INDIA'S MACRO FISCAL BIND: IS CO-OPERATIVE FEDERALISM A SOLUTION?[3]

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Abstract:
This piece discusses the contours of 'cooperative federalism' and its implications on national and state governments. Since the middle of the last decade the Union Government is the main source of fiscal deficit, while states have done reasonably well to contain their finances. Since the mid-1980s, states have received relatively lesser share of total revenue, while centre has not taken adequate responsibility in terms of investments on developmental priorities like education and health even though key centrally sponsored schemes like Sarvya Siksha Abhiyan (SAA) and National Health Mission (NHM) have been introduced. Given that our domestic saving rates are not very high, combined fiscal deficit is high and GDP is growing only moderately, prospects of revenue growth is bleak. We would need to spend the resources better. It would be fiscally prudent to provide greater fiscal power to states so that education and health receive greater investment.

I started my life after my Masters as an investment banker. I did investment banking for one year and I got thoroughly bored. Then I moved on to do a PhD for want of anything better. My thesis in the economics department was called the Politics of Fiscal Policy. Nobody in 1989 had any idea that you must have a theory of the State to be able to say anything meaningful about fiscal policy. Otherwise what you get in economics is that you have firms, you have consumers and fiscal policy is a distortion-correcting mechanism because all governments are just distortions. Then you get the theory of optimal taxation and you are home. On the other hand, trade by profession does not acknowledge nation states. The business of international theory is a business of correcting distortions. When countries trade, they do so because they exist as nation states imposing boundaries

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on free exchange which leads to suboptimal general equilibrium, which means distortion. So, two important and very lucrative areas of economics are about the strategy of distortions. I was pursuing my thesis when the collapse of both the Soviet Union and Yugoslavia happened. - Nation-states became problematic for economists, structural adjustments were into trouble, and people said, 'Oh my God we have to start thinking about something called political economics!' and Harvard and MIT started programmes on political economics.

I would like to take up a simple public policy proposition in India and illustrate how thinking about public policy in a multi-dimensional fashion enables you to come up with out-of-the-box solutions, and how a certain amount of intellectual opportunism helps you to make your point effectively in a public policy context as a policy wonk.

A phrase here that I've used, 'cooperative federalism' is a phrase I have taken from the Prime Minister's speeches. Is cooperative federalism a solution? What does this mean? Let me start the story. There seems to be a policy consensus that the fiscal deficit needs to be reduced. The question is, how to achieve this? There are some statements made quite often, 'you must spend less' or 'you must spend within your means' or 'the government must become more efficient'. They have no analytical value because the opposite is not argued. For however good your public finance is, you must always spend less if you can, and if you can, get more with less money.

How many of you understand the difference between revenue deficit as a concept and the fiscal deficit? It is very simple conceptually because you do it in your everyday lives. Let's say that you get a scholarship or that your parents send you some money. You go out and you buy yourself a Xiaomi MI3 phone from Flipkart and at the end of the month, you have obviously run out of money. So you borrow some money and you pay interest on that borrowing (let us assume that that facility exists). Another one of you, or let's say me, who is very fond of food, discovers a wonderful dhaba in Sonepat and goes there every second day. At the end of the month, I don't have money so I borrow. What is the difference between the person who bought the phone and me? Arguably what I have done is that I have consumed (literally), and because I have consumed more than my income, I have borrowed to consume some more. The other person has made an investment in something which hopefully, if you are lucky, will provide you with returns over time. That is borrowing for investment. In general, intuitively you will agree with me that borrowing for investment is something that we all do and that we understand the logic behind it and constantly borrowing for literal consumption is not a good idea.

When the government spends more than it earns, as in the case of India, it is called a revenue deficit. When does the government consume more than it earns? What does the government earn through? A government earns some fees such as license, fees, and toll fees, and taxes. I will reflect on taxes as an interdisciplinary concept for a minute before I go forward. I think your VC will be very pleased with me for saying this because other than the Ministry of Home Affairs, the people who have the most coercive power in this country over you is the Ministry of Finance. They can bug your phone, they can make your life difficult and they do, believe me. They can act with as much impunity as the police. The government earns its money through the use of the coercive power of the State and through taxation. Think about it, because obviously the use of coercive power in the medieval period is different from now, there are social contracts, there are political settlements and so on. But that is why it is important for an economist to understand that taxation is a coercive instrument. Will any economics textbook tell you this? No. I have researched them all, there is no economics textbook that talks about taxation in the context of coercive power. So, you'll need to go to law school and understand this business of coercive power. Get a feel for it, because otherwise you won't be good at public economics.

So, taxes minus consumption. Now, what is consumption? Consumption comes from that social contract. The oldest form of that social contract is what economists of my generation call 'regrettable necessities'— an Oxford term which people have forgotten, it is a lovely term. Regrettable necessities, what are they? So, a number of things which in economics we call general services – police, law, courts – these are regrettable necessities. The minimum thing a government does is that it spends on regrettable necessities. How does it provide that? It buys tanks— that is investment because it is a capital good and it hires people. So, the salaries the government pays plus things that a government buys that are consumed in that year viz., paper, pen, petrol, and so on— these are governmental consumption. Then the government does two other things. Because it has borrowed in the past, it pays interest on its debt, it has to pay that every year. That is also consumption. Then the government does something that other agents don't do. Well they do it, but in a very limited way, within the family. The government transfers money. It takes money from one person and gives it to another, it takes money from another and gives it to one. These can be in the form of direct transfers, DBT, or it can be in the form of subsidies. That is a separate issue. When you add up all these forms of expenditure, you get the total revenue expenditure. Then you take all the taxes. What is needed as taxes should cover at least this. Then there will be no revenue deficit. This is an important point to understand.

The government does more than that, it builds roads and runs railways for starters, and those are considered to be investments. So when the government creates physical or financial capital assets, that is investment. The revenue stream is the same. So, consumption plus investment minus taxes is the fiscal deficit. Consumption minus investment is the revenue deficit. So, the revenue deficit is a subset of the fiscal deficit. It can therefore be argued that the government should not borrow to consume, but it should borrow to invest.

Let us come to India, in particular, to the main forms of government in it—Centre and the State. They do most of the taxing. My theme is confined to the bigshots of the government- the Centre and the States and not touch-upon the local bodies. We have a huge fiscal deficit. States are also contributing to the fiscal deficit but they are not contributing as much as the Centre. This is the fiscal deficit, investment plus consumption. Now, let us look at the revenue deficit. What is happening here is that in India, a quiet revolution has been taking place over the last 10 years. The States of India, by and large, no longer borrow to consume and have not done so roughly since 2003. There are reasons for this. The centre has continued to do this every year since 1981, the centre borrows to consume.

There are general category states in the country. We also have states with special circumstances in our country— the states in the North East, Kashmir, they are called special States. Special States have specific needs, so it is not fair to count them in this. The general states are states that can reasonably be expected to stand on their own feet, barring the North Eastern states, Himachal, Uttaranchal, J&K. Many states were running revenue deficits between 1998-99 to 2003. The centre also ran a revenue deficit in this period. However, since 2003, rich states, poor states, northern states, southern states, BIMARU states, Gujarat, all the states have done away with revenue deficits . States that are quite affected by the financial crisis like Gujarat pull out and go back to surplus. Punjab, Kerala, West Bengal which have been running deficits for quite some time now. We shan't talk about them here, we will exclude them. But broadly, most of the states are doing well. At the same time, keep in mind that the centre keeps running revenue deficits. For example, in this year's budget, the revenue deficit is 78% of the fiscal deficit and I'll show you what that means in a minute.

This panoply of change is the most exciting thing that has happened in Indian public finance in the last decade. For the first time, we have governments that are fiscally fit within the constraints of our political economy. The Centre is collapsing because of revenue deficit from the

Finance Ministry perspective, from what I call the munim, the accountant's perspective. Within the political economy constraints of India, the accountants are good fiscal managers and have a track record to prove that.

This is a great fiscal journey and public finance is exciting, I hope some of you will see that now. It has huge transformatory potential. Now, some clever economists have argued that this has happened because of the Fiscal Responsibility and Budget Management (FRBM) Act. The Finance Commission decides the division of all the taxes earned from income between Centre and the States. The criticisms that the Finance Commission faces are—that it has been allocating the States more money; and that it has coercive power. The FRBM Act applies to both the States and the Centre but the Centre has coercive power over the States. The first criticism is just not true. Yes, money was moved from centrally-sponsored schemes to the state landscapes. But it said so in the interim budget. In fact the current government did a little less of that. The critics have not bothered to compare the old budget with the new budget. This is what different Finance Commissions have done in terms of transferring. Central transfers as a percentage of total state domestic product, across all General category states, was given by the Eighth Finance Commission (1983) as 5.9% and then it went up in the mid-80s and after that it just crashed. During the period of the 13th Finance Commission, which I was part of, it had not yet come back to the level of the '80s. Thus what we are seeing is a degradation of the centre-state share in a dynamic sense which has recovered, so this argument doesn't work.

This implies that the centre is not doing the heavy lifting in terms of public investment. The business of public investment has been done by the states for the last ten years. In Bihar, the public investment GSDP ratio is 5%. According to the government of India, the public investment GSDP ratio is less than 0.7% in the last budget. How is Bihar able to afford it? The beauty of revenue surplus is, Bihar does have a 2.1% revenue surplus, it has an FRBM ceiling on its fiscal deficit of 3%, so, 3+2.1 is 5. When you run into a revenue surplus, when you don't borrow to consume, then you save, you can invest. That is what Bihar, Maharashtra, UP, Tamil Nadu, Madhya Pradesh, and Gujarat are doing. The three states of Punjab, West Bengal and Kerala seem to have better prospects as well. I can see West Bengal is coming out of the deficit, Punjab also, Kerala perhaps.

Therefore, when we focus on the fiscal problems in India today the fiscal problems exclusively at the centre are focused on in large measure. At the central level the principal problem is the quality of public expenditure in India, of monies that are collected and spent by the Central government.

Whether they transfer it or not, they are responsible for it. Human development means you must spend on health and education. After building schools and healthcare facilities, drugs need to be bought, salaries need to be paid, teachers have to be hired and so on. That will always be the current expenditure. One may wonder as to why running a revenue deficit until those human capital returns kick in seems to be a problem. I worked for the UNDP for 15 years, I would not have kept my job if I were an infrastructure fascist. I believe in human development and I am willing to buy that this is what the United Progressive Alliance Government wanted to do. It started all these schemes and it wanted to improve health and education.

Earlier there used to be this Plan and Non-Plan distinction in expenditure. Think of Non-Plan as consumption, and Plan as investment. In Plan, people are investing, they buy the engines. In this decade, the Plan has ceased to be an instrument of investment. It is an instrument of consumption. So, Plan revenue expenditure today is 4/5th, 80% of the total plan. This is horrible if you are an infrastructure fascist, but if you are a human development supporter, you would say that all is being spent on health and education. It is certainly true that it is being spent on health and education and rural development. As a socialist, I think it a good thing to spend on health and education. I think public education is very important, public health is very important, and it is necessary that we spend on them, and if these were indeed the drivers of the revenue deficit, I support them wholeheartedly.

However there are two problems with this proposition. Look at them like a detective story because you have to join them. Problem No.1 is after all this spending has begun on health and education, after Sarva Shiksha Abhiyaan, National Rural Health Mission, etc., etc.. Compare what we spend on public education across the country in India with the other countries. We spend less than Nepal. This is very important fiscally. You are spending more than you ever did before and you are running a cost in terms of deficit but at the end of that huge effort, you are still spending less than Nepal. It's the same with health expenditure. Nowadays South Africa and Brazil are spending more. Note that fact.

Everything we spend from the central government, we spend unwisely. I will give you a simple illustration of that. The target of the 11th Plan was achieved. You take any metric, this is unprecedented in the history of any plan in India. This is the plan that brought about an increase in human development spending and revenue deficit. The GDP growth rate was not achieved, agriculture growth rate was not achieved, employment generation was not achieved, higher literacy rate was not achieved, the gender gap increased, infant mortality was not achieved, lowering of the sex ratio was not achieved, infrastructural development was not achieved, environmental targets were not achieved. The only thing that was achieved was an increase in forest cover. It is the only place where money didn't need to be spent. You don't cut trees. So, the only targets we achieved are targets where we did not have to spend money. It is facile to think that these targets are ambitious. No, because the way the budgeting process happens is that a target is given and a cost is estimated according to the target. Then the Ministry of Finance takes a view on it and then allocates resources. So, if you had a less ambitious target you would get less money. Therefore when you have a target and don't achieve it, you have spent money badly from a Finance Ministry perspective. Saying that a target was bad or ambitious does not sit well in the Finance Ministry's view.

Now, what is the political economy problem? We spend too little on education and what we spend, we spend badly. But this statement — what we spend we spend badly— is very difficult to sell because our public policy system is opaque. Conversations don't happen across a broad enough domain. People don't have information on the mechanics of spending money. This is kept within the State. This is not made clear. You get data on how much was spent. But what is spent badly is accounted for by a CAG report or by occasional newspaper accounts. There is no structured public policy dialogue. There might be now, with the Expenditure Management Commission, but so far there has not been one on how and where and why we spend money badly. Therefore, for Jean Dreze to intervene in the education sector and say, 'spend your money better' is impossible. But he is a pro-education economist, so what would he and the erstwhile National Advisory Council say? They will say spend more, knowing fully well that what is spent will be spent badly. So then you spend yet more money but you are still not spending enough and you are spending it badly. The human development approach is not working fiscally. It has not been working fiscally across two terms of the UPA government, and nobody has said anything about it. But the fiscal cost has been shown. The centre is borrowing to consume. Remember, we have got some light here, the States have not. Because all this spending, the Plan, was a Central Government plan and Central spending. So, this disease, if you are a doctor, forensically affects the central government. I've shown you, it is not affecting the State governments.

The problem here for the Finance Ministry is this, we haven't done too badly— given that the oil prices are where they are— in reducing our expenditure on fuel subsidy. The last government was very courageous about it. I was very surprised. Now, if oil prices come down, then we may be able to reduce the fuel subsidy. Food prices are controversial. I don't want to get into that. If you think that the Public Distribution System (PDS) is good, there's plenty to support that view as well. There is enough literature on the fuel subsidy being the most regressive subsidy in India. It goes exclusively to rich people, rich districts, rich states in proportion because these are the people who buy petrol more, directly or indirectly. So, I reduce it by raising the price. The moment you reduce it, and I get, say, 100 basis points reduction in revenue deficit, immediately Mr Jean Dreze will say, 'Spend more on education, you are spending less than Nepal, spend more on health, you are spending less than Ethiopia.' I can't refute these arguments, they are right. So, the consequence of spending money badly by the centre is that even when the centre reduces money on something which is universally acknowledged as bad, its policy room to minting that in the form of a lower revenue deficit is not there because then Jean Dreze and NAC will come and say spend more.

Now I am going to tell you another piece of bad news and then I will come to solutions and stop. Let us go to another interesting policy puzzle in India on the fiscal side. Why are the poor consuming kerosene? Because you have failed to provide them with the fuel that we all use. Secondly, kerosene is a very small part of the fuel subsidy, I could retain it. I am talking about the overall fuel subsidy. A majority of the subsidy is going to diesel. If you are saying that 1/25th of my fuel subsidy is pro-rich, fine, but the fuel subsidy is pro-poor. I can reduce my fiscal deficit by stopping investment and that is what we have done. We have destroyed investment in this country. The Central Government, as I have shown you, has stopped investing. Fiscal deficit is easy to reduce. Revenue deficit has not been reduced since 1981 ever, except when we have had growth. So as a percentage of GDP, it has gone down but in terms of pro-active effort, here you could reduce it because this is current expenditure. Remember that kerosene is a bad fuel, we shouldn't be using it. The subsidy encourages it because we are unable to deliver CNG, LPG etc. to villages because of piping and infrastructural reasons.

Let us now look at a problem Reserve Bank of India is facing. Historically if you ask foreigners, they would say that Indians are very thrifty people who save a lot of money. Since 1981-82, just see how our savings have jumped. The firms have improved their savings and are saving about 6% of GDP. Firms are never going to be, except in very rich countries, big savers because they have to invest, especially in growing economies. So, firms will be legitimately borrowing money. They are saving something, not distributing dividends, so, let us leave it at that, 6% is good. Households in India have been saving a lot since we liberalized and savings rates have really shot up to 30%. There are only two serious countries in the world which beat us, countries with populations of more than 10 million – one is Vietnam and the other is China – China we had better get used to.

Okay, what is the problem with this? This is great. This means 30% savings are available. Suppose we invest all of this in our country, forget FDI, 30% investment of our GDP. Our GDP is two trillion dollars, 600 billion dollars of investment, 9% growth which is no problem at all. Household savings in this country are composed of two things – financial savings and physical savings. What are physical savings? Physical savings are savings that never see a bank (when I say bank I mean fixed deposits (FD), not savings bank (SB)). They can go under your mattress, they can go straight from your SB account to paying for the down payment for your house. They can go straight to buying gold or diamonds. The point is that they never see a bank. It is very important for money to be deposited in a bank for two reasons. It is only if money is deposited in a bank that the organized manufacturing and the organized corporate sector can access it, as it is to enter somewhere where somebody can go and borrow it. Financial savings is when the money in the bank rotates, it leverages. I will explain that later if you like. You will get more out of your money when it sees a bank. So, when money does not see a bank, in effect the corporate sector does not have it. . So, a strange feature of the Indian economy is that instead of a proportionate increase in the amount of money seeing a bank, less and less money is seeing a bank. This is very important for us, it is a long term feature.. It keeps the Governor awake.

I will give you an example. Look at the consequence. Total savings were 30%. So the International Monetary Fund (IMF) will be very happy. Take away the physical savings and then take away the combined revenue deficit where the centre is borrowing to consume, who is going to pay for it? It'll come from your savings. Ultimately it is only one pool of savings because we don't borrow from abroad. So, if the revenue deficit is 4.4%, the physical savings is 14.3%, take it out. What are you left with? 29.5 minus those two is 10.8. The same 10.8% of GDP you are going to invest, you want 8% growth. You won't get that even in a casino. How can you get 8% growth with 10.8% saving? It is simple arithmetic. Now you see how serious the situation is. It gets worse.

This is where economics becomes really useful, this is good disciplinary knowledge. We know in economics that the consequences of trying to achieve a 10% growth when this is the situation can be a disaster. We set that target year after year because we are hounded to do so. It is not so this year, we have not done it. If we set a target of an 8% growth simply because, say, China has a growth rate of 9% which worries the Finance Minister and he sets the aforementioned growth rate, then two things will happen. One, trying to do too much with too little will cause the prices to rise at the macroeconomic level, thus resulting in inflation. You can also borrow money abroad and that is why we go for Foreign Direct Investments (FDI), Foreign Institutional Investments (FII). Now, if you borrow money from abroad, you are trying to add to your resources abroad, especially current resources, which leads to more imports and less exports. This leads to an inevitable depreciation of the currency which will lead to trouble like in 2013. That can happen when you believe that FDIs will happen but they do not, thus leading one to opt for FIIs i.e. portfolio investment. Portfolio investment is fickle, it will go in and out. Suddenly the equivalent of a viral fever afflicts the macro economy. Every six months the Governor can't sleep, the FM can't sleep, nobody can sleep. Everybody is tense, because of trying to achieve this 8% growth. However this results in inflation, then in a current account deficit —this is the twin deficit.

Now what are the policy options for the Finance Minister? Not very good, I'm afraid. They have moderated their growth forecast. If you look at the medium term macro framework, they have now settled for a growth rate of 5.5% for the next two years, which is achievable, but a bit low. Suddenly India is no longer an 8% economy, we are a 5.5% economy. I am an old man, I remember when we were at 3.5%, so I am happy with 5.5%. If you wish to grow at 7-8% you can get it, temporarily by tolerating a higher rate of inflation. The problem in India is a lot of this inflation is dirty inflation. I don't think even the RBI knows why but it is affecting the subzi (vegetables) and tomato prices which are going up by 80%. Inflation is thus unpredictable and the political costs are much higher when there is a moderate increase in the headline rate of consumer price inflation. It makes politicians nervous.

Or you can do something else entirely different. You can change the entire philosophy of India's growth story. The difference between India's growth story and China's growth story is that we don't export to grow. We grow because we are a large economy, we have domestic demands, that is our growth story. However, it is possible to solve the current account deficit by exporting to grow. But that means, for instance, that it is not necessary to invest in railways other than the amount necessary to get the trains to the Gujarat port or the Vizag port to sell textiles to Japan. If that is done, then the UP-Bihar railway and other internal railway lines are not needed, like China did. Then a string of pearls along the coast and good infrastructure are needed and the rest of the country needn't be developed. I don't think electorally this is possible, but I am saying that this is the stark nature of the change in economic policy strategic shifts we will have to make to solve this problem without accepting a low rate of growth or a low rate of inflation.

This is India's macro bind. When you have a combination of no savings but it is thought to be high savings, and a consistently high revenue deficit – GDP ratio caused by poor spending on infrastructure, which creates its own supply side problems, it has happened in history also. All points of crisis have seen this combination. It is happening now. What can be done?

There is one way you can improve the efficiency of public spending, and that is to cap the last revised estimate of the budget. Capping this and all departmental spending at the same time necessitates that the same services and functions be provided without throwing good money after bad, so to speak. That kind of across-the-board spending freeze will force— and it has happened in countries, it has happened in New Zealand, it has happened in the UK, it has happened in Africa— will temporarily force (you can't do this permanently) departments to look after their own bureaucratic interests, the Secretaries will be forced to look for improvements in productivity because they know that no more funds are available. At the moment they come and tell me, you can't cut non-plan. I say, why. Non-plan is all salaries. I said, so, sack them or don't fill posts. I will give you an example of this in a minute. Among the States, the most extreme example is Odisha. In Odisha, Mr Naveen Patnaik has not filled 37% of teachers posts, two-thirds of them are vacant. Forget the Secretariat, it is almost half empty. I have been in seminars with him and I have asked him this question myself. He said, 'Mr Roy, can you prove to me that employing another 100 teachers will improve the quality of education in Odisha?' I said no I could not. He said, 'When you can do that, tell me, otherwise I am not going to spend the money because I don't know how to improve the quality of education, I am convinced that hiring more teachers will not do it.' It sounds very bleak and pessimistic to decide not to spend any more money if the government is already so bad at public spending. That is the Naveen Patnaik story.

Second is the one I was telling you, we don't have a clue. Nobody has a clue. I have been back in this country for 14 months, I have systematically gone through every document, policy paper, research paper since 1980 in the RBI, in academia and I have not found a single paper on this. I have found lots of papers on how to measure it. But none on what drives it. Harvard also does not know. I have looked abroad as well. There has been no policy research or any kind of research on why this physical savings driver is going up. It is a very exciting area because nothing should be more musical to the ears of all you public policy researchers than the presence of an unsolved puzzle. It is tractable, the data is there, you need to apply your mind. But we need to review the share of sharing, there is a policy research agenda there that can be used now to help the RBI.

Finally, I think the time has come for us to decide that the central government should play a lesser role in spending on health and education and so on . I think the prime target for that is human development. To put it simply, the states are delivering good fiscal practice. Empower them on this basis by increasing radically their share in the total tax provision and shut down the responsibility of the central government for spending on health, education, unemployment and make it solely and exclusively the responsibility of the States. Note the total shares of the states in central taxes must increase by this amount and the Finance Commission will allocate to the states accordingly, which they have been doing quite well so far.

Now doing this of course does not solve the problem but I cannot do worse. I know that Mrs Jayalalitha can hand out free colour TVs, and I know that Mr Akhilesh Yadav can hand out laptops and not have a revenue deficit. So, whom should I trust?

The political trick is to have a pitch that has enough of an interdisciplinary connection to appeal to the policymakers and this pitch has something at the end that is politically intuitive to the policy-maker that will help sell it. The bad news is that unless policymakers come up with suitable formulations, an 8% growth rate will not even feature as a distant possibility. Instead, inflation or a permanent change in the terms of our growth story, which means huge inequality, will happen. But the important news here is that nobody in the finance ministry or anywhere else should take seriously anybody who writes in the newspapers or anywhere else that increasing tax revenues here will solve the problem, reducing expenditure here will solve the problem.