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A Thought for Today

I will pray for that concord among people at home by which Devas do not separate nor ever hate each other.

ATHARVAVEDA

Budgetary Policy

A Recipe For Stagflation

By DEEPAK NAYYAR

THE Union budgets of the recent past possess two characteristics which are new. First, there is a conscious attempt to transform the budget into a marketable product, so that its packaging rather than its substance determines perceptions in the media and among the influential. Second, the arithmetic of the budget can no longer be accepted at its face value because overestimated revenues and underestimated expenditures mean that actual outcomes turn out to be very different. Unfortunately, there is no equivalent of a trade descriptions act which would protect the consumer, in this case the citizen, from being misled.

The budget for 1994-95 provides ample support for both these propositions. Resources have been mobilised on a large scale, prior to the budget, through increases in administered prices which are estimated to yield more than Rs. 4,000 crores, while the sharp increase in passenger fares and freight charges announced by the railways would fetch another Rs. 1,000 crores. Such price hikes are bound to fuel inflation and hurt the silent poor. The budget itself emphasises structural reform, be it convertibility of the rupee or rationalisation of the tax system, combined with tax cuts worth Rs. 4,800 crores. These attributes would be of interest to, and benefit, the vocal rich.

The credibility of the budget is low. The revised estimates for 1993-94 diverge substantively from the budget estimates presented a year ago. The revenue shortfall is Rs. 8,100 crore while the expenditure overrun is Rs 12,500 crores. The fiscal deficit is Rs 21,600 crores larger and the revenue deficit is Rs 16,400 crore more than the original estimates. Such huge divergences are unprecedented. Consequently, the fiscal deficit which was estimated at 4.7 per cent of GDP would now be 7.3 per cent of GDP, whereas the revenue deficit which was estimated at 2.4 per cent of GDP would now be 4.2 per cent of GDP. A repeat performance is probable in 1994-95.

Fall In Revenue

There will, once again, be a shortfall in revenues. The concessions in the sphere of direct taxes add up to a revenue loss of Rs. 2,500 crores while the reduction in customs duties would cost the exchequer another Rs. 2,300 crores. The finance minister has simply assumed away the revenue foregone (estimated at Rs. 4,100 crores net of taxes imposed) in the pious hope that rationalisation of the tax structure would compensate through buoyant revenues. This faith in the Laffer proposition, that lower tax rates lead to higher revenues, is touching, for it is not borne out by experience anywhere. The notion that lower tax rates would somehow improve tax compliance without better administration and stricter enforcement is at best wishful thinking and at worst manipulative arithmetic. Similarly, given recent experience, an overrun in expenditure is almost certain. This is partly because the provisions in the expenditure budget may not be adequate in the sphere of defence, subsidies and some components of non-plan expenditure such as index-linked DA payments, as well as the fact that an expenditure control system does not exist.

It is, then, plausible to suggest that, during 1994-95, revenue may be Rs. 4,000 crores less than estimated and expenditure may be Rs. 5,000 mrores more than estimated. Thus, the fiscal deficit would not be six per cent of GDP as claimed, but at least seven per cent. Even worse, the revenue deficit estimated at 3.6 per cent of GDP would be more than four per cent. These are but symptoms. The real malaise is that the macro-economics of this budget is suspect. Indeed, it bears an uncanny resemblance to the profligacy of the late 1980s which landed the government in a fiscal mess and the economy in a debt crisis.

Mounting Imbalance

Budgets can be prudent and wise only if they preserve macro- economic balances which, in turn, create an environment that is conducive to economic growth and price stability. The latest budget reveals mounting imbalances in the fiscal system which are bound to accentuate the macro-economic disequilibrium even before the process of stabilisation is complete. This can only fuel inflationary pressures or strain the balance of payments, as in the recent past, and disrupt the process of growth. The mounting fiscal deficit, which would increase gross borrowing of the government, is bad news, irrespective of whether it is met by monetary-financing or debt-financing. Insofar as it means more borrowing from the Reserve Bank of India, it would fuel monetary expansion. Insofar as it means more borrowing from the capital market it would compound the increase in internal public debt. The higher interest rates now offered on government securities and a reduced reliance on borrowing from RBI would lead to an exponential increase in the burden of interest payments on the exchequer. We have learnt from experience that this can only mortgage the future.

The burgeoning revenue deficit represents the worst kind of fiscal laxity. For it was the revenue deficit, which averaged 2.7 percent of GDP in the second half of the 1980s, that was the root cause of the fiscal crisis. The revenue deficit remained almost unchanged at 2.6 per cent of GDP in 1991-92 and 1992-93 despite the reduction in the fiscal deficit. That was problematic enough. But the same revenue deficit has climbed to 4.2 per cent of GDP in 1993-94 without any prospect of a reduction in 1994-95. In other words, the government would continue to borrow more than four per cent of GDP to finance its consumption expenditure. In an ideal world, there should be a revenue surplus large enough to finance capital expenditure on defence and in the social sectors, where there are no tangible returns, so that borrowing is used only to finance investment expenditure that yields a future income flow to the exchequer.

It is being argued by the finance ministry that we should not worry about government deficits because the expansionary budget would revive growth. There is a serious flaw in this argument. Deficits, in themselves, do not create growth. Indeed, deficits that finance consumption expenditure of governments can stimulate real economic activity only where underutilised capacities are attributable to a lack of effective demand. In economies such as India, characterised by structural rigidities and supply constraints, deficit financing of consumption expenditure may simply lead to inflation. It is only if deficits are used to finance investment that growth is possible. The crucial thing is to increase investment, not so much for the sake of generating effective demand but for the sake of accelerating capacity creation to ensure a rapid growth in output. It would also induce a demand expansion in the short- term and ease supply constraints in the medium-term. The budget, it appears, has done precious little for investment, which declines in real terms, however we measure it. The provision for capital expenditure in the Central Plan and in Central Assistance for State Plans - perhaps the best aggregate measure of resources allocated to finance public investment - contracts by six per cent in nominl terms, Rs 19,672 crores to Rs 18,520 crores, so that the decline would be substantial in real terms.

Supply Response

These cuts in public investment are bound to constrain the supply responses of the economy in the medium-term. The problem may be accentuated because evidence available in India, both from the past and from the present, suggests that public investment crowds-in rather than crowds-out private investment. It is futile to expect that cuts in direct taxes would stimulate private investment. In my view, the macro-economics underlying the budget is cavalier at one level and flawed at another level. It is bound to deepen the fiscal crisis. It cannot stimulate growth. It would almost certainly spur inflation. Indeed, without fundamental correctives, the medium-term prospect may be stagflation.

(The author was formerly the chief economic adviser to the Union government)