

Vision and Illusion in Fiscal Correction

In a bid to contain the fiscal deficit, the government has in this budget targeted outlay on subsidies. This note focuses on the likely consequences in the case of the food subsidy.

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I In a Fiscally-Challenged Polity

India today is a fiscally challenged polity. The reference to the polity rather than the economy is to suggest that the current fiscal situation is the outcome of a political process, requiring a solution that must be politically mediated. It is fiscally challenged in the sense that the finances of the Indian state are set in a quagmire of its own making. The continuation over time of the condition, with parties of varying persuasions in power, suggests that this has little to do with ideology. More crucially, it suggests that any improvement in the government's finances would require a visionary finance minister who is no less a courageous politician. His third budget does not help Sinha earn such a description. Altogether, he has failed to correct the underlying weakness of public finances, shown little initiative in shaping the course of the economy and, worse still, has allowed the market, via its valuing of the IT sector, to determine at least some part of his judgment. Being the statement of the financial intent of the government a budget must perforce touch upon every aspect of its expenditure and cite every source of its revenue. In stark contrast here, in this paper only those proposed outcomes and those instrumental changes envisaged which are of some significance are discussed.

II On Picking the Right Deficit

Speaking of the outcome of his exercise which left a fiscal deficit of 5.1 per cent Sinha had the following to say for his efforts: "...I had to carefully balance the need for fiscal consolidation with the need

to nurture the recovery phase of a growth cycle" (p 38, 'Speech of Shri Yashwant Sinha', Part-B, Budget Documents). Actually, it is possible to argue that there has been no fiscal correction worth the name in this budget.

It was the Washington Consensus – no longer a confident position – which gave rise to the suspicion associated with a concern for the fiscal deficit. The obsessive attention bordering on fundamentalism, the shoddy use of economic theory and, what is much worse, the poor empirical fit between the deficit and the variables of interest – notably inflation and the balance of payments – all lent a certain spuriousness to the repeated concern. However, this result¹ is unfortunate for the management of the public finances is far from irrelevant to both economic growth and the sustainability of any budgetary welfare provision.

The fiscal deficit precisely captures the extent of intended borrowing by the government. Where the government borrowing goes to finance public investment one can find little economic grounds upon which to object. On the other hand, where the fiscal deficit goes also to finance expenditure on revenue account, or current consumption, it would not do to view the fiscal deficit benignly. And this is the situation in the Indian economy today. Far from borrowing by government going exclusively into the building of assets capable of yielding revenue in the future a part of borrowing is going into the financing of current consumption. In the Table are presented some statistics meant to provide a sharp angle on both the state of the public finances and an anatomy of the kind of adjustment that has occurred in this budget. The series has been, deliberately, kept brief – extending up to three years only – so that focus is maintained. Note that the share of the fiscal deficit (borrow-

ing) going to finance capital spending (public investment) has declined while the share of the fiscal deficit going to finance the revenue deficit has increased over the three years for which data are provided. No matter that in this budget the finance minister has raised the share of investment over the previous year, he has not been able to reverse the trend. The trend in the deterioration of the management of the revenue deficit is more rapid and the magnitude of the deficit in relation to the fiscal deficit by now unacceptably high. It is in this sense that the adjustment claimed by the finance minister is an illusion. This little snapshot should be enough to convince one to think deep about the measures upon which evaluation of the management of the public finances is based. For we see how a lower fiscal deficit can be co-terminus with a higher revenue deficit.

In this brief note we shall not attempt to track the reasons for the worsening situation with respect to the revenue deficit. This is, however, an urgent task. It is also crucial to see this very situation in perspective. A deficit on the revenue account is a relatively recent development in the history of Indian public finance. In fact, the combined balance on revenue account of the centre and the states was in surplus even into the eighties. If the account was in surplus for the first three decades of the republic there is nothing inevitable about the recent emergence of a deficit on revenue account. Indeed, it only represents mismanagement and a violation of the principle of sound public finance that consumption must be financed by current income. Consumption financed through borrowing only postpones the inevitable adjustment. In this sense, consumption financed through borrowing, or even the running down of assets, is unsustainable. Equally, when the adjustment does come, failing the tapping of fresh sources of revenue the first cut must fall on consumption.

The maintenance, for a period beyond

Table

	1998-99	1999-2000	2000-2001
Fiscal deficit (FD)			
as share of GDP	5.0	5.6	5.1
Capital spending			
as share of FD	54.6	46.5	51.6
Revenue deficit			
as share of FD	59.9	67.5	69.5

Source: Calculated from the Budget Documents and Economic Survey 1999-2000, Gol.

that of an emergency, of a revenue deficit contravenes a basic tenet of public finance. And to the extent that the fiscal deficit conceals a revenue deficit, changes in the former viewed in isolation could be a poor indicator of its soundness. After all, correction allegedly signalled by a reduction in the fiscal deficit is consistent with an increase in the revenue deficit. Indeed, this would be a kind of perverse adjustment, with borrowing for consumption purposes now replacing the borrowing for investment that had existed. Those with an eye to the history of Indian public finance will be able to see that the term fiscal deficit is of relatively recent vintage in terms of its usage in the Indian context. Historically, even into the seventies, the government of India and the Reserve Bank of India appear to have preferred 'budgetary deficit'. The budgetary deficit of course excludes receipts from borrowing (as it should), capturing the unborrowed deficit and thus, under normal circumstances, the extent of monetisation. The shift of focus to the fiscal deficit internationally has largely to do with the shift in thinking on macroeconomics with the New Classical Macroeconomics on the ascendant. Irrespective of one's views on the new macroeconomics, however, it is easy to see that both the fiscal deficit and the budgetary deficit emphasise the macroeconomic consequences of borrowing and monetary growth, respectively. These consequences themselves are not uncontroversial. On the other hand, revenue deficits have clear negative implications as discussed here. I have elsewhere [Balakrishnan 1997] contrasted more elaborately the macroeconomic versus the public finance perspectives on deficits.

III PDS, Food Security and Fiscal Balance

In a bid to contain the fiscal deficit the government has, in this budget, targetted the budgetary outlay on subsidies. The major subsidies in the economy are on food and fertiliser. By increasing the price at which the recipients, households and farmers, respectively, are entitled to purchase these goods, the finance minister believes he can reduce the outlay on these subsidies. We focus on the likely consequences in the case of the food subsidy. There are two issues here, those of an improvement in the fiscal balance and of the maintenance of food security. For some years now we have argued [Balakrishnan and Ramaswami

1997] that, given the current state of the public distribution system (PDS) in India, hiking the issue price is unlikely to serve the purpose of lowering the budgetary outlay termed 'food subsidy', even though this may be expected on grounds of economic theory. This is so because there is evidence of lower off-take as the difference between the market price and the issue price narrows. This has implications for the food subsidy and thus to efforts at improving the fiscal balance. At the same time, consumers substitute PDS grain by open market supplies, which has implications for food security.

Lower off-take from the PDS implies, *ceteris paribus*, larger stocks with the government. Under the circumstances, a hike in the issue price expands the subsidy through a pincer movement in reverse as it were. The food subsidy is defined as the difference between the operating cost of the Food Corporation of India (FCI) and its realisation from sales. The subsidy will be enlarged if the increase in operating costs, due to the carrying cost of a larger stock-pile, exceeds any positive change in realisation from sales (since sales = price × quantity, the change in sales would depend on the elasticity of demand for foodgrain). To take a cue from the nineties, raising the issue price has not resulted in any reduction of the subsidy even as off-take has not increased, signalling that the mechanism that we are speaking of here is very likely at work. To digress a bit, we find that the relationship between PDS off-take and the price differential holds irrespective of how it is brought about. That is, the relationship survives even in situations where the issue price is fixed but the market price rises over the crop cycle following the harvest.

Our point regarding the unlikely success of lowering the food subsidy via issue-price hikes made, we move on to the role of the PDS in relation to food security. First, a theoretically trivial but nonetheless crucial observation. The PDS is a form of supply management and cannot deal with chronic malnutrition arising out of the lack of purchasing power. Generically, it is not even a particularly radical intervention from this point of view. In its implementation in India, it is not universal in practice even though it may be in principle. Some sections, often the most needy – such as migrant labourers without a certifiable address – have no access, apart from entire cohorts in the rural areas of much of the country, a geography determined by the history of the PDS as an ad hoc measure devised

during the Second World War to keep the cities supplied with grain.

Now then a significant section, indeed the bulk, of India's poor must depend upon the market for their purchase of grain [Dev and Suryanarayana 1991]. Quite counter-intuitively though, they are not left unaffected by a rise in the issue price. Indeed this section is made worse off. How is this so? We have evidence that the issue price and the market price of foodgrains are positively correlated. This implies substitution of market purchases for the hitherto PDS purchases as the issue price rises in relation to market price. The higher market demand drives up the market price. Substitution of this type must imply that consumers view the PDS grain as inferior to the grain in the market. This may be established as follows: if the grain sold though the PDS is identical in quality to that sold in the open market a rise in the PDS price will not cause a demand switch of the type being discussed here, and thus an increase in the market price. Indeed the market price may be expected to fall. Not only do we have evidence [Balakrishnan and Ramaswami 1997] of changes in the issue price being directly related to changes in the market price, we have also estimated an econometric model [Balakrishnan and Ramaswami 2000] which shows consumer switching out of the PDS when the price differential narrows.

The precise reasons why consumers see PDS grain as inferior in quality to that in the open market is not obvious to us. We have of course suggested [Balakrishnan and Ramaswami 1997] some specific ones. However, our observations here are not dependent upon an identification of these reasons. We have two comments to make. The first is that where the stockpile is endogenous to the price-quality configuration of PDS grain, using the 'economic cost' of the FCI as the benchmark in fixing the PDS price, as has been proposed in this budget, would be to institutionalise the poor quality of the system as a whole. For after all, the economic cost would be higher as the stockpile rises due to higher carrying cost. It would be an apposite case of what Rajiv Gandhi appeared to have had in mind when he remarked: "We have been running an inefficient system, calling it socialism and billing it to the poor." Secondly, we would like to caution those who have embarked upon such an exercise that the factors which contribute to the perception that PDS grain is of lower quality, an indication of the 'inefficiency of the PDS, cannot be captured in comparisons of the

operating cost of the FCI and that of private traders. Conversely, the PDS can never be universally competitive so long as measure for measure of identical cost of supplying the good, its grain may be seen as being of lower quality than what is available in the market, at least by some. A lower food subsidy cannot come about without an improvement in the functioning of the PDS. In the absence of this, hiking the issue price is likely to fail as a strategy, apart from lowering food security for many as it raises the open market price. Elsewhere [Balakrishnan and Ramaswami 2000] we have argued why a lower quality of grain in the PDS is not an optimal intervention, in the sense of inducing self-selection by the poor, thus satisfying the criterion of targetting. Moreover, where the grain when originally sold to the FCI is of the same quality as that sold to the private traders the decline in its quality as it passes through the PDS marketing chain is a 'deadweight loss' and not a transfer.

We hope to have conveyed that the relation between poverty levels and the budgetary allocation currently termed the 'food subsidy' is tenuous. This is not so on an a priori grounds, it has to do with the definition of the subsidy in the government's accounts – whereby the higher the stocks the higher the recorded per unit subsidy, due to carrying cost – and of the manner in which the PDS is managed which contributes to consumer perception of poor quality. The PDS answers to a limited definition of food security, and to persist with it as it is would not necessarily be a service to the poor. Food stamps entitling the poor to larger rations than now, for instance, would not only be more radical in intent than preserving the PDS per se but would also manage to avoid the inefficiency of the PDS contained in private perceptions of it. Under a system of food stamps, rupee for rupee, a rise in the subsidy would reflect a pure transfer to the poor, not, as it does now, the inefficiency of the system that we have spawned. We hope also to have demonstrated here that a criticism of the PDS, therefore, need not be based on the view that subsidies are for the cutting, but that criticism may be based solely on a concern for whether the system delivers food security. Above all, we hope to have demonstrated that an efficient PDS is necessary not only to maintain fiscal balance but also to strengthen food security. And, what is not the same thing, improving the efficiency of the PDS means seeing both food security and the fiscal balance improve.

Finally, note that when the issue price is transmitted across the foodgrains market the number of persons made worse off is much larger than the original cohort of those with access to the PDS. Where many among those outside the PDS are among the poorest in the economy, improving the efficiency of the PDS might even have positive equity implications.

IV Guns or Grain? A False Dilemma

In this article we have pointed out that with subsidies, as in the case of the PDS, there is more than a danger of subsidising inefficiency. C Subramaniam, the man almost entirely responsible for the political arrangements underlying the Green Revolution, has recently suggested [Subramaniam 2000] that this may well be the case with the Retention Price Scheme associated with the production of fertiliser in this country. However, none of the arguments made here are either against the provision of the subsidy per se, nor is there a rule proposed for the levels of subsidy that may apply. Indeed it is abhorrent that after 50 years we are faced with a situation where expenditure on defence is increased by a record margin while the provision for food is less. A reduction in the outlay of food is not the only necessary outcome even if, for purely for argument's sake, the hawks have the right picture on our defence requirements. For, while the expenditure on food and fertiliser is visible since it is explicitly accounted for, the underpricing of a whole host of human services and of natural resources results in a loss of income to the exchequer which is the so-called invisible subsidy. So long as we stick to the central budget the argument may be made that these invisible subsidies are incurred by the states. But this can hardly serve as an argument from the point of view of food security. States after all have the option of raising surpluses on the services they provide so that they may subsidise food further than that permitted by the level of the central issue price for PDS grain. Where the moneys are fungible, both at the centre and in the states, we can see a direct relationship between waste or loss of public income due to unmerited subsidy elsewhere in the economy and what is available for food. Even a slight rationalisation of the range of subsidies that exist currently may well be sufficient to ensure that the food subsidy need not be cut.

Despite high and continuing outlay on subsidies neither their level nor that of the

level of public services is particularly high in India when compared in per capita terms to what exists internationally. It is not difficult to see though that increasing public provision, as is evident from the experience of both the advanced capitalist economies of the west and of the newly industrialised economies of the east, can come about only with growth. Increasing the subsidy or consumption generally, other things being the same, makes less available for investment. It must lower the rate of growth in the next period cutting into the prospect of a permanent increase in level of consumption. This has been the role of the widening deficit on revenue account of the government of India, left unaddressed in Yashwant Sinha's third budget. And it is in this sense that a credible time-bound plan to eliminate this deficit must be a part of any serious development strategy for India. [77]

Note

[Ramaswami's liability extends only to Section 3. For Balakrishnan, alas, liability is not thus limited.]

- 1 It may be of some interest to those concerned with the development of ideas that economists in India were debating the country's public finances long before the fiscal deficit was raised to its current prominence in international discussions of what is good economic policy. For instance, I recall this being discussed at the Department of Economics in my university where Sukhamoy Chakravarty had come visiting, as the Jawaharlal Nehru professor for the year, in the first half of the eighties. Like all scholars, Chakravarty was naturally quite alert to the individual sources of ideas. In this context, he was quick to point out that he had been the first ("even before 'X'") to use 'fiscal crisis of the state' to describe the contemporary Indian situation! This had left us agitated, for 'X' had been our own, and in our eyes most glamorous, teacher back in India. At that time, it had only endeared Sukhamoy to us as all too human. Today, one laments the passing of the confidence associated with Indian economists of that generation who were able to evaluate ideas for what they are worth, irrespective of their area of origin.

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