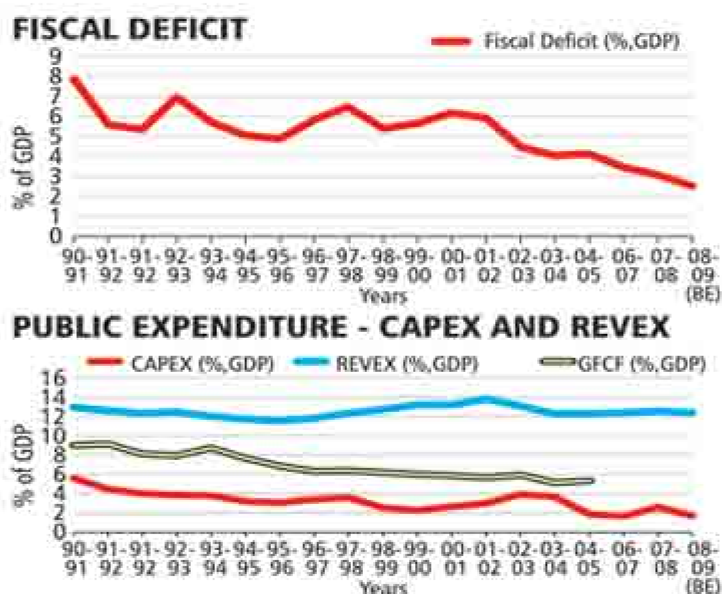
Subir Gokarn: Fiscal spillovers

Subir Gokarn | New Delhi June 30, 2008 Last Updated at 00:00 IST

The true fiscal deficit, already above the 2.5% estimated in the Budget for 2008-09, will increase.

There is a view that the current macroeconomic instability does not really threaten the long-term growth prospects of the Indian economy. The feeling is that, once we have managed to get inflation under control, things will just get back on track. A distinction is made between the factors driving the "trend" rate of growth, which is comfortably in the 8-9 per cent range, if not higher, and the "cyclical" nature of the current disruption, which, after an uncomfortable few months, will normalise.

This is not an unreasonable view. Business cycles do not typically affect the long-term performance of the economy. The policy responses to short-term instability are well-understood and should do their bit without significantly impacting on the trend. However, an opposing view also has to be considered. Certain kinds of policy responses to cyclical movements may, in fact, change the landscape enough to influence long-term prospects. If perceptions about the future are changed by these responses, investment decisions, in particular, will be impacted, which, in turn, will affect the trend rate of growth.



Of the various threats that the Indian economy has to deal with in sustaining a high-growth path, the abysmal condition of its infrastructure is at or close to the top of the list. Years of high growth have exacerbated the problem, with the supply of infrastructure simply unable to keep pace with surging demand. Policies to facilitate private investment have been initiated, but most sectors are in the very early stages of attracting private investment and the macroeconomic benefits of this process are still years away.

Further, even as private investment increases, it is unlikely to ever become a complete substitute for public investment. It was, essentially, this recognition that placed public investment in a central position in the fiscal reform strategy. The Fiscal Responsibility and Budget Management (FRBM) Act of 2003 permitted the central government to borrow up to 3 per cent of GDP to spend on capital formation. Fiscal reforms at the state level also mandate that governments can only borrow in order to create assets.

While the UPA government formally committed itself to the FRBM objectives, over the past year, its commitment has come unstuck. Its use of fiscal measures to deal with the rising global prices of oil and fertilisers has clearly reversed the process of fiscal consolidation and the time-bound convergence with the FRBM targets. With the quantum of oil and fertiliser bonds assuming alarming proportions in the second half of last year, the Finance Minister brought the issue out into the open in his Budget announcements last March.

However, even though these bonds, strictly speaking, represent borrowing by the government and should therefore be counted in the fiscal deficit, the Budget estimates kept them out. The only circumstance in which

this could be justified is if the borrowings were short-term in nature, being repaid within the fiscal year. Given subsequent movements in the global prices of these two commodities, it is pretty obvious that not only will that not happen, but the magnitude of these sources of borrowing will increase further. This highlights the limitations of subsidies, which is what the bonds are being used to finance, in dealing with a supply shock that persists for any length of time.

As a result of this, the true fiscal deficit, already above the 2.5 per cent estimated in the Budget for 2008-09, is only going to increase further. Several analysts see a return to the bad old fiscal days when the combined central and state deficits exceeded 10 per cent of GDP. In a press release last week, Standard & Poor's and CRISIL estimated the central government's fiscal deficit in 2008-09 to be 6.2 per cent of GDP and the combined central and state deficit to be 8.7 per cent of GDP "" not as pessimistic as some forecasts, but clearly indicating a sharp reversal away from the FRBM objectives.

This is where concerns about the links between short-term policy responses and long-term growth performance arise. The basis of these concerns is the way in which the central government dealt with mounting fiscal pressure. As the figure on top in the adjacent space shows, over the period beginning 1991, the central government has generally moved towards a lower fiscal deficit, although the movement has not always been smooth. It is only in the past few years that the trend has been reinforced, but as was pointed out above, when the oil and fertiliser bonds are brought into the picture, there has been a reversal in the last couple of years.

The figure below shows how the fiscal deficit was narrowed. Clearly, it was much easier to do it by reducing capital expenditure than by squeezing revenue expenditure. While the latter (as a percentage of GDP) has remained relatively steady, the former has been in steady decline, with the exception of a brief period earlier this decade when the highway development programme was at its peak. Strikingly, Gross Fixed Capital Formation (GFCF) by the public sector, reflecting total capital expenditure by all levels of government and the public sector, also shows a steady decline. There is little doubt that this is the root of the yawning gap between demand for and supply of infrastructure.

The question is whether this history will repeat itself. As the pressure on the government to rein in the fiscal deficit mounts, will it take the easy way out and place the burden on capital expenditure? Given the various rigidities in revenue expenditure, of which interest payments and salaries are a large component, there is a high likelihood of this happening. Of course, one could argue that, unlike in the past, private investment is in a far better position to step in and fill the breach. But, we cannot delude ourselves into believing that it will provide an adequate offset. The rationale for allowing the government to run a fiscal deficit to finance capital expenditure is enduring.

While there are other linkages to worry about, to my mind, the fiscal constraint poses significant risk to rapid growth. The prospect of shrinking public commitments to infrastructure will unquestionably change the investment climate for the worse. Unfortunately, there is a stark trade-off between the use of subsidies to suppress current inflation and the ability to sustain, leave aside increase, public capital expenditure, which is so critical to sustaining high growth. Long-term performance is clearly not insulated from short-term policies.

The writer is Chief Economist, Standard & Poor's Asia-Pacific. The views are personal