

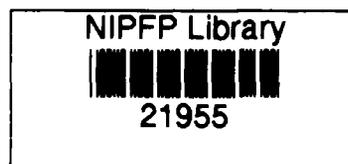


**THE MACROECONOMIC ADJUSTMENT PROGRAMME :  
A CRITIQUE**

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"And zealotry has virus so concealed,  
It's hard to tell the poison from the cure!"

Goethe, Faust, Part I

Faced with the balance of payments problem and the fiscal crisis, the Government of India has initiated far reaching changes in economic policies on all major fronts. The debate over these changes has run on fairly predictable lines with the liberal economists firmly reasserting their faith in the free market mechanism and the leftists voicing their deep suspicion of the IMF conditionalities, especially those in respect of liberalization of trade, finance and industry. It is necessary however to go beyond articles of faith and examine how far or to what extent the policy package adopted by the government, irrespective of its source, is suitable for attaining our major economic objectives (about which there appears to be a large measure of unanimity among economists of all hues).

The long-term objective of the new policies is to promote efficiency and enterprise through delicensing of industries, liberalization of the financial market, decontrol of foreign trade and free entry of foreign capital. Meanwhile a programme has been chalked out for macroeconomic adjustment over the short and the medium run in

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order to resolve the fiscal crisis and tackle the problems of inflation and the balance of payments. Our primary focus in this paper will be on the macro-economic adjustment policies embodied in the Union budget, though we have also to consider the medium run macro implications of the Exim policy, delicensing of industries and financial liberalization.

There is a fair degree of consensus regarding the basic causes and characteristics of macroeconomic imbalances in the Indian economy during the eighties. Attention has repeatedly been drawn to the increasing reliance on borrowing and deficit financing to meet government expenditure; to the higher rate of inflation experienced in this period compared with the earlier decade; and to the growing foreign indebtedness and worsening balance of payments situation. The Ministry of Finance has in fact identified the fiscal deficit as the villain of the piece and suggests, "At a macroeconomic level, fiscal deficits inevitably spill into balance of payments problems and create inflationary pressures in the economy" (Economic Survey 1990-91, p.99). Hence the Finance Minister accords top priority to the reduction of fiscal deficit from 8.4 per cent of GDP in 1990-91 to 6.4 per cent in 1991-92. In order to realise this objective the budget proposes curbs on government expenditure on both the revenue and the capital account; a 20 per cent disinvestment in shares of selected public sector undertakings; and greater reliance on the issue of bonds and debentures by public enterprises to finance their investment projects.

The fiscal management undertaken in the budget raises a number of important issues that have not received adequate attention from the proponents or the critics of the new policy. First, how far is the Finance Ministry's perception - which incidentally is identical with that of the IMF - of the impact of fiscal parameters on macroeconomic variables correct? Second, assuming that the government's diagnosis of the ailing economy is sound, do the proposed steps constitute the right cure for correcting the macro imbalances? Finally, what are the implications and costs of the macroeconomic adjustment initiated by the

government, or does the budget seek to minimize the burden of adjustment without sacrificing the basic short and long run objectives?

## **I. Fiscal Roots of Macroeconomic Imbalance**

There can be little doubt that fiscal policy played an important role in influencing the behaviour of the Indian economy over the last decade. But students of economics cannot but be puzzled by the focus on the fiscal deficit as the chief explanatory variable and the most important policy parameter of the Ministry of Finance. Indeed, neither empirical evidence nor economic logic suggests that reduction of fiscal deficit should be the prime concern of the government in the process of macroeconomic adjustment.

Consider first the empirical evidence for the eighties during which the fiscal imbalance assumed alarming proportions. Fiscal deficits, as Table 1 indicates, can in no way be regarded as an explanatory variable for inflation or trade deficit. Since the data seem to run counter to the most important presumption behind the IMF/ Finance Ministry approach, let us go into the problem a bit more carefully. Column (1) of the table gives the fiscal deficits of the union government as a percentage of gross domestic product at current prices. It may be argued that the more relevant measure of fiscal deficit in this connection would be the borrowing of the public sector consisting of the central government, state governments, union territories and public sector undertakings (net of intra public sector loans). Hence in our simple regression analysis it is this broader measure of fiscal deficit (to be denoted by  $FD_b$  hereinafter) that is used as the explanatory variable, though the qualitative results are the same for both the narrow and the broad measures of fiscal deficit.

Our analysis suggests that fiscal deficits cannot account for the rate of inflation in the eighties: the regression line, as shown in Fig.

Table 1

## Fiscal Deficit, Balance of Trade and Inflation

Year	Fiscal Deficit	Public Sector Borrowing	Export	Import	Import-Export Gap	Current Account Deficit in BOP	Rate of Inflation
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1980-81	10.0	9.0	4.8	9.2	4.4	1.2	16.7
1981-82	8.8	8.4	4.9	8.7	3.8	1.5	2.4
1982-83	9.2	9.5	5.1	8.4	3.2	1.3	7.2
1983-84	10.1	9.6	4.9	7.7	2.8	1.1	7.2
1984-85	11.4	11.1	5.2	8.1	2.9	1.2	6.0
1985-86	11.6	10.4	4.4	8.1	3.7	2.3	4.8
1986-87	13.2	12.3	4.5	7.7	3.2	2.0	5.1
1987-88	12.1	11.6	4.9	7.7	2.8	1.9	10.7
1988-89	11.7	11.2	5.3	8.9	3.5	2.7	5.7
1989-90	12.7	12.8	6.4	9.3	2.9	2.3	9.1

Note: \* All figures except those in column (7) are percentages of GDP.

Source: Economic Survey, 1990-91.

1, in the Appendix, is almost horizontal and constitutes a severe indictment of conventional wisdom in this regard. So far as the import-export gap is concerned, not only is the regression result almost insignificant, but the sign of the coefficient of  $FD_b$  turns out to be negative (Fig. 2 in the Appendix). In fact, similar counter-intuitive results are obtained for exports and imports separately. Even when the lagged value of  $FD_b$  is introduced as an additional explanatory variable, things do not improve: the regression results remain insignificant and the values of  $R^2$  abysmally low. It is only in the case of current

account deficits in the balance of payments that the regression result becomes significant even though  $R^2$  (.378) is not very high (Fig, 3 in the Appendix).

A moment's reflection suggests that, notwithstanding the widely held view, it would have been surprising if we got robust empirical evidence regarding the effects of fiscal deficits or public sector borrowings. In interpreting the regression results it is useful to remember the mechanism through which fiscal deficits are assumed to generate inflation and balance of payments problems. We propose to examine later the interaction between domestic demand and balance of payments. Even without going into the details of this interaction, it is not very difficult to see that in a regime of import control domestic demand can have an effect mainly on the export but not on the import front. However, the impact of  $FD_b$  does not appear to be significant even on exports : in the regression result (not shown) the coefficient of  $FD_b$  has in fact the wrong sign! The presumed causal link running from  $FD_b$  would not work for other items in the current account deficit in the balance of payments, viz., interest on foreign debt, remittances from abroad or foreign assistance. If a substantial part of government borrowing is used to meet the servicing of foreign debt, we will find an association between  $FD_b$  and the current account deficits in the balance of payments, but here the causation runs from the latter to the former rather than the other way round. Alternatively, easy availability of foreign loans might induce the government to go in for a spending spree abroad. These examples illustrate the danger of the poor specification of the causal mechanism in analysing economic phenomena or drawing policy conclusions.

The government's concern at the growing fiscal deficits is due not only to their effects on inflation and the balance of payments, but also to the apprehension that the deficits would become unsustainable in the none too distant future when the fiscal machinery of the government becomes, or is perceived to be, incapable of meeting its debt

obligations. If matters indeed come to such a pass, creditors at home and abroad would lose faith in the solvency of the government and economic chaos and confusion rule supreme. This is quite a legitimate concern, but the problem is that the fiscal deficit is not a good indicator of the sustainability of government borrowing in the medium or the long run. In order to spell out the nature of the problem and identify the policy parameters relevant in the context of macroeconomic adjustment, we need first to take a quick stock of the various concepts of deficits used in the budget document and indicate their economic significance and their relevance for analysing the macroeconomic impact of budgetary operations.

## II. Fiscal and Budgetary Deficits: Some Definitions and Issues

In recent years the official documents have listed the following concepts of deficits in the government accounts.<sup>1</sup>

- (1) RD (Revenue Deficit) = Revenue Expenditure - Revenue Receipts
- (2) BD (Budgetary Deficit) = Total Expenditure - Total Receipts  
(excluding net sale of Treasury Bills)
- (3) DF (Deficit Financing) = Increase in Net RBI Credit to the  
Government
- (4) FD (Fiscal Deficit) = Total Expenditure - (Revenue Receipts +  
Recovery of Loans + Receipts from the sale  
of assets).

For the sake of completeness we may include two other concepts of

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1. The Budget papers define the deficits as receipts minus expenditure - a procedure which may cause confusion and error unless one is careful about the signs. Thus in Budget at a glance 1991-92 the figure for fiscal deficit is computed correctly, but the two sides of the algebraic relation defining the fiscal deficit are not the same if one uses the usual algebraic rule.

deficits that figure in the literature on public finance:

(5)  $DCA$  (Deficit on Capital Account) = Capital Expenditure - Capital Receipts (excluding net sale of Treasury Bills)

(6)  $PD$  (Primary Deficit) = Fiscal Deficit - Interest Payments.

$RD$  is the deficit generated through current transactions in the budget and denotes the dissaving of Government Administration and Defence.  $BD$ , as noted in (2), indicates the amount of government expenditure financed through net sale of Treasury Bills during the financial year (irrespective of who buys these bills).  $DF$  gives the net increase in the Reserve Bank holding of Treasury Bills plus other government securities less increase in government deposits with the Reserve Bank. Hence  $DF$  is nothing but the increase in the reserve or high power money on account of net lending to the government by the Reserve Bank.  $FD$ , it is clear from the r.h.s. of (4), constitutes the increase in gross indebtedness of Government Administration and Defence to the rest of the economy (or the world). It follows from the earlier relations that  $DCA$  is the sum of net sale of Treasury Bills less the revenue deficit of the government. Finally,  $PD$  stands for gross borrowings of the government required to meet all expenditure less interest payments.<sup>2</sup>

The relevance or the usefulness of these various concepts of deficits depends on the purpose at hand and on the extent they can be manipulated by the government for attaining its economic objectives. From the viewpoint of economic analysis and policy prescription our focus, let us remember, has to be on the significance of these deficits for the generation of aggregate demand or inflationary pressures; for

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2. Thus the implication of a zero primary deficit (with a positive fiscal deficit) is that were there no debt inherited from the past, government borrowing would not have been necessary to finance its expenditure.

the overall saving ratio or economic growth; for the transfer of resources between the private and the public sectors; and for the sustainability of public debt or the solvency of the government.

### III. Aggregate Demand, Inflation and Balance of Payments

The deleterious macroeconomic effects of the fiscal (or other) deficits are generally identified through the following saving-investment relation for an open economy:

$$(7) \quad (I_p - S_p) + (I_g - S_g) = M - X$$

where  $I_p$  = private sector investment;  $S_p$  = private sector saving;  $I_g$  = government sector investment;  $S_g$  = government sector saving;  $M$  = imports of goods and services; and  $X$  = exports of goods and services. For medium-run policy analysis, it may be useful to recast (7) in following terms:

$$(7a) \quad (i_p - s_p) + (i_g - s_g) = (m-x)$$

where the lower case letters stand for the ratios of the corresponding macro variables to the gross domestic product.

The l.h.s. of (7) indicates the excess of domestic investment over domestic saving and the r.h.s. the net inflow of foreign resources (or the increase in the net indebtedness of the country to the rest of the world). On the basis of (7) or (7a) it may not seem unreasonable to argue that an increase in the investment - saving gap in the government sector will raise excess demand in the domestic market and hence add to the inflationary pressures and enlarge the import-export gap. It may also be claimed that inflationary tendencies and loss of competitiveness of the country's exports will be the greater, the closer the economy operates to the full capacity level. But even if the argument is

correct, it is not appropriate to focus on the fiscal deficit as the key policy parameter for solving the problems of inflation and the balance of payments. Note that the fiscal deficit does not represent the investment-saving gap in the government sector - the variable through which the macro-imbalances are assumed to occur. For one thing, in the usual definition of fiscal deficit the operations of public sector enterprises, as we have noted, are left out of the picture. The broader concept of fiscal deficit,  $FD_b$ , for the government sector comprising government administration and defence and public undertakings is given by

$$(8) \quad FD_b = FD + \text{Borrowings of public sector enterprises (excluding loans from the central and state governments)} - \text{Recovery of Loans and sale of assets by public sector enterprises} \\ = \text{Increase in gross indebtedness of the government sector.}$$

However, as may be seen from the following relations, even this broader definition of the fiscal deficit fails to indicate the investment - saving gap in the government sector. Note that

$$(9) \quad FD_b = RD + I_g + \text{Loans given (or financial claims acquired) by the government sector} - \text{Retained profits of public enterprises} - (\text{Recovery of loans plus sale of assets by the government sector})$$

But since  $S_g$  is nothing but retained profits of public enterprises less the revenue deficit, equation (9) yields

$$(9a) \quad (I_g - S_g) = FD_b + \text{Net recovery of loans}^3 + \text{Sale of assets}$$

The difficulty with even the broader concept of fiscal deficit, it is thus clear, lies in its treatment of tax collections and sale of

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3. i.e., recovery of loans less new loans given.

government assets on exactly the same footing - a palpably absurd procedure for any macroeconomic evaluation of the budget. As the relation (9a) suggests, if the investment - saving gap in the government sector is indeed the relevant indicator of the inflationary and the balance of payments effects of budgetary operations, the impact of government sector borrowings, recovery of loans and sale of shares in public undertakings would be the same and the opposite to that of revenue receipts or profits of public enterprises. Before examining the causal connection subsumed in this approach, let us estimate, ignoring market borrowings and other relevant items in the state budgets, the investment-saving gap in the government sector as per the central government budget for 1991-92. The gap for 1991-92 amounts to Rs 56,142 crore against a fiscal deficit of Rs 37,727 crore (Table 2). Even so, if the budgetary calculations do not go awry, the gap will be lower in absolute terms than in the earlier year and come down from 11.1 to 9.6 per cent of gross domestic product - a decrease of 1.5 rather than 2 percentage points.

**Table 2**

**Fiscal Deficit and Saving-Investment Gap in the Government Sector**

		(Rs. crore)	
Year		1990-91 (Revised Estimates)	1991-92 (Budget Estimates)
1.	Fiscal Deficit (FD)	43,331	37,727
2.	Recoveries of Loans	6,005	5,666
3.	Sale of Shares of Public Undertakings	-	2,500
4.	Debentures/ Bonds <sup>1</sup>	4,933	5,869
5.	External commercial borrowing/ suppliers' credit <sup>2</sup>	2,533	2,001
6.	Others <sup>3</sup>	2,251	2,379
7.	Investment-saving gap (I <sub>g</sub> -S <sub>g</sub> ) = (1)+(2)+(3)+(4)+(5)+(6)	59,073	56,142

- Notes: 1. Represent public loans floated by the enterprises within the country.  
 2. Represent commercial borrowings outside the country.  
 3. Include deposits raised by the enterprises and inter-corporate transfers.

Source: Govt. of India, Ministry of Finance, Budget at a Glance 1991-92.  
 Govt. of India, Ministry of Finance, Expenditure Budget 1991-92, Vol. I.

Should we then regard the current fiscal exercise as a step in the right direction in spite of the misplaced focus? In the present context the answer to the question depends partly on the validity of the investment-saving gap as a good measure or indicator of macroeconomic imbalance. Before turning to the economic significance of this measure, let us look at the empirical evidence once again.

Table 3

**Investment-Saving gap in the Government Sector, Inflation and Balance of Trade**

Year	Public Sector Investment (1)	Public Sector Saving (2)	Investment-Saving gap in Public Sector (3)	Rate of Inflation (4)	Import-Export Gap (5)
1980-81	8.7	3.4	5.3	16.7	4.4
1981-82	10.5	4.5	6	2.4	3.8
1982-83	11.3	4.4	6.9	7.2	3.2
1983-84	9.8	3.3	6.5	7.2	2.8
1984-85	10.8	2.8	8	6.0	2.9
1985-86	11.1	3.2	7.9	4.8	3.7
1986-87	11.7	2.7	9	5.1	3.2
1987-88	10.4	2.2	8.2	10.7	2.8
1988-89	9.9	2	7.9	5.7	3.5
1989-90	10.7	1.7	9	9.1	2.9

Note: @ Except those in column (4) all other figures are percentages of Gross Domestic Product at current prices.

Source: Economic Survey, 1990-91.

It is fairly obvious from Table 3 that neither the rate of inflation nor the import-export gap in the eighties can be attributed to

the excess of investment over saving in the public sector : regression results (not reported here) for both the relations turn out to be insignificant. Even if there is strong empirical support for the hypothesis that the investment-saving gap in the government sector widens the trade gap and generates inflationary pressures, there remain serious problems of interpreting the evidence and using it for the formulation of budgetary policies. For an appreciation of these problems we have to go into the mechanism through which the discrepancy between  $i_g$  and  $s_g$  may conceivably affect the rest of the economic system.

Note, first, that relation (7) or (7a) by itself does not give any clue to the economic mechanism involved in the determination of the three gaps: these relations, as stated, are no more than identities and the causal links among the variables can be forged only by incorporating the behavioural relations of the economic agents, e.g., consumers, private investors and foreign buyers and creditors and by taking explicit account of the fiscal, monetary, trade and other policies. Further, neither the fiscal deficit nor the investment-saving gap in the government sector is a primary policy parameter. The government can perhaps control its expenditure in nominal terms, fix the tax rates and prices of goods and services produced in the public sector and even manage to secure the targeted amount of borrowing in nominal terms by forcing the Reserve Bank and commercial banks (through variations in Statutory Liquidity Ratio) to meet the shortfall in the amount of loan extended by the public (or foreign creditors). But the Ministry of Finance cannot directly attain its targets for revenue receipts and for investment, saving and other macrovariables in real terms or as percentages of the gross domestic product. Indeed, in order to target the budget deficit of any hue (including the investment-saving gap) the government has to know the relevant macromodel and the numerical coefficients of the behavioural and other relations entering the model.

What is more important to recognise in the present context, even

when the government can hit the bull's eye in respect of its planned levels of fiscal or other deficits, their economic consequences cannot be judged without reference to the primary policy parameters used to achieve the targets. We have examined elsewhere the economic impact, in the Indian context, of the major budgetary instruments at the disposal of the government and here we propose no more than to recapitulate the main conclusions (Rakshit, 1986, 1987). First, the expansionary effect of a budget, as students of public finance are repeatedly told, depends not only on the deficit but also on the size of the budget : a large budget with little fiscal deficit or investment-saving gap in the public sector can be more expansionary than a small one with a sizeable difference between expenditure and receipts. Second, for a given amount of revenue receipts, personal income tax and export duties tend to reduce aggregate demand to a larger extent than other forms of taxes and hikes in administered prices. Third, the demand generation effects of subsidies and (current) transfers are generally less than government consumption and investment. However, the conclusion is reversed if the transferees belong to the poorer groups or the import content of government expenditure on goods and services is sufficiently high. Finally, while deficit financing is clearly expansionary, there are substantial differences in the crowding-out effects of different categories of other loans. The crowding-out effect of borrowing from commercial banks (through the SLR requirement) is almost one to one, but the collections from NSC or other highly attractive financial assets floated by the government and public undertakings do not generally have any crowding-out effect whatsoever.

To summarize, it is the size and composition of receipts and payments and not simply the magnitude of fiscal and other deficits that are crucial in determining the effects of budgetary operations on aggregate demand. Hence even if there were strong econometric evidence in support of the widely held hypothesis in respect of the spillover effects of budget deficits, the reason would generally be that during the reference period (i) there were no significant structural changes in

the economy, and (ii) the composition of the budget or the relative weights of fiscal and other parameters remained fairly stable. There is thus no escape from looking at the more primitive relations in evaluating budgetary measures or suggesting some alternative policy package.

In an earlier study we have put forward, with explanatory notes, a rough and ready manual for estimating the demand generation impact of the budget (Rakshit, 1986). We do not propose to repeat the exercise here and remain content with a broad assessment of the main items of receipts and expenditure in the Union budget for 1991-92. There are two major provisions in the current budget that are clearly deflationary. First, the absolute level of government expenditure in real terms is going to be cut and what is more important, the cut is much larger for expenditure on final goods and services, especially for public sector investment (note that the major increase in government expenditure will be in interest payments). Second, deficit financing is proposed to be reduced to the tune of Rs 5,280 crore which with a money multiplier of three plus can severely limit the growth of bank credit in the economy. There has been no significant change in the tax structure, nor is disinvestment in the equity of public sector enterprises likely to have any crowding-out effect if the prices fixed for the shares are less than market clearing. So far as the expansionary forces are concerned, they can emanate from lower market borrowings, the boost to private investment in the wake of the new industrial policy and the removal of the ceiling on the interest rate on debentures. On balance the overall effect of the budget is likely to be contractionary, at least in relation to the growth of productive capacity in the economy.

### **Inflation and Balance of Payments**

Does our assessment mean that the Ministry of Finance is on the right track in its quest for the solution to the problems of inflation

and balance of payments? Before answering the question let us briefly recapitulate the conventional mechanism regarding the spill-over effects of an increase in aggregate demand. On the domestic front the effect is taken to be manifested in rising prices or/and output depending on the initial degree of slack in the economy. Both the output and the price effect will, however, tend to widen the trade gap because of (i) an increase in income-induced imports, and (ii) a decline in exports along with a rise in imports as domestic prices go up relatively to their international counterparts.<sup>4</sup> Again, there is a feed-back from the external to the domestic sector, though these tendencies cannot cause changes in the direction of movements in prices, output or the balance of trade.

However, there are important clogs or "wheels within wheels" in the mechanism noted above, especially in the Indian context, and these seem to have escaped the attention of most of the economists commenting on recent policy changes. Consider first the balance of payments effects of an increase in aggregate demand. Apart from the fact that the direct plus indirect import content of different categories of final goods varies all the way from 100 to zero per cent, in India imports, we must bear in mind, have been and continue to be controlled through a wide array of measures. By and large, the expenditure on imported goods is sought to be restricted, often with a time lag, to what may be called "the disposable foreign exchange receipts" (DFER) which is given by the relation -

$$(10) \text{ DFER} = (\text{Earnings from the export of goods and services}) + \\ (\text{Foreign assistance plus remittances and external loans}) - \\ (\text{Servicing of foreign debt}).$$

In the short run the second and the third (bracketed) items on the r.h.s. of (10) are not directly affected by an increase in aggregate demand so that under an import control regime characterised by the above relation,

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4. Assuming that the modified Marshall-Lerner condition is satisfied.

there is not much room left for the spillover of domestic demand to balance of trade : the empirical evidence cited earlier should thus come as a surprise to only those who try to apply text-book results without any regard to the basic assumptions and economic structure in which these results make sense.

An important application of the above line of reasoning is that the availability of foreign loans may cause an increase in trade deficits and when these loans are in the government account they show up in a larger fiscal deficit and investment-saving gap in the public sector. In such cases it is the external factor reflected in trade deficits that generates the investment-saving gap and not the other way round. In fact, in the eighties the government policy of permitting imports of capital goods (irrespective of their domestic availability) so long as the imports could be financed by suppliers' credit or (tied) foreign loans very often contributed towards an increase in the import-export gap; the decline in domestic production and government saving; and the accumulation of foreign debt. To be more specific, instances are not rare when some State Electricity Boards were eager to place their order for machinery and equipments with BHEL, but had to take recourse to imports since while the requisite foreign loans were available for imports, financial institutions in India were unwilling to extend credit for investment from the domestic source. In these instances not only were we storing up troubles for the future on the balance of payments front, but there was also an immediate cutback in domestic production and an almost equal fall in the profits of public sector enterprises so that the gap in government finances appeared in the form of a decline in saving rather than an increase in investment. The provision in the current budget relating to capital goods imports by foreign investors in India is likely to have similar deflationary effects on the domestic sector (if not cause balance of payments problems in future). Such contractionary tendencies originating in the trade sector may, however, be moderated or even reversed to the extent a larger share of the expected increase in export proceeds has to be

earmarked for servicing external debts. It is thus a moot point whether the budgetary measures, the requirement of servicing external debt and the response of foreign investors to the policy package will increase or reduce aggregate demand in the domestic sector. While the present writer perceives the overall impact to be deflationary, he is by no means prepared to bet his last farthing on such an outcome.

Assuming that there is going to be a curb on aggregate demand, what are the prospects of inflation in the near future? Indian economists appear to be sharply divided in their assessment of the inflationary potential of the budgetary and other measures initiated by the government. Attention has been drawn to the cost-push effects of devaluation and increases in the administered prices of petrochemical and other products. But at the same time the devaluation has enabled the government to withdraw export subsidy which along with the additional revenue netted through higher administered prices, curbs on government expenditure and other measures is expected to cause a reduction in deficit financing and aggregate demand so that not only the monetarists but the Keynesians also should expect a substantial fall in the rate of inflation. Should we then turn agnostic and suggest that the outcome would depend upon the relative strength of the two opposing forces, the demand-pull and the cost-push?

Fortunately, it is not too difficult to give a categorical answer to the question posed above. Most of the economists dealing with the macroeconomic problems of developing countries have come round to the view that while open market prices of agricultural goods are flexible, almost all prices in the organised sector (including the public sector) are administered or fixed on a cost-plus basis (Kalecki, 1976; Taylor, 1983; Rakshit, 1982, 1989). Hence arises the need of identifying the sectoral demand and supply shocks in any assessment of the inflationary potential in countries like India. In the light of this approach it is not very difficult to see that industrial and other prices in the organised sector are bound to rise as a result of devaluation and other

cost-push factors noted above. If this effect is coupled with a fall in demand, the result will be an inflationary contraction in the organised sector characterised by higher underutilization of capacity, lower growth and rising prices. So far as the agricultural sector is concerned, it may perhaps be argued that the fall in output and incomes in the organised sector should reduce the demand for farm products and hence their prices. Even if the argument were correct, the (demand-induced) fall in prices would be accompanied by a reduction in agricultural employment and raise thereby the incidence of poverty in rural areas. However, since in the short and the medium run labour is almost a fixed factor in the organised sector of our economy, the decline in the demand for food and other agricultural goods, originating from the non-agricultural sector, is unlikely to be significant. Much more important will be the supply-side shock going to be administered through the new economic policy. First, while fertiliser prices are expected to go up by 30 per cent (under the revised provision), no corresponding adjustment in the procurement prices of foodgrains (and other agricultural products) seems to have been made : the estimated increase in food subsidy is only of the order of Rs 150 crore! The government, it is thus clear, is not going to extend the coverage of the public distribution system and to maintain a price-cost ratio that would induce farmers to supply the required amount of foodgrains.

Second and no less important, even the intended supply of agricultural goods cannot be realised unless adequate production loans are made available to the farmers and there are strong grounds for believing that the package of measures adopted by the government would result in a severe shortage of agricultural credit. While the increase in the prices of fertiliser, pesticides and other inputs is going to raise the amount of loans required by farmers, the fairly large cut in deficit financing will curb the capacity of commercial banks to extend credit. Again, financial liberalization or rather unfreezing of interest rates on bank loans cannot but cause a sharp decline in the amount of credit going to the agricultural sector, unless special steps

are taken to supply adequate loans to farmers at a relatively low rate interest - steps which do not appear to be on the cards.

Our analysis suggests that the IMF approach to macroeconomic policy adjustment initiated by the government is fraught with grave consequences for the Indian economy in the short and the medium run. If the policies proposed are implemented through thick and thin, the economy will experience a decline in the growth of output in both the industrial and the agricultural sectors; a strengthening of inflationary tendencies; and a sharp rise in the incidence of poverty. Viewed against this scenario the Prime Minister's promise of the provision of a "safety net" for the indigent cannot but appear as a cruel joke : the government has sought to keep the promise by allotting a princely sum of Rs 2,230 crore under the Anti-Poverty Programmes (Budget at a Glance, 1991-92) for more than 370 million Indians estimated to "live" below the poverty line (Minhas, Jain and Tendulkar, 1991) - a sum which works out to a little over Rs 6 per head per annum.

#### **IV. Growth and Sustainability of Budget Deficit**

We have already emphasized that contrary to the popular view, fiscal deficits cannot be regarded as the source of inflation or trade imbalances in the eighties. In fact, there are reasons to believe that in this period the increase in government expenditure in relation to revenue collections might have played an important role in enabling the Indian economy to scale the barrier of the Hindu rate of growth. Should we then advocate the continuation of the fiscal policy pursued in the eighties?<sup>5</sup> The answer, in spite of our serious reservations regarding the IMF-World Bank diagnosis, is in the negative.

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5. With appropriate changes in respect of the policy regarding foreign borrowings and their utilization.

There can be little doubt that the demand-driven growth in the eighties characterised by rising budget deficits and a mildly declining overall saving ratio cannot be sustained and must founder against the rock of supply side factors, e.g., low rate of addition to capacity, shortage of energy or foreign exchange bottlenecks. It is for this reason that we require to reverse the trend of declining saving in the public sector if the tempo of growth is to be maintained or raised. Also, with stagnant government revenues and rising public debt as ratios of gross domestic product, the solvency of the public sector itself will be in jeopardy (Butler and Patil, 1991). Thus the twin considerations of growth and sustainability of budget deficits require fairly drastic changes in some of the policies followed so far.

At the macroeconomic level the first and most important objective in the medium run must be a step-up in the overall saving rate which nose-dived from 23.2 per cent to 18.2 per cent between 1978-79 and 1984-85 and then crawled to 21.2 per cent in 1989-90 (Economic Survey, 1990-91). Clearly, the public sector has to play an important role in attaining the objective, especially since the decline in the saving rate can largely be attributed to the poor performance of the government in this regard : between 1978-79 and 1989-90 public sector saving as a percentage of gross domestic product registered a fall from 4.6 to 1.7 : the performance will appear truly dismal when these rates are viewed in the background of huge public sector investment undertaken since the mid-fifties.

But if promotion of saving is the major concern of the government, the focus should not be on the reduction of fiscal deficits.<sup>6</sup> Public sector saving, let us recall, consists of the revenue surplus of the government plus retained profits of public undertakings<sup>7</sup>, while fiscal

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6. Gulati (1991) also makes the same point.

7. So that ceteris paribus higher dividends from these enterprises raise the revenue surplus, reduce fiscal deficits, but does not affect the level of public sector saving.

deficits comprise revenue deficits as also deficits on the capital account less recovery of loans and "other capital receipts". A reduction in fiscal deficits can thus go merrily along with a rise in revenue deficits (and a fall in public sector saving) if the government effects a sufficient cut in its investment and lending or sells off part of its financial and physical assets. However, reduction of revenue deficits also figures in the Finance Minister's agenda for macroeconomic adjustment. But then it is the reduction of revenue deficits and not the fiscal deficits that should have been the cornerstone of macroeconomic management. From the viewpoint of the promotion of saving and growth the focus on fiscal deficits, let us repeat, does not make economic sense unless it is presumed that not only are public investments relatively unproductive, but loans advanced by the government for financing private investment also have an adverse effect on the economy - a presumption rooted more in zealotry than in objective assessment.

It can be argued that though the social marginal productivity of public investment might be high, financing of such investment through borrowings becomes non-viable when its return to the government is significantly less than the interest cost. This is quite an important issue in the Indian context, but it is not clear how far the measures adopted by the government would contribute towards the solvency of the public sector without an avoidable decline in economic growth.

Now the problem of solvency cannot be dissociated from that of economic growth. If government policies promote saving, efficient allocation of resources and hence economic growth, the apprehension regarding the sustainability of public debt would generally be unfounded : "Take care of growth", it may be argued, "and solvency will take care of itself". It is true, public investment with a high yield to the economy promotes growth irrespective of the return realised by the government. However, such growth cannot be maintained if the increase in government revenue proves inadequate to meet interest payments (and

other revenue expenditure), i.e. if there is a declining trend in public sector saving. In other words, though the short-run social return on public investments might be high, they can conceivably have a negative impact on the long run economic growth through a reduction in the saving ratio. It is for this reason that the simplistic application of the social marginal productivity criterion might yield a suboptimal allocation of investible resources.

It is useful in this context to distinguish between public investments in social or economic infrastructure and those in industrial undertakings. In India the return to the government on the first group of investment is extremely low. However, there is substantial scope for raising the earnings from this category of capital formation where the beneficiaries can be clearly identified, e.g., in the case of higher education, hospital, irrigation or public transport. In many of these instances the beneficiaries belong to the upper income groups and the (indirect) subsidies enjoyed by them are many times the combined total of subsidies on the public distribution system and the amount spent on Anti-Poverty Programmes.<sup>8</sup> Also, the poor yield on public investment is due in no small measure to the inordinate delay in the completion of projects, overmanning and high salary in the public sector compared with that prevailing elsewhere. One looks in vain at the current policy package for any sensible wage-price or other policies which could have contributed substantially towards the generation of a revenue surplus and the promotion of growth with equity.

There are a number of public investments which have large (positive) external effects or which yield public goods. It is not possible in such cases to make the beneficiaries pay for the services provided, but there are indirect returns to the exchequer by way of

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8. Mundle and Rao (1991) estimate that the unrecovered cost to the government in providing economic and social services is to the tune of 16 per cent of gross domestic product.

extra revenues from the additional incomes generated through these investments. Indeed, one can go further and suggest that, even if these indirect returns are negligible as of now, there is nothing wrong in borrowing for purposes of public investment with a high social rate of return. If such borrowings threaten the solvency of the public sector, the malady lies not in these investments or borrowings, but in the failure of the government to make the beneficiaries pay for the services or to devise an effective tax machinery in order to service the public debt. While the huge public investment in roads, electricity and other infrastructural facilities have raised land values many times the increase in the general price level, no step worth mentioning has yet been taken to mop up at least a part of the unearned gains accruing to the private land owners. Such instances of the failure of the tax machinery are legion, but in its obsession for reducing fiscal deficits the Ministry of Finance seems to have taken the soft option of cutting down the scale of public investment and has failed to initiate the much needed reform in the sphere of taxation and other sources of government revenue. It may also be that the government does not have the will or the ability to make the tax system effective and serve the basic economic objectives.

So far as other forms of investments are concerned, the government, notwithstanding its protestations, seems to have come round to the view that public enterprises are inherently inefficient. It is widely recognised among the researchers in this area that the inefficiency of these enterprises is due primarily to the lack of managerial autonomy and accountability and to the absence of any sensible and quantifiable norm against which their performance can be judged. Though there is some talk of ensuring autonomy with accountability for public sector units, nothing substantive has been done in this regard and the government does not seem to repose much faith in its ability to effect the necessary organisational reforms or to put an end to the political and bureaucratic interference in running these enterprises. Here also the case for scaling down the size of

public sector investment appears to lie not so much in economic logic, but more in the lack of political will or incentive.

An important factor behind the present fiscal crisis is the borrowing policy of the government in the eighties (Rakshit, 1987). During this period interest rates on all categories of government borrowings were raised with substantial tax concessions to boot in quite a few of them. In fact in some cases the cost to the exchequer by way of interest-cum-tax relief amounts to more than 30 per cent - a rate at which most investment projects would turn non-viable. If the government were serious in promoting saving and solvency of the public sector, all tax concessions on the various saving schemes should have been withdrawn. The cynic would perhaps view the energetic inaction of the government in this regard as quite in keeping with its other omissions and commissions : after all, these concessions are larger for people in the higher income groups and cannot be availed of by more than 99 per cent of households (who do not pay the income or the wealth tax).

No less queer is the proposal for disinvestment in shares of public enterprises in order to reduce fiscal deficits. We have already examined why, from the viewpoint of public sector saving or generation of aggregate demand, capital receipts on this count are no different from ordinary borrowings. Nor can the sale of these shares be regarded as an appropriate step for resolving the fiscal crisis. For one thing, the proposed scheme will necessarily be limited to profit-making public enterprises. The steps taken in this connection so far suggest that the prices fixed for the shares will be less than market clearing, i.e., the sale will involve a subsidy to the buyers. Even if the shares are sold through auction or in the open market, for each rupee collected under the scheme the cost will be higher than that under borrowing. The market prices of shares, let us note, are related positively to the prospective earnings from the shares and negatively to the interest cost and subjective risk premium of the buyer. While the faith of the private lender in the ability of the government to service its debt is

as yet unwavering, investors in India are notoriously risk averse in their choice among different financial assets : in spite of the emergence of the so-called equity cult, household savings in shares constitute less than 10 per cent of total financial saving (RBI, 1990). The implication is that government can borrow (if it wants to) at a rate of interest that is much lower than the discount rate (inclusive of risk premium) relevant for the buyer of equities. This together with the current perception of the average investor regarding the prospective profits from public sector investments suggests that disinvestment in shares of profit-making public enterprises is a much costlier way of raising funds than borrowing.

A final point regarding the reliance on private initiative for delivering the goods. This reliance seems to be coupled with the government's tacit admission that nothing much can be done towards making the fiscal apparatus effective and equitable or towards curbing the growth of black money. This displays almost total nonchalance on the part of the policy makers regarding the evil consequences of the market mechanism unhindered by any efficient machinery for redistribution and enforcement of laws. These consequences, let us remember, consists in gross distortion in the allocation of resources, in creation of islands of prosperity in the midst of poverty and squalor, and in serious financial crisis for the government. Irrespective of whether we rely on the private or the public enterprises for our economic salvation, there is no substitute for an effective and equitable tax system and an efficient government machinery; but no serious attempt seems to have been made to initiate any policy reform in this crucial sphere.

## **V. An Overview**

There is a general consensus that correction of the current macroimbalances of the Indian economy would require major policy reforms

on various fronts. The adjustment process initiated by the government seems to be based on a few key premises, explicit or implicit. First, a reduction in aggregate demand, irrespective of the way it is brought about, contributes towards an improvement in balance of payments and curbs inflationary tendencies in the domestic sector. Second, the key to the aggregate demand management and solvency of the public sector lies in a reduction in fiscal deficits. Third, nothing much can be done to make the tax system effective, to curb the growth of black money or to make the income distribution equitable. Finally, public sector enterprises are beyond redemption and liberalization is the most effective means of attaining our economic objectives. However, these premises display either an inadequate appreciation of the macrobehaviour of our economy or lack of political will or enterprise to carry through policies that would resolve the fiscal and the balance of payment crisis and promote economic growth without hurting the indigent sections of the community.

No wonder, the overall policy package adopted by the government is not particularly well-designed to tackle the major problems confronting the economy. In fact some of the measures would in all probability have a deleterious effect on growth, government finances and distribution of income. The most important of these measures are curbs on capital accumulation in the public sector; disinvestment of equity holding in public enterprises; reliance on the issue of debentures for financing investment projects of public undertakings; reduction in fertilizer subsidy and financial liberalization without any safeguard for ensuring adequate short-run and long-run supply of the basic necessities of life; and the signal given through the provision for whitening black money.

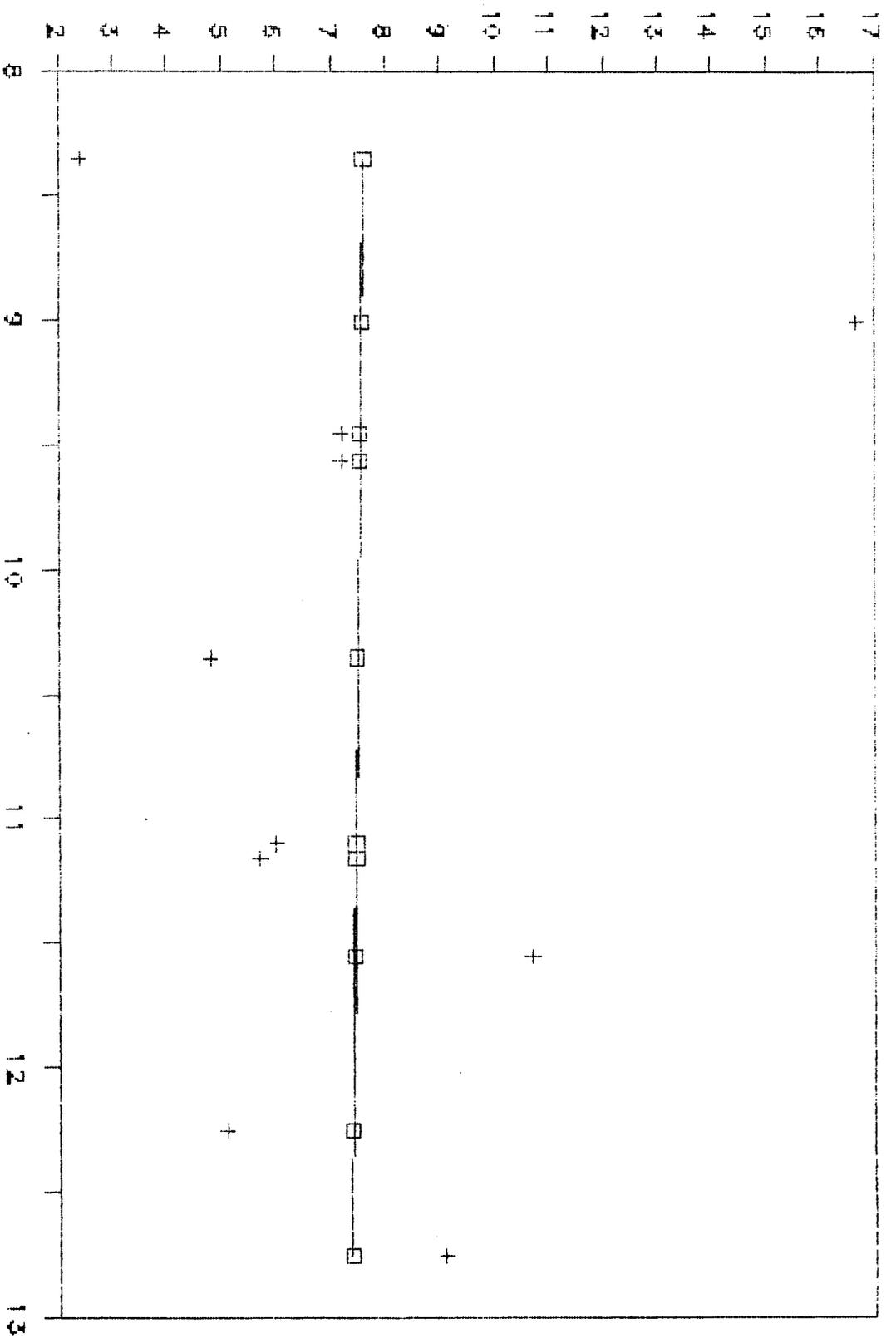
The failure of the new policy initiatives in respect of omissions is much more glaring. No attempt has been made to withdraw the various unnecessary tax concessions under the present system; to appropriate part of the huge gains from public investment accruing to the private

sector; to recover the cost of public services enjoyed by the wealthier groups of people even when the beneficiaries can be clearly identified; or to make the public enterprises autonomous and accountable. In the context of the fiscal and the balance of payment crisis an incomes policy for the organised sector in general and the public sector in particular should have been high in any agenda for economic reform; but in the numerous policy statements issued so far the government has maintained an eloquent silence on this crucial issue.

## **APPENDIX**

**Public Sector Borrowing, Inflation and Foreign Trade  
Scatter Diagrams and Linear Regression Results**

Rate of Inflation



Public Sector Borrowing as % of GDP  
 □ Figure 1

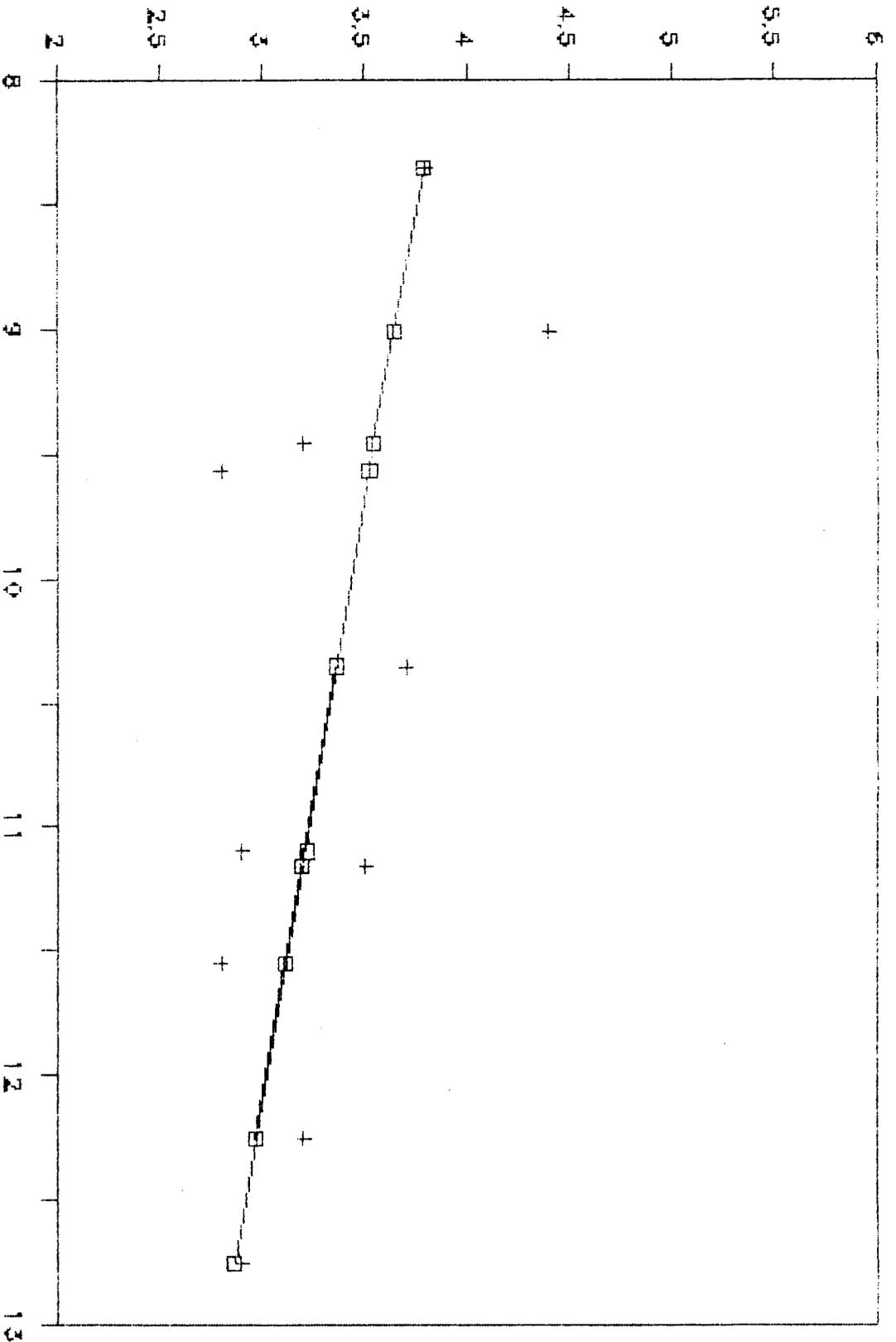
$$Y = 0.0409 - 0.0521X$$

(10.2023) (0.9560)

$$R^2 = 0.0003706$$

$$\bar{R}^2 = -0.1246$$

Import-Export gap as % of GDP



Public Sector Borrowing as % of GDP  
 □ Figure 2

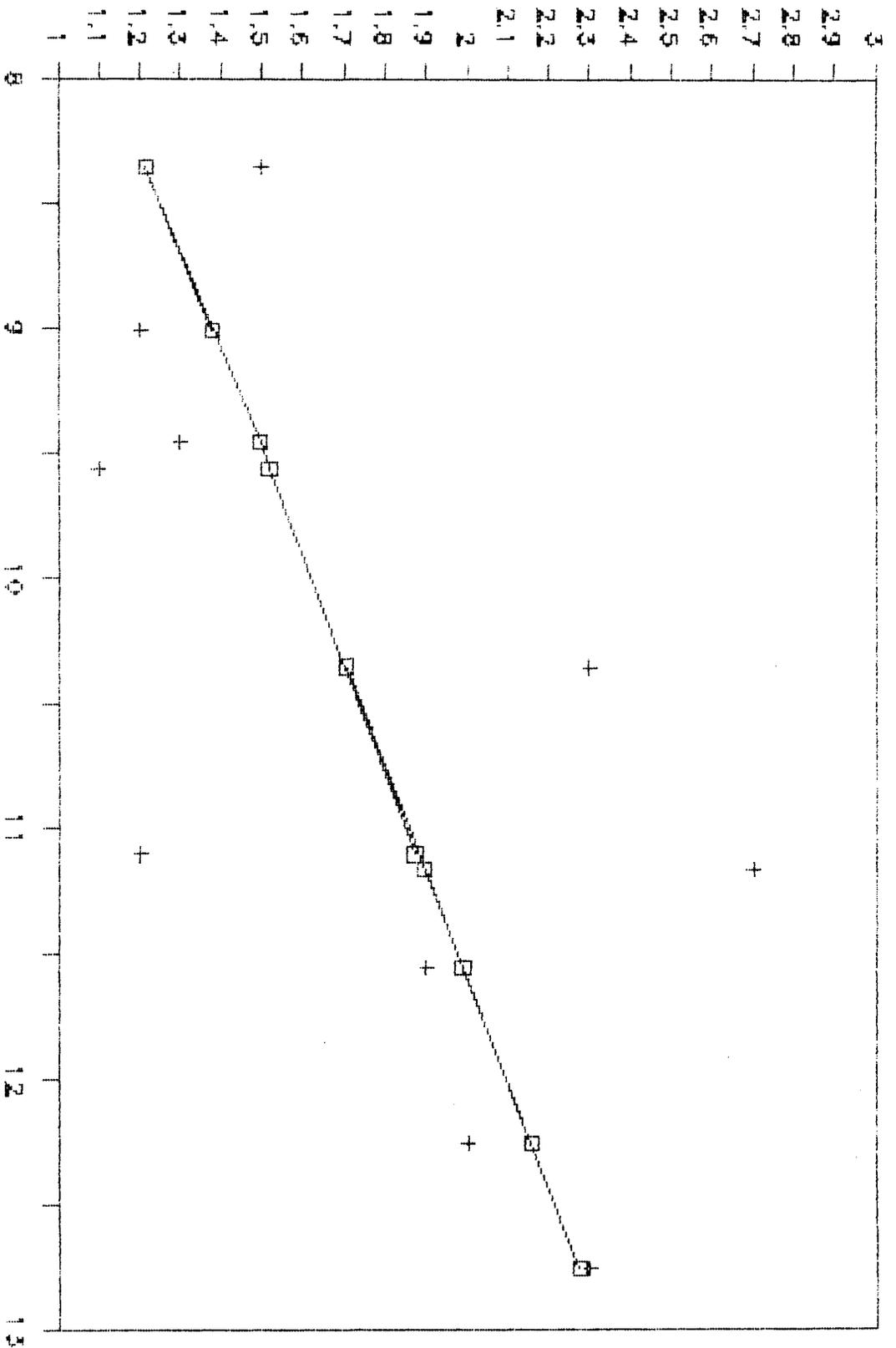
$$Y = 5.5 - 0.2061X$$

(1.1066) (0.1036)

$$R^2 = 0.3308$$

$$\bar{R}^2 = 0.2472$$

Current Account Deficit



Public Sector Borrowing as % GDP  
 □ Figure 3

$$Y = -0.7377 + 0.2351X$$

(1.1515) (0.1079)

$$R^2 = 0.3725$$

$$\bar{R}^2 = 0.2940$$

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