Lowering revenue deficit, subsidies hold key to fiscal consolidation

The Government of India needs to take some hard decisions in the upcoming Union Budget for 2000-01. There are several reasons why it is important to do so right now.

India's political system is more than ever in consensus about the basic direction of reforms. The current government enjoys a strong electoral mandate. This is the first year in office for this government, and is, therefore, the most suitable time to undertake harsh measures.

A decade of opening of the economy has produced new dynamism, most dramatically in the information technology sector, but in others as well. GDP growth rates can be raised and sustained beyond 6 to 6.5 per cent if certain critical reforms are implemented soon.

Keeping in view the fact that the fiscal deficit still remains very high, the process of fiscal consolidation needs to be pursued much more vigorously in the budget.

Considering the excessive preemption of the community's savings by the government, the potential for crowding out the requirements of the enterprise sector, the pressure on interest rates, and rising interest payments on government debt, it is extremely essential to reduce the fiscal deficit, mainly by lowering the revenue deficit.

Correction of these deficits would, inter-alia, require considerable refocusing and reduction of large hidden subsidies associated with underpricing in crucial areas, such as power, irrigation, urban transport and higher education. Food and fertilizer subsidies are other major areas of expenditure control.

Be that as it may, the process of fiscal consolidation needs to be accelerated through more qualitative adjustments to reduce government dis-savings.

We believe that India's overall government spending, currently around 33 per cent of GDP, needs to be brought down substantially as a proportion of national product in order for India to achieve its reform goals of macroeconomic stability and long-term rapid growth.

Large and persistent fiscal deficits in India are a serious cause for concern. There are several risks with high fiscal deficits.

First, budget deficits could once again spill over into macroeconomic instability, if the government resorts again to inflationary finance. This would happen, for example, if the government meets increasingly onerous terms in financing the increasing stock of public debt on the open market, and, therefore, turns to the Reserve Bank of India for increased financing.

Second, the budget deficits imperil national saving rates, thereby reducing overall aggregate investment, and jeopardising the sustainability of high growth. The effects of low investment rates on overall GDP growth are not hard to see. Most directly, low levels of public investment
have rendered India's physical infrastructure incompatible with large increases in national
product. Without an increase in the scale and rate of growth of infrastructure investment, growth
rates in India are bound to remain moderate at best.

Third, the continuing large budget deficits, even if they do not spill over into macroeconomic
instability in the short run, will require higher taxes in the long term, to cover the heavy burden
of internal debt. High tax rates will place India at a significant disadvantage relative to other fast-
growing countries.