HEMANT MISHRA

DEEPAK NAYYAR

"The Revenue Deficit is a Bigger Problem"

FOR some time now, Jawaharlal Nehru University professor Deepak Nayyar has been expressing concern about the state of central government finances. In an interview to BusinessWorld's *Palakunnathu G. Mathai, the former chief economic advisor to the government argues that the current fiscal crisis is far worse than the last one. Excerpts:*

■ Are central government finances in a mess?

Yes. This situation isn't new. It has persisted for 10 years. Although there has been an ostensible attempt to resolve the problem, the fiscal crisis in the late nineties runs deeper than it did in the late eighties. The solutions, I believe, have compounded the problem.

Comparing the second half of the eighties with the first half of the nineties shows that there has been a moderate reduction in the central government's gross fiscal deficit, from an average of 8.2% of gross domestic product (GDP) to an average of 6.1%. But this is associated with a discernible increase in the revenue deficit (the excess of consumption over income).

The almost exclusive emphasis on reducing the fiscal deficit is both inappropriate and misplaced. More serious is the revenue deficit, which is supported by borrowing. During the second half of the eighties, the government borrowed at an average annual rate of 2.5% of GDP to finance its consumption expenditure. During the first half of the nineties, however, the government borrowed, on an average, 3.1% of GDP every year. In an ideal world, there should be a revenue surplus large enough to finance capital expenditure on defence and on the social sectors where there are no immediate, tangible returns. This would ensure that borrowing would be used only to finance investment expenditures which yield a future income flow to the exchequer. So long as the income flow is greater than the burden of servicing the accumulated debt, government borrowing remains sustainable. But the reality in India, despite the so-called fiscal adjustment, is just the opposite.

The size of the fiscal deficit is the symptom, not the disease. And nothing in economics stipulates an optimum level to which the fiscal deficit must be reduced as a proportion of GDP. Indeed, it is possible that a fiscal deficit at 6% of GDP is sustainable in one situation while a fiscal deficit at 4% of GDP isn't sustainable in another. The real issue is the use to which borrowing is put in relation to the cost of borrowing.

The adjustment implemented in India cannot provide a sustainable solution to the fiscal crisis despite the reduction in the gross fiscal deficit.

■ Why?

The cost of government borrowing has risen significantly in the nineties. Firstly, because the government has sharply reduced its borrowing at lower interest rates from the Reserve Bank of India. Secondly, the government is borrowing much larger amounts in absolute terms and at a significantly higher cost from the commercial banking system and from the domestic capital market. That's because the interest rate on government securities has been raised steadily to the market level in the belief that this might be a disincentive for the government to borrow. But the reality is that the government is continuing to borrow more. What's more, the use of the borrowing in the nineties is even more unproductive than earlier, with a much higher proportion being used to finance consumption expenditure.

■ When the crunch comes, what will be the consequences?

Fiscal crises are more like treadmills and less like time bombs. They're associated with implosions, not explosions. But when the crunch comes, the fiscal crisis spills over into an unmanageable balance of payments situation and an acceleration in the rate of inflation. We know that from our experience in 1991. This time around, however, comebacks will be much more difficult.

■ The government's focus so far has been on raising more revenue. Can't it cut expenditure?

We cannot talk about cutting expenditure unless we're willing and able to consider cutting activities.

■ How do you solve these fiscal problems?

I'd impose two simple rules. The government should not be allowed to increase its expenditure in any year by more than the increase in its revenues. The government should ensure that the proportion of its total borrowing used to support consumption expenditure is progressively reduced.

Revenue receipts also must be increased, in particular, tax revenues, over the next five years by at least 2% of GDP. This would have to be done by broadening the base of taxation and improving tax compliance. Finance ministers should not be applauded simply for reducing tax rates. They should not be allowed to get away by saying that I'm cutting taxes and I'm increasing expenditures. From where will the money come? It is this politics of populism and economics of soft options that have landed us in the fiscal mess. ■