tax (VAT) from April 1, 2005; (v) implementation of the 4 ± 2 per cent annual inflation-targeting framework for five years by the Reserve Bank of India (RBI) from April 2016;[47] and (vi) implementation of the uniform Goods and Services Tax (GST) throughout the country from July 1, 2017. Let me elaborate a little on a few of these.

It may seem bizarre to some of you young students that until 1991-92, the Budget document of the Central Government did not even report the fiscal deficit figure; what was reported instead was the 'budgeted' or uncovered deficit, which was the excess of total expenditure (both revenue and capital) over total receipts (both revenue and capital). The budgeted or uncovered deficit was the gap between planned expenditure and planned receipts – not only revenue receipts but borrowed funds as well – and indicated little more than how much more funding had to be secured. The best way to forget about any hypertension problem is not to measure your blood pressure.And, it was like a patient having hypertension who does not even measure her blood pressure! The switch from budgeted deficit to fiscal deficit followed the recommendation to this effect by the Committee to Review the Working of the Monetary System – more popularly

[46]Out of the consolidated Rs. 22,028.86 billion tax revenues of the Centre and States combined, the Centre's tax revenues were almost 62 per cent at Rs. 13,594.74 billion in 2014-15.

[47] Upon the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework Report (January 2014), the subsequent Agreement on Monetary Policy Framework by Government of India and RBI on February 20, 2015and the amendment of the Reserve Bank of India Act in May 2016 paving the way for the adoption of flexible inflation targeting framework for monetary policy and the constitution of a Monetary Policy Committee.https://www.rbi.org.in/scripts/PublicationsView.aspx?id=17393

known as the Chakravarty Committee – in April 1985. No, it did not come immediately. It came six years later in 1991-92, when the poor fiscal deficit finally found its place in the Union Government's Budget.

Second, imagine having a bank that can print currency notes and being able to take as much of it as you want, whenever you want! That was more or less the privileged situation for the Central Government until 1997. For its cash-flow problems, the government had and has recourse to a very special bank, the RBI. Unlike your and my bank, the RBI can print currency![48]Before April 1, 1997, the Union Government was free of any 'cash problem.' Whenever the cash balance of the government fell below an agreed minimum, the government account was replenished by automatic issue of the government's ad hoc treasury bills.[49] In due course, these ad hoc treasury bills, which were intended to be an instrument to finance short-term cash deficit, turned out to be a means of building up a staggering debt with continuous roll-over and accumulation of these T-Bills. From April 1, 1997, the system of such ad hoc T-Bills was discontinued.[50]

Third, every year, Parliament, duly elected by the people, had been deliberating on the annual budget and voting on every rupee of expenditure by the government.[51]When expectation that government finances thus would be managed responsibly was belied by the experience of more than half a century, Parliament passed the FRBM Act (FRBMA)to tie its own hands, at least in a symbolic way. After receiving Presidential assent, FRBMA became an act on August 26, 2003. According to its preamble, the FRBMA seeks to achieve long-term macroeconomic stability, by embedding fiscal management in a medium-term framework of generating budget surpluses and managing public debt prudently.[52]This related only to the Central government. The

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[48] Under Section 22 of the RBI Act, 1934, the RBI has the sole authority to print currency notes.

[49] With an exchange of letters between the RBI and the Government in January 1955, it was decided that the Government shall maintain with the RBI a cash balance of not less than Rs.50 crore on Fridays and Rs.4 crore on other days and whenever the balance in the Government account falls below the minimum agreed to, the account will be replenished by the creation of *ad hoc* Treasury Bills in favour of the RBI. .

[50] This followed the agreement between the RBI and the Union Government on September 9, 1994. The old system was replaced by ways and means advances within specified limits and with fresh floatation of government securities once 75 per cent of the ways and means advances were drawn. https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=18556

[51]This excludes some 'charged items' such as the President's salary and interest payments.

[52]It stated that the Centre will take appropriate measures to eliminate revenue deficit by March 31, 2008. The NDA government under Atal Bihari Vajpayee, which had been in power since October 13, 1999, dissolved the 13th Lok Sabha ahead of its full term on February 6, 2004. The FRBM Rules were notified by the first UPA government on July 2, 2004 and came into force on July 5, 2004. While notifying the Rules, the FRBMA was amended to postpone the date for elimination of the revenue deficit from end-March 2008 to end-March 2009.

Indian states, saddled with considerable debt, also needed a dose of fiscal discipline. The Twelfth Finance Commission headed by Dr. C. Rangarajan, in its report submitted on November 30, 2004, recommended debt relief to the states subject to the states enacting their FRBM legislation.[53] The states soon passed their FRBM Acts.

The fourth reform, namely replacement of the sales tax at the state level by the Value Added Tax (VAT) from April 1, 2005, is well-known to you all, and I will not repeat the details. This was an important milestone of progress in macroeconomic policy.[54]

Fifth, a little less than a year and a half ago, there was a clear specification of policy priority for the RBI. The RBI website states that the core purpose of the RBI is "to foster monetary and financial stability conducive to sustainable economic growth and ensure the development of an efficient and inclusive financial system." RBI's mission as far as monetary policy is concerned was far broader than a narrow focus on inflation alone and involved 'a multiple target-multiple instrument approach.' However, given that inflation in India from the year 2000 was among the highest in G-20 countries, from mid-2016, RBI has moved to a new Monetary Policy Framework with a statutory and institutionalised Monetary Policy Committee framework and an annual inflation target for the five years ending on March 31, 2021 of 4 ± 2.per cent.[55,56]

[53]The 12th Finance Commission submitted its report on November 30, 2004 and also provided an incentive for early enactment by making the debt relief available prospectively when the FRBM legislation is enacted.

[54] All states introduced VAT on April 1, 2005, except Chattisgarh, Gujarat, Jharkhand, Madhya Pradesh and Rajasthan, which introduced it on April 1, 2006, Tamil Nadu on January 1, 2007, Puducherry on July 1, 2007 and Uttar Pradesh on January 1, 2008. VAT is a non-cascading, multilevel tax on goods with credit provided for the taxes paid at earlier stages. The VAT system also introduced some uniformity in the structure of taxation across states. There were 2 basic rates of 4% and 12.5%, besides an exempt category and a special rate of 1% for a few selected items. There was also a category with 20% floor rate of tax, but the commodities listed in this schedule were not be vatable. It is also pertinent to mention here that States had been given the flexibility to select 10 items each as "goods of local importance", which could be put in the 0% or the exempted schedule. It may be recalled that the central excise duty, which dated back to at least the 1920s, used to operate as a gross turnover tax was transformed into MODVAT in 1986 with set-off for taxes paid on inputs at earlier stages, but only for a few select commodities. Tax on selected services and tax credit for selected capital goods came in 1994-95, and was extended over time. Though MODVAT was renamed CENVAT in 2000-01 with some rate rationalisation and set-off for all capital goods, input tax credit across goods and services was also allowed only from 2004-05.

[55] The Expert Committee to Revise and Strengthen the Monetary Policy Framework in its report in January 2014 recommended a flexible inflation-targeting framework. An "Agreement on Monetary Policy Framework" was reached between the Government of India and the RBI on February 20, 2015 adopting this flexible inflation-targeting framework. The RBI Act, 1934 was amended by the Finance Act, 2016, to provide for a statutory and institutionalised framework for a Monetary Policy Committee, for maintaining price stability, while keeping in mind the objective of growth.https://www.rbi.org.in/scripts/PublicationsView.aspx?id=17393

[56]The Monetary Policy Committee was entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level. The provisions of the RBI Act relating to Monetary Policy were brought into force through a gazette notification on June 27, 2016 and the annual inflation target for the five years ending on March 31, 2021 of 4 ± 2.per cent was notified on August 5, 2016.http://pib.nic.in/newsite/PrintRelease.aspx?relid=151264

Sixth is the full integration of services in the indirect taxation framework and introduction of the nation-wide goods and services tax (GST) from July 1, 2017.[57]GST is a tax reform of unparalleled importance in India – it integrates goods and services under a uniform taxation system, and subsumes as many as eight central and nine state taxes under it, and by introducing uniformity across states and through the levy of integrated GST (IGST) facilitates inter-state trade in goods and services.

VULNERABILITIES – MUCH TALK, UNEVEN PROGRESS

So, despite these impressive reforms on the macroeconomic front, why do I say that vulnerabilities remain? I say that because, despite the rhetoric, there is uneven progress on the macroeconomic front. The relative neglect of macroeconomic issues since independence, which we have already discussed, continues with the deficit bias of Indian democracy. Furthermore, some remain unconvinced about the need for any fiscal consolidation, particularly because of its deleterious effect on 'development expenditure' and some others continue to think that the rates of interest are too high and need to be brought down by the RBI by loosening monetary policy.

First let us look at the uneven progress since 1991. Progress on the macroeconomic policy front stalled half-way through the Narasimha Rao's government's tenure. Central government's gross fiscal deficit, which as a proportion of GDP at market prices, had been brought down from 6.4 per cent in 1990-91 to 4.6 per cent in 1992-93 was back at 6.2 per cent in 1993-94 (Figure XII).[58,59,60] It declined thereafter to reach 4.1

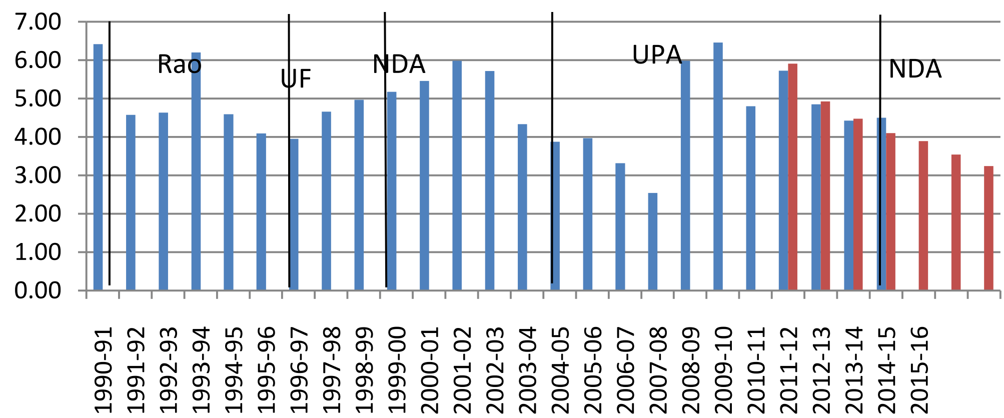
[57]The issue of who can levy a tax on services was not explicitly mentioned in the Constitution. With services excluded from the domain of indirect taxation, the increasing share of the services sector in GDP had an adverse effect on the indirect tax-to-GDP ratio in the 1970s and 1980s. Half-way through the Narasimha Rao government's tenure, the service tax got introduced in a limited way from July 1, 1994. Under the residuary entry No.97, List I in the Seventh Schedule of the Constitution, three services – telephone services, stock-broking and general insurance – were brought under a new tax, called service tax, in 1994-95. The list of such services that are taxable rapidly expandedfrom just three services to 18 in 2006-07,and 46 in 2011-12. Rather than specifying which services are taxable, Finance Act 2012 inserted Section 66D in Finance Act, 1994, providing for a negative list of services on which service tax is not leviable.The list of negative services was **notified to be effective from July 1, 2012vide** Notification No. 19/2012-ST dated 5 June 2012..

[58] The fiscal deficit shot up because of an increase in the Plan outlay, higher than budgeted interest payments and optimistic revenue projections in the 1993-94 Budget. Some observers had pointed out the unrealistic nature of the Budget estimates as early as April 1993. A. Viadyanathan: "Budget of 1993-94 – Some Sceptical Notes," Economic and Political Weekly, Vol. 28, No. 15, April 10, 1993. Pp. 709-711.

[59] The new GDP series with base 2011-12 is available from 2011-12, while the old series with base 2004-05 is available only until 2013-14. The bars are shown in blue when the denominator is GDP with base 2004-05, and in red when the base is 2011-12. The bars available in both colors for the period 2011-12 to 2013-14 indicate that the fiscal deficit as a proportion of GDP is about a tenth less when the new series is taken as the denominator.

per cent in 1995-96, the last full year of the Rao government.[61] In the period of unstable politics thereafter during June 1996 to April 1999, under two United Front (UF) governments and a short-lived National Democratic Alliance (NDA) government, gross fiscal deficit of the Central Government, as a proportion of GDP, climbed up to 5.2 per cent in 1998-99.

Figure XII. Gross fiscal deficit 1990-91 to 2014-15
as a proportion of GDP, in per cent



Source: For fiscal deficit, Ministry of Finance: Public Finance Statistics 2015-16, Table 4.3 http://dea.gov.in/sites/default/files/IPFS%20English%202015-16.pdf and Budget 2018-19, http://www.indiabudget.gov.in/ub2018-19/bag/bag1.pdfand RBI Handbook of Statistics.Table 1 for GDP at current market prices, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications.

An NDA government came to power after the election of 1999 and realized that there was a need to move to a rule-based, transparent and predictable fiscal policy framework. It introduced the FRBM Billin 2000. The bill took three years to get passed by Parliament and become the FRBMA, 2003. In the process, some claim that the Act's teeth were removed. The explicit annual targets, as a proportion of GDP, for reduction of

[60] In 1999-2000, there was a change in the treatment of the share of small savings made available to state governments. Before that year, such loans were intermediated by the Centre and showed up as a Central Government liability. Following the R. V. Gupta Committee Report, the National Small Savings Fund (NSSF) was set up, and states' shares of fresh small savings were disintermediated. Fiscal deficit figures for 1990-91 to 1998-99 have been adjusted for states' share of NSSF.

[61] Narasimha Rao resigned as Prime Minister on May 10, 1996. After Rao's caretakership, a United Front (UF) government headed by Deve Gowda came to power on June 1, 1996.

fiscal (0.3 per cent) and revenue deficits (0.5 per cent) were eliminated from the legislation. The Act simply stated that the Centre will take appropriate measures to eliminate revenue deficit and contain the fiscal deficit as a proportion of GDP below 3 per cent by March 31, 2008.[62] Annual numerical targets were left to the government to formulate in the FRBM Rules under the delegated authority of the FRBMA.

The NDA government that got the FRBMA passed did not last to promulgate the Rules. United Progressive Alliance (UPA) came to power after the general election of 2004, and by winning the next general election in 2009, continued in office for a second term. Under the first UPA government, the FRBM Rules came into force from July 5, 2004. While notifying the Rules on July 2, 2004, an amendment to the Act was passed for a one-year postponement of the target year for eliminating the revenue deficit to 2008-09. Before the ink on the FRBM Act was dry, the Finance Minister, in his Budget Speech for 2005-06, pressed the pause button vis-à-vis the FRBM Act because of the drastically changed pattern of devolution and funding recommended by the 12th Finance Commission. In March 2005, Shankar Acharya published an article in this newspaper entitled "Farewell fiscal responsibility?"

What followed indeed looks like a farewell to fiscal responsibility. The FRBM path of fiscal correction was halted from 2008-09 because of unanticipated changes in the prices of fuel and fertiliser. Outlays on major subsidies shot up from Rs 67,498 crore in 2007-08 to Rs 1,23,581 crore in 2008-09. Off-budget bonds issued to the petroleum and fertiliser companies amounted to a further Rs 95,942 crore or 1.8 per cent of GDP in 2008-09. On August 28, 2008, the central government asked the 13thFinance Commission to lay down a revised road map for fiscal consolidation.

With elections for the 15th Lok Sabha scheduled for April-May, 2009, an Interim Budget for 2009-10 followed on February 16, 2009. A new Finance Minister, in office for only three weeks, called the economic circumstances extraordinary and announced extraordinary measures. The FRBM targets were relaxed to boost demand and counter the impact of the global financial meltdown. Post-election, the Budget for 2009-10 presented on July 6, 2009, included a fiscal stimulus package. Between 2008-09 and 2009-10, as a proportion of GDP, the fiscal deficit shot up from 6.0 per cent to 6.5 per

[62] FRBM Act and Rules also had the objectives of limiting guarantees within 0.5 per cent of the GDP in a financial year, to limit additional liabilities (including external debt at current exchange rate) to 9 per cent of GDP in 2004 exchange rate) to 9 per cent of GDP in 2004 -05, 8 per cent of GDP in 2005 06, 7 per cent of GDP in 2006 2007 etc and not to borrow directly from the RBI with effect from April 1, 2006.

cent, with an even bigger increase in revenue deficit from 4.5 per cent to 5.2 per cent. Of course, the medium-term commitment to fiscal consolidation and a return to the FRBM targets at the earliest were reiterated.

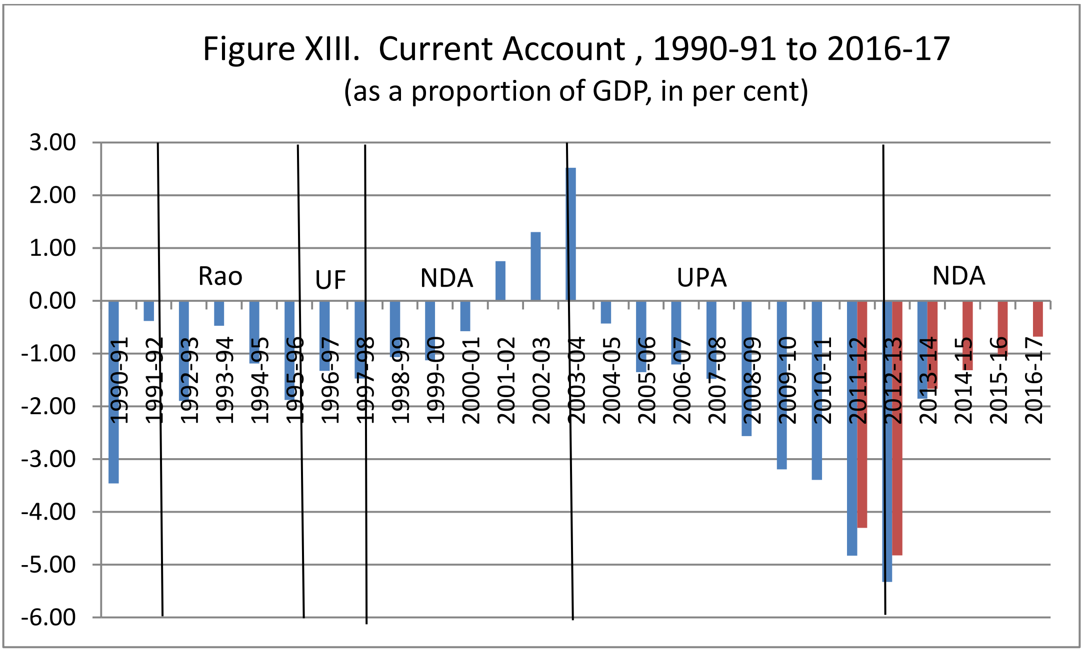
In the context of FRBM, the 13thFinance Commission, in its report submitted on December 29, 2009, argued against disturbing the existing classification of revenue and capital expenditure in an ad hoc manner. Yet, in what was described as the "Godzilla of all fudges played out in this country in the guise of fiscal consolidation", Budget 2011-12 quietly introduced the concept of "effective revenue deficit." It is the revenue deficit adjusted for grants to states for asset creation. The Budget of 2012-13 went farther. Through the Finance Act, known for its missile-like efficiency for getting passed without elaborate discussion or amendments, it changed the FRBM Act itself. The Centre's commitment to eliminate its revenue deficit was dumped for the elimination of the tenuous concept of "effective revenue deficit".[63] The amended FRBM Rules of May 7, 2013, stretched the time for its elimination by six years to March 31, 2015, and for bringing the fiscal deficit down to three per cent of GDP by eight years to March 31, 2017.In 2018-19, as a proportion of GDP, the budget estimate of revenue deficit of the central government continues to be far above zero at 2.2 per cent!The Finance Bill currently in Parliament removes the elimination of revenue deficit as a target and stipulates the target date for containment of fiscal deficit below 3 per cent of GDP to March 31, 2021.

With ups and downs in fiscal consolidation, how did the country perform on the balance of payments, inflation and growth front? While the country avoided any crisis requiring recourse to exceptional balance of payments support, the current account deficit was at $78 billion and over $88 billion in 2011-12 and 2012-13, respectively. At over 5 per cent of GDP in 2012-13, it did look ominous (Figure XIII).[64] In spite of buoyant capital inflows, the country lost foreign currency reserves of over $14 billion during 2011-13. In 2013, when there was talk of the Federal Reserve tapering off the quantitative easing it had done after the financial meltdown in 2008, a Morgan Stanley analyst put India, together with Brazil, Indonesia, South Africa and Turkey, as the 'fragile five' emerging economies who were dependent on foreign investment flows and affected adversely. There were concerns that these five would display 'taper tantrums'! India did

[63]Fortunately, the Finance Bill 2018 removes the "effective revenue deficit' as a concept from the FRBM bill.

[64] The new GDP series with base 2011-12 is available from 2011-12, while the old series with base 2004-05 is available only until 2013-14. The bars are shown in blue when the denominator is GDP with base 2004-05, and in red when the base is 2011-12. The bars available in both colors for the period 2011-12 to 2013-14 indicate that the current account deficit as a proportion of GDP is about a tenth less when the new series is taken as the denominator.

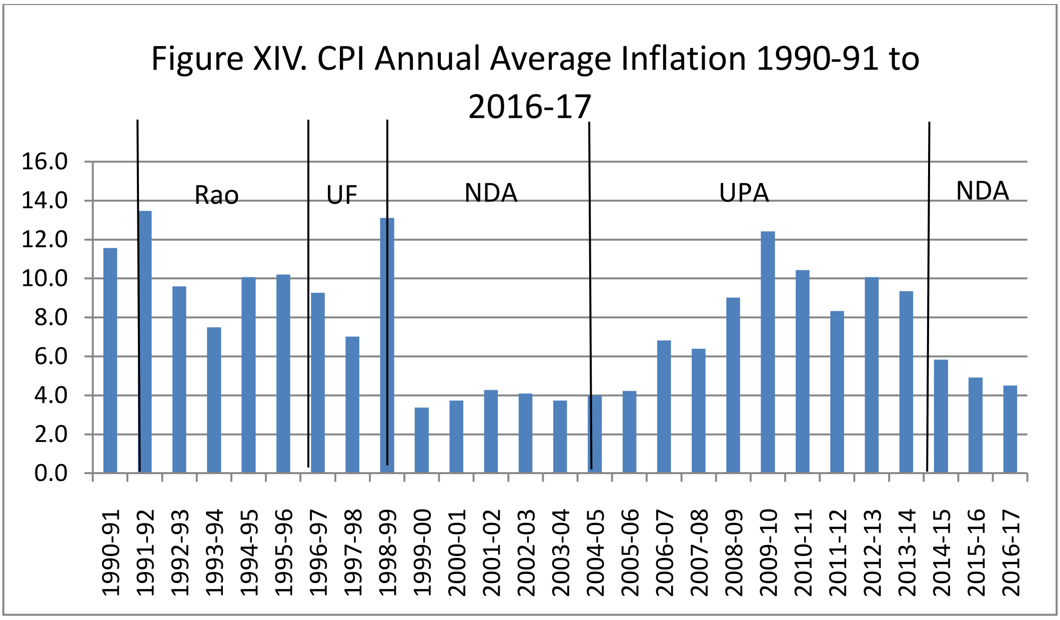
display some tantrums in the form of a steep loss of value of the rupee vis-à-vis the US dollar during the year, but came out more or less unhurt in the end.



Source: RBI Handbook of Statistics. Table 1. Macroeconomic Aggregates (at current prices) and Table 144. Key Components of India's Balance of Payments – Rupees.

On the inflation front, it has been a rough ride (Figure XIV). In terms of CPI, during the twenty seven years of 1991-2016, that is post-1991 reform but before the adoption of the inflation-targeting monetary policy framework, inflation was in double digits in 7 years, above 6 per cent in 16 years, above 5 per cent in 17 years and above 4 per cent in 21 years.[65]

[65] CPI inflation has been calculated from CPI-Industrial Workers (IW) base 1982=100 for the period 1990-91 to 2006-07, from CPI-IW base 2001=100 for the period 2007-08 to 2011-12 and from New CPI Combined, base 2012=100 for 2012-13 to 2016-17. I choose 4, 5 and 6 per cent as the cut off because of the inflation target of 4 ± 2 per cent fixed under RBI's annual inflation-targeting framework for five years from April 2016



Source: RBI Handbook of Statistics, Table 41.

CONCLUSION

Let me conclude by saying that since the launch of the 1991 reforms, India has avoided any macroeconomic crises that were more or less a regular feature of the economy since 1956. However, the economy has demonstrated persistent vulnerabilities in the form of bouts of high inflation and current account deficits. A rule-based, transparent and predictable macroeconomic policy framework has a lot to commend itself in India. This may seem counter-intuitive as target dates for containing the fiscal deficit of the central government to below 3 per cent of GDP under FRBM have come and gone, only to be pushed back several times.[66,67] It has been a history of shifting goal-posts and bypassing

[66] "The Union Government's FRBM Act came into effect in August 2003. It was amended in July 2004. Rules were modified twice over the years and were breached in practice. The conventional rule, as understood, of financing current expenditure by current revenue was discarded and an artificial concept of effective revenue deficit was introduced in the statute in 2012. We note that FRBM Rules in conducting the stated fiscal policy correction or fiscal adjustment path, as recommended by the FC-XIII, have not been effective, in the absence of hard budget constraints and any cost of non-compliance for the Union Government except for a threat of downgrade by sovereign rating agencies." 14th Finance Commission Report, p. 197.

[67] i) 2004 while notifying the rules, target date changed from March 31, 2008 to March 31, 2009; ii) 2005-06 Budget paused the adjustment for 2005-06; iii) 2008-09 Budget pushed the target for elimination of revenue deficit to March 31, 2010; iv) Interim Budget 2009-10 deviated from the stipulated FRBM path because of the Great Recession; v) Budget 2009-10 deviates further from the stipulated FRBM path; vi) Budget 2010-11 continues with deviations from FRBMA Rules path as well as path recommended by the 13th Finance Commission; vii) Budget 2012-13 postpones target date indefinitely and FRBMA amended in by Finance Bill in May 2012 introducing 'effective revenue deficit' and

of the Act and Rules in spirit. So, the question is: is there merit in continuing with such a rule-based policy framework such as the FRBMA and RBI's annual inflation targeting framework?

In this context, it is instructive to recall what the Report of the Parliamentary Standing Committee on Finance, chaired by Shivraj Patil, in December 2000, had to say about the FRBM Bill of 2000. It said that planned deficit financing of government expenditure is useful as long as it creates productive assets. It argued against numerical ceilings and time frame for consolidation in the Act itself as it would "…induce excessive rigidity into the decision making depriving the Government of the flexibility needed to respond to the exigencies in an appropriate manner, to serve the national interest best." In a dissent note, two communist members argued "The objective of this Bill is to impose some self-discipline on the government on fiscal matters. But this is no more than an eyewash (sic). If the government has the required political will to control deficit, then it does not need any legislation. If on the other hand, it lacks political will in this matter, no amount of legislative self-discipline would work."[68]

It is important to emphasise three points in this context. First, what is needed is not zero fiscal deficit. Some deficit for creating assets should be welcome as long as productivity clearly rises in response. But, not an excessive fiscal deficit that is inconsistent with macroeconomic stability. Exigencies will arise and the government will need to respond to downturns and demand recessions with fiscal stimulus. But there needs to be restraint in normal times. Exhausting the fiscal space by expansionary stance even in relatively normal years leaves a government with little elbow room to respond by a stimulus package without jeopardising macroeconomic stability, when a demand shortfall actually arises.

Second, legislature consisting of the elected representatives of the people will, and should, have the power to formulate laws and change them at their discretion. The durability and success of fiscal rules ultimately depend on popular support for such rules. Pursuit of a virtuous rule, even when diluted, leads to mobilisation of popular support. In

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a revised fiscal adjustment path of achieving fiscal deficit of 3 per cent of GDP by 2016-17 and reducing revenue deficit to below 2 per cent of GDP by 2014-15; vii) 14th Finance Commission recommends new path for reducing revenue deficit to 0.93 per cent of GDP by 2019-20 and achieving fiscal deficit of no more than 3 per cent of GDP by 2016-17; viii)

[68]The two members were Biplab Dasgupta and Prabodh Panda.http://www.thehindu.com/todays-paper/tp-business/twists-and-turns-in-fiscal-responsibility-act/article8349958.ece

the 1950s and 1960s, there were only lonely voices of economists such as B R Shenoy against fiscal profligacy. With the FRBMA, there is now a larger constituency against fiscal excesses.

Third, despite the slippages, there seems to have been some limited progress in fiscal consolidation since FRBMA was enforced in 2004. Fiscal deficit as a proportion of GDP came down from the previous year's level in six out of first thirteen years of the post-reform period before the enforcement of FRBMA that is between 1991-92 and 2003-04 (both inclusive). The same deficit ratio declined in nine out of the thirteen years after the enforcement of FRBMA. Furthermore, there has been a lot more discussion about fiscal slippages, including explanatory statements by the government. I do not comment on RBI's inflation-targeting framework because of the short time-span that has elapsed since its introduction in April 2016. But indications are that rewards are already flowing from its introduction.

Fourth, there is a consensus that, with so much poverty, unemployment, infrastructural deficit and lack of education and health care facility in India, government needs to spend more and spend wisely. What is needed for this is not deficit-financed expenditure, but more revenues for financing the expenditure without triggering inflation or balance of payments problems. Having a rule-based fiscal policy regime, without shifting goalposts and bypassing of its spirit, will enhance the priority attached to revenue enhancement and open up avenues for augmenting development outlays without threatening macroeconomic stability.

Fiscal consolidation is like quitting smoking. Not easy. A minority of smokers are in denial of the deleterious health effect of smoking; they quote the cases of celebrities like Sir Winston Churchill. Churchill smoked heavily and yet survived until the ripe old age of 90. Most smokers recognise smoking as injurious to health, and want to quit, but, not now and here. There are short-term costs in the form of withdrawal symptoms, frayed tempers and mood swings. Similarly, a few politicians and policy makers deny the need for fiscal consolidation; the rest want fiscal consolidation; but only in the medium term, not the current year. Taxes are painful, and cutting expenditure hurts some constituency. Finally, not consolidating this year, like continuing smoking for another day, does not have immediate disastrous consequences. What we should take heart from is that, after multiple attempts, just as many smokers have quit the habit, many countries have achieved fiscal consolidation.

Democracies are also known to have a 'deficit bias.' Public expenditure benefits specific groups, and it is easier for specific groups, such as the farmers, industrial workers or public servants, to get organised than the people as a whole. Thus, politically, support for more expenditure on specific items is easier to mobilise than the opposition to increasing deficits. The deficit bias problem of a democracy is logically quite similar to the 'tragedy of the commons' observed in marine fisheries or public grazing lands. If a farmer puts more cows on her grazing field, her cows will have less fodder to feed on the following day. But if she puts more cows on the 'common' land belonging to everyone in the village, the loss of what her cows eat today is shared by all the villagers whose cows graze on the commons. The benefits of targeted spending accrue entirely to the target group today, but everyone in the future shares the costs in terms of higher taxes or lower spending.

Researchers have also found that parliamentary and proportional democracies have greater government spending than presidential forms. They suggest that "A new majoritarian and presidential democracy cuts government consumption by almost 2 percent of GDP, while a new parliamentary democracy raises it considerably. The difference in spending between the two forms of government is a highly significant 5 percent of GDP"[69]Independent India with a parliamentary democracy has validated the pattern.

There appears to be strong evidence that high fiscal deficit and large recourse by the government to credit from the RBI leads to inflation or balance of payments difficulties or both. Sometimes it happened not immediately, but with a lag. It is erroneous to argue that high deficits and monetisation of such deficits do not matter. The successful countries in East Asia have achieved miraculous growth with macroeconomic stability not by resorting to high fiscal deficits but by containing them at prudent levels. There are no known examples of successful developing countries with sustained, high fiscal deficits. The country now has rule-based, transparent and predictable frameworks for fiscal and monetary policies. Let us persevere with them, plug the loopholes as and when they arise and provide the country with macroeconomic stability so essential for rapid growth and poverty alleviation.

Thank you.

[69]Torsten Persson and Guido Tabellini Source: "Democracy and Development: The Devil in the Details," The American Economic Review, Vol. 96, No. 2 (May, 2006), pp. 319-324. P. 322.

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