Printed from
THE TIMES OF INDIA

# TOP ARTICLE | A Tough Balancing Act

May 27, 2009, 12.00 AM IST

With an economy still struggling to recover from the impact of a deep global economic crisis on the one hand and a strong mandate for good inclusive governance on the other, the new government has a tough balancing act to perform. How to design an economic programme that will restore growth and at the same time provide the poor income security and address their basic needs? That is the question.On restoring growth, there is a view that given the limited space for a fiscal stimulus, it may be better to rely on a reform stimulus. There is indeed vast room for reforms in many branches of the economy, as discussed in detail in the 11th Five Year Plan and elsewhere. However, reforms lead to higher growth only after a considerable time lag. Restoring growth in the short term will depend on fiscal and monetary measures.

Following the slew of monetary measures implemented by the RBI, the main thrust now has to come from the fiscal side in the July budget. The fiscal stimulus introduced in the interim budget has to be fully implemented, if not further reinforced. However, it need not depend entirely on deficit financing. Even a zero-deficit budget can provide a stimulus based on the balanced budget multiplier. The interim budget leads to a total deficit of over 10 per cent of GDP, including off-budget items and state government deficits. Coming on top of a large deficit of 11 per cent of GDP in 2008-09, it will amount to a massive increase in public debt. Depending on how it is financed, this could lead to a public debt trap, crowd out private investment or trigger high inflation.

**Congratulations!**

You have successfully cast your vote

Login to view result

The Fiscal Responsibility and Budget Management Act introduced to contain the deficit had to be cast aside to deal with the economic crisis. But it is imperative to finance at least a part of the stimulus package through additional revenue mobilisation and contain the deficit. On the tax revenue side, the proposed goods and services tax will not be ready for introduction till 2010 and the options for additional tax revenue at this stage are limited. Barring a possible modest increase in the CENVAT, it would be best not to arbitrarily tamper with indirect tax rates till there is a comprehensive review.

On the direct taxes side, any proposal to raise the exemption limit for income tax should be postponed. The main steps for mobilising revenue have to come from non-tax sources. Administered prices of some items such as petroleum products should be raised. The other major revenue option is partial divestment in select public enterprises, provided there is a commensurate increase in growth-promoting infrastructure and human development expenditure.

Such revenue measures notwithstanding, there will still be a large deficit. If it is entirely financed by public borrowing, this will continue to pre-empt the desired reduction in interest rates and crowd out private investment. It can also lead to an internal debt trap, an unsustainable debt spiral. A standard rule of thumb suggests we are headed in that direction since real interest rates, adjusted for inflation, are above the rate of growth.

The other option is monetisation of the deficit, that is, government borrowing from the central bank, overriding the MoU restricting such borrowing. This can lead to inflation under certain conditions. This is not a particular concern for the headline inflation rate which is very low at present. However, the consumer price index is inflating at 9.3 per cent and the price index for food and related items is inflating at 12.2 per cent. There is a great risk that any shock in food supply such as a poor monsoon can lead us into a serious inflationary crisis. Given the limits and risks on all options, it is best to adopt a balanced approach. The expenditure stimulus can be partly financed through revenue measures such as divestment, partly through public borrowing and partly through deficit monetisation.

What about the mandate for inclusiveness? This will mainly have to be tackled on the expenditure side of the budget. The new government has made clear it will give special emphasis to infrastructure projects, essential for high growth. But it is equally important to prioritise social and welfare programmes providing direct support to the poor. Politicians and commentators agree that these programmes played a key role in the Congress winning a decisive mandate. These were also key for winners from other parties, non-Congress governments that effectively delivered. Most important for the mandate was the National Rural Employment Guarantee scheme. Other programmes included Sarva Shiksha Abhiyan, the National Rural Health Mission, the

Jawaharlal Nehru National Urban Renewal Mission and special support programmes for disadvantaged groups such as SCs, STs, OBCs and minorities.

The 11th Plan provides for a massive increase in social and welfare expenditure, and this was reflected in the interim budget. The July budget must ensure that the 2009-10 time slices of these programmes remain fully funded. Fiscal prudence will require a switching of government expenditure from untargeted subsidies and other wasteful items of expenditure to these targeted social and welfare programmes.

The writer is emeritus professor at the National Institute of Public Finance and Policy.