# Budget TRACK

Volume 2, Track 1, October 2004

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# Foreword

The first issue of the second volume of Budget Track is coming out at what seems like a transitional phase in the journey of the world's largest democracy. The UPA Government at the centre has spent more than a quarter of a year in power, when the political dynamics- both at the centre as well as in many of the States- have been changing. The influence of these larger political processes on the functioning of the new Government is manifested in a wide range of its policies, including those which directly affect the poor and marginalized sections. It may be argued that, on the economic policy front, the attempt has been towards striking an ostensible balance between neo-liberal orthodoxy and the needs of the poor which became evident in the verdict of the last General Elections. Taking these developments as the context, the present issue of Budget Track discusses the performance of the UPA Government in the first 100 days, the implications of the declared perspectives of the new Planning Commission for rural India, implications of the Kelkar recommendations for the poor, and the desirability of containing the fiscal deficit for the vulnerable sections of our population. It also presents a brief overview of the recent developments in the economy, a Guest Column by Prof. C. P. Chandrasekhar on financial liberalisation and the consequent shrinking of policy space of the government, and notes from an interview with Shri A. Vijayaraghawan, M. P. Rajya Sabha, on the performance of the UPA Government vis-à-vis the promises for rural India made in the CMP.

IN THIS ISSUE

# 100 Days of UPA Government

## Promises and Performance

The incumbent United Progressive Alliance (UPA) assumed power on May 29, 2004 under the Prime Ministership of Dr. Manmohan Singh and worked out a Common Minimum Programme (CMP) as its guiding principles of governance. The CMP itself is an outcome of a larger political coalition, led by the Congress, in which the perspectives of a number of regional and the left parties have been incorporated. It was claimed by the UPA constituents that CMP is a reflection of the aspirations of the common people of the country who ousted the anti-poor NDA in 2004 General Elections. Though not part of the present government, the left parties' support of the UPA government from outside is crucial for its very existence. Thus, while evaluating the performance of the government, these larger political processes have to be seen as the backdrop.

The UPA government completed its first 100 days in power on September 5, 2004. It is too short a period to make any statement and draw conclusions on the performance of this government. However, we can look at the direction in which this government is heading with regard to its promises made in CMP concerning common people of India. We shall look into the issues, which did not induce any 'feel-good factor' among rural constituency of India under the rule of previous NDA government. The promises made in the CMP as regards employment, agriculture, education, health, etc., which are the primary concern of our rural electorate, can certainly be compared with the performance of the present government on at least the policy initiation front. Below we have looked at the UPA's performance vis-à-vis these crucial issues.

### EMPLOYMENT

Loss of employment in the rural and urban areas during the previous NDA regime is considered one of the most important reasons of its routing in the General elections. The UPA rightly analysed that providing employment is the most important task at hand for the new government. In this regard the CMP seeks to provide relief to the suffering masses by providing guaranteed employment to them through a National Employment Guarantee Act (NEGA) immediately. The said act will provide "100 man-days of work to at least one able-bodied person in every rural, urban poor and lower-middle class household every year at minimum wages". But the action has not been undertaken in the same earnest as shown in the CMP in this regard. However, the National Advisory Council formed by the ruling alliance to supervise the implementation of CMP has prepared a draft report on Rural Employment Guarantee Act, 2004 and the Prime Minister has promised to place the Act before parliament in the next session. The proposed draft needs to be critically examined by experts, so that we can have a full proof system in place, after the Act becomes a law. Also, as the title of the proposed draft suggests, urban poor and lower-middle class people have not been included in it. This aspect should also be considered at full length before we enact such a law.

It can be noted in this regard that the Planning Commission has expressed some doubts over the proposed Employment Guarantee Scheme. In its approach paper to the Mid-term Appraisal of the Tenth Five Year Plan, the Commission has noted that the proposal had obvious relevance in the context of the persistent unemployment in rural areas. However, it says that implementation of the scheme depended critically upon whether the necessary resources could be provided annually. Preliminary estimates made in the Planning Commission place the likely cost of introducing an employment guarantee for rural areas only at between Rs. 21,000 crores and Rs. 40,000 crores which could be shared by the Centre and the States. The Commission further stresses that the feasibility of embarking on such a commitment will have to be examined on the basis of the overall resources picture and demands of other sectors and the feasibility of increasing the employment content of investment expenditure, especially in rural areas.

These apprehensions about the enormity of funds required to implement such a scheme are not well founded. It must be remembered in this regard that such a programme does not involve an expenditure of resources for the sole purpose of creating employment. Rather, the idea is to use the workers productively in activities that will build or maintain assets in the countryside, or provide important social or economic services. **So such expenditure will yield dividends not only in terms of higher levels of economic activity in the present but also through improving the conditions of production in rural areas**. There are many such potential activities that can have important effects on supply conditions, productivity and sustainability of rural economic activities, in both agriculture and non-agriculture. For example, constructing and maintaining roads and other connectivity (which has thus far been the most popular form of activity in such schemes) has direct and indirect effects in agricultural marketing and a whole range of other economic activities, besides generally improving the conditions of rural residents. But other activities, which are often far less capital-intensive, such as building and maintaining bunds, minor irrigation works, clearing out and desilting ponds and rivers, also have very positive short-run and long-run effects on production conditions and can also improve the sustainability of cultivation patterns generally, implying important social gains. Considering this, the recent announcement by the Planning Commission to launch a Rs. 2,020 crore food for work programme in 150 districts of the country is a welcome move. However, this amount is substantially less than what is required to generate employment of such scales.

The CMP also promised, a revamp of Khadi and Village Industries Commission (KVIC), however there was no increase for the same in the budgetary allocations. But the decision taken by the Railways to purchase kahdi products for it's needs, will certainly help in revamping of khadi and village industries in the country. However, the revival of Rural Infrastructure Development Fund (RIDF) announced in the FM's speech is also a welcome move. Rs. 8, 000 crore is proposed to be provided as corpus to this fund for rural infrastructure projects. This would help generate some employment for the rural people, as new infrastructure projects come up.

## AGRICULTURE

Turning to the most crucial and also the most neglected sector during the last one and half decades, i.e., agriculture, the CMP promised to step up public investment in agricultural research and extension, rural infrastructure and irrigation in a significant manner. However, the initiatives in this direction do not seem to be moving at a pace as promised in the CMP as far as public expenditure in the agriculture sector is concerned. Increase in allocation for Department of Agriculture and Cooperation in 2004-05 budget, over the 2003-04 allocation (BE) was just 19 per cent, which is not a substantial increase, considering the fact that the agriculture sector has been starved of public investment for long. However, the Department of Animal Husbandry and Dairying got about 60 percent higher allocations over the last year's allocation (BE). The important fact to note is, the allocations were same as in the interim budget presented by the previous NDA government before the elections, both the governments allocating Rs.5, 303.73 crore to agriculture.

Similarly, the Ministry of Water Resources, which looks after irrigation and flood control, has also got just 8 per cent higher allocation than the last year's budgeted amount. However, the increase is about 45 per cent over the last year's revised estimates, indicating that the utilisation by this ministry had been well below the budgeted amount during 2003-04.

However, in its first budget the UPA government had also provided Rs. 10,000 crores as gross budgetary support (GBS) to the state and centre plans. It had been said in the Expenditure Budget that this amount would serve the objectives enlisted in the CMP. In a recently held meeting of the Planning Commission, it was decided to increase this amount to Rs. 12,000 crore. Out of this, just Rs. 540 crores has been earmarked for agriculture. Thus, as far as increased investment is concerned, the agriculture sector has not got much this year.

***Allocation to Select Sectors/Programmes from Rs. 12,000 crore GBS by the Planning Commission***

*(In Rs. Crore)*

| Sector/Programme | Amount |
|---|---|
| Food for Work | 2,020 |
| Agriculture | 540 |
| Mid Day Meal Scheme | 1,232 |
| Sarva Shiksha Abhiyan | 2,000 |
| Secondary and Higher Education | 25 |
| Railways | 1,137 |
| Drinking Water Supply | 248 |
| Sceince and Technology | 286 |
| Bio-technology | 40 |
| Urban facilities in Rural areas | 9 |

Source: The Hindu, dated September 10, 2004.

Another major step promised in the CMP was doubling the flow of rural credit in three years. The UPA government has announced a "comprehensive policy on agricultural credit" on June 18, 2004. The proposals included raising farm credit by 30 per cent this fiscal, making 50 lakh new farmers borrow from banks and evolving a four-point strategy to restructure debt, including a one-time settlement of loans by defaulting farmers. Banks would also be permitted to advance loans to those under distress due to borrowing from non-institutional lenders (village moneylenders)-based on local knowledge-against

"The CMP also promised, a revamp of Khadi and Village Industries Commission (KVIC), however there was no increase for the same in the budgetary allocations" "appropriate collateral or group security." The FM announced in his budget speech that the government has entrusted the implementation of the policy to the public sector and private sector banks, the regional rural banks (RRBs) and the cooperative banks. It was also announced in the budget speech that a task force would be appointed to examine the reforms required in the cooperative sector.

## EDUCATION AND HEALTH

The other major area of concern for our marginalized section of society has been access to education and health facilities. In this regard, the CMP promised to raise public spending in education to at least 6% of the GDP with at least half of this amount being spent on primary and secondary schools. It promised that the UPA Government would introduce a cess on all Central taxes to finance the commitment to universalise access to quality basic education. This promise has been kept and a 2% cess has been introduced when our Finance Minister presented the budget this year. The CMP also pledged to take immediate steps to reverse the trend of communalisation of education. On the healthcare front, it promised to raise public spending on health to at least 2-3% of the GDP over the next five years, with focus on primary healthcare. It further said that a national scheme for health insurance for poor families would be introduced and the UPA Government would take all steps to ensure availability of life-saving drugs at reasonable prices.

"To raise the level of spending on education to 6% of GDP over the period of five years, there is a need for additional allocation of 11,200 crores per year"

Given the widely acknowledged precarious situation of States' finances, the onus of meeting these targets falls on the shoulders of the Central Government. To raise the level of spending on education from the current 4% to 6% of GDP in a phased manner over the period of five years, there is a need for additional allocation of 11,200 (0.4% of GDP) crores per year. The government will be able to raise only about 4,000 – 5,000 crores through a 2% cess on all central taxes. Out of Rs. 12,000 crores GBS as mentioned above, the education sector gets the highest allocation of Rs. 3,482 crores. But there still remains a wide gap, which needs to be covered. How the government is going to fill this wide gap between its promise and action is yet not clear. The only good news in this regard is that the Prime Minister has promised to place the entire revenue collection on account of the cess in a separate fund, which shall be solely used for the purpose of meeting expenditure on education.

As regards health and family welfare, the Planning Commission has increased its allocation by Rs. 688 crores from the above-mentioned budgetary support. The allocations in this sector are far below the level required to meet CMP promise in this regard. To meet the target set in CMP the Central Government needed to increase its allocation to this sector substantially from the combined existing level of expenditure of the Central as well as State Governments. An additional allocation of Rs. 5,600 crores to Rs. 11,200 crores is needed annually over the next five years to reach the level of spending promised in the CMP. We hardly find that happening in the current financial year.

As noted above, the UPA is working in a larger political context, where it is trying to strike a balance between the neo-liberal economic policies, originally initiated by the Congress itself, and the aspirations of rural and urban poor expressed through the 2004 Election verdict. In light of the mandate of the people, the UPA government needs to put its acts together and take proper steps to implement the promises made in the CMP. A beginning in this direction, although not very substantive, has already been initiated and this momentum has to be accelerated and enlarged in scope. If this is not done earnestly, as was the case with 'India-shining' rumour mongers, our electorate are mature enough to express their displeasure as and when they make their choices.

The UPA Government has constituted a new Planning Commission, under the Chairmanship of Prime Minister Dr. Manmohan Singh. The new Planning authority is expected to take up the crucial responsibility of introducing policy correctives and taking new initiatives in critical areas in the context of the priorities outlined in the National Common Minimum Programme. Moreover, it will also be responsible for drafting the next Five-year Plan for the country. We present below a note on the perspective of the new Planning Commission about the rural economy, as presented in its 'Approach Paper to Mid-term Appraisal of the Tenth Five-year Plan'.

# Mid-term Appraisal of the Tenth Plan

## Implications for Rural India

The newly constituted Planning Commission has brought out a document called *'Approach to the Mid-term Appraisal of the Tenth Plan (2002-07)'*, which presents some of the issues (relating to the strategy envisaged in the Tenth Five Year Plan and the progress made in achieving various goals) that would be addressed in the Mid-term Appraisal (MTA). The objective of MTA by the new Planning body would be to introduce policy correctives and new initiatives in critical areas in the context of the new priorities outlined in the National Common Minimum Programme. Also, in the coming years, this team is expected to prepare the Eleventh Five Year Plan for the period 2007 to 2012. Therefore, it is important to know the perspective of the new Planning Commission on every issue that matters, and the Approach Paper presents significant indications in this respect.

This note focuses on the perspective of the new Planning Commission about the rural economy, as presented in the said document. First, it tries to capture the strengths of the approach of the new Plan body towards India's rural economy. And then, it presents some of the areas in which needs of rural India seem to have been neglected.

### POSITIVE ELEMENTS IN THE APPROACH TOWARDS RURAL INDIA

**1.** The Approach Paper candidly admits that India's growth performance over the last decade has been the worst in the agriculture sector. Growth of agricultural GDP had decelerated from a level of 3.2 % per annum during 1980-1996 to 2.6 % per annum during the period 1996-2002. The Tenth Five Year Plan had aimed for a reversal of this trend and targeted 4 % per annum growth in the agriculture sector over the Plan period of 2002 to 2007. However, the average agricultural growth in the first two years of the Tenth Plan period has been 1.8 % and it is unlikely to exceed 1.5 % in the current year. Therefore, the Approach Paper opines that the targeted agricultural growth is nowhere near being achieved and the failure in this area is a major factor underlying rural distress which has been visible in the recent years. It says that the MTA will focus on corrective policies needed in this area. Also, it declares that the MTA will give special emphasis to promoting public investment in rural areas based on the possibility for absorbing unemployed labour for asset creation.

**2.** The Approach Paper rightly points out that in addition to the inadequacy of the growth in agriculture, the position regarding employment is clearly disturbing. In the 1990s, the role of agriculture in providing additional employment opportunities was virtually zero. The main solutions proposed by the Tenth Plan were bringing waste and degraded lands into production and encouraging diversification to more labour intensive crops. Neither has progressed much and the approach needs to be reviewed, notes the said document. The other sector identified as holding promise for large-scale employment creation, especially for the unskilled and semi-skilled, is construction.

**3.** Irrigation and more effective water resources management are understood to be crucial for agricultural development. In this respect, the Approach Paper observes that quicker completion of the on-going irrigation projects under the Accelerated Irrigation Benefit Programme (AIBP), a comprehensive policy framework to address the problem of water scarcity in the existing irrigated areas, restoration of natural recharge systems of primary water sources and creation of artificial recharge mechanisms, and putting in place a more structured and monitorable system of watershed development with much greater community participation, demarcation of water rights for restoration of traditional water harvesting structures are some of the important issues that should be addressed.

**4.** With respect to the prerequisites for successfully bringing in wastelands and degraded lands into productive use, it is observed that not much progress has been made in the two major initiatives in this area, viz. the bamboo mission and the bio-diesel programme, largely because the issue of land rights is yet to be resolved. It has been acknowledged that, for both forest and government lands, it is difficult to involve local communities unless land ownership is given to them.

Mid-term Appraisal of the Tenth Plan

"problems associated with the sunrise sectors, like, the lack of their spread into different regions of the country, rural youth's lack of access to the jobs in these sectors, etc. have been left untouched"

**5.** The Approach Paper also notes that non-farming rural activities have seen a secular decline in recent years. The reasons identified for this are the slow down in agricultural growth and, more importantly, the absence of any strategic approach to this issue in terms of policies and programmes. It observes that the Tenth Plan itself had envisaged nothing in this regard but for the initiatives on Self-Help Groups (SHGs). Agro-processing and rural services have been cited as the two areas which should be focused on.

**6.** As regards rural infrastructure, it is noted that the rural roads programme, which potentially has strong backward and forward linkage effects, has not developed any noticeable momentum. One of the reasons identified for this lack of progress is that the rural roads programme is entirely dependent upon the flow of budgetary support without any effort at leveraging the cess funds through borrowing (which in fact has been done in case of the National Highway Development Programme). Also, it is observed that the position with regard to State highways and district roads is even worse, and there is no programme to ensure that these too come up to the standards necessary for a high quality road network in the country.

**7.** The Approach Paper presents some of the important issues relating to the slow pace of roll-out of the *Sarva Shiksha Aviyan (SSA)*, such as the need for adequate support to be given to the States for running this scheme, the Mid-day Meal Scheme which has proved to be an important instrument for improving retention in schools, and the need for greater emphasis on secondary education in future. Also, it points out that unlike the case of primary education, where a well-designed intervention in the form of SSA exists, there is no real blueprint for the development of the primary healthcare sector. Hence, it observes that there is need to initiate a fresh approach in this area that can be initiated within the Tenth Plan period even if it can be fully operationalised only in the Eleventh Plan period.

**8.** Panchayati Raj Institutions (PRIs) have been considered to be crucial not only for democratic decentralization but also for improving the efficiency and accountability of the delivery systems for a number of publicly provided services. It is observed that the initiatives in the areas of primary education, nutrition and food security, watershed development and employment guarantee cannot be successful without the active participation of PRIs at appropriate levels, and conversely, well financed and well directed thrusts putting these areas firmly within PRI jurisdiction may accelerate PRI empowerment.

**9.** Finally, the approach towards assessing the Fiscal responsibility and Budget Management (FRBM) Act and the possible consequences of its implementation deserves a mention here. It has been noted that the FRBM Act introduces targets for containing the fiscal deficit which have implications for the size of Gross Budgetary Support in the years ahead. The Approach Paper says that the FRBM targets (of deficit control) indicated to the Parliament are based on optimistic assumptions which include early implementation of major tax reforms. And, more realistic projections about the likely impact of tax reforms suggest that if the fiscal deficit targets are insisted upon then the Gross Budgetary Support to the Plan as a ratio of GDP may decline in the next two years. **However, instead of accepting clearly the need for greater resources for the Plan, the Approach Paper states that the trade off between having a larger Plan size and "risking" a higher fiscal deficit will have to be explored in depth with the Finance Ministry.**

## WEAKNESSES EVIDENT IN THE APPROACH TO MID-TERM APPRAISAL

**1.** While commenting on the sectoral growth performance, the emergence of knowledge-based industries, such as business process outsourcing (BPO) and bio-technology etc., as front-runners in the global market place has been hailed as the brightest spot in India's economic performance in recent years. It is stated that the MTA will identify the factors behind our success in this sector in order to ensure that we strengthen and creatively build upon them. However, the need for making the growth of these industries much more inclusive has been completely neglected. The problems associated with these sunrise sectors, like, the lack of their spread into different regions of the country, rural youth's lack of access to the jobs in these sectors, etc. have been left untouched. The new Planning Commission must take into account the necessity for involving the poorer regions as well as the rural population in the growth of the service sector and the thrust required for this purpose.

**2.** As regards the proposed Employment Guarantee Scheme, the likely cost of introducing such a scheme in the rural areas have been estimated at somewhere between Rs. 21,000 crore to Rs. 40,000 crore. However, the new Planning authority talks about examining the feasibility of embarking upon this, which does not send a very promising signal about its realization of the acute need for the fulfillment of this commitment. Also, it talks about this cost being shared between the Centre and the States, without expressing any concern about the inability of the poorer States to provide funds in this regard. This again shows in poor light the approach of the Planning Commission towards implementation of the Rural Employment Guarantee Scheme in the economically backward States where it is needed the most.

Mid-term Appraisal of the Tenth Plan

**3.** The attention given to the acute problem of lack of availability of agricultural credit and the inability of the farmers to repay debt is rather inadequate.

**4.** As regards food security and nutrition, the Approach Paper lists the Central schemes providing food support, which are Targeted Public Distribution System (TPDS), Antyodaya Anna Yojana, Mid-day Meal Scheme, Integrated Child Development Scheme (ICDS), and Food for Work Scheme. It is rather unfortunate that instead of arguing for a Universal Public Distribution system or a substantial expansion of the coverage of the other schemes, the Approach Paper talks about identifying the overlap between these schemes and "rationalizing" the food and nutrition interventions being made by the government.

The Planning Commission is expected to prepare the Mid-term Appraisal (MTA) along the lines suggested in the Approach Paper and submit it to the National Development Council (NDC) early next year. At this point of time, we can only hope that it will not only take corrective steps in the areas identified but will also incorporate other critical issues in its domain which seem to have been neglected in its Approach Paper.

*We present next, some relevant snippets about the recent developments in the economy which can have a significant impact on the lives of majority of the population.*

# Update on the Economy

The UPA Government is in power for a while now, and it has not been a happy honeymoon for the UPA Government. Right from the day one it's being a mix of controversies in and out, starting from the appointments of tainted ministers to the Planning Commission's appointment of foreign consultants. The UPA government had managed to come out with the CMP and the Budget 2004-05 on time. This is the right time to start appraising the UPA Government, as it is no longer new. Some of the significant decisions made by the UPA Government are more or less identical to the stands of the previous Government. This is very high time for the UPA Government to take the right direction or to take a course different from the one fashioned by the NDA to address the issues of significance to the common lives. Let us not forget the core campaign issues, which helped UPA snatch the power at Centre from NDA. In this section we present some recent snippets, which may have significant impact on the lives of majority of the population.

## CONCERNS OVER NREG ACT

The National Advisory Council had cleared the draft National Rural Employment Guarantee Act, which seeks to guarantee jobs to all able-bodies persons for at least 100 days. It was modelled closely on the Maharashtra Government's employment scheme, but vests elected local self-government bodies such as the Panchayats with far greater powers. The bill is the important instrument to fulfil the CMP's promise of providing job to all the unemployed persons for at least a hundred days in a year. A study commissioned by the Planning Commission has concluded that a sum of Rs. 21, 000 crore to Rs. 41, 000 crore would be needed to finance employment guarantee scheme in just the rural areas. Such a huge amount, according to the Government manages, cannot be mobilised by the Government unless the subsidies are slashed in some measures - a proposal that is virtual red rag to the political parties.

It has been proposed that the money needed to finance the scheme will be shared between the Centre and the States. The treasury of most of the State Governments are, however, empty and they do not have the resources required to pay off their share. But it very much looks like that the paucity of finds is just a ruse to derail the programme. If such a scheme can provide employment to all the able-bodied persons at least for 100 days then the Government has to compromise somewhere else to commence the scheme immediately considering lives of the vast economically marginalized sections in this country.

## FOOD FOR WORK IN 150 DISTRICTS

Recently, the UPA Government at the Centre announced the launch of food for work programmes in 150 poorest districts of the country. Though it is a positive decision from the Government, whether it is a step in the direction of fulfilling the promised Employment Guarantee Act is something still not clear.

## WELFARE OF SC/ST

The long awaited due will finally be paid back to the Scheduled Castes and Scheduled Tribes to some extent. The Rural Development Ministry will spend about Rs. 4, 000 crore on individual beneficiary schemes and development of need-based infrastructure under the Sampoorna Grameen Rozgar Yojana (SGRY) in the Scheduled Caste and Scheduled Tribe habitations. This will in any case serve two purposes – one providing the much-needed infrastructure, and the second would be providing employment during the construction period. The plan comes along with the cash component and 50 lakh tonnes of food grains worth Rs. 5, 000 crore for creating wage employment. This scheme will surely enhance the living status in such habitations, but what would be the total coverage of such a scheme is not clear like any other beneficiary scheme.

## WB AND ADB ASSISTANCE TO PMGSY

The World Bank and the Asian Development Bank have agreed to give a loan of $400 million each to assist the Rural Development Ministry's ambitious Pradhan Mantri Gram Sadak Yojana. The loans will help cover at least 10 States under the scheme. The Rural Development Ministry has also sought an additional allocation of Rs. 1, 500 crore from the Finance Ministry exclusively for the upgradation of rural roads under the PMGSY. With Rs. 20, 000 crore expected as the share of the diesel cess from the Central Road Fund up to the end of the Tenth Plan and a similar amount expected from external funding agencies over the next 8-10 years, a gap of Rs. 93, 000 crore is still needed to cover the scheme. The gap will have to be met from the continuing flow of the diesel cess as well as borrowings from domestic and multilateral financial institutions.

Update on the Economy

***Government Finances at a Glance***

(In Rs. Crore)

| Details | 2004-05 Budget Estimate | Actuals upto October 2004 | % of Actuals to Budget Estimates |
|---|---|---|---|
| Tax Revenue | 233906 | 93568 | 40.0 % |
| Non Tax Revenue | 75416 | 39222 | 52.0 % |
| **Total Receipts** | 340422 | 171480 | 50.4 % |
| Plan Expenditure | 145590 | 60755 | 41.7 % |
| Non-Plan Expenditure | 332239 | 172860 | 52.0 % |
| **Total Expenditure** | 477829 | 233615 | 48.9 % |
| **Fiscal Deficit** | 137407 | 62135 | 45.2 % |
| **Revenue Deficit** | 76171 | 63879 | 83.9 % |
| **Primary Deficit** | 7907 | -981 | -12.4 % |

Source: Controller General of Accounts, GOI

## MONETARY AND CREDIT POLICY

The Monetary and Credit Policy for 2004-05 released by the Reserve Bank of India (RBI) on September 11, 2004 has hiked cash reserve ratio (CRR), to be maintained by Banks, by 50 basis points to 5 per cent of their demand and time liabilities. CRR is the reserve, which the banks have to maintain with itself in the form of cash reserves or by way of current account with the Reserve Bank of India (RBI), computed as a certain percentage of its demand and time liabilities. The objective is to ensure the safety and liquidity of the deposits with the banks. The CRR will be raised in two stages by 25 basis points each: First, from the fortnight beginning September 18 and then from October 2. The move, which is expected to drain around Rs. 8,000 crore worth of liquidity from the system, contradicts RBI's medium-term objective of reducing the CRR to a minimum of 3 per cent as stated in the 2002-03 annual policy. The RBI has also reduced the interest payable to banks on their eligible cash balances maintained with RBI under CRR requirement, to 3.5 per cent per annum from 6 per cent. The RBI has stressed, that it will continue to pursue its medium-term objective of reducing CRR to its statutory minimum of three per cent, while retaining the option to use the CRR in both directions for liquidity management, as and when essential, in addition to other instruments. The CRR was reduced to 4.50 from 4.75 per cent in the bank's annual policy statement of April 2003.

"RBI has stressed, that it will continue to pursue its medium-term objective of reducing CRR to its statutory minimum of three per cent"

***Sources of Financing the Deficits***

(In Rs. Crore)

| Details of Borrowings | 2004-05 Budget Estimate | Actuals upto October 2004 | % of Actuals to Budget Estimates |
|---|---|---|---|
| **External Financing** | **8076.52** | **8040.19** | **100 %** |
| **Domestic Financing** | **129330.79** | **54095.01** | **42 %** |
| Market Borrowings | 90365.18 | 26149.54 | 29 % |
| Securities against Small Savings | 1350.00 | 0.00 | — |
| State Provident Fund | 4000.00 | 967.22 | 24 % |
| NSSF | 6786.32 | 1857.37 | 27 % |
| Cash Balance {Decrease (+), Increase (-)} | 13597.22 | 7376.57 | 54 % |
| **Total Financing** | **137407.31** | **62135.20** | **45 %** |

Source: Controller General of Accounts, GOI

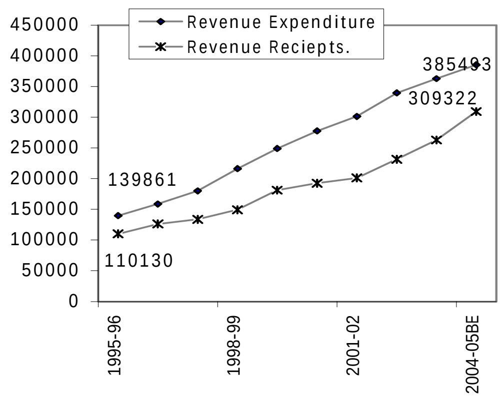
*The Fiscal Responsibility and Budget Management Act, proposed originally by the NDA Government and brought into force subsequently (with minor changes) by the UPA Government, marks the legalisation of neo-liberal orthodoxy in fiscal policy in India. The NDA Government had appointed a Taskforce led by Vijay Kelkar to recommend changes in the fiscal policies for implementing the said Act. In the following section, we present a brief discussion of the implications of the Kelkar recommendations.*

# Implications of Kelkar Taskforce Recommendations

The Taskforce appointed by the previous NDA government on implementations of the Fiscal Responsibility and Budget Management Act (FRBM Act-2003) has submitted its report in July 2004. The recommendations of the Taskforce under the chairmanship of Mr. Vijay Kelkar has been hailed by several outfits, which keep track of the fiscal dynamics of the country, as *path breaking suggestions* in improving the fiscal health of our economy. We have tried to present a brief analysis of this 219 page document for the readers in a broad perspective of overall macroeconomic conditions prevailing in our country and its possible implications to be faced by the large cross section of our population.

**Chart-1**

***Gap between Revenue Expenditure and Receipts***




The report of the taskforce represents the supposed fiscal crisis that is continuing since 1980s. The gap between revenue expenditure and revenue receipts (revenue deficit) is widening year after year (see Chart-1). The tax to GDP ratio of India is perched at around 10 percent only where as many countries of the world are maintaining it at a much higher level. For Example, in UK the Tax-GDP ratio is around 34 percent where as in USA it is around 20 percent (see Table-1). In spite of the fact that over the years, contribution of the service sector has increased from 37.18 percent of GDP in 1980-81 to around 51 percent in 2003-04 (see Table-2), the tax revenue from that sector is abysmally low. Therefore, the Taskforce had recommended introduction of a Goods and Service Tax (GST) at both the central and the state levels. The FRBM Act itself has been a controversial issue both at the level of policy and implementation in terms of highly unrealistic and undesirable targets. The report of the Taskforce while endorsing the FRBM Act has been quite optimistic about meeting the targets defined in the FRBM Act. It is in this sense; we need to have a close look at the recommendations of the Taskforce.

**Table-1**

***Tax GDP Ratio of Some Selected Countries***

| Countries | Tax to GDP Ratio (Approx.) |
|---|---|
| South Africa | 27% |
| UK | 34% |
| Germany | 25% |
| Brazil | 21% |
| Japan | 18% |
| USA | 20% |
| India | 10% |

## MAJOR RECOMMENDATIONS OF THE KELKAR COMMITTEE

The report argues along the lines of critics of the FRBM Act that ***fiscal consolidation in India should be revenue led***, rather than requiring cuts in expenditure. It even favours an enhanced capital expenditure for counterbalancing the contractionary effects of fiscal reforms in a demand-constrained economy like India. Some of its suggestions such as those for widening the tax base, effective tax compliance system, removal

**Table-2**

***Composition of GDP***

| Year | Agriculture | Manufacturing | Service |
|---|---|---|---|
| 1980-81 | 41.82 | 21 | 37.18 |
| 1985-86 | 38.59 | 22.5 | 38.91 |
| 1990-91 | 34.92 | 24.5 | 40.58 |
| 1995-96 | 30.58 | 25.46 | 43.96 |
| 2000-01 | 26.24 | 24.9 | 48.86 |
| **2003-04** | **24.43** | **24.58** | **50.99** |

of rebates, simplification of the collection processes and enhancing the cannon of equity are some of the major welcome features. However, the problem lies with the assumptions made and also the methodology for achieving the goals is not fee from criticism. The Major recommendations of the Kelkar task force are as under.

The Provisions

- More revenue mobilisation through low and few tax rates.

- Widening the tax base and shifting the incidence of taxation upon consumption covering almost all consumer goods and services.

- Income tax at two slabs- 20 % for income levels of Rs. 1 lakh to Rs. 4 lakh per annum and 30 % for income levels above Rs. 4 lakh.

- No tax exemptions, barring housing loans and schemes relating to senior citizens and women.

- No standard deduction for salaried tax payers.

- Reduction of tax rate from 35. 87 percent to 30 percent for domestic corporate houses.

- Deduction of general depreciation rates from 25% to 15 % for corporates.

- *Grand fathering* of all existing tax incentives- ie., no incentives for new units.

- Introduction of Goods and Services Tax (GST) in the form of a countrywide single Value Added Tax system.

- No demarcation between goods and services on which power to tax will lie entirely with state or centre.

- Within the framework of GST, a floor rate of 10 % (6%-centre, 4% -state), a standard rate of 20 percent (12% -centre, 8% state) and a peak rate of 34 % (20%-centre, 14 %-state) shall be levied.

## THE TARGETS

- On the basis of the above-mentioned recommendations, the Kelkar committee has made projections about the major fiscal indicators in India during 2004-09. (See Table below)

- On the basis of the proposed reforms in the tax regime, the buoyancy estimate as envisaged by the Kelkar committee will be 2.06 for all direct taxes, 1.31 for indirect taxes and 5.39 for service taxes. (Tax buoyancy measures the degree of responsiveness of tax revenues to a change in income or tax base. The base used, is usually a country's GDP)

- The direct tax collections are expected to grow at around 25.38 percent and that for indirect taxes will be 16.15 percent where as the service tax collections will grow at 66.54 percent

- The tax- GDP ratio will be around 12.96 percent in 2008-09

- The absolute value of revenue deficit will be maintained at such a level that at the end of the year 2008-09 it will turn to a surplus amounting to Rs 7429 crores.

- The absolute value of fiscal deficit will increase

## Implications of Kelkar Taskforce Recommendations

"No demarcation between goods and services on which power to tax will lie entirely with state or centre"

**Table-3**

***Projections of Major Fiscal Indicators After Implementing Kelkar Recommendations***

*(In Rs. Crore)*

| Items | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | Average Annual Growth 04-09 | Buoyancy Base line | Buoyancy With Proposed Reforms |
|---|---|---|---|---|---|---|---|---|
| Direct Taxes | 137000 | 160883 | 209070 | 260565 | 320405 | 25.38 | 1.87 | 2.06 |
| Income Tax | 50009 | 55310 | 74744 | 92130 | 112042 | 22.71 | 1.68 | 1.84 |
| Corporation Tax | 86846 | 105573 | 134326 | 168436 | 208363 | 27.03 | 1.98 | 2.19 |
| Indirect Taxes | 175823 | 217481 | 254867 | 285735 | 320343 | 16.15 | 0.74 | 1.31 |
| Excise | 107699 | 110491 | 130941 | 146357 | 163507 | 12.10 | 0.75 | 0.98 |
| Customs | 53500 | 46980 | 45342 | 48221 | 51269 | 0.77 | 0.56 | 0.06 |
| Service Tax | 14000 | 60010 | 78584 | 91157 | 106326 | 66.52 | 1.77 | 5.39 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Gross Tax Collection | 312823 | 378363 | 463937 | 546301 | 643287 | 20.34 | 1.26 | 1.65 |
| Educational Cess | 4910 | 5939 | 7282 | 8575 | 10097 | — | — | — |
| Total Gross Tax | 317733 | 384302 | 471219 | 554875 | 653384 | 20.71 | 1.28 | 1.68 |
| GDP at Market Prices | 3104857 | 3477440 | 3903426 | 4391355 | 4962231 | 12.35 | — | — |
| Tax-GDP Ratio (in %) | 10.08 | 10.88 | 11.89 | 12.44 | 12.96 | — | — | — |
| Revenue Expenditure | 385493 | 418394 | 462559 | 496760 | 547283 | — | — | — |
| Capital Expenditure | 92335 | 99803 | 113199 | 139206 | 162265 | — | — | — |
| Revenue Deficit | 76171 | 61328 | 41802 | 14319 | (-)7429 | — | — | — |
| Fiscal Deficit | 137407 | 140236 | 138776 | 137436 | 138746 | — | — | — |

Source: Compiled from Government of India (2004), "Report of the Taskforce on Implementation of the Fiscal Responsibility and Budget Management Act-2003", Ministry of Finance, July 2004.

"projections regarding tax buoyancy are highly optimistic"

from Rs. 137407 crores in 2004-05 to Rs. 138746 crores in 2008-09 and as a proportion of GDP it will decline from 4.4 % to 2.79 % between 2004-09

## AN ASSESSMENT OF THE RECOMMENDATIONS

- At the outset, the Kelkar taskforce's basic perception is that fewer and lower rates of taxation will lead to greater compliance of revenue and generate more tax buoyancy. The argument is based on the '*Laffer Hypothesis*', which states that there exists an optimal level of tax rate at which the total tax collection will be maximum. Therefore it is possible to enhance the tax revenue by reducing the existing tax rates if it is above that optimal point. However, this proposition of Arthur Laffer followed by Mr. Kelkar is difficult to be established without reasonable doubt. It is discarded in the country of its origin (US) as first of all, it is very **difficult to determine such an optimum tax rate and such a rate, even if it exists, can not remain static in an agile economy** where levels of output, income and employment are ever changing. Therefore, there is no reason to believe that lower rates will generate higher revenue without major changes in tax enforcement

- The projections regarding tax buoyancy are highly optimistic. Since the taskforce proposes a drastic decline in customs duties, the buoyancy is projected at a low level for such duties. However, for all other taxes it is estimated at a very high level and there is no justification behind such a projection. The gross tax revenue is assumed to grow by around 21 percent per annum. This is based on another assumption that the growth rate of GDP will be more than 10 percent over the reference years and even around 13 percent during 2008-09. It is quite unrealistic to have such high projections of GDP in Indian context where even a bad monsoon can drag the GDP down. **The customs duties are downed and this implies that the government is favouring imports at the cost of domestic producers.** This will have a detrimental impact on the overall production of the manufacturing sector in coming years. Even the GDP will get affected. A 66 percent growth envisaged in the service tax collection is also unrealistic. Though it is desirable to expand the tax base even in the indirect tax sector, it should be remembered that in India most of the services are provided in an unorganised framework. Bringing them into the tax net may be successful through steps like lower tax rates and not the reverse. Thus, the total tax revenue very likely to fall short of the expectations.

- The FRBM Act requires that the Central Government should reduce the fiscal deficit by 0.3 percent per annum and revenue deficit by 0.5 percent per annum. If such targets are not possible through increased tax revenue, then because of the compliance conditions envisaged in the Act, the government should go for drastic reduction in the expenditure side.

- The Mid Term Fiscal Policy Statement of the present Finance Minister envisaged a cut in deficit by assuming a reduction in the subsidies through better targeting. **But the budget 2004-05 or any other policy document are mysteriously silent about the strategy to be adopted for better targeting.** The present government accepts its inability to curtail the non-plan revenue expenditure and stresses on having a check on it. Even then actual revenue expenditure may cross the estimates due to the charged commitments towards higher interest payments and compensation to the states for implementing VAT through GST.

- Generally the government finances its deficits through borrowing from RBI i.e., deficit financing which also includes printing of new currency notes. As per the FRBM Act, the government cannot borrow from RBI after three years. This implies that the government is restricted from resorting to cheap source of credit and is forced to borrow at much higher interest rates and a further increase in the revenue expenditure.

- Under such situation, it is unlikely that the government can achieve such targets as per the FRBM norms. In a mood of desperation, the government will certainly try to reduce expenditure on social and economic services, capacity creation and crucial sectors like health, education and agriculture. Already, there is an apathy towards these sectors. A further decline in actual allocations may hamper the overall welfare of the economy.

Thus, it can be said that some of the intentions of the Kelkar committee are welcome but the problem lies partly in the original act itself and partly in the means to achieve the targets. It is true that such high targets are desirable, but it requires an aggressive attitude towards enforcement and punishment of the tax evaders rather than lowering the rates and simplification of the processes. The government of the day may not be interested in enforcing taxes very aggressively due to political reasons and until that happens, the direct fallout of any fiscal consolidation along the lines of FRBM Act or the recommendations of the Kelkar Taskforce will continue to adversely affect the welfare sectors in general and the poor and the marginalized in particular.

As regards the effects of the recommendations of Kelkar Committee on the poor and the marginalized sections, it can be argued that they are going to be hit hard. The first reason is that while everyone pays some amount of indirect taxes, very few pay direct taxes. Expanding the base for indirect taxes and making the incidence of taxation upon consumption covering almost all consumer goods and services is going to hit poor people hard, as they would end up paying more taxes than before on account of its expansion which would cover even the bare subsistence goods and services for them. Further, the compliance conditions envisaged in the recommendations shall squeeze public expenditure on social sector, which is grossly inadequate at present, thereby rendering the provision of basic facilities such as education, health, potable water etc. less than before. It is a well-established fact by now that with lowering of public expenditure in social sector, marginalized people suffer more and their living conditions deteriorate much faster.

**Empowered Committee says no to Kelkar Committee Report**

The empowered committee on VAT has decided not to consider the latest report of Kelkar committee. The empowered committee of state finance ministers on VAT consider that a lot of views generated in the report were digressive in nature and would only divert the group away from the basic issue.

*The advocates of neo-liberal economic policies have picked out the fiscal deficit or rather the extent to which a government can restrict the fiscal deficit as one of the most important parameters to judge the performance of the government in the sphere of economic policy-making. We present below a brief analysis of the desirability of such orthodoxy in fiscal policy.*

Implications of Kelkar Taskforce Recommendations

"the direct fallout of any fiscal consolidation along the lines of FRBM Act will continue to adversely affect the welfare sectors"

# Containing the Fiscal Deficit

## For the Rich or the Poor ?

### THE CONCEPT OF FISCAL DEFICIT

Fiscal deficit of the government is the difference or gap between total government expenditure (which includes expenditure of all kinds, including interest payments) and total non-debt-creating receipts of the government (i.e., *fiscal deficit* = total government expenditure – total non-debt-creating receipts of government). Now, *non-debt-creating receipts* are all such kinds of receipts for which the government does not incur any debt liability. For example, tax revenue receipts are non-debt-creating receipts, whereas loans (from internal as well as external sources) are debt-creating receipts. Since it is the excess of total expenditure over total non-debt-creating receipts, fiscal deficit represents the total debt liability of the government. Which means, the government must incur debt equal to the amount of fiscal deficit, in a particular financial year, in order to expend all of the allocations stated in its Budget for that financial year. Fiscal deficit can be covered by borrowing from the Reserve Bank of India (also known as deficit financing or money creation) and borrowing from the market (which is mainly from banks).

### MISLEADING ARGUMENTS FOR CONTAINING THE FISCAL DEFICIT

After the onset of economic liberalisation in 1991, India has undertaken financial sector liberalisation to a considerable extent by now. As a result, our economy today has many foreign firms who operate in the financial services sector. Their profits depend on the real value of money across different points in time (or the time value of money). If the value of money in India goes down over time, which does happen when there is *inflation* (i.e., a persistent phase in which prices rise faster than the volume of output) in the economy, the profits of the financial firms get eroded. Thus, all such firms are strongly opposed to any kind of government policy which can be thought of as leading to a higher rate of inflation (and also of late these firms have managed to become quite vocal in the debates and discussions on economic policies taking place in our country). And, those who support a greater liberalisation of the financial services sector hold the view that a greater fiscal deficit of the government does lead to an acceleration of the rate of inflation. Hence, they have picked out the fiscal deficit or rather the extent to which a government can restrict the fiscal deficit as one of the most important parameters to judge the performance of the government in the sphere of economic policy-making.

There is another prominent ground on which many economists have attacked the fiscal deficit, which is the view that a higher fiscal deficit leads to a higher value of the real interest rate. *Real interest rate*, which is the nominal interest rate minus the rate of inflation, represents the cost or price of borrowing money. So the commonly propagated view is that if the real interest rate is high, entrepreneurs will find it difficult to borrow money and hence *investment* (or creation of additional capital stock) in the economy will slow down. In this context it is argued that a higher fiscal deficit will require the government to borrow money to a greater extent, which will raise the interest rates in the money market, and this in turn will lead to a slow down of investment.

A third argument is based on the idea that there is a fixed pool of savings in the economy. Therefore, if the government exhausts more from that pool, less savings would be left for private investors. As a result investment by private sector will shrink.

### CONSEQUENCES OF ADHERENCE TO MISLEADING ARGUMENTS

Now, if we accept the propositions given above as correct, the government can neither resort to deficit financing (as it will supposedly cause an acceleration of inflation), nor can it borrow money to a greater extent from banks (as this apparently leads to a slow down of investment), which are the two major ways in which the fiscal deficit can be covered.

It follows, from the above arguments, that the government should cut down its fiscal deficit to as low a level as possible. Before we try to demystify each of those arguments, let's see how, according to the advocates of fiscal deficit reduction, should the government go about this job. Now, there are two ways in which the fiscal deficit can be reduced- by raising revenues or by reducing expenditure.

Raising the revenues would require the government to impose higher taxes on the rich and the business class, but that again is resisted heavily by the same sections who we have been talking about. Their view is that instead of raising direct taxes, the government must give tax-cuts and tax-concessions to the entrepreneurs in order to provide them with greater incentives for raising their level of economic activities. However, advocates of such policies blatantly ignore the fact that a majority of our population lacks the purchasing power to buy even the essential commodities. This problem of lack of purchasing power with a major chunk of our population, especially the rural population, has got aggravated in the era of liberalisation mainly because the rich have become richer and the poor have become poorer. As a result, there has been a deficiency in demand in our economy for quite some time. In such a scenario, giving more incentives to the entrepreneurs through lower taxation does not solve our problems. The government should rather try to generate more employment opportunities, especially in the rural areas, which will not only alleviate the problems of the poor but also boost demand for all kinds of commodities by raising the purchasing power of a majority of our population, and this in turn will lead to a significant expansion of production, employment as well as income. But unfortunately, the governments at the centre over the last decade have neither realised the necessity for boosting demand from the rural areas, nor did they show any political will to tax the rich to a greater extent. In fact the *tax-GDP ratio* (which expresses the volume of tax revenue in a year as a proportion of the Gross Domestic Product for that year) in our country, which has been quite low in comparison to many developed as well as developing countries, has gone down further over the last few years.

As a consequence, **the main impact of the policy of fiscal deficit reduction has been on government's expenditure**. This has had a number of effects. First, government investment in sectors such as agriculture has been cut. Secondly, expenditure on rural employment generation programmes have been reduced leading to greater hardship for the poor already bearing the brunt of liberalisation. And, government expenditure on social sectors, like public healthcare facilities, education and poverty alleviation have been brought down. Most importantly, the government has not been allowed to play any active role for boosting demand at a time when the economy faced acute shortage of demand. If these consequences are something that we are worried about even slightly, we must try to see the fallacies in the arguments of those who strongly advocate a reduction of the fiscal deficit. However, it may be important to mention here that a higher public expenditure (in the social sector and on rural employment generation and asset creation, etc.) alone cannot achieve the desired results. Currently we get a very poor return for each rupee spent. We should not only spend more but also spend it more efficiently- with less corruption, less leakage of funds from the public expenditure channel, and better outputs from the expenditure.

## REALITIES ABOUT THE FISCAL DEFICIT IN THE INDIAN CONTEXT

Let's take up inflation first. No doubt, inflation, if allowed to reach a very high level, causes many difficulties for people. But **fiscal deficit does not necessarily lead to inflation**. There are two commonly propagated arguments which link a high fiscal deficit to inflation. The first is based on the fact that a part of the fiscal deficit, which the government finances by borrowing from the RBI, leads to an increase in the money stock. Now, some of the advocates of fiscal deficit reduction hold the unsubstantiated view that a higher money stock necessarily leads to inflation as "more money chases the same goods". First of all, more money in the economy does not chase the "same goods", since there is a strong possibility for the output of goods to increase as a result of the increased fiscal deficit (and hence increased government expenditure). In the case of our economy, where we have sizable proportion of unutilised resources, output is held in check by the shortage of demand (resulting from a lack of purchasing power among the majority, which we discussed above). Therefore, **a high fiscal deficit, arising because of higher government expenditure, may lead to greater demand for output, which in turn would lead to a situation in which "more money (than before) is chasing more goods (than before)"**. Secondly, the speed with which money "chases" goods is not a constant; rather this speed varies as a result of changes in other economic variables. Thus, even if a part of the fiscal deficit leads to a larger money stock in the economy, it need not lead to inflation.

The second argument linking fiscal deficit with inflation is that in an economy where output of some of the essential commodities cannot be increased, the increase in demand caused by a higher fiscal deficit will raise prices. There are flaws with this argument as well. First of all, this argument does not seem to be quite applicable for the Indian economy, where we have had adequate supplies of foodgrains (we are talking about production of foodgrains, not consumption) and a more than comfortable level of foreign

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"the main impact of the policy of fiscal deficit reduction has been on government's expenditure" exchange reserves. Secondly, even if some particular commodities are in short supply; the government has numerous strategies to adopt, like, rationing, in order to check a price rise. Also, if we accept the argument of the advocates of fiscal deficit reduction- that output in our economy is constrained by supply rather than inadequacy of demand- as correct, then not just a higher fiscal deficit but any mechanism that increases demand (such as higher private investment) will lead to inflation.

Then, as regards the argument that a higher fiscal deficit leads to a slow down of investment through a rise in the real interest rates, the first point to be understood is that investment does not depend solely upon real interest rates or the cost of borrowing money. Entrepreneur's investment decisions are driven also by their expected profits, which in turn depend on the level of demand for their output. Secondly, it has been shown both theoretically as well as by empirical exercises that **there is no plausible reason to accept that the fiscal deficit, financed by government borrowing, would necessarily raise the real interest rate in the economy**. In fact, advocates of such a misleading argument assume that the economy has its resources fully employed, which is incorrect not only for India but for most developing countries as well. Let's see how the assumption of full employment gives rise to misleading propositions. We had noted, in the beginning, the argument that at any point in time there is only a fixed pool of savings in the economy. So if the government exhausts more of that pool for its expenditure less is left over for private investment. But the fallacy in this argument arises from the ignorance of the fact that total savings in an economy depend, among other things, on its total income, and the pool of savings can certainly expand, as a result of government expenditure on various activities, if there is an increase in the level of total income. However, if we assume that the economy already has its resources fully employed, then higher government expenditure (financed by greater borrowing) cannot augment total income of the economy. But how realistic is it to assume full employment in the Indian case?

"no plausible reason to accept that the fiscal deficit, financed by government borrowing, would necessarily raise the real interest rate in the economy"

Besides these common misleading arguments that are put forward by the advocates of fiscal deficit reduction, we need to throw light on another concern relating to fiscal deficit that haunts many of us. And, that is the fact that a larger fiscal deficit raises the accumulated debt of the government and increases its interest burden. First of all, **we should understand that the process of liberalisation pursued so zealously over the last fourteen years has put upward pressures on interest rates charged by the banks on borrowings (but the same has not happened in case of interest rates offered for deposits). In the era of liberated mobility of finance capital with respect to our country, the interest rates have been kept high for preventing capital outflow. As a consequence, the interest burden of the government has increased over the years. So blaming the fiscal deficit (or government expenditure) as mainly responsible for this problem is unfair**. Secondly, a growing domestic debt (i.e., not from external sources) is not a problem for a government in the same way in which growing debt is a problem for a household. For, the government can always raise its receipts through taxation and by printing money. And, we have already discussed why printing money does not necessarily lead to inflation. Finally, we must remember that a higher expenditure by government can also lead to higher earnings in future. When the government is spending money on creation of capital goods or assets, it does get back the money in the form of earnings from those assets after a time lag. Even if the government allocates more to revenue expenditure (which does not lead to creation of any asset), the increased expenditure has further multiplier effects because of the subsequent spending of those whose incomes go up because of the initial expenditure. The overall expansion in economic activities in turn means that tax revenues of the government also increase. Therefore, **a higher fiscal deficit at the present, necessitated by higher government expenditure, does not create perpetual problems of debt for the government**.

Thus, we must see who benefits from the obsession of containing the fiscal deficit- the poor, unemployed and underprivileged masses of our country who can benefit hugely from increased government expenditure on poverty alleviation, employment generation, agriculture, provision of public healthcare facilities and free education; or those affluent classes whose interest coincides with that of the foreign financial firms? No doubt it is the latter who can hope to benefit from this obsession, but at the cost of reduced government expenditure aggravating the misery of the poor and marginalized sections.

*The following section presents a note on financial liberalisation in our country and the consequent shrinking of policy space available for our Governments.*

## Guest Column: *Prof.C.P. Chandrasekhar*

# Financial Liberalisation and the Government's Budget

One of the very first moves of the UPA government was to notify the Fiscal Responsibility and Budget Management (FRBM) Act passed under the previous regime. That Act requires the government to reduce its revenue deficit to zero over the next few years and substantially curtail the fiscal deficit relative to GDP. Given the evidence of a substantial erosion of the government's tax base, reflected in a decline in the tax-GDP ratio, the implementation of the FRBM Act would result in fiscal contraction that entails reduction in capital and social sector expenditures.

This acceptance of a deflationary stance cannot be attributed purely to pressure from the Bretton Woods institutions. Very clearly, the NDA government and the Congress have internalized the logic of fiscal reform and chosen to enact a legislation that voluntarily ties the hands of the government when it comes to exercising fiscal autonomy. What explains this adherence to an economic policy framework that would make it extremely difficult, if not impossible, for the government to implement many other of its policy pronouncements, including the National Common Minimum Programme of the UPA?

The answer to that question must turn to the effects of the capital inflow that the process of financial liberalization has unleashed. In fiscal 2003-04, India received the equivalent of $22 billion as net capital flows. Most of this was the result of portfolio investment inflows, which accelerated as a result of the privatization drive launched by the NDA government. We must recall that India did not need these flows to finance its balance of payments. Rather, because of current account inflows on account of remittance ($18 billion) and software and IT services exports ($12 billion), India recorded a comfortable surplus on its current account. We did not require capital to finance our import bill. This has been true for the last four years.

Further, there is very little of this capital which can be seen as contributing to new investment. Portfolio investment is directed at stocks traded in secondary markets. And even what is identified as foreign direct investment flows (where the investor holds 10 per cent or more equity in a firm), consists very often of investment in the purchases of an additional stake in foreign controlled companies in India by the parent or in the wholesale acquisition of Indian companies. Thus, it is not just that India does not need these large inflows for financing the balance of payments, they also do not serve as a source of finance for fresh investment in new capacity.

On the other hand, large capital inflows have resulted in a substantial increase in the foreign exchange reserves of the central bank and have strengthened the rupee vis-à-vis the dollar, eroding to an extent the competitiveness of our exports. This is, however, not the only effect of volatile capital inflows. The accumulation of financial assets purchased with such inflows creates the danger of a possible exodus of capital, if and when the confidence of financial investors is undermined. And once such an exodus begins there is a cumulative collapse of confidence which can generate a financial/currency crisis.

Hence, even though India does not need this capital for balance of payments purposes or is not benefiting in the form of new capacity, the very presence of these investors makes it imperative for the government to keep them happy. The only other option is to adopt a variety of capital controls, which implies a reversal of financial liberalization that the present or previous government has been unwilling to pursue.

One requirement for keeping financial investors happy is to substantially reduce the deficit of the government or its expenditures financed with borrowing. Financial interests are against deficit-financed spending by the state for a number of

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reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is "autonomous" in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Finally, if deficit spending leads to a substantial build-up of the state's debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Given the consequent dislike of expansionary fiscal policy on the part of financial investors, countries seeking to attract financial flows or satisfy existing financial investors are forced to adopt a deflationary fiscal stance, which limits their policy option.

Further, if a country is successful in attracting financial flows, the consequent tendency for its currency to appreciate, forces the central bank to intervene in currency markets to purchase foreign currency and prevent excessive appreciation. The consequent build-up of foreign currency assets, while initially sterilized through sale of domestic assets, especially government securities, soon reduces the monetary policy flexibility of the central bank. Governments in Asia, especially India, faced with these conditions are increasingly resorting to trade and capital account liberalization to expend foreign currency and reduce the compulsion on the central bank to keep building foreign reserves. That is, if financial liberalisation is successful, in the first instance, in attracting capital flows, it inevitably triggers further liberalization, including of capital outflows, leading to an increase in financial fragility.

Thus, financial liberalisation that successfully attracts capital flows limits the policy space of the government. In particular, it introduces a deflationary bias in fiscal policy, independent of the circumstances with regard to supply-side constraints and demand deficiency. This erodes the ability of the State to deliver on its policy promises as appears to be true currently of the National Common Minimum Programme.

"financial liberalisation that successfully attracts capital flows limits the policy space of the government"

***Portfolio Investment in Total Foreign Investment Inflow to India***

| Details | 1990-91 | 1991-92 | 1992-93 | 1993-94 | 1994-95 | 1995-96 | 1996-97 | 1997-98 | 1998-99 | 1999-2000 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| A.Direct Investment (in US $ Million) | 97 | 129 | 315 | 586 | 1,314 | 2,144 | 2,821 | 3,557 | 2,462 | 2,155 | 4,029 | 6,131 | 4,660 | 4,675 |
| Proportion (in %) | 94.17 | 96.99 | 56.35 | 14.11 | 25.57 | 43.83 | 46.00 | 66.05 | 102.54 | 41.59 | 59.35 | 75.21 | 82.64 | 29.12 |
| B.Portfolio Investment (in US $ Million) | 6 | 4 | 244 | 3,567 | 3,824 | 2,748 | 3,312 | 1,828 | -61 | 3,026 | 2,760 | 2,021 | 979 | 11,377 |
| Proportion (in %) | 5.83 | 3.01 | 43.65 | 85.89 | 74.43 | 56.17 | 54.00 | 33.95 | -2.54 | 58.41 | 40.65 | 24.79 | 17.36 | 70.88 |
| Total (A+B) (in US $ Million) | 103 | 133 | 559 | 4,153 | 5,138 | 4,892 | 6,133 | 5,385 | 2,401 | 5,181 | 6,789 | 8,152 | 5,639 | 16,052 |

Note: Data on FDI have been revised since 2000-01 with **expanded coverage**. These data, therefore, are not comparable with FDI data for previous years.

Source: www.rbi.org.in

*The next section presents the views of Shri A. Vijayaraghwan, Rajya Sabha M.P., on the performance of the UPA Government vis-à-vis the promises for rural India made in the National Common Minimum Programme.*

**Q:** How do you view the CMP?

**A:** CMP is a set of guidelines for the government. UPA is an alliance of different political parties and is also supported by left parties. So, naturally, all these political parties have their own view about political aspect as well as the economic aspect of country, unlike the NDA government, which was implementing the BJP agenda. About BJP agenda, there were two parts, one was the communal agenda of RSS and the second was economic agenda of the Hindutva, which was totally pro-rich and anti-people. That was the reason of the setback of that government led by BJP. These policies resulted in incidences like committing suicides by the peasantry. So these defects must not be repeated. So naturally, the new political front needs a guideline for running the government. For a coalition government that is a must. The CMP reflects the wishes of the Indian people in general.

**Q:** So, you say that the CPM is a guideline, which is all inclusive of its partners and also it reflects the wishes of the common people and this government started working on the guideline. **Though 100 days are not long enough time to evaluate a government's performance but one can see how it has started. So considering that, how do you evaluate first three months of the government?**

clear. There is no attempt from the government to divide the people. (During the NDA government) main problem was, there was an attempt on part of the central government to divide the mindset of the general public on the caste and communal lines, which was totally against the basic foundation of the country. As far as this new government is concerned, there is no such attempt. That itself is a relief for a country like ours.

**Q:** Coming to the rural and agricultural sectors, **what specific steps are coming to your mind, which the government took in this short period?**

**A:** You just go through the budget (2004-05). The orientation is towards these sectors. There is an attempt for increasing the rural infrastructure, which will enhance the productivity in agriculture. Secondly, the rural employment scheme and rural development schemes, have been streamlined in a way that will provide rural employment. So that orientation is there but I have a feeling that the government has to give more emphasis on the implementation (part). With regard to the previous government, they were also promising big benefits for the rural poor and peasantry but they never implemented. That should not be repeated. Now the orientation

# Interview: **Shri A.Vijayraghawan**

**A:** The country is passing through a very difficult period since there is a big crisis in agriculture. The foremost issue is to address this problem of peasantry, specially of the poor agricultural worker, second issue is unemployment, specially in rural areas, then there is malnutrition, suicide deaths ... These are the areas, where the urgent attention of government is needed. Then of course, we have problems related to the economy – public sector privatization, and many other things. At the time of the BJP, thrust was totally towards privatization - irrational privatization - that would benefit only to a microscopic minority, the richer section of our society. So after this government coming to power, we can create space, in the society. In order to provide assistance to rural areas, the 10 thousand crore which was given for neglected areas, for agriculture, food for work, mid day meal scheme etc. That it is better than BJP.

**Q:** The new government has not been able to ...

**A:** We cannot expect the sea change in the 100 days but thrust is clear and the consent is very much visible and there is an earnest effort from the new government and at every level some kind of coordination is needed.

**Q:** The CMP promises, "The UPA Government will immediately enact a National Employment Guarantee Act." What is the progress?

**A:** Yeah, that is an area on which urgent attention is needed. Because the employment is not increasing in accordance with the increase in the population. It is rather less, the population growth is 1.8% and employment growth rate is 0.95%, just half. So naturally, there are problems, migration is reported from rural areas to the urban areas. For example, nearly about 1.3 million women workers migrated from the villages and nearly about 110 million agricultural workers and rural poor have already migrated from the rural areas to the urban areas. That itself is a very big problem. The main reason is the drop of employment in the agriculture sector, during the period of liberalisation. Earlier there was nearly

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about 120 days or so of employment in a year for the workers, now the working days have come down to some 70-80 days of work. And the (previous) central government even took a decision to not collect data on employment in rural areas. They are not keeping a database for the employment available in the rural areas. What does it show? They are quite afraid about that. If such a report would come in front of the nation that will adversely affect the image of the government. So naturally, when they are no more in the office, urgent step should be taken to implement the employment grantee scheme.

There are so many employment generation schemes, but with regard implementation they don't have any flexible rules, and there is a uniform pattern through out the country. The problems in Kerala would be different that that in Bihar. Therefor it should be flexible. Secondly, there is an attempt to bypass the PRIs. That should be stopped. So many schemes are there, which could be implemented properly by PRIs. The bureaucrats are bypassing the PRIs by promoting NGOs. The rural employment scheme money is not being utilised properly, because there is a nexus between the corrupt NGOs and corrupt bureaucrats. That is mainly responsible. This is bypassing the PRIs. The PRIs have to be taken as the implementing agencies of the employment generation schemes.

"The PRIs have to be taken as the implementing agencies of the employment generation schemes"

Q: **There are two aspects of this act. One, this act has to be passed in the parliament. And the other is reallocation of the resources.** About the first part, is there any progress? Is there any committee formed, or how is it going?

**A: That is only 100 days for this government and it will take time. But we will have to pressurize the government. In my view utmost priority should be given to this act.**

**Q:** Is there any specific suggestion on your part on how some more resources can be generated for this purpose?

**A:** There are different schemes and grants; we have to put all the programmes together and some additional resources. I think the resource would not be a problem. A national consensus will evolve naturally, because it is needed for the country.

**Q:** CMP promised "Immediate steps will be taken to ease the burden of debt and high interest rates on farm loans." **What steps have been taken in this regard by the government?**

**A:** The loans of the small farmers should be written off i.e. the loans up to Rs. 1 lakh should be written off. Once it is done the poorer section will be out of the crisis. For the middle peasantry, the interest should be lowered. So the approaches for the different class of the farmers should be different.

**Q:** But the farmers have taken loans from private moneylenders and are in such a crisis that they are committing suicides. **How can the government provide immediate relief to those farmers who have taken loans from the private moneylenders?**

**A:** There are two ways. One, proper action should be taken against these moneylenders. And second, the government should promote people's associations to act against the private moneylenders. People's support is needed through Gram Sabha and other mechanisms to control the local private moneylenders. Also, legal action should be taken against them to get back the bank documents, ration cards and other documents, which they have taken from the people. So, these actions and also financial assistance through banks, cooperatives etc. is needed.

Q: Is there any action on part of the government in this direction?

**A:** The state governments can take actions; these actions cannot be taken from Delhi. A general direction can go from here and the state governments have the role to play.

**Q:** We have talked about agriculture and employment in the rural areas. What about the basic services like drinking water, education and health in the rural areas?

**A:** The Rs. 10,000 corore budgetry support provided in the budget has been raised to Rs. 12, 000 crore. This money will be used for these purposes. Rural infrastructure and health and education.

Q: As an MP are you satisfied with the direction this government is taking or is there a disappointment?

**A:** I cannot say that there is a drastic change. But we are hopeful.

Q: Is there anything specific thing, which you as an MP had expected this government will take up, very immediately in two three months, which they delayed or have not done?

**A:** Two things. One is the speedy implementation of these programmes, which has to be earmarked by the Planning Commission. Secondly, they have to check the inflation. Even though it is a legacy created by the previous government. Government has to check the inflation.

***Shri A. Vijayaraghawan, CPI(M)** is Member of Parliament, Rajya Sabha*

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